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ERSTE BANK

Financial Market Report CEE

Volume 1 · December 2007

International Finance Market Data: Assessments and Expectations
ZEW Economic Sentiment Indicator for Central and Eastern Europe, Supported by Erste Bank

ZEW, the Centre for European Economic Research, Mannheim, and Erste Bank der oesterreichischen Sparkassen, Vienna, carry out a monthly survey for Central and Eastern Europe, Austria, and the Eurozone asking financial market experts about their assessment and expectations with regard to economic and financial market data. The results of the present survey conducted between 30 October and 19 November 2007 are published in this issue of the "Financial Market Report CEE", December 2007. 73 financial market experts participated in this month's survey.

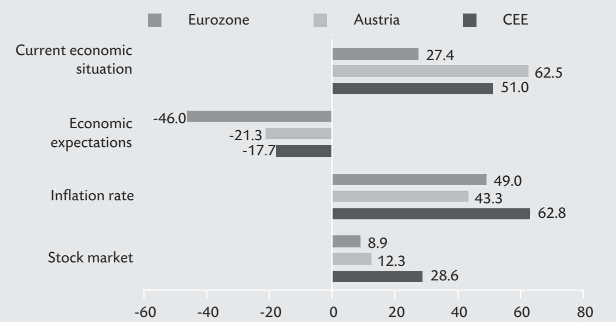
Pessimistic Economic Expectations for the CEE Region Prevail

The financial market experts who are asked about their economic expectations for the CEE region in a monthly survey conducted by the ZEW, the Centre for European Economic Research, Mannheim, supported by Erste Bank der oesterreichischen Sparkassen, Vienna, are increasingly pessimistic. The sentiment indicator has decreased in November and now stands at -17.7 points. The experts' assessment of the current economic situation is also lower compared to the previous month's survey. The survey participants attest the Austrian economy to be in a good state but expectations have declined markedly.

Economic Outlook for CEE countries, Austria and the Eurozone

The ZEW-Erste Bank Sentiment Indicator CEE that gives the balance of positive and negative assessments for the economic development in CEE countries within the next six months has decreased in November again by 6.3 points. The pessimism of the financial market experts is now relatively clear with a balance of -17.7 points. However, the majority of experts, 62.7 percent, does not expect a change of the economic development. For Austria, the economic expectations have declined markedly. The stabilisation that seemed to be on the way in the October survey has not continued. On the contrary, the balance reached a new minimum value. For the euro area, the decline in economic expectations is even more pronounced than for Austria. This leads to a balance of -46.0 points indicating that the experts forecast a less dynamic economic development in the next six months. The assessment of the current economic situation is still mostly positive, especially for Austria and the CEE region. However, the balance for the CEE countries has decreased by 7.2 points and now shows a level of 51 points. The evaluation of the Austrian economic situation has decreased only slightly, and the balance shows 62.5 points compared to 65.2 points in the previous month's survey. For the Euro zone, the picture is different because most experts now describe the state of the economy as acceptable (68.6 percent) and the respective balance declined to 27.4 points.

Indicators for CEE, Austria and the Eurozone (balances)



Balance of positive and negative assessment category chosen by respondents of the Financial Market Survey CEE
Source: ZEW

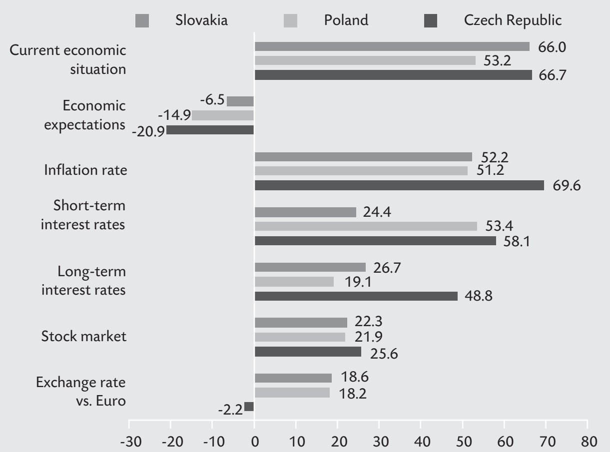
The financial market experts expect higher inflation risks accompanying the worsening forecasts of the business cycle. For Austria, the Euro zone as well as for the CEE region, the survey participants expect higher inflation rates within the next six months. All three balances have increased; especially for the CEE and the Euro zone.

The respondents' expectations do not seem to reflect the view that the forecasted rising inflation risks for Austria and the euro area as a whole are met by monetary policy actions in the middle term. The financial market experts forecast rising short-term interest rates but the projection is much less pronounced compared to the October survey.

The experts' expectations with regard to the stock market development have declined markedly this month. For the ATX and the EuroStoxx50, the balances only reach 12.3 and 8.9 points in the November survey. The balance of the NTX has decreased even more clearly than that of the ATX but from a higher level.

Czech Republic, Poland, and Slovakia: Less dynamic economic development starting from a high level

Indicators for the Czech Republic, Poland, and Slovakia



Balance of positive and negative assessment category chosen by respondents of the Financial Market Survey CEE Source: ZEW

The financial market experts assess the current state of the economies in the Czech Republic, Poland, and Slovakia as very good. Starting from a high level of economic activity, they forecast a less dynamic development within the next six months. All three balances describing economic expectations have declined. The smallest drop can be observed for Slovakia (-4.4 points) and the largest for the Czech Republic (-17.0 points).

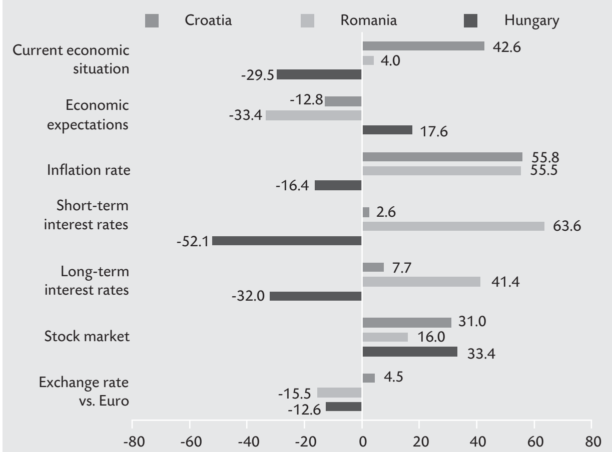
The experts' evaluation of a worsening economic environment continues with the assessment of inflation risks. For Slovakia and the Czech Republic, the balances indicating inflation expectations have risen markedly. For Poland, the sentiment of the survey participants has only changed by 0.1 points showing that inflation expectations are beginning to stabilise on a high level.

The expectations with regard to short- and long-term interest rates have changed compared to last month. The balances for the Czech Republic and Poland indicate that the financial market experts forecast increasing short-term interest rates. The differences between the share of experts who project rising interest rates and the share of experts who forecast decreasing rates is almost equal for the two economies. For Slovakia, the balance is lower indicating less pronounced expectations for rising interest rates. For long-term interest rates, the expectations for an increase are highest for the Czech Republic, as was the case in the October survey. For Slovakia, the picture has clearly changed. The experts are now much more biased in direction of increasing rates.

The overall picture of less optimistic expectations with regard to the stock market development that is signalled in the balance for the NTX, also translates into a more detailed view on stock market expectations. The clear ranking of balances of the previous month's survey has disappeared. Especially the balances of the SAX and the WIG are now more or less equal with the PX 50.

Croatia, Hungary, and Romania: Situation and expectations indicator point to weaker economic sentiment

Indicators for Croatia, Hungary, and Romania



Balance of positive and negative assessment category chosen by respondents of the Financial Market Survey CEE Source: ZEW

For Croatia, Hungary and Romania, financial market experts forecast the same development with regard to the economic sentiment as for the other CEE countries. They assess the economic situation as well as the economic prospects of the three countries more negative compared to the previous month's survey. However, the decline in optimism varies. Whereas the experts' evaluation of the current economic situation in Croatia is still largely "good", the balance for Hungary is even more negative than in the October survey. The balance of Romania for the economic situation has seen the smallest drop. For economic expectations, there are now two negative balances, for Hungary as before and in addition for Croatia. For Romania, the share of experts forecasting an improving economic development outweighs the share expecting a worsening.

As for the other countries included in the survey, financial market experts see more inflation risks for Croatia, Romania and Hungary. The respective balances shifted in the direction of increasing inflation rates. However, the balance for Hungary is still negative, indicating lower inflation expectations of the survey participants on balance.

The experts' expectations for interest rates show almost the same qualitative picture as in the October survey. Short- and long-term interest rates are expected to fall in Hungary whereas the experts project rising rates for Croatia and Romania, where the largest shift occurred. In October, the experts forecasted decreasing long-term interest rates for Croatia. These expectations changed to increasing long-term rates on balance.

The expected stock market development for the three Central and Eastern European countries fits the overall picture. The balances for the Croatian Crobex, the Hungarian BUX as well as the Romanian BET declined markedly indicating less optimistic forecasts for these stock market indices in the upcoming six months.

Special Question: Competitive advantages of CEE economies

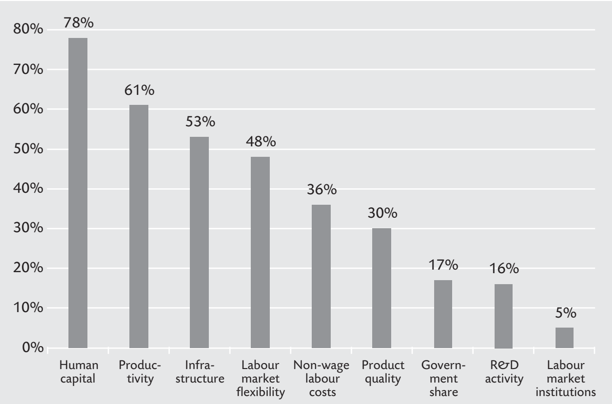
The CEE region is mostly characterised by transition economies that are engaged in a catching up process to the western European countries. The transformation goes along with high GDP growth rates that copy the text book examples of growth theory suggesting the convergence to a new steady state. As theory predicts, the process rests on a growing capital stock as well as on technological progress. However, at its current stage of development, the transforming CEE region still lacks the capital and innovation base of the United States and even the western EU member states. At the same time, the cost and resource capabilities of Brazil, Russia, India and China (BRIC) are considerably more attractive than the CEEs to many multinational enterprises. With the emergence of BRIC or break-out industrializing countries, it is becoming increasingly questionable if low-cost locations in CEE countries are enough of a reason for multinational companies to switch their investments to the region. These developments could worry the CEE countries since none of them have the resource endowments of the BRIC. Attracting the necessary capital to foster the catching-up process would be more difficult in light of these developments.

At the same time CEE economies are competing with each other for foreign direct investments from foreign companies. Therefore, the CEE public policymakers have a crucial role in supporting the competitiveness of the CEE economies through the use of incentives such as taxes, special trade zones, discounts on land purchases and so forth.

In the November survey, the financial market experts are asked to assess the competitiveness of the CEE countries compared to the CEE average (see Figure A). The experts evaluate the economies of the Czech Republic, Slovakia and Slovenia to have a higher than average competitiveness. Bulgaria, Croatia and Hungary get average grades from the survey participants for their competitiveness. Here, the bias is rather in direction of lower than average. Especially for Bulgaria, the frequency for the two categories is not that different. For Poland, the results of the survey are not decisive because the categories “average” and “lower than average” are equally occupied. Serbia gets mostly lower than average grades with regard to the comparative advantages within the CEE region.

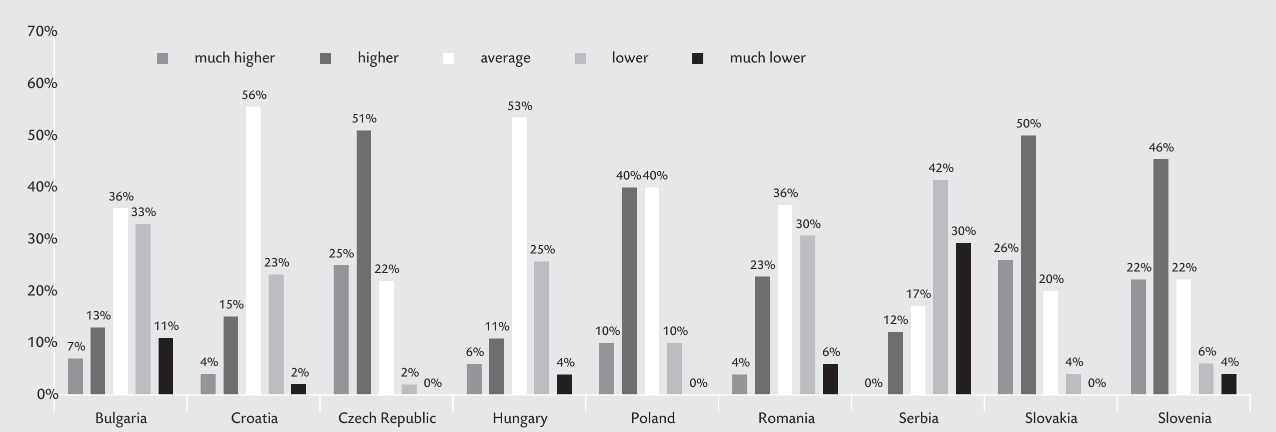
The literature distinguishes between long- and short-term capital that is attracted into an economy. Whereas short-term capital inflows can be reversed quickly, long-term capital flows in form of foreign direct investment are not easily inverted and need a stable economic environment to be attracted into an economy. As already mentioned, the competition for the most favourable locational conditions has many dimensions. One that is broadly discussed in the literature is tax competition. But tax competition is just one condition among others. In the second part of the special question, the experts were asked about their opinion on the determinants of competitive advantages within the CEE region. As the ranking (see Figure B) shows, the experts assign the human capital endowment to be most important in whether an economy can win the competition in the CEE region. The next two important influences are productivity and the infrastructure. The different aspects of the labour market regulation are also judged to be important, reaching from labour market flexibility to non-labour costs and to a minor extent labour market institution in the broadest sense.

Figure B: Determinants of the competitive advantage in the CEE region



Answers of the participants of the Financial Market Survey CEE Source: ZEW

Figure A: Comparison of country-specific competitive advantage compared to the CEE average



Answers of the participants of the Financial Market Survey CEE Source: ZEW

ZEW-Financial Market Survey: November 2007

Current economic situation	good		acceptable (normal)		bad		balance	
Austria	62.5	(-2.7)	37.5	(+2.7)	0.0	(+/-0.0)	62.5	(-2.7)
Croatia	44.7	(-13.1)	53.2	(+11.0)	2.1	(+2.1)	42.6	(-15.2)
Czech Republic	66.7	(-3.8)	33.3	(+5.8)	0.0	(-2.0)	66.7	(-1.8)
Hungary	11.7	(+4.0)	47.1	(-18.3)	41.2	(+14.3)	-29.5	(-10.3)
Poland	59.6	(-2.9)	34.0	(+4.8)	6.4	(-1.9)	53.2	(-1.0)
Romania	30.0	(+4.5)	44.0	(-15.6)	26.0	(+11.1)	4.0	(-6.6)
Slovakia	66.0	(+0.1)	34.0	(+4.2)	0.0	(-4.3)	66.0	(+4.4)
CEE	51.0	(-7.2)	49.0	(+7.2)	0.0	(+/-0.0)	51.0	(-7.2)
Eurozone	29.4	(-17.8)	68.6	(+15.8)	2.0	(+2.0)	27.4	(-19.8)

Economic expectations	improve		no change		worsen		balance	
Austria	8.5	(-0.3)	61.7	(-13.9)	29.8	(+14.2)	-21.3	(-14.5)
Croatia	8.5	(-7.7)	70.2	(+0.4)	21.3	(+7.3)	-12.8	(-15.0)
Czech Republic	6.2	(-5.6)	66.7	(-5.8)	27.1	(+11.4)	-20.9	(-17.0)
Hungary	39.2	(-5.9)	39.2	(-3.9)	21.6	(+9.8)	17.6	(-15.7)
Poland	6.4	(-12.0)	72.3	(+11.1)	21.3	(+0.9)	-14.9	(-12.9)
Romania	7.8	(-7.1)	51.0	(+4.2)	41.2	(+2.9)	-33.4	(-10.0)
Slovakia	8.7	(-4.1)	76.1	(+3.8)	15.2	(+0.3)	-6.5	(-4.4)
CEE	9.8	(+0.4)	62.7	(-7.1)	27.5	(+6.7)	-17.7	(-6.3)
Eurozone	6.0	(-5.1)	42.0	(-13.6)	52.0	(+18.7)	-46.0	(-23.8)

Inflation rate	increase		no change		decrease		balance	
Austria	47.8	(+3.3)	47.7	(-3.4)	4.5	(+0.1)	43.3	(+3.2)
Croatia	65.1	(+6.6)	25.6	(-6.1)	9.3	(-0.5)	55.8	(+7.1)
Czech Republic	76.1	(+7.4)	17.4	(-7.6)	6.5	(+0.2)	69.6	(+7.2)
Hungary	32.6	(+6.6)	18.4	(+6.4)	49.0	(-13.0)	-16.4	(+19.6)
Poland	64.5	(+2.3)	22.2	(-4.5)	13.3	(+2.2)	51.2	(+0.1)
Romania	71.1	(+6.7)	13.3	(-4.5)	15.6	(-2.2)	55.5	(+8.9)
Slovakia	58.7	(+14.3)	34.8	(-5.2)	6.5	(-9.1)	52.2	(+23.4)
CEE	66.7	(+16.7)	29.4	(-16.6)	3.9	(-0.1)	62.8	(+16.8)
Eurozone	55.1	(+12.8)	38.8	(-13.1)	6.1	(+0.3)	49.0	(+12.5)

Short-term interest rates	increase				no change				decrease				balance			
	[abs.]		[rel.]		[abs.]		[rel.]		[abs.]		[rel.]		[abs.]		[rel.]	
Croatia	18.4	(-9.3)	24.3	(+15.7)	65.8	(+10.2)	54.5	(-16.9)	15.8	(-0.9)	21.2	(+1.2)	2.6	(-8.4)	3.1	(+14.5)
Czech Republic	67.4	(-8.2)	42.1	(-2.1)	23.3	(+3.3)	21.1	(-16.1)	9.3	(+4.9)	36.8	(+18.2)	58.1	(-13.1)	5.3	(-20.3)
Hungary	12.5	(-6.2)	11.9	(+1.0)	22.9	(+8.3)	16.7	(+3.7)	64.6	(-2.1)	71.4	(-4.7)	-52.1	(-4.1)	-59.5	(+5.7)
Poland	58.1	(-6.1)	47.4	(-1.3)	37.2	(+6.2)	34.2	(-7.3)	4.7	(-0.1)	18.4	(+8.6)	53.4	(-6.0)	29.0	(-9.9)
Romania	72.7	(+0.2)	64.9	(+7.0)	18.2	(-1.8)	24.3	(-7.3)	9.1	(+1.6)	10.8	(+0.3)	63.6	(-1.4)	54.1	(+6.7)
Slovakia	31.1	(+5.5)	20.5	(-1.4)	62.2	(-9.9)	56.4	(-4.6)	6.7	(+4.4)	23.1	(+6.0)	24.4	(+1.1)	-2.6	(-7.4)
Eurozone	26.0	(-14.4)			54.0	(+5.9)			20.0	(+8.5)			6.0	(-22.9)		

Long-term interest rates	increase				no change				decrease				balance			
	[abs.]		[rel.]		[abs.]		[rel.]		[abs.]		[rel.]		[abs.]		[rel.]	
Croatia	28.2	(+6.6)	9.1	(-8.1)	51.3	(-0.1)	57.6	(+0.5)	20.5	(-6.5)	33.3	(+7.6)	7.7	(+13.1)	-24.2	(-15.7)
Czech Republic	55.8	(+0.3)	18.9	(-26.3)	37.2	(+1.6)	56.8	(+6.8)	7.0	(-1.9)	24.3	(+19.5)	48.8	(+2.2)	-5.4	(-45.8)
Hungary	19.1	(+6.0)	17.1	(+5.7)	29.8	(+8.1)	14.6	(-1.3)	51.1	(-14.1)	68.3	(-4.4)	-32.0	(+20.1)	-51.2	(+10.1)
Poland	38.1	(+3.1)	19.4	(-7.7)	42.9	(-9.6)	41.7	(-4.2)	19.0	(+6.5)	38.9	(+11.9)	19.1	(-3.4)	-19.5	(-19.6)
Romania	58.5	(+2.0)	45.4	(-3.1)	24.4	(-1.2)	27.3	(-1.3)	17.1	(-0.8)	27.3	(+4.4)	41.4	(+2.8)	18.1	(-7.5)
Slovakia	36.5	(+17.0)	13.5	(+/-0.0)	53.7	(-14.6)	59.5	(-2.7)	9.8	(-2.4)	27.0	(+2.7)	26.7	(+19.4)	-13.5	(-2.7)
Germany	34.8	(-3.5)			47.8	(-1.1)			17.4	(+4.6)			17.4	(-8.1)		

Stock market indices	increase		no change		decrease		balance	
EURO STOXX 50	40.0	(-20.4)	28.9	(+14.9)	31.1	(+5.5)	8.9	(-25.9)
ATX (Austria)	39.1	(-20.9)	34.1	(+16.6)	26.8	(+4.3)	12.3	(-25.2)
NTX (CEE)	50.0	(-26.2)	28.6	(+19.1)	21.4	(+7.1)	28.6	(-33.3)
CROBEX (Croatia)	50.0	(-17.5)	31.0	(+16.0)	19.0	(+1.5)	31.0	(-19.0)
PX 50 (Czech Rep.)	46.5	(-17.8)	32.6	(+11.2)	20.9	(+6.6)	25.6	(-24.4)
BUX (Hungary)	55.6	(-5.8)	22.2	(-0.5)	22.2	(+6.3)	33.4	(-12.1)
WIG (Poland)	51.2	(-12.2)	19.5	(+4.9)	29.3	(+7.3)	21.9	(-19.5)
BET (Romania)	45.5	(-8.4)	25.0	(-3.2)	29.5	(+11.6)	16.0	(-20.0)
SAX (Slovakia)	41.7	(-8.3)	38.9	(+4.7)	19.4	(+3.6)	22.3	(-11.9)
SBI 20 (Slovenia)	41.7	(-19.4)	33.3	(+8.3)	25.0	(+11.1)	16.7	(-30.5)

Exchange rates (vs. Euro)	appreciate		no change		depreciate		balance	
Kuna (Croatia)	25.0	(+3.6)	54.5	(-0.3)	20.5	(-3.3)	4.5	(+6.9)
Koruna (Czech Rep.)	26.7	(-8.8)	44.4	(-4.5)	28.9	(+13.3)	-2.2	(-22.1)
Forint (Hungary)	16.6	(-12.6)	54.2	(+4.2)	29.2	(+8.4)	-12.6	(-21.0)
Zloty (Poland)	40.9	(-9.1)	36.4	(+2.3)	22.7	(+6.8)	18.2	(-15.9)
Lei (Romania)	28.9	(-2.0)	26.7	(+0.5)	44.4	(+1.5)	-15.5	(-3.5)
Koruna (Slovakia)	34.9	(-8.2)	48.8	(+3.3)	16.3	(+4.9)	18.6	(-13.1)
US-Dollar	30.4	(-4.9)	26.1	(+2.6)	43.5	(+2.3)	-13.1	(-7.2)

Note: 73 Financial experts participated in the November survey which was conducted during the period 10/30/07-11/19/07. Analysts were asked about their expectations for the next 6 months. Numbers displayed are percentages (month-over-month percentage point changes compared to the survey in October in parentheses). Balances refer to the differences between positive and negative assessments.

IMPRINT

Financial Market Report CEE – published monthly
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