ERSTE Group

CEE countries with bigger breathing space for higher government bond yields

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- **No big CEE bonds sell-off comparable to post-Lehman so far, including the case of Hungary**
- **Romania, Czech Republic and Slovakia with biggest room for manoeuvre in case yields would spike; Hungary should avoid financing at +6%**
- **Investment grade determines quality of investor pool – Czech Republic, Poland and Slovakia to benefit from good ratings and low levels of private and public debt**
- **Budget deficit in CEE6 to shrink to 3.6% of GDP in 2012, Eurozone average estimated at 3.4% of GDP**

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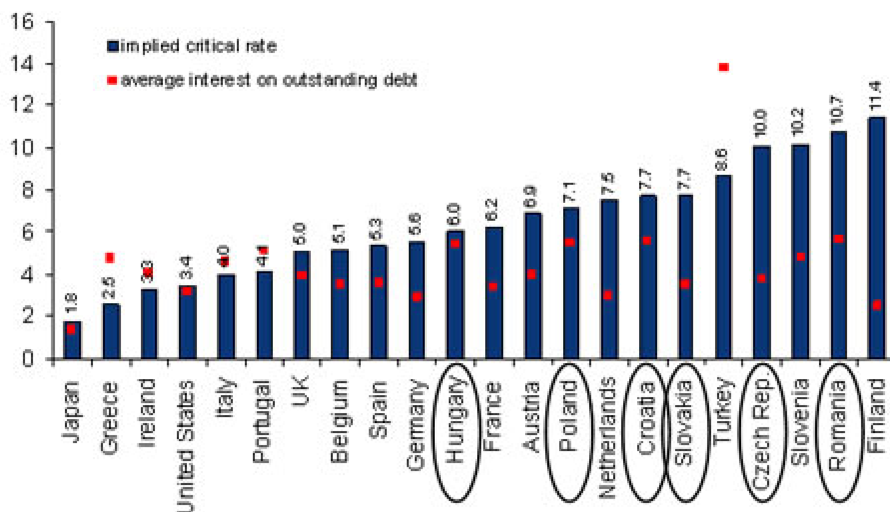
Even though the ongoing sovereign debt crisis in the Euro Area and increased risk aversion dented demand for CEE government securities, Erste Group analysts do not see any sizable sell-off comparable to post-Lehman. "However, the current turmoil in the Euro Area increased pressure on yield spreads and opened discussions about the yield level that countries could afford from the liquidity point of view", said Juraj Kotian, Co-Head Macro/Fixed Income Research CEE at Erste Group and author of the Special Report.

Critical rates and the average interest costs (2012F)



Source: EC Autumn Forecasts, Erste Group Research

Erste Group calculations show sufficient breathing space even if yields spike in Romania, the Czech Republic and Slovakia

Erste Group analysts took as a benchmark the ratio of interest costs on state debt to government revenues. This is also watched by the rating agencies in their heat maps. In line with the assumption that “solvency of a sovereign debtor is traditionally defined as the state being able to service its debt by collecting taxes” Erste Group analysts set the critical level of interest costs at 1/10 of tax revenues. “We calculated the critical point for individual countries at which the interest costs would exceed 10% of tax revenues. In case of sudden market turbulences, the debt spiral can be triggered via higher borrowing costs. Fortunately, Romania, the Czech Republic and Slovakia have much higher thresholds of average interest rates on state debt, meaning the critical point that would put the public finances under heavy pressure is more distant. Hungary should avoid any heavy financing above 6% in order to stay below the critical rate”, explained Kotian.

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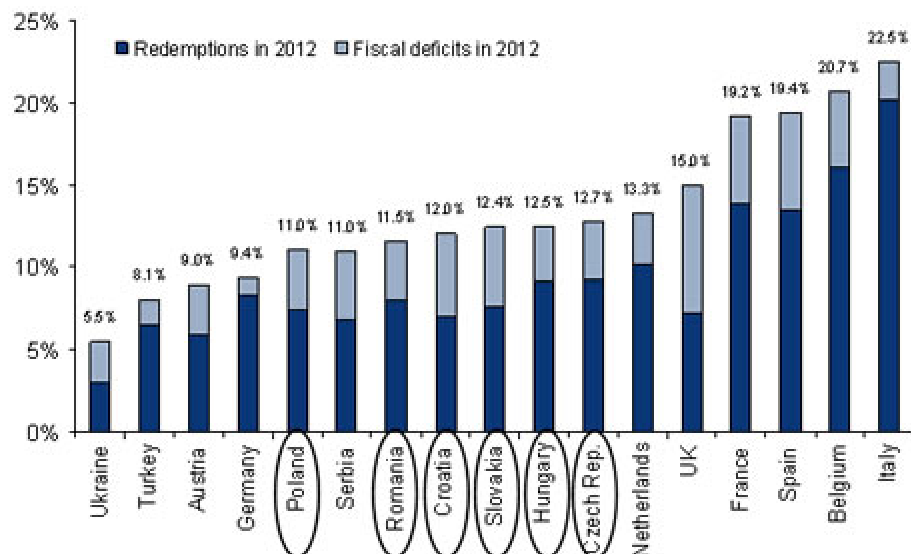

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ECB long-term refinancing operation with positive effect on CEE assets

The 3-year long-term refinancing operation (LTRO) conducted by the European Central Bank (ECB) had a stimulating effect on the tensions in the European Banking sector and reduced the borrowing costs for governments, not only in the Eurozone but also through improved sentiment in CEE. “Given that many funds and insurance companies have investment restrictions based on sovereign ratings, the pool of countries in which they can invest has been shrinking. The Czech Republic, Poland and Slovakia (all three with investment grade) may benefit from their relatively good rating and low level of both private and public debt,” said Kotian.

Issuance of Eurobonds in order to extend average maturity

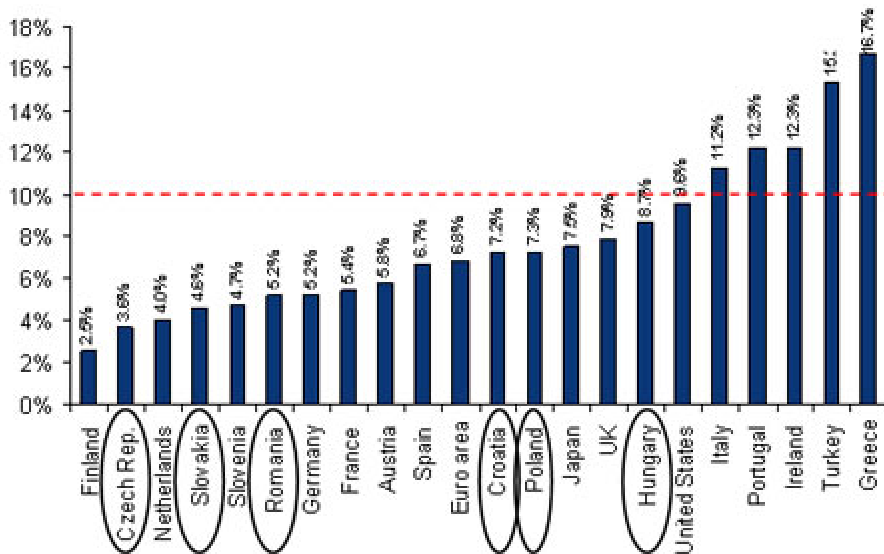
CEE governments are tapping foreign markets with Eurobonds or syndicated loans in order to extend the average maturity of outstanding debt. Slovakia already successfully placed EUR 1 billion of 5-year syndicated bonds in 2011, Czech Republic is expected to follow this year. “The main reason for foreign issuance would be the diversification of the investor pool and perhaps the further extension of maturity since the average maturity of government securities is relatively short in CEE, about four years, compared to about six to seven years for major Euro Area countries. Implemented pension reforms, completed liberalisation of prices and consistently prudent and predictable fiscal policy would increase demand for long-term bonds issued in local currency,” commented Kotian.

CEE treasury funding needs 1/9 of Eurozone level

Governments in CEE6 are also to continue their fiscal consolidation in 2012 and, after the reduction of the deficit from 6.4% in 2010 to an estimated 4.1% of GDP on average in 2011 the deficit is to further shrink to 3.6% of GDP on average in 2012.

Conservatively assuming that governments will not raise money through the sale of state assets, CEE6 countries would need to issue about EUR 35 billion of new debt in 2012. Compared to the net issuance in the Euro Area of about EUR 300 billion, the treasury funding needs of the Eastern European peers are relatively low.

Interest costs to tax revenues (2012F)



Source: EC Autumn Forecasts, Erste Group Research

Considering the fact that CEE6 governments would need to rollover redeeming debt worth EUR 72 billion (8% of GDP on average), the total gross issuance of government securities in CEE6 amounts to EUR 107 billion. About half of the net issuance of government securities are financed by non-residents, such as mutual and pension funds and insurance companies. Overall, Erste Group analysts are expecting organic demand of domestic financial institutions for government securities should vary between 1.5 to 2.5% of GDP in CEE, thus financing about one third to one half of forecasted fiscal deficits (net issuance). The rest is assumed to be financed by non-residents.

Presentation [pdf; 321.5 KB]

Report [pdf; 157.4 KB]

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