

CEE Insights

Fixed Income and Foreign Exchange – 27 August 2010

Croatia: Budget rebalance: Fiscal policy course unchanged

Czech Republic: Second board member indicates unease with current low rates

Hungary: Government talks add to market's disquiet

Poland: Unemployment rate continues to ease, retail sales just slightly below expectations

Romania: Budget deficit at 3.9% of GDP at end of July

Turkey: Foreign trade deficit to widen further, inflation to rise above 8%

Ukraine: VAT bonds expected next week

Market outlook

This week saw some interesting news from central bank(er)s. As expected, the Hungarian National Bank left interest rates unchanged on Monday, but altered its economic projections quite significantly. GDP growth was revised downwards, inflation upwards, and the estimates for fiscal deficits are higher than the government's target. With these estimates, the future interest rate trajectory has become more uncertain, adding the possibility of a rate hike. Next to inflation risks, NBH Governor Simor made it quite clear that any increase of the risk premium would be countered by the central bank through higher rates. The obvious concern is the future of the IMF loan program. The rate setting meeting in Poland was not so eventful. Rates remained unchanged and the following statements were a notch more dovish than previously. At the same time, statements from rate setters clearly showed that higher rates before the end of the year remain on the table. The situation in the Czech Republic is similar, as a second member of the seven-member rate setting body has started thinking aloud about the sustainability of the low interest rate level. In our view, the case for a rate increase before year-end is strong, while markets still expect monetary tightening only later on.

CEE capital markets were hit by a renewed wave of weak economic data from the US and resulting risk reduction by investors. Hungary was further battered by the comments from NBH Governor Simor. We think that the higher fiscal deficit projections were particularly behind the unease. However, the main topic on international capital markets at present is the ultra-low yield levels on major markets. We examined the extent to which this spilled into the region and looked at Eurobond yields (please see page 4) for possible clues on the issuance structure ahead.

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| | Instrument | Current | w/w | m/m | ytd | Spreads vs. Euroland | | |
|----------------|----------------|---------|-------|-------|-------|----------------------|------|------------|
| | | | | | | current | - 1m | 02/01/2010 |
| Czech Republic | EUR/CZK | 24.77 | 0.3% | 0.0% | 6.3% | | | |
| | 3Y (yield/bp) | 1.92 | -4 | 0 | -34 | 125 | 107 | 63 |
| | 10Y (yield/bp) | 3.34 | -15 | -49 | -57 | 121 | 108 | 52 |
| | 5Y CDS | 90 | 3 | -2 | -4 | | | |
| Croatia | EUR/HRK | 7.279 | 0.1% | -0.4% | -0.1% | | | |
| | 3Y (yield/bp) | 5.57 | 5 | 11 | -110 | 482 | 437 | 457 |
| | 10Y (yield/bp) | 6.52 | 7 | -9 | | 436 | 386 | |
| | 5Y CDS | 272 | 27 | -3 | 43 | | | |
| Hungary | EUR/HUF | 285.1 | -2.2% | 0.0% | -5.3% | | | |
| | 3Y (yield/bp) | 7.06 | 67 | 1 | -24 | 640 | 607 | 567 |
| | 10Y (yield/bp) | 7.20 | 58 | -6 | -72 | 507 | 451 | 453 |
| | 5Y CDS | 357 | 25 | 36 | 130 | | | |
| Poland | EUR/PLN | 3.992 | -0.4% | 0.4% | 2.8% | | | |
| | 3Y (yield/bp) | 4.76 | 6 | -11 | -65 | 410 | 389 | 378 |
| | 10Y (yield/bp) | 5.41 | 7 | -6 | -88 | 327 | 309 | 290 |
| | 5Y CDS | 150 | 14 | 14 | 24 | | | |
| Romania | EUR/RON | 4.244 | -0.4% | 0.2% | -0.2% | | | |
| | 5Y (yield/bp) | 7.25 | -14 | -18 | -285 | 601 | 569 | 768 |
| | 5Y CDS | 381 | 43 | 19 | 95 | | | |
| Slovakia | 3Y (yield/bp) | 2.11 | -3 | -13 | -98 | 133 | 111 | 147 |
| | 10Y (yield/bp) | 3.66 | -11 | -32 | -75 | 152 | 122 | 113 |
| | 5Y CDS | 80 | 4 | -2 | 0 | | | |
| Turkey | EUR/TRY | 1.94 | -0.6% | 2.0% | 10.8% | | | |
| | 2Y (yield/bp) | 8.07 | -1 | -10 | -99 | 580 | 732 | 773 |
| | 10Y (yield/bp) | 9.02 | -8 | 7 | n.a. | 627 | 620 | n.a. |
| | 5Y CDS | 180 | 15 | 15 | -2 | | | |
| Ukraine | EUR/UAH | 10.04 | -0.1% | 2.9% | 14.8% | | | |
| | 2Y (yield/bp) | 12.3 | 0 | -25 | -1275 | 1164 | 1162 | 2367 |
| | 5Y CDS | 562 | 33 | 41 | -709 | | | |

Source: Reuters, Bloomberg (+ means strengthening / - means easing of the exchange rate)

Positions

| # | Position | Date of opening | Instruments | Values | | | P/L (%) | | | Target P/L (%) | | |
|----|---------------|-----------------|--------------------------------|------------|--------|--------|----------|--------|------|----------------|-------|-------|
| | | | | Entry | Today | Target | curr. | +carry | p.a. | flat | p.a. | |
| 29 | short 10CZGB | 18/12/2009 | CZ 5.0 10/25/19 PL 5.5 4/11/19 | 107.8/94.5 | 114.15 | 100.8 | 99/103.5 | -0.2% | 0.2% | -0.2% | 24.6% | 33.5% |
| | long PLGB | | CZK/PLN | 6.26 | 6.20 | 6.51 | | | | | | |
| 32 | long CZ2Y IRS | 10/3/2010 | 2Y CZ IRS | 2.13 | 1.53 | 2.45 | -0.60 | - | 0,00 | 32bp | - | |

Rationale at inception

29) We see the potential for narrowing of the spread between Czech and Polish government bond yields which, in our view, is fundamentally unjustifiably high. Time horizon is 9 months and target P/L including carry is close to 30%.

32) Czech 2Y swap are too low given the expected development of the economy and the associated IR development (we expect the average CNB repo rate at 2.2% in 2011 and continuing rise in 2012).

Closed positions

| # | Recommendation | opened | closed | P/L inc.carry |
|----|----------------------------------|------------|------------|-----------------|
| 1 | long: PLGB10y / 4m Euribor | 16/09/2005 | 27/10/2005 | -3.0% |
| 2 | short: CZGB15y / 6m PRIBID | 16/09/2005 | 21/11/2005 | 6.0% |
| 5 | long: SKK/CZK | 09/11/2005 | 20/01/2006 | 1.9% |
| 3 | short EUR/SKK | 29/09/2005 | 07/02/2006 | 3.5% |
| 4 | EUR/PLN options | 21/10/2005 | 28/07/2006 | -2.7% |
| 6 | SKK/CZK long | 23/03/2006 | 30/10/2006 | 2.2% |
| 7 | FRA 9*12 short | 28/07/2006 | 08/11/2006 | 8bp |
| 8 | long HUGB 5y | 13/10/2006 | 29/01/2006 | 5.7% |
| 9 | short CZGB/ long GDBR | 09/01/2007 | 27/02/2007 | 1.8% |
| 10 | long CZK/EUR | 27/02/2007 | 19/03/2007 | 2.3% |
| 11 | short CZGB/ long PLGB | 07/03/2007 | 10/05/2007 | 5.5% |
| 14 | long SKKFRA 9x12, short EURFRA 9 | 16/07/2007 | 13/08/2007 | 30 bp |
| 13 | short EUR/CZK | 07/06/2007 | 14/09/2007 | 3.0% |
| 15 | short EUR/RON | 23/10/2007 | 21/11/2007 | -4.9% |
| 12 | short EUR/SKK | 04/06/2007 | 04/12/2007 | 1.6% |
| 16 | long USD/CZK | 29/11/2007 | 14/01/2008 | -3.1% |
| 17 | long 3y HUGB / 3m Pribor | 05/12/2007 | 08/02/2008 | -6.8% |
| 20 | short EUR/SKK | 22/01/2008 | 13/02/2008 | 2.9% |
| 19 | long USD/CZK | 21/01/2008 | 18/02/2008 | -3.6% |
| 18 | short EURRON | 31/12/2008 | 28/02/2008 | -0.6% |
| 21 | Short USD/RON | 02/04/2008 | 10/04/2008 | 3.9% |
| 22 | Buy EURFRA, sell SKKFRA | 04/04/2008 | 18/04/2008 | 26bp |
| 23 | Long EUR/CZK | 29/04/2008 | 19/06/2008 | -3.8% |
| 24 | short EUR/RON | 05/08/2008 | 14/10/2008 | -4.7% |
| 25 | short EUR/PLN | 09/09/2008 | 21/10/2008 | -3% (stop-loss) |
| 27 | short GEGB/long CZGB | 12/08/2009 | 22/10/2009 | 4.9% |
| 28 | long 4y HUGB / 6m Euribor | 08/09/2009 | 18/11/2009 | 7.4% |
| 26 | short EUR/PLN | 12/08/2010 | 14/01/2010 | 5.5% |
| 30 | Short EURCZK | 05/01/2010 | 17/01/2010 | 3.2% |
| 33 | Short EURPLN | 20/05/2010 | 18/08/2010 | 6.0% |
| 31 | Long 5yr ROGB | 08/02/2010 | 18/08/2010 | 2.4% |

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Question of the week

As major market yields have dropped strongly, how have Eurobond spreads developed since the end of July? Has financing with Eurobonds become cheaper in absolute terms for governments?

Spreads have increased on **Romania's** Eurobonds since the end of July, while yields have seen only a marginal reduction. Considering the managed floating regime and the fact that the leu has been comparatively less volatile than other currencies in the region, as well as the higher yields on the local currency, it would be cheaper for Romania to issue Eurobonds.

Dumitru Dulgheru, Banca Comerciala Romana

Slovak bonds were not unaffected by the decline of German yields. Since end-June, the 10Y yield declined by some 30bp to below 3.7%. At the same time, the spread over German Bunds has widened from 140bp to 150bp.

Maria Valachyova, Slovenska sporitelna

The **Czech** Eurobond spread narrowed from about 100bp to around 65bp. Eurobond financing has become cheaper over the summer - as has local financing. Two sets of reasons are responsible for this - first, global panic buying (see German bonds), dragging local yields down as well; secondly, domestic developments: the new government, raised rating outlook, low local issuance and plans to issue more on the short end.

Martin Lobotka, Ceska sporitelna

Polish Eurobond yields have receded as well. For example, the yield on a 10Y bond issued in 2006 dropped from 3.7% in mid-July to some 2.6% as of today. Given the yield developments on German bonds, the spread has narrowed by some 50bp.

Jana Krajcova, Ceska sporitelna

On average, **Croatian** Eurobond yields have been more or less stable in recent weeks, implying practically unchanged financing conditions on the Eurobond market.

Alen Kovac, Erste Bank Croatia

There do not seem to have been any major changes in **Turkish** Eurobond spreads since the end of July. Spreads for the 2021 Eurobond, for instance, have been hovering around 250bp against 10-year US treasuries since May. In absolute terms, on the other hand, financing has become relatively cheaper, with yields coming down to 5.0%, from around 6.1% in May.

Ali Cakiroglu, Erste Securities Istanbul

Since the end of July, spreads in **Ukraine** have increased quite substantially, by around 30-50bp. However, the spreads are still three-fold lower compared to those at the beginning of the year. The government can realistically borrow at 6-7% in USD for 10Y on international markets and will most probably do so by year-end. A few months ago, the government withdrew from its planned 10Y Eurobond placement, as it considered yields of 8-9% to be too high.

Maryan Zablotsky, Erste Bank Ukraine

The **Hungarian** Eurobond yield for 10Y maturity has dropped by about 50bp since the end of July, keeping the spread stable compared to the German benchmark. Thus, financing in euro has indeed become cheaper for the government and is at roughly the same level as at the beginning of the year.

Rainer Singer, Erste Group

Major markets

Trichet's comments after ECB council meeting in focus

For the Eurozone, the release calendar is light. Only Thursday's ECB meeting will get major attention. Any change in monetary policy can almost be ruled out. But this is the first meeting after the release of the strong 2Q GDP data. So, perhaps Trichet will put the released numbers into perspective with his expectations for this and the following quarters. Before that comments can be expected from Trichet who is participating at the central banker's meeting in Jackson Hole this weekend. Trichet will likely reiterate the differences between the ECB's current monetary stance and that of the US Fed.

Important releases ahead unlikely to change outlook; central bankers meet in Jackson Hole

Starting today, a dense release schedule lies ahead. The second estimate of 2Q GDP will bring a significant downward revision, as the actual trade deficit in June was higher than the estimate used for the first calculation of 2Q GDP. Markets will scrutinize the data for any revision of domestic demand components. Also today, the Univ. of Michigan index will show the status of consumer sentiment. The monthly consumer confidence index will do the same on Tuesday. Wednesday will bring the ISM index, showing the development among the largest US manufacturers. We agree with the market and expect another decline, as the previous number was still too high in relation to the overall status of the economy. The same day, ADP numbers will give a first glimpse as to how private employment developed in August. Anything other than a minor change would move expectations for the economy. This applies of course even more to the official labor market data released on Friday. Markets expect a minor increase of private payrolls, while the government likely further reduced jobs related to the census. The unemployment rate likely increased marginally. Looking at the data ahead, we see little chance of any change of sentiment. However, non-farm payrolls are the indicator with the greatest uncertainty. Finally, expect comments from central bankers, as their meeting in Jackson Hole proceeds until Sunday. Bernanke is scheduled to speak today (Friday).

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Forecasts

| | Intervention Rate | | 3m Money Market Rate | | | | 10y Govt. Yield | | FX | |
|--------|-------------------|----------|----------------------|------|------|------|-----------------|------|---------|-------|
| | EUL | USA | EUL | Fwd | USA | Fwd | EUL | USA | EUR/USD | Fwd |
| Spot | 1.00 | 0 - 0.25 | 0.89 | | 0.30 | | 2.13 | 2.49 | 1.272 | |
| Sep-10 | 1.00 | 0 - 0.25 | 0.90 | 1.06 | 0.40 | 0.39 | 2.40 | 2.70 | 1.30 | 1.272 |
| Dec-10 | 1.00 | 0 - 0.25 | 1.00 | 1.50 | 0.50 | 0.84 | 3.10 | 3.30 | 1.35 | 1.272 |
| Mar-11 | 1.00 | 0 - 0.25 | 1.20 | 1.64 | 0.60 | 1.11 | 3.20 | 3.50 | 1.33 | 1.271 |
| Jun-11 | 1.25 | 0.50 | 1.50 | 1.55 | 0.70 | 1.20 | 3.40 | 3.80 | 1.30 | 1.271 |

Croatia

2Q GDP down 2.5% y/y

According to the first flash estimate, GDP in 2Q repeated the 1Q performance, posting a 2.5% contraction. The figure came in somewhat below our forecast and the market consensus (ESBe: 2.2% y/y; market 2.3% y/y), showing the ongoing fragile economic development. The detailed breakdown should be revealed as the end of September. We expect the GDP performance to have remained subject to a strong negative impact from contracting investment activity, which likely remained in double-digit negative territory. Private consumption could also remain a burdening factor, still likely showing some stabilization with respect to 1Q (-4.1% y/y). Trade balance statistics, on the other hand, suggest a continuation of the strong net export offsetting effect. For 3Q, we anticipate stabilization, due to encouraging preliminary tourist season figures (7% y/y more overnight stays in July) and additional stabilization of private consumption. Merchandise trade should also remain supportive, though likely to a lesser extent than in the robust 2Q. Overall, our FY10 GDP forecast remains in the 1.5% region.

Budget rebalance: Fiscal policy course unchanged

After several weeks of speculation regarding potential action on the revenue and expenditure sides, the government decided to maintain the status quo. Fortunately, the widely discussed Hungarian-style banking tax has at least been postponed, thus limiting the potential negative effects, particularly the potential withdrawal of capital/depreciation pressures and more scarce and expensive credit. VAT remained flat at 23% and increased excise duties on cigarettes and gasoline were the sole measure to boost the revenue side. Along with no additional tax burden, the government failed to present a stronger commitment towards consolidation on the revenue side, as public sector wages and pensions remained untouched. As a result, the updated budget mathematics confirmed the under-performing revenue side (revenues are expected to be 4.0% lower than initially planned, adding HRK 4.5bn to the budget gap; the initial gap was set at HRK 8.6bn, an amount fully utilized already in January-July). Despite the proclaimed savings on expenditures (HRK 1.5bn), the revenue side should miss the target by almost 1% (HRK 900mn), up almost 2% compared to 2009. The deficit target for 2010 has therefore been revised by 1.7% of GDP to 4.2% of GDP (HRK 14bn), implying the need for additional financing in the region close to EUR 1bn. Details on financing actions were not revealed, but if the external environment would allow it, we think it is likely that the government would tap external markets. Nevertheless, domestic banks are likely to step in if global market sentiment deteriorates. Still, with public debt to GDP approaching the 60% threshold, and with a low likelihood of stronger fiscal consolidation in the election year 2011, risks remain pronounced. Some optimism comes from the announced fiscal responsibility law, which should cap the 2011 budget at this year's level. However, given the level of fiscal credibility, we take this with some reserve.

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Czech Republic

Dramatic yield drop

This past week, bonds continued to be the major story for the markets, the Czech one being no exception. Panic-driven buying sent prices up and yields down to levels not seen for quite a long time (and for Germany, never before). The CZ 10Y bond was priced at 3.30% at one moment. While the original drop from 4.20% in June to below 4% could be justified by the improved macro outlook, new government and promised reforms, the current level of 3.30% is due to the extremely low German yields. We do not think that this will hold – the macro outlook is not the one that is priced in the bonds. Czech govies will rise back, but it may take time.

Second board member indicates unease with current low rates

Also this past week, CNB board member Janacek said 'it is certain that the period of low interest rates and their decline has ended' and that he is positive that the board will debate their level in 4Q. Janacek is another central banker (after Zamrazilova) who recently indicated that these extraordinarily low rates may pose a danger for the economy and financial stability in particular (this idea was already floated at the last two meetings, as evidenced in the minutes). This is in line with our forecast (we remain probably the only ones to expect a hike in the Czech Republic this year) and we think that, once the revised 2Q GDP data comes in (we expect an upward revision), this outlook will gain support. So far, there are only two members saying outright that rates are probably too low, but strong economic data should persuade others

before year-end. This supports our view of rising yields in the coming months, although the main determining factor will be the financing structure (domestic – foreign) and the end of the current panic.

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Hungary

Central bank's new prognosis less optimistic, uncertainty about rate path increases

In line with expectations, the central bank left rates unchanged on Monday. The decision, according to Governor Simor, came after 'a long debate and consideration.' The council discussed three options (a 25bp cut, no change and a 25bp hike), adding to the evidence that it was a difficult decision. The new economic forecast was likely a reason behind the ambivalence, as it indicates lower growth expectations (down from 3.2% to 2.8% for next year), but a higher inflation trajectory (up from 3.0% to 3.5% for 2011). The former revision is due to weak domestic demand, driven by tight credit conditions (no signs of a lending activity trend reversal by the end of this year), increased servicing costs of FX loans (due to the weaker forint) and increased unemployment. The main upside inflation risks stem from food and commodity prices and the forint exchange rate. The central bank also notes somewhat improved risk assessment (especially as regards the forint and forint government bonds), pointing out, though, that CDS spreads and spreads on FX bonds remain elevated. Governor Simor warned that, if inflation risks continue or the country's risk premium rises, interest rates would have to be increased. The central bank also expressed some doubts about the fiscal deficit, expecting it to reach 4.3% of GDP for this year, thus some 0.5pp above the government's target, without any additional (to those proposed already) measures. For the following years, the NBH expects only a slow reduction of the deficit. Markets reacted with unease to the central bank's statements. Still, one has to keep in mind that, even with the central bank's estimates, Hungary would post one of the lowest deficits in the EU. For the time being, we maintain our year-end yield forecasts, although short-term risks are rising – and could intensify if the discussion on a replacement for Governor Simor heats up.

Government talks add to market's disquiet

On Tuesday, the Ministry of the Economy announced that Economy Minister Matolcsy will replace CB Governor Simor as the country's representative in meetings with the IMF. Simor mentioned this possibility on Monday and agreed to the step. The news itself was not too troublesome for the markets, but certainly did not help to improve the sentiment after Monday's statement from the central bank. On Wednesday, more (perplexed) statements came out. After an IMF spokesman said on Tuesday evening that the IMF is trying to bridge the differences with Hungary on the current loan, the media reported the next morning that negotiations with the IMF on the loan program will resume in autumn and an agreement should be reached. Shortly thereafter, the Economy Ministry reacted, saying that talks will take place in autumn under the framework of the economic consultations carried out with every country, denying any attempt to agree with the IMF on new specifications for the loan program. Hungary will, according to the ministry, rely on market financing in the coming period. After this news, the forint dropped to a new record low vs. the Swiss franc (past 219), driven by both the weakness of the forint and strength of the franc. The next day, the forint, together with the Polish zloty and the Czech koruna, corrected vs. the euro, which meant a slight correction vs. the franc as well.

Thursday auction met demand, but at higher yields

The government sold 3-, 5- and 10-year bonds on Thursday for a total of HUF 50bn. Total demand for 3-year bonds reached HUF 28.85bn and the debt management agency sold HUF 20bn at an average yield of 6.88% (up from 6.82 at the preceding auction on August 12). Demand for 5-year bonds reached HUF 31.49bn; the agency sold HUF 15bn at an average yield of 7.0%, up from 6.87% on August 12. Finally, the agency sold HUF 15bn in 10-year bonds with total demand at HUF 28.40bn and an average yield of 7.05%, down from 7.09% on August 12. Bid-to-cover ratios for all three maturities were lower than at previous auctions and, according to Reuters, a big investor from the US seen earlier did not show up this time. The whole curve rose by 10-20bp after the auction. In the coming months, we expect a sideways movement of the curve.

This week, data on retail sales and the unemployment rate was released, both more or less in line with expectations. Retail sales in June (after adjusting for working days) dropped by 4.6%, against our expected -4.3% and the market's more pessimistic -5.6%. In m/m terms, retail sales

contracted by 0.1%. The unemployment rate was just in line with expectations, having eased to 11.0% (from 11.1%), partly thanks to positive seasonal affects and the continued pick-up in the industrial sector. Next week, only data of secondary importance is set for release - producer prices and the final estimate of the trade balance.

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Poland

NBP gives less hawkish statement, due to weaker data flow

In line with market expectations, the MPC kept rates unchanged on Tuesday. Not much new can be learned from the statement - only that it sounds somewhat less hawkish (which is not very surprising, given the latest data inflow, most of which has been a negative surprise). Importantly, the council does not seem to worry too much about the planned VAT hike and its impact on inflation. The statement points out the positive development on labor market, which has, however, failed to translate into more pronounced wage growth. Overall, the council speaks about 'stabilizing economic growth' in Poland – which sounds about the same as June's assessment, but somewhat less optimistic than earlier references to the 'continued economic recovery'. The major source of uncertainty is global developments, especially the signs of slower dynamics from the US. As regards the inflation outlook, the council expects only a minor pass-through of the VAT hike to prices (about 1pp VAT hike to contribute around 0.3pp to inflation). In the coming months, inflation should increase gradually, driven by food and energy price developments on global markets. The NBP's statement also points to the continued weakness of core inflation. The council also expressed some worries about the government's fiscal plan. In particular, the members would like to see more savings on the spending side. The members appreciate the effort to create a multi-year program. The reference to the informal bias of the monetary policy seems to have disappeared for good; instead, the document simply states that 'the council has discussed factors that may fuel inflationary pressures in the medium term.' Three days later, two rate setters spoke, basically just confirming the message from Tuesday's press conference. Elzbieta Chojna-Duch reiterated that rate hikes this year are not off the table, but that does not mean that it is a done deal either; the council will watch the data flow. She also recommended that the government exert more effort as regards the budget. Adam Glapinski just repeated his (hawkish) view that the council should send a strong signal to the market by introducing a larger (than 25bp) hike, followed by stability, confirming that the rate setters' views are quite divided. Overall, the council does not seem to be rushing into monetary tightening and they can still afford a wait-and-see approach for now. A more cautious statement will likely be caused by weaker data inflow and less optimistic expectations for EMU growth in 2H. At this point, the chances of a rate hike in September/October (our call) seem smaller, but it can all change quite quickly, should the worries about 2H prove exaggerated. At this point, we maintain our forecast of 25-50bp in hikes by the end of the year, the first one most likely to come in October.

Unemployment rate continues to ease, retail sales just slightly below expectations

July's unemployment rate was in line with expectations, having eased another 0.2pp to 11.4%. The data is positively affected by seasonality, but also confirms that the good performance of the Polish industrial sector is starting to filter into the labor market, suggesting positive prospects for consumer demand in the coming months. We believe that the seasonally adjusted unemployment rate has already peaked in Poland, while the NSA figure could return to some 12.2% in early 2011. Polish retail sales released this week just added to the flow of negative surprises this month, even though here the disappointment was minor. In annual terms, retail sales added 3.9% (Erste: 4.7%, market: 4.1%), after June's 6.4%. The working day effect was a negative factor in July's reading (both annually and monthly). We think that the data confirms the solid individual demand, which is supported by the slowly improving situation on the labor market (thanks to the externally-driven recovery of Polish manufacturing), as well as the improving dynamics of household credit growth. This all points to good prospects for 3Q growth and therefore supports monetary tightening before the end of this year.

Next week, the attention will be focused on the 2Q GDP data. Based on monthly releases, we expect a strong performance, driven mainly by strong external demand and a consequent pick-up in industrial production. Looking at the components, we expect net exports and inventories to have contributed the most to the annual growth. The support of individual consumption likely also remained solid. Fixed investment, however, likely dragged the growth down in 2Q. Overall, we expect +3.3% y/y.

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Romania

Detailed structure of 2Q10 real GDP due next week

The breakdown of 2Q10 real GDP will be watched closely by the markets next Wednesday. According to the flash estimate, real GDP increased by 0.3% q/q (seasonally adjusted data), but remained in negative territory compared to the same quarter of 2009 (-0.5% y/y). Similar to the previous quarters, the support of external demand from Eurozone countries played an important part in this evolution. This time, the good news could be stronger support offered by household consumption to economic growth compared to the previous quarters. In June, retail sales entered positive territory in annual terms for the first time since the onset of the economic recession in 4Q08. Besides the temporary effect determined by accelerated purchases of goods ahead of the VAT hike, retail trade is currently showing tentative signs of a recovery. Government consumption remained depressed, due to the ambitious fiscal consolidation program followed under the stand-by arrangement with the IMF. Real GDP could again enter negative territory in 3Q10, due to the deep cuts in public expenditures and the recent hike in VAT. However, the austerity measures are likely to be absorbed rather quickly by the Romanian economy and we expect a slow and constant upward trend in q/q terms beginning with 4Q10.

Additional steps towards reform of public sector

This week, the government presented the draft of a new version of the law regarding a unified pay scale in the public sector that could come into force in 2011. The law should correct the excesses of the past in terms of personnel spending in the government sector and is a top request of the IMF and EC. Government expenditure for the compensation of employees should decline from 9.5% of GDP in 2009 to 7.9% this year and to 6.1% by 2015. In a separate event, the upper house of the Parliament backed the 5pp hike in VAT to 24%, which was already effective from July 1. The final vote will take place in the next few weeks in the lower chamber of the Parliament. The ambitious reforms of the public sector will increase the confidence of foreign investors in the Romanian economy, free up additional resources for infrastructure projects and improve competition between the public and private sectors on the labor market. The continuation of the fiscal consolidation program in 2011 is good news for the capital markets and we maintain our forecast of 5Y government yields at 6.8% next June.

Budget deficit at 3.9% of GDP at end of July

The deficit of the consolidated state budget (cash standards) increased to RON 20bn after the first seven months of this year. Total revenues went up by 1.2% y/y, while expenditures advanced by 3.2%. Monthly revenues from VAT increased by 17% y/y in July alone, after the 5pp hike to 24%, and more positive effects are expected in the coming months. Cumulated revenues from excise advanced by 7.7% in January–July, proving that the fight against tax evasion in the area of tobacco and alcohol has intensified. Both personal and corporate income tax stood in negative territory, as the recession continues to take a toll on the revenues of households and profits of companies. On the expenditure side, personnel expenditures decreased by 4.7%, but social assistance continued to place a heavy burden on the state budget (+11.2%), following the resolution of the Constitutional Court to declare unconstitutional the cut in nominal pensions as of July. The budget deficit target of 6.8% of GDP agreed with the IMF for 2010 is achievable, but more efforts should be done to reduce the stock of domestic arrears in the next few months. At the same time, a widening of the taxation base by eliminating some legal exceptions that are unfair and tend to place a heavy tax burden only on some contributors should rank high on the agenda of the government ahead of the next talks with the IMF.

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Turkey

Capacity utilization fell short of expectations in August

This week's only data release was the August capacity utilization figures. Capacity utilization turned out at 73.4%, posting a 1.3pp m/m decline. Meanwhile, the seasonally and working day adjusted capacity utilization fell by 0.5pp in August (to 72.4%), according to our calculations. The decline in seasonally and working day adjusted capacity utilization supports our view of a slowdown in the economic activity in the second half of the year. Separately, the CBT disclosed the results for the August business tendency survey. Following the 0.8% m/m increase in July, real sector confidence deteriorated by 1.5% m/m to 111.0 in August. This was in line with our expectations. Looking at the details, the decline seems to have resulted from the sharp decline in the total amount of orders received in the last three months (-9.4% m/m) and the decline in new orders received (-3.5% m/m). Nevertheless, expectations regarding production in the following three months rose by 3.6% m/m and prevented the overall index from declining further. Moreover, given the expected slowdown in Turkey's main trading partners, we expect capacity utilization to remain under pressure during the remainder of the year. We foresee capacity utilization hovering around 73-75% going forward, which in turn would suggest weaker industrial production growth rates.

Credit rating could be raised if government opts to save

S&P's Turkey analyst Frank Gill stated that Turkey's sovereign credit rating may be raised, should the government maintain the counter-cyclical fiscal policy. Moreover, Gill noted that Turkey was leaning towards a more accommodative medium-term fiscal stance, which in turn would put pressure on the current account and raise questions on Turkey's competitiveness and creditworthiness, amid mounting twin (current account and fiscal) deficits. As we stated previously, we do not expect to see any rating upgrades from the rating agencies until after the general elections, which are scheduled to take place in July 2011. Recall that S&P currently rates Turkey at 'BB' with a 'stable' outlook.

Foreign trade deficit to widen further, inflation to rise above 8%

Next week will start with a public holiday on Monday. On Tuesday, Turkstat will disclose July's foreign trade figures at 9:00 CET. The market consensus for June's foreign trade deficit stands at USD 5.7bn. Above the market consensus, we expect the foreign trade deficit to come in at USD 6.1bn, which, if realized, would bring the 12M trailing figure up to USD 54.9bn, from USD 52.6bn in June.

Separately, the Treasury will also disclose the August borrowing strategy on the same day, after the market close. According to the preliminary announcement, the Treasury has a total redemption of TRY 14.2bn, of which TRY 12.7bn will be to the markets. The heaviest redemption to the markets will be executed on September 29, with TRY 4.5bn, followed by the redemption on September 15 (TRY 4.2bn). We do not expect any major impact on bond yields, unless global sentiment deteriorates further.

Turkstat will announce CPI and PPI realizations for August on Friday at 9:00 CET. Pretty much in line with the expectations released in the CBT's expectations survey, we expect CPI inflation to post a 0.26% m/m increase in August. After declining for three consecutive months, we believe that food prices will likely have a bolstering effect on August inflation. We expect food prices to rise by around 0.9% m/m in August, mainly due to the Ramadan effect. We also expect modest increases in housing and transportation prices, while we expect the clothing component to decline by around 4.5% m/m, due to seasonal discounts, hence trimming some 0.3pp from the headline figure. If our estimation proves correct, the annual inflation will edge up to 8.2%, from 7.6% one month ago.

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Ukraine

VAT bonds expected next week

As the first two days of this week were public holidays (Independence Day), we did not see many developments on the financial market. Next week, we are likely to see the long-awaited VAT bond issuance from the government. These 5Y bonds (with semi-annual amortization) will be granted to Ukrainian companies in exchange for VAT refund arrears. In total, as much as UAH 17bn (EUR 1.7bn) may be issued. The government already conducted a 'test' tranche of just UAH 48mn (EUR 4.8mn). The second tranche may reach UAH 12bn (EUR 1.2bn). This could create significant stress for the market, as non-state-owned banks and non-residents currently hold UAH 23bn of government securities. However, the liquidity surplus within banks is at a record high, while demand for loans is low; thus, willingness to go further into government debt is high. The main intrigue for the VAT bond issue is the participation level of the NBU. Although it was stated that the NBU would not buy VAT bonds directly, it may decide to provide loans to state-owned banks for them to buy the bonds. The NBU helping banks buy a significant portion of the VAT bonds is the most likely scenario, in our view. Under such conditions, we would not see a strong rise in government bond yields, but the bond issuance would still force yields to remain close to current levels, at least in the short term. Ukrainian government bonds remain an attractive investment opportunity, as yields remain well above inflation. Bonds with 2-3-year maturity yielding 12-13% are the most attractive investment opportunity. One should only wait to see if the yields go even higher if the NBU decides not to intervene in the process.

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Capital markets forecasts

| | Exchange Rate vs EUR | | | | | | | | | | | | | |
|---------------|----------------------|------|------|------|-------|-------|------|------|------|------|------|------|-------|-------|
| | CZK | Fwd | HRK | Fwd | HUF | Fwd | PLN | Fwd | RON | Fwd | TRY | Fwd | UAH | Fwd |
| Spot | 24.8 | | 7.28 | | 285.0 | | 3.99 | | 4.25 | | 1.93 | | 10.05 | - |
| Sep-10 | 25.1 | 24.8 | 7.28 | 7.28 | 280.0 | 285.6 | 3.92 | 4.00 | 4.23 | 4.35 | 1.95 | 1.94 | 10.53 | 10.21 |
| Dec-10 | 24.7 | 24.8 | 7.30 | 7.30 | 270.0 | 288.3 | 3.75 | 4.02 | 4.22 | 4.43 | 1.99 | 1.97 | 10.70 | 10.41 |
| Mar-11 | 24.6 | 24.8 | 7.30 | 7.30 | 265.0 | 291.0 | 3.66 | 4.04 | 4.20 | 4.49 | 2.00 | 2.00 | 10.24 | 10.59 |
| Jun-11 | 24.4 | 24.8 | 7.25 | 7.25 | 262.0 | 293.1 | 3.61 | 4.07 | 4.15 | 4.55 | 1.98 | 2.03 | 10.01 | 10.75 |

| | Intervention Rate | | | | | | | 3M Money Market Rate | | | | | | | | | | |
|---------------|-------------------|------|------|------|------|------|------|----------------------|------|------|------|------|------|------|------|------|------|------|
| | CZ | HR | HU | PL | RO | TR | UA | CZ | Fwd | HU | Fwd | PL | Fwd | RO | Fwd | TR | Fwd | UA |
| Spot | 0.75 | 6.00 | 5.25 | 3.50 | 6.25 | 7.00 | 7.75 | 1.24 | | 5.35 | | 3.81 | | 6.69 | | 7.47 | | 3.13 |
| Sep-10 | 0.75 | 6.00 | 5.25 | 3.75 | 6.25 | 7.00 | 7.75 | 1.15 | 1.25 | 5.25 | 5.40 | 4.00 | 3.90 | 7.10 | 7.32 | 7.50 | 7.97 | 3.00 |
| Dec-10 | 1.00 | 6.00 | 5.25 | 4.00 | 6.25 | 7.00 | 7.75 | 1.25 | 1.21 | 5.20 | 5.47 | 4.10 | 4.08 | 7.30 | 6.18 | 7.50 | 8.78 | 3.00 |
| Mar-11 | 1.00 | 6.00 | 5.25 | 4.00 | 6.00 | 7.00 | 7.25 | 1.25 | 1.24 | 5.20 | 5.48 | 4.20 | 4.30 | 6.90 | 5.98 | 7.60 | 8.70 | 4.00 |
| Jun-11 | 1.25 | 6.00 | 5.25 | 4.25 | 6.00 | 7.00 | 7.00 | 1.33 | 1.94 | 5.20 | 5.73 | 4.20 | 3.95 | 6.70 | 5.52 | 7.60 | 8.31 | 4.00 |

| | 10y Govt. Yield | | | | | 5y Govt. Yield | 2y Govt. Yield | 2y Govt. Yield |
|---------------|-----------------|------|------|------|------|----------------|----------------|----------------|
| | CZ | HR | HU | PL | SK | RO | TR | UA |
| Spot | 3.34 | 6.52 | 7.35 | 5.38 | 3.67 | 7.85 | 8.11 | 12.3 |
| Sep-10 | 3.80 | 6.20 | 7.00 | 5.60 | 3.80 | 7.50 | 8.30 | 14.0 |
| Dec-10 | 3.90 | 6.10 | 7.10 | 5.65 | 4.40 | 7.40 | 8.90 | 13.0 |
| Mar-11 | 3.90 | 6.00 | 6.70 | 5.70 | 4.50 | 7.00 | 9.30 | 12.0 |
| Jun-11 | 3.90 | 6.00 | 6.30 | 5.70 | 4.60 | 6.80 | 9.50 | 11.0 |

Long-term forecasts

| Real GDP growth (%) | 2008 | 2009 | 2010f | 2011f |
|---------------------|------------|-------------|------------|------------|
| Croatia | 2.4 | -5.8 | -1.5 | 1.5 |
| Czech Republic | 2.3 | -4.0 | 1.8 | 1.7 |
| Hungary | 0.6 | -6.3 | 0.9 | 3.1 |
| Poland | 4.9 | 1.8 | 2.5 | 3.3 |
| Romania | 7.3 | -7.1 | -3.0 | 1.2 |
| Serbia | 5.4 | -3.0 | 1.3 | 3.1 |
| Slovakia | 6.2 | -4.7 | 3.1 | 4.0 |
| Turkey | 0.7 | -4.7 | 4.8 | 5.1 |
| Ukraine | 2.1 | -15.1 | 3.3 | 4.5 |
| CEE8 average | 4.1 | -3.7 | 1.4 | 2.8 |
| CEE8+Turkey | 2.7 | -4.1 | 2.8 | 3.8 |

| CPI (%), eoy | 2008 | 2009 | 2010f | 2011f |
|---------------------|------------|------------|------------|------------|
| Croatia | 2.9 | 1.9 | 3.8 | 3.0 |
| Czech Republic | 3.6 | 1.0 | 2.1 | 2.4 |
| Hungary | 3.5 | 5.6 | 3.6 | 3.2 |
| Poland | 3.3 | 3.5 | 2.4 | 3.2 |
| Romania | 6.3 | 4.7 | 8.0 | 4.3 |
| Serbia | 8.6 | 7.7 | 4.9 | 5.3 |
| Slovakia | 4.4 | 0.5 | 2.0 | 4.0 |
| Turkey | 10.1 | 6.5 | 7.0 | 6.8 |
| Ukraine | 22.3 | 13.0 | 12.5 | 9.0 |
| CEE8 average | 5.8 | 4.2 | 4.3 | 3.9 |
| CEE8+Turkey | 7.5 | 5.2 | 5.4 | 5.1 |

| Unemployment (%) | 2008 | 2009 | 2010f | 2011f |
|---------------------|------------|-------------|-------------|-------------|
| Croatia | 8.4 | 9.1 | 10.7 | 10.4 |
| Czech Republic | 5.4 | 8.1 | 9.1 | 9.2 |
| Hungary | 7.8 | 10.0 | 10.9 | 10.0 |
| Poland | 10.0 | 11.0 | 12.7 | 10.8 |
| Romania | 5.8 | 6.9 | 8.4 | 8.2 |
| Serbia | 13.7 | 16.1 | 18.5 | 18.0 |
| Slovakia | 9.6 | 12.1 | 14.3 | 13.5 |
| Turkey | 11.0 | 14.0 | 13.1 | 12.7 |
| Ukraine | 6.4 | 8.8 | 8.6 | 8.3 |
| CEE8 average | 8.2 | 9.9 | 11.2 | 10.3 |
| CEE8+Turkey | 9.3 | 11.6 | 12.0 | 11.3 |

| 3M rates (average, %) | 2008 | 2009 | 2010f | 2011f |
|-----------------------|-------------|------------|------------|------------|
| Croatia | 7.0 | 8.9 | 2.7 | 4.0 |
| Czech Republic | 4.0 | 2.2 | 1.3 | 1.5 |
| Hungary | 8.9 | 8.6 | 5.4 | 4.8 |
| Poland | 6.3 | 4.3 | 4.1 | 5.1 |
| Romania | 13.0 | 11.7 | 7.2 | 7.3 |
| Serbia | 15.6 | 14.4 | 9.0 | 8.5 |
| Slovakia | 4.2 | 1.2 | 0.8 | 1.6 |
| Turkey | 17.4 | 9.9 | 7.5 | 8.3 |
| Ukraine | 14.8 | 18.0 | 9.5 | 7.0 |
| CEE8 average | 8.1 | 7.0 | 4.6 | 4.8 |
| CEE8+Turkey | 11.9 | 8.2 | 5.8 | 6.2 |

| C/A (%GDP) | 2008 | 2009 | 2010f | 2011f |
|---------------------|-------------|-------------|-------------|-------------|
| Croatia | -9.2 | -5.4 | -3.5 | -3.9 |
| Czech Republic | -3.1 | -1.0 | -0.7 | -1.3 |
| Hungary | -7.1 | 0.2 | -0.4 | -1.1 |
| Poland | -5.0 | -1.6 | -3.1 | -4.8 |
| Romania | -11.6 | -4.5 | -5.3 | -5.7 |
| Serbia | -18.2 | -5.7 | -7.3 | -7.7 |
| Slovakia | -6.5 | -3.2 | -2.3 | -2.8 |
| Turkey | -5.7 | -2.3 | -4.4 | -4.5 |
| Ukraine | -6.7 | -1.7 | 0.0 | 0.0 |
| CEE8 average | -6.7 | -2.2 | -2.5 | -3.4 |
| CEE8+Turkey | -6.3 | -2.2 | -3.3 | -3.9 |

| Budget Balance (%GDP) | 2008 | 2009 | 2010f | 2011f |
|-----------------------|-------------|-------------|-------------|-------------|
| Croatia | -1.6 | -3.1 | -4.7 | -3.8 |
| Czech Republic | -2.1 | -5.3 | -5.3 | -3.9 |
| Hungary | -3.8 | -4.0 | -4.2 | -3.6 |
| Poland | -2.2 | -6.9 | -6.2 | -4.8 |
| Romania | -5.4 | -8.3 | -7.8 | -6.5 |
| Serbia | -2.5 | -4.0 | -4.8 | -3.5 |
| Slovakia | -2.3 | -6.8 | -7.5 | -6.0 |
| Turkey | -1.8 | -5.5 | -4.2 | -3.3 |
| Ukraine | -1.2 | -6.3 | -5.5 | -4.0 |
| CEE8 average | -2.7 | -6.2 | -6.0 | -4.7 |
| CEE8+Turkey | -2.3 | -5.9 | -5.3 | -4.1 |

Looking ahead

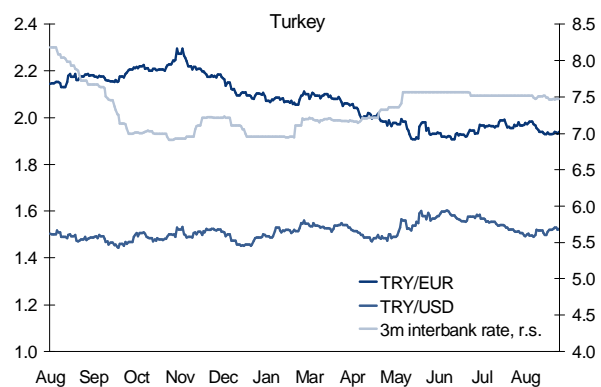
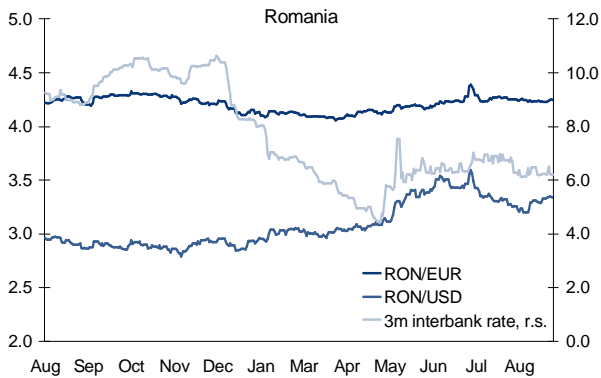
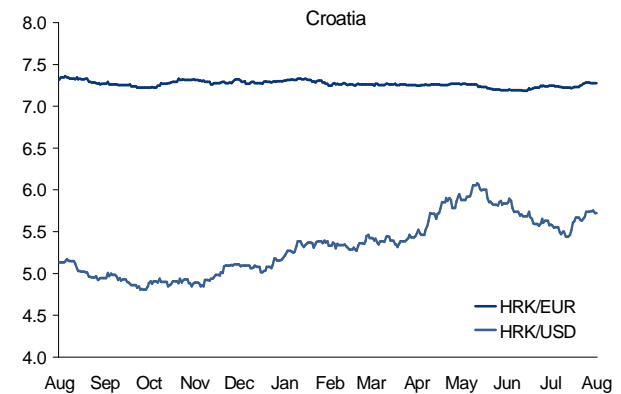
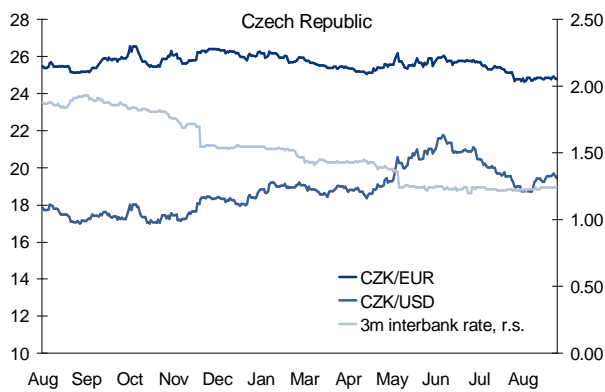
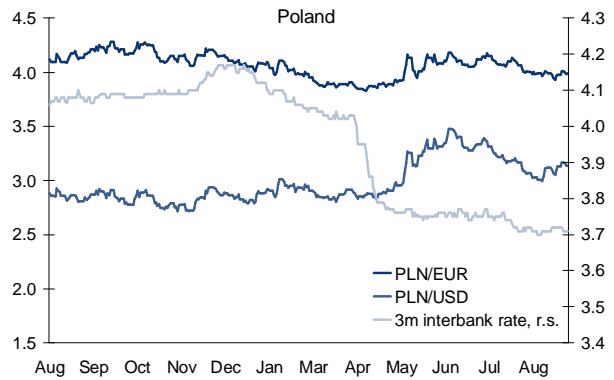
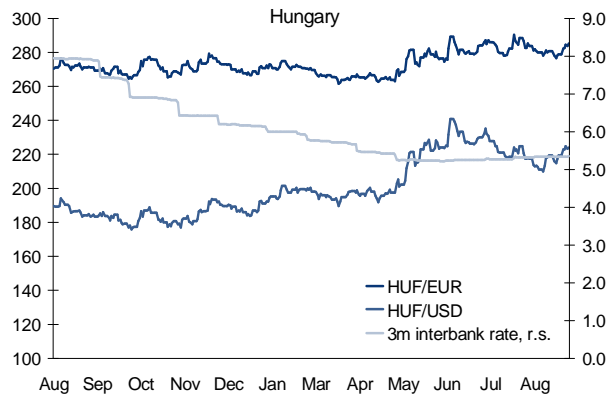
| Country | Date | Release/event/figures | Our expectation | Consensus* | Prior |
|-----------------------|--------|-------------------------------------|-----------------|------------|------------|
| Czech Republic | 3-Sep | Average Real Wage | | | |
| Croatia | 31-Aug | July retail trade | 0% y/y | | -1.5% y/y |
| | 31-Aug | July trade balance | € -575mn | | € -608mn |
| Hungary | 31-Aug | PPI, July, % y/y | | | |
| | 1-Sep | Trade balance, June F, EUR mn | 566.9 | | |
| Poland | 30-Aug | GDP, 2Q, % y/y | 3.3% | 3.2% | |
| Romania | 1-Sep | GDP - detailed press release (2Q10) | - | - | - |
| | 2-Sep | IPPI - July (y/y) | 7.5% | - | 6.23% |
| Slovakia | 2-Sep | Detailed 2Q GDP | 4.6% y/y | 4.6% y/y | 4.8% y/y |
| Turkey | 31-Aug | Foreign Trade, July | USD -6.1bn | USD -5.7bn | USD -5.6bn |
| | 3-Sep | CPI inflation, August | 0.3% | 0.3% | -0.5% |
| Ukraine | | | | | |

*Sources: Bloomberg, Reuters

Auction diary

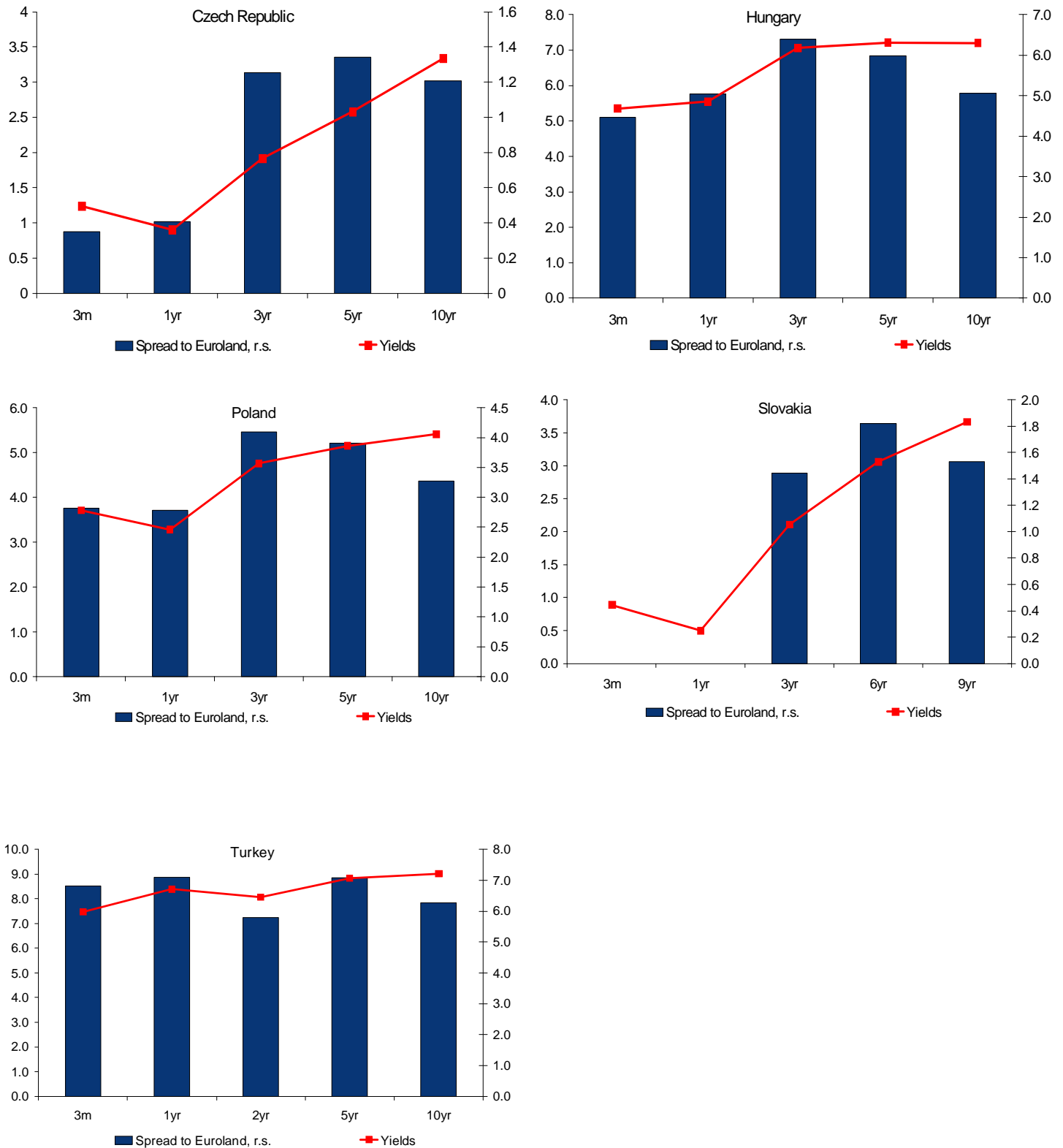
| Country | Auction-date | Pay-date | Maturity | Cupon | Offer | Forecast |
|-----------------------|--------------|----------|-------------|-------|---------------|------------|
| Czech Republic | 1-Sep | 6-Sep | Sep-01-2015 | | CZK 7 bn. | CZK 12 bn. |
| Hungary | 31-Aug | 8-Sep | 8-Dec-10 | | HUF 50bn | |
| | 2-Sep | 8-Sep | 27-Jul-11 | | HUF 50bn | |
| Poland | 1-Sep | 3-Sep | Oct-25-2012 | | n.a. | PLN 3.0bn |
| | 30-Aug-10 | 1-Oct-10 | 22-Aug-11 | | PLN 0.5-0.8bn | PLN 0.5bn |
| Slovakia | 30-Aug | 2-Sep | 2020-Apr-27 | 4.0% | | 3.65% |
| Ukraine | 31-Aug | 1-Sep | 2011-Feb-27 | | | 8.0% |
| | 31-Aug | 1-Sep | 2011-Aug-31 | | | 11.0% |
| | 31-Aug | 1-Sep | 2013-Aug-15 | | | 12.5% |

Exchange rates and interest rates (52 weeks)



Source: Bloomberg

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