Box 2

Outlook for Selected Central and Eastern European Countries[1]

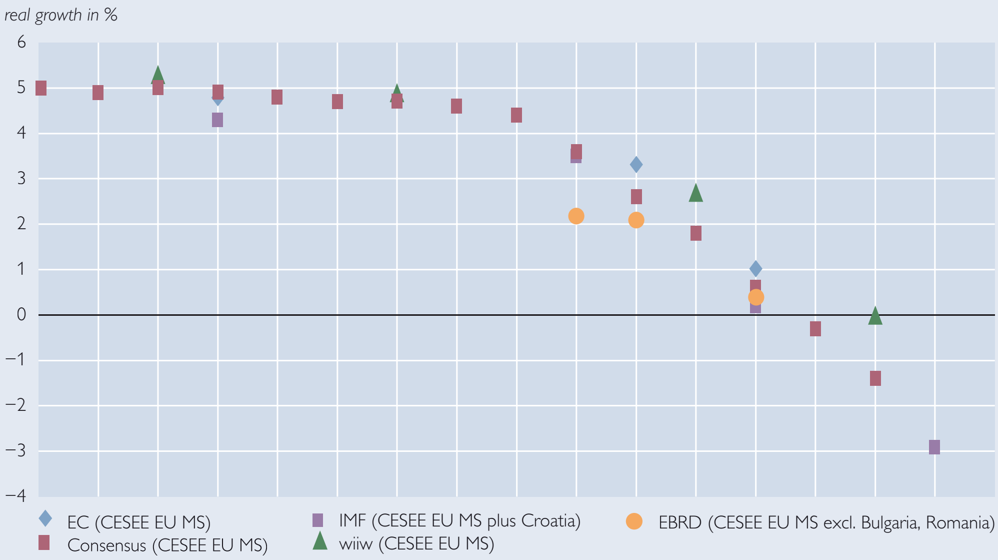
Region Not Immune to Global Downturn: 2009 to Bring Stagnation in Poland and Recession in the Czech Republic, Hungary and Russia; Comparatively Moderate Recovery in 2010 Hinges Strongly on Improvement of External Demand

Since the fall of 2008, the global financial crisis has intensified markedly, risk aversion has risen substantially, especially vis-à-vis emerging economies, and the repercussions of the crisis on the real economy have magnified very strongly across the globe. World-wide, forecasting institutions have undertaken repeated and very substantial downward revisions of growth projections. While forecasters started to moderately reduce their growth projections for the U.S.A. and the euro area already at the beginning of 2008, projections for CESEE countries remained broadly unchanged or were even revised upward in the case of Russia until August/September 2008, but declined sharply thereafter. The positive growth differential of about 3 percentage points between CESEE and the euro area, observed for many years, no longer figures in current projections. In 2009 and 2010, the growth differential between these two regions could amount to around 1 percentage point.

In the fourth quarter of 2008, growth decelerated markedly. Also, the development of important short-term activity indicators points to a further weakening of general economic dynamics in early 2009.

Chart 1

CESEE EU Member States: Development of Growth Projections for 2009



Source: Consensus Economics, EBRD, European Commission (EC), IMF, wiiw.

[1] *The OeNB and Suomen Pankki – Finlands Bank (BOF) compile semiannual forecasts of economic developments in the Czech Republic, Hungary, Poland and Russia, with the OeNB responsible for the projections for the three Central European countries and the BOF in charge of the forecast for Russia. The forecasts are based on expert judgment and estimates of long-run elasticities. For the first time, the projections for the three Central European countries are also informed by country-specific IS-LM models, which are, however, still being developed. (A detailed description of the model is forthcoming in a future issue of the Focus on European Economic Integration, and a preliminary version of this description is available upon request from julia.woerz@oenb.at). The forecast for Russia was prepared in cooperation with the BOF and is based on a structural VAR model. All forecasts are based on preliminary global growth projections and technical assumptions about euro area import growth, oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem in the context of broad macroeconomic projection exercises. Imports of the euro area are expected to shrink substantially in 2009 and to recover moderately thereafter. The price of oil will stay broadly stable in 2009 and is expected to rise slightly in 2010. The EUR/USD exchange rate is assumed to remain unchanged over the entire projection horizon at levels recorded at the end of March 2009.*

Having first turned negative in October 2008, industrial output growth contracted at an accelerating rate, which in January 2009 reached on average −17.1% (year on year) in the EU Member States covered in the main part of the report. Output likewise declined at a more or less comparable pace in Russia and Turkey, while a less pronounced reduction was observed in Croatia. Currently, industrial production in CESEE contracts at rates comparable with those seen in the euro area, the deterioration has, however, been more pronounced in CESEE countries, as this region's industrial production growth had been higher than in the euro area before the onset of the crisis.

The weakening of the industrial sector is also reflected in declining capacity utilization rates and worsening industrial sentiment. Both indicators continued their downward trend and reached long-term lows in recent months.

The household sector, in turn, has been affected less than industry so far. Growth of retail sales turned negative in December 2008 and averaged −1.4% in the EU Member States (excluding the Baltic states) in February 2009. According to most recent data, retail sales in Croatia and Russia still expanded in December 2008 (for Turkey no comparable data are available). While retail sales in the euro area contracted somewhat more strongly in February 2009, the deceleration over the past months was again more pronounced in CESEE. Consumer sentiment continued its downward trend and by March 2009, had sunk to levels which were even below industrial sentiment. Unemployment rates increased slowly in all CESEE countries in early 2009, thus lagging developments in a number of euro area countries, where unemployment soared recently.

Export orders in the region fell far below long-term average levels (comparable data for Croatia, Russia and Turkey are not available) and continued to go down in early 2009, which shows that recently external demand had shrunk further in key export markets, including the euro area, which receives more than 50% of all CESEE exports. Export expectations likewise declined markedly in early 2009 and reached negative levels in all countries.

The new OeNB-BOF projections were completed in early April 2009[2] and cover the three largest EU members in Eastern Europe, namely the Czech Republic, Hungary and Poland, which together represent more than 60% of the CESEE EU Member States' GDP, and Russia. According to these projections, the ***Polish economy*** *is expected to stagnate in 2009 and to start growing again in 2010. The Czech Republic and Hungary, both very open economies (more so than Poland), are affected particularly strongly by the downturn in external demand, with* ***Hungary*** *falling into a steeper and longer recession owing to more pronounced macrofinancial weaknesses (substantial public sector debt, high share of foreign currency loans to the nonbank private sector). The* ***Czech Republic*** *is being hit strongly by the current bust in the automotive industry, but is expected to recover sooner due to its greater leeway for anticyclical measures. The* ***Russian economy*** *will likewise experience negative growth in 2009 on the back of decreased oil prices reflecting weaker external demand. For all economies alike, the main growth drivers of recent years are dysfunctional at the moment. Much stiffer financing conditions as a result of the financial crisis and receding foreign capital inflows are weighing on the growth outlook. Domestic demand, which has suffered considerably in recent months, is holding up relatively well in Poland and is likely to react to stimuli from economic support programs in the Czech Republic and Russia. There is currently no room for such measures in Hungary. Some revival can be expected to come from EU-funded investment projects and the catching-up process, which, granted, has been slowed down very much by the crisis but is due to continue thereafter. An upswing in Central Europe is expected to rely heavily on a recovery of external demand, which is assumed to rise again gradually in 2010. For Russia, oil price developments remain key to the growth outlook.*

Against the backdrop of the global outlook, the highly export-oriented ***Czech economy*** *is now expected to shrink by 2.3% in 2009 compared with 2008 and to slightly recover*

[2] The cutoff date for all data and forecasts in this box was April 3, 2009, with the exception of the IMF World Economic Outlook figures in the table, which were released on April 22, 2009.

Table 1

Real GDP Growth in 3 CEE EU Member States and Russia

			Latest forecast			Previous forecast	
	2006	2007	2008	2009		2008	2009
	Annual change in %						
Czech Republic							
Historical data	6.4	6.5	..	..			
European Commission (November 2008)			4.4	3.6	European Commission (April 2008)	4.7	5.0
IMF (October 2008)			4.0	3.4	IMF (April 2008)	4.2	4.6
wiiw (October 2008)			4.3	4.3	wiiw (July 2008)	4.7	5.0
Consensus Forecasts (October 2008)			4.0–4.8	1.5–5.2	Consensus Forecasts (April 2008)	3.8–5.5	3.2–6.0
Hungary							
Historical data	3.9	1.3	..	..			
European Commission (November 2008)			1.7	0.7	European Commission (April 2008)	1.9	3.2
IMF (October 2008)			1.9	2.3	IMF (April 2008)	1.8	2.5
wiiw (October 2008)			2.0	1.0	wiiw (July 2008)	2.5	3.4
Consensus Forecasts (October 2008)			1.7–2.5	1.0–2.6	Consensus Forecasts (April 2008)	1.5–2.7	2.5–3.6
Poland							
Historical data	6.2	6.5	..	..			
European Commission (November 2008)			5.4	3.8	European Commission (April 2008)	5.3	5.0
IMF (October 2008)			5.2	3.8	IMF (April 2008)	4.9	4.5
wiiw (October 2008)			5.4	4.8	wiiw (July 2008)	5.5	5.3
Consensus Forecasts (October 2008)			5.0–5.4	3.3–4.6	Consensus Forecasts (April 2008)	4.7–5.8	4.1–5.5
Russia							
Historical data	7.3	8.1	..	..			
European Commission (November 2008)			7.1	6.0	European Commission (April 2008)	7.7	7.3
IMF (October 2008)			7.0	5.5	IMF (April 2008)	6.8	6.3
wiiw (October 2008)			..	..	wiiw (July 2008)	7.3	6.8
Consensus Forecasts (October 2008)			6.2–7.5	3.4–6.1	Consensus Forecasts (April 2008)	6.5–7.8	6.0–7.6

Source: European Commission, Consensus Forecasts, IMF, wiiw.

in 2010 (+1.4%). Private consumption and investment will suffer given the unprecedented drop of confidence indicators over the last half year, an expected marked rise in unemployment and tight financing conditions. Nevertheless, the effect of the crisis on domestic demand may remain relatively contained compared with other CEE countries.

The negative impact on both private consumption and gross fixed capital formation will be alleviated by significant monetary and fiscal stimuli. Česká národní banka lowered its key interest rate by 200 basis points to 1.75% in the 12 months up to March 2009. Fiscal stimulus measures will likely amount to about 2% of GDP and focus, in particular, on investment support as well as on the reduction of the tax burden and labor costs. Private consumption will also benefit from an increase of real disposable income thanks to lower inflation. Although net exports will certainly suffer from plunging import demand in the euro area so that a substantial contraction seems to be inevitable, the impact will be alleviated by massive fiscal measures in the euro area (particularly in the automotive sector) and also by the recently depreciated Czech koruna.

Against the backdrop of the assumed strengthening of external demand, net exports are expected to contribute positively to growth in 2010. Growth will also be supported by some revival of domestic demand. While public consumption growth will likely decelerate, private consumption is likely to pick up. Given continued tight financing conditions, we expect investment to stay broadly flat in 2010.

*The global economic crisis reached **Hungary** when the country was already experiencing difficult times, leading to a pronounced slump in economic activity in the fourth quarter of 2008 (GDP fell by 2.3% year on year, exports and imports by as much as 7.8% and 8.2%, private and public consumption decreased by 4.3% each). Given the global growth outlook and a new wave of domestic fiscal tightening measures – which are in line with the commitments made in connection with the international financial support provided by the IMF and the EU[3] – GDP is projected to decline by 4.1% in 2009 and by 0.4% in 2010. The announced fiscal package, which involves spending cuts and an increase in indirect taxes with the aim to reduce nonwage labor costs, is further dampening the short-term growth outlook and fueling inflation in the short term, and hence reduces private spending capacity.*

With respect to the individual demand components, private consumption will likely remain weak due to moderate wage growth (both in the private and the public sector), tightened financing conditions, reductions in transfers and savings measures in the pension system. Fiscal restraint will also hamper public investments. Private investments are discouraged mainly by the bleak economic outlook, deteriorated financing conditions and a declining profitability of the corporate sector, which presumably results in a contraction in investment over the projection horizon. With receding FDI, EU-funded projects will likely constitute the main pillar of investment. Exports will contract sharply in 2009 in response to lacking external demand. In this environment, the recent depreciation of the Hungarian forint cannot give the much-needed export stimulus, but puts additional pressure on the balance sheets of unhedged borrowers who have taken out foreign currency loans. Hence, there is no room for domestic economic stimuli, and the timing of a recovery will crucially depend on the recovery of export demand.

For 2010, based on the assumption of strengthening external demand, net exports will again contribute positively to growth but not outweigh a projected further decline in domestic demand. While private consumption will more or less stagnate, public consumption and investments will still decline. Hence, no growth impetus can be expected from domestic factors for 2010, and the revival of external demand will not be sufficient to lead to a recovery.

***Poland's** economy is expected to stagnate in 2009 and to start growing again in 2010, albeit at a moderate pace only. In 2009, private consumption will remain the main pillar of growth, with its growth rate still positive, but considerably smaller than in 2008. While consumer sentiment has already deteriorated markedly, the impact of the crisis on employment and retail sales will continue to lag somewhat behind the development in investment, exports and industrial output. At the same time, the personal income tax reduction that took effect at the beginning of 2009 may not boost consumption to a noticeable extent, as it mainly benefits higher-income households with a relatively high saving propensity. Moreover, credit extension to households will moderate further, and households burdened with foreign currency-denominated debt will probably restrain their consumption following the recent sharp currency depreciation.[4]*

After two years of capacity expansion that was far stronger (roughly at double or triple growth rates) than for its regional peers, the Polish economy will see a marked contraction of fixed investment given the negative sales outlook, considerably higher unit labor costs, tighter lending conditions of banks and reduced access to cross-border loans as well as funding and home market problems of foreign parent companies. The budget envisages enhanced public investment (as a fiscal stimulus), but such spending plans were always underexecuted in previous years.

[3] *For detailed information on the package see: http://www.imf.org/external/country/HUN/index.htm.*

[4] *The recent Polish request for an IMF credit line came after the cutoff date of our forecast.*

The contraction of foreign demand is resulting in a veritable slump of exports. In addition, there will probably be some negative fallout from losses on foreign exchange options in the corporate sector. Given the deterioration in all three major final demand components, imports will fall even more than exports, thus putting the contribution of net exports to GDP growth in positive territory. With employment trailing output contraction, manufacturing productivity dropped sharply, so that the depreciation of the złoty in recent months mainly served to compensate for considerably increased unit labor costs rather than boosting the foreign trade balance. Assuming an unchanged exchange rate, the recently achieved currency level will strengthen net exports, once external demand picks up.

For 2010, based on the assumptions for foreign demand, a stabilization of exports, some moderate recovery in investment growth and constant subdued private consumption growth are expected. The investment-driven recovery will imply import growth exceeding export growth.

The forecast for ***Russia*** *has been substantially scaled down in the wake of a massive deterioration in the external environment. The crash in oil prices is markedly squeezing domestic incomes, and capital can no longer be obtained on international markets. Growth in consumption is expected to fade and investment to decline markedly. Weak international demand is having a modest contractionary effect on export volumes. Import volumes will decline much more dramatically, in line with the depreciation of the ruble and soft demand. Total output growth is projected to reverse sharply into a modest decline this year (−2%) and then to gradually improve again in 2010 (+1%) based on a gradual recovery in the world economy and a moderate rise in oil prices.*

Private consumption growth, largely driven by the trickle-down effects of oil and staple revenues, is slowing substantially and projected to decline slightly this year, owing to weaker wage developments and rising layoffs and unemployment. Given the authorities' sizeable anticrisis measures already put in place and anticyclical fiscal policy, public consumption is projected to cushion the decline somewhat. Moreover, as Russian households are not highly indebted, there should be room for recovery of private consumption in 2010. With credit more expensive and harder to obtain, demand easing and company profits on the descent, volatile investment has been scaled back sharply in many branches. Public sector investment is also set to decline in the context of budget cuts in this area. Investment is thus estimated to decrease substantially in 2009, after which it should gradually resume positive growth.

The Russian export performance will continue to be determined largely by demand in the world markets and by domestic oil and raw material extraction and transport capacities (bottlenecks). After rapid growth in 2008, imports are expected to decline sharply in 2009 due to fading demand (squeezed incomes) and a weaker ruble (controlled devaluation in the period from November 2008 to January 2009 contributed to a 12% depreciation of the real effective exchange rate in the six months to end-February 2009). Furthermore, the weaker ruble may stimulate import substitution in some areas. As demand recovers, imports too should return to moderate growth in 2010.

As for risks to these projections, Russia's economic outlook depends heavily on what happens in the world economy through both oil prices and financial market developments. If the world economic crisis lasts longer and deepens, the price of oil falls further and financial markets remain in the doldrums, the situation in Russia will worsen. A renewed sustained deterioration of Russia's terms of trade would increase the downward pressure on the ruble and further destabilize the banking sector and the economy. Shrinking purchasing power due to a weaker ruble, high inflation and declining incomes could also set off popular unrest. In a worst plausible case, Russia's economic performance would be way below the one forecast here. Alternatively, a swift recovery of the world economy and a bouncing back of the oil price could set the stage for an above-forecast economic performance.