Monday, February 14,

Banking & Insurance

Central European Weekly

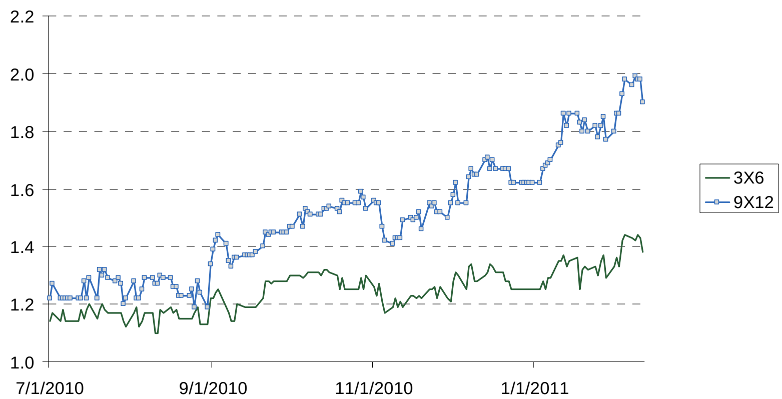
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Koruna and zloty give up part of their gains on less hawkish signals from central banks
- Czech headline inflation dipped surprisingly to 1.7% y/y
- This week's January inflation data may be important for the upcoming NBH meeting
- The Czech economy probably kept solid growth in the last quarter of 2010

Chart of the Week: Czech FRA rates slip lower

CZK FRA



Lower-than-expected headline CPI and dovish signal from CNB Minutes triggered a correction in the koruna FRA rates

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Market’s Editorial

Low Czech inflation stops koruna’s gains, …

Inflation in the Czech Republic sprang a big surprise. It was reported at the ultra-low level of 1.7% y/y. 2.4% Y/Y was expected. (see the subsequent detailed analysis for more information). January is an extremely important month, which sets the benchmark for the price development over the rest of the year. That said, prices are likely to remain far below the 2% target of the Czech National Bank for most of the year, thus not putting any great psychological pressure on the CNB Board to raise rates. After all, the minutes of the CNB Board meeting, just like the debate between the bankers and the analysts, showed that the strength of the doves will not falter in the months to come (we are holding to our scenario that the first rate hike will come in August).

Lower inflation as well as dovish comments immediately made themselves felt, not only in the Czech money market, but, above all, on the koruna. With no prospects for a quick positive development of the interest rate differential, the koruna came under pressure and weakened by more than 1.5%. With no prospect of an early monetary tightening, the koruna is set for a correction. This is also included in our new forecasts of long-term equilibrium exchange rates. According to those forecasts, the koruna significantly outpaced its sustainable rate of appreciation and its path to stronger levels might be difficult in the longer term.

…while the zloty’s suffers too from NBP’s more dovish tone.

Given the indecisiveness of the NBP, the zloty has also reached its limits in recent sessions. While central bankers started a cycle of monetary tightening at the beginning of the year, they are not very eager to continue to raise rates quickly. Even solid hawks such as Adam Glapinski are now very hesitant on the timing of further monetary policy tightening. We will see how the release of inflation figures, scheduled for this week, will influence the mood within Poland’s Monetary Policy Council. We expect inflation to exceed the upper threshold of the tolerance band at 3.5% for the first time since the summer of 2009,.

Upcoming NBH meeting: to hike not to hike?

The NBH Monetary Council may have an interesting debate about interest rates next Monday (February 21). After 25bps rate increases three consecutive times between November and January, this time the Council may decide on keeping rates unchanged at 6.00%. There are several arguments in favour of and against another rate hike. The most notable one is the recent strengthening of the currency, which moved from 280-285/€ in December to as high as 267.50/€ last week. This means that the central bank will have less concern about financial stability – caused by Swiss franc loans – and about the inflationary impact of a weaker currency level.

However, there could also be concerns remaining from December’s higher-than-expected inflation data (4.7% Y/Y vs 4.3% Y/Y expected) and its possible impact on the still low core inflation level (2.0% Y/Y).

Assessing the outlook seems very difficult. Uncertainty remains high as many things have changed at the same time and very often with opposite first-round impacts and unknown second-round effects. Summarising these is not easy due to their unprecedented nature, like introducing a flat personal income tax system at the time of fiscal consolidation.

The central bank also seems very divided on its interest rate policy as some members favoured a slower tightening cycle, while there was one vote for a 25bps rate cut in January, as well. That time, the 25bps rate hike got 4 votes, but the Council had to do a second round of voting as the first one ended 3-3 between the proposed hike and unchanged rates. This could mean that increasing the base rate from the current, higher level may receive even less support than the January one, which may not be enough to trigger another move.

This week’s January inflation data may be important in this game and the no-change scenario could gain probability if the consensus’ view for a lower inflation than December’s level would materialise.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.21	0.92%	↗	→
EUR/PLN	3.920	0.71%	→	→
EUR/HUF	271.9	0.93%	→	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	4.02	0.18	↗	↗
10Y PLN	6.26	0.03	↗	↗
10Y HUF	7.37	0.19	↗	↗

Review of Economic Figures

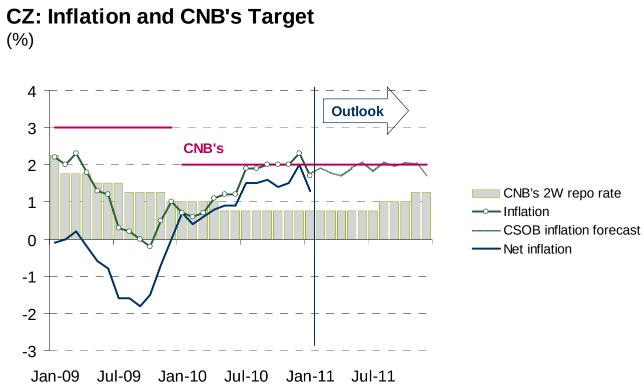
Czech inflation surprised on the downside

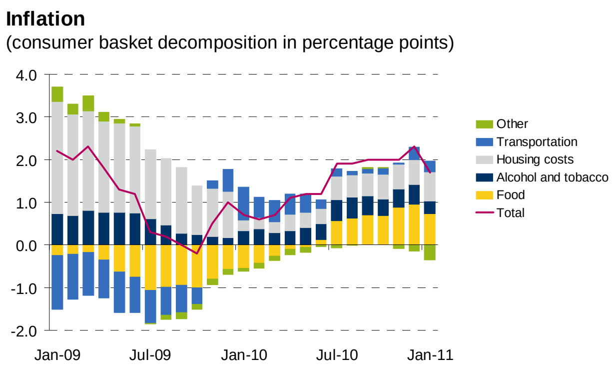
Consumer prices were up by only 0.7% m/m and 1.7% y/y, while the market consensus was 1.2% and 2.3% respectively. The main reason was the surprisingly low increase in regulated rents. There was a lot of concern about the rise in rents following the deregulation, but now appears that the average rent has basically increased only slightly, by 1.7%. However, the question is whether the rent increase has not just been postponed. The increase in food prices has also eased recently (+0.7%). Given the moderate increase in rents, it seems that future inflation may develop better than we had expected. Hence the CNB should have no problem meeting its inflation target in the months to come. After all, this is also signalled by net inflation, which is currently just 1.3%. Consequently, the CNB shouldn't be in a hurry to raise its rates, particularly if demand-pull inflation remains absent. The primary risks to inflation, both upside and downside, include the prices of oil and agricultural commodities – up until the beginning of harvest.

One CNB hawk leaves the nest

The latest inflation data don't support the scenario of a rate hike soon. After all, this is also indicated by the minutes of February's CNB Board meeting. At first glance, the outcome of the vote was very surprising, when three of the seven Board Members voted for a hike of the central bank's base rate by 25 basis points. The hawks on the Board seemed to have strengthened their position. Nevertheless, the transcript of the Board meeting makes us see this conclusion in a different light. In addition, after a small change among the CNB Board Members, the three votes have now shrunk to two. Professor Holman (as one of the three to have voted for a rate hike) is leaving the Board, to be replaced by a new Member, Lubomír Lízal.

Moreover, the transcript of the Board meeting indicates a strong dovish undertone. The minutes state that the argument on the lack of demand-pull inflationary pressures was repeatedly expressed. In addition, cost inflation pressures are curbed by the exchange rate developments. Also of interest is the sentence "…that a premature rate increase might have a larger negative impact on the economy than a delayed increase…" Along with the transcript of the meeting, the CNB also released its inflation report, which included the details of the latest forecast, about which we wrote last week. Some of the details that are of interest include: this year, the CNB expects 1) a steady decline in unemployment, 2) faster wage growth, and 3) fiscal consolidation having just a marginal impact on government consumption (-0.6% y/y). By and large, we can therefore say that everything seems to favour the continuation of the wait-and-see strategy at the moment. Thus rates may remain unchanged in the months to come. We maintain our scenario that the CNB may raise its rates in August for the first time, when this year's third forecast will be available to the central bank. Naturally, the latest data from the economy, the exchange rate of the koruna, and the direction of the ECB policy will play a crucial role in the meantime. We keep our rate outlook until the end of the year unchanged and still expect the repo rate to be 1.25 % in December. From this point of view, we are therefore far less optimistic than the FRA rates indicate.





CE Weekly Preview

TUE 9:00 — **HU Inflation (change in %)**

	Jan-11	Dec-10	Jan-10
CPI y/y	**4.4**	4.7	6.4

HU: Positive base effect should lower headline CPI

Government regulated prices could have moderated and may stand behind the lower reading, but the real question will be whether food price inflation continued or not during the month.

TUE 9:00 — **CZ PPI (y/y change in %)**

	Jan-11	Dec-10	Jan-10
m/m	**1.1**	1.0	0.5
y/y	**4.3**	3.6	-1.5

CZ: PPI on the rise

January's prices were again affected by higher commodity prices, of both agricultural commodities (the food industry) and energy commodities (refineries). In addition, the producer price index was significantly affected by the announced increase in electricity prices for the business sector. The PPI may peak at almost 5% in early 2011, and then it may start to decline to less than 3% at the end of the year. This is also why cost pressures on the consumer price index should slowly wane in the months to come.

TUE 9:00 — **CZ GDP (change in %)**

	Q4-10	Q3-10	Q4-09
GDP (y/y)	**2.8**	2.8	-3.2
GDP (q/q)	**0.5**	1.0	0.4

CZ: GDP maintains a strong growth rate

As usual, the flash GDP forecast is highly uncertain and rather approximate. The Statistical Office will not release its first GDP estimate based on a broader spectrum of data from the economy until March. However, the end of 2010 very likely saw reasonably strong economic growth, driven by exports and the solar boom then coming to an end. Nonetheless, the economy is not recovering across the board as construction and services continue to be curbed. Economic growth in the Czech Republic is completely owed to industry, notably the automotive industry.

MON 10:00 — **PL Inflation (change in %)**

	Jan-11	Dec-10	Jan-10
CPI y/y	**3.7**	3.1	3.6
Food (ex Alc.) y/y	**4.3**	3.9	3.0
Transport (including fuel)	**8.0**	6.9	10.9

PL: Inflation may exceed 3.5%

January's inflation may be as high as 3.7% y/y, and thus exceed the upper threshold of the tolerance band of the National Bank of Poland. The main reason for this should be the 1% increase in VAT rates, which may add 0.5% to the January's overall figure, according to our forecast. Food prices, which surprisingly stagnated on a month-on-month basis in December 2010, should also reflect the rising prices of soft commodities at last. The rising oil prices should also be relevant. We expect inflation will remain above the target for the entire year, with the monetary policy to be consequently tightened over the course of time.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
PL	14.2.2011	14:00	Money supply M3 (%)	01/2011			-0.4		2.5	
PL	14.2.2011	15:00	Budget balance (PLN M)	12/2010			-47 800		-42 525	
HU	**15.2.2011**	**09:00**	**CPI (%)**	**01/2011**			**1.1**	**4.4**	**0.4**	**4.7**
CZ	**15.2.2011**	**09:00**	**GDP (%)**	**4Q/2010 *P**	**0.5**	**2.8**	**0.8**	**3.2**	**1.0**	**2.8**
CZ	15.2.2011	09:00	PPI (%)	01/2011	1.1	4.3	1.0	4.2	1.0	3.6
HU	15.2.2011	09:00	Industrial output (%)	12/2010 *F					-11.8	6.0
HU	**15.2.2011**	**09:00**	**GDP (%)**	**4Q/2010 *P**		**4.4**		**2.1**		**1.7**
PL	**15.2.2011**	**14:00**	**CPI (%)**	**01/2011**	**1.1**	**3.7**	**0.8**	**3.4**	**0.4**	**3.1**
PL	16.2.2011	14:00	Wages (%)	01/2011			-11.3	5.1	9.1	5.4
HU	18.2.2011	09:00	Wages (%, ytd.)	12/2010				1.0		-1.2
PL	18.2.2011	14:00	PPI (%)	01/2011			0.6	6.3	1.1	6.1
PL	**18.2.2011**	**14:00**	**Industrial output (%)**	**01/2011**			**-5.3**	**9.8**	**-4.1**	**11.5**

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 24.0600 (break-up daily), with next levels at 23.9200/ .9100 (current reaction low off 25.3800/ weekly Bollinger bottom), where pause favored.

Failure to hold would see next levels at 23.8390 (weekly modified Standard Error band bottom), ahead of 23.7300 (1st target of long term Double Top off 25.0150: see graph) and 24.6810 (weekly modified Alpha Beta trend bottom).

Resistance at 24.2850 (current recovery high off 23.9200?), with next levels at 25.3350 (Jan 28 high), ahead of 24.4190 (Jan 20 high).

24.5150/ .5290 = Jan 10 breakdown on daily charts/ weekly modified Alpha Beta trend top: tough on 1st attempts.

EUR/HUF Daily Chart:

Currently trying to settle back above 272.25 (see graph: neckline Double Top).

Support at 270.28/ 269.85 (reaction low hourly/ gap daily): needs to settle back below to indicate return of better mood for HUF.

If unable to hold, next levels at 267.80 (weekly modified Alpha Beta trend bottom), ahead of 267.40/ .23 (current year low/ monthly envelope bottom): tough on 1st attempts.

Resistance at 274.70/ 275.33 (reaction high hourly/ falling weekly Short Term Moving Average), where pause favored.

If unable to cap, next levels at 275.70 (weekly modified Alpha Beta trend top), ahead of 276.55 (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 back above the Downtrend-line off 4.9300.

Support at 3.9065 (gap hourly), with next levels at 3.8939 (break-up daily): needs to settle back below to indicate return of better feelings for Zloty.

Failure to hold would see next levels at 3.8633/ .8538 (break-up hourly/ weekly Bollinger bottom), ahead of 3.8450 (Feb 07 low + weekly modified Alpha Beta trend bottom).

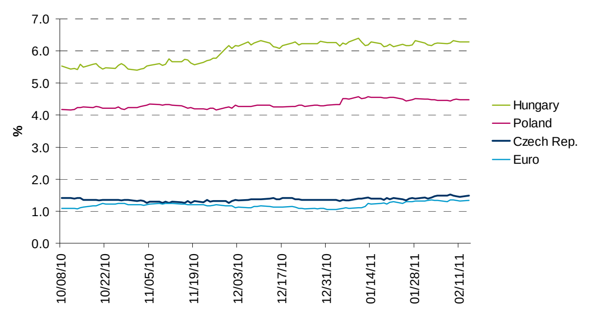
3.8290/ .8225 = current reaction low off 4.1100/ see above: tough on 1st attempts.

Resistance at 3.9443 (weekly Bollinger midline).

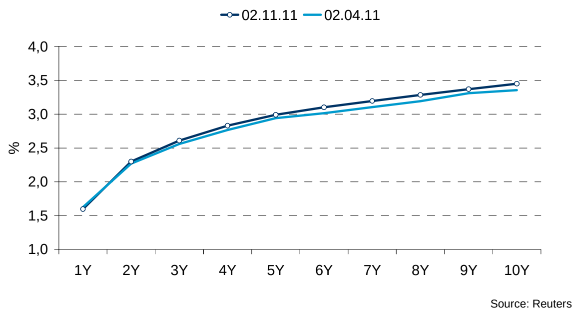
Failure to cap would see next levels at 3.9610/ .9695 (current recovery high off 3.8290 + neckline short term Double Bottom?/ 50% 4.1100 to 3.8290) and 3.9720 (falling weekly Long Term Moving Average), where pause favored to set in.

CE Fixed-income in Charts

FRA 3x6

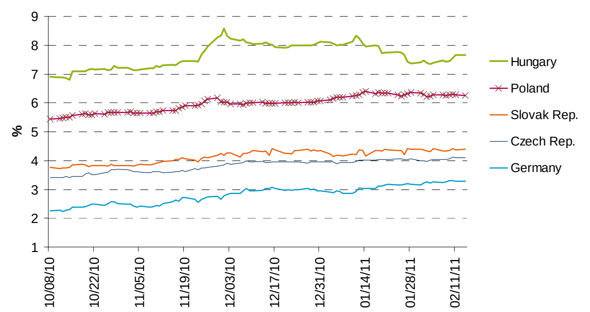


CZ IRS

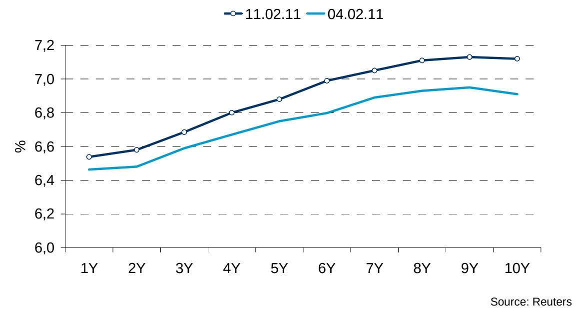


Source: Reuters

10Y GB Yields

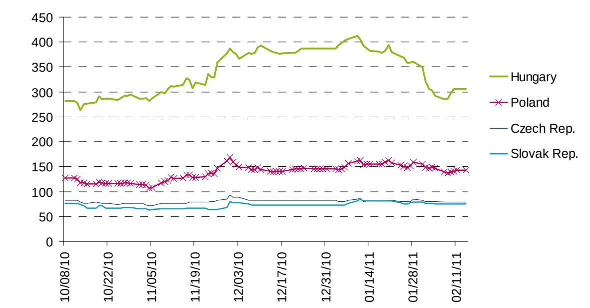


HU IRS

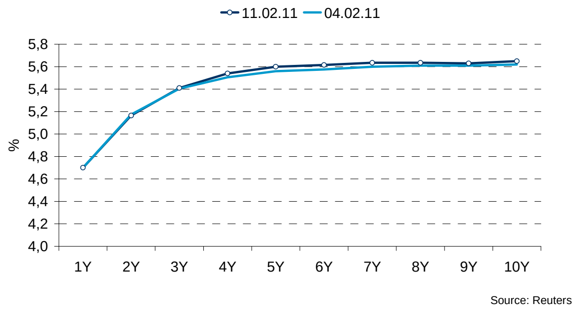


Source: Reuters

CDS 5Y



PL IRS



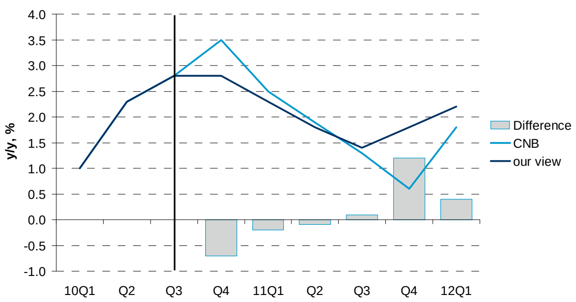
Source: Reuters

Medium-term Views & Issues

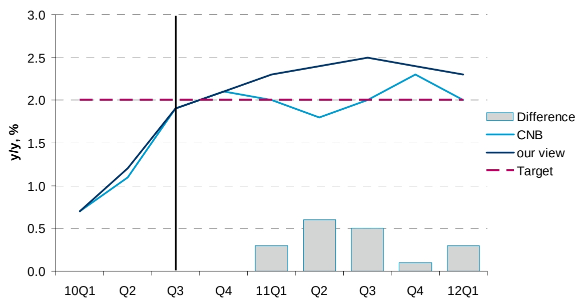
	The Czech Republic	Hungary	Poland
Growth & key issues	**The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage 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 expect 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 or third 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 a 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 a 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

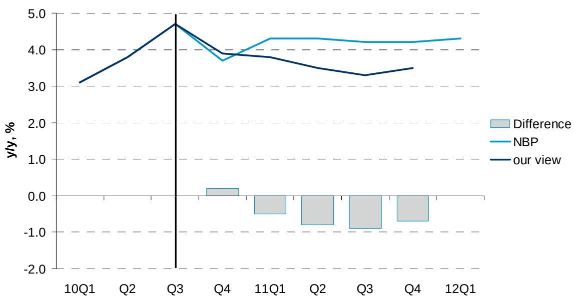
CZ: GDP Outlook



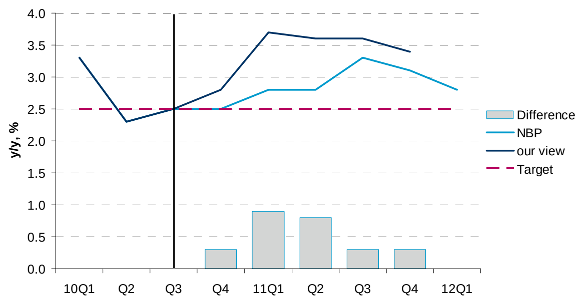
CZ: Inflation outlook



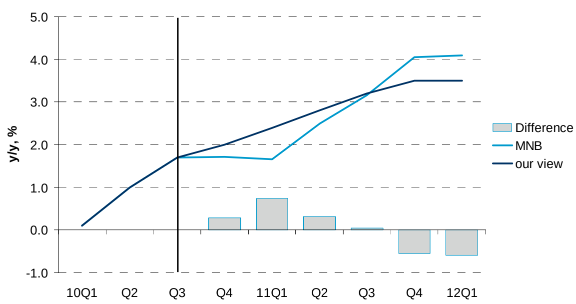
PL: GDP Outlook



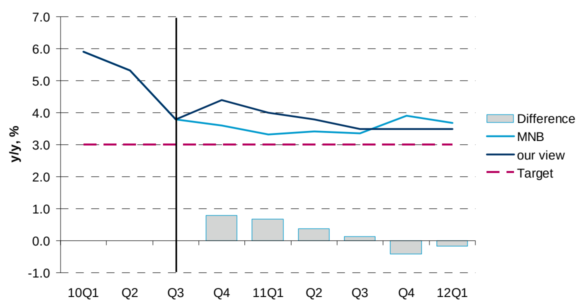
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	1.00	1.25	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.00	6.00	6.00	25 bps	1/24/2011
Poland	2W inter. rate	*3.75*	3.75	4.00	4.25	4.25	4.50	25 bps	1/19/2011

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

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	PRIBOR	*1.21*	1.22	1.35	1.45	1.60	1.72
Hungary	BUBOR	*6.10*	6.05	6.05	6.00	5.90	5.90
Poland	WIBOR	*4.11*	4.15	4.35	4.35	4.35	4.50

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

	Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	*3.47*	3.30	3.40	3.50	3.60	3.70
Hungary	*7.15*	7.25	7.75	7.50	7.25	7.00
Poland	*5.65*	5.80	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	EUR/CZK	*24.2*	24.7	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*272*	270	280	275	270	270
Poland	EUR/PLN	*3.92*	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)

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	2.0	2.4	2.4	2.2	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	-2.5
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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