



Central European Weekly

Monday, 23 July 2012

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Weekly Highlights:

- Czech yields at record and Polish at 6-year lows
- Hungarian forint approaches 2012 highs as talks with IMF-EU start...
- ...but Spanish fears kicked the zloty and forint off multi-month highs
- NBH should stay on hold in close call

Chart of the Week

Yields of Czech and Polish government bonds (10 Y, %)



Yields of Czech government bonds fell to an all-time low whereas Polish yields hit six-year lows. (Source: Reuters)

Market's editorial

Cheap money for Central Europe

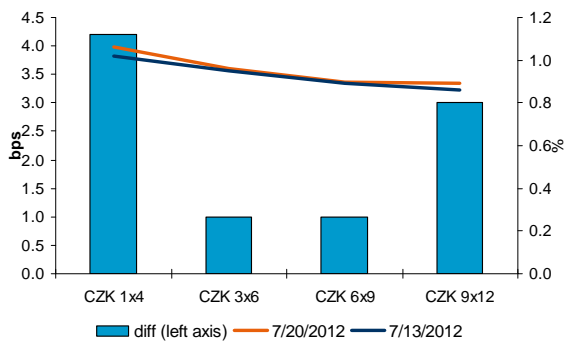
Czech 10Y yields have dropped to all-time lows, with investors being very eager to buy Czech securities in the last auction. A similarly positive situation exists in Poland, where the state is borrowing at the lowest cost over the last six years. Although the relative quality of Czech and Polish debts has been objectively improving, these countries are still far from being safe harbours.

The budget management of both Czech and Polish state coffers is not at all bad at first glance. While the Czech Republic's state budget may not necessarily meet the exact deficit plan for this year, the deviation from the planned deficit of CZK 105 bn is unlikely to be large, and a deficit close to 3% of GDP is a success in the current pan-European context. In addition, the Czech government is reasonably pre-financed from the first half of the year, with only 5% of the issues planned for this year still left. Poland's government deficit should be only slightly higher this year

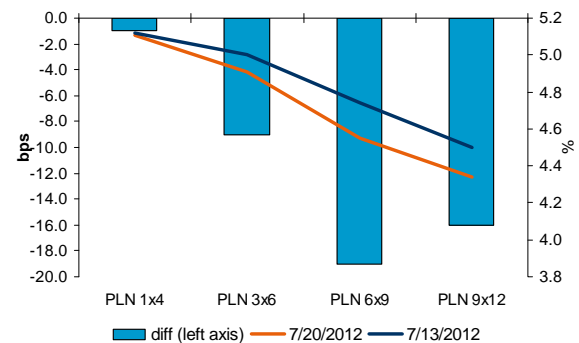
(less than 4% of GDP), with more than 80% of its funding needs for this year already covered.

Yet the Czech and Polish markets can hardly be viewed as safe heavens. The falling yields are due not only to domestic factors but also to global tendencies. Investors are afraid of decelerating growth, with a fall in yields being evident in virtually all safer locations. Risk margins, measured as CDS, have not even hit this year's lows thus far. Central European currencies are not yet behaving as safe harbours very much either, and there is likely a good reason for this. Above all, if the euro-crisis continues to culminate, the Czech economy will be extremely vulnerable, because of its openness and growing dependence on foreign trade. Czech austerity moves have been contributing to a record-breaking drop in domestic consumption this year, and the rapid drop in foreign demand, if any, would quickly put an end to the dream of the super-safe Czech bond.

FRA, weekly change



FRA, weekly change



In Focus: Bond markets in an upbeat mood

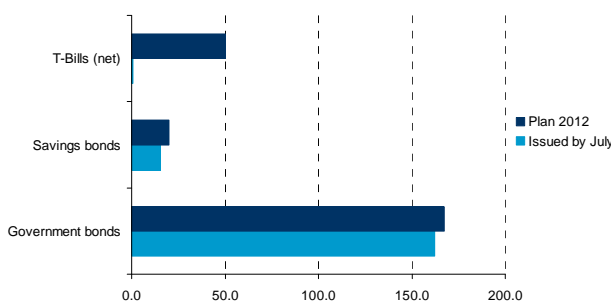
Yields in the Czech bond market hit a new all-time low last week. The yield of 10Y government bond temporarily dropped below 2.40%, and thus it has fallen by 125 basis points since the beginning of the year. Yields in the Czech market are primarily falling because of the European market mood, which is also driving German yields to record-breaking lows. The Czech market is also benefiting from the decreasing aversion to risk as well as from the very good position of the Ministry of Finance in the market. As evident from the results of government bond issues, the Ministry has almost met this year's plan for new bond issues, as presented in the Government Debt Financing and Management Strategy. The planned amount, including euro bonds and savings bonds, is CZK 187.5 bn, with 95% of it already covered. According to the plan, only bonds for a negligible amount are left to be sold and, apart from them, the Ministry will only need to issue treasuries; however, the Ministry of Finance can use the highly positive market situation and, within its discretion, build up stocks of cash or extend the debt duration, if it issues bonds in lieu of the remaining volume of treasuries, as it likes.

In relation to government debt financing, we cannot disregard certain risks associated with this year's state budget, which should post a deficit of CZK 105 bn. Given the worse anticipated performance of the economy (most recently yesterday, the Ministry of Finance reduced its

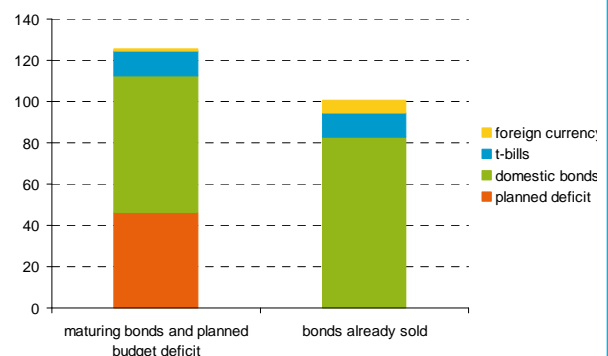
forecast for the GDP growth rate to -0.5%), the risks of failure to meet the revenue plan are not quite negligible. For the first six months of the year, there are clearly lower revenues from the VAT (approximately CZK 19 bn less than planned), from excise duties (CZK -6.5 bn), and from insurance contributions (CZK -6.4 bn). A potential risk to budget expenditure may stem from a failure, if any, to restore the cash flows from European funds completely. The likelihood of hitting the target deficit of CZK 105 bn is by far not as high as it was at the beginning of this year.

The situation of Poland is similar to that of the Czech Republic in many aspects. The Polish Ministry of Finance has covered most of this year's financing needs and consequently will not be under pressure for the rest of the year. In addition, its budget, unlike that of the Czech Republic, is based on a conservative economic growth forecast of 2.5%, which is likely to be exceeded. Hence the Ministry of Finance may also use the second half of the year for pre-financing under fairly favourable terms; the yields of 10Y bonds fell below 5% in July, a six-year low. However, the prices are also influenced by the market bets on a cut in official interest rates. These bets are related to the evident deceleration of the economy, which has been broadly anticipated, however. Hence Polish bond prices may be exposed to a certain risk.

CZ: 2012 borrowing needs vs. bonds issued by July (CZKbn)



PL: 2012 borrowing needs vs. bonds issued by July (bln PLN)



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: The NBH narrowly votes for rate stability

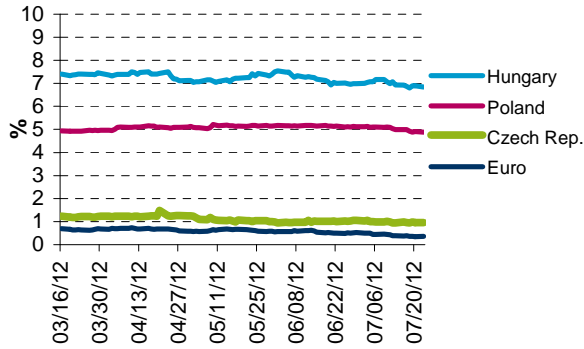
The National Bank of Hungary is gearing up for a rate cut; however, we believe that the bank will wait until its autumn meeting before it actually cuts rates. Now the NBH is probably going to be cautious as first tough weeks of negotiations with the IMF could re-new the weakness of Hungarian forint. Nevertheless, it is likely to be very close call, as doves appointed by pro-government Parliament are apparently strong.

Calendar

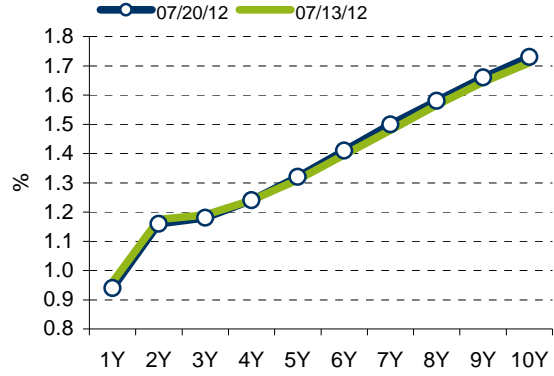
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	07/24/2012	9:00	Retail sales	%	05/2012					-2.2	-2.7
HU	07/24/2012	14:00	NBH meeting	%	07/2012			7		7	
PL	07/26/2012	10:00	Unemployment rate	%	06/2012			12.2		12.6	
PL	07/26/2012	10:00	Retail sales	%	06/2012			2.5	9	0.9	7.7

Fixed-income in Charts

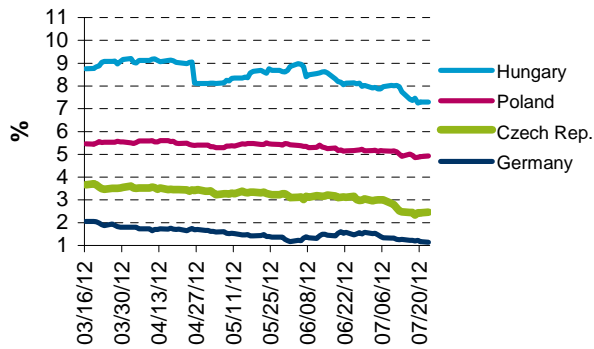
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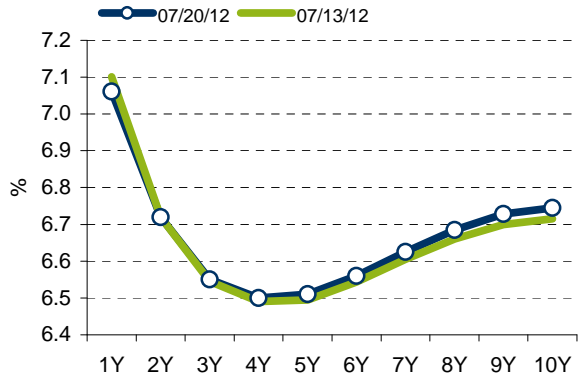
CZ IRS



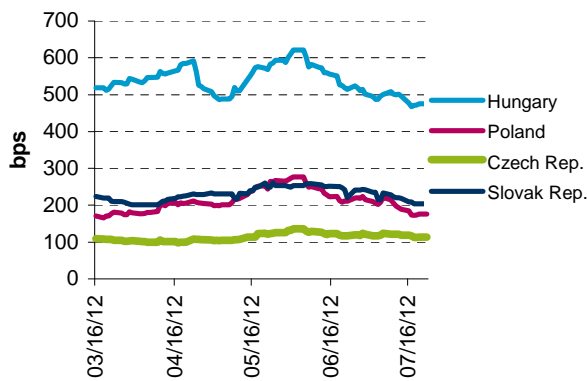
10Y GB Yields



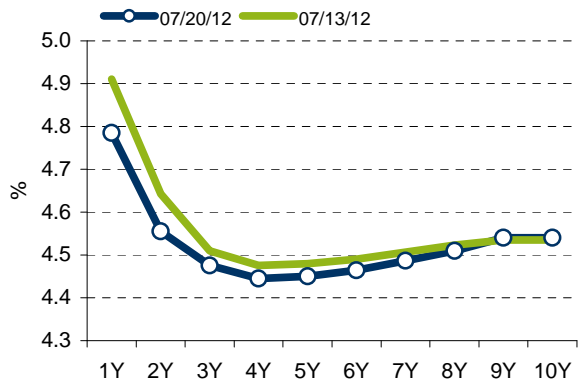
HU IRS



CDS 5Y



PL IRS

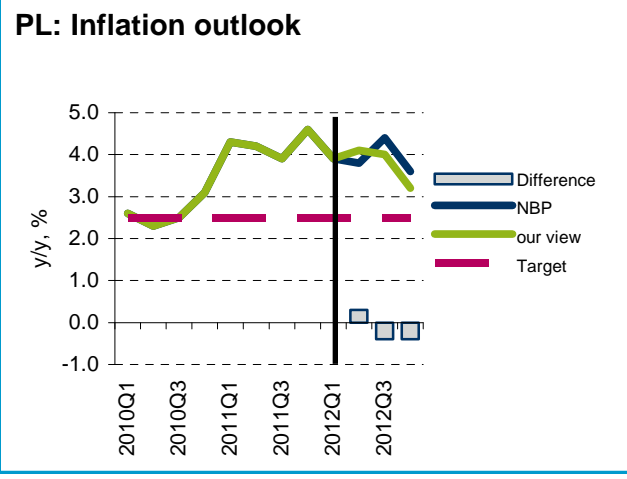
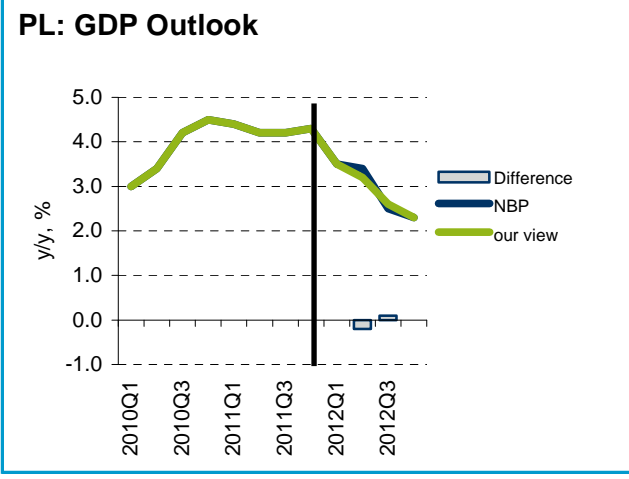
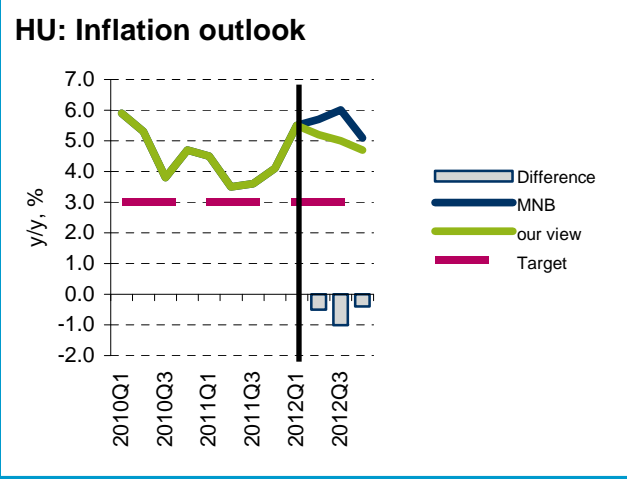
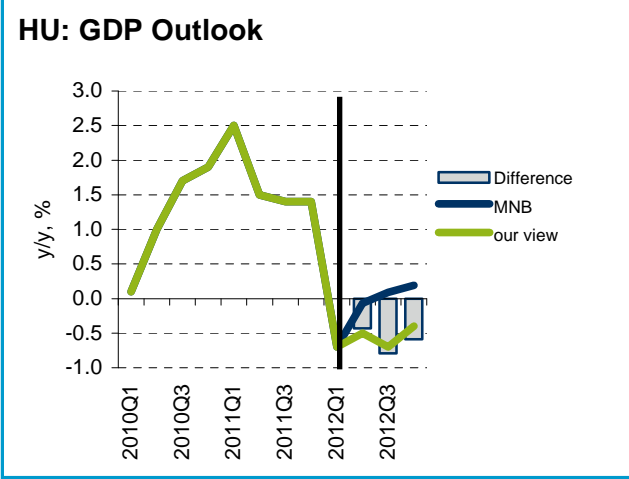
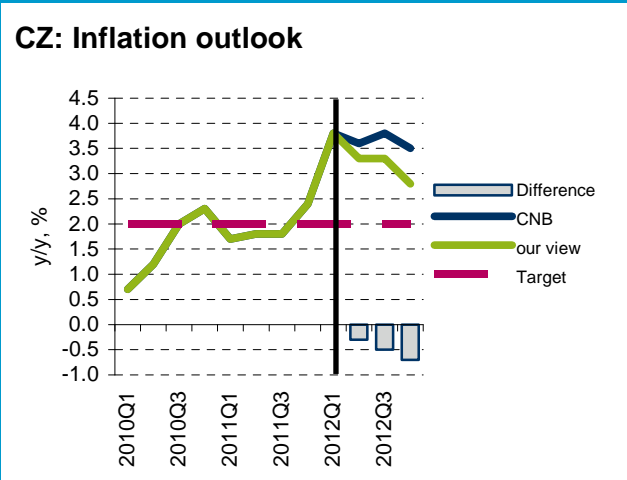
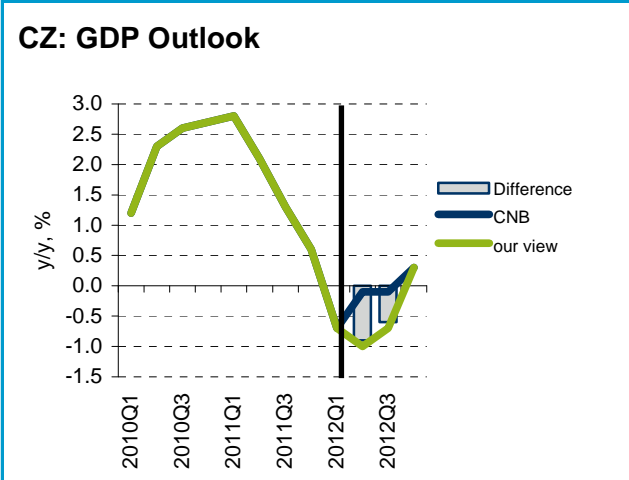


Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	<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.</p>	<p>The IMF accepted the most recent modification to the central bank law. This means that negotiations may start soon, according to the government around mid-July. The government said that the end date could be between mid-September and end-October.</p> <p>The government announced new tax cuts worth Ft300bn funded 1/3rd from budgetary reserves and 2/3rd from extending the transaction tax onto the central bank and state treasury. In case of the latter, it is only a temporary funding because the state owns both institutions. Although it has not yet been communicated, it may mean that revenue side will be used in 2013 and expenditure side in 2014.</p>	<p>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. Therefore, we expect that the Polish economy might grow by slightly less than 3%.</p>
Outlook for official & market rates	<p>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 cut its base rate to 0.5% in June.</p> <p>The first rate hike delivered by the Czech central bank is probable in 2013H2.</p>	<p>Shrinking domestic demand may keep inflationary pressures low and from this side rate cuts could come in Hungary. On the other hand foreign demand for Hungarian bonds is still important and this may go against this.</p> <p>We think the MNB could cut around 75-100bps in aggregate, also depending on external conditions.</p>	<p>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 inflation target (2.5%).</p>
Forex Outlook	<p>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.</p>	<p>Leaving aside the Greek (euro) crisis, the improved relationship with the IMF/EU should be beneficial for the forint in the medium-term.</p>	<p>Zloty's fundamentals should not permit the currency perform well in the short-run as the economy should slow down in the 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 as Spanish bank bailout and Greek package uncertainties may weigh on CE currencies .</p> <p>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>

Cent. Banks' Projections vs. Our Forecasts



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	0.50	0.75	0.50	0.50	0.50	0.50	-25 bps	6/29/2012
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	4.75	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	1.05	1.24	1.03	1.03	1.00	1.00
Hungary	BUBOR	7.19	7.00	7.20	7.00	6.50	6.25
Poland	WIBOR	5.13	4.60	5.13	4.80	4.80	4.90

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	CZ10Y	1.69	2.28	2.02	1.80	2.10	2.25
Hungary	HU10Y	6.74	7.10	6.71	6.75	7.50	7.25
Poland	PL10Y	4.54	5.00	4.74	5.20	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	25.5	24.8	25.5	25.2	25.0	24.5
Hungary	EUR/HUF	287	290	286	290	290	280
Poland	EUR/PLN	4.18	4.10	4.22	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	3.5	3.3	2.8	3.0
Hungary	3.6	4.1	5.5	5.6	5.0	4.7	3.7
Poland	3.9	4.6	3.9	4.3	4.0	3.2	2.7

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

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