

# *How stressful is the international economic environment on South Eastern Europe?*

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*July 11, 2008*

*Global Finance Investors' Meeting  
Global South Eastern Europe Fund*

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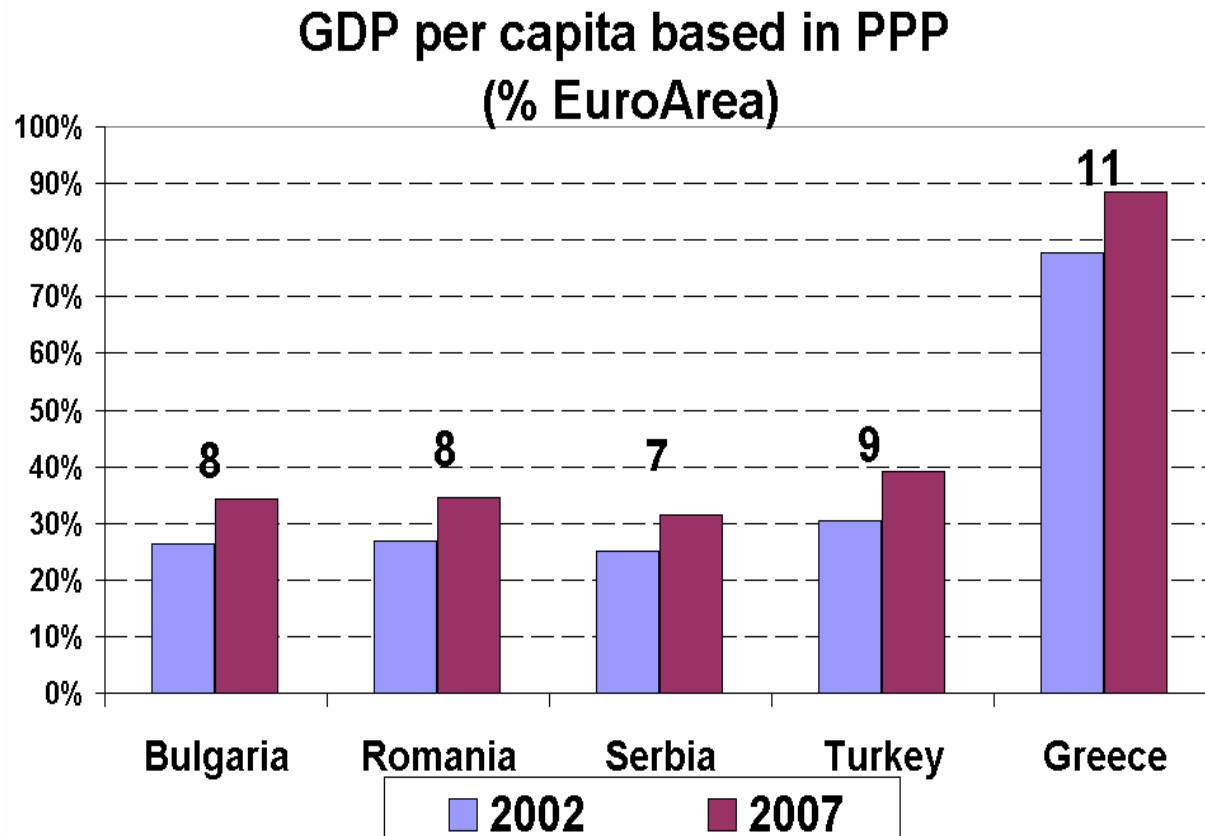
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- II. The two global negative shocks and their consequences**
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  - c) Romania**
  - d) Serbia**
  - e) Greece**

# I. SEE long-term driving force: EU & EMU

Attempt to join EU & EMU  
leads countries to  
follow correct policies:

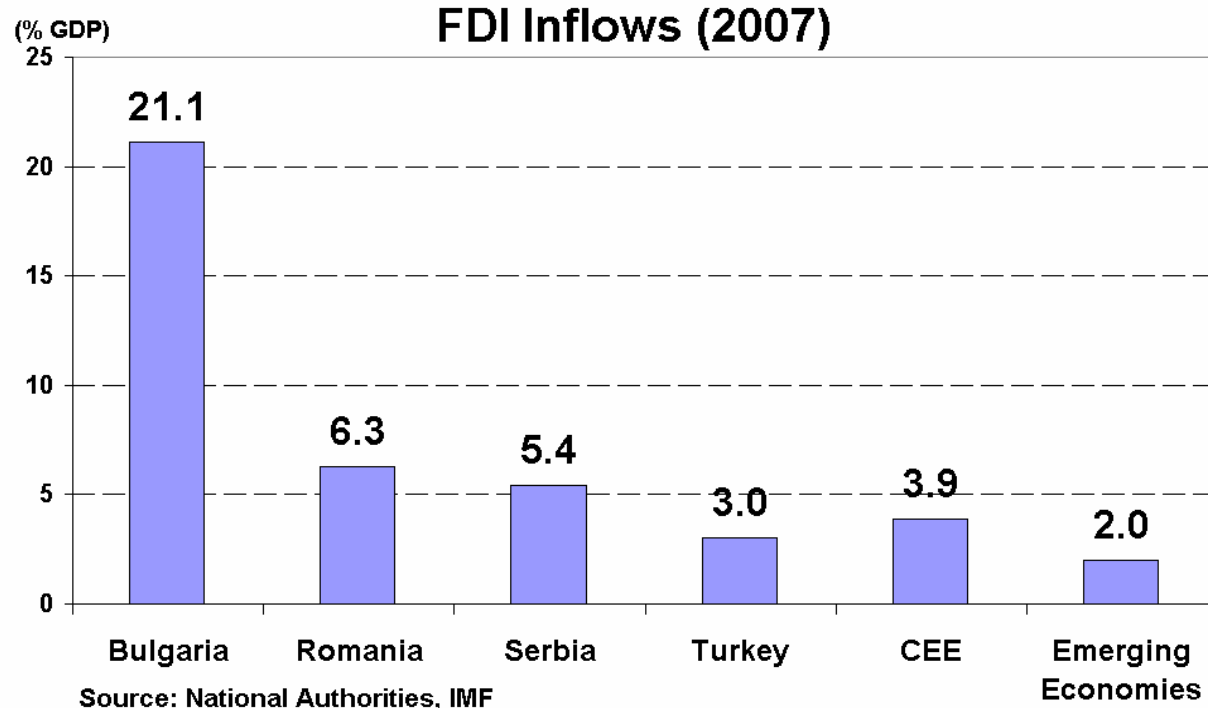
- ✓ Transparent legal system
- ✓ Fight corruption
- ✓ Import EU regulatory framework
- ✓ Improve competition
- ✓ Allow free movement of capital
- ✓ Tight fiscal policy
- ✓ Fight inflation



Local politics get dominated by the EU & EMU prospect, hence they only have a short-term effect on the economy

# I. FDI driven by EU-EMU prospect

- A larger inflow of FDI into SEE than
- ✓ in CEE
  - ✓ in emerging economies

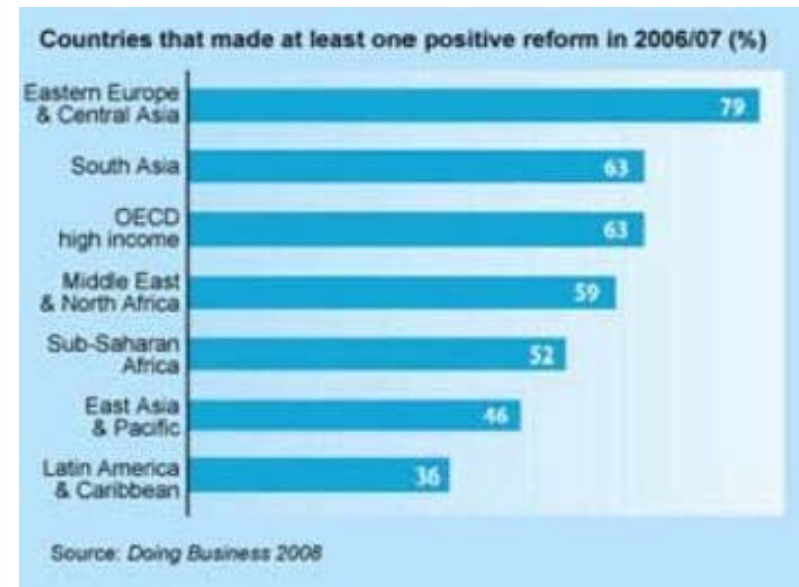
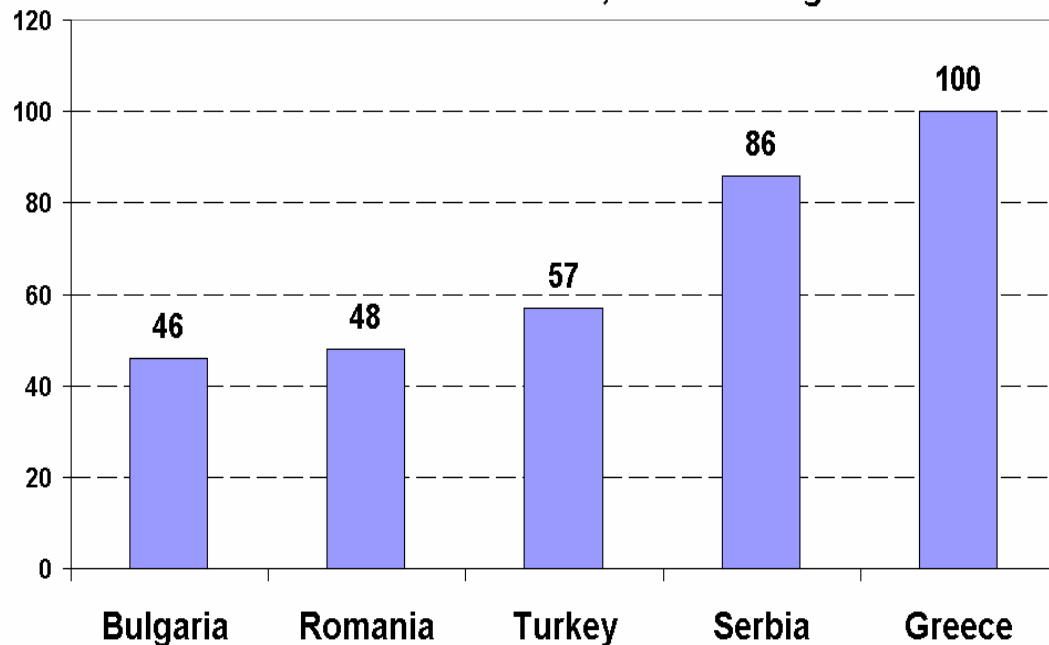


<b>Net private capital inflows, bn. USD</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>Emerging &amp; Developing countries, total</b>	231.9	605.0	330.7	441.5
<b>Central and Eastern Europe</b>	120.4	170.5	162.5	158.2
<b>Direct Investment</b>	64.7	73.2	74.7	75.7
<b>Portfolio Inflows</b>	9.9	-6.8	12.1	12.3
<b>Other flows</b>	45.8	104.2	75.6	70.1

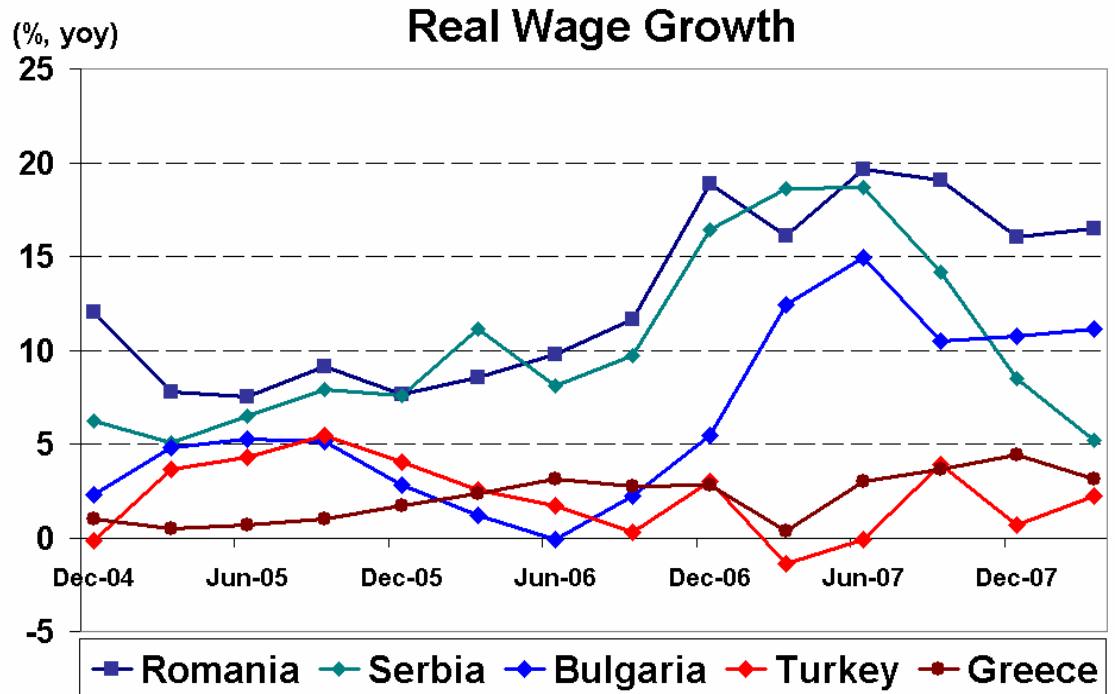
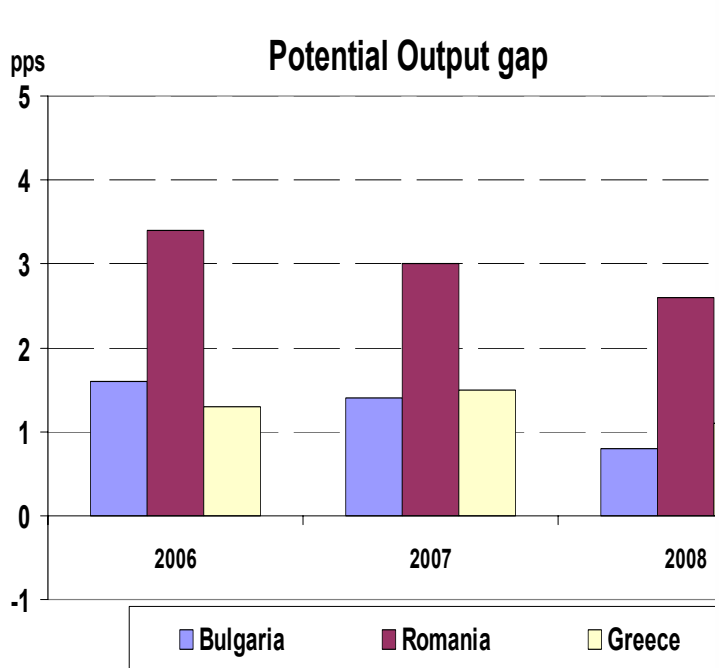
# I. Structural Reforms: Considerable room for improvement

## Ease of Doing Business 2008

Economies ranked from 1 – 178, with 1st being the best.



# I. Overheating: A theme before the global shocks



# II.

## Global shocks

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### II.1 Inflation

Oil prices

Agricultural commodities

Consequences

### II.2 The International Financial Crisis

It is not over

Global slow down with higher interest rates

# II.1 Oil prices on the rise

- The fall in global growth reduces the size of the increase in demand, but problems at the production and **refining** stage remain

## Real Oil Prices

(WTI spot price, USA CPI, 1982 - 1984)



Source: ECOWIN

	2000 (mil. bl per day)	7-year Growth	2007 (mil. bl per day)	Share in Total Growth
<b>Global Demand</b>	<b>76.4</b>	<b>12.3%</b>	<b>85.8</b>	<b>100%</b>
Advanced Economies	48.1	2.1%	49.1	10.5%
China	4.5	66.6%	7.5	32.0%
Other Developing Economies	23.8	22.7%	29.2	57.5%
<b>Global Supply</b>	<b>80.2</b>	<b>9.4%</b>	<b>87.7</b>	



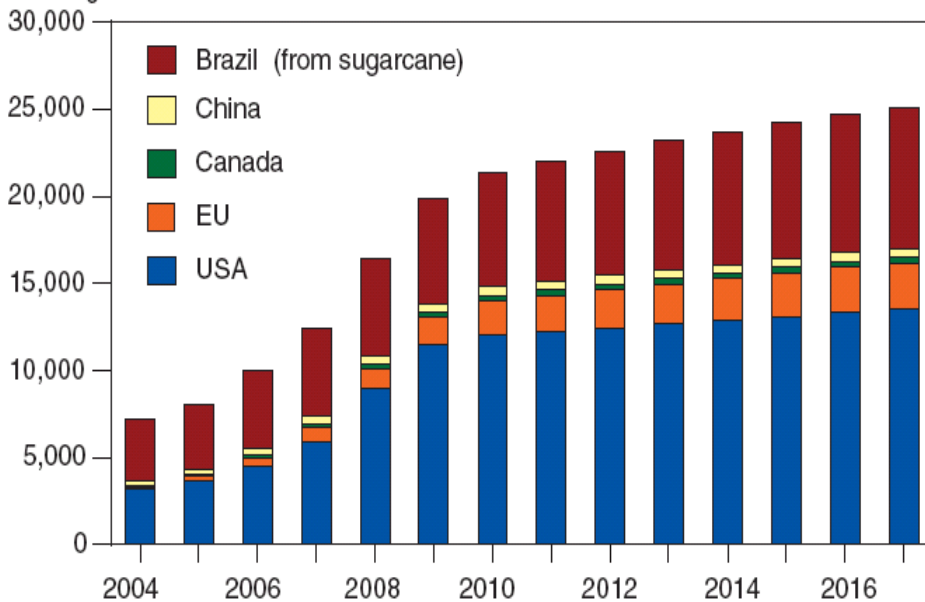
# 11.2 Food prices on a march forward

- Food prices picked up, albeit by **less than oil and metals**
- **Contributing factors:**
  - ✓ Increase in demand from China & developing economies
  - ✓ Increase in demand for bio-fuel production
  - ✓ Energy cost increases in production, processing and transportation
  - ✓ Restrictions in exports

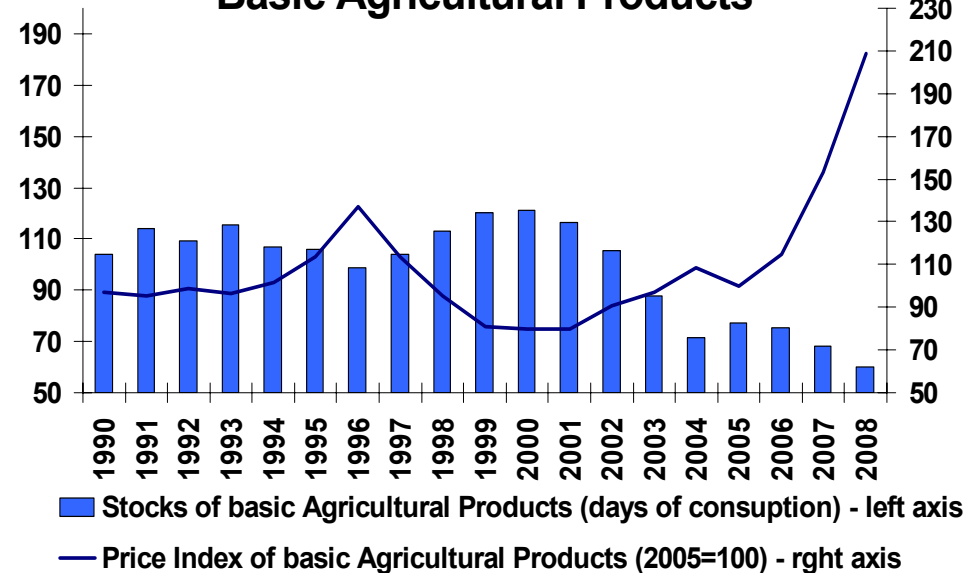
## Ethanol production

Mostly from grain feedstocks except for Brazil

Million gallons



## Basic Agricultural Products



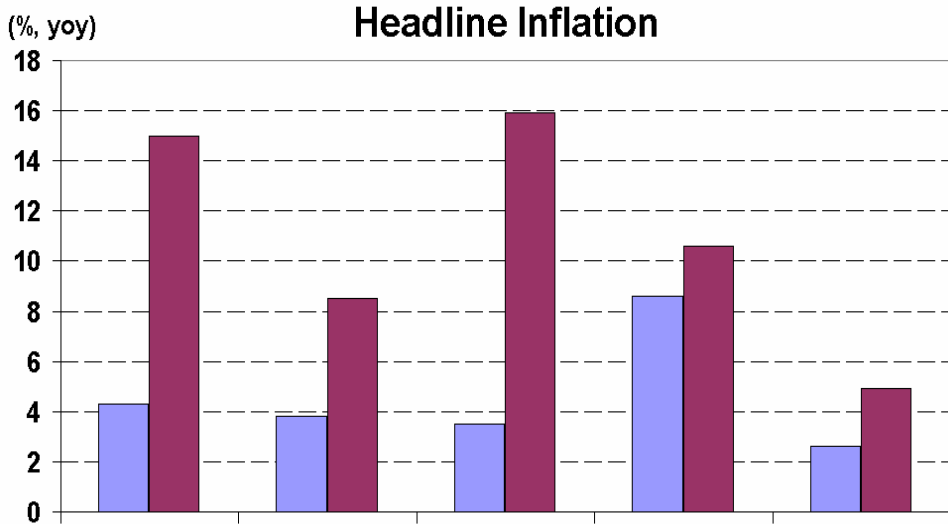
## Meat consumption in China

**20kg/person in 1980, 50kg in 1997**

**1kg of beef requires 7 kg of grains**

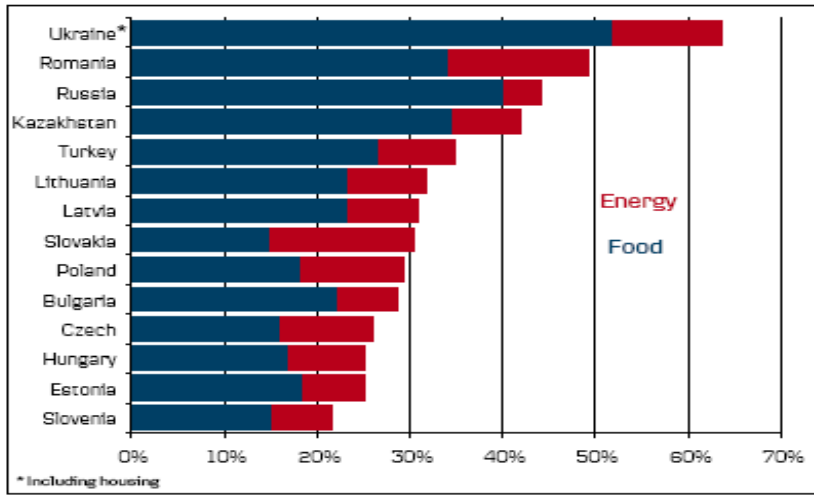
# II.1 Higher inflation reduces short-run overheating

Consumer takes a hit as food & energy have large weight in consumption baskets



Target End-08 3.8% (+/- 1%)  
 Target End-08 Core Inflation 3-6%  
 Target End-08 4% (+/- 2%)

Weight of food and energy prices in the consumer basket



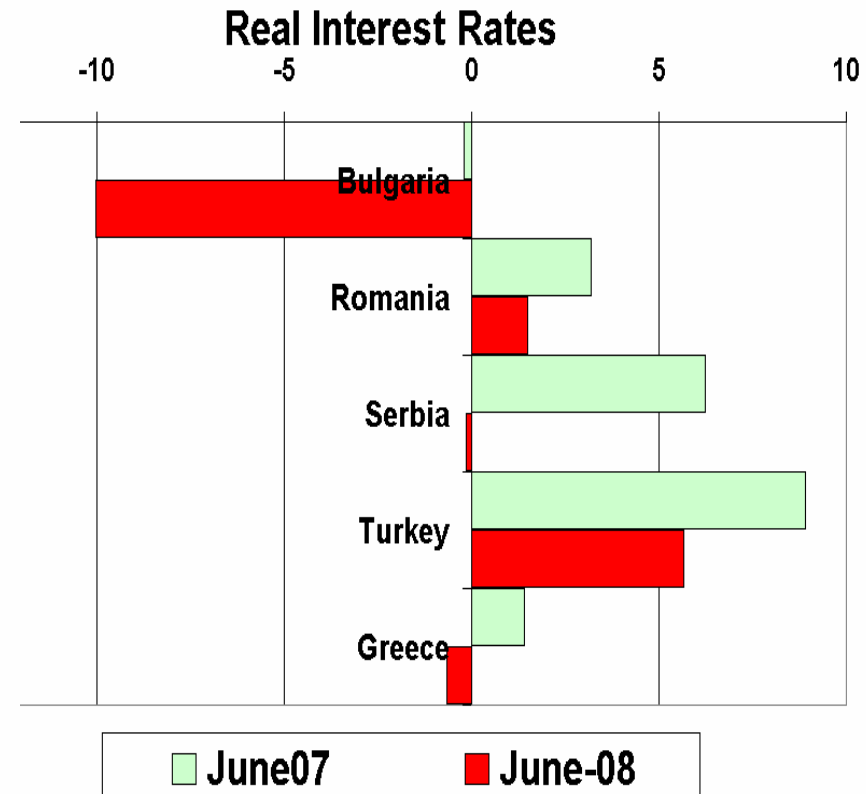
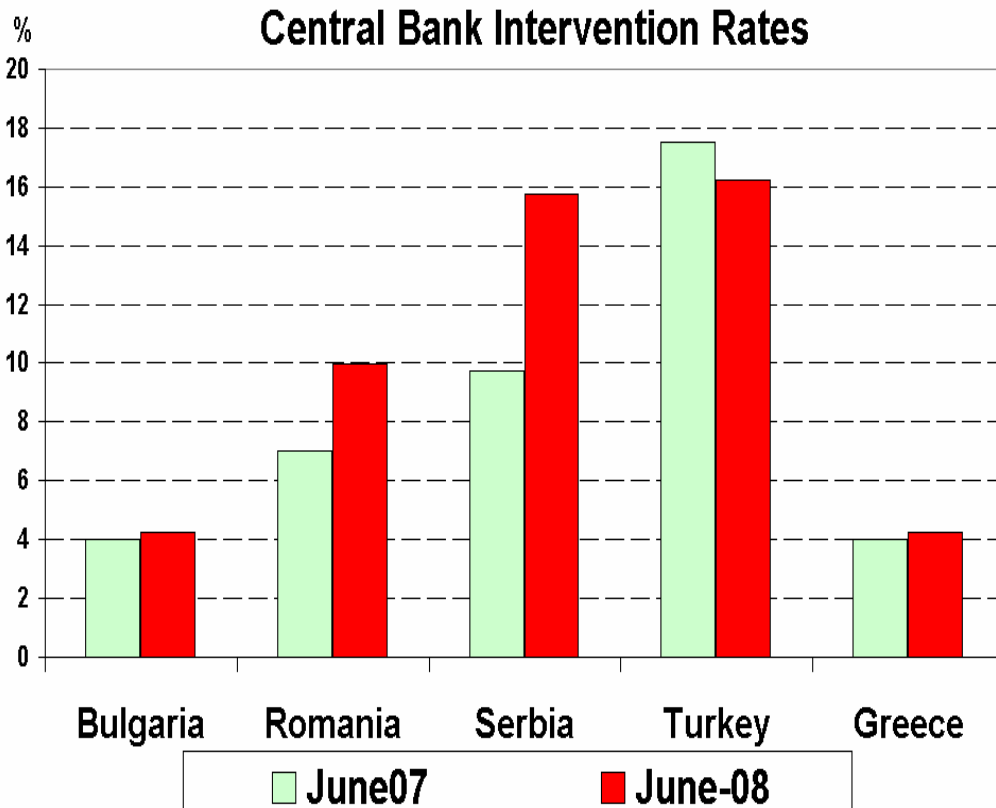
Higher inflation:

1. Controls the expansion in real incomes and in aggregate demand
2. Controls the expansion of real wages and promotes the growth in aggregate supply

Both factors cause a reduction in the positive output gap

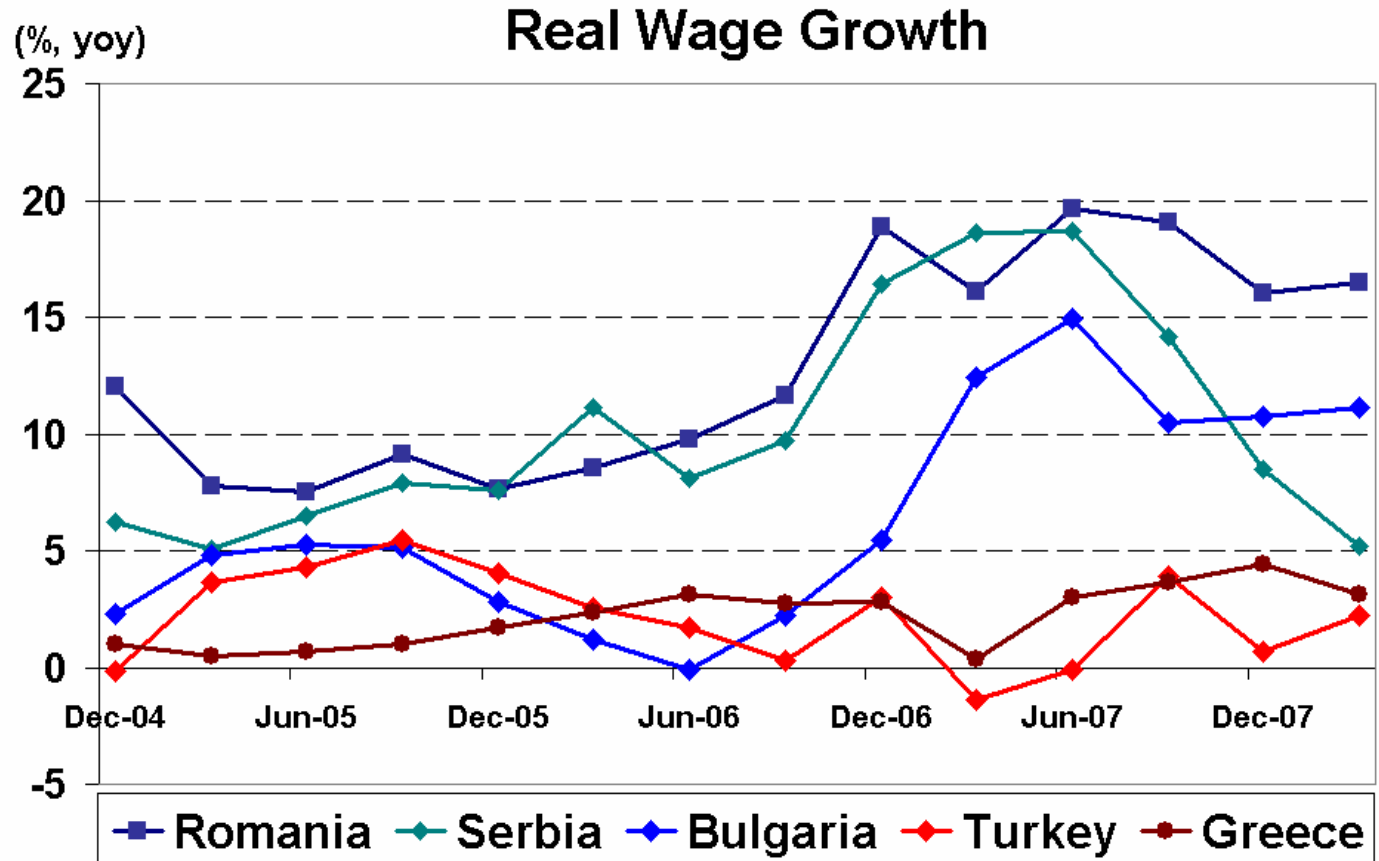
## II.1 ... but results in an overly-expansionary monetary policy ...

... as monetary authorities are sluggish to respond to higher inflation



# ... Inflation persistence is a risk as ...

- ✓ wage growth strong
- ✓ labor market conditions tight
- ✓ rigidities in labor & product markets
- ✓ inflation expectations high



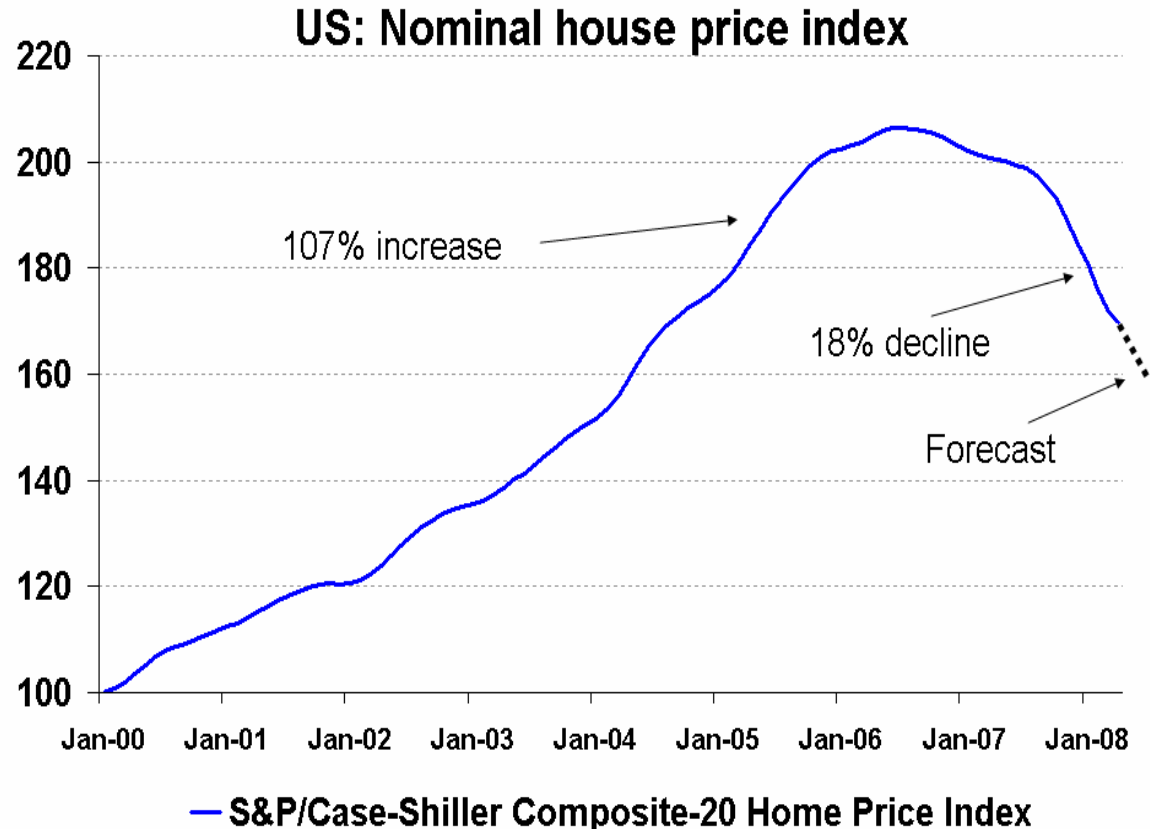
- ✓ low credibility in monetary policy
- ✓ robust credit growth

# 11.2 International Financial Crisis

## The worst financial crisis since the Great Depression

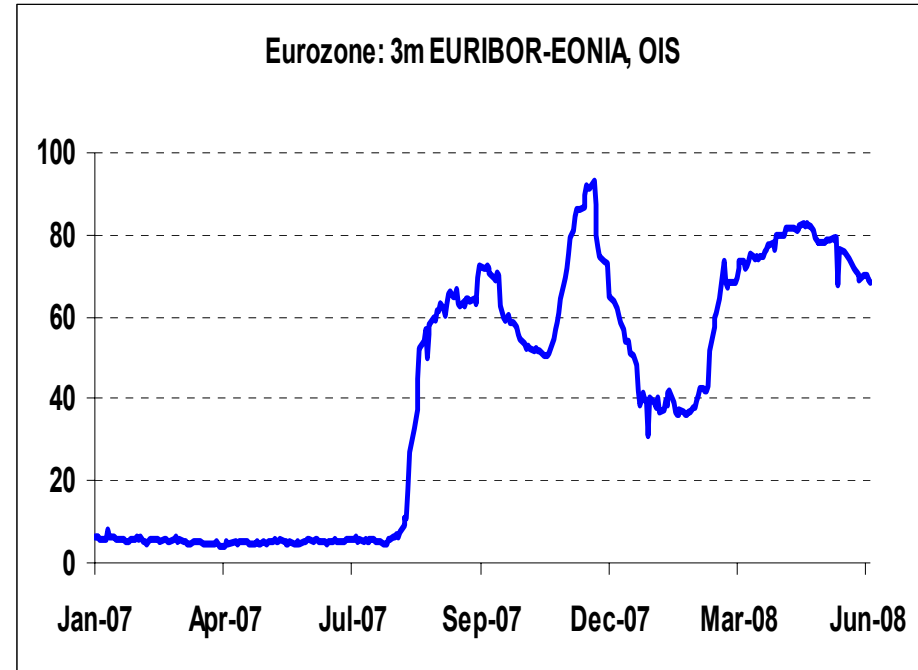
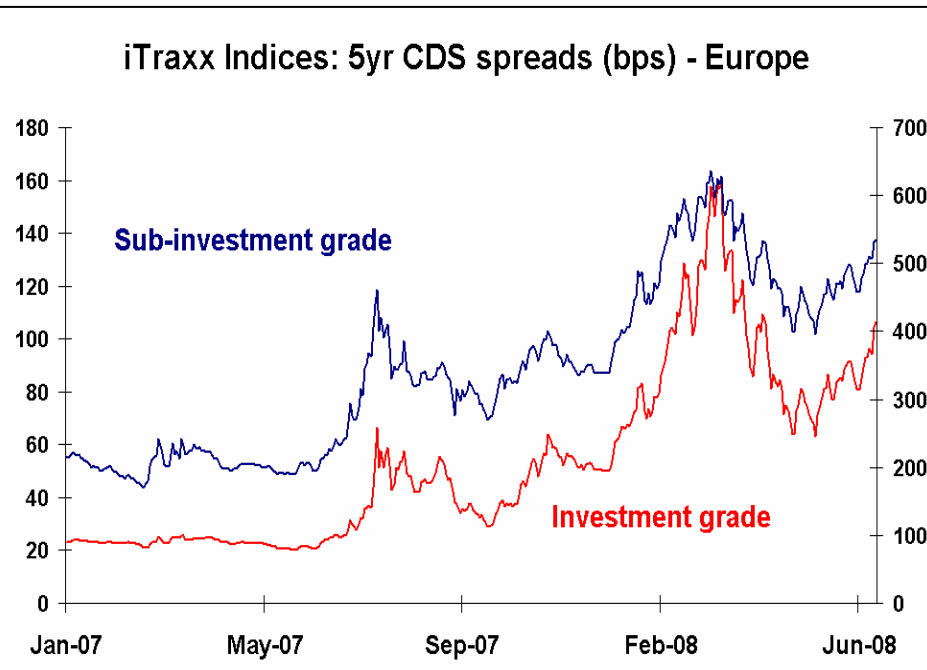
Began... because of the simultaneous development of three factors:

- 1) *The burst of a bubble in house prices in the US*
- 2) *The rapid expansion of subprime mortgages*
- 3) *The transfer of risk from the banks' balance sheets to third party investors through securitization*



- ✓ Crisis mushroomed *because the financial markets are integrated across the globe and because of over-leveraging and lack of transparency*
- ✓ Crisis continues as long as housing prices keep falling and de-leveraging continues

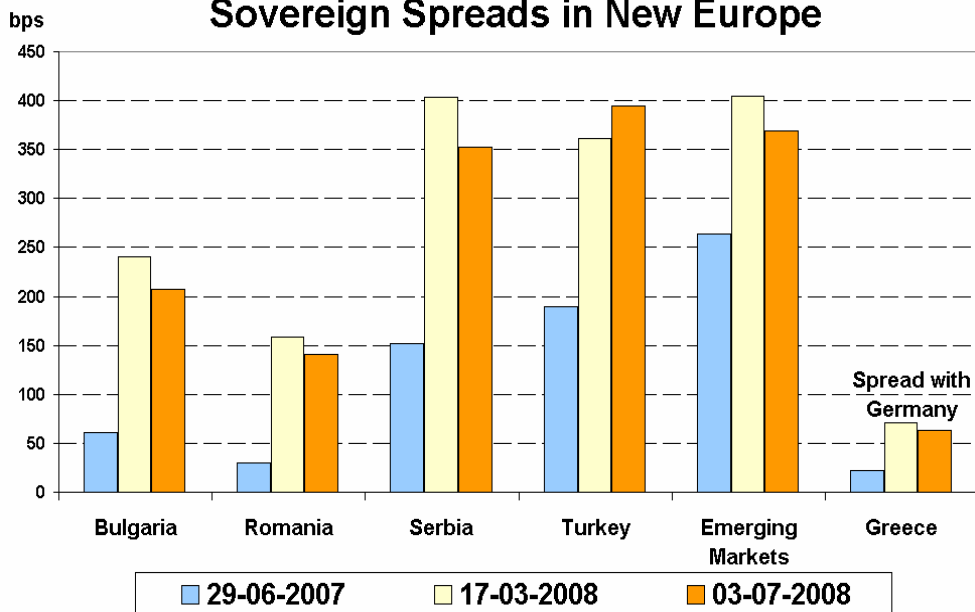
## 11.2 Credit Crisis: The worst is over... but worries linger



- ✓ Possibility of a meltdown is gone, following FED's initiative to rescue Bear Sterns in March 2008.
- ✓ Yet, more write-downs to come and interbank market under pressure
- ✓ Total write-downs of \$ 401 bn vs. \$ 320 bn capital increases up to end of June. IMF estimates them to climb to \$945 [\$225 billion on unsecuritized US loans + \$720 billion mark-to-market losses on related securities]

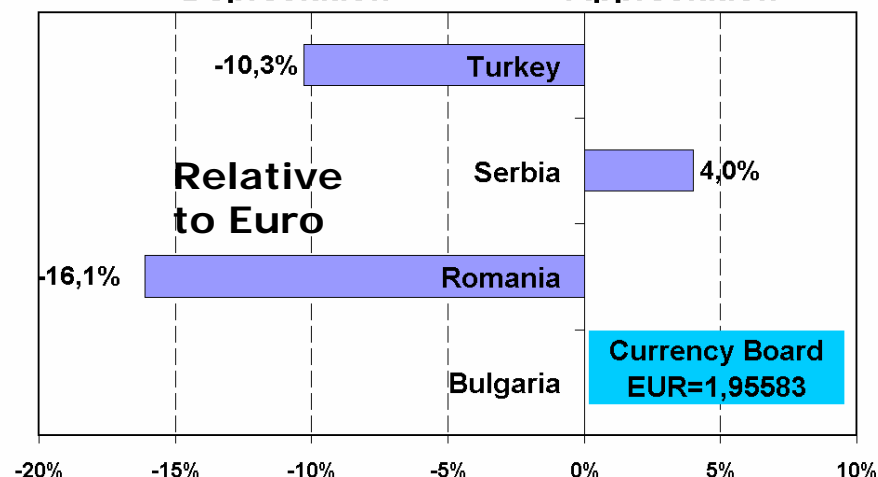
# 11.2 Financial markets under stress

### Sovereign Spreads in New Europe

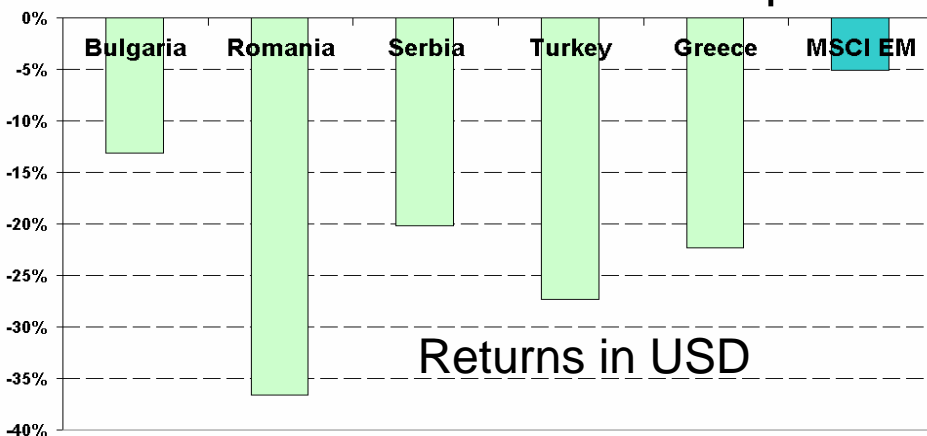


### Depreciation

### Appreciation



### Stock market returns in New Europe

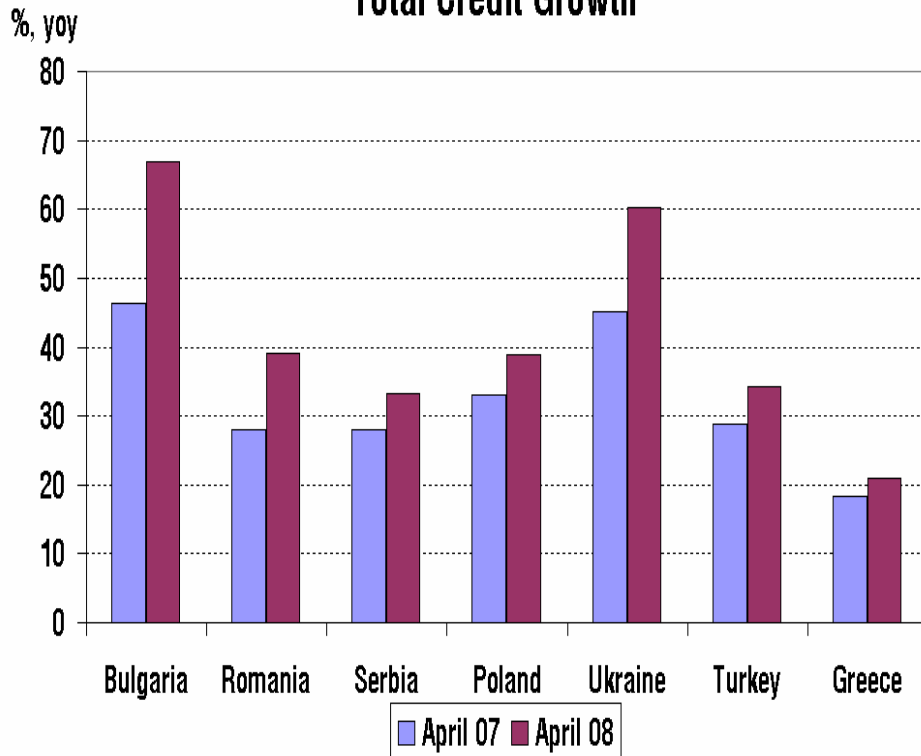


### VOLATILITY

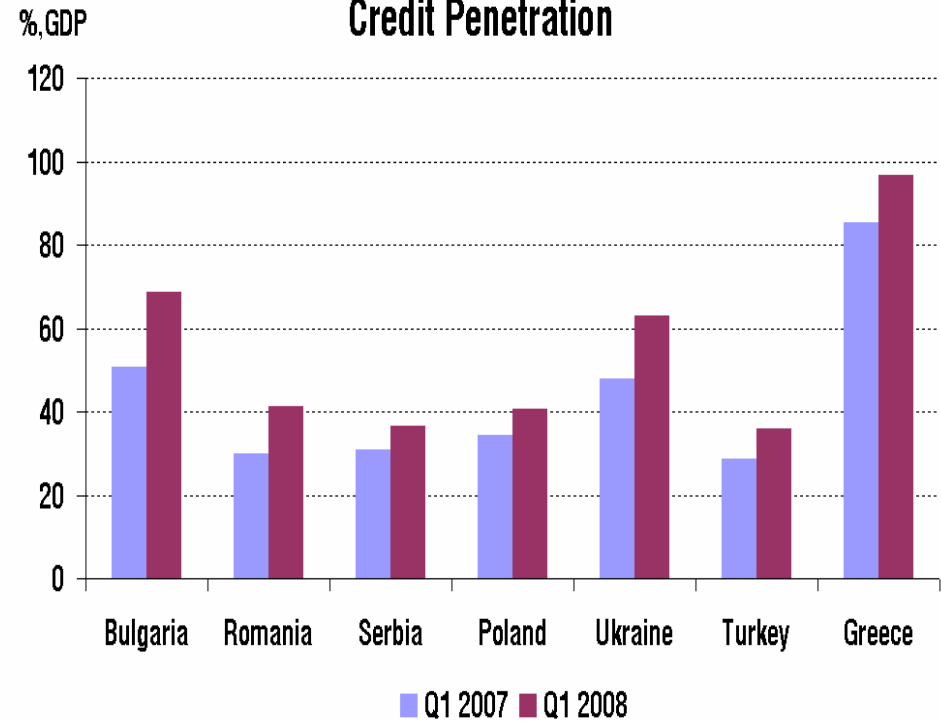
	Weekly Returns Standard Deviation		
	1H 2007	1H 2008	% Change
<b>Bulgaria</b>	2.3	3.5	53.1
<b>Romania</b>	1.9	4.0	112.4
<b>Serbia</b>	3.6	3.7	2.2
<b>Turkey</b>	2.8	3.3	20.2
<b>Greece</b>	2.5	3.6	42.6
<b>MSCI EM</b>	2.2	3.0	34.0

# 11.2 Credit growth rates not affected so far

### Total Credit Growth

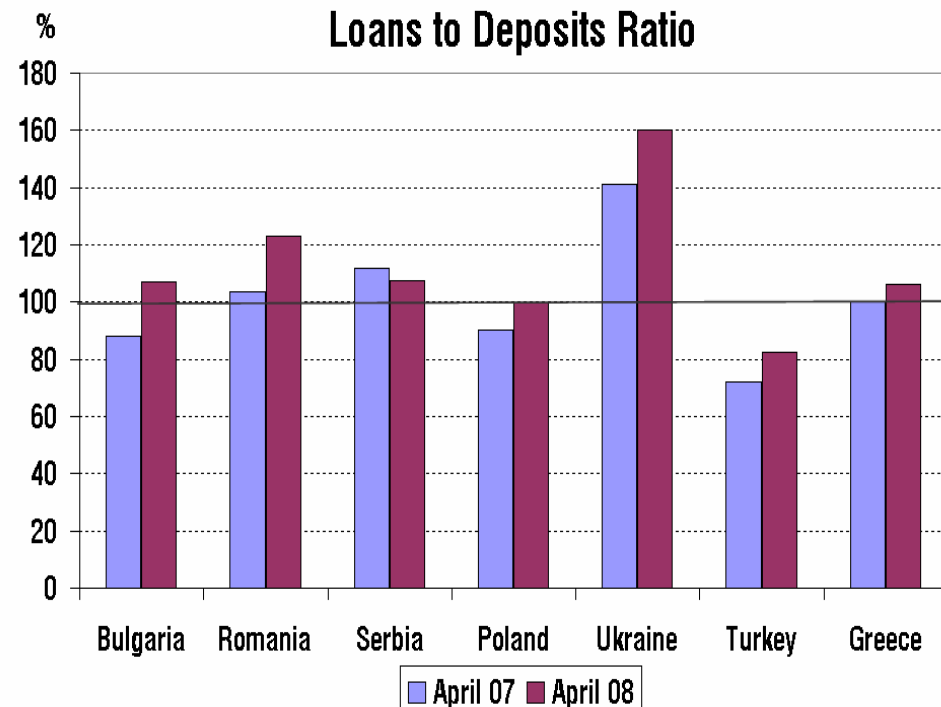
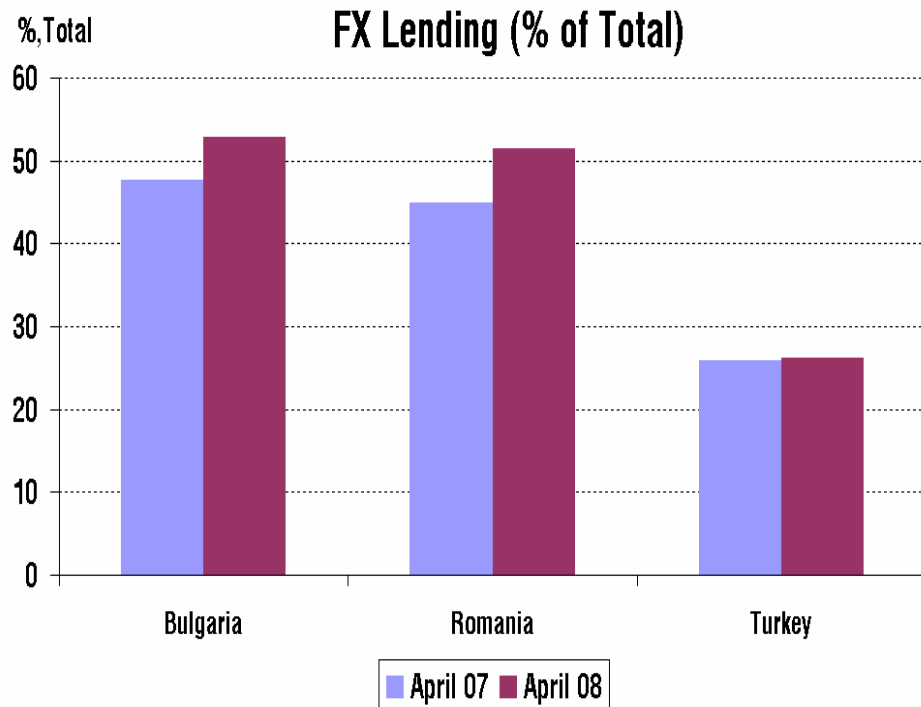


### Credit Penetration





# 11.2 Yet, liquidity risk is up & local deposits in need



# III.

## Individual countries: Pros & cons

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**Turkey:** *Political clash & growth slow down do not alter positive long term view*

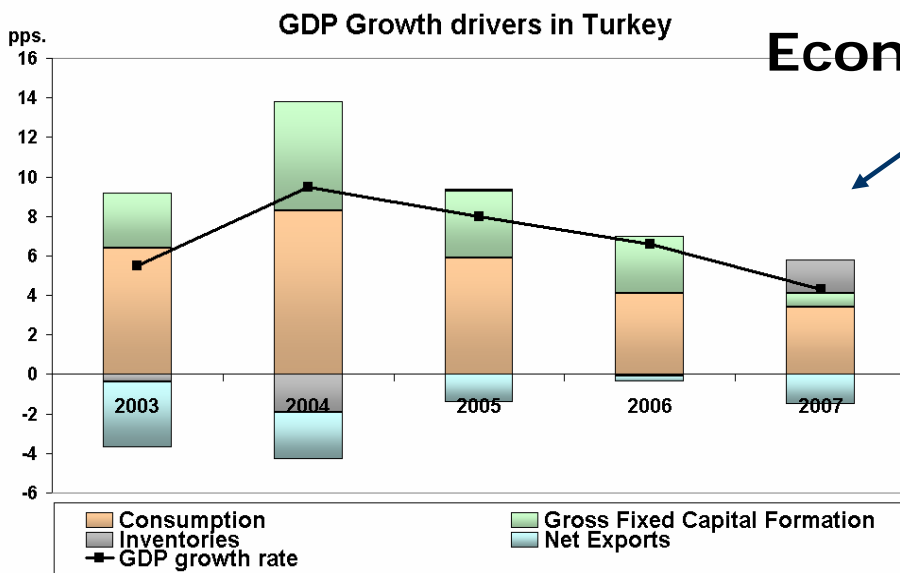
**Bulgaria:** *High growth but record-setting inflation enlarges imbalances*

**Romania:** *Monetary policy tightening ahead with solid prospects for continued growth*

**Serbia:** *Growth will continue, especially with a new pro EU government in place*

**Greece:** *Convergence to continue but growth slow down ahead*

# III. Turkey: The economy is slowing down.... while political risk is rising



**Economy slows down**

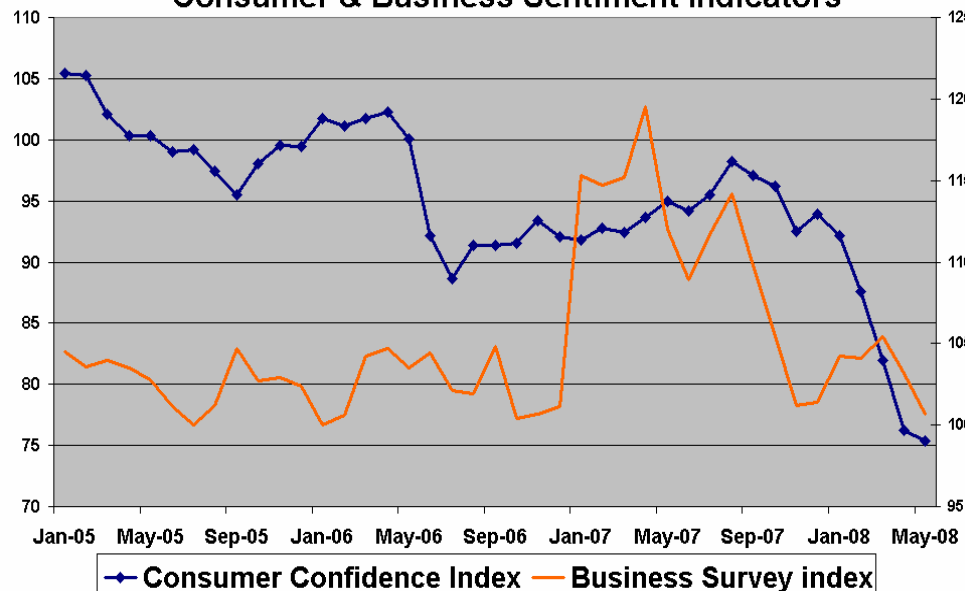
## Pros

- ✓ Big & young population (65% below age of 34), hence fast growing domestic market
- ✓ Important energy corridor, connecting East and West

## Cons

- ✓ Heightened political risk
- ✓ Inflation outlook deterioration
- ✓ Balance of payments concerns

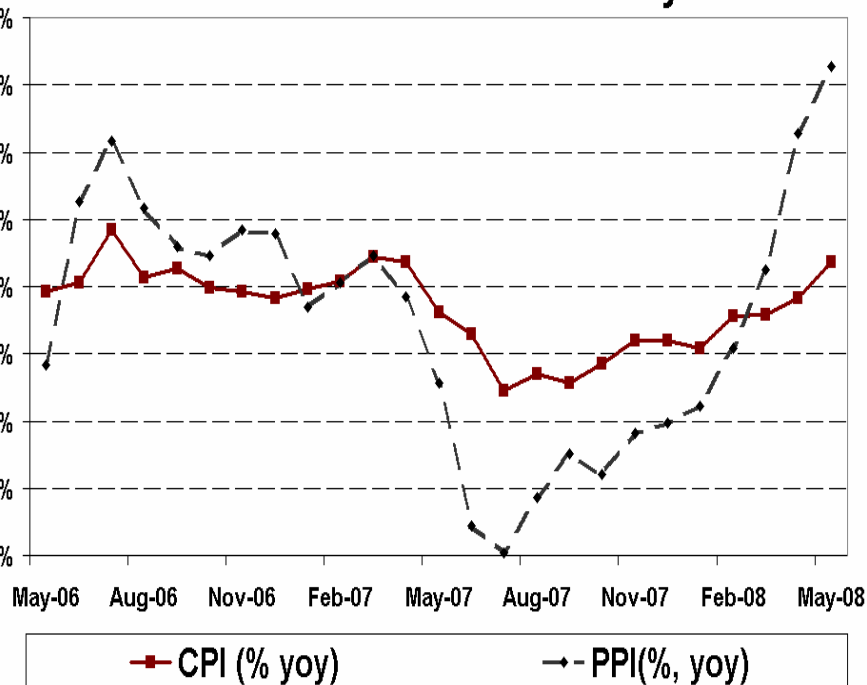
**Consumer & Business Sentiment Indicators**



**Consumer and Business sentiment plunge**

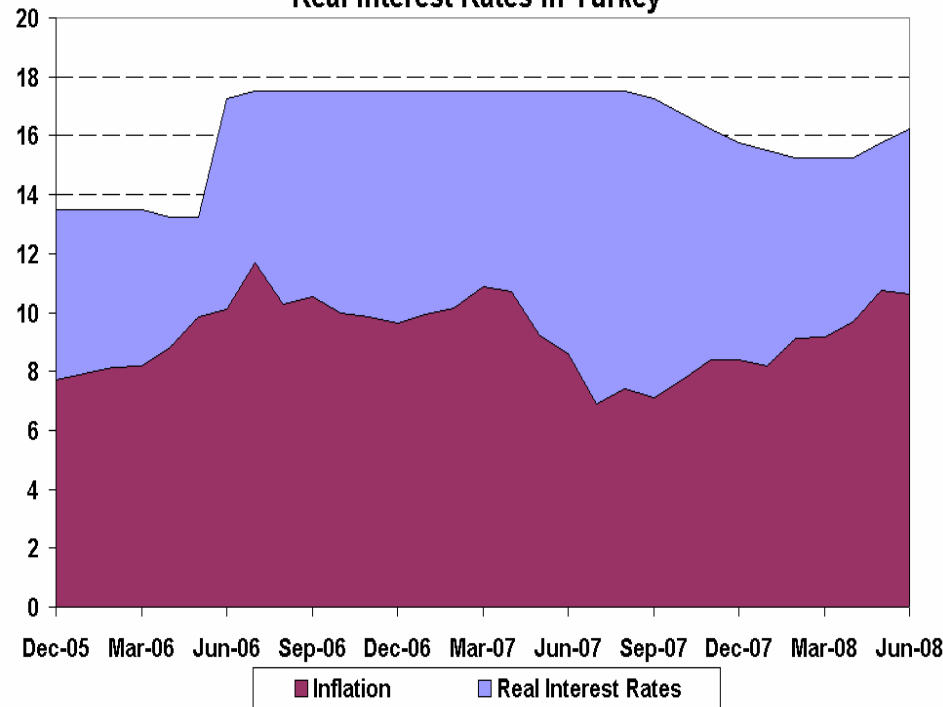
# III. Turkey: Inflation is rallying.... with second round effects showing up

CPI and PPI Indices in Turkey



**The PPI accelerates relative to the CPI**

Real Interest Rates in Turkey

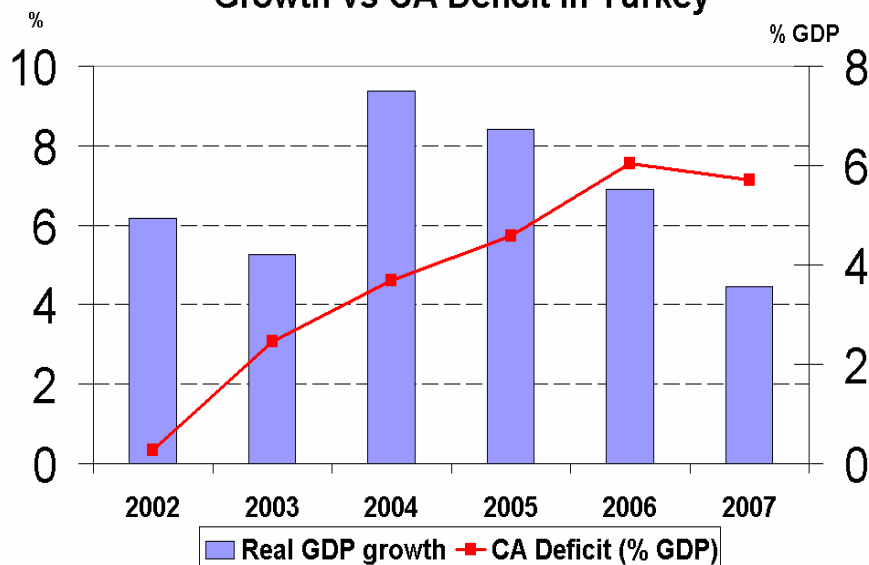


**Central Bank**

- ✓ Allowed real rates to decline
- ✓ But will be forced to a more aggressive tightening

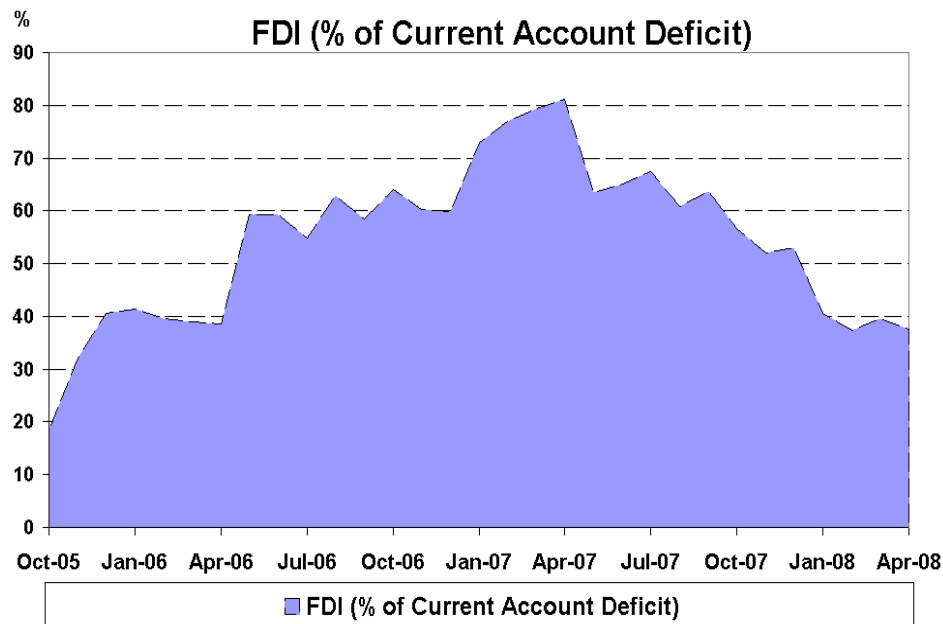
# III. Turkey: Balance of Payments risks linger...

### Growth vs CA Deficit in Turkey



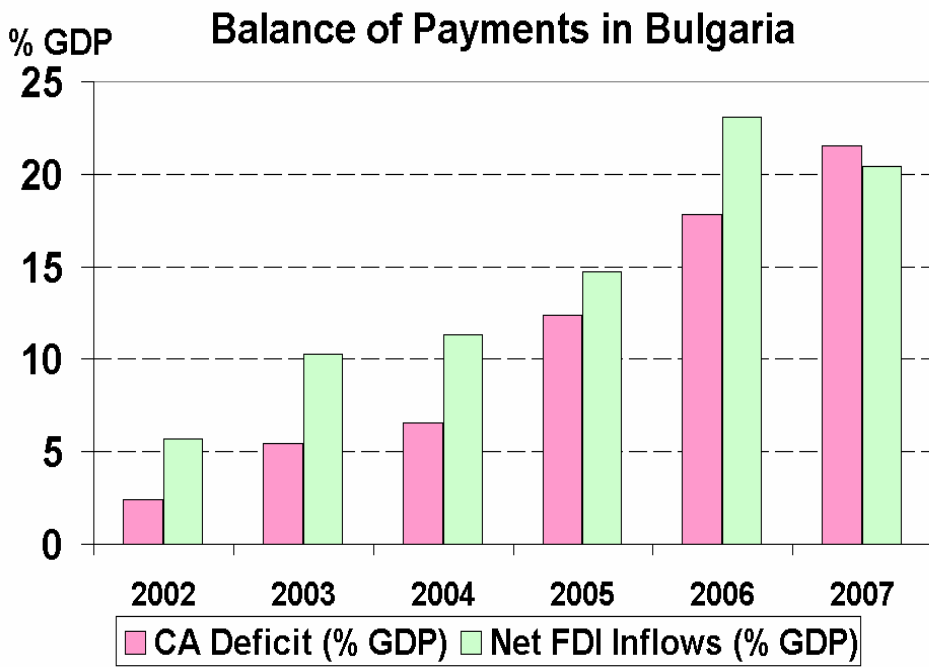
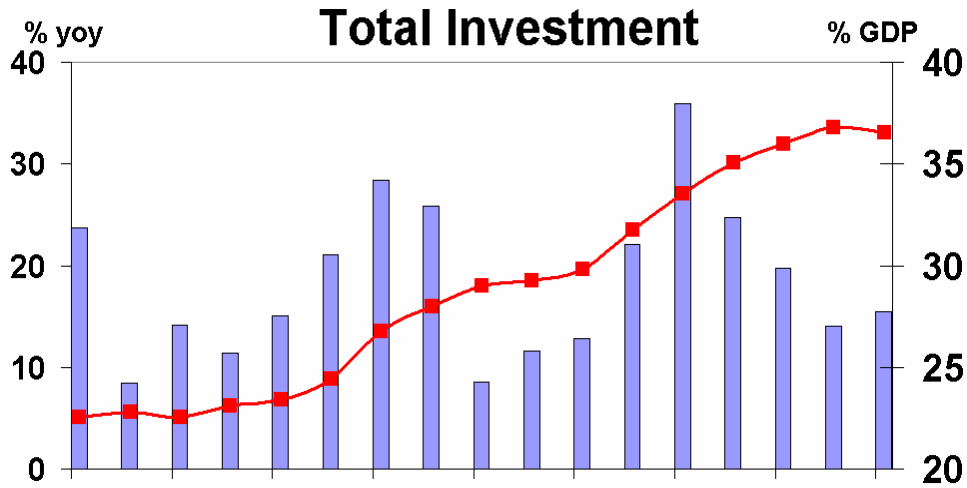
**Despite growth slowdown, current account fails to improve**

### FDI (% of Current Account Deficit)



**Financing quality of current account deteriorates**

# III. Bulgaria: Soft landing ahead



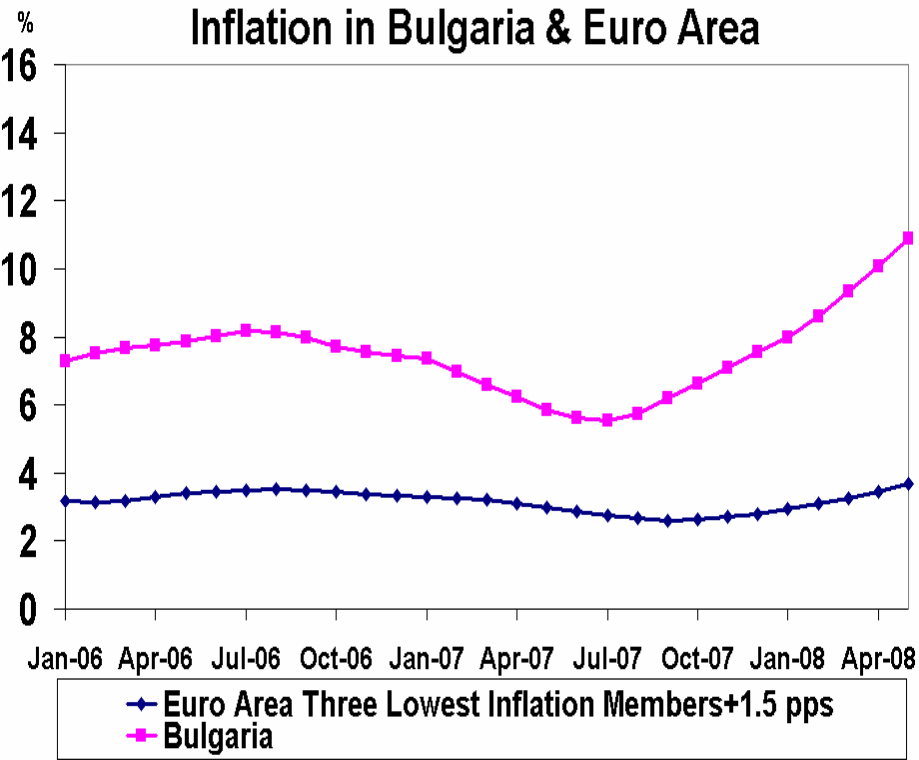
## Pros

- ✓ EU-27 Membership
- ✓ Political consensus over economic policies
- ✓ Fiscal discipline
- ✓ Short-term brisk growth outlook

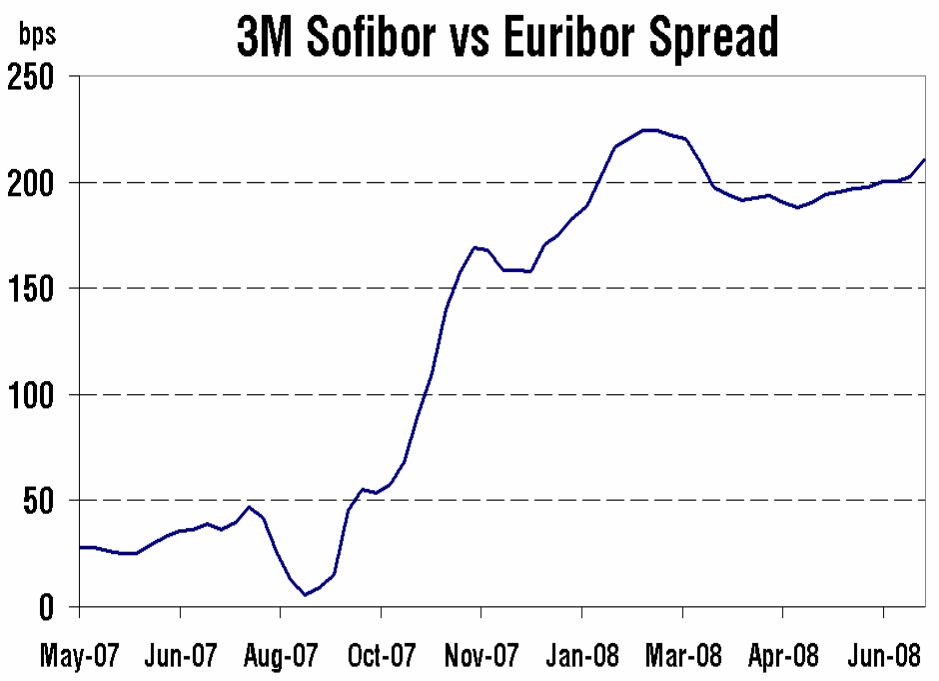
## Cons

- ✓ Inflation diverges from Maastricht criteria
- ✓ Current account deteriorates
- ✓ % FDI declining & half is real estate related
- ✓ Some EU-funds temporarily restricted

# III. Bulgaria: Inflation out of EMU range, currency board under pressure



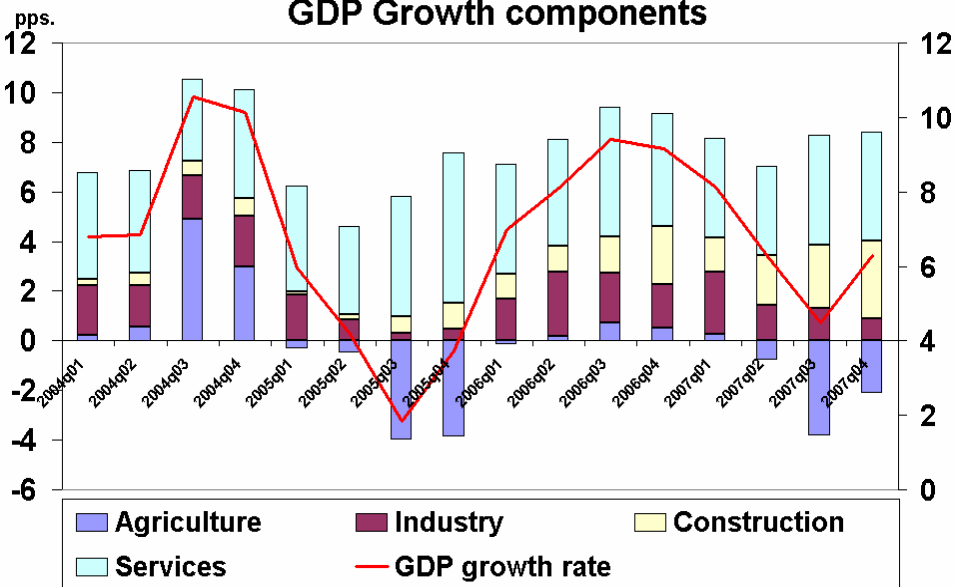
**Inflation diverges from minimum Maastricht levels**



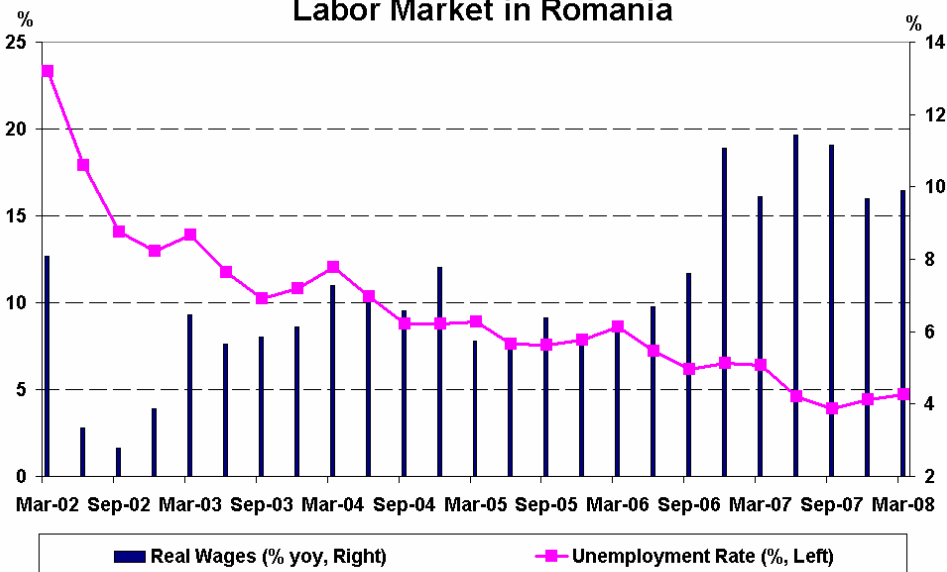
**Markets challenge the currency board**

# III. Romania: Growth above potential, with a tight labor market

GDP Growth components



Labor Market in Romania



## Pros

- ✓ EU-27 Membership
- ✓ 32 bn. euros in EU funds
- ✓ Big internal market: 21.5 mn

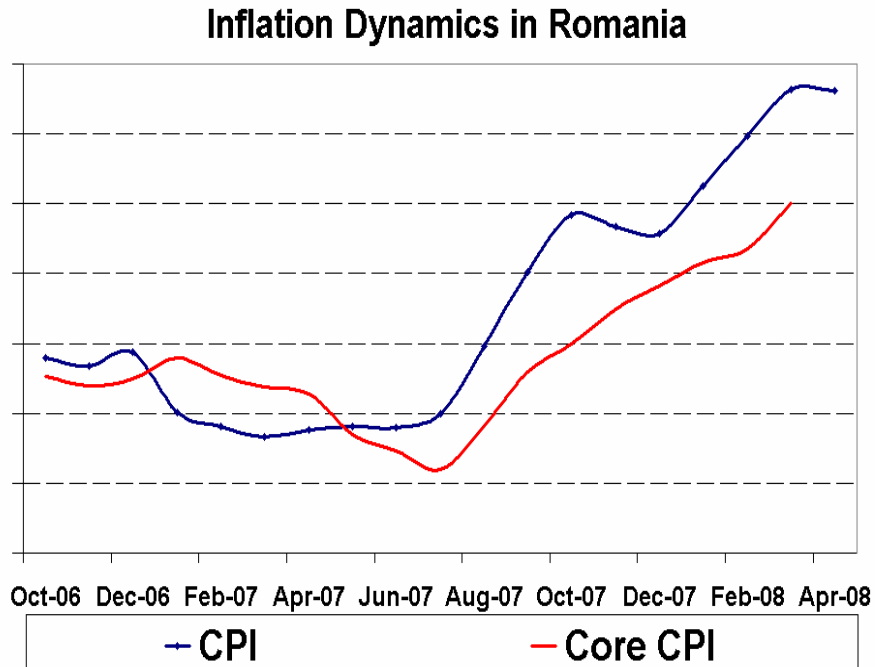
## Cons

- ✓ Risk of wage-price spiral
- ✓ Monetary policy not restrictive enough
- ✓ Expansionary fiscal policy with higher government consumption expenditure
- ✓ Financing quality of current account deteriorates, as FDI covers only 40%

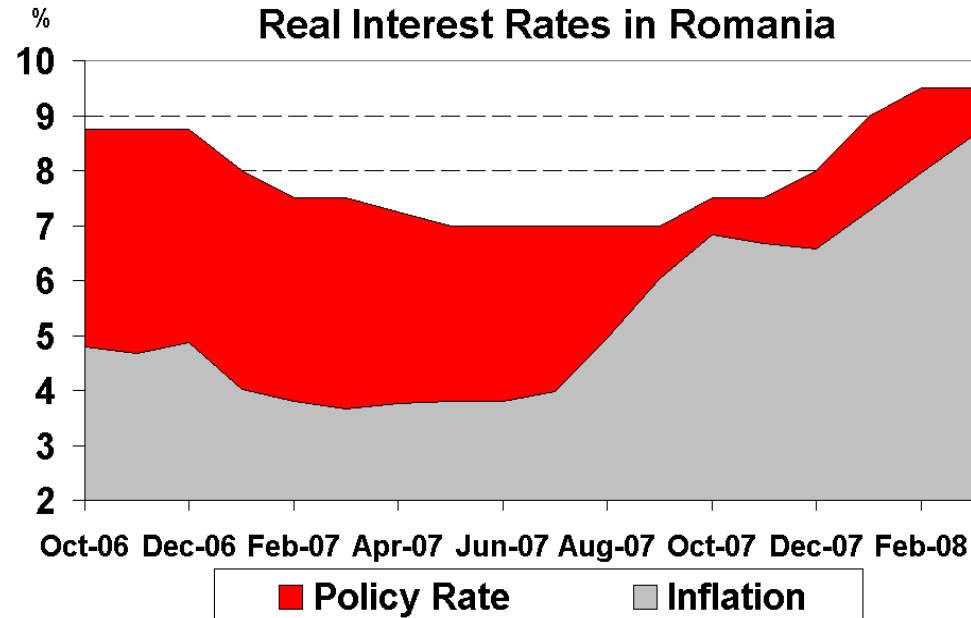


# III. Romania: Central Bank policy & inflation

**Inflation Dynamics in Romania**



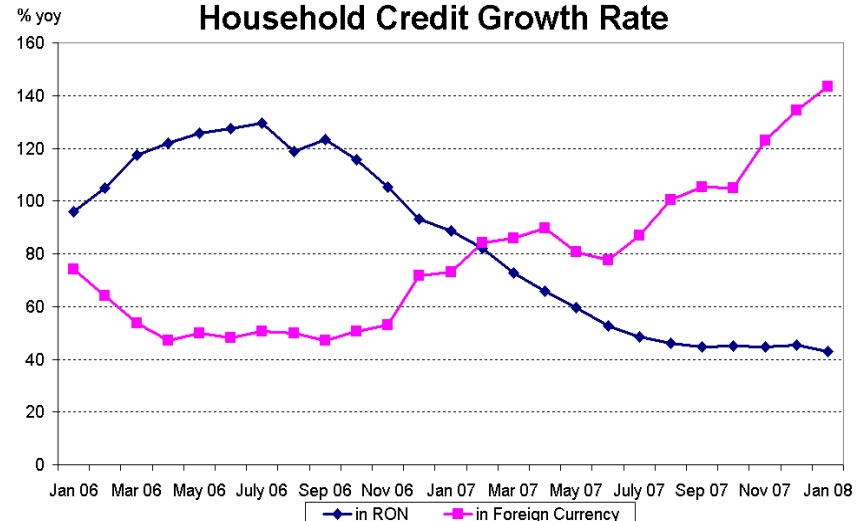
**Real Interest Rates in Romania**



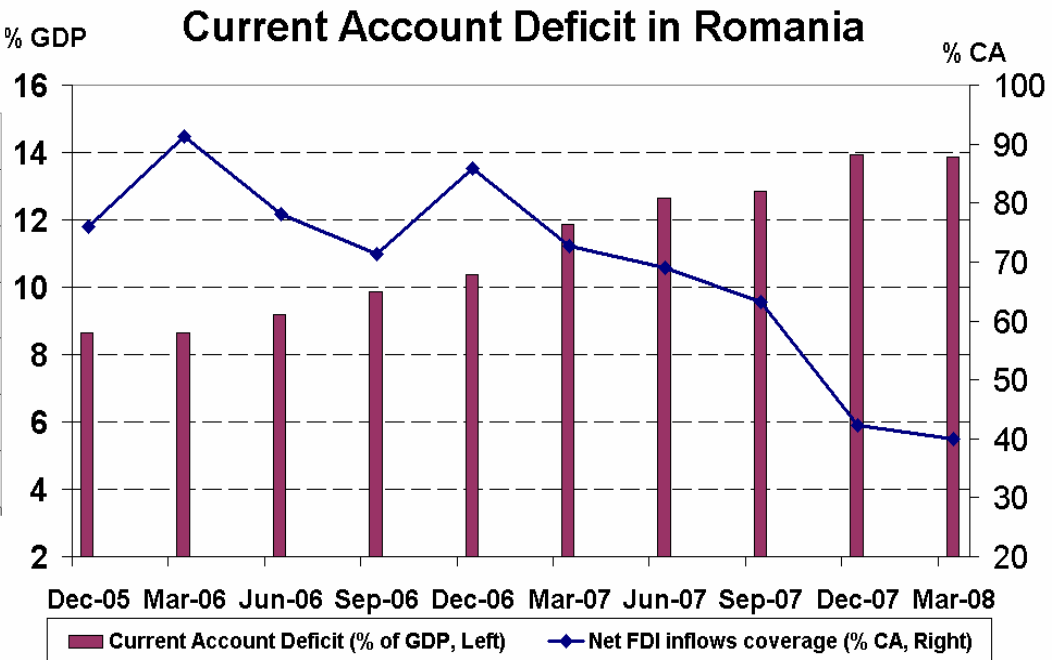
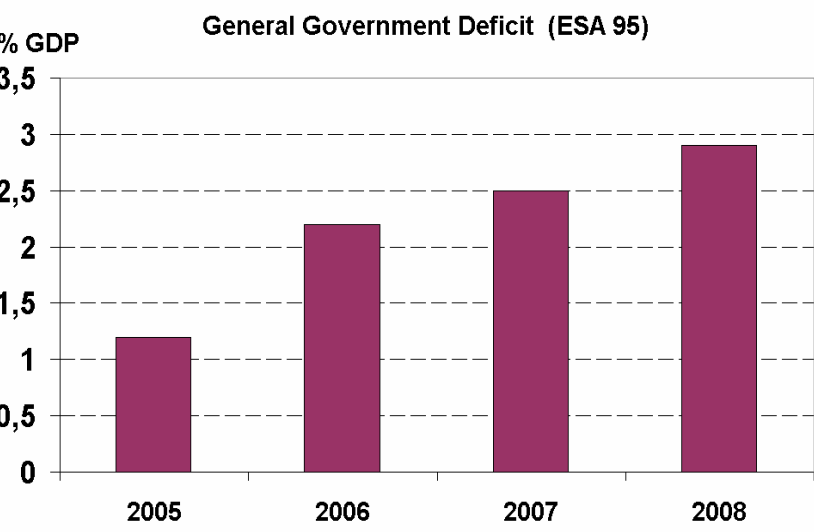
## Central Bank dilemma:

Raising rates to fight inflation is causing a switch to FX borrowing plus FX capital inflows

**Household Credit Growth Rate**



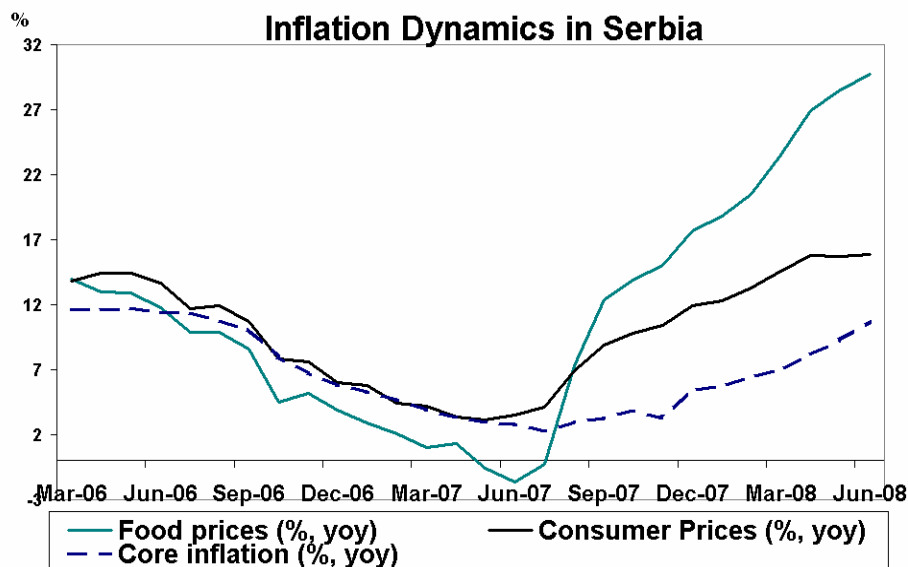
# III. Romania: Fiscal and external imbalances persist



Romania risks crossing the 3% ceiling on the budget deficit

FDI finances a smaller % of the current account

# III. Serbia: New Government confronted with inflation, need for structural reforms

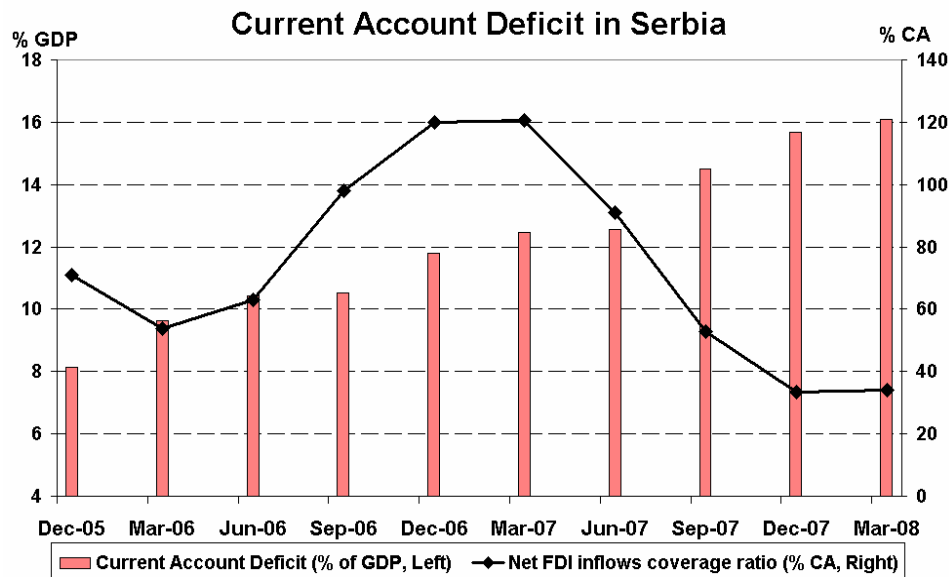


## Pros

- ✓ New pro EU government
- ✓ Stabilization & Association Agreement to be signed

## Cons

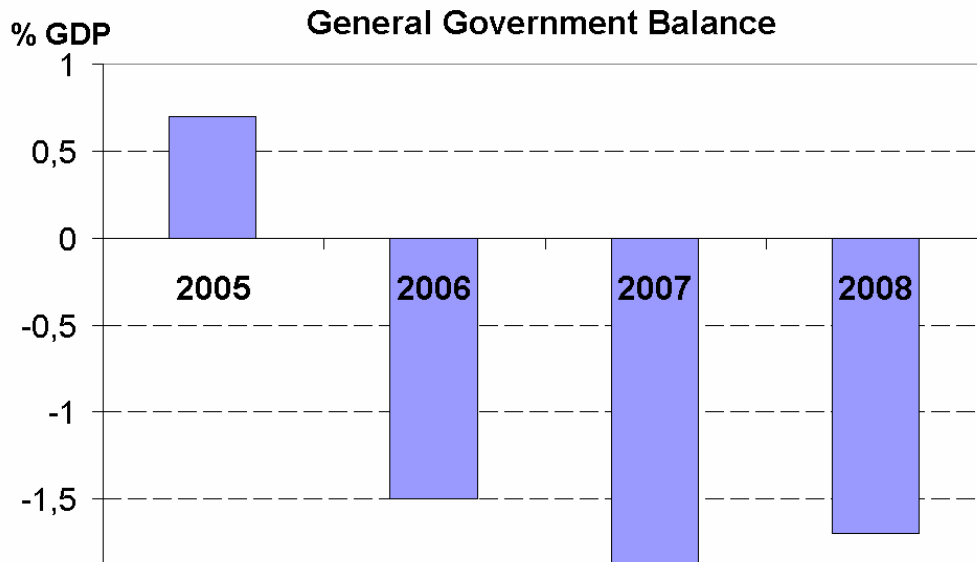
- ✓ Macroeconomic imbalances aggravated, CA:16.1% in Q1-2008
- ✓ Expansionary fiscal policy



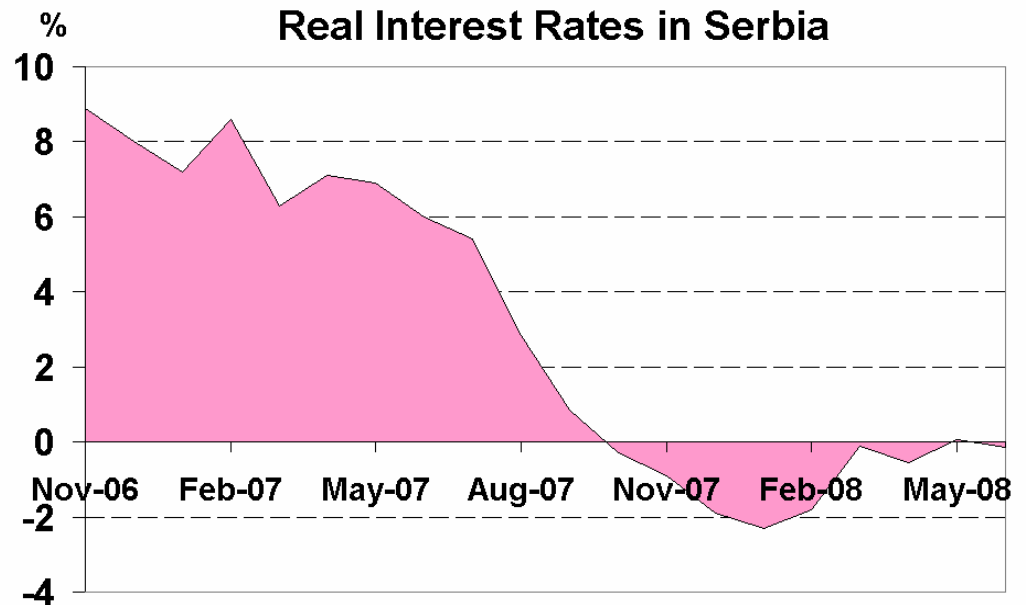
**New government has to push the privatization program**

# III. Serbia: Expansionary fiscal & monetary policies

Fiscal policy may get tighter

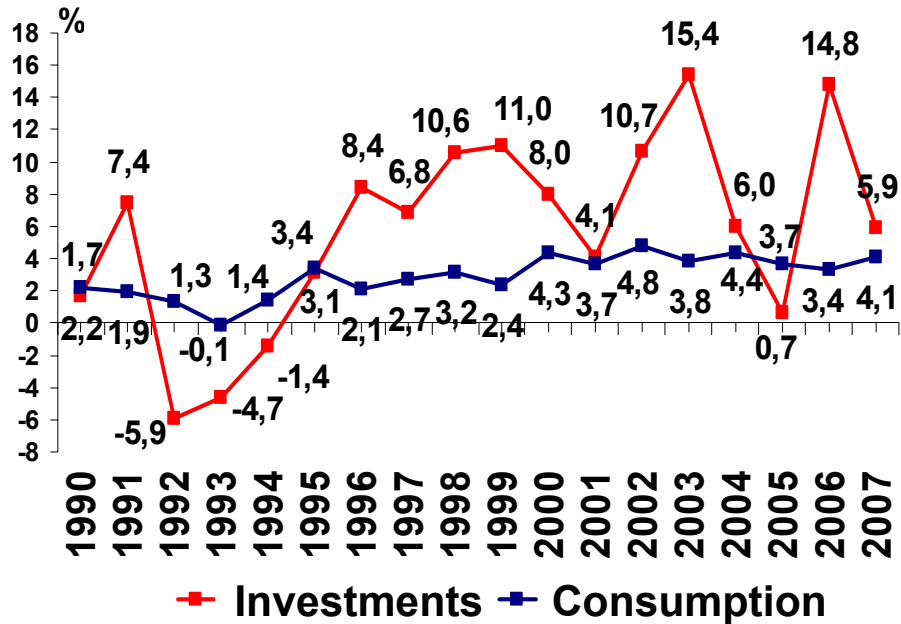


Nominal interest rates are expected to rise



# III. Greece: Growth as an investment story

Growth has been an investment story:  
Investment growth rates higher than consumption's



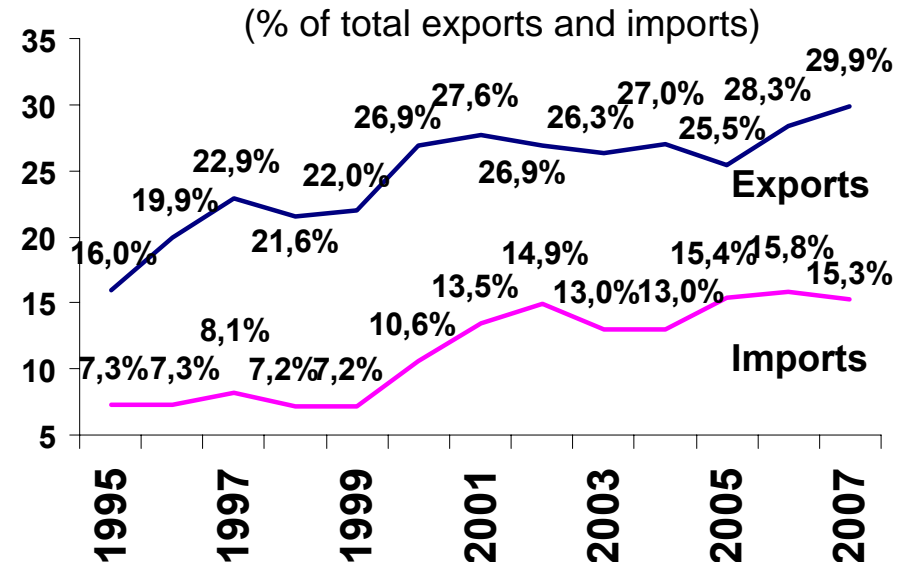
✓ *Investment in equipment was higher than investments in residential construction (with the exception of 2006 -2007)*

- ✓ Total Greek FDI have reached €12 bn (1<sup>st</sup> half of 2007) – approximately 9% of total FDI in the area
- ✓ No. 2 investor in Albania, Bulgaria, FYROM and Serbia

## Pros

- ✓ Investment to be supported by EU funds (3<sup>rd</sup> & 4<sup>th</sup> CSF, PPP) and the peculiar needs of the country
- ✓ Expansion to Eastern Europe
- ✓ Strong financial sector

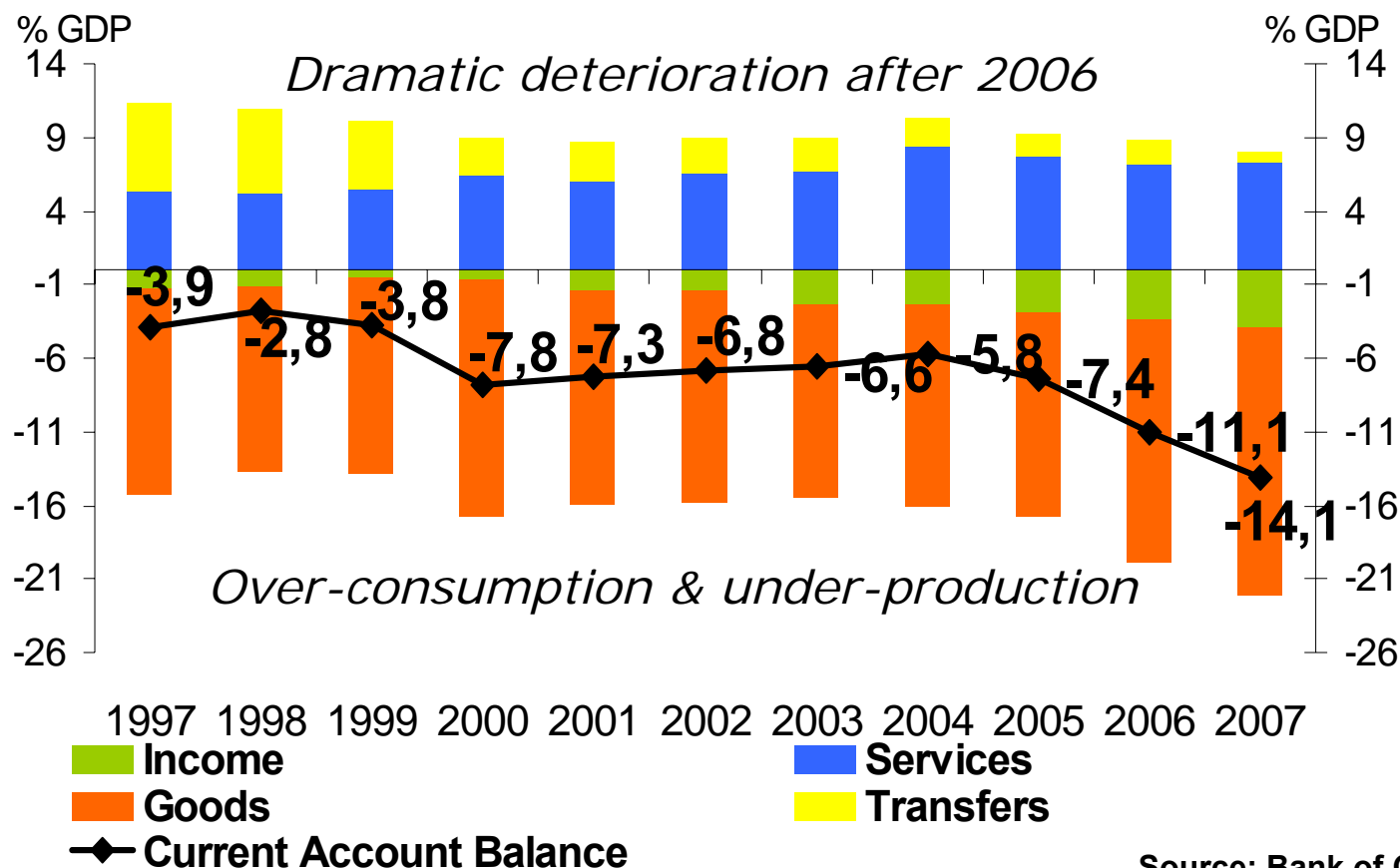
## Trade with Eastern Europe



# III. Greece: Major imbalances and lower growth rates ahead

## Cons

- ✓ **Deficit in competitiveness → Deteriorating Current Account**
  - World Bank: Greece ranks 100<sup>th</sup> among 178 countries in the “ease of doing business”
- ✓ **Fiscal deterioration with the ageing population**

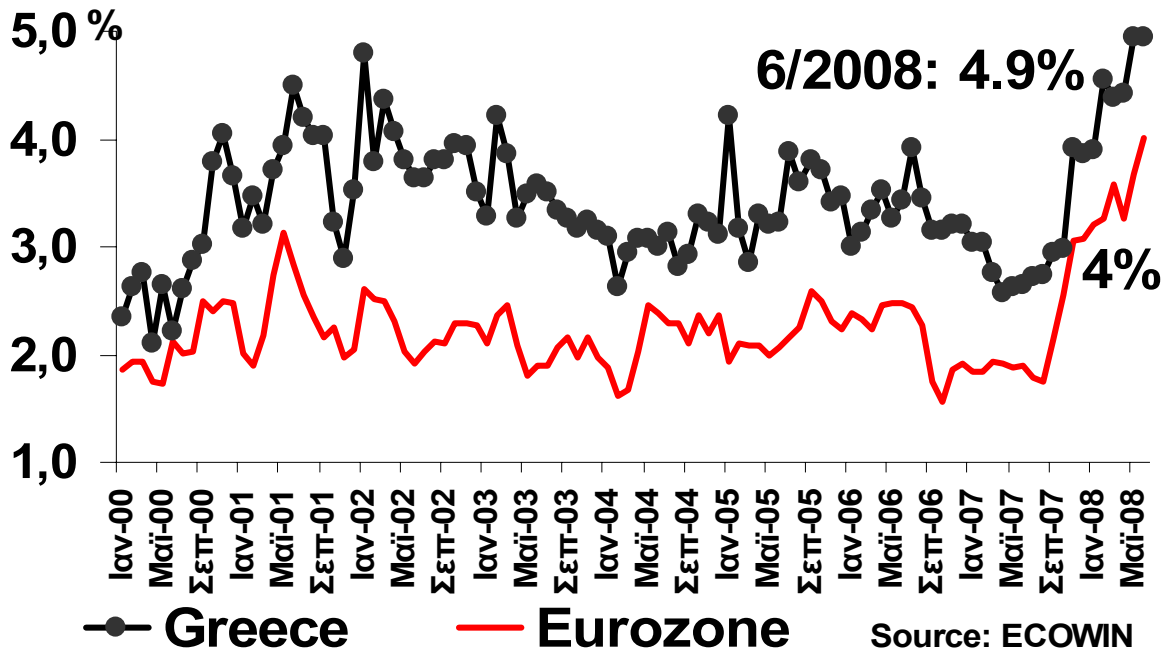


Source: Bank of Greece

# III. Greece: Inflation hurts competitiveness

- ✓ Inflation differential with EU likely to expand, as energy intensity higher
- ✓ Cumulative loss of competitiveness of 20% can be cured
  - with inflation dropping to Euro Area average
  - and productivity rising above EA productivity by 2% for 9 years

**Inflation Greece & Eurozone**



## Energy intensity of the economy

(1995 prices, consumption of oil equivalents in per 1000€ GDP)

	EU-13	Greece
1995	196.3	268.5
2005	183.4	236.5

- ✓ Need for structural reforms: product market competition, restricted professions, licensing, etc.
- ✓ Need for investment in the quality of education

# Conclusion

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- ✓ The global adverse shocks and global slowdown have exacerbated the imbalances but in most cases the risks appear manageable
- ✓ Potential entry into EU or EMU acts as an important disciplining device for following the correct policies, independent of local politics or other idiosyncratic events
- ✓ The region is expected to grow fast and become even more business friendly as structural reforms are in mid-way



# THANK YOU FOR YOUR ATTENTION!!

My thanks to the Research Department of Eurobank EFG for able research assistance and support

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