

04.12.2008

**Important to keep economic motor running and stabilize consumer confidence**

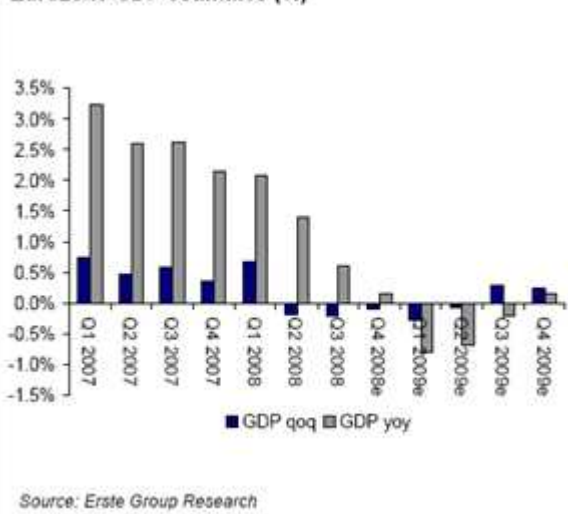
GDP to shrink in euro zone by - 0.4%, inflation expected to drop to 1.5%  
 ECB to lower key lending rate to record level of 1.75% in 1HY 2009  
 A year of sluggish economic growth ahead for US  
 Average CEE growth higher than euro zone  
 Bond market benefiting from the crisis (especially government bonds); middle 2009 to bring appetite for riskier investment classes (corporate bonds)



When the financial market crisis reached its climax in mid-September, this put such a damper on the global economy that massive support measures had to be taken by governments to rescue the situation. "Many different actions were initiated in an attempt to solve the global crisis," said Rainer Singer, Head of CEE Macro-/Fixed Income Research at Erste Group at the press conference. "Bailout plans for the economy and the banking sector were initiated not only as an attempt to stabilize the financial markets, but also to counteract the economic downwards spiral in an early stage. It is important to keep the economic motor running and to stabilize consumer confidence. Not only have investors become more risk averse, but consumers and businesses as well. High risk premiums are expected to prevail on the money market for some time to come," added Rainer Singer.

"The bond market is benefiting from the crisis and especially government bonds are considered safe harbours," stated Gudrun Egger, the interest rate and bond expert at Erste Group. The experts of Erste Group continue to recommend short maturities for the coming months. Around the middle of next year, government bonds might correct slightly, thus potentially increasing the appeal of riskier investment classes (corporate bonds).

**Eurozone GDP estimates (%)**



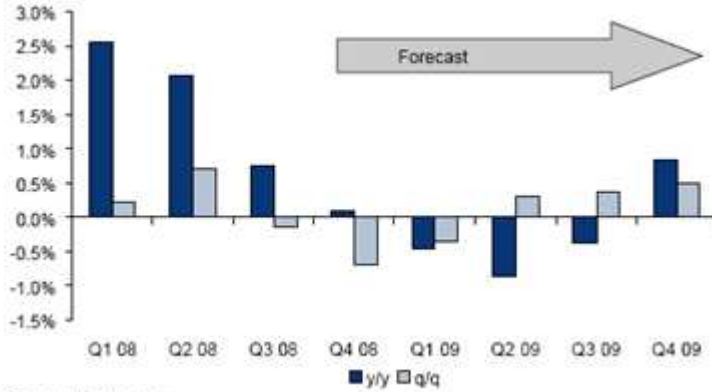
The growth cycle in the euro zone has entered into a contraction phase due to high inflation and the related decline in demand. The contraction of the economy was accelerated by the exacerbating financial market crisis as of mid-September. The depth of the recession and how long it will last are unclear. Therefore, consumers are exercising more restraint in spending and companies in key industries are responding by cutting back production and postponing investment plans. The analysts of Erste Group expect GDP to shrink in the euro zone in 2009 by -0.4%. The economic downswing, sinking commodity prices and base effects are expected to push inflation down to 1.5% next year. This would give the ECB more room for lowering the key lending rate in the first half of 2009 to the record level of around 1.75%, which would push down money market rates as well. Government bonds might initially rise even further due to the risk aversion of investors. With the end of the interest rate cutting cycle and more issues of government bonds, yields are expected to rise again slightly as of mid-2009.

**USA: A year of sluggish economic growth lies ahead for the US**

**Euro zone: Key lending rate expected to reach record of 1.75%**

The downturn of the **US**

## GDP forecast



Source: Erste Group Research, Bloomberg

**economy** is in full swing. What is unclear is how much of the downswing is a direct reaction to the financial market crisis and how steep the downslide will be that was triggered by the spending restraint of consumers over the past few months. How long will the downwards spiral feeding on worsening employment data and shrinking demand last? This also entails the question of whether the diverse rescue packages and economic stimulation plans of historic dimensions will be effective. According to the cautious

estimates of the team of analysts, the trust of the real economy in the financial sector should gradually be restored. What is uncertain is if this will also apply the other way around, i.e., how will lending develop. The degree of the insecurity is particularly high this time, but the analysts believe that even though the US economy is in for a very weak year, in the end, it will stabilize. One factor over which there is no doubt even now is that the budget deficit of the public sector will widen enormously, with all of the entailing risks for financing costs.

### CEE: Average CEE growth expected to be higher than euro zone average

The CEE region is also expected to face a weak economic year. Undoubtedly, exports to the most important export market - Euroland - will shrink. Moreover, a cyclical downswing after years of very robust growth is due. *"Nonetheless, the competitive advantages and the still large potential for catching up in these economies point to an average growth level above that of the euro zone, albeit with the situation varying widely from country to country,"* said Rainer Singer at the press conference. The current valuation of currencies and bonds reflects the insecurity caused by the financial market crisis and is too low if measured by the fundamental data. The capital markets of the CEE region therefore stand to benefit significantly from the stabilization of the global environment. Additional support for bond markets will come from falling inflation rates and lower key lending rates.

The **EUR corporate bond market** is marked by constant insecurity. The reason is the phase of economic contraction characterized by falling interest rates, sinking corporate earnings and a deterioration of credit quality. "After the economic low in the euro zone, we expect moderately rising corporate earnings, gradual debt reduction and a stabilizing trend in credit quality in the second half of 2009," stated Elena Statelov, the expert for Major Markets & Credit Research. Risk premiums are expected to be volatile at a high level with prospects of narrowing spreads only as of the second half of the year 2009. Investors will have the opportunity to buy into high returns, especially in the form of attractively priced new issues. However, the selection of the securities and also a fundamental credit analysis are of enormous importance in this context. The defensive sectors have meanwhile become expensive, but due to the generation of stable cash flows, the experts continue to have a preference for telecoms, utilities and non-cyclical consumer securities.





# Euro-Visions

## Economic and Capital Market Forecast – December 2008

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**Eurozone:** Investments are main driver of slowdown

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**ECB:** More monetary loosening ahead

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**US:** Recovery to hinge on stabilization of expectations

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**CEE:** Economies to weaken, but remain ahead of Euroland

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**Corporate bonds:** Slight tightening of spreads to start mid-2009

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# Overview

The economic growth cycle in the **euro zone** has entered into a contraction phase due to high inflation and the related decline in demand. The contraction of the economy was accelerated by the exacerbating financial market crisis as of mid-September 2008. The depth and length of the recession are at present unclear. Therefore, consumers are exercising more restraint in spending and companies in key industries are responding by cutting back production and postponing investment plans. We expect GDP to shrink in the euro zone in 2009 by -0.4%. The economic downswing, sinking commodity prices and base effects are expected to push inflation down to 1.5% next year. This would give the ECB more room for lowering the key lending rate in the first half of 2009 to the record level of around 1.75%, which would help lower money market rates as well. Government bonds might initially rise even further due to the risk aversion of investors. With the end of the interest rate cutting cycle and more issues of government bonds, yields are expected to rise again slightly as of mid-2009.

The downturn of the **US economy** is in full swing. What is unclear is how much of the downswing is a direct reaction to the financial market crisis and how steep the downslide will be that was triggered by the spending restraint of consumers over the past few months. How long will the downwards spiral feeding on worsening employment data and shrinking demand last? This also entails the question of whether the diverse rescue packages and economic stimulation plans of historic dimensions will be effective. According to our cautious estimates, the trust of the real economy in the financial sector should gradually be restored. What is uncertain is if this will also apply the other way around, i.e., how will lending develop? The degree of the insecurity is particularly high this time, but we believe that even though the US economy is in for a very weak year, in the end, the economic situation will stabilize again. One factor over which there is no doubt even now is that the budget deficit of the public sector will widen enormously, with the corresponding risks for financing costs.

The **CEE region** is also expected to face a weak economy in the coming year. Undoubtedly, exports to the most important export market - Euroland – will cool. Moreover, a cyclical downswing after years of very robust growth is due. Nonetheless, the competitive advantages and the still large potential for catching up in these economies point to an average growth level above that of the euro zone, albeit with the situation varying widely from country to country. The current valuation of currencies and bonds reflects the insecurity caused by the financial market crisis and is too low according to the fundamental data. The capital markets of the CEE region therefore stand to benefit significantly from the stabilization of the global environment. Additional support for bond markets will come from falling inflation rates and lower key lending rates.

The **EUR corporate bond market** is marked by constant insecurity. The reason is the phase of economic contraction characterized by falling interest rates, sinking corporate earnings and a deterioration of credit quality. After the economic low in the euro zone, we expect moderately rising corporate earnings, gradual debt reduction and a stabilizing trend in credit quality in the second half of 2009. Risk premiums are expected to be volatile at a high level with narrowing spreads expected only as of the second half of the year 2009. Investors will have the opportunity to buy into high returns, especially in the form of attractively priced new issues. However, the selection of the bonds and also a fundamental credit analysis are of enormous importance in this context. The defensive sectors have meanwhile become expensive, but due to the generation of stable cash flows, we continue to have a preference for telecoms, utilities and non-cyclical consumer securities.

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# Forecasts

## 3 month money market rates

End of the month	current	Mar-09	Jun-09	Sep-09	Dec-09
EURO	3.82	3.00	2.55	2.35	2.20
Japan	0.95	0.60	0.60	0.60	0.60
USA	2.22	1.50	1.20	1.20	1.20
Switzerland	1.24	0.50	0.50	0.50	0.50
Czech Republic	4.09	2.60	2.50	2.60	3.50
Hungary	11.08	8.90	7.90	7.40	6.00
Poland	6.55	5.60	5.20	4.80	4.00
Romania	14.03	10.30	9.80	9.10	7.60
Slovakia	3.42	3.00	2.55	2.35	2.20
Ukraine	24.58	22.00	15.10	14.00	8.00

Source: Erste Group Research

## 10y Yields

End of the month	current	Mar-09	Jun-09	Sep-09	Dec-09
Germany	3.12	3.00	3.70	4.00	4.40
Austria	3.77	3.40	4.00	4.30	4.70
Spread to GE	0.65	0.40	0.30	0.30	0.30
USA	2.72	3.60	3.80	4.00	4.00
Croatia	6.23	7.20	7.00	6.80	4.50
Czech Republic	4.31	4.10	3.90	3.80	3.60
Hungary	8.87	8.00	7.40	7.20	7.00
Poland	5.95	6.10	5.90	5.70	5.50
Romania*	11.20	10.50	9.80	9.30	9.00
Slovakia	4.96	4.70	4.60	4.60	4.80
Ukraine**	14.00	19.00	17.00	15.00	9.80

\* 5Y Primary market, \*\* 2Y

Source: Erste Group Research

## Exchange rates

End of the month	current	Mar-09	Jun-09	Sep-09	Dec-09
EUR/USD	1.261	1.33	1.33	1.30	1.30
EUR/JPY	117.6	129	133	133	135
USD/JPY	93.3	97	100	102	104
EUR/CHF	1.520	1.49	1.50	1.53	1.53
USD/CHF	1.205	1.12	1.13	1.18	1.18
EUR/HRK	7.131	7.25	7.20	7.25	7.30
EUR/CZK	25.67	25.0	24.8	24.5	24.1
EUR/HUF	262.3	253	250	245	245
EUR/PLN	3.854	3.55	3.40	3.37	3.4
EUR/RON	3.803	3.68	3.65	3.62	3.58
EUR/SKK	30.32	30.126	-	-	-
EUR/UAH	9.27	8.96	7.68	8.19	8.50

Source: Erste Group Research



# Forecasts

## Economy

### Changes y/y

<i>GDP growth</i>	<b>2007</b>	<b>2008f</b>	<b>2009f</b>	<b>2010f</b>
Austria	3.1	2.0	0.9	2.1
Germany	2.7	1.3	-0.8	1.2
France	2.1	1.0	-0.7	1.5
Italy	1.4	0.2	-1.0	0.8
Spain	3.8	0.9	-1.0	0.8
Netherlands	3.5	2.2	0.7	1.1
Euroland	2.6	1.1	-0.4	1.2
USA	2.2	1.4	-0.2	1.7
Japan	2.0	0.4	-0.3	0.6
Switzerland	3.1	1.7	0.0	1.3
Croatia	5.6	3.4	1.7	3.0
Czech Republic	6.6	4.1	2.5	3.5
Hungary	1.1	1.8	-0.8	2.5
Poland	6.7	5.2	3.0	4.4
Romania	6.0	8.3	4.4	5.3
Serbia	7.5	7.1	3.5	4.0
Slovakia	10.4	7.4	4.8	6.2
Ukraine	7.6	4.8	-2.5	5.5

Source: Erste Group Research

<i>Inflation</i>	<b>2007</b>	<b>2008f</b>	<b>2009f</b>	<b>2010f</b>
Austria*	2.2	2.9	2.2	1.9
Germany	2.3	2.9	1.4	1.9
France	1.6	3.1	1.2	1.8
Italy	2.0	3.2	1.6	2.1
Spain	2.8	4.0	2.0	2.6
Netherlands	1.6	2.0	2.2	2.5
Euroland	2.1	3.2	1.5	2.0
USA	2.8	4.2	1.5	2.2
Japan	0.1	1.5	0.1	0.2
Switzerland	0.7	2.6	1.1	1.1
Croatia	2.9	6.4	3.6	3.5
Czech Republic	2.8	6.3	2.0	2.3
Hungary	8.0	6.2	5.0	3.2
Poland	2.6	4.1	3.0	2.3
Romania	4.8	7.8	4.2	5.3
Serbia	6.5	11.0	8.0	5.5
Slovakia	2.8	4.7	3.0	3.9
Ukraine	12.8	22.8	18.0	9.4

\*national statistics

Source: Erste Group Research

# Euroland

Change yoy	in % of GDP	2005	2006	2007	2008f	2009f	2010f
Private consumption	56.5%	1.8%	2.0%	1.6%	0.3%	0.0%	0.8%
Public sector consumption	19.9%	1.5%	1.9%	2.3%	1.6%	1.8%	1.5%
Investments	22.0%	3.4%	5.9%	4.3%	1.4%	-2.9%	1.0%
Change in inventories		8.2	15.2	22.9	31.9	4.5	14.5
Domestic demand	98.7%	2.0%	2.9%	2.4%	0.9%	-0.7%	1.1%
Exports	44.8%	5.2%	8.1%	6.1%	3.4%	1.0%	2.6%
Imports	43.4%	5.8%	8.0%	5.5%	3.1%	0.9%	2.4%
Trade balance	1.4%	74.4	85.2	108.4	122.1	126.3	136.7
GDP real	100.0%	1.8%	3.0%	2.6%	1.1%	-0.4%	1.2%

Source: Datastream, Erste Group Research

## Economy

### In a nutshell

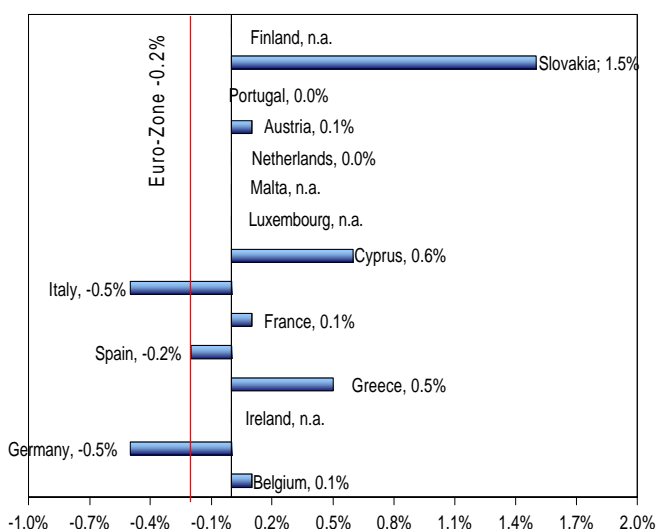
#### High inflation put an end to growth cycle

After a very strong first quarter, the growth cycle in the Eurozone embarked on a downturn in Q2. Rising prices especially in energy and food dampened domestic demand in the first half of 2008, while the high external value of the euro stifled exports. In the previous years positive net exports and continuously high investment activity had been the growth drivers in the Eurozone. The current decline in investments will hit those countries hardest that are suffering from a correction of their overheated property markets, such as Spain or Ireland.

#### Recession in the Eurozone

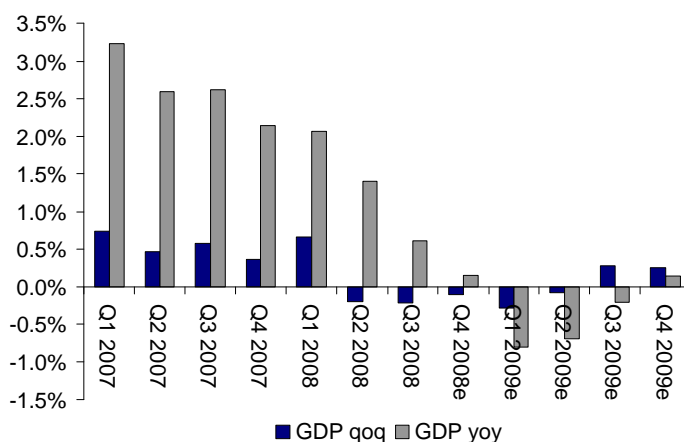
The GDP in the Eurozone shrank by 0.2% in the second quarter, and by an additional 0.2% in the third quarter, which means that a technical recession has got hold of the economy. The development in the various member states shows a mixed picture. The GDP of the former economic growth engine, Germany, shrank by 0.5%, mainly induced by weaker export dynamics and falling capital expenditure. The stable development of France in the third quarter came as a surprise, whereas the Italian economy – dependent as it is on domestic consumption (much like France) – declined by 0.5%. In Spain, the fall in GDP of 0.2% was primarily caused by weaker consumption and lower investment activity. The smaller member states provided positive contributions.

#### Q3 GDP, qoq (%)



Source: Eurostat

#### Eurozone GDP estimates (%)



Source: Erste Group Research

# Euroland

## Financial crisis accelerates downturn – 2009 will be a meagre year

The mentioned deterioration of the economy has seen a drastic acceleration since September on the back of the financial crisis. Although the available indicators of the performance of the real economy largely concern the month of September and it is therefore difficult to quantify the extent, the extremely weak sentiment indicators and curbed output in key industries (e.g. automobile manufacturers) already point to the imminent contraction of the economy. We expect the GDP to decline by 0.4% next year in the Eurozone. Coming out of the trough towards the end of the second quarter, the economy should be able to recover moderately in the second half of 2009, supported by the historically low key lending rates and lower inflation. In 2010 the economy should achieve moderate growth rates of about 1.2%.

## Support from the government to keep the economic engine running

Never before has there been such a degree of general agreement on the necessity of governmental intervention within Europe and even on a global scale. Bank bailouts and economic recovery programmes are mainly aimed at preventing the economic engine from stalling and at supporting employment. Even running a temporary budget deficit of beyond 3% in terms of GDP (as demanded by the Maastricht Treaty) has been made an option. The steps taken have been comprehensive in order to fight a downward spiral (i.e. weak demand, rising unemployment) at an early stage.

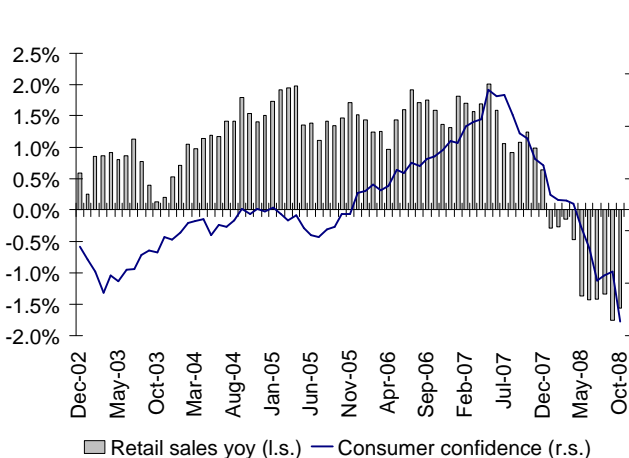
## Segments – capital expenditure as chock block

## Private consumption – uncertainty follows inflation

Up until a few months ago rising prices were the decisive factor in the deteriorating consumer sentiment, but now the uncertainty over the extent and the duration of the recession have put a different kind of weight on demand, especially on the demand for durable goods. In October, new registrations of passenger cars decreased by 15.5% in Europe, with the countries grappling with a property crisis (e.g. Ireland, Spain) most severely affected.

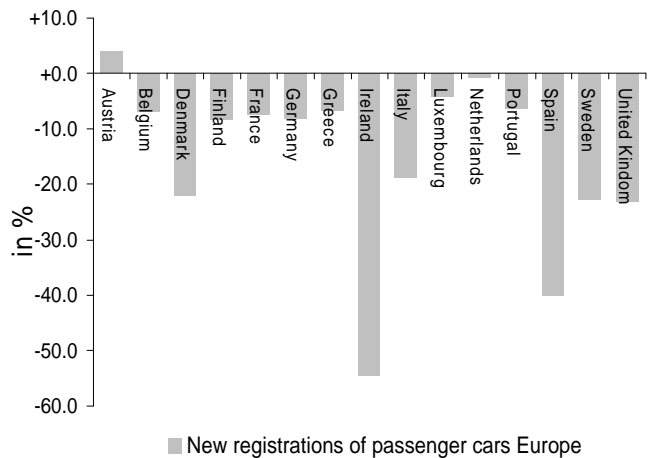
Private consumption has grown at disproportionately low rates in the past. Therefore it should also be a stabilising factor on the way down. Wage increases resulting from rising company profits over the past years and the rapid decline in inflation in the coming months will boost real income. In spite of falling asset values (house prices, equities), the gain in purchase power will make itself felt not the least due to the strong decline in energy prices and thus have a positive influence on the propensity to consume. If employment could be stabilised, consumer sentiment could rebound as soon as in the first half of 2009. Countries that have been more severely affected by the property and financial crisis (more restrictive lending policies for private households) can be expected to display a gloomier sentiment. We expect private consumption in the Eurozone overall to stagnate in the coming year.

Retail sales yoy (%) vs. consumer confidence



Source: Datastream, Erste Group Research

New registrations of passenger cars - October yoy (%)



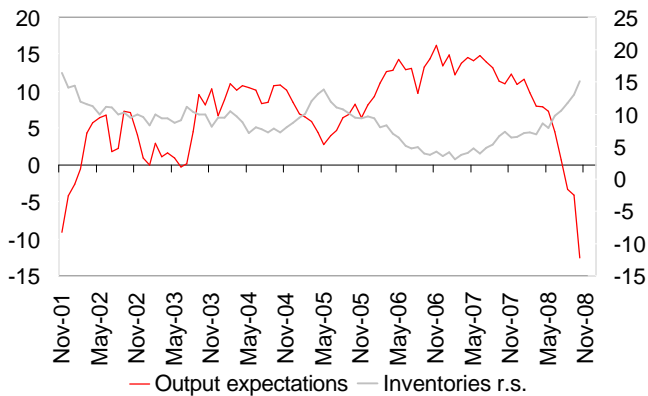
Source: European Automobile Manufacturers' Association

# Euroland

## Capital expenditure as key driver of the downswing

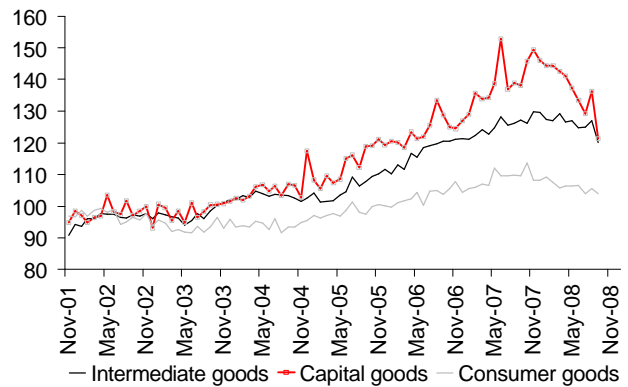
The strong decline in demand has led a number of companies in key industries (e.g. automobile, chemicals) to announce a temporary cut in production capacity. Industrial output has been edging lower since the third quarter, and we expect the largest decline for the winter months since on top of falling order intake we also envisage a temporary reduction in finished goods inventories. This will cause capacity utilisation to drop and investment dynamics to decline. Whereas at a growth rate of 6% investments were one of the growth drivers in 2006 (2007: +4.3%), we expect this parameter to decline by about 3% in 2009. Thus, weak investment activity will be one of the drivers of the downswing in 2009. The fact that banks are reducing company and sector specific risk and thus demanding more collateral when granting loans does not exactly help either. However the demand for loans is weakening, especially from structurally well-positioned companies with high cashflows.

## Output expectations vs. inventories



Source: Datastream, Erste Group Research

## Order intake Germany

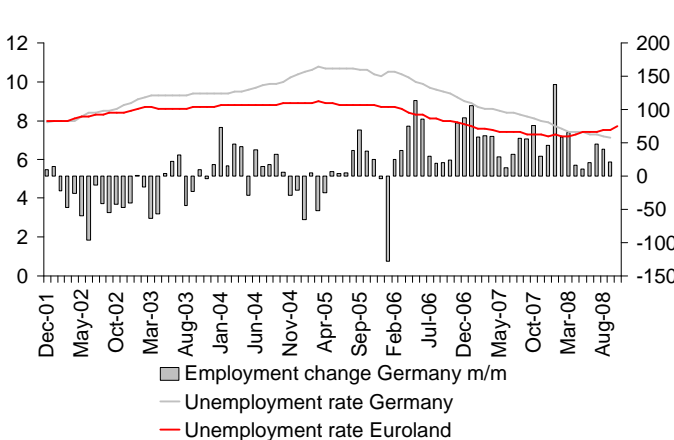


Source: Datastream, Erste Group Research

## Labour market reacts with time lag

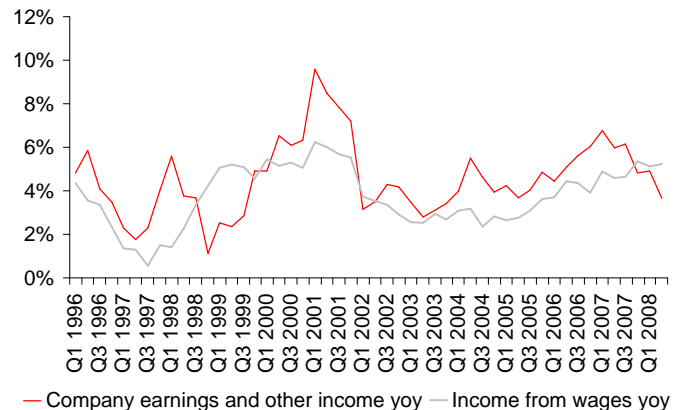
In the period of 2007 to 2008, 4 million jobs were created in the Eurozone, and the unemployment rate declined to a low of 7.2% in the first quarter of 2008. In view of the downturn of the growth cycle the unemployment rate is to be expected to rise over the coming two years. The European Commission has estimated an increase of about 1% until 2010. The labour market effects of the economic decline will be more noticeable in those countries that have also experienced higher unemployment rates in the past (e.g. Spain).

## New jobs ('000), unemployment rate (%)



Source: Datastream, Erste Group Research

## Company earnings, income from wages yoy (%)



Source: Datastream, Erste Group Research

# Euroland

## Trade balance should remain positive

Given the global recession, exports can be expected to weaken. Whereas the high external value of the euro had a dampening effect in the first half of 2008, the euro can now help stabilise the picture after its depreciation. In 2007 exports were one of the key growth drivers at +6%; for 2009 we only expect moderate export growth of 1%. In view of the recession in some member states of the Eurozone and the weak domestic demand we expect imports to exhibit an even weaker performance, thus allowing positive net exports to have a stabilising effect on the GDP.

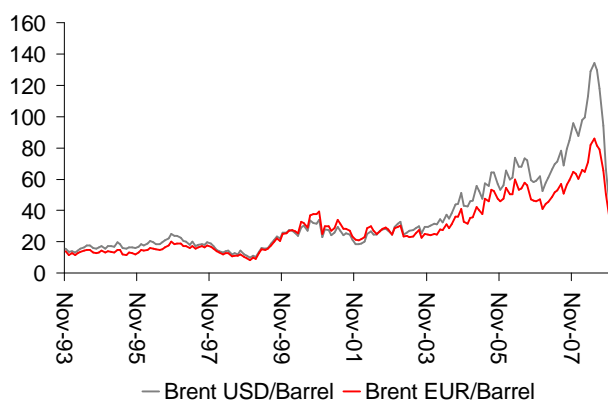
## Inflation

### Oil price pushed inflation to 4% during summer

Inflation forecasts had to be repeatedly revised upwards in the first half of the year. The hefty increase in energy and food prices pushed inflation up to 4% in July 2008. Since then we have seen a massive decline in the oil price as a result of the settlement of speculative positions (selling of commodities by investors) and the weak economy.

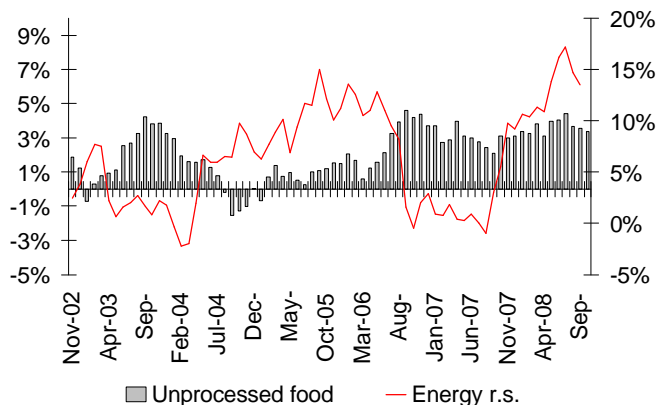
With regard to the future development of the oil price, it is in our view almost impossible to make meaningful estimates from the supply/demand ratio. One area of agreement is the fact that average production costs will be rising due to the decreasing volume of oil that can be produced cheaply. Although demand should fall temporarily because of the economic downswing, we expect industrial output to pick up again in the medium term which would lead to a moderately rising oil price, particularly as the latter is also in the best interest of the oil-exporting countries. Our inflation estimate for 2009 is based on an oil price of USD 70/barrel.

### Oil price in USD, EUR



Source: Datastream, Erste Group Research

### Prices of energy and unprocessed food yoy (%)



Source: Datastream, Erste Group Research

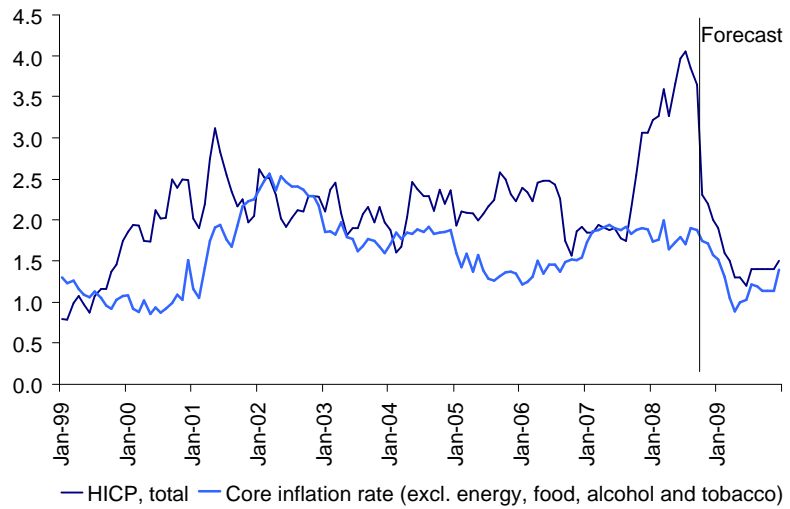
The low oil price as well as the falling prices of other commodities should take some weight off the companies' debit side, which in turn should lead to falling producer prices. This would take the upward pressure off consumer prices. The service industry is also expected to experience a considerable decline in inflation both on the cost and on the demand side in the first half of 2009. This area accounts for about 40% of the overall Consumer Price Index and for some 50% of core inflation (i.e. excluding energy and food).

### Inflation falling to 2.1% in November and should decline to 1.5% in 2009

The declining economy, falling commodity prices, and base effects should lead to a quick decrease in total inflation in the coming months. This assumption is supported by the latest Consumer Price Index of the Eurozone in October. After +3.6% in September, inflation had edged down to 3.2% in October and fallen further to +2.1% in November. For the full year of 2009 we expect inflation to dip to +1.5%, which would represent a low value by historic comparison. We envisage an average core inflation of +1.2%.

# Euroland

## Total and core inflation, forecast yoy (%)



Source: Datastream, Erste Group Research estimates

## Money market

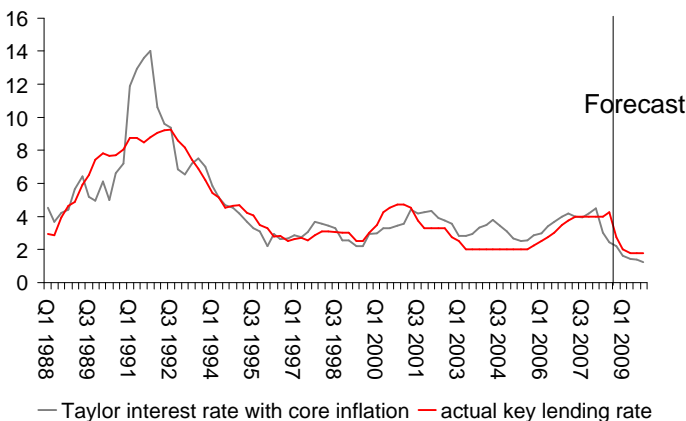
### ECB with changed attitude

The monetary policy of the ECB has seen a u-turn over the last weeks. Whereas in autumn some ECB Governing Council members were still harbouring fears that potential second-round effects might cause inflation risk in the medium term, the focus has now shifted to quickly supporting up the economy.

### Core rate was cut by 100 bps since October

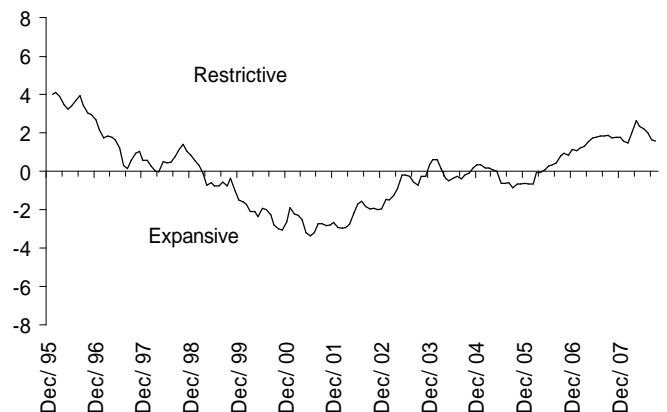
Within only a few weeks, key lending rates were cut by a total of 100bps – initially in a concerted action together with other central banks in October, and then again at the beginning of November. The pronounced decline in inflation has left the ECB with more wiggle room. In spite the drastically fallen external value of the euro caused a change of trend, the Monetary Condition index continues to indicate a restrictive monetary environment and confirms that a rapid decline in money market rates would make sense in the current setting.

## Taylor rule and development of key rates in %



Source: Datastream, Erste Group Research

## Monetary Condition Index



Source: Datastream, Erste Group Research

# Euroland

## Further interest rate cuts to historic lows

We expect key lending rates to be cut by about 50bps in December, and we envisage further steps for the beginning of 2009. In accordance with our GDP and inflation forecasts we see a chance that key lending rates may fall to 1.75% in the second quarter of 2009. The real economy tends to be affected by rate cuts with a time lag of two to three quarters.

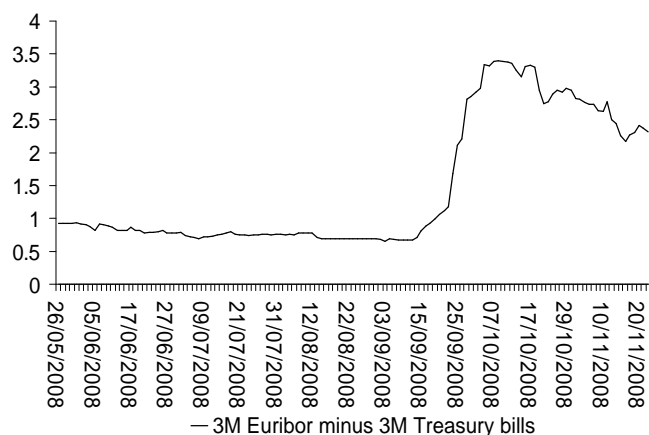
Even if central banks offer commercial banks cheaper ways of refinancing (i.e. lower central bank rates, higher refinancing volumes), debt-financed capital expenditure or debt-financed private consumption may still remain at low levels due to uncertainty and the resulting wait-and-see attitude. However, in the medium term surplus liquidity among banks and low interest rates should boost demand for goods.

## Money market rates are falling – spreads are narrowing

Expected further cuts of the key lending rates and particularly the generous supply of liquidity by central banks have led to falling money market rates. In the past weeks the ECB has allocated the requested liquidity in full at fixed interest rates and will continue to provide as much liquidity as necessary so as to avoid any new trouble from brewing on the money market.

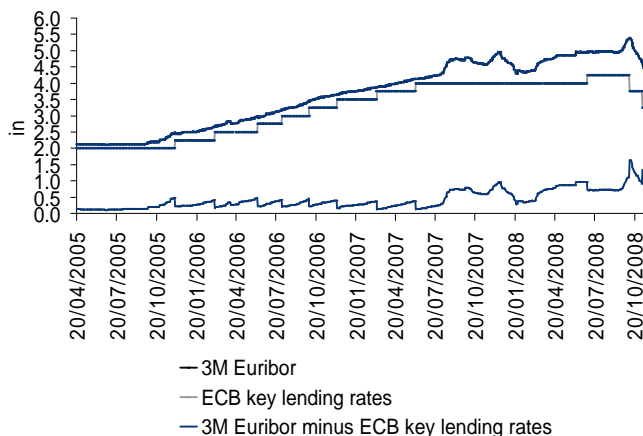
The spreads of the 3M Euribor relative to key lending rates soared to 125bps but in November came down to below 70bps (i.e. the level we had seen before Lehman's collapse). The risk aversion of the market participants had boosted the demand for short-term Treasury bills, and the spread between the current yield of 3M Treasury bills and the 3M Euribor soared in one big step. Although we can see first signs of the situation calming down, we expect the uncertainty over the extent of the bank risk to stick around for a while. For this reason we expect money market spreads to remain above the historic levels of 20 to 30bps in the coming year.

3M Euribor minus 3M Treasury bills, yield in%



Source: Bloomberg

3M Euribor and key lending rates in %



Source: Bloomberg

## Bond market

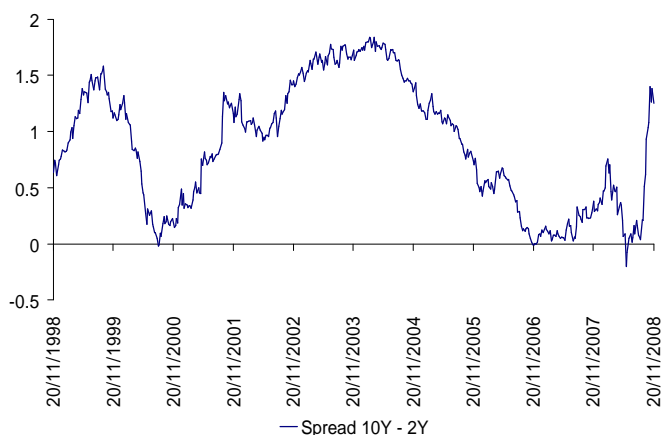
### Government bonds as safe haven

After an extended period of moving sideways, government bonds have recorded soaring prices since August. The 10Y yield of German government bonds has decreased by about 100bps in the past four months. The yields of short maturities (two years) fell by about 250bps over the same period, which is why the interest curve steepened; the margin between the two has increased to 140bps within a matter of weeks. The decrease in yields on the short end was not only triggered by the sudden realisation that key lending rates were going to be cut, but also – and primarily – by the investors' increased risk aversion. 2Y maturities in particular were seen as safe haven.



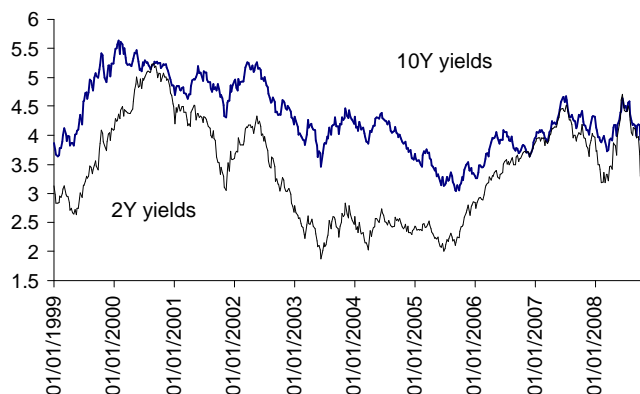
# Euroland

Slope of the euro interest curve in %



Source: Datastream, Erste Group Research

Yield of German government bonds in %



Source: Datastream, Erste Group Research

Along the lines of our inflation and economic forecast, key lending rates might see new lows in the second quarter of 2009 at 1.75%. Therefore we believe that the yields on the short end still come with potential for further declines. However, the potential for price increases on the long end is limited in our opinion, and we do not expect 10Y yields to fall below 3%. The latest rate cut cycle of the ECB caused the interest curve to steepen (10Y-2Y) to 175bps, and this time around this margin might even be exceeded.

## Steep interest curve due to special items

The steep interest curve normally indicates that the financial markets expect the economy to recover after a difficult phase. However, we believe that currently a number of special items are still dominating (i.e. the risk aversion of investors and the funding needs of the government).

## Government interventions require more money

There is no doubt that the primary goal of the governments has to be the timely supply of support packages for the financial markets and the economy so as to avoid any protracted downwards spirals. However, this will mean substantial financing needs for the Eurozone governments in the coming year.

- i) The **economic downturn** will increase the debt burden of some member states.
- ii) **Economic recovery packages** have been earmarked within Europe to the tune of about 1.5% in terms of GDP. EUR 170bn of the total EUR 200bn will be provided by the member states, and the remaining EUR 30bn will come from a central EU budget. Depending on the requirements of each state, the capital will be invested in an effort to stimulate the economy, which should in turn cushion any negative effects on the labour market.
- iii) On top of that, the governments will need substantial amounts of money to finance the **bailout programmes for the banking sector**. Along with the liquidity injections of about EUR 270bn, guarantees for debt of about EUR 1,200bn have been given. Depending on the extent to which the banks will be able to obtain liquidity themselves, said guarantees will or will not become relevant.

The governments will source the aforementioned liquidity by issuing government bonds. The additional supply on the government bond market might meet a sufficiently high demand. Spells of weak economic activity tend to stimulate the interest in low-risk investments. At the same time, we cannot exclude the scenario of central banks cooperating and buying the government bonds from the governments. The “money” thus created could be used to finance a higher deficit. Bonds could be issued across all maturities. Governments will be focusing their issues on the short and medium terms. That said, the 10Y area currently offers low yields as well.



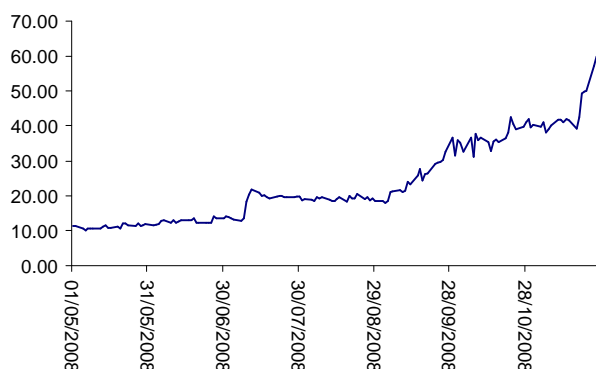
# Euroland

## Bond markets may come under pressure

Should potential investors expect governments to have an increasingly difficult time sourcing cheap credit (i.e. bonds) through rising budget deficits, abroad, or by means of public issues, they might demand higher yields, which would argue for rising yields in the course of the next year.

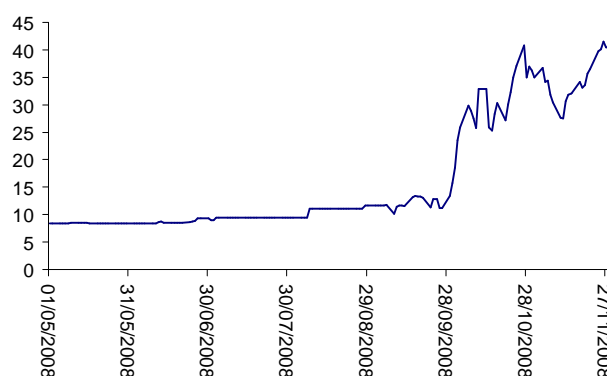
Increasing CDS spreads for government bonds support this rationale. It is obvious that investors expect higher credit risks in the wake of each additional financial package announced. American CDS spreads for government bonds have risen from 20bps in the summer to 57bps; German CDS for government bonds have soared from below 15bps to 42bps since the collapse of Lehman.

### CDS spreads US Treasuries in bps



Source: Bloomberg, Erste Group Research

### CDS spreads German government bonds in bps



Source: Bloomberg, Erste Group Research

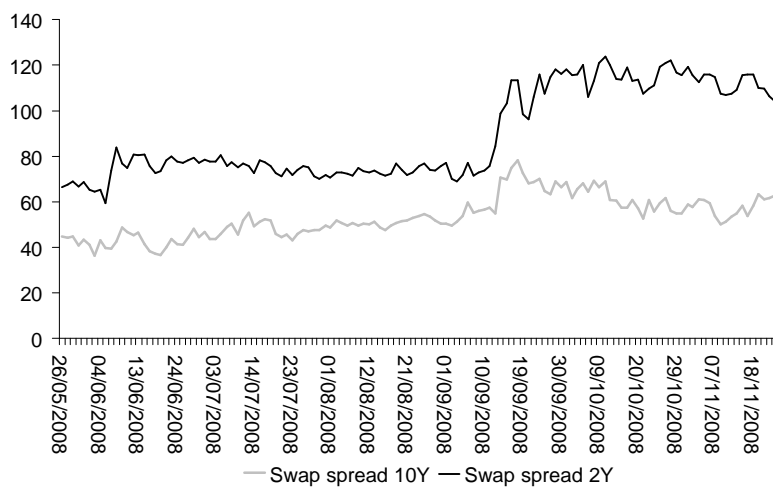
## Inflation pushes up yields in the medium term

We expect the economy to hit the trough towards the end of the second quarter of 2009. The cycle of rate cuts should come to an end in the first half of next year. The more expansive monetary policy should push inflation up in the medium term, which could put upward pressure on the yields of 10Y government bonds.

The swap curve has not steepened as much because the swap spreads at the short end increased massively due to the risk aversion of investors. The 10Y area, too, indicates that the uncertainty over the "rating" of the economy has led to widening spreads. Stabilising financial markets, substantially lower inflation, and historically low key lending rates (1.75%) in cooperation with the imminent economic recovery should gradually take swap spreads down to more "normal" levels of around 30 to 40bps. The swap curve should become steeper, as the rising government bond yields trigger an increase in long-term interest rates.

# Euroland

Swap spreads 2Y, 10Y in bps



Source: Datastream, Erste Group Research

Gudrun Egger

	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	2.0	1.4	-0.2	1.7
Private Consumption (growth y/y %)	2.8	0.5	-0.5	1.3
Fixed Capital Formation (growth y/y %)	-5.3	-6.0	-3.9	3.3
CPI (y/y, average%)	2.8	4.2	1.5	2.2
Current account balance (% of GDP)	-5.5	-5.0	-3.5	-3.5
Govt. budget balance (% of GDP)	-1.2	-5.0	-9.0	-3.5
Short term interest rate (3 months) year-end	4.7	2.5	1.2	2.6
Loc. Curr./EUR average	1.37	1.47	1.32	1.27

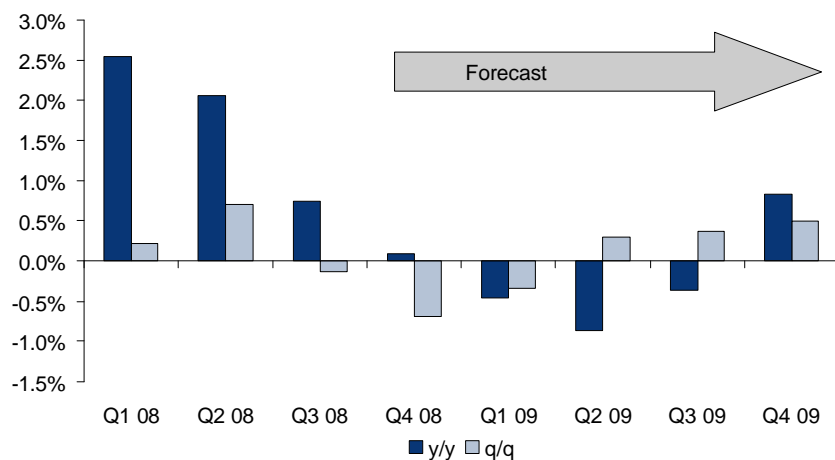
## Economy

### Economic downturn in full swing

The recovery of the US economy in the second quarter was, as expected, only a short intermezzo. In the third quarter, economic output shrunk and the downswing is expected to have accelerated in the fourth quarter. There is no doubt that the situation on the financial sector is worrying households, businesses and banks thus creating the corresponding effects on spending. This aggravates the constant adverse influence of the correction on the real estate market. Furthermore, the high level of indebtedness especially among households has eroded the resilience of the US economy. At present, the economic downturn is in full swing. Even if the turmoil on the financial markets were to ease, the US economy will recover only gradually, because past misallocations on the real estate market need to be corrected.

However, the question right now is when will the downturn slow down at least once. There are no indications of this yet. Although the flow of the horrifying news from the financial sector has ebbed, the newsflows from the "real economy" are putting a damper on sentiment now. Consequently, this is lowering expectations that lending by banks will soon normalize again. The course of current developments is unclear and thus buying and investment decisions are being postponed. At the same time, it seems as if the worst risk, namely a series of bank insolvencies has been warded off and this promises to bring calm. The release of the financial statements in the spring of next year does carry risks, but also opportunities. The risks certainly lie in the evaluation by external auditors of the write-downs up to now. Therefore, new negative headlines cannot be ruled out. However, the publication of this data could take some of the insecurity out of the market. But fears of households over jobs and the fears of businesses over the future development of demand remain. So, we expect economic output to shrink in 1Q 2009 as well. Even though the economy is being bolstered by lower oil prices and population growth in the US, this will not be enough to compensate the negative influences.

### GDP forecast



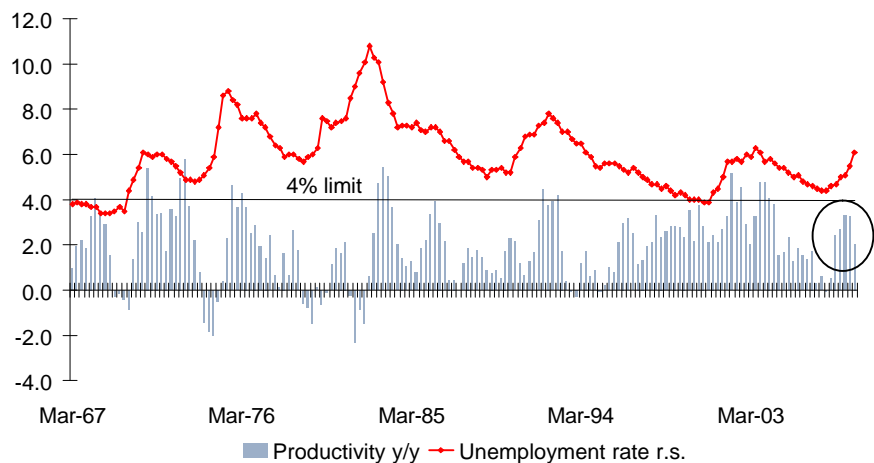
Source: Erste Group Research, Bloomberg

# US

## Unemployment rate expected to climb further

The labour market decline is in full swing with the spiral of weaker demand and higher unemployment just beginning. The process of adjusting employment to weaker demand will last far into next year. Not only do the consequences of the financial market crisis need to be dealt with, but the preceding phase of economic weakness in the US had only a relatively scant impact on the labour market. Therefore, companies will reduce staff in order to achieve a reasonable level of economic efficiency. Past observations have shown that companies only stop reducing staff when productivity growth climbs to more than 4%. We are far from this level (see Chart) and even the more optimistic assumptions imply that a trend reversal in the unemployment rate will only be seen around the end of 2009.

## Productivity and Unemployment Rate



Source: Bloomberg

## Lower oil price lifts real income

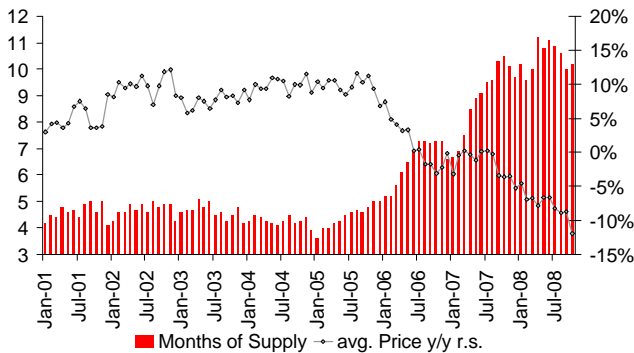
However, there will be a silver lining for private households – provided inflation decreases substantially. The decline of the oil price by around USD 100 since July corresponds to an increase in real wages of over 2%, but this is probably not enough to compensate the redundancies and general insecurity caused by the financial market crisis, although it does afford some relief.

## Real estate prices to drop further

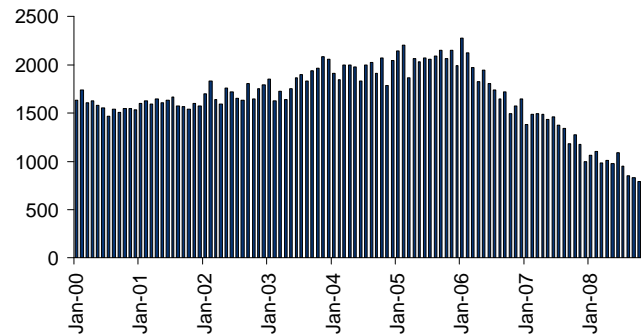
No good news is expected to come from the real estate market for some time to come. Despite the fact that construction activity (as measured by home construction starts) has shrunk by two-thirds in almost three years, up to now, only the rate of vacancies among new homes has decreased. In contrast, on the market for existing homes, which accounts for 85% of the total market, the vacancy rate is stagnating at a high level. Despite steadily shrinking construction activity and the stabilization of sales in the course of this year, the number of properties up for sale failed to decrease significantly, because the foreclosures constantly brought additional properties to the market. In the setting of the upcoming year, interest in buying homes is very likely to remain low, and therefore, a decrease in inventories will only begin when foreclosures also start to diminish. Even though the current figures point in this direction, it is still too early to identify a trend. Nonetheless, developments have moved in the right direction at least once in the past few months. Hopes that foreclosures might have peaked are also supported by the fact around two-thirds of subprime borrowers paying variable interest rates have already had their rates adjusted. The higher the number of debtors who have this “shock” behind them, the clearer it will become who can afford their homes at market conditions (and not at teaser interest rates they were baited with) and who cannot. As the rules governing the procedures from insolvency to foreclosure vary from state to state and can last up to one year, it is hard to determine how many foreclosers are still in the pipeline.

# US

## Existing homes



## Housing Starts, in ths, annual.

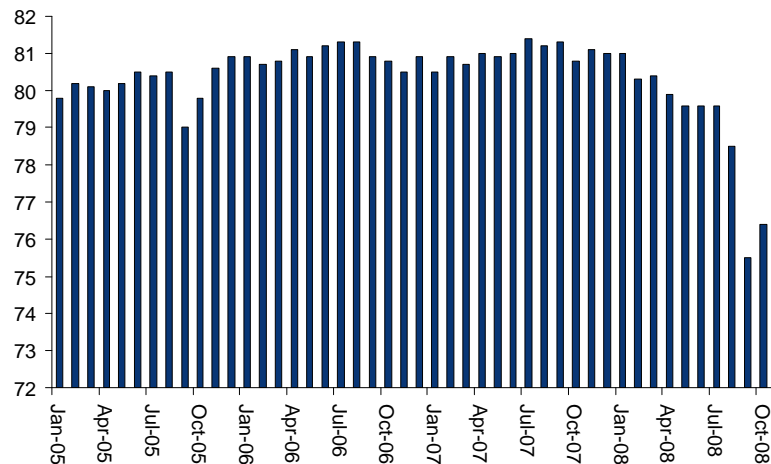


Source: Bloomberg

### Companies will continue to adjust capacities

If one leaves aside the financial sector and the automotive industry, US companies are a bit better prepared to cope with the crisis than they were in 2000. Earnings in relation to GDP are higher and the percentage of investments financed internally is higher. There is no doubt though that the weak economic environment will make more adjustments necessary. The productivity growth already mentioned has to be raised again and this is being done primarily by cutting jobs. Furthermore, capacity utilization is low and thus we will see restraint in investment activity for now. The adjustment process and the sluggish economy will certainly drag over several quarters keeping sentiment among businesses gloomy.

### Capacity Utilisation, in %



Source: Bloomberg

### Will the additional liquidity trickle down to households and businesses?

The largest factor of insecurity for the medium-term development of the economy is lending. The question being how long it will take until the situation normalizes. A major unknown variable is the effectiveness of the diverse bailout programmes. In addition to the USD 700bn package that was made available to the financial sector at the end of September from tax funds, the Fed caught everyone's attention when it announced another rescue package of USD 800 at the end of November. The two bailout programmes together account for more than 10% of US GDP. Some USD 250bn of the government's rescue programme is earmarked for shoring up the equity of banks and has essentially already been paid out. Around USD 400bn are to be used to facilitate credit card loans, student loans and car loans. More details are not known right now. The package of the Federal Reserve includes the purchase of mortgage loans for an amount of USD 600bn which is just slightly less than 6% of all US mortgage loans. Another USD 200bn is to be lent exclusively against collateral in the form of securitized credit card, car and student loans as well as loans to small businesses with the highest credit ratings.

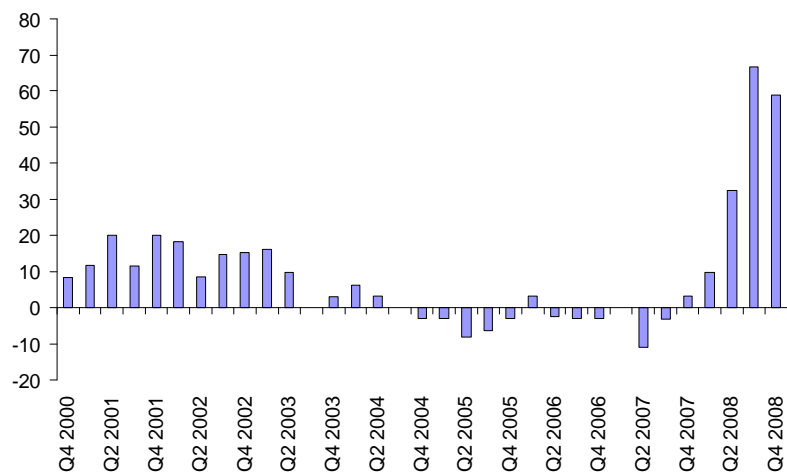
# US

These measures are designed to revive the market for these securitized loans. USD 200bn corresponds to around 8% of total outstanding consumer loans. The diverse measures and bailout packages of the Fed have already massively pushed up money supply growth since September. USD 800bn corresponds to almost 10% of M2 money supply. The purchases by the central bank will take place over several quarters (at least according to the release) and money supply will rise dramatically.

## Lending needs to normalize again as fast as possible

The excessive supply of liquidity is in line with the spirit of the US strategy to cope with the crisis. The aim is to flood the financial sector with liquidity in an attempt to stop as fast as possible the spiralling effect of economic downswing and ever more restrictive lending. Ultimately though, there is no guarantee that the banks will pump the additional liquidity back into the business cycle. The fact that the latest USD 800bn programme is targeted at specific, concrete areas shows the increasing scepticism of the Fed. The first rescue programme for the banks had been designed to make liquidity generally available by, among other things, widening the range of instruments eligible for collateral, while the latest USD 800bn rescue programme is intended to help bolster specific segments. Still, there are considerable risks threatening the success of these measures. If banks are assuming that the risk of credit default cannot be estimated because of the economic downturn, then they will keep the additional liquidity. Theoretically, the Fed could buy more securities from banks and thus convert them into liquidity. The longer such measures fail to yield results, the less the effectiveness of any additional programmes. If the downswing of the economy continues, the banks will not need more liquidity, because fear of credit defaults would already outweigh. This risk is revealed, among other things, by the latest regular senior loan officer survey of banks that indicates a further tightening of lending policies; the survey was conducted in the first half of October before the USD 800bn aid programme and in the midst the market turmoil.

## Share of banks reporting tighter lending policies for credit card borrowers



Source: Datastream

## Monetary Policy

## Lots of work ahead for Fed even as the key rate will hardly change

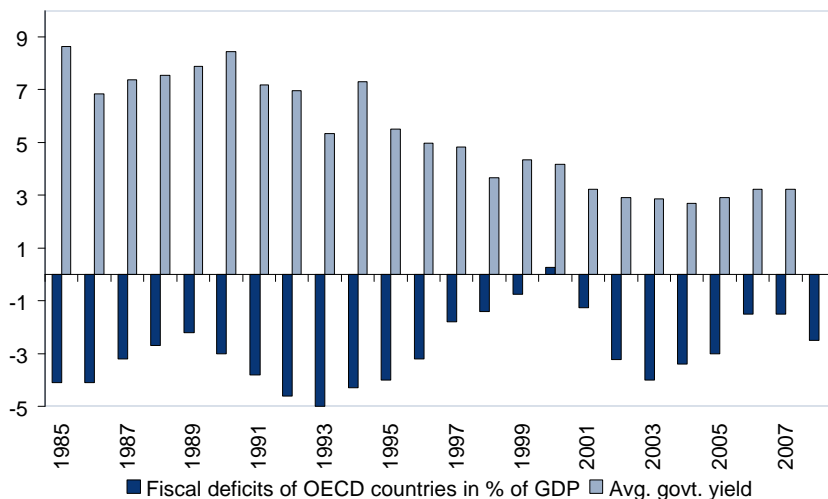
However, even under the most benign assumption that the measures by the Fed will soon begin to show an effect, the central bank will not be able to lay back and rest on their laurels. The next step is to gradually withdraw the liquidity injected in the year 2008 at the right pace, because an abnormal situation has been created by the numerous measures taken by the Fed. The banks would have enormously excessive liquidity for a non-crisis environment with all of the entailing risks this means. Thus, the task of the central bank will be to withdraw the patient's medication at the right pace without triggering a new collapse. In contrast, determining the interest rate level will be relatively little work. We expect the key lending rate to drop from 1% to 0.5% in December. The economic situation in the first quarter would permit a further decline to zero. However, it is unclear if the Fed would be willing to go this far, because such a move would have a signal effect, but in the end it doesn't make much difference.

## Bond Market

**US budget deficit will hit nearly 9% of GDP next year**

The US government will also have to master the challenge of coping with the crisis in the coming year. The old government already proved its willingness to spend deeply by passing its USD 700bn rescue programme for the financial sector. 2009 a deficit of around USD 500bn will be added to this sum. The economic stimulation package of the new president will be of similar size and include investments in infrastructure as well environmental protection measures distributed over a period of two years. Therefore, demand for financing from the public sector could expand to almost 9% of GDP, which is a magnitude unheard of before and almost twice as much as the already high deficit of 5% in 2008. There is no doubt that the US government can finance such an amount. The question is at what expense. Demand for secure government bonds will certainly be high and there are already signs of an increasing savings ratio. Neither was a connection identified in the past between higher government debt and yields on government bonds, at least on the average of the OECD countries. Though according to our estimates, the deficit of the OECD countries will hit a record level, and in conjunction with the more restrictive lending practices of banks, we expect relatively higher financing costs. The US will report the highest budget deficit by far (in absolute figures and relative to GDP) of the OECD countries, and therefore yield premiums are expected to be higher than otherwise commensurate with the economic environment. Though in the end, the savings ratio trend and the investment preferences of savers will be the decisive factor determining which debtors will pay higher financing costs and how much more.

### Deficits and Yields



Source: Datastream

## US-Dollar

**Worsening macro data and lower money market rates do not speak in favour of the USD**

The financing of the US deficit will not remain without impact on the USD either. The US will continue to need capital from abroad to satisfy its demand. These inflows should tend to support the USD but at the same time, the macro variables for the US will deteriorate. Currently, the USD is still profiting from the financial market crisis. "Save haven flows" are bolstering the USD. But when the storm is over, the US will be worse off compared to Euroland. The level of new government debt will expand to more than twice as much (but overall government debt will still be lower). Euroland will probably attain a balanced current account, while the US will report a considerable deficit, and finally, we continue to expect money market rates to be lower in the US than in Euroland. All of these factors point to a weaker USD. Support will come from the capital inflows needed to finance the deficit, and for this reason, our overall estimate is one of an only slightly weaker USD than at present.

*Rainer Singer*

# Croatia

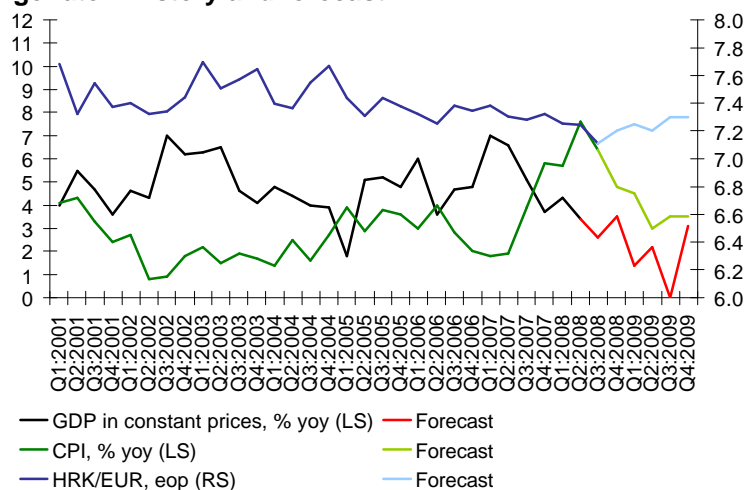
	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	5.6	3.4	1.7	3.0
Private Consumption (growth y/y %)	6.2	2.4	1.8	3.0
Fixed Capital Formation (growth y/y %)	6.5	9.5	1.8	4.0
CPI (y/y, average%)	2.9	6.4	3.6	3.5
Current account balance (% of GDP)	-8.6	-10.6	-10.8	-10.6
Govt. budget balance (% of GDP)	-1.6	-1.6	-2.0	-2.0
Short term interest rate (3 months) year-end	6.9	8.5	7.0	6.0
Loc. Curr./EUR average	7.34	7.22	7.27	7.23

## Economy

### Economic prospects deteriorating

The 1H08 GDP performance was in line with expectations, with GDP growth moderating from 4.3% in 1Q to 3.4% in 2Q. The private consumption contribution continued to decline, as private consumption spending moderated from the robust 2007. On the other hand, investment activity accelerated; in 2Q, investment activity growth entered the double-digit zone, contributing mightily to GDP performance. Also, government consumption has been supportive, while the net export contribution has been negative, as suggested by the poor trade balance trend. For 2H08, we see a further moderation of economic activity, predominantly in private consumption, which remains burdened by weaker credit, inflation pressures and the pronounced consumer confidence slump. For 2008 overall, we see GDP growth a notch below 3.5%, given the still solid investment activity and stable tourist sector performance. On the other hand, risks to the 2009 forecast remain pronounced, given the uncertainties related to investment activity and tourist sector performance. Also, private consumption contribution is expected at weaker levels, despite the anticipated favorable effect from the easing of inflation pressure. Credit conditions should tighten, while a possible freeze of public sector wages in 2009 would have a negative effect on purchasing power. The offsetting potential of government spending is limited, given the zero budget deficit target for 2009. While the government announced that it would continue with public infrastructure projects in 2009, a slowdown is inevitable. The export outlook remains rather poor, but overall weak domestic demand should support an adjustment on the import side. In line with the above-mentioned risks, we see GDP growth in the 1.5-2% region in 2009, while investment activity - sensitive to constraints related to the lower availability and higher cost of foreign funding - should play an important role in shaping the growth in the coming year. Current account trends are expected to stabilize in 2009, but after widening to above 10% of GDP in 2008, they should remain in the double-digit region. While we expect some improvement of the trade balance performance, there are upside risks to the service sector account, given the higher uncertainties related to the tourist sector performance in 2009. Hence, given the assumption of a mild slowdown of tourist sector activity in 2009, the C/A deficit is expected at slightly above the 10% threshold.

## GDP, inflation and exchange rate – history and forecast



Source: CBS, CNB, ESB



# Croatia

## **Inflation outlook improved**

After peaking at the beginning of 3Q08 (8.4% y/y), inflation pressures eased, given the favorable developments on the supply side - namely the moderation of oil and food prices. Also, the strong base effect began to unwind, pushing annual inflation to below 6%. Given the lack of demand pressures and favorable supply-side developments, inflation is expected to go below the 5% threshold towards the year-end. In 2009, inflation should ease further, due to shrinking demand pressures and expected favorable developments on the supply side, as well as a strong base effect supporting inflation developments in 1H09. The outlook for administrative prices hikes in 2009 is still unclear, as the announced hikes of gas and some other utilities prices could be postponed, given the weakening economic outlook and government incentives to freeze public wage growth. Thus, average inflation is expected at around 3.5% in 2009, with the major upside risk linked to a resurgence of supply-side pressures.

## **Monetary Policy**

## **CNB easing prudential measures**

The central bank recently eased monetary regulation by terminating the marginal reserve requirement and lowering the obligatory reserve requirement from 17% to 14%. The marginal reserve requirement was imposed in mid-2004 and was gradually increased to 55%, calculated on foreign-based financing. The aim was to moderate foreign debt and credit activity. Termination of the marginal reserve requirement gave banks additional maneuvering space by making foreign-based financing available at a reasonable cost to the banks, hence ensuring additional funding to support credit activity. Utilization of this channel, at least in the short run, will depend on the banks' ability to acquire foreign financing. In the mid run, we see banks tapping foreign markets more extensively. The CNB also lowered the obligatory reserve requirement by 3pp to 14%, freeing additional liquidity for the banking system, in order to stabilize money market pressure and ease public debt refinancing in the coming months. The CNB will likely stick to credit growth limits in 2009. Nevertheless, we see monetary trends moderating further in the coming year (given the expected drop of deposit activity), but still supportive of economic performance.

## **No final budget proposal – zero deficit target for 2009 announced**

The budget proposal draft has still not been revealed to the public, but, according to the first announcements, the government is to set the budget deficit goal at zero, which, if achieved, would be the first balanced budget since Croatia's independence. Major budget assumptions are not yet known. Hence, it is too early to address the feasibility of the budget. It is most certain that a greater level of discipline on the expenditures side is needed in 2009 to achieve the goal, as the revenues side will not be as supportive as in previous years and calls by interest groups for government help will be louder. Also, in order to achieve a zero deficit, the government is seeking a consensus with social partners to freeze wages in the public sector in 2009. It is still unclear if such a proposal would be supported. Nevertheless, this shows the willingness of the government to conduct a responsible fiscal policy in 2009, in order to avoid problems in refinancing maturing public debt.

## **Capital Markets**

## **Exchange rate robust**

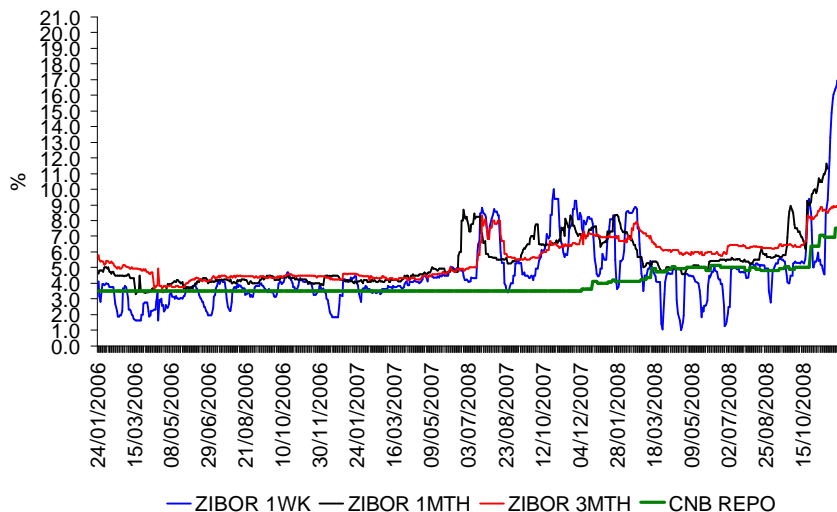
The exchange rate was stable throughout the last few quarters and, in contrast with regional peers, strengthened by some 2% to the current 7.10-7.15 range. Initially, pressures were supported by Hungarian company MOL's public offer for a further stake in national oil company INA. This was followed by the CNB's tight kuna liquidity management and continuation of high money market rates. For 2009, we do not see the kuna maintaining such levels, as pressures on the financing side and the ongoing high current account deficit will put pressure on the depreciation side. The CNB again showed a prudent approach in using the exchange rate as the nominal anchor of policy; hence, we see the exchange rate at slightly weaker levels in 2009. Exchange rate stability is not in jeopardy, as the CNB has significant maneuvering space to tackle eventual pressures. Therefore, for 2009, we see the exchange rate moving in the 7.20-7.40 band.

# Croatia

## Financial markets: yields under pressure

Money market conditions have been considerably tighter and more volatile of late, with MM rates on the shorter end of the curve ranging up to more than 20%. The CNB stance towards the creation of kuna liquidity has been tight, resulting in a higher CNB reverse REPO rate. The lasting nature of such trends and the lack of stabilization after the settlement of the large INA/MOL transaction resulted in the bond yield curve shifting upward by approximately 150bps to above 7% at present. Such developments put further pressure on the short-term public debt refinancing, as T-bill rates also increased to 7%. Given the global turbulence, the government should opt for refinancing on the domestic market. Hence, at the end of November, the MoF is to issue the first 2Y T-bill in the amount of HRK 2bn, supported by local institutional investors. Given the MM conditions and current T-bill rates, pressures toward a yield increase are likely. Further details on the complete financing plan for 2009 should be known in the coming weeks. Bond yields should be highly dependent on money market developments, which could put some pressures on yield levels, as long as the decline of the obligatory reserve requirement (valid from December) supports stabilization of the money market.

### Yields under pressure



Source: Reuters, CNB

Alen Kovac

# Romania

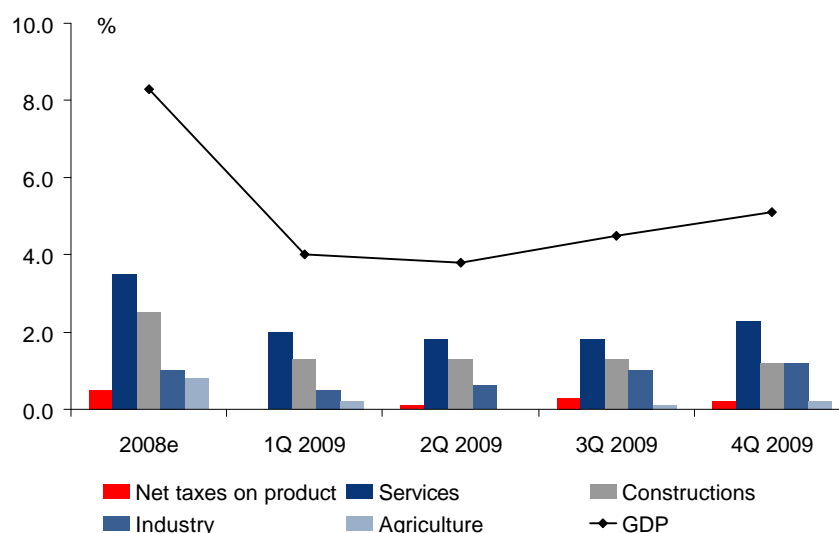
	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	6.0	8.3	4.4	5.3
Private Consumption (growth y/y %)	10.2	10.9	5.6	6.0
Fixed Capital Formation (growth y/y %)	28.9	25.5	9.3	10.5
CPI (y/y, average%)	4.8	7.9	6.2	5.3
Current account balance (% of GDP)	-14.0	-13.7	-12.6	-11.1
Govt. budget balance (% of GDP)	-2.3	-3.0	-3.0	-3.0
Short term interest rate (3 months) year-end	8.4	11.1	8.6	7.6
Loc. Curr./EUR average	3.33	3.67	3.63	3.57

## Economy

### Economic growth expected to cool off in 2009

The international financial crisis and the specific domestic developments (the negative base effect associated with the bumper crop and the very good collection of indirect taxes in 2008) will slow down economic growth in 2009. Industry (automotive, metallurgy, textiles) and construction are likely to suffer most from a decrease in external orders and higher financing costs. Companies have already begun to announce a halt in production, lower investments and layoffs. The international financial crisis will not skip over the Romanian economy, but we stick to our core scenario regarding a weaker negative effect compared to Eurozone countries. The Romanian economy is less opened and this might provide a certain degree of resistance to the global turmoil. The share of exports plus imports in GDP stood at around 66% in 2007 - this is not necessarily related to an underdeveloped economy, but rather to a more diversified structure of the national economy, with agriculture holding a share of around 8% in GDP. Investments in infrastructure supported by European funds should be among the key drivers of economic growth in 2009, with the Romanian government able (at least theoretically) to partly offset an overly steep decline in private sector construction work.

## GDP and contributions



Source: BCR Research, National Institute of Statistics

# Romania

## **Disinflation process to continue in 1H09**

The risks associated with this disinflation scenario are asymmetrically distributed, with those working on the upside somewhat stronger. Administered prices of natural gas and electricity are likely to grow in early-2009 after a delay caused by the parliamentary elections in November 2008. Fiscal and income policies were too lax in 2008 and it is uncertain how the next government will act on this issue. Aggregate demand related pressures will continue to work in the near future, pushing up the inflation rate. Additional risks are related to the agricultural output from 2009, which is dependent on weather conditions. On the other hand, lower economic activity might decelerate the increase in the general level of prices.

## **C/A deficit adjustment underway**

Exports were faster than imports in January–September 2008, as significant FDIs directed towards manufacturing in previous years have already begun to pay off. The outlook for net current transfers in 2009 is pessimistic, due to the economic difficulties encountered by other Latin EU countries that represent traditional destinations for Romanian workers. The income balance deficit might widen next year, as the high profitability of the international companies operating in the Romanian market could lead to higher dividend outflows.

### **Monetary Policy**

## **1Q09 to bring beginning of rate cutting cycle**

The central bank hiked the key rate to 10.25% in July 2008 and maintained it unchanged at the last two monetary policy meetings in 2008. Our base scenario indicates possible successive cuts of the key rate in the first part of 2009, following a disinflation process and worrying signals on economic growth. The minimum reserve requirement ratio for RON-denominated liabilities of credit institutions might be lowered further, due to the money market's need for liquidity. At the same time, the central bank seems determined to offer a competitive advantage for RON-denominated loans at the expense of FX loans; external developments (higher FX funding costs for commercial banks) will help it in achieving its goal. Short-term money market interest rates will stay around the key rate as a cushion in case of speculative attacks by non-residents against the RON.

### **Capital Markets**

## **RON appreciation to take break in short run**

We expect the RON to be traded mostly in the 3.6–3.8 interval during the next few months. The central bank does not feel comfortable with an exaggerated depreciation of the national currency and, according to recent experience, will step in to curb speculative moves by non-residents. High money market interest rates will be supportive for the RON. Imports should decelerate even more, due to weaker lending activity and households' insecurity about 2009 income development. This could lower (at least partially) the depreciation pressures on the RON. The evolution of the national currency in the first part of 2009 will be strongly linked to the first economic decisions by the next government.

## **Yields to go down next year**

The lower inflation rate should trigger consecutive cuts in the central bank's key rate and bond yields should therefore drop, especially those for longer maturities. The Ministry of Finance recently sent signals to the market that it was ready to adopt a strategy of selling T-bonds to individuals instead of to banks, if banks keep asking for higher yields. Insecurity related to future income development could shift households' preferences from consumption to saving, boosting the primary market of state securities in the segment of individuals. The exact configuration of the next government is uncertain (parliamentary elections will take place at the end of November 2008), as is its future strategy in terms of budget deficit financing. This might have quite an important impact on the government securities market, considering its small size (outstanding RON-denominated government securities represent around 2.5% of GDP).

*Eugen Sinca, BCR, eugen.sinca@bcr.ro*

# Poland

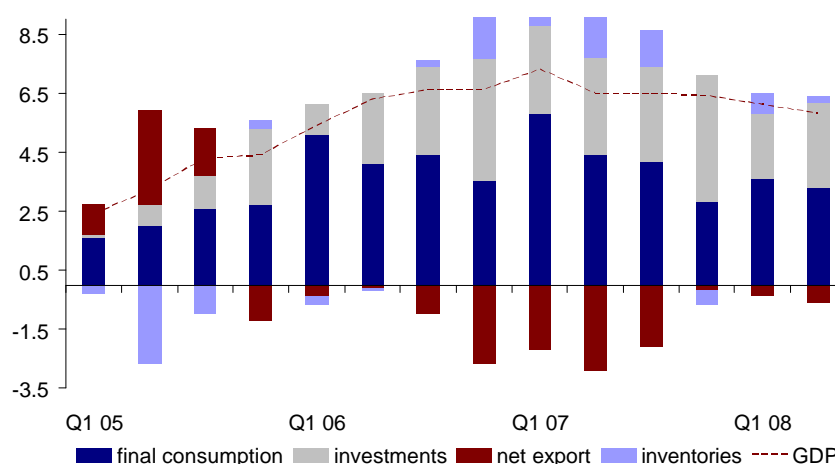
	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	6.7	5.2	3.0	4.4
Private Consumption (growth y/y %)	5.0	5.3	4.6	5.0
Fixed Capital Formation (growth y/y %)	17.6	13.0	5.0	8.5
CPI (y/y, average%)	2.5	4.3	3.0	2.3
Current account balance (% of GDP)	-4.7	-5.0	-5.0	-4.7
Govt. budget balance (% of GDP)	-2.0	-2.2	-2.3	-2.0
Short term interest rate (3 months) year-end	5.7	6.2	4.7	4.0
Loc. Curr./EUR average	3.78	3.48	3.46	3.30

## Economy

### Poland might be next in region to knock on euro doors

One of the events to watch in the first half of next year that might have strong short-term consequences for monetary policy, currency and capital markets and long-term implications for the economy as a whole are developments around the plan to introduce the euro in Poland. The current official plans are that 2011 would be the year by which Poland aims to meet all criteria for introduction of the common European currency (implying 2012 as the date when the euro actually gets into circulation). This is a tough, but manageable, ambition. We revised our central call for euro adoption to 2012, from the earlier 2013. However, the risks are relatively high at this stage and are twofold - market and political. First, if the current nervousness and high market volatility persist until the halfway point of next year (which we do not assume in our baseline), ERM II entry, and hence euro adoption, could be postponed, due to the fears that Poland might be quickly disqualified from meeting the Maastricht criteria (please note that, within the currency criterion, it is not simply enough to obey the 15% borders, but the exchange rate must also move 'without severe tensions'). Second, there are risks tied to the necessary change of the Constitution. The incumbent government does not control enough seats in Parliament to achieve this and it will need to persuade at least part of the opposition euro-skeptic Law and Justice party to back the move. However, this party has already refused to support EMU entry unless such a motion gets backing in a public referendum. It must attract at least half of eligible voters to be valid. A referendum is likely to inject higher volatility into the markets. If this hurdle is cleared, Poland could enter the ERM II regime already before the middle of next year.

## GDP and contributions



Source: Central Statistical Office, CS

# Poland

## Activity to cool, but domestic demand should save economy from recession

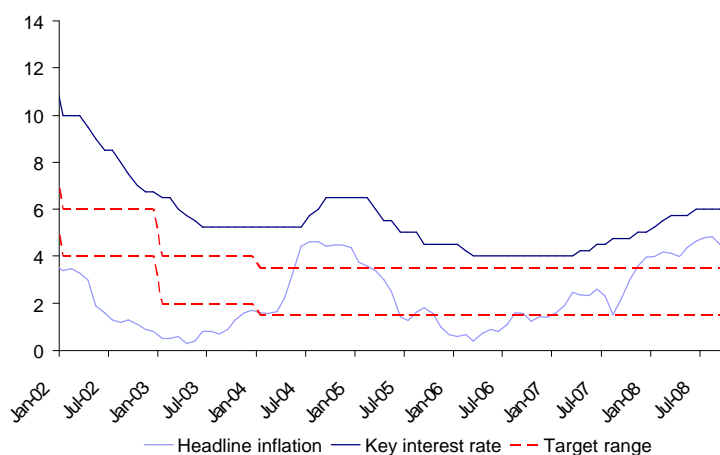
Like the other economies in the region, Poland will be hit by the global economic slowdown next year. The Eurozone absorbs more than half of Polish exports; thus, sluggish growth there will trickle down to slower Polish growth via lower demand for its exports. Also, investments are likely to slow down sharply amid lower liquidity worldwide, tighter credit policies at home, more expensive credit and worsened business sentiment. This will be partially offset by support from EU funds. The consumption of households should nevertheless stay robust and provide a partial shield against the adverse influences from abroad. Households' wallets will be padded by the still relatively strong labor market (despite expectations of a rise in unemployment, wage dynamics will remain solid and the inflation decline should boost real incomes) and remittance flows from those working abroad. Moreover, Poland announced tax changes for next year. The current three personal income tax rates of 19%, 30% and 40% are planned to be reduced to a mere two rates of 18% and 32%, with the vast majority of workers projected to pay the lower rate. This change should also boost households' spending appetites. On the fiscal side, the government plans to reduce the central budget deficit to PLN 18.2bn and aims to keep the public finance deficit at around 2.0% of GDP. However, the budget is based on an optimistic assumption of economic growth at 4.8% y/y next year. We think that, sooner or later, the cabinet will be forced to revise this assumption and either cut expenditures or hike the deficit. We assume that the reality will be somewhere in the middle and assume only a slight increase in the public finance deficit next year.

## External factors push inflation down

After a few months of growth, the inflation trend reversed and the August level of 4.8% y/y marked this year's peak, in our view. Inflation slowed visibly at the beginning of autumn, largely on the back of external factors and base effects. In particular, the slump in world oil prices and slowdown in food price dynamics (after the shock witnessed last year) helped to compress inflation. To the contrary, the net core measure (the headline number ex food and fuels) continues to march upwards, as domestic demand is still robust. Overall, inflation is still hovering well above both the target of the Polish central bank (2.5%) and the 1% tolerance band around it. Over the first half of next year, external influences (food and oil) should remain conducive to dampening the annual dynamics of consumer prices. The category of energy could nevertheless still witness some rise, due to the administrative regulations, which slow the transmission mechanism of previous oil price growth into inflation, as well as due to the use of multi-month averages in the price setting mechanism. Core inflation could exhibit some persistence and remain elevated for the first months of next year, especially if the zloty stays at weak levels. Nevertheless, core inflation should gradually start to adjust to the weakening demand and embark on a declining path in the course of the year. All in all, inflation should continue its downtrend in the first half of 2009, approaching and possibly breaking the upper end of the tolerance band (3.5%).

## Monetary Policy

### Key rate versus inflation development



Source: Central Statistical Office, NBP, CS

# Poland

## **Start of rate cutting cycle is close**

The central bank has ended its monetary policy tightening campaign, adding a last hike in June and changing its implicit bias to a neutral mode four months later. The combination of still elevated inflation expectations, rising core inflation and stubbornly robust wage dynamics (plus the relatively shaky zloty) have prevented the central bank from following its major market counterparts in deeply cutting the reference rate. However, given the outlook for gradually decelerating inflation and visible signs of cooling economic growth, we believe that the start of the monetary policy easing cycle is close. For the coming year, we expect 125bp of cuts in total. Euro adoption ambitions should prevent a deeper decline in the key rate. The current inflation target of the central bank stands at 2.5%. However, the bank might prefer to push inflation even lower, in order to create a safety margin in fulfilling Maastricht criteria (e.g. Slovakia lowered its target to 2%). Accordingly, plans to introduce the euro in 2012 create (ceteris paribus) the necessity of a stricter monetary policy in the short term.

## **Capital Markets**

## **Zloty to stay edgy in 1H09**

The Polish market will remain under the strong grip of global market developments in the first half of next year. The zloty will stay highly responsive to swings in risk aversion. Domestically, economic growth should be slowing, but remain above the level seen in the Eurozone, acting as a support to the zloty. On the domestic scene, developments around the euro story are likely to stay in focus among investors. As we stated above, the government will likely be compelled to stage a referendum on the 2012 date. The nervousness that would likely shroud the referendum (Will enough people vote? Will they support euro adoption as soon as 2012?) is likely to inject volatility into the exchange rate. In addition to the international market jitters, this is why we expect the zloty to stay weak in the first months of 2009. Assuming a successful outcome of the referendum, the ERM II entry at mid-year could (as in the case of Slovakia) lead to a jump in currency appreciation. Scrapping or delaying of the euro plans would imply a weaker zloty than in our baseline.

## **Barring further spike in risk aversion, yield curve should move south**

The earthquake on international markets, leading to a spike in risk aversion, drying up of liquidity and lack of confidence, nudged Polish bond yields higher in September-October. The shaping of risk appetite is the most important variable in predicting the course of further developments. We assume that the worst turbulence on international markets should be over by the middle of next year. The start of the monetary policy easing campaign in Poland (reinforcing expectations about further cuts) should drag the short end of the curve lower. The risk premium on the long and middle segment of the curve should narrow once the dust settles. Slowing growth and declining inflation will be reinforced by the convergence play related to the expected entry of Poland into the Eurozone (any delay in the plans would imply a higher spread). Hence, despite the expectation of a rise on Eurozone yields (from current levels), we see space for a southward movement of the Polish curve.

*Maria Hermanova*



# Serbia

	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	7.5	6.5	3.5	4.0
CPI (y/y, average%)	6.5	11.0	8.0	5.7
Current account balance (% of GDP)	-13.2	-17.3	-16.8	-17.3
Govt. budget balance (% of GDP)	-1.9	-2.5	-1.5	-2.0
Short term interest rate (3 months) year-end	11.3	15.6	16.0	13.5
Loc. Curr./EUR average	80.0	79.5	85.0	77.0

## Economy

### **Economic performance moderating, due to financial market turmoil**

The importance of political issues has declined in recent months, as, after early parliamentary elections in May, a new democratic government was assembled and the spotlight turned to global developments and economic issues. GDP growth slowed down in 2Q08 to 6.2%, from 8.4% y/y in 1Q. The service sector's performance slowed down, with the wholesale and retail segments recording the most significant slowdown (5.8% y/y). Manufacturing and construction activity remained supportive, growing 4.4% y/y and 7.9% y/y, respectively. On the other hand, the agricultural sector's performance was below expectations, with just 3.4% y/y growth. In 2H08, economic activity should moderate further, given falling domestic demand - both investment and consumption. Thus, we expect GDP growth at 6.5% y/y in 2008. Next year should bring more substantial growth moderation, as GDP could be under pressure from weaker domestic demand, while the export performance is expected to deteriorate, given the weakening of regional economic activity. Tighter monetary conditions and the higher degree of uncertainties regarding capital inflows should affect credit activity. Purchasing power is expected to remain negatively impacted by still strong inflation pressures and the higher loan repayment burden, given the weakening of the exchange rate. Investment activity should be affected by the lower availability and higher cost of financing, as well as the weaker business environment. Therefore, we see GDP moderating in 2009 to the 3.5% level.

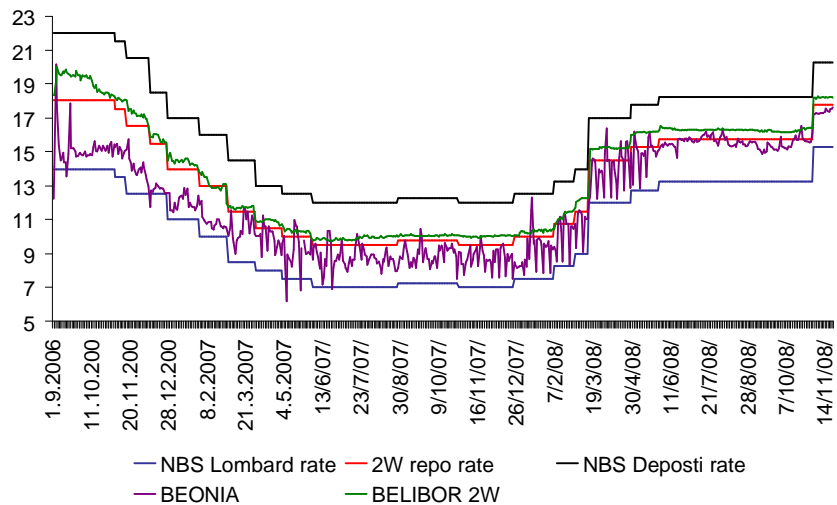
### **Financing side under pressure**

External imbalances remain pronounced, as the current account deficit is expected to widen to comfortably above 17% of GDP. A similar performance is also expected in 2009, as imports slow down, due to weaker domestic demand, although this is expected to be offset by a weaker export performance. In the current environment, some pressure on income and the current transfers account could be expected, given the increasing cost of debt financing and possible weaker remittances. Currently, the risks on the financing side are pronounced, as Serbia (due to the global crisis) has failed to profit from diminishing political risks. FDI inflows moderated in the course of 3Q and a weaker than previously anticipated FDI performance can be expected in the coming quarters. This would put pressure on debt-creating financing and usage of international FX reserves to cover the lack of FDI inflows. Overall macroeconomic risks related to external imbalances have materialized in recent months, as the global crisis buffeted the CEE and SEE regions. At present, given the high international reserves, <10% share of short-term debt in total external debt and the recently signed stand-by arrangement with the IMF, we see the macro risks as manageable in the short run. In the longer run, if pressures persist, more significant adjustment on the demand side would be inevitable to correct for the external imbalances, with a further negative impact on economic performance. The stand-by arrangement should also support fiscal policy credibility and efforts to contain the budget deficit at a reasonable <2% level, as well as increase the pressure to pursue structural reforms.



# Serbia

## Money Markets



Source: NBS, Reuters

### Inflation pressures persist

After hitting a peak at the end of 2Q, 3Q brought moderating inflation pressure, due to falling oil and agricultural product prices, thus managing to bring RPI inflation back to the single-digit region at the end of October. Inflation showed signs of acceleration at the beginning of 4Q, again entering the 10%+ region, fuelled by increased agricultural prices. Inflation expectations remain pronounced at the moment and adverse exchange rate movements are not supporting expectations of stabilization. The weaker dinar also contributed to higher imported inflation. The moderating supply side pressure and domestic demand, along with a more restrictive fiscal policy, are supporting lower inflation in the coming period. Nevertheless, an important factor here is exchange rate movements, which also shape inflation expectations; these currently indicate that further tightening of monetary policy cannot be ruled out. Overall, we anticipate inflation moderating from an average of 11% to around 8%, given the above-mentioned upside risks. The NBS core inflation target band is set at 3-6%, which may be a challenge to maintain, especially if pressures on the supply side resurge during 2009. Inflation remains at the top of the agenda for the coming period, as inflation has failed to drop significantly so far and maintaining a stable exchange rate is a prerequisite for curbing inflation expectations and pressures in 2009.

### Monetary Policy

### NBS hiked further, prudential measures eased

Given the ongoing inflation pressures and mounting exchange rate depreciation pressures, the NBS hiked the 2W REPO rate by a robust 200bps to 17.75%, just 25bps below the highest 18% level set upon the introduction of the REPO rate. The rationale for the hike (besides the still existing inflation pressures) was to support the exchange rate. Also, the NBS decided to ease prudential measures to allow banks to use foreign-based financing, terminating the high 45% reserve requirement. The NBS thus wanted to ease banks' refinancing and boost FX inflows, as well as offset any liquidity pressures. Overall, the banking sector looks well positioned to weather the global financial turmoil, as the liquidity buffer in the form of sterilized liquidity is almost 30% of total assets. The capitalization of the banking sector is robust, with capital adequacy just below 30%. Thus, the banking sector's capacities to offset potential losses (given the weaker economic environment) can be considered robust. Monetary policy prudential measures are well in place to ensure system stability. However, further rate hikes are not likely to produce the desired effects, given the relatively weak sensitivity of capital flows to the interest rate margin in the present market conditions. Moreover, the NBS intervention on the FX market to prevent further exchange rate losses also speaks in favor of this route.

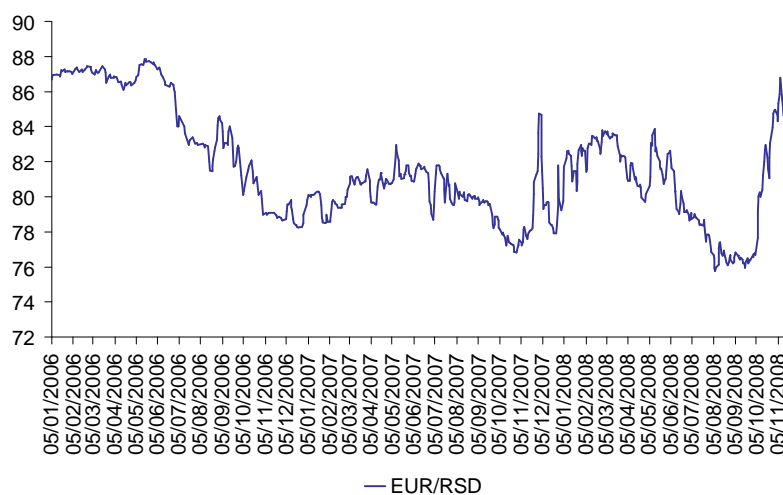
# Serbia

## Capital Markets

### Exchange rate under depreciation pressure

After a relatively stable 2Q at RSD 76-80 per EUR, since the beginning of 4Q, the exchange rate has been exposed to severe depreciation pressures. Hence, the exchange rate has depreciated more than 15% since the beginning of October, and now stands in the 88-89 region (closing the gap towards 90). The stand-by arrangement with the IMF and NBS actions have only managed to offset a proportion of the depreciation pressures. The NBS rate hike of 200bps failed to produce more pronounced effects, with the NBS relying heavily on FX interventions to support the dinar. The exchange rate remains under pressure, due to deteriorating FX inflows, and we continue to see the NBS using FX reserves extensively to support exchange rate stability, thus keeping inflation pressures under control and stabilizing the cost of loan repayments. Presently, the outlook remains dependent on regional sentiment and further pressure on the depreciation side may arise in the coming quarters. We thus see the exchange rate moving in the 85-95 band.

### EURRSD



Source: NBS

Alen Kovac

# Slovakia

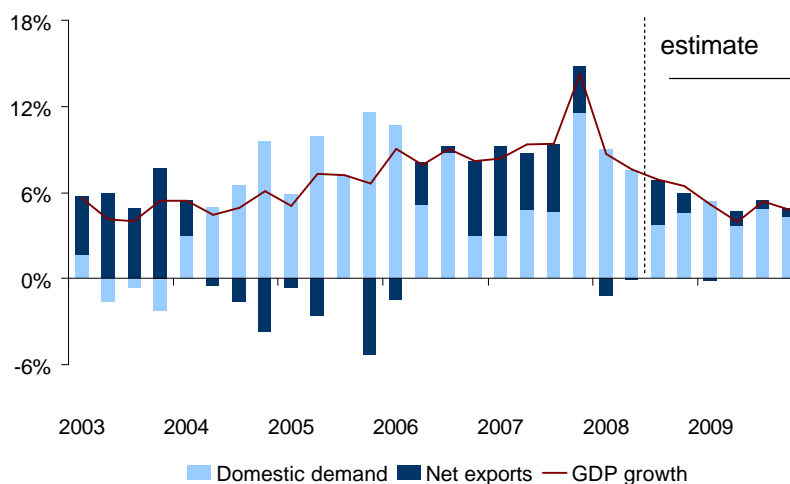
	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	10.4	7.4	4.8	6.2
Private Consumption (growth y/y %)	7.1	5.9	5.3	5.5
Fixed Capital Formation (growth y/y %)	7.1	7.4	3.7	6.8
CPI (y/y, average%)	2.8	4.6	4.3	3.9
Current account balance (% of GDP)	-5.3	-5.0	-4.6	-3.9
Govt. budget balance (% of GDP)	-2.0	-2.2	-2.4	-2.5
Short term interest rate (3 months) year-end	4.3	3.8	2.3	2.7
Loc. Curr./EUR average	33.8	31.2	30.1	30.1

## Economy

### Lower foreign demand should slow down growth

Amid the atmosphere of the financial crisis, the Slovak economy will not remain unscathed. With Germany already in recession and other major trading partners slowing down, foreign demand for Slovak goods and services has decreased, particularly affecting exporters of durable goods, such as carmakers and their suppliers. With generally tighter credit conditions and higher uncertainty, the economic environment should not be as conducive for investments as it was in the last couple of years (on the other hand, the government intends to speed up highway construction; nuclear plant construction is also planned). Although growth remained strong at 7.1% in 3Q08, by now, there are a few signs of domestic demand weakening. We revised our 2009 GDP growth forecast from the pre-crisis 6.0% y/y to 4.8% y/y (after 10.4% in 2007 and the expected 7.4% y/y this year), which should still keep Slovakia among the top spots within the European Union. Next year's growth should be to a large part driven by household consumption, while we expect government spending to add to the growth as well (to a lesser degree).

### Contributions to GDP growth



Source: Statistical Office, SLSP

### Inflation to decelerate

After following an upward path until September, inflation decelerated in October and should continue to manifest a slowing tendency in the next couple of months. The reasons include favorable base effect, due to food prices, which saw significant price surges in 2007 that did not repeat this year. The steep fall in oil prices led to cheaper fuels and has reduced pressure on energy prices. Previously an upward risk to our forecast, we now expect gas prices for households to stay unchanged at the beginning of next year. We expect annual harmonized inflation to slow down from 4.5% in 3Q08 to close to 4% by the year-end and to fluctuate around 3.5-3.8% in the first half of 2009. We reckon only a minor 'rounding' impact from euro adoption, worth up to 0.3pp. In the medium term, we expect harmonized inflation in Slovakia within the 3.5-4.0% range, particularly driven by prices of services, due to continuing price

# Slovakia

convergence (service prices stood at just around 43% of the EU average in 2007, while goods prices have already converged to around 80% of the EU average).

## Monetary Policy

### ECB takes over monetary policy

Since Slovakia is set to adopt the euro in January, the central bank does not have much room left for independent monetary policy. Indeed, the NBS has followed late ECB's moves without much delay and is expected to do so in case of further rate cuts by the ECB by the year-end. On the short end (up to 3M), there still needs to be some upward adjustment of the Slovak money market curve, since Slovakia lacks the Eurozone's liquidity premium at present, but will have to face it once in the Eurozone.

## Capital Markets

### Bond spread compression dependent on Eurozone recovery

On the bond market, the spreads over the Eurozone have widened amid generally higher perception of the credit risk. However, unlike in the case of its CE4 neighbors, investments in Slovak bonds do not carry the currency risk, due to the looming euro adoption. Hence, Slovak bonds tend to move along with German Bunds. In January, the switch from the koruna to euro denomination should enhance the liquidity of Slovak issues. A possible negative domestic impact could stem from higher T-bond issuance, as the government might renege on promises to cut the fiscal deficit to 1.7% of GDP (made in 2007). The prime minister recently admitted that there might be extra anti-crisis spending that would lead to a higher fiscal shortfall of around 1.7-2.0% of GDP, but we think the figure could be even higher. The other possible reason for a higher fiscal gap could be highway construction financed by the state deficit, instead of through PPP projects (as financing of PPP projects privately has become more expensive). Nevertheless, since we do not expect in our base scenario the recession in the Eurozone to last longer than a couple of quarters, negative risk appetite should eventually recede and we expect spread compression of T-bonds through 2009. In the second half of November, spreads of 3Y T-bonds stood at around 180bp, while 10Y T-bonds traded above 130bp above German benchmarks. By the end of 2009, we expect 10Y spreads to compress to 50-70bp and further to 20-30bp in 2010 during the Eurozone's expected recovery phase.

*Michal Mušák  
Mária Valachyová*

# Czech Republic

	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	6.6	4.4	2.5	3.5
Private Consumption (growth y/y %)	5.9	3.5	3.5	3.9
Fixed Capital Formation (growth y/y %)	5.7	3.6	1.2	2.1
CPI (y/y, average%)	2.8	6.3	2.2	2.3
Current account balance (% of GDP)	-2.5	-1.8	-2.1	-1.6
Govt. budget balance (% of GDP)	-1.9	-1.8	-2.0	-2.1
Short term interest rate (3 months) year-end	4.1	4.0	2.5	3.5
Loc. Curr./EUR average	27.8	24.9	24.8	23.7

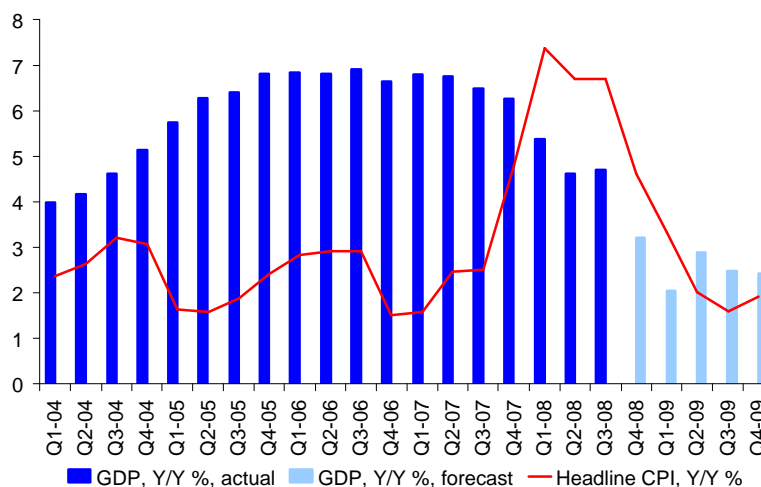
## Economy

### Economy being dragged down by EMU recession

The economic outlook has changed dramatically over the last half-year. Whereas six months ago the issue was whether the elevated inflation would filter into the expectations and the discussion was about what the CNB should do about it, now *the* major concern is how to avoid a dramatic economic slowdown. What happened?

Most importantly, the credit crisis that many observers thought had reached its apex with the demise of Bear Stearns in March took a turn for the worse in the fall, with investment banks collapsing, stock markets plunging and interbank markets in a deep-freeze. Impacts on the EMU economy became plain to see – car sales slumped, leading indicators took a dive and the economy entered a technical recession in 3Q08, etc.

### GDP, inflation - history and forecast



Source: Ceska sporitelna (estimates), Czech Statistical Office (actual data); data given as quarterly averages

Given the high degree of openness of the Czech economy and its exposure to the EMU, the impact of a slowdown in the EMU on the Czech economy will be substantial. Exports account for about 80% of annual Czech nominal GDP, with imports making up a little over three quarters. On top of that, net exports have been the driving force of growth this year (adding as much as 5.8pp to the 4.6% y/y growth seen in 3Q08), so their slowdown will be felt acutely. A substantial part of local industry (where most of the new jobs were created) is also export-oriented, so employment will also be hit.

We expect the growth to reach a mere 2.5% y/y next year, a marked slowdown from 12 quarters of 6+% y/y growth rates. The major drag on the growth will come from exports (already seen in the numbers - the trade balance for the last four months has been getting better only due to falling imports). The second half of the year will see rising unemployment and a falling nominal wage growth rate. The effect on consumption will be somewhat positive (especially in 1H09), as there will be a modest rise in real wages, due to the dramatic slowdown of inflation.

# Czech Republic

Investments are slowing down (mainly due to the rundown of inventories); in 2009, they will slow further on fixed investments falling, due to lower economic activity abroad and tight credit. About the only support will be provided by EU funds.

## **Inflation to head south on falling commodities and slowing economy**

This scenario is consistent with falling inflation. Even though the real economy at present is still only slightly anti-inflationary, it will turn more anti-inflationary next year. The domestic economy is still generating pro-inflationary pressures (as manifested in core inflation, presently hovering above 2%), driven by still high wage growth and the robust economic performance over the last three years. The external environment, on the other hand, turned decisively anti-inflationary – oil prices that just a few months ago culminated at around 145 USD/brl have fallen dramatically to as low as 50 USD/brl; other commodities largely followed suit. The strong currency also plays a role in taming inflation (see import prices). The effect of the strong currency is usually delayed, so there could be more of it felt in 1H09, as the slowing economy might prompt retailers to pass more of past exchange rate savings on to final customers. All in all, inflation has ceased to be the threat that it seemed to be not so long ago (the ECB, for its part, for example hiked as recently as in July and did not cut until fall), and this holds for the Czech Republic as well.

Putting the base effects, external development and recent strength of the koruna (import prices down some 20% y/y) together, we see a pretty quick return to the CNB target of 3% and below in 1Q09. There is still some deregulation planned for January (rent, electricity, etc.), but these might be smaller than originally expected (due to the crisis and lower commodity prices). Be that as it may, core inflation will drop relatively quickly, due to the weakening economy, dragging overall inflation down. We expect the average inflation to reach 2.2% in 2009; the risks are rather downward, given the downside risks to economic growth.

## **Monetary Policy**

## **Rates to fall further, subject to crown and extent of EMU slowdown**

In this respect, the maneuvering space of the CNB has widened substantially. Not so long ago, we (and the CNB) were concerned that the inflationary shock from fall 2007 and this January would find its way into expectations and thus become a threat to long-term price stability. This is a non-issue now, with the major headache being the threat to economic growth. The CNB became the first bank in the region to start easing monetary policy when it cut rates in August (by 25bps) in response to the brutal strengthening that the CZK experienced at that time. The CNB responded to the gloomier growth prospects by cutting more aggressively in November (75 bps), pushing the rates to as low as 2.75%. What happens next is a function of two things – the koruna and the EMU. We think the risks for the EMU are clearly to the downside; a deeper/prolonged recession in the EMU would push the growth rate down further and justify lower rates. On the other hand, slower growth would probably mean a weaker currency, which, in the case of the Czech Republic, is a fundamental input for monetary policy. We think that the equilibrium exchange rate is about 25.50, but given the changed perception of the CEE region (which used to be an 'island of stability'), the currency may move to the weaker side. Under the conditions that the CZK remains stable around its fundamentally justified levels and strengthens towards 24.1 at the end of 2009 and the EU stagnates in 2009, we see two more cuts to 2.25% (December 2008 and 1Q09) - this is our baseline. Slower growth and/or a stronger koruna would send the rates lower. However, the situation that seems quite likely now is that the koruna will overshoot to the weaker side – if, for example, the koruna gets above 26 and stays there for two quarters, no further cuts would be necessary, as monetary easing would be done via the exchange rate, obviating the need to cut rates.

## **Capital Markets**

Thus, as far as the koruna is concerned, we see two major possibilities. First (our baseline), the koruna would correct to around 25.50 and stagnate around there for some time (the first two quarters of 2009), drifting slightly downward (towards 25) before embarking on a strengthening path to 24.2 around the end of 2009. While the koruna would be held back in its strengthening by the worsening trade balance, it should (in this scenario) be supported by the still good perception of the Czech Republic ("they may not grow much, but they at least they *do* grow").

# Czech Republic

The second scenario, which would be more likely if a deeper/longer recession in the industrialized world became a reality, would see the koruna weakening, due to the bad perception of all emerging markets en bloc, pushing it above 26.00 and possibly even higher.

These factors also have a bearing on yield predictions. The short end is now under the influence of the tight money market (with liquidity premia at an unprecedented high), the rates on which are out of sync with the CNB repo. We think that the short end will drop dramatically (the CNB will in our view need to tackle the interbank market in the next half-year, unless it corrects itself) and that the long end of the swap curve will also trend downward, although the downward movement will be much more limited. We see the 3M PRIBOR at 2.4-2.5% at the end of the first half of 2009 (current levels are well above 4%) and the 10Y govt. yield at around 3.6-3.7%.

*Martin Lobotka*



# Ukraine

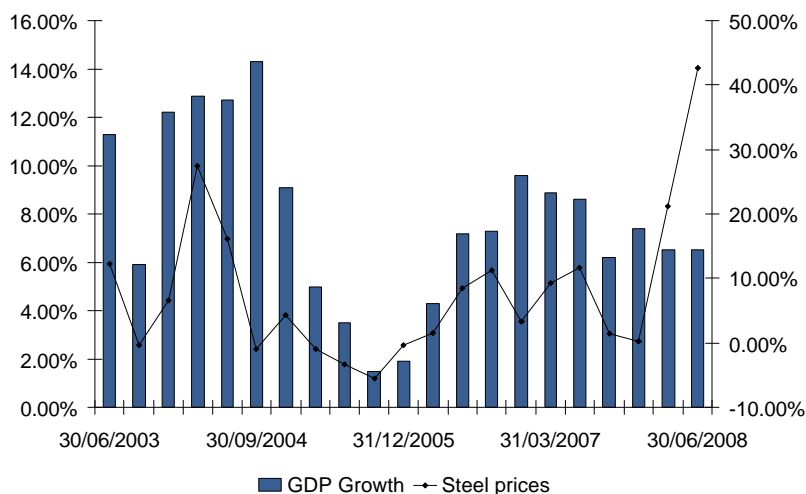
	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	7.6	4.8	-2.5	5.5
Private Consumption (growth y/y %)	17.1	9.0	-3.0	7.6
Fixed Capital Formation (growth y/y %)	24.8	3.0	-3.0	10.0
CPI (y/y, average%)	12.8	22.8	18.0	9.4
Current account balance (% of GDP)	-4.2	-6.7	-2.5	-4.0
Govt. budget balance (% of GDP)	-1.1	-2.0	-2.5	-1.5
Short term interest rate (3 months) year-end	8.7	25.0	13.5	8.0
Loc. Curr./EUR average	6.92	7.50	8.00	8.15

## Economy

### Economy will enter 2009 with recession

Ukraine has experienced average real GDP growth of 7.5% since 2000. This economic growth was resilient against rising energy prices and the uncertain political climate. However, GDP growth has strong cyclical effects, which arise from volatility in metal prices. Metallurgy accounts for 35% of exports and 25% of GDP and state budget income. In 2004, GDP growth accelerated to 12.1%, then fell to 2.7% in 2005 and rose by 7.6% in 2006 and 2007. Price volatility is typical for global steel prices. A downward price correction of 30-40% took place during 1996-99 and 2000-01. In 2005, steel prices fell by over 30% in the CIS region during a five-month period, but quickly recovered. After enjoying record gains, steel prices are currently collapsing amid the global economic slowdown. Thus, Ukraine is likely to witness another economic shock in 2009.

### GDP and Steel Prices



Source: Bloomberg, Ukrstat

The economy is likely to enter 2009 in recession. The decline in GDP will be strongly dependent on steel prices and demand. In light of historical precedent, it is estimated that a 10% steel price drop results in a 1.5% annualized drop of GDP in the quarter when the drop occurred. The effect disappears quickly during the following quarters and leaves a 0.75% GDP decline over a full year. The same 10% decline in steel prices leads to a 2% decline in inflation. We project a recession of 2.5% of GDP in 2009, with economic growth returning in 2H09. The current account is likely to shrink to just 3% of GDP in 2009, as slowing demand, the credit freeze and dropping commodity prices will hurt imports. The government and IMF have projected a strong inflation figure of 17%, which suggests strong local currency devaluation.



# Ukraine

## Monetary Policy

**NBU will introduce floating exchange rate regime**

For the last seven years, the local currency has been relatively unchanged vs. the USD, the currency to which the hryvnia is officially tied. Since 2008, the NBU has accelerated the shift to a flexible currency rate, which has not yet been achieved. The introduction of a floating exchange rate will result in local currency devaluation, which is supposed to support the real sector of the economy. The optimal level of the UAH/USD will depend on steel prices. At current metal price levels, we project the optimum level to be around 7 UAH per USD, with the hryvnia gradually moving towards this level. During the next several months, the hryvnia rate will depend on NBU actions – imposing the floating rate and administrative market regulation. Also, much will depend on liquidity in the banking system.

We don't expect further strong devaluation in local currency, as global commodity prices are already at low levels. Low hryvnya liquidity will be putting additional appreciation pressures on local currency. Anyway, in the mid-term further appreciations or devaluations of local currency will reflect the optimum level of exchange rate under which exporters will get sufficient support without significant inflationary pressures applying to economy.

## IMF LOAN

**Ukraine and IMF agreed on program to help the economy**

On November 5, the IMF approved a USD 16.4bn two-year stand-by loan. The first transfer of USD 4.5bn has been available since November 6. On November 4, Parliament adopted a law on "Countering the effects of the global financial crisis" as part of its agreement with the IMF. The IMF stated that "Ukraine has developed a comprehensive policy package designed to help the country meet the balance of payment needs... The strength of the program justifies the high level of access, equivalent to 800 percent of Ukraine's quota in the Fund." The program touches on fiscal, monetary and inflation policies and banking regulation.

Regarding fiscal policy, Ukraine is to cut spending to meet declining incomes in 2009. Ukraine will keep its inflation rate at 17% by end-2009. Nominal wages and social benefits are to increase only to cover the inflation process. Ukraine is to impose inflation targeting, based on the core inflation. The indicator is based on the exclusions of fresh fruit, housing services, administratively regulated food products and transportation services. Core CPI includes 45% of the CPI basket. Its implementation is likely in 2010, as it is not well known to the public, which is vital for the inflation targeting policy.

Regarding monetary policy, Ukraine is to impose a floating currency exchange rate regime, which will ultimately result in devaluation, at least during 1H09. Currently, the NBU is imposing measures to keep the official exchange rate in line with the market price. For the time being, the hryvnia exchange rate is administratively regulated, with the NBU having to make heavy use of its FX reserves. The UAH has gone through some depreciation, which is still below potential.

The IMF and the Ukrainian government agreed on the following measures for the banking sector:

- increase in the state fund guarantee for deposits from UAH 50,000 to UAH 150,000 (covering 99% of individual accounts)
- Ukraine and international experts will jointly monitor the biggest banks, which account for 60% of the market, and decide which should receive refinancing
- increase in refinancing activities by the NBU
- increase in transparency of publicly disclosed information from commercial banks

**Banking sector will go through a period of consolidation**

Additional measures by the government include the creation of a UAH 40bn stabilization fund, which will be used for issuing loans and conducting bailouts of banks. The government received the right to borrow money in foreign currency on the local market and use government bonds to buy troubled banks.

# Ukraine

These measures are enough to secure overall banking system stability, which is likely to go through a period of large-scale evolutionary changes. The IMF and Ukraine have effectively agreed on forcing further consolidation in the banking sector. Even with minimum capital requirements twice those in Europe, Ukraine has some 170 banks, a number that could fall sharply in 2009.

*Maryan Zablotskyy*

# Hungary

	2007	2008f	2009f	2010f
Real GDP (growth y/y %)	1.1	1.1	-0.8	2.5
Private Consumption (growth y/y %)	-1.8	0.2	-1.0	2.0
Fixed Capital Formation (growth y/y %)	1.5	-3.2	-2.5	4.5
CPI (y/y, average%)	8.0	6.2	3.5	3.2
Current account balance (% of GDP)	-6.4	-6.1	-4.7	-4.3
Govt. budget balance (% of GDP)	-5.0	-3.3	-2.4	-2.2
Short term interest rate (3 months) year-end	7.5	10.4	7.0	6.0
Loc. Curr./EUR average	251.3	252.1	255.0	240.0

## Economy

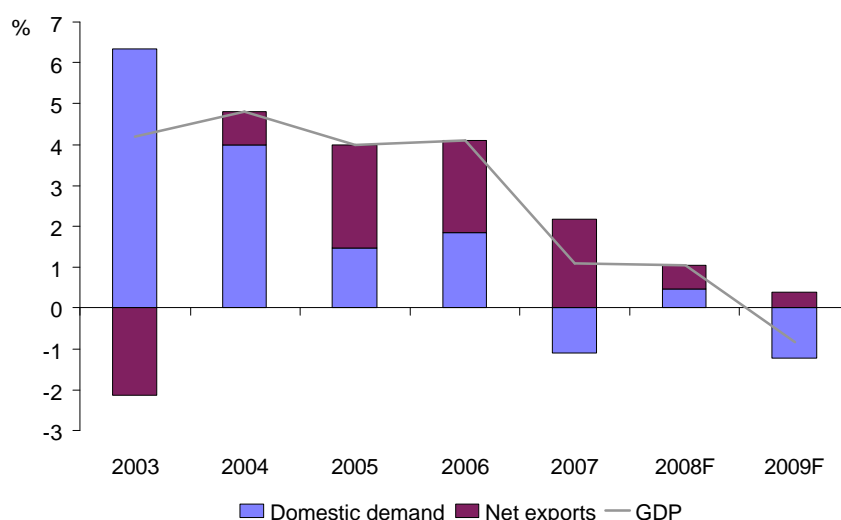
### Economy to drop by 0.8% in 2009

The 0.8% y/y flash estimate for the 3Q GDP growth caused a negative surprise; this was most likely due to the lower than expected performance of industrial exports. The figure shows that unfavorable processes seen in the Euro area negatively affected the performance of the Hungarian economy already in July-September, earlier than expected. As for the GDP growth prospects, the 3Q slowdown seems to have been just a beginning of a slump expected in Hungary for the coming quarters. Poorer growth prospects in the Eurozone should reduce demand for Hungarian exports and a recession affecting its major export partners could eliminate the last engine of growth in the country. Please note, however, that the coming export slowdown should bring an even greater slowdown of imports, as a very significant part of imports is related to the performance of exports, while imports for consumption purposes could even decrease next year, due to the poor prospects for domestic demand. Thus, the contribution of net exports could be in slightly positive territory (around +0.5%) in 2009. On the other hand, the contribution of domestic demand to GDP growth is very likely to remain in negative territory in the coming quarters. The expected drop in real disposable income of households - partly related to another fiscal austerity package - does not suggest any revival of domestic consumption. In addition, in an environment characterized by tighter credit conditions, there would be less opportunity for households to smoothen out their consumption, which was the case after the implementation of the 2006-07 budget tightening. Tighter credit conditions and poorer export growth prospects could prove more of a burden to the prospects for private investments. Last but not least, there is no room for stimulating domestic demand from budget sources, as fiscal policy should remain contractionary, in order to decrease the external financing needs of the state and, consequently, the financial vulnerability of the country.

Summarizing the above, after the tiny 1.1% y/y economic growth expected for 2008, GDP is expected to decline by 0.8% next year. The negative impacts could be the strongest in the first half of the year, with some revival possible in 2H, depending mainly on how long the global crisis negatively impacts the biggest economies of the Euro area.

# Hungary

## GDP and contributions



Source: CSO

### Budget deficit to fall to historically low levels

Budget consolidation has been continuing this year and the original budget deficit goal of 4% of GDP for 2008 will again be undershot (our expectation is 3.3% of GDP). The current financial market turbulence strongly demands strict control over public finances in the coming years as well. Aside from the extreme risk aversion seen on the markets, the strings attached to the IMF support will enforce very strict budgetary discipline in 2009. This will result in a further deficit reduction and prevention of pre-election overspending in 2009 and 2010. All in all, due to more cuts on the expenditure side and the cancellation of the earlier planned tax relief, we expect the budget deficit to stand at 2.4% of GDP in 2009, well below the Maastricht criterion of 3% of GDP. Next year, the EU should even abandon the EDP (Excessive Deficit Procedure) against Hungary. Last but not least, it could be seen as positive that Parliament passed the fiscal responsibility law in November, as this could help to ensure the long-term sustainability of the fiscal policy.

### Inflation further declining

CPI inflation has finally started to decline. Inflation slowed to 5.7% y/y in September and is expected to stand at 4.7% y/y in December, mainly based on the drop in the prices of foods and fuel. Lower food and oil prices, as well as poor economic growth prospects, will support a continuation of the disinflation process, despite the forint exchange rate, which now seems to be stabilizing in a weaker range. Moreover, concerns around the formation of nominal wages in the private sector, which earlier had been the main risk to the success of disinflation, should disappear, as hardly any wage increases are expected in the economy, due to the poor economic growth prospects. All in all, the 12-month inflation rate could be very close to the central bank's mid-term target of 3%, even by the end of the first half of next year.

### Monetary policy

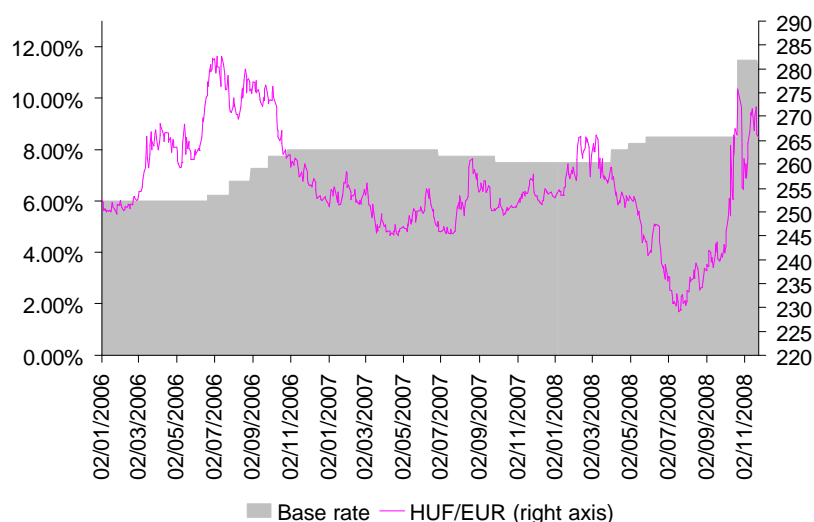
### More rate cuts in pipeline in coming months

As the state of the domestic financial markets had become frightening, the Monetary Council carried out an emergency, drastic hike of the base rate (from 8.50% to 11.50%) in October. In that situation, when a modest hike would not have done very much, protecting the forint from further falls became the top priority for the central bank. Surprisingly, the Monetary Council already "took back" 50bp at the November rate setting meeting; thus, the base rate was cut to 11%. For fundamental reasons, inflation and growth prospects suggest a continuation of the rate cutting cycle. According to the latest Inflation Report published in November, in the horizon relevant for monetary policy, the bank will undershoot the 3% inflation target, which could have been the main reason for the November loosening. In addition, according to the Monetary Council, the agreement with the IMF and further budget adjustment measures have reduced the risks to the financing of the country's external debt. The above reasons suggest that rate cuts should continue and that another 50bp rate reduction could come even in December.

# Hungary

However, uncertainties around the timing and magnitude of these reductions remain and possible rate cuts will strongly depend on the general state of capital markets (formation of the forint exchange rate as well as risk premia on forint assets, investor confidence). Supposing further improvement in the global market environment, the central bank is expected to cut the base rate to 8.50% (seen before the October crisis) by April-May 2009 and the base rate could stand at 7% at the end of next year.

## Base rate and HUF



Source: National Bank of Hungary

## Capital markets

### Domestic markets in difficult situation

Having reached historically high levels in the summer months (below 230 per EUR), driven by enthusiasm based on the new free float regime introduced in February, the forint exchange rate has significantly weakened. The latest wave of the sub-prime crisis, bankruptcies in the US financial sector and the collapse of prices on some stock markets has led to a global increase in risk aversion, which has affected domestic markets strongly. October brought an acceleration of the forint depreciation process. In extremely volatile trading, the exchange rate weakened to historically low levels (285-286 per EUR). Finally, the 300bp CB rate hike and the agreement with the IMF managed to stop further weakening of the forint exchange rate.

Since then, the exchange rate has improved somewhat. However, low global risk appetite and intensifying fears of a global recession have kept the forint vulnerable. Supposing some improvement in the global market environment, a slow appreciation process should come in the coming months. The high interest rate differential for the forint could be supportive. Another important fundamental argument for the forint is that lower financing needs of the state and the expected improvement in households' propensity to save should decrease the dependence on external financing next year, which should bring a decrease in the forint supply. Last but not least, given Hungary's increasing enthusiasm for euro adoption after the October crisis, the country's joining the ERM II in the first half of next year cannot be ruled out, which could also be an important factor in restoring market confidence.

The domestic bond market practically collapsed in October, with trade disappearing and yields jumping to unrealistic, fundamentally unjustified levels. The authorities have tried to ease tensions with different measures (bond buying by the central bank, cancellation of scheduled bond auctions). We think that bonds are attractive at their current levels. However, the situation is not expected to significantly improve until foreign buying interest returns and the forint starts to appreciate.

Nyeste Orsolya

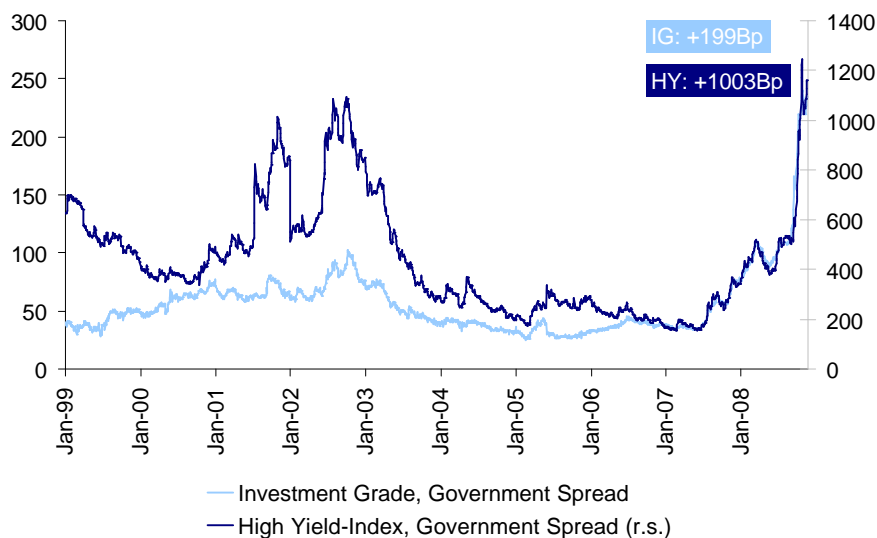
# Corporate Bonds

## Review

### Credit risks notably higher

It is common knowledge that corporate bonds are associated with a number of risks – spread risks, downgrade risks, and default risk being the most important ones. These risks have increased substantially in autumn, taking spreads to levels considerably above those seen during the last recession in 2001/2002. Since the beginning of the subprime crisis which in the event shape-shifted into a global financial crisis, spreads in the investment grade segment have increased by about 200bps, and those in the speculative segment have soared by about 1,000bps.

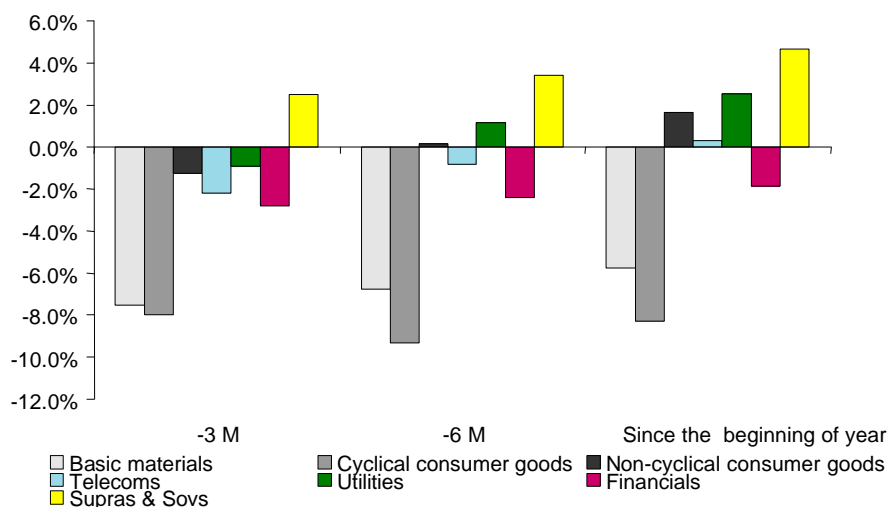
### Spread development (investment grade and HY index)



Source: Erste Group Research, JP Morgan Credit index

This gloomy sentiment did of course have a negative impact on the vast majority of sectors. All of them – with the notable exception of non-cyclical consumer goods and utilities – have recorded a negative overall performance in the past six months. The further clouding of the economic outlook both in the USA and in Europe hit cyclicals very hard. The US automobile industry, caught up in a perennial struggle with its massive problems as it is, and by now depending on help from the US government, has been most severely affected.

### Overall performance by sectors



Source: Erste Group Research, JP Morgan Credit index

# Corporate Bonds

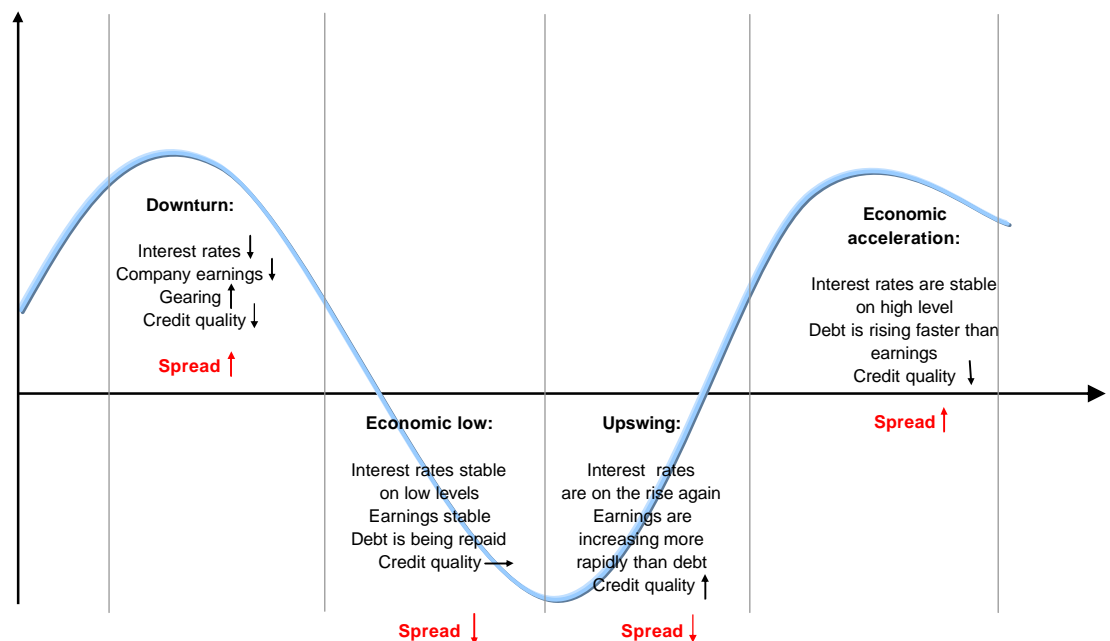
## Outlook

### Economy and credit cycle: what will the future bring?

The evaluation of the future development of corporate bond spreads is based on a range of different short-term and long-term factors. From a historic perspective, economic activity, the level of interest rates, equity market volatility, and the credit quality are the most important determinants of credit spreads.

The key factor of the onward route of relative corporate bond performance is the economic cycle which in turn has a substantial bearing on the credit cycle.

### How economic and credit cycle are linked



Source: Erste Group Research

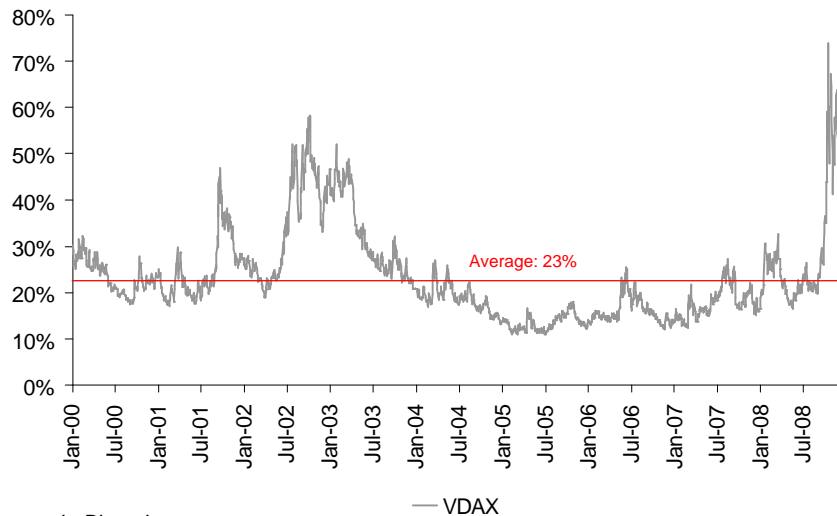
## Downturn phase

The question of where we currently are in the cycle is not a tough one to answer. The global economy is currently locked in a downturn phase with its characteristic features of falling interest rates, declining company earnings, and worsening credit quality. On top of that, the highly intense financial crisis with its ever-new peaks of severity represents a major disturbance to the markets and leads investors to stay away from credit and equity markets and to take up positions in the government bond market instead. The VDAX index, which measures the fluctuations of risk aversion among investors, would clearly indicate those movements.



# Corporate Bonds

## Development of risk aversion



Source: Erste Group Research, Bloomberg

## Funding and liquidity

- Financial institutions tighten their credit guidelines, especially at the long end
- Solid liquidity profile as decisive factor for good credit quality
- A large number of European companies have enough liquid funds to honour their short-term debt (<12months)
- Companies in cyclical industries and in speculative areas bear a higher risk of incurring liquidity shortages

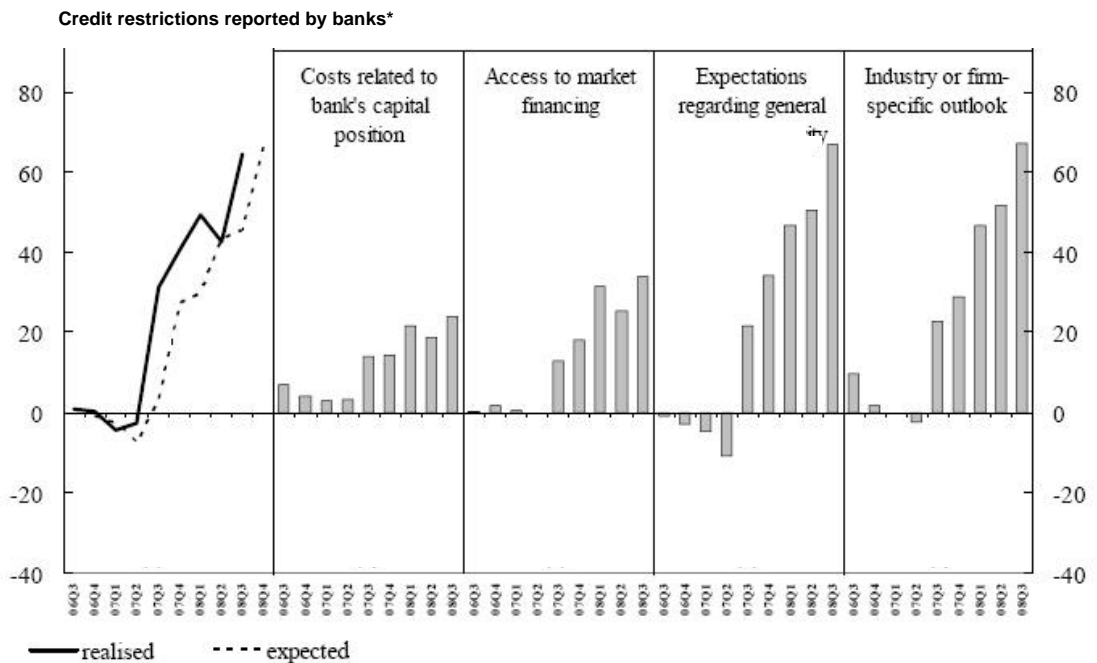
## Bank lending policies have become more restrictive

According to the quarterly bank survey<sup>1</sup> carried out by the European Central Bank (ECB), the share of banks pursuing a more restrictive lending policy increased drastically by 22% to 65% in Q3 of 2008 relative to the previous quarter. The reason given by the credit institutions is yet again the deteriorating economic outlook, as well as the increased refinancing costs incurred on the money and capital market. The banks continue to expect a lasting trend in the fourth quarter. In addition, they further raised their margins for risky loans. The more stringent credit terms affect above all debtors with low ratings. The Capital Requirements Directive (Basel II) weights the debtor's rating more strongly and attaches importance to the limitation of the risk involved, which comes with a direct impact on the volume of the loan and the rate of interest charged. Due to the risks inherent to the specific companies and industries, credit institutions have embarked on a much more cautious policy especially in the area of long-term credit.

<sup>1</sup> A survey of 110 leading banks in the Eurozone, including five Austrian credit institutions.

# Corporate Bonds

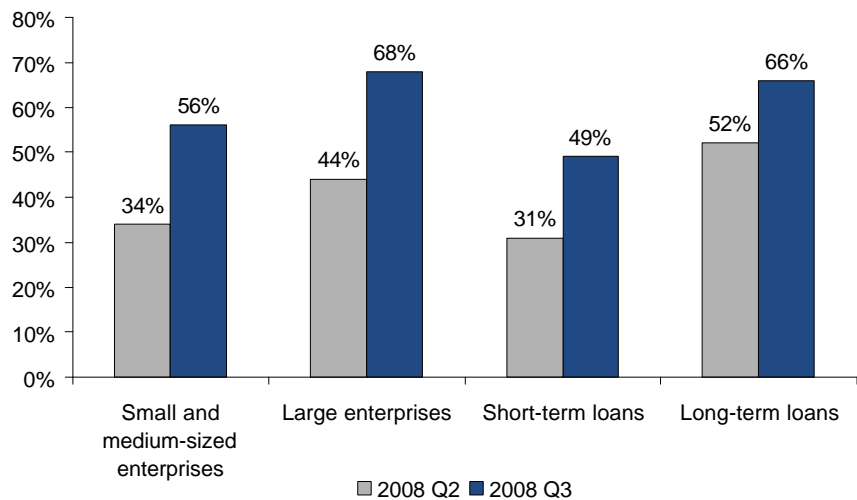
## Factors causing banks to employ more restrictive lending practices towards non-financial companies



\*The reported credit restrictions refer to the net value in percentage points, i.e. the difference between the number of banks reporting more restrictive lending policies and the number of those reporting less restrictive policies or no change at all.

Source: European Central Bank

## Net change\*\* in loans granted by banks to non-financial companies in the Eurozone



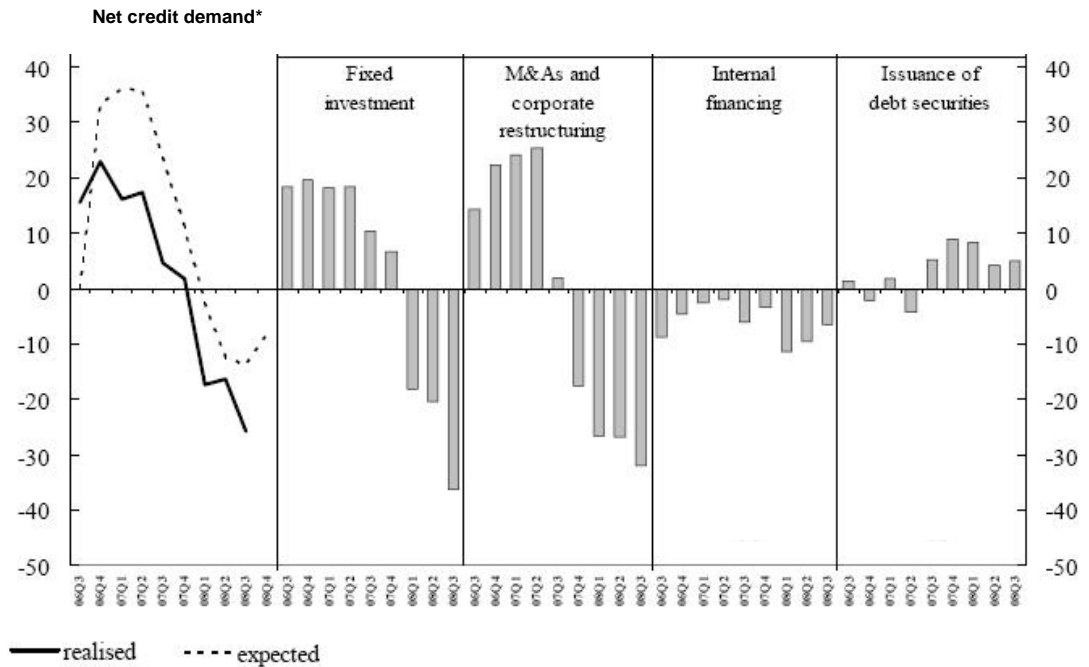
\*\*The net change refers to difference in percentage points between the number of banks reporting more restrictive lending policies and the number of those reporting less restrictive policies or no change at all.

Source: European Central Bank, Erste Group Research

Demand for credit among non-financial companies slumped in Q3 after a slight stabilisation in the previous quarter. This development was due to the decline in M&A activities and falling capital expenditure in fixed tangible assets (construction, machinery etc). However, the expected decrease in internal financing power and the massively widened spreads on the primary market for corporate bonds would rather more lead to rising demand for credit. Thus the negative net demand for credit is expected to fall from -14% in Q3 to -8% in the current quarter.

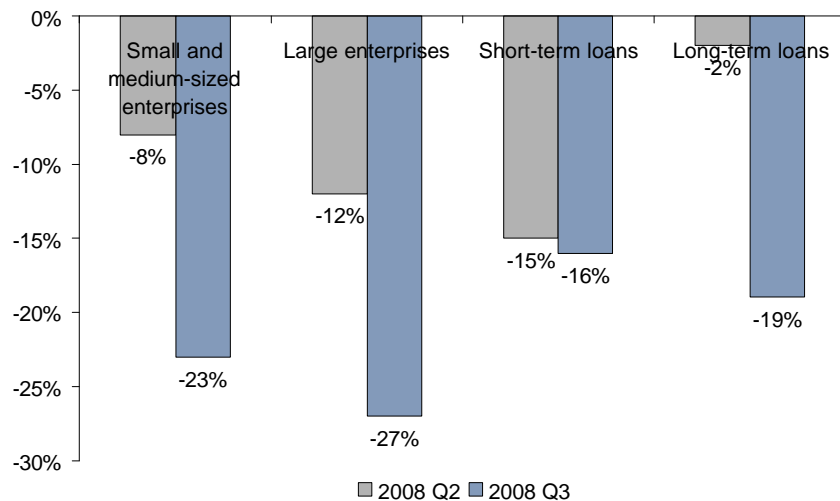
# Corporate Bonds

## Factors causing the demand for credit by non-financial companies in the Eurozone to change



\* Net demand refers to difference in percentage points between the number of banks reporting an increased volume in credit demand and the number of those reporting a lower volume or no change at all.  
Source: European Central Bank

## Net change\*\* in credit demand by non-financial companies in the Eurozone



\*\* The net change refers to difference in percentage points between the number of banks reporting an increased volume in credit demand by non-financial companies and the number of those reporting a lower volume or no change at all.  
Source: European Central Bank, Erste Group Research

# Corporate Bonds

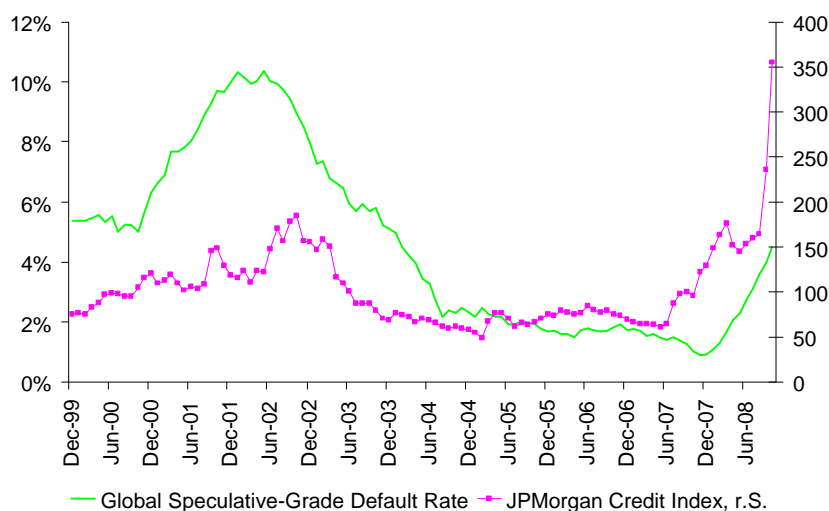
## A new era with more restrictive credit guidelines is upon us

The more restrictive credit guidelines followed by financial institutions clearly indicate that the era of cheap and easily granted loans of past years in a highly competitive banking environment has come to an end. For non-financial companies in the Eurozone that rely on bank credit as primary source of financing<sup>2</sup> this means that they will have to deal with more stringent loan conditions, i.e. higher interest rate margins, shorter terms, lower volumes, and higher collateral.

## Much more drastic increase in default rate expected

As repeatedly pointed out in our earlier reports, rating agencies have now come to forecast a much more drastic increase in global default rates than they did only a few months ago. According to Moody's, the global default rate of bonds with low ratings should reach 4.3% yoy at the end of this year; for the end of 2009, the rating agency even expects 10.4%, and it actually sees a chance of the previous highs during the US recessions in 1990/91 and 2000/01 being surpassed. While the default rate in Europe is expected to reach 9.7% at the end of 2009, in the USA it should even hit 11.2%. Since credit spreads react to changes in the default rate with a slight time lag, we expect corporate bonds to come under severe pressure from this area.

### Global speculative default rate and spread development



Source: Erste Group Research, Moody's

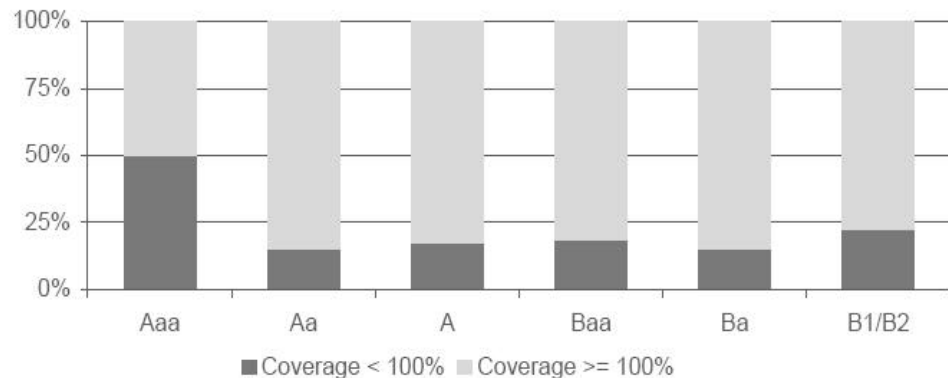
## Sufficient liquidity as decisive factor of credit quality

In this difficult market environment, sufficient liquidity is an important factor for companies to be able to honour their outstanding debt, ensure business operations and at the same time maintain their rating. According to Moody's the existing cash at hand and the unused credit lines should be sufficient for 81% of the non-financial companies in Europe (which equals the rating universe of Moody's) to settle their debt in the next twelve months. This conservative scenario is based on the assumption that some of the revolving credit facilities will not be extended – a fully plausible approach given the current market environment, as we believe.

<sup>2</sup> In 2006 bank loans accounted for 85% of the outstanding debt of non-financial companies in the Eurozone, source: ECB Financial Stability Review – June 2008.

# Corporate Bonds

## Share of European non-financial companies with a maturity of 1 year that are covered by cash at hand and unused credit lines

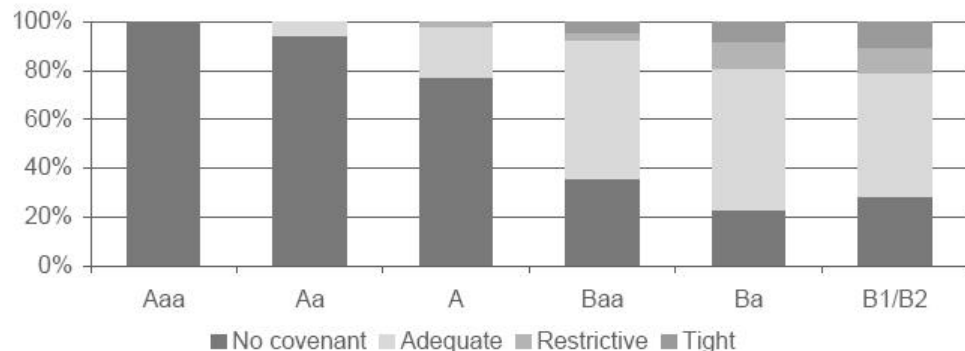


Source: Moody's, as of Q3 2008

Many sectors – among those the area of cyclical industrials – are expected to see a decline in operating cash flows in the coming year due to the difficult situation in their key markets. This might result in an increased number of companies breaching their covenants<sup>3</sup>. Negotiating new covenant terms is crucial for many companies especially in the speculative area so as to avoid short-term liquidity shortages.

Investment grade companies, on the other hand, are exposed to a much lower risk of short-term liquidity crunches according to Moody's, as only 6% of the higher rating class (in comparison with 20% in the speculative area) are exposed to restrictive or very tight covenants.

## Covenants of European companies by rating category



Source: Moody's

### In CEE sovereign supports GREs' liquidity

In the smaller European markets such as central and Eastern Europe (CEE), where part of the industrial sector has full or partial government ownership (GRE), companies receive additional support in the form of liquidity from their government investors. The government also contributes positively to the credit quality in the corporate sector by acting as guarantor for long-term loans. This group of companies account for about 52% of the rating universe of Moody's in CEE. Among those are the giant Czech power company CEZ (64% owned by the government), the Romanian utility Transelectrica (76% owned by the government), the Hungarian pharmaceutical company Gedeon Richter (25% owned by the government), and the Polish mining company KGHM Miedz (42% owned by the government).

<sup>3</sup> A covenant is a clause or regulation in credit agreements by which the borrower agrees to comply with certain terms, e.g. to achieve minimum key ratios such as cash flow to net debt.

# Corporate Bonds

## Primary market

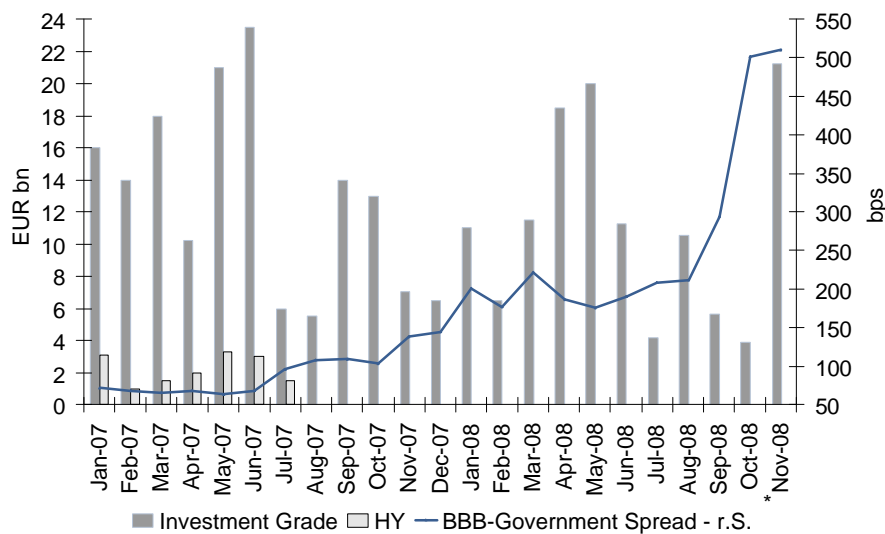
- Noticeable clustering of EUR-bonds to be refinanced in 2009 and 2010
- Companies are prepared to pay very high spreads for bond issues
- Large bandwidth of credit spreads, depending on sector and company
- Revaluation on the secondary market
- Attractive yields reflect the high risk aversion
- Security selection process and fundamental credit analysis are crucial

## Lively issuing despite high spreads

It is difficult to predict to what extent the accelerated downward spiral of the economy will affect the generation of cash flows and thus the liquidity profile of companies. In some sectors – among others telecoms, automobile manufacturers, and utilities – the volume of outstanding debt due by the end of 2009 is relatively high, which means that these companies will want to ensure the refinancing of their bonds even in a difficult capital market environment. Therefore new issue volumes of EUR-investment grade bonds have picked up over the past three weeks.

Utilities were by far the most active issuers on the primary market in spite of their stable cash flows and their available credit lines. In November alone bonds worth a total of more than EUR 21bn were issued (i.e. about 17% of the total volume in 2008). Most bonds are traded at minimum tradeable nominal amount of EUR 50,000, which means that they were mostly placed among institutional investors.

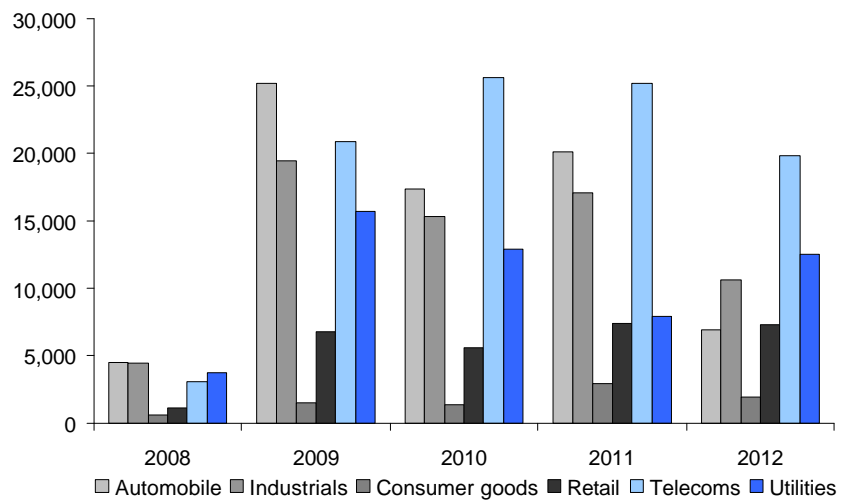
## New issues on the EUR-corporate market 2007-2008 vs. JPMorgan Credit index BBB Govt Spread



\* as of 25 November, 2008

# Corporate Bonds

Maturities for corporate bonds in EUR mn (as per end of October, 2008)



Source: Erste Group Research, Bloomberg

Refinancing conditions are of course anything but optimal for companies in view of the currently high spreads. However, after months of futile waiting for a more favourable setting on the primary market, issuers have ended up accepting the high spreads. The reasons for bond financing among companies are varied. Whereas especially automobile manufacturers tap the bond market in view of maturity of their outstanding debt, utilities are using the recent EUR-issues among other things to fund their M&A projects. The low volume of the outstanding bonds due by the end of 2009 (EUR 485mn) of the German power company RWE clearly indicates that the company could put the EUR 2bn bond issue to good use on its shopping tour. However, high yield companies remain excluded from the primary market (as they have been since July 2007).

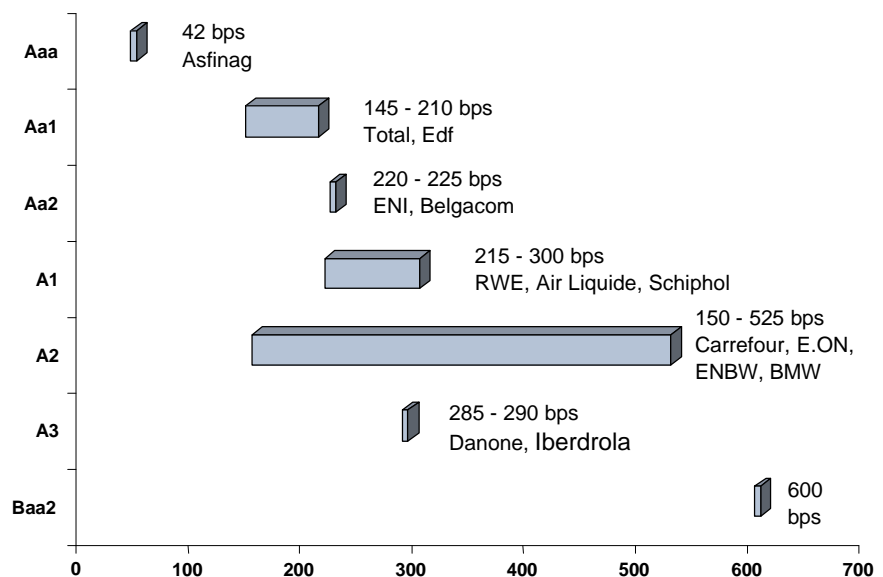


# Corporate Bonds

## Current new issues on the euro-corporate bond market

Date	Issuer	Sector	Coupon	Outstanding Volume in EURmn	Rating	Maturity	Spreads over Mid-swaps
26/11/2008	Total	Energy	4.750%	1,000	Aa1 / AA	10/12/2013	145 Bp
25/11/2008	DANONE Finance	Food	6.375%	1,000	A3 / A-	04/02/2014	285 Bp
25/11/2008	Vattenfall	Utility	6.750%	650	A2 / A-	31/01/2019	280 Bp
25/11/2008	Vattenfall	Utility	5.750%	850	A2 / A-	05/12/2013	230 Bp
21/11/2008	CARREFOUR SA	Retail	6.625%	700	A2 / A	02/12/2013	315 Bp
20/11/2008	METRO Finance	Retail	9.375%	500	Baa2 / BBB+	28/11/2013	600 Bp
18/11/2008	Electricite de France	Utility	5.875%	2,000	Aa1 / AA-	23/01/2013	210 Bp
18/11/2008	ENI Spa	Energy	5.625%	1,250	Aa2 / AA-	20/01/2014	220 Bp
17/11/2008	E.ON Int. Finance	Utility	4.750%	1,000	A2 / A	25/11/2010	150 Bp
17/11/2008	Air Liquide Finance	Industry	6.125%	600	A / A	28/11/2012	265 Bp
14/11/2008	BELGACOM	Telecom	4.125%	175	Aa2 / A	23/11/2011	225 Bp
14/11/2008	BELGACOM	Telecom	4.375%	200	Aa2 / A	23/11/2016	300 Bp
13/11/2008	IBERDROLA Finance	Utility	6.375%	1,000	A3 / A-	25/11/2011	290 Bp
13/11/2008	IBERDROLA Finance	Utility	7.500%	600	A3 / A-	25/11/2015	365 Bp
13/11/2008	BMW Finance	Auto	8.875%	750	A2 / A	19/09/2013	525 Bp
13/11/2008	ENBW	Utility	6.875%	750	A2 / A-	20/11/2018	275 Bp
13/11/2008	ENBW	Utility	6.000%	750	A2 / A-	20/11/2013	235 Bp
12/11/2008	RWE Finance	Utility	6.625%	1,000	A1 / A	31/01/2019	255 Bp
12/11/2008	RWE Finance	Utility	5.750%	1,000	A1 / A	20/11/2013	215 Bp
12/11/2008	SCHIPHOL Nederland	Airport	6.625%	700	A1 / A	23/01/2014	300 Bp
10/11/2008	ASFINAG	Motorway	4.125%	1,000	Aaa / AAA	14/03/2014	42 Bp

## Spread above mid swap 3Y to 5Y new issues on the corporate bond market



Source: Bloomberg, Erste Group Research, as of 26 November, 2008

# Corporate Bonds

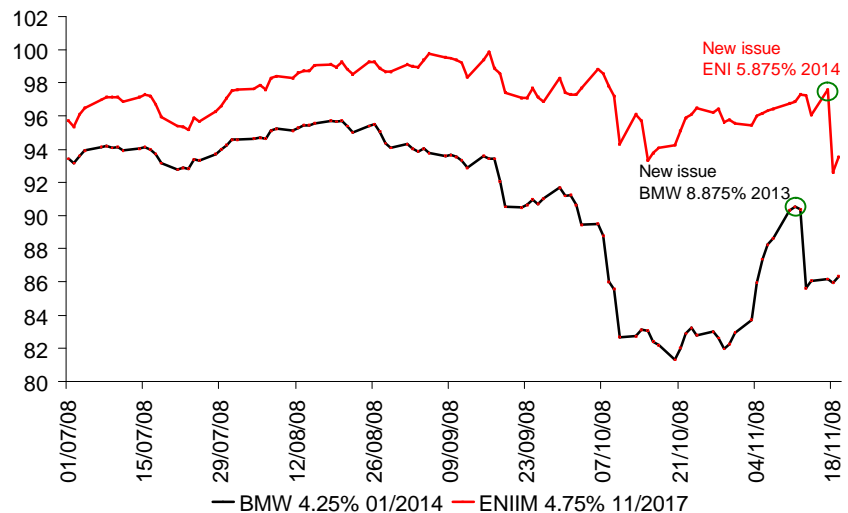
## Considerable bandwidth of credit spreads on new issues

Without a doubt, the spreads of EUR-denominated corporate bonds differ in accordance with their rating classes. That said, the large bandwidth of credit spreads on new issues within the same rating category is largely due to the fact that investors demand an additional premium for any form of risk. This is why the spreads of the current new issues of E.ON, Carrefour, and BMW are scattered within a band of 150 to 525 basis points. Although these bonds all belong to the same rating category (A2), both the liquidity profile of the companies and the sectors (especially the degree of cyclical and the defensive features) are rated differently. This means that investors may receive high yields at attractive coupons, but the selection process and a fundamental credit analysis are crucial.

## Revaluation on the secondary market

We expect some of the existing bonds to be subjected to revaluation on the secondary market due to the high spreads of the new issues. A case in point, the bond of BMW with a coupon of 4.25% (ISIN: XS0282510170) shed a substantial portion of its value after the issue of the bond with the same maturity and a yield of 8.22% (ISIN: XS0400017199). Something along the same lines happened to the Italian energy group ENI, where the issue of its new benchmark bond led to the revaluation of the existing bond, ENIIM 11/17.

### Revaluation on the secondary market



Source: Bloomberg, Erste Group Research

# Corporate Bonds

## Conclusion

The economic growth cycle of the Eurozone has come to an end for now. Falling interest rates, declining company earnings, and the deterioration of credit quality dominate the downturn phase. This has led to high volatility and to persistent uncertainty on the markets – two factors providing a fertile soil for a massive increase in credit spreads.

**Slightly  
narrowing  
spreads only in  
the 2HY 09**

In order for risk premiums on the EUR-corporate bond market to fall significantly, the economy has to reach the next phase of the economic cycle. We expect the economy to hit bottom – associated with increased rates of debt repayment in the corporate sector – in the third quarter of 2009. Therefore we envisage volatile spreads on a high level on the EUR-corporate bond market up until the second half of 2009, and we expect slightly narrowing spreads only in the second half of next year.

On a more positive note, a certain degree of trust in the Eurozone banking sector has returned in the wake of the steps taken to boost the banks' equity position and as a result of the governmental guarantees for senior bonds.

Investors currently have the chance to buy high yields through attractively priced new issues. However, the selection process and a fundamental credit analysis are crucial. The defensive sectors are already quite expensive, but given their stable cash flow generation we still prefer telecoms, utilities, and non-cyclical consumer goods.

*Elena Statelov  
Alihan Karadagoglu*

# Important web pages

## ERSTE BANK

Erste Bank <http://www.erstebank.at>  
Erste Bank Treasury <http://treasury.erstebank.com>  
Sparkassen <http://www.sparkasse.at>  
ecetra.com <http://ecetra.com>  
Brokerjet <http://www.brokerjet.at>  
Erste Netbanking <http://www.netbanking.at>

## International Organisations

OECD <http://www.oecd.org>  
Internationaler Währungsfond <http://www.imf.org>  
Weltbank <http://www.worldbank.org>

## European Institutions

Europäischer Rat <http://ue.eu.int/de/summ.htm>  
Europäische Kommission  
[http://europa.eu.int/comm/index\\_de.htm](http://europa.eu.int/comm/index_de.htm)  
Europäisches Parlament <http://www.europarl.eu.int/home/>  
Europäischer Gerichtshof <http://curia.eu.int/de/index.htm>

## Statistical Offices

Europa Eurostat <http://europa.eu.int/comm/eurostat/>  
Dänemark Denmark Statistics <http://www.dst.dk>  
Deutschland Statistisches Bundesamt <http://www.destatis.de/>  
Finnland Statistics Finland <http://www.stat.fi>  
Frankreich I.N.S.E.E. <http://www.insee.fr>  
Irland Central Statistics Office <http://www.cso.ie>  
Italien Istituto Nazionale di Statistica <http://www.istat.it>  
Luxemburg Service Central de la Statistique <http://www.statec.lu>  
Niederlande Central Bureau vor de Statistiek <http://www.cbs.nl>  
Österreich Österreichisches Statistisches Zentralamt <http://www.statistik.at>  
Portugal Instituto Nacional des Estatistica <http://www.ine.pt>  
Schweden Statistics Sweden <http://www.scb.se>  
Spanien Instituto Nacional de Estadistica <http://www.ine.es>  
UK Office for National Statistics <http://www.statistics.gov.uk>

## Central banks

Euroland Europäische Zentralbank <http://www.ecb.int>  
Belgien Nationale Bank van België <http://www.bnb.be>  
Dänemark Danmarks Nationalbank <http://www.nationalbanken.dk>  
Deutschland Deutsche Bundesbank <http://www.bundesbank.de>  
Finnland Suomen Pankki <http://www.bof.fi>  
Frankreich Banque de France <http://www.banque-france.fr>  
Italien Banca d'Italia <http://www.bancaditalia.it>  
Luxemburg Banque Centrale du Luxembourg <http://www.bcl.lu>  
Niederlande De Nederlandsche Bank <http://www.dnb.nl>  
Österreich Oesterreichische Nationalbank <http://www.oenb.at>  
Portugal Banco de Portugal <http://www.bportugal.pt>  
Spanien Banco de España <http://www.bde.es>  
Schweden Sveriges Riksbank <http://www.riksbank.se>  
UK Bank of England <http://www.bankofengland.co.uk>  
Schweiz Bank for International Settlements <http://www.bis.org/>

## Stock exchanges

Wiener Börse AG <http://www.wienerboerse.at>  
Deutsche Börse AG <http://www.deutsche-boerse.com>  
LIFFE <http://www.liffe.com>  
Matif <http://www.matif.fr>

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