

The Impact of September 11th, 2001 on Central & Eastern Europe and Russia

The impact of the terrorist attacks on September 11th has been felt in all areas of economic, commercial and political life. This report, compiled by CET's local offices, outlines CET's view of the implications of September 11th on business in Central and Eastern Europe, Russia and the former Soviet Union countries ("the Region").

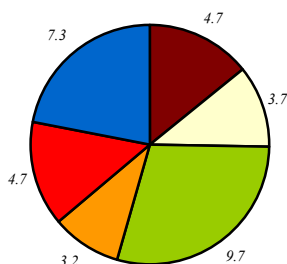
THE ECONOMY

Direct Trade

The most immediate impact of the terrorist attacks in macroeconomic terms is on consumer spending. A visible negative effect on consumer confidence is leading to a drop in demand for consumer goods. This is already leading to a reduction in exports to the US and growth forecasts have been adjusted downwards throughout the Region to reflect this fall in demand. However, the impact will vary between countries, depending on their level of exports to the US as a percentage of total exports. For example, exports to the US from Russia and Hungary are relatively high and are therefore more likely to be affected than those from Romania and Bulgaria, which are comparatively lower.

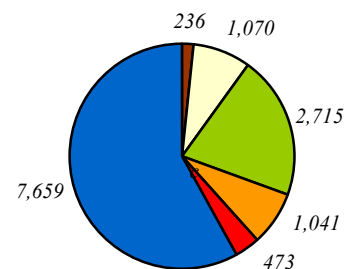
The impact of a decrease in demand for exports will vary, depending on the level of exports to the US, relative to total exports.

Exports to US as % of Total



Source: World Trade Organisation

Exports to US (\$m)



Source: US Census Bureau

A secondary economic impact is likely as the US slowdown starts to affect EU economic growth. For those economies more dependent on EU trade, for example, Poland and the Czech Republic, any sudden EU downturn will have a parallel effect.

Capital Markets

The capital markets of the Region will, to a great extent, share the same concerns about the global economic outlook as the New York Stock Exchange. Therefore, considerable uncertainty and volatility can be expected. However, the capital markets are also influenced by domestic factors. One reason for the rapid recovery of the Russian capital market after the 1998 fiscal crisis was the relatively low level of integration with external markets prior to the collapse of the rouble. The Russian economy retains an element of domestic self-sufficiency which, to some extent, isolates the Russian economy from external shocks in other parts of the world. This applies equally to any country with weak connections with the world capital markets, including Romania, Bulgaria and the countries of Central Asia.

Perceived impact on Foreign Direct Investment

Patterns and sources of FDI are changing around the world. Investors have become more cautious and the screening process for evaluating investments has become more stringent following dramatic losses on the world stock markets in 2000. This general cautionary trend has altered patterns of investment into the Region since the mid-1990s.

We see two main alternative scenarios related to investment in the Region. In the first scenario, investors will withdraw current levels of investment due to generally weaker economic conditions overall, as part of a general shift away from equities into less volatile securities. In this scenario, privatisations in the pipeline will be impacted by the non-provision of promised funds. However, for many countries, such as Hungary, large-scale privatisation is largely complete and therefore will not be affected to the same extent as those countries still heavily dependent on FDI to complete the privatisation process, such as Bulgaria and the former Yugoslavia. In the second scenario, investors will be looking to spread risk by investing in countries perceived to have lower exposure to terrorist attacks. Given the location of Central and Eastern Europe relative to Central Asia and the Middle East, investors looking to diversify their risk may well choose the region as a preferred investment haven.

Considerable volatility in the capital markets is anticipated. However, disruption in the Region may not be as severe as elsewhere.

Investors are seeking to spread their risk. Given the lower level of exposure to the terrorist threat, the Region may be considered a safer haven for investment. However, privatisations, sell offs and major licence tenders will have a bad time in the short term.

Foreign Direct Investment in US\$ million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000*
Bulgaria	4	56	42	40	105	98	138	507	537	806	500
Czech Republic	na	na	983	563	749	2526	1276	1275	2641	4912	6000
Hungary	311	1459	1471	2328	1097	4410	1987	1653	1453	1414	1650
Poland	0	117	284	580	542	1134	2741	3041	4966	6642	10000
Romania	-18	37	73	87	341	417	415	1267	2079	949	500
Russia	na	na	na	na	500	1663	1665	4036	1734	746	2000

Source: EBRD Transition Report 2000

* EBRD Projections

COMMERCE AND TRADE

Multilateral Assistance

Funding of assistance programmes is typically sourced from international institutions, such as the EU, EBRD and IFC, as well as from allocations of bilateral funding from national economies. Budgets are allocated a long time ahead and, politically, it would be very difficult to fund military operations by cutting aid. This means, for example, that EU funding of TACIS and PHARE projects will not be affected by additional expenditure on military operations in the Middle East.

Withdrawal of funds from multilateral assistance programmes is unlikely.

Winners

The impact on businesses in the Region is distributed unevenly. For those countries rich in oil and with a network of oil refineries, the prospects for growth in these industries are good. Russian oil companies stand to gain significantly if political upheaval raises world oil prices or disrupts supplies from the Middle East. However, increases in oil prices will lead to higher inflation than forecast for those countries which are net importers. Oil refineries will benefit from higher oil prices, but at the expense of other sources of energy, such as fossil-fuelled power generators. Of course, the alternative scenario of a continued fall in oil and commodity prices will have the opposite effect. Several months of oil prices below \$15 per barrel would result in problem for the Russian economy, including the payment of international debt obligations.

Commercial 'Winners' are likely to be those countries rich in natural resources, as long as prices hold up. But a prolonged fall in prices could have the opposite effect

Losers

The air travel industry, hotel and tourist industries have suffered. Airlines are threatening bankruptcy in the absence of huge injections of government subsidy. However, carriers in the Region are not necessarily impacted to the same extent as, for example, carriers in the US. Regional airlines are not under the same threat from terrorist attacks, because the majority of passenger flights are to destinations within the Region, which are not currently defined as high risk. While the countries of the Region remain outside the EU, they are not subject to the same restrictions on the provision of government subsidy. This means that, in the short-term, governments in the Region may provide enough assistance to stave off bankruptcy of the flag-carrying airlines. The insurance industry will suffer as the cost of insurance increases, while the full impact on the tourist industry is largely dependent on the consumer's perception of safety in air travel.

The 'Losers' are the airline industries, tourism and insurance companies.

POLITICS

CET has identified two key areas of concern for the Region in the political sphere. These relate to EU enlargement and NATO expansion.

EU Enlargement

Complex negotiations between the EU and the accession countries have been in progress for some years. The 2004 target date for the first wave of enlargement for five countries from Central Europe seems unlikely to be impacted, according to the official statements by the EU Commission. It is unlikely that the timing of the accession will be affected seriously by the events in the US, given the complexity of the completed negotiations and the inevitable loss of standing in the international community for the EU, should the process be stalled further. The increased security threat creates a strong case for consolidating European political structures, and one mechanism to achieve this is through a widened Union.

Now that a target for accession has agreed, deviation from the planned accession date seems unlikely.

NATO Expansion

Since the first round of NATO expansion in 1999 to bring in Poland, Hungary and the Czech Republic, the question of the next round has been highly controversial for Russia. Further expansion including the Baltic States, Ukraine and Belarus is resisted by Russia and is perceived as a direct security threat to Russia's pivotal position between Europe and Asia. However, the need for international co-operation to combat the threat of terrorism reaches beyond geopolitical borders. Co-operation is high on President Putin's agenda, demonstrated by his recent meeting with Lord Robertson, NATO Secretary General, in Brussels to discuss Russia's role in international affairs. Greater integration into the international organisations may in time reduce the risks associated with dealings in the Region.

The process of NATO expansion may become more inclusive, particularly with regard to Russia.

CONCLUSION

The Region is subject to the same macroeconomic constraints as the developed western world in terms of falling stock prices and reduced demand for consumer goods and services. Even without the September 11th shock, GDP growth was forecast to decline from 6% in 2000 to 4.5% in 2001 in Central Europe and from 8.3% in 2000 to 4-5% in 2001 in Russia (source: EIU). The weakened dollar may impact negatively on the bank reserves of those countries with high reserves in US dollars or US bonds, but conversely, current distressed assets may become a window of opportunity to enter Regional markets at reduced costs.

Overall, the tragic events of September 11th may lead to a more co-operative international environment, where previous suspicions are eradicated to combat a new enemy. This may lead to greater opportunities for closer working arrangements between the developed economies and the emerging markets of the Region. We conclude that Russia is likely to be the main beneficiary.



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