

When Will Stocks Rebound in Eastern Europe?

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Eastern European stock markets had a traumatic 2008. In several countries, including Bulgaria, Lithuania, Romania and Ukraine, the market indices dropped 75%. In all other countries but Slovakia, stocks lost about half their value.

Will 2009 be different? Do investors have something to look forward to?

Stock market returns depend primarily on the underlying company profits. In emerging markets, these depend on the global economic outlook, as a large share of production goes to foreign buyers. So to know when stocks will rebound, you need to know two things: when the economic downturn will end (both at home and in major export markets), and whether stock prices turn up before or after economic activity picks up.

We study the latest economic forecast by the World Bank to answer the first question. We look at historical data in emerging markets and two developed economies (the United States and the United Kingdom) to answer the second question. In particular, we investigate the relationship between changes in industrial production and changes in stock market indices during previous downturns in six emerging markets (Indonesia, 1997-98; Korea, 1997-98, Thailand, 1997-99; Malaysia, 1997-98; Russia, 1998-99, and Argentina, 2001-02); and the United States (1980, 1981-82, 1990-91, and 2001-02) and the United Kingdom (1990-92 and 2001-03).

The forecast calls for an end to the economic downturn in the United States and other major OECD markets in the fourth quarter of 2009. In emerging markets, there may be a delayed response as demand in rich countries picks up first, to pull their exports up. So a likely scenario for economic upturn in Eastern Europe is mid-2010.

We establish a pattern in the relationship between changes in industrial production (as a proxy for economic activity) and stock price movements: stock prices in emerging markets typically start rising only after industrial production has bottomed-out: on average, about 3 months after. In contrast, in the United States and the United Kingdom stock prices bottom-out 6 months before production turns up.

If history is any guide, these results suggest that stock prices in Eastern Europe will only turn up significantly in 2010.

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When Will the Downturn End?

First things first: how much longer will the economic downturn last? In the United States, most economists expect the recession to end in late 2009. The World Bank's latest *Global Economic Prospects*² predicts a half-percentage point decline in GDP in 2009, and an expansion starting in early 2010. The predictions for the European Union and Japan are similar: declines in 2009 (-0.6% and -0.1% of GDP, respectively) and an upturn the following year. The November 2008 update of the IMF's *World Economic Outlook* has similar numbers: a 0.7% decline in the US in 2009, coupled with a 0.5% decline in the European Union and a 0.2% decline in Japan.³

This is consistent with the historical evidence from previous recessions in the United States. On average, recessions since 1926 (before the Great Depression) have lasted 11 months, with the 1981-82 recession lasting 16 months. The US economy has already been in recession for a year, so the World Bank forecast would make it last approximately two years. This is somewhat longer than the 1981-82 recession, but short of the Great Depression, which lasted 43 months.

For East European countries, which depend on exports to Western Europe, mid-2010 is a good bet to be growing fast again. The World Bank predicts negative 2009 growth in Estonia, Latvia, Lithuania and Ukraine, with others experiencing about two-thirds declines from 2007 growth levels (table 1).⁴ The IMF predicts a 2.2% growth in the region in 2009, with Russia growing at 3.5%.

Table 1: Latest growth forecast

Country	2009 proj.
Bulgaria	2.40%
Croatia	2.30%
Czech Rep.	3.40%
Estonia	-2.10%
Georgia	4.00%
Kazakstan	1.90%
Lithuania	-0.30%
Latvia	-3.50%
Poland	4.00%
Romania	3.20%
Russia	3.00%
Turkey	1.70%
Ukraine	-3.00%

Source: World Bank.

One can look at the recent crises in emerging markets for comparison. In East Asia, it took about 18 months since the start of the 1997-1998 recession for countries to record growth. Even Indonesia, whose economy shrank by 13.7% in 1998, grew a modest 0.2% in 1999. Korea's turnaround was the fastest: from -5.8% growth in 1998 to 6.6% growth

² See Chapter 1, at http://siteresources.worldbank.org/INTGEP2009/Resources/10363_WebPDF-w47.pdf.

³ See <http://www.imf.org/external/pubs/ft/weo/2008/update/03/index.htm>.

⁴ See Table A4, page 131 of *Global Economic Prospects*.

in 1999. On average, the four main crisis countries (Indonesia, Korea, Malaysia and Thailand) shrank by 8.6% in 1998 and grew by 3.1% in 1999. The downturn in Eastern Europe will be smaller than that experienced in East Asia a decade ago; the recovery will be somewhat slower too, as it will partly depend on now-sagging West European markets.

When will stocks turn up?

With this growth scenario in mind, the second question is when stock markets in Eastern Europe will start turning up. Analysis of previous downturns in emerging markets suggests: about 3 months after industrial production bottoms out.

Looking at the economic crises in emerging markets over the last decade, we identify six relevant episodes: Indonesia, 1997-98; Korea, 1997-98, Thailand, 1997-99; Malaysia, 1997-98; Russia, 1998-99, and Argentina, 2001-02. We compare the trend in industrial production and the trend in stock prices. In Indonesia (figure 1a), industrial production bottomed out in May 1998, while the stock market bottomed out in October, five months later. In Korea, industrial production turned up in July 1998, while stock prices turned up in September, two months later (figure 1b). In Thailand, production turned up four months before the stock market (May and September 1998, respectively, figure 1c). In Malaysia, production and the stock market rebounded simultaneously (August 1998, figure 1d). In Russia, the two indices also went up simultaneously (production in September 1998 and the stock market in October). Only in Argentina did the stock market start climbing before industrial production turned up (in November 2001 as opposed to February 2002; figure 1f).

The historical evidence thus suggests that the real sector recovers before the stock market does.

The sequence is different in the United States. In 1980, the US stock market started turning up four months before production registered sustained increases (figure 2a). In 1981-82, the stock market turned up three months before industrial production bottomed out. In the milder 1990-91 recession, stocks turned up six months before the lowest point of production (figure 2b). In 2001, stock prices again turned up four months before production bottomed up (figure 2c).

The relationship between stock prices and industrial production is similar in the United Kingdom. In the 1990-91 recession, stock prices picked up 7 months earlier than did industrial production (September 1990 and April 1991, respectively; figure 3a). In the 2001-03 downturn, stock prices picked up 5 months earlier (March and August 2003, respectively; figure 3b).

There may be several explanations why stock markets in the US and the UK anticipate the end of the economic downturn, while stock markets in emerging economies lag it. First, there is better economic data in rich countries, so economic forecasts are more accurate and investors act on them. Second, the majority of revenues of US- and UK-listed companies come from their home market and hence knowing how domestic sales

would fare gives sufficient information to guide investment decisions. In contrast, many businesses in emerging economies depend primarily on export markets and they may lack advance information on the economic conditions there. Third, institutional investors are more prevalent in emerging markets as a share of total equity investment. These have to abide by certain limits on what credit ratings their portfolio has. As the economic crisis has slashed credit ratings across Eastern Europe, portfolio investors would need to wait until the ratings are revised upwards before putting money.

Whatever the reasons for this difference, don't expect a strong rebound in East European stock prices this year.

Figure 1a: Indonesia, Stock Market Index & Change in Industrial Production

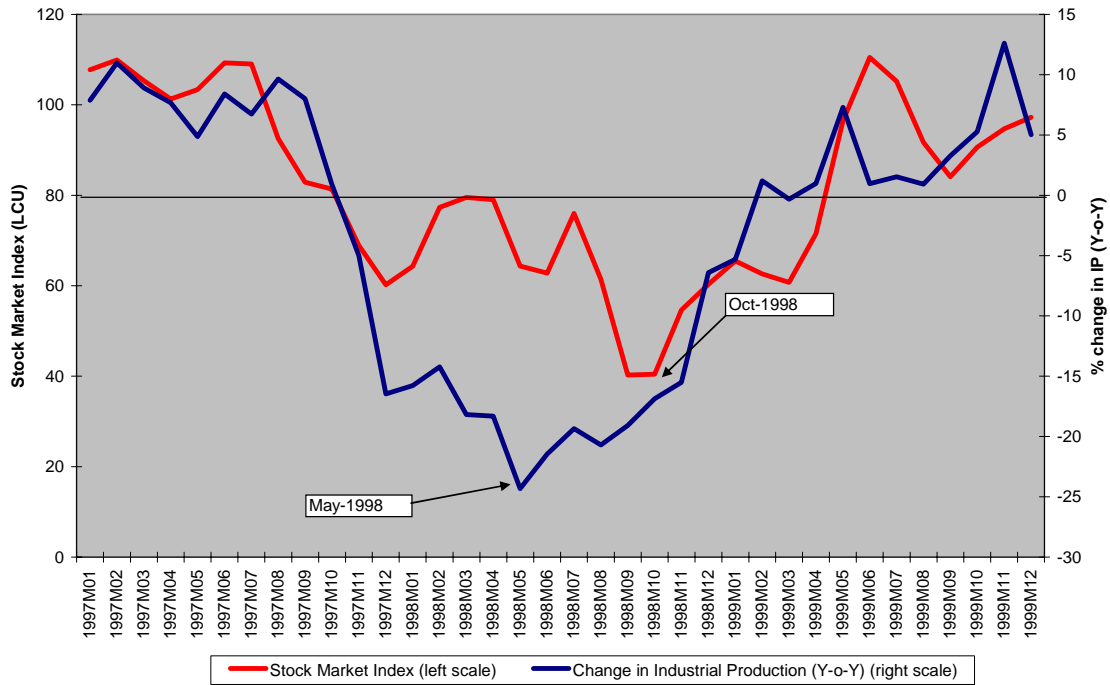


Figure 1b: South Korea, Stock Market Index & Change in Industrial Production

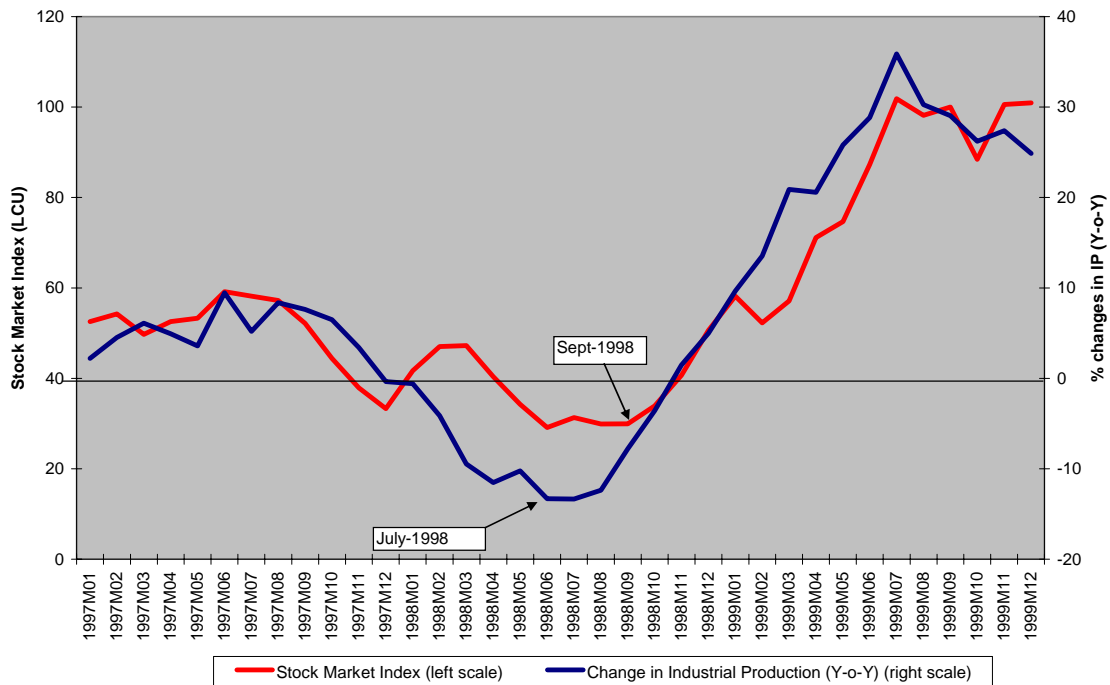


Figure 1c: Thailand, Stock Market Index & Change in Industrial Production

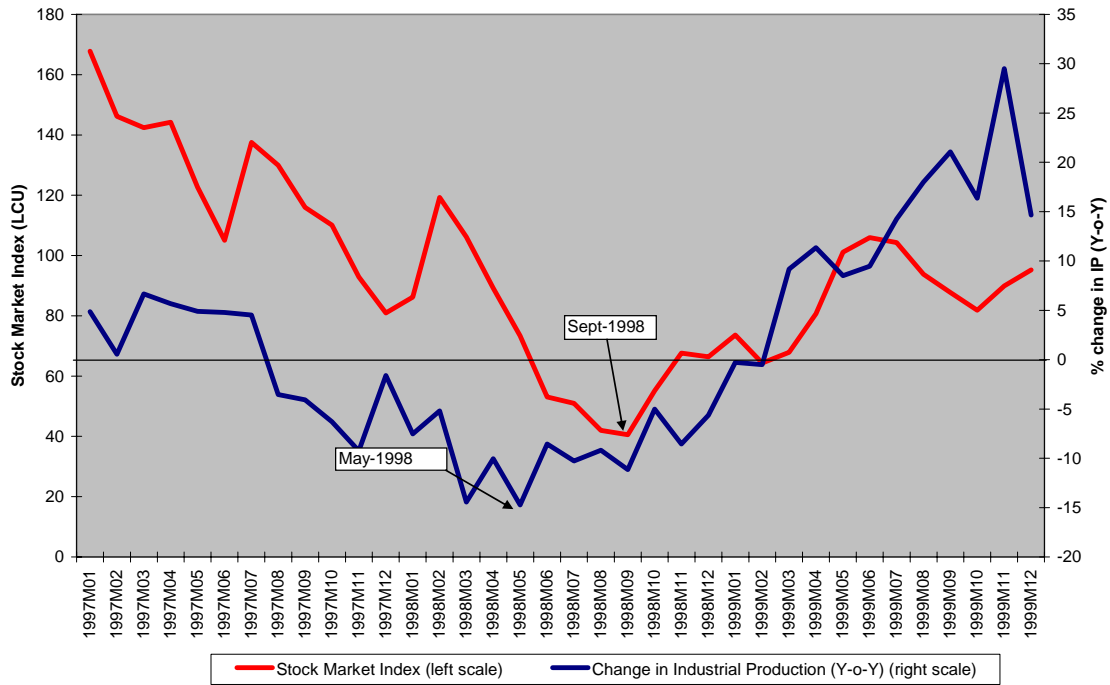


Figure 1d: Malaysia, Stock Market Index & Change in Industrial Production

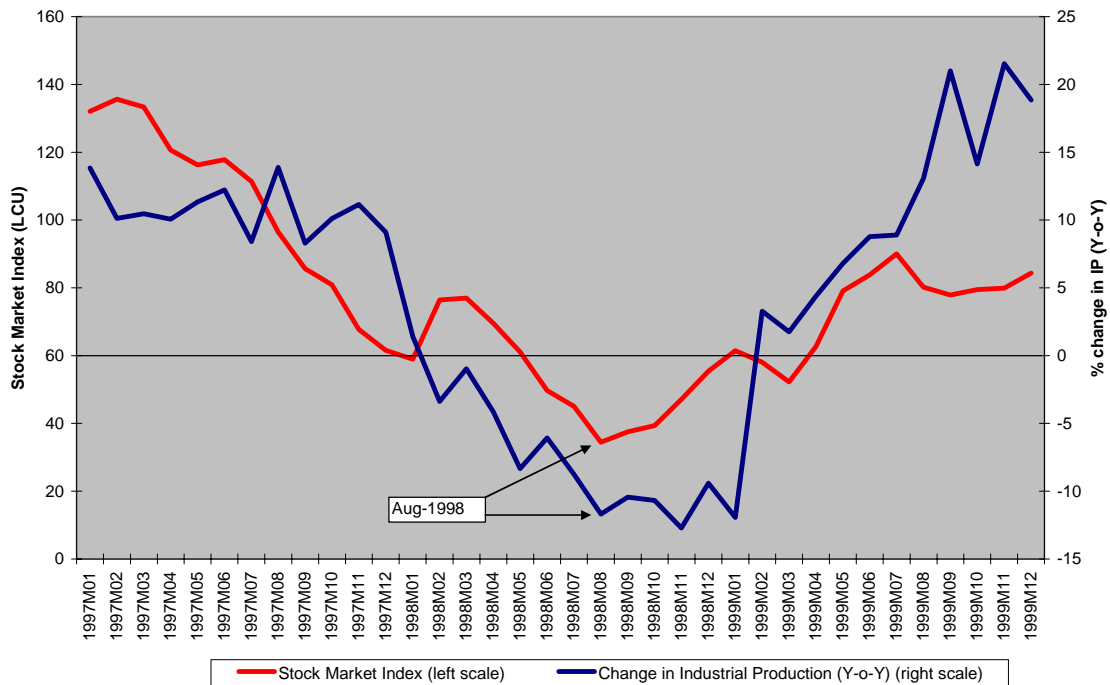


Figure 1e: Russia, Stock Market Index & Change in Industrial Production

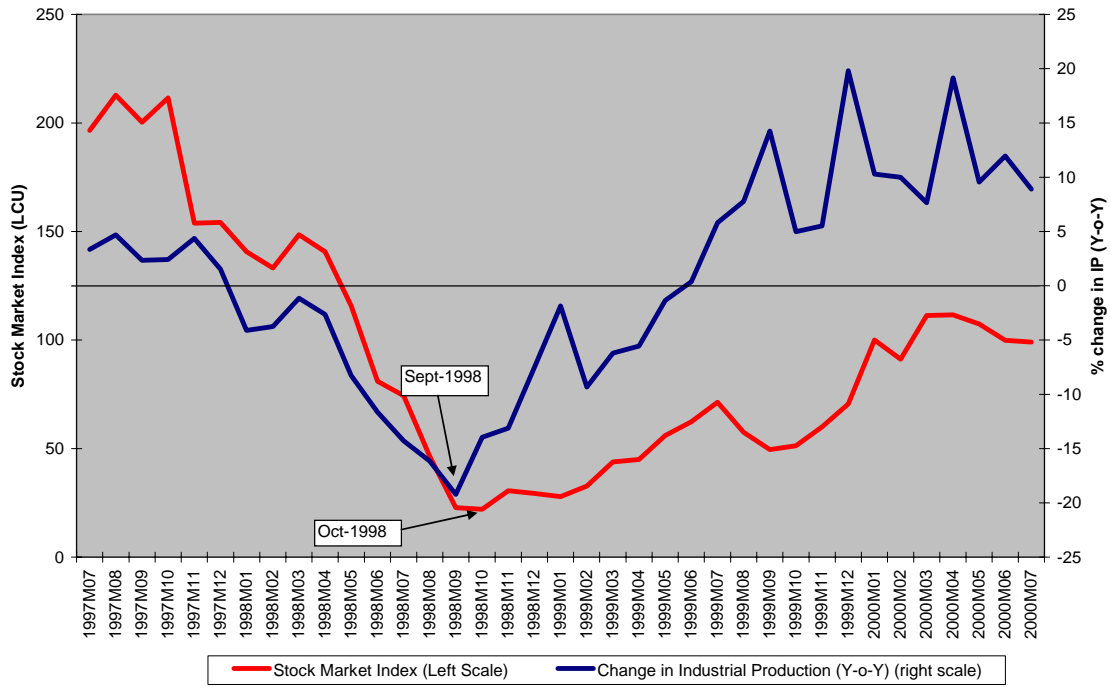
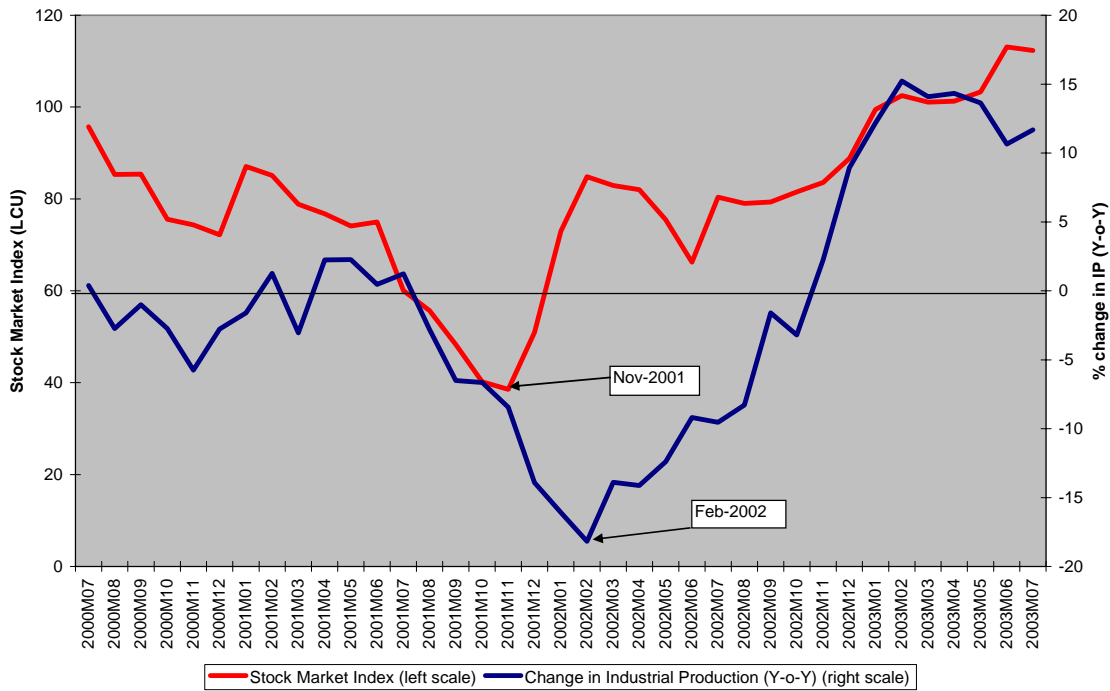
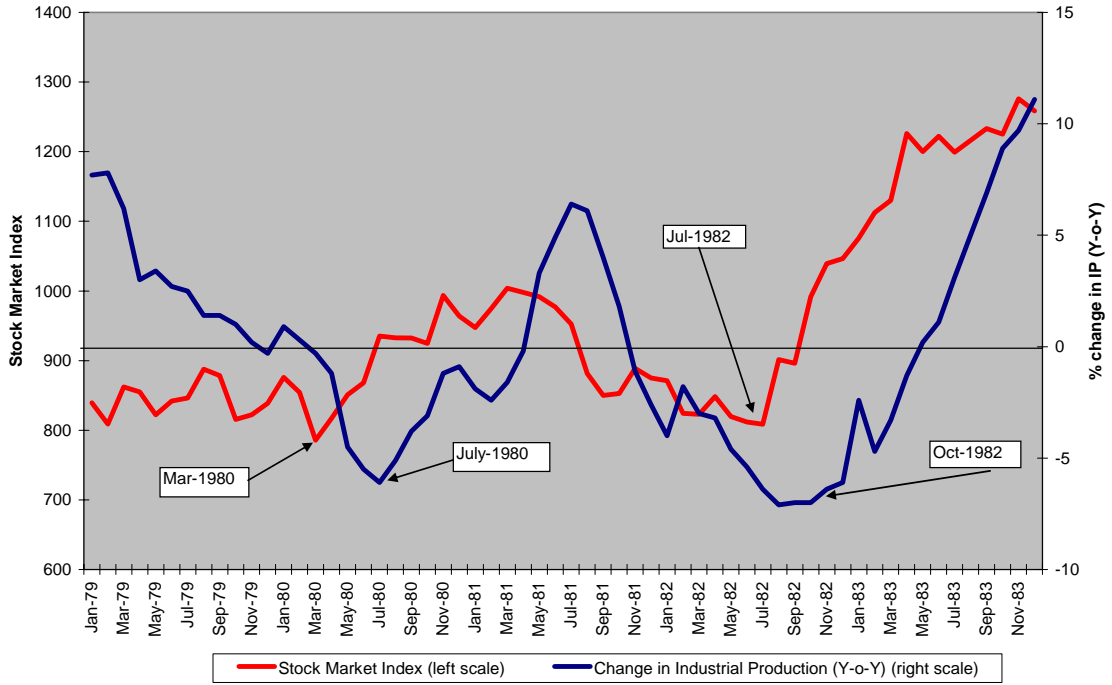


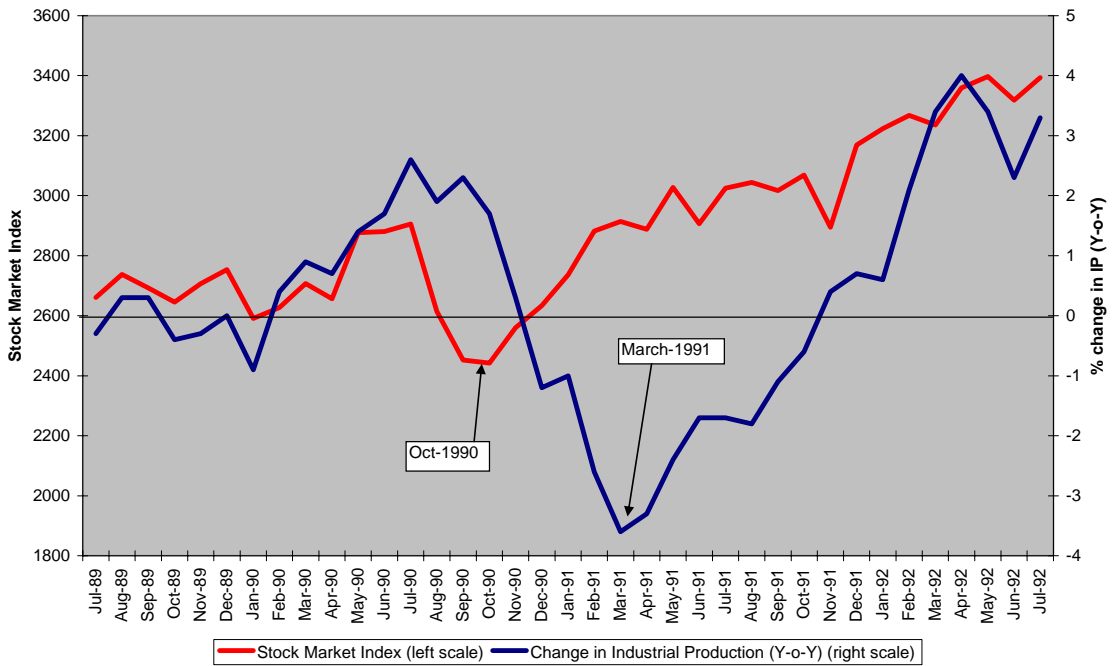
Figure 1f: Argentina, Stock Market Index & Change in Industrial Production



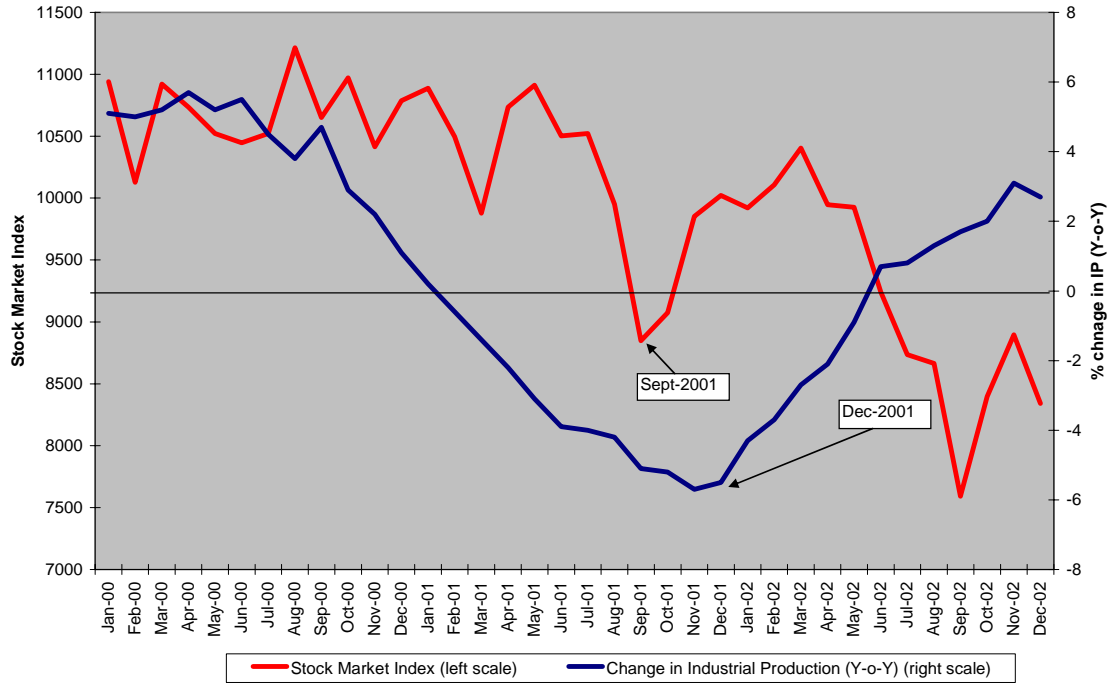
**Figure 2a: United States, Stock Market Index & Change in Industrial Production
1980 & 1981-82 recessions**



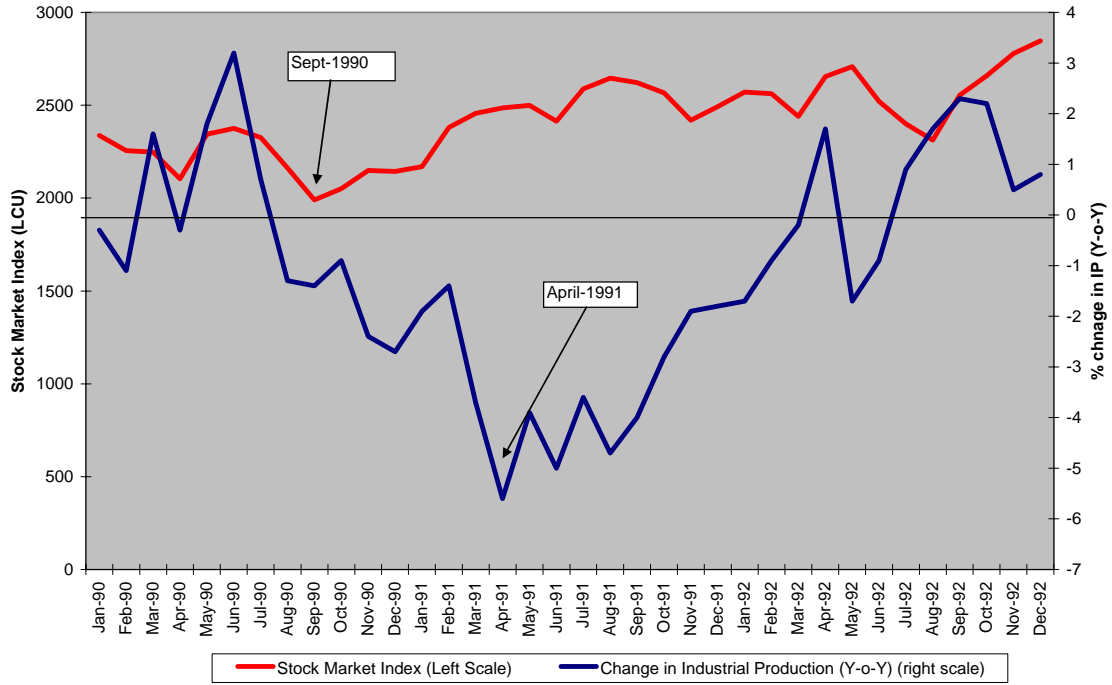
**Figure 2b: United States, Stock Market Index & Change in Industrial Production
1990-91 Recession**



**Figure 2c: United States, Stock Market Index & Change in Industrial Production
2001 Recession**



**Figure 3a: United Kingdom, Stock Market Index & Change in Industrial Production
1990-02 Recession**



**Figure 3b: United Kingdom, Stock Market Index & Change in Industrial Production
2001-03 Downturn**

