



Central European Weekly

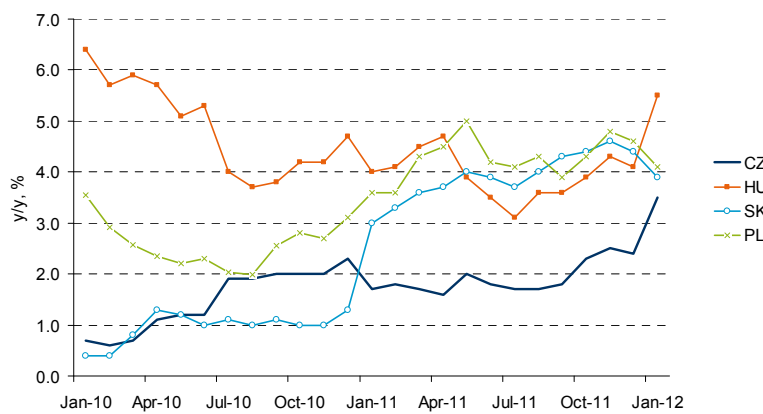
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- MNB tries to ease its policy by introducing new monetary tools
- VAT rate hikes pushed inflation rates higher in Czech R. and Hungary
- Czech economy flirted with recession at the end of 2011

Chart of the Week: Inflation rates in Central Europe

Inflation



Czech and Hungarian inflation (y/y) moved significantly higher due to VAT rate hike, which taken effect at the beginning of the 2012.

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Market's editorial

MNB tries to ease its policy in non-standard way

The National Bank of Hungary (MNB) has likely not only stopped raising rates, it is even going to follow the example of the ECB and the US Fed by directly supplying the economy with money. The MNB announced three new measures to boost forint credit in the banking system:

1. 2-year refinancing loan collateralised - somewhat similar to ECB
2. mortgage purchase program where all banks could participate - basically eliminates the current differentiation between mortgage and non-mortgage banks and also gives financing
3. widens the eligibility criteria behind central bank credit and lowers BBB- rating to lower (not specified) - could mean that the Hungarian Development Bank's newly issued bond could be eligible, which may create funding for the state-owned bank to support SMEs.

Overall, the above measures could help somewhat in the current deleveraging world, but the central bank also admits that current situation is more of the case of lack of willingness, where these may not help much.

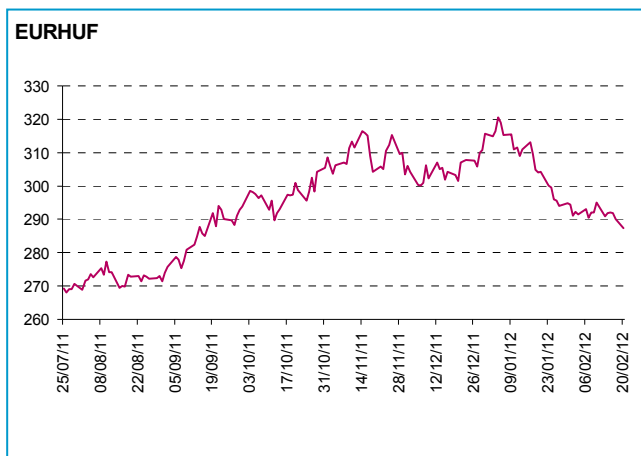
Nevertheless we believe the MNB announcement could be essential in case of the two-year refinancing credit facility for commercial banks which gives them the opportunity to finance their liabilities and bond portfolios by central bank funds at an average interest rate of the base rate – so without time premium. This could decrease interest rates paid on bonds as current interest rate difference between bond yields and interbank swap rates is 100 to 150 basis points.

MNB measures help, but IMF's talk's still eyed

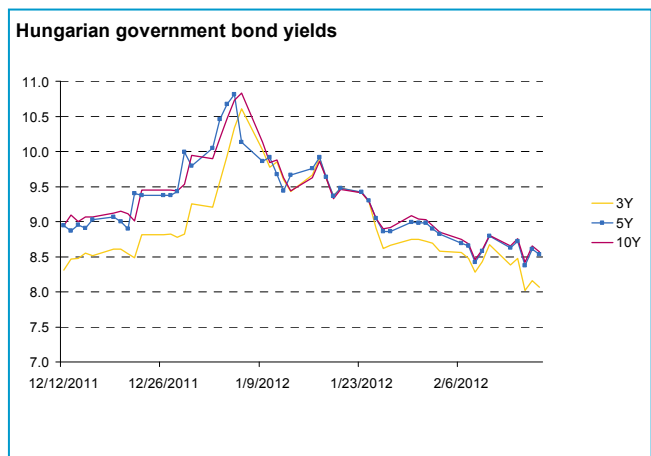
Meanwhile, Hungarian government bond yields are recently following the fluctuation of the HUF. Still, in spite of last weeks' drop (in bond yields), there are still higher yields on Hungarian bond markets compared to especially the 1-2% yield of developed countries and to regional bonds such as Polish yields around 5%. Hungarian ones exceed 1-2% the premium of Romanian papers where an IMF standby agreement helps the financial stability of the state, but a new government has been formulated recently, so political uncertainty is higher.

As long as international circumstances remain basically stable and EURHUF stays around and under 290 levels it is possible that 5 and 10-year bond yields could approach to 8%. As we have a look at the unsolved situation of EU countries in crisis, HUF strengthening in the past few weeks is remarkable. It is important to be aware of the international trends and investors' sentiment as the volatility of bond yields would not drop in the near future.

In the Hungarian outlook the IMF agreement will still have a crucial role. On Friday the Hungarian government sent an answer for the European Commission to the controversial questions (independence of Central Bank, ombudsman for data protection, age limit for judges) so it would turn out in the next 2-3 weeks whether Hungary should face further challenges given by the Commission or they give green light to start negotiations. We suppose negotiations could last for 1-1.5 month so in a positive scenario an agreement could be reached till late March-mid April.



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.9	-0.68%	↘	→
EUR/HUF	288	-1.20%	↘	→
EUR/PLN	4.18	-0.09%	↘	→



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.16	0.93	↗	↗
10Y PLN	7.10	-2.74	↗	↗
10Y HUF	4.87	-1.81	↗	↗

Review of Economic Figures

Czech January's inflation wave

In January, the **Czech** consumer prices of goods and services were up by 1.8% m/m. The year-on-year increase was even as high as 3.5%. The main contributors to the rapid price rise included the increased VAT rate and deregulation. That said, not only food but particularly housing is costlier now, i.e., water and sewerage rates, heat, electricity, gas and, after all, also rents. Fuel prices also went up in January, hitting new highs. Year-on-year inflation is developing worse than expected by both the market and the CNB (by 0.2 percentage point); however, this involves absolutely no demand-pull inflation that would require any intervention. On the contrary, domestic demand remains curbed, with prices being primarily driven by increasing input costs, administrative measures, and the temporarily weakened koruna. January's year-on-year inflation basically bore out the expectations that wages would decline in real terms this year for the first time since the recession of late 1998 and early 1999. January's inflation has raised the benchmark for the price developments in the months to come. This is why we believe that inflation will remain above 3% throughout this year. The CNB will stick to its wait-and-see policy and thus continue to keep its base rate unchanged.

Hungary's consumer price index for January rose faster than had been anticipated. January headline inflation accelerated to 5.5% Y/Y from 4.1% Y/Y on VAT hike (direct effect is 1.6pp, so pass through was strong) and core inflation rose to 4.9% Y/Y. Tax-adjusted inflation also rose to 3.6% Y/Y.

The reading is a bit mixed in our view, short-term negative, but stronger pass through could hurt purchasing power of households and may later become anti-inflationary. This could have been behind the central bank Inflation Report which saw this year inflation around 5%, but falling to 2.2% by end-2013.

1. The central bank said before that it will concentrate on net core inflation figure. If we strip out 1.6pp from the 4.9%, we get 3.3%, slightly above the target, but you can say it is tolerable.

2. December inflation report assumed 1Q12 headline inflation rate of 5.0%, so we are 0.5pp above that, which means that now there is upside risk to their forecast.

Further tightening does not look needed now, but definitely the VAT hike does not seem to pass on smoothly. However, higher inflation may help the budget on the revenue side. Overall, cautious monetary policy is warranted, i.e. they may wait with reducing the base rate even in case of the agreement with the EU/IMF.

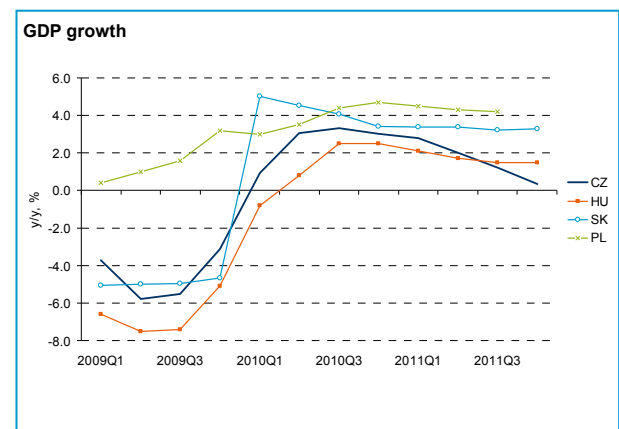
January's inflation in Poland, unlike that in the rest of the region, ended up closely below the market consensus and decelerated to 4.1% y/y. In accordance with expectations, the main contributors to the price rise included food, the prices of which were up by a huge 1.5%

compared to December. Although we predict another inflation fall, to less than 4% y/y, at the end of the first quarter of the year, we do not anticipate any monetary policy response in Poland either. Owing to last year's fairly evenly distributed price rise, inflation should again accelerate in the middle of the year, and remain well above the central bank's target in 2012. In addition, notwithstanding last year's monetary tightening, the Polish economy seems to be set to grow by around 3% this year, and thus rates are not very likely to go down. Consistent with this are the latest comments made by the central bankers, who mostly preferred rate stability, and, should the rates change, they spoke only of a rate hike.

Hungary still grows, while Czechs step on brakes

The drop in the **Czech** economy by 0.3% q/q at the end of the year is absolutely consistent with the economic downturn of both the EU and the eurozone. The CR, just like the EU, is currently on the brink of a recession. Given poor domestic demand, the CR has seen its GDP fall for two quarters, and this actually means the onset of an economic recession. Thus far, the economy has only been upheld by foreign trade, while domestic demand has remained curbed. And this will also be true of this year; however, unlike last year's 1.7% growth, this year's growth will not be better than zero, because the economy cannot rely on domestic consumption this year either, and thus may only be encouraged by foreign trade. However, Europe as a whole is heading for a recession, and although it should not be as dramatic as the previous recession of late 2008 and early 2009, the contribution of exports to GDP growth will not be as strong as in 2011.

Contrary to the general expectation, the **Hungarian** economy did not run out of breath in the last quarter of 2011 either; according to a preliminary forecast, the GDP grew by 0.3% q/q and 1.4% y/y. For 2011 as a whole, the Hungarian economy grew as fast as the Czech economy (1.7%), being primarily driven by agriculture and foreign demand for industrial production. Unlike the positive developments in 2011, we expect a moderate GDP fall by approximately 0.5% this year.





Weekly Preview

WED 9:00

CZ PPI (y/y change in %)

	Jan-12	Dec-11	Jan-11
m/m	1.0	0.1	1.4
y/y	4.3	4.6	4.6

CZ: Producer price inflation is continuing to rise

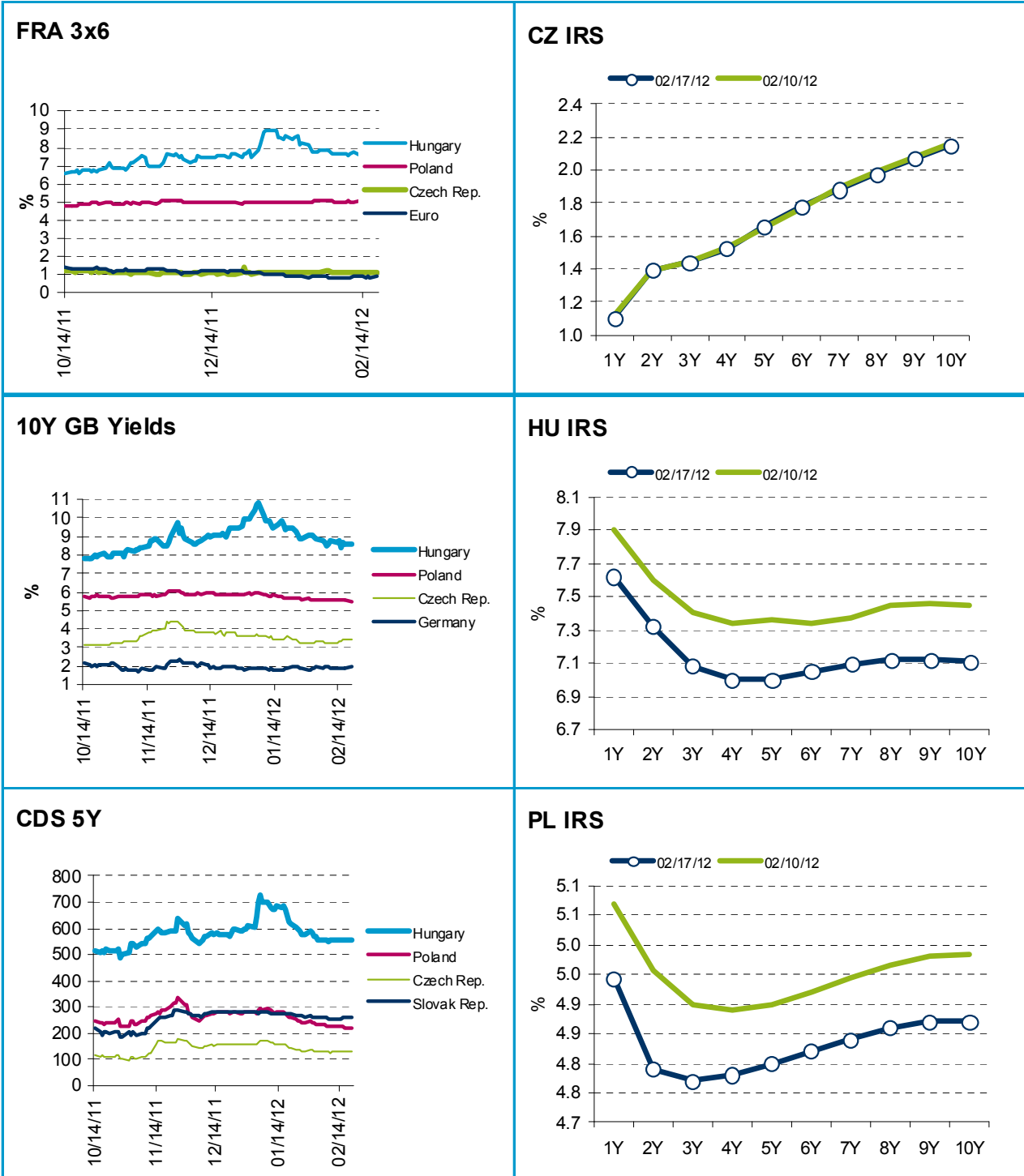
January's rise in the producer price index was likely due to the increased prices of energy and oil products, followed by food industry products. By contrast, the declining orders of numerous industrial firms should curb any across-the-board price increases, which used to happen at the beginning of a new year. Last year's PPI rise in excess of 6% should not reoccur, while price pressures in production should slowly wane.



Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	02/21/2012	9:00	Wages	% , ytd.	12/2011					6	6
CZ	02/22/2012	9:00	PPI	%	01/2012	1	4.3	0.9	4.1	0.1	4.6
PL	02/23/2012	10:00	Unemployment rate	%	01/2012			13.3		12.5	
PL	02/23/2012	10:00	Retail sales	%	01/2012			-25	13.8	20.8	8.6
HU	02/24/2012	9:00	Retail sales	%	12/2011				0.9		1.1

Fixed-income in Charts

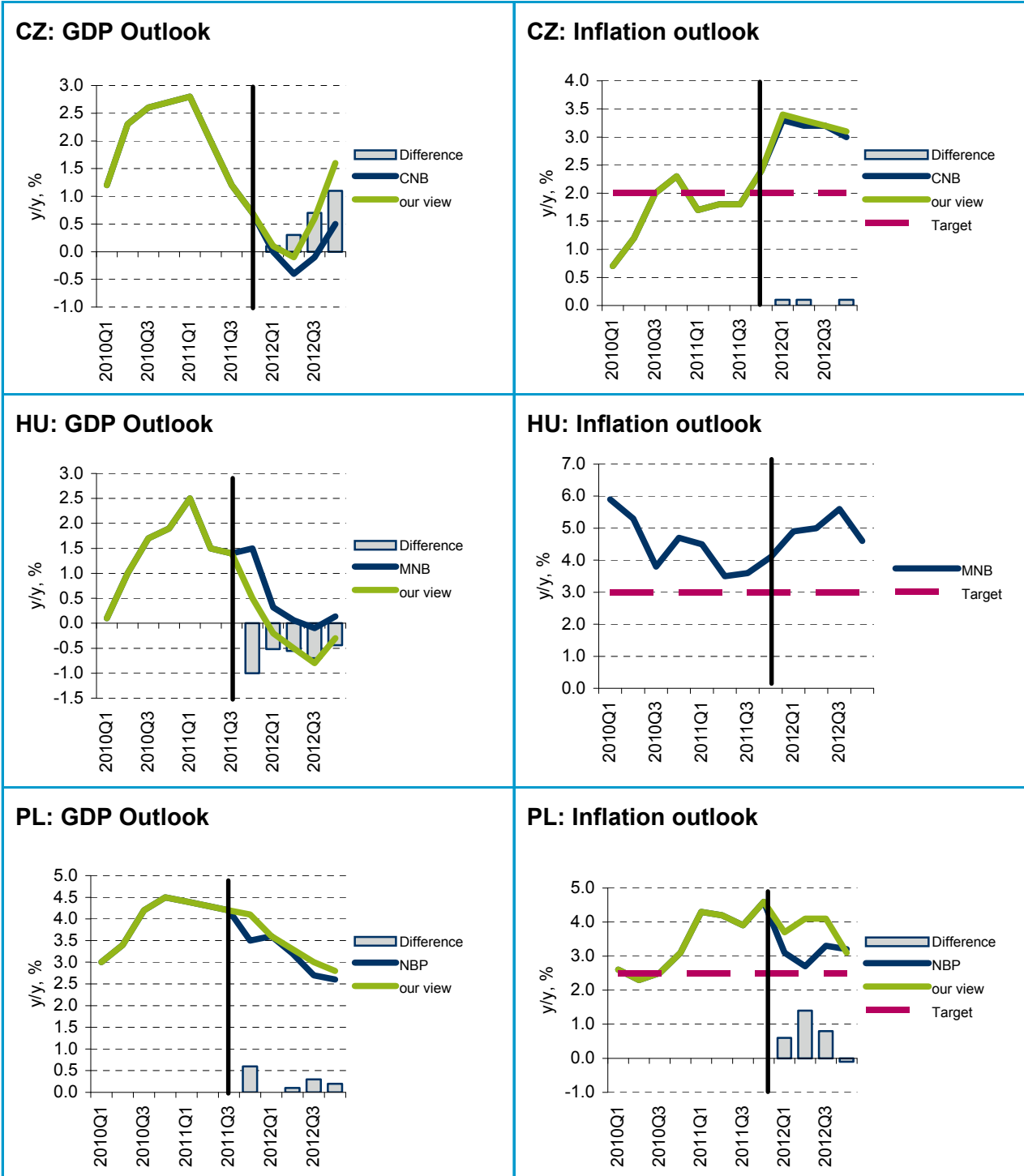


Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	<p>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.</p>	<p>In the Hungarian outlook the IMF agreement will evidently have a crucial role. The Hungarian government sent an answer for the European Commission to the controversial questions (independence of Central Bank, ombudsman for data protection, age limit for judges) so it would turn out in the next 2-3 weeks whether Hungary should face further challenges given by the Commission or they give green light to start negotiations. We suppose negotiations could last for 1-1.5 month so in a positive scenario an agreement could be reached till late March-mid April.</p>	<p>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.</p>
Outlook for official & market rates	<p>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.</p>	<p>The MNB announced three new measures to boost forint credit in the banking system. Overall, I could help somewhat in the current deleveraging world, but the central bank also admits that current situation is more of the case of lack of willingness, where these may not help much. Meanwhile, the headline inflation accelerated to above 5% Y/Y on VAT hike. Further tightening does not look needed now, but definitely the VAT hike does not seem to pass on smoothly. Overall, cautious monetary policy is warranted, ie. the MNB may wait with reducing the base rate.</p>	<p>Although the inflation should somewhat decelerate and growth slow down in 2012, we do not believe in monetary easing. The inflation should still remain above the target for the whole year and the volatility of the zloty could have impact on inflationary expectations, if the NBP started with easing once again.</p> <p>On the other hand pretty low job creation should keep also the hawks on hold. Hence we bet on interest rate stability over the whole year 2012.</p>
Forex Outlook	<p>The Czech koruna should stabilize after the second Greek bailout deal and extend gains in reaction to the global optimism. On the other hand the eurozone issues could continue to weigh on the CEE later during the year. Also the 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 25.00 EUR/CZK.</p>	<p>EURHUF stays around and under 290 levels. As we have a look at the unsolved situation of EU countries in crisis, HUF strengthening in the past few weeks is remarkable. It is important to be aware of the international trends and investors' sentiment as the volatility of bond yields would not drop in the near future.</p>	<p>The Polish zloty has stabilized on Greek hope. Similarly to the koruna, the Greek deal may help to ensure further gains. Nevertheless the fundamentals should not permit gains below 4.00 EUR/PLN - the economy should slow down in second half and the rates remain flat. During the summer we may see some renewed selling pressure after the European championship in football takes place and the Greek issue potentially comes back to the table. The motivation by official authorities to defend the zloty may be weaker this time due to changed methodology of debt/GDP calculation and lower sensitivity to FX volatility...</p>

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	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	1.21	1.17	1.17	1.12	1.10	1.12
Hungary	BUBOR	7.43	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	2.17	2.05	2.24	2.25	2.40	2.60
Hungary	HU10Y	7.10	7.50	7.50	9.25	9.25	9.00
Poland	PL10Y	4.88	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	24.9	25.0	26.0	24.8	24.5	25.0
Hungary	EUR/HUF	288	295	280	290	290	290
Poland	EUR/PLN	4.17	4.35	4.10	4.10	4.00	4.30

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



Central European Weekly

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