



TALKING POINTS

Economic Growth Prospects in
Central and Eastern Europe

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In early 2009, many analysts feared that Central and Eastern Europe (CEE) was hurtling toward a regional crash reminiscent of the East Asian crisis of the late 1990s.

The implosion of global financial markets exposed the vulnerability of the region's banking sector, while shortfalls of foreign capital threatened the ability of CEE countries to finance their current account deficits. Housing bubbles burst in some CEE countries, while currency devaluations imperiled regional households that had assumed foreign exchange-dominated mortgages in the pre-crisis years. European Union authorities voiced misgivings over the EU's eastward enlargement project, which extended membership to post-socialist economies that now appeared as heavy burdens on West European member states grappling with their own economic woes.

However, by year's end Central and Eastern Europe showed cleared signs of having weathered the economic storm. Regional stock and bond markets staged a slow recovery from the losses of 2008-09. Interbank lending rates fell and long-term yields rose in most CEE countries, signaling a stabilisation of the region's fragile financial systems. CEE exports, which had plummeted in response to falling demand in Western Europe, began a gradual rebound. The contraction of GDP (which surpassed double digits in the Baltic Republics and approached 10 percent in Bulgaria, Hungary, and Romania) had bottomed out, setting the stage for the resumption of economic growth in 2010.

But Central and Eastern Europe's incipient recovery from the Great Recession will be (using the terminology of the World Bank's October 2009 report on the CEE countries entitled *From Stabilisation to Recovery*) "feeble and uneven". At the regional level, CEE growth appears unlikely to reach pre-crisis levels in the foreseeable future, and will fall well below growth rates of other emerging markets. At the country level, the CEE states display wide variations in GDP growth trajectories that demonstrate the region's increasing diversity.

Links Between EU-15 and EU-10

Central and Eastern Europe's resilience to the turmoil that roiled global financial markets in 2008-09 illustrates the region's distinctive position among emerging markets. In particular, the pivotal role of the European Union in the CEE countries (manifested in an broad web of commercial, financial, and institutional connections between the EU-15 and EU-10 member states) distinguishes Central and Eastern Europe from other emerging markets.

For the CEE economies, these EU links cut in both directions. On the one hand, the European Union provides a regional supplement to multilateral assistance to the CEE countries that is unavailable to other emerging markets. On the other hand, the small economies of Central and Eastern Europe are heavily dependent on West European export markets whose growth prospects in coming years are weak at best.

In contrast to previous emerging market financial crises (e.g., Mexico 1994, East Asia 1997-98, Russian Federation 1998, Argentina 2001) that triggered extensive capital flight, CEE's foreign investors did not flee when financial turbulence hit the region. Nordic-based banks, heavily exposed to the "hard landing" of the Baltic states, remained committed to their subsidiaries in Estonia, Latvia, and Lithuania.

Similarly, Raiffeisen and other Austrian banks with large investments in Hungary held their positions as that country reeled under the impact of the financial crisis. Along with Latvia and Romania, Hungary received a standby loan from the International Monetary Fund, whose coordination with EU institutions (notably the European Central Bank) helped the CEE countries weather the financial storm.

The IMF also provided a \$20.6 billion Flexible Credit Line (a special facility for countries with strong macroeconomic fundamentals) to Poland, the CEE region's best-performing economy. The Fund's response to the CEE financial crisis demonstrates how Central and Eastern Europe benefits from lessons learned by an international financial institution whose interventions in earlier emerging market crises were widely derided.

The commitment of West European investors to Central and Eastern Europe amid the financial meltdown reflects the tight integration of the EU-15 and EU-10 economies, which well surpasses links between other developed/emerging markets (e.g., Japan and East Asia, U.S. and Mexico). The experience of 2008-09 has prompted the EU's consideration of accelerating the CEE countries' adoption of the Euro, a common currency zone that has no counterpart in other emerging markets.

Economic Growth Trends

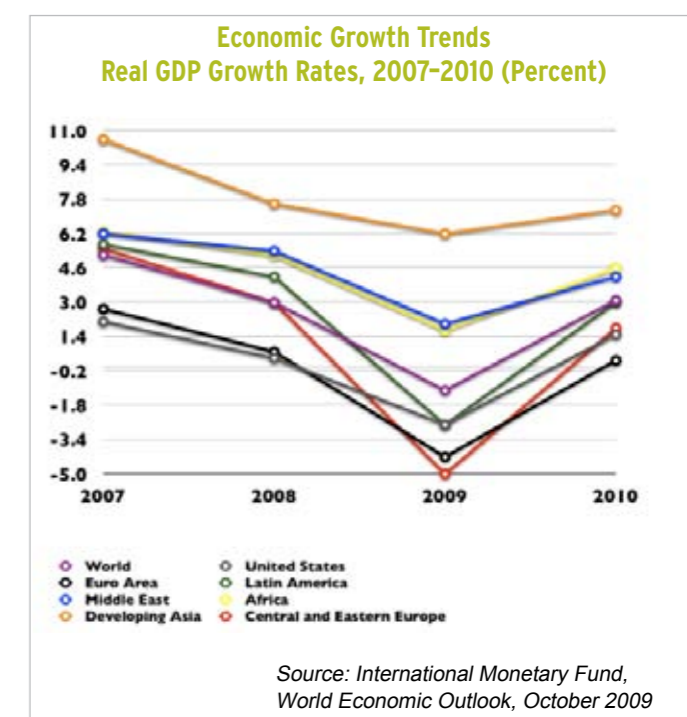
But the close interconnectivity of the EU-15 and EU-10 economies also illustrates the degree to which the growth prospects of Central and Eastern Europe hinge on the resurgence of demand in Western Europe, which represents upwards of 80 percent of CEE exports.

Most of the EU-15 countries are expected to resume GDP growth in 2010. But projected growth rates in the CEE region's primary export markets (Germany, France, Italy, Netherlands, Sweden, U.K.) are tepid and dependent on fiscal/monetary stimulus programs whose effects will soon dissipate. Growth of underlying consumer demand in Western Europe (and hence demand for CEE exports) will remain weak in coming years as the repercussions of the Great Recession slowly unwind.

Furthermore, export companies headquartered in Central and Eastern Europe appear ill-disposed to boost exports in markets outside the

European Union. China and India, which have already resumed strong GDP growth paths, enjoy insurmountable scale and cost advantages over the CEE countries. Other large, well-endowed emerging economies (Brazil, Indonesia, Russia) are better positioned to exploit the anticipated growth in commodity demand as the global economy recovers.

For these reasons, Central and Eastern Europe's growth prospects are guarded. As shown in **Exhibit 1**, the Great Recession exacted a higher toll on Central and Eastern Europe than other regions. Regional economic output fell by 5 percent in 2009, surpassing the GDP contraction of the Euro area (4.2 percent), the United States (2.7 percent), and Latin America (2.7 percent). The IMF forecasts a 2010 GDP growth of 1.8 percent in the CEE region, above the Euro zone and U.S. but below Developing Asia, Latin America, Middle East, and Africa.

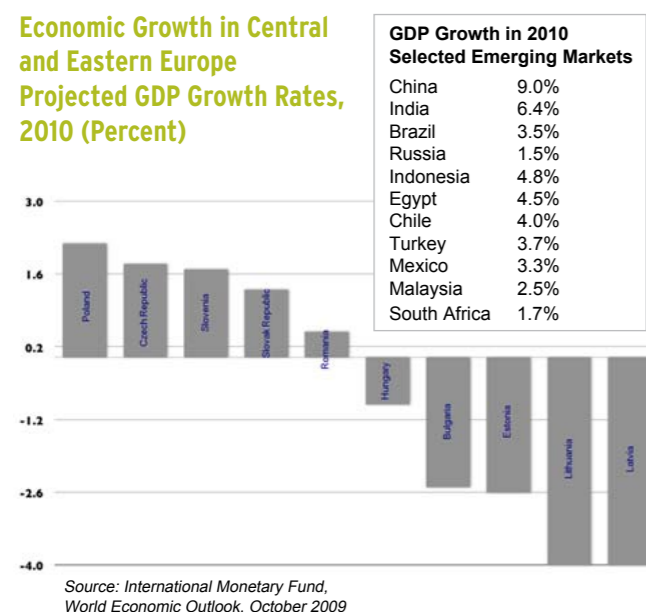


Intra-Regional Patterns

The variations in GDP growth within Central and Eastern Europe reveal much about the economic profiles of the CEE countries.

Exhibit 2 reports the forecasted GDP growth rates of the EU-10 countries in 2010. For comparative purposes, the exhibit also displays the project growth rates of selected emerging markets outside Central and Eastern Europe.

Economic Growth in Central and Eastern Europe Projected GDP Growth Rates, 2010 (Percent)



The CEE region breaks down roughly into three groups: (1) Poland, the region's largest and most robust economy; (2) four countries projected to attain modest GDP growth in 2010 (Czech Republic, Slovenia, Slovak Republic, and Romania); and (3) five countries whose economies are expected to contract in 2010 (Hungary, Bulgaria, Estonia, Lithuania, and Latvia).

Robust Growth: Poland

Poland is unambiguously the CEE region's strongest economy, and indeed the only European country to achieve positive GDP growth in 2009.

Poland's economic strength reflects the following factors:

- A large domestic market, which lowers the economy's dependence on exports and enables Polish companies to pursue local sales amid flagging demand in foreign markets
- A diversified economic base covering aerospace, agro-processing, construction, energy, food and beverages, machinery, medical devices, motor vehicles, pharmaceuticals, and other industries
- Strong human capital drawing on a sizable cohort of young professionals, many of whom returned to Poland after stints in Ireland and the United Kingdom
- A number of economically significant regional clusters (Bydgoszcz, Gdańsk, Katowice, Kraków, Łódź, Poznań, Rzeszów, Szczecin, and Wrocław in addition to Warsaw) that distinguish Poland from smaller CEE countries whose commercial hubs are concentrated in capital cities
- The residual effects of Poland's shock therapy program in the 1990s, which rendered the country better able to manage the economic downturn than other CEE countries (e.g., Hungary) that delayed structural reforms

These assets bolster Poland's capacity to attract foreign direct investment, a key determinant of sustainable growth as the short-term effects of counter-recessionary stimulus programs ebb. A July 2009 survey of international corporate executives conducted by the United Nations Conference on Trade and Investment (World Investment Prospects Survey 2009-2011) ranked Poland 13th in the list of the world's leading destinations for foreign direct investment, just behind Mexico and ahead of France. (China placed first in the survey, followed by the U.S., India, and Brazil.)

Modest Growth: Czech Republic, Slovenia, Slovak Republic, Romania

The second group includes the Czech Republic, whose strong ranking in UNCTAD's foreign investment survey (along with Poland the only CEE economies to place in the top 30 FDI destinations) underscores the pull of the country's strong engineering base and skilled work force. Czech Republic's capabilities in advanced manufacturing and favorable geographic locale make it a preferred site for Austrian, German, and Swiss multinationals seeking lower labour costs and weaker trade unions.

At the same time, Czech Republic's status as a high-wage economy in Central and Eastern Europe has heightened competition by Slovakia and other lower cost CEE countries. This development underscores the need for continuing investments in human capital, technology, and infrastructure needed to boost Czech productivity growth.

As the only EU-10 states to have entered the Euro zone by the time of the global financial crisis, Slovenia and the Slovak Republic are comparatively insulated from turbulence in foreign exchange markets. But Euro membership also denies those countries use of the exchange rate as an adjustment mechanism and constrains their ability to run fiscal deficits to spur growth. The small market size and high labour costs of Slovenia narrow that country's appeal to foreign investors, while Slovakia's exposure to adverse trends in the automotive industry (which represents an outsized share of the country's FDI portfolio) limits its growth potential.

Romania suffered one the region's biggest GDP contractions in 2009 (8.5 percent), reflecting both the impact of the global recession and the suspension of capital flows to a country that was running an unsustainable current account deficit. The IMF projects mildly positive growth (0.5 percent) of the Romanian economy in 2010. But Romania's large size (second most populous country in Central and Eastern Europe after Poland) and strong resource base (including oil and gas) indicate

substantial scope for growth in coming years. By the IMF's estimate, Romania will reach 5.0 percent GDP growth by 2014.

Economic Contraction: Hungary, Bulgaria, Estonia, Lithuania, Latvia

Hungary, once one of post-socialist Eastern Europe's best-performing economies, registered mediocre growth numbers in the pre-crisis years (1.2 percent real growth in 2007 against a regional level of 5.5 percent) before slowing to virtually zero growth in 2008 and then a 6.7 percent GDP contraction in 2009. Fiscal mismanagement, a shaky banking system, and an over leveraged household sector have eroded investor confidence in the Hungarian economy.

But Hungary's large installed multinational base (which resulted from heavy inflows of manufacturing-intensive FDI in the 1990s and which generates a disproportionate share of national exports) remains a significant competitive asset. Whether Hungary succeeds in leveraging that asset for sustainable growth hinges on the country's ability to surmount a domestic political impasse that has long delayed structural reforms.

Bulgaria's huge current account deficit (25.5 percent of GDP, the largest in Europe after Iceland and Montenegro) left the country in a highly vulnerable position when the global credit crunch hit in fall 2008. The resultant fall in capital flows to Bulgaria forced a sharp reduction in imports that halved the external deficit. But this externally imposed adjustment also limits the growth potential of an economy that displays one of the European Union's lowest per capita incomes and that requires Western imports to bridge the developmental gap.

The three Baltic states have suffered a dramatic reversal of fortune in recent years. Latvia was Europe's fastest growing economy in the mid-2000s, posting 10-12 percent yearly growth rates. Estonia and Lithuania grew in the high single digits during the pre-crisis period.

But the combination of large current account deficits, excessive credit growth, and mounting housing bubbles precipitated an economic crash that dashed expectations of a soft landing in the Baltics. Estonia and Latvia were already registering negative GDP growth in 2008 (before the other CEE countries) and endured output falls of 14.0 and 18.0 percent respectively in 2009. The Lithuanian economy contracted by 18.5 percent in 2009, the steepest GDP decline of any European country and one of the biggest in the world.

Similar to Bulgaria, the Baltic Republics are undergoing an externally imposed adjustment that has narrowed their current account deficits. Indeed both Latvia and Lithuania posted current account surpluses in 2009, a trend that is expected to continue in 2010. As tiny, vulnerable economies operating in a newly constrained global capital market, the Baltic states have no choice but to enact deep import cuts to correct their external imbalances.

But that correction limits the Baltics' access to the technology and equipment needed to modernise their economies and bridge the income gap with the wealthier CEE countries and Western Europe. IMF economists believe that it will take several years for the Baltic Republics to wind down their external imbalances and resume GDP growth. Furthermore, what economic growth rates Estonia, Latvia, and Lithuania do achieve in coming years will fall far short of the levels that earned them the title of "Baltic Tigers" in the early/mid 2000s.

Conclusion: Central and Eastern Europe in the Global Recovery

Central and Eastern Europe enjoys significant competitive advantages over the BRICs (Brazil, Russia, India, China) and other emerging markets. The region's geographic centrality in the 500 million person EU market affords major logistical advantages over emerging market competitors. Large inflows of EU Structural and Cohesion Funds are modernising regional infrastructure and expanding CEE access to the pan-European market. The region's convergence toward EU-style intellectual property laws has reduced the risks of IP-sensitive investments relative to other emerging economies. And the strong human capital of the CEE countries bolsters their capacity to attract foreign investment by leading West European companies and FDI by non-European multinationals seeking platforms to service the huge EU market.

The Great Recession has not eliminated these competitive assets. But the contraction of the CEE economies in 2008-09—and the expectation of modest growth rates in 2010 and beyond—has heightened the challenges of competing with China and other emerging markets that have already resumed strong GDP growth paths.

BIOGRAPHY

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David Bartlett, Economic Consultant, has over ten years' experience of consulting, researching and teaching on international corporate strategy. He specialises in international growth, global manufacturing, foreign sourcing and distribution and corporate risk management.

David's clientele includes multinational corporations and international financial institutions in North America, Europe, Asia-Pacific and the former Soviet Union.

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