

CESEE Update – July 2010

Next issue: October 2010

CURRENCY	EUR exchange rate				3m Interbank rate (bps)				5y gv bond YTM (bps)				CDS (5y USD)
	21.07.10	31.12.09	Perf.10	Perf.09	21.07.10	31.12.09	Perf.10	Perf.09	21.07.10	31.12.09	Perf.10	Perf.09	21.07.10
EUR					0,88%	0,70%	18	-219	1,62	2,42	-80	11	
CZK	25,33	26,32	3,89%	1,65%	0,84%	1,26%	-42	-197	2,81	3,31	-50	-51	96
HUF	284,15	270,35	-4,86%	-2,52%	5,32%	6,19%	-87	-381	7,55	7,80	-25	-175	360
HRK	7,24	7,31	1,01%	0,76%									318
PLN	4,09	4,10	0,32%	0,27%	3,62%	4,07%	-45	-161	5,42	5,91	-49	58	146
RSD	104,91	95,88	-8,61%	-6,68%	10,53%	10,84%	-31	1084	-	-	-	-	275
RON	4,26	4,24	-0,51%	-5,26%	6,71%	10,15%	-344	-374	7,90	10,75	-285	75	386

* Local Currency; RS: € ; SK: 4y; bps: basis points

Source: Thomson Reuters

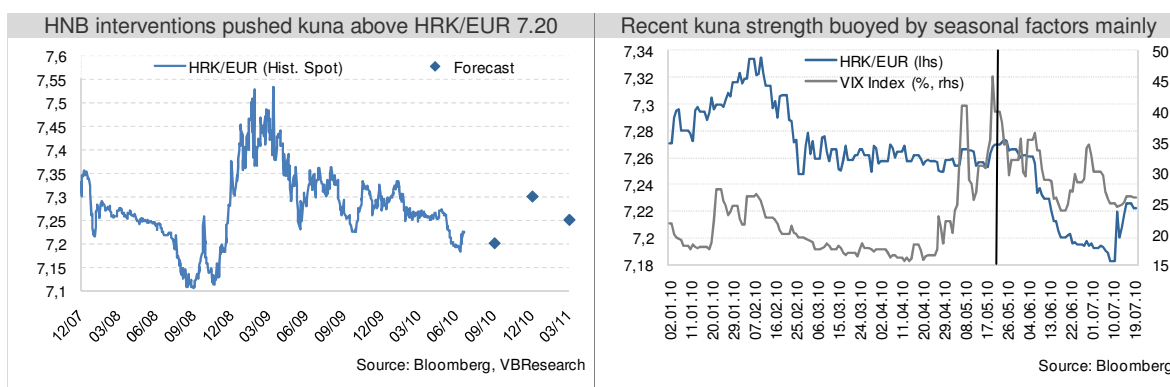
CROATIA

Long-term foreign currency rating and outlook

Baa3 (stable) (Moody's)	BBB (negative) (S&P)	BBB- (negative) (Fitch)
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Fluctuating in the familiar HRK/EUR 7.24-7.28 region during the March-May period, the **Croatian kuna appreciated slightly** since our *SEE Quarterly Q2 2010* was published in end-May. Until the deadline of this publication on July 20, the currency gained around 0.5% against the euro.

Supported by the (approaching) tourist season, solid FX-linked T-bill issuance and further trade balance adjustment (-14% y/y in April with exports +4% y/y and imports -5% y/y), the Croatian unit even **undershoot the HRK/EUR 7.20** threshold in mid-July. In line with our expectations this triggered the HNB to intervene on the local FX market, as the central bank is still committed to reduce short-term volatility and fears that premature currency strength could stall the nascent, export-led recovery. Indeed, **economic recovery remains sluggish with GDP recording a -2.5% decline in Q1 2010**. On top of that, disappointing April industrial production (-6.6% y/y) and retail trade figures (-8,0% y/y) suggest very fragile developments, at least for Q2 2010. In addition, rising fiscal concerns and the likely slowdown of the EU recovery imply increased downward risks to our -1% full-year (FY) 2010 GDP forecast, increasing the likelihood of a downward revision towards -1.5%.



Nevertheless, after the HNB recently purchased a total of EUR 363.4 mn in three moves to tame kuna gains, the exchange rate weakened above the HRK/EUR 7.20 threshold. In the coming weeks, we see the **HRK/EUR stabilizing in the 7.18-7.23 band**, as the kuna should continue to be supported by the tourist season, lower corporate FX demand and the adjusting trade balance. Moreover, given competitiveness concerns and the comfortable inflation outlook, the HNB seems to remain comfortable with its dovish stance, thus we do not anticipate a monetary policy change.

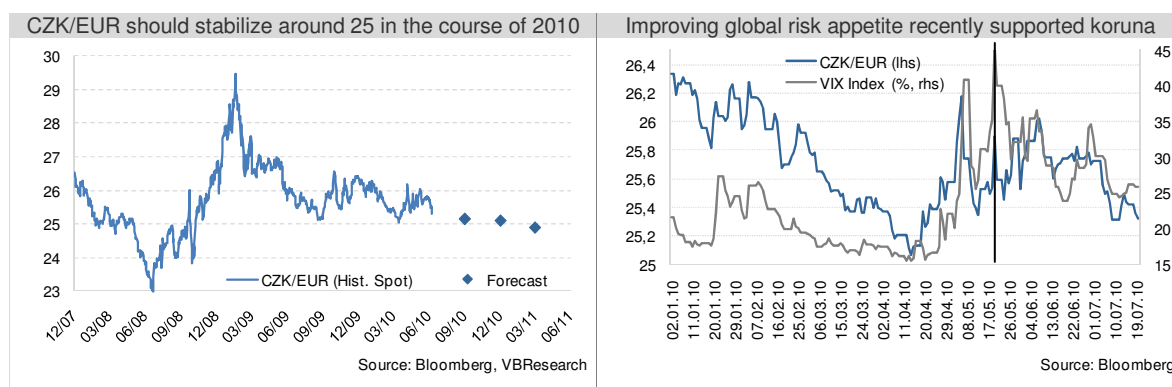
CZECH REPUBLIC

Long-term foreign currency rating (and outlook)

A1 (stable) (Moody's)	A (stable) (S&P)	A+ (positive) (Fitch)
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In the time frame between the end of May 2010 (publication date of our *CEE Quarterly Q2 2010*) and the deadline of this publication, the **Czech koruna entered a gradual appreciation path** amid heightened volatility. Standing at CZK/EUR 25.35 on July 20, the currency gained nearly 1.5% against the euro in that period.

After mounting concerns on the Greek / European sovereign debt crisis took a heavy beating on the domestic currency and pushed CZK/EUR to above 26.1 in mid-May, the **local unit started to appreciate gradually** in the following weeks. Since the CZK/EUR cross uses to react very sensitive to changes in global / regional sentiment (indicated by the VIX index in the chart below), the improving level of global risk appetite helped the Czech unit to strengthen to **below CZK/EUR 26.4 most recently**. At the same time, some not everyday domestic factors lent additional support: First, the **surprising victory of the Czech Right** in early-June and the announcement of an impressive array of reforms in early-July. Second, Q1 2010 GDP numbers were revised upwards to +1.1% y/y and +0.5% q/q (from +0.2% q/q). In terms of Q2 2010 growth expectations, we anticipate no major change in the story, as inventories and exports should be the main drivers (June PMI index underlines the continued expansion of the Czech economy). Finally, the **current account surprised on the upside**, mainly due to much lower dividend outflow than expected.



Looking ahead, we continue to expect a slightly **strengthening exchange rate in the remainder of 2010**. Assuming the anticipation of a gradual widening of the interest rate differential versus the Eurozone from end-2010 onwards (Czech base rate was kept unchanged at an all-time low of 0.75% in June), the Czech unit should benefit from that, as well as from the country's **trade surplus, low foreign-debt obligations and a possible rating upgrade**. Factors that could push the koruna toward a weaker position, though, include global and regional effects from CEE (particularly Poland and Hungary). All in all, a sustained favourable level of risk appetite – driven by the assessment of the European sovereign debt crisis – is a crucial assumption to our outlook.

HUNGARY

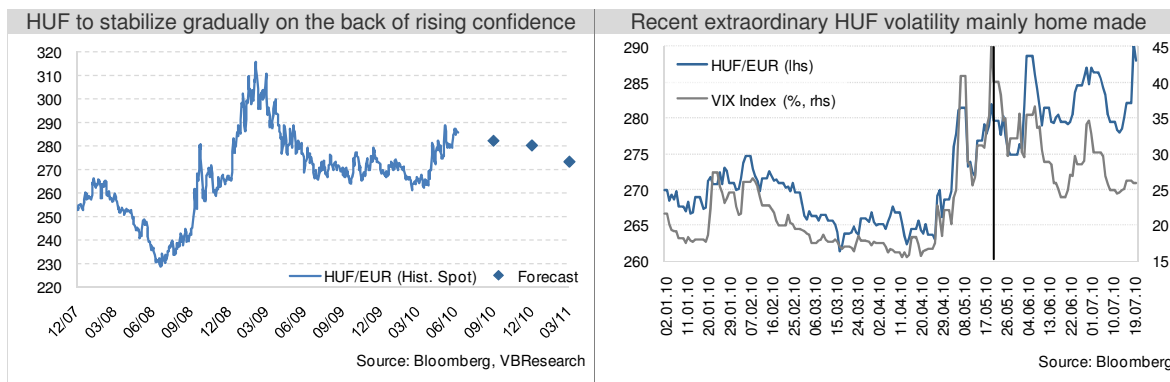
Long-term foreign currency rating (and outlook)

Baa1 (negative) (Moody's)	BBB- (stable) (S&P)	BBB (negative) (Fitch)

Since our last *CEE Quarterly Q2 2010* published on May 20, the Hungarian **forint took a roller-coaster ride**, fluctuating in a wide range between HUF 270-290 / EUR. This was mainly due to external factors, but also to uncertainties surrounding the new government's economic policy agenda and its feasibility respectively. Amid high market nervousness, the domestic currency lost around 3% against the euro until July 20.

Following a sharp drop in mid-May caused by mounting concerns on the European sovereign debt crisis, the forint started to appreciate in late-May, thanks to improving global sentiment. Subsequently, prominent leaders of the new ruling party Fidesz stated that Hungary might only narrowly avoid a **Greek-style scenario, pushing the Hungarian currency close to HUF/EUR 290**. After this turmoil, however, markets were calmed by a significant change in the communication and a new economic programme presented by PM Orbán. Due to the **commitment of the new government to keep the 2010 budget deficit target of -3.8% of GDP** the Hungarian currency pared some of its losses. In mid-June, though, the local currency slid against both the EUR and CHF, after consolidating at around 280 vs. the euro. The depreciation can be attributed to the gloomy investor sentiment, but the not yet fully repaired credibility created by the government communication turmoil and the high **Swiss franc indebtedness** of the domestic economy have also played a role. Following a temporary firming in mid-July, the forint weakened to 290/euro again on the back of the collapse of the IMF/EU talks conducted in order to agree on a new credit facility for the period after the current one expires in October. Most recently, however, the **government affirmed its com-**

mitment to the 2010 budget deficit target of -3.8% agreed with the international lending community, helping the forint to gain ground against the euro (HUF/EUR 286).



On a three months horizon **risk assessment and progress in implementing the announced reforms** should be the main drivers for the exchange rate. The relatively favourable developments on the fundamental side should not be in the limelight in the coming weeks, but should, at the same time, not pose any meaningful risks to the exchange rate. On balance, we anticipate high market volatility to continue with the return of the IMF mission – expected for September/October – being crucial. Against this background and our expectation of dwindling doubts in terms of the feasibility of the budget deficit target, we see a **stabilizing HUF/EUR rate as the year progresses**.

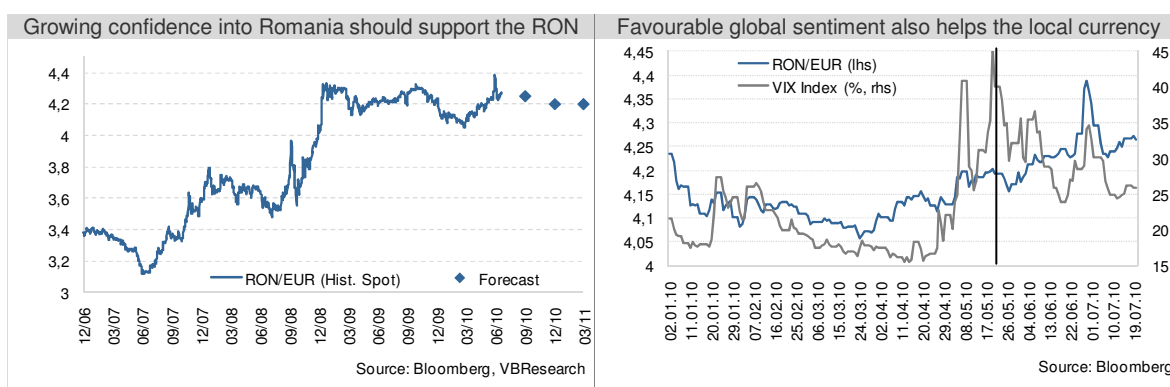
ROMANIA

Long-term foreign currency rating (and outlook)

Baa3 (stable) (Moody's)	BB+ (stable) (S&P)	BB+ (stable) (Fitch)

Since the publication of our *SEE Quarterly Q2 2010* (end of May), the **Romanian leu entered a gradual depreciation path amid high volatility**, mainly on the back of difficulties regarding the implementation of fiscal austerity measures. Until the deadline of this analysis (20th of July), the leu weakened by around 1.7% against the euro and arrived at RON/EUR 4.27.

On top of the global developments – possibility of a global double dip scenario and risks stemming from the European sovereign debt crisis – domestic issues came on the agenda at the beginning of June. Just as the **2010 outlook for economic recovery worsened**, fiscal reforms are of paramount importance for keeping the agreement with the IMF and EC on track. The 2010 deficit target agreed with the IMF is at -6.8% of GDP, while in a scenario consistent with no action from the Romanian authorities, it would increase to around -9% of GDP.



Against this backdrop, the government presented the **fiscal consolidation reforms** in early-June including a 25% cut in public wages, a 15% cut in pensions and other social allowances. In terms of the feasibility of the harsh austerity package, the fact that a favourable resolution of the Constitutional Court was needed, exerted considerable depreciation pressures on the exchange rate. And indeed, doubts were legitimate: At the end of June, the **Constitutional Court decided that the cuts are illegal**, triggering a huge negative reaction on the financial markets with the **RON weakening sharply to an all-time low of 4.40** (companies and households started to convert their

RON-denominated deposits into FX deposits). In the meantime, the government was forced to look for alternatives and decided to hike the VAT to 24% (+5pp). Finally, mainly thanks to the disbursement of the **fifth IMF loan tranche worth EUR 0.9 bn** and the NBP decision to keep the **key rate at 6.25% unchanged**, the RON entered a strong appreciation trend in July and returned to the 4.30/EUR region again, even approaching the RON/EUR 4.20 support zone.

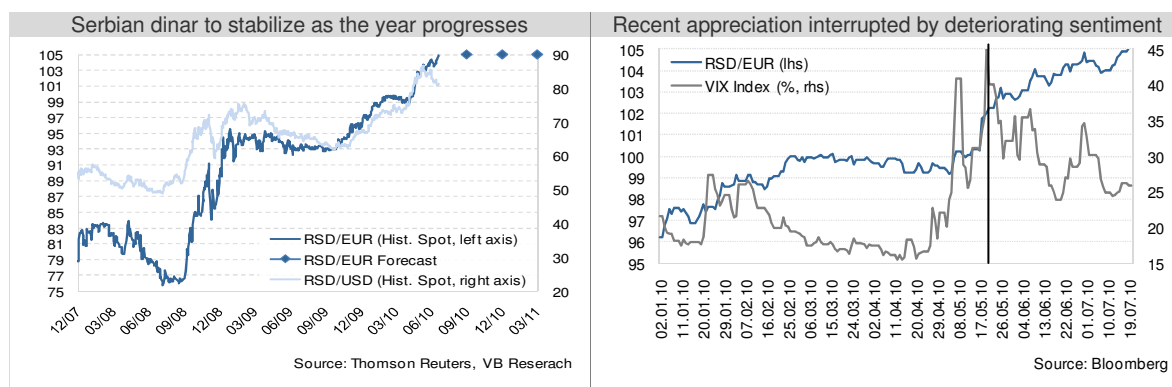
The easing bias of the central bank puts continued downward pressure on the leu, as further rate cuts – depending on the risk assessment of the Romanian economy – cannot be ruled out in H2 2010. In addition, Romania's **lagged exit from the current recession** is likely to weigh further on the outlook (we revised our GDP projection considerably downwards from -1.0 to -3.0% y/y). On the other hand, growing confidence in the austerity measures, more favourable growth perspectives in the medium term, the end of monetary loosening and the anticipated stabilization of the C/A deficit should be supportive for the domestic currency as the year progresses. Furthermore, we anticipate the IMF program to remain well on track. On balance, we expect the leu to quote **more or less unchanged around 4.2 / euro in Q3 2010**, before appreciating slightly in Q4 2010 again. As always, a favourable level of risk appetite is an inevitable assumption to our forecast with the European sovereign debt crisis currently in focus – posing substantial contagion risk to countries with deep fiscal gaps – like Romania.

SERBIA

Long-term foreign currency rating (and outlook)

Moody's	S&P	Fitch
--	BB- (stable)	BB- (negative)

The Serbian dinar **continued to experience severe depreciation pressures** since our last *SEE Quarterly Q2 2010* was published in late May. The Serbian unit fell from one all-time-low to another, depreciating by more than 3% against the European single currency in that time frame and approximately 8% year-to-date (YTD).



The dinar-euro rate continued its downward movement in June/July and still forced **the NBS to spend considerable sums of FX reserves** in an attempt to curb the stubborn depreciation trend. So far, the central bank has sold EUR 1.51 bn since the start of 2010 and recently reported that its currency reserves fell by EUR 238.1 mn to EUR 10.49 bn in June, mainly due to its FX intervention strategy. On balance, however, interventions were not successful to stem the dinar fall, but are likely to have limited the degree. The ongoing weakening of the Serbian unit against the euro is mainly due to **monetary easing**: Following a 1.5 percentage points in cuts between March and May in order to tame prices and a sluggish economic recovery, the NBS left its key policy rate at 8% at its last policy meetings. The NBS is facing the dilemma that a rate rise could harm economic recovery, while a rate cut would further weaken the dinar, which, in turn, burdens the highly FX indebted private sector. On top of that, economic recovery turned out to be more sluggish than anticipated with the 0.6% Q1 2010 GDP coming in below earlier official estimates of 1%, another unfavourable factor for the dinar. Still, **potential spillover risks from Greece** are lingering: While Serbia's trade links are small and Greek bank subsidiaries account for around 15% of Serbia's banking assets, the exposure of their parent banks in direct cross-border lending to Serbian corporates raises concerns.

Apart from NBS interventions, factors that should have decelerated the pace of the dinar slide were the **approval of the USD 472.9 mn disbursement** from the IMF in late-June (so far, about USD 2.22 bn from the total USD 4 bn financial support) and the **favourable development of external**

balances (Q1 2010 C/A deficit plunged by -21% y/y). On the political scene – good news use to have a significant impact on investors' sentiment, and, in turn, on the exchange rate – months after Radovan Jelasic's resignation the **nomination of Dejan Soskic as the new central bank chief** was welcomed by the markets. Furthermore, Serbia took an important step forward on the road to joining the EU, with EU governments rewarding its improved cooperation with the U.N. war crimes tribunal for former Yugoslavia. EU foreign ministers agreed to start **implementing an accord with Serbia known as the Stabilisation and Association Agreement (SAA)**, a prerequisite of any further assessment of a country's prospects for membership.

Looking ahead, we assume that the NBS could tighten monetary conditions as early as September, as keeping rates on hold is a signal that the bank is satisfied with the exchange rate. However, it will be reluctant to raise interest rates too soon, as the economy only emerged from recession in the first quarter. Against this background, we believe that the **dinar should stabilize against the euro during the months to come around its current levels**. Delays in privatization (privatization of public Telekom shares expected for this autumn) and lower than anticipated FDI, as well as possible contagion from the EMU debt crisis argue for some risks of further RSD depreciation. Nonetheless, with sufficient FX reserves, including the latest IMF tranche, the **NBS still has plenty of firepower** to prevent the dinar from sliding too much, but, on the other hand cannot hold the 105 dinars per euro barrier forever. This has also been underlined by Prime Minister Cvetkovic, who stated that the dinar is not expected to be a major problem in the near future and that Serbia will not defend the currency at any cost.

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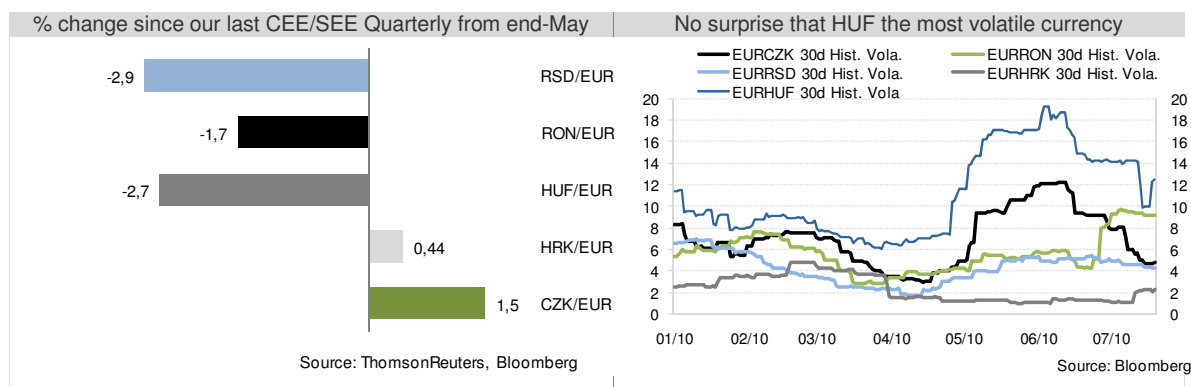
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Appendix

Summary	Current -- 21.07.2010	Q3 2010 (eop, f)	2010 (eop, f)	Q1 2011 (eop, f)
CZK/EUR	25,3	25,2	25,1	24,9
HRK/EUR	7,24	7,20	7,30	7,25
HUF/EUR	284	282	280	273
RON/EUR	4,26	4,25	4,20	4,20
RSD/EUR	105	105	105	105

eop: end of period; f: forecast

Source: ThomsonReuters, VBRResearch



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