

## CEE - to grow or not to grow?

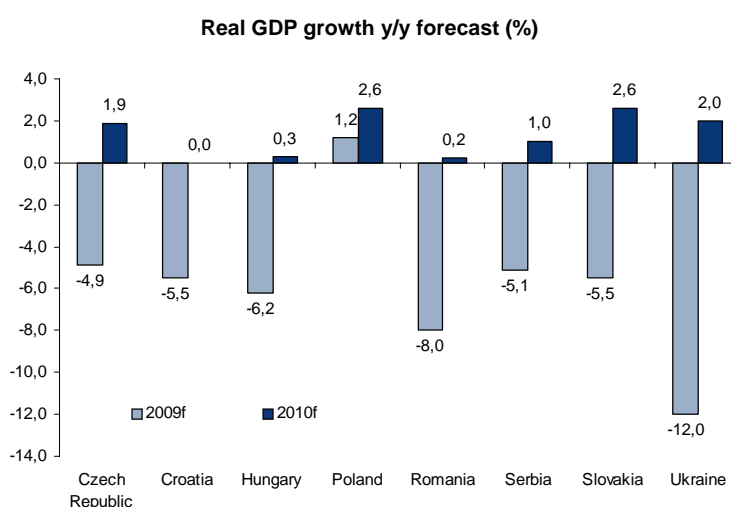
### More people at work, converging technologies and sustainable business environment decide the growth in CEE rather than capital inflows

- Poland avoided recession, Czech Republic, Slovakia and Ukraine reached bottom in 1Q09, all of them are to grow 2-3% y/y next year
- Romania, Hungary, Croatia and Serbia are lagging about 1-2 quarters behind and will stagnate 2010
- Adjustment of current account imbalances, which hammered domestic demand, is close to end
- Investments are to stabilize at lower levels, implying about 4.1% potential growth on average for future

CEE8 economies have followed the global economic slowdown this year, with most economies contracting 5-6% y/y. Some countries are estimated to contract more (Ukraine, Romania, Hungary), some less (the Czech Republic), while one country (Poland) is to avoid recession entirely. There were various factors behind the contraction this year: a sizable adjustment of current account deficits (Romania, Serbia, Ukraine), falling exports (the Czech Republic, Slovakia, Hungary) and undergoing fiscal consolidation (present only in Hungary this year). "However, we have seen first signs of stabilization in the region, as the industrial production is getting better in the Czech Republic and Slovakia, while the increase of seasonally-adjusted unemployment has been slowing down", says Juraj Kotian, Co-Head Macro/Fixed Income CEE. Poland has been the only country to totally avoid recession. Countries with wide current account deficits like Romania, Hungary, Croatia and Serbia are lagging in bottoming out by about 1-2 quarters. The contraction of domestic demand was much stronger, driven by faster than previously anticipated adjustments of current account deficits and speeded up by global deleveraging. Given the subdued domestic demand, it will continue to narrow in the next two quarters, which will reduce external financing needs. Consumer confidence and retail sales are still depressed in these countries and preconditions for their upturn are stabilization of the job markets and stable currencies. The latter has already been proven, while unemployment is to peak in the next two-three quarters.

#### To grow or not to grow?

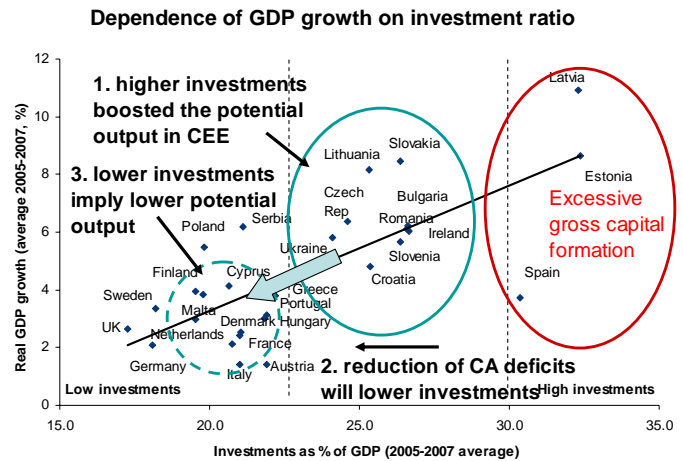
Next year's growth will be influenced mainly by the low base of exports and diminishing negative effect of destocking in inventories. "The Czech Republic, Slovakia, Poland and Ukraine should grow about 2-3% y/y next year, which means well below their potential", predicts Kotian. "Countries that have not bottomed out yet, i.e. Hungary, Croatia, Romania and Serbia, are to grow by up to one percent next year or stagnate as the recovery starting later than in 1Q would not be adequately captured in the full-year growth next year." To say more about growth beyond 2010, it is more interesting to look at potential output. Erste Group's model implies about a 5-40% decline of investments to remove current account deficits, the highest in the Baltics, and up to a 10% decline in consumption, the lowest in the Czech Republic and Poland.



Source: Eurostat, Erste Group Research

### Lower investment ratio reduces the potential output in the years to come

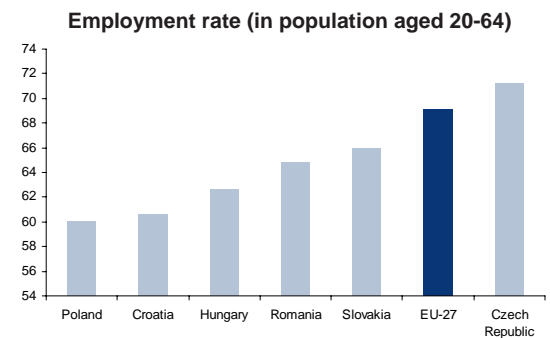
Extraordinarily high investment ratios (especially in the Baltic states), funded by foreign capital inflows, increased the potential output in the boom period, but at the expense of mounting current account deficits resulting from the big gap between investments and domestic savings. After the crisis emerged, the lack of external financing forced countries with a high current account deficit to slash investments and increase savings (through cuts in consumption), in order to reduce demand for external financing or even bring down outstanding external debt. There is a relatively strong long-term correlation between the investment ratio and GDP growth: A decline of investments not only have a short-term negative effect, but stabilization of the investment ratio at a lower level reduces the potential output in the following years. *“The results are similar to the pattern we observe in CEE economies”*, analyzes Kotian further, *“a 5-40% decline of investments, the highest in the Baltics, and up to a 10% decline in consumption, the lowest in the Czech Republic and Poland”*. After the full adjustment, the investments would come down from +30% of GDP to about 20% of GDP on average. The Czech Republic, Slovakia and Estonia, countries with a typically high level of national savings, can afford the highest investments, while, in other countries, self-financed investments would stabilize at about 18-21% of GDP. However, these are still levels that imply potential growth of about 3-4%.



Source: Erste Group Research

### Growing labour participation might increase the GDP growth

Employment growth will in the long run be affected by demography. In some countries, such as Slovakia and Poland, the working age population grew by as much as 0.9% p.a. and 0.7% p.a., respectively, over 2000-07, and thus contributed to higher GDP growth. In Hungary and Romania, the impact was close to zero, while the Czech Republic and the Euro Area fell in between with 0.5% annual growth of the working age population. Due to demographic trends, the positive impact on GDP growth should diminish in the years to come in some countries, unless they adjust their retirement age<sup>2</sup>. On the other hand, CEE countries tend to have higher unemployment rates and lower labor participation rates compared to European economies. *“If the markets succeed in implementing some structural reforms in the labor market and increase the labor participation rate, labor input should also provide support for GDP growth in the medium term”*, is Kotian confident.



Source: Erste Group Research

<sup>1</sup> Simplified analysis with a 60:40 split for the current account deficit to be eliminated by a decline of investments and increase of the saving ratio. From production factors, only physical capital was considered, while the current account deficit was fully eliminated - which is too conservative assumption for the long run.

<sup>2</sup> Hungary recently lifted its retirement age to 65.

**The institutional and technological convergence in CEE brings higher economic growth**

Since the fall of the socialist regimes, CEE countries have followed a path of gradual (albeit uneven) institution strengthening and transfer of technology and know-how<sup>3</sup>. This was further reinforced by EU entry. While CEE countries moved forward, this institutional and technological convergence still has a long way to go and will likely continue in the years ahead. *“Thus, CEE countries might bet not only on capital and labor inputs for growth, but also on efficiency gains, which should ensure that CEE will continue to enjoy higher economic growth than its peers from Western Europe”*, explains Kotian. Of course, this premium growth does not have to be uniform throughout CEE. The coming months should clarify the political situation in Romania, where the ruling coalition has fallen apart. The Czech Republic, Hungary and Slovakia are to hold elections in 2010. The governments established by these elections and the structural reforms they undertake might be important determinants of potential output in the coming years. *“As we expect capital flows to have a smaller impact in the future, reforms that lead to a better business environment will be an even more important source of economic growth”*, summarizes Kotian.

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<sup>3</sup> For example, corruption has abated (see Transparency International's Corruption perception index); it is easier to set up a business or register a property (see World Bank's Doing Business reports).

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