

Regional overview

CEE households navigating troubled waters

Fabio Mucci

- The households sector has been clearly feeling the economic crisis. Peaking unemployment and falling income growth have marked a reversal of the usual trend in terms of convergence in living standards. The decline in consumption has been matched by a rising saving propensity, even in a context of poor saving capacity.
- Households' net financial savings recovered in 2009, thanks to both lower consumption and debt growth and some positive stimulus stemming from the capital market's performance and higher returns on savings. Going forward we expect some additional gradual growth, with improving economic conditions being matched by a still relatively higher saving propensity of households. Strong regional differentiation is however likely to be confirmed.
- Recovery in the mortgage market will remain gradual, but the long-term potential is clear, as confirmed by the relative underpenetration versus that recorded in more mature markets. This is not the case in the consumer credit industry, where penetration levels peaked in the pre-crisis period.

1.1 Weaknesses in labour markets and subdued dynamic in income to provide the basis for only marginal recovery in the financial conditions of households

Following years of rapid improvement in the financial conditions of households, fostered by solid income growth and rapidly improving living standards, late 2008 and particularly the first nine months of 2009 marked a visible deterioration in the sector's overall standing. The deep economic adjustments observed in the entire region during 2009 resulted in rising tensions on labour markets, thereby cutting growth in wages and households' disposable income. A drop in income was recorded in the Baltic States and some SEE and CIS countries, where wage growth in real terms is expected to have entered negative territory after several years of double-digit growth. On average, real wages in the region should have contracted by 4% last year compared to an almost 8% increase in 2008. Unemployment has started to rise again, with the average regional unemployment rate at around 10.5% at the end of September 2009 (6.9% in August 2007)¹. In such a context of strong downward pressures on income growth and still constrained saving capacity particularly in some areas, the crisis has led to a clear reduction in the consumption propensity of households, translating into some additional saving propensity.

Household financial assets at the regional level are anticipated to have rebounded, up by more than 12% last year (from -5.5% recorded one year earlier) to reach 44% of GDP (2008: 33%). Attractive returns on bank deposits and the good performance of local bond markets provided some support. Rallying stock markets have helped push up the value of CEE households assets. Following the unprecedented drop recorded in CEE financial markets, with stock exchanges down in the range of 50% to 80% in 2008, the first months of 2009 attested to a recovery in investor confi-

dence with the positive mood gradually being restored, driving up financial markets' performance. The MSCI EME index was up 68% at the end of November and a stunning 100% since the beginning of March 2009, when it reached its low for the year. Turkey and Hungary, together with Romania and the Czech Republic, have led the turnaround, although the rest of CEE financial markets also turned in robust performances. Despite a noticeable reduction in exposure to riskier assets (especially listed shares) experienced at the peak of the crisis and gradually reversed since Q1 – Q2 2009, the still relatively high weight of those instruments particularly in the case of Romanian, Croatian and Turkish households should have clearly supported the improvement in the accumulation of financial assets.

Growth in the financial liabilities of households gradually faded during 2009, thus reversing the boom registered since the beginning of the last decade in all countries. Mounting tensions in labour markets and slower wage and disposable income growth coupled with a visible deterioration in households' financial conditions resulted in weakening loan demand. Tighter credit market conditions and a more cautious approach by banks toward lending combined with rising concern for credit quality, clearly exacerbated the situation, pushing lending growth to the households sector into negative territory in the first nine months of 2009, notably in countries such as Russia, Croatia, Romania and other CIS countries. Overall, lending activity is expected to have remained quite weak in the remaining months of last year as well, resulting in modest 2.3% annual growth at the regional level (down from 16.7% in 2008)².

The increasing financial stress recorded by CEE households has clearly damaged consumer confidence and influenced spending behaviour. Household consumption in most of the region was not affected dramatically by the global financial crisis during most of

¹ According to ILO definition. Average including the Baltics, Bulgaria, Croatia, Czech R., Hungary, Poland, Romania, Russia, Slovakia, Slovenia, Turkey
² Not adjusted for FX movements

2008. But the situation changed considerably in the aftermath of Lehman Brothers collapse as indicated by the significant decline in retail sales, particularly in SEE countries and the Baltic States, as households were forced to retrench their spending to deal with a much dimmer economic outlook and a rise in the debt servicing ratio. Uncertainty over income and employment prospects coupled with a tightening of credit standards have been the main factors responsible for the visible adjustment in the consumption pattern of households.

Expectations of households with regard to the state of the economy rapidly deteriorated during last year, reaching unprecedented levels of pessimism in March. Worsening labour market conditions are likely to have been the largest contributor to lower consumer confidence. Some marginal improvement was however recorded

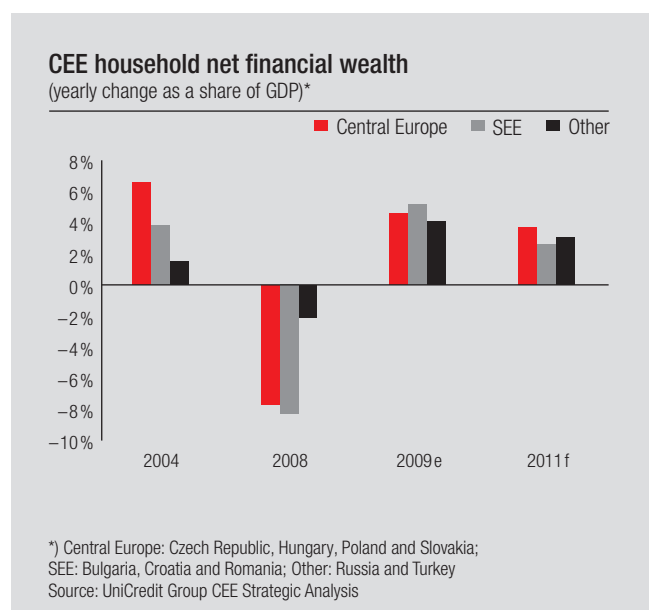
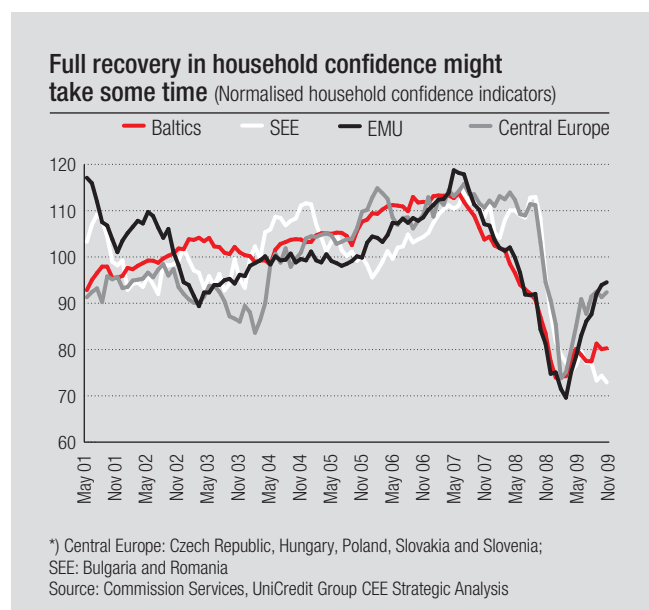
during last summer on the back of a sharp pickup in sentiment indicators in Western Europe as well, as the global economy confirmed signs of increasing stabilisation. According to the most recent household condition surveys, consumer concern about growing unemployment and further deterioration in the general economic situation were further contained particularly in Central European countries and above all in Poland. At the same time, hardly any improvement was observed in SEE countries, reinforcing signs that full recovery in household confidence is likely to take some time.

The economic backdrop and recovery in leading indicators are likely to remain drivers for the accumulation of net financial assets during 2010. Despite this, the persistent tensions in labour markets and slower growth in households wages and disposable

Structural indicators of CEE households sector (1), (2)

	Central Europe			South-Eastern Europe			Other countries			CEE		
	2007	2008	2011 f	2007	2008	2011 f	2007	2008	2011 f	2007	2008	2011 f
Fin. Assets (EUR bn)	401.8	383.5	506.2	91.2	83.1	109.7	405.5	382.6	548.8	898.5	849.2	1,164.7
Fin. Liabilities (EUR bn)	142.1	176.1	226.3	45.9	55.9	61.1	147.3	159.3	195.9	335.2	391.3	483.3
Financial Assets % GDP	68 %	56 %	72 %	47 %	38 %	49 %	29 %	23 %	33 %	41 %	33 %	45 %
Financial Liabilities % GDP	24 %	26 %	32 %	23 %	26 %	27 %	10 %	10 %	12 %	15 %	15 %	19 %
Net Financial Wealth % GDP	44 %	31 %	40 %	23 %	12 %	22 %	18 %	14 %	21 %	26 %	18 %	26 %
Fin. Liab. % of Fin. Assets	35 %	46 %	45 %	50 %	67 %	56 %	36 %	42 %	36 %	37 %	46 %	41 %
Per capita Financial Assets	6,287	5,992	7,901	2,715	2,483	3,319	1,908	1,795	2,566	2,897	2,734	3,745
Per capita Financial Liabilities	2,223	2,752	3,532	1,366	1,669	1,849	693	748	916	1,081	1,260	1,554
Per capita Net Fin. Wealth	4,064	3,240	4,369	1,348	814	1,469	1,215	1,048	1,650	1,816	1,474	2,191

Note: (1) To ensure consistency, total financial wealth excludes assets invested in unquoted shares and other equities. Other accounts receivable are also excluded. Data on household liabilities also includes loans granted by non-bank financial institutions; (2) Central Europe: Czech R., Hungary, Poland, Slovakia; South-Eastern Europe: Bulgaria, Croatia, Romania; Other countries: Russia, Turkey
Source: UniCredit Group CEE Strategic Analysis



income, coupled with still tight credit market conditions are expected to put a damper on the accumulation of financial savings. Overall, net financial wealth is projected to stabilise around 25% as a percentage of regional GDP this year, in line with 2009. Although this represents a huge improvement relative to the trough of 18% recorded in 2008, it also confirms that full recovery is likely to materialise only starting from 2011 when net financial wealth is expected to approach the level prevailing before the crisis.

Strong regional differentiation in the financial behaviour of households is likely to be confirmed going forward. New inflows of net financial assets relative to GDP (a proxy for the household financial savings ratio) in SEE is set to gradually decline from the 5.2% expected to have been recorded in 2009 to some 2.6% in 2011, as households struggle with low income growth and a high share of their consumption still being devoted to primary consumption. The persistence of some volatility in capital market performance coupled with still tense labour market conditions (at least for most of 2010) is likely to lead to only a mild re-acceleration in household financial savings in Central Europe and other CEE countries, with net financial wealth as a share of GDP projected to stabilise at around 40% and 20% in these two sub-regions.

1.2 On the assets side, a gradual return to risky instruments is emerging

The global financial turmoil has dealt a major blow to the trend of diversification of CEE households' wealth accumulation started in the years immediately before the crisis. The climate of uncertainty and rising risk aversion which dominated financial markets until the end of 2008 have clearly influenced individual investment choices, forcing massive redemption of sophisticated instruments such as equity and mutual funds in favour of safer asset classes. The stabilisation of financial markets and the gradual restoration

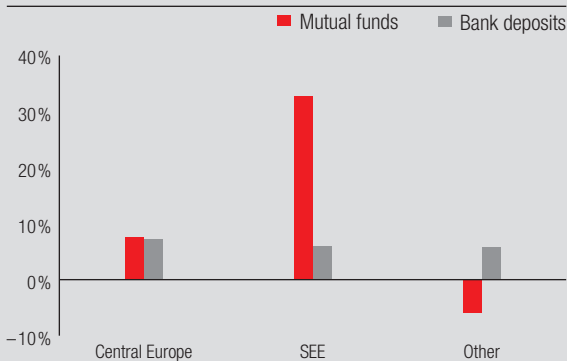
of confidence observed at the beginning of 2009, however, contributed to some reversal of the trend, thus supporting some gradual transfers of money back to riskier instruments.

Traditional savings instruments benefited most during the escalation of the crisis in the last part of 2008 despite some episodes of net outflows from bank deposits recorded during October backed by concern over global banking sector stability, but contained by a prompt increase in the threshold of deposit guarantees. 'Flight to quality' is a rather common phenomenon particularly during turbulent times but was partly motivated by supply, as competition for traditional funding among banks intensified. Accumulation into bank deposits has been particularly strong in SEE countries, maintaining a solid dynamic until Q1 2009 when a renewed interest in riskier asset classes fuelled by the rebound in financial markets contributed to some reversal of the flows. In countries like Slovakia, the search for safer assets and particularly the Euro adoption process significantly influenced the behaviour of households between the end of 2008 and first half of 2009, bringing large amounts of cash into commercial banks mainly in the form of short-term deposits.

More than a year ago, the asset management industry was quaking in its boots. A combination of tumbling markets and fleeing investors saw assets under management in the region contract in the range of 40% to 70% in 2008. Net redemptions have been particularly severe in the case of Poland and Croatia, where total net outflows in the whole industry topped roughly EUR 9.4 bn and EUR 1.5 bn during the year, respectively, with the negative trend persisting until the first months of 2009. Similar trends were also recorded in the rest of CEE with the only exception Romania, where renewed interest toward those instruments starting from October 2008 has also been fuelled by the appearance of bank-related monetary investment funds offering very attractive yields.

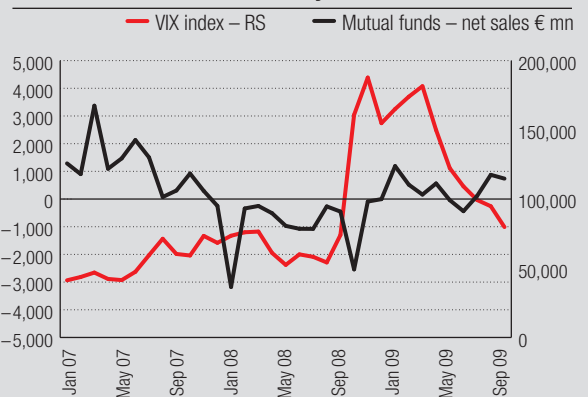
CEE households deposits and mutual funds

(YTD % change up to September 2009)*



*) Central Europe: Czech Republic, Hungary, Poland and Slovakia; SEE: Bulgaria, Croatia and Romania; Other: Russia and Turkey
Source: UniCredit Group CEE Strategic Analysis

CEE mutual funds and financial markets volatility*



*) Net sales in selected CEE investment funds markets: Poland, Romania, Slovakia and Turkey
Source: UniCredit Group CEE Strategic Analysis

The restoration of investor confidence particularly since February 2009 and recovery of equity markets contributed to lifting individuals' subscription into investments funds mostly all over the region. CEE investment funds attracted a net EUR 1.7 bn in Q3 2009³, the best showing since H2 2006. New subscriptions were mostly concentrated toward equity and balanced funds, with some higher preference for more liquid funds (money market and bond funds) particularly in the case of Turkey and Romania, stimulated by relatively good returns associated with lower risk relative to other classes of funds.

It is however worthwhile to remember that retail investors in CEE remain very much momentum driven, given the poor tradition of investing in sophisticated instruments with a long-term approach. If combined with the significant influence exerted by market volatility in driving investment choices particularly in mutual funds and stocks, it is quite logical to expect that for a large number of individuals, it would surely take some time before regaining their nerve and returning to the fray.

The favourable market performance recorded since the beginning of 2009 has clearly supported some return to riskier asset classes as well, such as investment in listed shares. This was particularly the case for Romanian and Turkish households, traditionally more keen on riskier investments, whose share of equity in total financial wealth likely expanded in the range of 2 to 5 percent at the end of last year compared to 2008.

The recent crisis put a brake on the very high dynamic recorded by investment into insurance schemes over the past years (20 % yearly average growth in the 2002–2007 period) with life insurance the most affected by falling assets in late 2008 and early 2009. The uncertainty induced by the crisis in the personal finances of CEE households coupled with growing mistrust in the reliability of institutional companies contributed to a dramatic decrease in the appetite for life insurance products. The large number of surrenders of life policies was not only

driven by the worsened financial situation, but also to some extent by peoples' emotional reaction under the impact of a much grimmer economic outlook. Following the crisis, single premium products have been abandoned in favour of products with regular payments, and riskier unit-linked policies were more penalised in favour of traditional life insurance schemes.

Similar trends were also observed in the non-life insurance segment whose dynamic remains very much dependent on motor vehicle insurance, representing around 60 % of the non-life portfolio in the region. The massive drop recorded in car sales starting from H2 2008 (despite the scrap incentives) had a major influence on non-life business volumes in the region resulting in only marginal recovery in their growth dynamic relative to 2008.

Accumulation in defined contribution schemes has been rapidly improving in recent years peaking at 4.3 % of GDP on average in the region at the end of 2007 but drastically dropping in 2008 to 3.4 %. The crisis has been particularly affecting countries where defined-contribution plan exposure to equity risk

Mandatory defined-contribution pension assets average yields, selected countries⁽¹⁾

Country	2007	2008	YTD (Q3 2009) ⁽³⁾
Bulgaria ⁽²⁾	11.3 %	-4.0 %	-8.1 %
Croatia	6.8 %	-12.5 %	6.5 %
Hungary	5.8 %	-19.9 %	19.0 %
Poland	6.2 %	-14.2 %	10.7 %
Romania	-	-	14.6 %
Russia	6.0 %	-0.5 %	4.1 %
Slovakia	3.7 %	-6.3 %	0.5 %

Note: (1) Russia is presently in transition from pay-as-you-go pension scheme to personal savings scheme. All pension contributions, up to 20% of labour income are presently divided into 3 parts – 1 part "base" (6% of incomes) is dedicated to finance existing pay-as-you-go pensions for present pensioners. Another part "insurance" (8%) is used for the same purposes, but is also counted to determine size of pension for the current payer. The remaining amount (6%) is redirected toward a mandatory savings scheme; (2) Figures refer to 2Y cumulative returns; (3) YTD until October for Hungary and Romania
Source: UniCredit Group CEE Strategic Analysis

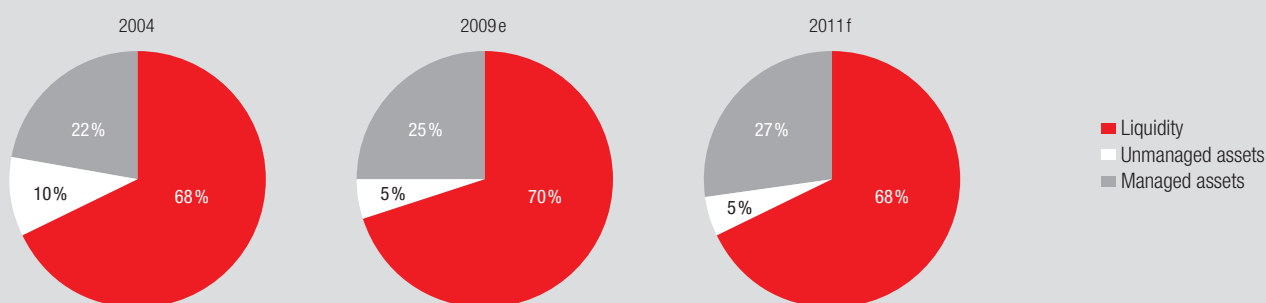
³ Including net sales for total investment funds market in selected CEE countries: Croatia, Czech Republic, Poland, Romania, Slovakia and Turkey

Equity share in total portfolio of mandatory pension funds, selected countries

Country	2007	2008	Q3 2009	Existing limits on total investment in equity and foreign assets
Bulgaria	-	6.9 %	8.0 %	Equity: up to 20 % of total managed assets
Croatia	-	-	15.5 %	At least 50 % of managed assets should be invested in bonds and other securities issued by Croatian government and CNB. Limit for investments in all types of assets from OECD states currently set at 20 %
Hungary	-	-	40.5 % ⁽¹⁾	Equity: for classic portfolios up to 10 %, for balanced ones up to 40 %
Poland	34.9 %	21.6 %	28.0 %	Naturally bound not to take excessive risk as returns should not be lower than a minimum guaranteed. Limit to invest in foreign assets currently set at 5 %
Romania	-	-	28.7 % ⁽²⁾	Equity: up to 50 % of total managed assets (with a limit on both investments in domestic and EU listed shares currently set at 35%)
Russia	-	-	-	Pension funds can invest only in government securities and limited number of fixed income assets, mostly guaranteed by the Russian government
Slovakia	15.1 %	6.4 %	0.9 % ⁽²⁾	Equity: up to 80 % for Yield funds, up to 50 % for Balanced and 0 % for Conservative type of funds

Note: (1) As of October 2009; (2) As of June 2009
Source: UniCredit Group CEE Strategic Analysis

CEE household financial assets mix (1), (2)



(1) CEE: including new EU members (w/o Slovenia and Baltic states) + Russia and Turkey; (2) Liquidity: currency and deposits; unmanaged assets: listed and securities; managed assets: mutual funds, insurance technical reserves and pension funds
Source: UniCredit Group CEE Strategic Analysis

CEE household financial assets (LC CAGR 2009–2011)*

	Bulgaria	Croatia	Czech R.	Hungary	Poland	Romania	Slovakia	Turkey	Russia	CEE
Currency	-6.8%	-1.1%	4.3%	2.3%	6.5%	6.3%	73.6%	13.3%	2.9%	7.2%
Bank deposits	6.3%	2.1%	5.3%	4.4%	7.7%	14.3%	3.0%	13.0%	13.1%	10.0%
Securities	-14.9%	9.3%	37.9%	3.6%	6.6%	-12.1%	-	-7.0%	-	2.0%
Listed shares	-0.1%	11.1%	11.9%	12.7%	9.5%	27.2%	-	35.4%	-	20.1%
Mutual funds	3.2%	-0.4%	7.0%	5.4%	13.7%	86.7%	6.2%	20.6%	10.5%	12.9%
Insurance reserves	4.3%	6.8%	5.5%	9.0%	5.5%	3.2%	7.3%	10.4%	11.3%	8.0%
Pension funds	15.1%	26.2%	7.3%	17.2%	15.8%	76.3%	29.4%	19.1%	30.4%	20.5%
Total financial assets	4.9%	5.2%	6.0%	6.9%	9.5%	15.7%	11.8%	13.8%	13.6%	11.1%
Net financial wealth	10.0%	8.9%	3.4%	11.3%	11.1%	52.1%	11.6%	13.2%	21.8%	14.2%

* Bank deposits in Croatia, Czech Republic and Slovakia include also savings kept in construction banks and building societies
Source: UniCredit Group CEE Strategic Analysis

was largest as in the case of Hungary, Poland and Croatia. The performance of such schemes has been significantly affected by the financial markets turmoil, with systems such as those in Hungary heavily exposed to equity and foreign exchange risk recording close to a 20% drop in 2008. The rebound in global financial markets since the beginning of 2009 has clearly supported major improvement in the performance of such schemes. In Romania, where the second pillar was only established at the beginning of 2008, the relative prevalence of conservative schemes and high returns offered by government bonds coupled with progressive contribution hikes resulted in a quite relatively high performance in the first ten months of 2009, with total assets under management tripling in less than a year.

Looking ahead, the attitude of households toward more sophisticated asset classes is anticipated to regain some strength with above average growth expected in 2010 and 2011 for other forms of savings particularly in the segment of mutual funds and in less developed markets such as Romania and Russia. The preference for liquidity and orientation toward

more traditional savings products are instead expected to lose some appeal, resulting in a drop in their relative weight in the region's total financial wealth to some 68% on average by 2011.

The segment of long-term investment vehicles, particularly of pension funds, still provides some of the most solid potential in the near future. This trend is even reinforced by clients' need to secure their investments after the crisis. Overall, growth in pension fund investments is expected to average around 19% in the 2010–2011 period, with a particularly rapid dynamic anticipated in the case of Romania, Russia, Slovakia and Croatia (with growth rates in the range of 25% to 45%).

1.3 Solvency problems and subdued demand to weigh on lending activity

During the past several years through 2008, households' appetite for debt was spurred by a combination of powerful factors ranging from very favourable lending conditions and easier access to credit to optimism regarding rapid income convergence and improvement in overall financial conditions.

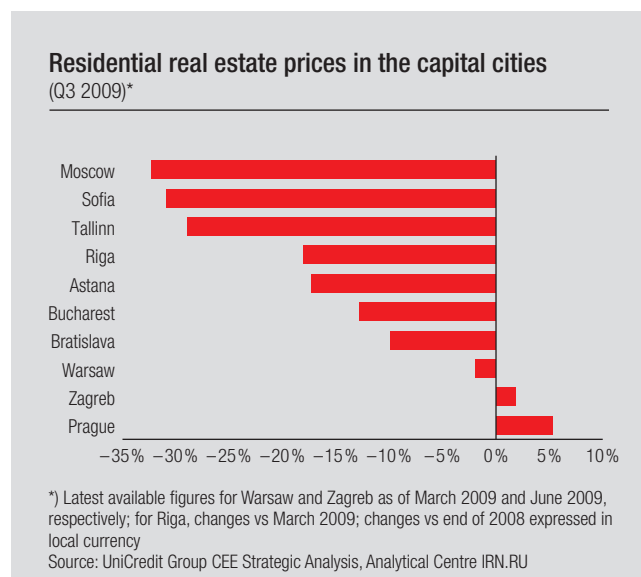
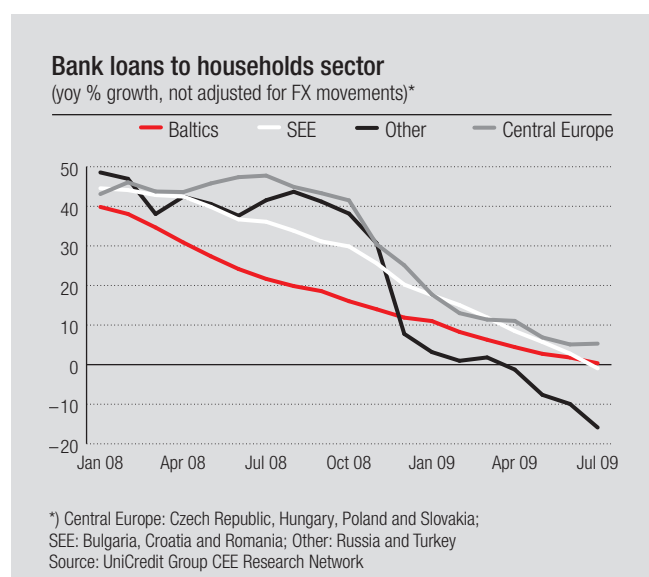
The crisis, particularly after the Lehman collapse, brought a strong reversal in the trend observed in the recent past. Uncertainty over income and employment prospects coupled with tightening of credit standards were responsible for a visible adjustment in the behaviour of households, resulting in weakening demand for new loans. Tightening of lending terms and standards (also through a sizeable reduction in loan-to-value ratios for mortgages and more stringent collateral and LTI requirements for consumer loans) have also implied more difficult access to bank financing, resulting in a gradual cooling of lending activity to the households sector. Already in the first half of last year, average regional growth in retail loan volumes remained in negative territory, down by almost 2% ytd as compared to 16% yoy growth in 2008⁴. The following months brought only an insignificant improvement with growth in household financial liabilities expected to have recorded a mere 2.3% increase for the whole of 2009. The slowdown in the dynamic of household indebtedness has been particularly evident in the SEE region (mainly Romania and Croatia) and CIS countries in addition to the Baltic States, where credit demand largely con-

tracted on the back of ongoing stabilisation in the real estate market and deep economic adjustments. In the rest of the CEE region demand remained more resilient, with Central European countries such as the Czech Republic and Slovakia representing an exception as retail lending should have recorded still respectable growth in 2009, given that both countries failed to experience the credit boom in the last years.

Among technical forms, consumer credit has reacted first with visible drops, while mortgage lending remained more stable, benefiting from longer maturities and some ongoing renegotiation activities. Some divergent patterns were indeed recorded in CIS countries, where short-term products such as credit cards and cash loans continued to expand even in the midst of the crisis at the expense of other lending products with longer duration.

The overall dynamic in mortgage lending has been clearly influenced by the ongoing adjustments taking place in the residential real estate market. Despite the persistence of some qualitative and quantitative gaps on the supply side, the residential housing market in most of the CEE region went into a tailspin over a burst-

4) Including only bank loans, not adjusted for FX movements



CEE household financial liabilities (LC CAGR 2009–2011)

	Bulgaria	Croatia	Czech R.	Hungary	Poland	Romania	Slovakia	Turkey	Russia	CEE
Mortgage loans	5.3%	3.5%	11.2%	3.6%	6.7%	7.5%	11.1%	16.3%	9.6%	9.3%
Personal loans	-0.5%	-1.3%	5.1%	2.8%	8.1%	3.7%	7.1%	-1.1%	1.7%	2.9%
– granted by banks	-0.6%	-1.3%	9.7%	2.9%	8.1%	4.1%	11.6%	-4.3%	1.7%	3.0%
– granted by non-banks	0.1%	–	-4.3%	-2.9%	–	-0.4%	-3.6%	8.3%	–	-0.3%
Overdraft	4.0%	8.5%	6.8%	16.1%	11.8%	–	10.4%	–	–	11.9%
Other loans	-1.7%	–	16.4%	5.2%	2.4%	-5.7%	17.3%	18.4%	–	17.2%
Revolving credit cards	0.4%	0.9%	8.1%	–	8.6%	–	18.5%	12.3%	–	12.5%
Financial leasing	-1.8%	17.3%	-1.8%	-3.0%	2.6%	-2.2%	6.2%	14.0%	–	-0.6%
Total financial liabilities	2.3%	1.7%	9.5%	2.9%	7.6%	4.0%	12.2%	15.0%	4.2%	7.3%

Source: UniCredit Group CEE Strategic Analysis

ing housing bubble particularly in the capital cities, and demand dried up both domestically and internationally. House prices in the capital cities had fallen far more quickly than expected with year to date decreases until September ranging between 10% to 35% of the value recorded at the end of 2008 and only two out of ten capital cities under review recording marginal positive growth.

Unfavourable factors such as higher unemployment, slower wage growth and higher financial leverage are likely to weigh on the demand for housing going forward. This coupled with still some significant stock of unsold dwellings especially in the capital cities may lead to further correction in house prices, thus prolonging the recovery phase. However it is expected that the bulk of demand in the mid-term is likely to originate from the internal market, as external demand (particularly that of a speculative nature) might not recover to the level experienced in the past several years.

Looking ahead, lending to households is expected to remain more constrained in the short term relative to the corporate segment. We forecast around 10% annual average growth at the regional level in 2010 and 2011, with some significant dynamic only in the case of Turkey, Slovakia and the Czech Republic and a relatively sluggish performance in all the other countries. Throughout the region, the mortgage segment is anticipated to continue to drive growth despite some below potential dynamic on the back of further stabilisation in the residential real estate market and the still cautious approach of banks to financing. The market potential is still there, particularly considering that in CEE some gap in terms of supply in the residential real estate market still exists and overall mortgage market penetration is projected to have reached 9% (excluding Russia) at the end of last year compared to a 38% ratio in the Euro area. The potential is less clear on the consumer credit market, where the gap relative to the Euro area is less evident. We forecast around 6% average yearly growth in the following two years, almost half of that expected in the mortgage segment (11%).

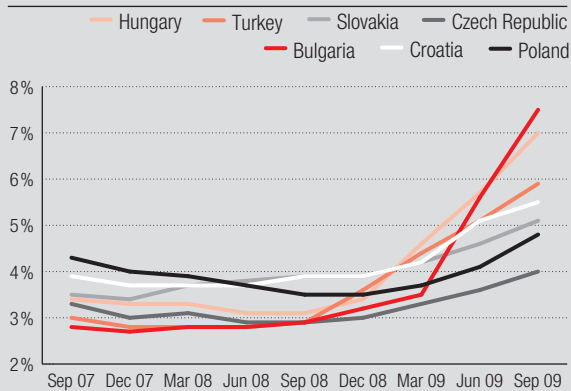
Credit quality will remain a key challenge with risks to the households sector's solvency remaining skewed on the upside and a peak in distressed assets related to this segment expected only toward the end of 2010.

The cooling in lending activity and households' rising financial stress recorded during 2009 was accompanied by increasing signs of deterioration in their solvency. The share of non-performing loans has increased rapidly starting from the end of 2008 particularly in SEE and CIS countries also in the wake of a more unstable financial position of the households sector (due to an historical lack of accumulated wealth), while it was more contained in Central Europe with the exception of Hungary. Higher non-performing loans were generally recorded for riskier types of loans to households, especially car, revolving credit cards and consumer loans. In some countries such as Poland, Hungary and Romania, the relatively high weight of FX-denominated/indexed loans in the context of flexible exchange rate regimes (with the relevance of "exotic" currencies such as the CHF and JPY particularly in the first two countries, in addition to EUR-denominated loans), has clearly complicated the situation, triggering a new wave of discussion concerning a tightening of FX lending regulations.

Different proposals are currently under discussion in addition to the EU draft directive aimed to increase capital absorption for those loans in FX toward un-hedged retail clients. Some CEE countries have already taken formal steps to address the issue. This is the case in Turkey, where starting from June last year, FX lending to individuals has been banned by the local supervisory authority. On its last session in December, the Hungarian Parliament approved a new regulation (effective from Jan 1st 2010) aimed at reducing the risks to households imposing, among other restrictions, more stringent criteria for FX-denominated loans.

CEE households non-performing loans

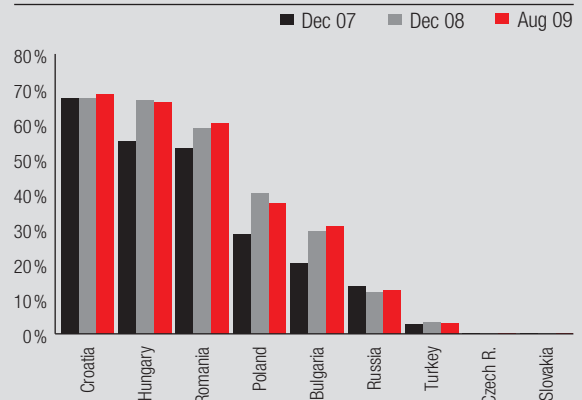
(percentage of gross loans)



Source: UniCredit Group CEE Strategic Analysis

Bank loans to households sector*

(share of foreign-denominated/indexed to total)



*) Romania and Russia as of July 2009
Source: UniCredit Group CEE Strategic Analysis

Focus 1

CEE labour markets hit by the crisis

Fabio Mucci

In line with global trends, labour markets across CEE countries have considerably weakened since the onset of the crisis with more than three million workers having joined the ranks of the unemployed overall in the region¹. The average unemployment rate soared by more than 3.5 p.p. since August 2007 and may not have peaked yet in most of the countries under review. However, the starting month and intensity of the situation varies widely across countries. The sharpest increase has clearly been recorded in those countries facing the largest adjustment in economic activity, notably the Baltic States. Labour markets were more resilient in countries such as Poland, thanks to still solid economic growth and structural factors which served as a buffer from the crisis, compared to the other economies in the CEE region.

Even as financial and stock markets begin to stabilise and indications that CEE economies may have reached the bottom have increased, a number of factors tend to confirm that the situation for workers in CEE might remain grim for some time and that it could probably take years before returning to pre-crisis employment levels. An indication of the intensification in labour market

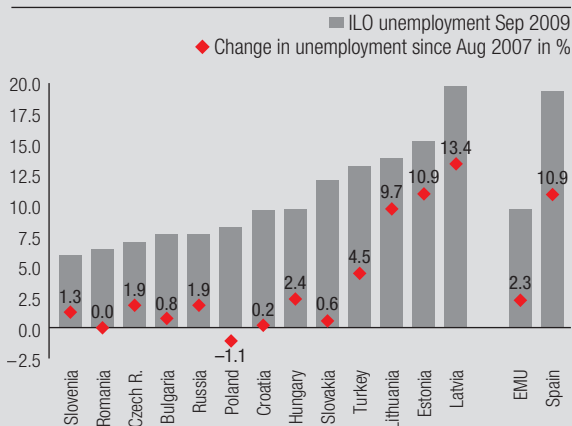
tensions is the declining number of job openings. Since mid-2007, vacancies have fallen by more than 50% on average with a growing number of unemployed persons competing for increasingly fewer jobs. The situation is also complicated by the fact that recovery in some of the sectors which were previously booming and important sources of employment in the past years (such as construction) might turn out to be quite long, with companies forced to undergo deep restructuring processes.

CEE households' expectations regarding the future development of labour market conditions clearly deteriorated as the crisis deepened, reaching unprecedented levels of pessimism in March 2009. Expectations have recovered somewhat in the second half of the year following the trends recorded in Western European countries. But important cross-country differentiation still holds, with Central European countries such as Poland and Slovakia recording the biggest improvement, while fears of unemployment still remain high particularly in countries such as Romania and Bulgaria.

With problems intensifying, particularly since the beginning of this year, it is hardly surprising that the labour market is weighing heavily on consumer sentiment and households' behaviour. While among Eurozone households, the perception

¹ Change in the number of unemployed between August 2007 and September 2009 including the following countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia, Turkey

Financial crisis hits CEE labour markets*



* Latest available data for Lithuania, Romania and Turkey is June 2009
Source: Eurostat, UniCredit Group CEE Strategic Analysis

Declining number of job openings



Source: Eurostat, UniCredit Group CEE Strategic Analysis

about changes in their financial conditions over the last twelve months has recorded steady improvement while remaining well below the pre-crisis level, in the CEE region and notably in the Baltics and SEE, there are hardly any such indications, with households increasingly stretched by the ongoing deceleration in disposable income and rising debt burden.

To minimise the impact of the crisis on domestic labour markets and prevent the risk of mass unemployment, many countries have taken discretionary steps to reinforce both active and passive measures on top of additional ones targeting a quicker reintegration of the unemployed into the labour market. The level and effectiveness of these measures obviously differ from one country to another. Automatic stabilisers have been an important part of the anti-crisis strategies put in place. Many governments have also been turning to short-time work schemes, similar to the one in place in Germany, or are planning to do so (as in the Czech Republic) to encourage firms to pare back the hours of their employees rather than terminate them. This is the case in Bulgaria and Croatia, although in the latter country its introduction came a bit late (end of May 2009) and with some restriction (firms should not have debts to the central and local budget) resulting in only a few firms having requested financing from such a scheme.

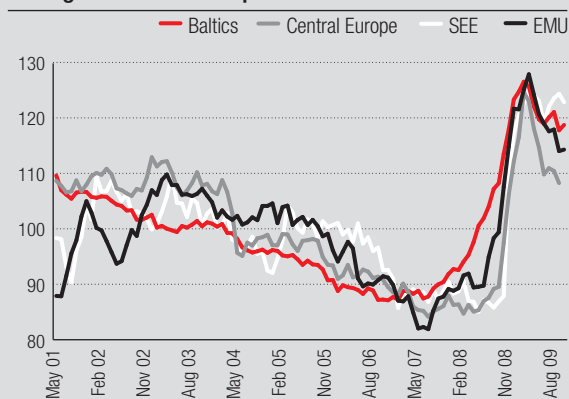
Large resources, also leveraging on the European Social Fund (ESF) in the case of EU member states, have been allo-

cated to support the creation of new jobs and training programmes. In Romania, the ESF are expected to subsidise around 15,000 jobs for unemployed persons, single parents and persons with disabilities. Similar measures also have been implemented outside the EU as for example in Russia, where participants in a specific training programme are also entitled to receive a salary during the training period.

A number of initiatives were also devised to encourage business start-up initiatives (including some co-payments under EU-related programs) as in the case of Bulgaria, Slovakia and other CIS countries.

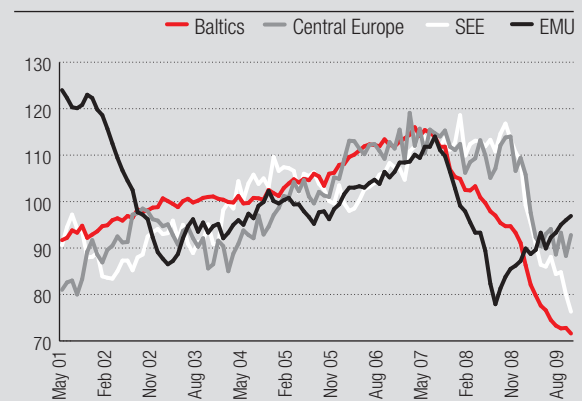
Unemployment allowances are also an important measure among the policies used to provide income support to people who are temporarily out of the labour force. During the present economic crisis, many amendments to the prevailing regulations have been made, for example with regard to the amount, eligibility criteria and duration of entitlement. The Czech government, for example, has opted for a weighting system in the benefit regime entitling claimants to receive 130 % of monthly benefit in the first two months then decreasing to 100 % for the subsequent two months. In Romania, the period through which the unemployed are entitled to receive the subsidy has been increased from six to nine months, while starting from 2010 the minimum wage will be increased by 18 % to reach RON 705 (or roughly EUR 165).

Expectation of labour market pressures easing somewhat for SEE*



*) Central Europe: Czech R., Hungary, Poland, Slovenia and Slovakia; SEE: Bulgaria and Romania; normalised unemployment expectations over next 12 M
Source: Commission Services, UniCredit Group CEE Strategic Analysis

CEE households' financial condition under stretch*



*) Normalised indicators about household financial situation over last 12 M
Source: Commission Services, UniCredit Group CEE Strategic Analysis

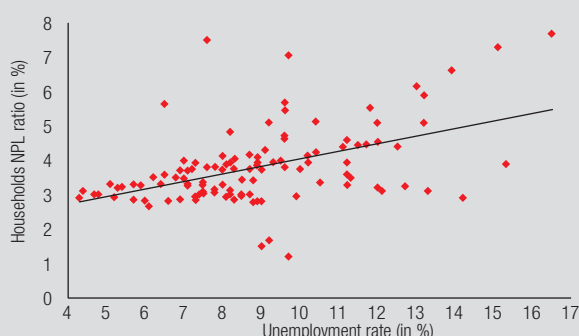
Governments also have put other measures in place in order to give social assistance to people who are detached from the labour market due to the recession and who are experiencing problems meeting their debt obligation, mainly in connection with mortgages. All over the region, the tense situation in the labour market, the lower dynamic of wages and the rising debt burden – particularly due to the large share of FX-denominated loans in some countries – are clearly driving a contraction in households' repayment capacity, triggering an increase in the default rate.

Variables such as unemployment have been proven to largely explain non-performing loan levels in empirical models. In line with the experience of other emerging economies, in the case of CEE countries as well, the empirical evidence tends to confirm the existence of a strong positive relationship between those two variables, with a one percent increase in the unemployment rate translating into a roughly 0.31 increase in the households non-performing loans ratio². Although loan quality generally lags the business cycle, past development in the CEE region suggests that in most of the cases the dynamic in non-performing loans follows phases of economic downturn and an increase in unemployment levels without a time lag with a few exceptions such as Croatia, where the highest correlation occurs at the third lead.

² Estimated through a panel regression for the period 2005: Q4 – 2009: Q3 including the following countries: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Slovakia and Turkey

Unless growth turns out to be much stronger than expected it therefore seems unlikely that unemployment will start to decline in a sustained fashion before the end of 2010 to mid-2011, reinforcing the expectation that the peak in households' solvency problems will not be reached before that time.

Credit quality problems strongly linked to tight labour market conditions*



* Sample of CEE countries including Bulgaria, Croatia, Czech Republic, Hungary, Poland, Slovakia and Turkey for the period 2005: Q4 – 2009: Q3
Source: UniCredit Group CEE Strategic Analysis

	Gross wage in 2008 (EUR)	Minimum wage 2008 (EUR)	Subsidy paid in case of unemployment
Central Europe			
Poland	905	313	18 months prior to unemployment a person must have worked at least 12 months and paid a social security contribution. If the person worked less than 5Y, the subsidy amounts to 80% of basic unemployment payment; b/w 5 and 20 years, it equals 100%, and if more than 20 years – 120%. The duration of the subsidy ranges b/w 6 and 18 months depending on a number of criteria (including age, number of family members and number of working years).
Hungary	799	273	Min. 60%, max. 120% of minimum wage. A person, who is losing his/her job is entitled to a benefit if he/she has worked at least 365 days in the previous 4 years before he/she became unemployed. Amount of the benefit is calculated on the last four quarters' average income. There are two phases of disbursement. In the first period (max 91 days) the max benefit is 60% of avg income's pension base. For the remaining time the amount is 60% of minimum wage. However, the upper amount is set as well, which is 120% of minimum wage.
Czech Republic	910	321	65% to 45% of net monthly salary; 65% in the first two months, 50% in the next two months, 45% in the remaining 1 – 7 months depending on the age of the unemployed; max. subsidy amounts to 58% of the average wage in the economy
Slovakia	723	243	50% of wage in the first 6 months. After 6 months material need benefit based on minimum living wages (not everyone is allowed to get this payment, the income of the entire household is considered)
Slovenia	1,391	227 ⁽¹⁾	The amount of financial social assistance to other entitled persons is determined as the difference between the minimum income to which the eligible person is entitled and his/her income determined in the manner specified by the Social Security Act. In case of financial assistance to a family the incomes of all the other family members are also considered. Financial social assistance is not granted to a single person or a family with savings or property amounting to or exceeding the level of 60 minimum incomes.

	Gross wage in 2008 (EUR)	Minimum wage 2008 (EUR)	Subsidy paid in case of unemployment
Baltics			
Estonia	819	278	An unemployed person has the right to receive either an unemployment insurance benefit or an unemployment allowance: (1) unemployment allowance if the person has been employed for at least 180 days during the 12 months prior to registering as unemployed; (2) people who have worked and paid unemployment insurance contributions for at least 12 months within the 36 months prior to losing their job have the right to receive unemployment insurance benefits for no longer than 360 calendar days depending on the insurance period. During the first 100 days of unemployment, the benefit is paid at the rate of 50% of the worker's previous pay. On the 101st day, the benefit goes down to 40% of the worker's previous pay.
Latvia	682	229	Unemployed persons who have been insured for not less than one year, and who have had compulsory social insurance contributions for unemployment made on their behalf in Latvia for not less than 9 months in the last 12 months period before the date of registration as unemployed are eligible for unemployment benefits. The amount of the unemployment benefit is calculated on the basis of the duration of employment and the unemployment insurance contribution earnings. The benefit is paid over 9 months and is calculated on the basis of the average insurance contribution earnings over the period of 6 months.
Lithuania	654	232	Unemployment insurance benefit is paid to unemployed persons who have paid unemployment insurance contributions for at least 18 months in the last 36 months. If unemployment insurance contributions were paid: (1) for less than 25 years, the insurance benefit will be paid for 6 months; (2) from 25 to 30 years, it will be paid for 7 months; (3) from 30 to 35 years, it will be paid for 8 months; (4) for 35 years and over, it will be paid for 9 months. Unemployment insurance benefit consists of two parts – a fixed part and a variable part. For the first three months, the unemployed person receives the total amount of the unemployment insurance benefit, for the rest of the time, the fixed part of the unemployment insurance benefit and 50% of the variable part.
SEE			
Bulgaria	268	113	From EUR 64 to 141. 60% of the daily average remuneration (working days only) in the past 9 months – but within limits set by the yearly state budget (minimum 6 BGN and maximum 12 BGN daily – working days only – in 2009) – payments are for a period of 4 to 12 months depending on work experience (at least 25 years experience needed to receive the maximum of 12 monthly payments; the payment period is extended by three months in 2010, thus payments will be paid for between 7 and 15 months in 2010).
Croatia	1,044	359	70% of the last 3 months average individual wage, but not more than minimal wage reduced for compulsory deductions for health insurance for the first 3 months of unemployment; 50% of the last 3 months average individual wage, but not more than 80% of corrected minimal wage for period of 3 to 12 months of unemployment. Starting from end of July 2009, the maximum subsidy for first 3 months of unemployment is HRK 2,183.52 (approximately EUR 300) and for 3–12 months of unemployment HRK 1,764.80 (approximately EUR 242).
Romania	348	141	Minimum subsidy paid in case of unemployment: 75% of the minimum wage for 9 months.
Other CEE			
Turkey	943	322 (2)	A system of severance compensation by the employer itself is in place. Workers get a payment in accordance with the numbers of months they worked times 2,200 YTL divided by 12 regardless of their salary, plus one month of their own salary.
Ukraine	234	64	Unemployed are entitled for 12 months of payments. To be eligible, a person should have been employed for at least 26 weeks in the preceding 12 months. The size of the subsidy is calculated based on their average salary in the last 6 months and the number of years worked. The maximum payment is: 70% for those with more than 10 years of work, 6–10 years – 60%, 2–6 years – 55%, up to 2 years – 50%. In the first quarter the subsidy is 100% of maximum, second quarter – 80%, subsequently – 70%.
Kazakhstan	343	79	Subsidy paid are for up to 4 months depending on the employment period. Different coefficients are applied for calculating final sum of subsidy.
Russia	471	96	Min EUR 21, Max 108. The payment period can not exceed 12 months (in general) within 18 months' period. The maximum subsidy is paid at the beginning of the period, gradually falling to the minimum at the end of the period.

Note: (1) Starting from July 2009; amounts are net. For every next adult person in the family: EUR 158.76; for a child: EUR 68.04; increase for single parent family: EUR 68.04; (2) As of 2009
Source: UniCredit Group CEE Strategic Analysis, Eurostat

Focus 2

Global household financial wealth during the turmoil

Daniele Fano and Teresa Sbrano – PGAM Research

How has the recent financial turmoil affected the financial choices of households? Has the impact been homogeneous or different across countries? And, when different, what factors emerge?

The USA, the Eurozone, CEE: three areas, three different stories

We will try to answer this question by looking at CEE countries, the Eurozone and the USA. In all countries, not surprisingly, the crisis shock has triggered a flight to security, with bank deposits and short-term bonds, money market mutual funds and government bonds becoming more popular.

But what are the longer-term implications of the crisis? We will focus on overall financial wealth and on the role of managed assets and will show that no “catch-all” answer is possible. The differing importance of long-term savings vehicles and also, most probably, different asset allocation traditions and regulations appear to have played a key role.

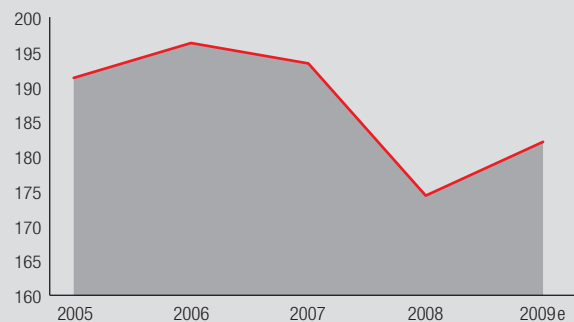
At the trough of the 2009 first quarter, when financial markets were shaken by a global fall in equities, USA household financial wealth touched 286% of GDP, down from 353% in 2007, or a loss close to 25%. In other words in the USA financial wealth has been affected by the crisis even more than GDP. A similar, though less dramatic story holds for the Euro area. Here, for the same period the decline was from 193% to 174% of GDP, or 11%. In contrast, CEE countries have experienced only a minor contraction in the households financial assets to GDP ratio.

Highlighting the differences

■ Different social security systems and long-term savings incentives

In all countries the issue of aging has produced an increasing focus on long-term savings. One of the explanations of the higher household financial wealth to GDP ratio in the USA vs Europe is the different social security tradition. With the exception of the Netherlands, Continental Europe has a “bismarckian” tradition with a strong public first pillar. Occupational second pillar vehicles and third pillar individual retirement solutions have only recently been incentivised. In France, Germany and Italy the latter through insurance policies rep-

EMU: Total Financial Assets (% of GDP)



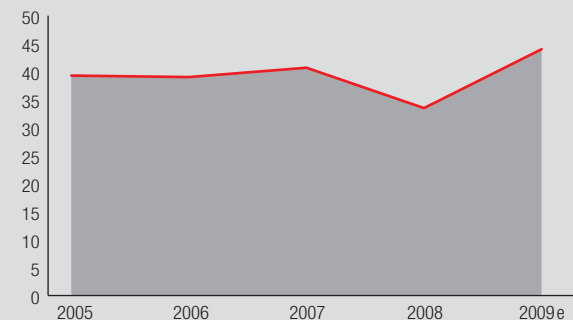
Source: PGAM Research on ECB data as of second quarter 2009

US: Total Financial Assets (% of GDP)



Source: PGAM Research on Federal Reserve data as of second quarter 2009

CEE: Total Financial Assets (% of GDP)



Note: CEE aggregate including Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia and Turkey
Source: UniCredit Group CEE Strategic Analysis

represent the bulk of households' long-term savings. On the other hand, in the USA (and in the Netherlands) pension funds represent an important component of household wealth.

In the CEE pension funds were introduced with the economic reforms in the nineties.

In many countries saving in these funds is either compulsory or strongly incentivised. This explains the very strong role and resilience of longer term savings in the CEE countries.

In all countries we observe much greater volatility in the mutual fund sector, the shorter-term segment of managed assets. The new popularity of non-managed assets mainly reflects the flight to bank deposits.

■ Different stages of growth

The level of financial wealth is also a reflection of stages of growth. As CEE countries catch up with other developed nations, we expect financial wealth to continue to increase faster than GDP with some clear differentiation across countries. Financial wealth is a "superior good" and its accumulation reflects both the spreading of affluence and the expansion of the economy.

■ Different asset allocation preferences and systems

Last but not least, differences in asset allocation explain much of the volatility experienced. The greater risk propensity of US investors has certainly allowed them to accumulate wealth at a much higher pace than Europeans in the eighties and nineties. Such higher risk propensity has, however, also exposed them to a greater shock.

Lessons and caveats for the future

Looking ahead, it is the key role of asset allocation we should focus on. In a world that is bound to remain, to a greater or lesser extent, characterized by uncertainty and volatility, the quality of portfolio diversification will be key. No asset class alone can provide the appropriate returns and hedges. What yesterday provided high growth or a safe-haven may become less rewarding tomorrow and vice versa. The development of institutional asset management, be it through long-term vehicles such as pension funds and life insurance or through shorter term vehicles such as mutual funds, has the potential for attaining even broader diversification in household portfolios.

USA

	2005	2006	2007	2008	2009 e
Pension and life insurance (% of GDP)	94.5	100.5	101.4	82.0	85.5
Mutual funds (% of GDP)	29.1	31.8	33.6	24.3	26.5
Non managed assets (% of GDP)	204.6	215.8	217.7	189.7	202.7

EMU

	2005	2006	2007	2008	2009 e
Pension and life insurance (% of GDP)	52.2	54	54.6	52.1	54.7
Mutual funds (% of GDP)	16.2	16.4	15.0	10.5	12.1
Non managed assets (% of GDP)	122.9	125.9	123.8	111.7	115.2

CEE

	2005	2006	2007	2008	2009 e
Pension and life insurance (% of GDP)	5.6	6.2	6.6	5.3	7.3
Mutual funds (% of GDP)	3.5	3.6	4.4	2.3	3.0
Non managed assets (% of GDP)	30.2	29.3	29.8	25.9	33.6

Source: PGAM Research and UniCredit Group CEE Strategic Analysis

Focus 3

Bond markets showed a very different path ... equity was almost equally hit

UniCredit CEE Research

The impact of the financial crisis on the local bond markets differed significantly within the CEE region. Countries with relatively smaller public/private debt levels were able to significantly reduce their interest rates (Turkey, Poland and the Czech Republic). On the other hand, in countries where the private sector had accumulated a significant amount of FX debt the central bank had to keep monetary conditions relatively tight and could cut rates when the external markets improve. This differentiation was reflected in local bond market performances.

Looking ahead, we believe that the bond market outlook will be determined by the central banks' response to potential FX appreciation pressure. Overall we expect that the significant external balance improvement will put further appreciation pressure on FX, which central banks will continue to resist with a dovish monetary policy. In addition to a temporary inventory driven deterioration we expect CEE current accounts to continue to deliver positive surprises as household demand is still very weak (lower wages, soft lending growth) vs. a somewhat improved outlook for exports. We believe that the associated FX appreciation pressure is still unwelcome and central banks will continue to resist it with low rates and interventions. Against this backdrop, although both Poland and the Czech Republic signaled the end of their easing cycles we think that no imminent rate hikes are on their agenda.

We expect Turkey to be first country where the central bank hikes rates given our expectations that the Turkish economy will be the

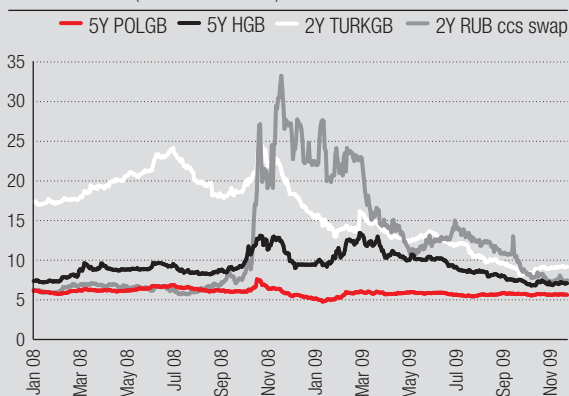
fastest growing economy in 2010. Against this backdrop we see relatively strong bond market performance in H1 2010 across the region (as central banks are trying to prevent their FX from appreciating the short ends will outperform). In the second half of the year we expect softer bond market performance as by then all of the central banks will be done with rate cuts.

The CEE equity markets were severely hit by the crisis and they underperformed Latin American and Asian markets between Sept 2008 and March 2009. Banks were the obvious candidates for selling equities but other sectors also suffered. Since early March in line with the stabilisation of the global markets, CEE equity markets have improved.

Even after another period of stellar returns in EME, it appears that the range of opinions on the direction of markets is still quite wide. We believe that the rally in EME equities will last into Q1 2010, with support from firm commodity prices, a falling cost of equity, a weak USD and a prolonged surge in liquidity. Volatility continuing to track down will be key ahead of a cresting of the wave as we move further into 2010.

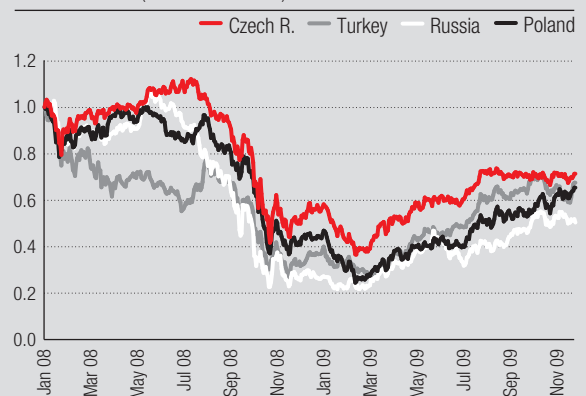
The crucial issue will be to time the next upper cyclical turning point of business expectations. This will probably be the case in the course of H1 2010 and a rising vulnerability of equities to stress factors is to be expected thereafter. Once the scope for a further re-rating of multiples is largely exhausted, stock markets will, no doubt, be extremely dependent on the continuation of earnings momentum.

Bond market performance since the outbreak of the crisis (selected countries)



Source: UniCredit CEE Research, Bloomberg

Equity market performance since the outbreak of the crisis (selected countries)*



* MSCI index, local currency USD unhedged
Source: UniCredit CEE Research, Bloomberg