Tuesday, November 29,

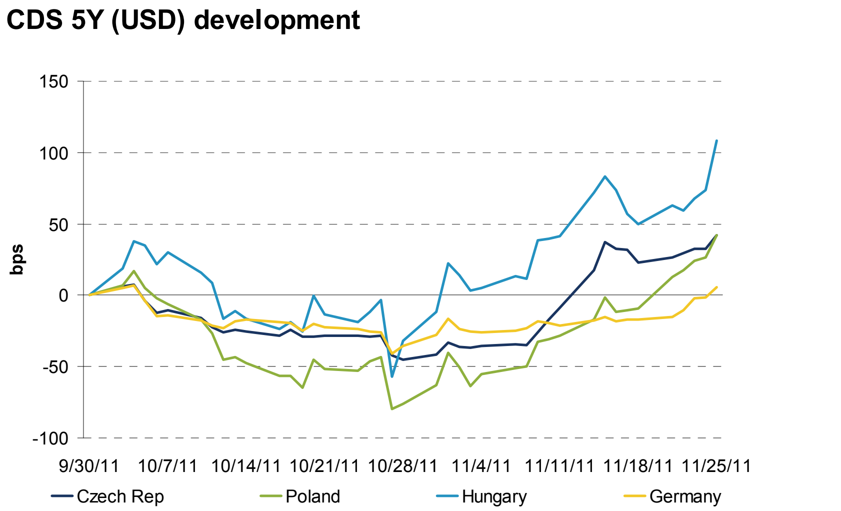
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Hungary downgraded below investment grade by Moody’s
- Forint sharply lower despite ongoing IMF talks
- Fear of euro break-up weighs on zloty and koruna…. both at multi-week lows
- We expect NBH to defend forint with 50 bps hike
- Business sentiment deterioration hits Czech economy

Regional CDS spikes:



Regional CDSs spikes in reaction to the eurozone break-up fears and Hungarian downgrade

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Market’s editorial

While the financial contagion from the eurozone had only slightly ‘tiptoed’ around Central Europe until a week ago, it has been clear to everyone in recent days that the debt crisis has also fully set foot in this region.

Contagion spreading across the region

Virtually no Central European market managed to avoid a dramatic sale, with the falls in government bond markets being the most dramatic. While the sale of Czech and Polish government bonds accelerated with the unsuccessful auction of German Bunds, the huge sale in Hungary was triggered by a Moody’s rating downgrade.

Thus the contagion is spreading, and everything looks somewhat like the crisis period of 2008/2009, when investors stopped making distinctions and started to lump all of the countries (i.e., markets) of the region together. This is again being fuelled by articles in the key financial media (Financial Times and Wall Street Journal), which are warning that the situation in the region will continue to deteriorate, because foreign banks may aggressively reduce their funding. This may indeed happen somewhere, and consistent with this, for example, is the decision by the Austrian regulator, which wants to ban the funding of banking subsidiaries in countries where the debt to deposit ratio exceeds 110%; yet, we doubt that such a measure alone might bring the situation in Central Europe to a head like in early 2009.

CEE more healthy than pre-Lehman, but still vulnerable

Unless a complete Armageddon should happen, i.e., a break-up of the eurozone or a bankruptcy of one of the large countries of the monetary union, Central European economies and financial markets should be able (albeit with the IMF’s possible assistance to Hungary or Poland) to withstand the current crisis better than they did two years ago, because, for example, Hungary’s current account has shown high surpluses for a prolonged period, or because exporters in the Czech Republic and Poland have (over)hedged their exchange rates to a much lesser extent than in 2008, thus being able to use the depreciation of the local currency to their benefit this time.

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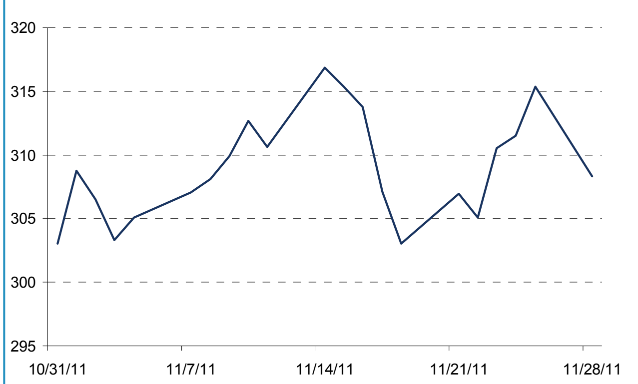
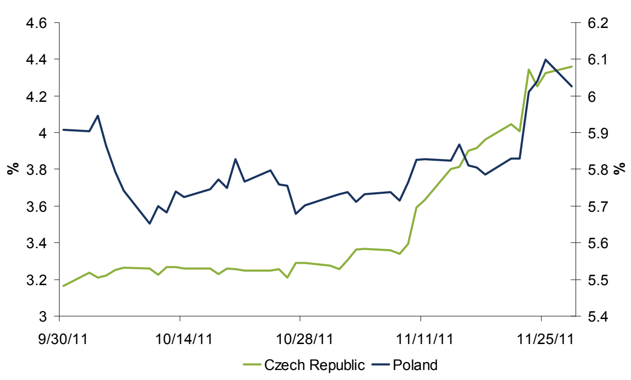
EUR/HUF



10Y bond yields



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*25.9*	*1.37%*	↗	→
EUR/HUF	*310*	*1.72%*	↗	→
EUR/PLN	*4.51*	*1.07%*	↗	→

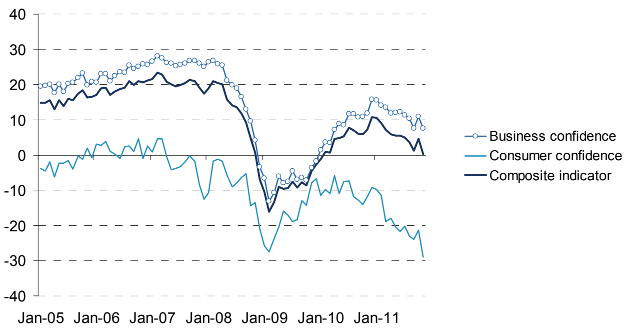
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.51*	*6.81*	↗	→
10Y PLN	*7.50*	*1.90*	↗	→
10Y HUF	*5.23*	*3.62*	↗	→

Review of Economic Figures

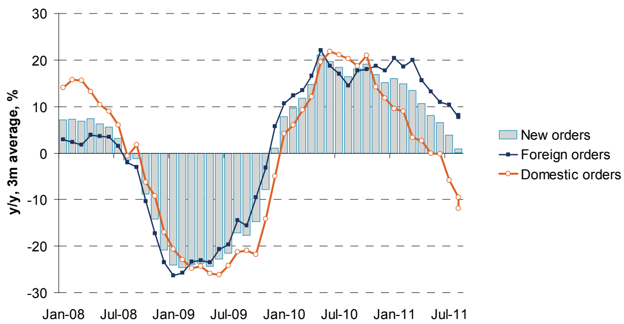
Business and consumer sentiment deterioration hits Czech economy.

While Western Europe is replete with discussions as to how to ‘resolve’ the persisting debt crisis, the economy is continuing to generate negative figures. Wednesday’s industrial contracts in Europe clearly signalled that the deceleration of the European economy was increasingly evident. September’s new orders dropped unusually quickly in the euro area, by 6.4% m/m, most notably in Italy (-9.2%) and France (-6.2%). Nonetheless, Germany’s figure was not positive even this time, with its industrial contracts falling for three consecutive months, last time by 4.4%. Demand in Europe is declining, and Europe’s industry is running out of steam accordingly. Europe’s deceleration, as clearly signalled by contracts as well as the PMI, will also hit the Czech economy. Although the Czech economy is still riding a wave of foreign demand for new cars, the period for which the economy will be able to resist the deteriorating developments in Europe may be measured only in months. After all, the pessimism has also affected the confidence in the Czech economy among businesses and consumers. November’s short-term survey conducted by the Czech Statistical Office also confirms the worsened expectations in the Czech Republic. The mood among firms operating in industry, construction, trade, and services, and, after all, also among consumers, has deteriorated. Confidence among consumers is even at its lowest level in the last twelve years. The reasons include the increasing fear of unemployment, the deterioration of household finances, and price increases, etc. This must affect consumers’ willingness to spend money, and consequently household consumption in late 2011. With consumption very unlikely to recover next year either, poor domestic demand will be one of the main factors driving the Czech economy down. And, as we can see from the development of new orders and moods in Europe, we cannot even rely on foreign demand.

CZ: Economic sentiment



CZ: Industrial new orders



Weekly Preview

TUE 14:00	MNB base rate	
	This meeting	Last change
rate level (in %)	**6.50**	1/2011
change in bps	**50**	25

HU: The NBH helps the forint

The developments in the forex market will compel the National Bank of Hungary to resort to the undesired action of a rate hike. By changing rates more aggressively, the NBH will try to stabilise the forint and the market (paradoxically), including the bond market, which has been under huge pressure since the rating downgrade and anticipates an aggressive move from the central bank.

WED 10:00	PL GDP (y/y change in %)		
	2011Q03	2011Q2	2010Q3
GDP	**4.1**	4.3	4.2

PL: Economic growth still in excess of 4%

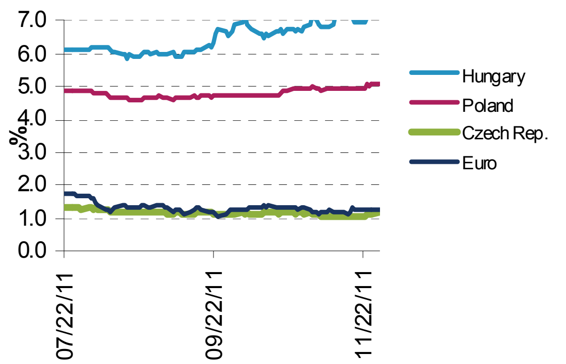
Wednesday's release of the GDP growth data for the third quarter of this year should confirm the persisting very good condition of the Polish economy. The economy grew by 4.1% y/y, according to our forecasts. Industrial output sped up slightly in the third quarter, and went up by 5.9% y/y on average, with the chemical industry faring very well. Construction has also recovered significantly over the last two years. As far as demand is concerned, particularly domestic demand should again be crucial, as Polish households are willing to spend money on consumer goods (computers, food) in spite of higher unemployment. The effect of foreign trade on GDP growth should be negative.

Calendar

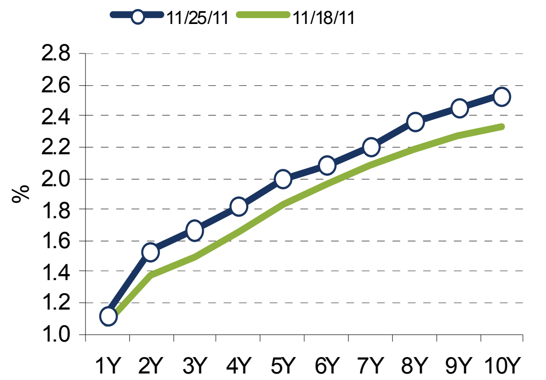
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	11/28/2011	9:00	Unemployment rate	%	10/2011			10.7		10.7	
HU	11/30/2011	9:00	PPI	%	10/2011				7	3.3	4.1
PL	11/2011	10:00	GDP	%	3Q/2011		4.1		4.1	1.1	4.3
CZ	11/30/2011	11:00	Money supply M2	%	10/2011						4.4
CZ	11/30/2011	12:00	CZ Bond auction 4.00%/2017	CZK B	11/2011			8			
PL	12/01/2011	9:00	PMI manufacturing		11/2011						
HU	12/01/2011	9:00	PMI manufacturing		11/2011					48.2	
CZ	12/01/2011	9:30	PMI manufacturing		11/2011						
HU	12/01/2011	12:00	GB bond auction/fixed rate	HUF B	12/2011						
CZ	12/01/2011	14:00	Budget balance	CZK B	11/2011					-91.5	
HU	12/02/2011	9:00	Trade balance	EUR M	09/2011 *F					741.5	

Fixed-income in Charts

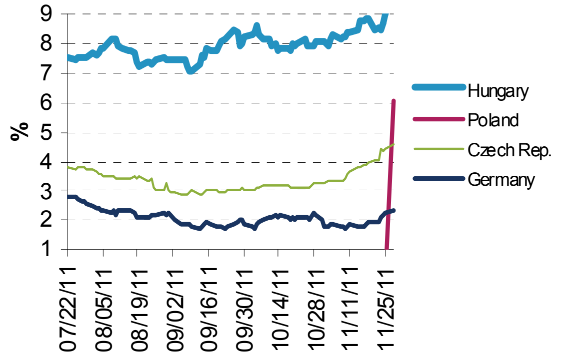
FRA 3x6



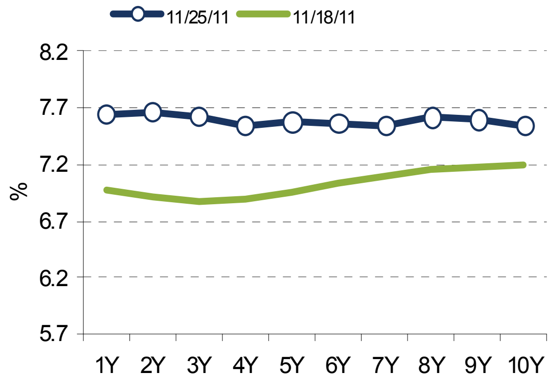
CZ IRS



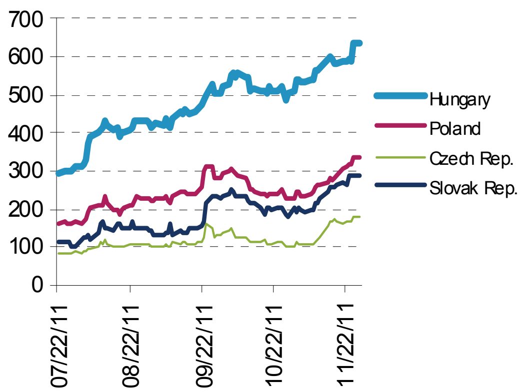
10Y GB Yields



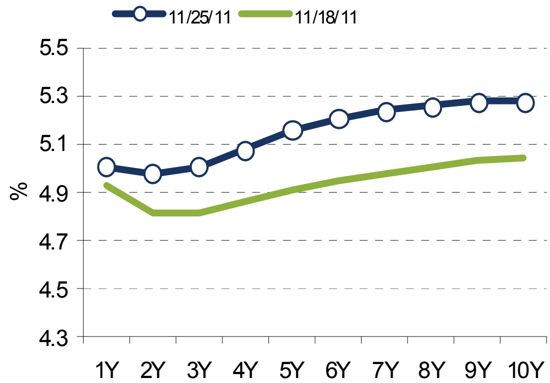
HU IRS



CDS 5Y



PL IRS



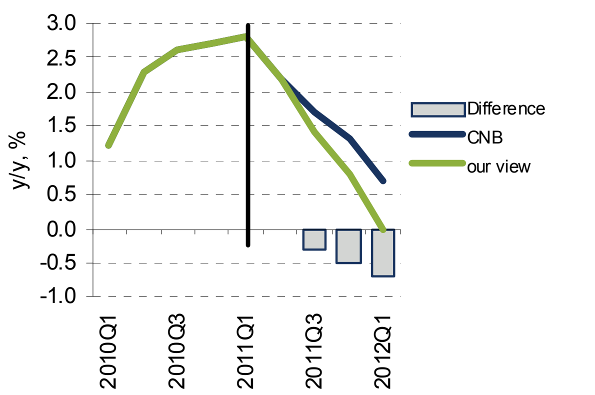
Source: Reuters

Medium-term Views & Issues

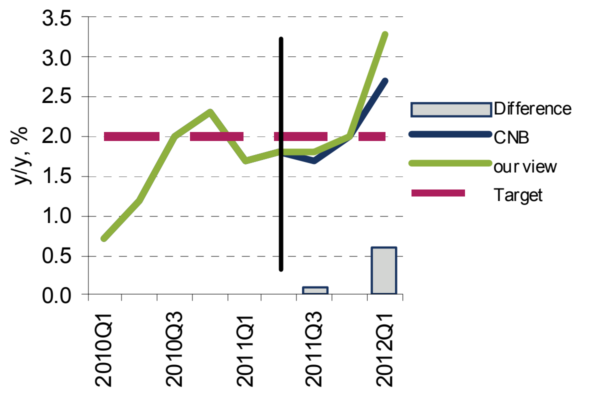
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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 increased above the central bank's target in October driven by food and fuel prices. Fuel prices as well as prices of agricultural commodities continue to pose a risk for future inflation. In January the inflation will jump above the 3% as a result of V.A.T. increase. On the other hand, weak domestic demand should counter a rise in inflation. We expect the CNB to maintain its wait-and-see policy at least until the end of the next year. The first rate hike delivered by the Czech central bank is probable in 2013H1.	We highlight the possibility of a surprise rate hike on worsening inflation outlook and deteriorating external environment. The government fiscal consolidation package contains VAT hike and several other tax increases, which deteriorate the inflation outlook, while the Greek tragedy creates a deteriorating external environment for the forint.	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	For the next few months, the Czech koruna should remain under pressure because of the escalating tension surrounding Greece and more dovish stance of CNB. Nevertheless, after the Greek issue is resolved, the koruna has potential to appreciate. 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.	Negative sentiment on global markets continued to weigh on the forint, which slid to as EURHUF reached a new record high 300. The stabilisation in 5y5y forward spread over the euro is a necessary condition for the forex market has become more optimistic about the long-term outlook.	The Polish zloty remains under pressure. The coordinated action of Polish state owned bank BGK and Polish central bank (NBP) provided certain relief to the Polish currency. Nevertheless it is questionable whether the weakness of the Polish zloty is over. It is not very clear whether the NBP or the Ministry of Finance have any strategy how to defend the currency. The markets were used to the fact that Polish authorities were comfortable with the range 3.8-4.25 EUR/PLN, where the pair stayed for nearly two years. Nevertheless this time the authorities did not mind much weaker zloty before stepping in.

CB's Projections vs. Our Forecasts

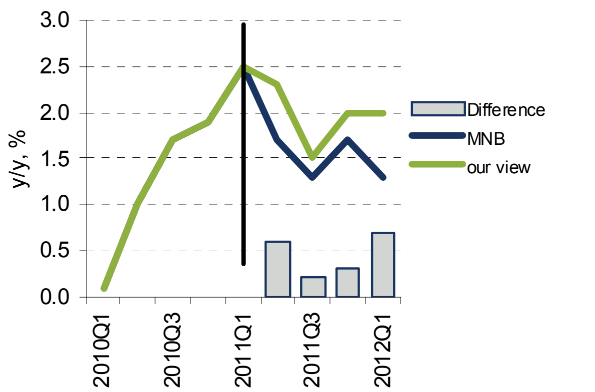
CZ: GDP Outlook



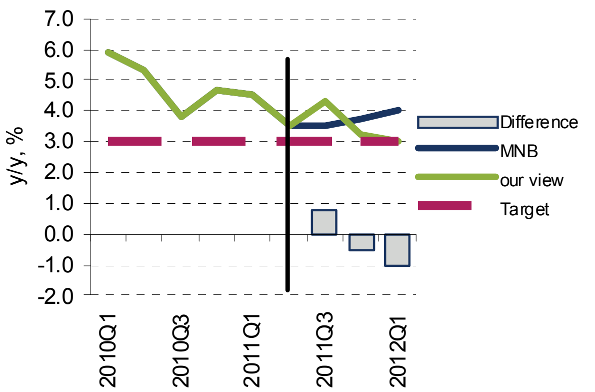
CZ: Inflation outlook



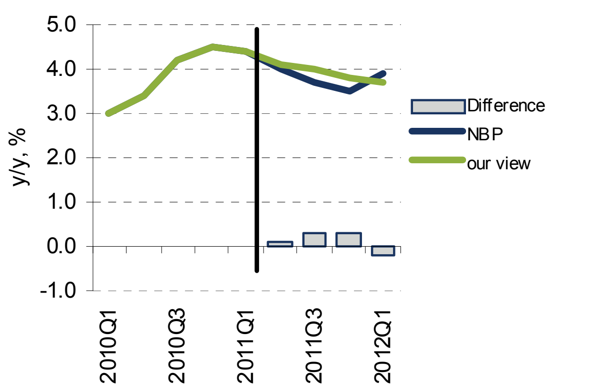
HU: GDP Outlook



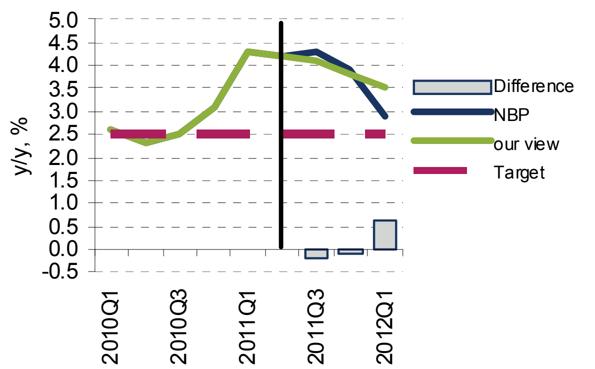
HU: Inflation outlook



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	0.75	-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	*1.15*	1.17	1.17	1.18	1.20	1.21
Hungary	BUBOR	*6.64*	6.00	6.50	7.00	7.00	7.00
Poland	WIBOR	*4.96*	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	*2.51*	2.05	2.20	2.30	2.50	2.85
Hungary	HU10Y	*7.50*	7.50	7.50	7.50	7.50	7.50
Poland	PL10Y	*5.23*	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	*25.9*	25.0	26.0	25.3	25.0	24.7
Hungary	EUR/HUF	*310*	295	280	270	270	268
Poland	EUR/PLN	*4.51*	4.35	4.10	3.95	3.90	3.90

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	*2.8*	2.2	1.4	0.8	0.0	0.4	1.4
Hungary	*2.5*	1.5	1.5	2.0	2.0	1.8	1.8
Poland	*4.4*	4.3	4.0	3.8	3.7	3.5	3.3

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

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	*1.8*	1.8	2.0	3.3	3.3	3.0	3.0
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	-5.0

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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