

Research

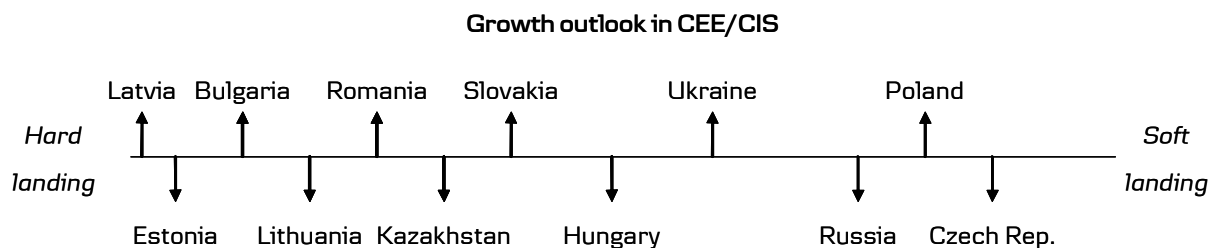
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CEE/CIS: The engine is cooling down

- Growth is set to slow down in Central and Eastern Europe and in Eurasia. Luckily the slowdown is set to be fairly soft in the larger economies in the region such as Russia and Poland, while the smaller economies in the Baltics and south-eastern Europe are set for a significantly harder landing.
- The slowdown in growth is especially driven by significantly tighter credit conditions in the region - especially in the Baltic states and Kazakhstan.
- The slowdown will particularly be visible in domestic demand and we expect a fairly strong slowdown in private consumption, property prices and construction activity.
- Rising inflation and wage growth is a problem everywhere in the region. The acceleration in inflation on the back of in particular, higher food and energy prices, could weigh on private consumption.



Growth still robust but set to slow

From boom to slowdown

Growth in the former communist countries in Central and Eastern Europe and Eurasia has been very strong over the last couple of years. Growth has mostly been driven by a significant acceleration in domestic demand fuelled by easy credit conditions that have spurred strong growth in both investment

activity - mostly in the construction sector - and by very strong growth in private consumption.

The strong pick-up in growth has had its obvious positive consequences in terms of lower unemployment, strong profit growth and a general rise in consumer and business confidence. However, there have also been some clear negative trends - most worryingly in the countries that have seen a rise in

external imbalances, as well as higher inflation and a wage boom that has not always been accompanied by a similar rise in productivity. Hence, even though growth still continues to be robust in most of the region it is also obvious that it increasingly has become more imbalanced and therefore for that reason alone there is a need to slow domestic demand growth.

Hence, the need to rebalance growth should in itself be expected to cool down the growth engines in the region. Furthermore, the region has been hit by a number of external shocks, which also will have a negative effect on growth. These shocks are:

- The global **credit crunch** has increased stress in the money markets in the region. This is especially the case in Kazakhstan and the Baltic states. Tighter global and local credit conditions are likely to slow credit expansion significantly in many countries in the region as credit institutions have tightened lending policies significantly. The lagged impact of European monetary policy and local tightening of monetary conditions will also contribute to a slow-down in credit growth.
- **Inflation** has risen dramatically – driven by in particular higher food and energy prices, but also very strong wage growth and strong domestic demand. In particular the rise in food and energy prices – items which in some countries in the region constitute nearly half of the consumption basket – are eroding real disposable incomes and hence slowing private consumption growth.
- **Property prices** have risen dramatically in the last couple of years and there are signs of bubble tendencies in some of the regional property markets. However, we are now seeing that property prices are beginning to decline in some countries. Over the last couple of months we have especially seen signs of fairly strong declines in property prices in Estonia, Latvia and Kazakhstan. In other countries such as Lithuania and Poland it looks like property prices have peaked and it is obvious that the tightening of credit conditions combined with high valuations in the region's property markets should lead to a drop in property prices in the region over the coming year. The cooling of the property markets in the region is likely to lead to lower construction activity – as we are seeing already in for example Estonia – in most

of the regions. Lower property prices are also likely to slow private consumption growth through a wealth effect.

These shocks have or are likely to hit the majority of the countries in the region, but the growth impact is likely to vary from country to country. Overall the impact is likely to be hardest in the countries with the largest initial imbalances and the highest degree of leveraging. Below we take a look at the different areas in the region.

Growth picture		
Ann rate.	Real GDP	
	2006-07	2008-9
Core CEE	5-7%	4-5%
Baltics	9-12%	3-5%
SEE	7-8%	4-5%
CIS	7-9%	6-7%

Between soft and hard

Core CEE – mostly a soft landing with some risks

The core CEE economies, Poland, Hungary, the Czech Republic and Slovakia, are generally in quite good shape and growth is buoyant, with the exception of Hungary, where fiscal policy has been tightened significantly and has sent growth plummeting. That said, we are probably getting close to a peak in the business cycle and there are signs that especially capacity constraints and rising production costs are beginning to limit the upside in growth.

Furthermore, as in the rest of the region, the abovementioned factors are likely to dampen domestic demand and it seems pretty clear that construction activity is likely to soften.

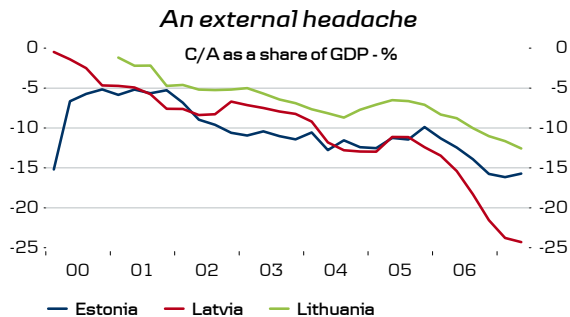
Even though we expect a slowdown in the core CEE markets we expect a soft landing rather than a hard landing. The main reason for our relative optimism for the core CEE countries is that the external imbalances are fairly small and inflation fairly subdued in especially Poland and the Czech Republic. That said, we are, however, concerned that there are some signs that the property markets are in "bubble mode". Hence, even though we expect a soft landing overall in the economies it could be fairly hard in the construction sector. That is especially likely to become the case if banks tighten credit policy significantly on the back of a worsening of the situation in other areas of the region and if foreign currency loans (mostly denominated in CHF and

EUR) rise in cost. Foreign currency loans are especially an issue in Poland and Hungary.

Another risk to growth in the core CEE countries could be the lagged impact of the worsening of competitiveness on the back of significantly higher wage inflation and fairly strong currencies. That said, we would expect the export-oriented sectors to do fairly better than the retail and construction sectors that could face a fairly sharp slowdown.

The Baltic states - this could be pretty hard

Growth has been spectacular in the Baltic states over the last couple of years, but so has the increase in imbalances in the economies. Most notable are the huge current account deficits in all three countries and high and significantly accelerating inflation. For example, the current account deficit in Latvia is now close to 30% of GDP and in September inflation rose to 11.5%. Hence, there is no doubt that the imbalances in especially the Latvian economy, but also in Lithuania and Estonia, are very large. Furthermore, the Latvian lat has been under significant pressure since February and money market rates have gone up significantly in all three countries. Given the very large imbalances in the Baltic economies it seems very hard to avoid quite a hard landing in the economies and further financial distress should clearly be expected.



In particular the construction sector is expected to take a hard hit. We are already seeing quite dramatic declines in property prices in both Estonia and Latvia, while Lithuanian property prices seem to have peaked and also here we would expect a fairly large drop in the overheated property market.

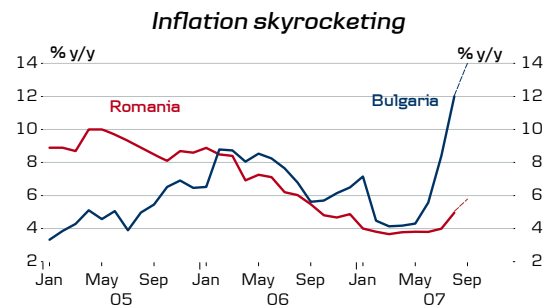
We are clearly seeing a worsening of credit conditions in all three Baltic countries on the back of rising money market rates and a tightening of credit policies in the Baltic banking sector. This combined with falling property markets and the prospect for rising unemployment will surely weigh heavily on private consumption that could very well go into a

slump. Despite this there is reason to continue to be optimistic for longer-term growth perspectives.

SEE - Landing nearly as hard as in the Baltics

The most overheated economies in the region are to be found in the north-east - the Baltic states - and in the south-east - Bulgaria and Romania and other Balkan economies. In that sense it can be said that the outlook for the Balkan economies is similar to that for the Baltic states - hence we could be heading for a hard landing in countries such as Bulgaria and Romania as excesses are getting unwound.

In recent months, inflation has skyrocketed in most south-eastern economies - especially in Bulgaria. The very strong rise in inflation will clearly have a negative impact on growth mostly through a reduction in real income growth and therefore on private consumption.

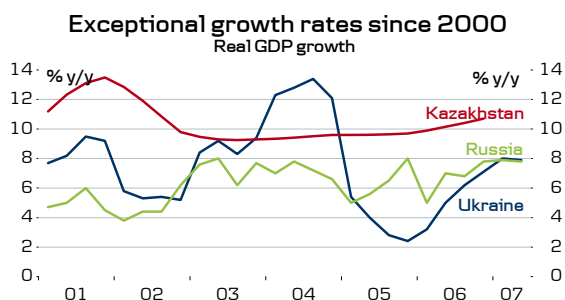


Furthermore, the tightening of global credit conditions is also visible in the south-eastern markets and this very likely will lead to a slowdown in credit growth. This is likely to lead to a slowdown in investment and consumption growth. Furthermore, we see some risk to the property markets that continues to be red hot and not yet slowed down in any visible way.

We see a fairly large risk of a hard landing in growth in both the Romanian and Bulgarian economies and the most fragile sectors are the usual suspects: construction and retail sales.

CIS - Moderating growth ahead

The CIS region has been among the fastest growing in this decade. While the pick-up in growth initially was driven by exports – surging energy and commodity prices – the main growth driver in recent years has been domestic demand, mostly via private consumption and to some extent higher investments, predominantly in the construction sector.



The region has benefited from favourable external conditions such as healthy global growth, high demand for commodities, and rich liquidity. These factors have consequently fuelled local financial markets with hefty amounts of liquidity.

Rich liquidity and easy monetary conditions have stimulated credit growth and have been supportive for private consumption as well as most asset classes. Thus local equity markets and property markets have performed very well in the last few years.

Private consumption growth rates have moved into double-digit territory across the region, and there is no doubt that the demand side of the economies has been expanding more rapidly than the supply side. This has led to a rapid rise in imports and increased inflationary pressures. In Kazakhstan and Russia the C/A surplus is shrinking, while in Ukraine the C/A deficit is widening.

Inflationary pressures are quite strong in the region, further boosted by accelerating food prices this summer. Price growth is now approaching dangerous levels especially in Ukraine (roughly 14% y/y). In Russia and Kazakhstan it is still below 10% y/y, but for how long? There is a clear risk that inflation will move higher over the coming months, driven by in particular the rising food prices, and that will dampen the effect on consumer spending, as the food component in an average consumer basket is fairly large in CIS.

We in general expect that growth will moderate in the region in the coming quarters as the effects from the tighter credit conditions feed into consumer spending as well as the construction sectors. The local money markets have been severely under pressure in the last couple of months, especially in Kazakhstan, but also to some extent in Russia and Ukraine.

The squeeze in the local Kazakh markets is yet another example that the global credit crunch is becoming visible in Emerging Markets – especially in highly leveraged economies or in countries with a weak financial architecture – see *Flash Comment - CIS: Why we should care about problems in the Kazakh banking sector*, October 5.

Money market rates have moved significantly higher, liquidity has dried up, and local credit institutions are tightening lending and borrowing policies. This will reduce credit expansion and thus have a (needed) moderating impact on growth in the region looking ahead. The problems in the local banking sectors look worst in Kazakhstan, where banks are heavily addicted to foreign borrowing. Foreign borrowings exceed 50% of Kazakh banks' liabilities, whereas the figures in the Russian banking system are not above 20%. As a consequence, Kazakh banks have mostly dollar liquidity, whereas in Russia it is predominantly rouble. We hence believe that the Russian banks in general will recover relatively fast from the weakness, but they will also have to adjust their lending and borrowing policies in a more prudent direction.

We expect growth to remain healthy in Russia although it will move a little lower. In Ukraine and Kazakhstan the picture is less clear. The growth outlook in Ukraine is blurred by the current political uncertainties after the recent parliamentary elections – see *Flash Comment - Ukraine: Both sides claiming victory*, October 2. Will the new government be successful in implementing reforms or will new deadlocks arise after a very close race in the elections? In Kazakhstan, the slow down could be a bit more severe, at least in the next couple of quarters.

The economic expansion in CIS will go from being somewhat above longer-term potential growth rates and we expect it to land between 6%-7% y/y in the coming years rather than the 7%-9% y/y we have seen in the last two years. In the longer run the region still has a huge catch up potential.

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