Monday, March 21, 2011

Central European Weekly

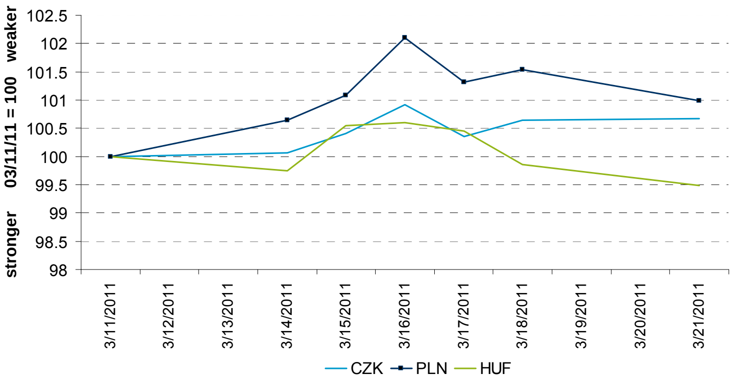
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Zloty finally hit by Japan's tsunami,
- CE bond investors should watch commodity prices
- Polish inflation surprises on the downside
- New MNB Council: doves or hawks?
- Effects of Japanese events on the Czech economy should be insignificant
- CNB rates will almost certainly remain unchanged

Chart of the Week: Zloty got a hit from Japan's tsunami and lower inflation

CE exchange rates since earthquake hit in Japan (against the €uro)



The Zloty has clearly underperformed the rest of the region in recent days.

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Market's Editorial

Zloty finally hit by Japan's tsunami

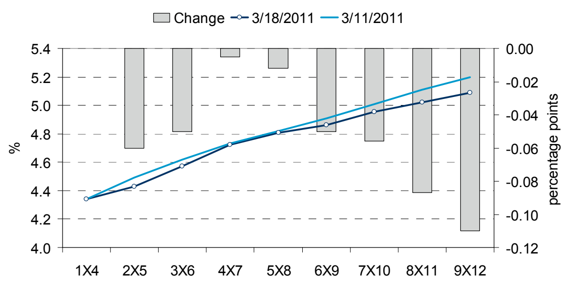
It seems that Japan's tsunami, which led to increased volatility on global markets, has finally hit Central Europe as late as last week. In reaction to the events surrounding Japan's nuclear reactors, the Polish zloty weakened to a nine-month low. To some extent, this move was also followed by the Czech koruna and the Hungarian forint. Nevertheless, the zloty is offsetting its losses hand in hand with the recovery of global stock markets. In the end, the zloty hasn't depreciated by much more than 1% since the date of the earthquake.
Regional bond markets reacted in a very calm way. The direct impact of the events in Japan on the economies in the region should be absolutely negligible.

As regards the indirect impact of Japan's earthquake on CE markets, the impact should not be very significant either unless the Japanese disaster would trigger a fundamental change in the appraisal of risky assets. The low-yielding Swiss franc, which is strengthening hand in hand with the yen, may slightly trouble Hungarian households, whose loans are denominated in that currency, but this should in no way be dramatic.

Regional bond markets should worry, if commodities would come back quickly

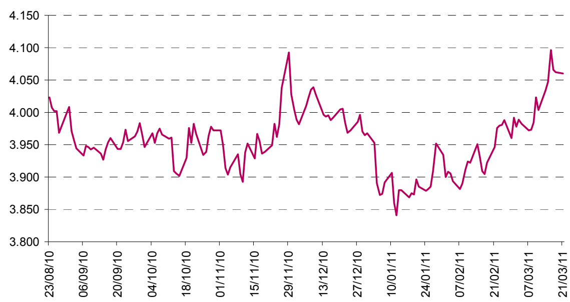
Nevertheless, Central Europe may be exposed to a certain risk in the medium term, due to the development of commodity prices, which may recover soon after the initial (negative) shock. In addition, oil and consequently fuel prices may also be driven upwards by the Libyan crisis in the weeks to come. Likewise, electricity prices may be increased by Germany's decision to shut down temporarily some of its nuclear power plants. This may lead to persisting upward pressure on producer prices and, in small open economies, such pressure may affect the consumer price index fairly soon. Such developments would not be good news for bond markets, which would have to start considering whether central banks in the region will need to tighten their monetary policies, following the example of the ECB.

PL FRA



Source: Reuters

EURPLN



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.38	0.45%	➘	➔
EUR/PLN	4.057	0.67%	➘	➘
EUR/HUF	273.3	0.25%	➘	➘

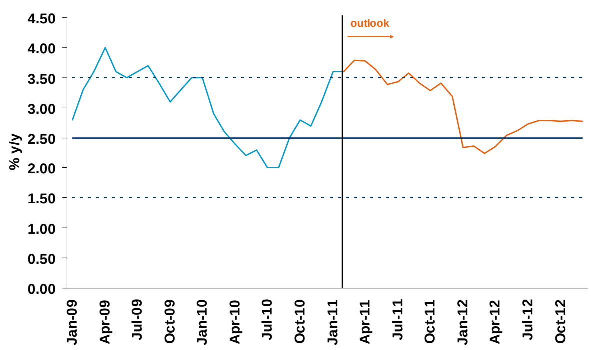
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.90	-0.04	➔	➚
10Y PLN	6.26	-0.04	➔	➚
10Y HUF	7.19	-0.14	➔	➚

Review of Economic Figures

Polish inflation surprises on the downside

The February inflation data from Poland, released on Tuesday, can be described by a single word: surprising. The rise in prices lagged far behind our expectations as well as those of the market (actual inflation of 3.6% y/y, compared to the anticipated 3.9% y/y). Given the revision of weightings in the consumer basket, January's inflation was also revised downwards (3.6% y/y), due in particular to lower food and soft drink prices. However, even after the revision, inflation remains above the upper threshold of the central bank's tolerance band.

Inflation and inflation target



Prior to the release of the inflation data, Jerzy Hausner, member of the Monetary Policy Council (MPC), said that the monetary tightening would continue, but that the exact timing of the moves was unclear (even he had expected prices to rise by almost 4% y/y; the Chairman of Poland's Statistical Office even foresaw that inflation would exceed that level). The much lower than expected inflation, along with previous statements by Marek Belka, President of the National Bank of Poland, pose a significant risk to our scenario, which envisages a rate hike as early as the April MPC meeting.

Particularly the position of Governor Belka will be crucial.

In January, Belka said that rates should be raised, if possible, in generally calmer times, to meet the objective – i.e., the appreciation of the zloty. In addition, demand-driven pressures, which numerous central bankers use as a basis for their assessment, have not yet occurred. Markets were primarily disappointed by the rise in average gross wages for February, which was only 4.1% y/y (compared to the anticipated 4.9% y/y). By contrast, the structure of the producer price index (7.3% y/y, compared to the anticipated 6.7% y/y) confirms that the Polish economy does not stand out as an exception and that the rise in prices is primarily driven by rising commodity prices. If we take account of the exchange rate of the zloty, which is fluctuating at levels where it last stayed for a prolonged period in July 2010, this is definitely no pleasant combination.

The expectations for a rate hike are slightly declining at the moment as investors are disappointed by the recent data. Since Monday, the spread between the three-month WIBOR and the 1x4 FRA rate shrank by 5 bps, currently standing at 12 basis points. While our basic scenario still envisages a rate hike at the next meeting in April, the latest market developments have increased the risk that rates will be raised later during the second quarter of the year.

The new MNB Council: doves or hawks?

The Monetary Council will have four newly appointed members and likely all four will be able to attend the meeting on March 28. It seems that the government decided on independent economists, who are not far from the government's political thinking, but have independent thoughts about monetary policy. Two were nominated earlier in the month. Andrea Bartfai-Mager and Ferenc Gerhardt worked in the central bank before, although not on monetary policy or related areas. The newly appointed member Janos Cinkotai is a respected economist, who has been researching inflation for decades and could be self-committed to maintain price stability in Hungary. The fourth, Gyorgy Kosziczky is an economics professor from Miskolc University, who is the least known and his stance could be less certain for markets.

In general, we think the new Council will have a fairly neutral stance. It might have a somewhat higher tolerance level towards first round price changes since the current Council reacted quickly to the recent energy- and food price shocks that pushed this year's average inflation from 3.5% Y/Y to at least 4.0% Y/Y. This tolerance shift was clear from Mr Cinkotai's comment during the Parliamentary hearing, as he said that 'the central bank should not jump on inflation immediately'.

Currently, headline inflation is 4.1% Y/Y, while core inflation is a tad below 2% Y/Y. So, the likelihood of the achievability of the 3% inflation target depends on the assessment on how this gap will shrink over the next quarters. Should demand-driven inflation remain subdued in the economy, Hungary may finally achieve price stability, which has been an ongoing target since the inception of the inflation-targeting regime in 2001.

In Focus: Effects of Japanese events in the Czech economy

The impact of Japan's disaster on the Czech economy will be limited and indirect.

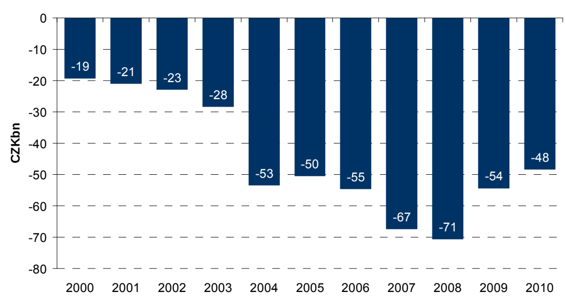
Japan is not very significant as a trading partner of the Czech Republic, with just a 0.2% share of Czech exports and 1.3% of Czech imports over the last two years. However, given the structure of the goods imported from Japan, we cannot rule out an impact on certain industries in the CR, notably the electronics industry, which primarily gets the components for its production from Japan. These primarily include components for PCs and mobile phones, as well as diodes and transistors for other types of products. Printer accessories constitute the largest portion of imports from Japan. Automotive industry imports are not very significant (5.2 bn for 2010), half of which are spare parts. Hence the direct dependence of the industry on imports from Japan is not substantial enough to affect the overall performance of Czech industry, should those imports be interrupted.

The recovery of the Japanese economy is likely to have an impact on the willingness of Japanese firms to invest abroad. Statistically speaking, Japan's FDI in the CR is fairly low (EUR 1.1 bn) but the figure excludes investment by Japanese subsidiaries registered in Europe. Yet the impact on the Czech economy should not rise much even if the latter were included.

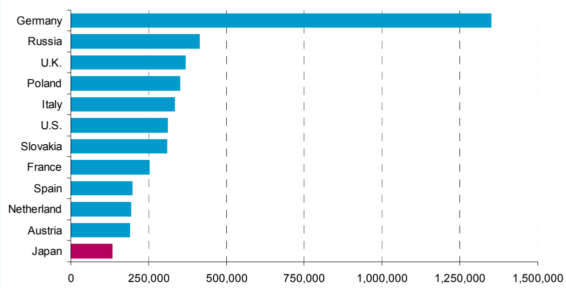
Tourism will be one of the first sectors in the Czech Republic to feel adverse consequences of Japan's disaster. The Czech Republic, as a popular destination of Japanese tourists (the 12th most numerous visitors in this country), who typically spend larger amounts of money, may lose many of those approximately 133,000 visitors per year.
One of the strongest effects of Japan's earthquake on the Czech economy is its direct impact on commodity markets, the prices of which will affect Czech inflation. However, not even this should spring any great surprises, as commodity prices had already gone up significantly over the previous weeks and months. While fuel prices have absorbed that impact fairly quickly, prices of other goods and services in the economy are only reacting step by step (e.g., the chemical industry, transport prices, food industry, and agriculture). There is a risk that electricity prices, after the temporary shutdown of Germany's nuclear power plants, will stabilise at a higher level. This would automatically mean an increase in electricity prices for businesses and households in the Czech Republic next year. If the prices go up by 10%, the inflation impact would be 0.35% for the CPI and 1.8% for the PPI.

Since the beginning of 2011, the koruna has been highly immune to most shocks from global markets. Neither the tension at the periphery of the euro area nor the Middle East crisis has put the Czech currency at any great risk. This may be partly due to the fairly disciplined budgetary policy of the Czech government, which also makes itself felt in stable risk premiums on Czech debt, and partly due to the extremely low interest rates in the Czech Republic. Low-interest currencies usually withstand negative external shocks better than their high-yielding counterparts (zloty, forint). This is why the Czech koruna, unlike its regional neighbours, is likely to weaken to a lesser extent (2-3%) in reaction to the Japanese crisis and, after the tension is gone, will also strengthen to a lesser extent, of course. The impact of Japan's disaster on Czech rates, and notably yields, is likely to be only limited and temporary. The CNB's monetary policy will not be influenced by the developments in Asian markets, and the central bank will continue to cite the need to terminate the period of record-low interest rates after some time. Hence our main scenario continues to envisage that the CNB will raise its base interest rate sooner than indicated by its forecast (Q4/2011). We still consider August, when the CNB Board is to discuss this year's third inflation forecast, to be an appropriate month to do so.

CZ: Trade balance with Japan



Number of tourists in the CR (2010)



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: CNB rates will almost certainly remain unchanged

After the last meeting, where three of the four members voted for a rate hike, a proposal to rise in interest rates is likely to be tabled again. One vote for a rate hike is almost certain. The second CNB Board Member who voted for a rate hike will not take part in the meeting this time. The third proponent of a rate hike was replaced by a new member, after the term of office of the former had expired. Given the moderate forecast and basically due also to poor economic developments, it seems that the CNB might not hasten to change rates this time either. The economy is growing at a much slower rate than the CNB has planned thus far (2.6%, compared to the predicted 3.5%). Inflation also remains below the target (by 0.2%), as well as below the forecast (by 0.3%), in spite of the rapid rise in commodity prices. Thus the forecast has not yet materialized. We still consider August, when the CNB Board is to discuss this year's third inflation forecast, to be an appropriate month to raise rates.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
PL	21.3.2011	14:00	Trade balance (EUR M)	01/2011			-610		-1 106	
PL	21.3.2011	14:00	Current account (EUR M)	01/2011			-1 280		-1 573	
PL	22.3.2011	14:00	Core CPI (%)	02/2011			0.2	2.0		
HU	23.3.2011	09:00	Retail sales (%)	01/2011				0.3		-1.7
PL	23.3.2011	10:00	Unemployment rate (%)	02/2011			13.2		13.0	
PL	**23.3.2011**	**10:00**	**Retail sales (%)**	**02/2011**			**-2.5**	**7.4**	**-28.6**	**5.8**
CZ	23.3.2011	12:00	CZ Bond auction floating rate/2016 (CZK B)	03/2011			7			
HU	24.3.2011	12:00	GB bond auction/fixed rate (HUF B)	03/2011 *A						
CZ	**24.3.2011**	**12:30**	**CNB meeting (%)**	**03/2011**	**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:

Below long term Triangle bottom (see graph).

Support at 24.2550/ .2150 (reaction lows hourly), with next levels at 24.1800/ .1400 (March 03 low/ break-up hourly), ahead of 24.0600/ .0310 (break-up daily Feb 08/ monthly envelope bottom), where pause favored.
If unable to hold, next levels at 23.9900 (weekly modified Alpha Beta trend bottom), ahead of 23.9200 (current reaction low off 25.3800 and 29.6900 + monthly Bollinger bottom): tough on 1st attempts.

Resistance at 24.5650/ .5960 (neckline short term Double Bottom: see graph/ weekly Bollinger midline + weekly modified Alpha Beta trend top), where pause favored.
In unable to cap, next levels at 24.6200 (weekly Long Term Moving Average↓), ahead of 24.6500/ .6650 (50% 25.3800 to 23.9200/ 4th wave off 25.3800 on hourly charts): tough on 1st attempts.

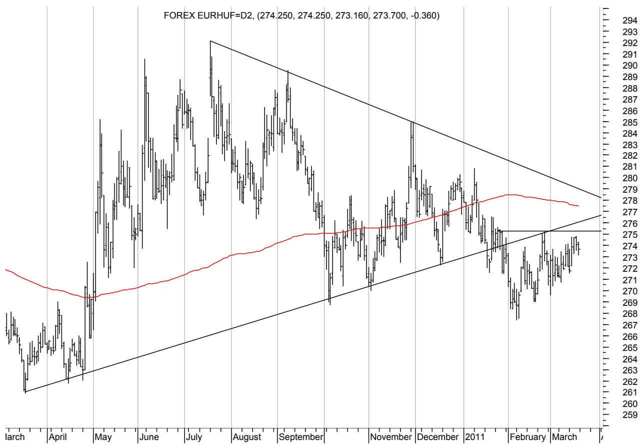
EUR/HUF Daily Chart:

Above Downtrendline off 4.2400 (see graph) and has met targets off 3.9610 (neckline Double Bottom).

Support at 4.0138 (weekly Short Term Moving Average↑), ahead of 4.0000/ 3.9950 (reaction low hourly/ break-up hourly) and 3.9860 (break-up daily March 09): needs to settle back below to indicate return of better fortune for Zloty.
If unable to hold, next levels at 3.9616/ .9565 (March 08 low + weekly modified Alpha Beta trend bottom/ broken weekly Long Term Moving Average→), ahead of 3.9488/ .9469 (March 01 low/ weekly Medium Term Moving Average↑), where pause favored.

Resistance at 4.1005 (reaction high hourly), ahead of 4.1135/ 1225 (monthly modified Standard Error band top/ current spike recovery high off year low? + weekly modified Alpha Beta trend top), where pause favored.
Failure to cap would see next level at 4.1695 (weekly Starc top): tough on 1st attempts.

EUR/PLN Daily Chart:



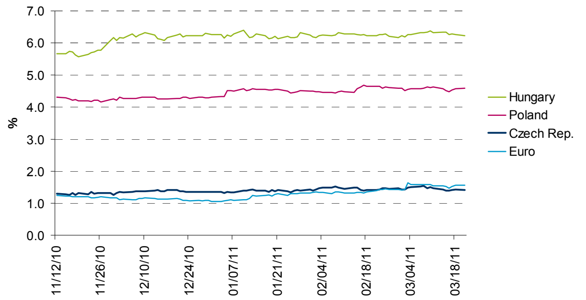
. Rebound off year low retested the broken Uptrendline off 2010 low (see graph).

Support at 271.35 (break-up hourly), with next levels at 270.70/ .39 (March 08 low/ reaction low hourly), ahead of 269.60/ 269.00 (March 01 low/ Feb 17 low), where pause favored.
If unable to hold, next levels at 268.61 (weekly Bollinger bottom), ahead of 267.40 (year low) and 266.10 (monthly envelope bottom): tough on 1st attempts.

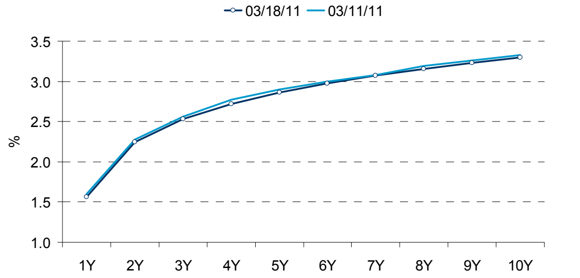
Resistance at 274.67 (weekly + monthly Bollinger midlines), ahead of 275.20 (current recovery high off 267.40 + see graph: neckline Double Bottom), where pause favored.
If unable to cap, next levels at 275.50 (weekly modified Alpha Beta trend top), ahead of 276.24/ 276.55 (monthly envelope top/ Jan 20 high) and 276.88 (broken 50 Week Moving Average↑): tough on 1st tests.

CE Fixed-income in Charts

FRA 3x6

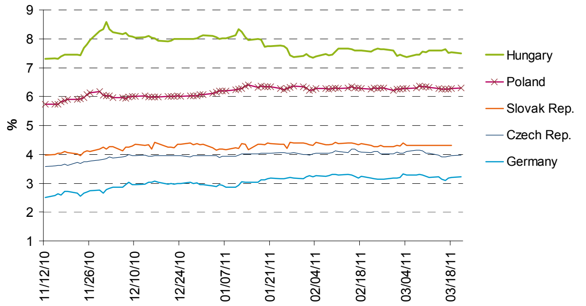


CZ IRS

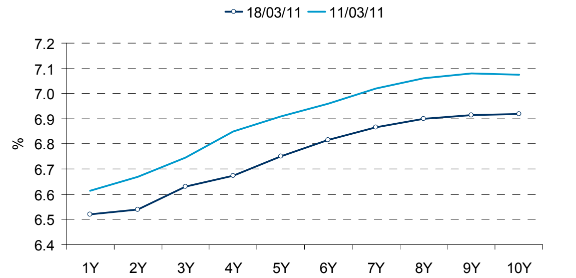


Source: Reuters

10Y GB Yields

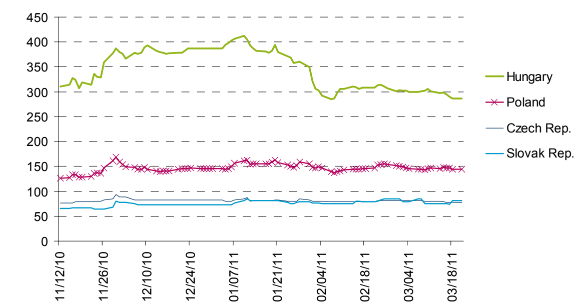


HU IRS

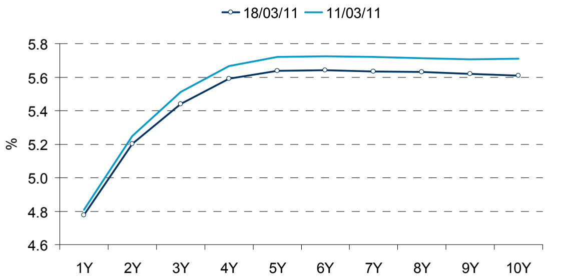


Source: Reuters

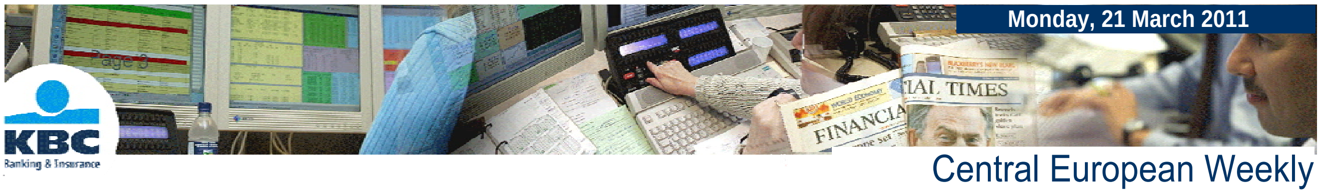
CDS 5Y



PL IRS



Source: Reuters

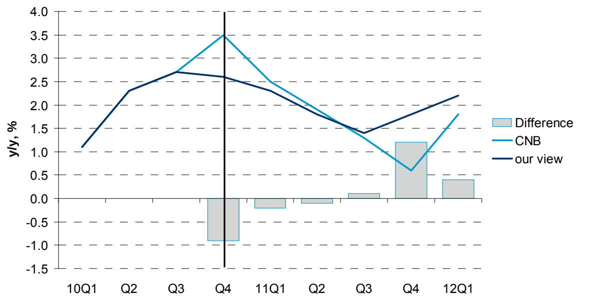


Medium-term Views & Issues

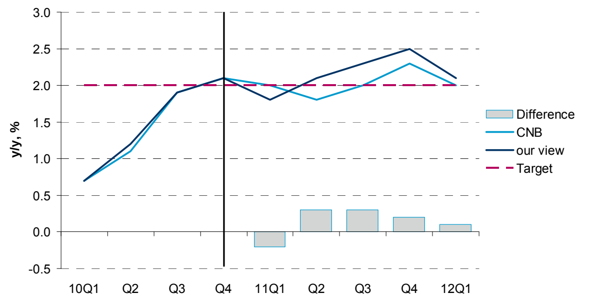
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage 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.	Hungary's government decided to carry out a large-scale fiscal overhaul program over 3-years (2011-2013) in order to boost growth. The impact on the economy will come from higher activity of the working age population and shrinking size of government spending. Lower spending helps to cut the deficit amid tax reductions and the program overall cuts the deficit by 2% of GDP in 2012 and further 1% of GDP in 2013. The long-term outlook mainly depends on the execution. We recommend waiting until the 2010 ESA budget deficit number is released in March before deciding on investments.	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 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. On the other hand more aggressive ECB stance should lead the NBP to at least three more hikes during this year (April, Q3, Q4) to 4.50% by December 2011.
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.	Optimism before the government's spending reform package also boosted appetite for Hungarian assets. In this situation, it will be difficult to meet expectations and markets may thus correct in the coming weeks. Relatively mild positioning of foreign investors together with the forint's neutral performance visá- vis its peers make a sharp correction unlikely for now, except if global outlook changes significantly by for example an oil-price triggered slowdown In the longer term positive impact could depend on the productivity boost.	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 o 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

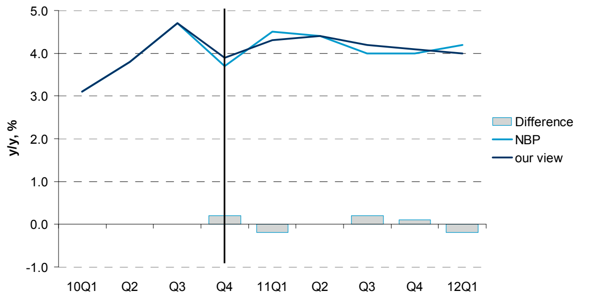
CZ: GDP Outlook



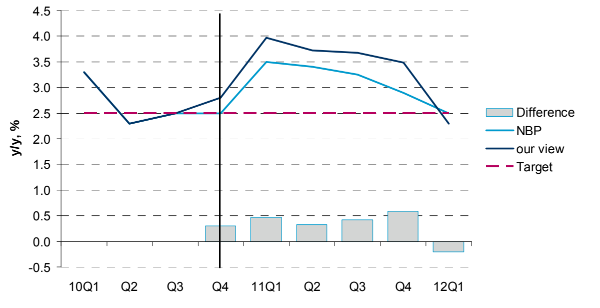
CZ: Inflation outlook



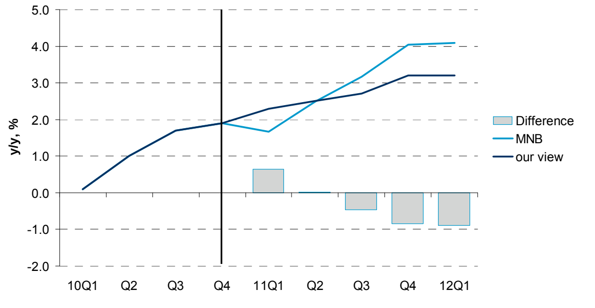
PL: GDP Outlook



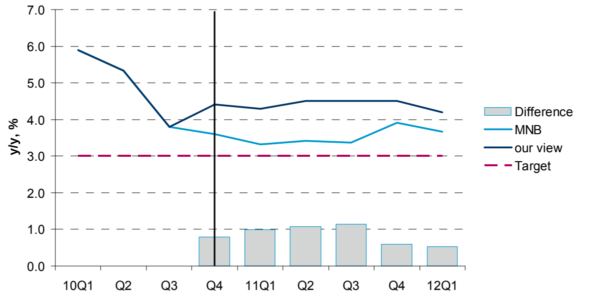
PL: Inflation outlook



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	6.25	6.25	25 bps	1/24/2011
Poland	2W inter. rate	*3.75*	3.75	4.00	4.25	4.50	4.75	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	*1.20*	1.22	1.35	1.45	1.60	1.72
Hungary	BUBOR	*6.10*	6.10	6.00	6.00	6.25	6.25
Poland	WIBOR	*4.18*	4.15	4.35	4.50	4.55	4.55

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	*6.95*	7.50	7.50	7.25	7.00	7.00
Poland	*5.6028*	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	*274*	280	280	275	270	270
Poland	EUR/PLN	*4.06*	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.	2.6	2.2	1.9	1.3	1.7	2.5
Hungary	2.0	2.3	2.5	2.7	3.2	3.2
Poland	*3.9*	4.3	4.4	4.6	4.2	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	3.5	3.5
Hungary	4.3	4.5	4.5	4.5	4.2	4.0
Poland	3.8	3.5	3.5	3.3	2.5	2.6

Current Account as % of GDP

	2010	2011
Czech Rep.	-3.8	-3.6
Hungary	0.5	1.0

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

	2010	2011
Czech Rep.	-5.9	-5.0
Hungary	-3.8	-2.9

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