Erste Group analysts: CEE economies not facing credit crunch risk

With the turmoil on financial markets spreading to Europe from the US, many in the market are bracing for a worst-case scenario in the short term. “The market is not willing to account for fundamentals,” ac-cording to Erste Group research analysts. “We do not see risks of a credit crunch, decline of invest-ments or excessive demand for foreign currency that would result in a running out of FX reserves.”

With most CEE economies still labor-intensive (for which access to capital is essential for further in-vestments) and the turmoil on the financial markets (spreading to Europe from the US), surging short-term rates emerged, alongside widened credit spreads and a clear preference for liquidity. All of these factors threaten to make external financing of CEE economies less easy than in the past. Thus, the main concern on the market is that any credit crunch caused by a lack of liquidity might derail CEE economies from their strong growth path.

Erste Group analysts view it differently: “Although some CEE economies are very open (measured by volume of trade to GDP), their competitive production brings them some immunity*). In bad times, com-panies operating in mature markets are usually forced to improve efficiency and shift more of their pro-duction to cheaper regions like CEE,” says Juraj Kotian, co-head of CEE Macro & Fixed Income Re-search at Erste Group. Moreover, Kotian adds, domestic demand is on an uptrend in CEE economies (except Hungary, due to austerity measures), providing a temporary cushion against falling external demand.

Should a major threat to CEE economies be identified, Erste Group research analysts say, this would be a secondary effect of the crisis: a tight credit market, as issuing new debt or rolling FX-denominated debt over might be more difficult. Nevertheless, same analysts point out, profits should not drop signifi-cantly due to higher credit spreads, given the high return on capital and relatively low level of debt lev-erage in CEE. “We focus rather on liquidity and the structure of the external debt in CEE countries to explore whether the risks are serious,” says Kotian.

In this regard, Kotian identifies several causes for the current growth of external borrowing:

- Export-oriented companies have started to use foreign currency loans as a natural hedge against currency appreciation.
- The negative interest rate differential (except for in the Czech Republic) played in favor of for-eign currency loans and carry trades on financial markets.
- Many new greenfield projects were only partially financed through equity; the majority of the fi-nancing came through loans from non-resident banks or inter-company loans (loans from parent companies), representing long-term financing.

Erste Group research analysts remain optimistic: The asset quality in CEE stands at comfortable levels, so a credit crunch would only come from a lack of liquidity on local markets or extremely high interest rates. However, in recent years, there has been a liquidity surplus and central banks had to withdraw excessive liquidity from the market. Even if one adds current account deficits to short-term external debt and disregards any FDI inflows during the year, FX reserves should be sufficient to cover induced de-mand for foreign currency.

*)Unit labour costs vary between 20% and 40% of the EU 15 average