Erste Group analysts: CEE economic growth to decelerate in 2009, but no recession in sight

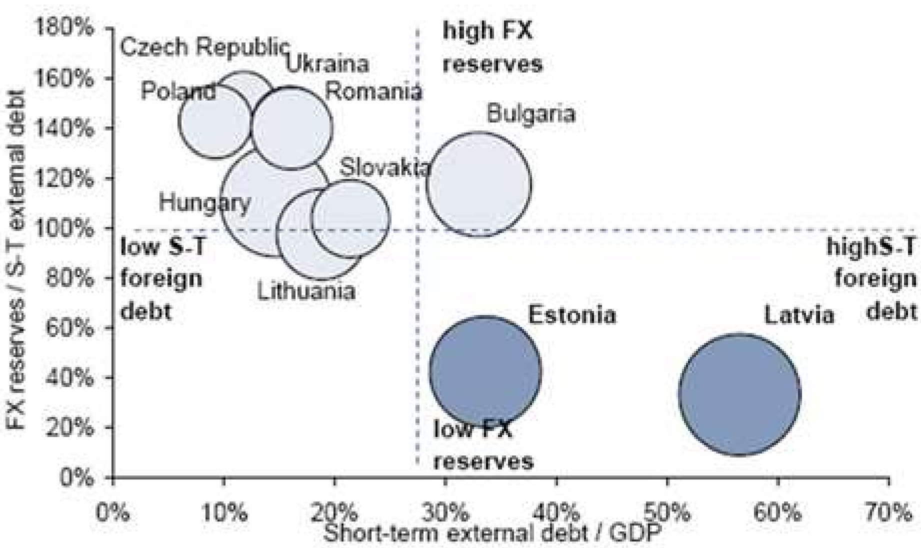
13.10.2008

Monetary policy and flexible exchange rates provide buffer against external shocks – repeat of Baltics problems unlikely
Inflation worries are fading
Deceleration of credit growth, but no credit crunch

CEE economies have been enjoying strong growth in recent years but the current global economic downturn is testing how solid the roots of this growth really are. Recently, Latvia and Estonia, the two economies with the fastest growth in CEE during the last decade, have showed how quickly high-growth economies can fall into recession. Should a similar scenario be expected for the rest of the region?

No Baltics scenario
Erste Bank analysts do not think so. The Baltics have had a unique cocktail of three risk factors that made these economies significantly prone to a slowdown – economic overheating for a long period of time, currency pegs, no anti-cyclical monetary policy – in place and furthermore have had the highest proportion of short-term external debt in their economies, says Juraj Kotian, Co head of CEE Macro/Fixed Income Research at Erste Group in Vienna. The structure of external debt is much better in non-Baltic CEE countries. FX reserves comfortably cover all short-term external debt - which is less than half that of the Baltic countries in relation to GDP. Furthermore, central banks in CEE countries (ex Baltics) have taken action against excessive growth by tightening monetary conditions or introducing other restrictive measures to hamper credit growth to avoid overheating in the future. Sovereign monetary policy and flexible exchange rates have helped CEE economies react to external shocks in a much better way, says Kotian.

Short-term external debt and FX reserves (1Q2008)



Source: IMF, OECD, Erste Group Research

Inflation worries are fading
Since the summer of 2007, all CEE banks have raised interest rates, slowing down economic growth and keeping inflation in check. Erste Group analysts think the tightening cycle could be close to an end. A risk of rate hikes persists in Romania and Ukraine, but the expected disinflation in the next couple of months makes further tightening unlikely. On the other hand, elevated interest rates and diminishing inflation risks could trigger a rally on CEE currencies soon. Central banks in CEE might start with rate cuts next year in reaction to currency moves and disinflation. Leading the way, the Czech National Bank has already started with a 25bp rate cut, and it will probably deliver the next cut in November.

Growth of credit to continue at slower pace, due to slower investment growth

Erste Group analysts consider it is almost certain that investments will slow down next year because of eroding external demand and the higher cost of capital. They say banks will be more selective in lending, charging higher credit spreads, which will decelerate the loan growth - especially in the corporate sector and foreign currency loans. The deceleration of credit growth (no credit crunch expected to happen) should not liquidate investments, though, as the return on capital and share of capital return in value added are relatively high (also because of low labour costs), which means that companies should be able to finance increased credit spreads and some capital expenditures from their operating profits.

Economic growth 4.3% in 2009, no recession in CEE

Deteriorating confidence among both manufacturers and consumers in the Eurozone is pointing to a further economic slowdown in the Eurozone, or even towards stagnation. That is not good news for CEE economies, which have been exporting a sizeable portion of their export production to Western Europe. However, these tough times will put more pressure on evaluating efficiency worldwide and, at the end of the day, may speed up the process of shifting production from Western Europe to CEE, where labour costs are far below the European average, says Juraj Kotian.

The average economic growth in CEE is expected to decelerate to 4.3% in 2009, from the 5.4% estimated for 2008. Therefore, GDP growth will, until the dust settles, be below expected output for a while. The biggest risk to economic growth in CEE currently lies in the fear of a more extensive economic slump in Euroland, which would dampen external demand. Stagnation or a recession in the Euroland economy would shave about 0.2-0.5 percentage points from forecasted growth rates in CEE. Nevertheless, growth in CEE economies should remain very solid and the threat of recession seems rather distant, concludes Kotian.

GDP growth forecasts (%)

GDP growth (%)	2007	2008f	2009f	2010f
Czech Republic	6.6	4.3	2.5	3.2
Croatia	5.6	3.4	3.7	5.0
Hungary	1.1	2.0	1.6	3.5
Poland	6.6	5.2	4.2	5.2
Romania	6.0	8.3	6.0	5.8
Serbia	7.5	6.8	7.0	7.0
Slovakia	10.4	7.4	4.8	6.4
Ukraine	7.6	6.6	6.0	5.5
CEE average	**6.3**	**5.4**	**4.3**	**5.0**

Source: Eurostat, Erste Group Research

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How will the global economic slowdown affect growth in CEE region?

October 13th, 2008 - Vienna

Juraj Kotian

co-Head of CEE Macro and Fixed Income Research, Erste Group Research

Decelerating growth in Eurozone increases concerns about sustainability of growth in CEE

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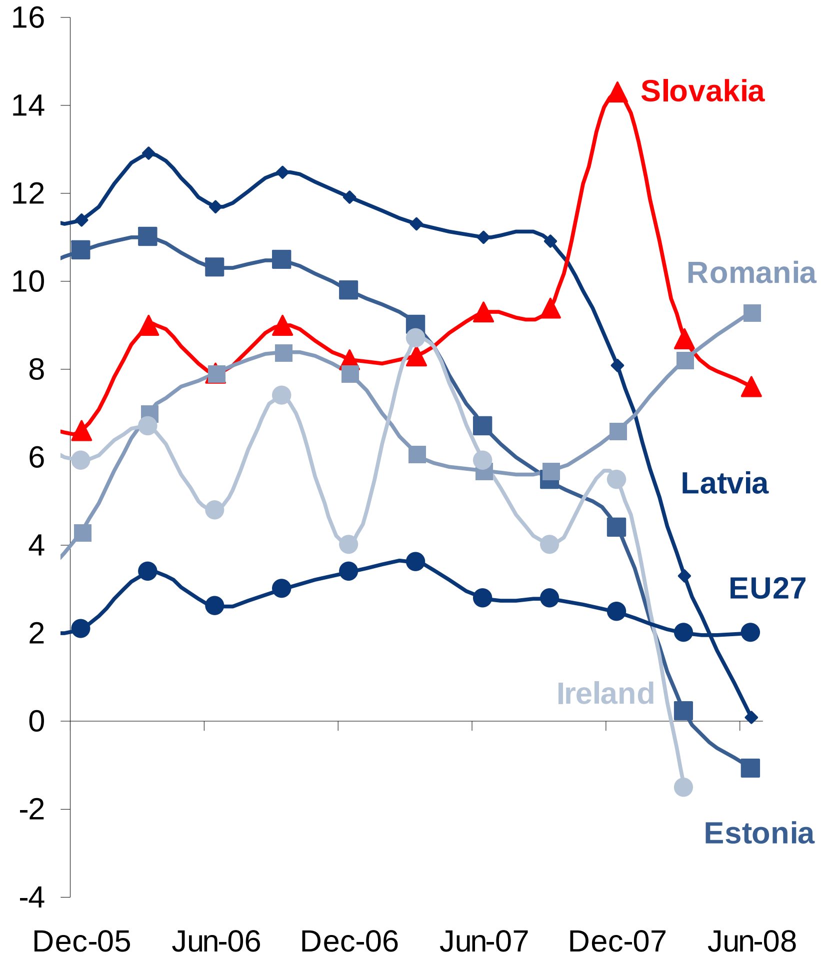
GDP growth q/q s.a. (%)

	2007q03	2007q04	2008q01	2008q02
Slovakia	2.2	2.0	1.7	1.9
Poland	1.4	1.8	1.4	1.5
Czech Republic	1.4	1.3	0.9	0.9
Lithuania	2.9	1.3	0.3	0.9
Slovenia	1.5	0.6	2.0	0.9
Greece	0.9	0.7	1.1	0.8
Cyprus	1.1	1.0	1.0	0.8
Finland	0.4	0.9	0.3	0.8
Malta	1.1	0.8	0.7	0.7
Denmark	1.6	-0.2	-0.8	0.6
Hungary	0.3	0.2	0.6	0.6
Austria	0.6	0.7	0.6	0.4
Portugal	0.0	0.6	-0.2	0.3
Belgium	0.7	0.5	0.5	0.2
Spain	0.6	0.6	0.3	0.1
Netherlands	1.1	1.3	0.4	0.0
Sweden	0.4	0.5	0.1	0.0
United Kingdom	0.6	0.6	0.3	0.0
Euro area	0.6	0.4	0.7	-0.2
France	0.7	0.4	0.4	-0.3
Italy	0.1	-0.4	0.5	-0.3
Ireland	0.6	0.1	-0.2	n/a
Latvia	1.5	0.3	-0.4	-0.4
Germany	0.6	0.3	1.3	-0.5
Estonia	0.5	0.1	-0.9	-0.8

Source: Eurostat, Erste Group Research

GDP growth y/y (%)



Source: Eurostat, Erste Group Research

What are determinants of the extend of spillover?

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External factors

- **Global credit crunch (affecting funding in FX)**
- **Risk averseness and denting investment inflow**
- **Weakening external demand**

Internal factors

- **Foreign debt (high level of short-term external debt)**
- **Indebtedness of companies and households + asset bubbles**
- **Monetary and fiscal policy response**
- **Soundness of banking sector (liquidity and capital)**

The global liquidity shortage will affect mainly countries with a high level of short-term debt

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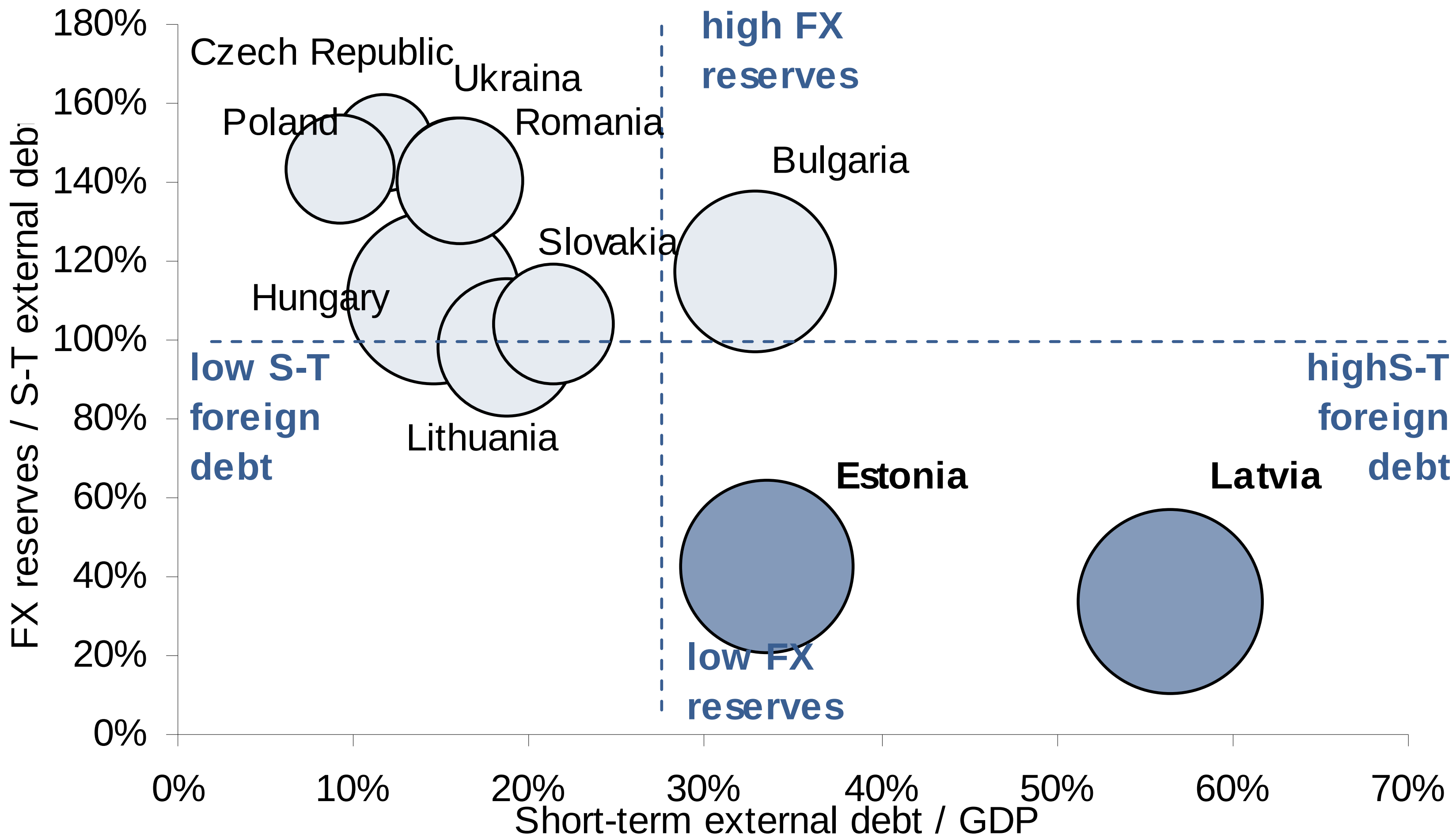
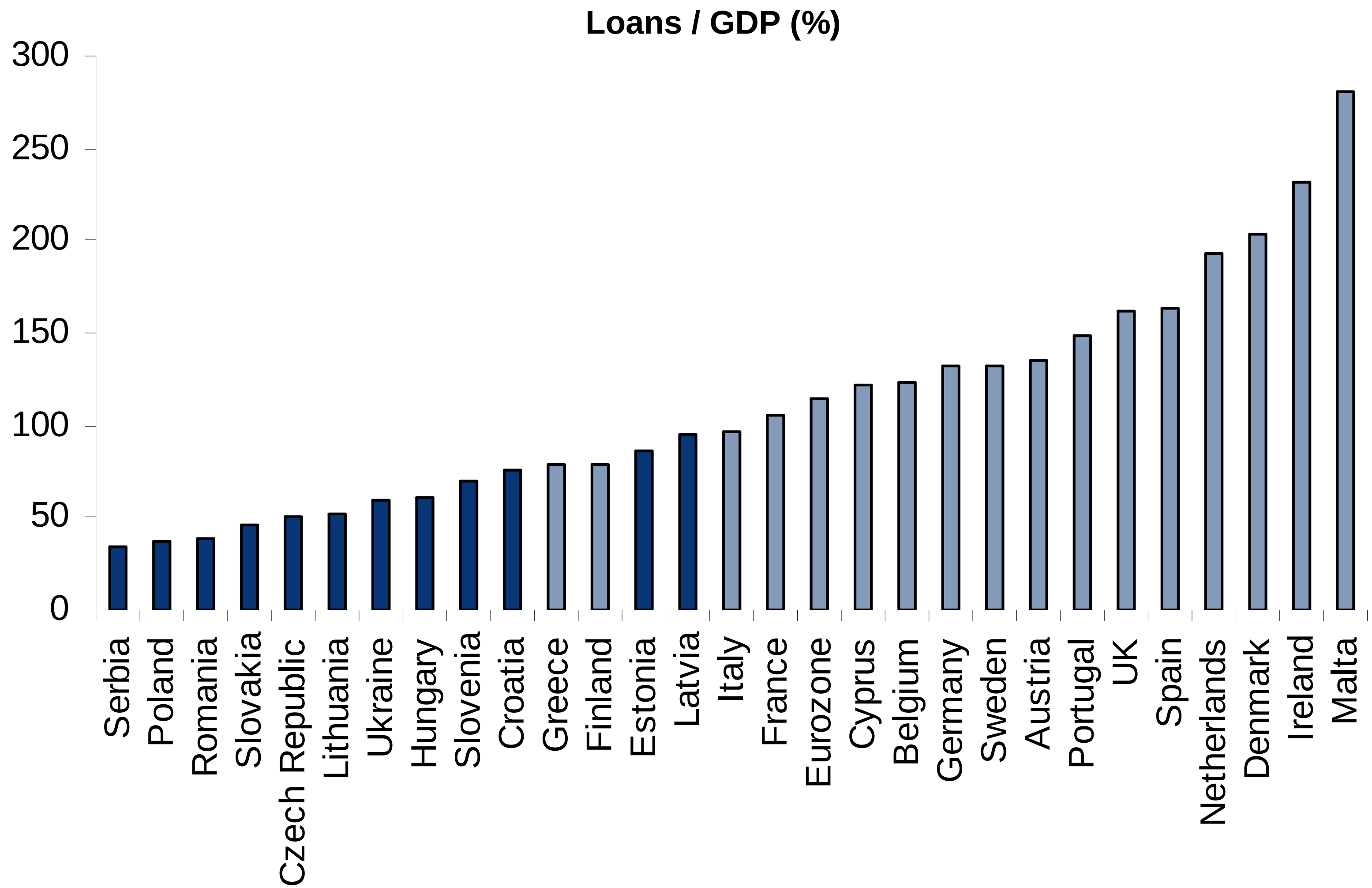


Source: World Bank, IMF, Eurostat, Erste Group Research

Lower level of financial intermediation makes growth in CEE economies less vulnerable to financial crises



Source: ECB, Eurostat, Erste Group Research

CEE region might benefit from higher pressure on efficiency in EU during the economic slump

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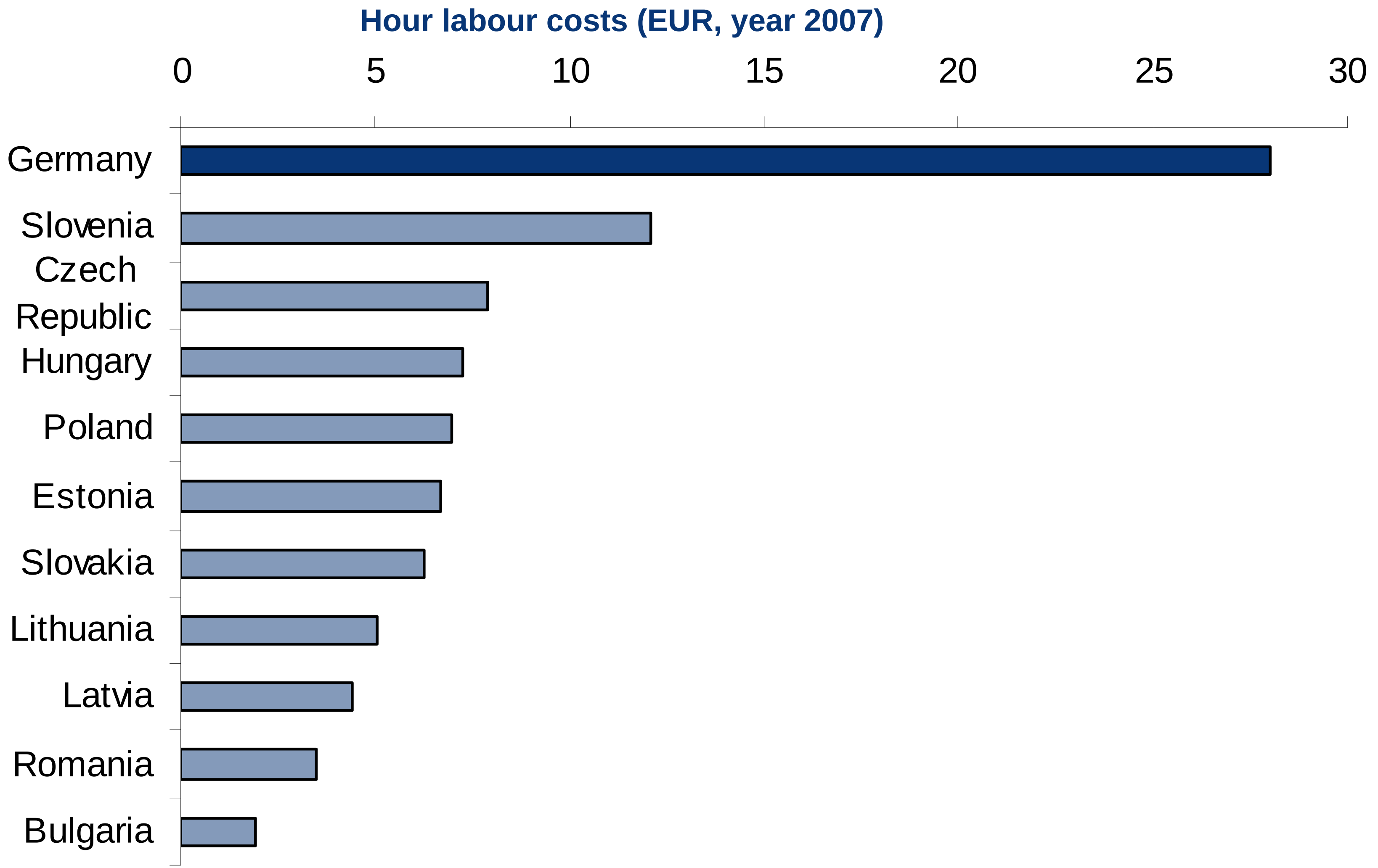

Source: Eurostat, Erste Group Research

CEE economies have been more flexible in delivering monetary policy response

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	Key interest rates		Outlook for next year
	Oct-07	Oct-08	
Ukraine	8.00	12.00	stable rates
Romania	7.50	10.25	-200bps next year
Hungary	7.50	8.50	-100bps next year
Poland	4.75	6.00	-75bps next year
Croatia	3.50	6.00	-175bps next year
Eurozone	4.00	3.75	-25bps this year, -50bps next year
Czech Republic	3.25	3.50	-25bps this year, next year flat

- **CEE banks have shown a strong commitment to inflation targeting**
- **Interest rates have already peaked**
- **Inflation is on downward trend**
- **Monetary easing will start in the 1Q2008 at latest**

Source: Erste Group Research, Reuters

Economic growth in CEE will moderate next year, but threat of recession is rather distant

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GDP growth (baseline scenario,%)

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CEE average	**6.3**	**5.4**	**4.3**	**5.0**

Source: Eurostat, Erste Group Research

- baseline scenario - deceleration of average GDP growth in CEE to 4.3% in 2009 (from 5.4% in 2008) calculates with 0.6% GDP growth in Eurozone in 2009

Reasons

- peak of economic cycle is over
- tightened monetary conditions
- weaker external demand
- liquidity squeeze on global markets

Risk factors

- stagnation or recession in Euroland
- economic stagnation in Euroland would shave our GDP forecasts by 0.2 in average

Conclusion

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- The global crises will affect countries with high level of financial intermediation and short-term external debt (what is not case of CEE countries)

- High competitiveness of CEE economies and responsive monetary policy should be advantage during the economic downturn

- Growth in CEE will moderate but the threat of recession is rather distant

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Special Report – October 13, 2008

How will the global economic downturn affect growth in CEE?

Economic slowdown, but no recession in CEE

Strong wage growth to support economies

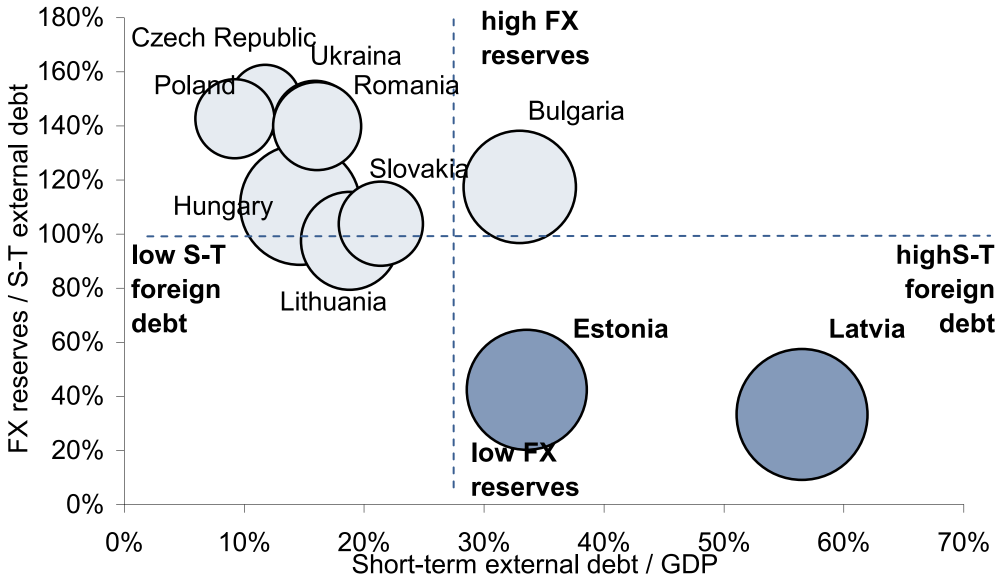
Financial markets remain in good condition

CEE economies have been enjoying strong growth in recent years and the current global economic downturn should prove how solid the roots of this growth are. Recently, Latvia and Estonia, the two economies with the fastest growth in CEE during the last decade, showed how quickly high-growth economies can fall into recession. Should we expect a similar scenario for the rest of the region? We do not think so.

How deep could economic slowdown be in CEE economies?

There is a clear distinction between the Baltic countries and the rest of the region. The Baltics have had a unique cocktail of three risk factors that made these economies significantly prone to a slowdown – economic overheating for a long period of time, currency pegs, no anti-cyclical monetry policy in place and the highest proportion of short-term external debt in their economies. The latter factor has only been a catalyst for the slowdown since the global liquidity squeeze and widened credit spreads have hit emerging markets.

Short-term external debt and FX reserves (1Q2008)



Source: IMF, OECD, Erste Group Research

Sovereign monetary policy matters

Fortunately, the structure of external debt is much better in non-Baltic CEE countries. FX reserves comfortably cover all short-term external debt, which is less than half that of the Baltic countries in relation to GDP. Furthermore, central banks in CEE countries (ex Baltics) have taken action against excessive growth by tightening monetary conditions or introducing other restrictive measures to hamper credit growth and avoiding overheating - followed by a hard landing - in the future. Sovereign monetary policy and flexible exchange rates have helped CEE economies react much better to external shocks.

Key interest rates in CEE

	Key interest rates		Outlook for next year
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Ukraine	8.00	12.00	stable rates
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Czech Republic	3.25	3.50	-25bps this year, next year flat

Source: Reuters, Erste Group Research

Inflation worries are fading out

Since the summer of 2007, all CEE banks have raised interest rates, slowing down economic growth and controlling inflation. It now seems that the tightening cycle is close to the end. A risk of rate hikes persists in Romania and Ukraine, but the expected disinflation in the next couple of months makes further tightening unlikely. On the other hand, elevated interest rates and diminishing inflation risks could trigger a rally of CEE currencies soon. Finally, we expect that central banks in CEE might start with rate cuts next year in reaction to currency moves and disinflation. Leading the way, the Czech National Bank has already started with a 25bp rate cut, and it will probably deliver the next cut in November.

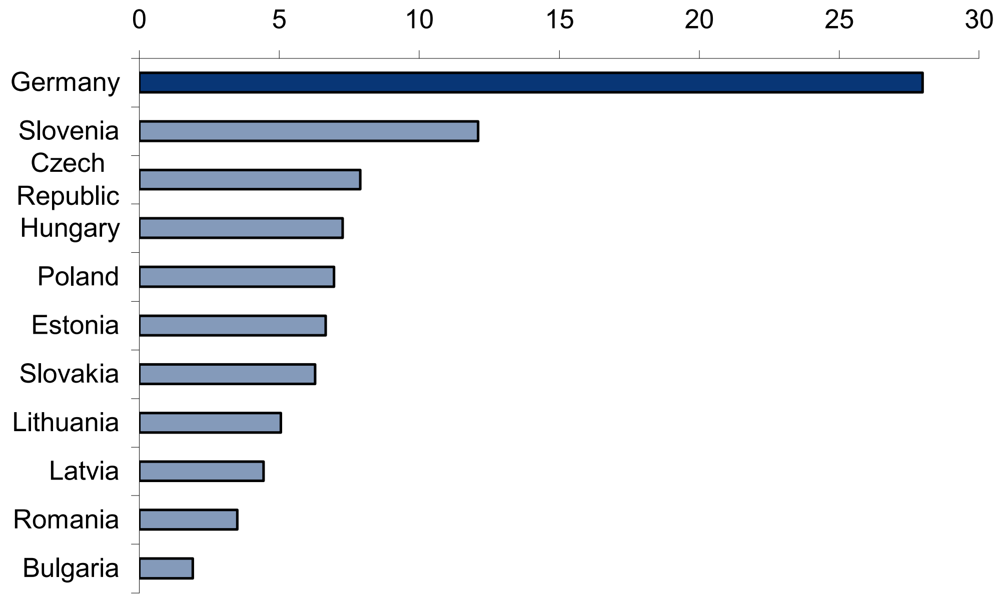
Interbank markets are functioning well in CEE

Deteriorating US financial assets and increased counterparty risk (stemming from the diminishing solvency of US banks) have been spreading a lack of confidence in the dollar on the interbank market. While it is difficult to finance in USD at maturities longer than overnight worldwide, local currency interbank markets in CEE have been functioning well. Also, spreads between treasury yields and money market rates suggest much higher confidence among local banks in CEE, due to the limited exposure to risky US assets, lack of big write-offs and the capital deterioration that has not occurred.

Global economic downturn hurts

The recent turbulence on US and European financial markets has brought much more uncertainty about the extent of the crisis and its impact on global demand. Deteriorating confidence among both producers and consumers in the Eurozone points to a further economic slowdown in the Eurozone, or even stagnation. That is not good news for CEE economies, which have been exporting a sizeable portion of their export production to Western Europe. However, these tough times will put more pressure on evaluating efficiency worldwide and, at the end of the day, may speed up the process of shifting production from Western Europe to CEE, where labor costs are far below the European average.

Hourly labor costs in manufacturing (in EUR, year 2007)

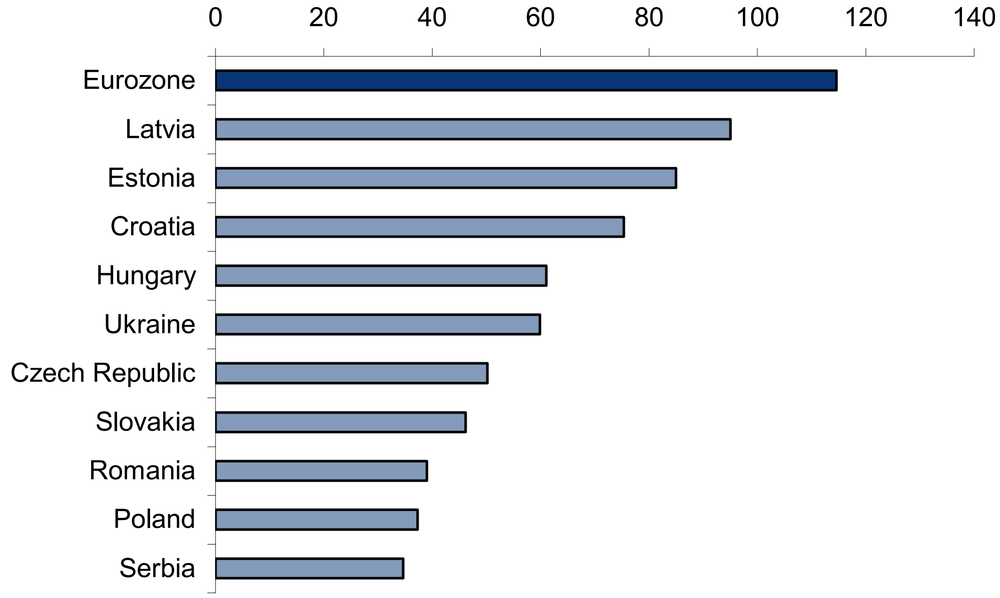


Source: Eurostat, Erste Group Research

Growth of credit to continue at slower pace, due to moderating investment growth

It is almost certain that investments will slow down next year because of eroding external demand and the higher cost of capital. Banks will be more selective in lending, charging higher credit spreads, which will decelerate the loan growth - especially in the corporate sector and foreign currency loans. The deceleration of credit growth (we do not expect a credit crunch to happen) should not extinguish investments, as the return on capital and share of capital return in value added are relatively high (also because of low labor costs), which means that companies should be able to finance increased credit spreads and some capital expenditures from their operating profits.

Loans to non-financial sector / GDP (%, Dec 2007)



Source: Eurostat, ECB, Erste Group Research

Strong wage growth will support CEE economies

Household consumption is to remain robust in CEE next year, despite less aggressive lending. Given the weakening external demand and slowdown of investments, household consumption will become the most important driver of GDP growth in CEE next year. We have seen pretty strong wage growth in all CEE countries. Given the expected disinflation, real wages might even accelerate next year. Some wage growth figures might raise questions about sustainability (the average wage growth in Ukraine and Romania reached 50% and 20% y/y, respectively). But these growth rates should be seen in the light of the abnormally low initial level of unit labor costs and a undergoing convergence process. GDP per capita in Ukraine is only half the GDP per capita in Romania, i.e. Ukraine is at the level Romania was at four years ago.

Figure: GDP growth forecasts (%)

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Ukraine	7.6	6.6	6.0	5.5
CEE average	**6.3**	**5.4**	**4.3**	**5.0**

Source: Eurostat, Erste Group Research

Economic slowdown, but no recession in CEE

We expect the average economic growth in CEE to decelerate to 4.3% in 2009, from the 5.4% estimated for 2008. Thus, GDP growth will come in below the potential output for a while, until the dust settles. The biggest risk for economic growth in CEE currently lies in the fears of a more extensive economic slump in Euroland, which would dampen external demand. Stagnation or a recession in the Euroland economy would shave about 0.2-0.5 percentage points from forecasted growth rates in CEE. Nevertheless, growth in CEE economies should remain very solid and the threat of recession seems rather distant.

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