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Central European Weekly

Monday, 21 May 2012

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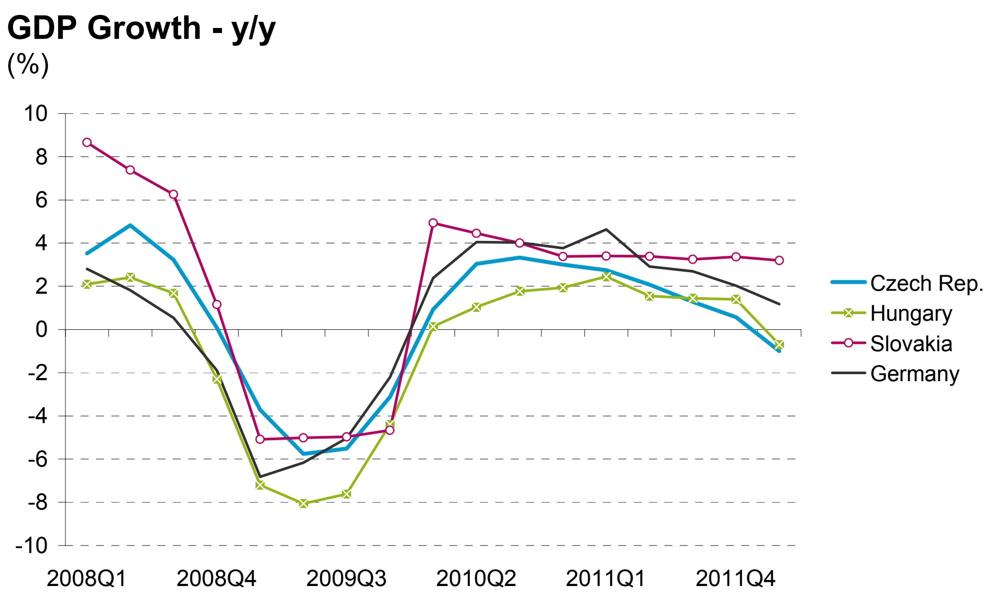
Weekly Highlights:

- Central Europe faces contagion from the eurozone – still sell-off has been limited so far
- Czech and Hungarian GDP growth disappoint, but details might not as bad as headline figures suggest

Chart of the Week:



Although performance of the German economy was quite solid both the Czech and Hungarian growth slipped into negative territory.

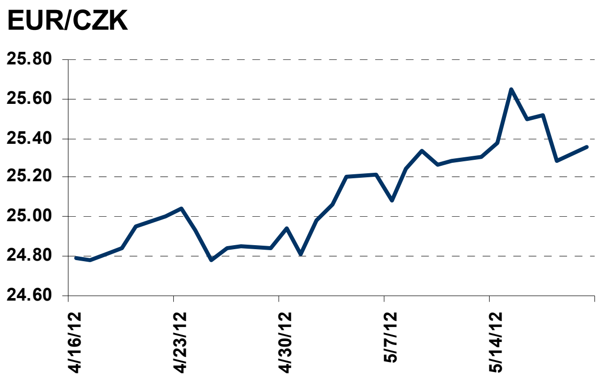
Market's editorial

Contagion back in the region, but in limited fashion

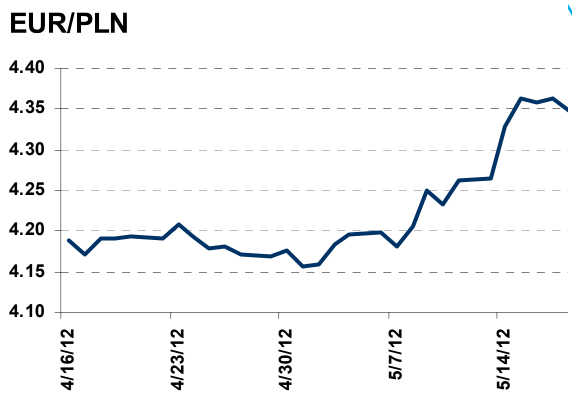
Contagion coming from the eurozone to Central Europe is on the rise, with both forex and bond markets being affected; nevertheless, the depreciation of regional currencies and the increase in (credit) risk premiums are fairly limited at the moment, perhaps due to the fact that the sources of potential problems inside Central Europe have been eliminated somewhat. For example, Hungary has succeeded in securing its credit backing from the IMF and the vulnerability of the Polish zloty has been at least reduced by a hawkish move by the National Bank of Poland.

GDP contraction is surprise – let's wait for details

Even so, investors who bet on the Central European region might by concerned by the fact that the export-oriented economies of the Czech Republic and Hungary fell in the first quarter of the year. Their GDP growth was negative, even though their largest trading partner – Germany – continued to perform well in the first quarter. This is certainly not encouraging news, but, while we do not wish to play down the drop in Czech and Hungarian economies, two major aspects that slightly reduce the initial negative impression should be borne in mind. Firstly, the released forecasts are the first preliminary figures, which may be slightly revised upwards. Secondly, the performance of both countries is affected by a strong fiscal restriction, which significantly curbs domestic demand. However, the foreign trade of both the Czech Republic and Hungary is still faring well (due also to their ties to Germany), and otherwise, while the overall GDP figure is not very impressive, the structure of the performance of the economy is not all that bad.



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*25.2*	*-1.91%*	➔	➚
EUR/HUF	*297*	*0.77%*	➔	➚
EUR/PLN	*4.32*	*-1.06%*	➔	➚



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.87*	*-3.11*	➔	➔
10Y PLN	*7.12*	*0.07*	➔	➚
10Y HUF	*4.88*	*-1.71*	➔	➚

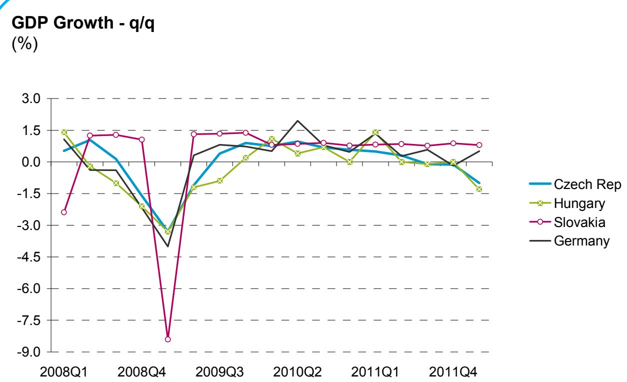
Review of Economic Figures

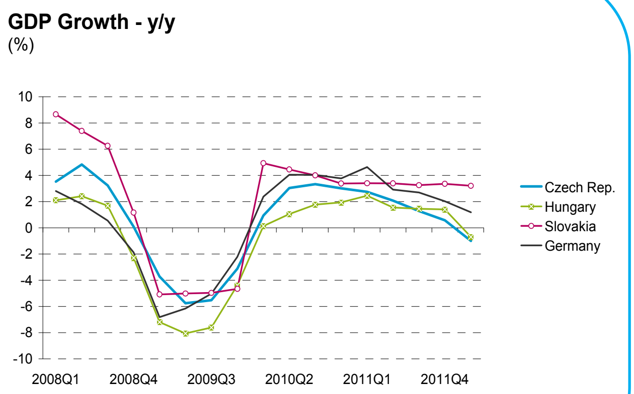
The Czech GDP growth surpassingly in negative territory

The preliminary forecast of the development of the Czech economy for the first quarter of this year confirmed a further deterioration of the recession. The 1% drop, whether on a quarter-on-quarter or year-on-year basis, is a cold shower, which strongly contrasts with the good figures from industry and exports at the beginning of this year. It also contrasts with the developments west of the Czech Republic; Germany's 0.5% growth was a nice surprise, and even the eurozone as a whole 'only' stagnated. At the moment, the Czech economy is fuelled by the success of the manufacturing industry – i.e., carmakers in particular – and this helps it partly offset the weakness of domestic and foreign demand. Services, just like construction, suffer from lack of domestic demand, which is primarily affected by uncertainty. This is also the source of poor consumer demand, which is also affected by the drop in real wages, the public and private sectors' unwillingness to invest and, in the end, by the fiscal restriction prescribed to reduce the debt dependence of the State. However, more detailed data on GDP developments will not be available until June. At the moment, it seems that, after the very poor first quarter, the economy may start to stabilise and even grow slightly in late 2012. Uncertainties persist, albeit they come from abroad rather than from the Czech Republic.

Hungary's economy still copes with fiscal restriction

Like in the Czech Republic., Hungary's first quarter GDP figures came in well below expectations as Q/Q growth was just -1.3%, while the economy fell 0.7 in year-on-year terms. Details are not yet available, but we suspect that both contraction domestic demand and probably weaker export demand played significant roles. The government has been carrying out deep austerity program this year to curb the deficit to 2.5% Y/Y of GDP.



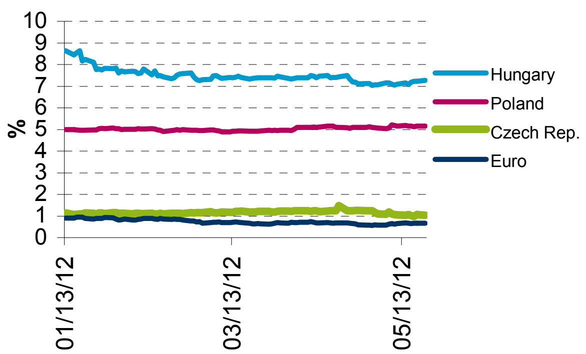


Calendar

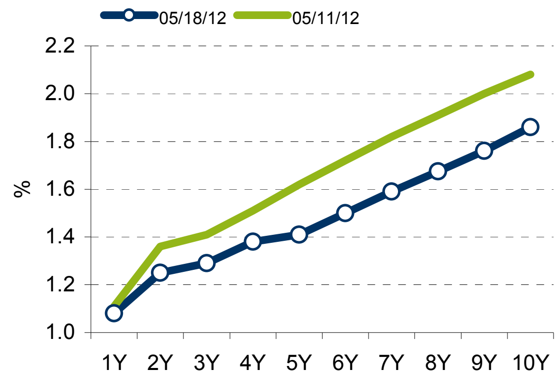
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	05/21/2012	14:00	Industrial output	%	04/2012			-7.2	2.8	10.7	0.7
PL	05/21/2012	14:00	PPI	%	04/2012			0.5	4.3	0.1	4.5
PL	05/22/2012	14:00	Core CPI	%	04/2012			0.5	2.6	0.3	2.4
CZ	05/23/2012	12:00	CZ bond auction floating rate/2023	CZK B	05/2012						
CZ	05/23/2012	12:00	CZ bond auction 4.60%/2018	CZK B	05/2012						
HU	05/24/2012	9:00	Retail sales	%	03/2012				-0.8		-1.4
PL	05/25/2012	10:00	Retail sales	%	04/2012			1.5	9.1	15.7	10.7
PL	05/25/2012	10:00	Unemployment rate	%	04/2012			12.9		13.3	

Fixed-income in Charts

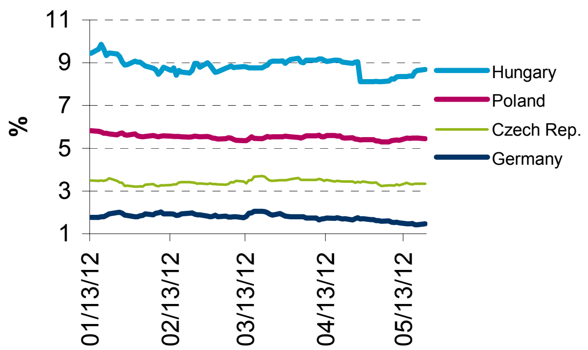
FRA 3x6



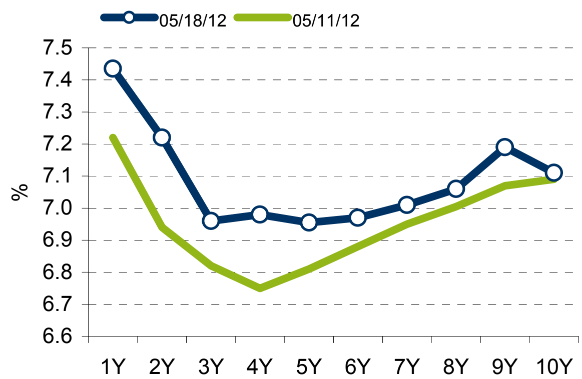
CZ IRS



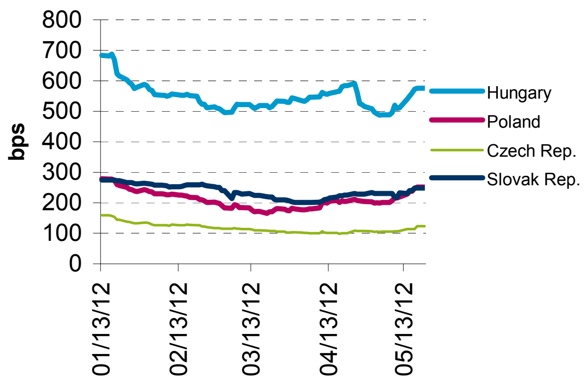
10Y GB Yields



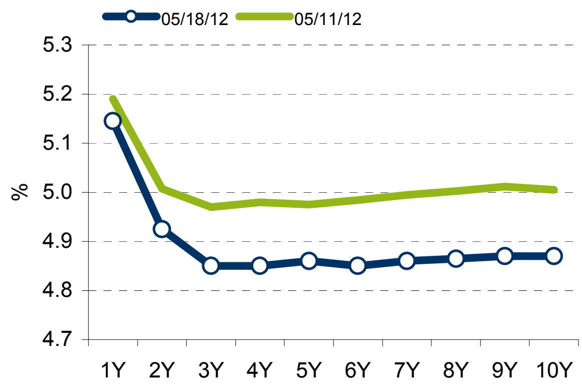
HU IRS



CDS 5Y



PL IRS



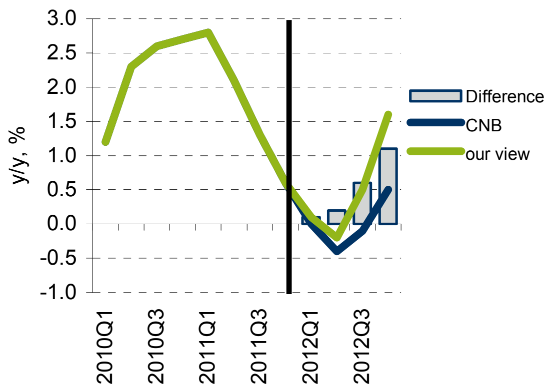
Source: Reuters

Medium-term Views & Issues

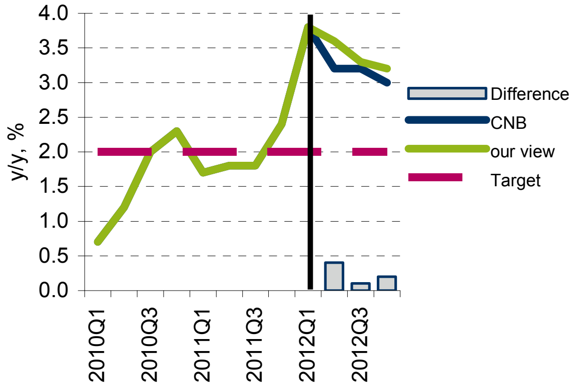
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion 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 in the Euro-zone.	The EU gave green light to the talks, but the IMF stated that it has also prerequisites, namely definite steps regarding the central bank's independence. They gave no further details, so the government withdrew some proposal from the central bank law's, while kept others. Currently the ball is in the IMF's court, we do not rule out that they will not accept the steps taken so far and will ask for additional changes. Of course, this will not be beneficial for the forint, but the government can take further steps before the summer break, therefore the beginning of the talks by June is not out of the question. The risk of autumn talks is that the implementation of market financing slips to the last months of the year with the risk of the market situation at that time.	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 caused by high fuel and food prices and also by V.A.T. increase. On the other hand, weak domestic demand should counter a rise in demand-pull inflation. In spite of higher inflation the CNB still maintains its waitand- see policy. In fact there are some voices for another rate cut as two board members (incl. governor) voted for cut. So the probability of another monetary policy easening has been increasing. The first rate hike delivered by the Czech central bank is probable in 2013H2.	The April inflation in Hungary came in above expectations at 5.7% Y/Y on higher tobacco and fuel prices. This may reverse in May, when the fuel prices dropped about 5% on cheaper oil and stronger currency, but generally the trend looks to be quite negative as inflation could remain high around 5.5% and may not fall to the central bank's 3% target by the end of next year. Thus, we still believe that the next move of the MNB base rate will be down.	While the rate hike did not surprise us, owing to the well-managed communication by the NBP, we believe that it was not quite appropriate and we expect rate stability for the rest of this year (while the market has started to bet on another rate hike). What primarily makes us believe so is the more modest rhetoric by the NBP and the expectations of the future development of the Polish economy. Its growth should decelerate significantly in the second half of the year, and this should also lead to a gradual inflation fall towards the target.
Forex Outlook	Stronger USD dollar may keep further gains limited for the koruna. Also the Czech domestic factors do not look very supportive - slow continuation of real convergence and dovish CNB do not argue for dramatic gains of the Czech currency over 2012. That said, the koruna may be more vulnerable to potentially negative news from eurozone as well as to the domestic political tensions.	Leaving aside the Greek crisis, the Improved relationship with the IMF/EU should be beneficial for the forint, but the government can take further steps before the summer break, therefore the beginning of the talks by June is not out of the question. The risk of autumn talks is that the implementation of market financing slips to the last months of the year with the risk of the market situation at that time.	Zloty's fundamentals should not permit the currency perform extremely well in the short-run as the economy should slow down in second half and the rates should remain flat after the one off hike in May. During the summer we may see some renewed selling pressure after the European championship in football takes place and the Greek/Portugal 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...

Cent. Banks' Projections vs. Our Forecasts

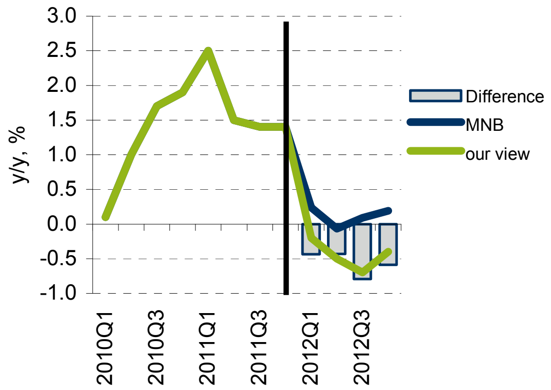
CZ: GDP Outlook



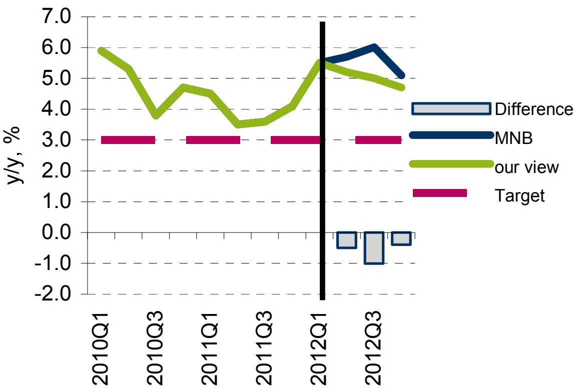
CZ: Inflation outlook



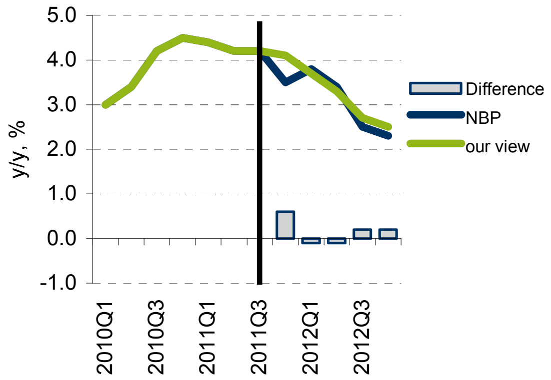
HU: GDP Outlook



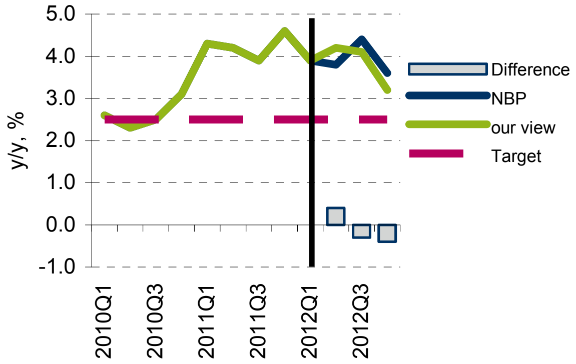
HU: Inflation outlook



PL: GDP Outlook



PL: Inflation outlook



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	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*	7.00	7.00	7.00	6.50	6.25	50 bps	12/20/2011
Poland	2W inter. rate	*4.75*	4.50	4.50	4.50	4.50	4.75	25 bps	5/9/2012

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*1.24*	1.24	1.22	1.20	1.25	1.30
Hungary	BUBOR	*7.21*	7.00	7.00	7.00	6.50	6.25
Poland	WIBOR	*5.08*	4.60	4.75	4.80	4.80	4.90

Long-term interest rates 10Y IRS (end of the period)

		Current	2012Q1	2011Q4	2012Q3	2012Q4	2013Q1
Czech Rep.	CZ10Y	*1.87*	2.28	2.24	2.60	2.85	3.15
Hungary	HU10Y	*7.12*	7.10	7.50	7.75	7.50	7.25
Poland	PL10Y	*4.88*	5.00	5.00	5.20	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	*25.2*	24.8	26.0	25.2	25.0	24.5
Hungary	EUR/HUF	*297*	290	292	290	290	280
Poland	EUR/PLN	*4.32*	4.10	4.50	4.25	4.20	4.15

GDP (y/y)

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	2.1	1.3	0.6	0.1	-0.2	0.5	1.6
Hungary	1.5	1.4	1.4	-0.2	-0.5	-0.7	-0.4
Poland	4.2	4.2	4.4	3.7	3.3	2.7	2.5

Inflation (CPI y/y, end of the period)

	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	1.8	2.4	3.8	3.6	3.3	3.2	2.0
Hungary	3.6	4.1	5.5	5.2	5.0	4.7	3.7
Poland	3.9	4.6	3.9	4.2	4.1	3.2	2.8

Current Account

	2012	2013
Czech Rep.	-2.3	-2.6
Hungary	1.5	1.0
Poland	-3.5	-3.1

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-3.3	-2.8
Hungary	-2.5	-2.2
Poland	-3.0	

Source: CSOB, Bloomberg

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