

# New Europe Weekly

23-27 February 2009

Investment research

## Key events in the coming week

- *Lithuanian industrial production (IP) continues to fall sharply. We expect January's IP to contract by 10.0%, down from December's -4.4% y/y, cf. page 4*
- *We expect the Hungarian central bank to keep the key policy rate on hold at 9.50%*
- *South African Q4 GDP and CPI for January are due for release, cf. page 6*
- *We expect the Polish central bank to cut key policy rate by "only" 25bp to 4.00%, cf. page 3*
- *Retail trade numbers for January due for release in Lithuania and Latvia, cf. page 4*

## Coordination? Anybody?

This week the crisis in the CEE markets has intensified dramatically after the publication of a number of reports putting a negative focus on Western European banks' exposure to the overly leveraged CEE economies.

The crisis is clearly developing in an explosive fashion and there is a very clear risk of an Asian crisis style meltdown. The economies in the region are already in free fall, and at least one country - Ukraine - is dangerously close to sovereign default. Rapidly rising concerns have led policy makers across Europe to call for immediate action to avoid a dangerous collapse that potentially could spill into the euro zone. However, policy makers seem very divided on what to do in the current situation.

Earlier this week Lithuanian Prime Minister Andrius Kubilius called for coordinated action from the EU to try to solve the problems in CEE. Later in the week the World Bank's president Robert Zoellick echoed Kubilius' cry for help.

However, the EU Commission does not seem very excited about a coordinated effort to avoid meltdown. Rather Joaquín Almunia, EU monetary affairs commissioner, this week said that he would prefer a country-by-country approach to crisis management.

In our view, a country-by-country approach to crisis management entails a number of risks, as there is a strong potential for contagion from one CEE country to another due to the significant integration in the financial sector across the region. Therefore, we think that there is urgent need for a more coordinated effort to stabilise the situation- otherwise this crisis will drag out and uncertainty remain elevated for an extended period.

# Calendar – week 9

## EMEA Data and Events in Week9

Monday, February 23, 2009				Period	Danske Bank	Consensus	Previous
EEK	8:00	Trade balance	bn. EEK	Dec			-3.1
LTL	10:00	Industrial production	y/y	Jan	-10.0%		-4.4%
HUF	14:00	Central Bank meeting (rate decision)			9.50%	9.50%	9.50%
Tuesday, February 24, 2009				Period	Danske Bank	Consensus	Previous
HUF	9:00	Retail trade	y/y	Dec	-3.0%	-2.5%	-2.0%
PLN	10:00	Retail sales	y/y	Jan	-1.0%	0.1%	6.6%
PLN	10:00	Unemployment	%	Jan	10.2%	10.2%	9.5%
ZAR	10:30	Gross domestic product (annualized, sa)	q/q	4th quarter	-1.8%	-1.4%	0.2%
ZAR	10:30	Gross domestic product (nsa)	y/y	4th quarter	1.5%	1.4%	2.9%
Wednesday, February 25, 2009				Period	Danske Bank	Consensus	Previous
PLN	-	Monetary Policy Council meets			4.00%	3.75%	4.25%
ZAR	10:30	CPI	y/y	Jan	7.5%	7.5%	9.5%
Thursday, February 26, 2009				Period	Danske Bank	Consensus	Previous
ZAR	10:30	Producer prices	y/y	Jan	10.2%	9.6%	11.0%
Friday, February 27, 2009				Period	Danske Bank	Consensus	Previous
HUF	9:00	Unemployment		Jan		8.3%	8.0%
LTL	10:00	Retail trade	y/y	Jan	-16.0%		-8.8%
LVL	12:00	Retail trade	y/y	Jan	-18.0%		-16.9%
ZAR	13:00	Trade balance	bn. ZAR	Jan		-5.5	-1.6
TRY	16:00	Trade balance	bn. USD	Jan		-2.7	-3.6

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 Note that all releases are CET.

**Danske Bank**

## CEE

### Weak CEE currencies influence central bank actions

#### Poland

- This year the sell-off in the Polish zloty has accelerated dramatically and it is now very obvious that the sell-off can no longer be ignored by Polish policy makers. Both the Polish Prime Minister Tusk and a number of Polish central bankers have been saying that the sell-off is excessive.
- The currency's weakness is having an impact on monetary policy through two channels. First, Polish inflation is coming down slower than previously expected, and second the debt servicing costs for Polish households with foreign currency loans is automatically increased, raising concerns over the state of the Polish financial sector.
- In our view, the sell-off in the zloty is likely to prompt the Polish central bank (NBP) to become less aggressive in the monetary easing cycle. Therefore, we now expect the NBP to cut its key policy rate by "only" 25bp to 4.00% at next week's Monetary Policy Council meeting - while the consensus expectation is a cut of 50bp. Furthermore, NBP might signal that is willing to take a "pause" in the monetary easing cycle and maintain its key policy on hold for some months.

#### Hungary

- The Hungarian central bank (MNB) is facing a similar challenge to the Polish central bank, with concerns over the forint's sell-off and a sharp drop in economic activity. We think the MNB will do the natural thing in this environment and that is to wait-and-see and maintain the key policy rate on hold at Monday's Monetary Council meeting.

#### Czech Republic

- Next week will be a rather quiet week in terms of economic data, but surely another busy week in terms of flow of news regarding the concerns over the state of the CEE economies, with the Czech Republic no exception. Due to the lack of economic data in Czech Republic, the main focus will be on developments in the Czech koruna. Last week the koruna, among other CEE currencies, came under strong selling pressure after investors lost confidence in CEE markets on the back of concerns over the deepening recession there and the knock-on effect on European banks. The CZK weakening accelerated so significantly that the Czech central bank (CNB) had to defend the currency with verbal intervention. Furthermore, the CNB board member Vice Governor Miroslav Singer added a day later that if needed he could not rule out another verbal intervention. While talking about the health of the Czech banking sector, Mr Singer said that "according to our calculations, even the current economic decline should not get banks into more serious problems". It is important to mention that due to the banking crises in the 90s, the Czech banks (now owned by the Western banks) implemented rather conservative policies and do not face such a big risk of default like other CEE countries (such as Romania, Hungary but also Poland) where the weakening currencies and large FX loans have significantly raised the risk of default.
- Given the CZK weakness, which we believe is not over yet, the CNB might pause any further monetary easing or perhaps deliver only moderate monetary easing going forward.

# Baltic States

## No good news for the retailers

### Estonia

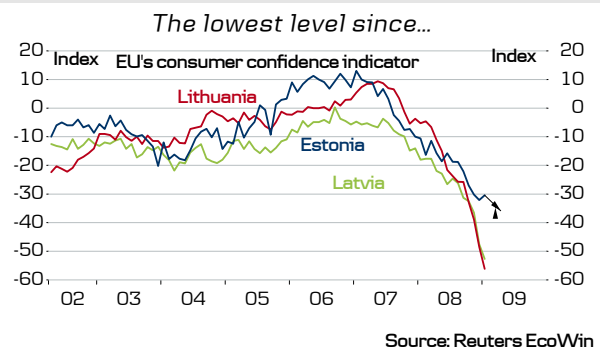
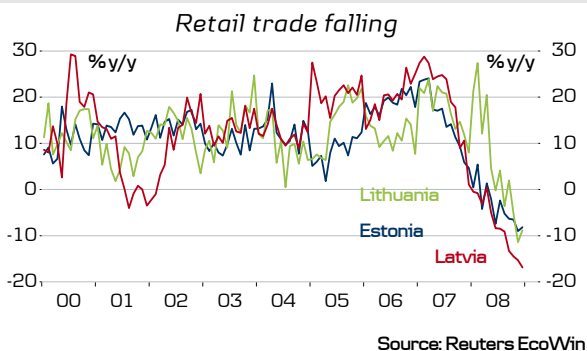
- A rapidly deteriorating labour market and declining consumer confidence have led to increasing pressure on the retail trade. The rising unemployment rate, which by the end of 2008 reached 7.6%, might start to affect the financial balance of households more intensively. The further drop in consumer confidence is an obvious indicator of more pessimism in households' expectations.
- In February the consumer confidence indicator carried out by the Estonian Institute of Economic Research decline to -35, the lowest level for this survey since 1992. The latest data on GDP showed a significant drop in growth (by 9.6% y/y in Q4 08), well below consensus forecast. This could further strengthen negative expectations.

### Lithuania

- We expect retail trade sales to decline almost 16% y/y in January from 8.8% y/y in December. An acceleration in consumer price growth has had a dampening effect on retail trade as well, however we expect this measure to be relatively short-lived. In the coming month we expect retailers would rather compensate for the higher VAT rates from their profits than further raise prices. There was a big decline in the consumption of some goods (such as meat) for which the VAT hike more than doubled. The situation is being exacerbated by the ongoing depreciation of neighbouring country currencies, especially the Polish zloty. Over the last month, turnover in the supermarkets on the border with Lithuania increased by almost 50%.
- We expect industrial production to deteriorate further and could drop 10% y/y in January from the 4.4% decline in December. The manufacturing sector in all three Baltic States has been negatively affected by a deterioration in both internal and external demand, and will continue to fall in the coming months this year as well.

### Latvia

- The Latvian economy is in freefall: retail trade dropped by almost 17% y/y, industrial production by 14% y/y in December. We expect this trend to continue in the retail trade sector; turnover could decline 18% y/y in January on the back of the deteriorating purchasing power, and still extremely negative consumer confidence.



# CIS

## Dreadful economic data released shows bleeding manufacturing sectors

### Russia

- The Russian Economy Ministry expects GDP to drop 2.2% y/y in 2009. One month ago we lowered our forecast to a 3% drop in GDP in 2009 - see [here](#). In general there is still a perception among watchers that Russia will not face a contraction in real GDP for the whole of 2009. However, with the recent economic deterioration in mind, we find this highly improbable.
- Standard & Poor's expects nominal GDP in USD-terms to drop 20% in 2009 (we project a drop of 25-30% in USD-terms).
- This week data showed that industrial production dropped 16% y/y in January. Further wage arrears jumped nearly 50% last month affecting half a million people now. Unemployment is going up rapidly, jumping more than 2.5%-points in half a year, and real wages are now declining for the first time since 1999, on the back of abating wage pressures and persistently high inflation. The number unemployed jumped to 6.1m or 8.1%. Despite governmental efforts to boost employment, by running a fiscal deficit by up to 8.5% of GDP during 2009, unemployment is likely to rise further as the recession kicks in. This could lead to rising social unrest, like in 1998.

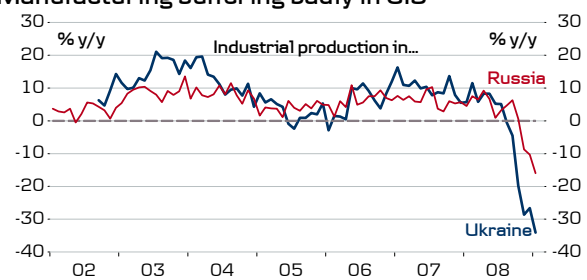
### Ukraine

- The ratings agency Standard & Poor's this week warned Ukraine it could face another ratings cut, saying it distrusted Ukraine's ability to implement a crucial IMF deal. The agency said it could cut Ukraine's B foreign currency rating and B-plus local currency rating by one or more notches.
- Hence Ukraine's commitment to adjust is wavering against a backdrop of contracting growth, especially in the manufacturing sector (industrial production dropped an exorbitant 34.1% y/y in January), and the upcoming presidential elections in January 2010. Recently an IMF mission failed to sign off on a first review of Ukraine's performances under the USD 16.4bn [IMF programme](#) during a recent visit, sparking fears of non-implementation. Ukraine says it may approach other countries including Russia for additional financial help.
- S&P said it was awaiting the government's clarification on the IMF programme before deciding on the rating and warned the economy faced growing refinancing risks. We share the agency's concerns, and we fear that the Ukrainian administration has not fully realised the urgent need to tighten fiscal policies, as required by the IMF stand-by agreement.
- Data earlier this week showed that Ukraine's trade deficit nearly doubled in 2008 from the previous year. Rising fears over external balances pose a key risk for the hryvnia (UAH). We expect the currency to plunge even more going forward.

Labour markets conditions worsen in Russia



Manufacturing suffering badly in CIS



Source: EcoWin, Reuters

# EMEA

## Further slowdown of the South African economy

### Turkey

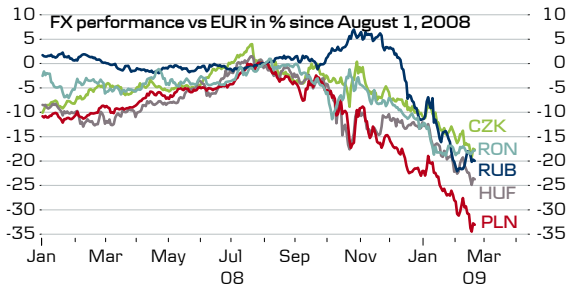
- At its latest monetary policy meeting, the Turkish central bank (TCMB) cut its key policy rate (the borrowing rate) by a whopping 150bp to 11.50% and its less important lending rate by 150bp to 14.00%. The bank's decision was more aggressive than our expectation of a 100bp cut and the consensus expectation of a 50bp cut. The borrowing rate has now been lowered by 525bp since November from 16.75% to 11.50%.
- Even though aggressive rate cuts can be justified on macroeconomic grounds and lower inflation, we nonetheless believe that the TCMB by such aggressive monetary easing has now jeopardised the stability for the lira going forward. Furthermore, there is a lot of concern about developments in the CEE markets, which have been tumbling in recent weeks, on the back of fears over external imbalances. This sell-off has thus far not affected the Turkish financial markets to a very large extent. However, there is a risk that it might do so in the coming weeks. **Overall, we recommend reducing exposure towards Turkish markets. The lira could weaken significantly and Turkish rates have fallen aggressively in recent months, and are probably very close to a bottom.**

### South Africa

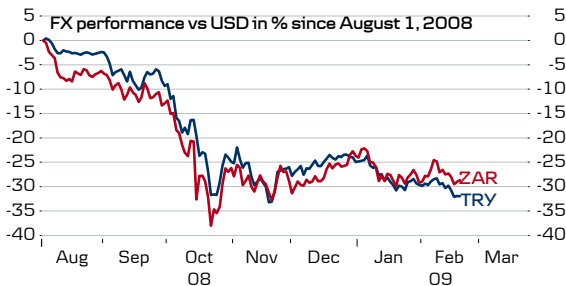
- Plenty of important economic data such as Q4 2008 GDP numbers, inflation and producer prices for January are due for release next week. To give a quick glance where the South African economy stands - an ongoing deterioration in economic activity and further slowdown in the inflation rate.
- The Q4 GDP numbers will be the centre of interest next week. We expect real economic growth to ease substantially further in Q4 to -1.8% q/q (seasonally adjusted and annualised) down from 0.2% q/q in Q3 2008. Consensus forecast expects real GDP growth in Q4 to drop by -1.4% q/q - hence slightly better than our forecast. We expect annual GDP growth at 1.5% y/y in Q4, down from 2.9% y/y in Q3. Consensus expects annual growth in Q4 of 1.4% y/y. The main culprit is the persistent deterioration in the mining, manufacturing, retail and wholesale sectors. The fiscal policy of the government with large spending on infrastructure should be the main economic driver going forward.
- The good news is that inflation will continue to head downwards. Our forecast for CPI inflation for January (the new re-weighted and re-based CPI index effective from January 2009) is for a further drop to 7.5% y/y (down from December's 9.5%), which is in line with the consensus forecast.
- A sharply deteriorating economic outlook and falling inflation have prompted the first 50bp interest rate cut in December last year. Since then the South African central bank (SARB) continued the monetary policy easing and very likely will continue to do so as long as it does not result in undue weakness in the rand. However, we do not anticipate too aggressive monetary easing, and expect the key policy rate to bottom out at 8.00%. We expect the SARB to cut the key policy rate by yet another 100bp at its next Monetary Policy Committee Meeting (MPC) scheduled for April 16. This would bring the key policy rate down to 9.50%.

# FX update

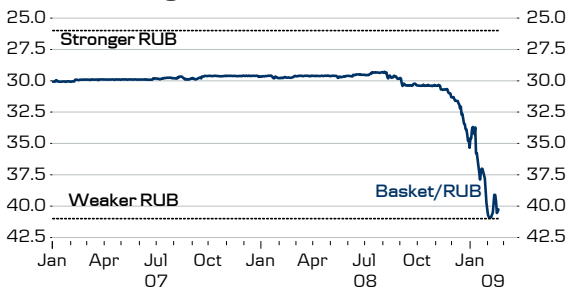
## CEE currencies remain under pressure



## TRY could weaken more on aggressive rate cut



## RUB heading towards weak end of the band



Source: Ecwin, Reuters - updated 19 February 2009

## Another bloody week

### CEE FX: The central banks fight weakening currencies

The week was one of the toughest for the CEE currencies for a very long time. It went so far that some of the central banks in the CEE region made public announcements in an attempt to stop the freefall of their currencies amid financial meltdown of all CEE currencies on the back of concerns over the region's economies and financial sectors.

The latest economic numbers showed that the economic slowdown might be even more pronounced in many of the CEE countries. For instance Polish industrial production in January came out much worse than expected, outlining that the GDP contraction will be much steeper.

A grim economic outlook, bearish mood towards the region and fears of an Ukrainian default have significantly raised the risk of default on oversized foreign currency loans.

Unfortunately the currency markets are not distinguishing between those countries where the concerns over external financing and the banks' health are well-founded, and those where the banking sector is in fairly good shape, e.g. the Czech Republic.

# FX forecasts

Currency Forecast, New Europe/EMEA						
Feb -20 , 2009		EUR	USD	SEK	NOK	DKK
USD	Actual	1.26	-	876.9	693.4	591.1
	+3m	1.24	-	887	685	601
	+6m	1.26	-	841	659	591
	+12m	1.30	-	754	631	574
PLN	Actual	4.78	3.79	231.2	182.8	155.9
	+3m	4.80	3.87	229	177	155
	+6m	4.90	3.89	216	169	152
	+12m	4.95	3.81	198	166	151
HUF	Actual	305.0	242.0	3.62	2.86	2.44
	+3m	315	254	3.49	2.70	2.37
	+6m	325	258	3.26	2.55	2.29
	+12m	330	254	2.97	2.48	2.26
CZK	Actual	28.9	23.0	38.2	30.2	25.7
	+3m	29.5	23.8	37.3	28.8	25.3
	+6m	30.0	23.8	35.3	27.7	24.8
	+12m	30.5	23.5	32.1	26.9	24.5
EEK	Actual	15.6	12.4	70.6	55.8	47.61
	+3m	15.7	12.6	70.3	54.3	47.6
	+6m	15.7	12.4	67.7	53.0	47.6
	+12m	15.7	12.0	62.6	52.4	47.7
LVL	Actual	0.71	0.56	1564.1	1236.7	1054.3
	+3m	0.70	0.56	1571	1214	1064
	+6m	0.70	0.56	1514	1186	1064
	+12m	0.70	0.54	1400	1171	1066
LTL	Actual	3.45	2.74	320.1	253.1	215.8
	+3m	3.45	2.78	319	246	216
	+6m	3.45	2.74	307	241	216
	+12m	3.45	2.65	284	238	216
RON	Actual	4.27	3.40	258.0	204.0	173.9
	+3m	4.80	3.87	229	177	155
	+6m	5.00	3.97	212	166	149
	+12m	5.10	3.92	192	161	146
BGN	Actual	1.96	1.55	564.8	446.6	380.7
	+3m	1.96	1.58	563	435	381
	+6m	1.96	1.55	542	425	381
	+12m	1.96	1.50	501	419	382
TRY	Actual	2.15	1.71	513.7	406.2	346.3
	+3m	2.25	1.81	489	378	331
	+6m	2.35	1.87	451	353	317
	+12m	2.40	1.85	408	342	311
RUB	Actual	45.4	36.1	24.3	19.2	16.4
	+3m	50.3	40.6	21.8	16.9	14.8
	+6m	53.4	42.4	19.8	15.5	13.9
	+12m	57.2	44.0	17.1	14.3	13.0
UAH	Actual	10.62	8.45	103.8	82.1	70.0
	+3m	11.78	9.50	93	72	63
	+6m	12.60	10.00	84	66	59
	+12m	13.00	10.00	75	63	57
ZAR	Actual	12.85	10.22	85.8	67.9	57.8
	+3m	13.64	11.00	81	62	54.6
	+6m	14.18	11.25	75	59	52.6
	+12m	14.95	11.50	66	55	49.9

Source: Bloomberg and Danske research forecasts

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