Flash Comment

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CEE: This looks like a meltdown

Market update – it looks like a meltdown

Overnight the sell-off in Central and Eastern European markets accelerated further after Moody's announced that it may downgrade Swedish and Austrian banks with exposure to Central and Eastern Europe. This move will further exacerbate concerns over the state of CEE economies and markets.

The region's large imbalances and significant currency mismatch has long been a problem for us and there is no doubt that the CEE countries can expect a very sharp drop in economic activity. Despite already depreciating substantially, we see no reason why the sell-off of CEE currencies should cease soon absent substantial intervention from the EU and/or the ECB to support markets. We think it unlikely that local authorities will be able to muster sufficient resources to curb the sell-off in CEE currencies in the present environment. To us this looks like a market meltdown on the same scale as occurred during the Asian crisis of 1997. No currency in the region will be unaffected by this. Doubtless the markets have decided that the CEE region is the subprime area of Europe and now everybody is running for the door. In addition, it is not just regional currencies that are under pressure. Stock markets are also being sold off with yields and rates beginning to rise significantly. Furthermore, Credit Default Swaps have risen dramatically across the region during the last couple of weeks.

Macro economic implications – sharp drop in GDP in all CEE countries

Continuing aggressive "deleveraging" of CEE economies due to Western European banks tightening their credit policies in the region and the serious outflow of capital from it effectively represents a "sudden stop" to the funding of large current account deficits in the area. Foreign direct investment in the region is also likely to plummet.

The reversal of both portfolio flows and FDI will undoubtedly have a serious negative impact on regional investments. Furthermore, with many households and corporations highly exposed to FX loans (especially in Swiss francs) debt servicing costs are rising dramatically. This is likely to have a substantial negative effect on private consumption, especially in Poland, Hungary and Romania.

In our view GDP growth is like to be negative in *all* CEE countries this year. In those countries "least" affected by the crisis (i.e. Poland, the Czech Republic, Slovakia and Slovenia) GDP is like to drop at least 2-5%, while those countries worst affected (i.e. the Baltic States, Bulgaria, Romania and Ukraine) are likely to face double digit declines in GDP. In other words, in terms of expected output lost in the region this is as bad as or even worse than the Asian crisis of 1997-98.

Policy implications – Will the EU have to step in?

The current development is so explosive and the scale of the losses to market participants in the region so large that outside help is clearly warranted. The IMF has already provided rescue packages for Latvia, Hungary, Serbia and Ukraine. Clearly, we expect the IMF to be involved in providing rescue packages for several other countries in the region. Those offered to Hungary and Latvia also involved EU participation. This is also likely to be the case for other new EU countries that might seek IMF help. That, however, raises the question of whether Western European tax payers will be willing to pay to bail out CEE economies. We don't know the answer to this question but with the expected cost of such bail outs rising dramatically this is likely to become a highly contentious political issue in several Western European countries sooner rather than later.

In our view the most likely scenario is that the EU will have to step in to stabilise the situation although at the same time the EU (and the IMF) will not be able to "save" all countries in the region and especially not those outside the EU. Our biggest concern is that the EU does not have a clearly defined framework defining how it will cope with these kinds of economic challenges, a situation exacerbating current uncertainty in CEE markets.

Monetary policy – will short-cut the monetary easing cycle

Given the slowdown in economies and declining commodity prices, we have for some time expected inflation to fall across most Central and Eastern European countries. However, inflation data for January suggest the disinflationary process is coming to an end in most CEE economies, and that with the sharp sell-off in CEE currencies inflationary pressures are rising once again. This presents regional monetary authorities with a significant challenge – should monetary easing be continued in order to spur economic growth or should the easing cycle be halted to curb inflationary pressures. Furthermore, the large exposure to FX loans in several CEE countries probably means that central banks in the region are becoming increasingly concerned regarding the impact of currency weakness on financial sector stability.

In our opinion, worries regarding increased inflationary pressures and the implications for financial sector stability as a result of the sell-off in CEE currencies are beginning to overshadow growth concerns. This means that the easing cycle in CEE countries is likely to be coming to an end faster than we previously thought and faster than is presently discounted by markets. We would therefore expect money rates to continue to rise in most CEE countries in the coming days and weeks.

Comments from central bankers in both Poland and the Czech Republic in recent days are a clear indication that the weakness in CEE currencies has moved to the top of the monetary policy agenda.

Market recommendations – remain short and beware of contagion

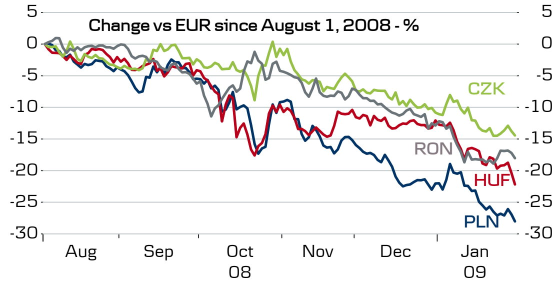
Despite the sharp sell-off in CEE currencies we do not see much value in being long in any currencies within the region at present. Therefore, we continue to recommend hedging all currency risk in CEE. Some currencies should obviously do better than others but with volatility spiking and liquidity very thin it will be very hard to pick any (relative) winners in this market. Nevertheless, we see less risk in the Czech koruna (CZK) than any other currency in the region due to Czech fundamentals and the fact there are no problems with currency mismatching. However, even the CZK is likely to remain under selling pressure in this environment.

So far there has been quite limited negative spill-over to non-CEE EMEA currencies such as the Turkish lira and South Africa rand, partly due to the fact that these currencies' usual positive correlation with the dollar rather than the euro provides some protection in the present environment when EUR/USD continues to move downward. However, we think it only a matter of time before the CEE crisis spreads to Turkey and possibly also to South Africa. Therefore, we recommend reducing exposure towards both the Turkish and

South African markets.

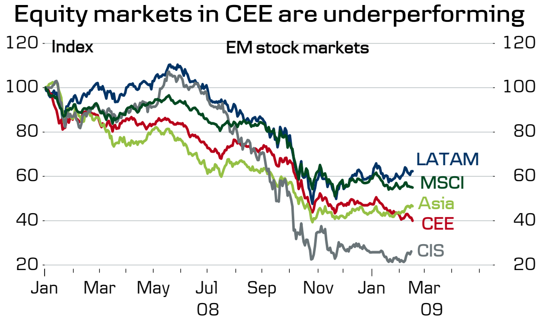
In conclusion, the crisis in Central & Eastern Europe (CEE) is getting out of hand and investors are aggressively exiting CEE markets. The most likely outcome is a very sharp fall in economic activity across the region. Pressure on CEE markets will probably continue until either the EU and/or the IMF intervene decisively.

It looks like a meltdown in CEE FX markets

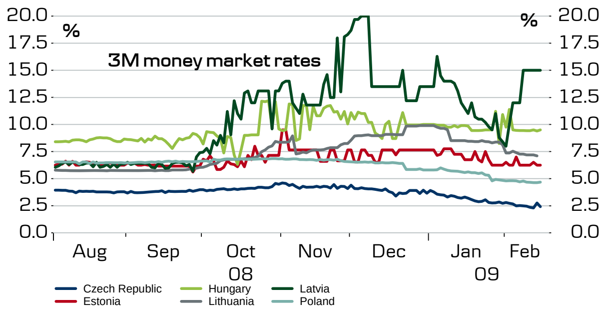


Not much better in CIS

Equity markets in CEE are underperforming



No more downside for rates



Source: EcoWin

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