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Approaching storm. Report on transformation

Central and Eastern Europe and the eurozone crisis

22nd Economic Forum

Krynica Zdrój, Poland
4-6th of September 2012

pwc

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The deep financial and economic crisis that has been developing over the last few years continues to have a strong and negative impact on the economies of Central and Eastern Europe.

Nowadays, the biggest problems are created by the unsolved debt crisis in the eurozone, a crisis caused both by the excessive indebtedness of the southern European countries, and by the inappropriate functioning of the policy coordination mechanisms in the common currency area. The most likely outcome for the coming year is the recession in Western Europe, combined with the financial turmoil of an unknown scale.

It is a sad paradox that the strong links to Western Europe that should be a major development asset for Central and Eastern European countries, are seen today – at least in the short-term – as a major liability. Nevertheless, the countries of the region should be well prepared to face the approaching storm.

The structural weaknesses of their economies are likely to make the situation even more dangerous. The success depends on the flexibility of their real sector, appropriate management of the financial institution, prudent and skilful economic policy, good regulatory framework, vigorous structural reforms, and the efficient cooperation of the government and private sector. In any case, Central and Eastern European countries should be prepared for a long period of an unfavourable external environment, reduced economic growth, and financial instability.

The present report is the fourth one in a row, presented by PwC to the Economic Forum in Krynica. We hope you find it valuable.

Olga Grygier-Siddons
Chairman
PwC Poland

Witold Orłowski
Chief Economic Advisor
PwC Poland

Sources of data used in the report:

Bank for International Settlements (BIS), ***www.bis.org***

Bruegel, ***www.bruegel.org***

Eurostat, ***http://epp.eurostat.ec.europa.eu/portal/***

European Bank of Reconstruction and Development (EBOR), ***www.ebrd.com***

Fitch, ***www.fitchratings.com***

International Monetary Fund (IMF), ***www.imf.org***

PwC, ***www.pwc.com***

Standard & Poor's, ***www.standardandpoors.com***

Statistical offices and central banks of CEE countries

Executive Summary

As the new wave of the global financial crisis approaches, Central and Eastern European (CEE) countries once again have serious challenges to face. The strong economic and financial links with Western Europe make the situation even more difficult.

As recessionary triggers, along with waves of the current financial instability, are coming mainly from the eurozone, the CEE region faces two main risks. The first danger is that, as with all the emerging economies, CEE countries may easily become victims of a possible global financial panic and the resulting 'flight to security' behaviour. The second danger is caused by the very strong links of the region with western European economies and with the fate of the euro.

Both the deteriorating financial situation in the Southern part of the eurozone and the plausible widespread recession in the EU are likely to have a deep impact on CEE countries. Their ability to deal with a new threat crucially depends on the strengths and weaknesses of their respective economies.

The significance of the Western Europe's recession for the CEE countries obviously depends on the extent to which their economies are open to trade and dependent on the exports to southern European eurozone members. Moreover, CEE countries with little room to manoeuvre in their macroeconomic policy will not be able to compensate for external shocks with any domestic stimulus.

In contrast with the southern European eurozone members, the main financial problem of CEE countries is neither connected with the unreasonably high public debt, nor with the excessive consumption levels. Nevertheless, relatively low saving rates combined with high investment needs in these countries led to the accumulation of private debt owed to foreigners. The bigger the country's exposure to foreign financing, the bigger the financial risk. Structural problems in the banking sector of CEE countries may greatly intensify the effects of the economic slowdown and of the external financial turmoil.

The main threats to the economic situation in CEE countries, created by the possible new wave of the crisis, may be divided into four areas; the recessionary impact, the limited room to manoeuvre for the macroeconomic policy in counteracting the recession, possible problems with foreign debt, and potential problems in the banking sector.

Our overall analysis suggests that the country which is most vulnerable to a crisis is Latvia, followed by Slovenia, Hungary, and Belarus. Very serious threats jeopardize the development of Bulgaria, Serbia, and Ukraine. Strong caution is also required in the case of Lithuania, Croatia, Slovakia, Romania, Estonia, and Poland, and to a lesser degree the Czech Republic. Russia's situation is much more comfortable, mainly due to the large room for manoeuvre with their macroeconomic policy.

CEE region and the eurozone crisis

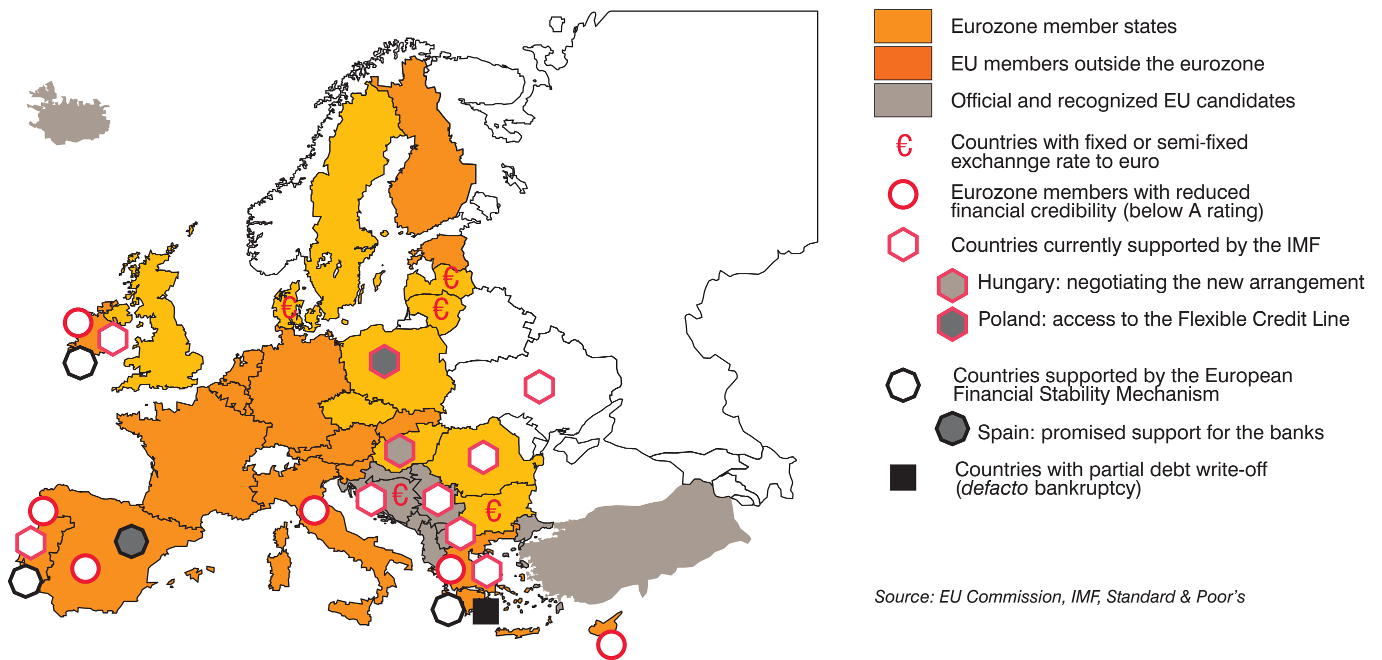
The new, approaching wave of the global financial crisis once again puts the economic development of Central and East European (CEE) countries at a risk.

As recessionary triggers, along with waves of the current financial instability, are coming mainly from the eurozone, the CEE region faces two main risks.

The first danger is that, as with all the emerging economies, CEE countries may easily become victims of a possible global financial panic and the resulting 'flight to security' behaviour. In a situation of great uncertainty and market instability, the global investors typically decide to change their portfolio, reducing the share of assets regarded as 'risky' and searching for 'safe havens'. The typical 'risky' assets are the equities and bonds issued by the emerging countries, while the typical 'safe havens' are bonds issued by the most credible governments of mature economies (e.g. Germany and USA).

If the developments in the eurozone lead to global market panic, the availability of credit for the emerging markets may fall dramatically, up to the extreme level of a total freeze of international financial markets. Under these circumstances, CEE countries would have to immediately and radically cut their borrowing requirements, under threat of an imminent bankruptcy. Such a cut, in turn, could lead to sharp currency depreciation, possible problems in the banking sector, and to a deep recession. The scale of the shock depends mainly on the scale of the necessary cuts in the borrowing requirements, as well as on the scale of the internal structural economic problems.

Financial troubles in Europe, July 2012



The second danger is caused by the very strong links of the region with West European economies. The eurozone economies constitute the main and crucial export market for the CEE countries belonging or aspiring to the European Union. The economic situation of Russia, on the other hand, is vitally dependent on the Western Europe's demand for oil and gas. A deep recession in the eurozone represents, therefore, a great and imminent threat for the entire CEE region.

The financial stability of the CEE region is also linked to the fate of the euro. Out of the 10 current EU members, 3 belong to the eurozone, and 3 others have their currency pegged to the euro.

The banking sector in the majority of the CEE countries is closely connected to the West European banking groups, with the Balkan countries exposed to a special threat due to the significant role of the Greek banks. The initial financial conditions are not encouraging: even today, before the new wave of instability has arrived, as many as 9 CEE economies use or negotiate the IMF balance of payments support, together with 4 highly indebted eurozone countries. With a ticking bomb in the Southern part of the eurozone, the situation may easily become much more dangerous.

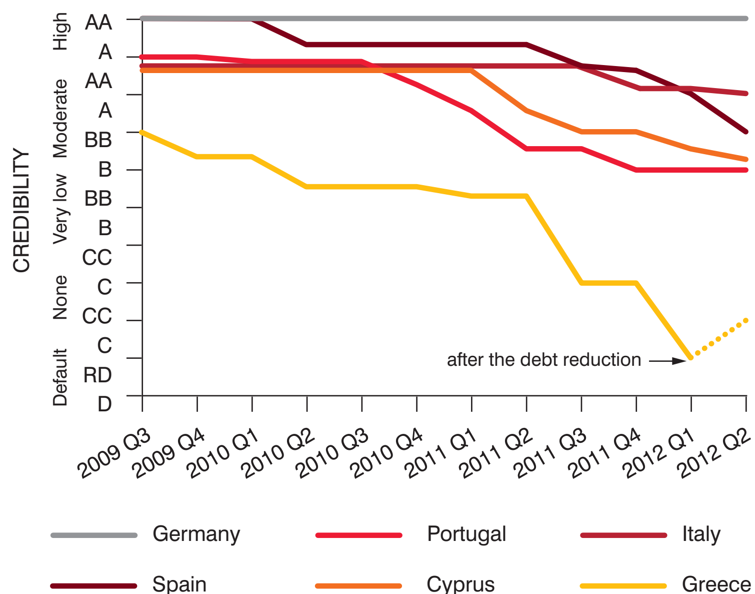
Approaching storm

As the debt crisis in the Southern European eurozone remains unsolved, the risk of a major recession and an overwhelming financial turmoil constantly increases.

The debt crisis in the Southern European eurozone members has been aggravated dramatically over the last 2 years. With the public debt to GDP ratio ranging from 80% in Spain and Cyprus, to 120% in Portugal and Italy, and even to 160% in Greece, combined with the huge problems in the banking sectors, the Southern European eurozone members have become highly vulnerable to a financial crisis. Until 2010 the financial market players seemed to ignore the growing risk and assume that the major eurozone powers, first of all Germany, somehow underwrite the debts of the weaker members.

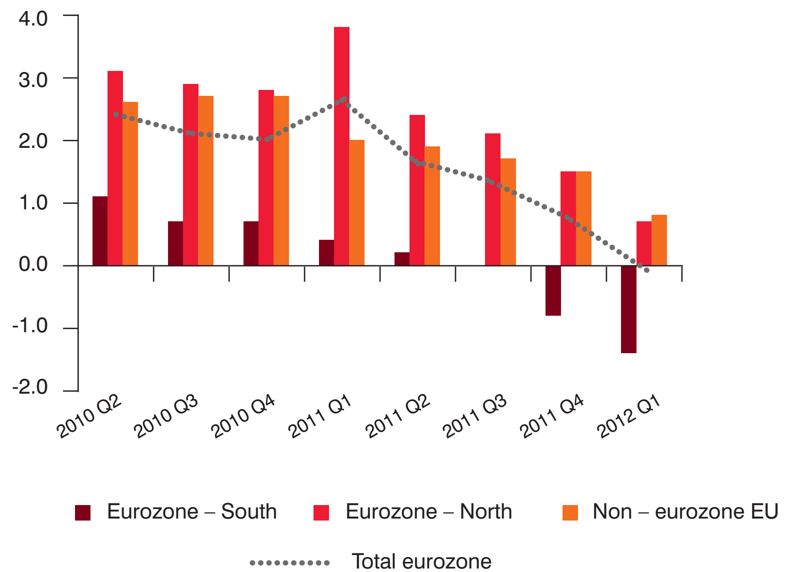
Once it became obvious that such a guarantee does not exist, and despite the creation of the eurozone stability fund aimed at supporting the countries in trouble, the financial credibility and ratings of the highly indebted Southern European eurozone members started dropping dramatically, while the interest rates on their debt radically increased. Until now only Greece was, in fact, forced into a partial sovereign default, but the fate of the other endangered countries is not clear.

Towards a financial crash: ratings of South European eurozone countires



Source: Standard & Poor's, Moody's, Fitch

Towards a recession: quarterly GDP growth in the EU



Source: Eurostat

The debt crisis in the Southern European eurozone members led to a dramatic deterioration of the business sentiment throughout Europe. The heavily indebted countries started deep austerity programs, aimed at stabilizing their economies. That, in turn, led to the decrease of their import demand and to the slowdown in other European economies. The unclear financial prospects forced both the consumers and firms to reduce their spending, particularly the investment expenditures. Altogether, the debt crisis has already caused a recession in the whole EU, the depth and the length of it is still unknown.

Taking into account the strength of the economic and financial ties between the CEE region and Western Europe, both the deteriorating financial situation in the Southern part of the eurozone, as well as the plausible widespread recession in the EU, are likely to have a deep impact on CEE countries. Their ability to deal with the new threat crucially depends on the strengths and weaknesses of their respective economies.

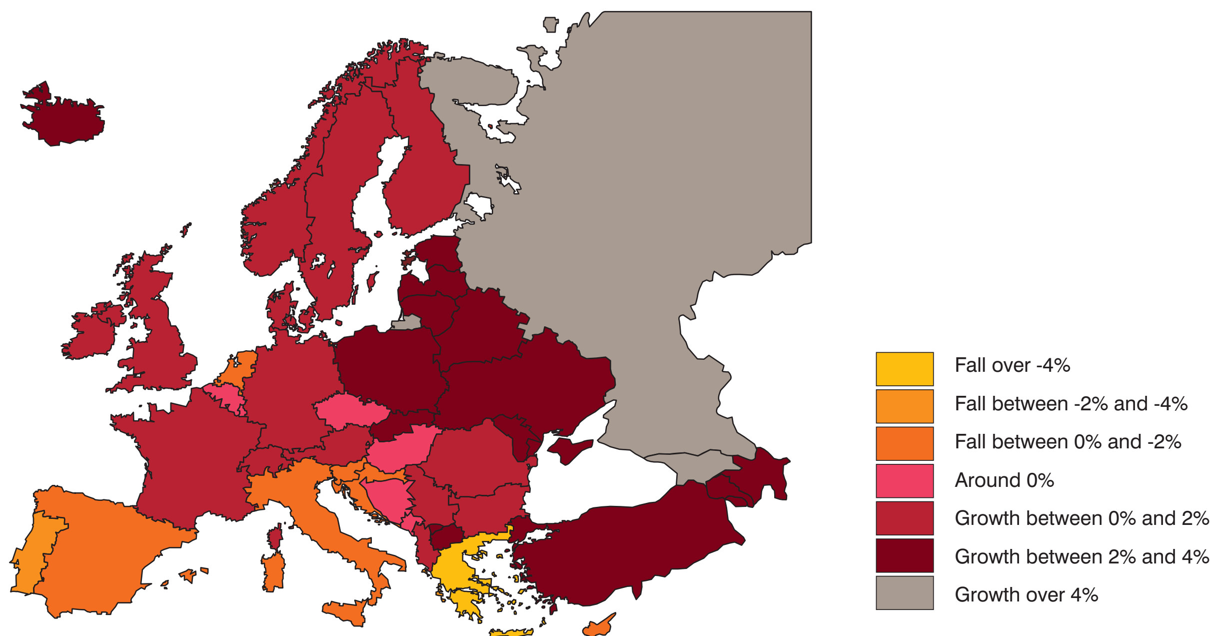
CEE in 2012-2013: growth prospects

For the time being, the economic forecasts point to a relatively moderate slowdown of GDP growth in CEE countries. The situation, however, may turn out to be more serious.

According to current IMF forecasts, the economic slowdown or recession in the eurozone is expected to be relatively short and shallow. Only in the case of a few highly indebted Southern European countries, a considerable GDP fall is forecast for 2012, while the majority of Western Europe should record a moderate growth of below 2%. By 2013, the GDP growth in the majority of the EU countries should accelerate once again.

Unfortunately, one should remember that such a forecast must be assessed as relatively optimistic, and that the actual economic situation in Europe in 2012-13 may appear much more difficult. As the eurozone countries are still far away from finding a common solution to the debt problem, the business sentiment and the financial situation of the debtors may deteriorate even more.

Forecasted change of GDP in Europe, 2012



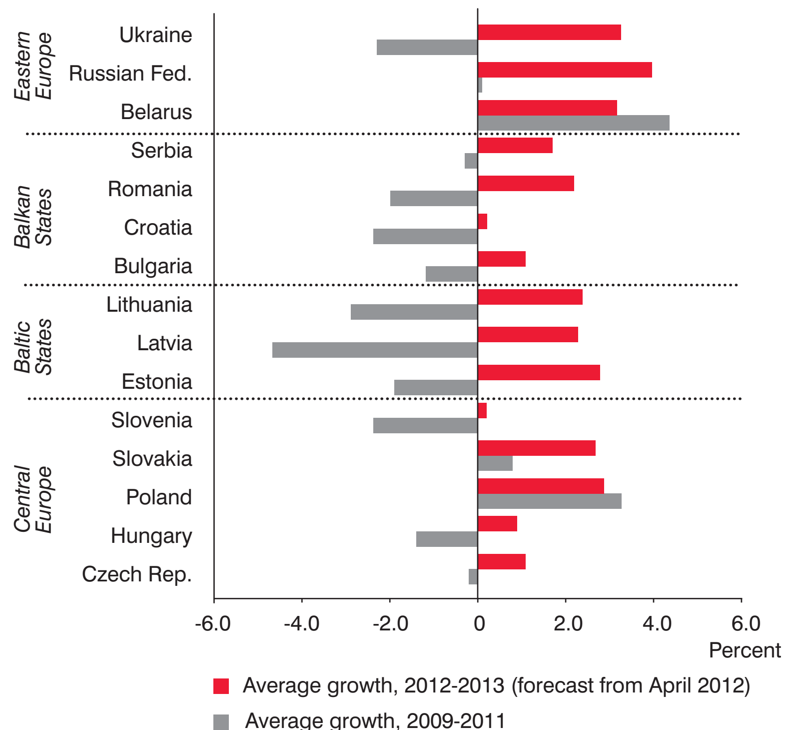
Source: IMF

Taking into account a relatively optimistic forecast for Western Europe, the current economic forecasts for the majority of CEE countries indicate a slowdown of GDP growth only. The situation is expected to be more serious in the Balkan states, due to bigger exposure to the South eurozone impact. As far as Central Europe is concerned, the forecasts are more pessimistic for the highly indebted Hungary, as well as for the economies that are the most dependent on exports to Western Europe: Slovenia and the Czech Republic.

After a temporary slowdown in 2012, with a possible shallow recession in Slovenia and Croatia, CEE growth should accelerate once again in 2013.

Compared to the previous period of 2009-2011, the forecast problems look relatively mild. One should keep in mind, however, that the situation may become much more dangerous if the recession and the financial turmoil in the eurozone turns out to be deeper than previously assumed.

GDP growth in the CEE region: data and forecasts, 2009-2013



Source: IMF

Risks for the real economy

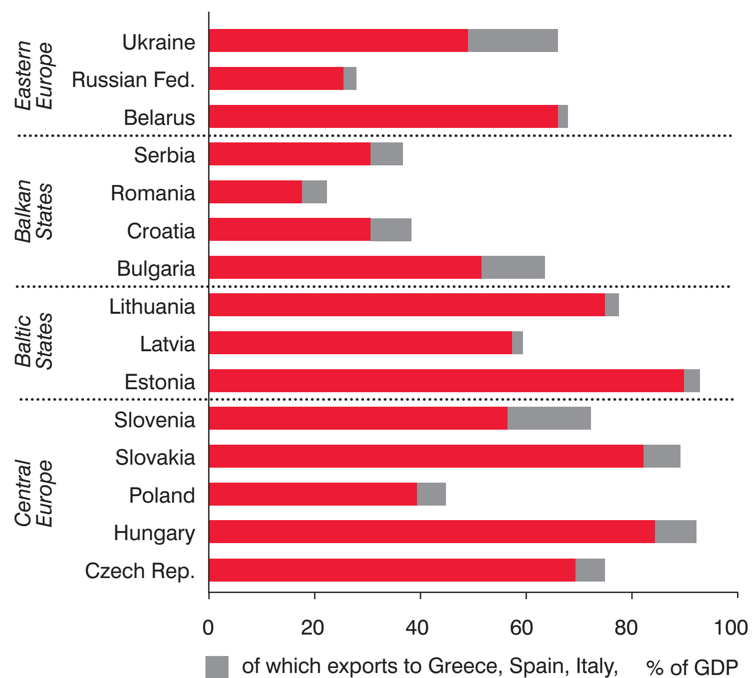
As the eurozone may be heading towards a painful recession, strong dependence on exports to Western Europe creates a serious risk for CEE countries.

Although access to the whole European market is one of the biggest long-term development assets of the CEE countries, it may lead to serious problems in the short run. The significance of Western Europe's recession for CEE countries obviously depends on the extent to which their economies are open to trade and dependent on exports to the Southern European eurozone members. If trade openness is measured by the total ratio of exports to GDP, it turns out that Hungary, Slovakia, Estonia, Lithuania, Slovenia, and the Czech Republic may be facing the largest recession threats.

The relatively big share of exports to the recession-affected South European countries creates additional problems for Bulgaria and Slovenia, while the situation in Belarus is made complicated by a huge dependence on exports to Russia.

Another type of problem may be caused by an export monoculture (excessive dependence on a single type of exported goods), especially if the market for those goods is very sensitive to global economic conditions. This concerns Russia in particular (due to the overwhelming reliance on oil and gas exports), Ukraine (due to the role of steel products) and Slovakia (due to the role of the motor industry). The slowdown of transfer inflows from emigrants may prove particularly painful for Croatia and Serbia.

Exports of goods and services as percent of GDP, 2011

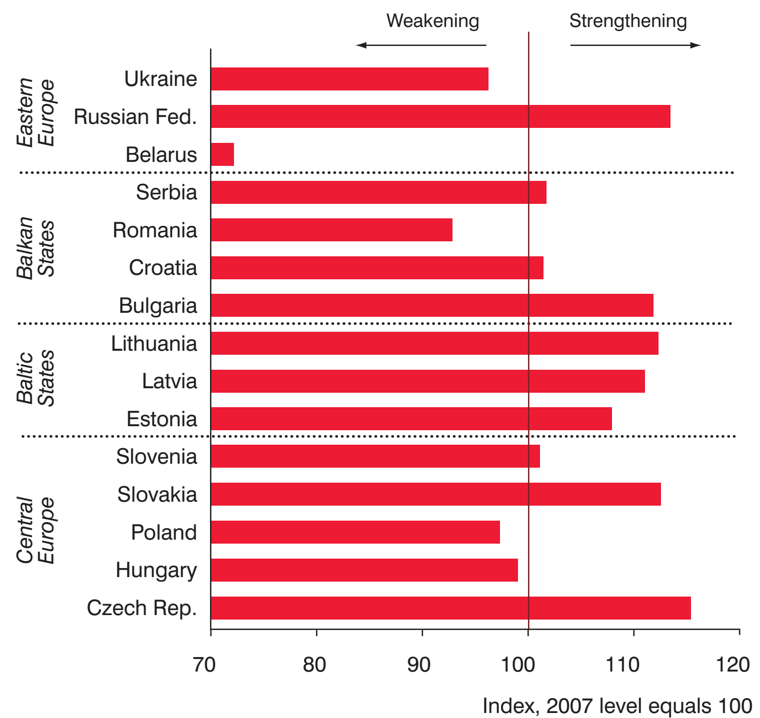


Source: IMF, CEE statistical offices

The impact of the West European recession on CEE economies depends also on changes in their competitiveness. A combination of the changes in exchange rates and domestic inflation rates leads to the real weakening or strengthening of the currencies, making the country, respectively, more or less competitive. Having a weaker currency makes the risk of a painful recession lower for Belarus, Romania, Poland, and Hungary, whilst having a stronger currency in recent years has increased the risk for the Czech Republic, Slovakia, the Baltic states, Bulgaria and Russia.

The strengthening of currency does not have to influence exports if a country can increase the productivity or reduce the wage level. That type of a policy, however, normally leads to higher unemployment and weaker domestic demand, also translating into a deeper recession.

Real Effective Exchange Rate, 2007-2011



Source: IMF, Bruegel

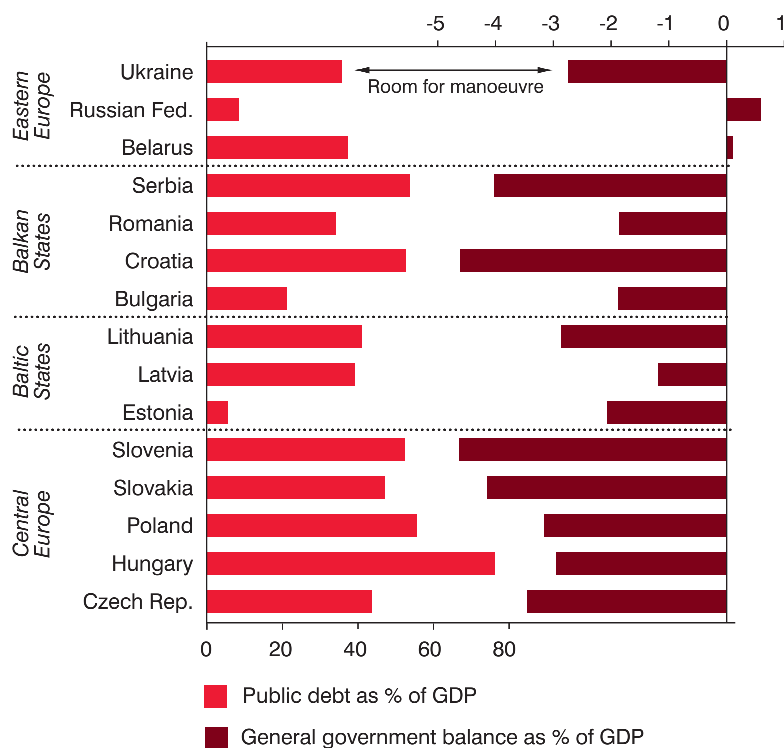
Room to manoeuvre with the macroeconomic policy

The more imbalanced the economy, the less room there is to manoeuvre with the macroeconomic policy. CEE countries with less room to manoeuvre will not be able to compensate for the external shocks with domestic stimulus.

The room to manoeuvre in the fiscal policy depends on the initial situation of the public finance sector. On one hand, highly indebted governments cannot afford further growth of public debt, putting the long-term financial credibility of the country at risk. On the other hand, running high fiscal deficits during the financial turbulence is a gamble as sudden troubles with financing them may appear. However, a country with a safe level of public debt and a low deficit level, can afford using fiscal stimulus, i.e. it can allow for a temporary increase in the deficit that creates an additional market demand and helps the economy to deal with the recession.

Looking at the current situation of the public finance sector in the CEE region, one can assess that the biggest room to manoeuvre with the fiscal policy exists in Russia, Estonia, Belarus, and Bulgaria. On the other end of the scale one can locate Hungary, Slovenia, Croatia, and Serbia, with almost no freedom for fiscal action.

Room for manoeuvre in the fiscal policy: general government balance and public debt, forecast for 2012



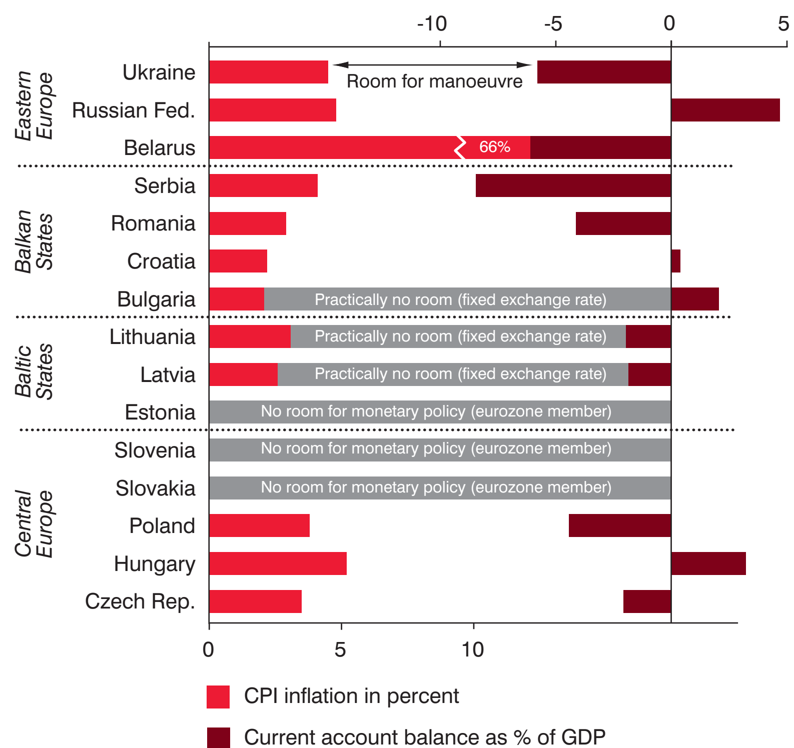
Source: IMF

The room to manoeuvre in the monetary policy depends on the initial level of internal and external imbalances in the economy (demonstrated by, respectively, the inflationary pressure and the current account deficit). A country with a low level of inflation, and a low level of current account deficits (or a current account surplus), can afford using a monetary stimulus, i.e. it can ease the monetary policy and therefore stimulate the domestic demand. Obviously, countries using the euro cannot make such a decision, as the monetary policy is set by the European Central Bank.

The countries with the currency pegged to the euro can theoretically do it by changing this policy, but with a very serious risk of destabilizing the economy.

Taking into account the current level of internal and external imbalances, the biggest freedom of the monetary action seems to exist in Croatia and Russia, followed by Poland, Hungary, the Czech Republic, and Romania.

Room for manoeuvre in the monetary policy: current account balance and inflation, forecast for 2012



Source: IMF

Problems of indebtedness

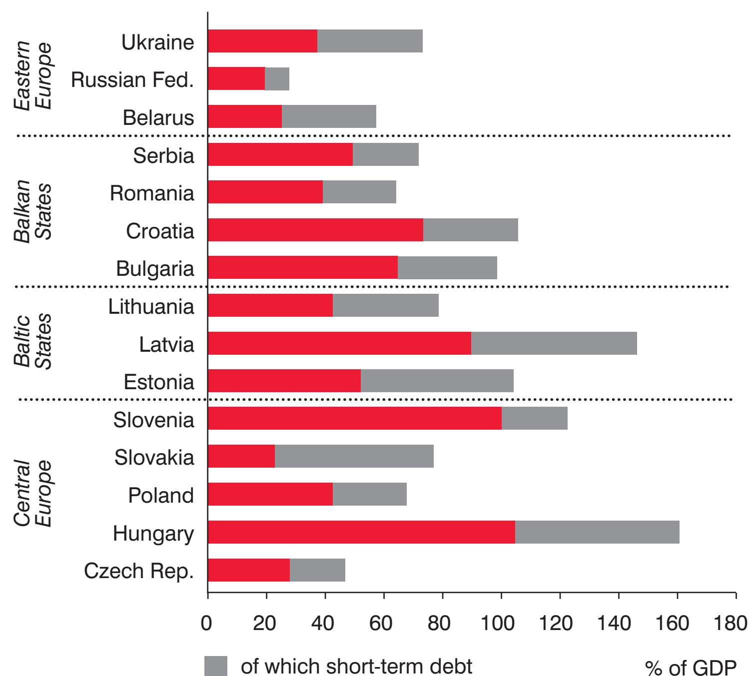
A high foreign debt and a high dependence on foreign financing represent the main source of worry for CEE economies.

In contrast with the Southern European eurozone members, the main financial problem of CEE countries is neither connected with the unreasonably high public debt, nor with the excessive consumption levels. Nevertheless, relatively low saving rates combined with high investment needs in these countries led to the accumulation of private debt owed to foreigners. Therefore, a global financial turmoil that may seriously limit the ability to raise new capital may also increase a risk of default on foreign debt.

The level of the foreign debt compared to GDP is quite high in a number of CEE countries, especially in Hungary, the Baltic states, Slovenia, Croatia, and Bulgaria.

What is more dangerous, however, is the structure of this debt in several countries. In particular, high risk may be connected with the elevated level of short-term foreign debt (due in one year's time). Any problem with paying back or rolling over this type of obligation may lead to the radical increase of interest rates demanded by foreign investors, market panic, and eventually even to insolvency. In the case of Slovakia, Estonia, Belarus, and Ukraine the share of short-term debt exceeds half of the total. The size of short-term debt exceeds 50% of GDP in Hungary, Slovakia, Latvia and Estonia.

Foreign debt as percent of GDP, 2011



Source: EBRD, BIS, IMF

The relatively low level of saving in the CEE region makes the countries highly dependent on the import of capital, leading to the emergence of current account deficits. Before the crisis, current account deficits of CEE countries were quite elevated, particularly in the Baltic and Balkan states. Russia was the only country in the region to record a large current account surplus connected with huge revenues from oil and gas exports.

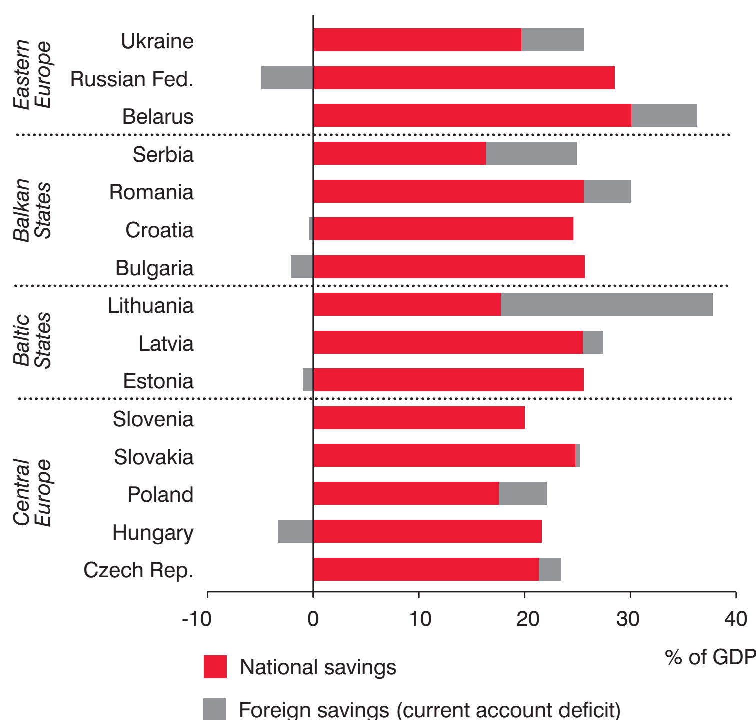
The recession recorded in 2009, followed by low growth rates in many countries, caused a rapid reduction of investment needs and of the demand for foreign capital. Currently, apart from Russia, the capital needs are fully covered by the domestic saving in Bulgaria, Croatia, Estonia, Slovenia, and Hungary.

Nevertheless, several CEE countries are still running substantial current account deficits, particularly high in Serbia, Belarus, Ukraine, and – to a smaller degree – in Poland and Romania.

Although the level of foreign debt is of vital importance for the country's long-term credibility, the short-term ability to satisfy the financing needs, and therefore to maintain the investors' confidence, depends on the sufficient scale of the central banks' foreign exchange reserves. The scale of the reserves should be compared with the estimated short-term foreign exchange needs of a country: a sum of the short-term debt and the current account deficit. A ratio close to or above 100% means that the central bank has sufficient stock of convertible currencies to cover the yearly financing needs of the country even if it is not possible to borrow money on the international markets.

The ratio of foreign exchange reserves to short-term debt and current account deficit is on a safe level in the majority of the CEE countries. It may be, however, assessed as insufficient in the case of Hungary and Lithuania, and dangerously low in the case of Latvia, Ukraine, and Belarus.

Financing pattern of the domestic investment, 2012 forecast

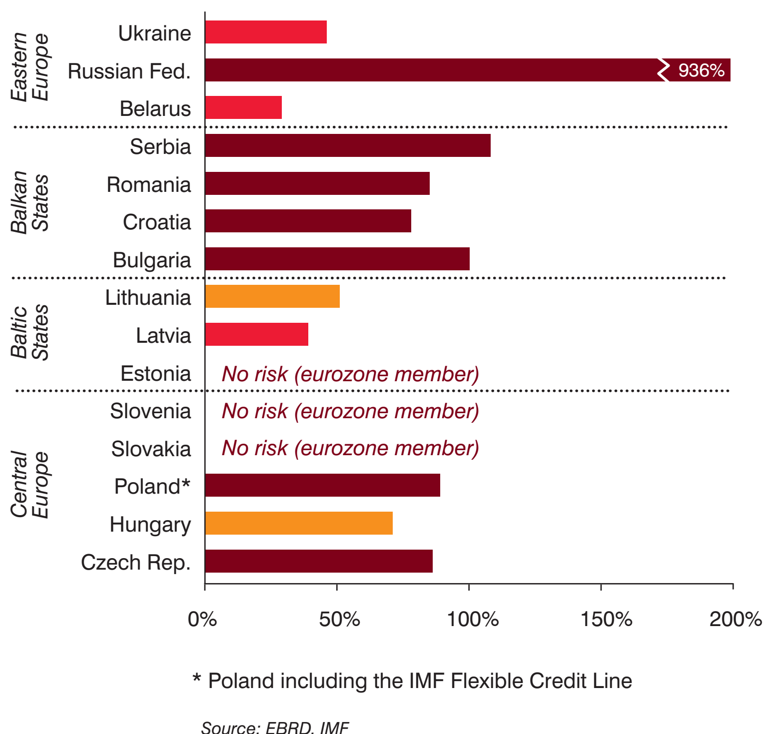


Source: IMF

A normal way of satisfying the short-term financing needs of a country is to raise the foreign exchange on international financial markets, however, it is only possible if a country is seen as a credible borrower. The credibility is assessed by the specialized agencies that give the country a rating (or assessment of the country's ability to pay back the debt), ranging from AAA (no risk) to D (default).

The assessment of the credibility of CEE countries is quite diversified. The Central European countries (except for Hungary) and Estonia enjoy the high trust of the market, confirmed by A-grade credit ratings. It means that they should not have serious problems with financing their needs on the market. Credibility of other CEE countries is limited or low, which means difficulties in finding capital and a high cost of obtaining it. The rating agencies carefully watch and assess all the changes in the financial stance of the countries, as well as currently issued warnings about the possible reduction of the ratings in the case of 5 CEE countries.

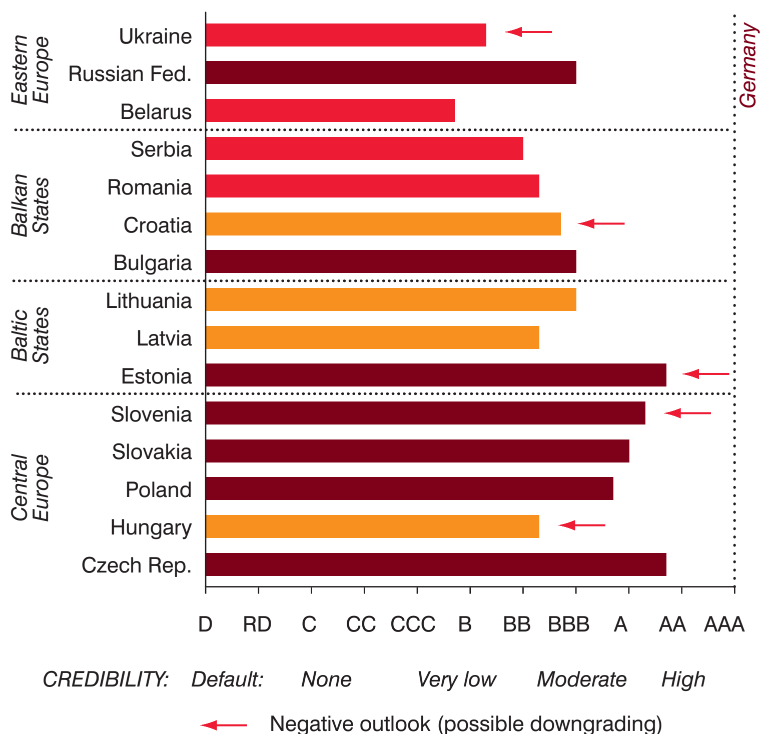
Ratio of foreign exchange reserves to short-term debt and current account balance, mid-2012



* Poland including the IMF Flexible Credit Line

Source: EBRD, IMF

Country credit rating, July 2012



Source: Standard & Poor's

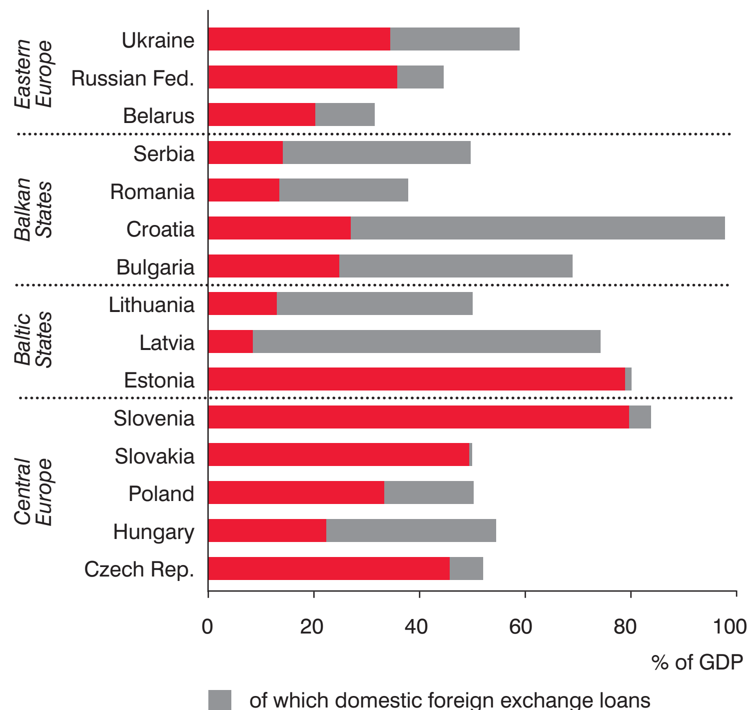
Risks in the banking sector

Structural problems in the banking sector of CEE countries may greatly intensify the effects of the economic slowdown and of the external financial turmoil.

Economic slowdown or recession, combined with the external financing problem induced by the next wave of the global financial crisis, may easily translate into huge problems for the domestic banking sector. The more structural the problems in the banking sectors of CEE countries, the bigger the risk of great intensification of the effects caused by external shock.

The current level of indebtedness of the private sector (households and firms) in the domestic banks, measured in relation to GDP, can be assessed as quite high in the case of Croatia, Slovenia, Latvia, and Bulgaria. What is more dangerous, however, is a high share of debts denominated in foreign currency, in which case any depreciation of the currency may immediately translate into a dramatic rise in the share of non-performing loans. The ratio of debts denominated in a foreign currency to GDP is particularly high in Croatia and Latvia, followed by Bulgaria, Serbia, Hungary, and Lithuania.

Loans to private sector as percent of GDP, 2011

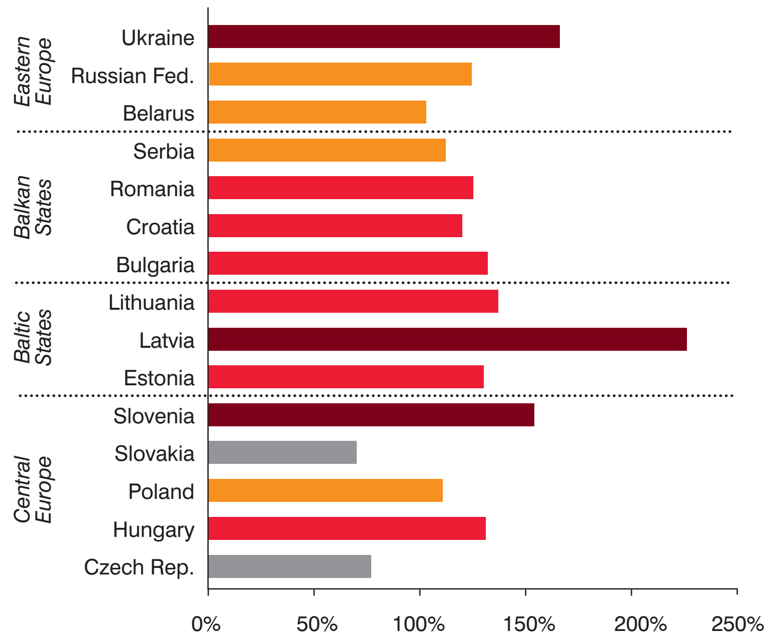


Source: EBRD, national banks

One of the most important factors determining the stability of the country's banking sector is the relation between loans and deposits. Generally speaking, if the relation is below 100% it means that credits are financed from domestic savings. A relation of above 100% suggests that the banks were financing loans mainly by borrowing money from abroad. That makes them extremely vulnerable to the situation on the global financial markets and creates a major risk for the country's banking sector in the case of global turmoil.

The banking sector's situation may be assessed from that point of view as totally safe only in the case of the Czech Republic and Slovakia, and – to a certain degree – in Poland, Serbia, Russia, and Belarus. On the contrary, the loans to deposits ratio remains dangerously high in Latvia, Slovenia and Ukraine.

Private sector loans to deposits ratio, 2011

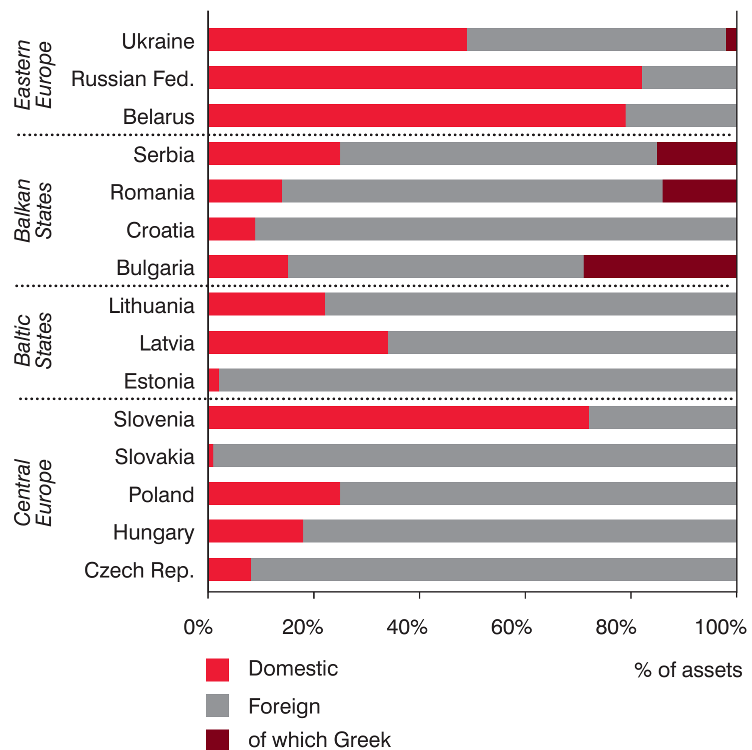


Source: EBRD

Apart from internal characteristics of the banking sector in CEE countries, the situation may be additionally complicated by the ownership structure of the banks. In the case of a high share of foreign ownership, the domestic banks may become easily contaminated with problems affecting their parent banks in Western Europe. The risk becomes even bigger due to the fact that, as past experience suggests, the policy conducted by foreign banking groups cannot be adequately controlled by domestic financial supervisory institutions.

The foreign banking groups, particularly from Western Europe, control the majority of assets in the CEE banking sector except for Eastern Europe and Slovenia. Moreover, in the case of Bulgaria, and to a smaller degree Serbia and Romania, the risk is increased by the large presence of banks from Greece that may become easily insolvent in the case of the aggravation of the eurozone debt problem. On the other hand, the problems of Eastern Europe's banks may arise from insufficient supervision and structural weaknesses caused by their connections with large companies of the non-financial sector.

Ownership structure of the banking sector, 2011



Source: EBRD, national banks

Vulnerability to shock

The level of exposure of CEE countries to a possible new wave of the crisis is diversified and depends on various characteristics of their economies.

The main threats to the economic situation in the CEE countries, created by a possible new wave of the crisis, may be divided into four areas.

1. The recessionary impact comes mainly from the high dependence on exports to Western European markets, or on the highly sensitive exports of raw materials. The countries especially exposed to this risk are Slovenia, Bulgaria, Belarus, and Slovakia. Nevertheless, the threat is serious for all the countries in the region.

2. The room to manoeuvre for the macroeconomic policy in counteracting the recession is strongly limited in Slovakia, Slovenia, and Serbia, and somehow limited in all the other CEE countries except for Russia.

3. Possible problems with foreign debt are likely to be particularly strong in Belarus, which once again may face the risk of insolvency. The situation of Latvia, Hungary, Serbia and Ukraine can be assessed as dangerous as well.

4. Potential problems in the banking sector may seriously affect Bulgaria, and to a smaller degree Latvia, Croatia, Romania, and Serbia.

	Recessionary impact	*Room to manoeuvre*	*Foreign indebtedness*	*Banking sector*
Czech Republic	High	Medium	Low	Medium
Hungary	High	High	High	Medium
Poland	Medium	High	Medium	Medium
Slovakia	High	Very high	Low	Medium
Slovenia	High	Very high	Medium	Medium
Estonia	High	High	Low	Medium
Latvia	High	High	High	High
Lithuania	Medium	High	Medium	Medium
Bulgaria	High	High	Medium	Very high
Croatia	Medium	Medium	Medium	High
Romania	Medium	Medium	Medium	High
Serbia	Medium	Very high	High	High
Belarus	High	High	High	Medium
Russian Federation	High	Low	Low	Low
Ukraine	High	High	High	Medium

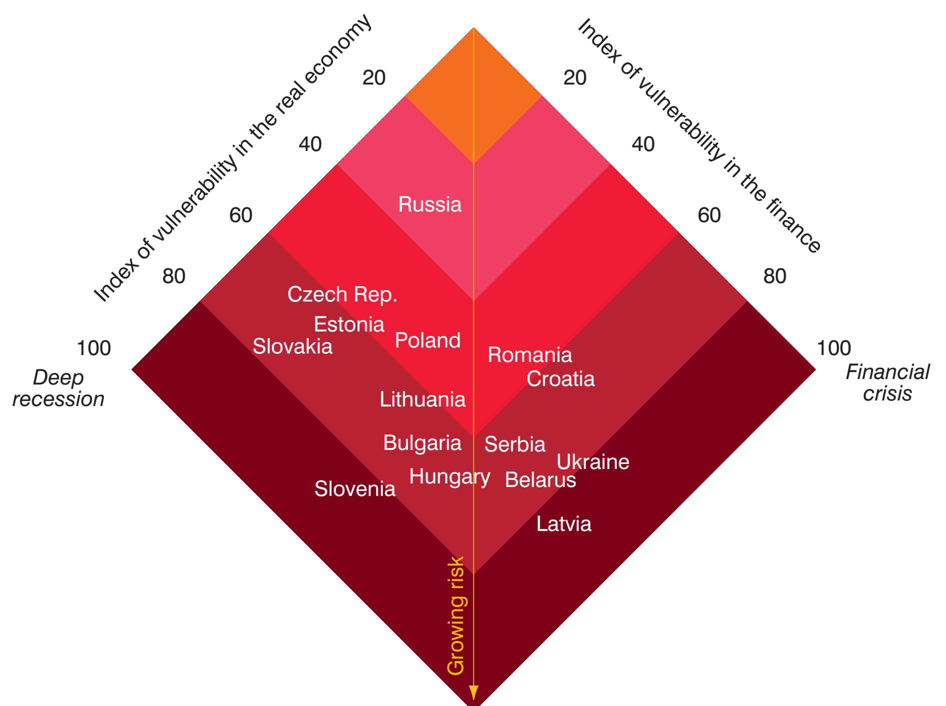
Legend
Vulnerability: *Low* *Medium* *High* *Very high*

Overall assessment of all the threats that CEE countries have to face due to the possible aggravation of the eurozone crisis requires looking, at the same time, at the risks for the real economy and for the financial market.

As far as the vulnerability of the real economy is concerned, the biggest risk of a deep recession exists in Slovenia, Slovakia, Bulgaria, and Hungary, followed by Estonia, Lithuania, and the Czech Republic. At the financial side, the biggest risk of a severe financial crisis exists in Latvia, Belarus, and Ukraine, followed by Hungary, Serbia, and Croatia.

Our overall analysis suggests that the country that is the most vulnerable to the crisis is Latvia, followed by Slovenia, Hungary, and Belarus. Very serious threats jeopardize the development of Bulgaria, Serbia, and Ukraine. Strong caution is also required in the case of Lithuania, Croatia, Slovakia, Romania, Estonia, Poland, and to a lesser degree the Czech Republic. The situation in Russia is much more comfortable, mainly due to the large room for manoeuvre with the macroeconomic policy.

Vulnerability of the CEE countries to the eurozone crisis



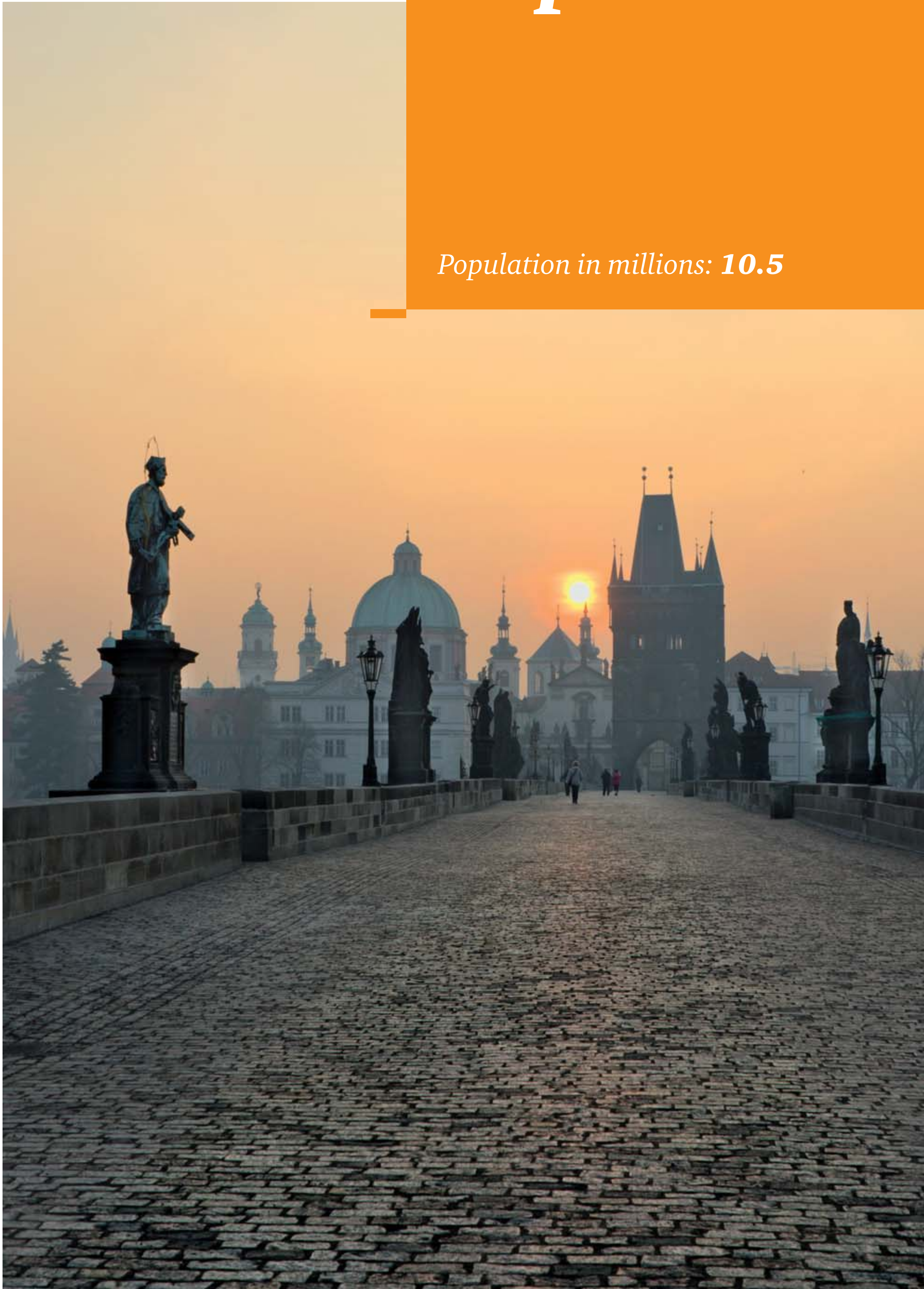
Source: PwC

Report on transformation

23	Czech Republic
29	Hungary
35	Poland
41	Slovakia
47	Slovenia
53	Estonia
59	Latvia
65	Lithuania
71	Bulgaria
77	Croatia
83	Romania
89	Serbia
95	Belarus
101	Russian Federation
107	Ukraine

Czech Republic

Population in millions: ***10.5***



Czech Republic

Basic data (2011 or latest available data)	Czech Republic	CEE Region	Region=100
Population in millions	10.5	310.8	3.4
GDP, billions of US$	215	3 531	6.1
GDP per capita, thousands of US$*	27.1	15.9	170.2
GDP growth rate, average 2009-12	-0.1	0.7	x
CPI inflation	1.9	8.3	x
Exports as percent of GDP	74.9	41.6	x
Net FDI as percent of GDP	2.0	1.3	x

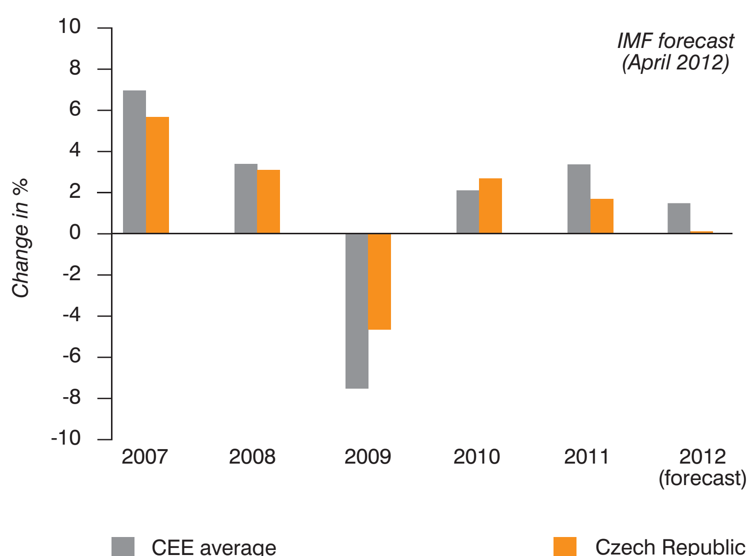
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Czech economy recorded a relatively weak performance during the crisis. It suffered -4.6% economic contraction in 2009, less than the CEE average. The growth rate returned in 2010. However, it is apparent that the economic performance since then continues to decline. Relatively unfavourable growth performance over the last years is mainly a result of sluggish domestic demand – private consumption is practically stagnant and investment levels are volatile. The economic growth was strongly supported by export performance, in particular in 2011.

The forecast for upcoming years is not optimistic. Due to the deteriorating situation in the eurozone, the export led economy will continue to slow down in 2012. The possible economic improvement strongly depends on external developments.

GDP growth rates



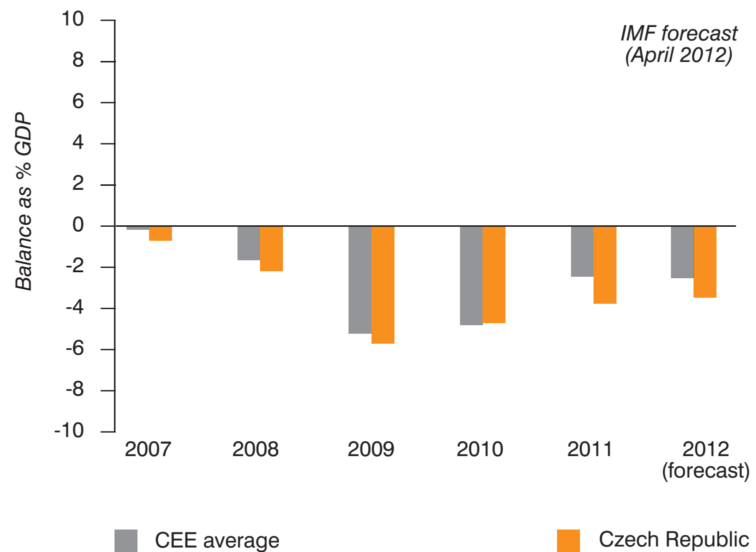
Source: IMF

Public finance

The stance of the Czech public finance sector deteriorated during the global financial crisis, as the increasing public deficit served as an automatic stabiliser to support the struggling economy. As a result, the general government deficit increased from about 2% of GDP in 2008 to almost 6% in 2009. Since then, the government gradually stabilised the public finances – both revenues and expenditures. The general government debt, although higher as compared to the pre-crisis level, is still relatively low – slightly above 41% of GDP in 2011.

The expected developments in the fiscal sphere in the Czech Republic are moderately positive, with a likelihood for the deficit to gradually reduce. Nevertheless, the public debt will strongly depend on developments in the real sector.

General government balance



Source: IMF

Czech Republic vis-à-vis the euro

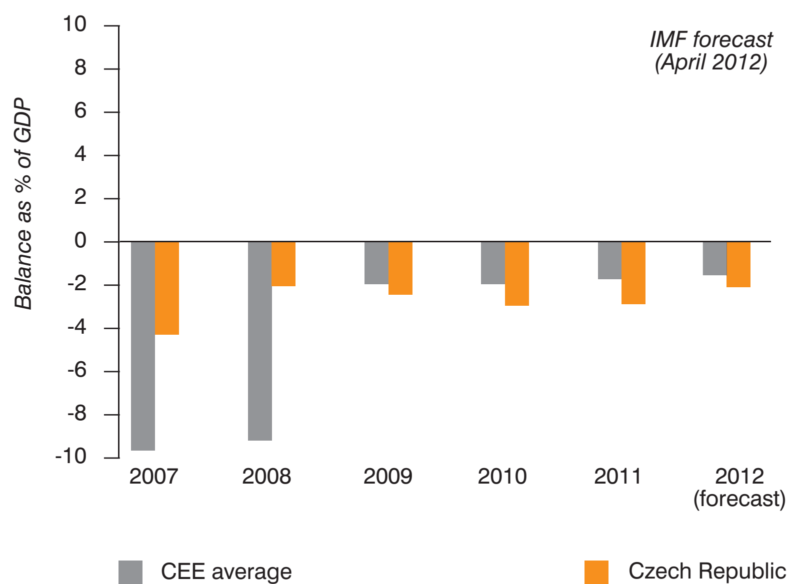
- *Czech Republic is an EU member that currently does not use the euro.*
- *There is no fixed date of the euro introduction but it is widely expected not to happen before 2017.*
- *Czech Republic uses a flexible exchange rate policy but the koruna is relatively stable and strong.*
- *There is no major risks for instability as the level of indebtedness is low and the macroeconomic situation seems to be stable.*

The external balance

The current account balance is slightly negative with a tendency of improvement. In 2011 the deficit was close to 3% of GDP and was slightly smaller than in 2010. The positive situation of the current account is a result of an exceptional export performance and restrained imports – in fact, the trade balance is positive and the deficit results from large negative net flows of factor incomes (specifically the transfer of profits). The deficit is mainly financed by FDI inflows and by portfolio investments. Official reserves are big enough to cover short term financing needs.

Forecasts for the external balance are rather optimistic. Good competitiveness of Czech exports creates a solid ground for the continuous gradual improvement of the external balance. Due to positive productivity performance and stable macroeconomic situation, the Czech economy is expected to remain attractive for FDI.

Current account balance



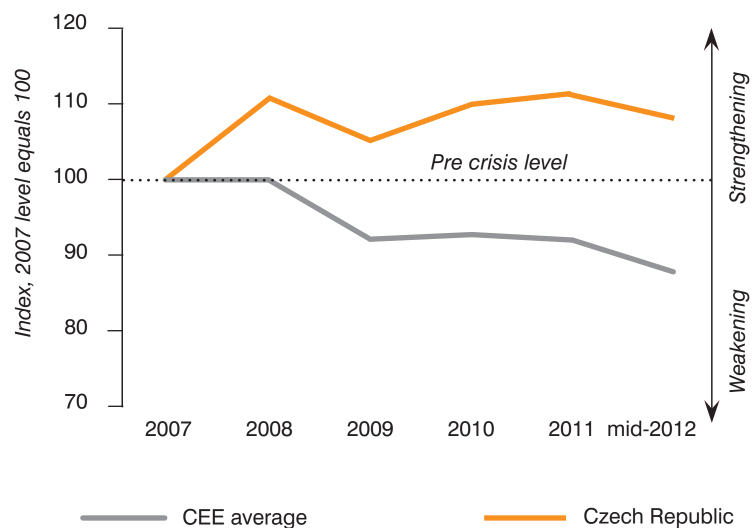
Source: IMF

Stability of the currency

Stable economy, good public finance performance and a safe external balance support the relative appreciation of the Czech koruna both against the euro and against other CEE currencies. It is the only CEE country outside the eurozone with a currency that strengthened in nominal terms against the euro during the crisis.

As the external situation of the Czech Republic is not expected to deteriorate in the nearest future, the stability of the currency is expected to continue. The only risk factor derives from the highly possible, negative external shocks in the eurozone.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Czech Republic	CEE Region
General government balance	-3.8	-0,9
Public debt	41.5	28.3
Foreign exchange loans	6.3	16.6
Loans to deposits (ratio)	77%	127%
Current account balance	-2.9	0,3
Foreign debt	46.7	54.4
Short-term debt	18.7	21.0
Coverage of financing needs by reserves (ratio)*	86%	142%
Credit rating (S&P)	AA-	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

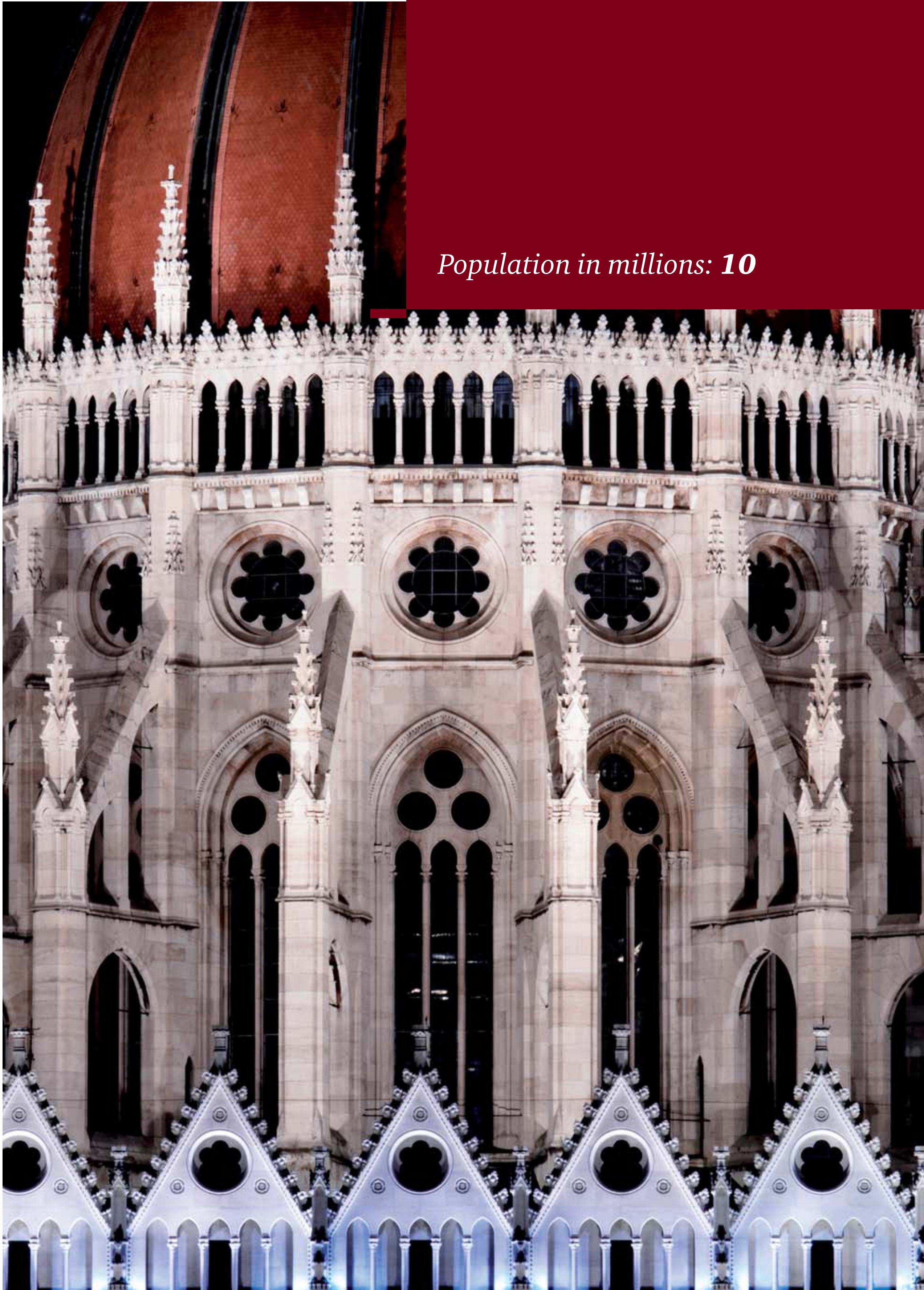
As the exposure of the country to foreign financing is rather low and the fiscal situation continues to improve, the financial situation of the Czech Republic looks relatively comfortable. The only major risk may come from the real economy.

Due to the prudent fiscal policy, the general government balance should be gradually reduced below 3% of GDP, and the debt to GDP ratio should not grow above 45%. The ongoing fiscal reforms will additionally support the consolidation of the Czech public finance sector.

The banking sector is exceptionally strong. Czech banks are self-financed and highly profitable. The loans to deposit ratio is low and the exposure to exchange rate instability is limited due to a low share of foreign exchange denominated credits. The only risks come from possible external spill-overs.

The major risks, primarily resulting from external factors, come from the real sector. Strong dependency on exports may hurt the economy in case of unfavourable developments in the eurozone. Due to this, the economic situation may rapidly decline in the next economic contraction in the Czech Republic.

Hungary



Population in millions: ***10***

Hungary

Basic data *(2011 or latest available data)*

	Hungary	CEE Region	Region=100
Population in millions	10.0	310.8	3.2
GDP, billions of US$	140	3 531	4.0
GDP per capita, thousands of US$*	19.6	15.9	123.2
GDP growth rate, average 2009-12	-1.0	0.7	x
CPI inflation	3.9	8.3	x
Exports as percent of GDP	92.3	41.6	x
Net FDI as percent of GDP	-0.1	1.3	x

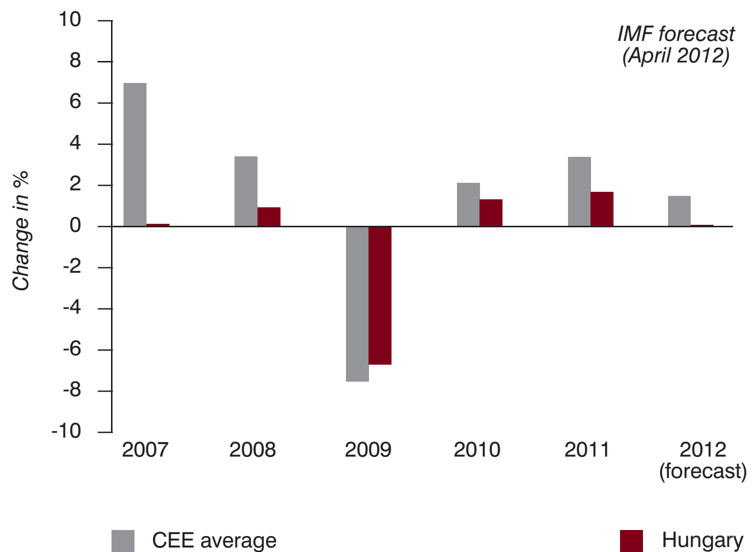
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Hungarian economy has been recording a relatively weak growth performance since the beginning of the global financial crisis. The economy contracted by 6% in 2009 and GDP has not grown faster than 2% per year since then. Sluggish domestic demand is the primary reason behind the slow economic recovery. On the other hand, exports, strongly connected to German demand, remains the growth engine during tough times.

The forecast for years to come is not optimistic. The economy is expected to remain stagnate in 2012. Afterwards, the expected GDP growth rate may be only slightly higher than 2%. It results, among others, from structural problems of the Hungarian economy with very low labour force participation, declining productivity, high indebtedness and low investment rate.

GDP growth rates



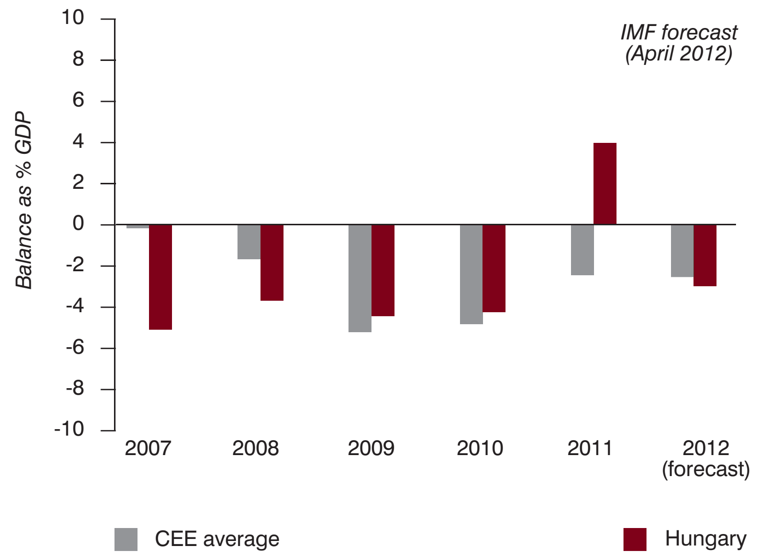
Source: IMF

Public finance

The Hungarian public finance sector was in trouble even before the start of the economic crisis in 2008. The government runs a chronic general government deficit of magnitudes ranging from 6% to even 9% of GDP. Only in 2003 did the situation started to improve, only to decline once again in 2009 and 2010. The positive fiscal balance of 2011, albeit remarkable, was mainly the result of a one-off transfer of pension assets, and cannot be seen as sustainable.

The level of public debt in Hungary is high by CEE standards (80% of GDP in 2011) and the access to foreign financing is limited. With a vulnerable financial position, Hungary has no choice but to continue fiscal tightening policies despite the negative consequences it might have on the real sector.

General government balance



Source: IMF

Hungary vis-à-vis the euro

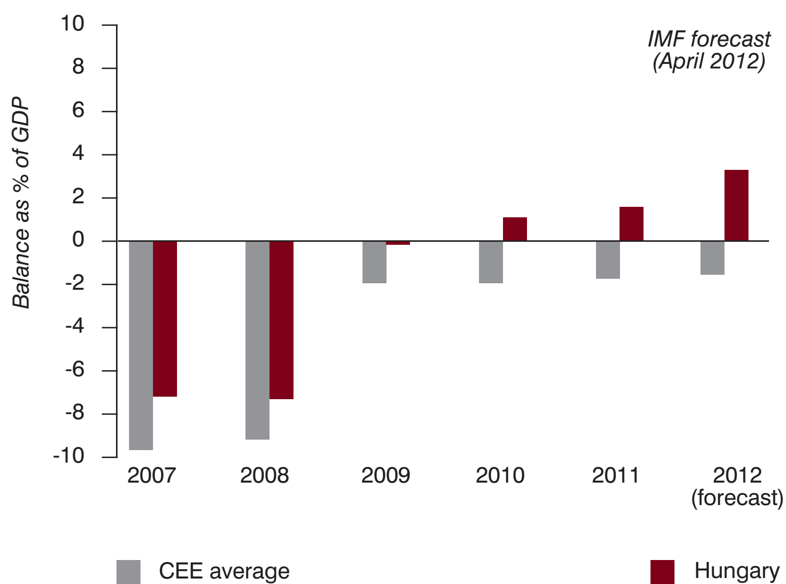
- *Hungary is an EU member that currently does not use the euro.*
- *There is no fixed date of the euro introduction.*
- *Hungary is using a flexible exchange rate that supports Hungarian exports, which are highly dependent on the eurozone situation.*
- *With a large public debt and high level of external indebtedness, the risks for exchange rate stability are high. With high financing needs, the current account surplus reduces these risks only to a certain degree.*

The external balance

Before the economic crisis, Hungary was a country running large current account deficits. Since 2009 the stagnant domestic demand and relatively good export performance resulted in a slightly positive current account balance. Such a result somehow helps to reduce the large external debt (140% of GDP in 2011).

By continuing the fiscal tightening policy, keeping the domestic demand down, it should help to keep the external balance improvement on track. The current account is expected to record an increased surplus in 2012.

Current account balance



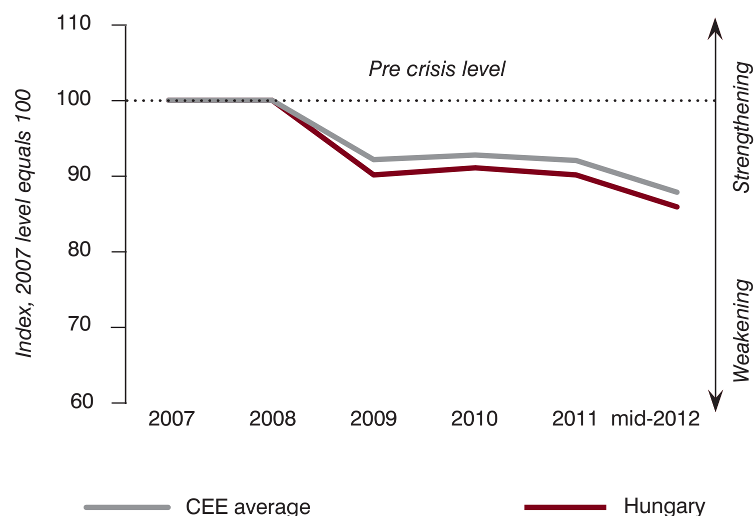
Source: IMF

Stability of the currency

Hungary uses a flexible exchange rate policy that helped improve the Hungarian external balance in recent years. Over the crisis, the Hungarian forint depreciated against the euro by around 10%. The weakening of the currency led to a CPI inflation increase above the target set by the national bank. An increase in policy rates, despite the low demand, might therefore be the only possible way to keep prices on track and stabilise investors' expectations.

As reserve levels are relatively low, the external indebtedness is high, and the investors' sentiment in general is not favourable; the stability of the Hungarian forint might be a matter of concern. On the other hand, the reinforced government commitment to the prudent fiscal policy and structural reforms may support the forint performance on the foreign exchange market.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Hungary	CEE Region
General government balance	4.0	-0.9
Public debt	80.4	28.3
Foreign exchange loans	32.1	16.6
Loans to deposits (ratio)	131%	127%
Current account balance	1.6	0.3
Foreign debt	160.5	54.4
Short-term debt	55.7	21.0
Coverage of financing needs by reserves (ratio)*	71%	142%
Credit rating (S&P)	BB+	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

The high dependence on exports, the high exposure to foreign financing, as well as the risk of a rapid loss of credibility, make Hungary highly vulnerable for any external and internal shocks.

The banking sector remains vulnerable due to a high share of foreign exchange credits and rising number of non-performing loans. Due to significant pressures in the eurozone, parent foreign institutions controlling 2/3 of Hungarian banking assets may be more reluctant to support their subsidiaries.

On the other hand, one has to observe that the fiscal tightening works in an opposite direction, albeit at a considerable cost to the real economy.

It is expected that the fiscal situation will improve in the short and medium term. Authorities are also trying to support external credibility, renegotiating the joint IMF and EU financial support.

Much effort is necessary to implement structural reforms in the real sector that would increase the country's long term growth potential.

Poland

Population in millions: ***37.9***

Poland

Basic data *(2011 or latest available data)*	Poland	CEE Region	Region=100
Population in millions	37.9	310.8	12.2
GDP, billions of US$	514	3 531	14.6
GDP per capita, thousands of US$*	20.3	15.9	127.9
GDP growth rate, average 2009-12	3.1	0.7	x
CPI inflation	4.3	8.3	x
Exports as percent of GDP	44.8	41.6	x
Net FDI as percent of GDP	1.8	1.3	x

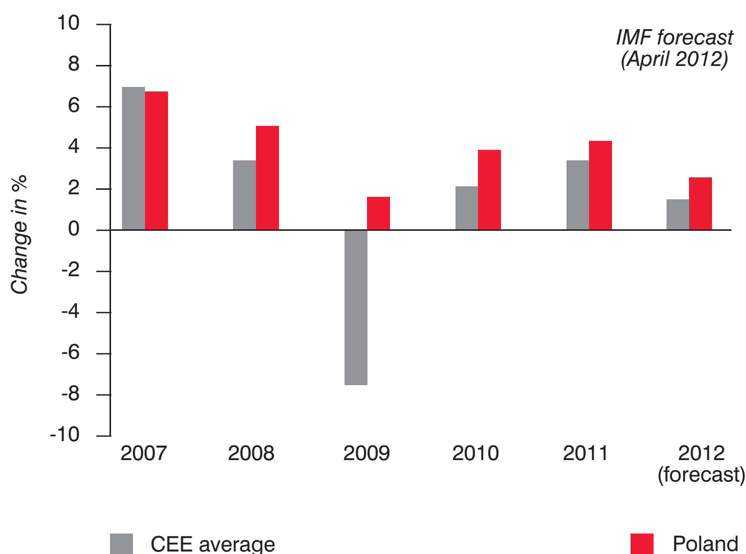
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Polish economy recorded a solid growth performance during the entire period of the global financial crisis. The main reasons behind the continuous GDP growth were: the relatively low level of dependence on exports, the moderate indebtedness, the strong banking sector, and the strong fiscal stimulus financed partly through EU structural funds.

In the coming years, the growth outlook is expected to be bleaker, especially due to the fact of necessary fiscal consolidations. Together with weaker exports to the eurozone markets, both phenomena are likely to lead to a serious slowdown of growth that may be further accelerated if the eurozone turmoil results in problems with the financing of the current account.

GDP growth rates



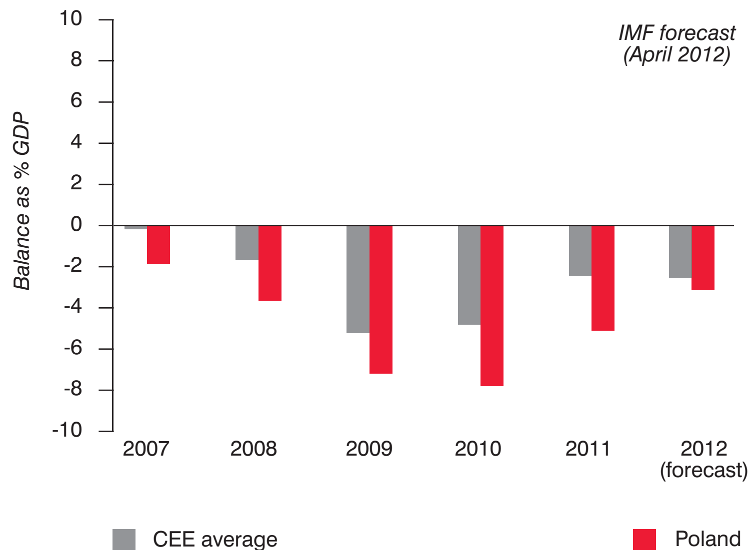
Source: IMF

Public finance

The position of the Polish public finance sector deteriorated during the global financial crisis as the government was actively using the fiscal policy to stimulate the economy. Although the strong banking sector did not require any public support and a large portion of the infrastructure development costs were covered by the inflow of EU funds, the general government deficit increased to 7-8% of GDP in 2009-2010, leading to the increase of public debt during the crisis from 45 to 55% of GDP.

Currently, the space to manoeuvre the fiscal policy is greatly reduced as Poland is undertaking a necessary fiscal consolidation program with the aim of approaching a 3% fiscal deficit level in 2012, which is a requirement set out by EU treaties.

General government balance



Source: IMF

Poland vis-à-vis the euro

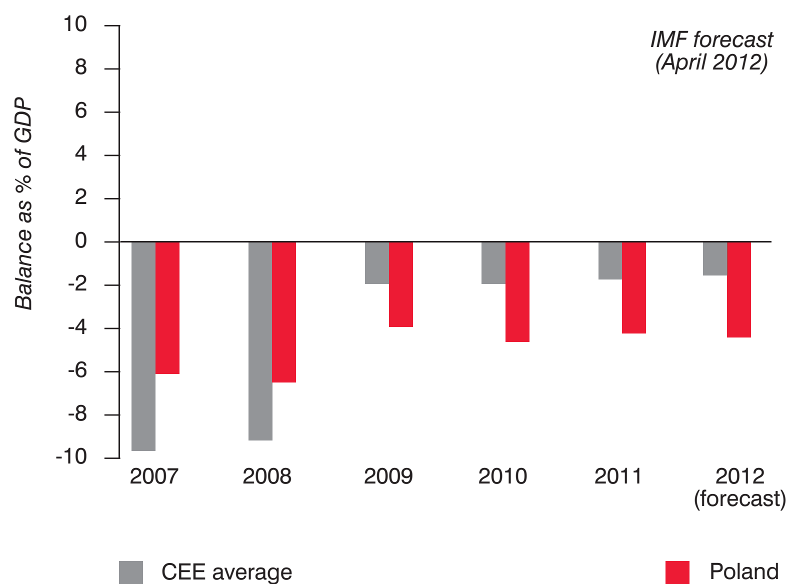
- *Poland is an EU member that currently does not use the euro.*
- *There is no fixed date of the euro introduction and entering ERM2.*
- *Poland is using a flexible exchange rate policy that helps the economy to deal with the crisis.*
- *The risk of a major instability of the currency is limited as the indebtedness is moderate, the banking sector strong, and the financial credibility relatively high.*
- *A weak point is a relatively high dependence on foreign financing (quite elevated current account deficit).*

The external balance

Poland is a country with a chronic deficit of domestic savings, insufficient to finance the country's capital needs. Therefore, Poland has been running current account deficits for years while at the same time building foreign debt. In normal times, the current account deficit was comfortably financed primarily through large FDI inflows.

The current account deficit was reduced during the global financial crisis to 4-5% of GDP. Given the relatively high financial credibility of the country (A- rating), continuous inflow of FDI, as well as the sufficient level of foreign exchange reserves, the situation does not look dangerous.

Current account balance



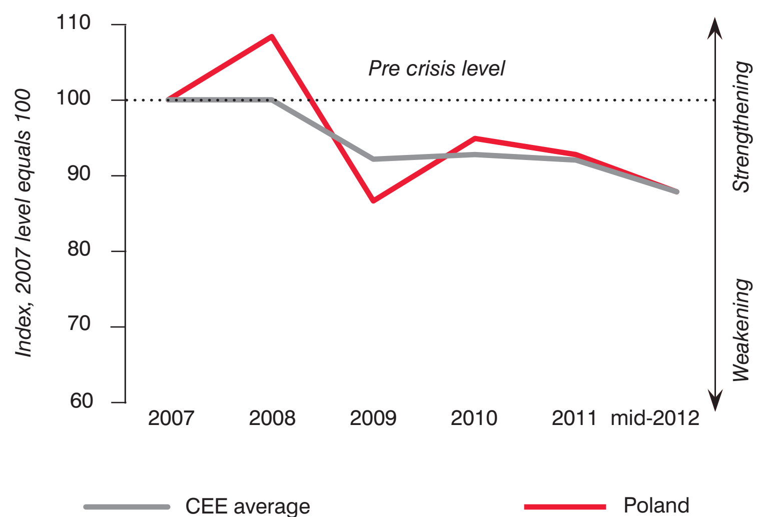
Source: IMF

Stability of the currency

Poland is using a flexible exchange rate policy that helps the real economy deal with the effects of the economic slowdown or recession in the eurozone. Over the crisis, the Polish zloty weakened in comparison to the euro by ca. 10%. The depreaciation of the currency, albeit considerable, did not lead to a significant increase in inflation. Nevertheless, the increase of CPI inflation to 4% raises concerns about a possible policy response.

The stability of the currency is strengthened by a solid banking sector. With a moderate size of foreign exchange denominated domestic loans, the banking sector can comfortably deal with strong currency fluctuations without risk of any general failure.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Poland	CEE Region
General government balance	-5.2	-0.9
Public debt	55.4	28.3
Foreign exchange loans	16.9	16.6
Loans to deposits (ratio)	111%	127%
Current account balance	-4.3	0.3
Foreign debt	67.3	54.4
Short-term debt	25.0	21.0
Coverage of financing needs by reserves (ratio)*	89%	142%
Credit rating (S&P)	A-	x

**Ratio of foreign exchange reserves to short-term debt and current account balance*
*** Including the IMF flexible credit line*
Source: IMF, EBRD, Standard & Poor's, central banks

Albeit the exposure of the country to foreign financing is considerably high, and the fiscal situation requires continuous consolidation efforts, the situation of Poland looks relatively comfortable.

Due to austerity measures, the general government balance is likely to be reduced to 3% of GDP with the debt to GDP ratio stabilized at 56% of GDP. Nevertheless, there is a small amount of room to manoeuvre the fiscal policy, and therefore its ability to counteract the economic slowdown, is quite limited.

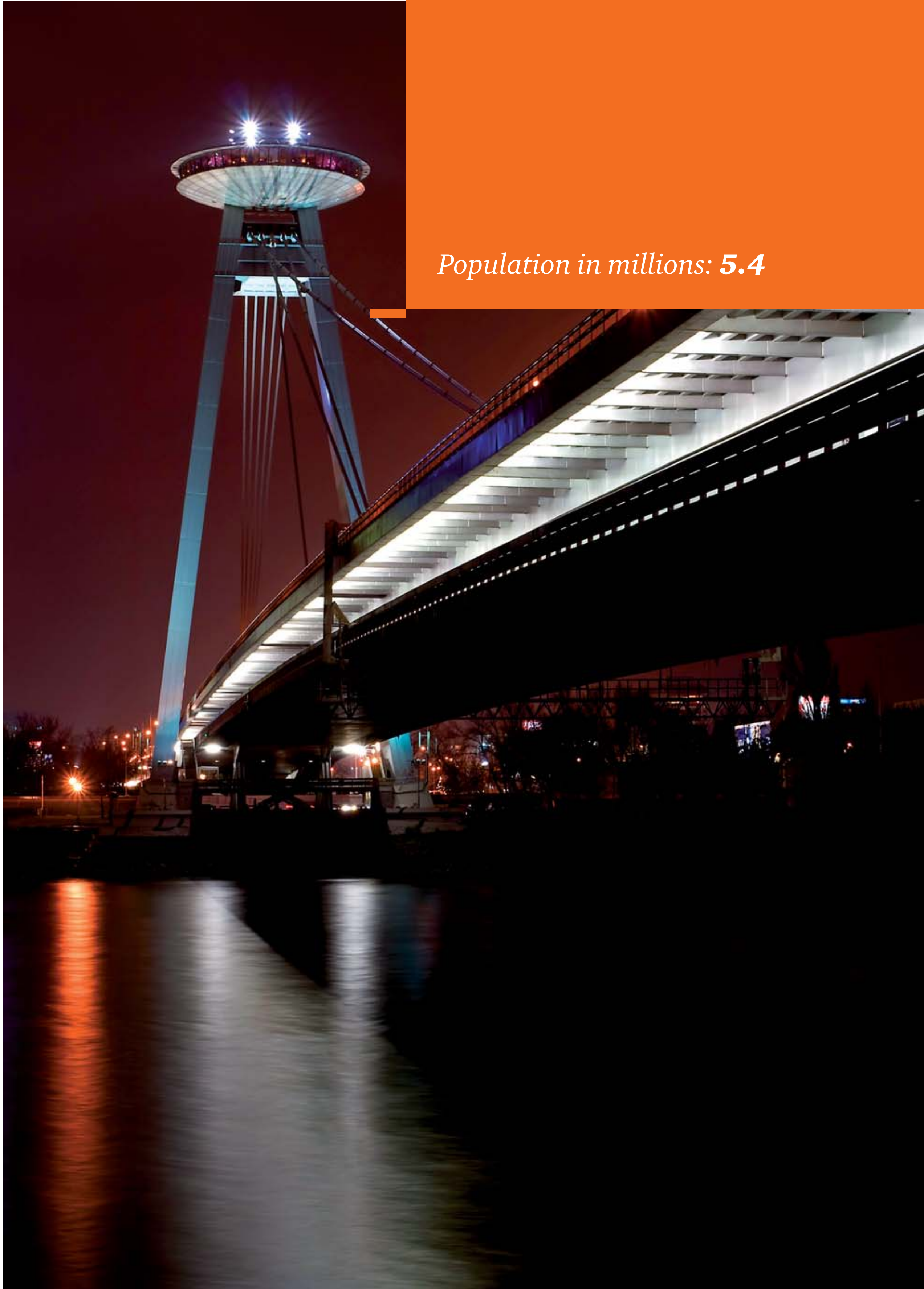
The banking sector remains quite strong. Its vulnerability to exchange rate fluctuations, as well as to the risk of freezing international financial markets is limited.

However, the high share of foreign banking groups in total assets raises fears about possible contagion effects.

The country's exposure to external financial risks, albeit considerable due to the quite elevated current account deficit, is mitigated by the relatively high financial credibility, sufficient foreign exchange reserves (increased by a special flexible credit line secured by the IMF) and the continuously high attractiveness for FDI.

Slovakia

Population in millions: ***5.4***



Slovakia

Basic data *(2011 or latest available data)*

	Slovak Republic	CEE Region	Region=100
Population in millions	5.4	310.8	1.8
GDP, billions of US$	96	3 531	2.7
GDP per capita, thousands of US$*	23.3	15.9	146.5
GDP growth rate, average 2009-12	1.2	0.7	x
CPI inflation	4.1	8.3	x
Exports as percent of GDP	89.1	41.6	x
Net FDI as percent of GDP	1.7	1.3	x

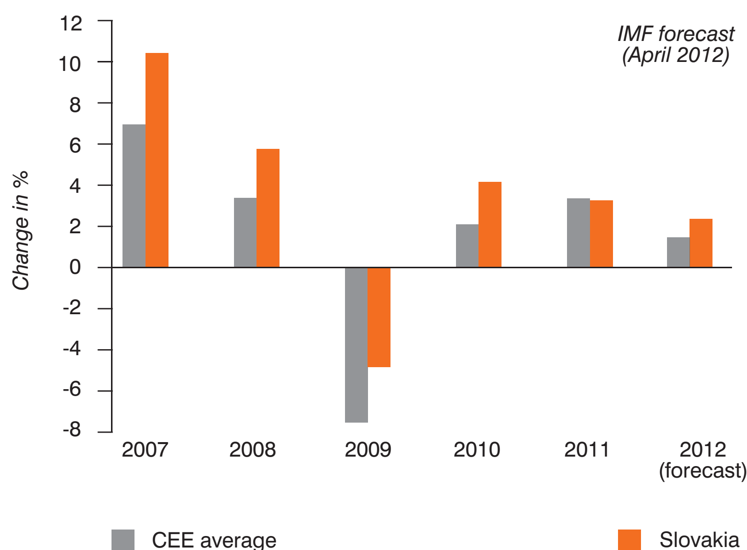
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Slovak economy recorded a 4% slump of GDP in 2009, but afterwards, the growth performance was solid. The recovery of the Slovak economy has been mainly export driven, strongly dependent on the growth of their main trading partners. The worrisome feature of the Slovakian real sector is the high unemployment rate, mainly due to structural imbalances (currently on a level of 14%).

As in the case of other export led, small economies, the performance of the real sector is strongly dependent on the international market. As expectations in this regard are mostly pessimistic, the growth prospects of the Slovak economy also look bleaker. The economy is likely to slow down slightly in 2012 with only modest expected growth rates for later periods – around 3% in the long term.

GDP growth rates



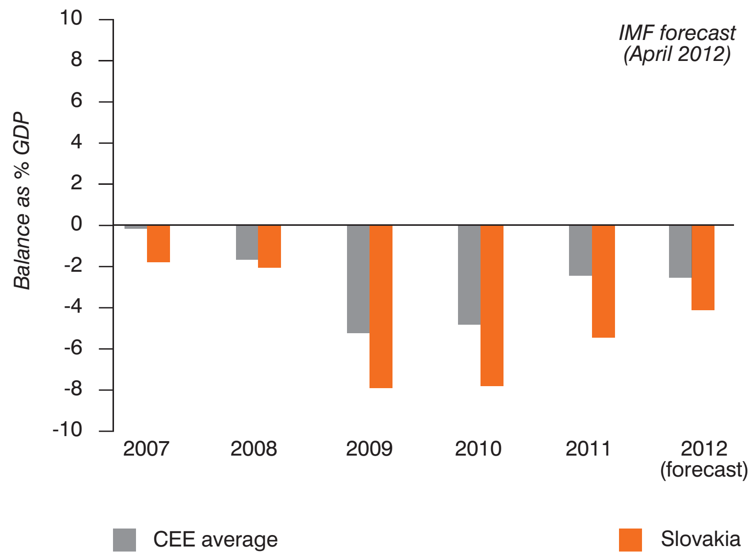
Source: IMF

Public finance

Before the crisis, the Slovak public finance sector recorded a small deficit of 2% of GDP. As a result of the crisis, the government decided to run an expansionary fiscal policy, leading to a surge of the general government deficit to 8% of GDP. The fiscal consolidation is currently supported by significant cuts on the expenditures side, with a stable fiscal revenue to GDP ratio.

Although the level of public debt has been increasing in recent years and has not been stopped yet, debt to GDP ratio is still better than in most CEE countries. The continuation of the current fiscal policy should lead to the gradual improvement of the situation, so the risks on the fiscal side are quite limited.

General government balance



Source: IMF

Slovakia vis-à-vis the euro

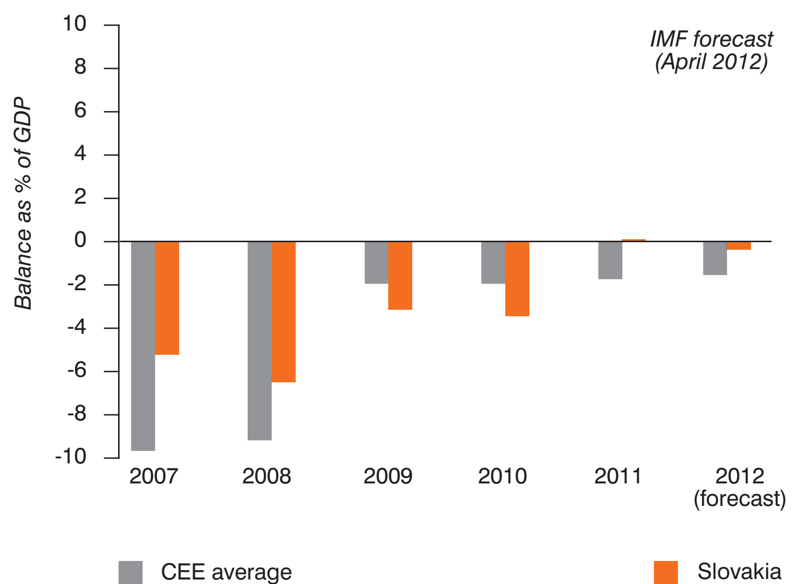
- *Slovakia is a member of the EU and joined the eurozone on the 1st of January 2009.*
- *Improving external balance and fiscal balance, sound banking system and a solid GDP growth influence the country's resilience to potential problems.*

The external balance

Slovakia has been running a relatively large current account deficit before the crisis. As a result of the GDP fall in 2009, followed by a relatively slow, primarily export led growth afterwards, the situation has been improving. In 2011 Slovakia recorded a small current account surplus.

The level of foreign debt is manageable, while the membership in the eurozone makes Slovakia more resilient to potential external financial threats.

Current account balance



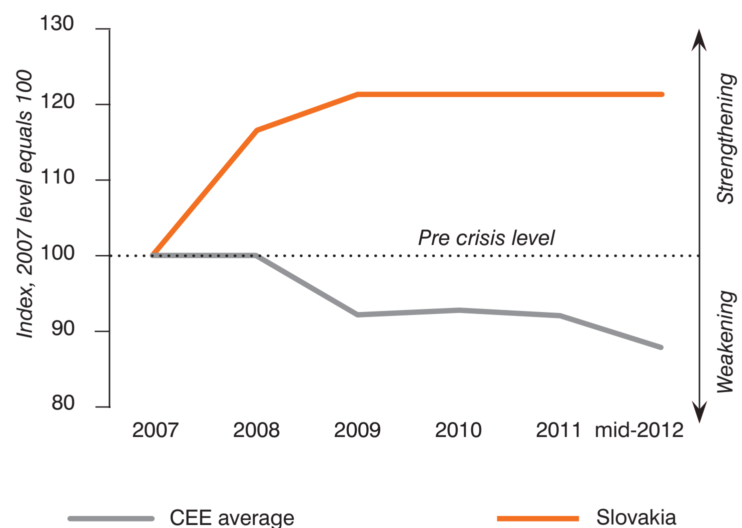
Source: IMF

Stability of the currency

Slovakia joined the eurozone in 2009 and the exchange rate of the Slovak koruna had appreciated strongly just before the adoption of the euro. The stable currency worked against the short run competitiveness of the Slovak economy and was one of the reasons of a relatively deep recession in 2009.

Since then, as a member of the eurozone, Slovakia can enjoy the stable currency environment allowing Slovak exporters to rebuild their competitiveness.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Slovak Republic	CEE Region
General government balance	-5.5	-0.9
Public debt	44.6	28.3
Foreign exchange loans	13.7	16.6
Loans to deposits (ratio)	70%	127%
Current account balance	0.1	0.3
Foreign debt	76.9	54.4
Short-term debt	54.1	21.0
Coverage of financing needs by reserves (ratio)*	..**	142%
Credit rating (S&P)	A	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
*** Member of the eurozone (common pool of reserves)*
Source: IMF, EBRD, Standard & Poor's, central banks

The risks faced by the Slovak economy are mainly external. The economic growth recently has been export led with 85% of the exports being directed towards EU markets.

This means that the country's economic development is strongly dependent on the developments in the eurozone. Given the lack of an independent monetary policy, a long recession could lead to severe problems for Slovakia, particularly in the manufacturing sector.

The current account balance is positive, the level of public debt is low and foreign debt is manageable. Additionally, ratings of Slovak sovereign debt are very high.

The only major internal risks result from high unemployment, which in case of an economic slowdown, could rise to a socially unacceptable level.

Slovenia

Population in millions: ***2***

Slovenia

Basic data *(2011 or latest available data)*

	Slovenia	CEE Region	Region=100
Population in millions	2.0	310.8	0.7
GDP, billions of US$	50	3 531	1.4
GDP per capita, thousands of US$*	28.6	15.9	180.1
GDP growth rate, average 2009-12	-2.0	0.7	X
CPI inflation	1.8	8.3	X
Exports as percent of GDP	72.3	41.6	X
Net FDI as percent of GDP	2.1	1.3	X

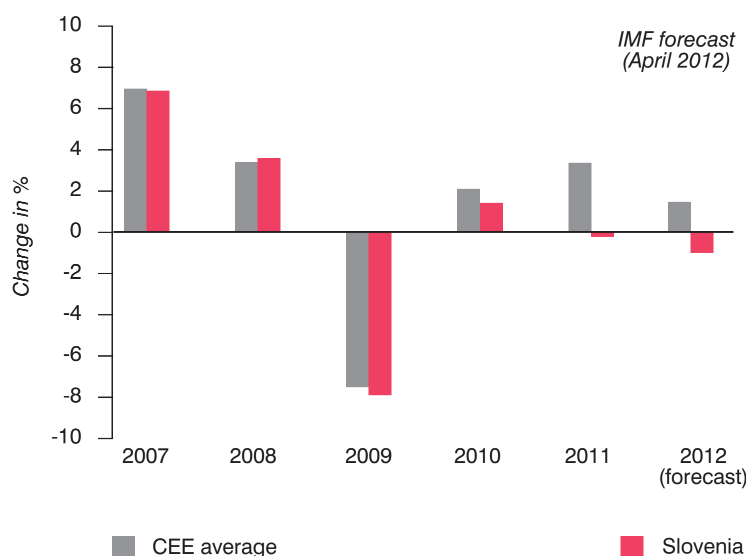
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Slovenian economy, growing on a reasonable level before the crisis, experienced a dramatic slump as a direct result of the economic crisis. It resulted from both the declining external demand and the end of the domestic construction boom. The recovery is weak and unstable, with GDP growth already falling below zero in 2011. Such an outcome is a result of the weak competitiveness of Slovenian manufacturing combined with the continuous process of domestic banks deleveraging, leading to the reduction of available credit.

The expectations for the future are also bleak. Without substantial and potentially unpopular structural reforms, e.g. labour market reforms, the Slovenian economy will not be able to return to a solid growth track, particularly when faced with external shocks.

GDP growth rates



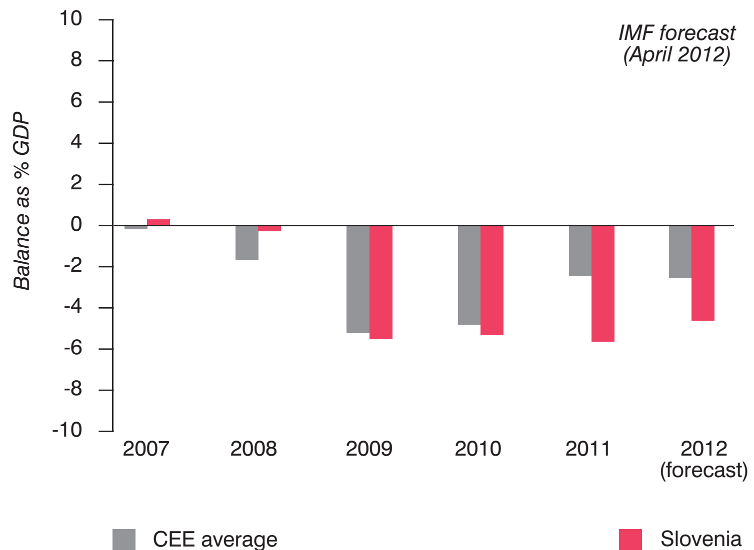
Source: IMF

Public finance

Before the crisis, Slovenia was able to run a close to balanced budget policy. As a result of the crisis, the earlier imbalances in the financial sector were partially absorbed by public finances, with the government deciding to give a direct fiscal stimulus to the economy by cutting taxes and extending subsidies. As a result, the general government deficit increased to 6% of GDP and stabilized at this high level.

As the economy is shrinking and expenditure pressures are still in place, the situation of the public finance sector is not likely to improve in the nearest future. The government deficit will remain high and the public debt, which before the crisis amounted to 22% of GDP, will only shortly rise to over 50%. The situation is not sustainable in the medium and long term and asks for a serious policy action.

General government balance



Source: IMF

Slovenia vis-à-vis the euro

- *Slovenia is a member of the EU and joined the eurozone on the 1st of January 2007.*
- *Improving external balance makes the country more resilient to external shocks.*
- *On the other hand, the real economy is stagnant and highly dependent on exports, the fiscal performance is weak, and the situation of banks is deteriorating.*
- *Extensive foreign debt may result in financial stability problems, similar to these faced by southern European countries, and external financial assistance might become necessary.*

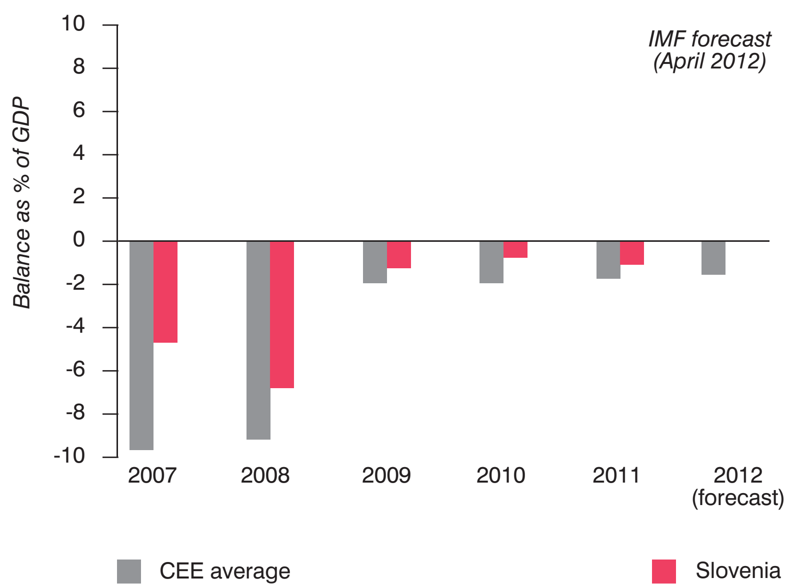
The external balance

As the result of the crisis, the situation of the Slovenian current account improved considerably, as imports have decreased due to low domestic demand. Although imports volume resumed growth, the rate is reduced and fully matched by exports.

Apart from trade deficits, the external balance of the country was also negatively influenced by the banking sector financing its huge domestic activity with foreign credit.

Deleveraging of the banking sector is an ongoing process that still negatively influences the economy. Deeper reform of the financial sector calling for recapitalisation and cleaning up balance sheets is currently one of the most important challenges faced by the Slovenian economy.

Current account balance

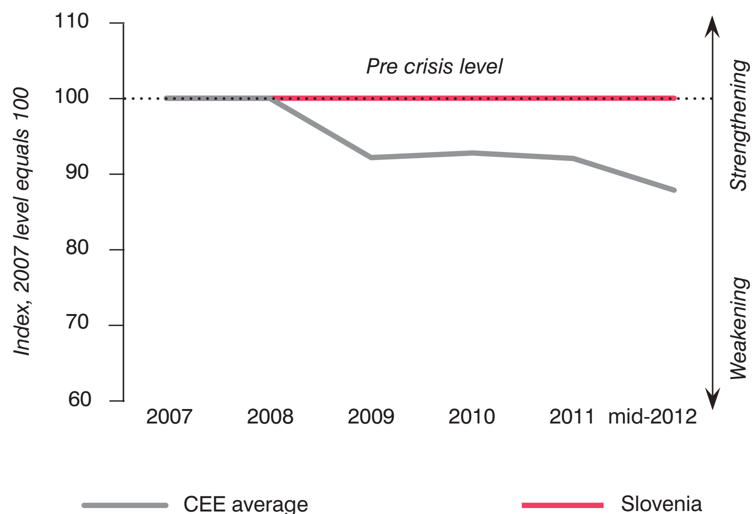


Source: IMF

Stability of the currency

As Slovenia is a member of the eurozone, the stability of the currency is not in danger in the short run. On the other hand, however, the existence of large foreign debt levels, fiscal problems, falling competitiveness, and shrinking economy looks dangerously similar to the situation observed in southern eurozone countries. Therefore the situation of the country will strongly depend on current and future development in the eurozone.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Slovenia	CEE Region
General government balance	-5.7	-0.9
Public debt	47.3	28.3
Foreign exchange loans	4.1	16.6
Loans to deposits (ratio)	154%	127%
Current account balance	-1.1	0.3
Foreign debt	122.3	54.4
Short-term debt	22.4	21.0
Coverage of financing needs by reserves (ratio)*	..**	142%
Credit rating (S&P)	A+	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
*** Member of the eurozone (common pool of reserves)*
Source: IMF, EBRD, Standard & Poor's, central banks

There are numerous risks faced by the Slovenian economy. First of all, it's economy is shrinking and the expectations for the future are rather bleak.

The fiscal situation is quite bad and calls for immediate deep austerity measures, as public debt is dynamically rising.

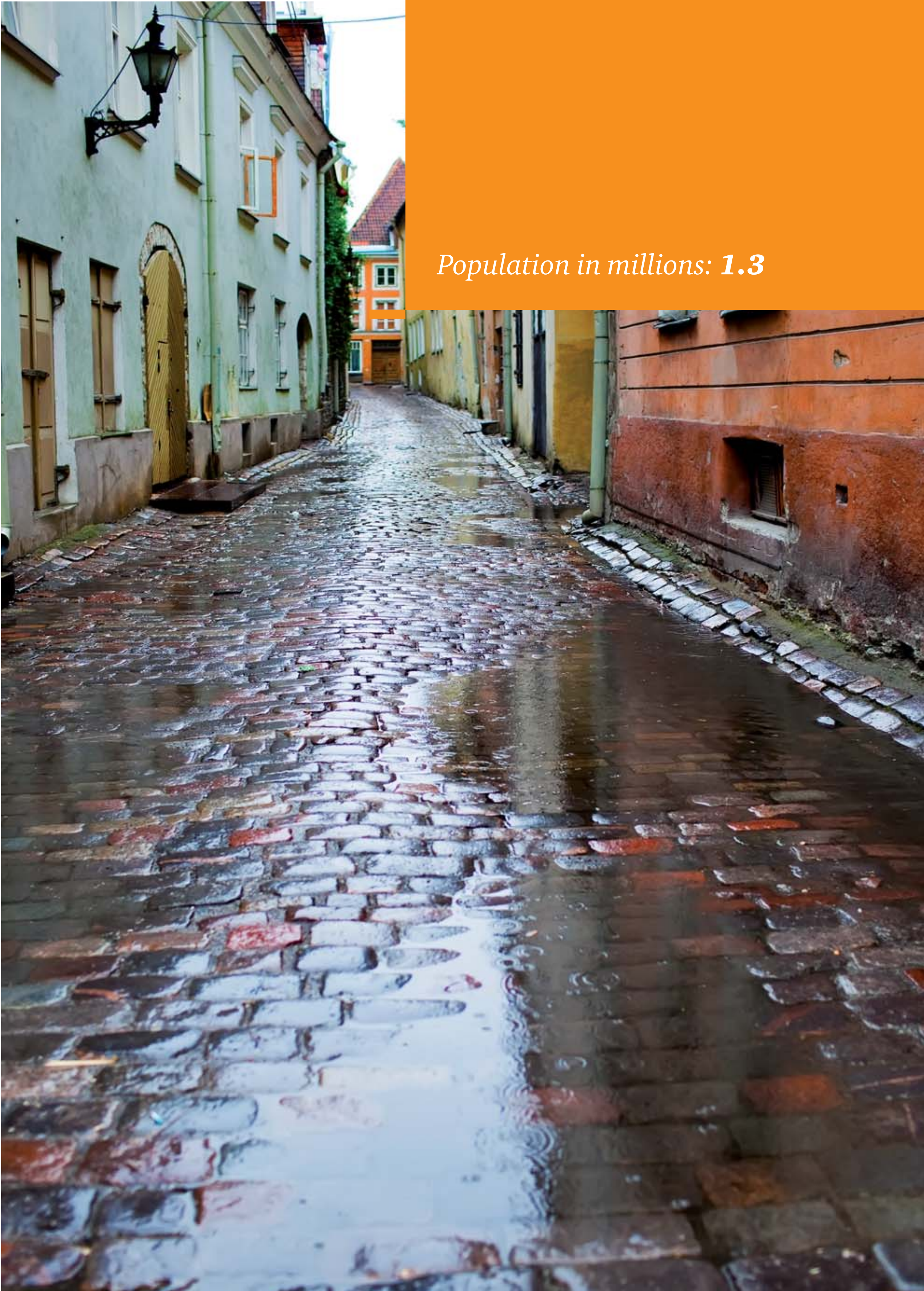
Although the current account is close to zero, the economy is uncompetitive in the long run and deeply indebted.

The situation is additionally aggravated by the unstable situation in the banking sector.

Therefore in spite of the membership in the eurozone, Slovenia seems to be highly vulnerable to external shocks.

Estonia

Population in millions: ***1.3***



Estonia

Basic data (2011 or latest available data)	Estonia	CEE Region	Region=100
Population in millions	1.3	310.8	0.4
GDP, billions of US$	22	3 531	0.6
GDP per capita, thousands of US$*	20.4	15.9	128.2
GDP growth rate, average 2009-12	-0.9	0.7	X
CPI inflation	5.1	8.3	X
Exports as percent of GDP	92.7	41.6	X
Net FDI as percent of GDP	7.4	1.3	X

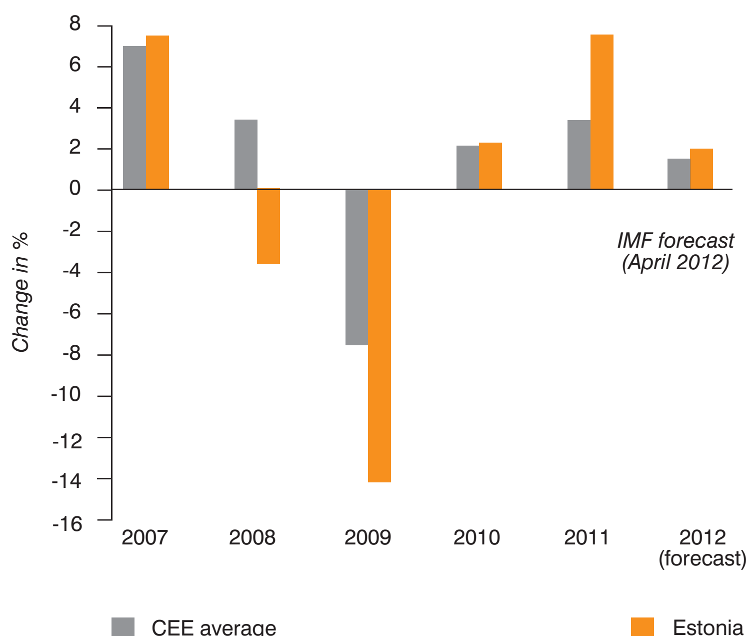
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

Estonia recorded an exceptionally high GDP contraction in 2009 (-14.3%) as a result of the economic crisis. In 2010 and 2011, the economy started to regain momentum reaching a GDP growth rate of 7.6% in 2011. Net exports remained, even in the toughest period, the key growth engine for the Estonian economy (in 2009 mainly thanks to a drastic reduction of imports), whereas investments and private consumption dragged the economy down.

In a more recent period, all factors positively contributed to GDP growth. According to the most recent IMF forecast in 2012, the demand for Estonian exports will diminish once again due to the European-wide economic slowdown, resulting in a negative net-export contribution to GDP. Nevertheless the GDP growth rate may still remain positive and is expected to re-accelerate again in 2013.

GDP growth rates



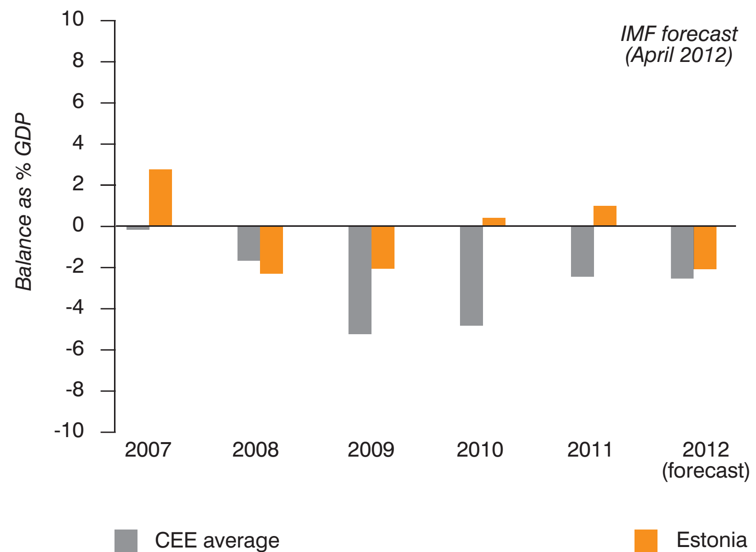
Source: IMF

Public finance

Although the situation of the Estonian public finance sector slightly deteriorated as a result of the economic crisis in 2008-2009, it is still much better than in most CEE countries. In 2011 the general government balance recorded a surplus of 1%. It is a result of the long-standing commitment to fiscal prudence. The level of public debt is also exceptionally low – reaching only 6% of GDP in 2011.

The fiscal situation in Estonia should also remain exceptional in the nearest future. The general government deficit of about 2% of GDP that is expected in 2012 will mainly result from an economic slowdown and will work as an automatic fiscal stabiliser that prevents the economy from contracting.

General government balance



Source: IMF

Estonia vis-à-vis the euro

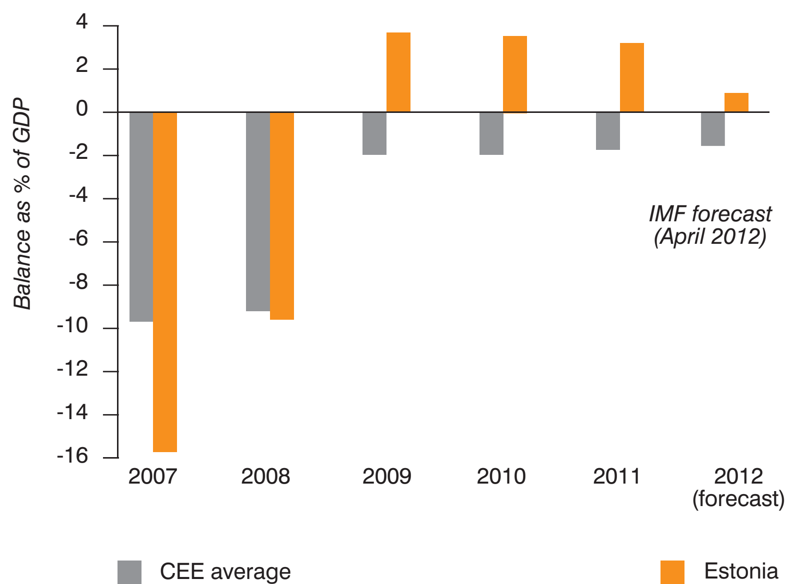
- *Estonia is a member of the eurozone since the 1st of January 2011.*
- *Before the euro adoption, the country was running a fixed exchange rate policy for several years (currency board).*
- *Positive current account balance, positive general government balance and very low level of public debt influence the country's resilience to financial distress.*
- *The primary negative feature is a high dependence on exports and the resulting vulnerability to the real sector.*

The external balance

The current account balance was largely negative before the crisis and was financed mainly by heavily leveraged banks.
The situation sharply improved since 2009 as imports fell by 35% and the volume of exports by 23%. Since then the country runs a current account surplus of about 3% of GDP. Banks deleveraged and the external debt pressure is mitigated.
The FDI inflow to Estonia is also reasonably high – reaching 7% of GDP in 2010-2011.

The current account will also stay on the positive side in 2012, whereas it may slightly decline later as the result of higher domestic demand and increasing imports. Further deleveraging in the banking sector will result in further reduction of the external debt.

Current account balance



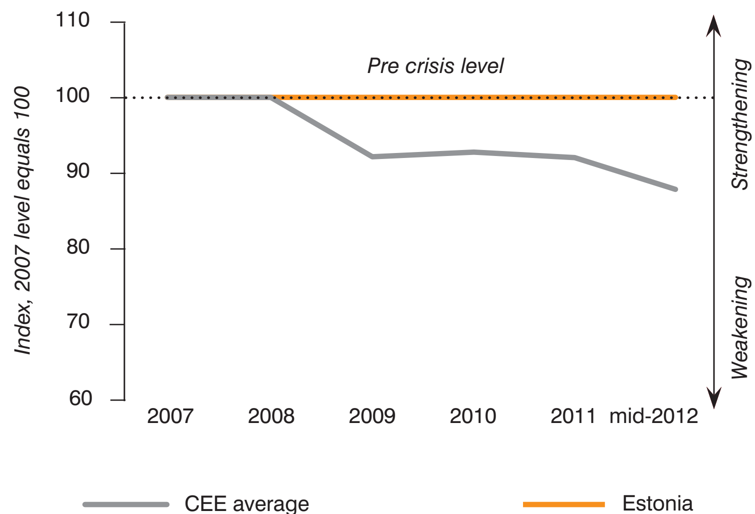
Source: IMF

Stability of the currency

As Estonia is a eurozone member, there is no exchange rate risk. As far as the external debt is kept in manageable magnitudes, there is no risk that Estonia will suffer the pressures similar to those experienced by southern European countries.

A prudent fiscal policy is also a strong support for external sector stability.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Estonia	CEE Region
General government balance	1.0	-0.9
Public debt	6.0	28.3
Foreign exchange loans	1.2	16.6
Loans to deposits (ratio)	130%	127%
Current account balance	3.2	0.3
Foreign debt	103.9	54.4
Short-term debt	51.8	21.0
Coverage of financing needs by reserves (ratio)*	..**	142%
Credit rating (S&P)	AA-	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
*** Member of the eurozone (common pool of reserves)*
Source: IMF, EBRD, Standard & Poor's, central banks

The risks faced by the Estonian economy are primarily external. With 2/3 of its exports directed towards EU markets, and with an extremely high export dependence of the economy, the country is highly vulnerable to any negative development in the European Union.

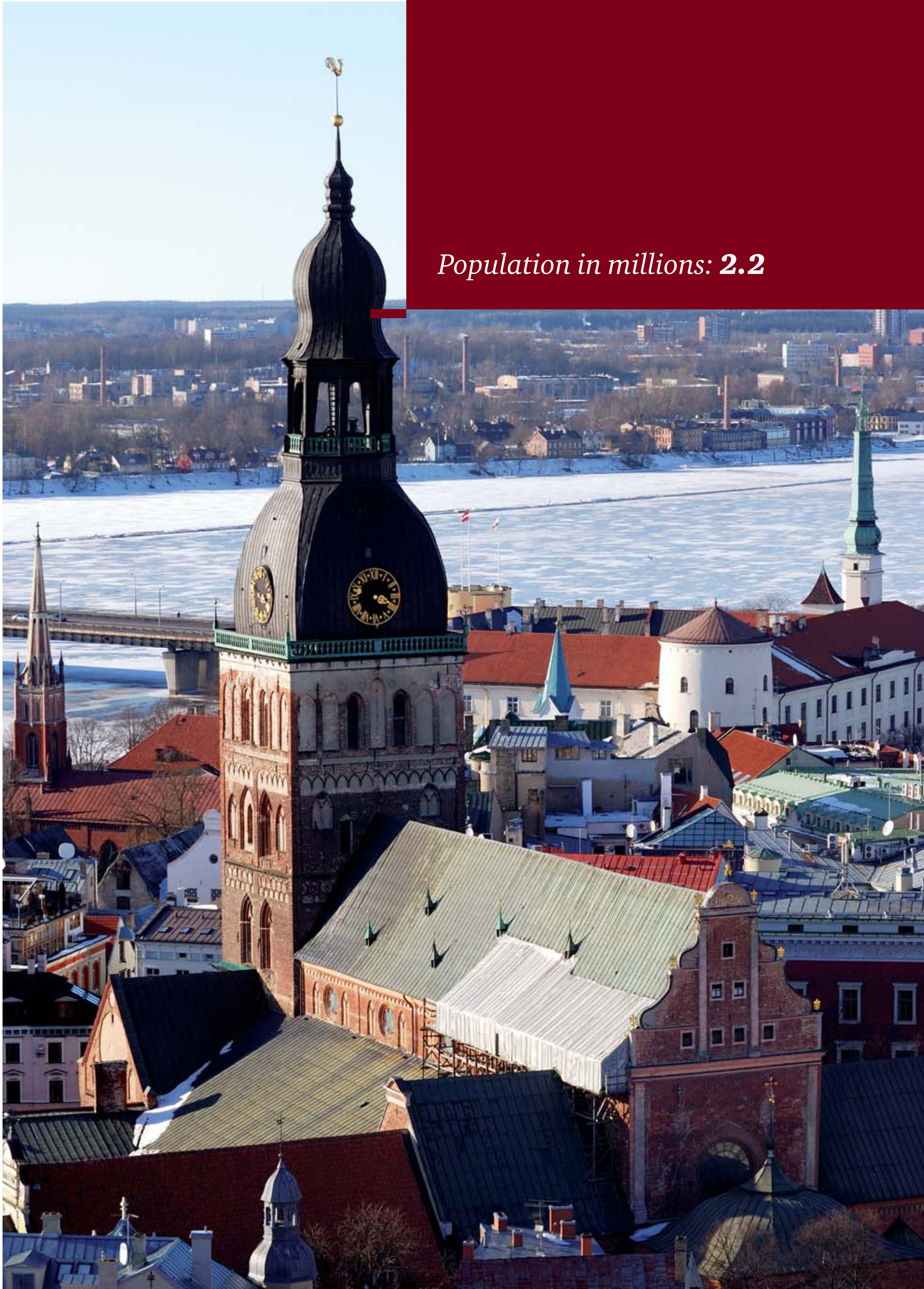
Although external risks are strongly limited as Estonia is a member of the eurozone, high external indebtedness may also constitute a certain risk factor. While the loans to deposit ratio has strongly diminished in recent years, it still remains high.

The activities of Estonian banks, with 98% of their assets controlled by foreign owned institutions, are strongly dependent on the availability of resources from their parent institutions.

There are no serious risks on the fiscal side, as the government is strongly committed to running a small budget surplus with a public debt level being negligible.

Latvia

Population in millions: ***2.2***



Latvia

Basic data *(2011 or latest available data)*

	Latvia	CEE Region	Region=100
Population in millions	2.2	310.8	0.7
GDP, billions of US$	28	3 531	0.8
GDP per capita, thousands of US$*	15.7	15.9	98.5
GDP growth rate, average 2009-12	-3.1	0.7	x
CPI inflation	4.2	8.3	x
Exports as percent of GDP	59.3	41.6	x
Net FDI as percent of GDP	5.2	1.3	x

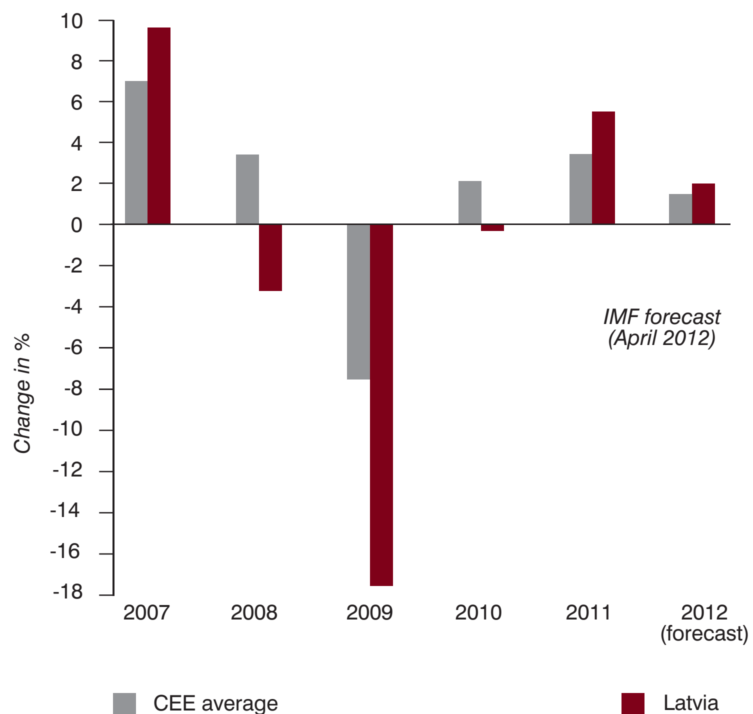
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

After a period of dynamic growth, the Latvian economy suffered a dramatic GDP contraction between 2008 and 2010. The cumulative GDP fall over that period reached 20%. It was primarily a result of the deep reduction in consumption and investments, necessary to balance the economy. Net exports had a positive contribution to growth during these tough times, mainly due to rapidly falling imports. The economy has just restarted to grow in 2011, thanks to gradually restoring domestic demand.

For the coming years, only a modest GDP growth is expected. Both weaker exports to the eurozone markets and a continuously tight fiscal policy are likely to result in the growth rate of about 2%-3% per annum. The situation may be even worse if the eurozone turmoil will appear more severe.

GDP growth rates



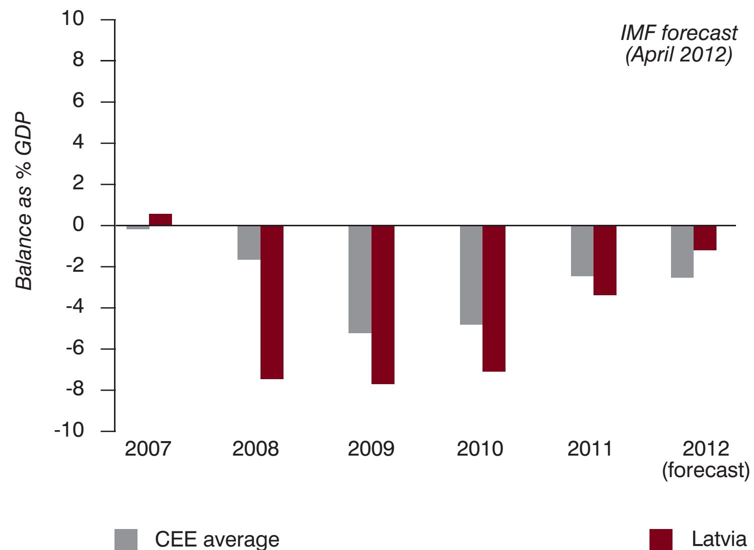
Source: IMF

Public finance

The financial crisis resulted in a dramatic deterioration of the fiscal situation in Latvia. The general government deficit was above 7% of GDP between 2008 and 2010, leading to the quick growth of public debt. Afterwards, as part of the IMF support program, the country's authorities implemented a substantial fiscal consolidation. This was achieved primarily by severe spending cuts as well as tax increases.

Strong government commitment to fiscal discipline will most likely result in a further improvement of the fiscal balance. Pressure may surface from social spending as the unemployment level in the country is high (over 15% in 2011) and the poverty rate is quite large with almost 40% of the population facing poverty risk.

General government balance



Source: IMF

Latvia vis-à-vis the euro

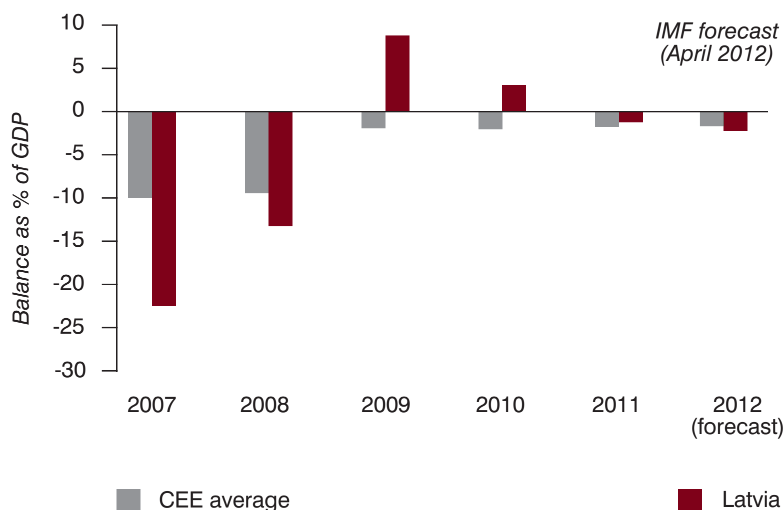
- *Latvia is an EU member that currently does not use the euro.*
- *It is a member of ERM2 since May 2005.*
- *The exchange rate is set at 0.7 lat/euro and floats within 1% of that rate (practically meaning a fixed exchange rate).*
- *There is a risk of strong market pressures against the lat presence in ERM2, as the foreign indebtedness is relatively high and economic performance after the crisis was not satisfactory.*
- *The external balance was supported by the joint financial assistance programme of the EU, IMF, EBRD, Nordic Countries and the World Bank.*

The external balance

Before the crisis, Latvia recorded huge current account deficits of over 20% of GDP, resulting from high levels of consumption and investment. The crisis resulted in a rapid improvement of the current account balance leading to positive figures in 2009-2010. Although the gradually restoring domestic demand has pushed it back below zero in 2011, the current account deficit remains quite modest.

Any improvement in the real sector will most likely result in higher levels of the current account deficit in the nearest future. It may be mitigated by the expected positive export performance resulting from a significant improvement in the country's international competitiveness in recent years, obtained by internal devaluation (wage cuts).

Current account balance



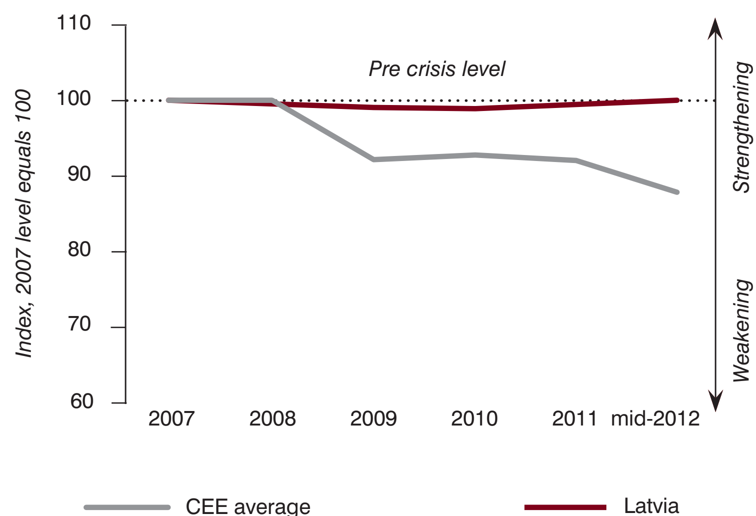
Source: IMF

Stability of the currency

Defending the Latvian lat exchange peg with the euro, and hence Latvia's presence in ERM2, was one of the primary targets of the government during the crisis. This task was supported by loans from international donors (EU, IMF, EBRD, Nordic Countries and the World Bank). Foreign exchange reserves were then rebuilt and Latvia could once again return to foreign capital markets.

The country's vulnerability to financial turmoil however still remains high. Foreign indebtedness has increased and the financial needs are substantial. The country will also have to repay much of the debt resulting from international support in 2014-2015, therefore cautious managing of foreign reserves is a must.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Latvia	CEE Region
General government balance	-3.4	-0.9
Public debt	37.8	28.3
Foreign exchange loans	65.8	16.6
Loans to deposits (ratio)	226%	127%
Current account balance	-1.2	0.3
Foreign debt	145.8	54.4
Short-term debt	56.3	21.0
Coverage of financing needs by reserves (ratio)*	39%	142%
Credit rating (S&P)	BBB-	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

The exposure of the country to foreign financing is considerably elevated mainly due to a high level of foreign debt (especially short term debt).

Due to a remarkable austerity program, the general government deficit is likely to be reduced below 1% of GDP, and the debt to GDP ratio may fall below 40%. Nevertheless, the fiscal policy may suffer from strong pressure for spending.

The banking sector managed to stabilize its position in recent years, but the share of non-performing loans is still high. The parent foreign banks keep deleveraging, negatively influencing the country's international reserves position.

The biggest risk, however, is created by the huge share of foreign exchange denominated loans. Therefore, any deviation from the fixed exchange rate policy could lead to a dramatic deterioration of the economic situation.

The situation of the financial sector may be aggravated in case of a perverse development in the eurozone. It would also harm the relatively positive export performance of recent periods and can have significant negative consequences for the country's external balance.

Lithuania

Population in millions: ***3.3***

Lithuania

Basic data *(2011 or latest available data)*	Lithuania	CEE Region	Region=100
Population in millions	3.3	310.8	1.1
GDP, billions of US$	43	3 531	1.2
GDP per capita, thousands of US$*	18.9	15.9	118.6
GDP growth rate, average 2009-12	-1.7	0.7	x
CPI inflation	4.1	8.3	x
Exports as percent of GDP	77.8	41.6	x
Net FDI as percent of GDP	2.5	1.3	x

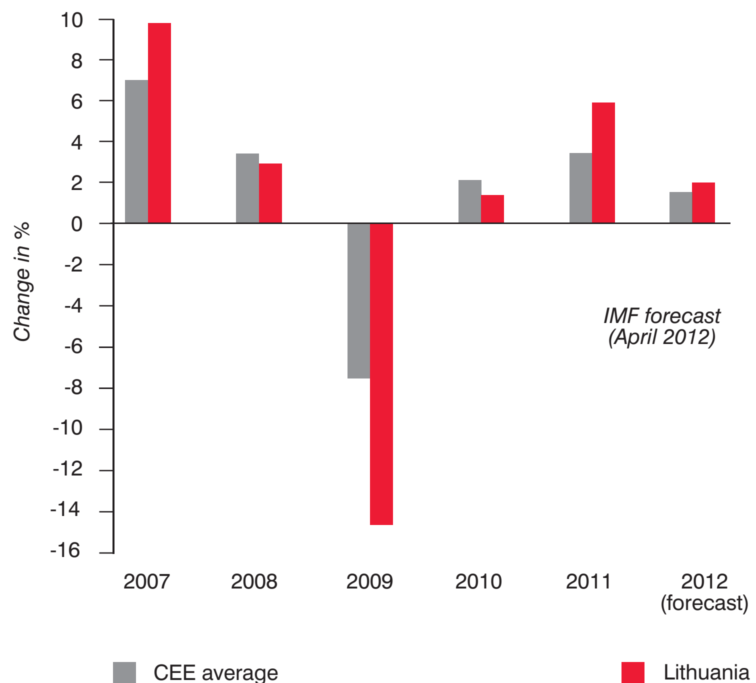
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Lithuanian economy recovered quite quickly after a huge 15% GDP contraction suffered in 2009. In 2010 it experienced positive GDP growth, and in 2011, the economy grew at a satisfactory rate of 5.8%. This impressive recovery was mainly fuelled by a growth in exports.

Due to unfavourable external conditions, the GDP growth is expected to slow down in years to come. It is also expected to be a result of rising domestic demand as employment levels are on the rise and wages are growing once again. The risks originate primarily from the external environment.

GDP growth rates



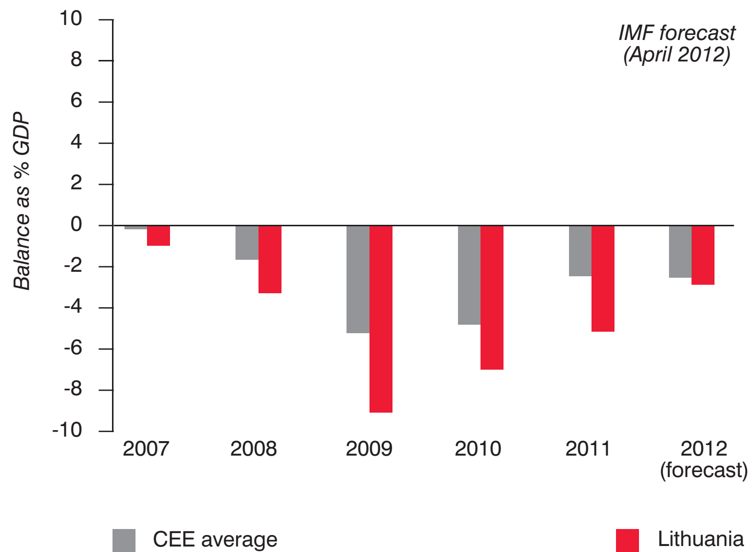
Source: IMF

Public finance

After a surge in the budget deficit during the crisis, the government consequently runs a fiscal policy centred primarily on expenditure restraints and revenue growth, therefore leading to an improvement of the economic situation in the country. The budget deficit level, albeit much higher than before the crisis, is moderate (39% of GDP in 2011).

Provided that the external situation does not change dramatically, the Lithuanian fiscal situation should continue to improve. Fiscal deficit is expected to gradually decrease, and the level of public debt should stabilise.

General government balance



Source: IMF

Lithuania vis-à-vis the euro

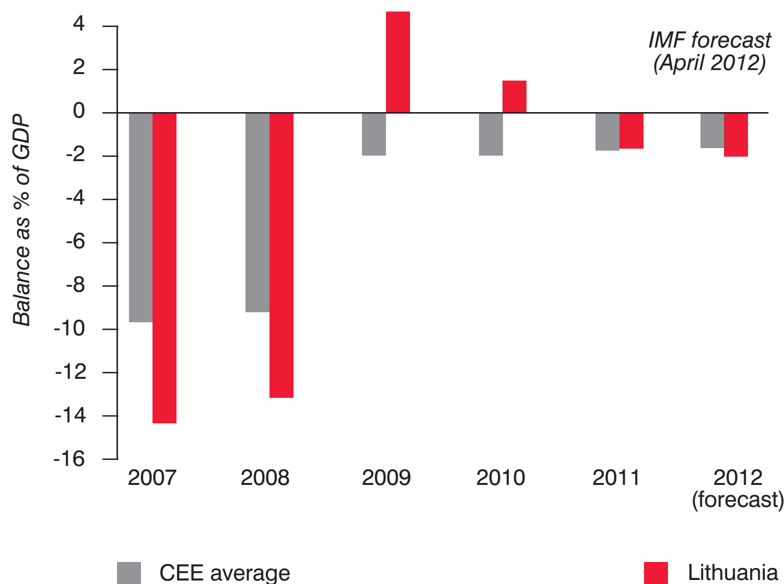
- *Lithuania is an EU member that currently does not use the euro.*
- *It is a member of ERM2 since June 2004.*
- *The exchange rate to the euro is set at 3.45.*
- *Lithuania has been unsuccessfully trying to join the eurozone since 2006.*

The external balance

Before the crisis, the country ran large current account deficits resulting from a booming domestic demand. The crisis resulted in the rapid improvement of the current account balance leading to positive figures in 2009-2010. As the domestic demand started to improve, it returned to below zero. The present level of the current account deficit is rather modest (1.7% in 2011). The external debt is on a relatively high, but manageable, level of 78%.

As the situation in the real economy improves, the current account deficit is expected to gradually rise in the nearest future. The external balance will also be supported by favourable performance of exports resulting from regaining competitiveness. The limited trade deficit is also more then covered by FDI inflows and incoming EU transfers.

Current account balance



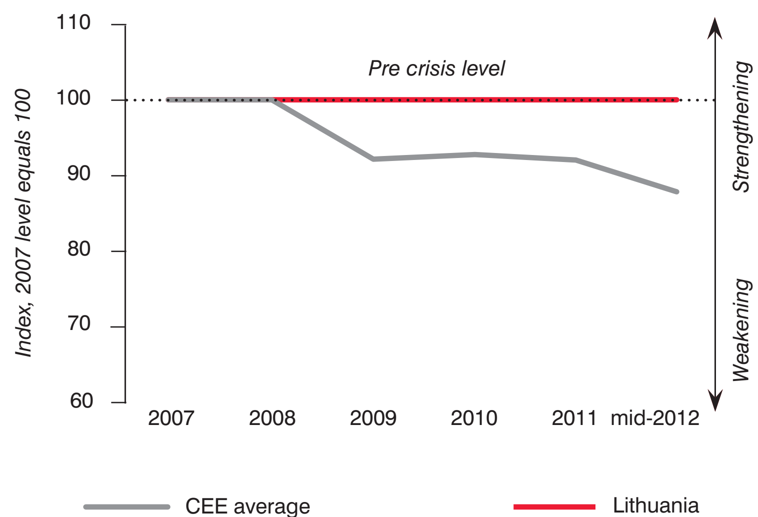
Source: IMF

Stability of the currency

Lithuania is a member of ERM2 and the Lithuanian litas is pegged to the euro at a central rate of 3.45. The Lithuanian authorities are committed to join the eurozone and the only Maastricht criterion that is currently not fulfilled by the country is the inflation rate.

There are currently no internal risks for exchange rate stability in the country. Much will depend however on further developments with the euro turmoil.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Lithuania	CEE Region
General government balance	-5.2	-0.9
Public debt	39.0	28.3
Foreign exchange loans	37.0	16.6
Loans to deposits (ratio)	137%	127%
Current account balance	-1.7	0.3
Foreign debt	78.5	54.4
Short-term debt	36.0	21.0
Coverage of financing needs by reserves (ratio)*	51%	142%
Credit rating (S&P)	BBB	x

**Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

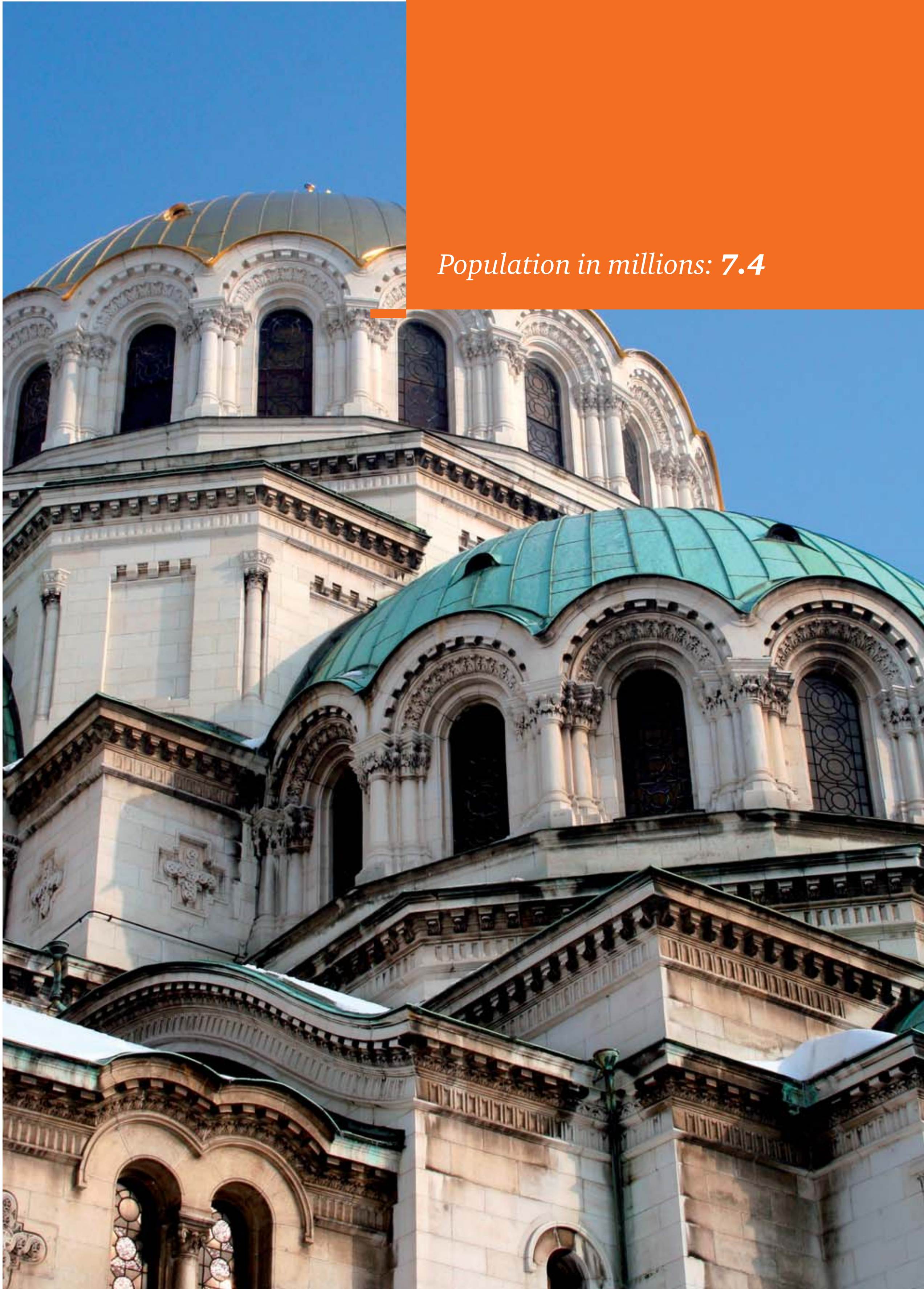
The exposure of the country to foreign financing is limited mainly thanks to a prudent fiscal policy.

The level of foreign debt is manageable; however, as a large portion of it is short term debt, it may put pressure on the country's financing needs.

The banking system as a whole is currently profitable and well capitalised. Banking system liquidity is high enough to support the government if it needs to depend more on domestic financing. It results from the limited credit demand from the private sector.

The country's ratings of sovereign debt are on reasonably good levels as all three major agencies consider the Lithuanian bonds as investment assets.

Bulgaria



Population in millions: ***7.4***

Bulgaria

Basic data *(2011 or latest available data)*	Bulgaria	CEE Region	Region=100
Population in millions	7.4	310.8	2.4
GDP, billions of US$	54	3 531	1.5
GDP per capita, thousands of US$*	13.6	15.9	85.5
GDP growth rate, average 2009-12	-0.7	0.7	x
CPI inflation	3.4	8.3	x
Exports as percent of GDP	63.4	41.6	x
Net FDI as percent of GDP	3.1	1.3	x

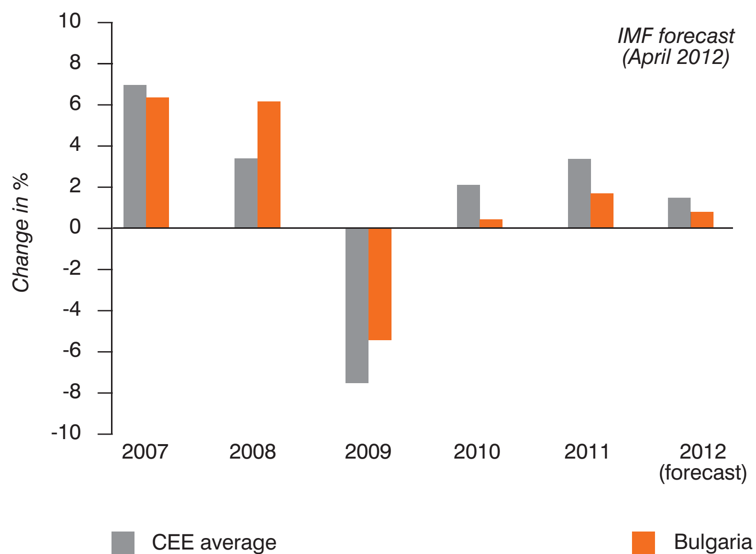
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Bulgarian economy recorded a relatively weak growth performance in recent years. The main reasons behind the weak GDP performance were: the reduction of domestic demand mainly resulting from a rapid decline in investments (particularly FDI) as well as a decline in exports.

The expected growth rates for years to come are also relatively low. Albeit the exports seem to have regained the pre-crisis dynamics, the investment demand is still stagnant. The expected growth rate for 2012 is below the CEE average. According to IMF forecasts, it is not expected to return to pre-crisis figures until at least 2015.

GDP growth rates



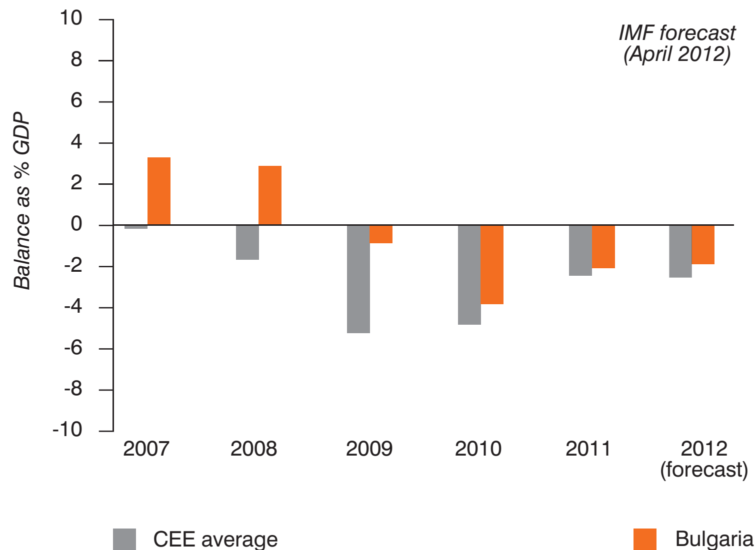
Source: IMF

Public finance

On the other hand, the situation of the Bulgarian public finance sector is relatively good, although it has also deteriorated in 2009-2010 mainly due to a severe reduction in budget revenues, which work as a natural fiscal stabiliser. Since 2010, however, the government has been introducing reforms aimed at improving revenue, resulting in a reduction of the fiscal deficit. The level of general government public debt in Bulgaria is one of the lowest in the CEE and in the EU with it being only slightly higher than 17% of GDP in 2011.

According to the forecasts, and provided that the external situation will not severely harm the Bulgarian economy, the fiscal situation is expected to further improve in the nearest future. According to long term IMF forecasts, the budget is expected to return to a positive balance in 2015 and public debt reduced to around 12% of GDP.

General government balance



Source: IMF

Bulgaria vis-à-vis the euro

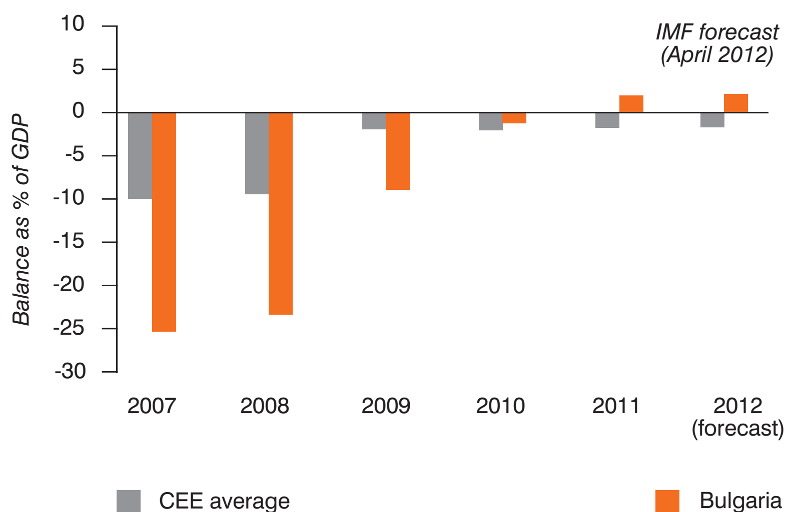
- *Bulgaria is a member of the EU since 2007, however it is not yet a eurozone member.*
- *The Bulgarian government planned to join the ERM2 in 2012 and the eurozone in 2015 (recently announced a postponement of the planned eurozone entry).*
- *Currently, according to ECB data, Bulgaria fulfils all convergence criteria required to join the eurozone except for ERM2 participation.*
- *Bulgaria uses a fixed exchange rate with a so called "currency board" system. The Bulgarian lev is pegged to the euro at 1.95 lev/euro.*

The external balance

Due to a high level of investment spending and a decrease in private savings, the current account deficit in Bulgaria before the crisis was extremely high, reaching 25% of GDP in 2007. As a result of the crisis and rapid reduction of imports and investments, the current account deficit started to decrease. Improving export dynamics resulted in a positive balance in 2011.

Although the current account situation is good, the stock of private external debt in Bulgaria is still relatively high, resulting in significant financing needs. It is expected that the deleveraging process will be continued and the debt will fall from the current 98% level, to less than 70% by 2016.

Current account balance

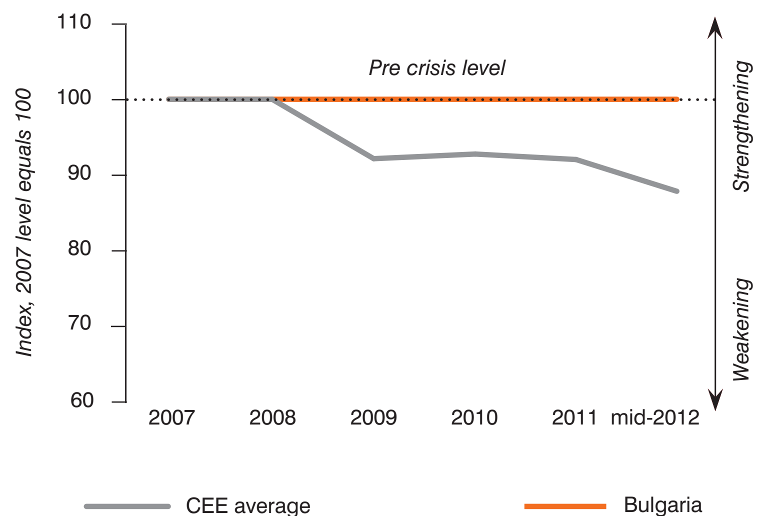


Source: IMF

Stability of the currency

The exchange rate of the Bulgarian lev to the euro is fixed and backed by a currency board system which seems to be sustainable in the nearest future. Therefore, the stability of the exchange rate is not something to worry about either for Bulgarian businesses nor policymakers.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Bulgaria	CEE Region
General government balance	-2.1	-0.9
Public debt	17.0	28.3
Foreign exchange loans	44.1	16.6
Loans to deposits (ratio)	132%	127%
Current account balance	1.9	0.3
Foreign debt	98.1	54.4
Short-term debt	33.6	21.0
Coverage of financing needs by reserves (ratio)*	100%	142%
Credit rating (S&P)	BBB	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

The weak performance of the real sector seems to be the most worrisome characteristic of the Bulgarian economy after the crisis.

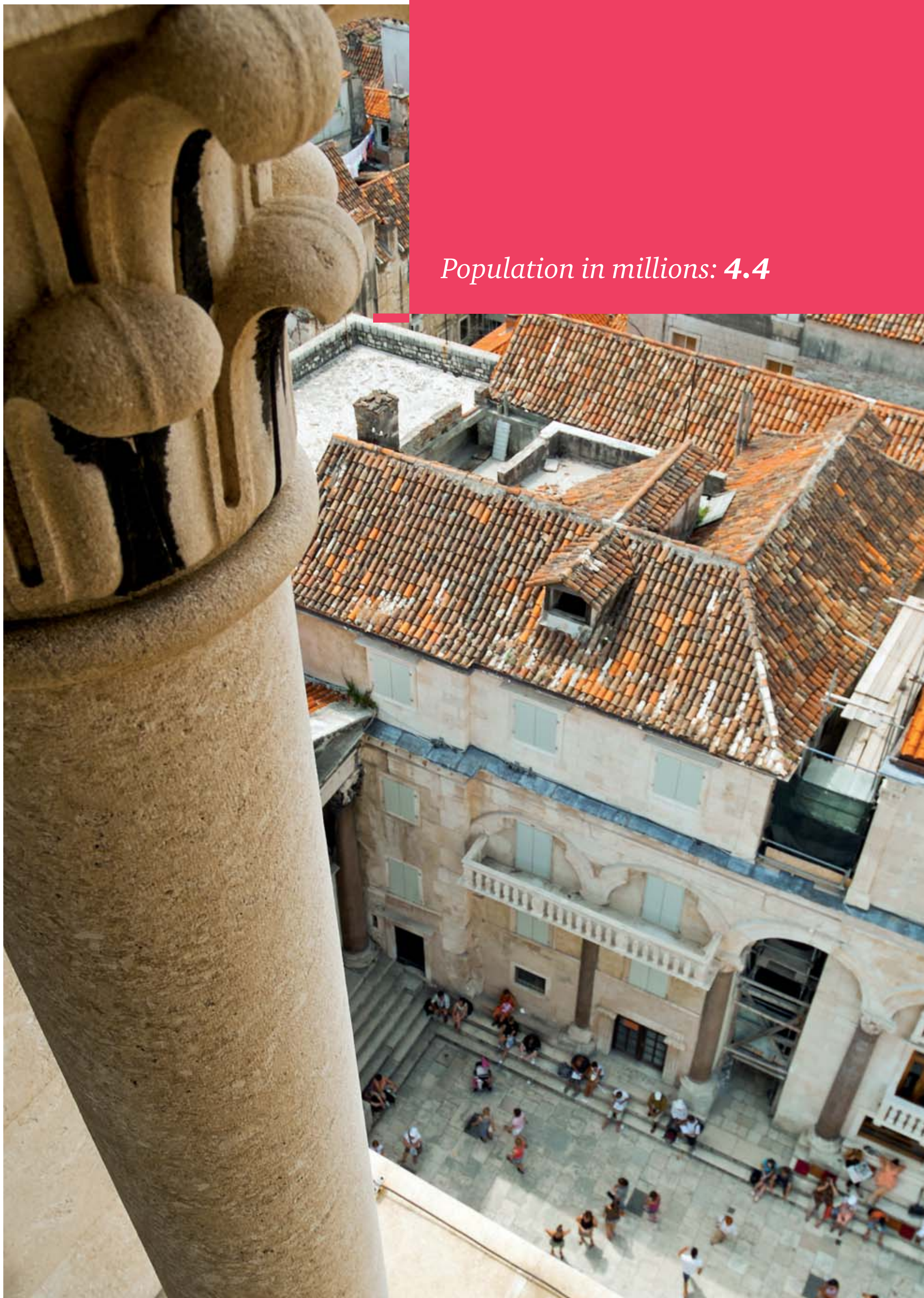
The growth rate is low and unemployment is high – reaching 12.5% in 2012. Another risky factor is created by very strong real and financial ties with the neighbouring Greek economy.

The fiscal situation is good and the current account balance is positive. Bulgarian fiscal and international reserves may therefore serve as a buffer against potential spill-over effects from tensions in southern EU countries.

This risk in Bulgaria is relatively high, as almost 20% of the country's exports are directed to Southern Europe. Additionally, banks from the region are also strongly active in the mostly foreign-owned Bulgarian banking sector, with Greek banks controlling almost one-third of the total assets.

Croatia

Population in millions: **4.4**



Croatia

Basic data *(2011 or latest available data)*	Croatia	CEE Region	Region=100
Population in millions	4.4	310.8	1.4
GDP, billions of US$	64	3 531	1.8
GDP per capita, thousands of US$*	18.2	15.9	114.4
GDP growth rate, average 2009-12	-2.0	0.7	x
CPI inflation	2.3	8.3	x
Exports as percent of GDP	38.3	41.6	x
Net FDI as percent of GDP	2.2	1.3	x

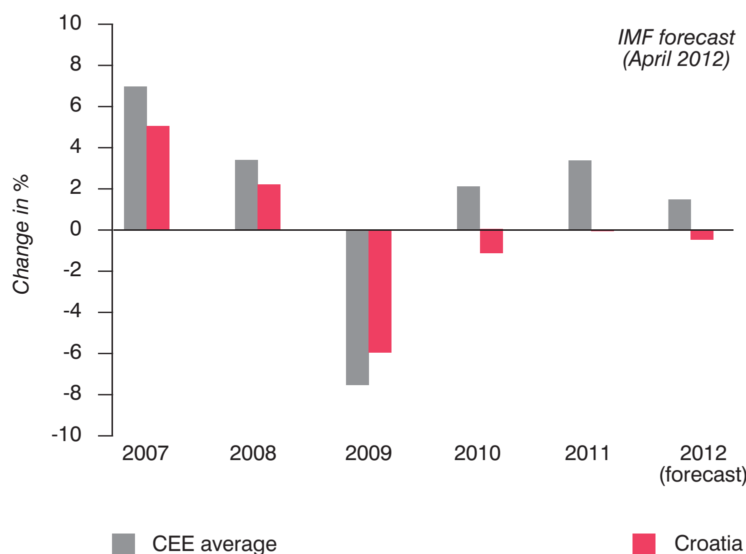
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Croatian economy has not been growing since the beginning of the crisis. It has mainly been a result of the stagnant domestic demand with a negative investment contribution to GDP growth. Rising exports are insufficient to stimulate the economy, due to a relatively low level of export dependence. The slow growth results in a high unemployment rate over 13%.

The short term forecast for the Croatian economy is not optimistic. The economy is expected to continue contracting in 2012. It may not begin growing until 2013. Improving the competiveness is a necessary condition for the economy to return to the growth path. In a stable exchange rate environment, it may be achieved by wage restraints and productivity enhancing, structural reforms. The upcoming EU accession is an opportunity to attract more FDIs which could boost the productivity growth.

GDP growth rates



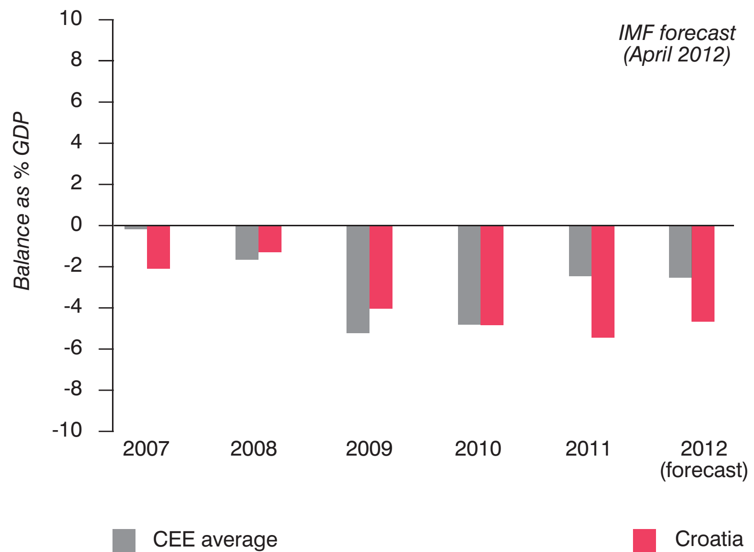
Source: IMF

Public finance

The stance of the Croatian public finance sector has radically deteriorated as a result of the economic crisis. The general government deficit increased from below 2% before the crisis to more than 5% in 2011. Rising deficit and a contracting economy have also led to the quick increase of public debt – growing from less than 30% of GDP in 2008 to 45% in 2011.

The public finance perspective for the nearest future is not optimistic. The fiscal balance will be hard to improve when the economy is stagnant, while serious expenditure cutting reforms may result in social problems. According to the forecasts, the deficit is expected to remain at a high level with public debt continuing to grow.

General government balance



Source: IMF

Croatia vis-à-vis the euro

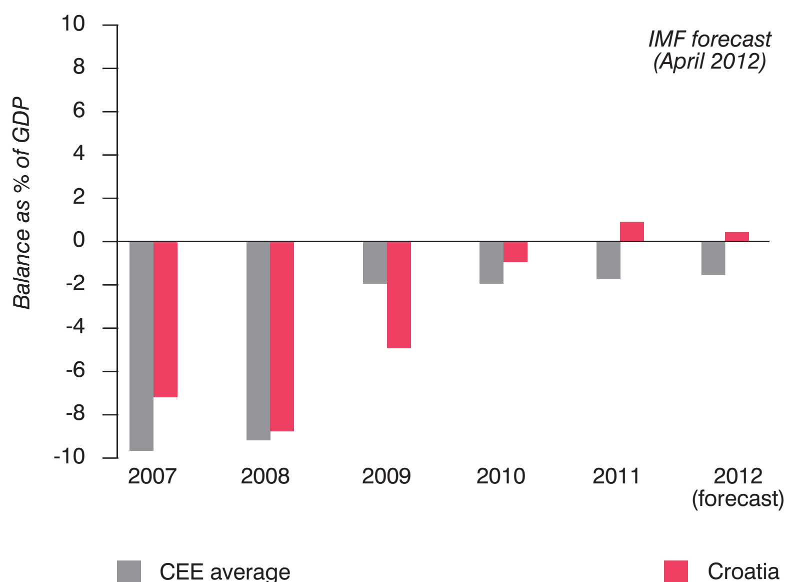
- *Croatia will become an EU member on the 1st of July 2013 and will be obliged to adopt the euro in the future.*
- *Croatia is currently fulfilling most of the convergence criteria of joining the eurozone, although the fiscal situation is deteriorating.*
- *Croatia uses a managed float exchange rate policy, although the Central Bank tries to run a stable exchange rate policy.*
- *The main challenge is a contracting economy, calling for measures to improve competiveness.*

The external balance

Sluggish economy and weak domestic demand help to improve the country's external balance. The current account already records a small surplus. It results both from a decrease in imports and an increase in exports. Despite a positive trend of the current account, Croatia is still considered vulnerable to external balance shocks due to a relatively high level of external debt and large financing needs.

The expected growth of FDI inflows which could be triggered by the EU accession, as well as the growing access to EU funds, will additionally support the balance of payments position of the country. On the other hand, any improvement in the real sector may increase import demand and deteriorate the current account situation.

Current account balance



Source: IMF

Stability of the currency

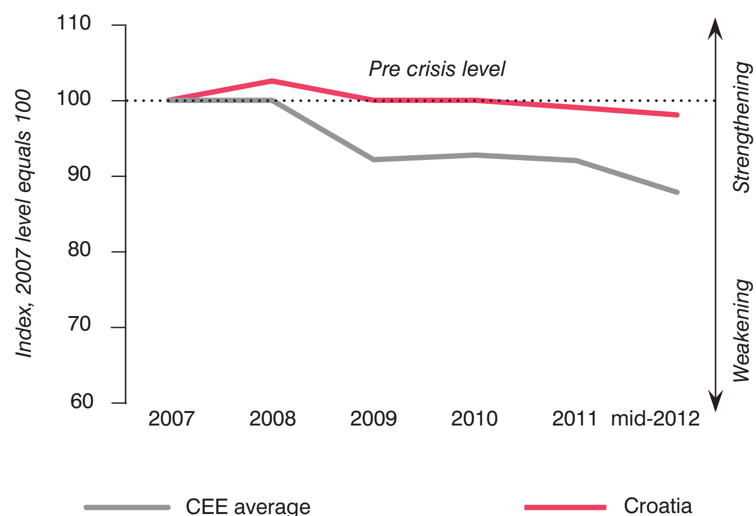
Although the Croatian kuna exchange rate is formally subject to a managed float system, the Central Bank has been running a stable exchange rate policy over the last several years, partly to avoid big problems in the banking sector caused by a high share of foreign exchange denominated loans. As a result, the exchange rate is stable against the euro and has not depreciated, as was the case with most CEE currencies due to the crisis.

The stability of the currency is currently supported by the current account surplus. It may however be endangered by large foreign debt, deteriorating government balance and a relatively low level of foreign exchange reserves.

The authorities are strongly committed to the stable exchange rate policy, as it increases the countries credibility and helps to keep macroeconomic stability.

It might be argued, however, that gradual currency depreciation could support the competitiveness, particularly in the tourist sector.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Croatia	CEE Region
General government balance	-5.5	-0.9
Public debt	45.6	28.3
Foreign exchange loans	70.8	16.6
Loans to deposits (ratio)	120%	127%
Current account balance	0.9	0.3
Foreign debt	105.6	54.4
Short-term debt	32.1	21.0
Coverage of financing needs by reserves (ratio)*	78%	142%
Credit rating (S&P)	BBB-	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

Sluggish economic growth, high unemployment rate, deteriorating fiscal situation and low competitiveness are the biggest challenges for the Croatian economy both in the short and medium term.

Additionally, the situation is aggravated by high external indebtedness and large financing needs. The main risk for the banking sector is connected with a dangerously high share of foreign exchange denominated loans.

There are also significant risks resulting from a strong link to the eurozone. The share of EU countries in Croatian exports is close to 60%, while the southern European countries constitute more than 20% of the foreign markets.

The connections of Croatia with the euro are also strong in the banking sector. More than 90% of total banks assets are controlled by foreign owned banks, and may be the source of financing problems if eurozone parents are adversely affected by sovereign debt problems. It may have further negative effects on the macroeconomic situation.

On the other hand, one has to observe that the current situation of the Croatian banking system is good: capitalisation is strong and liquidity remains satisfactory. The credit ratings are also relatively high and additionally supported by a successful stable exchange rate policy.

Romania

Population in millions: ***21.4***

Romania

Basic data (2011 or latest available data)	Romania	CEE Region	Region=100
Population in millions	21.4	310.8	6.9
GDP, billions of US$	190	3 531	5.4
GDP per capita, thousands of US$*	12.5	15.9	78.5
GDP growth rate, average 2009-12	-1.1	0.7	x
CPI inflation	5.8	8.3	x
Exports as percent of GDP	22.3	41.6	x
Net FDI as percent of GDP	1.4	1.3	x

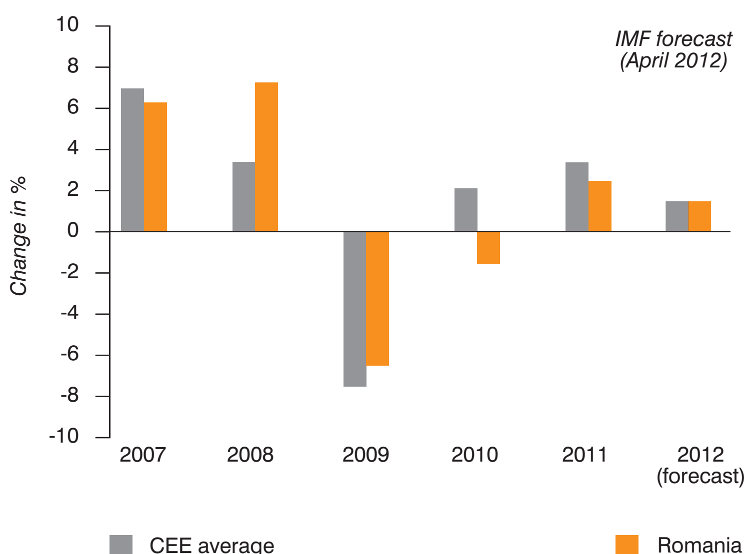
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The Romanian economy recorded a deep slump as a result of the crisis and was not able to regain momentum until 2010. In 2011 the GDP growth was still weak and below the region's average. Weak domestic demand and a strong dependence on imports are the main factors behind the unsatisfactory growth performance.

In the coming years, the growth outlook looks more optimistic. After the slowdown caused by external factors in 2012, the economy is expected to recover. Domestic demand will rise as a result of solid credit growth. Stronger absorption of EU funds should also support a better growth performance.

GDP growth rates



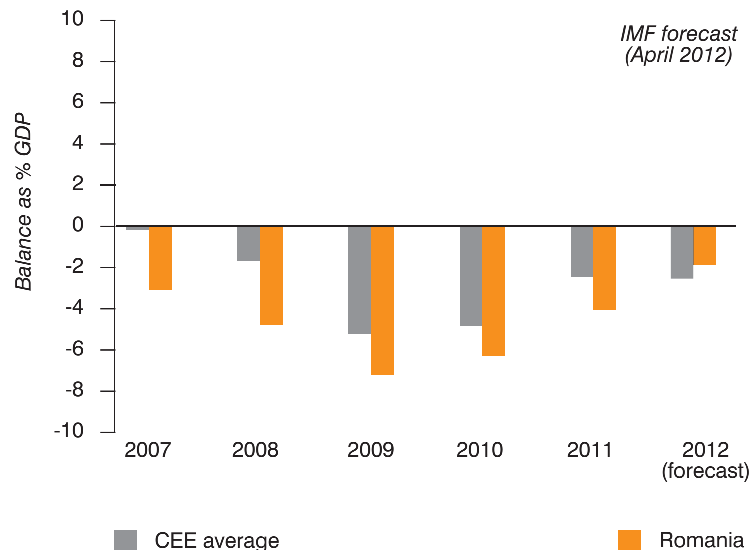
Source: IMF

Public finance

The situation of the Romanian public finance sector deteriorated during the global financial crisis as government spending was used to stimulate the economy. Currently, the position of the public finance sector in Romania is gradually improving, although the fiscal deficit is still relatively high and public debt still on the rise. The fiscal policy of the Romanian government is also closely monitored by donors participating in a current precautionary financial support programme.

Albeit the pressure to increase public spending is high, the outlook for the Romanian public finance sector looks rather optimistic with the public deficit falling below 2% of GDP in 2012.

General government balance



Source: IMF

Romania vis-à-vis the euro

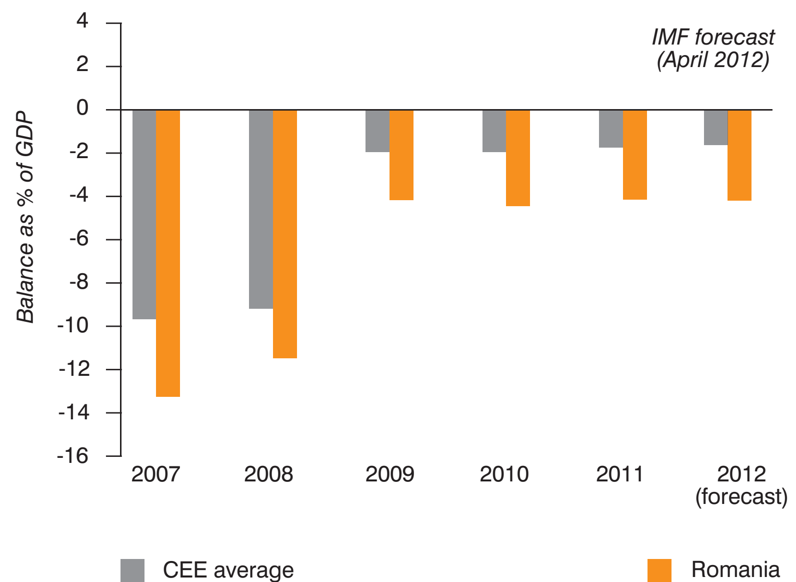
- *Romania is an EU member that currently does not use the euro.*
- *There is no fixed date of the euro introduction, although it is expected that Romania will not be able to join the ERM2 before 2013.*
- *Romania is using a flexible exchange rate policy.*
- *The risk of major currency instability is rather limited – the indebtedness is moderate, fiscal situation is relatively good, and the banking sector is stable.*
- *A weak point for Romania is a relatively high current account deficit, making the country strongly dependent on foreign financing.*
- *The country is currently subject to the Balance of Payment (BoP) precautionary assistance program implemented jointly by the EU, IMF, World Bank, EBRD and EIB.*

The external balance

Romania is a country with a long history of excessive current account deficits resulting from low domestic savings rates that do not match investment needs. Therefore, the Romanian foreign debt has been on the rise for the last couple of years reaching 64% of GDP in 2011. Before the crisis, the current account deficit had been safely financed by extensive FDI inflows.

The current account deficit declined during the global financial crisis to around 4% of GDP. Given the rising foreign exchange reserves, the short and medium term risks are manageable provided a relatively stable situation in the eurozone. The situation can become more complex once the government starts repaying its official debts, which is expected to happen in 2015.

Current account balance



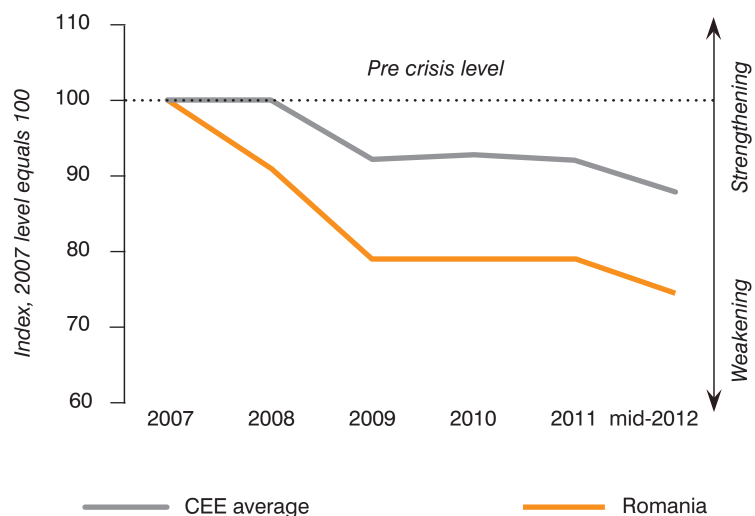
Source: IMF

Stability of the currency

Romania is using a flexible exchange rate policy, which constitutes as an important buffer against external shocks. Over the crisis, the Romanian leu has depreciated against the euro by more than 20%, leading to a considerable improvement in the country's competitiveness. Unfortunately, such a substantial weakening of the currency has also led to an increased level of inflation.

Nowadays, the external balance looks stable, reserves are rising and cover short term payment needs, and the fiscal policy leads to a gradual deficit reduction. Therefore, the stability of the currency is not a short term risk. Nevertheless, the leu may experience further gradual depreciation as the monetary policy is rather relaxed.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Romania	CEE Region
General government balance	-4.1	-0.9
Public debt	33.0	28.3
Foreign exchange loans	24.3	16.6
Loans to deposits (ratio)	125%	127%
Current account balance	-4.2	0.3
Foreign debt	64.0	54.4
Short-term debt	24.8	21.0
Coverage of financing needs by reserves (ratio)*	85%	142%
Credit rating (S&P)	BB+	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

The exposure of the Romanian economy to foreign financing is considerably high due to a permanently high current account deficit resulting from structural characteristics of the economy.

The fiscal situation still requires continuous consolidation efforts. Due to spending cuts, the general government balance is likely to be reduced below 2% of GDP, and the debt to GDP ratio should fall below 30% of GDP.

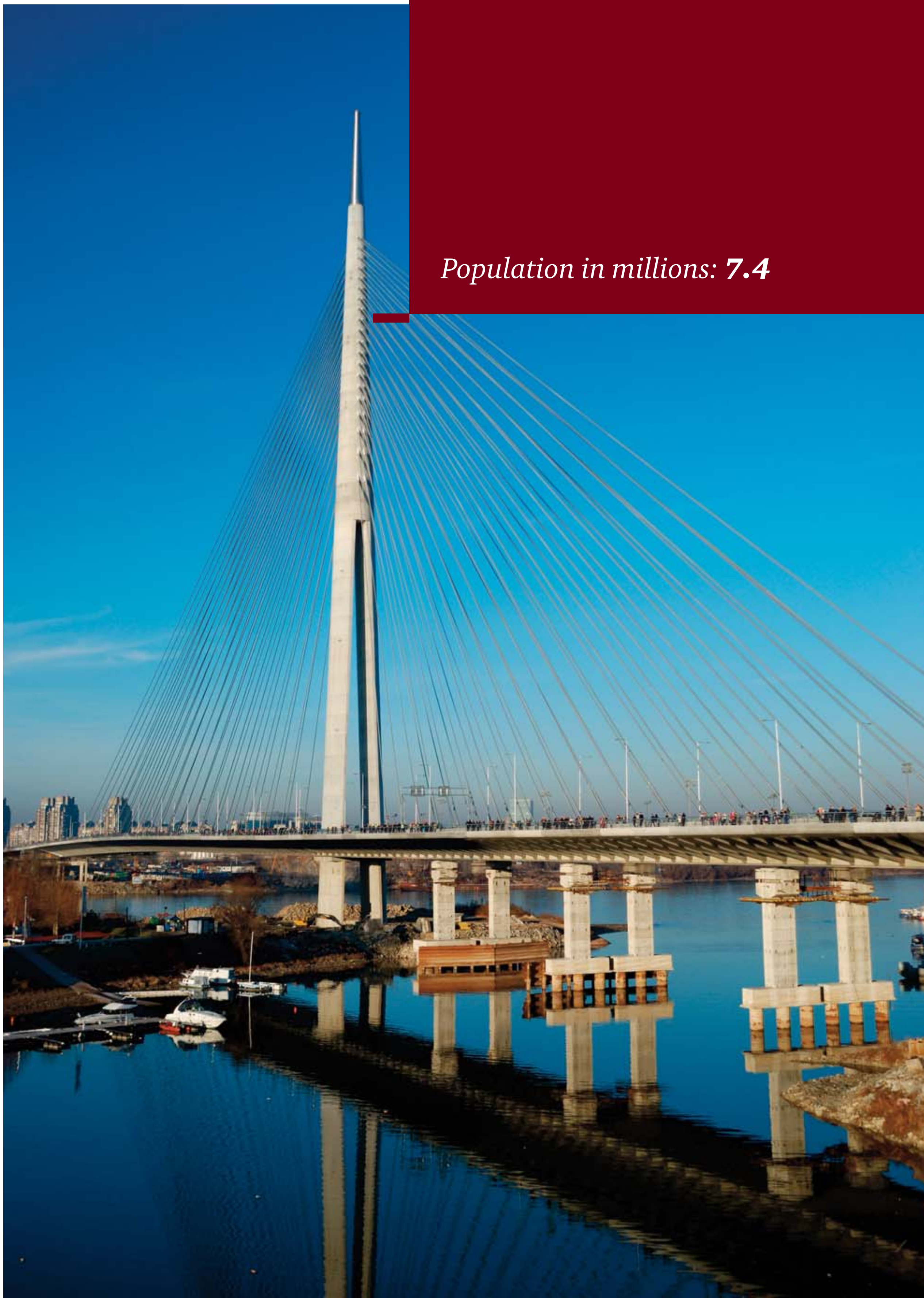
External balance has been supported by the large official financial assistance program which offset the falling FDI and low levels of EU transfers resulting from a weak absorption of funds. In the longer run, however, such a situation is not sustainable.

The banking sector remains relatively strong although the picture is mixed. The banks are well capitalised, however, with more than 80% of their assets controlled by foreign banks and 14% of their assets by Greek banks, the vulnerability to external shock remains substantial.

All this contributes to make the country's exposure to external financial risk considerable. On the other hand, a relatively good situation of the public finance sector, prudent debt management and high foreign reserves can be a source of optimism.

Serbia

Population in millions: ***7.4***



Serbia

Basic data *(2011 or latest available data)*

	Serbia	CEE Region	Region=100
Population in millions	7.4	310.8	2.4
GDP, billions of US$	45	3 531	1.3
GDP per capita, thousands of US$*	10.6	15.9	66.9
GDP growth rate, average 2009-12	-0.1	0.7	x
CPI inflation	11.2	8.3	x
Exports as percent of GDP	36.7	41.6	x
Net FDI as percent of GDP	5.6	1.3	x

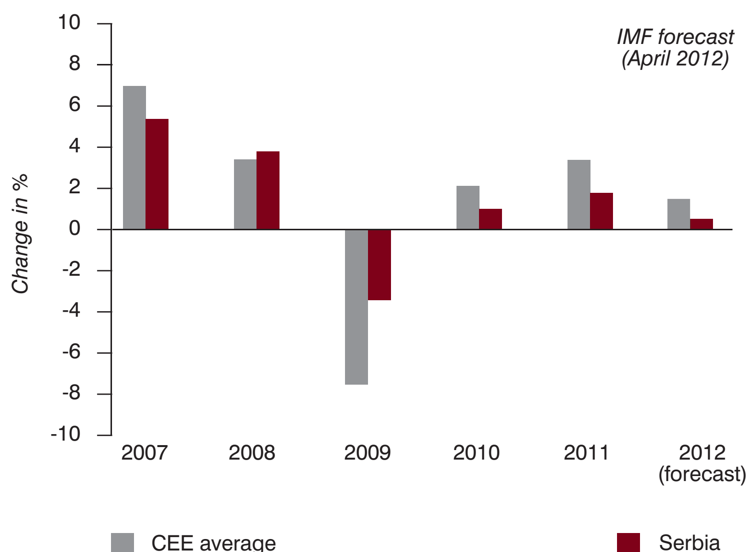
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

After the GDP slump in 2009, the Serbian economy is still struggling to return to the path of solid and sustainable economic growth. The GDP growth accelerated to 1.8% only in 2011. The poor growth performance is mainly a result of low export and investment dynamics.

The growth rate in 2012 is expected to continue its slowdown.
The unemployment rate is rising and is expected to reach almost 24% of the labour force in 2012. It negatively influences the domestic consumption; it is also a serious social risk. Additionally, exports are not improving.

GDP growth rates



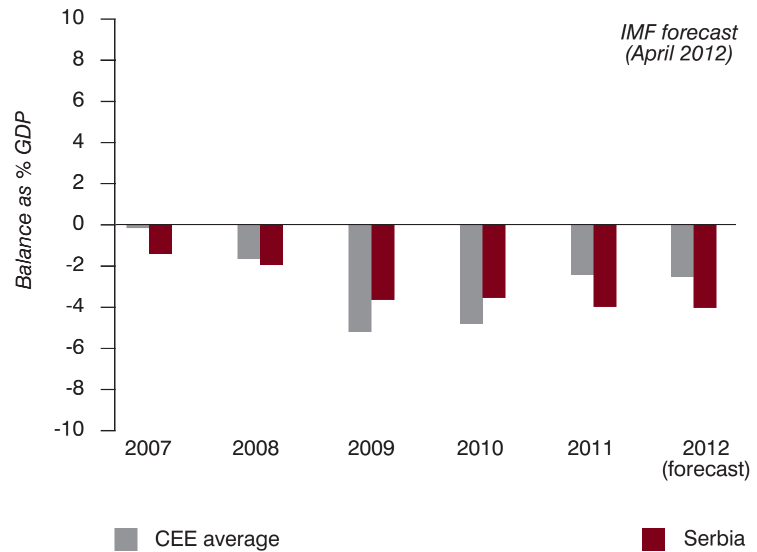
Source: IMF

Public finance

The situation of the public finance sector in Serbia continues to deteriorate since the beginning of the crisis. The level of general government deficit in 2011 reached 4% of GDP. As a consequence, the level of public debt is also on the rise. In 2011 it amounted to almost 49% of GDP.

As the pressures for spending are strong and revenues are stagnant due to poor GDP growth, the situation is not expected to improve in the nearest future. The government deficit in 2012 will most likely reach almost 5% with public debt climbing above 53%.

General government balance



Source: IMF

Serbia vis-à-vis the euro

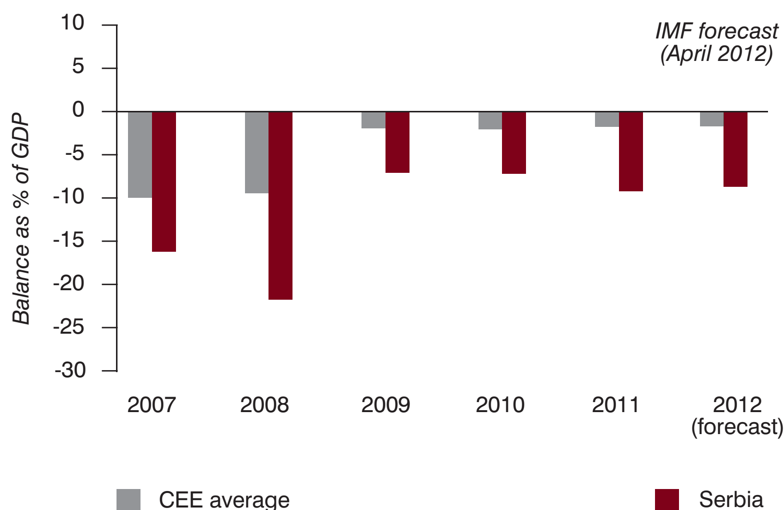
- *Serbia is not an EU member and hence is not a part of the eurozone.*
- *The Stabilisation and Association Process of Serbia has been initially agreed upon and is currently being ratified by member states.*
- *Serbia runs a managed float exchange rate policy.*
- *Currently Serbia is under a precautionary Stand-By agreement with the IMF. The financial resources to support the external balance are made available for the Serbian government to draw on in case such a need arises.*

The external balance

Before the crisis, Serbia recorded a very high current account deficit resulting primarily from high import dependence. The huge negative trade balance was mainly financed by current transfers and other investments – mainly net inflows to banks.

As the foreign debt is stable, and the level of international reserves can cover short term financial needs, the stability of the external balance does not seem to be in an imminent danger over the short and medium run. Additionally the government, anticipating the potential threat of perverse external developments, asked for financial assistance from the IMF. Much will therefore, depend on the situation in the eurozone.

Current account balance



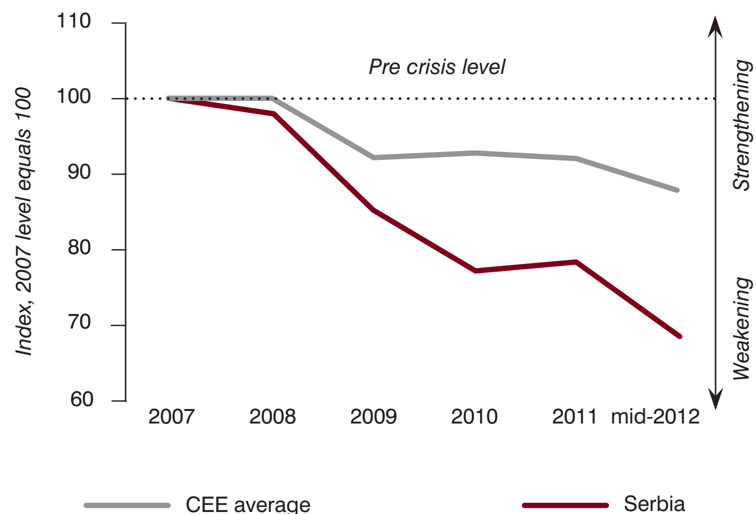
Source: IMF

Stability of the currency

The Serbian dinar exchange rate is more volatile than its regional peer currencies. The cumulative depreciation since the beginning of the crisis amounted to 30%. It is mainly related to high foreign financing needs in connection with the excessive current account deficit. The depreciating currency and large import dependence result in a high inflation rate. On the other hand, the monetary policy is tight, and despite incidental surges, the inflation rate is on a decline.

As the situation of the banking sector seems reasonably good with high capitalisation, FX buffers and good non performing loans encompass the main risks for financial stability, which originate externally.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Serbia	CEE Region
General government balance	-4.0	-0.9
Public debt	47.9	28.3
Foreign exchange loans	35.5	16.6
Loans to deposits (ratio)	112%	127%
Current account balance	-9.1	0.3
Foreign debt	71.5	54.4
Short-term debt	22.4	21.0
Coverage of financing needs by reserves (ratio)*	108%	142%
Credit rating (S&P)	BB	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

Given the poor situation of the public finance sector, a high dependence of foreign financing and poor performance of the real sector, the Serbian economy is highly vulnerable to any kind of external shocks.

On the other hand, the monetary policy is tight and financial sector is, in general, stable. The share of the short term foreign debt is modest and the foreign exchange reserves more than cover the current financing needs.

The FDI flow, also slowing down, is substantial and currently (2011) covers more than half of the current account deficit.

The depreciating currency helps the economy to stay competitive on international markets.

Additionally, the government asked for financial assistance from the IMF, which may provide a short term cushion in the case of a deepening eurozone crisis.

Belarus

Population in millions: ***9.4***

Belarus

Basic data *(2011 or latest available data)*	Poland	CEE Region	Region=100
Population in millions	9.4	310.8	3.0
GDP, billions of US$	55	3 531	1.6
GDP per capita, thousands of US$*	15.0	15.9	94.5
GDP growth rate, average 2009-12	4.0	0.7	x
CPI inflation	53.2	8.3	x
Exports as percent of GDP	67.8	41.6	x
Net FDI as percent of GDP	7.1	1.3	x

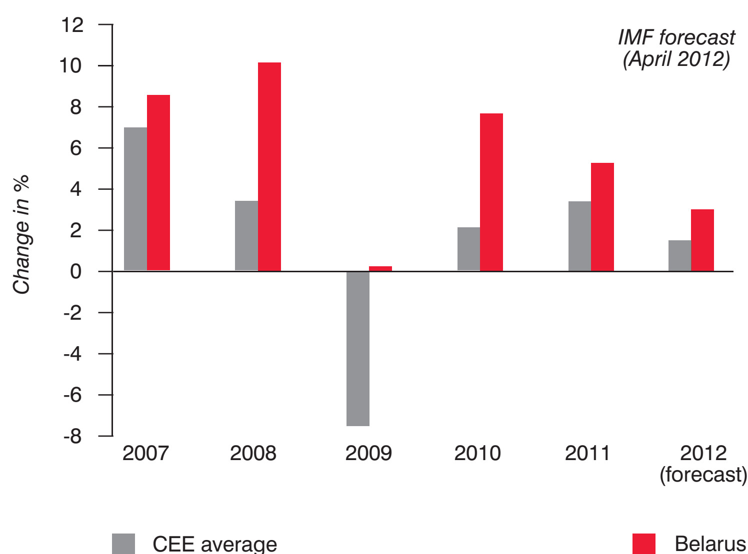
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The economy of Belarus recorded relatively good growth performance during the years of the financial crisis. Even in 2009, while most CEE economies suffered a severe GDP reduction, the Belarusian economy was stagnant. The main reason behind this relatively good growth performance was a very strong fiscal stimulus. Such a policy resulted in a shift of the government balance from a positive to negative position, additionally supported by the accommodative monetary policy of the Central Bank.

Although the expected growth rates for Belarus are still better than the CEE average, the difference is likely to narrow. However, relatively good growth performance will still be accompanied by a high, although decreasing, inflation rate, strongly negative current account balance and a weakening currency, which makes this growth model unsustainable in the long term.

GDP growth rates



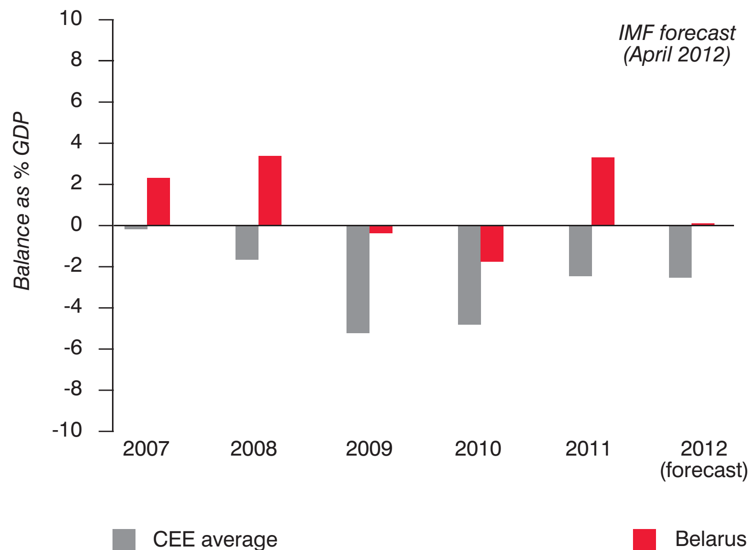
Source: IMF

Public finance

The stance of the Belarusian public finance sector deteriorated in 2008 and 2009, as the fiscal policy was used by the government to stimulate the economy. The general government balance deteriorated from an exceptionally good 3.4% of GDP surplus in 2008 to 1.8% of GDP deficit in 2010. In 2011, the government tried to return to the pre-crisis fiscal position by drastically cutting spending. However, it does not seem sustainable, although the budget forecast also looks relatively good when compared to other CEE economies.

On the other hand, and despite the surprisingly low budget deficits recorded by the official statistics, the general government debt in Belarus increased from about 22% of GDP in 2008 to more than 50% of GDP in 2011 due to massive "below the line" operations and weakening of the currency. The rapidly increasing public debt level is the main challenge ahead of the fiscal authorities in Belarus for the years to come.

General government balance



Source: IMF

Belarus vis-à-vis the euro

- *Belarus is neither a member of the EU nor has it applied for membership.*
- *It is not covered by the European Neighbourhood Policy although trade relations are based on the General System of Preferences with MFN (Most Favoured Nation) provisions.*
- *The authorities introduced a flexible exchange rate in October 2011; earlier it was set by the National Bank based on auction results.*

The external balance

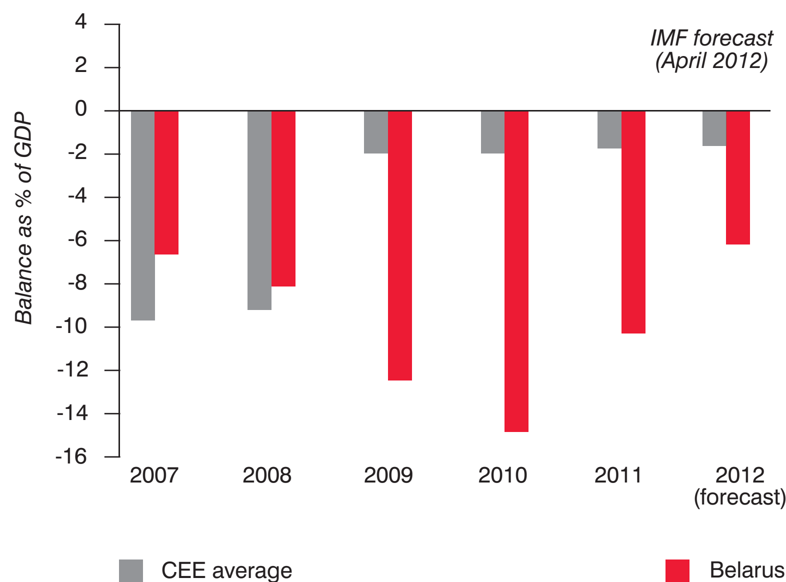
As a decrease in the country's total savings was one of the main engines of the relatively good GDP growth performance, it had to lead to the strong deterioration of the external balance. In 2008 -2010 the current account deficit increased from 8% of GDP to 15% of GDP.

As the government was unsuccessfully trying to defend the currency, the foreign exchange reserves fell dramatically, forcing Belarus to introduce a floating exchange rate, resulting in a strong depreciation of the currency.

The improved trade competitiveness led to the gradual improvement of the current account position. Apart from that, the balance of payments was also supported in 2011 by privatisation of incomes (mainly from Russian investors), the price of Russian gas and oil falling, as well as rescue loans coming from international organisations.

One has to remember, however, that this kind of policy is not sustainable and macroeconomic stability in the longer term can only be achieved by improved productivity combined with prudent fiscal and monetary policies.

Current account balance



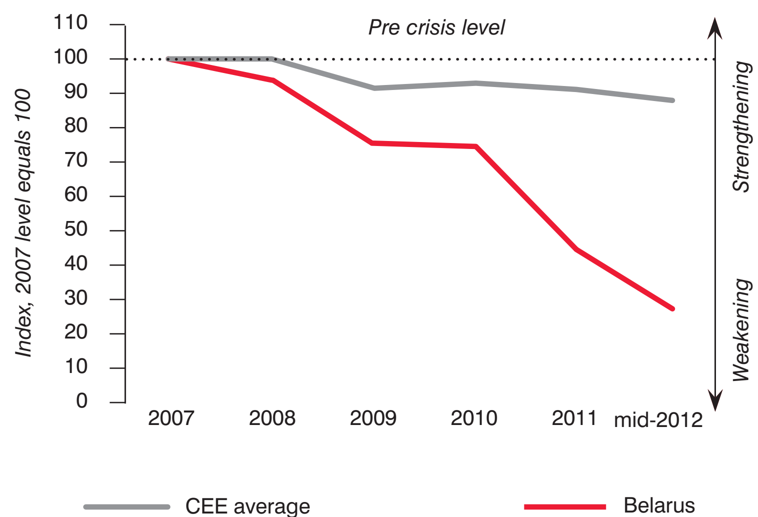
Source: IMF

Stability of the currency

Although Belarus had only just introduced a flexible exchange rate regime in 2011, it experienced the strongest currency devaluation among all the CEE countries analysed. Between 2007 to 2012 the Belarusian ruble depreciated by more than 70%. The deepest depreciation was recorded in 2011, which led to the increase of the euro/ruble exchange rate from about 4,000 at the beginning of the year to about 11,000 at year end.

The rapid depreciation of the ruble was the result of an earlier policy, keeping the domestic currency artificially strong and leading to the so-called "2011 crisis". Currently (in the first half of 2012) the exchange rate is relatively stable with a slight tendency to appreciate.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Belarus	CEE Region
General government balance	3.3	-0.9
Public debt	50.2	28.3
Foreign exchange loans	11.2	16.6
Loans to deposits (ratio)	103%	127%
Current account balance	-10.4	0.3
Foreign debt	57.2	54.4
Short-term debt	32.0	21.0
Coverage of financing needs by reserves (ratio)*	29%	142%
Credit rating (S&P)	B-	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

As the exposure of the country to foreign financing is very high and the fiscal situation requires continuous consolidation efforts, the situation of Belarus looks quite risky.

Due to austerity measures, the fiscal surplus has been regained; however much effort is still required to return to pre-crisis levels of the debt to GDP ratio. It mainly requires prudent macroeconomic policy and structural reforms enabling the country to achieve economic growth thanks to productivity improvements rather than because of the artificially stimulated growth of domestic demand.

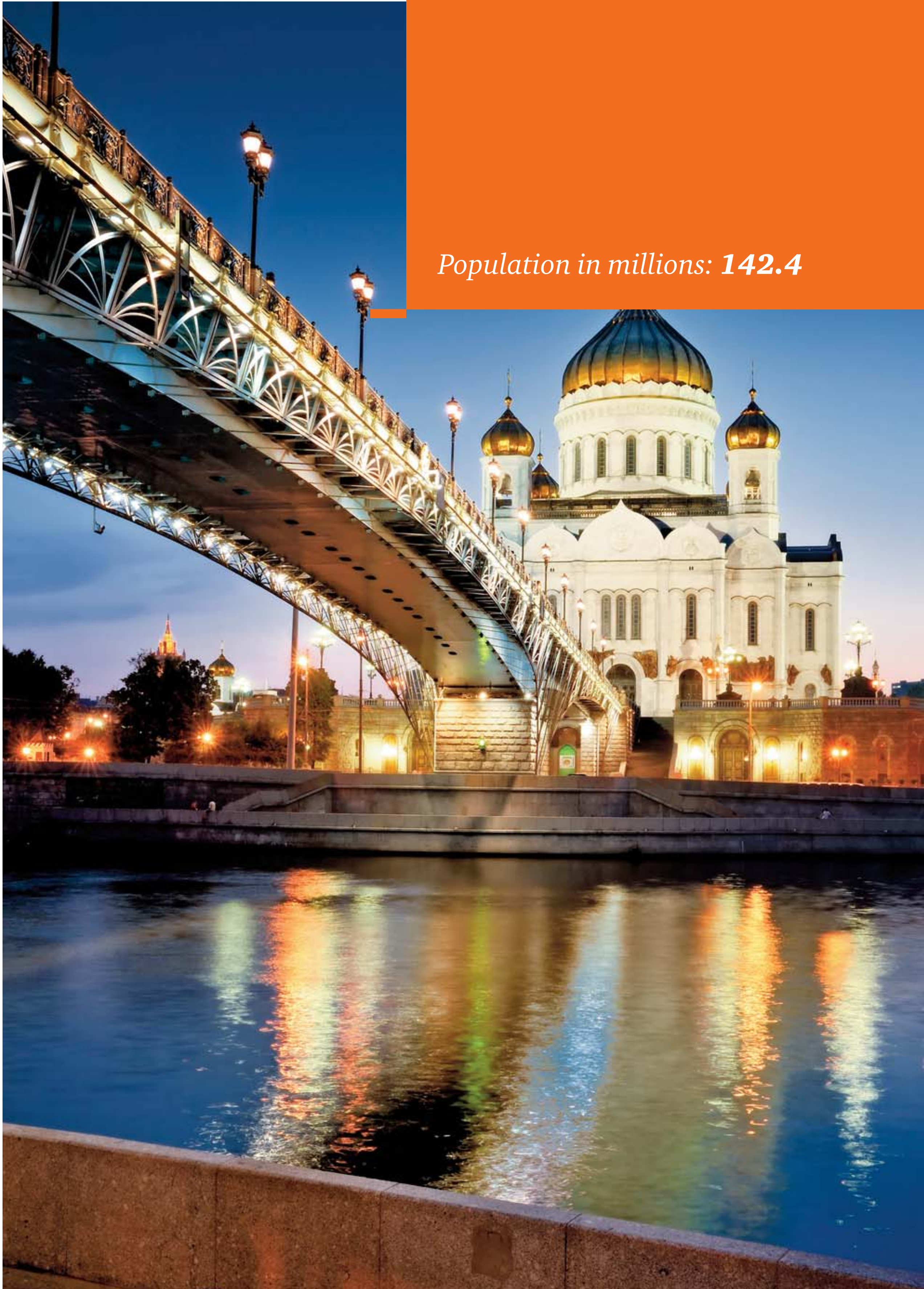
The situation of the banking system is relatively good. The deposits are increasing, although non-performing loans are also on the rise.

The banking systems survived the 2011 crisis: state owned banks have been recapitalised and Russian banks have obtained support from their parent banks. As the Belarusian banking system is not linked directly to the eurozone, the main risks come from a potential slowdown of the local economy.

The country's exposure to external financial risks is considerably high due to the elevated current account deficit. The credit rating is low and the economy is perceived as unstable. Achieving sustainable macroeconomic stability and starting structural reforms is the main challenge for the years to come.

Russian Federation

Population in millions: ***142.4***



Russian Federation

Basic data *(2011 or latest available data)*

	Russian Federation	CEE Region	Region=100
Population in millions	142.4	310.8	45.8
GDP, billions of US$	1 850	3 531	52.4
GDP per capita, thousands of US$*	16.7	15.9	105.2
GDP growth rate, average 2009-12	1.1	0.7	x
CPI inflation	8.4	8.3	x
Exports as percent of GDP	27.7	41.6	x
Net FDI as percent of GDP	-0.5	1.3	x

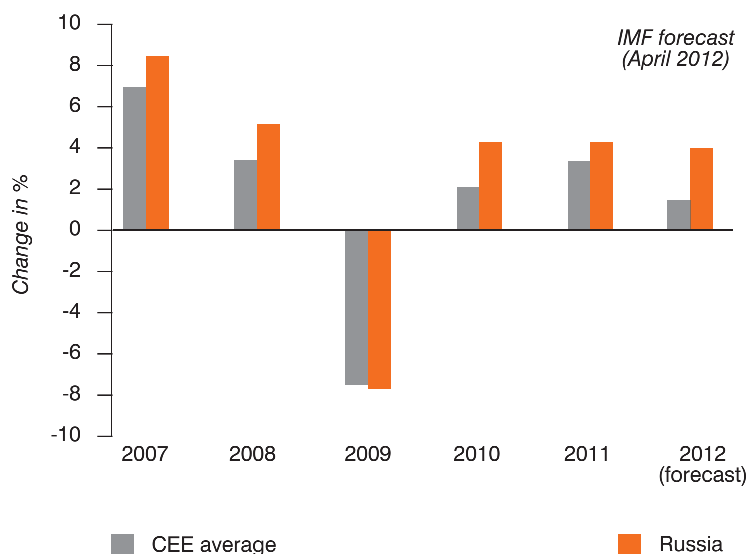
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

The performance of the Russian economy is strongly dependent on the global demand for energy and oil prices. Russia suffered a sharp GDP contraction in 2009, followed by a 4% growth in 2010-2011. Apart from improving revenues from energy exports, the growth was also fuelled by the rising industrial production.

The growth rate is expected to remain on a similar level for the next couple of years. Much will depend, however, on the global situation as a substantial fall of oil prices may severely harm the Russian economy.

GDP growth rates



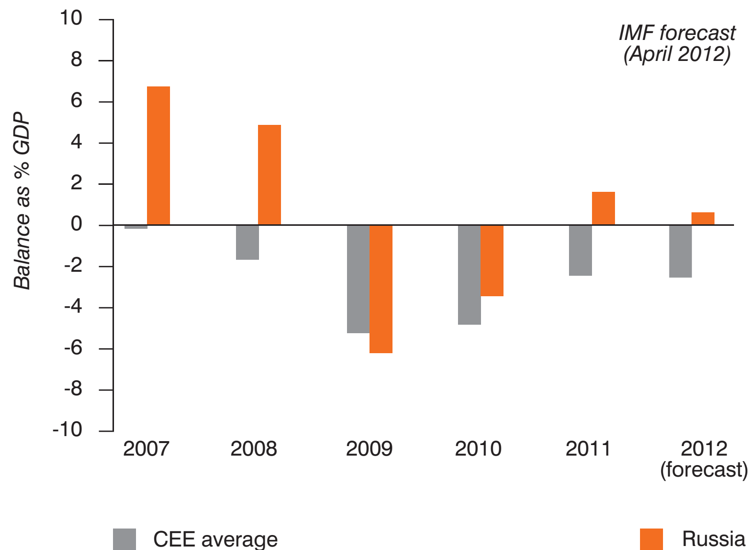
Source: IMF

Public finance

The situation of the Russian public finance sector substantially deteriorated in 2009-2010, as the government was supporting the economy with a large scale fiscal stimulus. Although, since then the balance has returned above zero, mainly thanks to improving oil prices. The balance of the Russian public finance sector, excluding oil and gas revenues, remains strongly negative and reached more than 10% of GDP in 2011.

A large dependence of the Russian public finance sector on oil prices makes it strongly vulnerable to external shocks.

General government balance



Source: IMF

Russian Federation vis-à-vis the euro

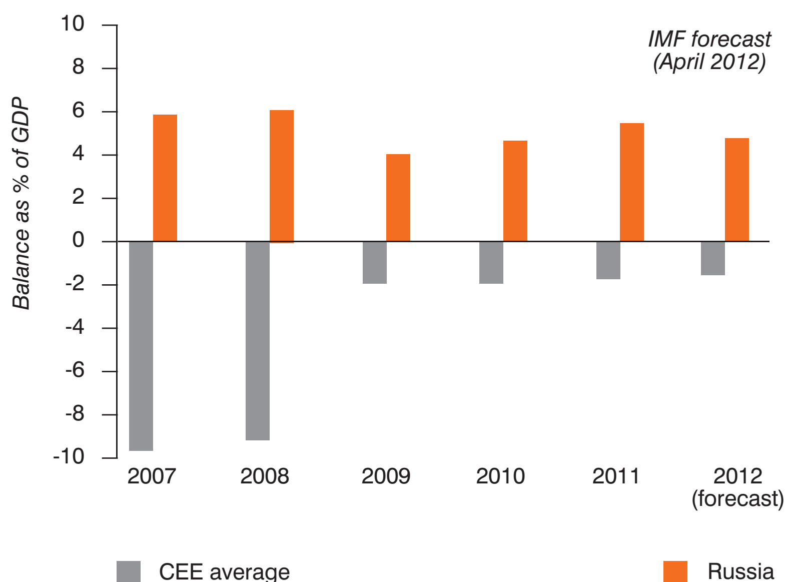
- *Russia is neither a member of the EU nor is planning to apply for membership.*
- *Russia runs a managed float exchange rate policy with the central bank regularly intervening on the market.*
- *The exchange rate is highly sensitive to changing oil prices and capital flows.*
- *The Russian ruble has depreciated against the euro since the beginning of the crisis by around 15%.*

The external balance

The Russian balance of payments is also strongly dependent on the situation of global energy markets. Nevertheless, the Russian current account balance remained strongly positive throughout the entire period of the crisis. On the other hand, the country experienced big capital outflows in this period, related primarily to the political uncertainty and a poor business climate.

High dependence on oil, combined with the weak competitiveness of the non-oil sector and big capital outflows, make the Russian external balance highly vulnerable to external shocks. On the other hand, a very high level of foreign exchange reserve safeguards the country from short-term financial instability. Nevertheless, high reserves are not a remedy for long-term structural problems faced by the Russian economy.

Current account balance



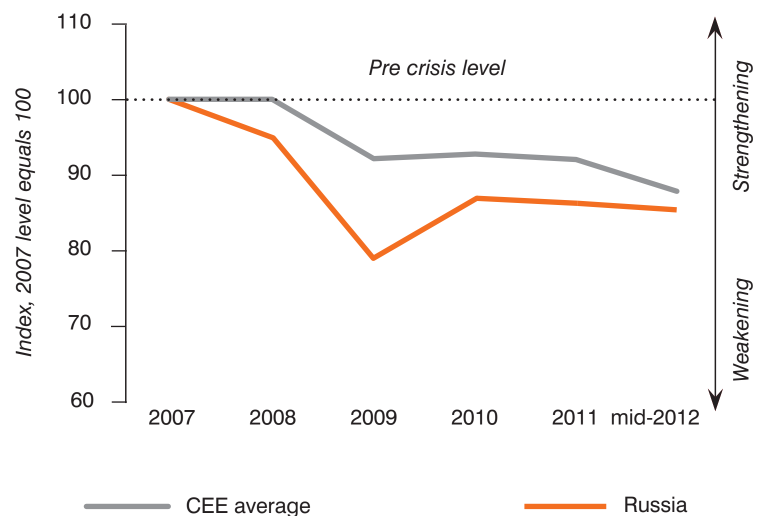
Source: IMF

Stability of the currency

Since the beginning of crisis, the Russian ruble depreciated against the euro by around 15%. It is a result of the expansionary fiscal and monetary policy, combined with a more flexible floating range of the currency. Both factors provide an automatic buffer against external shocks but may also lead to the increasing inflationary pressure and falling foreign exchange reserves.

Unless the oil prices fall substantially, the relatively healthy financial sector and high level of foreign exchange reserves should secure the currency stability in the short run.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Russian Federation	CEE Region
General government balance	1.6	-0.9
Public debt	9.6	28.3
Foreign exchange loans	8.1	16.6
Loans to deposits (ratio)	124%	127%
Current account balance	5.5	0.3
Foreign debt	27.6	54.4
Short-term debt	8.2	21.0
Coverage of financing needs by reserves (ratio)*	936%	142%
Credit rating (S&P)	BBB	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

The vulnerability of the Russian economy to external risk is rather high, primarily due to its strong dependence on energy exports and oil prices.

Nevertheless, huge foreign exchange reserves and large room to manoeuvre the macroeconomic policy should secure the country's financial stability as has been stated in the comparative part of this report.

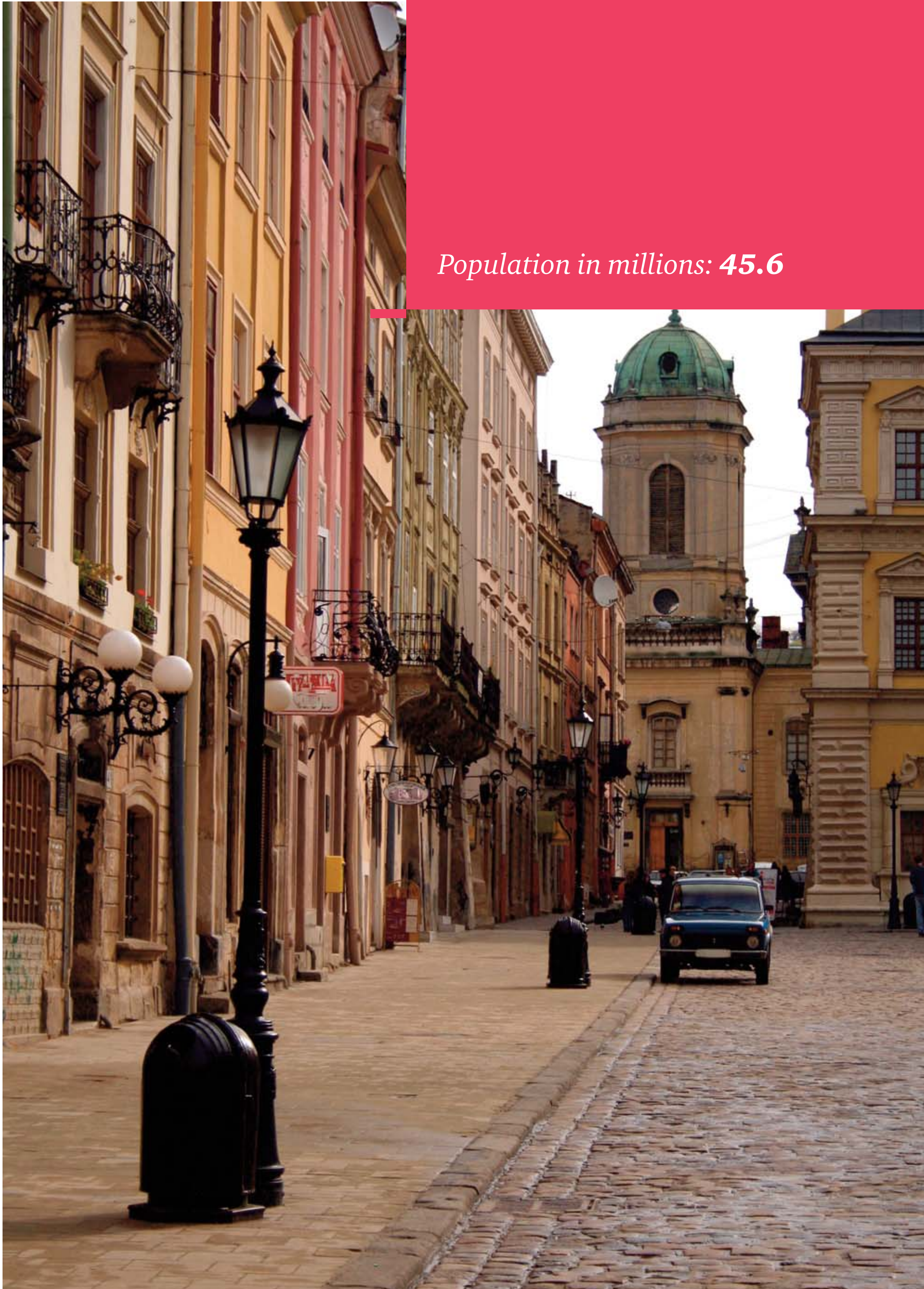
This strong dependence is most apparent in the public finance sector, as the deficit of the general government, excluding oil and gas revenues, reaches 10% of GDP.

It is also visible in the external balance, where the situation is additionally aggravated by potential capital outflows that may easily materialise if the economic situation of the country deteriorates.

An extremely high level of foreign exchange reserve constitutes as an effective short-term buffer from external risks. Nevertheless, the main problems faced by the Russian economy are long-term and call for serious structural reforms.

Ukraine

Population in millions: ***45.6***



Ukraine

Basic data *(2011 or latest available data)*	Ukraine	CEE Region	Region=100
Population in millions	45.6	310.8	14.7
GDP, billions of US$	165	3 531	4.7
GDP per capita, thousands of US$*	7.2	15.9	45.5
GDP growth rate, average 2009-12	-1.0	0.7	x
CPI inflation	8.0	8.3	x
Exports as percent of GDP	52.6	41.6	x
Net FDI as percent of GDP	4.0	1.3	x

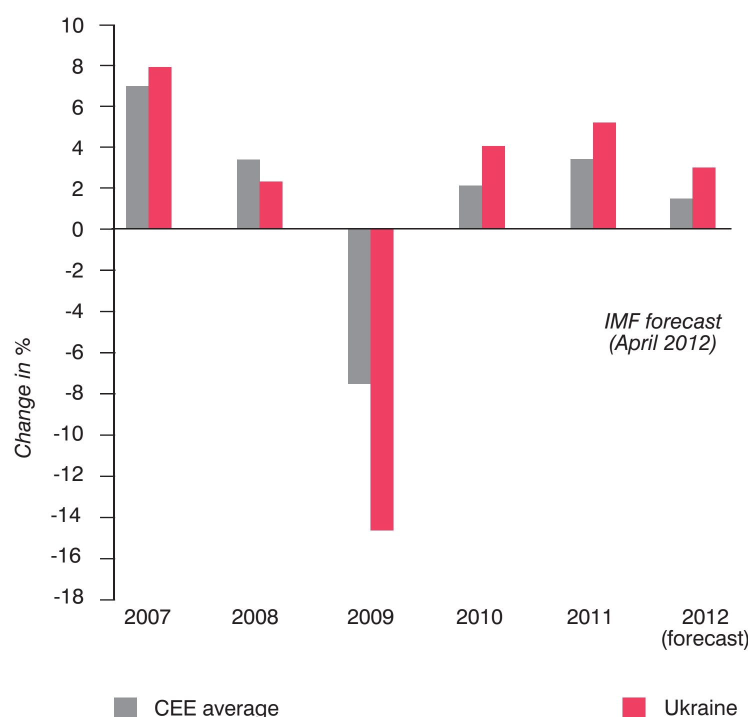
** According to purchasing power parity*
Source: IMF, World Bank, EBRD

Economic growth

After the tremendous drop of GDP in 2009, Ukraine experienced a strong economic recovery in 2010-2011. The recovery was driven by the growing demand for steel – the main Ukrainian export product. GDP growth was also fuelled by the increased investment activity in the country.

Unfortunately, the current external environment has become much less favourable and is leading to an economic slowdown. The situation is additionally aggravated by slow credit growth. The IMF expects the rate of growth to fall from a solid 5.2% recorded in 2011 to 3% in 2012.

GDP growth rates



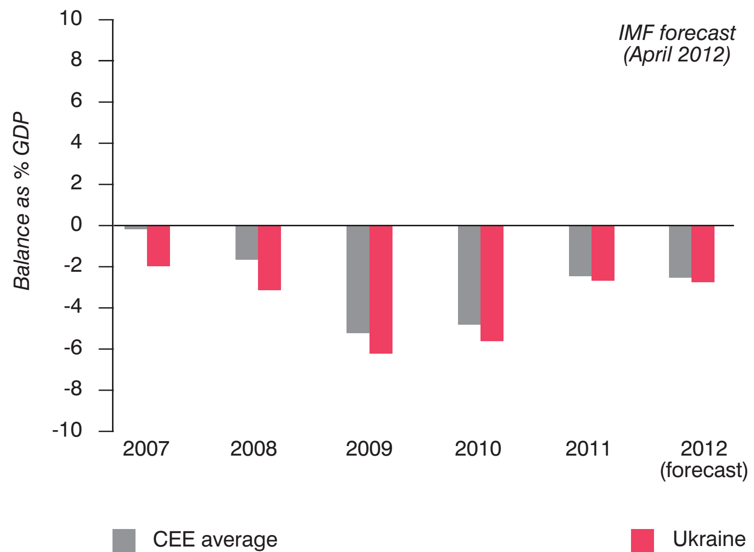
Source: IMF

Public finance

The situation of the public finance sector severely deteriorated during the crisis with the general government deficit reaching 6.2% of GDP in 2009. Afterwards the situation started to improve gradually leading to the fall of public debt from 40% in 2010 to 36% in 2011.

As growth is slowing down and the spending pressure increases, the fiscal balance is expected to deteriorate from 2.7% of GDP in 2011 to 3.2% in 2012.

General government balance



Source: IMF

Ukraine vis-à-vis the euro

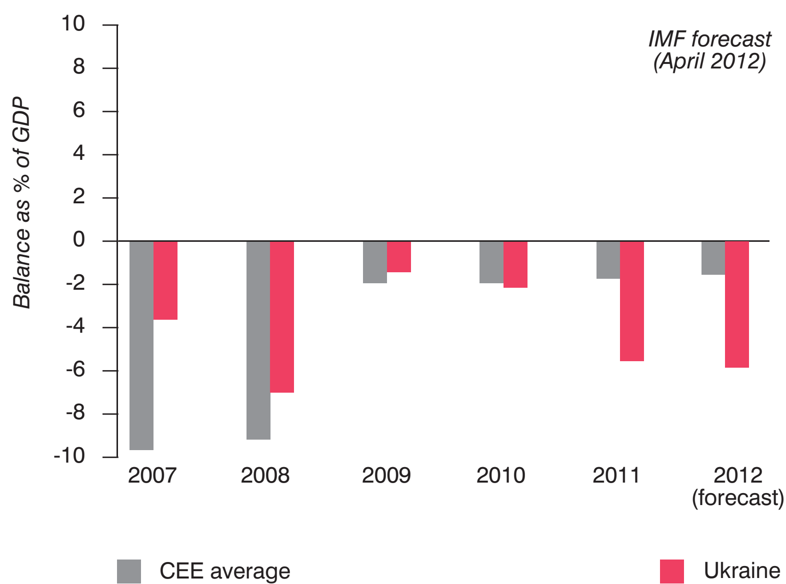
- *Ukraine is neither a member of the EU nor the eurozone.*
- *EU-Ukraine relations are shaped by the European Neighbourhood Policy.*
- *Ukraine is also covered by the Eastern Partnership scheme.*
- *Before the crisis, the Ukrainian hryvnia was pegged to the US dollar.*
- *Introduction of a flexible exchange rate policy was one of the main condition under the IMF Stand-By agreement.*

The external balance

The Ukrainian economy was recording a high current account deficit before the crisis, as the growing investment demand was accompanied by decreasing domestic savings and high consumption growth. The crisis resulted in a large reduction of imports and a radical improvement of the trade balance. As the economy recovered in 2010-2011, the external balance started to deteriorate once again.

Taking into account a high dependence of the Ukrainian exports on the demand for steel, as well as a high vulnerability of the steel market to global economic sentiment, the expectations for the nearest future are rather bleak. The trade balance will not improve and the foreign debt is expected to increase.

Current account balance



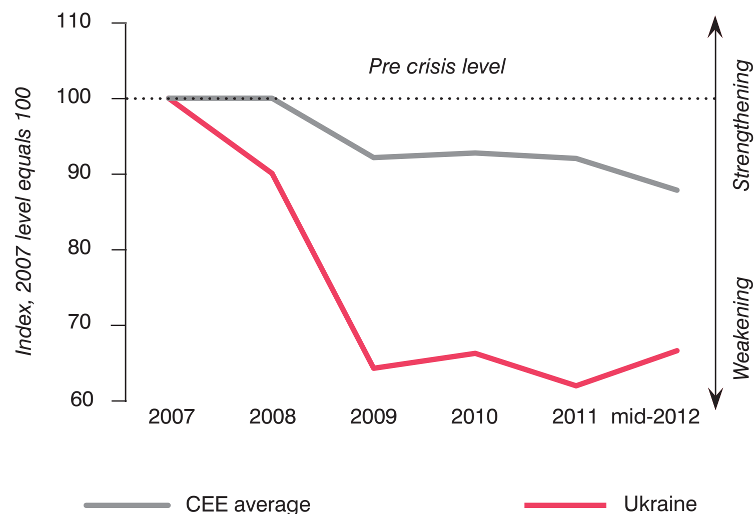
Source: IMF

Stability of the currency

Before the crisis, the Ukrainian hryvnia was pegged to the US dollar causing the national bank to continuously intervene on foreign exchange markets. After the currency experienced drastic depreciation in 2008, and the national bank's reserves at dangerously low levels, the interventions were stopped and the hryvnia lost over 30% of its pre-crisis value.

Taking into account the current level of international reserves, negative current account balance, and relatively high foreign debt, the country's currency is strongly vulnerable to external shocks. Further depreciation may also have negative effects on the banking system due to the high rate of dollarization of credits.

Exchange rate vis-á-vis euro



Source: Eurostat, EBRD

Indicators of vulnerability

as % of GDP, unless otherwise indicated; 2011 or latest available data

	Ukraine	CEE Region
General government balance	-2.7	-0.9
Public debt	36.5	28.3
Foreign exchange loans	24.4	16.6
Loans to deposits (ratio)	166%	127%
Current account balance	-5.6	0.3
Foreign debt	73.0	54.4
Short-term debt	35.7	21.0
Coverage of financing needs by reserves (ratio)*	46%	142%
Credit rating (S&P)	B+	x

** Ratio of foreign exchange reserves to short-term debt and current account balance*
Source: IMF, EBRD, Standard & Poor's, central banks

The exposure of the Ukrainian economy to external risks is rather high.

As steel constitutes a large part of the Ukrainian exports, deteriorating global economic sentiment and falling global demand for steel may strongly influence the real economy. The country has already experienced such a shock at the beginning of the crisis.

The current account balance is strongly negative and is not expected to radically improve in the nearest future.

The banking system, although sufficiently capitalized, is seriously exposed to exchange rate movements. The profitability is close to zero and the share of non-performing loans is high. This makes the quality of the banks' balance sheets highly questionable.

The level of foreign exchange reserves is dangerously low and the country is lacking financial credibility.

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