Economics

13 December 2011 | 16 pages

Central Europe Macro View

Trip Notes: 2012 likely to be more challenging than 2011

- These notes are based on meetings with government and central bank officials, local fund managers, political analysts and IMF economists in Hungary, Poland and Czech Republic.
- Due to its strong trade and financial links with euro area the Central Europe is facing serious challenges with growth set to slow substantially in 2012 and market volatility likely to continue. Policy responses differ country by country with Hungary seeking a program from the IMF and Poland implementing an ambitious fiscal adjustment. In turn, Czech officials are likely to intensify the fiscal tightening in early 2012, but we expect them to hesitate to go beyond this if we see a stronger recession in 2012.
- Hungary's negotiations with the IMF and the EU will start next month. Although the government would prefer access to the IMF's new Precautionary and Liquidity Line, we suspect that Hungary will accept a Precautionary Standby Arrangement. Government officials indicated that precautionary access to €10-15bn of funding might be appropriate
- Although there remain plenty of uncertainties, our meetings in Budapest left us with a relatively optimistic view about the chances of success. Since the Prime Minister has already spent some of his political capital in embracing the idea of an IMF agreement, it seems that the sensible option now is quickly to gain the benefits that such a deal would bring. And since elections are still over two years away, 2012 seems to provide a decent window in which to shore up Hungary's economic credibility
- Due to its geographical proximity to the eurozone Poland is exposed to negative shocks related to the sovereign debt crisis, though compared with its CEE peers, we view Poland as much more resilient. Successful prefunding of borrowing needs, an improved fiscal outlook and access to FCL from the IMF should help stabilize the bond market.
- In Poland, deleveraging by foreign banks could lead to tighter credit conditions but the risk of sudden halt to funding from parent banks for local subsidiaries appears small. Interestingly, according to the Finance Ministry November saw a substantial outflow of foreign capital from the government bond market as foreign banks cut their exposure to Poland. We expect this kind of deleveraging could continue in the near future.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

2012 likely to be more challenging than 2011

Hungary[1]

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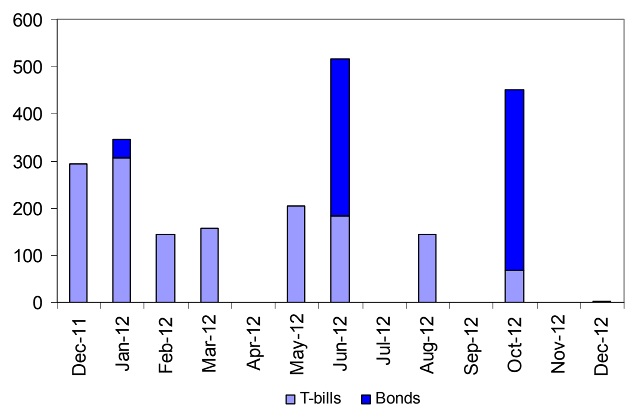
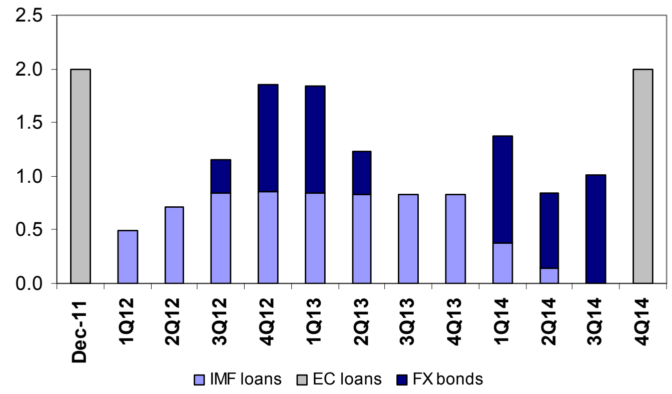
Negotiations with the IMF are at the heart of Hungary's outlook for next year. Both the IMF and Economy Ministry confirmed that talks will begin in January, although a date has yet to be set. Government officials expressed a preference for access to the IMF's new Precautionary and Liquidity Line (PLL), but acknowledged that a Precautionary Standby – which we think the IMF will insist on – would 'not be a tragedy'. The difference is an important one: countries pre-qualify for access to the PLL, and so there is no conditionality during the programme's life (up to a point); whereas a Precautionary Standby would have the same conditionality as a normal Standby Arrangement. The IMF and EU will negotiate together as fellow creditors, although decisions have yet to be taken about: i) how any financial commitments to Hungary will be shared between the two (Hungary's 2008 package split the burden 75% IMF, 20% EU and 5% World Bank); ii) what the duration of any Standby Arrangement will be (12 or 24 months); or iii) what amount might be available to Hungary. Government officials suggested that €10-15bn 'might be the right number'. This amount would be large enough to support market confidence, in our view, as it would cover Hungary's total gross issuance need for 2012, including fx debt maturities (€4.7bn), local currency debt maturities (€7bn) and annual budget deficit (€2.5bn).

Figure 1. LC Debt Redemptions (HUF bn, Nov 2011 – Dec 2012)



Source: Hungarian GDMA, Citi Investment Research and Analysis

Figure 2. FX Debt Redemptions (€bn) (Dec 2011 – Dec 2012)



Source: Hungarian GDMA, Citi Investment Research and Analysis

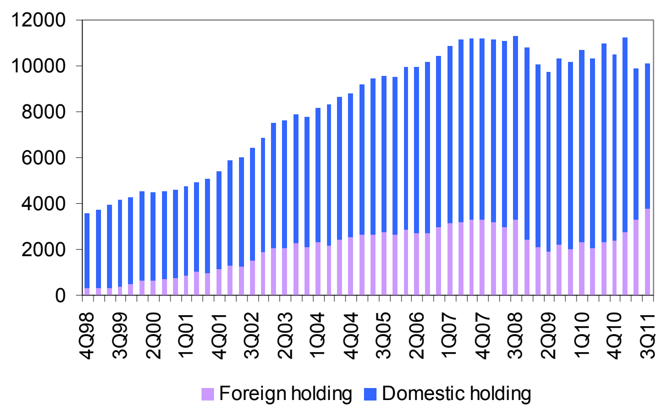
Recent evidence points to a cooperative relationship between the IMF and the Hungarian government, but politics create uncertainty. The IMF has essentially completed its latest Article IV review of Hungary, and, while the Fund wishes that there had been more implementation of the Szell-Kalman programme of structural reforms that was announced in February, the relationship between the IMF and the Hungarian government remains considerably calmer than it was in the summer of 2010 when PM Orban broke off relations with the Fund. And here lies the uncertainty. Orban's decision to break with the IMF last year was a popular one, and so a decision to embrace a Fund programme has complicated the political scene in Hungary. The National Economy Minister Matolcsy has not been appointed to the team responsible for negotiating with the IMF, creating uncertainty about the

[1] These notes are based on meetings in Budapest on 8 December 2011 with officials from the Hungarian Ministry for National Economy, the Hungarian National Bank, the IMF, the Hungarian Debt Management Agency (AKK); and with local investors and political analysts.

distribution of influence within the government; and it was announced recently that Orban's ally Tamas Fellegi, who was appointed to lead Hungary's negotiations with the Fund, has lost his job as National Development Minister. According to local media, Fellegi's resignation may be the first step towards further restructuring within the government, but it remains unclear how this would influence economic policy decisions.

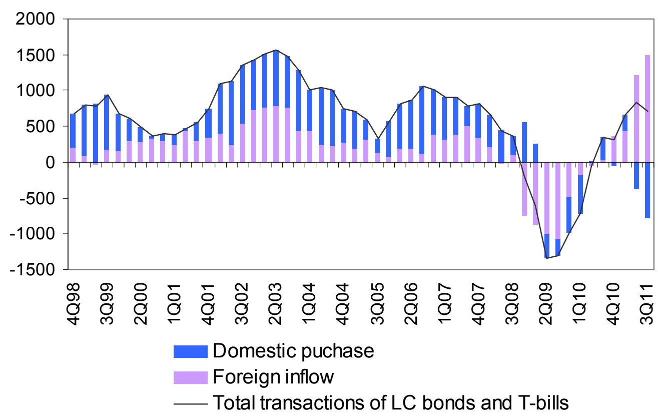
The government's policies towards the financial sector and the National Bank add to uncertainties but there may be signs of change. Two issues in particular might complicate Hungary's negotiations with the IMF and EU. The first is financial sector policy. A new law that allows Hungarian households to prepay their fx mortgages at a discount remains very unwelcome to the banks, which could be faced with losses of some €0.6-1bn, and this could accelerate financial sector deleveraging from Hungary. Participation in the program has so far been around 10%, slightly behind earlier estimates. A new law that allows employers to provide tax-free benefits to support fx mortgage pay-off may increase participation in the last month (the program is open until year-end) as public employees may receive such benefits, although these plans have not been officially acknowledged and funding sources remain unclear. The second issue is the National Bank of Hungary, where the government has proposed measures that would strip the NBH governor of his operational responsibilities at the Bank and pass them to the Monetary Council. This is a reminder of the tension that has characterized relations between the government and the NBH governor. Yet on both these issues there may be signs of change. The government is now negotiating with the Hungarian Bankers Association on ways of sharing the financial burden of fx mortgage losses between the banks, the government and households themselves. And the government has also indicated that it will postpone amendments to the law governing the National Bank and wait for the ECB's response before finalizing it. Both these issues should help to ease the government's negotiating process with the IMF and EU.

Figure 3. LC Bonds and T-Bills by Ownership (HUF bn)



Source: National Bank of Hungary, Citi Investment Research and Analysis

Figure 4. Purchase of LC Bonds and T-Bills (HUF bn, 4Q Rolling)



Source: National Bank of Hungary, Citi Investment Research and Analysis

Hungarian fiscal policy is not an obstacle to an agreement with the IMF and EU. The government remains committed to a 2.5% GDP budget deficit for 2012, as part of its attempt to escape the EU's Excessive Deficit Procedure. We would expect the IMF to be comfortable with a deficit higher than this, particularly since Hungary's growth outlook for 2012 is markedly worse than it looked in September, when the 2.5% deficit target was set in the context of a 1.5% GDP growth forecast for 2012. Government officials have indicated in speeches that this forecast will be revised 'heavily downwards' in the near term, but emphasized that the government

has two options to keep the 2.5% target credible. One is to rely on using its large fiscal reserve, which currently stands at around HUF 270bn (1% GDP). Officials estimate that a 1ppt fall in GDP growth produces a 0.4ppt increase in the budget deficit, and so in principle the fiscal reserve is big enough to keep the deficit at 2.5% even if Hungarian GDP contracts by 1% next year. A second option for the government – likely to be favoured by the EU – would be to implement additional adjustment measures: lifting tax exemptions, for example, or cutting spending. Next week will see the publication of an EU progress report under Hungary's Excessive Deficit Procedure, which will outline possible adjustment measures for 2012.

Other issues that will feature in the negotiations have varying degrees of importance. While we were unable to get a complete picture of all the issues that will form part of January's negotiations, we gained the impression that these will include i) pension reform; ii) local government reform; iii) the loss of authority of the Fiscal Council which was established to add credibility to fiscal policy; iv) the introduction of a multi-year budgeting framework; and v) the credibility of limits on Hungary's debt/GDP ratio, which will form part of a new constitution to come into effect on 1 January.

Overall it seems clear that Hungary's access to international capital markets next year is heavily dependent on whether an IMF deal emerges. The Hungarian government has €4.7bn of external debt repayments to make next year, of which €3.1bn are owed to the IMF (starting in February with a €0.6bn payment). The fx borrowing plan of the Debt Management Agency is €4bn, the same as 2011, and the €0.7bn of repayments not covered by this borrowing plan will be financed by disbursements of project finance-related lending by the European Investment Bank. The government is not without fx-denominated reserves: its current fx reserve amounts to €1.6bn, and the government will also receive fx cash flow from state entities (e.g. the Hungarian Development Bank) to which it on-lent IMF funds. In addition, the government has access to fx reserves in the Debt Reduction Fund, a €1bn portfolio of equities acquired by the government from pension funds earlier in 2011. Moreover, the sale of the state's 26% stake in MOL could generate an additional €1.4bn[2] at current market prices. But, even with these reserves in mind, the financing picture is by no means comfortable enough to allow Hungary to avoid international borrowing next year.

An IMF deal could create a virtuous circle for Hungarian financing, and on balance we are relatively optimistic that a deal can be reached. By the AKK's own admission, an early agreement with the IMF/EU would create a favourable background for international borrowing. Absence of an agreement, however, would strengthen the market's discomfort with Hungary's 2012 financing position, possibly triggering further capital flight. Although there remain plenty of uncertainties, our meetings in Budapest left us with a relatively optimistic view about the chances of success. Since the Prime Minister has already spent some of his political capital in embracing the idea of an IMF agreement, it seems that the sensible option now is quickly to gain the benefits that such a deal would bring. And since elections are still over two years away, 2012 seems to provide a decent window in which to shore up Hungary's economic credibility.

This is based on Hungary Macro View - Trip Notes

[2] For more detail on Hungary's liquidity position, see Eszter Gargyan's *Hungary Macro View: Moving Close to Sub-Investment Grade*, 14 November 2011

Poland[3]

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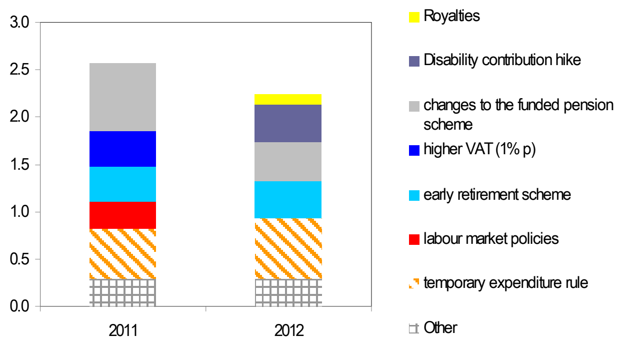
The key take-away from our Warsaw meetings is that Poland is a country with relatively good growth prospects (at least as compared with its EU peers), quickly improving fiscal policy and a central bank that is ready to react to external shocks. The potential weaknesses are not related so much to domestic factors but rather 'neighborhood risks' as the euro area crisis could potentially spill over to Central Europe. In other words from an investment point of view we think Poland offers an interesting mix of relatively low risk and relatively decent growth prospects (with emphasis on 'relatively').

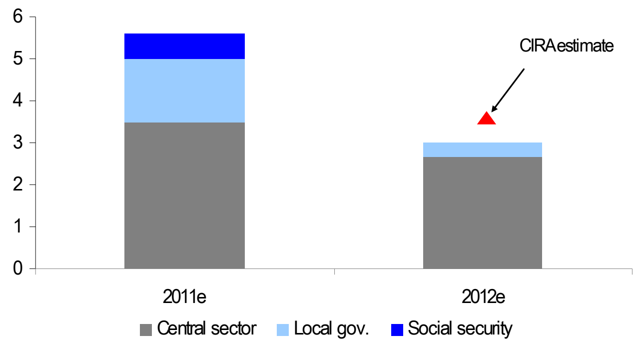
One of common themes discussed at meetings in Warsaw was the government's fiscal tightening program. The fiscal package that was announced by PM Tusk in November includes a set of measures that aim to improve long-term fiscal sustainability as well as to reduce next year's general government deficit towards 3% of GDP (see also: Less worried about fiscal numbers, published on 2 December 2011). Although we are somewhat more cautious in our forecasts and expect the 2012 fiscal gap closer to 3.5% we believe this is still quite an impressive fiscal tightening especially as compared to the 7.8% deficit recorded in 2010. With such a substantial tightening under way, domestic demand is likely to be constrained in coming quarters and we see a risk that 2012 growth could slow below 2.0% vs. 2.5% expected by the government (and 3% in the December Reuters poll). Indeed, according to our estimates based on OECD fiscal multipliers, the total fiscal tightening in 2011 and 2012 could deduct at least as much as 1.0% point from economic growth in 2012, while the consensus forecasts appear to underestimate such risks.

Figure 5. Finance Ministry is planning substantial fiscal adjustment in 2012 …



Source: Poland's Finance Ministry, Citi Investment Research and Analysis

Figure 6. … and hopes the general government deficit will fall to 3% of GDP despite weaker economic growth



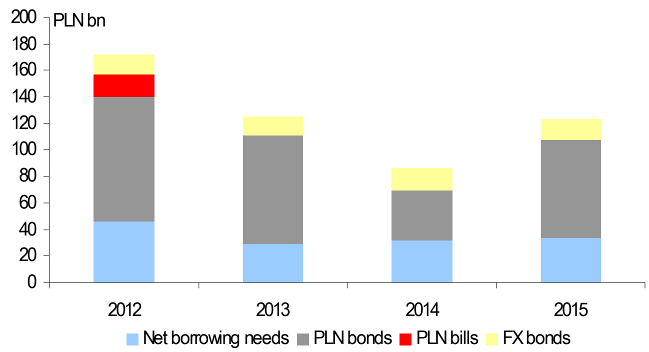
Source: Poland's Finance Ministry, Citi Investment Research and Analysis

The government appears serious about planned reforms. Commentary from political analysts suggests that PM Tusk may be focused more on a career on the European political stage than on winning a third election in a row in Poland. If this is the case, he could be trying to push for reforms to present Poland as an example of responsible economic policy, even at a risk of losing some political support in the country. This may partly explain why the new government's economic program includes a highly unpopular but at the same a necessary decision to extend the retirement age to 67 years for both women and men (from 60 and 65 years, respectively). It appears also that the government will continue its push to limit pension privileges for uniformed services (police, army) personnel. However, changes to the pension system for farmers will be limited, mainly because this kind of reform cannot bring substantial savings.

[3] On 7 December, we held a series of meetings with government and central bank officials, local fund managers, political analysts and IMF economists in Poland.

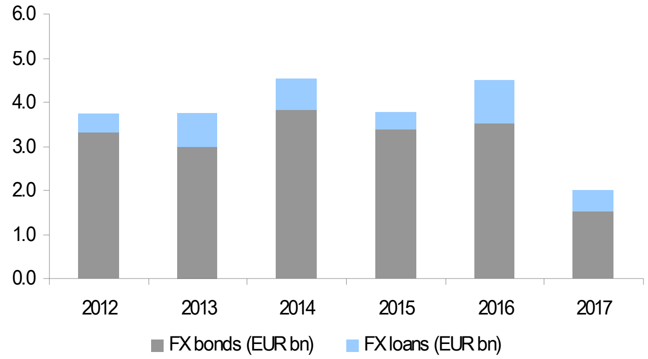
Interestingly the Finance Ministry declared a commitment to stick to a 3% of GDP deficit target even in the event of a deeper-than-expected slowdown, and possibly even a recession. It's hard to assess this commitment as officials didn't want (or weren't able) to share details of measures that would be launched in the event of such economic underperformance. Given that the Finance Ministry has proved very pragmatic in previous years, we suppose that under such a scenario the government would probably allow for some fiscal slippage in order to limit the negative impact on growth. We suspect that most investors, the European Commission and the IMF would understand some deterioration in the fiscal accounts in the event of a much deeper slowdown and would not press for painful spending cuts. Having said this, the rule of thumb is that each 1% point slowdown in GDP growth could translate into 0.4% of GDP deterioration in fiscal accounts. This implies that in the event of a 1% recession the Finance Ministry would need to ensure around PLN 20bn of additional revenues or spending cuts. This could be achieved through VAT hikes, a further freeze on wages in the public sector and possibly a suspension of pension indexation (constitution experts claim that the latter would be allowed only in the event of a serious fiscal crisis). On the government's side there appears no intention to cut further transfers to second-pillar open pension funds, though we suppose a suspension of such transfers would probably be revisited in the event of a large deterioration in the fiscal outlook.

Figure 7. Gross borrowing needs (PLN bn)



Source: Finance Ministry, Bloomberg, Citi Investment Research and Analysis

Figure 8. Foreign currency debt redemptions (€bn)

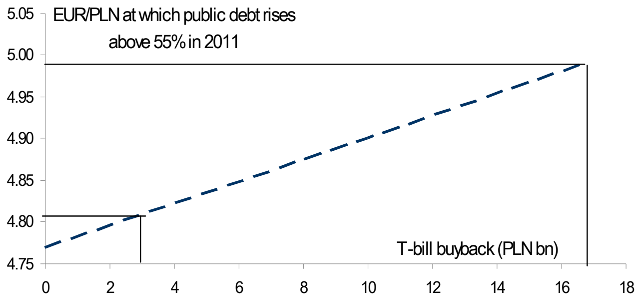


Source: Finance Ministry, Citi Investment Research and Analysis

Poland has substantial public borrowing needs next year but the Finance Ministry is managing these challenges well. The new Budget Act estimates these needs at PLN 176bn, consisting of PLN 46bn net borrowing needs and around PLN 130bn of maturing papers (Figure 7). However, the Ministry has already prefunded almost PLN 20bn of this amount, mostly through a series of switch auctions in recent months. It appears borrowing needs could be cut further if - as we expect - the upcoming 14th December switch auction is successful. The Finance Ministry is also planning to use its liquidity cushion (currently around PLN 50bn) to buy back T-bills, which would additionally help to cut next year's borrowing needs. Yet, officials say the size of the buy back operations - although still uncertain - will be probably closer to PLN 3bn rather than the PLN 16bn expected by some investors. Such operation should also cut 2011 public debt and therefore would lift the exchange rate at which public debt would breach the 55% of GDP threshold. According to our estimates if the Ministry buys PLN3 bn of T-bills, this would push the EUR/PLN trigger only marginally higher - from around 4.77 towards 4.81. In turn, if the total outstanding of bills (PLN 16.7bn) were bought back, this would push the EUR/PLN trigger towards around 5.00 (Figure 9). This reinforces our long-held view that concerns about public debt breaching 55% of GDP this year are overblown.

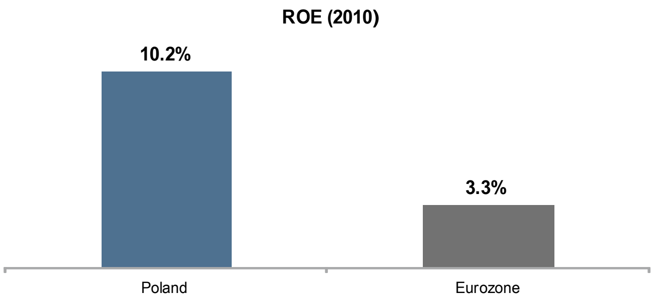
The government wants to fine-tune some of its fiscal rules but contrary to previous press reports it has no intention of changing the definition of the public debt. The new modified rule would probably work in a following way. Even if 55% threshold is breached fiscal adjustment is not triggered as long as the breaching is due to a short-lived currency weakening by the end of the year (if debt calculated based on the annual average FX rate remained below 55% of GDP). Furthermore, fiscal rules should not be triggered if the breaching of the 55% threshold is caused solely by pre-funding of next year's borrowing needs.

Figure 9. Buyback of T-bills will raise the FX rate at which public debt could exceed 55% of GDP



Source: CIRA estimates

Figure 10. Polish banks are more profitable than their euro area parents



Source: Eurostat, Citi Investment Research and Analysis

Another common theme during our meetings was a risk of deleveraging by European banks. Given that two-thirds of the banking sector is owned by foreign institutions, mostly from eurozone, such a risk is certainly an important factor to consider. The message that we received in almost all meetings is that deleveraging could take the form of a tightening of credit policy in Poland by European banks, but the risk of a sudden halt to funding from parent institutions to Polish subsidiaries is definitely smaller. We tend to share this view, as we have highlighted in our previous notes differences between 'soft' and 'hard' deleveraging[4], with former being a bigger risk in CEE. In our opinion, there are several reasons why the local banking sector is relatively safe and 'hard' deleveraging is not our base case for Poland. First, local subsidiaries of foreign institutions are supervised by the Polish regulator who is prepared and determined to prevent any liquidity drain. Second, the Polish banking sector is highly profitable, well capitalized and local subsidiaries usually are valuable assets for parent banks. Therefore any sudden and complete halt to funding appears unlikely as it would depress the value of the local bank and would make sale of these assets less profitable. Third, experience of previous months shows that parent banks attempting to sell their subsidiaries in Poland are having difficulties with finding buyers for their assets (see also Polish Banks - Viewing in 3D – Divestment, Deleverage, and Decelerating Growth).

Some form of deleveraging will be happening anyway. 'Soft' deleveraging through tightening of credit standards and thus gradual reduction of balance sheets appears much more likely. Obviously the Polish regulator would not have much impact on such a strategy and, given falling risk appetite, such a strategy appears likely with all its (negative) implications for Poland's economic growth. Interestingly it seems that deleveraging of European banks has already taken the form of reduction of their exposure to Polish local currency bonds. According to the Finance Ministry November saw a substantial outflow of foreign investors (mostly banks) from the

[4] Emerging Markets Macro and Strategy Outlook, 28 November 2011.

local bond market. Domestic investors and non-resident real money investors were on the other side of the flow. This raises a question about the vulnerability of the domestic bond market to further external shocks. We believe in such a scenario the Finance Ministry would be able to move issuances towards front end of the yield curve (replacing ten- or even five-year bond issuances with T-bills). This would probably attract domestic banks that have excessive liquidity of around PLN 100bn, which is usually absorbed in weekly operations by the central bank. According to deputy Finance Minister Radziwiłł, in an extreme scenario Poland could draw on a USD 30bn Flexible Credit Line from the IMF, which would cover two-thirds of 2012's gross borrowing needs.

FX interventions to continue. The central bank is willing to continue its policy of FX interventions in order to limit PLN volatility. However, there is no particular exchange rate level that will be defended by the NBP. Also the central bank has highlighted: 1) the intervention policy was 'independent' and 2) not driven by any rules. Therefore only some of the central bank's activity was coordinated with the BGK while other interventions were completely unrelated. The only aim of this activity was to reduce volatility; according to NBP officials this goal was achieved.

Market implications

Due to its geographical proximity to the eurozone Poland is exposed to negative shocks related to the sovereign debt crisis, though compared to its CEE (and more generally EU) peers, we view Poland as much more resilient. Successful prefunding of borrowing needs, an improved fiscal outlook and access to a Flexible Credit Line from the IMF should help stabilize the local bond market. However, given large holdings of Polish bonds by non-residents and the fact their positioning is skewed towards the longer end of the curve, we would prefer the short end of the curve. All the more so given that the central bank and many investors appear to underestimate risks to economic growth and thus the probability of rate cuts in Poland. We believe some continued outflow of foreign investors from the local bond market and likely rate cuts by 75bps next year will lead to a steepening of the curve. We expect the zloty to remain relatively weak in the coming months partly because of the above-mentioned reduction of bond positions by foreign investors. This will likely prompt sporadic interventions by the central bank or by BGK bank cooperating with the Finance Ministry with potentially particularly high activity in December 2012.

Czech Republic[5]

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Alternative scenarios are now addressing the possibility of a recession, not simply about a slowdown and both fiscal and monetary policy are facing significant uncertainty. Two months ago, the alternative scenarios for Czech policymakers addressed the question of a coming slowdown. However, it is now about how severe any recession will be – this is a factor that will likely lead to a change in behaviour of policymakers. In other words, while the Czech government still appears to be committed to fiscal consolidation, we believe that the stronger the recession will be, the weaker the authorities' commitment to meet the fiscal target in 2012. By contrast, while the majority of the CNB's Bank Board now sounds hawkish, reflecting the higher CPI inflation and weaker koruna, a deeper recession will likely ease the exchange rate pass-through into consumer price growth, as was the case in 2010.

Update on the economy – start of 4Q is not supportive

Third quarter GDP was revised down to 1.2%YoY from the provisional 1.5% estimate released last month. The weaker growth reflected several factors. *Firstly*, a more adverse base effect as a result of the recent major revision of the whole time series which showed a stronger recovery in 2010 (2.6%YoY instead of 2.2% previously) after a larger recession in 2009 (-4.5%YoY instead of -4%). *Secondly*, there was a 0.1%QoQ GDP contraction in 3Q11, while the flash estimate pointed to flat growth – which was also our initial forecast. However, value added remained flat in 3Q11 after a 0.7% cumulative increase in 1H11, while the previous data showed a decline of 0.3%. This is in line with the revision of manufacturing value added that fell by 0.6%QoQ in 3Q11 after 10.7% increase in 1H11, while it increased more modestly by 2.5% in 1H11 in previous time series.

Industrial production posted weak growth in October, increasing by only 0.1%MoM after falling 0.4% in September (when there was a shutdown in the refinery industry). Thus, the YoY growth only slightly increased to 2.1%YoY from 2% in September, while we had looked for a stronger recovery of 3.6%. For the rest of the year, we expect a 0.4% cumulative fall Nov-Dec11, which is likely to lead to the YoY growth to decelerate to 1.4% in 4Q11 from 8% in first three quarters of this year. This is likely to be followed by an almost 3%YoY contraction in 2H12 – a bit more than the November manufacturing PMI of 48.6 would suggest. We now expect the PMI to come in around 44-47 in the first half of 2012 (its bottom was 31.5 in January 2009 which was reached after six months of falls from current levels).

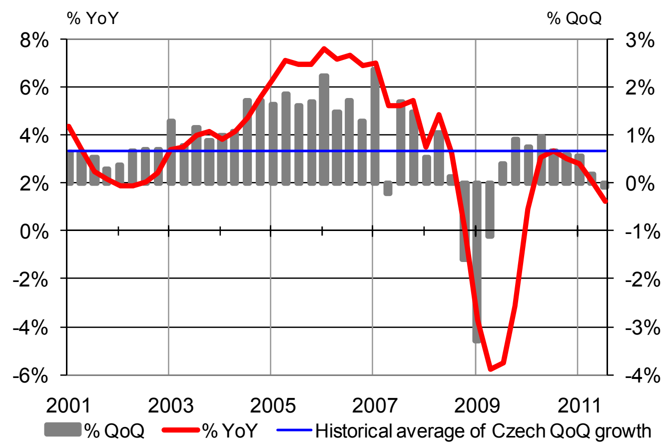
Industry is likely to be in recession next year. Industrial production has pretty much contracted MoM every month since June and we expect this to continue in 1H12. While foreign demand has so far supported the Czech industry as export sales in current prices increased by 13.1%YoY in October 2011, domestic sales dropped by 6.4%. The orders statistics point to a similar picture in the near-term as foreign orders increased by 8.4%, while domestic orders dropped by 7.8%. Hence, we expect industrial production to fall by 2%YoY in 2012 after experiencing 6.4% growth this year.

All in all, the third quarter GDP outturn posts a mixed outcome with downside risks likely to prevail. Weaker GDP outturn in 3Q11 partly reflects an upward revision of GDP in 1H11. However, fixed investment dropped in 3Q11 as well as other parts of domestic demand. Moreover, the 4Q dynamics in industry is disappointing and November confidence data look ugly. They point to flat YoY

[5] On Friday, 9 December, we met with representatives of the central bank, Ministry of Finance and the auto industry. Given that weak economic data were released during the trip we start by giving an economic update, before turning to discuss fiscal and monetary policy.

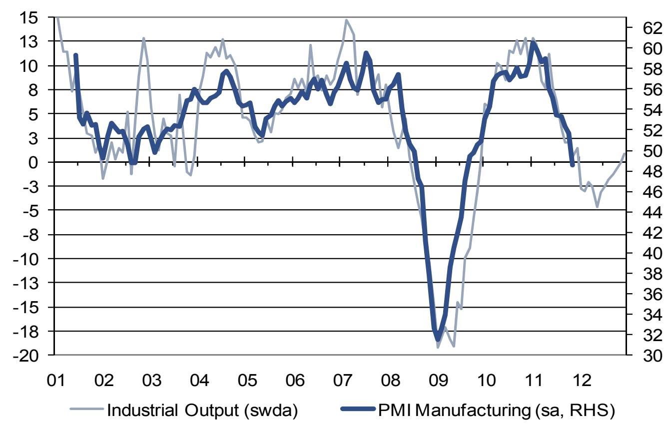
growth that would suggest a 0.7%QoQ drop in 4Q11s GDP. Our forecast is less negative, but it suggests a cumulative fall of 0.4% in 4Q11-1Q12 that, together with a slightly worse 3Q11 outturn, points to -0.1% growth in 2012 after 1.7% in 2010 (both down by 0.1% pt lower than our November forecast). However, our forecast assumes that fiscal policymakers slightly ease their commitment to fiscal consolidation. If the government remains committed to its fiscal targets, we would expect a fall of Czech GDP by up to 1% in 2012.

Figure 11. GDP is likely to continue to contract in 4Q11-1Q12



Source: CZSO, Citi Investment Research and Analysis

Figure 12. We expect Czech industrial production to fall by 2% in 2012



Source: CZSO, Haver, Citi Investment Research and Analysis forecast

Fiscal stabilisation function will depend on the economy

Parliament is likely to approve the budget for 2012, but the Ministry of Finance to continue work on revisions. Although 2012's budget is still based on the optimistic assumption of 2.5% GDP growth in 2012, Parliament approved the budget in the 2nd reading of its regular legislation process on 7 December (and is also likely to approve it in its 3rd reading later). Nevertheless, the Ministry of Finance is likely to introduce the new budget in early 2012 after the new GDP forecast in 2012 is presented. For the time being, we understand the new GDP forecast in 2012 could be close to zero – which is also around what we are currently forecasting.

If this scenario of flat growth materialises, we would expect the government to remain committed to its budgetary goal. Currently, we estimate that zero GDP growth in 2012 suggests an additional fiscal gap of almost CZK30bn. The Ministry of Finance has already adjusted the fiscal figures in its November "Fiscal Outlook" which pointed to GDP growth of 1% GDP next year. However, we do not think this scenario of lower GDP growth with the central government deficit of CZK105bn is based on additional austerity measures, rather partly on the expectation of lower interest rate expenditures. These measures were proposed by the government advisory council NERV today (12 December), not in the comprehensive form but as a list of options. These options do not aim to stimulate demand (excluding the proposal to increase the capital of state owned banks and insurance companies which support export activity), but rather to stabilise the fiscal budget (through hikes in taxes and cuts in expenditure) and increase the efficiency and transparency of the public sector. However, according to NERV, these options should be activated if GDP drops by more than 2%YoY. Additionally, the Ministry of Finance has to recalculate the impact of these proposals on the economy and then to decide which of them will be activated.

In contrast to this proposal, we think that government is likely to adopt a slightly different approach regarding the timing of the fiscal consolidation. We expect the Ministry of Finance to implement some form of austerity measures already in early 2012, if forecast growth is around zero next year. However, if there is a prospect of recession (around -1 or -2% of GDP) we would expect the government to hesitate over the introduction of another round of austerity measures beyond those likely to be introduced in early 2012. We believe early 2012 will be the only time they will be implement additional austerity measures as: i) political capital exists at the moment (owing to the euroarea fiscal crisis); ii) there are elections for regional governments and the Upper House of Parliament in autumn 2012 which we think could create tensions within the government coalition by late summer. During our meetings, we heard many times that, while fiscal policy in 2009 solved the question of how much of the fiscal stimulus is needed to support the economy, the current discussion revolves around how to ensure the automatic stabilisers work. However, the ability to keep the automatic stabilisers working could be limited by market sentiment in a scenario of recession which sees a 3% or more fall in GDP in 2012. If automatic fiscal stabilisers were unchanged, it would create an additional gap of CZK50-60bn above and beyond the targeted deficit of CZK105bn in 2012.

We estimate bond issuance of around CZK150-170bn is needed for 2012. However, for the local market, we believe the two most important factors will be issuance abroad and retail sales issuance. Both factors could substantially limit the issuance of local bonds. In our baseline, we expect the MoF to issue CZK20bn in retail bonds and, in an adverse scenario, CZK30-40bn. This should keep the issuance of long-term bonds below this year's level – or around it if the deficit is wider than planned in 2012. Moreover, if the Ministry of Finance were to issue €1-2bn of Eurobonds (we think the US market is also a possibility, but a six month road show would likely be necessary), it could be supportive for Czech bonds on the local market. From a demand perspective, we believe that two factors will be decisive. *Firstly*, the stability of investors in investment funds, if there is a more significant market meltdown. Secondly, Czech banks are likely to restart the crowding out of business loans by buying government bonds as in 2009-2010. However, their preference to buy Czech bonds could be limited by: i) the limits of exposure to the Czech government; ii) deleveraging process in the regional banking sector that could also indirectly influence Czech balance sheets.

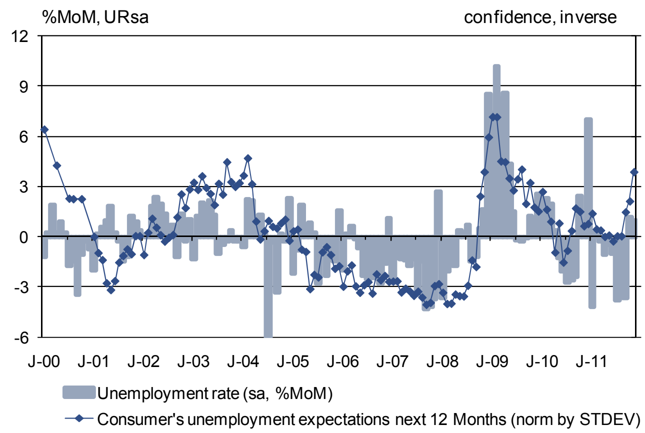
Mixed signals for the CNB's policy

November CPI inflation remains in the upper band of the inflation target after it accelerated to 2.5%YoY (0.4%MoM) from 2.3% (0.3%) a month earlier. Although it was just a tick above our forecast, it is 0.5ppt above the CNB's forecast. We think that this could mean upside risk for the CNB's forecast of the 3M PRIBOR up to 40bp compared to November's CNB forecast. However, for the month, the main drivers of inflation were food and gas prices, which could ease any pressures to hike the policy rate as: i) the higher CPI was not driven by adjusted core CPI; ii) higher food prices could already reflect the announced hike in the lower VAT in January 2012 (which is similar to autumn 2007). For the time being, we expect December inflation to ease to 2.3%YoY (due to the base effect, while still driven by higher gas prices monthly) before it will likely accelerate to 2.7% in 2012. This should be driven by hikes in the lower VAT rate, while adjusted core CPI is likely to contract as it has done in recent quarters owing to weak demand.

Koruna is likely to be important, but domestic demand is likely to rule CNB decision making – as usual. The CNB has become more careful with regards the koruna after it depreciated in recent months, particularly, after koruna weakness led to a hike in gas prices throughout all of 4Q11. While the CNB still works with an

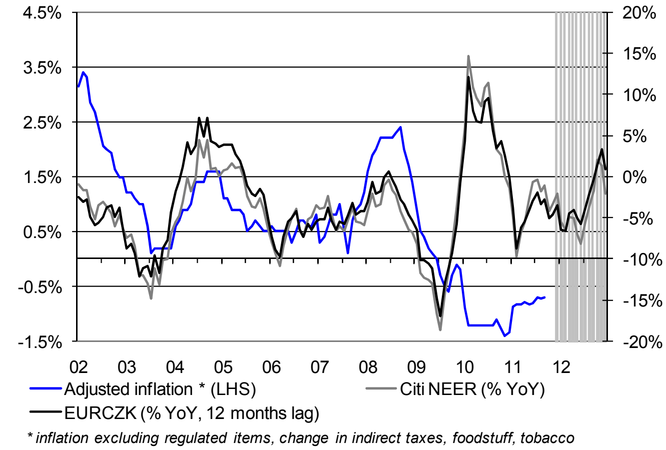
exchange rate pass-through assumption into consumer prices of around 15-20%, we think that it will likely be lower next year given demand weakness – as was the case in 2010 after koruna weakness in 2009. Although a weaker koruna and higher CPI are inflationary factors, there are also disinflationary factors – GDP growth came in at 1.2%YoY in 3Q11, while the CNB forecasts are based on 1.7%; the unemployment rate has deteriorated recently and prospects for wage growth is likely to be weaker as we think the weaker economic performance in 2012 will likely lead to milder nominal wage growth of 2.2%YoY in 2012, below the CNB alternative forecast of 2.8% growth which assumes that GDP contracts by 0.4%YoY.

Figure 13. Labour market is likely continue to worsen



Source: MPSV, Eurostat, Citi Investment Research and Analysis

Figure 14. Core adjusted CPI did not reflect koruna's weakness in 2010



Source: CNB, CZSO, Citi Investment Research and Analysis

All in all, the CNB has to manage its "koruna" dilemma and the performance of Czech bonds will be conditional on both local fiscal policy and external market sentiment. We forecast EURCZK to average 25.4 in 2012, but this should not trigger the CNB to hike the policy rate for two reasons: uncertainty and the ECB – we believe a euro area recession would lead to a 50bp cut in the ECB policy rate to 0.5% in mid 2012. This is well below the CNB assumption that has 3M EURIBOR coming in at 1.2% in 2012. Hence, the CNB model is likely to still envisage a koruna appreciation ahead that implies a 50bp cut in 3M PRIBOR, in our view. In other words, we think the CNB is likely to tolerate a weaker koruna as foreign demand is weak (CNB's Vice Governor Vladimir Tomsik said that koruna should act as a shock-absorber during the crisis; CNB, 9 December). Thus, we expect some form of verbal fine-tuning from the CNB to continue, i.e. sound hawkish to limit koruna weakness, but not too much to provide relief for exporters. However, higher CPI inflation and weaker koruna are important inflationary risks and so we see a risk of a hike in the CNB's policy rate in early 2012 under the following circumstances: i) the fiscal authorities do not remain committed to consolidation, reflected in a wider asset swap (we expect the CNB will be afraid of further weakening of koruna); ii) the koruna weakens above 26 against the EUR; iii) January CPI inflation surges beyond expectations.

Appendix A-1

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