ERSTE Group

Foreign capital inflows make a comeback to CEE

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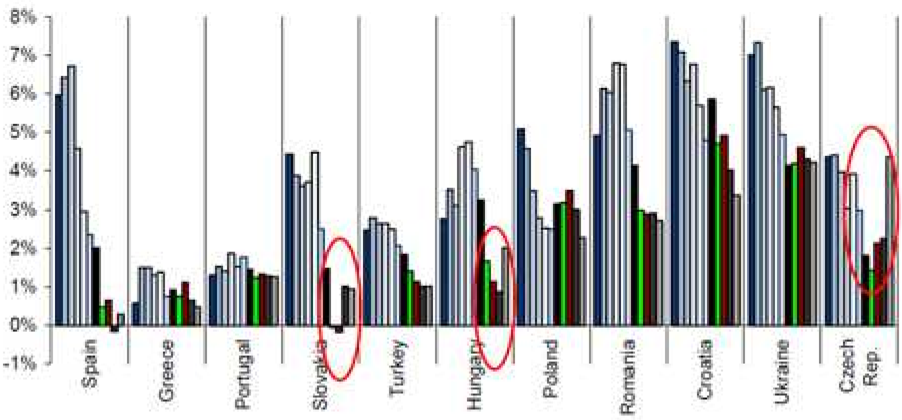
- **Foreign direct investments picked up by 9% in CEE; Czech Republic scored best in attracting FDIs**
- **CEE countries assessed by investors as more attractive than some better rated Euro area countries (Italy, Spain, Portugal)**
- **Current account deficits in CEE have shrunk considerably - less external financing is needed**

2010 brought a reversal of capital inflows into CEE countries. “After a deep slump in 2009 (-45% y/y), foreign direct investments have started to pick up (about 9% y/y). We see the most encouraging development in the Czech Republic, where FDI inflows more than doubled in 2010, making them the highest in the region. Good news also came from Hungary, where the negative trend has been reversed for the first time after the crisis, as well as from Slovakia and Ukraine. We also notice the markets are one step ahead rating agencies, having already acknowledged the strong fundamentals in CEE: CDS spreads are tighter than those of southern European countries,” commented Juraj Kotian, Co-Head CEE Macro Research at Erste Group.

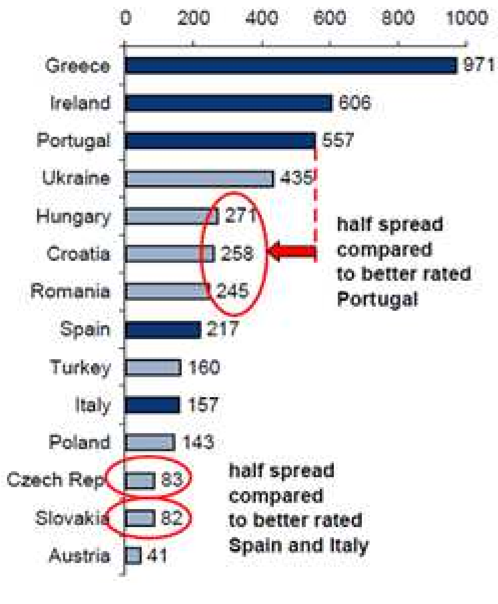


Foreign direct investments have started rebounding in CEE. The Czech Republic is the absolute champion in the region with FDI inflows more than double the levels recorded in 2010 (almost 4% of GDP). In nominal terms, FDI levels were even higher than in 2008. Hungary was also a positive surprise: according to preliminary data, the negative trend has been reversed and FDIs reached about 2% of GDP in 2010. FDIs also picked up in Slovakia reaching 1% of GDP, on a strong rebound of reinvested earnings and stabilization of inter-company loans between parent companies and their local subsidiaries. Given that the Hungarian economy posted a surplus on its current account (2 % of GDP), this creates a very solid basis for the sustainability of Hungary’s balance of payments. Ukraine kept its FDIs at high levels (close to 4% of GDP), which actually covers the whole current account deficit – this significantly reduces its external borrowing needs.

Portfolio investments invigorated in Poland and Czech Republic
Since 4Q09, there has been a rebound of portfolio investments, particularly into the Czech Republic and Poland. The vast majority of portfolio investment inflows went into debt instruments, mainly government bonds. Non-residents increased their exposure in Czech and Polish government securities by EUR 5bn and EUR 25bn, respectively (3.3% and 6.1% of the Czech and Polish GDP, respectively). Both countries have been favored by foreign investors because of their relatively low level of public debt and their economies' resilience during the global economic downturn. However, the lack of a fiscal consolidation effort in Poland and the uneven split of government financing between domestic and foreign investors make Polish assets more risky than those in the Czech Republic, in Erste Group analysts' view.

CEE countries assessed by investors as more attractive than some better rated countries (Italy, Spain, and Portugal)

Many CEE economies managed to stand on their own feet throughout the crisis (the Czech Republic, Slovakia, Poland and Croatia) and without severe tensions in external financing. Some countries had to undergo an economic rebalance (Hungary, Romania, and Ukraine) and adopt corrective measures, including structural reforms. Coordinated IMF & EU assistance has lowered the pressure on their external financing and helped them implement measures to narrow imbalances. On the other hand, Euro Area countries that faced a shortage of private capital inflow (Greece, Portugal) were able to buy time due to access to ECB refinancing, which served as a substitute for private capital inflows or external assistance. Thus, they were not pressured to correct their large external imbalances. Unfortunately, this "palliative" was short-lived and came without strict conditions, which meant the imbalances of southern Euro Area countries persisted or even grew in 2010, while CEE countries narrowed their current accounts substantially. Despite this marked contrast, it took rather long for markets to realize that many CEE countries are in a much better shape than some Euro Area members.



Source: Bloomberg, Erste Group Research

"The next question is: how long will it take for rating agencies to align ratings to fundamentals, or will ratings become partially ignored by markets as too rigid and outdated? We notice that the latter is already happening. The Slovak government (rated A+) pays a lower risk premium compared to the multi-notch better rated Spain (AA) or slightly better rated Italy (AA-). Croatia (BBB-) and Hungary (BBB-), which are both at the low end of the investment grade, and Romania (BB+), which was during the crisis downgraded to junk category, borrow more cheaply than Portugal, which is (even after recent multi-notch downgrades) still rated higher then them," Kotian added.

Current account deficits have shrunk considerably in Hungary and Romania - less external financing is needed
The first country hit by a reversal of flows was Hungary, where a significant reduction of portfolio investments paralyzed the Hungarian bond market and put pressure on the currency as well. Thus, the government was not able to issue new debt at reasonable yields and asked the IMF for assistance. Other CEE countries were not as sensitive to portfolio capital outflows (volume-wise), due to their significantly lower stock of portfolio investments. For instance, foreign investors held only about EUR 3bn (2% of GDP) of Romanian government securities at the time when the crisis emerged, while foreign investors held about EUR 30bn (29% of GDP) of Hungarian government securities. On the other hand, the global financial crisis constrained the opportunities for financing of the Romanian current account deficit (at that time, about 13% of GDP) and the economy had to adjust quickly in order to narrow its current account deficit. The adjustment has been eased by coordinated IMF & EU assistance, which has lowered the pressure on external financing and helped to install measures leading to a narrowing of imbalances. Also, the so-called Vienna initiative has played an important role there, as foreign banks operating in the country promised to maintain their exposure. The recent decision to replace the expiring IMF stand-by program in Romania with just a Precautionary Stand-By Arrangement (drawing funds is not expected) and not extend the previous program

Juraj Kotian, Co-Head CEE Macro Research der Erste Group

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demonstrates the progress Romania has achieved. Kotian concluded: “Both Hungary and Romania narrowed their current account deficits substantially and thus reduced their external financing needs to levels which can be smoothly financed on markets.”

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