ERSTE GROUP

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

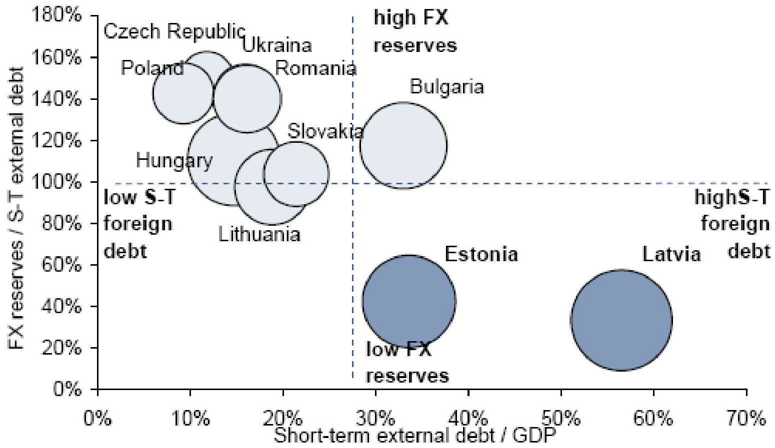
- **No Baltics scenario: monetary policy and flexible exchange rates provide buffer against external shocks**
- **Inflation worries fading out**
- **Deceleration of credit growth, but no credit crunch**

CEE economies have been enjoying strong growth in recent years but the current global economic downturn tests 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 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 an 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 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 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,* says Kotian.

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




Source: IMF, OECD, Erste Group Research

**Inflation worries fading out**

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 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 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 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 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. 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,* 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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