

# Special Report

– June 24, 2009

## Capital Flows and Growth in CEE

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Slump in investments will be greatest in countries with strongest housing boom in past

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Household savings rate will increase, denting consumption

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Cyclical effect is strong, but long-term outlook remains positive

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Strong adjustment in current account deficits – less capital inflows needed than in past

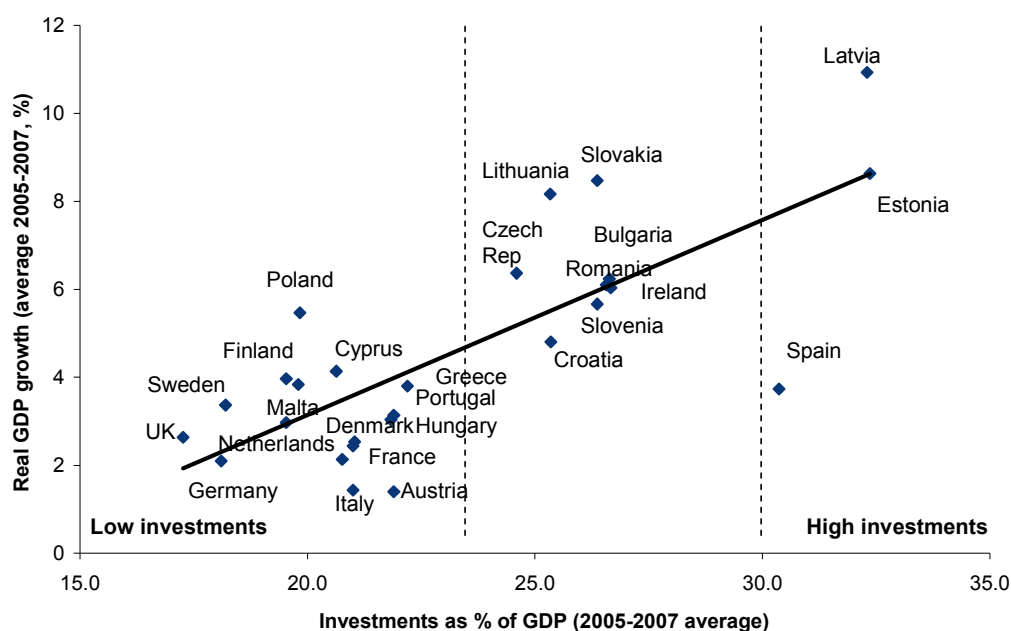
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## Special Report – Capital flows and growth in CEE

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.

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 in these economies. CEE economies have had much higher growth of investments, as well as higher investment ratios (about 26% of GDP on average for 2005-07) compared to the Euro Area (about 20-22% of GDP on average for the same period), boosting output in both the short run (cyclical component) and the long run (potential output).

### Investment ratio and GDP growth (2005-07 average)



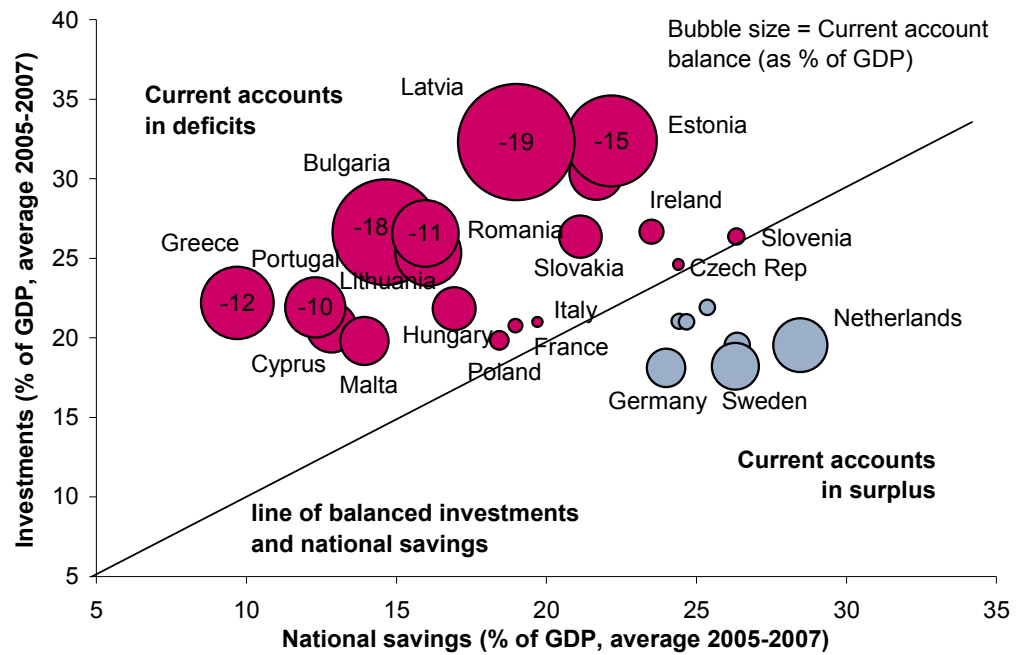
Source: Eurostat, Erste Group Research

There were also big differences in the structure of investments – in most CEE countries, investments were mainly focused on expanding production capacity, productivity upgrades and infrastructure projects. Investment rates of households in CEE (with the exception of Estonia) were far below the EU average (about 10.5% of disposable income of households). 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<sup>1</sup> 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.

<sup>1</sup> National savings are defined as the ratio of GDP less consumption to GDP.

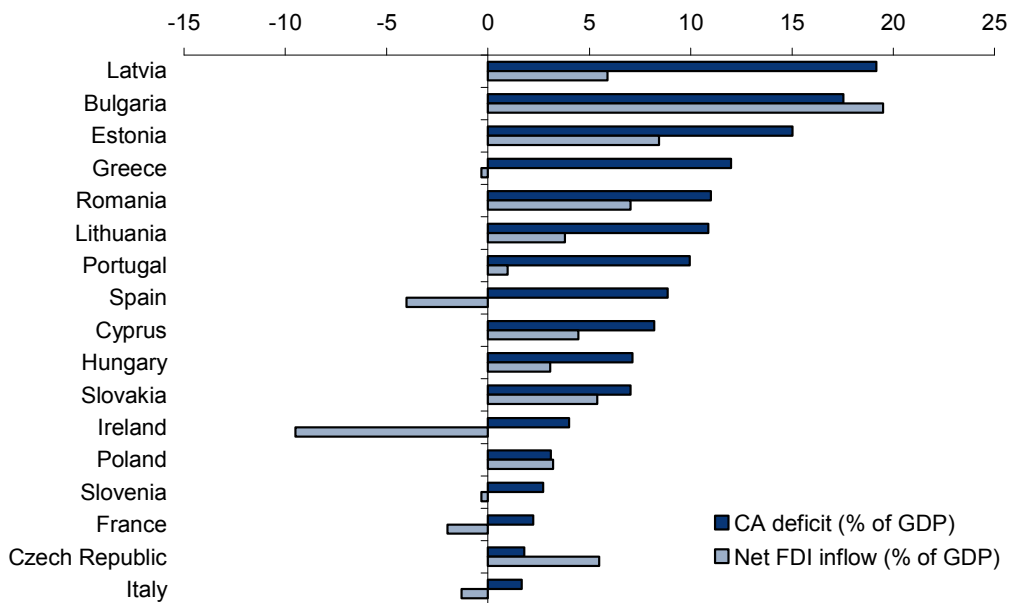
**Gap between investments and national savings vs. current account balance**



Source: Eurostat, European Commission, Erste Group Research

The amount and structure of capital inflows differed across the region. 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. On the other hand, net FDIs into Latvia, Lithuania covered only about one-third of current account deficits. Thus, external debt increased dramatically in these countries in recent years, making these economies more vulnerable to capital outflows.

**Current account deficit and net FDI inflow (average 2005-2007, % of GDP)**



Source: Eurostat, European Commission, Erste Group Research

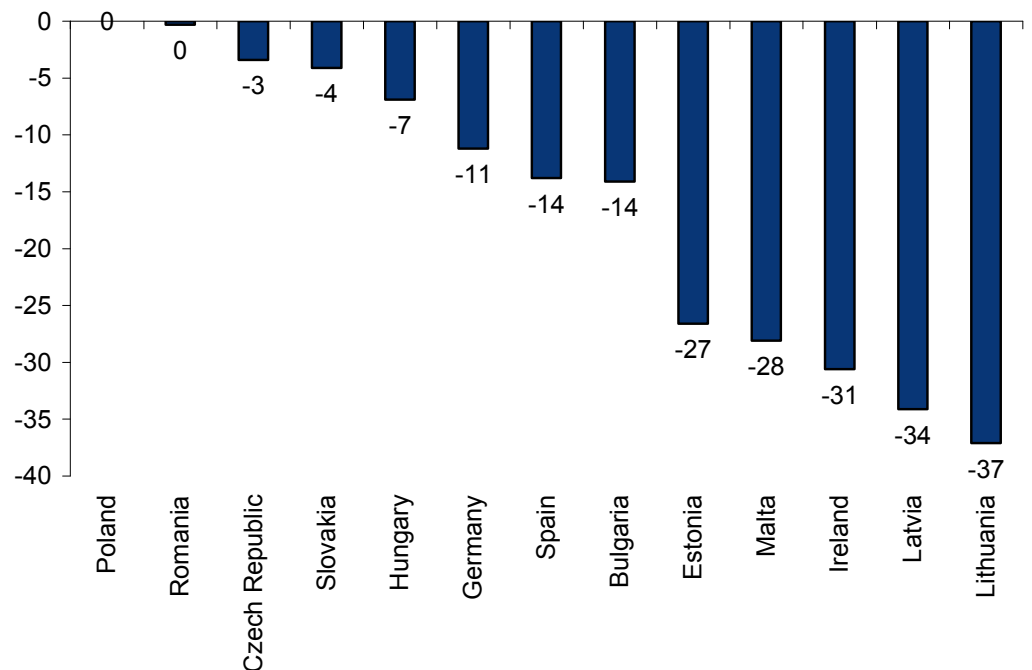
Given the global deleveraging process and drying up foreign capital inflows, it is no longer possible to get financing in order to run such large current account deficits. Thus, the gap between investments and national savings has to narrow significantly,

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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.

**Investments (y/y %, 1Q2009)**



Source: Eurostat, Erste Group Research

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.<sup>2</sup> The main driver will be a drop in consumption (especially of durable goods) and an improvement of the negative savings ratio. 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.

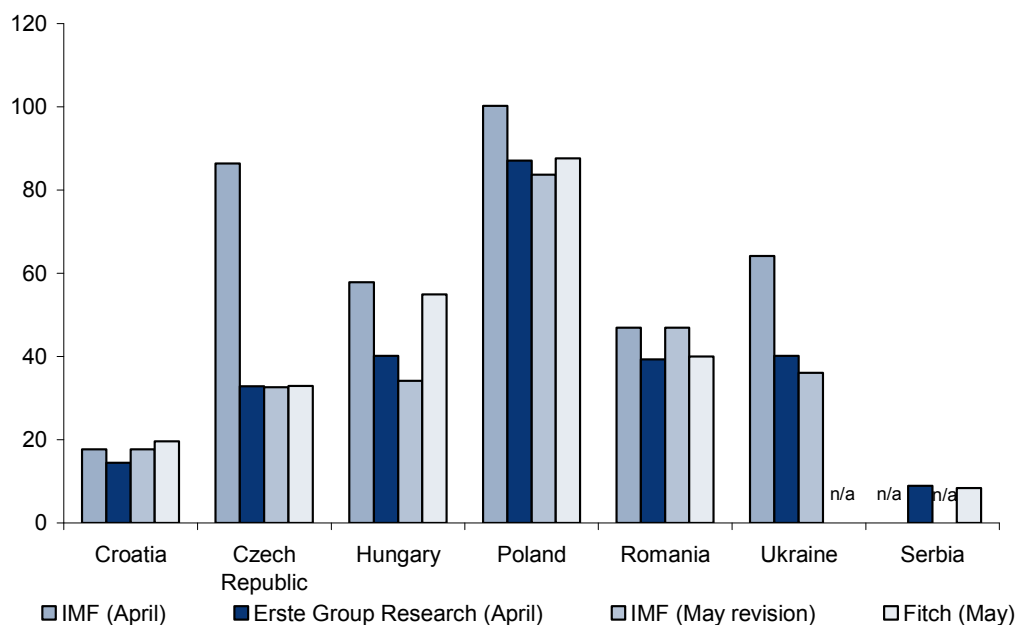
<sup>2</sup> Romania has had much lower current account deficits compared to the Baltics and Bulgaria, which have been running deficits of about 20-30% of GDP.

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There is one negative aspect and one positive aspect related to the quick improvement of the current account deficits. The negative one is that the negative cyclical effect will be stronger (faster), hammering the growth this year. The long-term effect depends on the investment growth after the cyclical shock is over. If the investment growth rate were to stabilize at half of the rate seen in previous years, it would choke about 1-3 percentage points off the average GDP growth rate seen in the past. 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 of the quick narrowing of current account deficits is that countries will need less foreign capital to finance the external gap.

We have carried out analyses of balance of payments for other CEE8 countries<sup>3</sup>, according to which we found that the IMF was very inaccurate with their figures published in April's Stability Report on external debt refinancing needs. Later, the IMF substantially scaled down its estimates for refinancing needs for the Czech Republic, Hungary and Ukraine. Recently, Fitch Ratings published a similar report on refinancing needs, concluding that, within CEE, only the Baltic countries are seen as high-risk regarding refinancing of external debt, while the Czech Republic is seen as low-risk and the rest are medium-risk.

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



Source: IMF Stability Report, Erste Group Research, Fitch Ratings

Assumptions on what portion of maturing external debt will be refinanced (rollover ratio) either by the same lender or another lender from abroad, are crucial in determining of potential capital outflow. We expect the lowest roll-over ratio (about 60%) for refinancing long-term corporate loans, a higher roll-over ratio for the banking sector (70-90%)<sup>4</sup>, while the roll-over ratio for government debt mainly depends on the attitudes and chances of governments to issue Eurobonds on foreign markets this year. For countries under the IMF program, we have conservatively assumed 0% roll-over ratios (IMF will rollover maturing external government debt), so the issuance of Eurobonds would improve their financing position. However, there are good chances that CEE8 countries will decrease their gross external debts (held by the private

<sup>3</sup> The Czech Republic, Croatia, Hungary, Poland, Romania, Serbia, Slovakia and Ukraine.

<sup>4</sup> The high proportion of financing through parent banks, which committed to maintaining their exposure in these countries, increases the roll-over ratio.

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sector), while the remaining financing gap (if any) will be financed through FX reserves and reduction of other foreign assets. So, 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.

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### Investment ratio and GDP growth (2005-07 average)

	Average investment ratio	Average GDP growth
Euro area	21.3	2.4
Belgium	21.0	2.5
Bulgaria	26.6	6.2
Czech Republic	24.6	6.4
Denmark	21.0	2.4
Germany	18.1	2.1
Estonia	32.4	8.6
Ireland	26.7	6.0
Greece	22.2	3.8
Spain	30.4	3.7
France	20.8	2.1
Italy	21.0	1.4
Cyprus	20.6	4.1
Latvia	32.3	10.9
Lithuania	25.3	8.2
Hungary	21.8	3.0
Malta	19.8	3.8
Netherlands	19.5	3.0
Austria	21.9	3.1
Poland	19.8	5.5
Portugal	21.9	1.4
Romania	26.6	6.1
Slovenia	26.4	5.7
Slovakia	26.4	8.5
Finland	19.5	4.0
Sweden	18.2	3.4
United Kingdom	17.3	2.6
Croatia	25.4	4.8

### National savings and Investment as % of GDP vs. C/A Balance as % of GDP (2005-2007 average)

	Average saving ratio	Average investment ratio	Average CA balance
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 Republic	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

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### C/A deficit and net FDI inflow (2005-2007 average)

	CA deficit (% of GDP)	Net FDI inflow (% of GDP)
Latvia	19.2	5.9
Bulgaria	17.5	19.5
Estonia	15.0	8.4
Greece	12.0	-0.3
Romania	11.0	7.0
Lithuania	10.9	3.8
Portugal	10.0	1.0
Spain	8.9	-4.0
Cyprus	8.2	4.5
Hungary	7.1	3.1
Slovakia	7.0	5.4
Ireland	4.0	-9.5
Poland	3.1	3.2
Slovenia	2.7	-0.3
France	2.2	-2.0
Czech Republic	1.8	5.5
Italy	1.7	-1.3

### Estimated external debt refinancing needs

	IMF (April)	Erste Group (April)	IMF (May revision)	Fitch (May)
Croatia	17.7	14.4	17.7	19.6
Czech Republic	86.4	32.8	32.6	32.9
Hungary	57.8	40.1	34.1	54.9
Poland	100.2	87	83.6	87.6
Romania	46.9	39.3	46.9	40
Ukraine	64.1	40.1	36.0	n/a
Serbia	n/a	8.9	n/a	8.4

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### Estimated external debt refinancing needs and funding of external financing gap

	Czech Republic		Croatia		Hungary		Poland		Romania		Serbia		Ukraine	
	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP
Current account balance in 2009	-6.1	-3.1%	-4.1	-6.4%	-5.4	-4.1%	-13.5	-2.4%	-10.2	-5.7%	-4.8	-11.2%	0.0	0.0%
FDI inflow in 2009 plus Capital transfers related to EU funds	4.5	2.3%	2.2	3.5%	4.9	3.7%	2.14	3.8%	7.7	4.3%	1.7	4.0%	4.5	3.6%
<b>CA financing surplus (+) / gap (-)</b>	<b>-1.6</b>	<b>-0.8%</b>	<b>-1.9</b>	<b>-2.9%</b>	<b>-0.5</b>	<b>-0.4%</b>	<b>7.9</b>	<b>1.4%</b>	<b>-2.6</b>	<b>-1.4%</b>	<b>-3.1</b>	<b>-7.2%</b>	<b>4.5</b>	<b>3.6%</b>
<b>Assumed capital outflow from decreased rollover of maturing external debt</b>	<b>-4.9</b>	<b>-2.5%</b>	<b>-2.8</b>	<b>-4.4%</b>	<b>-9.3</b>	<b>-7.1%</b>	<b>-13.0</b>	<b>-2.3%</b>	<b>-10.8</b>	<b>-6.1%</b>	<b>-4.1</b>	<b>-9.5%</b>	<b>-15.3</b>	<b>-12.2%</b>
Changes in equity portfolio investments (+inflow/-outflow)	0.0	0.0%	-0.3	-0.5%	0.3	0.2%	0.0	0.0%	0.0	0.0%	-0.2	-0.5%	0.0	0.0%
Other net debt	0.0	0.0%	1.6	2.5%	-1.5	-1.1%	0.0	0.0%	0.0	0.0%	0.5	1.2%	0.0	0.0%
<b>Financing gap (CA financing gap and capital outflows)</b>	<b>-6.5</b>	<b>-3.3%</b>	<b>-3.4</b>	<b>-5.3%</b>	<b>-11.0</b>	<b>-8.4%</b>	<b>-5.1</b>	<b>-0.9%</b>	<b>-13.4</b>	<b>-7.5%</b>	<b>-6.9</b>	<b>-16.0%</b>	<b>-10.8</b>	<b>-8.6%</b>
Committed loans (IMF, EU, EBRD, EIB) in 2009		0.0%	0.8	1.2%	16.0	12.2%	0.0	0.0%	16.9	9.5%	4.1	9.5%	11.5	9.2%
IMF		0.0%		0.0%	9.4	7.2%			12.2	6.8%	3.1	7.2%	9.5	7.6%
EU		0.0%		0.0%	6.4	4.9%			3.6	2.0%	0.2	0.5%		0.0%
others		0.0%	0.8	1.2%	0.1	0.1%			1.1	0.6%	0.8	1.9%	2.0	1.6%
<b>Implied change in reserves (or other foreign assets)</b>	<b>-6.5</b>	<b>-3.3%</b>	<b>-2.6</b>	<b>-4.0%</b>	<b>5.0</b>	<b>3.8%</b>	<b>-5.1</b>	<b>-0.9%</b>	<b>3.5</b>	<b>2.0%</b>	<b>-2.8</b>	<b>-6.5%</b>	<b>0.7</b>	<b>0.6%</b>
Initial stock of reserves	36.0	18.2%	13.0	20.3%	25.0	19.1%	71.0	12.7%	37.5	21.0%	11.5	26.7%	28.5	22.8%
Reserves at the year-end 2009	29.5	14.9%	10.4	16.3%	30.0	22.9%	65.9	11.7%	41.0	23.0%	8.7	20.2%	29.2	23.4%

	Czech Republic		Croatia		Hungary		Poland		Romania		Serbia		Ukraine	
	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP	USDbn	% GDP
<b>Gross external debt</b>	<b>80.4</b>	<b>40.7%</b>	<b>54.8</b>	<b>85.5%</b>	<b>208.3</b>	<b>159.0%</b>	<b>242.1</b>	<b>43.1%</b>	<b>101.5</b>	<b>56.8%</b>	<b>30.7</b>	<b>71.3%</b>	<b>103.2</b>	<b>82.6%</b>
Short-term external debt (excl. intercompany loans)	25.9	13.1%	6.7	10.5%	25.9	19.8%	50.8	9.1%	26.2	14.7%	3.4	7.9%	22.0	17.6%
Long-term external debt	44.1	22.3%	41.1	64.1%	110.9	84.6%	144.8	25.8%	52.8	29.6%	27.3	63.4%	77.0	61.6%
Government	15.1	7.7%	5.8	9.0%	50.9	38.8%	67.5	12.0%	14.3	8.0%	9.0	20.9%	14.6	11.7%
Monetary Authorities	0.0	0.0%	0.0	0.0%	0.9	0.7%	0.0	0.0%	0.0	0.0%	0.0	0.0%	4.7	3.8%
Banks	7.6	3.9%	8.8	13.7%	42.2	32.2%	30.6	5.5%	20.1	11.3%	3.2	7.4%	30.1	24.1%
Other private sector	21.4	10.8%	26.5	41.3%	16.9	12.9%	46.7	8.3%	18.4	10.3%	15.1	36.1%	27.6	22.1%
Intercompany loans	10.4	5.3%	7.0	10.9%	71.9	54.9%	46.4	8.3%	22.5	12.6%	n/a	n/a	4.2	3.4%
<b>Long-term external debt to be amortized in 2009 (estimate)</b>	<b>6.9</b>	<b>3.5%</b>	<b>7.7</b>	<b>12.0%</b>	<b>14.2</b>	<b>10.8%</b>	<b>36.2</b>	<b>6.5%</b>	<b>13.1</b>	<b>7.3%</b>	<b>5.5</b>	<b>12.7%</b>	<b>18.1</b>	<b>14.5%</b>
Government	0.4	0.2%	0.6	0.9%	4.6	3.5%	16.9	3.0%	1.4	0.8%	1.8	4.2%	3.7	2.9%
Banks	1.0	0.5%	2.6	4.1%	8.4	6.4%	7.7	1.4%	6.0	3.4%	0.6	1.5%	7.5	6.0%
Other private sector	5.5	2.8%	4.5	7.0%	1.2	0.9%	11.7	2.1%	5.7	3.2%	3.0	7.0%	6.9	5.5%
<b>Assumed Rollover ratio on short-term debt (through private sector)</b>	<b>90%</b>		<b>90%</b>		<b>90%</b>		<b>90%</b>		<b>75%</b>		<b>70%</b>		<b>70%</b>	
Assumed Rollover ratio on long-term government debt (through private sector)	90%		90%		0%		85%		0%		0%		0%	
Assumed Rollover ratio on long-term debt of banking sector (through private sector)	90%		90%		80%		90%		90%		90%		70%	
Assumed Rollover ratio on long-term of corporate sector (through private sector)	60%		60%		60%		60%		60%		60%		60%	

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