



SCENARIO 2020

Central and South Eastern Europe
A Success Story – to be continued

A comprehensive study on economic growth
in Central and South Eastern European countries
and for selected industries.

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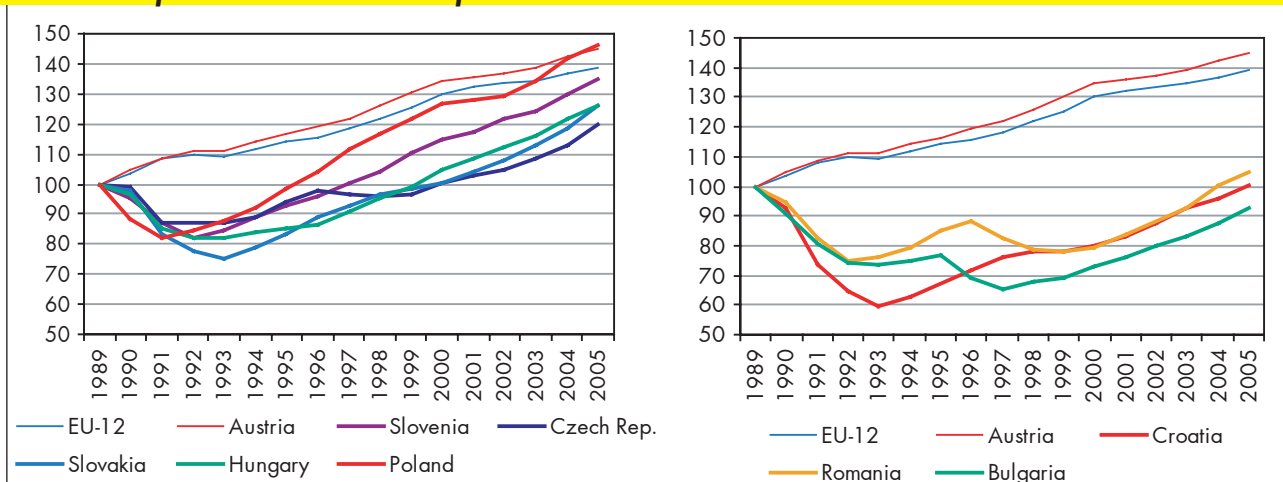
Executive Summary

Basic situation - the last 15 years

- Central and Eastern Europe (CEE) is a region that has experienced enormous growth in the last 15 years: successful transition from a centrally planned economy to a functioning market economy system
- Consistently achieves the second-strongest growth in the world (after China and India)
- Convergence process due to massive FDI has brought the new EU member countries (CE) 10-20 percentage points closer to EU average income in the last 10 years (between 50% for Poland to 80% for Slovenia in 2005)
- Convergence process in South Eastern Europe (SEE) really got underway at the beginning of this decade and has proceeded with great pace since then
- Ratio of FDI in SEE countries is increasing compared to the CE countries

These are the kind of headlines that characterise the great progress that has been made in transforming the region in Austria's immediate vicinity. From Austria, one need only travel a very short distance to find exceptionally robust economic growth. Austrian companies were among the first to enter the CE and SEE markets and continue to be among the most successful. Accordingly, Austria's economy has also benefited enormously from this forward-looking decision to take part in the economic development of Central, Eastern and South Eastern Europe. The result: Austrian economic growth has successfully disengaged itself from the sluggish development in Germany and has consistently achieved stronger GDP growth than the euro area. Corporate earnings have increased twice as strongly as in the euro area. On balance, we have seen the creation of new jobs, despite of the relocation of entire branches of manufacturing. Exports to CEE have tripled. And so on and so forth...

Transition process - GDP development indexed 1989-2005



Real GDP 1989=100

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

What does the next fifteen years hold in store?

Fifteen years of successful development in the CE region and in SEE, to a certain extent. But what of the future? What the next fifteen years hold in store? This question was the core focus and main motivation for this analysis. Will Eastern Europe continue to be the world's 2nd strongest growth region? What trends and structural changes will dominate the next fifteen years? And as a result of such, what opportunities will be opening up for Austria and Austrian companies?

Before we get started, please note that a **supply-side economic policy** and the **promotion of capital market development** formed the fundamental basis for the massive influx of foreign capital into CE and SEE, which has boosted the investment into modern production facilities and technology transfer. A change in these broad overall conditions or in the political stability in the regions would result in major changes in the overall scenario for the individual countries.

We used estimations of production functions in the individual economies in order to arrive at forecasts for growth potential. The three growth components are growth in employment, accumulation of capital and technical progress. In this regard, the following main aspects are striking:

1. Capital accumulation and technological progress/productivity growth will continue to function as important factors behind economic growth over the next 15 years
2. Economic growth will fall back in the second half of the next decade due to a decline in the working-age population after 2010-2012 and an absolute decline in total population (even more pronounced drop than in the "old" EU countries)
3. Relatively high rates of unemployment and migration from agriculture will provide a labour reserve buffer for the next five to eight years

EU accession will generate additional growth momentum in CEE

In total, **potential growth** over the next five to eight years in the CE region amounts to an average of around 4.3%, followed by a more significant decline from 2015 to about 3.2% in 2020. Potential growth in the SEE region is roughly 0.5 to 1 percentage points higher. The developments in GDP growth before and after the EU accession of Spain, Portugal and Austria suggest that **additional growth** momentum will be generated in the CE countries (which have been EU members since 1 May 2004) and in the new EU countries Romania and Bulgaria, which will be members from 1 January 2007. These "external" effects are likely to boost real growth by up to 0.5 percentage points via investments (subsidies and co-financing from the EU budget to 2013) through to 2009 (in the CE countries) and through to 2012 (for Romania and Bulgaria). For the CE countries, **total growth estimates** (in real GDP) for the next five years in a range of 4.5% to 5.5% are realistic (with the exception of Hungary), while growth in SEE countries will probably range between 4.75% to 6.0%. The region will thus continue to produce the 2nd strongest growth in the world!

Nonetheless, in 2020, only Slovenia and the Czech Republic will have reached a GDP per capita level close to that of the EU average. Hungary and Slovakia will be above the current level of EU-25 GDP

per capita, and Poland and Croatia will be close to the current level of EU GDP per capita. Despite robust growth, Romania and Bulgaria will remain far from the EU-25 level. GDP per capita in these two countries will increase from the current level of about 1/3 of the EU level to about 50%, and in Serbia and Bosnia-Herzegovina the level will rise from 25% to about 40% of the EUR-25 average.

- The outlook for above-average growth (GDP growth over and above the long-term potential growth rate) is best for the coming five years!
- CE/SEE will continue to be world's 2nd best growth region for the next five years!
- The SEE region will exhibit 0.5 to 1.0 percent higher GDP growth than the CE countries
- Decline in population/labour force between 2012 and 2020 will be more pronounced than in the "old" EU!
- Sharp deceleration of growth dynamics in the second half of the coming decade due to demographic developments

The dynamic growth forecast for the next five to seven years will be borne primarily by a robust expansion of investment activity in infrastructure, construction and capital goods. Because productivity growth in CE and SEE countries will initially be significantly higher than wage growth, lower unit labour costs will lead to higher competitiveness, growing market shares for companies producing for the foreign market and thus stronger-than-average growth in exports. In conjunction with EU financing, these effects should mainly be seen in the **industrial sector**.

Accordingly, following a moderate to sharp decline in the contribution of the industrial sector to GDP, we expect to see a temporary expansion of the secondary sector relative to GDP growth in the coming years. As a result, we project that industrial production growth will be higher than the potential GDP growth of around 4.5% (in CE) and 5.0% (in SEE). We also forecast similar developments in construction and transport & telecommunications. This "re-industrialization" will only last, however, until the beginning of the next decade and will then taper off from 2012. The contribution of industry to GDP by 2020 will only reach about 20% or even less in some countries.

In the **service sector**, the strong growth will mainly be borne by domestic companies, as the formation of domestic savings provides adequate capital. The biggest exceptions are the banking, insurance and tourism sectors, in which foreign capital is likely to be the dominant factor in the CE and SEE regions. Nevertheless, a decline in the importance of Europe and the USA as foreign direct investors is expected, compared to the rapidly expanding economies of Russia, China and India. On the other hand, expansion trends by CEE companies in traditional markets (e.g. the EU) will be more frequent.

Robust expansion of investment activity

"Re-industrialization" will taper off from 2012

Service sector will be the main driver of economic growth, in the next decade

On the whole, the service sector in the CE countries will be the main driver of economic growth, in particular in the next decade. With the exception of the traditionally industry-oriented countries (the Czech Republic, Slovakia and Poland), the level of value added from the service industry should climb well over 50% of GDP and thus approximate with the current structure in EU countries. The trend in favour of the service sector as the determining component of GDP should also be seen in the SEE region from 2012-2014.

There will be some interesting developments in **wages and prices**. The predominant trend towards a lower wage drift should reverse and turn towards a higher wage drift next decade (from 2012-2014). Factors expected to remain important in the coming years such as relatively high unemployment and extremely robust increases in productivity generally limit the possibility of (relatively) stronger increases in wages. The prospect of labour supply shortages and the increasingly disadvantageous demographic structure, however, will result in a trend reversal, as productivity growth begins to fade. Another factor which could exacerbate this is the opening of the EU labour market. The migration of qualified workers could also have a negative impact on technological progress.

Ageing of the population will also have a long-term impact on inflation

This cost effect and the significant ageing of the population will also have a long-term impact on inflation. The demographic shift will result in a marked change in the average consumer goods basket, in the respect that services will generally have a far higher weighting and consumer durables will have a far lower weighting. As the rates of inflation for services are tangibly higher than the price increases seen in consumer durables (which tend to be fairly stable due to globalization), rates of consumer price inflation in the CE and SEE countries will begin to rise moderately again, in particular in the second half of the coming decade.

Accession to the euro area could be faced with problems

In certain countries, **accession to the euro area** could be faced with problems, as early on efforts to consolidate their budgets were not ambitious enough and then later on inflation problems could materialise. To a certain extent, the situation will be alleviated by the fact that the "old" EU countries will also be facing the same problems, albeit in a less severe form. Nonetheless, when the euro has finally been adopted, we may see a relative decline in general competitiveness in the respective countries (2015 to 2020). While this will not be particularly relevant for the export-oriented industrial sector, it may have an impact on certain branches of the service sector.

Early on, price inflation may sink to historical lows, but during the next decade the inflation trend will turn around again. Inflation will have an impact - delays in adopting the euro and declining competitiveness for the respective countries in the euro area (2015 to 2020)

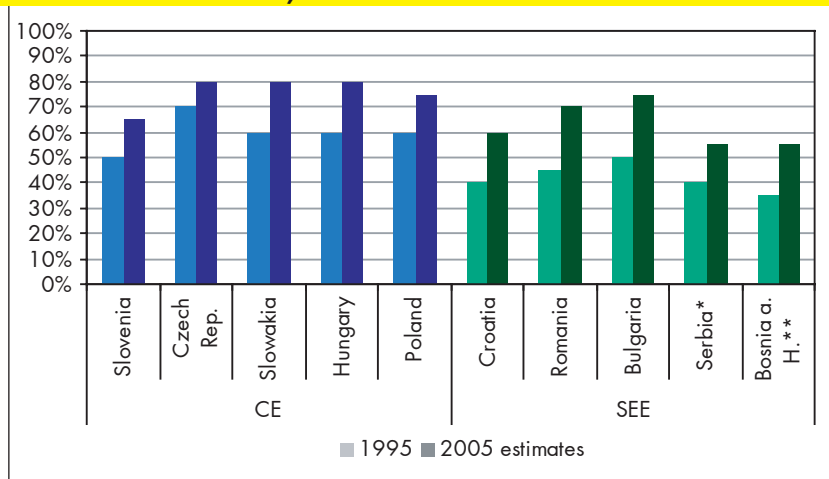
In order to show what these prospects for the future will really mean for certain sectors, we have included in this study the outlook for the

telecommunication, energy and banking sector. These case studies highlight the enormous growth potential still available in these markets. Austrian companies have successfully taken advantage of the opportunities that opened up on the CE and SEE markets. Over the coming years, there will be plenty more opportunity for further development and lucrative prospects for foreign companies in the CE and SEE countries, which is the region with the 2nd strongest growth in the world.

Ramifications for Austria

- Above-average growth opportunities mean that the involvement of Austrian companies in CE and in SEE in particular offers lucrative prospects.
- For industrial companies, the next five years appear to be more promising than the following decade, due to the expected resurgence of industrialization.
- For service sector companies, the above-average growth forecasts for the sector point to profitable opportunities.
- Excellent development opportunities are anticipated in construction, telecommunications, financial services, retail and transport.
- Export growth may be constrained by the migration of workers from CE and SEE countries, due to the demographic developments in these regions, which are expected to be considerably less favourable than in Austria or in the "old" EU. *)

Private sector share, in % of GDP



* no data available before 2000; ** no data available before 1998

Source: EBRD transition report 2005

*) Full liberalization of the EU labour market from 2011 coincides with a significant deterioration in the demographic situation. The migration of qualified labour from the CE and SEE countries would result in a painful loss of know-how and thus also have a detrimental impact on technological progress and productivity. "Bleeding off" the reserve of labour supply would also have a significantly negative impact on production and incomes, which would in turn cloud the export and sales prospects of Austrian companies to a certain degree. Accordingly, social fairness and economic common-sense mean that attempts should not be made to solve Austria's demographic developments at the cost of the CE and SEE countries, which are facing the same problems but of an even greater magnitude.