Emerging Europe Outlook Q1 2014

Foreign & Commonwealth Office

- *There continues to be steady improvement in growth across emerging Europe.*
- *This is supported by ongoing recovery in key exports markets and, for the first time since the crisis, strengthening domestic demand and investment.*
- *But it remains a fragile recovery: vulnerable to domestic policy challenges, including high external financing needs, weak credit growth and sustained unemployment.*
- *The crisis in Ukraine clouds outlook, but up to now has not had significant economic spill over. If the situation develops the region would be vulnerable to any changes in energy supply and prices.*
- *There is significant diversity within the region, with high growth in places. Poland, followed by Slovakia and Czech Republic are likely to emerge as top performers. Slovenia and Croatia face a more challenging period.*

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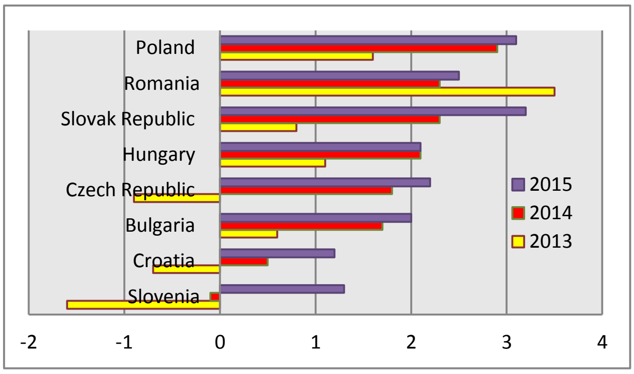
DETAIL

Steady improvement

1. **Macroeconomic fundamentals are slowly improving**. Growth will remain modest across the region, but its composition looks increasingly balanced and thus more sustainable. Export-oriented sectors, on the back of recovery in the euro-zone, will continue to support growth in these highly-open economies. Through 2014/15, domestic demand and investment, however, are expected to pick up for the first time since the crisis and become the main driver of growth in many economies. There will be pockets of high growth. Poland is likely to be the region's best performing economy this year and next (with consensus forecast higher than that of the EC's).

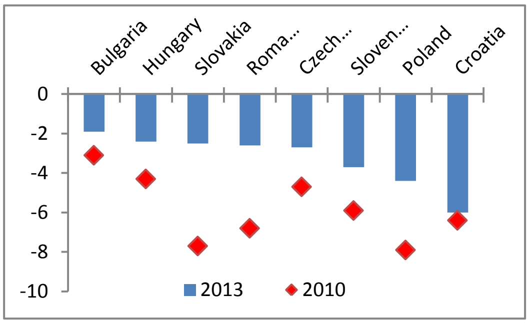
Fig 1: Real GDP Growth % (EC Winter Forecasts 2014)



2. In contrast, Croatia and Slovenia face more muted growth prospects. Croatia is emerging from five years of recession, but will start to see a positive contribution from exports and public sector investments, assuming increased use of EU funds. Slovenia is expected to register negative growth, but with an easing pace of contraction as export growth picks up. In addition, growth in the agricultural sector, which supported strong growth in Romania and Hungary last year, is unlikely to be lasting and, as it fades, growth will slow. Bulgaria's modest recovery is expected to continue.

3. **There have been continual improvements in public finances.** Many countries now have headline deficits around 3% of GDP (within the Maastricht limit). This has given them some flexibility to use fiscal policy to support growth. The Czech Republic and Slovakia have slightly eased restrictions on government spending. And Romania and Hungary are carrying out less fiscal consolidation after exiting the EU's Excessive Deficit Procedure last year (although Hungary may need to tighten again after the April election). Poland is set to loosen fiscal policy in light of this year's one-off improvement to the budget position due to pension reform. This means the 2013 budget deficit of -4.4% of GDP is projected to turn into a surplus of 5% in 2014. In contrast, Slovenia's fiscal situation will remain challenging as it absorbs the costs of the banking crisis (NB: the 2013 deficit is estimated to have reached -14.9% of GDP including the cost of bank recapitalisation). And Croatia has entered the Excessive Deficit Procedure, implying a more austere fiscal policy going forward.

Fig 2: Fiscal Deficits % GDP (EC Winter Forecasts 2014)



4. **Inflation has decreased markedly over the course of 2013**, in part due to low energy prices together with weak demand. Muted pressures and spare capacity in the economies are expected to keep consumer price inflation around 1-2% in 2014 across the region; and lower still in Croatia

and Bulgaria. With inflation subdued, monetary policy is likely to stay loose to support growth: keeping interest rates at all time lows. Hungary and Poland are likely to maintain accommodative monetary policy for a while yet and seem unlikely to launch rate-hiking cycles until late in 2014. These seem likely to be triggered by excessive easing and exchange rate depreciation in the former and improvement of growth and resumed inflationary pressure in the latter. The Czech National Bank, has likewise followed a loose monetary policy, but has launched FX interventions to weaken the koruna against the euro in an effort to move closer to its 2% inflation target. Meanwhile, for Bulgaria and Croatia, the recent sharp fall in inflation may help to restore external competitiveness which, given currency pegs to the euro and high levels of FX debt, can't be achieved via devaluation.

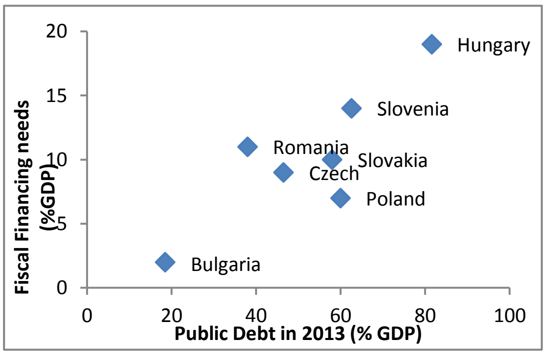
But recovery will be fragile....

5. **Risks to the growth outlook have become more balanced, but still weigh on the downside**. These vary across the region; but some overarching ones include developments in Ukraine, which have caused increased market volatility, continuing high levels of external financing needs, low credit growth and persistent unemployment.

6. **Developments in Ukraine, together with January's Emerging Market sell-off, have caused most stock markets and currencies to post losses since the turn of the year**. Over the coming period, markets and currencies are likely to remain volatile and, because of their regional proximity, highly sensitive to developments in Ukraine. For now, however, there is unlikely to be significant economic spill over into the real economy: with perceived risks to neighbouring economies offset by better growth prospects and recent positive data releases. If the situation develops the region would be vulnerable to any disruptions in energy supply and prices. Trade links between the Ukraine and the region are not significant. But there are notable trade links between Russia and the region; any sanctions imposed on Russia (and the response to this) could therefore have a material effect on growth. The region is also dominated by western European banks, such as the Austrian bank Raiffeisen, which are exposed to Ukraine and, especially, Russia through their operations there. The crisis could lead to the banks reducing their funding to the region, as they did during the eurozone crisis. Some CEE countries, like Poland and Hungary, also have large domestic banks, such as OTP, with operations in Ukraine. Highlighting further possible vulnerabilities.

7. **The region faces high external financing needs, making it vulnerable to market sentiment.** For many total external debt-to-GDP ratios will have increased during 2013, with Hungary and Poland of most concern because of their size. Financial market conditions improved during 2013 such that, on the whole, borrowing costs for the Czech Republic, Slovakia and Poland remained lower than those of Romania, Hungary and, in particular, Slovenia. Downside risks, however, still stem from any heightened financial instability in markets. In the local currency bond m

Fig 1: Public Debt vs Financing Needs (% of GDP) **(IMF)**



8. **The credit activity remains weak and largely inadequate to support higher growth**. This is particularly acute in Slovenia and Croatia, but remains sluggish across the region. Credit growth could remain anaemic as long as both the private and corporate sectors need to deleverage further. It could be further held back, if the implementation of the ECB's Asset Quality Review

and stress tests were to fail to clean up bank balance sheets and restore confidence. Weakness in credit activity, together with still high levels of non-performing loans and compressed margins, due to low interest rates and, in places, a challenging operating environment is causing ongoing difficulties for banks. This is particularly acute in Slovenia and Hungary, but also Romania, Bulgaria and Croatia.

9. **Across the region, labour markets stabilised during 2013, but developments remain broadly negative,** especially for the young, low-skilled and those in poorer regions. There is high and persistent unemployment, which risks becoming structural, for example in Bulgaria, Slovakia, Croatia and Poland. Labour market reforms will be needed. The agenda will vary by country but will include steps to raise participation rates, reduce restrictive labour regulations, ensure better skills matching and promote more flexible bargaining arrangements. The back-drop of an increasingly adverse demographic outlook—a reflection of low fertility rates and, in some cases, substantial emigration – will continue to reduce the size of the working age population, which will become a permanent drag on growth.

Potential as Europe's leading growth region

10. **The region is set to see improved growth over the next five years and, for some, at levels comparable to the BRICs' economies of Brazil and Russia**. GDP per capita ranges from US$27,191 in Czech Republic to US$7,000 in Bulgaria; significantly higher than major emerging markets and set to increase at rates on par with them (although still below the EU average of US$32,000). The region offers investment opportunities, with potential for higher earnings found largely in emerging markets, combined with regulatory and legal protections approaching those of older EU members. The region offers a platform to greater integration into the global economy through pan-European production chains. It also benefits from access to significant Structural and Cohesion Funds.

GDP per capita based on purchasing-power-parity (PPP) in US$ - IMF WEO

	2013	**2018 (IMF forecast)**
Advanced economies	41,520	50,423
Central and Eastern Europe*	16,206	20,686
Developing Asia	6,507	9,411
Latin America and Caribbean	12,629	15,701
Middle East and North Africa	10,697	13,038

* IMF includes Hungary, Poland, Bulgaria, Croatia, Romania

11. But there is significant diversity in the region. Most likely there will be some strong performers and some that are unlikely to see their risk premiums fall anytime soon. Poland is likely to be the region's best performing economy this year and next. With Slovakia and Czech Republic also doing well. Growth in Hungary may flatten post election and, as in Romania, on the back of weaker agricultural growth. While Bulgaria's modest recovery is expected to continue. In contrast, Croatia has lower medium-term potential growth and Slovenia a set of domestic fiscal and financial concerns that markets will be watching closely.

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