HUNGARIAN EXPORT CREDIT INSURANCE

ICEG EUROPEAN CENTER

ICEG EC - MEHIB
Southeast European Monitor

December 2007

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INFLATION FEARS IN ROMANIA

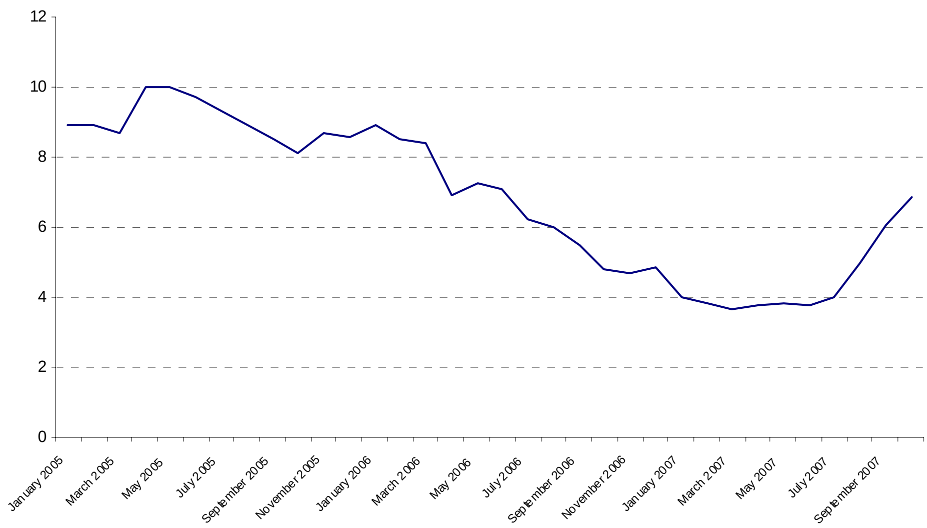
Romanian inflation rate for 2007 was 6.57 percent, much higher than the inflation target for the year of 4.3 percent. In its meeting of January 7 2008, the Board of the National Bank of Romania decided to raise the monetary policy rate to 8.0 percent per annum from 7.5 percent. The NBR Board believes that the persistence of demand-side pressures, along with prospects for prolonged effects of supply-side shocks, as well as the risks related to a possibly significant deterioration of inflation expectations requires tighter monetary conditions.

August 2005, the National Bank of Romania adopted a new monetary policy strategy, i.e. inflation targeting. This regime is based primarily on the anchoring of inflation expectations to the inflation target announced by the central bank and therefore on efficient communication with the public. The latest decision of the monetary board to push up interest rates is an explicit sign of inflation fears and a step towards trying to cool down inflation expectations. In the following, we take an insight into the Romanian inflation history, causes and prospects.

INFLATION DEVELOPMENTS

Chart 1 represents the Romanian year-on-year CPI inflation rates from January 2005:

CHART 1. EVOLUTION OF CPI IN ROMANIA, 2005-2007 (%)



Source: Statistical Office of Romania

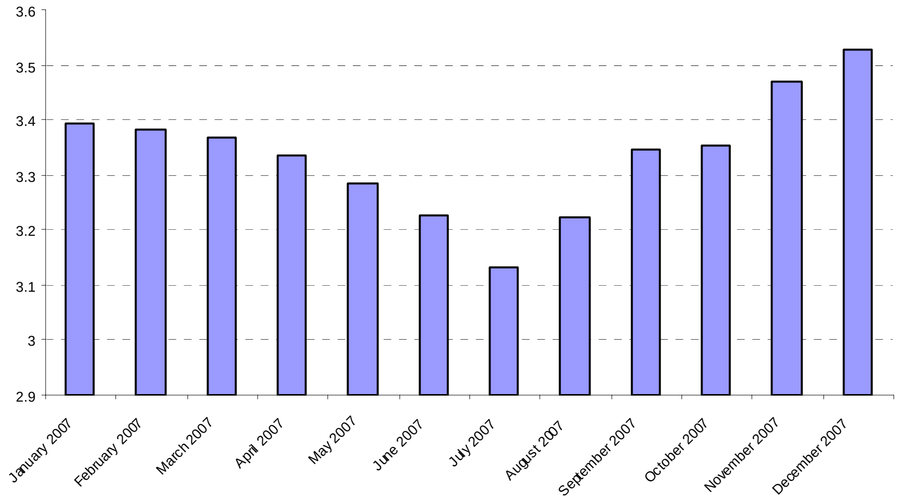
It is clear that the successful disinflation period stopped in 2007 and from September 2007 on there is an upward tendency in consumer prices. In the third Quarter of 2007, the 12-month inflation rate exceeded the upper limit of the target band of ±1 percentage point around the central target, and by the end of the year, the 6.57 percent CPI inflation has exceeded the tolerance band even with more than one percentage point.

COST PUSH SHOCKS

One of the major determinants of resurgent inflation was the higher-than-expected increase in some food prices. World prices of agricultural commodities have followed a steady upward path since 2001, their rate of increase accelerating significantly in 2007. According to the European Central Bank, price increases have mostly been driven by supply-side factors: higher energy and fertiliser prices, low levels of inventories and short crops caused by adverse weather conditions. The effects of this years' drought on food prices made themselves felt in particular at the end of the third Quarter of the year.

The second major adverse effect on CPI inflation came from the upward correction of the exchange rate of the Romanian currency (RON) in the context of turbulence on world financial markets as shown in Chart 2.

CHART 2. MONTHLY RON/EUR EXCHANGE RATE, 2007



Source: National Bank of Romania

This development confirmed the unsustainable nature of the rapid nominal appreciation of domestic currency in the previous period, which was not underpinned by similar changes in Romania's economic fundamentals. According to the Romanian National Bank, this aspect has been one of the major risks against continued sustainable disinflation in the medium term. Depreciation has an effect on import prices that seem to have been growing fast in Romania since July 2007.

DEMAND PULL PRESSURES

Recent statistical data reveal a continued high dynamics of domestic demand in Romania. Investments picked up and consumption remained at a very high level. Consumer demand is heated by rapid wage increases in excess of productivity gains and loose income policy of the authorities. In addition, wage growth encourages faster credit dynamics. According to the Romanian National Bank, rapid expansion of credit to the private sector (especially foreign currency loans) is one of the main reasons for boosting consumption.

Wage hikes could also fuel inflation directly by raising production costs, at least in those industries where excess labour demand is still present. There is an additional risk that excessive wage claims might spread across all sectors, which, if agreed to, would fuel inflation through higher unit labour costs, pushing them above the levels that producers can absorb by squeezing profit margins.

FUTURE PROSPECTS

The Romanian National Bank might have too ambitious inflation targets within 2.8-4.8 percent for 2008. The main risks which, should they materialize, could cause inflation to deviate from its projected path arise from further wage increases in excess of productivity gains, a renewed flare-up of inflation expectations, and larger than anticipated budget deficits. The deviation of the inflation rate from the projected trajectory could also be generated by stronger depreciation of the RON exchange rate, volatile prices of some food items, as well as fuel and administered prices.

The short-term inflation outlook has clearly worsened due to the heightened macroeconomic risks, especially those related to the government’s income policy and higher public spending in the run-up to the forthcoming elections in 2008. Romania's parliament approved at the end of 2007 next years budget with a deficit of 2.7 percent of gross domestic product, boosting social spending in a move that analysts say may hamper the fight against inflation.

Slight Deceleration of Economic Growth in Bulgaria and Romania

Real GDP growth decelerated slightly in course of 2007 compared to the previous year in both Bulgaria and Romania, according to the third quarter statistics. The main reason for deceleration was the severe droughts that hit both economies. Agriculture sector has a higher than EU average share in gross value added in Bulgaria and Romania as well. However, other sectors reached rapid growth in both economies during the analysed period. On the demand side, main engines remained unchanged and domestic demand fuelled both countries' economy. Although, a slight deceleration of the growth rate of consumption was observable.

Romania

In the third quarter of 2007 economic growth remained at almost the same level as in the previous quarter: it reached 5.7% in comparison with the corresponding period of the previous year. Now it is obvious that economic growth in Romania was lower in 2007 than a year earlier.

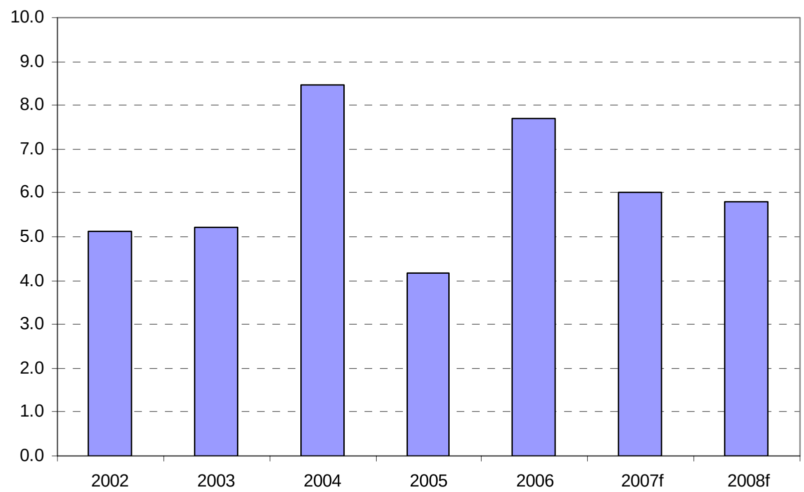
Agriculture was one of the main reasons for the deceleration of economic growth. In the third quarter, gross value added in agriculture decreased by 23.8%. Severe droughts had a significant negative impact on the performance of the sector. The decline was even higher than that in the second quarter, when the contraction reached 10% on a year-on-year basis. On the other hand, construction boomed in 2007; this trend was reflected in the third quarter figures as well. In that period value added in construction jumped by 37.4%, the highest growth rate in recent years. Both residential and non-residential construction increased rapidly (by more than 30%) in the first ten months of the year. Gross value added in industry increased by a mere 5.6% during the first nine months, just below real GDP growth. Manufacturing production growth was slightly higher (6.8%) than industry average (5.8%) and the most vigorous sub-sectors were tobacco production (27%), manufacture of wood and wood products (20%) and manufacture of transport equipment (17%). Gross value added in services increased by 8%: higher sales of food and beverages fuelled retail trade, while motor vehicle sales and the activities of hotels and restaurants also contributed considerably to the growth of market services.

On the demand side, the main engines of the Romanian economy have not changed in the third quarter; however, a slight shift was observable (as already indicated in our previous forecast). Private consumption growth fell below 10% for the first time in the last one-and-half years. The deceleration of consumption growth had started in the third quarter of 2006: since then its growth rate decreased gradually from 15.5% to 8.7%. Still, rapidly growing wages and credit expansion will keep supporting private consumption. Public consumption growth also decelerated slightly: its growth rate was 4.3% in the third quarter.

The other engine of the economy, investments strengthened. Gross fixed capital formation increased by a robust 32.2% in the third quarter of 2007. Investment in construction increased by almost 40%, but investment in equipment also rose by a sound 27%.

The significant negative contribution of net exports to GDP growth remained in the third quarter. While the export of goods and services increased by less than 2% in real terms, imports increased by 22.4% in the third quarter. In those months the depreciation of the leu had just started, so it may have had no significant impact on foreign trade. the positive impact of the depreciation on the export sector could materialise in the last quarter of 2007 and in early 2008.

CHART 3. REAL GDP GROWTH IN ROMANIA, 2002-2008 (%)



Source: Eurostat, ICEG EC; Note: f - forecast

In line with the aforementioned factors, GDP growth in 2007 could have reached 5.7%, 2 percentage points lower than in 2006. In 2008 there are many risks and uncertainties surrounding growth forecast. The main factors determining growth in 2008 are the impact of significant external imbalances on the currency, parliamentary elections in the second part of the year, the revival of agricultural output and external factors including oil and food prices. Taking all these uncertainties into account economic growth is expected to remain stable and reach 5.5% in 2008.

BULGARIA

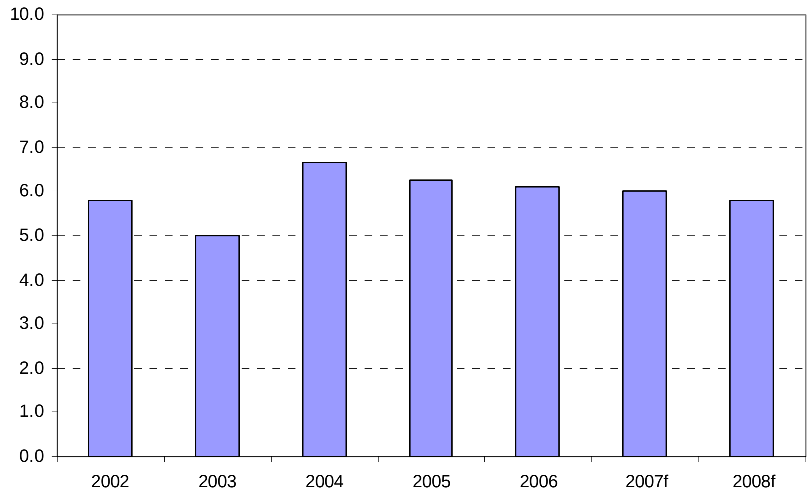
Economic growth in the third quarter of 2007 was significantly lower than in the previous two quarters: it decelerated from 6.2% and 6.6% to 4.5%. Accordingly, average economic growth in the first nine months fell below 6%.

On the production side, agriculture was the main reason for the deceleration. In the third quarter the gross value added of agriculture decreased enormously, by 43% due to aforementioned droughts in the summer. On the other hand, other sectors performed outstandingly in the third quarter. Gross value added in industry increased by 12.8%, while services also grew by 11.1%. Industrial production growth averaged around 9% in 2007. The highest growth was achieved in the manufacture of radio, television and communication equipment (57%), manufacture of office machinery and computers (38%) and manufacture of other transport equipment (29%). This reflects the technological upgrading of the Bulgarian economy thanks to foreign direct investments.

On the demand side, the structure of growth continued to change. The annual growth rate of private consumption decelerated further to 5% in the third quarter of 2007 from 8.1% in the first quarter. Investments also decelerated, therefore gross fixed capital formation growth was 19.7% in the third quarter. The investment ratio fell to 26% from almost 30% at the beginning of the year.

A positive shift was observable in the contribution of foreign trade. The growth rate of imports was still higher than that of exports, but the gap between the two rates narrowed as exports accelerated to 6.2%, while imports slowed to below 10% in the third quarter.

CHART 4. REAL GDP GROWTH IN BULGARIA, 2002-2008 (%).



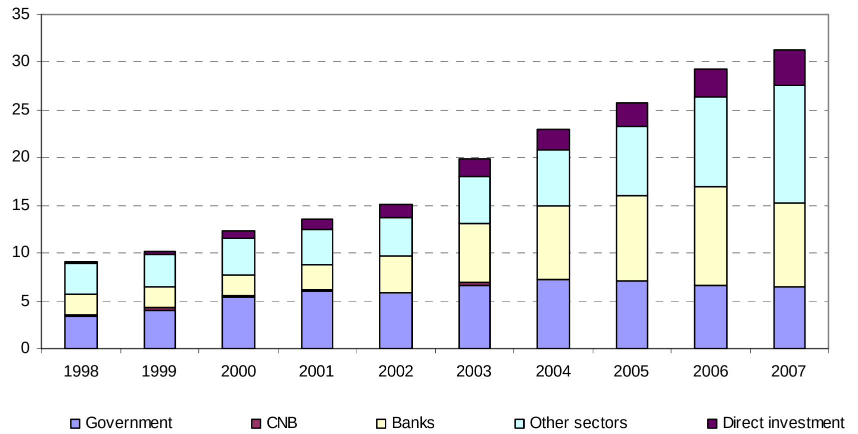
Source: Eurostat, ICEG EC; Note: f - forecast

According to estimates, economic growth could have reached 6% in 2007. In 2008 current tendencies are expected to continue; GDP growth could reach 5.8%. The role of domestic factors in economic growth will shrink slightly but remain dominant, while net exports will have a smaller drag on economic growth.

External Debt in Croatia – Old Friend in New Clothes

The conservative Croatian Democratic Union (HDZ) formed again a government in Croatia after the elections on 25 November 2007 and according to their programme decreasing the stock of external debt remains a priority also in the course of the upcoming mandate. The stock of external debt has been the source of the majority of concerns about the Croatian economy in the last decade as its proportion to GDP increased from 47.6% in 1998 to a predicted value of 86% in 2007.

Chart 5. Structure of external debt in Croatia (Billion EUR, 1998-2007)



Source: Croatian National Bank

While the external debt of the government has gradually decreased in the last few years (value of the end-year stock was EUR 7.26 billions in 2004 and EUR 6.55 billions in 2007), its value more than doubled in the case of the enterprises (from EUR 2.76 billions in 2003 to 7.48 billions in 2007) and it increased fourfold in the case of the household sector (from EUR 0.026 billions in 2003 to EUR 0.126 billions in 2007).

Regarding both the amount and the structure of the external debt stock, it worth to summarise briefly those factors which have been in the background of the past and current trends. After the dissolution of the Socialist Federal Republic of Yugoslavia (SFRY) – in the most difficult war years – Croatia (similarly to other former Federation states) did not have access to foreign capital markets as new credit lines had not been extended by foreign creditors until new debtors were determined for the total external debt of the former SFRY. Thus Croatia's position in the international financial scene started changing in 1995 when it agreed with the members of Paris Club on taking over the external debt owed by or guaranteed by legal persons from the territory of the Republic of Croatia (the so-called allocated debt) and 28.49% of the debt owed or guaranteed by the former SFRY and not attributable to any successor state (the so-called non-allocated debt)[1]. Later that year Croatia signed an agreement also with the London Club creditors, therefore the obstacles of external borrowing were eliminated which was extremely important for the country as domestic savings and other forms of finance (e.g. FDI) were not sufficient for covering the starting investments of reconstruction. The first syndicated

[1] The countries' share according to the agreed distribution key were: 36.52% - Serbia and Montenegro, 28.49% - Croatia, 16.36% - Slovenia, 13.20% -BiH, 5.40% - Macedonia.

loan agreement was signed by the government already in October 1996 and its first bond was issued in the foreign market in February 1997.

In the period until 2002 the government's external debt grew at the most significant rate, primarily due to the need to finance post-war restoration efforts, infrastructure projects and restructuring of the economy (the stock of external debt of the government sector increased from EUR 3.34 billions in 1998 to EUR 5.88 billions in 2002). The debt of banks and the corporate sector grew at a much slower pace (its stock increased from EUR 2.14 billions in 1999 to EUR 3.8 billions in 2002 and from EUR 2.05 billions in 1999 to EUR 2.34 billions in 2002 respectively). During this period significantly higher proportion of external debt was guaranteed by the public sector than currently (in 2002 non-publicly guaranteed private sector debt composed 48.68% of the total debt, while in 2007 this proportion was around 71%).

In 2002 a new period began due to the significant changes both in Croatia and in the wider region. During 1999 and 2000, Croatia's banking system was almost fully privatised and foreign investors obtained over 90% of commercial banks' assets. The revenues from the privatisation process was largely directed at financing government spending, thus the entry of foreign capital, as a contribution to this process, was considered as a positive development. In the second half of 2001 as a consequence of the possibility of euro-conversion without charges, a large share of domestic foreign currency savings – which had been previously held outside the domestic banking system – flew into the domestic banking system. In 2003 the process of financial liberalisation coincided with the period of strong slowdown in economic activity in the EU, which further increased the appeal of the Croatian market to foreign investors and foreign bank placements. Mainly as a result of the above-mentioned factors, banks' debt increased in 2003 alone by exceptionally high 38.13% y-o-y.

The majority of the funds which were received by the banks from abroad were channelled into placements to the household sector, which went up by 27.7% in 2003 and its average growth rate was 19.5% in 2004 and 2005. This resulted in personal consumption growth of an average 6.1% in 2002 and 2003, then 3.9% in 2004 and 3.4% in 2005. Loans extended to households were largely used for purchase of consumer durables (mainly cars). On the one hand, the rise of personal consumption significantly accelerated the growth of total import of goods, thus it negatively affected the current account balance (which averaged 7% of GDP between 2002 and 2006). On the other hand, the increase in personal consumption coupled with large investments in infrastructure (primarily motorways) by the government which resulted in relatively high real GDP growth rates in the period of 2002-2006 (averaging 4.8%).

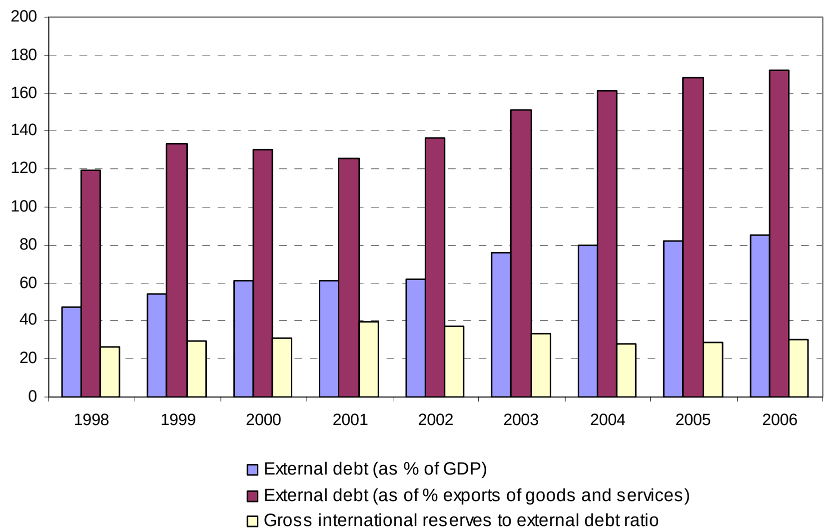
Strong bank borrowing in the period from 2002 onwards was followed by the corporate sector as well. However the increase in the corporate sector's debt may be partially attributed to the banks' own activity, which transferred shares of their operations to different types of non-banking companies (e.g. investment consulting) or referred some of their clients to direct borrowing from their parent banks abroad in order to avoid the CNB measures aimed at curbing external borrowing.

Until 2004 the government continued to rely on primarily foreign sources of finance because of the lack of sufficient current sources of finance. From then on the government implemented a new strategy (the budget deficit was gradually reduced and it was financed in the domestic capital market), which resulted in the reduction of the government's external debt in absolute terms for the first time in 2005 (it decreased from EUR 7.27 billions to EUR 7.05 billions) and this trend has lasted in the past two years as well. However, the crowding out effects have to be taken into consideration in the case of the reduction in the government's net external liabilities as in the circumstances of limited domestic saving it causes a rise in external liabilities of other domestic sectors (primarily banks).

In 2007 the external debt of the government and the CNB continued to decrease and the direct investment continued to increase, but - as far as data are available by now – 2007 can be considered as a turning point from the point of view of the proportion of the bank sector's and the corporate sector's debt within the total stock. In the case of the bank sector's debt the former upward trend changed into a descending tendency (its proportion to the total stock decreased from 35% in 2006 to 28% in 2007), while the corporate sector's debt significantly increased (its ratio to the total stock increased from 32.4% in 2006 to 40% in 2007), thus for the first time out of the five main sectors the corporate sector had accumulated the largest stock of debt.

The sustainability of the present situation can be partly evaluated by the main indicators of external indebtedness and liquidity.

CHART 6. RELATIVE INDICATORS OF EXTERNAL INDEBTEDNESS OF THE REPUBLIC OF CROATIA (%)



Source: Croatian National Bank

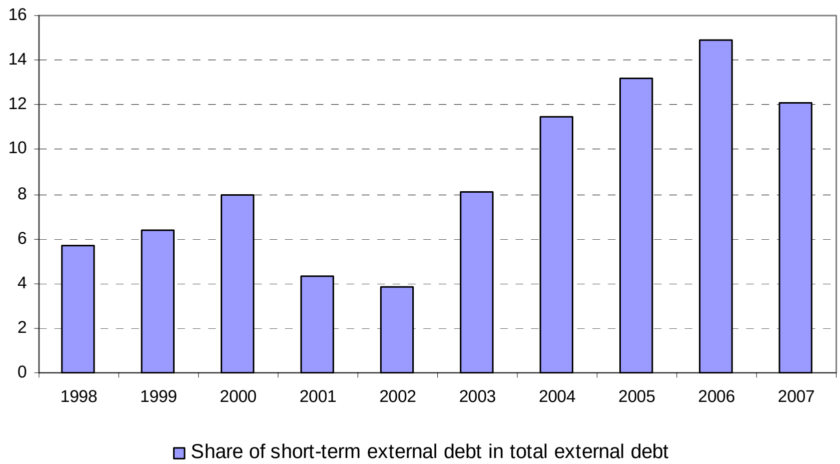
As it has been mentioned before, the ratio of external debt to GDP almost doubled during the past decade as its value increased from 47.6% in 1998 to 85.4% in 2006 (in its Quarterly Forecast the ICEG EC predicts 86% for 2007).

The ratio of external debt to export of goods and services increased from 119.4% in 1998 to 171.9% in 2006, thus it always remained below the critical value which is set at 220% by the World Bank. Above this threshold the given country is considered as severely indebted and it may face possible difficulties in regular servicing of foreign liabilities. The relatively favourable ratio of external debt to exports of goods and services in Croatia may be attributed to large income from services rendered in tourism, which are expected to grow over the following mid-term period. However the indicator has several features in general (e.g. export is the main source of foreign currency required for repayment of foreign liabilities, it is highly sensitive to armed conflicts, natural disasters etc.) and in the case of Croatia (e.g. the indicator's value has been continuously increasing over the past few years) which necessitates close monitoring of the indicator.

The ratio of international reserves to external debt is also above the critical threshold of 20% (29.9% in 2006), which indicates that the debt coverage by international reserves does not indicate that the country's external liquidity is threatened. The ratio has improved between 1998 and 2001 (it grew from 26.2% in 1998 to 39.2% in 2001), but in the last few years it has started to deteriorate (it decreased to 29.9% by 2006), which again highlights the possible financial risks which exist in the case of Croatia and which have to be handled by the new government during its upcoming mandate.

Finally, the maturity structure of the external debt may provide valuable information about the possible financial risks. Amongst the current circumstances of the prolonged global 'credit crunch', the financial markets experience a higher than usual degree of unpredictability, thus the large stock of short term debt may magnify rollover risk. The maturity structure of Croatia's external debt by original maturity developed in 2007 and it can be considered favourable. The proportion of short term debt decreased significantly in 2001 as a consequence of the reduction in short-term government debt year-on-year but it had been on a rise since 2003, primarily as a result of the rise in short-term bank liabilities. The indicator decreased from 14.87% in 2006 to 12.06% in 2007 partially as a result of the central bank measures aimed at limiting commercial credit growth which was supported by the government as well.

CHART 7. MATURITY STRUCTURE OF CROATIA'S EXTERNAL DEBT BY ORIGINAL MATURITY (%)



Source: Croatian National Bank

However, it has to be highlighted that the major portion of banks' foreign liabilities arises from borrowing from parent banks and that potential shocks in the market could lead to cuts in the debt maturity as a way for parent banks to soften their increased operating risks. This feature of the foreign liability structure poses another risk as a potential shock would significantly contribute to the sudden elevation in the stock of short term debt.

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