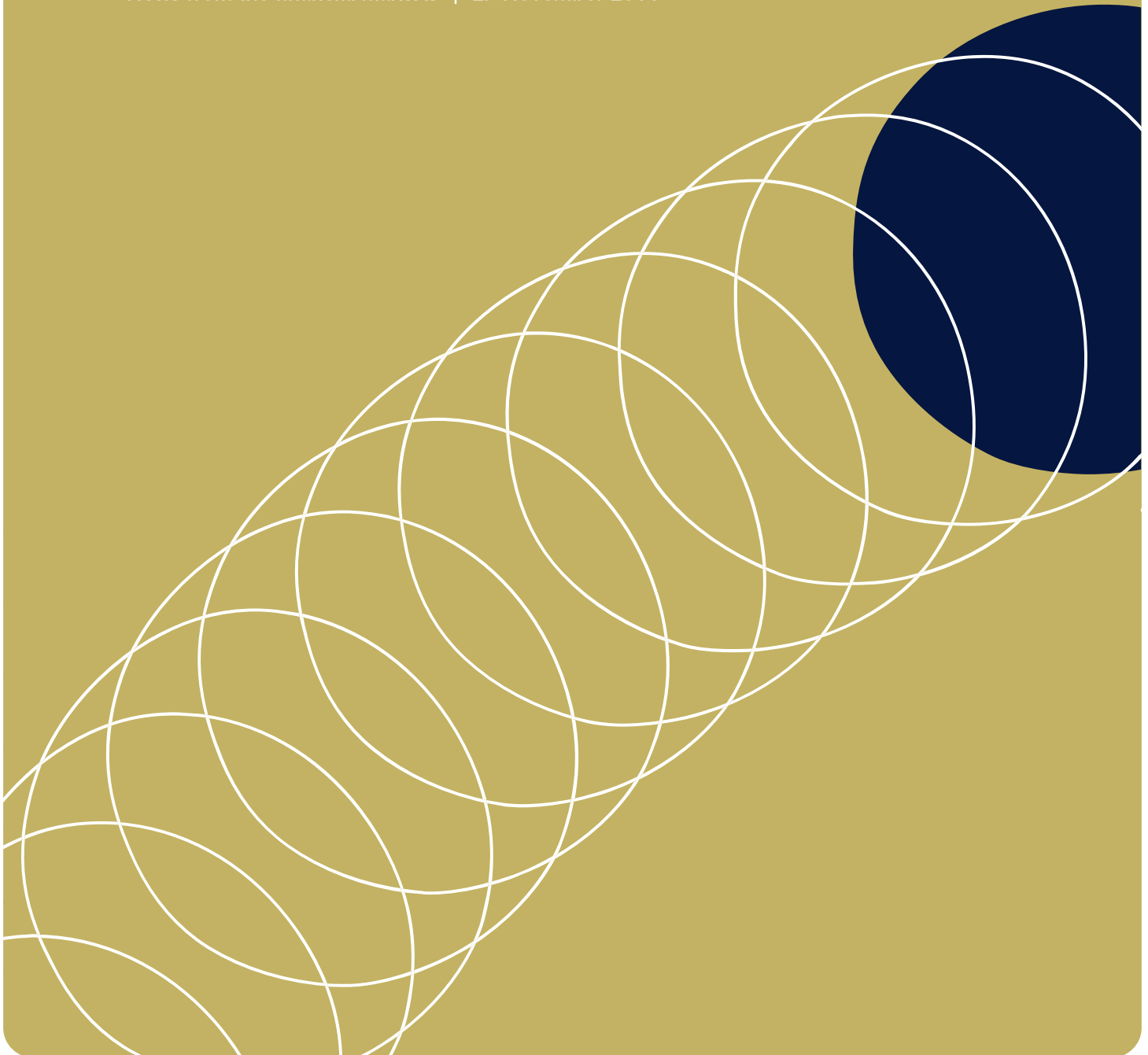


# Hungary no longer investment grade

Eastern European local currency markets under pressure

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# Hungary no longer investment grade

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**The Eastern European currencies are under pressure. In certain instances, the risk premiums even on EUR- and USD-denominated bonds of Eastern European issuers have also risen. The markets are particularly sceptical due to the high level of foreign-currency credits that have been granted in the past to the private sector. Rating agency Moody's has now responded with an initial downgrade: Hungary was recently cut from Ba1 to Baa3 and thereby lost its investment grade. We are reckoning with further losses, especially on the currency side.**

## Eastern Europe under renewed pressure

The interlinkage of the Eastern European financial sector with that of the euro zone is once again showing its drawbacks. The risk management operations of European banks are making a problem again out of the still-high foreign currency liabilities of the private sector in regions east of the euro zone.

- The heightened risk aversion in the financial markets that has prevailed since the summer months is putting pressure on the Eastern European currencies. That devaluation has made it increasingly difficult for borrowers to repay their foreign currency loans, most of which are denominated in Swiss francs.
- The increased need for writedowns is burdening the already battered banks in Italy. So out of risk considerations, their Eastern European business needs to be cut back, in some cases sharply.
- The Eastern European central banks have also ordered the leading commercial banks to lower their credit volumes in the region.

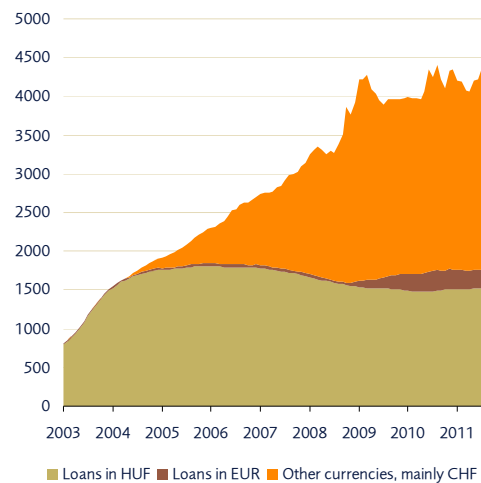
Liquidity bottlenecks in payment balances arise when credit lines are curtailed, and the anticipated recession in the euro zone will broaden that gap further. It is mainly the export-oriented countries that will take a hard hit from the decline in foreign demand. In order to compensate for that, the related currencies continue to lose ground, thereby making it even more difficult to repay foreign currency credits.

## Private sector affected the most

In recent years, the Eastern European countries have taken an austerity and consolidation route, as is evidenced by their significantly reduced budget and current account deficits. In Hungary, however, close to 60% of all private home building loans are denominated

in foreign currencies, primarily CHF. Because local incomes are earned in Hungarian forints, any sharp devaluation threatens the solvency of many private households. And for various Austrian and Italian banks, that risk is too high at present. They are cutting back those credit lines. If the financing of the balance of payments turns out to be lower than expected, the currency depreciates further and that move is reinforced by the drop in exports associated with the recession in the euro zone.

Hungary: Home building loans to private households (in HUF bn)



Source: Hungarian National Bank

So if international banks now curtail their lines of credit due to the precarious situation in the private sector, in worst case it can come to a balance of payments crisis. Ultimately, the risks of the private sector flow upwards into a general country-specific risk.

## EU member states are better protected

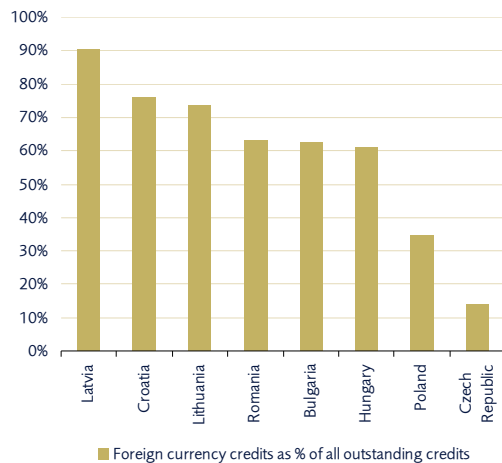
- We expect that Hungary and other Eastern European states will receive financial assistance if necessary, but for the time being we advise against new investments in the forint and other regional currencies.
- For the Eastern European EU members that have yet to introduce the euro, the EU Association Agreement provides for emergency financial assistance. Already in 2008 through 2010, Hungary, Romania and Latvia received large-scale aid payments from the EU.

- According to media reports, the European Bank for Reconstruction and Development (EBRD) and Austria's leading banks are drafting a new version of the Vienna Initiative aimed at avoiding liquidity bottlenecks.
- And finally, Hungary is seeking financial collaboration with the IMF. That could help to prevent a spillover of the Hungarian crisis into other countries in the region.

### Currencies are being pressured

Since September, the Hungarian forint has depreciated by almost 20% against the euro, and the Polish zloty has taken a ten per-cent hit. Inasmuch as the crisis in the euro zone can be expected to continue, the pressure on Eastern European currencies should remain high in the months ahead. And the larger the foreign currency obligations in the private sector, the greater the risk of further depreciation.

Foreign currency credits as % of all outstanding credits



Source: EBRD, national central banks

Accordingly, Hungary and Romania are subject to the highest risks of devaluation; Poland and the Czech Republic, the lowest. The currencies of Latvia, Croatia, Lithuania and Bulgaria are remaining firm against the euro. For the latter, we are reckoning with stable exchange rates for the time being.

### The bottom line

We advise against new investments in Eastern European currencies. Further price declines are probable in most of those units. Equally spoken, we expect that international financial assistance will be provided in order to avert liquidity bottlenecks. Risk-tolerant investors with a view to the long term can therefore maintain their existing positions. Eastern European government bonds denominated in hard currencies are presently valued at a level consistent with the specific issuer risk.



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