

# New Europe Weekly

29 September - 6 October 2008

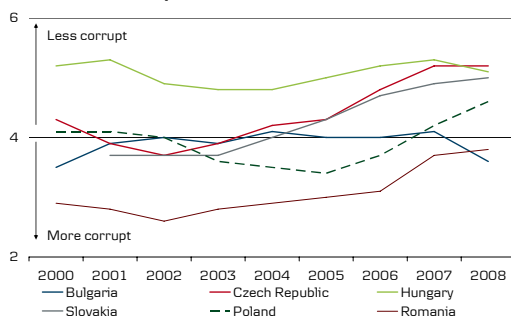
Investment research

## A lot of good news for CEE

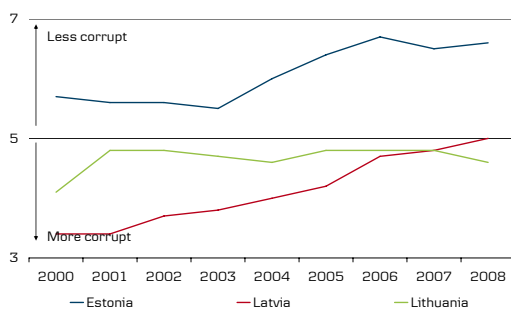
Corruption perception Index	
Country/Year	00 01 02 03 04 05 06 07 08
Estonia	5.7 5.6 5.6 5.5 6.0 6.4 6.7 6.5 6.6
Czech Republic	4.3 3.9 3.7 3.9 4.2 4.3 4.8 5.2 5.2
Hungary	5.2 5.3 4.9 4.8 4.8 5.0 5.2 5.3 5.1
Latvia	3.4 3.4 3.7 3.8 4.0 4.2 4.7 4.8 5.0
Slovakia	3.5 3.7 3.7 3.7 4.0 4.3 4.7 4.9 5.0
Lithuania	4.1 4.8 4.8 4.7 4.6 4.8 4.8 4.8 4.6
Poland	4.1 4.1 4.0 3.6 3.5 3.4 3.7 4.2 4.6
Romania	2.9 2.8 2.6 2.8 2.9 3.0 3.1 3.7 3.8
Bulgaria	3.5 3.9 4.0 3.9 4.1 4.0 4.0 4.1 3.6
Ukraine	1.5 2.1 2.4 2.3 2.2 2.6 2.8 2.7 2.5
Russia	2.1 2.3 2.7 2.7 2.8 2.4 2.5 2.3 2.1

Source: Transparency International. Scores are from 1-10, where one/ten indicates high/low degree of corruption.

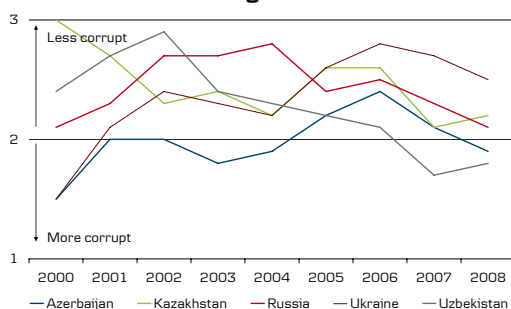
## Structural improvements are visible in CEE



## Estonia and Latvia advances



## CIS sinking even lower



## Corruption becoming less widespread in CEE

This week, Transparency International, the world's leading organisation addressing corruption, published its annual Corruptions Perceptions Index (CPI)

Although we recognise that corruption is still an issue in Central and Eastern Europe (CEE), a lot of improvements have occurred over the last decade, at least in the Baltic States and the Visegrad countries - Poland, Hungary, Czech Republic and Slovakia, and to some extent Romania.

Since last year's report, Poland achieved the biggest improvements, according to Transparency International. Countries like Estonia, Latvia, Slovakia and Romania advanced a little, while the degree of corruption seems to be rising a little in Hungary and quite a lot in Bulgaria.

Overall the development has been very positive in CEE and the Baltic countries over the last decade. It is encouraging for the longer term outlook for the region that corruption is being tackled; this improves the business climate, which in turn should be supportive for much needed foreign investment into the region.

In the former Soviet states (CIS-countries) the story is quite different. The countries there in general receive a very low score, and the development is going in the wrong direction too.

From 2007 to 2008, Russia has dropped four places down the overall corruption list, and is now ranked 147 out of the 180 countries that are included in the survey - it is ranked below countries such as Bangladesh and Kenya.

In Russia, the CPI score has in fact fallen back to the levels seen in 2000; this is quiet worrisome as it adds to the string of bad news concerning the business climate in Russia.

# Calendar – week 40

## EMEA Data and Events in Week40

Monday, September 29, 2008			Period	Danske Bank	Consensus	Previous
EEK	-	Current account	2nd quarter			
HUF	9:00	Unemployment	Aug			7.5%
HUF	14:00	Central Bank meeting (rate decision)		7.5%		7.5%

Tuesday, September 30, 2008			Period	Danske Bank	Consensus	Previous
SKK	-	Central bank meeting		4.25%		4.25%
HUF	8:30	Current account	2nd quarter			-1160.0
HUF	9:00	Producer prices	Aug			3.7%
LTL	10:00	GDP	2nd quarter	5.3%		6.4%
LVL	12:00	Retail trade WDA	Aug	-7.0%		-8.5%
ZAR	13:00	Trade balance	Aug			-14.3
PLN	14:00	Current account	2nd quarter			-4038

Wednesday, October 1, 2008			Period	Danske Bank	Consensus	Previous
EEK	8:00	Retail Trade	Aug	-3.2%		-3.0%

Thursday, October 2, 2008			Period	Danske Bank	Consensus	Previous
ZAR	11:00	Naamsa vehicle sales	Sep			-30.3%

Friday, October 3, 2008			Period	Danske Bank	Consensus	Previous
CZK	9:00	Trade balance	Aug			7.2
HUF	9:00	Trade balance, final	Jul			-238.6
TRY	16:00	CPI	Sep			11.8%
TRY	16:00	PPI	Sep			14.7%

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Note that all releases are CET.

**Danske Bank**

# FX update

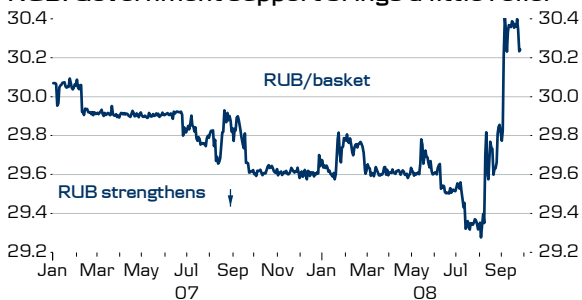
FX vs EUR	Change, %		
	Last week	Last month	Last year
PLN	-0.5	0.0	11.6
HUF	1.4	-1.1	4.6
CZK	-1.4	1.0	11.3
SKK	-0.1	0.1	11.0
RON	-0.3	-4.1	-8.5
RUB	-0.6	-1.0	-3.7
TRY	1.9	-2.7	-3.6
ZAR	-1.2	-4.0	-20.5

Note: Previous day's close. A green (red) cell denotes a strengthening (weakening) of the currency vis a vis EUR by more than two times the standard deviation

FX vs USD	Change, %		
	Last week	Last month	Last year
PLN	1.5	-0.6	14.5
HUF	3.0	-2.2	7.7
CZK	0.8	0.3	14.2
SKK	1.5	-0.8	13.8
RON	2.1	-4.5	-5.0
RUB	1.6	-1.7	-0.3
TRY	4.0	-3.4	-0.2
ZAR	0.8	-4.5	-16.2

Note: Previous day's close. A green (red) cell denotes a strengthening (weakening) of the currency vis a vis USD by more than two times the standard deviation

## RUB: Government support brings a little relief



## UAH: More bad news from rating agencies



## CEE

With all eyes on policymakers in the US, it has been a remarkably quiet week for currencies in CEE. Volumes are very low and so is trading activity ahead of 30. September – end Q3 2008.

Central bank meetings in Poland, Czech Republic and Romania did not affect markets. Most CEE FX-rates have been stable against EUR over the last week. In fact PLN, CZK, HUF and SKK are at the same levels as a month ago against the euro, while the Romanian leu (RON) has underperformed.

We expect CEE FX markets to follow global sentiment in the coming days, but we do not expect much movement ahead of end-Q3. Looking further ahead, we are still bearish on the outlook for especially high-beta currencies like RON and HUF.

## EMEA

We have in recent weeks been advocating that TRY should outperform ZAR. This week we got further confirmation of this, as we received another round of negative news from South Africa. President Mbeki was ousted by his own party, in a move that adds to political uncertainties there. Meanwhile the economy is sinking into an even deeper hole, as a stagflationary scenario currently seems to be playing out. Inflation data, released this week, shows that price growth continues to accelerate – 13.6% y/y (CPIX). Despite inflation being well above the 3%-6% y/y target, 200bp worth of cuts is priced into forward rates on South African markets. Going forward the outlook for TRY and ZAR looks very fragile. However we see more downside for ZAR than TRY in the short run.

## CIS

Government support has brought down money market tensions in Russia – at least temporarily. RUB rebounded roughly 0.5% against its bi-currency basket. Going forward we expect a stable RUB, with some downside risks.

The outlook is much more uncertain for Ukraine, which saw a negative rating action on Thursday, with Fitch cutting Ukraine's outlook to negative. The rating agency warned of rising risks of a currency crisis. We share this view, and see considerable downside potential for the Ukrainian hryvnia (UAH), going forward.

## CEE

### High inflation is still a concern for NBP

#### Poland

- As expected, the Polish central bank (NBP) left its key policy rate unchanged this week at 6% for the third meeting in a row. Following the rate decision, however, the door was left open for further monetary tightening as the NBP is concerned that high inflation – well above target – could increase the risk of second-round effects. The bank said that it could not exclude that bringing inflation back to target in the medium term will require further monetary tightening; however, they will first need to evaluate the effects on the Polish economy of recent monetary tightening. In our view NBP is in a wait-and-see mode at the moment. On one hand, it would like to deliver further hikes to haul down inflation, while, on the other hand the slowing Polish economy does not support further monetary tightening. Finally, the NBP policy rate is currently well above the ECB policy rate, which is not favorable for Polish plans of ERM2 entry and a euro adoption. We expect NBP to keep the key rate unchanged at its next meeting in October. For now NBP will await the inflation projection due in October.
- This week the numbers on Polish core inflation in August came out at 4.0% y/y from 3.5% y/y in July – a bit above our expectation of 3.8% y/y and the consensus expectation of 3.9% y/y. Polish retail sales dropped to 7.7% y/y in August from 14.3% y/y in July – we expected a decline to 12.0% y/y. Going forward we expect Polish inflation to start declining throughout the year and the economy to start slowing.

#### Hungary

- At the Hungarian central bank's (MNB) monetary policy council meeting on Monday next week, we expect the council to keep the key policy rate unchanged at 7.5% for the third consecutive month. Hungarian inflation is likely to have peaked and should finish the year at around 6% y/y and then drop further at the beginning of 2009. At the same time, Hungarian economic growth is still not performing well, although increasing in both Q1 and Q2 08. Going forward the positive outlook on inflation and the lackluster economic growth could form an argument for cutting rates. However, the main unknown variable is the Hungarian forint. If it remains stable there is a chance that MNB will deliver a rate cut in early 2009. For now, however, MNB will probably leave rates unchanged – mainly because of the current stress in global financial markets.

#### Czech Republic

- The Czech central bank (CNB) left the key policy rate unchanged at 3.5% at this week's meeting. However, two members of the CNB board voted for cutting interest rates by 25bp. This is a good indication that the CNB is likely to cut in the coming months – maybe as soon as next month's board meeting.

#### Slovakia

- Slovakia is set to join the euro zone on 1 January 2009 and the Slovakian central bank (NBS) is therefore following ECB and should leave rates unchanged at 4.25% at Tuesday's central bank meeting. This should be a total non event for the markets.

# Baltics

## Bearish growth outlook

### Estonia

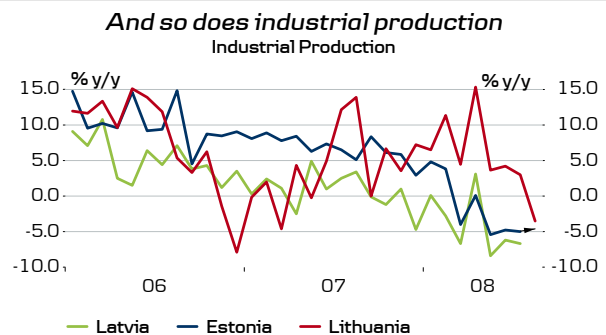
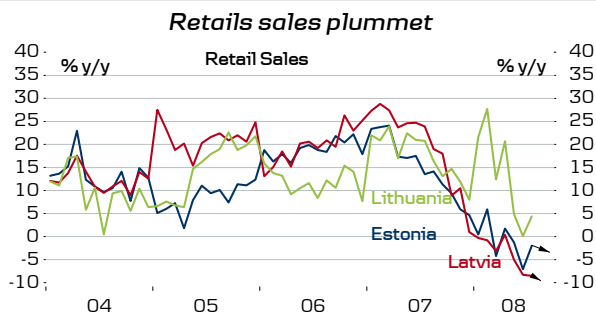
- Next week the Estonian Statistical Office will publish figures for industrial output and retail trade. We expect a further slump in industrial production: 4.7% y/y s.a. in August from 5.2% y/y s.a. in July. Negative consumer confidence indicates that retail trade is cooling down fairly rapidly, thus we expect a continuation of this trend. We forecast retail trade to drop further: 3.2% y/y in August from 3.0% in July. Judging from these data developments, we would expect GDP growth to dip more than 1.0% y/y on average this year.

### Lithuania

- Lithuanian industrial output fell by 3.6% y/y (12.2% excluding the oil industry) in August. This is a clear sign that GDP growth over the H2 2008 will be more subdued compared with the quite robust first half of the year (6.1% y/y). However, Lithuania's growth will decelerate at a slower pace than the other two Baltic countries, which are already in technical recession.
- However, there is some downside risks to the main macroeconomic scenario mainly related to the threat of economic retaliation from Russia after the conflict in the Caucasus.

### Latvia

- Unsurprisingly, Moody's cut Latvia's outlook to negative on the back of the slowdown. It was broadly expected that due to rising global funding costs and a further cooling of the European economy, the Nordic banking expansion to Latvia would decelerate. Moody's forecasted that foreign banks will continue to support their branches, although there is some risk that the government will be forced to provide additional liquidity to the Latvian financial system in any extreme scenario. Nevertheless, Moody's noted that the strength of the government's balance sheet, the structure of the foreign exchange market, and the structure of the banking system (foreign ownership) mean that the situation could be contained.
- We do not expect a quick rebound and have a more pessimistic scenario of Latvia's development over the next couple of years, and look for negative growth in 2008 - 2009. We are more in agreement with the IMF, which is expecting a recovery of the Latvian economy in 2012-2013.



# CIS

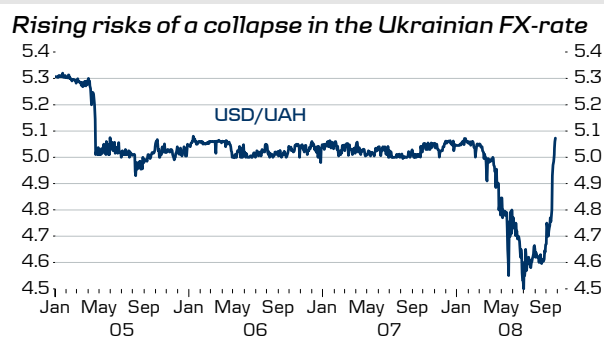
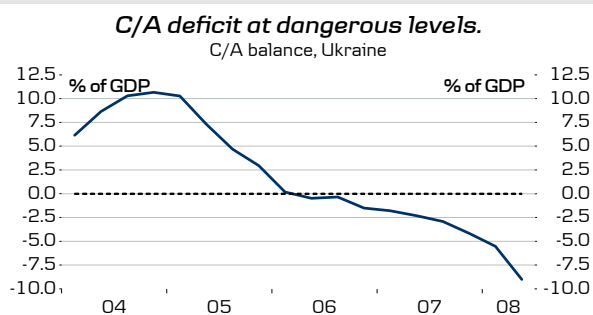
## IMF lowers Russian GDP forecasts for 2008-09

### Russia

- Liquidity in Russia's banking sector has improved this week thanks to a rescue package from the authorities, including plentiful offerings of budget funds for deposits at commercial banks. Money market rates have consequently come down, at least in the short end of the curve. However, market activity is very low.
- Weekly FX-reserves numbers from the Russian central bank (CBR) show that Russia's FX reserves have dropped to USD 559.4bn as of 19 September, down from a peak of USD 597.5bn in the beginning of August. A large bulk of the drop can be explained by falling EUR/USD, but it also reflects large capital outflows as foreign investors lose confidence in the Russian economic model.
- Updated data on inflation shows that Russian consumer prices rose 0.2% in the week to 22 September. Since the start of the month prices have now risen 0.5%. The inflation outlook is not particularly bright, and we expect that it will gradually slow towards 13%-13.5% y/y.
- Going into 2009 we expect the Russian economy to see slower domestic demand. The construction sector in particular looks very fragile with rising funding costs and tighter liquidity. Yesterday IMF lowered its growth forecast for Russian GDP over the next two years: for 2008 to 7.1% y/y from 7.8% y/y (our forecast is 7.0% y/y); and for 2009 to 6.0%-6.5% y/y. We believe that growth could slow even more in 2009 – our estimate for is 5.5%-6.0% with some downside risks.

### Ukraine

- The economic outlook is very uncertain. Yesterday, Fitch revised its credit outlook on Ukraine from stable to negative – citing worries about a possible currency crisis.
- We share Fitch's view – in fact we view Ukraine as the most likely candidate in the CEE for a sharp slowdown in growth going into 2009. The economy is highly imbalanced, the C/A deficit is approaching 10% of GDP, real interest rates are very negative, the political uncertainties are very high, and the risks of an economic retaliation from Russia after the recent Caucasus crisis are very high with gas price hikes very likely.
- In order to retain the stability of FX-reserves and the currency, Ukraine is heavily in need of foreign capital flows. Those will become much harder to get in the current environment. We therefore see a very large downside potential for the Ukrainian hryvnia and markets going forward



# FX forecast

Currency Forecast, New Europe/EMEA						
Sep - 26, 2008		EUR	USD	SEK	NOK	DKK
USD	Actual	1.46	-	664.8	567.9	511.8
	+3m	1.40	-	679	571	533
	+6m	1.35	-	700	585	553
	+12m	1.35	-	696	578	553
PLN	Actual	3.37	2.31	287.7	245.8	221.5
	+3m	3.40	2.43	279	235	219
	+6m	3.40	2.52	278	232	219
	+12m	3.45	2.56	272	226	216
HUF	Actual	240.8	165.2	4.03	3.44	3.10
	+3m	245	175	3.88	3.27	3.04
	+6m	250	185	3.78	3.16	2.98
	+12m	255	189	3.69	3.06	2.93
CZK	Actual	24.4	16.8	39.7	33.9	30.5
	+3m	24.5	17.5	38.8	32.7	30.4
	+6m	25.0	18.5	37.8	31.6	29.8
	+12m	25.3	18.7	37.2	30.9	29.5
SKK	Actual	30.3	20.8	32.0	27.3	24.6
	+3m	30.1	21.5	31.5	26.6	24.8
	+6m	30.1	22.3	31.4	26.2	24.8
	+12m	30.1	22.3	31.2	25.9	24.8
EEK	Actual	15.6	10.7	61.9	52.9	47.68
	+3m	15.7	11.2	60.7	51.1	47.7
	+6m	15.7	11.6	60.4	50.5	47.7
	+12m	15.7	11.6	60.1	49.8	47.7
LVL	Actual	0.71	0.49	1368.3	1168.9	1053.4
	+3m	0.70	0.50	1357	1143	1066
	+6m	0.70	0.52	1350	1129	1066
	+12m	0.70	0.52	1343	1114	1066
LTL	Actual	3.45	2.37	280.7	239.8	216.1
	+3m	3.45	2.46	275	232	216
	+6m	3.45	2.56	274	229	216
	+12m	3.45	2.56	272	226	216
RON	Actual	3.69	2.53	263.0	224.6	202.4
	+3m	3.70	2.64	257	216	202
	+6m	3.80	2.81	249	208	196
	+12m	3.90	2.89	241	200	191
BGN	Actual	1.96	1.34	495.4	423.2	381.4
	+3m	1.96	1.40	486	409	382
	+6m	1.96	1.45	483	404	382
	+12m	1.96	1.45	481	399	382
TRY	Actual	1.81	1.24	536.8	458.6	413.3
	+3m	1.85	1.32	514	432	403
	+6m	1.90	1.41	497	416	393
	+12m	1.95	1.44	482	400	383
RUB	Actual	36.6	25.1	26.5	22.6	20.4
	+3m	35.8	25.6	26.5	22.3	20.8
	+6m	35.0	25.9	27.0	22.6	21.3
	+12m	35.0	25.9	26.9	22.3	21.3
UAH	Actual	7.36	5.05	131.6	112.4	101.3
	+3m	7.42	5.30	128	108	101
	+6m	7.43	5.50	127	106	100
	+12m	7.43	5.50	127	105	100
ZAR	Actual	11.89	8.15	81.5	69.6	62.8
	+3m	11.62	8.30	82	69	64.2
	+6m	11.48	8.50	82	69	65.0
	+12m	11.75	8.70	80	66	63.5

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*New Europe Weekly is updated every week.*

*First date of publication*

*Please see the front page of this research report.*

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