

3 March 2009

# Economic News

EXCHANGE RATE TRENDS IN POLAND, CZECH REPUBLIC AND HUNGARY

## Emerging Europe in the wake of the crisis

The financial market crisis has now engulfed the EU states in Central and Eastern Europe. Since the start of the year, the main currencies have fallen steeply and concerns about the solvency of countries have grown. In the near to medium term, the Polish zloty, Czech koruna and Hungarian forint are likely to remain soft. However, we expect them to firm over the coming 12 months as a gradual recovery takes hold in the western industrialised states and general risk aversion subsides. However, historically the currencies will probably still be weak at the start of the coming year.

### Poland: zloty in a downward spiral

After strengthening up to September 2008 and hitting 12-year highs, the Polish zloty has depreciated extremely rapidly and steeply. The daily fluctuations have increased considerably and testify to the nervousness in the markets. The zloty is currently trading at PLN/EUR 4.73 – a level similar to that prevailing prior to Poland's accession to the EU in 2004. The close foreign trade and capital links to Western Europe make the new EU states heavily dependent on the performance of the economy in Western Europe. As a result, the collapse in the West is reflected in the East with a certain lag. However, Poland, with its large domestic market and a comparatively low export ratio of 41%, is less affected by the collapse in demand for exports than other countries. Nevertheless, Q4 growth in Poland also slumped dramatically.

#### FORECASTS

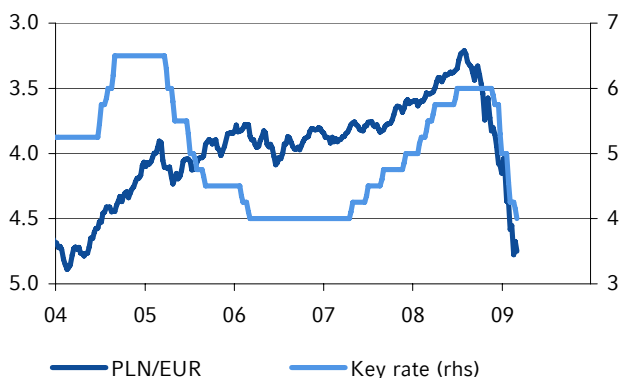
in %	in 3 in 6 in 12			
	current	months	months	months
<b>Poland</b>				
PLN/EUR	4.73	4.75	4.75	4.20
Key rate	4.00	3.25	2.75	2.00
3M money	4.36	3.5	3.1	2.4
10Y govt bonds	6.27	5.9	5.9	6.1
<b>Czech Republic</b>				
CZK/EUR	28.04	28.50	28.50	27.00
Key rate	1.75	1.50	1.25	1.25
3M money	2.45	2.2	1.8	2.0
10Y govt bonds	4.97	4.9	4.8	5.0
<b>Hungary</b>				
HUF/EUR	306	300	300	270
Key rate	9.50	8.50	8.25	6.75
3M money	10.52	9.0	8.8	6.5
10Y govt bonds	11.02	11.0	10.0	8.0

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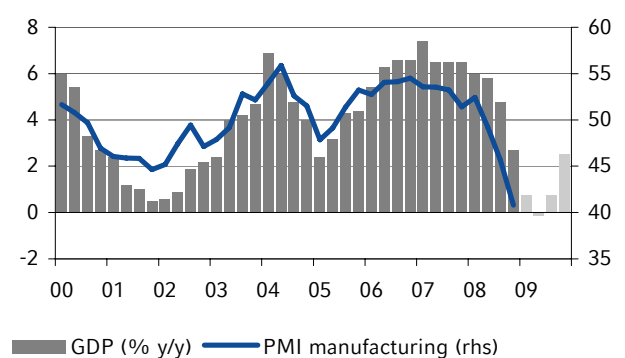
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Poland: exchange rate and key rate  
PLN/EUR, %



Source EcoWin, WestLB Research

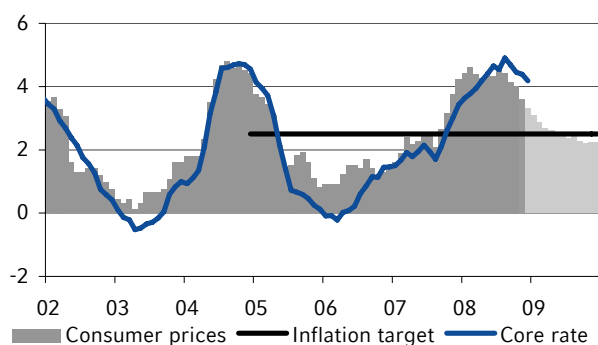
Poland: GDP and purchasing managers' index



Source EcoWin, WestLB Research

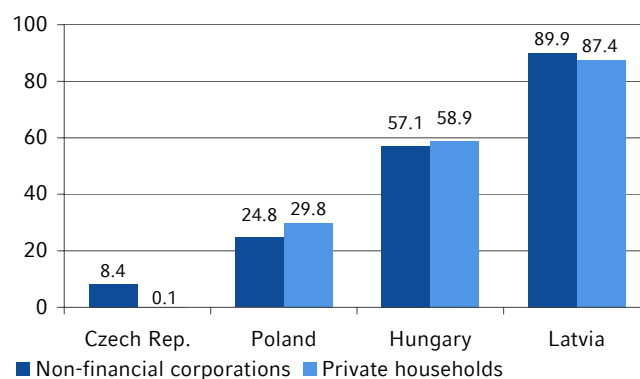
In November 2008, the central bank began the rate-cutting cycle and lowered the key rate by 200 basis points within four months. Up to mid-2008, inflation concerns had predominated. Once these eased as oil and commodity prices declined, the central bank had room to cut rates. The central bank is after all pursuing an inflation target that provides for the rate to fluctuate around 2.5% ( $\pm 1$  percentage point).

**Poland: consumer prices**  
% y/y



Source EcoWin, WestLB Research

**Foreign currency debt**  
% share



Source Reuters, WestLB Research

The zloty's sudden change of direction at a time when the financial market crisis had been smouldering for a over year, is due not least to a change in market assessment. The steep drop in Polish economic activity had evidently not been expected by many market players. The central bank then cut rates faster and more deeply than expected and thus once again underscored the seriousness of the situation. In addition, the situation in the western industrialised states has not eased at all. Banks and companies are still grappling with liquidity difficulties. Moreover, state intervention in the form of bank rescue and economic stimulus packages has significantly raised the western industrialised states' need for capital. This fuels fears of a crowding-out resulting in emerging markets no longer being able to cover their capital requirements and therefore facing payment difficulties. In addition, individual countries in Eastern Europe such as Hungary and Latvia have indeed suffered from payment difficulties and been forced to seek assistance from the IMF. Even though these countries are in a much worse position fundamentally than Poland, their negative assessment still spills over to countries in the region.

### Fear of contagion

### Central bank attempts to put a brake on excesses

The depreciation in the zloty has now taken on its own momentum and no longer reflects the fundamentals. It should instead be seen as an overshooting on the part of the markets. This has now prompted the government and central bank to intervene. Besides verbal interventions to the effect that the zloty is undervalued, EU funds have also been exchanged into zloty to stabilise the rate. In addition, the Polish, Czech, Hungarian and Romanian central banks – in other words all the new EU states with freely fluctuating exchange rates – have published a joint declaration affirming that they will take action to counter any excessive devaluation of their currencies.

Furthermore, the Polish central bank in February lowered the key rate only slightly – namely by 25 basis points to 4.00%. In view of the weak economy further rate cuts are called for. However, the central bank is likely to exercise moderation in order not to destabilise the zloty rate. We expect the key rate to drop to 2.25% by year-end 2009.

### Entry into Exchange Rate Mechanism II should stabilise zloty

Entry into ERM II in H2 at the earliest

A tactically astute move on the part of the Polish government last year was to bring Poland's possible accession to EMU in 2012 into play. Last year, this announcement helped the zloty to firm considerably for a time. Market participants expected the zloty to show a similar successful trend as the Slovakian koruna, whose central rate was revalued upwards several times. In the meantime, however, optimism has faded, especially as the government and central bank disagree on whether early entrance into ERM II is desirable. Before joining EMU, a state first has to be member in ERM II for two years and there must be no unilateral devaluation. If Poland entered into ERM II, a central rate would have to be set for the zloty in agreement with the ECB. The currency may fluctuate around this in a band of  $\pm 15$  percentage points. If one assumes a central rate of PLN/EUR 4.10 for example, the zloty may fluctuate within a band of PLN/EUR 3.49 to 4.72. The Polish government is seeking to enter into ERM II at an early date and hopes that this will stabilise the zloty, especially as fixing the central rate should point the way ahead. However, we believe entry into ERM II before mid-2009 is unrealistic as the ECB is likely to insist on the zloty first stabilising to be sure that it will also move within the fixed bands in the future.

### Outlook: lean period has to be overcome

General risk aversion weighs on zloty

Fundamentally, Poland is relatively well positioned compared to other Central European states. At about 45% of GDP, government debt is well below the 60% limit. Last year, the budget deficit was still a comparatively low 2% and this year should rise to a good 3%. The Polish government is making great efforts not to endanger the consolidation course despite the adverse circumstances. For example, it plans to pay for measures designed to boost the economy by cutting expenditure in other areas. Last year, the Polish current account deficit climbed to about 5.5% of GDP – which is still acceptable, but only just.

General risk aversion weighs on zloty

Nevertheless, in the near term persistently high risk aversion, the poor economic outlook and further rate cuts are likely to keep up the pressure on the zloty rate. We therefore expect that while the current overshooting should be corrected to some extent, the zloty will remain weak over the coming 12 months and trade at around PLN/EUR 4.75. Given the still smouldering financial market crisis, temporary, powerful volatility cannot be ruled out.

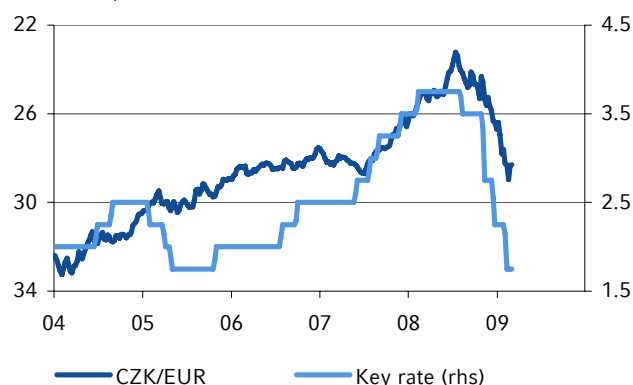
The key to the sustained strengthening of the zloty lies in Western Europe. If evidence emerges of a slight recovery in the western industrialised states in the second half of the year – as we expect it will – general risk aversion should gradually ease somewhat. This should help the zloty to firm to rates of around PLN/EUR 4.20 over the coming 12 months. Even then, the zloty would still be on a low valuation historically.

## Czech Republic: central bank intervenes

Foreign trade links make the country heavily dependent on Western Europe

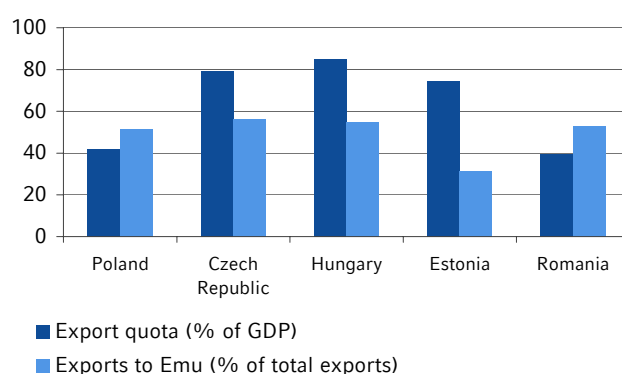
Trends in the Czech Republic have been very similar to those in Poland. Despite the international financial market crisis, the Czech koruna also hit new highs against the euro in mid-2008. Since then, it has lost some 20% of its value and is now trading at around CZK/EUR 28.04 – a level similar to that of 2006. Like Poland, the Czech Republic is not really one of the countries in crisis in Eastern Europe. With government debt at 29% of GDP, a government deficit of some 2.5% and a current account deficit of around 3% last year, its fundamental data remain relatively good. However, in contrast to Poland the Czech Republic is hit harder by any economic downturn in Western Europe. The Czech Republic is a small, open country and exports account for some 80% of GDP. As a result, not even the opening of a new car plant last year – and thus considerable growth in the country's export capacity – was able to prevent the Czech economy from experiencing a sharp downturn. A further weak point is that the highly cyclical automotive industry is one of the Czech Republic's key industrial sectors. After q/q growth rates of about one percent of GDP in the first three quarters of 2008, economic output fell abruptly by 0.6% q/q in Q4. The decline is likely to continue this year and push the Czech economy into recession.

**Czech Republic: exchange rate and key rate**  
CZK/EUR, %



Source EcoWin, WestLB Research

**Foreign trade ties**



Source EcoWin, national statistical offices, WestLB Research

The Czech government recently announced a stimulus package equivalent to 1.1% of GDP. If the tax cuts that have already been effected as planned are also taken into account, the stimulus represents about 1.9% of GDP. Since August last year, the Czech central bank has also trimmed rates by 200 basis points. The key rate is currently 1.75%. However, the latest slide in the koruna has prompted a rethink by the central bank. It has warned the markets that it will raise rates to counter any further slide in the koruna. The Czech central bank is well known for incorporating exchange rate policy considerations into its rate decisions and it pursues a managed floating policy for the koruna. As monetary conditions have already eased considerably given the depreciation in the koruna, the central bank's rate-cutting cycle should soon be over.

Falling inflation rates provide room for interest rate cuts

Like its Polish counterpart, the Czech central bank is pursuing an inflation target, which is 3% this year and 2% next year ( $\pm 1$  percentage point in both cases). The inflation rate, which dropped to 2.2% in January and which should decline further over the coming months, is currently comfortably within the band. However, looking ahead to 2010 and having regard to the stricter inflation target as well as the delayed impact of monetary policy, there will be less scope for further rate cuts. As the currency devaluation is also inflationary, the central bank will probably lower the key rate by just 50 basis points to 1.25% over the coming months.

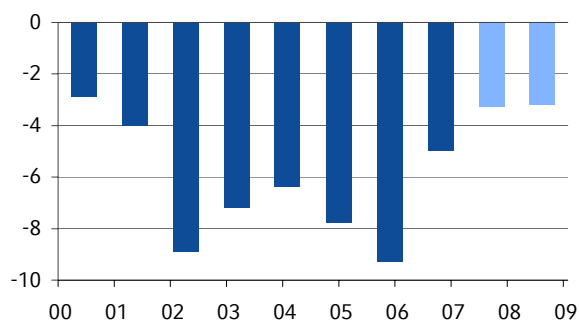
The Czech koruna is also likely to be adversely affected over the coming months by general risk aversion and in particular aversion to Central and Eastern Europe. As a result, it should fluctuate around CZK/EUR 28.50 over the next six months. Over the coming 12 months, we do not expect the koruna to firm at rates around CZK/EUR 27.00 until evidence of a recovery in Western Europe emerges.

## Hungary: a balancing act

### Home-made problems in Hungary

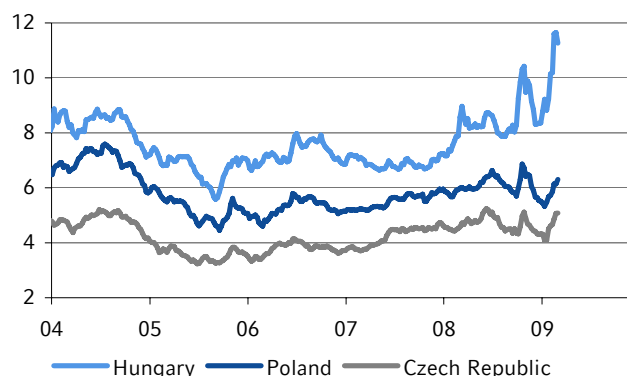
In contrast to Poland and the Czech Republic, the problems in Hungary are largely home-made. Fiscal policy has been lax for years and the government is well known for bestowing extensive gifts on voters before parliamentary elections. In the last five years, the government deficit averaged 6.5% a year. This resulted in a sharp rise in government debt. At 66% of GDP, this is an average level in a Western European context. Compared to the Central and Eastern European states, it is far higher than average. Besides the government deficit, the current account deficit – over 6% of GDP – has been relatively high in the last five years. In addition, foreign debt is rising considerably and foreign currency debt of the private sector is also growing, which makes the country vulnerable to exchange rate fluctuations. These fundamental weaknesses are the reason why yields on Hungarian government bonds for example has been well above those on Polish government bonds and why the Hungarian interest rate was one of the highest in the region even prior to the eruption of the financial crisis.

**Hungary: state budget deficit**  
as % of GDP



Source EcoWin, WestLB Research

**Yield on 10Y government bonds**  
(%)



Source EcoWin, WestLB Research

The financial market crisis brought Hungary's problems to a head. It was therefore not surprising that Hungary was one of the first countries from Central and Eastern Europe to get into difficulty and seek assistance from the International Monetary Fund (IMF). The Hungarian government has willingly bowed to the demand of the IMF and is now pursuing a restrictive fiscal policy despite the slowdown in economic activity. The IMF's first review was positive and the conclusion of an agreement with the IMF should only be a formality. Accordingly, the second tranche of the IMF loan should be paid out in April. This should avert any payment problems. In addition, Hungary wants to return to the capital markets in the coming months and launch new issues.

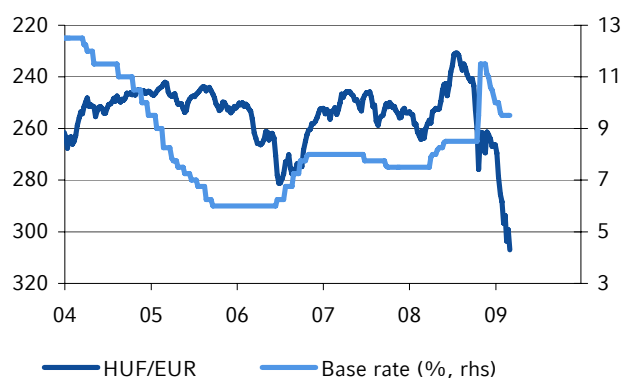
### Hungarian forint in free-fall

### Forint: from 10-year high to historical low

Despite the more critical position, the Hungarian forint was still trading at a 10-year high in July last year. Since then, it has lost some 23% of its value and is currently trading at a historical low of HUF/EUR 305. The conclusion of the agreement with the IMF in October last year slowed the slide only temporarily. The steep fall in the rate is exacerbating

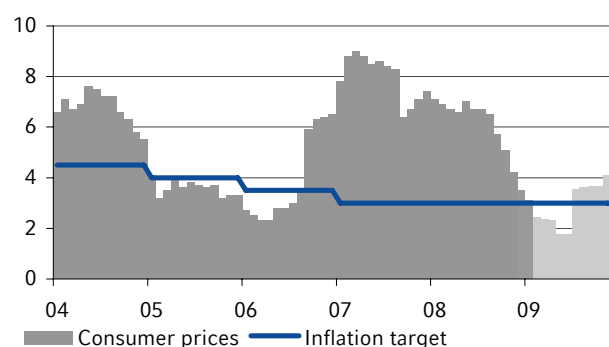
Hungary's position insofar foreign currency debt accounts for a high proportion of private sector debt (some 60%). The lower exchange rate raises the debt service in local currency, which in turn increases the danger that private households and businesses will no longer be able to bear the increased costs and will become insolvent. This in turn adds to the pressures on the banking sector. At its latest meeting, the Hungarian central bank accordingly emphasised that it would intervene to stabilise the forint in the case of strong exchange rate fluctuations.

**Hungary: exchange rate and key rate**  
HUF/EUR, %



Source EcoWin, WestLB Research

**Hungary: consumer prices**  
% y/y



Source EcoWin, WestLB Research

The current rate-cutting cycle for example, which began in November last year, was also slowed by the depreciation of the forint. After raising the key rate by 300 basis points in October, the central bank lowered it again by 200 basis points in several steps over the following months. In February, the central bank then left the key rate unchanged. From an economic perspective – Hungary is in deep recession – further substantial rate cuts are called for. Further, the inflation rate is unlikely to drop as fast as first expected given the planned hike in the VAT rate in July.

The central bank's inflation target is 3% ( $\pm 1$  percentage point) and quantitative targets have also been agreed with the IMF regarding the inflation rate. Against this backdrop, the Hungarian central bank will probably proceed more cautiously in its interest rate policy. Nevertheless, depending on the market situation, we expect further rate cuts and we forecast a key rate of 7.25% at year-end.

### Outlook: forint vulnerable to loss of confidence

The Hungarian central bank is unlikely to cut key rates until the risk assessment on Hungary has improved at the same time. Despite rate cuts, we therefore expect the forint to strengthen slightly over the coming 12 months. Hungary still offers an attractive rate level which, once the general risk aversion subsides, should move more into the foreground. While the fundamental weaknesses of the Hungarian economy have not been eradicated, we believe IMF support and the positive steps towards consolidating the government budget should pave the way for Hungary to access the international capital markets again. Accordingly, the forint should firm at around HUF/EUR 270 over the coming 12 months. However, as in the case of the Czech Republic and Poland, this presupposes that the financial markets in the western industrialised states start to stabilise and that economic activity begins to pick up at least slightly in H2. Yet, as the situation in Hungary is likely to remain tighter than in the Czech Republic and Poland in the longer term, the forint remains susceptible to fluctuations.

Overshooting will gradually be eliminated

**Key data compared**

	Poland			Czech Republic			Hungary		
	2008	2009E	2010E	2008	2009E	2010E	2008	2009E	2010E
Real GDP (% y/y)	4.8	1.0	1.5	3.5	-0.8	1.8	0.6	-3.5	0.5
Consumer prices (% y/y)	4.2	2.5	2.0	6.3	1.5	2.5	6.1	3.0	3.6
Budget deficit (% of GDP)	-2.0	-3.2	-3.5	-0.5	-3.5	-3.0	-3.3	-3.3	-3.0
Unemployment rate (%)	9.8	11.5	12.5	5.4	7.5	8.0	7.7	8.7	9.0
Current account deficit (% of GDP)	-5.4	-5.5	-5.0	-2.9	-3.8	-2.7	-7.3	-6.0	-5.0

2008 estimated in part

Source EcoWin, WestLB Research

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