Monday, June 27, 2011

KBC
Banking & Insurance

Central European Weekly

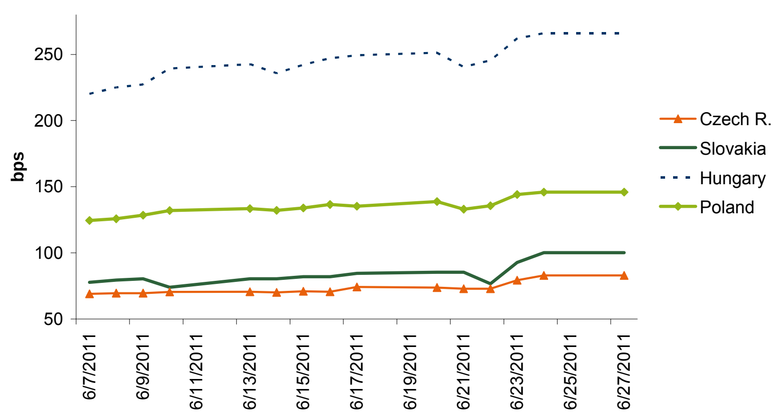
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Greek strike and parliamentary vote will test region’s immunity to contagion
- CNB is not in a hurry to increase rates
- Revisions of the Polish balance-of-payments could worsen country’s fundamentals

Chart of the Week: Sovereign Risk Is Gradually Rising in Central Europe

CDS (5Y) of CE Countries



Although contagion from the EMU periphery has been limited, Central Europe CDS spreads have moved a bit higher.

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Market's Editorial

Impact of Greek contagion still limited

Central Europe is still fairly immune to the Greek contagion, although the credit premium (CDS) on Hungarian and Polish debt went up somewhat. Especially, in terms of the developments in Central European forex markets, the impact of the Greek events still appears to be surprisingly moderate, albeit another Eastern European currency, the Romanian lei, is weakening quite dramatically because of Greek banks' involvement in Romania.

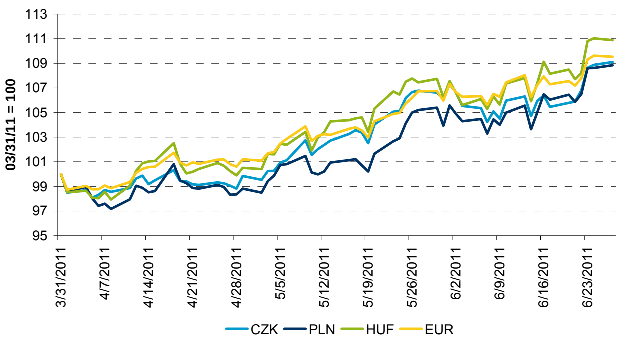
Nevertheless, this week, there will be another general strike and a key vote on another reform package in Greece: a true test of Central European markets' resistance to the contagion from the periphery of the eurozone. It is quite possible that, owing to Greece, markets will be exposed to increased volatility this week (as it already is the case for the Czech koruna), before they switch to a calmer holiday mood.

Polish revisions closely watched

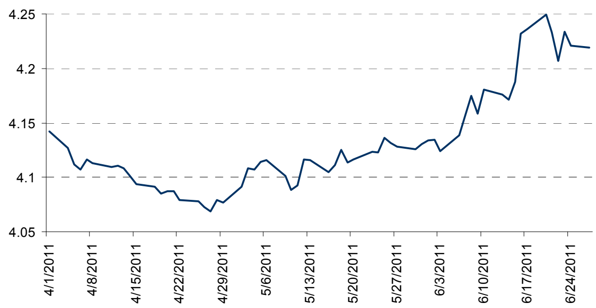
Otherwise, the revision of Poland's balance of payments statistics is another highlight in Central European markets. Bear in mind that the recent discovery by markets that Poland's balance of payments contained errors and omissions, to the tune of a few percent of GDP, was a small sensation. It really undermined investors' confidence in the reliability of Poland's fundamentals, because Poland's errors and omissions were on the debit side; accordingly, if the revision of the balance of payments confirms it, it leads to the deterioration of numerous key indicators, ranging from the current account deficit to the GDP or, for example, the closely followed government debt to GDP ratio. Thus, the revision will be important not only in terms of its final extent, but also in terms of whether the errors and omissions will be directly detrimental to increased imports (which would automatically lead to a downward GDP revision).

In any event, Poland's revision may attract more attention than usual, given that, with the acute situation surrounding Greece, the zloty may be more sensitive to any negative information.

Swiss frank against selected currencies CHF in 2011Q2

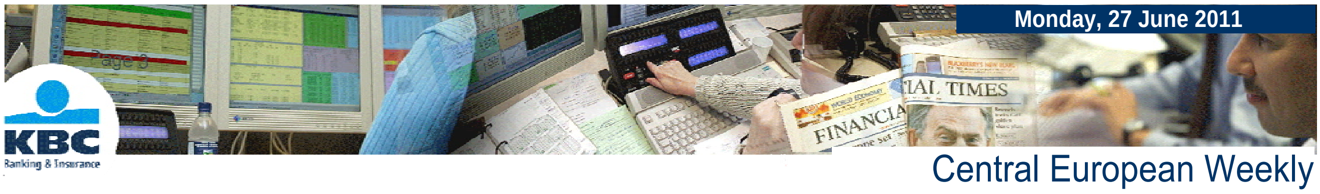


Development of EUR/RON in Q2/2011



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.36	1.07%	↗	↘
EUR/PLN	3.989	0.26%	↗	↘
EUR/HUF	269.2	0.40%	↗	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.70	-0.02	↗	↗
10Y PLN	5.86	-0.04	↗	↗
10Y HUF	7.25	0.11	↗	↗



Review of Economic Figures

CNB is in no hurry to change rates

At its June meeting – this year's fourth – the Czech National Bank Board voted 5:2 to leaving rates unchanged. Just like at its previous meeting, only two members voted for a 25 bps rate hike. The CNB evaluated the risks of the inflation forecast as balanced and is still inclined to the conclusion that "consistent with the forecast, it expects a broad stability of market interest rates in the near future and a gradual rise in rates starting in 2011 Q4". The CNB's moderate position is based on its balanced assessment of the current risks of the forecast. According to the CNB, major upside risks to inflation currently include higher current inflation, a less anti-inflationary domestic economic environment (i.e., faster growth of the GDP) and the anticipated VAT increase at the beginning of next year. By contrast, the CNB views a lower foreign interest rate outlook and the persisting debt crisis in the euro area as major downside risks to inflation.

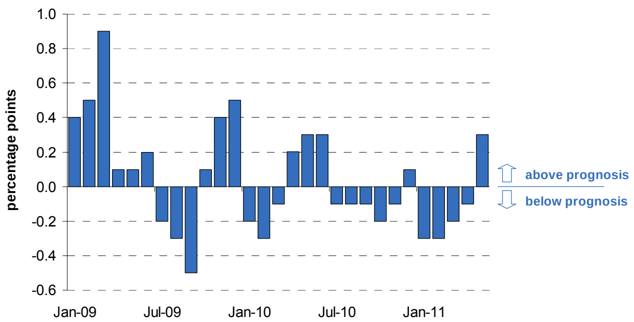
In any event, the economy has been performing much better this year than the central bank expected. The GDP is growing 0.5% faster and wages have even outpaced the forecast by 0.7%, while unemployment is falling more than the CNB believed in its last forecast. Under these conditions, inflation is 0.3% above the forecast, due in particular to rising costs rather than demand. Likewise, the anticipated developments in the euro area, which the CNB uses in its forecast, are also diverging, with the increasing forecasts of the rise in both the CPI and the PPI as well as in the rates of economic growth. On the other hand, the bets on the ECB raising rates rapidly have diminished. In addition, the current market forecast of the euro area's economic growth (2.7% in 2011 and 2.3% in 2012) may seem to be too optimistic.

The CNB has again maintained its dovish position and is sticking to its wait-and-see attitude. Yet we still believe that rates may be raised at its August meeting. The likelihood of this move is not at all as high as it was at the beginning of the year, but is still above 50%. Without doubt, the CNB's decision will be based on further domestic economic figures, i.e., whether domestic demand will begin to improve or continue to be muted just like to date; whether or not the problem of Greece will be resolved; and, as always, above all else, the Czech koruna, which will most likely see a further widening of the negative interest rate differential after the ECB raises rates, as early as in July.

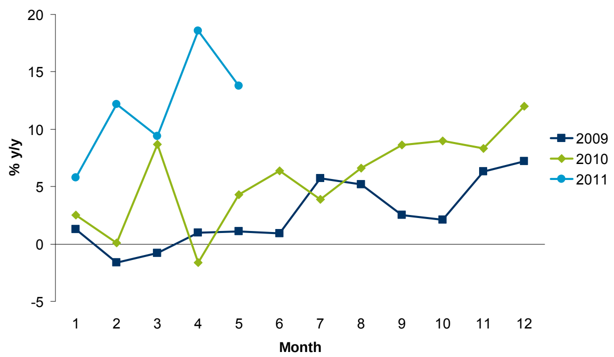
Polish retail sales show further strong growth

In May, Polish retail sales surprised on the upside again as it grew by 13.8%, i.e. by 0.7 percentage point faster than expected. Hence, the result was far above the crisis levels (see the chart). Even if we take into account that the rate of inflation reached 5% in the same month, we get real growth around 9% which was approximately the average y/y growth in 2008.

CZ: Inflation v. the CNB's current forecast



PL: Retail sales



CE Weekly Preview

PL: Polish NBP set to revise CA on imports

The NBP is set to revise 2004-2010 data on current account balance on Wednesday. According to NBP higher car imports should add to current account deficit in 2010 1pp (to 4.3% GDP). What is more importnat is the effect on GDP estimate, as debt/GDP level threshold at 55% has been nearly reached. Although Poles has not announced the date for GDP revision, it is expected to come afterwards. Theoretically in ideal scenario the impact of higher cars imports, could be offset be higher domestic consumption. That would mean only the change in structure of the GDP, not volume. Nevertheless this is an ideal scenario, which one can find hard to believe.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	29.6.2011	09:00	Unemployment rate (%)	05/2011			11.1		11.4	
PL	29.6.2011	14:00	Current account (EUR M)	1Q/2011			-3 815		-5 275	
HU	**30.6.2011**	**08:30**	**Current account (HUF B)**	**1Q/2011**					**366**	
HU	30.6.2011	09:00	Trade balance (EUR M)	04/2011 *F					479	
HU	30.6.2011	09:00	PPI (%)	05/2011				1.5	-0.3	4.9
CZ	30.6.2011	11:00	Money supply M2 (%)	05/2011						1.2
HU	30.6.2011	12:00	GB bond auction/fixed rate (HUF B)	06/2011 *P						
CZ	1.7.2011	14:00	Budget balance (CZK B)	06/2011					-81.5	

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:

Back below 24.5900/ .5650 (March high/ see graph: neckline medium term Double Bottom) and currently above with 24.3800 (neckline short term Double Bottom).
Support at 24.3800/ .3500 (see above/ reaction low hourly), with next levels at 24.2700 (idem + weekly envelope bottom) and 24.1520 (break-up daily), where pause favored.
If unable to hold, next levels at 24.0870 (weekly Bollinger bottom), ahead of 24.0700/ 0450 (June 14 low/ April 27 low): tough on 1st attempts.

Resistance at 24.4830/ .5000 (weekly Long Term Moving Average↓/ today's + current reaction high off 24.0700?), where pause favored.
If unable to cap, next levels at 24.5500/ .5630 (50 Week Moving Average↓/ weekly envelope top), ahead of 24.6650 (May 26 high): tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound off year low trying to extend above Downtrendline off 289.55 (see graph).
Support at 267.11/ 266.45 (weekly Short Term Moving Average↑/ June 21 low), 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 269.88 (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 271.00/ 271.15 (weekly Long Term Moving Average↓/ May 23 high + see graph) and 271.41 (38.2% 285.00 to 263.01): tough on 1st attempts.

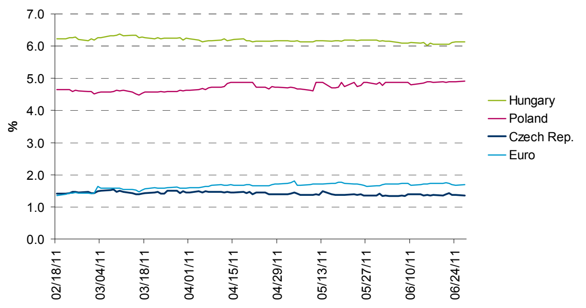
EUR/PLN Daily Chart:

Rebound off 3.9235 (June 14 low) trying to extend above 3.9900 (neckline short term Double Bottom: see graph).
Support at 3.9552/ .9530 (broken weekly Medium Term Moving Average→/ 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.

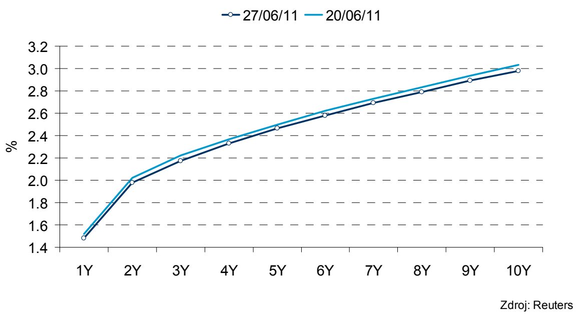
Resistance at 4.0190 (June 23 high), ahead of 4.0280/ 4.0332 (monthly envelope top/ 61.8% 4.1225 to 3.8888), where pause favored.
If unable to cap, next levels at 4.0446 .0464 (weekly Bollinger top / April 01 high), ahead of 4.0565/ .0673 (1st target off 3.9900?/ 76.4%): tough on 1st attempts.

CE Fixed-income in Charts

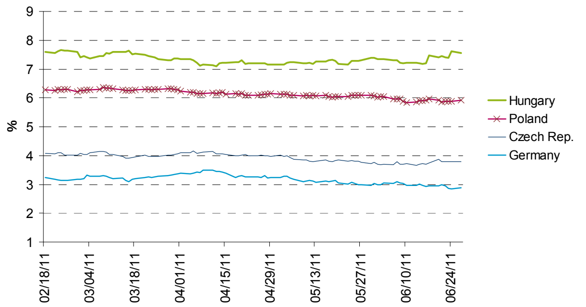
FRA 3x6



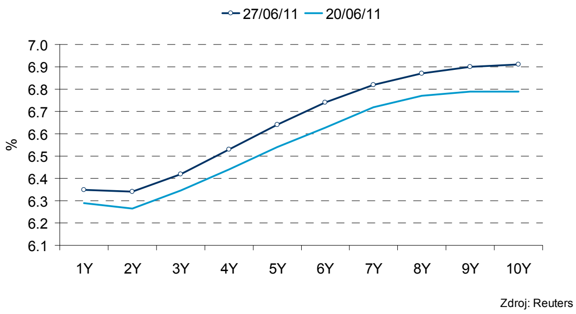
CZ IRS



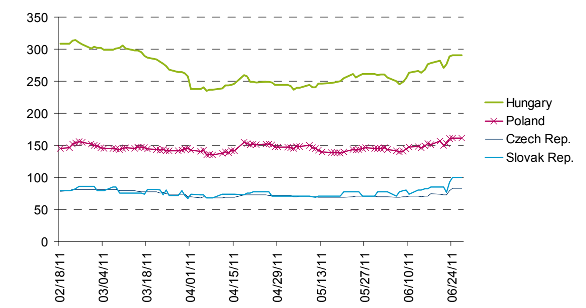
10Y GB Yields



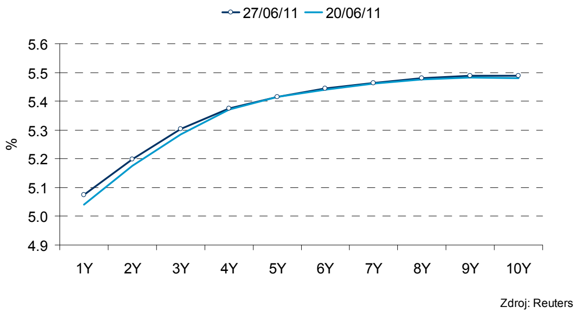
HU IRS



CDS 5Y

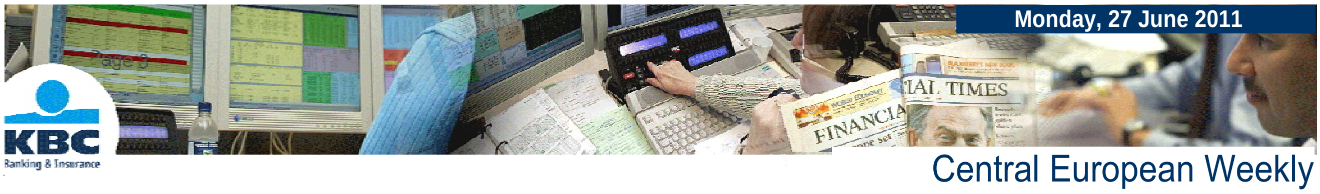


PL IRS



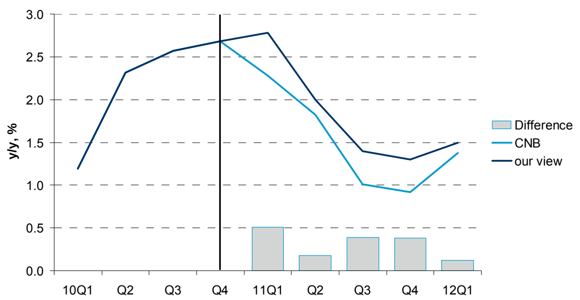
Medium-term Views & Issues

	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.**

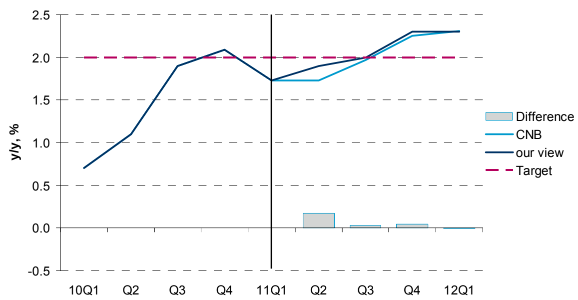


Central Bank's Projections versus Our Macro Forecasts

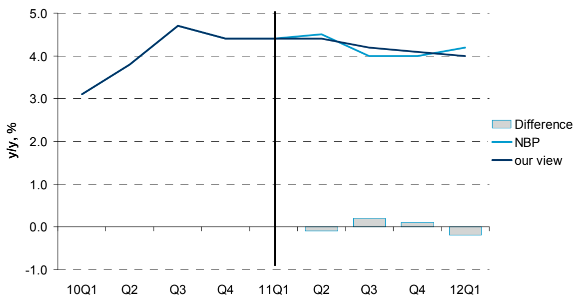
CZ: GDP Outlook



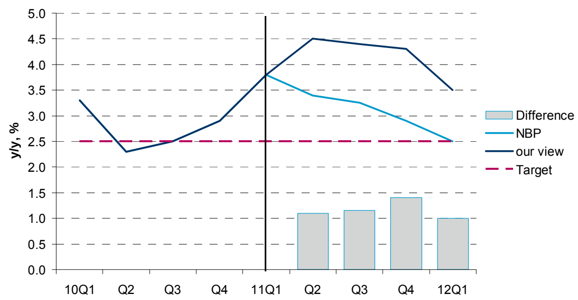
CZ: Inflation outlook



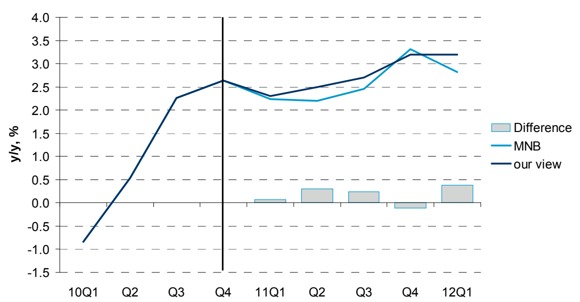
PL: GDP Outlook



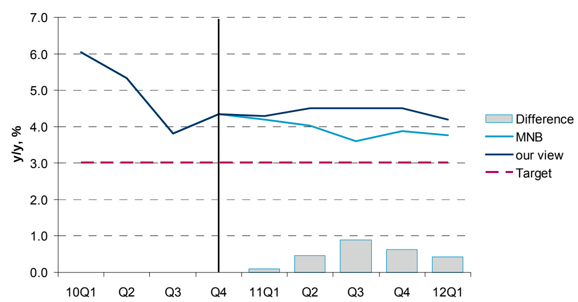
PL: Inflation outlook



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*	1.20	1.45	1.60	1.65	1.85
Hungary	BUBOR	*6.10*	6.00	6.00	6.25	6.25	6.30
Poland	WIBOR	*4.69*	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*	3.10	3.30	3.45	3.55	3.65
Hungary	*6.91*	7.50	7.25	7.00	7.00	6.90
Poland	*5.45*	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*	24.5	24.6	24.4	24.0	23.7
Hungary	EUR/HUF	*269*	280	275	270	267	265
Poland	EUR/PLN	*4.00*	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	1.4	1.1	1.3	2.6	3.5
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.	2.2	2.3	2.5	2.4	2.2	2.1
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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