Monday, September 05,

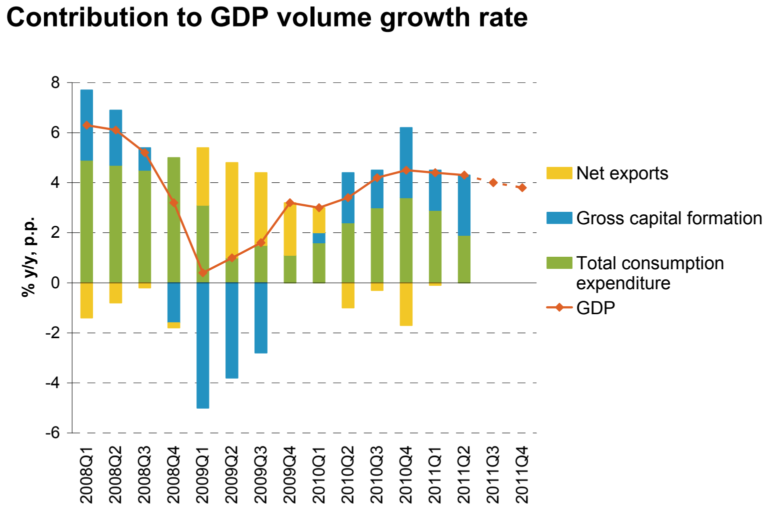
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Polish GDP slightly better than expected
- Regional PMIs still hover above 50
- CEE currencies remain under pressure on global fear
- Czech and Hungarian industry expected to slow down in July

Chart of the Week: Polish GDP growth



Polish GDP posts solid growth on domestic demand

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Market’s editorial

Hard data lag deterioration in soft indicators

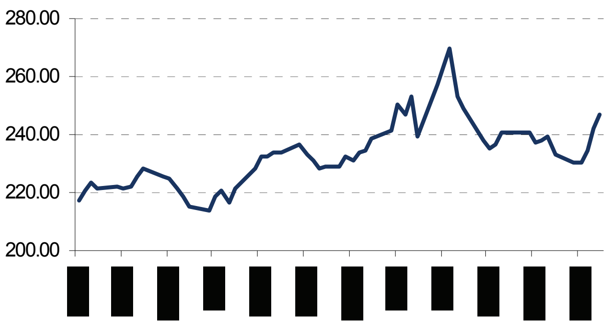
The upswing situation in Europe is changing quite dramatically – for the worse, unfortunately. We mean not only the macroeconomic indicators of the overly indebted countries of the eurozone, but also the series of negative surprises that have hit Germany, the core of the monetary union, to which Central European economies are tied significantly.

So far the growth deceleration is primarily making itself felt in Central Europe in soft data, i.e., business or consumer sentiment indices, where declining new orders are the most worrisome. By contrast, if we look at what is known as hard data, such as the recently released GDP growth figure in Poland, we find that the data still shows swift growth, due to inertia. This week and the weeks to follow may indicate that exports and consequently industrial output are decelerating rapidly. That said, the risk of stagnation or even a recession in the region will basically become imminent. And how will the reflections on that unfavourable macroeconomic scenario impact on regional financial markets?

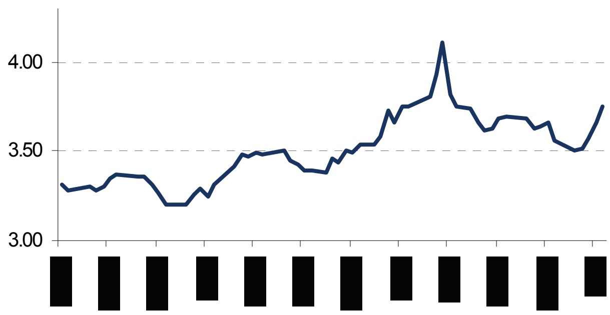
CE currencies come under downward pressure

Aside from the negative consequences of financial contagion, imported to Hungary and Poland by the strengthening Swiss franc (which undermines the balances of the households that are indebted in that currency), the worsened growth prospects of the export-oriented economies of Central Europe primarily lead to pressures for the depreciation of their respective currencies. In effect, Central European currencies have already started to depreciate. We believe that the question as to whether the regional currencies will continue to weaken or not will depend on two factors: firstly, how much the fear of the developments at the periphery of the eurozone, and consequently the value of the Swiss franc, will increase; and secondly, how deep of a decline markets will price in with respect to the leading EU economies. In both events, it is very difficult to predict how long this market process will be in the end. Yet we do already know one thing with a great deal of certainty: the process is definitely not over.

CHF/HUF



CHF/PLN



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.4	1.60%	↗	↗
EUR/HUF	277	1.78%	↗	↗
EUR/PLN	4.22	1.43%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.1409	-14.74	→	→
10Y PLN	6.52	-0.91	↗	↗
10Y HUF	4.68	-3.15	↗	↗

Review of economic figures

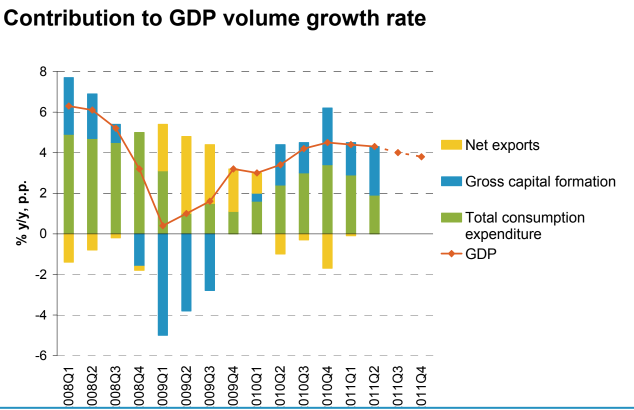
Polish GDP growth still solid

According to the preliminary forecast by Poland's Statistical Office, the domestic economy grew by 4.3% y/y in the second quarter of this year, springing a moderate upside surprise to markets as well as to us.
As concerns demand, it was again primarily driven by household consumption, which contributed 2.2% to growth; however, compared to previous quarters, investment activity also recovered significantly. The contribution of investment to growth (after eliminating the effect of inventory replenishments) was 1.4%, thus hitting the greatest value since the last quarter of 2008. The most dynamic sector in terms of generating added value in the second quarter was construction, which went up by a whopping 17% y/y. Clearly positive news is that services saw their greatest year-on-year rise since the end of 2008 (4.1%), thus going up as rapidly as industry.
In spite of the very good figures for the first half of this year, we believe that the Polish economy will decelerate in the months to come. The factors that fuelled the economy over the recent financial crisis should slowly wane. The fairly high government debt, which climbed to the vicinity of 55% of GDP last year, i.e., a level that automatically triggers austerity measures, in accordance with Poland's Constitution, should curb government expenditure in the years to come. Poland's Ministry of Finance has already announced that it envisages a deficit of approximately 3% of GDP next year (as opposed to the planned 5.6% of GDP this year). In addition, high commodity prices have made the central bank tighten Poland's monetary conditions quite aggressively. Thus the increased interest rates and a more austere budget policy should together make the economy grow at a slower rate in the second half of this year as well as during next year. Therefore we predict economic growth of 4.1% for this year and 3.6% for next year.

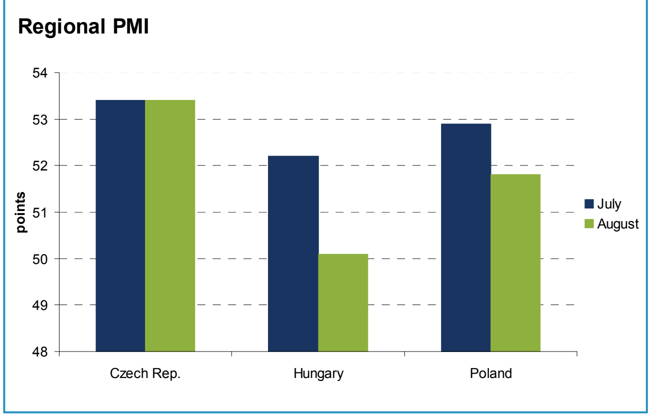
Regional PMI hover above 50

In contrast to the PMI data in the countries to the west of the Czech Republic, Central Europe fared quite decently. While the PMIs in both Poland and Hungary fell, they are still above 50. The Czech Republic's PMI did not even decline, having stood pat at 53.4, owing to the highly positive development of new contracts. Given the drops in the eurozone, this is quite a surprising figure, particularly if we take account of the Czech economy's dependence on exports. On the other hand, Czech businesses are also exposed to the uncertainty about the future development of European demand, and this affects employment.
Total contracts in Poland also went up, albeit export contracts worsened this time. Poland again seems to be able to withstand deteriorating foreign demand, due to its increasing domestic contracts, just like during the previous European recession. Hungary's PMI, unlike that of the Czech Republic and Poland, is remaining just very closely above 50 (50.1), fuelled by increasing output and employment, while new contracts plummeted.
Although the Czech Republic's PMI remained at its previous level, the overall sentiment in the economy is deteriorating. As indicated by the upswing survey conducted by the Czech Statistical Office, overall confidence in the economy is falling. The situation is deteriorating in industry, construction, and services. Consumer confidence is also falling, due to increased concern about an unemployment increase. The only group whose optimism has increased is retailers, albeit this fairly contrasts with their sales over the last two months. Year-on-year retail sales for June and July dropped, and it seems that consumer appetite is not very likely to improve in the second half of the year.

Poland:



Central Europe:



Weekly Preview

TUE 9:00 — **CZ Industry (y/y change in %)**

	Jul-11	Jun-11	Jul-10
Monhtly	**4.7**	7.4	6.0
cummulative (YTD)	**10.0**	10.8	8.8

CZ: Industry should slow down significantly

July's poor industrial output should be primarily due to a lower number of working days as well as a lower rate of new contracts in the preceding months. Production data is likely to be favourable in the automotive industry, metal production, electric equipment production, and engineering. By contrast, manufacturers of electronics, food, chemical products and probably also energy firms likely saw their production fall. New orders, which will indicate the direction of industry in the months to come, will again be more important than the data about the output increase. The development of new order has diverged thus far: while foreign orders kept going up, domestic ones have been falling for a number of months.

WED 14:00 — **HU Industrial production (%**

	Jul-11	Jun-11	Jul-10
y/y	**0.00**	1.00	12.5

HU: Industrial production stagnates on year-on-year basis

It is likely that the rise in Hungary's industrial output has virtually come to a complete halt. The last time that this has happened in the economy was 2009.

THU 9:00 — **CZ Unemployment Rate (in %)**

	Aug-11	Jul-11	Aug-10
Rate	**8.4**	8.2	8.6

CZ: Unemployment little changed

We expect that August's unemployment rate rose slightly to 8.4%, in line with seasonal developments. Seasonal work is in full swing, and therefore the number of newly created – temporary – jobs in services, agriculture, and construction was not very large last month.

By and large, the labour market situation is stabilised. Adjusted for seasonal effects, unemployment is no longer falling; it is stagnating. On the other hand, concern about a rapid deceleration or even a recession is on the rise in Europe, and thus the outlook for the Czech labour market is very unclear at the moment. The unemployment rate is likely to climb to the vicinity of 8.5% by the end of the year.

FRI 9:00 — **CZ Inflation (change in %)**

	Aug-11	Jul-11	Aug-10
CPI m/m	**0.0**	0.3	-0.3
Food m/m	**-0.9**	-0.3	-0.8
Housing, energy	**0.1**	0.3	0.0
Transportation	**0.3**	0.0	-0.8

CZ: Headline inflation unchanged in August

The consumer price index as a whole likely remained unchanged in August. Food prices probably went down, as did seasonal clothing and shoes, while package tour and fuel prices went up slightly. Nevertheless, the overall rise in prices is very moderate, still strongly curbed by poor domestic demand. We do not believe that this will change in the months to come either. Inflation will remain close to the Czech National Bank's target, and thus there is still no reason for the central bank to change rates. Inflation will not soar until the beginning of next year, when an increase in the reduced VAT rate is scheduled, pushing inflation to more than 3%.

Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	08/29/2011	9:00	Unemployment rate	%	07/2011			10.7		10.8	
PL	08/30/2011	10:00	GDP	%	2Q/2011		4.1		4.2	1	4.4
CZ	08/2011	11:00	Money supply M2	%	07/2011						2.2
HU	09/01/2011	12:00	GB bond auction/floating rate	HUF B	09/2011						
SK	09/01/2011	14:00	Budget balance	EUR B	08/2011					-1675	
CZ	09/01/2011	14:00	Budget balance	CZK B	08/2011					-61.1	
HU	09/02/2011	9:00	Trade balance	EUR M	06/2011 *F					615	
CZ	09/02/2011	9:00	Retail sales	%	07/2011						-3.5

Forex Technicals

EUR/CZK Daily Chart:

Reapproached 24.0400 (Aug 10 low) and currently reapproaching the Downtrendline off May 2010 high (see graph).

Support at 24.3300 (break-up hourly), with next levels at 24.2050/ .1900 (weekly envelope bottom/ break-up daily), where pause favored.

If unable to hold, next levels at 24.0700/ .0400 (see graph: neckline Head And Shoulders Top/ Aug low), ahead of 24.0110 (weekly Bollinger bottom) and 23.9200 (year low): tough on 1st attempts.

Resistance at 24.4460 (50 Week Moving Average→), ahead of 24.5100 (Aug 22 high) and 24.5450/ .5680 (July 19 high/ weekly envelope top), where pause favored.

24.6650 = May 26 high: tough on 1st attempts

EUR/HUF Daily Chart:

Summer spike reapproached May 2010 high (4.2400) and currently above the neckline of a long term Head And Shoulders bottom (4.1100: see graph).

Support at 4.1598 (break-up daily), with next levels at 4.1483 (weekly envelope bottom), ahead of 4.1265/ 4.1216 (Aug 31 low/ Aug 17 low + neckline short term daily Double Top): pair must sustain back below to signal return of better fortune for Zloty.

If unable to hold, new levels at 4.0996 (38.2% May low to 4.2300), ahead of 4.0613/ .0594 (weekly Medium Term Moving Average↑/ 50%): tough on 1st attempts.

Resistance at 4.2123/ .2250 (weekly Bollinger top/ Aug 18 high), where pause favored.

Failure to cap would see next levels at 4.2300/ .2333 (Aug 10 high/ weekly channel top off year low) and 4.2400/ .2455 (May 2010 high/ 38.2% 4.9300 to 3.8225): suspect tough to sustain through on 1st attempts.

EUR/PLN Daily Chart:

Rebound from new year low puts pair above channel top off 292.10 and tested widening pattern top (see graph).

Support at 274.70/ .25 (break-up daily/ weekly + weekly Short Term Moving Average↑), with next levels at 272.60/ 272.50 (reaction low hourly/ break-up daily) and 270.72/ .45 (weekly Medium Term Moving Average↑/ reaction low hourly), where pause favored.

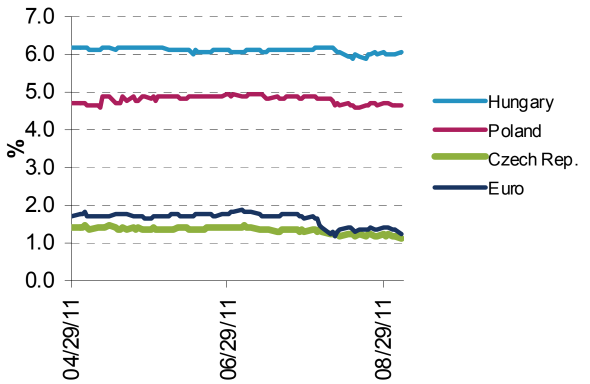
268.47/ 268.14 (current reaction low off 278.25/ % 261.90 to 278.25): pair must sustain back below to signal better fortune for HUF.

Resistance at 276.94 (weekly Bollinger top), ahead of 278.25 (Aug 09 high + weekly envelope top), where pause favored.

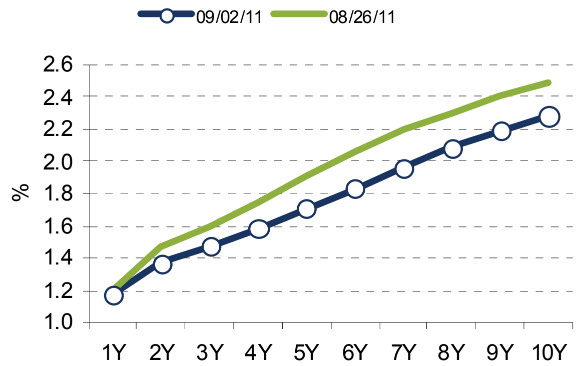
If unable to cap, next level at 280.80 (current year high: tough on 1st attempts..

Fixed-income in Charts

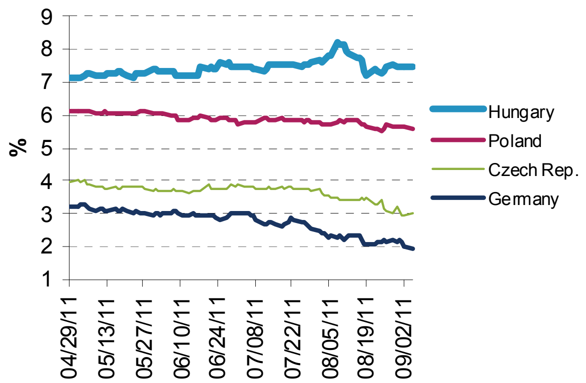
FRA 3x6



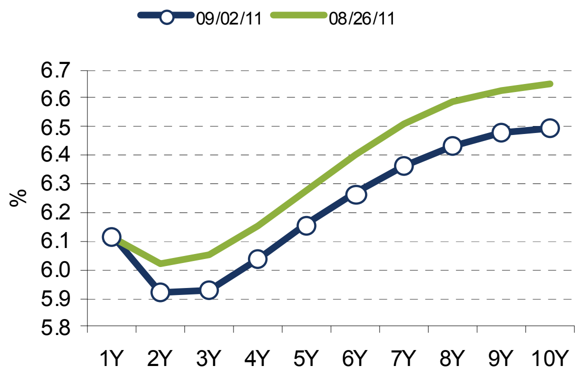
CZ IRS



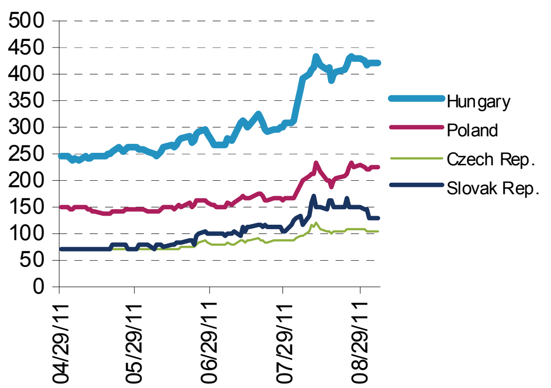
10Y GB Yields



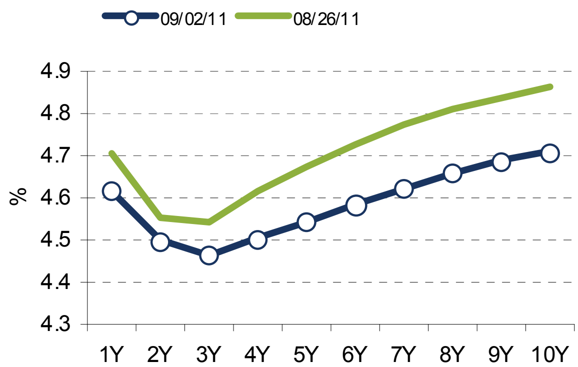
HU IRS



CDS 5Y



PL IRS



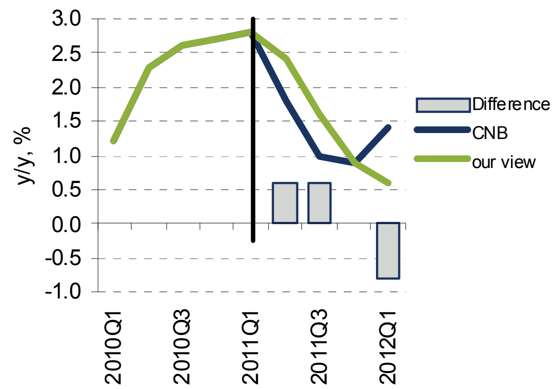
Source: Reuters

Medium-term Views & Issues

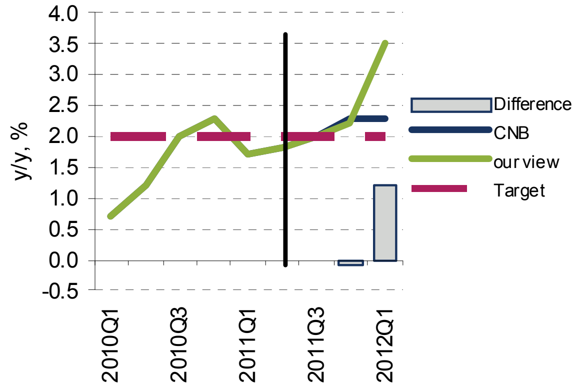
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically and to unify gradually the VAT rate in order to push the deficit below 3 percent of GDP by 2013. Despite the positive outlook of the public budgets, the government does not intend to set a target date for the euro adoption in the Czech Republic.	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.	We believe that factors that kept the Polish economy growing during the World Financial Crisis will gradually step aside and we estimate that the economy will grow at a slower pace next year. More specifically, a room for relatively loose fiscal policy seems to have diminished as the debt-to-GDP ratio almost reached the constitutional threshold of 55 % in 2010. As regards monetary conditions, higher interest rates should, in our view, contribute to a slowdown in both households' consumption as well as private and public investment during the next year.
Outlook for official & market rates	Inflation declined below the central bank's target in spite of higher fuel and foodstuffs' prices and inflation boosting administrative measures. Fuel prices as well as prices of agricultural commodities continue to pose a risk for future inflation. On the other hand, weak demand and strong koruna should counter a rise in inflation. We expect the CNB to maintain its wait-and-see policy at least until next spring. The first rate hike delivered by the Czech central bank is probable in Q2/Q3 2012 (in contrast to the current prognosis implying it in 4th 2011).	Inflation rose temporary 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 stabilized and employment growth remains sluggish. Furthermore global risk has somewhat intensified recently. Hence we believe the NBP should stay on hold for some time, at least through 1st quarter 2012.
Forex Outlook	We expect the koruna to weaken moderately after recent rally, triggered by rating upgrade. 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 as well as slow-down in eurozone economies, which should weigh on export-oriented Czech economy. 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. We continue to see the koruna stronger in 12-month horizon at 23.40 EUR/CZK.	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. 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 given our outlook the near term potential is not very encouraging. Further more we are afraid that nervousness on the eurozone peripheries combined with the risk of recession both in US and eurozone 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. Hence we believe the pair should not get significantly above 4.25 EUR/PLN.

CB's Projections vs. Our Forecasts

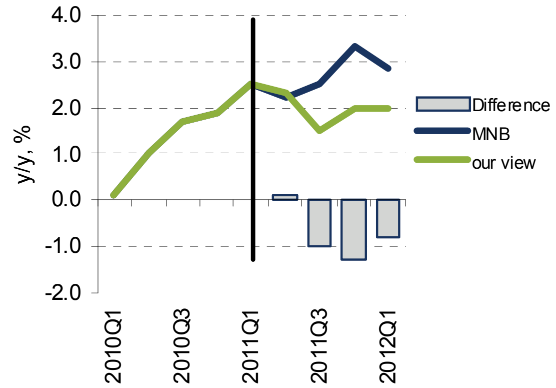
CZ: GDP Outlook



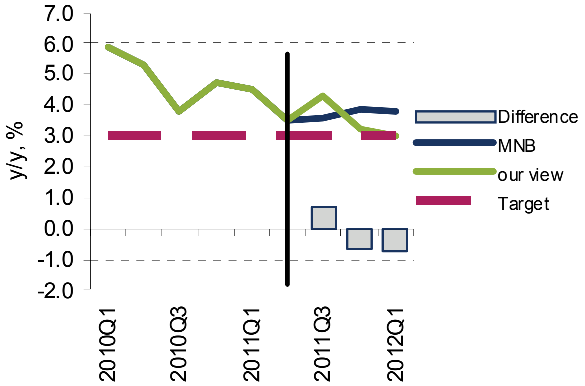
CZ: Inflation outlook



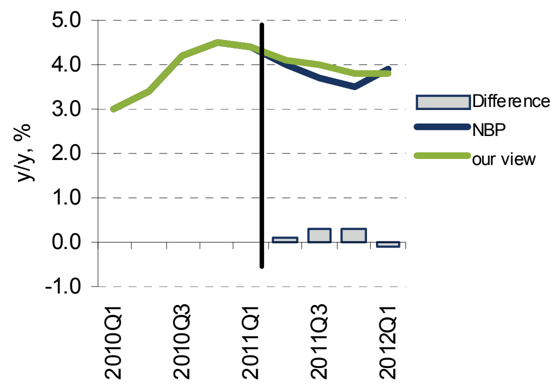
HU: GDP Outlook



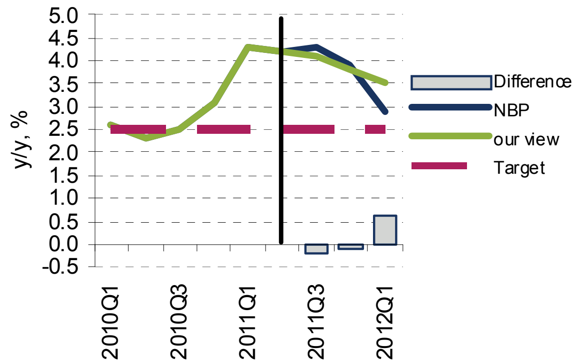
HU: Inflation outlook



PL: GDP Outlook



PL: Inflation outlook



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecast

Official interest rates (end of the period)

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	0.75	1.00	-25 bps	5/7/2010
Hungary	2W deposit r.	*6.00*	6.00	6.00	6.00	6.00	6.00	25 bps	1/24/2011
Poland	2W inter. rate	*4.50*	4.50	4.50	4.50	4.75	4.75	25 bps	6/9/2011

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

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	PRIBOR	*1.17*	1.20	1.22	1.25	1.35	1.55
Hungary	BUBOR	*6.08*	6.00	6.00	6.00	6.00	6.00
Poland	WIBOR	*4.72*	4.60	4.60	4.60	4.75	4.80

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

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	CZ10Y	*2.1409*	2.50	2.70	2.75	3.10	3.25
Hungary	HU10Y	*6.52*	7.50	7.50	7.50	7.25	7.00
Poland	PL10Y	*4.68*	4.80	5.00	5.00	5.10	5.20

Exchange rates (end of the period)

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	EUR/CZK	*24.4*	25.0	24.4	23.7	23.5	23.4
Hungary	EUR/HUF	*277*	270	270	268	265	265
Poland	EUR/PLN	*4.22*	4.20	3.90	3.80	3.70	3.70

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q3	2012Q1	2012Q2	2012Q3
Czech Rep.	*2.8*	2.4	1.6	1.6	0.6	1.0	1.8
Hungary	*2.5*	2.3	1.5	1.5	2.0	1.8	1.8
Poland	*4.4*	4.1	4.0	4.0	3.8	3.7	3.5

Inflation (CPI y/y, end of the period)

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	*1.8*	2.0	2.2	3.5	3.7	3.3	3.3
Hungary	*3.5*	4.3	3.2	3.0	2.8	2.8	2.8
Poland	*4.2*	*4.1*	3.8	3.5	3.0	2.8	2.5

Current Account

	2010	2011
Czech Rep.	-3.8	-3.6
Hungary	0.5	2.9
Poland	-2.1	-2.9

Public finance balance as % of GDP

	2010	2011
Czech Rep.	-4.7	-4.3
Hungary	-3.8	-2.9
Poland	-7.1	-6.9

Source: CSOB, Bloomberg

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