**Tuesday, February 14,**

Banking & Insurance

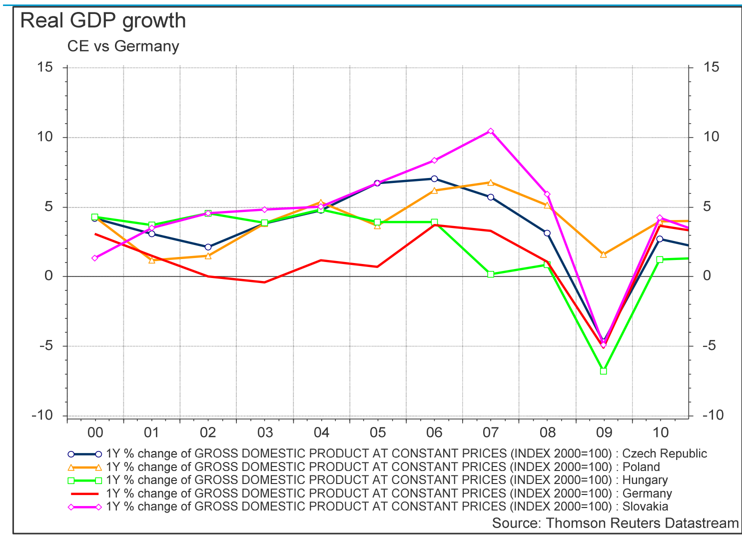
# Central European Weekly

Written by CSOB Prague and K&H Budapest

## Weekly Highlights:

- The vanishing story of real convergence in Central Europe
- Czech industry: Decent figures vs. poor orders
- Czech foreign trade surplus record
- In focus: What are the leading indicators of Czech industry? ...ČSOB Flash

## Chart of the Week:




The real convergence of CE economies has significantly slowed in recent years.

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# Market's editorial

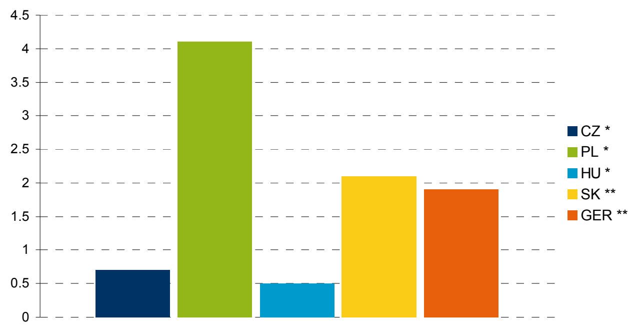
## The vanishing story of real convergence in Central Europe

Preliminary growth figures for the last quarter, and consequently for the whole of 2011, will be released in most EU countries this week. Except for Poland, this will also apply to Central European countries.

Although the release of the GDP data is unlikely to have any significant impact on Central European markets in any of the countries, the figures will be interesting in any event, particularly if compared to the eurozone data, notably Germany's. Such a comparison may reveal a fairly unpleasant fact, that what is known as real convergence is no longer the main macroeconomic story dominating the Central European region. While it is true that, in terms of growth, Poland and Slovakia are still outpacing the eurozone and Germany, no such thing has been evidently true of Hungary and the Czech Republic for a prolonged period. The explanation as to why this is happening is primarily based on poor domestic demand, which continues to be curbed mainly by poor private consumption, stemming from stagnating real wages and the fairly strict fiscal policy. In addition, poor domestic demand will continue to be the typical feature of the Czech and Hungarian economies in 2012, and thus the two small open economies, dependent as they are on exports, are unlikely to grow faster than the eurozone as a whole (not to mention Germany).

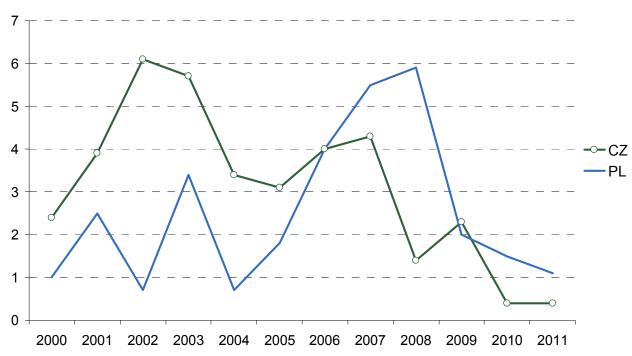
While we dare not say that the real convergence story no longer applies in Central Europe (i.e., particularly from the Czech Republic and Hungary) in the long-term horizon, Central European currencies may be affected quite significantly even if the real convergence is undermined in the medium term. That said, the real convergence story had, for a long time, maintained the hypothesis of the long-term appreciation of the real exchange rate; however, now that the real convergence between the Czech and German economies has been halted for a few years, investors may start to seek other stories to explain the behaviour of Central European currencies, namely of the koruna and the forint.

**GDP growth in Q4/2011**
(estimates)




source: * CSOB/K&H, ** Bloomberg consensus

**Gross real wages**
(Y/Y growth, %)




| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| EUR/CZK | 25.1 | 0.95% | ↗ | ↗ |
| EUR/HUF | 291 | 0.41% | ↗ | ↗ |
| EUR/PLN | 4.20 | 0.85% | ↗ | ↗ |

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| 10Y CZK | 2.19 | 2.34 | → | ↗ |
| 10Y PLN | 7.33 | -0.95 | → | ↗ |
| 10Y HUF | 4.98 | 1.74 | ↗ | ↗ |

# Review of Economic Figures

## Czech industry: Decent figures vs. poor orders

December's industrial output was influenced by one less business day in the month as well as by the weakening European demand. Carmakers, whose output was up by 11.5%, continued to maintain their leading role. Engineering and producers of electrical equipment posted very good figures. Electronics producers saw another consecutive double-digit decline. However, the positive impression of industrial output was affected by a 1.2% drop in orders, due in particular to domestic orders (-17.1%) while foreign ones are still on the rise (+10.3%). Carmakers, engineering and chemical firms, as well as electrical equipment producers can enjoy increases in their orders.

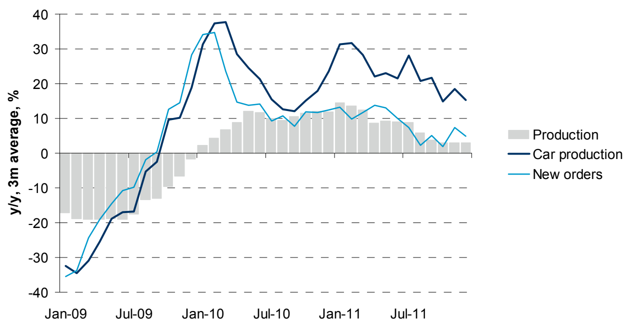
2011 was a fairly successful year for Czech industry; its output went up by almost 7%, and industry as a sector maintained its position as the driver of the whole economy. Nonetheless, not even industry will avoid a deceleration of output in 2012 because of poor demand, although it might not necessarily drive industry into an overall depression. This year's industrial output will again primarily depend on European demand, which will be hit by a wave of budget austerity and likely also by worsened access to loans, triggered by another regulatory tightening in the financial sector. For industry, just like for the whole economy, the poor first half of 2012 should be followed by a moderate recovery of growth in the second half of the year.

## Czech foreign trade surplus record

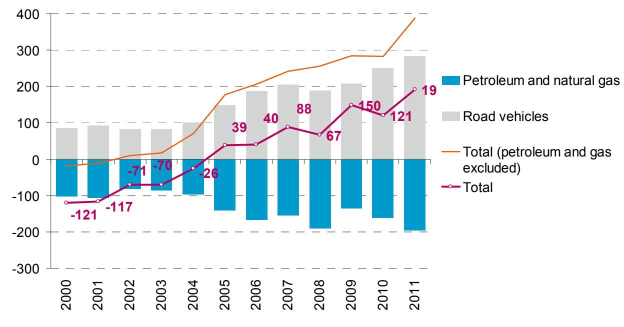
In the last month of last year, the trade surplus climbed to as high as CZK 10.5 bn, a new December record. December also saw a significant increase in exports of machinery and means of transport, which dominate Czech exports as well as industry as a whole. By contrast, imports were affected by costlier raw materials, which troubled the Czech economy throughout last year.

For 2011 as a whole, foreign trade showed a surplus of CZK 191.4 bn, thus surpassing the existing 2009 record by nearly CZK 42 bn. The main contributors to the excellent foreign trade data primarily include carmakers, who succeeded in selling their products even on the declining European market and particularly on the growing Eastern markets. The 2011 trade surplus in road vehicles went up by CZK 32 bn to CZK 282 bn. The foreign trade, namely industry, thus continued to drive the entire economy last year. The question is how successful it will be this year, which will be affected by the strong deterioration of demand in Western Europe, because exports, unlike domestic demand, are the only element on which the Czech economy may rely in 2012.

**CZ: Industrial production and new orders**



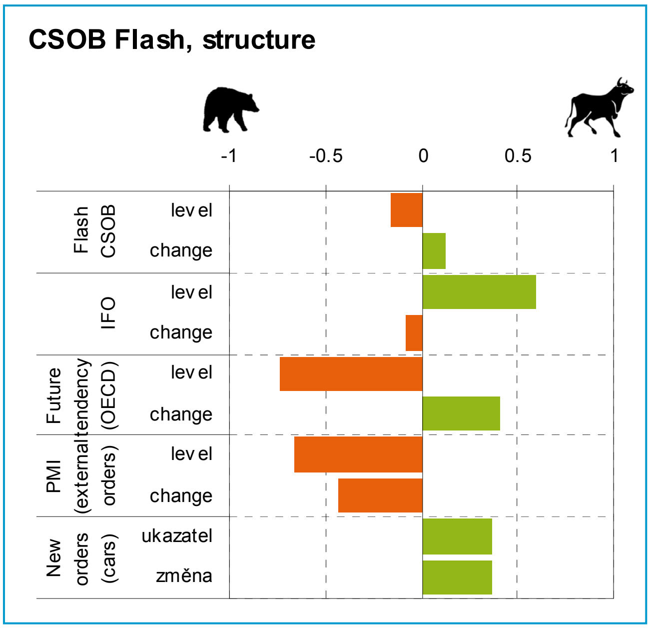

**CZ: Trade balance**
(CZK bn)

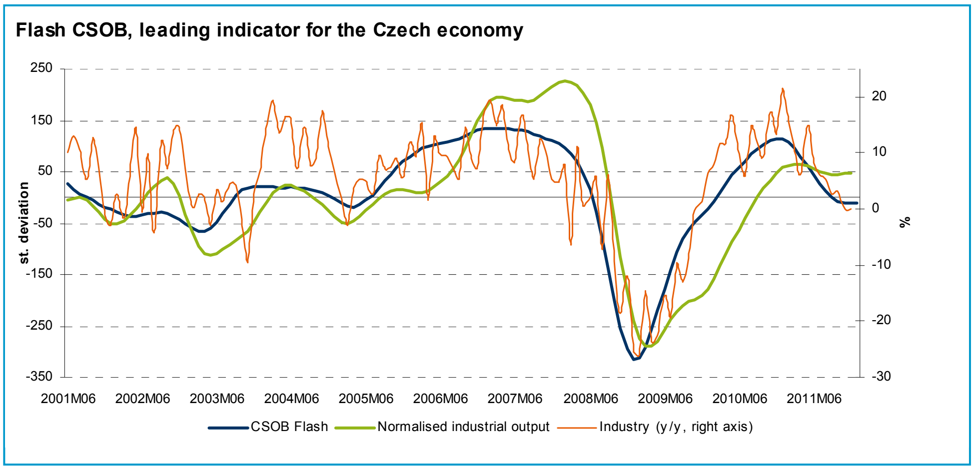


# In focus: CSOB Flash, the Czech leading indicator

Indicators that can provide an early indication of economic cycle reversals are often more important to markets than the current information on the performance of economies, because markets are most susceptible to such indicators. For the best possible detection of points of reversal in the Czech economic cycle, we have created a Czech leading indicator, the "ČSOB Flash"; it is composed of four components and, on average, is more than 3 months ahead of the economic cycle. Since 2001, the success of our index in detecting points of reversal has been 78%. While the Flash is more successful in predicting the tops, it has also reliably predicted major bottoms, such as that after the fall of Lehman Brothers (Details are going to be discussed in the detailed reports scheduled to be released soon).

At the moment, the Flash shows stabilisation. It showed a decline throughout 2011. Today it still remains in the negative territory, but January 2012 (according to preliminary figures) saw the first moderate growth after 12 months. The growth is still too fragile for the change in the trend to be certain, particularly if we take account of the conflicting tendencies inside the index; on the one hand, foreign orders (according to the PMI) remain highly negative, while by contrast, the German business sentiment index Ifo and new orders from carmakers alike remain strong, with the latter even continuing to increase. Nevertheless, the figures from carmakers are only available for December at the moment, and we need to wait to see whether orders from carmakers remains strong after the beginning of 2012 and in spite of the declining registrations of new cars in the European Union. If the positive trend is borne out, this will mean a continuing cautious recovery of industry later in the first half of 2012.



# Weekly Preview

**WED 9:00** **CZ GDP (change in %)**

| | **Q4-11** | Q3-11 | Q4-10 |
|---|---|---|---|
| GDP (y/y) | **0.7** | 1.2 | 3.0 |
| GDP (q/q) | **0.0** | -0.1 | 0.6 |

## CZ: The economy is subdued

We expect that the last quarter of 2011 saw no new trends in the economy. Thus consumption most likely declined, as did investment. By contrast, foreign trade continued to develop well. In late 2011, the economy stagnated at the level of the previous quarter, while year-on-year growth shrank from the previous 1.2% to 0.7%. The hallmark of 2011 as a whole was the decline in domestic demand, and thus foreign trade, i.e., export-oriented industry, was again the crucial factor. Agriculture is also likely to show positive figures, while services as a whole probably remained muted. 2012 will be a year of persisting uncertainties. Domestic demand in the Czech Republic will not recover from its decline this year either, and thus everything continues to be at the mercy of exports…

**WED 14:00** **PL Inflation (change in %)**

| | **Jan-12** | Dec-11 | Jan-11 |
|---|---|---|---|
| CPI y/y | **4.0** | 4.6 | 3.8 |
| Food (ex Alc.) y/y | **3.8** | 4.7 | 4.8 |
| Transport (including fuel) | **7.6** | 9.0 | 7.2 |

## PL: Inflation will fall to the vicinity of 4%

Poland's inflation decelerated significantly in the first month of this year, according to our forecasts. Although prices could increase by up to 0.6% m/m, the significant base effect (inflation soared by 1.2% in January last year) should prevail, and thus prices might go up by 4% y/y. As usual, the rise in food prices (+1% m/m) should be crucial. By contrast, transport prices, which might only go up slightly this time, owing to the appreciation of the zloty, could have a fairly positive effect on inflation. As concerns the inflation outlook for 2012, we predict its average rate at 3.8% this year.

**THU 9:00** **CZ Inflation (change in %)**

| | **Jan-12** | Dec-11 | Jan-11 |
|---|---|---|---|
| CPI m/m | **1.5** | 0.4 | 0.7 |
| Food m/m | **1.9** | 2.0 | 0.7 |
| Housing, energy | **2.4** | 0.5 | 1.7 |
| Transportation | **0.8** | 0.1 | 0.9 |

## CZ: January's inflation soars

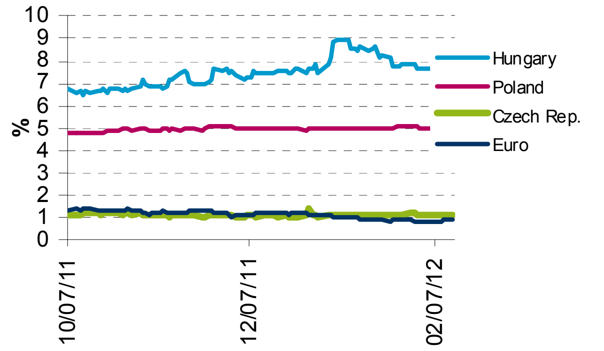
As usual, January's inflation forecast is the most challenging one, because the price developments are influenced by deregulated prices, notably for rent and energy, followed by the change in the reduced VAT rate. However, the latter already started to affect food prices in late 2011. By and large, we believe that January's consumer prices were up by 1.5% on average. The greatest contributors included housing and food prices. By contrast, the seasonal sale of clothing and shoes led to a moderate reduction in the prices of those items. The year-on-year consumer price index was up by 3.2%, the fastest increase over the last three years. Inflation is thus accelerating while wages are not. This is why we believe that this year's real wages will fall, and this will be followed by another decline in the real consumption of households.

# Calendar

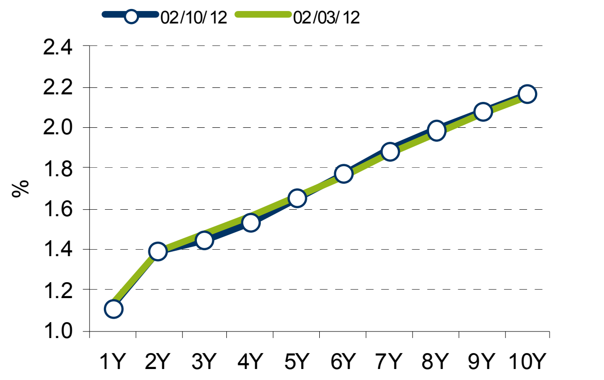
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| CZ | 02/13/2012 | 10:00 | Current account | CZK B | 12/2011 | -7.5 | | -3.25 | | 6.61 | |
| PL | 02/13/2012 | 14:00 | Current account | EUR M | 12/2011 | | | -1170 | | -1034 | |
| PL | 02/13/2012 | 14:00 | Trade balance | EUR M | 12/2011 | | | -934 | | -749 | |
| HU | 02/14/2012 | 9:00 | Industrial output | % | 12/2011 *F | | | | | -7.4 | 6.7 |
| HU | 02/14/2012 | 9:00 | CPI | % | 01/2012 | | | 1.7 | 5.1 | 0.2 | 4.1 |
| PL | 02/14/2012 | 14:00 | Money supply M3 | % | 01/2012 | | | -1.4 | | 3.2 | |
| HU | 02/15/2012 | 9:00 | GDP | % | 4Q/2011 *P | | | | 0.8 | 0.5 | 1.4 |
| CZ | 02/15/2012 | 9:00 | GDP | % | 4Q/2011 *P | 0 | 0.7 | 0 | 0.6 | -0.1 | 1.2 |
| CZ | 02/15/2012 | 12:00 | CZ bond auction 4.60%/2018 | CZK B | 02/2012 | | | | | | |
| CZ | 02/15/2012 | 12:00 | CZ bond auction floating rate/2023 | CZK B | 02/2012 | | | | | | |
| PL | 02/15/2012 | 14:00 | CPI | % | 01/2012 | | | 0.9 | 4.2 | 0.4 | 4.6 |
| PL | 02/15/2012 | 15:00 | Budget balance | PLN M | 12/2011 | | | | | -21.5 | |
| CZ | 02/16/2012 | 9:00 | CPI | % | 01/2012 | 1.5 | 3.2 | 1.4 | 3.2 | 0.4 | 2.4 |
| PL | 02/16/2012 | 14:00 | Wages | % | 01/2012 | | | -11.8 | 4.7 | 9 | 4.4 |
| PL | 02/17/2012 | 14:00 | PPI | % | 01/2012 | | | 0.2 | 8.1 | 0.3 | 8.1 |
| PL | 02/17/2012 | 14:00 | Industrial output | % | 01/2012 | | | -5.3 | 9.1 | -4.9 | 7.7 |

# Fixed-income in Charts

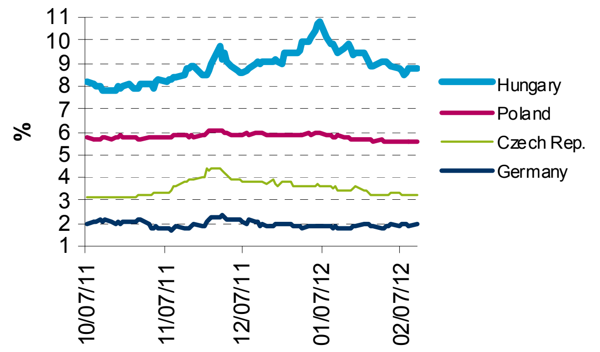
## FRA 3x6



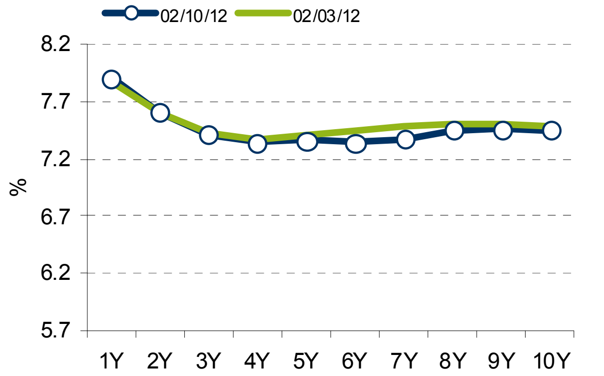

## CZ IRS



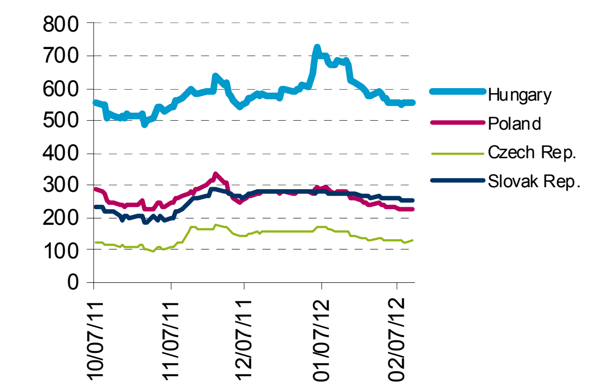

## 10Y GB Yields



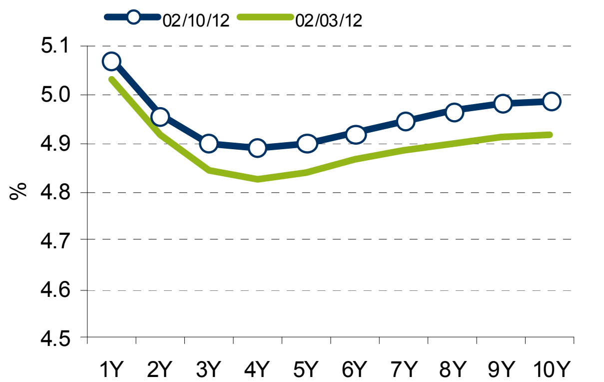

## HU IRS




## CDS 5Y




## PL IRS



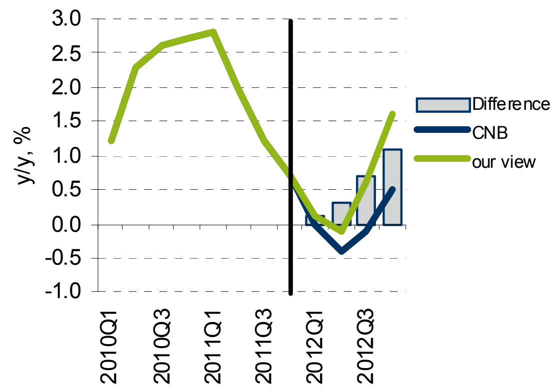

Source: Reuters

# Medium-term Views & Issues

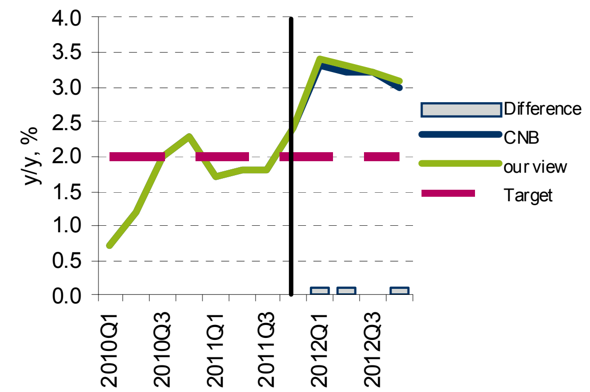
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| **Growth & key issues** | The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition 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.<br>quarter 2012. |
| **Forex Outlook** | The Czech koruna should stabilize after the second Greek bailout deal. On the other hand the worst case scenario of eurozone meltdown is still not avoided and the CEE currencies may feel it with next interim report on Greece. Also Czech domestic factors do not look very supportive - slow continuation of real convergence does not argue for dramatic gains of the Czech currency over 2012. We continue to see the koruna only mildly 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 stabilizes as well. Similarly to the koruna, the Greek deal may help to ensure further gains. Nevertheless the selling pressure may reoccur in the summer and the motivation by official authorities to intervene in 2012 may be weaker due to changed methodology of debt/GDP calculation and lower sensitivity to FX volatility. Also the domestic fundamentals do not offer significant argument pro-zloty as we expect the veconomy to slow down and the rates to remain flat. Hence we limit the bet on gains over 2012 to 4.00 EUR/PLN.. |

# CB's Projections vs. Our Forecasts

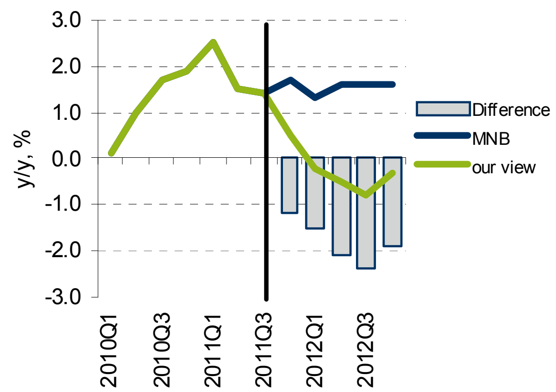
## CZ: GDP Outlook



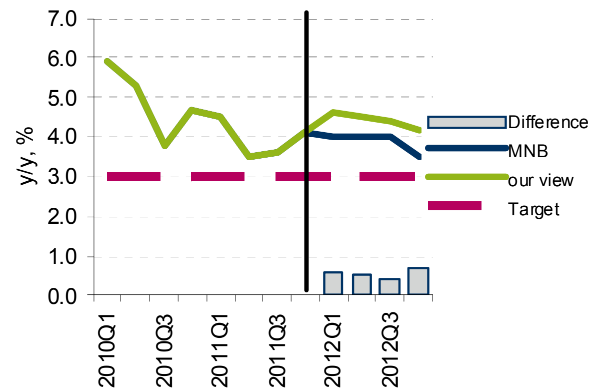

## CZ: Inflation outlook



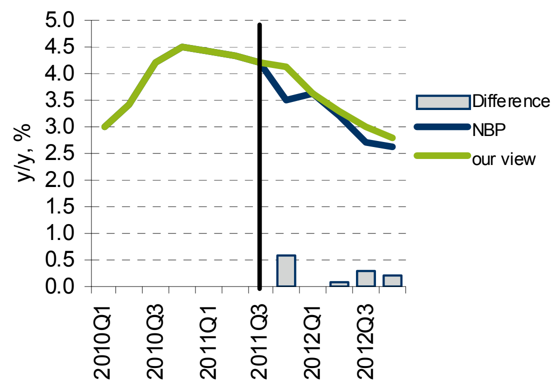

## HU: GDP Outlook



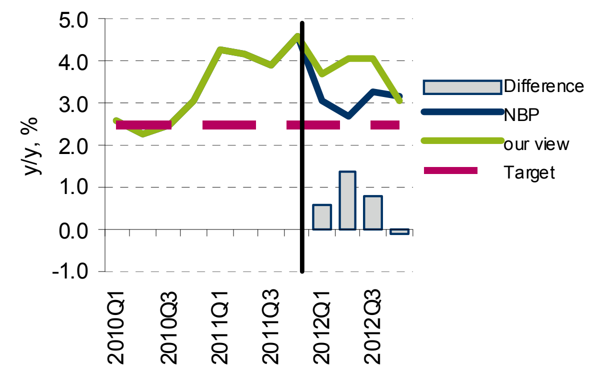

## HU: Inflation outlook




## 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 | 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 | *7.43* | 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 | *2.19* | 2.05 | 2.24 | 2.25 | 2.40 | 2.60 |
| **Hungary** | HU10Y | *7.30* | 7.50 | 7.50 | 9.25 | 9.25 | 9.00 |
| **Poland** | PL10Y | *4.98* | 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 | *25.1* | 25.0 | 26.0 | 26.2 | 25.0 | 24.7 |
| **Hungary** | EUR/HUF | *292* | 295 | 280 | 310 | 300 | 290 |
| **Poland** | EUR/PLN | *4.19* | 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 | 4.1 | 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 | 3.7 | 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) | |
|---|---|
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| Global Sales Force | |
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| 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 |
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