

# CEECs: convergence tested by the crisis

Alexandre Vincent

For almost 20 years, the rapid transformation of the former socialist Central and Eastern European countries (CEECs) was equal to the hopes raised when the Berlin Wall collapsed. The profound mutation in their economic structures, which was particularly evident in rising living standards and sustained by growing integration in the European bloc, highlights real convergence. Although uneven, progress in this direction has been encouraged by European Union membership<sup>1</sup>.

The world crisis that broke in the autumn of 2008 exposed intrinsic weaknesses in the CEEC growth model, however. Abundant external financing has generated high foreign debt and permitted a swift expansion in credit, notably in foreign currencies. At the same time, vigorous domestic demand in many CEECs meant overheating, with inflationary pressure and substantial current-account deficits that no longer appeared sustainable. By undermining agents' solvency, the international liquidity squeeze and consequent pressure on exchange rates emphasised the risks for these economies of heavy dependence on potentially volatile foreign capital.

Given that the entire region, Poland excepted, suffered severe recession in 2009, it is legitimate to ask whether the abrupt halt to its growth trajectory could prove durable. In several CEECs, the crisis has increased exchange rate volatility and upset government budgets, hampering nominal convergence. The latter is defined in terms of maintaining the major macroeconomic equilibria. The prospects of euro zone entry have therefore suffered, potentially undermining these countries' attractiveness. Already threatened by unhelpful trends in labour competitiveness and demographics, their potential growth could be affected. Either way, and given the magnitude of the challenges ahead, the convergence of the past two decades may not be over but its pace could well slow markedly from now on.

## Convergence boosted by insertion in the EU

Once over the shock of their break with the structures that characterised the communist bloc, CEECs reported vigorous growth and economic transformation between the mid-1990s and 2008. Closer European integration was a major factor, in trade, financial and institutional terms.

### A catch-up phenomenon cut short

#### *Rapid GDP growth*

The CEECs first post-communist years involved painful adjustments, with the break-up of a system governed by plans and Comecon instructions derailing all economic relationships. All these countries went through a period of contracting GDP, which ended in 1992 in Poland but lasted until 1998 in Bulgaria. The return to market mechanisms was undoubtedly helped by the fact that the CEECs were fully integrated in the international trading system until the Second World War. Once the initial shock was over, the combination of privatisation and the gradual liberalisation of prices, current accounts and capital accounts facilitated spectacular expansion. The region posted average annual GDP growth of 4.2% between 1994 and 2008, with an acceleration to 5.4% between 2004 and 2008 (cf. chart 1).

Naturally, this catch-up phenomenon raised average per capita income. Between 1992 and 2007, and in purchasing power parity (PPP) terms<sup>2</sup>, it climbed from 37% to 52% of that of the original 12 euro zone countries. By way of comparison, Portugal's per capita income was unchanged at 67% over the same period, for example. Living standards in CEEC countries had started to close on those in Western Europe, even

### Real GDP annual growth, %

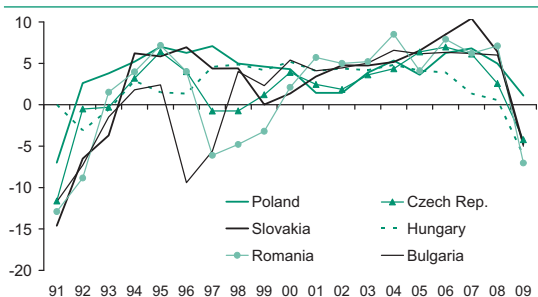


Chart 1

Sources: National statistical institutes

though convergence was very partial. The overall trend also masks considerable disparities. In 2008, per capita income ranged between 34% of the euro zone average in Bulgaria to 80% in Slovenia.

Investment has been the main engine of growth, and represented an average 25% of the region's GDP between 1990 and 2008. The investment rate was especially high in smaller CEECs, at over 27% of GDP on average in Estonia, Slovakia and the Czech Republic, and surged dramatically in Bulgaria after EU entry. In contrast, it was around 20% in Poland for almost the entire period.

### A boom in wages

The sustained increase in regional GDP until 2008 permitted a sharp rise in employment income. In PPP terms, the gross monthly wage jumped from an average €720 in 2001 to €1,100 in 2008, or by an average 6.2% per year (cf. chart 2).

### Monthly gross average wage, EUR (PPP)

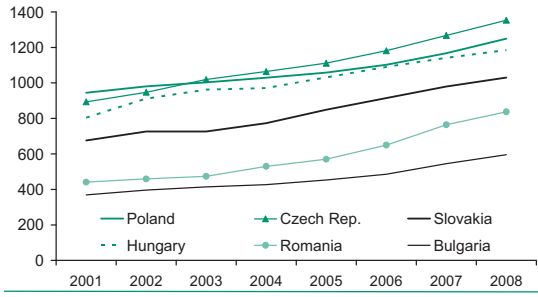


Chart 2

Source: WIIV

This catch-up phenomenon has been most vigorous in countries where remuneration was initially the lowest,

i.e. in Romania and Bulgaria. Starting with average gross monthly wages of €440 and €370, respectively, they have seen annual average gains of 9.5% and 7%. In the Baltic States, where gross remuneration was around €550-650 per month, wage inflation has been around 8% per year. At the other end of the scale, the average monthly wage in Poland climbed from €940 to €1,250 between 2001 and 2008, or by 4% per year. Slovenia's rose from €1,360 to €1,740, or 3.6% per year.

### Rigid labour markets

The boom in wages in CEECs highlights the fact that labour markets have remained relatively inflexible. Unemployment rates generally fell until 2008. In Poland, for example, and using the ILO definition, it dipped from 10.2% to 7.1% between 1998 and 2008, although with marked volatility (it was over 20% between mid-2002 and mid-2004). The same trends were observed in Bulgaria and Slovakia. Only Hungary suffered a rise in unemployment between 2004 and 2008, following a breakdown in its convergence (cf. chart 3). We return to this point below.

### Unemployment rate, % (ILO definition)

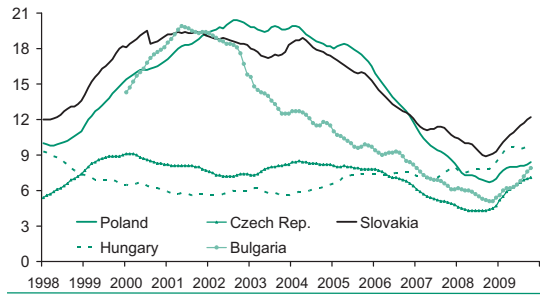


Chart 3

Source: Eurostat

The decline in unemployment overall after 2004 mainly reflected a robust expansion in employment, with employment rates<sup>3</sup> progressing from 50.4% to 63.8% in Bulgaria and from 58.6% to 69.4% in Latvia, for example. Yet there has been considerable dispersion here too, with particularly low employment rates in Poland (59% in 2008), Romania (59.3%) and Hungary (56.6%). These differences reflect participation rates<sup>4</sup> that themselves vary between 61.4% in Hungary and 73.5% in Estonia (2008).

On this evidence, it seems that the labour markets in smaller CEECs – the Baltic States, Slovenia and to a slightly lesser extent the Czech Republic and Slovakia – have not featured the same rigidities as those in their bigger neighbours, like Poland, Romania and Hungary. The latter are distinguished by marked internal disparities and a high incidence of long-term unemployment, even though some sectors (construction, for example) suffer from labour shortages.

### Shifting migratory flows

The pressure on the labour market throughout the region has been amplified by migration to Western Europe, often to the UK or Ireland<sup>5</sup>. Surprisingly, these flows appear to have been more marked in the five years preceding EU membership in January 2004 than in the following years. Swelling employment and higher incomes in the new Member States partly explain this apparent paradox. Indeed, returning migrant workers have outnumbered outward flows of labour in Poland since 2008.

Some CEECs have themselves fallen back on foreign workers, often from Ukraine or Byelorussia, to ease labour market pressure wrought by emigration. The Czech Republic, Hungary, Slovenia and Slovakia all reported net immigration between 2004 and 2007.

Although incomplete, the catching-up that CEECs have done bears witness to their dynamism throughout the transition period. More fundamentally, their entire economic structure has altered in the process.

## Benefits from integration into the European productive system

### Changes in economic structure

CEEC economic structures have been profoundly altered over the past 20 years, with a degree of convergence towards those seen in Western Europe. This process is particularly evident in the relative shares of the primary, secondary and tertiary sectors in value added. In 1990, agriculture accounted for 13% of GDP in CEECs, while industry represented 47% and services 40%. These proportions were 3%, 34% and 63%, respectively, in 2005, compared with 1%, 27% and 71% in the first euro zone countries<sup>6</sup>.

However, the statement that similarities between Western Europe and the CEECs are increasing should be qualified according to more detailed data. For example, the share of manufacturing in value added jumped from 12% to 26% in CEECs between 1995 and

2005<sup>7</sup>, while in the euro zone it has tended to decrease and is about 20%. Relocation from the euro zone to CEECs has plainly been at work, heightening regional specialisation within Europe. Elsewhere, we note that certain services have expanded enormously in CEECs, such as retailing, hotels and restaurants, property and company services. The latter category could expand a great deal more, as it accounted for 11% of GDP in 2005 (it was 1.5% ten years earlier), compared with around 20% in the euro zone.

At the same time, the quality of goods produced in the CEECs has improved steadily, with a shift in output towards more technology-intensive sectors, towards more complex goods within these sectors and towards greater value-added in consumer goods<sup>8</sup>. Once again, this general observation masks national disparities, and although Bulgaria, Romania and the Baltic States have shared in the trend towards more technology-intensive sectors they remain specialised in the least sophisticated products. That said, and given these nuances, the fact remains that the major characteristics of CEEC production are much closer to Western Europe's than they were 20 years ago.

### Opening to international trade

Heightened integration into the European economic system is also illustrated by expanding trade flows. The CEEC openness ratio<sup>9</sup> climbed from 39% in 1989 to 65% in 1990 and 116% in 2007, compared with a rise from 53% to 80% for the euro zone over the same period (cf. chart 4). While the relatively small size of most CEECs partly explains their high ratios, the speed of the change emphasises just how fast they have turned towards Western Europe, their main trading partner. Domestically, expanded trade has helped to raise living standards by increasing the range of goods available to consumers.

Openness ratio

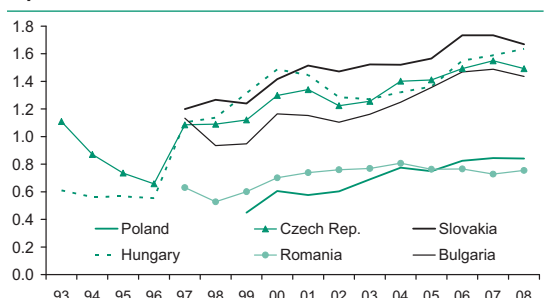


Chart 4

Source: Eurostat

A closer examination of the expansion in regional trade reveals that the biggest gain has been in intra-branch trade. This lends support to the idea that trade development has been part and parcel of the international division of production processes, furthered with the support of foreign direct investment (FDI). Marked specialisation now characterises several CEECs. For example, the auto sector represents around 40% of Slovakian exports and has a high profile in the Czech Republic and Hungary, while the IT sector accounts for a growing share of activity in Poland.

### ***More synchronised cycles***

The convergence of economic structures with those in Western Europe, closer trade links and the growing integration of productive processes have resulted in more synchronised economic cycles, already evident by the mid-2000s<sup>10</sup>. Even so, the theoretical literature has sometimes argued that closer trade links and FDI flows can mean sector specialisation for some countries, which in turn may work against cycle synchronisation<sup>11</sup>. From this viewpoint, the systemic importance of the auto industry in Slovakia and to a lesser extent in the Czech Republic and Hungary constitutes a specific point of fragility for these countries that could materialise with the end of scrapping bonuses in France and Germany.

In more general terms, the extent of the 2008-09 crisis has pretty well destroyed the notion that CEEC fortunes could be decoupled from Western Europe's. But before turning to the ways in which the crisis spread from the euro zone to CEECs, we attempt to show just how the process of European integration promoted the real convergence we have just described, at least until 2008.

### ***EU integration as stimulus for convergence and catch-up***

The transformation of CEECs in the years following the collapse of the Berlin Wall took place in a context of globalisation, which clearly had a major impact on the speed of this change. Even so, several studies focus on the specific impact of EU integration on this process<sup>12</sup>. The results of this work may not be particularly robust, as it is difficult to isolate the effect of EU integration, but they generally indicate that EU integration had a significant impact, worth around 1% per year in per capita GDP growth. Naturally, this overall contribution is the net outcome of several different phenomena, which may be grouped into changes in the institutional and

macroeconomic policy framework on the one hand and substantial capital flows on the other.

### ***The contribution of institutional reform***

Changes to the institutional framework in its widest sense have played a major role. The adoption of EU legislation and regulations was itself a powerful engine of change, notably in terms of guarantees of central bank independence and of property rights. The EBRD transition indicator highlights the progress made in the light of very general criteria<sup>13</sup>. On a scale ranging from 1 to 4.33, no CEEC was rated better than 2.5 in 1991, yet all have been at between 3 and 4 since 2000, with a tendency to converge on the same level in recent years.

### ***Economic governance***

In terms of macroeconomic stability, the convergence criteria laid down in the Maastricht treaty – tame inflation, limited government deficits and debt, stable exchange rates and long-term interest rate convergence – set clear guidelines for the conduct of economic policy<sup>14</sup>. Not that all CEECs have implemented exactly the same policies: inflation has been pretty well contained in countries that opted for targeting, thanks to nominal exchange rate appreciation, but has soared in the Baltic States and Bulgaria, which opted to peg their currencies to the euro. Moreover, until 2008 we saw tighter budgetary discipline in the smallest CEECs than in the largest ones. The former did not include solely those constrained by the defence of a fixed exchange rate but also the Czech Republic and Slovakia, where historically small deficits had kept government debt to below 30% of GDP. In contrast, the larger CEECs have struggled to rein in public expenditure.

### ***The prospect of euro zone membership***

Independently of the nominal anchor provided by the Stability and Growth Pact in terms of the conduct of monetary policy, the objective of euro adoption, already reached by Slovenia in 2007 and Slovakia in 2009, has itself offered encouragement for capital flows. Apart from these two countries, problems in achieving nominal convergence have so far prevented EMU entry and have even sparked debate over the pertinence of the Maastricht criteria for transition economies.

Despite everything, the pre-crisis prospect of euro zone membership in relatively short order for most CEECs had a 'halo' effect that lasted until the autumn of

2008. Confident in the budgetary discipline imposed by the Stability Pact, and above all with the assumption that imminent euro adoption would confer implicit EU guarantees, the markets started to assimilate the new EU Member States to euro zone countries. This resulted in tighter spreads than the fundamentals would have justified and stimulated already abundant external financing for these economies.

### Massive financial flows

EU integration also accelerated CEEC catch-up by triggering large transfers of the resources needed to finance economic development. These transfers took several forms.

#### - Structural funds

The EU has itself made a direct contribution via the European Regional Development Fund, the European Social Fund and the Cohesion Fund. The sums allocated for 2007-13 represent an average 2.4% of CEEC GDP per year.

#### - European bank penetration

Betting on catch-up phenomena, Western European investors were attracted by prospects of rapid growth in local markets lacking initial capital, guaranteeing high returns. European banks have been increasingly active in these markets, notably Swedish banks in the Baltic States and Austrian banks in Central Europe, helping to deepen capital markets and improving access to international finance. In 2008, foreign institutions owned around 67% of banking assets in Poland, 84% in Hungary and 96% in Slovakia.

#### - FDI inflows

We have already mentioned the importance of investment in the catch-up phenomenon, and particularly that of FDI in transforming the economic system. FDI often involved greenfield projects<sup>15</sup> in which credit went beyond simply providing finance to promoting technology transfers and boosted CEEC productivity<sup>16</sup>. Well-educated labour forces were crucial in this process. The stock of FDI rose sharply as a share of GDP during the period under review, although unevenly. In Bulgaria, it surged from 2% to 96% between 1995 and 2008, with a massive increase upon EU entry. At the same time, it climbed from 27% to 60% in Hungary. By 2008, the ratio of the stock of FDI to GDP was 55% for the Czech Republic and 48% for Slovakia, although was limited to 33% in Poland and 38% in Romania.

All in all, CEEC catch-up reflects trade, financial and institutional integration in Europe. By slowing international trade and hampering financial flows, the world crisis has upset this entire process.

## Latent weaknesses exacerbated by the crisis

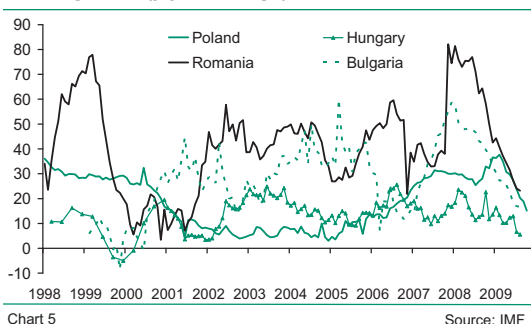
Sustained by rapid growth, CEEC convergence was also founded on macroeconomic disequilibria, both external and in terms of inflation. The crisis initially imported from the euro zone was all the more severe in CEECs because it revealed latent weaknesses in their growth model.

### Inflationary pressure induced by overheating

#### The credit surge

Abundant external financing promoted rapid credit growth (cf. chart 5), which may be attributed largely to a catch-up phenomenon. Financial intermediation was embryonic at the start of the transition period and despite considerable progress has remained relatively modest. The credit to GDP ratio jumped from 54% to 81% in Hungary between 2000 and 2008, and from 35% to 96% in Estonia following aggressive Scandinavian bank penetration in the Baltic States. But it remained stable at around 50% in the Czech Republic and 57% in Slovakia, while rising from 27% to 50% in Poland. Spectacular credit growth in Romania throughout the period lifted its ratio from 14% to 40%.

Credit growth (y/y % change)



Despite the still moderate degree of financial intermediation in the region, rapid credit growth has

proved destabilising for at least two reasons. Firstly, by sustaining domestic demand it has added to pressure on consumer prices and on the prices of residential property. Secondly, and given that the private sector was a heavy borrower of foreign currencies, it increased CEEC exposure to exchange rate risk just as external disequilibria were liable to boost exchange rate volatility. We return to this point below.

### Price pressure

The credit boom was sometimes accompanied by procyclical fiscal policies. Thus in 2008, Poland's government deficit to GDP ratio was 3.6%, Hungary's was 3.8% (despite efforts to rein it in since the autumn of 2006) and Romania's 5.5%. Some countries, with the notable inclusion of those with fixed exchange-rate systems, suffered greater inflationary pressure than the Balassa-Samuelson effect would have automatically generated all on its own (cf. chart 6). Even without reference to the hyperinflation that affected Romania until the mid-2000s, HICP inflation rates in 2008 were 12% in Bulgaria, 10.6% in Estonia, 11.1% in Lithuania and 15.3% in Latvia. Hungarian HICP inflation was 7.9% in 2007.

**Inflation rate (HICP, y/y % change)**

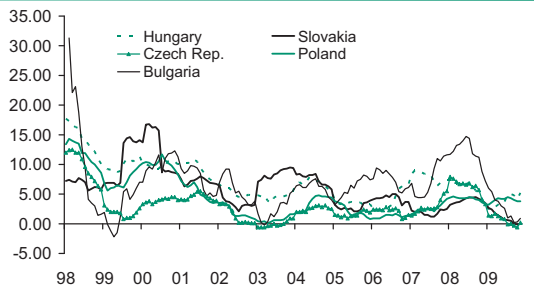


Chart 6

Source: Eurostat

Characteristic of the overheating that affected many CEECs before the crisis, inflationary pressure also resulted in asset price bubbles. These appeared on the property market, especially in the Baltic States but also in Poland (nominal home prices rose by over 30% y/y in 2005 and 2006) and in Bulgaria, where trends were very similar to Poland's between mid-2007 and mid-2008. Both the Polish and Bulgarian property markets featured marked regional disparities, however. Bubbles appeared on several stock markets, too, notably the smallest. Benchmark indices rose over 3.5 times over in Bulgaria

and Romania between April 2004 and 2007, and doubled in Poland, Slovakia, the Czech Republic and Hungary.

### A problem of competitiveness

Inflationary pressure resulted in wage-price spirals in several CEECs. On tight labour markets, where demographic change required to draw in foreign workers, employees' bargaining power was all the stronger for often decentralised wage negotiations and for the use of public sector pay as a benchmark (public sector pay rose very quickly in some countries). Wage inflation was often high as a result.

Increases in labour costs were exaggerated in CEECs whose floating currencies appreciated on trend against the euro, especially at a time of yen and dollar depreciation. In most cases, these increases outstripped productivity gains, which on average were hampered by a limited stock of disposable capital. The resulting hikes in unit labour costs – 16.2% in Bulgaria in 2008, 15.2% in Romania and 27% in Latvia in 2007 – undermined price competitiveness. This development illustrates the importance of the quality improvements mentioned above and FDI-promoted technology transfers in maintaining CEEC competitiveness and in establishing the region's toehold in international trade.

Apart from its role in generating inflationary pressure and undermining competitiveness, CEEC overheating also resulted in deteriorating external accounts.

### Largely unsustainable external disequilibria

#### An explosion in foreign debt

Although it went hand-in-hand with European integration, thereby promoting convergence in many ways, the use of foreign capital to finance CEEC development also swelled foreign debt. Note that FDI, which does not generate debt, constituted only part of total capital inflows.

Foreign debt has gradually reached levels difficult to sustain, especially in Hungary (136% of GDP at end-2008), Latvia (almost 130%), Estonia (120%) and in Bulgaria (102%). As a proportion of exports, foreign debt has climbed to 117% in Poland and 155% in Romania, which are also relatively high.

#### Wider current-account deficits

A large share of investment, FDI included, has been funnelled into protected sectors such as property,

retailing and financial services. These logically reflect the property bubble, the boom in household consumption and the emergence of new financing circuits for the economy. More generally, vigorous domestic demand, and notably demand for capital goods, induced wider current-account deficits (cf. chart 7). This deterioration has been particularly marked in countries whose currencies were pegged to the euro. 2008 current-account deficits were 23% of GDP in Bulgaria, 13% in Latvia (22.5% in 2006 and 2007), 12.4% in Lithuania and 9.1% in Estonia (17% in 2006 and 2007).

**Current account deficit (% of GDP)**

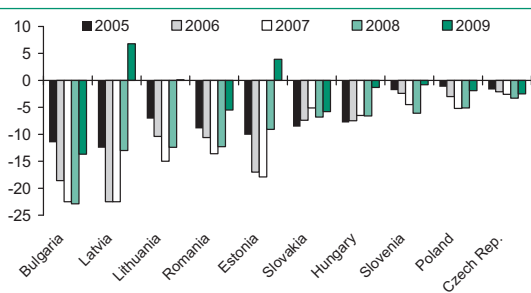


Chart 7

Source: European Commission

Independently of currency pegs, which have made the problem worse by preventing currency depreciation, all CEECs have to deal with structural current-account deficits arising from economic catch-up. The Czech Republic and Poland are no exception, with respective deficits of 3.1% and 5.5% of GDP in 2008, let alone Hungary (6.6%) and Romania (12.4%).

### **The risk of heightened exchange-rate volatility**

Such disequilibria have aggravated regional currency risk. Although floating currencies appreciated on trend as part of the catch-up process, worsening external deficits cast doubt on its continuation, which had become very sensitive to inflows of foreign capital. This met the conditions for an increase in these currencies' volatility and additional pressure on pegs, especially in Latvia. The macroeconomic consequences were by no means negligible. It seems that over the brief history of CEEC convergence, exchange rate volatility has been associated, all other things being equal, with slower growth and less FDI<sup>17</sup>.

Above all, the risk of exchange-rate volatility has increased in a context of massive private-sector debt in foreign currencies. In the years preceding the crisis, households and firms took on colossal debt in euros, sometimes in dollars and (notably in Hungary) in Swiss francs, with the aim of paying lower interest than that charged on local-currency loans. They failed to hedge their currency risk because they anticipated continuing appreciation, whether from the Hungarian forint, the Romanian leu or the Polish zloty, or the maintenance of the euro peg in the case of the Baltic currencies and the Bulgarian leva. By 2008, the share of credit denominated in foreign currencies had hit 34% in Poland, 57% in Romania and Bulgaria, 65% in Hungary and Lithuania and 85-90% in Estonia and Latvia. From that point on, household and business exposure to heightened currency risk weakened their solvency and in the final analysis increased the credit risk.

Even before the crisis broke, therefore, CEECs were rendered vulnerable by the disequilibria inherent in their growth model. The implication is that the convergence described in the first part of this article was probably unsustainable, at least at its pace of the past few years. But it took the crisis to reveal this point clearly.

## **A violent downturn with diverse national impacts**

### **Differentiating the crisis in CEECs**

The world crisis that broke in the autumn of 2008 affected CEECs in diverse ways, and depending on their ex ante fragility. The timing and magnitude of the downturn were by no means identical across the region.

#### **- Baltic States**

The Baltic States were the most obviously overheated CEECs leading up to the crisis and recession hit in 2008. The Estonian and Latvian economies started to contract even before Lehman Brothers collapsed, slipping into recession in the first and second quarters, respectively. Lithuania appeared to be in a stronger position but GDP started contracting anyway in the fourth quarter. The Baltic States are reporting the worst recession in the region over 2009 as a whole, with GDP possibly declining 14% in Estonia, 16% in Lithuania and 18% in Latvia.

#### **- Hungary and Romania**

Hungary's trend growth was interrupted in 2007, as was its convergence, following the introduction of budgetary austerity by the Gyurcsany government in the autumn of 2006. The crisis therefore hit the country

when growth was already depressed and amplified perceptions of the country's structural shortcomings, both in terms of its foreign debt and its public finances, which were proving hard to tame. Capital outflows unleashed a balance of payments crisis severe enough to prompt IMF intervention as early as November 2008, with the support of the EU, the EBRD and bilateral donors. The IMF intervened in similar fashion in Latvia in December 2008 and in Romania in the spring of 2009. The countries most affected by the crisis were therefore those that were already in the weakest positions in terms of their current-account and budget deficits. Hungarian GDP will have contracted by around 6.5% in 2009 after a poor 0.6% gain the year before, while Romania's will have dropped 7.5% after a 6.2% increase in 2008.

#### *- Bulgaria*

Bulgaria is in a rather unusual situation. Handicapped by its exchange-rate regime, it was running very large current-account deficits right into the crisis, but rightly concerned about maintaining its peg made strenuous efforts to deliver budget surpluses year after year. The country was hit hard by the crisis, with GDP falling 6% after a 6% increase in 2008, but without any real pressure on its peg and without the need for IMF help.

#### *- Czech Republic, Slovakia and Slovenia*

The absence of any marked rise in foreign debt or deterioration in public finances before the crisis did not prevent the Czech Republic, Slovakia and Slovenia sliding from respective growth rates of 2.5%, 6.4% and 3.5% in 2008 to a likely -4%, -5% and -7.5% in 2009. The scale of this reversal highlights the critical importance of trade flows for these small, very open economies. By the same token, the recovery in Western Europe will mean an early end to recession for these countries, following an adjustment period limited to a few months.

#### *- Poland*

Poland will be the only CEEC to report positive GDP growth in 2009, probably around 1.5% after 5% in 2008. The depth of the domestic market has been the key factor in this respect, as it cushioned the international demand shock in the first quarter while zloty depreciation against the euro bolstered exports. Above all, sound corporate finances, especially among SMEs – which are carrying very little debt – have enabled Poland to limit the deceleration in activity relative to other CEECs.

### ***The transmission mechanisms***

If we rise above national differences and attempt to characterise the crisis for CEECs, we might say that the virtual absence of exposure to subprime debt kept most of them out of trouble until the summer of 2008. They then suffered more than most other regions of the world, particularly because they had been overheating for several years preceding the crisis.

#### *- A shock to exports*

European integration meant that the demand shock affecting the euro zone was transmitted quickly to CEECs, for which it is the main trading partner. Slowing exports fed through to domestic demand, in proportions depending on the importance of the export sector, with contracting investment and rapid increases in the unemployment rate, amounting to around 2-3 points in the Czech Republic, Slovenia and Slovakia and 8-9 points in the Baltic States.

#### *- Unfavourable capital flows*

In addition to the effect of weaker international trade on growth, the crisis made matters worse by prompting outflows of portfolio investment and discouraging inward investment, thereby imperilling the sustainability of balance of payments deficits. These developments may be attributed to investors' sudden awareness of certain countries' weaknesses just as the crisis heightened risk aversion. They played a critical role in the Hungarian crisis of October 2008.

#### *- The private-sector foreign-currency debt problem*

Credit growth also started to slow, partly because of the liquidity constraints affecting parent banks. Although European banks took care to avoid a massive withdrawal from the region, as affirmed in the Vienna process initiated by the IMF and EBRD in April 2009, they have nonetheless been increasingly selective about extending new loans. Since the spring or summer of 2009, we have seen credit crunches in the Baltic States, Hungary and Romania, for example, which have complicated private sector refinancing and helped to weaken domestic demand. That said, we accept that it is difficult to identify the relative contributions of banks' restrictive credit policies on the one hand and pessimistic expectations on the part of households and firms on the other, which have led them to solicit the banks less than before. At the same time, the depreciation of floating currencies has created problems for borrowers that have to evaluate their debt in local currency terms as well as the burden of their commitments.

Poland apart, CEECs reacted to the international crisis with severe recessions, which proved more dramatic than those in Western Europe. Following years of rapid growth, 2009 therefore marks an interruption in the CEEC catch-up phenomenon. In these circumstances, it is legitimate to ask what the longer-term effects of the crisis could be.

## Slower convergence?

The crisis has had at least the merit of reducing the macroeconomic disequilibria associated with overheating. Current-account deficits have diminished, although they remain worrying in the Baltic States and Bulgaria, for example, and inflationary pressures have eased. Indeed, the danger now is that some CEECs slip into deflation. Several equity and property markets have corrected substantially. But the downturn has increased pressure on public finances and exchange rates, dimming prospects of euro zone membership. In the light of the problems all CEECs now face, doubts are surfacing on the dynamism of growth in the years ahead.

### Fiscal policies under strain

Despite the institutional and financial framework that applies to CEEC public finances, the political uncertainty plaguing many CEECs could contribute to lasting damage.

#### **Safeguards against excessive public spending**

In many CEECs, fiscal policies are constrained by international agreements. This is most obviously the case for Hungary, Latvia and Romania, which have made promises to the IMF-led institutions that came to their aid during the crisis, including the EU, EBRD and bilateral donors. And quite apart from the discipline imposed by the IMF, which although perhaps more flexible than in the past is by no means undemanding<sup>18</sup>, aspirations to euro zone membership and the implications for respecting convergence criteria are clearly also an important consideration. Poland has even imposed a supplementary constraint on itself, in the form of a legal obligation to limit government debt to 55% of GDP. Governments have to adopt appropriate budgetary austerity in response to any breach of this limit.

Such institutional rules limiting the scope for fiscal stimulus are backed with financial constraints, as the cost of new debt has increased since the crisis. Sovereign spreads widened considerably in early 2009 but are still well above their pre-crisis levels, by some 200-300 basis points for Bulgaria, Hungary and Romania and by around 120 basis points for Poland (cf. chart 8). The halo has clearly faded. Since the IMF's intervention in Hungary, the financial markets have returned to pricing CEECs in line with other emerging countries.

**5-year sovereign CDS spread, basis points**

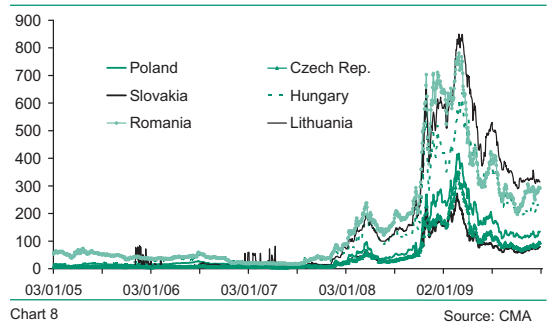


Chart 8

Source: CMA

#### **Worsening deficit and debt ratios**

Despite the constraints on their policy choices, CEEC government deficits have widened since the autumn of 2008 (cf. chart 9). It is not as though budgetary austerity has been entirely lacking: as we have seen, Hungary took that path more than two years ago, for example, and Latvia has scarcely been less ardent in this regard. The problem is the severity of the recession in 2009, which gave full play to automatic stabilisers. This was even the case in Poland, where a lax fiscal policy started to produce a rising deficit in 2008. It amounted to 3.6% of GDP that year, at a time when annual economic growth was still humming along at around 5%.

More generally, and with the exceptions of the Czech Republic, Slovakia and Bulgaria, which were running balanced budgets or surpluses before the crisis, CEECs typically opted for pro-cyclical policies that cruelly limited their leeway when the crisis struck. Most are now making strenuous efforts to limit the damage to their public finances, and the cost of doing so is of course much higher than it used to be. In the meantime, government deficits have widened to around 6% of GDP

in Poland and Slovakia, 7% in the Czech Republic and 8% in Romania.

### Public deficit (% of GDP)

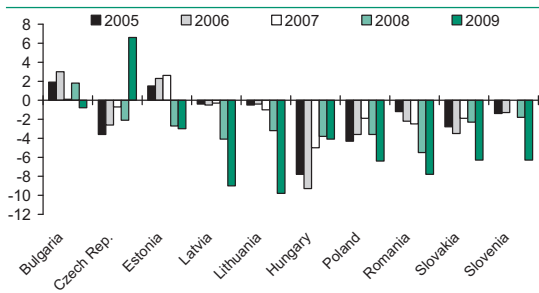


Chart 9

Source: European Commission

The upshot has been rapidly mounting government debt to GDP ratios (cf. chart 10). While the latter remain benign in countries where they were initially low, such as below 30% in the Czech Republic and Slovakia, they are more problematic when they reach 80% or so, as in Hungary, or get close to the 55% limit in Poland. On average, emerging countries are managing to stabilise or reduce their government debt ratios, but CEECs are closer to developed countries in this respect. We can only stress that these unhelpful trends are an automatic consequence of the recession, and may not be attributed to significant stimulus packages. In a sense, the requirements of nominal convergence are working against real convergence, which could have demanded ambitious fiscal stimulus.

### Public debt (% of GDP)

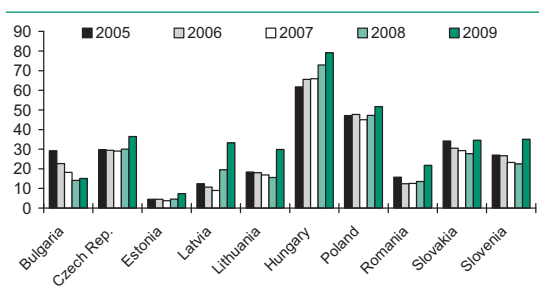


Chart 10

Source: European Commission

### A lack of political visibility

Medium-term visibility on the region's general budgetary orientation is being clouded by political risk, which is rendering coherent adjustment policies

uncertain. The past few months have seen the fall of several governments: Latvia's in February, then in Hungary and the Czech Republic, where in the absence of any agreement on an election date an interim administration is to run affairs until next spring. The coalition that was underpinning the Romanian government has also imploded, yet it urgently needs to vote a budget in response to IMF demands.

The Hungarian example shows that political instability need not necessarily induce budgetary slippage. But major elections are approaching in most of the above-mentioned countries (and Poland is set for presidential elections in 2010 and legislative elections in 2011) and the temptation to relax fiscal policy is bound to grow.

### Persistent exchange rate volatility

#### High volatility since the summer of 2008

By destabilising CEEC external finances, the crisis triggered marked depreciation among the region's floating currencies, completely confounding the firmly established expectations of appreciation that had buoyed foreign-currency household and company debt. Between the summer of 2008 and the winter of 2009, the zloty depreciated by over 50% against the euro, the forint by almost 40%, the Czech koruna by almost 30% and the Romanian leu by 25% (cf. chart 11). The private sector's solvency was eroded as a result, and in a context of contracting economic activity and pressure on liquidity, which prompted the increase in credit risk already mentioned.

### Exchange rate, basis 100=01/01/08

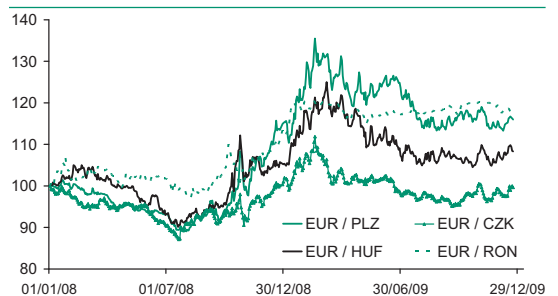


Chart 11

Source: Reuters

Regional currencies have been appreciating again since February or March 2009, however, reflecting healthier current-account balances. Over 2009 as a

whole, their parities against the euro are now largely unchanged. But uncertainty over trends in public finances and the possibilities that current-account deficits will yawn again once domestic demand regains a measure of strength suggest that exchange rates will remain volatile in the months ahead. Local banks appear to be committed to reducing their foreign-currency loans, but problems related to credit risk could persist in the years ahead. The status of CEEC debt in euros is all the more precarious for the fact that the likely timing of euro zone membership appears to be drifting.

### ***Euro zone entry timetables open to question***

Exchange rate instability could interfere with the aim of most CEECs to join the EMU in the near future. They first need to join the ERM 2 exchange rate system, which fixes central parities around which their currencies may not fluctuate by more than 15% either way for two years. The Slovakian example showed that it is possible to adjust the central parity upwards during the probation period, after which the country may adopt the euro so long as it meets the nominal convergence criteria set out in the Stability and Growth Pact.

The present exchange rate volatility now makes defining a central parity a delicate exercise. On the other hand, the flexibility conferred by floating exchange rates and particularly the possibility of depreciation to boost exports are proving useful during these troubled times. In any case, the crisis may have lowered inflation across the region but its impact on public finances will probably block euro entry for several years yet.

The three Baltic States are already in the ERM 2 but only Estonia seems to have any chance of meeting the Maastricht criteria in the reasonably near future, and even then amid considerable uncertainty on budget projections. Moreover, Estonia, the Czech Republic and Bulgaria are the only CEECs to have escaped the European Commission's excessive deficit procedure. The state of public finances rules out imminent euro adoption for the other CEECs, and changes to the Maastricht criteria appear unlikely as they would require unanimous approval from all Member States.

Poland was extremely proactive until April 2009. The government sought euro zone entry in 2012, but was forced to reconsider this objective and abandoned it explicitly in July. Given that the excessive deficit procedure is now forcing the country to restore its public finances by 2012, euro zone entry could come in 2014

assuming the other criteria are met. Hungary has to reduce its deficit to under 3% of GDP by 2011, but its government debt will remain an obstacle for a good while yet. Bulgaria has a sound budget balance, but ERM 2 entry would require the removal of macroeconomic disequilibria such as a current-account deficit amounting to about 13% of GDP in 2009 and probably 10% in 2010. In the Czech Republic, the recession has meant a much wider budget deficit, as we have seen, and that could last until 2013. In any case, the political consensus in favour of the country's rapid euro zone entry seems to be lacking.

All in all, worsening public finances and delays to EMU membership could affect CEEC growth in the next few years.

### ***More modest growth prospects***

#### ***Towards a sluggish recovery***

The magnitude of the recession in almost all CEECs in 2009 matches the scale of adjustments required after years of overheating. The recovery in Western Europe will stimulate their exports over the next few quarters, but with the possible exception of smaller, very open economies like the Czech Republic and Slovakia (and for the latter, assuming a buoyant auto sector), the contribution of foreign trade will not be large enough to restore the sorts of growth rates that prevailed before the crisis.

In the absence of vigorous domestic demand, the average growth rate in the CEECs should fall short of 2% in 2010. The Baltic States will probably report further contractions in GDP, perhaps as great as 4%, and the same could go for Hungary and Bulgaria, where room for manoeuvre has been particularly limited by initial disequilibria (Hungary) and peg constraints (Bulgaria).

#### ***The potential growth challenge***

Beyond the near horizon, the crisis may have reduced potential growth rates. Failure to adopt the euro and exchange rate volatility could worry investors, even though it seems certain that all CEECs will adopt the euro at some point. Investors have already altered their approach to CEECs, particularly once Hungary had called in the IMF, and note has been taken of the importance of FDI in technology transfer and updating the productive system. As public finances are under strain, foreign capital will remain vital in infrastructure development and R&D.

Qualitative improvements are rendered all the more pressing for the fact that CEEC competitiveness problems will recur in the years ahead. Demographics already present a challenge<sup>19</sup>. Between 2004 and 2030, the average age of the population will increase by 5-7 years, from 37.5 to 44.5 in Poland, from 41 to 47.5 in Bulgaria and from 40 to 45 in Hungary, for example. By comparison, it will increase from 39 to 43 in France over the same period. This demographic ageing will test rigid labour markets, as it will make the employment problem of elderly workers more acute, given their increasing share in the total population. The ongoing changes in the structure of the population by age groups will also lead to an increase in health and pension spending, thus putting additional pressure on the public finances and possibly resulting in a rise in tax levy and labour cost.

There remains little scope for institutional improvement, except perhaps in respect of the legal system. This certainly applies to Romania and Bulgaria, where problems of corruption were emphasised by the European Commission in the summer of 2008. Generally speaking, these two countries – the most recent EU members – offer the most potential for structural progress.

The region could also struggle from competition from the ex-Yugoslavian countries, once their political situation stabilises and they seek EU entry, for they will eventually benefit in turn from structural funds and investor interest in high returns on capital and cheap labour. And beyond Europe, CEECs will have to take account of growing competition from Asia and countries like Morocco, which is already evident in the textile industry and perhaps one day in the auto sector as well.

CEEC integration in Europe, whether in terms of trade, finance, institutions or politics, is an historical inevitability and that will not change in the years ahead. The consequences of this integration will continue to stimulate debate, however, with the international division of productive processes prompting rapid CEEC industrialisation and specialisation in some sectors that will become vulnerable to competition from outside Europe. The crisis could well have reduced long-term potential growth, making it all the more important that CEECs improve their infrastructures and raise the quality of their output.

21 December 2009  
*alexandre.vincent@bnpparibas.com*



## NOTES

<sup>1</sup> Apart from Cyprus and Malta, which we do not consider here, Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary and Slovenia joined the EU on 1 May 2004. Romania and Bulgaria joined them on 1 January 2007. Slovenia and Slovakia adopted the euro on 1 January 2007 and 1 January 2009, respectively.

<sup>2</sup> The purchasing power parity is an exchange rate that facilitates comparisons of living standards between countries. It expresses the ratio between the quantities of currency needed to procure the same basket of goods and services in different countries.

<sup>3</sup> The employment rate is the ratio between the number of employed and the total labour force (i.e. the population of working age in employment or seeking employment).

<sup>4</sup> The participation rate is the ratio between the labour force (employed or seeking employment) and the population of working age.

<sup>5</sup> cf. F. Ferdinand Heinz and M. Ward-Warmedinger, *Cross-border labour mobility within an enlarged EU*, European Central Bank, Occasional Paper Series n° 52, 2006.

<sup>6</sup> cf. D. Ritzberger-Grünwald and J. Wörz, "Macroconvergence in CESEE", in Oesterreichische Nationalbank, *1989 – 2009 Twenty years of East-West integration : Hopes and achievements*, Focus on European economic integration, Special issue 2009.

<sup>7</sup> cf. M. Timmer, M. O'Mahony and B. van Ark, *The EU KLEMS growth and productivity accounts : an overview*, University of Groningen and University of Birmingham, [www.euklems.net](http://www.euklems.net), 2008.

<sup>8</sup> cf. U. Dulleck, N. Foster, R. Stehrer and J. Wörz, "Dimensions of quality upgrading : evidence from CEECs", in *Economics of Transition* 13(1), 2005.

<sup>9</sup> The sum of exports and imports as a share of GDP.

<sup>10</sup> cf. F. Faure, "L'intégration des pays d'Europe centrale dans l'UEM: le plus tôt serait-il le mieux ?", in BNP Paribas, *Conjoncture*, September 2004.

<sup>11</sup> cf. European Commission, *Five years of an enlarged EU, economic achievements and challenges*, European Economy 1, 2009.

<sup>12</sup> cf. M. Cihak and W. Fonteyne, *Five years after : European Union membership and macro-financial stability in the new Member States*, International Monetary Fund, IMF working paper WP/09/68, 2009.

<sup>13</sup> The EBRD's transition indicator is based on progress in privatisation, corporate restructuring, price liberalisation, the trade and exchange rate system, competition policy, banking sector reform, the liberalisation of interest rates, financial markets and non-bank financial institutions and structural forms in general.

<sup>14</sup> The government deficit must be smaller than 3% of GDP, government debt must be below 60% of GDP, the inflation rate should not be more than 1.5 points higher than the average inflation rate for the three EU Member States with the lowest inflation rates the preceding year, and long-term interest rates should not be more than 2 points higher than in these same three EU Member States over the preceding year. Moreover, the exchange rate against the euro should have remained within a range of plus or minus 15% relative to its central parity throughout the two years of ERM 2 membership.

<sup>15</sup> Greenfield investments involve the creation of productive facilities from scratch.

<sup>16</sup> cf. K. E. O. Alho, V. Kaitila and M. Widgren, *Offshoring, relocation and the speed of convergence in the enlarged European Union*, Centre for Economic Policy Research, Discussion paper series n° 7000, 2008.

<sup>17</sup> cf. O. Arratibel, D. Furceri and R. Martin, *Real convergence in central and eastern European EU Member States: Which role for exchange rate volatility?*, European Central Bank, Working Paper Series n° 929, 2008.

<sup>18</sup> cf. V. Gligorov, "The new IMF approach and the EU", in V. Gligorov, J. Pöschl, S. Richter et al., *Where have all the shooting stars gone?*, wiiw, Current analyses and forecasts, 4, 2009.

<sup>19</sup> cf. T. Tivig, K. Frosch and S. Kühntopf, *Mapping regional demographic change and regional demographic location risk in Europe*, Rostocker Zentrum zur Erforschung des Demografischen Wandels, Series on Sustainability and CSR, vol. 2, 2008.

## Economic Research Department

<b>Philippe d'ARVISENET</b> Chief Economist – OECD countries	01.43.16.95.58	<a href="mailto:philippe.darvisenet@bnpparibas.com">philippe.darvisenet@bnpparibas.com</a>
<b>Head of OECD countries</b>		
<b>Structural issues, Single European Financial Market</b>		
<b>Eric VERGNAUD</b>	01.42.98.49.80	<a href="mailto:eric.vergnaud@bnpparibas.com">eric.vergnaud@bnpparibas.com</a>
<b>Country economics</b>		
Caroline NEWHOUSE-COHEN	01.43.16.95.50	<a href="mailto:caroline.newhouse-cohen@bnpparibas.com">caroline.newhouse-cohen@bnpparibas.com</a>
<b>UNITED STATES, CANADA</b>		
Jean-Marc LUCAS	01.43.16.95.53	<a href="mailto:jean-marc.lucas@bnpparibas.com">jean-marc.lucas@bnpparibas.com</a>
<b>JAPAN, AUSTRALIA, NEW ZEALAND, BENELUX, PENSIONS, LONG TERM FORECASTS</b>		
Raymond VAN DER PUTTEN	01.42.98.53.99	<a href="mailto:raymond.vanderputten@bnpparibas.com">raymond.vanderputten@bnpparibas.com</a>
<b>EURO ZONE, ITALY, EUROZONE LABOUR MARKET</b>		
Clemente De LUCIA	01.42.98.27.62	<a href="mailto:clemente.delucia@bnpparibas.com">clemente.delucia@bnpparibas.com</a>
<b>FRANCE, EURO ZONE PUBLIC FINANCES</b>		
Frédérique CERISIER	01.43.16.95.52	<a href="mailto:frederique.cerisier@bnpparibas.com">frederique.cerisier@bnpparibas.com</a>
<b>GERMANY, AUSTRIA, SWITZERLAND, EU ENLARGEMENT</b>		
Catherine STEPHAN	01.55.77.71.89	<a href="mailto:catherine.stephan@bnpparibas.com">catherine.stephan@bnpparibas.com</a>
<b>SPAIN, PORTUGAL, GREECE</b>		
Philippe SABUCO	01.43.16.95.54	<a href="mailto:philippe.sabuco@bnpparibas.com">philippe.sabuco@bnpparibas.com</a>
<b>UNITED KINGDOM, NORDIC COUNTRIES</b>		
Caroline NEWHOUSE-COHEN	01.43.16.95.50	<a href="mailto:caroline.newhouse-cohen@bnpparibas.com">caroline.newhouse-cohen@bnpparibas.com</a>
<b>BANKING ECONOMICS</b>		
<b>Laurent QUIGNON</b> Head	01.42.98.56.54	<a href="mailto:laurent.quignon@bnpparibas.com">laurent.quignon@bnpparibas.com</a>
Céline CHOLET	01.57.43.02.91	<a href="mailto:celine.choulet@bnpparibas.com">celine.choulet@bnpparibas.com</a>
Philippe SABUCO	01.43.16.95.54	<a href="mailto:philippe.sabuco@bnpparibas.com">philippe.sabuco@bnpparibas.com</a>
<b>COUNTRY RISKS</b>		
<b>Guy LONGUEVILLE</b> Head	01.43.16.95.40	<a href="mailto:guy.longueville@bnpparibas.com">guy.longueville@bnpparibas.com</a>
<b>François FAURE</b> Capital flows to emerging markets, Turkey	01 42 98 79 82	<a href="mailto:francois.faure@bnpparibas.com">francois.faure@bnpparibas.com</a>
<b>ASIA</b>		
Delphine CAVALIER	01.43.16.95.41	<a href="mailto:delphine.cavalier@bnpparibas.com">delphine.cavalier@bnpparibas.com</a>
Christine PELTIER	01.42.98.56.27	<a href="mailto:christine.peltier@bnpparibas.com">christine.peltier@bnpparibas.com</a>
<b>LATIN AMERICA</b>		
Sylvain BELLEFONTAINE	01.42.98.26.77	<a href="mailto:sylvain.bellefontaine@bnpparibas.com">sylvain.bellefontaine@bnpparibas.com</a>
Valérie PERRACINO	01 42 98 74 26	<a href="mailto:valerie.perracino@bnpparibas.com">valerie.perracino@bnpparibas.com</a>
<b>AFRICA</b>		
Stéphane ALBY	01.42.98.02.04	<a href="mailto:stephane.alby@bnpparibas.com">stephane.alby@bnpparibas.com</a>
Jean-Loïc GUIEZE	01.42.98.43.86	<a href="mailto:jeanloic.guieze@bnpparibas.com">jeanloic.guieze@bnpparibas.com</a>
<b>EASTERN EUROPE</b>		
Central Europe, Baltic countries, Balkan countries		
Alexandre VINCENT	01.43.16.95.44	<a href="mailto:alexandre.vincent@bnpparibas.com">alexandre.vincent@bnpparibas.com</a>
<b>RUSSIA, FORMER SOVIET REPUBLICS</b>		
Anna DORBEC	01.42.98.48.45	<a href="mailto:anna.dorbec@bnpparibas.com">anna.dorbec@bnpparibas.com</a>
<b>MIDDLE EAST – SCORING</b>		
Pascal DEVAUX	01.43.16.95.51	<a href="mailto:pascal.devaux@bnpparibas.com">pascal.devaux@bnpparibas.com</a>



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Registered Office: 16 boulevard des Italiens – 75009 PARIS

Tél : +33 (0) 1.42.98.12.34 – Internet : [www.bnpparibas.com](http://www.bnpparibas.com)

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