5th Vienna Economic Forum
Welcome Speech
Dr. Stepic, November 10th 2008

Your Excellencies, Ladies and Gentlemen

A very good morning to all of you!
It is a great pleasure for me to welcome you here in the Raiffeisen Hall in the Name of RZB Group.

Since we founded the VEF Five years ago, the organisation has constantly grown and has met the interests of decision makers from both sides – the business side and the political arena. As of today the organisation has **12 member countries**. **This year** participation reached a new record with over **530 registrations out of 37 countries.**

When we set the topic of my statement in July, the **financial crisis** was **still very much limited to the US** and some western European **banks** that had **invested in sub-prime** mortgage **paper**.

With the **collapse of Lehman Brothers** (previously considered as too big to fail) in mid September, the **speed of infection increased** dramatically and **has reached the real economy!**

This is the **first time** a financial **crisis has emerged in the developed world** and spilled over to emerging markets.
As a result, in 2009 the **US and developed Europe will most probably face a recession.**

Although **CEE counties**, as we have already seen within the last weeks, **can not fully resist the crisis**, most CEE countries will have lower, but still growing GDP's.

The **main factors lowering GDP growth** rates also in the CEE region **are:**

1. **Lower Exports**
2. **Slower FDI influx**
3. **Reduced loan growth**

- **Ad 1: Demand for CEE exports will weaken substantially** due to the region's close trade relations with Western Europe, in particular Germany. This trend is mitigated, as CEE countries are low-cost producers of products in the lower price segment, which could mitigate some negative effects. Another potential mitigating effect is intra-regional trade within the CEE countries, which could maintain higher dynamics even in a global downtrend.

- **AD 2: Foreign Direct Investment in CEE will markedly slow down**. **Western European companies** are also the **largest investors in CEE**. Thus, a **decline in investment activities** in Europe, **caused by** the recession on the one hand and **tighter credit conditions** on the other, **is very likely**. Even if there was some **outsourcing from Western Europe into CEE** similar to the last downswing of Western European economies it would **only** have a **marginal short-term effect**.

- **AD 3: Loan growth in CEE will cool down significantly** as the availability of **external funding has dried up** and **risk premiums have soared** over the past weeks and months. Although the announced **government packages for western European banks will** undoubtedly **improve** the situation, **loan growth will be significantly lower – if there is growth at all**. **Measures/packages by CEE authorities are still missing!**

Effects:

- **RZB Research**, which is even **more conservative than the IMF** in it's recent publication, calculated a **3.3% GDP growth forecast for the CEE economies** (including Russia and CIS) in 2009 (**-0.1% for the Eurozone)**. [*IMF forecasts 3.4% for CEE (excluding CIS) in 2009. (0.2% for the Eurozone)]*.

  This underpins that the CEE region will maintain a robust growth advantage over **Western Europe**. *The IMF also forecasts 5.5% for Russia (here we have been more conservative* *already before with 5%) and only 2.5% for Ukraine. Our risk scenario for Ukraine is between 1 and 2% real GDP growth in 2009.*

Despite the deterioration in economic conditions, CEE can master the crisis.

- **Mitigating factors** for the CEE countries are their **cost advantage** in production. **Although great improvements in** the **quality** of production has been achieved, the **CEE economies** also have remained **particularly strong in the lower cost segment** of products, which **could gain market share** at a time **when** companies and **consumers are forced to economize** (and thus somewhat mitigate the impact of weaker demand from abroad). → positive effects on current account deficit and inflation

  In the last Western European economic downswing there was even some **outsourcing from Western Europe into CEE**. *However, this could have mitigating effect in the short-term (and overall FDI has still to be expected to decrease significantly).*

- **Rising employment** and the **very strong wage growth** over the past years has **boosted household incomes** and, thus, **domestic demand**.

  The **average annual increase of monthly wages** in EUR terms in the period 2002 to 2007 reached **6.9% in**

Central Europe, **13.2% in South Eastern Europe** *(and as much as 21% (annually!) in Russia and Ukraine)*.
In other words, there is subsequently more consumable income available as there was in the mid 90-ties or in 1998 in Russia

- Yes, there are overheated prices for commercial property and prime locations in some CEE capitals, but there is **no housing bubble or subprime in CEE**. **Structural (catch-up) demand for quality housing will remain high** while the supply remains weak. **Mortgages** are almost exclusively **taken** up **to finance apartments and houses to live in**.

- Also the region could maintain some additional dynamics from the **robust domestic demand** and **intra-regional trade** (which was spurred with EU accession).

- A **stabilising factor for economic growth** should also be the **support from the EU budget,** which is aimed mainly at regional development (incl. infrastructure) and agriculture. Depending on the countries' success to tap the available funds (with suitable projects being approved and successfully co-financed where necessary) the **net payments from the EU budget can easily reach 1 to 2 per cent of GDP** of the new EU member countries (with the exception of Slovenia).

- Clearly a **risk factor** is **loan growth**, which does **depend on** the **state of the global financial sector**.

Biggest threat: Credit Crunch!

Dried up finacial markets – quick action needed!

Growth can not happen **if there are no liquid resources** that can be used for the production process.

At the moment **this is exactly where we stand**. **Money/ liquidity is the principle resource to keep economies going**. It is **the blood circulating in the veins of every economy**. **Without it**, **no investments** can be made, **no projects** can be financed and **no goods** can be bought.

So far, **despite** the **dried up money markets**, the **economies** in CEE have **not** come to a **standstill**. But growth has lost momentum!

What the **markets need** in order to keep functioning is fast and **concerted actions of the local governments together with the Central Banks** to **ensure**, that money **circulation** is kept afloat.

Western European **Governments have reacted** quite **swiftly** to design **"banking packages" in collaboration with the banks** aimed to:

- **Guarantee** customer **deposits**
- **Recapitalize banks**
- **Provide** short and medium term **funding**

These Packages are **extraordinary measures to cope with** an **extraordinary situation** - an **absolute necessity in times of the worst financial crisis** that the world has seen since many decades.

So far, **with the exception of very few** countries, **CEE governments** and **Central Banks** have been **reluctant to take actions**.
This does not only put the single economies at risk! In times of globalisation and an increased interlinkage of trade and services among the CEE countries,

The **primary goal** has to be, to **avoid a credit crunch** as this would **severely damage local economies** and **destroy** a lot of the **achievements made during the past years**.

Central and South Eastern Europe beyond the global financial crisis

In a **mid to longer term perspective Central and South Eastern European countries remain competitive production locations** for the European market.

- On **average unit labour costs** in Central and South Eastern European economies were **still less than 50% of** that in **Western Europe** in 2007

- **Average gross wages** in Central and South Eastern European countries, despite a strong and steady increase over the past years, were **still less than a third of those in Western Europe** ***for CE-member countries*** *that joined the European Union already in 2004*, **and less than a fifth** for the **South Eastern European countries including EU members Bulgaria and Romania.**

After 50 years of Commonism the inherent natural demand →"catch up process remains" with or without the crisis.

This also means that there remain a **huge potential and need to generate productivity advances** in the economies of the region. **European integration and foreign direct investment** (predominantly European companies invested around EUR 250 bn in CEE in the 5-year period 2002-2007) **greatly increased** the pace of **productivity growth**, **and** hence overall **GDP growth** over the past 10 years.

Clearly this is a **win-win situation** for both the **companies** who can **increase their competitiveness** and profitability by investing in the region as well as the **population**, which **benefits from** the creation of **jobs and the rise in** average **incomes**.

- **We are thoroughly convinced that this will continue to be the case at least over the next 10 to 20 years when the current financial crisis will have found its way into history books.**
- **CEE will remain a highly attractive region for investment in production and services and as a growing market for European products.**
- This is not a normal crisis! Governments and Central Banks have to act to arrange for liquidity for the local banking industry avoiding a credit crunch before the economy dries up, together with EU authorities, IMF and other supranationals.
- **Times of crisis** are also **times of exceptional chances! Central and Eastern Europe** remains to be a **growth region and bears many, but again: quick action is needed!**