ERSTE GROUP

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Resuscitation of consumption in CEE

Consumption to finally pick up next year

From export-led recovery to more diversified growth next year

Disposable incomes are to bottom out this year

Some countries underwent huge adjustment in their saving and net borrowing ratios

Household consumption in CEE is to grow about 1.0-2.5% next year

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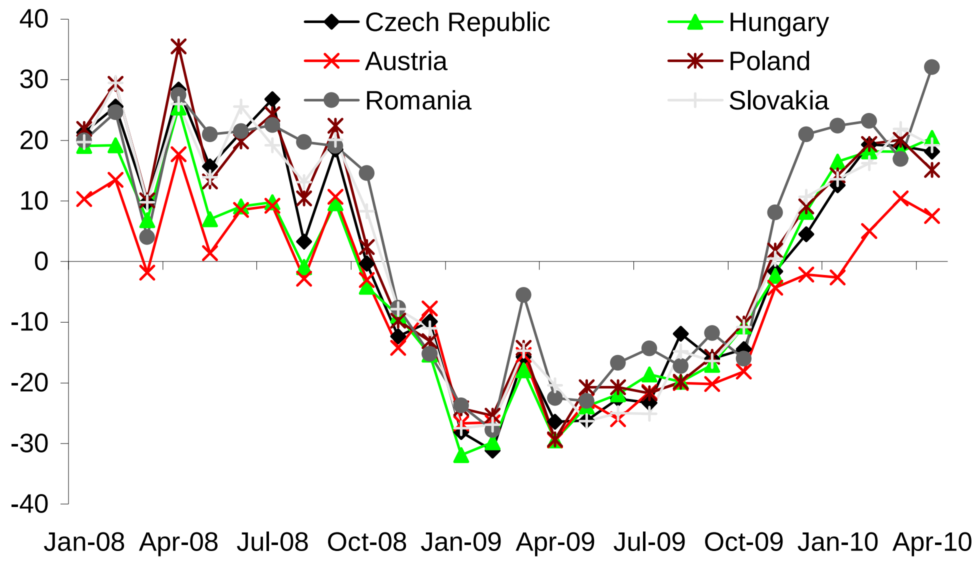
Income convergence was one of the main motivations for EU enlargement and capital inflow into the CEE region, which had a positive impact on economic growth there. GDP per capita in EUR doubled in many CEE countries during the last decade and, adjusted for different price levels, ranged between 50% and 80% of the EU average last year.

In some countries, the speed of income convergence or capital inflows allowed for fast consumption and investments, which resulted in rising external imbalances. After the bubble burst and consumption collapsed, there was an important question on whether and when consumption would pick up again and what might be the rate of sustainable growth. What is the role of credit in household consumption, and for how long will unemployment keep consumption subdued? In this report, we will focus on the relationship between income and consumption, particularly savings ratios and investments of households. These questions are gaining in importance, given the uncertainty over global demand and thus concerns about the lasting effect of any export-led recovery.

Two main transmission channels brought the economic growth in CEE down in late 2008 and 2009. The first one was the contraction of foreign trade, as a result of the dent to global growth, hitting mainly export-oriented economies like Slovakia, Hungary and the Czech Republic. Their exports collapsed by about one quarter y/y, bottoming out in 1Q09. Since then, exports have started to pick up from the very low base and are currently the main pillar of economic recovery. Exports have been posting double-digit y/y growth in many CEE countries in recent months, but in unit terms are still below the pre-crisis level. The diminishing base effect and the urgent need for fiscal consolidation in the EU increase concerns about the future strength of the export-led recovery.

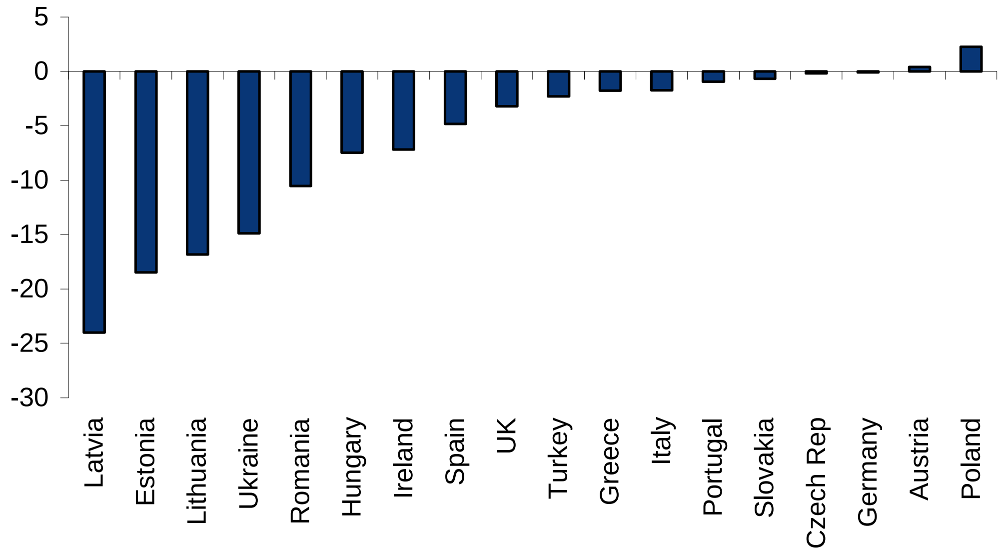
Exports y/y%



Source: Eurostat, Erste Group Research

The second factor that affected CEE economies and came with a certain time lag was the contraction of consumption and investments (to a different extent). Consumption was hit hard in countries with large external imbalances, like the Baltic countries, where consumption collapsed more than 15% y/y last year. Consumption also plunged in more advanced economies like Ireland, Spain and the UK, due to the sharp reversal in net borrowing and bursting of the housing bubble. Hungarian households were bearing the costs of another austerity package, hit by a 5pp increase of VAT. Consumption also declined slightly in countries with neither of these problems (the Czech Republic, Slovakia), due to the prompt decline of employment in 2009. Poland and Austria were among the few EU countries where household consumption grew last year.

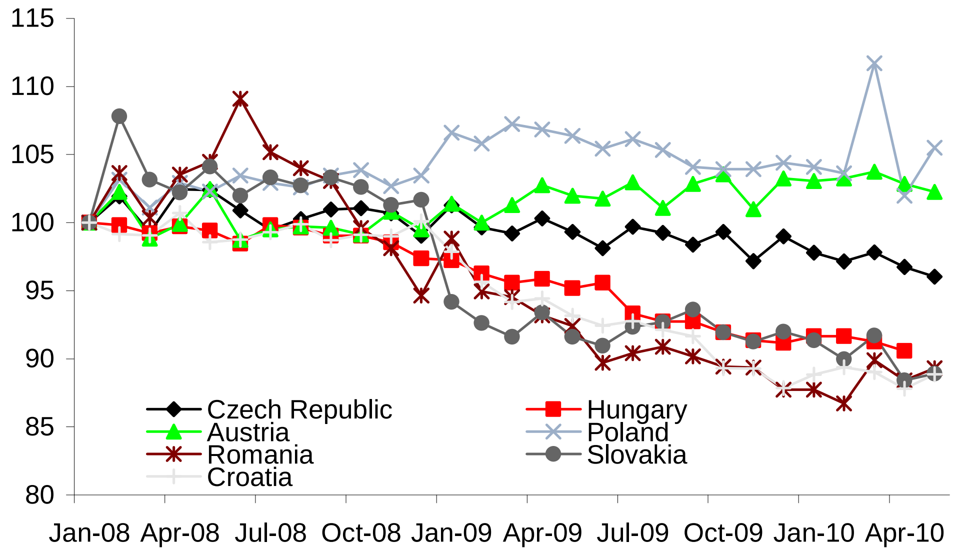
Household consumption (2009, y/y %)



Source: Eurostat, Erste Group Research

Unfortunately, in contrast with the quick recovery of exports, consumption has remained subdued in many CEE countries, with limited signs of an uptick when looking into short-term business indicators, like retail sales or consumer/retail sector confidence indicators. For an explanation of this development, we have to look at what happened with incomes and changes in net borrowing of households.

Retail Sales (seasonally-adjusted real index, 2008=100)

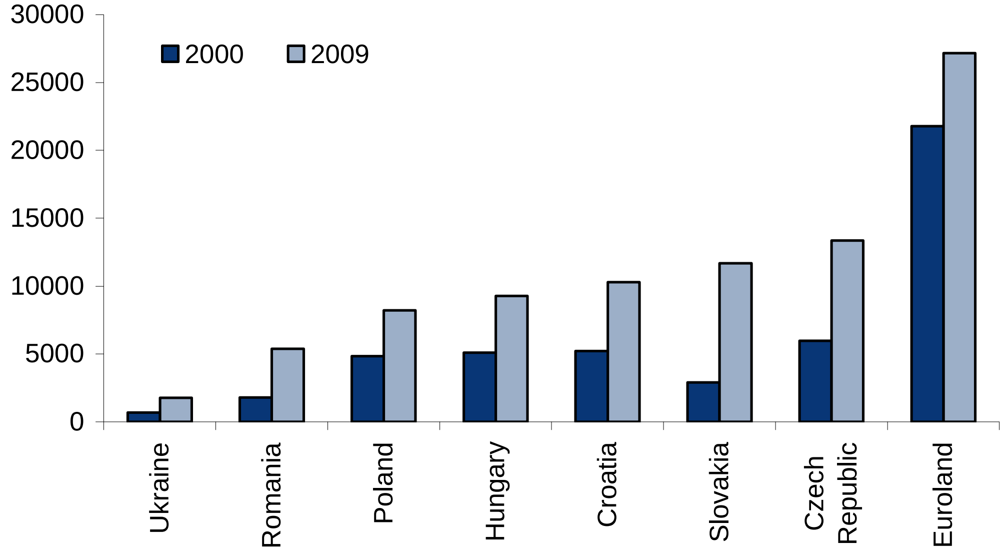


Source: Eurostat, Erste Group Research

At the beginning of this report, we want to discuss some alternative measures of incomes and their convergence. Using the most conventional measure of income, 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 Euro

Area GDP per capita increased by only a quarter over the same period. However, despite the much faster nominal growth in CEE compared to advanced economies, GDP per capita in EUR remains far below that of the advanced economies. It reached only about 1/5 and 1/2 of the Euro Area average in EUR terms at market exchange rates.[1] 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. In 2009, GDP per capita declined sharply in EUR terms in many countries, due to large swings in the exchange rate (i.e. in Ukraine by one third).

GDP per capita (in EUR)



Source: Eurostat, Erste Group Research

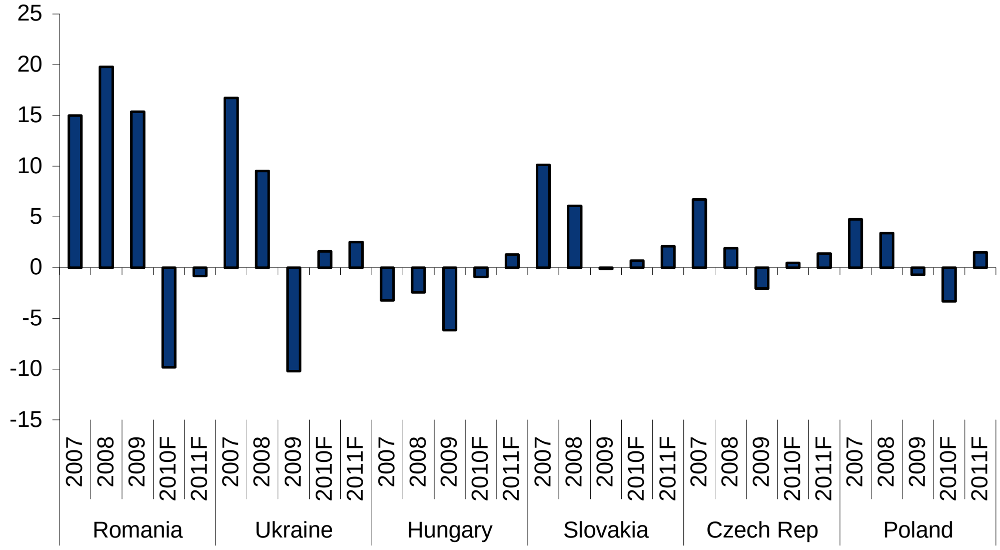
However, for households, more relevant than GDP in EUR terms is the GDP calculated in Purchasing Power Parity exchange rates, reflecting the difference in price levels across economies and muting the effect of swings in market exchange rates on purchasing power (unless they pass through into consumer prices). Given the lower price level in CEE countries (especially in the sector of services), the income level measured by GDP per capita in PPP is much higher, about 50-80% of the EU average. Thus, real income level has been more advanced and convergence less volatile compared to GDP in nominal terms (at market exchange rates).

While GDP is a good proxy for households' incomes in the long run, it is too broad to explain short-term fluctuations in the income of households. It also takes other parts of the economy into consideration and does not reflect changes in the split of income between the government sector, households and the remaining private sector. From this perspective, the disposable income of households is the most appropriate measure, 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. It is more appropriate than looking at average wage dynamics, which do not say too much about changes in employment, taxation of incomes, development of pensions and other social benefits and incomes. Disposable income reflects all of them. In average, disposable income of households accounts for about 65% of GDP in the EU.

Disposable income has been hit by rising unemployment recently and the erosion of other income (rents, profits, interest income).

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

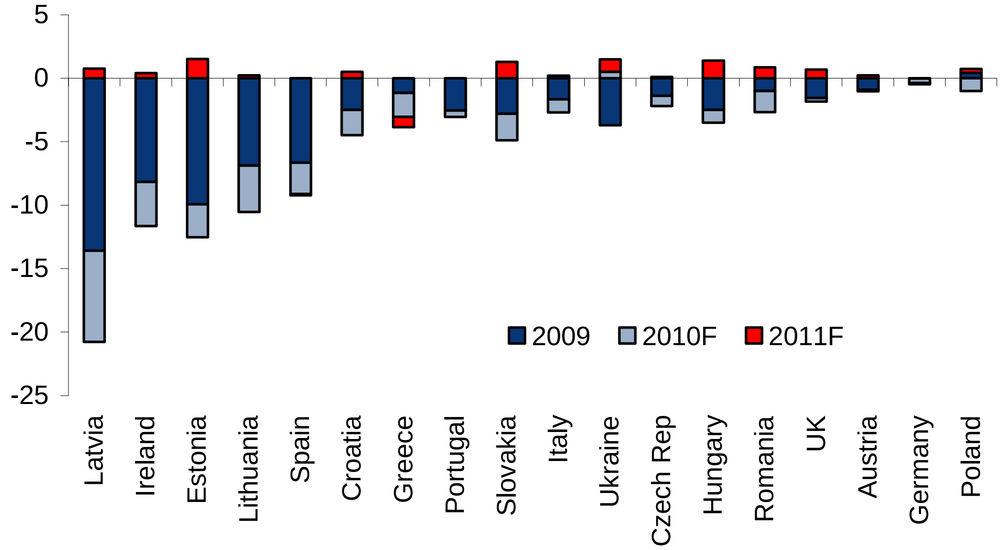
Real disposable income y/y (%)



Source: AMECO, Erste Group Research

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[2]. We can see that employment 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 had been witnessing real estate bubbles and external imbalances and could not smooth the adjustment through the weakening of currencies (the Baltics, Ireland and Spain[3]).

Employment y/y



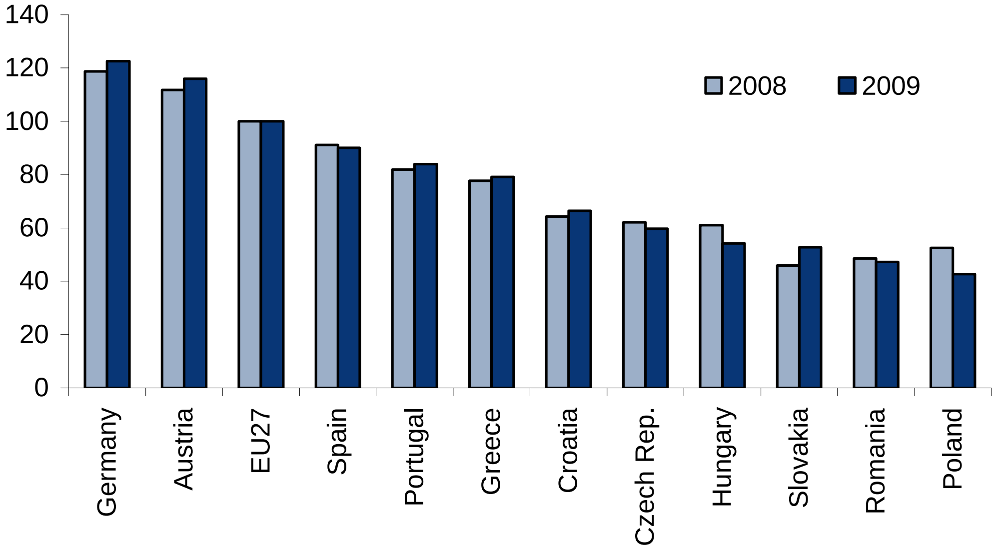
Source: AMECO, Erste Group Research (CEE countries)

[2] 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.

[3] Greece bought time through unprecedented fiscal loosening, but, given its lack of competitiveness, the urgent need for fiscal consolidation and huge share of the public sector in total compensation of employees will call for deeper structural changes on the labor market in the following years.

Seasonally-adjusted employment data already points to stabilization[4], 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. In this respect, CEE countries have a big opportunity cost-wise and in terms of the challenge of labor market reforms. 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). There has been a strong bias of policy makers during the fiscal consolidation to keep labor costs competitive and avoid raising taxes associated with labor costs (increase of personal income tax, social contributions).

Unit labor costs (EU27=100)

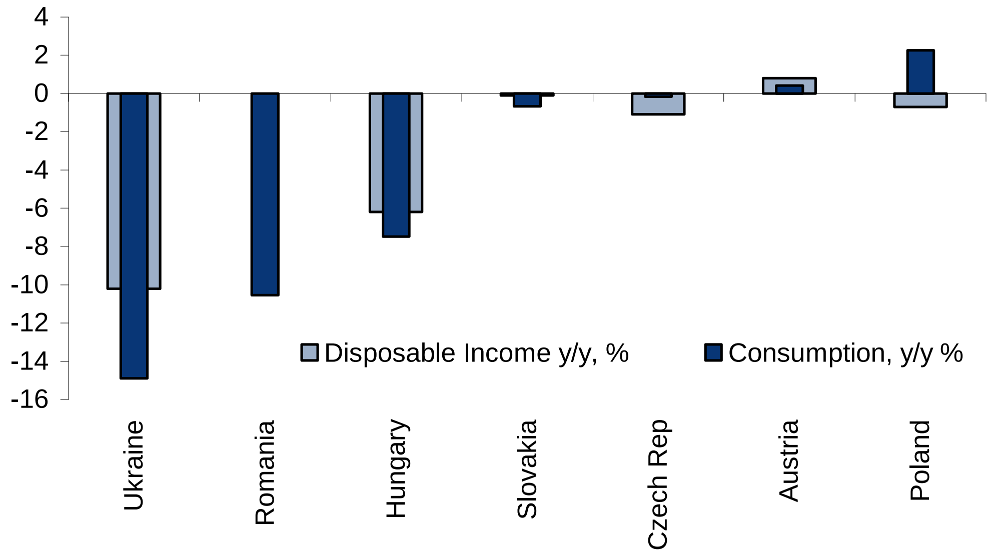


Source: AMECO, Erste Group Research

The adverse effect of the deteriorated job market has been partially softened by slightly growing pensions[5] and other social benefits, which acted as automatic stabilizers. That is why disposable income fell less than the drop in employment would imply. Given rising productivity, a positive outlook for growth of wages in the private sector and 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.

[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%).
[5] Pensions are usually indexed and the number of people in post-productive age has been increasing.

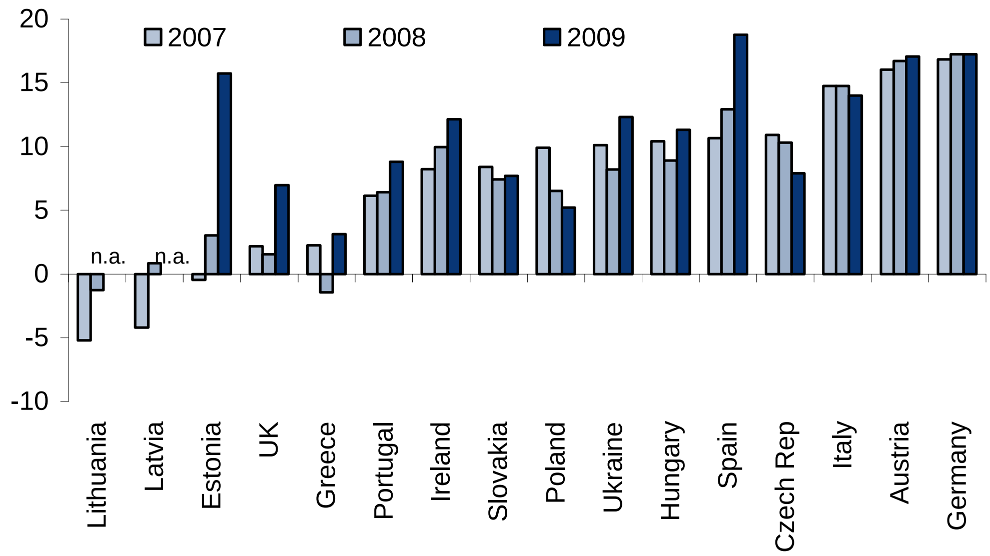
Growth of real disposable income and consumption (2009)



Source: Eurostat, Erste Group Research

The reason why the drop of household consumption was much deeper compared to the dynamics of disposable income in many countries was that households adjusted their gross saving rate, the portion of their disposable income they do not use for consumption. Adjustment was strong in countries that used to have very low saving rates in the past, like the Balkan and Baltic countries. Also, in many advanced economies, the saving rate had to adjust strongly (in Spain and the UK by 6pp) in order to reduce net borrowing. According to preliminary data published by the local 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.

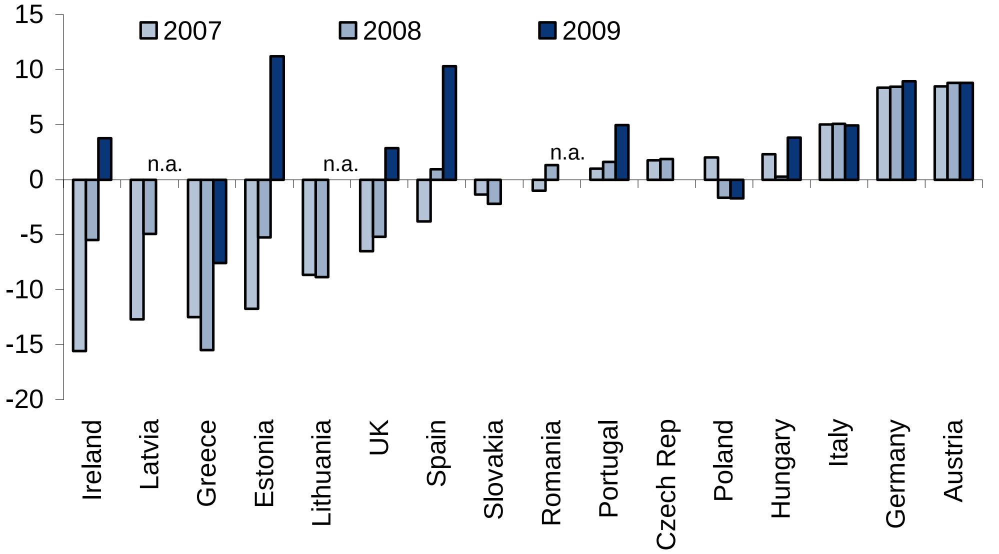
Adjustment of saving rates (% of disposable income)



Source: Eurostat, Erste Group Research

Even some countries with positive saving rates had been net borrowers when investments are added on top of consumption.[6] The largest net borrowers were Greece and countries with a strong real estate boom in past years, like Ireland, Spain and the Baltics. Net borrowing used to add about up to 15% of extra money on top of disposable income in these countries. However, these countries were exposed to a substantial risk of a sharp adjustment in net borrowing, resulting in a significant contraction of household consumption and investments which materialized in the course of the crisis.

Reversal in net lending(+)/borrowing(-) of households (% of disposable income)



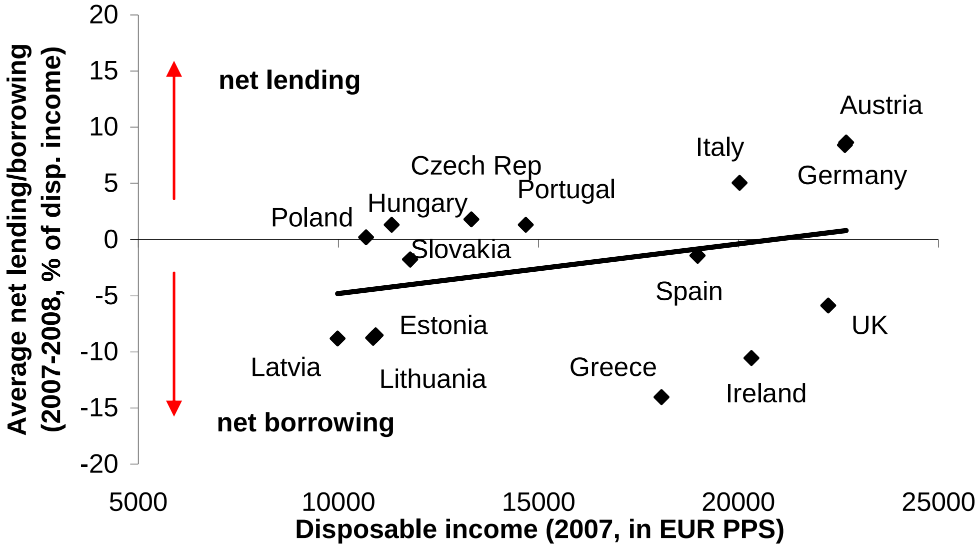
Source: Eurostat, Erste Group Research

Consumption in countries where households have been in a net lending or balanced position (flow-wise) was hit less during the downturn, as they did not need to change their saving rate sharply. They could afford to smooth consumption through a temporary reduction of the saving ratio, like the Czech Republic or Poland did in 2009.

But even among countries in which households have been heavy net borrowers, there were big structural differences. The main economic benefit of taking a credit is to increase the utility from frontloading of consumption and investments, especially if future income growth is high enough to compensate for the interest paid on credit. This explains the economic rationale of households in converging economies to be net borrowers in the early stage of income convergence, but it does not explain the heavy borrowing in more advanced countries (Greece, Ireland, UK), where prospects for future income growth proved to be more limited. Another reason was speculation on a never-ending increase of asset (real estate) prices, which proved to be exaggerated in many countries.

[6] Gross savings are further used for financing households' fixed investments or financial investments - net lending to other sectors of the economy. If consumption and investments exceed disposable income, households had to be net borrowers in that year.

Average net lending-borrowing (% of disposable income) vs. disposable income per capita (in PPS)



Source: Eurostat, Erste Group Research

Conclusion

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. This means that consumption will be strongly tied to the growth of disposable income and less affected by changes in saving ratios. While employment is still falling y/y and denting the disposable income of households in comparison with the previous year, the seasonally-adjusted unemployment data shows some signs of stabilization or even reversal of the trend, which should result in an increase of employment next year. We expect disposable income to pick up about 1-2.5% y/y in real terms in the region next year, due to the competitiveness of the labor force. The exception is Romania, where higher inflation (due to the VAT increase) will bring real disposable incomes down 0.8% y/y next year.

Thus, after the negative contribution of household consumption in 2009 (apart from Poland) and partially in 2010, household growth of consumption is to range about 1-2.5% next year, providing support to GDP growth. The economic revival, which is currently purely export-led, should be more balanced. Furthermore, more sustainable saving ratios and net borrowing/lending ratios should make consumption growth less vulnerable to sentiment swings in the coming years.

Comments of country analysts on household consumption and disposable income

In **Hungary**, we expect disposable income to increase mildly in 2010 in nominal terms, after the plunge in 2009. Slight growth is expected for compensations and social benefits are also expected to remain subdued, on the back of the tight budgetary situation. Growth of compensations should be slightly higher in 2011, as the economy's growth rate accelerates, but the social contribution growth should remain subdued in 2011. Net lending, in the meantime, is expected to continue to grow in the coming years, after the increase in 2009. The possibilities for households to take out loans are assumed to remain difficult for the household sector, which negatively affects both consumption and investments into housing. The increased cautiousness of households is also seen as a positive contributor to saving.
Zoltan Arokszallasi, Erste Bank Hungary

The **Czech Republic** should see disposable income increasing slightly this year, after the work-income-induced fall in 2009, helped by social benefits (mainly). For 2011, we see another decline in unemployment and slightly higher nominal wages on one hand, with cuts in social benefits on the other hand. The aggregate disposable income should thus rise slightly, but there is nothing to support a consumption boom. The savings rate will remain above 10%, as households have learned that having a buffer for worse times might pay off. Also, borrowing is not exactly hot these days, as heightened uncertainty regarding the future lingers.
Martin Lobotka, Ceska sporitelna

On average, the **Slovak** unemployment rate will be higher this year than it was in 2009; therefore, we assume consumption will provide a limited growth impulse to the economy in 2010. In 2011, an increase in employment and private sector wages should transform into real consumption growth of around 2%. Households will likely remain cautious in their consumption/savings habits in the next two years and the saving rate could remain near 8%.
Maria Valachyova, Slovenska sporitelna

After two consecutive years of sharp declines, household consumption could increase by around 1% in 2011 in **Romania,** as new consumer loans will probably gain some speed. A continuation of the monetary policy easing cycle through cuts in minimum reserve requirements and an increase in the volume of financial resources available for the private sector (due to the ambitious fiscal consolidation process followed by the government) are supportive for this scenario. At the same time, nominal wages are likely to rejoin an upward trend next year.
Eugen Sinca, Banca Comerciala Romana

In **Poland,** we expect both disposable income and household consumption to maintain soft growth, which is only to start accelerating in 2011. As for household consumption, next year it will benefit from a gradual recovery on the labor market, although the still tight credit market will limit its growth. The proximity of parliamentary elections will likely prevent any dramatic savings measures that would hamper domestic demand, but necessary fiscal consolidation in the coming years will curb the growth of social spending.
Jana Krajcova, Ceska sporitelna

In **Ukraine,** disposable income is likely to increase at the pace of nominal GDP growth. Previously, household incomes rose more quickly than GDP, due to hard social policies of governments and high employment. The share of household income in GDP has thus been rising steadily. We will not likely see this trend in 2010 and 2011, due to the high employment and austerity measures set in the IMF program. Net borrowing will be subdued, due to the high share of FX loans to households. It is unlikely that FX credits to households will be restarted on any notable scale until 2012. New UAH credits, in turn, will not be able to compensate for the redemption of FX loans.
Maryan Zablotskyy, Erste Bank Ukraine

A recovery may be expected in 2011 in **Croatia**, on the back of a stabilization of employment and minor wage growth, albeit rather limited. Pensions are expected to remain stagnant, given the fiscal constraints, while social transfers are likely to remain under pressure, given the increasing unemployment. Household preferences for new credit in 2010 will likely remain subdued, given the weak confidence and deteriorating credit worthiness, while some improvement can be expected in 2011. Hence, we see disposable income in 2010 as largely flat and in mildly positive territory in 2011.
Alen Kovac, Erste Bank Croatia

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