Monday, September 12, 2011

Banking & Insurance

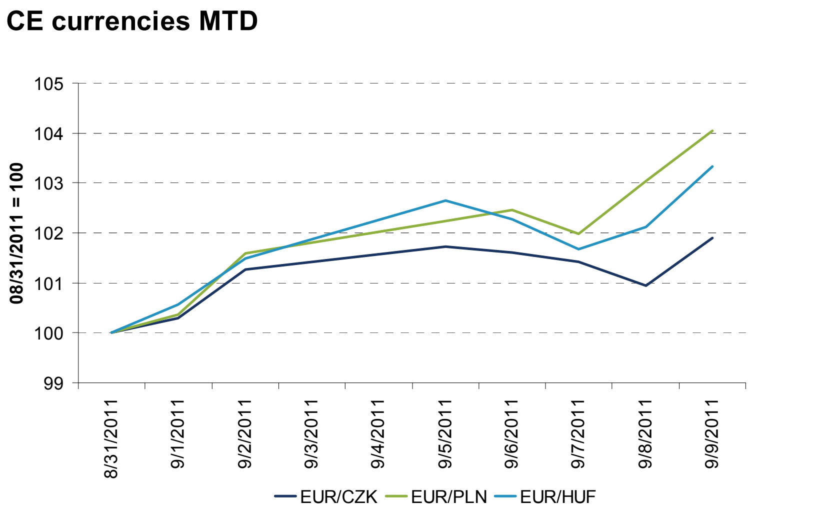
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- CE currencies face sell-of triggered by the EMU debt crisis
- Zloty defended by euros coming EU funds
- Hungarian PM Orban outlines new plan for distressed FX loans for households
- GDP details for 2Q point again to weak domestic demand in Czech R. and Hungary
- August inflation figures could be interesting across CE region

Chart of the Week: CE currencies under selling pressure



Zloty's losses were highest among CE currencies despite FX intervention.

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Market’s editorial

Contagion hits CE region

Concern about global slowdown, in combination with the risk of Greece’s bankruptcy, fully hit Central European forex markets, even though until recently the markets had shown remarkable immunity to the contagion from the eurozone. However, the last few sessions saw a great change, as all Central European currencies weakened significantly. While the zloty and forint were only temporarily encouraged by the pegging of the Swiss franc to the euro (with this slightly relieving those households indebted in the Swiss currency), the Czech koruna could not resist the regional pressure and also weakened in the end. Even so, the fact that investors or speculators partly consider the koruna to be a safe harbour in Central Europe led to a fairly small depreciation of the Czech currency, which consequently hit its strongest level ever against the Polish zloty.

Poland defends the zloty by interventions

If the global aversion to risk continues to increase, Central European currencies may, naturally, continue to depreciate; nevertheless, the regional currencies may fluctuate against each other somewhat differently, reflecting the fact that Poland’s Ministry of Finance is prepared to use its euros from EU funding for interventions in favour of the zloty (as it has demonstrated a couple of times, most recently on Friday).

New Hungarian plan for Hungary’s FX loans

Hungarian PM Orban should outline its new plan today, but it was already announced by the ruling Fidesz faction on Friday. The plan will propose to fix the exchange rate on early repayments of foreign currency based loans. For CHF/HUF loans the proposed rate is 180, some 20% below the current rate of 230 and for EUR/HUF loans at 250, some 11% below the current market rate of 281. The proposal would generate a major loss for banks, if 1/3rd of the outstanding Sfr24.8bn foreign currency debt is paid back, banks would suffer about Ft400bn loss of 1.4% of GDP. This loss is equal to 17% of the banks' capital and thus would require capital injection at some of the banks to meet the legal requirement. We think the idea will be discussed with banks and could be modified before approval. In the Parliament, the Fidesz faction has 2/3 majority and one of the three opposition parties said that they may accept to put it on the Parliament's table. Socialists and liberal LMP said that they are against. We think the proposal could be modified before accepted and banks will lobby hard to at least increase the exchange rate closer to market rates, but still it may take a heavy toll on their balance sheets.

August inflation figures could be interesting too

As concerns the high volatility on forex markets, the macroeconomic data to be released this week may catch the eye this time, where we should primarily highlight inflation in Hungary and Poland, and partly also the data on Poland’s balance of payments. Although the behaviour of Central European currencies will depend on developments in foreign markets, domestic macroeconomic data may bring the situation to a head in either direction. Particularly the forint and the zloty might be affected, if inflation were to surprise with very low levels, as was the case in the Czech Republic. That said, our forecasts of the inflation for August indicate that this scenario may happen in Hungary rather than Poland, and this is, by the way, another reason why we do not believe in a further rapid depreciation of the Polish currency.

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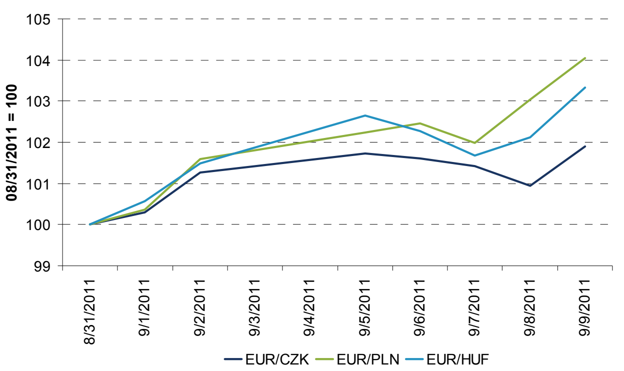
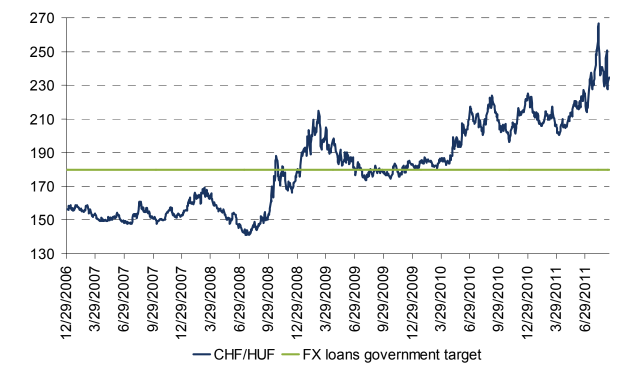
CE currencies MTD



CHF/HUF



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*24.5*	*-0.12%*	↗	↗
EUR/HUF	*282*	*1.17%*	↗	↗
EUR/PLN	*4.30*	*1.38%*	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.15*	*-1.87*	→	→
10Y PLN	*6.38*	*2.90*	↗	↗
10Y HUF	*4.76*	*4.97*	↗	↗

Review of Economic Figures

Weak domestic demand in Hungary…

Hungary's second quarter growth data repeated the preliminary 1.5% Y/Y growth. Domestic demand contracted, while net export added almost 3pp to the growth rate. The substantial drop of investment was the major reason behind the deceleration from the 2.5% Y/Y growth rate in the first quarter. Manufacturing investment is booming at a 21.6% Y/Y pace, but other investments, especially real estate are declining. The outlook is not very promising as the global slowdown could impact the export-lead recovery. Fiscal policy will also be tighter in 2012 because the government wants to lower this year's underlying budget deficit of around 5% of GDP to 2.5% of GDP.

Hungary's trade balance in July was affected not only by weak domestic demand but by the global slowdown as the trade surplus decreased to €370m from around €500-600m in the previous months. Export growth however remained relatively strong at 6.6% Y/Y, while import growth was only 3% Y/Y. There could be some further deceleration in the coming months, but tight fiscal policy could keep the balance in a surplus in the next year, as well.

and in the Czech economy too…

The economy is growing even more slowly than indicated by the first forecast for the second quarter of the year. The actual GDP grew by only 2.2%, as opposed to the originally reported 2.4%. An even greater deceleration is evident if we compare individual quarters. While GDP growth at the beginning of the year was 0.9% (q/q), it shrank to only 0.1% in the second quarter. The economy is waning hand in hand with the deteriorating foreign demand, with domestic demand being no contributor to the economy at all. Both household consumption and government consumption are declining, with only investment and inventory indicating improvements. Thus the Q2 economic growth was primarily driven by foreign trade.

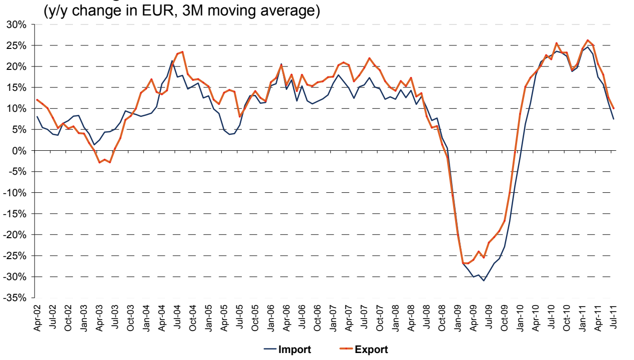
The fact that the manufacturing industry, which drives the economy, decelerated significantly in the second quarter (-2.1% q/q) is quite a surprise. Thus only the mining industry, construction, and certain services drove the GDP into the black. A look into the structure of the supply and demand sides of the economy does not provide much cause for optimism for the months to come. Although the latest hard data from industry (July) was not very bad, the industrial contracts and mood indicate the deterioration of demand. Thus the second half of the year will be certainly worse for the economy, as it will be determined by foreign, i.e., European demand, which is also unlikely to improve decently – at least within the next few quarters.

points to low inflation pressures

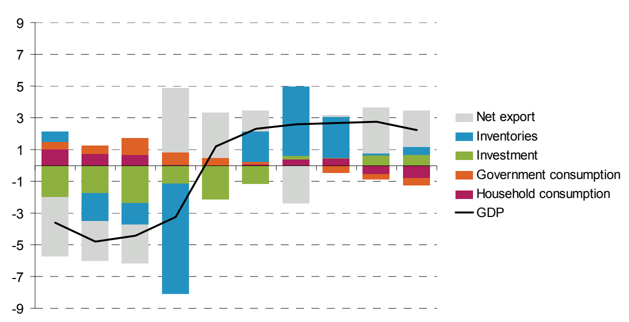
Poor demand, along with the strong koruna, curbs inflationary pressures. Thus August's inflation was even better than the market expected. The consumer price index was down by 0.3% m/m, meaning the same year-on-year price rise as in July – by only 1.7%. The main contributors to the decline in inflation again included food, the prices of which have been going down for three consecutive months. Year-on-year inflation is falling below the CNB's target, thus confirming that inflationary pressures in the economy are still absent.

Low inflation provides the central bank with another argument not to change rates for a longer period of time. Inflation is low, economic growth is easing, and the overall economic outlook keeps deteriorating. Demand-pull inflation basically does not exist and, as we cannot expect an improvement in consumer demand next year either, inflation will not pose a risk in the future. While inflation will soar at the beginning of next year, this will only be due to VAT changes. Thus the CNB may stick to its wait-and-see policy, not only until the end of this year, as indicated by its latest forecast, but also in the first half of next year.

HU: Foreign trade
(y/y change in EUR, 3M moving average)



CZ: GDP Growth Contribution
(percentage points)



In focus: Why CZK is not CHF

The Polish zloty has started to depreciate in an unprecedentedly rapid manner. On Friday, the Polish currency weakened to more than PLN 4.35 per EUR and fell to an all-time low of PLN 5.65 per CZK. This was triggered by the persisting tension on global markets and particularly by the rapid appreciation of the dollar. Curiously, the Czech koruna (otherwise so sensitive to the EUR/USD) has remained calm this time. One of the explanations may be that, after pegging the Swiss franc to the euro, the Czech currency has become a more popular safe haven for investors fleeing the forint and the zloty when global tension increases; however, markets can hardly play such a game for long. Our view is based on three strong arguments – two having to do with Poland and one with the Czech Republic.

1) The Czech economy can hardly serve as a safe haven when the situation on global markets as well as in the economy really heats up. The Czech financial market is very small and the country's real economy is too cyclical. The insight into the GDP for the second quarter indicates that the Czech Republic's growth is broadly based on decelerating foreign demand and investment by export-oriented engineering and automotive industries at the moment. Domestic consumption is low, because the government is austere and households are confronted with persisting high unemployment. Such a growth mix would be very vulnerable if the climate on global markets were to worsen. Thus we can hardly imagine that the CNB would be willing to tolerate any monetary tightening through the strengthening koruna if inflation were to be below its forecast and the central bank were facing deteriorating external factors. If, by contrast, global risks wane, the Czech koruna may easily become a currency to finance carry trade positions in the neighbouring currencies that bear much higher interest.

2) Poland's growth, compared to that of the Czech Republic, is like the other side of the same coin. Domestic demand is the fundamental driver, while foreign trade has rather been a burden to Poland's economy for more than a year. Thus the vulnerability to divergences in external demand is somewhat smaller than in the Czech Republic or Hungary. On the other hand, the weak zloty is, according to the minutes from the latest NBP meeting, the reason why the central bankers are still afraid of inflation. Although we believe that a rate hike, if any, will not occur until 2012, we cannot rule out more interventions, or at least verbal ones, if the zloty is too weak.

3) Poland's Ministry of Finance regularly, through the BGK bank, uses the periods of a weaker zloty (last time it was around the EUR/PLN 4.35 level) to sell euros from EU funding. Also, given its own foreign debt, the Ministry of Finance would not like the zloty to depreciate significantly. That said, the government strives to keep the public debt below the lawful limit of 55% of GDP, and a weak local currency may fairly complicate this. Hence we anticipate major interventions at the current levels.

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PLN/CZK

FX Correlation Matrix

	EUR/PLN	EUR/HUF	EUR/USD	EUR/CHF
EUR/CZK	0.45	0.38	-0.35	-0.29
EUR/PLN		0.63	-0.32	-0.23
EUR/HUF			-0.35	-0.35
EUR/USD				0.39

correlations of 30 min changes

over past 5 sessions

Weekly Preview

TUE 9:00 **HU Inflation (change in %)**

	Aug-11	Jul-11	Aug-10
CPI y/y	**2.9**	3.1	3.7

HU: Inflation falls because of food prices

Hungary's inflation likely fell significantly as lower food prices as domestically produced goods enter the market.

TUE 14:00 **PL Inflation (change in %)**

	Aug-11	Jul-11	Aug-10
CPI y/y	**4.3**	4.1	2.0
Food (ex Alc.) y/y	**5.5**	5.3	2.3
Transport (including fuel)	**7.0**	6.1	3.2

PL: Inflation peaks for the second time this year

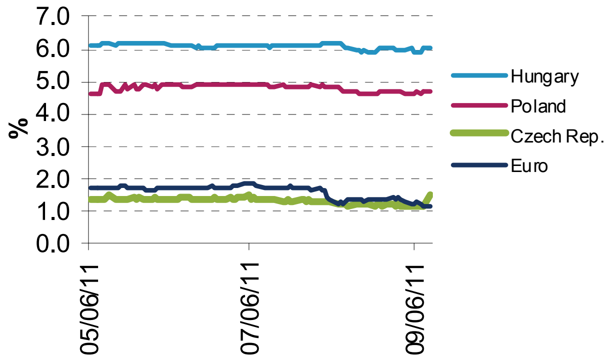
After July's surprisingly lower inflation, August's price rise should mark the second peak of the year, at 4.3% y/y. As we anticipate a moderate seasonal decline in food and soft drink prices (their weight in the consumer basket is 24%) and a month-on-month stagnation of the transport sub-index, the primary factor in the year-on-year inflation rise compared to July should be a decline in the comparative baseline (prices were down by 0.4% m/m in August last year). Although August's price rise is also likely to be well above the target of the NBP, inflation should slowly fall in the months to come, and, for the end of the year, we predict the year-on-year price rise to be in the vicinity of the upper threshold of the central bank's tolerance band, which is 3.5%.

Calendar

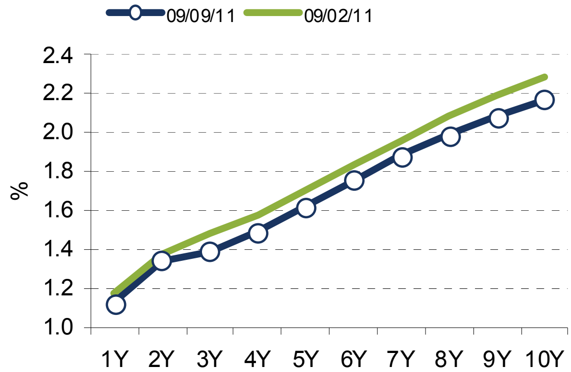
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	09/12/2011	10:00	Current account	CZK B	07/2011	-21		-20		-9.3	
PL	09/12/2011	14:00	Trade balance	EUR M	07/2011			-1081		-1065	
PL	09/2011	14:00	Current account	EUR M	07/2011			-1600		-1596	
HU	09/13/2011	9:00	CPI	%	08/2011		2.9	-0.1	3.4	-0.3	3.1
PL	09/13/2011	14:00	CPI	%	08/2011		4.3		4.2	-0.3	4.1
CZ	09/14/2011	12:00	CZ Bond auction floating rate/2016	CZK B	09/2011			8			
PL	09/14/2011	14:00	Money supply M3	%	08/2011					0.2	
HU	09/15/2011	9:00	Industrial output	%	07/2011 *F					0.8	2.7
CZ	09/15/2011	9:00	PPI	%	08/2011	0.2	6	0	5.7	-0.1	5.4
HU	09/16/2011	9:00	Wages	%, ytd.	07/2011				4.7		4.7
PL	09/16/2011	14:00	Wages	%	08/2011					0.3	5.2
PL	09/16/2011	15:00	Budget balance	PLN M	08/2011					-21.1	

Fixed-income in Charts

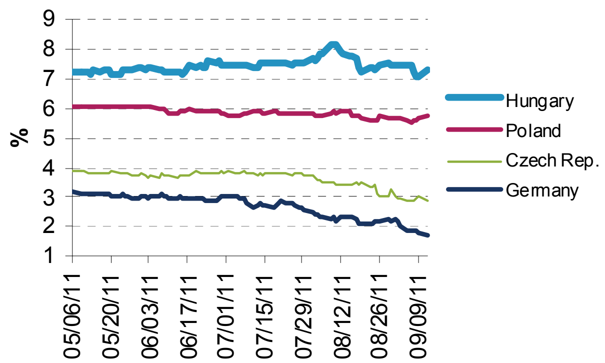
FRA 3x6



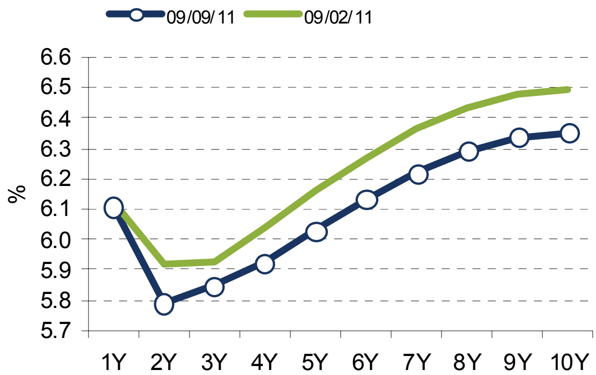
CZ IRS



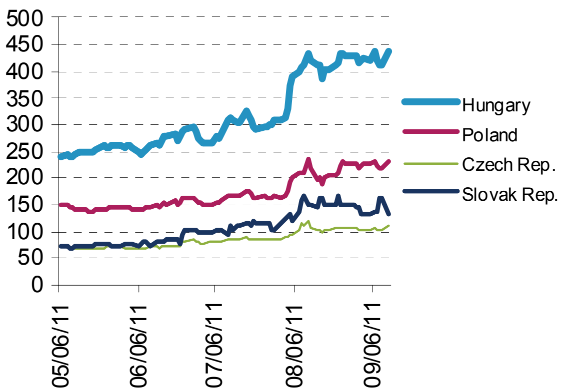
10Y GB Yields



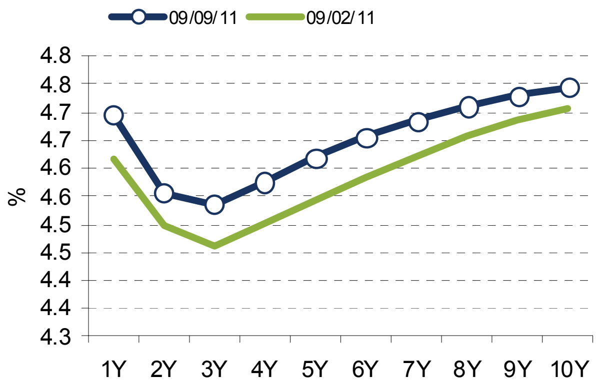
HU IRS



CDS 5Y



PL IRS



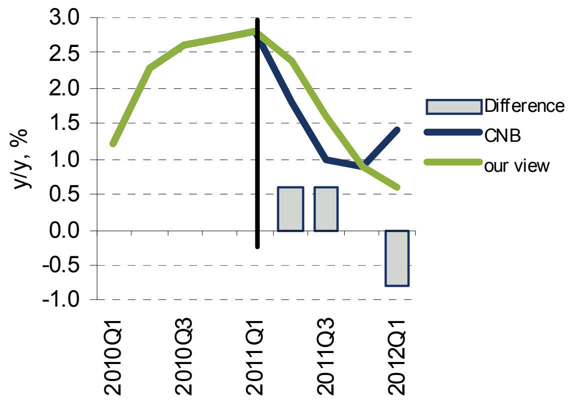
Source: Reuters

Medium-term Views & Issues

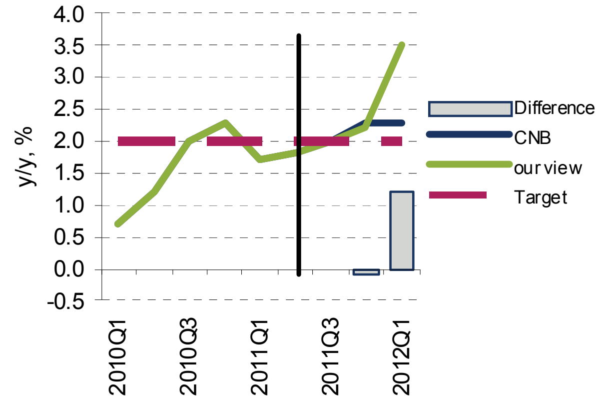
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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 Euro zone peripheries combined with the risk of recession both in the US and the Euro zone 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

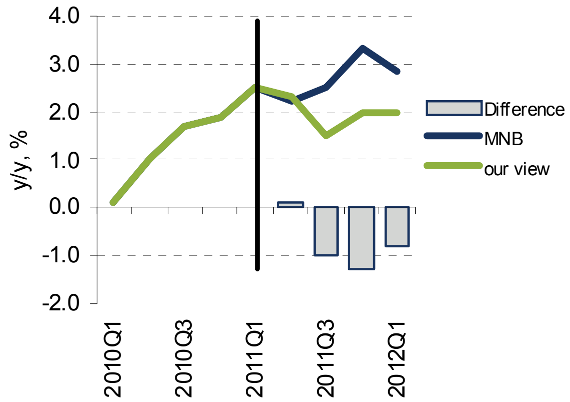
CZ: GDP Outlook



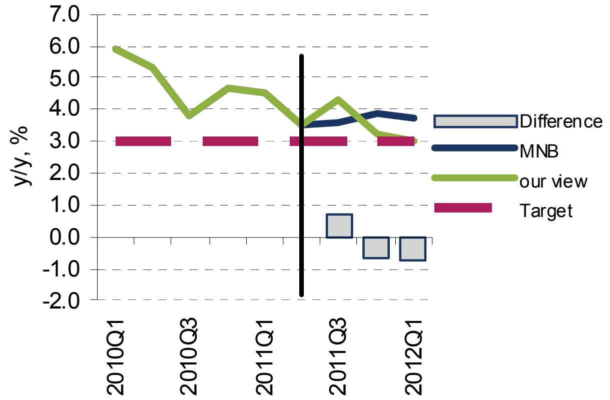
CZ: Inflation outlook



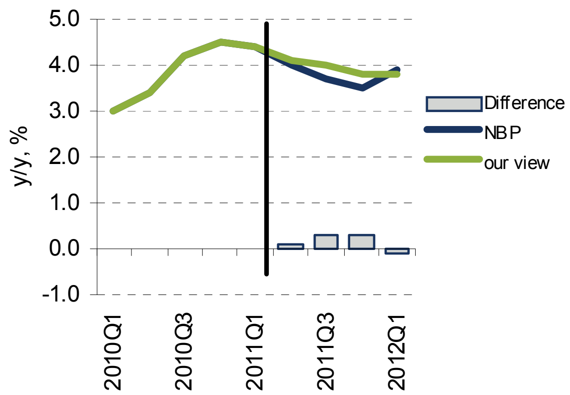
HU: GDP Outlook



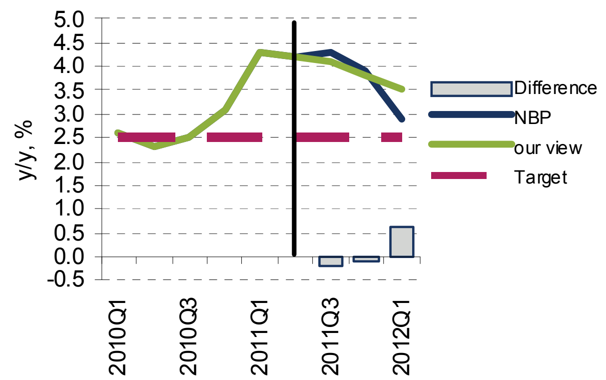
HU: Inflation outlook



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	*4.74*	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	*2.15*	2.50	2.70	2.75	3.10	3.25
Hungary	HU10Y	*6.38*	7.50	7.50	7.50	7.25	7.00
Poland	PL10Y	*4.76*	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	*24.5*	25.0	24.4	23.7	23.5	23.4
Hungary	EUR/HUF	*282*	270	270	268	265	265
Poland	EUR/PLN	*4.30*	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

Brussels Research (KBC)	
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