

Can CEE countries afford their public debt?

- Governments in the CEE region are far less indebted compared to euro area average; refinancing needs are accordingly lower
- The liquidity surplus on CEE markets should keep the local demand for government bonds strong
- Fiscal deficits in CEE have widened; countries must now do their homework to reverse negative developments
- CEE6 countries expect less painful consolidation than euro area, yet strictly required sustainability may delay euro adoption to 2015-2016
- CEE countries' fiscal performance will shrink sovereign spreads this year

Mounting public debts and potential difficulties in financing them are increasingly causing anguish in Europe. Last year, the fiscal deficit problem was concealed by generous liquidity supplies meant to stabilize the financial sector. Today, many governments in the EU have to foot the bill for the previous fiscal loosening, by delivering austerity measures which might slow down the economic recovery.

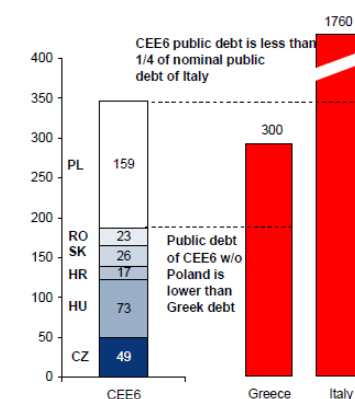
Public debt of all CEE countries below 60% of GDP, Hungary at the euro area average level

"The public debt of CEE6 countries¹ is much lower both in nominal and relative terms (as a share of GDP) than in euro area countries. The public debt of Hungary, Czech Republic, Slovakia, Romania and Croatia combined stands at about EUR 200bn, which is less than the public debt of Greece (EUR 300bn). If we add Poland, the public debt of the whole CEE6 region would be below EUR 400bn - still less than in Spain (estimated at EUR 700bn) and less than a quarter of the public debt of Italy (estimated at EUR 1,800bn)," explains Juraj Kotian, Co-Head Macro/Fixed Income CEE. In relative terms, all CEE countries (except for Hungary) have kept their public debt below 60% of GDP. Hungary's public debt is estimated at about 80% of GDP for 2009, which is exactly the euro area average level.

One important indicator when referring to public debt is the share of government securities held by non-residents. When this ratio is high, it increases the likelihood of a rapid sell-off. This is the case of Greece, where about 2/3 of its public debt (90% of GDP) is held by non-residents through investment in Greek government bonds. By comparison, this ratio is about 1/4 (2-23% of GDP) in CEE6.

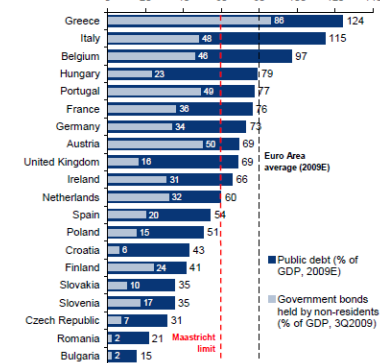
Erste Group analysts therefore point out that "given the much lower level of outstanding public debt and fiscal deficits of CEE economies compared to euro area countries, borrowing in the former will be much lower." The Czech Republic, Slovakia and Romania will benefit from their low levels of debt and, consequently, the lowest volumes of maturing debt (of about 4-5% of GDP) to be revolved. Poland, Croatia and Hungary need to refinance higher volumes of maturing government securities, worth about 8-10% of GDP.

Nominal public debt (2009E, EURbn)



Source: AMECO, Erste Group Research

Public debt (% of GDP, 2009E)



Source: AMECO, JEDH, Erste Group Research

¹ This report covers six CEE countries - Poland, Hungary, Czech Republic, Slovakia, Romania and Croatia. It does not include Serbia and Ukraine, which would not form a homogenous region with CEE6 - they are not EU members (or anytime soon) and have less securitized financing of public debt.

The liquidity surplus on CEE markets should keep the local demand for government bonds strong

Although refinancing needs are lower compared to the euro zone, the question 'who will buy the CEE6 government debt?' still arises. "Liquidity surplus on CEE markets should keep the local demand strong," Kotian goes on to explain. On the one hand, banks will continue to invest a big proportion of increased deposits in government securities, given that credit growth will continue to be subdued. The net demand of local banks for government securities stemming from the change of customer deposits and loans should total up to about 1% of GDP. Aside from banks, demand for government securities from local pension funds, insurance companies and mutual funds is to total about 0.5-2.0% of GDP in 2010. Poland managed to issue Eurobonds early this year and it is very likely that the Czech Republic, Hungary, Romania, Slovakia and Croatia will approach international markets too, which should ease the situation on the local bond market.

Fiscal deficits in CEE have widened; countries must now do their homework to reverse negative developments

Fiscal deficits in CEE6 have recently widened and the reason is twofold. Firstly, these countries have not taken advantage of the good years to push their deficits even lower during the economic boom. High economic growth boosted tax revenues. In turn, this catalyzed an even higher growth of expenditures and masked growing structural deficits during 2005-07. The sharp economic deceleration that followed unveiled this lack of deep consolidation. Secondly, some of the governments were too late in revising their budgets and adjusting expenditures according to the changed macro assumptions. This resulted in further deterioration of structural deficits in all countries except Hungary and Romania, which, under the IMF program, had to take prompt action and closely monitor the growth of expenditures.

Hungary as a frontrunner in fiscal consolidation

Countries in the CEE6 region have, nevertheless, taken measures to reverse the negative development in public finances. To increase revenues, many of them (Hungary, Croatia, Czech Republic) relied on VAT hikes. Romania avoided an increase of the VAT, but introduced measures that would keep it on track with the IMF this year (downsizing of personnel costs in the public sector, cutting other non-mandatory expenditures, as well as some structural changes, like revision of the pension law). Hungary stands out as the frontrunner in fiscal consolidation – it managed to cut its fiscal deficit from 9.4% to less than 4% of GDP in three years, despite the sluggish economic growth and being hit hard by the global economic crisis.

CEE6 countries expect less painful consolidation than euro area, but strictly required sustainability may delay euro adoption to 2015-2016

"Given the fact that the deficits of CEE countries are lower than the euro area average and that some of these countries started earlier with consolidation (mid-2009 and the beginning of 2010²), their consolidation will be more achievable and less painful than in Euro Area countries," Kotian says. According to its convergence program, Hungary is to cut its deficit to below 3% by 2011. Poland and Romania should correct their excessive deficits by 2012, the Czech Republic and Slovakia by 2013. The former two will need to consolidate their deficits by almost 2 percentage points per year from the 2009 level in order to meet their goals by 2012.

Erste Group analysts envision that, on top of **curbing the fiscal deficit** to below 3% of GDP, the European Commission will pay more attention to the fulfillment of Maastricht criteria in 'a credible and sustainable manner'. This means that candidate countries will likely be asked to fulfill the criteria with a wide margin and/or keep their deficit below 3% of GDP for a longer period of time (not just at one point in time) before positive assessment. The European Commission might also require structural deficits to be below 3% of GDP³ and structural reforms to be put in place (healthcare reform, pension reform), which should reduce the vulnerability of public finances to longevity. This would mean a positive evaluation of Maastricht criteria at least one year after the deficit is reduced to below 3%, which might delay euro adoption to 2015-16 for CEE countries (except for Estonia⁴).

² Hungary started with consolidation already in 2007 after the fiscal deficit reached 9.3% of GDP in 2006.

³ Slovakia would not have qualified for the euro if the adjustment of the deficit for the cyclical component had been considered during assessment.

⁴ Estonia is likely to adopt the euro in 2011, also thanks to historically low deficit and public debt.

CEE countries' fiscal performance will shrink sovereign spreads this year

Fiscal performance is expected to have a much bigger impact on sovereign spreads than in previous years. Given the reduced vulnerability of the Hungarian and Romanian currencies and the fiscal consolidation already put in place, central banks can continue with monetary easing. This will in turn trigger a further compression of yields. For instance, Romania has one of the lowest public debts in the EU, which increases the likelihood that its deficit will be substantially reduced. Erste Group analysts expect yields on Romanian government bonds to decline from today's 8% towards 6.5% in the summer of this year. In Hungary, a country with one of the lowest deficits, the yields might drop from the current 7% towards 6% by year-end. Given the high net issuance of Czech and Slovak government securities, yields face an upward risk if sentiment towards CEE worsens. The liquidity surplus of Czech banks is relatively high, which might help to absorb heavy supply. Conversely, Slovak banks are already have full supplies government securities (20% of total assets), as they already moved their free liquidity into government bonds after joining the euro area.⁵ This leaves the financing of new Slovak debt more dependent on demand from non-residents and refinancing from the ECB.

⁵ Currently, Slovak banks are net borrowers from the ECB, obviously playing on opportunistic carry trades like other Euro Area members (refinancing via the ECB and purchasing eligible government bonds with higher yields).

Group Research:

Juraj Kotian (Co-Head CEE Macro Research)

Tel: +43 50100 – 17357

E-Mail: juraj.kotian@erstegroup.com**Press department:**

Hana Cygonková (Head of External communications)

Tel: +43 50100 - 11675

E-Mail: hana.cygonkova@erstegroup.com

Ionut Stanimir (Group Press Officer)

Tel: +43 50100 - 11676

E-Mail: ionut.stanimir@erstegroup.com

Alina Costache (Group Press Officer)

Tel: +43 50100 - 11681

E-Mail: alina.costache@erstegroup.com

Erste Group, 1010 Wien, Graben 21, Fax: +43 50100 – 19849

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