

CEE outlook beyond the crisis

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**Raiffeisen
RESEARCH**

RZB Group

CEE outlook

beyond the crisis

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Explanation:

e ... estimate

f ... forecast

p ... preliminary figures

Eurozone ... Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Spain

CE ... Central European countries - Poland, Hungary, Czech Republic, Slovakia, Slovenia

SEE ... South East European countries - Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia

CIS ... European CIS (Commonwealth of Independent States) countries - Russia, Ukraine, Belarus



Executive Summary

Sailing hostile waters

The unprecedented scale of the global financial crisis and the prospects of abrupt economic downturn in the developed world pushed the situation in the CEE region into a completely new dimension. Unsurprisingly, the CEE region is facing a severe crisis stemming from its strong reliance on the export-growth model oriented towards the EU and the large influx of external investment in recent years. Indeed, the years of economic growth and credit boom led to the accumulation of unsustainable external imbalances in many CEE countries, so their domestic economies will have to undergo a period of painful economic deleveraging. In the interim, we believe the risks of an economic hard landing are very high in case of the majority of CEE. Indeed, in the absence of foreign credit and with huge deficits being accumulated, the most obvious path of correction would be a sharp economic decline and a significant drop in domestic demand.

We believe that a certain degree of caution should be used when comparing the CEE crisis to the crises experienced in South Asia and Mexico. This stems from the unparalleled nature of the present crisis, which disrupted major global lenders in the commercial credit market. Therefore, the magnitude of adjustment and the duration of this crisis will remain highly contingent on the recovery in the developed world. Moreover, if one takes a closer look at CEE risk, it becomes clear that CEE banking systems are predominantly foreign owned (except for Russia and Ukraine), making the risk of a systemic banking crisis fairly insignificant as opposed to past historical examples. This factor cannot be overlooked because systemic banking crises often amplify the severity of financial crises and lead to more pronounced economic declines. And for the sake of accuracy, it must be assumed that ownership by foreign banks also improves credit rollover chances. In many CEE countries, external banking debt is high, but a large portion of that is owned by foreign subsidiary banks. So removing this figure from total external short-term debt could substantially improve liquidity ratios of quite a few CEE banks.

With regard to the impact of large external imbalances, we must say that, according to past experience, such imbalances will have to be corrected via economic deceleration. The fact that many CEE countries have rather high deficits (Russia is the only exception) can only accelerate the pace of the economic decline. However, current accounts represent only a part of the problem. Another part of the prob-

lem is substantial short-term debts in CEE that are due within the next 12 months. As long as financing from abroad is virtually absent, the situation will exert enormous pressure on local currencies and the international reserves of national banks in the region. Consequently, the economic recession will hit a number of CEE countries and the lack of credit can only aggravate this. We believe it is highly probable that the region will suffer an economic hard landing. That being said, the cleansing of external imbalances will also likely lead to the creation of more solid ground for future growth, which will ensure the return of the CEE region to the convergence path. Furthermore, the region will retain a bigger advantage vis-à-vis Europe after the crisis in the form of declining ULC versus economic productivity. So perhaps we can claim that this speedy and large-scale adjustment in the CEE economies will also lay solid ground for a return to economic growth, whereby European producers such as automobile manufacturers will be inclined to use their operating capacities first in the countries with less expensive costs.

Another important issue is the fact that CEE countries cannot be lumped together because of substantial differences existing between particular countries, so country risks must be assessed on a case-by-case basis rather than on the aggregate scale. We would like to point out that one must distinguish between countries with regard to the strength of their economies and their liquidity situations. While the Baltic countries can be said to represent the worst crisis example in the region, we believe the Czech Republic and Slovakia will remain relatively immune. In another example, Croatia – despite having large external debt – surprisingly has far better coverage ratios in comparison to Bulgaria or Romania. The situation regarding liquidity and sustainability is even better in Russia, which runs healthy external surpluses and commands the third largest stock of international reserves in the world, but whose private sector is highly dependent on short-term external debt. Essentially, the crisis in CEE bears more resemblance to a liquidity crisis, whereas sustainability issues might only be triggered in very few cases such as the Baltic states, Hungary and perhaps Bulgaria. Sadly, the anti-crisis “toolbox” of most CEE governments looks fairly limited. With the exception of Russia, which has managed to introduce substantial implied deficits for this year that cover its resources without triggering instability, most CEE countries have very limited fiscal capacity to stimulate their economies. As a result, most CEE countries are expected to take the path of monetary

easing, which has its own limitations and can affect currency stability. In this regard, the fiscal outlook for the CEE region will deteriorate sharply in 2009 as governments will need to go beyond their normal capacity, while dramatic fiscal consolidation will be needed in 2010 and beyond to restore fiscal balances. Monetary policies will remain lax throughout 2009 and early 2010. In the more distant future, the easing bias reversal in CEE will be closely interlinked with the EU monetary cycle.

The aforementioned factors will continue to apply devaluation pressures on some CEE currencies, but we should not forget the devaluations that have already taken place in Russia, Ukraine, Hungary and Romania, partially offsetting the speed of future declines. In countries like Russia or Ukraine, devaluations will also help commodity-based exports, while sharp devaluations will lead to substantial decreases in imports in nearly all cases.

Furthermore, according to our analysis, the temporary shocks experienced by all CEE currencies do not reflect long-term fundamentals. While liquidity problems and external imbalances lead to painful adjustments in real effective exchange rates (the value of a country's currency compared to those of its major trading partners), the same cannot be said about the economic viability or competitiveness of CEE currencies. Our analysis shows that many CEE currencies remain fairly well positioned for recovery if we look at fundamentals. Consequently, many CEE countries had healthy productivity gains, offsetting their REER appreciation. The same conclusion can be made when analysing the PPP valuation of CEE currencies. This does not mean that CEE currencies will not depreciate in the short term, but this allows us to suggest a speedy recovery in the currencies once external imbalances are corrected. Obviously, the issue of currency sustainability goes hand-in-hand with the balance of payments outlook. With regard to the balance of payments outlook, we believe that a major adjustment of the deficits is underway. The devaluations and sharp deceleration of economic activity will lead to substantial reductions of all types of imports, whereas CEE exports can still retain a certain competitive advantage over the EU. The devaluations in a number of CEE countries could become problematic as they trigger a decline in the competitive advantage within the CEE region, but we believe that this issue will not be a problem unless competitive devaluations become widespread.

The balance of foreign investment poses a substantial risk for CEE. We have seen large portfolio investment outflows leading to market calamity in quite a few CEE countries. Furthermore, FDI into the region could decline somewhat as the present crisis is unprecedented in both scale and severity. The major suppliers of FDI – the developed countries – are deeply affected themselves and are scaling back economic activity and investment. Yet, we do not expect a dramatic decline in FDI as previous crises studies have revealed the relative resilience of FDI flows to the market crisis in the case of Southeast Asia. In particular, the studies found that FDI did not suffer much in most cases during the Southeast Asian debacle and in some other cases as well. However, we must bear in mind that the developed economies were healthy at the time of the Asian crisis as opposed to the present situation. So perhaps some loss of FDI must be factored into the outlook.

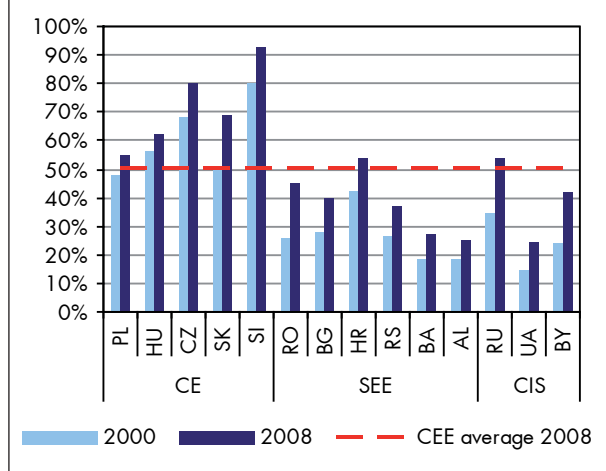
In conclusion, we believe the CEE region will undergo a painful adjustment process, exerting pressures on both the economic and social side. Nevertheless, the speed of this adjustment will lead to a fast recovery once the signs of economic improvement begin to emerge in the developed countries. In this regard, one can expect the recovery in CEE to be more powerful in comparison to the developed world. Yet prior to this, the loss of wealth in CEE will be significant as well. As concerns about imbalances are addressed both economically and institutionally, the situation should begin to improve. This should change the outlook for the region from negative to stable in 12–18 months, while the improvements will be reflected in ratings upgrades across the region no earlier than 18–24 months from now. That being said, the EU anchor and the IMF agreements with countries facing problems will play a crucial role in the overall economic recovery in the region.

Gintaras Shlizhyus

Painful adjustments underway as we enter a new economic era

Over the past decade the Central and Eastern European (CEE) economies have progressed along their paths of convergence at a very fast pace. Fuelled by the EU integration process and, over the last few years, a credit boom, the average real GDP growth of the CEE economies outpaced that of the Eurozone by nearly 4% percentage points from 2000 to 2008. By 2008 the average GDP per capita in CEE reached 50% of the EU-27, up by 12 pp from 38% in 2000.

GDP per capita (at PPP, in % of EU-27 avg)



Source: wiiw, Raiffeisen RESEARCH

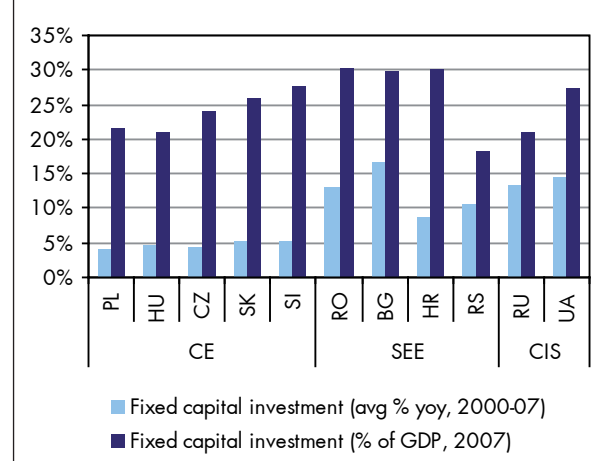
Speaking in very general terms, the successful economic model of the CEE countries has been cheap labour and the import of foreign savings. The import of foreign savings (i.e. current accounts in deficit) made a lot of sense because the savings ratios of the CEE economies were too low to finance the investments that were needed to accommodate such a fast transition process. Foreign investors also were able to find profitable investment opportunities in CEE. The import of capital and know-how significantly boosted productivity in the CEE economies and allowed for a rapid increase of average household incomes. Overall employment increased as well, which was important given the high unemployment rates in many CEE countries at the beginning of the decade.

Although this has clearly been a win-win situation for the CEE countries and their foreign investors, the global financial crisis has put the sustainability of this economic model in question. Foreign savings (be it in the form of foreign direct investment or external financing) have become much more scarce and expensive in a period of global recession and extreme risk aversion. Not only does this affect the prospects of future investment (and consumption), but the neces-

sary refinancing of maturing external debt has also become extremely challenging under the current conditions on the global financial market and, in some cases, has forced countries to ask the IMF and the EU for support.

Although financial support by the IMF can ease fears on the financial markets and stabilise the exchange rates, which is crucial for the financial sectors in CEE that have a high percentage of loans denominated in foreign currencies, the accompanying fiscal restrictions greatly reduce the ability of the countries to support their economies from the fiscal side (see the separate chapter on this issue). On the positive side, the European Union has also proven its willingness and ability to support member countries in financial distress together with the IMF (e.g. in Hungary and Latvia). Eventually this would certainly also apply to Romania and Bulgaria, which joined the EU in 2007. But we believe this commitment should also extend to the Southeastern European candidate countries (in the widest sense), whose economic and political stability are of much greater importance for Europe than the potential costs of bailing out some of these small economies.

Fixed capital investment



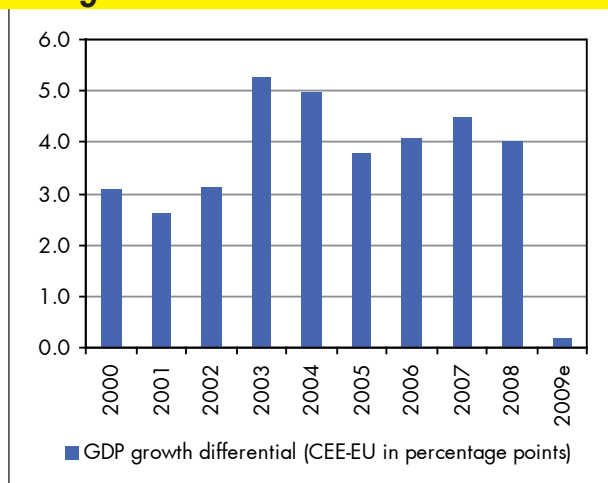
Source: wiiw, Raiffeisen RESEARCH

However, the available financial support from the IMF, the EU and international institutions like the World Bank, the EBRD and the EIB does not save the countries in the region from having to undergo a period of structural economic adjustments in order to realign their economic model with what is probably a whole new economic era. An increase in the savings ratio, which is also likely given the increase in household incomes over the past few years as well

as the current economic uncertainty, could somewhat offset the drop in external financing and support the stability of the banking sectors.

In any case, the drop in external demand, foreign direct investment and external funding will lead to at least a temporary slowdown in the pace of economic convergence. In fact, due to the graveness of the global economic and financial market crisis, it has become increasingly likely that the differential in GDP growth vis-à-vis the Eurozone will completely disappear in 2009 and will also be much smaller in 2010 (and possibly 2011) compared with the past decade. Given that we are currently facing the worst (non-war) economic downturn of the past two generations, the mostly small and open CEE economies will not be able to separate themselves from these developments and will contract to a similar extent as well. Unfortunately, this will also include a painful increase in unemployment and add further pressure on public budgets.

GDP growth differential

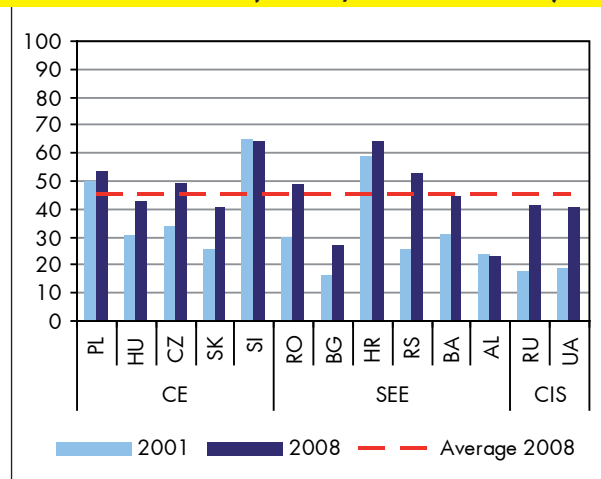


Source: wiiw, Raiffeisen RESEARCH

Some economists suggest that in order to overcome the crisis the global economy will have to enter a whole new economic era. Although we do not know yet what this could look like (energy efficiency and renewable energies might be the most obvious guess, but it could well be genetic engineering or something we have not heard from at all), what we know is that the economies in Central and Eastern Europe have to adapt to the sudden and sharp changes in the economic and financial market environment. These adjustments will lead to a further restructuring of the economies by weeding out their weakest and most uncompetitive parts. Although this may be a painful

process in the short run, it should increase the efficiency in the utilisation of production factors and, hence, boost the prospects for economic growth in a longer term perspective. Major supportive factors are the benefits from EU membership or from the prospect of becoming a member in the foreseeable future. This concerns substantial available funds from the EU budget for agriculture and regional development, in particular investments in infrastructure. There is huge potential for productivity gains in agriculture as well as to boost energy efficiency, which is still very low in many CEE countries. The prospect of EU membership also provides a crucial anchor to candidate countries with regards to economic, legal and institutional reforms.

Unit labour costs (at PPP, Austria = 100)

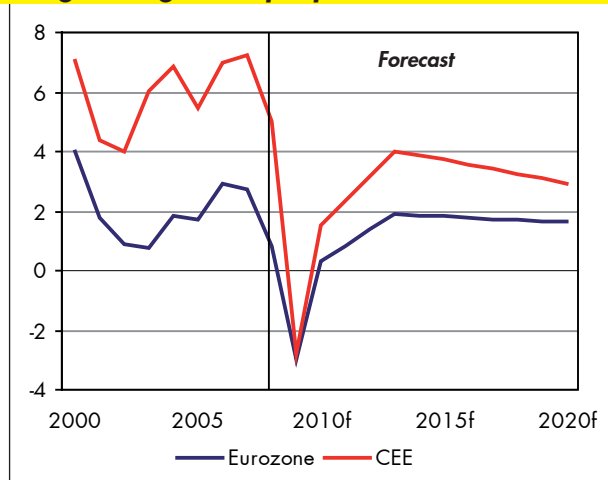


Source: wiiw, Raiffeisen RESEARCH

The CEE economies clearly remain among the most competitive production locations for the European market. Despite the strong increase over the past years, the average wages of a well-educated and motivated workforce remain far behind those in Western Europe, giving the region an advantage in unit labour costs that will put them in a favourable position when the global economy manages to crawl out of its current slump. Then, the CEE economies should achieve a sustainable growth differential between two and three percentage points on average vis-à-vis the Eurozone, which is also needed to close the gap between per capita incomes over the next decades. Although this would be less than the average growth differential we experienced over the past five years, such an assumption is also in line with the long-term growth projections from our Scenario 2020 series published in 2007/2008.

If we connect our updated medium term growth forecast up to 2010 with the projections from our Scenario 2020 series, we derive an estimate for longer term growth that appears quite reasonable in our view. When the global economy manages to recover, the CEE countries should be able to return back to what we consider potential growth levels by 2013.

Long-term growth projections



Real GDP (% yoy) and adopted estimates for potential output growth
Source: Raiffeisen RESEARCH

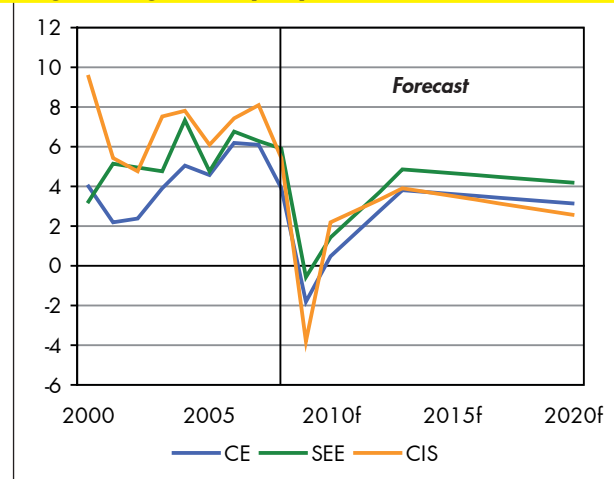
The reasons why consider the sustainable growth differential to be lower than in the past decade are an increasingly negative demographic development, fading supportive effects from EU enlargement, and the structural break in the financial sector, where loan growth will be more in line with deposit growth. In our view this is not a negative result, as the projected growth differential will allow for a sustainable convergence of per capita incomes, where the most advanced countries (Slovenia, Czech Republic) could well exceed the EU-27 average already by 2020.

Real GDP (% yoy)

Countries	2000	2001	2002	2003	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Poland	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.7	4.8	-0.8	0.0	1.3	2.6	3.9
Hungary	5.2	4.1	4.3	4.1	4.9	4.2	4.1	1.1	0.6	-5.0	-1.0	0.5	2.1	3.6
Czech Rep.	3.6	2.5	1.9	3.6	4.5	6.3	6.8	6.0	3.1	-2.6	1.3	2.1	2.9	3.7
Slovakia	1.4	3.4	4.8	4.7	5.2	6.5	8.5	10.4	6.4	0.8	3.5	3.9	4.2	4.6
Slovenia	4.1	2.7	3.5	2.7	4.4	4.0	5.7	6.8	3.5	-3.0	0.5	1.5	2.5	3.5
Croatia	2.9	4.4	5.6	5.3	3.8	4.3	4.8	5.6	2.4	-3.2	1.1	2.1	3.0	4.0
Bulgaria	5.4	4.1	4.5	5.0	6.6	6.2	6.3	6.2	6.0	-1.5	1.5	2.6	3.7	4.8
Romania	2.1	5.7	5.1	5.2	8.5	4.2	7.9	6.2	7.1	0.5	1.5	2.6	3.8	4.9
Serbia	4.5	4.8	4.2	2.5	8.4	6.2	5.7	7.1	5.4	-1.5	1.0	2.2	3.3	4.5
Russia	10.0	5.1	4.7	7.3	7.2	6.4	7.4	8.1	5.6	-3.5	2.5	3.0	3.5	3.9
Ukraine	5.9	9.2	5.2	9.6	12.1	2.6	7.3	7.9	2.1	-8.0	-1.0	0.7	2.3	4.0
Belarus	5.8	4.7	5.0	6.8	11.0	9.4	10.0	8.2	10.0	0.0	2.0	2.6	3.2	3.7
Eurozone	4.0	1.8	0.9	0.8	1.9	1.7	2.9	2.7	0.8	-3.0	0.3	0.8	1.4	1.9
Eurozone	2.1	2.3	2.3	2.1	2.1	2.2	2.2	2.1	3.3	0.3	1.3	1.9	1.9	1.9

Source: Raiffeisen RESEARCH

Regional growth projections

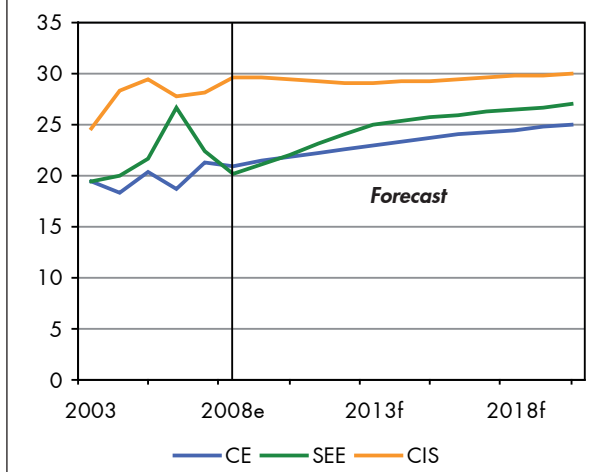


Adopted estimates for potential output growth
Source: Raiffeisen RESEARCH

In a regional comparison the differences in potential growth rates are moderate, particularly considering that they are subject to increasing uncertainty the longer we look into the future. Potential growth in SEE is higher because the differences in per capita incomes are substantially larger. Also some of the SEE countries can still benefit from the positive effects from EU enlargement, including substantial funds from the EU budget once they become full members. The difference of per capita incomes is also large for the CIS countries. However, they lack a clear institutional anchor for reform like the prospect of EU membership and are strongly commodity oriented, which is can be a disadvantage for economic modernisation. Of course a return to high oil prices would go a long way towards boosting the growth in that region at least temporarily beyond our estimates.

Coming back once again to the longer term impacts of the global economic and financial market crisis

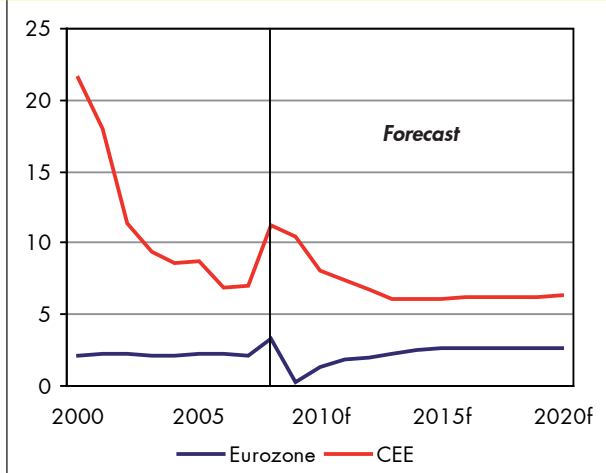
Estimated private savings ratios (% of GDP)



Source: Raiffeisen RESEARCH

we already mentioned that an increase in domestic savings will likely be a prerequisite in order to return to potential growth. Foreign savings, be it in the form of direct investment or external funding, could remain much more scarce and expensive compared with the situation pre-crisis even in a longer term perspective. Thus, we assume an increase in domestic savings between three and six percentage points of GDP for the CE and SEE countries, while it is traditionally higher for Russia thanks to its substantial energy exports and the resulting strong current account.

Long-term inflation projections

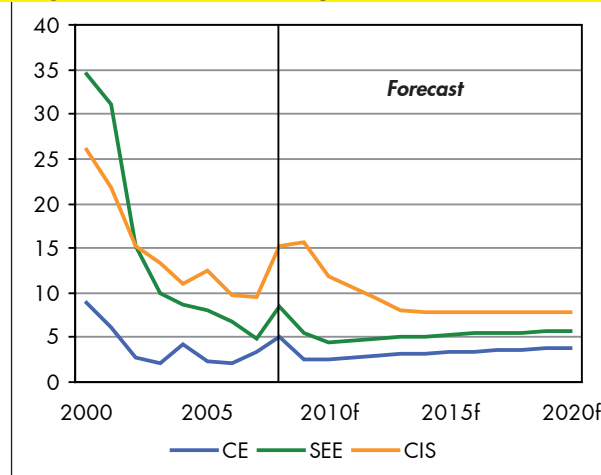


Adopted estimates for inflation
Source: Raiffeisen RESEARCH

Finally we turn to our longer term inflation projections. This has become a strongly debated subject with the US Fed having to fall back to exceptional measures of so-called quantitative easing after it had

exhausted its regular monetary policy tools. Clearly the current economic environment of a global recession is strongly disinflationary, and some developed countries including the US will experience a temporary period of deflation in 2009. For the CEE countries this will probably also result in a relatively strong decrease in average inflation until the economies manage to return to their potential growth. The impact will be strongest for the CE and SEE countries, while the CIS countries are even expected to see another rise in average inflation in 2009 due to the devaluation of their currencies that took place in late 2008/early 2009.

Regional inflation comparison



Adopted estimates for inflation
Source: Raiffeisen RESEARCH

In a longer term perspective, however, the exceptional monetary policy measures carry a substantial risk for future global inflation development. If (or rather when) the massive liquidity that is currently pumped into the global financial system (and remains stuck there for the time being) finds its way into the real economy, central banks will have to act quickly. However, particularly the US Fed is likely to be very careful in order to not quash an eventual recovery too early. Even disregarding these risks, average inflation will likely be higher in the long run as the aging European population can be expected to shift its consumption patterns towards services like healthcare and leisure, where productivity gains are more difficult to achieve. In the case of the CEE countries the average price levels remain far below that of Western Europe. Full EU integration, including the opening of the labour markets, should result in a faster convergence of price levels and, thus, inflation levels in CEE will have to remain above those in the Eurozone on average for the foreseeable future.

Walter Demel

Emerging market crises: History will teach us nothing?¹

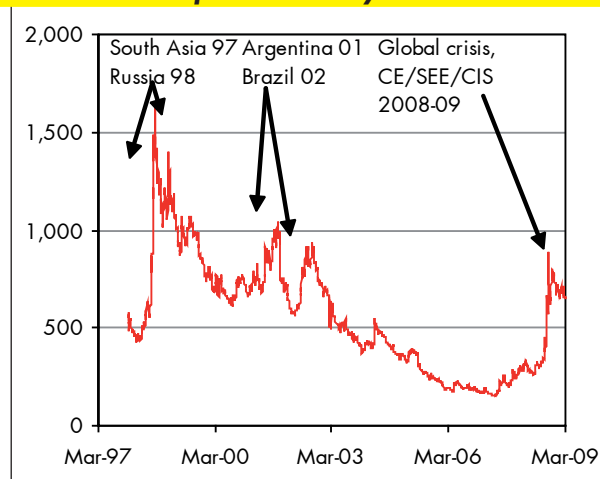
Despite our cautious optimism expressed at the beginning of Q1, the situation has worsened in CEE and CIS. The market was plagued by the problems of global credit scarcity and deteriorating outlooks for particular markets and issuers. Whereas the Eastern European segment was considered the least risky in the past, this situation has abruptly changed since mid-2008. As a matter of fact, many Eastern European countries and some CIS countries accumulated substantial external debts and imbalances and suffered a severe liquidity test once global credit stopped flowing and investors started rushing for the exits. The eruption of the global financial crisis in the developed world led to an abrupt cut in external financing, pushing the Eastern European economies into a stress situation. As is often the case, the panic selling on the market and subsequent rating downgrades across the region added fuel to an explosive mix.

During the transition years, most of the emerging market countries in the region experienced some kind of more or less severe financial crisis or speculative attack. We would like to highlight three major emerging market crises that have occurred since the mid-1990s.

In 1994–1995, the so-called “Tequila Crisis” emerged in Mexico. The cause that is most often cited is the country’s systemic current account deficit. While the fiscal situation was gradually improving before the crisis escalated, rising interest rates in the United States and political troubles triggered a sudden capital outflow, speculation against the economy and consecutive problems with the financing of the short-term government debt. A substantial depletion of foreign reserves convinced policymakers to abandon the currency peg to the US dollar. The significant depreciation of Mexican pesos led to problems in financing private-sector debt denominated in US dollars. However, unprecedented support from the IMF, the US government (the “Brady Plan”) and the BIS helped the economy to cover the financing needs and a growing external economy enabled a relatively fast recovery of the Mexican economy. However, the consequences of the crisis were significant and the contagion effect was felt deeply throughout Latin America.

Yet, in terms of regional effects and contagion, the Southeast Asian (“Asian Tigers”) financial crisis in 1997 was more significant than the Tequila Crisis.

EMBIG USD spread history



Source: Source: Thomson Financial Datastream

The roots of the Southeast Asian crisis were currency pegs that led to currency mismatches, crony capitalism or relationship lending that led to bad investments, risky portfolios, a substantial amount of short-term capital and poor supervision/regulation. The currency pegs also facilitated a loss of competitiveness and resulted in large external imbalances. A sudden reversal of capital inflows to outflows put enormous pressures on national currencies, leading to the collapse of fixed currency regimes and large devaluations. The devaluation uncovered the systemic risk stemming from unhedged FX (USD-denominated) liabilities and the balance sheets of corporations and banks deteriorated rapidly. Although the region was hit dramatically as a whole and the contagion effect ensued across the region, the impact of the crisis on particular countries differed. The average rate of the currency depreciation for the region amounted to around 45%, but while the Indonesian currency fell by more than 80%, the Philippines lost 40% and the Singaporean currency devalued by only 20%. Meanwhile, Hong Kong was able to keep its currency board despite severe attacks. Due to the acute nature of the Southeast Asian crisis, the IMF had to provide large amounts of financial support to the affected countries. Yet, the level of support and the success of the IMF programme varied from country to country. Whereas the crisis and its consequences lasted longer in Thailand and the impact was most profound in the case of Indonesia, neighbouring Malaysia and Singapore were least affected and faced only mild shocks from the crisis. The subsequent recovery was remarkably fast, but the risk aversion lasted longer, holding on until at least 1999.

¹ “History will teach us nothing” created and performed by Sting in the album “Nothing Like the Sun” (1991)

The 1998 financial crisis in Russia was yet another extremely serious financial crisis in 1990s. On the one hand, it can be seen as a part of the global emerging market crisis that started in Southeast Asia in 1997. On the other hand, the Russian crisis was homemade, resulting from poor reforms that caused a decade of stagnation, large chronic public deficits and a fixed currency regime. Huge capital outflows led to a devaluation of the Russian rouble, further worsening the government debt problem. The devaluation also put pressure on local banks that held significant shares of rouble-denominated government debt and hedged FX risks for foreign investors. The IMF agreement collapsed because of the government's unwillingness to implement fiscal saving and the government had to announce a debt moratorium on both private and public debt in the aftermath of the rouble devaluation. Russia experienced large after-shocks resulting in debt default on sovereign debt and a systemic banking crisis. The economic recovery that took about three years preceded the market recovery, which lasted four years in total. The negative impact of the Russian crisis and closer trade links also put Eastern Europe and CIS under pressure, leading to speculative attacks on their domestic currencies. There were considerable negative consequences in Kazakhstan, Ukraine, Belarus and Moldova. However, the Baltic States, which were also hit hard, managed to defend their currency boards despite a high degree of direct linkage to the Russian economy. The contagion also spread to Hungary, partially to Slovakia, and Poland but did not have the same profound consequences as in CIS.

However, in almost all of the crisis countries, the imbalances – monetary, fiscal or the private sector's savings-investment imbalance – were not of such an important magnitude to explain the virulence of the crises that followed. On the other hand, many observers agreed in their assessment that the main common element was the financial panic that took place and the self-fulfilling nature of the events that followed. Thus, the recent crises should be characterised as capital account crises (as opposed to current account crises), where balance sheet issues are central in explaining the build-up, onset and propagation of the crises. These episodes are essentially refinancing problems, concerning either public or private debt. Thus, the magnitude, maturity and currency composition of debt are crucial.²

Typically, many emerging market crises have had the following common causes:

- a) Many of the affected economies were considered star performers by market participants and international financial institutions.
- b) However, as is always the case, there were some voices that warned of forthcoming problems. Overall, many of these economies were considered fundamentally sound. Most of the crises, in fact, were not anticipated.
- c) The magnitude of these crises, both in terms of capital account reversals and GDP contractions, was much larger than expected.

Various research papers point to the two major distinctions regarding crises facing emerging markets. In the discussions on the causes of recent emerging market crises, the distinction between liquidity and solvency crises has played a major role, both among academics and policymakers. The crises in Russia, Ecuador and Argentina highlighted the fact that the run on assets could also be the result of fears of insolvency. A liquidity crisis arises because investors experience a confidence crisis, exhibit herd behaviour or because a country faces contagion from another emerging market. In this context, a liquidity crisis occurs if a solvent borrower is unable to obtain fresh funds from capital markets in order to remain current on debt servicing obligations even though this borrower has the net worth to repay the debt in the long run. The unwillingness or inability of capital markets to provide fresh loans to the illiquid but solvent borrower is the key to this matter.

On the contrary, a solvency crisis is the result of deterioration in an economy's capacity to fulfil its financial obligations. The distinction is made using debt sustainability criteria. However, these results are extremely sensitive to the assumptions made about the future behaviour of several macroeconomic variables in the country, such as its rate of growth, the evolution of commodity prices and the level of future interest rates and exchange rates. For example, if a country with a liquidity crisis is not given support, the reaction of interest rates and the exchange rate – and the possibility of social and political instability – could be such that the country is driven towards

² Per Jacobsson Lecture, Basel, Switzerland
"Recent Emerging Market Crises: What have we learned?" Guillermo Ortiz

– Governor, Banco de Mexico

insolvency. Therefore, although the analytic distinction between solvency and liquidity crises is a natural starting point to establish a classification of recent emerging market crises, its applicability to sovereign debt faces several shortcomings.

Hence, the most recent emerging market crises fall into the “multiple” category. If a country is given the opportunity to address its imbalances in an orderly way – without panic on the part of creditors – and its internal political structure allows for the implementation of the appropriate policies, the crisis will prove to be one of liquidity. However, if the panic is not addressed it can easily evolve into a solvency issue.

Another issue would be to make a distinction between the roles of government and the private sector in the creation of the crises. The main examples of situations in which public finances represented a clear source of vulnerability are found in the cases of Brazil in 1998, Russia in 1998, Argentina in 2000–2001, and Turkey in 2001. However, the story of the fiscal-driven crisis does not apply to all crises. In particular, it does not help in understanding the Mexican devaluation of December 1994 or the Asian crises of 1997–98. In those cases, public finances were mostly healthy. However, the private sectors of these countries were running high deficits and becoming highly indebted in the run-up to their external financing crises.

Another element that was present in recent balance-of-payments crises was that of contagion. As is well known, during the late 1990s there were several episodes in which a balance-of-payments crisis in one country was followed by intense pressure on the balance of payments of other countries. The clearest case of financial contagion occurred as a result of the Russian crisis in 1998. This led to a large increase in spreads for a very large number of emerging market countries. Among these were European transition economies, and in those cases there were rather extensive links to Russia.

We cannot deny the fact that the crisis in Emerging Europe has quite a few similarities to the Southeast Asian crisis of 1997–98, while there are fewer parallels with the Mexican crisis of 1994 or the Russian crisis of 1998. With regard to the present crisis, the considerable reliance of the CEE and CIS economies on the export-led growth model and external borrowing led to acute problems in terms of external financing and liquidity, a situation which is quite similar to

that experienced by the Southeast Asian countries in 1997. While most Eastern European countries are not highly indebted, the risks are dramatically skewed to short-term liquidity and refinancing as well as to currency mismatches due to the devaluations. However, unlike in the past, this time the “English patient” is the private sector, not governments. Most CEE and CIS governments have fairly low or moderate levels of indebtedness, whereas the corporate sector and banks account for the lion’s share of the respective country’s total external debt. A high number of short-term foreign claims vis-à-vis the domestic private sector and nearly absent external credit are leading to a severe liquidity shortage and putting pressure on local currencies and credit which in turn is creating a vicious cycle that is reinforcing the downward spiral.

Domestic bank credit to the private sector

	90-99	00-04	2005	2006	2007
Emerging Asia	10.0	11.4	10.1	13.0	12.9
Latin America	10.3	-0.5	18.1	26.3	21.0
CE/SEE/CIS	2.7	14.4	27.6	25.4	24.4
Central Europe	6.6	4.0	17.7	18.2	19.7
Baltic states	10.4	27.6	46.5	39.4	23.4
South East Europe	-7.8	17.6	25.7	23.8	30.9
Russia	3.7	26.0	21.9	36.1	34.9
Turkey	3.8	5.6	33.7	40.6	17.3

* Weighted average of the economies shown based on 2000 GDP and PPP exchange rates. For CEE, simple average of countries listed.

In real terms, in per cent per annum

Source: BIS, IMF, International Financial Statistics

Needless to say, in many cases the level of international reserves is fairly low, which is triggering the need for IMF assistance, as we have seen in the case of quite a few countries in the region. The problem of external financing is aggravated by economic imbalances such as high current account deficits, reflecting structural imbalances of the export growth models and triggering sharp adjustments in the national currency equilibrium and the real economy. The main outcome of such an adjustment is a period of sharp growth deceleration and economic stagnation, which often goes hand-in-hand with national currency devaluations. On the other hand, existing fiscal deficits could constrain the fiscal flexibility of local governments in the region. As a result, the anti-crisis toolbox would be fairly limited, consisting mostly of monetary policy stimulus. However, monetary policy is not the easy answer because the easing cycle itself may be counterproductive and can come at the cost of the weakening of national currencies. Apparently, many CEE countries and Ukraine are facing exactly this

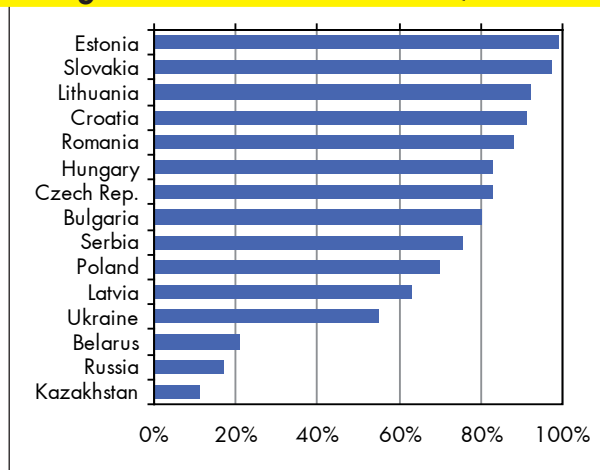
type of dilemma in which national governments cannot respond effectively to the challenges and have to delegate this work to monetary authorities who have to take care in striking a delicate balance between providing the much needed stimulus without triggering unwanted effects.

However, there are a few distinct features that will likely boost CEE's resistance to the current crisis. First of all, with the exception of the three Baltic countries and Bulgaria (along with Bosnia and Herzegovina), the CEE countries have fairly flexible currency exchange regimes. Certain questions might arise in Croatia, where the national bank maintains an informal peg to the euro. However, in most cases the systems are fairly flexible, giving them a greater capacity to absorb shocks. We are already witnessing a fairly quick reduction of current account deficits in a few countries as a result of flexible currencies.

Second, most CEE and CIS countries are not heavily indebted, as their public and external debts do not exceed the conventional thresholds of 50–60% of GDP. In fact, most CEE countries have fairly low public debts by comparison, while external debt problems are concentrated in the private sector. Nevertheless, there is a certain risk to the sustainability, as the devaluations of national currencies could also worsen these ratios in some countries. Whereas most countries are experiencing liquidity constraints stemming from abrupt capital withdrawals, very few countries, Ukraine being one of them, are also experiencing a type of sustainability crisis because of the low level of international reserves and large currency mismatch being triggered by huge currency devaluation.

Third, and this is perhaps the most important factor, national banking systems in many CEE countries are stable thanks to the large presence of foreign banks that ensures a good level of capitalisation and better risk management as opposed to the systems dominated mainly by local banks. Banks across CEE excluding CIS today are far better capitalised and managed in comparison to the Southeast Asian banks back in 1997. In this context, foreign ownership of banks serves as a kind of insurance policy against systemic banking crises. Incidentally, foreign banks operating in CEE will likely act in a way similar to the lenders of last resort because of the strong links to their parent banks. Indeed, foreign banks receiving capital from parent banks and benefiting from stimulus packages and capital injections from their own governments will continue to operate in CEE.

Foreign banks dominance in CEE/SEE



Share of foreign banks in domestic banks' capital
Source: BIS, National banks, Raiffeisen RESEARCH

And the fact that the IMF is actively surveying the lending plans of foreign banks with large CEE networks only confirms this conclusion. In this regard, the dominance of foreign banks in CEE is an undisputable advantage.

Fourth, we expect capital mitigating inflows from established FDI and foreign banks, who will continue their operations in CEE, although the inflows will be on a smaller scale due to the crisis in the developed world and the EU. Furthermore, if one looks at short-term external debt across CEE, intercompany loans and cross-boarder lending of foreign banks to their subsidiaries can perhaps be excluded. Implicitly, such a situation across many CEE countries would likely dampen severity of the payment liquidity crisis to some extent. In some countries, where foreign banks control 70–90% of national banking systems, the volume of short-term external debt among banks is often significant, leading us to assume that these debts will indeed be the debts of foreign banks present in these countries.

In addition, many CEE countries are fairly well prepared economically and structurally. Aside from a few Southeastern European countries, most CEE countries have managed to implement deep structural reforms and boost transparency and management levels. Their economies are also much more diversified today compared to ten years ago. However, close ties to the EU in terms of export orientation could also exert some dampening pressure on the economies in the region. That being said, there is no single country that would be exposed to a single commodity or good, unlike Russia or Ukraine, where the economies

are far less diversified and exports solely depend on raw material prices. Finally, we believe the IMF and EU membership are of paramount importance. There is a clear commitment from the EU and the rest of the developed world through the IMF, and the recent decision to double the IMF's loanable funds to USD 500 bn is a step in this direction. The swiftness of the IMF's response to requests from countries has also been unprecedented. Hungary, Latvia and later Romania were all able to conclude their respective deals in a very expedient manner. Furthermore, the EU maintains its own emergency funds, which it is willing to make available to EU member countries from CEE that are experiencing distress, as seen in the cases of Hungary and Latvia. Certainly, many governments in CEE are also demonstrating a great deal of willingness for fiscal adjustment, something the Southeast Asian governments were less willing to do back in 1997. Monetary stimulus in the form of rate cuts is better founded in the case of CEE in comparison to other historical emerging market crises.

With regard to possible outcomes, we do not believe that any CEE or CIS country will escape the economic decline and, in many cases, it is possible to talk about hard landings. Nevertheless, we believe that, with the exception of Ukraine and Latvia, most CEE countries including Russia are facing the risk of a liquidity crisis rather than the risk of a sustainability crisis. However, the question remains

open for Bulgaria and Croatia. We believe that most CEE countries will face substantial economic decline, which should facilitate a quick correction of external imbalances.

The IMF loans will be instrumental in bridging the remaining gaps, while a portion of external short-term debt will be refinanced by foreign banks and companies operating in CEE. However, the danger of a prolonged crisis and a stoppage of private capital inflows for a longer period of time could result in more severe liquidity constraints, which could also trigger sustainability issues. Yet, we do not believe that such a scenario will materialise. Once the panic on the market declines, private capital will return to the market and the real economy sector can likely count on an early resumption of capital inflows. We have to highlight that speculative portfolio flows are not too high in many of the CEE countries. Last but not the least, we assume that rating downgrades in many CEE countries (excluding the Baltic States and a few countries in Southeastern Europe) are reflecting the situation for the most part. Hence, the pace of rating downgrades is likely to moderate somewhat and the outlook for the region could change from negative to stable in the next 12-18 months.

Gintaras Shlizhyus, Michal Brozka

Sovereign EM market debt restructuring precedents

Deal year	Country	PDI recognition	Haircut as % of notional*	GDP per capita, USD
1990	Mexico	-	35%	3,160
1990	Venezuela	-	30%	2,500
1993	Jordan	Yes	35%	1,100
1994	Poland	Yes	45%	2,600
1994	Gabon	Yes	0%	4,120
1994	Argentina	Yes	35%	7,500
1994	Brazil	Yes	35%	3,550
1994	Ecuador	Yes	45%	1,480
1995	Bulgaria	Yes	50%	1,150
1996	Panama	Yes	45%	3,000
1996	Peru	Yes	45%	2,330
1999	Pakistan	-	0%	475
2000	Ukraine	-	0%	825
2000	Russia	Yes	38%	1,790
2001	Ecuador	Yes	40%	1,100
2003	Uruguay	-	0%	3,150
2004	Argentina	No*	63%	3,500

* Haircut is expressed as a percentage of Nominal (Face) Value of Old Debt; Argentina conceded to recognize only little PDI which accrued till the end of December 2001. This attitude amounts to a de-facto refusal to recognize PDI with the exception of tiny amount accrued till the end-2001.

Argentina per capita GDP stands in the upper range for the precedents given here while Argentina requests maximum debt write-off which does not merit its economic situation.

Source: Rating agencies, IMF

Emerging market crises: selective retrospective

Country/ Region	Date	Event	Symptoms	Trigger/causes	Consequences
Western Europe	ERM crisis 1992-1993	Succeeding attacks on several currencies in West Europe	Currency misalignment, higher interest rates in Germany	A 'No'-vote on referendum about Maastricht treaty	Substantial devaluations and widening of the ERM band
Mexico	1994-1995	Currency crisis, Banking crisis	Current account deficit and overvalued currency, large external borrowings in private sector	Rising interest rates in USA, domestic political turmoil, capital flight	Large devaluation, banks' recapitalization, help from IMF, fast recovery
South East Asia	1997	Twin deficit crisis, a threat of debt crisis	Bad regulation, loss of competitiveness, large external disbalance	Capital flight and wrong policy response	Large devaluations, help from IMF, fast recovery
CE/SEE/CIS					
Albania	1992 -1994	Banking crisis	Fast growth of nonperforming loans, bad governance	Prevailing problems from Yugoslavian conflict	
	1997	Political crisis Currency crisis	Continuation of problems, explosion of financial "pyramids"		Recession, high inflation
Belarus	1995, 1998	Banking troubles, forced mergers and nationalisation	Nonperforming loans Poorly capitalized banking system		
Bosnia and Hercegovina	1992 -	Banking crisis	Nonperforming loans	Civil war	
Bulgaria	1996-1997	Twin deficit crisis	Nonperforming loans	Liquidity problems, Bank run, a 'NO' to bailouts from the government	Introduction of currency board, Recapitalization of viable banks
Croatia	1996-1998	Banking crisis	Failure of many banks, poorly capitalized banking system	Weakness of the banking sector and poor sector regulation	Help from the National bank and Banking Rehabilitation agency
Czech Rep.	1996	Failures of many small banks – banking crisis	Crony capitalism, nonperforming loans	Rising external imbalances, banking sector weakness	Bank restructuring program
	May-97	Attack on the currency	Overheated economy, bad loans, current account deficit	External imbalances, currency overvaluation	Currency peg abandoned
Estonia	1994, 1998 -1999	Banking crisis	Poorly capitalized banking system, poor regulation	contagion from Russia, high risk exposure	Financial losses, banks restructuring, bankruptcies
Latvia	1995 - 1998	Banking crisis	Failure of many banks, poorly capitalized banking system, poor regulation	contagion from Russia, high risk exposure	Financial losses, banks restructuring, bankruptcies
Lithuania	1995-1996 1999	Banking crisis	Failure of many banks, poorly capitalized banking system, poor regulation	contagion from Russia, high risk exposure	Financial losses, banks restructuring, bankruptcies
Hungary	1994-1995	Currency crisis, Banks' failures	Twin deficits, external debt, overheating economy	Contagion from Mexican "Tequila crisis"	Devaluation, introduction of crawling currency peg, stabilization package
	1998	National currency devaluation		Contagion from Russian crisis	
	2003	Speculative pressure on domestic currency	Decreasing government credibility, low fiscal discipline, efforts to keep too strong forint	Fiscal imbalances, rising twin deficits	Devaluation, Fiscal deficit cutting measures
Macedonia	1993- 1995	Banking crisis	High share of nonperforming loans		Banks' closures, overtaking of foreign currency liabilities by the government
Poland	1998, 1999	Increased speculative pressure on zloty	Overheating and negative effect of the Russian crisis		
Romania	1998, 1999, 2000	Banking troubles	Nonperforming loans		
Russia	1998	Currency, banking and debt crisis	Overvaluation of the ruble, high systemic budget deficit, high government debt	Decline of commodity prices, capital flight,	Large devaluation, corporate and bank bankruptcies, Debt restructuring
			Insolvent banks	Breach of the IMF agreement	
Slovakia	1997	Speculative pressure on currency,	Rising foreign debt and twin deficits	Political instability, contagion from Czech crisis 1997, and Russian crisis 1998	Devaluation,
	1998	Banking crisis	Nonperforming loans		Bank restructuring program
Turkey	1994 2000	Banks' failures Banking and currency crisis	Overvaluation of currency, poorly capitalized banking system	Currency misalignment, very high public deficits, high domestic short-term debt of the government	Devaluation, 19 private banks were taken over by the state's Savings Deposit Insurance Fund, banking sector restructuring
Ukraine	1997-1998	Banking crisis	Currency misalignment, high public deficits, bad loans	Contagion from Russia, liquidity problems, fiscal deficits	Devaluation, debt restructuring

Source: IMF, WB, Rating agencies

Rated sovereigns: history - foreign currency debt in default, 1824-2004

Issuer	Foreign Currency Bond Debt (years)	Foreign Currency Bank Debt (years)
Argentina	1828-57, 1890-93, 1989, 2001-04	1982-93,2001-04
Austria	1868-70, 1914-15, 1932-33, 1938, 1940-52	
Bolivia	1875-79, 1931-48, 1989-97	1980-84,86-93
Brazil	1826-29, 1898-1901, 1902-10, 1914-19, 1931-33, 1937-43	1983-94
Bulgaria	1916-20, 1932	1990-94
Burkina Faso		1983-96
Cameroon		1985-2003
Chile	1826-42, 1880-83, 1931-47	1983-90
China	1921-36, 1939-49	
Colombia	1826-45, 1850-61, 1873, 1880-96, 1900-04, 1932-34, 1935-44	
Cook Islands		1995-97
Costa Rica	1828-40, 1874-85, 1895-97, 1901-11, 1932-52, 1962, 1984-85	1981,83-90
Croatia		1992-96
Czech Republic*	1938-46, 1959-60	
Dominican Republic	1872-88, 1892-93, 1897, 1899-1907, 1931-34	1982-94
Ecuador	1826-55,1868-90,1894-98,1906-08,1909-11,1914-24,1929-54,1999-2000	1982-95
Egypt	1876-80	
El Salvador	1828-60, 1898, 1921-22, 1932-35, 1938-46	
Germany	1932-38, 1939-53	
Ghana		1987
Greece	1826-78, 1894-97, 1932-64	
Guatemala	1828-56,1876-88,1894,1899-1913,1933-36,1989	
Hungary	1932-37, 1941-67	
Indonesia		1998-99, 2000, 02
Italy	1940-46	
Jamaica		1978-79,81-85,87-93
Japan	1942-52	
Jordan		1989-93
Macedonia		1992-97
Madagascar		1981-2002
Mexico	1828-30, 1833-41, 1844-50, 1854-64, 1866-85, 1914-22, 1928-42	1982-90
Morocco	1903-04	1983,86-90
Mozambique		1980,83-92
Pakistan	1999	1998-99
Panama	1932-46, 1987-94	1983-96
Paraguay	1874-85, 1892-95, 1920-24, 1932-44, 2003-04	1986-92
Peru	1826-48, 1876-89, 1931-51	1976,78,80,84-97
Philippines		1983-92
Poland	1936-37, 1940-52	1981-94
Portugal	1837-41, 1850-56, 1892-1901	
Romania	1933-58	1981-83,86
Russia/USSR	1918,1998-2000	1991-97
Senegal		1981-85,90,92-96
Slovenia		1992-96
South Africa		1985-87,89,93
Spain	1824-34, 1837-67, 1827-82	
Trinidad & Tobago		1988-89
Tunisia	1867-70	
Turkey/Otto. Empire	1876-81, 1915-28, 1931-32, 1940-43	1978-79,82
Ukraine	1998-2000	
Uruguay	1876-78, 1891, 1915-21, 1933-38, 2003	1983-85,87,90-91
Venezuela	1826-40, 1848-59, 1860-62, 1865-81, 1892, 1898-1905, 1995-97	1983-88,90
Vietnam		1985-98

* Former Czechoslovakia

Sources: Standard & Poors and Debt Cycles in the World Economy, Westview Press



After recession follows stagnation

USA

Current **economic data** from the USA is **inevitably extremely weak** and befits the deepest recession since at least 1982. We expect this **severe recession to continue** with strongly negative GDP growth **in the first six months of 2009**. By contrast, the **early leading economic indicators** (e.g. the ISM business surveys) have recently **recovered somewhat**, which fits in nicely with our original forecast of the leading indicators bottoming out and stabilising in the first quarter.

Economic forecasts

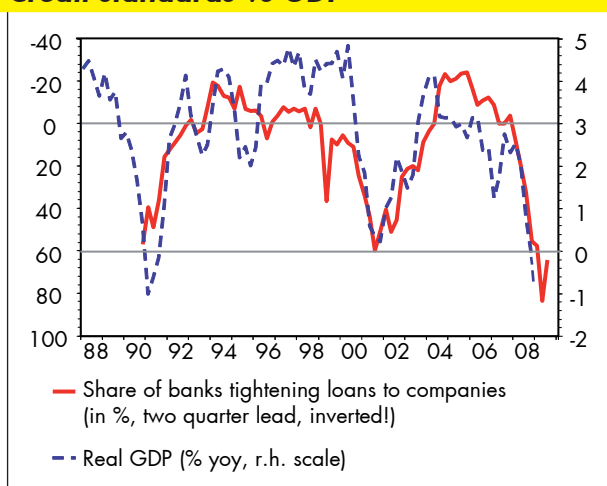
	2007	2008	2009e	2010f
GDP (% yoy)	2.0	1.1	-3.0	0.9
CPI (% yoy)	2.9	3.8	-0.5	2.6
Core inflation (% yoy)	2.3	2.3	1.3	1.3
Current account*	-5.3	-4.7	-3.5	-3.7
Ø EUR/USD	1.37	1.47	1.42	1.45

* in % of GDP

Source: Thomson Financial Datastream, Raiffeisen RESEARCH

These encouraging signals are all the more important as there are also some fundamental reasons for betting on a **stabilisation of US economic activity in the second half of 2009**, followed by **weak GDP growth in 2010, once again in positive territory**. Inflation will soon slide **below zero** and by the middle of the year may even fall way past -2% yoy.

Credit standards vs GDP



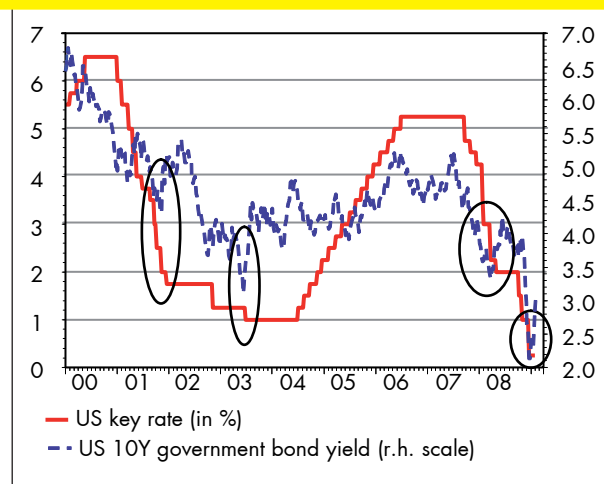
Source: Thomson Financial Datastream, Raiffeisen RESEARCH

In line with the consensus the **US Federal Reserve** decided at its rate-setting meeting on 28 January to keep the **US key interest rate at less than 25 basis**

points (between 0 and 25bp). In a very aggressive response to the crisis the US Fed has already cut its key rate to below 25 bp, and is increasing the monetary base very rapidly by employing all means of quantitative easing. So far this comprises planned direct purchases by the Fed of USD 1250 bn MBS, USD 200 bn agency bonds, USD 300 bn government bonds, and USD 1000 bn of ABS refinancing. All in all the balance sheet of the Fed, which has already almost doubled to USD 2000 bn since the Lehman default, is on course to double again until year-end. Consequently, there is still no end in sight to the lax monetary policy! **Interest hikes will become an issue again in the latter months of 2010 at the earliest**. On the **US government bond market** the steep price rally in the second six months of 2008 has been replaced by a volatile phase of sideward movements (yields bottoming out), with the **risk of falling bond prices dominating in the longer term**.

Valentin Hofstätter

Interest rates at record low



Source: Thomson Financial Datastream, Raiffeisen RESEARCH

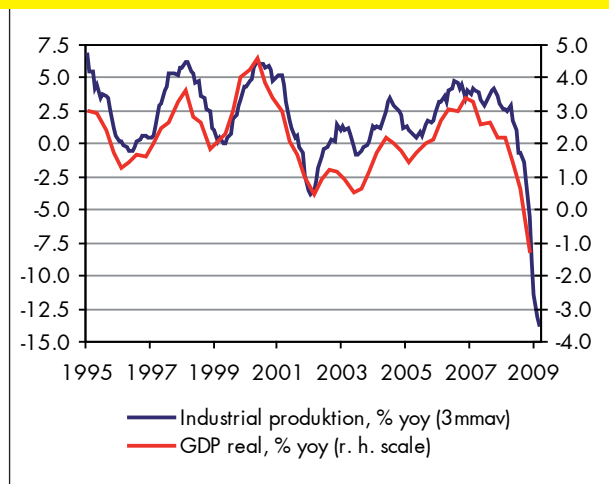
Euro area

Economic recovery – no more than hope

As feared, GDP data for the euro area turned out particularly weak at the end of 2008. The economy appeared to have slammed the brakes on, which was attributable to sharp declines in industrial output as well as in investment and export demand. If we take a look at the big fives, the overall downturns in Germany (-2.1% p.q.) and Italy (-1.8% p.q.) really stand out, France (-1.2% p.q.), Spain (-1.0% p.q.) and the Netherlands (-0.9% p.q.) reported less declines than euro zones' average (-1.5% p.q.). Moreover, widely

watched leading indicators like the Ifo index or PMIs are at record lows and have still not bottomed out. Hence, the severe recession will continue in H1 2009 and a lot bad news is still to come. Reports of short-term work, layoffs and rising unemployment rates are set to increase in frequency in the coming months. Germany, for example, is registering a record high in employment, despite the severe recession – a situation that is hardly sustainable.

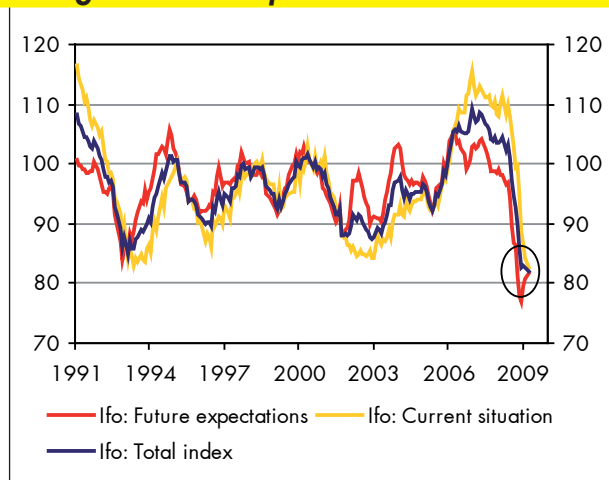
Severe recession in the Euro area



Source: Thomson Financial Datastream

Nevertheless, looking at the details of the latest news, there are some emerging signs of stabilisation. For example, the latest declines in leading indicators were caused by deterioration of the current situation. By contrast, the assessment of the future outlook has started to improve. This is the kind of pattern one expects to see preceding a change in the trend.

First glimmer of hopes

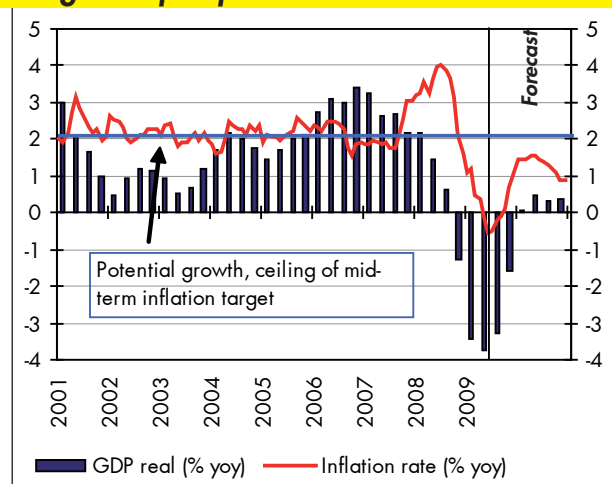


Source: Thomson Financial Datastream

Surveys and sub-components of leading indicators that look ahead further into the future are moving higher, while the part of the survey that deals with the current situation is dragging down the overall index.

True, the assessment of a turnaround in economic activity is only based on hopes, and the extent and timing of a rebound can only be roughly estimated. At any rate, we think that the monetary policy and fiscal measures will begin to take effect in the second half of the year and lead to a stabilisation in economic activity. But it remains to be seen, however, whether this will pave the way to substantial increases in production activity in 2010. We remain cautious as downturns in combination with financial crises have proven not to be only more severe (as we can feel now) but also to last longer. A period of falling credit growth due to the financials limited ability or willingness to lend leads to a process of deleveraging which in turn will put a lid on economic growth. We hence forecast a more or less stagnant economy for 2010 – with signs of normalisation late in the year.

Long term perspectives subdued



Source: Thomson Financial Datastream

The economic and financial environment is strongly deflationary. In addition, latest commodity price developments will lead to a steep fall in inflation rates in the months ahead; we expect values below 0% yoy by mid year. Accordingly the ECB should find enough arguments for even more key rate cuts and ongoing measures to fight financial stress. We forecast the key rate cycle to bottom out at 1% in the second quarter and remain at these all-time lows on a one year horizon.

Gottfried Steindl

Commodities

higher prices in the long-term

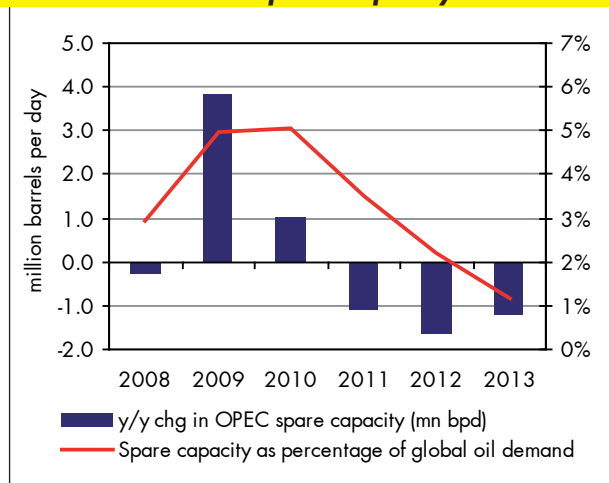
Oil market

We currently expect that 2010 will be the last year of significant output increases for the non-OPEC countries. But as global demand should be growing again in any case by the middle of 2010, and as the growth rate should be approaching 1.5% starting in 2011 (especially because of strong demand from the emerging countries including China and India), we think the chances are good that the oil price will reach significantly higher levels by no later than 2010. The fact that a number of projects may well be put on ice because of the hefty oil price drop and the fact that the extraction rate at the fields currently in operation is falling more rapidly on average than originally assumed, this situation is only going to worsen. While roughly 26 mn bpd in additional capacity will be coming onto the market worldwide by 2013 (not accounting for the potential and certain postponement of projects because of the current oil price decline), the market will lose nearly 25 mn bpd by then according to current estimates (assuming a 4.8% output decrease at the existing fields). The difference of 1 mn bpd would only allow oil demand to grow by not even 0.6% per year for 2010-2013, and this is considerably below the historical medium- and long-term average. In our opinion, the only way to compensate for this insufficient supply is through a higher oil price.

We are expecting a long-term oil price of at least USD 80-90 per barrel of Brent.

Hannes Loacker

Forecast of OPEC spare capacity



Source: IEA, Medium term outlook, Juni 2008, Raiffeisen RESEARCH

Industrial metals market

The situation remains tense for industrial metals in light of the persistently gloomy economic prospects. Weak demand in the sector is especially reflected in the drastic increase in LME Warehouse Stocks. Furthermore, a race is still underway between falling demand and capacity cutbacks for industrial metals. Although producers have already started to react to this situation, additional dramatic cutbacks will be necessary in order to prevent supply surpluses in 2009. The current price levels for industrial metals, which are making the majority of producers unprofitable, also suggest that we will see additional production cutbacks. Therefore, high warehouse stocks could also be accompanied by further price decreases in the short term.

However, we believe the long-term situation will be quite different. The economic slump has not only led to considerable losses in profit and turnover for producers, but has also resulted in a much more restrictive financing environment. As a result, companies do not want to put unnecessary strains on their liquidity and have therefore made significant cuts in their investment budgets. On one hand, this has caused delays in the modernisation of existing plants, which will likely result in decreased mining efficiency. On the other, it has caused delays in the development of new projects. Although this will not have any positive effect in the short term, the mining companies' supply pipeline will become significantly weaker in the long term and will not be sufficiently equipped to deal with a sustained recovery in demand. Bearing all of these factors in mind, we expect to see considerably higher prices for industrial metals in the long term.

Johannes Mattner

Commodities forecasts

Yearly	2009e	2010f	2011f	2012f
Oil				
Brent	54	70	92	95
WTI	54	71	93	96
Metals*				
Aluminium	1,700	2,000	2,480	2,469
Copper	3,737	4,519	5,178	5,952
Nickel	10,850	12,309	13,859	14,771
Zinc	1,170	1,513	1,981	2,161

* consensus forecasts

Source: Bloomberg, Raiffeisen RESEARCH

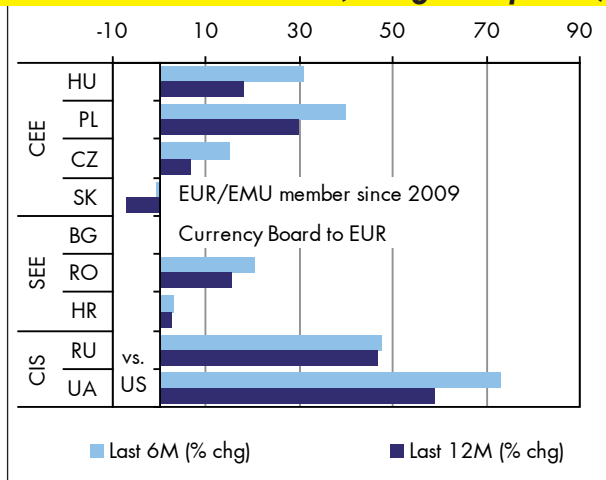
It's the money, stupid!¹

Or, where have all the creditors gone?

EMU: Ins, outs, and super-outs

The CEE region is highly differentiated in many respects. Monetary and fiscal affairs are no exception. There are substantial differences in public sector indebtedness and the extent of borrowing requirements, the structure and sustainability of the balance of payments, monetary policy arrangements and exchange rate regimes, the resistance of economies and currencies against external shocks and the depth of financial markets and the robustness of the financial sectors.

Local currencies' trends (% chg over period)



* minus = appreciation, Russia and Ukraine currencies vs USD, other vs EUR
Source: Reuters, Raiffeisen RESEARCH

Bulgaria, Croatia, the Czech Republic, Hungary, and Slovakia all have small open economies. Poland and Romania have somewhat bigger economies and their internal markets play a slightly bigger role in their economic structure but the difference compared to the smaller countries mentioned above is not crucial. Russia and the Ukraine, on the other hand, have large economies with large internal markets that are dependent on the export of fuel, raw materials, and low-value-added manufactured products such as iron and steel. In the turbulent times of today, a key factor for a small open economy is the stability of its currency. Therefore, Slovakia, a new addition to the Eurozone in January (or one of the "ins", to use the "Eurospeak" heard in Brussels), has a fundamental competitive advantage over its counterparts: the euro has given Slovakia a stable currency and increased its credibility in the eyes of investors and traders.

¹ According to Wikipedia, "It's the economy, stupid" is a phrase in American politics that was widely used during Bill Clinton's successful 1992 presidential campaign. The phrase is often referenced in American political culture, usually starting with the word "it's" and with a different word sometimes being used in place of "economy".

Another sub-group in CEE are the "outs", i.e. EU member states not yet participating in the third phase of the EMU that plan to introduce the euro in the more or less foreseeable future (some of these countries have recently announced their desire to accelerate the entry process, but these wishes are hardly realistic now). This sub-group can also be broken down further: there are the three Central European countries, the Czech Republic, Hungary, and Poland, which are already more advanced in terms of the degree of adoption of European legislation and integration with the "old" EU member states after five years of EU membership and long preparatory periods prior to entry, and the two Balkan member states, Bulgaria and Romania, which are not as far along in the integration process. However, they would still receive the support of the Union in case of acute financial distress. While the situation for the future member Croatia is more vulnerable than that of the existing EU members, the country can still at least partially rely on possible EU aid. In contrast, the situation for Russia and Ukraine is completely different. As large countries that are not part of the EU, they certainly will not enjoy any shelter from the EU's shield of protection. Together with other relevant matters related to economic stability, these differences are clearly reflected on the financial markets: While the Czech koruna has lost less than 10% of its value against the euro over the last six months, the Romanian leu has lost almost 19%, the Russian rouble and Hungarian forint about 25% each, the Polish zloty almost 35%, and the Ukrainian hryvnia 40%.

On the importance of public sector borrowing requirements

The currency losses are certainly not the only way in which the markets are reflecting the situations of individual countries. Similar differentiation can be seen in bond yield spreads and credit default swaps. The characteristics of individual CEE countries certainly differ when it comes to their fiscal positions as well. These characteristics are now particularly important because they limit the capacities of governments to cope with the recession through appropriate fiscal easing.

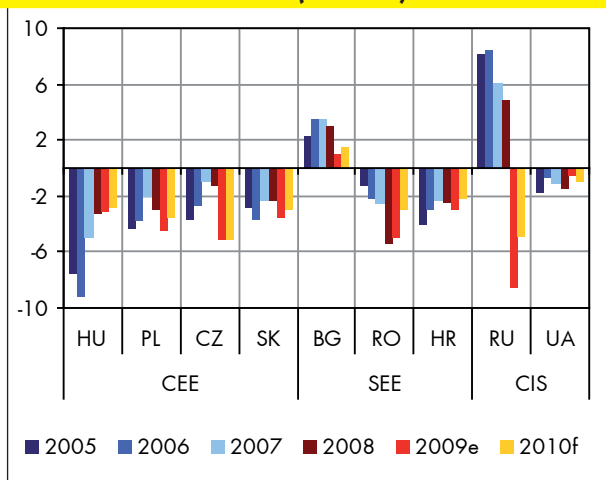
Fiscal deficit is the most frequently observed fiscal parameter. However, in these times of global financial crisis, the level of public sector indebtedness may be more important.

With regard to fiscal deficit, most CEE countries run little if any deficit. Hungary is the only country that

has had severe fiscal deficit problems in recent years as a result of irresponsible populist behaviour on the part of its earlier governments. The country's fiscal deficit peaked in 2006 at 9.3% of GDP; this was followed by a badly needed fiscal austerity programme. The cuts in public expenditures caused a home-made recession in Hungary; unfortunately, the 2008 global recession hit a Hungarian economy that was already squeezed by a decline in aggregate demand. However, the fiscal deficits shrank in 2007 and 2008 and Hungary's fiscal balance was already below 4% in 2008, i.e. close to the Maastricht threshold of 3%. Nevertheless, Hungary's initial fiscal situation at the outset of the global financial crisis and recession was significantly worse than the fiscal situations of its regional peers.

With regard to the other CEE countries being discussed here, Croatia, the Czech Republic, Poland, Slovakia, Romania, and Ukraine had been running moderate fiscal deficits in previous years, roughly in line with the Maastricht threshold. Bulgaria and Russia had fiscal surpluses (Russia a large one, which makes sense in times of skyrocketing oil and gas prices). All-in-all, the entire CEE region was relatively prudent in terms of fiscal policy in the years preceding the crisis and the fiscal deficits were acceptable in light of the rapid economic growth being experienced there. Hungary was the only exception confirming the rule and reminding us that fiscal easing should never be exaggerated, not even in good times.

Public fiscal balance (% GDP)



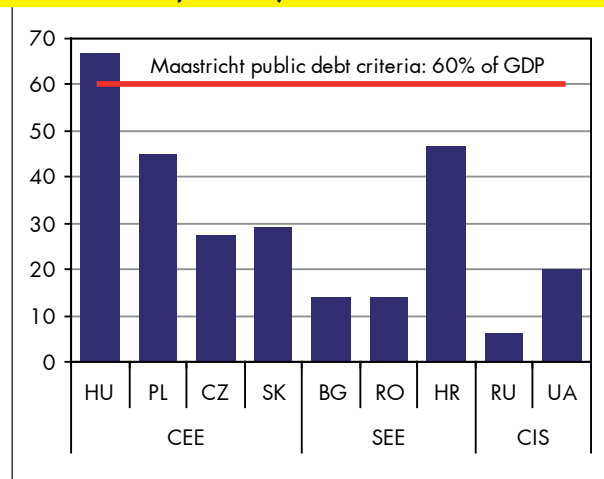
Source: Eurostat, Thomson Financial Datastream, Raiffeisen RESEARCH

The picture of indebtedness among CEE governments is less rosy. Hungary's public debt exceeded 65% of

GDP (it had been growing aggressively since 2001 due to lax fiscal policies), and Poland's public debt is above 45% of GDP. Croatia has a similar level of public sector indebtedness. The Czech Republic and Slovakia each have public debt amounting to just below 30% of GDP. The other countries have much smaller public debt ratios: Public debt is significantly below 20% of GDP in Bulgaria, Romania and Ukraine, and Russia's public debt is negligible. Particularly for the less advanced countries with small public debt ratios, the fiscal situation at the beginning of the global financial crisis was not bad. However, the problem with financial crises is that the level of public indebtedness can easily skyrocket. The possible failure of the financial sector, which must be covered by the government, may increase the level of public indebtedness by double-digit figures, as demonstrated by the recent events in Iceland and Ireland.

The fiscal flexibility of the country, i.e. the capacity which the government has to deliver an anti-recession fiscal stimulus package, is an important issue. Countries with low deficits and low public debt can obviously afford bigger supplementary public spending or bigger tax cuts. However, the question is the depth of the economic slump. If GDP declines by 3% yoy or more, the fiscal balance of almost any country suddenly worsens significantly, shifting by several percentage points of GDP. The fiscal stimulus of 2% of GDP – the level agreed to within the EU – is therefore the maximum that most CEE countries can afford. In any case, we should expect significant deterioration of public finances across the CEE region – similar to in the Eurozone, the United States and many other economies worldwide, both large and small.

Public debt (% GDP)

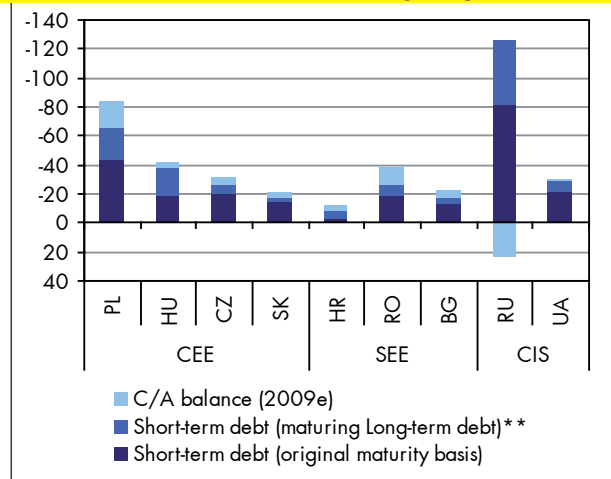


Source: Thomson Financial Datastream

So far, a few countries – the Czech Republic, Poland, Slovakia, and to a lesser extent also Bulgaria and perhaps Croatia (here the government’s plan is still in the preparation phase) – have come up with EU-style fiscal stimulus packages, which have typically been rather modest in size. Tax cuts prevail over additional expenditures, and guarantees for companies endangered by a risk of secondary payment insolvency in order to make them creditworthy for the banking sector are also playing an important role. Some countries – specifically Hungary, Romania, and Ukraine – have had to ask for IMF stabilization loans and now have to vigorously cut their public expenditures to fulfil IMF loan criteria, putting any fiscal stimulus to the real economy out of reach. Russia is a special case: The country’s banking sector suffered similarly to that of the United States, and the government and central bank supported banks by providing vast amounts of refinancing and recapitalization in order to prevent the systemic crisis in the Russian banking sector from becoming fully pronounced. In addition to the rescue of the banking system – combined with the preferential treatment of banks with state interest – the government prepared a generous rescue plan for the 300 largest Russian corporations that resembles plans seen in the early 1990 in the transition economies. The package fully ignores market conformity for the state aid and competition rules. The operation and ownership of Russian businesses after the financial crisis and recession will likely be much different than it is today, with the government and related interest groups playing a much larger role.

The biggest problem for some CEE governments – more important than the level of fiscal deficit or the extent of public debt – is the actual level and structure of the public sector borrowing requirements. In this time of global liquidity crisis, it may be difficult for some borrowers to attract any private financing, even very small sums. The level of indebtedness of the country might be irrelevant at the moment. This is an issue that some CEE countries have had to cope with recently, and no government in the world is exempt from such risks at this point. With regard to the structure of the borrowing requirements, the key issue is the extent to which the government is dependent on foreign credit. Countries with strong domestic lending activities, i.e. with strong financial institutions eager to absorb local currency bonds (e.g. the Czech Republic, where the foreign portion of the total public debt amounts to only about 25%) are much better off. And being a Eurozone “in” like Slovakia is a certainly a significant supportive factor.

Short-term external financing requirement*

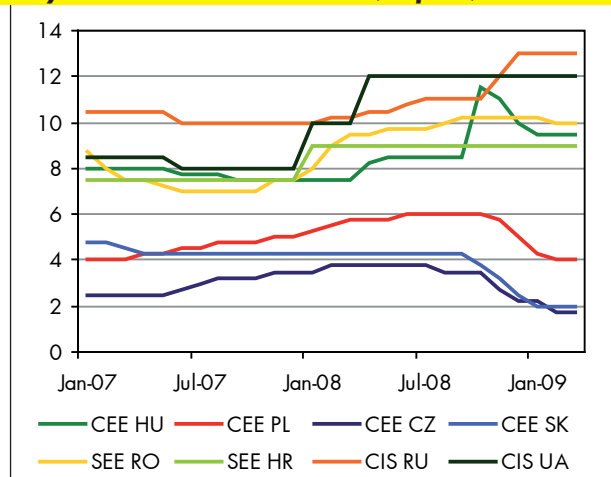


* in EUR bn
 ** assumption of 15% of long term debt due in 12 month for all countries
 Source: IMF, National banks, Raiffeisen RESEARCH

Monetary policy and currency sustainability

The monetary policy in times of recession could turn out to be a difficult and tricky issue. A severe recession usually calls for lowering interest rates in order to ease monetary conditions and support the real economy by making financing more affordable. This could be especially important in case there is a need for simultaneous fiscal tightening. However, currency depreciation could easily emerge at the same time, in which case monetary policy would likely shift to focusing on the support of the national currency – i.e. raising interest rates in order to increase the interest rate differential against the benchmark currency. This may be particularly desirable in the case of an immediate risk of a currency crisis.

Key interest rates - trends (% p.a.)

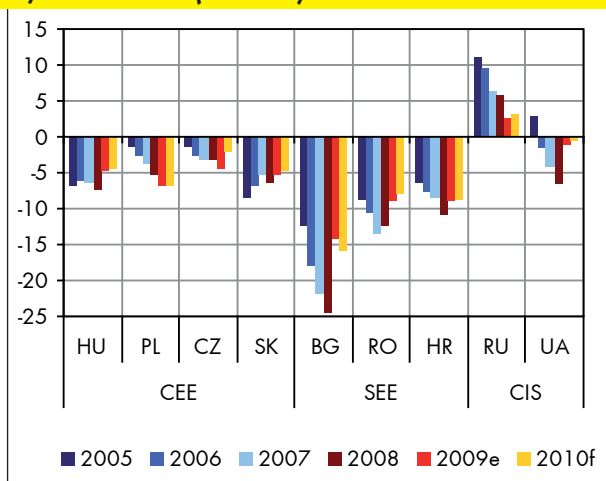


Source: Thomson Financial Datastream, National Banks

However, such policies naturally tighten monetary conditions and could have strong pro-cyclical downward-heading side effects.

This instant dilemma is currently being resolved by the central banks in practically all of the CEE countries, with flexible exchange rates being implemented to varying degrees. From the countries being reported on, this applies for the Czech Republic, Croatia, Hungary, Poland, Romania, Ukraine, and Russia. The central banks in these countries have been more inclined to hike than to cut their policy rates recently, and when they have decided to enter into rate cutting cycles in line with the Eurozone and other major global economies (the Czech Republic, Poland), they have at least verbally warned against the likelihood of a switch toward rate hikes provided that the excessive weakening of the currency does not stop.

C/A balance (% GDP)



Source: Eurostat, Thomson Financial Datastream, Raiffeisen RESEARCH

The situation is quite different for Bulgaria, which operates a currency board with the euro. Here, the key issue is the sustainability of the currency board considering Bulgaria's large double-digit current account deficits, which have been expanding since 2005. While Bulgaria's current account deficit reached 12.4% of GDP that year, it was already up to more than 22% of GDP last year. And, unlike in the past, it is no longer sufficiently covered by FDI inflows. In combination with a substantial share of loans provided to Bulgarian companies and households in foreign currency (namely the euro) – close to 50% of total bank loans – the unsustainable current account represents an explosive mixture. Thus it is no surprise that the Bulgarian officials recently assured market participants that maintaining the currency board at

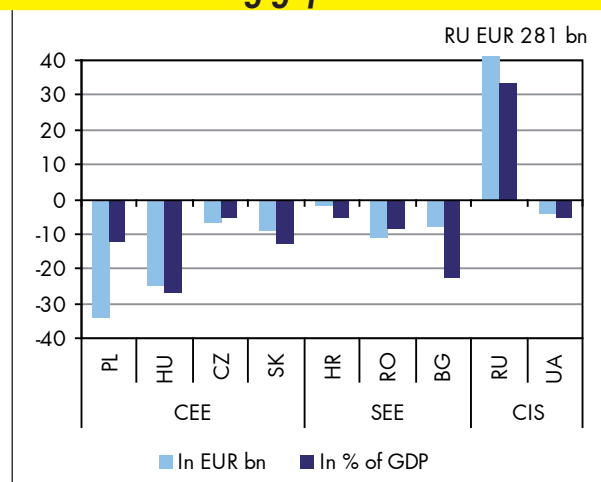
the existing parity level is the country's utmost economic and political priority. Only time will tell how realistic this is.

Money matters once again

The global recession was triggered by a global financial crisis that spread from the United States to the rest of the world, and then on to the most distant corners of the global economy. Money matters once again: We are currently witnessing a grand process of global deleveraging. Financially robust and structurally strong countries have a significant advantage in this process. They are affected by the decrease in external demand and risk aversion on the part of investors the same as anyone else, but for them the external shocks do not interplay with domestic structural and financial weaknesses.

The positive feature of most CEE countries during times of scarce liquidity and deleveraging is the low depth of some credit markets, i.e. low indebtedness among the population and a relatively low level of public debt. The weak point is the high dependence of most (but not all) CEE countries on external financing. Several of these countries have already had to face the fact that relief from their severe financial crises is not available through private funding and the IMF, the European Union, and other international public institutions have had to step in. Other countries continue to struggle, with different results and outlooks.

External financing gap



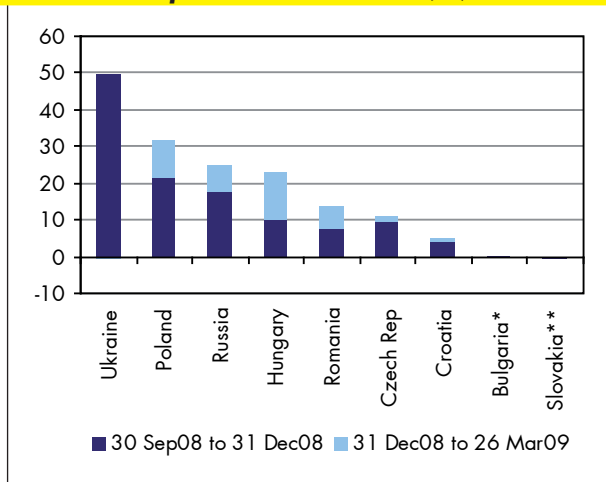
* external financing gap is defined as a sum of external debt payments falling due within next 12 months plus current account balance and minus foreign exchange reserves excluding gold and SDR
Source: IMF, National banks, Raiffeisen RESEARCH

Pavel Mertlík, Gintaras Shlizhyus

Fundamental factors for FX developments in CEE

Several CEE currencies were hit hard in Q4 2008 and early 2009 and depreciated substantially against the euro and the US dollar. Was this a necessary adjustment to previous overvaluation, or has this sell-off now left the currencies deeply undervalued? And what is the outlook for the individual currencies?

Nominal depreciation vs. EUR (%)



* currency board to EUR

** entry in euro zone on 1 Jan 2009

Source: Thomson Financial Datastream, WM/Reuters

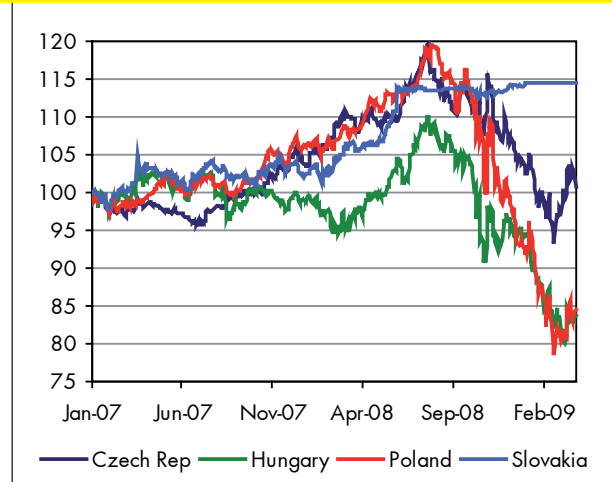
In order to get some indications regarding the answers to these questions, we would like to take a look at some economically fundamental factors, which in our opinion affect nominal exchange rates in the long term:

- real effective exchange rate (REER) developments,
- industrial productivity growth differential to the Eurozone
- the concept of purchasing power parity (PPP)

And more relevant in the short and medium term:

- Balance of payments developments and short-term external financing needs.

Nominal FX to EUR in CE (Jan 07=100)



Source: Thomson Financial Datastream, WM/Reuters

Nominal FX to EUR in SEE/CIS (Jan 07=100)



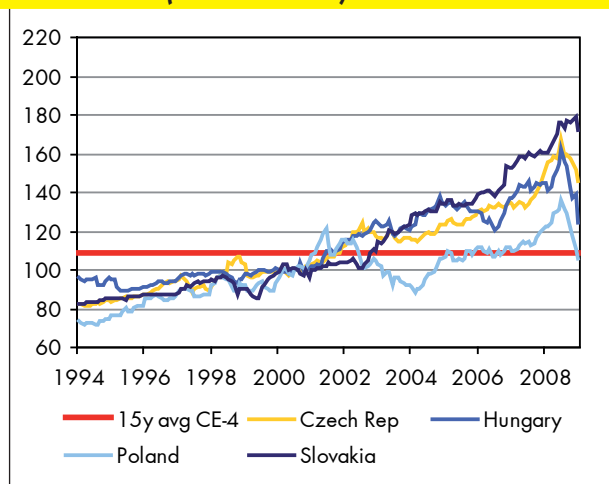
Source: Thomson Financial Datastream, WM/Reuters

Real exchange rate

Real effective exchange rate (REER) developments account for both changes in the nominal exchange rate as well as in the inflation differential between a country and its main trading partners. Thus, the real exchange rates compare not currencies, but the price of a basket of goods produced in a home country with an equivalent basket of foreign goods. A strong real exchange rate (= high cost of domestic goods) in comparison to its long term average can be seen as an indication of overvaluation. It may weaken the competitiveness of the domestic tradable sector as these goods become more expensive to foreigners and imports become less expensive at home. Therefore the real exchange rate can be interpreted as a measure of the competitiveness of a country.

An example of an overvalued/strong real exchange rate is the Russian rouble (and the Ukrainian hryvnia) before the Russia crisis of 1998, which contributed to depreciation expectations and ultimately resolved in a sharp nominal depreciation.

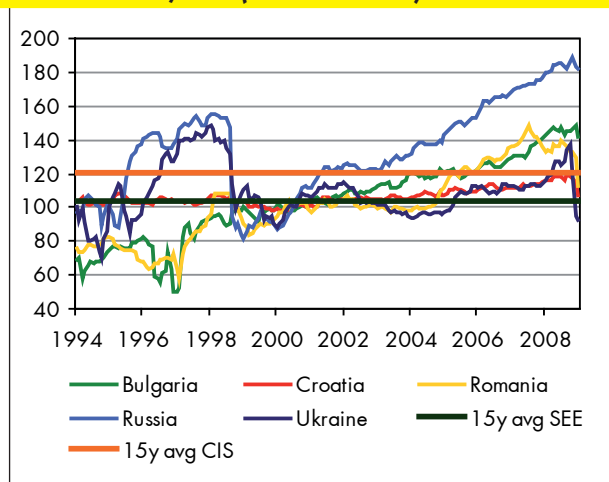
REER in CE (2000 = 100)



REER is CPI based

Source: Thomson Financial Datastream, IMF, Raiffeisen RESEARCH

REER in SEE/CIS (2000 = 100)



REER is CPI based

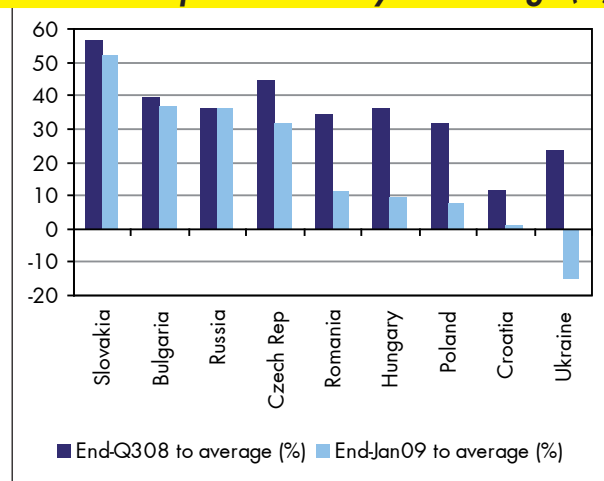
Source: Thomson Financial Datastream, IMF, Raiffeisen RESEARCH

At the end Q3 2008, all of the CEE currencies had appreciated to levels above the 15-year average of REER: All countries excluding Ukraine and Croatia had currencies that were more than 30% stronger at that point in time, led by Slovakia with 56% and the Czech Republic with 44% above the average. The situation has changed dramatically in recent months leading up to the end of January (the last data point we have for REER as calculated by the IMF): Heavy

nominal depreciation in CEE considerably lowered the "overvaluation" for several countries. For one country – Ukraine – we have even observed a lower-than-average value, which might indicate downwards overshooting. For Romania, Hungary and Poland, the latest data are more in line with the long term average. As Slovakia and Bulgaria have fixed exchange rate regimes (Eurozone membership and currency board to EUR), changes for these countries were naturally far less pronounced.

The single focus on real exchange rates points to an "overvaluation" of several CEE currencies, notably Slovakia, Bulgaria, Russia and Czech Republic, at the end of January 2009, although nominal depreciation had already reduced the differences compared to long-term REER averages.

REER in comparison to 15 year average (%)



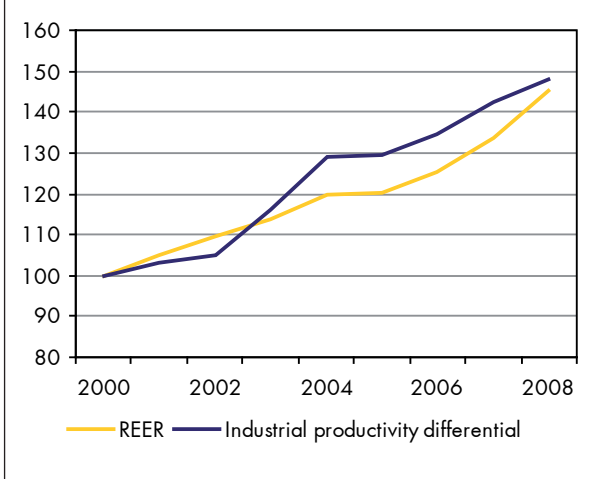
Source: Thomson Financial Datastream, IMF, Raiffeisen RESEARCH

Productivity-adjusted real exchange rate

In addition to the nominal exchange rate and price developments, productivity differentials between a country and its trading partners also play a role. Higher industrial productivity growth compensates an increase in REER as productivity gains contribute to the external competitiveness of the economy.

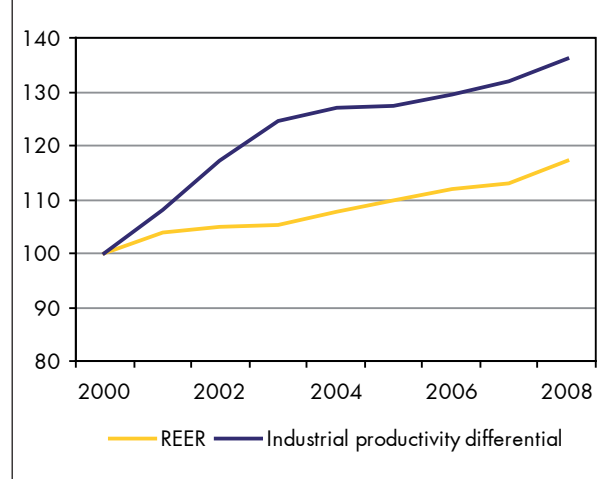
We calculated both the cumulative appreciation of the REER and the cumulative differential in industrial sector productivity growth of the respective countries compared to the Eurozone for the period from 2000 to 2008. Industrial productivity growth in the Eurozone is taken as a proxy for all trading partners, as the Eurozone represents a major share of trade with the CEE region.

Bulgaria (% , 2000 = 100)



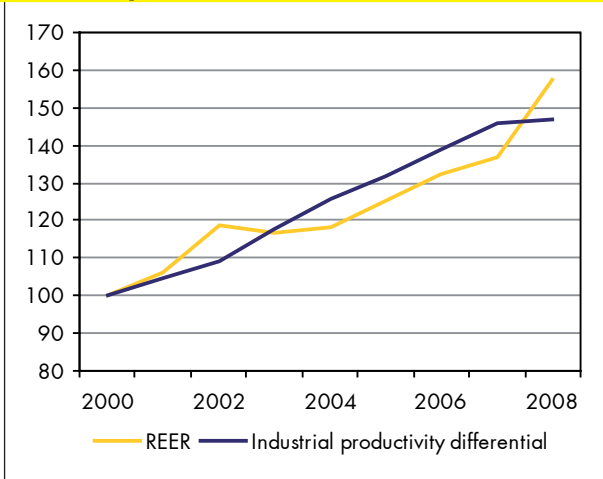
Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

Croatia (% , 2000 = 100)



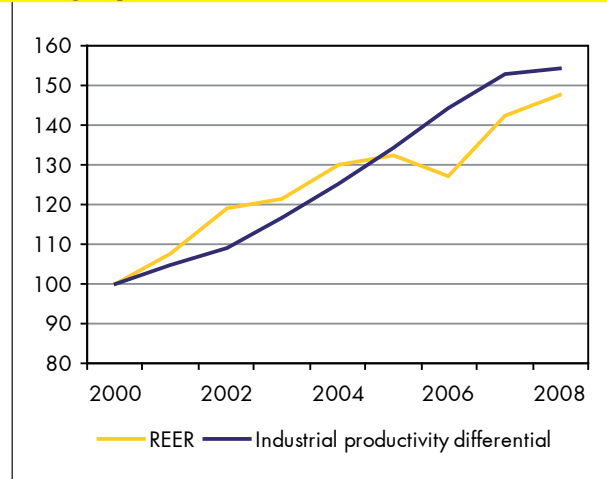
Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

Czech Republic (% , 2000 = 100)



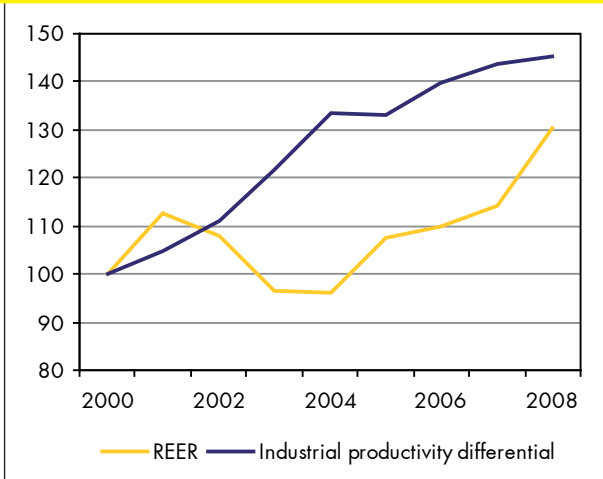
Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

Hungary (% , 2000 = 100)



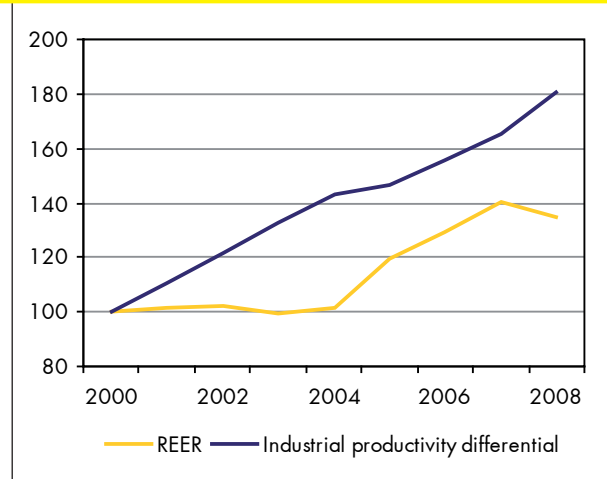
Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

Poland (% , 2000 = 100)



Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

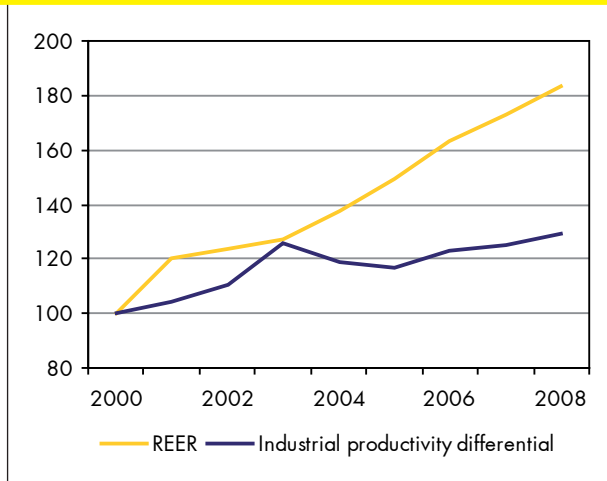
Romania (% , 2000 = 100)



Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

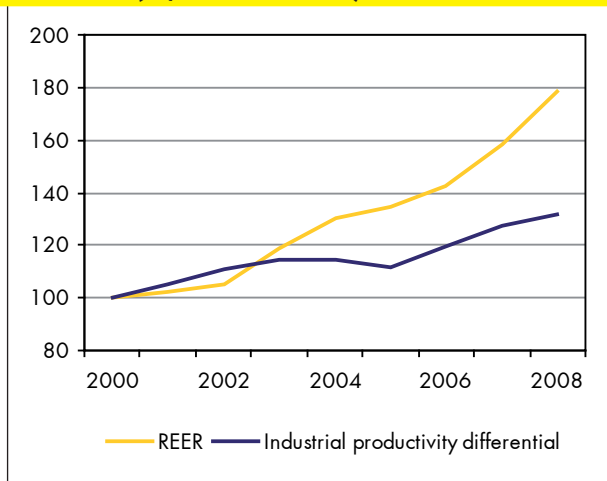
Industrial productivity differential is defined as the excess in productivity growth of the respective country over industrial productivity growth in the Eurozone. Both the real exchange rate (REER) and the industrial productivity growth differential are indices, which are based to 2000 = 100. Productivity growth data for H2 2008 was not available for several countries (Bulgaria, Romania, Slovakia). Thus the available data was used for approximation of the 2008 figure.

Russia (% , 2000 = 100)



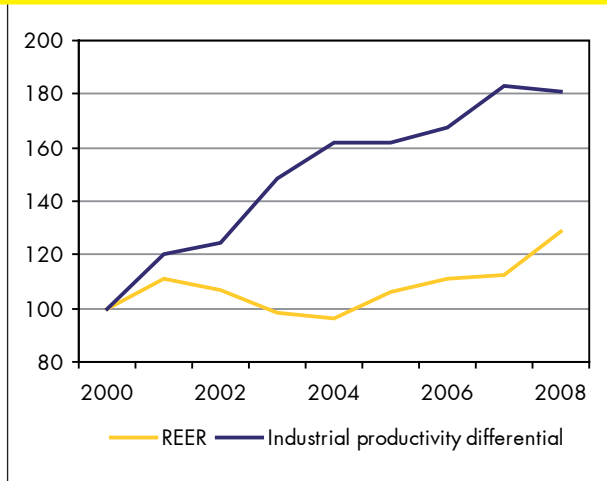
Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

Slovakia (% , 2000 = 100)



Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

Ukraine (% , 2000 = 100)



Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

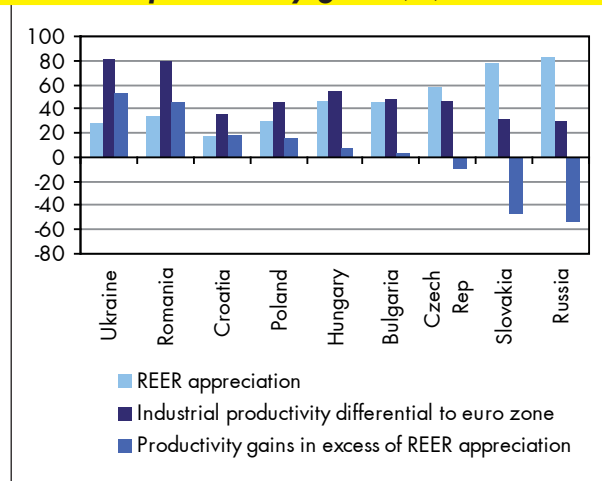
The result shows that REER appreciation was usually more than compensated by faster rising productivity versus the Eurozone. The only exceptions are Russia and Slovakia (and to a lesser extent the Czech Republic), which appreciated the most in real terms in the period under review.

Both Ukraine and Romania saw outstandingly high productivity growth. In our opinion, this is partly attributable to the absolute low productivity level of these countries, which is much more conducive to fast increases.

If one looks at productivity growth it is apparent that, for most CEE countries, even faster real appreciation would have been consistent with the productivity increases achieved in the industrial sector.

Therefore, from this point of view most CEE currencies still have potential for real appreciation.

REER and productivity gains (%)¹



Cumulative from 2000 to 2008

Source: IMF, wiiw, Eurostat, Raiffeisen RESEARCH

Purchasing power parity – the price level

In a (very) long term perspective the price level and the concept of purchasing power parity (PPP) is often used as an argument for under- or overvaluation. A widely popularised concept is the simple Big Mac index published by the weekly journal Economist, which is based on a form of absolute PPP. It uses the price of only one standardised product – McDonalds' Big Mac hamburger – in different countries.

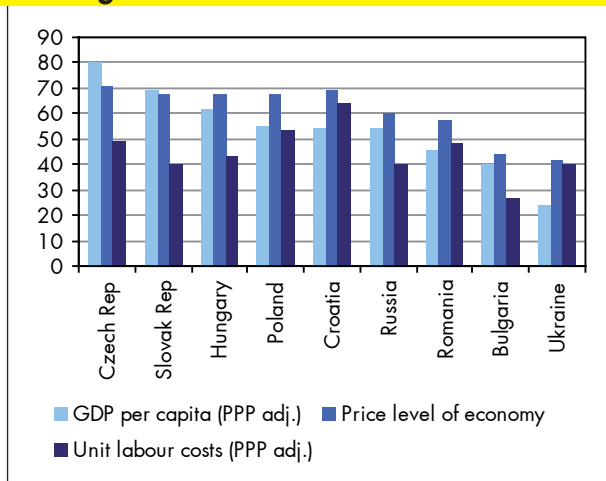
¹ Cumulative productivity gains in excess of REER appreciation are calculated by subtracting REER appreciation from the industrial productivity growth differential between the respective countries and the Eurozone. The cumulative industrial productivity growth of the Eurozone was 20.3%, which implies an average of 2.3% per year. In H2 2008 productivity data was not available for several countries; the months that were available for 2008 were used for approximation.

We look at price level indices derived from the 2005 International Comparison Project of the World Bank, which measured the overall price level for many economies.

In comparison to the EU-27 average, all of the CEE countries have lower price levels to different degrees and are therefore undervalued according to PPP. The correlation between the stage of economic development measured by PPP-adjusted GDP per capita and the price level is visible. As expected, higher GDP is usually accompanied by higher prices.

If long-term convergence towards the absolute form of PPP is assumed (i.e. convergence towards the average EU-27 level), CEE still has room for considerable real appreciation in the future.

Looking at PPP



GDP per capita and the price level are in % of EU-27 average level; Unit labour cost are in % of Austria, all data preliminary for 2008

Source: wiiv

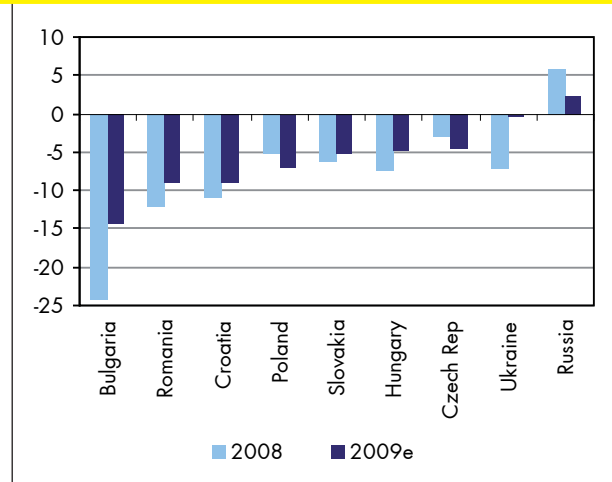
Balance of payments I – Current account deficits

Imbalances in the balance of payments also give an indication of FX adjustment needs, especially if the imbalances prove to be unsustainable in the face of external shocks, i.e. the sudden stop/reversal in capital flows or a sharp decrease in export demand as seen in the current crisis.

Current account deficits, which have existed in most of the CEE countries for many years, require an equally high net inflow of capital – either lending or investment inflows – or a reduction in the central banks' FX reserves to equate the balance of payments (to zero).

If this financing of the current account via the capital account is unsure – as is currently the case – pressures on the currency will rise; thus, current account deficits indicate potential depreciation pressure.

Current account balance (% of GDP)



Source: Statistical offices, Raiffeisen RESEARCH

Balance of payments II – External financing needs

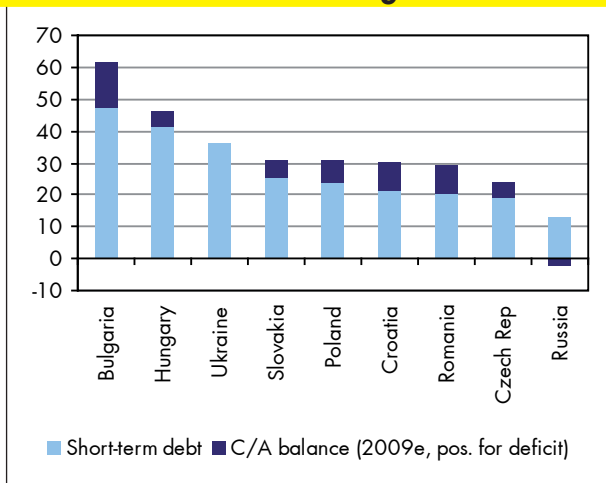
The focus on current account deficits can be extended by examining short-term external debt levels (debt maturing within less than 12 months). Short-term debt has to be either refinanced or repaid in the next 12 months. Because external debt in CEE is mostly denominated in foreign currency (primarily euros, dollars and Swiss francs), the debtors have to buy FX on the market when the time comes for repayment.

With external credit more scarce for emerging markets, we assume that only part of the debt can be rolled over.

The Institute of International Finance (IIF) has projected that private capital flows to emerging markets will drop from an estimated USD 465 bn in 2008 to just USD 165 bn in 2009. For Emerging Europe, the institute expects capital flows to drop from USD 254 bn in 2008, of which USD 49 bn are net FDI inflows and –of particular importance here – USD 18 net credit outflows, to USD 30 bn in 2009.

In terms of expected GDP in 2009, particularly Bulgaria, Hungary and Ukraine are exposed to high external financing needs. Russia, although having the largest amount of short-term debt in absolute numbers, is better off due to its bigger economy and a current account surplus.

12 month external financing needs*



* % of estimated GDP in 2009; Debt data as of end-Q3 2008. Short term debt includes debt with <12 month original maturity and an estimate of maturing long term debt.

Source: Joint External Debt Hub (JEDH), Central Banks, Raiffeisen RESEARCH

All in all we expect to see persistent pressure on nominal exchange rates, especially for the riskier and/or more indebted countries.

Andreas Schwabe

Regional FX outlook

Bulgaria

Bulgaria's lev has been fixed to the euro at EUR/BGN 1.95583 since the establishment of the currency board in 1997. The Issue Department of the Bulgarian National Bank serves as a currency board. The Issue Department's liabilities (monetary base and deposits by the government and other budget institutions) are fully covered with assets denominated in foreign currencies. At the end of February 2009 the ratio of FX reserves to the monetary base stood at 193% and the FX reserves to M3 monetary aggregate was 52%. Despite the negative flow of funds in December 2008 and January 2009, we expect the coverage of the monetary base by FX reserves to remain at a level well above 100% in Bulgaria. Hence, the exchange rate of Bulgaria's lev to the euro is expected to remain unchanged in 2009 and 2010.

Croatia

During Q4 2008 the EUR/HRK exchange rate recorded a record low as a result of the strong capital inflows (INA takeover). Although depreciation pressures have intensified since the start of 2009, the kuna has seen relatively modest nominal deprecia-

tion. Conservative monetary policy has led to rather mild volatility on the domestic FX market despite pronounced risks for the domestic currency. At the same time, the country has experienced acceleration in price growth as a result of a hike in government controlled prices (utility services, health care costs). Furthermore, inflation has a structural character in Croatia, as the competitiveness and efficiency of domestic companies is rather low. We expect to see stable exchange rates (around 7.50 kuna per euro) until at least autumn due to tourist receipts from abroad (although much lower than in 2008). If risk aversion towards the region remains high during Q4, we expect to see a limited weakening of the kuna, as the central bank will most likely react strongly to keep the domestic currency stable. In the somewhat longer period, EU accession (higher capital inflow) will lead to appreciation in the kuna and trading levels near 7 kuna per euro.

Czech Republic

The Czech crown has followed a relatively smooth appreciation trend against the euro since 1999. In this time, there were two strong deviations from the trend when the crown appreciated strongly in H1 2002 and again in H1 2008. Like in 2002/2003, the excessive appreciation in 2008 was followed by a correction that brought the crown to levels in H1 2009 that are somewhat weaker than what would be indicated by the long-term trend. Other than in 2002, the correction was not triggered by massive central bank interventions and interest rate cuts, but rather the global economic and financial market crisis. According to our models, the crown is currently fairly valued, if not somewhat undervalued, in terms of fundamentals and should be able to continue along its sustainable long-term appreciation path (of 2-4% p.a.) once the economy regains its momentum.

Hungary

The forint has depreciated by around 30% from the highs seen in the summer of 2008. The global economic outlook as well as the imbalances have caused investors to increase their risk aversion and pull out their money. According to our models, the forint seems fairly valued around the current levels of EUR/HUF 300. While volatility is likely to remain fairly high in the coming months, we project at least a slight increase in stability in the second half of 2009. A bottoming out of the current global crisis and the first signs of relief from leading indicators in the US and the Eurozone is also likely to support the forint. With the return of investors to riskier assets, the forint

should have at least moderate room for appreciation towards EUR/HUF 270 towards the end of 2009. We believe that a process of slow recovery towards 260 on average for 2010 is realistic.

Poland

The zloty took a dive against the euro (Eurozone countries being the largest trading partners for Poland) in Q4 2008 and at the beginning of Q1 2009. This also had a tremendous impact on the real exchange rate index, which fell back to 2005 levels within just a few months. Our calculations suggest that, taking the productivity differences into account, the zloty would be undervalued at the moment. However, adjustments to equilibrium levels take quite a long time in FX markets. We believe that short-term factors are weighing negatively on the zloty at the moment. Therefore, a sustainable move towards equilibrium levels is to be expected in Q3 2009 at the earliest. In 2010 we expect the zloty to appreciate towards levels below 4.00 against the euro.

Romania

The leu depreciated significantly at the end of 2008 and in the first month of 2009, as foreign investors' risk aversion towards Romania increased. We believe that the leu is now undervalued in relation to the euro (by around 10%). However, we do not expect the leu to appreciate rapidly towards its equilibrium level in the coming months. Instead, the convergence will likely take place at a slow pace over a longer period of time. We believe that the financing package negotiated with the international institutions will likely be the main factor behind the improvement of leu parity in the coming months and years, as it should reduce investors' fears regarding the financing of the country's external funding gap. At the same time, an undervalued leu will likely support the adjustment of the foreign trade deficit.

Russia

The devaluation of the Russian rouble reflects two obvious trends: a) an adjustment to the balance of payments due to falling oil prices and capital outflows; b) reduction of economic output and productivity. The rouble has already lost about 32% against the dual currency basket and about 52% against the dollar since August 2008. Since the crisis erupted in Russia as a result of global turmoil and the high dependence of Russia's private sector on foreign credit, the central bank has been pursuing a policy of measured rouble devaluation. The policy of the bank is aimed at restoring the rouble equilibrium vis-à-vis worsening

terms of trade (declining oil prices). As a result of this policy and the dense repayment schedule of the Russian private sector, the central bank's international reserves have decreased by more than USD 200 bn. Our calculations show that, as a result of devaluation, the rouble exchange rate has shifted closer to the equilibrium both in terms of trade and economic competitiveness. Still, the rouble remains some 10% above the long-term cumulative REER average and some 6% above the parity of the productivity-adjusted REER. Excluding the effect of short-term debt payments we believe the rouble's fair value is between 30 and 35 to the dollar assuming a constant euro/dollar exchange rate. In one year and beyond, we see terms of trade and oil prices as being crucial for determining the rouble valuation. Should oil prices remain at USD 50/bbl or higher, the rouble could potentially appreciate to 30 against the dollar. The year 2009 will bear the biggest risk to our outlook, as steep economic decline and oil price fluctuations could change the direction of the rouble. However, in a one-year perspective the rouble has good chances of gaining against both the dollar and the euro assuming stable oil prices. Furthermore, Russia might consider cancelling the targeted exchange rate and introducing a free float for the rouble from a long-term perspective (2–3 years), which will allow for swifter rouble adjustments. Traditionally, a flexible exchange rate would be recommendable for countries with a high share of exports to GDP (economic openness) and a significant amount of commodities in their exports. Therefore, we feel it would make sense for Russia, whose exports account for about 28% of GDP, with 67% of exports coming from the energy sector (as of 2008), to adopt a free float regime for the rouble.

Ukraine

The Ukrainian currency has devalued dramatically in the last six months – from around USD/UAH 5 to USD/UAH 8. This has reduced the real exchange rate and will lead to the closing of the current account deficit of 7.2% of GDP in 2008 to an estimated 0-1% in 2009. Political uncertainty, high inflation and FX financing needs pose considerable risks in the short and medium term. Nevertheless, we believe that the long-term fair value of UAH will come in stronger than the current level, at around USD/UAH 6, given favourable productivity developments and a relatively low price level.

Exchange rate regime - key features

	Bulgaria	Croatia	Czech Republic	Hungary
FX regime description				
Currency:	Bulgarian lev (BGN)	Kuna (HRK)	Czech koruna (CZK)	Hungarian Forint (HUF)
Rate mainly oriented to	EUR	EUR	EUR	EUR
Current regime:	currency board at EUR/BGN 1.95583 (since 1999)	managed free-float	free-float	free float
FX policy tools in use	CB sells and buys FX on demand of market players	FX interventions, open market operations (interest rate differential)	verbal interventions, FX interventions (very rare), interest rate	verbal interventions, FX intervention (unofficial), interest rate
Exchange rate regime and policy tools details:	Monetary liabilities of the currency board (monetary base + government deposits) are more than 100% covered by FX reserves. New BGN are issued only on demand of market players. Daily balancing of FX supply/demand is automatic.	In recent years central bank reoriented its actions from FX interventions towards open market operations (regular reverse repo auction). Furthermore, in current conditions CB prefers lower kuna liquidity and usage of banking sector FX reserves as main tools for tackling depreciation pressures.	The exchange rate regime is officially defined as managed float (followed currency is EUR), but the Czech national bank uses its policy instruments to affect EURCZK FX rate only in extreme cases. Market intervention was used last time more than 5 years ago.	ERM-II compatible exchange rate regime was abandoned in February 2008 (EUR/HUF central parity was set at 282 - exchange rate could move within a +/-1.5% fluctuation band). Nevertheless, from time to time, the NBH has certain (not public) currency targets - the aim is not allow extreme currency movements.
Convertibility on current account transactions:	yes	yes	yes	yes
Convertibility on capital account transactions:	yes	Restrictions regarding treasury bonds. Liberalisation of the capital account was planned for the start of 2009. However, it was postponed as risks for kuna increased.	yes	yes
FX regime outlook				
Outlook and possible changes	maintaining of the currency board at the current exchange rate; application for entry into the ERM-II expected.	EMU entry in 2015 if EU entry in 2012	EMU entry discussed by the government annually (in autumn), positive decision in 2009 not ruled out. In such case possible switch to ERM-II mechanism in 1H 2010	no EMU entry plan yet
Possible future policy tools	no change	no change	no change	FX interventions
Technical details of FX market				
Major players:	local banks, CB	banks, corporate sector	London and Frankfurt based large banks, local banks,	local banks, CB, foreign banks
Market instruments:	spot	spot, forwards, swaps, options	spot, forwards, options	spot, forwards, options
Daily average turnover on FX market in 2008:	EUR 1 bn	EUR 524 mn	EUR 6 bn	EUR 1 bn

CB = central bank, Slovakia not included in the table as the euro was adopted in 2009
Source: Central Banks, Raiffeisen RESEARCH

Exchange rate regime - key features

	Poland	Romania	Russia	Ukraine
FX regime description				
Currency:	Polish zloty (PLN)	Romanian leu (RON)	Russian rouble (RUB)	Ukrainian Hryvnia (UAH)
Rate mainly oriented to	EUR	EUR	USD	USD
Current regime:	free float	managed free-float	managed free-float vs EUR/USD basket (0.45 EUR+0.55 USD)	managed free-float
FX policy tools in use	verbal interventions, interest rate	FX indirect and direct interventions, verbal interventions	FX interventions, administrative measures, verbal interventions, interest rate	FX interventions, FX auctions, administrative measures, verbal interventions
Exchange rate regime and policy tools details:	CB uses FX swaps to supply liquidity in foreign currency, mostly in CHF and EUR; CB reference rate (=rate on 7-days open market operations with CB bills)	The CB reserves the right to step in the FX market when it considers it "necessary". Usually, this happens in case of large swings in the exchange rate. In the past, interventions were efficient due to the low development stage of the market (low liquidity, few products) and due to the control over RON liquidity by the CB.	Very wide FX band: 35% of recent basket value, but market participants don't believe in that and think that de facto band is much narrower. CBR buys or sells FX on the bounds of the band. Central bank also gives banks special "recommendations" not to increase their FX positions beyond a certain level under threat of reducing refinancing.	Weekly currency auctions to special groups at preferred rates (debt payers, importers, individuals with FX debt), almost daily interventions, pressure on banks to use certain FX rates. Several exchange rates in use: official rate, market intervention rate, FX auction rate(s), interbank market rate - CB influenced, interbank market rate - "free"
Convertibility on current account transactions:	yes	yes	yes	yes
Convertibility on capital account transactions:	yes	yes	yes	restrictions on hryvnia holdings by non-residents and on money transfers abroad; fee on non-cash FX conversion operations
FX regime outlook				
Outlook and possible changes	EMU entry planned for 2012	EMU entry planned in 2014	two ways: either liberalisation (free float) or reintroduction of capital controls to defend exchange rate	rising re-dollarisation due to heavy nominal devaluation, agreement with IMF on liberalisation (free float); however, introduction of capital controls discussed (compulsory repatriation of 50% of export proceeds)
Possible future policy tools	FX interventions	no change	restrictions on convertibility on capital account transactions	restrictions on convertibility on current account transactions
Technical details of FX market				
Major players:	local banks, CB	local and foreign banks, CB	local banks, CB	local banks, CB
Market instruments:	spot, forwards, fx swaps	spot, forwards (liquid up to 1 year), swaps, options	tomnext, currency futures (not liquid), NDF (up to 1 year)	spot, NDF
Daily average turnover on FX market in 2008:	USD 6.5bn (as of 04/2007, spot, forwards, fx swaps with PLN contribution)	EUR 670 mn (interbank FX market) plus EUR 1100 mn (transactions with clients)	USD 19.4 bn	USD 421.5 mn (of that 335.5 mn denominated in USD)

CB = central bank, Slovakia not included in the table as the euro was adopted in 2009
Source: Central Banks, Raiffeisen RESEARCH

The biggest challenge in modern history

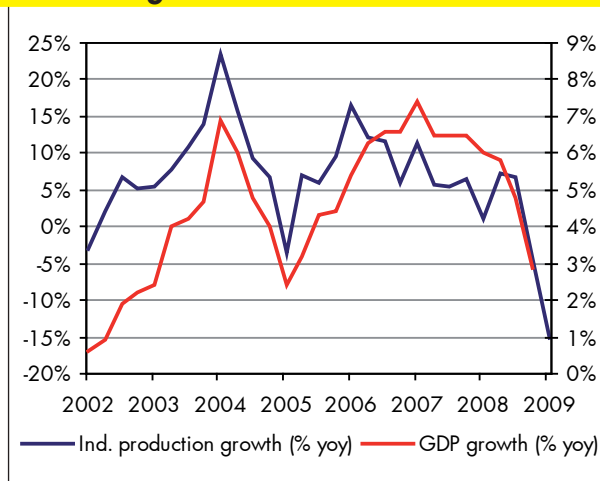
The global crisis poses one of the biggest challenges to the Polish economy in modern history. Over the past six years, Poles got used to the fact that economic conditions are only improving, and that their financial situation is getting better and better. For some time, we have been expecting that the crisis would only have a limited effect on internal demand because of the significant improvements on the labour market over the previous years. Now, it is apparent that these expectations were more than optimistic.

The first signs that the global crisis will not be leaving the Polish economy untouched came from the export sector, which already saw a sharp fall in new foreign orders in Q3 2008. A few months later, real data showed significant declines in exports. Due to pessimistic forecasts for Poland's main trading partners (Germany, France and Italy), we expect that exports may contract by more than 14% yoy in 2009 (see the third section for more information on exports).

As exports lost steam, production began to fall significantly in a number of sectors. In January 2009, annual industrial production growth fell below zero and the vast majority of sectors (26 out of 34) reported declining output. Cuts in production resulted in the first wave of layoffs, and the unemployment rate jumped by 1% from 9.5% to 10.5% in January alone. We expect that it will climb to 14.9% by the end of 2009 – a level we have not seen since 2006. That would mean that the number of people with no job could rise by an unprecedented 650,000 in the next 10 months.

Such negative prospects for the labour market do not make stable internal demand likely. On the contrary, we think that private consumption will grow by a weak 1.8% yoy in 2009 and remain close to zero in 2010. Investments, which are susceptible to both, the negative overall outlook and to a lack of financing sources, are already slowing down and might fall by more than 10% yoy. EU funds are becoming one of the few stimulants for GDP growth, but the PLN 16.8 bn of these funds that are budgeted for this year will not be enough to help GDP growth above -0.8% yoy in 2009.

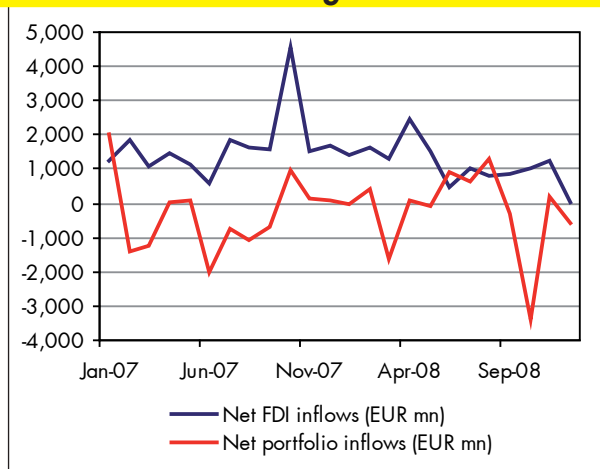
Economic growth slams on the brake



Source: GUS

After three good years for the budget already at the beginning of 2009, the Ministry of Finance (MoF) is certainly running into trouble. The government believed for too long that the Polish economy would remain strong even in times of global storms. Because of this, the assumptions for this year's budget bill are unrealistic, many sources of revenue are uncertain and expenditures are rising. In the first two months of 2009, the government already spent almost 16.5% of the planned funds. A budget amendment (with an increase in revenues and/or a higher planned deficit) seems to be inevitable and harbours two risks: first, political disorder and second potential problems with placing additional government debt on the market.

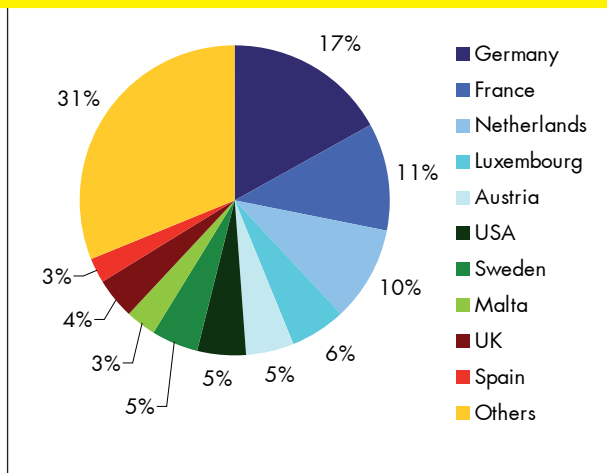
Net FDI inflows heading south



Source: NBP

For a person in the street, the most visible result of the crisis is the currency market and the rapid weakening of the zloty. One of the main reasons for that is a huge change in capital flows – a fall in FDI and an outflow of speculative funds. Outflows of portfolio capital totalled EUR 4.8 bn in the last four months of 2008 alone. We expect net FDI inflow for 2009 to drop to 1.5% of GDP and for 2010 to 1.2% of GDP. We think that there is little potential for improvement in the capital inflows as long as the main countries from which the inflows emerged will be in recession. In particular nearly 40% of foreign direct investments were flowing from Germany, France and the Netherlands to Poland in 2007. For Germany alone (which was the largest investor in Poland in 2007) we expect a real GDP growth of -3.5% in 2009. The list of disadvantageous factors for the PLN is much longer and makes us certain that 2009 will be characterized by a weak zloty. We project its average value for this year at 4.65.

Main investors in Poland in 2007

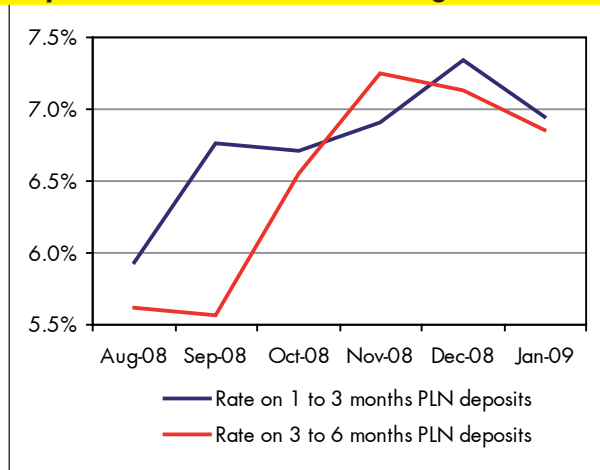


Source: NBP

Savings, no-Keynesian solutions

The short-term liquidity squeeze in the banking system was the first visible sign of the global crisis in Poland. The central bank effectively helped to overcome it by introducing a “confidence package” consisting of more elastic repo operations and CHF/PLN swap operations. The banks were dealing only on O/N and T/N money in November, while all tenors up to one month are currently liquid. However, banks realised that using short-term liquidity to fund long-term loans (as they did over the past 15 years) is not an option anymore, and they started price wars on customer deposits in order to bring the loan/deposit ratio to one.

Deposit rates soared to new highs



Source: NBP

The government, led by the Ministry of Finance, started working on two separate bills for the banking sector in December. The “liquidity bill” includes two different measures: state guarantees for banks’ medium-term debt (3 months to 5 years), which will be made available to banks at market conditions, and state bond borrowing measures in case of liquidity emergencies (especially bond purchases with delayed payments). The first instrument aims at providing medium-term liquidity to the banking system but at market prices – banks will buy the guarantee from the state. The second instrument addresses the extreme short-term illiquidity of a commercial bank. In order to avoid bankruptcy, troubled banks will be able to obtain short-term loans from the state (via government bonds). The “liquidity bill” is in its final stages in parliament. Work has not yet progressed as far on the state intervention bill – which would allow the government to buy shares and rescue banks. This intervention is being prepared to prevent financial institution failures when the available short-term liquidity assistance proves to be insufficient.

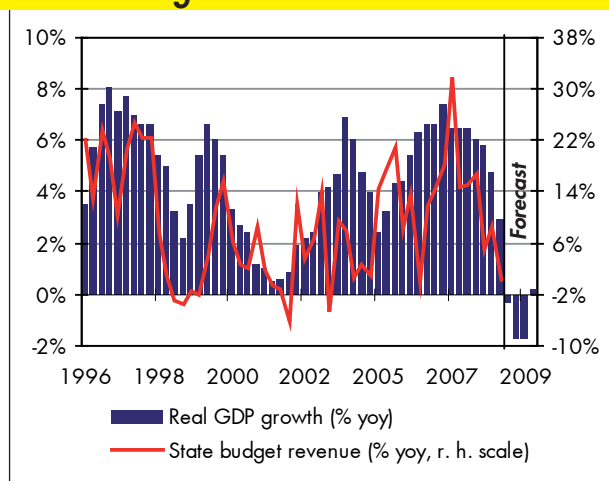
Measures from S&D plan

Measure	PLN bn	2009/2010 budget spending
State guarantees limit	40.0	No
Credits for SMEs*	20.0	Yes (2 bn)
EU funds	16.8	No
EU funds prepayment	3.0	No
New state fund	1.5	Yes (1.5 bn)
Lower taxes	10.0	No

* after money creation
Source: MoF

Preliminary cost estimates for the state guarantees (up to 100bp) show that this solution is not attractive for the banking system now. Other measures are strictly limited to banks with rather serious liquidity or financial problems. At the beginning of December 2008, the government introduced a rescue package called the Stability and Development Plan (S&D Plan) worth PLN 91.3 bn for 2009 and 2010 (roughly 7% of GDP). The plan encompasses a broad range of financial and non-financial activities that the state has undertaken or will undertake to prevent Poland from being hit by the crisis.

Revenue targets will be hard to achieve



Source: Thomson Financial Datastream, Raiffeisen RESEARCH

The MoF did not see any impact of the plan on the budget. At the end of January, the MoF called for savings in the central budget, and the government cut spending by approximately PLN 20 bn mainly by curtailing investments. Currently, the MoF wants to keep the budget deficit unchanged despite strong pressure from falling revenues.

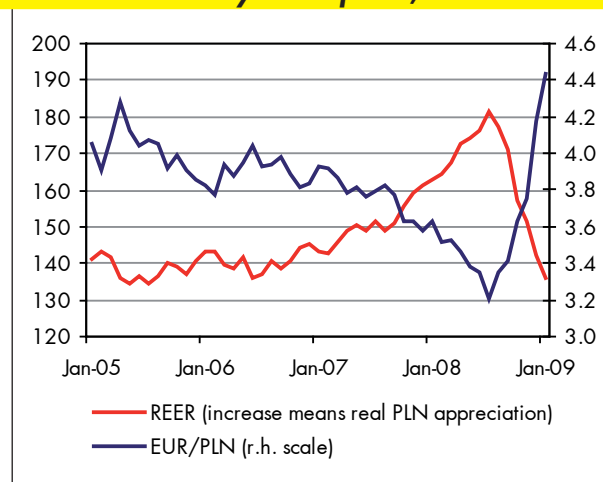
The MoF chose to cut budget spending in this time of crisis instead of increasing it. The S&D Plan is based on guarantees and ways of supporting the economy that do not entail additional spending. The MoF also chose to lower spending in order to keep the nominal budget deficit unchanged. We agree with the ministry's approach to budget spending, especially in light of the increasing problems with raising financing. However, we think that cutting spending by PLN 20 bn will not be enough to keep the budget deficit unchanged, and expect an increase in indirect taxes in mid-2009.

The government also insists on quick ERM II entry as a way to counter the zloty's weakness. However we are sceptical about a quick ERM II entry due to huge economic and market problems. The general government-sector deficit will be extremely difficult to keep at 3%, and the zloty is too volatile. Only political will, especially from the EU side, and a relaxation of the Maastricht criteria could result in a quick ERM II and Eurozone entry.

Few winners, many losers

The export sector is undoubtedly the first and, for now, biggest victim of the crisis. Indications of the slide in the export sector were already seen in 2008 when many still believed that the CEE countries may remain a kind of safe haven in the global storm. But falling new foreign orders were not reflected in the export data for quite some time. The first sharp decline in export growth was seen in October 2008. One month later, export growth was already 11% lower than in 2007 and is falling further. Output is down sharply in nearly all export sectors, especially in the automotive sector where vehicle production has declined by more than 40% yoy. The list of further major underperformers correlates strongly with a list of sectors with the highest share of exports, especially producers of metals, plastics and chemicals. The most recent weakening of the PLN has made Polish exports more attractive. But due to falling demand in the economies of Poland's main trading partners, this positive effect on exports will be rather limited and restricted mainly to sectors of basic goods such as foodstuffs.

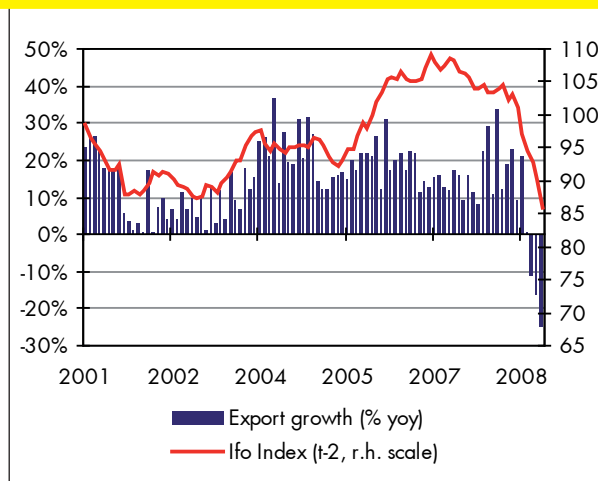
Weaker PLN may lift exports, but...



Source: Thomson Financial Datastream, Bloomberg

The second sector which could suffer highly from the global crisis is financial services, mainly banking. The first problem is so-called toxic options. Many Polish companies have entered into derivative contracts on EUR/PLN to hedge their euro revenues against zloty appreciation. Many of them preferred asymmetrical (and also free-of-charge) instruments and, in seeking additional gains, hedged positions which exceeded the value of their export contracts. As the PLN started to weaken sharply, all these bets turned sour. It is estimated that combined exposure to toxic options amounts to approximately PLN 18 bn (and these are only rough estimates). Several companies have disclosed heavy losses or filed for bankruptcy. Losses from such constructions are also expected in the banking sector as banks are forced to form provisions to protect against the potential default of "toxic" clients. As many big companies have suffered from such contracts, the Ministry of Economy is trying to reduce their losses and has proposed calling off the derivative contracts or allowing companies to walk away from them. Such decisions (though hardly probable) are putting bank's future results at even greater risk. It is worth noting that the 2007 net profit of the entire banking system was PLN 12.3bn, and the net profit of all non-financial enterprises in Q2 2008 was PLN 52.5 bn.

... demand from abroad will be subdued



Source: Thomson Financial Datastream, NBP

One of the sectors that may be the biggest beneficiary of the current situation, or that may at least remain relatively unaffected by the crisis, is activity that strongly correlates with government spending and EU funds. The lion's share of this money is being invested in infrastructural programs. The Ministry of Regional Development assumes that Poland will spend PLN 16.8bn from the EU funds in 2009.

Key economic figures and forecasts

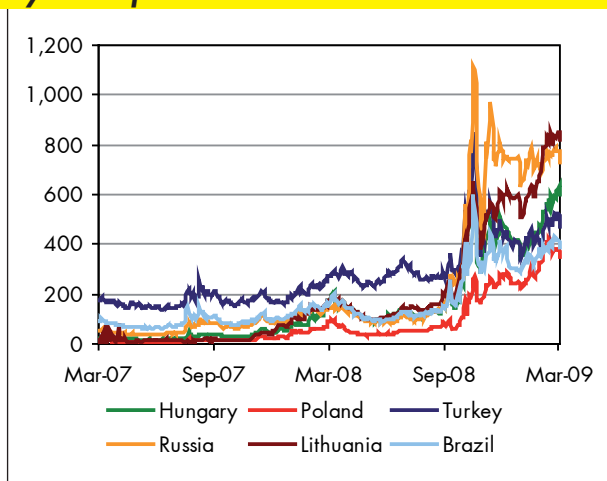
	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	204.0	244.4	272.2	308.4	363.7	275.2	326.5
Real GDP (% yoy)	5.3	3.6	6.2	6.7	4.8	-0.8	0.0
Industrial output (% yoy)	12.6	3.7	11.2	11.2	3.5	-9.0	0.7
Unemployment rate (avg, %)	19.5	18.2	16.2	12.7	9.7	13.0	14.0
Nominal industrial wages (% yoy)	4.5	2.1	5.0	9.1	10.3	3.4	3.3
Producer prices (avg, % yoy)	7.0	0.7	2.3	2.3	2.6	1.5	2.1
Consumer prices (avg, % yoy)	3.5	2.1	1.0	2.5	4.2	2.8	2.4
Consumer prices (eop, % yoy)	4.4	0.7	1.4	4.0	3.3	2.8	2.1
General budget balance (% of GDP)	-5.7	-4.3	-3.8	-2.0	-3.0	-4.4	-3.5
Current account balance (% of GDP)	-4.0	-1.2	-2.7	-3.8	-5.4	-6.9	-6.8
Official FX reserves (EUR bn)	27.1	36.1	36.8	45.0	44.7	39.6	39.9
EUR/PLN (avg)	4.53	4.02	3.90	3.78	3.52	4.65	4.02
USD/PLN (avg)	3.64	3.24	3.09	2.76	2.39	3.28	2.77

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Severe contraction recession in full swing

Hungary is now in the middle of an at least four-year slide. While the country enjoyed a steady and solid 4.3% average growth rate between 2001 and 2006, growth plummeted to 1.1% in 2007 and fell further to 0.6% in 2008. The economy will severely contract in 2009. A closer look reveals even more reason for concern. While the past deceleration was clearly due to the turn in fiscal policy, net exports of manufactured goods still fuelled tepid expansion. With the external environment turning ice-cold, this sector is now in freefall.

5y CDS spreads

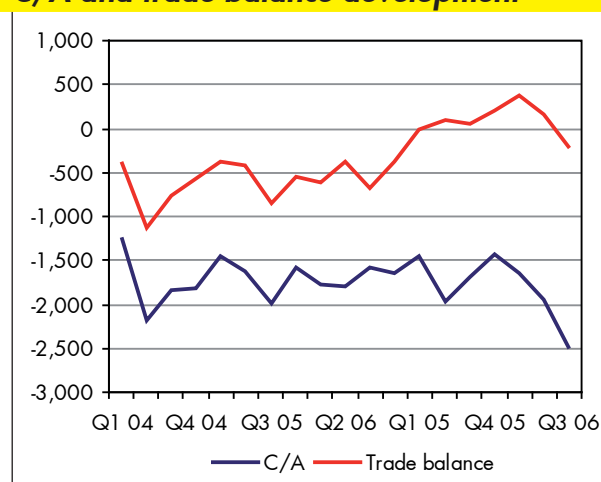


Source: Thomson Financial Datastream, Raiffeisen RESEARCH

The economy contracted by 1.3% in Q4 compared to Q3, while output diminished by 2.3% in annual comparison. The quarterly change in Q2 and Q3 was also negative (-0.1 and -0.6%), so the Hungarian economy already fulfilled the technical criteria for a recession in 2008. The bad news is that the recession is set to deepen further, and the decline in the first half of the year will probably be over 6% yoy – and 5% for the full year. Bleak export orders sent Hungarian industry into a dive at the end of last year (Q4: -13% yoy). This was the first time that the Hungarian Central Statistical Office has recorded a yearly contraction in output since 1992. Domestic sales have been fluctuating at around the same level for almost a decade, and export sales were the main driver of industry; this makes the 26.5% (yoy) contraction in December worrisome. We project that manufacturing will be dragged down by external developments throughout the year, as Hungarian industry is essentially reliant on orders from the European Union.

January data proved the deteriorating trend: industry output fell by almost 23% yoy, while manufacturing industry output got close to a collapse: electronics output dropped by almost 30%, automotive industry by over 40% yoy. January export plummeted by more than 30% yoy.

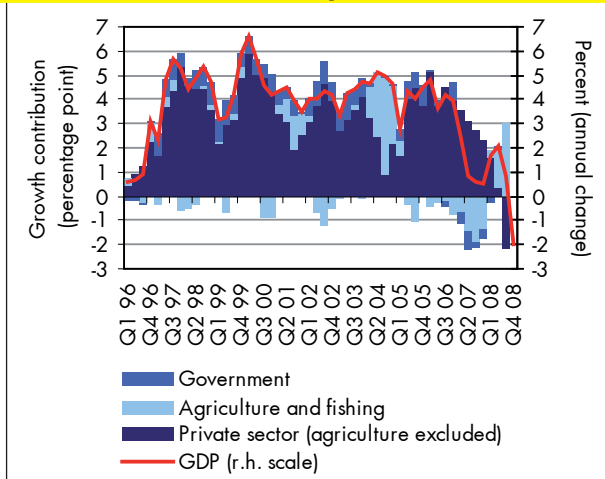
C/A and trade balance development



Source: MNB, Raiffeisen RESEARCH

Construction has been one of the weakest links over the last two years: output has been sliding since Q2 2007. Somewhat brighter figures came in 2008 (around -5% yoy), but that is mostly the result of base effects. Housing construction is estimated to have fallen at a double-digit rate at the end of last year, but industrial operations were buoyant in Q4 (no official statistics yet). As demand is weak due to the tightening credit requirements, housing construction is expected to slide further in 2009, while infrastructure construction is projected to expand thanks in large part to fiscal stimulation. The intention of the government is to partially offset the deep economic crises with an intensified utilisation of the EU funds. Several public sector developments are planned, nevertheless, most of the projects (public transport infrastructure development; upgrading sewage and waste management systems; road and train network developments; upgrading health care and education infrastructure) will not be finished in 2009.

GDP contribution to output*

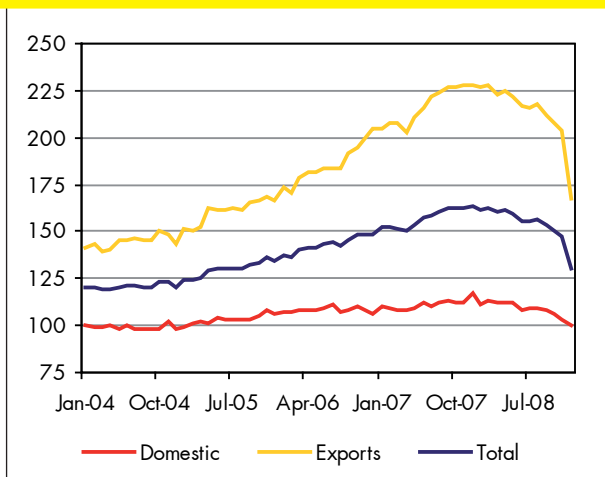


* preliminary data from CSO for the fourth quarter of 2008
Source: MNB

The service sector lost momentum over the course of last year. Transportation and storage (-1.8% yoy in H2) were dragged down by poor industrial output figures, while financial intermediation (estimated at over -5% yoy in H2) was hurt by the Post-Lehman storm. Public services remained relatively stable as the government froze spending at last year's level. A contraction of at least 3.5% is expected to come in the tertiary sector in 2009 as the recession deepens in the first half of the year.

The one positive contributor to GDP up until now has been agriculture with an outstanding 43% yoy growth in value added in 2008. This is clearly unsustainable due to the low base figures and last year's good weather conditions.

Volumen indices of industrial sales



Source: KSH

Government rescue plans and economic measures

Measures implemented by the National Bank of Hungary:

Establishment of an overnight and a 6M EUR/HUF FX swap window (no tender has yet been made for 6M). A joint 1W EUR/CHF FX swap facility with the SNB has also been announced. The total amount of these facilities is a maximum of EUR 5 bn.

- Narrowing of the overnight repo corridor to 1%
- Introduction of two kinds of repo tenders (2-week fixed rate and 6-month variable rate)
- Reduction of the MRR to 2.00% (from 5.00%)
- Introduction of government bond buy-back auctions (suspended on December 15)

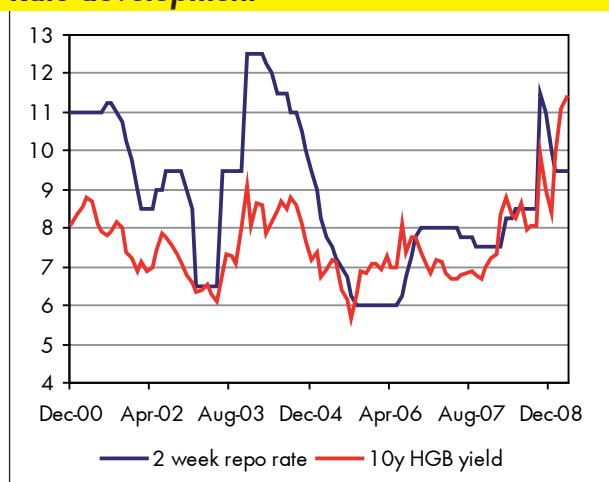
Measures taken by the Hungarian government:

- Abolishment of limitations on bond holdings for pension funds to boost liquidity on the HGB market.
- The amount of indemnification was raised to HUF 13 mn (approximately EUR 48,000) per person and per credit institution.
- A declaration was made about providing unlimited deposit guarantees, but no statutory provisions have been adopted on this issue yet.
- The National Deposit Insurance Fund raised its regular annual fee from 0.009% to 0.02% of the stock of deposits insured by the fund.
- Introduction of a bank rescue plan, which includes strong debt guarantees for banks (up to HUF 1,500 bn) and capital injections (up to HUF 300 bn) funded by IMF loans and which covers all Hungary-based institutions (none have participated yet).
- The 2009 budget included some measures: Public sector wages were frozen for 2009 and no bonus 13th monthly salary is to be paid.
- Two months after the acceptance of the 2009 budget plan, a tax package was introduced which includes proposals for 2009 and 2010. According to the government, the package aims to keep the budget deficit under 3% of GDP, and at the same time to mitigate the negative effects of the crisis on employment.

Other events:

- The IMF, the EU and the World Bank grants Hungary a EUR 20 bn credit line.
- The key interest rate was raised by 300bp in an extraordinary meeting to pull the rug out from under speculative attacks against the HUF. The NBH has been in an easing cycle since (200bp cuts have been made).

Rate development



Source: Reuters, Raiffeisen RESEARCH

Outlook

Hungary has been underperforming its regional peers over the past couple of years. Domestic demand has been declining over 2007 and 2008 due to fiscal restrictions. The only driver of the economy was manufacturing exports, and in 2008 a surge in agricultural output thanks to the extraordinarily good weather.

Given the fact that Hungary is living off of the IMF-EU-World Bank loan facility, there is no room at all for any type of counter-cyclical fiscal policies (apart from the government plan to intensify the utilisation of the EU funds). On the contrary: in the upcoming period (2009–2011), the government should implement further fiscal spending cuts. This would definitely drag domestic demand down further. Therefore, the Hungarian economy is set to underperform further in 2009 and 2010 (we expect -5% and -1% GDP growth rates, respectively).

The only source of potential stimulus in the long run is reducing the tax burden. The current government plans to reduce the tax wedge and cut social secu-

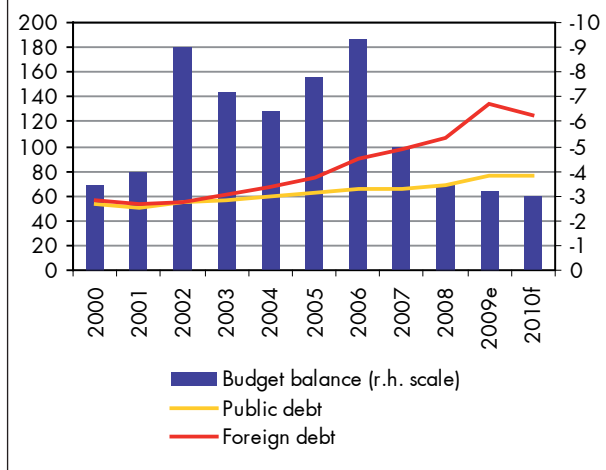
urity contributions and personal income tax – although VAT is to be hiked at the same time. Apart from these measures, the government also plans to marginally lower the corporate income tax rate from 20% to 19%. So far, there is no clear picture exactly what measures will be implemented in 2009. The Socialist government is in minority in the Parliament and it should secure the support of at least one of the two small parties (centre-right MDF, and liberal SZDSZ). The government plans can be labelled as minor steps into the good direction. Nevertheless, both MDF and SZDSZ favours more radical measures (this is an alternative programme of the “Reformszövetség” – a loose alliance of business experts), while Socialist MP’s are reluctant to fully support the government proposals. At the same time, the depth of the economic contraction pushes the government to implement even more painful measures in order to keep the budget deficit below 3% of GDP.

There is a further point that should be considered: next elections are due in Q2 2010. Early elections have extremely limited likelihood – practically we can rule them out. The IMF-EU-World Bank loan facility runs until exactly Q2 2010. Therefore the current government does really act as only a caretaker government without much vision of how to push the economy into a sustainable growth track in the medium-run.

Due to these circumstances our guess is that most of the government proposals will be passed with material impact for this year only in the form of increasing tax revenues (i.e. increasing VAT from 20% to 23% and increasing excise duty on tobacco, alcohol and fuel from July) – the rest of the package is about the future steps, most if them really out of scope of the current political cycle. Plus, there is a need to further cut expenditures. Ad hoc measures are likely to come in this regard.

It is difficult to predict what happens after Q2 2010 – i.e. after the elections and after the current IMF deal is over. Opinion polls display a strong lead of the opposition Fidesz ahead of the Socialists. Nevertheless, politics is unpredictable (opposition Fidesz was unable to secure election victory in Q2 2006 despite leading the polls since 2003 August), moreover little is known about the economic policy plans of Fidesz. In any case, common sense dictates that future fiscal policy should be centred around tax cuts and spending cuts (irrespective of the political parties and therefore irrespective of the next elections results in Q2 2010).

Debt and budget development



Source: MNB, KSH, Raiffeisen RESEARCH

The construction industry has been performing very poorly over the past years. The last double-digit growth in construction output was seen in 2002. In the years from 2003 to 2008 the construction output contracted by 2% and an acceleration of the negative trend began in 2007 and 2008. Now the government plans to intensively utilise EU funds for infrastructure developments in order to support the construction industry – but this alone will not be enough to buck the trend. Even in a best-case scenario, we expect the construction industry to produce roughly zero growth in 2010.

With the recession in full swing the economic outlook will remain weak throughout 2009 and for the overall economic development probably also into 2010. Nevertheless, we see some sectors that should be

the first to show some sign of improvement once the dust settles. Hungary's economy is dependent on the development in the EU and we think that once the recession passes, Hungary's export-oriented manufacturing industry may be able to recuperate swiftly. With the planned tax measures, the recent noticeable fall of the HUF and the lack of workforce bottlenecks (with unemployment set to rise further from 8% in 2008 to 12% in 2010), all signs are pointing to an improved competitive position for Hungarian companies.

There are two other business activities that are likely to benefit especially from the turn in business climate in the future: logistics and business services. Over the past years, the expansion of the motorway network and the growing number of logistics hubs around the country coupled with Hungary's geographical location enable the logistics industry to outperform. The very high enrolment ratio of students in higher education and the relatively good infrastructure, coupled with the low costs made Hungary a favoured location of business services (for example international call centers, accounting centers, development centers etc.) already in the past years, and should also secure a flow of new jobs in the future.

For the overall economy we expect a slower recovery. While the worst should be over in 2009 concerning the GDP decline we still project a small decline in GDP for 2010 before the economy will recover towards its potential output probably no earlier than 2012.

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	82.3	88.9	89.9	101.1	109.0	91.0	102.7
Real GDP (% yoy)	4.6	4.2	4.1	1.1	0.6	-5.0	-1.0
Industrial output (% yoy)	8.3	7.3	10.0	8.1	-0.8	-8.0	1.0
Unemployment rate (avg, %)	6.6	7.2	7.5	7.4	7.9	11.5	12.0
Nominal industrial wages (% yoy)	10.0	7.2	8.5	9.0	7.0	2.0	4.0
Producer prices (avg, % yoy)	3.5	4.3	6.5	0.1	5.3	5.2	1.6
Consumer prices (avg, % yoy)	6.8	3.6	3.9	8.0	6.1	4.2	3.0
Consumer prices (eop, % yoy)	5.5	3.3	6.5	7.4	3.5	6.0	1.3
General budget balance (% of GDP)	-6.6	-7.5	-9.2	-5.0	-3.4	-3.2	-3.0
Current account balance (% of GDP)	-8.5	-6.8	-6.1	-6.4	-7.4	-4.8	-4.6
Official FX reserves (EUR bn)	11.7	15.8	16.4	16.5	24.0	24.0	24.0
EUR/HUF (avg)	251.7	248.0	264.3	251.3	250.4	289.1	260.0
USD/HUF (avg)	202.3	199.5	209.8	183.4	170.2	203.6	179.3

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Down but not out

Recession arrived before Christmas

The golden era of Czech economic growth has been brought to a halt by the global recession. With exports accounting for over 80% of the country's GDP, the Czech economy was hit by a strong external shock. According to the preliminary figures, annual GDP growth decelerated to just 1% yoy in Q4 2008 from 4.2% in Q3 2008. The economy's slide was particularly driven by the slump in industrial output. Industry recorded a 13% yoy fall in real terms, and new orders decreased by some 28% yoy. The slump hit all segments of industry, but the automotive industry – which is crucial for the Czech economy – saw the worst of it. Almost one-fourth of total industrial sales are generated by the production of transport equipment. In line with the economic textbooks, the deepest production cuts are now being seen in consumer durables (including cars) and investment goods (machinery). While these cyclical sectors are being forced to reduce their production by more than one-fourth, production of energy and consumer non-durables (food, beverages, dry goods, toys, etc.) is falling less dramatically. Dwindling production had a second-round impact on the domestic service sector, which is responsible for up to 58% of gross value added in the Czech economy. Car sales and labour recruitment were hit hardest and saw double-digit drops. Nevertheless, the fall in demand hit all service segments including retail sales and personal services. The only exceptions are telecommunications and IT services. Production slippage, rising unemployment and extremely high uncertainty regarding the future also caused a fall in residential building and the construction of manufacturing facilities. Civil engineering activity is still rising thanks to public projects.

Robust external balance but vulnerable export performance

The Czech Republic (CR) has been running a trade surplus since 2005, and the current account deficits have been moderate. In 2008 the current account deficit reached CZK 111.8 bn, or 2.9% of GDP. For 2009, the dividend outflow is likely to decrease as profits have started to decline, but they will still be sufficient to increase the current account deficit in absolute terms. The current account deficit is likely to reach CZK 140 bn, but that means that it should stay well below 4% of GDP. The surplus on the financial account is likely to decrease, and this could put some further pressure on the reserves and the currency. Since October 2008, the Czech koruna (CZK)

has weakened by 16% against the EUR, wiping out two years of appreciation. It seems that most of the CZK adjustment to the anticipated current account deterioration has already taken place. The currency still remains very vulnerable to developments in the CEE region. However, if there is a need and the will, the central bank has many tools at its disposal to fight eventual currency depreciation. Besides verbal or direct interventions, an agreement that the government will not change the EU funds directly on the FX market is also still in place. Such an agreement, which is a relic from last year when the CZK appreciated wildly, can easily be abandoned. The CR's foreign indebtedness is relatively low. The very low interest rates gave no stimulus for foreign currency borrowing, and the foreign debt of households is almost zero. Total foreign debt to GDP is slightly below 40%. The share of net investments to GDP is even better (35%), signalling that a decline in FDI or the expected outflow of profits should not endanger external stability. The potential depreciation of the CZK could be a positive factor for export growth over the medium term, and debt-servicing capacity should be relatively secure. Short-term debt accounts for roughly 35% of the total foreign debt. In fact, the short-term financing needs are possibly the major discomfort factor. The share of short-term foreign-currency debt to foreign reserves jumped from 70% to slightly over 80%. But given the above-mentioned variables and circumstances, this doesn't seem to be alarming for the foreseeable future.

The Czech "New Deal"

A ten-member National Economic Council was set up by the government to prepare The National Counter-Crisis Plan. The plan covers seven topics which concern stimulating business activity (such as gradually reducing the tax burden on enterprises by 2bp between 2009 and 2010), investments (such as the faster depreciation of assets) and employment, boosting public spending on environmental protection and infrastructure, measures to keep companies operating (such as faster VAT refunds and guarantees on loans) and securing financing during reorganisation, and a moratorium on bankruptcies. The immediate assistance measures are expected to include an export promotion programme. The state-owned Czech-Moravian Guarantee and Development Bank is running a support programme for SMEs totalling CZK 40 bn. The registered capital of the Czech Export Bank will be increased by CZK 2 bn as well. The macroeconomic context of the government's stimu-

lus package can be summarised into four points. (1) These measures represent 2.6% of GDP (CZK 98.8 bn) and have impacts on the public budget amounting to 0.85% of GDP (CZK 32.2 bn using the ESA 95 methodology). (2) 70% of these measures are supply-side oriented. (3) Parliament must approve 30% of the package. (4) The Czech government's crisis scenario is based on a 2% decline in GDP in 2009. And the consequences? We expect them to be as follows: (a) Almost all room for additional fiscal stimulation is used up. (b) There is likely no way to stop the public deficit from rising above 3% of GDP. (c) This will likely slow the euro adoption process in the Czech Republic.

Winners and losers

The essential question now is who will emerge from the recession as a winner, and who as a loser? Answering this question is extremely complicated now because of extraordinarily high uncertainty, but we believe that the available indicators such as non-domestic sales and export orders, total sales and labour productivity can help us to identify pink segments (sectors that have a relatively high chance of surviving the current economic crisis because of their production backlog and buffer), and black segments (sectors that could be fatally hit by the recession). The following segmentation is relative, so production and sales in these segments could even fall, but not faster than average. The pink segments are also not automatically defensive (telecommunications, pharmaceuticals, utilities, beverages, and tobacco). We assume that better-than-average sales, order books and labour productivity might help companies survive the current economic downturn.

Pink segments:

Infrastructure development, utilities, telecommunications, the sales of everyday consumption goods except food (because of very intensive pressure on the margins over the last couple of years), IT services, chemicals production and electrical and optical equipment.

Black segments:

Repetitive glass production, leather, wood and furniture, paper, wearing apparel, car sales, labour recruitment, transport, specialised food stores, residential building and the construction of manufacturing facilities.

We put construction companies that are already involved or could be expected to be involved in public infrastructure projects at the top of the pink list. Without government programmes, we would place the strongly cyclical industrial sector and the automotive industry on the black list as well. The rescue packages for US and European carmakers including the "scrapage" premium and tax stimulus that the Czech government will try to put through (faster depreciation and VAT deductions) is likely helping automakers in the CR, but for how long? For one quarter as Skoda Auto estimates? The uncertain effect might also push the faster depreciation of investment goods including computers through. In spite of the fact that all of these measures are not intended to prevent the economy from falling into a recession, they may help the economy get back on its feet down the road.

Helena Horská, Aleš Michl, Michal Brožka

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	88.2	100.2	113.5	127.3	148.3	136.3	154.1
Real GDP (% yoy)	4.5	6.3	6.9	6.0	3.1	-2.6	1.3
Industrial output (% yoy)	9.6	6.7	11.2	9.0	0.4	-12.0	2.5
Unemployment rate (avg, %)	9.2	9.0	8.1	6.6	5.4	7.8	9.3
Nominal industrial wages (% yoy)	7.0	4.7	6.0	7.4	8.2	0.0	3.0
Producer prices (avg, % yoy)	5.7	3.0	1.6	4.1	4.5	-1.5	3.5
Consumer prices (avg, % yoy)	2.8	1.9	2.5	2.8	6.3	1.2	2.2
Consumer prices (eop, % yoy)	2.8	2.2	1.7	5.4	3.6	2.0	2.2
General budget balance (% of GDP)	-3.0	-3.6	-2.7	-0.6	-1.5	-5.1	-5.2
Current account balance (% of GDP)	-5.2	-1.3	-2.6	-3.2	-3.1	-4.5	-2.1
Official FX reserves (EUR bn)	20.9	25.1	23.9	23.7	26.6	23.5	25.0
EUR/CZK (avg)	31.9	29.8	28.3	27.7	25.0	27.5	25.1
USD/CZK (avg)	25.6	24.0	22.5	20.2	17.0	19.4	17.3

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Escape to the Eurozone

Period of record growth comes to an end

In Q3 2008, hardly anyone saw an impending crisis in the national Slovakian statistics. GDP grew by 6.6% yoy along with strong employment and wage growth. In October, however, we saw a first worsening of industrial production that went into free fall. In December we observed a 19% decline in production, a fall the likes of which was only seen after the collapse of communism. The decline hit virtually all sectors. The leading indicators suddenly became the most closely watched numbers. The fall of these indicators stopped, and stabilisation at low levels gives hope that industry could be at the bottom of this recession.

The labour market followed the worsening of production with a few months time lag. The number of unemployed persons jumped in December and in January as well. Cumulatively from October to January, around 30,000 people lost their jobs, lifting the unemployment rate by 0.8%, and more layoffs have already been announced. For the first time since 2000, the number of Slovaks working abroad started to diminish. Around 180,000 are still working abroad but this number has fallen by 10,000. We expect this trend to intensify since the crisis will also hit foreign jobs. Therefore, the unemployment rate will be under pressure from this side as well.

GDP growth declined for the first time in Q4 2008. GDP growth remained positive, but its level of 2.5% was far below any number posted in recent years. Household and government consumption were key drivers of GDP growth in the last quarter of 2008. In Q1 2009, we expect GDP growth to slow further to around 0%, with further downside risk. The fall in industrial production was intensified by the gas supply shortage in January, which should drive the statistics for January down (-25% yoy). The Slovakian industrial sector is very dependent on Eurozone performance and since leading indicators from the Eurozone do not show improvement in Q1 2009, we still cannot expect any improvement in Slovakian industry. Private consumption will suffer from layoffs and meagre wage increases in H1 2009. We expect employment statistics to worsen further, especially in the industrial sector, in H1 2009. There, nominal wage growth should fall to around 4% while the average in the national economy should not exceed 5.5%. The fall in oil prices will bring average inflation down to 2.6%, which keeps real wage growth at a decent 2.8%.

In the second half of 2009, we expect a gradual rebound of economic activity. Our GDP growth forecast of +0.8% in 2009 is based on the assumption of a rebound in industrial production to 2008 levels in H2 2009. Currently, the pessimism among entrepreneurs poses a negative risk to our projections. If industry posts a permanent 15% drop in 2009, GDP growth could easily slide into negative territory.

Despite the fact that Slovakia is perceived as a country strongly oriented towards the automotive industry, this sector does not make up a large share of GDP. According to 2007 national account data, only 7% of nominal GDP was created in the automotive sector, while the secondary impact via connected industries (e.g. plastics) could be of similar magnitude. Moreover, two of the three factories in the country (PSA and KIA) focus on the production of smaller cars that should not feel such sharp drop in demand. Therefore, the dramatic global decline in demand for new cars should not hit Slovakian GDP as drastically as one might expect.

Government measures to cushion the crisis

The economic and financial crisis caused the government to adopt a number of measures that should mitigate the negative effects of the current situation. Since Slovakia is a very open economy (exports account for 90% of GDP) it is clear that there are no feasible government measures that could offset a drop in foreign demand. Nevertheless, the government can come up with measures to ease the situation for unemployed people, stimulate the production side, decrease bureaucracy, bring stability to the banking system and so on. The ultimate aim of the measures should be to jump start economic growth as quickly as possible when the crisis passes.

The government prepared and approved a number of measures to react to the negative effects of the crisis. While the first set of them was rather formal, the second set approved in February brought some impulses to the economy worth roughly EUR 300 mn (0.4% of GDP). The biggest emphasis of the measures was on the fast implementation of large PPP infrastructure projects (motorways), whose impact could be as high as 2% of GDP. Unfortunately, the financing of these projects is still questionable due to the current liquidity crisis.

Additionally, the government approved the following changes:

- Lower effective personal income tax by increasing the deductible amount. This will raise the net income of a worker with average wages by around 1.6%.
- Allowing the fast deduction of investments for corporations
- Other tax changes that should decrease bureaucracy for small entrepreneurs
- The state will subsidise the creation of new jobs or will pay the social insurance contributions for these people

The government is preparing other measures such as provision of state guarantees for: loans to SMEs, which should ease the access to loans (55% of principal is guaranteed by a state agency and the maximum amount of the loan has been increased to EUR 1 mn) and helping with mortgage payments for recently unemployed people. If the person will not be able to meet his/her obligation to a bank, the mortgage will be transferred to the government. The Ministry of Finance released a new macroeconomic forecast in January 2009 projecting GDP growth of +2.4% in 2009. This is well below October's forecast. Consequently, projected public finance revenue was reduced by 1% of GDP. The government declared that it wants to keep the deficit below 3% of GDP, but additional spending cuts are required. Given the prevailing risk of a more negative macroeconomic forecast (we have since revised our growth projection to +0.8%), the budget deficit could easily end up above 3% of GDP.

Winners and losers

The Slovakian manufacturing sector rests on three pillars: the machine industry, electronics and the automotive industry. The automotive sector is the one that is being hit the hardest. Though its impact on GDP will not be dramatic, it will have a very negative impact on employment. Similarly, conditions in the machine industry will be poor because of low demand for investment goods in Western Europe. Consumer electronics (Sony and Samsung LCD factories) should not see such big drops and will help stabilise the situation in the industry. The service sector should fare relatively well in comparison to the industry, and will come out of the crisis stronger. Slovakia enjoys a relatively good position in these turbulent times. The introduction of the euro completely eliminated the exchange rate risk that is problematic for other Central European countries. The banking system is healthy with a surplus of liquidity (loan-to-deposit ratio below 80%). The banking sector will be able to finance economic growth when the crisis eases. The industry is very competitive, with above-average-growth potential over the medium term. This makes us optimistic about a rebound to high GDP growth when the crisis passes. The rapid depreciation of other Central European currencies can potentially create a burden for the Slovakian economy. Depreciation of the Polish zloty and the Czech koruna against the euro motivates Slovaks to travel to neighbouring regions to shop. At the same time, the purchasing power of Polish and Czech tourists at Slovakian holiday resorts has significantly decreased, as clearly shown in a sharp decline in holiday visits.

Robert Prega, Juraj Valachy

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	34.0	38.5	44.5	54.8	64.8	69.6	74.3
Real GDP (% yoy)	5.2	6.6	8.5	10.4	6.4	0.8	3.5
Industrial output (% yoy)	3.9	3.9	10.1	12.8	2.0	-5.0	4.0
Unemployment rate (avg, %)	18.1	16.1	13.3	11.0	9.6	12.1	11.9
Nominal industrial wages (% yoy)	10.2	7.2	6.7	6.4	7.1	4.5	6.0
Producer prices (avg, % yoy)	3.4	4.7	8.4	2.1	5.8	3.5	2.5
Consumer prices (avg, % yoy)	7.5	2.7	4.5	2.8	4.6	2.6	3.0
Consumer prices (eop, % yoy)	5.9	3.7	4.2	3.4	4.4	1.9	3.5
General budget balance (% of GDP)	-2.4	-2.8	-3.7	-2.2	-2.3	-3.5	-2.9
Current account balance (% of GDP)	-7.8	-8.4	-7.0	-5.3	-6.3	-5.2	-4.8
Official FX reserves (EUR bn)	12.0	12.5	10.7	13.0	13.5	12.0	12.9
EUR/SKK (avg)	40.1	38.6	37.2	33.8	31.2	30.1	30.1
USD/SKK (avg)	32.2	31.1	29.5	24.7	21.2	21.2	20.8

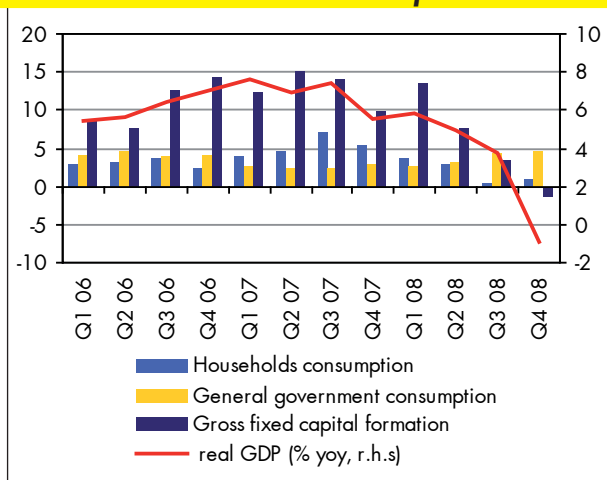
Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

To bury the head in the sand

Not possible!

Real GDP grew by 3.5% yoy in 2008. This was substantially lower than the 6.8% increase achieved in 2007. After good performance in the first half of 2008 with high GDP growth of 5.6%, economic expansion slowed noticeably in the third quarter (3.9%), and even slipped into the red in the fourth quarter (decreasing by 0.8% compared to the fourth quarter of 2007, the first GDP contraction since the second quarter of 1993). In the fourth quarter of 2008, GDP adjusted for seasonal effects and working days decreased by 4.1% compared to the third quarter of 2008 and by 0.9% compared to the fourth quarter of 2007. Economic activity is expected to slow substantially in 2009 because of weaker domestic and foreign demand. In particular, investment growth, which has been a key driving force over the past few years, will turn negative. Given the poor economic prospects for Slovenia's main export partners, export growth will cool down substantially.

Selected indicators of final expenditure



Source: Statistical Office of the Republic of Slovenia

Growth rates for many macroeconomic aggregates decreased substantially in the fourth quarter of 2008. The most pronounced was the 9.4% decrease in goods exports in real terms; this decrease contributed the most to the negative GDP figure. Goods imports also decreased in real terms (by 7.3%). Due to the positive growth of exports of services, total exports of products decreased less than imports of products. Thus, the external trade balance contributed positively to GDP growth.

Gross fixed capital formation decreased in real terms as well (by 5.3%). After reaching 16.9% in the first quarter of 2008, gross fixed capital formation went negative at the end of the year. Among all components, investments in private vehicles decreased the most (by 20.4%).

Industrial production growth slowed down from month to month and even turned negative for 2008 as a whole. In manufacturing, production fell sharply in the leather and textiles sectors and in the manufacture of food and wood products. Value added in manufacturing decreased in real terms in the third quarter already (-0.6%), and deteriorated markedly in the fourth quarter as value added plummeted by 10.5%. Production in the automotive industry, Slovenia's largest exporter, decelerated due to the challenging global conditions and as export demand declined. Some automotive components suppliers have already been seriously affected by the crisis. Value added in the real estate, renting and business services sectors also decreased (by 1.7%). Value added in other more important economic segments saw positive but much slower growth than in the previous quarters. The most distinctive was the slow-down in value added growth in construction (from 17.9% in the first three quarters to 3.1% in the fourth) and in trade (from 6.8% in the first three quarters to 1.7% in the fourth quarter of 2008).

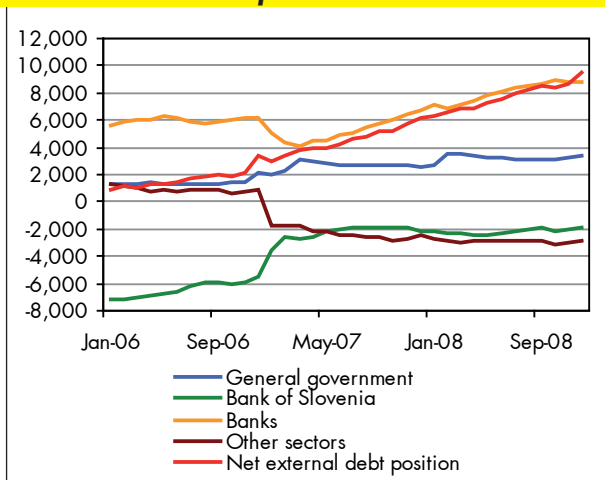
Although employment growth has been decreasing since the beginning of 2008, the contraction of GDP is not yet fully reflected in the employment figures. In 2008, employment growth was only slightly lower than in 2007 (2.9% in 2008 and 3.0% in 2007), with particularly high growth in construction, business services, transport and communication. However, labour force survey (LFS) data indicate employment growth of a mere 0.5%. In 2008 unemployment reached an all-time record low of 4.5%; the registered unemployment rate stood at 6.9%. The Public Employment Service expects the number of unemployed to increase by 15,000 to 20,000 by the end of 2009. In response to growing unemployment in Slovenia, the government reduced the work permit quotas for foreigners in 2008.

In December 2008, the government announced a stimulus package worth EUR 858 mn to counteract the overall economic crisis. The measures were mainly aimed at increasing liquidity in the banking system, cutting public expenditure and keeping jobs by providing additional incentives for the economy. The lending activity of banks is also to be boosted by funds acquired from the sale of the new, three-year government benchmark bond in the amount of EUR 1 bn, which was issued at the beginning of February 2009.

The second stimulus package, which expanded the first package with concrete measures, was adopted in February 2009. A considerable amount of funds is

still aimed at boosting the lending activities of banks to improve liquidity and enhance lending to enterprises, while some of the funds are intended for development-oriented measures. Along with the second package, the Slovenian government also adopted cost-cutting measures which will allow for annual savings in the amount of up to EUR 130 mn in 2009.

Net external debt position



Source: Bank of Slovenia

The measures in the second package are temporary (until the end of 2010). The highest permitted amount of state guarantees was already agreed in December and is limited to EUR 12 bn, of which around EUR 1.5 bn is currently reserved, mainly within the framework of additional borrowing by commercial banks. To revive lending to enterprises, the second package envisages a guarantee scheme for the general award of loans to enterprises (EUR 1 bn) and individual state guarantees for enterprises in the amount of EUR

500 mn. Within the measures to improve capital adequacy, EUR 160 mn is earmarked for the recapitalisation of the SID (Slovene Export and Development) bank (to EUR 300 mn). Besides guarantees and the increase in the capital adequacy of the SID bank, the second package also envisages additional funds in the total amount of about EUR 300 mn. The measures will be financed from the integral budget, from the SID bank's funds, by redirecting cohesion policy funds and through funds from the EIB's credit line. Measures to protect endangered industrial sectors also represent a vital part of the stimulus package. They involve shortening the payment periods for VAT reimbursement from 60 to 21 days (EUR 120 mn), support for research and development in the area of clean and technologically advanced industries (EUR 100 mn) and low-value aid within the new de minimis scheme for SMEs (EUR 20 m). These measures are set to increase the working capital of enterprises and improve their competitive position on the global market. The government also adopted measures to improve labour market operation, stimulate life-long learning and increase social security (EUR 21 mn), to promote energy-related renovation of publicly-owned buildings (up to EUR 20 mn) and provide broadband Internet access to public institutions (EUR 15 mn).

Slovenian economy is tightly connected to the major European countries, especially Germany, Italy and France. The global recession has therefore had significant influence on the GDP's performance during the last quarters. Nevertheless, we expect that Slovenia will still be able to outperform most of the EU countries over the next years.

Primoz Kovacic, Martin Stelzeneder

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	26.8	28.2	30.5	34.5	37.1	36.9	38.2
Real GDP (% yoy)	4.4	4.1	5.7	6.8	3.5	-3.0	0.5
Industrial output (% yoy)	5.5	3.4	6.5	6.2	-1.5	-6.0	1.0
Unemployment rate (avg, %)	10.6	10.1	9.4	7.7	6.7	7.5	7.4
Nominal industrial wages (% yoy)	7.1	5.8	5.5	6.7	4.4	3.0	3.5
Producer prices (avg, % yoy)	4.3	2.7	2.3	5.4	6.0	3.0	3.0
Consumer prices (avg, % yoy)	3.6	2.5	2.5	3.6	5.7	1.5	2.0
Consumer prices (eop, % yoy)	3.2	2.3	2.8	5.6	2.1	1.2	2.0
General budget balance (% of GDP)	-2.2	-1.4	-1.2	0.5	0.5	-1.0	-0.5
Current account balance (% of GDP)	-2.7	-1.8	-2.5	-4.2	-5.9	-3.0	-3.2
Official FX reserves (EUR bn)	6.5	6.8	5.3	0.7	0.6	0.6	0.6
EUR/SIT (avg)	238.9	239.6	239.6				
EUR/USD (Jahresdurchschnitt)	1.24	1.24	1.26	1.37	1.48	1.42	1.40

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Placing great hopes in the financial package

Economic growth has been impressive since 2000, coming in at an annual average of 6.2% between 2001 and 2008. Growth remained high even in 2008, with real GDP expanding by 7.1% over 2007. However, the picture changed entirely in the second half of the year. Economic activity remained strong in the first two quarters of 2008 in spite of the mounting crisis on the external markets. Real GDP excluding agriculture (which is the best indicator of economic activity in Romania) advanced by 9.1% yoy from January to June, but the trend flipped in the third quarter when the crisis on the external markets amplified.

GDP growth indicators (real, % yoy)

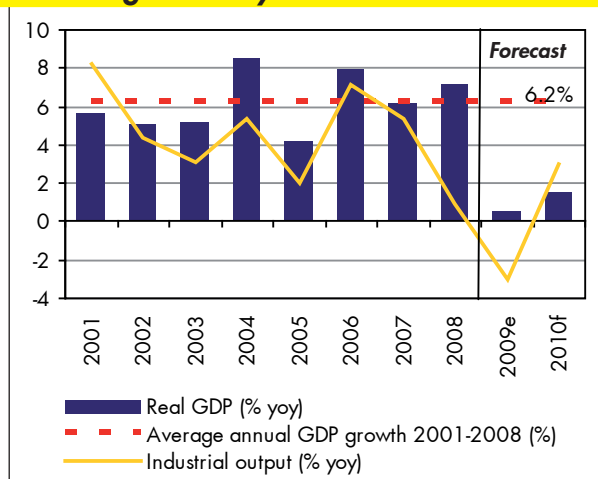
	Q1 08	Q2 08	Q3 08	Q4 08
Real GDP	8.2	9.3	9.2	2.9
Real GDP without agriculture	8.5	9.7	6.0	1.4
Domestic demand	16.7	15.8	10.4	-1.9
- Household expenditures	15.6	13.5	16.1	-4.7
- Government expenditures	5.4	-0.8	4.2	3.9
- Gross fixed capital formation	33.2	30.0	24.3	2.8
Gross value added	8.1	9.3	10.0	3.4
- agriculture	-0.4	3.7	34.8	18.2
- industry	5.4	6.2	3.1	-7.7
- construction	32.5	33.9	29.1	18.9
- services	7.6	8.2	4.2	2.3
Exports	25.8	30.7	21.1	-0.2
Imports	35.1	28.8	19.5	-10.4

Source: Eurostat, National Institute of Statistics, Raiffeisen RESEARCH

Economic conditions deteriorated significantly in the fourth quarter of 2008 after the collapse of Lehman Brothers and the lockup on the international credit markets. Activity decelerated in all sectors of the economy (industry, services, and construction) as internal demand (consumption and investments) and external demand weakened noticeably. Consumption and investments suffered due to more difficult and more expensive access to financing, and due to increasing uncertainty regarding the economic outlook for the next years, while the recession on the external markets began eating away at exports. As a result, GDP without agriculture expanded only by 3.5% yoy in the second half of 2008.

Industry was hit hardest by the crisis. After expanding by 6% yoy in the first half of 2008, industrial output advanced by only 2.5% yoy in Q3 2008 and plunged by 10.4% yoy in Q4 2008. Metals, chemicals and the automotive industry (including car manufacturing and car parts and accessories) were most affected in recent months. Companies in these sectors are oriented mainly towards external markets and suffered from the sharp fall in external demand. These companies account for around 44% of total exports, and also for a large share of total production value in the manufacturing sector (37% in 2007). At the end of 2008, the companies in these sectors decided to cut or even stop production. In the last two months of 2008, output in the chemicals industry plunged by 43% yoy (fertilizer and rubber tyre manufacturers were strongly affected), output in the metals industry shrank by 37% yoy, output in the transport equipment sector fell by 31% yoy, and output of electrical apparatus fell by 32% yoy (most likely due to a decrease in the manufacture of cables and wires for the automotive industry). So, the fall in external demand had a strong direct impact on some industrial sectors. The food industry, which is a defensive sector, still continued to perform well at the end of 2008.

Shrinking economy



Source: National Institute of Statistics, Raiffeisen RESEARCH

Romania has also been affected by the increase in risk aversion on the external markets and by the lockup on the international credit markets. Perceiving the large current account deficit (12.3% of GDP in 2008) and the country's high reliance on external borrowing as important vulnerabilities in the context of the turmoil and recession on the external markets, foreign investors became more pessimistic about

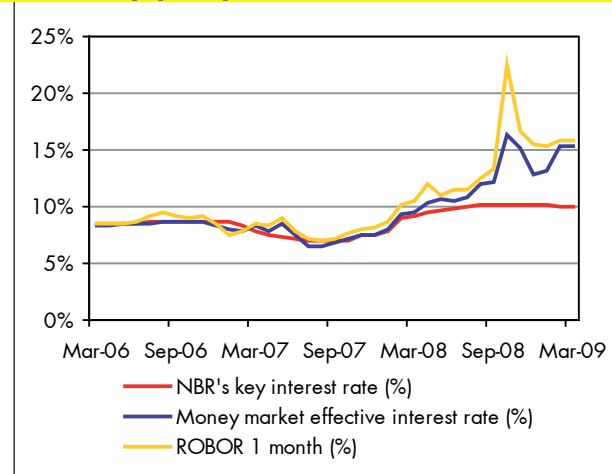
Romania's economic prospects. At the same time, S&P and Fitch cut Romania's sovereign ratings to non-investment grade (BB+, with a negative outlook) at the end of 2008. The expected decrease in the availability of funds from abroad and negative economic prospects made banks more reluctant to expand lending to households and companies, and the increase in the country's risk premium inflated borrowing costs in foreign currencies. So, more difficult and more expensive access to credit started to put downward pressure on domestic aggregate demand (consumption and investments). However, the resulting deceleration was much lower in this case. Investments (in equipment and residential properties) were hit first, but household consumption should also slow starting in Q1 2009, when wage growth should start to falter and unemployment should start to rise.

The room for manoeuvre for the government and the central bank to adopt expansionary policies is limited because of the macroeconomic disequilibria that have formed over the past years. The authorities are trying as much as possible to avoid a hard landing for the economy (especially by limiting the leu's depreciation and by trying to restore the confidence of foreign investors).

Monetary policy is very tight at the moment (high interest rates in the domestic market and partly high minimum reserve requirements), but an easing of monetary policy is difficult at the moment given that such a step would likely put additional depreciation pressure on the leu. The central bank seems to be more concerned about leu depreciation (because of the negative impact this could have on the stability of the financial system given that loans in foreign currencies account for more than 55% of total loans) than about the economic slowdown. In the last quarters, the central bank has struggled to defend the leu and has succeeded until now given that the leu depreciated by much less than its regional peers. In order to defend the leu, the NBR intervened on the FX market and tightly controlled the liquidity in the money market. The NBR will likely continue to keep tight monetary conditions at least until foreign investors' confidence in the leu starts to improve (this might happen if the government measures to cut the budget deficit are effective, if Romania receives financing from international financial institutions, or if the risk aversion on the external markets decreases). This means that market interest rates are likely to remain close to their current level (15%) over short term, with a fall being most probable in the second half of 2009 (when the

NBR should start cutting its monetary policy rate and minimum reserve requirements will be lower).

Monetary policy rate

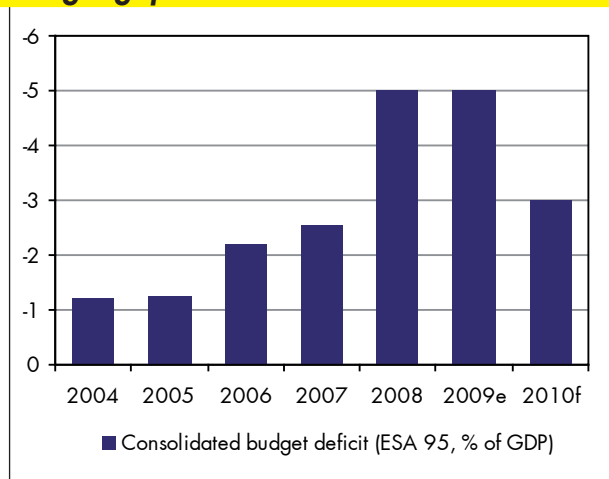


Source: National Institute of Statistics, Raiffeisen RESEARCH

By the end of March the NBR decided to keep the monetary policy rate unchanged at 10% and to lower the reserve requirement ratio for banks' long-term liabilities in foreign currency with residual maturity over two years from 40% to 0%. The decision is effective starting 24 May 2009. Reserve requirements for banks' foreign liabilities with maturity up to two years remained unchanged at 40%. According to our estimations, the decision would release around EUR 2 bn in the banking system. Moreover, the longer term impact would be more important, as we could expect a switch of financing from short-term to long-term maturities due to the incentive created. The NBR's decision to ease reserve requirements for foreign currency came shortly after Romania agreed with the international institutions (International Monetary Fund (IMF), European Commission, World Bank, and the EBRD) a two-year EUR 20 bn financing package and after foreign shareholders of the most important local banks pledged to keep their exposures in Romania. In fact, the decision will become effective shortly after Romania would receive the first money from the IMF (EUR 5 bn at the beginning of May). The decision has the potential to stimulate lending in foreign currencies (in terms of availability and cost of lending). Also, the decision is likely to stimulate foreign banks to swap current short-term funding of local subsidiaries with long-term funding (which is positive because it would reduce the country's short-term debt and the maturity mismatch between assets and liabilities).

The former government had a strong pro-cyclical fiscal policy, which resulted in a consolidated budget deficit of around 5% of GDP at the end of 2008. Even after the crisis hit the external economies with dire effect, the government continued increasing pensions and wages in the public sector and spending large sums of money on goods and services. These measures were certainly motivated in large part by the parliamentary elections last November. However, the new government (established in December 2008) seems to be more pragmatic and more committed to dealing with the lax fiscal policy in the previous years. The new government's first move was to set the budget deficit target in 2009 to only 2% of GDP in order to gain the confidence of foreign investors. But to achieve this cut, the government has to limit its increases in public spending. Although the target is not entirely plausible (we expect the budget deficit to remain close to 5% of GDP again in 2009 given the high risk of declining public revenues), the measures to limit public spending are likely to send a positive signal as they favour investment spending over public sector spending on wages and goods and services.

Budget gap



Source: Eurostat, Raiffeisen RESEARCH

The government implemented some measures in an attempt to limit the impact of the crisis. It decided to pay companies for goods and services purchased by public institutions in 2008 (past due amounts were significant at around EUR 2 bn). Reinvested earnings are to be tax-exempt starting Q2 2009. The government will pay a premium of around EUR 1,000 to people who trade in their old cars for new ones (up to 60,000 vehicles). The government also wants to increase the absorption capacity of structural funds from the European Union, and the guarantee fund

for small and medium-sized enterprises is to become operational. But in order to offset some of the expected decrease in revenues, the government had to increase social contributions by 3.3% (thus reversing the cuts made in the second half of 2008). At the same time, the government said that it would increase its equity stake in the state-owned banks (CEC and Eximbank) in order to support lending for small and medium-sized enterprises. The banks are also highly solvent, and the existing capital could cover some of the losses that will be incurred in the coming period.

In March 2009 Romanian authorities reached an agreement with the IMF, the European Commission (EC) and the World Bank for a financing package of around 20 bn. The funds will be disbursed over the next two years. During this period, the IMF will lend Romania EUR 12.95 bn, the European Commission EUR 5 bn, the World Bank EUR 1-1.5 bn, and other international creditors (i.e. EBRD) up to EUR 1 bn. Romania might take effectively the first funds from the IMF in May (around EUR 5 bn) and from the European Commission in the summer months. According to the IMF and the European Commission Romania has to take steps to reduce the budget deficit in the next years (to below 3% until 2011). However, IMF and European Commission agreed for a budget deficit of 4.5% of GDP in 2009 (5.1% of GDP according to ESA 95 methodology), which is almost at the same level from 2008. The high budget deficit was allowed due to pessimistic expectations of IMF regarding economic growth in 2009 (4% yoy contraction in 2009). The government is also expected to take measures to reform the system of public wages and pensions, and to reform public companies. As the government will be forced to tighten its fiscal policy due to the large budget deficit an increase in taxes (most likely personal income tax or VAT) cannot be ruled out in the coming years.

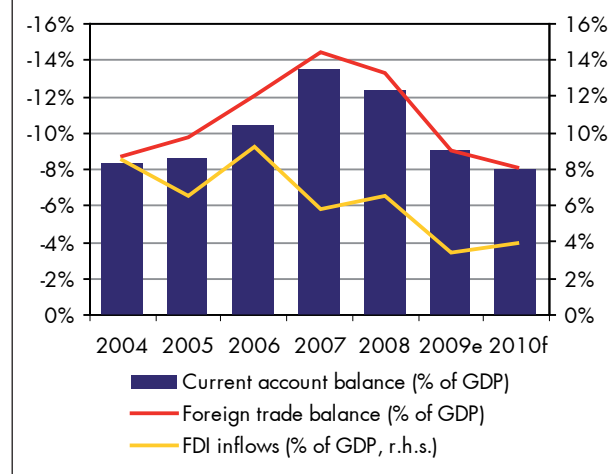
According to our estimations, the package covers completely the country's external financing gap for this year and it offers also an important liquidity buffer for 2010. The loan will allow the country to better deal with the economic slow down in the next two year and with the adjustment process of the current account deficit. The external loan might limit the pressures for leu depreciation, as the main part of the loan will go directly to the NBR reserve in order to ensure the financing of the balance of payment and this would boost confidence in the Romanian economy.

A sharp deceleration in economic activity is almost a certainty in 2009. We still expect to see a slightly positive GDP growth rate in 2009 (0–0.5%), but the potential for a contraction should not be underestimated. Economic activity should be very weak in the first three quarters of 2009 (with slightly negative annual growth rates). We don't expect a rebound until the end of 2009. Given that the world's major economies are in a recession, external demand for Romanian products will continue to suffer and the metals, chemicals and automotive sectors will be negatively affected (in spite of the stimulus received by the local car maker Dacia from the car industry package in Germany). However, the impact of weak external demand on the Romanian economy should be much lower than in the case of other CEE countries given that exports only account for 30% of GDP (the lowest level among the new EU member countries). Strong financing constraints will also pull domestic demand, consumption growth and investments down close to zero (or even into negative territory in the case of investments) from the double-digit levels of the previous years.

The sharp deceleration of the economy comes hand in hand with a contraction of the current account deficit. It decreased from 13.5% of GDP in 2007 to 12.3% of GDP in 2008. We expect it to decrease further to 9% of GDP in 2009. The adjustment of the current account deficit should also be a positive factor.

Over the long term, we think the profit opportunities offered by the Romanian economy will remain high.

Current account benefits



Source: KPMG

In 2007, per capita GDP in Romania amounted to only 42% of the EU 27 average, which means that there is much room for real convergence. Large FDI inflows in recent years point to the same thing. The low level of wages is still a potential advantage for Romania in many sectors. The government has also to play an important role in the convergence process, given the important size of pre-accession funds Romania might receive from the European Union (around EUR 30 bn between 2007 and 2013). Increasing the absorption capacity should be a key issue for the government. Experiences over the past years are not very promising, but the new government said strengthening absorption capacity is a key goal of the current anti-crisis package.

Ionut Dumitru, Nicolae Covrig

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	61.0	79.7	97.8	123.7	136.8	129.4	151.4
Real GDP (% yoy)	8.5	4.2	7.9	6.2	7.1	0.5	1.5
Industrial output (% yoy)	5.3	2.0	7.1	5.4	0.9	-3.0	3.0
Unemployment rate (avg, %)	6.8	5.8	5.4	4.3	4.0	5.5	5.7
Nominal industrial wages (% yoy)	23.0	16.9	15.7	21.6	21.3	3.0	5.0
Producer prices (avg, % yoy)	19.1	10.6	11.6	8.1	15.8	7.0	6.5
Consumer prices (avg, % yoy)	11.9	9.0	6.6	4.8	7.9	5.7	4.2
Consumer prices (eop, % yoy)	9.3	8.6	4.9	6.6	6.7	4.5	4.0
General budget balance (% of GDP)	-1.2	-1.2	-2.2	-2.5	-5.0	-5.0	-3.0
Current account balance (% of GDP)	-8.4	-8.6	-10.4	-13.5	-12.3	-9.0	-8.0
Official FX reserves (EUR bn)	10.8	16.8	21.3	25.3	26.2	25.0	25.0
EUR/RON (avg)	4.05	3.62	3.52	3.34	3.68	4.25	3.92
USD/RON (avg)	3.26	2.92	2.80	2.44	2.50	2.99	2.70

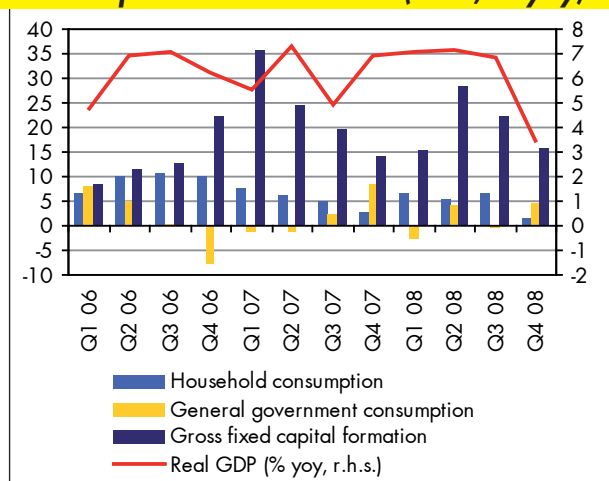
Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Putting a good face on a matter

Macroeconomic environment in 2008

Stable economic growth – The Bulgarian economy grew by 6% in real terms in 2008, driven by investments, capital flows including FDI and continued buoyant domestic demand fueled by credit growth.

Final expenditure indicators (real, % yoy)



Source: National Institute of Statistics

Increasing average income – Incomes in the country showed a clear upward trend in nominal and real terms. The average monthly wage increased from EUR 220 in 2007 to EUR 268 in 2008 – an increase of 8.3% yoy in real terms.

Falling unemployment rate – The stable macroeconomic environment contributed to the favourable development of the labour market and the creation of new jobs mainly in the private sector. The unemployment rate fell from 6.9% in 2007 to 5.6% in 2008.

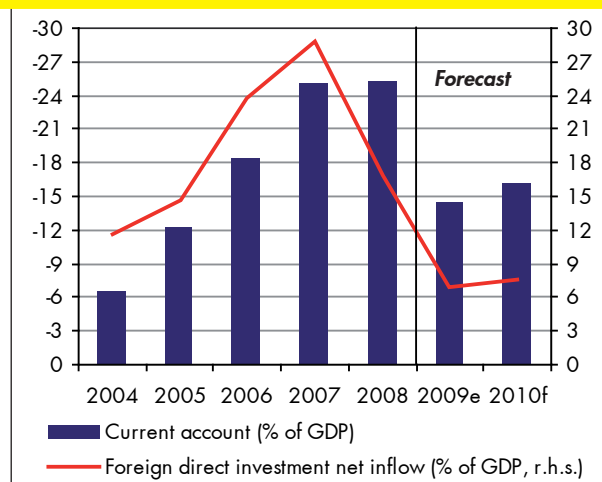
Fiscal policy – The budget surplus stood at 3% of GDP at the end of 2008. Fiscal policy was focused on maintaining stability given the rising external imbalances and met the requirements and recommendations of the European Commission.

Falling public debt – Public debt declined in absolute and relative terms from EUR 5.7 bn in 2007 to EUR 5.47 bn in 2008. It declined from 19.8% of GDP in 2007 to 16.2% of GDP in 2008 due to policies targeting budget surpluses.

Balance of payments – In 2008 the trade deficit reached 25.7% of GDP due to faster growth in imports than exports. The growth of domestic demand outpaced GDP growth, with the current account deficit widening to 25.3% of GDP in 2008, which

was fully covered by the surplus in financial account. However, the net FDI coverage of the current account deficit declined from 114% in 2007 to 65.8% in 2008, mainly as a result of risk aversion towards CEE economies on the part of investors.

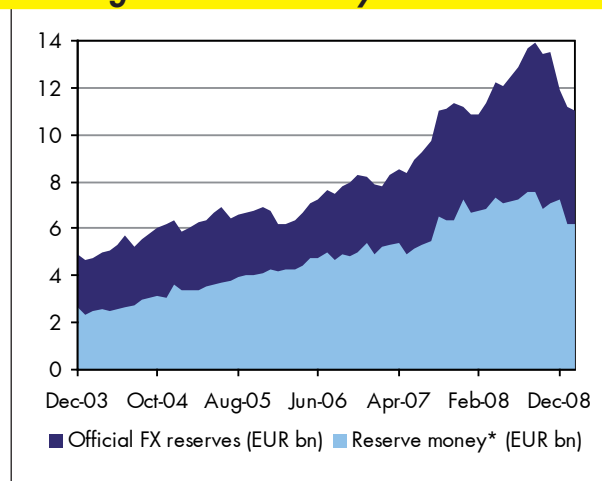
Current account balance



Source: Thomson Financial Datastream, wiiv, Raiffeisen RESEARCH

Increasing foreign exchange reserves – Large capital inflows and a positive overall balance of payments led to an increase in the central bank's official reserves of EUR 776 mn to EUR 12.7 bn in 2008, supporting the coverage of the liabilities of the currency board with reserve currency.

Coverage of the monetary base



* money in circulation and deposits of other MFIs

Source: Bulgarian National Bank

Rising external debt – External debt increased significantly in 2008, reaching EUR 36.6 bn up from EUR 28.9 bn in 2007 (up by 27%). Private external debt

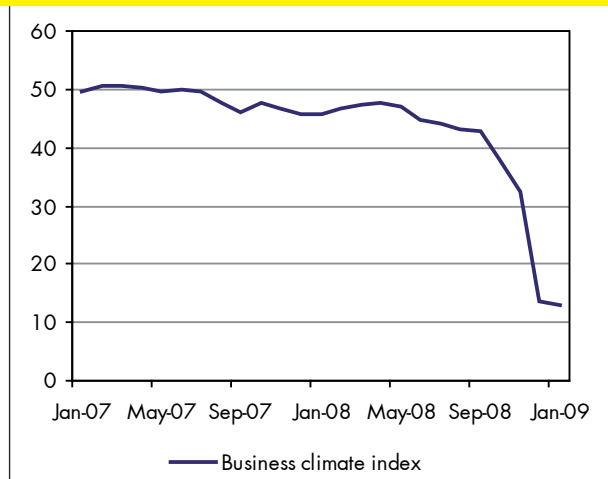
stood at 94% of GDP at the end of 2008, up from 85.7% of GDP in 2007. Short-term debt made up 36.4% of the gross external debt.

Inflation – The HICP-based annual average inflation rate accelerated to 12% in 2008 from 7.6% in 2007. Continuing credit growth and capital inflows led to a higher money supply in the country. Simultaneously, soaring prices of raw materials, fuels and food on the international market and rising excise duties as a result of compliance with EU legislation contributed further to the acceleration of inflation.

First signs of global crisis detected in Bulgaria in Q4 2008

The global financial and economic crisis spilled over to Bulgaria during Q4 2008. The main effects emerged from lower external demand and limited capital inflows. There was a deceleration of economic activity and a decline in consumer and business confidence in the country.

Business climate



Source: National Institute of Statistics

Significant developments in the key economic indicators during Q4 2008 compared to Q3 reflected the worsening global economic environment:

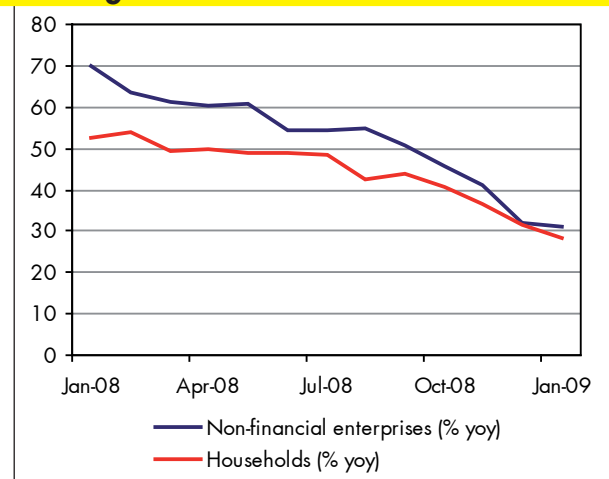
- Manufacturing production fell by 3%;
- Merchandise exports decreased by 21.6% in nominal terms;
- Merchandise imports decreased by 10.5% in nominal terms;
- The number of employed persons declined by 54,000 in Q4 compared to Q3, while the same

figure declined by 9,000 in Q4 2007 compared to Q3 2007.

In December the inflation rate decelerated to 7.2% yoy from 14.7% yoy in June due to the decrease in international commodity prices.

The sectors that saw the most negative effects in January 2009 were the manufacture of fabricated metal products with a decline of 59%; metal ore mining with a decline of 51%; motor vehicle, trailer and semi-trailer manufacturing with a decline of 50%; textile manufacturing with a decline of 47%; and furniture manufacturing with a decline of 35%. Other sectors, such as construction and real estate, were also hit hard by the economic uncertainty and limited bank financing – the process continued to deepen in January with real estate prices falling by 25%–30%. Pharmaceutical product manufacturing saw positive effects, rising by 257% on an annual basis, while basic metal manufacturing maintained its production level from January 2008 in January 2009.

Credit growth rate



Source: Bulgarian National Bank

Measures taken and/or in the pipeline

The government has initiated a number of measures to mitigate the influence of the global crisis on the Bulgarian economy based on maintaining financial stability and adherence to active economic policies focused on improving flexibility and competitiveness.

- Increasing state guarantees on bank deposits to BGN 100,000 (EUR 51,129).
- Increasing the capital base at the Bulgarian Development Bank by EUR 255.6 mn in order to

provide stimulation for small- and medium-sized enterprises; aimed at improving the process of utilising EU funds.

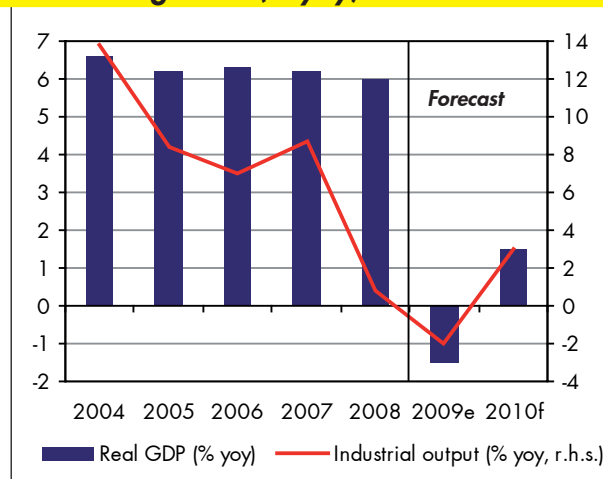
- Provision of guarantees by the Bulgarian Development Bank in order to share risk with commercial banks.
- Decreasing the minimum reserve requirements for commercial banks from 12% to 10% of the total attracted funds as of December 2008; as of January 2009 the minimum reserve requirements on funds attracted from foreign residents were further reduced to 5%, while the reserve costs on state and municipal funds were set at 0%.
- Lowering the rate of social security payments by 2% and maintaining 10% flat rates for personal and corporate income taxes.
- Differentiating unemployment benefits, allowing reduced and more flexible working hours and providing funds to support employment. As a result of the new regime, workers whose wages are reduced will be paid an additional benefit amounting to 50% of the minimum wage.
- Increasing capital expenditures in the state budget by 18.5% in 2009 to EUR 2.9 bn.
- Limiting the non-interest spending and transfers from the government budget to 90% of the planned level. They could be limited further in order to avoid a deficit in the consolidated budget if the projected revenues are not collected.
- Limiting the growth rate of wages in the public sector.
- Budget surplus of 3% of GDP in 2009 – This is considered to be the necessary buffer to offset possible fiscal loosening.
- Limiting public spending to 40% of GDP.

Expectations and challenges for 2009

Economic activity is anticipated to decline substantially in 2009 compared to 2008. The annual GDP growth rate is expected to slump significantly and even to reach negative territory, while the fiscal and monetary measures will be targeted at mitigating the repercussions of the global crisis on Bulgaria.

The consequences of the global turmoil are expected to be more negative for the non-financial sector and for the industrial sector in particular. Industrial production and sales will likely fall further in 2009 due to declining orders, which will lead to lower capacity utilisation and layoffs. As a result, the unemployment rate is expected to rise gradually and the positive employment trend seen in recent years will possibly be reversed.

Real GDP growth (% yoy)



Source: Thomson Financial Datastream, wiiv, Raiffeisen RESEARCH

Rolling over the short-term debt, which represents over one-third of Bulgaria's gross external debt, is expected to be a major challenge due to the country's limited access to the international financial markets for refinancing and the short-term liquidity available on the foreign money markets.

The inflation rate will likely decelerate significantly in 2009 as a result of falling disposable income, slowing employment growth and tighter credit conditions. Wages are expected to increase slightly on average given the expected modest growth in total productivity, although they will drop in some sectors due to decreasing demand and output.

Capital inflows are widely expected to shrink. The global financial crisis is likely to reduce capital flows to Central and Eastern Europe, including Bulgaria. Given the risk aversion on the part of investors, FDI is expected to decline. Therefore, it will be difficult to offset the sizable current account deficit through the positive financial account as was the country's strategy in previous years.

Contracting foreign demand and declining commodity prices are anticipated to lead to a drop in exports in nominal and real terms. The main export partners are EU countries (almost 60% of total exports). The EU is already experiencing a significant economic downturn that will likely lead to a drop in demand for Bulgarian products. Another factor is the structure of exports, which is dominated by commodities with already falling prices and the falling demand for clothing, footwear, iron and steel among foreign trade partners.

Shrinking domestic demand and reduced capital inflows will likely lead to falling imports. The consumption is expected to stagnate, which would cut the costs for foreign consumer goods. Businesses will also have less demand for imported commodities as a result of anticipated lower production and the forecasted drop in sales. Thus, the current account deficit is expected to narrow in relative terms to GDP in 2009 compared to 2008.

The Bulgarian government has clearly announced its intentions to stay in line with the course of its fiscal policies over the past few years. The official target for the consolidated budget balance is 3% of GDP. There are certain risks for the implementation of the budget with regard to the revenue side given the slowing down of economic activity and falling commodity prices.

In addition, 2009 is an election year, which further increases the overall uncertainty. Polls indicate that the next government will likely be a coalition once again. The main political parties currently insist on maintaining the currency board regime and the present level of the fixing and claim that they fully support the fixed peg until Bulgaria's entry to the Eurozone.

Undoubtedly, the global financial crisis will have a negative impact on Bulgaria. The Bulgarian economy is expected to experience negative real growth in 2009 for the first time since 1997. There are significant risks concerning the prospects for economic growth in the country. A worse than expected recession in Bulgaria's trading partners could lead to a more rapid drop of exports and capital inflows, which could increase the pressure on the existing im-

balances. However, Bulgaria entered into the crisis in relatively good shape given the existing surpluses and the volume of foreign exchange reserves. According to Moody's recent statement, Bulgaria is among the soundest economies in Eastern Europe.

Possible measures

- Implement additional insurance/guarantee schemes aimed at providing companies with easier access to financing from commercial banks;
- Support municipalities in order to strengthen administrative capacities and absorb a higher volume of EU funds through FLAG.
- Improve the business environment by removing the bureaucratic obstacles involved in starting and closing a business and introducing an obligatory impact assessment system for proposed normative acts.

Dimitar Chobanow

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	19.8	21.9	25.2	28.9	34.1	35.3	37.2
Real GDP (% yoy)	6.6	6.2	6.3	6.2	6.0	-1.5	1.5
Industrial output (% yoy)	13.8	8.4	7.0	8.7	0.8	-2.0	3.0
Unemployment rate (avg, %)	12.0	10.1	9.0	6.9	5.6	7.5	6.9
Nominal industrial wages (% yoy)	6.2	8.2	10.9	20.0	22.0	8.0	7.0
Producer prices (avg, % yoy)	6.0	6.9	6.9	8.4	10.6	6.0	4.0
Consumer prices (avg, % yoy)	6.2	5.0	7.3	8.4	12.3	5.0	4.0
Consumer prices (eop, % yoy)	4.0	6.5	6.5	12.5	7.8	4.0	3.5
General budget balance (% of GDP)	1.7	2.3	3.6	3.5	3.0	0.5	1.5
Current account balance (% of GDP)	-6.6	-12.4	-18.4	-25.1	-25.3	-14.5	-15.6
Official FX reserves (EUR bn)	6.3	6.7	8.2	11.2	11.9	11.0	11.5
EUR/BGN (avg)	1.956	1.956	1.956	1.956	1.956	1.956	1.956
USD/BGN (avg)	1.57	1.57	1.55	1.43	1.33	1.38	1.35

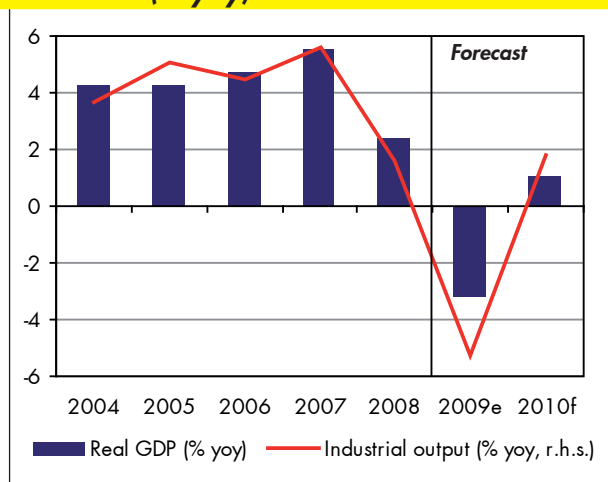
Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Getting through the day

Fiscal policy on the move

Initially, the escalation of the financial crisis on the global markets during autumn 2008 had only a limited impact on the domestic financial system. Despite changes in the structure of the domestic financial system in recent years, it has remained mostly bank-centric and significant deposit withdrawals especially in October came as no surprise. Luckily, things have changed tremendously since the last decade of the twentieth century, when we saw several crises among domestic banks. First, the majority of domestic banks were successfully privatized and the new owners (mostly internationally renowned financial institutions) increased capital and also transferred know-how. Second, the CNB maintained a conservative and strict monetary policy during the years of credit expansion (despite some criticism). This gave the domestic banks a high level of capitalization and FX liquidity even in comparison with banks operating in the EMU. The other significant move was the government's increase in the deposit guarantee threshold from HRK 100,000 to HRK 400,000. Most of the deposits returned to the banking sector by the end of 2008. Additional problems were seen in the other segments of the financial market when unfavourable trends on the global equity markets put more downside pressure on financial assets. Growing regional risks also led to further decreases in domestic bond and equity prices, especially after Hungary applied for assistance from international financial institutions. Furthermore, no visible depreciation pressures were recorded at that time. Actually, EUR/HRK hit a historic low at the start of October, mostly due to the huge foreign capital inflow that came with the finalisation of the INA takeover transaction.

Real GDP (% yoy)



Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

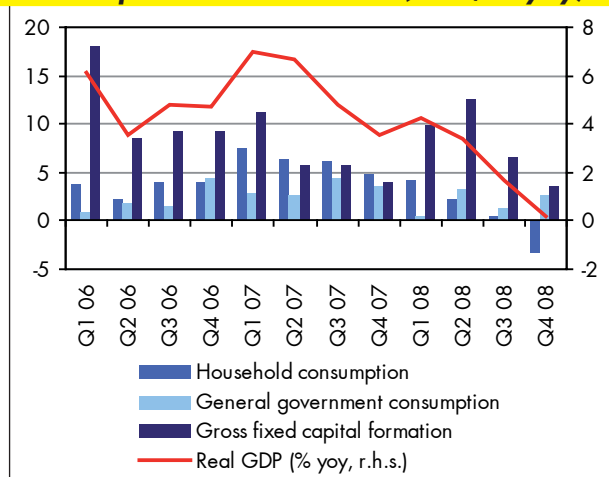
On the other hand, Q4 2008 data from the real economy already suggested that the impact of the global recession and interrupted capital flows on the Croatian economy will be stronger than expected. For instance, retail sales fell for the first time in ten years, while industry posted the slowest growth in this period. Unemployment was also on the rise. The prospects for the domestic economy are even gloomier this year, and we expect GDP to shrink by some 3% in real terms mostly due to decreased household consumption and decreased investments. The following sectors will be affected most in Croatia by the current conditions on the global markets:

- **Tourism** – Probably the most important sector for the Croatian economy as it generates a high level of revenues from the export of services and mitigates pressures on the CAB from the foreign trade deficit. Global tourism will most likely see its most challenging year in 2009, and we expect to see a decline of the number of tourist arrivals and overnight stays in Croatia. This decline will most likely be partially offset by some comparative advantages in the domestic tourism sector, the most important one being proximity to the Western market countries. However, the decline in tourist receipts will be even bigger as most tourists will modify their consumption to current unfavourable trends. An expected decline in revenues accompanied with higher financing costs will decrease the already low profitability of domestic hotels, and this will negatively impact necessary future investments in this sector.
- **Trade** – Employment already fell at the start of 2009 due to current negative trends in the retail segment, but also due to some administrative changes. The projected decrease in turnover for 2009 will come mostly from a decrease in employment and slower wage growth. Furthermore, most categories of retail-sector loans (except housing loans) could fall during the year and bring household consumption down further. The biggest decline of sales in real terms is expected in motor vehicles and other durable goods.
- **Construction and real estate** – After the slow-down at the end of last year, the recession will seriously impact the real estate market in 2009, and sales fell by as much as 80% at the start of the year. Average real estate prices can realistically be expected to decline by 10% to 15% this year. We must take into account that this is the average correction for the entire market, and that exclusive properties will see a much smaller price

correction, in some cases none at all. At the same time, properties of lower-quality construction or at less-attractive locations are likely to see price declines of up to 25%. Lower demand and reduced property sales will lead to a decrease in construction activity. Furthermore, the government will have to cut its investments in infrastructure projects during the upcoming period as capital is becoming increasingly scarce. Since construction work accounts for nearly 55% of all capital investments in Croatia, it is obvious that negative trends in this sector will also reflect strongly on the GDP figures.

- Low-value-added manufacturing sectors – Low production efficiency accompanied by lower foreign and domestic demand and simultaneous high international competitive pressure will most likely lead to a significant decline of production capacities and employment. This could be most pronounced in the textile and wood processing industries. We also cannot forget that Croatia promised the European Commission that it will decrease its production capacities in the ship-building industry in order to achieve sustainable development in this sector.

Final expenditure indicators (real, % yoy)

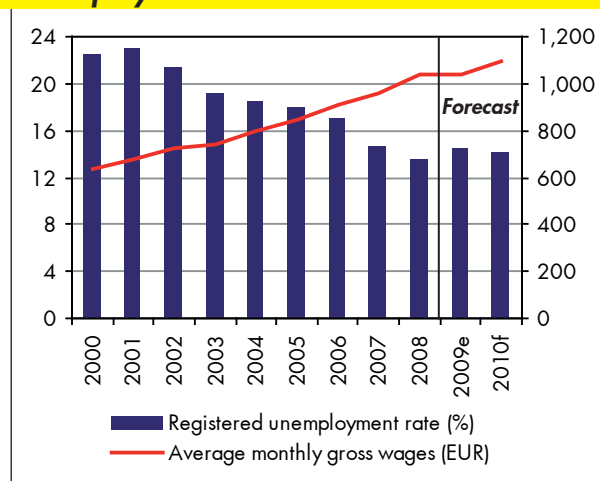


Source: National Institute of Statistics

Croatian companies will have a harder time accessing credit on the international and domestic markets. Higher borrowing costs for domestic banks and higher operational risks will negatively affect the ability of the corporate sector to borrow. Most companies in most sectors will face significant challenges during 2009, though some sectors may be affected less by negative global developments. Sectors that produce goods with non-elastic demand (such as food and

beverages) will weather this storm somewhat better. We expect to see consolidation and more M&A activity in most sectors of the domestic economy.

Unemployment rate



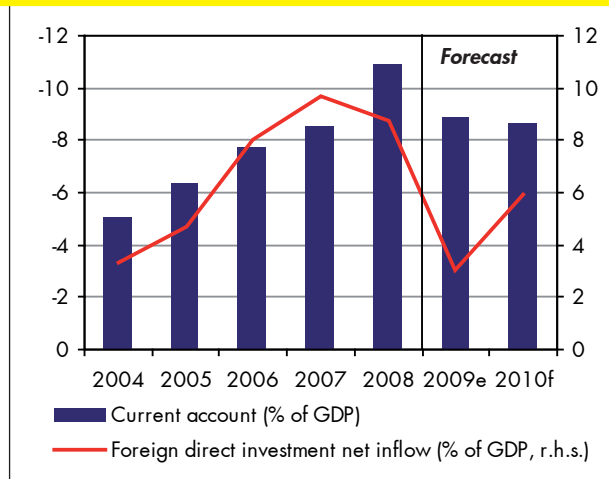
Source: National Institute of Statistics, Raiffeisen RESEARCH

However, the contraction of the economy and increasing unemployment might not be the most significant problem for policymakers in 2009. The biggest question for this year is: Will fiscal policy follow the restrictive monetary policy in order to tackle present imbalances in the domestic economy, especially external ones, as countries from the region find it more difficult to finance their external gaps? We should not forget that the countries in the region have little room to tackle the recession by implementing expansionary monetary and fiscal policies, so efforts have to be focused on stabilising the economy. At the start of 2009, the depreciation pressure on the kuna (resulting mostly from the low supply of foreign currency) confirmed the fact that most of the CEE and SEE economies are becoming extremely vulnerable under the current conditions. The central bank reacted strongly by decreasing kuna liquidity and by decreasing the banking sector's FX reserves. As a result, interest rates on the MM reached record highs. Since any sharp decrease in official FX reserves would most likely lead to downward corrections of credit ratings, we believe that the CNB will continue to focus primarily on the interest rate differential to mitigate depreciation pressures.

At the end of February, the government presented a package of so-called antirecession measures that was prepared in cooperation with independent expert body Economic Council. This package includes the following measures:

1. Additional stabilisation of the macroeconomic environment – a revision of the 2009 budget was announced and the government will continue with its efforts to finance some of this year's deficit on foreign capital markets
2. Decrease of the para-fiscal burden for the corporate sector
3. Public companies and state-owned companies must decrease their expenditures and help improve liquidity in the real economy
4. Reallocation of government aid
5. Strengthening the financial position of the CBRD with the objective of subsidising exporters' finance costs
6. Support for the tourism sector
7. FDI promotion activities
8. Measures aimed at supporting the construction sector by stimulating a higher level of activity on the real estate market
9. Stronger control of imported goods quality
10. Support to the most vulnerable segment of population

Current account balance

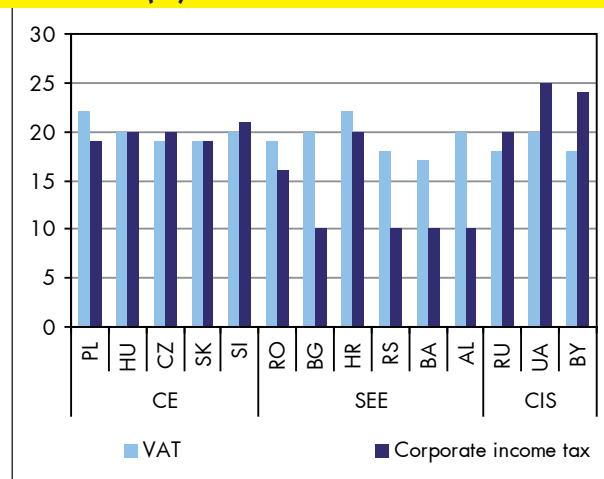


Source: Thomson Financial Datastream, wiiv, Raiffeisen RESEARCH

Since no additional details of these measures have been revealed yet, it is still too early for any assessment. However, it is clear that the most important point will be the revision of this year's budget. The 2009 budget deficit will interfere somewhat with the central bank's efforts to keep the domestic currency stable. Furthermore, the corporate sector will be less exposed to the "crowding out" effect. We not only need to see a clear decrease in expenditures, but also significant changes in their structure. However, there are several obstacles on the path to fiscal consolidation. First, the majority of the most significant

expenditures (pensions, wages, healthcare, etc.) are rather fixed with only little leeway for cuts over the short term. Furthermore, the upcoming local election in May and presidential elections at the start of 2010 might make the government's less inclined to implement some of the unpopular reforms that are needed. Croatia will only start to recover after activity in the Eurozone starts to pick up, but most likely not before risk aversion towards the SEE region decreases. Under these circumstances, we do not think that a package of measures from the government will be enough to pull the domestic economy out of the recession. This means that these measures can only be viewed as an instrument to offset some of the negative impacts of the unfavourable economic trends on the domestic private sector.

Tax rates (%)



Source: KPMG

In our opinion, most of the activities should be aimed at implementing the stabilisation measures to decrease budget expenditures and the current account deficit over the short term. Over the longer term, the crucial factor will be how fast and how successfully structural reforms can be implemented. The model of growth based on strong domestic consumption and high foreign capital inflows that we saw in the SEE region over this decade will be very hard to repeat, so reforms must be implemented that will allow potential GDP growth to increase. Although the kuna has remained fairly stable and Croatia does not have FX liquidity problems for now, we think that it would be wise to make an arrangement with the IMF at least as a preventive measure. An arrangement with the IMF would also most likely speed up some of the reforms, especially in the public sector. Credit ratings have not fallen significantly yet, mostly due

to prudent monetary policy and the resulting stable financial system and domestic currency and high FX reserves. Nevertheless, we may see some corrections as risks for the SEE region increase. Recent snags in negotiations with the EU might put additional pressure on the credit ratings.

Long-term debt ratings in CEE

	S&P (LCY/FCY)	Moody's (LCY/FCY)	Fitch (LCY/FCY)
Albania	not rated	B1/B1/stable	not rated
Belarus	BB/B+/negative	B1/B1/negative	not rated
Bosnia a. H.	not rated	B2/B2/stable	not rated
Bulgaria	BBB/BBB/ negative	Baa3/Baa3/ stable	BBB/BBB-/stable
Croatia	BBB/BBB/ negative	Baa2/Baa3/ stable	BBB+/BBB-/ stable
Czech Rep.	A+/A+/stable	A1/A1/stable	AA-/A+/stable
Hungary	BBB-/BBB-/ negative	A3/A3/negative	BBB+/BBB/ negative
Macedonia	BBB-/BB+/ negative	not rated	BB+/BB+/stable
Poland	A/A-/stable	A2/A2/stable	A/A-/stable
Romania	BBB-/BB+/ negative	Baa3/Baa3/ stable	BBB-/BB+/ negative
Russia	BBB+/BBB/ negative	Baa1/Baa1/ stable	BBB/BBB/ negative
Serbia	BB-/BB-/negative	not rated	BB-/BB-/negative
Slovakia	A+/A+/stable	A1/A1/positive	A+/A+/stable
Slovenia	AA/AA/stable	Aa2/Aa2/ positive	AA/AA/stable
Turkey	BB/BB-/negative	Ba3/Ba3/stable	BB/BB-/stable
Ukraine	B-/CCC+/ negative	B1/B1/under revision	B/B/negative

Source: Rating agencies

Zdeslav Santic, Anton Starcevic

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	28.7	31.3	34.2	37.5	41.2	39.6	42.1
Real GDP (% yoy)	4.3	4.3	4.8	5.6	2.4	-3.2	1.1
Industrial output (% yoy)	3.7	5.1	4.5	5.6	1.6	-5.3	1.8
Unemployment rate (avg, %)	18.5	18.0	17.0	14.7	13.5	14.5	14.2
Nominal industrial wages (% yoy)	6.7	6.1	7.4	6.6	6.0	-1.2	3.1
Producer prices (avg, % yoy)	3.5	3.0	2.9	3.4	8.4	1.2	3.9
Consumer prices (avg, % yoy)	2.1	3.3	3.2	2.9	6.1	2.8	3.8
Consumer prices (eop, % yoy)	2.7	3.6	2.0	5.8	2.9	3.8	3.4
General budget balance (% of GDP)	-4.8	-4.1	-3.0	-2.3	-2.4	-3.0	-2.1
Current account balance (% of GDP)	-5.1	-6.4	-7.7	-8.6	-10.9	-8.9	-8.7
Official FX reserves (EUR bn)	6.4	7.4	8.7	9.3	9.1	8.2	9.2
EUR/HRK (avg)	7.50	7.40	7.32	7.34	7.22	7.47	7.35
USD/HRK (avg)	6.03	5.95	5.81	5.36	4.91	5.26	5.07

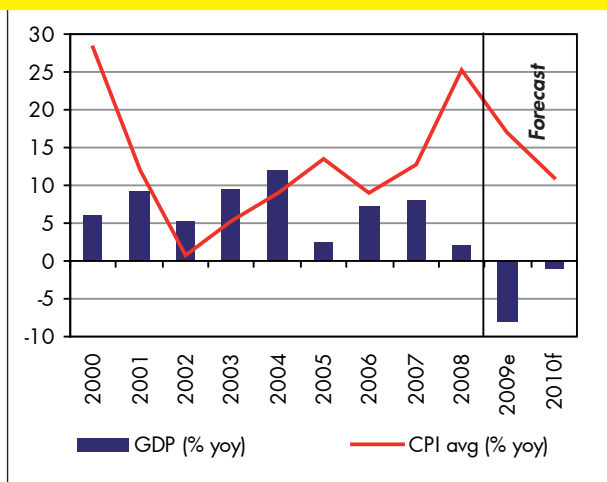
Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

A story of boom and bust

development of internal market needed

The Ukrainian economy demonstrated buoyant growth in recent years with GDP expanding by almost 8% on average from 2003–2007. On the one side, robust economic performance can be attributed to favourable external developments – surging global prices for the main Ukrainian exports (steel and chemicals), strong demand for Ukrainian machinery in Russia, and artificially low gas import prices. At the same time, over recent years Ukraine enjoyed large capital inflows owing to abundant global liquidity and the growing presence of foreign banks. As a result, credit inflows into the economy surged enormously (the average annual credit growth rate was 70% from 2005 to 2007), stimulating domestic demand and contributing to the formation of asset bubbles (real estate, stock market, etc.). The consumption boom was also propelled by clearly pro-cyclical economic policies. First, to defend the de-facto peg to the USD in the environment of persistent external surpluses, the Central Bank had to execute large-scale FX interventions that resulted in rapid money supply growth. Second, against the background of persistent political battles, the government was regularly using populist fiscal measures to “buy” votes. As a result, the fast growth of public wages and social benefits led to an increase of budget expenditures by 7% of GDP from 2004 to 2008.

Real GDP and inflation

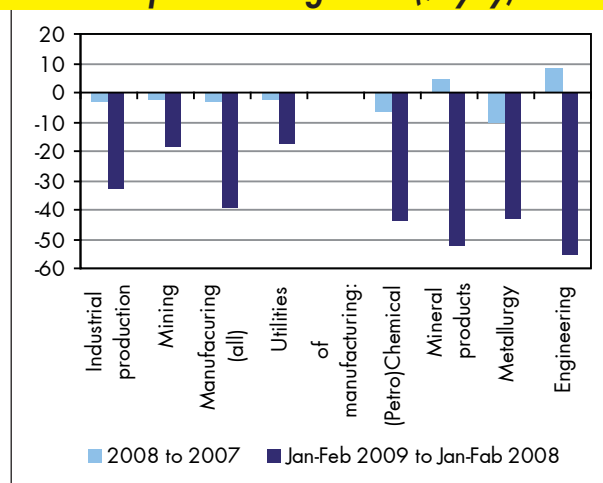


Source: State Statistics Committee of Ukraine, Raiffeisen RESEARCH

Thus, the combination of an external bonanza and loose domestic economic policies resulted in the overheating of the Ukrainian economy: Robust GDP growth was accompanied by skyrocketing inflation, a widening current account deficit and surging external debt. However, robust economic performance in recent years masked the fundamental weaknesses of

the Ukrainian economy. Specifically, while economic growth was surprisingly resilient against persistent political instability, key structural reforms (such as land and judicial reforms, the completion of a pension reform, energy sector restructuring) have stalled due to political tensions. As a result, the economy was plagued by a number of structural problems including a lack of export diversification, low energy efficiency, an unfavourable business climate, shallow domestic capital markets, etc.

Industrial production growth (% yoy)



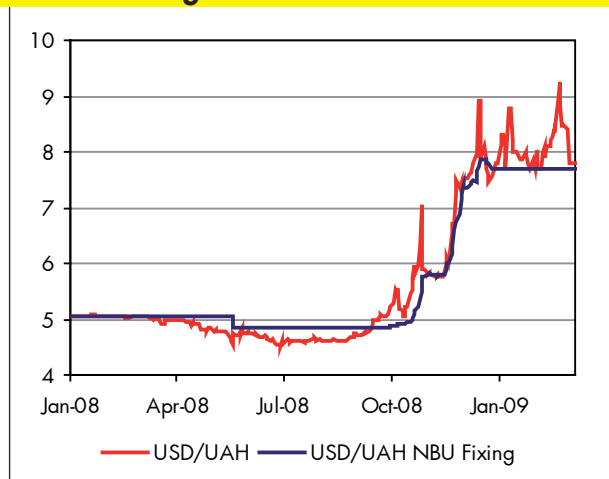
Source: State Statistics Committee of Ukraine

The domestic economic boom turned to a bust in the last quarter of 2008 following the steep fall in domestic and external demand (due to plunging global commodity prices, a sharp economic slowdown for major trading partners and frozen credit activity). These negative effects were further exacerbated by 60% hryvnia depreciation since September and persistent political turmoil, which reduced policymakers' ability to tackle the economic crisis. As a result, industrial output fell by 20–30% yoy in the last quarter of 2008. Consequently, industrial production shrunk by 3.1% in 2008, while cumulative GDP growth fell to 2.1% by the end of 2008. Apparently due to the weak fundamentals and highly unstable expectations (fed by tumultuous political conflict), the economy fell into the deep recession as soon as the temporary growth drivers (favourable external conditions, easy access to credit) evaporated.

The sharp economic decline in the last quarter has affected almost all sectors of the economy. The construction industry has been hit the most severely – output in this sector plunged by 17.4% in 2008. At the same time, the agricultural and transport sectors

were the main drivers of GDP growth last year recording 17.5% and 6.8% expansion, respectively.

UAH exchange rate



Source: Reuters

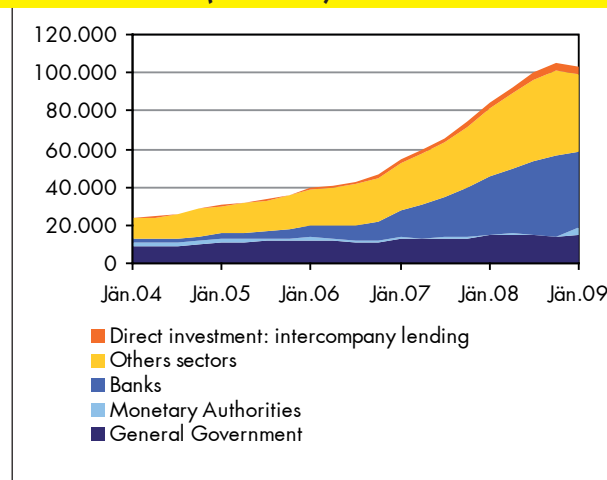
The agricultural sector benefited strongly from an extremely bountiful harvest of around 53 mn tonnes, more than 60% higher than in 2007. Across the industries, the largest production slump was registered in export-oriented sectors – the output volume in the steel (which accounts for 40% of exports) and chemicals industries fell by 10.6% and 6.2% respectively in 2008. Severe output contraction in these industries continued in 2009, and reached 46% and 49.6% yoy, respectively, in January. However, according to recent reports, the steel industry has started to recover thanks to cost-cutting measures, a partial restoration of external demand and 60% depreciation. In February, the average daily output of Ukrainian steel mills rose by 22% mom. The sharp economic slowdown in Russia (the main destination of Ukrainian machinery exports) led to the remarkable reversal of the growth trend in the Ukrainian machine building industry – output growth fell from 29.3% at the end of June 2008 to 8.6% as of the end of 2008, and then sunk by 58.2% yoy in Jan 2009.

Help from the IMF

As Ukraine was hit relatively hard by the decline in steel prices already in autumn 2008, the country turned to the IMF quite early for assistance. On 5 November 2008, the IMF Management and Executive Board approved a two-year USD 16.5 bn stand-by arrangement for Ukraine, which is relatively large in comparison to the country and its IMF quota (802%). The programme can be characterised as heavily front

loaded, with the first tranche of USD 4.5 bn or 27% of the overall volume disbursed at the beginning of the programme. The IMF programme should help the authorities to stabilise the economy against the background of a deteriorating external position (due to falling prices for Ukraine's major exports, steel and chemicals, and a lack of access to external financing) and aims to shore up confidence.

External debt (USD mn)



Source: State Statistics Committee of Ukraine

A so called Memorandum of Economic and Financial Policies (MEFP), which was signed under the loan agreement, included the transition to a flexible exchange rate regime (including a change in the methodology of official exchange rate calculation now defined as the preceding day's market exchange rate), the resolution of the case of the hard-hit Prominvest Bank and legal approval of a recapitalization mechanism for banks.

Also, the authorities committed to implement certain policies in a number of areas:

Exchange rate policy

- The development of a transparent FX intervention strategy via regular auctions and targets for FX reserves. These targets were included as quantitative criteria into the programme and are to be reviewed every three months until the end of the programme in October 2010.
- The suspension of the foreign exchange transaction tax until end April 2009.

Monetary policy

- The authorities committed to reduce CPI inflation to 17% by the end of 2009.



- As soon as financial market stresses abate, the NBU should tighten monetary policy by restoring previous reserve requirements and raising interest rates on deposits at the NBU bringing them closer to the refinance rate. Also the NBU reviewed the list of acceptable collateral, excluding bank shares.
- The Central Bank pledged to move to an inflation-targeting regime defining it as a main medium-term goal.

Financial sector policy

- The moratorium on deposit withdrawals should be abolished as soon as deposit outflow stabilises.
- The NBU committed to enhance the disclosure of banks' financial information (including detailed balance sheets and income statements) according to the best international practices.
- The authorities should develop a comprehensive bank resolution strategy that includes a diagnostic study of the largest banks, financial support for banks in the form of recapitalisation, and necessary legal amendments to facilitate bank resolution.
- Finally, the NBU plans to enhance the cooperation with home supervisors of foreign banks and develop a high-frequency bank-by-bank monitoring system.

Fiscal policy:

- Goal of a deficit-free budget for 2009
- Zero real growth in public wages, pensions and other social transfers in 2009
- The gradual increase of gas tariffs for households and communal heating entities to bring them to economically justified levels (starting with a 35% increase on 1 December).

Seen in retrospect from late March 2009, five months after the approval of the IMF loan, some components were implemented successfully, while others were not. Especially the condition of a minimal deficit budget was violated by the adoption of a budget with an envisaged 3% deficit in late 2008. Also, as the currency came under heavy pressure and depreciated quickly, the National Bank resorted to almost daily FX sales and administrative measures in addition to the currency actions envisaged by the programme. The rule that the official FX rate should not deviate from the interbank market rate was adhered to initially, but then abandoned in an attempt to prevent further nominal depreciation.

However, in light of the lack of a purely domestic programme to fight the economic crisis, the IMF stand-by arrangement is so far the only comprehensive anti-crisis package for Ukraine. Political differences between politicians and deviations from the agreed targets led to fears that the programme is "off track". We think that the successful continuation of the programme is of the highest importance for winning back confidence inside and outside of Ukraine.

Key issues for economic prospects

Given the depressing outlook for the global economy and financial markets for the next few years, it is apparent that the main growth drivers of the Ukrainian economy in recent years are no longer available. In particular, a recovery similar to the export-led recovery of Southeastern Asia after the 1998 crisis is impossible at the moment due to the severe slump in global demand. In our opinion, there are a few key issues related to Ukraine's macroeconomic prospects. First, in contrast to many CEE economies, Ukraine has a deep domestic market. Therefore, the recovery strategy should be based on developing sustainable domestic demand by implementing a set of structural reforms including regulatory, judicial, pension, land ownership and other reforms. The second important step is to diversify the structure of exports by increasing the share of high-value-added products and promoting Ukraine's exports in different countries and regions. In this respect, we would like to emphasise the importance of the composition of FDI inflows. In recent years, the majority of FDI inflows in Ukraine went to the high-earning financial and real estate sectors, contributing to the formation of speculative bubbles. Instead, future FDI should be channelled into the highly productive industrial sector, which will lead to an increase in exports and also boost productivity. Last but not least is the issue of political stability – we strongly believe that any efforts on economic recovery will be to no avail if political consensus is not reached.

At the same time, we would like to warn against the temptation to stimulate a recovery of the Ukrainian economy by promoting exports by keeping the hryvnia undervalued. This was exactly the mistake made by Ukrainian policymakers in the early 2000s when a weak hryvnia, combined with surging global commodity prices, drove the recovery of the Ukrainian economy but eliminated incentives for structural reforms. We want to stress that efforts to regain competitiveness should be based on faster productivity growth, not an undervalued exchange rate.

With regard to individual sectors of the economy, the Ukrainian agricultural industry certainly has the potential to be one of the driving forces behind the domestic economy as a result of the country's rich land resources and favourable geographic location. The success of the agricultural sector is dependent upon policy measures such as the reform of land ownership and the streamlining of state support for this sector. We also expect domestic agricultural producers to benefit from the country's WTO membership and a future free trade agreement with the European Union.

The steep decline in global demand and prices for steel in the middle of last year led to the shutdown of steel production facilities and massive layoffs in Ukraine and raised concerns about the future of the Ukrainian steel industry. Despite a rather gloomy outlook at the moment, we believe that this sector has bright prospects, although the competitive landscape of the industry could change substantially as a result of the current crisis. Specifically, it appears likely that a number of domestic steelmakers that lack vertical integration and have a non-diversified production structure will be forced to exit the market. At the same time, a number of domestic and international producers appear to be more stable because they managed to upgrade their production facilities during the period of high steel prices, raising productivity and improving energy efficiency.

The machine building industry also has the potential to be one of the backbones of the domestic economy in the coming years. This sector has demonstrated buoyant growth in the past mostly due to the robust demand for Ukrainian machinery in Russia, as production links between the two countries in machine building have been largely preserved since Soviet

times. However, production in the Ukrainian machine building industry has decreased significantly following the steep economic decline in Russia. Nevertheless, this sector has both domestic and external potential looking forward as a result of highly qualified human capital, a favourable geographic location and a deep domestic market. On the domestic side, the machine building industry may benefit from large-scale infrastructure projects, which will generate sustainable demand for machinery products. Internationally, the focus should be placed on the diversification of machinery exports away from just a single country. The Ukrainian machine building sector has a high potential to attract FDI, as a large number of lucrative assets are still set to be privatised.

The current crisis is likely to substantially change the shape of the Ukrainian banking sector. So far it has been characterised by low concentration and consolidation as well as skyrocketing credit growth (primarily in the retail segment) fed by cheap foreign funding and lax supervision practices. However, the new business model will be vastly different – in the absence of FX retail lending, the focus will shift to lending in the national currency (funded by domestic deposits) and fee-based services. In addition, the market will be restructured – a certain number of banks are likely to go out of business through acquisitions, mergers and bankruptcies. Foreign-owned banks are likely to be on the winning side of the restructuring of the industry (assuming that they do not pull out of Ukraine during the hard times). Given strong backing from the parent institutions, higher operational efficiency and better risk management practices, we expect the market share of foreign-owned banks to increase in the near future.

Dmytro Sologub, Andreas Schwabe

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	52.1	69.6	86.1	104.6	123.0	81.4	99.9
Real GDP (% yoy)	12.1	2.6	7.3	7.9	2.1	-8.0	-1.0
Industrial output (% yoy)	12.5	3.1	6.2	10.2	-3.1	-12.0	0.5
Unemployment rate (avg, %)	8.6	7.2	6.8	6.4	6.7	11.2	10.8
Nominal wages, whole economy (% yoy)	27.7	36.6	29.2	29.7	33.7	8.0	12.0
Producer prices (avg, % yoy)	20.5	16.7	9.6	19.5	35.5	8.0	12.0
Consumer prices (avg, % yoy)	9.0	13.5	9.1	12.8	25.2	17.0	11.0
Consumer prices (eop, % yoy)	12.3	10.3	11.6	16.6	22.3	14.6	9.0
General budget balance (% of GDP)	-3.2	-1.8	-0.7	-1.1	-1.5	-1.0	-1.0
Current account balance (% of GDP)	10.7	2.9	-1.5	-3.7	-7.2	-0.4	0.0
Official FX reserves (EUR bn)	7.0	16.1	16.6	21.7	22.2	16.7	17.9
EUR/UAH (avg)	6.62	6.34	6.32	6.89	7.73	12.10	11.00
USD/UAH (avg)	5.32	5.10	5.03	5.03	5.26	8.50	7.60

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH



Severe economic decline to be reversed

Two key factors are shaping negative developments in the Russian economy: the decline of world prices for the country's key export goods and the turmoil on the credit market.

An almost threefold slump in oil prices has had a severe impact on the national balance of trade (in 2008, petroleum products and natural gas accounted for almost 65% of exports) and has created the conditions for the devaluation of the rouble. Furthermore, the federal budget's fiscal revenues have had a very harmful effect and created a huge budget deficit. Also, the tumble in world metal and fertiliser prices has effectively made the export of such goods from Russia unprofitable.

Since September, the banking sector has experienced a succession of negative shocks. In mid-September, due to the slide of the stock market, some players in the repo market were unable to honour their obligations, triggering an almost complete shutdown of the money market and virtual default by several banks. The reports on the problems affecting the banking sector in turn caused a panic among depositors and precipitated a run on the banks. Also, due to the decline in oil prices, expectations of devaluation cropped up in Russia and intensified further when in mid-November the Central Bank set about gradually weakening the rouble. In September 2008–January 2009, currency flight amounted to approximately USD 170 billion. In an attempt to prevent currency speculation, the Central Bank drastically curtailed the scope of currency swap operations, raised the rates applicable to refinancing instruments and imposed a number of administrative constraints. As a result of all these shocks, the banks faced a huge rouble liquidity squeeze and interest rates began to grow markedly, reaching as much as 100% per annum for a number of instruments. Given the situation since November 2008, bank loans have become almost entirely unavailable to the real sector and individual borrowers. Corporations gained access to financing only with the help of the government, and the scope of new consumer loans has shrunk dozens of times.

Unfavourable conditions in the global raw materials market and crisis trends in the banking sector have caused a deep decline in the manufacturing sector (-24% yoy in January), construction (-17%) and power generation (-7%). Problems in one industry have caused a chain reaction in a number of sectors of the economy.

Now, nearly the entire spectrum of industry has suffered setbacks, with the automotive, steelmaking, chemical, woodworking, construction materials and equipment manufacturing sectors being most affected by the decline. Underperformance in the construction industry, steelmaking and automotive industries is the most sensitive issue for the economy, since these industries have until recently been the drivers of economic growth.

The construction industry started to experience problems as early as in summer 2008. Difficulties were provoked by a high degree of leverage among construction companies and the unavailability of new loans. However, an almost complete loss of availability of mortgage loans, growth of unemployment, and a general lack of consumer confidence have resulted in decreased demand for residential property, while problems in the corporate sector have significantly depreciated commercial property. There is now uncertainty concerning the future economic efficiency of the sector.

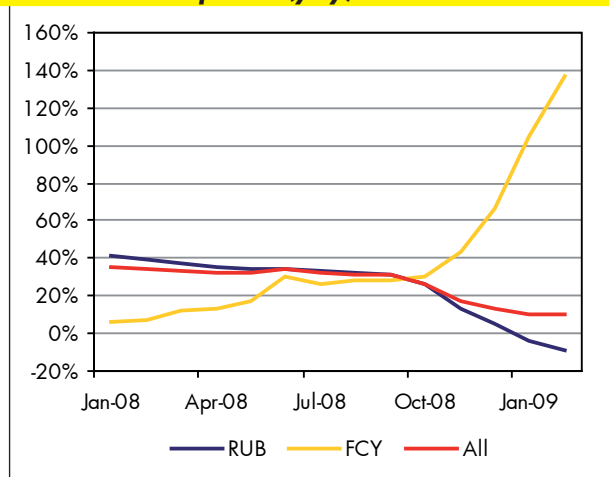
Similar problems affect the automotive industry, where demand has plummeted several times over. Many banks have virtually discontinued their car loan business, while others have substantially limited the scope of lending and increased interest rates. According to a number of estimates, car sales through loans accounted for 30–40% of total sales. Furthermore, growing unemployment and a general lack of consumer confidence have resulted in dwindling demand for nonessential goods – and cars were at the top of that list. Another negative factor included the difficulties experienced by the car dealers. Short-term bank loans for operating purposes were no longer available. As a result, car manufacturers became overstocked and had to halt production for a protracted period. Car manufacturing in January 2008 decreased by 80%–90% yoy. Although we believe that such a severe plunge is short-term in nature and is due to the sale of accumulated inventory, it is clear that the industry is faced with serious problems.

The steelmaking sector experienced several negative shocks at once. As has been noted, at a certain point in time, world ferrous and non-ferrous metal prices fell below the production cost in Russia. The vast majority of non-ferrous metals produced in Russia are exported, so this factor was of critical importance to them. As for ferrous metals, the pre-crisis export of steel accounted for about 40% of total production. The key domestic steel consumer (about 40%

of domestic consumption) is the construction sector, and suspension of construction projects has dragged down the steelmaking industry. Other metal-intensive Russian industries have also suffered: the automotive, machine-building and pipe-manufacturing industries. As a result, many metallurgical companies had to reduce their working week and decrease the number of work shifts, and began laying off personnel. The suppliers of steel mills – producers of coking coal and iron ore – have found themselves in a similarly difficult situation.

As of today, oil production and refining in Russia appear to be the industries least affected by the crisis. In January, oil production decreased by 0.8% yoy, oil refining by 4%–5%. The decline in world oil prices has not resulted in a dramatic decrease of the export profitability of these products due to the specific nature of the Russian tax regime: tax rates and export duties are tied to world oil prices and are progressive. However, on the back of deteriorating demand, oil companies have substantially decreased their investment activity, which has negatively affected oil equipment and pipe manufacturers.

Household deposits (yoy)

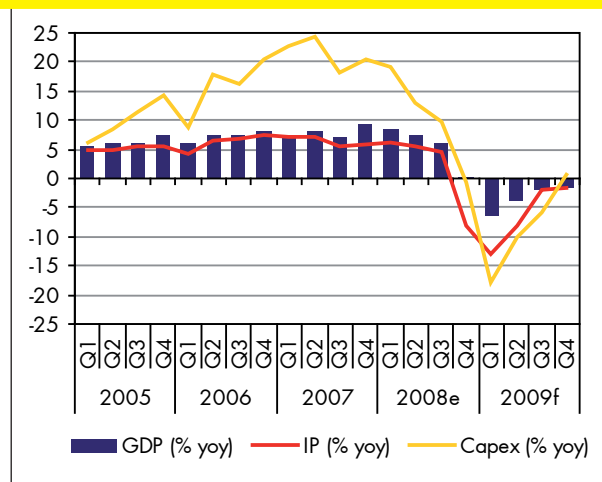


Source: Central bank of Russia

The shortfall of production in the food industry as compared to other sectors is also fairly moderate. Almost all food produced in Russia is consumed domestically, and demand for the majority of these types of goods is inelastic. However, this sector indubitably relies on the state of the labour market, dynamics of household real income (which in January showed a decrease of 6.7% yoy) and unemployment levels (8.1% in January as compared to 5.3% in September 2008) as these factors degrade the demand for food

products, which has also started to decline. Furthermore, many companies in the food industry and food retailers have faced problems having their credit lines refinanced and obtaining short-term credit, which has had an adverse effect on their business.

Economic recession hits



Source: Russian Statistical Office

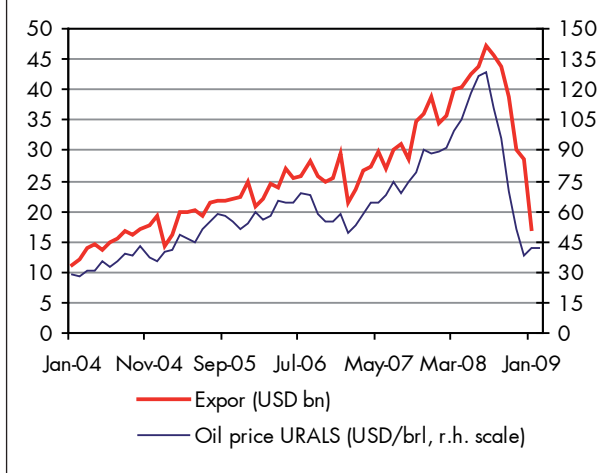
Government measures

The anti-crisis measures taken by the government and the Central Bank to support the banking sector are in many ways similar to the path taken in the United States and Western European nations. In view of the liquidity squeeze, the Central Bank substantially reduced the collateral requirements for refinancing operations. However, this proved insufficient and the Central Bank introduced unsecured lending to the banks, which by the end of February exceeded EUR 42 bn. In addition, the government and the Central Bank extended EUR 28 bn in long-term subordinated loans to the banks to strengthen their capital. The government-owned banks received 98% of such debt. To avoid depositor panic, coverage under the deposit insurance system was raised from EUR 4,500 to EUR 15,500. The Russian government vigorously attempted to bail out distressed financial institutions. Government entities took over and purchased some of the most severely distressed banks on an expeditious basis, and later the deposit insurance agency received significant financial resources to work with the distressed banks.

As for state support for the real sector, the government first gave Russian companies an opportunity to borrow funds from the Bank for Development and Foreign Economic Affairs (Vnesheconombank, VEB)

in order to repay foreign loans. The potential scope of financing was declared at USD 50 bn, but as of the end of February, VEB extended only USD 11 bn and the government has indicated that this programme will be discontinued. To restore domestic lending operations and to prevent a wave of corporate defaults, the government has in various ways put pressure upon state-owned banks to make them extend credit to certain companies. The state-owned banks were also directed by the government to build up their credit portfolios at the rate of at least 2% per month. The government drew up a list of 300 backbone companies that will be helped out on a priority basis, in particular through the subsidisation of interest rates and issuance of state guarantees. The government allocated several billions of euros to purchase housing for the military, and made an equity contribution of about EUR 1.5 bn to the Agency for Housing and Mortgage Lending and has promised to provide more funds.

Oil price impact on trade

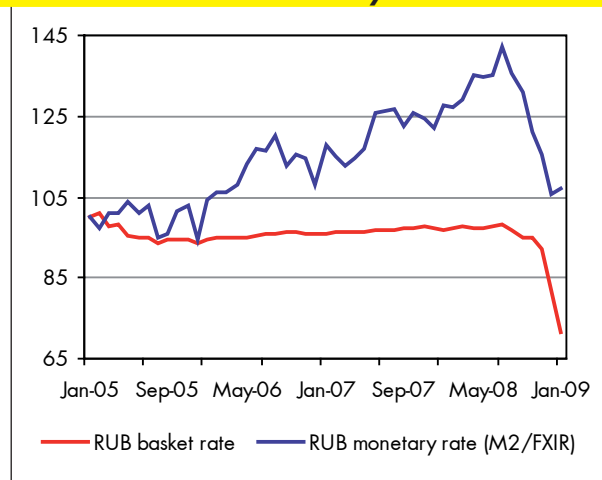


Source: Central Bank of Russia, Reuters

In response to the slump in oil prices and deteriorating trade conditions, the Central Bank has set about gradually weakening the rouble since mid-November. Initially, the rouble weakened at 1%–2% per week, but since the end of December it has gained momentum to reach 1%–1.5% daily in January. On January 23, the Central Bank announced that the gradual rouble weakening was over, and fixed the upper bound of the bi-currency basket (0.55 USD/0.45 EUR) at RUR 41, which is 35% higher than in early November and approximately 10% higher than on the last day of gradual weakening. At the same time, with a view to stabilising the rouble exchange rate, the Central Bank has maintained its fairly tough inter-

est rate policy. Although such actions by the Central Bank have mitigated expectations on devaluation, such speculations not disappear altogether and the risk of another attack against the rouble in 2009 remains fairly high.

Rouble basket vs monetary rate*



* index Jan-2005=100

Source: Central Bank of Russia, Raiffeisen RESEARCH

By way of a preliminary summary of the results of actions undertaken by the government and the Central Bank, it must be said that these appear to have achieved modest success. First, they warded off public panic and partially restored trust among the banks, which almost fully stopped the deposit run and resumed money market operations. Furthermore, the government bailout of the banks and corporations allowed the prevention of a full-fledged non-payment crisis. But it is still too early to speak about a material recovery of lending activities. Due to the economic turmoil, an increasing number of defaults and delinquent loans, banks are seeking to curtail their lending business and are extremely reluctant to even roll over loans. To encourage bank lending, the government intends to continue implementing both market and administrative measures. In particular, the government announced another tranche of subordinated loans that will be made available to the banks on a scale similar to the previous initiative. At the same time, the Central Bank is sending special representatives to banks that received the majority of the government bailout money. They will monitor the use of the government funds by the banks to see whether they are in fact lending to the real sector.

Apart from conditions on the credit market, the outlook for the Russian economy in 2009 and 2010 depends upon two factors – how strong the effect

of the recent rouble devaluation on the real sector is and whether the government stimulus fiscal policy is truly large-scale and efficient.

In our view, the recent rouble devaluation will first of all help export industries, such as steel and fertiliser makers, to make it back to profitable levels and to some extent restore production volumes. However, a prerequisite for this will be a stop in the decline of world prices for the goods exported from Russia. This will depend upon the state of the global economy, and on the dynamics of national currencies in the countries that compete with Russia in these markets. We are sceptical about the possibility of major import substitution taking place as a result of devaluation. The only industry where this might happen is the food sector. The current Russian import structure mainly includes high-techs products: cars, household appliances, and various other devices which do not have any domestically produced competitive equivalents. The same is true for pharmaceutical goods. The negative effects of devaluation that existed in 1998 should also be noted: growth of imported goods prices reduces people's real incomes and may dry up the consumption of certain domestic goods and services that qualify as luxury such as restaurants, beauty parlours, cars and real estate.

At the same time, while devaluation such as seen in 1998 by all means creates conditions for economic recovery, there is also a need for a powerful factor driving the growth of aggregate demand. A nearly 100% increase in oil prices became just such a factor in 1999–2000. Fiscal policy may also boost aggregate demand. The Russian government

has already taken a number of steps to achieve this goal. The profit tax rate was decreased from 24% to 20%, while some tax benefits and the unemployment allowance have been increased. Also, government officials have announced a launch of various infrastructure projects, the creation of jobs and so forth. However, no specific details on these have as yet been unveiled. We believe the huge budget deficit that the government is facing will make it extremely difficult to implement a stimulus policy. Government efforts have focused on stabilisation, and the prevention of bankruptcies among large companies and banks, while many investment expenses have to be cut back.

In 2009, many sectors of the Russian economy will have to go through painful restructuring, an effort complicated by underdeveloped laws and the inefficiency of the judicial system. As a result, even relatively profitable and promising sectors of the Russian economy, such as the food sector, may experience a huge setback related to uncertainty regarding the ownership of assets. Any positive effect that improved macroeconomic conditions, which many expect to occur in 2010, may have on a particular sector will depend on the pace at which restructuring progresses.

Anton Pletenev

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	476.3	614.8	779.9	920.6	1136.6	951.8	1136.9
Real GDP (% yoy)	7.2	6.4	7.7	8.1	5.6	-3.5	2.5
Industrial output (% yoy)	8.0	5.1	6.3	6.3	2.1	-7.5	3.5
Unemployment rate (avg, %)	8.2	7.6	7.2	6.2	6.3	9.5	8.9
Nominal industrial wages (% yoy)	24.0	25.2	25.5	26.0	27.4	10.0	15.0
Producer prices (avg, % yoy)	23.4	20.7	12.4	14.2	21.4	-8.4	12.2
Consumer prices (avg, % yoy)	11.0	12.5	9.8	9.1	14.1	15.6	11.9
Consumer prices (eop, % yoy)	11.7	10.9	9.0	11.9	13.3	15.5	11.5
General budget balance (% of GDP)	4.5	8.1	8.4	6.0	4.8	-8.8	-5.0
Current account balance (% of GDP)	10.0	11.0	9.6	6.2	5.9	2.8	3.9
Official FX reserves (EUR bn)	88.9	149.1	223.7	319.7	296.0	205.0	254.4
EUR/RUB (avg)	35.79	35.17	34.47	35.83	36.55	45.16	43.39
USD/RUB (avg)	28.77	28.30	27.35	26.15	24.85	31.80	29.93

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Real GDP (% yoy)

Countries	2007	2008	2009e	2010f
Poland	6.7	4.8	-0.8	0.0
Hungary	1.1	0.6	-5.0	-1.0
Czech Rep.	6.0	3.1	-2.6	1.3
Slovakia	10.4	6.4	0.8	3.5
Slovenia	6.8	3.5	-3.0	0.5
CE	6.0	3.9	-1.8	0.5
Croatia	5.6	2.4	-3.2	1.1
Bulgaria	6.2	6.0	-1.5	1.5
Romania	6.2	7.1	0.5	1.5
Serbia	7.1	5.4	-1.5	1.0
Bosnia a. H.	6.8	5.5	-1.0	2.0
Albania	6.3	6.0	2.5	3.5
SEE	6.2	5.9	-0.6	1.5
Russia	8.1	5.6	-3.5	2.5
Ukraine	7.9	2.1	-8.0	-1.0
Belarus	8.2	10.0	0.0	2.0
CIS	8.1	5.4	-3.8	2.2
Turkey	4.7	1.1	-2.5	3.0
Austria	3.1	1.8	-2.5	0.2
Eurozone	2.7	0.8	-3.0	0.3
USA	2.0	1.1	-3.0	0.9

Source: wiiw, Raiffeisen RESEARCH

Consumer prices (avg, % yoy)

Countries	2007	2008	2009e	2010f
Poland	2.5	4.2	2.8	2.4
Hungary	8.0	6.1	4.2	3.0
Czech Rep.	2.8	6.3	1.2	2.2
Slovakia	2.8	4.6	2.6	3.0
Slovenia	3.6	5.7	1.5	2.0
CE	3.5	5.0	2.6	2.5
Croatia	2.9	6.1	2.8	3.8
Bulgaria	8.4	12.3	5.0	4.0
Romania	4.8	7.9	5.7	4.2
Serbia	6.5	11.7	11.5	9.0
Bosnia a. H.	1.5	7.4	1.0	1.3
Albania	2.9	3.3	3.0	3.0
SEE	5.0	8.5	5.6	4.5
Russia	9.1	14.1	15.6	11.9
Ukraine	12.8	25.2	17.0	11.0
Belarus	8.4	14.8	16.0	12.9
CIS	9.5	15.2	15.8	11.8
Turkey	8.8	10.4	6.4	6.1
Austria	2.2	3.2	0.2	0.8
Eurozone	2.1	3.3	0.3	1.3
USA	2.9	3.8	-0.5	2.6

Source: wiiw, Raiffeisen RESEARCH

Current account balance (% of GDP)

Countries	2007	2008	2009e	2010f
Poland	-3.8	-5.4	-6.9	-6.8
Hungary	-6.4	-7.4	-4.8	-4.6
Czech Rep.	-3.2	-3.1	-4.5	-2.1
Slovakia	-5.3	-6.3	-5.2	-4.8
Slovenia	-4.2	-5.9	-3.0	-3.2
CE	-4.2	-5.3	-5.7	-5.1
Croatia	-8.6	-10.9	-8.9	-8.7
Bulgaria	-25.1	-25.3	-14.5	-15.6
Romania	-13.5	-12.3	-9.0	-8.0
Serbia	-15.9	-17.5	-14.0	-12.0
Bosnia a. H.	-12.7	-15.4	-13.2	-12.6
Albania	-11.2	-12.5	-10.0	-9.0
SEE	-14.4	-14.5	-10.5	-9.9
Russia	6.2	5.9	2.8	3.9
Ukraine	-3.7	-7.2	-0.4	0.0
Belarus	-6.6	-8.1	-7.3	-6.1
CIS	4.9	4.2	2.1	3.3
Turkey	-5.9	-5.7	-2.8	-3.2
Austria	3.2	2.7	2.0	2.2
Eurozone	0.1	-0.7	-1.5	-1.5
USA	-5.3	-4.7	-3.5	-3.7

Source: wiiw, Raiffeisen RESEARCH

General budget balance (% of GDP)

Countries	2007	2008	2009e	2010f
Poland	-2.0	-3.0	-4.4	-3.5
Hungary	-5.0	-3.4	-3.2	-3.0
Czech Rep.	-0.6	-1.5	-5.1	-5.2
Slovakia	-2.2	-2.3	-3.5	-2.9
Slovenia	0.5	0.5	-1.0	-0.5
CE	-2.1	-2.5	-4.1	-3.6
Croatia	-2.3	-2.4	-3.0	-2.1
Bulgaria	3.5	3.0	0.5	1.5
Romania	-2.5	-5.0	-5.0	-3.0
Serbia	0.5	-2.6	-3.1	-2.0
Bosnia a. H.	1.3	-0.3	-0.5	0.1
Albania	-4.8	-5.2	-4.2	-3.3
SEE	-1.2	-3.1	-3.5	-2.0
Russia	6.0	4.8	-8.8	-5.0
Ukraine	-1.1	-1.5	-1.0	-1.0
Belarus	0.4	0.1	-1.9	-2.0
CIS	5.2	4.1	-7.9	-4.5
Turkey	-1.7	-1.9	-3.2	-0.7
Austria	-0.5	-0.3	-4.5	-6.0
Eurozone	-0.6	-2.0	-4.4	-4.8
USA	-1.4	-5.7	-12.0	-10.0

Source: wiiw, EU Commission, Raiffeisen RESEARCH

Exchange rate EUR/LCY (avg)

Countries	2007	2008	2009e	2010f
Poland	3.78	3.52	4.65	4.02
Hungary	251.3	250.4	289.1	260.0
Czech Rep.	27.7	25.0	27.5	25.1
Croatia	7.34	7.22	7.47	7.35
Bulgaria	1.96	1.96	1.96	1.96
Romania	3.34	3.68	4.25	3.92
Serbia	80.0	81.5	94.7	91.4
Bosnia a. H.	1.96	1.96	1.96	1.96
Albania	123.6	122.7	130.6	127.7
Russia	35.8	36.5	45.2	43.4
Ukraine	6.89	7.73	12.10	11.00
Belarus	2942	3140	4170	4790
Turkey	1.79	1.92	2.27	2.25
USA	1.37	1.47	1.42	1.45

Source: wiiw, Raiffeisen RESEARCH

Exchange rate forecasts

Countries vs EUR	actual	Jun-09	Sep-09	Mar-10
Poland	4.72	4.70	4.80	4.35
Hungary	307.1	300.0	280.0	265.0
Czech Rep.	27.6	28.2	27.0	25.6
Croatia	7.48	7.45	7.55	7.45
Romania	4.24	4.25	4.20	4.00
Serbia	94.6	96.0	94.0	93.0
Albania	131.1	133.0	131.0	129.0
vs USD				
Russia	34.01	32.20	33.26	31.02
Ukraine	8.00	9.50	8.00	8.00
Belarus	2794	3000	3000	3200
Turkey	1.70	1.65	1.60	1.60
EUR/USD	1.32	1.40	1.45	1.50

Source: wiiw, Raiffeisen RESEARCH

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Abbreviations

Currencies and Countries

ALL	Albanian lek
BAM	Bosnian marka
BGN	Bulgarian lev
BYR	Belarusian Rubel
CNY	Chinese yuan
CZK	Czech koruna
EKK	Estonian kroon
HUF	Hungarian forint
HRK	Croatian kuna
ITL	Lithuanian litas
IVL	Latvian lats
PLN	Polish zloty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
SIT	Slovenian tolar
SKK	Slovak koruna
TRY	Turkish lira
UAH	Ukrainian hryvnia

CE	Central European countries - Poland, Hungary, Czech Republic, Slovakia, Slovenia
SEE	South East European countries - Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia
CIS	European CIS (Commonwealth of Independent States) countries - Russia, Ukraine, Belarus
CEE	Central and Eastern Europe (CE + SEE + CIS)

Economic abbreviations

%-chg	Percentage change (not in percentage points)
avg	average
bp	basis points
C/A	Current Account
CPI	Consumer Price Index
FDI	Foreign Direct Investments
FX	Foreign Exchange
GDP	Gross Domestic Product
LCY	Local Currency
mom	month on month
pp	percentage points
PPI	Producer Price Index
T/B	Trade Balance
ULC	Unit Labour Costs
yoY	year on year

Stock Exchange Indices

BET	Romanian stock index
BUX	Hungarian stock index
CROEMI	Croatian stock index
PX	Czech stock index
RTSI	Russian stock index
WIG 20	Polish stock index

Equity related

DY	Dividend yield
EG	Earnings growth
LTC	Long term (earnings) growth
P/E	Price earnings ratio
RS	Recommendation suspended
UR	Under Revision

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