EMERGING EUROPE CHART BOOK

Sept. 2009

Fiscal concerns coming to the fore

- As deep recessions in the region have unfolded, all countries in Emerging Europe have experienced a sharp deterioration in their public finances. Some nations, particularly those that have turned to the IMF for funding assistance have already been forced by conditions of their loans to tighten fiscal policy. However, the public finances are a growing concern even in the healthier economies. The Czech Republic and Turkey have recently outlined tightening measures and we expect that Poland will also be forced by constitutional rules to tighten fiscal policy next year. This is just another reason to expect the region's recovery to be weak.

- The **Russian** economy is no longer in freefall but a planned fiscal tightening and strains in the banking sector present clear challenges to the recovery. Official interest rates were lowered to 10% during September but such cuts may yet have to be reversed next year. (Page 2.)

- The **Turkish** Central Bank continued its monetary easing-cycle this month, cutting interest rates to 7.25%. While modest budget cutbacks contained in the government's Medium-Term Economic Plan will weigh on the recovery, growth could still average 3% in 2010 as a whole. (Page 3.)

- **Polish** GDP growth accelerated to +1.1% y/y in Q2, while interest rates were kept on hold again at 3.5%. Still, constitutional limits on public debt are likely to force the government to tighten fiscal policy next year. (Page 4.)

- The **Czech Republic's** interim government announced a package of measures earlier this month to bring the budget deficit back to 5% of GDP next year. Meanwhile, inflation fell to a record low of 0.2% in August. (Page 5.)

- The **Hungarian** economy remains held back by its fragile banking sector, prevalence of fx-denominated debt and an IMF-imposed fiscal tightening. Interest rates were cut by a further 50bps to 7.5% in September. (Page 6.)

- **Slovakia's** fiscal deficit rose to an all-time high in August. Meanwhile, HICP inflation edged lower still to 0.5%. A short period of deflation now looks likely. (Page 7.)

- With **Bulgaria's** new government targeting a balanced budget, and **Romania's** IMF loan conditional on fiscal tightening measures, the recoveries in the Balkans will be held back. (Page 8.)

- In the **Baltic States,** the Latvian current account surged into surplus in Q2. However, the need for further deep fiscal cuts puts the entire IMF programme at risk. (Page 9.)

- Conditions in **Ukraine** appear to have improved modestly. But the economy remains propped up by its IMF loan and political risks could yet result in the programme collapsing. (Page 10.)

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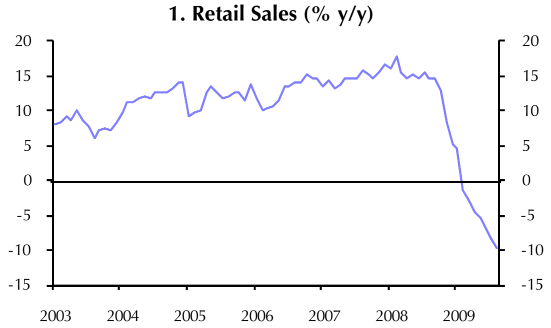
Russia

- The Russian economy is no longer in freefall, but at the same time it does not yet appear to have returned to positive growth. Admittedly, retail sales rose by 1.8% m/m in August, but this was largely due to seasonal effects. The annual pace of decline accelerated to 9.8%, from 8.3% in July **(1)**. Meanwhile, the annual pace of contraction in industry accelerated to 12.6% in August, from 10.8% in July, on the back of weaker manufacturing output. The downturn in investment has also gathered pace **(2)**.

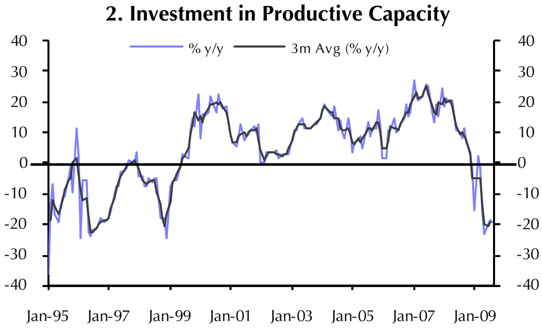
- A combination of a continued pick-up in world demand and huge fiscal stimulus, coupled with a boost from the inventory cycle, should ensure growth turns positive by the end-09. But the recovery will be extremely fragile and there is a strong chance of 'double dip'. The banking system remains under strain and the government is planning to tighten fiscal policy next year in order to cut the budget deficit to 6.8% of GDP, from over 9% in 2009 **(3)**.

- A drop in food prices caused inflation to slow to 11.6% in August **(4)**. Overall prices were flat on the previous month for the first time since 2005. In response, the CBR cut official interest rates by a further 75bps in September **(5)**. The ruble has continued its appreciation trend in recent weeks, but with downside risks to the currency growing, it is likely that rate cuts will be reversed over the course of next year **(6)**.

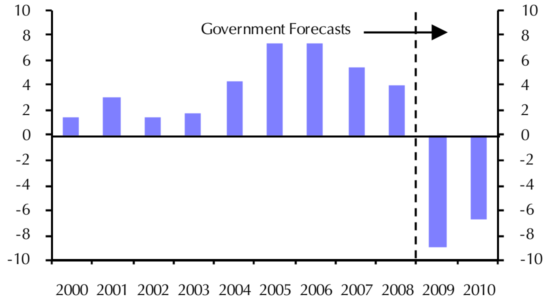
1. Retail Sales (% y/y)



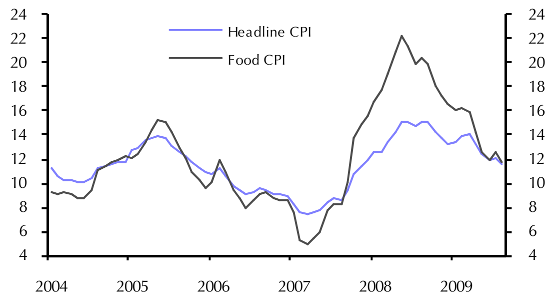
2. Investment in Productive Capacity



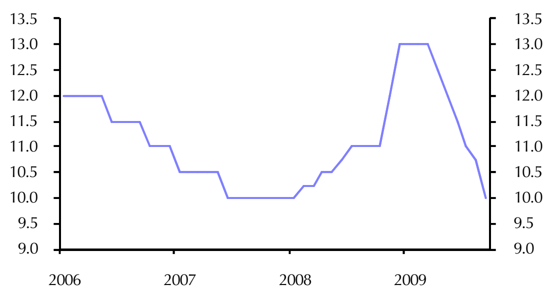
3. Government Deficit (% of GDP)



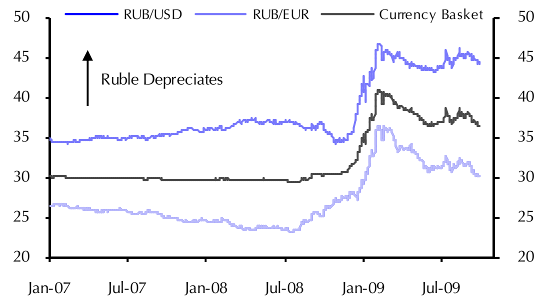
4. Inflation (%)



5. Interest Rates (%)



6. Exchange Rate

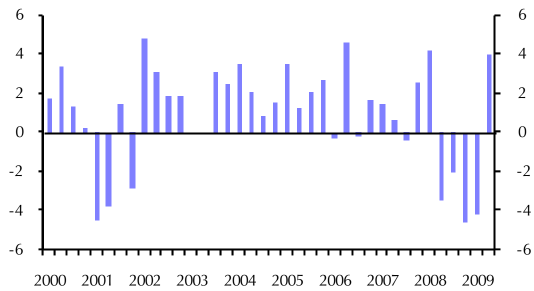


Sources – Thomson Datastream, Bloomberg, Capital Economics

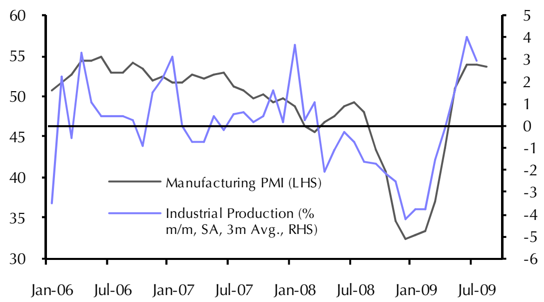
Turkey

- The annual rate of decline of Turkish GDP eased to -7% in Q2 from -14.3% in Q1. We estimate that this corresponds to seasonally-adjusted growth of around 4-5% q/q, although government estimates puts it closer to 7% q/q. Either way, the return to growth was driven by a combination of a boost from the stock cycle, a pick-up in private consumption and a positive contribution from net trade **(1)**. Meanwhile, output in the industrial sector continued to expand in July, growing by a seasonally-adjusted 2.5% m/m **(2)**.
- However, while the economy looks on course to post the strongest growth in the region next year, the modest fiscal tightening prescribed by the government's recent Medium-Term Economic Plan will weigh on the nascent recovery **(3)**. Stimulus measures (including cuts in sales taxes) have already been partly reversed and consumer confidence remains fragile. **(4)**.
- Against this backdrop, and with inflation well below its end-2010 target of 6.5%, the Central Bank continued its monetary-easing cycle in September, and cut interest rates by 50bps to 7.25% **(5 & 6)**. While the markets are pricing in rate hikes from the start of 2010, we think that monetary policy will remain supportive in the short-term and do not expect interest rates to be raised until the final quarter of 2010.

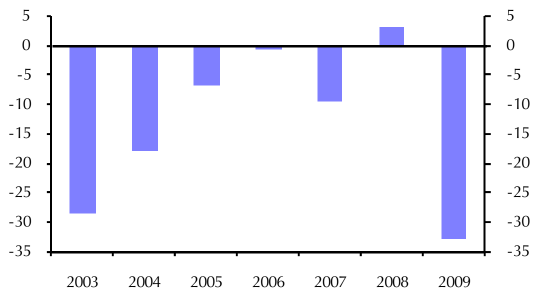
1. Real GDP (% q/q, SA)



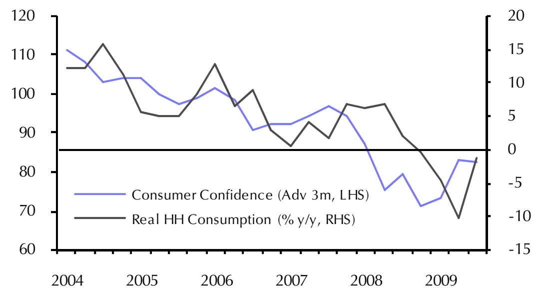
2. Industrial Production and Manufacturing PMI



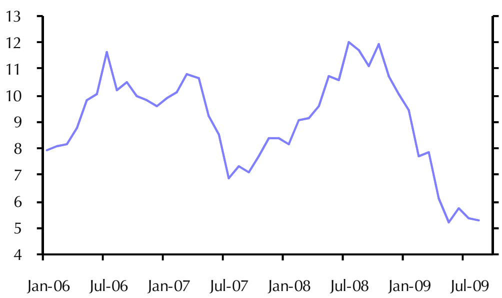
3. Central Government Balance (TRY bn, Year to Aug.)



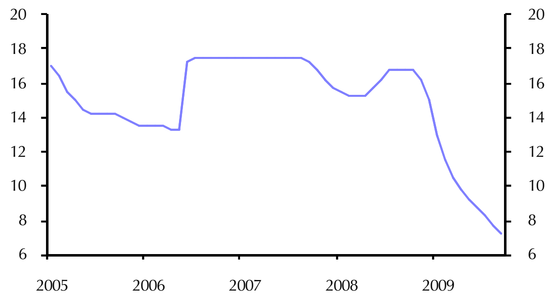
4. Consumer Confidence and Consumption



5. CPI Inflation (%)



6. Interest Rate (%)

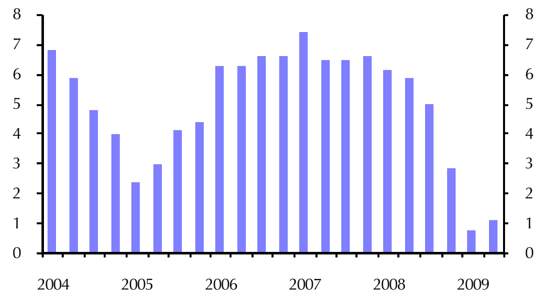


Sources – Thomson Datastream, Bloomberg, TurkStat, CBRT, CE

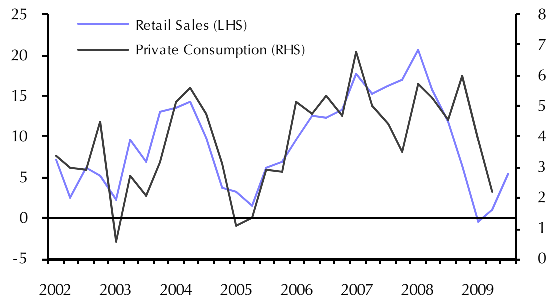
Poland

- Growth accelerated to 1.1% y/y in Q2 from 0.8% y/y in Q1 **(1)**. We estimate that this corresponds to broadly flat quarterly growth on a seasonally-adjusted basis. Meanwhile, retail sales grew by 5.2% y/y in August – a marked rebound from a low of -1.6% in February and a level consistent with modest private consumption growth **(2)**. The annual rate of decline of industrial production has also eased markedly from earlier this year and leading indicators suggest that this trend will continue over the short-term at least **(3)**.
- Such positive signs, along with stubbornly high inflation, will have contributed to the Central Bank's decision to keep interest rates unchanged once again at 3.5% in September **(4)**. At 3.7% in August, headline inflation edged further above the Bank's 2.5±1% target while core inflation is also approaching the band's upper bound **(5)**.
- However, with constitutional rules on the rising stock of public debt likely to force the government into tightening fiscal policy by around 2.5% of GDP in 2010, the recovery is likely to be relatively weak **(6)**. Consequently, we have not pencilled in any interest rate hikes before the start of 2011.

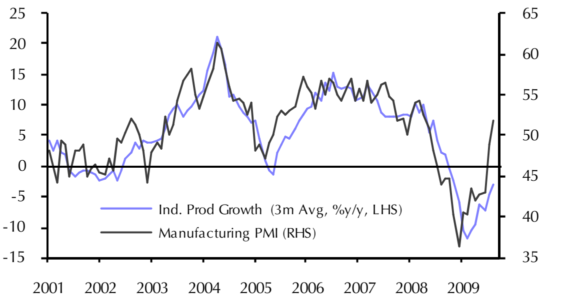
1. Real GDP (% y/y)



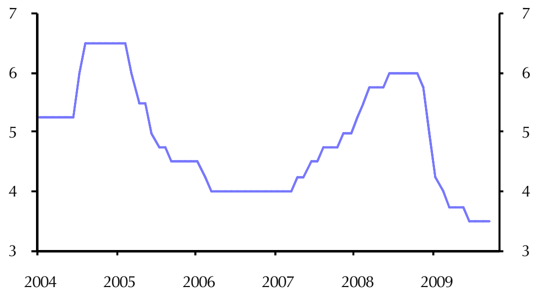
2. Retail Sales & Private Consumption (% y/y)



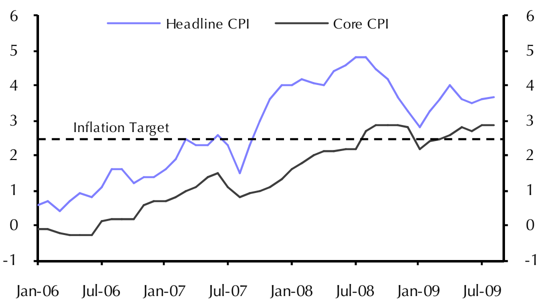
3. Industrial Production and Manufacturing PMI



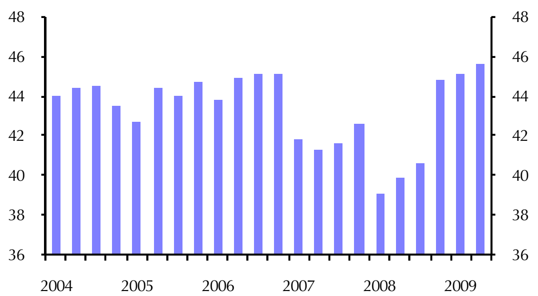
4. Interest Rates (%)



5. Inflation (%)



6. Central Government Debt (% of GDP)

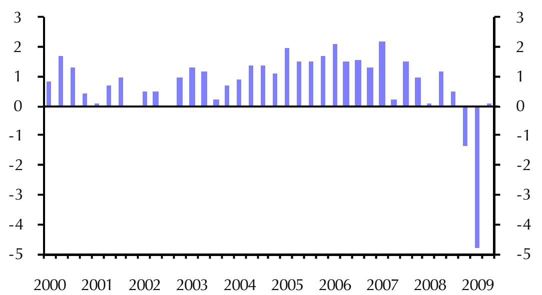


Sources – Thomson Datastream, Bloomberg, EC, Markit

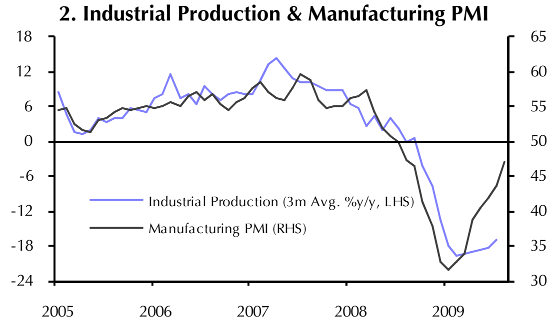
Czech Republic

- Despite official Q2 GDP growth being revised down to +0.1% q/q on a seasonally and working day adjusted basis (from +0.3% previously), the Czech Republic has undoubtedly benefited from the demand generated by Western European car-scrapping schemes **(1)**. Indeed, the annual pace of decline in industry has eased over recent months and indicators suggest that this trend will continue over the short-term **(2)**.
- However, while the economy could outperform the region as a whole next year, the recovery faces significant headwinds. For a start, to the extent that car-scrapping schemes just bring demand forward, the risk of a double-dip recession is growing. Moreover, the consumer sector remains under pressure, and the unemployment rate rose to 8.5% in August – its highest level since late-2005 **(3)**. Although consumer confidence has edged up over recent months, retail sales growth has yet to pick up **(4)**.
- What's more, the interim government's proposed fiscal tightening, aimed at bringing the deficit down to 5% of GDP next year, will also weigh on the nascent revival. Against this backdrop, and with the inflation rate currently at just 0.2%, we think that interest rates are likely to remain at historic lows until the final quarter of next year **(5)**. In fact, a simple Taylor Rule suggests that policy is currently too *tight* rather than loose **(6)**.

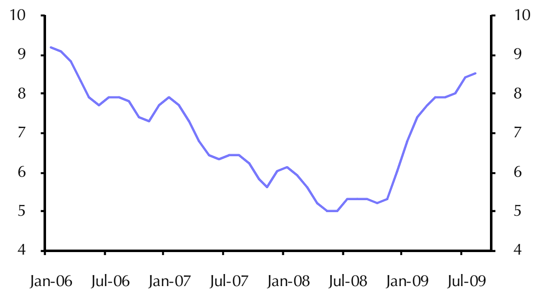
1. Real GDP (% q/q, SWDA)



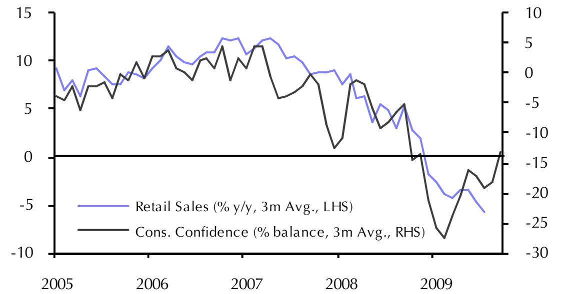
2. Industrial Production & Manufacturing PMI



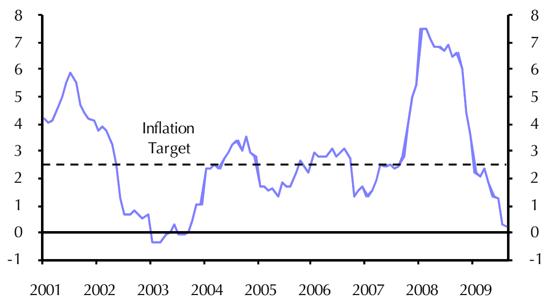
3. Unemployment Rate (%, Nat. Measure)



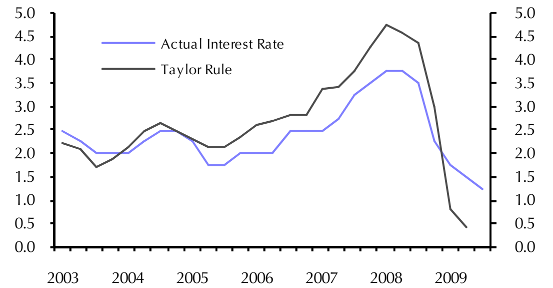
4. Retail Sales & Consumer Confidence



5. Headline Inflation (%)



6. Interest Rates and Taylor Rule (%)

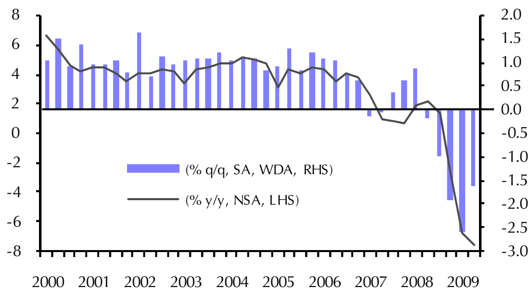


Sources – Thomson Datastream, Bloomberg, Capital Economics

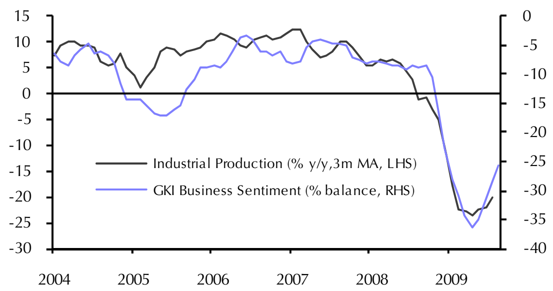
Hungary

- While many countries in the region are just beginning to tighten fiscal policy, Hungary's budget cutbacks, required under the conditions of its IMF-led loan programme, have already exacerbated the current recession. The revised seasonally-adjusted 1.6% q/q fall in GDP in Q2 was the fifth quarter in a row that the economy has contracted (1).
- Following the modest improvement in key exports markets, industry has shown some signs of stabilisation (2). But under the weight of the fiscal tightening measures, domestic demand remains under intense pressure. Retail sales volumes slumped by 2.3% m/m in July following the 5%-pt VAT hike at the start of the month (3). Sales volumes have now posted annual falls for 30 consecutive months and, with higher inflation keeping real wage growth in negative territory, they are unlikely to buck this trend anytime soon (4 & 5).
- Meanwhile, the Central Bank once again capitalised on favourable financial market conditions and cutcinterest rates by 50bps to 7.5% in September (6). However, given the fragile banking sector and significant overhang of fx-denominated debt, credit conditions in the real economy look set to remain tight for some time to come.

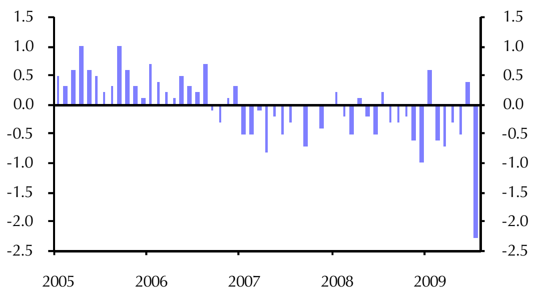
1. Real GDP



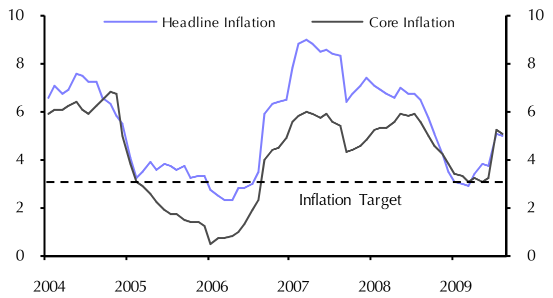
2. **Industrial Production vs. GKI Survey**



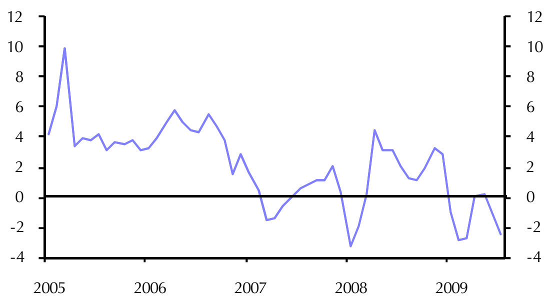
3. Retail Sales Volumes (% q/q)



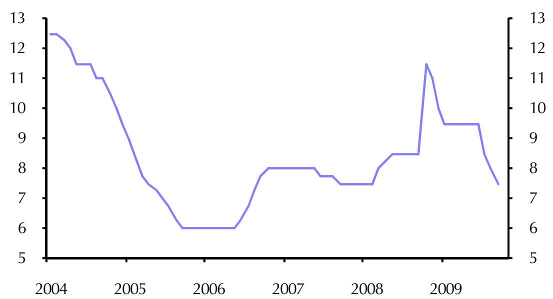
4. Inflation (%)



5. Real Wages (% y/y)



6. Interest Rates (%)

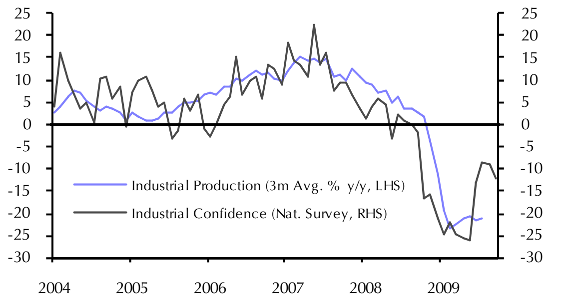


Sources – Thomson Datastream, Bloomberg

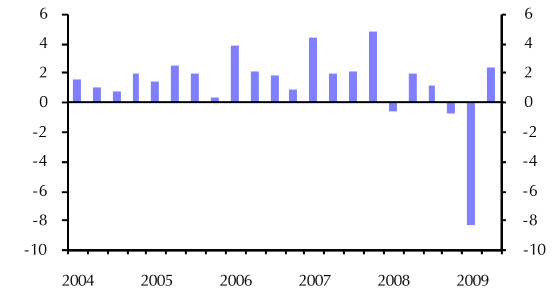
Slovakia

- As in the Czech Republic, Slovakia has benefited from Western European car-scrapping schemes. The annual rate of decline of industrial production has eased from its lows at the start of the year and business confidence has picked up **(1)**. In addition, net trade made a positive contribution to GDP growth of 2.3% q/q in Q2 **(2)**.
- Nevertheless, to the extent that car-scrapping schemes just bring demand forward, this raises the risk of a double-dip. Indeed, the household sector remains under pressure. Unemployment rose to 12% in July and real wages also fell by 1.6% y/y **(3 & 4)**. Against this fragile backdrop, HICP inflation dropped to 0.5% in August and, while base effects are likely to lift the rate at the start of next year, a short period of deflation looks likely over the coming months **(5)**.
- Meanwhile, as elsewhere in the region, the downturn has hit the public finances hard. With revenues down by over 10% y/y in August, the deficit is at a record high **(6)**. Although Slovakia's euro-zone membership means that it may be under less immediate pressure to tackle this shortfall than euro-candidate countries, it also means that exporters will not get a competitive boost from a weaker currency. Growth is unlikely to top 1% in 2010.

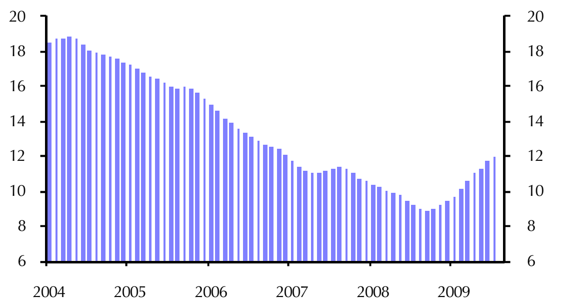
1. Industrial Production & Confidence



2. Real GDP (% q/q, SA)

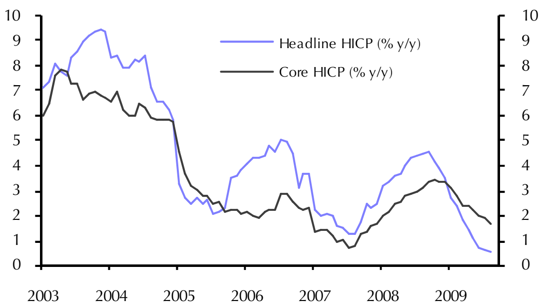


3. Unemployment Rate (%)

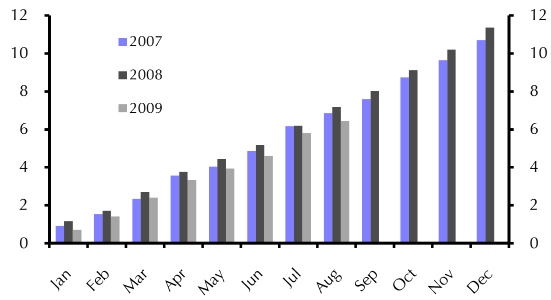


4. Real Wage Growth

5. Inflation



6. State Budget Revenues (euro bn)

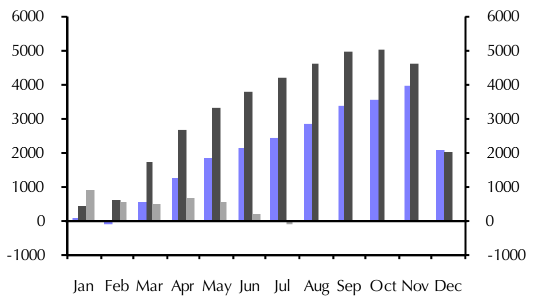


Sources – Thomson Datastream, Bloomberg, Eurostat, Capital Economics

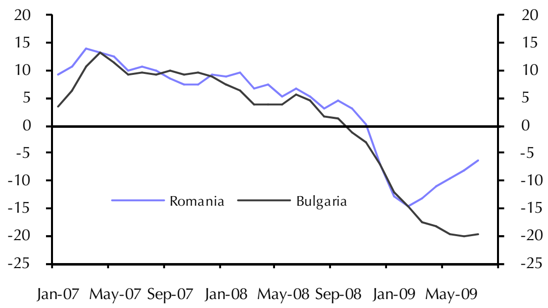
Bulgaria and Romania

- In a marked contrast to recent years, Bulgaria posted a budget deficit (albeit small) in August **(1)**. The introduction of a package of fiscal tightening measures by the new Bulgarian government, along with conditions attached to Romania's IMF-led loan, means that fiscal cutbacks will weigh on the recovery in the Balkans.
- While the annual rate of decline of industrial production in Romania has eased from the start of the year, output remains down by around 20% y/y in Bulgaria **(2)**. In addition, with the household sector under pressure, retail sales volumes have contracted sharply **(3)**. Such weak demand has put inflation on a firm downward trend in both countries **(4)**.
- The Romanian Central Bank cut interest rates by 50bps to 8% in September although, strains in the banking sector mean that credit conditions in the real economy are likely to remain tight for some time to come **(5)**. However, the weaker leu has at least helped to restore some degree of competitiveness to Romania's real exchange rate, which should benefit exporters and support the eventual recovery **(6)**. By contrast, in the absence of a devaluation of its currency board, prices and wages will have to fall in Bulgaria. As a result, its recession is likely to last longer.

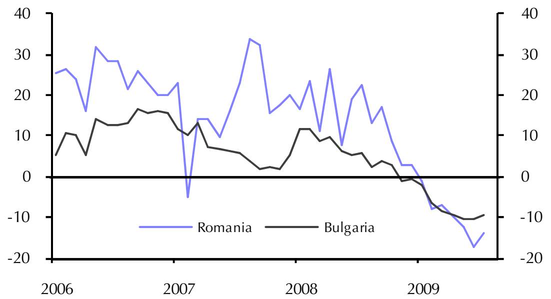
1. Bulgarian Central Government Balance (Lev mn)



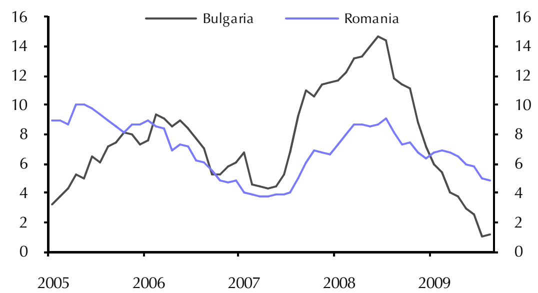
2. Industrial Production (% y/y, 3m MA)



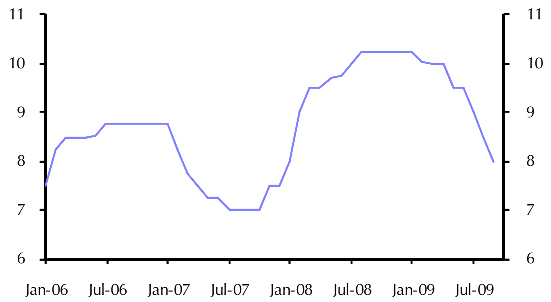
3. Retail Sales (% y/y)



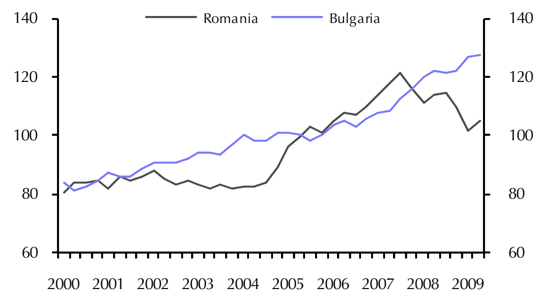
4. Inflation (% y/y)



5. Romanian Interest Rates (%)



6. Real Effective Exchange Rate (2005 = 100)

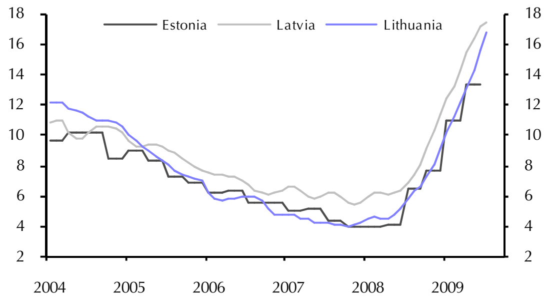


Sources – Thomson Datastream, Bloomberg, Capital Economics

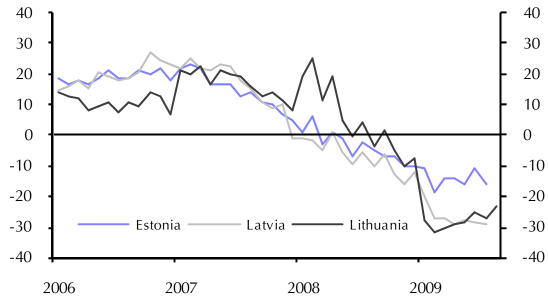
The Baltic States

- The painful process of rebalancing the Baltic economies through 'internal devaluation' policies continues. Anecdotal evidence suggests that wage cuts of over 30% are not uncommon and unemployment rates have soared **(1)**. Predictably, retail sales volumes have collapsed, and we think that all of the Baltic nations will have fallen into deflation by the start of 2010 **(2 & 3)**.
- The collapse of domestic demand has led to sharp falls in imports, over and above the steep drops in exports **(4)**. Indeed, Latvia recorded a current account *surplus* of over 14% of GDP in Q2 – in stark contrast to the colossal deficits of the boom period **(5)**. This has prompted some to conclude that the painful process of re-balancing the economy away from domestic demand-led growth and towards net exports has been completed.
- However, with the real exchange rate still looking over-valued we think the process has further to run. We estimate that it could have to fall by 25% to restore competitiveness **(6)**. With little public or political appetite for the further cuts in government spending being demanded by the IMF, the loan programme's future is in doubt, leaving devaluation looking ever more likely.

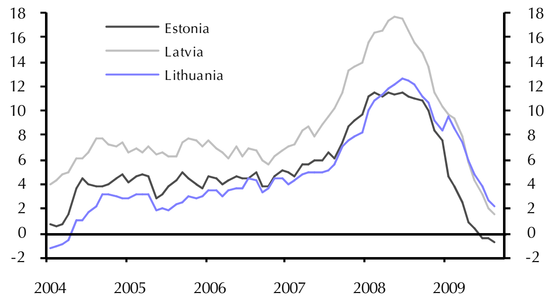
1. Unemployment Rate (%)



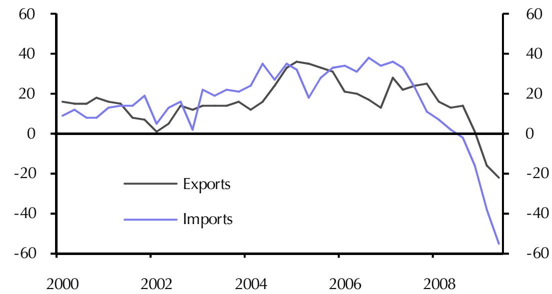
2. Retail Sales (% y/y)



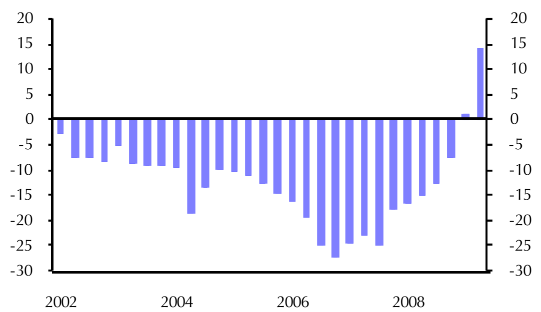
3. Consumer Prices (% y/y, HICP)



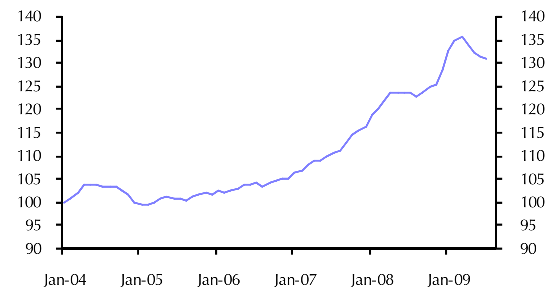
4. Latvia Trade (% y/y, Goods & Services)



5. Latvia Current Account (% of GDP)



6. Latvia Real Exchange Rate (Jan '04 = 100)

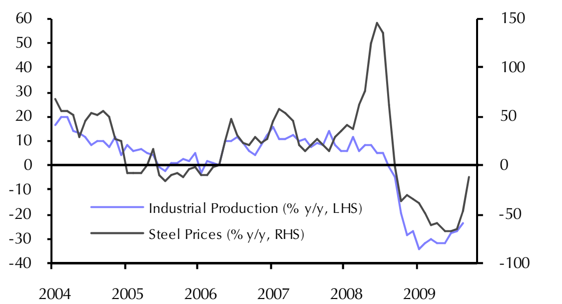


Sources – Thomson Datastream, Bloomberg, Capital Economics

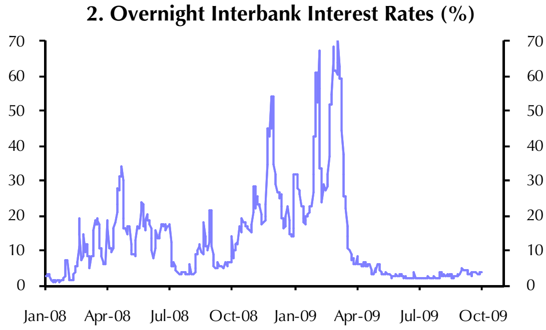
Ukraine

- Following the calamitous first half of the year, rising steel prices and a US$16.5bn IMF-led loan have helped to stabilise Ukraine's economy. Industrial output appears to have bottomed out **(1)**. Meanwhile, interbank lending rates have eased significantly and the hryvnia has clawed back some of its earlier losses **(2 & 3)**. Despite remaining above 15% in August, inflation is also on a clear downward trend and should fall into single-digits during Q1 2010 **(4)**.
- However, while the Fund has increased the permitted ceiling on the fiscal deficit to 8.6% of GDP this year, from its initial demands for a balanced budget and has also allowed Naftogaz to be brought onto the state's balance sheet, this has only put off inevitable cutbacks that will prolong the recession. What's more, domestic demand remains very weak. Retail sales were down by over 20% y/y in August, although a sharp drop in imports has at least contributed to the marked fall in the trade deficit **(5 & 6)**.
- The highly uncertain political outlook also presents significant risks to the continuation of the IMF deal, especially given the possibility of a fiscal blow-out in the run-up to next year's elections. The collapse of the programme would likely trigger a vicious sell-off in the hryvnia.

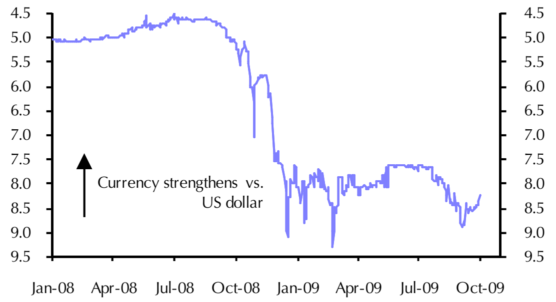
1. Industrial Production and Steel Prices



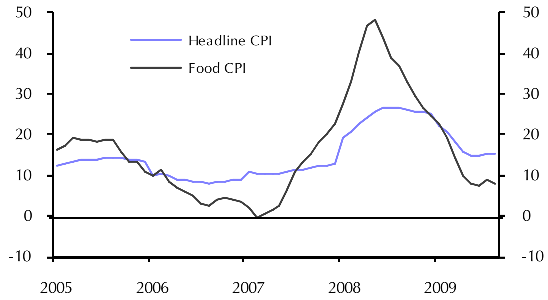
2. Overnight Interbank Interest Rates (%)



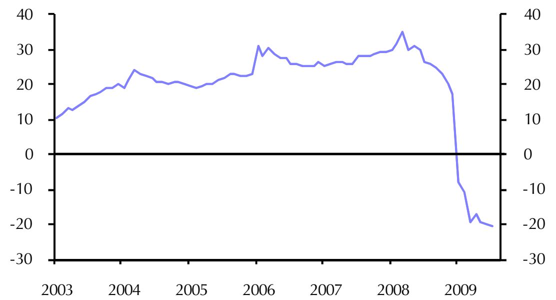
3. Exchange Rate (vs. dollar)



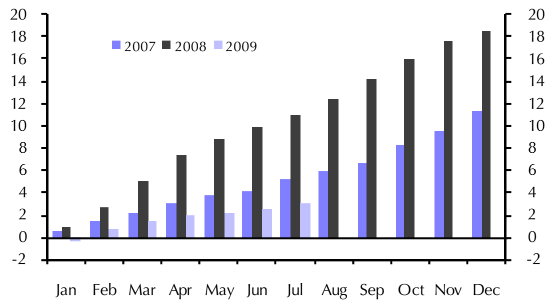
4. Inflation (%)



5. Retail Sales (% y/y)



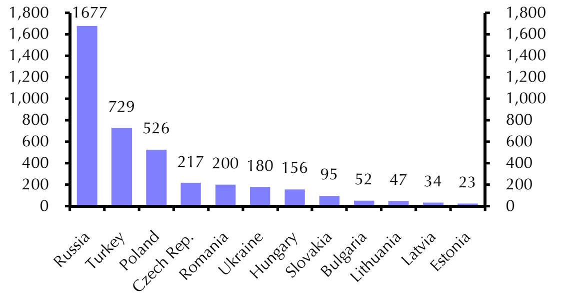
6. Trade Deficit (US$ bn, cumulative)



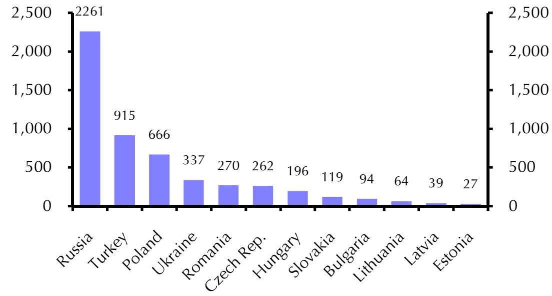
Sources – Thomson Datastream, Bloomberg

Background Data

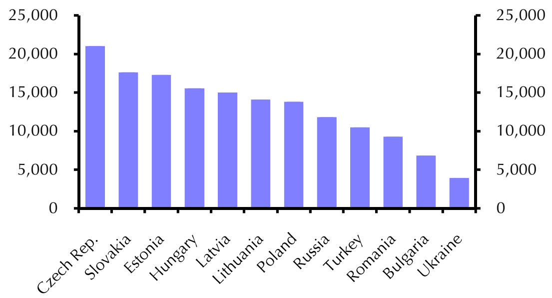
1. Current Price GDP ($bn, 2008, Market Exchange Rates)



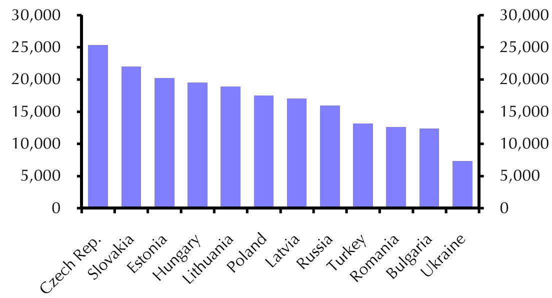
2. Current Price GDP ($bn, 2008, PPP)



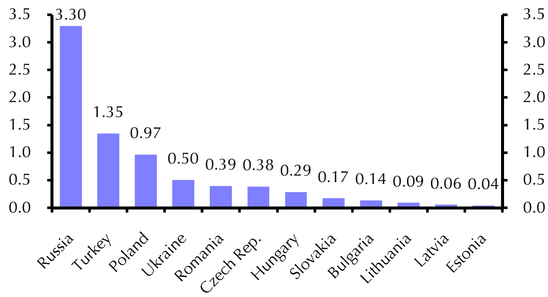
3. GDP Per Capita ($, 2008, Market Exchange Rates)



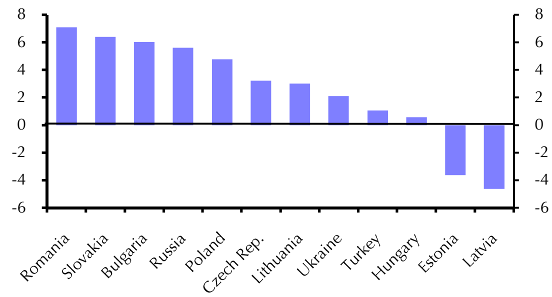
4. GDP Per Capita ($, 2008, PPP)



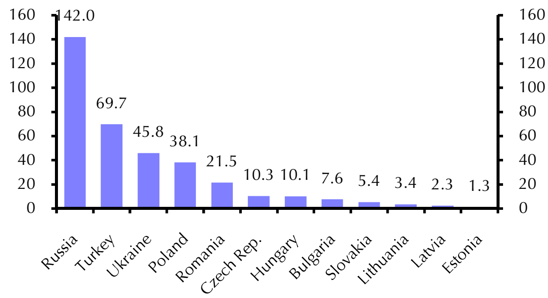
5. Share of World Output (%, 2008, PPP)



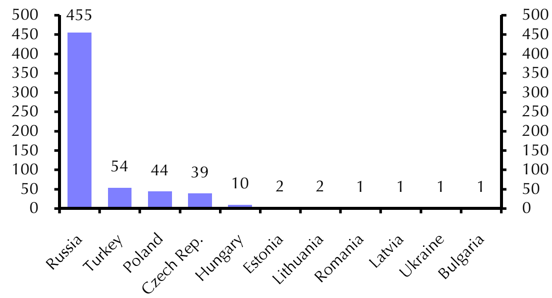
6. Real GDP Growth (% y/y, 2008)



7. Population (2008, Millions)



8. Stock Market Capitalisation ($bn, Jul. '09)



Sources –IMF, Bloomberg, Capital Economics