Usual growth factors remain supportive in CEE economies, but vulnerabilities are arising. The new international environment reveals long-term weaknesses especially

Sub-prime crisis testing New Europe's economies

by Debora Revoltella

in South Eastern Europe and in the Baltics. And more serious concerns arise in the short term for Kazakhstan, a bridge between East and West

Lower growth in the US and the euro zone, great uncertainty and volatility and a general repricing of risk are the main features characterising the new global environment. If proactive monetary policies are leading to fast declines in interest rates, especially in the U.S., still the risk of a potential deeper recession in the US remains. The view of international financial markets is on the pessimistic side. Uncertainty about the true size of international banks' write-off related to the US sub-prime crisis is still great. Equity markets have proved to be extremely nervous and volatile.
"Repricing" of risk at international level is also clear: CDS spreads (Credit Default Swap, an indication of the risk priced by financial markets) have doubled or tripled all around the world since July 2007 and the Central Eastern European (CEE) region was not an exception. Moreover, international investors are starting to be quite selective, penalising most the countries which show greater imbalances.
How CEE economies are reacting to the global turbulence? Two possible contagion channels can affect the CEE economies, namely a tightening of credit conditions (financial channel) and low euro zone demand (real channel, trough external trade).
The CEE region remains in a position to cope with the new environment: indeed, the usual growth drivers remain supportive. Consumption is fuelled by rising household income and declining unemployment, though high inflationary pressures and tighter monetary conditions are leading to some moderation. Despite credit tightening, prospects for investment activity remain positive thanks to a relatively lively corporate sector and a number of infrastructure projects financed by structural funds (in EU member countries) or investment and growth funds (in former CIS countries).
Lower growth in the euro zone and rising production costs will be reflected in some pressure on export performance of CEE countries. Still, the region remains competitive in absolute terms and selected industries might even benefit from major competitive pressures: in "Old" Europe several companies further tend to maximise the return on their past delocalisation strategy. Moreover, oil and raw material prices remain supportive for

former CIS countries.
However, it's very clear that vulnerabilities are arising: financing domestic growth with international savings is now an issue. In recent years most countries in the region have been relying on external savings (from abroad) to finance their growth. Rising current account deficits were financed by foreign direct investment (FDI), but also by external debt. The banking sector has also played a role, being largely financed from abroad. In 2007 the region has attracted roughly 100 bn euro of international debt, while the banking sector has almost doubled net access to foreign funding.
The "repricing" of risk at international level has led to a hike in the cost of such external financing, enhancing the risk of some general tightening of credit conditions. Countries with bigger external imbalances and greater dependency on foreign funding are also those facing the bigger increase in the cost of risk, thus being more likely to suffer from some credit tightening.
Central European countries (Poland, Hungary, Czech Republic and Slovakia) are largely unaffected, with some cyclical tightening on the cards. Countries in the region are less sensitive to a possible credit squeeze, as external imbalances are under control and the cost of risk, despite increasing sharply, remains relatively low. Some cyclical tightening is expected, in the wake of rising inflationary pressures and growing production capacity constraints, particularly in Poland and the Czech Republic. In the latter, the new tax system is likely to have a negative effect

_ The financial crisis triggered by the sub-prime loans is starting to affect Central and Eastern Europe, with a tightening of credit conditions and low euro zone demand

on consumption growth. It should be noted that the strong pace of growth, combined with inflationary pressures, suggests some counter-cyclical tendencies where the euro zone is concerned – this might become an issue for Slovakia, which is planning to enter the euro zone at the beginning of 2009 and should then adopt an easier monetary policy stance, and for Slovenia, which entered the euro zone in 2007. Hungary remains the tricky country in Central Europe, still reaping the consequences, in terms of growth, of the fiscal correction plan. The country is the most sensitive in Central Europe to deterioration in the global environment.

The new international environment reveals long-term vulnerabilities in South Eastern Europe and in the Baltics. These economies are expected to slowdown in the next years. All these countries have small and very open economies, which have largely financed their growth in recent years from external savings. Such funding has come in the form of foreign direct investment (FDI), but also in the form of external debt, with the – largely foreign-owned – banking sector playing a role. Global repricing of risk has particularly hit these countries in view of their structural imbalances: CDS spreads raised briskly. Such an increase in the cost of risk is likely to lead to some moderation in capital inflows.

Some slowing in growth can even be considered welcomed in the Baltics, where "overheating" concerns were repeatedly addressed in recent years. The increase in the cost of risk is leading to some credit tightening. Local currency markets are pricing in some devaluation risks, but very minor: the market is, however, possibly too shallow for speculative attacks against Baltic currencies.

The markets' mood towards Romania has changed substantially in the last year. While growth prospects remain positive, the country is paying the cost of its long-term vulnerabilities and of a rather incoherent political environment. The

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exchange rate has lost roughly 20% in half a year, and remains quite volatile. In the short term, the Central Bank is opting for high interest rates as a strategy to maintain Romanian assets attractive. In the long term, we believe the challenge is to preserve overall competitiveness, remaining attractive for productive FDI. In Bulgaria too, markets are starting to price a higher cost of risk for the country, amidst its high current account deficit and rising inflationary pressures, which raise questions about the long-term sustainability of the currency board (the agreement that pegs the local currency the Euro). However, macroeconomic policies are very coordinated, focused towards some moderate cooling, in order to prevent overly strong real appreciation, and towards increasing flexibility in order to enhance the economy's efficiency and competitiveness. In Croatia, the Central Bank's strategy of cooling domestic credit growth, while limiting local banks' external indebtedness and forcing their recapitalisation, has proved successful. Domestic lending is being squeezed, constrained by fixed targets (trough administrative limits), while the economic impact of such tightening is smoothed by the increasing relevance of cross-border lending (corporations financed from abroad).

In the Western Balkans, the political scenario is still a source of risks. In Serbia, even though incumbent Boris Tadic won February's presidential election, the political environment will remain uncertain with a continued possibility of early parliamentary elections. The consequences of Kosovo's unilateral declaration of independence and the effects on the economy are still not clear. Though gradually easing, continued high external imbalances might pose an additional threat in the context of a new deteriorated global environment. In Bosnia-Herzegovina the domestic political environment is also crucial and raises questions about whether agreement on

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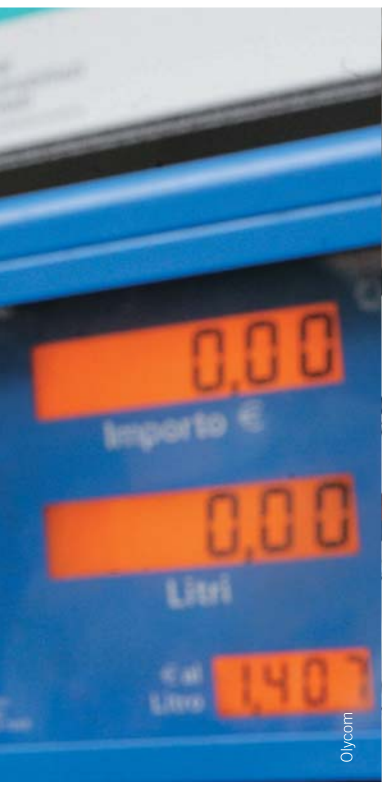

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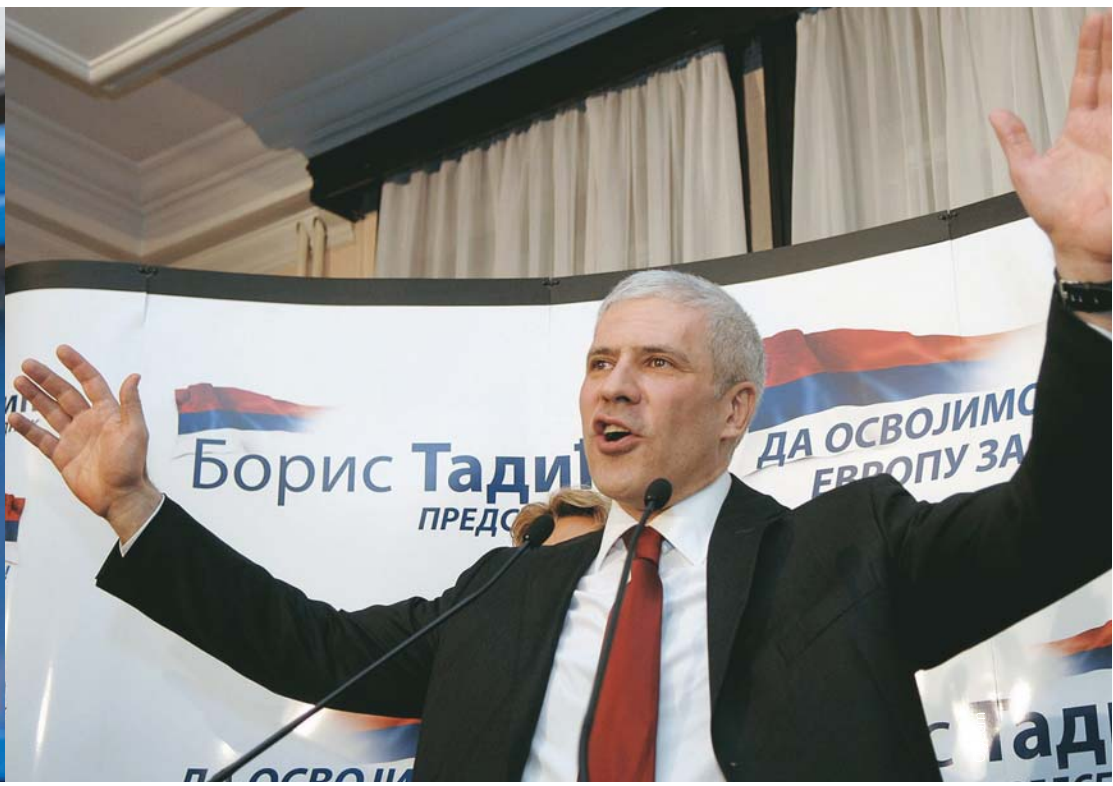

the form of a new constitution will be reached and signing of the SAA (Stabilization and Association Agreement) with the EU will take place.
Countries in the rest of Central Eastern Europe are even more sensitive to the international "repricing" of risk, but they are continuing to show very high growth. In Russia, both banks and medium and large Russian companies relied heavily on external funding in recent years. The main evidence so far relates to a deceleration in corporate deposit growth and hikes in corporate lending growth, which are both a sign of reduced access by the corporate sector to direct external funding. The banking sector in general remains liquid and banks like Sberbank, VTB or the smaller foreign-owned banks continue to have wide access to international financial markets and cheap funding. Big companies could have access to international markets as well.
The Turkish economy slowed down significantly during 2007, which was a very eventful year, dominated by both local elections and global uncertainties. Despite the fragile global environment, prospects for the Turkish economy are not gloomy. Firstly, policy rates are now much lower than five months ago and this trend will provide support for investment activity and growth prospects. Secondly, the political uncertainties were dispelled, and the government, backed by the president and by a stable parliamentary majority, is promoting important reforms (reform of the controversial article 301 of the penal code, a new constitution, the Kurdish issue and the "turban problem"). However, Turkey – as an emerging and "high beta" country – still remains exposed to financial contagion stemming from abroad more than other CEE countries.

More serious concerns arise for Kazakhstan in the short term, with medium- to long-term potential preserved. A liquidity crisis is visible and already translating into a clear credit squeeze in Kazakhstan. The consumption and investment boom which has been behind the impressive growth of recent years is severely constrained. Companies have reduced access to international debt markets, while the banking sector, which was fuelling a credit boom through external borrowing, now has to severely limit lending expansion. The construction industry, which was one of the most dynamic sectors of recent years, is now overheating and cooling is likely to further impact on banking sector performance. The growth rate of the economy in 2008 will probably be half than the rate registered in 2007. However, the country's long-term potential will be maintained, as with high energy and raw material prices the country has money and commitment enough to prevent any major crisis.

Kazakhstan preserves its medium to long term growth potential, but in the short term a liquidity crisis in the banking sector is visible and already translating into a clear credit squeeze