REUTERS

Baltics, Balkans brace for hard landing

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By Michael Winfrey – Analysis

PRAGUE (Reuters) - The credit crunch has killed a consumer-led boom in the European Union's Baltic newcomers and now threatens the bloc's Balkan economies with a bumpy economic landing at best.

Latvia and Estonia are in recession, and economists expect Lithuania to see a sharp drop in growth this year.

To the south, Romania and Bulgaria are expected to actually accelerate, but analysts say chances are growing that their fast-paced economies will slam on the brakes as credit dries up.

"A credit crunch would have a devastating impact on these economies, which have heavily relied on credit growth to finance the expansion," BNP Paribas said in a report.

"Even in those countries that are not burdened by excessive external and/or domestic imbalances, a credit crunch would markedly reduce the growth rate."

Of the biggest ex-communist EU economies -- Poland, the Czech Republic and Hungary -- only the last has relatively high exposure to foreign currency loans. But all are suffering from a slowdown in the euro zone that has hit their exports.

On the positive side, less credit could help let some air out of huge Baltic and Balkan current account deficits and blunt the bite of high inflation due to waning consumer demand.

But a worst case scenario includes a protracted collapse in growth that will led to a deep recession and job losses that could set these countries years back in their goal to catch up with their richer EU counterparts.

BALTIC WOES

The global credit crunch has hit emerging markets -- the Icelandic crown dropped 23 percent in one move on Monday -- as investors pull out of traditional higher-risk, higher-return assets and hoard cash due to trouble finding cheap ways to borrow.

That has exacerbated a crisis in Latvia and Estonia that started with a retreat of Scandinavian banks last year which popped the housing bubble, one major driver of growth.

"We expect to see negative growth in both Estonia and Latvia during 2008 and 2009," said Anssi Rantala, Nordea economist for the Baltics. "We think the recession will be a protracted one. Growth will not pick up before 2010."

On Friday, ratings agency Fitch downgraded Lithuania, Latvia and Estonia and kept their outlooks negative, citing worries about the countries' current account deficits.

Lithuania has so far withstood the storm best, with growth easing only to 5.2 percent in the second quarter, from 8.8 percent in all of 2007. But Estonia's economy contracted by 1.1 percent, from 7 percent for last year.

Economists say Latvia may come off relatively worst, with growth diving to 0.1 percent between April and June, from 11 percent a year earlier.

Without new abundant sources of credit, firms are struggling to find funds, and economists said a "hard landing", which happens when an economy abruptly goes from a period of expansion to recession, was already underway.

"Latvia is facing at best a period of stagflation and at worst a full blown recession the like of which has not been experienced in post-Soviet Latvia," said the Riga-based Baltic International center for Economic Policy Studies.

"Cumulatively the Latvian economy may lose more than two years worth of GDP growth relative to the previous trend."

BALKAN SHADOWS

Romania's leu currency has dropped 10 percent since September 12, the day before U.S. investment bank Lehman brothers filed for bankruptcy, starting a new phase of the credit crisis.

The issue here is that, unlike the Baltics and its southern neighbor Bulgaria who fix their currencies to the euro in currency board regimes, Romania's floating leu poses risks.

That means that households could face higher debt payments on loans taken in foreign currencies, which "could lead to problems for corporates and households, and potentially a collapse of the FX borrowing cycle", JP Morgan said.

Another problem is that Romania's 3-month interbank rate has risen 3.5 percentage points since March. Western parent banks now account for 70 percent of local bank financing, which could dry up if credit markets in western European remain bogged down.

In Bulgaria, which has seen booming growth in the real estate and construction sectors, the government expects growth to slow to 6 percent or slightly less next year, from 7.1 in the first half of 2008, but some analysts say it fall to 4 percent.

"The main source of trouble is the squeeze on consumption in case foreign equity swiftly withdraws from the real estate and construction sectors," 4Cast said in a report. "The resulting rise in unemployment reduces household's abilities to meet their credit obligations."

BANKS, CURRENCIES

Central bankers across the region have clamored to reassure depositors and investors that their banking sectors are sound.

But economists warn that countries with wide current account deficits and whose financial sectors are most exposed to foreign currency loans will face the most pressure.

Despite those dangers, none of the four ex-communist EU countries with regimes pegging their currencies to the euro -- Latvia, Lithuania, Estonia or Bulgaria -- are expected to devalue their units, because doing so could potentially spark a banking crisis, even if the pegs hurt growth.

"Irrespective of any turmoil globally, the Bulgarian economy will continue to adjust within the currency board arrangements and the existing fixed exchange rate," said Bulgarian central bank Governor Ivan Iskrov. "This is our permanent anchor."

(Reporting by Michael Winfrey; editing by Patrick Graham)