Tuesday, March 13, 2012

Central European Weekly

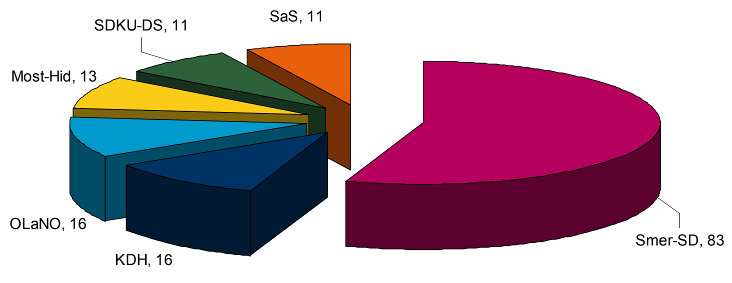
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Slovak left-wing opposition claim land-slide victory
- Czech economy down, inflation up
- Mixed output data from Hungary
- In focus: Parliamentary elections in Slovakia

Chart of the Week:

Distribution of seats in the Slovak Parliament



Smer (left wing); **KDH** - Christian Democrats (right wing); **OLaNO** - Ordinary people and independent personalities; **Most-Hid** - Bridge (ethnic hungarians); **SDKU-DS** - Slovak Democratic and Christian Union (right wing); **SaS** - Freedom and solidarity (right wing - liberals)

The Slovak left-wing opposition party (Smer) claimed land-slide victory in parliamentary elections, receiving a clear majority of parliamentary seats.

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Market's editorial

Slovakia turns left; bond market remains calm

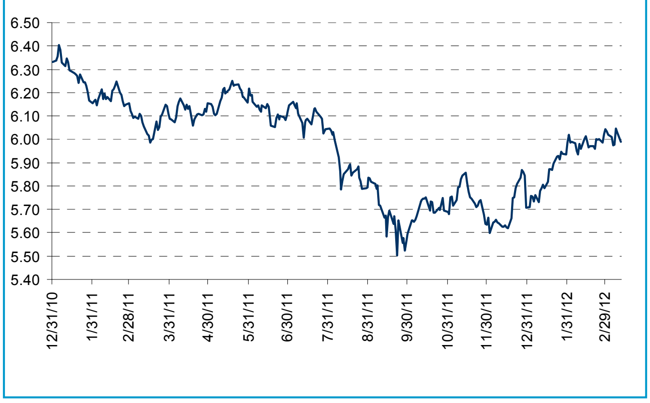
Slovakia held early Parliamentary elections on Saturday. The left-wing Smer party defeated the rightist coalition that ruled country only less than two years. Smer gathered 44.41% of votes which means 83 out of 150 seats in the Parliament. The clear majority will lead to a one-coloured government.
What can we expect on the field of economic policy? Slovakia has to decrease the public finance deficit to below 3% of GDP till the end of 2013 from current 4.6% of GDP (preliminary result). It is not an easy task and the deficit reduction by more than € 1bn will lead to unpopular measures. The spending cuts are necessary and markets will keep a close eye on the first steps of new government (see .
The credit markets are calm so far. We expect that the GIIPS story will be more important for small EMU countries now. But as time goes by the decisions of Smer government including the proposal of new state budget will be crucial for Slovak CDS and GB spreads

On the front between the zloty and the koruna

The sentiment in CEE looks rather positive, at least on Czech and Polish markets. The forint is continuing to be the regional scapegoat, curbed by Hungary's disputes with the European Commission, because of which the start of official talks with the IMF has been postponed.
However, the view of the comparison of the EUR/PLN and EUR/CZK currency pairs is also interesting. While the correlation coefficient remains high (0.85 for the last 30 days), it has started to decline at a moderate rate in recent weeks and did not prevent a much faster appreciation of the zloty, which led to PLN/CZK fluctuations. Thus the zloty has again climbed to its strongest level against the koruna since August 2011.
Two reasons may be responsible for this. The conventional short-term explanation is that the low-interest and safer koruna typically remains more stable in periods when there is a regional sell off, while it lags behind the zloty in times of global optimism, which has occurred in recent weeks in the wake of the approval of the second bailout package for Greece.
Nevertheless there might be also longer-term argument in favour of the Polish zloty´s strength relatively to the koruna, as we can see the longer trend of the strengthening zloty, which started in October 2011, rather than just short-term volatility. That said, the variables that can explain this may also include the relatively stronger Polish and weaker Czech fundamentals.
While Poland, in spite its anticipated deceleration, is likely to grow by more than 3% this year, the Czech economy is going to stagnate. Although the latest data from Czech industry and foreign trade does not look bad, these figures are largely attributable to car manufacture and machinery, while Poland's growth is much more evenly distributed. Although higher growth in Poland is nothing new, it has gone hand in hand with similarly high inflation in both the Czech Republic and Poland this year. The Czech Republic's higher inflation and poor growth are heavily affecting the ambitions of the Czech currency, not only vis-à-vis the euro but also vis-à-vis the neighbouring Polish zloty.

Slovakia: CDS 5Y (USD)

PLN/CZK



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.6	-1.12%	↗	→
EUR/HUF	293	-0.58%	↗	→
EUR/PLN	4.11	-1.54%	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.21	2.79	→	↗
10Y PLN	7.22	-1.23	→	↗
10Y HUF	4.81	-2.34	→	↗

Review of Economic Figures

Czech economy down, inflation up

The new data on the GDP for the last quarter of 2011 was slightly better than signalled by the original forecast. Yet there is no reason to rejoice at the favourable figure, because it was due to households building up stocks ahead of a VAT change and tobacco firms building up stocks ahead of an excise duty increase. At the end of the year, the economy dropped by 0.1% q/q (as opposed to the predicted 0.3%), thus having fallen for two consecutive quarters. That said, this basically marks a recession, which is primarily based on poor domestic demand. On the year-on-year basis, the GDP grew by 0.6% at the end of the year, and by as much as 1.7% for the whole of 2011. Even so, the economic deceleration has been increasingly evident since as long ago as the middle of 2010. What is more, the bottom of the current economic cycle is likely not over, and therefore we expect the economy to be in a recession in the first half of this year. An improvement is unlikely to occur before late 2012, when inflation starts to fall and the situation in eurozone markets is likely to improve.

This year, we cannot rely on domestic demand either; unemployment is rising, real wages are falling, businesses are cutting their investments, and consequently this year's performance of the economy will be completely at the mercy of exporters. The very first figure of this year – January's trade balance – sprang a very pleasant surprise; the foreign trade surplus climbed to almost CZK 30 bn. Exports maintained their strong growth rate in January (+11%), primarily on the strength of very successful exports of machinery and means of transport. Carmakers again played the main part, as they succeeded in gaining a share of the European market to the detriment of their rivals. Imports show two conflicting tendencies: expensive oil and natural gas, pushing imports up, and poor domestic demand, driving imports down. We consider January's trade balance figure to be excellent. At a time when domestic demand is falling and the EU is experiencing another episode of its debt crisis, Czech exporters are faring well. We can only hope that they will also do so in the months to come.

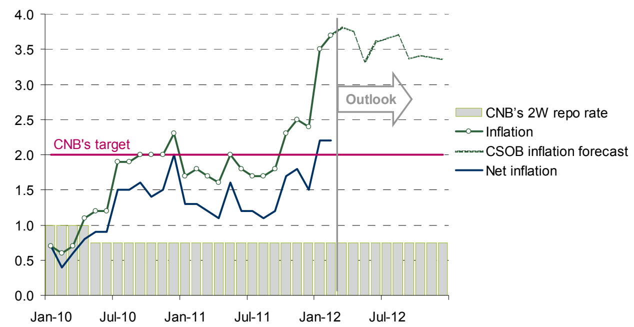
While the current export developments are very hopeful, domestic demand is curbed by increased inflation and slow wage growth. Although the latest payroll data is available for the last quarter of 2011, it clearly indicates the direction of this year's payroll developments. That said, nominal wage growth lagged behind inflation in late 2011, and this meant a drop in average wages in real terms for the first time in a long while, albeit by only 0.4% for the moment. A rapid inflation rise, also confirmed by February's data, has increased the likelihood of an even faster decline of the average real wage, because year-on-year inflation has climbed to as high as 3.7%, due primarily to the increases in VAT, excise duties, and food and fuel prices. Inflation will continue to go up in the months to come, when it is again going to be affected by food prices, fuel prices, as well as excise duties. Hence it will culminate at nearly 4%, and will not start to return towards 3% until the second half of the year.

Mixed output data from Hungary

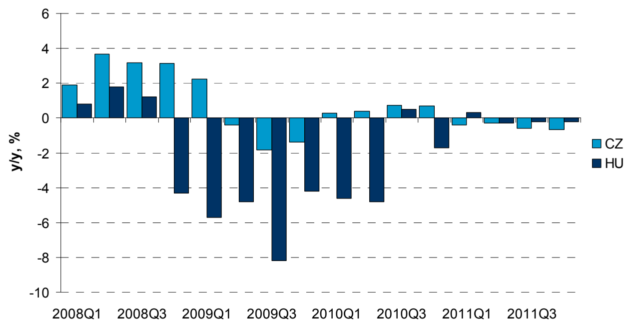
The GDP data confirmed the trend that Hungary is still goinf through an adjustment process of domestic demand as both household consumption and investment fell in the last quarter of 2011. This means that Hungary will exposed to the eurozone outoook, except if the nely built car plants will start production soon and give a lift to the economy. Earlier estimations suggested that new capacities could boost growth by about 1% Y/Y, which could be enough to keep the economy broadly flat throughout the year.

The industrial output showed 0.5% drop during the month against expectations for a small rise, which let the year-on-year figure to slow down to 2%. Uncertainty in the eurozone could have played a role behind as manufacturing also slowed, but generally this is a cold shower for economists. If the output level stays broadly unchanged during the year, it would almost guarantee a recession for the economy, which would have consequences. Hungary is vulnerable because of its high debt ratios and sustainability naturally depends on the growth outlook, as well.

CZ: Inflation and CNB's Target
(%)



CZ, HU: Household consumption

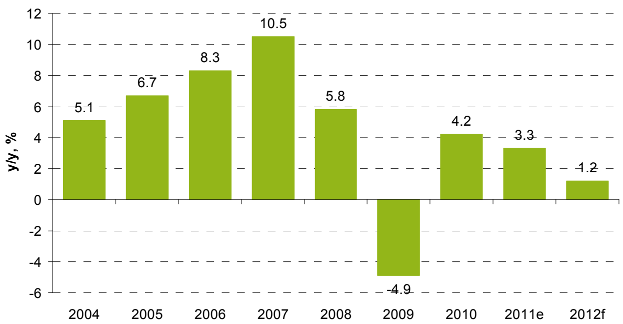


In focus: Parliamentary elections in Slovakia

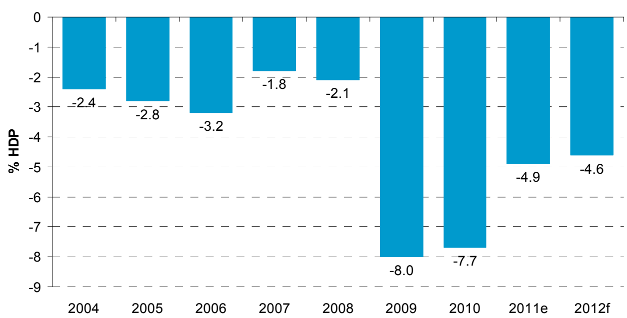
The Parliamentary election in Slovakia had an unambiguous outcome. For the next four years, voters have elected the left-wing Smer, which won more than a half of the seats in Slovakia's National Council. This gives Smer the chance to assemble a single-party cabinet that could launch into the fulfilment of its electoral platform without compromises. Above all, we must look at the kind of economic waters that the new, probably purely left-wing government, will enter. Slovakia is still a country with solid economic growth, but at the same time, it continues to suffer from relatively high unemployment, higher inflation and, above all, it has a high public finance deficit. Last year's government budget deficit of EUR 3.3 bn and the debt now payable do not offer much room for strengthening the social supports offered by left-wing politics, especially given that the strongest party talks about budget consolidation. Smer's objective is to increase public income relative to GDP, by means of making tax more progressive for individuals, increasing the income tax for legal entities, taxing dividends and profit shares, and introducing taxes on financing transactions. These measures, however, leaving the adverse impact on foreign investors aside, will not bring enough money into public coffers to allow the government to easily comply with the euro-compact it signed, support economic growth, and enhance social supports for the population.

The topical question is whether it can pose any threat, for example, to the prices of Slovak assets – in particular to government bond prices. We rather expect that after the election, pragmatism will in the end win out in Slovakia in the economic sphere, of the kind that Smer practiced during its reign in 2006-2010. The Eurozone bond markets require tough fiscal discipline, and since the announcement of the early election, Slovakia has not been in a position to ignore the voice of the markets in the form of high risk margins. Furthermore, the recently signed EMU fiscal pact essentially does not allow for any expansion. The new government can therefore get close to its programme in the budgetary area primarily by higher taxation on higher income groups and corporations – see above. Any such intervention will benefit Slovak bonds rather than knocking the legs out from under them. In any event, in the upcoming weeks it will pay to watch for the programme statement that the new government will present, i.e., what the government's programme statement will say in terms of budget deficits and bonds.

GDP growth
(Source: Eurostat)



General government deficit
(Source: Eurostat, Ministry of Finance SR)



Weekly Preview

TUE 9:00 **CZ Industry (y/y change in %)**

	Jan-12	Dec-11	Jan-11
Monhtly	**2.0**	2.0	16.2
cummulative (YTD)	**2.0**	6.9	16.2

CZ: Industry tracks performance of carmakers

Thus far, industry has benefited from the increase in orders, which had not eased before December. January's industrial output was also encouraged by one more business day in the month. The automotive industry likely continued to grow at a strong rate in January, followed by machinery and the production of electrical equipment. By contrast, metal production, textile and paper industries, as well as electronics production likely performed less favourably this time. The data on new orders, which will signal the possible direction of the strongest sector of the economy in the coming months, will be an even more interesting figure than industrial output. We predict the year-on-year growth rate of orders to remain close to zero.

TUE 9:00 **HU Inflation (change in %)**

	Feb-12	Jan-12	Feb-11
CPI y/y	**5.6**	5.5	4.1

HU: Inflation again slightly up

Like in the whole region – the Hungarian year-on-year inflation readings are still point north.

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

	Feb-12	Jan-12	Feb-11
CPI y/y	**4.2**	4.1	3.6
Food (ex Alc.) y/y	**3.8**	4.4	5.0
Transport (including fuel)	**10.4**	8.7	6.5

PL: February's inflation accelerates slightly

February's inflation in Poland accelerated slightly, to 4.2% y/y, according to our forecasts. We believe that the month-on-month rise by 0.3% was primarily based on transport prices, despite the significant appreciation of the Polish zloty. By contrast, clothing prices should fall for a second consecutive month, this time by 2.3%. Food prices, which are traditionally the most relevant, only went up by a negligible 0.3% m/m in February, according to our forecasts. Let us add that the complete structure of January's index, recalculated with new weights of consumer basket items, will also be released this month.

THU 9:00 **CZ Retail Sales (change in %)**

	Jan-12	Dec-11	Jan-11
Sales	**0.2**	1.6	7.3
cummulative (YTD)	**0.2**	1.9	7.3

CZ: Retail still drive mainly by car sales

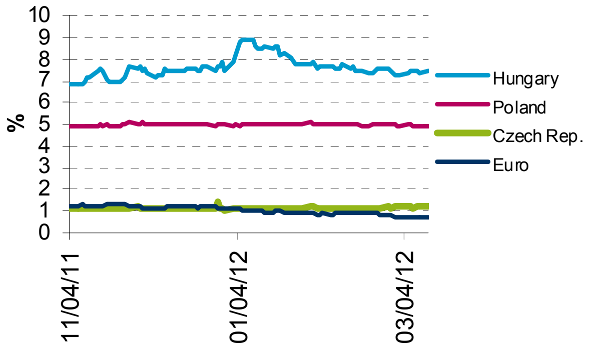
We believe that retail sales only went up very slightly at the beginning of this year. Moreover, it was primarily new car sales that again pushed retail sales into the black this time. Thus the retail sector, excluding the automotive segment, likely went down again. This is primarily due to an anticipated decline in real household income, triggered by increased inflation and the deterioration in the Czech labour market.

Calendar

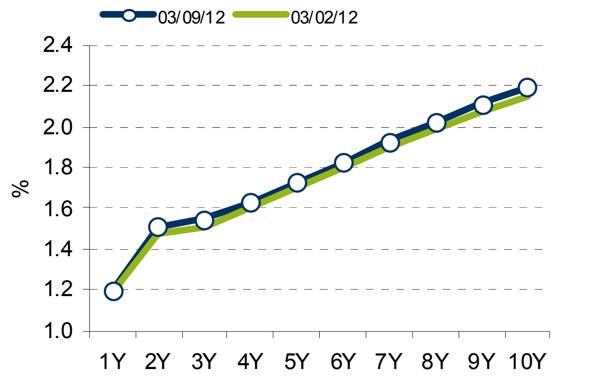
Country	Date	Time	Indicator		Period	Forecast m/m	Forecast y/y	Consensus m/m	Consensus y/y	Previous m/m	Previous y/y
CZ	03/13/2012	9:00	Industrial output	%	01/2012		2		2.8		2
CZ	03/13/2012	9:00	Construction output	%	01/2012						14.6
HU	03/13/2012	9:00	CPI	%	02/2012		5.6	0.4	5.5	2.1	5.5
CZ	03/13/2012	10:00	Current account	CZK B	01/2012	8		9.5		-8.93	
PL	03/13/2012	14:00	Current account	EUR M	01/2012			-1024		-1337	
PL	03/13/2012	14:00	Trade balance	EUR M	01/2012			-382		-1076	
PL	03/13/2012	14:00	CPI	%	02/2012	0.3	4.2	0.3	4.2	0.7	4.1
HU	03/14/2012	9:00	Industrial output	%	01/2012 *F					2.1	-2.7
PL	03/14/2012	14:00	Money supply M3	%	02/2012			0.6		-0.8	
CZ	03/15/2012	9:00	Retail sales	%	01/2012		0.2		0.7		1.6
CZ	03/15/2012	9:00	PPI	%	02/2012	0.3	3.8	0.3	3.9	1	4.1
PL	03/15/2012	15:00	Budget balance	PLN M	02/2012					-5278	
PL	03/16/2012	14:00	Wages	%	02/2012			-1.9	5.3	-8.7	8.1

Fixed-income in Charts

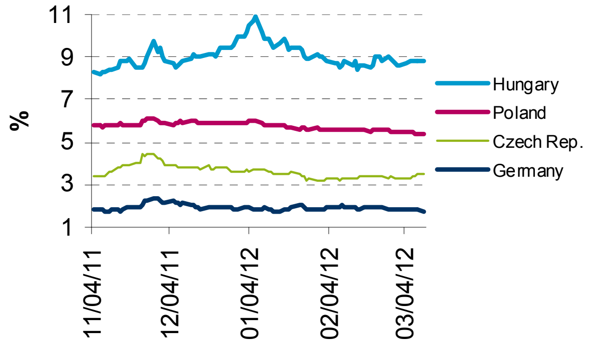
FRA 3x6



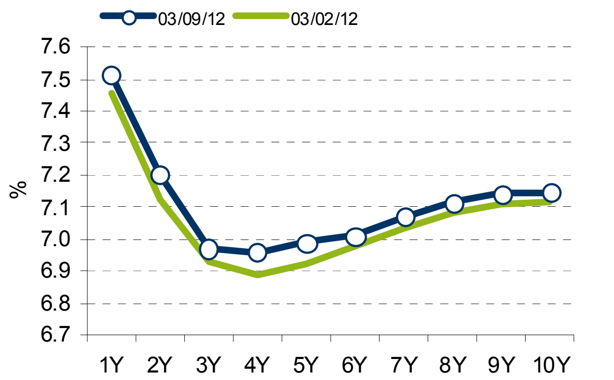
CZ IRS



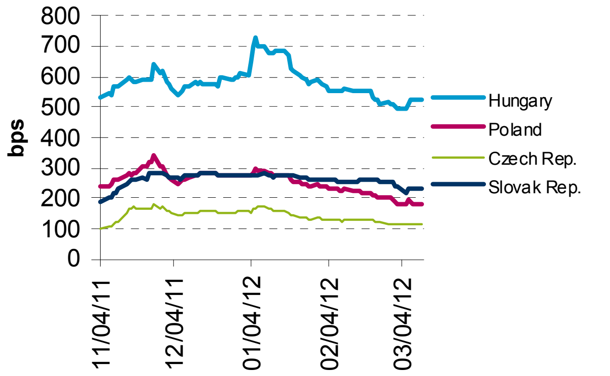
10Y GB Yields



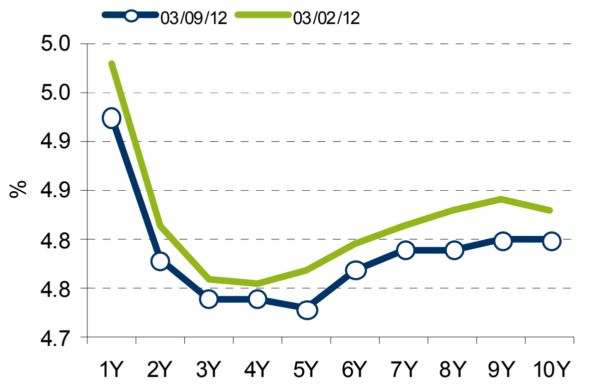
HU IRS



CDS 5Y



PL IRS



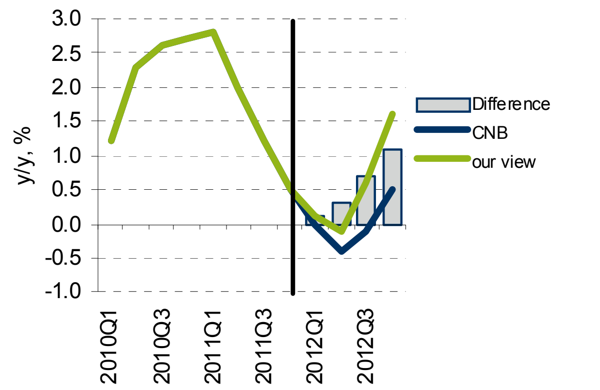
Source: Reuters

Medium-term Views & Issues

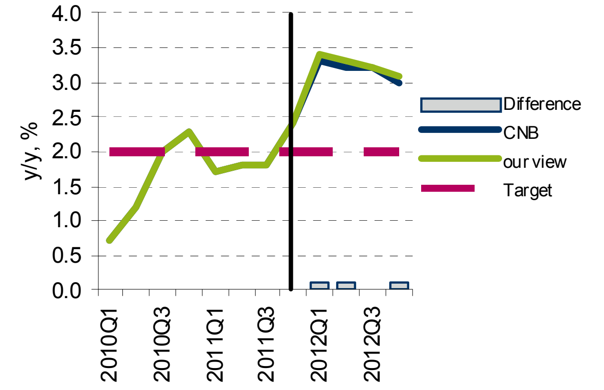
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion 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 EU/IMF talks have been ongoing in the background and the government sent its reply to the Commission, where it stand up to its demand about the oath of the central bank leaders and the retirement age of judges. We think it would be unlikely if Hungary does not get the loan facility because of these issues and the loan agreement could come in May- June.	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 stay in a wait-and-see mode.	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 290 levels. As we have a look at the 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

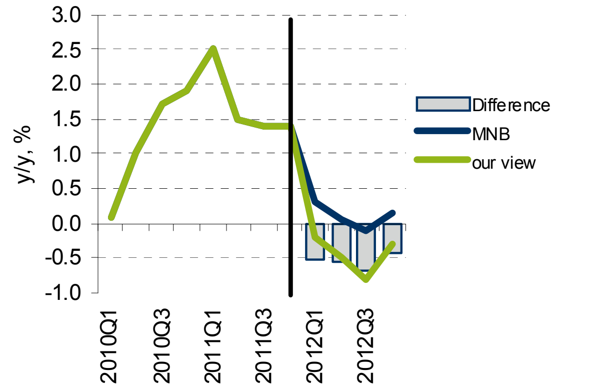
CZ: GDP Outlook



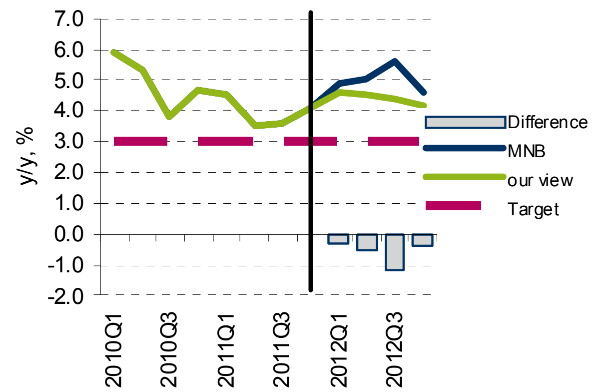
CZ: Inflation outlook



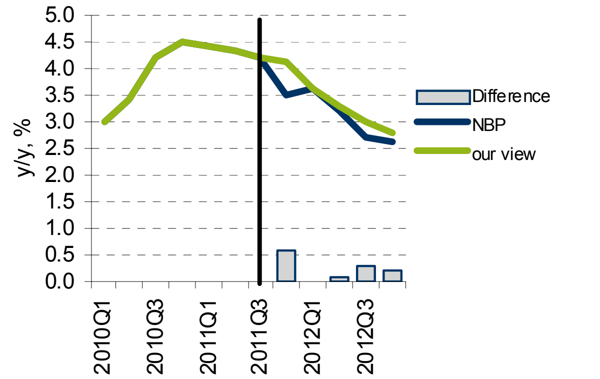
HU: GDP Outlook



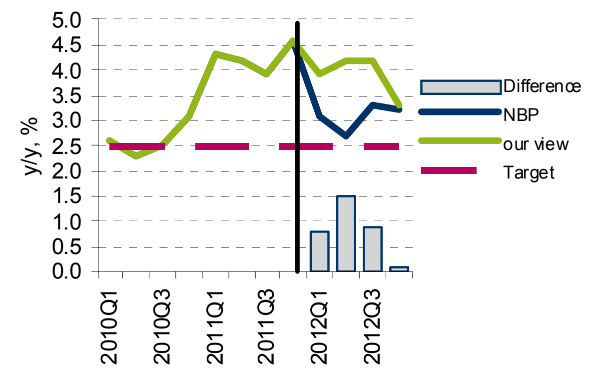
HU: Inflation outlook



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	4.50	4.50	25 bps	6/9/2011

*Short-term interest rates 3M *IBOR (end of the period)*

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	PRIBOR	*1.23*	1.17	1.17	1.12	1.10	1.12
Hungary	BUBOR	*7.31*	6.00	6.50	7.00	7.00	7.00
Poland	WIBOR	*4.94*	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	*2.2*	2.05	2.24	2.25	2.40	2.60
Hungary	HU10Y	*7.20*	7.50	7.50	9.25	9.25	9.00
Poland	PL10Y	*4.80*	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	*24.6*	25.0	26.0	24.8	24.5	25.0
Hungary	EUR/HUF	*293*	295	280	290	290	290
Poland	EUR/PLN	*4.11*	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	0.5	0.1	-0.1	0.6
Hungary	2.5	1.5	1.4	1.4	-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	3.9	4.2	4.2	3.3

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

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