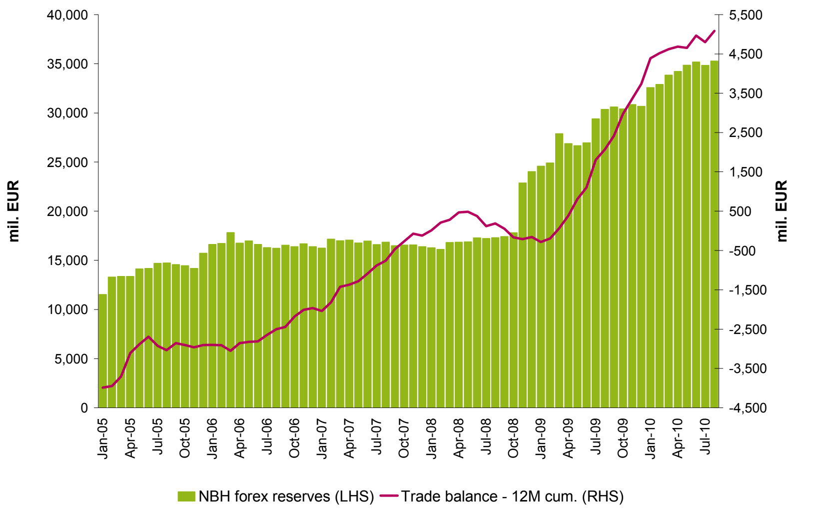
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- While sell-of in Hungary intensifies, Government talks with the IMF will be crucial
- Higher Czech inflation and unemployment rate undermine consumer spending
- In Focus: New EUR/CZK outlook for 2012
- Weekly Preview: While Polish inflation dips, NBP stay on hold

Chart of the Week: Hungary's FX reserves and trade balance



Although the forint is under huge pressure Hungary's foreign trade is in a record surplus and FX reserves stand at all-time highs too.

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Market's editorial

Hungary still in focus

Hungary is again under fire from financial markets, this time because of domestic mistakes by the creator of Hungary's economic policy, rather than because of contagion from the eurozone. These mistakes (quite unnecessarily) prompted investors to doubt that Hungary (i.e., its government) may have a problem covering its foreign debt service.

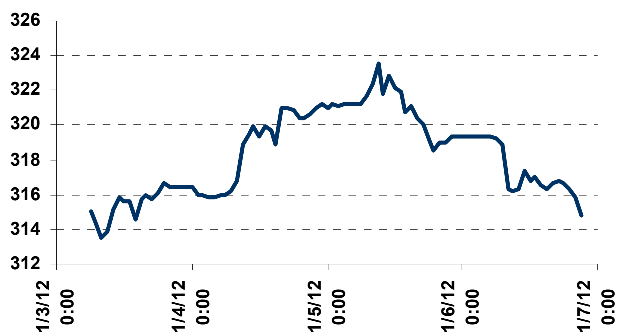
Better fundamentals, but not all

Before we start to explain Hungary's urgent problems, we should perhaps briefly summarise the latest macroeconomic developments in this vulnerable economy. Bear in mind that in 2008, before the global financial crisis broke out, Hungary had to apply to the IMF for a loan. At that time, the country's current account deficit was in excess of 6% of GDP and its own forex reserves were far from being able to cover the short-term debt due in the following year. Strict domestic austerity measures have improved Hungary's balance significantly since then, and thus Hungarians can now enjoy a current account surplus and their forex reserves cover more than 130% of the short-term debt due next year. What is the problem then?
Although the current account shows a surplus, the overall foreign debt remains high, due in particular to overly indebted households (160% of GDP). Hungarians either have to repay the debt or refinance it on markets, which need to trust the country. And therein lies the greatest problem. The Hungarian government has achieved the current account surpluses by means of a set of non-standard measures, beginning with imposing extraordinary taxes on supranational corporations, then nationalising the private pension system, and now reducing the central bank's independence. In short, representatives of the Orban government say that the Hungarian central bank has to cooperate and assist the economy. Ideas like that, which undermine the independence of the NBH, rightly scare foreign investors. In addition, another conflict is looming with the European Union and the International Monetary Fund, and at an unpleasant time: the situation on global markets is not good, and Hungarians have to return almost EUR 4.6bn to the IMF this year. Although they could use their forex reserves (more than EUR 35bn), a country with a high foreign debt and shrinking forex reserves would quickly lose the remaining confidence of not only markets but also its own public.

Talks with the IMF will be crucial this week

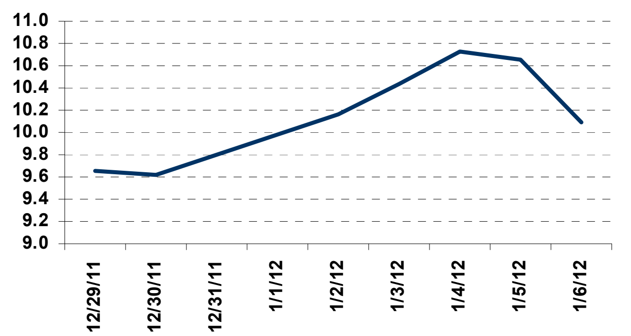
This week will be crucial in that regard, because a Hungarian government delegation will hold talks with the IMF in Washington, to obtain a new stand-by loan. At the moment, it seems clear that Hungary cannot live without an agreement with the IMF, and thus it should quickly find common ground with its rescuers. Otherwise, the depreciation of the forint and government bonds would be disastrous, and it would ultimately be up to the stubborn NBH to stop the sale of Hungarian assets, by means of (interest rate or forex) interventions, in any event.

EUR/HUF



EUR/HUF, over past week. Source: Reuters

HU: 10Y government bond yield



HU GB 10Y, over past 7 days. Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25,8	0,02%	↘	↗
EUR/HUF	315	-0,47%	↘	↗
EUR/PLN	4,49	0,40%	↘	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2,17	0,00	→	↗
10Y PLN	7,87	0,13	→	↗
10Y HUF	5,06	2,02	↘	↗

Review of Economic Figures

Czech unemployment went up sharply at the end of the year

At the end of the year, the unemployment rate jumped up to 8.6%. Compared to November, that means growth by six tenths of a percent. At first glance, that is a large jump, but unemployment growth is typical for December, even in good years. Even so, unemployment at the end of 2011 was one percentage point lower than in 2010. Given the popularity of limited-term employment agreements, December brings a significant expansion of the ranks of the unemployed. Furthermore, last year, certain companies that are facing a lack of orders, have started to layoff. 2012 will be marked by unemployment growth – in some months even in excess of 9%. In spite of that, we expect that at the end of the year, unemployment will be in the vicinity of nine percent.

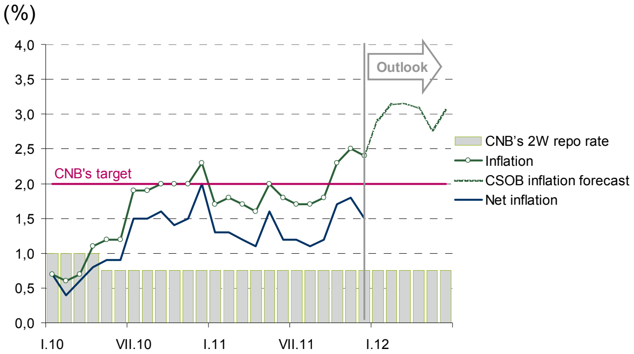
End of the year marked by higher food prices

The year-on-year inflation rate in December dropped from November's 2.5%, to 2.4%. In December, however, the trend of increasing consumer prices continued, rising by 0.4% in that month alone. Consumers paid more primarily for food. It was again confirmed that retailers had been preparing for the increase of the lower VAT rate for several months and increased their prices in advance. On the other hand, it will also mean that in January the jump in food prices has not been as significant. In spite of that, January's inflation will most likely exceed three percent, due to the effect of the higher VAT and regulated prices jump. But even higher inflation should not make the central bank increase the main interest rate, which remains at its record low. This year's higher inflation will probably entirely erase the wage increase, and real wages will also drop as well as domestic demand.

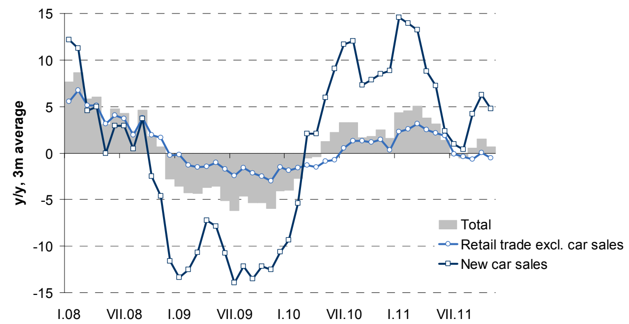
Consumers again spent a bit more in November

Contrary to expectations, retail revenues grew due to the strong new car sales in November. But – as media reported –an important part of new car sales are headed abroad. What was not surprising, however, is the decline of the retail in general (excluding automotive segment). It is evident that people are spending relatively carefully and only car vendors and e-shops are doing well. The December figures were most likely similar. We do not think that Christmas sales were stronger than in 2010. The more that people spend in e-shops and abroad, the less they spend in domestic retail outlets. 2012 will be marked by a further weakening of retail sales as a result of real wages drop and fear of unemployment.

CZ: Inflation and CNB's Target



CZ: Retail sales



In Focus: New EUR/CZK outlook for 2012

Here we go with our updated outlook for EURCZK:

1. The Czech koruna should remain under pressure for the next few months, due to the escalating tension in the eurozone. We believe that three moves need to be taken to eliminate the tension. Firstly, a larger haircut of the Greek debt has to be agreed upon. The effort to reach an agreement among Greece, the IMF, and financial institutions is still going to be complicated (it should be complete by the end of January). Secondly, the ECB will likely have to back Italy and Spain. Both countries are solvent in long term (unlike Greece); however can face serious liquidity problems in the short term without the ECB's. Especially Italy should find it difficult to refinance more than €150bn of its debt over the first four months of this year. And thirdly, European banks should boost capital to meet new requirements (9% capital adequacy) as fast as possible. Capital-hunting maintains extraordinary tensions and uncertainity on the markets today (Uncicredit is the most obvious example).

Warding off the worst scenario of the euro breakup may relieve all risky assets, including the koruna, in the end; however, managing the crisis will not at all be easy. This is why the Czech currency may face increased volatility soon, with a potential depreciation to the EUR/CZK 26.6 level.

2. **In the first half of the year, the volatility of the koruna may also be augmented by regional factors.** Before the Hungarian government reaches an agreement with the IMF (the first quarter of the year probably), the Czech koruna may suffer from increased sensitivity to negative news from global markets. Poland's reduced willingness to defend the zloty by interventions may have the same effect in the end.

3. If the eurozone succeeds in pulling the emergency brake in 2012, all Central European currencies, including the Czech koruna, may also fetch a sigh of relief. **The koruna should subsequently strengthen, primarily owing to the re-pricing of system risks. Nevertheless, long-term fundamentals will not favour any huge appreciation in 2012.** Just like in 2011, the real convergence will continue to be very slow, and the Czech National Bank should not help the koruna either, as the central bank is likely to keep interest rates at all-time lows throughout 2012, because of poor domestic demand.

Updated outlook for EUR/CZK pair:

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
EUR/CZK (avg)	25.8	25.5	24.8	24.6	24.3	24.0	23.9	23.4
EUR/CZK (eop)	26.2	25.0	24.7	24.5	24.2	24.0	23.8	23.3

Weekly Preview

WED 14:00 — **NBP rate (in %)**

	This	Last change
rate level	**4.50**	5/2011
change in bps	**0**	25

PL: Poland's central bank will keep rates at 4.5%

Although the Polish economy grew at a reasonable rate in the third quarter (4.2% YoY), the development of the leading indicators is disconcerting. PMI for December showed further deterioration of market sentiment as both new orders and employment components overshadowed current output and the index fell further below 50 points and reached the lowest level since September 2009. We think that if the Polish economy were currently not way above its inflation target and were not troubled by the weak zloty, it would nearly be high time to consider a monetary easing. Nevertheless, given above mentioned circumstances we believe that the NBP will keep interest rates unchanged.

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

	Dec-11	Nov-11	Dec-10
CPI y/y	**4.6**	4.8	3.1
Food (ex Alc.) y/y	**4.1**	4.6	3.9
Transport (including fuel)	**8.9**	11.0	6.9

PL: Inflation slightly decelerates

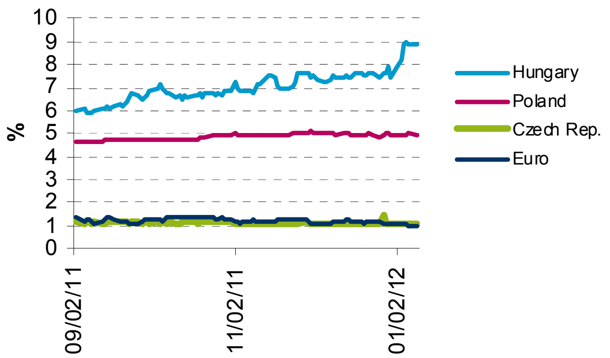
Inflation likely decelerated somewhat in the last month of 2011, falling to 4.6%, according to our forecasts, after the November's unexpected rise to 4.8% y/y. Nonetheless, it still remains well above the central bank's target (2.5%), and the price rise for the whole of 2011 may be up to 4.2%. This time, the negative effect of food and transport prices should primarily stem from the weakened zloty, and might be largely eliminated by the increased comparative baseline. In addition, seasonally falling clothing and shoe prices should also curb inflation.

Calendar

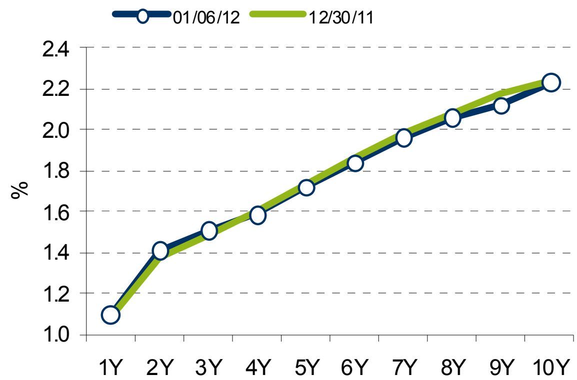
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	01/09/2012	9:00	Trade balance	EUR M	11/2011 *P			790		490,3	
CZ	01/09/2012	9:00	Retail sales	%	11/2011		-0,6		-1		1,5
CZ	01/2012	9:00	Unemployment rate	%	12/2011	8,5		8,5		8	
CZ	01/09/2012	9:00	CPI	%	12/2011	0,4	2,4	0,5	2,5	0,4	2,5
HU	01/09/2012	17:00	Budget balance	HUF B	12/2011					-1247,9	
PL	01/11/2012	14:00	NBP meeting	%	01/2012			4,5		4,5	
HU	01/13/2012	9:00	Industrial output	%	11/2011 *F					4,2	3,5
HU	01/13/2012	9:00	CPI	%	12/2011			0,6	4,4	0,7	4,3
CZ	01/13/2012	10:00	Current account	CZK B	11/2011	-0,5		0		1,31	
PL	01/13/2012	14:00	Money supply M3	%	12/2011			2,1		2	
PL	01/13/2012	14:00	Current account	EUR M	11/2011			-1525		-1622	
PL	01/13/2012	14:00	Trade balance	EUR M	11/2011			-890		-652	
PL	01/13/2012	14:00	CPI	%	12/2011	0,2	4,6	0,3	4,7	0,7	4,8

Fixed-income in Charts

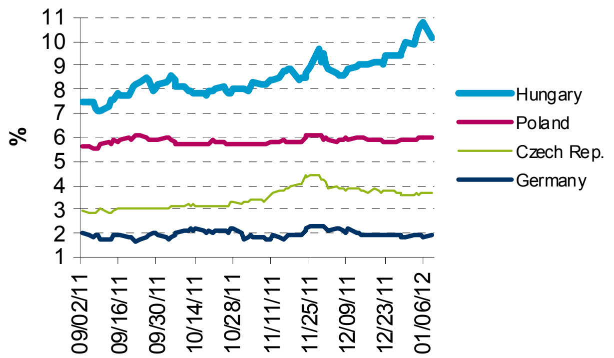
FRA 3x6



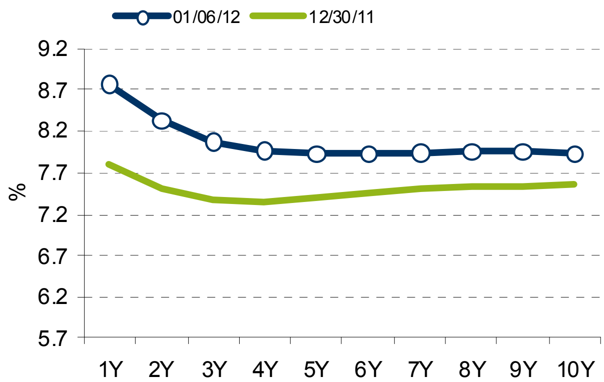
CZ IRS



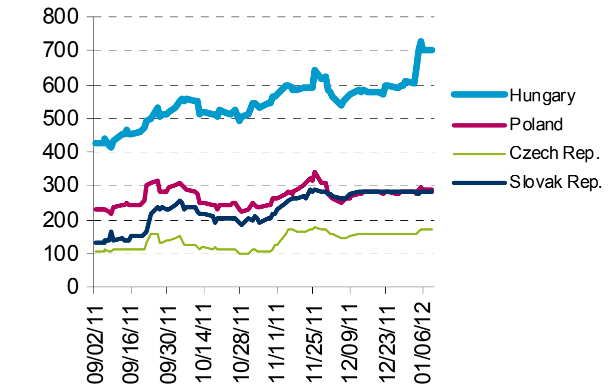
10Y GB Yields



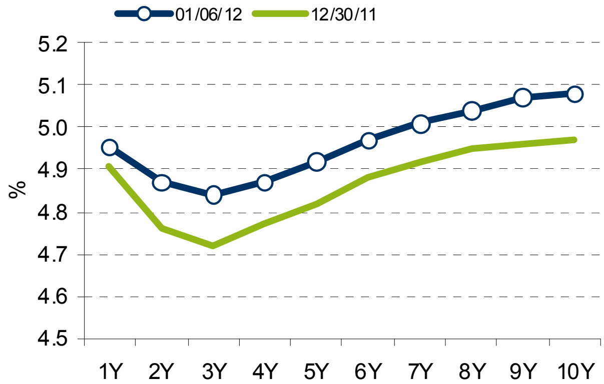
HU IRS



CDS 5Y



PL IRS



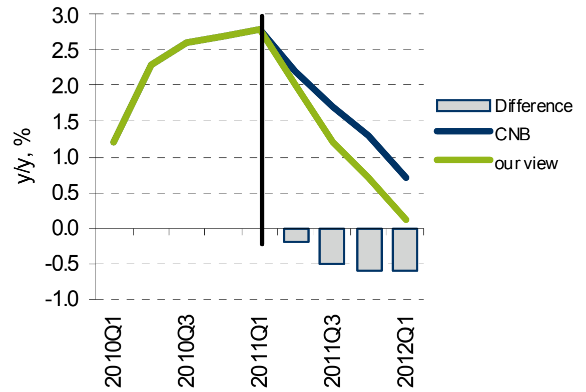
Source: Reuters

Medium-term Views & Issues

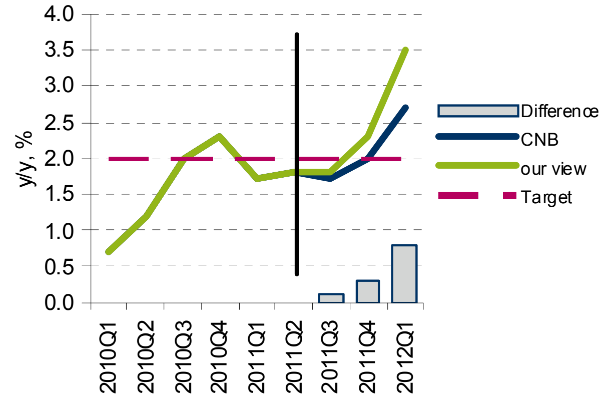
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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 1. 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. However, after re-pricing of systemic risks, slow continuation of real convergence does not argue for dramatic gains of the Czech currency over 2012. Putting it together, after current correction with short term target around 26.6 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 the motivation to intervene in 2012 may be weaker due to changed methodology of debt/GDP calculation and lower sensitivity to FX volatility. Hence we are afraid escalating tensions on the eurozone markets can weigh heavily on the Polish markets and the zloty can easily move above 4.80 EUR/PLN in 3month horizon.

CB's Projections vs. Our Forecasts

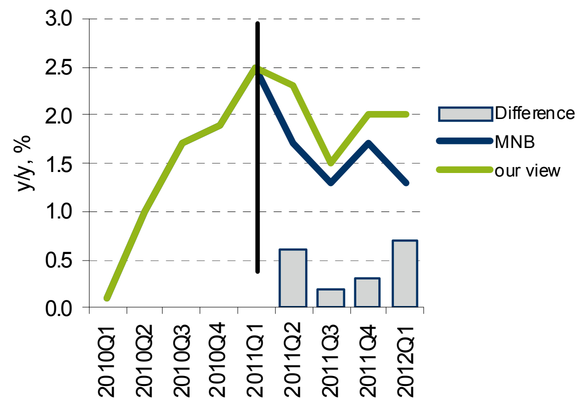
CZ: GDP Outlook



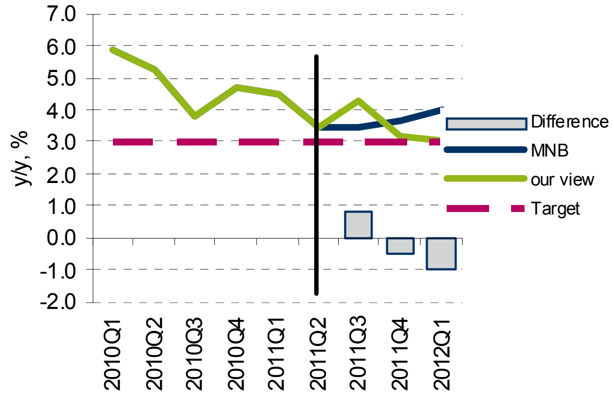
CZ: Inflation outlook



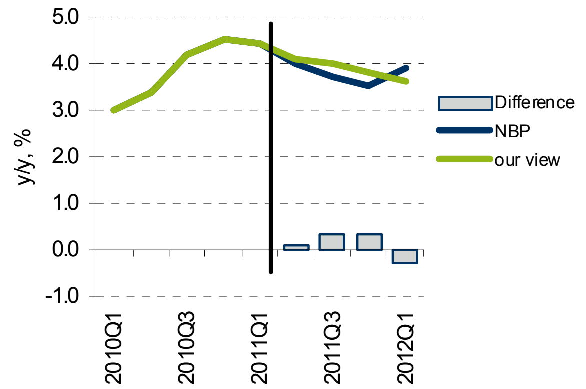
HU: GDP Outlook



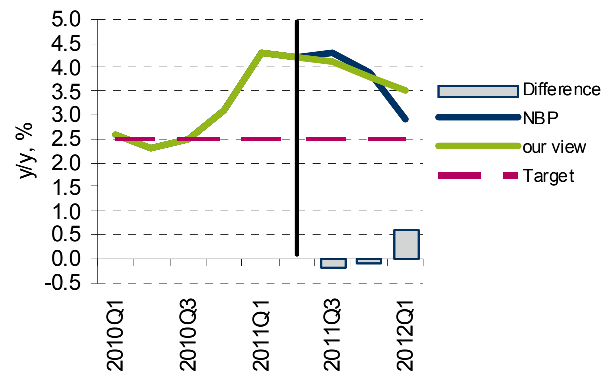
HU: Inflation outlook



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.	*7.00*	6.00	7.00	7.00	7.00	7.00	50 bps	12/20/2011
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	1.15	1.15	1.15	1.17
Hungary	BUBOR	*7.58*	6.00	6.50	7.00	7.00	7.00
Poland	WIBOR	*4.99*	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	*2.2459*	2.05	2.25	2.30	2.55	2.85
Hungary	HU10Y	*7.96*	7.50	7.50	7.50	7.50	7.50
Poland	PL10Y	*5.04*	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	*25.8*	25.0	26.0	26.2	25.0	24.7
Hungary	EUR/HUF	*315*	295	280	270	270	268
Poland	EUR/PLN	*4.49*	4.35	4.10	3.95	3.90	3.90

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	2.8	2.0	1.2	0.7	0.1	-0.1	0.5
Hungary	2.5	1.5	1.4	2.0	2.0	1.8	1.8
Poland	4.4	4.3	4.2	3.8	3.6	3.3	3.0

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

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	1.8	1.8	2.3	3.5	3.4	3.3	3.1
Hungary	3.5	3.6	3.2	3.0	2.8	2.8	2.8
Poland	4.2	3.9	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

Brussels Research (KBC)		Global Sales Force	
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Mathias Van der Jeugt	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
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