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KBC Banking & Insurance

Central European Weekly

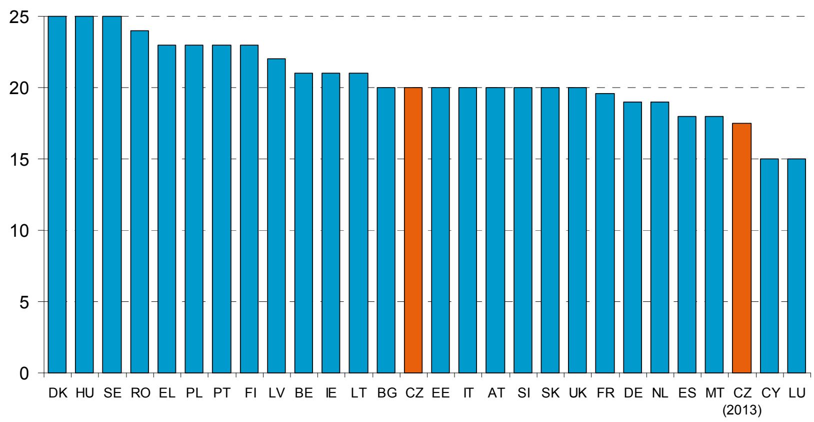
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Polish hawks are getting the majority. The NBP may front-load tightening
- In Focus. Revolution in the Czech VAT
- CE preview: Polish GDP expected to have grown strongly in Q1

Chart of the Week: VAT rates across Europe

VAT standard rates



The Czech Rep. might unify the VAT for all goods and services at lower range of the EU spectrum.

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Market's Editorial

Polish Hawks are getting the majority

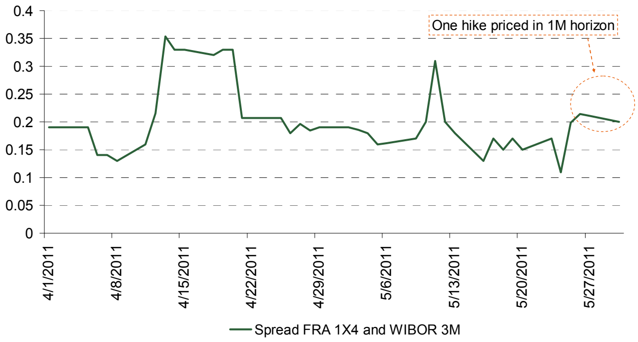
The latest series of comments from the National Bank of Poland leaves no doubt that the hawks have clearly gained ascendancy. Even fairly moderate bankers, who, in company with Governor Belka, advocated a more cautious approach, are changing the tenor of their statements now. Andrzej Kazmierczak, who had voted against a rate hike at the March meeting, clearly said that rates had to continue to rise because of high inflation. Other doves, such as Adam Glapinski and previously Zyta Gilowska, have made similar statements. That said, the current rise in inflation above 4%, is irritating even those central bankers who are otherwise doves.

Nevertheless, the central bank doesn't need to significantly increase its medium-term inflation outlook. Current inflation is overwhelmingly due to an increase in prices of food, petrol, and energy. Given persisting unemployment and very slow real wage growth, domestic demand-pull pressures do not pose any great risk at the moment. Therefore we still believe that rates need not be raised more aggressively than envisaged in our basic scenario – i.e., twice by the end of the year, to 4.75% and no more.

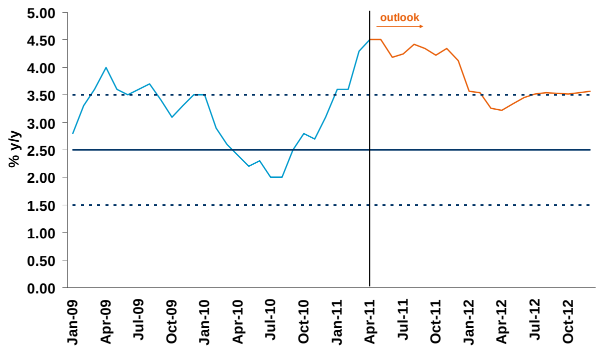
NBP may front-load tightening

However, in light of the latest statements, it is likely that the National Bank of Poland may speed up the pace of its tightening by making the most of its rate hikes in the months with high inflation. Today's negative real interest rates (ex-post, measured by current inflation) are really uncomfortable to at least some Monetary Policy Council members, who believe that, if rates go up faster now, they may remain lower in the end. Hence we do not rule out another hike at the next meeting, scheduled for June, followed by a rate hike during the summer.

Polish money market



Inflation and inflation target



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.57	0.21%	↗	→
EUR/PLN	3.977	0.71%	↗	→
EUR/HUF	268.3	-0.69%	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.71	-0.05	↘	→
10Y PLN	6.08	0.05	↘	→
10Y HUF	7.00	0.02	↗	↗

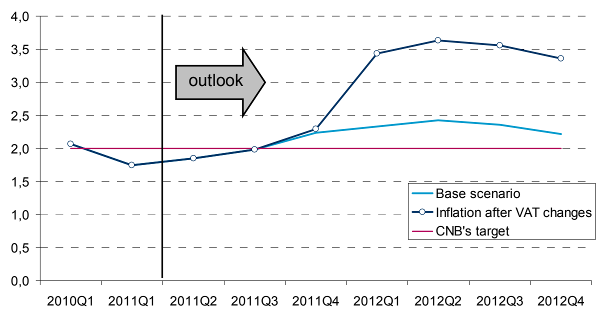
In Focus: Revolution in the Czech VAT

The Czech government has approved the proposal, put forward by the Ministry of Finance, to change the VAT rates over the next two years. The objective of the changes is to generate additional funds to finance the pension reform, which consists of the introduction of the second pillar – based on pension funds. As a first step, the reduced VAT rate, which primarily applies to food, medicines, mass transport, etc., should go up at the beginning of next year, from today's 10% to 14%, while the standard rate should remain at 20% for the moment. As the second step, both rates should combine at 17.5% from the beginning of 2013. This will amount to the most significant VAT change since the VAT introduction in 1993 and will increase the proportion of indirect taxes to public budget revenues, which are still primarily dependent on direct taxes. Nonetheless, at this point, the Bill proposing the changes is only heading to Parliament.

What may be the benefits of the VAT changes?

According to information from the media, the Ministry of Finance expects to generate an additional amount in excess of CZK 20bn owing to the increase in the reduced VAT rate, but this will not be the net revenue from the VAT change. In addition to having to change the tax revenue sharing (for the additional portion of the revenue not to end up outside the state budget), retirement pensions will certainly be adjusted (by an estimated CZK 8bn) and the taxation of families with children will be modified. That said, the net revenue from the VAT change may most likely not even reach half the intended amount.

Inflation forecast



What will the new VAT mean for consumers?

The VAT increase will certainly lead to a rapid inflation rise in early 2012. The VAT effect will likely be distributed over several months; yet, in the extreme scenario, it may reach 1.1% in 2012. The CNB anticipates an impact of 1% on inflation and a 0.4% decline in GDP growth. Hence inflation will easily exceed 3% in that year, and may culminate at just above 3.5% in the second quarter. In 2013, the VAT changes may not necessarily influence inflation at all, or may even be positive, due to the reduction in the standard 20% rate. The question is whether the VAT reduction will also lead to a reduction in retail prices.

The VAT increase will hit family budgets in the amounts of hundreds of koruna's

At the moment, we can only speculate as to the exact impact on consumer budgets. If we assume that the structure of the household consumer basket will not change significantly, the increased VAT will encumber family budgets with more than CZK 280 a month in 2012. However, the effect will differ greatly depending on the individual type of household. For families with children, it may be more than CZK 380 on average, as opposed to approximately CZK 200 per household for the families of pensioners. In 2013, the VAT changes may be counterbalanced and may even reduce the costs of consumer budgets slightly. Nevertheless, this will depend on how retailers will react in the end, i.e., whether they will prefer consumers or their profit margins.

The VAT increase alone will not accelerate a rate hike

In any event, we can say that the overall effect of the VAT changes on the budget will not be as great as is often cited. However, it will be very significant in terms of inflation, although households will be less affected in the end, owing to social security compensation for families with children and pensioners. Although inflation will climb to more than 3.5%, this will not be a reason for faster CNB rate hikes than those currently being considered, because monetary relevant inflation (indirect tax changes excluded) will remain moderate. The secondary effects of the VAT changes will only be negligible, at least in the first step. However, VAT will not be the only upside inflation factor in early 2012, because regulated electricity prices and tobacco excise duties are likely to go up again.

CE Weekly Preview

TUE 10:00	PL GDP (y/y change in %)		
	2011Q1	2010Q4	2010Q1
GDP	**4.4**	4.5	3.0

PL: The economy continues to perform well

Tuesday's release of the GDP growth data for the first quarter of this year should confirm the good condition of the Polish economy. The economy grew by 4.4% y/y according to our forecasts. The good industrial output figures during the first quarter indicate that industry should continue to be the main contributor to growth. As concerns demand, reasonable household consumption should play an important role (in spite of fairly high unemployment). By contrast, the effect of the replenishment of stocks should wane, but this may be partly offset by increased investment. The effect of foreign trade on the GDP will then be negative.

FRI 9:00	CZ Retail Sales (change in %)		
	Apr-11	Mar-11	Apr-10
Sales	**0.8**	2.1	-4.5
cummulative (YTD)	**3.8**	4.9	-1.8

CZ: Retail sales slowdown

We expect a significantly lower retail sales increase in April than in previous months. Weaker car sales together with a lower number of working days are the main reasons for the sales slowdown as well as a worsening of consumer sentiment. The latest data from the retail sector will probably confirm that consumer demand will not boom this year. Demand inflation pressures, therefore, will remain subdued and the CNB will not have to rush to increase its rates.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	30.5.2011	09:00	Unemployment rate (%)	04/2011			11.6		11.6	
HU	31.5.2011	09:00	PPI (%)	04/2011						6.6
PL	**31.5.2011**	**10:00**	**GDP (%)**	**1Q/2011 *P**		**4.4**		**4.4**		**4.4**
CZ	31.5.2011	11:00	Money supply M2 (%)	04/2011						2.5
CZ	1.6.2011		GB issuance calendar	3Q/2011					-67.5	
CZ	1.6.2011	14:00	Budget balance (CZK B)	05/2011					-67.5	
HU	2.6.2011	09:00	Trade balance (EUR M)	03/2011 *F					831.1	
HU	2.6.2011	12:00	GB bond auction/fixed rate (HUF B)	06/2011						
CZ	3.6.2011	09:00	Retail sales (%)	04/2011		0.8				2.1

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 above 24.5900/ .5650 (March high/ see graph: neck-line Double Bottom).
Support at 24.5250 (weekly Long Term Moving Average↑): needs to settle back below to envisage respite for CZK.
If unable to hold, next levels at 24.4120/ .4000 (weekly Medium Term Moving Average↑/ May 19 low), ahead of 24.3420/ .3340 (break-up daily May 12/ weekly Bollinger midline) and 24.2600 (break-up weekly), where pause favored.

Resistance at 24.6650/ .6700 (current recovery high off 24.0450?/ 50 Week Moving Average↓) and 24.7150 (Equality C wave off 24.0450), where pause favored.
If unable to cap, next levels at 24.8200/ .8460 (61.8% 25.3800 to 23.9200/ weekly Starc top + weekly modified Alpha Beta trend top): tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound off year 11 low retested Downtrendline off 285.00 and currently back above 268.40 (see graph).
Support at 267.54/ .26 (break-up hourly/ broken weekly Medium Term Moving Average↓), ahead of 266.26 (May 20 low) and 265.75 (break-up daily May 11), where pause favored.
If unable to hold, risk back towards 263.10/ 263.01 (May 11 low/ year low): tough on 1st attempts.

Resistance at 271.15 (current new recovery high off year low), ahead of 271.31/ .50 (weekly modified Alpha Beta trend top/ breakdown weekly), where pause favored.
If unable to cap, next levels at 271.90/ 272.00 (50% 280.80 to 263.01/ weekly Long Term Moving Average↓): tough on 1st at-tempts.

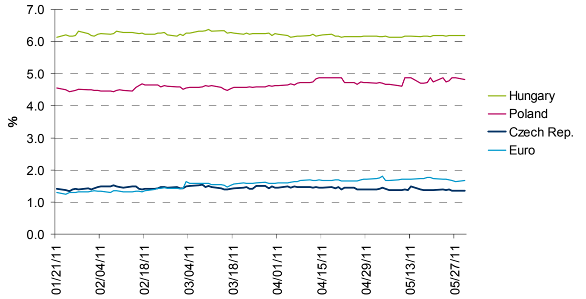
EUR/PLN Daily Chart:

Has met 1st target off 3.9820 (neckline short term Double Top) and currently toying back with this area (see graph).
Support at 3.9316/ .9264 (break-up daily/ weekly modified Alpha Beta trend bottom), ahead of 3.9125 (May 18 low), where pause favored.
If unable to hold, next levels at 3.8888/ .8850 (current reaction low off year high/ weekly modified Standard Error band bottom): tough on 1st attempts.

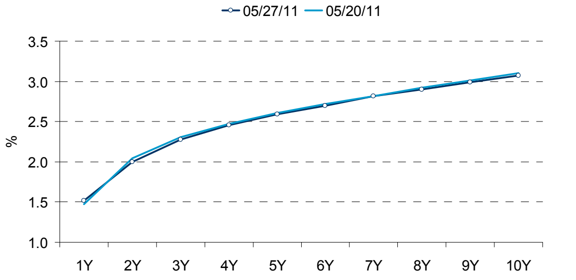
Resistance at 3.9900 (current recovery high off year low?), where pause favored.
If unable to cap, next levels at 4.0002/ .0056 (April 18 high/ 50% 4.1225 to 3.8888), ahead of 4.0332 (61.8%), ahead of 4.0520 (weekly Bollinger top): tough on 1st attempts.

CE Fixed-income in Charts

FRA 3x6

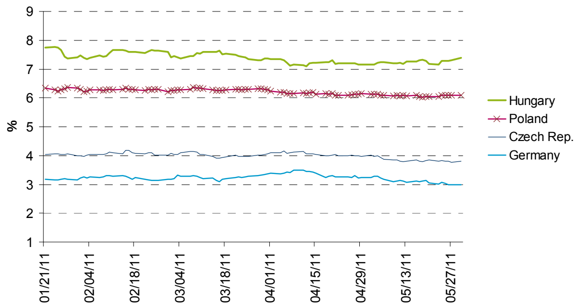


CZ IRS

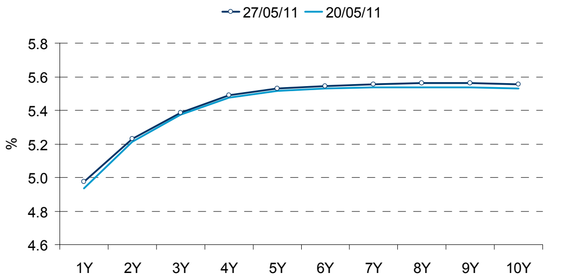


Source: Reuters

10Y GB Yields

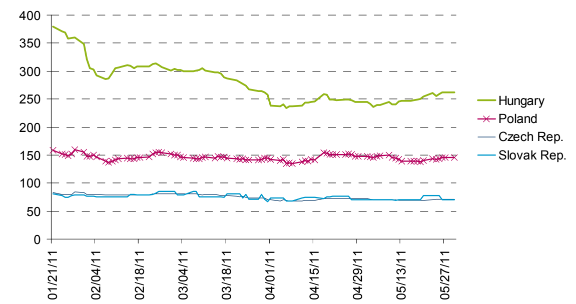


PL IRS

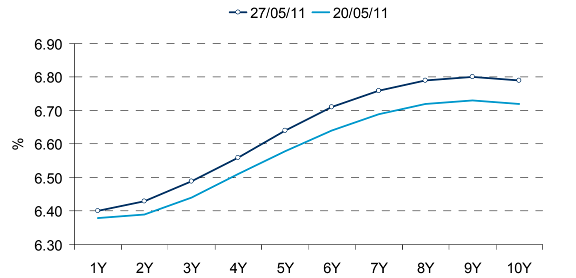


Source: Reuters

CDS 5Y



HU IRS

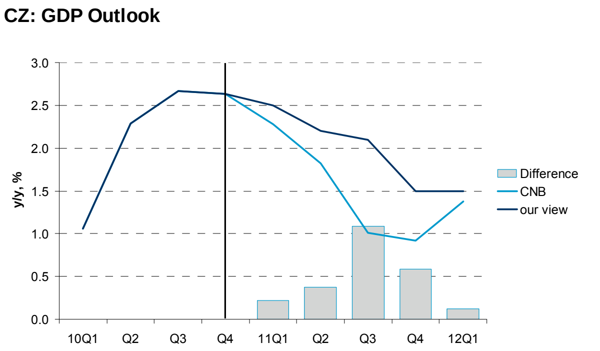


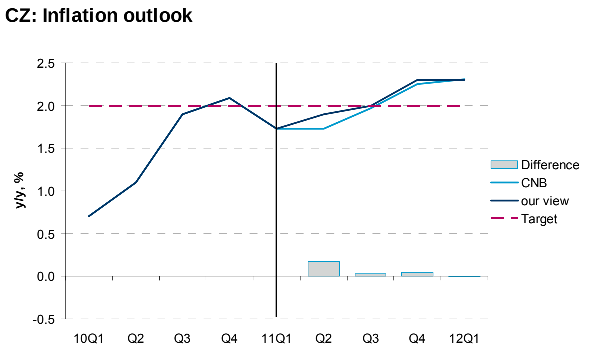
Source: Reuters

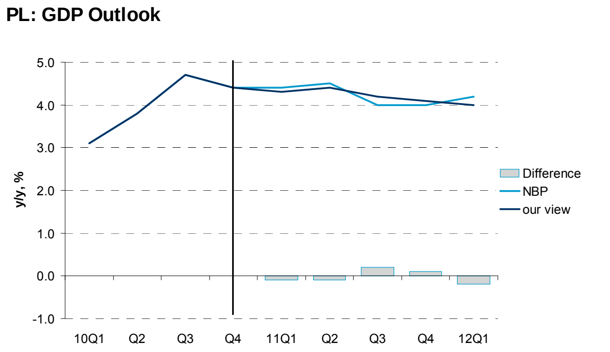
Medium-term Views & Issues

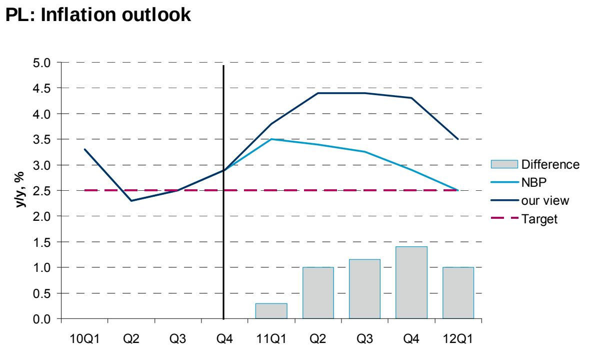
	The Czech Republic	Hungary	Poland
Growth & key issues	The situation in the governing coalition after some turmoil again stabilized. The government can continue to prepare the reforms needed to reduce the deficit of public finances. The general government deficit even felt to 4.7% of GDP in 2010. The 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.

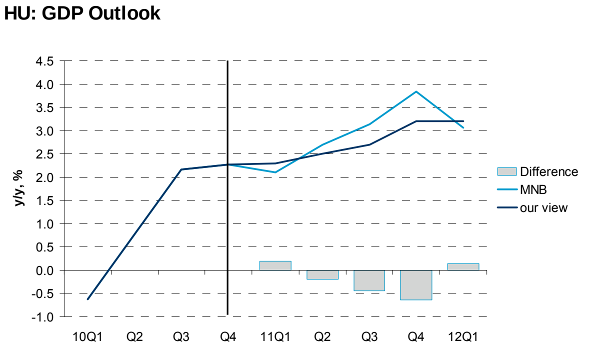
Central Bank's Projections versus Our Macro Forecasts

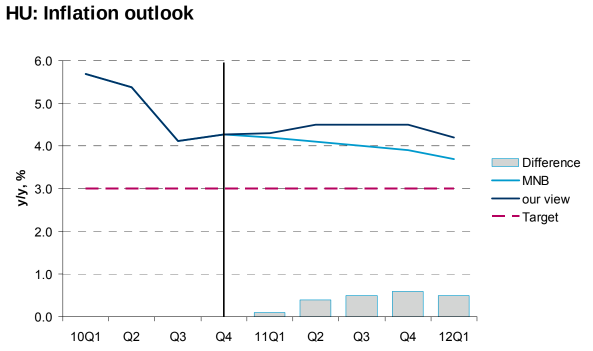












Summary of Our Forecast

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*	4.50	4.75	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	*1.21*	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*	4.60	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		*5.56*	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	*24.5*	24.5	24.6	24.4	24.0	23.7
Hungary	EUR/HUF	*268*	280	275	270	267	265
Poland	EUR/PLN	*3.97*	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	
								6190
Czech Rep.		2.2	2.1	1.5	1.5	2.5	3.0	10.18
Hungary		2.5	2.7	3.2	3.2	3.2	3.2	0.2%
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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