Central European Weekly

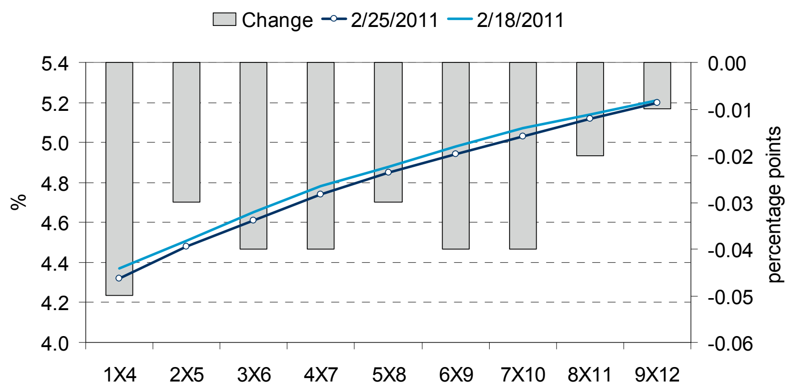
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- CE markets little affected by higher risk aversion – NBP and ECB meetings eyed
- Polish retail sales and wages do not support a rate-hike scenario
- Confidence in the Czech economy declined in spite of positive signals from Germany
- The NBP should wait with another rate hike till April

Chart of the Week: Polish bets on rate hike lower ahead of the NBP meeting

PL FRA



Source: Reuters

Table of Contents:

Market's Editorial

Higher risk aversion only slightly visible in CE Markets

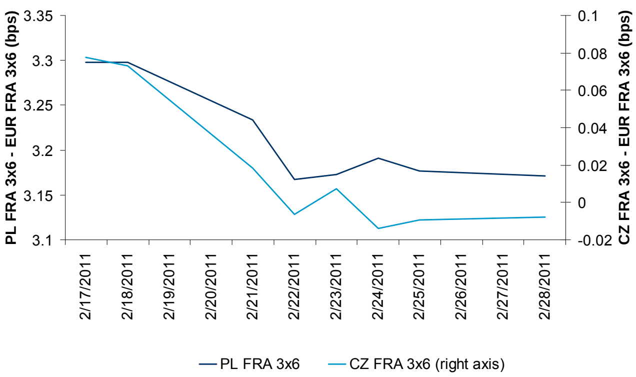
With surprising ease, Central European markets overcame the increase in the aversion to risk, related to the persisting unrest in the Arab world. What is more, if we look back at last week's developments in the bond market, we find that bond prices in Central Europe even rose slightly. This means the recurrence of a scenario that has transpired several times before, i.e., in spite of negative bond developments at the periphery of the euro area, Central European bond markets were able to go their own – slightly more favourable – way.

The situation on regional forex markets is somewhat different, as these performed worse. Nevertheless, we believe that the depreciation of the zloty and others is due to the stronger tenor set by the ECB, rather than a result of the increased aversion to risk, i.e., the increased oil prices (which should imply the depreciation of the real exchange rate). With the neutral (very short-term) outlook of the regional central bankers, this tenor led to the deviation of the interest rate differential in favour of euro rates.

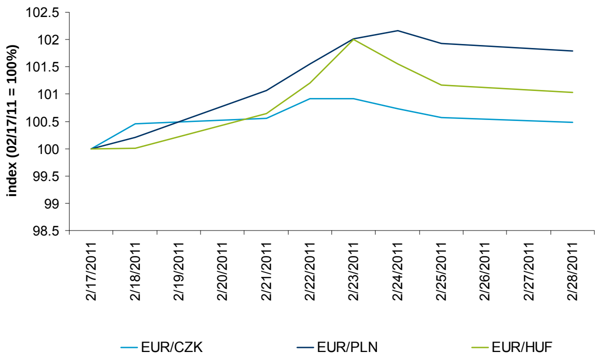
CE currencies need to watch ECB and NBP very closely

Hence the progress of this week's meetings of the European Central Bank and the National Bank of Poland will be highly important for Central European currencies. While the ECB press conference will get ample attention, because the bank will probably scale back its exceptional measures of liquidity providing and speak tough on inflation, the outcome of the vote by the Polish Monetary Policy Council may have even higher impact for CEE currencies. Unlike us, numerous banks in the market anticipate a hike in the base rate of the NBP, and thus a decision to leave rates unchanged may trigger another stimulus to the zloty to depreciate and a correction of the rate hike expectations embedded in the short end of the yield curve.

Interest rate differencial against EMU



Weaker CE exchange rates against Euro



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.47	2.01%	↗	↗
EUR/PLN	3.971	2.01%	↗	↗
EUR/HUF	273.0	1.33%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.93	0.10	→	↗
10Y PLN	6.28	0.05	↘	↗
10Y HUF	7.29	0.11	↗	↗

Review of Economic Figures

Polish retail sales and wages do not support a rate-hike scenario

Polish January's macroeconomic figures indicate that demand-pull pressures pose no risk at the moment. January's retail sales disappointed markets, rising by only 5.8% y/y (while markets had anticipated 8.5%), with the worsened figure being largely attributable to the purchases of motor-vehicles and their parts (-4.1% y/y), which must have been partly affected by the New Year's increase in a VAT rate. After all, the stockpiling ahead of the VAT increase is also signalled by deviations against the usual seasonal developments (upwards in December, downwards in January). Food purchases also disappointed, as they stagnated on the year-on-year basis, as did the purchases of newspapers and books (-16.3%). In addition, the decelerated rise in nominal retail sales goes hand in hand with the accelerated rise in January's prices. Thus consumption is rising slower in real terms than most analysts had expected at the beginning of the year. Nonetheless, we need to wait to see how much the stockpiling and the severe winter are responsible for this.

Not only retail sales but also January's unemployment rate sprang a slightly negative surprise, with the latter rising by 0.7% against December and hitting 13% (bear in mind that the rise in January's gross average wages also disappointed markets).

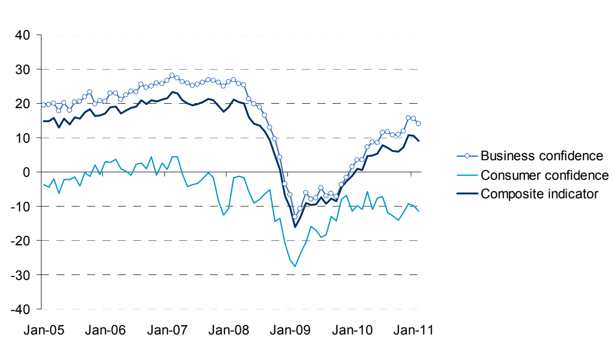
Thus it seems that the causes of inflation primarily lie in areas beyond the control of the central bank's monetary policy, although a rate hike would certainly encourage the exchange rate of the Polish zloty, which still lets the central bankers down in their fight against inflation.

Confidence in the Czech economy declined in spite of positive signals from Germany

While Germany's Ifo breaks a new record each month, the confidence in the Czech economy declined slightly in February. As usual, the mood worsened in the construction sector, where businesses anticipate another deceleration of their construction activities as well as a decline in unemployment. Remarkably, the confidence level in industry also deteriorated, despite industry's strong increases and a fairly reasonable increase in contracts thus far. Yet the expectations in respect of demand in the months to come have worsened. Even so, industrial firms believe that their output will go up and that they will continue to hire new staff. Traders are more optimistic, while consumers' view of the months to come is not that positive. They expect a deterioration of their financial position, albeit they currently view the risk of unemployment as less serious than before. The currently discussed pension reform, involving the transfer of goods and services to the 20% VAT rate, will not increase their optimism in that context. Therefore we believe that consumer spending will be very modest in the months to come, and consequently household consumption will only improve at a moderate rate. By contrast, the financial position of industry and its outlook for demand in the months to come are likely to improve again. As usual in recent years, foreign demand and rising commodity prices continue to be the overall risk to the economy. A no less serious problem is also that the economy is not recovering across the board, because the current recovery is primarily based on the automotive, engineering, and electrical industries. Services remain subdued, while construction is heading increasingly downwards.

Unemployment and retail sales (y/y)

CZ: Economic sentiment



CE Weekly Preview

WED 14:00 **NBP rate (in %)**

	This meeting	Last change
rate level	3.75	1/2011
change in bps	0	25

PL: The NBP likely to leave rates unchanged

Last week, Marek Belka, President of the National Bank of Poland, confirmed our expectations of the week before last, as he said that the central bank should be moderate until the rise in prices starts to make itself felt in increased wage pressures. Belka added that the central bankers were aware of the risk of increased inflation but this did not imply such a series of rate hikes as seen, for example, in Hungary.

As January's macroeconomic data (retail sales and unemployment), released last week, disappointed markets and failed to indicate the existence of any major demand-pull pressures.

Thus, we believe that a decision to leave rates unchanged will be made at the Wednesday monetary policy meeting. We expect the central bank to raise rates two more times this year, in April for the first time and in the third quarter of the year for the second time. Perhaps only the exchange rate of the Polish zloty may trouble the central bankers, with the currency likely being weaker than they expected.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	28.2.2011	09:00	Unemployment rate (%)	01/2011			11.1		10.8	
CZ	28.2.2011	11:00	Money supply M2 (%)	01/2011						3.3
HU	1.3.2011	09:00	PPI (%)	01/2011				7.5		8.1
CZ	1.3.2011	14:00	Budget balance (CZK B)	02/2011					10.6	
PL	**2.3.2011**	**10:00**	**GDP (%)**	**4Q/2010**				**4.4**		**4.2**
PL	**2.3.2011**	**14:00**	**NBP meeting (%)**	**03/2011**	**3.75**		**3.75**		**3.75**	
HU	4.3.2011	09:00	Trade balance (EUR M)	12/2010 *F					456.9	

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, with rebound from 23.9200 (year low) reapproaching the broken bottom of pattern (see graph).
Support at 24.3800/ .3650 (break-up hourly/ daily), with next levels at 24.2770/ .2600 (break-up daily Feb 11/ break-up hourly): needs to settle back below to indicate return of better fortunes for CZK.
If unable to hold, next levels at 24.0600 (break-up daily Feb 08), ahead of 23.9480/ .9200 (weekly Bollinger bottom/ current reaction low off 25.3800), where pause favored.

Resistance at 24.5650 (current recovery high off 23.9200?), where pause favored.
In unable to cap, next levels at 24.6190 (weekly Medium Term Moving Average↓), ahead of 24.6500 (50% 25.3800 to 23.9200): tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound off year low retested the broken Uptrendline off 2010 low: currently back below 273.88 (neckline short term Double Bottom (see graph).
Support at 270.85 (break-up daily + broken weekly Short Term Moving Average↓), where pause favored.
If unable to hold, next levels at 269.00/ 268.50 (Feb 17 low/ weekly Bollinger bottom + reaction low hourly), ahead of 267.40 (year low) and 266.61 (weekly modified Alpha Beta trend bottom): tough on 1st attempts.

Resistance at 275.20 (current recovery high off 267.40?), ahead of 275.95 (weekly modified Alpha Beta trend top), where pause favored.
If unable to cap, next level at 276.55 (Jan 20 high + broken 50 Week Moving Average↑) and 278.00/ .20 (breakdown daily/ 61.8% 285.00 to 267.40): tough on 1st tests.

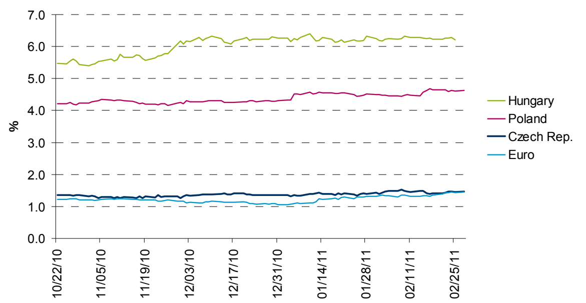
EUR/PLN Daily Chart:

Tested Downtrendline off 4.2400 (see graph) and currently above 3.9610 (neckline Double Bottom).
Support at 3.9615/ .9495 (break-up hourly/ daily): needs to settle back below to indicate return of better mood on Zloty.
If unable to hold, next levels at 3.9280/ .9240 (break-up hourly/ break-up daily Feb 18), ahead of 3.8970/ .8939 (Feb 17 low/ break-up daily Feb 08): tough on 1st attempts.

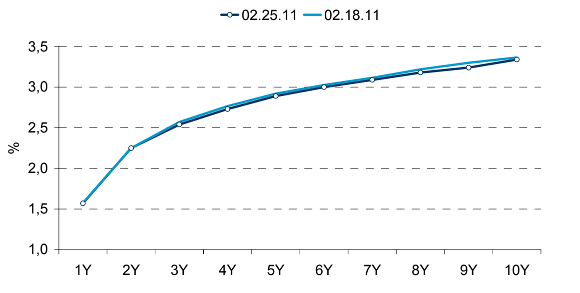
Resistance at 4.0030 (current recovery high off 3.8290), where pause favored.
Failure to cap would see next levels at 4.0150 (breakdown daily Dec 10), ahead of 4.0398/ 4.0436 (weekly Bollinger top/ 76.4% 4.1100 to 3.8290): tough on 1st attempts.

CE Fixed-income in Charts

FRA 3x6

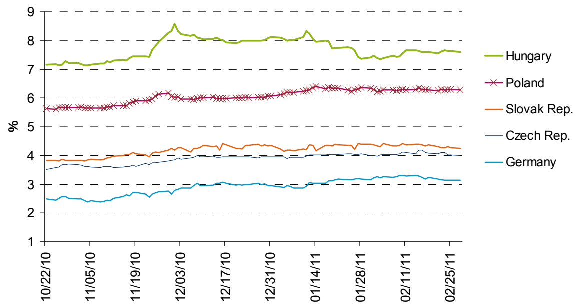


CZ IRS

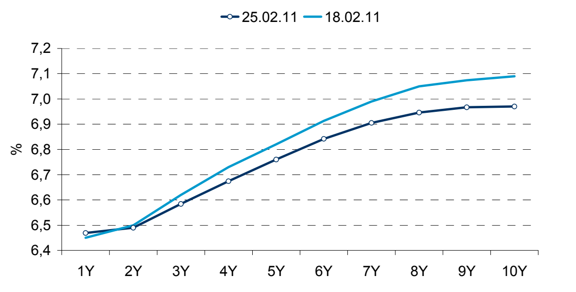


Source: Reuters

10Y GB Yields

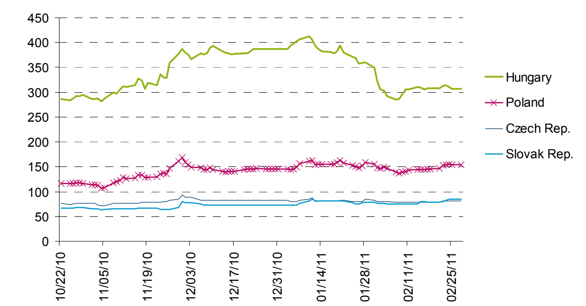


HU IRS

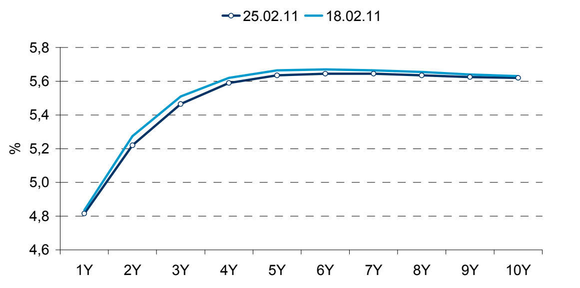


Source: Reuters

CDS 5Y



PL IRS



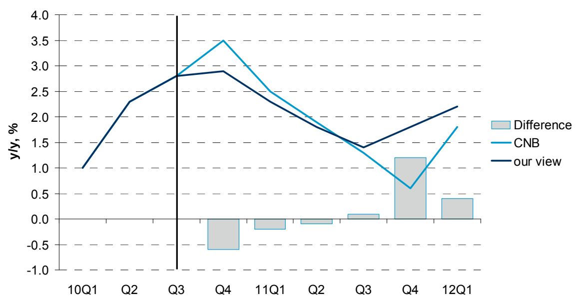
Source: Reuters

Medium-term Views & Issues

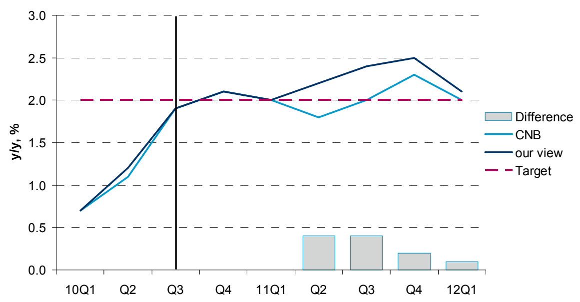
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage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

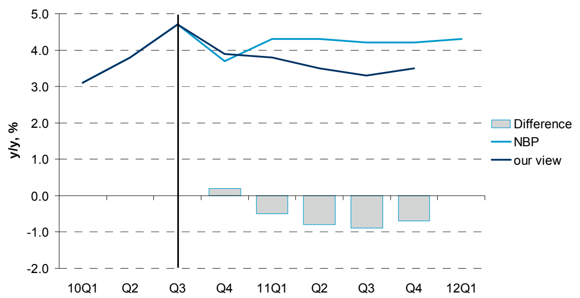
CZ: GDP Outlook



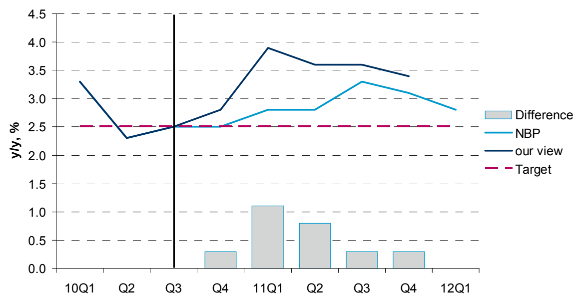
CZ: Inflation outlook



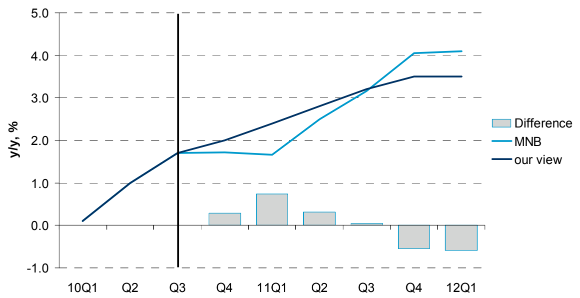
PL: GDP Outlook



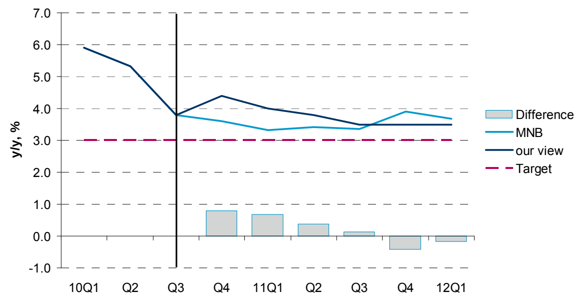
PL: Inflation outlook



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.	*3.3*	3.30	3.40	3.50	3.60	3.70
Hungary	*7.02*	7.25	7.75	7.50	7.25	7.00
Poland	*5.6203*	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	*24.5*	24.7	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*273*	270	280	275	270	270
Poland	EUR/PLN	*3.97*	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.	2.9	2.4	2.1	1.5	1.5	2.5
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	2.5	2.4	4.5	4.8
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

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-2.6
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

Brussels Research (KBC)	
Piet Lammens	+32 2 417 59 41
Peter Wuyts	+32 2 417 32 35
Didier Hanesse	+32 2 417 59 43
Joke Mertens	+32 2 417 30 59
Mathias Van der Jeugt	+32 2 417 51 94
Dublin Research (KBC Bank Ireland)	
Austin Hughes	+353 1 6646892
Prague Research (CSOB)	
Jan Cermak	+420 2 6135 3578
Jan Bures	+420 2 6135 3574
Bratislava Research (CSOB)	
Marek Gabris	+421 2 5966 8809
Budapest Research (K&H)	
Gyorgy Barcza	+36 1 328 99 89

Global Sales Force	
Brussels	
Corporate Desk	+32 2 417 45 82
Commercial Desk	+32 2 417 53 23
Institutional Desk	+32 2 417 46 25
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