Tuesday, February 01,

Banking & Insurance

Central European Weekly

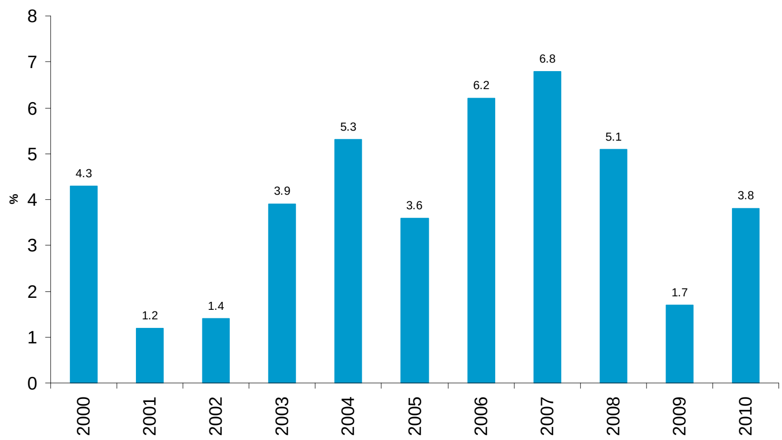
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Polish and Hungarian Central Banks raised rates in January…
- …but February might be different…
- The Polish economy performed well…..
- ….as private consumption drives growth
- CNB bucks the trend leaving rates unchanged for now

Chart of the Week: Polish economy on strong footing

Polish GDP
(annual rate of growth)



The Polish economy grew at a very reasonable rate of 3.8% in 2010.

Table of Contents:

Market's Editorial

In January, Central banks tightened,…

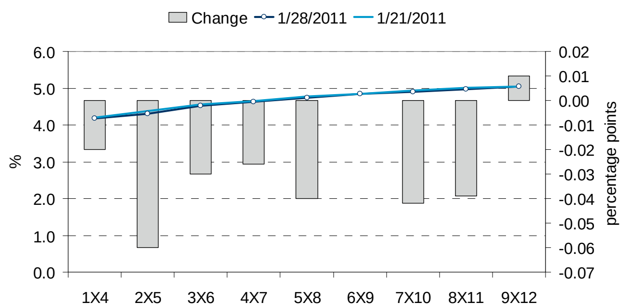
The main feature of January was without doubt the tightening of monetary policy in both Poland and Hungary. Both the National Bank of Hungary and the National Bank of Poland raised official rates by 25 bps. While the Czech National Bank stood put, more hawkish comments by several bankers didn't go unnoticed either. From the point of view of the Central Banks, it is mission accomplished. Indeed, not only went market money market rates up, which is what should be expected, but also the currencies strengthened, which is a crucial factor in the smaller Central European economies. In February, Central Banks may be less of a factor, which may also influence regional financial markets.

…but February might be different…

Still, the Czech National Bank may stir things up with its inflation report this week, as this report will push the CNB's inflation forecasts to the upside.

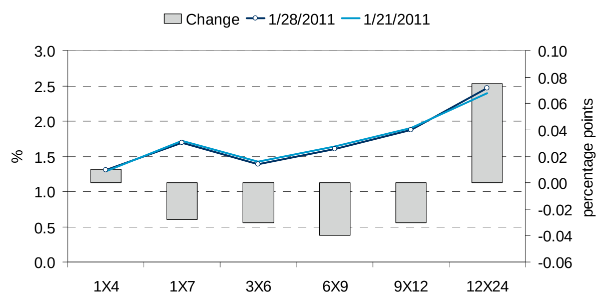
However, the hawkish rhetoric in Central Europe should wane afterwards, because the central banks should be satisfied with the tightening the monetary conditions over the first few weeks of this year. They probably don't want a further tightening of monetary conditions. This became evident in recent comments of CNB Board Members. Central bankers in Poland have made it clear that rates are unlikely to be raised again until the second quarter of the year, while Hungary is facing a somewhat politicised debate as to whether the last hike in its base rate was even necessary (there was even at least one vote for a rate cut).
That said, the most important argument against aggressive rate hikes is that the rise in inflation in Central Europe has been and will be primarily driven by items that the monetary policy cannot influence (fuel or food prices). Hence it won't be a surprise if Central European central bankers reiterate the above argument as part of their 'calming' campaign in the weeks to come.

PL FRA



Source: Reuters

CZ FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.26	-0.14%	↘	↗
EUR/PLN	3.925	1.42%	→	↗
EUR/HUF	271.9	-0.85%	→	↗
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.95	0.05	→	→
10Y PLN	6.34	0.02	→	↗
10Y HUF	7.10	-0.36	→	→

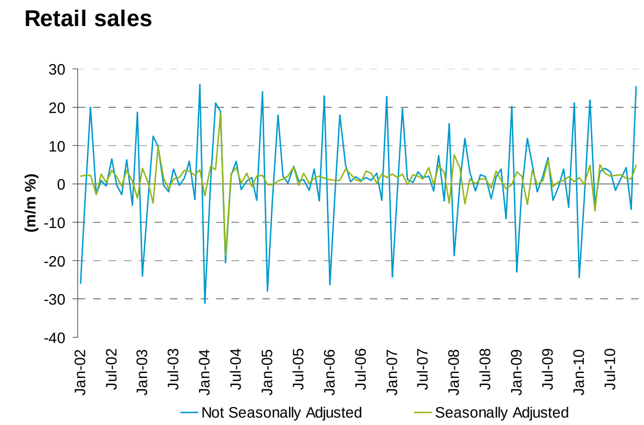
Review of Economic Figures

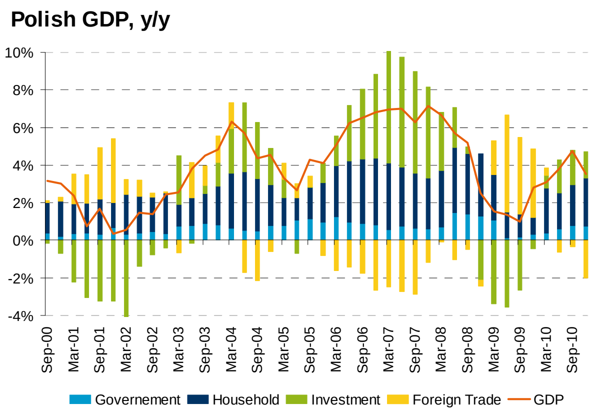
The Polish economy performs strongly

The Polish economy performed again well in the last quarter of 2010. According to the first forecasts released by Poland's Statistical Office, the Polish economy grew at a encouraging rate of 3.8% in 2010, which translates in a year-on-year growth in Q4 of approximately 4.5%. Thus the Polish economy successfully continued its development from 2009, when it was the only economy among the EU countries to avoid recession. The Q4 growth figure showed that the economy entered 2011 with accelerating momentum.
As far as the sector-specific structure is concerned, industry was the greatest contributor to the gross value added. The replenishment of inventories was the primary expenditure item. However, the rate of household consumption also developed positively, as its growth rate accelerated to 3.2% in 2010, from 2.1% in 2009.

consumption growth accelerates

The positive development of Poland's consumption is also evident from the retail sales data for December 2010. The sales were up by 12% y/y and, compared to November, went up by a huge 25.3%. Even after seasonal adjustment, December's retail sales rose at the above-average rate of almost 5%; deflated with the rise in consumer prices (0.4% m/m in December), retail sales were up by approximately 4.5% in real terms compared to November.
Car sales and the sales of car parts grew most dynamically on the year-on-year basis (38.6% y/y) while book and magazine sales went up the most on the month-on-month basis (37.4%) but this can be largely attributed to Christmas shopping. Apart from the effect of Christmas, building up stocks ahead of the 1% VAT increase that took effect in January 2011 was likely also relevant to some extent.





In focus: CNB leaves rates unchanged for now

The new forecasts highlight the potential inflationary pressures and stronger growth.

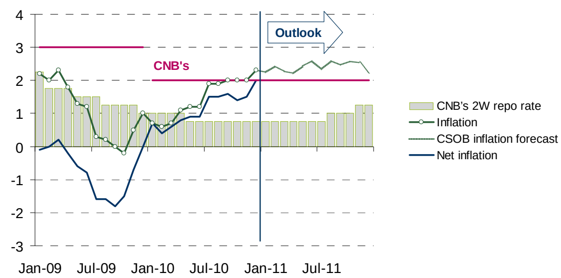
A new forecast will mark this year's first CNB Board meeting. The previous forecast was very conservative in terms of economic growth, as well as optimistic in terms of the inflation outlook. To date, the existing data, as well as market outlook, signalled that this year's GDP growth will surpass the central bank's forecast of 1.2%, primarily owing to the favourable development of foreign demand. The inflation outlook, by contrast, is likely to be less favourable. The rapid rise in food and fuel prices indicates that the difference between actual inflation and the 2% CNB target will be even greater. The fundamental factor in terms of the future development of year-on-year inflation will be the hardly predictable January inflation figure, which will reflect the continuing price deregulation (notably rent deregulation) and other administrative moves. However, this figure will not yet be available to the CNB Board when it meets.

The improved GDP outlook and increased inflation are the main arguments, we think, as to why the CNB should raise its rates much sooner than stated in the latest forecast, which does not envisage a rate hike until early 2012. For a prolonged period, there have been calls within the central bank suggesting that rates might be raised earlier. Nevertheless, this does not mean that the CNB will tighten its policy at its very next meeting. While at least one CNB Board Member is likely to vote for a rate hike, the outcome from the upcoming meeting will most probably be the emphasise on upside inflation risks and perhaps also an increase in the inflation forecast.

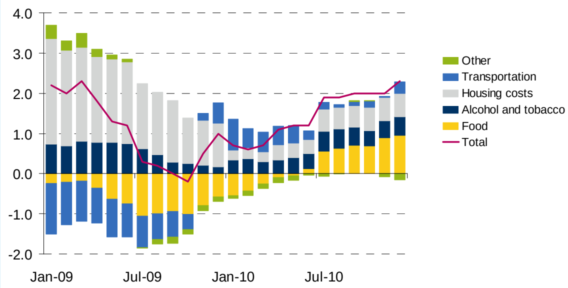
Therefore the central bank will raise its rates faster than signalled by the previous CNB forecast. One rate hike is likely to occur within the next six months and two rate hikes by the end of the year. Basically, markets (FRA) already anticipate that rates will be raised earlier within the next six months. As usual, foreign developments, which have a strong impact on a small open economy such as the Czech one, pose uncertainty. Another unknown that is relevant at the moment is the change of a few CNB Board Members. The term of office of two CNB Board Members expires in February, and it is unclear at present whether their term will be extended or whether the Czech President will replace them by new Members.

BOX:

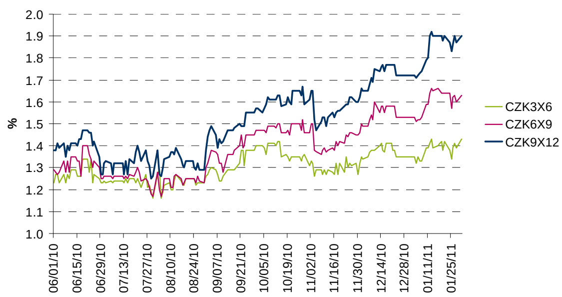
CZ: Inflation and CNB's Target
(%)



Inflation
(consumer basket decomposition in percentage points)



CZK FRA



CE Weekly Preview

THU 13:00 **CNB base rate**

	This meeting	Last change
rate level (in %)	**0.75**	5/2010
change in bps	**0**	-25

CZ: No change of the CNB's rates

We think the CNB will leave its rates unchanged this week. Compared with the previous forecast, we expect that the central bank will focus on the inflation risks from rising prices of agricultural and energy commodities. It is also likely that the new forecast will assume the faster rate hike compared to the previous prognosis (which suggested a first hike in Q1 2012). In our opinion, the CNB will increase its rates in August this year, ie about half a year earlier than previous forecasts predicted.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	31.1.2011	09:00	PPI (%)	12/2010				8.9	1.5	8.2
CZ	31.1.2011	11:00	Money supply M2 (%)	12/2010						3.6
CZ	1.2.2011	14:00	Budget balance (CZK B)	01/2011					-156.3	
PL	1.2.2011	15:00	Budget balance (PLN M)	12/2010			-47 800		-42 525	
HU	2.2.2011	09:00	Trade balance (EUR M)	11/2010 *F					651.5	
CZ	**3.2.2011**	**12:30**	**CNB meeting (%)**	**02/2011**	**0.75**		**0.75**		**0.75**	

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 24.1300 (current reaction low off 25.3800?), where pause favored.
Failure to hold would see next levels at ahead of 24.1000 (1st Irregular B off 25.3800), ahead of 24.0510 (weekly Bollinger bottom) and 23.9490 (2nd Irregular B off 25.3800): tough on 1st attempts.
In case of runaway activity, 23.7300 = 1st target of long term Double Top off 25.0150 (see graph).

Resistance at 24.3150 (falling weekly Short Term Moving Average), ahead of 24.4190 (Jan 20 high): ideal area to stay below to keep current mood on CZK.
Failure to cap would see next levels at 24.4700/ .4800 (reaction highs hourly), ahead of 24.5150 (breakdown daily) and 24.6650 (4th wave hourly off 25.3800 + weekly Bollinger midline): tough on 1st attempts.

EUR/HUF Daily Chart:

Currently back below Triangle pattern and trying to extend below 272.25 (see graph: neckline Double Top).
Support at 271.50 (current year low?), with next levels at 270.54 (weekly Bollinger bottom), ahead of 270.00/ 269.90 (Nov 02 low/ 1st target of short term Double Top off 275.10), where pause favored.
Failure to hold would see next levels at 269.40 (2nd target), ahead of 268.70/ .28 (Oct 06 low/ 76.4% 260.93 to 292.10 + weekly modified Alpha Beta trend bottom): tough on 1st attempts.
In case of runaway activity, 263.70 = 1st target off 272.25.

Resistance at 274.60 (falling weekly Short Term Moving Average), with next levels at 275.60 (reaction high hourly + weekly Bollinger midline) and 276.55 (Jan 20 high): ideal area to stay below to keep current mood on HUF.
Failure to cap would see next level at 277.40/ 278.00 (breakdown hourly/ breakdown daily + weekly modified Alpha Beta trend top): tough on 1st tests.

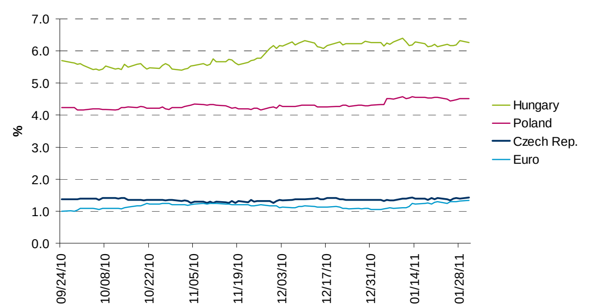
EUR/PLN Daily Chart:

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 3.8620/ .8558 (Jan 25/ 18 lows), with next levels at 3.8422 (break-up hourly), ahead of 3.8290/ .8225 (current reaction low off 4.1100/ see above + weekly modified Alpha Beta trend bottom), where pause favored.
If wrong, next level at 3.8000 (psycho): tough on 1st attempts.

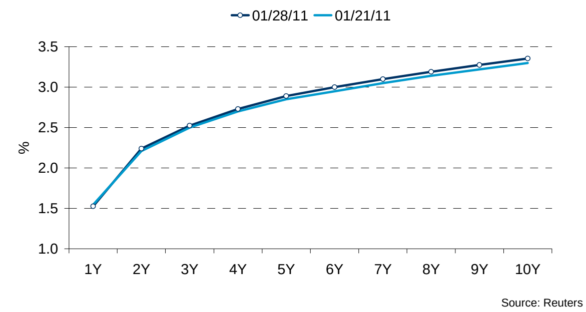
Resistance at 3.9200 (current reaction high off 3.8290?): ideal area to stay below to keep current mood on Zloty.
Failure to cap would see next levels at 3.9340/ .9363 (breakdown hourly/ 38.2% 4.1100 to 3.8290), ahead of 3.9450 (breakdown daily + flat weekly Medium Term Moving Average) and 3.9525 (weekly modified Alpha Beta trend top), where pause favored to set in.

CE Fixed-income in Charts

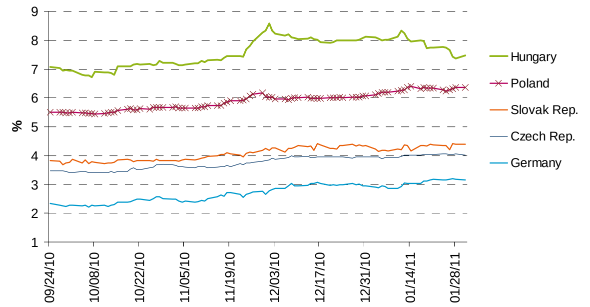
FRA 3x6



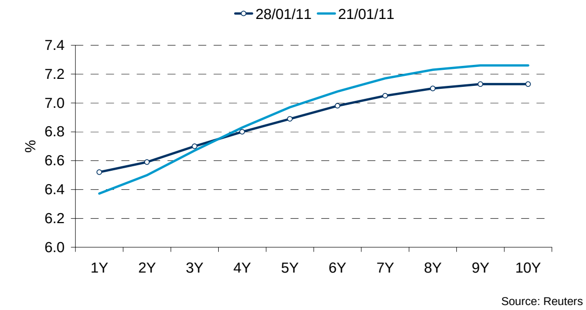
CZ IRS



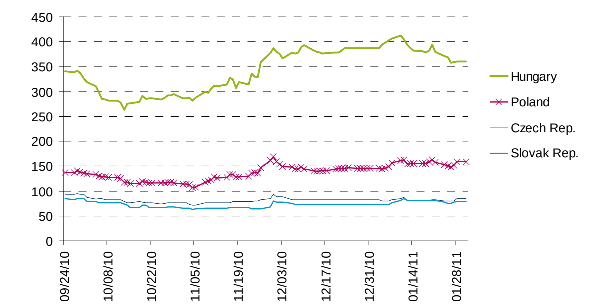
10Y GB Yields



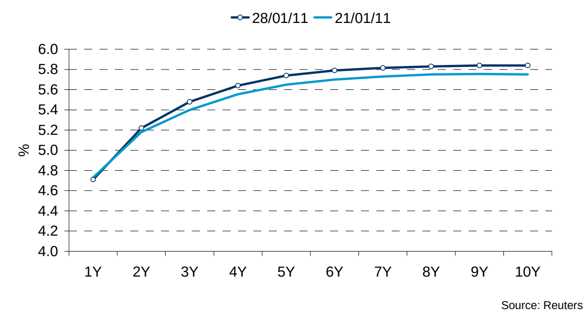
HU IRS



CDS 5Y



PL IRS

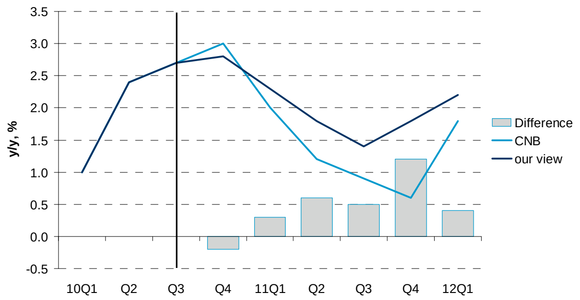


Medium-term Views & Issues

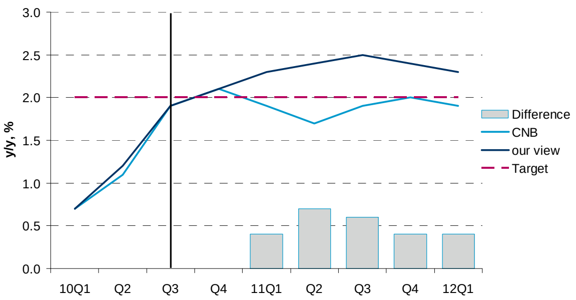
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage point per year is reasonable and doesn't pose a 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.	The medium-term outlook improves, as growth has been accelerating, while the trade balance moved well into surplus. Depending on the developments in the peripheral euro countries, some hiccups for Hungary this year remain possible. However, with a 2/3rd majority behind the government and gaining economic momentum due to the tax cut (personal income tax rate lowered to 16%), Hungary may surprise the outside world.	Q4 2010 GDP figures confirmed strong growth of 4.7% y/y (on season-ally adjusted basis) The main drivers were domestic consumption of household and government and rebuilding of inventories. Although the low contribution of core investments (ex-inventories) is somewhat of a disappointment, 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 climbed 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 out 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.		Given solid growth prospects for the second year in a row supported by positive labour market developments, it might have been indeed the right moment for the normalisation of interest rates, which have been sitting at record lows (first rate hike occurred in January 2011). Indeed, inflation should increase further above central bank's target (2.5 %) in upcoming months. Nevertheless due to persisting global uncertainties, the tightening should be gradual. In a one-year horizon we see the official interest rate at 4.25 (75 bps higher).
Forex Outlook	Fundamentals behind the Czech currency continue to be very strong. 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 the tightening cycle and growing inflow of EU funds. Nevertheless, the CZK might be on the defensive due to euro-zone crisis in the short term. Beside that, at the end of the 2011 the Polish elections may put some pressure on CE currencies including the CZK.	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 weigh on the HUF, 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 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 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

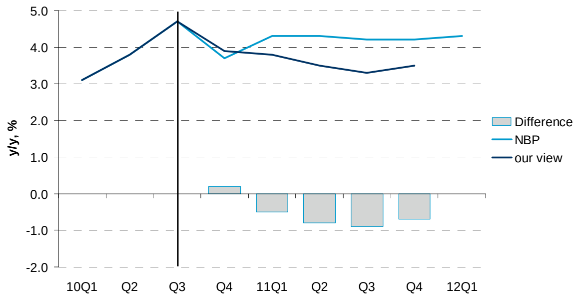
CZ: GDP Outlook



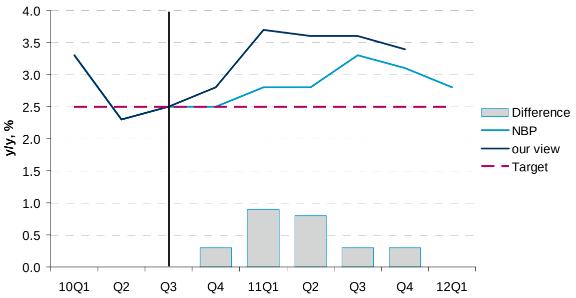
CZ: Inflation outlook



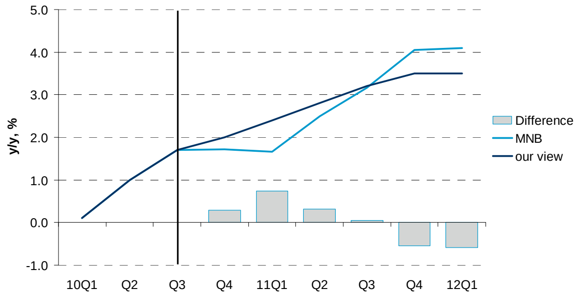
PL: GDP Outlook



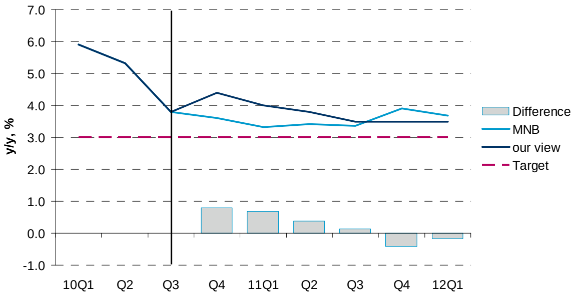
PL: Inflation outlook



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	1/24/2011
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	*1.20*	1.22	1.26	1.45	1.60
Hungary	BUBOR	*6.08*	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.	*3.35*	3.15	3.30	3.40	3.60
Hungary	*7.075*	7.75	7.75	7.50	7.50
Poland	*5.8407*	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*	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*272*	273	277	273	270
Poland	EUR/PLN	*3.93*	3.90	3.60	3.70	3.60

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

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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