Monday, February 21,

Banking & Insurance

Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Inflation surprises on both sides in Central Europe
- NBH: End of the rate hike cycle?
- Czech GDP disappoints, the Hungarian one meets expectations

Chart of the Week: Polish inflation has breached tolerance band (1.5-3.5)

CPI inflation and prices of food and non-alcoholic beverages

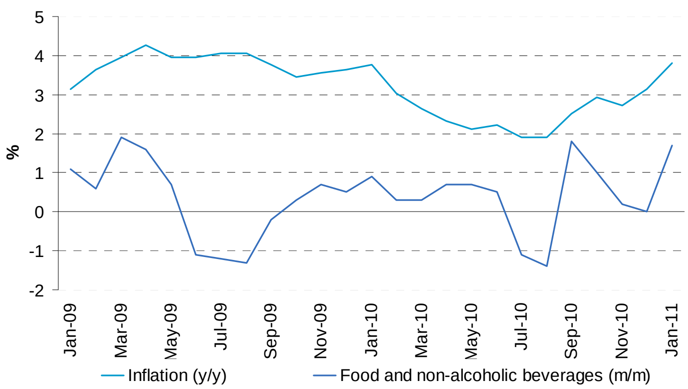


Table of Contents:

Markets' Editorial	2
Review of Economic Figures	3
In focus	4
CE Weekly Preview	5
Weekly Calendar	6
CE Forex Technicals	7
CE Fixed-income in Charts	8
Medium-term Views & Issues	9
Central Bank's v. Our Macro Forecasts	10
Summary of Our Forecast	11
Contacts & Disclosures…	12

Market's Editorial

Inflation surprises in Central Europe

The analysis of inflation figures from Central Europe is starting to be increasingly interesting and also important. Evidence of this is not only the Czech inflation data, released in the week before last, but also January's inflation data from Hungary and Poland, released last week. Somewhat paradoxically, the released data sprang **a surprise on both sides** – by a much lower than expected value in Hungary, and a surprisingly high value in Poland. Both inflation levels have significantly approached each other but the consequences for the Hungarian and Polish forex and bond markets may be very different, because the implications for the policies of the respective central banks will differ greatly.

NBH: End of the rate hike cycle?

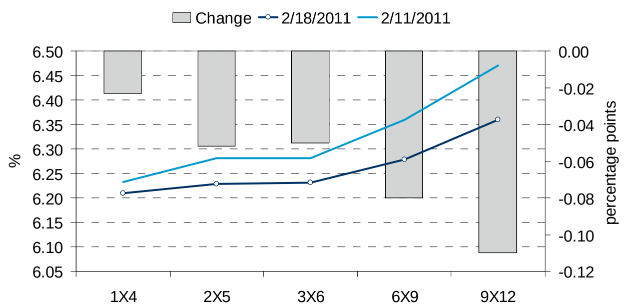
Surprisingly **low inflation in Hungary** will put an end to the series of official rate hikes, which started in the last quarter of 2010. There was an evident opposition to raise rates inside the NBH Monetary Council even before the last monetary tightening. This opposition will now be even stronger, encouraged by the inflation data. Thus, another rate hike has become less likely and 'less' means it has almost zero probability. Domestic inflation and rate hike stories look to have ended now in Hungary.

High inflation readings should support PLN

By contrast, surprisingly high inflation may be good news for the exchange rate of the zloty (but not for Polish bonds) because it should encourage central bankers to continue to raise rates.

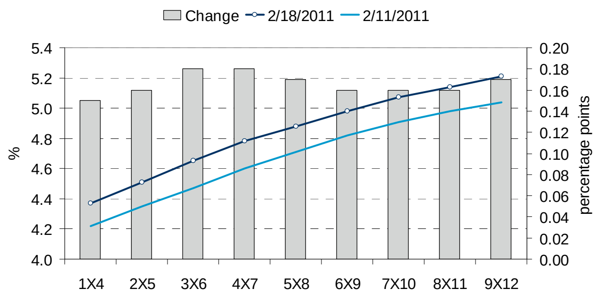
Nevertheless, the question is how much higher the markets may push their anticipation on rate hikes by the NBP, because the current market expectations are already set very aggressively, with the anticipation of rate hikes by a total of almost 100 basis points. According to our forecasts, however, the NBP might only proceed to two (more) 25 bps rate hikes this year as the strong zloty should dissuade the bank from overly aggressive behaviour.

HU FRA



Source: Reuters

PL FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.42	0.90%	↗	↗
EUR/PLN	3.919	-0.03%	→	↗
EUR/HUF	269.8	-0.77%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.98	-0.03	↗	↗
10Y PLN	6.26	0.00	↗	↗
10Y HUF	7.25	-0.12	→	→

Review of Economic Figures

Polish headline inflation above target

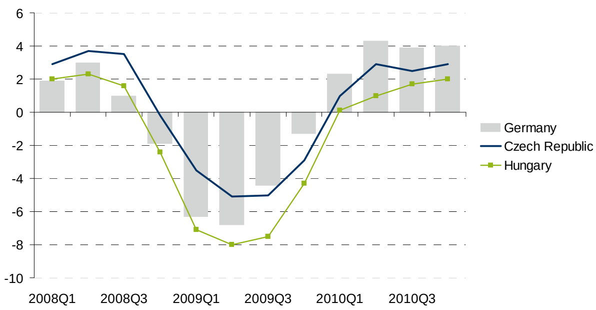
The **Polish inflation** hit 3.8% level in January, thus exceeding the expectations of both the market and the central bankers. The month-on-month CPI was up by 1.2%. The most rapidly rising items of the consumer basket included transport prices (7.1% y/y) and housing costs (6.1% y/y). The rising prices of soft commodities also made themselves felt, unlike in December. The sub-index of food and soft-drink prices even went up by 1.7% m/m and 4.8% y/y. We expect that inflation will continue to rise. However, due to the revision of the weights of the individual CPI items, the detailed index structure, required for February's inflation forecast, is not available at the moment. For purely seasonal reasons (i.e., notwithstanding the rising commodity prices), the rise in consumer prices is likely to hit values closely below 4% y/y in the months to come.
Inflation exceeding the upper threshold of the target band (1.5 - 3.5%) soon became a target of Members of the Monetary Policy Council in their comments. Anna Zielinska-Glebocka, a representative of the hawkish group inside the MPC, said in reaction to the January inflation release that we might expect more steps in this regard as early as at the March meeting. Her colleague Jan Winiecki stated that if a vote on a rate hike would be a subject at the March meeting, he would vote in favour of it. On the other hand Waldemar Pawlak, Minister of the Economy and the Deputy Prime Minister of the Polish Government, said that another rate hike would be completely ungrounded and would stifle the economy.

According to the latest figures from the labour market, specifically those regarding average gross wages, inflation primarily driven by commodities and administrative measures has not significantly influenced wage negotiations thus far and demand-pull pressures remain subdued at the moment. Therefore we expect that NBP Governor Belka's prudence will again prevail at the March meeting and rates will remain unchanged. According to our forecasts, the NBP might proceed to two additional 25 bps rate hikes this year, while we expect the first rate hike during the second quarter of the year, likely in April.

Czech GDP went up by 0.5% only, Hungary's growth in line with expectations

According to the flash estimate, the Czech economy grew by 0.5% q/q and 2.9% y/y in the last quarter of 2010. The GDP figure was not that surprising even as the market had anticipated an acceleration of the growth rate to 3.2% at the end of last year. Growth in the manufacturing industry was strong (the automotive and electrical industries and engineering) but construction contracted and services performed poorly. Thus the economy shows a clear uptrend, but growth is still far from being across the board and continues to be highly dependent on foreign demand. The latest figure even lags behind the expectations by CNB, which had expected that the economy would grow by 3.5% at the end of the year. Hence the latest GDP data bears absolutely no evidence of any early rate hike. Growth was first of all driven by foreign demand, which supported the domestic export-oriented industry (particularly the automotive industry). The inventory replenishment cycle, which had also positively influenced the GDP, was drawing to an end. Last but not least, economic growth was also boosted by the solar boom, driven by high feed-in tariffs. On the other hand, the government consumption eased last year and household consumption also remained poor. Rising unemployment, along with moderate wage growth, curbed household spending. After all, this was already evident from the retail sector data. However, more detailed GDP data will not be available until March 11, and therefore we can only speculate about the development of the structure of growth at the moment.

GDP (y/y, %)



In Hungary, Q4 GDP data was in line with expectations with a Y/Y reading of 2.0%, but the Q/Q growth rate was only 0.2% or 0.8% annualised, which is far from the level needed for this year's 2.5-3.0% growth rate. Industrial output fell more than 10% M/M in December, which could have dragged down the quarterly growth rate, but it may bounce back in the coming months as export markets – mainly Germany – look to have been expanding steadily. A low base could even help this year's growth outlook, but it may warrant some cautiousness about the outlook, especially if the new spending cuts will have a negative impact on domestic demand.

CE Weekly Preview

MO 14:00	MNB base rate	
	This meeting	Last change
rate level (in %)	**6.00**	1/2011
change in bps	**0**	25

HU: NBH's tigthening cycle already ended in January

The Monetary Council will meet today to discuss the level of interest rates again, which is currently standing at 6.00%. Since the January meeting – the central bank increased the base rate by 25bps that time – we have had a lower inflation figure, stronger currency and narrower spreads at the long-end, while widening of the monthly budget deficit could be a concern.

The Council had the closest voting ever as it was a draw of 3-3 between the 'no change' and the '25bps hike' scenarios due to one member's preference for a 25bps cut, whom otherwise would have decided the outcome. The Governor had to ask for a second round of voting, which decided in favour of the 25bps move. We have not yet seen two rounds of voting in the last 10-years.

Economists expect an unchanged rate without any hesitation, so a move would be very surprising for markets. The consensus also expects the base rate to stay here for a considerable period as inflation is expected to return to 3% only in 2012, while second-round effects of the recent energy- and food price increase look to be moderate.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**21.2.2011**	**14:00**	**NBH meeting (%)**	**02/2011**	**6.00**		**6.00**		**6.00**	
HU	23.2.2011	09:00	Retail sales (%)	12/2010				0.4		-0.3
PL	**23.2.2011**	**10:00**	**Retail sales (%)**	**01/2011**			**-26.2**	**8.5**	**25.3**	**12.0**
PL	23.2.2011	10:00	Unemployment rate (%)	01/2011			13.0		12.3	

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:

Below long term Triangle bottom (see graph), with new reaction low off 29.6900 scored.
Support at 24.1400 (break-up hourly), with next levels at 24.0600 (break-up daily), ahead of 23.9200 (current reaction low off 25.3800 + weekly Bollinger bottom), where pause favored.
Failure to hold would see next levels at 23.7470/ .7300 (weekly modified Standard Error band bottom/ 1st target of long term Double Top off 25.0150: see graph) and 24.7020 (weekly modified Alpha Beta trend bottom): tough on 1st attempts.

Resistance at 24.3700 (current recovery high off 23.9200?), with next levels at 24.4190 (Jan 20 high).
In unable to cap, next levels at 24.5150 (Jan 10 breakdown on daily charts), ahead of 24.4780 (38.2% 25.3800 to 23.9200) and 24.5930 (weekly modified Alpha Beta trend top): tough on 1st attempts.

EUR/HUF Daily Chart:

Failed so far to settle back above 272.25 (see graph: neckline Double Top).
Support at 269.00/ 268.50 (reaction lows hourly), where pause favored.
If unable to hold, next levels at 268.00 (weekly modified Alpha Beta trend bottom + weekly Bollinger bottom), ahead of 267.40/ .23 (current year low/ monthly envelope bottom): tough on 1st attempts.

Resistance at 272.60 (reaction high hourly + weekly modified Alpha Beta trend top), where pause favored.
If unable to cap, next levels at 273.88 (Feb 11 high), ahead of 275.00 (weekly Bollinger midline + weekly falling Medium Term Moving Average): tough on 1st tests.

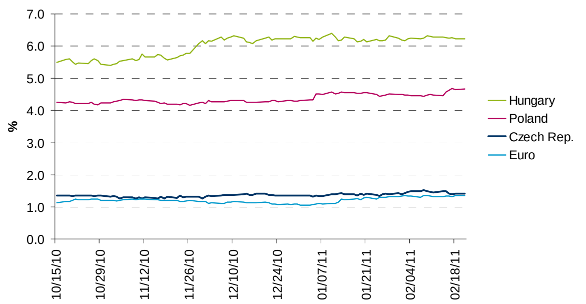
EUR/PLN Daily Chart:

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 3.8939 (break-up daily): needs to settle back below to indicate return of better feelings for Zloty.
Failure to hold would see next levels at 3.8680/ .8633 (reaction low hourly/ break-up hourly), ahead of 3.8470/ .8450 (weekly Bollinger bottom + weekly modified Alpha Beta trend bottom/ Feb 07 low).
3.8290/ .8225 = current reaction low off 4.1100/ see above: tough on 1st attempts.

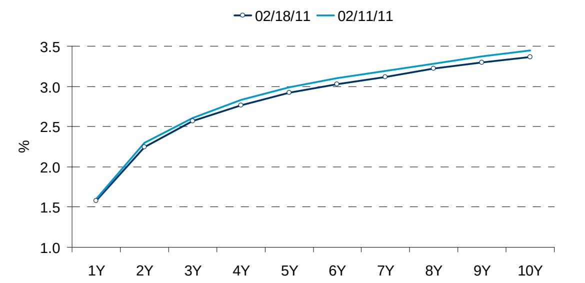
Resistance at 3.9364 (breakdown hourly), where pause favored).
Failure to cap would see next levels at 3.9549 ((Feb 14 high), ahead of 3.9610/ .25 (current recovery high off 3.8290 + neckline short term Double Bottom?/ falling weekly Long Term Moving Average) and 3.9695 (50% 4.1100 to 3.8290), where pause favored to set in.

CE Fixed-income in Charts

FRA 3x6

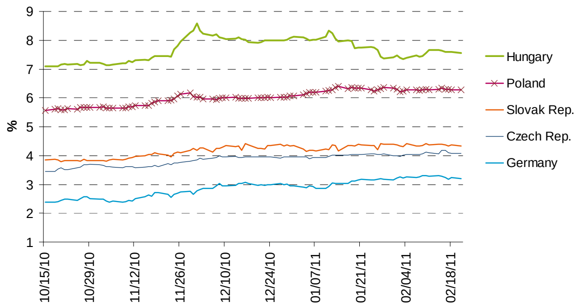


CZ IRS

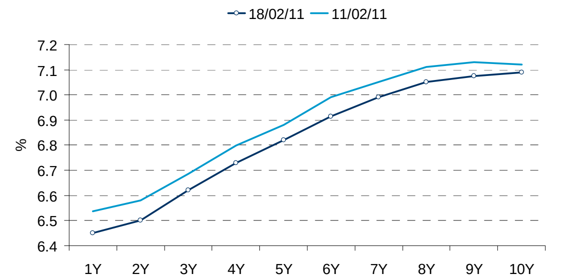


Source: Reuters

10Y GB Yields

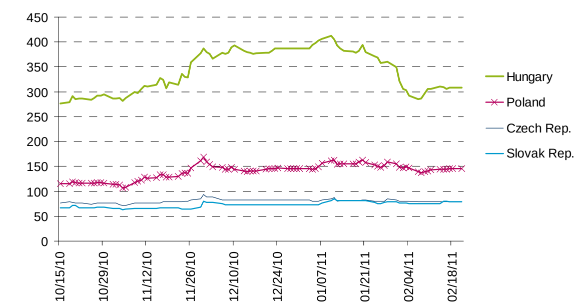


HU IRS

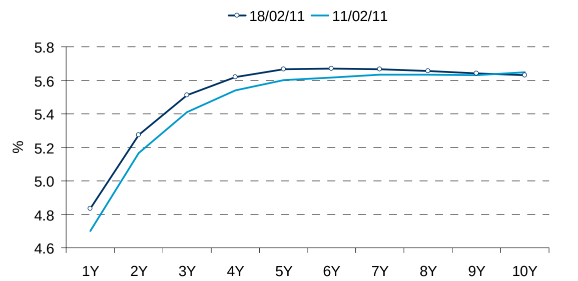


Source: Reuters

CDS 5Y



PL IRS



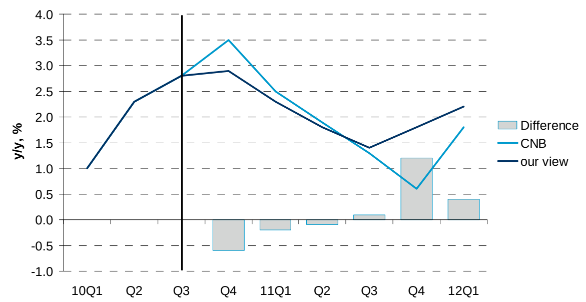
Source: Reuters

Medium-term Views & Issues

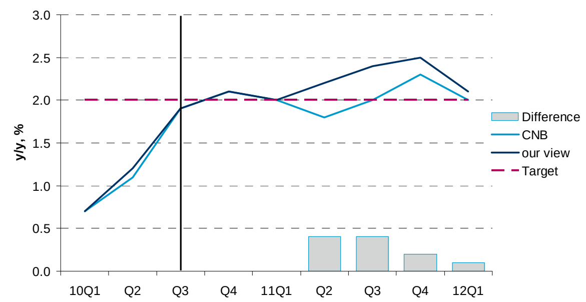
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage 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 the 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.	Since the November meeting – the central bank increased the base rate by 75bps, so it stands at 6.0 %. Economists together with us expect an unchanged rate without any hesitation. So a move would be very surprising for markets. The consensus also expects the base rate to stay here for a considerable period as inflation is expected to return to 3% only in 2012, while second-round effects of the recent energy- and food price increase look to be moderated. Domestic inflation and rate hike stories look to have ended now.	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 into the defensive at the end of 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 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

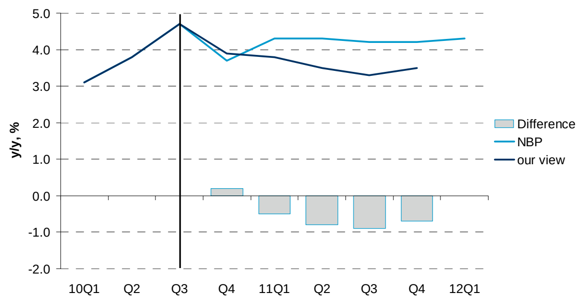
CZ: GDP Outlook



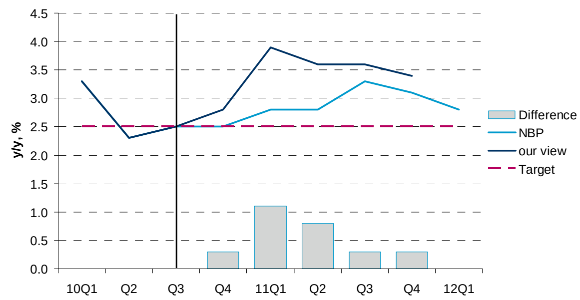
CZ: Inflation outlook



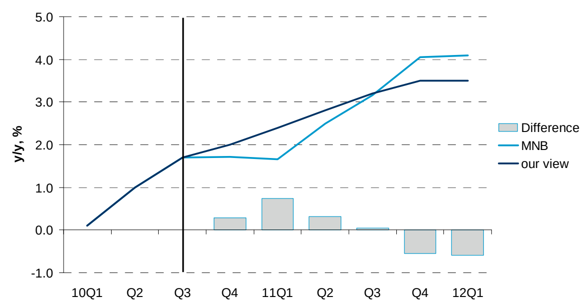
PL: GDP Outlook



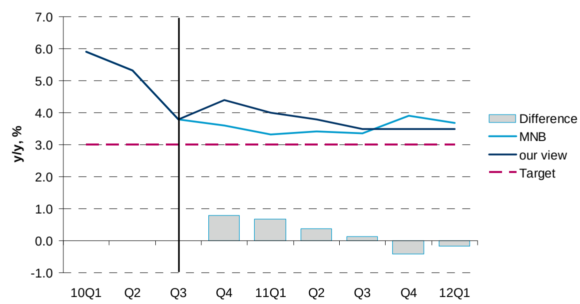
PL: Inflation outlook



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	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.	*3.33*	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	*24.4*	24.7	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*271*	270	280	275	270	270
Poland	EUR/PLN	*3.93*	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	4.0	4.0	4.0	3.8	3.7	3.5
Poland	3.8	3.5	3.5	3.3	2.5	2.6

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41		
Peter Wuyts	+32 2 417 32 35	Brussels	
Didier Hanesse	+32 2 417 59 43	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Commercial Desk	+32 2 417 53 23
Mathias Van der Jeugt	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
Dublin Research (KBC Bank Ireland)			
Austin Hughes	+353 1 6646892	London	+44 207 256 4848
Prague Research (CSOB)		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Jan Bures	+420 2 6135 3574	New York	+1 212 541 06 97
		Singapore	+65 533 34 10
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	Prague	+420 2 6135 3535
		Bratislava	+421 2 5966 8436
Budapest Research (K&H)		Budapest	+36 1 328 99 63
Gyorgy Barcza	+36 1 328 99 89	Warsaw	+48 22 634 5210
		Moscow	+7 495 228 69 61

Our reports are also available on: www.kbc.be/dealingroom