The World Bank

EU10 Regular Economic Report

February 2009

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The EU10 refers to Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The EU10+1 includes Croatia.

Summary

Main Report

As the international economic crisis continues to unfold, spreading from financial markets into the real economy, the EU10 economies find themselves especially hard hit. External demand has collapsed, driven by recession in the region's main trading partners. Foreign capital inflows to the EU10 are drying up, especially intrabank lending (between EU15 parents and EU10 subsidiaries) and foreign borrowing by companies. A credit crunch within the EU10 has further undermined production, as banks weather a crisis of confidence of lending to each other and to the private sector.

Prospects for global recovery, for private capital flows, and for growth in the EU10 continue to deteriorate. Forecasts are subject to very high degrees of uncertainty, mostly on the downside. The EU10 economies face the challenges of a dearth of international liquidity, exposure to vulnerable banks, and collapsing export markets. The impact will now be felt strongly in the real sector as defaults spread and foreclosures creep up, and as unemployment rises sharply.

The EU10's heightened vulnerability to this crisis is a by-product of the region's great success at integrating with the EU and globally, linked through financial as well as trade channels. That integration, although differentiated across the 10 countries, has brought major benefits, including rapid convergence in incomes, improvements in living standards, and a sharp decline in poverty rates. But the easy flow of credit that made this possible was mirrored in rising private sector debt, growing exposure to foreign exchange risks, and easily-financed large current account deficits. The unprecedented series of external shocks have now revealed the financial sector in the EU10 as even more volatile than those in more advanced economies, while the extreme export dependence of some of the EU10, though supportive of high growth in the past, is now pulling the economies downward.

Recent data suggest that external accounts may have deteriorated further in the fourth quarter of 2008, driven by the unfavorable external environment, with export performance weakening more quickly than imports. Furthermore, on the back of weakening investor sentiment, the financing of external positions has proved more difficult for emerging markets in recent months, including for the EU10 where, in many cases, central banks have had to reach into their reserves.

EU10 policymakers' options are limited. Monetary easing is constrained in a number of countries, and almost all of these countries have little to no room for fiscal stimulus because of financing and budgetary constraints. Instead, governments will need to focus on other measures to stabilize the financial sector and on better quality of spending to deliver core services and provide safety nets to the most vulnerable within tight expenditure envelopes. Into the future, the EU10 should continue on the path of integration but with greater cognizance of vulnerabilities and so more focus on, for example, better banking supervision and the management of private capital flows.

In Focus: External Financing Risks in the Banking Sector

In Focus: Interbank Markets and Spillover from the Global Crisis

In Focus: Domestic Credit Developments

In Focus: Is Fiscal Policy Being Used as a Stabilization Mechanism?

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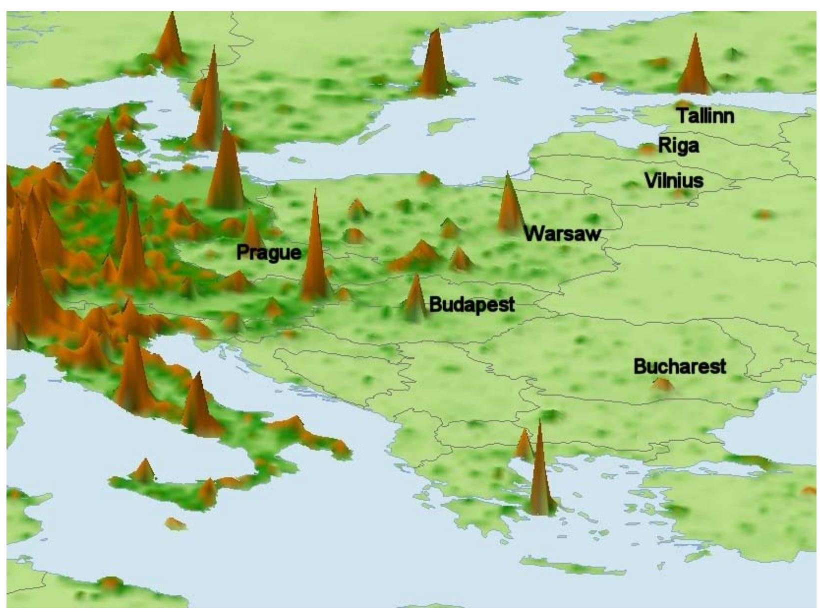
Special Topic

The ongoing crisis should spur deeper European integration, rather than a return to the nationalism of the past. The World Development Report 2009, *Reshaping Economic Geography*, spotlights the implications of the report for EU New Member States. Taking a long-term view which utilizes insights from economic geography and history, it recommends continued efforts to:

- **Make economic borders 'thinner'.** In the EU10, economic divisions to the mobility of people and products remain considerable, and reforms to reduce these divisions should remain high on the agenda even during the financial crisis. In the EU15, as governments deliberate economic stimulus programs, they should resist the temptation of nationalism that would make their borders 'thicker'.
- **Welcome rising economic density.** The lesson of history is that greater international convergence is accompanied by a concentration of production in leading areas and cities. The EU10 should not resist the domestic concentration of economic activities: they are a necessary part of strategies for growth and competitiveness.
- **Deepen institutional convergence.** While infrastructure and place-based investments are often seen as the most needed policy measures, the mainstay of a strategy for economic integration in Europe is common institutions that facilitate the mobility of goods, services, capital and labor. New member states should continue their efforts to harmonize trade, financial and employment regulations.

EU New Member Sates are near global markets but lack sizable domestic markets



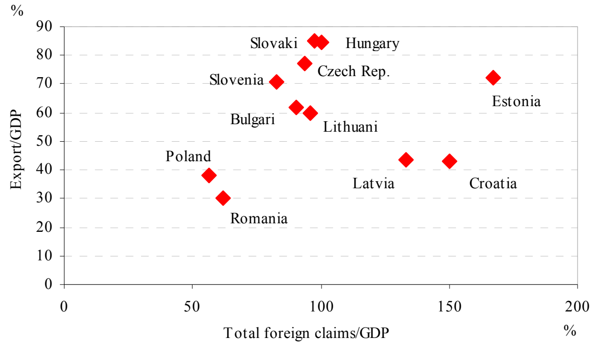
Source: World Bank Staff

EU10 Regular Economic Report
In Focus: Summary

External Financing Risks in the Banking Sector

Large capital inflows have resulted in a build-up of external liabilities across the region in order to finance a growing demand for domestic credit. In the EU10, many countries are exposed to the same external lenders via cross-border loans to banks from their international parent banks. Reliance on cross-border funding exposes these banks to the potential balance sheet pressures of their parent banks. Recently, local liquidity requirements may have become more stringent, disrupting the free flow of funds between parent and subsidiary or branch necessary for well-functioning centralized liquidity management. Given the openness of these economies, the deteriorating global economic outlook has prompted many banks to reassess their business outlook. This assessment may lead to tightened lending conditions, with implications for the real economy.

Level of foreign trade and financial integration in the countries of the region, 2008

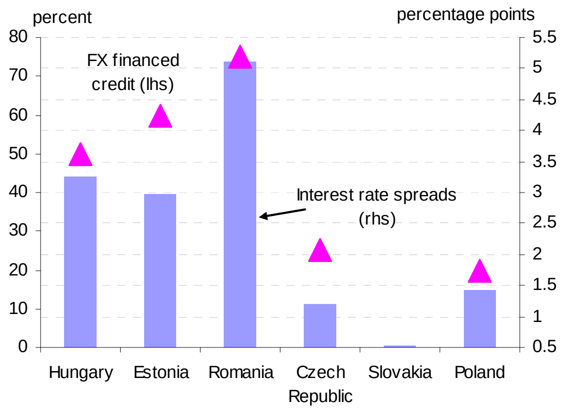


Sources: BIS, EUROSTAT, Bank Staff calculations

Interbank Markets and Spillover from the Global Crisis

Tensions in international money markets spilled over to domestic interbank markets in the EU10 and Croatia (EU10+1) during 2008. The high levels of foreign borrowing and lending of EU10+1 banks has created significant dependence on well-functioning FX swap markets. But liquidity in these markets was significantly impaired in the last quarter of 2008. Pressures spread from the FX swap markets to the EU10+1's overall domestic interbank markets and FX spot markets, with particularly disruptive effects on the financial systems in Hungary and Latvia. Central banks have intervened to enhance access to domestic and foreign currency liquidity via reserve drawdowns, cuts in reserve requirements, and agreements with foreign central banks. Not surprisingly, local interbank markets were most disrupted in countries where credit growth had been significantly externally financed, highlighting ongoing risks to banks from FX lending.

Change in local interbank-Euribor interest rate spread and percent of credit growth externally-financed



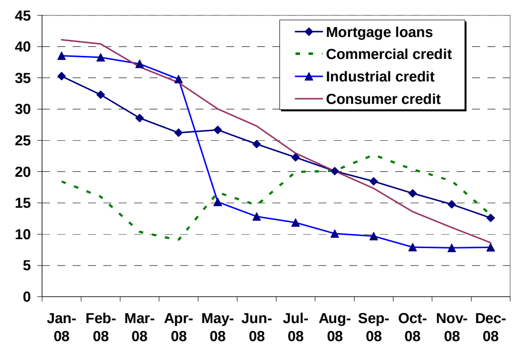
Note: Change in spreads between averages for December 2008 and in June 2008; 3-month maturity instruments. Credit growth contributions are derived from banking sector balance sheet data.

Source: Datastream and DB Research.

Domestic Credit Developments

The sharp deceleration of credit growth to the private sector in the EU10 and Croatia (the EU10+1) will inevitably squeeze households and enterprises and can only aggravate the worsening recession. Household indebtedness had grown rapidly, particularly mortgage debt; and loans in foreign currencies became dominant in most countries. Facing exchange rate and interest rate risk, households had become much more vulnerable to shocks. The sectors most reliant on bank financing--construction and durable producers—as well as less creditworthy market segments—small and medium enterprises--are likely to be the most affected by tightened credit conditions.

Latvia: Loans to residents, y/y, in percent

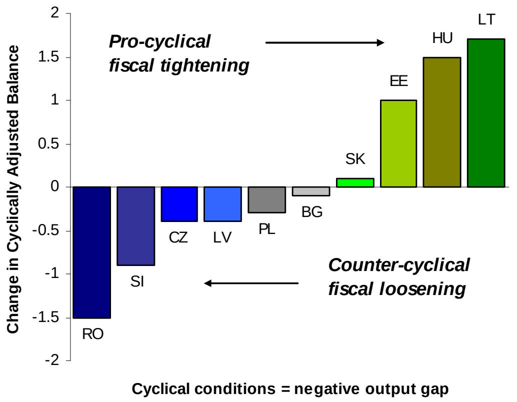


Source: Central Bank, Bank Staff calculations.

Is Fiscal Policy Being Used as a Stabilization Mechanism?

In recent weeks, governments around the world have announced huge fiscal stimulus packages in order to address falling output and rising unemployment, unprecedented over the last few decades. Countercyclical fiscal policy is one of the major weapons of core global economies against the crisis. The EU10 governments, however, have limited scope to deal with this crisis through fiscal easing, due to financing and budgetary constraints. Therefore, fiscal policy has not been actively used by EU10 countries to support aggregate demand. The expected deterioration of fiscal balances in the EU10 in 2009 is more likely to be driven by shortfalls in private demand (both structural and cyclical) rather than by discretionary government activism.

Fiscal Policy in EU10 in 2009 under "No Policy Change" Scenario*



Source: Convergence Programs, EC Interim Forecast January 2009, staff calculations.

*CAB = cyclically adjusted balance. *) The forecast is based on the policy measures disclosed by Governments by the time of the release of the EC report (see the Fiscal Policy section and the Fiscal Policy 'In Focus' note for details).Since then, Romania's revised 2009 budget would place the country in the pro-cyclical group.*

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Main Report

External Environment

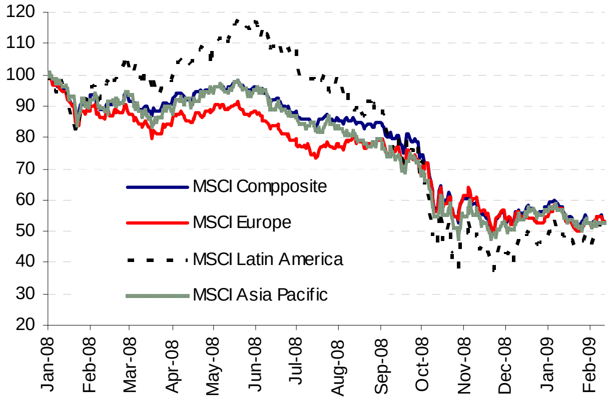
Since our last report in October, international financial markets have calmed somewhat, as conditions in interbank markets as well as equity and bond markets are less volatile. Rates have fallen sharply after massive monetary easing and liquidity injection by major central banks. The spread between US$ Libor and U.S. T-bill rates (TED spreads) has continued to narrow (Figure 1). However, tension in the term interbank market remains elevated, as reflected in the continued wide spreads between interbank rates and the expected overnight policy rates (overnight index swaps), which still remain above pre-Lehman levels. Beyond the interbank market, banks both in the US and Europe have also been able to issue bonds with government guarantees, relieving part of the short- and medium-term funding pressures. However, bank lending and capital market financing for non-financial borrowers have slowed substantially in both US and the euro area (in particular, Ireland and Spain) due to risk aversion and tightened credit standards and weakening demand. In fact, funding shortages have begun to push up corporate default rates.

Figure 1. TED Spread (in basis points)

Source: Reuters, World Bank Staff calculations.

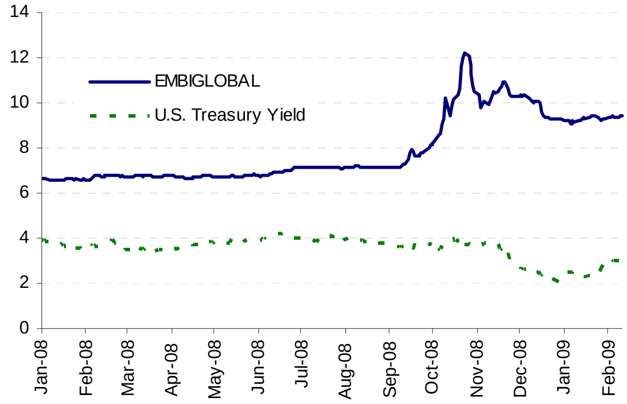
At the same time, equity and bond markets, including those in emerging market economies, have become more stable since October, but equity prices have not recovered and bond spreads remain high. The relative stability in equity markets through January was driven mainly by expectations that the impact of past and expected monetary easing and substantial fiscal relaxation would soften the global recession (Figure 2). EMBIG yields have declined somewhat from their November highs, driven by a continued fall in emerging market sovereign yields and to a lesser extent, a slight increase in US Treasury yields (Figure 3). The forthcoming fiscal stimulus and expected deterioration of fiscal balances have raised credit risk spreads and bond yields on U.S. Treasuries as well as European government bonds. Within the Eurozone, government spreads over German Bunds has continued to widen, particularly for the most heavily indebted countries. Standard and Poor's have signaled their concern about mounting government debt levels in Greece, Ireland, Portugal, and Spain, leading to a significant widening in spreads versus Germany (Figure 4, Figure 5).

Figure 2. MSCI Index (January 2008=100)



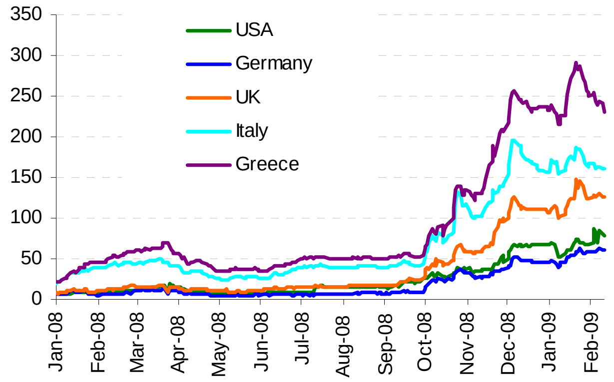
Source: Reuters, World Bank Staff calculations.

Figure 3. Emerging Market Bonds Yields vs. U.S. Treasury Yield (in percent)



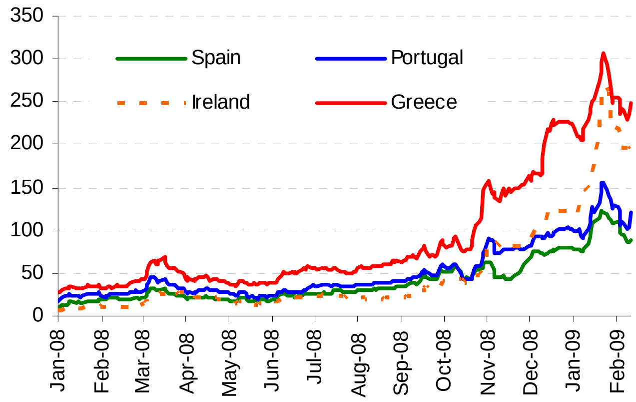
Sources: US Treasury, MorganMarkets, World Bank Staff calculations.

Figure 4. Cost of Protection Against Default for Sovereigns, 5-year CDS spread (in basis points)



Source: Reuters, World Bank Staff calculations.

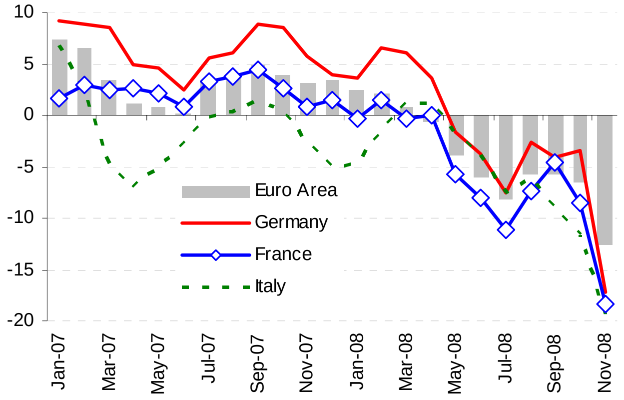
Figure 5. Government Bond Spreads over German Bund (in basis points)



Source: Reuters, World Bank Staff calculations.

Prospects for global growth in 2009 continue nonetheless to weaken: economic activity is forecast to contract significantly in the major economies, including the euro area. (Table 1) The most striking development of the last quarter remains the degree of synchronization across the global economy, reflected by the particularly sharp declines in manufacturing activity and trade volumes. Industrial production indices collapsed across the major Eurozone economies in late 2008, further undermining prospects for 2009. (Figure 6) The global economy is expected to stagnate in the year ahead and may enter a modest recovery only in 2010, according to the IMF's January 2009 *World Economic Outlook Update*, as expansionary fiscal and monetary policies take effect. However, the outlook is highly uncertain, and downside risks dominate. The euro area is already in a recession following a fall in GDP for the second consecutive quarter (real GDP dropped by 0.2 percent in the third quarter of 2008). In the euro area, the recession is expected to continue with a further decline of GDP in the first two quarters of 2009 and stabilization towards the end of this year.

Figure 6. Industrial Production in the Euro Area Countries (% change, yoy, saar)



Source: Eurostat, World Bank Staff calculations.

Table 1. Recent Forecasts of Economic Growth (in percent, annual)

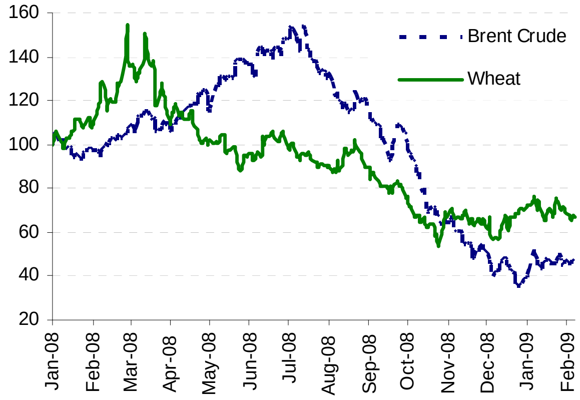
	2008e		2009f			2010f		
	EC	IMF	EC	IMF	*IMF*	EC	IMF	*IMF*
	Jan 2009	Jan 2009	Jan 2009	Jan 2009	*difference from Nov 2008*	Jan 2009	Jan 2009	*difference from Nov 2008*
World	3.3	3.4	0.5	0.5	*-1.7*	2.8	3.0	*-0.8*
USA	1.2	1.1	-1.6	-1.6	*-0.9*	1.7	1.6	*0.1*
Eurozone	0.9	1.0	-1.9	-2.0	*-1.5*	0.4	0.2	*-0.7*
Germany	1.3	1.3	-2.3	-2.5	*-1.7*	0.7	0.1	*-0.4*
Japan	-0.1	-0.3	-2.4	-2.6	*-2.4*	-0.2	0.6	*-0.5*
Russia	5.9	6.2	1.0	-0.7	*-4.2*	2.3	1.3	*-3.2*

Sources: EC January 2009 Interim Forecast, IMF World Economic Outlook November 2008 and Update from January 2009.

Economic activity in the emerging markets has been negatively affected by the marked deterioration of underlying global growth and worsening outlook for private capital flows. Net capital flows, projected by the Institute of International Finance, are expected to reach only $165 billion in 2009, down from $466 billion in 2008 and $929 billion in the boom year of 2007. While all components of net private capital inflows have been on the decline, the most pronounced drop is forecast for net bank lending. However, the impact of this slowdown will vary greatly across the region, reflecting a combination of exposure to commodities, exposure to the United States or eurozone as well as domestic policies. Thus, the prospects for the region look particularly bleak, given, variously, large external deficits, reliance on crisis-hit Western European banks, high foreign currency loan exposure or high exposure to exchange rate risk via derivative contracts. The gas conflict between Russia and Ukraine has added an additional downside growth risk, as some countries in the region had to restrict gas supply to large industrial producers (for example, Hungary, Bulgaria,, Bulgaria, and the Slovak Republic).

Global inflation is plunging in response to the deep economic downturn and the associated collapse in commodity prices. Fear of global recession drove the plunge in commodity prices in the second half of 2008 (Figure 7), but hopes that a global fiscal stimulus will be effective

Figure 7. Food and Petroleum Prices Index(January 2008=100, US$, and US$ per barrel)



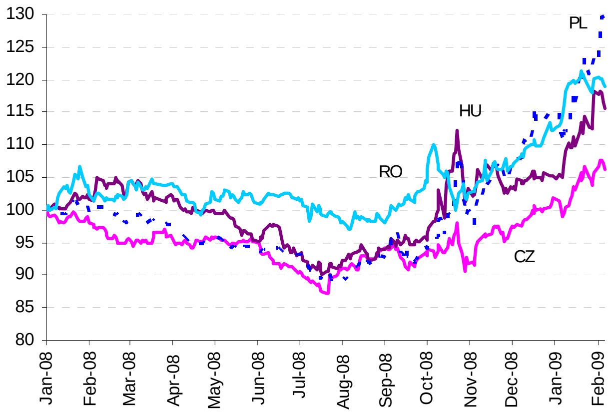
Source: GEM World Bank Database, World Bank Staff calculations.

have lifted prices slightly. Despite this, the most recent data point to sharp declines in December inflation across a range of countries in Europe, Asia and US. With headline inflation already dropping below central bank targets and resource utilization set to fall considerably further in 2009, monetary policymakers are moving aggressively to lower rates. However, in countries where interest rates are already close to the zero bound, the room for maneuver is limited, and there is a heightened risk of deflation.

EU10 Financial Markets

Financial markets in the EU10 have similarly been affected by global investors' sentiment and are even more volatile than those in advanced economies. EU10 financial markets have been vulnerable to deteriorating investors' sentiment leading to significant pressure for exchange rate depreciation (except for the Slovak Republic and Slovenia which are in the eurozone) and/or a decline in foreign reserves or huge fluctuations in prices of equity and fixed-income instruments. In Latvia, the pressure on the Lat in late 2008, which required central bank interventions of €1.2 billion, eased in mid December as Nordic central banks provided bridge financing before a €7.5 billion IMF-led stabilization package was finalized (for more information on the IMF packages in Latvia and Hungary please see Box 1). Countries with flexible exchange rate systems in the region experienced strong depreciation pressures especially in late January and early February: compared to end-2008, the Polish Zloty and the Hungarian Forint lost around 10 percent against the euro, while the Czech Crone and Romanian Leu lost around 5 percent (Figure 8). In early February, stock market indices were much below their levels in early 2008: 20 percent lower in the Slovak Republic, around 50 percent lower in the remaining Visegrad countries, and 70-80 percent declines in Romania, and Bulgaria (Figure 9). Also bond spreads exploded in the region in the fall of 2008 but declined a bit and broadly stabilized in January to early February (Figure 10).

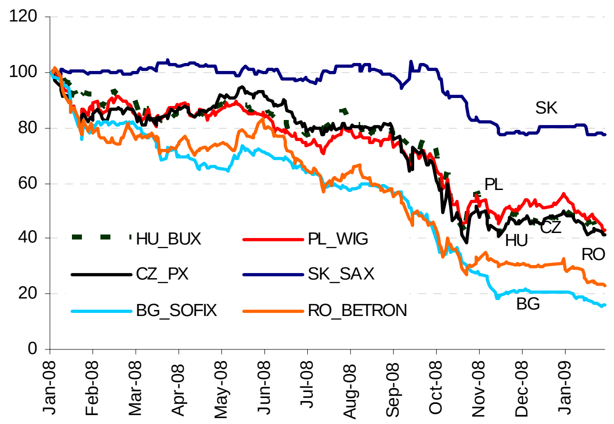
Figure 8. Exchange Rates Against the Euro (January 2008=100)



Source: European Central Bank, World Bank Staff calculations.

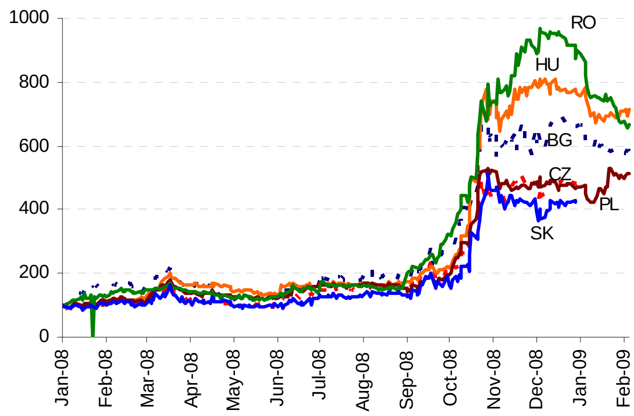
Note: An increase denotes LCU depreciation.

Figure 9. Stock Market Indices (January 2008=100)



Source: ISI, World Bank Staff calculations.

Figure 10. Euro EMBIG Spreads



Source: Morgan Markets, World Bank staff calculations.

Note: The difference between the yield on each bond and a euro government yield of the same maturity, duration weighted.

Furthermore, looming recession in core markets is further affecting prospects for emerging markets, including EU10. The recession in core markets is affecting the emerging markets through the sharp slowdown in trade and private capital inflows. This is undermining growth prospects also in the EU10, until recently seen as one of the safest regions across emerging markets but now it is increasingly exposed to credit worries, recession in the euro zone and increased banking problems. As a result, long-term foreign currency ratings and outlooks for EU10 countries have been cut in recent months, in particular for Baltic countries, Hungary, Bulgaria and Romania, with the latter now the only EU member state with a non-investment grade rating (Fitch and S&P). Some of these countries are on a negative watchlist and more downgrades are likely (Table 2).

Table 2. Current foreign currency sovereign ratings for the EU10

		S&P	MOODY's	FITCH
Bulgaria	rating	BBB	Baa3	BBB-
	outlook	Negative	Stable	Stable
Czech R.	rating	A	A1	A+
	outlook	Stable	Stable	Stable
Estonia	rating	A	A1	A-
	outlook	Negative	Negative	Negative
Latvia	rating	BBB-	Baa1	BBB-
	outlook	Negative	Negative	Negative
Lithuania	rating	BBB+	A2	BBB+
	outlook	Negative	Negative	Negative
Hungary	rating	BBB	A3	BBB
	outlook	Negative	Negative	Stable
Poland	rating	A-	A2	A-
	outlook	Stable	Stable	Stable
Romania	rating	BB+	Baa3	BB+
	outlook	Negative	Stable	Negative
Slovakia	rating	A+	A1	A+
	outlook	Stable	Positive	Stable
Slovenia	rating	AA	Aa2	AA
	outlook	Stable	Positive	Stable
Croatia	rating	BBB	Baa3	BBB-
	outlook	Negative	Stable	Stable

Sources: S&P, Moody's and Fitch.

Box 1. IMF Programs in Hungary and Latvia

Hungary was severely hit by the global credit crunch, which prompted a request for an IMF-led financing package in October 2008. Hungary was one of the first emerging economies affected by the financial crisis, despite the fact that the government has made an impressive effort to address the serious fiscal and macroeconomic imbalances generated in the first half of the decade and restore investor confidence. However, the crisis reduced overall risk tolerance, and Hungary was still perceived as a high risk country due to the large liabilities that had been accumulated since 2000. The international financial crisis started affecting Hungary and other emerging countries in mid-2007, with the suspension of redemptions from several investment funds in the US. This increased the overall awareness of a systemic crisis and resulted in a contraction of equity markets worldwide. The outflows from the Hungarian equity market and their impact on equity prices were pronounced and sustained. The second major shock happened in early 2008, when several negative pieces of news in the US (e.g., large bank losses, downgrading of instruments and bond insurers) led to additional contractions of international capital flows, affecting for the first time the Hungarian bond market. As a result, foreign holdings of government bonds declined substantially, sovereign CDS spreads increased, and government bond yields increased significantly above interbank swap rates with the same maturity. The third major shock happened in September 2008. Following the collapse of Lehman Brothers, Hungary experienced massive outflows from the government bond market and sovereign CDS spreads increased dramatically. The government debt market eventually became illiquid, as indicated by the high interest swap spreads. During this period, Hungarian banks also experienced net reductions in funding from third party institutions (foreign banks and other investors excluding parent banks), including restricted access to the FX swap market. The lack of access to foreign exchange resulted in a sharp depreciation of the exchange rate and eventually led the NBH to request a €5 billion facility from the European Central Bank. To counter these unprecedented pressures, the Government announced a consolidation package involving further lowering of budget deficit targets for 2009 beyond the targets set in Hungary's convergence plan for adopting the euro. In October, the government requested a €20 billion international rescue package led by the IMF and including the European Commission and the World Bank (under discussion), in order to restore investor confidence and stabilize financial markets. An IMF-supported program was approved in early November, aiming to limit the output costs of the current crisis, restore investor confidence, and avoid negative spillovers to other countries. The core measures under the program are designed to improve fiscal sustainability and strengthen the financial sector: fiscal consolidation, based on agreed spending cuts; passage of a fiscal responsibility law; progress on key structural reforms linked to long-term sustainability; establishment of a Capital Base Enhancement Fund and a Refinancing Guarantee Fund to increase bank capital and guarantee wholesale interbank funding; and MNB facilities to manage domestic currency liquidity within the inflation targeting framework.

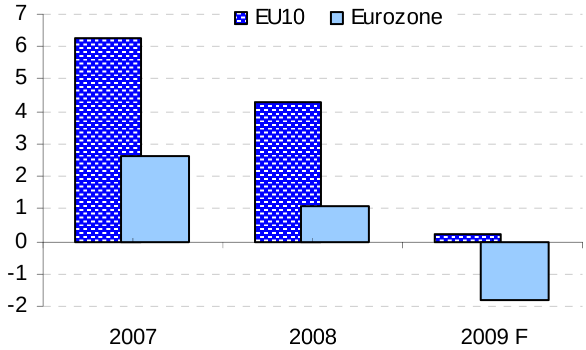
Later in December 2008, after sliding into recession and taking over its second-largest bank (PAREX Bank), Latvia also had to seek the support of an IMF-led €7.5 billion bailout package (or about 35 percent of GDP), with a leading role for the IMF and support from the EU, Nordic countries, the World Bank and others[1]. The 27-month IMF program is based on preserving the existing exchange rate within the narrow band and therefore requires exceptionally strong domestic adjustment policies and sizable external financing. Apart from the near-term focus on the financial sector stabilization, the program focuses primarily on fiscal and income policies with a large fiscal consolidation (7 percent of GDP in 2009), including measures both on the revenue side (mainly VAT rate increase and real estate/capital income tax) and on the spending side (15 percent cut of salary fund in public institutions, 25 percent cut in expenditure for procurement and for subsidies and transfers, excluding healthcare). Fiscal consolidation will be backed by complementary strategies in areas of debt restructuring and structural reforms, the latter including strengthening public financial management as well as comprehensive reforms of the education, civil service, state administration and the healthcare systems. Furthermore, policies will be introduced to support the rebalancing of the economy and recovery of growth prospects.

Output and Employment

The recession spillover from the old to the new EU member states, already visible last year, will further cut the EU10 average growth rate in 2009. With another downward revision for the eurozone countries in the wake of data on the unprecedented fall in industrial production in the last two months of 2008, projected 2009 growth for the EU10 dropped to below 0.3 percent (Figure 11). A combination of rapidly weakening domestic demand (Figure 13) and deteriorating external environment already pushed two Baltic countries (Estonia and Latvia) into recession in the third quarter, a state last observed in the late 1990's. In Lithuania and Hungary, growth rates turned negative in 4Q 2008 (Figure 12). The slowdown in 3Q 2008 was relatively broad-based across countries. Agriculture registered positive growth due to last year's good weather and low base from 2007 (and Bulgaria, Hungary, Romania displaying exceptional growth rates due to a particularly low base in 2007). Moreover, high frequency indicators such as industrial production suggest more countries in the region may enter a technical recession by early 2009 (Figure 14).

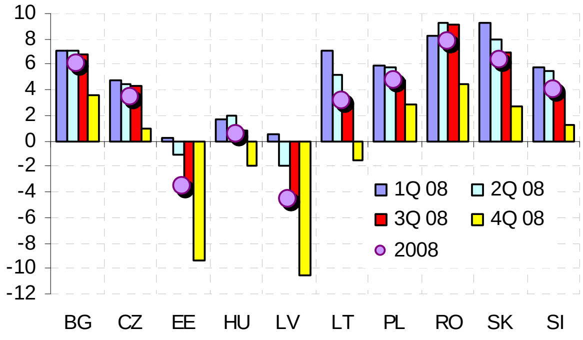
1 Of which the IMF will provide €1.7bn, the EU €3.1bn and Nordic states of Sweden, Denmark, Finland and Norway €1.8bn. In addition, the World Bank is to give €400m (under discussion) while the EBRD, the Czech Republic, Poland and Estonia will jointly give €500m.

Figure 11. Real GDP Growth (% change, yoy)



Source: Eurostat, Statistical Offices, World Bank Staff estimates.

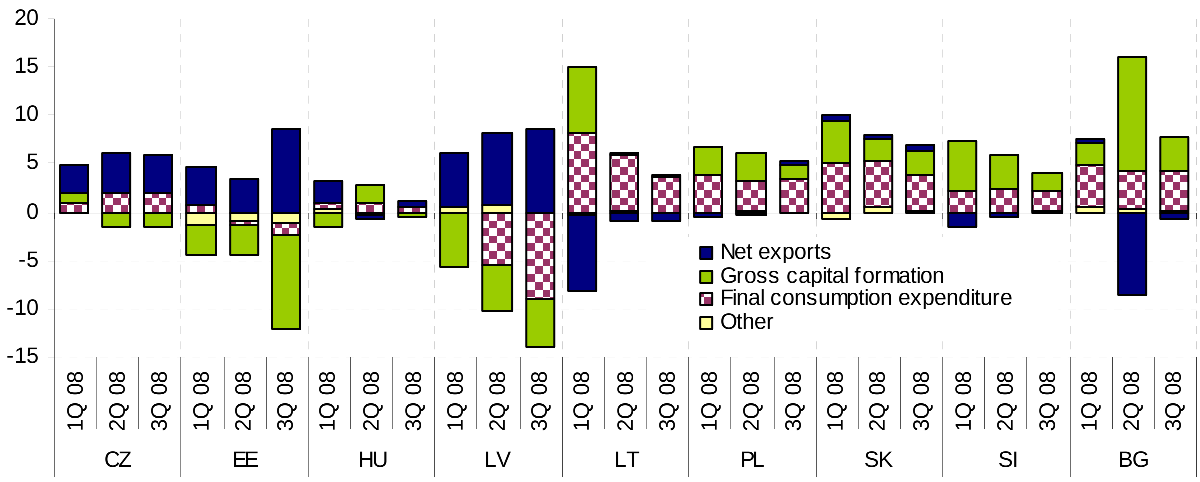
Figure 12. Real GDP Growth (% change, yoy)



Source: Statistical Offices.

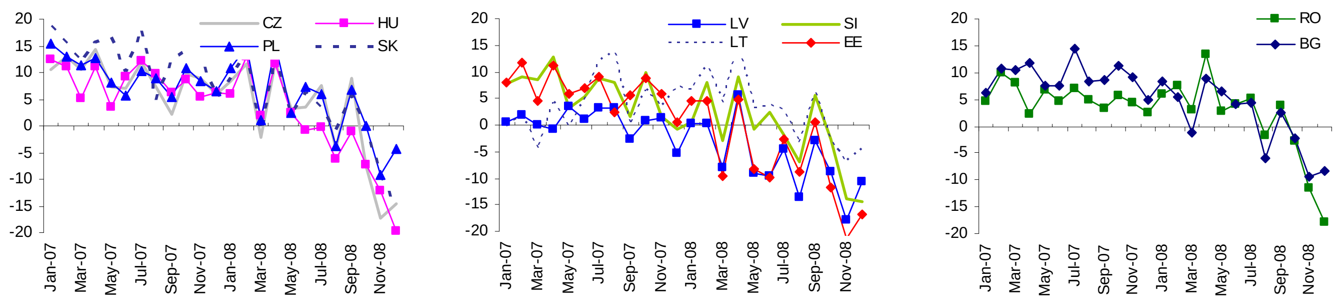
Note: Data for 2008 and 4Q 2008 preliminary.

Figure 13. Contribution to GDP Growth 1Q-3Q 2008 (in percentage points)



Source: Eurostat, Statistical Offices, World Bank Staff calculations.

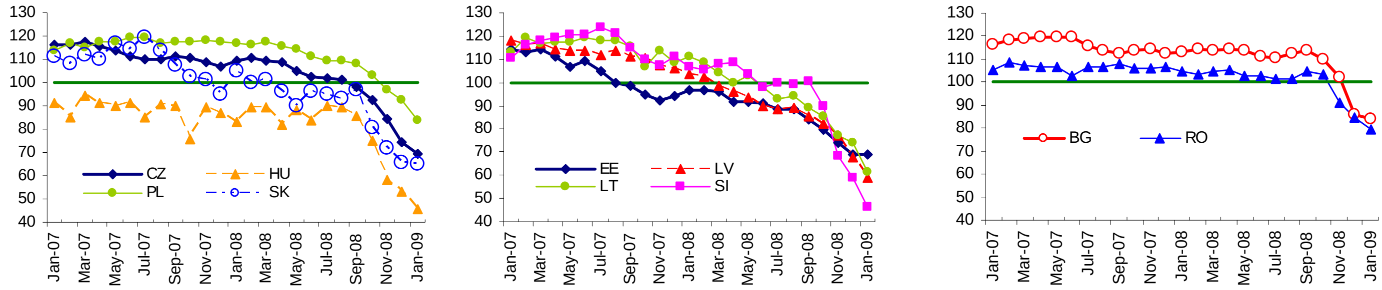
Figure 14. Volume Index of Industrial Production (% change, yoy, unadjusted)



Source: Statistical Offices, Eurostat, World Bank Staff calculations.

Economic sentiment and prospects have been deteriorating rapidly in the region (Figure 15). The economic sentiment indicators from January 2009 deteriorated well below the long-term average in all of the countries in the region. A broad-based recession might deepen in the Baltic countries, with GDP contracting in 2009 by 5 to as much as 7 percent (in Latvia), in Hungary by about 3 percent, while countries such as Bulgaria, the Czech Republic, Poland, Romania, the Slovak Republic and Slovenia might see growth decelerating to some zero to two percent. Private investment, which was a key driving force in the 2004-2007 upturn, faces an abrupt slowdown on the back of a substantial drop in capacity utilization rates, the deterioration of the external environment led by recession in the EU15 and tighter financing conditions. A rebound of investment and consumption will be the key determinants of any recovery in the region.

Figure 15. Economic Sentiment Indicator (a decline denotes deterioration)



Source: European Commission, World Bank Staff calculations.

The outlook for 2009 growth is gloomy and subject to high uncertainty, mostly on the downside. This is because of huge uncertainty related to the scale of influence of the global crisis on the EU10 economies via three main channels: i) *a collapse of external demand* due to a recession in the main trading partners (already visible in sharply falling car production in the Czech Republic, the Slovak Republic and Hungary), but also weaker prospects for exports to Ukraine and Russia; ii) *lower foreign capital inflow*, including lower FDI inflows which have been the backbone of fixed investment but also the drying up of intrabank lending (between EU15 parents and EU10 subsidiaries) and direct external borrowing by companies; and, iii) *credit crunch,* with banks less willing to lend to each other and the private sector due to the crisis of confidence. An additional external shock has been the halted supplies of natural gas from Russia in January which have harmed, in particular, Bulgaria, Hungary and the Slovak Republic. Following the large contraction in industrial production in late 2008, data for January may be even weaker as a result of suspended production in a number of companies owing to the January gas crisis and, more generally, deepened recession in trading partners.

The most recent official forecasts in Convergence Program (CP) updates from about November/December 2008 and the EC interim forecast from January 2009 assume a sharp slowdown of economic activity, disinflation, improvement of external imbalances, and deterioration of fiscal balances in 2009 as compared to 2008 (Table 3). Although in the past, differences between CP and EC forecasts often reflected greater optimism on the part of governments, in current circumstances, the differences largely reflect the timing of the forecasts and the ongoing deterioration in the macroeconomic environment.

Table 3. Recent official national and EU macroeconomic forecasts, in percent (as % of GDP in case of current account and fiscal balances)

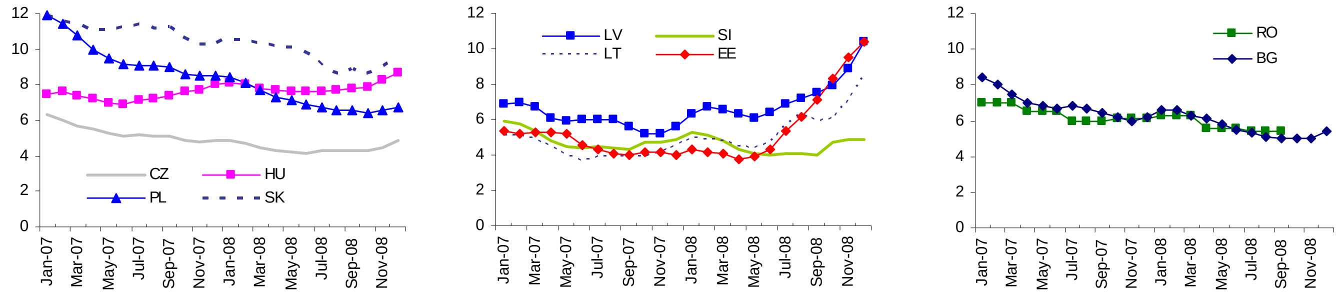
		Real GDP growth		HICP		CA Balance		Fiscal balance	
		2008	2009	2008	2009	2008	2009	2008	2009
Bulgaria	CP	6.5	4.7	12.4	6.7	-24.0	-22.2	3.0	3.0
	EC	6.4	1.8	12.0	5.4	-24.7	-20.8	3.2	2.0
Czech Rep.	CP	4.4	3.7	6.4	2.9	-2.4	-2.1	-1.2	-1.6
	EC	4.2	1.7	6.3	2.6	-0.9	-2.1	-1.2	-2.5
Estonia	CP	-2.2	-3.5	10.6	4.2	-12.2	-7.2	-1.9	-1.7
	EC	-2.4	-4.7	10.6	3.2	-10.1	-5.7	-2.0	-3.2
Latvia	CP	-2.0	-5.0	15.4	5.9	-14.8	-7.3	-3.5	-5.3
	EC	-2.3	-6.9	15.3	6.8	-14.9	-6.5	-3.5	-6.3
Lithuania	CP	3.5	-4.8	11.2	5.4	-12.6	-4.0	-2.9	-2.1
	EC	3.4	-4.0	11.1	5.6	-12.6	-7.0	-2.9	-3.0
Hungary	CP	1.3	-0.9	6.2	4.5	-6.8	-5.2	-3.4	-2.6
	EC	0.9	-1.6	6.1	2.8	-7.2	-5.5	-3.3	-2.8
Poland	CP	5.1	3.7	4.2	2.9	-5.1	-4.2	-2.7	-2.5
	EC	5.0	2.0	4.2	2.9	-5.6	-5.6	-2.5	-3.6
Slovakia	CP	na	na	na	na	na	na	na	na
	EC	7.1	2.7	4.0	2.9	-6.0	-6.2	-2.2	-2.8
Slovenia	SR	na	na	na	na	na	na	na	na
	EC	4.0	0.6	5.5	0.9	-6.0	-5.8	-0.9	-3.2
Romania	CP	na	na	na	na	na	na	na	na
	EC	7.8	1.8	7.9	5.7	-12.9	-11.9	-5.2	-7.5

Note: HICP – Harmonized Index of Consumer Prices; CA Balance – Current Account Balance; Fiscal Balance – General Government Balance according to ESA'95.

Source: Convergence Programs from November/December 2008 (CP) and EC Interim Forecast, January 2009 (EC).

The significant slowdown in economic activity has begun affecting EU10 labor markets. Unemployment was significantly up in last months of 2008 in the Baltics, and this trend is expected to continue through 2009 (Figure 16). In Latvia, the main wave of lay-offs is still ahead (including envisaged cuts in public sector employment), which may result in an unemployment rate increasing well above 10 percent in 2009. Although this may be in part due to seasonal factors, unemployment rates in Bulgaria, the Czech Republic, Hungary, and the Slovak Republic started to rise in late 2008 and early 2009 with sizeable layoffs in construction, automobile and electronics manufacturers as a result of shrinking orders amidst the global economic slowdown.

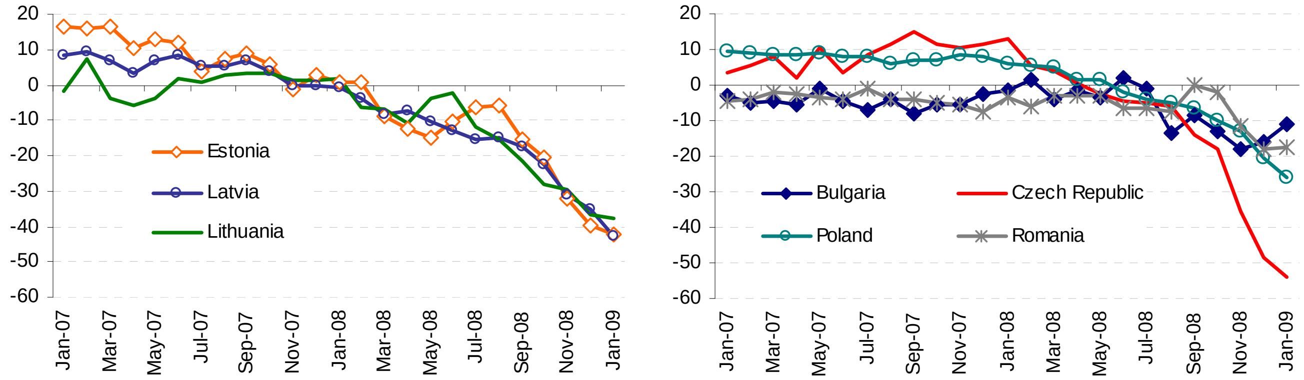
Figure 16. Harmonized Unemployment Rates (in percent)



Source: Eurostat, World Bank Staff calculations.

Judged from the hiring expectations of businesses in the region, there is little prospect for expansion of employment in 2009 (Figure 17). Construction, textiles and the car industry are expected to be the hardest hit. In Bulgaria, gas shortages have aggravated the difficulties facing exporters as orders had to be delayed or cancelled; these further cutbacks are expected to exert additional downward pressure on labor costs in 2009. Vacancies in the Czech Republic shrank by more than half in January 2009, according to employment intermediation agencies. In February 2009, Slovenia reconsidered subsidizing a shorter work week to salvage jobs as its €12 billion bank guarantee plan, announced in October, failed to revive lending and spur economic activity.

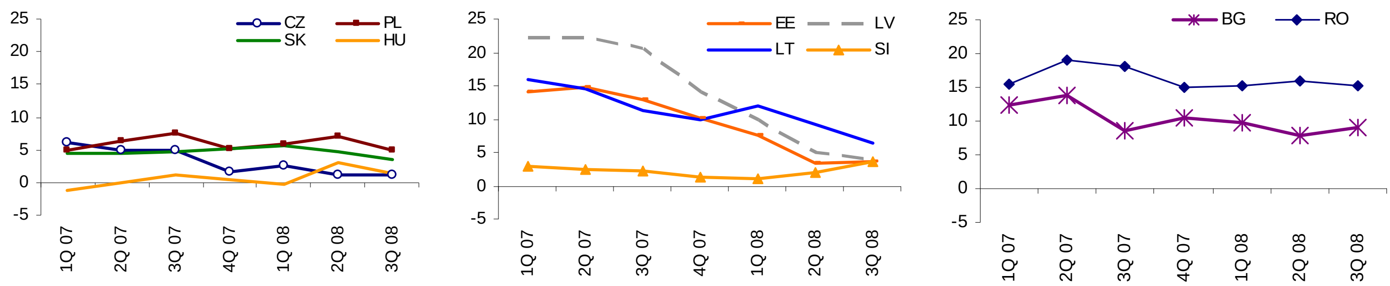
Figure 17. Business Climate Indicator - Employment Expectations for Three Months Ahead



Source: European Commission, World Bank Staff calculations.

Falling inflation and rising unemployment rates have begun to moderate wage pressures, although this is not yet visible in the figures available for Romania (Figure 18). In 2009, wage pressures should continue to lessen across the region, although the extent will depend on local labor market rigidities. In the third quarter of 2008, average real wages were still rising very quickly in the faster growing economies, led by Romania (15.4 percent from a year earlier) and Bulgaria (9.1 percent). In Poland, wage growth has been gradually decelerating. Such easing is not yet imminent in Romania which, despite the slowdown of the economy, still faces strong wage rigidity with the average real net wage up 14.0 percent in October (much above productivity growth, estimated at 8-9 percent y/y). In Hungary, a moderate growth of private sector wages of 3-5 percent was recommended for 2009 by the tripartite labor council. Sizeable layoffs are planned in relatively well-performing countries like Poland and the Slovak Republic.

Figure 18. Real Growth of Wages (% change, yoy)



Source: Statistical Offices, World Bank Staff calculations.

Inflation and Monetary Developments

With GDP growth weakening in late 2008 and into 2009, world commodity prices falling, current inflation and expectations for future inflation have eased dramatically across the region. After reaching its peak in mid-summer 2008 (Figure 19), consumer inflation started to fall back quickly. It has been pushed down by its all sub-components: core inflation (which is related to weakening domestic demand and restricted credit expansion), energy prices (especially of fluid fuels[2]), and lower food pressure (due to relatively good harvest and lower demand internationally). Sharp declines of headline (year-on-year) price indices resulted also from a very high statistical bases in the second half of 2007, when the region suffered from global food and fuel crisis.

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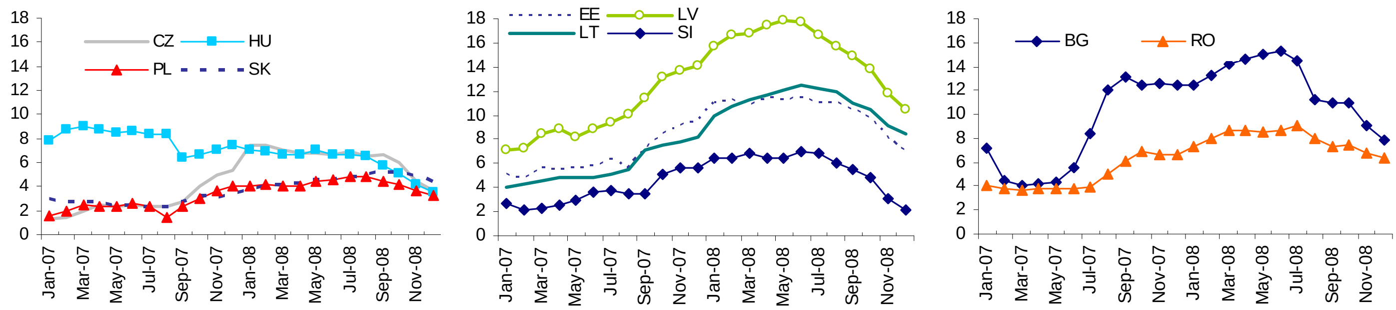
[2] While prices of "fuels and lubricants for personal transport equipment" increased in double digits in early 2008 across the region and above 20% in the Baltic Countries, in December 2008 they fell by a range from 9.8% y/y in Estonia to 21.7% y/y in the Czech Republic. This category constitutes from 2.9% (Slovakia) to 7.9% (Bulgaria) of the HICP baskets. A 10% decrease of fuel prices directly leads to a 0.3-0.8 percentage point lower headline inflation and contributes to lower inflation pressure of other goods and services indirectly.

Figure 19. Consumer Price Indices (% change, yoy)

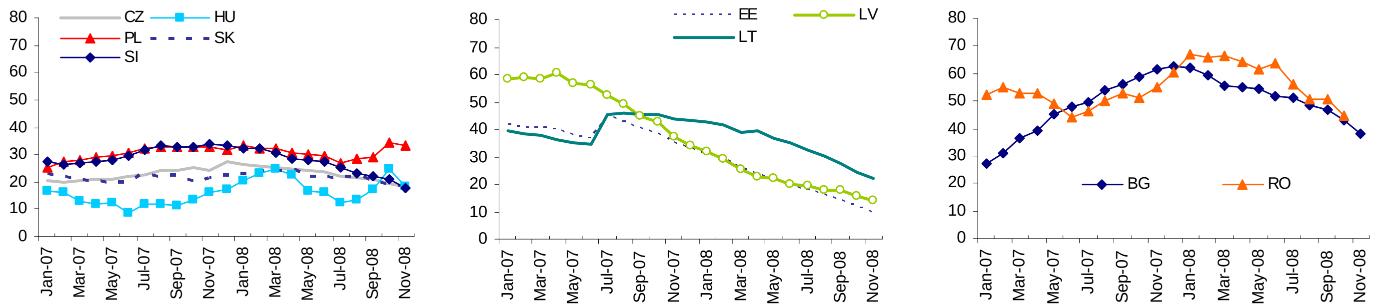


Source: Statistical Offices.

As noted above, the crisis is now beginning to feed through to higher joblessness rates, which will increasingly reduce cost-push factors (although not yet in Romania). In this context, even adjustments of regulated prices and indirect taxes in early 2009 did not change the positive inflation outlook for 2009. The bargaining power of employees changed drastically, and the mounting pressure on wage increases was replaced by concerns to preserve existing jobs. January is frequently a time for routine increases of regulated prices and indirect taxes, but these adjustments should not prevent the headline inflation from falling given the deflation of underlying energy products. In Romania, a freeze in administrative prices, especially of energy, is considered.

Inflation easing is also supported by a rapid deceleration in domestic credit, driven by more limited access to external funding, be it from parent foreign banks or from wholesale markets, and banks' reluctance to extend new credit (Figure 20). If the current trend continues in the Baltics, the stock of credit to the private sector will increase only by single-digit rates, if at all. In Bulgaria and Romania, the downward trend is also visible. In Visegrad counties and Slovenia, credit moderated slightly over the recent months. This may be misleading in case of Poland and Hungary, as taking into account the depreciation effect the data show significant slowdown of credit activity (see more in the '*In Focus' Note on Domestic Credit Developments*). Some countries already report a deteriorating quality of bank portfolios. In Estonia, non-performing loans (NPL) rose to 8.1 percent of total loans in November, up from 6.5 percent in October. In response to the escalating financial crisis, bank lending strategies have become more conservative. The pursuit of safety is now dominating the search for profit. This involves creating bigger liquidity cushions, reducing FX exposure, and increasing bank deposit rates.

Figure 20. Growth of Credit to Private Sector (% change, yoy)

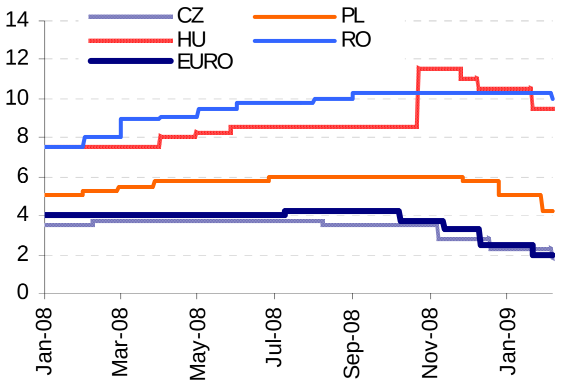


Source: Central Banks, World Bank Staff calculations.

Monetary authorities across the region have taken steps to maintain confidence and support the effective functioning of the financial systems. These measures are aimed at preserving trust and liquidity in financial markets through the expansion of term liquidity management operations and foreign exchange swap operations (Poland, Hungary), the reduction of mandatory reserve requirements (Bulgaria, Latvia), FX interventions (Latvia, Romania), or increased availability of repo operations (in some countries together with a reduction of key policy rates). See more on this in the *'In Focus' Note* on *Interbank Markets and Spillover from the Global Crisis*. All countries strengthened their deposit guarantee schemes for households in line with EU-wide guidelines (see the previous issue of the RER).

Where feasible, monetary authorities have cut interest rates (Figure 21). The Czech authorities started the easing cycle in monetary policy in late summer 2008, while Poland began in November 2008. In Hungary, interest rate policy over recent months (a gradual relaxation following a sharp increase of 300 basis points on October 22) has been connected to the easing of inflationary pressure and the situation on money markets as well as the emergency lending program led by the IMF and supported by the EU and the World Bank (under discussion). In Romania, interest rates have remained unchanged at a high level through early 2009 as the 3Q 2008 data suggested economic overheating, and fiscal policy turned highly expansionary in Q4. However, given a considerable economic slowdown envisaged by leading indicators, in early February 2009, interest rates were cut by 25 basis points.

Figure 21. Policy Interest Rates (in percent)



Source: Central Banks.

Looking forward, the recent large depreciations in countries with flexible exchange rate regimes limit the scope for monetary policy easing. As mentioned earlier in the report, in the late summer 2008 a trend of strong appreciation reverted to rapid depreciations, spurred by foreign capital outflow from debt and equity markets. Within a few months, local currencies lost more or less all that they had gained against the euro during the last three to four years. On the other hand, imported inflation is going down, and profit margins tend to be pro-cyclical.

Against this background, adoption of the euro has become both more attractive and more complicated. In January 2009, the Slovak Republic became the 16th member of the euro zone and enjoys the relative financial stability of a big monetary union. The transition from Slovak crowns to euro went technically smoothly. Euro adoption remains a strategic medium-term objective in the Baltic countries, with Estonia targeting 2011 and Latvia and Lithuania 2011-2012. While earlier the main obstacle was inflation above the reference value, now the main challenge ahead is meeting the Maastricht fiscal requirement. In late November 2008, the Polish government approved a road map to euro adoption in 2012. With that in mind, ERM2 entry is targeted for mid-2009. As euro adoption requires amending the Constitution, political consensus is needed but seems to be elusive. According to the CNB Governor, in the Czech Republic euro adoption is feasible in 2013-2015. This said, the financial and economic crisis is complicating fulfillment of almost all convergence criteria: exchange rate (due to huge exchange rate volatility), fiscal (as a drastic slowdown of growth or recession may push the deficit and debt levels up), and inflation (although countries in the region are currently experiencing rapid disinflation, the reference value may be very low as the EU15 enters into a recession).

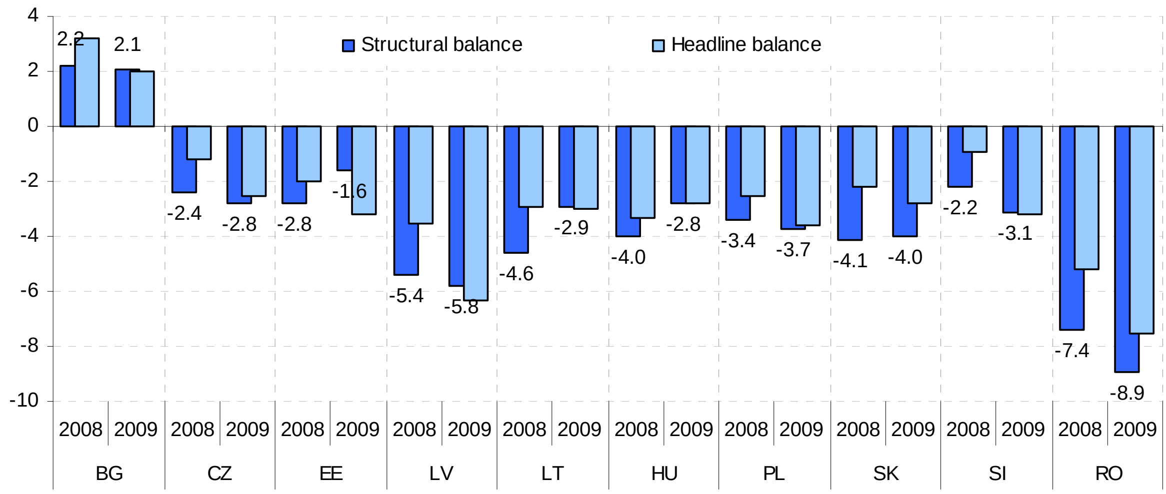
Fiscal Policy

Budget deficits have widened in 2008 in all EU10 countries but Bulgaria (with an ongoing surplus) and Hungary. The deceleration in economic growth coupled with high rigidity in spending have exacerbated fiscal pressures in the EU10.Governments have largely succeeded in containing these pressures through 2008, but 2009 is likely to present additional challenges. Only Hungary, Latvia and Romania have exceeded the 3 percent of GDP deficit threshold. Bulgaria was the only country that ended 2008 with a surplus of 3 percent of GDP (as initially planned), despite approved additional spending of around 1.2 percent of GDP earlier in the year. The Czech Republic, the Slovak Republic and Poland have largely attained their deficit targets. In Hungary, continued spending reduction and improved tax compliance has led to further fiscal consolidation and the budget deficit has declined to 3.3 percent of GDP, from around 5 percent of GDP in 2007.

The fiscal position has deteriorated substantially in Romania in 2008 despite robust growth, while budgets in the Baltic countries were severely affected by cyclical factors. In Romania, a highly pro-cyclical fiscal policy in an overheated economy coupled with a sharp deterioration of revenue collection in the last months of the year led to a record budget deficit of around 5.2 percent of GDP. In Lithuania, the fiscal deficit has widened to an estimated 2.9 percent of GDP, from an initial target of 0.5 percent of GDP primarily due to a low collection of indirect taxes and limited spending cuts in the context of the October 2008 elections. The economic contraction in Estonia has eroded the fiscal space, but the country has succeeded in containing its fiscal deficit to around 2 percent of GDP following emergency spending cuts in the summer, from an initially planned 1.3 percent of GDP surplus. In Latvia, poor revenue collection has pushed the budget deficit above 3 percent of GDP from an intended 1 percent of GDP surplus.

A further deterioration of fiscal balances can be expected in most EU10 countries in 2009 on the back of both cyclical and structural factors. Due to the economic downturn, revenue collection is likely to worsen in countries that face recessions or a rapid deceleration in economic growth, expected fall in employment, weakening export activity and declining consumer confidence. Furthermore, according to the recent EC forecast[3] (Table 3), in most of the EU10, structural fiscal positions could deteriorate further. In contrast, in Hungary, Lithuania, Estonia, and the Slovak Republic, structural positions are expected to improve (Figure 22), in the case of Hungary in the context of the IMF-EU support program. The new Romanian Government has just approved and submitted to the Parliament a budget deficit of 2 percent of GDP for 2009, which would represent a major improvement from the forecast. Depending on macroeconomic developments, governments in the region may need to further adjust expenditures, especially in countries which built their 2009 budgets on what appear now to be optimistic macroeconomic projections[4]. Bulgaria is planning a surplus of 3 percent of GDP in 2009 and is limiting spending releases to 90 percent of appropriated amounts, which provides a buffer of 2.4 percent of GDP in case of significant than planned worsening of revenue performance. Also the goal of some EU10 countries to join the eurozone in the near future should reinforce fiscal discipline.

Figure 22. Projected General Government (Headline) and Structural Fiscal Balance in 2008-2009 in the "No Policy Change" Scenario*, (percent of GDP)



Source: European Commission Interim Forecasts, January 2009

*Note: The structural fiscal balance is derived by subtracting the cyclical component of the budget balance and one-off and other temporary measures from the overall fiscal balance. *) The* forecast is based on the policies disclosed by Governments by the time of the release of the EC report (see text).

Given initial fiscal conditions and financing constraints, countries in the region have little or no room for discretionary fiscal impulses. The limited room for fiscal stimuli in some countries results also from high vulnerabilities related to external and internal imbalances. In the most vulnerable countries, the authorities are strongly committed to maintaining the existing fixed exchange rates, which in turn requires strong domestic adjustment policies, including in fiscal policy. As part of the IMF-led rescue package, Latvia aims for a 7 percent of GDP fiscal adjustment in 2009. Lithuania and

[3] The EC forecast is based on the policies disclosed by Governments by the time of the release of the report (January 2009). In the meantime, some countries have already adopted or announced additional policy measures (see the text for details).

[4] If the worst case scenario materializes and growth slows down to 1.7 percent in 2009 instead of 3.7 percent assumed in the drafting of the budget, the Polish Government has identified around 1.3 percent of GDP of potential budget savings, proposed by respective ministers and coordinated with the Prime Minister.

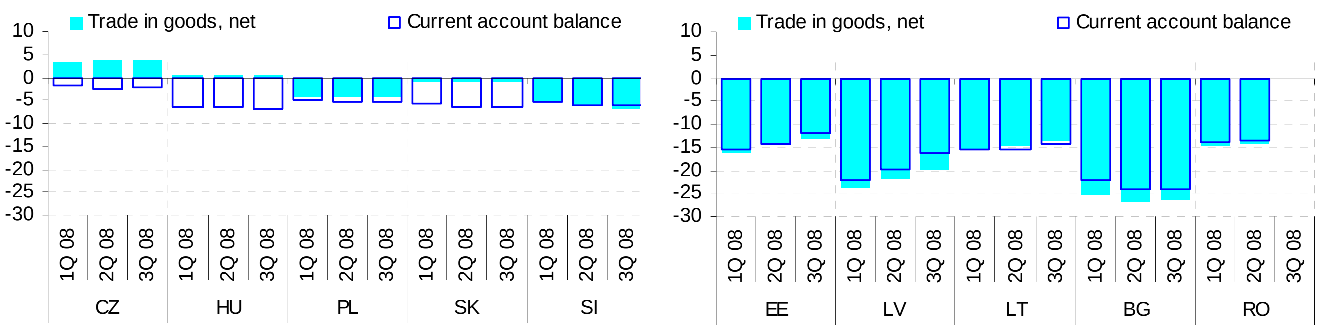
Estonia have also taken steps to stay within the 3 percent deficit limit, including by introducing belt-tightening measures for the public sector. A prudent fiscal policy reflected in a budget surplus in Bulgaria should help maintain confidence in the currency board. In Romania, the new Government has signaled its determination to correct existing fiscal slippages by unveiling a series of measures aimed at achieving a budget deficit of 2 percent of GDP. In response to the economic crisis and in line with the European Economic Recovery Plan, several EU10 countries have allowed automatic stabilizers to work, and a few adopted fiscal packages aimed at sustaining aggregate demand (see the '*In Focus' Note: Is Fiscal Policy Being Used as a Stabilization Mechanism?*). It is doubtful that they would have any further room for fiscal relaxation.

The context reinforces the need to devote more policy attention to institutional strengthening of the public finance management systems and its performance orientation to both manage fiscal consolidation and restore the sources of growth, including by improving the absorption of EU funds. Within current expenditure envelopes, governments will need to focus on better quality of spending to deliver core services and provide safety nets to the most vulnerable. Moreover, commitment to reverse the widening of the fiscal balances when the economy picks up again is important for the long-term sustainability of public finances and for avoiding debt upsurges.

Balance of Payments

Against this background of shrinking export markets, private demand slowdown and fiscal loosening, external positions are adjusting only slowly. The current account position of the Baltics, who experienced hard landing earlier, showed some improvement in Q3 but deficits remained broadly unchanged in other countries **(**Figure 23**).** Current account deficits (CADs) continued to narrow substantially in Estonia and Latvia, in the latter by 13 percentage points of GDP from a year earlier in the third quarter of 2008, as imports contracted in line with the rapid economic slowdown. Significant adjustment started also in Lithuania over the same period. In Bulgaria, the external deficit decreased only modestly, and the trade deficit remained very large, with imports pulled by still strong domestic demand while exports started to weaken under faltering external demand. Similar factors are affecting external trade in other countries, with trade balances starting to weaken gradually in the Czech Republic, Hungary, Poland, Slovenia and the Slovak Republic. In some of these countries, current account deficits increased, notably in Hungary where further drag came from deteriorating income balance affected by profit repatriation.

Figure 23. Current account and trade balances, 1Q-3Q 2008* (percent of GDP)

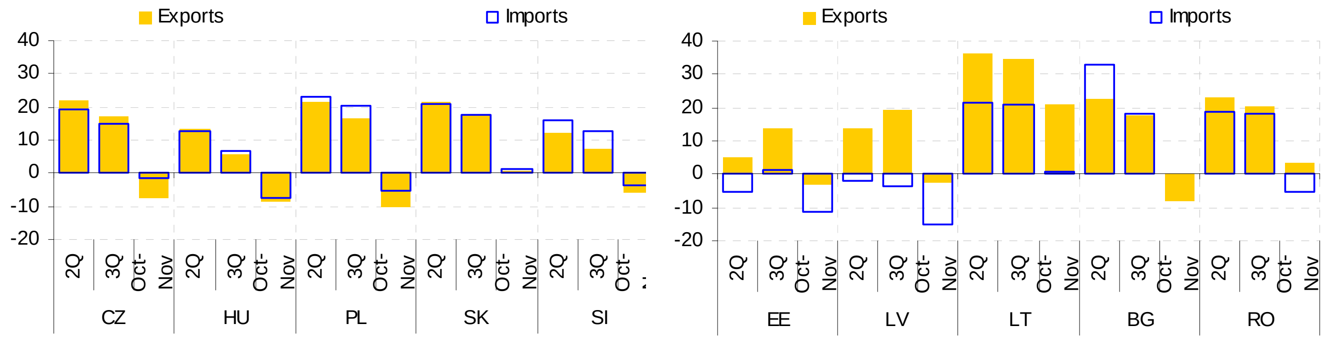


Source: Central Banks; World Bank Staff calculations.

* *On annualized basis.*

Most recent trends suggest external positions deteriorated further in the fourth quarter (except in the Baltic countries) as export performance weakened more quickly than imports. Looking at most recent monthly trade data (available until November), the adjustment trends have continued in the Baltics, with shrinking imports (and lower prices of energy) allowing for further current account adjustment. However, at the same time, export growth has slumped. Export weakening could be seen also in other countries (Figure 24). Prospects for further reductions in current account deficits driven by exports are increasingly bleak, undermined by the looming global slowdown. The expected improvement in 2009 in most of the EU10 will be based on import contraction.

Figure 24. Exports and Imports Growth (% change, yoy)



Source: Eurostat, World Bank Staff calculations.

To make matters worse, the financing of external positions has proved more difficult for emerging markets in recent months on the back of weakening investor sentiment, including for the EU10. In many cases, EU10 central banks have, therefore, had to reach into their reserves. While foreign direct investment remained relatively stable, most recent monthly data showed significant outflows of portfolio investment in the Czech Republic (in November) and in Poland (in October). In the former, this was balanced by other investment operations of the banking sector; in the latter, however, central bank reserves have been decreasing since September. In the Baltic countries, other investment (dominated by the operations of the banking sector), which had been the major source of financing for current account deficits, turned negative, leading to a decrease in reserves in Estonia and Lithuania[5]. In Bulgaria, reserves decreased in October (largely as a result of the reduction in the rate of minimum required reserves) while in November, they increased slightly as the current account deficit was largely financed by other investment.

Meanwhile, in several EU10 countries, the stock of external debt remains very large, reflecting the heavy dependence in recent years on debt flows to finance large external shortfalls. In Lithuania, gross external debt equaled 72 percent of GDP in the third quarter 2008, while in Bulgaria, Estonia, Hungary, Slovenia and Latvia, it exceeded 100 percent of GDP, in the last one reaching 137 percent. Moreover, in some countries significant part of external debt is short term, with this share exceeding 35 percent in Bulgaria, Latvia, and Estonia [see also the '*In Focus' Note on External Financing Risks in the Banking Sector*].

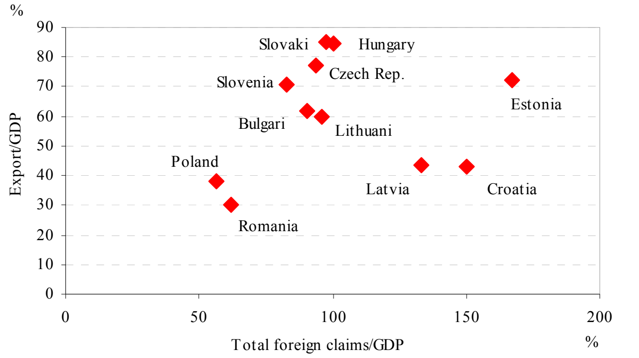
[5] Surprisingly, for Latvia balance of payments data show an increase in reserves, but this is accompanied by very large positions on net errors and omissions. This could be a result of under/overestimated flows in the current account, or some capital account flows.

EU10 February 2009

In Focus: External Financing Risks in the Banking Sector

Since the beginning of this decade, external factors--a prolonged period of low nominal and real interest rates driven by a global savings glut, and domestic factors--capital account liberalization, financial sector reforms and EU accession combined to spur large capital inflows into the EU10 countries. This high integration of EU10 financial markets with the global economy has been matched, in general, by equivalent integration of production and great success at exporting (Figure 25). This has brought major benefits to the countries in the region, including convergence in incomes, improvements in living standards and a sharp decline in poverty rates. At the same time, however, it has resulted in a build up of external liabilities across the region. Especially the Baltic countries, Croatia, Hungary, and the Czech Republic display high ratios of foreign liabilities to GDP. Moreover, the composition of capital inflows has changed over time. While foreign direct investment initially made up the bulk of the inflows, debt liabilities have gained importance in recent years. For a large part, this reflected intrabank lending between EU15-based parent banks and subsidiaries or branches in the EU10 to finance an accelerating demand for domestic credit. Direct external borrowing by non-bank financial intermediaries and non-financial corporations has increased rapidly as well, particularly after authorities tries to curtail the expansion of bank credit.

Figure 25. Level of foreign trade and financial integration in the countries of the region, 2008

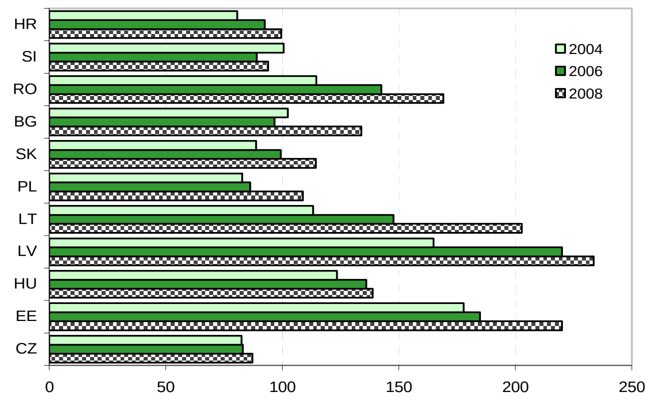


Sources: BIS, EUROSTAT, World Bank Staff calculations

Notes: Total foreign clams are BIS reporting banks' cross-border claims in all currencies plus the local claims of their foreign affiliates in foreign currency plus foreign affiliates local claims in local currency.

The banking sector's access to foreign capital has facilitated lending in foreign currency. In some countries, like Romania, this has been encouraged by restrictive monetary policies trying to compensate for pro-cyclical fiscal stances. Financial instruments denominated in or indexed to foreign currencies, in particular the euro, are widely used in the region, in particular in the Baltics, Hungary, Romania and Croatia. Foreign financing has enabled banks to expand lending more rapidly than the expansion of the domestic deposit base would have allowed (Figure 26). Also, the cost of funding in domestic markets for branches and subsidiaries is usually higher than the cost fro m their foreign parent banks. Moreover, the maturity of external funds may be more easily tailored to comply with the matching requirements of host country supervisors. When banks refinance themselves abroad to on-lend in foreign currency, the currency risk is passed to the client. But this, seemingly, did not matter for the client: exchange rate pegs in most EU10 countries have been perceived as credible and, hence, the associated currency risk has been considered low. Currencies with flexible rates, on the other hand, seemed bound to appreciate. But also in countries with more volatile exchange rates, such as Hungary, foreign currency borrowing by the private sector has been popular, perhaps because of the considerable

Figure 26. Loan to deposit ratio, in percent

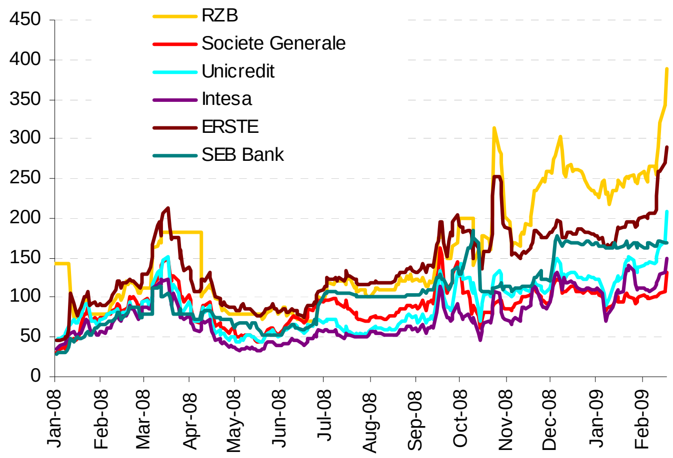


Sources: ECB, CBs

savings expected on interest payments as well as expectations of appreciating local currencies. Across the region, this dependence on foreign borrowing has made local banks dependent on a well–functioning FX swap market and has increased the risk of pressures that central banks may face on their FX reserves (see '*In Focus' Note: Interbank Markets and Spillover from the Global Crisis*). In countries with flexible exchange rates, banks also face elevated credit risk when borrowers have to reimburse FX loans in the face of a depreciating local currency.

Difficult liquidity and financing conditions have characterized the financial sector both globally and in EU10 countries since the second half of 2008. A lack of confidence in the banking sector led to soaring financing costs. Widening spreads confirm increased cost of funds. Developments in the published CDS[6] spreads of parent banks of domestic banks reflect the faltering confidence in the banking sector (Figure 27). At the same time, significant differences could be observed for individual banks, depending on their rating and business model. Bank rescue packages in a number of large EU countries and the US have improved conditions in global money markets, but normalization is far from being reached. In this environment, banks in the EU10 with large deposit deficits are particularly exposed. These deficits are especially high in the Baltic countries but also in Romania and Hungary.

Figure 27. European Banks, 5-year CDS (bps)



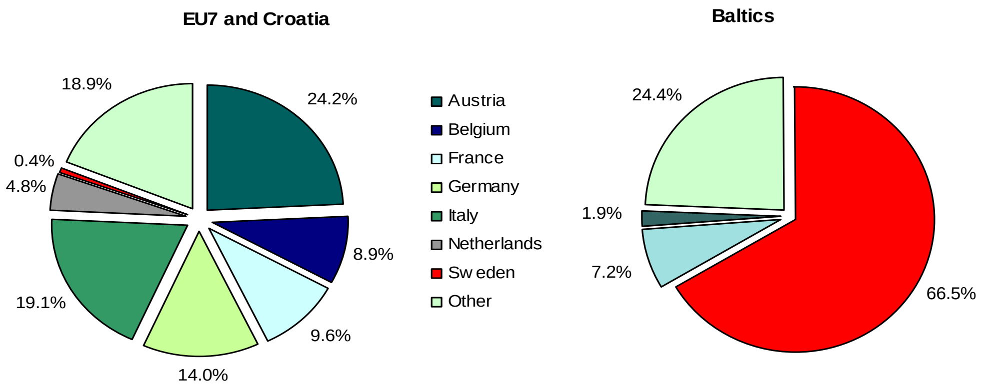
Source: Bloomberg, Datastream, World Bank Staff calculations.

In the EU10, many countries are exposed to the same external lenders via crossborder loans to banks from their international parent banks (Figure 28). From a creditor perspective, bank claims are concentrated in few countries—Austria, Belgium, France, Germany, Italy, the Netherlands, Greece and Sweden—which account for three-quarters of total claims on the region. In principle, foreign ownership can be a source of stability for emerging market banking systems, but the reliance on cross-border funding also exposes these banks to the potential balance sheet pressures of their parent banks in mature markets. If the foreign parents' ability to provide financing becomes limited, this adversely affects the availability of liquidity in local banks across the region. Lenders may also view the EU10 as a 'cluster' and may withdraw their funds if the outlook about the 'cluster' turns negative.

Home country regulators may create further tensions by forcing parent banks to build liquidity and, via asymmetries in the scope of regulation and supervision which are conducted largely nationally, the business practice of integrated cross-border financial institutions. A foreign bank's exposure might be small in the EU10 relative to its overall portfolio, but its exposure could be a significant share in the local market. Thus, it may create a mismatch in regulatory attention. Recently, local liquidity requirements may have become more stringent, disrupting the free flow of funds between parent and subsidiary or branch necessary for well-functioning centralized liquidity management. Local subsidiaries probably also do not benefit from government recapitalization schemes in the parent country, forcing greater reliance on domestic funding.

[6] A credit default swap contract is similar to insurance, allowing one party to buy protection against a company or country defaulting or restructuring debt over a certain period of time. CDS spreads are similar to regular corporate bond spreads in reflecting the market's view of default risk.

Figure 28. Geographic breakdown of foreign claims in the banking sector



Note: EU7 refers to EU10 without the Baltics
Source: BIS, World Bank Staff calculations

In light of ongoing uncertainty about the size of the downturn and the quality of bank assets, markets are exerting pressure on banks to improve their risk profile and build up capital buffers. In the absence of willing investors, many countries have been forced to inject capital into their banking sectors. Meanwhile, banks started shrinking their balance sheet and/or reallocated assets towards safe instruments such as government bonds. When creditworthy borrowers are denied credit, this behavior –collectively--not only amplifies the downturn but also contributes to a structural misallocation of resources, detrimental to growth in the more medium-run.

Finally, as most EU10 countries are highly open economies, the deteriorating global economic outlook has also prompted many banks to reassess their business outlook. This concerns especially highly trade-dependent economies such as Hungary, the Slovak Republic, the Czech Republic and Estonia. Such reassessment is also being associated with tightening lending conditions, with likely negative effects on the real economy. (See the '*In Focus' Note on Domestic Credit Developments*).

EU10 February 2009

In Focus: Interbank Markets and Spillover from the Global Crisis

Ongoing tensions and volatility in international money and interbank markets spilled over to the less-developed domestic interbank markets in the EU10 and Croatia (EU10+1) during 2008. The high levels of foreign borrowing and lending of EU10 banks has created significant dependence on well-functioning FX swap markets. But liquidity in these markets was significantly impaired in the last quarter of 2008, with bid-ask spreads surging in forward exchange markets. Pressures spread from the FX swap markets to the EU10+1's overall domestic interbank markets and FX spot markets, with particularly disruptive effects on the financial systems in Hungary and Latvia. Central banks have intervened to enhance access to domestic and foreign currency liquidity via reserve drawdowns, cuts in reserve requirements, and agreements with foreign central banks. The European Central Bank has provided some support for local FX swap markets. Not surprisingly, local interbank markets were most disrupted in countries where credit growth had been significantly externally financed, highlighting ongoing risks to banks from FX lending. These recent episodes will likely encourage policymakers to consider more carefully the risks to domestic banks generated by foreign exchange transactions.

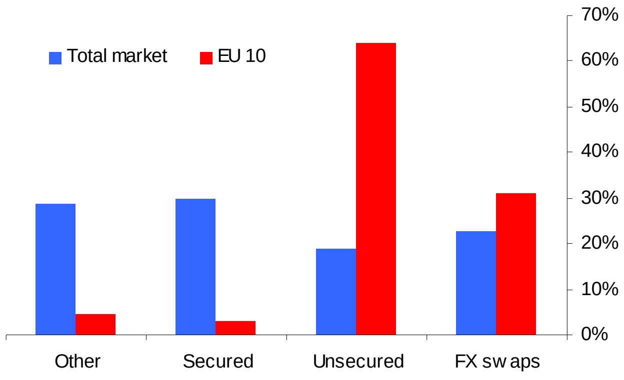
Interbank money markets in the EU10 are smaller and shallower than in the rest of the EU and are dominated by unsecured borrowing and FX swaps. In line with the EU10 countries' overall level of economic and financial development, their interbank markets are less developed than money markets in the some of the larger and older EU member states. While a large range of activities can be observed in the broader euro money markets, including important roles for interest rate derivatives and secured transactions (e.g., repos[7]), unsecured borrowing[8] and FX swaps account for the bulk of transactions in the EU10 (Figure 29). Reflecting short-term liquidity management needs of banks, turnover in the unsecured market in the EU10 is concentrated in the overnight segment. FX swaps are used by banks to raise foreign currency such as the euro at short maturities, to hedge foreign currency assets or to provide local currency liquidity to foreign banks investing in domestic securities. While the euro dominates FX swap markets, other currencies such as the Swiss franc are also relevant. The importance of FX swaps in the EU10 may stem from the extent of foreign bank ownership and parent-subsidiary liquidity relationships and/or substantial bank lending in foreign currency. It should be noted that while these statistics display the characteristics of euro-denominated money markets, we find similar patterns for local currency money markets.[9] But there are also differences within the EU10: in the small, nearly completely euro-ized Baltic economies, the turnover of local interbank transactions appears to be rather negligible.

[7] Repurchase agreements (repos) allow a party to borrow securities and sell them short in the belief that they can be bought back in the market at a cheaper price by the time they must be returned.

[8] Unsecured borrowing involves one bank entering into an agreement to borrow from another bank a certain sum, with the promise to repay at a certain maturity an amount equal to this sum plus interest accumulated over the period.

[9] For Poland, for example, see National Bank of Poland, *Financial System Development in Poland*, 2005.

Figure 29. Euro money market structure in 2007/2008 for the EU and "EU 10"

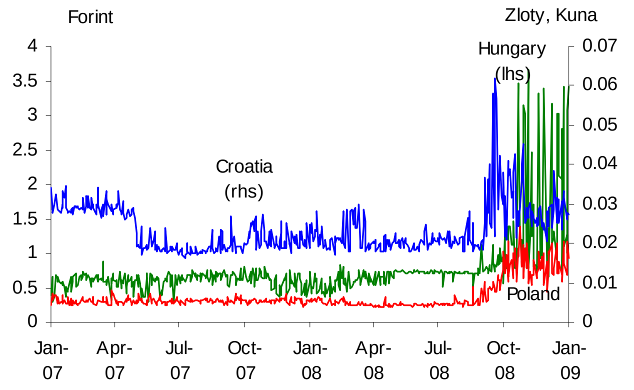


Note: "EU 10" refers to Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, the Slovak Republic, Malta and Cyprus.

"Other" includes T-bills, commercial paper, overnight index swaps, and other.

Source: ECB Money market studies (2007/2008).

Figure 30. Bid-offer spread of 3-month forward exchange rates against the euro



Source: Datastream.

Shocks emanating in global money markets spilled over to the economies of the EU10+1, to a large extent via FX swap markets. One defining characteristic of the current global financial crisis has been the occurrence of repeated, severe tensions and sporadic complete standstill of international money and interbank markets. Euro money markets had been experiencing significant strain since August 2007, but, reflecting increased concerns about liquidity and counterparty credit risk in the aftermath of Lehman Brothers' bankruptcy, LIBOR-OIS (overnight index swap) spreads in the major currencies surged to historical peaks in the second half of 2008.[10] US dollar FX swap markets also dried up, reflecting US banks' increasing reluctance to engage in FX swap transactions with increasingly fragile-looking EU financial institutions which needed US dollars to close liquidity gaps of associated structured vehicles incorporated in the EU but funded in US dollars.[11] Liquidity in the FX swap markets of the EU10+1 was significantly impaired in the last quarter of 2008 as evidenced by the sudden surge in bid-ask spreads in forward exchange markets (Figure 30). The timing of volatility peaks suggests that this occurred in many cases before other money markets and financial markets were affected (Table 4). Incorporated outside the eurozone, most banks in the EU10+1 have no direct access to the European Central Bank's provision of euro liquidity. Again, with foreign and parent banks hoarding euro liquidity, local institutions faced difficulties hedging their euro asset exposure through the euro FX swap market and could not raise short-term euro funding.

Stresses in FX swap markets have had repercussions in overall EU10+1 domestic interbank markets and in FX spot markets. In Hungary, domestic interbank markets dried up during October (Figure 31) as did the government bond market because foreign investors could no longer swap euros to obtain Hungarian forints necessary to rollover domestic public debt. Liquidity in domestic interbank markets has also been impaired in other countries, including Poland, Romania, and the Czech Republic. In Poland, the widened gap between euribor and implied euro funding rates since November highlight that liquidity tensions have persisted in domestic interbank markets in comparison with the eurozone (Figure 31). In countries with floating exchange rate regimes (such as Poland, the Czech Republic, and Hungary), currencies came under severe pressure as agents turned from the FX swap to the spot market to meet and hedge obligations. In a few cases, foreign currency shortages led depositors to question the viability of individual banks (e.g., OTP in Hungary,

[10] The LIBOR-OIS spread can be a measure of banking sector counterparty risk. Overnight Index Swaps (OIS) are instruments that allow financial institutions to swap the interest rates they are paying without having to refinance or change the terms of the loans they have taken from other financial institutions. Typically, when two financial institutions create an overnight index swap (OIS), they are swapping cashflows based on variable and fixed interest rates. Unlike the unsecured interbank loans referred to by LIBOR, the degree of counterparty risk in an OIS is small. When the LIBOR-OIS spread is increasing, it may therefore indicate that banks believe there is a higher risk of banking sector default and that the credit markets are not functioning as smoothly as they could be.

11 See ECB, December 2008 Financial Stability Report.

Parex bank in Latvia), requiring emergency measures, including large IMF-led rescue packages, to restore confidence.

Table 4. Volatility sequence in FX swap and interbank markets, August to December 2008

Start date of increased volatility	*Hungary*	*Czech Republic*	*Poland*	*Romania*
FX swap rate	9th October	20th September	13th September	17th September
Local currency interbank rate	27th October	10th October	10th October	10th October

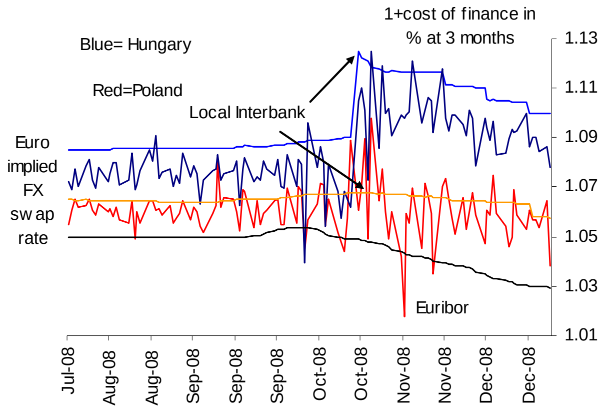
Note: Volatility measured as 17-day standard deviation for 3-months maturity.
Source: Datastream.

EU10+1 countries have responded to the stresses in interbank markets in various ways. Central banks throughout the region drew down foreign exchange reserves to meet demands by local banks. Croatia, Latvia, Bulgaria, and Hungary eased mandatory reserve requirements to enhance liquidity. The National Bank of Poland also considered such a move, and in late January 2009 decided to buy back early NBP bonds maturing in 2012. It also introduced FX swaps in operations with local banks. The Hungarian government's banking sector support package (costing about 2.2 percent of GDP) included guarantees to interbank lending.[12] Some central banks sought agreements with central banks in other countries. The ECB set up repo agreements worth up to €5 billion and €10 billion with Magyar Nemzeti Bank and National Bank of Poland respectively in October and November 2008 to support local FX swap arrangements with local banks.[13] Similar agreements were signed between the central banks of Denmark and Sweden with Latvijas Banka. Some central banks in the region lowered interest rates (Hungary, Poland, Czech Republic), facilitated by similar reductions in the ECB refinancing rate since November 2008 (Figure 31).

The extent to which disturbances in FX swap markets have spilled over to other markets appears to have depended on the particular characteristics and vulnerability of each country. In particular, countries where the contribution of external financing to credit growth has been important, such as Hungary, the Baltics, or Romania, have so far experienced a larger increase in the local interbank risk premium than countries such as the Czech Republic, the Slovak Republic, or Poland were credit growth has been mostly domestically financed (Figure 32).[14] Of course, the Slovak Republic's interbank rates were also driven by expectations about entry into the eurozone, which took place as planned in January 2009. Hungary's markets were also influenced by its relatively large domestic currency public debt stock that is partly financed through foreign portfolio flows. Given a smaller public debt and/or more reliance on domestic investors, rollover risks appear to have been smaller in the Czech Republic, the Slovak Republic and Poland.

[12] This mirrored the extension of guarantees to interbank lending announced by Eurozone governments in October 2009. Related measures have been under discussion in other EU10 countries.
[13] This followed a number of larger swap agreements between the central banks of major currencies in December 2007 and again in September 2008 and coincided roughly with bilateral agreements between the US Federal Reserve and a number of large emerging market economies (Mexico, Korea, and Singapore). See BIS, Quarterly Review December 2008, "International Banking and Financial Developments".
[14] For more on the financing structure of banks in central and eastern Europe, see Z. Walko " The refinancing structure of banks in selected CESEE Countries," OENB Financial Stability Report (December 2008).

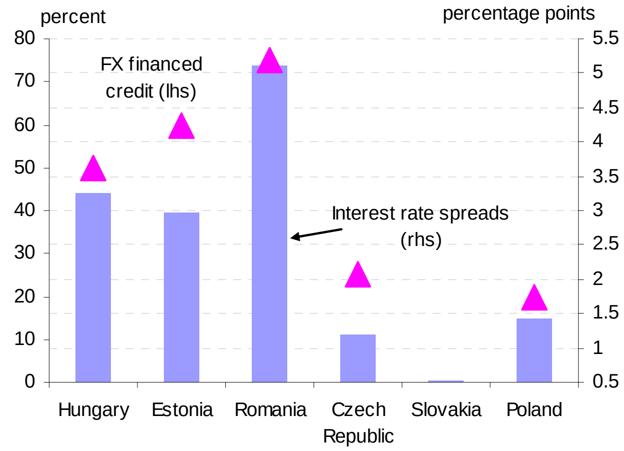
Figure 31. 3-month FX swap-implied euro rate, local interbank rates and euribor: Hungary and Poland



Note: The euro implied FX swap rate is the cost of borrowing in uncollateralized local currency (e.g., in forints) and swapping into euros with a forward agreement to reconvert into local currency at maturity. Under covered interest parity, this funding cost should be equal to funding for the same maturity at Euribor.

Source: Datastream.

Figure 32. Change in local interbank-euribor interest rate spread and percent of credit growth externally-financed



Note: Change in spreads between averages for December 2008 and in June 2008; 3-month maturity instruments. Credit growth contributions are derived from banking sector balance sheet data.

Source: Datastream and DB Research.

Recent experience has highlighted some lesser publicized channels through which FX transactions pose risks to banks. Until now, it was widely assumed that banks faced no direct FX risks from lending in foreign currency because exposures could be easily hedged via well-functioning FX swap markets. However, if FX markets dry up, banks can no longer hedge. Then, to avoid currency mismatches, they may turn to the spot FX market, but if exchange rates are floating, this activity will accentuate downward pressure on local currencies. Banks, in addition, face increased liquidity risks if they cannot honor liquidity commitments in foreign currency, exposing them to reduced market and depositor confidence. Countries with fixed exchange rates may see their FX reserve buffer erode, again with implications for market confidence. Finally, FX swap markets are, in some cases, crucial for the working of government bond markets, in particular when a large part of domestic currency debt is held offshore.

The recent stress episodes also suggest that policymakers in the region may want to assess how to incorporate these risks more directly into their policymaking framework. There may be implications for prudential policies on banks' liquidity risk management. Central banks might want to review insurance mechanisms to secure the provision of foreign exchange in periods of stress, including the optimal size and composition of FX reserves. Cooperation agreements with other central banks may also need to be examined. In many cases, arrangements were not available ex ante but were established during the crisis to restore confidence in the market. Beyond these general lessons, in the absence of detailed information on the precise mechanisms and on amounts drawn, it is difficult to assess how effective these measures have been and whether there is room for improvement.

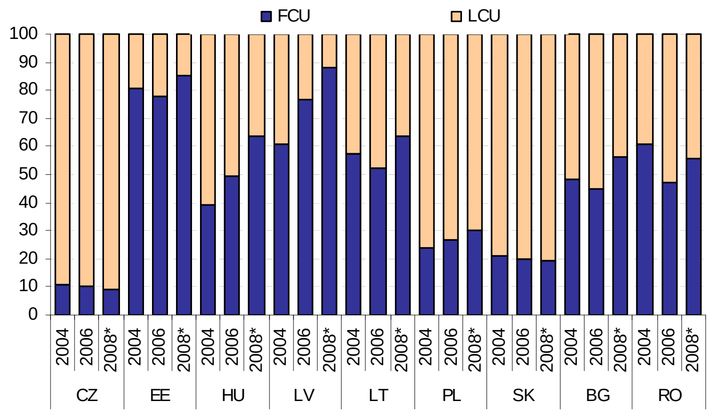
EU10 February 2009

In Focus: Domestic Credit Developments

The sharp deceleration of credit growth to the private sector in the EU10 and Croatia (the EU10+1), after half a decade of exuberance, will inevitably squeeze households and enterprises and can only aggravate the worsening recession. The region experienced very rapid credit growth in recent years, which was generally viewed positively as supporting rapid convergence to the EU15, but at the same time it contributed to the emergence of sizable macroeconomic and financial vulnerabilities. Household indebtedness has grown rapidly across the region and across income groups, accounted for by an increasing proportion of mortgages. With a large proportion of mortgages denominated in foreign currency or linked to the exchange rate and at floating interest rates, households have greatly increased their vulnerability to exchange rate and interest rate shocks. Lending to the corporate sector has been more subdued. By late 2008, loans in foreign currencies constituted the majority of bank loans in most countries in the region (except in the Czech Republic, the Slovak Republic, and Poland) (Figure 33). As highlighted in the previous note, stresses in domestic interbank markets have affected local banks and depressed credit supply. The sectors most reliant on bank financing--construction and durable producers—as well as less creditworthy market segments—small and medium enterprises--are likely to be the most affected by tightened credit conditions.

Over the last 5 years, bank credit to the private sector had expanded rapidly in all countries in the region, with growth ranging from 14 percentage points of GDP in Croatia to 42 percentage points in Latvia. Starting from relatively low levels, it more than doubled in Lithuania, Bulgaria, and Romania. While credit expansion in the Baltic countries, Slovenia, and Croatia peaked during 2005-2006, in the remaining countries (in particular, Bulgaria and Romania), it accelerated in 2007 and through the first half of 2008.

Figure 33. Share of FX Denominated Bank Loans in Loans to the Private Sector (percent, 2004-2008)



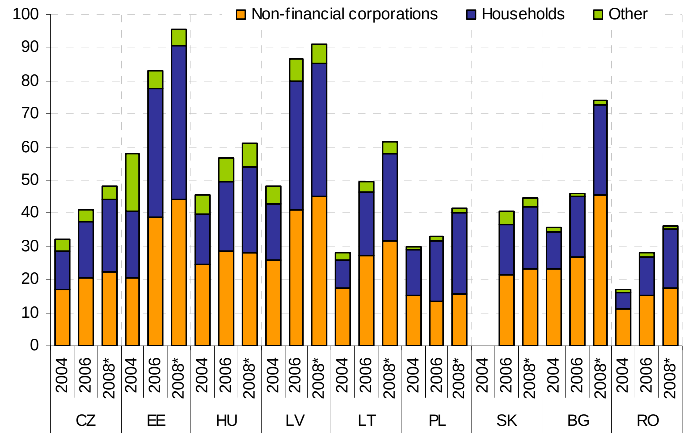
Source: Central Banks, World Bank Staff calculations.

The credit expansion in 2004-2008 was largely a result of increased loans to households, including both consumer and mortgage loans, while growth in corporate sector loans has remained more modest in most countries. The credit expansion of 2004-2008 was driven mainly by the household sector (Figure 34), partly because this segment was underdeveloped across the region. Credit to non-financial corporations expanded more slowly or remained broadly stable as a percentage of GDP with the exception of Bulgaria.[15] As a result, the share of household loans in bank portfolios has increased significantly in all countries. Among loans to households, mortgages have been growing particularly fast, especially in 2005-2006, while consumer credit accelerated strongly in 2007-2008 (Figure 35). In late 2008, the stock of households' non-housing loans was much higher than the stock of housing loans in Bulgaria and Romania and more or less the same in Hungary

[15] In 2004, the Bulgarian National Bank introduced a number of measures, including administrative ceilings on credit to contain its growth (which were subsequently revoked end-2006). These ceilings led to selling of some corporate loans abroad to parent banks. When the ceilings were removed, some of these credits were bought back by domestic banks, which helps to explain the jump in credit to corporates as a share of GDP in 2008 as compared to 2006.

and Poland. In the remaining countries, mortgage loans dominated the composition of bank loans to households.

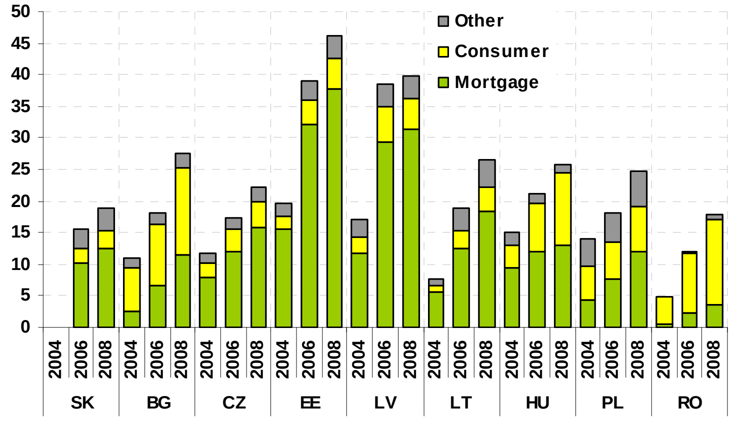
Figure 34. Structure of Bank Loans to the Private Sector (% of GDP, 2004-2008)



Note: 2008 refers to data from November 2008.*

Source: Central Banks, World Bank Staff calculations.

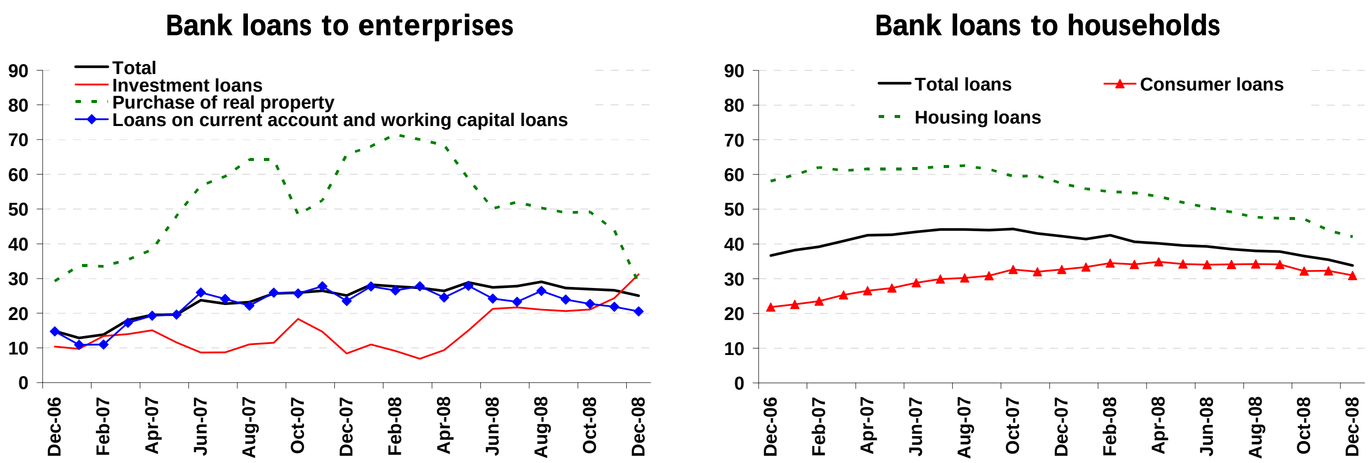
Figure 35. Household Loans by Purpose (% of GDP, 2004-2008)



Source: Central Banks, World Bank Staff calculations.

As mentioned in the Main Report, while the timing has varied across economies, credit growth has slowed down significantly across the region. The slowdown of credit is even more pronounced than suggested by raw data if the effect of depreciation on the stock of FX denominated loans is excluded. For example, in Poland, if the effect of zloty depreciation is removed, the downward trend is reasonably clear in recent months across most types of bank loans to households and enterprises (Figure 36). There is also evidence to suggest that the credit slowdown has caught all countries of the region, irrespective of their degree of vulnerability. In the Czech Republic (Figure 37), new flows of bank credit to households remained broadly stable in late 2008, but new loans to corporations declined in November and December. In Latvia, all major types of bank credit decelerated significantly in 2008, from around 40 percent y/y in early 2008 to around 10-15 percent in late 2008 (Figure 38). A recent NBP report (based on a survey of credit committees in banks) covering 2008 Q4 and perspectives for 2009 Q1 shows that banks in Poland have already tightened and expect further tightening of credit conditions for all borrowers (Figure 39).

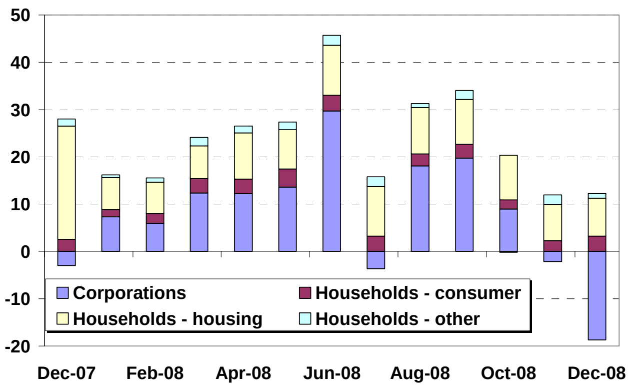
Figure 36. Poland: Loans excluding exchange rate depreciation (y/y, in %, Dec 2006-Dec 2008)



Source: NBP staff estimations, World Bank Staff calculations.

Debt vulnerabilities in the household sector have grown in recent years, exposing households to macroeconomic shocks and a rising risk of default. Although the share of households with a mortgage across the region is generally smaller than in the EU15 countries, it has been growing fast. A large share of housing loans is foreign currency denominated, exposing households to exchange rate risks. Naturally, the degree of vulnerability depends on exchange rate arrangements. In addition, mortgages with variable (adjustable) interest rates account for the largest share of mortgage lending, exposing households to interest rate shocks. According to World Bank estimations based on the Statistics on Income and Living Conditions (SILC) survey in Hungary and the Slovak Republic, mortgages are more common among richer households, but even in the lowest income quintile, significant numbers of households hold mortgages. Debt service is a higher share of income for poorer households, and stress testing shows that default risk is concentrated there. Importantly, the simulations also found that unemployment shocks (rather than exchange rate or interest rate shocks) have the highest impact on probability of default.

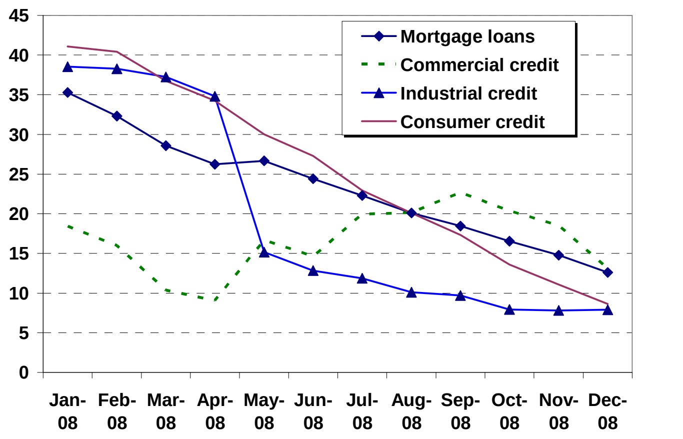
Figure 37. Czech Republic: Loans to non-financial sectors other than government: flows*, not seasonally-adjusted, in CZK billions



**) Note: Calculated from monthly differences in levels adjusted for reclassification, other revaluation, exchange rate variations and any other changes that do not arise from transaction. As of Feb, 2: 1EUR = 27.87 CZK.*

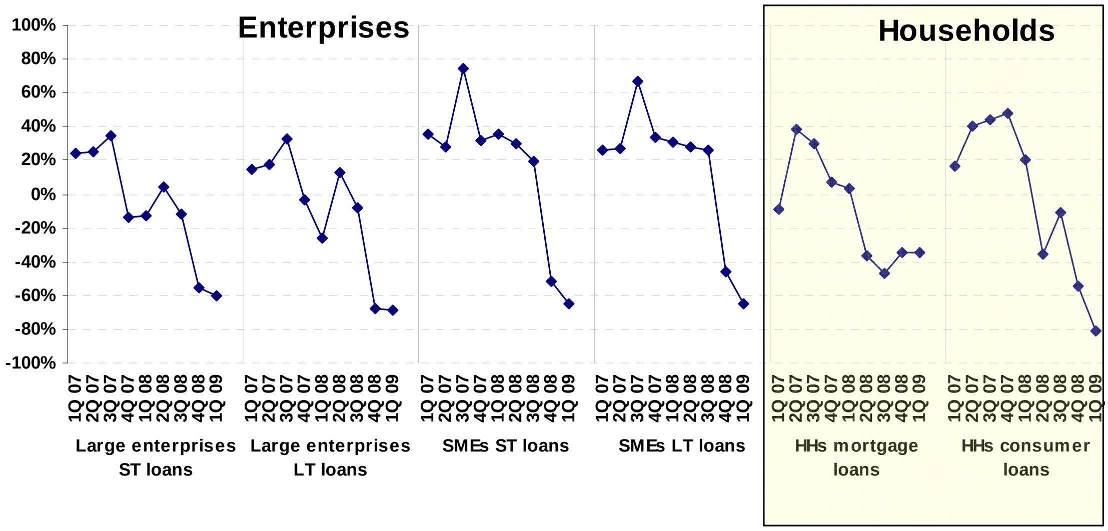
Source: CNB, World Bank Staff calculations.

Figure 38. Latvia: Loans to domestic financial institutions, non-financial corporations and households, y/y, not seasonally-adjusted, percent



Source: LNB, World Bank Staff calculations.

Figure 39. Poland: Expectations for credit conditions to the private sector, a decline means tightening of credit conditions, in percent



**) Note: The values are calculated as difference between positive and negative responses. ST – short-term, LT – long-term.*

Source: NBP survey of bank credit departments, World Bank Staff calculations.

Deteriorating economic conditions may have encouraged banks to adopt more prudent lending attitudes, and businesses and households are likely to face tighter credit conditions for some time to come. Recent significant depreciations in countries with floating exchange rate regimes have translated into higher debt burdens and raise the probability of debt servicing problems. Some countries in the EU10 are already reporting increases in non-performing loan ratios in late 2008 (for example, in the Baltic countries, Romania, and Poland). At the same time, banks' funding costs are being pushed up, due to higher spreads in FX wholesale markets and aggressive competition among banks to expand their retail deposit base. Many banks have also been drawing widely on central bank facilities. Asset price inflation has gone into reverse, reducing the value of collateral. All these factors will be reflected in weaker profitability of the banking sector and will discourage new lending, contributing to a potentially prolonged negative downward cycle.

The slowdown in credit is likely to dampen activity first in those sectors most reliant on bank financing. In combination with local recession—rising unemployment and shrinking incomes—along with the collapse of export orders—in particular for cars, data on production through November 2008 show construction and production of consumer durables (Figure 40-Figure 41) like cars (Figure 42) as hard hit, but subsequent data will provide a fuller picture of how credit constraints are feeding through the EU10 economies.

Figure 40. Production of consumer durables in Nov 2007-Nov 2008, y/y, percent

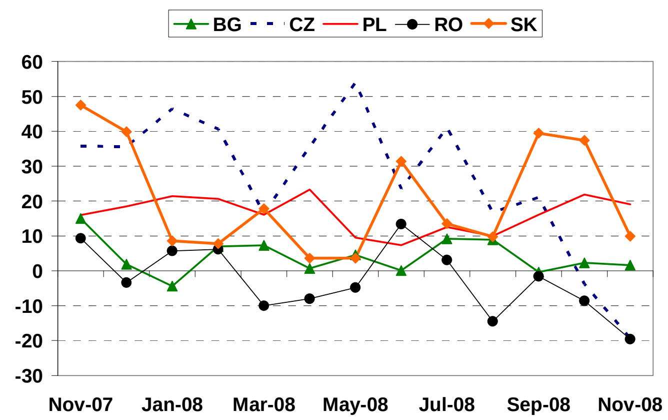


Figure 41. Production of consumer durables in Nov 2007-Nov 2008, y/y, percent

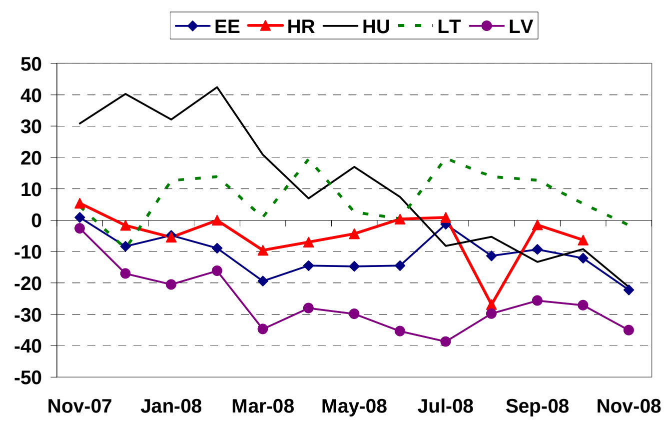
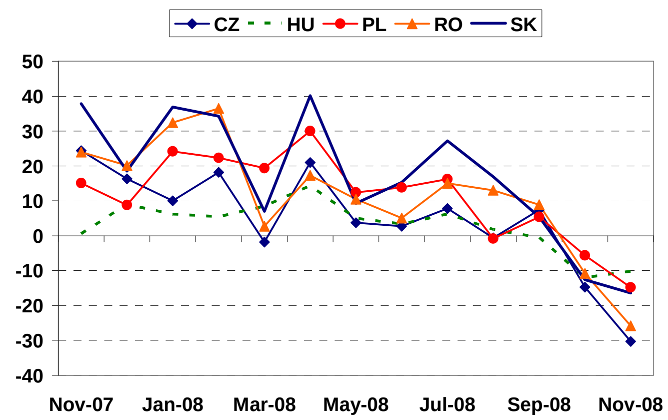


Figure 42. Manufacture of transport equipment, y/y, percent



Source: Eurostat, World Bank Staff calculations.

With concerns about solvency on the rise, banks may also be tempted reallocate assets towards highly creditworthy borrowers. Government bonds typically top the list of desirable assets in periods of high risk aversion. The scale of crowding out by credit to the public sector is naturally related to the level of public borrowing needs and whether bonds are issued in the domestic market or externally. In such circumstances, access to credit becomes most challenging for small and medium enterprises with weaker risk profiles. This may require public intervention through state guarantees, and some countries already announced these kinds of measures (for example, Poland and Hungary). October and November data from Hungary suggests a significant decline in (net) new loans to enterprises and households, offset somewhat by loans in foreign currencies (Figure 43) and the rising role of bank claims on the public sector in new bank claims on residents (Figure 44), a reflection of the deterioration of fiscal positions described in the main report.

How much room remains for such fiscal activism is the subject of the next *'In Focus' Note***.**

Figure 43. Hungary: Loans to non-financial corporations and households, transactions*, seasonally-adjusted, in HUF billions

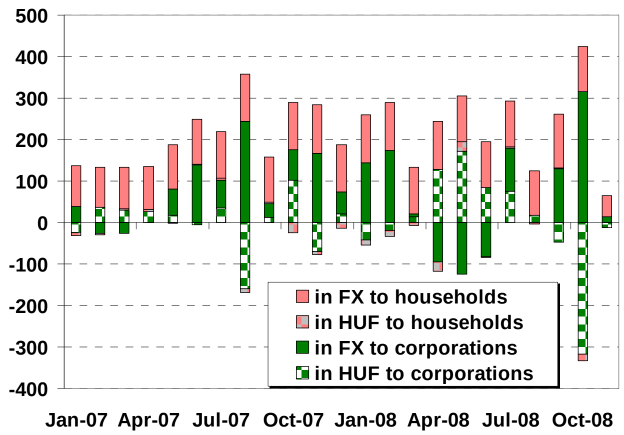
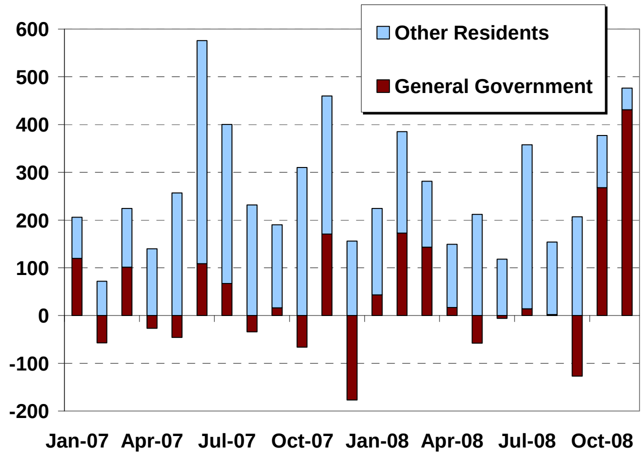


Figure 44. Hungary: Bank Claims on Residents, transactions*, not seasonally-adjusted, in HUF billions



**) Note: The data takes into account monthly changes in stocks caused by transactions, i.e. it does not include the effects of exchange rate changes, price changes and other volume changes.*

Source: National Bank of Hungary, World Banks Staff calculations.

EU10 February 2009

In Focus: Is Fiscal Policy Being Used as a Stabilization Mechanism?

Governments around the world have announced discretionary fiscal stimulus packages in recent weeks in order to address falling output and rising unemployment. From a global growth perspective, one of the largest plans announced so far has come from the Chinese government. The package of measures, with a total cost of US$586 billion, or about 7 percent of GDP[16], includes investments, mostly in transport and rural infrastructure, and environmental protection. Under the American Recovery and Reinvestment Program, just signed into law in the US, US$787 of additional spending, or about 3 percent to GDP, will be executed in 2009 and 2010. In Europe, the fiscal stimulus looks more modest. The European Economic Recovery Plan (EERP) called for a Europe-wide fiscal stimulus of around 1.5 percent of GDP (Box 2). So far, the EU governments have adopted discretionary fiscal measures amounting to 1.5 percent of GDP in 2009-10, with Germany being on the high side with packages (approved in October, November, and announced on January 12) that amount to over 1.25 percent of GDP in 2009 and another 0.5 percent of GDP in 2010, slightly above the total envisaged by the EERP. The total cost of the support package for the European economy in 2009 and 2010, including the effect of automatic stabilizers and extra-budgetary financing facilities, is estimated at around 4 percent of GDP.[17]

Box 2. European Economic Recovery Plan (EERP)

The European Commission adopted an ambitious EERP on November 26, 2008, which was endorsed by the European Council on December 12, 2008. The immediate priority of the EERP is to mitigate the potential impact of financial turmoil on the real economy and, thereby, boost market confidence. The Plan consists of two main pillars.

The first pillar is a major impulse to boost demand, amounting to €200 billion, or about 1.5 percent of EU GDP. It consists of a budgetary expansion in the Member States of €170 billion and EU funding in support of immediate actions worth €30 bn.

A second pillar supports a number of priority actions, grounded in the Lisbon Strategy. They are designed to adapt the EU economies to long-term challenges such as climate change and ageing. The Plan notes that implementation of structural reforms must continue with a view to raising potential growth.

Source: ECFIN Quarterly Report on the Euro Area, Volume 7 N° 4 (2008)

In the face of the global demand shock and with monetary policy reaching its limit in places, a discretionary impulse of significant magnitude, over and above the already important role of automatic stabilizers, is necessary to insure against the prospect of a deep and long-lived recession (Box 3). Of course, the debate over the appropriate role of fiscal policy in managing the business cycle has persisted for many years. One school of thought argues that taxes, transfers, and spending can be used judiciously to lean against fluctuations in the normal business cycle, especially to the extent that economic fluctuations are mainly due to markets falling out of equilibrium instead of reacting to changes in fundamental factors such as productivity. Others contend that fiscal policy actions are generally either ineffective or make things worse, because the actions are ill-timed or they create damaging distortions. However, the current crisis is quite obviously not a normal turn of the business cycle and now there is widespread recognition that monetary policy needs the support of fiscal stimulus, in particular because in some countries nominal interest rates have been approaching zero or the channels of monetary policy transmission has been in some way impeded. To enhance the effectiveness of fiscal stimuli, they should be timely, targeted, and temporary.[18] The stimulus should be targeted to areas where the budget multiplier is expected to be large and support the productivity of the economy in the medium- to long-run (e.g., public

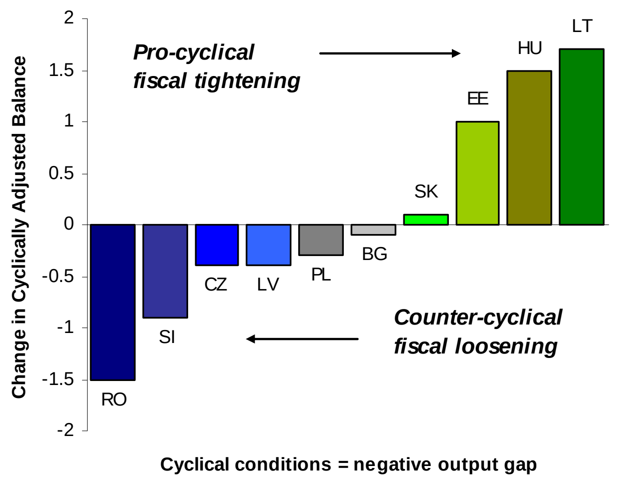
[16] Based on IIF estimates, *Global Economic Monitor,* January 2009.
[17] Based on ECFIN projections, *Quarterly Report on the Euro Area*, Volume 7 No 4, 2008.
[18] For a more detailed discussion, see Summers (2007), Sperling (2007), and Stone and Cox (2008).

investment or infrastructure). Moreover, its precise magnitude should depend on the extent of the expected decline in private sector demand and should therefore be reviewed in light of economic challenges (e.g., increasing unemployment, credit constrained firms and households). Although many countries might benefit from a fiscal stimulus, not all countries can afford it. The space for discretionary fiscal expansion is contingent on the state of the economy, and thus linked to external and internal balances as well as debt and reserve positions[19]. There is no question that a number of countries with large current account surpluses and low debt have considerable scope for fiscal activism.

Many EU10 governments, in contrast, have limited scope to deal with this crisis through fiscal easing, due to financing and budgetary constraints. In some cases, the room for fiscal expansion is limited by the fact that belt-tightening is required to restore order to the balance of payments and reduce large refinancing needs (Hungary, Romania, Croatia and the Baltic States). In Romania, the deterioration comes from the unfunded increase in pension benefits, cuts in the social security contribution rates, discretionary allocations to sub-national governments and other decisions of the outgoing government taken in 2008. The new government that came to power at the turn of the year has announced and approved a series of tightening measures that may at least partially offset the deterioration in the fiscal balance. Moreover, high public debt burdens or sizeable contingent liabilities put additional constraints on fiscal activism in Croatia and Hungary. In high deficit or high debt countries, a stimulus could prove less effective as it would further raise sustainability concerns and slow down necessary adjustment. To be sure, there are countries which have been running smaller external deficits in recent years (Poland, the Czech Republic, the Slovak Republic and Slovenia) and may have greater room for fiscal stimulation. In practice however, a strong fiscal expansion beyond the operation of automatic stabilizers is also limited in these countries in the view of fiscal challenges related to prospective euro adoption. For instance, in Poland, planned ERM II and eurozone entry impose a limit on fiscal expansion. In the Slovak Republic, tighter fiscal policy is needed to maintain low inflation in the long term. Hence, the size (and composition) of the fiscal stimulus varies sharply across the EU10 countries, at least in part aligned with the space for fiscal stimulus.

So far, fiscal policy has generally not been <u>actively</u> used by EU10 countries to support aggregate demand. Many of the governments in the region have decided not to strengthen automatic stabilizers with discretionary loosening of fiscal policy and have not offered discrete fiscal stimulus packages (Figure 45). Instead, the authorities seem to be counting on the effects from previously announced tax cuts (Czech Republic, Bulgaria, and Poland) or a reshuffling of existing plans rather than net new commitments, as well as accelerated absorption of EU funds (the latter in accordance with the European Economic Recovery Plan). On top of this, most of the national stabilization plans comprise various guarantees and loan subsidies (Table 5). Moreover, in countries where the scale of the economic downturn is set to be particularly severe (Romania, Hungary, Lithuania, and Estonia), the governments have had no option but to enact sizeable fiscal restraint. Most recently, the new government of Romania has approved a revised 2009 budget with a reduced

Figure 45. Fiscal Policy in EU10 in 2009 under "No Policy Change" Scenario *)(January 2009)



Source: Convergence Programs, EC Interim Forecast January 2009, staff calculations,

*CAB = cyclically adjusted balance. *) The forecast is based on the policy measures disclosed by Governments by the time of the release of the EC report (see the text and the Fiscal Policy section for details).*

[19] Generally, countries with large current account surpluses, fiscal surplus, low debt and large central bank reserves are best placed to initiate a fiscal stimulus. By contrast, in countries with large internal and external balances, a fiscal stimulus would further diminish the confidence of investors into the economy, and speed up capital outflows. See World Bank, *PREM note on the financial crisis*, January 2009.

deficit of 2 percent of GDP, driven by spending cuts, which would now place the country in the pro-cyclical group. Substantial expenditure cuts (Lithuania, Hungary), wide-ranging tax changes (Lithuania), and depletion of the fiscal reserves accumulated during boom times (Estonia) have more than offset the deterioration in the fiscal balances due to the financial crisis. Thus, for the countries mentioned, fiscal policy is likely to be a pro-cyclical and not a stabilizing force.

In contrast, Slovenia is offering some discretionary fiscal boost to its economies in 2009. This is reflected in a deterioration of its expected structural deficit (Figure 46). Slovenia is following the global trend and has adopted fiscal measures to cope with the financial crisis. The stabilization package, worth about 2 percent of GDP, includes both tax rate reductions and spending increases (e.g., subsidies for R&D, new technology investment, wages at the predefined companies.)

In the rest of the countries, fiscal policy is likely to be broadly neutral after adjusting for the cyclical component and taking into account a margin of possible error. However, any assessment of fiscal responses to the financial crisis must be interpreted with caution, as it is extremely difficult to size up the discretionary fiscal stimulus correctly. This is in part because plans are changing continuously; in part, because countries announce measures as part of the package that were already underway; in part, because the impact is spread out over different time periods and the estimation of the size of output gaps is difficult when the demand shock is so large and widespread.

Table 5. Summary of the national stabilization plans, EU10

	AFS offset by DFS	Only AFS	AFS strenghtened by DFS	Fiscal instruments		
				Spending	Revenue/Tax	Selected off-budget measures
CZ			√	redirection	↓ planned earlier	Capital injections to banks borrowing to exporters, SMEs
HR	√			↓ + redirection	↑ planned earlier	Decreased amount for guarantee issuance.
BG	√			↓ + redirection	↓ planned earlier	Capital injections to bank providing credit guarantees to exporters, SMEs.
HU	√			↓		EU-funded measures: investment subsidies, credit guarantees, and refinancing facilities to SMEs
LV	√			↓ + redirection	↓ direct taxes ↑ indirect taxes	Capital injections to a bank; system of export loan guarantees to be established
LT	√			↓ + redirection	↓ direct taxes ↑ indirect taxes	Stimulus package incl. support to business in getting credit, speeding up the use of EU funds and easing labor market regulations
EE	√			↓ , depleting reserve	↑	Credit guarantees for exporters (SMEs)
RO			√	↓ (new government) ↑ (old government)	↓ planned earlier ↑ direct taxes	Credit guarantees for SMEs and exporters planned as part of the anti-crisis plan; renewed focus on EU funds absorption
PL			√	↓ ↑+ redirection	↓ planned earlier	Increase in limit of state guarantees, support lending to SMEs, acceleration investment projects co-financed from EU funds
SK			√	↑ under discussion	↓ under discussion	Increase in limit for state-guaranteed loans by companies
SI			√	↑	↓	

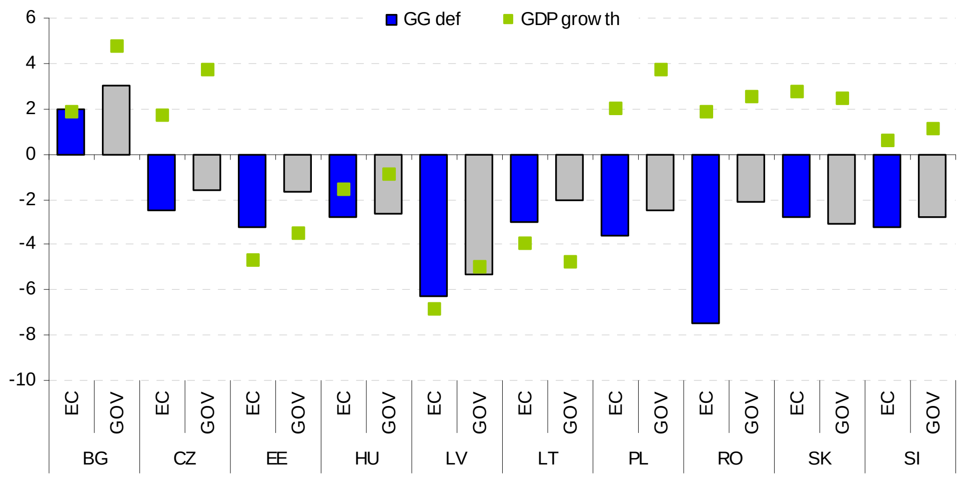
Source: World Bank Staff based on Fiscal policy Surveys

Notes: DFS- discretionary fiscal policy, AFS- automatic fiscal stabilizer, + "and"

To sum up, the expected deterioration in the EU10's public finances in 2009 is likely to be driven by cyclical and structural shortfalls rather than by discretionary government activism. Still, given the optimistic growth assumptions embedded in many budgets, fiscal balances are likely to deteriorate in almost all countries, as growth disappoints and inflation eases more quickly (Figure 46), (here referring to overall budget stances rather than the cyclically adjusted balances shown in

Figure 45). Romania and Latvia are facing substantial deteriorations in fiscal deficits, with Lithuania a more moderate deterioration. EU10 countries are, however, embarking on a range of other policy initiatives (Table 6) to counter the crisis, as discussed earlier. It is too early to assess the effectiveness of these other policy actions.

Figure 46. Economic growth and fiscal balance in 2009



Source: GOV = Convergence Programs, for Romania Budget 2009, for the Slovak Republic most recent MOF ‘s forecasts, EC Interim Forecast January 2009,

Box 3. Automatic fiscal stabilizers - key facts

Definition

The idea behind automatic fiscal stabilizers (AFS) is that they reduce output fluctuations via components of fiscal accounts (taxes, unemployment insurance system), which react automatically to changes in the economic cycle, increasing deficits in a downswing and decreasing them in an upswing. For example, in a recession, fewer taxes are collected, which operates to support private incomes and damps the adverse movements in aggregate demand. On the other hand, during an economic boom, more taxes are collected, counteracting the expansion in aggregate demand. Similarly, higher unemployment benefit payments in a downturn support domestic demand and act *vice versa* in an upswing.

The effectiveness of AFS

The effectiveness (or strength) of automatic fiscal stabilizers depends on:

- the degree of budget sensitivity (i.e., the response of government revenue and spending to economic fluctuations), including the size of the government sector, progressivity of the tax system, reliance on cyclically-sensitive tax bases, and the level and structure of unemployment benefits.
- the size of fiscal multipliers, (i.e., the subsequent impact on activity of these cyclically-induced changes in government revenue and spending); and,
- the type of economic shock.

The operation of automatic stabilizers depends also on whether macroeconomic shocks are on the demand or supply side and their duration. Stabilizers seem to be most effective in the case of temporary demand shocks, especially consumption shocks, as these tend to be "tax-rich". In the case of supply shocks, e.g., a temporary surge in oil prices that fuels inflation and depresses output, automatic stabilizers would help to boost output, but could raise inflation even further. If the supply shocks were permanent (e.g., long-term productivity or labor supply) and changed potential output, then the operation of automatic stabilizers could delay the necessary adjustment of the economy to the new equilibrium and result in higher inflation during the adjustment period.

Strength of automatic stabilizers in Europe

There have been a number of studies devoted to estimating the percentage of fluctuation in output smoothed by the operation of automatic stabilizers (Table B1). The results from empirical studies differ. Automatic stabilizers are estimated to be most effective in a 2005 OECD study showing smoothing of cyclical fluctuations by around 25 percent. In contrast, the National Institute of Economic and Social Research (NIESR) study of the eurozone countries indicates only 11 percent smoothing. Finally, the 2001 EC study based on QUEST model indicates that 20 percent of fluctuations are smoothed.

Table B1. Effectiveness of automatic stabilizers across the EU15 countries

	European Commission* QUEST model	OECD Interlink	NIESR Nigem**
Belgium	24	22	5
Denmark	31	–	–
Germany	17	31	18
Greece	22	14	–
Spain	17	17	13
France	23	14	7
Ireland	26	10	7
Italy	21	23	5
Netherlands	20	36	6
Austria	23	7	12
Portugal	30	–	10
Finland	20	58	7
Sweden	31	26	–
UK	18	30	–
Weighted Average	20	25	11

Source: UK Treasury 2003.

**) European Commission (2001), "Public Finances in EMU – 2001", European Economy No. 3, page 70 and pp.188-190.*

***) NiGEM results are from Barrell and Pina (2002).*

Source: Fiscal stabilization and the EMU, Discussion Paper, UK Treasury, 2003. Brunila A., M. Buti, and J. Veld, *Cyclical stabilization under SGP: How effective are automatic stabilizers?*, Discussion Paper, Bank of Finland, 2002. Di Bella, C. G., *Automatic fiscal stabilizers in France*, Working Paper, IMF, 2002. Girouard, N. and Ch. Andrer, *Measuring cyclically-adjusted budget balances for OECD countries*, Working Paper, OECD, 2005. Sperling, Gene, "Ways to get the economic stimulus right this time," Bloomberg.com, December 17, 2007. Stone, Chad and Kris Cox, "*Economic policy in a weakening economy: principles of fiscal stimulus*," Center on Budget and Policy Priorities, Washington, DC, January 8, 2008. Summers, Lawrence H., "*The state of the US economy*," Presentation at Brookings Institution forum, http://www.brookings.edu/~/media/Files/events/2007/1219_economy/20071219_summers.pdf, Washington DC, December 19, 2007.

Table 6. Policy Measures Other than Fiscal undertaken and planned between September 2008 and early-February 2009 in reaction to the Financial Crisis

	Bulgaria	Czech Republic	Estonia	Latvia	Lithuania	Hungary	Poland	Romania	Slovak Republic	Slovenia	Croatia
Quasi-Fiscal and Economic											
Increased credit lines to SMEs or exporters	√	√	Announced			√		Planned	√		√
Increase in Treasury Guarantees			Announced	Announced (but with limits)	Announced	√	Announced	Announced		√	Decrease due to savings plan
More effective absorption of EU funds	√	√		√	√	√	√	√	√		
Commitment to euro adoption											
Target year for euro adoption			In 2011	In 2012	In 2012		In 2012	In 2014	Euro since 2009	Euro since 2007	
Labor Market Regulations											
Flexible working hours	Announced				Announced		√			√	Ban on Sunday work
Temporary wage subsidies	√								√	√	
Moderation of public wages in 2009	10% increase	Wages to increase	Staff cuts and freezes	Staff cuts, 15% cut of salary fund	Proposed cuts of salaries	Nominal cuts		Reduction of bonuses, wages to increase 5%			6% increase
Monetary											
Interest Rate Cuts		175 bp				200 bp after an earlier hike of 300 bp	175 bp	25 bp	225 bp, including the ECB cuts in 2009	225 bp, made by the ECB	Fixed 6% repo rate
Lower Mandatory Reserve Requirements	From 12% to 10%, 5% for funds from abroad, and no MRR for govt. deposits			From 5% to 3% (maturities > 2 years), from 7% to 5% (other)		**From 5% to 2%**	Considered	From 20% to 18%			From 17% to 14%
Liquidity Provision											
- More REPO operations		√				√	√	Yes		√	√

- More flexibility in collateral requirements						√	√		√ (by ECB)	√ (by ECB)	
- FX swaps				Swap line of EUR 500 million from Sweden and Denmark		Swap facility of up to €5 billion in the ECB	In EUR and CHF, swap facility up to EUR10 billion in the ECB				Swap line of EUR260 million
- Other				Marginal lending facility			Early buy-back of NBP bonds				Reduced minimum required amount of FX claims from 28.5% to 25%
Exchange rate interventions				√				√			√
Support to Banking Systems											
Loans to financial institutions from the Treasury											
Loan guarantees to banks						√				√	
Capital injection		√		√		√ Capital Base Enhanceme nt Fund	Considered to state-owned banks	Savings Bank can be capitalized		√	
Asset purchases											
Bank nationalization				√							
Guarantees to bank deposits											
- Private Persons	√ to EUR 50 Thousand	√	√ to EUR 50 Thousand	√ to EUR 50 Thousand	√ to EUR 50 Thousand	√ to EUR 50 Thousand	√ to EUR 50 Thousand	√ to EUR 50 Thousand	√ Unlimited	√ Unlimited	√ to EUR 54 Thousand
- Enterprises											
- Interbank transactions						√					
Financial Supervision											
Tighter lending regulations, in particular on foreign currency lending	√					√ Reformed regulator (HFSA)	√	√	√ Towards enterprises		
	Bulgaria	**Czech R.**	**Estonia**	**Latvia**	**Lithuania**	**Hungary**	**Poland**	**Romania**	**Slovak R.**	**Slovenia**	**Croatia**

Source: World Bank Staff based on national sources.