Tuesday, February 28,

Central European Weekly

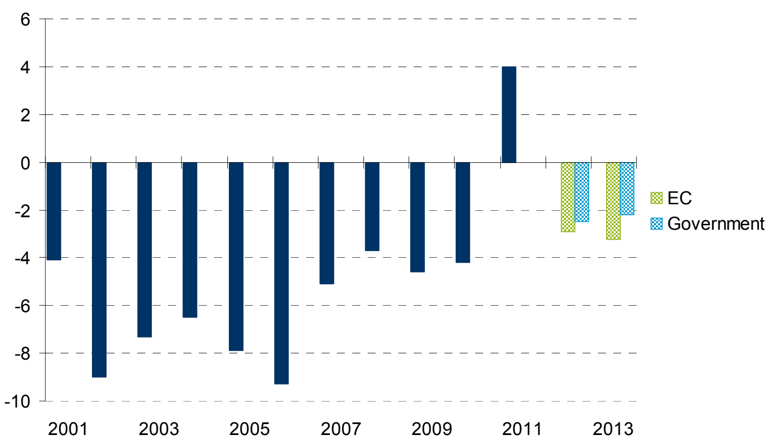
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Hungary is warned with suspension of EU funds
- Slovaks government issues debt in the Czech koruna
- Better times ahead for Germany & the Czech Republic
- MNB is going to leave rates unchanged, Poland’s GDP still growing rapidly

Chart of the Week: Hungary and its fight with budget deficits….

HU: Government balance as % of GDP



The European commission wants to punish Hungary for breaching the 3% GDP budget deficit target in 2013.

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Market's editorial

EU punishes Hungary, Slovaks issue debt in CZK

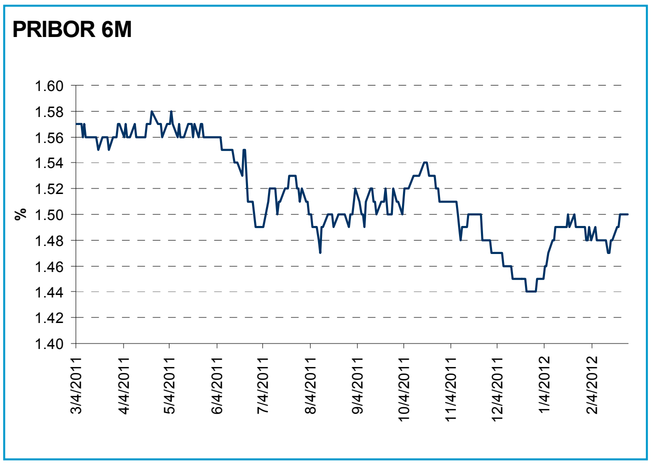
Last week's events in Central Europe that are worth noting and that we would like to highlight include another eruption of disputes between the EU and Hungary, and Slovakia's unusual debt issuance in the Czech koruna.

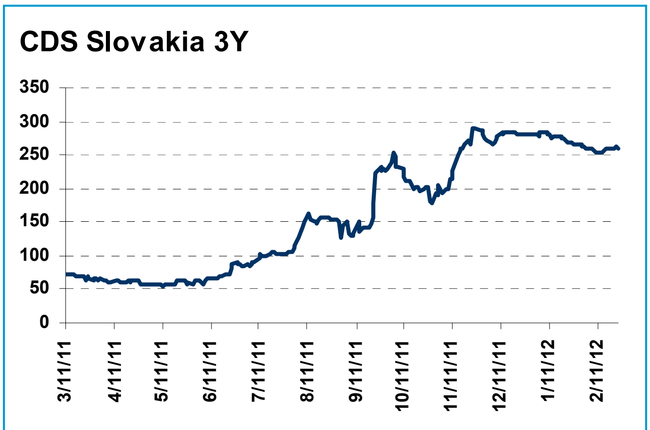
Hungary is warned with suspension of EU funds

Let's start with Hungary. Recall that the EU Commission threatened Hungary with suspending some €0.5bn from the cohesion funds or 0.5% of GDP from 1 January 2013. The reason is that Hungary has not been complying with the EU's 3% of GDP budget deficit rule since it joined the EU in 2004. Strictly applied this is not the case because last year the balance was a 3% of GDP surplus because of the one-off revenue from pension funds. This year the Commission also expects the deficit below 3% of GDP, albeit a bit higher than the government's 2.5% of GDP target.
Hence, the debate focuses on the 2013 budget deficit outlook, where the Commission expects 3.25% of GDP budget deficit, roughly 1pp above the government's 2.2% of GDP target.
The next step is the judgement of the Ecofin meeting on March 13 and if the proposal, Hungary will have to introduce additional measures until the year-end to avoid loosing money. Currently, the government sent a 100-pages reply to the Commission, but without agreement on two points. One is the oath of the central bank leaders, the other is the retirement age of judges. The ball is on the Commission's side now.

Slovaks credit risk premium three times higher that the Czech one in korunas

As regards the recently sold issue of Slovakia's government debt, there are at least two interesting aspects. Firstly, the fact alone that the contagion in eurozone bond markets has made the Slovak government issue its debt in (Czech) korunas rather than in its 'domestic' currency – i.e., the euro – catches the eye. The second interesting aspect is the amount of the risk premium the Slovak government had to pay on the koruna market. Despite having nearly the same rating as the Czech Republic, Slovakia had to pay approximately triple the risk premium required from the Czech government the spread for Slovakia reached around 180 bps above 6M Pribor). Apart from the above contagion, which punishes such eurozone countries as Slovakia and Slovenia, whose debts in relative as well as absolute terms are small and thus illiquid, the high credit premiums may be viewed as the toll for (investors') uncertainty ahead of the early general election to be held in Slovakia on March 10.





CDS Slovakia 5Y, last 250 days. Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.1	0.76%	↘	↘
EUR/HUF	292	1.85%	↘	↘
EUR/PLN	4.19	0.10%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.18	1.20	↗	↗
10Y PLN	7.30	2.96	↗	↗
10Y HUF	4.90	0.35	↘	↘

Review of Economic Figures

German business sentiment

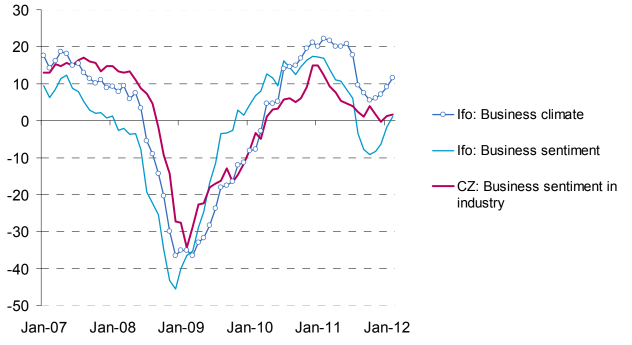
Ifo, the key German business sentiment index, has risen for a fourth consecutive month, which is good news for all CE economies, especially for the Czech Republic. Its industry has the strongest link to the German economy.

The IFO business climate indicator jumped from 108.3 to 109.6, while the consensus was looking for a more moderate increase to 108.8. The details show that strength was broad-based as both the current assessment (117.5 from 116.3) and expectations (102.3 from 100.9) sub-index improved in February. Also the sector breakdown indicates that the improvement was wide spread as manufacturing (14.3 from 13.4), construction (3.3 from -3.6), wholesale trade (14.9 from 10.5) and retail trade (3.6 from -0.5) all picked up in February. An IFO economist added that the domestic situation in Germany is particularly stable and said he does not see a recession in Germany for now. Earlier this week, the PMI's raised fears that the euro zone will have difficulties to avoid a new recession. This outcome suggests however that at least the German economy is likely to avoid a second consecutive quarter of contraction.

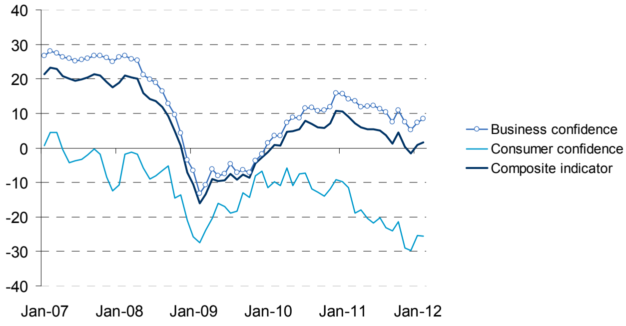
…so sentiment in the Czech economy has improved too; February's PMI could be interesting

Thus the strong pessimism that hit the economy in late 2011 has been at least partly mitigated by the improved expectations of the business sector. Particularly the moods in industry and services have improved. While industrial firms anticipate a moderate deceleration of their production in the months to come, they concurrently expect a better economic situation within the next three to six months. By contrast, the confidence among construction firms is as poor as in January, and the mood among retailers is again declining, in the wake of the January's price rise; likewise, consumer confidence is also going down slightly, as they are exposed to increased prices of consumer goods and services, a worsened economic outlook, and the risk of increased unemployment this year. By and large, the mood in the economy has improved slightly but is still well below that of February 2011. This is why we cannot overestimate the current figures and do not consider them a reason to change our view of the Czech economy. In this respect the upcoming release of the February PMI report for the Czech economy could be very interesting.

Ifo vs. Czech business sentiment



CZ: Economic sentiment



Weekly Preview

TUE 14:00	MNB base rate	
	This meeting	Last change
rate level (in %)	**7.00**	11/2011
change in bps	**0**	50

HU: MNB meeting should be quiet this time

After the surprise move in January - when the MNB did not hike – it could be a more quiet meeting. This time analysts expect no change after the forint appreciated some 4% since the previous meeting, which is a surprise in itself since lower interest rates would normally cause the opposite. We expect the base rate to stay unchanged for several months even in the case talks with the EU/IMF team advance because of the current inflation risk and the undervalued currency.

THU 10:00	PL GDP (y/y change in %)		
	2011Q04	2011Q3	2010Q4
GDP	**4.1**	4.2	4.7

PL: GDP growth in 2011/Q4 slightly above 4%

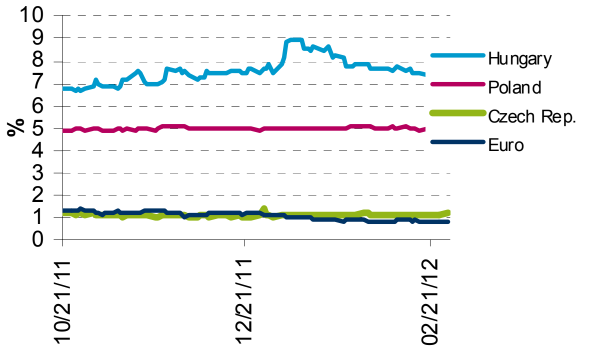
The Polish economy showed extraordinary resistance last year and grew by 4.3% according to preliminary forecasts, in spite of the increased uncertainty and significant rate hikes in the first half of the year. As concerns Poland's growth for the last quarter of 2011, we predict it at 4.1% y/y. As to the value added, industry should bear out its very good condition, with the major sectors that fared well primarily including the food industry and chemical production. Construction has also recovered significantly over the last two years, and this trend was also evident in the last quarter of 2011. As far as demand is concerned, domestic demand should again be the primary driver – Polish households are willing to spend their money in spite of fairly high unemployment.

Calendar

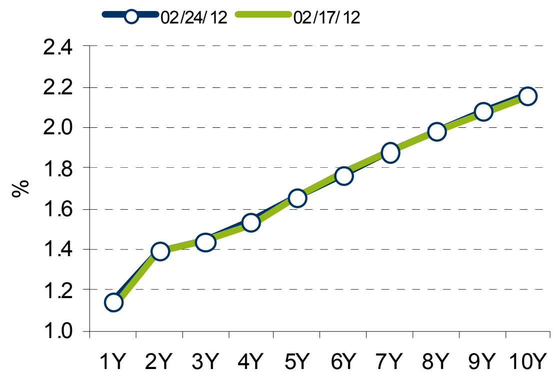
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	02/28/2012	9:00	Unemployment rate	%	01/2012			11		10.7	
HU	02/28/2012	14:00	NBH meeting	%	02/2012			7		7	
CZ	02/29/2012	11:00	Money supply M2	%	01/2012						5.2
HU	03/01/2012	9:00	PPI	%	01/2012				8.2	-0.5	7.5
PL	03/01/2012	9:00	PMI manufacturing		02/2012						
HU	03/01/2012	9:00	PMI manufacturing		02/2012					49.8	
CZ	03/01/2012	9:30	PMI manufacturing		03/2012						
PL	03/01/2012	10:00	GDP	%	4Q/2011					1	4.2
CZ	03/01/2012	14:00	Budget balance	CZK B	02/2012					21	
HU	03/02/2012	9:00	Trade balance	EUR M	12/2011 *F					352.1	

Fixed-income in Charts

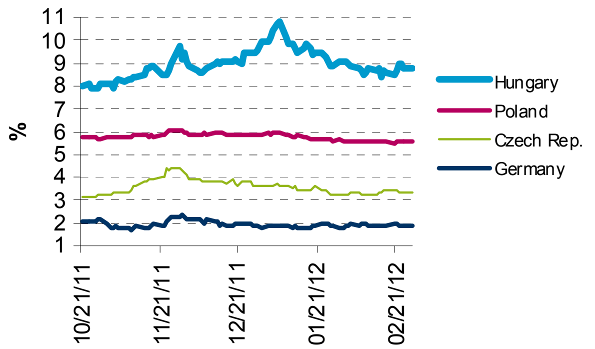
FRA 3x6



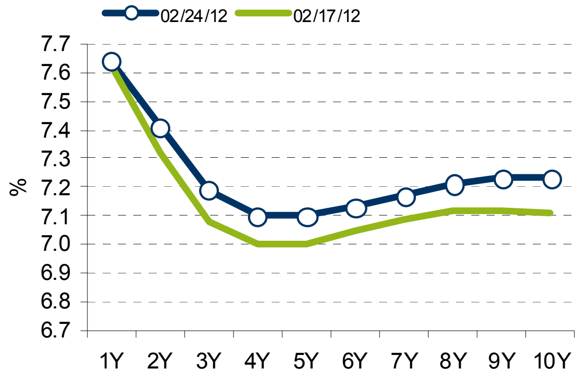
CZ IRS



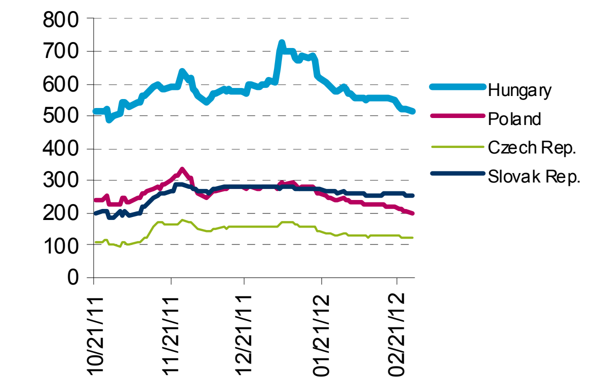
10Y GB Yields



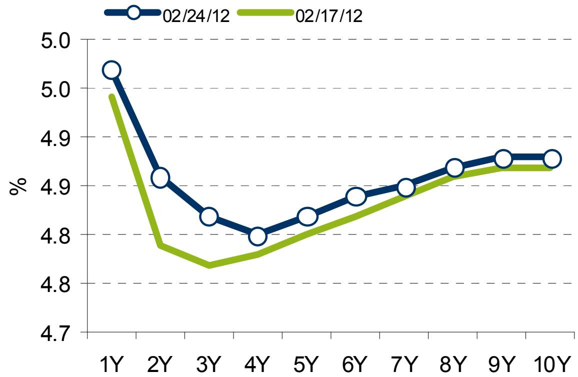
HU IRS



CDS 5Y



PL IRS



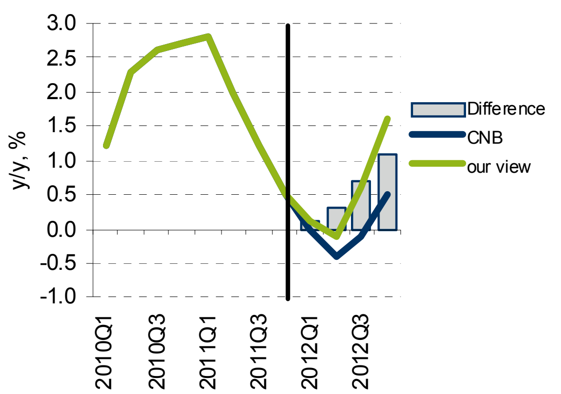
Source: Reuters

Medium-term Views & Issues

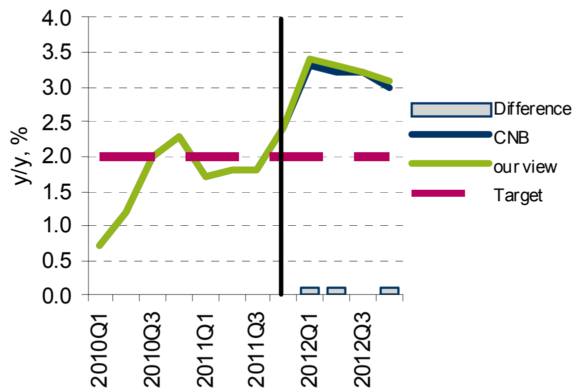
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion 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.	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 Marchmid April.	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 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.	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. 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.
Forex Outlook	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.	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.	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...

CB's Projections vs. Our Forecasts

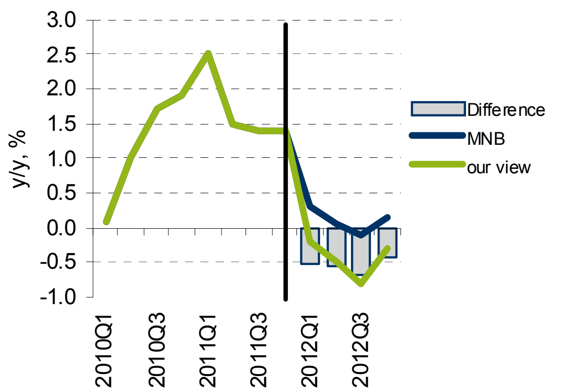
CZ: GDP Outlook



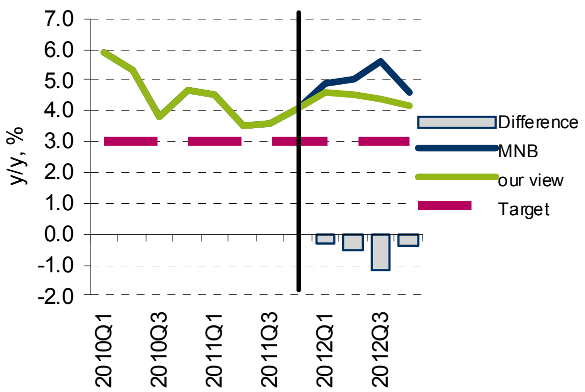
CZ: Inflation outlook



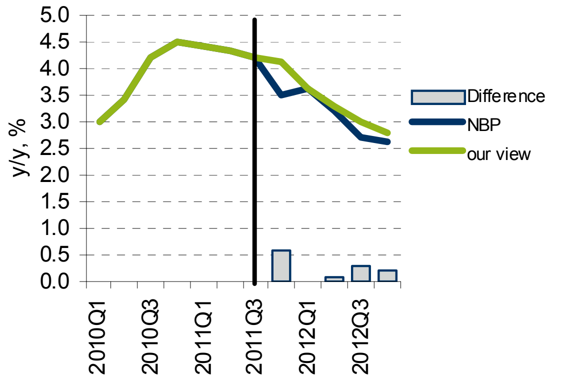
HU: GDP Outlook



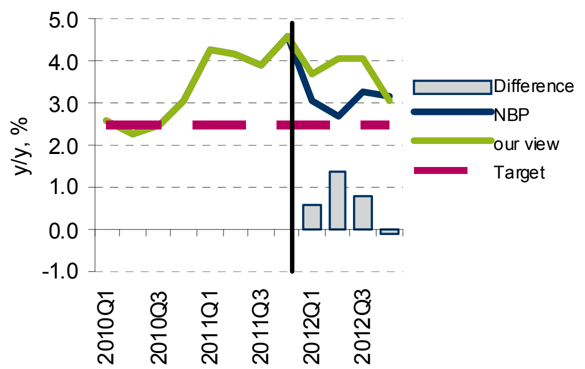
HU: Inflation outlook



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	*1.21*	1.17	1.17	1.12	1.10	1.12
Hungary	BUBOR	*7.38*	6.00	6.50	7.00	7.00	7.00
Poland	WIBOR	*4.96*	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	*2.1809*	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	*4.90*	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	24.8	24.5	25.0
Hungary	EUR/HUF	*292*	295	280	290	290	290
Poland	EUR/PLN	*4.19*	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

Brussels Research (KBC)		Global Sales Force	
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