



## Emerging Europe: Fourth Quarter 2011 Economic Review

The European Bank for Reconstruction and Development (EBRD) was established in 1992 to help the former communist states in their transition to market-based economies. The EBRD's mandate includes investments in Russia and its erstwhile satellite states such as Poland and Hungary, as well as in Turkey located in south-eastern Europe.

### At a Glance

- **Russia:** Though third quarter economic growth was impressive, the world's biggest commodities exporter may see slowing growth in the fourth quarter as the debt crisis in Europe has hit demand for oil and natural gas.
- **Turkey:** According to the data available for the month of September, the current account deficit stood at \$6.8 billion, which is nearly 80% more than the year-ago period. The increase in the deficit has taken the central bank by surprise.
- **Poland:** The European Bank for Reconstruction and Development said the economy's reliance on domestic demand makes it resilient to a slowdown in the Euro-zone despite vulnerabilities in the fiscal and financial sector.
- **Hungary:** The central bank said the country is likely to miss its budget deficit target for 2012. Hungary may find it tough to get an IMF loan as the agency suspended loan talks over the country's move to make its central bank less independent.
- **Czech Republic:** In a sign that the Euro-zone crisis is catching up with the export-oriented economy, a widely-watched manufacturing index showed contraction for the second month in December on weakening of domestic and export orders.

The Czech Republic, which was the first country to complete the transition process successfully, has come out from under the EBRD umbrella. According to the bank's latest forecasts, GDP growth in the central and eastern European region will be approximately 4.5% in 2011 and about 3.2% in 2012.

The downward revision in the bank's estimates for 2012 from its earlier view of a 4.4% growth reflects the ongoing debt crisis in the Euro-zone, which is expected to also affect growth in the emerging Europe region in 2012. However, the EBRD singles out Russia as less likely to be affected by the Euro-zone events compared to its former satellite states. For central Europe and the Baltic states, the bank sees growth slowing to 1.7% in 2012. Among the former communist countries, the London-based lender sees Hungary as the weakling due to its exposure to the Euro-zone. The bank said growth in Turkey will slow down to 2.5% in the current year due to a fall in capital inflows and credit growth, not to mention the weakening external demand.

### **Russia: Unexpected rate cut signals growth concerns**

**Toward the end of December, Russia unexpectedly cut its benchmark refinancing rate, signaling that slowing global growth may posing a bigger threat than inflation to the top energy exporter.** The refinancing rate was cut to 8% from 8.25%, according to a statement from the Bank of Russia. With this rate cut, Russia joins the ranks of other emerging economies, such as Brazil and Indonesia, which have also reduced borrowing costs in an attempt to tide over the effects of a European debt crisis and a slowdown in China. Meanwhile, inflation came down to 6.4% from 6.8% in November.

**Meanwhile, Russia's gross domestic product grew at the rate of 5.1% in the third quarter, which met analyst expectations.** Significantly, the quarterly growth was the first time the economy expanded since 2010. However, the world's biggest commodities exporter may be in for slowing growth as the debt crisis in Europe hits demand for oil and natural gas.

Understandably, the government predicts GDP growth below 4% for the fourth quarter. The economy minister said the outflow of capital, which is set to reach \$70 billion in 2011, and the insufficient quantum of investment should hamper Russia's growth in the subsequent quarters.

Despite slowing manufacturing growth during the last quarter, farm production, which came in 50% above last year's output, proved to be the saving grace for the economy after last year's devastating drought.

**Manufacturing growth in Russia slowed in December due to reduced new orders and weakening export demand.** The HSBC Purchasing Managers' Index clocked 51.6 during the month, compared to 52.6 in November, according to a *Bloomberg* news report. The slowing growth comes as a surprise after the scorching pace of expansion in November.

Amid the global gloom, Russia had something to cheer about in the dead of winter. **The country formally became a member of the World Trade Organization (WTO) in mid-December, having completed talks with all existing members of the global trade body.** The membership is expected to help Russia help diversify its economy from its traditional role as an energy exporter, a Russian academic opined in the *Financial Times*. It may also give a boost to the services sector in Russia, which is comprised of telecommunications and financial services. More importantly, the WTO accession also means the country is making a conscious effort to improve its investment climate. The WTO membership will require Russia to comply with a legal framework as far as investment and foreign trade are concerned.

### **Turkey: Current account deficit raises alarm**

**Turkey's burgeoning current account deficit seems to one of the key issues faced by the fast-growing economy. According to data available for the month of September, the deficit stood at \$6.8 billion, which is almost 80% more than the year-ago period.** The increase in the deficit has taken the Turkish central bank by surprise, which had hoped the slackening of demand growth would help reduce the deficit. According to an analyst quoted in the *Financial Times*, a further decline in energy prices and a slowing down of the economy would only help to bring down the deficit to acceptable levels. Predictably, the rating agency Fitch cut Turkey's long-term foreign currency rating outlook to "stable" from "positive", taking into account the record current-account deficit. Still, Turkey's economy clocked a growth rate of 8.2% in the third quarter, just behind China.

The central bank seems to stick to its unorthodox policy of keeping interest rates low. While maintaining the benchmark rate at 5.75%, the bank had doubled the cost of borrowing for banks in October in order to support its currency, the lira, and to combat inflation. Consumer price inflation came in at 7.7% in October after prices increased. The central bank believes inflation may touch 8.3%, above its target rate of 5.5%, by the end of the year. However, in its latest statement, the central bank said it will continue to follow a flexible monetary policy going into 2012.

Meanwhile, Goldman Sachs reduced its estimate for Turkey's GDP growth in 2012 to 0.5% from its current view of 1.5%, according to a *Bloomberg* news report. The investment bank said the domestic economy may experience a sharp downturn in view of the difficult "domestic and external financing conditions." Still, the Turkish central bank commented that the Turkish economy may bounce back in the second half of 2012 if the European crisis is resolved.

### **Poland: Growth seen to slow down next year**

#### **Poland managed to end 2011 without crossing its public debt threshold of 55% of the GDP.**

The Polish economy minister announced that the eastern European nation's debt to GDP ratio touched 54%, according to a *Financial Times* report. Moreover, the *FT* report said the Polish finance ministry forecasts that public debt will gradually fall from its 2011 level to a rate of 52.4% of GDP in 2012, which it hopes will go down to 47.4% by 2015. Meanwhile, Poland had another reason to cheer as rating agency Moody's reaffirmed the country's credit rating with a stable outlook citing its "strong and proven track record" of economic stability, as an *FT* report said.

Though Poland managed to avoid a recession during the financial crisis of 2009, the Euro-zone crisis is bound to affect the economy going forward. The country's currency, the zloty, weakened against the euro last year, while equities fell sharply. Recognizing the economic situation, the Organization for Economic Cooperation and Development said that the economy will grow at the rate of 4.2% in 2011 and by 2.5% in the current year, according to a *WSJ* report. However, the government's estimates for expansion are better at 3.2% growth for 2012. In its October

review, the European Bank for Reconstruction and Development (EBRD) said that the growth outlook for Poland has moderated, especially for 2012. The bank explained that the Polish economy's reliance on domestic demand makes it resilient to a slowdown in the Euro-zone despite vulnerabilities in the fiscal and financial sector.

However, Polish GDP increased 4.2% during the third quarter from the year-earlier period, which also came in above analyst forecasts of 4%. **The uninterrupted GDP growth in Poland for the fifth quarter in a row has been attributed to an increase in private consumption, growth in investments, and the contribution from exports.** Industrial output also posted a 7.7% growth during the quarter, helped by export-oriented industries.

The re-elected Prime Minister Donald Tusk promised to address the issue of Poland's rising budget deficit in November. Tusk said he plans to cut the budget deficit to 3% of GDP by 2012, from the current levels of 5.8%. Meanwhile, Morgan Stanley said the Polish central bank is likely to alter its current policy of defending the zloty to a stance that would include a monetary stimulus program to counter a possible European recession in 2012, according to a *Bloomberg* news report.

### **Hungary: Open to loan talks with the IMF**

**The Hungarian central bank recently said that the country is likely to miss its budget deficit target during the current year.** The deficit may reach 3.7% of the GDP in 2012, overshooting the government's target of 2.5%, the central bank said. On December 20th, the bank increased its benchmark interest rate to 7% from 6.5% earlier, the highest rate in the entire European Union. The rate hike also strengthened the public perception that the central bank and the Viktor Orban government are at loggerheads when it comes to policy matters. **Meanwhile, the central bank said the country's public debt jumped to 82.6% of the GDP at the end of the third quarter, according to a *Bloomberg* news report.** The central bank also revised the GDP forecast down for 2012 to 0.1% from its earlier forecast of a 0.6% growth. At the same time, the bank raised the projected inflation rate from 3.9% to 5%.

**Hungary, which had availed itself of a loan from the International Monetary Fund (IMF) in 2008, approached the Washington-based lender again in its hour of crisis. However, in December, the IMF and the European Union suspended talks about offering a loan package to Hungary over the government's move to curb the independence of the central bank.** Still, in a positive development, Hungary recently said it was open to fresh negotiations with the IMF over a standby loan without any conditions attached. A Hungarian minister said the country is also willing to discuss the controversial act concerning the central bank.

The Viktor Orban administration is hugely unpopular due to some extreme measures taken last year, such as the implementation of bank taxes and the nationalization of pension funds. With the country seeking IMF help yet again, rating agencies Moody's and S&P both downgraded Hungary and stripped the economy of its investment-grade rating. Moody's also said there is quite a bit of uncertainty over the government's ability to achieve its goal of reducing public sector debt and fiscal consolidation, according to a *Bloomberg* news report. As well, ratings firm Fitch cut the country's credit rating to negative on fiscal concerns.

The European Bank for Reconstruction and Development also has a dim view of Hungary's economic situation. The bank said the country has exposure to risks from the Euro-zone, thanks to its export-dependent economy. It added that the crises taxes imposed on various sectors such as banking would affect their capacity for lending.

**Though Hungary seems to be in the news for all the wrong reasons, the third-quarter GDP data offered a breather for the beleaguered economy.** The eastern European country, which had come out of the recession only in the first quarter of 2010, posted 1.4% growth in GDP for the third quarter, thanks to good farm input. The positive data also raised hopes that the economy may be able to avoid a recession going into 2012. However, according to government estimates, the Hungarian economy is likely to grow less than 2% in 2011.

## **Czech Republic: Manufacturing slows as exports shrink**

**In a sign that the Euro-zone crisis is catching up with the export-oriented economy of the Czech Republic, a widely-watched manufacturing index showed contraction for the second month in a row in December due to weakening of domestic and export orders.** The Czech economy is 70% dependent on exports to Euro-zone states such as Germany, especially those from automobile maker Skoda Auto AS. Third-quarter GDP data also showed contraction as the economy grew only 1.6% from the year-ago period and expanded less than the 2.2% in the previous quarter.

**Considering the slowdown in economic activity, the Czech central bank decided to leave interest rates unchanged at 0.75% in December.** The inflation rate increased to a 35-month high of 2.5% in November primarily on food costs, according to a *Bloomberg* report. Meanwhile, the Organization for Economic Cooperation and Development (OECD) urged the Petr Necas administration to limit spending cuts as it could affect economic growth, a *Bloomberg* news report said. The OECD also said the Czech economy is at an advantage over its neighbors as it has its own currency and a relatively healthy banking system.

Looking ahead, Czech policy maker Kamil Janacek commented that in light of the slowdown in Europe, he expects growth below 2% in 2011 and between 1.5% and 2% in the current year. He added that a 3% growth would return only by 2013, according to a report in *Bloomberg*. Janacek also opined that interest rates should be left unchanged until at least the end of the first quarter of 2011 to properly assess the impact of the debt crisis on the economy. 🌐

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