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Euro zone: Slower dynamic in second half-year due to high commodity prices – Inflation expected to rise to over 3% this year

US economy: Risks for second half-year are still substantial – Unchanged key lending rate expected into 2009

CEE: Slight weakening of economic growth forecasted – Inflationary risks on the rise

EUR Corporate bond market: Diminishing earnings dynamic offset by sinking investment activity – No deterioration of debt situation of companies

Eurozone

"The economy in Euroland has held up quite well up to now despite the diverse burdening factors," said Veronika Lammer, analyst at Erste Bank Research, optimistically. "After a strong first quarter, we expect a technical correction in the second quarter." In the second half-year, the dynamic will remain subdued due solely to the high commodity prices. We expect the quarterly growth rates to accelerate in 2009, but as the starting level is high, the annual growth rate will remain low at 1.7%. The inflation rate is expected to settle at above 3% this year, while a sharp decline to 2.2% is expected for 2009 assuming commodity prices remain stable. Money market interest rates are expected to decrease slightly after an interest rate hike in July, as the risk premium should gradually decrease. Government bonds have undergone a hefty correction in the past few weeks which should lead to a consolidation over the short-term. We expect a rise in yields on ten-year German government bonds to 4.7% in 3Q.



US economy

"The US economy roughly stagnated in the first half of the year despite the difficult setting. The risks for the rest of the year are considerable though. It is unclear how far the oil price will climb, and if the effects of the financial market crisis on lending practice will be lasting," said Rainer Singer, Co-Head CEE Macro/Fixed Income Research at Erste Bank. The correction on the real estate market is any case expected to continue, but together with a stabilization of the other two factors, it should not stand in the way of a moderate recovery of the US economy. The oil price will, of course, play a key role for inflationary developments. Stabilization and a slower pace of increase of housing costs are indicators of lower inflation rates in the opinion of Erste Bank Research. Thus, the US central bank will not have to tighten the interest rate screw and we expect an unchanged key lending rate into the year 2009. This means that the long maturities on the bond market will probably be exposed to a greater risk as soon as the economic data improves a bit. The latter should also lead to a firming of the US dollar, albeit only moderately.



CEE

Economic growth in the countries of Central and Eastern Europe will weaken slightly this year. This may be attributed mainly to cyclical factors, as after years of very strong growth, the inflationary risks – which the central banks are already counteracting by raising interest rates – are on the rise. Any statements on the region can only be very general and the macroeconomic starting point in each case is decisive for the outlook:

Poland, Czech Republic and Slovakia are still reporting strong growth across a broad base.

The economic recovery in **Hungary** is progressing only slowly after the fiscal consolidation.

Romania will probably attain solid growth this year again and the principal challenge will be how to check the



foreign trade deficit.

Forecasts predict economic growth to slow to a solid level in **Croatia**.

After the May elections, coalition negotiations are still underway in **Serbia** the outcome of which will be decisive for the direction of foreign policy of the country

The **Ukrainian** economy is driven by robust domestic and foreign demand. Erste Bank Research analysts expect the Ukraine to post the highest inflation rates of all countries covered.

Conclusion: Depending on the degree of risk tolerance, **we perceive solid potential for investors in Croatia, Hungary, Romania and the Ukraine.**

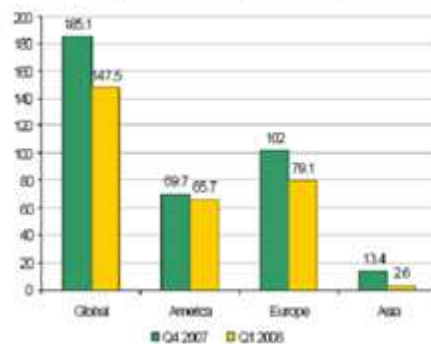
Corporate Bond Markets

In the second half of the year, the effects of the financial crisis on the real economy are the greatest unknown variable for the further development of spreads on the EUR corporate bond market. "An additional burdening factor is in our view the higher risk of inflation in Euroland which means that businesses might continue to be exposed to high financing costs," said Elena Statelov, analyst of Erste Bank. "Nonetheless, we believe the situation of European companies to be fundamentally sound and thus the decreasing earnings dynamic in 2008 will be offset by sinking investment activity. Therefore, the indebtedness of companies should not deteriorate," said Statelov. "Until year end, we expect the spreads to move on a sideways trend with a chance of a slight narrowing as the most likely scenario."



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Write-offs and credit losses from lending transactions (in USD bn)



Source: Bloomberg

Write-offs and capital increases by major banks (in USD bn)

