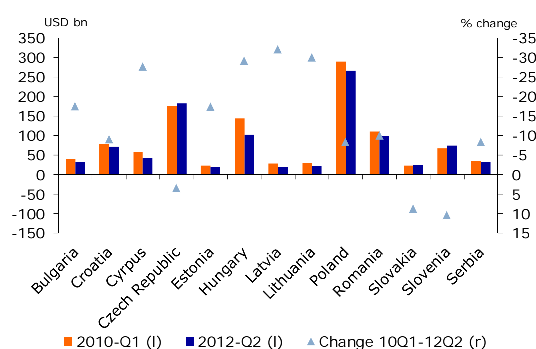
Not out of the woods yet

The start of 2012 saw many Emerging European economies fall back into recession. Although the outlook for 2013 is somewhat less bleak, there is still little reason for optimism. The region's proximity to and integration with the eurozone renders it vulnerable to the ongoing debt crisis. In addition, an overleveraged private sector, combined with fiscal consolidation will keep domestic demand depressed. Consequently, although we do expect Emerging Europe to come out of recession in 2013, the recovery will be slow.

Figure 1: Claims by foreign banks



Source: BIS

Given the large risks posed by the eurozone crisis, this regional outlook first of all considers the various routes through which the eurozone debt crisis has impacted and will continue to impact Emerging Europe. Next to that it looks at the domestic factors that contribute to these adverse effects. We conclude by providing a regional outlook for 2013. Although we consider Turkey as part of Emerging Europe, the country is analyzed separately at the end of this report.

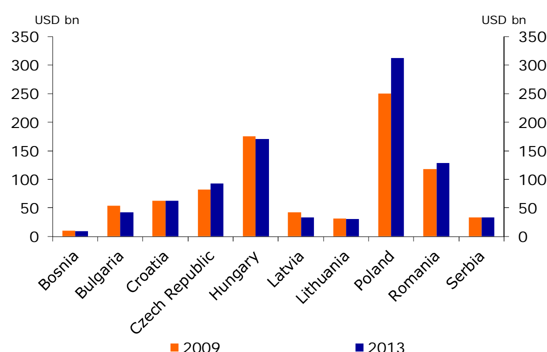
Dependency on foreign banks

One of the factors explaining the region's poor recovery is the ongoing deleveraging by eurozone banks. This has impacted and will continue to impact liquidity in Emerging Europe, given the region's dependence on foreign banks. Over the past decade, many eurozone banks branched out to Emerging Europe, in search of unexplored markets. The relatively underdeveloped financial sectors in the former communist countries meant that there was a large gap to be filled, while overbanked western markets left many banks in search for higher profit margins. Consequently, roughly 75% of all Emerging Europe financial assets (averaging 79% of GDP) are held by foreign banks. What appeared to be a match made in heaven back then has become a vulnerability following the crisis. Especially given that eurozone banks are heavily exposed to the sovereign debt crises in their home countries. As a result, confidence in and among eurozone banks has fallen sharply, which is obstructing their ability to acquire funding. Simultaneously, new capital requirements meant eurozone banks had to obtain a minimum core tier one ratio of 9% by mid-2012. In order to bolster their balance sheets, banks needed to obtain additional funding or deleverage. It was widely feared that Emerging Europe would fall victim to this deleveraging.

As mentioned above we did see a reduction in eurozone bank funding of Emerging European subsidiaries, but the impact of eurozone bank' deleveraging on Emerging Europe has not been as severe as previously feared (figure 1).

The so-called Vienna Initiative, which was initiated in the wake of the 2008/09 financial crisis and got Western banks to give their commitment to Central Europe, has helped in this regard. The second round was less successful. More recently, the long-term refinancing operations by the European Central Bank (ECB) in November 2011 and March 2012 reduced funding uncertainty and costs for European banks, thereby reducing their need to pull out of Emerging Europe.

Figure 2: Foreign currency denominated debt



Source: EIU

We do expect that data for the second quarter of 2012 will see a somewhat steeper reduction in assets held by foreign banks, a trend we expect to continue for the rest of 2012. Nonetheless, with both the ECB and the FED expected to support liquidity through monetary easing, it is unlikely that European banks will collectively pull out of Emerging Europe. Instead, they are expected to gradually build down their exposure, to reach a more sustainable level in the medium term. Clearly, this outlook is subject to some large downside (tail) risks, including a eurozone break-up. Moreover, local conditions in Emerging European economies also play a role. Especially in Hungary, and to a lesser extent in Romania, we expect European banks to decrease their exposure. Both countries were hit hard by the crisis, while their dependence on foreign banks is significant. In the case of Hungary, the additional uncertainty created by the government will further motivate banks to reduce their exposure on this country.

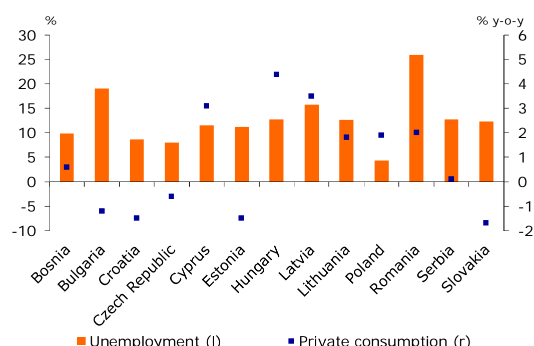
In addition to the volume of funds provided, in most Central European countries, the type of credit facilities provided by banks has changed as well. Banks, both foreign and domestic, became less willing to fund long-term, capital intensive projects, such as infrastructure, while also small and medium-sized businesses are struggling to obtain funding. Stringent credit conditions in these sectors are not expected to loosen significantly in 2013, which will weigh down on production and thus growth.

Distressed households

Over the last five years, borrowing in non-local currencies increased sharply in Emerging Europe. As many countries were expected to join the eurozone in the short term, perceived exchange rate risk on euro-denominated loans was low. In addition, interest costs on euro-, yen and Swiss franc-denominated loans were much lower than those on local currency loans. As a result, many households opted for foreign currency denominated mortgages and consumption loans (see figure 2).

Unfortunately, as the crisis unfolded, entering the euro became a distant dream (or nightmare), rather than a short-term reality. Moreover, as investor confidence in the region dropped (see below), Emerging European currencies weakened vis-à-vis the euro, Swiss franc and yen. Consequently, overleveraged households are struggling to repay their debt. At this moment, only countries that maintain a (semi-) floating exchange rate are suffering from increased debt costs induced by weakening currencies. These include Hungary, Poland, Serbia, the Czech Republic and, to a lesser extent, Romania.

Figure 3: Domestic demand



Source: EIU. Data: 2012

Over the course of 2011, we witnessed a process of deleveraging, as households are reducing their debt loads. As a result, domestic demand has been low in the region in general, and the highly indebted countries in particular. In addition, the ongoing crisis in the eurozone has reduced the need for Eastern European workers, who returned home unemployed. The resulting spike in unemployment, combined with a fall in remittances, further reduces private demand. This fact is clearly illustrated by a reduction in private consumption.

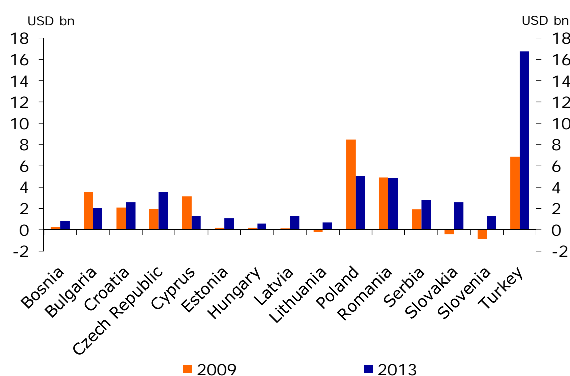
For 2013, we expect private consumption to increase slightly in some countries, while further contracting in others (figure 3). It should be noted however that there is a clear difference between the Central European countries and the Baltics. In the latter, the recession was far deeper than in the rest of Emerging Europe and came with a far steeper fall in private consumption. However, all three countries are experiencing strong recoveries and we expect private consumption in these countries to grow at higher rates. In addition, although private consumption growth is expected to slow somewhat in Poland, a relatively strong domestic sector has so far shielded Poland from the worst of the worst, and we expect it will continue to do so in 2013.

Foreign direct investments

As the crisis increased risk aversion, investors have become less eager to commit to long-term funding, resulting in a fall in FDI flows. Before the crisis, its proximity to and integration with the eurozone made Emerging Europe an attractive destination for inward direct investments. Consequently, end-2009, FDI stocks averaged 43% of GDP. The good news is that foreign direct investments are much harder to withdraw than for example portfolio investments. We therefore have not seen and do not expect to see a rapid decline in stock values of FDI.

Nonetheless, since the start of the global crisis we witnessed a reduction in long-term foreign investment and funding, while short-term (portfolio) investments increased. For the coming year, we fear that continuing stress in eurozone (and global) capital markets will keep investors risk averse in general. Although we do expect a slight improvement in overall inflows of FDI, inflows as a share of GDP will remain well below pre-crisis levels (figure 4).

Figure 4: FDI flows



Source: EIU

Naturally, the repercussions of reduced FDI inflows will be most pronounced for countries that depend heavily on FDI and/or are already struggling to keep their economies afloat. This is especially true for Hungary, Bulgaria, the Czech Republic and Croatia. Not only because of the large presence of FDI in these countries, but also because investments are concentrated in export sectors. As exports have been driving the recovery in these countries, a withdrawal of FDI could thus prove especially harmful.

Export demand

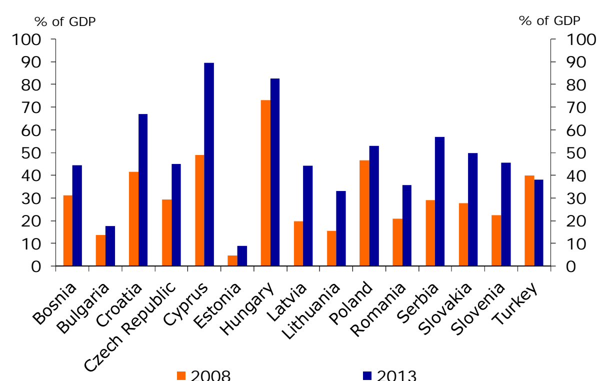
With domestic demand crippled by high debt repayment costs and fiscal austerity measures, post-2009 recovery in much of Emerging Europe has been driven by external demand. Unfortunately, the region is extremely dependent on demand from the eurozone, which is the single most important export destination for all the countries considered. The previous recession was a stark reminder of Emerging Europe's vulnerability to demand shocks in the eurozone. Between 2008 and 2009, exports plummeted, falling by 22% across the board.

Since the start of 2012, reduced demand from the eurozone and specifically Germany, combined with slowing demand from China, has decelerated demand for Emerging European exports. Nonetheless, slowing external demand in general has been partly offset by increasing demand for cars and car parts. Over the past years, distressed western car manufacturers have reallocated parts of their operations to low-wage Emerging European countries, specifically Hungary and Romania. As a result, exports have not slowed in these countries. For 2013, we expect exports to grow marginally, but it remains highly dependent on developments in the eurozone. In addition, slowing growth in China is expected to reduce demand for automobiles.

Indebted governments

Even though most countries entered the crisis with a budget deficit, public debt levels in Emerging Europe were relatively low. However, stimulus measures combined with a fall in revenue has pushed up debt levels considerably in most countries (with Estonia and Bulgaria being two notable exceptions). In addition, as public debt has partly been financed by foreign investors and sometimes is also denominated in foreign currencies, governments too are vulnerable to shocks in investor sentiment and currency depreciations. The situation is especially dire in Slovenia, Cyprus, Hungary and Serbia. All four countries have had to call on the IMF and Europe for a rescue package, which they have yet to receive. In Slovenia, falling revenues combined with distressed state-owned banks have placed a large burden on public finances, with public debt doubling between 2008 and 2012. We see a similar situation in Cyprus, although the situation is even there more severe, with public debt expected to reach 83% of GDP by end-2012. Cyprus' role as a financial hub means that it accommodates a large banking sector, which unfortunately is highly exposed to Greek public debt. With the government unable to provide a full bailout, help has to come from abroad. In Hungary it is not just the banking sector, but also a struggling economy combined with an extremely unpredictable government that has sent investors running for the exits.

Figure 5: Public debt



Source: EIU

Finally in Serbia, a struggling economy combined with the government's inability to pass credible and drastic austerity measures continues to keep yields elevated and forced the IMF to suspend its stand-by agreement. Malta's public debt level is also considered high, but the fact that most of this debt is held domestically is a risk mitigant.

Despite the clear need for austerity measures we do not expect all governments to perform equally well in this area. For one, Bulgaria, Cyprus, Lithuania, Romania and Malta will all hold general elections before the end of 2013. We expect pre-election spending in these countries to add to public expenditure. In addition, in a number of countries, including Bosnia, Latvia, Slovenia and Serbia, unstable or minority governments are deemed unfit to push through unpopular spending cuts. We expect better outcomes in Poland were the ruling PO-PSL coalition has promised to continue with fiscal consolidation after winning the October 2011 elections. Fiscal consolidation is currently on track and the pension age was recently increased, but also in Poland more structural reforms are still needed.

Still, the difference among countries cannot mask the fact that in the entire region, increased public discontent over the current economic conditions, combined with generally fragile political institutions has added to political instability. While populism is on the rise, coalitions have become weaker. For instance in the Czech Republic, an increasingly unpopular government could be forced to call early elections, which would jeopardize the austerity program currently being implemented.

In some cases IMF involvement (or the desire to obtain an IMF stand-by agreement) reduced the impact of the political instability by forcing governments to implement reforms and austerity measures (regardless of their political stance) and by providing them with a scapegoat. Nonetheless, IMF conditions themselves are also a source of discontent. This is especially true for Romania and Hungary. In the latter, the government is frantically seeking for a solution that keeps voters appeased, while also securing an IMF stand-by agreement.

Emerging Europe in 2013

For 2013 we expect Emerging Europe to come out of recession, although growth will be slow. The main drivers of GDP growth include slightly improving private consumption and (slow) export growth. The worst performers will be the countries with the highest levels of public debt, where GDP growth is expected to stay below 1%. Slovakia and Poland are the notable exceptions; although debt levels in both countries are substantial, fiscal consolidation in previous years means that expenditure cuts will be less drastic than in other countries. In addition, the large domestic market in Poland will continue to drive economic growth, which is expected to come in between 2% and 3% in 2013. The Baltic countries are also expected to report relatively strong growth rates (roughly 3%), on the back of a recovering private sector.

Still, downside risks remain substantial, as an escalation of the eurozone problems will have major repercussions for Emerging Europe. As mentioned above, most countries are ill-prepared to face such shocks. While indebted governments have little room to maneuver, central banks are constrained by inflation expectations. Rising food prices and one-off VAT increases are expected to keep inflation high.

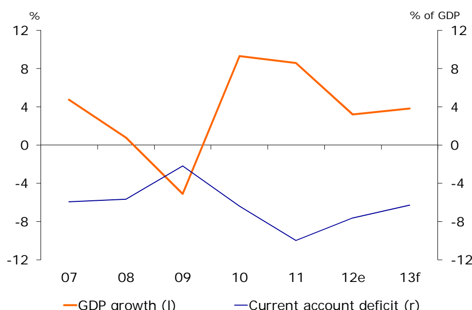
Turkey in 2013

After the Turkish economy grew by a high 8.6% in 2011, growth has come down over the course of this year and appears to be headed for a soft landing. In the first half of 2012, growth came down to 2.9% y/y. This is a comforting sign and we expect a growth rate of 3.5% for 2012 as a whole. Equally comforting is the fact that whereas the high growth rates in 2011 were primarily driven by domestic demand, fuelled by a massive inflow of portfolio investments, the positive contribution of domestic demand has since disappeared and exports are now driving growth.

Still, the volatility of the past three years is a clear sign that the large and persistent deficits on the current account have left the country vulnerable to external shocks. In addition, since 2009, the current account deficit (CAD) is mostly financed out of short term debt and portfolio investments, both of which are very volatile. The vulnerability created by this external imbalance became very apparent in 2009, when capital dried up, resulting in a 5% GDP contraction. Subsequently, monetary easing in Europe and the US resulted in a large inflow of portfolio investments and short term debt, which caused the economy to overheat in 2011, when the current account deficit shot up to 10% of GDP. At the same time FX reserves are relatively low, currently covering roughly four months of imports and only 60% of total debt service due.

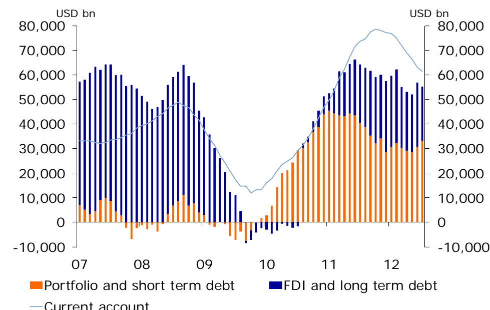
In light of Turkey's vulnerability to external shocks it is comforting that its financial sector is in excellent shape. Over the course of the past decade, Turkey's financial system, perceived as one of the country's main weaknesses only 11 years ago, has been transformed into one of the most stable systems in Europe. This was underscored by the sector's robust performance throughout the recent global crisis. Banks remained well capitalized, with an average capital ratio of 16%, while NPLs stand at a low 2.5% of all outstanding loans (relative to over 30% in 2001). In addition, even though banks are the largest holders of external debt (both in domestic and foreign currencies), improved regulation forces them to hedge their positions, while it has become more common for banks to obtain external debt denominated in domestic currency, thereby removing exchange rate risks. Plus, during the last episode of massive hot money inflows, the Central Bank of Turkey (CBRT) increased the banks' reserve requirements in general, and those on FX reserves in particular, while also curtailing the amount of short-term loans banks were allowed to extend.

Figure 6: Current account dynamics



Source: EIU

Figure 7: Financing the CAD



Source: CBRT and Yapi Kredi

In addition to a strong banking sector we derive comfort from the fact that public debt holdings are relatively low and the government appears well aware of the risks of running high deficits. Although slowing growth will reduce public revenues, the government already announced that it will not introduce any stimulus measures. For 2013, we expect the budget deficit to remain at 2.6% of GDP.

Given Turkey's vulnerability to global shocks and the high risk of external shocks, growth forecasts are subject to wide margins of uncertainty. Assuming that the crisis in the eurozone does not deteriorate significantly and further assuming that the ECB and the FED will continue to support liquidity, we expect the Turkish economy to grow by 3.5% in 2013. As in 2012, growth will be driven by export growth. In addition, we expect domestic demand to pick up. Still large downside risks remain, including a sudden outflow of capital, or a eurozone break-up. Another risk is the ongoing war in Syria, which threatens to spill into Turkey. Although we do not expect a full-blown war between the two neighbors, tensions are likely to reduce security along the Turkish-Syrian border. Negative headlines as a result of this political crisis could deter investors, as well as tourists. However, as the Syrian trade route has quickly been replaced by other trade routes, the impact on total exports has been (and will be) limited.

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Economic growth (Real GDP % change pa)							
	2007	2008	2009	2010	2011	2012e	2013f
Bosnia and Herzegovina	6.1	5.7	-3.1	0.7	1.3	-0.2	0.8
Bulgaria	6.8	6.0	-5.7	0.5	1.8	0.5	1.9
Croatia	5.1	2.1	-6.9	-1.4	0.0	-1.4	0.5
Cyprus	5.1	3.6	-1.9	1.1	0.5	-1.2	0.5
Czech Republic	5.7	3.1	-4.7	2.7	1.7	-1.0	0.6
Estonia	7.5	-3.7	-14.3	2.3	7.6	2.1	2.9
Hungary	0.1	0.9	-6.8	1.3	1.6	-1.2	0.8
Latvia	9.6	-3.3	-17.7	-0.3	5.5	3.1	3.3
Lithuania	9.8	2.9	-14.8	1.4	5.9	2.4	2.6
Malta	4.3	4.0	-2.7	2.4	2.1	-0.4	1.0
Poland	6.8	5.0	1.7	3.9	4.3	2.4	2.1
Romania	6.3	7.3	-6.6	-1.6	2.5	0.9	2.5
Serbia	5.4	3.8	-3.5	1.0	1.6	-0.5	1.5
Slovak Republic	10.5	5.8	-4.9	4.2	3.3	1.9	1.9
Slovenia	7.0	3.4	-7.8	1.2	0.6	-2.0	0.2
Turkey	4.7	0.8	-5.1	9.3	8.6	3.2	3.8

Source: EIU

Budget balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Bosnia and Herzegovina	-0.3	-3.6	-5.7	-4.5	-3.1	-3.7	-2.2
Bulgaria	3.3	2.9	-0.9	-4.0	-2.0	-1.5	-2.0
Croatia	-0.9	-0.9	-3.4	-4.6	-4.7	-4.5	-4.2
Cyprus	3.5	0.9	-6.1	-5.3	-6.3	-4.3	-4.2
Czech Republic	-0.7	-2.2	-5.8	-4.8	-3.1	-3.2	-3.0
Estonia	2.5	-2.8	-1.8	0.3	1.0	-2.4	-1.2
Hungary	-5.1	-3.7	-4.5	-4.3	4.2	-2.9	-3.1
Latvia	-0.4	-4.2	-9.7	-8.1	-3.5	-2.7	-2.7
Lithuania	-1.0	-3.3	-9.4	-7.3	-5.5	-4.2	-3.7
Malta	-2.4	-4.6	-3.8	-3.7	-2.7	-3.8	-3.5
Poland	-1.4	-1.9	-1.8	-3.2	-1.7	-2.1	-1.7
Romania	-3.1	-4.8	-7.3	-6.4	-4.1	-2.4	-2.3
Serbia	-2.0	-2.3	-4.5	-4.8	-4.9	-6.7	-4.5
Slovak Republic	-1.6	-2.0	-8.0	-7.7	-4.8	-4.8	-3.1
Slovenia	0.3	-0.3	-5.5	-6.0	-6.3	-3.5	-2.4
Turkey	-1.6	-1.8	-5.5	-3.7	-1.3	-2.6	-2.6

Source: EIU

Public debt (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Bosnia and Herzegovina	32.9	31.2	36.1	39.6	40.6	43.8	44.4
Bulgaria	17.2	13.7	14.6	16.3	16.3	16.8	17.7
Croatia	40.6	41.5	50.7	59.6	64.0	66.1	67.1
Cyprus	58.8	48.9	58.5	61.5	71.6	80.9	83.7
Czech Republic	28.3	29.2	34.8	38.1	41.2	43.9	45.0
Estonia	3.7	4.5	7.2	6.6	5.9	8.0	8.8
Hungary	67.1	73.0	79.8	81.4	80.8	81.3	82.5
Latvia	9.0	19.8	36.7	44.7	43.7	44.0	44.3
Lithuania	16.9	15.6	29.6	38.6	36.8	36.5	33.1
Malta	62.2	62.3	68.0	69.4	71.9	77.0	78.2
Poland	44.6	46.7	49.4	52.8	53.4	53.8	52.8
Romania	19.1	20.8	26.2	28.5	31.2	33.8	35.8
Serbia	30.9	29.2	34.8	42.9	45.1	60.0	57.0
Slovak Republic	26.6	27.9	35.6	41.1	43.3	48.6	50.3
Slovenia	22.9	22.4	31.2	33.4	41.9	45.4	45.6
Turkey	39.6	40.0	46.4	43.1	40.0	40.4	38.0

Source: EIU

Consumer prices (% change pa, average)							
	2007	2008	2009	2010	2011	2012e	2013f
Bosnia and Herzegovina	1.6	7.4	-0.4	2.1	3.7	2.2	2.1
Bulgaria	8.4	12.3	2.8	2.4	4.2	2.4	2.9
Croatia	2.9	6.1	2.4	1.1	2.3	2.9	2.6
Cyprus	2.4	4.7	0.4	2.4	3.3	3.4	2.4
Czech Republic	2.9	6.3	1.0	1.5	1.9	3.3	2.7
Estonia	6.6	10.4	-0.1	3.0	5.0	3.3	2.6
Hungary	8.0	6.0	4.2	4.9	3.9	5.6	4.6
Latvia	10.1	15.4	3.5	-1.1	4.4	2.5	2.6
Lithuania	5.7	10.9	4.5	1.3	4.1	3.4	2.8
Malta	1.3	4.3	2.1	1.5	2.7	2.5	2.1
Poland	2.4	4.3	3.8	2.7	4.2	3.6	2.9
Romania	4.8	7.8	5.6	6.1	5.8	3.0	3.6
Serbia	6.9	12.4	8.1	6.2	11.2	6.2	6.5
Slovak Republic	2.8	4.6	1.6	1.0	3.9	3.6	3.0
Slovenia	3.6	5.7	0.9	1.8	1.8	2.5	1.9
Turkey	8.8	10.4	6.3	8.6	6.5	9.1	8.0

Source: EIU

Current account balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Bosnia and Herzegovina	-10.8	-14.1	-6.3	-6.1	-8.6	-7.9	-6.4
Bulgaria	-20.7	-22.9	-8.8	-1.2	0.9	1.1	0.5
Croatia	-7.3	-8.7	-4.9	-1.5	-0.7	-0.4	-0.8
Cyprus	-8.4	-15.4	-10.6	-10.0	-10.3	-8.9	-7.3
Czech Republic	-4.4	-2.1	-2.5	-3.8	-3.0	-1.9	-1.9
Estonia	-15.9	-9.2	3.5	2.9	2.1	2.3	-1.2
Hungary	-7.3	-7.2	-0.1	1.2	1.5	1.8	1.8
Latvia	-22.3	-13.4	8.8	3.0	-1.3	-1.7	-3.3
Lithuania	-14.6	-13.3	4.7	1.5	-1.6	-2.5	-2.4
Malta	-6.3	-5.4	-7.2	-4.2	-3.0	-2.6	-3.6
Poland	-6.2	-6.6	-4.0	-4.7	-4.3	-3.8	-3.6
Romania	-13.5	-11.6	-4.2	-4.4	-4.3	-4.5	-5.9
Serbia	-18.3	-22.5	-7.9	-8.6	-9.3	-11.6	-11.6
Slovak Republic	-5.3	-6.6	-2.6	-2.5	0.1	0.6	0.0
Slovenia	-4.7	-6.1	-0.7	-0.6	0.0	0.6	2.1
Turkey	-5.9	-5.7	-2.2	-6.4	-10.0	-7.6	-6.3

Source: EIU