Eastern Europe’s Economic Outlook

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Central and Eastern Europe Have Enjoyed a Rare Period of Rapid Growth

- Economic transition finally paid off
- Ten countries from the region joined EU, two will have adopted the euro by 2009, others will follow during the next five years
- Safe for a few exceptions, they have been fully integrated into the European and world economy by now
- Highly attractive region for foreign investment

<table>
<thead>
<tr>
<th>GDP Growth in %</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<td>3.4</td>
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<td>6.4</td>
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Central Europe and the Baltic Region: A Slowdown is Due
Big Success, Big Risks—How Likely is a Boom-Bust Cycle?

• Central Europe caught up rapidly with Western Europe since 2004 backed by strong and often overheating domestic demand:
  + Rising wages, falling unemployment supported consumer confidence
  + High FDI inflows raised productivity, labor demand
  + EU transfers supported infrastructure investment, gave spur to already-hot construction sector
  + Foreign exchange borrowing was facilitated by quasi-eliminating exchange rate risks through currency pegs

• The downside:
  - Massive current account deficits across the region
  - Huge foreign debt stock was accumulated
  - Rising inflation threatened pegged exchange rate
  - Public sector deficit remained too large
After more than five years of strong growth, a cyclical slowdown is due.
Positive effects of EU accession are losing strength:
- Access to common European market
- Access to EU regional funds, EU transfers for infrastructure modernization
Correction of large, often massive structural imbalances is underway.
Many households are overloaded with debt.
Spendthrift consumer trends have to change, saving has to increase.

Global financial market risks compound the slowdown:
- Foreign investors reconsider positions, risk awareness increases
- Direct impact from bankrupt institutions
- Indirect impact through weak external demand
The Balts are Facing Hard Times...

Quarterly YY GDP-Growth in the Baltic Region
(Percent)

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While some major countries in Central Europe are coming close to what could be called safe havens.
Inflation Accelerated Due to External Effects But Also Due to Strong Domestic Demand...

Central Europe's CPI Inflation
(Percent)

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...Overheating in Some Places

Consumer Price Inflation in the Baltic Region

(Percent)

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Current Account Deficits Became Entrenched, Foreign Debt Rose Rapidly

Central Europe's Current Account Balance
(Percent)

-24 -22 -20 -18 -16 -14 -12 -10 -8 -6 -4 -2 0

2004 2005 2006 2007

Czech Republic  Hungary  Poland  Slovakia  Slovenia
Slovakia  Slovenia
Romania

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Serious External Vulnerabilities Have Been Exposed, Raising Questions of Refinancing and Debt Rollover

Current Account Balance in the Baltic Region

(Percent)
A Pan-Central European Economic Crisis?

• Highly vulnerable countries exist, yet a region-wide contagion following a currency crisis in one country seems very unlikely
• Regional dependencies through trade and cross-border investment have increased since EU accession
• Equally important were rising trade and investment volumes with non-EU members, especially Russia
• Central Europe was lucky so far to largely escape direct impact of global financial crisis, banking crisis did not spread over
• Indirect effects will do harm though
• Investors in general are more risk-aware, vulnerable central European markets could get in deep trouble, while others still thrive
Russia and Ukraine: At the Receiving End of the Commodities Boom
Russia’s Economy is Boasting an Impressive Recovery

- Soaring oil revenues turned Russia from a bankrupt country to one of the wealthiest within just ten years
- Steady GDP growth at 7-8% per year
- More than US$50 billion FDI inflows in 2007 (outflows almost as high)
- Twin surplus in public finance and current account

! On the downside are overheating trends as inflation remains at double-digit level

! Oil dependency is the Achilles’ heel of the Russian economy

The fossil resource extraction sector accounts for:
- Around a quarter of GDP (depends on how you measure it)
- Two thirds of Russia’s merchandise exports
- Almost 40% of fiscal revenues
- …but only for 1.5% of employment.
Ukraine’s Economic Record is Also Impressive, but Overheating Threatens Stability

- Surging export revenues, benefitting from the steel boom during the last five years, triggered an unprecedented boom
- High foreign investment since a major breakthrough in 2005 (close to US$10 billion in 2007)
- Ukraine still has a huge potential for catching up in terms of per-capita income
- Domestic demand soared, backed by wages, household incomes, new credit facilities

On the downside: The economy is in overheating mode:
- A huge current account surplus swung deep into deficit
- Inflation hit decade-high at 31% yy in May 2008
- Policy mistakes have aggravated overheating trends:
  - Populist fiscal policies raised social transfers too much
  - Monetary strategy obstructed by U.S. dollar peg
While Russia Has Surprised On the Upside in 2008, Ukraine is Heading For a Slowdown and Possible Downward Correction

Quarterly YY-Growth in Russia and Ukraine
(Percent)
Inflation Has Remained a Key Headache in Russia and Ukraine

CPI Inflation in Russia and western CIS
(Percent)

- Russia
- Belarus
- Ukraine

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Russia Boasts a Huge External Surplus, While Ukraine’s External Balance Swung Deep Into Deficit

Current Account Balance in Russia and western CIS
(Percent)

-8 -6 -4 -2 0 2 4 6 8 10 12

2004 2005 2006 2007

Russia Belarus Ukraine

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Central and Eastern Europe‘s Medium Term Outlook: Solid Growth and Highly Vulnerable Countries Side-By-Side
Central and Eastern Europe’s outlook—Weakening Domestic Demand Compounded by Sluggish Exports

- Global growth will recover, not before 2010
- Oil price should recover and stay fairly high at around US$110 per barrel for the next three years
- Financial crisis to threaten global and regional trends for at least another year
- Nevertheless, the direct impact of the global financial crisis should remain relatively benign for the region (except for Russia perhaps)
- Western Europe’s outlook has clearly deteriorated for 2009, Germany is edging closer to stagnation
- The cyclical slowdown in the region will prevail for the next two years before growth accelerates again
- Anticipation of euro adoption during 2010-15 could support recovery
Central Europe: Robust Domestic Demand Cushions Against External Shocks, Weak Global Growth

Central Europe's GDP Growth

(Percent)

2007 2008 2009 2010

Czech Republic
Slovakia
Poland
Romania

Hungary
Slovenia
Bulgaria

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Baltic Region Will Need at Least Two Years to Adjust After The Boom

Real GDP Growth in the Baltic Region
(Percent)

2007 2008 2009 2010

Estonia Latvia Lithuania
Unless Oil Price Plunges Below US$60, Russia Will Grow Robustly

Real GDP Growth in Russia and western CIS
(Percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Russia</th>
<th>Belarus</th>
<th>Ukraine</th>
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<tbody>
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<td>2007</td>
<td>8.0</td>
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<td>2008</td>
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<tr>
<td>2009</td>
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<tr>
<td>2010</td>
<td>5.6</td>
<td>6.0</td>
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</tbody>
</table>
Ukraine Threatened By Political Crisis, Gas Price Hike, Overheating Trends, Dysfunctional Markets

Current Account Balance in Russia and western CIS (Percent)

-2007 2008 2009 2010

Russia
Belarus
Ukraine

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Central and Eastern European Country Risk Scoreboard

+ **Russia** (very robust demand, though dependent on oil, political risks)
+ **Poland** (fairly strong and balanced recovery, still concerns over public finance)
+ **Czech Republic** (strong growth though concerns over public finance)
+ **Slovakia** (high growth level though auto export boom loses traction)
+ **Slovenia** (strong recovery with modest overheating trends)

- **Ukraine** (political risks, gas price in 2009, current account deficit, hryvnia stability)
- **Baltic countries: Estonia, Latvia, Lithuania** (current account deficit and external financing concerns)
- **Romania** (current account deficit and external financing concerns)
- **Bulgaria** (current account deficit and external financing concerns)
- **Hungary** (public sector restructuring)
Thank You

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