Monday, July 25, 2011

Central European Weekly

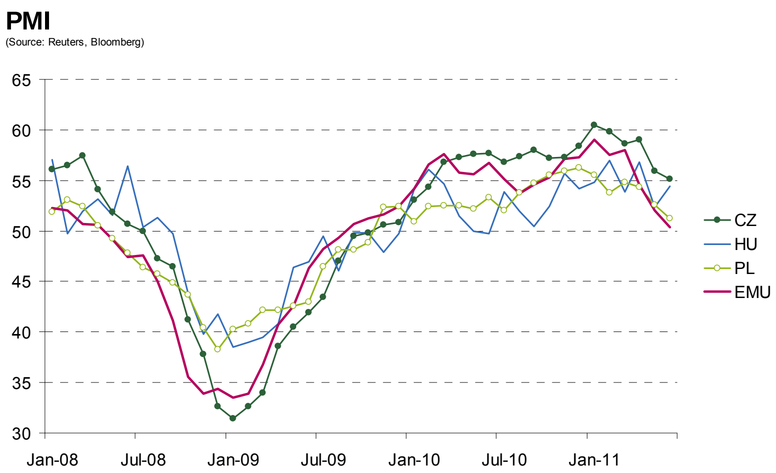
Written by CSOB Prague and K&H Budapest

Dear readers, the next CE Weekly will be released after our summer break on August 29th

Weekly Highlights:

- Contagion from Euro debt markets eases, focus turns to growth story
- In Focus: Polish households should withstand pressure coming from strong CHF
- Weekly Preview: MNB is going to stay on hold

Chart of the Week: Will regional PMIs follow disappointing figures from EMU?



Business sentiment has deteriorated in the Euro-zone manufacturing in July, PMIs in Central Europe might follow the trend in the West

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Market's Editorial

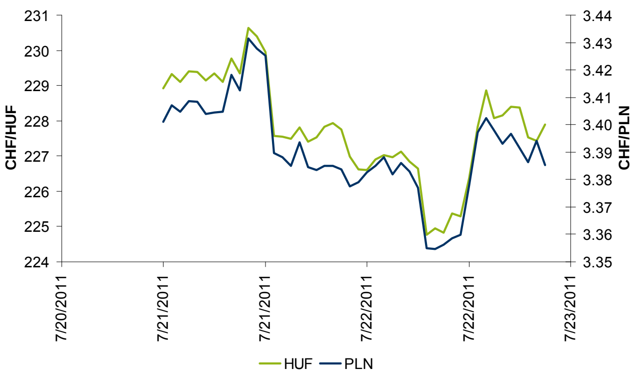
Credit risk and forex volatility ease

After Thursday's meeting of the key actors, the debt crisis in the Euro zone has entered another stage. In any event, markets, at least at the beginning, viewed the summit conclusions positively, and this led to an increased appetite for risky assets. The entire Central European region also benefited from this. Particularly fetching a sigh of relief were the forint and the zloty, i.e., the currencies of the economies where a significant portion of household mortgages (approximately 10% of GDP) are denominated in Swiss francs. Thus the strengthening Swiss currency (against the euro and other currencies) served as an evident channel for contagion from the Euro zone (read our Focus on Poland).

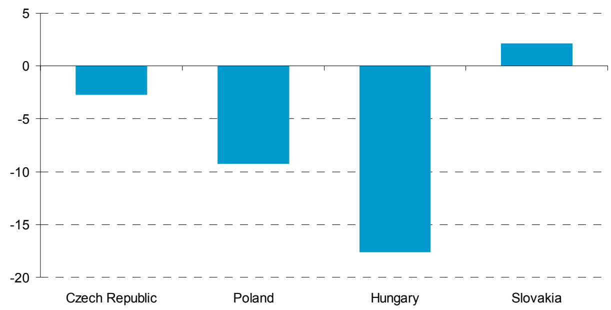
Growth worries instead of euro-debt contagion?

While the financial aspect of the debt crisis, in terms of the risk of uncontrolled contagion, may diminish in the days and weeks to come, markets may gradually shift their attention to the real economy. However, the latest data from the Euro zone, to which trade in Central European economies is very closely tied, is not very encouraging. Notably the gradual deterioration of the leading indicators of Germany, the Western European economy's flagship, to which Czech and Hungarian industries are especially tied, sparks concern. Therefore the question of future growth, i.e., the risk of a rapid deceleration, may come to the forefront as regards the forthcoming developments in Central Europe, and this may be of no less importance or even of greater importance to the small open economies in Central Europe than the risk of contagion from the periphery of the Euro zone.

CHF/HUF and CHF/PLN last week



Change of 5y CDS after announcement of Greek bailout II



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.38	0.88%	→	↗
EUR/PLN	4.038	2.21%	→	↗
EUR/HUF	272.6	3.32%	→	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.71	0.06	→	→
10Y PLN	5.84	0.08	→	↗
10Y HUF	7.26	0.20	→	↗

Contagion from Euro-zone comes to Poland via strong CHF

The new wave of concern associated with the debt problems of Greece has led to a significant increase in the aversion to risk on financial markets. This is why investors are starting to look for safer assets, such as German bonds, gold, and the Swiss franc. The huge flow of money into Switzerland and the appreciation of the franc may trouble numerous Polish households. Why? Just as in Hungary, a significant portion of Poland's mortgages are denominated in the Swiss currency. Thus the significant appreciation of the franc increases the mortgage payments made by Polish households, which cannot efficiently protect themselves from exchange rate risks. Consequently loan providers see the credit risk of their clients increase. On the other hand, this effect is mitigated by lower interest rates (in CHF) and the fairly positive domestic labour market developments. Therefore Polish mortgages in CHF may after all not pose outside risk to the financial stability and future growth of the country.

The low-interest Swiss franc and the zloty, which has been appreciating in the long term (the zloty strengthened by more than 34% against the Swiss franc from 2004 to the summer of 2008; see Graph 1) enticed Polish banks and households to finance their housing loans in Swiss currency. In the summer of 2008, when the proportion of new mortgages denominated in the Swiss currency peaked (at as high as 68.9% in June; see Graph 2), the franc sold at approximately PLN 2. While such a model of housing financing reduces the monthly amount of payments, it exposes households to a significant exchange rate risk (with banks being exposed to the associated credit risk as a result). This was evident with the outbreak of the global financial crisis, when the CHF/PLN currency pair soared.

A similar scenario has reoccurred now, as the CHF/PLN spot rate trades around 3.4. As the proportion of mortgages in francs is still approximately 53% of the overall volume of mortgages (despite the year-on-year decline by 10%; see Graph 3), numerous Polish households saw their monthly payments go up significantly. At the end of 2010, this ratio was 55%, i.e., approximately 10% of GDP. Another, rather potential, problem is that the strengthened franc has effectively increased the overall value of a mortgage, while real estate prices were falling during the economic crisis. As a result, the National Bank of Poland estimates that the loan-to-value ratio of certain mortgages has increased significantly (this primarily applies to the years 2007 and 2008) and, in certain cases, has even exceeded 100% (this means that the current real estate price does not fully cover the mortgage amount and, should the debtor fail, the creditor will automatically incur losses even from the sale of the real estate).

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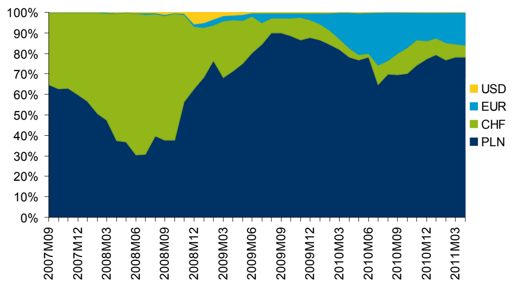
CHF/PLN cross rate since 2004

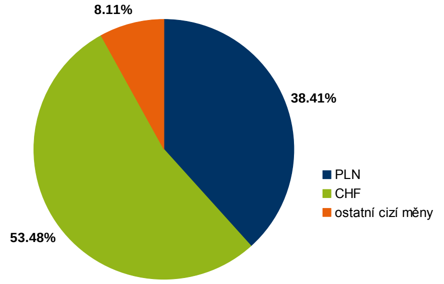
Graph 1: Development of the exchange rate of the Polish zloty against the Swiss franc since the beginning of 2004. From 2004 to the summer of 2008, the zloty strengthened by more than 34% against the Swiss franc (data source: Bloomberg)

Currency structure of mortgages of Polish households (new loans)



Graph 2: The granting of housing loans in Swiss francs peaked on the eve of the outbreak of the global financial crisis during the summer of 2008, when almost 69% of new mortgages were denominated in Swiss francs. At that time, the CHF/PLN currency pair fluctuated at all-time lows below PLN 2 per CHF. At the moment, the Swiss franc sells at approximately PLN 3.4 (data source: NBP)

Currency structure of mortgages of Polish households (total stock in May 2011)



Graph 3: Currency structure of Polish households' mortgages as at the end of May 2011 (data source: NBP)

On the other hand, this effect was partly neutralised by the significant decline in interest rates during the crisis (see the Case Study) as well as by the domestic labour market developments. According to a survey conducted by the Statistical Office in 2009, 94% of households repaying mortgages were economically active in that year, while average wages also went up decently (see the Case Study). The strong growth in Poland's nominal wages (unlike, for example, Hungary) largely counterbalanced the increase in mortgage payments due to the depreciation of the zloty against the franc, and thus the relative burden to family budgets might not be that dramatic. In other words, the negative impact of the strong Swiss franc on Polish household consumption might not be that dramatic for the moment. Also, according to the recently released NBP's Financial Stability Report, Swiss franc mortgages pose no fundamental problem at the moment. In spite of the fairly rapid increase, the NBP registers 1.4% of impaired loans in francs, out of the total volume of mortgages, even though this figure is likely deviated downwards because of the conversion of bad loans into the Polish currency.

To sum up: The problem of Polish mortgages in Swiss francs should in no way be underestimated. A fatal combination for the Polish economy, i.e., for the financial sector, would occur if the situation in the Euro zone came to a head and pushed the Swiss franc to new highs, while the Polish labour market deteriorated. However, this is not our basic scenario. Hence we believe that Polish households as well as the economy as a whole will be able to absorb the increased mortgage payments in Swiss francs. Another factor that should not be underestimated either is that both the NBP and the Ministry of Finance hold large volumes of euros, which they can use to intervene in favour of the zloty if necessary

Petr Baca, CSOB Prague

***Case-study*: How could a Polish household see its housing costs, financed by CHF, increase?**

Imagine the example of a household that in 2007 decided to finance its housing (a 50 m2 flat) by a mortgage in Swiss francs. Suppose the mortgage is due in 25 years. The average price of such a flat was PLN 372,713 in Poland in the last quarter of 2007. Calculated at the average exchange rate at that time, the loan would be for CHF 169,300.

According to the data from the National Bank of Poland, the average interest rate on a mortgage that was for more than 10 years was 4.56% (approximately 180 basis points above the three-month CHF Libor) in the fourth quarter of 2007. The average rate in May this year is approximately 2.2%.

If we consider the most usual repayment method, i.e., monthly payments of an unvarying amount, a monthly mortgage instalment at the time of borrowing was CHF 947, i.e., PLN 2,084 after conversion, in our simplified example. By contrast, under the current conditions, the payments in Swiss francs have decreased to CHF 718, owing to a lower interest rate; but, given the significant depreciation of the zloty, to PLN 3.4 per CHF, households need to pay PLN 2,457 a month, i.e., approximately 20% more.

At the time the mortgage was arranged, Poland's average monthly wage was PLN 3,096, and thus the instalment made up 67% of the average wage. Interestingly, this proportion is 68% now, because the average wage already reached PLN 3,600 in June 2011. That said, as concerns an average household, our example does not indicate any significant real increase in payments. Let us add that, were the mortgage structured differently (such as with a due date in 20 years), the impact of the strengthened franc would be more evident, and the relative increase in payments would be more significant. In that event, the proportion of payments to an average wage would increase by approximately 5%.

CE Weekly Preview

TUE 14:00 **MNB base rate**

	This meeting	Last change
rate level (in %)	**6.00**	+25
change in bps	**0**	4/2011

HU: MNB to leave its base rate at 6.0%

Even though the headline inflation fell significantly in June and the forint recovered from its all-time lows, the MNB has no reason to change its policy, so its base rate will remain unchanged.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**26.7.2011**	**14:00**	**NBH meeting (%)**	**07/2011**	**6.00**		**6.00**		**6.00**	
HU	26.7.2011	09:00	Retail sales (%)	05/2011				-0.4		-1.3
PL	26.7.2011	10:00	Unemployment rate (%)	06/2011			11.8		12.2	
PL	**26.7.2011**	**10:00**	**Retail sales (%)**	**06/2011**			**11.8**	**2.2**	**13.8**	**-1.1**
PL	29.7.2011	14:00	Inflation expectations (%)	06/2011						4.2

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:

EURCZK= 24.4100

Back below 24.5900/ .5650 (March high/ see graph: neckline medium term Double Bottom) after having approached Down-trendline off May 2010 high.
Support at 24.2800/ .2600 (break-up daily/ hourly): pair must sustain back below to signal better standing for CZK.
Failure to hold would see next levels at 24.1000 (July 11 low), ahead of 24.0700/ 24.0450 (June 14 low/ April 27 low).
23.9200 = current year low: tough on 1st attempts.

Resistance at 24.5450 (July 15 -- July 19 highs), where pause favored.
If unable to cap, next levels at 24.6650 (May 26 high), ahead of 24.8230 (61.8% 25.3800 to 23.9200).
25.2820 = 23.6% 29.6900 to 23.9200: tough on 1st attempts.

EUR/HUF Daily Chart:

EURPLN= 4.0100

In long term Triangle pattern (see graph).

Support at 3.9618/ .9541 (break-up daily/ 61.8% 3.8888 to 4.0600): pair must sustain back below to signal return of better fortune for Zloty.
Failure to hold would see next levels at 3.9261/ .9235 (July 08 low/ June 14 low), ahead of 3.9125 (May 18 low)
3.8888 = May 11 low: tough on 1st attempts.

Resistance at 4.0264 (breakdown daily): ideal area to stay below to keep current short term better mood on Zloty.
Failure to cap would see next levels at 4.0469 (July 18 high) and 4.0600/ .0673 (July 12 high/ 76.4% 4.1225 to 3.8888): inability to hold would be puzzling for longer term outlook of Zloty but suspect tough to sustain through on 1st attempts.

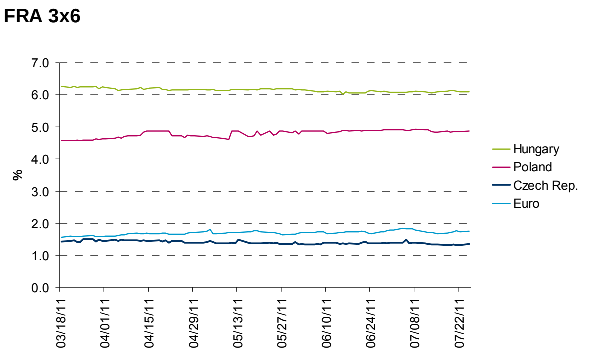
EUR/PLN Daily Chart:

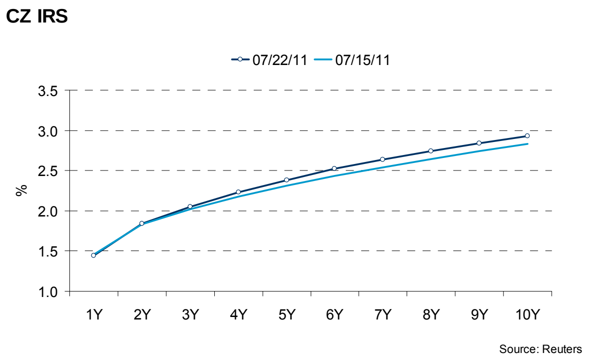
EURHUF= 269.80

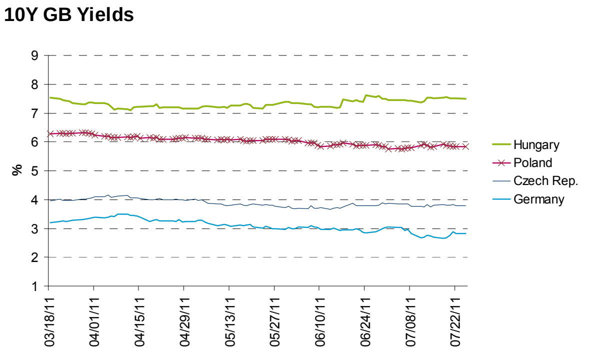
Rebound from new year low tested channel top off 292.10 (see graph).
Support at 266.00 (current reaction low off 273.40), with next levels at 264.75/ 264.61 (break-up daily/ 76.4% 261.90 to 273.40): pair must sustain back below to signal better fortune for HUF.
Failure to hold would see next levels at 261.90 (new year low), ahead of 260.93 (2010 low) and 259.18 (1st Irregular B off 273.40): tough on 1st attempts.

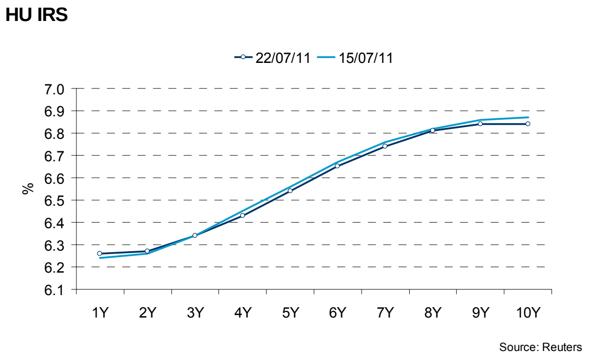
Resistance at 270.70 (current reaction high off 266.00?): ideal area to stay below to keep current short term better mood on HUF.
Failure to cap would see next levels at 273.40/ 273.43 (July 18 high/ 38.2% 292.10 to 261.90) and 274.80/ 275.20 (March 17/ 24 highs): tough on 1st attempts..

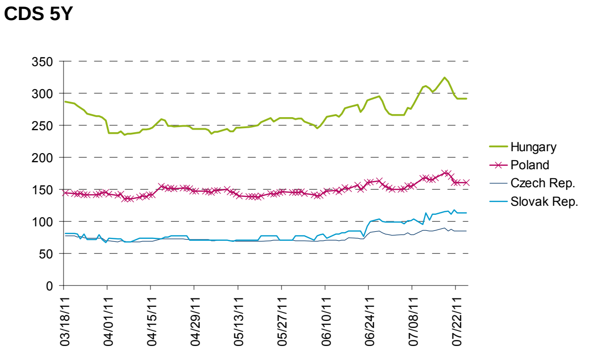
CE Fixed-income in Charts

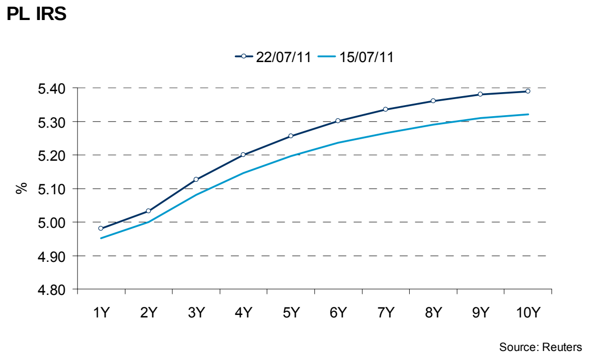










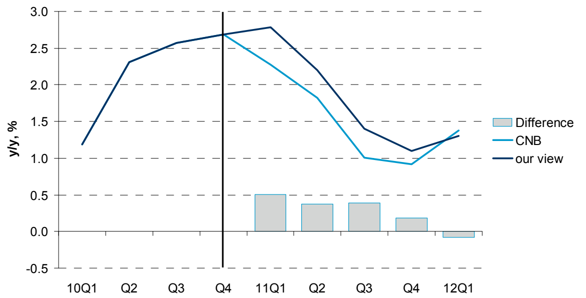


Medium-term Views & Issues

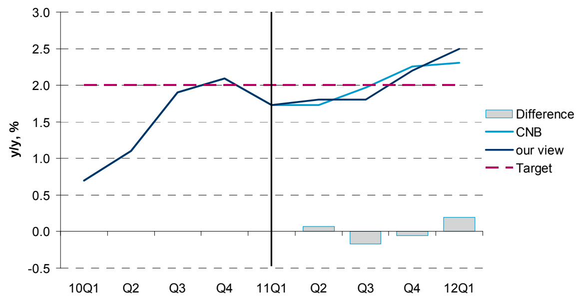
	The Czech Republic	Hungary	Poland
Growth & key issues	The situation in the governing coalition after some turmoil again stabilized. The government can continue to prepare the reforms needed to reduce the deficit of public finances. The general government deficit even felt to 4.7% of GDP in 2010. The 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 actually declined below the central bank's target in spite of higher fuel and foodstuffs' prices and to administrative measures. Fuel prices as well as prices of agricultural commodities continue to pose a risk to inflation. On the other hand, weak demand and the strong koruna should counteract the rise in inflation. We think the CNB can maintain its wait-and-see policy and again leave interest rates unchanged at its August meeting. The first rate hike is probable in November as the present prognosis announced (2011 Q4).	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 third time this year by 25 bps to 4.50%. Although the rate of inflation should stay above the target in the rest of 2011, the inflation expectations have stabilised and employment growth remains sluggish. Hence we believe the NBP should stay on hold for some time, at least during the summer. We expect next interest rate hike in November, but only if the situation on the euro zone peripheries calms down.
Forex Outlook	We expect the koruna to be weaker during the summer 2011. The main reasons include a later start of the monetary tightening in the Czech Republic and the ongoing debt crisis at the peripheries of the eurozone. Nevertheless, the accelerating inflow of money from EU Funds, in addition to the slow continuation of real convergence, should remain a positive long-term factor for the Czech currency. The CNB may be quite busy warding off the positive impact of Brussels' money on the koruna.	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 that nervousness on the eurozone peripheries may weigh on the whole region in the near term. 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

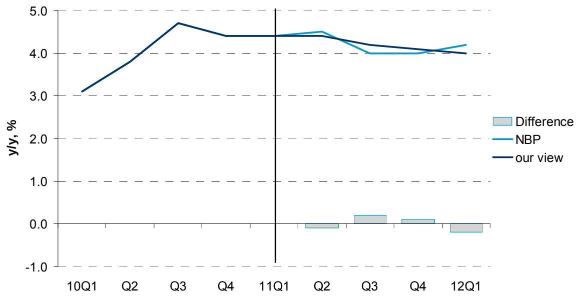
CZ: GDP Outlook



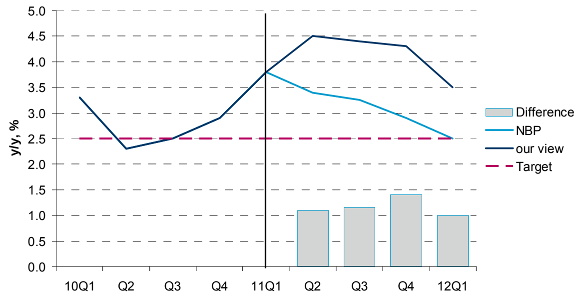
CZ: Inflation outlook



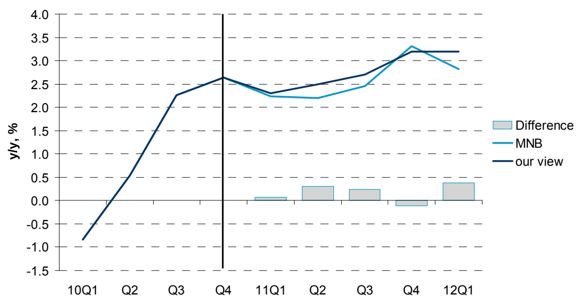
PL: GDP Outlook



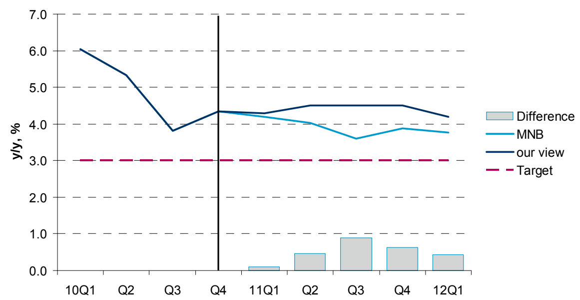
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.25	1.50	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	*4.50*	4.50	4.75	4.75	4.75	5.00	25 bps	5/11/2011

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

		Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Czech Rep.	PRIBOR	*1.20*	1.25	1.48	1.65	1.85	1.88
Hungary	BUBOR	*6.09*	6.00	6.25	6.25	6.30	6.30
Poland	WIBOR	*4.7*	4.60	5.00	5.10	5.15	5.15

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

		Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Czech Rep.		*2.9*	3.30	3.45	3.55	3.65	3.90
Hungary		*6.86*	7.25	7.00	7.00	6.90	6.90
Poland		*5.42*	5.95	6.00	6.10	6.15	6.20

Exchange rates (end of the period)

		Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Czech Rep.	EUR/CZK	*24.4*	25.0	24.4	23.7	23.5	23.4
Hungary	EUR/HUF	*269*	275	270	267	265	265
Poland	EUR/PLN	*4.00*	4.20	3.90	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.		1.9	2.1	2.5	2.4	2.3	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	2.9
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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