KBC
Banking & Insurance

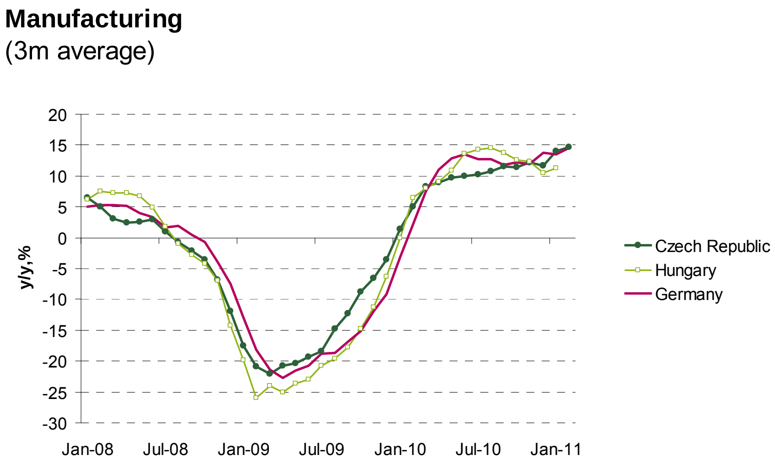
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Koruna and forint still well supported by export rally
- Despite inflation pressures almost everywhere, the Czech inflation remain low
- In focus: NBP strikes for the second time and increases its base rate to 4.0%
- CE data preview: headline inflation in focus

Chart of the Week: Czech, Hungarian and German Industrial Output



The Czech and Hungarian industry post very strong gains in February. Both indicators are in sync with the surging German industrial production.

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Market's Editorial

Export rally support forint and koruna

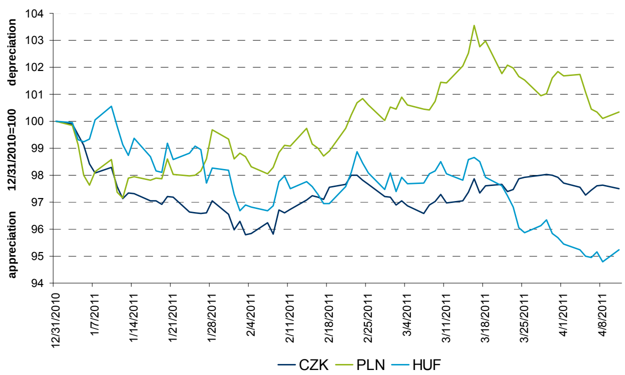
The upswing in German industry is not waning; likewise, the export-oriented sectors of the Czech and Hungarian economies are performing very well. The latest industrial output data for February are very promising (a double-digit year-on-year rise), and show no signs of future deceleration. The excellent performance of export-oriented industries has a very positive effect on the Czech and Hungarian trade balances, which, notwithstanding the high oil prices, are developing very positively, which is encouraging for both the koruna and the forint.

Fairly strong currencies and particularly the fact that, unlike the export-oriented part of industry, the other sectors of the Czech and Hungarian economies are performing rather poorly means the Czech National Bank and the National Bank of Hungary shouldn't be overly concerned about the start of the monetary tightening cycle in the euro area. Unlike the National Bank of Poland, confronted with a somewhat different macroeconomic constellation, the CNB and the NBH may temporarily afford to go their own way. However, this independence from the ECB policy will not last forever, most likely only for a few months. Afterwards, the forex (as well as bond) markets in the Czech Republic and Hungary will need to take into account that euro rates have increased significantly, and the process of catching up with the developments in the euro area will begin. Such a process might temporarily depreciate the currency and consequently lead to an (undesired) easing of monetary conditions. If the central banks in the Czech Republic and Hungary wish to neutralise those developments, they will have to raise their official interest rates in the end.

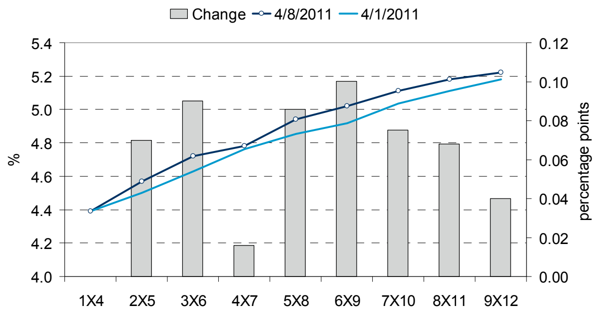
With exception of Poland, inflation data should not hurt

However, this is a fairly distant outlook. As early as this week, March's inflation will hold the spotlight in both the Czech Republic and Hungary; nevertheless, no big (unpleasant) surprises as expected despite the rise in fuel prices. The Czech March inflation report, released earlier today underpins such expectation.

CE exchange rates against EUR in 2011



PL FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.41	-0.16%	→	→
EUR/PLN	3.962	-1.78%	→	→
EUR/HUF	263.6	-0.82%	→	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	4.07	0.04	↗	↗
10Y PLN	6.14	-0.11	↗	↗
10Y HUF	6.83	-0.21	↗	↗

Review of Economic Figures

Hungary’s exports still lead recovery

Recent activity in Hungary data has been stronger than expected suggesting that the economy might grow faster in 2011 then thought.
Firstly, February’s industrial output data came in above expectations at 14.3% Y/Y, faster than the 10-12% Y/Y growth registered in the previous months. It seems that the dip in December – growth rate fell to 5.9% Y/Y – was a one-off and could have been caused by temporary slowdown of some companies, due to an upgrading of the production lines leading to a boost to output in recent months. Available preliminary data does not contain sector breakdown details.
Secondly, trade balance showed a record €816m surplus in the second month of the year on strong, 27% Y/Y export growth. This means that the 12-month cumulative trade surplus increased to 6.1% of GDP, which could widen the current account surplus for a second year in a row.
Overall, export and output data suggest that the economy could accelerate in the first quarter, underpinning the government 3% Y/Y growth forecast for 2011.

Industry pulls up the Czech economy

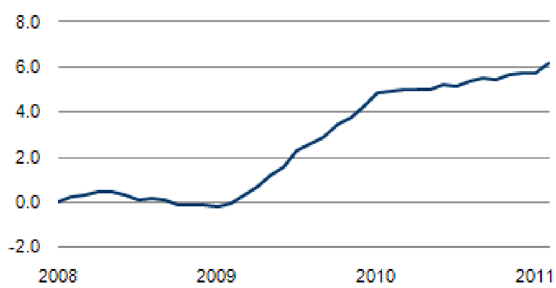
Like in Hungary the industrial output in the CR is cruising ahead at reasonable fast rate. The year-on-year rise by 13% is more or less in line with expectations, and the rapid increase in the output of cars, metal products, and the engineering industry is no surprise either. By contrast, the electrical industry’s production is running out of steam, with new contracts having dropped for the first time in fourteen months, mainly because of poor domestic demand. Overall output and contracts have already exceeded the level of the record-breaking years of 2008-2009. Industry thus remains the main driver of the economy, fuelled by foreign demand. As we can see, this will also hold true in the months to come, because new contracts are rising by 12.5%, with foreign contracts up by a huge 18.2%. The current data clearly indicates that the Czech economy remains a multi-speed economy, with strengthening industry on the one hand, and lagging services and construction on the other.

Czech inflation declines again

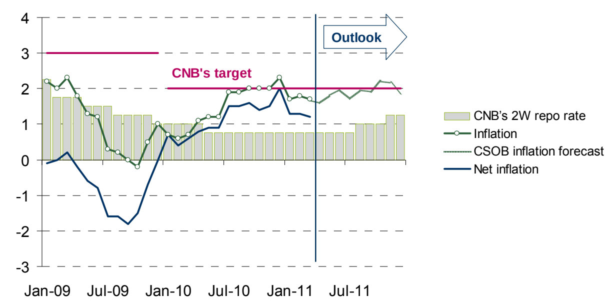
Year-on-year inflation was down by 0.1%-point to 1.7%, i.e. 0.3%-point below the central bank’s target and forecast. Although inflation is 1.7%, this is primarily due to the increased prices of agricultural and energy commodities on global markets. Prices in the Czech Republic are not being driven upwards by demand-pull inflation at all. What is more, plenty of consumer goods are even much cheaper on a year-on-year basis because demand has not yet recovered since the last economic recession. In addition, demand is curbed by fiscal austerity measures. No significant price increase is likely to occur on the Czech market in the months to come either. Thus inflation may remain below the 2% target of the Czech National Bank until the middle of the year at least. Costly oil is already included in fuel prices while food prices will start to seasonally fall over the course of time. We need to wait for a crop to see how food prices will continue to develop. Hence inflation is not and probably will not be a problem of the Czech economy – despite the unfavourable conditions on the global commodity market – because inflation with administrative moves excluded (net inflation) again fell, to 1.2% this time, as opposed to 2% as recently as in December. Czech inflation is primarily driven by external factors, on which the CNB policy has a negligible impact, whereas demand-pull inflation is still nowhere.

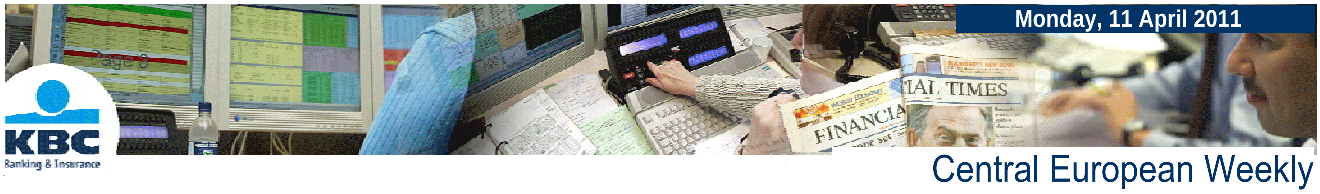
Hungary:

Foreign trade balance (% of GDP)



CZ: Inflation and CNB's Target
(%)

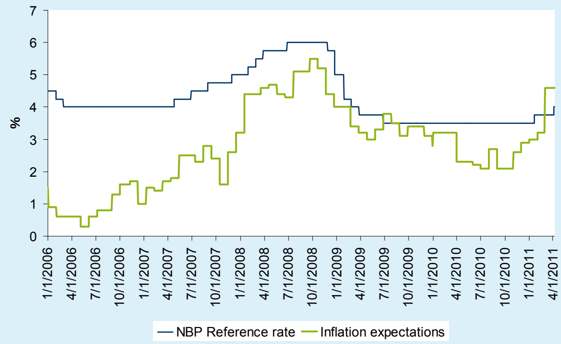




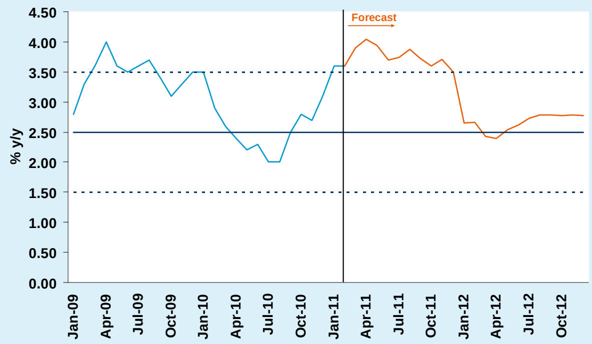
In Focus: NBP strikes for the second time

- NBP increases its reference rate by 25 bps
- The main reason - inflation expectations leapt to 4.6% in March
- We believe in two more 25 bps rate hikes this year, so the base rate should stand at 4.5% in December

Base rate vs inflation expectations of households



Inflation and inflation target



Inline with our expectations, the National Bank of Poland (NBP) decided to increase the reference rate by 25 basis points to 4% on Tuesday. It happened despite the fact that headline inflation has been driven mainly by high commodity prices. According to the NBP official press release, a significant increase in inflation expectations was the main reason for the rate hike.

Importantly, NBP Governor Belka and the key median voter in the MPC, said during his press conference that he could not say that the central bank was nearing the end of the tightening cycle. Nevertheless, he added that the majority of the Monetary Policy Council members thought that the current pace of growth was not strong enough to accelerate inflation per se. But the NBP tightening cycle is far from over.

Since we estimate that the CPI inflation grew to almost 4% on year-on-year basis in March and might even breach this level in April, we bet on two more hikes this year. In this respect, we think that the next one might come at July's monetary policy meeting and the second hike might take place in the last quarter of this year.

Concerning the market reaction, the zloty has posted solid gains and drifted below 4 EUR/PLN level after the NBP decision. In this regard, renewed rate hike bets might trigger some short-lived rally, but one should take into account that a lot of rate hikes have been already priced in (e.g. FRA 6x9 stand at around 5.0 %).

CE Weekly Preview

TUE 9:00	HU Inflation (change in %)		
	Mar-11	Feb-11	Mar-10
CPI y/y	**4.2**	4.1	5.9

HU: Headline inflation little changed

We expect fuel prices to push up the headline inflation a bit, but core inflation is expected to remain low, hence for the broadly unchanged expectation.

WED 10:00	CZ Cur. Account (CZK bn)		
	Feb-11	Jan-11	Feb-10
C/A monthly	**2.5**	-0.3	5.6
cummulative (YTD)	**2.2**	-0.3	20.9
Trade bal. monthly	**4.3**	7.3	7.9
cummulative (YTD)	**11.5**	7.3	18.6

CZ: Current account slightly above zero

The current account likely showed a moderate surplus in February. We anticipate a surplus in the balance of goods and services on the one hand, while, on the other hand, the balance of income will remain in the red, as usual: this time – before the dividend season begins – its deficit will be still moderate. After the dividends start to leave the Czech Republic in March, the current account will return to the red, where it will remain until the end of the year. For 2011 as a whole, we currently anticipate a deficit in excess of 3% of GDP, just like last year.

WED 14:00	PL Inflation (change in %)		
	Mar-11	Feb-11	Mar-10
CPI y/y	**3.9**	3.6	2.6
Food (ex Alc.) y/y	**5.9**	5.0	1.4
Transport (including fuel)	**7.7**	6.5	8.4

PL: Inflation heading towards 4%

Even after the revision of weightings in the consumer basket, Poland's year-on-year inflation, which hit 3.6% y/y in January and February, remains high above the central bank's target (2.5% y/y) as well as above the upper threshold of the tolerance band (3.5% y/y). In addition, our forecasts indicate that the CPI went up by 3.9% y/y in March. The main reasons continue to be the high commodity prices, notably oil prices (the sub-index of transport prices was likely up by more than 2% m/m). The central bank has already responded to the March increase in the inflationary expectations, having raised rates for the second time this year by 25 bps to 4%.

FRI 9:00	CZ PPI (y/y change in %)		
	Mar-11	Feb-11	Mar-10
m/m	**0.4**	0.5	0.1
y/y	**5.8**	5.4	-0.8

CZ: The producer inflation is peaking

The producer price index likely continued to go up rapidly in March. The reason was again expensive oil, which increases the prices of refining and chemical industry products. Prices in the food industry likely also continued to rise. Even though the year-on-year PPI rise will be close to 6%, the CPI remains moderate. Poor domestic demand significantly curbs any potential increases in the prices of consumer goods on the domestic market. In addition, the PPI is likely to peak, and the months to come should see the pressures on the PPI wane.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	**11.4.2011**	**09:00**	**CPI (%)**	**03/2011**	**0.1**	**1.7**	**0.2**	**1.7**	**0.1**	**1.8**
HU	**12.4.2011**	**09:00**	**CPI (%)**	**03/2011**		**4.2**	**0.9**	**4.3**	**0.4**	**4.1**
CZ	13.4.2011	10:00	Current account (CZK B)	02/2011	2.5		3.85		-0.31	
ČR	13.4.2011	12:00	CZ bond auction floating rate/2023 (CZK B)	04/2011			8			
PL	13.4.2011	14:00	Current account (EUR M)	02/2011			-308		-930	
PL	13.4.2011	14:00	Trade balance (EUR M)	02/2011			-184		275	
PL	**13.4.2011**	**14:00**	**CPI (%)**	**03/2011**		**3.9**	**0.5**	**3.8**	**0.2**	**3.6**
HU	14.4.2011	09:00	Industrial output (%)	02/2011 *F					0.9	14.3
PL	14.4.2011	14:00	Money supply M3 (%)	03/2011			0.9		0.8	
CZ	15.4.2011	09:00	PPI (%)	03/2011	0.4	5.8	0.6	5.9	0.5	5.4
PL	15.4.2011	15:00	Budget balance (PLN M)	03/2011					-14 421	

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

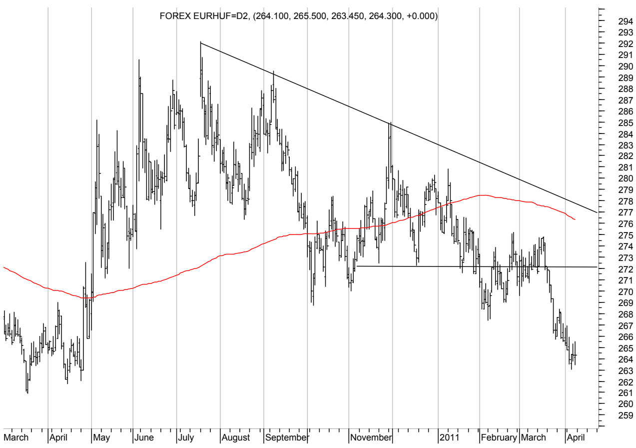
CE Forex Technicals

EUR/CZK Daily Chart:

Below long term Triangle bottom (see graph).
Support at 24.3160 (24.3160 (March 18 low): sustained trade below needed to indicate return of better tone for CZK.
If unable to hold, next levels at 24.2550 (reaction low hourly + weekly modified Alpha Beta trend bottom), ahead of 24.1800/ .1570 (March 07 low/ monthly modified Alpha Beta trend bottom) and 24.1400/ .1160 (break-up hourly/ monthly envelope bottom), where pause favored.
23.9200 = current reaction low off 25.3800 and 29.6900: tough on 1st attempts.

Resistance at 24.5650/ .5900 (neckline short term Double Bottom: see graph/ current recovery high off 23.9200), where pause favored.
In unable to cap, next levels at 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:



New year low scored (has met 1st target off 272.25: see graph: neckline medium term Double Top).
Support at 263.04 (current new year low?), where pause favored.
If unable to hold, next levels at 261.19/ 260.93 (monthly Bollinger bottom + monthly modified Alpha Beta trend bottom/ 2010 low), ahead of 259.50 (2nd target off 272.25): tough on 1st attempts.

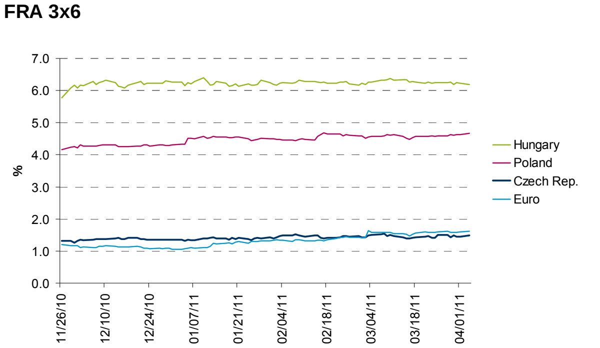
Resistance at 265.30/ 266.35 (breakdown hourly/ weekly Short Term Moving Average↓): ideal area to stay below to keep current short tem mood on HUF.
If unable to cap, next levels at 268.40 (March 29 high), ahead of 269.00 (breakdown daily) and 270.79 (monthly Short Term Moving Average↓): sustained trade above would indicate end of current love affair with HUF.

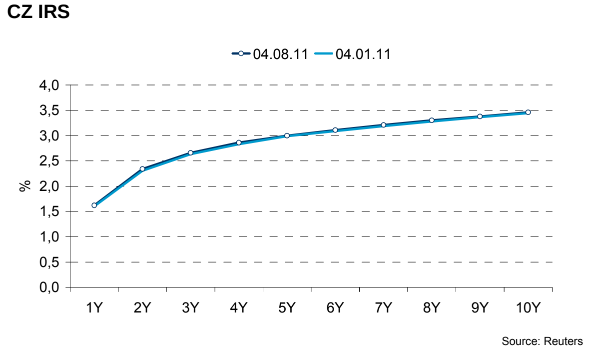
EUR/PLN Daily Chart:

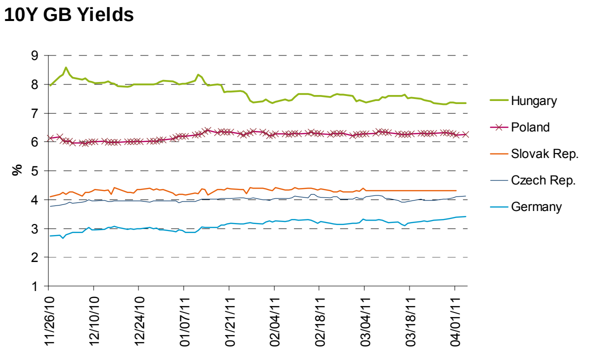
Toying back with Downtrendline off 4.2400 (see graph) and 3.9610 (neckline medium term Double Bottom).
Currently below 3.9820 (neckline short term Double Top: see graph).
Support at 3.9505/ .9441 (current reaction low off 4.1225?/ 50% 3.8290 to 4.1225), ahead of 3.9340/ .9324 (break-up hourly/ monthly envelope bottom), where pause favored.
If unable to hold, next levels at 3.9240 (break-up daily Feb 18 + monthly modified Alpha Beta trend bottom), ahead of 3.9176/ 3.9125 (1st target off 3.9820/ 50 Month Moving Average↑), where pause favored.

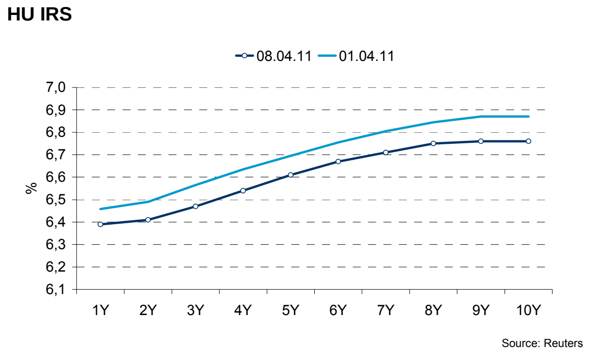
Resistance at 3.9820 (see above), ahead of 3.9960/ 4.0060 (reaction high hourly/ breakdown hourly): Zloty on better footing while below this area.
If unable to cap, next levels at 4.0129 (broken weekly Short Term Moving Average→), ahead of 4.0464 (April 01 high): tough on 1st attempts.

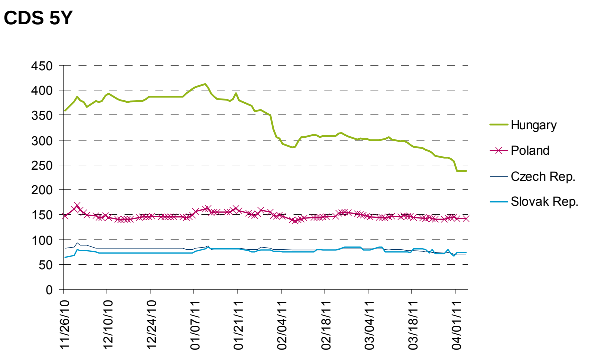
CE Fixed-income in Charts

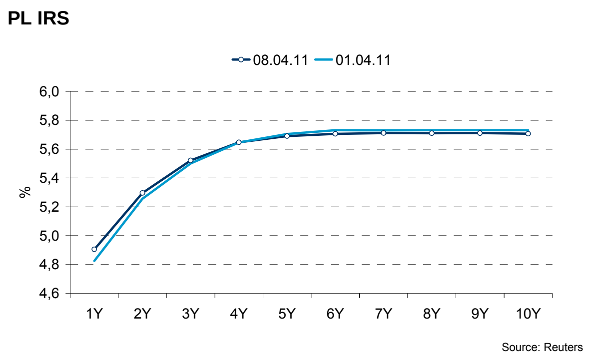










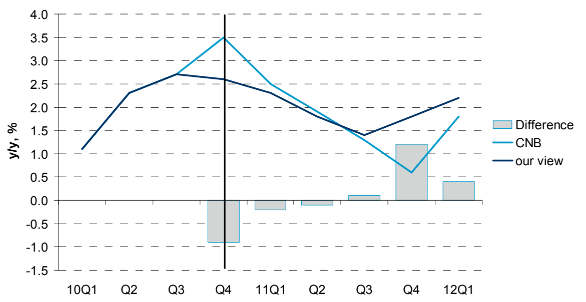


Medium-term Views & Issues

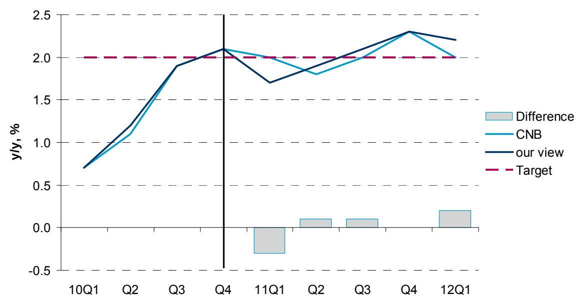
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage point per year is reasonable and doesn't pose a huge risk to the ongoing economic recovery. Already last year's budget ended with a lower than planned deficit. The general government deficit even felt below 5% of GDP in 2010. The fundamental precondition for hitting the budget targets is the launch of reforms, notably of the social security and pension system.	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.	According to our estimates, the Polish economy grew in Q1/2011 at more or less the same pace as in the last quarter of the previous year. Given the recent set of data, we revise the expected growth up to 4.4% in 2011. Mainly domestic consumption and investment should drive the growth with government and external sector having more or less a neutral impact. However, one should bear in mind that there is risk of revisions of previous figures due to huge errors and omissions line of the balance of payments (around 4% of GDP).
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.	A sharp increase in inflation expectations led to the further round of monetary tightening in Poland. In line with our expectations, the National Bank of Poland increased the reference rate by 25 bps to 4%. Given the fact that the rate of inflation should stay above the target in the rest of 2011, we expect that interest rates in Poland should rise further. We think that two more hikes hang in the air. Our scenario bets on the first hike as early as at July's Monetary Policy Council's meeting. The second hike could take place during Q4/2011.
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.	Tighter monetary policy has not helped the zloty very much so far and we believe even further monetary tightening has only limited potential to boost the Polish currency. First of all because market has already priced in our interest rate outlook. The effect of domestic tightening may also be somewhat offset by interest rate hikes in eurozone. Furthermore we are afraid of negative effect of errors in Polish balance of payments on Polish GDP and especially on highly important debt/GDP ratio. Given that uncertainty ahead of Parliamentary elections, we remain more or less neutral on Polish currency at levels around 4.00 EUR/PLN.

Central Bank's Projections versus Our Macro Forecasts

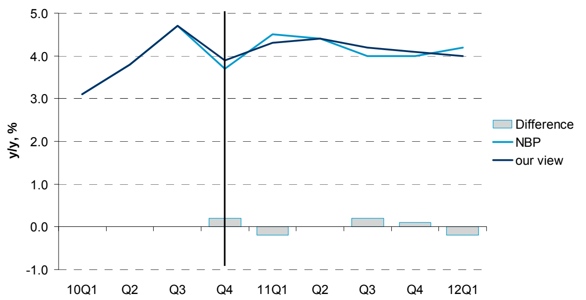
CZ: GDP Outlook



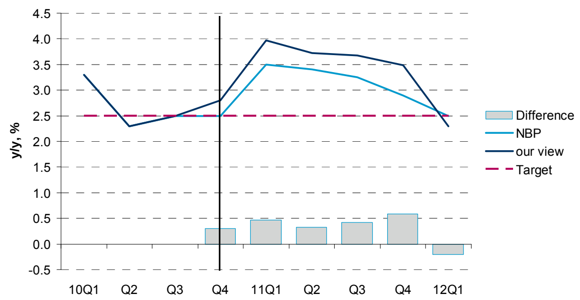
CZ: Inflation outlook



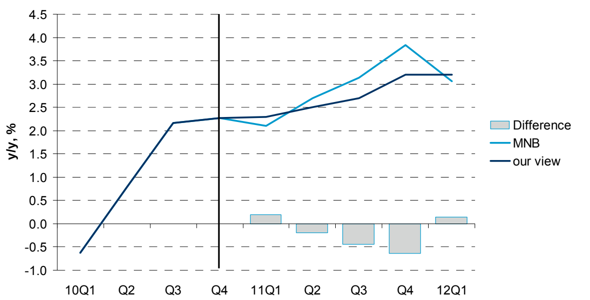
PL: GDP Outlook



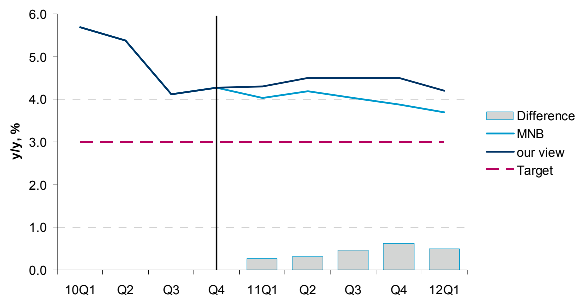
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Last change	
Czech Rep.	2W repo rate	*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	6.25	6.25	25 bps	1/24/2011
Poland	2W inter. rate	*4.00*	4.00	4.25	4.50	4.75	25 bps	4/6/2011

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

		Current	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	PRIBOR	*1.21*	1.35	1.45	1.60	1.72
Hungary	BUBOR	*6.10*	6.00	6.00	6.25	6.25
Poland	WIBOR	*4.26*	4.35	4.50	4.55	4.55

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

	Current	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	*3.46*	3.40	3.50	3.60	3.70
Hungary	*6.76*	7.50	7.25	7.00	7.00
Poland	*5.7053*	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	EUR/CZK	*24.4*	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*264*	280	275	270	270
Poland	EUR/PLN	*3.96*	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.	1.7	2.0	2.1	2.2	2.2	2.2
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.	-4.7	-4.3
Hungary	-3.8	-2.9

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