

New Europe Weekly

Latvian devaluation fears

Over the last couple of weeks, fears over a possible devaluation of the Latvian lat have escalated. This has led to a sharp spurt in money market rates, not just in Latvia, but also Estonia and Lithuania. Furthermore, markets are clearly nervous that a possible devaluation in Latvia could spark trouble in other Central and Eastern European markets, which, to a larger or lesser degree, have similar economic imbalances to Latvia.

Why are the markets increasingly pricing in a risk of devaluation in Latvia? In our view the renewed devaluation fears have to be seen in light of both worsening Latvian news flow, and news out of Stockholm. There is little doubt that the very sharp drop in economic activity in Latvia – with GDP down 18% y/y in Q1 – has sparked a debate both inside and outside Latvia as to whether maintaining a peg against the euro is the right policy. This week the IMF is expected to finalise its mission to Riga, after which it will announce whether the fund will pay the next instalment on Latvia's IMF loans, or whether the money will be withheld because the government has failed to make the budget adjustment needed to fulfil the terms in the Standby agreement.

However, the biggest change in market perception of the Latvian situation was not sparked by news out of Riga, but rather by news out of Stockholm. Most important last week was the Riksbanken announcing that it would increase its currency reserves by SEK 100bn. Market participants view this as the Riksbanken's attempt to build a "buffer" against potential problems for the Swedish banking sector stemming from the Baltic crisis.

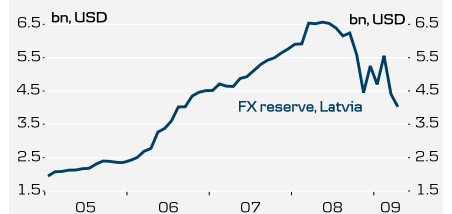
Former Riksbank head, Bengt Dennis, prompted further speculation of a possible devaluation when he said in an interview with Swedish TV this week that it was not a question of *whether or not* there would be a devaluation in Latvia, but rather *when*. Bengt Dennis is highly influential both in Sweden and Latvia – he was central bank governor in 1992 when Sweden was famously forced to give up its fixed exchange rate policy and he is an official advisor to the Latvian government.

Given the news flow out of Riga and Stockholm over the last two weeks, it is no surprise to us that markets now fear a Latvian devaluation more than any time before, and that the situation is becoming increasingly unsustainable. We are crossing our fingers that whatever decision the policy makers in Riga make in the coming weeks, that it will be for the long term benefit of the Latvian economy.

Today's key points

- Busy week in terms of economic data ahead.
- May inflation due for release in many CEE countries such as Czech Republic, Hungary, Romania, Lithuania and Latvia. See page 3-4.
- Final GDP numbers out in Hungary, Czech Republic, Romania, Estonia, Latvia.
- Minutes from the latest monetary policy meeting in Hungary out next Friday

Running out of money?



Source: Danske Markets, World Bank

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Calendar

EMEA Data and Events in Week24

Monday, June 8, 2009				Period	Danske Bank	Consensus	Previous
CZK	9:00	Trade balance	bn. CZk	Apr		11.3	23.38
TRY	9:00	Industrial production	y/y	Apr		-18.0%	-20.9%
CZK	10:00	Current account	bn. EUR	1st quarter			-2.29
LTL	10:00	CPI	y/y	May	5.2%		6.3%
LVL	12:00	CPI	y/y	May	4.6%		6.2%
Tuesday, June 9, 2009				Period	Danske Bank	Consensus	Previous
EEK	8:00	GDP (final)	y/y	1st quarter	-15.6%		-9.7%
CZK	9:00	Unemployment rate	%	May	8.1%	8.0%	7.9%
CZK	9:00	CPI	y/y	May	1.5%	1.4%	1.8%
CZK	9:00	GDP (final)	y/y	1st quarter	-3.4%	-2.4%	0.7%
HUF	9:00	GDP (final)	y/y	1st quarter	-6.4%		-2.3%
HUF	9:00	Trade balance	m. EUR	Apr			
RON	9:00	Industrial production	y/y	Apr			-12.1%
RON	9:00	GDP (final)	y/y	1st quarter	-6.4%		
LTL	10:00	Trade balance	bn. LTL	Apr			-0.55
LVL	12:00	GDP (final)	y/y	1st quarter	-18.0%		-10.3%
LVL	12:00	Trade balance	m. LVL	Apr			-124.6
Wednesday, June 10, 2009				Period	Danske Bank	Consensus	Previous
TRY	-	Current account	bn. USD	Apr		-1.3	-1.0
RON	9:00	CPI	y/y	May			6.5%
ZAR	13:00	Manufacturing production nsa	y/y	Apr			-11.7%
Thursday, June 11, 2009				Period	Danske Bank	Consensus	Previous
RUB	-	Trade balance	bn. USD	Apr	7.5	7.5	6.8
RUB	-	Exports	bn. USD	Apr	21.7	21.8	21.2
RUB	-	Imports	bn. USD	Apr	14.2	14.4	14.4
CZK	9:00	Construction output	y/y	Apr			-9.4%
HUF	9:00	CPI	y/y	May	2.6%		3.4%
CZK	9:00	Industrial production (final)	y/y	Apr	-23.2%	-23.0%	-17.0%
Friday, June 12, 2009				Period	Danske Bank	Consensus	Previous
HUF	14:00	Central bank releases Minutes from monetary policy meeting					

The editors do not guarantee the accurateness of figures, hours or dates stated above
Note that all releases are CET.

Source: Danske Research

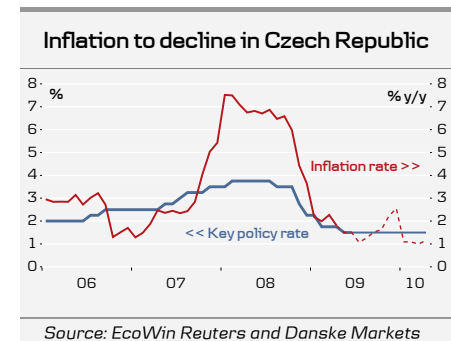
CEE: Inflation continues to decline in the Czech economy

Hungary

- Inflation in Hungary is due for release next week. We expect a temporary drop in inflation in May to 2.6% y/y, down from April's 3.4% y/y. We believe that inflation will bottom out in May, and that it will rise going forward – not least due to the planned VAT hike effective from July, which will boost inflation considerably. See our inflation outlook to the right.

Czech Republic

- Busy week in terms of economic data with May's inflation, April's trade balance, final Q1 GDP figures and final industrial production for April due for release next week.
- Inflation will most likely get the most attention. We expect inflation to decline to 1.5% y/y in May, slightly higher than consensus expectation of 1.4% y/y but lower compared to 1.8% y/y April. The Czech central bank (CNB) sees inflation in May somewhat lower than our forecast at 1.2% y/y. Looking forward, we see inflation declining further in the coming months. This should not however trigger any further interest rate cuts as we believe that the monetary easing has come to the end. However, we must admit that the latest comments from the CNB board members, namely Vice-Governor Miroslav Singer, sounded rather dovish. Mr Singer said that monetary easing might not be over especially if the disinflation process continues, the economic situation continues to worsen or if the ECB cuts interest rates further. Nonetheless, taking into account that we expect the ECB to keep the key policy rate unchanged at 1.00% over the next 12 months, we stick to our scenario that the CNB will keep interest rates flat with the key policy rate at 1.50% in 3,6 and 12 months respectively.



Baltic States: Declining inflation

Estonia

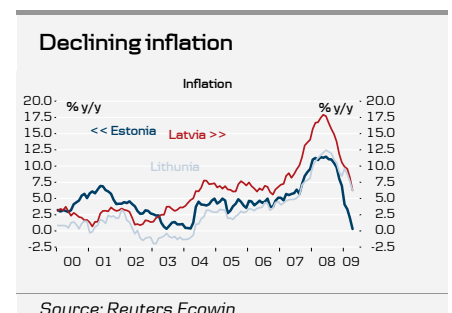
- **Final Q1 09 GDP is due for release next week.** We do not expect a significant change from the flash estimate of -15.6% y/y in Q1. However, there is some risk of a minor downward revision. The full-year outlook depends on the coming quarter's performance. If we see an even steeper slowdown, the annual decline might be worse than our base scenario of a decline of almost 16% y/y.
- Monthly data for April didn't show a clear picture: industrial production is still in free fall while the retail trade contraction stabilized somewhat. Sharply declining consumer prices improve consumer confidence, but the deteriorating labour market is still one of the major risks for the economy.

Lithuania

- **Next week inflation figures will be released.** We expect inflation to decline to 5.2% y/y in May from 6.3% y/y in April. Looking forward, we see inflation declining further in the coming months, especially in July due to lower energy prices (gas and electricity). Average inflation in 2009 will be around 4.3%.
- As was broadly expected, Lithuanian unemployment jumped to 11.9% in Q1 09 from 7.9% in Q4 08 and is currently the highest among the Baltic states. We expect unemployment to rise more sharply in the coming quarters up to an average of 15% for the whole year.

Latvia

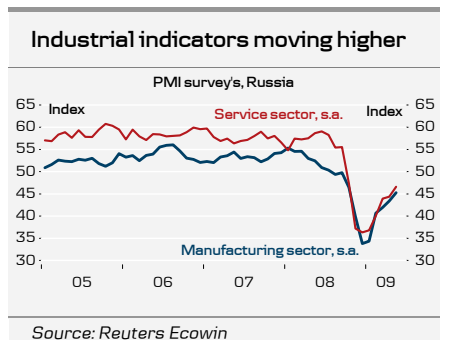
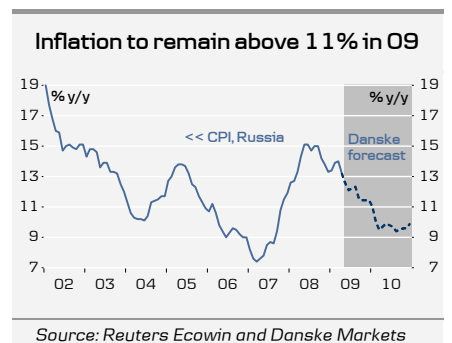
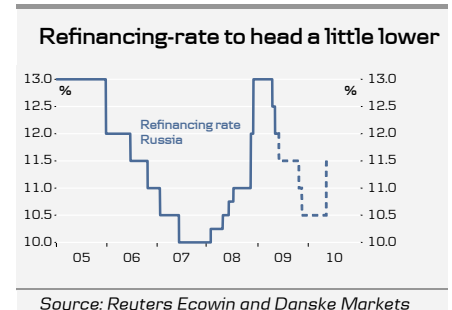
- **We expect consumer price inflation in Latvia to decline to 4.6% y/y in May** from 6.2% y/y in April. Going forward inflation should decelerate further on the back of a sharp drop in domestic demand. We forecast the average consumer price level to rise by 3.6% in 2009.
- **Final Q1 09 GDP is due for release next week:** according to the flash estimate, GDP fell 18.0% y/y in Q1. This was the sharpest drop in growth among the EU countries. We expect GDP to drop 20% on average for 2009. There was a positive surprise in April with Latvian industrial production declining by 16.9% y/y – much less than the -24.3% we expected. However, the retail trade slumped by almost 30% y/y in April. Thus, it's too early to say that this is a stabilization.
- The Latvian government passed the new budget amendments through parliament, implying a budget deficit equal to 9.2% of GDP. This is a clear indication that the agreement made with the IMF about fiscal tightening, which should be implemented as soon as possible, has not yet been reached. Thus, the risk that Latvia might not receive the second part of the international financial support package is very high.



CIS: Policy rates lowered again

Russia

- The Russian central bank (CBR) yesterday cut its refinancing rate for a third time in six weeks. The bank cut its key refinancing rate by 50bp to 11.50%, effective from today. Further, the minimum rate for direct repo auctions will be 8.5%. The decisions comes as no surprise to us – in May the CBR had indicated that it was planning to do this. The CBR said that it does not exclude more rate cuts this year – we expect another 100bp worth of cuts in 2009.
- The rate cuts are being prompted by decreasing inflation. Inflation has dropped 3pp from its peak to around 12.5% – roughly 2pp above the refinancing rate. We expect inflation to head down towards 11.5% y/y by year-end. The CBR today said that it will lower its year-end inflation expectation from 13% to possibly below 12% – fairly in line with our view. Risks to this forecast could come from a lower oil price, since this would exert downward pressure on the rouble, which would lift inflation on imported foods. Going forward we see RUB risks skewed to the downside and we recommend hedging potential RUB risks (see *recommendation*).
- PMI data in May advanced further both in the manufacturing and service sectors, indicating that that the worst might be behind us – at least in terms of economic activity. In fact the PMI surveys suggest that industrial activity could stabilise during May and June and maybe even advance a little.
- Worryingly, the CBR yesterday said that it may stagger demands on commercial banks' mandatory reserves on liabilities, and raise reserve requirements on foreign borrowings as well as foreign currency reserves. If implemented, this would be a step towards restriction on capital mobility and would be rouble-negative, as foreign investors would likely become more reluctant to place funds in Russia's markets. Deputy central bank chief Alexei Ulyukayev though said the bank was looking at these options but "not in the practical sense" for the time being (*Source: Reuters*).
- Trade balance data for April is due next week. We look for an increase in the surplus to USD 7.5bn in April from USD 6.8bn in March on the back of rising oil prices and lacklustre imports. We estimate that the trade surplus for 2009 will be roughly USD 100bn



EMEA: Will South Africa remain fiscal conservative? We doubt it.

Turkey

- Turkish inflation continues its descent. This was confirmed this week when CPI and PPI data for May were published. CPI declined to 5.2% y/y in May from 6.1% y/y – below our expectation of 5.5% y/y. Lower than expected Turkish inflation leaves the door open for further monetary easing in the coming months. We expect another 75bp rate cut at the next MPC meeting scheduled for 16 June, bringing the key policy rate down to 8.50%.

South Africa

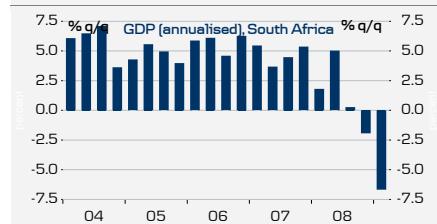
- South Africa's new president Jacob Zuma made his first state-of-the nation address this week. In his speech, Zuma stuck to his moderate rhetoric, basically reiterating his election promises and confirming that the ANC remains committed to promises made before the elections.
- A key issue for the new government is to reduce job losses by: creating half a million job opportunities by the end of this year based on the public work programs (mainly new infrastructure projects); and ensuring that workers who would otherwise face retrenchment due to the recession would be kept in employment for a period of time and re-skilled. Zuma also pledged to create another 4 million jobs over the next five years. While talking about the economic situation, Zuma said that given that South Africa has entered recession, the new government needs to act to minimise the impact of the downturn on those most vulnerable. Reducing poverty will be the cornerstone of the government's strategy. Furthermore, the fight against criminality and AIDS will be also another important task for the government.
- What is our impression of President's speech? Zuma definitely tried to keep the population's spirits up by emphasising that things are going to be better. We nevertheless recognise that Zuma's new administration faces big challenges given the deep recession in South Africa; and if the government sticks to the conservative fiscal policy adopted by the previous government, it needs to scale down some of its promises. Doing otherwise would significantly worsen the fiscal situation.

Turkish inflation continues to fall



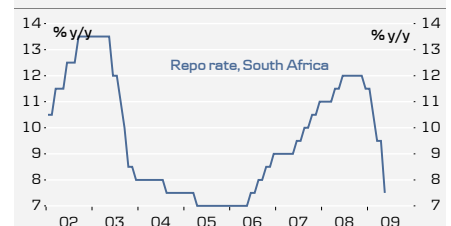
Source: Reuters EcoWin

SA economy in deep recession



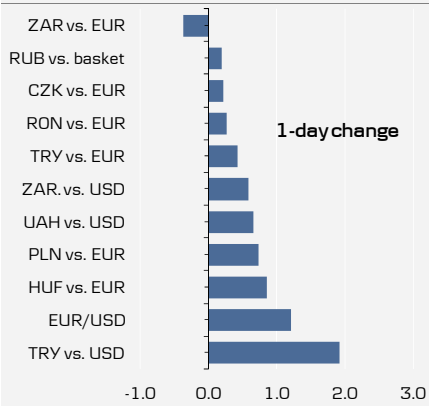
Source: Reuters EcoWin

SARB will continue monetary easing



Source: Reuters EcoWin

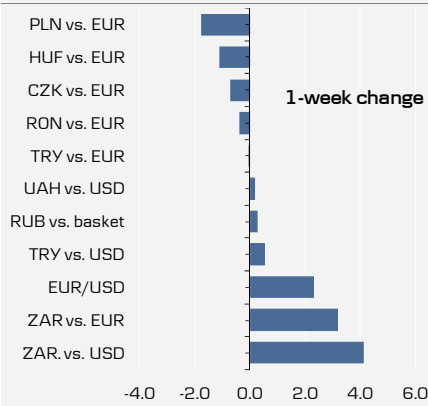
One-day FX-Performance



Data updated: 29/05 - CET: 15:37

Source: Reuters EcoWin

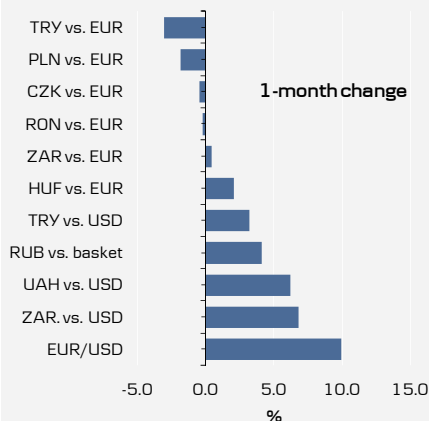
One-week FX-performance



Data updated: 29/05 - CET: 15:38

Source: Reuters EcoWin

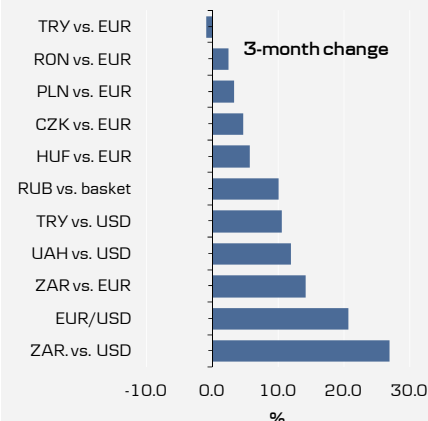
One-month FX-performance



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Source: Reuters EcoWin

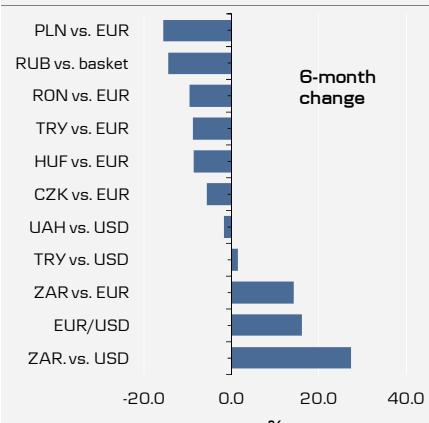
Three-month FX-performance



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Source: Reuters EcoWin

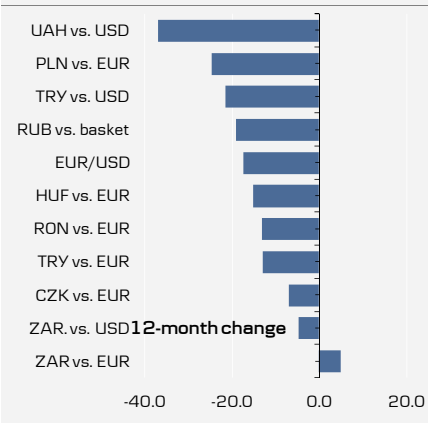
Six-month FX-performance



Data updated: 29/05 - CET: 15:39

Source: Reuters EcoWin

12-month FX-performance



Data updated: 29/05 - CET: 15:39

Source: Reuters EcoWin

FX forecasts						
Currency Forecast, New Europe/EMEA						
Jun - 4, 2009		EUR	USD	SEK	NOK	DKK
USD	Actual	1.41	-	747.9	623.6	527.1
	+3m	1.38	-	761	616	540
	+6m	1.44	-	708	576	517
	+12m	1.40	-	714	586	533
PLN	Actual	4.46	3.16	236.6	197.3	166.8
	+3m	4.50	3.26	233	189	166
	+6m	4.55	3.16	224	182	164
	+12m	4.60	3.29	217	178	162
HUF	Actual	280	198.5	3.77	3.14	2.66
	+3m	310	225	3.39	2.74	2.40
	+6m	320	222	3.19	2.59	2.33
	+12m	325	232	3.08	2.52	2.30
CZK	Actual	26.8	19.0	39.5	32.9	27.8
	+3m	27.2	19.7	38.6	31.3	27.4
	+6m	27.3	19.0	37.4	30.4	27.3
	+12m	27.4	19.6	36.5	29.9	27.2
EEK	Actual	15.6	11.1	67.5	56.3	47.58
	+3m	15.7	11.3	67.1	54.3	47.6
	+6m	15.7	10.9	65.2	53.0	47.6
	+12m	15.7	11.2	63.9	52.4	47.7
LVL	Actual	0.71	0.50	1488.9	1241.5	1049.4
	+3m	0.70	0.51	1500	1214	1064
	+6m	0.70	0.49	1457	1186	1064
	+12m	0.70	0.50	1429	1171	1066
LTL	Actual	3.45	2.44	305.9	255.1	215.6
	+3m	3.45	2.50	304	246	216
	+6m	3.45	2.40	296	241	216
	+12m	3.45	2.46	290	238	216
RON	Actual	4.18	2.96	252.5	210.6	178.0
	+3m	4.40	3.19	239	193	169
	+6m	4.50	3.13	227	184	166
	+12m	4.70	3.36	213	174	159
BGN	Actual	1.96	1.39	540.0	450.2	380.6
	+3m	1.96	1.42	537	435	381
	+6m	1.96	1.36	522	425	381
	+12m	1.96	1.40	512	419	382
TRY	Actual	2.16	1.53	489.5	408.1	345.0
	+3m	2.20	1.59	477	386	339
	+6m	2.25	1.56	453	369	331
	+12m	2.30	1.64	435	357	324
RUB	Actual	43.4	30.7	24.3	20.3	17.1
	+3m	49.0	35.5	21.4	17.4	15.2
	+6m	54.4	37.8	18.7	15.2	13.7
	+12m	56.6	40.4	17.7	14.5	13.2
UAH	Actual	10.77	7.63	98.1	81.8	69.1
	+3m	12.42	9.00	85	68	60
	+6m	14.40	10.00	71	58	52
	+12m	16.80	12.00	60	49	44
ZAR	Actual	11.39	8.07	92.7	77.3	65.4
	+3m	13.52	9.80	78	63	55.1
	+6m	14.69	10.20	69	57	50.7
	+12m	14.28	10.20	70	57	52.2

Source: Danske Markets

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Disclosure

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First date of publication

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