Tuesday, February 08,

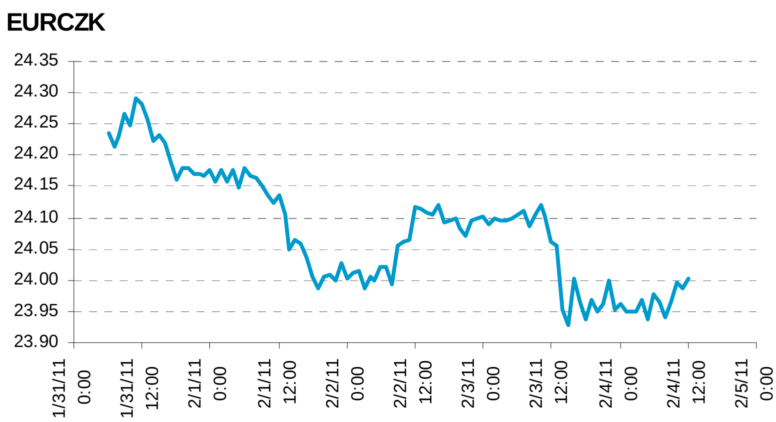
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- The Czech national bank surprises on the hawkish side
- 3 members of the board support interest rate hike despite rather dovish forecast
- Czech koruna attacks 24.00 EUR/CZK in immediate reaction
- Hungarian forint breaks to 9-month high as PM Orban denies changes to inflation target
- Polish markets cautious on uncertainty about further monetary policy tightening
- Czech and Polish January inflation in focus in the upcoming weeks

Chart of the Week: Czech koruna sharply stronger after hawkish CNB…



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Market's Editorial

CNB is hawkish

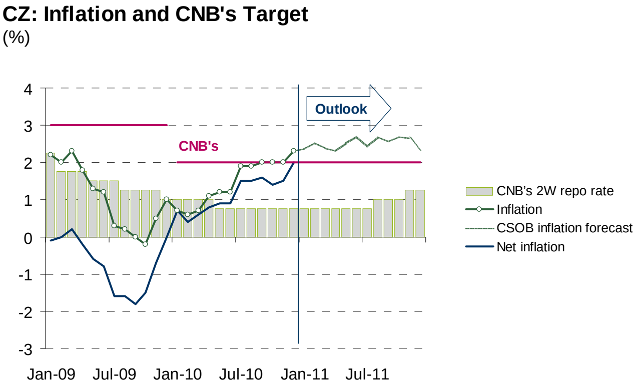
As expected, the Czech National Bank left rates unchanged last Thursday; however, the narrowness of the CNB Board's 4:3 vote for leaving rates unchanged came as a surprise. **That said, a significant number of CNB Board Members wish to hike rates, notwithstanding the new forecast, which is still fairly pessimistic** (see the Review of economic figures). The forecast for market interest rates is as follows: stable in the short term, with no increase until later this year. However, three out of seven Members wish to raise rates immediately.

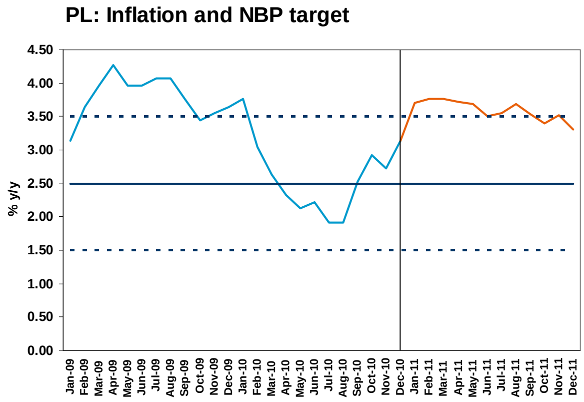
Inflation is knocking at the doors of CEE

Attention, not only in the Czech Republic but also in neighbouring Poland, will now focus on inflation figures. These are likely to be the key variables to influence the timing of the start of the monetary tightening in the Czech Republic and of another rate hike in Poland. As far as Hungary is concerned, we do not anticipate any further rate hike at the moment, given the past monetary tightening in that country. Regarding inflation in both Poland and the Czech Republic, two aspects should be monitored. The first will be January's inflation figure. Due to the large share of regulated prices in the consumer basket, January is a key month in both countries that sets the benchmark for the rest of the year. January's inflation figure in the Czech Republic will be released on Wednesday with our forecast being slightly above the consensus (2.4% y/y versus 2% target) Poland's figures will be available a week later. The inflation should rise to 3.7% (above consensus and 150 bps above target) on changes in regulated prices, further increase in food and fuel prices and one off VAT adjustment.

The second critical factor for both countries should be **the level where the inflation stabilises**. We expect the inflation to peak at 2.6% in the Czech Republic (June) and 3.8% in Poland (March). Naturally, food and fuel prices continue to be uncertain variables.

Also of importance in the central banks' decision making will be the development of the exchange rate. The Czech koruna is top of the class in the region and, unlike the Polish zloty, is providing much more assistance to the Czech National Bank in curbing inflation risks while reducing the necessity of interest rate hikes.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	23.99	-1.11%	↘	→
EUR/PLN	3.892	-0.84%	→	↘
EUR/HUF	269.4	-0.92%	→	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.84	-0.12	↗	↗
10Y PLN	6.23	-0.11	↗	↗
10Y HUF	7.18	0.08	↗	↗

Review of Economic Figures

CNB: 4:3 for leaving rates at current level

The Czech National Bank (CNB) has left rates unchanged - which was expected - but the result of the vote by the Bank Board was surprising: a close 4:3 for leaving rates unchanged. **It seems that a significant part of the Bank Board wants higher rates and basically does not identify with the latest forecasts discussed today.**

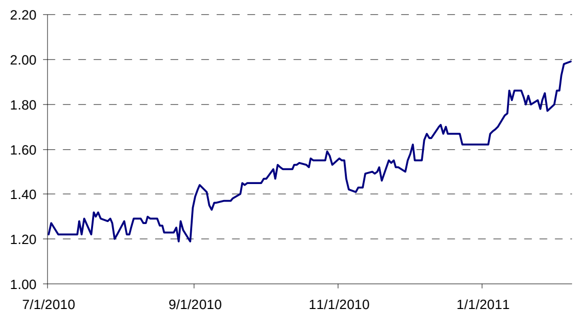
In line with expectations, the CNB increased its estimate of the economy's growth for this year to 1.6% (from the original 1.2%), the inflation outlook also increased over the year to 2.0% (earlier 1.9%) and they expect the CZK to be 0.1 higher this year and next year. **The governor commented that the Bank Board sees higher risks than previously.** The board's various members differ in their opinions on to what extent the CZK's exchange rate can compensate for inflationary pressures. Some of them find the current rate level inappropriately low, taken into account the current trends in the economy. **The forecast for market rates is the following: stability in the short term, growth at the end of the year.** It would therefore seem appropriate that the first increase in CNB rates, according to the forecast, could come in the last quarter of this year, i.e. a quarter earlier than specified in the previous forecast. Nevertheless, three people out of the seven want higher rates immediately. Unfortunately, we will learn who voted in favour of a rate hike on Friday. The governor very probably did not vote for higher rates looking to his dovish speech at the press conference after the meeting.

Our current outlook assumed that the CNB would raise rates more than half a year earlier than it has said in its forecast until now. **Given the close vote, we wonder whether it could be even earlier than the August date we expected.** What could convince at least one more board member to raise his hand for an increase in rates? In our opinion, it could be inflation which, at least at the start of this year, will be higher than the CNB forecasts. On the other hand, the stronger CZK will act as a brake. This is because the central bank expects an average exchange rate of CZK 24.5/EUR for the first quarter and CZK 24.30/EUR for the second quarter. With regard to the tendency of some members of the Bank Board to change rates at a meeting where new forecasts are available, **according to us the first change in rates could be either at the May or the August meeting**. Looking at the total amount of rate hikes this year, we believe that the market's current expectation, a triple increase by 25 points, is too high.

The closest milestones that will influence the timing are: the January inflation figure (Wednesday), the minutes of the Bank Board's meeting (Friday), any changes to the configuration of the board (this week) and the first GDP estimate for the last quarter of 2010 (15 February). The above indicates that things will be clearer in the middle of February.

CNB's prognosis		new	previous	change
GDP	2011	**1.6**	1.2	↑
GDP	2012	**3.0**	2.5	↑
Inflation	2011Q4	**2.3**	2.0	↑
Monetary-relevant inflation	2011Q4	**2.3**	2.0	↑
PRIBOR 3M	2011Q4	**1.4**	1.3	↑
EUR/CZK	2011Q4	**24.0**	24.1	→
External assumptions		**new**	**previous**	**change**
GDP-EMU	2011	**2.2**	2.0	↑
Inflation-EMU	2011	**1.9**	1.7	↑
EURIBOR 3M	2011	**1.2**	1.2	→
Brent	2011	**95.4**	86.4	↑
USD/EUR	2011	**1.32**	1.32	→

CZK FRA 9X12



CE Weekly Preview

TUE 9:00 **CZ Unemployment Rate (in %)**

	Jan-11	Dec-10	Jan-10
Rate	**9.9**	9.6	9.8

CZ: Unemployment

The unemployment rate might have remained slightly below ten percent (9.9%) in January. Compared to December, unemployment likely went up only very slightly; much less than, for example, in previous years. Nonetheless, this does not mean that the labour market situation is improving. That said, in recent months, the unemployment rate has been influenced by changes in the conditions for unemployment benefit payments. New parameters, effective from January, made many of those who have been dismissed hasten to register with the labour offices before the end of the year, to be eligible for unemployment benefits governed by last year's rules. The unemployment rate will remain close to 10% until the start of spring seasonal works.

WED 9:00 **CZ Inflation (change in %)**

	Jan-11	Dec-10	Jan-10
CPI m/m	**1.3**	0.5	1.2
Food m/m	**1.8**	2.0	1.9
Housing, energy	**2.8**	0.0	1.3
Transportation	**1.6**	1.6	1.4

CZ: January marked by increased inflation

We predict that consumer prices were up by 1.3% m/m and as much as 2.4% y/y. As usual, the main reason for such a rapid price rise at the beginning of the year was the increase in housing costs; the increase in regulated rents was the greatest contributor; however, this time households had to pay larger amounts for electricity, gas, heat and water. Another reason for the January price rise was costlier food, and we should not forget about increased fuel prices either, as these react promptly to global commodity prices. The effect of the other prices in the consumer basket was much smaller in January. January's year-on-year inflation remains above the CNB's target, and this will also hold true in the following months of this year. The prices that rose most rapidly over the last year included those for food, housing, alcohol and tobacco. By contrast, clothing and shoes, furniture, home electronics and cars are cheaper than last year. Even so, the CNB need not hasten to raise rates, because demand-pull inflation still remains out of sight.

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

	Dec-10	Nov-10	Dec-09
C/A monthly	**-13.2**	-2.0	-16.8
cummulative (YTD)	**-105.4**	-92.2	-37.0
Trade bal. monthly	**7.3**	19.3	5.2
cummulative (YTD)	**201.3**	194.0	180.6

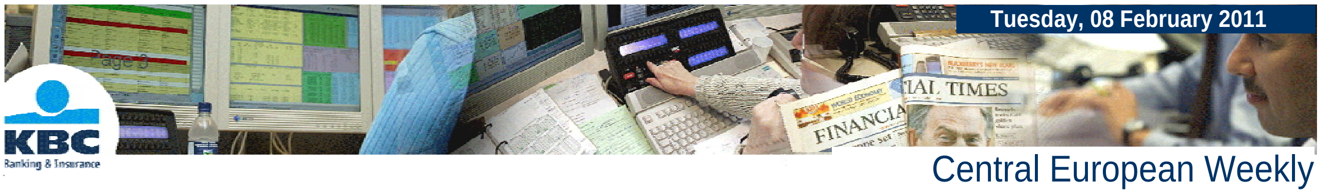
CZ: The C/A posts a moderate deficit

December 2010 likely had no significant effect on the current account. We predict the deficit to have been CZK 13.2bn, due in particular to a deficit in the balance of income, stemming from the aftermath of dividend payments, deficit services (what is known as branding) and transfers. For last year as a whole, the current account deficit almost tripled and exceeded CZK 100bn, a level last hit in 2007. One reason is the boosted dividend trend, and another reason is the inclusion of what is known as branding, which has a significant impact on the balance of services. Expressed as a share of GDP, the current account deficit likely remained closely below 3%.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	**7.2.2011**	**09:00**	**Trade balance (CZK B)**	**12/2010**	**0.0**		**0.0**		**11.8**	
CZ	7.2.2011	09:00	Retail sales (%)	12/2010		1.0		3.1		5.0
CZ	7.2.2011	09:00	Construction output (%)	12/2010						-0.1
CZ	7.2.2011	09:00	Industrial output (%)	12/2010		13.0		14.0		15.9
HU	8.2.2011	09:00	Industrial output (%)	12/2010 *P				15.7	4.3	14.5
CZ	8.2.2011	09:00	Unemployment rate (%)	01/2011	9.9		9.8		9.6	
HU	8.2.2011	17:00	Budget balance (HUF B)	01/2011					-869.8	
CZ	**9.2.2011**	**09:00**	**CPI (%)**	**01/2011**	**1.3**	**2.4**	**1.2**	**2.3**	**0.5**	**2.3**
HU	9.2.2011	09:00	Trade balance (EUR M)	12/2010 *P			396.5		651.9	
CZ	11.2.2011	10:00	Current account (CZK B)	12/2010	-13.2		-13.2		-1.98	
PL	11.2.2011	14:00	Current account (EUR M)	12/2010					-2 286	
PL	11.2.2011	14:00	Trade balance (EUR M)	12/2010			-1 235		-1 254	

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:

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

Support at 23.9200 (current reaction low off 25.3800?), ahead of 23.8900 (weekly Bollinger bottom), where pause favored.
Failure to hold would see next levels at 23.7300 = 1st target of long term Double Top off 25.0150 (see graph), ahead of 23.4760 (weekly modified Alpha Beta trend bottom) and 23.4100 (2nd target).

Resistance at 24.0860 (falling weekly Short Term Moving Average), ahead of 24.1700 (breakdown daily): ideal area to stay below to keep current mood on CZK.
Failure to cap would see next levels at 24.3350 (Jan 28 high), ahead of 24.4190 (Jan 20 high).
24.5150 = Jan 10 breakdown on daily charts: tough on 1st attempts.

EUR/HUF Daily Chart:

Currently back below Triangle pattern and below 272.25 (see graph: neckline Double Top).

Support at 268.40/ .28 (current year low?/ 76.4% 260.93 to 292.10), with next level at 267.23 (monthly envelope bottom), where pause favored.
If wrong, next levels at 265.54 (weekly modified Alpha Beta trend bottom), ahead of 263.70 (1st target off 272.25): tough on 1st attempts.

Resistance at 272.40/ .79 (breakdown daily/ falling weekly Short Term Moving Average): ideal area to stay below to keep current mood on HUF.
If unable to cap, next levels at 274.70 (reaction high hourly + weekly Bollinger midline) and 276.10/ 276.55 (weekly modified Alpha Beta trend top/ Jan 20 high): tough on 1st tests.

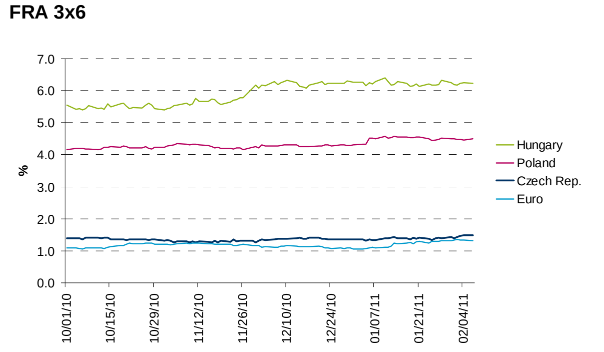
EUR/PLN Daily Chart:

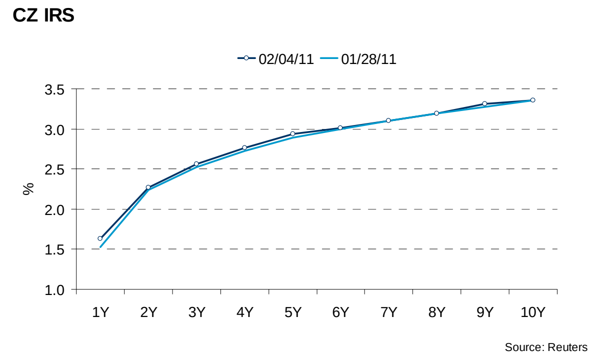
Approached key Support area (see graph) at 3.8225 (2010 low + neckline long term Double Top) and currently back above the Downtrendline off 4.9300.

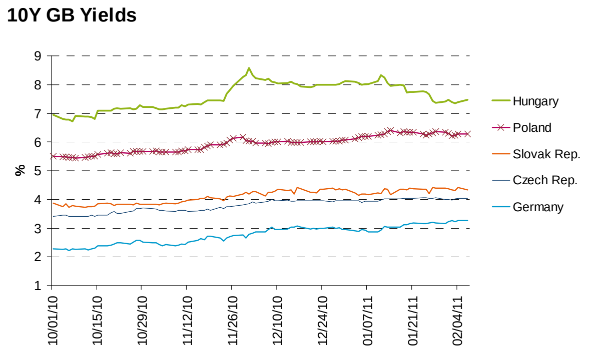
Support at 3.8620/ .8558 (Jan 25/ 18 lows), with next levels at 3.8422/ .8367 (break-up hourly/ weekly modified Alpha Beta trend bottom), ahead of 3.8290/ .8225 (current reaction low off 4.1100/ see above), where pause favored.
If wrong, next level at 3.8000 (psycho): tough on 1st attempts.

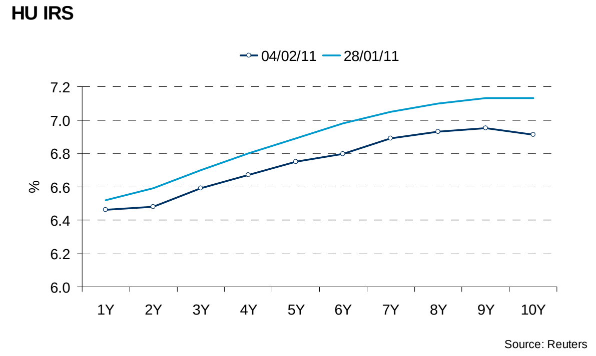
Resistance at 3.9229 (breakdown daily).
Failure to cap would see next levels at 3.9460/ .9473 (weekly Bollinger midline/ weekly Medium Term Moving Average) and 3.9610 (current recovery high off 3.8290), where pause favored to set in.

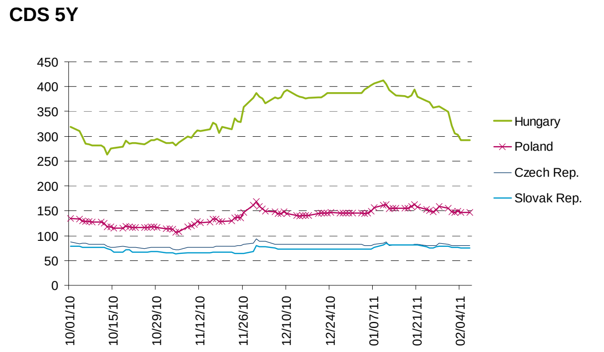
CE Fixed-income in Charts

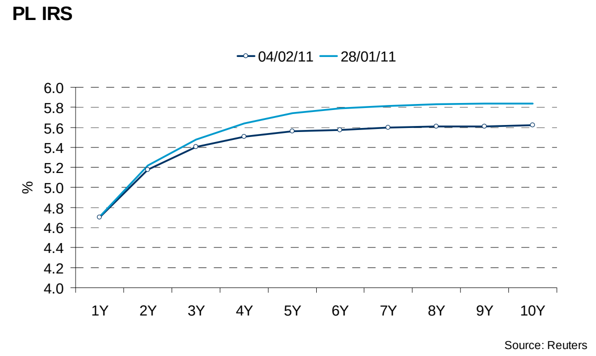










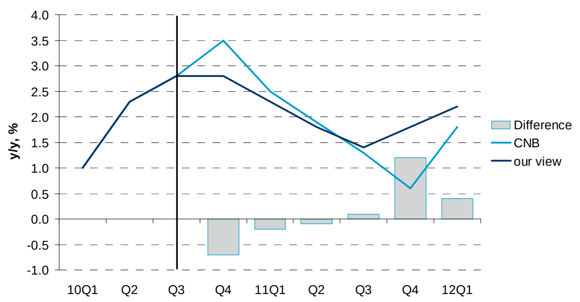


Medium-term Views & Issues

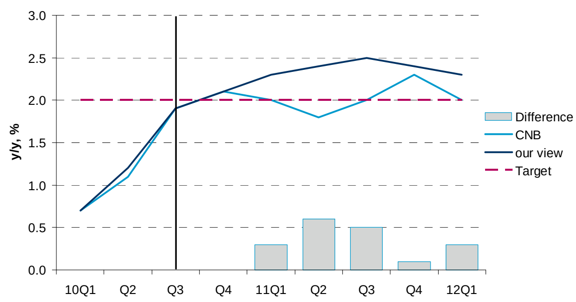
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage 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 fundamental precondition for hitting the budget targets is the launch of reforms, notably of the social security and pension system.	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.	The Polish economy slightly slowed down in the fourth quarter judging from a flash estimate of whole year GDP growth. For 2011 we believe the growth should be nearly the same as in 2010 (3.7% y/y). Mainly domestic consumption and investment should drive the growth with government and external sector having more or less neutral impact. Despite the fact that demand pulled inflation remains muted, CPI should further rise in January. According to our estimates, the infl. might even breach 1 p.p. point tolerance band, mainly due to one-off adjustments of VAT and commodities prices.
Outlook for official & market rates	Inflation climbed above the central bank's target due to higher fuel and foodstuffs' prices and to administrative measures. Fuel prices continue to pose a risk to inflation. On the other hand, weak demand and strong koruna should counteract the rise in inflation. We still think that the CNB will hike its rates sooner than its new prognosis announced (2011 Q4). We believe that rates may be raised as early as in the second quarter of this year. The CNB's repo rate should reach 1.25% by the end of 2011.	The NBH is now worried about inflation, as it rose to well above the 3% target. Inflation is driven by food and energy prices, so non-core elements, but the central bank is trying to limit second-round effects and lower yields at the long-end. Similar cases happened years ago and it succeeded that time, so we see no reason to worry about this now. Since the outcome of the January meeting was close and there was at least one vote for a cut, the February meeting may keep the base rate unchanged at 6.00%.	The Polish central bank started hiking cycle at the beginning of the year as we expected. On the other hand, we are no fan of aggressive monetary tightening for now .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. At this stage, we believe even moderate monetary tightening should be enough to prevent any spill-over to the core inflation. Beside interest rate hikes also stronger Polish zloty may help to curb inflation expectations. Hence we bet on only two more 25 bps hikes this year (2nd and 3rd quarter).
Forex Outlook	Although fundamentals behind the Czech currency continue to be strong (the Czech economy should outperform euro-zone and the external balance should remain at reasonable levels), our long term model suggests that recent gains were too aggressive. Nevertheless the Czech koruna may continue to profit from approaching start of interest rate hiking cycle in short term (3-6 month). It may move to defensive later at the end of the 2011. The profit taking could be triggered by the Polish elections and the related weakening of the Polish zloty.	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 more clearly 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

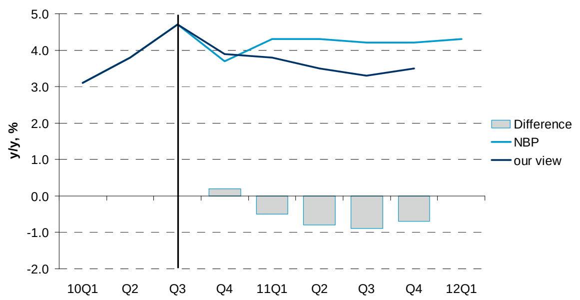
CZ: GDP Outlook



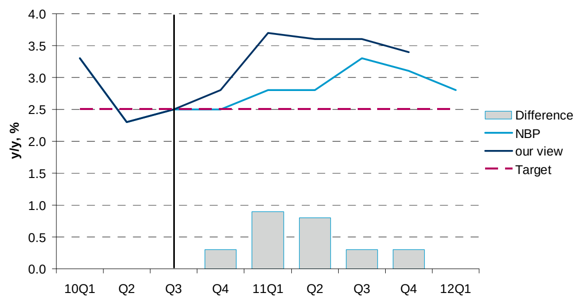
CZ: Inflation outlook



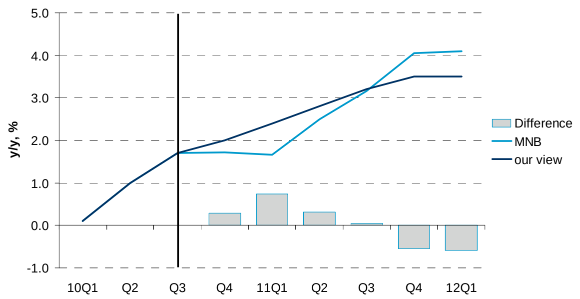
PL: GDP Outlook



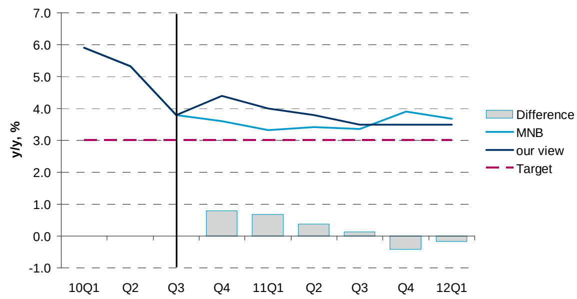
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	III.11	VI.11	IX.11	XII.11	III.12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.00	1.25	1.25	-25 bps	6.5.2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.00	6.00	6.00	25 bps	24.1.2011
Poland	2W inter. rate	*3.75*	3.75	4.00	4.25	4.25	4.50	25 bps	19.1.2011

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

		Current	III.11	VI.11	IX.11	XII.11	III.12
Czech Rep.	PRIBOR	*1.22*	1.22	1.38	1.45	1.60	1.72
Hungary	BUBOR	*6.08*	6.05	6.05	6.00	5.90	5.90
Poland	WIBOR	*4.09*	4.15	4.35	4.35	4.35	4.50

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

	Current	III.11	VI.11	IX.11	XII.11	III.12
Czech Rep.	*3.35*	3.30	3.40	3.50	3.60	3.70
Hungary	*6.95*	7.25	7.75	7.50	7.25	7.00
Poland	*5.61*	5.80	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	III.11	VI.11	IX.11	XII.11	III.12
Czech Rep.	EUR/CZK	*24.0*	24.7	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*269*	270	280	275	270	270
Poland	EUR/PLN	*3.89*	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
Poland	*4.2*	4.0	4.1	4.3	4.3	4.0

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

	III.11	VI.11	IX.11	XII.11	III.12	VI.12
Czech Rep.	2.3	2.5	2.6	2.3	2.1	1.9
Hungary	4.5	4.3	4.0	3.8	3.7	3.5
Poland	3.8	3.5	3.5	3.3	2.5	2.6

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-3.0
Hungary	0.5	1.0
Poland	-2.1	-2.9

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

	2009	2010
Czech Rep.	-5.9	-5.0
Hungary	-3.8	-2.9
Poland	7.1	-7.9

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