CEE Bond Outlook 2012

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Erste Group Research

How much are CEE6* governments going to borrow in 2012?

*CEE6: Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia

With the exception of Hungary and Croatia, CEE6 countries have been advancing in their fiscal consolidation

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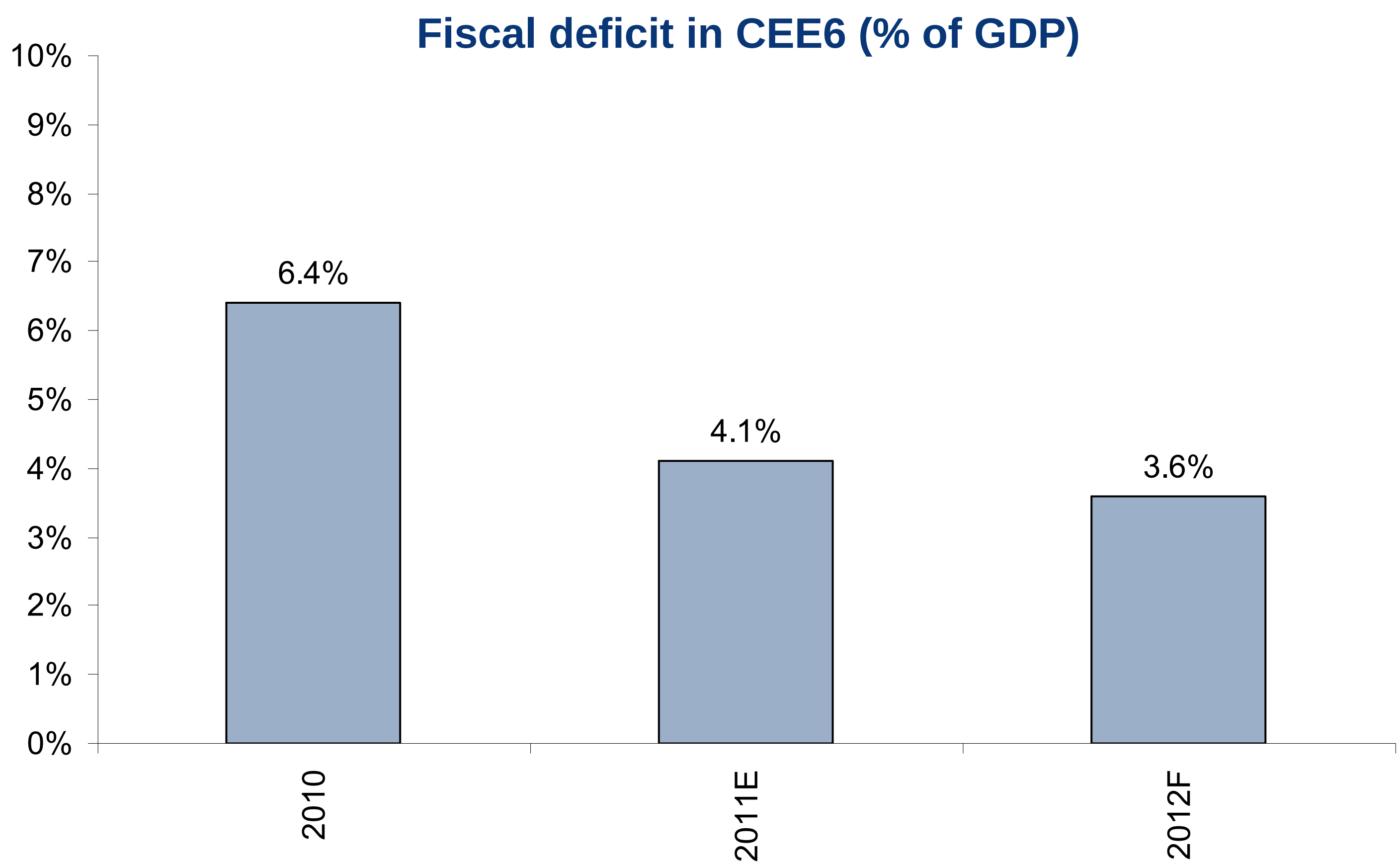
- we have seen decisive action being taken by governments to curb the gap right after the elections in Poland

- after the reduction of the deficit from 6.4% in 2010 to an estimated 4.1% of GDP on average in 2011, the deficit is to further shrink to 3.6% of GDP on average in 2012

- the six pack should strengthen budget surveillance and thus make the consolidation process less vulnerable to sudden turnarounds in politics



Source: Eurostat, Erste Group Research

CEE6 governments have to rollover redeeming debt worth EUR 72bn (about 8% GDP on average)

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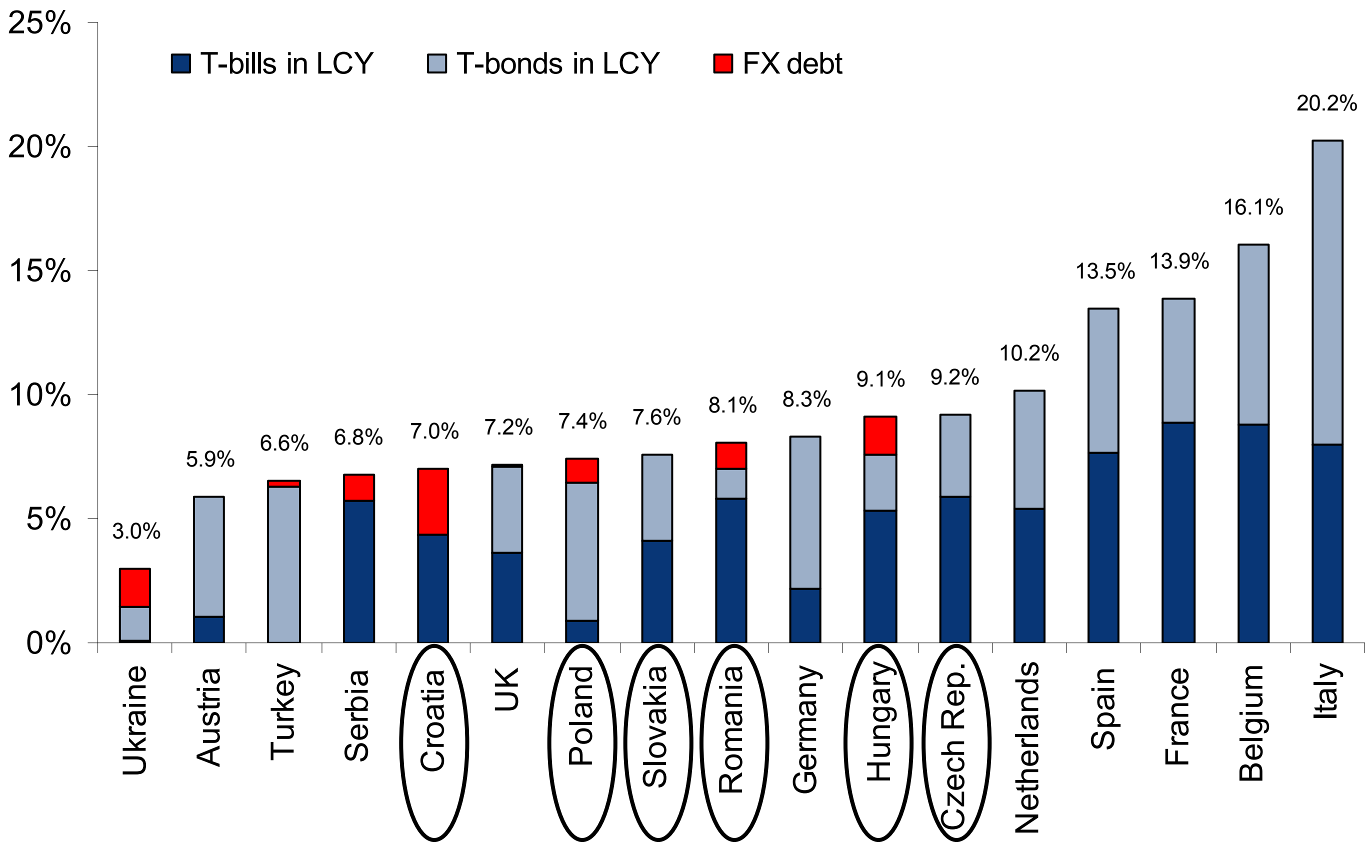
- CEE6 maturing debt is predominantly in the local currency
- A more challenging situation will be the rollover of maturing Italian, Spanish, French and Belgium debt worth 13.5-20.5% of their GDP

Redemptions in 2012 (% of GDP)



Source: EC Autumn 2011 Forecasts, Erste Group Research

Gross issuance of government securities in CEE6 to be EUR 107bn (or 12% of GDP in average)

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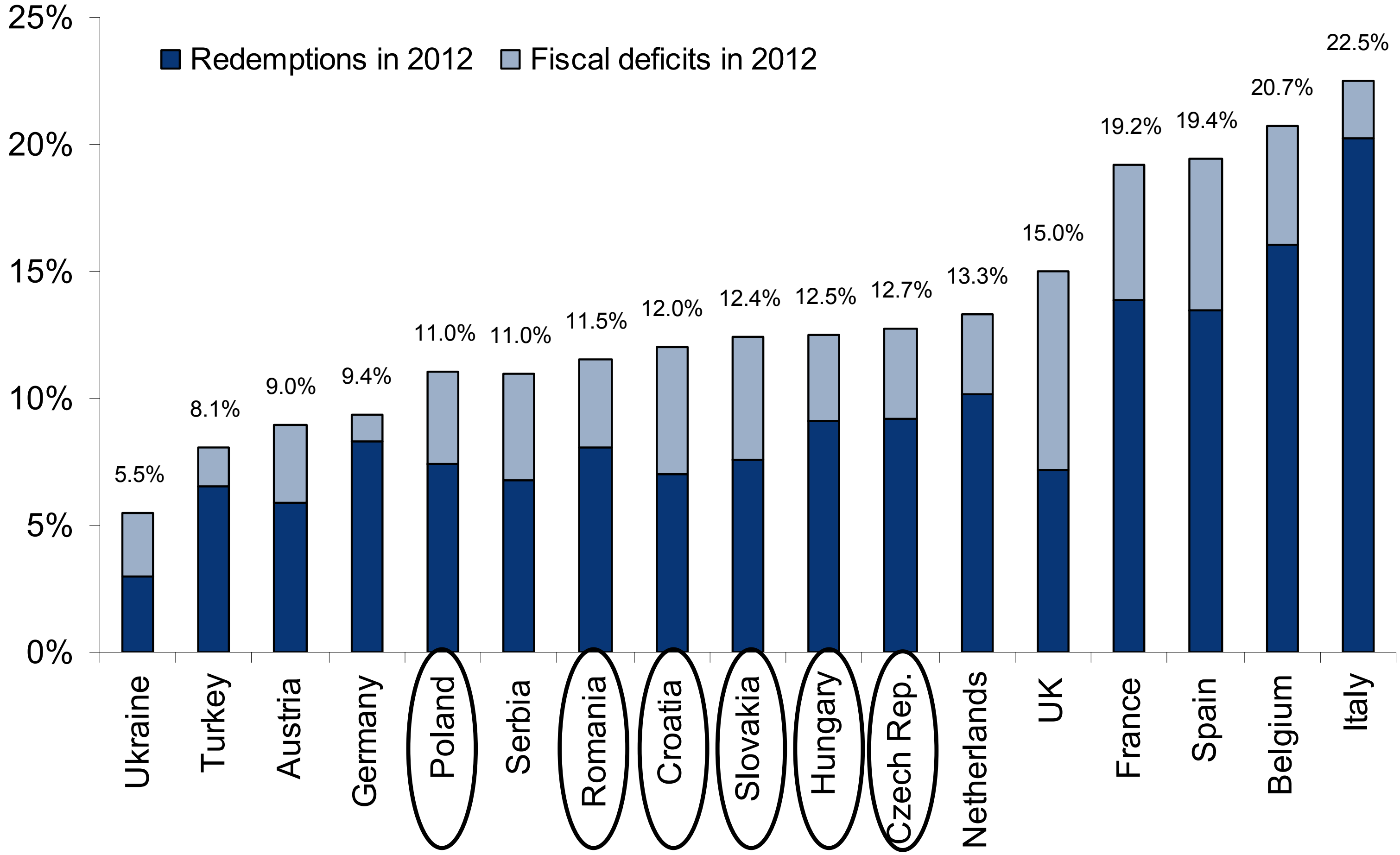
Estimated gross issuance (% of GDP)

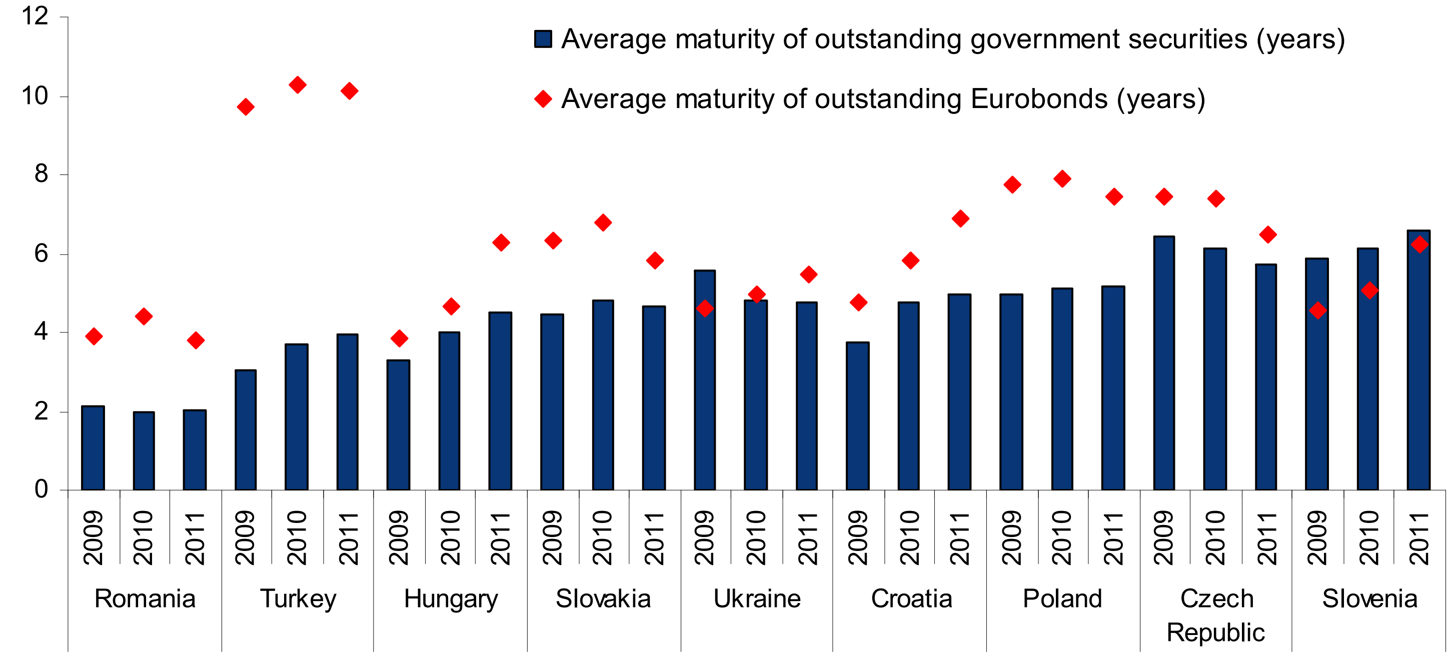


Source: EC Autumn 2011 Forecasts, Erste Group Research

Issuance of Eurobonds will aim to extend the average maturity of outstanding debt

- The Polish government placed already two new tranches of their existing EUR and USD Eurobonds in January (EUR 750m and USD 1bn, respectively).
- Romania and Turkey managed to place EUR 1.5bn and USD 1.5bn in 10Y Eurobonds in January, while the Slovak government placed EUR 1bn of 5Ysyndicated bonds in January.
- The Czech Republic and Croatia could issue Eurobonds soon.

Average maturity of government securities (years)



Source: Bloomberg, Erste Group Research

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Who is going to buy government bonds?

We have not seen any sizable sell-off comparable to the post Lehman shock

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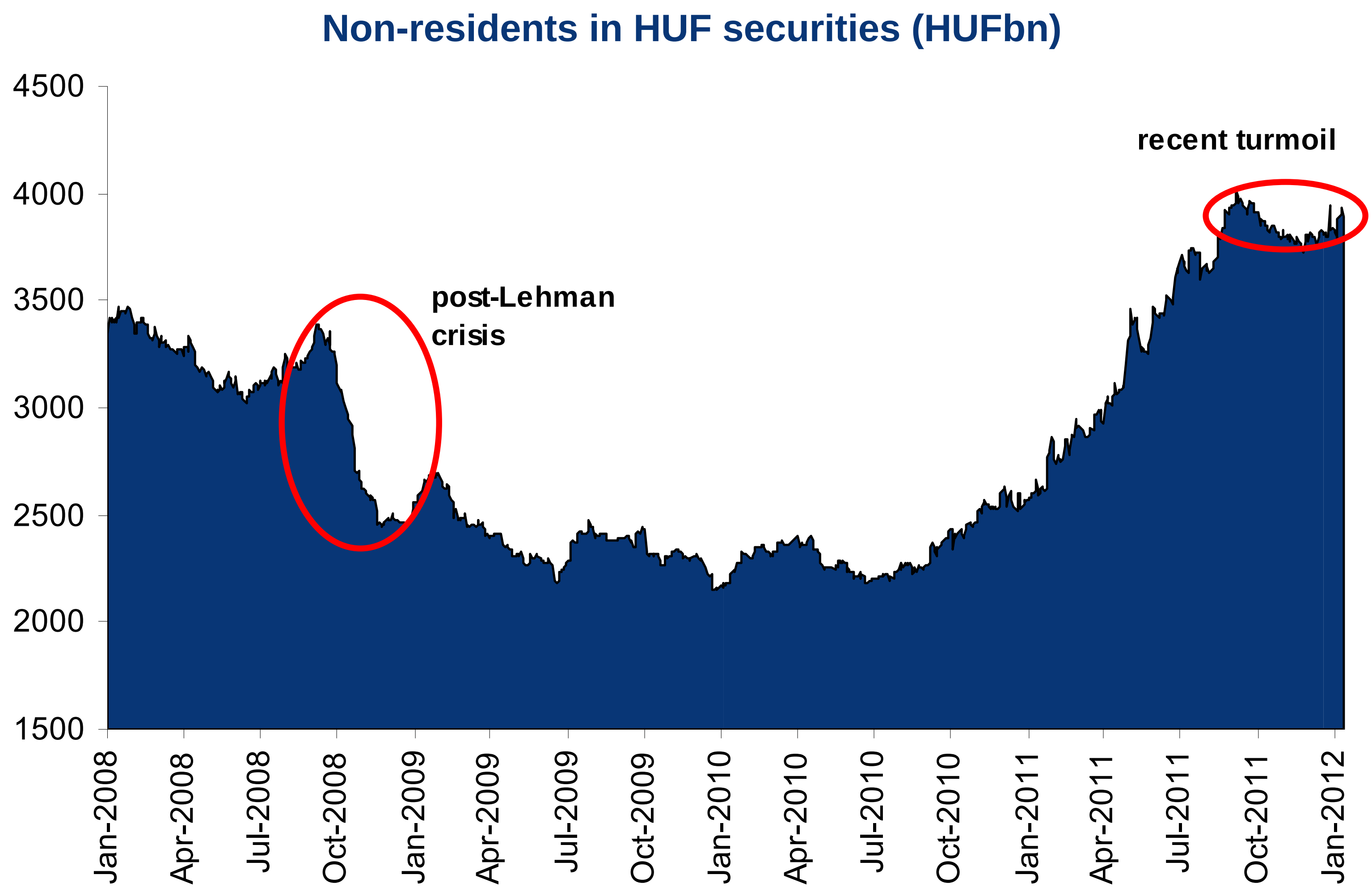

Source: AKK, Erste Group Research

ECB 3Y LTRO had positive effect on CEE assets

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- We expect that the environment of very low interest rates both in the US and the Eurozone
- generous LTROs conducted by the ECB will keep demand for govies strong, definitely for short-term securities
- CDS on CEE sovereign debt narrowed by about 50-100bp in January and bond yields collapsed further
- We expect that there might be some downside risk in the next couple of months, given that the Eurozone sovereign debt crisis is far from resolved
- Greek default could hit sovereign bonds as an asset class globally

The bulk of foreign investors who buy CEE bonds are definitely not banks

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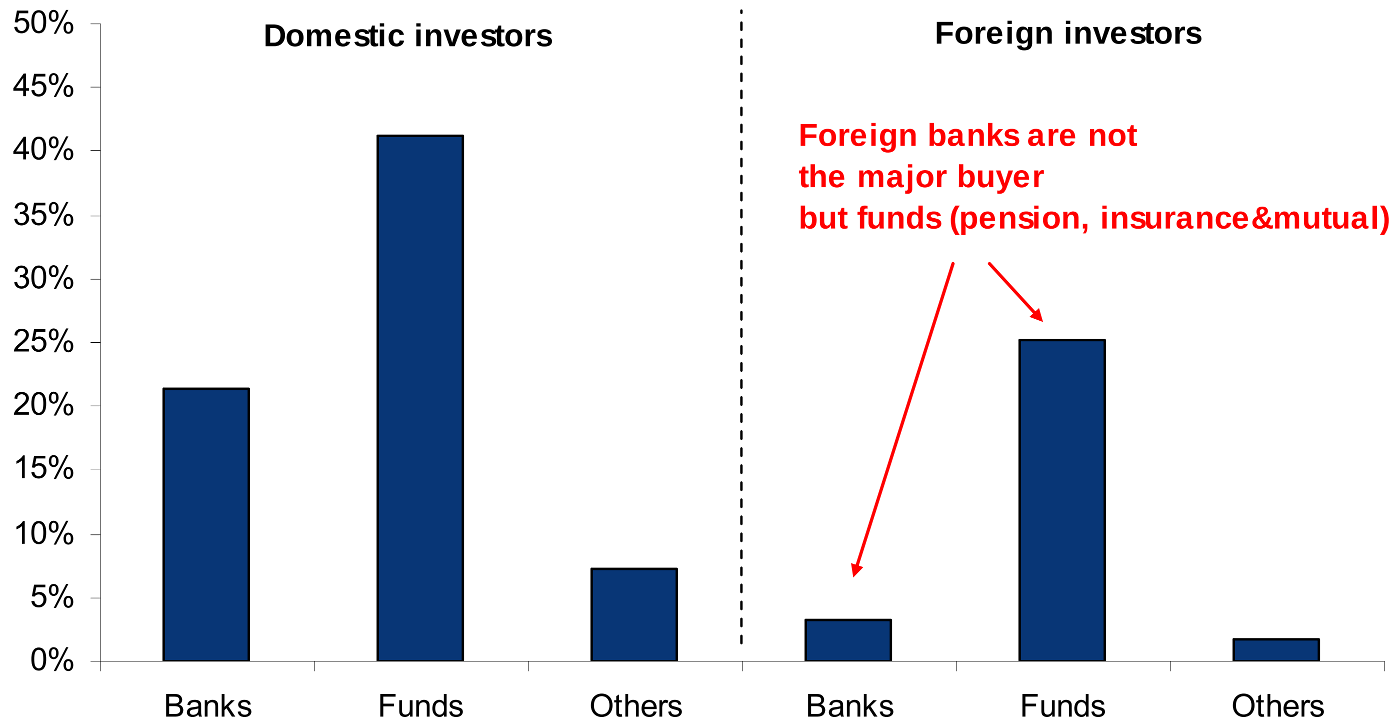
Breakdown of investors in Polish government bonds

- The foreign insurance companies and funds (mutual and pension) are a far more important player, with an 85% share among non-residents holding Poland's T-bonds.
- Investment grade matters, country has access to broader pool of investors
- Hungary, due to its recent downgrade to Junk, might lose this large investor group.



Source: Ministry of Finance, Erste Group Research

Ratings of many CEE countries have improved in relative terms against the widening group of downgraded Euro Area countries

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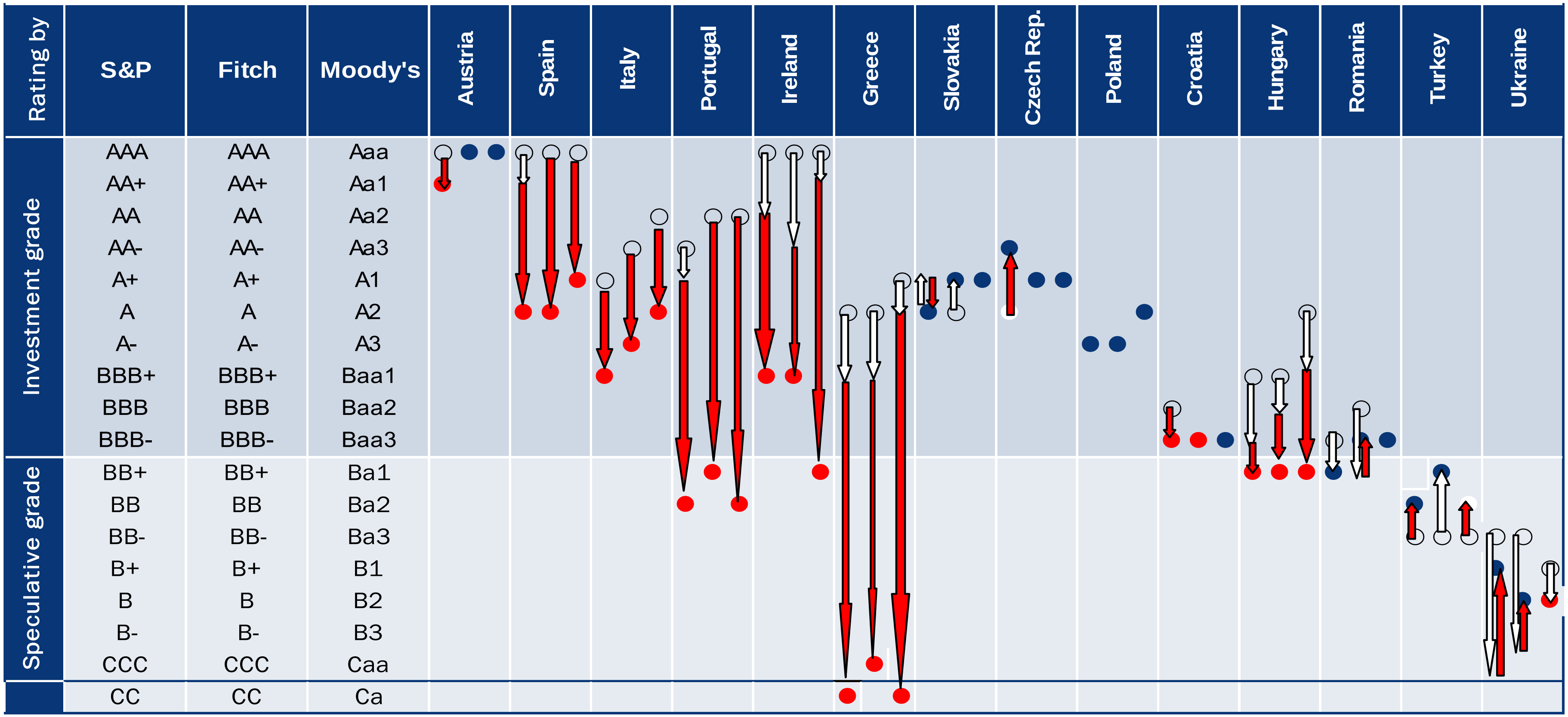
Relative ratings of CEE countries have improved



● blue/white/red = stable/positive/negative outlook

○ the rating as of mid 2008

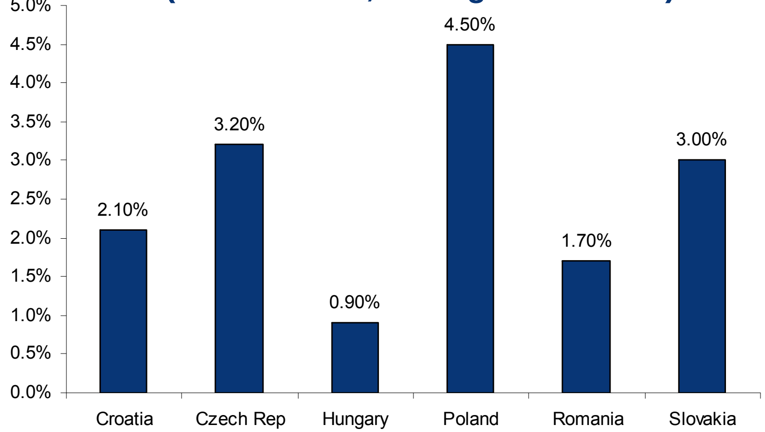
change between Jun 2008 and Dec 2009

change since Jan 2010

Source: Bloomberg, Erste Group Research

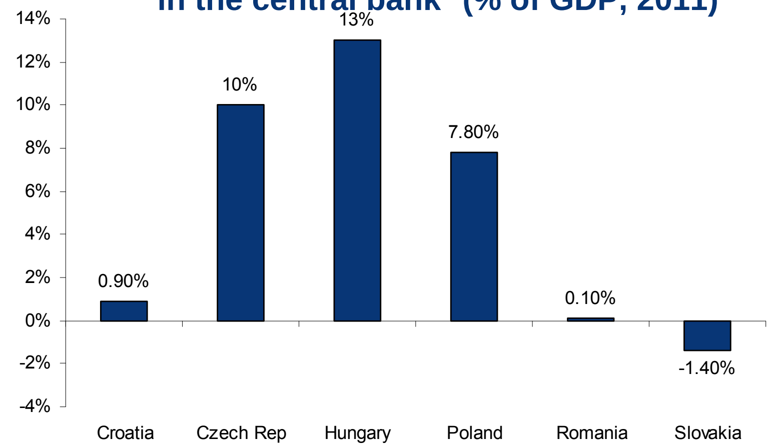
Given likely moderation of credit supply, banks can allocate move more funds into the government securities

Annual increase of private deposits (as % of GDP, average 2010-2011)



Source: Central banks, Erste Group Research

Net assets of commercial banks in the central bank* (% of GDP, 2011)



Source: Central banks, Erste Group Research, *less reserve req.

- Organic demand of domestic financial institutions for government securities should vary between 1.5-2.5% of GDP in CEE, thus financing about one third to one half of forecasted fiscal deficits (net issuance)
- The rest will be financed by non-residents or from the liquidity surplus which banks have accumulated over past years.
- Besides committed credit lines, governments can spend their cash, sell their liquid assets and last but not least privatize state-owned assets

But what if demand and supply meet at a high price, causing a debt spiral?

What is an affordable interest rate?

Otmar Issing: “solvency of a sovereign debtor is traditionally defined as the state being able to service its debtby collecting taxes”

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- the debt level of CEE countries is much lower, not only in the public sector, but also in the private sector.
- extremely low yields have enabled many advanced countries to stay above water and service their high stock of debt without serious problems
- the turmoil in the Euro Area increased pressure on yield spreads and opened discussion about the yield level, which would be still affordable from the solvency/liquidity point of view
- we look at the **ratio of interest costs on state debt to government revenues**, as watched by the rating agencies in their heat maps
- We arbitrarily **set the critical level of interest costs at 1/10 of tax revenues** - far from thresholds that would lead to default, but high enough to trigger market fears and discomfort for governments with high interest payments.

CEE countries are less stressed by their interest costs, there should be less concerns for investors

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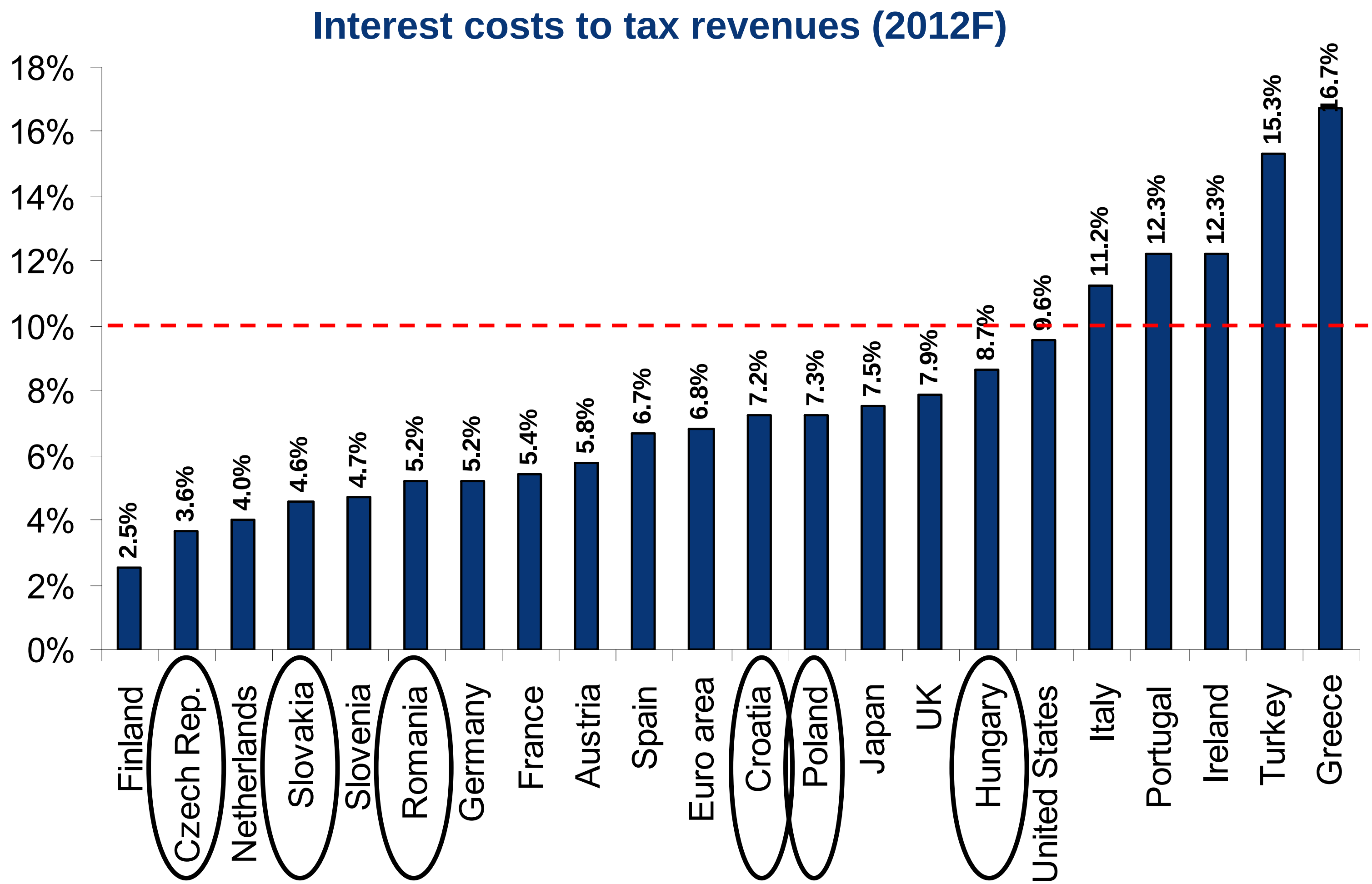

Source: EC Autumn 2011 Forecasts, Erste Group Research

Romania, the Czech Republic and Slovakia can afford higher interest rates if markets are under pressure

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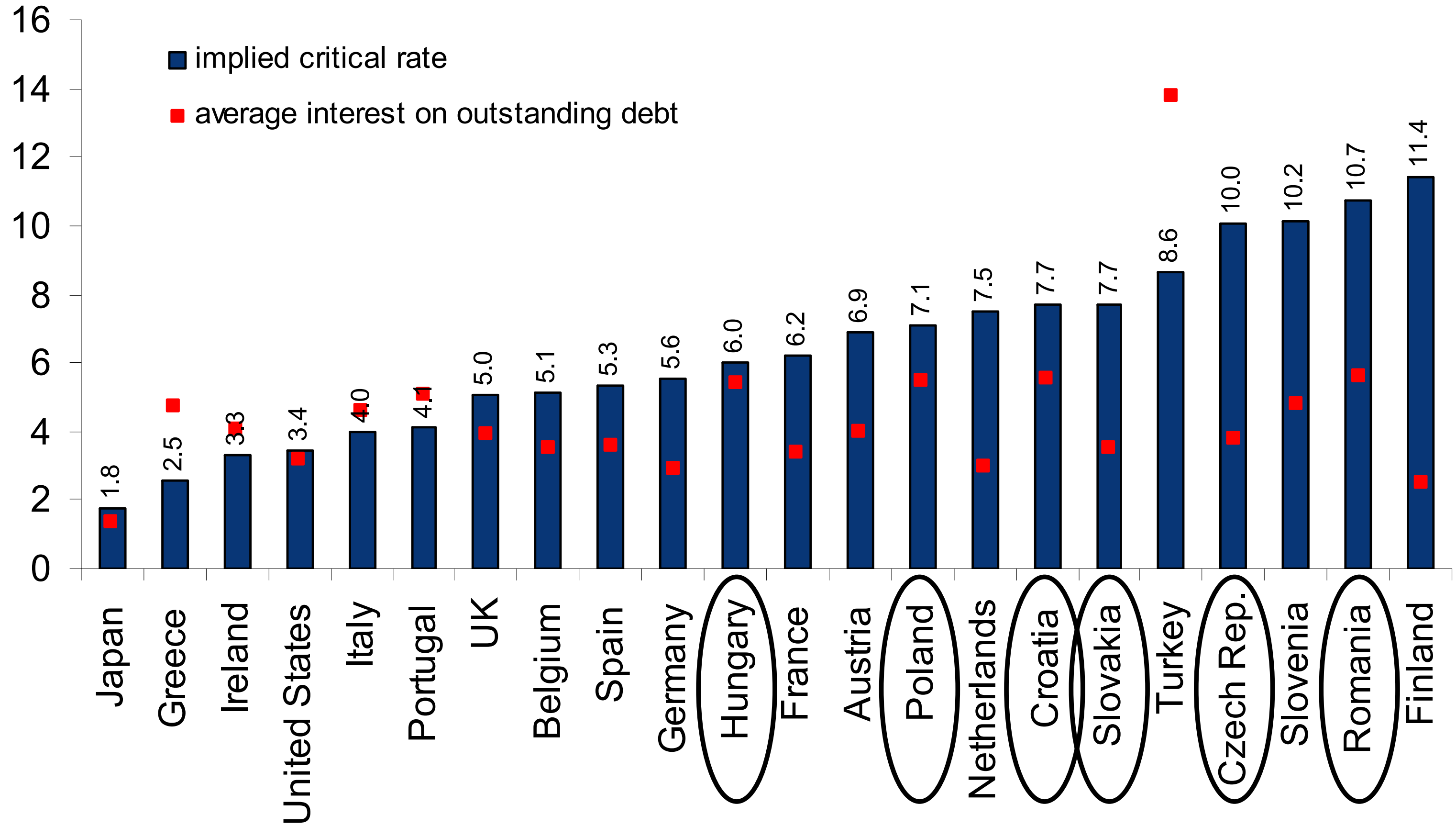
Critical rates and the average interest costs (2012F)



Source: EC Autumn 2011 Forecasts, Erste Group Research

Summary

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- CEE government bonds provide a reasonable reward to investors at a time when government bonds of the core euro area countries have become extremely expensive and bear very low yields (if any)

- Despite a successful 3Y LTRO and its positive impact on sovereign spreads both in the euro area and CEE, we see some upward risk for yields in the European benchmarks and a steepening of the yield curve

- A global credit event (i.e., a Greek default) or frustration from mounting public debt, higher capital requirements for holding the sovereign debt could have a negative impact on bonds as an asset class worldwide

- The Czech Republic, Romania and Slovakia can afford higher interest rates if markets are under pressure. Hungary should avoid any heavy financing above 6% in order to stay below the critical rate.

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