Monday, May 23, 2011

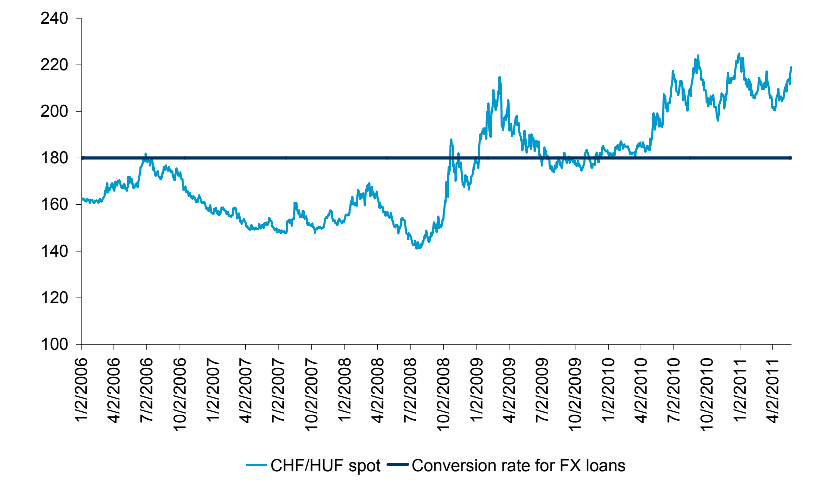
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Czech short rates continue to diverge from euro rates. We doubt it will last long.
- Is Poland exposed to the secondary effects of high inflation?
- Hungary reveals agreement on FX loans for households

Chart of the Week: Spot rate versus conversion rate for FX loans in Hungary



The conversion rate for household loans in Swiss franks significantly deviates from the current spot CHF/HUF rate.

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Market's Editorial

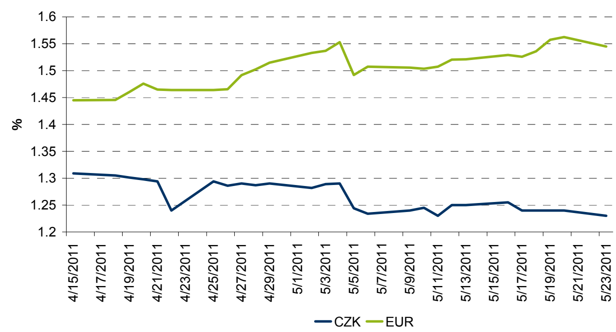
Differential between euro and CZK rates continues to widen

The divergence among market interest rates in Central Europe persists. While this is certainly not the first time that this phenomenon has occurred in the region, it is remarkable it is happening at a time when euro rates are rising, driven by the ECB monetary tightening.
While Hungarian interest rates have been stable since the meeting of the National Bank of Hungary, Czech rates have continued to fall in recent days, and thus the widening of the differential vis-à-vis their euro counterparts has accelerated. This has been taking place against the backdrop of the dovish tenor from the Czech National Bank, to which the domestic market recently attached surprisingly greater significance than to foreign developments. Nevertheless, as the interest rate differential is widening while the koruna is weakening we doubt whether such developments are sustainable. Let us remind that FRA rates indicate that the market has already shifted its expectations as to CNB rate hikes to the last quarter of this year. Although this is consistent with the central bank forecast, we believe that the CNB Board, due also to a weaker koruna will not wait for such a long time to raise rates. In other words, **we see the room for a further widening of the differential between euro and koruna rates to be increasingly limited**.

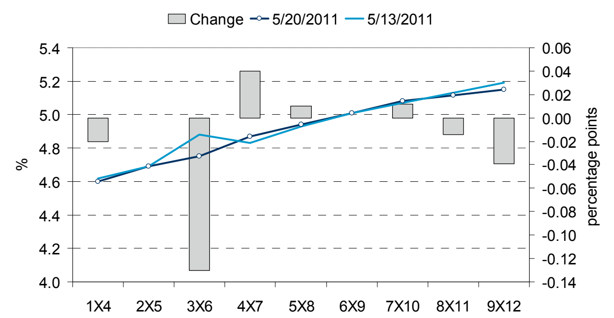
Polish rates track the trend of euro rates

Unlike Czech and Hungarian interest rates, Polish rates, just like the euro ones, are maintaining a rising trend. In the wake of increased inflation and the surprising rate hike at the last meeting, markets have boosted their bets on further monetary tightening. We consider today's market expectations to be more or less adequate – 50 bps by the end of the year; however, with the increasing prevalence of hawks on the Monetary Policy Council and persisting high inflation, we expect market rates to continue rising.

FRA 1x4: CZK vs EUR



PL FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.48	0.52%	↗	↗
EUR/PLN	3.918	-0.33%	→	→
EUR/HUF	268.1	0.02%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.80	0.05	→	↗
10Y PLN	6.00	0.00	→	↗
10Y HUF	6.86	-0.10	↗	↗

Review of Economic Figures

Is Poland exposed to the secondary effects of high inflation?

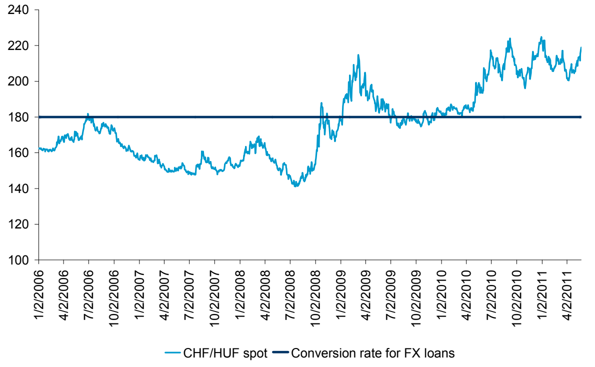
According to the newly released minutes of May's MPC meeting, the surprising rate hike the week before last was due to concerns about inflation persisting above the central bank target even in the medium term. According to most MPC members, high inflation, driven by commodities, may influence inflation expectations, and this, in combination with stable interest rates, may drive real interest rates into negative territory.
We believe that the labour market data released last week does not confirm such a concern at the moment. Gross average wages in the business sector were up by 5.9% y/y in April (5.8% after the subtraction of the effect of bonuses), and thus easily exceeded expectations; nonetheless, adjusted for the year-on-year price rise for the same month, as measured by the consumer price index (4.5%), real wage growth is approximately 1.3% y/y, which is a very moderate rate compared to the long-term average (see the graph). In addition, we believe that the freeze on the volume of funds for this year's wage payments in the public sector, along with the persisting, fairly high, unemployment rate, curbs any significant pressure on wages to rise further.
The figures from industry, released today, are mostly positive and confirm the decent recovery of the Polish economy, which grew by 4.4% in real terms in the first quarter of this year, according to our forecasts. Although April's rise in industrial output slightly lagged behind expectations, it hit 6.5% y/y, thus rising slightly faster than it did in 2000-2010 on average. Nevertheless, the rise in the producer price index also sprang a surprise on the upside; however, prices in the mining industry, which were up by 23% y/y, were again the primary contributor to the PPI.

Hungary reveals agreement on FX loans

Banks and the Hungarian government are close to an agreement about foreign currency based mortgage loans. The key elements of the agreement will likely be:
-temporary fixing of the exchange rate at CHFHUF 180 on mortgage loans (90% of the loans are denominated in CHF)
-the exchange rate loss above this will be set aside to a special account bearing BUBOR interest rate for 3-4 years,
-the accumulated loss will increase the outstanding loan after 3-4 years and will translate back into monthly installments, as well
-temporary fixing of the exchange rate could help debt service payments temporarily, which could boost domestic demand by 0.5-1.0% of GDP depending on how many borrowers switch to the fixing
-if unemployment drops and real wages increase by 2013, share of non-performing loans could decline from the expected peak of around 10% in 2011
-banks will have to finance the loss for 3-4 years at basically zero margin and they will be more exposed to exchange rate risk, especially of the EURCHF
-banks will be allowed to foreclose between 1% and 5% of the mortgage portfolio per quarter; this will allow them to clean up their balance sheet gradually
Overall, we think that agreement will be an insurance for the government against the risk of further Swiss franc appreciation and its negative impact on domestic demand. Banks will be allowed to start to foreclosed bad loans. This will slow down the country's repayment of fx-debt, but could lead to faster growth in the next 2-3 years. Neutral overall in our view.

This year's development of selected indicators vs. long term average

Spot rate versus conversion rate for FX loans in Hungary



Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	24.5.2011	09:00	Retail sales (%)	03/2011				0.2		0.2
PL	**25.5.2011**	**10:00**	**Retail sales (%)**	**04/2011**			**0.0**	**14.5**	**18.8**	**9.4**
PL	25.5.2011	10:00	Unemployment rate (%)	04/2011			12.6		13.1	
CZ	25.5.2011	12:00	CZ Bond auction floating rate/2016 (CZK B)	05/2011			7			
HU	26.5.2011	12:00	GB bond auction/floating rate (HUF B)	05/2011						

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 and reapproached 24.5900 (see graph: neckline Double Bottom).
Support at 24.3420 (break-up daily + broken weekly Medium Term Moving Average→), ahead of 24.2230 (weekly modified Alpha Beta trend bottom) and 24.1450 (break-up hourly + weekly Bollinger bottom), where pause favored.
If unable to hold, next level at 24.0700/ 0450 (May 06 low/ 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 24.5200 (current recovery high off 24.0450 + weekly Long Term Moving Average→), ahead of 24.5900 (recovery high off current year low + see above) and 26.6290 (weekly modified Alpha Beta trend top): tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound off May 11 low retested 268.85 (April 18 high) and channel top off 285.00 (see graph).
Support at 265.75/ .50 (break-up daily/ weekly modified Alpha Beta trend bottom), ahead of 263.10/ 263.01 (May 11 low/ year low), where pause favored.
If unable to hold, next levels at 261.37 (1st Irregular B off 269.95), ahead of 260.93 (2010 low) and 260.35/ .29 (2nd Irregular B/ monthly Bollinger bottom): tough on 1st attempts.

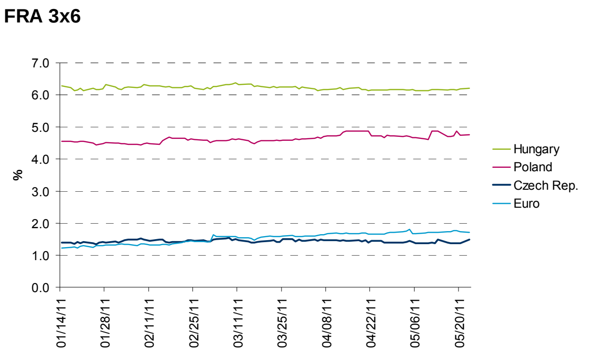
Resistance at 267.85 (breakdown hourly), ahead of 269.95 (current new recovery high off year low + weekly modified Alpha Beta trend top), where pause favored.
If unable to cap, next levels at 271.65/ .90 (breakdown weekly/ 50% 280.80 to 263.01): tough on 1st attempts.

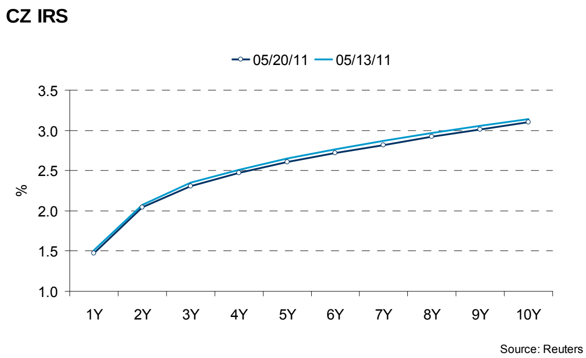
EUR/PLN Daily Chart:

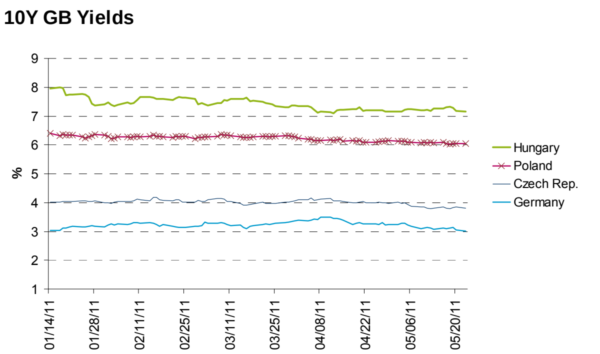
Has met 1st target off 3.9820 (neckline short term Double Top) and currently below Uptrendline off year low (see graph).
Support at 3.8888 (weekly modified Alpha Beta trend bottom + current reaction low off year high), ahead of 3.8736 (monthly envelope bottom), where pause favored.
If unable to hold, risk would extend towards 3.8468/ .8450 (weekly Bollinger bottom/ Feb 07 low) and 3.8415 (2nd target off 3.9820): tough on 1st attempts.

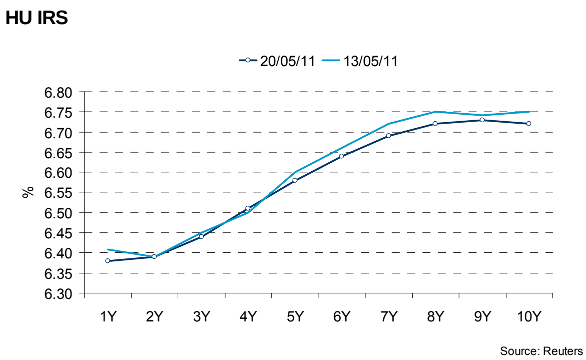
Resistance at 3.9482/ .9550 (weekly Bollinger midline/ May 09 high + broken weekly Long Term Moving Average→): Zloty on better footing while below this area.
If unable to cap, next level 3.9740 (May 05 high + broken weekly Medium Term Moving Average→): tough on 1st attempts.

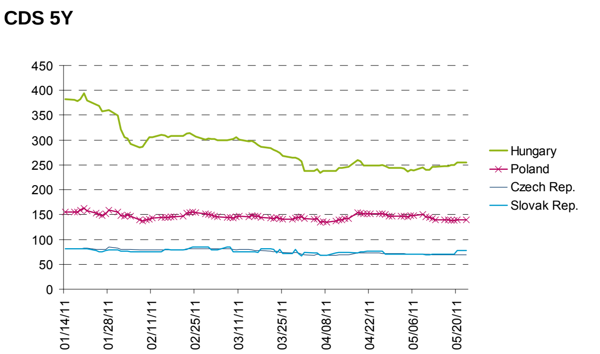
CE Fixed-income in Charts

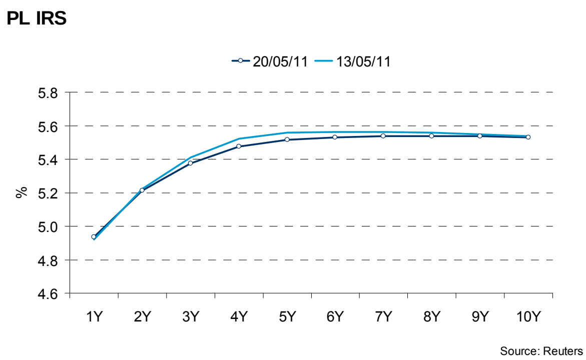








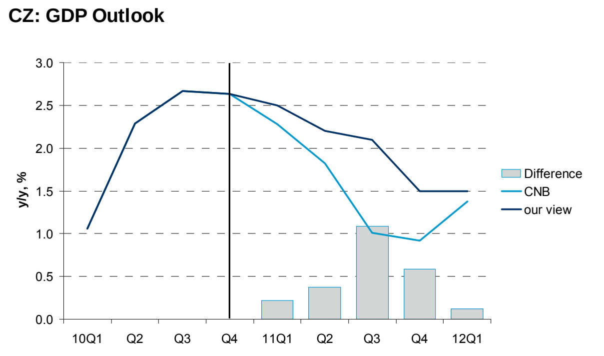


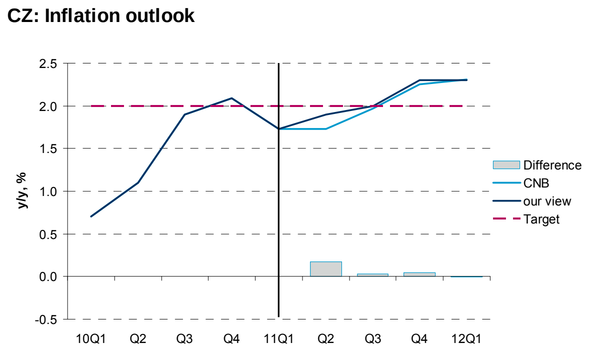


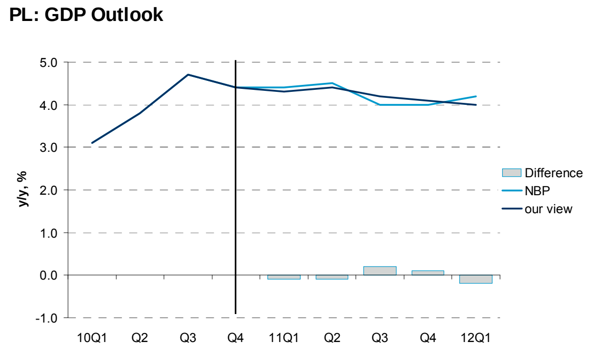
Medium-term Views & Issues

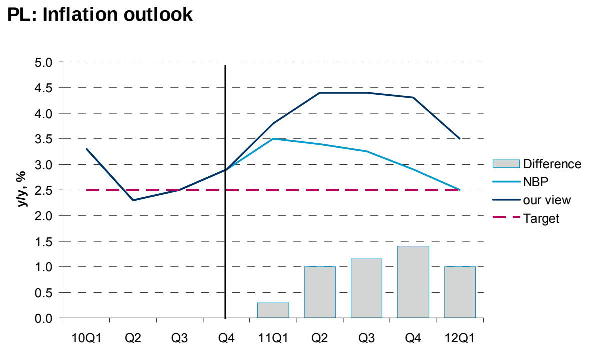
	The Czech Republic	Hungary	Poland
Growth & key issues	The situation in the governing coalition after some turmoil again stabilized. The government can continue to prepare the reforms needed to reduce the deficit of public finances. The general government deficit even felt to 4.7% of GDP in 2010. The government intends to cut the deficit below 3% by 2013. The fundamental precondition for hitting the budget targets is the launch of reforms, notably of the social security and pension system. Despite the positive outlook of the public budgets, the government still does not intend to set date for euro adoption in the country.	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 (though it may change after the new proposal).	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 gains from the beginning of the year were too aggressive and calls for certain correction. On the other hand probably not substantial as the Czech koruna may start to feel support from the approaching start of interest rate hiking cycle (August 2011).	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. Commodity correction and renewed fears about Greece caused the forint to dip. Overall, in a short run risks for the forint seem balanced. In a longer run, should investors' confidence strengthen in the government policies, inflows into the domestic bond market may appreciate the currency further.	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 despite higher than expected inflation we believe that market has already priced in our interest rate outlook. 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. On the other hand in case of more severe selling pressure the Ministry of finance can sell the euros from structural funds and NBP would probably consider more aggressive monetary policy.

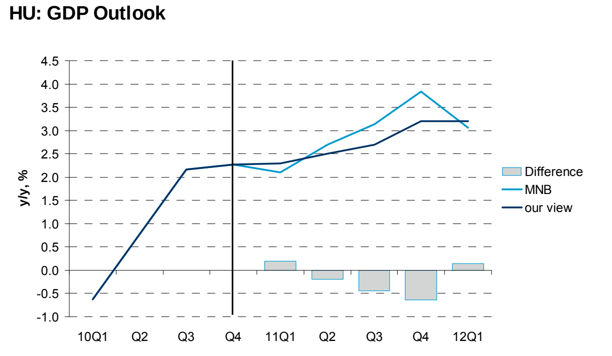
Central Bank's Projections versus Our Macro Forecasts

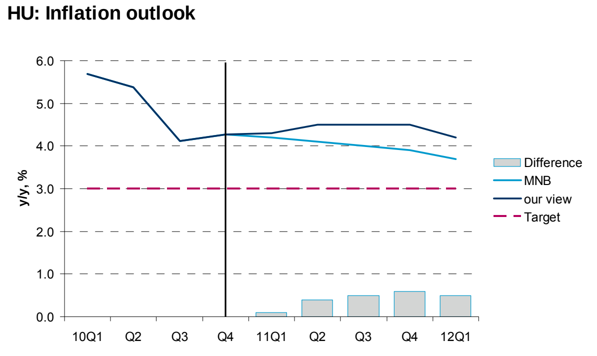












Summary of Our Forecast

Official interest rates (end of the period)

		Current	VI.11	IX.11	XII.11	III.12	VI.12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.25	1.25	1.50	-25 bps	6.5.2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.25	6.25	6.25	25 bps	24.1.2011
Poland	2W inter. rate	*4.25*	4.25	4.50	4.75	4.75	4.75	25 bps	11.5.2011

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

		Current	VI.11	IX.11	XII.11	III.12	VI.12
Czech Rep.	PRIBOR	*1.22*	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	*4.45*	4.45	5.00	5.10	5.15	5.15

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

	Current	VI.11	IX.11	XII.11	III.12	VI.12
Czech Rep.	*3.09*	3.40	3.50	3.60	3.70	3.85
Hungary	*6.78*	7.50	7.25	7.00	7.00	6.90
Poland	*5.5299*	5.95	6.00	6.10	6.15	6.20

Exchange rates (end of the period)

		Current	VI.11	IX.11	XII.11	III.12	VI.12
Czech Rep.	EUR/CZK	*24.6*	24.5	24.6	24.4	24.0	25.5
Hungary	EUR/HUF	*270*	280	275	270	267	265
Poland	EUR/PLN	*3.95*	4.00	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)

	IX.11	XII.11	III.12	VI.12	IX.12	XII.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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