Monday, February 06,

Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Third steepest rise in Poland's PMI history
- CNB left the rates unchanged and worsened its prognosis
- NBP meeting in focus as inflation expectations drift upwards

Chart of the Week:

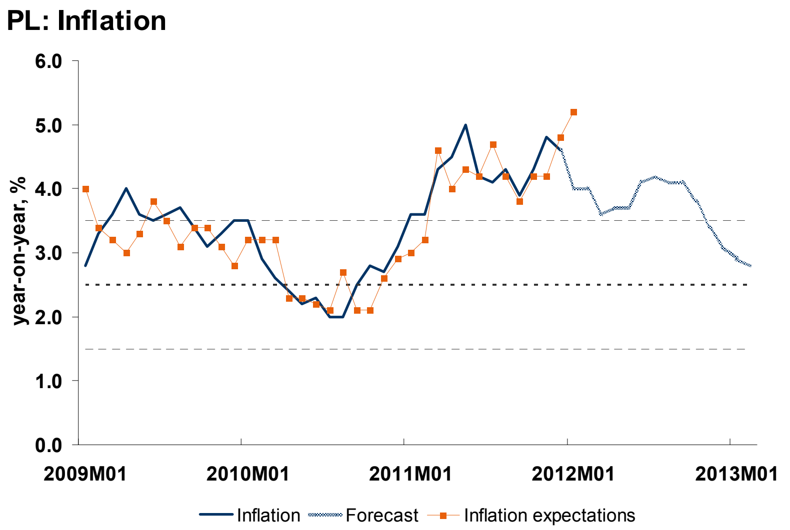


Table of Contents:

Market's editorial

The Czech-Polish crossroads

For the first time in a while, the Polish and Czech economies are again starting to diverge. The latest business mood data (PMI) indicates the return of a good mood to Poland's industry at the beginning of the year, while the business mood in the Czech Republic remains poor.

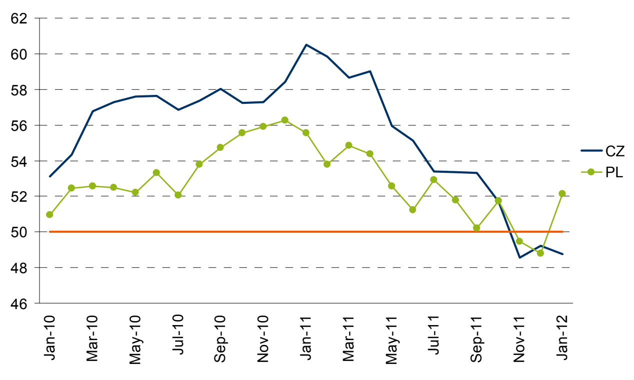
PMI indices decouples

Poland's index soared from 48.8 to 52.2 points, the third steepest rise in Poland's PMI history. The view into the structure also looks positive. While production is still falling, new orders are improving, and this usually indicates a future rise in the index. In the Czech Republic, by contrast, the index fell deeper below the critical level of 50 points (to 48.8 from 49.2), and new orders remain particularly low (47.1). The negative developments may be due to the worsening situation in the automotive industry, which saw an unusually successful year in 2011 and kept the entire Czech economy afloat.

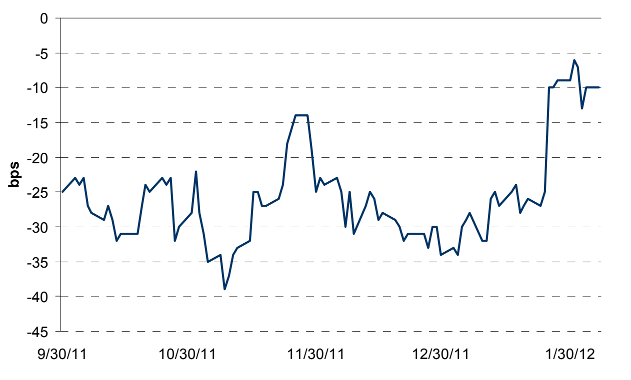
CNB and NBP in different corners

The differences in growth rates were also evident in the divergent money market developments in the Czech Republic and Poland. While investors in Poland, under pressure from somewhat better figures and comments from the central bank, eliminated their bets on a rate cut, nothing like that is happening in the Czech Republic. The Czech National Bank's new forecast is worse in terms of growth than the previous one and still implies a moderate decline in rates, albeit later than the old forecast predicted, with the Governor considering such a move to be highly improbable. Thus our main scenario, of the long-term stability of Czech rates, remains unchanged.

Polish vs. Czech PMI



PL: Spread between FRA9x12 and WIBOR 3M



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*25.0*	*-1.48%*	→	↗
EUR/HUF	*291*	*-1.04%*	→	↗
EUR/PLN	*4.16*	*-1.80%*	→	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.15*	*0.47*	→	↗
10Y PLN	*7.49*	*-2.92*	→	↗
10Y HUF	*4.89*	*-0.41*	→	↗

Review of Economic Figures

CNB left its base rate unchanged

At its February meeting, the CNB Board again left its base interest rate unchanged at 0.75%, i.e., the level where the rate has been since May 2010. All of the six Board members present voted for rate stability. Thus the CNB Board's decision itself sprang no surprise; nevertheless, the tenor of the forecast on the basis of which the CNB Board decided was a surprise.

CNB expects stagnation of the economy

In line with expectations, the CNB lowered its economic growth forecast from the original 1.2% to as low as zero, while raising this year's inflation forecast to 3% for the end of the year (as opposed to the original 2.8%). The currently anticipated stagnation is no great surprise; but what was really unexpected is the interest rate outlook, because the central bank expects the three-month Pribor to drop to as low as 0.8% during the year (as opposed to the current 1.18%), and this means that the CNB basically indicates a cut in its base rate during the second half of the year. That said, when the economy again starts to recover, as indicated by the forecast, the rates should go down(?) The reason should be the anticipated positive inflation developments in 2013, when prices should go up by only 1.4%, while the economy will grow by nearly 2%. At the press conference, however, the CNB Governor quite strongly played down the presented rate cut, saying that it applied to the second half of the year and that more monetary meetings would be held before then. Thus the important information is that concerning short-term rate stability, while further developments will depend on new figures from the economy. Hence there is no reason to change our view of rates; that said, we still anticipate the stability of CNB rates throughout 2012.

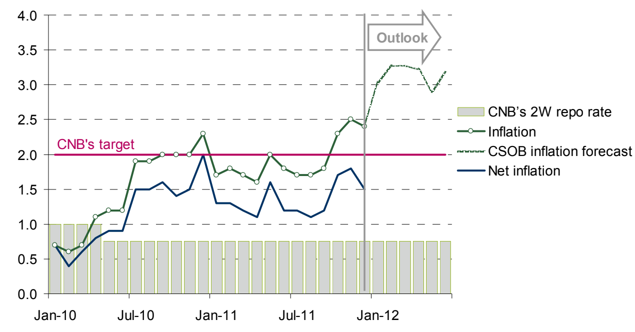
CNB forecast brings revision of bullish CZK view

The new forecast also includes a significant revision of the exchange rate outlook for the koruna. Up to now, the CNB had expected the Czech currency to strengthen to as much as EUR/CZK 22.70 y the end of this year, but now it expects only EUR/CZK 24.50. After all, the table below shows how much the current forecast has changed against the previous one.

To sum up the outcome of February's CNB Board meeting, we now clearly find the central bank to be much less optimistic as concerns economic growth and the exchange rate of the koruna, while the bank has increased its inflation outlook. Consequently, the CNB is now closer to our forecast of this year's economic developments, one of the expectations of which is the rate stability until the first half of 2013.

CNB's prognosis		Feb-12	Nov-11	change
GDP (y/y)	2012	**0.0**	1.2	↓
GDP (y/y)	2013	**1.9**	2.7	↓
Inflation	2012Q4	**3.0**	2.8	↑
Monetary relevant inflation	2012Q4	**1.8**	1.7	→
PRIBOR 3M	2012Q4	**0.8**	1.0	↓
CZK/EUR	2012Q4	**24.5**	22.7	↑
External assumptions		**Feb-12**	Nov-11	change
GDP - euro area (y/y)	2012	**0.5**	1.4	↓
Inflation - euro area	2012	**2.1**	2.0	→
EURIBOR 3M	2012	**1.0**	1.2	↓
Brent	2012	**111.2**	102.6	↑
USD/EUR	2012	**1.29**	1.34	↓

CZ: Inflation and CNB's Target
(%)



Weekly Preview

TUE 9:00 **CZ Foreign trade (CZK bn)**

	Dec-11	Nov-11	Dec-10
Balance	**5.0**	18.4	0.1
cummulative (YTD)	**183.5**	178.5	121.2
Exports (y/y in %)	**7.3**	9.3	26.0
Imports (y/y in %)	**4.9**	6.3	28.0

CR: A record-breaking trade balance figure

December's foreign trade was very favourable. The primary export drivers included carmakers, while imports were encumbered with the increased import prices of commodities. By and large, the Czech Republic's trade balance posted a record-breaking surplus for 2011 – perhaps as high as CZK 180 bn, which means that trade continued to be the main driver of the otherwise decelerating economy in late 2011.

TUE 9:00 **CZ Unemployment Rate (in %)**

	Jan-12	Dec-11	Jan-11
Rate	**9.1**	8.6	9.7

CZ: Unemployment above 9%

Unemployment likely hit 9% at the beginning of the year again. However, rather than any dramatic change in the labour market, this was a traditional seasonal divergence, which regularly occurs when one year is ending and a new one starting. People's fixed-term job contracts, whether in services or construction, usually expire at that time, and these people are unemployed until seasonal jobs begin. In addition, people from businesses affected by the deceleration of the economy also registered with employment offices. This is why 2012 as a whole will see a moderate increase in unemployment.

WED 14:00 **NBP rate (in %)**

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

PL: NBP on hold as inflation expectations remain high

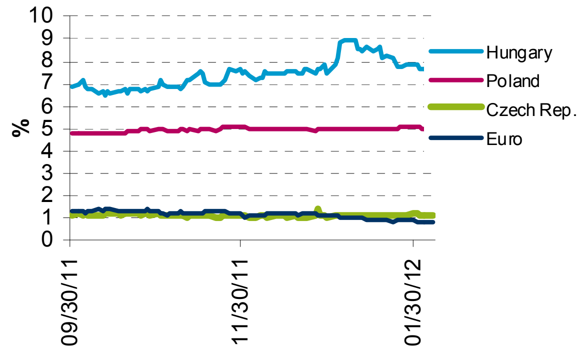
The National Bank of Poland (NBP) is unlikely to change rates at its Wednesday meeting. Although the market had bet on a rate cut within a nine-month horizon, the news from the last meeting as well as central bankers' comments have made it fairly clear that rates are unlikely to change soon. According to a preliminary GDP forecast for last year, the Polish economy grew by 4.3%, in spite of rate hikes in the first half of the year, and the start of 2012 was also very good – January's business mood figure surprised the market very positively, and the aggregate index even hit 52.15 points. Moreover, households' inflation expectation soared above 5% which is another piece of hawkish news. However, this should be partly eliminated by the strengthened Polish zloty.

Calendar

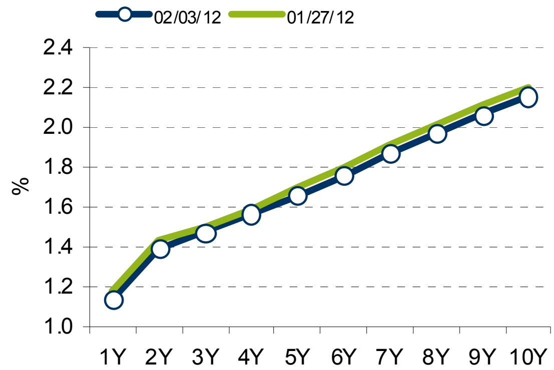
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	02/06/2012	9:00	Industrial output	%	12/2011		3.3		1.5		5.4
CZ	02/06/2012	9:00	Construction output	%	12/2011						-2.3
CZ	02/07/2012	9:00	Unemployment rate	%	01/2012	9.1		9.1		8.6	
CZ	02/07/2012	9:00	Trade balance	CZK B	12/2011	5		4.2		18.4	
HU	02/07/2012	9:00	Industrial output	%	12/2011 *P				9.5	4.2	3.5
HU	02/07/2012	17:00	Budget balance	HUF B	01/2012					-1734.4	
HU	02/08/2012	9:00	Trade balance	EUR M	12/2011 *P			400		663.4	
PL	02/08/2012	14:00	NBP meeting	%	02/2012			4.5		4.5	

Fixed-income in Charts

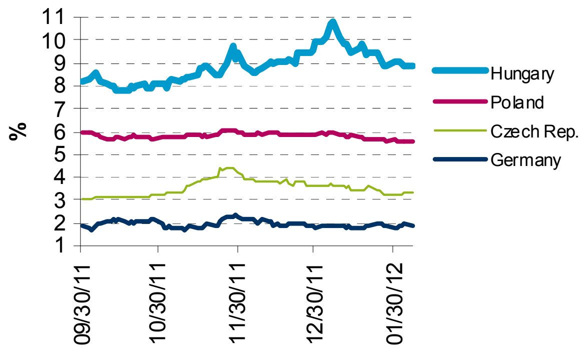
FRA 3x6



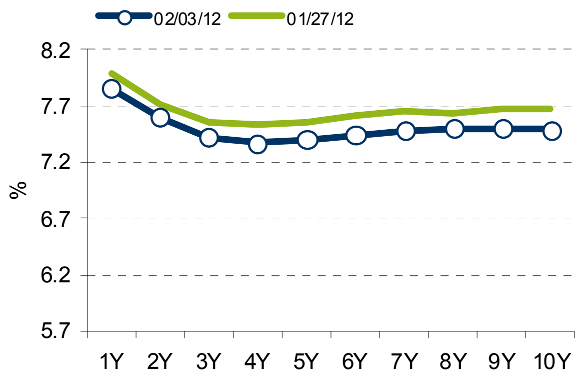
CZ IRS



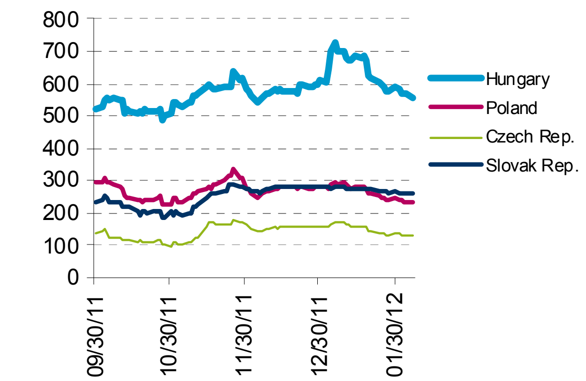
10Y GB Yields



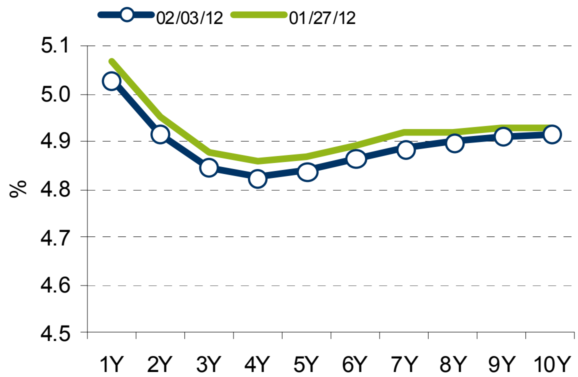
HU IRS



CDS 5Y



PL IRS

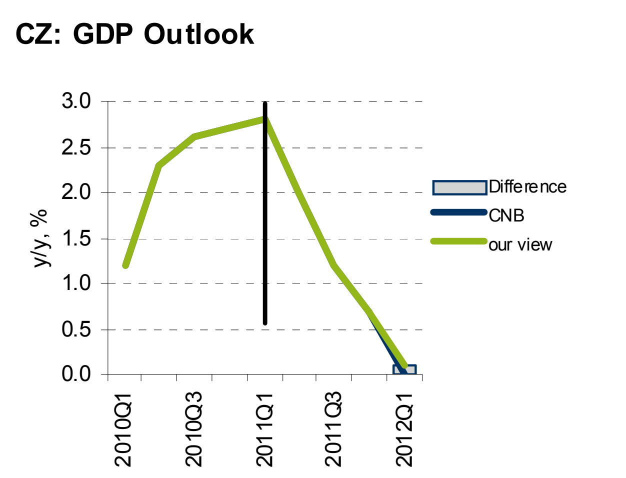


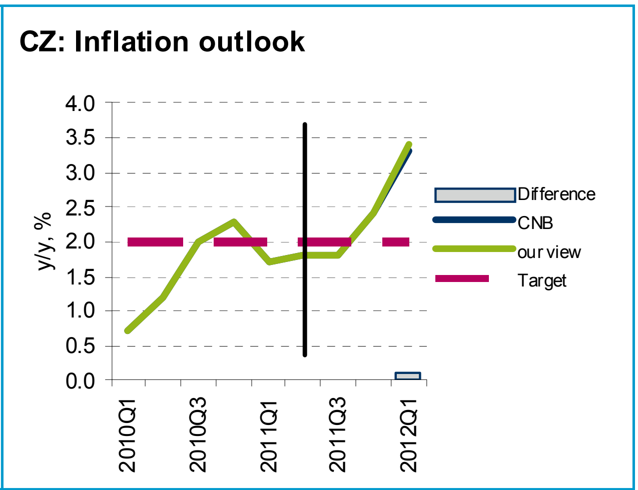
Source: Reuters

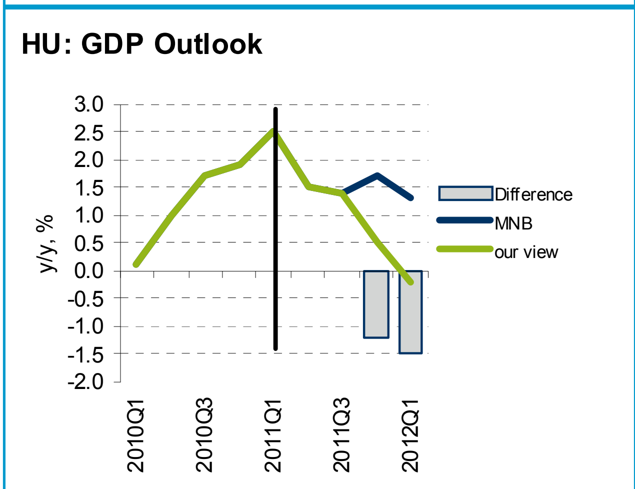
Medium-term Views & Issues

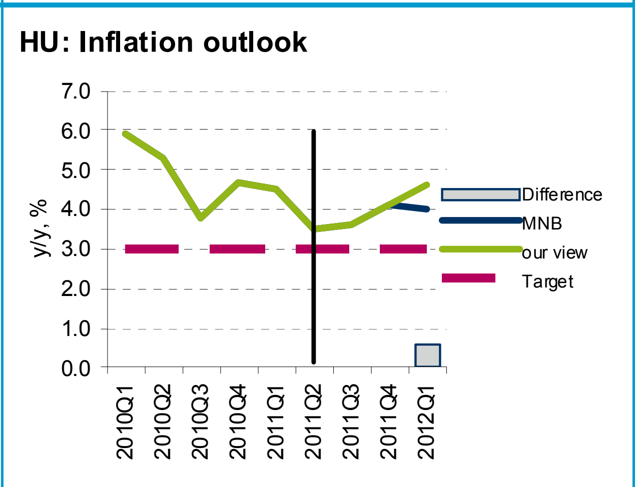
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion of tax increases may be considered. It can not therefore exclude the growing tensions in the government coalition. The government does not intend to set a target date for the euro adoption in the Czech Republic. On the other hand, CR will lend more money to the IMF to address the debt crisis Eurozone.	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 point in the IMF talks. A weaker growth outlook may also require additional fiscal measures. The IMF would like to see 'tangible' steps from the government, but did not specify what tangible means here. The next step could be that the EU also replies to the government message and that we may see how negotiations could continue. As a base case, we think a deal could be reached till the end of February.	According to preliminary estimates, the Polish economy grew by 4.3% last year. 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 100bps in aggregate by the end of 2011. We expect two more 50bps rate hikes, so the base rate should hit 8.00% in 2012.	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.	Talks between Hungary and the IMF/EU has been ongoing slowly, which means that on the positive side there is some advance, while negotiations will take time because both side are giving in concessions only marginally.. The FX market may react to incoming news over the short-term, which is probably a range between 308 and 315/€, while we expect the forint to appreciate after negotiations reach a key point and the main fundamentals of the agreement are formulated. We expect the currency to appreciate to 290/€ by the year-end.	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.

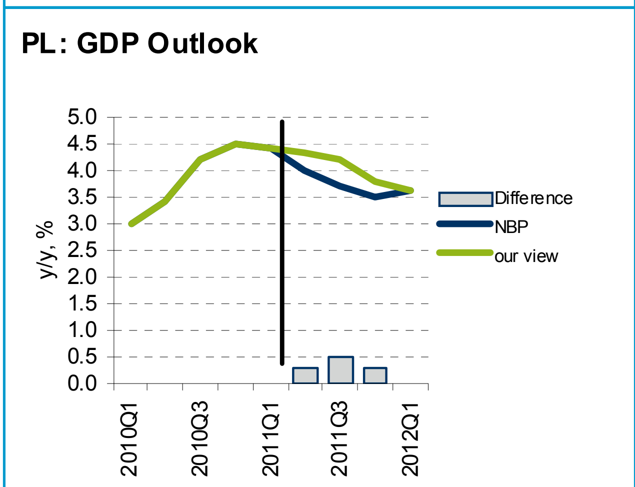
CB's Projections vs. Our Forecasts

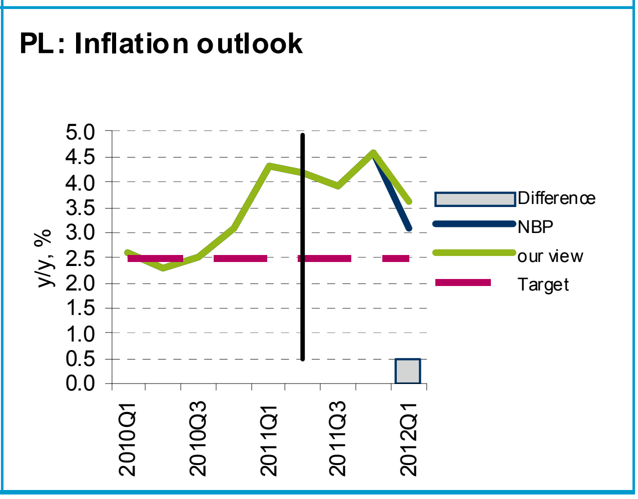












Source: CNB, NBP, MNB, CSOB

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	8.00	8.00	8.00	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	*1.18*	1.17	1.17	1.12	1.10	1.12
Hungary	BUBOR	*7.47*	6.00	6.50	8.00	8.00	8.00
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	*2.15*	2.05	2.24	2.25	2.40	2.60
Hungary	HU10Y	*7.49*	7.50	7.50	9.25	9.25	9.00
Poland	PL10Y	*4.89*	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	*25.0*	25.0	26.0	26.2	25.0	24.7
Hungary	EUR/HUF	*291*	295	280	310	300	290
Poland	EUR/PLN	*4.16*	4.35	4.10	4.60	4.40	4.20

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	2.8	2.0	1.2	0.7	0.1	-0.1	0.6
Hungary	2.5	1.5	1.4	0.5	-0.2	-0.5	-0.8
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	2.4	3.4	3.3	3.2	3.1
Hungary	3.5	3.6	4.1	4.6	4.5	4.4	4.2
Poland	4.2	3.9	4.6	3.6	4.1	4.1	3.1

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)	
Piet Lammens	+32 2 417 59 41
Peter Wuyts	+32 2 417 32 35
Joke Mertens	+32 2 417 30 59
Mathias Van der Jeugt	+32 2 417 51 94
Dublin Research	
Austin Hughes	+353 1 6646892
Prague Research (CSOB)	
Jan Cermak	+420 2 6135 3578
Jan Bures	+420 2 6135 3574
Petr Baca	+420 2 6135 3570
Bratislava Research	
Marek Gabris	+421 2 5966 8809
Warsaw Research	
Budapest Research (K&H)	
Gyorgy Barcza	+36 1 328 99 89

Global Sales Force	
Brussels	
Corporate Desk	+32 2 417 45 82
Commercial Desk	+32 2 417 53 23
Institutional Desk	+32 2 417 46 25
London	+44 207 256 4848
Frankfurt	+49 69 756 19372
Paris	+33 153 89 83 15
New York	+1 212 541 06 97
Singapore	+65 533 34 10
Prague	+420 2 6135 3535
Bratislava	+421 2 5966 8436
Budapest	+36 1 328 99 63
Warsaw	+48 22 634 5210
Moscow	+7 495 7777 164

Our reports are also available on: www.kbc.be/dealingroom

This non-exhaustive information is based on short-term forecasts for expected developments on the financial markets. KBC Bank cannot guarantee that these forecasts will materialize and cannot be held liable in any way for direct or consequential loss arising from any use of this document or its content. The document is not intended as personalized investment advice and does not constitute a recommendation to buy, sell or hold investments described herein. Although information has been obtained from and is based upon sources KBC believes to be reliable, KBC does not guarantee the accuracy of this information, which may be incomplete or condensed. All opinions and estimates constitute a KBC judgment as of the data of the report and are subject to change without notice.