Monday, December 12,

Central European Weekly

Written by CSOB Prague and K&H Budapest

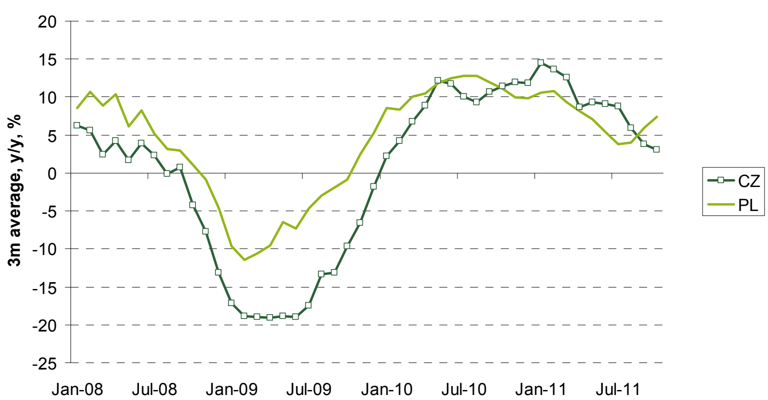
Dear clients, this the last CE weekly issued this year. The next on will be released on January 9th 2012.

Weekly Highlights:

- Industrial output finally slows in Czech Rep. and Hungary
- Czech GDP growth for Q3/2011 revised to -0,1% Q/Q
- In focus: The kiss of death called foreign-currency mortgages
- Polish inflation will further deviate form NBP target in November

Chart of the Week:

Industrial Production



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Market’s editorial

Contagion from EMU threatens real economy

October’s poor industrial output data from the Czech Republic and Hungary has again made us think that the debt crisis in the euro zone will, sooner or later, hit the real economies of even those countries that quite evidently find themselves outside the epicentre of the crisis. Particularly the drop in new orders is a warning signal, as it recalls Central Europe’s bad macroeconomic experience of late 2008 and early 2009.

The Hungarian and Czech economies are the most susceptible to a drop in foreign orders. Both economies’ exports to the EU, expressed as a share of GDP, are almost double Poland’s exports. Also, both economies excel in car and machinery exports, which are the first to be affected when the economic climate worsens. Numerous Czech machinery businesses can still well recall the autumn of 2008, when the onset of the financial crisis deprived them of virtually all new orders and froze their access to funding. The Polish economy is less vulnerable through this channel, as it is larger, slightly more closed, and above all less dependent on cars, machinery, and the manufacturing industry in general.

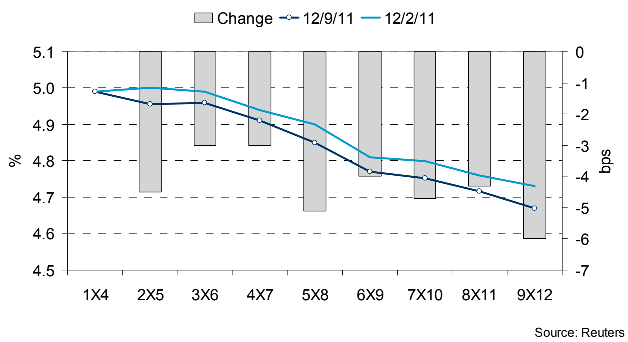
FX Mortgages pose another risk

However, the direct impact of foreign trade is not the only form of negative contagion. If governments, households, banks, or businesses with large foreign debts (or annual deficits) are active in the economy, this poses problem number two. A global financial crisis usually freezes access to foreign funds, and the debt burden becomes much heavier. As for households, Hungarians have the greatest problem with foreign debt. Governments are trying to resolve the situation by non-standard methods, the outcomes of which are mixed. If the crisis escalates and the forint weakens even more, Hungarian banks may incur capital losses of up to several per cent of GDP.

Nevertheless, the situation of the Poles is not significantly better than that of the Hungarians. More than 60% of all mortgages are denominated in foreign currencies in both countries. Poland’s only advantage is that foreign-currency mortgages have only been granted to clients with very good creditworthiness, and the depreciation of the zloty has been basically counterbalanced by rapid (nominal) wage growth. This is also why its share of problematic mortgages is not very high at the moment.

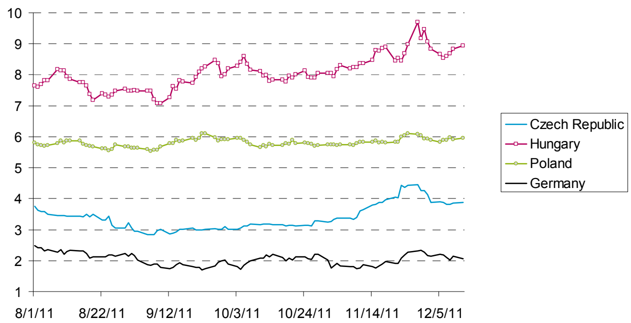
Let us add that no problem of household loans in foreign currencies exists in the Czech Republic, because none of its banks has ever launched such financing. Given the steadily low interest rates in this country, there was no reason to do so. Therefore the Czech economy is also the least vulnerable to the collapsing euro zone.

PL FRA



Source: Reuters

10Y GB Yield



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*25.6*	*1.09%*	↗	↗
EUR/HUF	*305*	*1.67%*	↗	↗
EUR/PLN	*4.53*	*-0.03%*	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.32*	*-1.28*	↗	↗
10Y PLN	*7.45*	*2.48*	↗	↗
10Y HUF	*5.06*	*0.60*	↗	↗

Review of Economic Figures

Czech economy slowing significantly

According to new figures, the Czech GDP in the third quarter dropped quarter on quarter by 0.1%. The economy was kept afloat only by foreign trade, whereas domestic demand is still in decline. Households are saving, the government is saving even more, and even investment is beginning to decline. Up to this point, the economy has been driven by manufacturing, but the third quarter clearly shows that it is running out of steam. Industry, construction, and market services have gone into a decline, leaving only agriculture, finance, and non-market services in the black. The more precise results of the Czech economy are definitely not positive. They confirm how our economy depends on the development of foreign demand, while domestic demand wanes. One more consecutive drop in GDP and we will be talking about a recession. In year-on-year terms, the economy has slowed to 1.2% and is growing slower than the entire EU and the Eurozone. And we are far from seeing the last of weak figures from the Czech economy. Next year, we are expecting further cooling in growth due to weakening foreign demand. In the better case scenario, GDP will remain in the black, but given the deepening debt crisis, a recession cannot be ruled out. After all, the most recent GDP figure is signalling the beginning of a recession.

While Czech carmakers motor on, industry slows

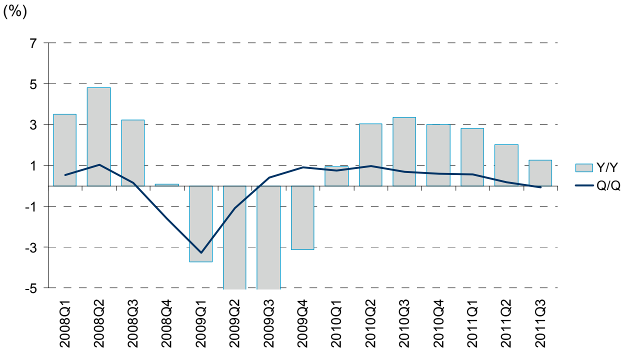
Or at least October's industrial output data indicates a rapid deceleration in the output of this driver of the economy. This time, the output only went up by 1.7% y/y and 0.1% m/m. October's figure was again primarily driven by car production, rising at a double-digit rate, while other industries lagged significantly behind it. By contrast – and in line with expectations – the electrical and food industries are falling. No change for the better is evident in orders either. Orders went up by only 2.1% y/y, with foreign orders rising, while domestic ones continued to fall rapidly. This time, even the orders in the automotive industry were not as high as expected. Industrial growth, the current driver of the Czech economy, is easing hand in hand with the decelerating foreign demand. Given the latest developments in foreign moods as well as in the purchasing managers index, we can only anticipate a further deceleration of industry in late 2011; and the end of the year will also see layoffs, which have not been evident in industry thus far. The prospects for next year – or at least its first half – are not at all encouraging, and thus the beginning of next year is very likely to see the first declines in industrial output since the last recession.

Czech inflation up due to expected VAT hike

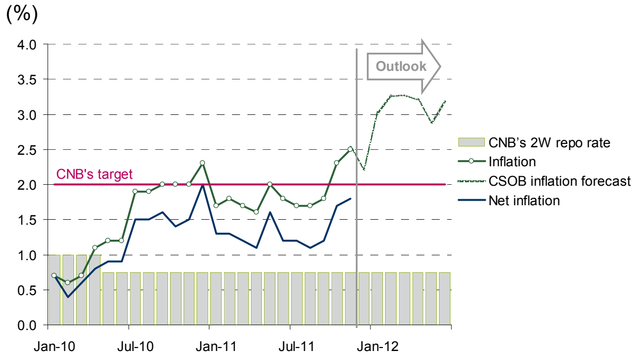
With the end of this year drawing near, Czech inflation is starting to accelerate. This time, the accelerated price rise was primarily fuelled by food prices, which went up by 1.6% m/m. We probably no longer need to speculate as to whether or not the rise in food prices accelerated because of retailers 'gearing up' for the January VAT increase. In addition to food prices, households also saw their housing costs increase rapidly this time, due to an increase in natural gas prices. Year-on-year inflation has climbed to a three-year high of 2.5%.

Furthermore, this is not the end of the price rise. January's VAT increase will also affect the prices of food, books, magazines, heat, transport… On the other hand, the persisting poor domestic demand should curb inflation at least in part. Even so, inflation is about to exceed 3% quite soon.

CZ: GDP Growth



CZ: Inflation and CNB's Target



In focus

The kiss of death called foreign-currency mortgages

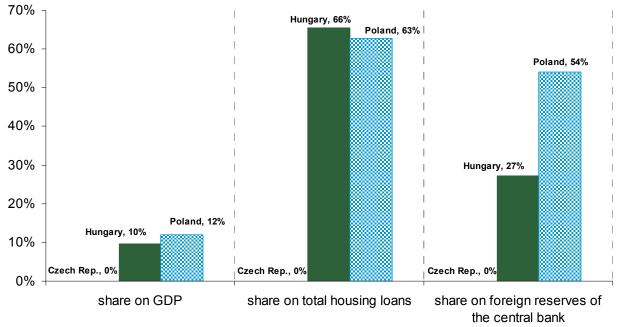
One of the channels through which the debt crisis in the eurozone is having an impact on the regional economies is the household mortgages in foreign currencies (we gave a detailed description of the loan problem in Poland in). The most significant change since July has been the fact that the Swiss National Bank (SNB) no longer likes the dramatic appreciation of the franc. Threatening interventions, the bank has basically reduced the latitude for appreciation, to prevent the currency from strengthening to less than EUR 1.20 per CHF, and, as a matter of fact, the bank has also greatly benefited Polish and Hungarian households. Given the long-term low interest rates in the Czech Republic, the volume of foreign-currency mortgages in this country is virtually negligible, expressed as a share of GDP and also as a share of the total volume of housing loans granted (see the chart).

While the above move by the SNB has reduced the unpleasant debt burden for Polish and Hungarian households (in August, one franc cost even more than 4 zlotys or 266 forints, i.e., weaker levels than at the end of last year, by 27.5% and 19.7% respectively), the further worsening of the debt crisis in the euro zone, along with the subsequent depreciation of regional currencies against the euro and the fairly stable EUR/CHF exchange rate, again squeezed family budgets. As we wrote in July, while Poland's economic growth and associated wage growth counterbalanced the depreciation of the zloty quite reasonably, this was not true of Hungary.

According to the calculations by the National Bank of Poland (NBP), the additional 30% depreciation of the zloty against the Swiss franc increases the household expenditure on mortgage payments by an additional 6% in the cohort of the least well-off Polish families (expenditures not exceeding PLN 1,000 a month), and for the largest group of households, with monthly expenditures of PLN 2,000-3,000, the estimate is 3%. Another problem, which is rather potential at the moment, is that the strengthened franc has effectively increased the total mortgage value, while real estate prices were falling during the economic crisis. As a result, the NBP estimates that the Loan-to-Value ratio of certain mortgages has increased significantly (this primarily applies to the years 2007 and 2008), with certain mortgages having even exceeded 100% LTV (meaning 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). However, notwithstanding the above facts, foreign-currency housing loans of Polish households do not pose a substantial risk to the country's financial stability.

While the situation in Poland is not particularly serious, the inability of numerous Hungarian households

Share of foreign currency housing loans on GDP, total amount of housing loans and foreign reserves



to keep up with their mortgage payments poses a significant problem, and has already made the government resort to aggressive measures. The government offered to refinance household mortgages originally denominated in Swiss francs at the fixed exchange rate of HUF 180 per CHF, i.e., with the forint value nearly 30% stronger than its current market value. Nonetheless, there are a few catches in the apparently attractive offer. Firstly, given the fairly high share of problematic mortgages (only 0.6% of households took mortgages in Swiss francs at an exchange rate higher than HUF 200 per CHF, and more than 95% even took mortgages at an exchange rate lower than HUF 180 per CHF) the National Bank of Hungary (NBH) estimates that the refinancing might be available to (only) approximately 30-40% of households. Secondly, the NBH rightly warns that the programme itself may put additional pressure on the forint to continue to depreciate, thus increasing the mortgage payments for households not participating in the programme. Hence the NBH took measures to neutralise the programme's impact on the forex market, by selling foreign currencies to the participating banks from its foreign exchange reserves, to cover mortgages repaid early. Nevertheless, the conversion of mortgages into forints will, in any event, involve re-pricing losses, which will be borne by the banking sector. Certain banks will consequently need to raise their capital in order to meet regulatory requirements. If the negative scenario should happen (a 1.2% GDP fall in 2012 with an average exchange rate of HUF 275 per CHF), the NBH predicts the capital needs at HUF 196 bn (0.7% of GDP at the target capital adequacy of 8%) or HUF 294 bn (1.1% of GDP at the target capital adequacy of 9%). Naturally, this would discourage banks from continuing to lend money, and the freezing of the lending activity would affect the real economy, thus worsening the existing problems.

That said, the outbreak of a financial crisis would have virtually no impact, through foreign-currency mortgages, on the Czech Republic. As concerns Polish banks, some troubles are likely to occur, but given the overall positive economic developments in this country and it having the greatest resistance to external shocks, i.e., a GDP decline in the euro zone, we believe that Polish households and consequently the entire Polish economy will be able to absorb the increased mortgage payments in Swiss francs. Finally, the financial crisis would have the most dramatic impact on the Hungarian banking sector, which would require additional capital injections higher than one per cent of GDP.

Weekly Preview

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

	Nov-11	Oct-11	Nov-10
CPI y/y	**4.1**	3.9	4.2

HU: Inflation will leave the inflation band of the NBH

After six months, the year-on-year inflation rate is likely to return above the upper threshold of the inflation band of the National Bank of Hungary (4.0%). The reasons for the inflation acceleration will include the weakened forint, increased fuel prices, and seasonally increased food prices.

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

	Nov-11	Oct-11	Nov-10
CPI y/y	**4.6**	4.3	2.7

PL: Inflation likely to accelerate

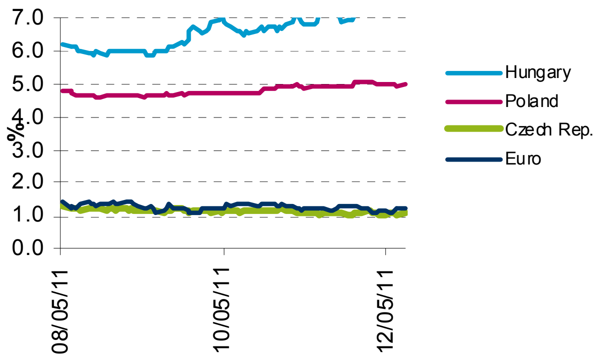
Poland's inflation is likely to accelerate to 4.6% y/y in November, due to seasonal factors and the weak zloty. Thus inflation will remain 100 bps above the upper threshold of the tolerance band of the National Bank of Poland (3.5%) and, along with the weak zloty, will continue to curb the doves on the Monetary Policy Council. Next year, the high comparative baseline and the worsening situation on the labour market should push inflation back to the target band.

Calendar

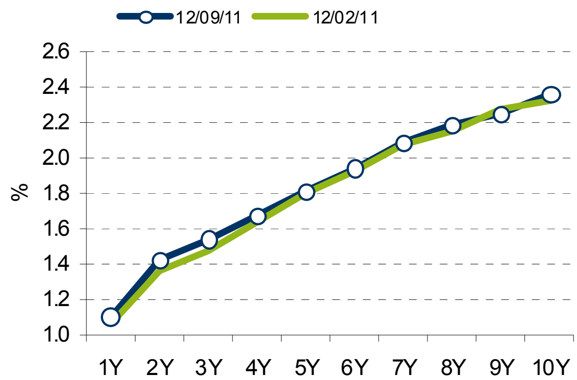
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	12/13/2011	9:00	CPI	%	11/2011		4.1	0.6	4.2	0.7	3.9
CZ	12/13/2011	10:00	Current account	CZK B	10/2011	-6.3		-2		5.17	
PL	12/2011	14:00	Trade balance	EUR M	10/2011			-584		-454	
PL	12/13/2011	14:00	Current account	EUR M	10/2011			-1715		-1901	
PL	12/13/2011	14:00	CPI	%	11/2011		4.6	0.3	4.4	0.7	4.3
PL	12/14/2011	14:00	Money supply M3	%	11/2011			0.9		0.6	
CZ	12/15/2011	9:00	PPI	%	11/2011	0.2	5.3	0.1	5.2	0	5.6
HU	12/15/2011	9:00	Industrial output	%	10/2011 *F					-0.9	3
HU	12/15/2011	12:00	GB bond auction/fixed rate	HUF B	12/2011 *A						
HU	12/16/2011	9:00	Wages	%, ytd.	10/2011				4.5		5.2
PL	12/16/2011	14:00	Wages	%	11/2011			2.3	5.4	1	5.1
PL	12/16/2011	15:00	Budget balance	PLN M	11/2011					-22.5	

Fixed-income in Charts

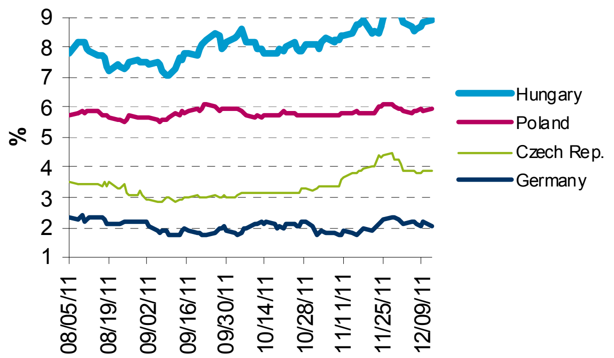
FRA 3x6



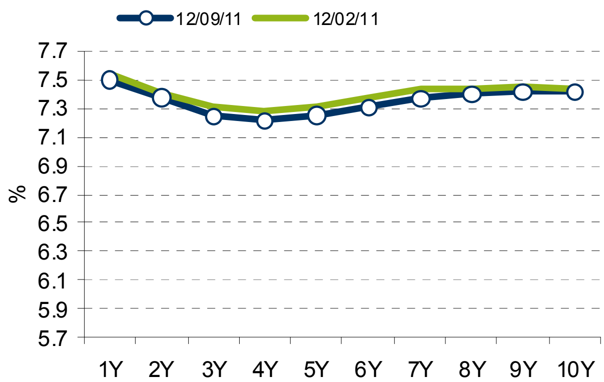
CZ IRS



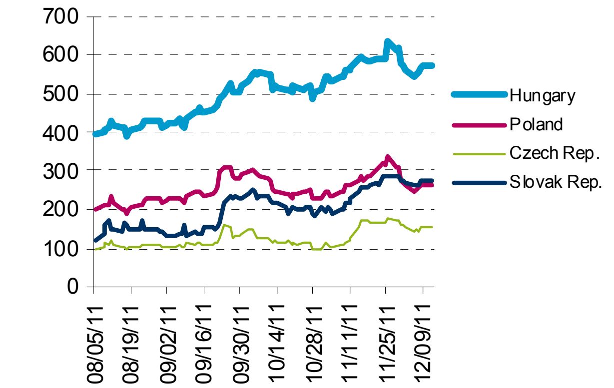
10Y GB Yields



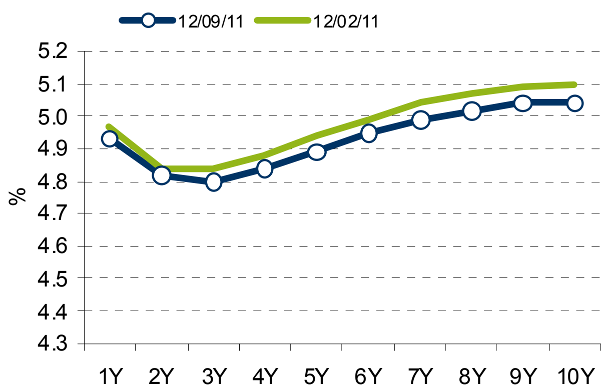
HU IRS



CDS 5Y



PL IRS



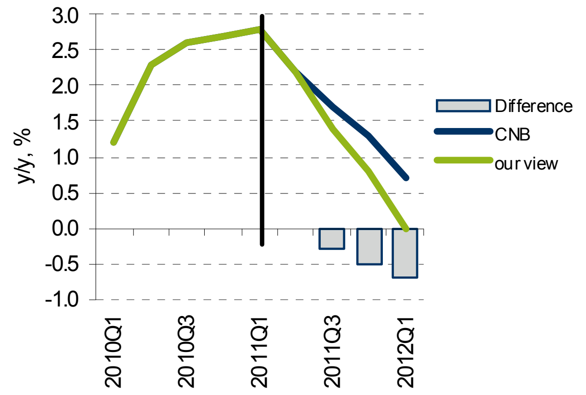
Source: Reuters

Medium-term Views & Issues

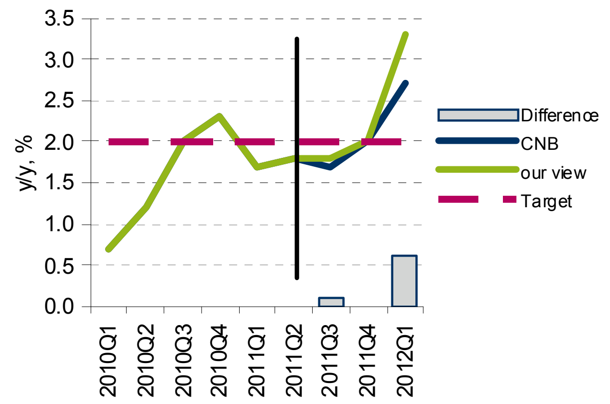
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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.	Most of the economists now expect a recession for Hungary in 2012 partly because some foreign banks will have to drastically improve their loan/deposit ratios. The growth forecast could be a key point in the upcoming IMF talks and probably this is the reason why the government has been talking to the central bank about it. A weaker growth outlook may also require additional fiscal measures, especially if the IMF opens only the stand-by loan facility instead of the precautionary credit line.	We believe that Poland's economic growth for may be 4.1% in 2011 (due to the very favourable figures for the first three quarters). Nevertheless, we expect 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 and higher interest rates should, in our view, contribute to a slowdown in both households' consumption as well as private and public investment.
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.	The Hungarian central bank matched analysts' expectations and hiked the base rate by 50bps to 6.50%. As expected the MNB highlighted inflation concerns due to the weaker currency in the statement. It added that it may continue to tighten if financial risks remain elevated, implying another 50bps move on the next meeting in December.	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	The Czech koruna should remain under pressure because of the escalating tension surrounding euro-crisis management. Nevertheless, if the worst case scenario of eurozone meltdown is avoided, the koruna has potential to appreciate. Slow continuation of real convergence, should remain a positive long-term factor for the Czech currency. Hence after current correction with short term target around 26.10 EUR/CZK, we continue to see the koruna stronger in 12-month horizon at 24.50 EUR/CZK.	Upcoming weeks will show whether the recent MNB policy change (into more hawkish stance) will be sufficient to stabilize the currency. We believe that yesterday's rate hike goes into a right direction, but naturally a lot will depend on the euro-zone crisis and outcome of the IMF talks.	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

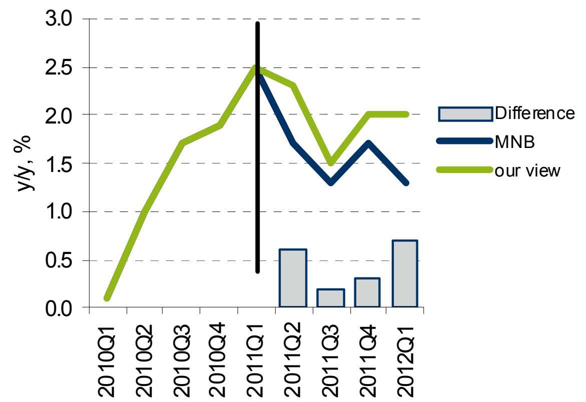
CZ: GDP Outlook



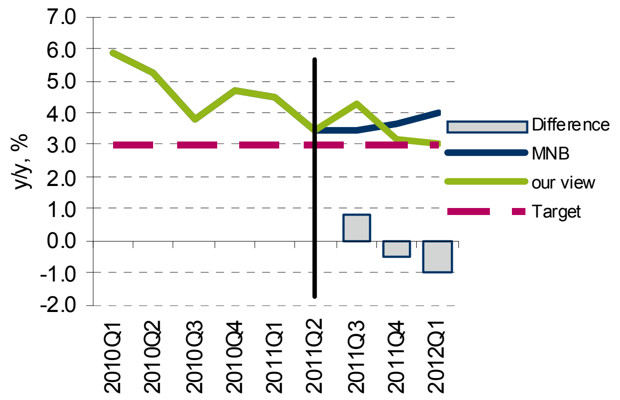
CZ: Inflation outlook



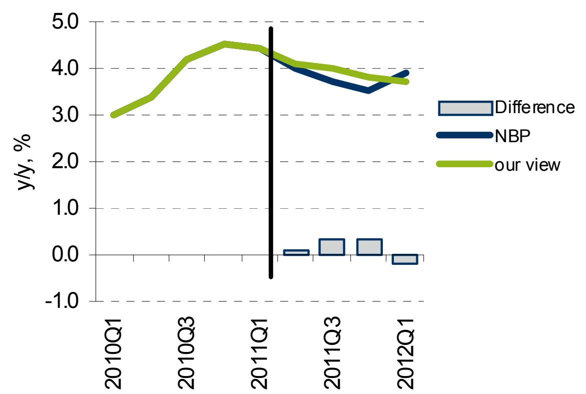
HU: GDP Outlook



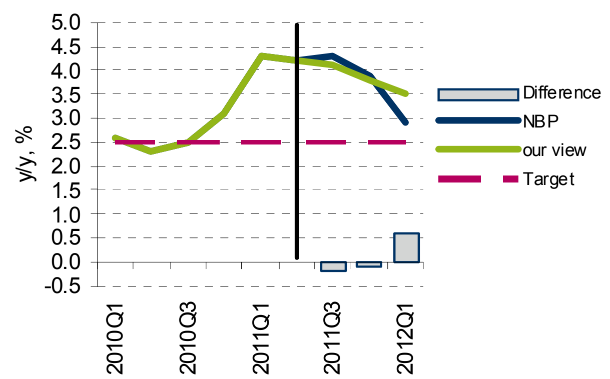
HU: Inflation outlook



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.	*6.50*	6.00	7.00	7.00	7.00	7.00	25 bps	11/29/2011
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	*1.16*	1.17	1.17	1.18	1.20	1.21
Hungary	BUBOR	*6.99*	6.00	6.50	7.00	7.00	7.00
Poland	WIBOR	*4.98*	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	*2.32*	2.05	2.20	2.30	2.50	2.85
Hungary	HU10Y	*7.45*	7.50	7.50	7.50	7.50	7.50
Poland	PL10Y	*5.06*	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	*25.6*	25.0	26.0	25.3	25.0	24.7
Hungary	EUR/HUF	*305*	295	280	270	270	268
Poland	EUR/PLN	*4.53*	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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