

CEE government bonds see their appeal boost in the upcoming period

- **Better fiscal discipline advocates for CEE government bonds**
- **CEE public debt at very low level; net issuance of government bonds thus expected to be rather low**
- **Liquidity situation and further monetary easing should increase demand for CEE government bonds**

Growing financial needs of governments in Western Europe, ballooned by bailouts, fiscal stimulus packages and an adverse effect of recession on the revenue side of budgets, raises the question of whether the low level of long-term yields is sustainable, given the massive issuance of government bonds. In this respect, the situation in CEE8 (except Ukraine) seems much better, as there have hardly been any bailouts or generous stimulus packages adopted that would inflate bond issuance. Most promoted stimulus packages are either repackaged existing public expenditures or more efficient drawing and co-financing of EU funds.

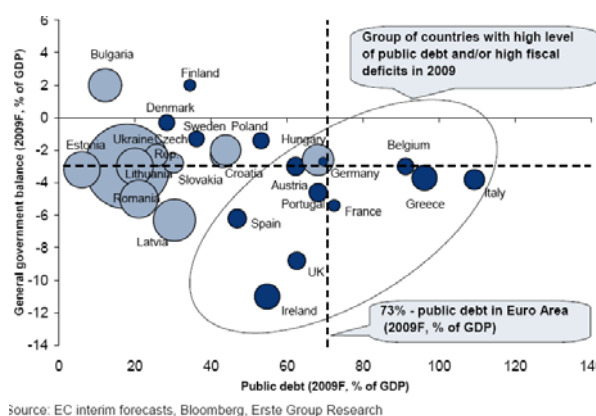
Better fiscal discipline advocates for CEE government bonds

A negative cyclical effect related to the increasingly negative output gap will likely be the main contributor to fiscal loosening in CEE. Some mild tax cuts are being discussed in Slovakia and the Czech Republic, but, in most cases, fiscal deficits should stay below or close to 3% of GDP.

What is more, countries with IMF support (Ukraine, Hungary and Serbia) have strong commitments to continue in fiscal consolidation, despite the high political costs paid for painful tightening of cyclically-adjusted deficits. The highest deficit among CEE8 countries should be in Romania (up to 5% of GDP) as most of the approved bills in the election year (2008) bear their full costs in 2009. However, it is very likely that markets will force the Romanian government to open the budget and make changes alone, rather than with the IMF, which would result in higher political costs. If Romania goes for IMF help, we would see such a decision as bond-supportive, as the program would offer a credit line that would reduce the net issuance of government bonds and trigger more aggressive monetary easing.

CEE public debt at very low level; net issuance of government bonds expected to be rather low

Given the relatively low level of public debt and fiscal deficits in CEE8, the supply of government bonds should remain at reasonable volumes, despite the relatively shorter average maturity of government papers. The highest gross issuance will be in Hungary, as a big amount of government debt (19% of GDP) matures in 2009. However, given the agreement with the IMF/EU, which should roll over about 5% of maturing debt, the Hungarian government will not need to go on foreign markets to borrow and the net issuance will be negative and done in local currency only. At the end of the day, there will be less outstanding Hungarian government securities on the market compared to 2008. Thus, the local market should be able to absorb the supply of government securities just by rolling over maturing securities. Besides the negative net issuance, the short-term rates heading south should also be supportive of government securities.

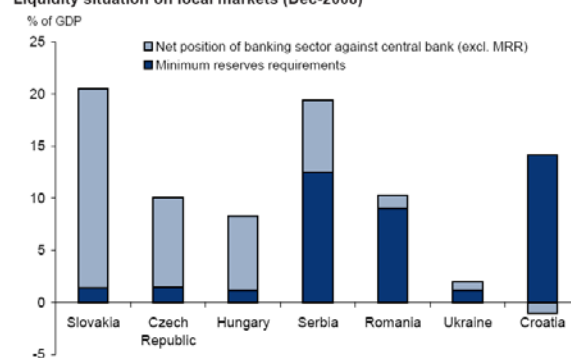


source: EC interim forecasts, Bloomberg, Erste Group Research

Liquidity situation and further monetary easing should increase demand for government bonds

“In general, we expect that the contraction of strong credit growth in CEE8 and the growing market of pension funds (mainly valid for Poland and Slovakia) will increase the demand for government securities of about 1-2% of GDP” points out Juraj Kotian, co-head of CEE Macro & Fixed Income Research at Erste Group. On top of that, most CEE8 banking sectors have excess liquidity (the highest in Slovakia – almost 20% of GDP). Thus, banks will be in a hurry to place this excess liquidity in government bonds, rather than put it on central bank deposits at low interest rates. There has been solid demand for government securities already in the first month of this year, with auctions heavily oversubscribed. Besides rate cuts, central banks might opt for cutting the minimum reserves

Liquidity situation on local markets (Dec-2008)



Source: Central banks, Erste Group Research

requirement in order to ease monetary policy and support credit growth/government bond issuance. Hungary, Ukraine, Romania and Croatia have already cut (or partially cut) their abnormally high minimum reserves requirements, which had been draining too much liquidity from the market. We expect that central banks will continue in “normalization” of their minimum reserves requirements (especially in local currency) in 2009, releasing locked liquidity back to the market. Given the deceleration of credit growth, such high minimum reserves have become obsolete and might only have an adverse effect on these economies, government yields and credit growth through too tight liquidity constraints.

Prospects for CEE value trades are enhanced

The gloomy global economic outlook, high risk aversion and aggressive monetary easing have sent yields on government securities on major markets to extremely low levels. This has not been the case for CEE8 countries, where spreads on government bonds and CDS have remained elevated, despite falling inflation, sharp deceleration of growth and further monetary easing in the pipeline for most CEE8 countries. “We expect to see a compression of spreads on CDS and government bonds in the following months, driven by increased demand for government papers (mainly from domestic investors), and at the same time upward risk for spreads for some heavily indebted countries in Western Europe”, Kotian further highlights. This creates very good room for value trades, like the Czech Republic, Slovakia, Hungary and Romania (with implicit backing from the IMF) against Ireland, Greece or Spain.

Country-by-country analysis: Do you expect any difficulties in financing the fiscal deficit on local or international markets?

- “Based on revised growth forecasts, we now expect **Slovakia's fiscal deficit at close to 3% of GDP**, even if no new major spending initiatives are carried out (the government intends to find funds by reshuffling expenditure)” explained Michal Mušák, macro analyst at Slovenska Sporitelna. „However, the government should have no problem raising extra funds, as in late 2008 people brought money from under their pillows to banks ahead of euro adoption. This year, demand at government auctions has been heavy, as banks sought to invest these new deposits”
- “Although the 2009 budget draft in **Romania** is very ambitious in terms of cutting public spending, postponing some wage hikes and suspending bonuses in the public sector, **we see the cap for the budget deficit at around 5% (2% is the government's target)**” stated Lucian Anghel, chief economist at Banca Comerciala Romana. “The Romanian government has thus far only announced a stimulus package, but it remains to be seen if it this is to be included in the final 2009 budget (after it is approved by Parliament). The central bank's support in financing the budget deficit in 2009 is very important, while Eurobonds should be seen as a second option and only for smaller amounts. At the same time, securing additional funding from an international financial institution to fund the budget deficit could have positive effects on the FX rate, as well as on credibility, and improve investor sentiment towards the Romanian market”
- “As the decline of GDP in 2009 is likely to be below the planned -1% y/y in **Hungary**, revenues worth around 1% of GDP could be missing from the budget. **This suggests that the cap for the fiscal deficit this year is 3.5-3.6% of GDP**” stated Orsolya Nyeste, macro-analyst at Erste Bank Hungary. “All in all, capital markets

would not tolerate a higher budget deficit than 3% of GDP, nor would the IMF. Our base forecast, however, is that the 2.6% of GDP deficit goal will remain untouched, as – by increasing its credibility - it should make it easier for the country to shift from the current non-market-type financing (IMF loan) to market-type financing, as soon as possible. Due to the IMF standby loan, we should not see financing difficulties in the short run, but as this situation is artificial, there is still no way for Hungary to significantly increase its financing needs.”

- “There is no strict limit in the **Czech Republic** on the size of the deficit. The talk is still that the Maastricht criterion of **3% of GDP** should be respected, but we think it will not be held sacred and, should the activity drop well below zero, **it might easily be exceeded** (especially if fiscal stimulus is implemented)” pointed out Martin Lobotka, macro-analyst at Ceska Sporitelna . “As for the financing, the local bond market in the Czech Republic has fixed itself a little since the fall (evidenced for example in narrower bid-ask spreads) and demand is improving. Regarding the foreign market (which is crucial for the upcoming Eurobond issue), markets are open, but come at a price. For example, Poland priced the recent 5Y euro-denominated issue at mid-swaps + 300 bps”
- “The fiscal deficit for 2009 in **Ukraine is projected at 3% of GDP**, but we think that this is unrealistic, given the recent low figures for budget income in January. Currently, the government is unable to attract funds on the local market, although it was able to refinance some of the guaranteed state debt using external financing. We think that the budget will be reviewed soon, in order to reduce the widening gap between expenditures and revenues” stated Maryan Zablotsky, macro-analyst at Erste Bank Ukraine.
- “We expect that the **Croatian** fiscal deficit will not meet the targeted goal of 0.9% of GDP, given the overly optimistic planning assumptions. Hence, given the negative cyclical component, we expect the fiscal deficit in the **2.5-3% region**” highlighted Alen Kovac, macro-analyst at Erste Bank Croatia. Currently, the Ministry of Finance is oriented to the domestic market and has thus far been successful in meeting financing needs. However, in the mid run, capacity limitations are likely to play a role. Therefore, the Ministry of Finance announced that it would try to arrange a bond issue on international markets, which - if successful - would alleviate the pressure from the domestic market”

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