Written by ČSOB Prague and K&H Budapest

Central European Weekly

Tuesday, 11 September 2012

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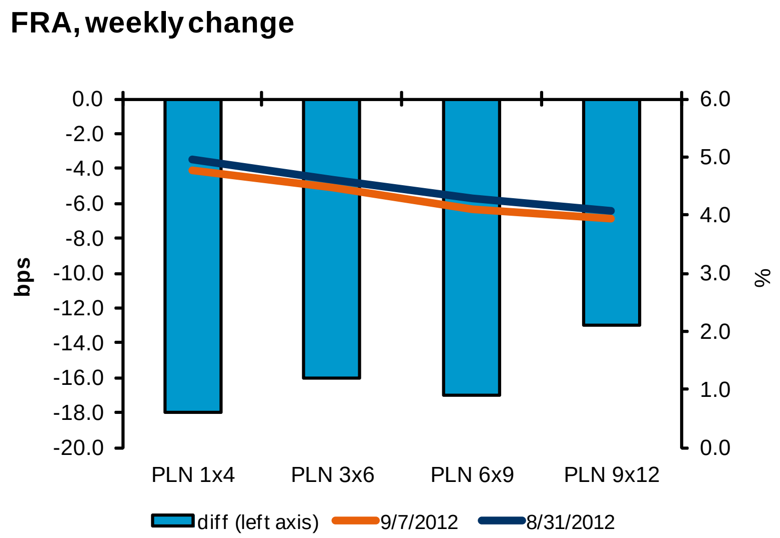
Weekly Highlights:

- NBP's Belka confirms a U-turn in monetary policy
- PM Orban says Hungary still needs IMF help
- Household consumption continues to weigh on Czech GDP growth
- Polish inflation to fall below 4%

Chart of the Week



Market expectations of interest rate cuts in Poland further intensified last week. (Source: Thomson Reuters, CSOB).

Market's editorial

Central Europe begins the school year aggressively

The beginning of the new school year stirred up Central European financial markets at last, with this having led to significantly increased volatility. The trading in Central European currencies and government bonds was influenced not only by major global events but also regional events, especially a meeting of the NBP and a statement by the Prime Minister of Hungary, who again hardened the tone in his country's negotiations with the IMF and the EU.

As concerns the NBP, it did not change its official interest rates at its meeting, but left no one in doubt that it was set to start easing its monetary policy again. This represents a fairly quick about-face, because, as recently as in May, the NBP raised rates to the current 4.75%.

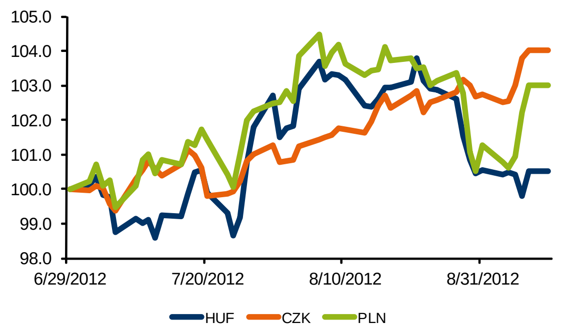
Polish central bankers are concerned about decelerating domestic demand and the concurrent deterioration of the prospects for Polish exports. Both domestic consumption and investment decelerated in the second quarter of the year, while net exports improved owing only to declining imports. A look at the labour market gives no great cause for optimism either, as unemployment has been slowly rising for a second consecutive year, and this is likely one of the reasons for the deceleration of credit dynamics. In addition, we can see leading indicators from the eurozone – the primary market for Polish exporters – deteriorate month by month.

Thus everything apparently favours a rate cut, with the only problem for doves still being inflation, which is more than 1.5% above the NBP's target of around 4%, and inflation expectations (of the public) are not decreasing either. Yet money markets now clearly bet on a 25 bps rate cut in October. Given the clearly dovish statement by NBP Governor Belka at a press conference, we believe that the market bets on an October cut in the official rates are right.

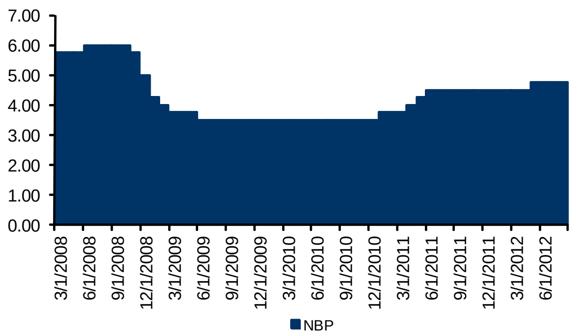
As concerns the latest statements from Hungarian Prime Minister Orbán, he gave a speech on Facebook that the IMF demands in the letter sent in July contains unacceptable measures, like lower pensions, higher retirement age, cut in social subsidies, scrapping the bank tax etc. However, he somehow softened his previous comments and said that the government will not cancel the negotiations, but it would create its own program that could be the starting point for the negotiations. Moreover, he reiterated that Hungary needed IMF help and that it would reach agreement with international lenders.

We would not overestimate consequences of the "Facebook speech" either. Firstly, according to the IMF's representative in Budapest the list of requirements, which has been published in newspapers and deemed to be the Fund's requirements, contains significant inaccuracies; secondly, Hungary, in view of the amount of its reserves, does not currently need a new credit facility in any event.

CE currencies agains the euro



Official interest rate



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.5	-1.38%	↘	↘
EUR/HUF	285	0.30%	↘	↘
EUR/PLN	4.11	-1.97%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.68	4.35	↗	↗
10Y PLN	6.53	-0.31	↘	↘
10Y HUF	4.42	0.68	↘	↘

Review of Economic Figures

NBP of Poland is set to cut rates

The National Bank of Poland did not alter its rates at its September meeting; however, it left nobody in doubt that it was set to start easing its monetary policy again. This represents a fairly quick about-face, because, as recently as in May, the MPC raised rates to the current 4.75%.

Polish central bankers are concerned about decelerating domestic demand and the concurrent deterioration of the prospects for Polish exports. Both domestic consumption and investment decelerated in the second quarter of the year, while net exports improved owing only to declining imports. A look at the labour market gives no great cause for optimism either, as unemployment has been slowly rising for a second consecutive year, and this is likely one of the reasons for the deceleration of credit dynamics. In addition, we can see leading indicators from the eurozone – the primary market for Polish exporters – deteriorate month by month.

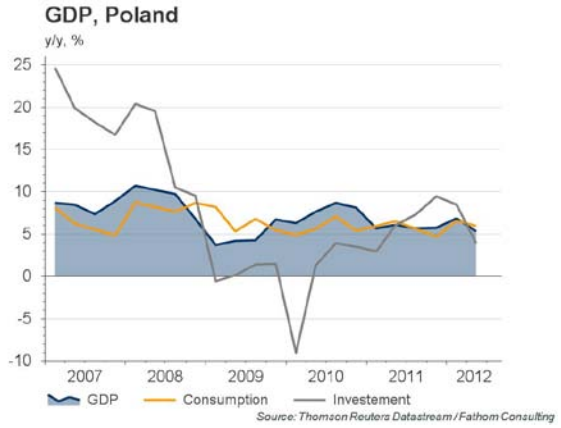
Thus everything apparently points to a rate cut. The only problem for doves continues to be inflation, which is at 4% more than 1.5 percentage point above the target of the NBP.

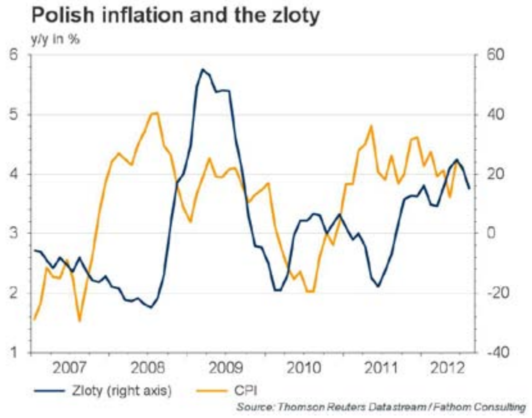
In its minutes after the meeting, the central bank said that the Monetary Policy Council would consider a rate cut if the economic data continued to deteriorate and the inflation risk waned. Governor Belka subsequently said that this might easily happen next month. What will be the crucial factors then? Above all, August's inflation and industrial output. If inflation falls to less than 4% and the highly volatile inflation expectations also decrease, the Polish central bank may decide to cut rates as early as in October.

The Czech economy remains in a recession

According to the latest data from the Czech Statistical Office, GDP fell by 0.2% q/q in the second quarter of the year, while the year-on-year decline accelerated from the revised 0.5% to 1.0%. Although the statisticians revised the figure for the first quarter upwards by 0.2%, the performance of the economy continues to decline. This is primarily due to household consumption, which is falling at a record-breaking rate, this time by 3.3%. The second quarter also saw slightly lower government consumption and the stabilisation of investment. The drop in domestic demand, which is rapidly dragging the economy down, is being at least partly counterbalanced by the excellent performance of foreign trade. This is yet more evidence that the current recession is primarily due to domestic restriction (increased taxes and consequently increased inflation) and households' concern about future developments, which leads to negative expectations and lower consumption. As for the generation of GDP, it is again evident that the manufacturing industry continues to be the best performer in the current situation, while the performance of construction is still poor, as is the performance of certain services such as trade and telecommunications. In addition, an improvement is unlikely to occur in the second half of the year either, because the expectations of industrial and construction firms remain negative. Even so, July's data from industry holds out the hope that the situation may not necessarily worsen, as the data confirmed a continuing rise in production and orders in the largest sector of the Czech economy.

Although Czech industry is gradually losing pace, the deceleration is by far not as rapid as in the countries west of the Czech Republic, because July's industrial output rose by 4.2% y/y. July included one extra business day, and thus the figure was slightly lower (+1.7%) if adjusted for the number of business days, but still very decent. The main contributors to the favourable data from industry again included carmakers, which are succeeding in raising their output and market share in the falling European market. In addition, electrical equipment producers are also faring well. New orders also look very promising, as they were up by 16% y/y, primarily fuelled by foreign demand. Cars are again the primary contributors (+41.6%). Hence industry may continue to curb, at least to some extent, the fall in other sectors of the Czech economy; however, not all businesses in the sector are performing as well as the overall figures indicate. Thus another moderate decline in the number of employees in industry, this time by 0.6%, comes as no surprise.





Weekly preview

TUE 9:00 — HU Inflation (change in %)

	VIII.12	VII.12	VIII.11
CPI m/m	0.0	-0.1	-0.1
CPI y/y	5.8	5.8	3.6

THU 14:00 — PL Inflation (change in %)

	VIII.12	VII.12	VIII.12
CPI y/y	3.8	4.0	4.3
Food (ex Alc.) y/y	4.7	5.0	4.5
Transport (including fuel)	6.2	6.8	7.9

HU: Will the recent price shock continue?

The key issue in Hungary's inflation is whether the food price shock continued or not, when domestically produced vegetables and fruits came into the market during the summer. If yes, the central bank could face a difficult issue of higher inflation at the time of recession. Currently, consensus is looking for further rates cuts, which will likely remain, but the expected base rate in 9-months time could rise from the current 6% level. The base rate is now at 6.75%.

PL: Inflation back below 4%

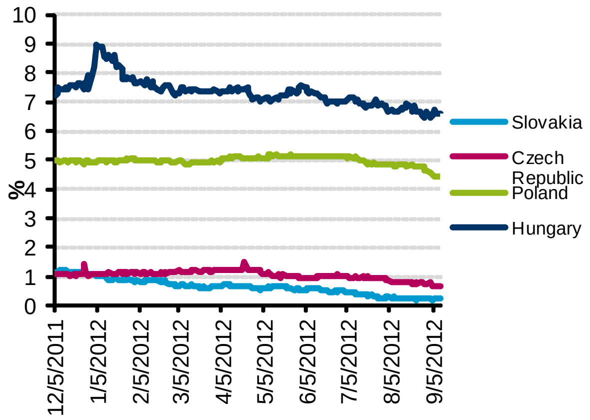
August's inflation fell to 3.8% y/y, according to our forecasts, while month-on-month prices were down by 0.2%. Notably the seasonally falling food and clothing prices should have a crucial impact on the decline in prices this time. By contrast, a moderate seasonal fall in fuel prices may not necessarily occur this time, given the significant increase in oil prices – transport prices were up by approximately 0.5%, according to our forecasts.

Calendar

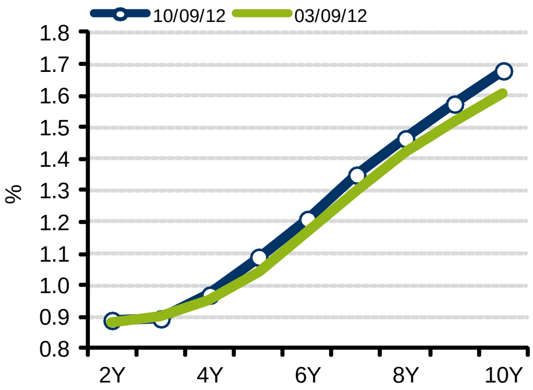
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	09/10/2012	9:00	CPI	%	08/2012	-0.1	3.3	0	3.3	-0.1	3.1
CZ	09/10/2012	9:00	Unemployment rate	%	08/2012	8.3		8.3		8.3	
HU	09/11/2012	9:00	CPI	CZK B	08/2012				6	-0.1	5.8
CZ	09/11/2012	10:00	Current account	EUR M	07/2012	-2.5		-12		-9.13	
PL	09/11/2012	14:00	Current account	USD B	07/2012			-1306		-1240	
PL	09/11/2012	14:00	Trade balance	USD B	07/2012					-412	
PL	09/13/2012	14:00	CPI	USD B	08/2012			-0.25	3.8	-0.5	4
HU	09/14/2012	9:00	Industrial output	%	07/2012 *F						0
PL	09/14/2012	14:00	Money supply M3	%	08/2012				9.65		11.1

Fixed-income in Charts

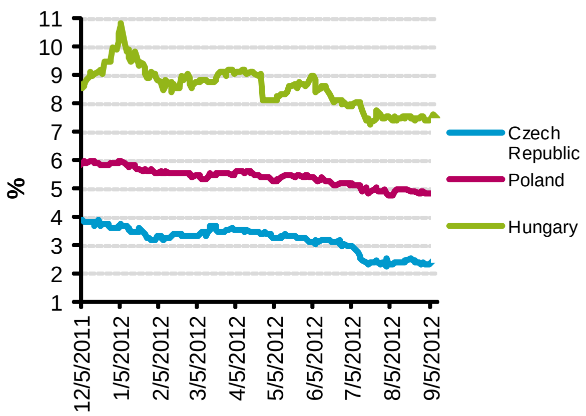
FRA 3x6



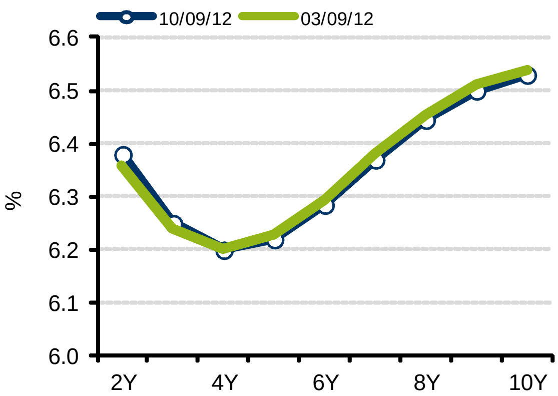
CZ IRS



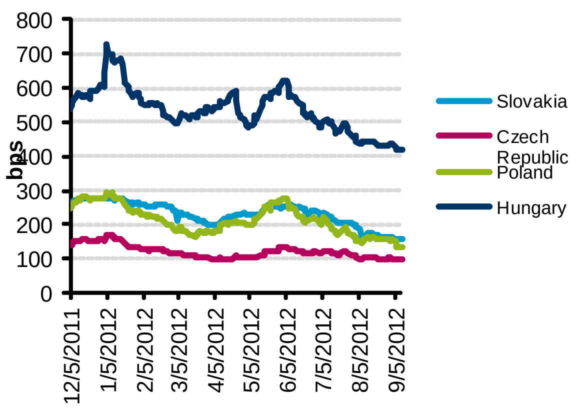
10Y GB Yields



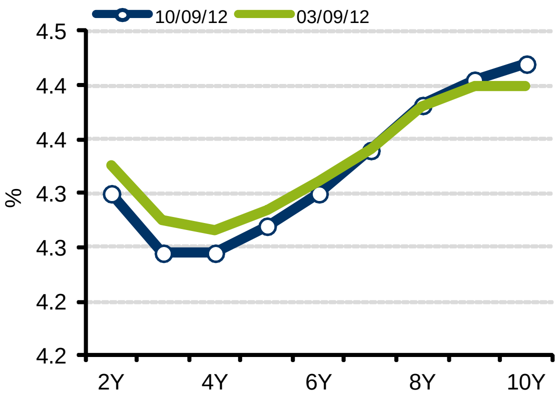
HU IRS



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.	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. 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.	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.
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 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.	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. 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.	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.
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 euro zone at the beginning of the autumn and may come back above 25.00 EUR/CZK.	Leaving aside the Greek (euro) crisis, the improved relationship with the IMF/EU should be beneficial for the forint in the medium-term.	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.

CBs' Projections vs. Our Forecasts

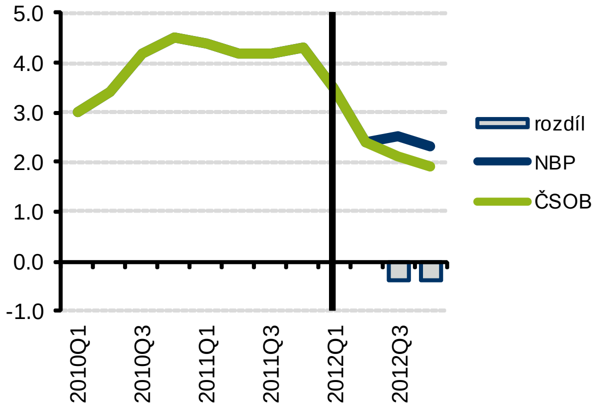
CZ: GDP outlook (Y/Y, %)

CZ: Inflation outlook (Y/Y, %)

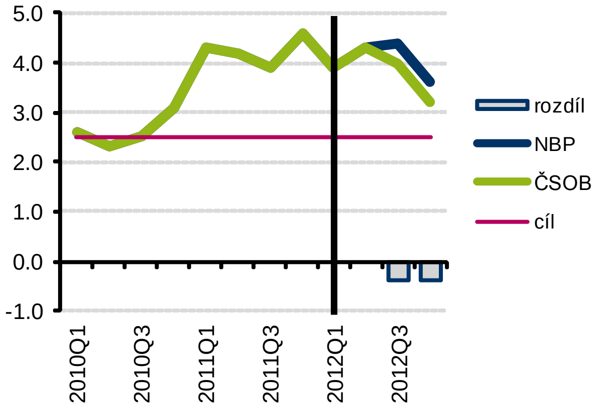
HU: GDP outlook (Y/Y, %)

HU: Inflation outlook (Y/Y, %)

PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (Y/Y, %)



Zdroj: ČNB, NBP, MNB, ČSOB

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	0.25	0.25	0.25	-25 bps	6/29/2012
Hungary	2W deposit r.	*6.75*	7.00	7.00	6.75	6.50	6.50	50 bps	8/28/2012
Poland	2W inter. rate	*4.75*	4.50	4.75	4.75	4.50	4.50	25 bps	6/5/2012

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*0.88*	1.28	1.03	0.70	0.70	0.70
Hungary	BUBOR	*6.90*	7.25	7.20	6.70	6.50	6.40
Poland	WIBOR	*4.96*	4.94	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	*1.68*	2.25	2.02	1.60	1.70	1.80
Hungary	HU10Y	*6.53*	7.36	6.71	6.75	7.50	7.25
Poland	PL10Y	*4.42*	4.95	4.74	5.20	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	*24.5*	24.8	25.5	25.2	25.0	24.5
Hungary	EUR/HUF	*285*	294	286	290	290	280
Poland	EUR/PLN	*4.11*	4.14	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	-1.2	-1.2	-1.0
Hungary	1.5	1.4	1.4	-0.7	-1.2	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	2.4	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	3.3	2.9	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.	-2.2	-1.9
Hungary	1.5	1.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-3.0	-3.8
Hungary	-2.5	-2.2
Poland	-3.5	-4.0

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		

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