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ECONOMICS: EMERGING EUROPE, MIDDLE EAST AND AFRICA PERSPECTIVES—OCTOBER 21, 2011

EEMEA: When the Euro-Area Catches Cold...

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We expect the emerging economies of the EEMEA region to feel the most pain from the euro-area slowdown. Viewed through the lens of trade dependence and policy flexibility, Hungary's growth outlook seems the most vulnerable while South Africa's seems the least.

The outlook for growth in the euro area remains clouded by uncertainties surrounding the sovereign-debt crisis—and the potential damage its resolution may cause to European financial institutions. Business and consumer confidence have already suffered, and the plans for fiscal retrenchment extend well beyond smaller peripheral countries.

These developments have led to reductions in economic growth projections in the euro area over the past month or so, including our own estimates. We now predict that the euro area will experience a mild recession from this quarter through the first quarter of next year. This could then be followed by a flat second quarter and a gradual recovery in the second half of 2012. The risks to this forecast are skewed distinctly to the downside.

Vulnerability Defined by Trade and Financial Links

The emerging economies of the EEMEA region are likely to be the most severely affected by the slowdown. Their trade and financial systems are closely linked to the euro area's core economies, particularly Germany and France. These links are tightened by both geographic proximity and other factors. For some countries, the additional links stem from closely integrated product, labor and capital markets within the structures of the European Union—Poland and Hungary are notable examples.

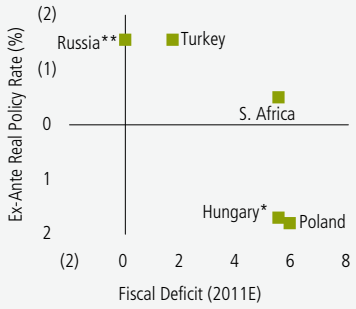
For all of the EEMEA economies, the euro area is the single largest trade partner, and for most countries it has been the single largest source of foreign direct investment and other cross-border capital flows. All of these will be negatively affected when the euro area slows.

However, not all EEMEA economies have the same exposure. Their vulnerability is determined by their trade openness, which we measure by the size of exports as a percent of gross domestic product (GDP), and by the share of exports headed to the euro area **(Display 1)**. Based on this simple litmus test applied to the countries

Display 1
Most Basic Vulnerability Litmus Test

As of March 31, 2011
Source: Haver Analytics and AllianceBernstein

Display 2
Who Has the Room for Stimulus?



As of October 21, 2011
* Fiscal balance excludes one-off revenue items.
** Policy rate is the one-day repo rate.
Source: Haver Analytics and AllianceBernstein

for which we provide economic forecasts, Hungary is the most vulnerable—being the most open economy and the most euro area–oriented. It's followed in descending order of vulnerability by Poland, Russia, Turkey and South Africa.

Varying Degrees of Policy Flexibility

But the differences extend beyond trade. Some EEMEA countries are more flexible than others when it comes to their ability to use fiscal and monetary stimulus to offset the slowdown in external demand over the next four quarters.

Display 2 on the previous page summarizes the latest real, or expected inflation-adjusted, policy interest rates (a measure of monetary policy flexibility) and the current year's expected fiscal balances (a measure of flexibility on the fiscal side). These indicators offer a consolidated, although admittedly somewhat simplistic picture of which countries are best and worst positioned to use conventional macroeconomic tools to stimulate growth.

Hungary again stands out as having little to no room to pursue expansionary macro policies. This is after we adjust for the central bank's need to maintain very high real policy rates to ensure stability in the exchange rate, due to the large exposure of households to mortgages denominated in foreign currencies.

On the fiscal front, the critically important and very ambitious debt-reduction program is the key constraint. Furthermore, these conditions exist against a backdrop of domestic demand that's already very weak.

Russia, by contrast, seems to be at the other extreme, appearing much more able to prop up domestic demand fiscally. However, that ability will also critically depend on the prices of its exports—oil, gas and metals. Proceeds from these exports feed into fiscal revenues, and they'll be affected by the euro-area slowdown and, by extension, reduced demand from China, both of which should reduce global commodity demand.

In terms of policy flexibility, the other large EEMEA economies fall somewhere between Hungary and Russia. *Poland* enters the slowdown with strong domestic demand, but also with plans for substantial fiscal tightening in 2012 on the order of 2.5% of GDP. This tightening is intended to keep the country from breaching the general government debt limit mandated by the public finance law, and to remove Poland from the short list of European economies struggling to contain fiscal imbalances exacerbated by the 2008–2009 global recession.

On the other hand, monetary policy in Poland may be loosened somewhat on the heels of a one-percentage-point rate tightening earlier this year. But it's not clear to what extent lower rates would help, or how much they would further undermine the strength of the zloty—currently a major concern for both the central bank and the government.

In *Turkey*, domestic demand has slowed from record-high growth rates, pulled

Display 3
Some Econometric Evidence

	Hungary	Poland	Russia	Turkey	South Africa
Regression Results: Dependent Variable = Real GDP Growth, QoQ SAAR*					
Euro-Area Growth	1.29 (2)	0.50 (2)	1.02 (4)	0.42 (2)	0.47 (4)
Real Effective Exchange Rate	—	–0.20 (4)	–0.12 (4)	0.35 (3)	-
Credit Impulse	—	0.26 (4)	0.60 (2)	—	0.15 (4)
Real Wage Growth	0.30 (2)	—	—	—	—
Adjusted R^2	0.73	0.47	0.64	0.38	0.45
GDP Growth Projections					
2011 Model Projection**	**1.3**	**4.5**	**3.1**	**6.4**	**3.0**
Current 2011 AB Forecast	1.1	4.1	3.4	7.2	3.1
2012 Model Projection**	**0.7**	**4.1**	**2.1**	**6.1**	**2.7**
Current 2012 AB Forecast	1.5	3.1	3.5	2.5	2.9

As of October 21, 2011
*Cumulative elasticities based on an OLS regression involving polynomial distributed lags of independent variables. Numbers in parentheses indicate number of lags included in the regression.
**Mechanistic model projections that assume all country-specific drivers unchanged at close to first-half 2011 levels.
Source: AllianceBernstein

down by a sharp depreciation of the lira starting last November and "stealth" monetary tightening, which has been carried out since the second quarter of this year. However, Turkey's ability to stimulate the economy through rate cuts or more fiscal spending remains capped by concerns about the large current account deficit—a gap the central bank had to finance almost completely from reserves during the past two months, as capital inflows largely dried up.

So, after Turkey's initial rate cut in August, its central bank most recently had to widen the upper limit of its policy-rate corridor, hoping that higher market interest rates would halt the lira's slide and stop the hemorrhaging of its relatively thin foreign exchange reserves. Since early August, Turkey's central bank has used more than $7 billion of reserves (or 8% of its total) to support the lira, which it believes is undervalued by between 10% and 15%.

Fiscally, there seems to be plenty of room for Turkey to take action, given the modest headline budget deficit this year, which is expected to be only 1.7% of GDP. But concerns about the current account deficit have compelled the government to tighten rather than loosen, moving to reduce the fiscal deficit by imposing more special consumption taxes for 2012, thereby mostly targeting a slowdown of imports.

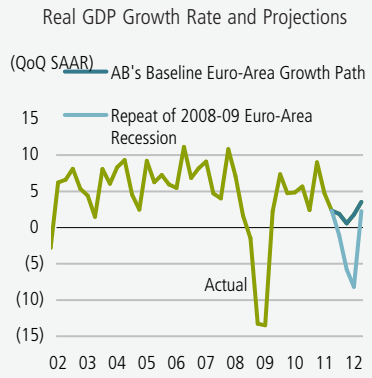
South Africa has little room for fiscal stimulus through spending, although the authorities are likely to allow the economy's automatic stabilizers to kick in if the economy slows. As for monetary policy, we believe that South Africa's central bank could reduce rates as part of a coordinated global monetary easing. However, we don't believe that the central bank will ease independently, since it doesn't view the cost of borrowing (which it never began to normalize after the 2008–2009 global crisis) as the constraint on economic activity.

Quantitative Analysis Supports Qualitative

To complement this largely qualitative analysis, we've also estimated a number of econometric models that tie individual countries' growth rates to euro-area growth and a number of domestic, country-specific "control" variables. These variables include the real effective exchange rate, real wage growth and the domestic private credit impulse. This impulse is measured as the amount of bank credit injected each quarter into the economy relative to the size of the country's GDP.

Display 3 on the previous page summarizes our findings, which generally confirm the results of our qualitative analysis: Hungary's economic outlook stands out as the most at risk compared with the other EEMEA economies. Curiously, the econometric estimates imply that Russia's growth rate is also highly sensitive to the euro-area growth path, despite the country's relatively modest trade links to the euro area. We believe that this high sensitivity is due to the high correlation between euro-area growth and commodity prices, which are ultimately the dominant driver of Russia's real economic activity.

Display 4
EEMEA Growth Scenarios



As of October 21, 2011
Mechanistic model projections that assume all country-specific drivers unchanged at close to first-half 2011 levels. EEMEA growth rates are 2010 nominal GDP weighted averages of QoQ SAAR for Hungary, Poland, Russia, Turkey and South Africa.
Source: Haver Analytics and AllianceBernstein

The estimated models also allow us to run sensitivity scenarios with which we can project the path of GDP for the EEMEA economies under a set of country-specific assumptions and varying euro-area growth paths. **Display 4** illustrates projected growth paths for the EEMEA region implied by our estimated models under two different assumptions for euro-area growth: one is our current baseline we described earlier, and the other would mirror the euro-area recession during late 2008 and early 2009.■