Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 25 June 2012

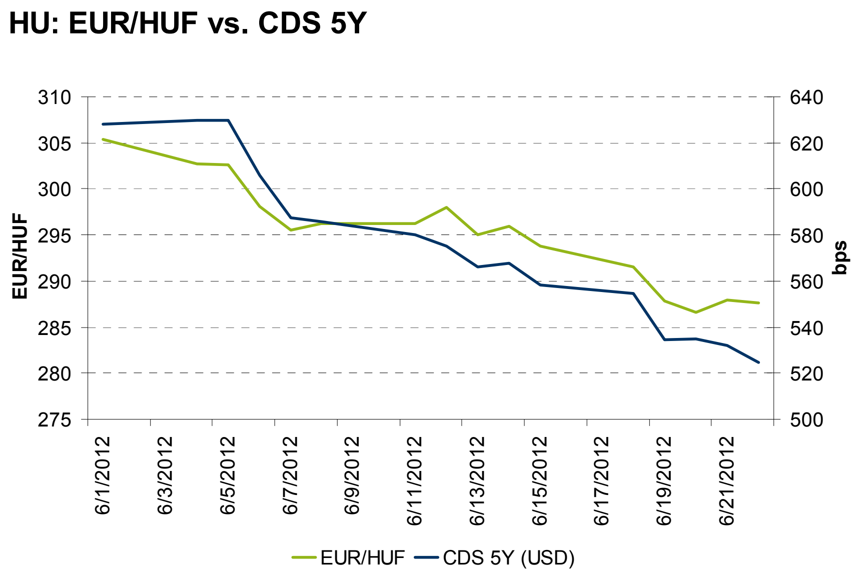
Table of contents

Weekly Highlights.........................1
Market's Editorial.........................2
In Focus..3
Weekly Preview............................4
Calendar...5
Fixed-income in Charts...............6
Medium-term Views & Issues....7
Cent. Banks' Projections vs. Our Forecasts......................................8
Summary of Our Forecasts.........9
Contacts.......................................10

Weekly Highlights:

- The forint outperforms its PEERs as markets feel progress in talks between government and the IMF
- In Focus: QE3 might be around the corner, should we expect another rally in CE Forex markets?
- The CNB will cut its repo rate to fresh all-time lows

Chart of the Week



Year-on-year inflation rates diverge in Central Europe as Poland leads in the region, while the Czech inflation remain at the lowest levels.

Market's editorial

The Czech koruna underperforms the forint

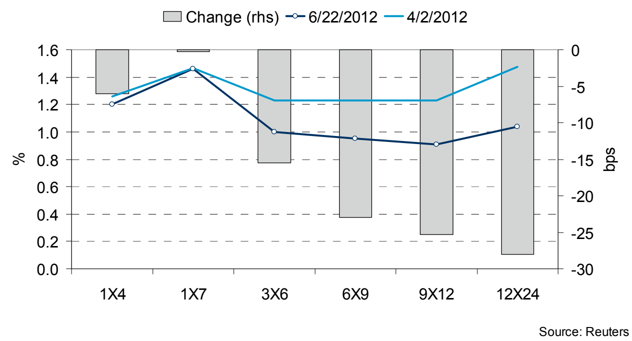
If we look at Central European forex markets, we can obtain a brief view of the main economic and political events that have happened in the region recently and are going to happen there within the next few days. At first glance, the depreciation of the Czech koruna against the backdrop of the appreciation of the forint catches the eye.

The appreciation of the Hungarian currency is clearly due to the positive news about the progress in talks between the Hungarian government and the IMF as well as the EU. First, the government made a 'U-turn' in its communication with the IMF and withdrew the modification quickly. This opened the possibility for negotiations and the government made it clear that there is a possibility of a quick arrangement before the summer break of the Parliament. The government also added that it has enough money to finance itself until the end of the year, thus there is no pres-sure on them to make a deal quickly. The next move could come if negotiations start around July, but we expect difficult talks here again because the IMF may have demands, like changing the flat-tax regime, which looks politically almost impossible. Secondly, another positive news for Hungarian assets was the fact that Ecofin had reviewed its decision to halt (starting from 2013) transfers from EU Cohesion Funds.

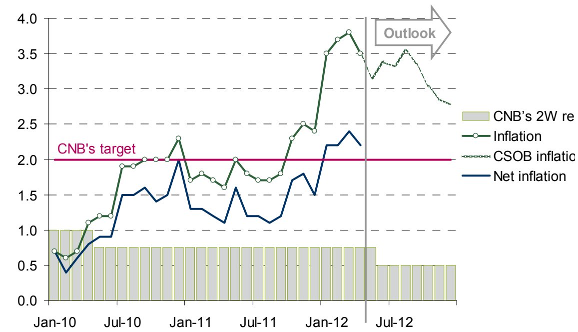
The dovish CNB could be behind the weak Czech currency

By contrast, the Czech koruna is troubled not only by the lingering euro-crisis but also by the dovish position of the central bank, with the Czech National Bank likely to cut its base rate by 25 basis points to a new all-time low of 0.50% at its forthcoming meeting. Two CNB Board members already voted for a rate cut the last time, while more calls for easing the monetary policy have come from the CNB since. The central bank's position is facilitated by the fact that inflation is lower than envisaged by the current forecast, while the economic downturn is faster. Thus the CNB is likely to ease its monetary policy earlier than both the ECB and the Fed, and this is evidently not something the Czech currency would like.

CZ FRA



CZ: Inflation and CNB's Target (%)



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.8	0.62%	↗	↘
EUR/HUF	288	-1.36%	↗	↘
EUR/PLN	4.26	-0.94%	↗	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.91	0.53	↘	↘
10Y PLN	6.76	-2.59	↗	↘
10Y HUF	4.77	-1.04	↗	↘

In Focus

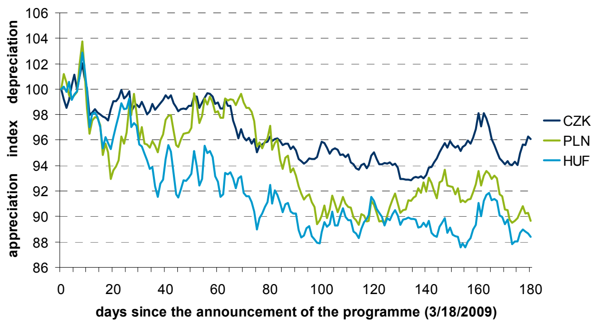
Another round of QE might come. What should be an impact on CE currencies?

The persisting crisis in the eurozone, the decelerating Chinese economy, and the deterioration of U.S. macroeconomic indicators has made the Fed consider launching another round of quantitative easing (QE), i.e., buying bonds to be included in the Fed balance. While, for the moment, the Fed 'only' announced the extension of 'Operation Twist' after its Wednesday meeting, Fed chief Bernanke suggested a further support for the economy might come, should the fall in unemployment lag behind expectations. In other words, we may see more QE in the months to come. This is why it is worth recalling how the exchange rates of Central European currencies developed in the wake of the announcements of the previous rounds of QE, and thinking about possible developments in the event of a third wave.

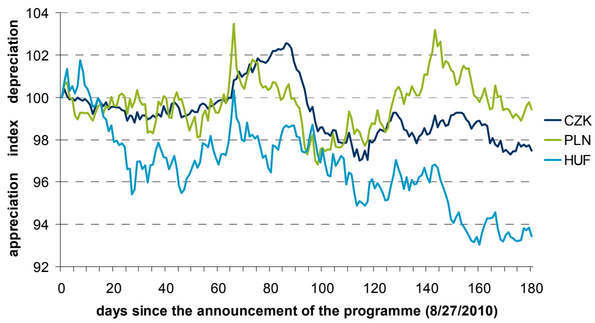
After QE I, the greatest appreciation of Central European currencies occurred in the first 100 days following the announcement of the scheme, with the appreciation ranging from 18% (CZK) to 23% (HUF). The positive effect of the QE 2 announcement was not as great, and with it being drawn out over a period of more than 100 days, it is even disputable whether it was the QE 2 effect. Not every fluctuation of the regional currencies can be attributed to the Fed's decision; some of the other relevant factors included the development of domestic interest rates and, for Hungary, the dynamics of its talks with the IMF.

We believe that, if another round of QE is launched, the impacts on Central European currencies would be probably lower than in previous two cases. In our view, the QE 3 would be smaller than the previous two rounds and markets would not be that greatly surprised. Moreover, some favourable domestic (regional) factors have already been priced, while the CNB for instance will play a dovish play, which could undermine recovery of the Czech currency.

QE I: development of CE currencies against the euro



QE II: development of CE currencies against the euro



Weekly preview

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

Another uninteresting MNB meeting

The central bank will have rate-setting meeting on Tuesday, which is again a non-interesting one where economists expect a no change vote with one exception for a cut in order to indicate that the risk is on the lower side due to the ongoing IMF talks. Rise of yields on core markets did not have significant impact on the forint and it is still the best performing currency on emerging markets this year. Yield levels have stabilised around 8% at the end of last week implying 550bps of 5y5y forwards giving leeway for further compression, while investors are somewhat more cautious about the IMF talks after the sharp rally in April reversed in May-June. The recent rally could sustain more in our view, but the government will also likely have heightened talks even if they start, so we recommend to buy on the dips and dips could mean 290/€ or 8.5% for bonds.

THU 13:00	CNB base rate	
	This meeting	Last change
rate level (in %)	**0.50**	5/2010
change in bps	**-25**	-25

CNB will cut its repo rate to new all-time low

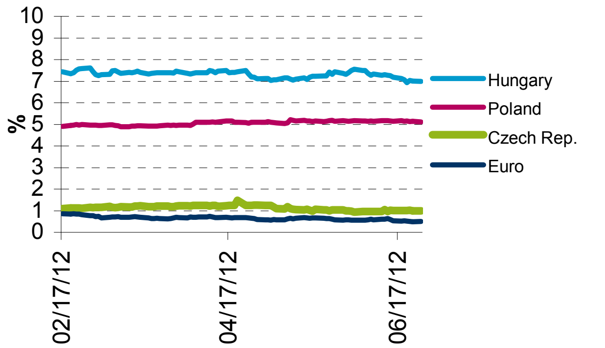
The Czech National Bank is likely to cut its repo rate by 25 basis points to a new all-time low of 0.50% at its June meeting. Two CNB Board members already voted for a repo rate cut the last time, while more calls for easing the monetary policy have come from the CNB since. The central bank's position is facilitated by the fact that inflation is lower than envisaged by the current forecast, while the economic downturn is faster. June's anticipated rate cut might be followed by a long period of record-low rates, lasting until at least the middle of next year.

Calendar

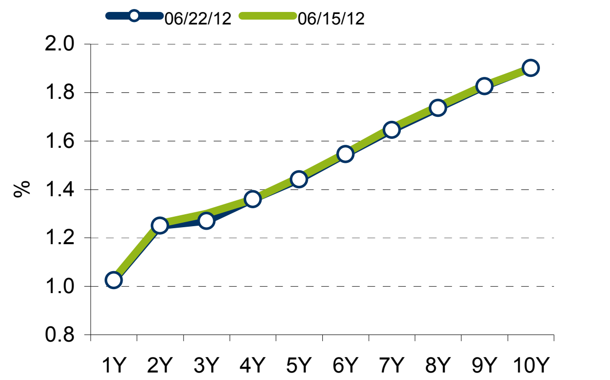
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	06/25/2012	9:00	Retail sales	%	04/2012				-0.3		0.9
PL	06/26/2012	10:00	Unemployment rate	%	05/2012			12.6		12.9	
PL	06/26/2012	10:00	Retail sales	%	05/2012			0.7	7.3	-2.4	5.5
HU	06/26/2012	14:00	NBH meeting	%	06/2012	7		7		7	
HU	06/28/2012	9:00	Unemployment rate	%	05/2012			11.3		11.5	
CZ	06/28/2012	12:30	CNB meeting	%	06/2012	0.5		0.5		0.75	
HU	06/29/2012	8:30	Current account	HUF B	1Q/2012			132		149	
HU	06/29/2012	9:00	PPI	%	05/2012				7.1	0.3	7.1
CZ	06/29/2012	11:00	Money supply M2	%	05/2012						6.5
PL	06/29/2012	14:00	Current account	EUR M	1Q/2012			-3623		-4964	

Fixed-income in Charts

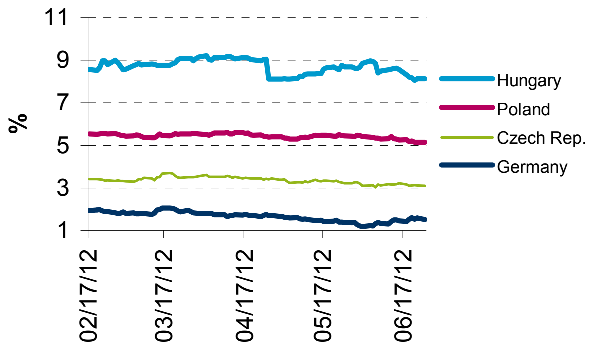
FRA 3x6



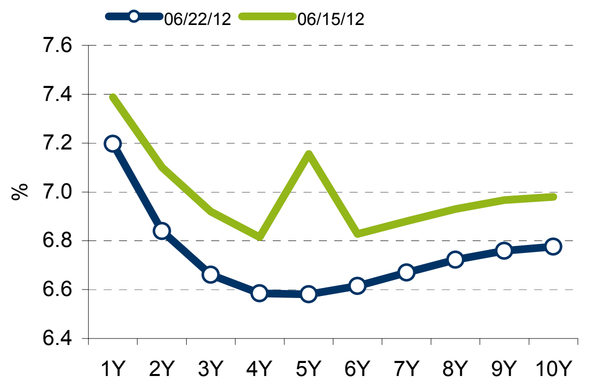
CZ IRS



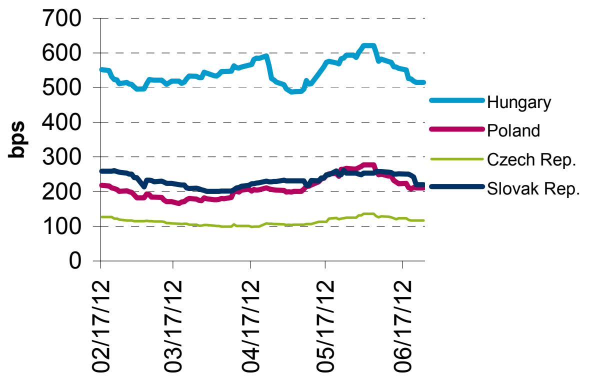
10Y GB Yields



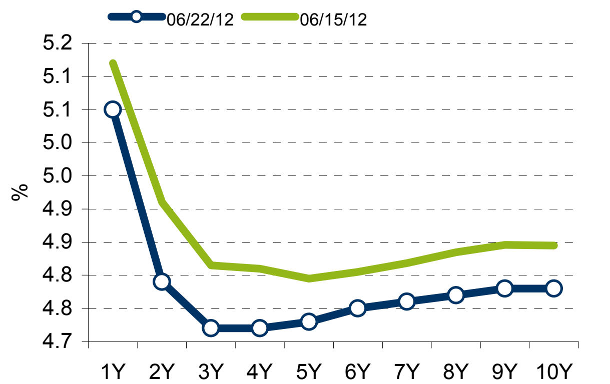
HU IRS



CDS 5Y



PL IRS



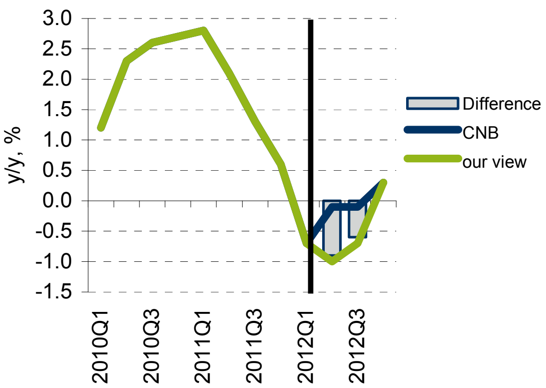
Source: Reuters

Medium-term Views & Issues

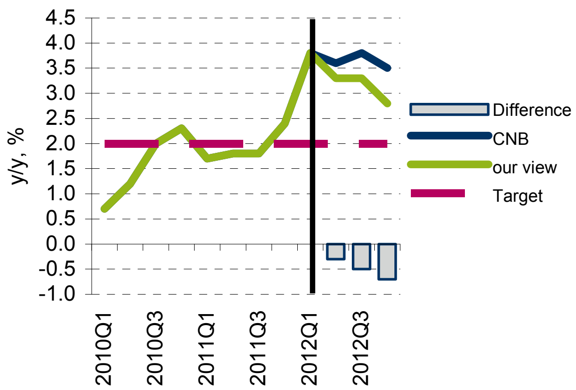
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion 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 the Polish Statistical Office, the pace of growth of the Polish economy fell to less than 4% in the first quarter of 2012. 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 continue to slow down in following quarters. 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 waitandsee 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. 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 US 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 issue 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

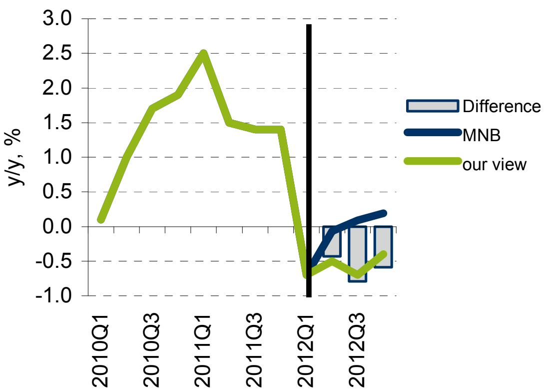
CZ: GDP Outlook



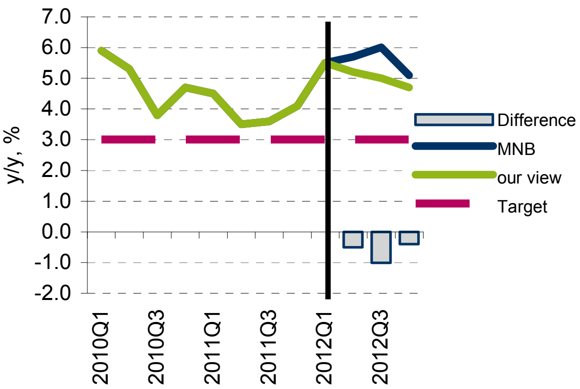
CZ: Inflation outlook



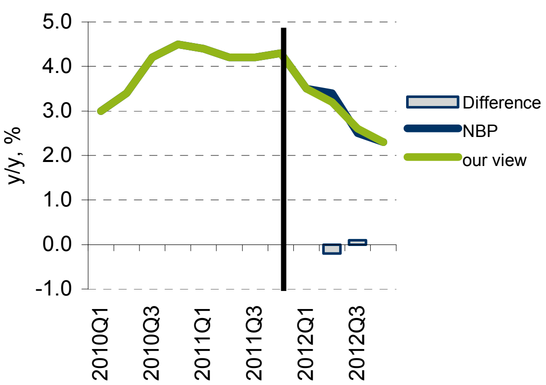
HU: GDP Outlook



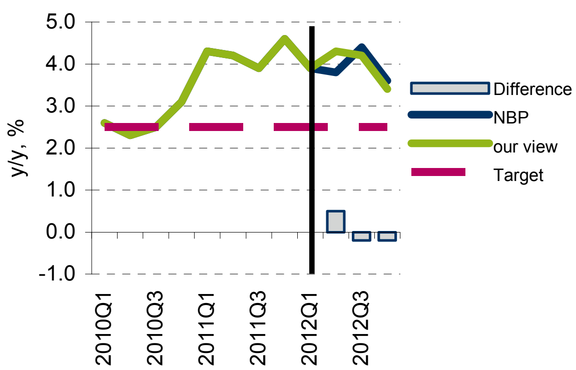
HU: Inflation outlook



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	0.50	0.50	0.50	0.50	-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	6/5/2012

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*1.22*	1.24	1.00	1.00	1.00	1.00
Hungary	BUBOR	*7.20*	7.00	7.00	7.00	6.50	6.25
Poland	WIBOR	*5.12*	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	*1.91*	2.28	2.24	1.90	2.10	2.25
Hungary	HU10Y	*6.76*	7.10	7.50	7.75	7.50	7.25
Poland	PL10Y	*4.77*	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	*25.8*	24.8	26.0	25.2	25.0	24.5
Hungary	EUR/HUF	*288*	290	292	290	290	280
Poland	EUR/PLN	*4.26*	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	-0.7	-1.0	-0.7	0.3
Hungary	1.5	1.4	1.4	-0.7	-0.5	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	3.2	2.6	2.3

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

	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	1.8	2.4	3.8	3.3	3.3	2.8	3.0
Hungary	3.6	4.1	5.5	5.2	5.0	4.7	3.7
Poland	3.9	4.6	3.9	4.3	4.2	3.4	3.0

Current Account

	2012	2013
Czech Rep.	-2.3	-2.6
Hungary	1.5	1.0
Poland	-4.3	-3.7

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

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	Brussels	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Commercial Desk	+32 2 417 53 23
Mathias Van der Jeugt	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 6646892	Frankfurt	+49 69 756 19372
Prague Research (CSOB)		Paris	+33 153 89 83 15
Jan Cermak	+420 2 6135 3578	New York	+1 212 541 06 97
Jan Bures	+420 2 6135 3574	Singapore	+65 533 34 10
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)		Prague	+420 2 6135 3535
Marec Gabris	+421 2 5966 8809	Bratislava	+421 2 5966 8436
Warsaw Research (CSOB)		Budapest	+36 1 328 99 63
		Warsaw	+48 22 634 5210
Budapest Research (CSOB)		Moscow	+7 495 7777 164
Gyorgy Barcza	+36 1 328 99 89		

ALL OUR REPORTS ARE AVAILABLE ON WWW.KBC.BE/DEALINGROOM