

EMERGING EUROPE CHART BOOK

Aug. 2007



Markets hit by increased investor risk aversion

- The troubles in US credit markets prompted a sell-off in Emerging Europe assets last month. Equity markets initially fell by around 2-7%, currencies by 2-5% and bond spreads rose by around 40bps as investor risk aversion increased. Those countries with the largest current account deficits were generally hit the hardest. Most notably, the Turkish lira dropped by 5% and the equity market fell by 7% although part of these losses have since been reversed.
- The boom in **Russia** continues and the recent acceleration in investment should boost potential growth. But inflationary pressures are also building and the Central Bank will now struggle to meet its year-end target of 8%. ([Page 2.](#))
- **Turkish** markets responded positively to last month's parliamentary election, but all of the gains were lost during the subsequent global sell-off. Markets are likely to remain volatile over the coming months as the presidential election nears and investors undertake a wider assessment of risk ([Page 3.](#))
- Strong growth in **Poland** is showing no sign of slowing and capacity constraints are beginning to bite. While the National Bank kept interest rates on hold 4.5% last month, the market is pricing in further hikes to nearly 5% by the end of the year. ([Page 4.](#))
- Likewise, strong growth in the **Czech Republic** is also creating capacity constraints and interest rates were raised by 25bps to 3% last month. ([Page 5.](#))
- **Hungary** remains the sick man of Central Europe. During the recent sell-off spreads against 10-year Bunds rose by over 40bps against, the BUX Index fell by over 4% and the forint fell by nearly 3% ([Page 6.](#))
- **Slovakia** remains Central Europe's star performer. The recent surge in industrial production is now being complemented by a pick-up in consumer spending, and, while medium-term price pressures remain, EMU entry in 2009 looks increasingly likely. ([Page 7.](#))
- **Romania** was hit reasonably hard by the recent sell-off - the leu fell by 2% and the equity market fell by nearly 10%. By contrast, **Bulgaria** escaped relatively unscathed and the equity market actually gained 1.5% during the week of the sell-off. ([Page 8.](#))
- Preliminary estimates suggest that GDP growth in Lithuania cooled slightly in Q2. But concerns about overheating in the **Baltics** remain. Inflation has accelerated once again in Latvia and further policy tightening is required if a 'soft-landing' is to be achieved. ([Page 9.](#))

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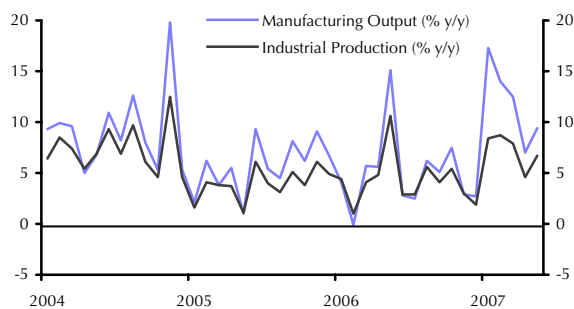
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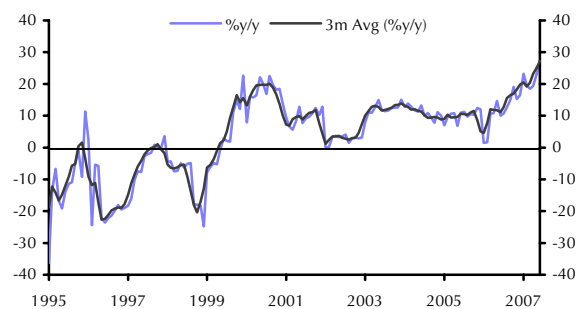
Russia

- The Russian economy remains in rude health. Industrial production growth accelerated to 6.7% y/y strong in June, on the back of a pick-up in manufacturing output (1). This appears to reflect a surge in domestic demand for capital goods – the production of hydraulic turbines rose by a massive 320% y/y. What’s more, investment in productive capacity grew at a record rate of 27% in June (2).
- The recent rise in oil prices has increased liquidity in the banking system and points to a further fall in interest rates (3). This, in turn, will stoke domestic demand and heighten concerns about the inflation outlook. CPI rose to 8.5% in June from 7.8% in May. But the pick-up in producer prices is perhaps of more concern as it suggests that the Central Bank will now struggle to meet its end-year target to reduce CPI to 8% (4). The CBR are therefore likely to engineer a further appreciation in the ruble but lags in the pass-through to domestic prices mean that this is unlikely to have an impact on inflation for around six months (5).
- The MSCI index of emerging market equities fell by more than 6% during the recent market sell-off. By contrast, high oil prices cushioned the drop in the RTS index, which fell by only 4% (6).

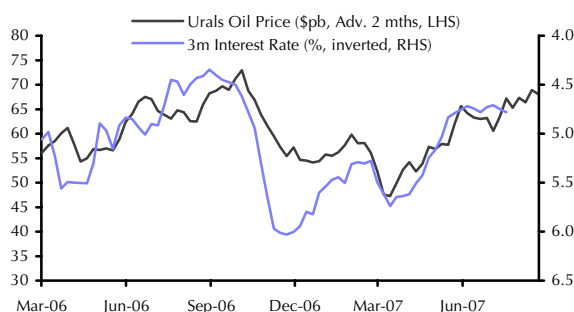
1. Industrial Production & Manufacturing



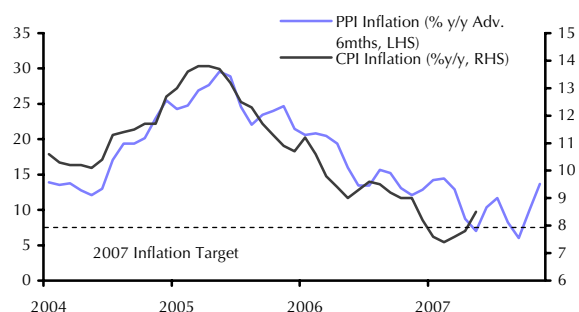
2. Investment in Productive Capacity



3. Oil Prices & Interest Rates



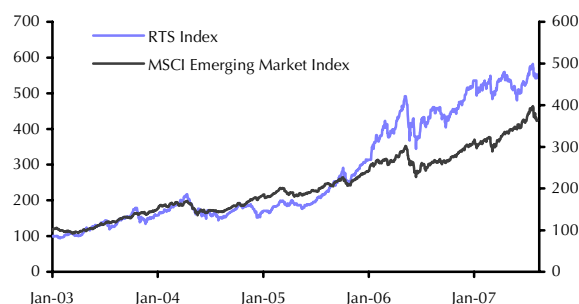
4. Consumer & Producer Prices



5. Exchange Rate



6. Equity Market



Sources – Thomson Datastream, Bloomberg, Eurostat

Turkey

- Turkish markets have been extremely volatile over the last month. Following the AK Party's strong performance in the parliamentary elections, the equity market rallied to record highs, bond spreads fell and the lira strengthened by around 2.5%. However, rising investor risk aversion in the wake of the US sub-prime crisis caused all three markets to subsequently tumble. The ISE 100 Index is down 7%, the lira has fallen by 5% against the US dollar and bond spreads have spiked sharply to over 225bps. **(1, 2 & 3)**.
- Headline CPI fell to 8.6% y/y in June, from 10.9% in March. The reduction has been driven by lower core inflation, which is now below 9% y/y **(4)**. With price pressures fading, speculation of interest rate cuts has resurfaced. But the recent market volatility means that rates are likely to remain on hold at 17.5% until Q4 **(5)**.
- Elsewhere, our forecast for a soft-landing in the real economy remains on track. Consumer confidence has rallied in recent months and is likely to strengthen further following the AK Party's return to power. On the face of it, this would be consistent with growth in private consumption of over 5% y/y for the rest of the year **(6)**.

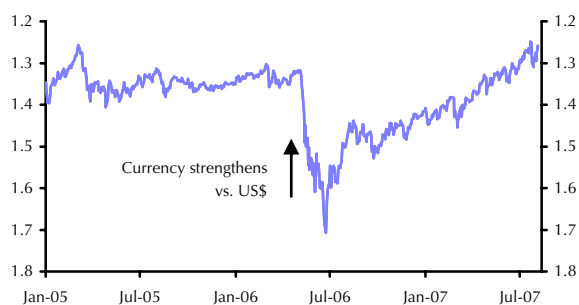
1. Stock Market (ISE Index)



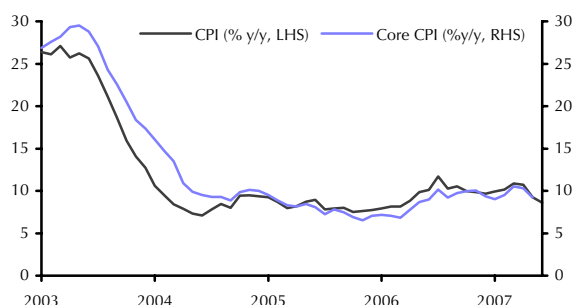
2. 10 yr. Bond Spreads (vs. US, bps)



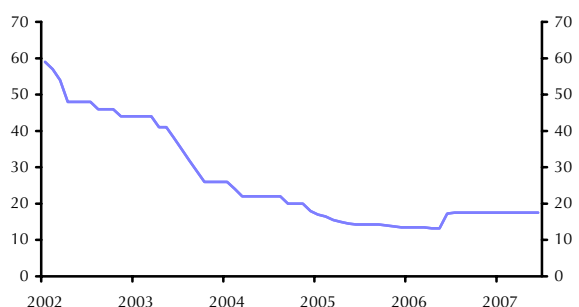
3. Exchange Rate (vs. US\$)



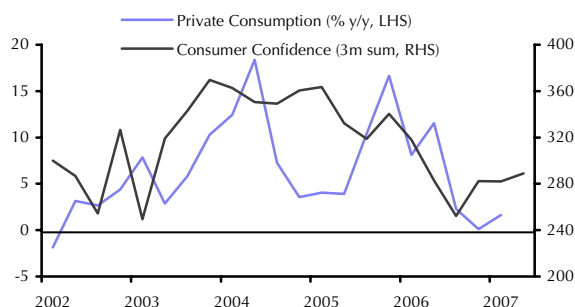
4. Consumer Prices (% y/y)



5. Benchmark Interest Rates (%)



6. Private Consumption & Consumer Confidence

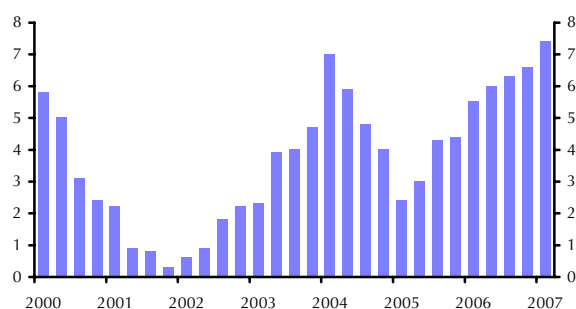


Sources – Thomson Datastream, Bloomberg

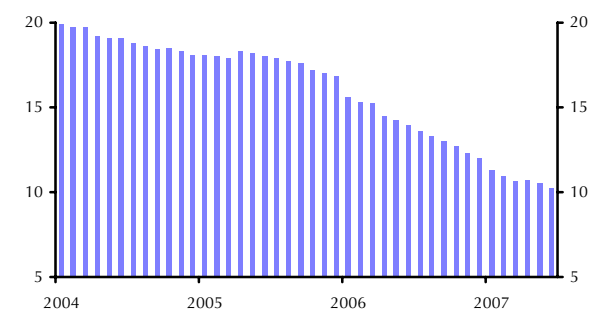
Poland

- GDP growth in Poland has accelerated in each of the last eight quarters and reached 7.4% y/y in Q1 **(1)**. But capacity constraints are now beginning to bite. The labour market has tightened significantly over the last few months, with unemployment hitting a record low of 10.2% in June. **(2)** And with wage growth now outstripping productivity growth in certain sectors of the economy, there are signs that unit labour costs are beginning to rise **(3)**.
- Headline CPI hit accelerated to 2.6% y/y in June, slightly above the National Bank's target of 2.5% **(4)**. But price pressures are likely to build over the next few quarters. In its latest inflation report the National Bank forecasts inflation hitting 2.8% by the end of the year. Interest rates were kept on hold at 4.5% in July's meeting of the MPC but the market is pricing in a hike to nearly 5% by the end of the year **(5)**.
- The zloty fell by 1.5% to 3.80/euro during the recent emerging market sell-off **(6)**. But the prospect of further interest rate hikes mean that the latest bout of currency weakness could prove to be short lived.

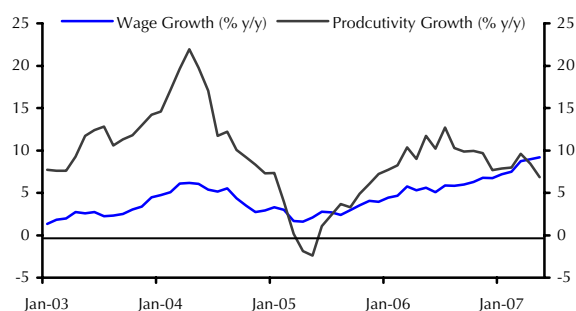
1. GDP Growth (% y/y)



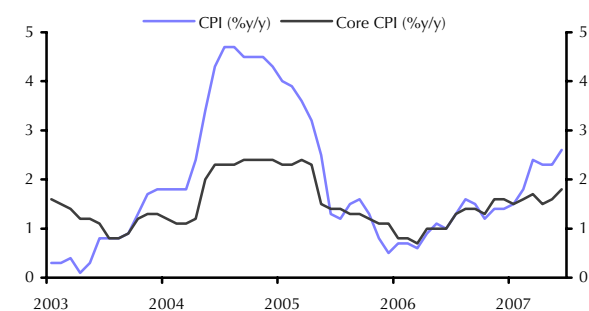
2. Unemployment (%)



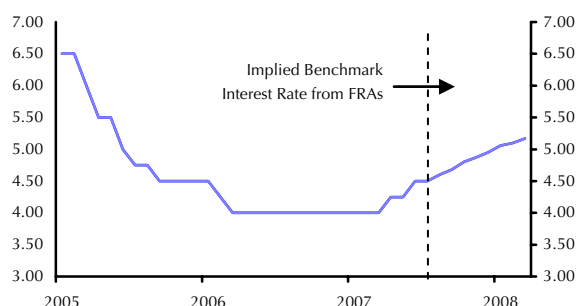
3. Wage Growth & Productivity (Industry)



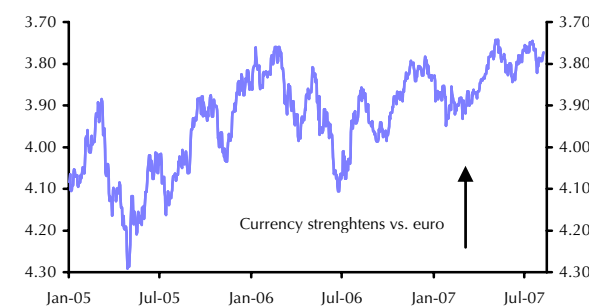
4. Consumer Prices (% y/y)



5. Benchmark Interest Rate (%)



6. Exchange Rate (vs. euro)

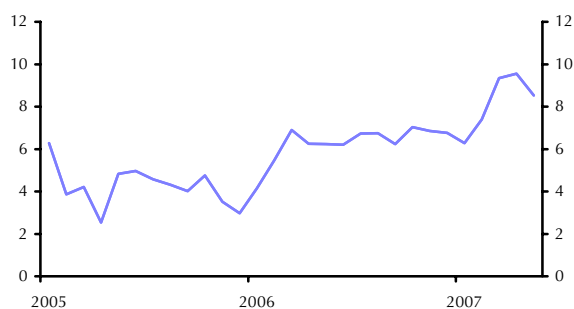


Sources – Thomson Datastream, Bloomberg, Eurostat

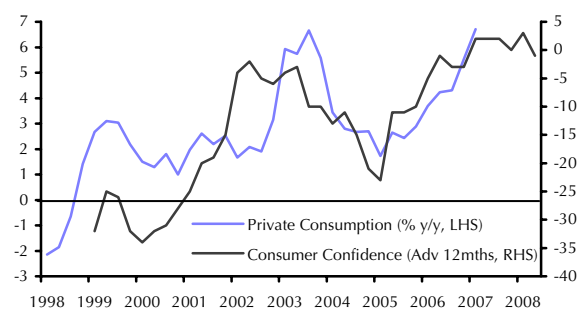
Czech Republic

- Retail sales growth dipped to 8.5% y/y in May from 9.6% in April but the Czech economy remains in good shape **(1)**. Consumer confidence remains very high by historic standards and points to growth in private consumption of around 6% y/y over the next year or so **(2)**. This should ensure that GDP growth remains comfortably above its potential rate of 4.5%.
- Like Poland, strong growth has caused the labour market to tighten dramatically in recent months. Unemployment has fallen to record lows and wage growth is running at 8% **(3)**. While this has fed into a pick-up in core inflation hikes in excise duties have also played a role in pushing headline inflation to 2.6% in June **(4)**. More importantly, the CNB's latest inflation report forecasts CPI to hit 4.2% by the end-2008 – well above its central target of 3%.
- In response, interest rates were hiked by 25bps to 3% in July and the market is pricing in a further rise to 3.5% by the end of the year **(5)**. Much will depend on the currency though. Expectations of further interest rate hikes have driven the koruna up in recent weeks. But the fact that it did not strengthen further during the recent bout of market volatility suggests that its use as a financing currency for carry trades is not as prevalent as initially believed **(6)**.

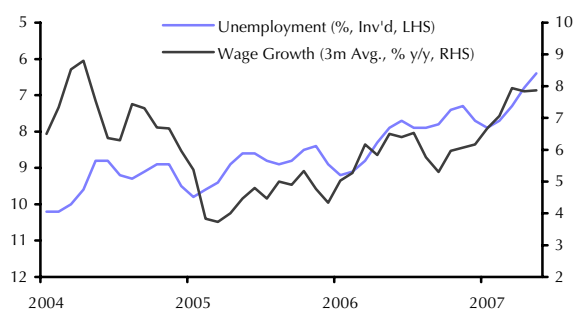
1. Retail Sales (% y/y, 3m Avg.)



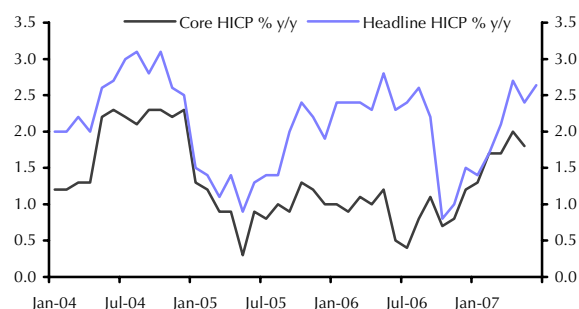
2. Private Consumption & Consumer Confidence



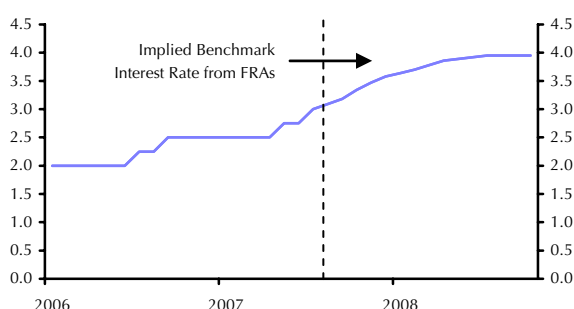
3. Wage Growth & Unemployment



4. Consumer Prices (% y/y)



5. Benchmark Interest Rates (%)



6. Exchange Rate (vs. euro)

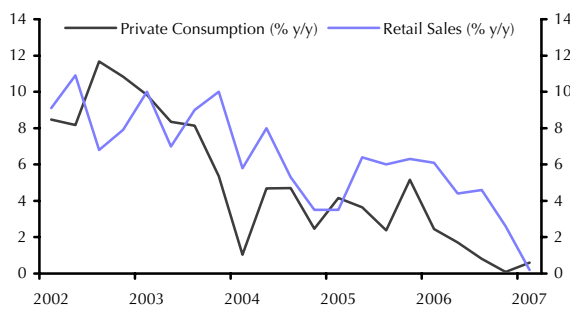


Sources – Thomson Datastream, Bloomberg

Hungary

- Hungary remains the sick man of Central Europe. Domestic demand has slumped as a result of the government's much needed fiscal austerity plan, with the result that retail sales and private consumption are barely growing at all **(1)**. By contrast, the export sector has been performing reasonably well. The ongoing recovery in the euro-zone has supported demand for industrial products, although there are now signs that output growth is beginning to fade **(2)**.
- Stronger than expected growth in net exports helped to cushion the slump in domestic demand and bolster government receipts. The budget deficit tends to grow faster in the first half of the year, and data to June suggests that the government is on track to reduce the deficit to its target of just over 1,500bn HUF for this year **(3)**.
- But this would still leave the deficit at over 6% of GDP and Hungary remains a relatively risky prospect for investors. During the recent market sell-off spreads against 10-year Bunds rose by over 40bps against, the BUX Index fell by over 4% and the forint fell by nearly 3% **(4, 5 & 6)**.

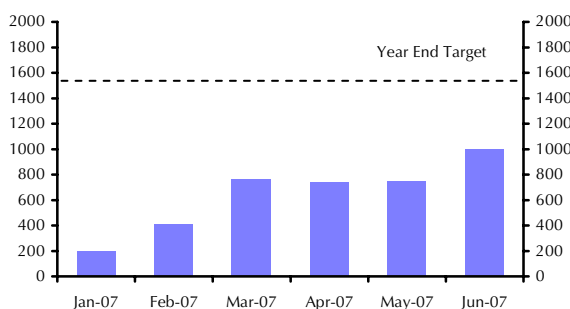
1. Private Consumption & Retail Sales



2. Industrial Production (% y/y, 3m Avg.)



3. General Gov't Budget Deficit (YTD, HUF Bn.)



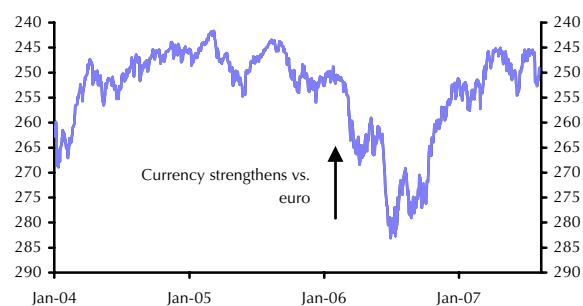
4. Bond Spreads (vs. 10yr Bunds)



5. Equity Market



6. Exchange Rate (vs. euro)

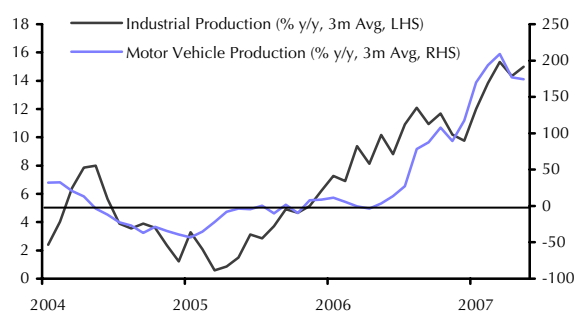


Sources – Thomson Datastream, Bloomberg

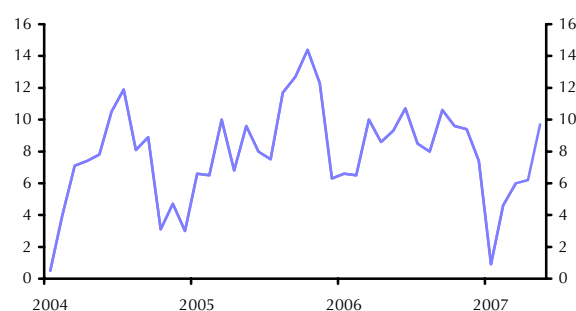
Slovakia

- Slovakia remains Central Europe's shining star. GDP growth of 9% y/y is being driven by a massive surge in industrial production, which in turn owes much to recent foreign investment in the auto sector (1). But there are signs that consumer demand is also starting to pick up. Retail sales growth accelerated to 9.7% y/y in May, the fastest rate in almost a year and up from 6.2% in April (2).
- Like Poland and the Czech Republic, strong growth is causing the labour market to tighten. Unemployment fell to an all-time low of 8.3% in May and real wage growth accelerated to 6.8%, the fastest rate in over two years (4).
- For the time being inflation remains under control. While the national measure of CPI rose to 2.5% y/y in June from 2.3% in May, the Harmonised measure of CPI, which is used to assess performance against the Maastricht Criteria, remained flat at 1.5%. (5). With EMU entry looking increasingly likely in 2009, interest rate decisions are increasingly determined by currency considerations. The National Bank has kept interest rates on hold at 4.25% since April, but could hike to 4.5% by the end of the year in order to keep pace with tightening by the ECB (6).

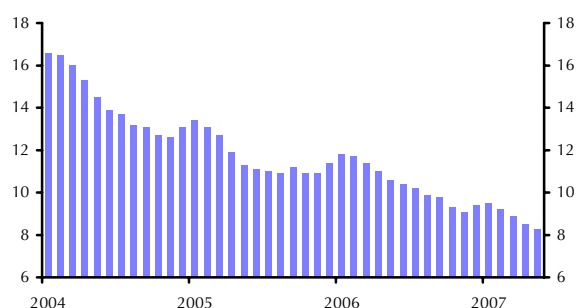
1. Industrial Production & Vehicle Production



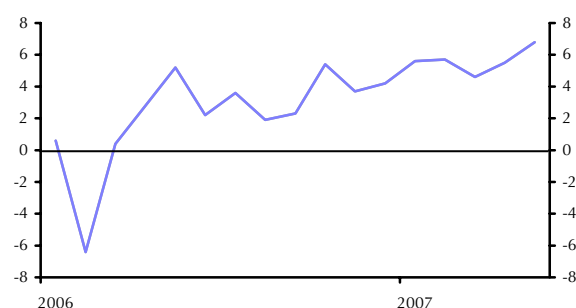
2. Retail Sales (% y/y)



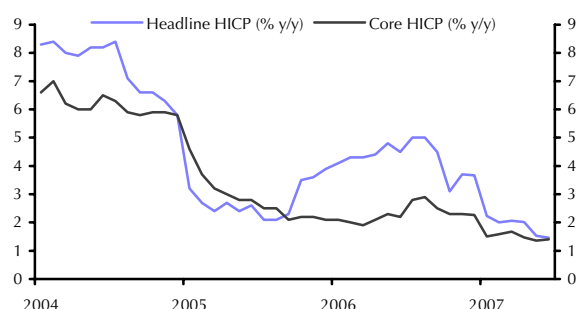
3. Unemployment (%)



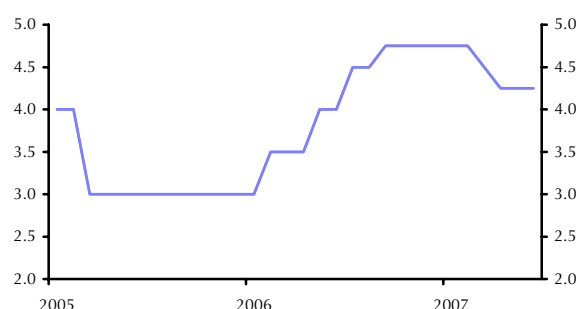
4. Real Wage Growth (% y/y)



5. Consumer Prices (% y/y)



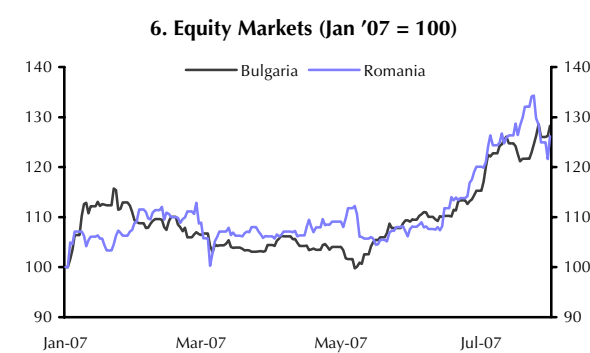
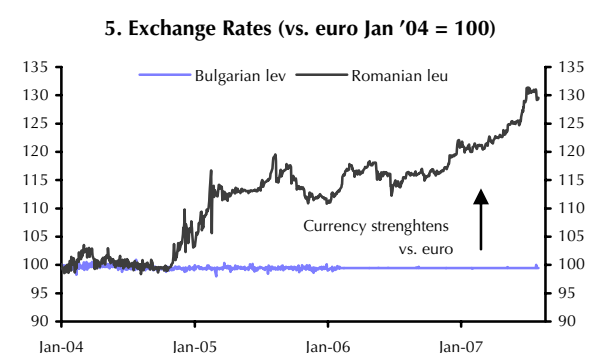
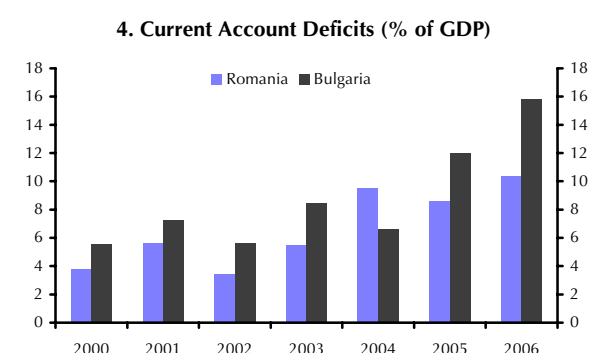
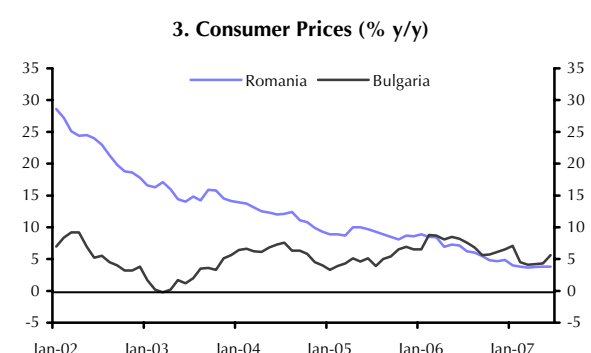
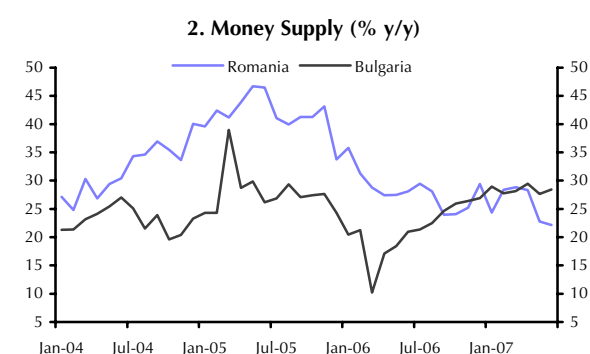
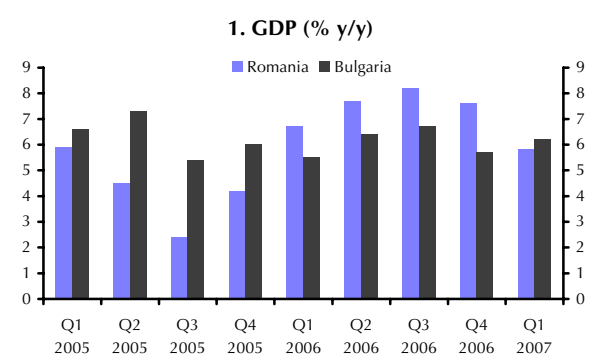
6. Interest Rates (%)



Sources – Thomson Datastream, Bloomberg, Eurostat

Bulgaria and Romania

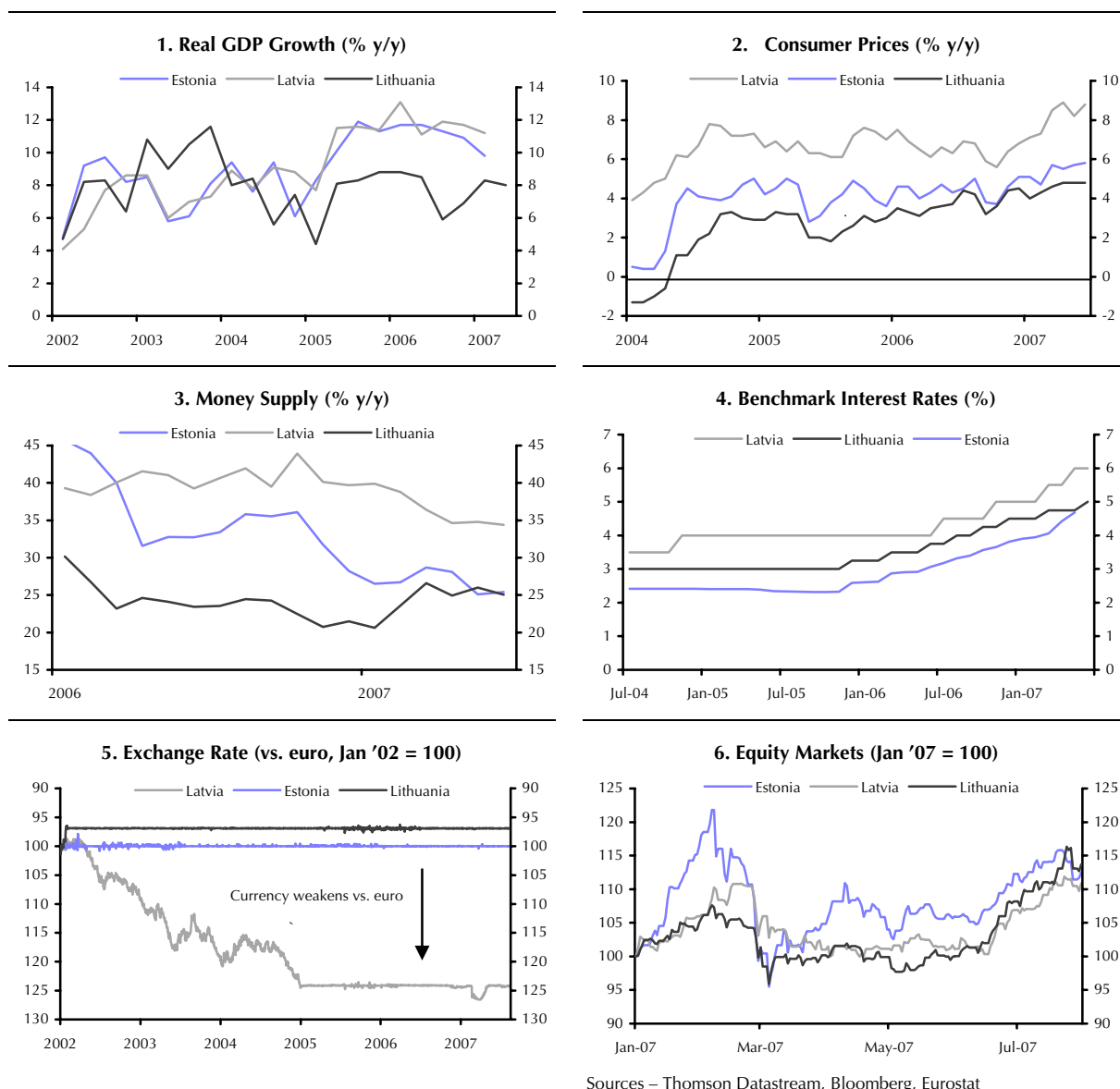
- Rampant domestic demand is driving growth of around 6% y/y in Bulgaria and Romania (1). Private consumption and business investment is being supported by the rapid development of credit markets in both countries. This pushed money supply growth to 30% in the early part of this year, although the recent moderation in Romania may point to a slowdown in lending (2).
- Although CPI inflation has been on a downward trend in both countries, the risks to inflation appear to lie on the upside. The reduction in inflation in Romania has been largely down to rapid exchange rate appreciation. And CPI in Bulgaria actually picked up to 5.6% in June from 4.3% in May (3).
- Because growth in domestic demand has outstripped that of output, current account deficits in both countries have ballooned (4). While Bulgaria operates a currency peg to the euro, the Romanian leu did fall by around 2% during the recent sell-off (5). The equity market in Romania also sold off heavily, falling by nearly 10% in one week. By contrast, the Bulgarian market actually strengthened by 1.5% during the week of the sell-off (6).



Sources – Thomson Datastream, Bloomberg, Eurostat

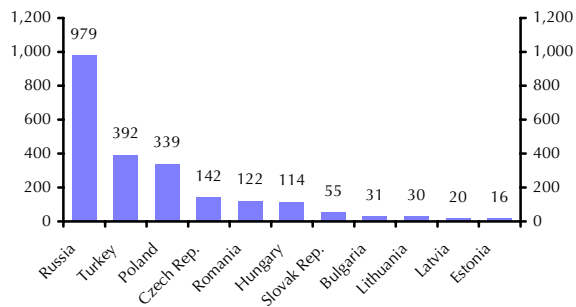
The Baltic States

- The Baltics continue to grow at a breakneck pace. Preliminary estimates put Q2 GDP growth in Lithuania at 8%, only marginally below the 8.3% recorded in Q1 and still well above potential **(1)**. Indeed, concerns about overheating remain in all three countries. This is especially true of Latvia, where CPI inflation has accelerated once again to 8.8% in June from 8.2% in May **(2)**.
- The authorities continue to play down such concerns about overheating, claiming that credit growth, which has fuelled much of the recent boom, is slowing. But this is not really evident in the monetary data and we continue to believe more needs to be done to cool growth if a hard landing is to be avoided **(3)**. The decision by the Latvian Central Bank to keep interest rates on hold at 6% in June is therefore a concern **(4)**.
- All three countries operate a currency peg against the euro. In Latvia, the huge current account deficit led to pressure to depreciate the lat earlier this year, but the currency seems to have emerged from the recent sell-off unscathed **(5)**. By contrast, equity markets across the region were affected. The biggest drop came in Estonia, where the leading index fell by 3.5% **(6)**.

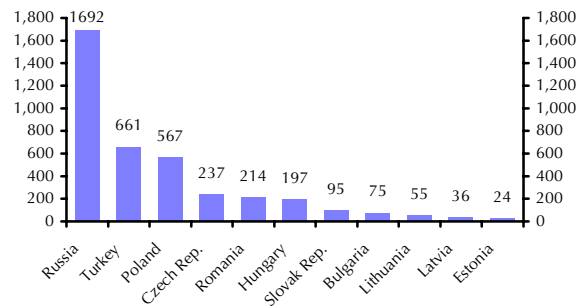


Background Data

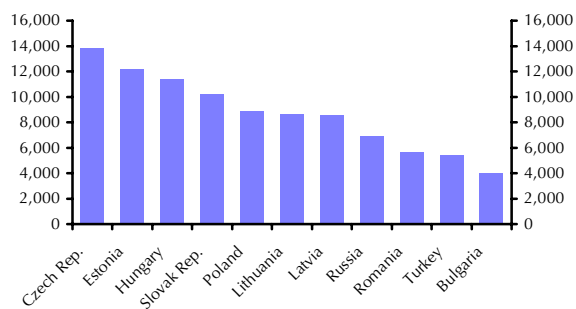
1. Current Price GDP (\$bn, 2006, Market Exchange Rates)



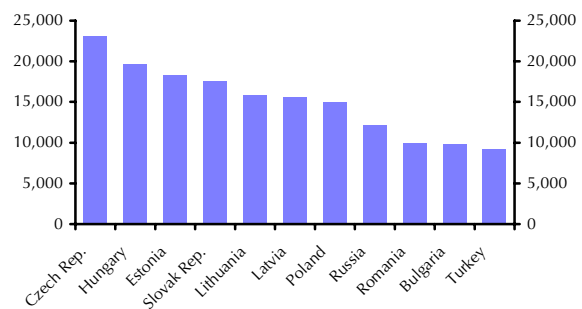
2. Current Price GDP (\$bn, 2006, PPP)



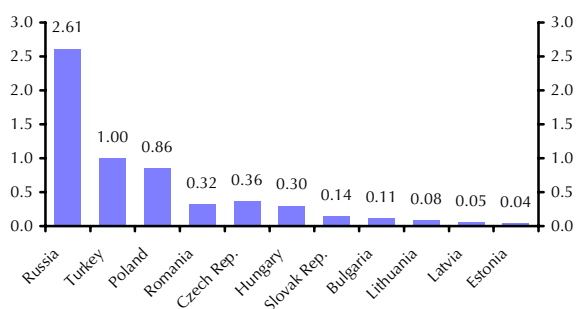
3. GDP Per Capita (\$, 2006, Market Exchange Rates)



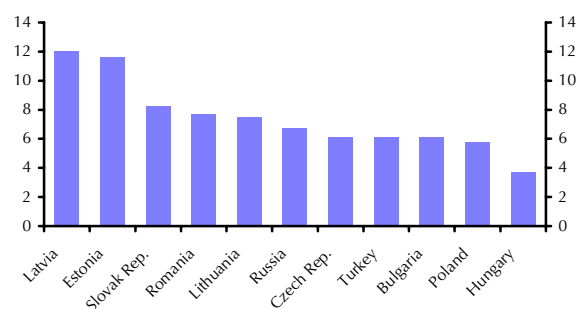
4. GDP Per Capita (\$, 2006e, PPP)



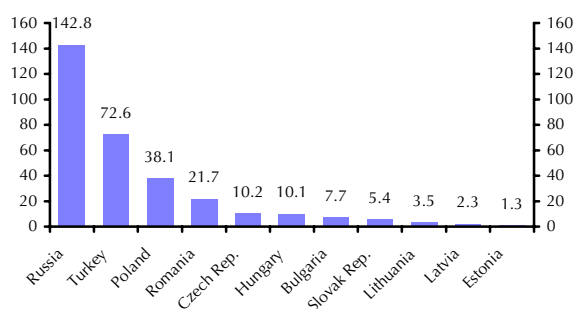
5. Share of World Output (% , 2006e, PPP)



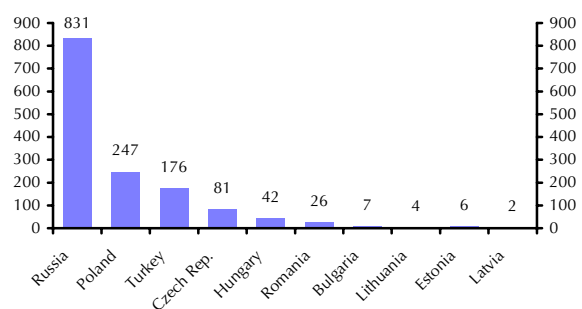
6. Real GDP Growth (% y/y, 2006e)



7. Population (Millions)



8. Stock Market Capitalisation (\$bn)



Sources –IMF, Bloomberg, Capital Economics