Monday, September 19,

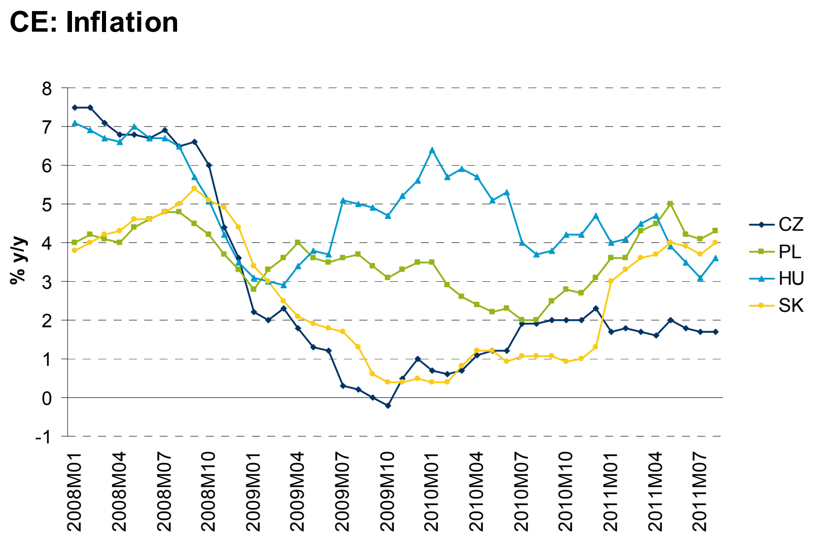
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Hungarian markets under pressure on repayment scheme uncertainty
- We expect Polish authorities to intervene in favour of the zloty
- Both Polish and Hungarian inflation surprise on the upside in August
- NBH and CNB will stay on hold, but rhetoric might be interesting

Chart of the Week: Headline inflation in Central Europe



Year-on-year inflation rates diverge in Central Europe as Poland leads in the region, while the Czech inflation remain at the lowest levels..

Table of Contents:

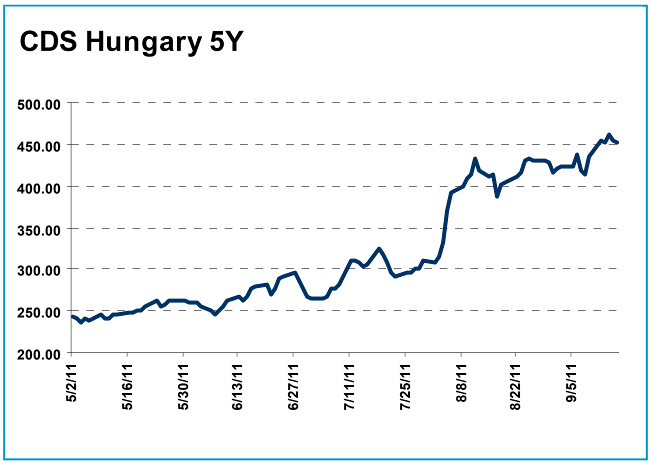
Market's editorial............................. 2
Review of Economic Figures 3
Weekly Preview 4
Calendar 5
Forex Technicals 6
Fixed-income in Charts.................... 7
Medium-term Views & Issues 8
CB's Projections vs. Our Forecasts . 9
Summary of Our Forecast 10

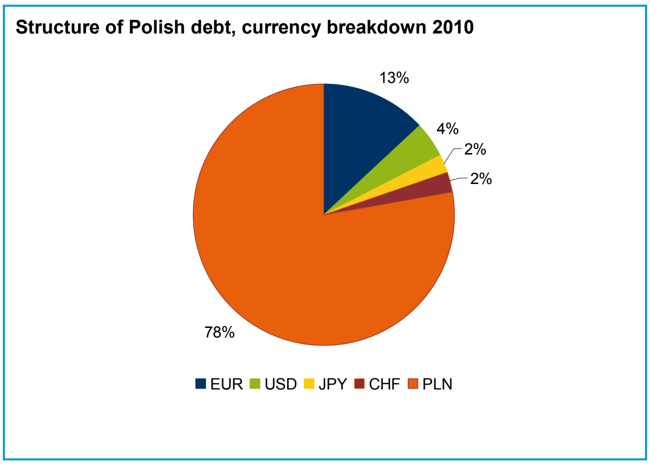
Market's editorial

Hungary's politics have stirred the region. Hungarians are masters of budgetary improvisation. They are going to have banks bear most of the costs related to household loans made in Swiss francs. The main question is the size of foreign currency demand from banks that will come from the early repayment scheme until the year-end. Expectations vary on a wide scale because nobody knows how many borrowers will be able to get a forint loan to repay their FX loan. We think that 10-20% of the foreign currency mortgages will be repaid under the scheme, which would amount to €2-4bn and banks would have a loss of 20% on this.

Hungarian bonds as well as the forint came under strong pressure, for if the foreign-currency mortgages were to be repaid earlier than scheduled, the banks would require billions of euros in cash. The pressure may ease somewhat if the Hungarian government succeeds in adopting an austerity budget for 2012.
The Polish zloty last week was affected not only by the Hungarian tensions, but also global ones, as it hit its weakest levels over the last 26 months. We are slightly surprised to see that the state-owned bank BGK, which is usually using weak-zloty periods to convert euros from Brussels, has not been very active thus far. Should the zloty continue to be exposed to pressure, the Ministry of Finance would be highly interested in defending the Polish currency, because the public debt might otherwise exceed 55% of GDP (due to a significant share of foreign debt in Poland's overall debt).

Thus far, the zloty has weakened by almost 8% since the beginning of the year. With Poland's foreign debt comprising more than 20% of its public debt, the current depreciation of the zloty may increase the public debt, expressed as a share of GDP, by nearly 1.5 percentage points. In addition, interventions in favour of the zloty are more effective if the Ministry of Finance proceeds to them in time. Furthermore, the weak zloty may irritate the central bank, which is still troubled by persisting inflation expectations. Last week, we saw that two fairly moderate bankers (Glapinski, Gilowska) would not rule out further monetary tightening..





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*24.5*	*-0.13%*	↗	→
EUR/HUF	*289*	*1.52%*	↗	↘
EUR/PLN	*4.35*	*0.41%*	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.245*	*2.51*	→	↗
10Y PLN	*6.87*	*4.41*	↗	↗
10Y HUF	*4.98*	*2.15*	↗	↗

Review of Economic Figures

Poland's inflation slightly higher than expected

According to information from Poland's Statistical Office, inflation hit 4.3% y/y in August, having slightly surprised markets (the consensus was 4.2%). Food prices went down more than we had expected and, for a third consecutive month, fell by more than 1% m/m. In spite of its significant decline from this year's highs (5% y/y), the inflation rate is well above the upper threshold of the central bank's tolerance band of 3.5% (see the chart).

According to our preliminary forecasts, inflation should go down within the remaining months of this year, and in December it might return to less than 4% for the first time since February 2011. The greatest risk to the forecast is currently the exchange rate of the Polish zloty, which is, at least for the moment, the regional currency most severely affected by the latest developments in the debt crisis in the Euro zone. Nevertheless, the slower growth of the Polish economy should also push inflation back to its target next year.

Hungary's inflation has surprised on upside too

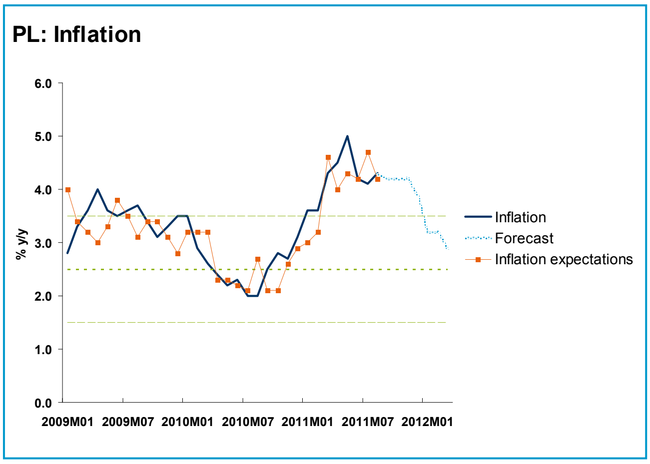
Hungary's inflation was quite a significant surprise in August, when its year-on-year rate accelerated to 3.6%. The accelerated rise is more or less due to external factors, such as the noticeably increased petrol prices and a smaller (seasonal) decline in food prices. By and large, this means that core inflation decelerated (to 3.1% y/y), unlike headline inflation.

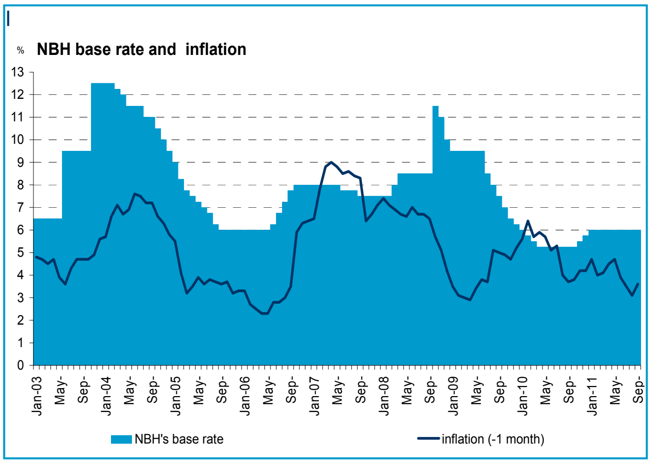
Hungary's inflation outlook remains mixed, as the price rise may be slightly boosted by the weakened forint and by the increase in certain excise duties. In both events, the contribution to the inflation rise should be 0.1-0.2%. By contrast, the outlook for 2012 continues to be fairly good, when poor demand should make (year-on-year) inflation go down slightly, towards 3%.

Hungary sticks to ambitious fiscal target

Hungary's government has recently re-introduced its fiscal plans. Recall that the government bets on 1.5% GDP growth for 2012, while it is expected to meet the deficit target of 2.5% GDP. The Government will increase taxes by Ft450bn (VAT rate will be hiked from 25% to 27%) and will lower spending by only Ft300bn.

Overall, good news for financial markets that the government plans to lower the public debt level to 72% of GDP from 73% of GDP, but the measures are a step back from the previous Szell Kalman Plan.





Weekly Preview

TUE 14:00	MNB base rate	
	This meeting	Last change
rate level (in %)	**6.00**	1/2011
change in bps	**0**	25

HU: NBH base rate still unchanged

Although the NBH will leave its base rate unchanged it could be interesting if the central bank says something about the current turbulence. Moreover the NBH may indicate that worsening inflation outlook may not be tolerated forever.

THU 13:00	CNB base rate	
	This meeting	Last change
rate level (in %)	**0.75**	5/2010
change in bps	**0**	-25

CZ: No change to CNB rates

The Czech National Bank's base interest rate has remained unchanged at an all-time low for 16 months, and money market rates are also close to their lows. While the central bank forecast indicates that the Czech Republic's interest rates should go up at the turn of the year, the worsened outlook for the European economy will work as a very strong curb to rate hikes in the Czech Republic. Hence we will see a prolonged period of central bank interest rate stability, albeit this does not mean that long-term interest rates will not continue to break away from their recent lows in the months to come.

Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	09/19/2011	14:00	Industrial output	%	08/2011			-1	2.7	-6	1.8
PL	09/19/2011	14:00	PPI	%	08/2011			0.2	6.4	0.4	5.9
HU	09/2011	14:00	NBH meeting	%	09/2011			6		6	
PL	09/20/2011	14:00	Core CPI	%	08/2011			0	2.4	0.1	2.4
HU	09/21/2011	9:00	Retail sales	%	07/2011				-1.2		-0.5
CZ	09/21/2011	12:00	CZ bond auction 2.75%/2014	CZK B	09/2011			8			
HU	09/22/2011	12:00	GB bond auction/fixed rate	HUF B	09/2011 *A						
CZ	09/22/2011	12:30	CNB meeting	%	09/2011	0.75		0.75		0.75	
PL	09/23/2011	10:00	Retail sales	%	08/2011			-0.5	9.2	0.7	8.2
PL	09/23/2011	10:00	Unemployment rate	%	08/2011			11.6		11.7	

Forex Technicals

EUR/CZK Daily Chart:

Above Downtrendline off May 2010 high (see graph).
Support at 24.3800/ .3700 (last week low/ break-up hourly), with next levels at 24.3220 (weekly Long + Medium Term Moving Averages↑), ahead of 24.2870/ .2700 (weekly envelope bottom/ Sept 09 low) and 24.1900/ .1630 (break-up daily/ hourly), where pause favored.
If unable to hold, next levels at 24.0700/ .0400 (see graph: neckline Head And Shoulders Top/ Aug low), ahead of 24.0290 (weekly Bollinger bottom) and 23.9200/ .8790 (year low/ monthly envelope bottom): tough on 1st attempts.

Resistance at 24.6150/ .6200 (Sept 13 high/ weekly envelope top), ahead of 24.6370 (weekly Bollinger top), where pause favored.
If unable to cap, next levels at 24.6650 (May 26 high).
24.8220 = 61.8% Dec 2010 high to 23.9200: tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound from new year sent the pair retesting the Uprendline off low and 285.00 (neckline long term Double Bottom: see graph).
Support at 284.51/ .11 (broken weekly Bollinger top/ weekly envelope bottom), with next levels at 282.82/ .29 (current reaction low off 288.60/ 23.6% 261.90 to 288.60), ahead of 280.85/ 280.36 (last week low/ weekly Short Term Moving Average↑): needs to sustain below to call end of alert for HUF.
Failure to hold would see next levels at 278.40 (38.2% 261.90 to 288.60), ahead of 276.39 (break-up weekly), where pause favored.

Resistance at 288.60/ 289.13 (current new year high?/ weekly Starc top), where pause favored.
If unable to cap, next levels at 290.25/ .52 (weekly envelope top/ weekly modified Alpha Beta trend top), ahead of 292.10 (July 2010 high): tough on 1st attempts.

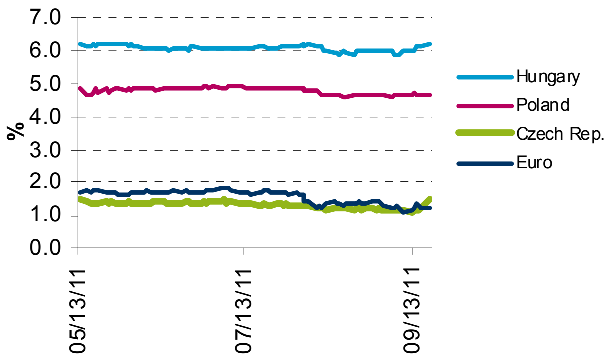
EUR/PLN Daily Chart:

New year high scored on move above the neckline of a long term Head And Shoulders bottom (4.1100: see graph: 2dt target at 4.3910 has been met) and retested the broken Uptrendline off low.
Support at 4.2815 (current reaction low off 4.4080), with next levels at 4.2713/ .2711 (23.6% 3.8290 to 4.4080?/ weekly envelope bottom) and 4.2640/ .2527 (break-up daily/ weekly Short Term Moving Average↑): needs to sustain back below to indicate lost upside momentum for €.
If unable to hold, next levels at with next levels at 4.2328 (break-up daily Sept 07), ahead of 4.2000/ .1868 (reaction low hourly/ 38.2%): tough on 1st attempts.

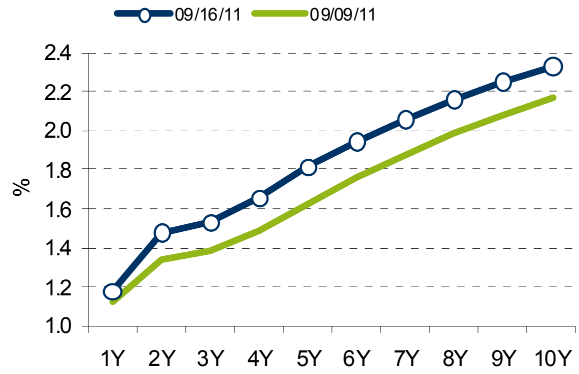
Resistance at 4.3725/ .3755 (breakdown hourly/ weekly envelope top), where pause favored.
Failure to cap would see next levels at 4.4052/ .4080 (weekly Starc top/ new year high).
4.5069 = 61.8% 49300 to 3.8225: suspect tough to sustain through on 1st attempts.

Fixed-income in Charts

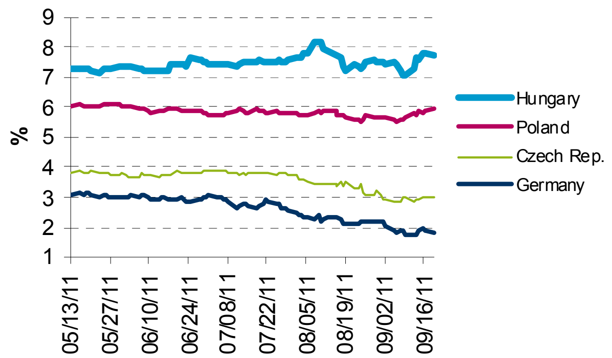
FRA 3x6



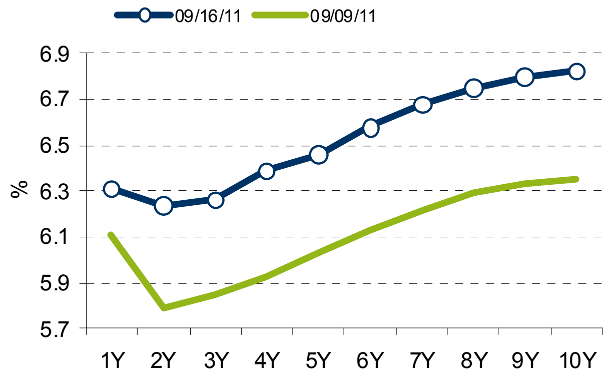
CZ IRS



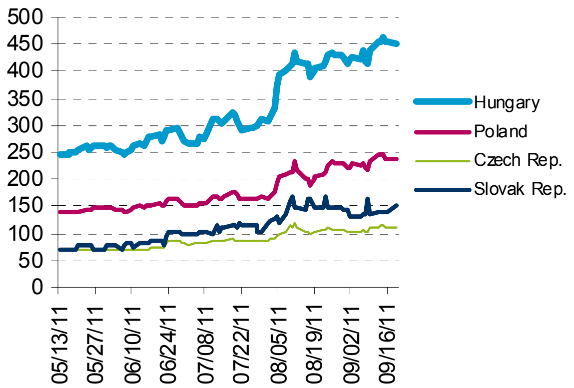
10Y GB Yields



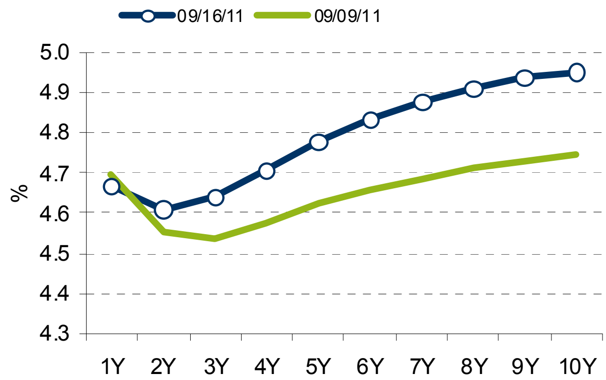
HU IRS



CDS 5Y



PL IRS



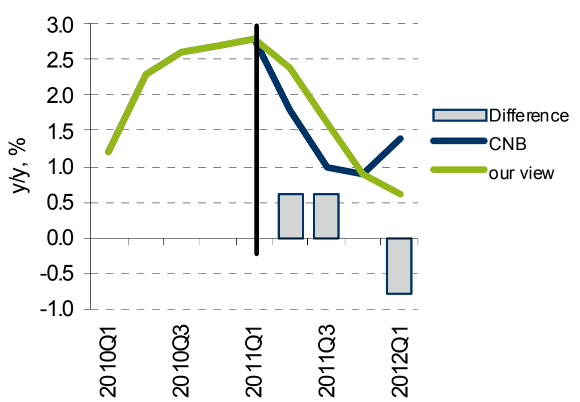
Source: Reuters

Medium-term Views & Issues

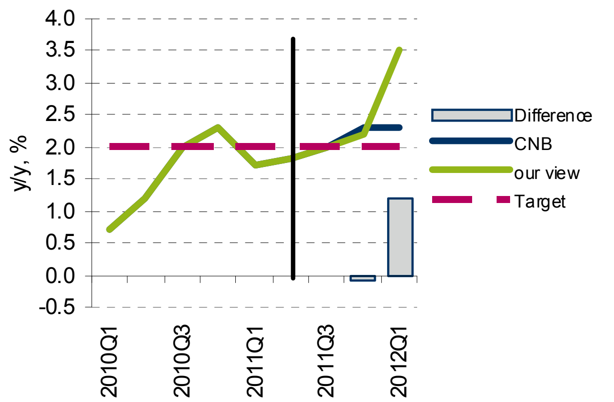
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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 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

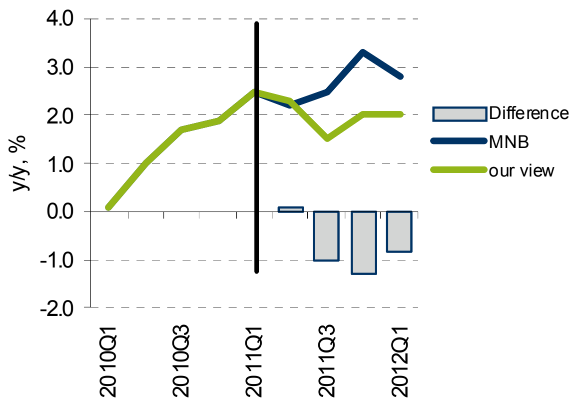
CZ: GDP Outlook



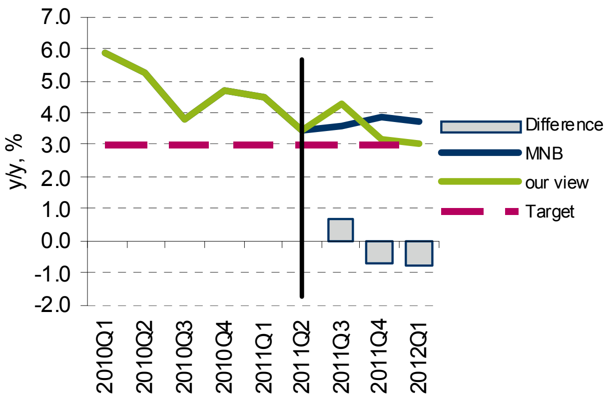
CZ: Inflation outlook



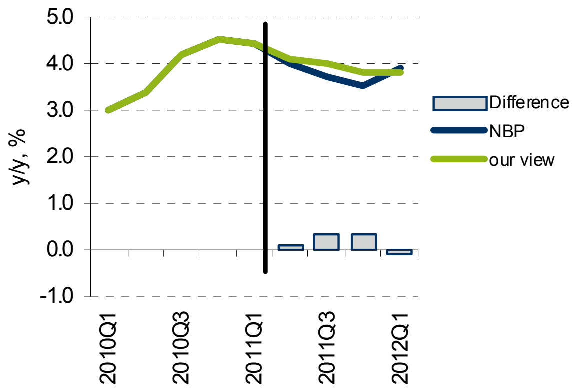
HU: GDP Outlook



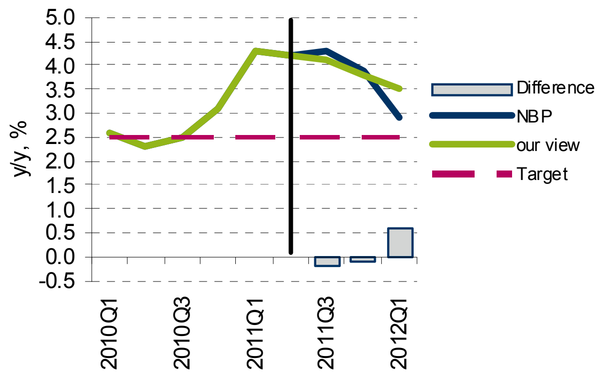
HU: Inflation outlook



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*	1.18	1.19	1.22	1.25	1.47
Hungary	BUBOR	*6.09*	6.00	6.00	6.00	6.00	6.00
Poland	WIBOR	*4.76*	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	*2.245*	2.20	2.40	2.55	2.70	2.80
Hungary	HU10Y	*6.87*	7.50	7.50	7.50	7.25	7.00
Poland	PL10Y	*4.99*	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	24.0	23.8	23.8
Hungary	EUR/HUF	*289*	295	280	270	270	268
Poland	EUR/PLN	*4.35*	4.35	4.10	3.95	3.90	3.90

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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