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EUROPEAN MARKET COMMENTARY

ALL QUIET ON THE ***EASTERN*** FRONT?

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All Quiet on the *Eastern* Front?

Emerging Europe is booming. Even compared to other emerging markets, economic growth has been rapid, with real GDP growth averaging over 5.0% across the region since 2000, with expectations of 6.0% growth for 2007. Real estate prices have been rising and equity markets have soared over the same period, with bourses in Poland, Hungary, and the Czech Republic earning average annual compound returns (AACRs) of 15.5%, 19.6%, and 36.4%, respectively, while "frontier" markets such as Lithuania, Slovakia, and Romania have seen AACRs in the range of 15% to 40% (Tables B and C).

A wave of economic liberalization and development has swept the region, as the bulk of Central and Eastern European countries have sought, and won, "accession" into the European Union (EU) and are reaping the rewards of acceptance into the broader European community. In order to integrate and "converge" with Western Europe, a host of economic reforms have been implemented, resulting in the opening of markets, falling levels of inflation, lower interest rates, and rising standards of living.

While the region has benefited tremendously from economic integration, are emerging European economies beginning to overheat? Recent growth has increasingly been driven by strong domestic demand, which in turn has been fueled by large foreign fund inflows and booming credit growth. Unlike the majority of emerging markets in Asia and Latin America, emerging European economies are running large current account deficits and have low levels of foreign currency reserves. Indeed, emerging Europe is exhibiting some of the classic traits of emerging markets booms that in the past have led to financial crises: large current account deficits financed by foreign inflows, growing levels of external currency debt, inflexible exchange rates, and large government deficits[1] (Table E).

Given the relative calm in global financial markets amid a period of policy tightening by global central banks (which in the past has coincided with emerging markets panics) should investors be concerned about a financial crisis in emerging Europe? Or has the EU accession/convergence story reduced the vulnerability of these economies to external shocks and therefore reduced the investment risks associated with these markets?

From Bratislava to Zagreb

Any discussion of "emerging Europe" must begin with a clarification of terms. This grouping sometimes encompasses the full swath of the Eurasian land mass, spreading northeast through Poland to the Baltics and down through Hungary and the Balkans to Turkey, with Russia and its former Soviet

[1] Emerging markets investors (both neophyte and veteran) should not forget the external debt/currency crisis suffered by Mexico in 1994, the Asia Crisis of 1997, the Russian financial crisis in 1998, and the Argentine Peso Crisis in 1999.

states of Ukraine, Belarus, the Caucasuses, and Central Asian countries (Georgia, Kazakhstan, etc.) included as well.

For our purposes, we are concerned with those economies most linked with "Western Europe" as recent members of the EU, the so called Central and Eastern Europe 10 (CEE 10) countries.[2] We have grouped these countries into Central Europe (Poland, the Czech Republic, Hungary, Slovakia, and Slovenia), the Baltics (Estonia, Lithuania, and Latvia), and Southeastern Europe (Romania and Bulgaria) (Table A).[3]

Linkages Between "Old" and "New" Europe

The integration of "old" Europe and "new" Europe can be seen in part by trade flows and financial linkages. In terms of trade, developed Europe (measured here as the 12 Eurozone members[4]) accounts for 47% of total CEE 10 exports and 51% of imports. The region is a large export market for developed Europe, accounting for 14% of 2006 exports (Table F). Closer analysis shows Germany is the main source of these linkages. Germany alone accounts for 45% of all Eurozone exports to the CEE 10 and for 47% of Eurozone imports from the region. Overall, the CEE 10 accounts for 10% of German exports, a larger share than the United States (9%), United Kingdom (7%), Japan (2%), and China (3%).

In terms of financial linkages, developed Europe is overwhelmingly the primary source for foreign fund flows to emerging Europe, not only in terms of foreign direct investment (FDI), but in portfolio and "other" fund flows. Data from the Bank for International Settlements (BIS) reveals that of the US$780.9 billion in foreign bank claims in emerging Europe, a staggering 92.8% were held by banks in developed Europe, with Germany alone accounting for 16.5% of the European share. Swedish banks are very active in the Baltic economies as well, supplying the majority of bank loans. Another sign of deepening financial integration is that a majority of the "domestic" banks in emerging Europe are in effect, foreign-owned and relatively well capitalized. According to the European Commission, in most parts of the region more than two-thirds of total banks are effectively foreign owned.

[2] In 2004 Poland, the Czech Republic, Hungary, Estonia, Latvia, Lithuania, Slovenia, Slovakia (as well as Malta and Cyprus) were admitted to the EU, while Bulgaria and Romania joined in 2007. This expansion has brought the EU to 27 member states.

[3] While Russia and some of her former satellites are also growing briskly and attracting the attention of foreign investors, these countries remain far less integrated into the broader global financial system (except for Russia, which is a growing force in international markets). Furthermore, the internal dynamic for these economies is built more upon a commodity/energy boom, rather than a domestic credit boom. Ukraine is a notable exception, but is far from joining the EU.

[4] Admission into the EU does not grant entry into the European Monetary Union (EMU), which is composed of those countries that share the euro as a common currency. The Eurozone12 refers to Germany, France, Italy, Spain, Portugal, the Netherlands, Belgium, Luxembourg, Austria, Finland, Ireland, and Greece. Currently the Eurozone encompasses 13 members, with the addition of Slovenia in January 2007. For our purposes we have kept Slovenia among the CEE 10.

Boiling Over or Just Simmering?

The boom-time conditions seen throughout much of emerging Europe (Poland being a large exception recently) are in many ways a natural reaction to deepening financial and economic integration and increased "off shoring" of manufacturing and other jobs from high-cost developed markets to the low-wage "East." Economic polices aimed at EU convergence have seen a decline in real short-term interest rates from an average of over 6% in 1999 to effectively negative real rates today, while inflation has fallen from double-digit growth in the late 1990s to roughly 4% today. As a result of sounder macroeconomic conditions, credit growth in the region has soared, growing between 30% and 50% annually over the past few years in some countries. While eye-catching, such strong credit growth stems from an extremely low base. Private sector credit-to-GDP-ratios remain in the 30% to 70% range, well below the 100%+ levels seen in the Eurozone and other developed economies. Furthermore, given the low level of aggregate savings in these economies (especially relative to ten years ago) foreign fund flows are necessary to finance capital investment and achieve sustainable economic growth.

Yet, increasingly the nature of fund flows have shifted from FDI (which helps build infrastructure and productive capacity) toward the household sector to finance home loans and to a lesser extent consumer finance loans. Data from the International Monetary Fund (IMF) show that while FDI has accounted for the bulk of fund flows into emerging Europe since 1990, private debt and portfolio flows have outpaced FDI by a wide margin since 2003, accounting for 58% of all inflows in 2005 (Table E).

Most troubling is the rising share of foreign-denominated debt among the corporate and household sector. To some extent, this is also a rational response. Hopes of EU convergence and eventual adoption of the euro have resulted in households taking on increasing amounts of euro-denominated debt to finance home purchases and consumption, taking advantage of lower interest rates and more readily available credit, with the assumption that by repayment time, incomes will be earned in euros. So long as current exchange rates remain loosely pegged to the euro, rising foreign exchange exposure is manageable.[5] However, if expectations about the timetable for euro adoption turn out to be too optimistic, and are forced to change rapidly, such foreign currency exposure will create significant risk, especially if financial markets turn against these currencies.

Disturbingly, this is precisely what is occurring. By December 2006, every single CEE 10 member announced postponements of their target dates for entry into the EMU, save Slovenia, which successfully adopted the euro in January 2007. The delays in adopting the euro stem from either failure to meet economic requirements, usually due to large government deficits and/or high levels of inflation resulting from booming domestic demand, or from political resistance to continuing reforms and budding "euro-skepticism." Smaller countries, notably the Baltics, suffer from the former, while larger countries (such as Poland, the Czech Republic, and Hungary) suffer from the latter. Poland, the largest country in

[5] The Baltic countries and Bulgaria have adopted de facto currency pegs to the euro, while most other CEE economies allow their currencies to float, with the goal of maintaining some level of parity with the euro.

the region (and arguably the most economically sound) has refused to set a date for joining the euro, while Hungary and the Czech Republic have abandoned their 2009-10 targets. Smaller countries seem to be hoping for adoption by 2009, while brand-new members, Romania and Bulgaria, are shooting for adoption dates even further out.

The Turkish Connection

Regardless of one's view on whether or not Turkey is culturally a part of Europe and should be admitted into the EU, its macroeconomic dynamics and precarious balance of payments situation closely resembles that of certain emerging "European" economies. Turkey's dynamic has been one of lower inflation and interest rates leading to a credit boom, also supported by foreign inflows. While its status as an EU candidate continues to be mired in ugly politics, for a while it seemed to benefit from a perceived "euro convergence" trade among global investors. Turkey is just as vulnerable to a crisis as is emerging Europe, (currencies and markets in both Hungary and Turkey were shaken by last June's emerging markets sell-off) and a crisis on the Bosporus may spark trouble for its CEE neighbors.

So is it 1997 All Over Again?

Not quite. While the region increasingly shows an unhealthy reliance on foreign fund flows and growing external currency indebtedness, these flows (so far) are not of the extreme short-term speculative variety that ultimately led to the collapse of the Thai *baht* in the summer of 1997. According to the BIS, short-term bank loans account for only 39% of foreign claims. Furthermore, up until recently, FDI has been the dominate source of inflows. While "hot money" can turn on a dime, it is much harder to uproot factories overnight. Also, unlike Asia in 1997, the majority of banks are partly foreign owned, which in theory should add stability to the financial system.

Yet the obvious macro imbalances and dependence on foreign inflows combined with growing uncertainty over the time table for adoption of the euro makes the region especially vulnerable to any rise in risk aversion or slowdown in global or European growth. The real "shock" from the Asia Crisis was not that Thailand was forced to devalue the *baht*, but that such an idiosyncratic event was amplified across the region and caused capital flight from economies with less troubling fundamentals (e.g., Korea, Indonesia). In other words, while some observers anticipated the events in Thailand (George Soros comes to mind) few foresaw the contagion that would strike the region and reverberate across the global financial system.

From this perspective, Europe may be more exposed to a "financial accident" than most realize, especially given the increasing financial linkages between the "old" and "new" EU members. Eric Chaney, Morgan Stanley's chief European economist, recently commented that "the weakness of the EU's financial system is its fragmentation and, to some extent, lack of depth and transparency. Since the system has never been tested since monetary union took place in 1999, it might have hidden fault lines."

Indeed, conditions in emerging Europe aside, there are growing real estate bubbles in some of the large developed economies (France, Spain, and Scandinavia), on which both the European Central Bank and OECD have commented. The proliferation of over-the-counter derivatives and leveraged credit structures employed by aggressive European buyout firms and hedge funds amid nonexistent levels of risk premia in European credit markets is also a source of concern.[6] With most global investors focusing on the U.S. economy and its own credit excesses, investors may be overly complacent regarding the possible macro-risks facing Europe. Trouble often strikes from where it is least expected, and as Morgan Stanley's Chaney also postulates, the real surprise to global markets could be a large-scale financial accident originating in Europe, not the United States.

Whether or not turmoil in emerging Europe is the trigger for such an "accident" remains to be seen. While countries such as Poland and the Czech Republic seem insulated given their less-stretched economic fundamentals, the risk of contagion in the region resulting from financial distress in one economy cannot be ignored. The IMF, in its September 2006 *World Economic Outlook* phrases it as such; "While the extent of risks varies considerably across countries…reducing vulnerabilities is a policy priority, not least in the view of possible regional spillovers, given that the countries share similar vulnerabilities and common creditors." A recent European Commission paper[7] noted that "the high degree and interwoven pattern of foreign ownership raises concerns about cross border financial contagion… foreign bank penetration and the sector's ramifications across the region mean that shocks which generate financial market turbulence in one country can easily spill over to other countries through these linkages."

The precarious situation in Hungary makes it a prime candidate for a crisis, although the Hungarian *forint* has stabilized after falling for most of 2006 and has strengthened even amid open protests in the streets of Budapest over government misdeeds and the need for harsh reforms. While Hungary's macroeconomic problems may be the most high profile (alongside those of Turkey), there are red flags popping up elsewhere in the region; Standard & Poor's recently downgraded its outlook for Latvia's sovereign debt from neutral to negative.

So how exposed are global investors? Given the limited development of emerging European stock markets, investors have only marginal direct exposure from a benchmark standpoint. Both the MSCI and S&P/IFC Emerging Markets indices only include the larger markets of Poland, Hungary, the Czech Republic, and Turkey in their investible indices. These markets combined account for only 5% of the MSCI Emerging Markets Index, and only 1.3% of a Pan-European equity allocation, such as the MSCI AC Europe Index. The extent to which active managers over/underweight the region or take out-of-benchmark bets on "frontier markets" within a portfolio will of course vary. The real exposure, in our opinion, is the risk embedded in the large financial sector weighting of developed Europe.[8] Financials account for 30% of the MSCI Europe ex U.K. Index, and given the direct exposures of European banks to

[6] Please see our October 2006 European Market Commentary: *Is European Credit an Accident Waiting to Happen?*
[7] "What Do the Sources and Uses of Funds Tell Us About Credit Growth in Central and Eastern Europe?" European Commission Occasional Papers, No. 26, November 2006.
[8] Please see our September 2006 European Market Commentary: *European Equity Leadership Still Concentrated.*

emerging Europe, a rash of defaults has the potential to hit earnings and sentiment. So while the impact of *economic* contagion between emerging and developed Europe is debatable, a serious currency/financial crisis in emerging Europe will most certainly have some effect on the bottom lines of European banks (consider HSCB's travails with the U.S. sub-prime mortgage market), and the extent to which a financial crisis impacts economic growth, developed European equity markets may have to re-price an outlook for sectors with export exposure to emerging Europe (e.g., industrials, consumer goods).

Dark Clouds on a Bright Horizon

The growth story in emerging Europe is of a long-term structural nature. The extent to which governments effectively enact policies to reduce deficits, slow credit growth, and hasten adoption of the euro, the risks of a financial crisis diminish. However, should "reform fatigue" set in and policymakers, lulled into complacency by benign global conditions, tolerate rising foreign inflows and high levels of foreign currency debt, emerging Europe may soon be faced with an "Asia-style" financial fallout. While such an outcome would deal a painful blow, it would certainly not reverse the progress made over the past ten years. Indeed, such a shake-out is often the catalyst needed to re-forge commitment to sustainable, investment-led economic growth, which was certainly the case in Asia post 1997-98. Should the region reasonably weather any upcoming storm, and policymakers see the error of their ways and learn the lessons of Asia and Latin America, the prospects for emerging Europe will be bright indeed. Given the small size and relatively underdeveloped nature of emerging European equity markets, private equity investments may be a better way to gain access to the region. Indeed, a financial rout may offer increased opportunities for experienced managers with strong local presence and knowledge.[9]

[9] For further discussion of private equity investing in emerging Europe, please see "Central and Eastern Europe—From Submergence to Convergence?" in our Winter 2005-06 of *Capital Call*.

Table A

THE CENTRAL AND EASTERN EUROPE 10 COUNTRIES

Source: www.nato.int.

Table B

CENTRAL AND EASTERN EUROPE 10 MARKET PROFILES

Country	EU Accession	Market Capitalization (US$ Millions)	Number of Companies	Total Returns (%)							5-Year
				2000	2001	2002	2003	2004	2005	2006	AACR (%)
Czech Republic	2004	18,665.0	7	1.6	-2.0	44.2	66.2	87.3	46.2	34.7	54.6
Hungary	2004	23,594.0	4	-26.8	-9.2	30.7	32.3	92.5	18.5	33.7	39.4
Poland	2004	42,182.2	22	-4.0	-27.4	1.3	35.5	61.5	25.0	41.9	31.5
Frontier Markets											
Bulgaria	2007	1,383.7	12	-34.7	-6.3	62.2	193.2	86.2	17.7	31.4	68.8
Estonia	2004	1,483.4	8	7.9	-0.4	73.3	46.2	91.5	27.3	34.8	52.8
Latvia	2004	208.2	9	45.8	64.1	-11.8	64.9	49.9	33.3	2.1	24.3
Lithuania	2004	1,237.5	16	6.5	-23.0	25.7	117.9	60.1	10.2	13.0	40.4
Romania	2007	5,700.0	13	-24.3	-20.2	96.7	42.5	99.4	61.1	56.2	69.7
Slovakia	2004	346.7	8	4.3	39.7	30.0	57.5	150.5	16.9	33.3	51.6
Slovenia	2004	6,568.3	10	-8.2	5.1	78.3	42.1	45.1	-5.4	76.7	43.8

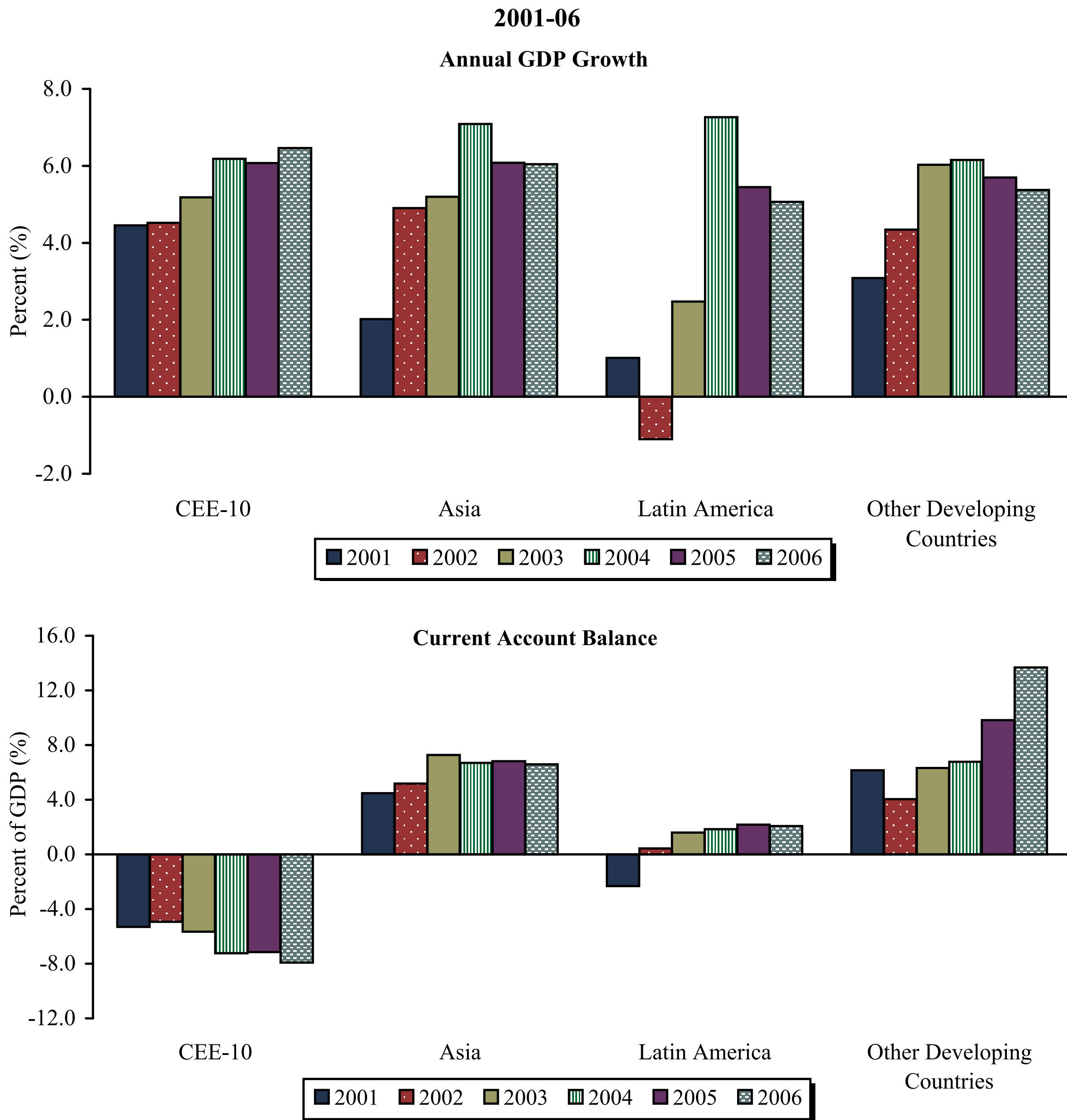
Sources: The Bloomberg, Morgan Stanley Capital International, Standard & Poor's Emerging Markets Database, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Market capitalizations and companies are as of January 31, 2007, and based on MSCI and S&P/IFC Frontier indices. MSCI data are used for Czech Republic, Hungary, and Poland while S&P/IFCG data are used for the remaining countries.

Table C

EMERGING MARKETS GDP GROWTH AND CURRENT ACCOUNT BALANCES

2001-06



Sources: International Monetary Fund and World Economic Outlook Database.

Notes: Regional figures based on an unweighted average of country data. CEE-10 is made up of Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. Asia is made up of Hong Kong, Korea, Singapore, Taiwan, China, India, Indonesia, Malaysia, the Philippines, and Thailand. Latin America is made up of Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. Other developing countries is made up of the Middle East, South Africa, Russia, and Turkey.

Table D

MACROECONOMIC PROFILES

2004-05

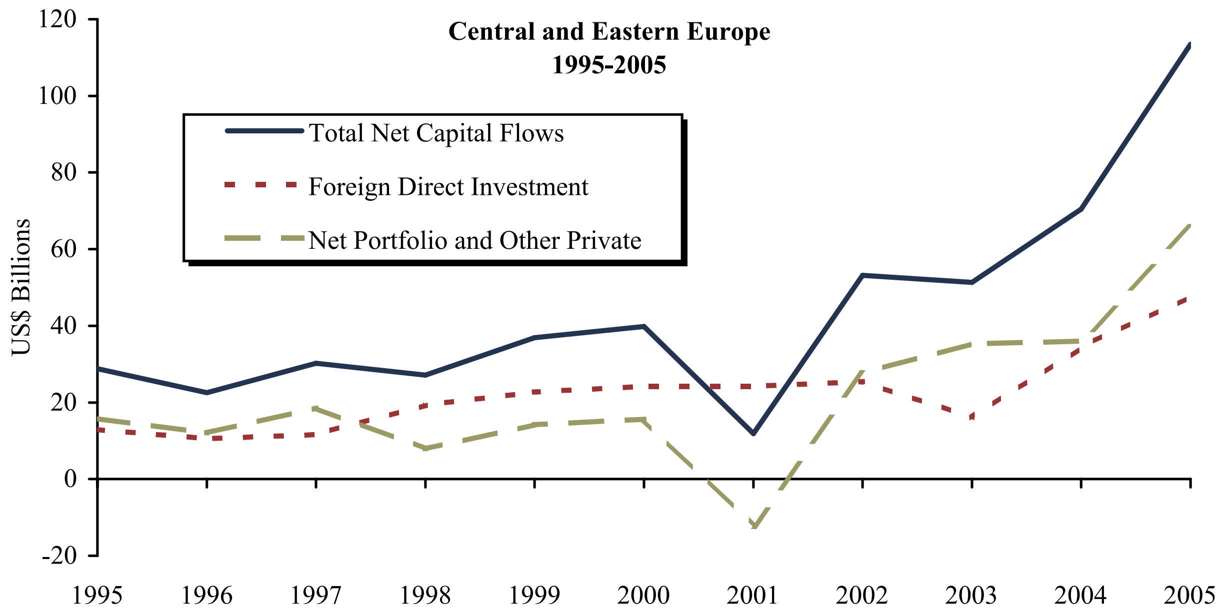
Country	Real GDP Growth (%)	Domestic Demand Growth (%)	Credit Growth (%)	Inflation (%)	Government Budget Balance as a % of GDP	Current Account Deficit as a % of GDP	External Debt as a % of GDP
Bulgaria	5.6	10.6	33.6	5.2	2.0	-8.8	69.0
Czech Republic	5.1	2.6	0.9	2.5	-2.7	-4.0	39.3
Estonia	8.8	8.0	30.6	4.3	1.7	-11.3	86.3
Hungary	4.7	2.6	17.5	4.4	-7.1	-8.0	75.1
Latvia	9.4	11.4	51.3	7.2	-1.1	-12.7	96.8
Lithuania	7.4	12.2	43.5	3.0	-1.9	-7.3	47.1
Poland	4.4	4.2	5.9	2.5	-4.9	-2.8	47.1
Romania	6.3	11.0	34.6	8.9	-0.9	-8.6	34.0
Slovakia	5.8	7.2	9.5	4.8	-3.7	-6.1	56.8
Slovenia	4.0	3.2	22.1	2.7	-1.2	-2.4	65.5
Turkey	8.2	11.6	57.4	8.4	-7.2	-5.8	37.0

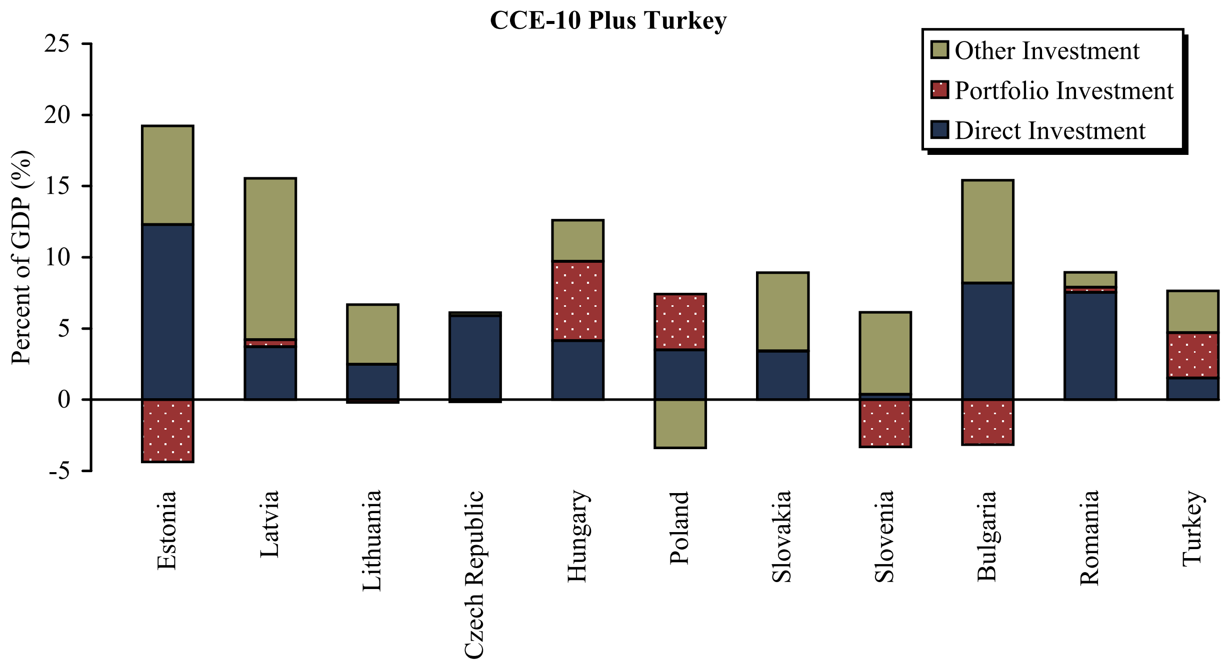
Sources: Economist Intelligence Unit, European Bank for Reconstruction and Development, International Monetary Fund, Thomson Datastream, and World Economic Outlook Database.

Notes: Data for 2005 are estimated. All data are averaged for 2004 and 2005.

Table E

NET PRIVATE CAPITAL INFLOWS



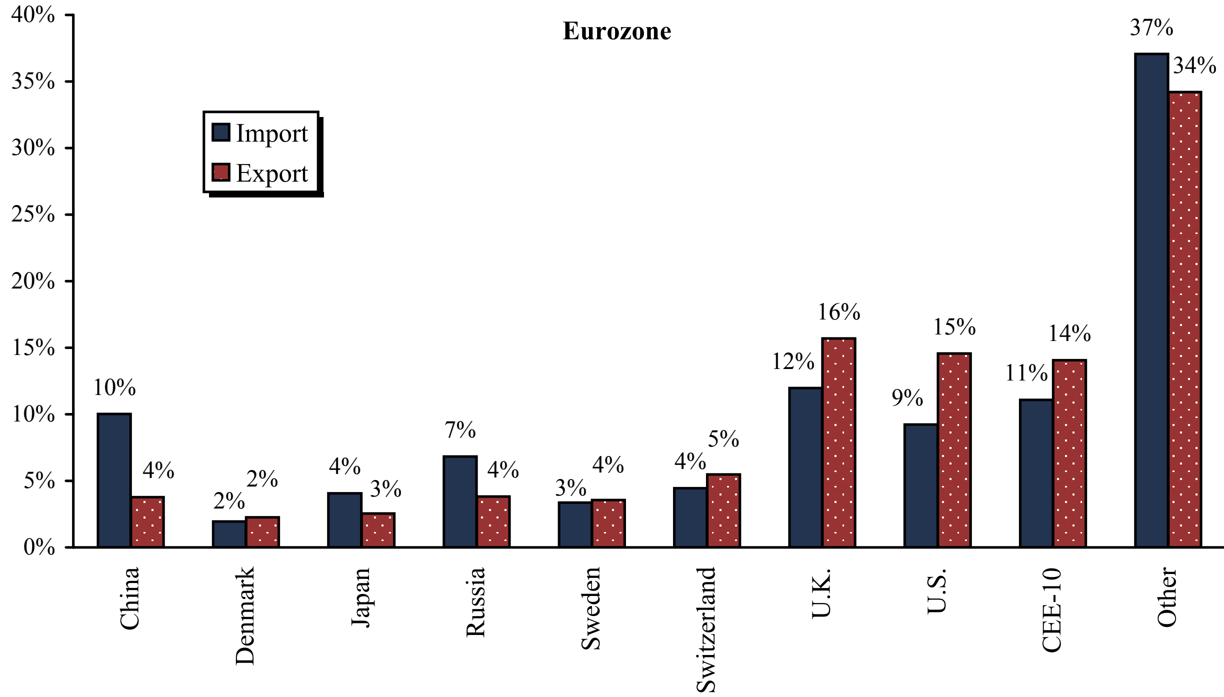


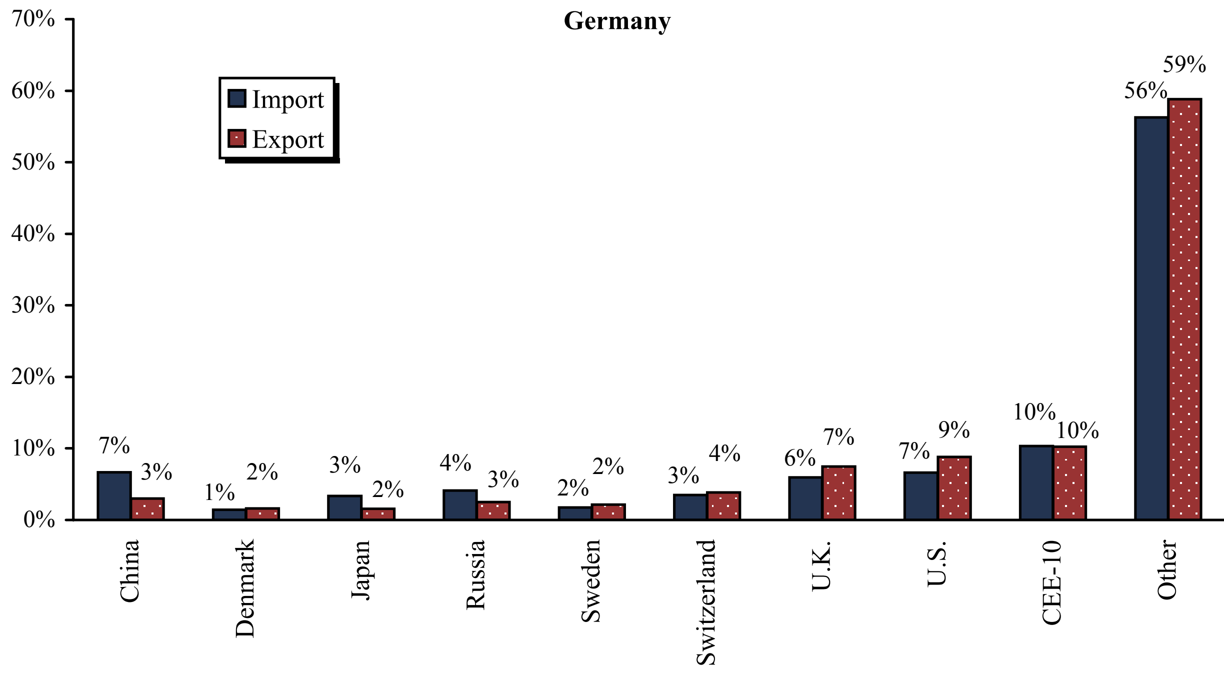
Sources: International Monetary Fund and World Economic Outlook Database.

Notes: Central and Eastern Europe regional data are based on the IMF definition. Country data are averages for 2004 and 2005.

Table F

TRADE LINKAGES





Sources: Deutsche Bundesbank, Eurostat, and Thomson Datastream.

Note: Data are for the 12 months ending October 31, 2006.