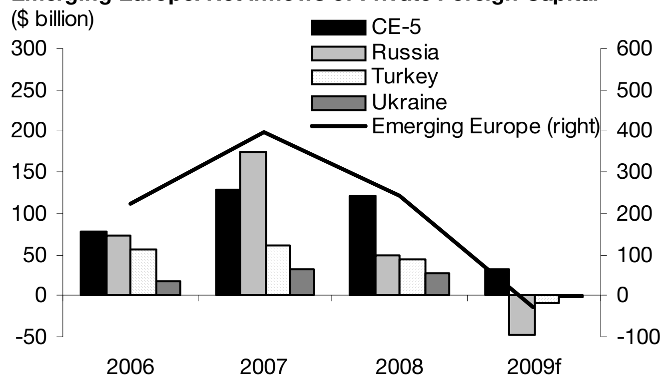
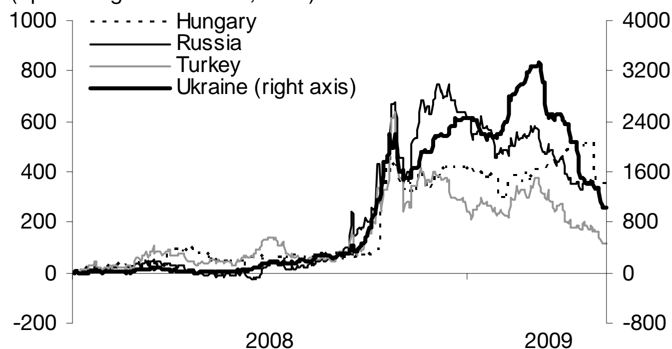
INSTITUTE OF INTERNATIONAL FINANCE

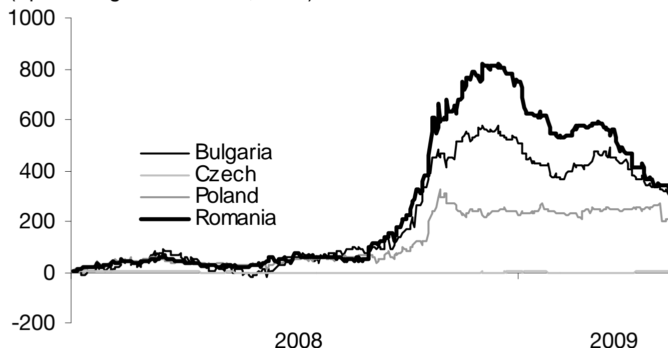
Regional Overview: Emerging Europe

Weak Foreign Demand, Capital Outflows and Procyclical Fiscal and Credit Contractions Will Cut Output and Narrow External Imbalances

May 2009







f = IIF forecast
CE-5: Czech Republic, Poland, Hungary, Romania and Bulgaria

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For questions or comments, please contact:

Jeffrey Anderson: janderson@iif.com
Lubomir Mitov: lmitov@iif.com

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Summary and Key Issues

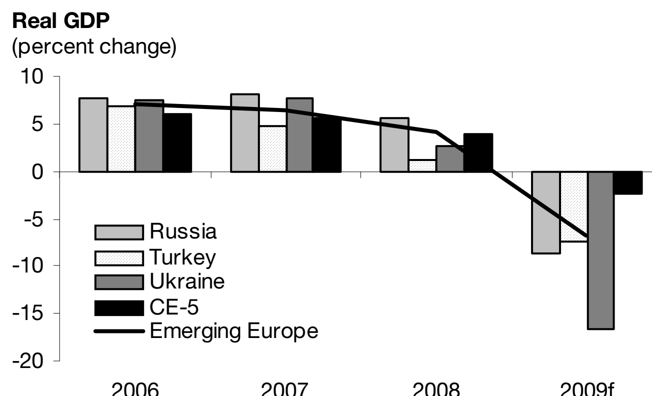
- Emerging Europe has been hit hard this year by weakened foreign demand and by scarcer and more expensive foreign exchange liquidity. Recovery looks likely to be constrained next year by still sluggish foreign demand, which is likely to remain limited by ongoing deleveraging and little scope for further fiscal easing after sizable deteriorations in public finances this year. Domestic spending will be constrained by the same factors, together with increases in unemployment from 9 percent on average early this year and much slower expansions of credit or outright contractions after the strong increases of recent years.

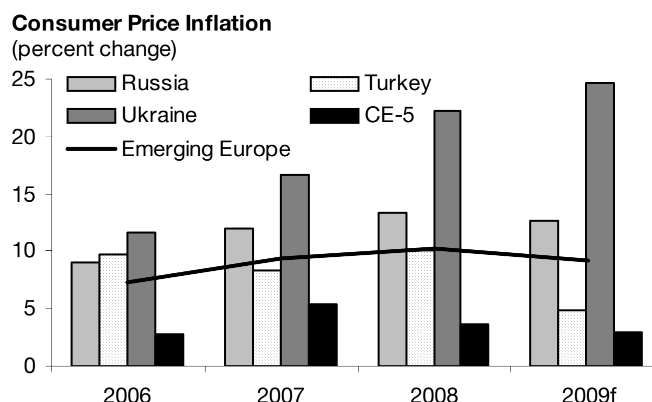
- After growing 6 percent a year from 2003 to 2008, aggregate real GDP looks set to contract by 7 percent this year in the eight larger economies in central and eastern Europe as Euro area real GDP contracts by 4 percent. Output declines are likely to be largest in Russia, Turkey and especially Ukraine, but much smaller in the Czech Republic and Poland. Large currency depreciations and decreases in investment and consumption will reduce imports more than exports this year. In the first quarter, indeed, import volumes fell an aggregate 29 percent from a year before while export volumes dropped 24 percent.

- Reduced current account deficits are likely to be accompanied by a shift of foreign private capital to an aggregate net outflow of $27 billion this year from net inflows of $241 billion in 2008 and $396 billion in 2007. Net inflows are likely to be sustained in central Europe, but reverse sharply in Russia, Turkey and Ukraine. Foreign commercial banks look likely to receive net repayments of as much as $65 billion, mainly from companies and locally owned banks, even though foreign parent banks active in the region have sustained or increased exposures to their own local subsidiaries, boosting capital as needed.

- Cyclical revenue weakness will widen fiscal deficits and narrow surpluses this year despite sizable spending cuts in most countries to cope with tightened financing constraints and meet IMF program targets. Scope to reduce interest rates should grow as a result of expanded IMF and other official support, especially if global risk appetite continues the recent improving trend. Central banks, however, will want to avoid renewed exchange rate weakness.

- With activity sharply reduced and foreign exchange liquidity shortages persisting despite IMF support for several countries, banking sector concerns are likely to grow. Credit losses will rise, especially among corporations, whose revenues have been hit hard by export losses. Credit quality among household borrowers has been much stronger, except perhaps for credit card claims and on foreign exchange loans in the countries further east whose currencies have weakened the most.





External Financing[1]
($ billion)

	2006	2007	2008	2009f
Private flows	223.9	396.1	241.4	-26.7
Equity investment	49.1	81.0	50.4	43.7
Direct investment	48.5	75.3	70.4	48.4
Portfolio investment	0.6	5.7	-19.9	-4.7
Private creditors	174.9	315.0	191.0	-70.4
Commercial banks	107.9	211.4	117.3	-65.2
Other private creditors	67.0	103.6	73.7	-5.2
Official flows	-27.2	-3.7	10.5	37.6
IFIs	-3.3	-2.5	14.5	32.5
Official bilateral creditors	-23.9	-1.2	-4.1	5.2
Resident lending/other[2]	-93.9	-173.5	-254.3	-107.2
Reserves (- = increase)	-127.7	-190.9	33.0	127.6

[1] Net financing.

[2] Including net lending, monetary gold and errors and omissions.

f = IIF forecast

CE-5: Czech Republic, Poland, Hungary, Romania and Bulgaria

A Difficult Outlook as Economic Activity Falters and Financial Strains Persist

Hit hard by sharply tighter global liquidity and the severity of the downturn in the Euro area, real GDP looks set to contract across emerging Europe in 2009. Global credit strains have depressed domestic spending and slowed activity by undercutting foreign demand and trade financing and by constraining the ability of local banks to sustain the strong domestic credit expansions of recent years. With access to foreign exchange liquidity sharply curtailed as global credit stresses have persisted, bank have begun to conserve liquidity and capital by reining in new lending as worries about credit losses have grown. Tight credit will reinforce contractionary pressures as governments trim spending to contain the fiscal deteriorations caused by cyclical revenue weakness. Increased financial support from the IMF and tentative improvements in confidence are likely to provide some scope for further measured monetary easing in most of the region, but only if further rate cuts do not trigger renewed currency weakness.

Reductions in import volumes look likely to exceed those in export volumes this year across the region. Narrower current account deficits should be broadly offset, however, by the erosion of Russia's surplus due to sharply reduced energy exports. Private capital flows look likely to recover from an especially weak first quarter, but still look set to shift to an aggregate net outflow of $27 billion this year as a whole from net inflows averaging $275 billion from 2005 to 2008. Banks abroad are set to receive as much as $65 billion in net repayments, half the average of yearly net disbursements from 2005 to 2008. Two-thirds of this year's net repayments to foreign banks will be by Russian banks and companies and most of the rest by borrowers in Turkey and Ukraine. **Net inflows of foreign private capital should be sustained in central Europe, supported by ongoing FDI and continued backing from foreign parent banks for their subsidiaries.**

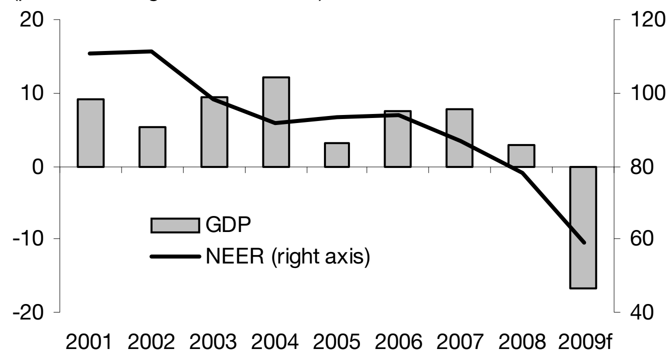
- **Ukraine** will face the greatest strain this year among the eight larger countries in emerging Europe with real GDP set to fall as much as 17 percent. Sharply reduced import volumes look likely to cut the current account deficit as much as four-fifths from 8 percent last year, despite markedly worsened terms of trade. External debt servicing will remain problematic, given the loss of access to private markets for most borrowers. Even assuming optimistically that policies are kept on track for the remainder of 2009, allowing the full disbursement of the $17 billion in official credit promised this year under the IMF program, as much as one-third of $36 billion in private creditors' claims maturing this year may end up in arrears or restructuring. Loan losses will require recapitalization of most locally and foreign-owned banks.

- Steadier economic policies and ample foreign exchange reserves, losses since August notwithstanding, leave

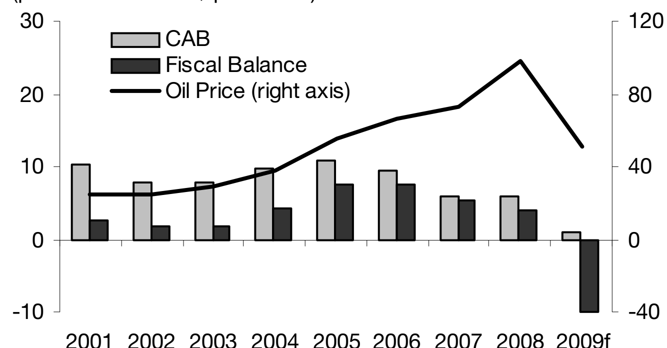
Real GDP
(percent change)

	2006	2007	2008	2009f
Emerging Europe	7.0	6.5	4.1	-6.9
(EU countries)	(6.0)	(5.5)	(3.9)	(-2.3)
Bulgaria	6.3	6.2	6.0	-3.7
Czech Republic	6.8	6.0	3.2	-2.0
Hungary	4.0	1.1	0.5	-6.0
Poland	6.2	6.7	4.9	-1.0
Romania	7.9	6.2	6.6	-4.0
Russia	7.7	8.1	5.6	-8.7
Turkey	6.9	4.7	1.1	-7.5
Ukraine	7.4	7.7	2.7	-16.7

Ukraine: Real GDP and Nominal Effective Exchange Rate
(percent change and 2005=100)



Russia: Current Account Balance, Fiscal Balance and Oil Price
(percent GDP and $ per barrel)



f = IIF forecast

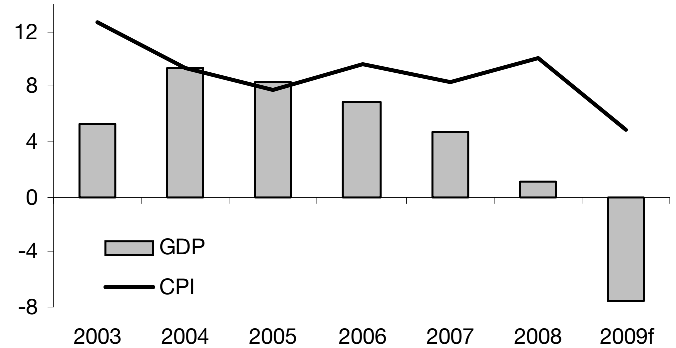
Russia better off than Ukraine despite a still larger drop in its terms of trade and the need to repay to foreign lenders much of the outsized borrowing undertaken in 2006 and 2007. Using one-third of nearly $600 billion in reserves at their peak last August to help fund foreign debt repayments and provide liquidity and capital for banks, the Russian authorities let the ruble weaken by one-third against a dollar/euro basket from November through March. Strong steps to tighten monetary policy and restrict liquidity have steadied the currency since. Whether further adjustment can be avoided will depend on how tight monetary policy is kept over the remainder of the year, when the government swings to a sizable deficit and natural gas export receipts decrease further, given the lagged link of their prices with those for oil.

- Slack exports and large contractions in consumption and investment leave real GDP likely to fall 7-8 percent this year in **Turkey.** Weaker imports, meanwhile, look set to narrow the current account deficit to 1 percent of GDP this year as a whole. Agreement on a new IMF stand-by arrangement is needed, all the same, to limit external financing risks and sustain market confidence, the buoyancy of which has helped contain both depreciation pressures and borrowing costs. Benign market conditions may tempt the government to defer agreeing a new IMF program, especially if the IMF continues to push for substantial fiscal tightening this year. Without an IMF program soon, lira weakening may be difficult to avoid, especially if slowing inflation prompts further interest rate cuts.

- In central Europe, economic prospects look most challenging in **Hungary,** where real GDP is likely to contract 6 percent or more, further complicating the fiscal consolidation targeted by the IMF program. Forint weakness will limit scope for monetary easing, as will the higher headline inflation likely to result from indirect tax hikes. Near-term financial risks should be contained, with the current account deficit likely to ease to 2½ percent of GDP and ample official financing available. Risk perceptions will deteriorate next year, however, if the approach of parliamentary elections and the expiration of the IMF program, both set for April, trigger worries of renewed fiscal easing.

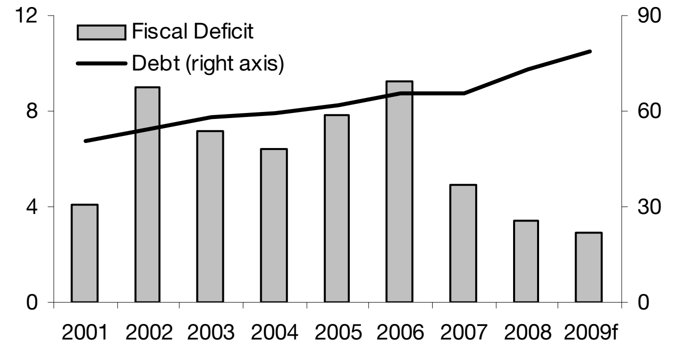
- Marked fiscal tightening under the recently agreed IMF stand-by arrangement and sharply slower growth in bank lending are likely to cut real GDP 4 percent this year in **Romania**. Inflation should ease as a result and the current account deficit nearly halve to 6½ percent of GDP. Financing available under the IMF program should help bolster market confidence, enabling the leu to recover some of its losses and the central bank to begin easing monetary policy. Fiscal slippage cannot be ruled out, however, ahead of the November presidential election, which could trigger the suspension of IMF lending and renewed leu weakness.

Turkey: Real GDP and Consumer Prices[1]
(percent change and 12-month percent change)

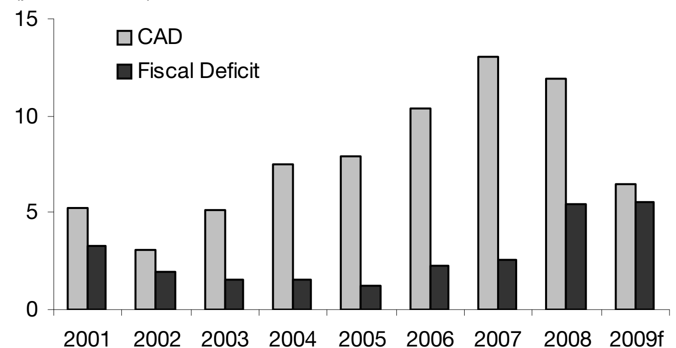


[1] December-December.

Hungary: Government Deficit and Debt
(percent GDP)



Romania: Current Account Deficit and Fiscal Deficit
(percent GDP)



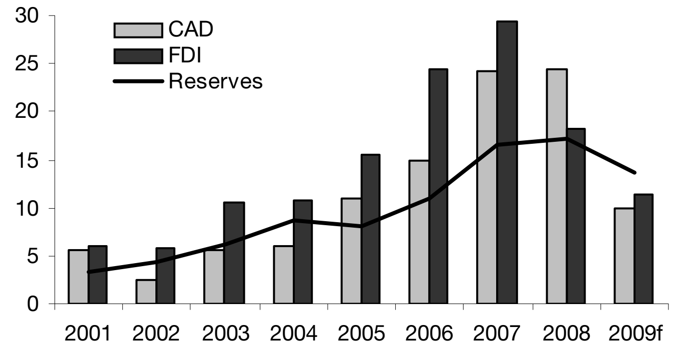
f = IIF forecast

- Weak foreign demand and reduced capital inflows are likely to cause real GDP to decrease as much as 3.7 percent this year in **Bulgaria**. Sharply contracting investment and faltering consumption should slow inflation markedly and help narrow the current account deficit to around 10 percent of GDP from 23 percent in 2008. Together with ample foreign exchange and fiscal reserves, broad-based political consensus on the need to sustain fiscal surpluses makes likely the substantial real adjustment needed to absorb financial pressures without recourse to the IMF for financial support. Confidence in the currency board arrangement will be sustained over the longer term if banks' credit losses are well contained, giving no grounds for deposit flight and the associated depreciation pressures. These look likely to remain the greatest threat to the currency board arrangement, were they to materialize.

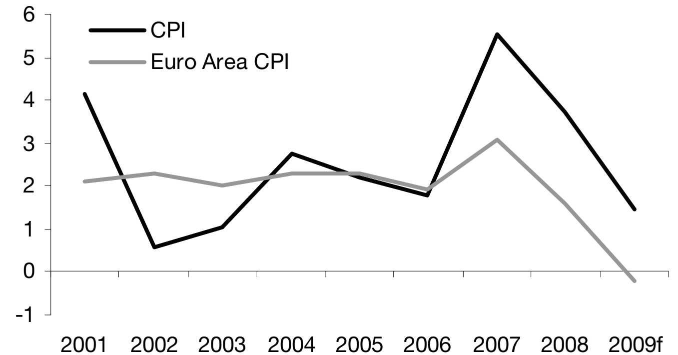
- Supported by more accommodative fiscal and monetary stances than elsewhere in the region, real GDP should fall by only 2 percent this year in the **Czech Republic** despite the predominance of automobiles in output and exports. Cyclical revenue weakness and stimulus measures look set to more than triple the fiscal deficit to nearly 5 percent of GDP. Even though interest rates have been now cut to 1½ percent, growing economic slack has moderated price pressures, with 12-month inflation set to slow toward nil by midyear. Sharply reduced exports, meanwhile, leave the current account deficit likely to nearly double to 4 percent of GDP. Financial pressures should remain less than in other countries, given the surplus of bank deposits over bank loans, the limited amount of foreign exchange loans to domestic borrowers and low levels of government and foreign debt. The deteriorating fiscal position, however, has caused borrowing spreads to widen substantially since the start of the year.

- Stronger momentum in domestic spending and a smaller decline of exports, thanks partly to the sharp weakening of the now undervalued zloty, suggest that economic activity will slow much less this year in **Poland** than elsewhere in the region. Domestic demand will be less constrained by fiscal tightening than seemed likely earlier, with the government now disinclined, it appears, to pursue the quick ERM-2 entry seen earlier this year as a solution to excessive depreciation pressures. With tighter lending standards likely to slow credit expansion despite the relatively limited dependence of banks on foreign financing, real GDP may contract 1 percent this year. Despite growing economic slack, zloty depreciation since last year looks likely to keep inflation in the upper half of the central bank's 2½ percent, ±1 percent target range. Further interest rate reductions are likely, as a result, only if they are consistent with keeping the zloty near its recent level.

Bulgaria: Current Account Deficit, FDI and Reserves
(percent GDP and $ billion)

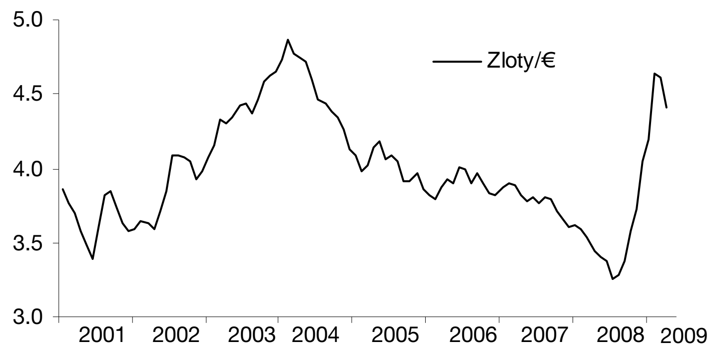


Czech Republic: Consumer Prices[1]
(12-month percent change)



[1] December-December.

Poland: Exchange Rate
(zloty per euro)



f = IIF forecast

Deeper Contractions of Output and Demand Have Tempered Inflation Despite Currency Weakness

Amid tightened financing constraints, weaker foreign and domestic demand intensified output contractions in early 2009. Aggregate regional GDP appears to have dropped 7.7 percent from a year earlier during the first quarter after decreasing 0.8 percent from a year before during the fourth quarter of 2008 and growing 4 percent last year as a whole. Despite weaker exchange rates, price pressures eased over the same period due to increased economic slack, lower energy prices and smaller increases in food prices.

- Output contraction has been steepest in **Ukraine** and **Russia**, thanks to sharply lower commodity export prices and large reversals of capital inflows. First-quarter real GDP appears to have dropped 18 percent from a year before in **Ukraine** as steel prices and exports fell further and foreign financing was cut off for many companies and banks. Bank credit contracted in **Russia** as well, combining with sharply reduced energy earnings and massive cutbacks by firms under pressure to repay debt. Real GDP dropped 9½ percent from a year before as a result, shifting from year-on-year increases of 1.2 percent in the fourth quarter and 5.6 percent last year as a whole. Large depreciations have offset slower increases in food prices since August, keeping 12-month inflation in March at 18 percent in **Ukraine** and 14 percent in **Russia**.

- With domestic spending in **Turkey** already having slumped since March 2008 in response to marked monetary tightening, weaker exports, investment cutbacks and rising unemployment are likely to have resulted in a year-on-year drop in first-quarter real GDP of as much as 9-10 percent. Domestic demand remained weak despite a surge in government spending ahead of local elections in March. Progress reducing inflation has been impressive, with 12-month inflation slowing to less than this year's 7 percent target, enabling interest rates to be cut to single digits.

- Slack domestic spending and lower exports are likely to have cut real GDP by 6 percent from a year before in **Hungary** during the first quarter. With markedly procyclical fiscal tightening to comply with IMF program targets and efforts to exit the EU's excessive deficit procedure, and with bank lending constrained by pressures on bank capital and liquidity and the need to refinance domestic foreign exchange exposures, households and firms have cut spending sharply. Demand pressures have weakened enough, as a result, to slow 12-month inflation to less than 3 percent by March from more than 7 percent early last year even though the forint weakened by 25 percent against the euro through March from its July peak.

Real GDP
(12-month percent change)

	2007	2008	2008		2009
			Q3	Q4	Q1e
Emerging Europe	6.6	4.0	4.5	-0.8	-7.7
(EU countries)	(5.5)	(3.9)	(4.2)	(1.5)	(-1.5)
Bulgaria	6.2	6.0	6.8	3.5	-2.5
Czech Republic	6.0	3.2	4.0	0.2	-2.2
Hungary	1.1	0.5	0.8	-2.3	-5.9
Poland	6.7	4.9	5.0	3.0	0.5
Romania	6.2	7.0	9.2	2.9	-4.5
Russia	8.1	5.6	6.0	1.2	-9.5
Turkey	4.7	1.1	1.2	-6.2	-9.5
Ukraine	7.7	2.7	7.1	-7.9	-18.3

Domestic Demand
(12-month percent change)

	2007	2008	2008		2009
			Q3	Q4	Q1e
Emerging Europe	10.7	6.4	7.3	0.2	-9.8
(EU countries)	(6.4)	(3.7)	(3.3)	(2.1)	(-3.1)
Bulgaria	9.7	7.2	8.0	3.2	-10.7
Czech Republic	5.3	1.2	-0.1	2.1	-0.5
Hungary	-1.0	-0.1	0.3	-2.6	-7.1
Poland	8.6	5.5	4.9	3.7	-1.8
Romania	15.0	7.8	10.6	-2.3	-10.9
Russia	15.2	11.0	12.7	4.8	-9.8
Turkey	5.7	-0.5	-0.5	-10.7	-13.8
Ukraine	16.3	10.4	15.2	-3.9	-29.5

Consumer Prices
(12-month percent change)

	2007	2008			2009
		Q2	Q3	Q4	Q1
Emerging Europe	9.6	12.3	12.0	10.4	9.9
(EU countries)	(5.4)	(6.1)	(5.6)	(3.7)	(3.3)
Bulgaria	12.5	15.3	11.0	7.6	4.9
Czech Republic	5.5	6.9	6.7	3.7	2.3
Hungary	7.4	6.7	5.7	3.5	2.9
Poland	4.0	4.6	4.5	3.3	3.6
Romania	6.7	8.7	7.3	6.3	6.7
Russia	11.9	15.2	15.1	13.3	14.1
Turkey	8.4	10.6	11.1	10.1	7.9
Ukraine	16.6	29.3	24.6	22.3	18.1

e = IIF estimate

- A smaller but still substantial year-on-year contraction is likely to have occurred in **Romania**, where first-quarter real GDP probably fell 4½ percent from a year earlier. This represented a sharper turnaround than in the rest of central Europe, given growth last year as a whole of 7 percent. Exports were hit by the drop in foreign demand, but not markedly more than elsewhere. Domestic spending was hit by a sharper deceleration of bank lending, which has all but ceased after growing 43 percent, adjusted for exchange rate changes, in the 12 months through September. Leu weakening, however, caused 12-month inflation to rise to 6.7 percent by March from 6.3 percent in December.

- Output contraction has been more moderate in **Bulgaria,** amounting to perhaps 2½ percent from a year before during the first quarter. The year-on-year decline in export volumes was smaller than in much of the rest of the region, thanks partly to newly expanded capacity and despite sizable competitiveness losses vis-à-vis countries with currency depreciations barred in Bulgaria by the currency board arrangement. Domestic spending was also supported by rising government spending, which narrowed the fiscal surplus substantially last year and further from a year before during the first quarter. Smaller increases in food prices and lower energy prices helped slow 12-month inflation to 5 percent by March from a 15 percent peak last June.

- More resilient domestic spending is likely to have limited the year-on-year decline in real GDP to 2 percent during the first quarter in the **Czech Republic** despite the adverse effect of sharply weaker foreign demand, especially for automobiles. Domestic demand has held up better than in the rest of the region, thanks partly to increased government spending and the more limited role of foreign exchange lending and foreign funding for banks. Twelve-month inflation decreased further, slipping to 2.3 percent in March from a peak of 6.9 percent in July 2008. The March figure was higher than in January and February, thanks to substantial koruna weakening since October.

- Buoyant domestic demand until recently and a smaller year-on-year contraction in export volumes left **Poland** as the sole country in the region where real GDP is likely to have risen in year-on-year terms during the first quarter. In seasonally adjusted terms, output is likely to have contracted, but only perhaps by 1 percent, less than any other country in emerging Europe. Low unemployment and buoyant real wage incomes kept core inflation on an upward trend until recently, even as smaller increases in food prices led 12-month headline inflation to ease to just within the central bank's 2½ percent, ±1 percent target range by December. Larger food price increases and a 30 percent depreciation against the euro after July pushed the 12-month figure above the target range again by March.

Unemployment
(percent)

	2007	2008	2008		2009
			Q3	Q4	Q1e
Emerging Europe	7.6	7.4	7.0	8.1	8.9
(EU countries)	(8.1)	(6.7)	(6.6)	(6.5)	(7.2)
Bulgaria	6.9	5.9	5.2	6.0	7.1
Czech Republic	5.3	4.7	5.3	4.4	5.0
Hungary	7.4	7.8	7.7	8.0	9.7
Poland	9.6	7.2	6.9	6.9	7.4
Romania	6.4	5.9	5.6	6.1	6.7
Russia	6.2	6.4	5.9	7.1	8.4
Turkey	9.9	10.6	9.8	12.3	12.2
Ukraine	7.2	6.9	6.5	6.9	7.5

Export Volume
(12-month percent change)

	2007	2008	2008		2009
			Q3	Q4	Q1e
Emerging Europe	8.9	5.4	8.7	-4.9	-23.6
(EU countries)	(12.4)	(5.7)	(7.1)	(-9.1)	(-21.7)
Bulgaria	9.1	9.8	9.8	-7.1	-17.9
Czech Republic	14.1	4.3	6.4	-12.4	-21.4
Hungary	18.5	3.8	-0.5	-13.7	-28.3
Poland	7.1	6.5	10.2	-4.5	-16.8
Romania	13.5	10.2	14.7	-6.3	-26.4
Russia	4.5	5.3	8.4	0.7	-28.6
Turkey	9.1	3.6	10.1	-11.1	-17.4
Ukraine	11.1	7.2	20.6	4.6	-17.6

Import Volume
(12-month percent change)

	2007	2008	2008		2009
			Q3	Q4	Q1e
Emerging Europe	17.0	9.2	11.6	-2.8	-28.6
(EU countries)	(15.5)	(4.7)	(6.4)	(-8.5)	(-24.8)
Bulgaria	17.2	4.1	2.9	-15.8	-31.3
Czech Republic	14.6	3.5	2.4	-7.5	-20.7
Hungary	11.0	5.5	4.6	-9.2	-28.3
Poland	14.7	5.0	9.1	-6.5	-21.1
Romania	25.0	5.0	11.2	-10.9	-33.4
Russia	24.9	21.8	22.0	20.0	-29.5
Turkey	9.3	0.0	1.0	-19.7	-34.6
Ukraine	19.6	21.3	40.2	0.3	-38.7

e = IIF estimate

Narrower Current Accounts Accompany Reduced Capital Inflows

Lower energy prices and sharper declines in import volumes than in export volumes helped narrow current account imbalances markedly across emerging Europe in early 2009. Reductions in import volumes from a year earlier ranging from one-fifth to one-third appear to have helped shrink the aggregate first-quarter current account shortfall of the five larger emerging economies in central Europe to 0.8 percent from 4.9 percent a year before and from 6.5 percent last year as a whole. A larger decrease in **Ukraine's** deficit and a shift in **Turkey** to near balance are likely to have more than offset a sharp decline in **Russia's** current account surplus, shifting the aggregate regional current account back to slight surplus in the first quarter from similarly modest deficits near 1 percent of aggregate GDP last year as a whole.

- **Bulgaria** is likely to have registered the sharpest shift in its current account, with its shortfall shrinking to 10½ percent of GDP in January-March from 26 percent a year before and 25 percent last year as a whole. The reduction in **Romania's** deficit, to perhaps 4½ percent of GDP from 15½ percent a year before was less than half as large. **Turkey's** deficit narrowed to 0.9 percent of GDP from 7 percent a year before. **Russia's** surplus declined by a similar magnitude to 4 percent of GDP during the first quarter as energy export prices fell and the natural gas pricing dispute with **Ukraine** contributed to a 30 percent year-on-year drop in export volumes.

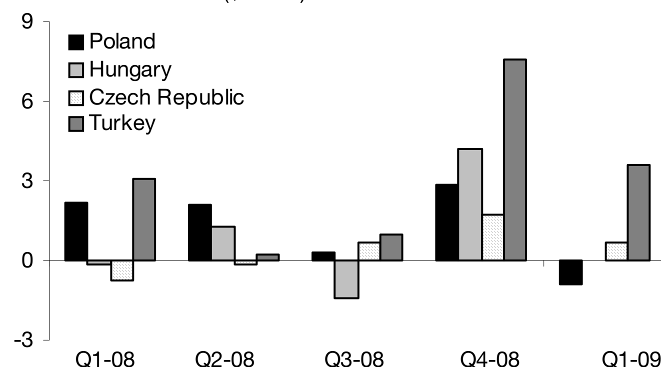
- Estimates of current account balances and reserve transactions suggest that net capital to the region has reversed to an outflow of $42 billion during January-March from a net inflow of $9 billion a year earlier. Within these totals, foreign investors and lenders may have withdrawn $10 billion during January-March, mainly as a result of foreign debt repayments by banks and companies in **Russia** and **Ukraine** (and in **Turkey,** to a lesser extent) and further net sales of portfolio equity and local currency government securities. FDI inflows are likely to have nearly halved from $41 billion a year earlier, as new investments were curtailed and profits and reinvested earnings fell. These factors were only partly offset by moves to boost capital among foreign banks' local subsidiaries, especially in **Ukraine**.

- Resident capital outflows appeared to have slowed to $33 billion during the first quarter, perhaps, from $81 billion a year earlier, including unrecorded items, and $338 billion last year as a whole. The slowdown mainly reflected a drop-off in Russia, where resident outflows surged to $99 billion during the fourth quarter. Reflows in **Turkey** reflected shifts into lira out of foreign exchange deposits and reflows of foreign assets held by companies to repay debt.

Current Account Balances
(percent GDP)

	2007	2008	2008 Q3	2008 Q4	2009 Q1e
Emerging Europe	-0.9	-0.8	0.0	-2.4	1.1
(EU countries)	(-6.3)	(-6.5)	(-6.2)	(-7.4)	(-0.8)
Bulgaria	-27.4	-24.6	-14.1	-29.8	-10.6
Czech Republic	-2.6	-2.2	-3.0	-5.2	0.2
Hungary	-5.3	-7.3	-8.8	-9.4	-1.8
Poland	-3.6	-4.3	-4.1	-5.0	1.0
Romania	-12.8	-12.1	-10.9	-8.3	-4.4
Russia	5.8	6.0	6.2	2.2	4.0
Turkey	-5.9	-5.6	-3.7	-3.9	-0.9
Ukraine	-4.2	-7.1	-3.7	-9.2	-4.3

Net Foreign Purchases of Government Securities Denominated in Local Currencies ($ billion)



Net Foreign Borrowing and Refinancing[1]
($ billion and percent)

	Net Foreign Borrowing[2] 2008Q4	Net Foreign Borrowing[2] 2009Q1	Refinancing Ratio[3] 2008Q4	Refinancing Ratio[3] 2009Q1
Emerging Europe	-68.4	-21.5	79	85
(EU countries)	(-5.4)	(-3.1)	(106)	(94)
Bulgaria[4]	0.5	-0.8	104	93
Czech Republic[4]	-3.9	-1.8	91	81
Hungary[5]	0.1	-0.6	127	100
Poland[4]	-5.3	2.3	97	108
Romania[4]	3.2	-2.2	128	74
Russia	-45.4	-10.1	52	73
Turkey	-13.5	-6.3	71	80
Ukraine	-4.1	-2.0	48	69

[1] Excluding IMF and EU disbursements; [2] Including portfolio debt; [3] Excluding portfolio debt; [4]January-February; [5] Q1 = IIF estimate.

e = IIF estimate

Mostly Procyclical Fiscal Tightening Will Contribute to Output Contraction and External Adjustment

Limited scope for deficit financing, wider borrowing spreads and IMF program targets will force most governments in emerging Europe to reduce spending to offset much of the large cyclical declines likely in revenues this year. Underlying fiscal stances look likely to ease only in **Russia** and the **Czech Republic**, where government debt is low, the fiscal reserve sizable (in Russia) and euro adoption accorded low priority (in the Czech Republic). Headline deficits should exceed budget targets everywhere, combining with falling output and depreciated exchange rates to boost government debt markedly, except in **Russia** and **Bulgaria**.

- Fiscal policy will be tightened the most this year in **Ukraine**. The 2009 budget calls for the deficit to be little changed from last year at 3 percent of GDP, but with real GDP likely to fall sharply, aggressive measures to boost revenues and trim outlays are needed to keep revenue losses from widening the deficit to double digits. After originally targeting fiscal balance this year, the IMF program was recently revised to allow a 4 percent of GDP deficit. Adjusting, however, for the cyclical drop in revenues, the target implies that the underlying fiscal stance will need to be tightened by 6.5 percent of GDP.

- In **Romania,** the new IMF program calls for the fiscal deficit to narrow slightly to 5.1 percent of GDP this year after nearly doubling in 2008. Weak revenues and the large pension hikes enacted last year will require sizable cuts in nonwage current outlays, caps on government wages and improved tax collection. A first-quarter deficit equal to 8 percent of GDP will necessitate a second round of spending cuts a third again larger than the 1.1 percent of GDP already agreed with the IMF. Spending cuts will be difficult before the November presidential election, leaving IMF lending at risk. Assuming deferred spending measures leave the deficit little changed from last year at 5½ percent of GDP, cyclically weaker revenues imply underlying fiscal tightening equal to 3 percent of GDP.

- To facilitate renewed capital market access and to assure exit next year from the EU's excessive deficit procedure, the new interim government in **Hungary** looks likely to adhere to the revised IMF program targets calling for the fiscal deficit to narrow to less than 3 percent this year. Politically difficult measures to abolish bonuses for government workers and pensioners look likely, along with additional spending cuts and a hike in the upper VAT tax rate. Net of cyclical effects and larger receipts of EU budget transfers, the underlying fiscal stance will need to tighten by nearly 3½ percent of GDP this year.

- In **Poland,** government efforts to accelerate ERM-2 entry and euro adoption were dealt a blow by data confirming that weak revenues and buoyant local government spending widened the fiscal shortfall to 3.9 percent of

General Government Balances[1]
(percent GDP)

	2006	2007	2008	2009f
Emerging Europe	1.7	1.2	0.4	-6.6
(EU countries)	(-3.9)	(-2.2)	(-3.4)	(-4.1)
Bulgaria	3.0	0.1	1.5	0.3
Czech Republic	-2.7	-1.0	-1.5	-4.8
Hungary	-9.3	-4.9	-3.4	-2.9
Poland	-3.9	-1.9	-3.9	-4.0
Romania	-2.2	-2.5	-5.4	-5.5
Russia[2]	7.9	5.6	4.6	-9.8
Turkey	-0.8	-2.4	-2.6	-5.6
Ukraine	-1.4	-2.0	-2.6	-4.5

[1] EU members: ESA95 basis. Russia, Turkey and Ukraine: cash basis.
[2] Excluding bank recapitilization costs.

Fiscal Impulse[1]
(percent GDP)

	2006	2007	2008	2009f
Emerging Europe	1.1	1.5	1.5	1.9
(EU countries)	(0.2)	(-0.2)	(0.5)	(-0.5)
Bulgaria	-0.5	-0.2	3.5	-1.4
Czech Republic	0.9	-1.1	1.0	2.0
Hungary	2.2	-2.5	-0.9	-3.6
Poland	-0.4	-0.5	1.8	-1.7
Romania	2.8	0.5	3.6	-2.9
Russia[2]	1.7	2.9	1.6	6.6
Turkey	0.8	1.6	1.0	-0.6
Ukraine	0.3	2.9	2.1	-6.5

[1] Decrease in fiscal surplus or increase in deficit net of cyclical effects, one-off items not affecting demand, net interest payments net receipts of EU transfers, pension reform costs and energy export taxes and other energy-related revenues (in Russia).

General Government Debt
(percent GDP)

	2006	2007	2008	2009f
Emerging Europe	27.2	24.4	23.5	28.7
(EU countries)	(40.9)	(39.4)	(41.5)	(44.9)
Bulgaria	22.6	18.2	14.3	17.0
Czech Republic	29.6	28.9	30.4	35.6
Hungary	65.6	65.8	73.0	78.6
Poland	47.7	44.9	47.1	49.8
Romania	17.0	19.9	21.7	27.2
Russia	8.2	7.1	6.3	8.5
Turkey	46.0	39.4	37.7	44.0
Ukraine	13.6	12.4	11.9	17.1

f = IIF forecast

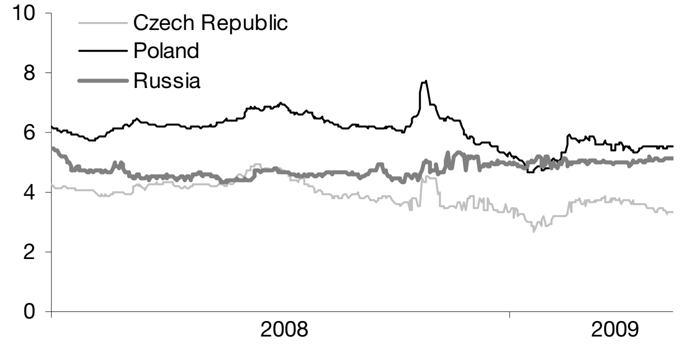
GDP last year from 1.9 percent of GDP in 2007. With the drop in Euro area output making a decline in real GDP in **Poland** difficult to avoid, weak revenues and efforts to increase infrastructure outlays will make it hard to reduce the deficit this year. Keeping the deficit little changed at 4 percent of GDP, meanwhile, implies an underlying tightening equal to 1.7 percent of GDP, assuming a 1 percent decline in real GDP and factoring in increases in receipts of EU budget transfers similar to those likely in other new EU member states.

- Revenues in **Bulgaria** will fall short of target by more than 3 percent of GDP, with real GDP likely to fall this year as much as 3.7 percent rather than increase 4.5 percent as the budget assumes. Doubling last year's 1.5 percent of GDP surplus (as the budget targets) looks unlikely, with provisions currently in effect limiting allocations to 90 percent of budgeted amounts (for items other than wages and pensions) likely to offset roughly only half the shortfall. Additional spending cuts equal to 1½ percent of GDP will be needed, but are likely to be deferred until after parliamentary elections in July. Cuts adequate to keep the surplus from shifting to deficit imply an underlying tightening of 1½ percent of GDP.

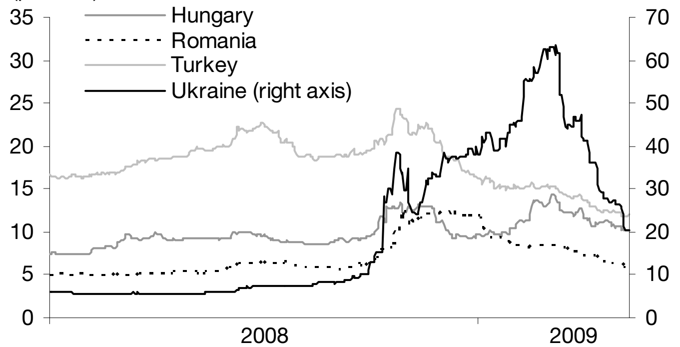
- In **Turkey,** plans to widen the noninterest surplus from 1.8 percent of GDP last year have been put on hold. Weak revenues and spending overruns resulted in a first-quarter noninterest deficit equal to 1.6 percent of GDP and an overall deficit of 8 percent of GDP, compared with 2.6 percent last year as a whole. With real GDP set to fall 7-8 percent, spending will have to be cut by 3½ percent of period GDP over the remainder of the year just to narrow the noninterest deficit to balance this year as a whole. Agreement on a new IMF stand-by arrangement will likely require still larger spending cuts, tightening the underlying fiscal stance by 0.6 percent of GDP, as well as a meaningful fiscal rule and tax reforms to reduce reliance on high indirect taxes.

- Underlying fiscal easing looks likely this year, by contrast, in the **Czech Republic,** where weak revenues and 1½ percent of GDP in additional spending look set to widen the fiscal deficit to nearly 5 percent of GDP, and in **Russia**, where the revised budget calls for the federal government to shift to a 7.4 percent of GDP deficit this year from a 4 percent surplus in 2008. Assuming real GDP in **Russia** falls by 8¾ percent, rather than the 2 percent assumed in the budget, and Brent crude averages $55 a barrel, a 10 percent of GDP deficit looks more likely. Spending is slated to increase 10 percent in real terms, or by 2 percent of GDP, mainly to recapitalize banks, assist troubled enterprises and boost social support. Net of cyclical effects and the drop in revenues due to energy exports, which tax foreigners in effect, the underlying fiscal stance looks set to ease by 6½ percent of GDP, more than three times as much as in the **Czech Republic**.

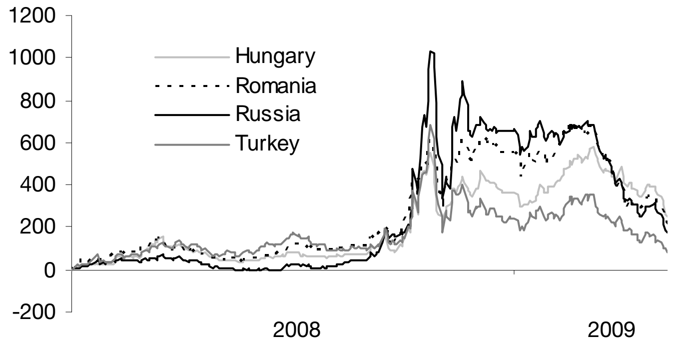
Benchmark Bond Yields
(percent)



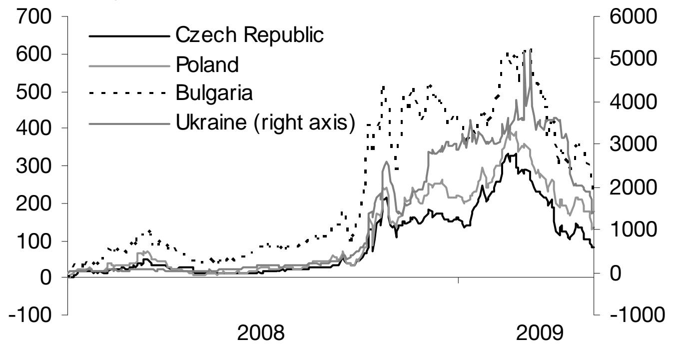
Benchmark Bond Yields
(percent)



5-year CDS Spreads
(bps change from Jan. 1, 2008)



5-year CDS Spreads
(bps change from Jan. 1, 2008)



Procyclical Credit Tightening Because of Liquidity Stresses, Capital Strains and Exchange Rate Risks

A tentative improvement in risk appetites has helped ease financial market pressures since March, providing more scope for further monetary easing. Currencies have firmed across the region from early March lows in response to stronger statements from central banks that they would act to support exchange rates and in response to the increased official support signaled by IMF agreements on a stand-by arrangement for **Romania** and a new flexible credit line for **Poland.** Earlier depreciations, however, more than reversed strong appreciations under way until last summer, leaving real effective exchange rates below trend and likely equilibria in most cases. Except for **Bulgaria**, where the lev remains pegged to the euro, weaker exchange rates should help facilitate external adjustment and spur output recovery when foreign demand begins to revive.

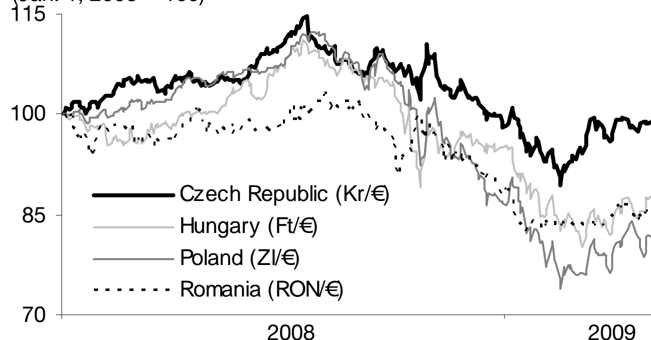
- Currency pressures were sparked initially by foreign investors' need to withdraw liquid assets and by net debt repayments from borrowers unable to refinance maturing debts. Currency selling intensified when markets concluded that mounting output weakness would lower inflation enough that strong exchange rates would no longer be needed by inflation-targeting central banks. This conviction was reinforced by earlier substantial cuts in interest rates triggered by improved inflation outlooks and signs of weakening output. Lower interest rates contributed to weaker demand for the region's currencies by narrowing risk premia when economic and financial risks were judged to be rising.

- Believing depreciation pressures were greater than justified by fundamentals, central banks in central Europe moved in March to make clear that they were prepared to act as needed, including by raising interest rates, to forestall excessive exchange rate weakness. In part, this was aimed at reassuring foreign investors that holdings of government bonds denominated in local currencies were not at ongoing risk. Central banks were also concerned with limiting the contractionary effects of further depreciation on domestic demand where households and companies held significant amounts of unhedged foreign exchange debt.

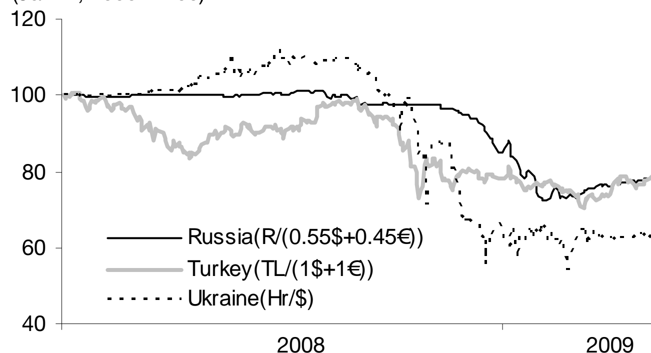
- Rate cuts resumed in May once financial market pressures eased. Policy interest rates have been cut by 200 basis points or more since November in **Poland,** the **Czech Republic** and **Hungary**. (Cuts in **Hungary** followed a 300 basis point hike in October before agreement was reached on €20 billion in financial support from the IMF, the EU and the IBRD.)

- After having been hiked substantially in January, interest rates have been cut only marginally in **Russia** since and not at all in **Ukraine**. Depreciation pressures in both countries were reinforced by external debt repayments and asset outflows funded partly by liquidity

Exchange Rates
(Jan. 1, 2008 = 100)



Exchange Rates
(Jan. 1, 2008 = 100)



Central Bank Policy Rates
(percent)

	2008			2009	
	Jun	Sep	Dec	Mar	May[1]
Bulgaria	5.0	5.2	5.8	3.5	2.3
Czech Republic	3.8	3.5	2.3	1.8	1.5
Hungary	8.5	8.5	10.0	9.5	9.5
Poland	6.0	6.0	5.0	3.8	3.8
Romania	10.0	10.3	10.3	10.0	9.5
Russia	10.8	11.0	13.0	13.0	12.5
Turkey	16.3	16.8	15.0	10.5	9.8
Ukraine	12.0	12.0	12.0	12.0	12.0

[1] May 11, 2009.

support from the government and central bank. With leu selling reflecting mainly growing worries about the fiscal deficit, **Romania's** policy interest rate was lowered only 25 basis points until last week's 50 basis point cut, enacted after the approval of its IMF program .

- In **Turkey,** the lira has been more resilient despite 700 basis points in cuts in the central bank's policy interest rate since October to 9¾ percent. Supported by a shift among residents into lira-denominated assets and by sizable resident capital reflows, the lira has recovered to nearly its October level against a $1/€1 basket after weakening 10 percent through March. Recent declines in foreign exchange reserves suggest, however, that capital reflows have tapered off, limiting scope for further interest rate cuts if agreement is not reached soon on a new IMF program.

- Liquidity concerns and capital pressures have brought credit expansion to a halt despite interest rate cuts. Credit to nongovernment borrowers fell 1 percent during the first quarter for the region as a whole, adjusted for exchange rate changes, after slowing to an increase of 2 percent in the fourth quarter from 8 percent a quarter on average earlier in the year. Twelve-month increases slowed to 17 percent as a result for the region by March from 29 percent in 2008 and 48 percent in 2007. Credit fell in six countries during the first quarter, thanks to weak borrowing demand, as in **Turkey** and **Romania**, or reduced funding, as in **Russia** and **Ukraine**.

- Financial pressures have been strongest for banks in **Russia** and **Ukraine**, where capital outflows and deposit withdrawals have been accompanied by losses from open foreign exchange positions among lenders and borrowers as currencies have weakened. Financial stresses have been more limited, by contrast, in central Europe and **Turkey**, where most banks are foreign-owned and supervision is more rigorous.

- Growing concerns about deteriorating loan portfolios are contributing to the curtailment of bank lending. Nonperforming loans have risen, but not yet substantially, among most banks, especially in central Europe and **Turkey**. Further and larger increases look likely this year and next. Loss provisions have risen even more as banks have sought to build capital buffers to cover future write-offs. Market concerns about refinancing risks and capital needs will leave domestic banks reluctant to expand credit anytime soon. Loan losses look likely to be much larger among corporations hard hit by weaker revenues, than among households, where credit quality has generally remained much stronger, except for credit card claims (mostly denominated in local currency), and on foreign exchange loans in the countries further east whose currencies have weakened the most.

Loans to Nongovernment Borrowers
(12-month percent change)

	2007	2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar
Emerging Europe	45.2	46.7	44.5	39.0	28.7	16.6
(EU countries)	(36.6)	(37.7)	(36.0)	(32.6)	(25.9)	(17.5)
Bulgaria	62.5	55.5	52.0	46.6	31.6	24.0
Czech Republic	29.1	28.5	26.9	23.8	17.1	12.3
Hungary	19.9	22.8	19.7	17.8	11.7	6.6
Poland	36.0	37.3	37.0	34.6	30.9	21.9
Romania	57.6	59.3	52.6	42.9	27.8	13.9
Russia	52.2	53.6	50.0	42.3	32.4	18.8
Turkey	34.7	36.9	38.7	35.7	21.1	7.5
Ukraine	74.6	75.8	66.9	56.5	35.1	15.9

Real Effective Exchange Rates
(2005=100)

	2007	2008	2008		2009
			Q3	Q4	Q1
Bulgaria	129.8	141.7	141.5	144.0	146.3
Czech Republic	127.0	144.5	148.3	141.9	134.1
Hungary	134.3	138.0	146.1	132.4	121.3
Poland	109.3	119.3	125.5	112.8	96.3
Romania	137.2	130.8	133.6	128.1	118.5
Russia	164.6	175.6	176.2	181.6	157.0
Turkey	115.0	117.9	123.3	112.4	107.1
Ukraine	115.4	124.4	129.4	124.5	109.2

Real Effective Exchange Rates vs. Trend
(percent change)

	Latest 12- Trend	April vs. Peak[1]	April vs. Trend	Peak vs. Trend[1]
Bulgaria	5.1	... (Apr)	2.5	...
Czech Republic	4.2	-7.7 (Jul)	-0.5	9.9
Hungary	-1.2	-17.2 (Jul)	-3.7	13.9
Poland	-2.5	-22.2 (Jul)	-5.5	16.2
Romania	-2.4	-8.9 (Aug)	-2.4	4.5
Russia	0.2	-13.0 (Nov)	-1.4	12.0
Turkey	1.8	-13.6 (Aug)	-6.3	9.3
Ukraine	0.7	-23.3 (Oct)	-6.9	21.1

[1] Peak is last year's peak.

Bulgaria Outlook	2006	2007	2008	2009f
Real GDP, % change	6.3	6.2	6.0	-3.7
Consumer prices, % change[1]	6.6	12.5	7.6	2.8
General gov't balance, % GDP	3.0	0.1	1.5	0.3
Current account balance, % GDP	-14.9	-24.1	-24.3	-9.9
Reserves excluding gold, $ billion	10.9	16.6	17.2	13.7
(Months' imports)[2]	(4.7)	(5.3)	(4.4)	(5.2)
	(percent change)			
Export volume	13.8	10.1	13.5	-10.0
Import volume	16.1	15.0	9.2	-19.8
Terms of trade	2.0	-0.5	-5.7	-3.0
Real effective exchange rate[3]	4.5	4.9	9.2	2.6

Romania Outlook	2006	2007	2008	2009f
Real GDP, % change	7.9	6.2	6.6	-4.0
Consumer prices, % change[1]	4.9	6.7	6.3	4.5
General gov't balance, % GDP	-2.2	-2.5	-5.4	-5.5
Current account balance, % GDP	-10.4	-12.8	-11.6	-6.6
Reserves excluding gold, $ billion	28.1	37.0	36.5	30.1
(Months' imports)[2]	(6.2)	(6.0)	(5.0)	(5.6)
	(percent change)			
Export volume	7.7	6.5	6.9	-8.8
Import volume	22.9	27.0	7.3	-14.4
Terms of trade	6.0	8.3	4.5	4.7
Real effective exchange rate[3]	8.2	7.5	-4.7	-9.5

Czech Republic Outlook	2006	2007	2008	2009f
Real GDP, % change	6.8	6.0	3.2	-2.0
Consumer prices, % change[1]	1.8	5.5	3.7	1.4
Fiscal balance(ESA95), % GDP	-2.7	-1.0	-1.5	-4.8
Current account balance, % GDP	-2.3	-2.7	-2.2	-4.0
Reserves excluding gold, $ billion	31.2	34.5	36.6	33.8
(Months' imports)[2]	(3.2)	(2.7)	(2.4)	(2.7)
	(percent change)			
Export volume	16.1	14.1	4.3	-19.6
Import volume	14.7	14.6	3.5	-20.6
Terms of trade	-1.4	2.3	-1.4	-1.1
Real effective exchange rate[3]	4.7	1.4	13.8	-2.8

Russia Outlook	2006	2007	2008	2009f
Real GDP, % change	7.7	8.1	5.6	-8.7
Consumer prices, % change[1]	9.0	11.9	13.3	12.6
General gov't balance, % GDP	7.9	5.6	4.6	-9.8
Current account balance, % GDP	9.5	5.8	6.0	1.1
Reserves excluding gold, $ billion	295.3	466.7	411.5	254.5
(Months' imports)[2]	(13.4)	(15.5)	(10.5)	(9.0)
	(percent change)			
Export volume	4.6	1.7	2.3	-11.1
Import volume	23.7	22.7	18.2	-23.5
Terms of trade	15.0	4.1	21.1	-28.1
Real effective exchange rate[3]	10.4	4.5	6.7	-10.5

Hungary Outlook	2006	2007	2008	2009f
Real GDP, % change	4.0	1.1	0.5	-6.0
Consumer prices, % change[1]	6.5	7.4	3.5	2.3
General gov't balance, % GDP	-9.3	-4.9	-3.4	-2.9
Current account balance, % GDP	-6.9	-5.3	-7.4	-2.6
Reserves excluding gold, $ billion	21.5	24.0	33.8	34.5
(Months' imports)[2]	(2.6)	(2.3)	(2.8)	(3.8)
	(percent change)			
Export volume	17.8	16.9	6.5	-19.7
Import volume	15.2	12.3	6.2	-20.7
Terms of trade	-1.4	-0.1	-0.6	2.6
Real effective exchange rate[3]	-5.0	10.3	2.8	-12.5

Turkey Outlook	2006	2007	2008	2009f
Real GDP, % change	6.9	4.7	1.1	-7.5
Consumer prices, % change[1]	9.7	8.4	10.1	4.8
Central gov't balance, % GDP	-0.8	-2.4	-2.6	-5.6
Current account balance, % GDP	-6.0	-5.8	-5.7	-1.1
Reserves excluding gold, $ billion	60.8	73.3	71.0	59.5
(Months' imports)[2]	(4.6)	(4.6)	(3.8)	(4.6)
	(percent change)			
Export volume	14.8	9.2	8.1	-6.8
Import volume	11.8	9.4	-1.0	-19.6
Terms of trade	-2.7	2.5	-6.6	4.3
Real effective exchange rate[3]	0.2	8.0	2.5	-3.7

Poland Outlook	2006	2007	2008	2009f
Real GDP, % change	6.2	6.7	4.9	-1.0
Consumer prices, % change[1]	1.4	4.0	3.3	3.5
Fiscal balance(ESA95), % GDP	-3.9	-1.9	-3.9	-4.0
Current account balance, % GDP	-2.1	-3.6	-4.4	-2.0
Reserves excluding gold, $ billion	46.4	63.0	59.3	57.2
(Months' imports)[2]	(3.4)	(3.6)	(2.7)	(3.6)
	(percent change)			
Export volume	14.0	7.5	7.0	-16.0
Import volume	17.1	15.6	6.4	-18.1
Terms of trade	-0.3	2.0	-2.3	1.1
Real effective exchange rate[3]	2.0	2.8	9.1	-19.0

Ukraine Outlook	2006	2007	2008	2009f
Real GDP, % change	7.4	7.7	2.7	-16.7
Consumer prices, % change[1]	11.6	16.6	22.3	24.7
General gov't balance, % GDP	-1.4	-2.0	-2.6	-4.5
Current account balance, % GDP	-1.5	-4.2	-8.1	-1.6
Reserves excluding gold, $ billion	21.8	30.8	30.8	25.3
(Months' imports)[2]	(4.7)	(4.9)	(3.5)	(5.1)
	(percent change)			
Export volume	2.3	4.7	-1.6	-12.1
Import volume	10.1	22.2	20.9	-36.0
Terms of trade	-1.9	9.1	16.3	-18.9
Real effective exchange rate[3]	6.8	0.0	7.9	-9.3

f = IIF forecast; [1] December-December; [2] Goods, services and income;
[3] Relative consumer prices, - = depreciation.