Monday, May 02, 2011

KBC Banking & Insurance

Central European Weekly

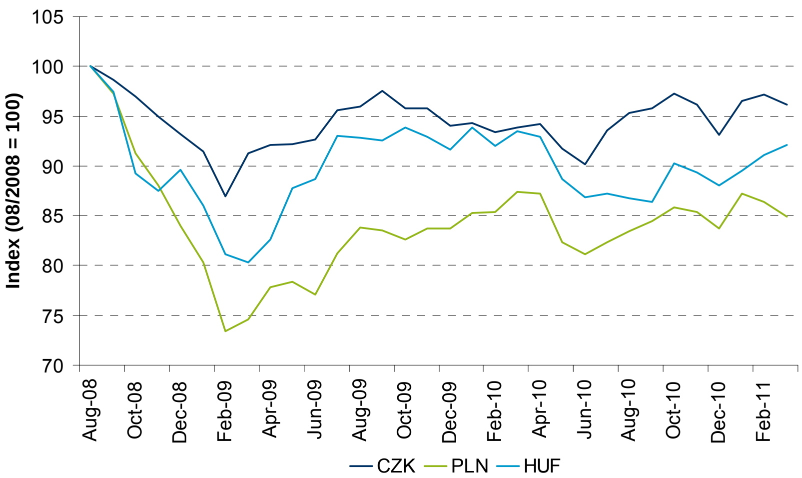
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Widening of rate differential between ECB and CNB rates is a risk for Koruna
- Inflation expectations of Polish public fall
- In focus: Koruna helps CNB tighten monetary conditions
- CE Weekly Preview: CNB will stay on hold despite hawkishness of ECB

Chart of the Week: CE Real Exchange Rates still below pre-Lehman era

CE: Real Effective Exchange Rate



Despite higher inflation and stronger zloty against euro, the real effective exchange rate of the Polish currency has not reached its pre-Lehman level.

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Market's Editorial

CNB stays on hold despite hawkish ECB

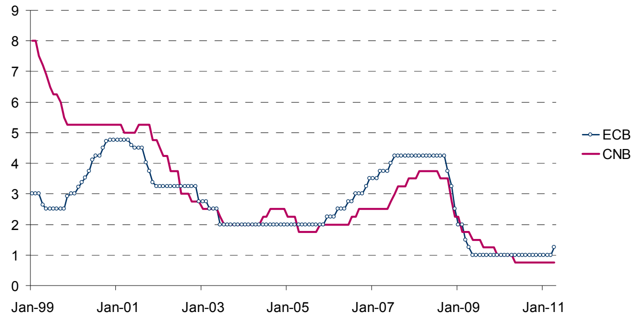
The post-Easter week was outright calm on Central European markets, as if the holiday period was prolonged. Almost all of the volatility on the forex and bond markets vanished, as not even events on leading markets gave a lift to those in Central Europe. A more attractive calendar of economic events for this week suggests that a certain degree of volatility may reappear in the next days.

The upcoming CNB meeting, coincidentally scheduled for Thursday when also the ECB meets, merits all attention. While the ECB, given April's high inflation rate, is likely to up its anti-inflationary rhetoric, the Czech National Bank should remain fairly calm on inflation and inflation outlook. Time is closing in when the differential between the base rate of the ECB and that of the CNB will be 75 basis points (in favour of euro rates) as we expect the ECB to increase rates in June.

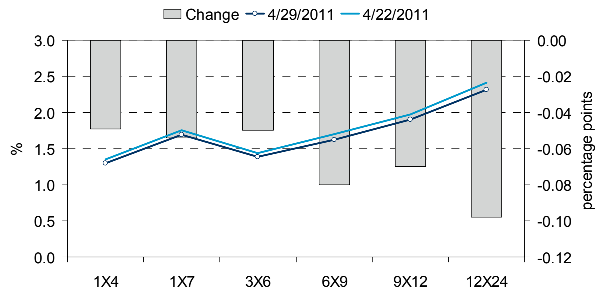
Widening of the rate differential between the ECB and the CNB rates might be risk for CZK

This spread widening is a challenge for the Czech koruna in particular, which, notwithstanding the divergent policy stance of ECB and CNB, continues to appreciate moderately. However, risks increase that the widening rate differential at some point will trigger a correction of the koruna. This may subsequently ease the Czech monetary conditions, obliging the CNB to react by raising rates to offset the monetary easing caused by a weaker koruna. So, we bet that in August, the CN>B will start its tightening cycle.

CNB and ECB base rates
(eop, %)



CZ FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.17	-0.99%	↗	↗
EUR/PLN	3.929	-0.83%	↗	↗
EUR/HUF	264.2	0.24%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.92	-0.15	↗	↗
10Y PLN	6.11	-0.04	↗	↗
10Y HUF	6.85	0.02	↗	↗

Review of Economic Figures

Inflation expectations in Poland fall

Poland has been evidently confronted with the problems of numerous and particularly emerging global economies in recent months. The rising commodity prices (of oil and notably food raw materials) are driving inflation upwards, while demand-pull pressures remain largely subdued.

March's data illustrate this trend. The consumer price index was 4.3% y/y and the producer price index also went up faster than expected (9.3% y/y, as opposed to the anticipated 8.3%). On the other hand, the real economy indicators fall short of expectations. Wage growth decelerated to 4.1% y/y while the unemployment rate reached the expected 13.1%. Industrial output, in spite of the reasonable performance of construction, lagged behind the market forecast by 1.6%. The only figures that surprised markets positively were retail sales. Nevertheless, looking into the structure, it is evident that fuel prices, which have increased by almost 20% y/y, had a strong hand in the outcome. .

The negative trend also affected March inflation expectations, the increase of which was, according to the minutes of the Monetary Policy Council (MPC) meeting, the main reason for April's rate hike. While April's figure, released on Friday, unveiled a significant decrease in inflation expectations, the figure at 4% still remains well above the central bank target (2.5%).

The Zloty does not prevent high April inflation

Unfortunately for Poland's central bankers, the exchange rate of the zloty is not very helpful in fighting the inflation rise. Governor Belka, whose position among the central bankers is influential, as shown by the available results of votes on monetary policy settings, said in last week's interview that the zloty had become the subject of speculator interest and that it had consequently become very difficult to influence the exchange rate. In addition, Belka significantly cooled market expectations that the central bank would react to the unfavourable developments by another rate hike as early as at its May meeting (May 11). Belka said that the MPC's decisions are not based solely on monthly data and that every supply shock only has a short-term effect. That said, the Ministry of Finance decided to come to the aid of the monetary policy; last week, it unveiled its plan to exchange part of the money from EU funding into zlotys during the current quarter. The reaction of the Polish currency was fairly clear; the EUR/PLN currency pair fell below 3.95 level EUR. Nevertheless, we believe that the potential for a further appreciation of the zloty has been largely curbed, due primarily to the uncertainty surrounding the revision of the balance of payments data, scheduled for June.

In addition, April's inflation might even rise to 4.5% y/y according to our forecasts, and thus the return to the inflation target is definitely not a matter of just a few months. **Therefore we expect two additional central bank rate hikes this year, with the first coming as early as June**.

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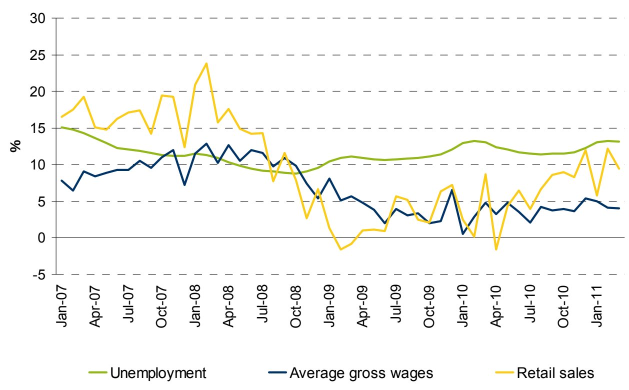
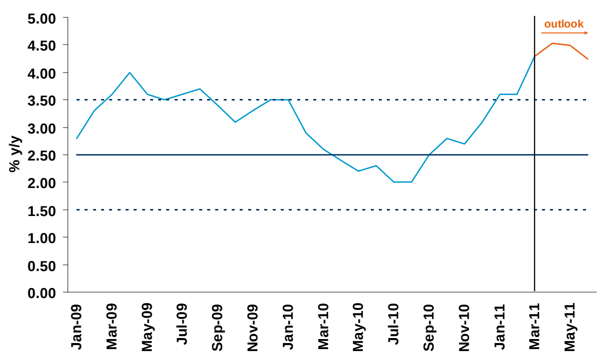
PL: Selected indicators



Inflation and inflation target



In Focus: Koruna helps CNB tighten monetary conditions

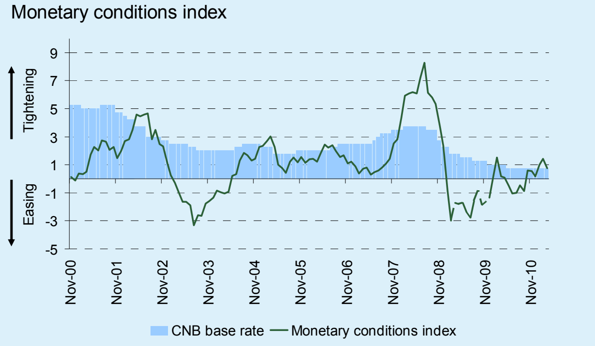
Strong Czech currency helps to offset rising inflation expectations and slowly tightens monetary conditions.

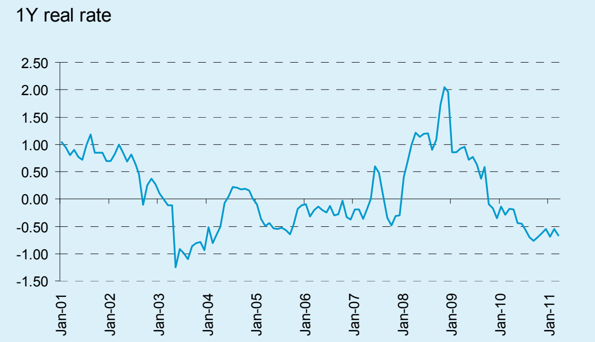
The Czech National Bank is running into an interesting situation. The countries around the Czech Republic have started to raise rates quite rapidly. In March, the ECB raised rates from all-time lows, while the National Bank of Poland has raised rates twice this year and is likely to carry on in that direction. The CNB, by contrast, has been able to afford to wait thus far, owing to poor domestic demand and the government's restrictive fiscal policy. As indicated by our analysis, monetary conditions have started to tighten themselves in recent months, notwithstanding the CNB policy, mainly because of the strengthening koruna.

The monetary conditions index (see the graph below) is a weighted average of the change in the real interest rate and the change in the real effective exchange rate and should reflect the actual effect of monetary policy on the economy more fairly than the simple view of CNB rates. This especially applies to small open economies such as that of the Czech Republic, where the influence of the currency exchange rate on growth and inflation is significant.

The developments in terms of the components of the monetary conditions index were mixed in recent months. On the one hand, inflation expectations have increased decently in the last few months, driving the real interest rate downwards. This alone may be a reason for concern in a recovering economy. On the other hand, the rapidly appreciating koruna, which has strengthened decently against the euro and particularly against the dollar in recent months, worked against the falling real rate. Owing to this, the monetary conditions have started to tighten themselves, notwithstanding the wait-and-see attitude of the CNB and the increase in inflation expectations.

The strong koruna is the key argument as to why there is no need to hasten the launch a rate hike cycle in the Czech Republic at the moment. Not only that the koruna is automatically tightening monetary conditions, it has also obviously outpaced the rate of the real convergence of the Czech economy, and its further appreciation might pose a risk to the ongoing recovery.





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: Despite hawkish ECB, the CNB stays on hold

The lack of demand-pull pressures, the relatively strong koruna, and inflation below the CNB target will make the majority of the CNB Board members decide to leave the repo rate at an all-time low. Drawing attention this time may be not only the outcome of the CNB Board's vote (we believe that it may be 5:2, with the latter group voting for a rate hike) but also a new forecast. The forecast may be of interest if the CNB increases the implied trajectory for short-term market rates, i.e., the 3M Pribor.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	4.5.2011	09:00	Trade balance (EUR M)	02/2011 *F					816.4	
HU	5.5.2011	12:00	GB bond auction/fixed rate (HUF B)	05/2011						
CZ	**5.5.2011**	**12:30**	**CNB meeting (%)**	**05/2011**	**0.75**		**0.75**		**0.75**	
CZ	6.5.2011	09:00	Retail sales (%)	03/2011						6.5
HU	6.5.2011	09:00	Industrial output (%)	03/2011 *P					0.9	14.3
HU	6.5.2011	17:00	Budget balance (HUF B)	04/2011					-742.1	

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:

Currently below neckline of Double Top (24.1800: see graph), with 2nd target off 24.3160 (neckline short term Double Top: see graph) at 24.0420 having been approached.
Support at 24.0450/ .0420 (current reaction low off 24.5900?/ see above), ahead of 24.0000 (weekly modified Alpha Beta trend bottom), where pause favored.
If unable to hold, next level at 23.9200 (year low).
In case of move to new medium term lows, next levels at 23.7700/ .7610 (1st target off 24.1800/ 1st Irregular B off 24.5900) and 23.7300 (1st target of long term daily Double Top off 25.0150): tough on 1st attempts.

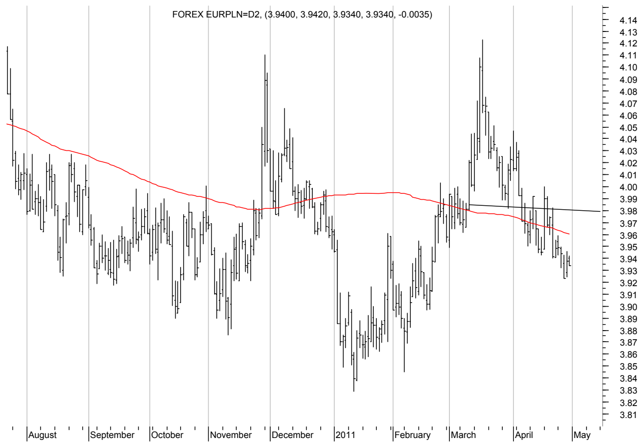
Resistance at 24.1800 (see graph), ahead of 24.2500/ .2660 (April 20 high/ weekly Short Term Moving Average↓): ideal area to stay below to keep current better tone on CZK.
Failure to cap, would see risk towards 24.3110/ .3400 (weekly Medium Term Moving Average→/ breakdown daily), where pause favored.

EUR/HUF Daily Chart:

Drop from 268.85 (April 18 high) sent the pair back towards new year low (263.01).
Support at 263.01 (see above), ahead of 262.27 (weekly modified Alpha Beta trend bottom), where pause favored.
If unable to hold, next levels at 261.63 (1st Irregular B off 268.85), ahead of 260.93/ .77 (2010 low/ 2nd Irregular B): tough on 1st attempts.

Resistance at 265.70 (April 25 high), ahead of 266.60 (breakdown daily): ideal area to stay below to keep current positive tone on HUF.
If unable to cap, next levels at 267.83 (weekly Medium Term Moving Average↓), ahead of 268.85 (see above): sustained trade above would indicate end of current love affair with HUF.

EUR/PLN Daily Chart:

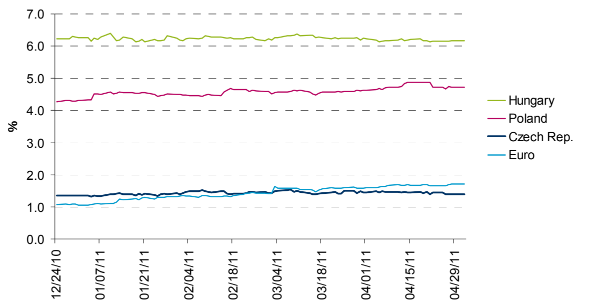


Below 3.9820 (neckline short term Double Top: see graph), with Feb 18 break-up area 3.9240 having been retested.
Support at 3.9230 (current reaction low off 4.1225?), with next levels at 3.9176 (1st target off 3.9820) and 3.9050 (weekly modified Alpha Beta trend bottom).
3.8982/ .8970 = 76.4% 3.8290 to 4.1225/ Feb 17 low: tough on 1st attempts.

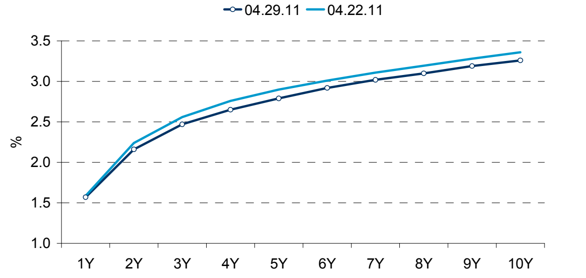
Resistance at 3.9590 (April 24 high), ahead of 3.9682 (broken weekly Medium Term Moving Average→): Zloty on better footing while below this area.
If unable to cap, next levels 3.9780/ .9820 (breakdown hourly/ see above).
4.0002 = April 18 high: tough on 1st attempts.

CE Fixed-income in Charts

FRA 3x6

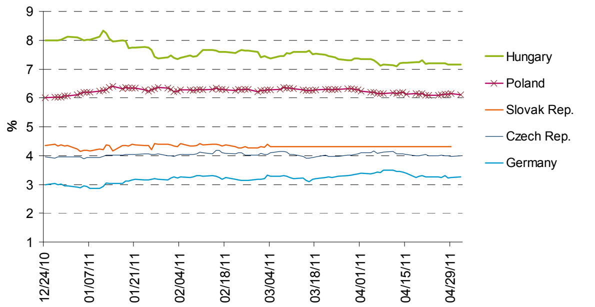


CZ IRS

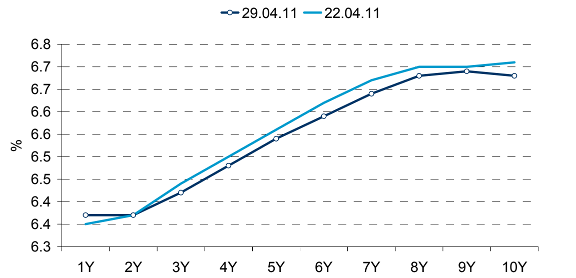


Source: Reuters

10Y GB Yields

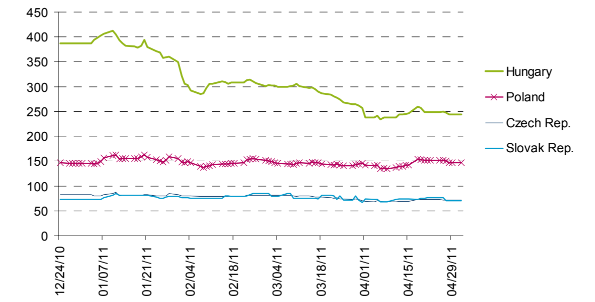


HU IRS

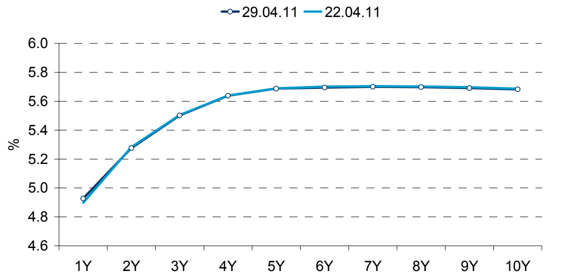


Source: Reuters

CDS 5Y



PL IRS



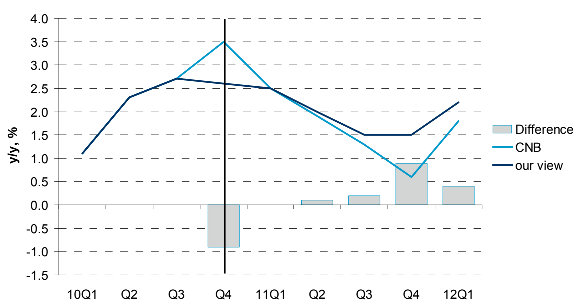
Source: Reuters

Medium-term Views & Issues

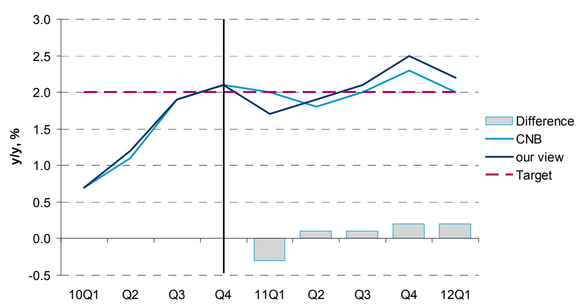
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage 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.	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 neutral impact. However, one should bear in mind that there is risk of revisions of previous figures due to 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 even 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.	The forint recovered to between 264 and 265 after its correction to 268/€ ended. After the Szell Kalman Plan and the Convergence Program were priced in, investors moved to the sideline and wait to see the implementation of these programs. Monthly deficit figures point for a higher-than-targeted budget deficit for the year, but we need more time to judge whether the announced Ft250bn spending freeze will be enough to compensate the shortfall.	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. Further more 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

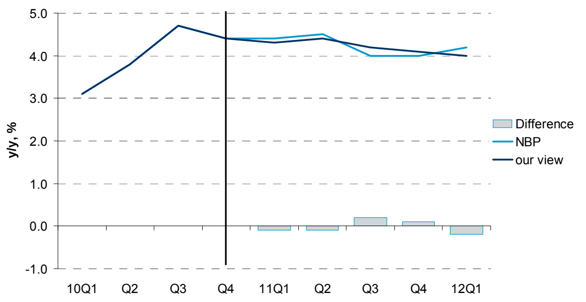
CZ: GDP Outlook



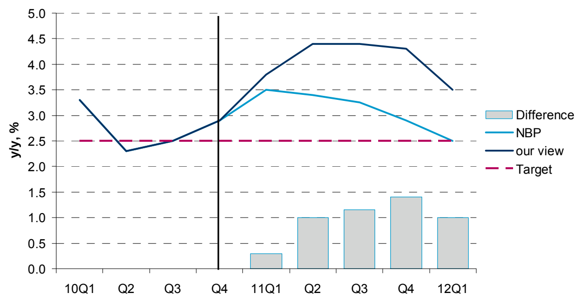
CZ: Inflation outlook



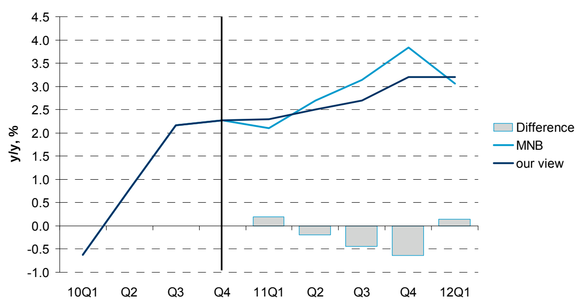
PL: GDP Outlook



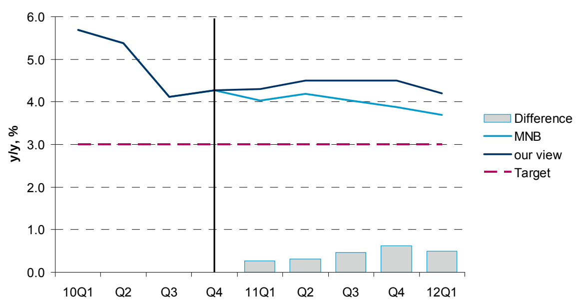
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	VI.11	IX.11	XII.11	III.12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.25	1.25	-25 bps	6.5.2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.25	6.25	25 bps	24.1.2011
Poland	2W inter. rate	*4.00*	4.25	4.25	4.50	4.75	25 bps	6.4.2011

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

		Current	VI.11	IX.11	XII.11	III.12
Czech Rep.	PRIBOR	*1.20*	1.35	1.45	1.60	1.72
Hungary	BUBOR	*6.10*	6.00	6.00	6.25	6.25
Poland	WIBOR	*4.3*	4.35	4.50	4.55	4.55

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

	Current	VI.11	IX.11	XII.11	III.12
Czech Rep.	*3.23*	3.40	3.50	3.60	3.70
Hungary	*6.74*	7.50	7.25	7.00	7.00
Poland	*5.6877*	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	VI.11	IX.11	XII.11	III.12
Czech Rep.	EUR/CZK	*24.2*	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*264*	280	275	270	270
Poland	EUR/PLN	*3.93*	3.90	3.60	3.70	3.60

GDP (y/y)

	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012
Czech Rep.	2.2	1.9	1.3	1.7	2.5
Hungary	2.3	2.5	2.7	3.2	3.2
Poland	4.3	4.4	4.6	4.2	4.0

Inflation (CPI y/y, end of the period)

	VI.11	IX.11	XII.11	III.12	VI.12
Czech Rep.	2.0	2.1	2.2	2.2	2.2
Hungary	4.5	4.5	4.5	4.2	4.0
Poland	4.3	4.5	4.2	3.4	3.5

Current Account as % of GDP

	2010	2011
Czech Rep.	-3.8	-3.6
Hungary	0.5	1.0
Poland	-2.1	-2.9

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

	2010	2011
Czech Rep.	-4.7	-4.3
Hungary	-3.8	-2.9
Poland	7.1	-7.9

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