

## Summary

- *Sizable FDI inflows in central Europe and higher commodity export prices further east should combine with robust credit expansions and agricultural recoveries to sustain strong output growth this year. Borrowing from capital markets abroad has slowed, especially by Russia and Ukraine, in line with wider risk premia (that have narrowed again in recent weeks). Bank borrowing from foreign parents and depositors has increased, supporting strongly expanding domestic lending.*
- *Inflation has become the main policy challenge in most countries. Surging prices for food and energy and tighter labor markets raised 12-month inflation to 11.2 percent in April for the region as a whole from 7.1 percent a year earlier. Above-target inflation will prompt further interest rate hikes.*
- *Cyclically strong revenues have helped narrow fiscal deficits. Spending reforms have lagged, however, and look likely to combine with rising outlays for wages, investment and social support to ease underlying fiscal stances this year and next, reinforcing demand pressures.*
- *External vulnerabilities increased last year as current account deficits in Bulgaria, Romania and the Baltic states widened to 15 percent of GDP or more. Worries have moderated recently, however, amid signs that slowing growth in domestic spending and rising exports have begun to contain or narrow current account shortfalls. Fiscal discipline will need to be reinforced, however, to keep external vulnerabilities from growing again over the medium term.*
- *Monetary tightening has strengthened currencies to well above trend in the Czech Republic and Poland but has been just enough to counter increased investor concerns in Hungary and Romania. Downside financial risks remain in both countries given uncertain domestic politics. Risks will grow in Ukraine as the current account deficit widens toward 11 percent of GDP next year.*
- *Banking vulnerabilities appear well contained at present in central Europe and in Turkey, but may be more substantial in Russia and Ukraine, given faster credit expansion, greater dependence on financing from foreign capital markets and the more limited role played by foreign banks.*
- *Inflation pressures will delay euro adoption until 2012 at the earliest, except for Slovakia, which will join the Eurozone next year even though inflation looks set to rise substantially in 2009 and 2010.*

## Output Growth Has Remained Strong...

Preliminary data suggest that buoyant exports and robust domestic demand have sustained output growth at a strong pace during early 2008. Year-on-year increases in first-quarter real GDP are likely to have approached or exceeded last year's pace in most of the region. Consumption has been supported by strong growth in employment and bank lending while investment outlays rose in response to rising capacity utilization and upward pressures on labor costs. Export gains firmed as a result of FDI-financed expansions of output capacity reflecting a further round of outsourcing by Eurozone producers facing growing competitiveness pressures due to euro appreciation. Slowdowns have been limited to the **Baltics** and **Ukraine**, where rising inflation has slowed increases in real incomes and eroded competitiveness. Growth in the Baltics has also moderated as tighter lending standards have slowed credit expansions. Output expansion appears to have slipped from last year's strong pace also in **Slovakia** and the **Czech Republic** as higher inflation has helped temper private consumption.

Strong growth this year follows a robust performance in 2007, when the aggregate real GDP of the major emerging European economies rose 6.6 percent. This was little changed from 2006, despite sharp drought-related contractions in agriculture across much of the region (Table 1). Among the larger of the new EU members, growth was strongest in **Slovakia**, led by surging exports of automobiles and electronics and a shift toward domestic suppliers. In **Poland**, output benefited from further gains in fixed investment and firming consumption. Growth continued at a strong pace in the **Czech Republic** as exports were sustained by new investments and a firmer increase in consumption. Growth was buoyed in **Russia** and **Ukraine** by further

**Table 1**  
**Real GDP**

(percent change)	2006	2007	2008f	2009f
Emerging Europe (EU members)	6.9 (6.3)	6.6 (6.0)	6.3 (6.1)	5.2 (5.6)
Bulgaria	6.3	6.2	9.1	8.0
Czech Republic	6.4	6.5	5.3	5.8
Hungary	3.9	1.4	1.2	2.3
Poland	6.2	6.6	6.3	5.5
Romania	7.9	6.0	8.5	6.2
Russia	7.4	8.1	7.4	5.0
Slovakia	8.5	10.4	9.5	8.5
Turkey	6.9	4.5	4.7	5.3
Ukraine	7.1	7.6	6.2	4.0

f = IIF forecast

increases in commodity export prices, expansionary fiscal policies and accelerations of bank lending, much of it financed by foreign borrowing.

While EU accession helped boost real GDP growth outside agriculture to about 10 percent last year in both **Bulgaria** and **Romania** from roughly 7 percent in 2006, severe drought cut the increase in overall GDP to roughly 6 percent. **Turkey** and **Hungary** were also hit by drought but experienced slowdowns outside agriculture as well. Both countries felt the effects of sharp monetary tightening from 2006. Hungary, in addition, was hit by severe fiscal retrenchment, while in Turkey demand was supported by fiscal easing ahead of the July parliamentary election and interest rate cuts beginning in September.

**Rising Inflation Has Accompanied Strong Output Growth...**

**Higher prices for food and energy have combined with growing labor costs to boost inflation above target everywhere there is a target.** Hikes in indirect taxes and administered prices have added to inflation in some cases, as has the harmonization of excises in the new EU members. Limited economic slack, tightening labor markets and accelerating wage growth have boosted core inflation in most countries, threatening to unanchor inflation expectations.

Inflation has risen most where exchange rates have been pegged (Chart 1). Twelve-month inflation was highest in April in **Ukraine** at 30 percent, close to three times as much as in December 2006. Lax fiscal and monetary policies have played a role, alongside surging food and energy prices. The hryvnia's informal peg to the depreciating dollar has added rising import prices to demand pressures. Similar factors boosted inflation in **Russia** to half the rate seen in Ukraine, with the ruble's appreciation vis-à-vis the dollar limiting its depreciation in nominal effective terms. Labor market pressures have also accelerated inflation to double-digit annual rates in **Latvia, Estonia** and **Bulgaria**, all with currency board arrangements pegged to the euro.

Inflation has risen less where flexible exchange rates have been allowed to appreciate to help limit price increases. Despite marked appreciations thus far this year, headline inflation has risen in the **Czech Republic** and **Poland**, thanks to growing wage and demand pressures as well as increases in food and energy prices. Inflation has continued to trend upwards in **Slovakia** as well, mainly due to rising food prices, with the effects of firming demand pressures offset thus far by koruna appreciation since early last year (Chart 2).

Strong leu appreciation was the main factor behind a spectacular slowdown in inflation in **Romania** last year. This has been reversed now, with the currency 20 percent

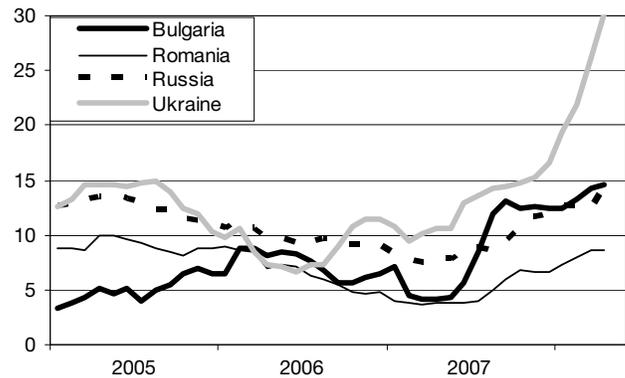
off its mid-2007 peak, and nonagricultural output booming due to expansionary fiscal and incomes policy and continued strong credit growth. Renewed currency weakness has contributed to a further increase in inflation in **Turkey**, which further clouds the central bank's credibility after two successive years during which its formal inflation targets were overshoot by sizable margins.

**Hungary** alone among the larger European emerging markets has had headline inflation slow this year. At 6.7 percent in March, however, 12-month inflation was still more than twice the central bank's 3 percent target and above the recent low of 6.4 percent seen in September 2007.

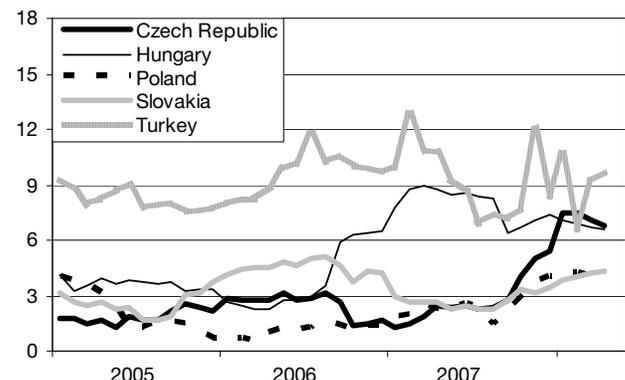
**Strong Revenues Have Helped Cut Government Deficits And Reduce Fiscal Vulnerabilities...**

**Cyclically strong revenues helped sustain fiscal surpluses last year or narrow deficits to less than the 3 percent of GDP Maastricht limit everywhere but Hungary** (Table 2). In aggregate, however, the regional fiscal surplus declined because of the near halving of **Russia's** surplus even though the combined deficits of the other large European emerging economies narrowed by more than 1½ percent of GDP.

**Chart 1: Consumer Price Inflation**  
(12-month percent change)



**Chart 2: Consumer Price Inflation**  
(12-month percent change)



This report is based on information available up to May 16, 2008.

**Table 2**  
**General Government Balances<sup>1</sup>**  
(percent GDP)

	2006	2007	2008f	2009f
Emerging Europe (excluding Russia)	0.9 (-3.9)	0.4 (-2.3)	0.6 (-2.4)	-0.7 (-2.6)
Bulgaria	3.0	3.4	4.4	4.0
Czech Republic	-2.6	-1.6	-2.5	-2.8
Hungary	-9.2	-5.5	-4.0	-4.6
Poland	-3.8	-2.0	-2.5	-2.7
Romania	-2.2	-2.5	-2.9	-3.3
Russia	7.5	4.2	5.7	2.5
Slovakia	-3.6	-2.2	-1.8	-1.1
Turkey	-1.1	-2.3	-2.2	-1.5
Ukraine	-2.1	-2.1	-3.5	-4.0

f = IIF forecast

<sup>1</sup> EU members: ESA95 basis; Russia, Turkey and Ukraine: cash basis.

Underlying fiscal adjustments in central Europe were outweighed last year by marked easings in **Russia** and **Turkey** caused by election-related surges in spending (Table 3). Fiscal tightening in central Europe mainly reflected severe retrenchment in **Hungary**, where indirect tax increases combined with sharp real reductions in government wages and employment, investment outlays and nonwage consumption spending. The **Czech Republic** and **Poland** registered smaller adjustments, mainly reflecting buoyant revenues and reductions in capital outlays and social spending. **Slovakia** saw a similar-sized tightening thanks to a surge in excise receipts caused by the prestocking of cigarettes ahead of an excise tax increase at the start of this year. Underlying fiscal positions eased significantly in **Romania** and

**Table 3**  
**Fiscal Impulse<sup>1</sup>**  
(percent GDP)

	2006	2007	2008f	2009f
Emerging Europe (EU countries)	0.6 (0.2)	1.7 (-0.3)	0.7 (0.3)	-0.2 (0.0)
Bulgaria	-0.8	-0.1	-0.2	0.4
Czech Republic	1.1	-0.6	1.2	0.3
Hungary	2.2	-4.7	-0.5	0.5
Poland	-0.1	-0.8	1.1	-0.4
Romania	1.4	1.0	1.6	0.3
Russia	0.9	4.0	1.2	-0.5
Slovakia	1.5	-0.6	1.2	0.5
Turkey	-0.1	1.6	-1.1	0.1
Ukraine	1.1	0.9	1.3	0.0

f = IIF forecast

<sup>1</sup> Change from previous year in cyclically adjusted noninterest balance, net of one-offs, pension reform costs and net budgetary transfers from the EU ( + = expansion; - = contraction).

**Ukraine** as extra revenues due to strong growth were used to boost spending rather than to advance fiscal consolidation.

Underlying fiscal stances look set to ease much less this year for the region as a whole. This should be due partly to a smaller expansion in **Russia** as the new government moves to limit growth in noninterest spending to help fight inflation. Tax cuts and increased infrastructure outlays look likely to result in relaxations this year in **Poland** and the **Czech Republic** similar in size to the 1.2 percent of GDP likely in Russia. These developments will be reinforced in **Poland** by additional pension indexation and insufficiently offset in the **Czech Republic** by cutbacks in government wage outlays and social benefits the ruling coalition will find difficult to enact in the evenly split parliament. Compensation for Soviet-era bank deposit losses and rising quasi-fiscal losses among state-owned utilities (not allowed to pass along higher energy import costs) look likely to ease the underlying fiscal stance in **Ukraine** by ½ percent of GDP this year as well.

More substantial underlying relaxation looks likely this year in **Slovakia**, even if the headline deficit narrows further because of cyclically strong revenues and increased receipts of EU budget transfers. Additional revenues will be used to finance larger-than-planned outlays as the lack of prioritizing spending reforms makes it difficult to sustain ad-hoc across-the-board cuts in employment and budget allocations. Institutional weaknesses and election-related political pressures are likely to result in slack spending discipline again this year in **Romania**, widening both the headline and underlying fiscal deficits despite another year of cyclically strong tax revenues.

With rising inflation limiting noninterest spending to a smaller real increase than that for tax revenues, the underlying fiscal stance should tighten this year in **Turkey**, partly reversing last year's 1½ percent of GDP relaxation. **Hungary** should see further fiscal adjustment this year as cuts in government employment and nominal freezes for wages and other consumption outlays cause government spending to decrease again in real terms. Despite recent decisions to boost spending for pensions and wages, strong revenue growth should keep **Bulgaria's** underlying fiscal surplus little changed this year.

### External Vulnerabilities Have Grown, However, As Current Account Deficits Have Widened...

External shortfalls grew to outsized magnitudes last year in several emerging European economies, mostly where exchange rates have been fixed or appreciated strongly in nominal terms in recent years (Table 4).

Current account deficits widened to 21 percent of GDP in **Latvia** and **Bulgaria**, to 15-16 percent in **Estonia** and **Romania** and to 12 percent in **Lithuania**. Only in Bulgaria, among these countries, were FDI inflows large enough to cover the current account shortfall. FDI inflows amounted to less than half Romania's deficit and only a third or less of those in the Baltics.

**Table 4**  
**Current Account Balances**  
(percent GDP)

	2006	2007	2008f	2009f
Emerging Europe (excluding Russia)	0.7 (-4.8)	-1.2 (-5.5)	-1.5 (-6.0)	-2.6 (-6.2)
Bulgaria	-15.0	-20.3	-20.8	-18.4
Czech Republic	-2.8	-2.0	-2.5	-3.0
Hungary	-5.7	-4.0	-3.1	-2.5
Poland	-2.1	-2.6	-4.2	-4.9
Romania	-10.3	-14.7	-15.3	-14.9
Russia	9.6	6.2	4.9	-0.1
Slovakia	-7.1	-4.7	-3.3	-2.9
Turkey	-5.9	-5.8	-6.5	-5.6
Ukraine	-1.6	-5.0	-9.2	-10.8

f = IIF forecast

In central Europe and **Turkey**, by contrast, current account deficits narrowed last year, except in **Poland**, to no more than 6 percent of GDP mainly as a result of strong export expansion. **Hungary's** deficit narrowed in line with the contraction of domestic demand. **Ukraine's** shortfall widened, by contrast, thanks to booming domestic demand, sharply eroding competitiveness and marked increases in the price for imported natural gas. **Russia's** current account surplus narrowed markedly despite further large increases in commodity export prices, shifting the aggregate current account of emerging Europe to a 1.2 percent of GDP deficit from a surplus nearly as large in 2006. Excluding Russia, the aggregate deficit widened to 5.5 percent of GDP.

Substantially wider deficits look likely this year across most of the region, as does the further reduction of the current account surplus in **Russia** despite still higher energy export prices. In **Ukraine**, the current account deficit looks set to widen to 9 percent of GDP or more as a result of strongly rising import volumes and another increase in the price of imported natural gas. **Turkey's** deficit has begun to widen again this year, on the back of rising energy import costs and renewed momentum in import volumes in line with recovering domestic demand.

Surging exports and moderating import growth suggest that the deficits could stabilize this year in both **Romania** and **Bulgaria**. Sharply slower growth in domestic demand should narrow the current account

deficits in the **Baltics** markedly this year and next, helping to allay market concerns.

**Slovakia's** current account deficit looks set to narrow further this year, thanks to continued strong growth in automobile exports. Those of the **Czech Republic** and **Poland** are likely to widen, however, in line with robust growth in domestic demand. Weak domestic demand should reduce Hungary's current account deficit further, however.

### Capital Inflows Have Eased, But Remain Strong...

Net inflows of foreign private capital to emerging Europe slowed to \$80 billion in early 2008 from \$89 billion a year earlier (Table 5). The slowdown was confined to **Russia**, **Turkey** and **Ukraine**, however, as inflows to central Europe rose more than one-third to \$38 billion. FDI inflows declined as foreign portfolio investors sold equity holdings.

**Table 5**  
**Net Inflows of Foreign Private Capital**  
(billions of dollars)

	2006	2007	Q1 2007	Q1 2008
Emerging Europe <sup>1,2</sup>	252.3	436.4	89.4	79.9
FDI inflows <sup>3</sup>	113.4	142.4	39.9	34.2
Portfolio equity	7.9	18.3	-1.3	-1.4
Borrowing, net	153.7	310.3	61.8	58.5
Government	-15.2	2.3	5.8	7.5
Banks	77.9	127.3	18.9	23.3
Other <sup>3</sup>	91.0	180.7	37.2	27.7
Central Europe <sup>2,4</sup>	99.9	142.2	24.9	37.8
FDI inflows <sup>3</sup>	56.3	58.5	11.2	10.9
Portfolio equity	-0.5	-2.2	-0.1	0.9
Borrowing, net	57.5	105.4	16.7	29.2
Government	10.0	16.6	4.0	10.3
Banks	11.9	47.1	6.8	12.2
Other <sup>3</sup>	35.6	41.8	5.9	6.6

<sup>1</sup> Excluding Kazakhstan and the Baltics.

<sup>2</sup> Does not sum due to the inclusion of FDI borrowing both in FDI inflows and in other borrowing.

<sup>3</sup> Including FDI borrowing.

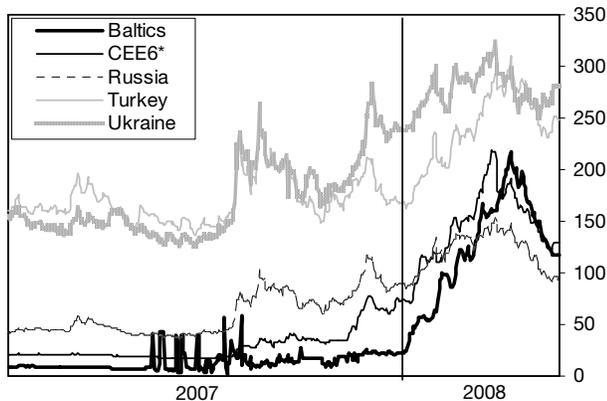
<sup>4</sup> Including Poland, Czech Republic, Slovakia, Hungary, Romania and Bulgaria.

Source: National central banks and IIF estimates.

In line with sharply wider sovereign CDS spreads, publicized loans and bonds issued by borrowers in the region fell by more than half to \$35 billion during January-April from \$85 billion a year earlier (Chart 3; Table 6). **Russia**, **Ukraine** and **Turkey** accounted for 90 percent of the decrease, however, much of which was due to decreased borrowing by Russian corporates. (Rosneft, for example, borrowed \$22 billion

**Chart 3: Sovereign CDS Spreads**

(basis points)



\*CEE6 = Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia

**Table 6**  
**Publicized Foreign Loans and Bond Issues**

(billions of dollars)

	2006	2007	Jan-Apr	
			2007	2008
Emerging Europe	<u>125.3</u>	<u>186.7</u>	<u>84.9</u>	<u>35.1</u>
Russia	57.1	115.1	55.1	23.5
Ukraine	6.2	10.1	3.6	0.8
Turkey	27.3	30.1	16.0	5.0
Central Europe <sup>1</sup>	32.3	27.8	9.2	4.7
Baltics	2.4	3.6	1.0	1.1
<b>Memoranda:</b>				
Financial Institutions	<u>36.5</u>	<u>33.6</u>	<u>11.4</u>	<u>6.2</u>
Russia	16.6	15.1	4.6	2.6
Ukraine	2.2	5.6	2.8	0.5
Turkey	13.5	7.7	2.0	0.6
Central Europe <sup>1</sup>	3.2	3.0	1.4	2.0
Baltics	1.0	2.1	0.6	0.5

<sup>1</sup> Including Poland, Czech Republic, Slovakia, Hungary, Romania and Bulgaria.

Source: Thomson Reuters Financial.

in March 2007.) Loan and bond issues by banks fell by a bit less than half for the region as a whole, increasing, in fact, for central Europe from a year before.

Measured in net terms, balance of payments data suggest that net borrowing from abroad during the first quarter slipped only to \$59 billion from \$62 billion a year before. This mainly reflected decreased borrowing by corporations, mostly by Russian firms, but also smaller net purchases by nonresidents of local currency-denominated bonds issued by **Hungary** and **Turkey**. Reserve-related borrowing by **Poland's** central bank increased. Net borrowing by banks from central Europe rose by half in euro terms to the equivalent of nearly \$12 billion, much of it from foreign parents to support lending by local subsidiaries (Table 7). Turkish banks

borrowed \$3 billion in net terms after having made \$2 billion in net repayments a year earlier, with foreign parents likely to have provided substantial funding as well. Net borrowing by Russian banks, by contrast, fell by half to \$7 billion. Most of the latter was probably denominated in rubles from lenders hoping to profit from accelerated ruble appreciation.

**Table 7**  
**Net Foreign Borrowing by Banks**  
(billions of dollars)

	2006	2007	Q1	Q1
			2007	2008
Emerging Europe	<u>77.9</u>	<u>127.3</u>	<u>18.9</u>	<u>23.3</u>
Russia	48.6	63.5	13.2	7.1
Ukraine	5.7	13.0	1.2	0.9
Turkey	11.7	3.7	-2.3	3.1
Central Europe <sup>1</sup>	11.9	47.1	6.8	12.2
Baltics	8.3	16.4	3.4	0.1

**Memorandum:**

Kazakhstan	16.8	13.5	5.6	-4.2
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<sup>1</sup> Including Poland, Czech Republic, Slovakia, Hungary, Romania and Bulgaria.

Source: National central banks and IIF estimates.

**Credit Expansion Has Remained Strong Despite Monetary Tightening...**

Policy interest rates have been raised since the start of 2008 in **Poland**, the **Czech Republic**, **Russia**, **Romania**, **Hungary** and, most recently, in **Turkey** (Charts 4 and 5). Interest rates have remained unchanged only in **Slovakia** to help limit currency appreciation. Borrowing costs have risen in **Bulgaria** and the **Baltics** even though the ECB has been on hold since mid-2007 as a result of tensions in foreign interbank markets and worries about the future of their exchange rate pegs given the size of their current account deficits. Reserve requirements have also been raised in a number of countries and provisioning requirements tightened on foreign exchange lending in at least one country.

Monetary tightening has had little effect on credit growth thus far, however. Credit to nongovernment borrowers rose 42 percent in year-on-year terms in March for the region as a whole, only slightly less than the 45 percent increase registered last year. Credit expansion was, in most countries, sustained by continued foreign borrowing and ample domestic deposit funding, together with continued strong credit demand amid rapidly rising incomes.

Among the larger European emerging markets, credit growth slowed only in **Russia** and **Bulgaria**, and then only to 47 percent and 60 percent, respectively, in the 12 months through March (Chart 6). In Russia, credit

Chart 4: Policy Interest Rates

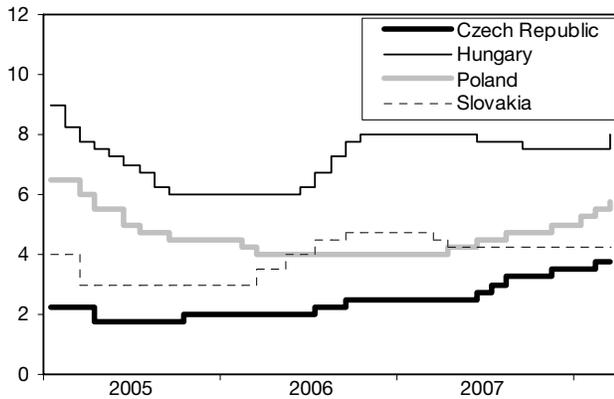


Chart 5: Policy Interest Rates

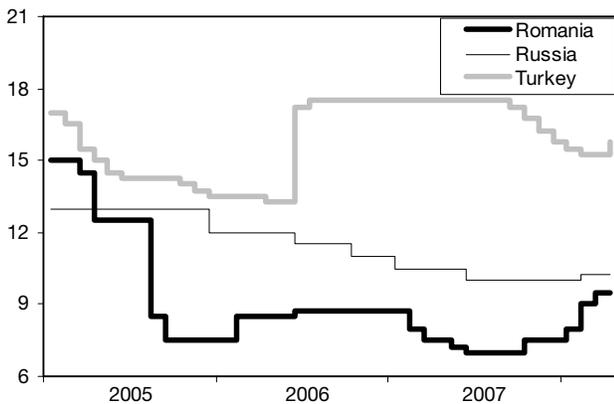


Chart 6: Credit to Nongovernment Borrowers  
(12-month percent change, exchange-rate adjusted)

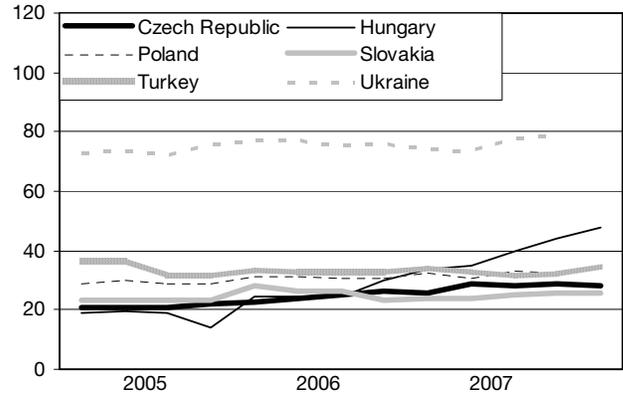
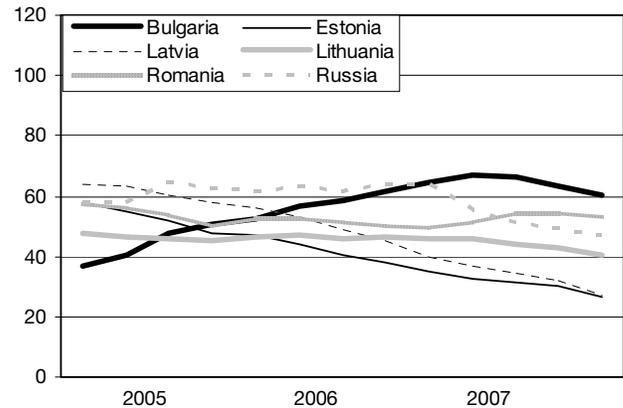


Chart 7: Credit to Nongovernment Borrowers  
(12-month percent change, exchange-rate adjusted)



growth appears to have slowed less because of the drop-off in external funding (banks drew down excess reserves with the central bank and deposits held abroad) and more because of tighter lending standards and increases in both lending rates and funding costs, the latter due to hikes in minimum reserve requirements. In **Bulgaria**, credit growth slowed for similar reasons, with lending standards tightened and funding costs higher because of a September hike in minimum reserve requirements and an increase in risk premia due to the size of the current account deficit.

Credit expansion has continued at last year's pace near 30 percent in the **Czech Republic** and **Slovakia** and above 50 percent in **Romania**. Credit demand was little affected by sizable interest rate hikes in the Czech Republic or by the reversal of interest rate cuts, currency depreciation and increases in reserve and provisioning requirements in Romania.

Bank lending has accelerated, by contrast, in **Hungary, Poland, Turkey** and **Ukraine** (Chart 7).

Credit expansion was strongest in **Ukraine**, amounting to 78 percent from a year before in February. Most of this was in foreign exchange, underpinned by strongly increasing household incomes and financed mainly by drawings on foreign assets and deposits held with the central bank, as well as stepped-up borrowing from the central bank. In **Poland**, bank lending picked up in response to increased investment and rising employment and real incomes that helped boost creditworthiness among households.

Credit growth accelerated most in **Hungary**, where households sought to sustain consumption, despite declining real incomes, by increasing borrowing, mainly of lower-cost foreign exchange credits. Credit growth picked up much less in **Turkey**, after slowing sharply last year. This partly reflects restrictions on lower-cost foreign exchange borrowing by households and others without foreign exchange incomes. Domestic credit has been complemented also by stepped-up corporate borrowing from the offshore branches of Turkish banks to avoid such restrictions, funded, in turn, by their head

offices. Adjusting for the latter, lending grew 34 percent from a year before in March, compared with 28 percent during 2007.

### Financial Pressures Likely To Be Weathered And Strong Growth Continued In Most Countries...

Aggregate real GDP growth is likely to slow only moderately this year, with exports supported by continued strong inflows of FDI and domestic spending buoyed by rising employment, capacity expansions and further increases in commodity export prices. Demand looks likely to sustain inflation, prompting further monetary tightening and stronger currencies as net inflows of debt capital continue despite ongoing global credit strains.

Downside risks remain, of course, and will be greater where FDI inflows cover smaller portions of the current account deficits, as in **Romania** and the **Baltics**, where nonresidents hold a large part of locally issued government bonds, as in **Hungary** and **Turkey**, or where domestic banks have depended more on funding from unaffiliated foreign investors, as in **Russia** and **Ukraine**. Global financial stresses may have more negative spillover effects than has been the case thus far should liquidity problems intensify anew or losses increase among foreign parents, constraining lending by their local subsidiaries in emerging Europe. The more marked credit slowdowns that would then result would trigger still sharper decelerations of private consumption and investment, mainly focused in **the Baltics** (and **Kazakhstan**, in central Asia).

Risks related to the size of current account deficits may have begun to ease amid indications that external shortfalls have begun to decline or level off where they have been the largest. **Turkey** may be the most vulnerable to net sales of locally issued government bonds by foreign portfolio investors, with the current deficit likely to widen this year, fiscal policy set to ease over the medium term and uncertain domestic politics and hesitant monetary tightening likely to keep financial markets somewhat on edge. More difficult access recently to foreign financing may limit the extent to which financial pressures can intensify in the future in **Russia** and **Ukraine**. The need for foreign borrowing will grow, however, as Ukraine's current account deficit widens sharply this year and next.

Unhedged foreign exchange exposures have increased across most of the region, especially where exchange rates have been pegged. High domestic interest rates have triggered somewhat smaller, but still sizable, increases where flexible currencies have made borrowers and lenders more aware of exchange rate risks. Trend nominal appreciations, nonetheless, have given borrowers strong incentive to profit from longer-termed foreign

exchange borrowing. The prevalence of direct inflation targeting among central banks, in addition, has left debt denominated in local currencies with shorter tenors or floating interest rates vulnerable to longer-lasting increases in borrowing costs than borrowing with foreign exchange obligations. Even so, the increase in foreign exchange debts owed by households has been large enough to pose serious risks to output and expenditures only in the **Baltic** countries, should currencies be forced to adjust.

With slower expansions of bank lending and domestic demand helping to narrow current account deficits markedly this year, however, concerns about the **Baltic** countries appear to have eased. (Spreads of domestic interbank rates over Euribor have fallen sharply from last year's peak, as have sovereign CDS spreads.) Concerns have begun to recede about **Bulgaria** as well, even though credit growth has moderated much less, given a surge in exports that appears to have stabilized the current account deficit for now. Markets have also been reassured by the government's restatement of its resolve to tighten fiscal policy as much as needed to prevent a further increase in external imbalances.

**Romania's** current account deficit appears to have leveled off as well, thanks to the leu's sharp depreciation since mid-2007 and forceful monetary tightening since late last year. Medium-term risks remain, all the same, with further fiscal deterioration likely ahead of the November parliamentary elections and political pressure strong to reverse efforts to tighten incomes policy. Policy drift seems set to continue with the most likely outcome of the November elections to be another weak, divided coalition government. With current policies, the fiscal deficit could widen to 3¼ percent of GDP next year, keeping inflation elevated, the current account shortfall outsized and the leu at significant risk of further slippage.

Medium-term prospects look most challenging, perhaps, in **Hungary**. Dysfunctional domestic politics have left a succession of governments unable to advocate, let alone implement, the deeper spending reforms needed to achieve durable fiscal adjustment. Steadily increased taxation has been the result, together with periodic reliance on higher inflation to temporarily compress real government spending, both of which have prompted large-scale tax evasion and weak investment. Potential output growth, in turn, has decreased by half in recent years to roughly 3 percent, or less than half that in the other new EU members, and looks unlikely to recover without the spending reforms needed to reduce the deficit and lower taxation. Tax cuts and additional social spending look likely to be the result of the 2010 parliamentary elections, leaving already large risk premia set to rise further and forcing the central bank to keep interest rates high despite weak output growth.

High commodity prices should help limit risks this year in **Russia** and **Ukraine**. Output growth should remain strong and inflation high as large export receipts and cyclically strong revenues sustain strong growth in domestic spending. Central banks in both countries are likely to allow capital inflows to appreciate their currencies this year (more this year than last year in Russia) to help contain inflation. Surging imports are likely to narrow Russia's current account surplus, shifting it to deficit next year despite continued high oil prices. Ukraine's current account will deteriorate much more, with the deficit more than doubling to near 9 percent of GDP this year. A further increase in the deficit to 11 percent in 2009 will be difficult to finance if global financial conditions do not improve, leaving the hryvnia at growing risk of a major downside correction if the authorities continue to delay the fiscal adjustment needed to curb domestic demand.

**Turkey's** near-term prospects have been clouded by the central bank's delayed response to rising inflation and the increase in political uncertainty that has resulted from a lawsuit currently before the constitutional court that would ban the ruling political party. An outright ban looks unlikely at present, but lingering uncertainty will

continue to weigh on markets, leaving risk premia and the lira under pressure. Delays advancing privatization and a ban on real estate sales to foreigners will constrain FDI, moreover, adding to borrowing needs as the current account deficit widens. To contain inflation and restore credibility weakened to two successive years of overshoot inflation targets, the central bank will need to raise its key policy interest rate by another 75-100 basis points or so this year from 15¾ percent at present.

Rising inflation pressures look set to complicate efforts by other EU members to bring forward euro adoption, now that **Slovakia** looks set to join in 2009. Fiscal deficits should narrow further this year and next as a result of buoyant growth in output and tax revenues, but underlying demand pressures will remain strong as labor markets tighten further. Greater focus will be needed on fiscal adjustment, backed by deeper spending reforms, along with overdue reforms to improve labor market flexibility and encourage increased participation. This will take time however, leaving central banks likely to raise interest rates to firm currencies and bring inflation (and inflation expectations) back towards their targets by late 2009 or 2010. Euro adoption looks unlikely as a result before 2012 for the remaining new EU members.