



Central European Weekly

Monday, 03 September 2012

Table of contents

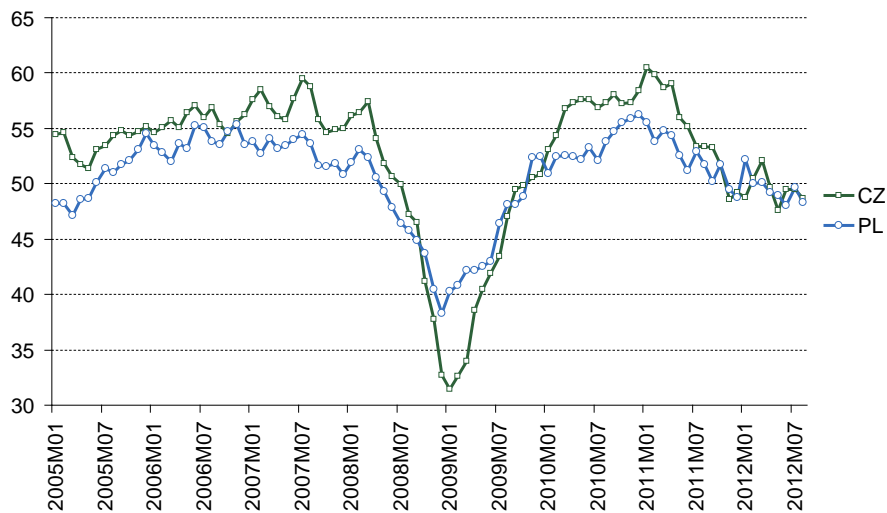
Weekly Highlights:	1
Chart of the Week	1
Market's editorial	2
Review of Economic Figures	2
Weekly preview	2
Calendar	2
Fixed-income in Charts	2
Medium-term Views & Issues	2
CBs' Projections vs. Our Forecasts	2
Summary of Our Forecasts	2
Contacts	2

Weekly Highlights:

- Polish GDP slows sharply
- Regional PMI further deteriorates
- Signs of further delay in Hungarian talks with IMF
- Czech real wages decline further

Chart of the Week

PMI: CZ vs PL



Polish and Czech PMI's pointed out to a further deterioration in sentiment in August...

Market's editorial

Data point to further monetary easing

Czech and Polish fundamentals do not provide much hope and the bets on at least some rate cuts seem to be justified. Polish growth fell well short of expectations in second quarter (see review of economic figures) while the Czech economy fell nearly 1% year to date on record drop of household consumption. The outlook is even gloomier.

The Polish PMI fell to 48.3 - the second lowest figure in 35 months and the output sub-index (the best leading sub-index for the Polish industrial output) sank to a 38 month low. Putting it together with disappointing GDP data, we now believe that the NBP is about to cut interest rates by 25 bps in November. The only risk to our cut call is weakening zloty, which could keep inflation expectations at uncomfortably elevated levels. Anyway currently the market has already priced in even more cuts – 75 bps in 6X9 FRAs.

The Czech PMI also fell further below 50 (to 48.7) driven mainly by fall in new export orders. These are declining for the tenth month in a row and as a key component of our Czech leading indicator they paint a gloomy 3-5 month

outlook. The domestic demand is extremely weak and as nearly 1% real decline in real wages shows, there is not much hope ahead of Czech consumers neither. That is why we are more convinced the CNB is also getting ready for further easing during the autumn. Here the decision of the CNB should not be as koruna-dependent as in the case of more volatile zloty in Poland.

As far as the Hungarian central bank concerns, it surprised markets slightly with a 25bps rate cut from 7.00% to 6.75%. Although this had been priced in by markets – the 3x6 FRA was trading at 6.50% - it was followed by forint weakening, which could actually backfire to the yields curve and further rate cut expectations. That implies that in case the currency weakens more, there could be reaction on the money market and the central bank could just stop the rate cut cycle. For now we continue to see the space for one more 25 bps cut by the end of the year and 50bps more in 2013.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.9	0.52%	↗	↗
EUR/HUF	285	1.26%	↗	↗
EUR/PLN	4.19	2.03%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.61	1.90	→	↗
10Y PLN	6.57	0.15	→	↗
10Y HUF	4.39	-1.83	→	↗

Review of Economic Figures

Polish growth falls short of expectations

Last Thursday, the Polish statistical office (GUS) released its estimate of GDP growth for the second quarter of this year. The figure showed that the Polish economy is much less resilient to euro zone woes than expected - GDP grew by 2.4% Y/Y whereas market estimated more decent slowdown to 2.9% Y/Y (from 3.5% in the first quarter).

Weakening domestic demand is a drag on growth

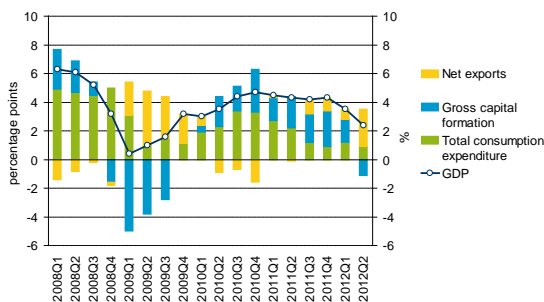
Weaker than expected result was caused mainly by falling domestic demand - private consumption grew at the lowest pace in last three years and investment fell by 6.4% Y/Y (although, abstracting from the change in inventories, it grew by nearly 2% Y/Y). The figures reflected more stagnation or even a moderate decline in real wages as well as lower investment activity in aftermath of the European Football Championship. Regarding contributions to growth, net exports' contribution was again positive (+ 2.6 percentage point). It was, however, caused mainly by the decrease in imports - exports growth was the slowest since the end of 2009 and was clearly hit by a lingering euro zone debt crisis. As far as the supply side is concerned, a significant deceleration of gross value added in construction is hardly a surprise as it was indicated by monthly data as well as nearly a stagnation of trade. Gross value added in

industry showed the lowest growth since Q3 2009. In light of recent figures, we estimate that the Polish economy might grow at about 2.5% in 2012.

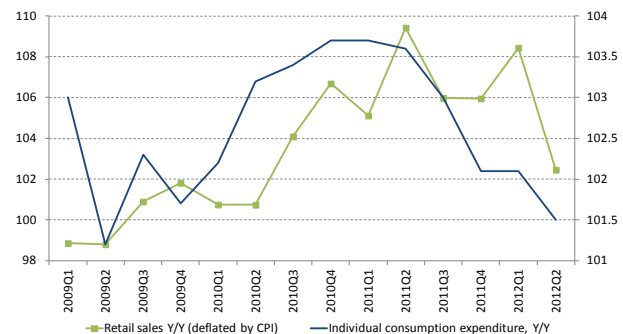
NBP might cut rates in November

As far as the policy impact is concerned, the figure further undermined the zloty and bets on a rate cut heightened (FRA 6x9 fell by about 10 bps). Although we think that the likelihood of a decline in official rates by the end of this year has risen significantly, we do not expect cut at either September's or October's meeting. Recall that the Monetary Policy Council (MPC) decided to increase interest rates back in May, i.e. only four months ago. Moreover, hawks among Polish central bankers have had a clear majority in the past months - 8 out of 10 voted for the above mentioned rate hike. On the top of that, inflation expectations of Polish households (which are closely watched by MPC) soared to 4.4% in August. More likely, we expect that the central bank (NBP) might cut interest rates in November during the introduction of new inflation report. By then, inflation expectations might ease as well hand in hand with falling inflation.

PL: Contributions to growth



PL: Retail sales vs individual consumption expenditure



Weekly preview

WED 14:00

NBP rate (in %)

	This	Last change
rate level	4.75	5/2012
change in bps	0	25

NBP on hold for now

We believe the NBP should stay on hold now. Although deteriorating macro-figures point to the possibility of interest rate cut, hawks among Polish central bankers have had a clear majority in the past months - 8 out of 10 voted for the rate hike in May. On the top of that, inflation expectations of Polish households (which are closely watched by MPC) soared to 4.4% in August. More likely, we expect that the central bank (NBP) might cut interest rates in November during the introduction of new inflation report. By then, inflation expectations might ease as well hand in hand with falling inflation.

THU 9:00

CZ Foreign trade (CZK bn)

	Jul-12	Jun-12	Jul-11
Balance	25.0	29.4	12.5
cummulative (YTD)	195.0	170.0	111.4

CZ: Two times higher than last year's surplus

We assume that the positive trend of foreign trade continued in July. Successful domestic automakers contributed to the growth of exports and industrial production. In contrast, weak domestic demand inhibits import to the Czech Republic. Import is thus primarily driven by fluctuating prices of basic raw materials.

THU 9:00

CZ Industry (y/y change in %)

	Jul-12	Jun-12	Jul-11
Monthly	1.8	-2.2	3.7
cummulative (YTD)	1.1	1.0	9.4

CZ: Slightly positive industrial production

Although the PMI and the mood in the industry are rather negative, the industry still holds in the black. In July, a higher number of working days also helped to higher growth in industrial production. Car manufacturers still show a positive trend despite faltering European demand for new cars. In subsequent months, however, we expect further slowdown in industrial production as new orders gradually stagnate and domestic demand shows no signs of improvement.

WED 9:00

HU Foreign trade (EUR m)

	Jul-12	Jun-12	Jul-11
Balance	600.0	773.1	404.1

HU: Foreign trade extends its surplus

The July trade balance could have remained high of €500m+ as we have seen in previous months this year. This is the consequence of the government's fiscal consolidation, which has been depressing domestic demand.

FRI 9:00

HU Industrial production (%)

	Jul-12	Jun-12	Jul-11
y/y	-0.20	0.50	3.4

HU: Industry declines on slow exports

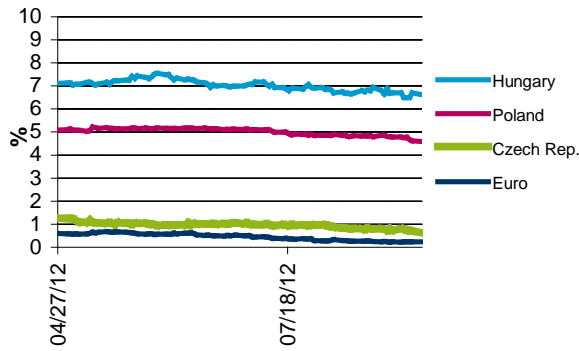
The July industrial production likely declined in July due to the weakening export prospects, which could be a disappointment for markets as the consensus is looking for a monthly increase of 0.5%.

Calendar

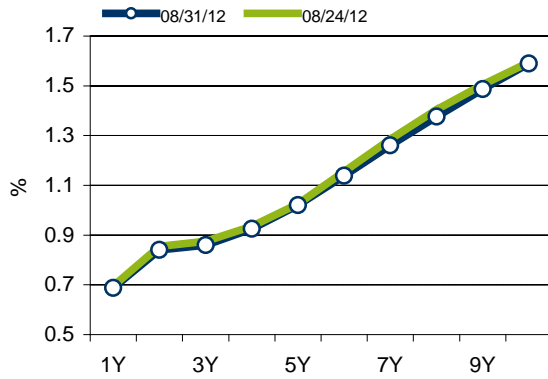
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	09/03/2012	9:00	Wages	%	2Q/2012				0		-0.1
PL	09/03/2012	9:00	PMI manufacturing		08/2012			48.95		49.7	
HU	09/03/2012	9:00	PMI manufacturing		08/2012					51.9	
CZ	09/03/2012	9:30	PMI manufacturing		08/2012			48.9		49.5	
CZ	09/03/2012	14:00	Budget balance	CZK B	08/2012						-51.7
CZ	09/05/2012	9:00	Retail sales	%	07/2012		1		0.5		-1
PL	09/05/2012	14:00	NBP meeting	%	09/2012			4.75		4.75	
HU	09/05/2012	17:00	Budget balance	HUF B	08/2012						-437.5
CZ	09/06/2012	9:00	Industrial output	%	07/2012		1.8		2		-2.2
CZ	09/06/2012	9:00	Trade balance	CZK B	07/2012	25		21		29.4	
CZ	09/06/2012	9:00	Construction output	%	07/2012						-8.4
HU	09/06/2012	9:00	Trade balance	EUR M	07/2012 *P					773.1	
HU	09/06/2012	9:00	GDP	%	2Q/2012 *F					-0.2	-1.2
CZ	09/06/2012	10:00	Current account	CZK B	2Q/2012					1416.6	
CZ	09/07/2012	9:00	GDP	%	2Q/2012 *F					-0.2	-1.2
HU	09/07/2012	9:00	Industrial output	%	07/2012 *P					-2.2	0.6

Fixed-income in Charts

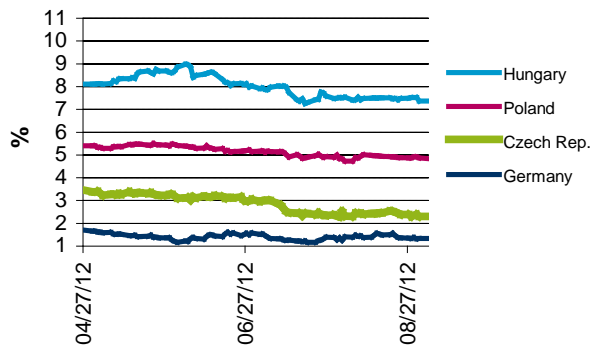
FRA 3x6



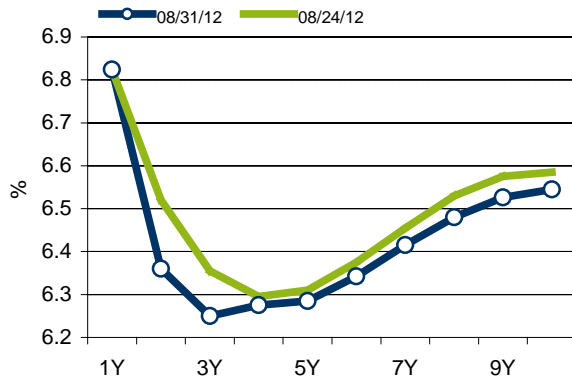
CZ IRS



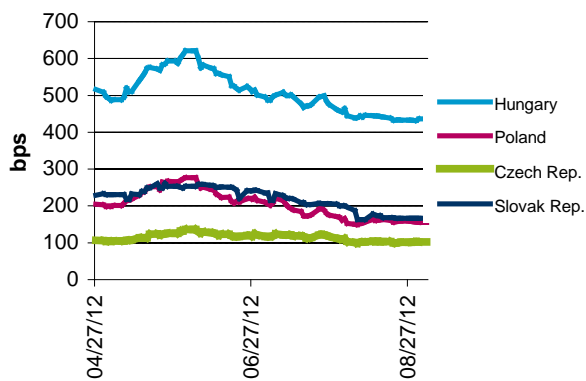
10Y GB Yields



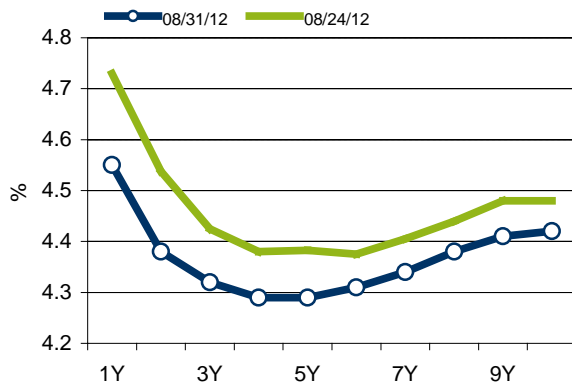
HU IRS



CDS 5Y



PL IRS



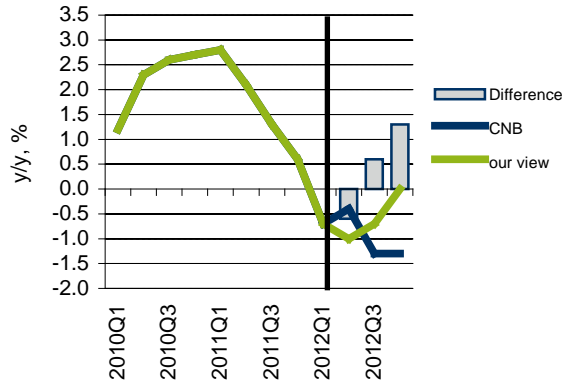
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	<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 2.4% in the second 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, although at a more moderate pace. 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 about 2.5% in 2012.</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. Another rate cut can be expected in Autumn as the GDP as well as inflation have been falling faster than the CNB expected.</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>For now we continue to see the space for one more 25 bps cut by the end of the year and 50bps more in 2013.</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. For now the deteriorating macro-figures start to argue for a rate cut. However this might not come till November when inflation expectations cool down and new forecast is on the table.</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 euro zone at the beginning of the autumn and may come back above 25.00 EUR/CZK</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 slows down and the Central bank is about to change its course. At the beginning of the autumn we may see some renewed selling pressure as uncertainties around ECB intervention on the secondary markets and Greek package may weigh on CE currencies .</p>

CBs' Projections vs. Our Forecasts

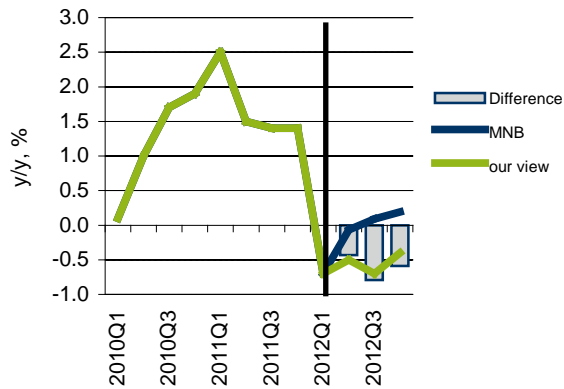
CZ: GDP Outlook



CZ: Inflation outlook



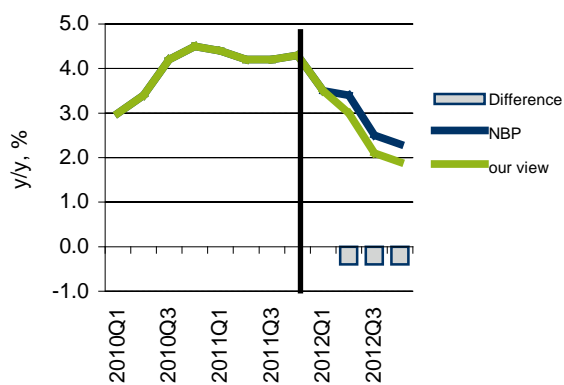
HU: GDP Outlook



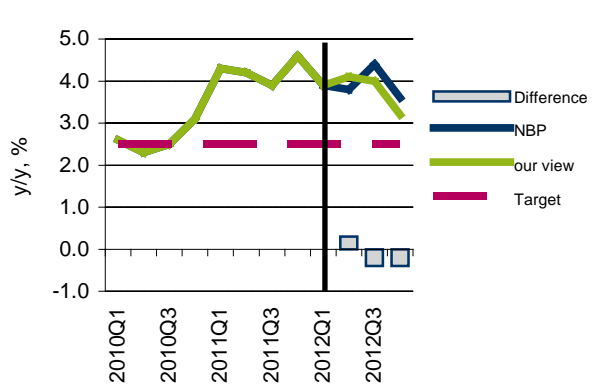
HU: Inflation outlook



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	0.50	0.75	0.50	0.50	0.50	0.50	-25 bps	6/29/2012
Hungary	2W deposit r.	6.75	7.00	7.00	7.00	6.50	6.25	-25 bps	8/28/2012
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	0.93	1.24	1.03	1.00	1.00	1.00
Hungary	BUBOR	6.90	7.00	7.20	7.00	6.50	6.25
Poland	WIBOR	4.98	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	1.61	2.28	2.02	1.80	2.15	2.10
Hungary	HU10Y	6.57	7.10	6.71	6.75	7.50	7.25
Poland	PL10Y	4.41	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	24.9	24.8	25.5	25.2	25.0	24.5
Hungary	EUR/HUF	285	290	286	290	290	280
Poland	EUR/PLN	4.19	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	0.0
Hungary	1.5	1.4	1.4	-0.7	-0.5	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	3.0	2.1	1.9

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	3.5	3.1	2.9
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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