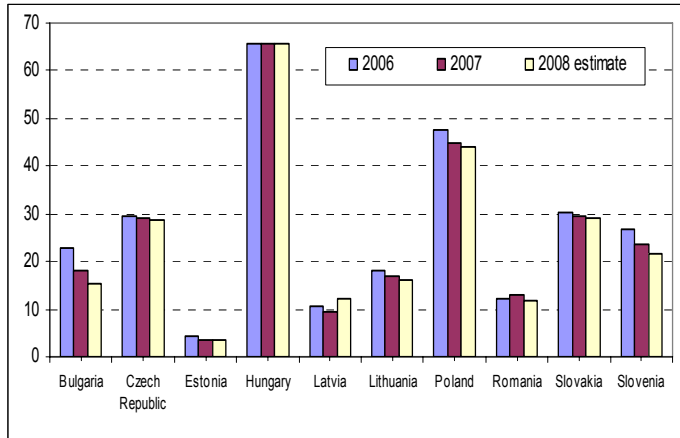


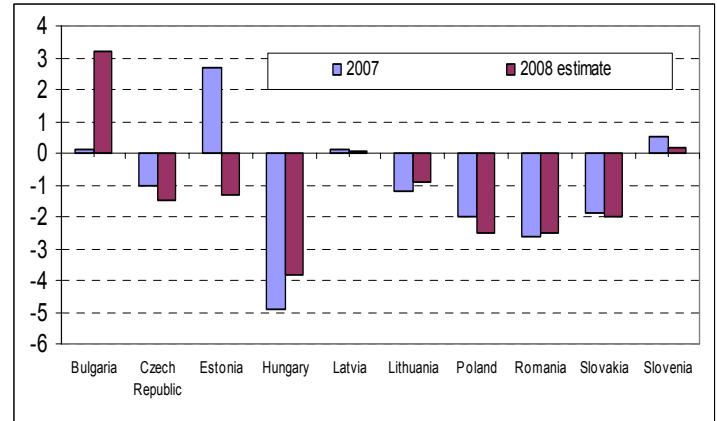
Lithuania, the current draft 2009 budget envisages the deficit of 2.3 percent of GDP (for general government excluding social security fund), despite repeated calls to government institutions to cut spending levels.

Figure 20. General Government Debt, 2006-2008 (% of GDP)



Sources: Eurostat, Ministries of Finance, World Bank staff calculations.

Figure 21. General Government Balance, 2007-2008 (% of GDP)



Note: A decrease in Bulgaria's fiscal surplus in 2007 from 3.4 percent of GDP is due to new information on a debt cancellation towards Iraq.

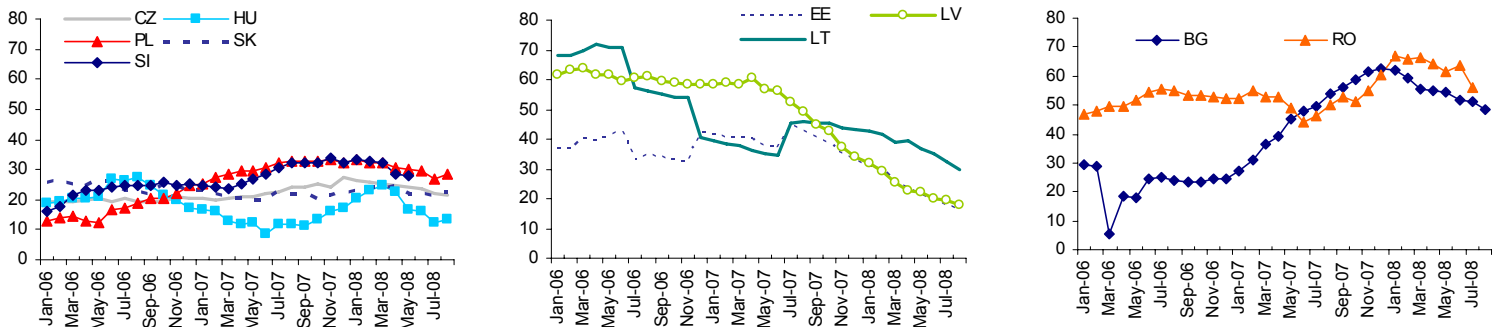
Sources: EDP Notification, October 2008, Eurostat, staff calculations.

As the EU10 adjust to the ongoing slowdown in growth and pressure on revenues and budgets, it will be important not to put the burden of adjustment on targeted social protection spending. Indeed, times of economic downturn require continued commitment to well-funded and well-targeted social protection schemes to help alleviate the pressure on the most vulnerable members of society. It will also be important to ensure that fiscal policies are not pro-cyclical, as they were in many EU10 countries during the times of strong economic growth. Counter-cyclical fiscal policies help build cushions to use in times of need, and they help limit macroeconomic and fiscal imbalances.

Monetary Developments

In the course of only a few months, the emphasis of central banks in the region has shifted from reacting to rising inflation to dealing with the possibility of a stronger decline in inflation and the global financial turmoil. In the Czech Republic, large exchange rate appreciation led the central bank to cut its key policy rate by 25 basis points in August to 3.5 percent. Despite earlier expectations of further monetary tightening, central banks decided to keep rates unchanged in September in Hungary, Poland and Romania, given easing inflation pressures and the ongoing financial turbulence.

Figure 22. Credit to Private Sector (% change, yoy)



Source: Central Banks

The tighter financial conditions, growing concerns about credit risk amid the intensifying global financial crisis and weakening economic expansion have resulted in slower growth in domestic credit in most countries (Figure 22). Banks are tightening lending requirements, which, together with slowing demand for

credit, has helped slow credit growth substantially in the Baltics, Bulgaria and Romania. In Romania, the central bank issued new regulations to help slow credit growth in response to a sharp pick up in non-performing loans. The new regulations require commercial banks to set, with the approval of the central bank, maximum indebtedness ceiling for clients along several dimensions including the type and currency of the credit, category of client, maturity and type of interest. For banks that did not comply by October 6, 2008, the maximum ceiling was set at 35 percent of income, compared with up to 70 percent earlier. In September, Latvia's central bank reduced the reserve requirement to 5 percent of gross deposits from 6 percent, in an attempt to alleviate liquidity constraints. In Hungary, four banks have ordered their Hungarian subsidiaries to stop lending in foreign currencies in recent days, while many banks have already announced changes in their lending policies in order to limit CHF lending.

Two of the most significant policy responses to currency weaknesses thus far have come from Romania, which has tightened liquidity to squeezed Leu shorts, and Hungary, where the NBH raised rates 300bps to 11.5 percent in an attempt to stop the weakening of the forint. All of the central banks, however, are ready to intervene on the forex market if necessary.

These are trying times indeed, but governments and central banks have shown that they had taken the measure of the challenges and were determined to act with the full force of all the instruments at their disposal. Cross-border coordination among them has also strengthened. With the additional support of European and multilateral institutions, where needed, there is every reason to trust that the EU10 will weather the storm, as they have previous ones.