

EMERGING EUROPE CHART BOOK

Dec. 2011



Sliding back into recession

- The past month has brought further evidence – if any were needed – that Emerging Europe will not escape unscathed from the gathering storm in the euro-zone. Unsurprisingly, perhaps, the region's most export-dependent economies have so far been hit the hardest. Indeed, leading indicators suggest that the Czech Republic and Hungary may already be in recession. By contrast, the region's larger economies – Russia, Turkey and Poland – have proved to be more resilient. Nonetheless, this is likely to change during the course of next year. In Poland, there is now much less scope than in 2008-09 for policy stimulus to offset weaker external demand. In Russia, civil unrest is stoking capital outflows, which in turn are threatening a liquidity squeeze in the banking sector. Finally, in Turkey the current account deficit still looks unsustainably large and points to the need for a painful adjustment in domestic demand over the next year. Of course, much depends on just how bad things get in the euro-zone. For now, we expect the region to broadly stagnate next year, following growth of around 4.5% this year. But in the event of a “disorderly” break-up of the single currency, entailing a banking crisis in Western Europe, all bets would be off – in the extreme, Emerging Europe could be plunged into a recession to rival that of 2008-09.
- **Russia** has been hit by a wave of protests amid accusations of vote rigging in parliamentary elections earlier this month. It goes without saying that the outlook is highly uncertain, but it seems that the economy is already feeling the effects – capital outflows seem to be accelerating, which in turn has led to a further tightening of liquidity conditions in the banking sector. ([Page 2.](#))
- The **Turkish** economy continued to grow rapidly in Q3. But with the current account deficit still worryingly large and the lira sliding, if anything, the conditions look set for the central bank to tighten policy even further. ([Page 3.](#))
- **Poland** continues to outperform its Central European neighbours. But leading indicators suggest that a slowdown is on the cards in Q4. ([Page 4.](#)) Meanwhile, the **Czech Republic** is feeling the heat from deepening problems in the euro-zone and looks set to be the first economy in the region to fall back into a recession. ([Page 5.](#)) In **Hungary**, the news has been dominated by the bumpy progress of negotiations with the IMF but activity indicators suggest the key industrial sector is coming to a stand-still. ([Page 6.](#)) The **Slovakian** economy's strong recovery appears to be coming to an end on the back of weaker euro-zone demand. ([Page 7.](#))
- **Romania's** 2012 budget looks set to exacerbate the slowdown next year by bringing in yet more fiscal austerity. ([Page 8.](#)) Meanwhile, activity data for **Bulgaria** and **Croatia** continue to disappoint as their economies are being hit hard by their linkages to the weaker euro-zone periphery. ([Page 9.](#))
- Weaker external demand is weighing on the **Baltic States'** industrial sectors. ([Page 10.](#)) In **Ukraine**, despite robust activity data, external financing risks are mounting. ([Page 11.](#))

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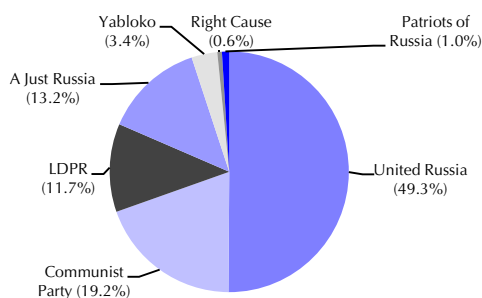
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Russia

- Russia has been hit by a wave of civil unrest following parliamentary elections earlier this month. The vote itself was won by the ruling United Russia party, albeit with a much-reduced majority from 2007 (1). But allegations of vote-rigging have led to widespread protests calling for a re-run of the poll.
- For now, this seems unlikely and PM Putin is still odds-on favourite to be returned to the Presidency in elections due in March next year. But the rise in political risk has hit the markets. The RTS equity index has fallen by over 10% since the protests started (2). And while the ruble has remained relatively stable, we suspect this is due to FX intervention by the CBR. Indeed, concerns over the currency seem to be behind the CBR's decision to reduce the amount of funds it provides to banks via overnight repo auctions (3). This move exacerbated the squeeze in the banking sector with interbank lending rates rising to their highest level in almost two years (4).
- On the activity front, industrial production growth picked up to 3.9% y/y in November (from 3.6% y/y in October). Meanwhile, the manufacturing PMI rose to an eight-month high of 52.6 (5). But it's worth noting that the link between industrial production growth and the PMI has weakened recently, and that output has remained near stagnant in monthly terms (6). Tighter credit conditions, weaker global demand and signs of unrest at home all point to much weaker growth next year.

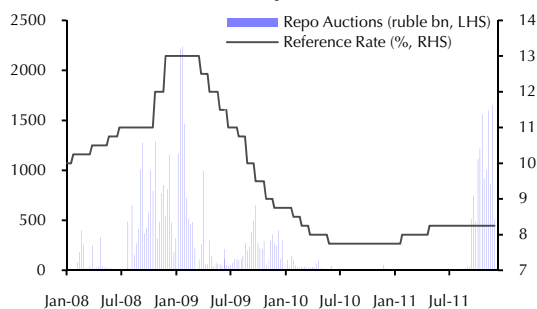
1. Election Results Breakdown



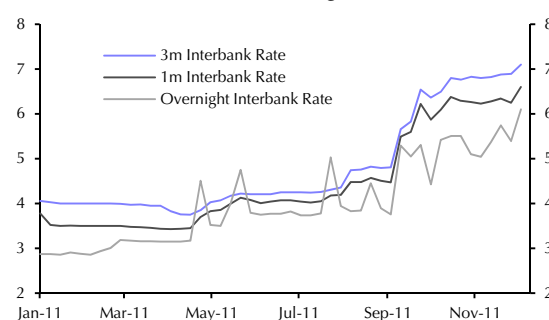
2. RTS Index



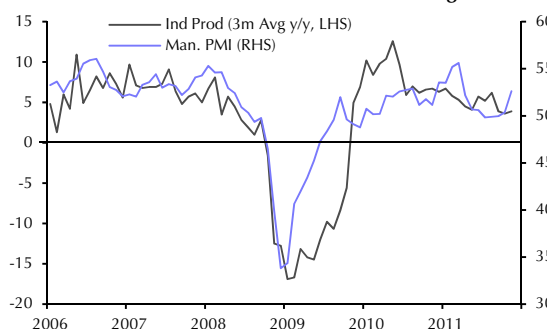
3. CBR's Repo Auctions



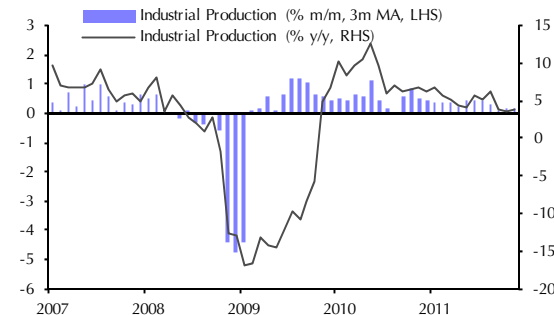
4. Interbank Lending Rates (%)



5. Industrial Production & Manufacturing PMI



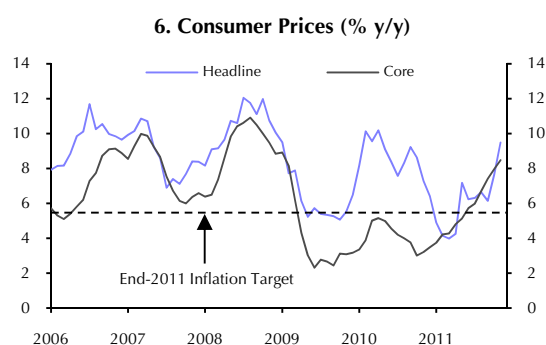
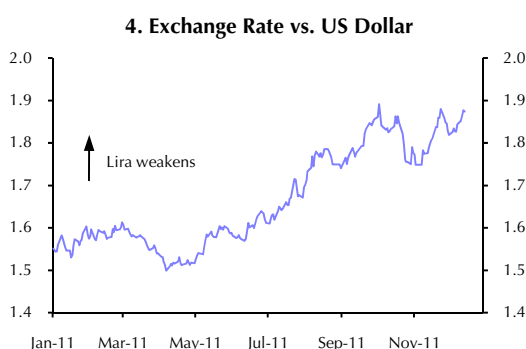
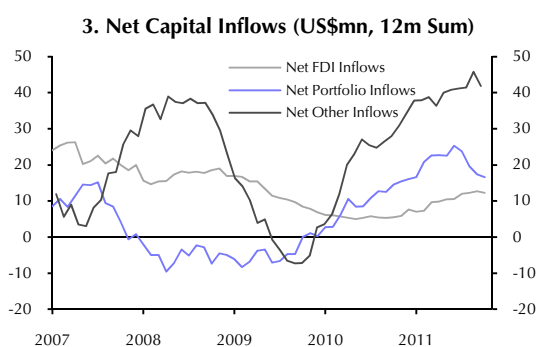
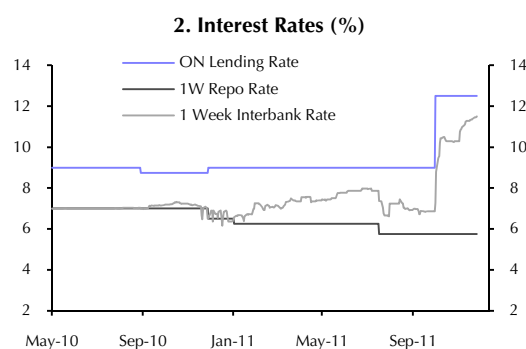
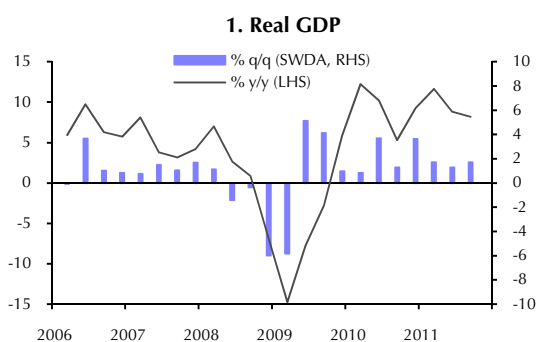
6. Industrial Production



Sources – Thomson Datastream, Bloomberg, CBR, Markit, CIKRF, CE

Turkey

- The Turkish economy continued to grow at a rapid pace in Q3, expanding by 8.2% on an annual basis (up from 8.8% in Q2) and by 1.7% over the quarter (up from 1.3% in Q2) **(1)**. This was higher than the consensus for 6.3% y/y growth, but the real issue is that this is already old news and does not reflect much tighter monetary policy, introduced in October, to prevent a disorderly balance of payments adjustment.
- To recap, the central bank has tightened policy by providing less liquidity via its benchmark 1-week repo auctions (at an interest rate of 5.75%) and more via its overnight facility (at 12-12.5%). In reality, interest rates have settled towards the top of this 'interest rate corridor' **(2)**. And, if anything, further tightening looks likely. October's current account data showed that the economy is still dependent on short-term bank ('other') and portfolio inflows to fund its current account deficit, while the lira has continued to slide this month, breaching 1.88/US\$ **(3&4)**.
- The good news is that indicators for the manufacturing sector actually improved in October and November **(5)**. But we think this is unlikely to last given the deteriorating global economy. Meanwhile, inflation picked up to a 19 month high of 9.5% y/y in November (from 7.7% y/y in October) due to excise tax hikes and food inflation **(6)**.

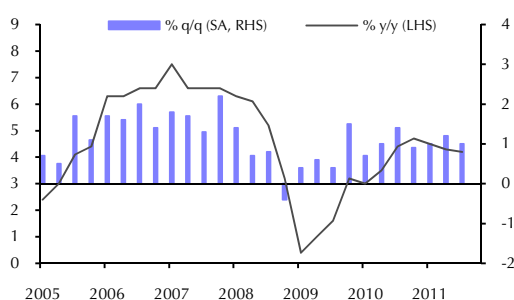


Sources –Thomson Datastream, HSBC/Markit, CE

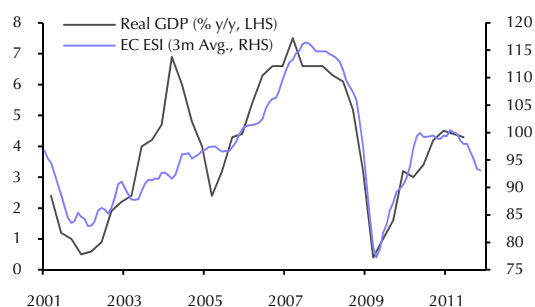
Poland

- Poland remains Central Europe's strongest performer. The economy expanded by 4.2% y/y in Q3, down slightly from 4.3% y/y in Q2, but still much faster than in its peers (1). This was equivalent to 1.0% growth over the quarter (down from 1.2% in Q2). Domestic demand was the key driver of the expansion, while net exports were a drag on output. However, Q4 GDP data could well report a sharper slowdown in growth. (2).
- Admittedly, the hard activity data suggest that both the industry and retail sectors have held up reasonably well in recent months (3&4). Nevertheless, the soft data (surveys and so on) suggest the economy is slowing. The manufacturing PMI fell to its lowest level since late 2009 in November and is consistent with stagnation in industry (4). The EC Economic Sentiment Indicator suggests that growth could slow to 3% y/y or so over the next quarter.
- This wouldn't be a disaster given the problems in the euro-zone, but it would probably be sufficient to trigger a loosening of monetary policy in the first half of next year. For the time being however, above-target inflation – which rose to 4.8% y/y in November from 4.3% y/y in October – and the fall of the zloty suggest that rate cuts will be left until late Q1 or Q2 (5 & 6).

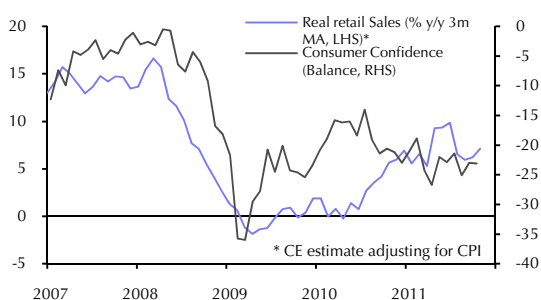
1. Real GDP



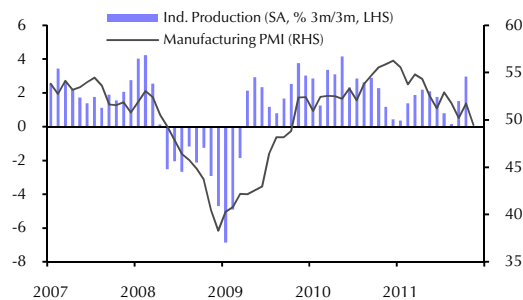
2. Real GDP & EC Economic Sentiment Indicator



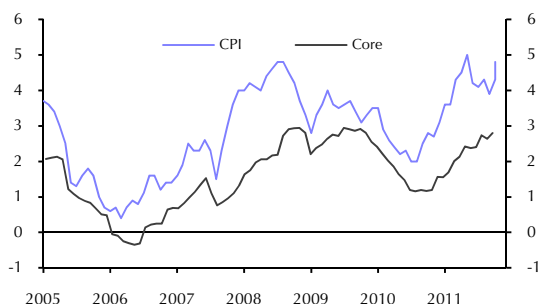
3. Retail Sales & Consumer Confidence



4. Industrial Production & Manufacturing PMI



5. Consumer Prices (% y/y)



6. Exchange Rate vs. Euro

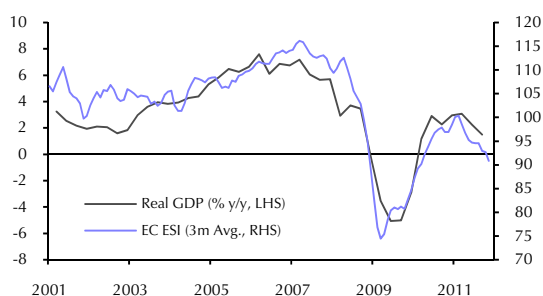


Sources – Thomson Datastream, Bloomberg, Markit, CE

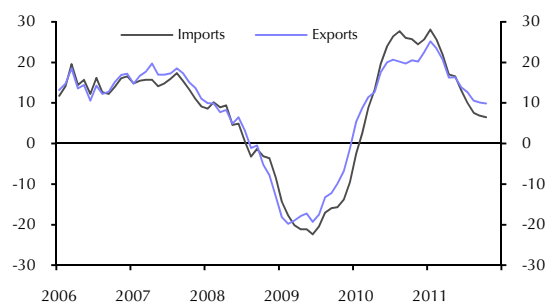
Czech Republic

- As the most open economy in Emerging Europe, the Czech Republic is among the first to be feeling the heat from the escalating euro-crisis. Revised GDP figures show that the economy contracted by 0.1% between Q2 and Q3. Moreover, leading indicators suggest that Q4's GDP data will be even worse, implying that the Czech Republic could well be the first economy in the region to fall back into recession **(1)**.
- The economy is reliant on its export-led manufacturing sector. Admittedly, export growth appears to have stabilised at around 10% y/y over the past few months, but other data go from bad to worse **(2)**. The manufacturing PMI fell to its lowest level since August 2009, and industrial production is contracting on a quarterly basis **(3)**. Meanwhile, domestic demand is subdued, but plummeting consumer confidence points towards much worse to come **(4)**.
- Of course, the deteriorating growth outlook argues in favour of policy easing. Nevertheless, so far, policymakers have been reluctant to do so due to currency weakness and above-target inflation (which rose to 2.5% y/y in November from 2.3% y/y in October) **(5&6)**. But with the koruna gaining ground and domestic inflationary pressures subdued, we don't think policymakers will hold off for too long and have pencilled in a rate cut in Q1.

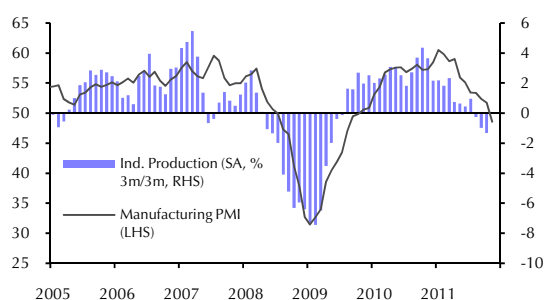
1. Real GDP and EC Economic Sentiment Indicator



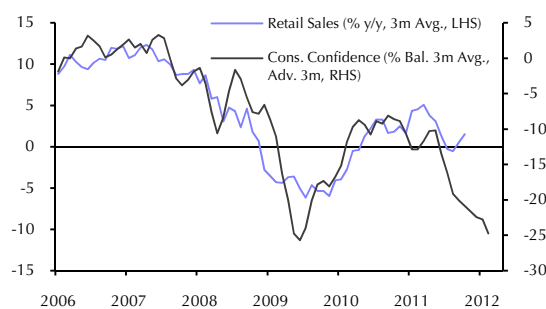
2. Trade (% y/y 3m MA)



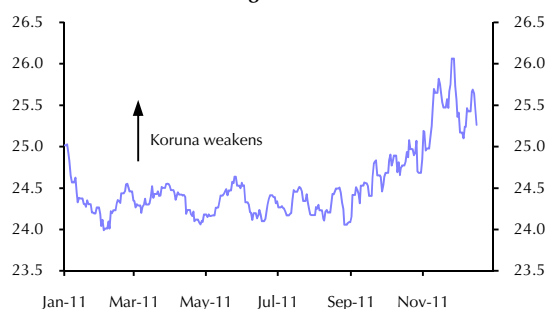
3. Manufacturing PMI & Industrial Production



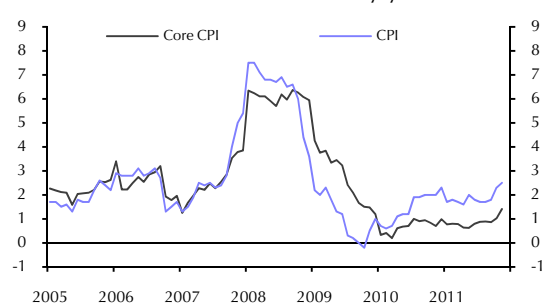
4. Retail Sales & Consumer Confidence



5. Exchange Rate vs. Euro



6. Consumer Prices (% y/y)

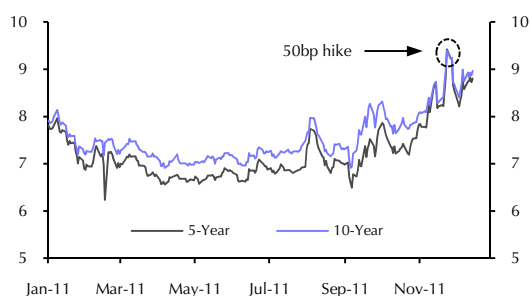


Sources – Thomson Datastream, Bloomberg, CSO, Markit, CE

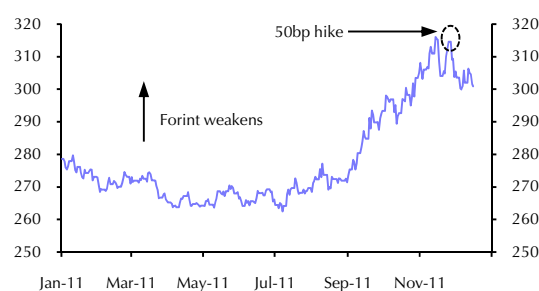
Hungary

- Hungary's request for IMF assistance last month, coupled with the central bank's 50bp rate hike, appear to have restored some calm to its financial markets **(1&2)**. But the government is still under the spotlight. On the one hand, an agreement with banks to shoulder some of the losses resulting from households' FX debt was treated warmly. But on the other hand, a draft central bank law, which was criticised for threatening the bank's independence, led to the IMF walking out of (informal) negotiations.
- The bumpy progress of negotiations with the IMF has been the focus of attention, but news from the real economy is not good either. Industrial production is near stagnation, while the manufacturing PMI fell to its lowest level since 2009 in November **(3)**. Meanwhile, consumer confidence is collapsing, which bodes poorly for household consumption – and is likely to get worse as further government austerity kicks in next year **(4)**.
- Meanwhile, labour market conditions show little sign of improvement **(5)**. And while headline inflation picked up to 4.3% y/y in November (from 3.9% y/y in October), this was driven by excise tax hikes (to alcohol, tobacco, gambling and motor fuels) and domestic inflationary pressures remain muted **(6)**.

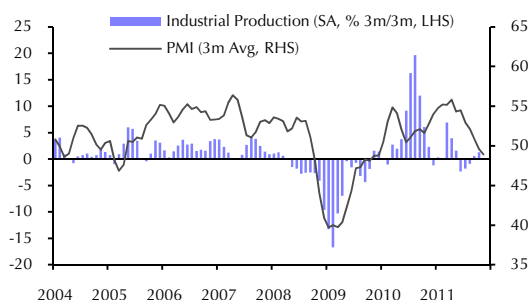
1. Government Bond Yields (%)



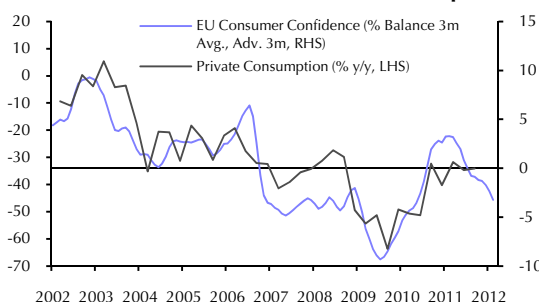
2. Exchange Rate vs. Euro



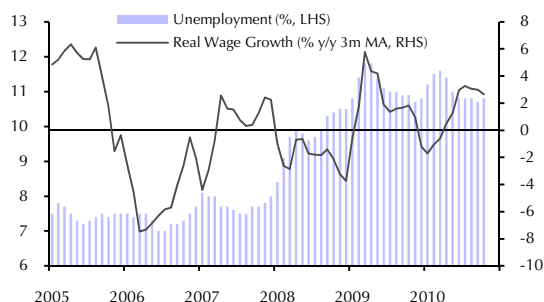
3. Industrial Production & Manufacturing PMI



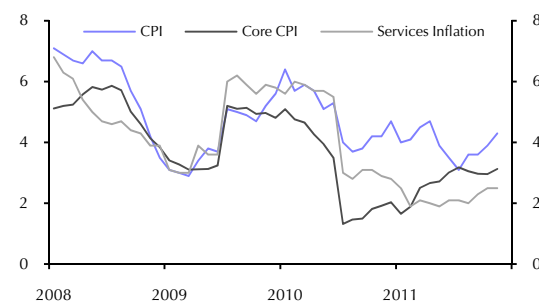
4. Consumer Confidence & Private Consumption



5. Real Wages & Unemployment



6. Consumer Prices (% y/y)

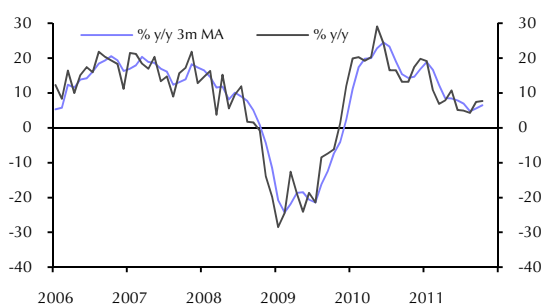


Sources – Thomson Datastream, Bloomberg, CE

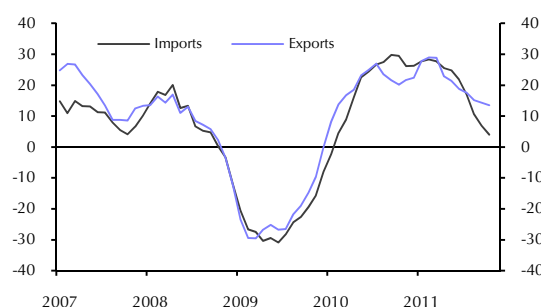
Slovakia

- Slovakia's export-led recovery appears to have hit the buffers on the back of weakening demand from the euro-zone. Industrial production growth has fallen from double-digit rates earlier in the year and exports have continued to slow down, although not by as much as imports (**1&2**).
- Import weakness reflects the frail state of domestic demand, which shows no sign of picking up the slack left by falling external demand. Indeed, retail sales have contracted on an annual basis throughout this year, while consumer confidence plunged in November (**3**). One factor behind weak domestic demand is high and rising inflation, which reached 4.6% y/y in November, up from 4.4% y/y in October (**4**). As this year's VAT hike falls out of the annual comparison in January, households' purchasing power should receive a boost.
- However, fiscal tightening will have the opposite effect on domestic demand. This month, the government passed its 2012 budget which envisages the budget deficit narrowing to 4.6% of GDP from just under 6% this year (**5**). But this appears to be based on over-optimistic growth forecasts (1.7%, CE: 0.0%). The markets also look unconvinced. Bond yields – although not high by euro-zone standards – are now much higher than in November (**6**).

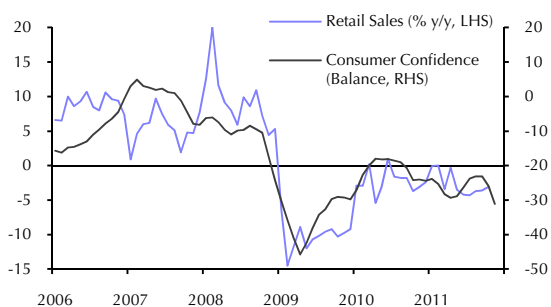
1. Industrial Production



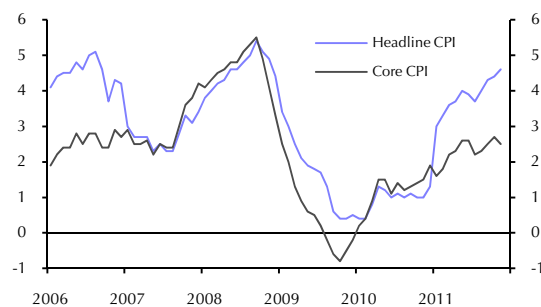
2. Trade (% y/y 3m MA)



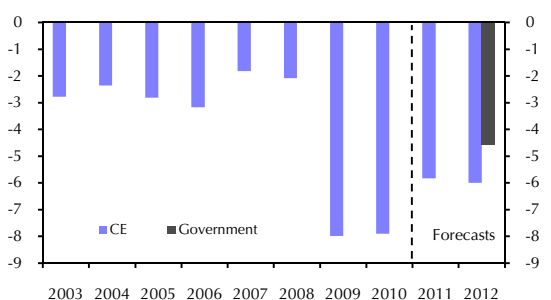
3. Retail sales & Consumer Confidence



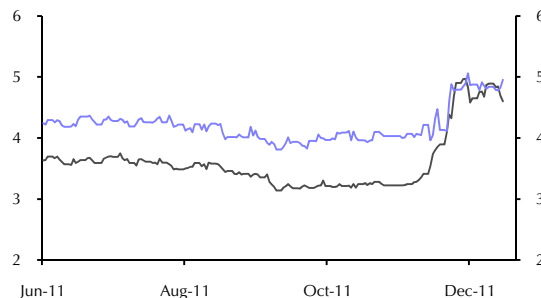
4. Consumer Prices (% y/y)



5. Government Budget Balance (% of GDP)



6. Bond Yields (%)

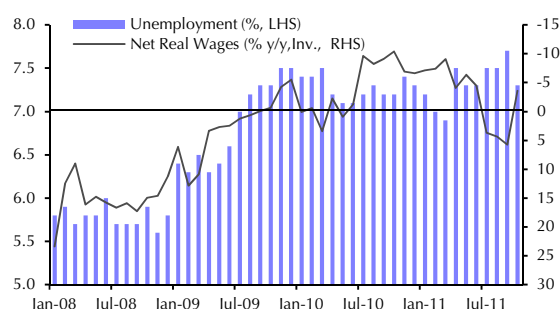


Sources – Thomson Datastream, Bloomberg, CE

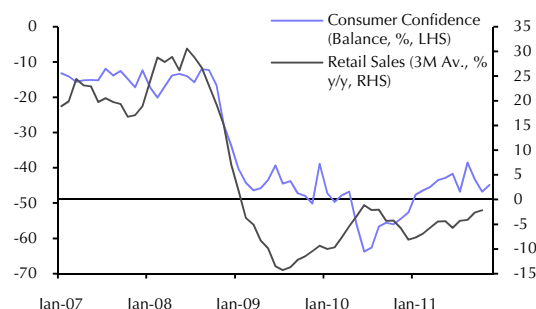
Romania

- The Romanian parliament approved the draft 2012 budget this month, introducing yet more austerity next year with wage and pension freezes as well as cuts in public sector employment. This looks set to weaken an already depressed labour market (1). So far, real wages have contracted by almost 3% this year (on an annual basis), translating into meagre retail sales growth and low consumer confidence (2).
- With domestic demand already subdued, the Romanian economy has become dependent for growth on its export-led industrial sector (3). But with recession looming in key euro-zone trading partners, external demand is set to tumble. Indeed, industrial production growth fell in October to 4.0% y/y (from 5.6% y/y in September) on the back of fading industrial new orders (4).
- Given the combination of the weak external and domestic environments, the impressive rebound in GDP in Q3 looks set to fall back. Unsurprisingly, weak domestic activity means that underlying inflationary pressures are subdued (5). We think this should allow the National Bank of Romania to cut the benchmark interest rate at its next meeting in January to support the economy, despite the recent weakness in the currency (6).

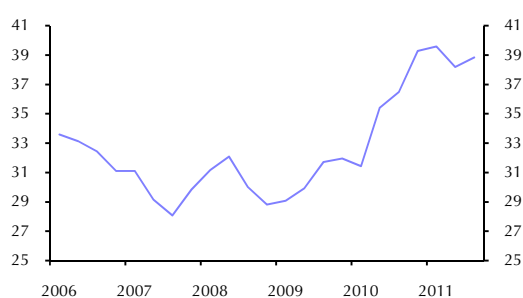
1. Real Wages & Unemployment



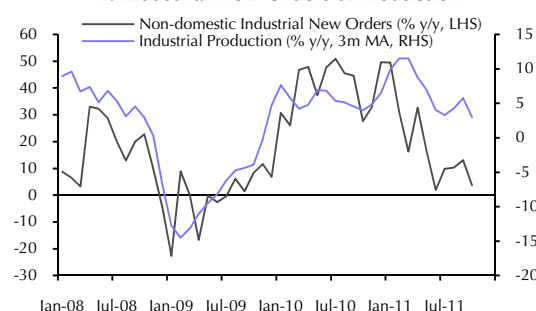
2. Consumer Confidence & Retail Sales



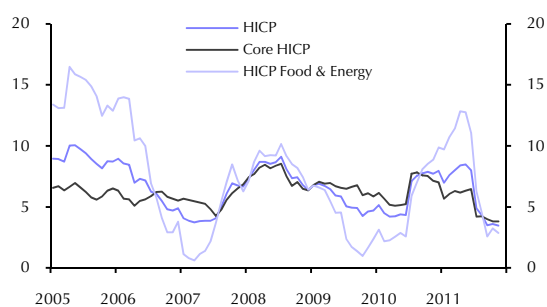
3. Exports (% GDP)



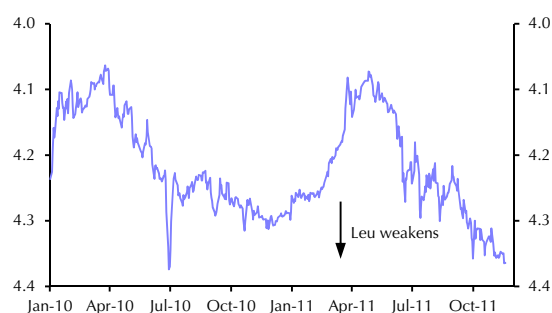
4. Industrial New Orders & Production



5. Consumer Prices (% y/y)



6. Exchange Rate vs. Euro

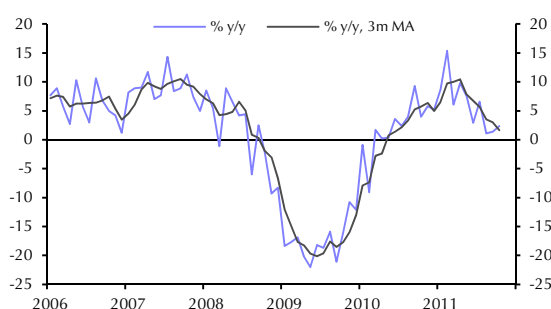


Sources – Thomson Datastream, Bloomberg, Eurostat, CE

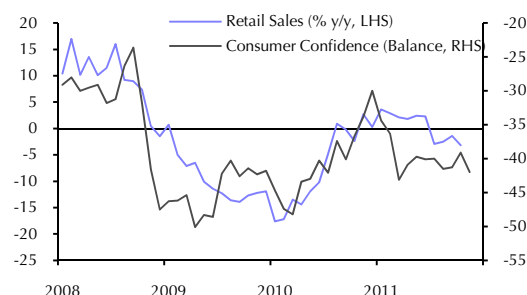
Bulgaria & Croatia

- The Bulgarian economy (and its key export-led industrial sector) has continued to slow. Export growth decelerated to 2.3% y/y in Q3 from an average of almost 20% y/y in the first half of the year on the back of weaker demand from Europe, the destination for over 60% of Bulgaria's total exports. What's more, despite last month's uptick in industrial production to 2.4% y/y from 1.4% y/y in September, the trend remains downwards **(1)**.
- The outlook for the Bulgarian consumer sector has also deteriorated over the past month. Real retail sales contracted on an annual basis for the fourth consecutive month in October **(2)**. And weak domestic demand has helped to keep underlying inflationary pressures subdued **(3)**.
- Meanwhile, in Croatia, the ruling conservative Croatian Democratic Union party lost its majority to a centre-left coalition in parliamentary elections held earlier this month, as was widely expected. But the new government is faced with a near stagnant domestic economy. Growth in industrial production is still struggling to pick up momentum, while exports contracted by a whopping 25% y/y in October **(4&5)**. This, in turn, has kept the unemployment rate hovering at around 18%, putting further pressure on already weak domestic demand **(6)**.

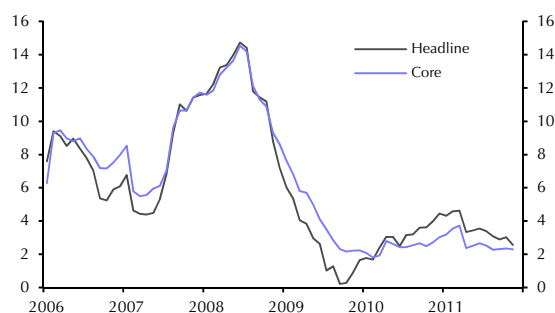
1. Bulgarian Industrial Production



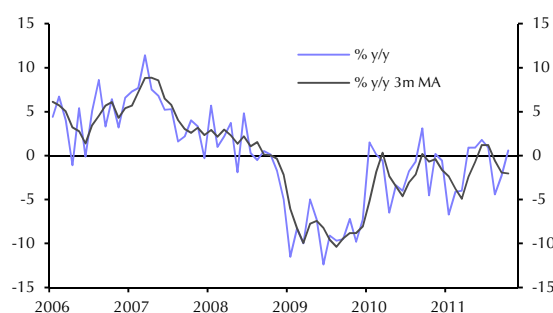
2. Bulgarian Retail Sales (% y/y)



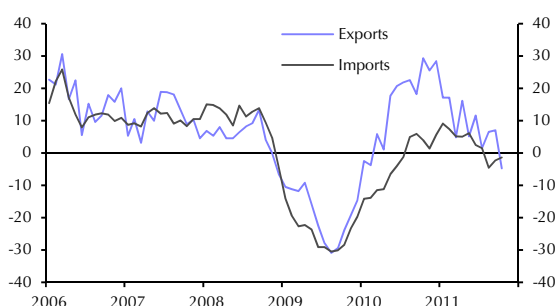
3. Bulgarian Consumer Prices (% y/y)



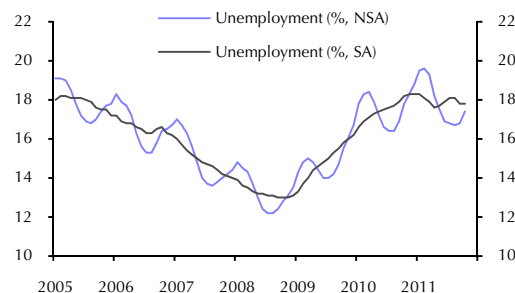
4. Croatian Industrial Production



5. Croatian Trade (% y/y 3m MA)



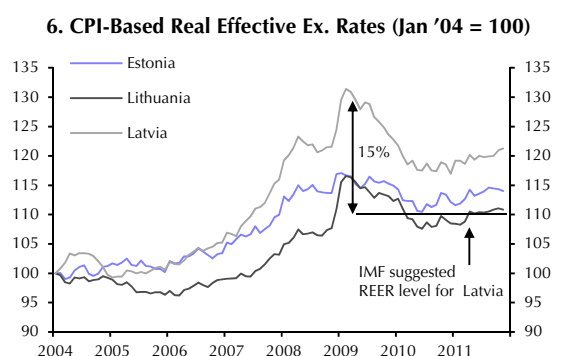
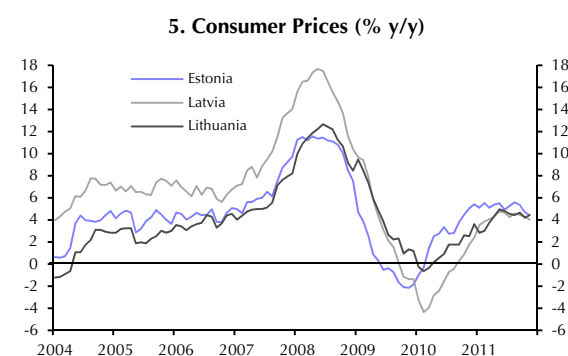
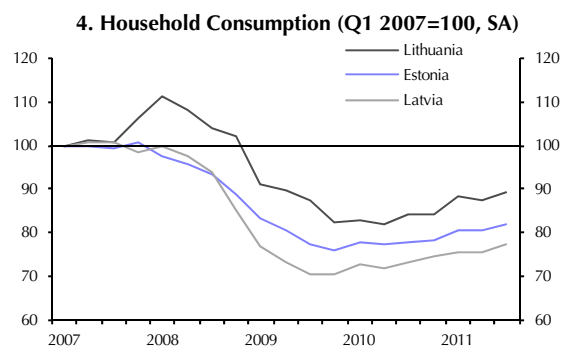
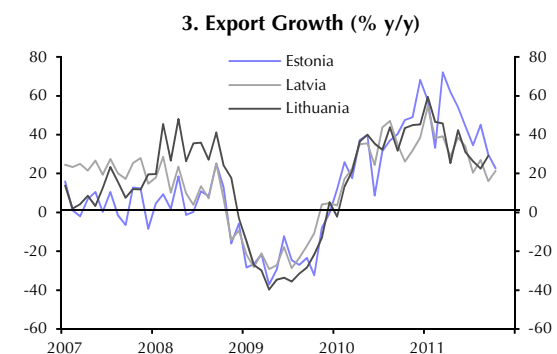
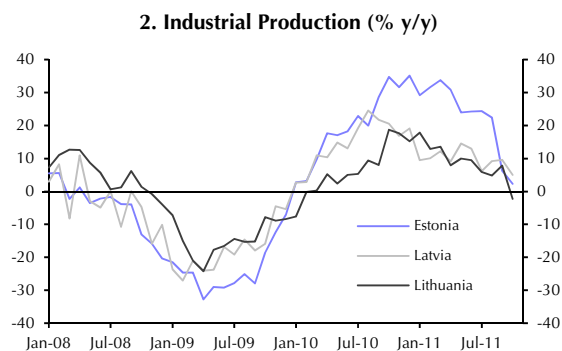
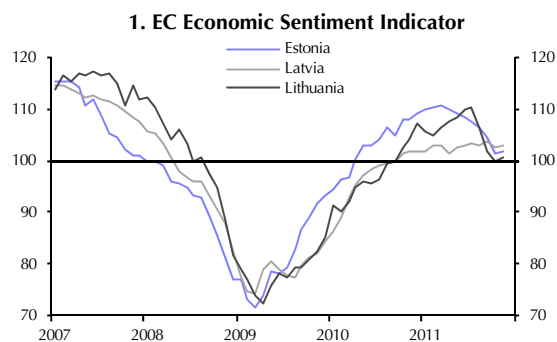
6. Croatian Unemployment



Sources – Thomson Datastream, Bloomberg, CE

The Baltic States

- This year's strong rebound in the three Baltic economies has continued to fade over the past month. Despite a modest pick-up in the EC's Economic Sentiment Indicator in November, it still points to a sharp slowdown ahead **(1)**. The key export-oriented industrial sector looks set to be hit the most – industrial output growth decelerated (and even contracted in Lithuania) in October on the back of slowing external demand **(2&3)**.
- As we have mentioned before, the recent deterioration in the external outlook is all the more worrying for the Baltic States as growth has been largely driven by exports this year. In fact, household consumption is still well below its pre-crisis levels in seasonally adjusted terms **(4)**. And with government austerity set to continue next year (particularly in Latvia), we expect domestic demand to remain weak.
- With economic activity slowing, underlying inflationary pressures are subdued. This year, the headline rate has been driven largely by high energy inflation but as last year's commodity price shock unwinds, we expect inflation to fall back next year **(5)**. This, in turn, should help to improve competitiveness through real exchange rate depreciation (which would be particularly beneficial for Latvia) **(6)**.

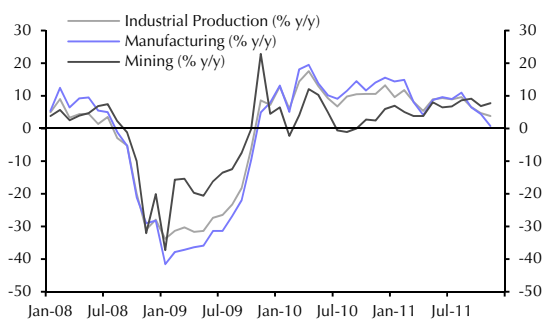


Sources – Thomson Datastream, Bloomberg, BIS, CE

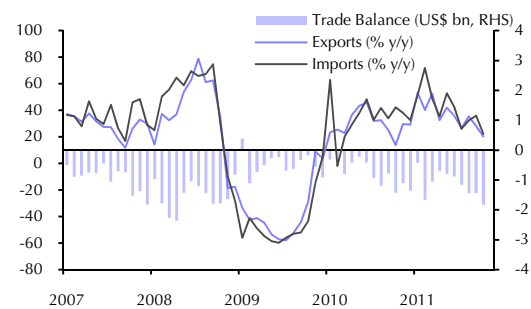
Ukraine

- Despite a strong rebound in growth this year, a slowdown is looming in the Ukrainian economy. Industrial production growth fell to 3.8% y/y in November from an average of almost 9% in the first half of the year. Growth in industry has been largely driven by the mining sector, but with steel prices falling back, this now looks set to decelerate **(1)**.
- This comes against the backdrop of a deteriorating outlook for industry in Ukraine's key trading partners (Russia and Europe). Export growth slowed in November, pushing the trade balance further into negative territory **(2)**. Meanwhile, robust growth in agricultural production continued to take the pressure off food inflation, causing the headline rate drop to a record low of 5.2% y/y in October **(3&4)**.
- But external financing problems continue to weigh on the economy. The failure to secure any sizeable discount on Ukraine's gas payments to Russia means that gas prices for households will continue to be subsidised from the federal budget. Hence, any help from the IMF is still off the cards. Meanwhile, interest rates of around 18% mean that borrowing from international markets is prohibitively expensive. Accordingly, the currency remains under pressure, forcing the National Bank of Ukraine to continue draining its FX reserves **(5)**. What's more, the domestic banking sector is starting to feel the strain – interbank lending rates have shot up over recent weeks **(6)**.

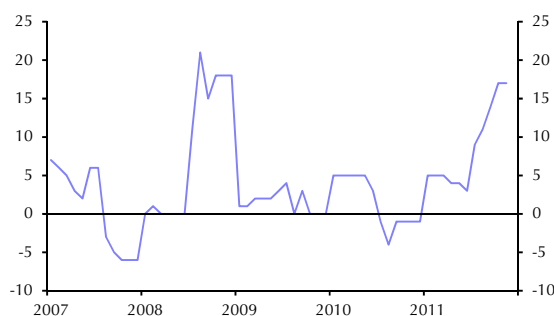
1. Industrial Production



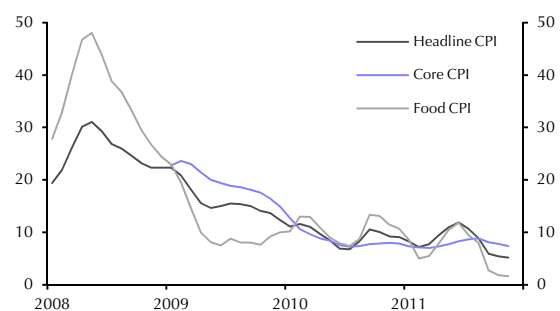
2. Exports & Imports



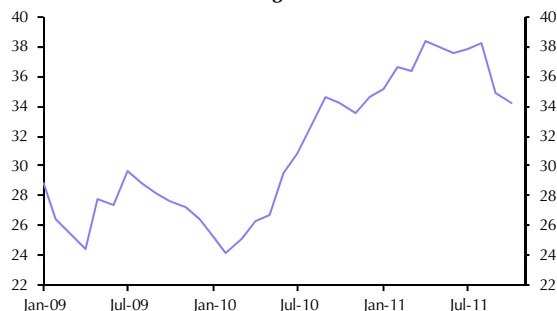
3. Agricultural Production (% y/y)



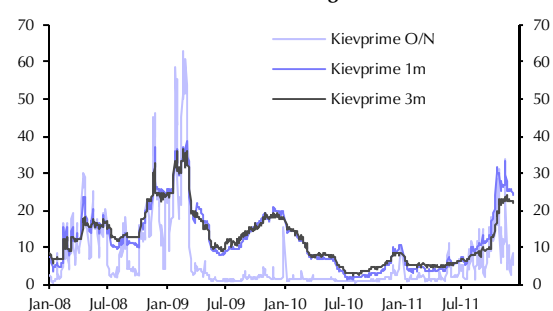
4. Consumer Price (% y/y)



5. Ukraine Foreign Reserves (\$US bn)



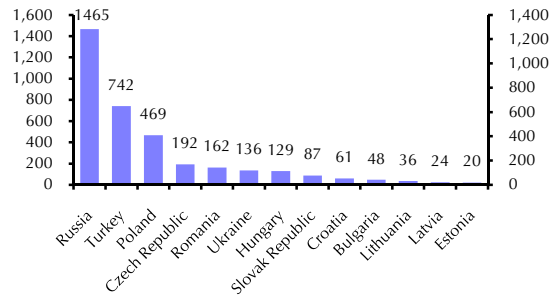
6. Interbank Lending Rates (%)



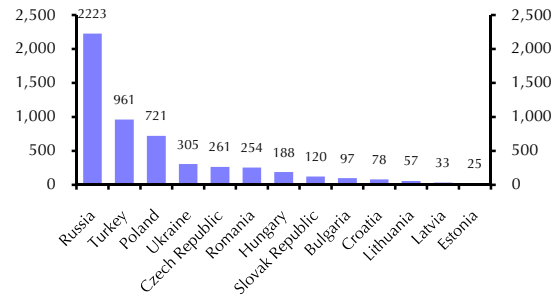
Sources – Thomson Datastream, Bloomberg, National Bank, CE

Background Data

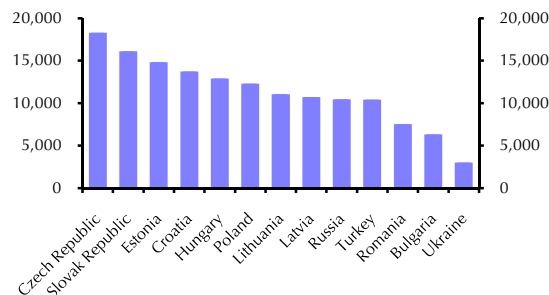
1. Current Price GDP (\$bn, 2010, Market Exchange Rates)



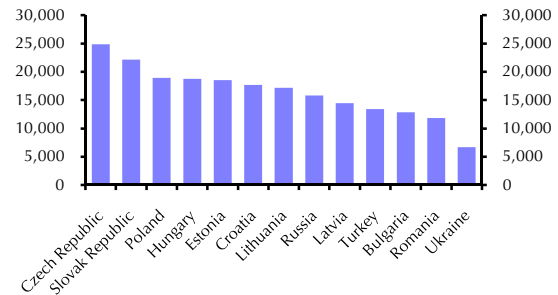
2. Current Price GDP (\$bn, 2010, PPP)



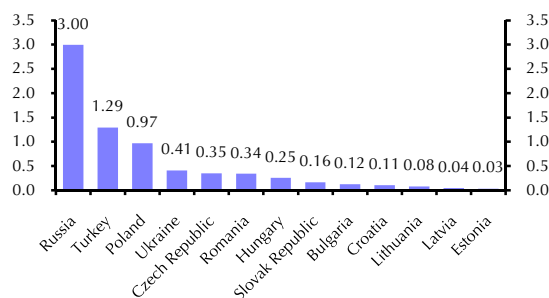
3. GDP Per Capita (\$, 2010, Market Exchange Rates)



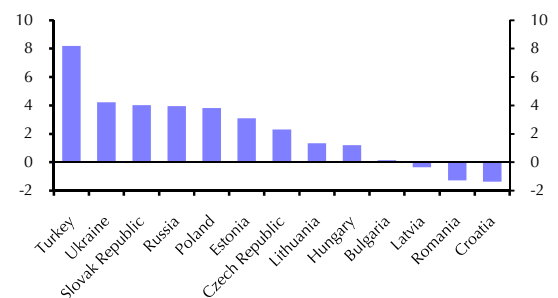
4. GDP Per Capita (\$, 2010, PPP)



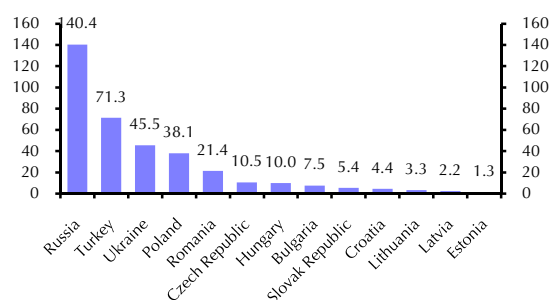
5. Share of World Output (% , 2010, PPP)



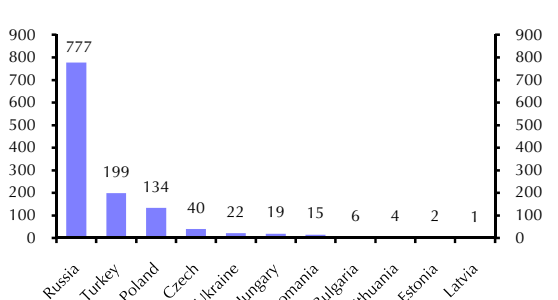
6. Real GDP Growth (% y/y, 2010)



7. Population (2010, Millions)



8. Stock Market Capitalisation (US\$bn, Dec. '11)



Sources – IMF, Bloomberg, Capital Economics