



# The IMF's Stand-by Arrangements and the Economic Downturn in Eastern Europe

## The Cases of Hungary, Latvia, and Ukraine

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# Contents

Executive Summary.....	1
Introduction.....	2
Background: The Economic Environment in Central and Eastern Europe .....	2
Looking Back: The Role of Foreign Credit in the Recent Central and Eastern European Boom .....	3
Looking Forward: The Spread of the Risk to Western Europe.....	5
The Stand-by Arrangements .....	6
Hungary: Caught by the International Crisis When Attempting to Cool Down.....	6
Latvia: Trapped by a Currency Peg .....	11
Ukraine: Pro-cyclical Policies and Political Tension .....	19
Conclusion .....	24

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## Executive Summary

This paper looks at three Central and Eastern European (CEE) countries that have been hard-hit by the world economic recession, and have turned to the IMF for assistance: Hungary, Latvia, and Ukraine. In all three countries there were mistakes in economic policy that increased their vulnerability to external shocks. The governments' responses to the downturn, along with IMF conditions for assistance, are also seen to have caused harm with pro-cyclical policies.

In Hungary, a surge of foreign borrowing allowed the country to run large current account deficits in 2006 and 2007 (7.5 and 6.4 percent of GDP, respectively), as well as a large fiscal deficit in 2006. The current account deficits became much more problematic as foreign capital inflows dried up and then were reversed during the world economic slowdown. Private sector balance sheets were also hit hard when, in response to these reversals, the domestic currency depreciated sharply – since the private sector had borrowed heavily in euros.

The response to the crisis, however, seems to have made matters worse than necessary. The IMF stand-by arrangement included measures to bring the government deficit, as a percent of GDP, down to 3.4 in 2008, and to 2.5 in 2009. This may not have been appropriate, given that Hungary is now projected to undergo a sharp economic contraction of 6.7 percent of GDP. This pro-cyclical fiscal policy has also been accompanied by pro-cyclical monetary policy.

The Fund's forecasts indicate that it did not anticipate the severity of Hungary's contraction, with its July 2007 projection of just -1.0 percent growth for 2009. Also, about a year before the crisis in Hungary's financial sector, the IMF wrote in its report on Hungary's economy that “the financial sector remains sound.”

Latvia also suffered from a large reversal of capital flows that was common to the CEE economies, following a boom fueled by foreign credit, which increased by 60 percent annually from 2002-2006. But here too, a combination of pro-cyclical fiscal and monetary policy – supported by an IMF agreement as well as funds from the European Union – appears to have worsened the contraction. By some estimates, the Latvian economy will contract by as much as 18 percent this year – much deeper than the IMF's projection as of January 2009 of -5 percent.

The decision by the Latvian government, in conjunction with the European Union and the IMF, to maintain Latvia's pegged exchange rate with the euro, has made recovery much more difficult. With the currency fixed rate, the only way to reduce the country's current account imbalance is through shrinking the economy, which reduces imports faster than exports and may also reduce real wages. This is similar to the IMF-sponsored policies in the deep Argentine recession of 1998-2002, where a fixed, over-valued currency worsened and prolonged the downturn until the Argentine currency collapsed in 2002.

Ukraine was also hard hit by the world slowdown. There was a sharp decline in the price of steel (a major export) and, on the import side, a significant increase in the price of natural gas from Russia. Like the other CEE countries, Ukraine also suffered from a reversal of capital flows, threatening liquidity in the banking system. From October 2008 to March 2009 the National Bank of Ukraine lost US\$14 billion in reserves in an unsuccessful effort to defend the currency.

The Fund also prescribed fiscal tightening for Ukraine, where GDP is now projected to decline by 9 percent in 2009. The IMF stand-by arrangement approved in October 2008 provided for a zero fiscal balance. This was later relaxed to a deficit of 4.0 percent of GDP. Ukraine total public debt is low – just 10.6 percent of GDP, so it would make sense to borrow in order to finance an expansionary fiscal policy and reduce the severity of the recession. It is worth noting that the Fund also greatly underestimated the depth of Ukraine's recession, with its December 2008 forecast of a decline of -3.0 percent of GDP for 2009. Ukraine has also pursued a pro-cyclical (contractionary) monetary policy under the IMF agreement.

In all of these countries, it would appear that there were more sensible responses to the crisis that would have reduced the loss of employment and output, cuts in social services, and political instability that have resulted from the downturn. It is worth emphasizing that the main constraint for these countries pursuing expansionary fiscal and monetary policies, particularly in a time of falling inflation, is that they have sufficient foreign exchange to avoid a balance of payments problem. The IMF, especially with its vastly expanded resources, is capable of providing the necessary foreign exchange to allow for counter-cyclical policies – yet it has opted instead for pro-cyclical policies in these countries.

## Introduction

As in other parts of the world, the global economic crisis has brought much tension to the emerging countries of Europe. Some of these countries have attempted to resolve their problems by signing Stand-by Arrangements with the International Monetary Fund (IMF), only to find that the conditions attached to those agreements may be difficult to meet, and could involve the use of pro-cyclical policies – i.e. policies that exacerbate these countries' economic downturns.

This report examines the recent experience of Hungary, Latvia, and Ukraine and the stand-by arrangements they have signed with the IMF. We start by presenting a general overview of the current economic and financial environment in Central and Eastern Europe (CEE), and then provide a more detailed analysis of each of these three countries and their agreements with the Fund.

## Background: The Economic Environment in Central and Eastern Europe

The three countries that we analyze in this report are particularly interesting, as they all have been severely hit by the global crisis, but each of them faces a particular set of conditions which has made it more difficult to apply corrective measures. In Hungary, the congress approved a fiscal responsibility law which prevents the government deficit from rising above 3 percent of GDP, thus limiting the use of a fiscal stimulus to counteract the downturn. In Ukraine, political disagreements<sup>1</sup>

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<sup>1</sup> There are clear political tensions between Prime Minister Yulia Tymoshenko and President Victor Yushchenko. Their differing views on how to fix the Ukrainian economy have spread through the congress and has complicated the relationship with the IMF. See for example New York Times (2009a).

have made it difficult to pursue the necessary measures to alleviate the crisis. Finally, in Latvia, the country's insistence on maintaining the foreign exchange peg (with encouragement from the European Union) has deepened the vulnerability of the balance of payments situation.

As a consequence of the crisis, all three countries have suffered from political instability and social unrest. In Hungary, the President resigned at the end of March as a result of the pressures and discontent arising from the difficult economic situation. In Latvia, the Prime Minister presented his resignation in February amid growing discontent and projections putting GDP growth at about negative 12 percent for 2009.<sup>2</sup> He was able to negotiate funding packages worth about US\$10 billion from the European Union, the IMF and other sources; but in exchange for the aid Latvia committed to severe austerity measures to try to prevent a devaluation of the Lat.<sup>3</sup> These measures have included cuts in the wages of public employees, including teachers, police officers, and judges,<sup>4</sup> which were highly unpopular. Finally, in Ukraine, dependence on steel industry exports (severely hit during the crisis), and on Russian gas (the price of which rose sharply) has led to thousands of lost jobs. Meanwhile, as indicated above, a clash between President Victor Yushchenko and Prime Minister Yulia Tymoshenko over the IMF recommendations has complicated the decision-making process as the recession deepens.

## Looking Back: The Role of Foreign Credit in the Recent Central and Eastern European Boom

Hungary, Ukraine, and Latvia, as others in Central and Eastern Europe enjoyed very strong (and in some cases, stellar) economic performances in the years before the current crisis. Ukraine and Latvia, along with Armenia and Belarus, posted rates of GDP growth well above 7% on average from 2004 to 2007. Their outstanding levels of activity were based on export growth, capital inflows, and access to cheap credit from international sources. Foreign debt rose to dangerous levels, in the hands of private firms and households, as banks in Western Europe saw opportunities to profit from a growing demand for credit, and from recent or expected future inclusion into the European Union (EU).

This dramatic increase in foreign lending was due in part to currency appreciation (or expectations thereof), macroeconomic stability (as represented especially by lower inflation rates), and prospects for increased profitability from potential European Union membership.<sup>5</sup> Lower spreads on foreign currency borrowing for new EU members (such as Hungary and Latvia), as compared to those for other emerging market economies, have also been mentioned as important determinants of soft lending conditions for this region.<sup>6</sup>

Access to foreign capital led to rapidly increased consumption and investment, as the population sought to catch up with the standard of living in Western Europe. From 2002 to 2006, credit in the

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2 New York Times (2009a).

3 See Wall Street Journal (2009) and New York Times (2009b).

4 Cnews (2009).

5 IMF (2006).

6 See for example IMF (2007a).

Baltics expanded at an average annual rate of 44 percent,<sup>7</sup> while the annual growth of credit in emerging Central Europe reached 14 percent in the same period.<sup>8</sup> A recent Swiss National Bank study finds that, as of February 2009, “households and non-banking sector firms in several CEE economies have accumulated the equivalent to \$250 billion worth of debt denominated in foreign currency.”<sup>9</sup>

As the global slowdown hit the region, and export revenues and capital flows declined, so did access to foreign credit resources, and balance of payments difficulties rapidly emerged. In Hungary and Ukraine in particular, currency depreciation severely affected balance sheets in households and firms, and commercial banks saw a rise in non-performing loans.

Auer and Wehrmüller (2009) estimate that the losses resulting from currency depreciation in the non-banking sector in ten CEEs could reach US\$ 60 billion in the period from August 2008 to February 2009. They also show that Hungary and Poland suffered the highest losses, amounting, respectively, to 18 percent and 8 percent of GDP.<sup>10</sup> Meanwhile, in Latvia the government has applied drastic austerity measures and the Central Bank has had to aggressively step in to defend the currency peg.

The condition of the monetary and external sectors in the CEE countries has become a delicate matter. The years of easy foreign funding are over, and the credit crunch has severely hit the region. According to a February 2009 report by the Institute of International Finance, the current decline in net private capital flows to emerging markets is becoming “the most dramatic on record.”<sup>11</sup> Emerging Europe was the most adversely affected region, with a *net outflow* of US\$32.8 billion, down from net *inflows* of US\$214 billion in 2008, and US\$383 billion in 2007. All elements of private capital flows have been affected by the recession, but the most important decline is concentrated in net bank lending. In this category, Emerging Europe again posted a *net outflow* of US\$53.5 billion in 2009. In 2008 and 2007, the *net inflow* of credit to this region reached US\$79 billion and US\$169 billion, respectively.<sup>12</sup> This situation also implies that borrowers in Eastern Europe, (already severely affected by currency depreciation) will have a hard time rolling their debt over, and this could lead to an increase in non-performing loans.

The situation of the CEE region turns even more delicate when we look at the balance of payments disequilibria that these countries accumulated during the easy credit days. In Latvia, Lithuania, Serbia, and Bulgaria, for example, the current account deficit as a percent of GDP reached levels ranging from over 13 to more than 25 percent in 2008.<sup>13</sup> External imbalances in this region are much higher than those observed just before the Asian crisis of the 1990s.<sup>14</sup>

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7 For example, according to IMF (2006), Latvia saw credit to households increase by more than 60 percent per year during the same period.

8 IMF (2006).

9 See Auer and Wehrmüller (2009). Their research included 10 countries, 9 from Eastern Europe (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Slovakia, and one country from Western Europe (Austria).

10 Ibid.

11 See Third World Network (2009).

12 See Institute for International Finance (2009, pp. 5 and 11).

13 Information from the IMF, World Economic Outlook Data Base.

14 In 1996, the current account deficits in Thailand, South Korea and Indonesia were 6, 4.4, and 3.4 percent of GDP, respectively. The following year, Thailand's deficit rose to 7.9 percent of GDP, but fell to 2 percent in 1998. See IMF (2000).

## Looking Forward: The Spread of the Risk to Western Europe

Early in 2008, the situation described above generated concerns about the links between foreign debt in East Europe and commercial banks in Western Europe. Referring to the difficulties the European economies were going through in early 2008, Gros (2009, p.1) wrote: “The deteriorating foreign exchange and financial conditions of satellite countries in the euro area – from the Baltic region to Eastern Europe, Turkey, and Ukraine, not to mention the imploded Icelandic financial system – add yet another source of uncertainty”. He feared that European Union banks were not strong enough to take potential losses from the CEE countries. He was not alone in his appreciations, though. Last February *Evans –Pritchard* wrote:<sup>15</sup> “Almost all East bloc debts are owed to West Europe, especially Austrian, Swedish, Greek, Italian, and Belgian Banks”. The author questioned, at that time, the IMF’s ability to bail out those countries (as well as others potentially facing similar difficulties), and to help preserve the region’s financial stability.

Most of these concerns originated from the financial stability report published by the IMF in January 2009. According to this report, several banking systems in Western Europe (particularly those of Austria, Belgium, and Sweden), “remain highly exposed to a deterioration in asset quality in emerging Europe”.<sup>16</sup>

The exposure of European banks to East Europe has generated controversy. In April this year, Paul Krugman’s comments that Austria was one of several European countries at risk from their exposure to Eastern Europe generated bitter reactions from Austrian government officials: Joseph Pröll, the country’s Finance Minister, referred to Krugman’s statements as “Absolutely absurd.”<sup>17</sup> Interestingly, the head of the IMF, Dominique Strauss Kahn, told the Austrian media that he believed the Austrian situation was “fairly good.”<sup>18</sup> But Krugman’s argument was based on data showing the huge exposure (more than 70% of GDP) of Austrian Banks to East Europe’s foreign debt.<sup>19</sup>

In May 2009, the IMF issued a statement apologizing for “faulty figures ... which inflated the risk for Central and Eastern European economies.” But rather than suggesting that Western Europe should not be concerned about exposure to debt in the East, the IMF added in the same statement that the basic analysis was still valid and that “there was an increased risk in emerging markets, including those of Eastern Europe.”<sup>20</sup> Apparently the ratios of foreign debt to foreign currency reserves were overestimated for some countries, but this does not change the fact that Western European banks, either operating in Austria or in other locations, were highly exposed to foreign debt in Eastern Europe. This situation is highlighted in the most recent IMF Financial Stability Report, particularly in the section referring to banking systems’ exposure to emerging markets.<sup>21</sup>

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15 Evans-Pritchard (2009a).

16 See IMF (2009a, p. 5, figure 7).

17 Krugman’s comments were made at an event in the Foreign Press Club in New York on April 13 this year. See Vienna Review (2009).

18 See Filger (2009).

19 Krugman’s reply may be found in his New York Times blog:

<http://krugman.blogs.nytimes.com/2009/04/15/austria/>

20 The specific countries affected were Czech Republic, Estonia, and Ukraine. See Earth Times (2009).

21 The figures on bank systems exposure to emerging markets (by country of origin of the bank system, figure 7 of the report) have not been modified or replaced by the IMF, so we may assume they are correct. See IMF (2009a).

Roubini (2009) argues that a great cause for concern is “the strong presence of Western European Banks ... in Central and Eastern Europe, where they hold 60% to 90% market share.” He notes that “Austria is far and away the Western European country most heavily exposed to the CEE region” especially through two Austria-based banks with a collective exposure to the region that exceeds 70% of Austria’s GDP. He also argues that Belgium and Sweden are the next in line, with their lenders showing an exposure to the region of around 20 to 25% of GDP.<sup>22</sup>

## The Stand-by Arrangements

As in the cases of several other countries,<sup>23</sup> the arrangements signed with the IMF by the countries analyzed in this article allow for certain “flexibilities” on the fiscal front, but counteract those flexibilities with tight monetary policy. Given the sharp falloff in economic growth in these European countries, it is not clear why any of these governments would want to pursue a restrictive monetary policy. It is true that these measures may be aimed at protecting their foreign sectors from further imbalances, but it is also true that the policy could be pushing these economies off a cliff. Recessions cause a decline in disposable income, and falling incomes contribute to the accumulation of non-performing loans; these, in turn, weaken the financial system and scare investors away from the country. Hence, the pursuit of external balance by means of tight monetary policy during the present global recession may end up aggravating – rather than solving – external imbalances.

The allowed “fiscal flexibility” pertains to the realm of government deficit accounting; but reality tells us a different story. The IMF has allowed countries to miss their government balance targets (in some cases by substantial amounts). But with tax revenues declining (as a result of a dramatically underestimated recession), there is no way the targets could have been met. So this is not really a loosening of fiscal policy.

Moreover, in order to prevent further growth of the public deficit, the stand-by arrangements have followed the usual recipe: reducing government spending (even if that ends up hurting areas like health and education) to meet the lower levels of tax revenue. These arrangements have failed to take into account the temporary nature of the global recession, and that once recovery is under way, revenues will start to rise and the deficits may be reduced.

In the next sections we provide a more detailed analysis of the conditions in each of these three Central and Eastern European countries.

### Hungary: Caught by the International Crisis When Attempting to Cool Down

The case of Hungary is similar to that of Costa Rica in that it also overheated before the global recession hit the local economy.<sup>24</sup> As shown in **Table 1** (under “Original Estimates”), in 2006 the Hungarian budget deficit reached more than 9 percent of GDP, and both the money supply and

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22 See Roubini (2009).

23 See an analysis of Costa Rica in Cordero (2009). Also see Weisbrot, Cordero, and Sandoval (2009), for an analysis of other IMF agreements.

24 The difference is that, in Hungary, the economy peaked in 2006, while in Costa Rica it reached the highest levels in early 2008. See Cordero (2009).



credit increased well beyond the inflation rate. The current account deficit hit 7.5 percent of GDP, but this did not cause much concern, as capital flows were abundant at the time.

**TABLE 1**  
**Hungary: Stand-by Agreement, Selected Economic Indicators**

Economic Indicator	2006	2007	Original Estimates		Revised Estimates	
			2008	2009	2008	2009
<b>GDP Indicators (annual percent change)</b>						
Real GDP	3.9	1.1	1.8	-1.0	0.5	-6.7
Private consumption	1.9	-1.9	0.9	-3.9	-0.1	-6.6
Gross fixed investment	-2.5	0.1	1.0	-0.9	-2.6	-10.3
Exports	19.0	14.2	7.6	2.1	4.6	-15.1
Imports	14.7	12.0	8.1	0.7	4.0	-16.7
Domestic demand	1.3	-1.8			-0.4	-8.0
<b>Balance of Payments (millions euros)</b>						
Current account		-6,510	-6,632	-1,915	-8,902	-3,557
Capital account		1,139	1,384	1,785	1,121	1,840
Financial account		7,100	5,049	-9,393	10,643	-5,995
Errors and omissions (net)		-1,595	-3,751	-2,626	-2,382	-1,622
Prospective financing			2,000	5,500	2,000	5,500
From European Union			2,000	4,500	2,000	4,500
From World Bank			0	1,000	0	500
Bank Guarantee Fund			-1,034	0	0	-2,360
Change in Net Reserves (- denotes increase)		-134	2,984	6,648	-2,479	6,694
<b>Other Information</b>						
CPI (% growth)	3.9	7.9	6.3	4.5	6.1	4.5
Real growth of money	9.9	3.1	-2.2	-3.2	3.1	0.0
Real growth of credit	12.8	10.9			4.5	-5.0
Current account balance (% of GDP)	-7.5	-6.4	-6.2	-2.0	-8.4	-4.1
General government overall balance (% of GDP)	-9.3	-4.9	-3.4	-2.5	-3.3	-3.9
Unemployment (%)	7.5	7.4	7.8	8.5	7.8	8.9
Gross official reserves (million euros)		16,385.0	19,479.0	19,830.0	24,040.0	22,401.0
Gross external debt (percent of GDP)		97.2	106.4	115.8	119.8	138.8
Gross official reserves in percent of short-term debt at remaining maturity (million euros)	123.6	88.9	67.2	79.5	85.0	80.5
Share of foreign currency loans in total credit to:						
Corporations (%)	47.1	52.6			60.3	
Households (%)	46.8	59.0			70.7	
Other loans (%)	75.4	81.7			87.2	

Source: IMF(2008).

A 2007 IMF Article IV Consultation report<sup>25</sup> suggests that the Fund's main concerns about this economy are the size of the government deficit and the need for fiscal reform to promote economic growth. The Fund's insistence on the fiscal balance (as opposed to financial sector reform, for example) is clear when they write that with high debt levels vulnerabilities remain, but: "The cost is

25 IMF (2007b).

borne not as visible financial crises ... The erosion of Hungary's growth potential coincides with its fiscal deterioration..." The IMF then argues that, in order to realize the potential of entry into the European Union: "pushing ahead with ongoing efforts to restore public finances ... will pay early dividends and allow competitive entry into the eurozone."<sup>26</sup>

The Fund's forecasts indicate that it did not anticipate the severity of Hungary's contraction, with its July 2007 projection of just -1.0 percent growth for 2009. Also, about a year before the crisis in Hungary's financial sector, the IMF wrote in its report on Hungary's economy that "the financial sector remains sound."<sup>27</sup>

In order to reduce the fiscal deficit several measures were taken in "reducing public employment, instituting co-payments by patients, rationalizing [sic] hospital beds, and scaling back pharmaceutical subsidies."<sup>28</sup> As a result of these measures, and also due to a recession-induced reduction in demand for imports, as well as higher export revenues, the fiscal balance (as a percent of GDP) rose from -9.3 in 2006 to -4.9 in 2007.

During 2008, the international financial crisis severely reduced Hungarian access to foreign capital, leading to difficulties in the banking system (including foreign banks operating within the country as well as local banks). The results in the financial account of the balance of payments – a deficit of 5.9 billion euros in 2009 (6.6 percent of GDP), as compared to a *surplus* of 10.6 billion euros in 2008 (10.1 percent of GDP)<sup>29</sup> – show how drastically conditions tightened in the international financial environment. Finally, Hungary requested IMF support to help face the crisis in the financial and foreign exchange markets.

The stand-by arrangement signed with the Fund included measures to bring the government deficit, as a percent of GDP, down to 3.4 in 2008, and to 2.5 in 2009, as shown in Table 1.<sup>30</sup> Hungary's projected GDP growth rate fell to only 1.8 percent in 2008, and to -1.0 percent in 2009. As time went by and the crises (both international and domestic) worsened, the estimates were revised. The government deficit would now reach 3.9 percent of GDP (up from the previously estimated 2.5 percent); GDP growth in 2008 would hit about half of one percent in 2008, and -6.7% in 2009.

In Hungary, tolerance for public deficits was limited and the government continued to pursue fiscal restraint. Even though the IMF accepted upward revisions of the fiscal deficit target, the prevailing goal continued to be one of containing spending. This trend has continued in spite of the obvious consequences that the international situation is having on the domestic economy.

At the end of last year, a drastic fiscal responsibility law was approved by the Hungarian parliament; the legislation included strict guidelines on spending. Among those guidelines are that the budget must define a primary balance target two years in advance, and the target cannot be a deficit. Second, the law sets strong guidelines for the evolution of public debt. Finally, every year, the budget must define the extent to which primary expenditures of the central government may change,

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26 See IMF (2007b, p.3). The emphasis on fiscal adjustment is thus very explicit, even vis-à-vis financial sector vulnerability.

27 Ibid, p. 1.

28 Ibid, p. 16.

29 See Table 1.

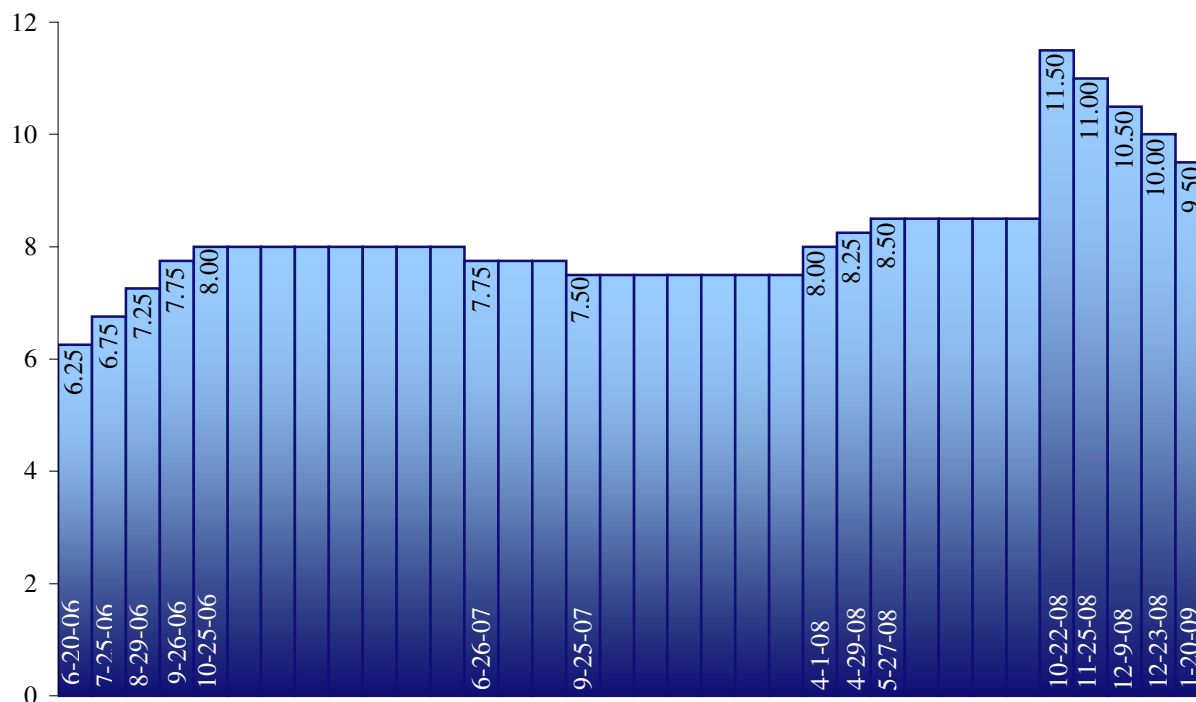
30 See the "original estimates" section in Table 1.

in real value, in the following year.<sup>31</sup> Under these conditions, the government runs out of space to stimulate the economy by means of public spending.

It does not help the Hungarian economy that the fiscal rigidities mentioned above have been accompanied by pro-cyclical monetary policy. As shown in Table 1, money supply continues to grow at a pace that is insufficient to make up for inflation (projected at 0.0 percent in real terms in 2009), and credit shows a similar situation: it is projected to shrink 5.0 percent in real terms in 2009.

As may be seen in **Figure 1**, the policy interest rate<sup>32</sup> stood at 10 percent at the end of 2008, much higher than the 7.5 percent in January 2008, and dramatically higher than the euro area rate of 3 percent. The 9.5 percent in early 2009 still looks much higher than the average for the euro zone.<sup>33</sup> With the fall in Hungary's inflation rate from 6.1 percent in 2008 to a projected 3.9 percent for 2009, real interest rates have increased significantly over the past year, despite the slight cut in nominal rates.<sup>34</sup>

**FIGURE 1**  
Hungary: Changes in the Policy Interest Rate, June 2006-January 2009



Source: Magyar Nemzeti Bank

31 For a more detailed description of the law, see Forbes (2008a).

32 The “policy rate” is a short-term interest rate set (or targeted) by the central bank in order to adjust the availability of money and/or the level of activity in the economy. The policy rate has an effect on the cost of funds in the inter-bank market and may be seen as analogous to the federal funds rate in the U.S.

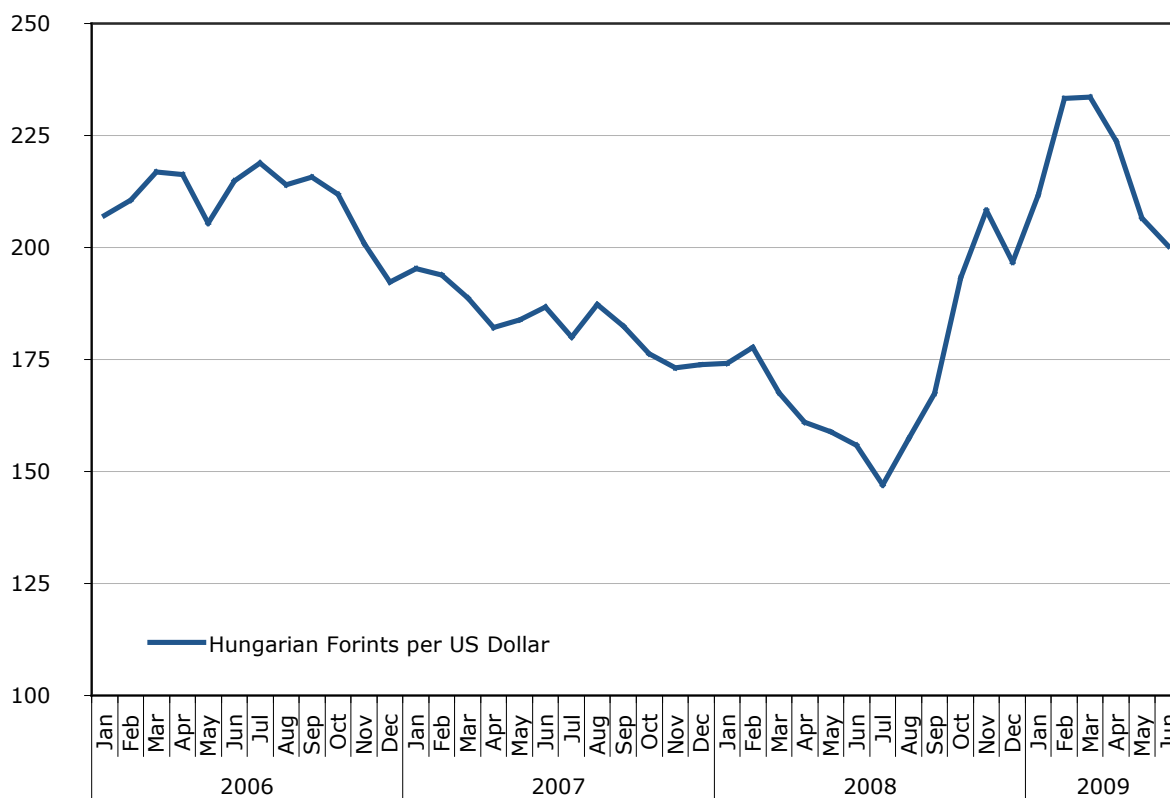
33 See Eurostat (2009).

34 As this article was going through its final revision, the National Bank of Hungary reduced the policy rate, first from 9.5 to 8.5 percent, and then to 8.0 percent. See Magyar Nemzeti Bank (2009).

The support received from the stand-by agreement has not been enough to prevent a worsening recession in Hungary. The unemployment rate is expected to climb above 9 percent in 2009, and economists have begun to fear that the government might miss the fiscal deficit target for this year.<sup>35</sup> Those fears were confirmed in May when the Hungarian Finance Minister announced that the IMF and the European Union had agreed that the fiscal deficit target for 2009 could be raised from 3.0 to 3.9 percent of GDP.<sup>36</sup>

The foreign sector balance continues to deteriorate and pressure has increased on the foreign exchange rate. **Figure 2** shows that, after a period of currency appreciation from October 2006 to July 2008, the forint depreciated sharply from August 2008 to March 2009: the rate of nominal depreciation was almost 60 percent in the eight-month period, and about 19 percent in just the four months from December 2008 to March 2009. With more than two thirds of the loans to the private sector denominated in foreign currency,<sup>37</sup> these depreciation rates clearly caused much damage to the balance sheets of households and firms. The resulting rise in non-performing loans, in turn, poses a threat to the banking sector.

**FIGURE 2**  
**Hungary: Nominal Exchange Rate, Monthly Average**



Source:

Magyar

Nemzeti

Bank

35 realdeal.hu (2009a), and realdeal.hu (2009b).

36 Erste Bank (2009).

37 See Table 1.

Hungary's largest bank, OTP, suffered a 90% decline in its stock value in the seven months prior to April 2009. The bank relied on cheap foreign credit to fuel its growth during the past few years, but faced difficult conditions when the sources of foreign funding shut their doors to them.<sup>38</sup> Of course, the devaluation did not help, and in April the bank accepted a US\$ 1.8 billion government loan (backed by the IMF), on the condition that it increase domestic lending.<sup>39</sup> OTP, which in the prior few years had bought banks in Serbia, Bulgaria, Russia and Ukraine, is also expecting additional funding from the European Bank for Reconstruction and Development.

Funding for OTP was possible probably because of fears that a deeper economic and financial crisis in Hungary could persuade investors to pull their money out of healthier Eastern European nations, such as the Czech Republic and Poland.<sup>40</sup> Another probable reason for continuing support to OTP is that it is considered "too big to fail."<sup>41</sup> Not only is OTP Hungary's largest bank, but also (as mentioned above) it has important operations in other CEE nations; a failure would send shock waves to those areas (which are already facing difficulties from the global slowdown). Hungary's GDP is expected to drop by at least 5 percent this year, but the newly appointed Prime Minister, Gordon Bajnai, has launched an economic agenda that includes "tougher fiscal measures, tax cuts and spending cuts in the budget."<sup>42</sup>

Of course Hungary's political instability has not improved business or investor confidence. At the end of March, Standard and Poor's lowered credit ratings of Hungary to "BBB minus" from "BBB". The ratings agency expected GDP to contract by 6 percent in 2009, and by 1 percent in 2010.<sup>43,44</sup>

The lower rating for Hungarian debt raised fears that the country's debt was "just a step away from falling to junk status."<sup>45</sup> This is definitely not good news for funds that had been attracted to Hungary to help in the process of convergence towards the euro zone, but which are not allowed to invest in sub-investment grade products.<sup>46</sup>

The situation in this Eastern European country thus looks very complicated, with pressure and instability on both the political front and in the financial markets (both local and international), and a combination of pro-cyclical fiscal and monetary policies. Recovery will depend partly on the speed at which the world economy, and especially Western Europe, picks up again; and on the duration and intensity of these pro-cyclical macroeconomic policies.

### **Latvia: Trapped by a Currency Peg**

From 2000 to 2007 Latvia's real GDP growth hit 9 percent per year, the fastest in the European Union. From 2004 to 2007 the annual expansion rate reached over 11 percent, easily one of the very fastest in the world.<sup>47</sup> As in the rest of the CEE region, rapid growth was fueled mostly by easy

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38 See New York Times (2009c).

39 New York Times (2009c).

40 New York Times (2009d).

41 New York Times (2009c).

42 Forbes (2009a).

43 realdeal.hu (2009c). At that time the agency indicated that those indicators suggested something we already know: the government will not be able to meet the proposed deficit to GDP ratio of 2.9 percent in 2009.

44 realdeal.hu (2009d).

45 Forbes (2009b).

46 Ibid.

47 IMF (2009b).

access to credit, especially from Western European sources; lending to households increased more than 60 percent per year in the 2002-2006 period.<sup>48</sup>

**Table 2** below shows that lending rose 51.8 percent in real terms in 2006, clearly providing enough stimulus to overheat the economy. In 2007 the increase in credit, after correcting for inflation, was close to 25 percent, still strong enough to feed a rise in spending. The most worrisome element in this scenario is that it was made possible by foreign credit. In Table 2 we can see that, out of the total loans provided to local residents, 76.9 percent were denominated in foreign currency in 2006; the rate went up to 86.4 and 88.2 percent in 2007 and 2008, respectively.

With such high rates of foreign borrowing, the ratio of Latvian gross external debt to GDP rose from 114.7 percent in 2006 to 134.1 percent in 2008. By 2006, the private sector held 95 percent of foreign debt.<sup>49</sup> In a 2006 Article IV Consultation report, the Fund warned that: “banks exposure to credit and market risks rose, and currency mismatches of households widened.” It continues: “With the real estate sector now accounting for nearly half of total loans, direct and indirect euro exposures have risen sharply.”<sup>50</sup>

These resources were lent mostly by Swedish banks. An IMF report on financial integration in the Nordic-Baltic region indicates that in 2006, two Swedish banks (Swedbank and SEB) controlled between 50 and 75 percent of the credit market in each of the Baltic countries.<sup>51</sup> In 2008, according to the IMF (2009b) the market share of foreign banks in the Latvian banking system (in terms of deposits) was close to 40 percent. Of this share, nearly 30 percent was occupied by Swedish institutions, while the remaining 10 percent went to other Nordic and West European banks.<sup>52</sup>

With the majority of foreign currency liabilities in the hands of the private sector, and high exposure of Swedish banks, the level of the current account deficit (over 22 percent of GDP in both 2007 and 2008) became a cause for concern. A tight situation in the balance of payments increases the risk of a devaluation, and hence the potential for a rise in non-performing loans.

The financial sector is a very sensitive area in the Latvian economy, especially because of the way it is connected to the rest of the system. As shown in Table 2, inflation was moderate in 2006 and even in 2007, but remained above the Maastricht levels, an important benchmark for countries pursuing admission into the Euro area. In 2006 the fiscal deficit was 0.9 percent of GDP, turning into a surplus of a little below 1 percent of GDP in 2007; the domestic balance was manageable.

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48 IMF (2006a).

49 By comparison, the ratio of gross external debt to GDP was 68.1 percent in 2001. In that year 86.8 percent of foreign debt was held by the private sector. See IMF (2006b, p.39).

50 IMF (2006b, p. 11).

51 See Wajid et al. (2007).

52 Measured in terms of assets, the market share of foreign banks in the Latvian banking sector was close to 60 percent, with Swedish banks making up 36 percent of this portion. The remaining 24 percent goes to other Nordic and West Europe banks. See IMF (2009b, p. 7).

**TABLE 2**  
**Latvia: Stand-by Arrangement, Selected Economic Indicators**

Economic Indicator	2006	2007	Original Estimates		Revised Estimates		
			2008	2009	2008	2009	
<b>GDP Indicators (changes in percent)</b>							
Real GDP	12.2	10.3	-2.0	-5.0	-2.3	-9; -12, -18*	
Private consumption	21.2	13.9	-6.3	-7.5	-6.6	-12.5	
Public consumption	4.9	4.8	1.0	-3.0	1.0	-5.0	
Gross fixed investment	16.3	8.4	-10.0	-12.0	-10.0	-15.0	
Exports	6.5	11.1	4.5	-3.0	4.5	-6.4	
Imports	19.3	15.0	-6.1	-9.5	-6.1	-12.1	
<b>Balance of Payments (millions euros)</b>							
Current Account	-3,571	-4,734	-3,217	-1,566			
Capital account	191	410	317	415			
Financial account	4,848	5,185	1,881	-2,583			
Direct investment (net)	465	1,190	1,411	1,046			
Portfolio investment (net)	25	-493	262	-295			
Financial derivatives	46	164	114	114			
Other investments	1,803	3,587		458			
Errors and omissions (net)	101	-146	-327	0			
Prospective financing			500	2,800			
Change in reserve assets (- denotes increase)	-1,569	-714	246	334			
<b>Debt</b>							
Gross external debt (GED, % of GDP)	114.7	134.1	129.2	138.1	127.5	140.7	
Net external debt (GED liabilities minus GED assets and int. reserves; % of GDP)	43.3	51.0	54.6	65.1	51.9	61.1	
Gross general government debt (% of GDP)	9.9	8.3	14.3	33.7	14.5	33.7	
Short-term external debt (original maturity, % of GED)	44.1	43.2	35.9				
GED of domestic private sector (% GED)	94.8	96.0	95.1				
FX deposits held by residents (% of total deposits held by residents)	40.3	46.8	47.1				
FX loans to residents (% of total loans to residents)	76.9	86.4	88.2				
<b>Other Information</b>							
Current account (% of GDP)	-22.5	-23.8	-14.8	-7.3	-13.4	-7.4	
Exports of goods and services (% of GDP)	43.9	43.6	45.3	44.8	44.1	38.5	
Imports of goods and services (% of GDP)	66.2	65.4	59.2	52.0	58.4	46.4	
CPI	6.6	10.1	15.5	5.9	15.3	6.2	
Real growth of money	7.2	0.9	-11.4	-4.6	-15.3	-6.2	
Real growth of credit to non government	51.8	24.1	-2.5	-6.4	-2.3	-11.2	
Fiscal balance (Basic Balance + Bank restructuring, % of GDP)	-0.9	0.7	-5.4	-17.3			
Basic fiscal balance (% of GDP)	-0.9	0.7	-3.0	-4.9	-3.5	-4.9	
Bank restructuring costs (incurred by the government; % of GDP)	0.0	0.0	2.3	12.4			
Unemployment (%)	6.8	6.2	6.7	9.0	6.7	11.1	
Gross official reserves (million euros)	3,439.0	3,966.0	3,720.0	3,386.0			

\*Note: Revision: -9; WEO: -12; Other estimates: -18

Source: IMF (2009b).

In a May 2007 press release, however, the IMF warned, again, that fast credit growth in euros had led to “large currency mismatches on the balance sheets of households and corporations and a boom in housing prices.” Moreover, the release indicates that “recent pressure on the Lats signals growing investor impatience with the limited policy response so far.”<sup>53</sup>

Early in 2008 the country faced a slowdown in foreign lending, particularly due to banks’ growing concerns on exposure to Latvia and its Baltic neighbors. As foreign funding dried up, private consumption and capital formation declined. In turn, the international economic environment contributed to a decline in exports.

Soon tighter conditions in credit markets slowed the real growth of money supply to -11.4 percent and the real growth of credit to -2.5 percent, as can be seen in Table 2. Short-term interest rates rose from 2.9 percent in 2006 to 13.9 percent in 2008; clearly the credit crunch had an important impact in the local financial system.

As seen in **Table 3** (which shows the evolution of the interest rates determined by the Bank of Latvia<sup>54</sup>) the refinancing rate has not changed much from early 2007 to 2009; but the marginal lending facility has seen important adjustments. The latter was set at 7.5 percent in May 2007; but in December 2008 it was decided that the rate would be raised to 15 percent if funds were used between six and ten working days (during the previous 30-day period), and to 30 percent if the funds were used more than eleven working days (during the previous 30-day period).<sup>55</sup>

Tightening conditions in the monetary market are also reflected by the behavior of the Rigibor, which more than doubled from a little over 3.5 percent in the March-August 2008 period to 7.76 percent in December of the same year, as shown in **Figure 3**.<sup>56</sup> In June 2009 the Rigibor passed 17 percent.<sup>57</sup>

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53 IMF (2007c).

54 The equivalent of the “policy rates” we mentioned in footnote 27.

55 In other words, for a commercial bank, the cost of central bank funding today would be a 7.5 percent interest rate if other central bank funds were utilized between 1 and 5 working days during the previous 30-day period (or if no central bank funds were utilized during such period). The rate charged on new funds requested today, however, would increase to 15 percent if in the previous 30-day period central bank funding was utilized between six and ten working days. Similarly, the rate on additional funds would move up to 30 percent if, in the previous 30-day period, funds were utilized more than eleven working days.

56 Rigibor stands for Riga Interbank Offered Rate. The Rigibor is an index of Latvia interbank credit interest rates. Along with the Rigibid (Riga Interbank Bid Rate), these indices are calculated by Latvia’s central bank: the Bank of Latvia.

57 The extreme increase in the Rigibor in June resulted from the Bank of Latvia’s continuing efforts to defend the currency and avoid devaluation (Bloomberg, 2009).



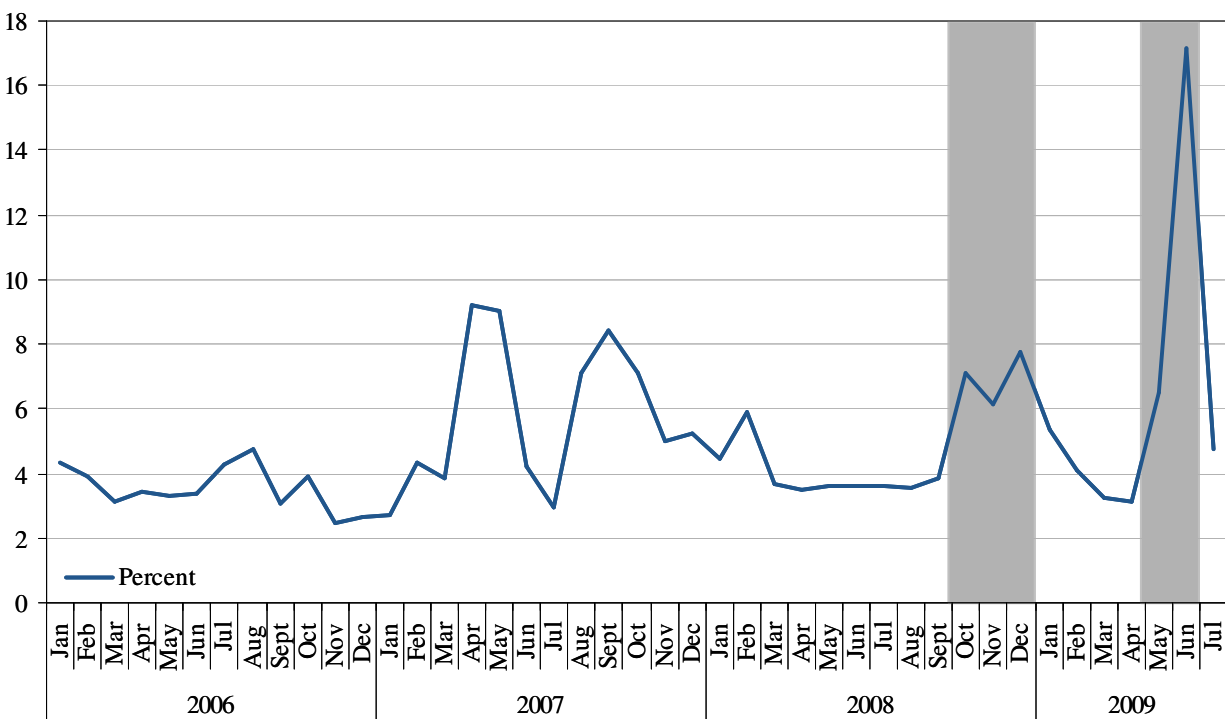
**TABLE 3**  
**Latvia: Evolution of Interest Rates Set by the Bank of Latvia**

Effective Date	Refinancing Rate <sup>1</sup>	Lombard Rates <sup>2</sup>		
		Until the 10th day	11th to 20th day	Over 20 days
July 15, 2006	4.5	5.5	6.5	7.5
Nov. 17, 2006	5.0	6.0	7.0	8.0
Marginal Lending Facility				
Mar. 24, 2007	5.5	6.5		
May 18, 2008	6.0	7.5		
Marginal Lending Facility				
		Up to 5 working days within previous 30 day period	6-10 working days within previous 30 day period	11 or more working days within previous 30 day period
Sept. 12, 2008	6.0	7.5	15.0	30.0
Mar. 24, 2009	5.0	7.5	15.0	30.0

Notes: 1) Refinancing rate refers to the rate at which commercial banks borrow from the Bank of Latvia, provided they do not borrow large amounts and have adequate collateral. 2) Lombard rates were applied to funds borrowed from the Bank of Latvia for up to a month. As of March 24, 2007 this option was replaced by the marginal lending facility, which stipulates loan repayment on the next day (see Bank of Latvia, 2007).

Source: Bank of Latvia

**FIGURE 3**  
**Latvia: Interbank Offered Rates (RIGIBOR)<sup>1</sup>: Overnight Rates**



Note: 1. The Rigibor is an index of interbank credit interest rates.

Source: Bank of Latvia

According to the IMF (2009b), during the second half of last year Parex, the second largest bank in the country, suffered a run that caused the loss of about a quarter of its deposits. Overall, the banking system lost 10 percent of deposits, and the central bank responded by providing additional liquidity to the system.

Towards the end of the year the government acquired 51 percent of Parex. However, this move failed to provide clients with the needed security and it became necessary for the government to provide additional liquidity.<sup>58</sup> Meanwhile, the central bank continued to lose international reserves.

To address the deepening financial and balance of payments crisis, Latvian authorities sought IMF support, a move that was also intended to help restore foreign investors' confidence on the economy.

On December 23, the IMF approved a stand-by arrangement, providing Latvia US\$2.4 billion. It also allowed the country to receive US\$4.3 billion from the European Union, US\$2.5 billion from the Nordic countries, and almost one billion additional dollars from various other sources.<sup>59</sup> In exchange for this support, the Latvian authorities committed to reductions in government spending, measures to restore depositor confidence, and the pursuit of external stability.

Last year, GDP growth fell to -2 percent (later revised to -2.3 percent). The government authorities expected a 5 percent GDP contraction in 2009, while the World Economic Outlook projects a 12 percent decline. By some estimates, the Latvian economy will contract by as much as 18 percent this year – much deeper than the IMF's projection as of January 2009 of -5 percent.<sup>60</sup> The fiscal targets for 2009 probably will not be attained, especially due to the decline in revenues that will accompany such a deep economic contraction.

In spite of the pressures on the balance of payments, the government and the European Union have insisted on maintaining the currency peg.<sup>61</sup> This insistence on keeping the peg is based on concerns about adverse balance sheet effects on households and firms, and on the need to adhere to Europe's fixed exchange-rate orthodoxy, especially with regard to the goal of joining the European union.

Latvia's exchange rate regime is based on a currency board system (comparable to the one Argentina had from 1992 through the early 2000s).<sup>62</sup> Under this framework, the money supply is backed by foreign exchange reserves. Monetary policy is aimed at maintaining the peg: the central bank must absorb the excess supply of foreign currency, and satisfy excess requirements when they arise. Clearly, under excessive pressure in the foreign exchange market, the central bank must step in and

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58 Straits Times. Breaking News. (2008).

59 The sources providing the additional US\$1 billion include the World Bank, the Czech Republic, the European Bank for Reconstruction and Development, Estonia, and Poland. See IMF (2008b).

60 The Local (2009a).

61 See, for example, IMF (2009b).

62 In January 1, 2005, the Bank of Latvia fixed the rate of the Lats to the euro at EUR 1=LVL 0.702804. As of that date: "the Bank of Latvia will unilaterally limit the lats' exchange rate against the euro to +/- 1% of the central rate". Bank of Latvia (2009a).

utilize international reserves to maintain the parity. As international monetary reserves decline, the money supply falls, thereby contributing to the downturn in economic activity.<sup>63</sup>

More recently, maintenance of the peg has caused even greater difficulties. On June 2nd the Latvian treasury was unable to sell US\$100 million in short-term debt in a public auction.<sup>64</sup> The failure raised fears that the government would not be able to hold the peg, but it also sent waves of concern to other emerging markets, as nervous investors could become more reluctant to provide money to those markets as well.

The situation is also a major concern for Swedish banks, whose exposure to the Baltic region amounts to about 19% of Swedish GDP.<sup>65</sup> The failed auction by the Latvian government triggered a decline in the stock value of several banks in Sweden and one in Norway, but the decline was particularly severe in two Swedish banks: Swedbank and SEB. While Riksbank (the Swedish Central Bank) expects the Swedish banks to lose some US\$22.5 billion in 2009 – mostly as a result of their activities in the Baltic region – it also claims that they have enough capital to weather the situation.<sup>66</sup>

The Latvian Prime Minister continues to rule out the devaluation option on the grounds that it will have severe social consequences, especially because of the high percentage of consumer and enterprise credit that is denominated in foreign currency. Recently the prime minister stated that he expected to receive an additional injection, totaling 1.2 billion euros, from the IMF and the European Union in July of this year.<sup>67</sup>

The pressure on the Lats has become so strong that Latvia's premier, while ruling out devaluation, conceded that if devaluation were to occur, it definitely would not be less than 15 percent; he added that it would likely be around 30 percent.<sup>68</sup>

The bottom line in the case of Latvia has been, in spite of the tremendously adverse local situation, a combination of pro-cyclical fiscal and monetary policy. With a huge current account deficit, but literally no access to foreign funding, and with a currency board system, the money supply has contracted. The IMF has recommended drastic reductions in government spending in order to reduce the fiscal deficit (or prevent it from growing), and in order to take pressure off the current account deficit and the balance of payments.

We may ask what policy options are available to prevent further deepening of the recession in Latvia. First, the currency peg system in place completely rules out the possibility of using

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63 In order to defend the currency (and the exchange rate peg) the central bank sells foreign currency at a given price. In the process the central bank receives local currency (lats) which are thus taken out of circulation. As a result the money supply decreases and spending falls, thus aggravating the economic downturn.

64 The Local (2009a).

65 See, for example, Stratfor: Global Intelligence (2009). Of course, other actors remain vulnerable to the situation in CEE countries: according to Evans-Pritchard (2009c) Austria's exposure (mostly to Central Europe and Ukraine) amounts to 70% of GDP.

66 The Local (2009b).

67 Forbes (2009c).

68 See Evans-Pritchard (2009b).

expansionary monetary policy (instead, the money supply tends to decline as a result of the continuing deterioration of the balance of payments).<sup>69</sup>

Second, maintaining the peg also prevents the government from allowing its currency to depreciate, which would not only stimulate growth but also adjust the current account, as exports become cheaper and imports more expensive. The preclusion of this policy option means that the only way to bring the current account deficit under control, with standard policy tools, is to shrink the economy. This reduces the current account deficit by reducing imports more quickly than exports fall. This is very similar to the case of Argentina during its severe recession of 1998-2002 – which in hindsight can be seen clearly as a grave mistake, as the currency eventually collapsed anyway, enabling a rapid and robust six year recovery to begin a few months later.

Third, expansionary fiscal policy is made more difficult because, with declining revenues (due to the recession), it is more difficult for the government to undertake projects with large multiplier effects. And it certainly cannot request central bank funding (as other governments are doing to fight the downturn), because of the currency board system.

Finally, authorities could resort to capital controls,<sup>70</sup> but that option (while quite effective in some cases) seems to be out of fashion these days, and the Latvian government has not mentioned this alternative. The IMF, on the other hand, has generally advised against such measures.<sup>71</sup>

In the end, the foreign exchange regime has left Latvia without policy options. The currency peg has led to a one-way road in which pro-cyclical monetary policy (itself resulting from the peg) reinforces pro-cyclical fiscal policy. The adjustment process is basically one in which unemployment in the local market forces wages down to the extent required to increase the competitiveness of exports. Even if it were to reduce the current account deficit, the social costs associated with this option are enormous, and are already being paid by the Latvian people, as various programs have been cut and public employment continues to fall. This process also undermines political stability, as we have seen already in this and other countries in the region.

Recent information on Latvia indicates that the government's economic advisors (the IMF and the European Union) see no reason to reconsider the peg.<sup>72</sup> As an example, Joaquín Almunia, Commissioner for Economic and Monetary Affairs of the European Commission, has been quoted as saying, in an interview: "everything should, and is, being done to avoid devaluation of the lat". He also said, in the same interview that: "budget cuts in Latvia were absolutely crucial and similar cuts will have to be made in 2010."<sup>73</sup>

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69 In a well functioning currency board regime the money supply is backed (and determined) by international monetary reserves. The system's requirement that the central bank does not intervene in the monetary market increases vulnerability to external shocks. Thus, in order to provide additional liquidity, if the need arises, central banks tend to hold foreign exchange reserves in excess of the monetary base. These excess reserves, however, may be depleted when the currency has to be continuously defended against the possibility of depreciation. See Bie and Hahnemann (2000).

70 Capital controls are mostly designed to impose restrictions on the amount of foreign currency that may leave (or enter) the economy.

71 See IMF (2009c).

72 Guardian (2009).

73 The quote was taken from *Latvijas Avize*, a Latvian newspaper which published an interview with Almunia last June 18th. The translation to English appears on the web site of the Commissioner for Economic and Monetary Affairs of the European Commission.

[http://ec.europa.eu/commission\\_barroso/almunia/presscorner/interviews/2009/press\\_interviews\\_en.html](http://ec.europa.eu/commission_barroso/almunia/presscorner/interviews/2009/press_interviews_en.html)

But the Latvian authorities have already imposed a very heavy adjustment burden on the people's shoulders. In addition to the nearly 18 percent decline in GDP, budget cuts have led to reductions in education, wages, pensions, and various social services. As indicated, more of these are yet to come, that is, if the Latvian government wants to please the European Commission, and thus maintain options to enter the Euro area some time soon.

Meanwhile, the IMF stands behind the European Commission's insistence on the peg. Olivier Blanchard, Chief Economist of the IMF, recently indicated to Reuters that: "The basis of the programme so far has been that this was going to be a programme with a peg". He added: "The programme has the peg, at this time we have no reason to reconsider."<sup>74</sup>

A devaluation of the Lat, the opposition of the European Union notwithstanding, could provide much needed support for an increase in exports, and by reducing wages (measured in foreign currency) it would also favor prospects for direct investment from abroad. This devaluation would surely hurt the Latvian households' balance sheets and the Nordic banks, and would probably shake other countries in Eastern Europe, but it may very well be the fastest and best route to economic recovery, and stop the current free-fall of the economy.

A devaluation could not only stop the downward spiral but could also help stabilize government revenues. These revenues could eventually be applied to find ways to restore the equity lost by households as a result of devaluation. Meanwhile, the European Union and the IMF could put aside their insistence on budget balance and concentrate on helping the government mitigate the adverse effects that the crisis is having on the vulnerable sectors of the population.

### **Ukraine: Pro-cyclical Policies and Political Tension**

Ukraine's GDP grew more than 12 percent in 2004; in 2005 the expansion was more moderate (2.7 percent), but in 2006 and 2007 growth was strong again, exceeding 7 percent each year.<sup>75</sup> The future looked promising even during the first eight months of last year, with GDP growth reaching 6.3 percent and the government budget showing a surplus; the current account balance posted a deficit, but it was easily financed with capital inflows.<sup>76</sup>

During the years of high growth, easy lending conditions fueled a property boom that turned Kiev, the capital, into an "Asia-style" boom town. An overvalued currency, low interest rates, and an opening of the financial sector led to a significant increase in foreign debt (within both the public and private sectors).<sup>77</sup> As shown in **Table 4**, total external debt exceeded 50 percent of GDP in 2008, and was expected to reach almost 80 percent in 2009. The table also shows that in 2006 and 2007, more than half the loans provided by the Ukrainian banking sector were denominated in foreign currency, while the rate jumped by almost one third in 2008 (and is expected to remain at that level in 2009). In 2008 the share of the public sector gross debt exposed to foreign exchange risk reached 69.3 percent.

Towards the end of 2008, the global slowdown hit this economy very hard and, in just the fourth quarter, GDP fell 8 percent, and industrial production contracted over 25 percent from November

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74 Forexpros.com (2009), and Guardian (2009).

75 IMF (2008c).

76 Segura (2009).

77 See McElroy and Wall (2008).

to December; exports fell 16 percent in those two months.<sup>78</sup> The situation worsened considerably during January and February 2009: industrial output decreased 32 percent and exports dropped 38 percent, while construction declined by 57 percent.<sup>79</sup> Annual GDP growth rates for 2008 and 2009, originally expected to reach 2.1 and -3.0, respectively, are now projected at 2.1 and -9.0 percent respectively.<sup>80</sup>

The crisis had two major determinants. First, a terms-of-trade shock was caused, on the export side, by a sharp decline in the price of steel (a major export of Ukraine); and on the import side, a significant increase in the price of gas. Russia's decision to reduce the gas subsidy was expected to increase the cost of gas imports from US\$180/tcm to US\$330/tcm.<sup>81,82</sup>

Second, the international environment caused a reversal of capital flows, threatening liquidity in the banking system; as shown in Table 4, the financial and capital account showed a balance of over US\$15 billion in 2007, which went down to a little over US\$7 billion in the following year. The projection for 2009 was a negative balance of more than US\$8 billion.

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78 See World Bank (2009).

79 See World Bank (2009) and Segura (2009).

80 See Table 7 and World Bank (2009).

81 See IMF (2008c).

82 And of course, it has not helped that "Ukraine has one of the highest levels of energy intensity in the world." See Energy Information Administration (2007).

**TABLE 4**  
**Ukraine: Stand-by Agreement, Selected Economic Indicators**

Economic Indicator	2006	2007	Original Estimates		Revised Estimates	
			2008	2009	2008	2009
<b>Real, Monetary and External Sectors (change in %)</b>						
Real GDP	7.3	7.9	6.0	-3.0	2.1	-9.0
Consumption	12.4	13.6			9.0	-18.8
Fixed investment	21.2	23.9			1.6	-31.4
Exports	-5.6	3.3			5.2	-10.1
Imports	6.8	21.5			17.1	-34.3
Current account (% of GDP)	-1.5	-3.7	-6.2	-2.0	-7.2	0.3
CPI	11.6	16.6	25.5	17.0	22.3	16.4
Broad money	34.5	51.7	37.2	9.4	30.2	3.8
Real growth in money	22.9	35.1	11.7	-7.6	7.9	-12.6
Short-term interest rate (% , overnight interbank rate)	2.1	3.8	15.0		12.9	47.3
Credit to nongovernment	70.6	74.0	40.9	-9.8	72.1	7.8
Real growth of credit	59.0	57.4	15.4	-26.8	49.8	-8.6
<b>Government</b>						
General government overall balance (% of GDP), including banks recapitalization	-1.4	-2.0	-2.0	-4.5	-3.2	-9.0
General government overall balance (% of GDP), excluding bks recap	-1.4	-2.0	na	0.0	-3.2	-4.0
Public sector gross debt (PSGD, % of GDP)	15.7	12.9	10.6	19.9	32.5	
PSGD exposed to exchange rate risk (% of PSGD)	15.7	13.0	69.3			
<b>Balance of Payments (millions U.S.\$)</b>						
Current account	-1,617	-5,272	-11,666	-2,703		
Financial and capital account	4,088	15,130	7,193	-8,092		
Direct investment and capital transfers	5,740	9,221	11,659	9,204		
Portfolio investment	2,822	4,423	64	614		
Bonds and medium and long-term loans (net)	6,406	15,763	8,284	-5,386		
Short-term capital (net)	-10,888	-14,277	-12,814	-12,523		
Gross official reserves (- denotes increase)	-1,999	-8,980	138	718		
<b>Other Information</b>						
Gross international reserves (millions USD)	22256.0	32463.0	31445.0	30727.0		
Total external debt (% of GDP)	49.7	57.8	54.3	78.2		
Foreign currency loans to total loans (%)	49.4	49.8	57.5	60.0		

Source: IMF (2008c).

From October 2008 to March 2009 the National Bank of Ukraine lost US\$14 billion in reserves, in a rather unsuccessful effort to defend the currency.<sup>83</sup> The unavoidable exchange rate depreciation turned the current account deficit into a surplus last January, but it has hurt borrowers<sup>84</sup> and encouraged capital outflows as depositors fled the Ukrainian banking system to safer institutions in

<sup>83</sup> World Bank (2009).

<sup>84</sup> The share of non-performing loans in the banking system is higher than in other countries (Segura, 2009). Also see in Table 5 the extent of currency depreciation against the US dollar and the euro.

Western Europe.<sup>85</sup> Of course, for borrowers, devaluation caused an increase in the value of their debt (in terms of hryvnia) which led to severe balance sheet losses (see **Table 5**).

**TABLE 5**

**Ukraine: Official Exchange Rate of Hryvnia vs. the Euro and the US Dollar, Average for Each Period (2006-2009)**

Currency	2006	2007	2008	2009					
				Jan.	Feb.	Mar.	Apr.	May	June
100 US Dollars	505.00	505.00	526.72	770.00	770.00	770.00	770.00	765.30	761.58
100 Euros	636.69	691.79	770.80	1029.04	985.86	1004.56	1017.52	1039.05	1066.93

Source: National Bank of Ukraine

In order to face the adverse economic conditions (both internal and external), the government requested a stand-by arrangement with the IMF, which was approved in November 2008. The IMF agreement provided for a zero fiscal balance. This was later relaxed to a deficit of 4.0 percent of GDP. Ukraine's total public debt is low – just 10.6 percent of GDP, so it would make sense to borrow in order to finance an expansionary fiscal policy and reduce the severity of the recession. It is worth noting that the Fund also greatly underestimated the depth of Ukraine's recession, with its December 2008 forecast of a decline of 3.0 percent of GDP for 2009. The proposed program included a tighter stand on monetary policy and conservative fiscal management. The latter was based partly on the reduction of energy subsidies and postponement of a raise in pension payments.<sup>86</sup>

Interest rate policy has been conducted to maintain the inflation projections within reach. As seen in **Figure 4**, the discount rate has remained at 12 percent since April 2008, and the average rate for all policy instruments has moved from 15.3 percent in January 2008 to 17.2 percent in April 2009, in spite of the severe downturn in the economy.<sup>87</sup>

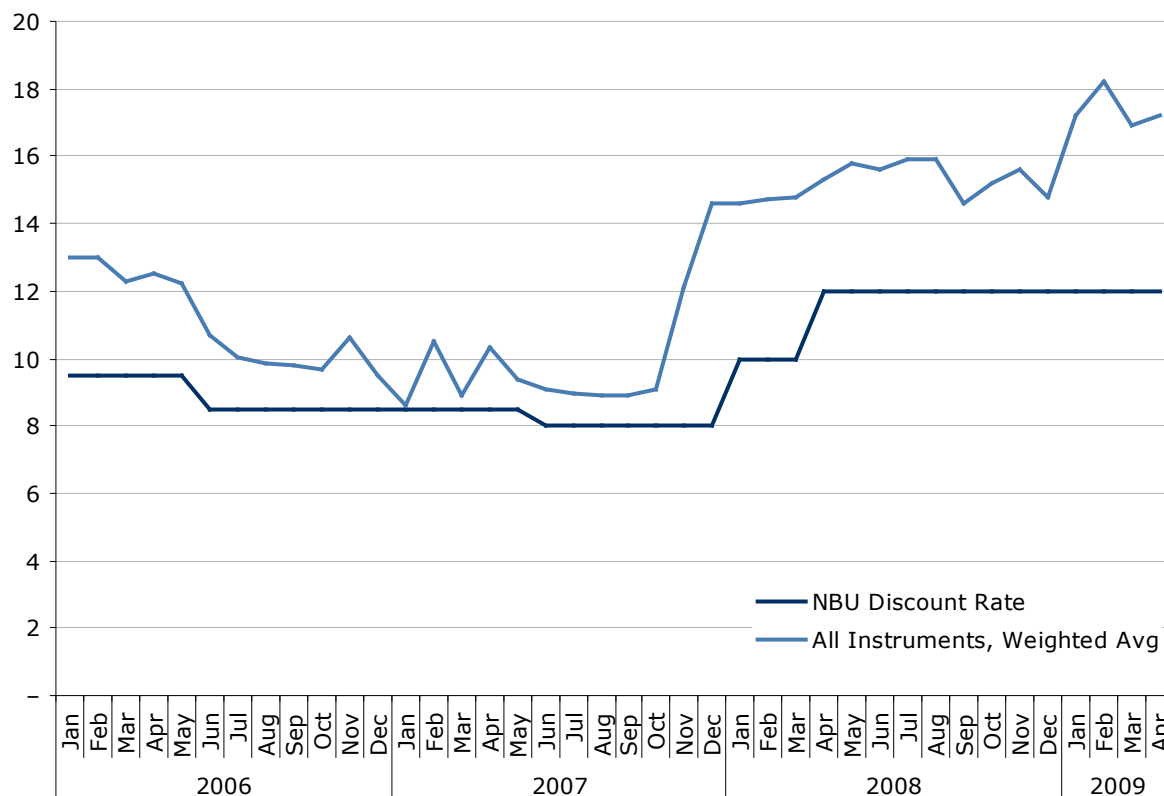
<sup>85</sup> World Bank (2009) and World Bank (2008).

<sup>86</sup> IMF (2008c).

<sup>87</sup> The weighted rates in December, November and October 2008 were 14.6, 12.1, and 9.1, respectively.



**FIGURE 4**  
**Ukraine: Refinancing Rates, Monthly Averages**



Source: National Bank of Ukraine

However, the true extent of the tightness in the monetary policy is shown by the projected rates of real growth of money supply and credit (as shown in Table 4). Clearly, liquidity and credit are growing more slowly than inflation. With production declining there will be plenty of room to accommodate more aggregate spending. It is true that part of the additional spending could go to more imports and thus affect the balance of payments situation, but it is also true that the IMF (and perhaps other multilateral sources) are more than capable of providing enough support to prevent a full-fledged balance of payments crisis.

So far the stand-by arrangement has made it difficult to Ukraine to adjust to unfavorable international conditions. Moreover, the Fund's insistence on reforms in sensitive issues has led to a clash between the most important political forces in the country: Prime Minister Tymoshenko and President Yushchenko. As an example, earlier this year the IMF declined to release the second tranche of the loan provided to Ukraine under the stand-by agreement, on the grounds that the fiscal deficit was not low enough. While the President has supported the pursuit of a balanced budget, the Prime Minister has insisted on the need to maintain social spending.<sup>88</sup> The resulting conflicts have not helped decision-making on the needed economic policies; meanwhile, the recession has continued its course.

<sup>88</sup> New York Times (2009f).

## Conclusion

We have analyzed the current situation of three CEE countries. They have been severely hit by the ongoing global recession, and have turned to the IMF in order to restore the normal operation of their economies.

The policy recommendations derived from the IMF stand-by arrangements, however, are mostly pro-cyclical and will make it difficult for these governments to stimulate their economies. In Hungary, a drastic public austerity law puts severe limitations on the use of counter-cyclical fiscal policy; in Latvia, insistence on maintaining a pegged exchange rate is imposing a heavy burden of adjustment through contraction of the economy, and in Ukraine, political tensions have made it difficult to move away from the pro-cyclical policies recommended in the IMF agreement.

In the cases in which the Fund has allowed certain room to increase the fiscal deficit, it has been within the framework of a tight monetary policy; as a result, government spending (though still insufficient) cannot have a positive impact on the economy. This result is in line with recent empirical evidence showing that the size of the government spending multiplier may be adversely affected by a restrictive monetary policy.<sup>89</sup>

In all of these countries, it would appear that there were more sensible responses to the crisis that would reduce the loss of employment and output, cuts in social services, and political instability that have resulted from the downturn. It is worth emphasizing that the main constraint for these countries pursuing expansionary fiscal and monetary policies, particularly in a time of falling inflation, is that they have sufficient foreign exchange to avoid a balance of payments problem. The IMF, especially with its vastly expanded resources, is capable of providing the necessary foreign exchange to allow for counter-cyclical policies – yet it has opted instead for pro-cyclical policies in these countries.

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89 See Christiano, Eichenbaum, and Rebelo (2009).

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