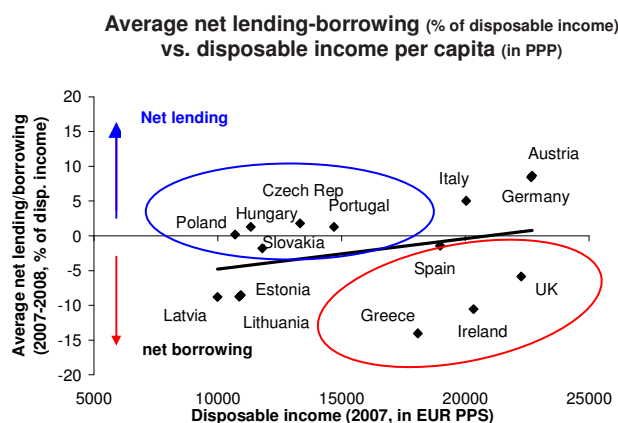


From export-led recovery to more diversified growth in CEE in 2011

- CEE consumption to pick up about 1-2.5% y/y in real terms in the region next year
- The currently purely export-led economic revival to get more balanced due to increased consumption
- Consumption growth in CEE to be less vulnerable in the coming years due to sustainable saving ratios and net borrowing/lending ratios
- CEE region as front-runner in the global competitiveness of labor due to low labor costs and expected labor market reforms

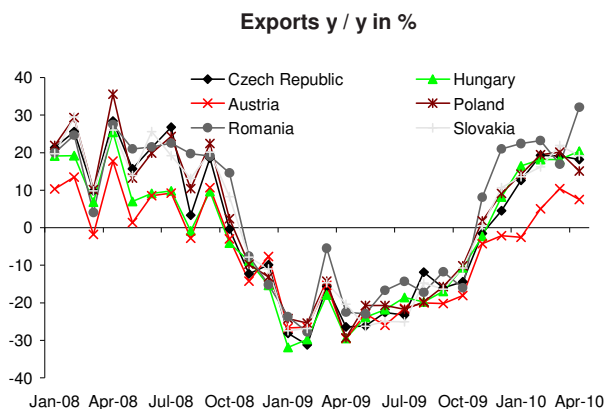
“Given the strong deceleration of credit growth and reversal of net borrowing over the last two years, there is fundamentally less need for further adjustments in saving ratios in CEE countries”, says Juraj Kotian, Co-Head CEE Macro Research at Erste Group. “Thus, consumption will be strongly tied to the growth of disposable income, which we expect to pick up about 1-2.5% y/y in real terms in the region next year, providing support to GDP growth”. The exception is Romania, where higher inflation (due to the VAT increase) will bring real disposable incomes down 0.8% y/y next year. “We therefore expect the currently purely export-led economic revival to get more balanced. Furthermore, sustainable saving ratios and net borrowing/lending ratios should make consumption growth in CEE less vulnerable in the coming years”.



Source: Eurostat, Erste Group Research

Foreign trade up again, but below pre-crisis levels

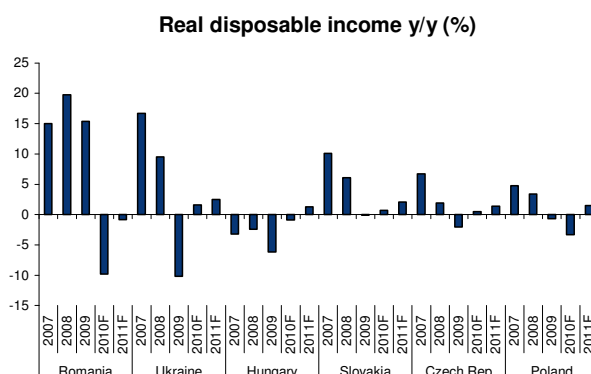
The contraction of foreign trade in late 2008 and 2009 hit mainly export-oriented economies like Slovakia, Hungary and the Czech Republic. After bottoming in 1Q09 exports have been posting double-digit y/y growth in many CEE countries in recent months and are currently the main pillar of economic recovery, but are still below the pre-crisis level in unit terms. The urgent need for fiscal consolidation in the EU increases concerns about the future strength of the export-led recovery.



Source: Eurostat, Erste Group Research

The real income convergence has been higher and less volatile compared to GDP in nominal terms and reached about 50-80% of the EU average

Despite the much faster nominal growth in CEE compared to advanced economies¹, GDP per capita in EUR remains far below that of the advanced economies reaching only about 1/5 and 1/2 of the Euro Area average in EUR terms at market exchange rates.² Also, the differences prevail in the CEE region, with the Czech Republic the richest country in the region and Romania, Serbia and Ukraine on the opposite end of the scale. However, for households, more relevant than GDP in EUR terms is the GDP calculated in Purchasing Power Parity exchange rates, reflecting the difference in price levels across economies and muting the effect of swings in market

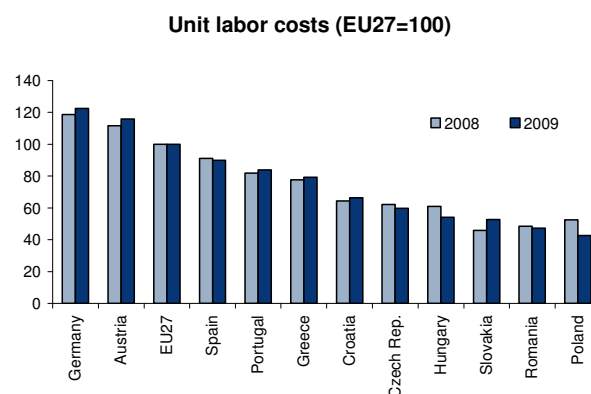


Source: AMECO, Erste Group Research

exchange rates on purchasing power (unless they pass through into consumer prices). “Given the lower price level in CEE countries (especially in the sector of services), the income level measured by GDP per capita in PPS is much higher, about 50-80% of the EU average”, points Kotian out. “Thus, real income convergence has been more advanced and less volatile compared to GDP in nominal terms (at market exchange rates).”

CEE countries have a big opportunity cost-wise and in terms of the challenge of labor market reforms

The employment³ collapsed about 1-4% in CEE (apart from Poland, where employment actually increased in 2009), while the largest drops in the EU (ranging from 7% to 13%) were experienced by countries that have been witnessing real estate bubbles and external imbalances and could not smooth the adjustment through the weakening of currencies (the Baltics, Ireland and Spain). Seasonally-adjusted employment data already points to stabilization⁴, but in a y/y comparison, employment will contract in 2010 (on average). “Future job recovery will strongly depend on the global competitiveness of labor and structural changes in the labor market and I see here the CEE region having a big



Source: AMECO, Erste Group Research

opportunity cost-wise as well as in terms of the challenge of labor market reforms”, suggests Kotian. Unit labor costs in CEE countries are significantly lower compared to the EU average and the labor participation rate can be increased through the elimination of barriers that keep some citizens out of the labor force (Hungary, Romania).

¹ GDP per capita measured in EUR doubled in the vast majority of CEE countries and, in countries like Romania and Slovakia, tripled in the last decade, while in the EU GDP per capita increased by only a quarter over the same period.

² Ukraine is an outlier in the region, with GDP per capita in EUR at less than 10% of the EU average.

³ For the calculation of the direct impact of job destruction on disposable income, the more relevant factor is the absolute number of people employed, rather than the unemployment rate. They are closely linked, but the unemployment rate is strongly affected by the level of participation rate, while neglecting the effect of the growing working-age population and thus employment.

⁴ Unemployment is expected to rise in Romania, where the government has announced sizable cuts of expenditures, namely overall compensation of employees in the public sector (down by 25%).

Disposable income of households⁵ in CEE is about 65% of GDP and is expected to rise by 1.0-2.5% in 2010 (except for Romania)

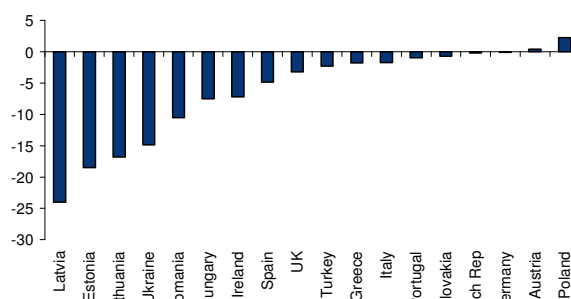
Disposable income, which accounts in average for about 65% of GDP, has been recently hit by rising unemployment and the erosion of other income (rents, profits, interest income). "As the adverse effect of the deteriorated job market has been partially softened by slightly growing pensions and other social benefits, the disposable income has dampened less than the drop in employment would imply", explains Kotian. "Given rising productivity, a solid outlook for growth of wages in the private sector and increase of unemployment nearing the peak, we expect disposable income to increase by about 1.0-2.5% next year".

In Romania, where the government approved ambitious austerity measures (including a 5pp hike of VAT), the growth of disposable income in real terms will remain in red figures next year, due to increased inflation.

Deeper drop of household consumption due to rise of savings rate

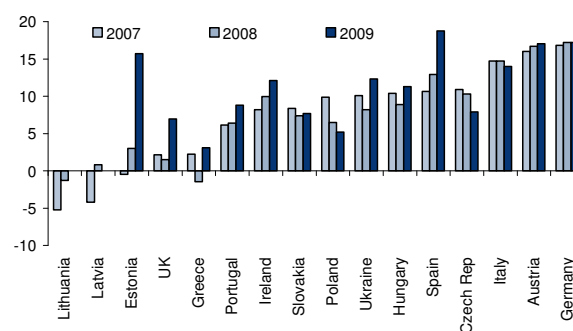
"The reason why the drop of household consumption was much deeper compared to the dynamics of disposable income in many countries was that households used the portion of their disposable income they do not use for consumption for savings", comments Kotian. Mainly in countries with very low saving rates like the Balkan and Baltic countries⁶ (but also in many advanced economies like Spain and the UK, where the savings rate had to increase by 6pp) it was necessary to reduce net borrowing. Consumption in countries where households have been in a net lending or balanced position (flow-wise) - like the Czech Republic or Poland - was hit less during the downturn, as they could afford to smooth consumption through a temporary reduction of the saving ratio. Net borrowing, which used to add about up to 15% of disposable income and was heavily used in Greece and countries with a strong real estate boom in past years (Ireland, Spain and the Baltics), has been substantially decreased and resulted in a significant contraction of household consumption and investments.

Household consumption y/y (% , 2009)



Source: Eurostat, Erste Group Research

Adjustment of saving rates (% of disposable income)



Source: Eurostat, Erste Group Research

⁵ The disposable income of households is the most appropriate measure to explain short-term fluctuations in the income of households, as it takes into account all incomes of households, including social benefits, profits, rents and interest received, while direct taxes are deducted from the overall income.

⁶ According to preliminary data published by the Romanian statistical office, Romania has experienced a strong adjustment of the saving rate, from about -5% in 2008 to 20% in 2009. However, the latest available official data published for Romania by Eurostat are only for 2007 and the above-mentioned figures will likely be subject to revision.

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