Monday, June 20, 2011

KBC
Banking & Insurance

Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Polish inflation touches 10-year high on food prices
- but central bank governor plays down hiking expectations
- as labour market looks weaker and producer prices decelerate
- Czech central bank is set to stay on hold
- as domestic demand remains weak and companies hesitate to invest
- Super-strong Swiss franc weighs on Hungarian and Polish households

Chart of the Week: Polish inflation touches 10-year high

PL: Inflation y/y

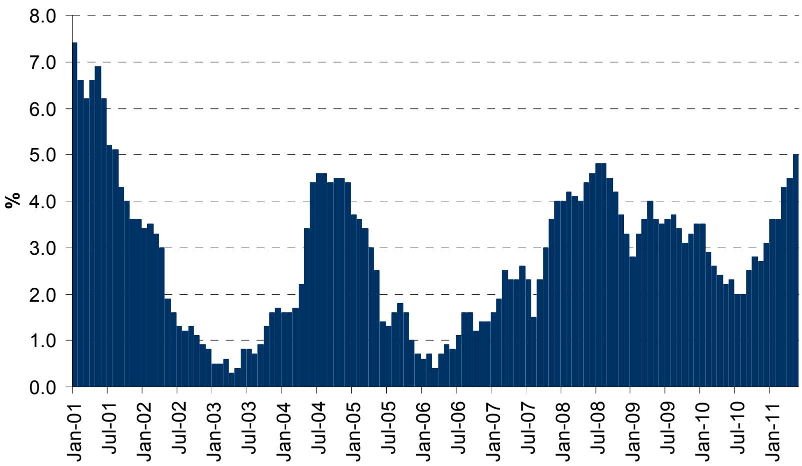


Table of Contents:

Markets' Editorial	2
Review of Economic Figures	3
In focus	4
CE Weekly Preview	5
Weekly Calendar	6
CE Forex Technicals	7
CE Fixed-income in Charts	8
Medium-term Views & Issues	9
Central Bank's v. Our Macro Forecasts	10
Summary of Our Forecast	11
Contacts & Disclosures…	12

Market's Editorial

The Swiss franc spreads the contagion from PIGS to Central Europe

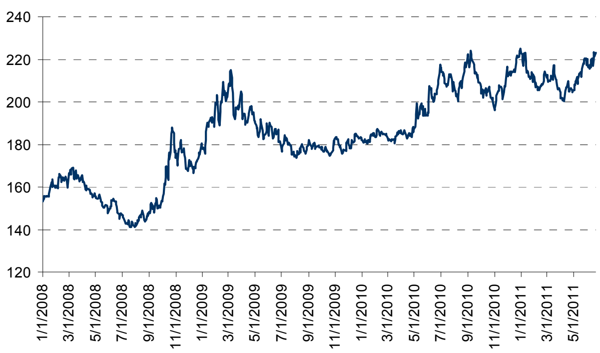
Were it not for the rise in the yields of Hungarian government bonds (i.e., CDS spreads) and the fairly moderate depreciation of the zloty, we could say that the latest wave of tensions in the periphery was just another tempest in a teacup for Central Europe. During the Greek crisis a year ago, the contagion from the bond markets in the euro zone periphery was much more evident.

Yet appearances are slightly deceptive. Concerning the rise in risk margins, Central Europe is not really affected by the contagion from the periphery, but the debt crisis has one unpleasant side effect for two of the region's countries (Hungary and Poland), which are exposed to the dramatic appreciation of the Swiss franc against the euro. The reason is that a significant portion of mortgage loans in Hungary as well as Poland are denominated in Swiss francs, and thus the global strength of the Swiss currency is having a hard impact on household's balances in those countries. The example of **Hungary**, which had already to struggle with the problem of foreign-currency mortgages during the global financial crisis, demonstrates how tricky this phenomenon is? And even more how tortuous the solutions are to which it may cause the government to resort. Bear in mind that, not very long ago, the Hungarian government came to an agreement with banks, that mortgages in Swiss francs would be converted into forints at the fixed exchange rate of HUF 180 per CHF. The difference, i.e., the increasing loss stemming from the strengthening franc, is being accumulated and subject to separate interest, with this amount to be added to households' existing mortgage principals in 2015. That said, Hungarian households may evade the strong franc for now; but, unless the situation substantially changes, the problem will hit them again in 2015.

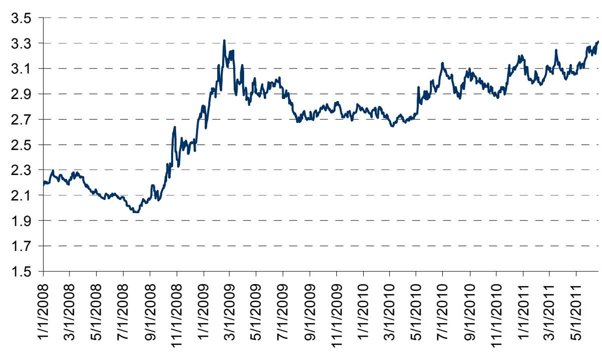
Polish case much the same as Hungarian

In Poland, where, just like in Hungary, 60% of mortgages are denominated in Swiss francs, government authorities (the cabinet and the central bank) currently give off the impression that the strengthening franc poses no risk to the economy or the banking system. Concerns about the unfortunate effects of foreign-currency loans were toned down in Poland (just like in Hungary in the past) by the argument that these loans were only granted to the most creditworthy clients; however, everything is a matter of degree, of course. Even the most creditworthy household will be affected if its monthly mortgage payments go up by 20%.

CHF/HUF



CHF/PLN



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.08	-0.17%	➚	➘
EUR/PLN	3.973	1.04%	➚	➔
EUR/HUF	267.7	1.27%	➚	➔

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.72	0.10	➚	➚
10Y PLN	5.92	0.08	➔	➔
10Y HUF	7.10	0.21	➚	➚

In Focus: The National Bank of Poland and the inflation dilemma

Last week's data sent highly mixed signals to Polish central bankers. On the one hand, May's inflation was very high, climbing to 5% Y/Y, a ten-year high. On the other hand, there were poor figures from the labour market, where the employment rate decelerated for a third consecutive month and wages are rising very slowly (4.1%), compared to an inflation reading of 5%.

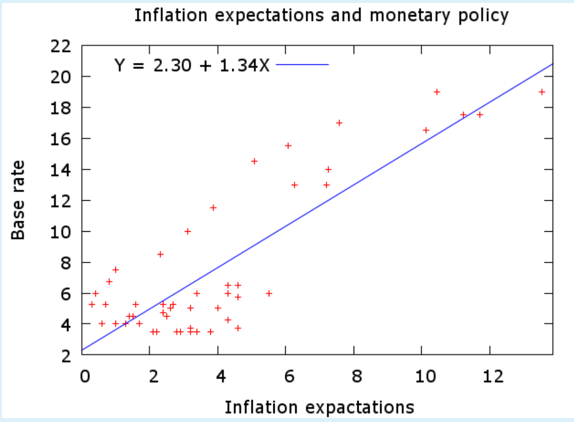
The poor data from the labour market should curb Polish central bankers and, **even with currently high inflation, favours the monetary tightening that we** have anticipated as coming during the summer break. In addition, Polish central bankers, just like others, are uncertain about future developments in the eurozone periphery, and hawks are not even encouraged by the deterioration of US data over the last few months, which raises questions as to the strength of the global recovery.

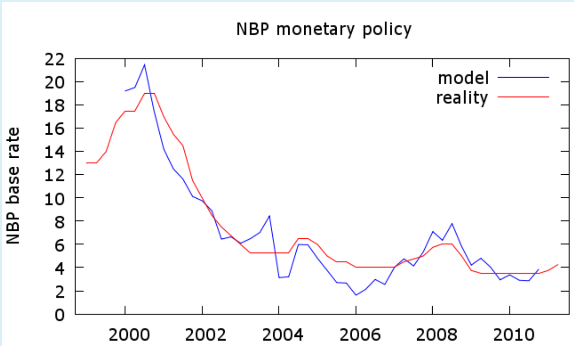
Even so, under certain conditions, we can imagine faster monetary tightening than that we anticipate at the moment (+25 bps in September and +25 bps in early 2012). The main risk is that currently increased inflation will have a greater impact on inflation expectations, to which the NBP has historically been very sensitive, as we can see from our analysis of the central bank's reaction function.

We have tested how the National Bank of Poland has been sensitive to various factors in its past decisions. Our model of the reaction function included the output gap, inflation expectations, rate of employment, exchange rate fluctuations, and the rate of industrial output. We found inflation expectations to be the most significant variable, particularly when we separated the period up until 2004 from the set of data, i.e., the period when the National Bank of Poland was facing historically higher inflation rates. In our model, a 1% increase in inflation expectations implies monetary tightening by approximately 1.15%. Another important variable is the rate of employment. The acceleration of the year-on-year rate of employment by 1% implies monetary tightening by approximately 0.4%. The other variables prove to be of little relevance.

Naturally, the reaction function is just a condensed historical experience; yet it provides something of a clue as to the future. The National Bank of Poland would start to tighten its monetary policy faster than we anticipate if today's increased inflation led to another increase in inflation expectations (4.3% at the moment) and the increase in employment concurrently accelerated.

Polish monetary policy





CE Weekly Preview

MO 14:00 **MNB base rate**

	This meeting	Last change
rate level (in %)	**6.00**	1/2011
change in bps	**0**	25

HU: The NBH will certainly leave rates unchanged

This time, the National Bank of Hungary will certainly leave rates unchanged. More likely, we may see the NBH Board threaten a future easing of its monetary policy. Both the significant inflation deceleration and the stability of the forint may be the arguments for the NBH.

THU 13:00 **CNB base rate**

	This meeting	Last change
rate level (in %)	**0.75**	5/2010
change in bps	**0**	-25

CZ: The Czech Republic: CNB rates again unchanged

We believe that the Czech National Bank will leave its rates unchanged at its June meeting. Although the forecast is not being quite fulfilled – with inflation diverging by 0.3%, and GDP by a huge 0.5%, from the CNB forecast – the CNB will not yet hasten to raise rates. August's meeting, when the further developments in the Czech and European economies may be clearer, appears to be a more appropriate date. A new forecast will be available to the CNB Board at that time, and thus its decision on rates will be made against the backdrop of a new outlook. That said, the CNB, unlike the ECB, needs be in no hurry to raise rates; yet the period of record-low interest rates in the Czech Republic is slowly drawing to an end.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**20.6.2011**	**14:00**	**NBH meeting (%)**	**06/2011**	**6.00**		**6.00**		**6.00**	
PL	22.6.2011	10:00	Unemployment rate (%)	05/2011			12.1		12.6	
PL	**22.6.2011**	**10:00**	**Retail sales (%)**	**05/2011**			**-1.3**	**12.6**	**2.3**	**18.6**
CZ	22.6.2011	12:00	CZ bond auction 2.75%/2014 (CZK B)	06/2011			8			
PL	22.6.2011	14:00	Core CPI (%)	05/2011			0.3	2.3	0.4	2.1
CZ	**23.6.2011**	**12:30**	**CNB meeting (%)**	**06/2011**	**0.75**		**0.75**		**0.75**	
HU	24.6.2011	09:00	Retail sales (%)	04/2011				0.2		-0.9

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 back below 24.5900/ .5650 (March high/ see graph: neckline Double Bottom).
Support at 24.0700 (June 14 low), ahead of 24.0510/ 0450 (weekly Bollinger bottom/ / April 27 low), where pause favored.
If unable to hold, next levels at 23.9660 (monthly modified Alpha Beta trend bottom), ahead of 23.9200 (year low + weekly envelope bottom) and 23.8410 (weekly Starc bottom): tough on 1st attempts.

Resistance at 24.2500 (breakdown hourly), ahead of 24.2940 (weekly Medium Term Moving Average↓) and 24.3800 (June 15), where pause favored.
If unable to cap, next levels at 24.4400/ .4510 (breakdown hourly/ daily), ahead of 24.4750/ .4770 (breakdown weekly/ weekly Long Term Moving Average↓): tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound off year low trying to extend above Downtrendline off 285.00 (see graph).
Support at 267.00/ 266.35 (break-up daily/ weekly Medium Term Moving Average↑), where pause favored.
If unable to hold, next levels at 265.10 (break-up daily), ahead of 264.10/ 263.70 (June 10 low/ current reaction low off 271.15), ahead of 263.10/ .01 (May 11 low/ year low): tough on 1st attempts.

Resistance at 269.80 (current reaction high off 263.70?), where pause favored.
If unable to cap, next levels at 270.65 (monthly channel top off historic high), ahead of 271.15/ .19 (May 23 high + see graph/ weekly Long Term Moving Average↓): tough on 1st attempts.

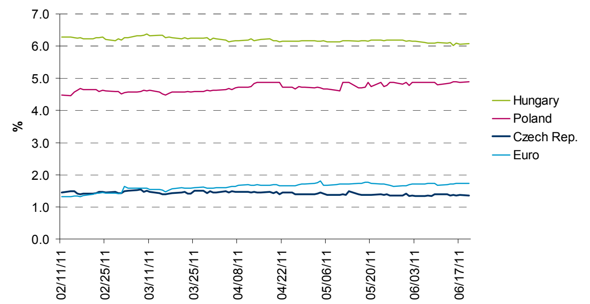
EUR/PLN Daily Chart:

Rebound off 3.9235 (June 14 low) testing 3.9900 (neckline Double Bottom: see graph).
Support at 3.9570/ .9560 (broken weekly Medium Term Moving Average→/ weekly envelope bottom)., ahead of 3.9530 (break-up daily).
Failure to hold would see next levels at 3.9235/ .9125 (June 14 low/ May 18 low), where pause favored to set in.
If wrong, 3.8896/ .8888 = monthly envelope bottom/ current reaction low off year high: tough on 1st attempts.

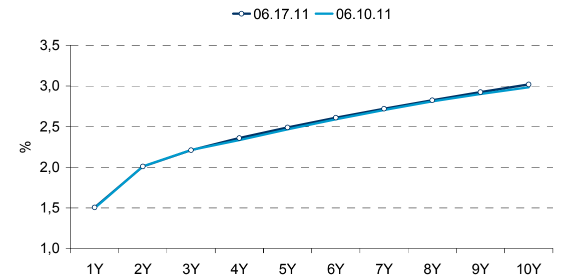
Resistance at 4.0002/ .0056 (April 18 high/ 50% 4.1225 to 3.8888 + weekly envelope top), where pause favored.
If unable to cap, next levels at 4.0280/ 4.0332 (monthly envelope top/ 61.8%): tough on 1st attempts.

CE Fixed-income in Charts

FRA 3x6

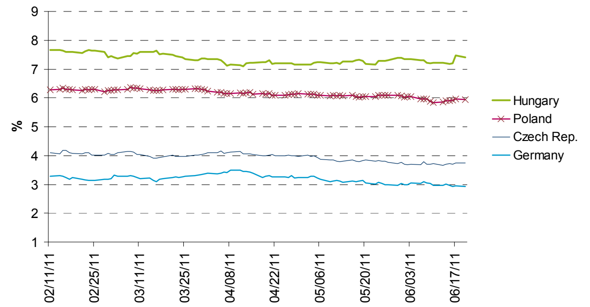


CZ IRS

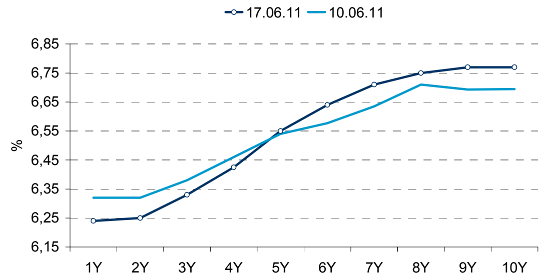


Source: Reuters

10Y GB Yields

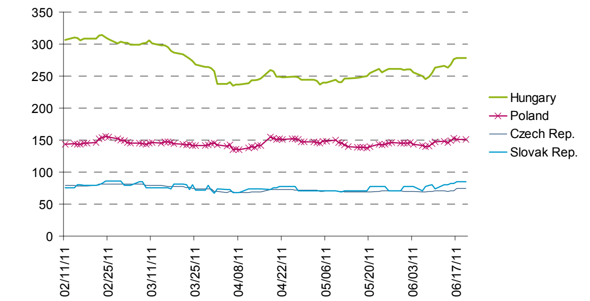


HU IRS

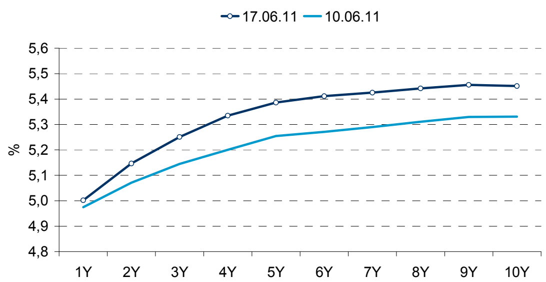


Source: Reuters

CDS 5Y



PL IRS



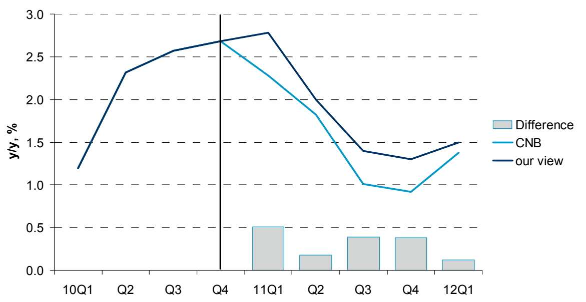
Source: Reuters

Medium-term Views & Issues

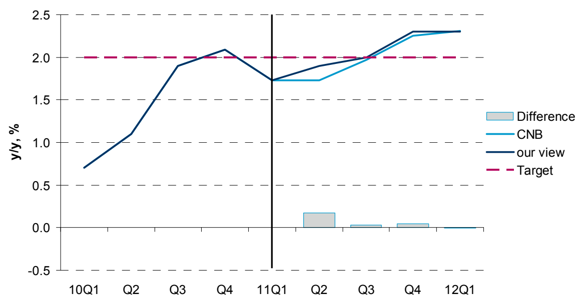
	The Czech Republic	Hungary	Poland
Growth & key issues	The situation in the governing coalition after some turmoil again stabilized. The government can continue to prepare the reforms needed to reduce the deficit of public finances. The general government deficit even felt to 4.7% of GDP in 2010. The 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 increased the reference rate already for the fourth time this year by 25 bps to 4.50%. 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 believe that the NBP might deliver this year's last hike as soon as at its September monetary policy meeting.
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

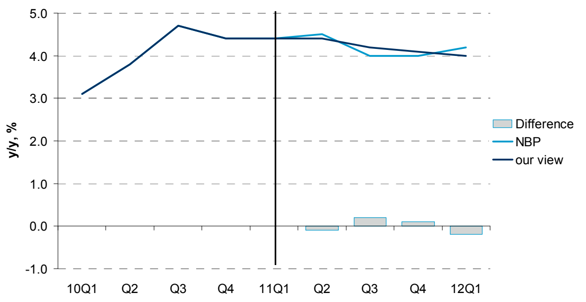
CZ: GDP Outlook



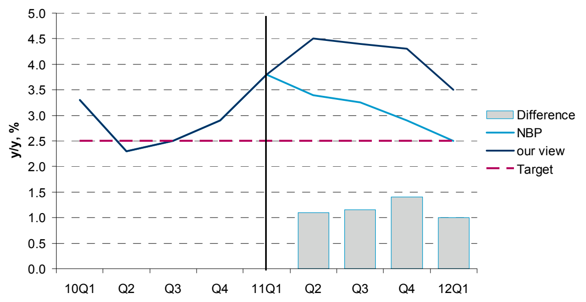
CZ: Inflation outlook



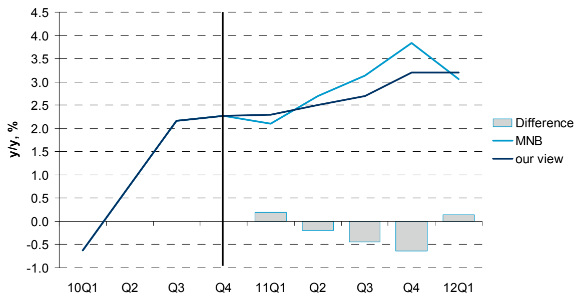
PL: GDP Outlook



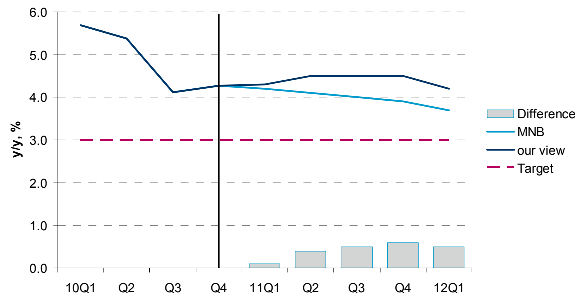
PL: Inflation outlook



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	*4.25*	4.50	4.75	4.75	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	*1.19*	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	*4.66*	4.60	5.00	5.10	5.15	5.15

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

	Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	*3.02*	3.40	3.50	3.60	3.70	3.85
Hungary	*6.80*	7.50	7.25	7.00	7.00	6.90
Poland	*5.46*	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	*24.1*	24.5	24.6	24.4	24.0	23.7
Hungary	EUR/HUF	*269*	280	275	270	267	265
Poland	EUR/PLN	*3.99*	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)

	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	-6.9

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Piet Lammens	+32 2 417 59 41		
Peter Wuyts	+32 2 417 32 35	Brussels	
Didier Hanesse	+32 2 417 59 43	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Commercial Desk	+32 2 417 53 23
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Dublin Research (KBC Bank Ireland)			
Austin Hughes	+353 1 6646892	London	+44 207 256 4848
Prague Research (CSOB)		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Jan Bures	+420 2 6135 3574	New York	+1 212 541 06 97
		Singapore	+65 533 34 10
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	Prague	+420 2 6135 3535
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