



## Erste Bank Research: "Effects of the sub-prime crisis to melt down in the second half of 2008"

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**Eurozone:** Inflation expected to remain around 3%, yet fall towards 2% in the second half of 2008

**US:** Fed seemingly to further cut interest rates in order to stabilise situation

**CEE:** Region to see economies cool, but mostly for cyclical reasons. Further stabilisation potential for the region's currencies

**Bond market:** Tension on the market to drop in the second quarter, risk premiums to shrink

### Eurozone

The economy in the Eurozone is supported by high employment figures, good corporate earnings, productivity gains and a continuing upward trend on the emerging markets. The current upswing is expected to slow down only slightly at around 2%. Due to higher energy and food prices, the inflation rate is expected to remain around 3% in the first half of 2008 and forecasted to fall towards 2% in the second half of the year.

"The monetary policymakers are, thus, stuck between economic uncertainty and turbulence on the capital markets on the one hand and the increasing risk of inflation on the other", say analysts of Erste Bank. "We expect that the ECB Governing Council will leave its key interest rates unchanged into the second half of the year, and that the key interest rates will then be lifted in the fourth quarter as the outcome of the credit crunch becomes clearer", add the same analysts.

### U.S.

The correction on the U.S. real estate market is expected to continue. This will eventually pull home prices down and hamper economic growth in the forthcoming quarters. The situation will be further exacerbated by uncertainty as to what extent U.S. financial institutions will have to write off more loans.

Conditions are likely to remain strained in the first quarter of next year as interest rate adjustments bring another wave of mortgage defaults. The financial market is currently focusing a great deal of attention on the Fed, and it seems possible that interest rate cuts will be made purely to stabilise the situation.

"We expect that the US dollar will recover next year. The market's expectations of U.S. interest rate cuts seem to be overblown, and the weakening of the greenback over the past months may have caused market players to sell dollars now instead of next year", say analysts of Erste Bank.

### CEE

With regard to CEE, analysts of Erste Bank expect CEE economies to cool, but mostly for cyclical reasons. Energy and food prices remain high and economic growth remains relatively robust.

"We see further stabilisation potential for the region's currencies, at least at the twelve-month horizon as most countries will apply a more restrictive monetary policy, though the basic conditions will vary considerably from country to country. Hungary and Slovakia will be the exceptions" say analysts of Erste Bank. "The development of the economy in Hungary will still be determined in large part by the measures to reduce the current account and budget deficits, whereby interest rates and inflation will both fall slowly. In Slovakia, the monetary policy will largely be determined by the decision on accession to the EMU in 2009", continue the analysts.

### Bond market

"We think that the bank crisis will be the greatest source of risk for the development of spreads on the EUR corporate bond market in the coming year. In general, we think that the crisis on the financial markets will continue into the first quarter of 2008 – therefore, spreads should remain volatile and high" say analysts of Erste Bank.

At present, government bonds are acquiring a security bonus and a liquidity bonus, which has pushed prices through the roof. Valuations are expected to return to normal as credit crunch cools down. Yields are forecasted to increase again as the year progresses and finally to return to their pre-crisis levels in the autumn of 2008.

Yield levels on the US bond market are being determined by the confidence crisis in the financial sector. Though slowly at first, the resulting risk premium is expected to shrink over the course of the first two quarters.