ERSTE GROUP

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CEE8 countries[1] should not face problems with external financing due to sharply shrinking C/A deficits

- **Higher investments in CEE translated into expanding capacity and productivity upgrades fuelled current account deficits in countries with lower savings rate**
- **Drying up foreign capital inflows led to lower investments and higher national savings**
- **As a consequence, current account deficits sharply decreased generating stronger GDP drop, but also significantly lower capital needs**
- **Given inflow of funds from international institutions and reasonable refinancing rates of maturing external debts, CEE8 should not have problems with external financing**

Over the last five years, the Central and Eastern European economies have been outperforming the growth in the Euro Area by almost four percentage points on average, having become a very attractive destination for foreign direct investments and portfolio investors. The global deleveraging process and collapse of global trade have hit the region hard, dragging down the growth to red figures, similar to those seen in the Euro Area. Which role do the capital flows play in the GDP growth in CEE?

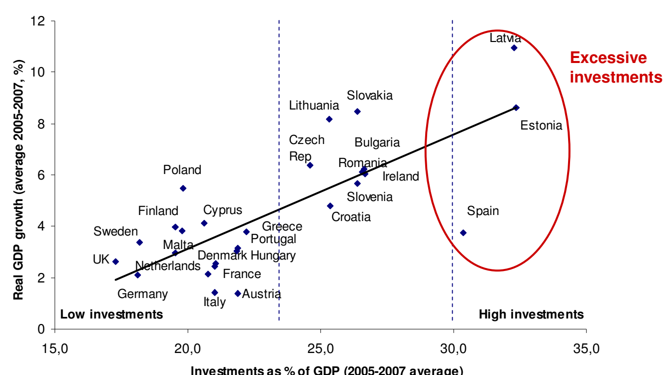
Higher growth of investments in CEE mainly to expand capacity & productivity

Before the crisis started, CEE economies had been benefiting from lifted trade barriers, surging exports and strong capital inflows, which had boosted investment growth, increased employment and the potential output. *"CEE economies have had much higher growth of investments, as well as higher investment ratios compared to the Euro Area (on average for 2005-07: about 26% of GDP in CEE vs. 20-22% of GDP in Euro Area), and were in the most CEE countries mainly focused on expanding production capacity, productivity upgrades and infrastructure projects"*, states Juraj Kotian, Co-Head Macro/Fixed Income CEE.

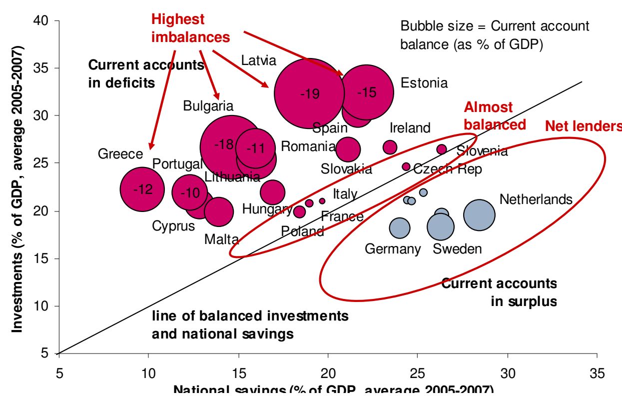
Different levels of national savings implied different needs for external financing: lowest in the Czech Republic, highest in the Baltics

The highest household investment rates were in Ireland (26%), Spain (15%) and Estonia (14%), contributing to a housing boom and bust cycle. Countries with excessive investments were facing external imbalances, as their national savings[2] were not high enough to cover investments. That was the case for the Baltics, where high investments were sponsored by capital inflows, driving increased current account deficits.

Higher investment ratios in CEE (26%/GDP) than in Euro Area (20-22%/GDP)



Baltics had the highest need for external financing, CZ and PL the lowest in CEE



Source 1st graph: Eurostat, Erste Group Research
Source 2nd graph: Eurostat, European Commission, Erste Group Research

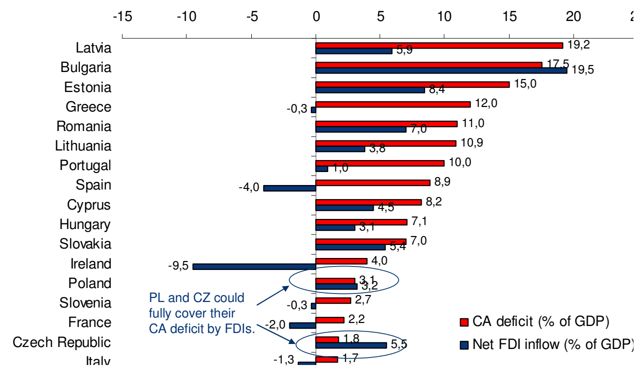
[1] CZ, CRO, HU, PL, RO, SRB, SK and UKR

[2] National savings defined as the ratio of GDP less consumption to GDP

National savings and FDI levels influence the C/A coverage

In Latvia and Lithuania, the net FDIs covered only about 1/3 of current account deficits, increasing dramatically the external debt and making these economies more vulnerable to capital outflows. In the opposite the Czech Republic, with a relatively high amount of national savings, needed less foreign capital and was able to cover the whole current account deficit by net FDIs over 2005 to 2007.

While in CZ and PL the C/A deficit was fully covered by FDI, in Latvia and Lithuania only 1/3 of C/A deficit covered by FDI
(average 2005-2007, in % of GDP)



Source 3rd graph: Eurostat, European Commission, Erste Group Research

Deleveraging and drying up foreign capital inflows forces narrowing gap between investments and national savings

Due to the global deleveraging process and drying up foreign capital inflows, the gap between investments and national savings has to narrow significantly, either through the scaling down of investments or an increase of national savings – through the collapse of consumption or strong fiscal consolidation. This is exactly what has been happening in countries that have been running large current account deficits: *"The biggest drop of investments has occurred in countries with high investment rates – Ireland, Latvia, Lithuania and Estonia – where investments collapsed about 25-40% y/y in 1Q09. These were the countries with the highest imbalances in the past. Declines of investments in the Czech Republic, Slovakia, Hungary, Poland and Romania were only single-digit in 1Q09, while investments in the Euro Area declined by 10% y/y"*, summarizes Kotian.

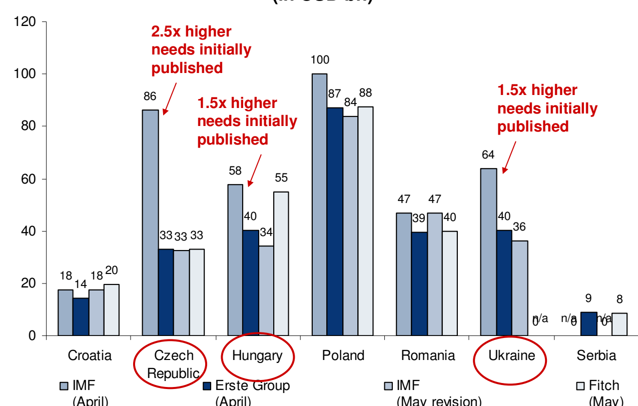
Negative aspect: fast improvement of the C/A deficit generates stronger GDP drop
Positive aspect: countries will need less foreign capital to finance the external gap

The negative aspect in the quick improvement of the C/A deficit is that the negative cyclical effect will be stronger. Cutting the investment growth rates to half compared to rates seen in previous years would choke about 1-3 percentage points from average GDP growth rates. *"We believe that there are good economic reasons (competitive labor costs and higher return on capital) to boost productive investments in these countries when growth resumes. The short-term positive aspect is that countries will need less foreign capital to finance the external gap"*, believes Kotian.

Juraj Kotian concludes: *"CEE8 countries should not have problems with external financing"*

- We expect the lowest roll-over ratio[3] (about 60%) for refinancing long-term corporate loans, a higher roll-over ratio for the banking sector (*70-90%, as the high proportion of financing through parent banks, which committed to maintaining their exposure in these countries, increases the roll-over ratio*), while the roll-over ratio for government debt mainly depends on the chances of governments to issue Eurobonds on foreign markets this year.

Estimated external debt refinancing needs in 2009
(in USD bn)



Source fort the 4th graph: IMF Stability Report, Erste Group Research, Fitch Ratings

3 Roll-over ratio: says, how much % will be refinanced by private non-resident lenders, when the debt matures.

- For countries under the IMF program, we have conservatively assumed 0% roll-over ratios (IMF to rollover maturing external government debt); issuance of Eurobonds would improve financing position.
- However, there are good chances that CEE8 countries will decrease their gross external debts (held by the private sector), while the remaining financing gap (if any) will be financed through FX reserves and reduction of other foreign assets.
- Given the already committed inflow of funds from international institutions and expected reasonable roll-over ratios for maturing external debt, *CEE8 countries should not have problems with external financing*.

Case study: Romania

Romania may halve its C/A deficit this year due to drop in consumption and an improvement of the negative savings ratio

Since the beginning of this year, current account deficits have been narrowing in almost all CEE countries, despite the difficult situation on export markets. *"It is very likely that we will see impressive improvement of the current account deficit in Romania this year, probably halving to about 6-7% of GDP, from about 13% of GDP seen in the past two years.*[4] *The main driver will be a drop in consumption (especially of durable goods) and an improvement of the negative savings ratio",* foresees Kotian. The depreciation of the RON/EUR of about 15% (vs. the average exchange rate for 2008) has made the current account adjustment in Romania less painful (less downward pressure on nominal wages, price competitiveness of domestic production over imports) compared to countries with fixed exchange rate regimes or currency pegs.

Data base:

Graph 2: Gap between investments and national savings vs. C/A balance (2005-2007 average, % of GDP)

	Savings	Investments	CA deficit
Belgium	24,4	21,0	2,6
Germany	24,0	18,1	6,4
Ireland	23,5	26,7	-4,0
Greece	9,7	22,2	-12,0
Spain	21,7	30,4	-8,9
France	19,0	20,8	-2,2
Italy	19,7	21,0	-1,7
Cyprus	12,8	20,6	-8,2
Malta	13,9	19,8	-8,0
Netherlands	28,5	19,5	9,0
Austria	25,4	21,9	2,6
Portugal	12,3	21,9	-10,0
Slovenia	26,3	26,4	-2,7
Slovakia	21,1	26,4	-7,0
Finland	26,4	19,5	4,3
Bulgaria	14,6	26,6	-17,5
Czech	24,4	24,6	-1,8
Denmark	24,7	21,0	2,6
Estonia	22,2	32,4	-15,0
Latvia	19,0	32,3	-19,2
Lithuania	16,1	25,3	-10,9
Hungary	16,9	21,8	-7,1
Poland	18,4	19,8	-3,1
Romania	16,0	26,6	-11,0
Sweden	26,3	18,2	7,9

Graph 4: Estimated external debt refinancing needs in 2009 (in USD bn)

	IMF (April)	Erste Group Research (April)	IMF (May revision)	Fitch (May)
CRO	17,7	14,4	17,7	19,6
CZ	86,4	32,8	32,6	32,9
HU	57,8	40,1	34,1	54,9
PL	100,2	87	83,6	87,6
RO	46,9	39,3	46,9	40
UKR	64,1	40,1	36,0	n/a
SRB	n/a	8,9	n/a	8,4

[4] Romania has had much lower current account deficits compared to the Baltics and Bulgaria, which have been running deficits of about 20-30% of GDP.

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