Monday, May 16, 2011

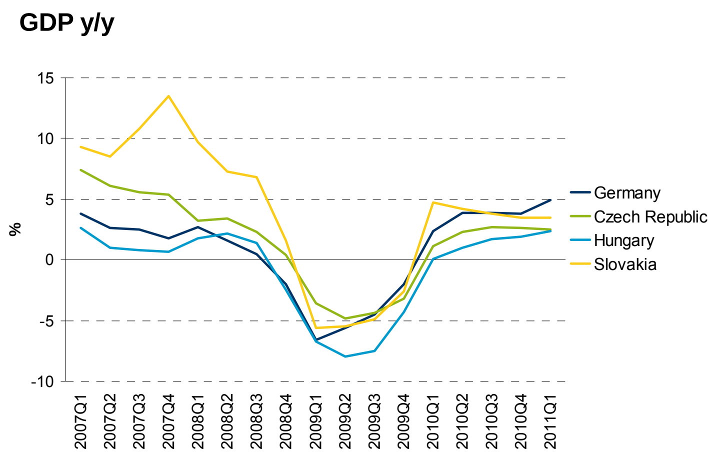
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Growth accelerates in the Czech Republic and Hungary
- Headline inflation stays significantly above the target in Poland and Hungary,
- In Focus: NBP raises rates for the third time this year
- Polish eco figures could bring some noise

Chart of the Week: GDP growth strengthened in first quarter of 2011



Growth in the CE region accelerated in Q1 but still can not catch the spurting German economy.

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Market’s Editorial

NBP surprises almost everyone

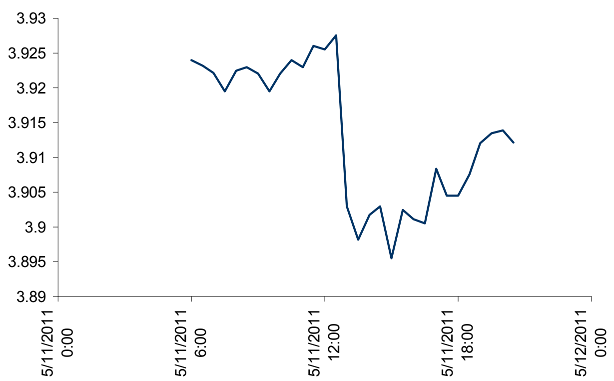
Last week, Central European markets were replete with macroeconomic events, clearly dominated by the meeting of the National Bank of Poland. The NBP, as if it was inspired by the ECB, clearly showed the markets that it is a central bank that can bring surprises. Given the moderate rhetoric coming from NBP Governor Belka, few had anticipated a 25 bps hike in the base rate, albeit high inflation had evidently prompted the Polish central bank to take action.

With the latest rate hike by the NBP not being this year’s first, the bank, in a way, has acted in line with our recently presented (and econometrically verified) finding, that the NBP shows the strongest tendency, out of the Central European banks, to follow on the heels of ECB policy. By contrast, the National Bank of Hungary and the Czech National Bank were not and are not, for very different reasons, willing to follow the ECB policy. For the National Bank of Hungary, the stability of the exchange rate and the level of the risk premium on government debt enter into its reaction function. The Czech National Bank is facing a completely different macroeconomic situation, because Czech inflation remains quite well below the target.

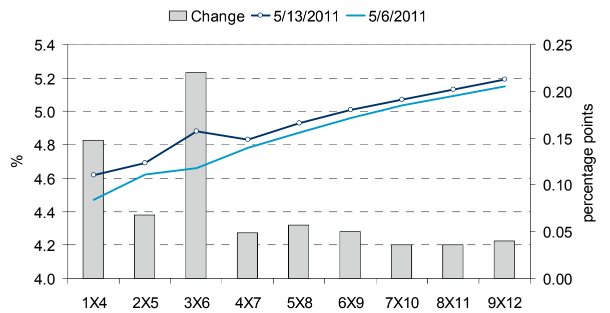
Central banks’ divergence in Central Europe

Even so, if the ECB continues to tighten its monetary policy rapidly, which seems to be more than likely after strong growth for the first quarter of the year in Germany and France, the divergence of the policies of the Central European central banks may at some point come to an end. Perhaps only the zloty, encouraged by both the policy of the NBP and the sales of euros acquired from EU transfers, will be able to face the hikes in the euro-zone. The koruna and the forint, by contrast, may gradually come under pressure, which may lead to the conclusion in both the Czech Republic and Hungary that some monetary tightening is inevitable (albeit the CNB and the NBH are somewhat reluctant to concede that anything like that will happen soon).

EUR/PLN



PL FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.41	0.99%	→	↘
EUR/PLN	3.917	-0.26%	→	↘
EUR/HUF	267.7	1.41%	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.75	-0.08	↗	↗
10Y PLN	6.07	0.03	→	→
10Y HUF	6.96	0.06	↗	→

Review of Economic Figures

Inflation in Central Europe…

The Czech consumer price index continued to rise at a moderate rate in April. In line with expectations, the CPI was up by 0.3% m/m, due in particular to the increase in food, clothing and fuel prices. Year-on-year inflation fell from 1.7% to 1.6% and lagging behind the CNB's latest forecast by 0.1%. Inflation remains below the CNB's 2% target as well as below the eurozone average, even at a time of record-breaking fuel prices and rising food prices, owing to the strengthening koruna and poor domestic demand. Demand-pull inflation is basically absent, and thus the CNB doesn't need to hasten to raise its rates even in the light of the latest data. Hence we still believe that the CNB will not raise rates until it discusses this year's third inflation forecast in early August. The reasons for the slower progress include a favourable inflation forecast as well as well-established inflation expectations on the market.

Poland's inflation sped up by 0.2% y/y to 4.5% y/y in April. As usual in recent months, commodities have also been primarily responsible for the price rise. The food and transport sub-indexes went up by more than 7.5% y/y. The developments in the months to come should be more favourable for the central bank. According to our forecasts, inflation hit one of its two peaks of this year in April. It may again return to the vicinity of its current values in August.

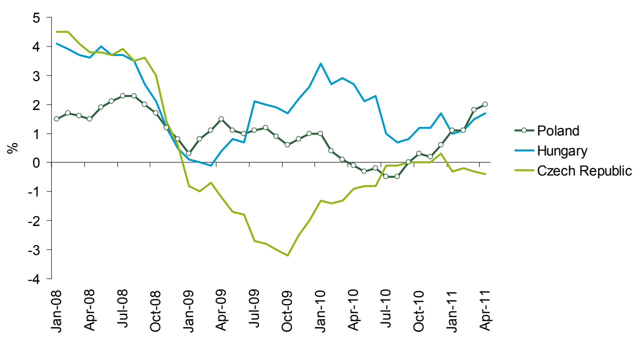
Hungary's inflation figure was in line with expectations at 4.7% y/y, up from 4.5% Y/Y in March. Core inflation also rose slightly to 2.7% Y/Y from 2.5% Y/Y. Food prices drove the index higher and the duration of the food price shocks seems to be the major question behind the development of inflation. Inflation of services and tradable goods however remained low, thus demand side inflationary pressures look to be low in the economy. Our forecast is that inflation will start to ease from next month and will gradually lower to below 4% by the end of the year. The central bank has a more optimistic forecast as its 4.0% projection for the average inflation implies around 3.5% Y/Y reading for December. Given that the underlying inflation is low, we do not expect the central bank to change its neutral stance.

Growth accelerates in Czech R. and Hungary

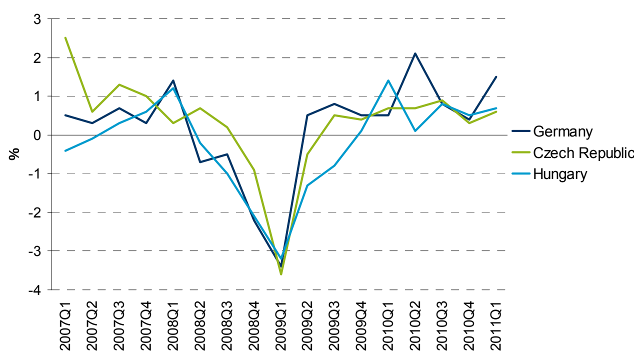
The **Czech economy** grew by 0.6% q/q and 2.5% y/y at the beginning of the year. Thus, compared to the developments in late 2010, the economy sped up slightly (from 0.3%), but the year-on-year rate only changed negligibly. The economic growth is primarily driven by the manufacturing industry, notably carmakers. The positive trends are also clear in other strong industries, such as steel production, engineering, and the electrical industry. By contrast, construction, services and agriculture are falling. On the demand side, the economy is being driven by foreign trade, while consumption is surprisingly lagging behind. The latest data sprang no surprise and thus our view of this year's further development of the economy remains unchanged.

Hungary's growth rate accelerated to 2.4% Y/Y from 1.9% Y/Y in the first quarter of 2011 on a strong export performance. The quarterly growth rate was 0.7%, underpinning our 2.7% growth forecast for 2011, which is close to the government's projection for 3.0% growth. This is goods news as there were fears that special taxes on some sectors will hurt the growth rate this year. So far the impact seems to have been moderate. The foreign trade balance was particularly strong in the first quarter, therefore export could have likely driven growth.

Inflation - divergence from the target



GDP q/q



In Focus: NBP raises rates for the third time this year

NBP increases its reference rate by 25 bps to 4.25%. The main reason was the fear of inflation persisting above target in the medium term. We still believe in just one more 25 bps rate hike this year.

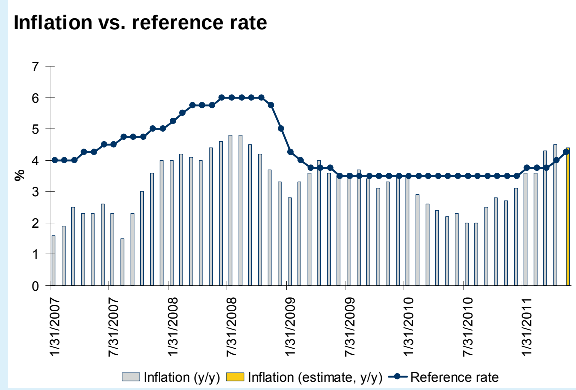
The National Bank of Poland greatly surprised markets as well as us. The outcome of the two-day meeting of the Monetary Policy Council (MPC) was a decision to raise rates by 25 bps. This was the third round of monetary tightening this year, with the base interest rate currently standing at 4.25%. However, it is unlikely that even this latest move by the NBP has put an end to this year's rate hike cycle in Poland.

According to the press release published by the NBP, the reason for the rate hike is the effort to suppress the risk of inflation persisting above the central bank target (2.5%) even in the medium-term horizon. That said, the MPC is afraid that the risk may materialize due to the continuing recovery in the labour market. In addition, the recent significant increase in inflation expectations by Polish households has also boosted the risk.

NBP President Belka told at the press conference that the MPC's decision was not unanimous, but added that there was consensus amongst the MPC members as to the total scale of monetary tightening cycle. Belka also said that the only dissonance had occurred with respect to the timing of the individual steps and that today's decision had only sped up the entire process. The NBP head expressed hope that the rate hike might lead to an appreciation of the zloty, which has not significantly helped the central bank in fighting inflation thus far.

The initial market reaction to the decision was aggressive, though logical. The EUR/PLN currency pair immediately strengthened to less than PLN 3.90 per EUR and FRA rates soared. The spread between the FRA 1x4 rates and the three-month WIBOR is currently 17 basis points, i.e., the market is largely betting on another rate hike as early as in June. Markets anticipate the end-of-year rates to be approximately 60 bps higher than at present.

Nonetheless, we consider the above expectations to be overly aggressive. Our scenario only envisages a single rate hike by the end of the year, likely at the beginning of the next quarter. One reason is that we rely on the strengthening zloty to continue to tighten monetary conditions; another reason is that (year-on-year) inflation is currently peaking, according to our forecasts. Hence Poland's Monetary Policy Council may calm down somewhat – particularly in the second half of this year.



Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	16.5.2011	09:00	PPI (%)	04/2011	0.7	6.2	0.5	6.2	1.0	6.3
CZ	16.5.2011	10:00	Current account (CZK B)	03/2011	-13.5		-8.5		15.95	
HU	**16.5.2011**	**14:00**	**NBH meeting (%)**	**05/2011**			**6.00**		**6.00**	
PL	16.5.2011	14:00	Current account (EUR M)	03/2011			-1 234		-685	
PL	16.5.2011	14:00	Trade balance (EUR M)	03/2011			-475		-163	
PL	16.5.2011	15:00	Budget balance (PLN M)	04/2011					-17 321	
HU	18.5.2011	09:00	Wages (%, ytd.)	03/2011						4.8
PL	18.5.2011	14:00	Wages (%)	04/2011			-2.0	4.8	6.2	4.0
HU	19.5.2011	12:00	GB bond auction/fixed rate (HUF B)	05/2011 *A						
PL	20.5.2011	14:00	Core CPI (%)	04/2011			0.3	2.1	0.5	2.0
PL	**20.5.2011**	**14:00**	**Industrial output (%)**	**04/2011**			**-9.1**	**6.8**	**15.3**	**7.0**
PL	20.5.2011	14:00	PPI (%)	04/2011			0.6	8.6	1.4	9.3

m/m - monthly change; y/y - yearly change; s.a. - seasonally adjusted; n.s.a. - non-seasonally adjusted; P - preliminary; F - final
EMU, USA, UK, JPY - figures seasonally adjusted, if not stated otherwise; Central Europe - figures seasonally non-adjusted, if not stated otherwise
Government Bond Auction: period = auction settlement date; m/m = total bids; y/y = supply

CE Forex Technicals

EUR/CZK Daily Chart:

Currently above Downtrendline off 25.3800 (see graph).
Support at 24.2080 (broken weekly Short Term Moving Average↓), ahead of 24.1240 (weekly modified Alpha Beta trend bottom) and 24.0700 (May 06 low + weekly Bollinger bottom), where pause favored.
If unable to hold, next level at 24.0450 (April 27 low), ahead of 23.9610 (monthly modified Alpha Beta trend bottom) and 23.9200 (year low).
In case of move to new medium term lows, next levels at 23.8180 (monthly envelope bottom), ahead of 23.7610 (1st Irregular B off 24.5900) and 23.7300 (1st target of long term daily Double Top off 25.0150): tough on 1st attempts.

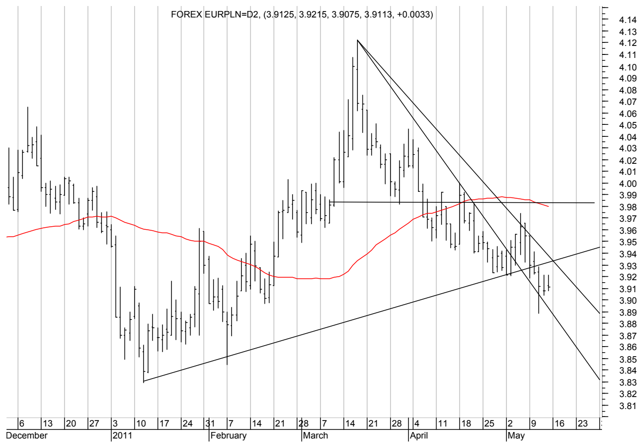
Resistance at 24.3820 (61.8% 24.5900 to 24.0450).
Failure to cap, would see risk towards 24.4180 (monthly envelope top), ahead of 24.4650 (April 07 high).
24.5700/ .5900 = weekly modified Alpha Beta trend top/ recovery high off current year low: tough on 1st attempts.

EUR/HUF Daily Chart:

Drop from 268.85 (April 18 high) sent the pair back towards year low (263.01).
Support at 263.53/ 263.01 (weekly modified Alpha Beta trend bottom/ year low), 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) and 260.29 (monthly Bollinger bottom): tough on 1st attempts.

Resistance at 267.51 (weekly Medium Term Moving Average↓), ahead of 268.85 (April 18 high), where pause favored.
If unable to cap, next levels at 269.80 (38.2% 280.80 to 263.01), ahead of 270.78/ 271.50 (weekly modified Alpha Beta trend top/ breakdown weekly): tough on 1st attempts.

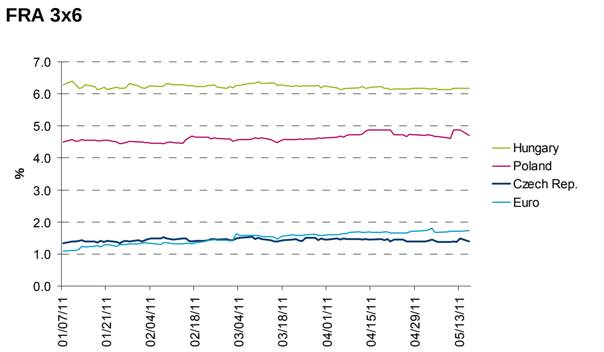
EUR/PLN Daily Chart:

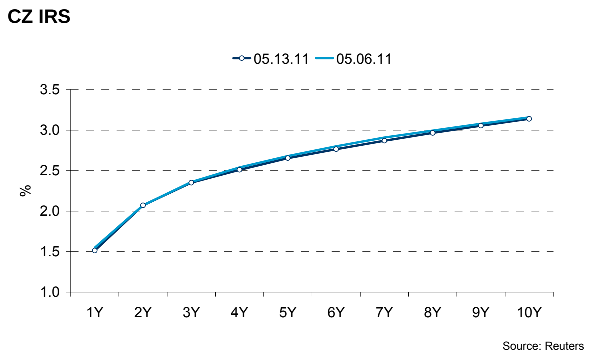


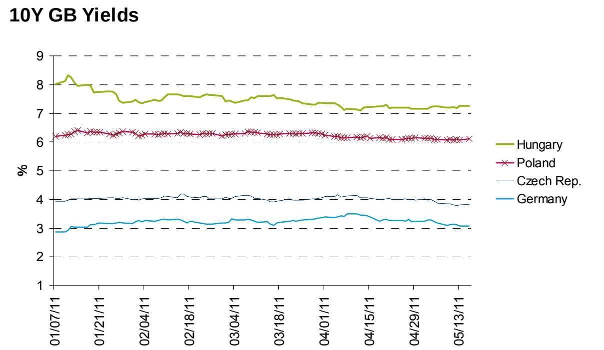
Has met 1st target off 3.9820 (neckline short term Double Top) and currently below Uptrendline off year low (see graph).
Support at 3.8963/ .8888 (weekly modified Alpha Beta trend bottom/ current reaction low off year high), ahead of 3.8736 (monthly envelope bottom), where pause favored.
If unable to hold, risk would extend towards 3.8450/ .8415 (Feb 07 low/ 2nd target off 3.9820 + weekly Bollinger bottom): tough on 1st attempts.

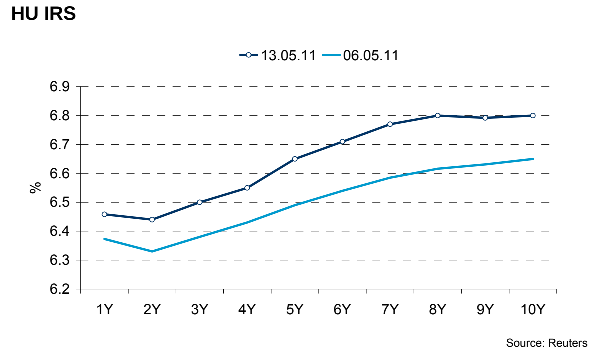
Resistance at 3.9313 (weekly Short Term Moving Average↓), ahead of 3.9550 (May 09 high + broken weekly Long Term Moving Average→): Zloty on better footing while below this area.
If unable to cap, next level 3.9727/ .9740 (broken weekly Medium Term Moving Average→/ May 05 high): tough on 1st attempts.

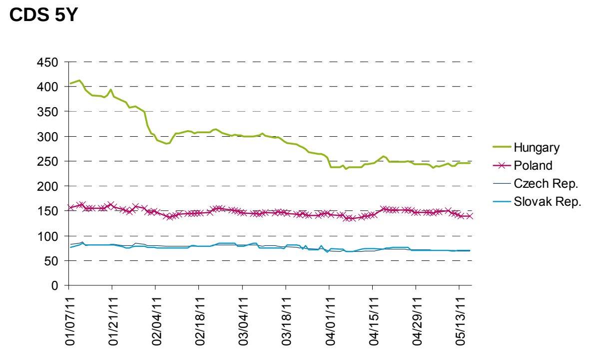
CE Fixed-income in Charts

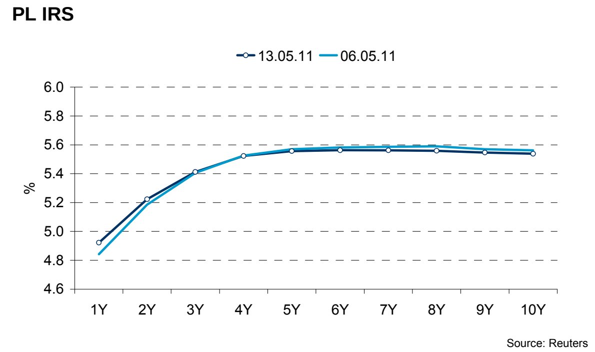










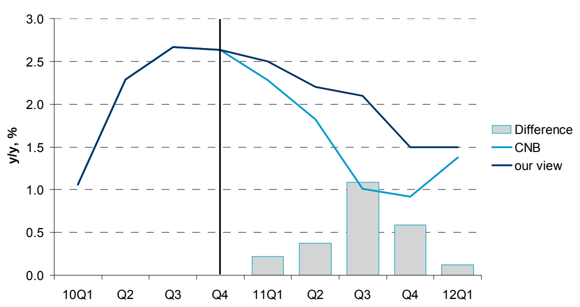


Medium-term Views & Issues

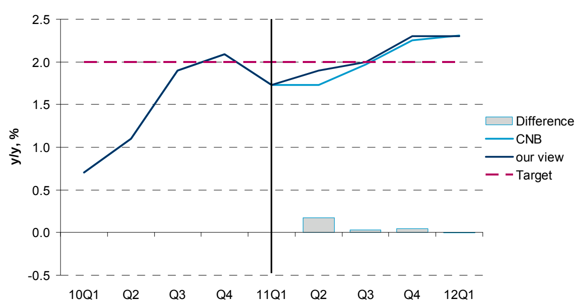
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage 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 on an ambitious fiscal consolidation program (Szell Kalman Plan) that sees 3% of GDP deficit reduction measures by 2013. The Convergence Program detailed this further and most importantly targeted the 2012 budget deficit below 3% of GDP without one-off revenues. This is an important step as previous plans saw some 1% of GDP revenues from the asset sale of second pillar pension funds, which were cancelled. Accelerating growth and fiscal policy constitute a positive outlook for Hungary.	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 declined below the central bank's target in spite of 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.	Inflation rose to well above the central bank's 3% target on higher food and fuel prices, but underlying inflation trend remained favourable. Demand side inflationary pressures are low in the economy and hence the central bank expects inflation to return to the target level by end-2012. We generally agree with this view, while acceleration of the economy may challenge this if domestic demand also revives. Currently it is depressed by the strong Swiss franc rate that costs much to foreign currency debtors.	Fears of inflation remaining above the target in medium term led to the further round of monetary tightening in Poland. The National Bank of Poland surprisingly increased the reference rate by 25 bps to 4.25%. 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 during Q3/2011 whereas the second one 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 has outperformed peers in 2011 Spring as fiscal consolidation plans allowed the government to refinance its large, €4bn redemption of bonds and loans, including the first tranche of the IMF loan. Should investors' confidence strengthen in the government policies, inflows into the bond market may appreciate the currency further. At levels stronger than the key 260/€ level, we believe the issue of rate cuts could come to the fore.	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

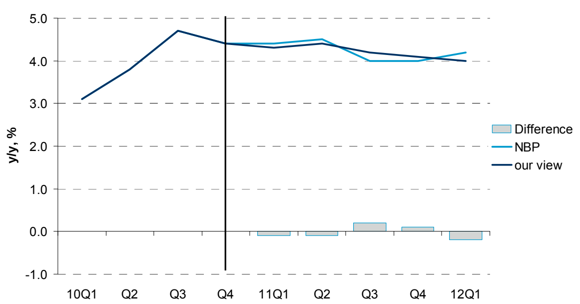
CZ: GDP Outlook



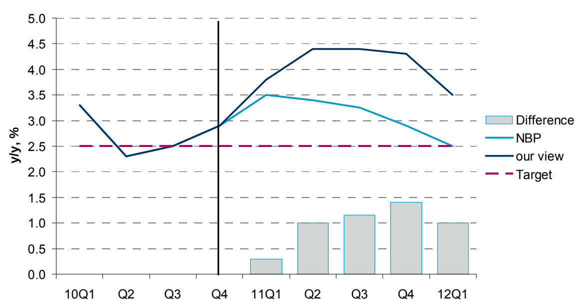
CZ: Inflation outlook



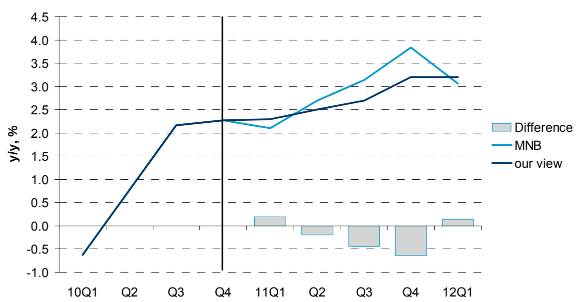
PL: GDP Outlook



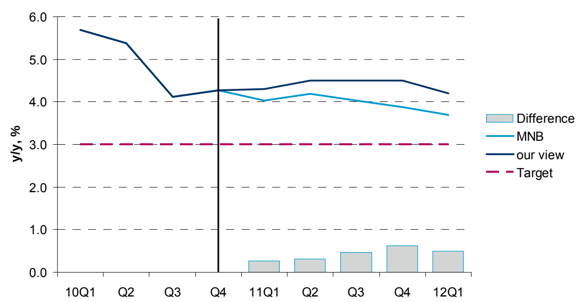
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.25	1.25	1.50	-25 bps	5/6/2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.25	6.25	6.25	25 bps	1/24/2011
Poland	2W inter. rate	*4.00*	4.25	4.25	4.50	4.75	4.75	25 bps	5/11/2011

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

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	PRIBOR	*1.23*	1.35	1.45	1.60	1.65	1.90
Hungary	BUBOR	*6.10*	6.00	6.00	6.25	6.25	6.30
Poland	WIBOR	*4.44*	4.30	4.45	4.60	4.65	4.70

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

	Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	*3.1309*	3.40	3.50	3.60	3.70	3.85
Hungary	*6.72*	7.50	7.25	7.00	7.00	6.90
Poland	*5.5368*	5.95	6.00	6.10	6.15	6.20

Exchange rates (end of the period)

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	EUR/CZK	*24.4*	24.2	24.6	24.4	24.0	25.5
Hungary	EUR/HUF	*268*	280	275	270	270	270
Poland	EUR/PLN	*3.93*	3.90	4.00	3.70	3.70	3.60

GDP (y/y)

	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012
Czech Rep.	2.2	2.1	1.5	1.5	2.5	3.0
Hungary	2.5	2.7	3.2	3.2	3.2	3.2
Poland	*4.4*	4.6	4.2	4.6	4.9	4.7

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

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Czech Rep.	2.1	2.1	2.2	2.2	2.3	2.0
Hungary	4.5	4.5	4.2	4.0	3.5	3.0
Poland	4.4	4.2	3.3	3.5	3.3	3.0

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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