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# Hard Landing 2

## Report on transformation

Central and Eastern Europe Facing the Debt Crisis

ECONOMIC FORUM

PRICEWATERHOUSECOOPERS

Although it appears that the most acute phase of the global financial crisis is behind us, its consequences will affect the economies of Central and Eastern Europe for a long time. Our region was affected by the crisis in a particularly severe way – some countries came close to bankruptcy, whilst others had to tighten their belts considerably to avoid this fate. Lower economic activity was directly translated into reduced tax revenues, and in many cases it was very difficult to cut budget expenditures without dramatic consequences for the economy and society. Therefore, certain countries in the region may now be threatened by a debt crisis, similar to the one observed in Western Europe, which may in turn lead to further financial destabilisation. In the publication we attempt to assess this risk on the basis of current indices reflecting the state of national economies, including data on the condition of public finances, which are of particular importance.
The conclusions drawn from the report unequivocally indicate that countries in Central and Eastern Europe must be prepared for a long period of reduced economic growth, which may be accompanied by considerable fluctuations in the financial markets. There is no doubt that better times will return in the end, although at this moment it is hard to determine when this is going to happen. The best way of surviving this difficult period is to pursue a prudent economic policy and implement vigorous structural reforms.

**We hope you find the report valuable**

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## Sources of data used in the report:

PricewaterhouseCoopers, www.pwc.com

CIA World Factbook, www.cia.gov

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

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

The World Bank, www.worldbank.org, www.doingbusiness.org

Transparency International, www.transparency.org

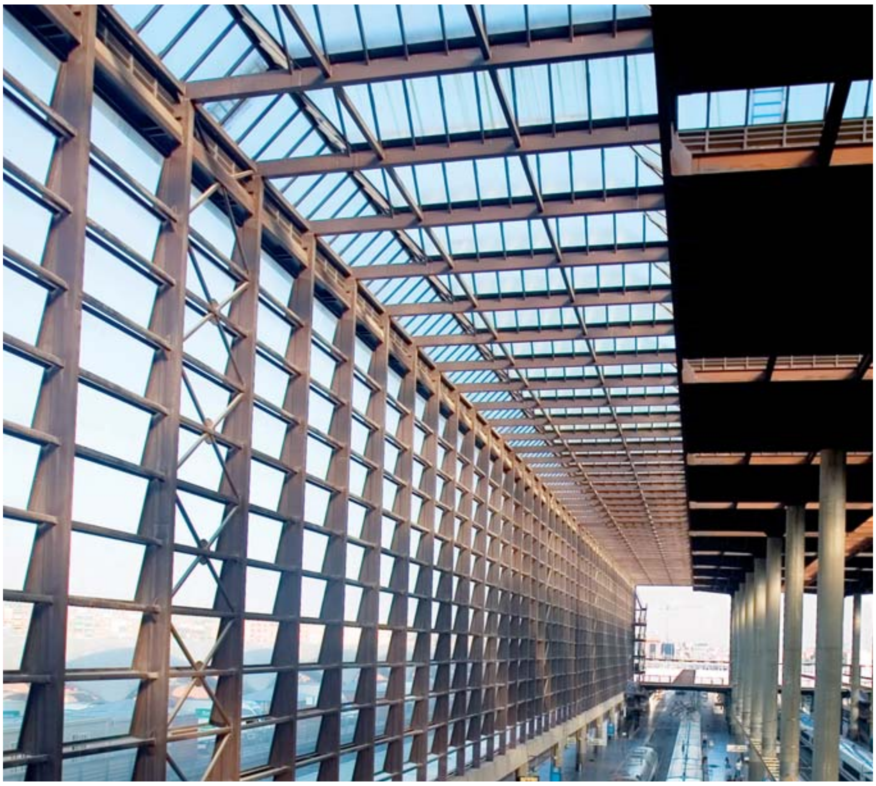
Rating information: Standard's & Poor, www.standardandpoors.com

Statistical offices and central banks of Central & Eastern European countries

# Contents

## Executive Summary

Central and Eastern Europe (CEE) was, arguably, a region of the world most painfully hurt by the global financial crisis. The economic development of the region over the last few years was particularly volatile, marked with extreme fluctuations and severe financial problems. Unfortunately, these problems continue with successive waves of the crisis hitting the global, European, and regional economy.



After the difficult recessionary year 2009, in 2010 slow growth returned to the majority of the CEE countries. Forecasts for 2011 have been relatively optimistic for all the countries in the region, with regional average GDP growth rate accelerating from 1-1.5% in 2010 to 3-4% in 2011. Unfortunately, the possible effects of the second wave of the financial crisis are likely to lead to cuts in forecast growth rates.

The condition of public finance in CEE countries drastically deteriorated during the course of the crisis. Prospects for the years 2010-2011 are bleak, with only a small reduction in deficits expected in the majority of the countries. By contrast, the level of public debt recorded in the majority of the CEE countries can still be assessed as moderate. What is worrisome, however, is the speed at which public debt levels deteriorated during the crisis in many countries.

The assessment of the external position of the region is less optimistic. Although the current account deficits do not look very high, more danger can be found in the size and structure of the debt. Debt levels are quite high in a number of CEE countries. The risk may be connected with the elevated level of short-term foreign debt that in some cases exceeds 50% of GDP. The ratio of foreign exchange reserves to short-term debt and current account deficit is dangerously low in a few countries. Finally, the assessment of the credibility of CEE countries is diversified, ranging from full credibility to the almost complete lack of it.

Economic slowdown and the problem of external financing, induced by the second wave of the global financial crisis, may easily translate into problems for the domestic banking sector. The current level of indebtedness of households and firms, as well as the share of debts denominated in foreign currency, can be assessed as quite high in several CEE countries. Also the loans and deposits ratio in some countries reaches 200%, indicating a major risk to the country's banking sector. Joint examination of all the threats that CEE countries have to face due to the second wave of the global crisis suggests that the country most vulnerable to the debt crisis is Latvia, followed by Lithuania. Very serious threats jeopardise the development of Belarus, Ukraine, and Bulgaria. Particular deliberation and caution is also required in the case of Hungary, Croatia, Romania, Estonia, and Serbia. Compared to the above, the problems facing Slovakia, the Czech Republic, and Russia, as well as Poland and Slovenia seem less dangerous.

CEE countries must be prepared for a long period of limited growth dynamics combined with continuous disturbances on the financial markets. Rapid growth will eventually return, but the timing of such a recovery still remains obscure. Cautious economic policy, supported by vigorous structural reforms, remains the best prescription for surviving difficult times in good shape.

## Hard landing 2

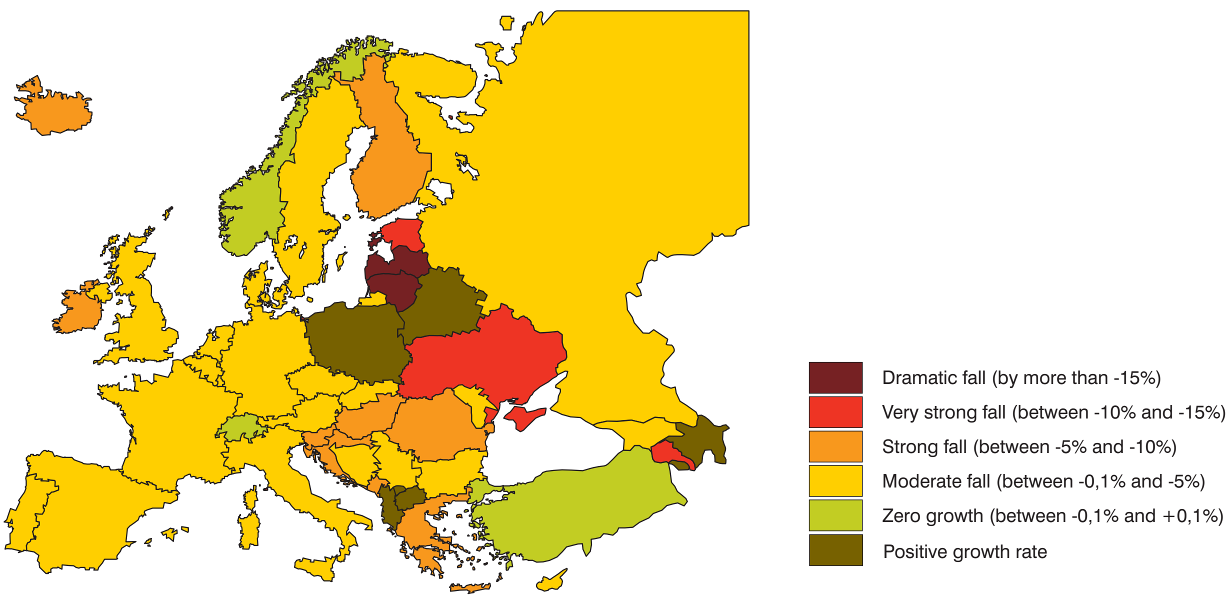
Central and Eastern Europe (CEE) was, arguably, a region of the world most painfully hurt by the global financial crisis. The economic development of the region over the last few years was particularly volatile, marked by extreme fluctuations and severe financial problems. Unfortunately, these problems continue with successive waves of the crisis hitting the global, European, and regional economy.

In the pre-crisis years, and especially in the period 2004-2007, CEE region was seen as a clear winner in the globalisation process. Once the bulk of the transition reforms was implemented, markets liberalised, the necessary institutions created, firms privatised, and EU membership granted to the most advanced reformers, the region started attracting sizeable foreign investment. Productivity and competitiveness was increasing, leading to a robust growth in income and living standards. Unfortunately, this rapid development came to an abrupt end when the global financial crisis broke out.

The first wave of the crisis was triggered by the collapse of Lehman Brothers in September 2008 and the following banking crisis and worldwide recession led to a dramatic fall in GDP in all the major countries of the region except Poland. Seven out of ten countries of the world that recorded the biggest fall in output in 2009 were in the CEE region, with the Baltic states and Ukraine recording the biggest GDP drop globally. Moreover, the freezing of the global financial markets and rapid evaporation of investors' confidence brought many CEE economies to the brink of insolvency. As a result, eight countries in the region were forced to ask for emergency IMF/EU financial support.

The next wave of the crisis, that hit the region in 2010, was mainly connected to the risk of global sovereign debt crisis. The huge fiscal costs of supporting the banking sector and stimulating economic growth in many economies, coupled with already excessive public debt levels and continuous instability on financial markets, caused a market panic and a dramatic deterioration in investors' mood. This wave of the crisis was triggered by the risk of bankruptcy for Greece, followed by a possible chain of several financially weak eurozone countries. Paradoxically, the CEE countries seem to be much more vulnerable to the crisis than others, despite a relatively low level of indebtedness. However, the next major slowdown in growth in Western Europe – only a short time after economies started to emerge from recession – combined with the likely collapse of investors' confidence in emerging markets, may once again make the region extremely vulnerable to the crisis.

Scale of the Shock: forecast of cumulated GDP change, 2009-2010




*Source: IMF, EBRD*

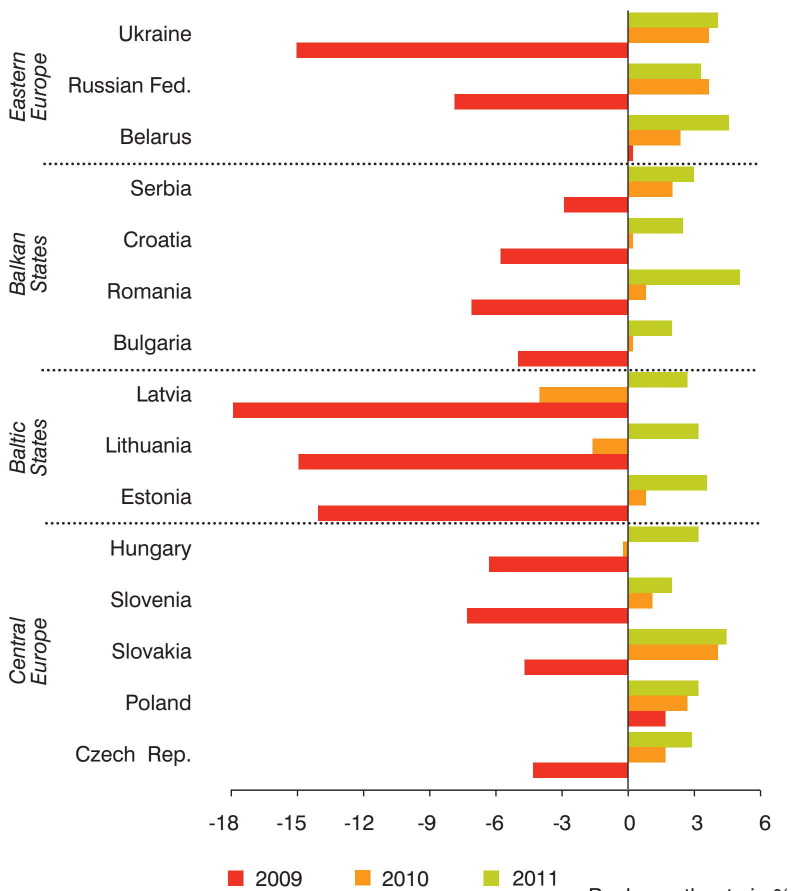
## Prospects of economic growth

The CEE region has been suffering greatly since the beginning of the global financial crisis. In 2009 exports to Western Europe dramatically decreased, FDI inflows declined by two-thirds, access to private capital was radically restricted.

That led to internal economic problems and to a strong fall in GDP. The biggest drop of – 18.0% was recorded in Latvia, with an only slightly less painful result of – 15% recorded in the other Baltic states and Ukraine. Other countries experienced a drop of between -4% and -8%. The only exception was Poland that managed to maintain a positive GDP growth rate of 1.7%, due to a combination of skilful policy, a depreciated currency, relative financial stability, a limited dependence on exports, and the sizeable inflow of EU development funds.

In 2010 slow growth returned to the majority of the CEE countries, with the exception of the Baltic states that were the most destabilised by the first wave of the crisis. Internal financial problems still cause close to zero growth in Hungary and several Balkan states. Forecasts for 2011 have been relatively optimistic for all the countries of the region, with the regional average GDP growth rate accelerating from 1-1.5% in 2010 to 3-4% in 2011. Unfortunately, the possible effects of the second wave of the financial crisis are likely to lead to cuts in forecast growth rates.

GDP change during the crisis, 2009-11 (forecast)




Source: IMF

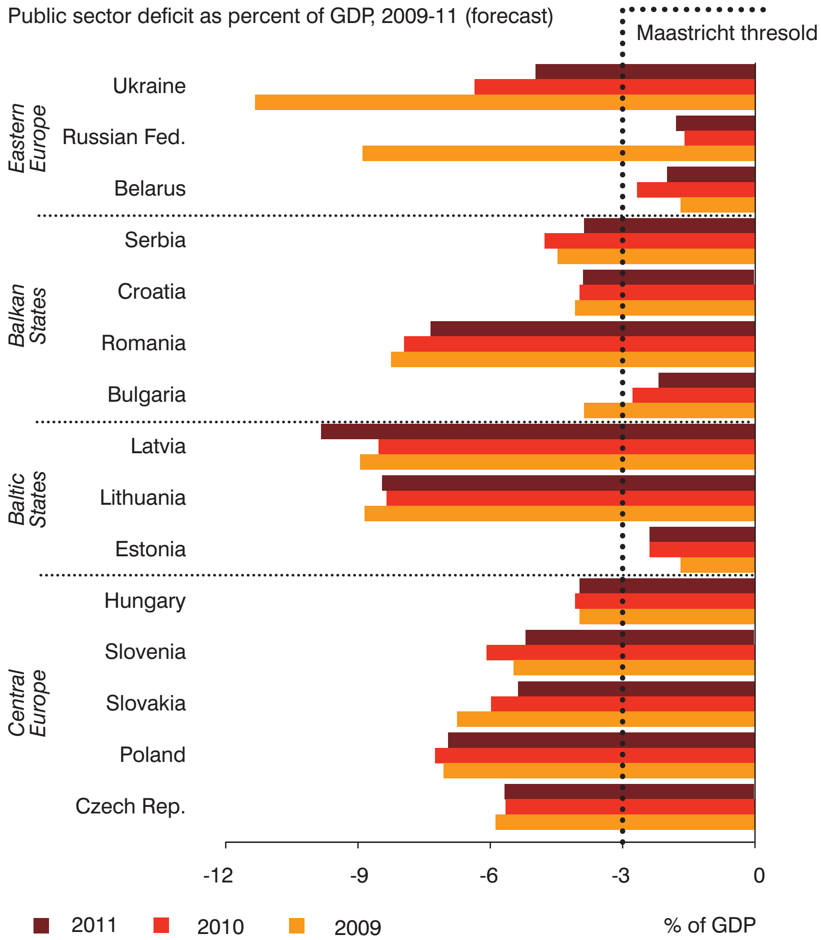
## Situation of public finance

The condition of public finance in CEE countries drastically deteriorated during the course of the crisis. In 2007 all the major countries of the region apart from Hungary had public sector deficits close to, or below the Maastricht Treaty threshold of 3% of GDP. In 2009 the situation was totally reversed: only Estonia and Belarus managed to meet this criterion (according to the IMF, Belarusian data should be treated cautiously due to non-transparent fiscal statistics). In Latvia, Lithuania, and the Ukraine deficits increased to dangerous levels of around 10% of GDP due to the rapid fall in tax revenues, while Russia experienced an only slightly smaller increase due to the implementation of a costly stimulus package aimed at supporting economic growth.

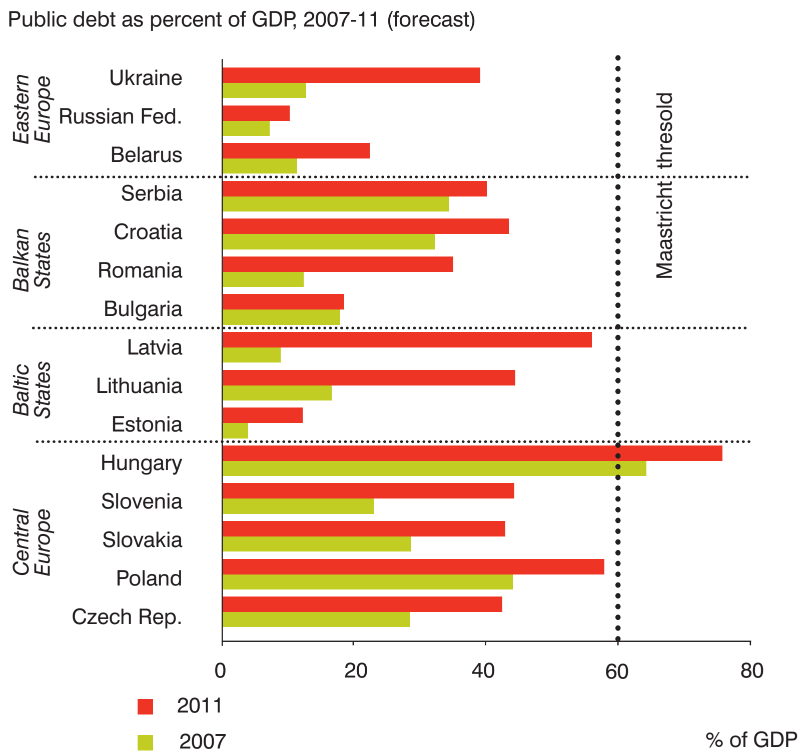
Prospects for the years 2010-2011 are bleak, with only a small reduction in deficits expected in the majority of the countries. Unless more radical fiscal consolidation programs are implemented, the continuously high level of fiscal deficits makes the region vulnerable to sovereign debt crisis.

By contrast, and somewhat paradoxically, the level of public debt recorded in the majority of the CEE countries can be assessed as moderate. By the year 2011 the public debt to GDP ratio is expected to exceed 60% only in the case of Hungary, with Poland and Latvia moving close to this limit. Such a level looks quite comfortable compared to the majority of eurozone countries: please note that in spite of the implemented austerity programs, by 2011 the public debt to GDP ratio is expected to reach 134% in Greece, 91% in Portugal and 87% in Ireland.

What is worrisome, however, is the speed at which public debt levels deteriorated during the crisis in many countries. If the high public sector deficits continue over the next few years, the situation may quite rapidly deteriorate further.




Source: European Commission, IMF




Source: European Commission, IMF

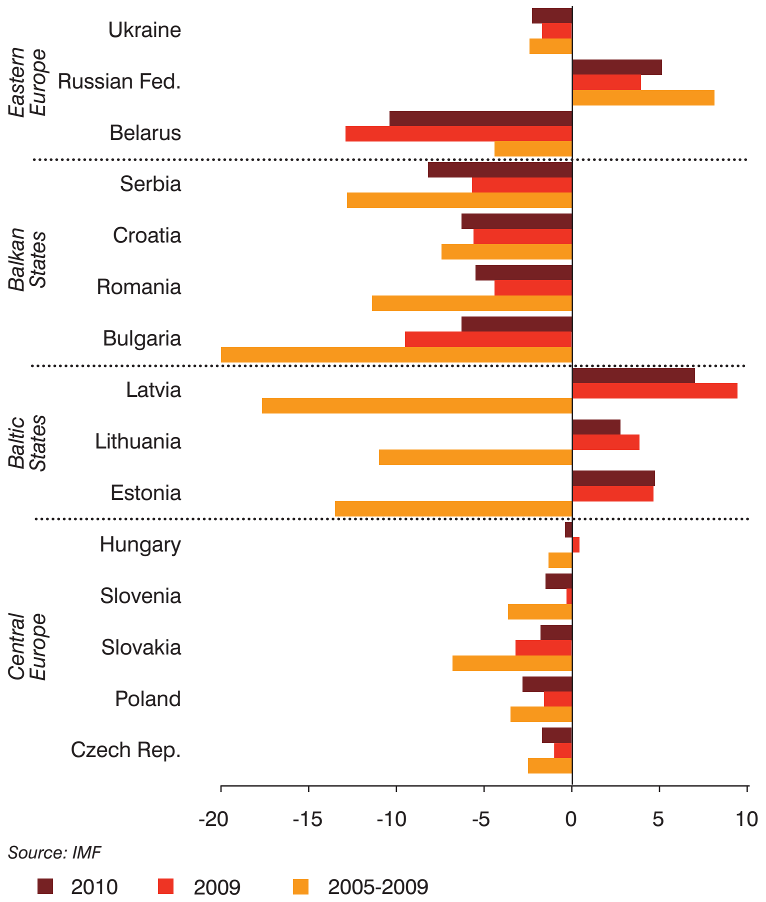
## External indebtedness

Although the situation of public finance in CEE countries still does not look particularly dangerous, with the exception of excessive fiscal deficits, worse news comes from the assessment of the external position of the majority of the countries of the region. The situation is quite the opposite here: although the deficits do not look very high, more dangers can be found in the size and structure of the debt.

Before the crisis, current account deficits of CEE countries were quite high, particularly in the Baltic and Balkan states. Russia was the only country in the region to record a large current account surplus connected to large revenues from oil and gas exports. The recession recorded in 2009 caused a rapid reduction in deficits, at the expense of a strong drop in domestic demand. Deficit levels expected in 2010 can be treated as dangerously high only in the case of Belarus and the Balkan states. The situation with Belarus is particularly risky, as the country does not have good access to the financial markets and its ability to finance the current account deficit seems to depend mainly on the political game with Russia.

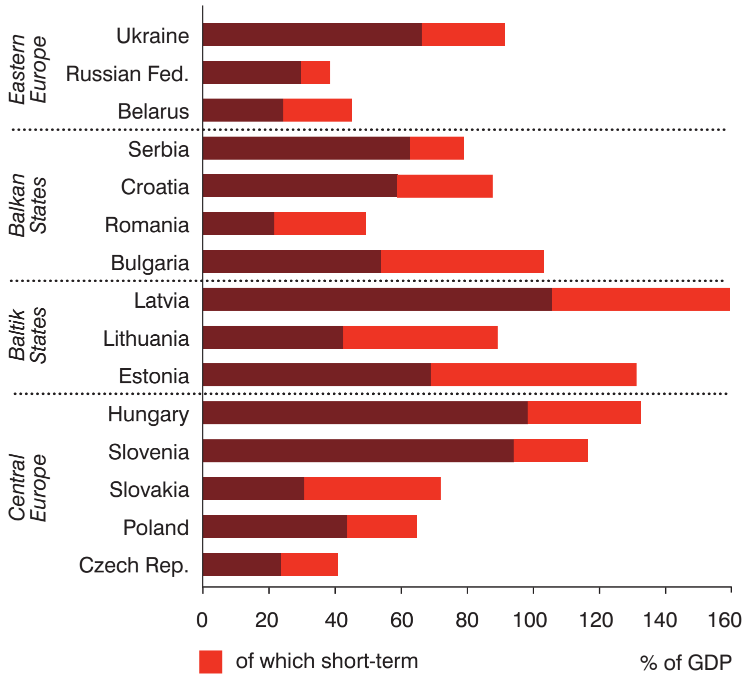
The level of foreign debt is quite high in a number of CEE countries, especially in the Baltic states, Hungary, Slovenia, Bulgaria, and the Ukraine. What is more dangerous, however, is the structure of this debt in several countries. In particular, a high risk is connected with the elevated level of short-term foreign debt (due in one year time). Any problem with paying back or rolling over this type of obligation may immediately lead to a radical increase in interest rates demanded by foreign investors, loss of credibility, market panic, and eventually to the insolvency of the country. In the case of Lithuania, Slovakia, and Romania the share of short-term debt exceeds half of the total. The size of short-term debt reaches or exceeds 50% of GDP in the Baltic states and Bulgaria.

Current account balance as percent of GDP, 2005-10 (forecast)




*Source: IMF*

Foreign debt as percent of GDP, 2009




*Source: EBRD, IMF*

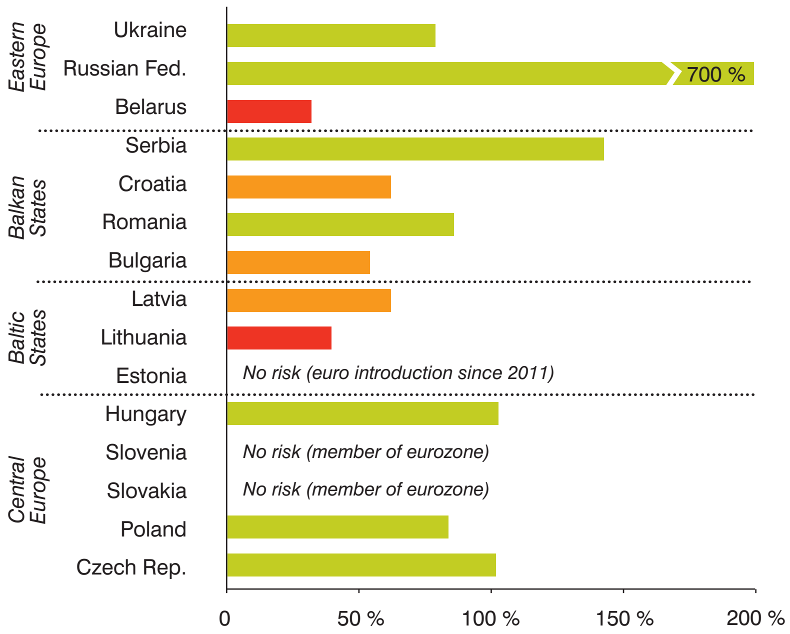
The ability of a country to satisfy its financing needs vis-a-vis external creditors, and therefore to maintain investors' confidence and avoid the risk of insolvency, depends first of all on the sufficient scale of the central banks' foreign exchange reserves. One can obtain the best assessment of the scale of the reserves by comparing them with the estimated foreign exchange expenditures of a country: a sum of the short-term debt and current account deficit. A ratio close to or above 100% suggests, that the central bank has sufficient stock of convertible currencies to cover the yearly financing needs of the country even if it is not possible to borrow money on the international markets.

The ratio of foreign exchange reserves to short-term debt and current account deficit is on a safe level in the majority of CEE countries, with the exception of Belarus and Lithuania, and to a smaller degree Croatia, Bulgaria, and Latvia. Please note, that the countries that use the euro (Slovenia, Slovakia, and from 2011 Estonia) do not have to keep high foreign exchange reserves, as their domestic currency is globally accepted for payment of their obligations.

Another way of satisfying the short-term financing needs of a country is to raise foreign exchange on international financial markets. It is possible, however, only if a country is seen as a credible borrower. Credibility is assessed by specialised agencies that give the country a rating (or an assessment of the country's ability to pay back the debt).

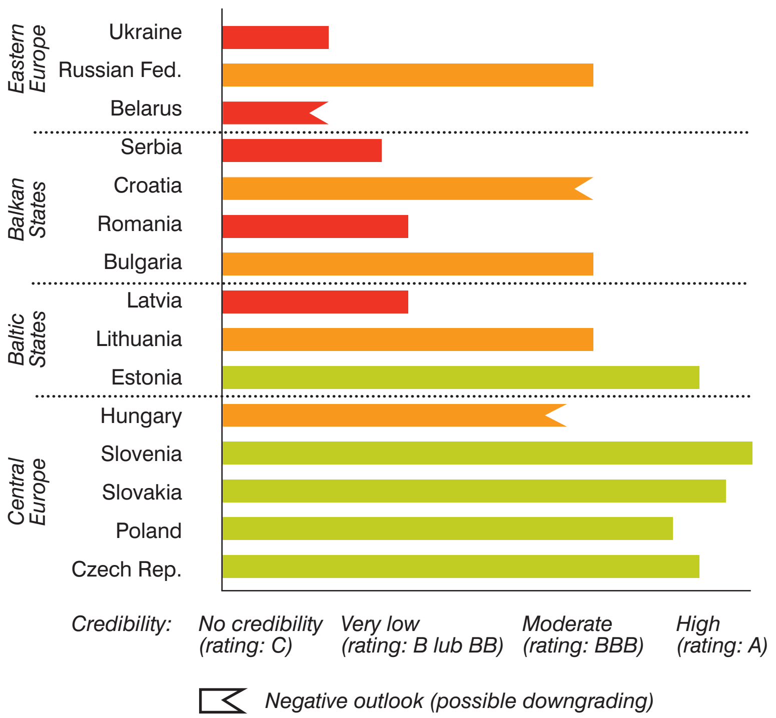
The assessment of the credibility of CEE countries is quite diverse. The majority of Central European countries (except for Hungary and Latvia), enjoy the full trust of the market, confirmed by high credit ratings. It means that they should not have serious problems with financing their needs on the market. The credit rating of other countries is limited or low, which means difficulties in finding capital and a high cost of obtaining it. Credibility is particularly low in the case of the Ukraine and Belarus. Please note, that the rating of Belarus is likely to be further downgraded, while the level of foreign exchange reserves of this country is insufficient.

Ratio of foreign exchange reserves to short-term debt and current account balance, 2009




*Source: EBRD, IMF*

Country credit rating, August 2010

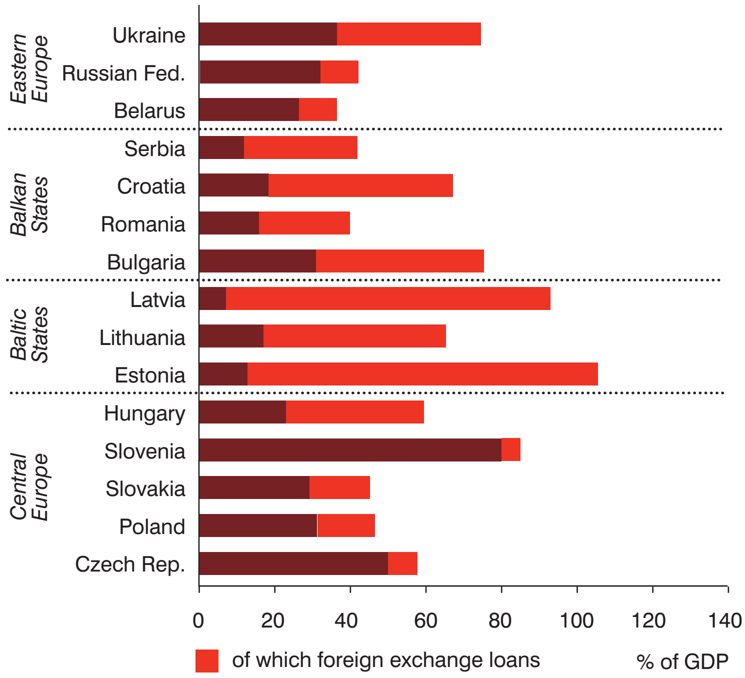



*Source: Standard & Poor's*

## Banking sector

Economic slowdown and the problem with external financing, induced by the second wave of the global financial crisis, may easily translate into problems for the domestic banking sector.

Loans to private sector as percent of GDP, 2009




*Source: EBRD, IMF, central banks*

Please note, that the factors that led to the most serious problems of CEE countries during the first wave of the crisis were: rapid expansion of domestic credit and growth in the indebtedness of households and firms in the pre-crisis period, and the high proportion of debts denominated in foreign currency leaving the sector extremely vulnerable to exchange rate fluctuations.

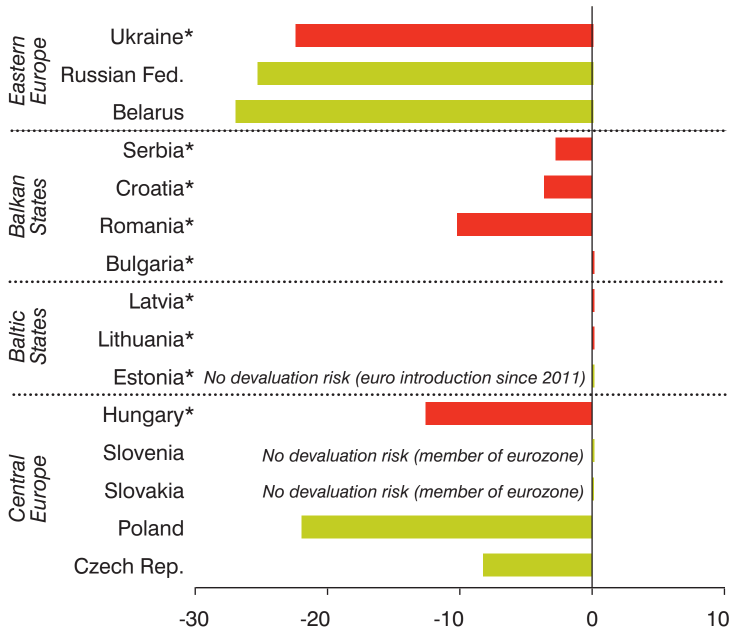
The current level of indebtedness of households and firms, measured in relation to GDP, can be assessed as quite high in the case of Latvia, Estonia, Slovenia, Ukraine, Bulgaria, and Croatia. What is more dangerous, however, is the high proportion of debts denominated in foreign currency recorded in all the Baltic states, and to a smaller degree in Bulgaria, Croatia, Ukraine, and Hungary. A high proportion of debts denominated in foreign currency may become dangerous in the case of a sharp devaluation of the domestic currency.

In such a case the payment obligations of indebted institutions, expressed in domestic currency, strongly increase. In such a case a big part of the debts may turn into non-performing debts that can endanger the profitability and stability of the whole banking sector. Please note, that currency devaluation may also play a positive role during recession, easing the fall in exports and output, and contributing to a reduction in unemployment. Therefore, the potential effects of currency weakening depend on the balance between the positive impact on the real economy, and negative impact on the financial sector.

For the time being, the CEE countries fall into two groups. One of them is using a fixed exchange rate regime that does not allow for any devaluation of the currency (Baltic states, Bulgaria) or belongs to the eurozone. The future stability of the exchange rate can be guaranteed only for the countries that use the euro (Slovenia, Slovakia, since 2011 Estonia).

The other Baltic states, as well as Bulgaria, are desperate to keep the fixed exchange rate, as the high proportion of debts denominated in foreign currency makes their banks extremely vulnerable to the effects of devaluation. The second group of countries is using a flexible exchange rate regime and allows for weakening of the currency. Due to the high proportion of foreign exchange debts such a policy may be dangerous for the Ukraine, Hungary and Balkan states, while it does not bring big risks for the Czech Republic, Poland, Russia, and Belarus.

Change of the exchange rate vis-a-vis euro in %, 2Q2010/4Q2008



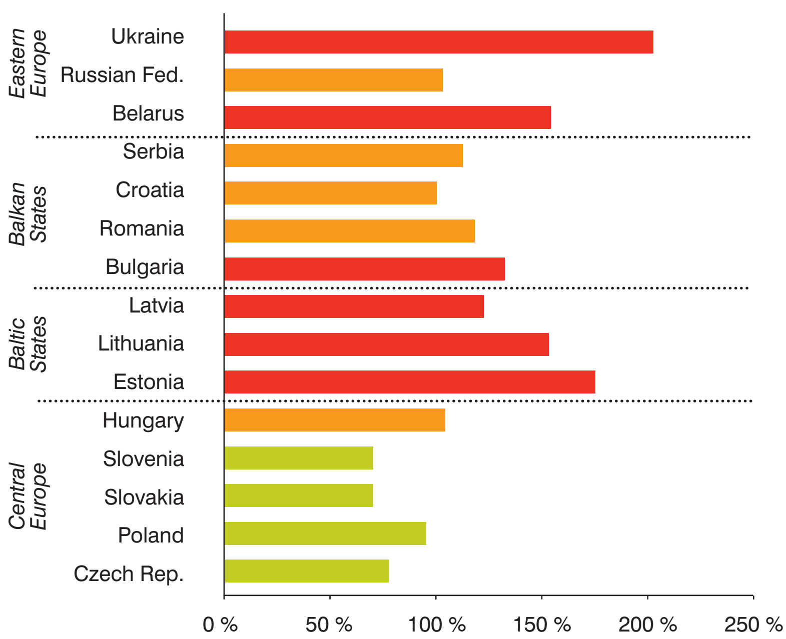

* Countries with high share of the foreign exchange loans to private sector (over 50%), red bars

*Source: EBRD, IMF*

Apart from the exposure to exchange rate fluctuations, the most important factor determining the stability of the banking sector is the healthy ratio between loans and deposits. Generally speaking, if the ratio is below 100% it means that credits were financed mainly from domestic savings. A ratio of above 100% suggests that banks were financing loans mainly by borrowing money from abroad. That makes them extremely vulnerable to the situation on global financial markets and creates a major risk for the country's banking sector.

The situation in the banking sector may be assessed as safe only in the case of Central Europe, except for Hungary. In other countries the ratio exceeds 100%, and in the case of the Baltic states, the Ukraine and Belarus reaches dangerously high levels. In other words, the banking sector in these countries is exposed to serious risks, that may easily materialise if the second wave of the global crisis hits with full force.

Loans to deposits ratio in the banking sector, 2009

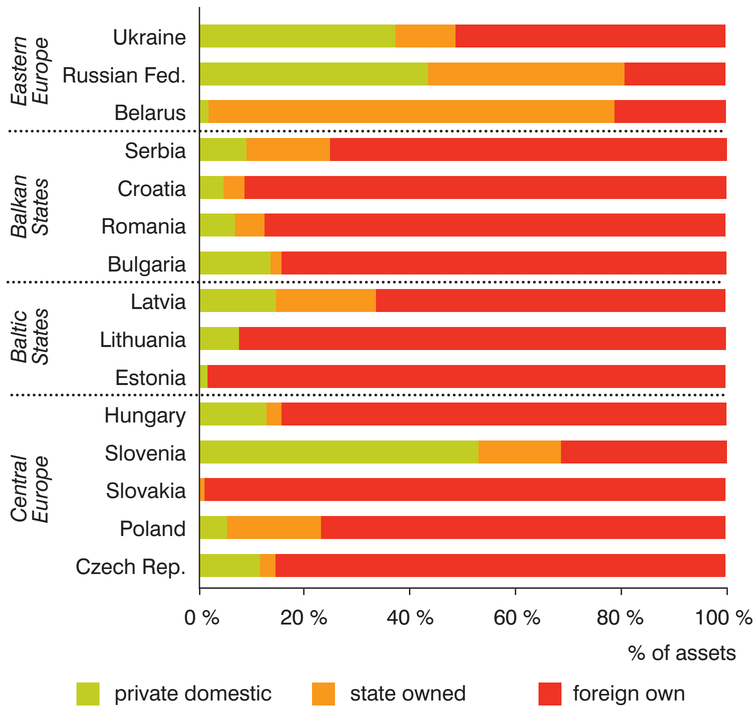



*Source: EBRD, IMF, central banks*

The last point that one should make about the situation in the banking sector in CEE countries is connected with the peculiarities of its structure. On the one hand, a danger may be created by the high proportion of state-owned banks. Albeit that some of them do not differ in their behaviour from private entities, in some cases one may expect problems, mainly caused by moral hazard issues. This is particularly the case with Belarus, and to a lesser degree Russia and Ukraine. The issues of the Eastern Europe banking sector may arise from insufficient supervision and structural weaknesses caused by the unclear connections between banks and large companies in the non-financial sector.

On the other hand, one should also notice the problem shared by all the other countries, except for Slovenia. It is the predominant role played on the market by foreign owned banks. The risk, already noticed during the first wave of the crisis, is that domestic banks may become infected with the problems affecting their parent banks in Western Europe and the USA.

Ownership structure of the banking sector, 2009




Source: EBRD

## Summary of threats

**The main threats to the economic situation in CEE countries, created by the debt crisis, may be divided into three areas.**

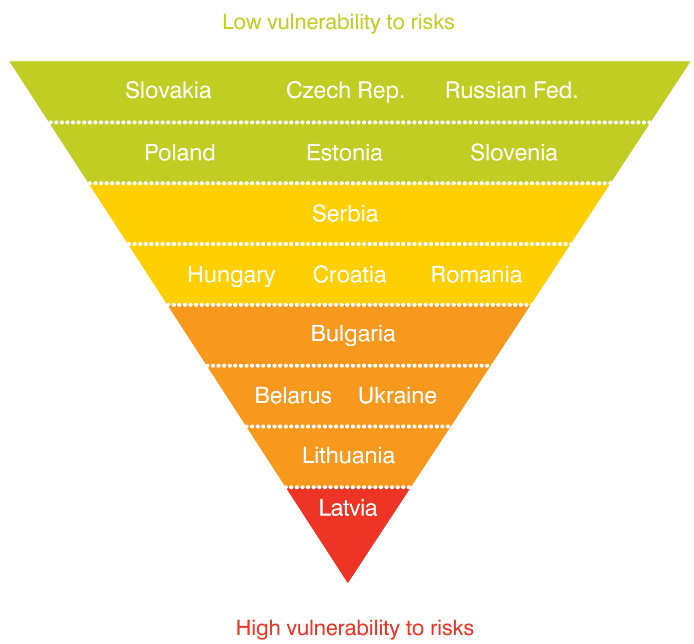
1. Potential problems with public debt may arise in all the CEE countries except Estonia, Slovakia, and Russia. The problems may be particularly strong in Hungary, Lithuania, and Romania. It is, however, Latvia that faces the biggest threats due to rapidly growing debt levels and bleak prospects for renewed growth.
2. Possible problems with foreign debt are likely to be particularly strong in Belarus, that may face the risk of insolvency. The situation of Lithuania, Latvia, and Bulgaria can be assessed as dangerous as well. Only the external debt situation of Central European countries (except for Hungary) and Russia can be assessed as safe.
3. Potential problems in the banking sector may affect all the Baltic states, Balkan states, and Eastern Europe (particularly Belarus and the Ukraine). The situation of Latvia, once again, can be assessed as the most serious.

Joint examination of all the threats that CEE countries have to face due to the second wave of the global crisis suggests that the country most vulnerable to the debt crisis is Latvia, followed by Lithuania. Very serious threats jeopardise the development of Belarus, Ukraine, and to a lesser degree Bulgaria. Particular deliberation and caution is also required in the cases of Hungary, Croatia, and Romania. An easier, albeit still potentially dangerous, situation confronts Estonia, and Serbia. Compared to the above, the problems facing Slovakia, the Czech Republic, and Russia, as well as Poland and Slovenia seem less dangerous.

CEE countries must be prepared for a long period of limited growth dynamics combined with continuous disturbances on the financial markets. Rapid growth will eventually return, but the timing of such a recovery still remains obscure. Cautious economic policy, supported by vigorous structural reforms, remains the best prescription for surviving these difficult times in good shape.

| | Possible problems with public debt | Possible problems with foreign debt | Possible problems in the banking sector |
|---|---|---|---|
| Czech Republic | ● (yellow) | ● (green) | ● (green) |
| Poland | ● (yellow) | ● (green) | ● (green) |
| Slovakia | ● (green) | ● (green) | ● (green) |
| Slovenia | ● (yellow) | ● (green) | ● (yellow) |
| Hungary | ● (yellow) | ● (yellow) | ● (yellow) |
| Estonia | ● (green) | ● (yellow) | ● (yellow) |
| Lithuania | ● (yellow) | ● (orange) | ● (yellow) |
| Latvia | ● (red) | ● (orange) | ● (red) |
| Bulgaria | ● (yellow) | ● (orange) | ● (yellow) |
| Romania | ● (yellow) | ● (yellow) | ● (yellow) |
| Croatia | ● (yellow) | ● (yellow) | ● (yellow) |
| Serbia | ● (yellow) | ● (yellow) | ● (yellow) |
| Belarus | ● (yellow) | ● (red) | ● (orange) |
| Russian Federation | ● (green) | ● (green) | ● (yellow) |
| Ukraine | ● (yellow) | ● (yellow) | ● (orange) |

*Legend:* ● (green) *Low* ● (yellow) ● (orange) ● (red) *High*



# Czech Republic

**Basic information**

| | Czech Republic | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 10,2 | 324 | 3,1 |
| GDP, billions of US$ | 192 | 2 672 | 7,2 |
| GDP per capita, thousands of US$* | 25,1 | 16,3 | 154,0 |
| Exports as percent of GDP | 58,7 | 39,4 | 149,0 |
| GDP growth rate, 2009 | -4,3 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 2,2 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 1,8 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

## Vulnerability of the country to the debt crisis

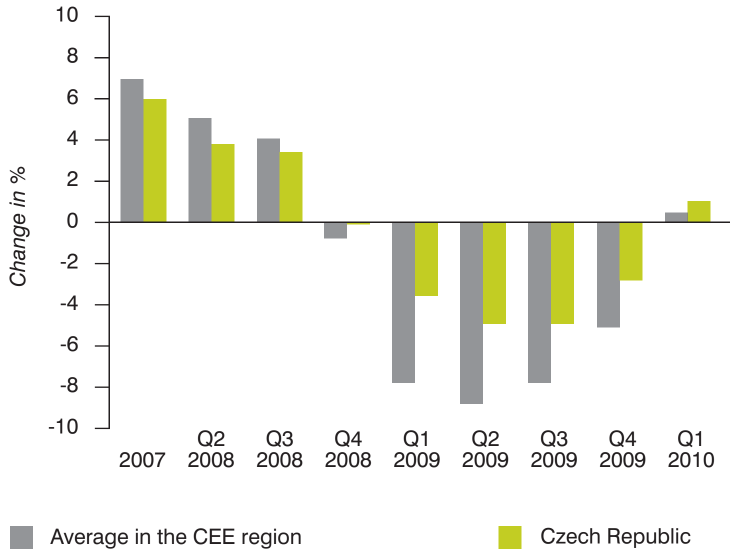
Strengths:
- Moderate public debt
- High credibility
- Moderate foreign debt
- Strong banking sector
- EU membership

Weaknesses:
- Too high fiscal deficits
- Bleak growth prospects
- Strong dependence on exports to Western Europe

## General assessment of the economic situation

The Czech Republic is emerging from a deep recession experienced in 2009, mainly due to a combination of reduced exports sales and lower investment.

GDP growth rates




*Source: IMF, EBRD, statistical office*

The growth prospects should improve in the years 2010-11, with a moderate GDP growth of over 2% forecast. However, as the Czech Republic is one of the most export-dependent countries in the region, and its economy is closely integrated with the western part of the EU, any major slowdown in Western Europe may hamper growth prospects.

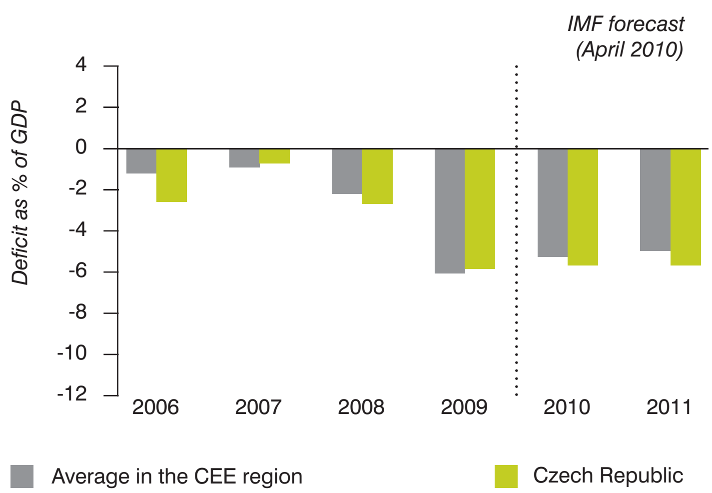
The situation of the Czech Republic is improved by strong macroeconomic foundations and a robust financial sector. Albeit that the growth record is somewhat disappointing, the country enjoys the reputation of being one of the most stable and credible economies in the region. According to IMF forecasts the Czech economy should grow by over 2% in 2010-11.

## Public finance

The Czech Republic has been carrying out a relatively prudent fiscal policy since the beginning of the transition process. Due to this fact, public debt is still quite low and stands at 35% of GDP.

Unfortunately, the global crisis and a domestic recession led to a rapid deterioration in the fiscal stance. The public sector deficit increased from below -3% of GDP in 2006-2008 to -5.9% of GDP in 2010. In the absence of a radical policy response, the European Commission expects the high deficits to continue over the next few years, bringing public debt to 44% by 2011.

Public sector deficit



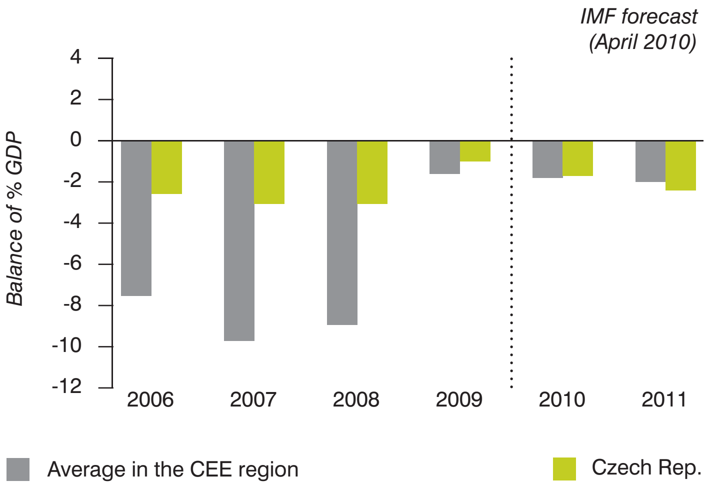

*Source: IMF*

## The external balance

The external situation of the Czech Republic looks relatively comfortable. The foreign debt level is quite low, reaching 41% of GDP. As opposed to most CEE countries, the Czech economy is characterised by a relatively high savings rate. Thanks to this, the Czech Republic – to a lesser degree than other countries – has to rely on borrowing foreign capital in order to finance its investment needs.

The current account deficit was at a safe level of below -3% of GDP even before the crisis broke out. During the crisis, the deficit was reduced to – 1% of GDP due to lower import demand and a weaker currency.

Current account balance



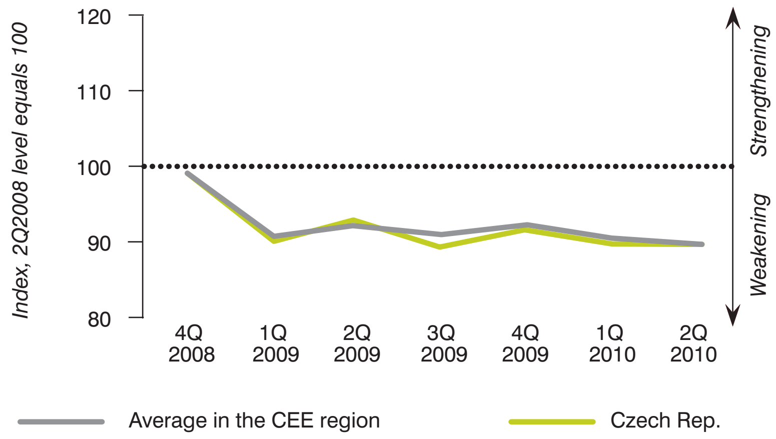

*Source: IMF*

## Stability of the currency

The Czech Republic uses a flexible exchange rate regime and allows for fluctuations in the value of the koruna.

Over the period of the crisis the koruna lost about 10% of its initial value vis-a-vis the euro, that helped exporters deal with the sharp fall in foreign demand. The remarkably low level of domestic indebtedness in foreign currency, due partly to very low domestic interest rates, makes a flexible exchange rate policy totally safe. The inflation rate in the Czech Republic remains low and stable, at below 2%.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

The tax burdens in the Czech Republic, with the exception of VAT, have recently become less severe. However, the existing bureaucratic barriers still make the country a relatively challenging environment for conducting business operations.

**The latest developments in the taxation system area are as follows:**

- the corporate income tax decreased by 1% – in 2009 it stood at 20% while the applicable rate in 2010 is 19%;
- the amendment to the Income Tax Act introduced in 2009 set forth the premises that allow, under certain conditions, depreciation of newly acquired assets over shorter periods;
- in 2009, an amendment to the Social Insurance Contributions Act was adopted, introducing reductions in social insurance and state employment policy contributions due; the social insurance contribution rates decreased from 8% to 6.5% for employees, from 26% to 25% for employers and from 34% to 30.6% for private entrepreneurs; the capped annual base for social and health insurance payments made by employees and private entrepreneurs increased from 48 times the average monthly salary (in 2008) to 72 times this amount (in 2010), i.e. EUR 68,280;
- an amendment to the VAT Act, effective as of 1 January 2010, was adopted, introducing a number of significant changes in this area;
- the VAT rates have increased temporarily by one percentage point as of 1 January 2010 – the applicable basic VAT rate now stands at 20% and the reduced VAT rate at 10%;
- the personal income tax rate has not changed and remains at 15%.

**The introduced legislative changes concern the following:**

- the Insolvency Act – since 2008, an innovative Insolvency Act has been in force in the Czech Republic, extending the range of possible solutions for solving bankruptcy cases and implementing the insolvency register and the electronic insolvency file system;
- the Act on Significant Market Power – regulating the position of strong purchasers on the food and agricultural product market in a truly revolutionary way;
- renewable resources energy promotion – the former support facilitating flourishing development of photovoltaic power plants in the Czech Republic was replaced in 2010 by regulations that render the criteria to be met by energy producers much stricter as well as decrease their return on investment;
- distrainment – an obligation to act adequately to the amount enforced has been implemented, among other things;
- data boxes – in November 2009, a data box information system was put into operation, enabling the sending to and receiving from public authority bodies of official documents in an electronic form.

**Jiží Moser**

Country Managing Partner
PricewaterhouseCoopers
Czech Republic

*Czech recovery is highly depended on the performance of our western neighbours where I can see many positive signs, such as increased growth expectations from both corporate and government sector members, from the end of H1 2010.*

*Also, cautious optimism expressed by Czech CEOs as well as by the owners of local companies expressed in PwC surveys promises revenue growth for the majority of businesses in 2010 and 2011.*

## Indicators of vulnerability, 2009

| | Czech Republic | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -5,9 | -6,1 |
| Public debt as % of GDP | 35,4 | 32,6 |
| Loans to private sector as % of GDP | 57,9 | 62,3 |
| Share of foreign exchange loans | 13% | 51% |
| Loans to deposits ratio | 77% | 126% |
| Current account balance as % of GDP | -1,0 | -1,6 |
| Foreign debt as % of GDP | 41,0 | 86,9 |
| Proportion of short-term debt | 42% | 37% |
| Coverage of financing needs by reserves* | 102% | 128% |
| Credit rating | A | |

** Ratio of foreign exchange reserves to short-term debt and current account balance*
*Source: IMF, CIA World Factbook, EBRD*

The Czech Republic belongs to the group of CEE countries that are the least vulnerable to the threat of a debt crisis.

Albeit that the fiscal deficit is too high, and for the time being no radical action has been proposed to reduce it, a low level of public debt makes a serious fiscal crisis quite unlikely.

The Czech banking sector is remarkably stable, due to a moderate level of indebtedness of firms and households, a very low proportion of debts denominated in foreign currency, and a favourable loans to deposit ratio of well below 100%. The external position of the Czech Republic looks solid, too. Neither the current account deficit nor foreign debt are at a dangerous level. The stock of foreign exchange reserves is quite sufficient and external credibility (measured by credit rating) remains strong.

# Poland

**Basic information**

| | Poland | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 38.4 | 324 | 11.9 |
| GDP, billions of US$ | 428 | 2 672 | 16.0 |
| GDP per capita, thousands of US$* | 17.9 | 16.3 | 109.8 |
| Export as percent of GDP | 32.6 | 39.4 | 82.8 |
| GDP growth rate, 2009 | 1.7 | -7.4 | x |
| Forecast GDP growth rate, 2010-11 | 3.0 | 2.2 | x |
| Forecast inflation rate, 2010-12 | 2.4 | 2.9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

**Vulnerability of the country to the debt crisis**

Strengths:

- Relatively strong GDP growth
- High credibility
- Moderate foreign debt
- Strong banking sector
- EU membership

Weaknesses:

- Too high fiscal deficits
- Fast growing public debt

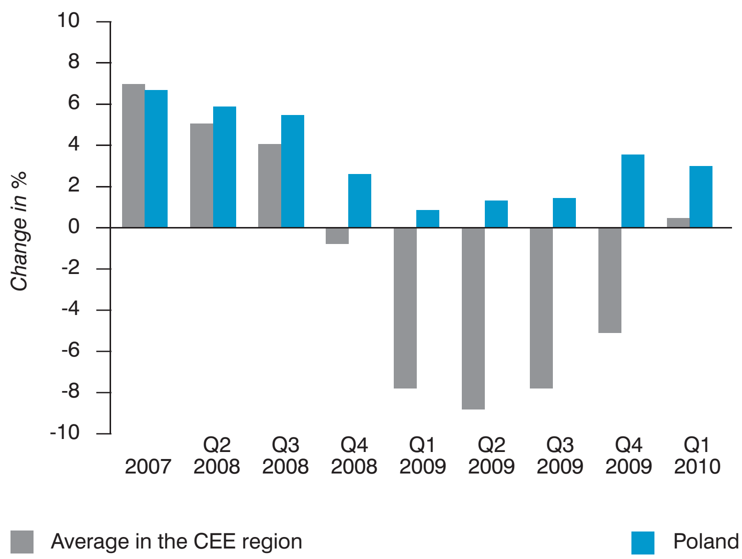
## General assessment of the economic situation

Since the beginning of the crisis, Poland has been the region's (as well as Europe's) best performer in terms of economic growth.

In 2009 Poland was the only country in the EU that maintained a positive growth rate of 1,7%, as a combination of a slight fall in domestic demand and a serious reduction in the foreign trade deficit. Moreover, prospects for the years 2010-11 remain among the best in the region, too. Albeit that the economy is not going to return to the high dynamics observed before the crisis, continuation of a solid 3% growth is forecasted by the IMF.

Even if the West European recovery is hurt by the new wave of the crisis, the relatively large internal market and moderate dependence on exports should allow Poland to continue development. The situation of Poland is improved by quite strong macroeconomic foundations and a robust financial sector. In spite of the fiscal problems the country is still considered as one of the most stable and credible economies of the region.

GDP growth rates



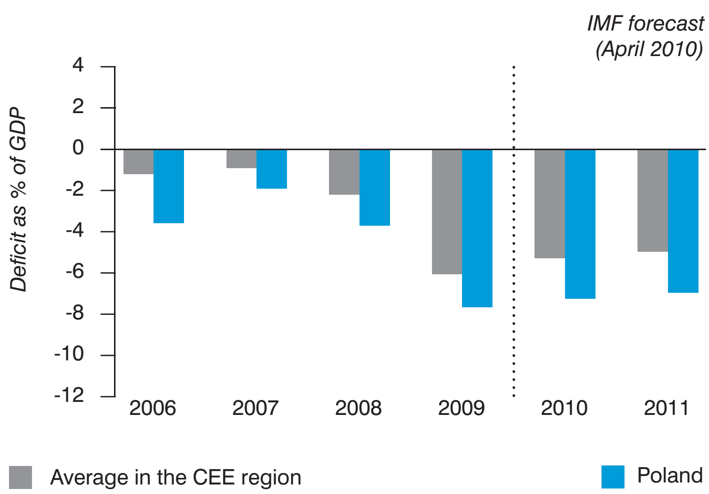

*Source: IMF, EBRD, statistical office*

## Public finance

Polish public finance is an area of concern. Although public debt is still moderate by West European standards and stands at a level of 51% of GDP, the risk of reaching the Maastricht threshold of 60% (set as an unbridgeable threshold by the Polish constitution as well) over the next 2-3 years is quite high unless firmer action is taken by the government.

The global crisis and domestic recession led to a rapid deterioration of the fiscal stance of Poland. The public sector deficit increased from below -2% of GDP in 2007 to -7,1% of GDP in 2010. In the absence of a radical policy response, the European Commission expects the high deficits to continue over the next few years, bringing public debt to 59% of GDP by the year 2011.

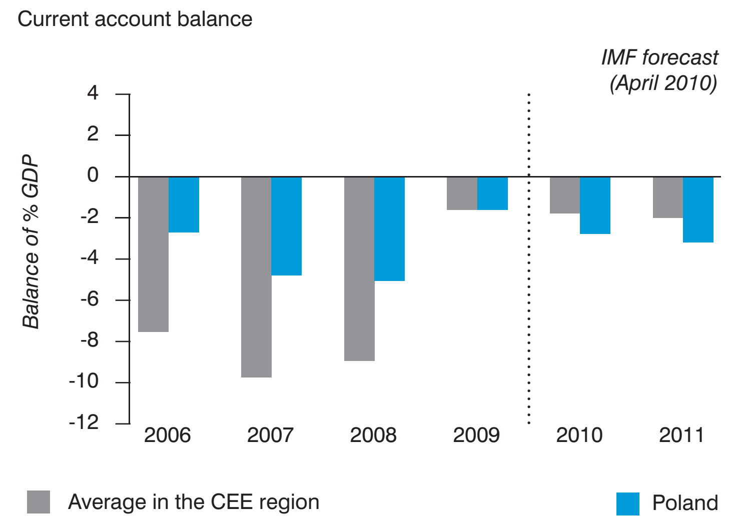
Public sector deficit




*Source: IMF*

## The external balance

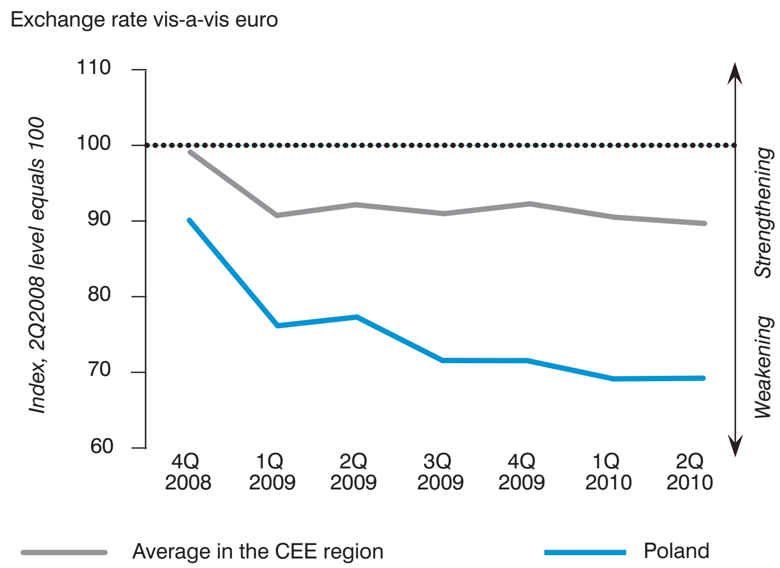
The external situation of Poland does not look dangerous. Albeit that foreign debt reaches 65% of GDP the country does not have problems with servicing it due to high financial credibility and continuously high – despite the global crisis – inflows of FDI. Reduced domestic demand coupled to a weaker złoty exchange rate helped in curbing the current account deficit to below -2% of GDP, with an expected gradual deepening taking place over the next two years. With a sufficient level of foreign exchange reserves, Poland seems to be well prepared to deal with possible problems on the global financial markets.




Source: IMF

## Stability of the currency

Poland uses a flexible exchange rate regime and allows for fluctuations in the value of the złoty.




Source: IMF

Over the period of the crisis the złoty lost about 30% of its initial value vis-a-vis the euro, almost the greatest weakening observed in the region. However, this larger scale currency devaluation than elsewhere is explained more by the scale of the Polish foreign exchange market, making it the most popular place in the region for short-term speculations, than by macroeconomic factors.

On the contrary, Poland has proven to be one of countries least vulnerable to the turmoil, while the weaker currency helped exporters to deal with the strong fall in foreign demand. The moderate level of domestic indebtedness in foreign currency makes a flexible exchange rate policy safe for the banking sector. The inflation rate in Poland remains low and stable, at below 3%.

## Taxation and conditions for doing business

Poland's business environment is relatively difficult for conducting businesses. However quite stable economic situation, huge internal market and advanced integration with other EU markets keep attracting foreign investors.

**Latest tax developments in Poland include:**

- In 2009 the possibility of registering a business in a "one-stop shop" simplified mode was introduced;
- From 8th January 2009, the minimum amount of share capital for limited companies and limited liability companies has been reduced;
- Since 24th January 2009, the settlement payments can be made in foreign currencies;
- From 1st January 2009, the rate of personal income was lowered and flattened; the rates are now 18% and 32%;
- In the beginning of 2010 the VAT Act amendment, which implements three EU Directives (the so-called "VAT package") came into force. It established new rules in the area of services, VAT refund and reporting requirements in order to prevent tax evasion;
- Provisions on the electronic submission of tax returns are being constantly improved.

The Ministry of Finance prepared new draft amendments to the VAT Act that include the following changes:

- Existing rates will be increased by 1% and a new rate of 5% will be introduced;
- Free of charge disposal of goods and provision of free of charge services: these transactions will be subject to VAT;
- New rules on the pro-rata calculation;
- Mandatory reverse charge mechanism for goods and services provided in Poland by foreign entities.

Those changes will most probably come into force on January 1, 2011.

**Olga Grygier-Siddons**

Country Managing Partner
PricewaterhouseCoopers
Poland

## Indicators of vulnerability, 2009

| | Poland | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -7.1 | -6.1 |
| Public debt as % of GDP | 51.0 | 32.6 |
| Loans to private sector as % of GDP | 46.2 | 62.3 |
| Share of foreign exchange loans | 33% | 51% |
| Loans to deposits ratio | 95% | 126% |
| Current account balance as % of GDP | -1.6 | -1.6 |
| Foreign debt as % of GDP | 65.0 | 86.9 |
| Proportion of short-term debt | 32% | 37% |
| Coverage of financing needs by reserves* | 84% | 128% |
| Credit rating | A- | |

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

*"According to numerous rankings, Poland is one of the most attractive foreign direct investment locations in the world. Stability, market access, liberalization and deregulation are the key factors in such an assessment. Other important factors include local resources, for example, the talent pool available and a large base of subcontractors. It is worth adding that the labour cost in Poland is still considerably lower than in Germany or in the United Kingdom. Another important factor which increases the competitiveness of the Polish economy is investment incentives.*

*If we consider that Poland offers a very favourable macro-economic environment, we can conclude that all these factors constitute a good base for the quick development of companies in various areas of the economy. Should Poland also take care of the development of the infrastructure and limit bureaucratic barriers, an even wider stream of foreign investments would flow into the country."*

Poland belongs to the group of CEE countries least vulnerable to the threats of a debt crisis.

Albeit that the fiscal deficit is too high, and the expected growth of public debt to the 60% of GDP threshold is worrying, no big threat of a serious fiscal crisis exists. However, the rating agencies and market players wait impatiently for radical action from the government to reduce the deficit, and the absence of such a move may result in a serious loss of credibility.

The Polish banking sector is stable, due to the moderate level of indebtedness of firms and households, the moderate proportion of debts denominated in foreign currency, and a favourable loans to deposit ratio of below 100%.

The external position of Poland looks well. Neither the current account deficit nor foreign debt are at a dangerous level. The stock of foreign exchange reserves is quite sufficient and the external credibility (measured by credit rating) remains strong.

# Slovakia

**Basic information**

| | Slovakia | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 5,5 | 324 | 1,7 |
| GDP, billions of US$ | 89 | 2 672 | 3,3 |
| GDP per capita, thousands of US$* | 21,2 | 16,3 | 130,1 |
| Exports as percent of GDP | 61,9 | 39,4 | 157,2 |
| GDP growth rate, 2009 | -4,7 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 4,3 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 1,4 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

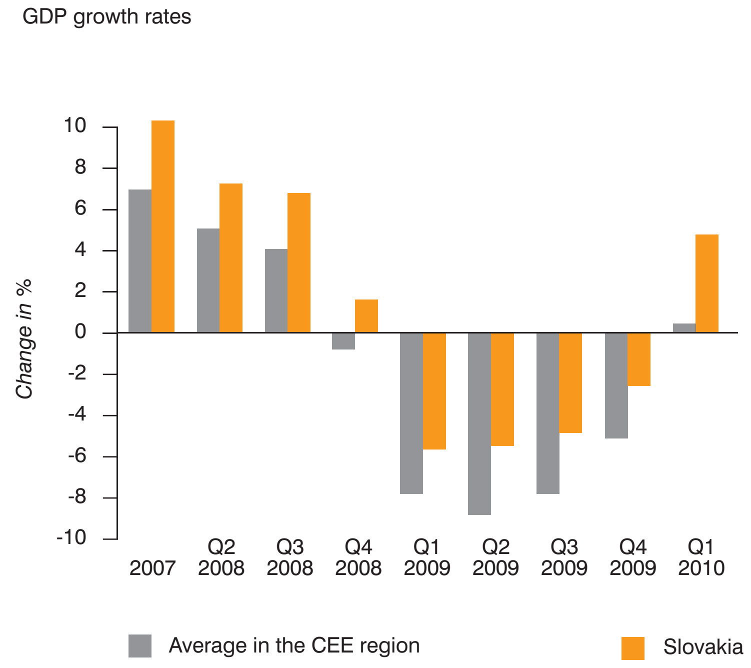
## Vulnerability of the country to the debt crisis

Strengths:
- Moderate public debt
- High credibility
- Strong banking sector
- Eurozone membership

Weaknesses:
- Too high fiscal deficit
- Small internal market
- Strong dependence on automobile industry exports

## General assessment of the economic situation

The crisis has been a serious challenge for Slovakia, previously one of the leaders in the economic growth of the region.




*Source: IMF, EBRD, statistical office*

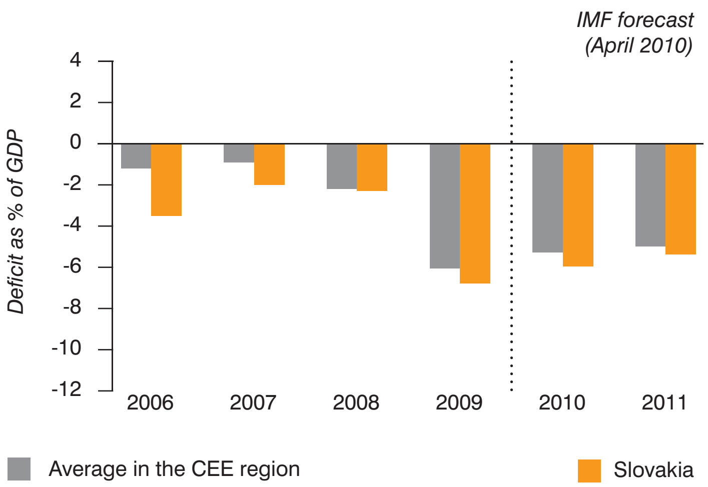
In 2009, the GDP dropped by as much as -4,7%, mainly due to the sharp fall in exports, especially in the county's dominant automotive industry. However, the economy is accelerating once again, as the better outlook for car producers translated directly into better results for the Slovak economy. Unless a new wave of the recession hits Western Europe, Slovakia should enjoy moderate growth in the coming years.

According to IMF forecasts the Slovak economy should grow by over 4% in 2010-11, taking it once again into the lead among new EU member states from the region.

## Public finance

Slovakia's fiscal deficits increased considerably during the crisis. The public sector deficit was -6.8% in 2009 with high deficits forecast to continue in 2010-11. Nevertheless, the situation does not pose any imminent danger, as public debt is maintained at a moderately low level of 36% of GDP. By 2011 debt is expected to increase to 45% of GDP.

Public sector deficit




*Source: IMF*

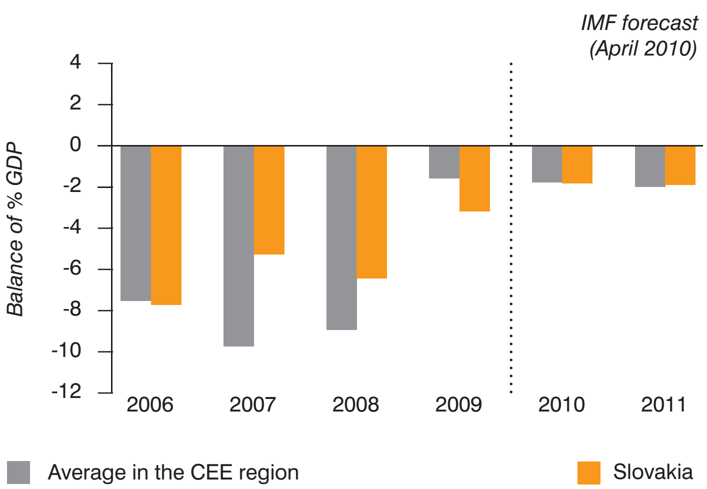
## External balance

The external situation of Slovakia looks quite comfortable, taking into account that the country is using the euro. The proportion of external debt in Slovak GDP is not alarming – it is currently 72% of GDP. In the years preceding the crisis, foreign capital was used to finance capital expenditure, as – unlike their Czech neighbours – the Slovaks have a lower propensity to save.

However, the proportion of short-term debt (whose repayment is due in less than 12 months) is much less favourable, as it exceeds 50% of the entire debt.

The current account deficit was at the rather elevated level of -6% of GDP before the crisis broke out. During the crisis, the deficit was reduced to -3% of GDP due to smaller import demand.

Current account balance




*Source: IMF*

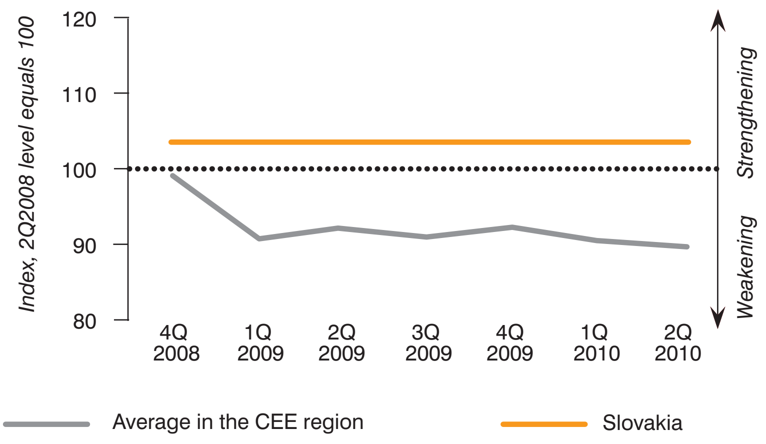
## Stability of the currency

### As Slovakia is a member of the eurozone, the exchange rate was stable during the slowdown.

On the one hand, no foreign exchange risk existed. On the other hand, however, the strong currency does not help Slovakia to deal with weak external demand.

The inflation rate in Slovakia is currently 1,4%, which is attributed to deflationary pressure resulting from the country's negative output gap. Inflation is forecast to reach almost 2% in 2010-2011 – significantly below the CEE average of nearly 3%.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

Slovakia's economic environment remains comparatively favourable for businesses. There has been a significant decrease in the level of tax burdens, while significant reforms affecting business operations are to be implemented soon.

The Slovak government has amended the Investment Aid law to render the overall requirements and eligibility criteria for receiving the state aid less strict. Additionally, the Tax Directorate of the Slovak Republic has prepared a new state aid scheme to enable small and medium-size enterprises to receive relief from, or reductions in, tax-related penalties.

The Slovak government has also approved an amendment to the Act on Employment Services setting out new contributions for employers and employees with the aim of softening the impact of financial crisis on the labour market. The new incentives include support for maintaining employment, subsidy for creating new jobs, co-financing of education schemes and preparation of employees for the labour market – provided to an employer to cover the training costs of the employees

A Tax law amendment facilitating VAT refunds, are met, has been approved. This could significantly improve the cash position of businesses. Furthermore, an increase in the monthly non-taxable personal allowance from EUR 286.27 to EUR 335.48 – translating annually to a rise from EUR 3,435.27 to EUR 4,025.70 – has been implemented. It is expected that this measure will ease the tax burden for low- and medium-income persons.

At the same time, it should be noted that the Slovak government considers an increase in the VAT rate from 19% up to possibly even 22%.

Significant changes affecting the conditions for conducting business operations are expected to be implemented in the second half of 2010 and throughout 2011. These will include changes in the Labour Code, decreasing the level of compensations for lay-offs and allowing more flexibility in hiring and dismissing employees. Changes are also expected in the area of Social Insurance and the due contributions (including employer and employee deductions). The system of social insurance contributions, health insurance and income tax is expected to be standardised and combined on a single platform in order to decrease the administrative outlays and save costs.

## Indicators of vulnerability, 2009

| | Slovakia | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -6,8 | -6,1 |
| Public debt as % of GDP | 35,7 | 32,6 |
| Loans to private sector as % of GDP | 45,3 | 62,3 |
| Share of foreign exchange loans | 35% | 51% |
| Loans to deposits ratio | 70% | 126% |
| Current account balance as % of GDP | -3,2 | -1,6 |
| Foreign debt as % of GDP | 72,2 | 86,9 |
| Proportion of short-term debt | 57% | 37% |
| Coverage of financing needs by reserves* | 0% | 128% |
| Credit rating | A+ | |

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

Based on the strong foundations of high labour productivity and industrial competitiveness, as well as a strong banking sector, the Slovak economy is quickly recovering from the recession.

The main engines of growth include growing industrial output and exports. However, an improvement in the economic position of other euro area countries is a prerequisite to growth over a longer-term horizon, as Slovakia remains strongly dependent on exports.

The vulnerability of Slovakia to financial turmoil is very high. Public finances suffered as a result of the crisis and an improvement in this area is among the government's top priorities, but the risk of a serious debt crisis over the next few years is very low. As a eurozone member, Slovakia does not have problems with hypothetical instability of the currency, especially given the fact that both the level of public and private debt is moderate.

# Slovenia

**Basic information**

| | Slovenia | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 2,0 | 324 | 0,6 |
| GDP, billions of US$ | 50 | 2 672 | 1,9 |
| GDP per capita, thousands of US$* | 27,9 | 16,3 | 171,2 |
| Exports as percent of GDP | 45,1 | 39,4 | 114,5 |
| GDP growth rate, 2009 | -7,3 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 1,6 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 1,9 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

## Vulnerability of the country to the debt crisis

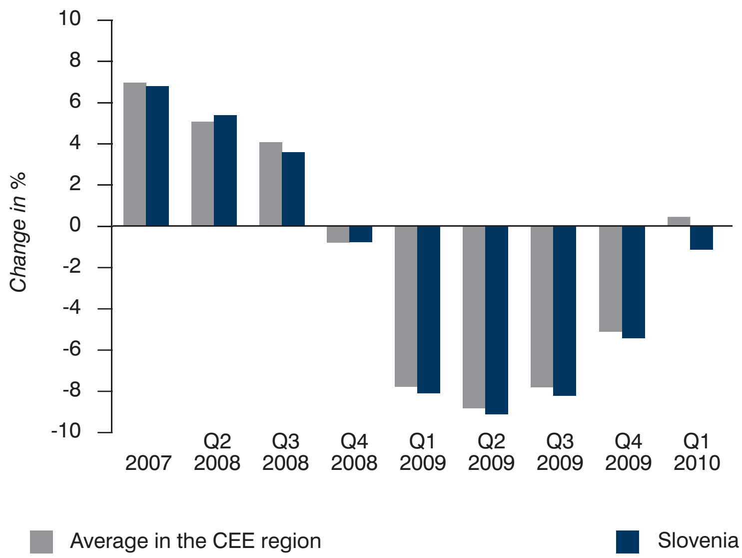
Strengths:
- High financial credibility
- Moderate public debt
- High level of macroeconomic stability
- Strong dependence on exports to Western Europe
- Excessive foreign debt
- Membership of the eurozone

Weaknesses:
- Strong dependence on exports to Western Europe
- Excessive foreign debt

## General assessment of the economic situation

The years before the crisis were characterised by rapid, but quite well balanced growth in Slovenian economy, secured by high rates of domestic savings.

GDP growth rates




*Source: IMF, EBRD, statistical office*

During the first wave of the global crisis Slovenia followed the main trend presented by the CEE countries. Growth stopped abruptly in the last quarter of 2008 and in 2009 the country suffered a deep recession. The GDP decrease was mainly as a result of falling exports. Therefore, the improvement in the economic situation of Western Europe in early 2010 led to the improvement in the situation of Slovenia, as well.

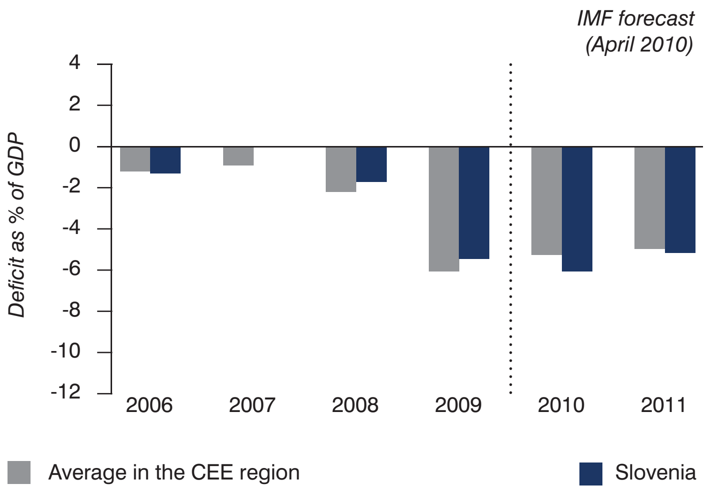
The outlook for the Slovenian economy is relatively good. Under conditions of continuous recovery in Western Europe, Slovenian GDP growth is likely to reach 1.5-2% in 2011. Obviously, a possible slowdown in Western Europe is a major risk to the country.

## Public finance

The state of Slovenia's public finances seriously deteriorated during the first wave of the global economic crisis. As a result, the public sector deficit slumped to -5.5% of GDP. Such a decline was induced both by an anti-crisis fiscal stimulus package, as well as by an increase in public sector wages (as part of the 2008 public wages reform).

Future prospects for Slovenia are not optimistic. Both in 2010 and 2011 deficits are likely to stay at a relatively high level. Comprehensive fiscal reform seems inevitable in the longer run, even though it may prove to be unpopular in terms of current politics.

Public sector deficit



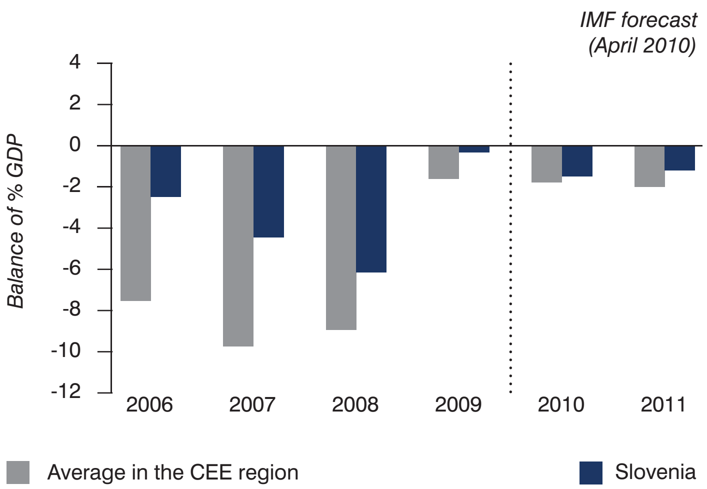

*Source: IMF*

## The external balance

The global turmoil resulted in a decline in Slovenia's domestic demand leading to reduced imports. Consequently, the country's current account deficit has narrowed to zero, with prospects for a slight increase in the years to come.

The country's problem is, obviously, significant foreign debt (far above 100% of GDP in 2009). Due to Slovenia's high credibility and the long-term character of the majority of the debt, the country can comfortably deal with the problem in the short term. However, in the long term the problem of high indebtedness needs to be addressed.

Current account balance



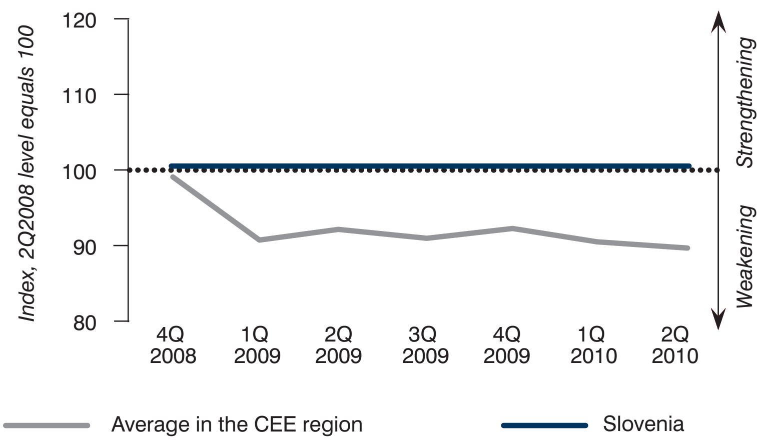

*Source: IMF*

## Stability of the currency

### As Slovenia is a member of the eurozone, the exchange rate was stable during the slowdown.

On the one hand, no foreign exchange risk existed. On the other hand, however, the strong currency does not help Slovenia to deal with weak external demand. The inflation rate in Slovenia is currently 0.9%, which is attributed to deflationary pressure resulting from the country's negative output gap. Inflation is forecast to reach almost 2% in 2010-2011 – significantly below the CEE average of nearly 3%.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

As global comparisons suggest, despite having the lowest corruption level among the countries of the region, Slovenia offers companies relatively difficult conditions for running their business activities – bureaucratic barriers being the key problem. Tax burdens are relatively high.

In response to the economic crisis, Slovenia introduced a series of measures including cutting the timeline for VAT refund payments, more tax relief on investments and the opportunity to pay obligatory taxes pro rata.

At the same time, a programme of a small reduction in corporate income tax rates is continuing – the programme, launched before the crisis, is being extended for four years. No significant action was taken to mitigate the high costs of running a business.

It is likely that a significant change to the pension system will be passed, probably with effect from 2011, either with or without transitional provisions. The proposed change includes raising the statutory retirement age, and reducing pension payments. There are also proposals to reduce public sector wages.

## Indicators of vulnerability, 2009

| | Slovenia | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -5,5 | -6,1 |
| Public debt as % of GDP | 35,9 | 32,6 |
| Loans to private sector as % of GDP | 85,0 | 62,3 |
| Share of foreign exchange loans | 6% | 51% |
| Loans to deposits ratio | 70% | 126% |
| Current account balance as % of GDP | -0,3 | -1,6 |
| Foreign debt as % of GDP | 116,7 | 86,9 |
| Proportion of short-term debt | 19% | 37% |
| Coverage of financing needs by reserves* | 0% | 128% |
| Credit rating | AA | |

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

The Slovenian economy is showing the first signs of recovery, but the improvement may be quite disappointing.

Albeit that using the euro means that the risk of major financial turmoil is limited, public debt and the public sector deficit must be limited as part a comprehensive fiscal reform package. Also the problem of excessive foreign debt should be carefully dealt with, to secure long-term growth.

The Slovenian banking sector seems strong enough to handle a gradual withdrawal of government guarantees. During the first wave of the crisis the guarantees helped limit the banks' vulnerability.

# Hungary

**Basic information**

| | Hungary | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 9,9 | 324 | 3,1 |
| GDP, billions of US$ | 126 | 2 672 | 4,7 |
| GDP per capita, thousands of US$* | 18,6 | 16,3 | 114,1 |
| Export as percent of GDP | 65,6 | 39,4 | 166,6 |
| GDP growth rate, 2009 | -6,3 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 1,5 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 3,4 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

## Vulnerability of the country to the debt crisis

Strengths:

- Improved fiscal situation
- Balanced current account
- Relatively low proportion of short-term debt

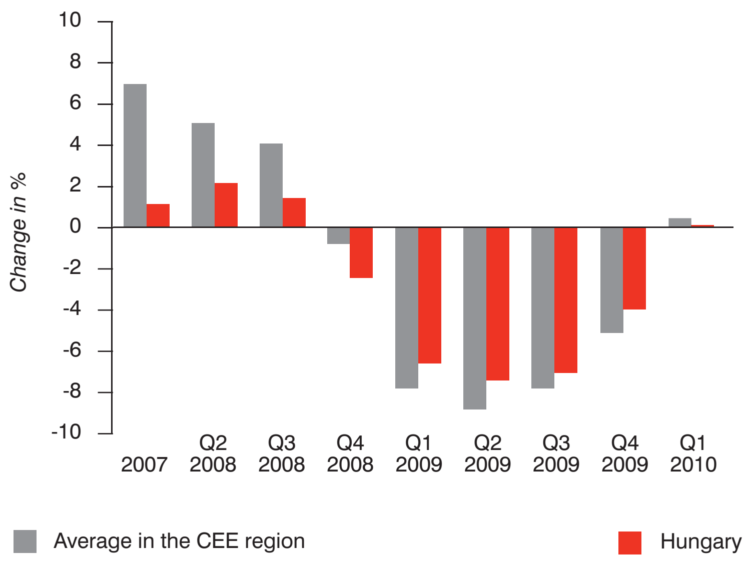
Weaknesses:

- Very high public debt
- High foreign debt
- High dependence on exports
- Vulnerability of the banking sector to exchange rate fluctuations

## General assessment of the economic situation

As the country's fiscal situation spiralled out of control in 2005-06, Hungary – unlike other CEE countries – had already had to implement a severe fiscal austerity program ahead of the crisis.

GDP growth rates



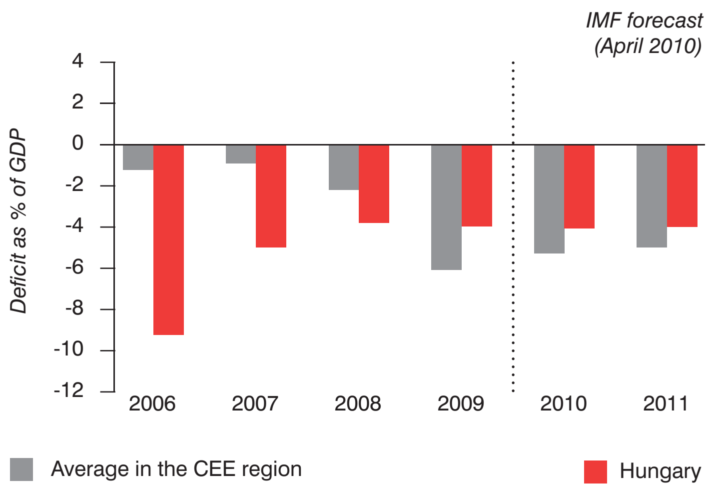

*Source: IMF, EBRD, statistical office*

After a modest 1-1.5% growth before the crisis the strong recession of 2009 came as a real shock. Despite support from the IMF and the EU, the financial situation of the country is still difficult. Moreover, the Hungarian economy is largely dependent on exports, mainly to Germany, a factor that may keep it from growing faster if the West European economic recovery slows down. According to IMF forecasts, Hungary is not likely to see any considerable increase in GDP growth rates before 2011.

## Public finance

There is a predominant political factor behind the recent trends in the Hungarian economy. Parliamentary elections (April 2010) were won by the Fidesz party, blaming the previous government for the miserable condition of the country's finances. Now the newly-elected decision makers face economic challenges very similar to those of their predecessors. The region's highest public debt of 78% of GDP is a millstone around the country's neck. Although Hungary has made a huge effort and reduced its public sector deficit to -4% of GDP in 2008-09, further progress may be crippled by weak economic growth. With excessive debt and deficit levels further painful structural reforms are vital to achieve a sustainable improvement in public finance.

Public sector deficit

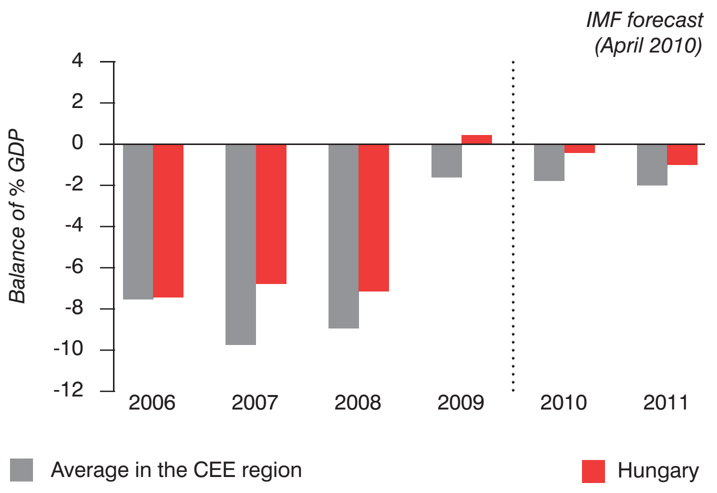



*Source: IMF*

## The external balance

Hungary's financial situation remains difficult. Although the country's current account balance changed into a small surplus of 0.4% of GDP in 2009, this success has been achieved at the very high cost of a sharp reduction in domestic demand. According to IMF forecasts the balance may start to deteriorate in the coming years despite the efforts of the government to curb fiscal expenditure. The core of the problem is very high foreign debt, reaching 133% of GDP – by far the highest ratio in the region. Despite a moderate proportion of short-term liabilities in the foreign debt, Hungarian economic policy needs to be extremely cautious especially when it comes to managing the country's relations with external creditors. Any resemblance to Greece may provoke foreign creditors into panic reactions. From that point of view a recent decision of the government to take a tougher stance in the negotiations with the IMF could be seen as a very risky move.

Current account balance

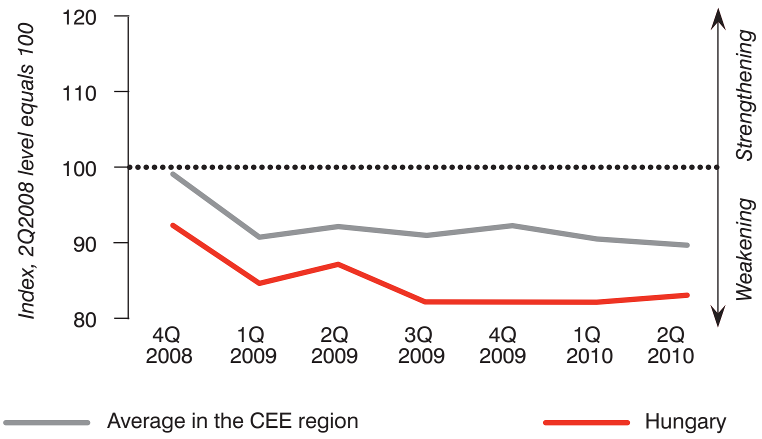



Source: IMF

## Stability of the currency

Over the last few quarters the forint has followed trends observed in other CEE countries with floating exchange rate regimes.

Exchange rate vis-a-vis euro

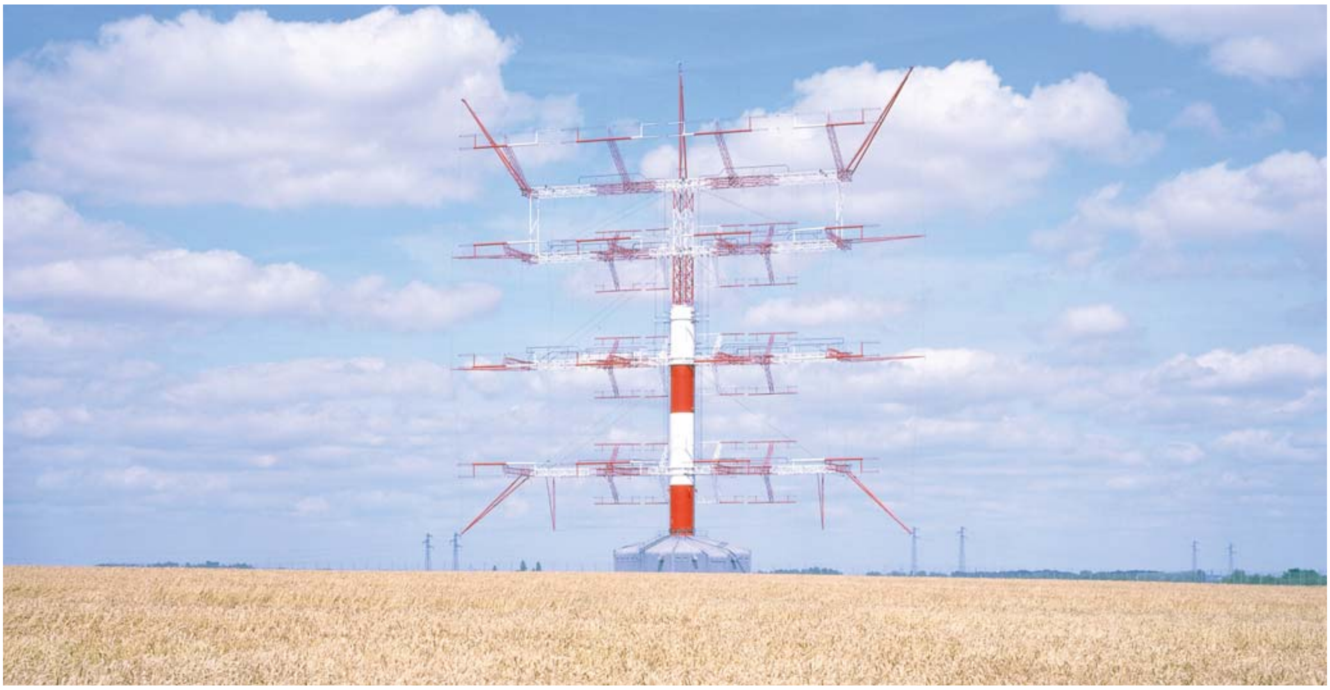



Source: IMF

Although the devaluation of the forint was deeper than the average in the region, it was not stronger than in Poland or the Czech Republic, both countries enjoying a much more favourable financial and economic situation. The markets still give the credit rating of confidence to Hungary. However, the negative outlook attributed to the rating means that the economic policies of the new government are closely watched. In the case of an absence of further fiscal austerity measures, or a pull out from the reforms already introduced, the rating may be reduced and the forint may suffer much stronger losses than now.

On the one hand, a stronger devaluation means good news for the export-driven economy. On the other hand, local debtors may be once again horrified by the plunging exchange rate of the forint.

As the proportion of foreign exchange loans reaches 61% of the total indebtedness, a further strong weakening of the currency may be risky for the stability of the banking sector.



## Taxation and conditions for doing business

Hungary offers relatively favourable conditions for conducting business operations. Several changes have been introduced in the taxation system, coming into force either as of 1 January 2010 or during 2010.

**Some of the major changes were as follows:**

- the corporate income tax rate increased from 16% to 19%, yet, at the same time the special profit tax of 4% was abolished as of 1 January 2010;
- a 75% exemption of interest income in corporate income tax was introduced as of 1 January 2010;
- the personal income tax was decreased from 18/36% to 17/32% and, in parallel to it, the upper limit of the lower bracket was increased from HUF 1.7 million to HUF 5 million as of 1 January 2010;
- Hungary implemented the EU VAT package through the Hungarian VAT legislation as of 1 January 2010;
- the cultural tax was abolished as of 1 January 2010;
- a corporate income tax rate reduced by 10% will apply to amounts up to HUF 500 million without any additional conditions, as opposed to the previously applicable level of HUF 50 million with additional conditions required to be met (already voted, awaiting official publication);
- a special bank tax will be introduced.

## Indicators of vulnerability, 2009

| | Hungary | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -4,0 | -6,1 |
| Public debt as % of GDP | 78,3 | 32,6 |
| Loans to private sector as % of GDP | 59,1 | 62,3 |
| Share of foreign exchange loans | 61% | 51% |
| Loans to deposits ratio | 104% | 126% |
| Current account balance as % of GDP | 0,4 | -1,6 |
| Foreign debt as % of GDP | 133,0 | 86,9 |
| Proportion of short-term debt | 26% | 37% |
| Coverage of financing needs by reserves* | 103% | 128% |
| Credit rating | BBB- | |

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

The weakness of Hungary's public finance and the external position, both due to excessive debt levels, have been mercilessly revealed by the global crisis.

Public debt reaching nearly 80% of the country's GDP, accompanied by continuously high budget deficits, is no longer acceptable to the financial markets. Also very high foreign debt – if not dealt with properly – may lead to investors losing confidence in Hungarian financial credibility and demanding much higher interest rates. To make the situation even worse, the banking sector in Hungary remains vulnerable to possible turmoil, which may be induced by a major weakening of the forint combined with weak economic growth.

In order to avoid such a pessimistic scenario a continuation of the painful fiscal austerity is a must for the new government. Moreover, when it comes to preventing the country from suffering a general economic meltdown, securing a wide political consensus on the reforms will be necessary. The coming months – starting with local elections planned for this autumn – will be a real test for Hungary.

# Estonia

**Basic information**

| | Estonia | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 1,3 | 324 | 0,4 |
| GDP, billions of US$ | 18 | 2 672 | 0,7 |
| GDP per capita, thousands of US$* | 18,7 | 16,3 | 114,7 |
| Export as percent of GDP | 49,8 | 39,4 | 126,5 |
| GDP growth rate, 2009 | -14,1 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 2,2 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 1,0 | 2,9 | x |

**According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

## Vulnerability of the country to the debt crisis

Strengths:

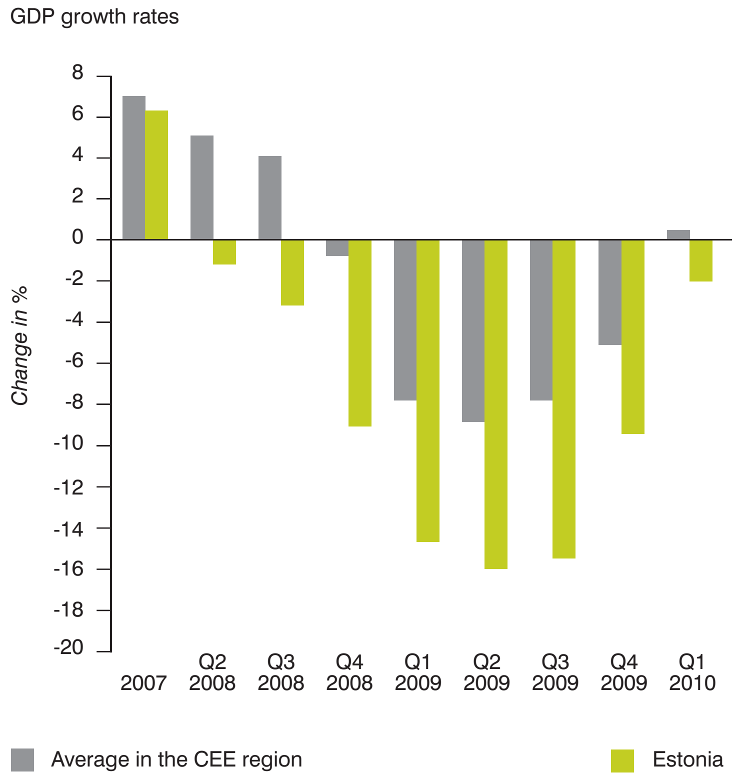
- Current account surplus
- Eurozone membership (from 2011)
- Low budget deficit and public debt

Weaknesses:

- Deep recession
- Excessive foreign debt
- Excessive indebtedness in the private sector

## General assessment of the economic situation

Estonia, as with other Baltic countries, suffered tremendously during the global crisis.




*Source: IMF, EBRDt, statistical office*

After rapid GDP growth of 10% a year in the pre-crisis period, the cyclical slowdown paired with the global financial turmoil resulted in a substantial drop in GDP, which was -14% in 2009. Some of the characteristics of the crisis are similar to those of Latvia and Lithuania. Limited access to external financing required an abrupt tightening in economic policy. The bursting of the speculative bubble in the financial and real estate markets caused a sudden collapse in domestic demand, forcing the implementation of a radical austerity program.

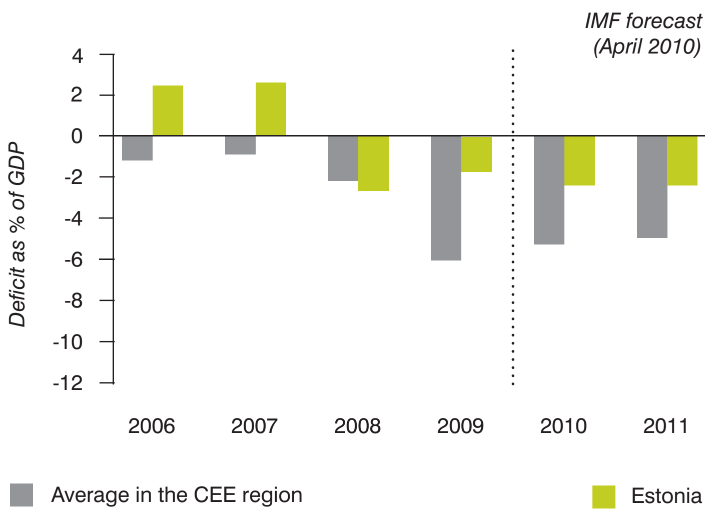
However, in other respects the economic situation of Estonia differs profoundly from its Baltic neighbours. The country maintained full control over its fiscal situation and fulfilled the eurozone entry criteria, therefore eliminating the risk of major internal financial turmoil. Growth is also returning faster than in the other 2 countries. According to IMF forecasts modest GDP growth is expected in 2010 and a full recovery in 2011.

## Public finance

Before the global downturn, Estonia was one of the few CEE countries enjoying a public sector surplus rather than a deficit. During the crisis the situation deteriorated, and the surplus turned to a deficit of -2,7% of GDP in 2009. Nevertheless, maintaining control over the scale of the deficit allowed Estonia to fulfill the Maastricht criterion and to apply successfully for eurozone accession. Public sector deficits of below 3% threshold are forecast for the next years too.

Thanks to a cautious fiscal policy the Estonian debt level is only 7,2% of GDP, making the country one of the champions of economic and financial prudency in Europe.

Public sector deficit

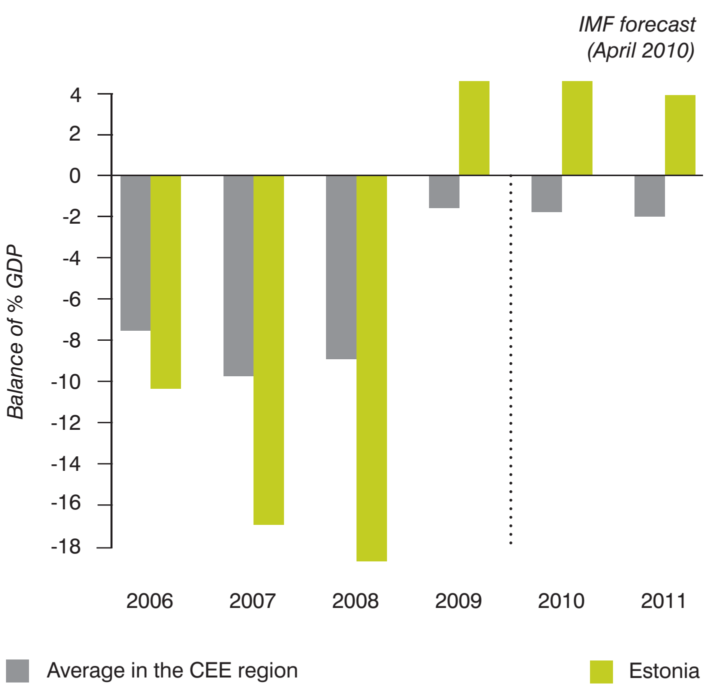



*Source: IMF*

## The external balance

A strong fall in imports, due to limited domestic demand, helped the Estonian current account balance to change from – 18% of GDP in 2007 to the current account surplus of 4,6% of GDP in 2009. Although the foreign debt level of 131% of GDP is excessive, the country does not face any imminent threat of external solvency due to the introduction of the euro. In the longer run however, the foreign indebtedness problem must be addressed by economic policy.

Current account balance

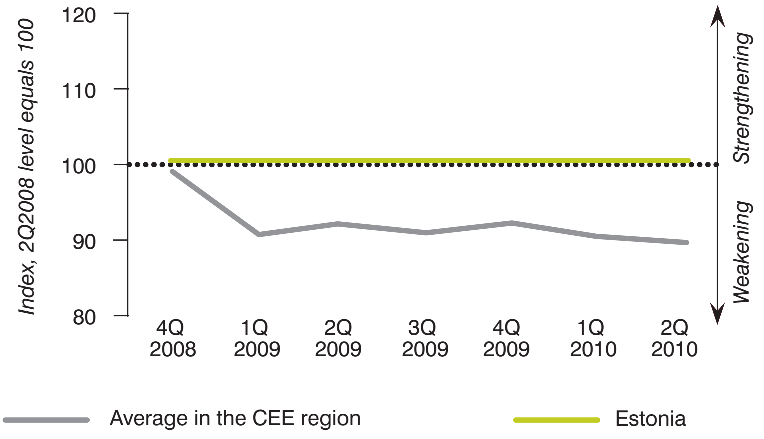



*Source: IMF*

## Stability of the currency

As Estonia was using a fixed exchange rate regime, no exchange rate fluctuations were observed over the period of the financial crisis. As the Estonian kroon will be replaced by the euro from 1 January 2011, the stability of the exchange rate will be secured by eurozone entry.

Exchange rate vis-a-vis euro




Source: IMF

## Taxation and conditions for doing business

Estonia is regarded as offering a favourable business environment, since all undistributed corporate profits are tax exempt. The exemption applies to both active (e.g. trading) and passive (e.g. dividends, interest, royalties) sources of income, as well as capital gains from the sale of all types of assets, including shares, securities and immovable property. This taxation system applies to Estonian companies and permanent establishments of foreign companies registered in Estonia. The taxation of corporate profits is postponed until the profits are distributed as dividends or deemed to be distributed, such as in the case of transfer pricing adjustments, expenses and payments that do not have a business purpose, fringe benefits, gifts, donations and entertainment expenses.

Distributed profits are generally subject to a 21% corporate income tax (21/79 on the net amount of profit distribution). However, the provision in the tax legislation that would have further reduced the income tax was abolished in 2009, and thus the 21% rate continues to be levied in 2010. The previous version of legislation envisaged a gradual reduction of income tax by 1 percentage point per annum until reaching an 18% income tax rate in 2012. Income earned by individuals continues to be subject to a flat-rate income tax of 21%.

The standard VAT rate was increased from 18% to 20% as of 1 July 2009. In addition, a 1% sales tax was introduced in Tallinn, the capital of Estonia, as of 1 June 2010.

## Indicators of vulnerability, 2009

| | Estonia | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -1,7 | -6,1 |
| Public debt as % of GDP | 7,2 | 32,6 |
| Loans to private sector as % of GDP | 105,2 | 62,3 |
| Share of foreign exchange loans | 88% | 51% |
| Loans to deposits ratio | 175% | 126% |
| Current account balance as % of GDP | 4,6 | -1,6 |
| Foreign debt as % of GDP | 131,4 | 86,9 |
| Proportion of short-term debt | 47% | 37% |
| Coverage of financing needs by reserves* | 0% | 128% |
| Credit rating | A | |

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

The Estonian economy, severely hit by the world crisis, seems to be on the way to a sustainable recovery.

At the same time prudent macroeconomic policy, aimed at meeting the criteria for joining the eurozone, allowed the elimination of the risk of financial instability and for a strengthening of the country's credibility.

The fiscal situation of the country poses no threat of instability.

Although the problem of the substantial foreign debt still exists, introducing the euro will lower the costs of borrowing capital abroad. The secured stability of the currency will help Estonia to deal with the problems of the banking sector that – as in other Baltic states – was developing in a too rapid, too imbalanced, and too risky way before the crisis.

# Lithuania

**Basic information**

| | Lithuania | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 3,5 | 324 | 1,1 |
| GDP, billions of US$ | 36 | 2 672 | 1,4 |
| GDP per capita, thousands of US$* | 15,4 | 16,3 | 94,5 |
| Export as percent of GDP | 45,1 | 39,4 | 114,4 |
| GDP growth rate, 2009 | -15 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 0,8 | 2,2 | x |
| Forecast inflation rate, 2010-12 | -1,1 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

## Vulnerability of the country to the debt crisis

Strengths:

- Current account surplus
- Moderate public debt
- EU membership

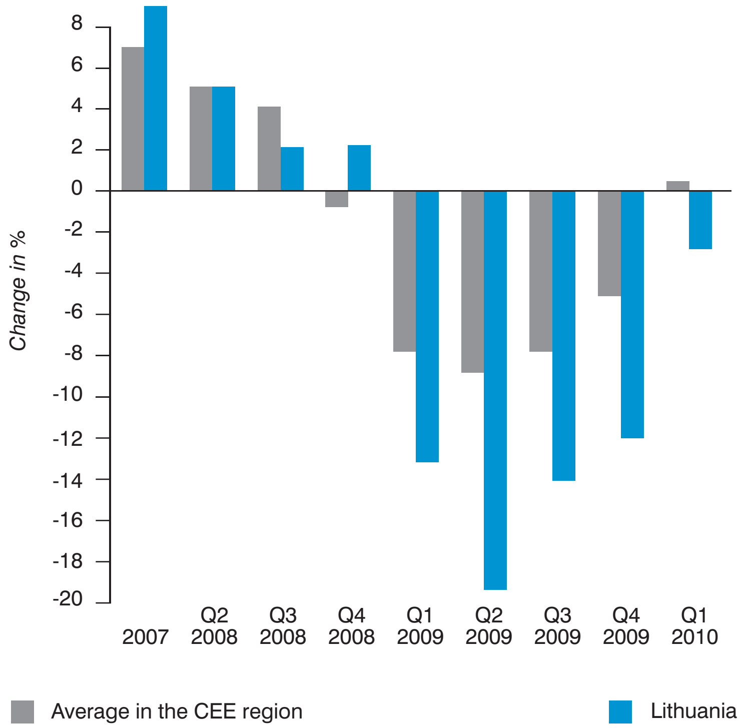
Weaknesses:

- Deep recession
- High public sector deficit
- Excessive foreign debt
- Insufficient foreign exchange reserves
- Excessive indebtedness of the private sector
- High exposure of the banking sector to possible exchange rate fluctuations

## General assessment of the economic situation

Lithuania's economic situation is very difficult, and similar to that of Latvia. The country suffered tremendous fluctuations in GDP growth rates.

GDP growth rates




*Source: IMF, EBRD, statistical office*

From the sky-high levels of nearly 9% in the pre-crisis years it plunged to -15% in 2009. Since the Lithuanian economy had been dramatically overheated for several years before the global crisis, the country was threatened by a serious slowdown due to the build-up of internal and external imbalances. This phenomenon overlapped with the effects of the global financial crisis drastically worsening the situation. Limited access to external financing required an abrupt tightening of economic policy. The bursting of the speculative bubble in the financial and real estate markets caused a sudden collapse in domestic demand.

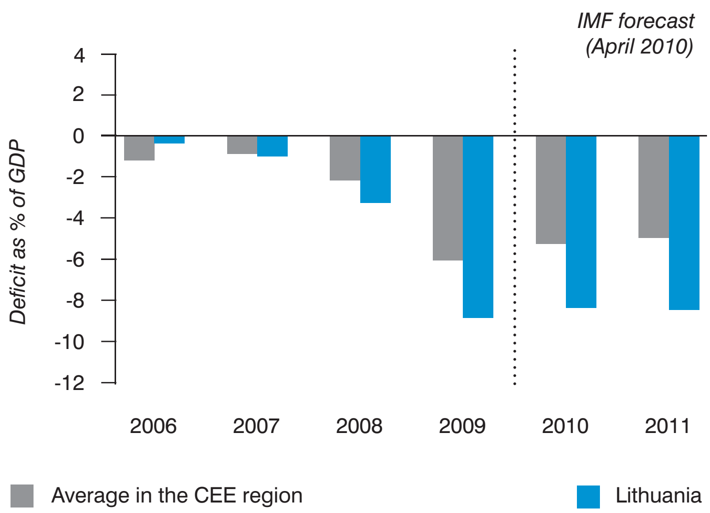
Given how serious the factors underlying the recession were, the growth prospects of Lithuania remain bleak. According to IMF forecasts a further drop in GDP may be expected in 2010 and a modest recovery in 2011.

## Public finance

The public sector in Lithuania has experienced a deep shock caused by the huge recession. Tax revenues declined dramatically and consequently the public sector deficit deepened to a dangerous level of -9% of GDP. In spite of radical austerity measures undertaken in 2009, the problem of large deficits is expected to continue in coming years.

The ultra-fast growth of public debt in Lithuania comes as another risk factor. Its level increased from 16% of GDP in 2008 (by then, one of the lowest debt burdens in the region) to 30% of GDP in 2009. According to forecasts, the debt burden will increase to 45% of GDP by 2011.

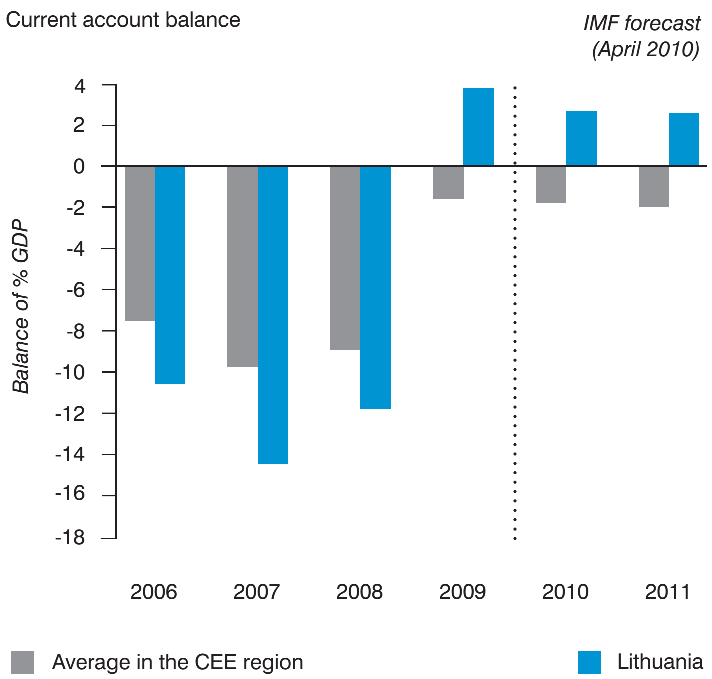
Public sector deficit




*Source: IMF*

## The external balance

Although Lithuania managed to move quickly from a current account deficit of – 12% of GDP in 2008 into a current account surplus of 4% of GDP in 2009, there are other problems, that make the picture far less optimistic. First of all, foreign debt is nearly 90% of GDP, which is far beyond a safe threshold. Secondly, short-term liabilities make up for more than half of this debt. Combined with the ratio of foreign exchange reserves to short-term financing needs (the sum of short-term debt and current account balance) at a level of only 39%, all these factors indicate a very difficult situation for Lithuania. In order to avoid the risk of insolvency, a very prudent and skillful economic policy is necessary.



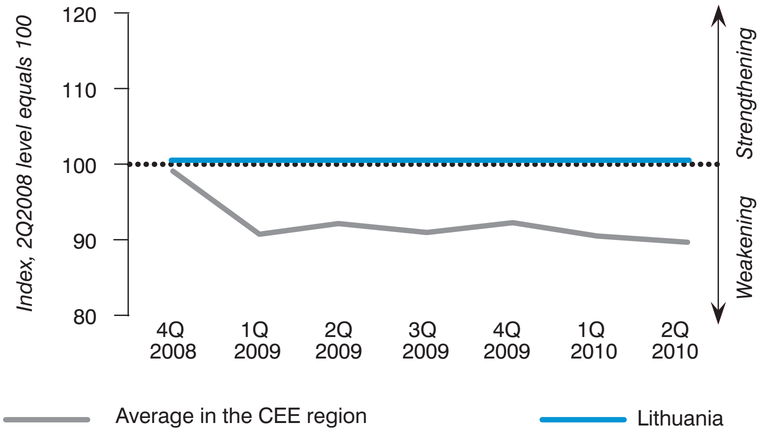

*Source: IMF*

## Stability of the currency

As the Lithuanian litas has a fixed exchange rate, no exchange rate fluctuations were observed over the period of the financial crisis. The real question is whether the country will be able to maintain the peg to the euro. Lithuania is desperate to keep the fixed exchange rate, as it represents the backbone of macroeconomic stability. At the same time, the high proportion of debts denominated in foreign currency makes Lithuanian banks extremely vulnerable to the effects of devaluation.

Lithuania was unlucky to be denied access to the eurozone in 2010. Currently, with huge fiscal deficits, no credible path to introduce the euro can be foreseen.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

**There have been recently introduced amendments to the binding law on corporate income tax ("CIT") and law on value added tax ("VAT") in Lithuania, entailing the following:**

- the standard CIT rate was reduced from 20% to 15%; the CIT rate for small and medium enterprises ("SMEs") was lowered from 13% to 5%;
- the VAT rate increased from 19% to 21%;
- entities involved in investment projects are entitled to reduce their taxable profits by up to 50% with the acquisition costs of fixed assets meeting certain criteria;
- as of 1 January 2010, the withholding tax ("WHT") on interest may be waved away if interest is paid to entities registered or otherwise organised in any of the European Economic Area ("EEA") member states or in countries with which a double taxation treaty is in force, and fulfilling the other relevant requirements of the CIT law.

The standard VAT rate was set at 21% (applicable as of 1 September 2009). Business entities with fewer than 10 employees and gross annual revenue of less than LTL 500,000 (approx. EUR 145,000) may take advantage of reduced corporate income tax of 5% (as opposed to the standard rate of 15%).

Enterprises involved in investment projects are entitled to reduce their taxable profits by up to 50% with the actually incurred acquisition costs of long-term assets meeting certain specific requirements. The taxable profits may be reduced by the operating costs incurred in 2009 – 2013.The costs exceeding the abovementioned 50% limit may be carried forward for four years.

Moreover, entities that invest in Lithuanian free economic zones may take advantage of a partial or full CIT relief (depending on the investment amount), an exemption from the real estate tax on and a 50% land lease tax relief.

As of 1 January 2010, the Lithuanian Law on Personal Income Tax was amended as regards recognition of benefits-in-kind, with the introduction of a final list of items that are not treated as such.

## Indicators of vulnerability, 2009

| | Lithuania | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -8,9 | -6,1 |
| Public debt as % of GDP | 29,3 | 32,6 |
| Loans to private sector as % of GDP | 65,1 | 62,3 |
| Share of foreign exchange loans | 74% | 51% |
| Loans to deposits ratio | 153% | 126% |
| Current account balance as % of GDP | 3,8 | -1,6 |
| Foreign debt as % of GDP | 89,1 | 86,9 |
| Proportion of short-term debt | 52% | 37% |
| Coverage of financing needs by reserves* | 39% | 128% |
| Credit rating | BBB | |

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

After the dramatic recession, and the serious threat of a financial meltdown in the banking sector, the economic situation of Lithuania remains extremely difficult.

The country remains highly vulnerable to external shocks, while internal stability may easily disappear unless the fixed exchange rate regime can be maintained. As the foreign exchange reserves may be too low to cover the country's financial needs Lithuania should make immediate efforts to mitigate the risk of forced devaluation. Further measures to discipline the state budget must be implemented, and the public sector deficit visibly reduced. Close collaboration with the IMF and the EU is a precondition to solving the problems. As the country will be challenged by extreme economic pressure, the faster that efficient remedies are introduced, the more likely it is that Lithuania will pass the second wave of the crisis without big losses.

# Latvia

**Basic information**

| | Latvia | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 2,2 | 324 | 0,7 |
| GDP, billions of US$ | 25 | 2 672 | 0,9 |
| GDP per capita, thousands of US$* | 14,5 | 16,3 | 89,0 |
| Export as percent of GDP | 29,4 | 39,4 | 74,6 |
| GDP growth rate, 2009 | -18 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | -0,7 | 2,2 | x |
| Forecast inflation rate, 2010-12 | -3,1 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

**Vulnerability of the country to the debt crisis**

Strengths:

- Current account surplus
- EU membership

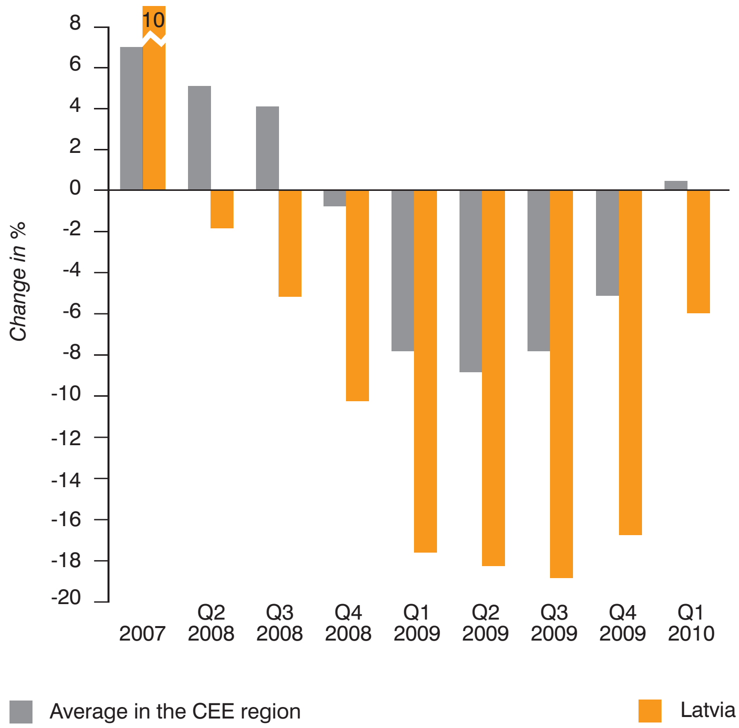
Weaknesses:

- Deep recession
- High public sector deficits
- Excessive foreign debt
- Insufficient foreign exchange reserves
- Excessive indebtedness of the private sector
- High exposure of the banking sector to possible exchange rate fluctuations

## General assessment of the economic situation

The Latvian economy – similarly to the Lithuanian – goes to the extremes. Once one of "the Baltic tigers", now Latvia remains as one of the countries suffering the most difficult situation in the region and globally.

GDP growth rates

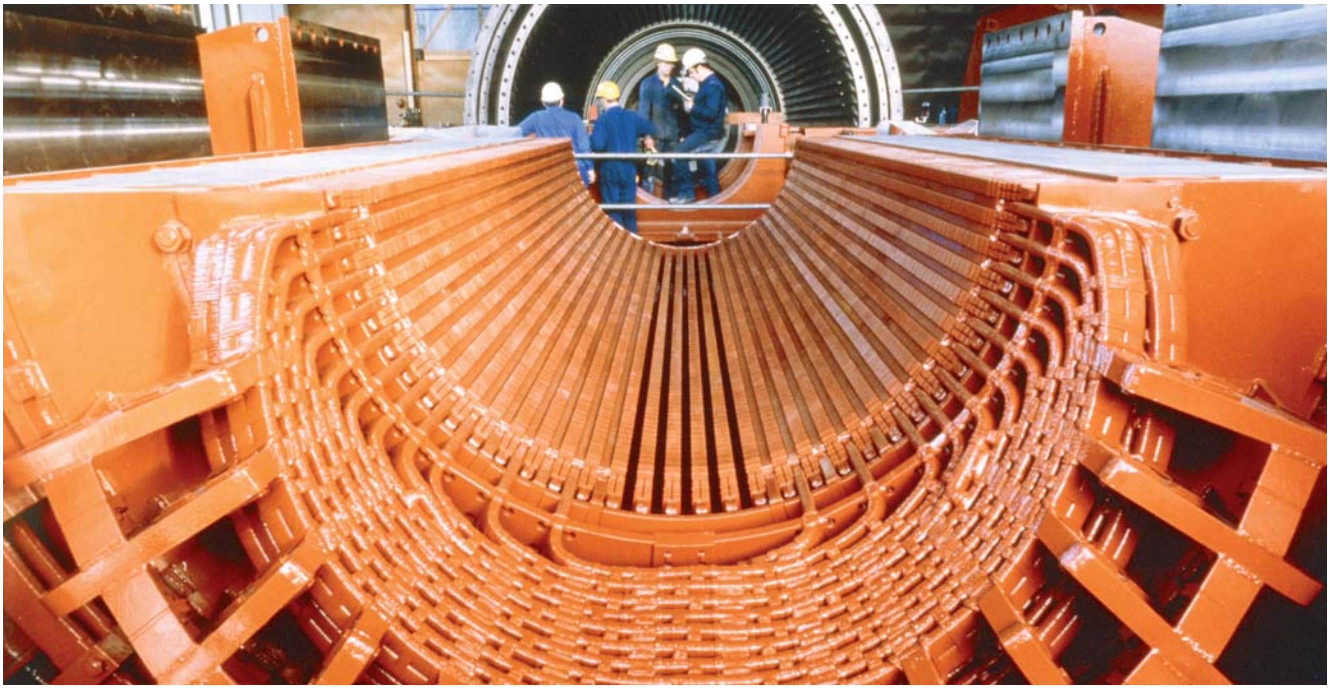



*Source: IMF, EBRD, statistical office*

In the pre-crisis period the economy was overheated, growing at the ultra-fast speed of over 10% a year. Cyclical slowdown coupled with the global financial turmoil, resulted in a substantial GDP drop, -18% in 2009 (the deepest recession recorded in the world). Limited access to external financing required an abrupt tightening up of economic policy.
The bursting of the speculative bubble in the financial and real estate markets caused a sudden collapse in domestic demand.

As a tightening up of economic policy and drastic budget savings were not sufficient to deal with the situation, the country was forced to seek financial assistance from the IMF and the European Union.

Given how serious the factors underlying the recession were, the growth prospects of Latvia remain bleak. According to IMF forecasts a further GDP drop may be expected in 2010 and a modest recovery in 2011.

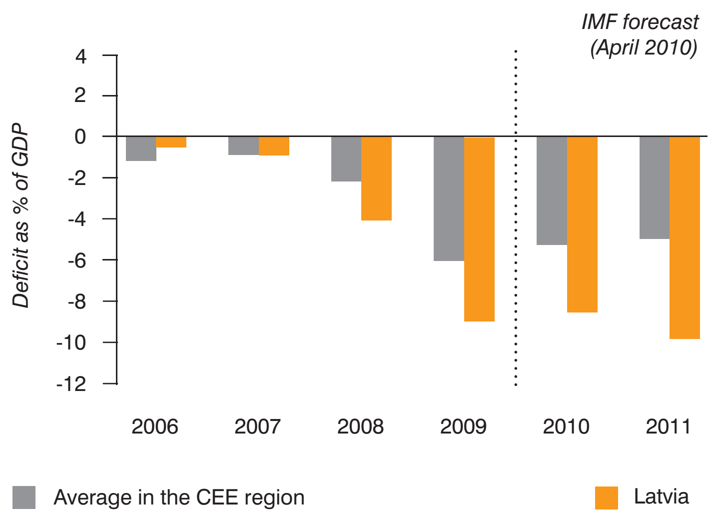


## Public finance

The public sector in Latvia has experienced a deep shock caused by the huge recession. Tax revenues declined dramatically and consequently the public sector deficit deepened to a dangerous level of -9% of GDP. In spite of radical austerity measures undertaken in 2009, the problem of high deficits is expected to continue in coming years. Courageous structural reforms are needed to achieve a healthy level of deficit.

The ultra-fast growth of public debt in Latvia comes as another risk factor. Its level increased from 9% of GDP in 2007 (by then, one of the lowest debt burdens in the region) to 36% of GDP in 2009. According to forecasts, the debt burden will increase to 57% of GDP by 2011, very close to the Maastricht limit of 60%.

Public sector deficit

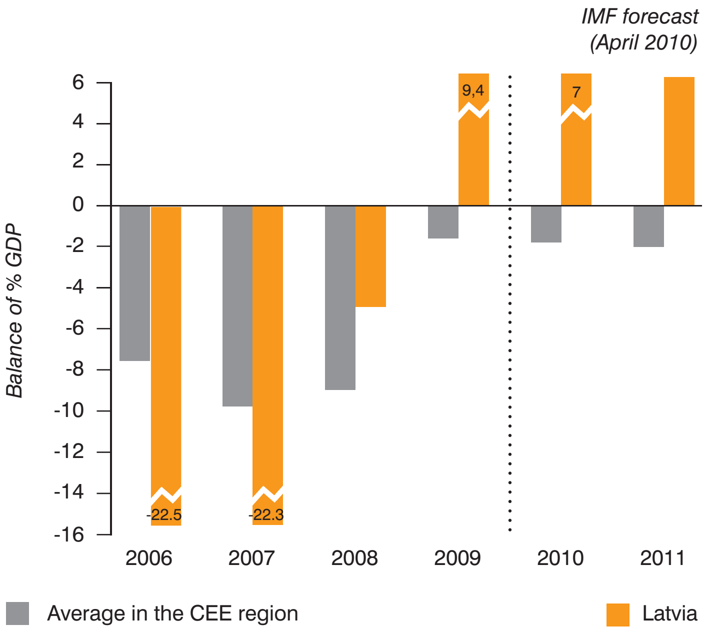



*Source: IMF*

## The external balance

A dramatic fall in imports, due to limited domestic demand, helped the Latvian current account balance to change from of -22% of GDP in 2007 into the current account surplus of 9% of GDP in 2009. Nevertheless, other extremely serious problems exist. First of all, Latvia suffers from an excessive level of foreign debt, reaching as much as 160 % of the country's GDP. Secondly, short-term liabilities make up 34% of this debt. Thirdly, the level of foreign exchange reserves is too small to cover short-term financing needs (the sum of short-term debt and current account balance). In order to avoid the risk of insolvency, an extremely prudent and skillful economic policy is necessary.

Current account balance



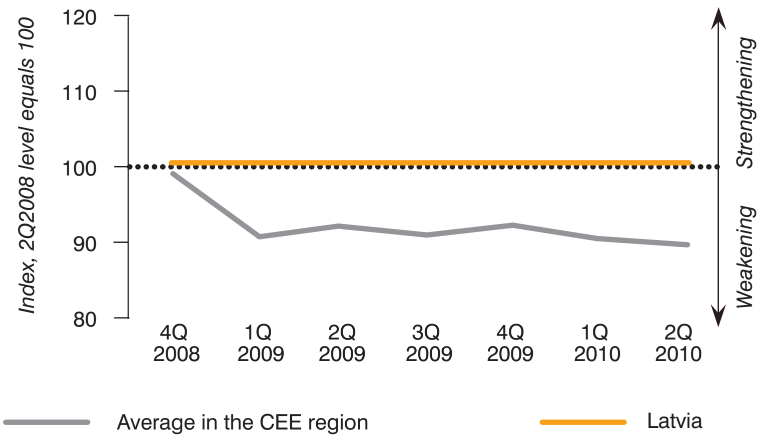

*Source: IMF*

## Stability of the currency

As the Latvian lat has a fixed exchange rate, no exchange rate fluctuations were observed over the period of the financial crisis. The real question is whether the country will be able to maintain the peg to the euro. Latvia is desperate to keep the fixed exchange rate, as it represents the backbone of macroeconomic stability. At the same time, the high proportion of debts denominated in foreign currency makes Latvian banks extremely vulnerable to the effects of devaluation.

Given the scale of the current fiscal problems, it is very unlikely for Latvia to meet the criteria that would allow the introduction of the euro, as planned before the crisis, in the foreseeable future.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

While the government of Latvia is minimising the bureaucratic obstacles faced by entrepreneurs in its efforts to close the deficit gap, tax burdens have increased. Latvia still offers one of the best business environments in the region, however, its unstable economy discourages new investors.

The following rates became applicable as of 1 January 2010:

**Income tax**

- 10% on income from capital (interest and dividends);
- 15% on capital gains;
- 26% on other types of income, including paid employment;
- 26% on trading income;
- 40% of entertainment expenses may be deducted from taxable income, as opposed to the former 60%.

**Real Estate Tax**

- increased rate for land and commercial buildings of 1.5%;
- charged high rate of 3% on uncultivated farmland;
- broader tax base, 0.1% to 0.3% charged from cadastral value on residential buildings;
- levy tax on engineering structures.

**VAT**

- the standard VAT rate was raised from 18% to 21%, while the reduced VAT rate was increased from 5% to 10% (applicable as of 1 January 2009);
- as of the end of 2009, several VAT settlement options (VAT grouping, deferral of VAT on imports, recovery of VAT on bad debts) were introduced.

**Ahmed Sharkh**

Country Managing Partner
PricewaterhouseCoopers
Latvia

*"The government of Latvia is reducing the bureaucratic obstacles by making the legal and judicial system more transparent, as well as creates a business-friendly environment for attracting foreign direct investments, which is important for the development of the economy. The Latvian Investment and Development Agency was set up to help new investors come to Latvia and make the investment process easier.*

*In addition to having an excellent strategic location, Latvia has a very good transport infrastructure (railway, seaports, road network, air transport) that provides a base for facilitating the trade between the EU and CIS.*

*People in Latvia are highly educated and qualified, particularly in industries like IT, manufacturing and professional services."*

## Indicators of vulnerability, 2009

| | Latvia | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -9,0 | -6,1 |
| Public debt as % of GDP | 36,1 | 32,6 |
| Loans to private sector as % of GDP | 93,0 | 62,3 |
| Share of foreign exchange loans | 92% | 51% |
| Loans to deposits ratio | 222% | 126% |
| Current account balance as % of GDP | 9,4 | -1,6 |
| Foreign debt as % of GDP | 160,0 | 86,9 |
| Proportion of short-term debt | 34% | 37% |
| Coverage of financing needs by reserves* | 62% | 128% |
| Credit rating | BB | |

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

Without a doubt, of all CEE countries Latvia faces the biggest threats of the crisis. It suffers from rapidly growing debt levels, bleak prospects for renewed growth, and low financial credibility.

After the dramatic recession, a serious threat of financial meltdown in the banking sector and the risk of external insolvency make the situation of Latvia extremely difficult. The country remains highly vulnerable to external shocks, while internal stability may easily disappear unless the fixed exchange rate regime can be maintained.

The Latvian banking sector is endangered, due to the very high level of indebtedness of firms and households, a large proportion of the debts denominated in foreign currency, and the extremely unfavourable loans to deposit ratio of 222%. As the foreign exchange reserves may be too low to cover the country's financial needs Latvia should make an immediate effort to mitigate the risk of forced devaluation. Further measures to discipline the state budget must be implemented, and the public sector deficit visibly reduced. A close collaboration with the IMF and the EU is a precondition to solving the problems.

# Bulgaria

**Basic information**

| | Bulgaria | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 7,1 | 324 | 2,2 |
| GDP, billions of US$ | 45 | 2 672 | 1,7 |
| GDP per capita, thousands of US$* | 12,6 | 16,3 | 77,3 |
| Exports as percent of GDP | 36,2 | 39,4 | 91,9 |
| GDP growth rate, 2009 | -5.0 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 1,1 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 2,5 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

## Vulnerability of the country to the debt crisis

Strengths:

- Low public debt
- EU membership

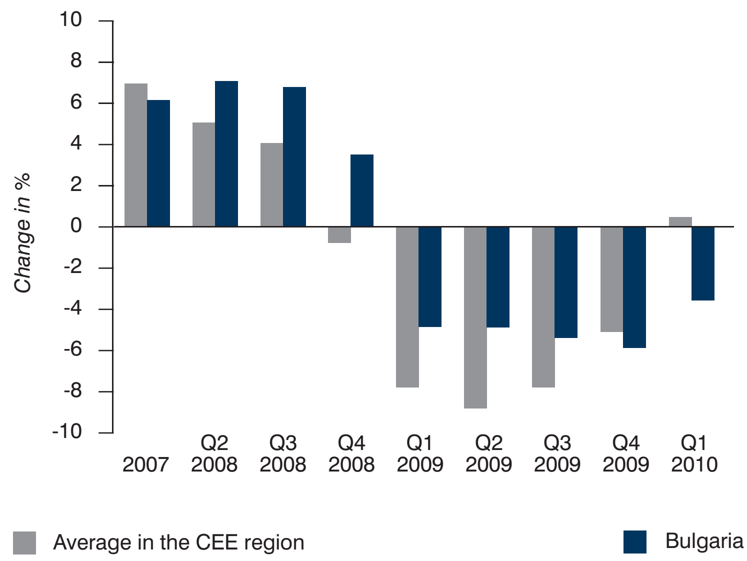
Weaknesses:

- High foreign debt
- High current account deficit
- Too low foreign exchange reserves
- High exposure of the banking sector to possible exchange rate fluctuations

## General assessment of the economic situation

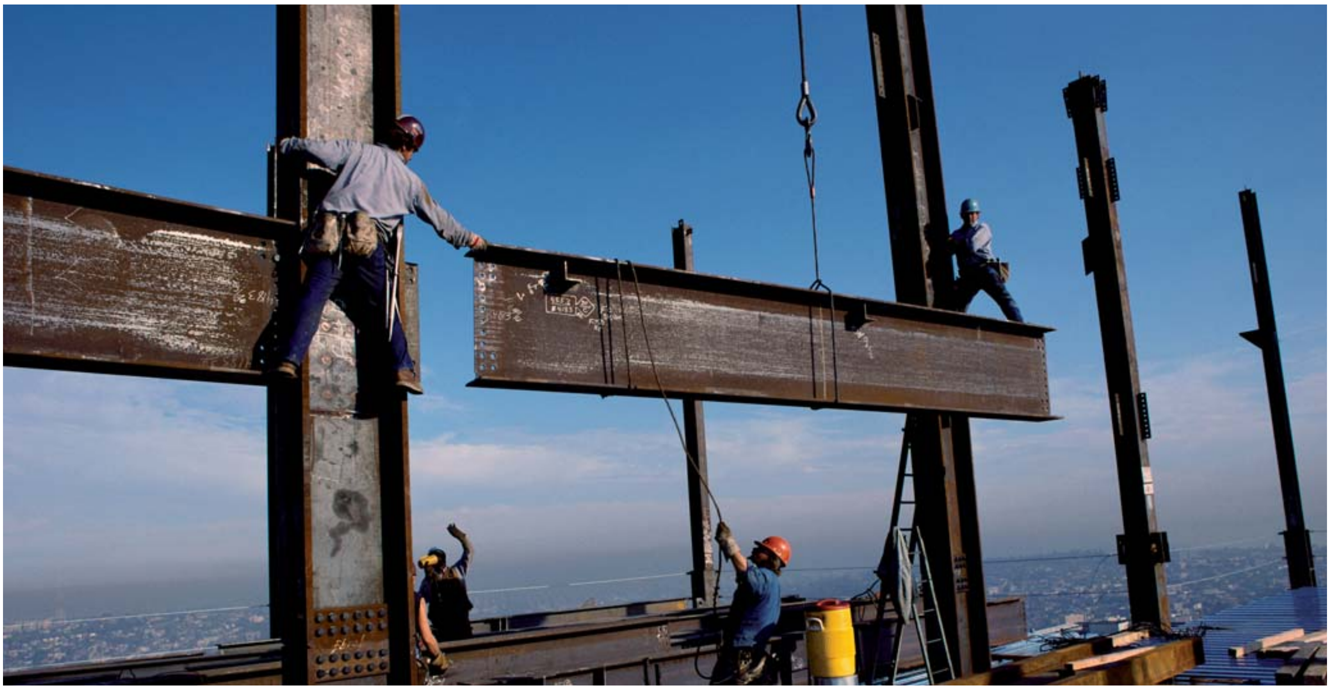
Bulgaria seems to be recovering from the recession induced by the global financial crisis. However, progress is much slower than in other countries of the region.

GDP growth rates




*Source: IMF, EBRD, statistical office*

The IMF forecasts zero growth in 2010, and moderate 2% GDP growth in 2011. Furthermore, there are many internal and external factors – including excessive foreign debt and the weak banking sector – which may keep the speed of recovery relatively low.

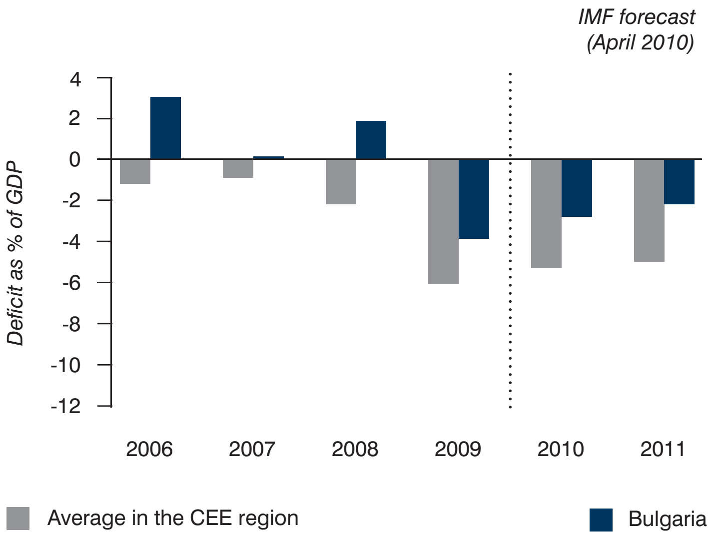


## Public finance

Compared to other CEE countries, Bulgaria enjoys a relatively good situation of public finance. Good fiscal policy and tax reforms implemented before the crisis led to a low level of public debt and a moderate increase in the public sector deficit despite a strong recession in 2009.

The public sector deficit reached -3.9% of GDP in 2009 and is expected to shrink to 2.2% in 2011, a figure that places Bulgaria among CEE leaders in controlling public sector deficits. Also the country's public debt remains at a low level of 14.8% of GDP in 2009.

Public sector deficit



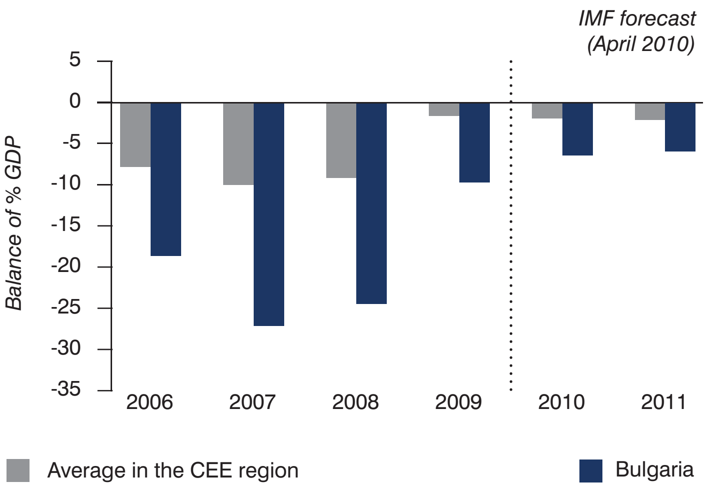

*Source: IMF*

## The external balance

As opposed to the satisfactory indicators of Bulgarian public finance, the country's external balance remains a matter of concern. Before the crisis broke out, the country was running huge current account deficits reaching as high as -26% of GDP. Although the current account deficit has shrunk significantly, to -9.5% in 2009, it still remains dangerously high. According to IMF forecasts, the country will also remain largely dependent on external financing in 2010 and 2011.

Another worrisome characteristic of the Bulgarian external balance is high foreign debt, reaching 103.5% of the country's GDP. Moreover, the proportion of short-term liabilities in the entire foreign debt reaches almost 50%. In the case of any problems securing necessary finance, Bulgaria may face a rapid increase in interest rates requested by investors and a fall in its credibility.

Current account balance



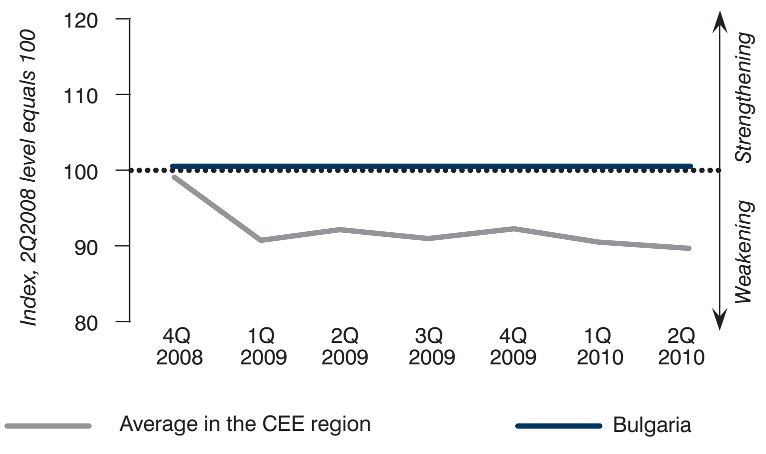

*Source: IMF*

## Stability of the currency

The Bulgarian leva remains pegged to the euro at a fixed exchange rate. Keeping the currency board mechanism is vital to reduce the risk of major instability. Due to the high ratio of loans denominated in foreign currencies (59%), any significant fluctuations in foreign exchange rates might seriously undermine the stability of the Bulgarian banking sector. To make the situation more difficult, in April 2010 Bulgaria was forced to abandon plans for fast eurozone entry because of the excessive budget deficit.

According to the IMF, the inflation rate in Bulgaria is expected to reach 2.5% by 2012, slightly below the CEE average (2.9%).

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

Although radical reforms have improved the conditions for conducting business activity in Bulgaria, widespread corruption remains one of the main problems for enterprises in this country. However, the clear signs of activism witnessed in early 2010 are harbingers of an ultimate improvement of the efficiency of combating corruption, improper influence practice or lack of civic control. The examples of this activism may be prompt disciplinary and criminal investigations of allegations concerning misuse of power on the part of magistrates, exertion of improper influence, etc.

**The recently introduced amendments to the tax legislation continue the trend of reducing the tax burdens in Bulgaria**

- A 10% flat-rate tax on personal income, irrespective of the tax residency status, was introduced as of 1 January 2008;
- WHT on dividends and liquidation quotas distributed to Bulgarian citizens and foreign residents was reduced from 7% to 5% as of 1 January 2008;
- Dividends to the EU/EEA-based companies are exempt from WHT without the requirement of special conditions to be met (such as participation or holding period) as of 1 January 2009;
- A Double Taxation Treaty with the USA, pending for several years, entered into force on 15 December 2008;
- As of 1 January 2010, the period for recovering VAT on general terms was shortened by approximately 45 days. Major amendments to the Bulgarian VAT Act as of 1 January 2010 implemented the provisions of Directive 2008/8/EC, introducing new rules for defining the place of supply for services rendered by and for persons established in different countries;
- Pension insurance contributions payable by both the employer and the employee were reduced as of 1 January 2010;
- The introduced legal developments include the adoption of a number of EU legislative mechanisms, such as new consumer credit and payment services regulations or certain improvements in the company laws, facilitating the execution of insolvency laws and rendering smoother the operation of the electronic (online) register of companies as well as other business and non business entities.

## Indicators of vulnerability, 2009

| | Bulgaria | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -3,9 | -6,1 |
| Public debt as % of GDP | 14,8 | 32,6 |
| Loans to private sector as % of GDP | 75,2 | 62,3 |
| Share of foreign exchange loans | 59% | 51% |
| Loans to deposits ratio | 132% | 126% |
| Current account balance as % of GDP | -9,5 | -1,6 |
| Foreign debt as % of GDP | 103,5 | 86,9 |
| Proportion of short-term debt | 48% | 37% |
| Coverage of financing needs by reserves* | 54% | 128% |
| Credit rating | BBB | |

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

Bulgaria's main problem is the excessive level of foreign debt and current account deficits.

In the unfriendly environment, created by the Greek debt crisis, a high dependence on short-term foreign financing represents a serious threat to the economy.
Also the level of foreign exchange reserves may appear too low to secure the fixed exchange rate regime. If the country is forced to devaluate the leva, serious problems may arise in the banking sector.

Both the proportion of foreign exchange denominated loans, as well as the loans/deposits ratio, are quite high and make the banking sector vulnerable to shocks.

In contrast, public debt is low and public sector deficits remain under control.
The situation in public finance does not pose any major risk to Bulgaria's recovery.

# Romania

**Basic information**

| | Romania | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 22,2 | 324 | 6,9 |
| GDP, billions of US$ | 163 | 2 672 | 6,1 |
| GDP per capita, thousands of US$* | 11,5 | 16,3 | 70,6 |
| Exports as percent of GDP | 24,8 | 39,4 | 63,1 |
| GDP growth rate, 2009 | -7,1 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 3,0 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 3,6 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

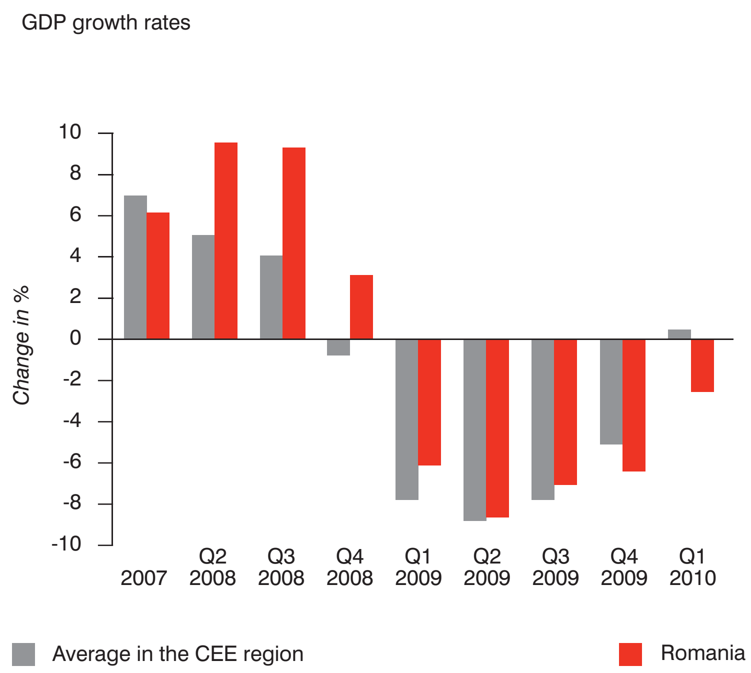
**Vulnerability of the country to the debt crisis**

Strengths:
- Low foreign debt
- Moderate public debt
- EU membership

Weaknesses:
- High public sector deficit
- High current account deficit
- Low financial credibility
- High exposure of the banking sector to possible exchange rate fluctuations

## General assessment of the economic situation

Romania is one of the countries caught by the crisis quite unexpectedly, as its overall investment attractiveness and moderate dependence on exports seemed to form a solid base for long term growth.




*Source: IMF, EBRD, statistical office*

Unfortunately, they were not enough to prevent Romania from a major downturn. After 9,6% growth in 2008, in 2009 the Romanian GDP dropped by -7%, due to falling FDI inflows, exports, and domestic demand. The country had to pay the price for the slowdown, after EU entry in 2007, of structural reforms meant to improve the economy's competitiveness.

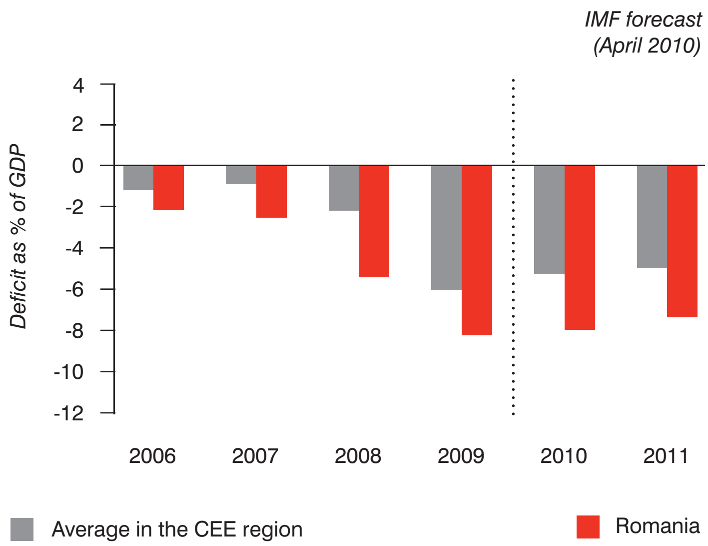
The IMF forecasts slow growth in 2010, and a return to rapid 5% GDP growth in 2011. However, there exist serious downward risks to this forecast, linked both to the external environment and to possible internal instability.


## Public finance

The public sector deficit increased during the crisis to more than -8% of GDP and is expected to remain at similar, excessive levels for a couple of years. Fortunately, the Romanian public debt was 24% of GDP in 2009, and is expected to rise to a still moderate level of 36% of GDP by 2011.

Albeit that no major risk of fiscal crisis exists, Romania's public sector needs urgent reforms. It is too large and is arguably unaffordable. The situation was aggravated over the years 2007-09, as during 3 years of intense infighting political rivals weakened public finances, offering undue financial benefits to voters. Under the IMF-led multilateral financing package, the government will have to curb budgetary spending and begin reforms to the budget system to improve long-term fiscal sustainability.

Public sector deficit



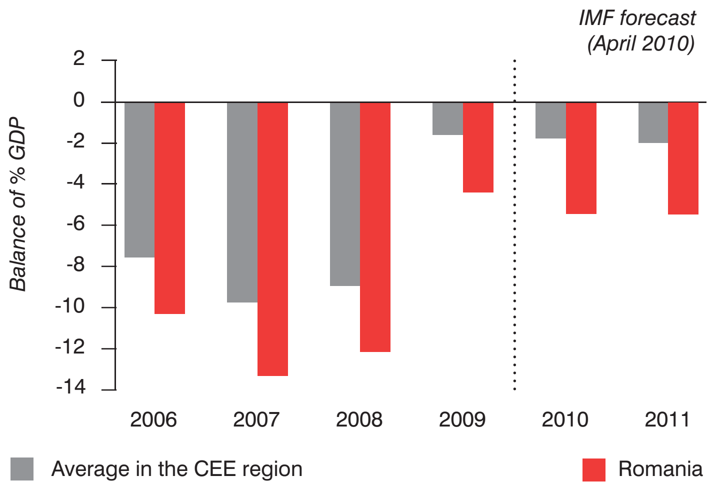

*Source: IMF*

## The external balance

The current account balance of Romania is under control. Due to weaker imports and a currency weakening in 2009 it was reduced to -4,4 % of GDP (a significant drop from -12,8 % a year before) and should not exceed a level of -6 % in 2010 – 2011.

Romanian foreign debt is at a moderate level of -49% of GDP, one of the lowest in the region. However, the situation is not fully comfortable, as the proportion of short-term debt (due in one-year time) is 57% of the total. Any problems with servicing or rolling over this debt may cause serious threats to the stability of the Romanian economy, given the low financial credibility of the country.

Current account balance



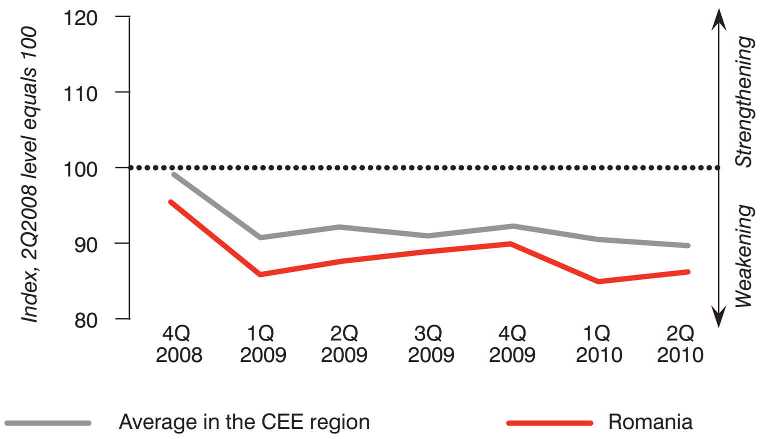

*Source: IMF*

## Stability of the currency

Romania uses a flexible exchange rate regime and allows for fluctuations in the value of the leu. Over the period of the crisis the leu lost about 15% of its initial value vis-a-vis the euro. The lack of major fluctuations in the exchange rate has been a relief to Romanian debtors – both companies and individuals. Otherwise they might have suffered, given the fact that 60% of all loans are denominated in foreign exchange. However, a risk of further weakening of the leu is quite high.

The increase in VAT from 18 to 23 % effective from July 1st will have a negative impact on inflation, pushing year-end inflation substantially well above the 3.5% target. Pressure on the leu, resulting from falling market confidence, may generate further inflationary pressures by driving up the price of imported energy and raw materials.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

Romania offers relatively favourable conditions for conducting business activity, however, some of the recently introduced changes entail greater tax burdens. The government increased the VAT rate from 19% to 24% (as of 1 July) in order to raise sufficient revenues to meet the budget deficit target, after a Constitutional Court ruling blocked cuts in pensions as part of a package aimed at narrowing the budget gap.

In 2010, the flat-rate tax for small businesses at the minimum level continues to be imposed on companies (a tax introduced in 2009 and calculated on the basis of income from 2008, payable also in the case of making a loss in 2009).

**The government is also proposing a whole range of smaller-scale measures to broaden the tax base, reduce allowances and increase tax rates:**

- in terms of solutions aimed at fighting tax evasion, the authorities focus on the implementation of the reverse charge mechanism for domestic operations concerning selected categories of goods such as grain, flowers, fruit and vegetables, meat, fish and sugar; they will no longer require VAT pre-financing along the sales chain involving several companies, with the VAT being actually paid by the end consumer;
- the tax authorities envisage broadening of the tax base for income tax, through the inclusion of income from interest, capital gains, meal vouchers, and compensation payments;
- excise duties are planned to be imposed on products other than harmonised excise goods;
- the legal requirements pertaining to the transfer of shares in limited liability companies, as intended in a bill prepared by the government, might prove a discouraging factor in the business environment, particularly the M&A market.

**Peter de Ruiter**

Partner,
Tax and Legal Services Leader
PricewaterhouseCoopers Romania

*Romania should not lose sight of keeping the tax burden within reasonable limits as a must in its aim to remain a competitive investment destination as compared with other countries in the region.*

*In this respect, the recent VAT increase of 5% is too much to be absorbed by the business environment. We praise the initiatives of the authorities aimed at fighting tax evasion and cutting the budget expenditure. But authorities should be careful to make sure that these measures don't bring Romania under the scrutiny of the EU for a breach of certain rules governing the Common Market. Apart from the measures announced by the authorities, which can merely remedy the current situation, a medium- and long-term tax strategy is required that will ensure a stable, predictable and clear taxation system. Maintaining the flat-rate tax is important, as is the guaranteeing of a certain level of taxation for a period of time that will allow companies to prepare realistic business plans, covering three to five years.*

## Indicators of vulnerability, 2009

| | Romania | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -8,3 | -6,1 |
| Public debt as % of GDP | 23,7 | 32,6 |
| Loans to private sector as % of GDP | 39,8 | 62,3 |
| Share of foreign exchange loans | 60% | 51% |
| Loans to deposits ratio | 118% | 126% |
| Current account balance as % of GDP | -4,4 | -1,6 |
| Foreign debt as % of GDP | 49,1 | 86,9 |
| Proportion of short-term debt | 56% | 37% |
| Coverage of financing needs by reserves* | 86% | 128% |
| Credit rating | BB+ | |

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

Romania's recovery is quite fragile and remains highly vulnerable to various shocks.

One of the county's biggest problems is the grey economy. It is estimated that the untaxed economy comprises 20-25% of GDP, largely because of the inability of the state to enforce its own financial rules.

As public debt remains moderate, no big risk of a fiscal crisis exists – even if fiscal deficits remain too high. A bigger threat is connected to foreign debt, as short-term liabilities represent a large proportion of it. Given the low financial credibility of the country, continuous support from the IMF and EU remains absolutely crucial to avoiding problems.

Finally, serious risks exist in the banking sector. High exposure of the banking sector to possible exchange rate fluctuations, indicated by the high proportion of foreign exchange loans and a high loans to deposits ratio, represent the potential for huge internal instability unless the process of further weakening of the leu is checked.

# Croatia

## Basic information

| | Croatia | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 4,5 | 324 | 1,4 |
| GDP, billions of US$ | 63 | 2 672 | 2,3 |
| GDP per capita, thousands of US$* | 17,6 | 16,3 | 108,0 |
| Exports as percent of GDP | 16,5 | 39,4 | 41,8 |
| GDP growth rate, 2009 | -5,8 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 1,4 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 2,5 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

## Vulnerability of the country to the debt crisis

Strengths:

- Moderate level of public debt
- Prospects of EU membership

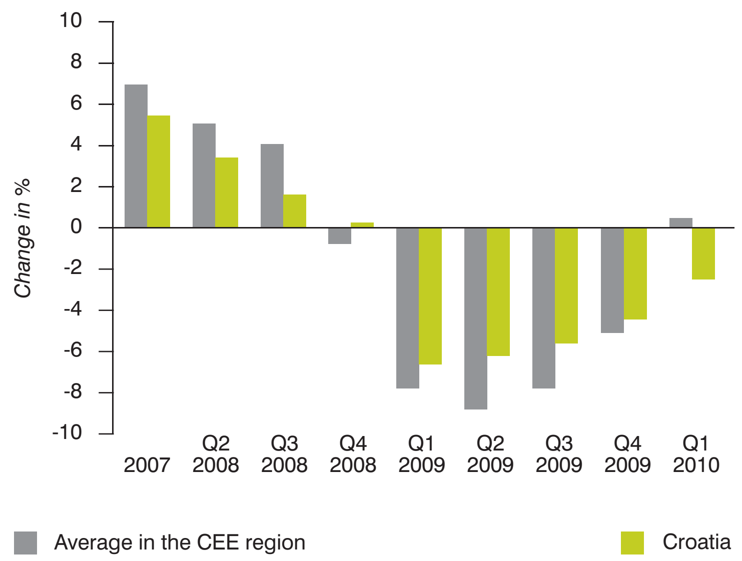
Weaknesses:

- High burden of foreign debt
- Excessive current account deficits
- Insufficient foreign exchange reserves
- High exposure of the banking sector to possible exchange rate fluctuations

## General assessment of the economic situation

Croatia suffered a deep recession induced by the global crisis and the country still lacks GDP growth.

GDP growth rates




*Source: IMF, Eurostat, statistical office*

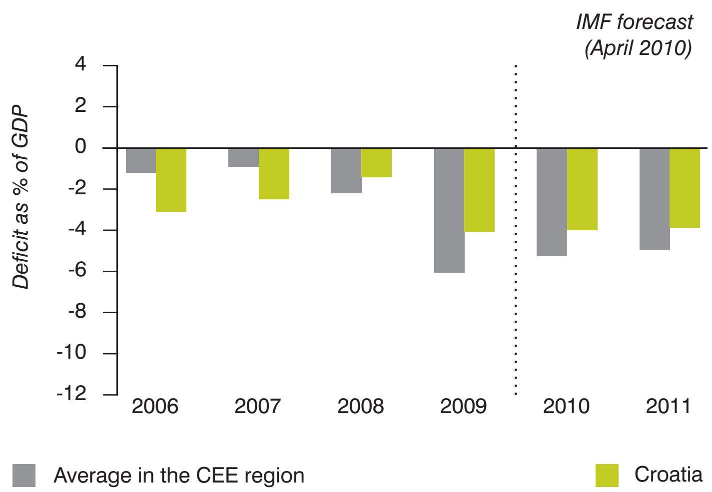
In recent years, the conditions for growth in Croatia have been more difficult than in Romania and Bulgaria, due to the still unfinished EU accession process. This resulted in Croatia having reduced financial credibility and smaller investment attractiveness, factors of crucial importance in times of limited access to external financing. However, it also forced the country to conduct a more careful macroeconomic policy in the pre-crisis period.

Croatia suffers from having a small internal market and significant dependence on exports (particularly of tourist services). First signs of the recovery can be seen already: tourism is on the rise, and the IMF forecast shows moderate growth in 2011.

## Public finance

Croatia had been struggling with public finance for some time. When the entire CEE region was hit hard by the slowdown and experienced deepening public sector deficits, Croatia capitalised on previous efforts and, together with tough new austerity measures, managed to maintain control over the fiscal situation. Nevertheless, the country's public sector deficit deepened to -4.1%, while public debt remains at a moderate level of below 40% of GDP. According to IMF forecasts, the deficit is going to continue to be a problem for Croatia for many years.

Public sector deficit



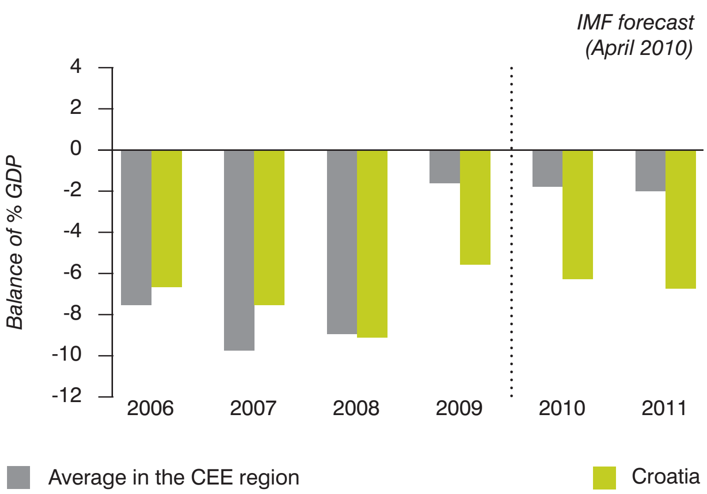

Source: IMF

## The external balance

The Croatian economy is charged with a heavy burden of foreign debt. Given the reduced financial credibility of the country, securing foreign financing remains one of the preconditions to GDP growth. Given the circumstances, the country's current account deficit of -5,6% of GDP should be assessed as too high. Furthermore, the IMF expects the current account deficit of Croatia to exceed 6% of GDP in 2010-11.

Croatia also needs to handle another problem related to its external balance. Insufficient coverage of the country's financing needs by foreign exchange reserves. If the global mood deteriorates, it may generate high short-term risk for the country's economic development.

Current account balance



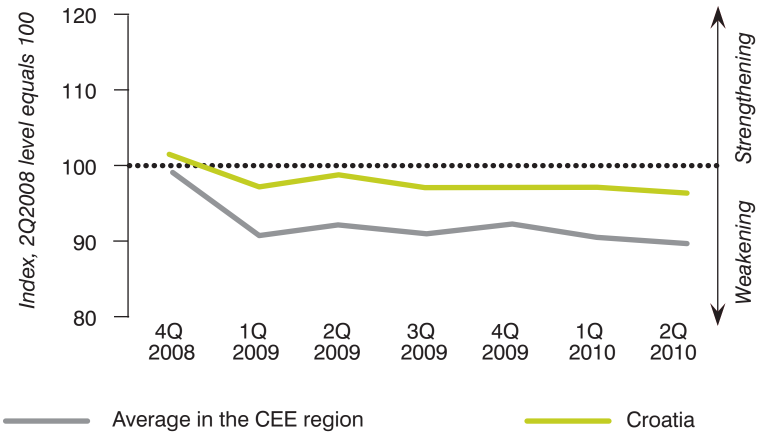

*Source: IMF*

## Stability of the currency

During the turmoil generated by the economic crisis the Croatian kuna remained relative stable.

A lack of major fluctuations in the exchange rate has been a relief to Croatian debtors – both companies and individuals. Otherwise they might have suffered badly, given the fact that 73% of all loans are denominated in foreign exchange. However, the risk of a further weakening of the kuna is quite high.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

**Generally, Croatia offers relatively difficult conditions for conducting business activities.**

The public finance problems have forced Croatia to introduce a package of tax changes. The basic VAT rate rose in mid-2009 from 22% to 23%. This was accompanied by an increase in excise tax rates on luxury goods (including cars, boats and aeroplanes), as well as the introduction of taxation of some mobile communication services.

Corporate income tax rates remained formally unchanged; however, for a definite period of time (between 2009 and 2010), an extraordinary income tax on salaries (crisis tax), of 2-4% was introduced (the rate depends on the amount of salary).

No significant actions, such as legal simplifications or reductions in bureaucracy, have been taken to improve the operation of the business environment.

## Indicators of vulnerability, 2009

| | Croatia | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -4,1 | -6,1 |
| Public debt as % of GDP | 38,5 | 32,6 |
| Loans to private sector as % of GDP | 67,3 | 62,3 |
| Share of foreign exchange loans | 73% | 51% |
| Loans to deposits ratio | 100% | 126% |
| Current account balance as % of GDP | -5,6 | -1,6 |
| Foreign debt as % of GDP | 87,8 | 86,9 |
| Proportion of short-term debt | 33% | 37% |
| Coverage of financing needs by reserves* | 62% | 128% |
| Credit rating | BBB | |

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

The Croatian economy is struggling with the results of the global crisis: the fall in GDP, increased unemployment and a plunge in international trade.

There are, however, some important areas which require thoughtful planning and efficient execution from local decision makers. Albeit that the situation in public finance is not dramatic, further actions are required to maintain the credibility of the country. Foreign debt and current account deficits represent the biggest threats to the country, particularly given the relatively low level of foreign reserves and the high proportion of foreign exchange denominated loans in the banking sector portfolio. A possible downgrading of rating is not going to help either. In a nutshell, the risks that Croatia has to face are quite serious and require carefully addressing.

# Serbia

**Basic information**

| | Serbia | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 7,4 | 324 | 2,3 |
| GDP, billions of US$ | 43 | 2 672 | 1,6 |
| GDP per capita, thousands of US$* | 10,4 | 16,3 | 63,8 |
| Exports as percent of GDP | 19,6 | 39,4 | 49,7 |
| GDP growth rate, 2009 | -2,9 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 2,5 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 4,8 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

**Vulnerability of the country to the debt crisis**

Strengths:

- Moderate level of public debt
- Moderate fiscal deficits

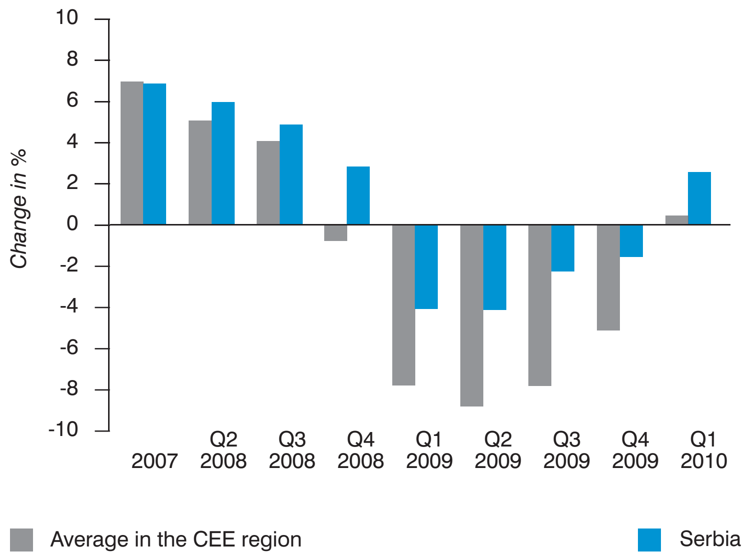
Weaknesses:

- High burden of foreign debt
- Excessive current account deficit
- Low financial credibility
- High exposure of the banking sector to possible exchange rate fluctuations
- No clear prospects of EU membership

## General assessment of the economic situation

The recession of 2009 was relatively shallow in Serbia, compared to the other Balkan economies, as the GDP decreased by 2.9%, mainly due to a significant decrease in exports to Western Europe.

GDP growth rates




*Source: IMF, Eurostat, statistical office*

In recent years, the conditions for growth in Serbia have been more difficult than in Romania and Bulgaria, due to the unclear and remote prospects of EU accession (Serbia applied for accession in 2009). This resulted in Serbia's reduced financial credibility and smaller investment attractiveness, factors of crucial importance in times of limited access to external financing.

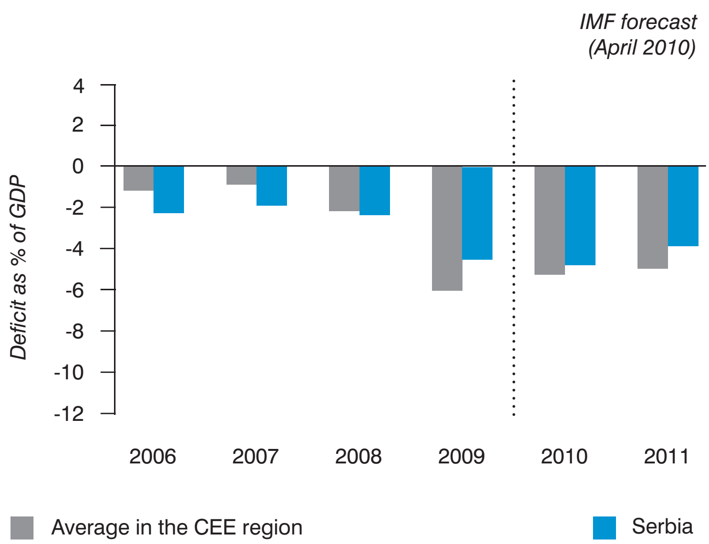
However, it also forced the country to conduct a more careful macroeconomic policy in the pre-crisis period.
The IMF forecasts GDP growth of 2-3% in 2010-11. Furthermore, there are many internal and external factors – including excessive foreign debt and a weak banking sector – which may slow down the speed of recovery.

## Public finance

Before the crisis, due to the awareness of its high dependence on external financing and low creditworthiness, Serbia conducted a prudent macroeconomic policy. Nevertheless, the crisis caused a serious deterioration in the situation. The country's public sector deficit deepened to -4.5%, and is expected to remain at a similar level for the next couple of years.

However, as Serbia capitalised on its previous efforts and, together with tough new austerity measures, maintained control over the fiscal situation, public debt remains at a moderate level of below 36% of GDP. According to IMF forecasts, debt will increase to 41% of GDP by 2011.

Public sector deficit



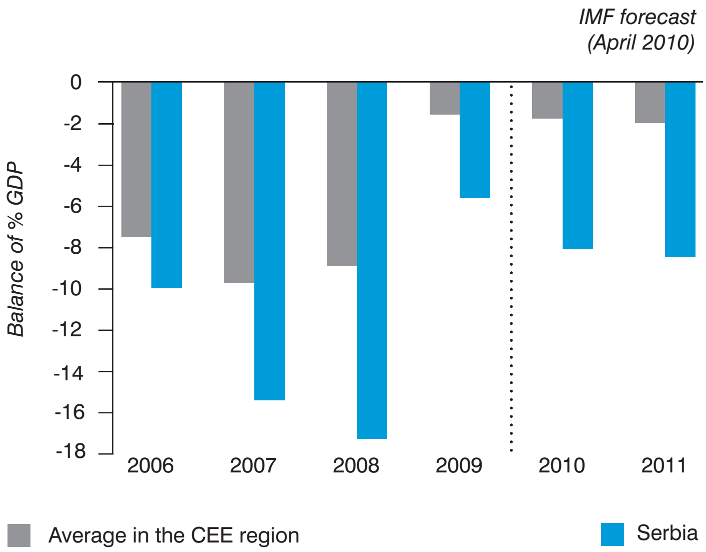

*Source: IMF*

## External balance

The Serbian economy is charged with a heavy burden of foreign debt. Given the low financial credibility of the country, securing foreign financing remains one of the preconditions to GDP growth. In such circumstances, the country's current account deficit of -5,7% of GDP should be assessed as too high. Furthermore, the IMF expects the current account deficit of Serbia to increase to over 8% of GDP in 2010-11.

Securing external financing is a crucial factor for Serbia, especially given its low creditworthiness. As the first wave of the financial crisis made it more difficult to obtain capital from the market, assistance from the IMF was practically the only hope for the Serbian economy. In the years to come the risk of major problems with external financing are likely to remain very high.

Current account balance



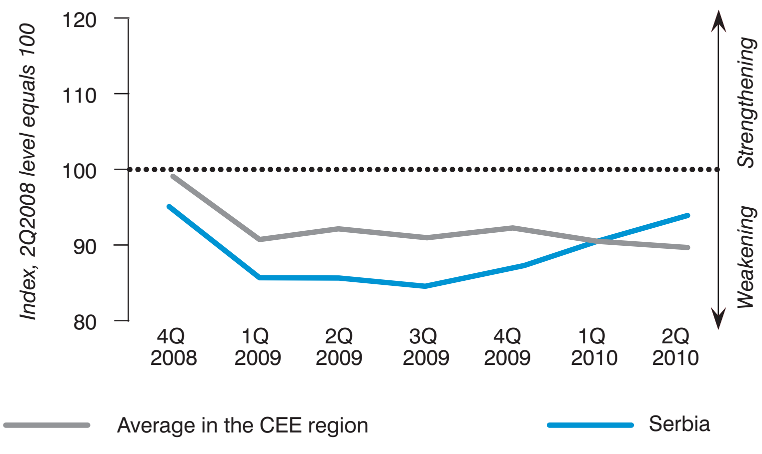

Source: IMF

## Stability of the currency

The strong dinar, resulting from the inflow of FDI and strong domestic demand is now history.

During the turmoil generated by the economic crisis the Serbian dinar remained relatively stable. The lack of major fluctuations in the exchange rate has been a relief to Serbian debtors – both companies and individuals. Otherwise they might have suffered, given the fact that 72% of all loans are denominated in foreign exchange. However, the risk of a further weakening of the dinar, with devastating effects for the banking sector, is quite high.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

The conditions for conducting business activity in Serbia remain difficult. However, the country is undergoing substantial regulatory reform as part of its EU accession process and as a result of continued efforts to create a stable and competitive business environment in the face of global downturn.

**The main developments in this area include:**

- steps undertaken at reducing the administrative burdens for companies – the regulatory guillotine;
- an Interim Trade Agreement with the EU – signed and in force; Free Trade Agreements in place with Russia, Belarus, Turkey; member of CEFTA and EFTA;
- expansion of the Double Taxation Treaty network to include over thirty countries;
- new Customs Law aimed at aligning the domestic regulations to correspond with those of the EU; further harmonisation of the Customs Tariffs system with the Combined Nomenclature of the EU;
- amendments to the Administrative Proceedings Law, Administrative Disputes Law and the Law on Tax Administration Procedure;
- amendments to the Corporate Income Tax Law – low tax rate maintained, certain incentives limited or abolished, further alignment with the relevant IFRS provisions and elimination of identified internal and external inconsistencies;
- introduction of new environmental protection regulations and imposing of related charges;
- activities aimed at attracting foreign investors, various tax-related incentives including tax holidays or subsidies for hiring new employees;
- new Law on Planning and Construction aimed at the privatisation of state owned land;
- new Laws on Foreign Trade and Competition, further harmonisation with the EU regulations;
- a set of new Intellectual Property

Laws adopted, which are aligned with the EU and other relevant international regulations.

**Dragan Draca**

Manager
PricewaterhouseCoopers
Serbia

*Attracting foreign direct investment has remained a priority for Serbia and various incentives have been introduced to facilitate this. Serbia has a well educated and inexpensive work force and current government measures include employment subsidies through which the government covers part of the employment costs. Major new investors are also being granted free land ownership for green field investments and tax holidays from both state and municipal level taxation. These measures complement various existing incentives and in combination with one of the lowest corporate income tax rates in Europe of 10% offer attractive opportunities to investors. Serbia is also working on maximising the potential of its favourable geographic location and preferential trade regimes by investing in infrastructure along the pan-European corridor lines.*

## Indicators of vulnerability, 2009

| | Serbia | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -4,5 | -6,1 |
| Public debt as % of GDP | 35,6 | 32,6 |
| Loans to private sector as % of GDP | 41,8 | 62,3 |
| Share of foreign exchange loans | 72% | 51% |
| Loans to deposits ratio | 112% | 126% |
| Current account balance as % of GDP | -5,7 | -1,6 |
| Foreign debt as % of GDP | 79,2 | 86,9 |
| Proportion of short-term debt | 21% | 37% |
| Coverage of financing needs by reserves* | 143% | 128% |
| Credit rating | BB- | |

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

Serbia belongs to a group of countries that is moderately exposed to the risk of a crisis. The economy is recovering from recession, but the recovery is dampened by difficulties in accessing sources of financing, and the large number of bankruptcies of companies that are suffering from currency volatility and which face liquidity problems.

Serbia's economic recovery will largely depend on the economic recovery of neighbouring countries and the progress of its integration into the European Union. There are, however, some important areas which require thoughtful planning and efficient execution from local decision makers. Albeit that the situation in public finance is not dramatic, further actions are required to maintain the credibility of the country. Foreign debt and current account deficits represent the biggest threat for the country. Given the low financial credibility, continuous support from the IMF remains absolutely crucial to avoid further problems.

Finally, serious risks exist in the banking sector. The high exposure of the banking sector to possible exchange rate fluctuations, indicated by the high proportion of foreign exchange loans and a high loans to deposits ratio, shows potential for huge internal instability unless the process of further weakening of the dinar is checked.

# Belarus

### Basic information

| | Belarus | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 9,6 | 324 | 3,0 |
| GDP, billions of US$ | 46 | 2 672 | 1,7 |
| GDP per capita, thousands of US$* | 11,6 | 16,3 | 71,2 |
| Exports as percent of GDP | 46,3 | 39,4 | 117,6 |
| GDP growth rate, 2009 | 0,2 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 3,5 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 6,8 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

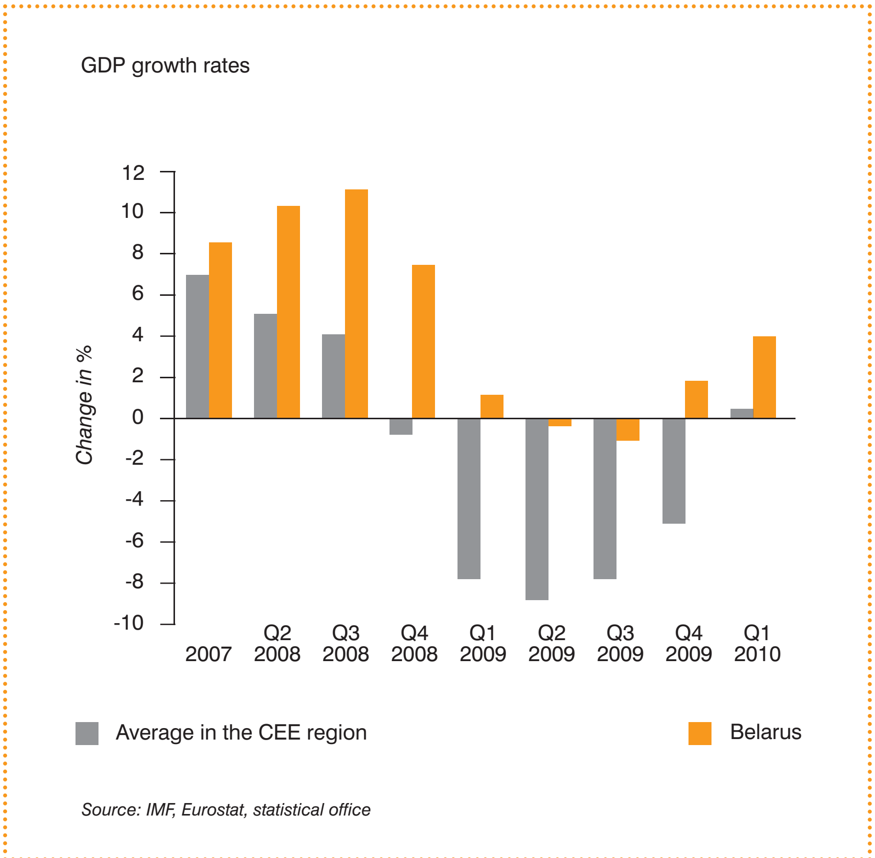
### Vulnerability of the country to the debt crisis

Strengths:
- Moderate public and private debt
- Low public sector deficit

Weaknesses:
- Low credibility
- Weakness of the banking sector
- High loans to deposits ratio
- High current account deficit
- Insufficient foreign exchange reserves
- Slow structural reforms

## General assessment of the economic situation

According to official statistics, Belarus has survived the global crisis in good shape with a very limited fall in GDP.




The prospects for 2010 are improving together with the gradual improvement of the economic situation in Russia, the country's crucial economic and trade partner. One should keep in mind, however, that the quality of Belarusian statistics is well below OECD/Eurostat standards, and therefore the figures should be treated with caution.

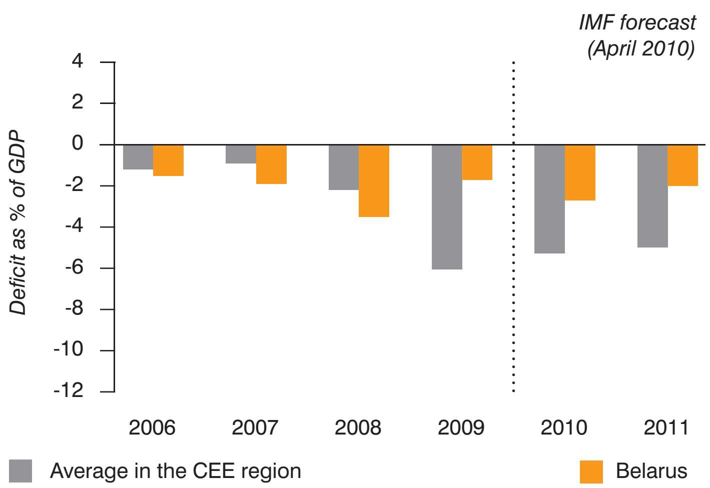
Nevertheless, the Belarusian economy has to deal with several extremely serious problems. One of them is the heavy dependency on vital energy imports from Russia, another is the slow path of transition that translates into very low financial credibility and many structural weaknesses.

## Public finance

Public finance in Belarus looks, on the surface, quite healthy. Public debt is quite low and stands at 25% of GDP, the public sector deficit is well below the 3% of GDP threshold. Unfortunately, as IMF reports indicate, the actual fiscal situation in Belarus may look much worse, mainly due to the lack of transparency in the fiscal accounts and the existence of quasi-fiscal deficits (e.g. deficits hidden in the accounts of state-owned firms, de facto guaranteed by the state budget).

The fiscal consolidation program agreed with the IMF, as the basis for the Fund's financial assistance, calls for the maintenance of the public sector deficit at a low level and for the acceleration of structural reforms.

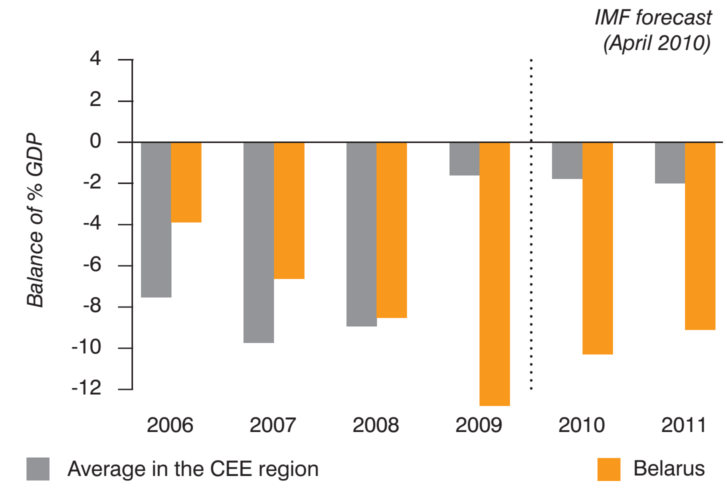
Public sector deficit




*Source: IMF*

## The external balance

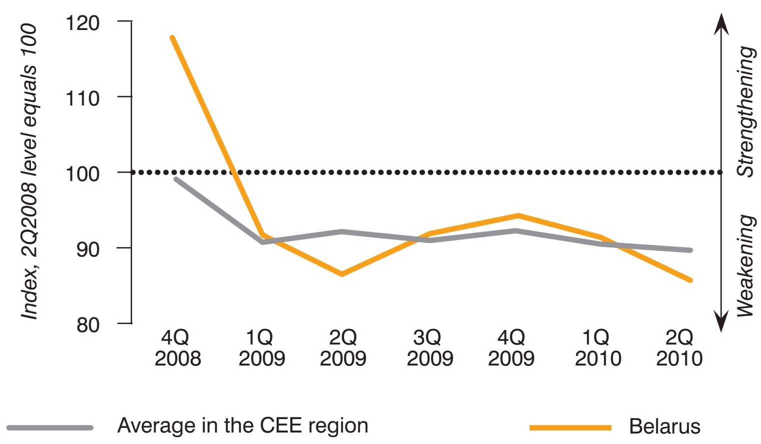
The external financial situation of Belarus is quite dangerous and requires a prudent and responsible policy to deal with it. Although the foreign debt level is moderate, reaching 45% of GDP, the situation may rapidly deteriorate if the terms of trade with Russia worsen (e.g. due to changes in energy prices). At the same time, the current account deficit has been increasing continuously up to a dangerously high level of -13% of GDP. Any negative development, particularly in economic relations with Russia, could immediately translate into a major external debt crisis. The same problem result if cooperation with the IMF breaks down.




*Source: IMF*

## Stability of the currency

Belarus uses a flexible exchange rate regime and allows for fluctuations in the value of the domestic currency. Over the period of the crisis the Belarusian ruble lost about 15% of its initial value vis-a-vis the euro. On the one hand, such a policy can be accommodated by the banking sector in a relatively safe way due to the moderate proportion of bank credits in foreign currency. On the other hand, however, the currency lacks internal stability, and devaluation easily translates into the risk of growing inflation. The forecast inflation rate in Belarus has reached 7%, with a possible further increase.




*Source: IMF*

## Taxation and conditions for doing business

In result of a major taxation system reform conducted in 2009, the Tax Code of Belarus replaced all other tax-related laws, effective as of 1 January 2010. Starting from this date, in order to establish a new tax or change the existing tax regulations, the Parliament will have to amend the Tax Code, except for cases when a new state tax is established by an Order or a Decree of the President of Belarus.

A new rule has been established for cases where there exists uncertainty or ambiguity surrounding the application of tax regulations to a given taxpayer. In such situations, the tax authorities are obligated to resolve the issue in favour of the latter.

**The conducted tax reform brought about several amendments effective as of 1 January 2010, which abolished the following taxes:**

- 1% turnover tax (state);
- 3% vehicle acquisition tax (state);
- 5% retail sales tax (local);
- parking tax (local).

In addition, certain changes in the applicable tax rates and the administrative procedures with regard to the value added tax (VAT) and corporate income tax (CIT) have been envisaged in the Tax Code.

The standard VAT rate increased from 18% to 20% and is levied on the supply of goods, work and services in 2010. The obligation to maintain records of purchases evidencing the input VAT deductions was abolished.

The timeframe for the issuance of a tax refund decision and notification as well as for its disbursement by the tax authorities was re-adjusted.

A reduced 12% CIT is levied on dividends derived from local or foreign sources, and on capital gains from the disposal of shares or stocks in a Belarusian entity. In addition, significant changes in the land tax regulations were also introduced.

## Indicators of vulnerability, 2009

| | Belarus | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -1,7 | -6,1 |
| Public debt as % of GDP | 25,2 | 32,6 |
| Loans to private sector as % of GDP | 36,3 | 62,3 |
| Share of foreign exchange loans | 27% | 51% |
| Loans to deposits ratio | 154% | 126% |
| Current account balance as % of GDP | -12,9 | -1,6 |
| Foreign debt as % of GDP | 44,9 | 86,9 |
| Proportion of short-term debt | 46% | 37% |
| Coverage of financing needs by reserves* | 32% | 128% |
| Credit rating | B+ | |

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

Belarus is one of the CEE countries most vulnerable to the debt crisis. The fiscal situation theoretically looks quite healthy, but the lack of sufficient transparency in the fiscal accounts makes any judgment very difficult.

IMF reports indicate that the actual fiscal situation may be worse than presented by official statistics.

The Belarusian banking sector is quite fragile and plagued by many structural deficiencies. A high ratio of loans to deposits is one of the most worrying symptoms of problems. Overall, the risk of a major banking crisis looks quite high despite relatively low levels of indebtedness of firms and households.

The external position of Belarus looks the most hazardous. The current account is dangerously high and the stock of foreign exchange reserves seems to be insufficient. Under conditions of very low financial credibility (measured by credit rating) any serious problems in economic relations with Russia, or with the IMF, could immediately translate into a major external debt crisis.

# Russian Federation

**Basic information**

| | Russian Federation | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 141,4 | 324 | 43,6 |
| GDP, billions of US$ | 1232 | 2 672 | 46,1 |
| GDP per capita, thousands of US$* | 15,1 | 16,3 | 92,6 |
| Exports as percent of GDP | 24,6 | 39,4 | 62,5 |
| GDP growth rate, 2009 | -7,9 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 3,5 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 6,3 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

**Vulnerability of the country to the debt crisis**

Strengths:

- Good growth prospects
- Accumulated reserves from the pre-crisis period
- Moderate foreign debt
- Low public debt

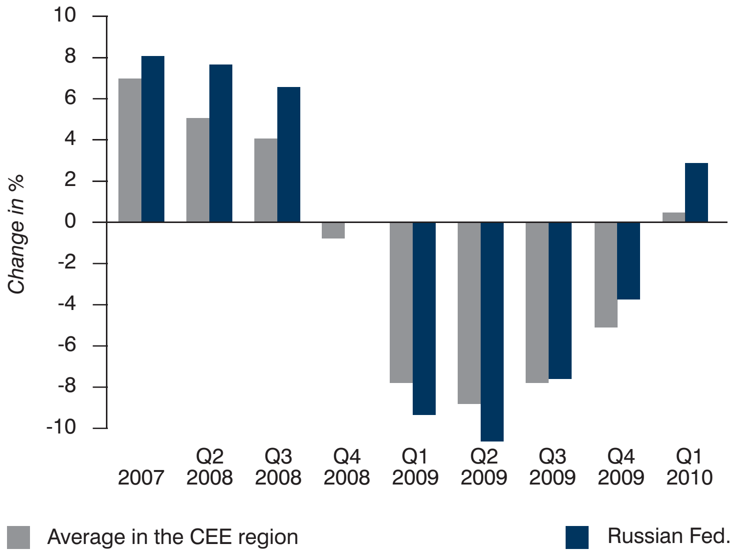
Weaknesses:

- Structural weaknesses in the banking system
- Excessive dependence on exports of energy resources

## General assessment of the economic situation

Russia, as with other countries of the region, was severely affected by the global crisis. The rapid GDP growth rate of 6-8% in the pre-crisis period rapidly changed into a -8% fall in 2009.

GDP growth rates




*Source: IMF, Eurostat, statistical office*

Despite this deep shock, Russia – in contrast to the vast majority of the CEE countries – was in a relatively comfortable position. A policy of running huge budget surpluses and accumulating foreign exchange reserves before the crisis, rather than spending windfall profits from oil and gas exports, allowed the government to react to the recession with a massive stimulus package. The package included large-scale support for Russian banks and private entities facing large, unhedged foreign exchange exposure. While some inflationary effects of such a move are quite possible in the longer term, the good state of the Russian budget before the crisis meant that the risk of excessive debt build-up could be avoided.

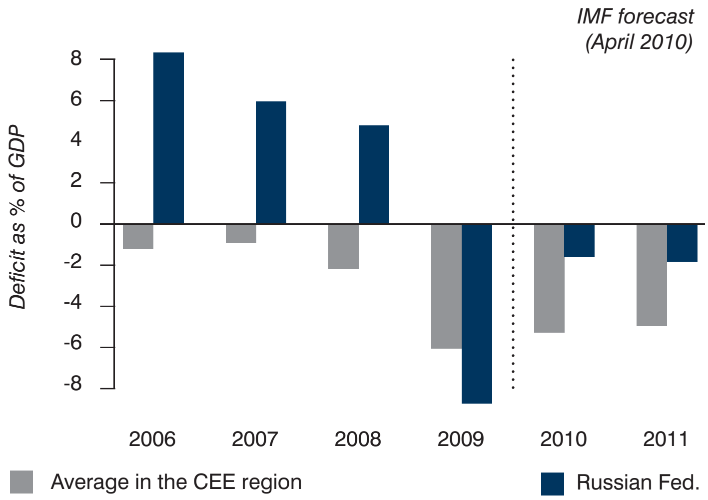
Thanks to higher oil prices, and a policy of stimulating demand and supporting banks and firms, the Russian economy is steadily recovering from the decline in output. The expected growth rate in 2010 is 3.7%, with continuing growth forecast for 2011. However, if the global economy is hit by a new recession, and oil prices fall once again, the possibilities of using a policy of stimulating demand will be much more limited than in 2009.

## Public finance

The massive amounts of money injected into the Russian economy under the government stimulus package were not neutral to the fiscal system. The public sector deficit deteriorated considerably to -8.8% of GDP in 2009, whilst in the pre-crisis years it had recorded surpluses of 5-8% of GDP. Although the price that the Russian government paid to defend the economy against the crisis was quite high, the country's fiscal system is well positioned to recover fairly quickly if oil prices remain at the current level or increase. In the coming years the public sector deficit is expected to fall below -2% of GDP.

Russia's public debt remains at a low level of 7.3% of GDP, which poses no major threat to the country in the short term. In the longer run, however, profound structural reforms are needed in order to ensure a sustainable model of public finance less dependent on the fluctuation of oil prices.

Public sector deficit



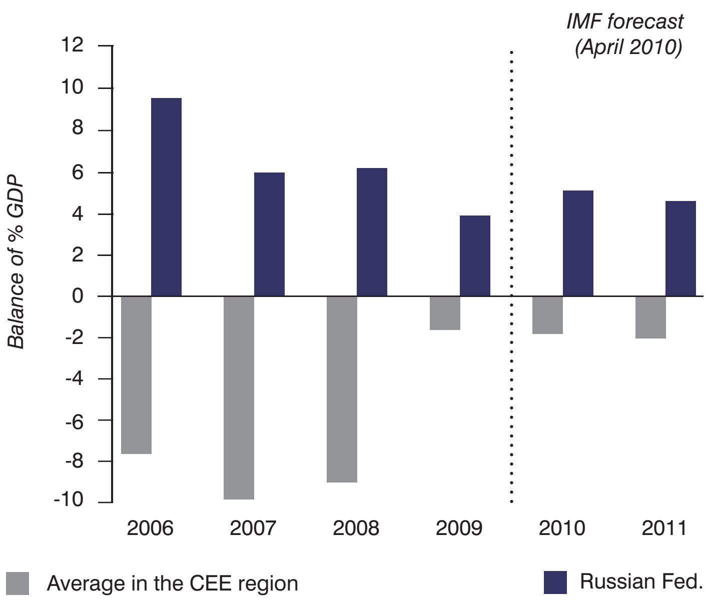

*Source: IMF*

## The external balance

Russia was the only CEE country to be running a current account surplus both before and during the crisis. Nevertheless, the surplus was significantly reduced during the global crisis, falling from 6.2% of GDP in 2008 to 3.6% in 2009. Such a result is not a surprise taking into account the scale of the demand stimulus administered by the government in 2009. In the coming years the current account surplus is likely to increase once again.

For the time being, foreign debt in Russia is not an area of major concern, as it represents less than 40% of GDP (far below the CEE average) mainly in long-term credits. The situation is even less risky due to the central bank's large foreign exchange reserves. The foreign exchange reserves are 7 times bigger than the cumulative total of the current account balance and short-term debt.

Current account balance



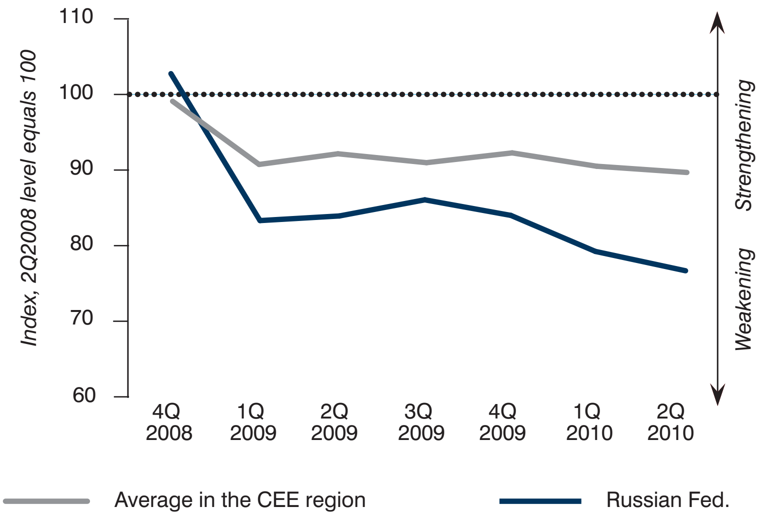

Source: IMF

## Stability of the currency

The ruble weakened seriously during the first wave of the crisis. Prior to the crisis a strong ruble created the backbone of the macroeconomic stability of the country. As oil prices increased, expectations for the ruble appreciation were strong. This situation encouraged financial markets and borrowers to take one-way bets on the ruble, which led to very large capital inflows. When the crisis broke, the large scale of liabilities left Russia vulnerable to the reversal of capital flows.

Albeit that the weak ruble helped the economy to deal with the crisis, its impact was reduced due to the structure of Russian foreign trade flows (exports dominated by raw materials). At the same time, however, weakening of the ruble may have quite a strong inflationary impact.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

Constraints on foreign business are being abolished and the regulatory environment has improved recently. However, several branches of economy remain closed to foreign investment. As part of government's plans to simplify the process by which investors can gain access to them, a law rendering more moderate the existing restrictions for foreign investment in Russia's strategic sectors and mineral resources is expected to be adopted.

The Russian investment policy includes tax reliefs, minimised administrative barriers and founding of private-public partnerships. The government is planning to provide financing for infrastructure projects to promote investment and to simplify the formalities to be complied with by foreign investment. Among the introduced improvements for investors, Russia has adopted the lowest corporate tax rate of any G8 or BRIC country, amended the laws to allow build-operate-transfer (BOT) projects, and created a framework allowing foreign investment in strategic areas.

The combination of a continuing upward trend in oil and commodity prices, tight monetary policy and balanced governmental support of core enterprises is fuelling a gradual recovery of the Russian economy, which creates new possibilities for foreign investors in 2010 and future years.

**Significant changes to tax legislation effective as of 2009:**

- the profits tax rate decreased from 24% to 20% as of 1 January 2009;
- the one-off deduction rate increased to 30% of the acquisition cost of fixed assets – for assets with useful life of 3-20 years; for other fixed assets it remains at 10%;
- certain types of R&D expenses are deductible with a 1.5 multiple.

**Significant changes effective as of 2010:**

- as of 1 January 2010, the Unified Social Tax (UST) was replaced with Social Insurance Contributions; the assessment rate is flat and stands at 26% for the year 2010 (which corresponds to the maximum UST rate) and the ceiling for calculating contributions is set at RUB 415,000 (approx. USD 13,833) per annum; a single tax base is established for contributions to all funds; starting from 2011, the overall assessment rate will reach 34%, and the ceiling will be adjusted accordingly to the annual inflation index.

**Peter Gerendasi**

Country Managing Partner
PricewaterhouseCoopers
Russia

*Russia has managed to start recovering quite successfully from the crisis and preserved macroeconomic stability despite being hit quite hard. Due to the strong governmental support the Russian economy has been steadily improving since the end of 2009. The investment climate is becoming more favorable for foreign investors attracting funds to major economic sectors. What is more Russia has chosen a new model of economic growth based on innovation and development. One of the top priorities is the stimulation of innovations aimed at modernizing the economy and getting rid of commodity dependence. The Government has approved the plan of measures to stimulate innovative activities of enterprises aimed at technological development of the companies and creation of the stimulus towards innovation in the state sector. A lot has already been done to move the process forward and many different projects focusing on the modernization of Russia and making it more open to the investors are underway.*

## Indicators of vulnerability, 2009

| | Russian Federation | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -8,8 | -6,1 |
| Public debt as % of GDP | 7,3 | 32,6 |
| Loans to private sector as % of GDP | 42,0 | 62,3 |
| Share of foreign exchange loans | 24% | 51% |
| Loans to deposits ratio | 103% | 126% |
| Current account balance as % of GDP | 3,9 | -1,6 |
| Foreign debt as % of GDP | 38,4 | 86,9 |
| Proportion of short-term debt | 23% | 37% |
| Coverage of financing needs by reserves* | 694% | 128% |
| Credit rating | BBB | |

** Ratio of foreign exchange reserves to short-term debt and current account balance*
*Source: IMF, CIA World Factbook, EBRD*

With promising results for 2010 and favourable forecasts for 2011, Russia is well-positioned to reverse the declining trend in its economy. The main challenge for encouraging further economic growth would be to improve the investment climate in Russia.

The main challenge for encouraging further economic growth would be to improve the investment climate in Russia. Economic policy should encompass structural reforms in the public sector, changes in the pension or healthcare systems, and liberalising reforms in the markets for goods, services and production factors. Albeit that no serious risk exists either in the area of public debt or external debt, the situation for the country is not totally comfortable. On the one hand, in order to avoid serious financial turbulence, the Russian banking system should be strengthened. The banking sector is still vulnerable to any major shock that may come from the global markets. Strengthened supervision from the central bank (the first steps in this area have already been made), as well as increased transparency, which would build wider confidence in the Russian banking system, are necessary to secure long-term sustainable growth.

On the other hand, the financial stance of Russia remains vitally dependent on the situation in the global oil market. Therefore, any reversal of the recovery of demand and prices for oil may have a serious impact on the economy.

# Ukraine

**Basic information**

| | Ukraine | CEE Region | Region=100 |
|---|---|---|---|
| Population in millions | 45,4 | 324 | 14,0 |
| GDP, billions of US$ | 117 | 2 672 | 4,4 |
| GDP per capita, thousands of US$* | 6,4 | 16,3 | 39,3 |
| Exports as percent of GDP | 34,5 | 39,4 | 87,6 |
| GDP growth rate, 2009 | -15,1 | -7,4 | x |
| Forecast GDP growth rate, 2010-11 | 3,9 | 2,2 | x |
| Forecast inflation rate, 2010-12 | 9,0 | 2,9 | x |

** According to purchasing power parity*

*Source: IMF, CIA World Factbook, EBRD*

**Vulnerability of the country to the debt crisis**

Strengths:

- Small current account deficit

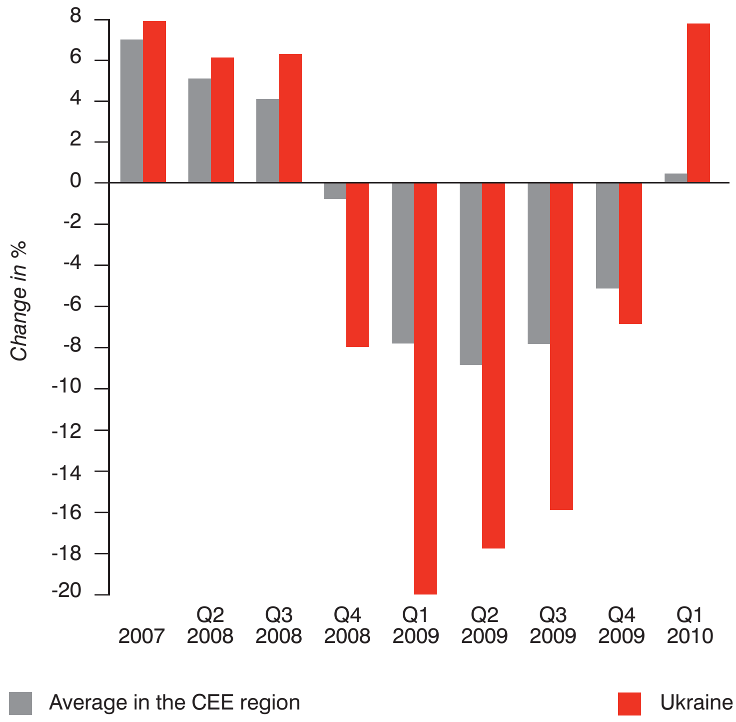
Weaknesses:

- Very high fiscal deficit
- High foreign debt
- Low financial credibility
- Slow progress of economic transformation
- High exposure of the banking sector to possible exchange rate fluctuations

## General assessment of the economic situation

Ukraine is among the countries which suffered the most during the crisis.

GDP growth rates




*Source: IMF, Eurostat, statistical office*

The lack of access to capital on the international markets, the dramatic drop in global demand for steel, an inefficient economy, the devaluation of the hryvna, and the almost complete paralysis of the structurally weak banking sector, are only some of the reasons behind a -15.1% decrease in GDP for the Ukraine in 2009. A loan from the IMF, which financed the fiscal deficit and strengthened the foreign exchange reserves, was the only hope for the Ukraine to avoid an open default.

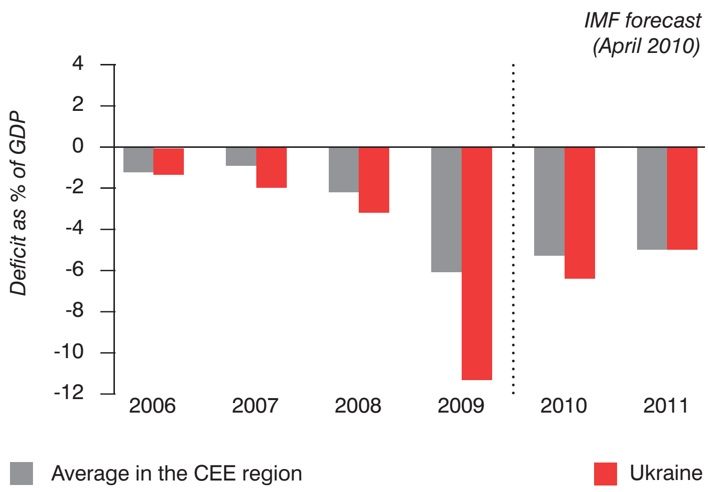
Despite the fact that the majority of these structural weaknesses in the Ukrainian economy are still in place, the short-term growth prospects are improving. According to IMF forecasts GDP growth in 2010-11 may reach around 4%. Obviously, the forecast is conditional on a relatively favourable external situation, that may not transpire.

## Public finance

Public finance reform is currently the main problem in the Ukraine. In order to obtain further tranches of the IMF loan, the authorities committed themselves to curbing the fiscal deficit which reached a huge level of -11,4% of GDP in 2009 (the worst result in the region). It is assumed that by 2011, the deficit will fall below -5% of GDP. In the short run the government in Kiev may try to shift a part of the burden to state-owned enterprises. However, in the longer run a reduction in social spending and subsidies will be unavoidable.

Public debt is still at a relatively safe level of 35% of GDP but it is expected to increase to 40% by 2011.

Public sector deficit

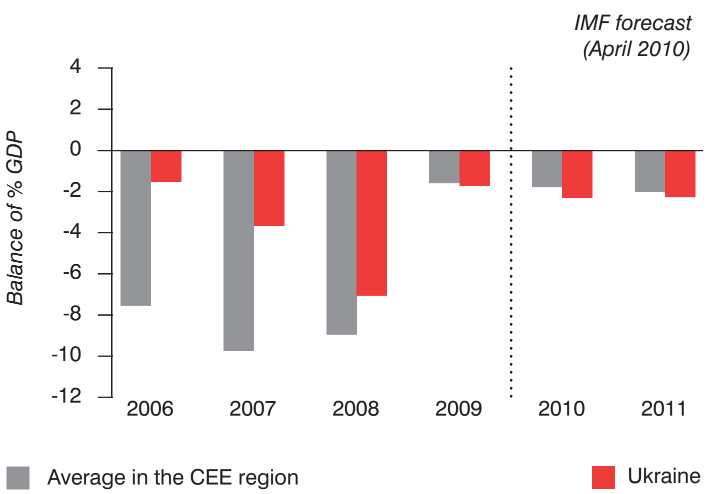



Source: IMF


## External balance

Ukraine's current account deficit gradually deepened in the years preceding the crisis, but the devaluation of the hryvnia and a decrease in imports reduced it fourfold: from -7.1% in 2008 to as little as -1.7% a year later. The Ukraine is characterised by a very low propensity to save – the proportion of loans is twice that of deposits. This means that funds for investments must be obtained, to a greater extent than in other countries of the region, from abroad. Therefore, foreign debt is as high as 91.7% of GDP, posing an additional risk to the financial stability of the country, in particular given its low creditworthiness.

Current account balance

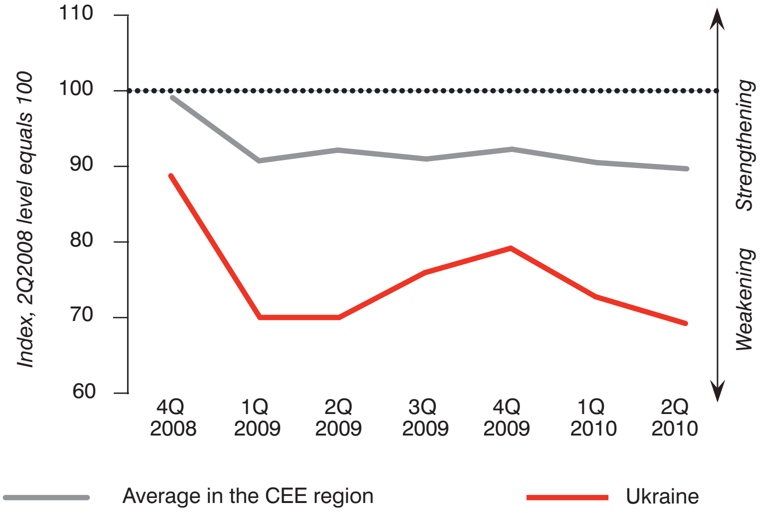



*Source: IMF*

## Stability of the currency

The Ukraine has a floating exchange rate regime. Over the period of the crisis the hryvna lost about 30% of its initial value vis-a-vis the euro, the greatest weakening observed in the region. If the problems with external solvency continue, a further significant drop can not be excluded. Taking into account the high proportion of foreign currency denominated loans in the banking sector, this is a serious risk to the stability of the economy. The crisis all but triggered a collapse of the Ukrainian currency and high inflation, with inflation rates of 9% predicted for the years 2010-2012. The continuously poor outlook for the hryvna, and the number of announced increases in the prices of goods and services, including natural gas, will not improve the outlook for the Ukrainian currency in the immediate future.

Exchange rate vis-a-vis euro




*Source: IMF*

## Taxation and conditions for doing business

Ukraine continues on the development and refining of its taxation system, with plans being made of introducing a comprehensive Tax Code in 2010, which should improve the compliance and facilitate the administrative processes. As of May 2010, the Code has not yet passed the Ukrainian Parliament.

Ukraine's corporate tax, at the standardised rate of 25%, applies to taxable profits earned by:

- Resident entities operating in Ukraine and abroad;
- Non-residents with the source of such profits in Ukraine;
- Reduced rates (0% and 3%) are applicable to income obtained by insurance companies;
- There are two VAT rates in force in Ukraine: 20% and 0%. The former applies to almost all transactions subject to VAT with the exception of exports of goods and related services, which are taxable at 0%.

The latter rate also applies to the supply of international transport services (in the part performed outside Ukraine) and toll manufacturing services. In practice, obtaining a VAT refund in this country is extremely difficult.

Generally, the legislation on personal income taxation has not changed greatly since 2004. However, the State Tax Administration of Ukraine (STAU) has recently altered to a significant degree its interpretation of certain PIT Law regulations pertaining to the tax residency determination and to the taxation of foreign nationals' income. Currently, STAU holds the following positions:

A double tax rate (30%) should apply to the salary income earned by non-residents employed by Ukrainian companies.

The previous STAU interpretation allowing for a 15% tax rate has been cancelled.

All foreign nationals are required to obtain a Ukrainian Tax Resident Certificate from the tax authorities; otherwise they will be treated as non-residents and required to pay income tax at the double rate (30%)

A Ukrainian Tax Resident Certificate may only be issued to a foreign national who has stayed in Ukraine for more than 183 days during the given calendar year.

## Indicators of vulnerability, 2009

| | Ukraine | CEE Region |
|---|---|---|
| Public sector deficit as % of GDP | -11,4 | -6,1 |
| Public debt as % of GDP | 35,4 | 32,6 |
| Loans to private sector as % of GDP | 74,7 | 62,3 |
| Share of foreign exchange loans | 51% | 51% |
| Loans to deposits ratio | 202% | 126% |
| Current account balance as % of GDP | -1,7 | -1,6 |
| Foreign debt as % of GDP | 91,7 | 86,9 |
| Proportion of short-term debt | 27% | 37% |
| Coverage of financing needs by reserves* | 79% | 128% |
| Credit rating | B+ | |

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

Of the economies in the region, the Ukraine remains one of the most exposed to various risks.

A high fiscal deficit, the significant proportion of loans in foreign currencies, the low propensity to save, an unstable currency, and the number of delays in reforming the economy (especially the natural gas sector) may combine to form an explosive mixture that could destroy the highly fragile financial stability. On the other hand, it seems that the government has no other choice but to implement painful social cuts and drastically reduce the deficit.

The authorities seem to be aware of this, as evidenced by the fact that they accepted the terms imposed by the IMF and declared that far-reaching reforms would be implemented. The only problem is that two years ago, before the disbursement of the first tranche of the IMF loan, similar declarations were made, but political games and the election campaign prevented these promises from being fulfilled.

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