Developments in Selected Countries

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1 Introduction

In the first quarter of 2005, real GDP growth in the Czech Republic, Hungary, Poland, Slovakia and Slovenia ranged between 2.6% and 5.1% year on year. Compared to the full year 2004, economic performance turned out to be weaker in most of these new Member States (NMS), while growth remained unchanged in the Czech Republic. The two candidate countries, Bulgaria and Romania, and Russia grew more strongly than the NMS, whereas Croatia lagged behind. However, these countries, with the exception of Bulgaria, also reported lower growth rates in the first quarter of 2005 compared to the full year 2004. In most countries under review the growth rate of private consumption decelerated in the first quarter of 2005 against the full year 2004, with the strongest declines being observed in Poland and Russia. The decline of consumption growth in most NMS resulted from lower real wage growth in the second half of 2004 and the beginning of 2005, as the inflationary impact of EU accession and energy price increases was not or only partially reflected in nominal wage growth. In Slovakia, Bulgaria and Romania, private consumption growth was stronger than in 2004. The highest acceleration of consumption growth took place in Slovakia and Bulgaria, while in Romania private consumption continued to grow at a double-digit growth rate (12.5%), more strongly than in the other countries under review. In these three countries, real wage growth had accelerated already by the end of 2004. In all countries with the exception of Slovakia, the growth rate of gross fixed capital formation decelerated in the first quarter of 2005; in Slovenia, it even turned negative (–0.5%) from a positive rate of 6.8%. Furthermore, Croatia had to cope with a noticeable slowdown of gross fixed capital formation growth (2004: 4.4%, first quarter of 2005: 0.3%). The slowdown in gross fixed investment growth resulted from the decline in consumption growth and from the weakening of export growth that was attributable to lower economic growth in the euro area and significant currency appreciation in some countries.

Table 1

Gross Domestic Product (Real)

Annual change in %	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
Czech Republic	1.2	3.9	2.6	1.5	3.2	4.4	4.6	4.4
Hungary	4.2	5.2	3.8	3.5	2.9	4.2	4.1	2.9
Poland	4.1	4.0	1.0	1.4	3.8	5.4	4.0	2.1
Slovakia	1.5	2.0	3.8	4.6	4.5	5.5	5.8	5.1
Slovenia	5.6	3.9	2.7	3.3	2.5	4.6	4.3	2.6
Bulgaria	2.4	5.4	4.1	4.9	4.5	5.6	6.2	6.0
Croatia	–0.9	2.9	4.4	5.2	4.3	3.8	3.6	1.8
Romania	–1.1	2.0	5.6	5.1	5.3	8.4	9.7	5.9
Russia	6.3	9.0	5.1	4.7	7.3	7.2	6.4	5.2

Source: Eurostat, national statistical offices, wiiw.

The combination of both weaker domestic demand and lower export growth led to import growth falling more than export growth and hence to an improvement in the contribution of net exports to GDP growth in the five Central European NMS. In the Czech Republic, the contribution of net exports to

GDP growth turned from just 0.4 percentage point in the full year 2004 and –1.2 percentage points in the first quarter of 2004 to 4.1 percentage points in the first quarter of 2005[1]. This more than compensated the decline in domestic demand growth and thus prevented GDP growth from falling. By contrast, the three EU candidate countries under review showed more negative contributions of net exports to GDP growth in the first quarter of 2005 than in the full year 2004. In Romania, the negative contribution even increased significantly (from –2.8 percentage points in the full year 2004 to –6.0 percentage points). Also in Bulgaria, the contribution of net exports to GDP growth was strongly negative in the first quarter of 2005 (–5.4 percentage points) – worse than in the full year 2004 (–3.9 percentage points), but significantly better than in the first quarter of 2004 (–11.3 percentage points).[2]

In the first quarter of 2005, the inflation rate (measured by changes in the period average HICP in all countries with the exception of Croatia and Russia, where inflation is based on CPI) declined in most countries compared to the full year 2004. In all new EU Member States but Hungary, inflation decreased further in the second quarter of 2005 and ranged between 1.2% and 3.6% year on year. Of all countries under study, only Russia reported double-digit inflation rates. In Romania, inflation declined to a single-digit rate in the last quarter of 2004 and in the first half of 2005 remained at or below 10% year on year. In the NMS, inflation decelerated strongly in 2005, as inflation-driving factors related to EU accession in 2004 led to favorable base effects in 2005 and no (substantial) inflationary second-round effects were recorded. Furthermore, the disinflation process was supported by strong currencies, falling unit labor costs in industry and a moderation of inflation expectations, despite further upward pressure from international energy prices.

Table 2

Consumer Price Index (here: HICP)

Annual change in %	2000	2001	2002	2003	2004	Q1 05	Q2 05
Czech Republic	3.9	4.5	1.4	–0.1	2.6	1.4	1.2
Hungary	10.0	9.1	5.2	4.7	6.8	3.5	3.6
Poland	10.1	5.3	1.9	0.7	3.6	3.6	2.2
Slovakia	12.2	7.2	3.5	8.5	7.4	2.6	2.4
Slovenia	8.9	8.6	7.5	5.7	3.6	2.8	2.2
Bulgaria	10.3	7.4	5.8	2.3	6.1	3.8	4.9
Croatia[1])	6.4	5.0	1.7	1.8	2.1	3.1	3.1
Romania	45.7	34.5	22.5	15.3	11.9	8.9	9.9
Russia[1])	20.8	21.6	16.0	13.6	11.0	12.9	13.4

Source: Eurostat, national statistical offices, wiiw.

[1]) CPI.

[1] *Revised data for the first quarter even show a contribution of 5.7 percentage points.*

[2] *Shortly after the cutoff date of this contribution, (preliminary) results for GDP growth in the second quarter of 2005 were released in the five Central European NMS. With the exception of Slovakia, all these countries posted higher year-on-year growth rates in the second than in the first quarter (Czech Republic 5.1%, Hungary 4.1%, Poland 2.8%, Slovakia 5.1%, Slovenia 5.2%). In Hungary, Poland and Slovenia, higher GDP growth was attributable to higher export and lower import growth, while in the Czech Republic import growth decreased more strongly than export growth. The fact that domestic demand contracted (or, in Slovenia, stagnated) stood behind the decline in import growth in these four countries; hence, the (higher) GDP growth resulted exclusively from the (higher) contribution of net exports to GDP growth.*

Both Standard & Poor's and Moody's continue to award Slovenia (AA–/AA3) the highest rating for sovereign long-term foreign currency debt among the countries discussed in this contribution. The Czech Republic and Hungary share the second-highest rating by both agencies (A–/A1). Additionally, Standard & Poor's ranks Slovakia equal to the Czech Republic and Hungary. Moody's upgraded Slovakia to rank three (A2) in January 2005 and continued to place Poland at the same level. At present, both agencies rank Croatia right after the NMS (BBB/Baa3) and higher than Bulgaria (BBB–/Ba1) and Romania (BBB–/Ba1). Standard & Poor's upgraded the rating for Croatia in December 2004; Moody's upgraded Romania's rating in March 2005 and Standard and Poor's in September 2005.

Table 3

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt

Currency	Moody's			Standard & Poor's		
	Former rating	Last change	Current rating	Former rating	Last change	Current rating
CZK	Baa1	12.11.02	A1	A	05.11.98	A–
HUF	A3	12.11.02	A1	BBB+	19.12.00	A–
PLN	Baa1	12.11.02	A2	BBB	15.05.00	BBB+
SKK	A3	12.01.05	A2	BBB+	13.12.04	A–
SIT	A2	12.11.02	Aa3	A+	13.05.04	AA–
BGN	Ba2	17.11.04	Ba1	BB+	24.06.04	BBB–
HRK		27.01.97	Baa3	BBB–	22.12.04	BBB
RON	Ba3	02.03.05	Ba1	BB+	06.09.05	BBB–
RUB	Ba2	08.10.03	Baa3	BB+	31.01.05	BBB–

Source: Bloomberg.

2 Czech Republic: Solid Economic Performance with Favorable External Conditions and a Strong Currency

In the Czech Republic, real GDP growth was 4.4% year on year in the first quarter of 2005 – the same as in the full year 2004 and marginally below GDP growth in the last quarter of 2004. In 2004 the growth rates of private and public consumption declined from quarter to quarter, resulting in growth rates of 1.7% and –3.9%, respectively, in the last quarter of 2004 (full year 2004: 2.1% and –2.0%, respectively). The composition of growth in the first quarter of 2005 was in parts similar to the one of the last quarter of 2004. In the first quarter of 2005 growth of private and public consumption was only marginally lower than in the last quarter of 2004, whereas the growth rate of gross fixed capital formation moderated from 7.0% to 5.5% (full year 2004: 7.6%). Remarkably, after the negative contribution of net exports to growth in the first nine months of 2004 (–0.8 percentage point), the contribution was strongly positive in the last quarter of 2004 (4.0 percentage points). In the first quarter of 2005, lower export growth than in the last quarter of 2004 went hand in hand with lower import growth rates. This resulted in an even slightly higher contribution of net exports to GDP growth (4.1 percentage points) than in both the previous quarter and the first quarter of 2004, leaving external trade at the forefront of growth drivers.

Table 4

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	1.2	3.9	2.6	1.5	3.2	4.4	4.6	4.4
Private consumption	2.1	2.9	2.6	2.8	4.6	2.1	1.7	1.4
Public consumption	5.4	0.2	3.8	4.5	3.8	–2.0	–3.9	–3.8
Gross fixed capital formation	–3.5	4.9	5.4	3.4	4.7	7.6	7.0	5.5
Exports of goods and services	5.5	16.5	11.5	2.1	7.5	21.9	23.0	17.9
Imports of goods and services	5.0	16.3	13.0	4.9	7.9	18.4	15.5	12.1
	Contribution to GDP growth in percentage points							
Domestic demand	1.3	5.0	4.9	4.2	4.6	4.1	0.7	0.4
Exports	3.4	10.8	8.5	1.7	6.1	18.6	20.9	16.5
Net exports	–0.1	–1.1	–2.2	–2.7	–1.3	0.4	4.0	4.1

Source: Eurostat, OeNB.

In the first quarter of 2005, the unemployment rate (ILO definition) stood at 8.4% and was somewhat lower than the five-year peak of 8.8% of the corresponding 2004 period. In the same quarter, the employment rate increased slightly to 64.1% against 63.7% in the comparable period of 2004. In 2004, industrial production growth was outstandingly high in the Czech Republic, reaching almost 13% in the second quarter (full year: 9.8%). In the first quarter of 2005, year-on-year growth of industrial production declined to 4.3% compared to 8.7% in the first quarter of 2004, whereas industrial employment increased by 0.7% after a decline of 0.8% in the first quarter of 2004. At just 3.5%, industrial labor productivity growth was comparably low (first quarter of 2004: 9.6%). Thus, after declining (or remaining constant) in the industrial sector over the last three years, unit labor costs (ULC) increased marginally for the first time in the first quarter of 2005, although nominal wages in the industrial sector grew at a weaker rate year on year compared to the corresponding period in 2004 (3.8% against 8.8%). However, this development still supported the further decline in industrial producer price inflation during the first half of 2005. HICP inflation reached 2.5% in December 2004 year on year. Thereafter, inflation started to decline, coming to 0.9% in May 2005, which was the lowest year-on-year rise since November 2003. Inflation started to pick up in the two following months (June: 1.3%, July 1.4%), mainly driven by rising prices in transport (due to higher automotive fuel prices) and housing, while it was restrained by a further fall of food prices (favorable base effect of EU accession). The current inflation target band (until end-December 2005) announced by Česká národní banka (ČNB) is set at 2% to 4%. As of the beginning of 2006, the ČNB will move to a 3% point target with a tolerance band of ±1%.

Table 5

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	−3.1	5.4	6.7	4.9	5.9	9.8	9.1	4.3
Labor productivity of industry (real)	3.6	9.1	6.1	6.8	7.9	9.7	9.0	3.5
Gross average wage of industry (nominal)	6.6	7.1	6.4	6.7	5.9	7.0	6.0	3.8
Unit labor cost of industry (nominal)	3.0	−1.8	0.3	−0.1	−1.9	−2.5	−2.8	0.2
Producer price index (PPI) of industry	0.9	4.8	2.9	−0.5	−0.4	5.7	8.1	6.8
Consumer price index (here: HICP)	1.8	3.9	4.5	1.4	−0.1	2.6	2.7	1.4
Exchange rate (nominal):								
CZK[1]) per 1 EUR, + = EUR appreciation	2.3	−3.5	−4.3	−9.5	3.3	0.2	−3.0	−8.7
EUR per 1 CZK, + = CZK appreciation	−2.2	3.6	4.5	10.6	−3.2	−0.2	3.1	9.5
	Period average levels							
Unemployment rate (ILO definition, %)[2])	8.8	8.9	8.2	7.4	7.9	8.4	8.2	8.4
Employment rate[3])	65.6	65.0	65.0	65.4	64.7	64.1	64.5	64.1
Participation rate[4])	72.0	71.3	70.8	70.6	70.2	70.0	70.2	70.0
Key interest rate per annum (%)	6.7	5.3	5.1	3.6	2.3	2.2	2.5	2.3
Exchange rate (nominal):								
CZK per 1 EUR	36.9	35.6	34.1	30.8	31.8	31.9	31.1	30.0
EUR per 1 CZK	0.027	0.028	0.029	0.032	0.031	0.031	0.032	0.033

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1]) CZK: Czech koruna.

[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

[3]) Ratio of employed persons to the working-age population (aged 15 to 64).

[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

The growth of credit to the private sector stood at 13.3% year on year in the first quarter of 2005 and at 7.5% in May 2005 (first quarter 2004: 7.7%, May 2004: 6.2%). Credit growth to households remained about stable in the first quarter of 2005 against the first quarter of 2004 (31.4% and 30.8%, respectively), whereas the growth rate of credits to the corporate sector increased from 0.2% to 5.7%. Net foreign asset growth was negative (–0.1%) in the first quarter of 2005, but accelerated to 5.5% in May 2005. Overall broad money growth amounted to 5.4% in the first quarter of 2005 (May 2004: 5.8%). In 2004 and into early 2005, the Czech koruna appreciated sharply, reaching its strongest nominal value in more than two and a half years at 29.3 CZK/EUR in the beginning of March. Thereafter, the currency weakened and traded around 30 CZK/EUR. This weakening was apparently attributable above all to external factors, whereas internal factors seem to have had only a minor effect. In mid-August, the koruna started to appreciate again to nearly 29.3 CZK/EUR, partly supported by good foreign trade data. The continuous disinflation process encouraged the ČNB to cut its key interest rate by 25 basis points both in January and March to 2.00%, and to 1.75% in April.

Table 6

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	8.9	6.5	10.8	7.1	5.2	10.3	9.9	5.4
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	13.0	8.0	8.0	7.9	1.2	2.9	5.0	–0.1
Domestic credit (net) of the banking system	–3.2	–1.1	0.2	–9.7	7.7	7.1	2.9	2.2
of which: claims on the private sector	*–3.8*	*–5.0*	*–5.6*	*–12.3*	*0.9*	*6.0*	*7.2*	*7.1*
claims on households	*0.1*	*0.3*	*1.1*	*1.7*	*3.3*	*4.4*	*4.9*	*4.9*
claims on enterprises	*–4.0*	*–5.3*	*–6.7*	*–14.0*	*–2.5*	*1.5*	*2.3*	*2.1*
net claims on the public sector	*0.6*	*3.9*	*5.8*	*2.5*	*6.8*	*1.2*	*–4.4*	*–4.8*
Other domestic assets (net) of the banking system	–0.9	–0.4	2.6	8.9	–3.7	0.3	2.1	3.3

Source: National central bank, OeNB.

Note: Data since 2003 according to ECB methodology.

In 2004, the budget deficit (–3.0% of GDP) turned out to be much less pronounced than expected, which was basically attributable to more vigorous growth and the fact that it was now possible, for the first time, to roll over unspent funds into the following year. Furthermore, the reclassification of state guarantees also helped reduce the deficit. The 2005 budget reflects a widening of the deficit and includes a target of –4.7% (convergence program of December 2004). On the back of higher-than-expected revenues, the budgetary situation has developed favorably, showing a surplus of CZK 10.26 billion over the period from January to July 2005 against a deficit of CZK 48.80 billion in the comparable 2004 period. The Ministry of Finance indicated that the 2005 deficit might turn out to be below the envisaged deficit of CZK 83.6 billion. In mid-2004, the Ecofin Council found that an excessive deficit existed and advised the Czech Republic to correct this deficit by 2008. The convergence program of December 2004 set the deficit target to 3.8% of GDP for 2006 and to 3.3% for 2007. On January 18, 2005, in its assessment of the updated convergence program, the Ecofin Council recommended the use of higher-than-planned revenues to reduce the deficit and, furthermore, emphasized the need to push forward pension and health care reforms. In its 2005 report "Public Finances in the EMU," the European Commission stated that the Czech Republic was the only country except Greece that faced the serious risk of not being able to guarantee the long-term sustainability of its public finances given expenditures related to the pension and health care system. However, decisions on pension and health care reforms are unlikely to take place before parliamentary elections in June 2006.

Table 7

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	39.2	38.5	39.1	40.2	41.6	42.7	41.8	41.0
Expenditures	42.9	42.1	45.0	46.9	53.3	45.7	46.3	45.1
of which: interest payments	*1.0*	*0.9*	*1.1*	*1.5*	*1.3*	*1.3*	*1.3*	*1.4*
Balance	–3.6	–3.7	–5.9	–6.8	–11.7	–3.0	–4.5	–4.0
Primary balance	–2.6	–2.8	–4.8	–5.2	–10.3	–1.8	–3.2	–2.6
Gross public debt	16.0	18.2	27.2	30.7	38.3	37.4	36.4	37.0

Source: European Commission.

[1]) f stands for forecast by the European Commission.

High FDI inflows over the past few years, largely in export-oriented industries, are now positively reflected in the external side of the economy. The current account balance turned from a deficit (–2.1% of GDP) in the first quarter of 2004 to a surplus (2.2% of GDP) in the first quarter of 2005. The improvement of the trade balance was the major reason for this positive outcome. In the first quarter of 2005, the trade balance turned strongly positive to 2.8% of GDP (first quarter 2004: 0.2% of GDP); the trade surplus amounted to CZK 37.96 billion over the period from January to June 2005, against a deficit of CZK 7.81 billion in the comparable period of 2004. The current account balance was also positively affected by a payment from Slovakia, which resulted from an international arbitration award granted to the Czech bank ČSOB in February 2005. However, the income balance in the first quarter of 2005 posted a deficit of 2.7% of GDP caused by the repatriation of profits and dividend payments of foreign firms. Net FDI inflows in the first quarter of 2005 remained strong and similar in size compared to the same period of the previous year (4.2% and 4.4%, respectively).

Table 8

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	24,651	31,509	37,271	40,713	43,053	53,787	11,458	14,629
Merchandise exports: year-on-year change in %	*6.9*	*27.8*	*18.3*	*9.2*	*5.7*	*24.9*	*8.8*	*27.7*
Merchandise imports	26,448	34,918	40,705	43,034	45,235	54,493	11,420	13,983
Merchandise imports: year-on-year change in %	*4.1*	*32.0*	*16.6*	*5.7*	*5.1*	*20.5*	*7.0*	*22.4*
Trade balance	–1,797	–3,409	–3,434	–2,322	–2,182	–706	38	646
% of GDP	*–3.2*	*–5.6*	*–5.0*	*–3.0*	*–2.7*	*–0.8*	*0.2*	*2.8*
Services balance	1,130	1,536	1,706	706	416	389	55	56
Income balance (factor services balance)	–1,265	–1,490	–2,450	–3,760	–3,757	–4,393	–547	–604
Current transfers	552	403	524	934	494	191	36	391
Current account balance	–1,379	–2,960	–3,653	–4,442	–5,029	–4,518	–418	489
% of GDP	*–2.5*	*–4.9*	*–5.4*	*–5.7*	*–6.3*	*–5.2*	*–2.1*	*2.2*
Capital account balance	–2	–6	–10	–4	–3	–450	12	48
% of GDP	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*–0.5*	*0.1*	*0.2*
Direct investment flows (net)	5,879	5,356	6,121	8,870	1,694	3,142	855	955
% of GDP	*10.6*	*8.9*	*9.0*	*11.3*	*2.1*	*3.6*	*4.4*	*4.2*

Source: Eurostat, national central bank, OeNB.

At the end of the first quarter of 2005, gross external debt stood at 38.3% – slightly lower than at the end of 2004. A breakdown by public and private debt showed that public external debt increased at the end of the first quarter of 2005 against end-2004, while private external debt decreased slightly. Gross official reserves went down marginally from 24.0% of GDP at end-2004 to 23.6% of GDP at the end of the first quarter of 2005.

Table 9

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (1999 including gold, from 2000 excluding gold)	12,771	14,043	16,269	22,483	21,189	20,746	21,101
Gross external debt	22,765	23,285	25,368	25,738	27,624	33,258	34,286
	% of GDP[1])						
Gross official reserves (1999 including gold, from 2000 excluding gold)	23.1	23.2	23.9	28.7	26.4	24.0	23.6
Gross external debt	41.1	38.5	37.3	32.8	34.4	38.5	38.3
	Import months of goods and services						
Gross official reserves (1999 including gold, from 2000 excluding gold)	4.8	4.1	4.2	5.4	4.9	4.0	4.0

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

3 Hungary: Reduction of VAT Rate to Cause Drop in CPI in 2006

Hungarian GDP growth slowed down to 2.9% year on year in the first quarter of 2005 from 4.2% in the full year 2004. The slowdown in growth dynamics during the first quarter of 2005 was attributable both to a deceleration in domestic demand growth and to a smaller positive contribution of net exports than in 2004. Among the domestic components, domestic consumption growth during the first quarter was slightly stronger than in the full year 2004, and recovered from the stagnation observed in the last quarter of 2004, as public consumption picked up again. Private consumption also went up slightly compared to the last quarter of 2004 – a trend which was attributable mainly to the fact that real wages went up and the number of employed persons decreased at a slower pace than in the fourth quarter. However, private consumption growth remained slower than in the full year 2004. Following the standstill in the last quarter of 2004, gross fixed capital formation strengthened at the beginning of 2005, but its growth rate remained slightly below that observed for the whole year 2004. During the first quarter of 2005, both export and import dynamics slowed down considerably from the high rates registered in 2004. Given that export growth slackened more sharply than import growth, the positive contribution of net exports to GDP declined from 2.3 percentage points in 2004 to 1.3 percentage points in the first quarter of 2005, thus constituting the main reason for the weaker GDP growth in the first quarter of 2005.

Table 10

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	4.2	5.2	3.8	3.5	2.9	4.2	4.1	2.9
Private consumption	5.6	5.4	5.8	10.3	7.7	3.0	1.6	2.0
Public consumption	1.5	1.9	6.2	5.4	5.7	–1.9	–4.0	1.9
Gross fixed capital formation	5.9	7.7	5.9	9.3	2.5	7.9	0.1	6.8
Exports of goods and services	12.2	22.0	8.0	3.9	7.8	14.9	10.8	6.2
Imports of goods and services	13.3	20.2	5.3	6.5	11.0	11.6	6.2	4.8
	Contribution to GDP growth in percentage points							
Domestic demand	5.1	4.6	1.8	5.7	6.0	1.9	0.1	1.6
Exports	7.9	15.4	6.5	3.3	6.6	13.1	10.1	6.0
Net exports	–1.0	0.6	2.1	–2.2	–3.0	2.3	3.9	1.3

Source: Eurostat, OeNB.

However, for the second quarter of 2005, industrial output and sales figures suggest a recovery of economic activity, which is supported in particular by stronger export sales. Reflecting the slowdown in economic activity, employment (according to the Labor Force Survey – LFS) continued to contract in the first quarter of 2005 in year-on-year terms, though less strongly than in the preceding three quarters. As a result, the employment rate decreased against the first quarter of 2004. At the same time, the unemployment rate climbed to 7% in the first quarter of 2005 – the highest level since the third quarter of 1999 – which reflects weak labor demand, but in part also an increase in labor supply (i.e. a higher activity rate). Following a 1% decline in 2004, net real wages grew by 7.6% during the first half of 2005. This high growth rate was largely attributable to the fact that the timing of nonregular payments in the public sector was different from 2004 and to the stronger-than-expected deceleration in inflation. The higher net real growth in total wages, however, masks the fact that nominal wage dynamics continued to decelerate in the private sector, thus supporting further disinflation. HICP growth slowed down to 3.3% year on year in March 2005 from 5.5% in December 2004, but accelerated again to 3.6% by July, mostly due to higher food and oil prices and an adverse base effect in healthcare prices. However, the underlying inflationary environment remains favorable as suggested by the continuous deceleration in core inflation (July 2005: 1.6%). This phenomenon is supported by the moderation of private consumption and by weak growth in industrial unit wage costs, especially as productivity growth is picking up again after a dip in the first quarter of 2005. In addition, stronger competition and the appreciation of the exchange rate since late May 2005 support low price dynamics. At the beginning of 2006, inflation is set to further decelerate on the back of a cut in the highest VAT rate from 25% to 20%, the direct effect of which Magyar Nemzeti Bank (MNB) estimates at 1.4 percentage points for 2006. The MNB expects inflation to rise from 1.6% in 2006 to 2.9% in 2007 (both annual averages), which would be in line with the medium-term inflation target of 3.0% (with a tolerance of ±1 percentage point).

Table 11

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	10.1	18.5	4.1	2.9	6.3	8.3	6.6	2.1
Labor productivity of industry (real)	5.1	17.0	5.4	4.9	8.4	10.6	9.4	4.4
Gross average wage of industry (nominal)	13.4	15.0	14.5	12.6	9.3	10.0	8.8	6.6
Unit labor cost of industry (nominal)	7.9	–1.7	8.6	7.4	0.8	–0.6	–0.6	2.1
Producer price index (PPI) of industry	5.0	11.4	5.7	–1.1	2.5	3.6	2.1	1.9
Consumer price index (here: HICP)	10.0	10.0	9.1	5.2	4.7	6.8	5.9	3.5
	Exchange rate (nominal)							
HUF[1]) per 1 EUR, + = EUR appreciation	5.2	2.9	–1.3	–5.3	4.3	–0.7	–5.3	–5.8
EUR per 1 HUF, + = HUF appreciation	–4.9	–2.8	1.4	5.6	–4.2	0.7	5.6	6.1
	Period average levels							
Unemployment rate (ILO definition, %)[2])	7.1	6.4	5.8	5.9	5.9	6.1	6.3	7.0
Employment rate[3])	55.6	56.3	56.2	56.2	57.0	56.8	57.0	56.4
Participation rate[4])	59.8	60.1	59.6	59.7	60.6	60.5	60.8	60.7
Key interest rate per annum (%)	15.2	11.5	11.1	9.1	8.6	11.4	10.3	8.6
	Exchange rate (nominal)							
HUF per 1 EUR	252.76	260.07	256.60	242.95	253.51	251.73	245.94	245.01
EUR per 1 HUF	0.00396	0.00385	0.00390	0.00412	0.00394	0.00397	0.00407	0.00408

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1]) HUF: Hungarian forint.
[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).
[3]) Ratio of employed persons to the working-age population (aged 15 to 64).
[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

Falling inflation (in particular core inflation), slowing wage dynamics in the private sector, weaker credit growth[3] and the broadly stable exchange rate paved the way for gradual monetary easing. Since the beginning of 2005, the MNB has trimmed its interest rates by a total of 325 basis points to 6.25% (August). As a result of these rate cuts, the MNB's forward-looking real policy interest rate fell to around 3.8% in July 2005 from around 5% at end-2004. Despite the positive inflationary environment, the MNB sees the budget deficit, the current account deficit and Hungary's reliance on foreign portfolio capital as the major monetary policy risks. Furthermore, the MNB has already signaled that it is looking at medium-term inflationary developments and will therefore not react to the temporarily disinflationary effect of the VAT rate cut to be effected in 2006.

[3] *The growth of credit to the corporate sector fell continuously from a peak of 24% year on year in the first quarter of 2004 to 15% year on year in the first quarter of 2005, while the growth of credit to households moderated continuously from a peak of 71% year on year in the second quarter of 2003 to 25% in the first quarter of 2005.*

Table 12

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	17.4	17.7	16.3	10.1	14.2	11.7	11.3	11.3
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	10.3	10.3	9.2	2.2	–1.1	–1.9	–1.4	–0.8
Domestic credit (net) of the banking system	6.0	6.0	10.7	12.3	22.4	17.9	14.9	14.5
of which: claims on the private sector	*8.8*	*16.2*	*17.2*	*15.4*	*18.7*	*21.7*	*17.2*	*17.0*
claims on households	*1.6*	*2.7*	*4.2*	*6.3*	*10.6*	*9.8*	*8.0*	*7.0*
claims on enterprises	*7.1*	*13.4*	*13.0*	*9.1*	*8.1*	*11.9*	*9.3*	*10.0*
net claims on the public sector	*–2.7*	*–10.2*	*–6.5*	*–3.1*	*3.7*	*–3.8*	*–2.4*	*–2.4*
Other domestic assets (net) of the banking system	1.1	–5.8	–3.6	–4.5	–7.0	–4.3	–2.2	–2.4

Source: National central bank, OeNB.

In response to the Ecofin Council's recommendation to Hungary (issued in early March 2005) to take effective action by July 8, 2005, regarding additional measures to achieve the 2005 budget deficit target, which was set at 3.8% of GDP excluding the net costs of the pension reform in the convergence program of December 2004, the Hungarian authorities officially notified the European Commission about pertinent measures at the beginning of July. These measures, which had already been publicly announced during the previous months, comprise an increase in the emergency budget reserves, a widening of the social security base, a rise in gambling tax, a change in the method of VAT collection for imports from non-EU countries and additional one-off revenues. In its assessment, the European Commission concluded that these measures were worth around 1.7% of GDP and, if implemented fully, should be sufficient to reach the 2005 deficit target. Therefore, no further steps were necessary under the excessive deficit procedure. However, the European Commission stated that Hungary's budgetary situation remained vulnerable and recommended that the Ecofin Council enhance budgetary surveillance should failures in implementing the planned corrective measures emerge at a later stage. The European Commission also suggested to closely monitor the budget plans for 2006. In its view, decisive action is needed, given that in 2006 budget revenues will decrease as one-off revenues taken in 2005 expire and tax cuts will take place (combined revenue effect of around 2% of GDP), while investment expenditure is expected to rise again also in the light of cofinancing requirements. The convergence program of December 2004 set the deficit target (excluding the net costs of the pension reform) to 3.1% of GDP for 2006 and to 2.4% for 2007.

Table 13

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	. .	45.3	45.0	44.1	44.5	47.5	44.0	43.2
Expenditures	. .	47.6	48.7	52.6	50.8	52.0	47.8	47.1
of which: interest payments	. .	*5.6*	*4.7*	*4.0*	*4.0*	*4.3*	*3.8*	*3.4*
Balance	. .	–2.4	–3.7	–8.5	–6.2	–4.5	–3.9	–4.1
Primary balance	. .	3.2	1.0	–4.5	–2.2	–0.2	0.0	–0.7
Gross public debt	60.9	55.4	52.2	55.5	56.9	57.6	57.8	57.9

Source: European Commission.

[1]) f stands for forecast by the European Commission.

The current account in Hungary showed a deficit of 7.5% of GDP during the first quarter of 2005, which was slightly higher than the deficit recorded in the same period of 2004. However, the current account deficit has been contracting continuously since mid-2004, which may be attributable to the weakening of domestic demand. The fact that the current account deficit widened against the first quarter of 2004 was attributable to a larger deficit on the income balance (due to larger net outflows on both debt and equity positions) and the disappearance of the surplus in net transfers. By contrast, the deficit on the goods and services balance declined by one percentage point to 1.1% of GDP. Annual export growth continued to outpace annual import growth in the first quarter of 2005, despite the moderation of year-on-year growth rates, which reflected both the development of real exports and imports and a deterioration of the terms of trade. Although the current account deficit widened, Hungary’s financing requirement declined against the first quarter of 2004, given a significant improvement in the capital account (by 1.2% of GDP). Net FDI inflows increased and covered 54% of the financing requirement, compared to 30% in the first quarter of 2004. Strong capital inflows on the back of the issuance of government eurobonds pushed net portfolio capital inflows to 11.9% of GDP, which helped raise the central bank’s reserve position.

Table 14

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	24,059	31,278	34,697	36,821	38,377	44,516	10,277	11,425
Merchandise exports: year-on-year change in %	*14.3*	*30.0*	*10.9*	*6.1*	*4.2*	*16.0*	*14.3*	*11.2*
Merchandise imports	26,102	34,457	37,193	39,024	41,274	46,907	10,679	11,614
Merchandise imports: year-on-year change in %	*14.8*	*32.0*	*7.9*	*4.9*	*5.8*	*13.6*	*11.3*	*8.8*
Trade balance	–2,044	–3,180	–2,496	–2,203	–2,898	–2,391	–402	–189
% of GDP	*–4.5*	*–6.3*	*–4.3*	*–3.2*	*–4.0*	*–3.0*	*–2.2*	*–0.9*
Services balance	816	1,234	1,661	587	–378	–6	22	–22
Income balance (factor services balance)	–2,713	–2,792	–3,192	–3,838	–3,682	–4,928	–1,021	–1,278
Current transfers	408	385	450	525	594	206	93	–8
Current account balance	–3,531	–4,352	–3,577	–4,929	–6,364	–7,118	–1,308	–1,497
% of GDP	*–7.8*	*–8.6*	*–6.2*	*–7.1*	*–8.8*	*–8.8*	*–7.3*	*–7.5*
Capital account balance	31.2	299.9	357.9	202.3	–32.5	321.9	–63.0	171.0
% of GDP	*0.1*	*0.6*	*0.6*	*0.3*	*0.0*	*0.4*	*–0.3*	*0.9*
Direct investment flows (net)	2,872	2,334	3,992	2,889	443	2,896	409	714
% of GDP	*6.4*	*4.6*	*6.9*	*4.2*	*0.6*	*3.6*	*2.3*	*3.6*

Source: Eurostat, national central bank, OeNB.

The country's gross external debt continued to increase, reaching 70.6% of GDP at the end of March 2005, up from 65.5% a year earlier. Net foreign debt came to 32% of GDP, up from 30.8% in 2004.

Table 15

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	10,722	12,038	12,164	9,887	10,108	11,671	13,223
Gross external debt	29,231	32,572	37,387	38,559	46,036	54,911	58,426
	% of GDP[1])						
Gross official reserves (excluding gold)	23.8	23.8	21.0	14.3	13.9	14.4	16.0
Gross external debt	64.9	64.4	64.5	55.9	63.4	67.9	70.6
	Import months of goods and services						
Gross official reserves (excluding gold)	4.3	3.6	3.4	2.6	2.5	2.5	2.9

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

4 Poland: Weaker Growth, but Stronger Currency

GDP growth in Poland continued to decelerate in the first quarter of 2005, falling to 2.1% year on year from 4% in the fourth quarter and 5.4% in the full year 2004. Both in the fourth quarter of 2004 and in the first quarter of 2005, economic growth fell sharply. Private consumption growth slowed markedly in the fourth quarter, as real wages in the total economy fell. The reduction in real wages reflected the fact that nominal wage growth declined although inflation remained high as a result of higher international energy prices. Real wages continued to contract in the first quarter, notwithstanding the onset of disinflation, before slightly increasing in the second quarter of 2005. Thus, the rise in oil prices rather had a dampening effect on consumption growth than an inflationary effect. In parallel, real exports contracted in year-on-year terms in both the fourth quarter of 2004 and the first quarter of 2005, partly as a consequence of the Polish złoty's strong appreciation since March 2004. The combination of both weaker domestic consumption and contracting real exports in the fourth quarter of 2004 probably contributed to the fact that gross fixed capital formation growth decelerated markedly in the first quarter of 2005, just after having expanded for the first time after three years of contraction. In addition, the exchange rate volatility as well as the tightening of monetary conditions toward the end of 2004 may have had an adverse impact on real investment decisions. As a result of weaker domestic demand growth and shrinking real exports, real imports contracted even more clearly than real exports. Thus, net exports improved, implying a positive contribution of 1.0 percentage point to GDP growth in the first quarter of 2005, i.e. significantly more than in the full year 2004.

Table 16

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	4.1	4.0	1.0	1.4	3.8	5.4	4.0	2.1
Private consumption	5.2	2.8	2.1	3.3	3.1	3.4	1.9	1.7
Public consumption	1.9	1.3	0.6	0.6	0.5	3.4	2.2	2.5
Gross fixed capital formation	6.8	2.7	–8.8	–5.8	–0.2	5.3	7.4	1.0
Exports of goods and services	–2.6	23.2	3.1	4.8	14.2	10.2	–0.5	–3.1
Imports of goods and services	1.0	15.6	–5.3	2.6	9.3	8.7	–2.3	–5.5
	Contribution to GDP growth in percentage points							
Domestic demand	5.2	2.8	–1.7	0.8	2.7	5.1	3.4	1.1
Exports	–0.7	6.2	0.9	1.3	4.2	3.5	–0.2	–1.2
Net exports	–1.1	1.2	2.7	0.6	1.1	0.3	0.6	1.0

Source: Eurostat, national statistical office, OeNB, wiiw.

Despite the growth slowdown, average employment in the whole economy (LFS-based) in the first quarter was 2.3% higher than a year ago. As the employment rate increased to 51.5% (from 50.5% in the first quarter of 2004) while the activity rate declined to 63.7% (from 64.0%), the average unemployment rate fell to 19.1% (from 21.0%). For the first time since the start of the economic transformation, average employment in industry was higher year on year in the first half of 2005, although industrial output growth was markedly weaker than in the full year 2004. However, it was primarily the slowdown in output growth that implied very low labor productivity growth. As a result, nominal ULC in industry increased slightly year on year for the first time since 2001, despite a considerably lower wage growth. The oil price-driven rise in industrial producer prices continued to decline from its peak at 9.6% year on year in May 2004 to only 0.1% in the second quarter of 2005, supported by the very moderate ULC development. Inflation (HICP), which had peaked at 4.9% in

August 2004, continuously contracted to only 1.3% by July 2005 – a value outside the monetary policy target band of 2.5 percentage points ±1. In recent months, the further inflationary impact from oil prices was largely offset by favorable developments in food prices. There are hardly any signs of demand-driven inflation. Assessing the risk of future inflation being below target as higher than that of it being above target, the Monetary Policy Council lowered the key interest rate (two-week rate on central bank bills) by a total of 1.75 percentage points to 4.50% in five steps at the end of March, April, June, July and August 2005.

Table 17

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	4.7	7.8	0.6	1.4	8.6	13.1	7.2	1.1
Labor productivity of industry (real)	9.6	17.9	6.1	7.4	11.4	13.5	7.3	0.2
Gross average wage of industry (nominal)	34.1	10.9	6.9	3.7	3.0	4.5	2.4	2.1
Unit labor cost of industry (nominal)	22.3	–5.9	0.8	–3.4	–7.5	–7.9	–4.6	1.9
Producer price index (PPI) of industry	5.7	7.8	1.7	1.1	2.7	7.1	6.7	3.5
Consumer price index (here: HICP)	7.2	10.1	5.3	1.9	0.7	3.6	4.5	3.6
Exchange rate (nominal):								
PLN[1]) per 1 EUR, + = EUR appreciation	8.0	–5.2	–8.4	5.0	14.1	3.0	–8.4	–15.7
EUR per 1 PLN, + = PLN appreciation	–7.4	5.5	9.2	–4.7	–12.4	–2.9	9.2	18.6
	Period average levels							
Unemployment rate (ILO definition, %)[2])	12.6	16.4	18.6	20.3	20.0	19.3	18.3	19.1
Employment rate[3])	57.5	55.0	53.4	51.5	51.2	51.7	52.4	51.5
Participation rate[4])	65.8	65.8	65.5	64.6	63.9	64.0	64.1	63.7
Key interest rate per annum (%)	13.7	17.9	16.0	8.8	5.6	5.8	6.5	6.4
Exchange rate (nominal):								
PLN per 1 EUR	4.23	4.01	3.67	3.85	4.40	4.53	4.23	4.03
EUR per 1 PLN	0.2365	0.2495	0.2725	0.2595	0.2274	0.2207	0.2362	0.2483

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1]) PLN: Polish złoty.

[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

[3]) Ratio of employed persons to the working-age population (aged 15 to 64).

[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

The real key interest rate (12-month moving average) increased continuously from a low of 0.5% in August 2004 to 4.8% in June 2005 as a consequence of the persistent disinflation since August 2004 and despite the cuts in nominal key rates effected since March 2005.[4] Both the increase of real interest rates and the real appreciation of the złoty against the euro by 13.7% (CPI-deflated) and 9.2% (PPI-deflated) from June 2004 to June 2005 had a tightening effect on monetary conditions. The average broad money growth rate of 12% year on year in the second quarter of 2005 resulted mainly from lending to households, which rose by 18%, and from net foreign assets. The latter went up by 22% year on year in euro terms, but by 8% as measured in złoty, with the difference reflecting the strong currency appreciation. Bank lending to enterprises, by contrast, was again lower than a year earlier even in nominal terms (–2.3% year

[4] *Ex post real key interest rate per annum as measured by the real (CPI-deflated) key rates per month compounded over the past 12 months. The PPI-deflated key interest rate per annum, which is measured in a similar way, increased from a low of –4.0% in May 2004 to a high of 6.8% in May 2005, before stabilizing at 6.3% in June and July 2005.*

on year), a fact which was attributable partly to the moderate ULC developments and the resulting high profitability of industry and partly to the weak demand for fixed investment.

Table 18

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	24.7	15.4	12.1	2.0	1.5	6.9	8.2	10.4
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	7.8	7.0	4.5	0.9	0.0	4.2	2.5	1.9
Domestic credit (net) of the banking system	25.1	13.5	7.2	7.1	5.2	3.7	2.8	2.9
of which: claims on the private sector	*18.5*	*15.7*	*8.3*	*3.4*	*3.8*	*4.1*	*3.9*	*2.5*
claims on households	*6.2*	*7.0*	*4.2*	*2.8*	*2.5*	*4.7*	*5.7*	*4.6*
claims on enterprises	*12.3*	*8.7*	*4.1*	*0.5*	*1.3*	*–0.6*	*–1.8*	*–2.1*
net claims on the public sector	*6.7*	*–2.1*	*–1.1*	*3.7*	*1.4*	*–0.5*	*–1.1*	*0.4*
Other domestic assets (net) of the banking system	–8.3	–5.1	0.4	–6.0	–3.8	–1.0	2.9	5.6

Source: National central bank, OeNB.

The convergence program of December 2004 set the deficit target for 2005 at 3.9% of GDP, departing from an assumed public deficit in 2004 of 5.4% (hence requiring a deficit reduction by 1.5 percentage points) and an economic growth of 5.0% in 2005. However, according to the March 2005 fiscal notification, the public deficit was 4.8% of GDP in 2004. In the meantime, the Polish finance minister announced that the 2005 deficit would amount to about 3.4% of GDP, implying a deficit reduction close to the originally envisaged size despite considerably lower-than-expected GDP growth. By the end of July, the central government budget deficit came to 50% of the deficit planned for the full year 2005. The convergence program set the deficit target to 3.2% of GDP for 2006 and to 2.2% for 2007. In September, however, parliamentary elections will be held, and the new government may propose a different budget for 2006. Moreover, all these deficit figures do not include the net budgetary costs of the pension reform, which will amount to about 1.8 percentage points of GDP in 2006 and 2007. Moreover, if the envisaged deficit target of 2.2% in 2007 is reached, the new requirements of the Stability and Growth Pact might imply the inclusion of only 40% (instead of 100%) of these pension reform costs (i.e. about 0.7% of GDP) into the deficit that would serve as the basis for assessing whether the 3% reference value was met and the current excessive deficit procedure could be abrogated.

Table 19

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	44.9	42.5	43.8	43.9	44.3	43.8	44.2	44.2
Expenditures	47.0	45.2	47.7	47.5	48.8	48.7	48.6	48.0
of which: interest payments	*2.0*	*3.1*	*3.2*	*2.9*	*2.9*	*2.6*	*2.6*	*2.5*
Balance	–1.4	–1.6	–3.9	–3.6	–4.5	–4.8	–4.4	–3.8
Primary balance	0.6	1.6	–0.7	–0.7	–1.6	–2.2	–1.9	–1.3
Gross public debt	40.1	36.8	36.7	41.2	45.4	43.6	46.8	47.5

Source: European Commission.

[1]) f stands for forecast by the European Commission.

Contrary to the development of real exports, the exports of goods and services in the balance of payments continued to grow strongly year on year in the fourth quarter of 2004 and in the first quarter of 2005, implying that the goods and services balance turned from a deficit of 2.2% of GDP in the first quarter of 2004 to a balanced position in the first quarter of 2005 and that the current account balance turned into surplus. In the second quarter of 2005, both the goods and services balance and the current account balance achieved a clear surplus position, as the moderate weakening of annual export growth was more than compensated by the drop in annual import growth. The financial account, by contrast, showed net direct investment outflows roughly corresponding to the size of the current account surplus in the second quarter of 2005.

Table 20

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	28,215	39,028	46,487	49,324	53,814	65,639	14,451	17,469
Merchandise exports: year-on-year change in %	*–2.5*	*38.3*	*19.1*	*6.1*	*9.1*	*22.0*	*19.4*	*20.9*
Merchandise imports	42,361	52,359	55,075	57,036	58,890	70,144	15,364	17,787
Merchandise imports: year-on-year change in %	*4.9*	*23.6*	*5.2*	*3.6*	*3.3*	*19.1*	*12.8*	*15.8*
Trade balance	–14,146	–13,331	–8,588	–7,712	–5,076	–4,505	–913	–318
% of GDP	*–9.2*	*–7.4*	*–4.1*	*–3.8*	*–2.7*	*–2.3*	*–2.1*	*–0.6*
Services balance	1,297	1,551	905	852	430	724	–46	325
Income balance (factor services balance)	–948	–1,609	–1,585	–1,990	–3,189	–3,707	–564	–695
Current transfers	2,078	2,595	3,226	3,433	3,726	4,536	875	1,064
Current account balance	–11,719	–10,794	–6,042	–5,417	–4,109	–2,952	–648	376
% of GDP	*–7.6*	*–6.0*	*–2.9*	*–2.7*	*–2.2*	*–1.5*	*–1.5*	*0.7*
Current transfers	51.0	41.0	81.0	–8.0	–40.0	803.0	–32.0	616.0
	0.0	0.0	0.0	0.0	0.0	0.4	0.0	0.4
Direct investment flows (net)	6,795	10,253	6,457	4,147	3,508	4,222	1,333	800
% of GDP	*4.4*	*5.7*	*3.1*	*2.0*	*1.9*	*2.1*	*3.1*	*1.5*

Source: Eurostat, national central bank, OeNB.

In the first half of 2005, sizeable net portfolio inflows by far exceeded negative net inflows from other investment (which resulted mainly from the prepayment of Paris Club debt), so that gross official reserves increased considerably to EUR 34 billion.

Table 21

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	26,224	28,555	29,031	27,367	26,000	25,904	28,408
Gross external debt	65,123	74,672	81,461	81,046	84,611	93,432	95,892
	% of GDP[1])						
Gross official reserves (excluding gold)	17.0	15.8	14.0	13.5	14.0	13.2	13.7
Gross external debt	42.2	41.3	39.3	40.0	45.7	47.6	46.1
	Import months of goods and services						
Gross official reserves (excluding gold)	6.4	5.5	5.4	4.9	4.6	3.9	4.2

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

5 Slovakia: Growth Driven by Domestic Demand

In the first quarter of 2005, real GDP growth in the Slovakia remained robust at 5.1% year on year, but was slightly lower than growth in the full year 2004 and in the fourth quarter of 2004. In the first quarter of 2005, year-on-year growth of major domestic demand components accelerated. Supported by strong wage increases, private consumption growth was much stronger than in 2004 (5.5% compared to 3.5% in the full year 2004). Growth of gross fixed capital formation jumped to 5.8%, after 2.5% in the full year 2004 and no more than 0.1% in the last quarter of 2004. Public consumption growth accelerated as well. However, the contribution of overall domestic demand to GDP declined to 5.4 percentage points, after 6.3 percentage points in the full year 2004 and 8.4 percentage points in the fourth quarter of 2004. This difference is mainly attributable to the considerably smaller contribution of inventory changes to GDP growth. In addition to weaker total domestic demand growth, the contribution of the published statistical discrepancy was significantly less positive. On the external side, real import and export growth in the first quarter of 2005 was lower than in 2004, with import growth contracting more strongly. The contribution of net exports to GDP remained negative, but went down to only –0.3 percentage point in the first quarter of 2005 from –0.8 percentage point in the full year 2004 and –2.6 percentage points in the last quarter of 2004.

Table 22

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	1.5	2.0	3.8	4.6	4.5	5.5	5.8	5.1
Private consumption	3.2	–0.8	4.7	5.5	–0.6	3.5	4.3	5.5
Public consumption	–7.1	1.6	4.6	4.9	2.7	1.1	–0.2	2.3
Gross fixed capital formation	–19.6	–7.2	13.9	–0.6	–1.5	2.5	0.1	5.8
Exports of goods and services	5.0	13.7	6.3	5.6	22.5	11.4	9.5	7.2
Imports of goods and services	–6.7	10.5	11.0	5.5	13.6	12.7	12.3	7.9
	Contribution to GDP growth in percentage points							
Domestic demand	–7.0	0.1	7.5	4.7	–2.1	6.3	8.4	5.4
Exports	3.3	9.4	4.8	4.3	17.7	10.6	9.4	6.9
Net exports	8.4	1.9	–3.7	–0.1	6.5	–0.8	–2.6	–0.3

Source: Eurostat, national statistical office, OeNB.

The unemployment rate (ILO definition) remained at a very high level of 17.6% (period average) in the first quarter of 2005, despite a decline by almost 2 percentage points compared to the first quarter of 2004. This decline resulted from both an increase in the employment rate from 56.1% in the first quarter of 2004 to 56.9% in the first quarter of 2005 and an decrease in the participation rate. In industry, employment edged up by a considerable 3.4% in the first quarter of 2005 year on year (first half of 2005: 2.3%). Industrial output growth slumped in the first quarter of 2005 to just 0.6% (first half of 2005: 1.7%). As in the previous quarter, weak industrial output growth was largely attributable to low output in the automotive sector caused by production line upgrades. High industrial employment growth in combination with low output growth resulted in a decline of labor productivity by 2.7%. Labor productivity had already dropped in the previous quarter for the first time since mid-1999. In the first quarter of 2005, industrial wage growth (nominal) accelerated to 12.2%, leading to a further, and strong, rise of ULC (+15.3%) above producer price inflation (2.5%). After a low of 2.1% year on year in February, inflation of industrial producer prices increased to 4.0% by May 2005. Largely driven by administered prices and indirect tax changes, HICP inflation still came to 7.4% in 2004. These inflation-driving factors were much less important in 2005, when they led to a pronounced slowdown. In addition, nominal effective exchange rate developments underpinned the moderation of inflation. In July 2005, the HICP inflation rate stood at 2.0% year on year, the lowest rate since the beginning of the transition process. However, the natural gas supplier in Slovakia, which enjoys a monopoly position, is planning to increase the gas prices for households by 22% from October and has asked the state regulator for approval. Nevertheless, according to Národná banka Slovenska (NBS), the gas hike would not bring out of reach the inflation target, which the NBS has defined as an HICP inflation of 3.5% ±0.5 percentage point at the end of 2005 and of below 2.5% at the end of 2006.

Table 23

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	–2.0	8.3	7.6	6.7	5.5	4.3	1.2	0.6
Labor productivity of industry (real)	1.0	11.8	6.6	6.5	4.9	3.9	–1.0	–2.7
Gross average wage of industry (nominal)	7.9	9.1	10.2	7.3	7.3	10.1	9.3	12.2
Unit labor cost of industry (nominal)	6.8	–2.4	3.4	0.7	2.3	6.0	10.4	15.3
Producer price index (PPI) of industry	3.9	10.8	6.5	2.0	8.3	3.4	4.5	2.5
Consumer price index (here: HICP)	10.4	12.2	7.2	3.5	8.5	7.4	6.0	2.6
Exchange rate (nominal):								
SKK[1]) per 1 EUR, + = EUR appreciation	11.7	–3.4	1.6	–1.4	–2.8	–3.5	–4.2	–5.6
EUR per 1 SKK, + = SKK appreciation	–10.5	3.6	–1.6	1.4	2.9	3.6	4.4	5.9
	Period average levels							
Unemployment rate (ILO definition, %)[2])	16.4	18.8	19.3	18.7	17.6	18.3	17.3	17.6
Employment rate[3])	58.1	56.8	56.8	56.8	57.7	57.0	57.5	56.9
Participation rate[4])	69.5	69.9	70.4	69.9	70.0	69.7	69.5	69.1
Key interest rate per annum (%)	. .	. .	8.8	7.9	6.4	4.9	4.3	3.8
Exchange rate (nominal):								
SKK per 1 EUR	44.1	42.6	43.3	42.7	41.5	40.0	39.5	38.3
EUR per 1 SKK	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1]) SKK: Slovak koruna.

[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

[3]) Ratio of employed persons to the working-age population (aged 15 to 64).

[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

Broad money growth (nominal average year on year) accelerated from 4% in the full year 2004 to close to 7% in the second quarter of 2005, driven by a stronger growth of domestic claims. While year-on-year growth of claims on the general government and on households remained high (at 14% and 38%, respectively, after 16% and 41% in the full year 2004), previously stagnant claims on enterprises started to grow at a rate of around 4%. The Slovak koruna appreciated sharply in 2004 and early 2005, reaching a rate of 37.56 SKK/EUR at the beginning of March 2005. The NBS intervened relatively heavily on the foreign exchange market to dampen the appreciation pressure. However, primarily as a result of external factors, the koruna started to depreciate in March, bottoming out at 39.85 SKK/EUR at the end of April. Thereafter, the exchange rate of the Slovak koruna has been fluctuating between 38.26 SKK/EUR and 39.36 SKK/EUR. In light of the ongoing disinflation process, the NBS continued to cut its key interest rate (two-week repo tender limit rate) by another 100 basis points to 3% in March 2005, after reductions totaled 2 percentage points in 2004. These interest rate cuts were also strongly motivated by the appreciation of the Slovak koruna.

Table 24

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	8.1	14.1	12.7	8.7	5.5	4.0	4.7	5.1
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	–4.9	6.6	2.7	13.5	7.7	–2.6	–3.9	–2.6
Domestic credit (net) of the banking system	13.6	3.7	12.2	0.4	–1.9	10.2	9.9	10.1
of which: claims on the private sector	*4.9*	*2.2*	*–13.9*	*–1.0*	*4.9*	*4.0*	*3.5*	*4.6*
claims on households	*1.7*	*2.0*	*1.2*	*1.4*	*2.2*	*4.0*	*4.3*	*4.4*
claims on enterprises	*3.2*	*0.2*	*–15.1*	*–2.3*	*2.7*	*0.0*	*–0.8*	*0.1*
net claims on the public sector	*8.7*	*1.5*	*26.1*	*1.4*	*–6.7*	*6.1*	*6.5*	*5.5*
Other domestic assets (net) of the banking system	–0.5	3.8	–2.2	–5.2	–0.4	–3.6	–1.3	–2.4

Source: National central bank, OeNB.

Note: Data after deduction of bad claims written off during bank consolidation.

In 2004, the budget deficit amounted to 3.3% of GDP, against an expected 3.8%. This better-than-expected outcome was largely the result of spending deferrals (e.g. of copayments for EU funds) and lower social security expenditures. For 2005, the deficit is expected to increase slightly to 3.8% of GDP including the budgetary costs of the pension reform (convergence program of November 2004), or to 3.4% excluding these costs. However, the budget deficit could turn out to be lower than targeted: In the period from January to July 2005, the budget showed a surplus of SKK 1.92 billion (January to July 2004: SKK –18.55 billion), while the full year budget deficit target amounts to SKK 61.5 billion. The ministry of finance expects that the budget deficit might be 0.15 percentage point below the original target. The convergence program set the deficit target (excluding the net budgetary costs of the pension reform of about 1% of GDP) to 2.9% of GDP for 2006 and to 1.9% for 2007. In its statement of February 17, 2005, on the latest convergence program, the Ecofin Council assessed the program as sufficient to achieve these deficit targets.

Table 25

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	49.8	47.6	45.5	45.2	35.4	35.1	36.1	34.8
Expenditures	56.9	59.9	51.5	50.9	39.2	38.5	39.9	38.8
of which: interest payments	*3.4*	*4.1*	*4.0*	*3.6*	*2.5*	*2.2*	*2.4*	*2.2*
Balance	–7.1	–12.3	–6.0	–5.7	–3.7	–3.3	–3.8	–4.0
Primary balance	–3.8	–8.2	–2.0	–2.1	–1.2	–1.1	–1.4	–1.7
Gross public debt	47.2	49.9	48.7	43.3	42.6	43.6	44.2	44.9

Source: European Commission.

[1]) f stands for forecast by the European Commission.

In the first quarter of 2005 the Slovakian current account reported a deficit of 1.9% of GDP compared to a surplus of 1.4% in the first quarter of 2004. The deterioration of the current account went hand in hand with a domestic demand growth that was considerably stronger than a year earlier. The goods and services balance turned into a deficit of 1.5% of GDP in the first quarter of 2005 (against a surplus of 0.4% in the first quarter of 2004), as goods and services export growth slowed down considerably while the corresponding import growth remained strong, contrary to the development of real imports. In addition, the income balance turned from positive to negative as high FDI inflows in recent years have led to rising dividend repatriation. At the same time, FDI inflows dropped considerably from 4.4% of GDP in the first quarter of 2004 to just 0.8% of GDP in the first quarter of 2005. FDI covered around 44% of the overall financing requirements.

Table 26

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	9,606.8	12,866.4	14,118.8	15,281.0	19,369.5	22,370.0	5,009.2	5,580.4
Merchandise exports: year-on-year change in %	*0.5*	*33.9*	*9.7*	*8.2*	*26.8*	*15.5*	*18.7*	*11.4*
Merchandise imports	10,633.4	13,837.7	16,494.4	17,539.5	19,935.2	23,552.8	5,026.8	5,844.8
Merchandise imports: year-on-year change in %	*–8.8*	*30.1*	*19.2*	*6.3*	*13.7*	*18.1*	*15.3*	*16.3*
Trade balance	–1,026.6	–971.3	–2,375.6	–2,258.5	–565.7	–1,182.8	–17.6	–264.4
% of GDP	*–5.4*	*–4.4*	*–10.2*	*–8.8*	*–2.0*	*–3.6*	*–0.2*	*–3.0*
Services balance	207.7	475.5	536.1	483.4	210.1	215.6	48.6	138.4
Income balance (factor services balance)	–281.0	–382.2	–349.8	–485.3	–106.9	–328.1	15.4	–59.9
Current transfers	183.9	128.1	236.6	206.2	217.4	134.4	60.8	18.3
Current account balance	–916.0	–749.9	–1,952.7	–2,054.2	–245.1	–1,160.8	107.1	–167.7
% of GDP	*–4.8*	*–3.4*	*–8.4*	*–8.0*	*–0.8*	*–3.5*	*1.4*	*–1.9*
Capital account balance	148.9	99.5	87.1	113.9	89.4	110.1	6.3	–0.7
% of GDP	*0.8*	*0.5*	*0.4*	*0.4*	*0.3*	*0.3*	*0.1*	*0.0*
Direct investment flows (net)	737.4	2,048.2	1,726.3	4,291.0	575.4	1,072.7	337.1	72.7
% of GDP	*3.9*	*9.3*	*7.4*	*16.7*	*2.0*	*3.2*	*4.4*	*0.8*

Source: Eurostat, national central bank, OeNB.

Gross external debt increased from 52.5% of GDP at end-2004 to 63.5% of GDP at the end of the first quarter of 2005 due to both higher official and private gross foreign debt. Gross official reserves augmented to EUR 21.732 million at the end of the first quarter of 2005, thus covering 6.2 months' worth of imports of goods and services.

Table 27

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	3,780.7	4,526.0	5,074.5	8,497.3	9,337.9	10,604.7	13,555.5
Gross external debt	. .	. .	. .	12,575.9	14,323.3	17,395.7	21,731.6
	% of GDP[1])						
Gross official reserves (excluding gold)	19.8	20.6	21.8	33.0	32.2	32.0	39.6
Gross external debt	. .	. .	. .	48.9	49.5	52.5	63.5
	Import months of goods and services						
Gross official reserves (excluding gold)	3.7	3.4	3.2	5.1	4.9	4.8	6.2

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

6 Slovenia: Solid Economic Background Supports Stable Currency

GDP growth in Slovenia decelerated sharply to 2.6% year on year in the first quarter of 2005, from 4.6% in the full year 2004. This deceleration was attributable to a slowdown in domestic demand, while the contribution of net real exports to the GDP growth rate improved sharply. Among the domestic demand components, consumption growth moderated slightly as a result of reduced private and accelerating public consumption growth. Private consumption was supported by robust growth in real wages and stronger real growth of lending to households, while employment growth continued to slow down. The growth rate of gross fixed capital formation fell sharply at the beginning of 2005, leading to a contraction of investment activity compared to the first quarter of 2004. Both annual export and import growth rates were lower in the first quarter of 2005 than in the previous quarters, but given the more significant decline in the growth rate of imports, net real exports contributed 1.3 percentage points to the GDP growth rate in the first quarter, following a negative contribution of 0.3 percentage point in the full year 2004.

Table 28

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	5.6	3.9	2.7	3.3	2.5	4.6	4.3	2.6
Private consumption	5.9	0.4	2.3	0.3	2.7	3.5	3.2	2.7
Public consumption	2.9	2.3	3.9	1.7	2.6	1.7	2.6	2.9
Gross fixed capital formation	21.0	0.6	4.1	3.1	6.3	6.8	5.7	–0.5
Exports of goods and services	1.6	13.0	6.3	6.7	3.2	12.6	13.3	8.9
Imports of goods and services	8.0	7.6	3.0	4.9	6.8	12.4	11.6	6.6
	Contribution to GDP growth in percentage points							
Domestic demand	9.4	1.5	0.9	2.3	4.9	4.9	3.8	1.3
Exports	0.9	7.1	3.7	4.1	2.0	8.0	8.5	5.9
Net exports	–3.9	2.4	1.8	1.0	–2.4	–0.3	0.5	1.3

Source: Eurostat, national statistical office, OeNB.

Table 29

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	–0.5	6.3	3.1	2.5	1.4	5.0	2.4	–2.5
Labor productivity of industry (real)	0.9	6.8	2.3	1.4	3.0	6.1	3.3	–3.0
Gross average wage of industry (nominal)	9.3	11.7	10.8	9.9	7.6	7.1	6.9	7.0
Unit labor cost of industry (nominal)	8.3	4.6	8.4	8.3	4.4	1.0	3.4	10.3
Producer price index (PPI) of industry	2.2	7.7	8.9	5.3	2.6	4.4	5.2	4.4
Consumer price index (here: HICP)	6.1	8.9	8.6	7.5	5.7	3.6	3.5	2.8
Exchange rate (nominal):								
SIT[1]) per 1 EUR, + = EUR appreciation	4.6	6.3	5.5	3.6	3.5	2.2	1.6	0.9
EUR per 1 SIT, + = SIT appreciation	–4.4	–5.9	–5.2	–3.5	–3.4	–2.2	–1.5	–0.9
	Period average levels							
Unemployment rate (ILO definition, %)[2])	7.6	6.9	6.3	6.5	6.8	6.5	6.6	6.9
Employment rate[3])	62.2	62.9	63.8	63.4	62.6	65.3	64.9	65.2
Participation rate[4])	67.3	67.5	68.1	67.8	67.1	69.8	69.5	70.0
Key interest rate per annum (%)	7.2	8.1	10.5	8.4	7.0	4.6	4.0	4.0
Exchange rate (nominal):								
SIT per 1 EUR	194.4	206.6	218.0	225.9	233.8	239.1	239.8	239.7
EUR per 1 SIT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1]) SIT: Slovenian tolar.

[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

[3]) Ratio of employed persons to the working-age population (aged 15 to 64).

[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

After industrial output growth had remained negative during the first quarter, it picked up modestly in the period from April to June 2005 (2.0% year on year), but these dynamics weakened in the course of the second quarter. Nevertheless, this development – along with a further strengthening of credit activity – suggests some economic recovery. Weaker economic activity in the first quarter went hand in hand with slower annual growth in employment. Moreover, as the further rise in the employment rate was fully matched by the increase in the participation rate, the unemployment rate declined only very slightly from 7.0% to 6.9%. Tighter labor market conditions have so far prevented a significant decline in nominal wage growth, despite the slowdown in inflation, which in fact has led to an acceleration of real net wages to 3.4% during the first half of 2005 (2004: 2%). Inflation (HICP) went down gradually in the second quarter of 2005 to 1.7% in June, before rising back to 2.0% in July. Disinflation was supported by weaker economic growth, more intense competition, a stable exchange rate, falling food and nonalcoholic beverage prices and by a sharp disinflation in recreation and culture. In the first quarter of 2005, robust wage growth coincided with decreasing industrial output and labor productivity, leading to higher unit wage costs. While output recovery in the second quarter likely mitigated the situation, moderate wage growth remains a key to keep price pressures limited in the future, as acknowledged by Banka Slovenije. In addition, fuel prices represent a risk factor, especially as the government has almost completely exhausted its room to cut excise duties in compensation for the rise in international oil prices. Banka Slovenije expects inflation to come to around 2.4% at end-2005. Inflation should pick up modestly in the next two years, mainly because the negative output gap is set to close and turn positive.

Since Slovenia entered ERM II on June 28, 2004, the exchange rate of the Slovenian tolar against the euro has fluctuated in a very narrow range of between 0.10% on the strong side and 0.17% on the weak side of the central rate. Between early April and late June 2005, the tolar's appreciation trend, which had been observed since October 2004, gained momentum, but the currency has weakened slightly since then. However, these are still very small exchange rate movements compared to those of other currencies in the region (trading band of 0.14% since early April 2005). Banka Slovenije last changed its key policy rates at the beginning of April 2005, when it raised the interest rate it charges on buy/sell foreign exchange swap operations (through which it temporarily alters tolar liquidity) and the main refinancing rate (which is linked to the former) by 25 basis points to 1.5% and 3.5%, respectively. Correspondingly, money market rates have been stable at around 4% for the past few months. As a combination of stable interest rates and falling inflation, real interest rates went up modestly during the first half of 2005. This notwithstanding, the real growth of credit to households and enterprises has been increasing, as the nominal year-on-year growth of credit to households accelerated to 22% on average in the first quarter from 16.5% in the full year 2004, that of credit to enterprises to 22.5% from 19.5% and that of credit to general government to 19.5% from 16.5%. This "discrepancy" can most likely be explained by the ongoing shift toward foreign currency borrowing.

Table 30

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	. .	13.7	19.2	22.8	12.7	5.1	4.4	7.4
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	. .	3.1	9.1	11.0	3.3	–8.1	–10.1	–10.1
Domestic credit (net) of the banking system	. .	15.1	14.4	12.2	8.1	14.0	15.1	17.9
of which: claims on the private sector	. .	*15.1*	*12.6*	*9.1*	*8.0*	*11.5*	*12.4*	*14.9*
claims on households	. .	*4.4*	*2.0*	*1.6*	*1.5*	*2.7*	*3.5*	*3.8*
claims on enterprises	. .	*10.7*	*10.6*	*7.5*	*6.5*	*8.8*	*8.9*	*11.1*
net claims on the public sector	. .	*0.0*	*1.7*	*3.2*	*0.1*	*2.4*	*2.6*	*3.0*
Other domestic assets (net) of the banking system	. .	–4.4	–4.2	–0.4	1.3	–0.8	–0.6	–0.4

Source: National central bank, OeNB.

In mid-June 2005, the Slovenian parliament approved a supplementary budget for 2005. The revised budget envisages a rise in both revenues and expenditures compared to the original budget. As an overall result of the changes, the budget deficit (national methodology) is now targeted at 1.4% of GDP, compared to the previous value of 1.7%. A revised deficit target according to the ESA methodology is not available, but if one assumes the same reduction as in the national methodology, this would result in a deficit of 1.6% of GDP (compared to 1.9% in the March 2005 fiscal notification to the European Commission and 2.1% envisaged in the convergence program of December 2004). Following intense discussion about the introduction of a flat tax system during the first half of 2005, the government's expert commission for tax reform finally abandoned the idea for the time being and proposed to only reduce the number of income tax brackets (to three from currently five) and to introduce separate tax treatment of capital and labor income. Aside from these measures, the finance minister explained that switching to a flat income tax system with potential risks for budget revenues was too risky before the introduction of the euro. The convergence program of December 2004 set the deficit target to 1.8% of GDP for 2006 and to 1.1% for 2007.

Table 31

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	. .	44.7	45.1	45.7	46.2	45.8	45.5	45.2
Expenditures	. .	48.2	47.9	48.1	48.2	47.7	47.6	47.2
of which: interest payments	. .	*2.4*	*2.4*	*2.3*	*2.1*	*1.9*	*1.7*	*1.6*
Balance	. .	–3.5	–2.8	–2.4	–2.0	–1.9	–2.2	–2.1
Primary balance	. .	–1.0	–0.4	0.0	0.1	0.0	–0.5	–0.5
Gross public debt	24.9	27.4	28.1	29.5	29.4	29.4	30.2	30.4

Source: European Commission.

[1]) f stands for forecast by the European Commission.

Slovenia posted a current account surplus of 0.3% of GDP in the first quarter of 2005, which was smaller than the surplus recorded in the same period of 2004. The deterioration in the current account was primarily attributable to the fact that the transfer balance, which traditionally shows a surplus, turned into a deficit of 0.8% of GDP due to payments into the EU budget. By contrast, the surplus on the goods and services balance almost doubled to 1.3% of GDP against the first quarter of 2004. For the first time since then, year-on-year export growth outpaced import growth, reflecting the developments in real exports and imports. Given a negative balance on the capital account, Slovenia had a financing requirement of 0.4% of GDP in the first quarter of 2005, which was related to net FDI outflows of 3.3% of GDP (partly resulting from the reversal of previous inward FDI) and significantly larger net outflows of portfolio capital than a year earlier. The resulting financing gap was covered by a sharp increase in net inflows of other capital, mainly on the back of bank deposits by nonresidents.

Table 32

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	8,103.2	9,574.2	10,454.3	11,081.6	11,414.0	12,736.1	2,991.0	3,317.6
Merchandise exports: year-on-year change in %	*0.2*	*18.2*	*9.2*	*6.0*	*3.0*	*11.6*	*8.3*	*10.9*
Merchandise imports	9,267.3	10,801.2	11,138.7	11,351.0	11,959.9	13,576.0	3,088.7	3,399.7
Merchandise imports: year-on-year change in %	*5.4*	*16.6*	*3.1*	*1.9*	*5.4*	*13.5*	*5.9*	*10.1*
Trade balance	–1,164.1	–1,227.0	–684.4	–269.4	–545.9	–839.9	–97.7	–82.1
% of GDP	*–5.8*	*–6.0*	*–3.1*	*–1.1*	*–2.2*	*–3.2*	*–1.6*	*–1.3*
Services balance	329.5	489.2	535.5	616.5	538.3	671.8	139.5	162.1
Income balance (factor services balance)	58.1	29.3	43.2	–153.8	–178.0	–101.2	–15.4	–15.1
Current transfers	112.2	125.5	143.6	142.0	94.2	30.6	7.8	–49.0
Current account balance	–664.3	–583.0	37.9	335.3	–91.4	–238.7	34.2	15.9
% of GDP	*–3.3*	*–2.8*	*0.2*	*1.4*	*–0.4*	*–0.9*	*0.6*	*0.3*
Capital account balance	–0.7	4.0	–4.0	–163.6	–165.5	–178.3	–23.7	–26.8
% of GDP	*0.0*	*0.0*	*0.0*	*–0.7*	*–0.7*	*–0.7*	*–0.4*	*–0.4*
Direct investment flows (net)	54.5	77.4	251.2	1,582.3	–114.9	21.0	–109.9	–205.5
% of GDP	*0.3*	*0.4*	*1.2*	*6.7*	*–0.5*	*0.1*	*–1.8*	*–3.3*

Source: Eurostat, national central bank, OeNB.

Slovenia's gross external debt reached 62.5% of annual GDP at the end of March 2005, with the ongoing increase in the debt ratio being solely attributable to the private sector. Net debt stood at 9.1% of annual GDP, up from 1.8% one year earlier. Gross official reserves increased slightly to cover 5.1 months' worth of imports of goods and services at the end of the first quarter of 2005.

Table 33

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	3,159.20	3,435.80	4,907.50	6,701.50	6,798.20	6,464.00	6,515.20
Gross external debt	8,012.30	9,490.60	10,402.60	11,482.90	13,305.00	15,397.00	16,313.00
	% of GDP[1])						
Gross official reserves (excluding gold)	15.9	16.7	22.5	28.5	27.7	25.0	24.9
Gross external debt	40.2	46.1	47.6	48.8	54.1	59.5	62.5
	Import months of goods and services						
Gross official reserves (excluding gold)	3.5	3.3	4.6	6.1	5.9	4.9	5.1

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

7 Bulgaria: Strong Economic Performance, But Current Account Problem Continues

Real GDP grew by 6.0% year on year in the first quarter of 2005, after the economy had expanded by 6.2% in the fourth quarter of 2004 and by 5.6% in the full year 2004. Private consumption and exports made the highest contributions to GDP growth. In the first quarter of 2005, growth of domestic consumption (private and public) exceeded the level of GDP growth, increasing to 7.3% year on year from 5.0% in the full year 2004 and boosting the contribution of domestic demand to GDP growth to 11.4 percentage points. Strong private consumption was fueled in particular by increasingly high wage growth (e.g. a 25% hike of minimum wages in January 2005) and very strong consumer credit growth. Growth of gross fixed capital formation, though, declined to 9.2%. Weaker domestic investment growth and a sharp slowdown in export growth led to a decline in import growth. However, as in the full year 2004, import growth outpaced export growth in the first quarter of 2005. Net exports of goods and services became even more negative. The deterioration of net exports reduced GDP growth by 5.4 percentage points, after it had dampened growth by 3.9 percentage points in the full year 2004 and by 11.3 percentage points in the first quarter of 2004.

Table 34

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	2.4	5.4	4.1	4.9	4.5	5.6	6.2	6.0
Private consumption	9.6	4.3	5.2	3.5	6.3	5.4	6.8	. .
Public consumption	6.3	18.8	0.3	4.4	8.1	2.8	5.6	. .
Gross fixed capital formation	20.9	15.4	23.3	8.5	13.7	12.0	9.9	9.2
Exports of goods and services	–4.6	16.6	9.9	7.2	7.9	13.2	19.8	8.8
Imports of goods and services	9.3	18.7	14.8	4.9	15.3	14.1	16.9	10.8
	Contribution to GDP growth in percentage points							
Domestic demand	11.0	8.7	9.2	4.3	12.1	9.5	10.0	11.4
Exports	–2.7	9.3	6.1	4.7	5.3	9.2	11.7	6.4
Net exports	–8.6	–3.3	–5.1	0.6	–7.6	–3.9	–3.8	–5.4

Source: Eurostat, OeNB, wiiw.

High GDP growth helped reduce the unemployment rate (ILO definition) to 11.5% in the first quarter of 2005 (average), down from 13.5% the same period a year earlier. The strength of domestic demand and the export surge contributed to the ongoing increase in industrial output in Bulgaria, which, however, continued to decelerate in the first quarter of 2005 and amounted to 11.0% year on year as compared to the exceptionally high rates observed in 2004. The slowdown of output growth reduced industrial productivity growth to 12.9% from 17.5% in the full year 2004, while nominal industrial gross wage growth accelerated despite declining inflation. However, industrial unit wage costs still continued to go down, albeit at a lower rate. Having fallen from a peak of 7.6% year on year in July 2004 to a low of 3.3% year on year in January 2005, inflation (HICP) increased to 5.1% in June 2005. The major factors driving up inflation remained primarily the sharp rises in energy prices and one-off events such as the upward adjustment of administered tariffs and excise taxes. In addition, the annual rise in both food and health care prices accelerated significantly in the course of 2005. According to the central bank, average annual inflation is forecast to decline to about 3.5% for the entire year 2005;

the Bulgarian National Bank thus warned that there were several external risk factors that might raise inflation, namely the possible surge in oil prices on global markets and the possible appreciation of the U.S. dollar against the euro.

Table 35

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	–9.6	5.3	2.5	4.7	14.1	17.7	19.4	11.0
Labor productivity of industry (real)	1.2	8.6	4.5	2.7	12.6	17.5	23.0	12.9
Gross average wage of industry (nominal)	8.0	8.1	5.6	3.5	3.8	7.1	8.1	8.4
Unit labor cost of industry (nominal)	6.7	–0.5	1.1	0.8	–7.8	–8.8	–12.1	–4.0
Producer price index (PPI) of industry	3.2	17.0	3.8	1.4	5.0	5.9	6.9	6.2
Consumer price index (here: HICP)	2.6	10.3	7.4	5.8	2.3	6.1	4.7	3.8
Exchange rate (nominal):								
BGN[1]) per 1 EUR, + = EUR appreciation	–0.7	–0.2	–0.2	0.1	0.0	0.2	0.3	0.2
EUR per 1 BGN, + = BGN appreciation	0.7	0.2	0.2	–0.1	0.0	–0.2	–0.3	–0.2
	Period average levels							
Unemployment rate (ILO definition, %)[2])	. .	17.0	20.5	18.3	13.9	12.2	12.0	11.5
Employment rate[3])	. .	50.4	49.7	50.6	52.5	54.2	54.1	53.0
Participation rate[4])	. .	60.7	62.5	61.9	60.9	61.8	61.5	59.9
Key interest rate per annum (%)	4.7	3.9	4.5	4.0	2.7	2.6	2.4	2.2
Exchange rate (nominal):	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BGN per 1 EUR	2.0	2.0	1.9	1.9	1.9	2.0	2.0	2.0
EUR per 1 BGN	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1]) BGN: Bulgarian lev.

[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

[3]) Ratio of employed persons to the working-age population (aged 15 to 64).

[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

In the first months of 2005, broad money growth (nominal, year on year) increased to close to 30% against 22% on average in 2004. Apart from a higher growth of net foreign assets, the very robust growth of lending to households reaccelerated to close to 80% (78.5% on average in 2004) and the growth of lending to enterprises rose to 55% in March and April (41% on average in 2004). The fact that Visa issued 126% more credit cards in Bulgaria in the first quarter of 2005 than in the same period in 2004 illustrates this credit boom. However, in May 2005, the annual growth of lending to enterprises weakened considerably. The package of measures addressed to commercial banks' credit activity, including the tightening of reserve requirements for commercial banks and the creation of ceilings for annual credit growth (in April 2005), may have contributed to this development. Nevertheless, these measures have not substantially constrained household credit expansion so far.

Table 36

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	7.9	27.4	27.8	18.3	16.3	22.3	20.6	26.3
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	–0.2	26.1	13.5	7.7	5.4	4.4	6.2	6.6
Domestic credit (net) of the banking system	2.0	6.8	15.0	12.1	14.5	21.8	19.8	25.4
of which: claims on the private sector	*9.5*	*8.7*	*8.1*	*13.6*	*19.9*	*26.3*	*27.2*	*31.0*
claims on households	*2.6*	*1.1*	*2.4*	*3.3*	*5.9*	*10.0*	*11.1*	*11.9*
claims on enterprises	*6.9*	*7.7*	*5.7*	*10.3*	*14.0*	*16.3*	*16.1*	*19.1*
net claims on the public sector	*–7.4*	*–2.0*	*6.9*	*–1.5*	*–5.4*	*–4.5*	*–7.4*	*–5.6*
Other domestic assets (net) of the banking system	6.0	–5.5	–0.7	–1.5	–3.6	–3.8	–5.5	–5.8

Source: National central bank, OeNB.

The Bulgarian government has been conducting a strict fiscal policy which provides for the stability of public finance and under a currency board helps ensure the country's economic stability. According to the fiscal notification by the authorities to the European Commission in March 2005, the fiscal balance in 2004 showed a surplus of 1.3% of GDP compared to an originally expected deficit of 0.7% of GDP. Based on national methodology, the consolidated fiscal budget in 2004 showed a surplus of 1.7% of GDP, which was used mainly to repay external debt. In the first quarter of 2005, the budget surplus came to about 5.5% of GDP according to this methodology and was thus higher than in the comparable period of 2004 (2.9% of GDP). The consolidated budget revenues-to-GDP ratio grew at a faster pace than the expenditures-to-GDP ratio. On account of impressive results for revenues and the strong surpluses to date given a significantly improved tax collection, Bulgaria's consolidated budget is outperforming the plan agreed in May 2005 with the IMF to reach a fiscal surplus of 1% of GDP for 2005; in November 2004, the Bulgarian government had envisaged a 2005 deficit of 0.5% in the PEP for the period from 2004 to 2007, and in March 2005 the fiscal notification had confirmed the expectation of a deficit of 0.5% of GDP in 2005. According to the law on corporate income taxation, the basic corporate tax rate on business profits has been reduced to 15% as of the 2005 financial year from 19.5% in 2004.

Table 37

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	56.6	58.2	53.5	. .	. .	. .	. .	. .
Expenditures	56.2	58.7	52.3	. .	. .	. .	. .	. .
of which: interest payments	*3.8*	*4.0*	*3.7*	*2.2*	*2.1*	*1.8*	*1.9*	*1.8*
Balance	0.4	–0.5	1.2	–0.1	0.6	1.4	–0.5	0.0
Primary balance	4.1	3.6	4.9	2.1	2.7	3.2	1.4	1.8
Gross public debt	79.3	73.6	66.2	54.0	46.3	38.8	32.5	29.8

Source: European Commission.

[1]) *f stands for forecast by the European Commission.*

In Bulgaria, the current account usually exhibits a seasonal pattern, with large deficits in the first, second and fourth quarters of the year, which are partly compensated by a huge surplus in the third quarter related to the tourist season. Thus, it did not come as a surprise that the current account deficit-to-GDP ratio in the first quarter of 2005 at 15.9% of GDP was much higher than in the full year 2004. However, the current account deficit, the main point of concern for the Bulgarian authorities and the IMF, continued to widen in the first quarter of 2005 also compared to the first quarter of 2004, when it was 12.2% of GDP. This development was attributable almost exclusively to the deterioration of the trade balance, which reflects lasting strong internal demand for capital and consumer durable goods as well as rising oil prices and the strengthening of the U.S. dollar versus the euro. According to balance of payments data, exports and imports grew at around the same rate in the first quarter of 2005; exports increased by 20.8% (first quarter of 2004: 5.1%), imports by 22.5% (first quarter of 2004: 15.7%), which means that the trade deficit worsened. Additionally, the services balance was to blame for the remaining deterioration in the current account balance. The deficit on income items widened only slightly. In the first quarter of 2005, net FDI inflows dropped and stood at EUR 265 million (first quarter of 2004: EUR 354 million), covering about one-third of the current account deficit, compared with three-quarters in the first quarter of 2004 – significantly less than in both full years 2003 and 2004.

Table 38

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	3,733.8	5,253.1	5,714.1	6,062.8	6,668.0	7,993.9	1,719.2	2,077.6
Merchandise exports: year-on-year change in %	*–0.3*	*40.7*	*8.8*	*6.1*	*10.0*	*19.9*	*5.1*	*20.8*
Merchandise imports	4,741.5	6,532.9	7,492.6	7,754.5	8,867.9	10,711.8	2,227.6	2,729.2
Merchandise imports: year-on-year change in %	*16.3*	*37.8*	*14.7*	*3.5*	*14.4*	*20.8*	*15.7*	*22.5*
Trade balance	–1,007.7	–1,279.8	–1,778.5	–1,691.7	–2,199.9	–2,717.9	–508.4	–651.6
% of GDP	*–8.3*	*–9.3*	*–11.7*	*–10.2*	*–12.4*	*–14.0*	*–12.4*	*–14.7*
Services balance	305.4	547.4	454.4	486.0	523.2	723.4	–28.4	–73.7
Income balance (factor services balance)	–167.1	–345.2	–339.6	–285.3	–566.5	–340.9	–136.6	–147.4
Current transfers	282.1	316.1	562.0	565.5	612.7	888.1	174.0	167.9
Current account balance	–587.3	–761.5	–1,101.7	–925.5	–1,630.5	–1,447.3	–499.4	–704.8
% of GDP	*–4.8*	*–5.6*	*–7.2*	*–5.6*	*–9.2*	*–7.4*	*–12.2*	*–15.9*
Capital account balance	–2.3	25.4	0.0	0.0	–0.2	0.0	0.0	0.0
% of GDP	*0.0*	*0.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Direct investment flows (net)	849.9	1,099.8	895.0	951.0	1,827.2	1,639.8	354.3	265.0
% of GDP	*7.0*	*8.0*	*5.9*	*5.7*	*10.3*	*8.4*	*8.6*	*6.0*

Source: Eurostat, national central bank, OeNB.

The country's gross external debt increased from 62.9% of GDP at end-2004 to 65.4% of annual GDP at end-March 2005. The position of the private sector deteriorated continuously, while the position of the public sector improved. Foreign currency reserves remained constant at EUR 6.3 billion, corresponding to about 5.7 months of import cover.

Table 39

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	2,878.7	3,390.6	3,734.0	4,247.1	4,981.0	6,444.5	6,325.1
Gross external debt	10,846.6	11,882.7	11,934.9	10,768.9	10,638.7	12,245.9	12,940.1
	% of GDP[1])						
Gross official reserves (excluding gold)	23.7	24.7	24.5	25.6	28.1	33.1	31.9
Gross external debt	89.2	86.7	78.3	64.9	60.0	62.9	65.4
	Import months of goods and services						
Gross official reserves (excluding gold)	5.6	4.9	4.8	5.2	5.4	5.8	5.7

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

8 Croatia: Economic Slowdown and Stabilization of External Debt

In Croatia real GDP growth considerably decelerated to 1.8% year on year in the first quarter of 2005 compared to 3.6% in the last quarter of 2004 (full year 2004: 3.8%), the lowest growth rate since the last quarter of 2000 (0.6%). This development is attributable to a slowdown in private consumption to 2.4% in the first quarter of 2005 from 3.8% in the last quarter of 2004 and, most importantly, can be traced to the marked drop in the growth rate of real exports to 1.0% in the first quarter of 2005 from 5.8% in the previous quarter. As import growth accelerated to 2.1% in the first quarter of 2005, net exports made a negative contribution to GDP growth (–0.8 percentage point), after a significantly positive contribution in previous quarters. Therefore, domestic demand remained the major contributor to GDP, notwithstanding the slowdown in private consumption and the stagnation of public consumption and gross fixed capital formation.

Table 40

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	–0.9	2.9	4.4	5.2	4.3	3.8	3.6	1.8
Private consumption	–2.9	4.2	4.5	7.5	4.1	3.9	3.8	2.4
Public consumption	2.8	–1.5	–6.2	–1.8	–0.3	–0.3	–0.6	–0.1
Gross fixed capital formation	–3.9	–3.8	7.1	12.0	16.8	4.4	0.9	0.3
Exports of goods and services	0.7	12.0	8.1	1.3	10.1	5.4	5.8	1.0
Imports of goods and services	–3.5	3.7	9.8	8.8	10.9	3.5	0.0	2.1
	Contribution to GDP growth in percentage points							
Domestic demand	–3.0	–0.3	5.8	9.4	5.8	3.3	1.2	2.6
Exports	0.3	5.1	3.7	0.6	4.6	2.6	2.4	0.4
Net exports	2.1	3.2	–1.4	–4.2	–1.5	0.5	2.4	–0.8

Source: National statistical office, OeNB.

The unemployment rate (registered unemployment) amounted to 19.2% in the first quarter of 2005, compared to 19.1% in the first quarter of 2004. Growth of average net wages declined to 4.9% (full year 2004: 5.9%) in nominal terms and to 1.7% (full year 2004: 3.7%) in real (CPI-deflated) terms, contributing to the slowdown of private consumption growth. In industry, average gross wages grew by 5.6% in the first quarter of 2005 (full year 2004: 5.5%). As labor productivity growth slowed down to 2.6% (full year 2004: 4.0%) as a consequence of the significant weakening of industrial production to 0.7%, which could not be compensated for by a decline of 1.9% in industrial employment, industrial ULC rose by 3.0% against a slight increase in 2004 (1.5%). Headline inflation accelerated to 3.9% year on year in March 2005 compared to the average annual inflation of 2.1% in 2004, mainly because higher prices of food, energy and services. By May 2005, CPI inflation had dropped to 2.8%, but then slightly increased to 3.1% in July mainly because of higher prices of food, transportation (fuel), leisure and culture, and a base effect. At the same time, the inflation rate excluding energy and food stayed at a stable 1.8%. Apart from food and energy, administrative price adjustments, higher indirect taxes and price dynamics in the services sector may be considered as the main factors driving inflation.

Table 41

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	–1.5	1.8	6.1	5.5	4.1	3.7	4.1	0.7
Labor productivity of industry (real)	1.6	4.4	7.8	7.8	3.5	4.0	4.5	2.6
Gross average wage of industry (nominal)	5.6	6.1	8.2	6.9	5.4	5.5	5.7	5.6
Unit labor cost of industry (nominal)	3.8	1.6	0.4	–0.8	1.8	1.5	1.2	3.0
Producer price index (PPI) of industry	2.5	9.5	3.4	–0.5	1.9	3.6	5.6	5.0
Consumer price index (CPI)[1]	4.3	6.4	5.0	1.7	1.8	2.1	2.3	3.1
Exchange rate (nominal):								
HRK[2] per 1 EUR, + = EUR appreciation	6.4	0.9	–2.1	–1.0	2.1	–0.9	–1.0	–1.3
EUR per 1 HRK, + = HRK appreciation	–6.0	–0.8	2.1	1.0	–2.1	0.9	1.0	1.3
	Period average levels							
Unemployment rate (registered unemployed, %)	19.1	21.1	22.0	22.3	19.5	18.2	18.4	19.2
Employment rate[3]	. .	. .	. .	53.4	53.4	54.7	54.5	. .
Participation rate[4]	. .	. .	. .	62.9	62.4	63.7	63.4	. .
Key interest rate per annum (%)	7.5	6.5	5.9	5.6	4.5	4.5	4.5	4.5
Exchange rate (nominal):								
HRK per 1 EUR	7.6	7.6	7.5	7.4	7.6	7.5	7.6	7.5
EUR per 1 HRK	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1]) *Retail price index until 2001, CPI since 2002.*

[2]) *HRK: Croatian kuna.*

[3]) *Ratio of employed persons to the working-age population (aged 15 to 64).*

[4]) *Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).*

The exchange rate regime in Croatia is a fairly tightly managed float regime, with the central bank intervening rather frequently. After the usual seasonal depreciation at the end of 2004, the exchange rate of the Croatian kuna against the euro registered an appreciation during the first six months of 2005, going up from 7.7 HRK/EUR in January to 7.3 HRK/EUR in June. This appreciation of about 4% motivated the central bank to sell a total amount of EUR 293 million of domestic currency against the euro on six occasions from January to June. In July, the appreciation trend stopped. Broad money growth remained stable at 8.5% in the first quarter of 2005 compared to 8.8% in the last quarter of 2004 (full year 2004: 8.3%). Money growth is dominated by the growth of lending to nongovernment nonbanks, which accelerated moderately to 13% (2004: 11.8%). While net foreign assets contracted more severely in 2005 (–19.8%) compared to 2004 (–1.8%), net credit to the government surged by 42%, after it had declined by 5.5% in 2004. However, these sharp changes had no large impact on money growth as the weight of these items is only small.

Besides foreign exchange interventions, the second main pillar of monetary policy in Croatia rests on mandatory reserve regulations, foreign currency asset-to-liability ratios and other quantitative measures. In addition to a mandatory reserve ratio of 18%, Croatian banks have to maintain a minimum coverage of their foreign currency liabilities in the form of short-term foreign currency assets (32% since February 2005). The marginal reserve requirement ratio, which requires banks to deposit (free of interest) with the central bank a specified percentage of the net increase in their foreign liabilities over the level registered in June 2004, was hiked from 30% to 40% in May 2005.

Without too strongly influencing the predominance of foreign exchange interventions and mandatory reserve regulations, Hrvatska narodna banka introduced, in April 2005, a new monetary operational framework aimed at providing a clear structure of interest rate instruments. This new framework comprises an interest corridor of 0.5% to 9.5% set by means of standing facilities, which actually coincide with fluctuations observed on the money market in the past, and open market operations classified into (1) regular operations, (2) fine tuning operations and (3) structural operations.

Table 42

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	2.6	14.0	30.9	32.4	11.3	8.3	8.8	8.5
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	–3.7	20.3	13.4	9.8	–7.7	–0.5	–0.3	–1.7
Domestic credit (net) of the banking system[1])	9.8	–1.2	21.1	23.2	19.5	9.4	10.5	12.6
of which: claims on the private sector	*5.9*	*–2.0*	*17.0*	*21.5*	*17.7*	*10.1*	*10.7*	*11.4*
claims on households	*5.6*	*3.8*	*10.0*	*11.3*	*11.9*	*7.5*	*7.2*	*7.8*
claims on enterprises	. .	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*3.9*	*0.9*	*4.1*	*1.7*	*1.8*	*–0.7*	*–0.3*	*1.2*
Other domestic assets (net) of the banking system	–3.4	–5.1	–3.6	–0.5	–0.5	–0.7	–1.4	–2.4

Source: National central bank, OeNB.

[1]) Local governments included in private sector. Claims on households excluding claims of the central bank.

In 2004, according to the fiscal notifications to the European Commission of March and April 2005, the general government's deficit stood at 4.9% of GDP (which corresponds to 5.2% when based on the new methodology) instead of the targeted 4.5% – a phenomenon that was chiefly attributable to weaknesses on the revenue side. Under the commitment the Croatian government set out in the PEP for 2005 to 2007, the general government's budget deficit is envisaged to decrease to 3.7% (which corresponds to 3.2% when based on the new methodology) in 2005 and further to 3.2% in 2007. The PEP expects the continued adjustment to come primarily from measures on the expenditure side; the expenditure-to-GDP ratio is expected to go down from 52.7% in 2004 to 50.8% in 2005 and 49.7% in 2007. The European Commission's 2005 spring forecast expects the general government deficit to come to 4.3% of GDP in 2005. Along these lines and in response to the revenue shortfall caused by weak economic growth, the general government deficit target envisaged for 2005 was officially acknowledged to be out of reach when Croatia and the IMF agreed on a new target of 4.2% (new methodology) during the second review of the 20-month precautionary Stand-By Arrangement with the IMF that runs until April 2006. The IMF recommends fiscal consolidation to comprise four steps: changing the pension indexation formula, reforming the health care system, reducing public subsidies to state-owned firms and promoting privatization. In July, parliament will decide on the revised 2005 budget, which comprises a cut of HRK 1.0 billion on the expenditure side.

Table 43

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	. .	. .	. .	. .	. .	. .	. .	. .
Expenditures	. .	. .	. .	. .	. .	. .	. .	. .
of which: interest payments	. .	. .	. .	. .	*2.0*	*2.0*	*2.2*	*2.2*
Balance	. .	. .	. .	. .	–6.3	–5.0	–4.3	–3.9
Primary balance	. .	. .	. .	. .	–4.4	–3.0	–2.1	–1.6
Gross public debt	. .	. .	. .	. .	51.6	53.8	53.1	52.5

Source: European Commission.

[1]) f stands for forecast by the European Commission.

In accordance with the long-observed seasonal pattern of the current account, the current account deficit reached 19.8% of GDP in the first quarter of 2005, slightly higher than the 19.2% registered in the comparable period of 2004 (the current account usually exhibits large deficits in the first, second and fourth quarters of the year, which are partly compensated by a huge surplus in the third quarter related to the tourist season). The slight worsening of the trade balance (–23.5% in the first quarter of 2005 against –23.2% in the comparable quarter of 2004) was counterbalanced by an improvement in current transfers, while the services and income balances remained largely unchanged compared to the first quarter of 2004.

Table 44

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	4,134.1	4,969.3	5,318.8	5,293.1	5,571.7	6,601.9	1,483.4	1,522.7
Merchandise exports: year-on-year change in %	*1.8*	*20.2*	*7.0*	*–0.5*	*5.3*	*18.5*	*7.2*	*2.6*
Merchandise imports	7,240.0	8,468.6	9,922.6	11,253.5	12,545.9	13,326.7	2,919.8	3,075.9
Merchandise imports: year-on-year change in %	*–5.5*	*17.0*	*17.2*	*13.4*	*11.5*	*6.2*	*6.9*	*5.3*
Trade balance	–3,105.9	–3,499.4	–4,603.8	–5,960.3	–6,974.2	–6,724.7	–1,436.5	–1,553.3
% of GDP	*–16.6*	*–17.5*	*–20.8*	*–24.6*	*–27.3*	*–24.3*	*–23.2*	*–23.5*
Services balance	1,544.5	2,470.5	3,302.8	3,284.8	5,046.9	4,903.6	221.5	203.4
Income balance (factor services balance)	–345.5	–419.8	–616.2	–573.8	–1,074.1	–626.9	–241.9	–248.5
Current transfers	594.0	958.9	1,099.5	1,152.2	1,244.5	1,189.7	269.0	291.7
Current account balance	–1,312.9	–489.9	–817.7	–2,097.2	–1,756.9	–1,258.3	–1,187.9	–1,306.7
% of GDP	*–7.0*	*–2.5*	*–3.7*	*–8.7*	*–6.9*	*–4.6*	*–19.2*	*–19.8*
Capital account balance	23.4	22.2	154.1	501.2	72.4	23.1	7.0	2.3
% of GDP	*0.1*	*0.1*	*0.7*	*2.1*	*0.3*	*0.1*	*0.1*	*0.0*
Direct investment flows (net)	1,314.8	1,140.6	1,326.9	597.2	1,695.4	696.5	233.0	147.7
% of GDP	*7.0*	*5.7*	*6.0*	*2.5*	*6.6*	*2.5*	*3.8*	*2.2*

Source: Eurostat, national central bank, OeNB.

Total gross foreign debt reached EUR 22.9 billion, which is equivalent to 81.6% of annual GDP at the end of the first quarter of 2005. The steady increase in foreign debt since 1994, which was particularly accentuated in 2003, came to an at least temporary halt as the foreign debt-to-GDP ratio has fluctuated within a range of 80% to 82% over the last four quarters (second quarter of 2004 to first quarter of 2005). As a matter of fact, the authorities aim at stabilizing and subsequently reducing external debt, a policy objective that – next to fiscal consolidation – represents the second cornerstone of the Stand-By Arrangement with the IMF.

Table 45

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	3,012.60	3,783.20	5,333.60	5,651.30	6,554.10	6,436.20	6,700.40
Gross external debt	10,101.29	12,109.30	13,458.31	15,054.81	19,810.62	22,675.40	23,042.46
	% of GDP[1])						
Gross official reserves (excluding gold)	16.13	18.95	24.07	23.34	25.69	23.29	23.88
Gross external debt	54.09	60.65	60.75	62.19	77.64	82.04	82.12
	Import months of goods and services						
Gross official reserves (excluding gold)	3.93	4.35	5.29	4.91	5.18	4.76	5.40

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

9 Romania: Robust Economic Growth, but Strong Currency Appreciation and Widening Current Account Cause Concern

Real GDP growth in Romania slowed to 5.9% year on year in the first quarter of 2005 from 9.7% in the previous quarter and 8.4% in the full year 2004. The robust economic performance was driven by domestic demand, and most strongly by private consumption growth, which came to 12.5%. Private consumption growth was largely supported by rapid real wage growth (total economy net wages deflated by CPI advanced by 13.1% year on year in the first quarter of 2005) and higher disposable income as a result of the reduction of the income and profit tax. Gross fixed capital formation expanded strongly over most of 2004, but fell back in the last quarter to just 2.7% before recovering to 5.2% in the first quarter of 2005. In the first nine months of 2004, export growth accelerated to 16.8%, but dropped to just 8.8% in the last quarter of 2004 and remained at this level also in the first quarter of 2005. Against the background of stronger growth in private and public consumption and gross fixed capital formation, import growth accelerated from 10.0% in the last quarter of 2004 to 18.4% in the first quarter of 2005. The resulting deterioration in net exports implied a negative contribution to GDP growth of 6.0 percentage points, a significantly more negative contribution than in the previous quarter (–1.4 percentage points) and in the full year 2004 (–2.8 percentage points).

Table 46

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	–1.1	2.0	5.6	5.1	5.3	8.4	9.7	5.9
Private consumption[1])	–1.1	0.3	6.7	5.0	7.1	11.2	12.8	12.5
Public consumption[2])	. .	. .	–1.8	5.5	4.3	3.4	3.6	5.8
Gross fixed capital formation	–5.5	5.3	10.5	7.5	9.1	9.9	2.7	5.2
Exports of goods and services	. .	24.3	13.7	17.1	11.5	14.2	8.8	8.8
Imports of goods and services	. .	28.5	18.9	11.8	16.0	18.1	10.0	18.4
	Contribution to GDP growth in percentage points							
Domestic demand	. .	. .	8.4	4.3	7.8	11.3	11.0	12.0
Exports	. .	. .	4.5	5.7	4.1	5.1	2.7	4.3
Net exports	. .	. .	–2.8	0.9	–2.5	–2.8	–1.4	–6.0

Source: National statistical office, Eurostat, OeNB, wiiw.

[1]) Household consumption expenditure, expenditure for individual consumption of general government and nonprofit institutions serving households.

[2]) Expenditure for collective consumption of general government.

The average unemployment rate (ILO definition) declined from 9.3% in the first quarter of 2004 to 8.9% in the first quarter of 2005, as the increase in the employment rate by 1.2 percentage points to 56.6% slightly exceeded the rise in the participation rate over this period. In industry, employment declined slightly by 0.2% year on year in the first quarter of 2005, while real industrial output increased by 5.4%. The resulting growth of labor productivity by 5.6% lagged behind industrial wage growth, leading to a 9.3% rise in nominal industrial unit wage costs. As a result, the decline in industrial wage growth helped moderate the rise in nominal industrial unit wage costs, which in turn will underpin the disinflation process. After having reached 10.1% in May 2005, inflation (HICP) started to decrease in June to 9.7% and further in July to 9.3%. Inflation was driven partly by supply-side factors (increases in administered prices, excise taxes and world oil prices), but also by very strong domestic demand growth. In August, the Banca Națională a României (BNR) shifted to inflation targeting and set the official inflation target at 7.5% for December 2005. For December 2006, the target is set at 5% on condition that the VAT rate will not be raised. Both targets have a ±1% variation interval.

Table 47

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	–7.9	6.2	8.3	4.4	3.2	5.4	8.0	5.4
Labor productivity of industry (real)	7.2	12.5	11.6	5.4	5.2	7.1	8.6	5.6
Gross average wage of industry (nominal)	44.0	41.7	51.1	23.6	19.5	23.0	22.1	15.5
Unit labor cost of industry (nominal)	34.3	25.9	35.4	17.2	13.6	14.8	12.4	9.3
Producer price index (PPI) of industry	41.6	53.8	38.7	23.2	19.6	19.1	18.0	13.5
Consumer price index (CPI)	45.8	45.7	34.5	22.5	15.3	11.9	10.0	8.9
Exchange rate (nominal):								
RON[1]) per 1 EUR, + = EUR appreciation	63.8	22.0	30.5	20.1	20.2	7.9	0.3	–8.6
EUR per 1 RON, + = RON appreciation	–39.0	–18.1	–23.4	–16.8	–16.8	–7.3	–0.3	9.4
	Period average levels							
Unemployment rate (ILO definition, %)[2])	7.6	7.9	7.3	9.1	7.5	8.5	8.5	8.9
Employment rate[3])	63.2	63.0	62.4	57.6	57.6	57.7	57.4	56.6
Participation rate[4])	68.4	68.4	67.3	63.4	62.2	63.0	62.7	62.2
Key interest rate per annum (%)	35.0	35.0	35.0	29.6	18.8	20.3	18.5	15.4
Exchange rate (nominal):								
RON per 1 EUR	1.63	1.99	2.60	3.12	3.75	4.05	3.98	3.71
EUR per 1 RON	0.612	0.502	0.385	0.320	0.266	0.247	0.251	0.270

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1]) RON: New Romanian leu; with effect from July 1, 2005, the new Romanian leu was introduced at a conversion rate of 1 RON = 10,000 ROL.

[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

[3]) Ratio of employed persons to the working-age population (aged 15 to 64).

[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

In the first five months of 2005, growth of credit to the private sector remained strong at about 35% year on year, but this figure was considerably lower than in the first quarter of 2004 (67%) and in the full year 2004 (55%). By contrast, the annual growth rate of net foreign assets accelerated throughout the last twelve months, from 6.1% year on year in the first quarter of 2004 to 23.4% in the first quarter of 2005. As a result of both the increase in net foreign assets and the strong growth of the other items net position, overall broad money growth increased to 41% in the first quarter of 2005 from 31.5% on average in 2004 and had accelerated further to 46% by June 2005. In July 2005, the BNR introduced measures to reduce the upswing in foreign currency borrowings: Effective as of end-August, a 30% reserve ratio on all foreign currency-denominated liabilities with maturities longer than two years was implemented, while the reserve ratio on leu-denominated liabilities with maturities up to two years was reduced from 18% to 16%. To dampen lending to households and to limit household lending risk, the monthly debt service ceiling was set to 40% of the borrower's net monthly income. The Romanian leu started to appreciate strongly in October 2004. The appreciation of the currency went hand in hand with the (anticipated) abandonment of the implicit crawling band in November 2004 and the announcement of a more flexible exchange rate. Furthermore, the anticipated further liberalization of the capital account, which was implemented in April 2005 in connection with the EU accession process, led to large capital inflows. After the leu had appreciated against the euro by 4.5% from end-September to end-December and by a further 8.5% until end-February 2005, the pace of appreciation slowed down markedly, following a massive intervention by the central bank in the foreign exchange market, namely the sale of domestic currency against the euro in order to restrain the appreciation trend. Moreover, motivated by the continuous disinflation process, but also by the aim to contain the differential between domestic and international interest rates against the background of an enhanced liberalization of the capital account, the Romanian authorities reduced the monetary policy rate step by step from 20.75% in June 2004 to 12.5% in April 2005.

Table 48

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	52.0	40.4	42.5	40.9	31.2	31.5	35.9	40.8
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	10.8	38.4	44.9	31.8	15.5	12.9	17.6	23.4
Domestic credit (net) of the banking system	42.3	14.0	10.2	18.7	23.9	26.0	21.6	12.9
of which: claims on the private sector	*24.3*	*3.6*	*18.3*	*24.1*	*28.2*	*32.2*	*28.2*	*22.7*
claims on households	. .	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*17.9*	*10.3*	*–8.1*	*–5.3*	*–4.3*	*–6.2*	*–6.6*	*–9.8*
Other domestic assets (net) of the banking system	–1.0	–12.0	–12.6	–9.6	–8.3	–7.4	–3.4	4.5

Source: National central bank, OeNB.

In 2004, the Romanian budget posted a deficit of 1.4% of GDP. In the latest fiscal notification reported by the Romanian authorities to the European Commission in March 2005, the projected deficit for 2005 was set at 0.5% of GDP, largely in line with the deficit target of 0.7% of GDP published in the PEP for 2004 to 2007 in November 2004, which is also the target the authorities agreed on with the IMF. However, in its assessment of the 2005 fiscal notification, the European Commission concludes that the deficit target of 0.5% of GDP might be overambitious as the introduction of the uniform 16% flat tax on income (replacing the progressive rate that ranged between 18% and 40%) and corporate tax (previously 25%) is underfinanced. Correspondingly, the European Commission assumed a much higher deficit for 2005 (2.4% of GDP) in its Spring Forecast in April 2005. Given the severe flood damages, the Romanian authorities have recently revised the target upward to 1% of GDP.

Table 49

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f [1])	2006 f [1])
	% of GDP							
General government								
Revenues	. .	. .	. .	. .	. .	. .	. .	. .
Expenditures	. .	. .	. .	. .	. .	. .	. .	. .
of which: interest payments	. .	. .	*3.2*	*2.2*	*1.6*	*1.3*	*1.5*	*1.5*
Balance	. .	. .	–3.5	–2.0	–2.0	–1.4	–2.4	–2.6
Primary balance	. .	. .	–0.3	0.2	–0.4	–0.2	–0.9	–1.1
Gross public debt	24.0	23.9	23.2	23.3	21.3	18.5	19.1	19.6

Source: European Commission.

[1]) f stands for forecast by the European Commission.

In the first quarter of 2005, the current account deficit expanded to 6.4% of GDP against 2.7% of GDP in the first quarter of 2004. This deterioration is partly attributable to a higher trade deficit (7.8% of GDP in the first quarter of 2005 against 6.0% of GDP in the comparable 2004 period) as a result of strong demand for capital and consumer durables. Moreover, the services balance turned negative (–1.0% of GDP) in the first quarter of 2005 from its balanced position in the first quarter of 2004, and the shortfall of the income balance more than tripled (in euro terms) during that period. In the first half of 2005, export growth was 16.6% year on year, whereas import growth amounted to 22.9% (as measured in euro). In this period, the current account deficit went up by 60.1% year on year (in euro terms). In the first quarter of 2005, net FDI inflows covered almost 50% of the current account deficit against full coverage in the first quarter of 2004.

Table 50

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	7,984.0	11,279.0	12,719.0	14,644.0	15,614.0	18,917.0	4,329.0	5,091.0
Merchandise exports: year-on-year change in %	*7.7*	*41.3*	*12.8*	*15.1*	*6.6*	*21.2*	*14.6*	*17.6*
Merchandise imports	9,169.0	13,150.0	16,045.0	17,392.0	19,569.0	24,241.0	4,933.0	6,131.0
Merchandise imports: year-on-year change in %	*–5.9*	*43.4*	*22.0*	*8.4*	*12.5*	*23.9*	*17.7*	*24.3*
Trade balance	–1,185.0	–1,871.0	–3,326.0	–2,748.0	–3,955.0	–5,324.0	–604.0	–1,040.0
% of GDP	*–3.6*	*–4.7*	*–7.5*	*–5.7*	*–7.9*	*–9.0*	*–6.0*	*–7.8*
Services balance	–372.0	–260.0	–127.0	6.0	62.0	–236.0	4.0	–134.0
Income balance (factor services balance)	–388.0	–304.0	–316.0	–490.0	–623.0	–1,052.0	–94.0	–322.0
Current transfers	589.0	937.0	1,280.0	1,614.0	1,639.0	2,299.0	425.0	632.0
Current account balance	–1,356.0	–1,498.0	–2,489.0	–1,618.0	–2,877.0	–4,313.0	–269.0	–864.0
% of GDP	*–4.1*	*–3.8*	*–5.6*	*–3.4*	*–5.7*	*–7.3*	*–2.7*	*–6.4*
Capital account balance	41.0	38.0	106.0	97.0	188.0	461.0	65.0	75.0
% of GDP	*0.1*	*0.1*	*0.2*	*0.2*	*0.4*	*0.8*	*0.6*	*0.6*
Direct investment flows (net)	948.0	1,161.0	1,315.0	1,193.0	1,591.0	3,938.0	407.0	413.0
% of GDP	*2.9*	*2.9*	*3.0*	*2.5*	*3.2*	*6.7*	*4.0*	*3.1*

Source: National central bank, OeNB.

Romania's gross external debt increased from 30.0% of annual GDP at the end of 2004 to 32.8% of annual GDP at the end of the first quarter of 2005. During that period, gross official reserves went up from 18.4% to 20.1% of annual GDP, covering 5.3 months of imports of goods and services, against 4.8 at end-2004.

Table 51

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	1,520.00	2,654.90	4,445.30	5,876.80	6,373.60	10,838.50	12,561.50
Gross external debt (medium- and long-term)	8,756.50	11,113.40	13,507.10	14,784.30	15,683.20	17,700.40	20,455.40
	% of GDP[1])						
Gross official reserves (excluding gold)	4.62	6.66	9.99	12.25	12.66	18.37	20.15
Gross external debt (medium- and long-term)	26.60	27.88	30.35	30.82	31.15	29.99	32.81
	Import months of goods and services						
Gross official reserves (excluding gold)	1.68	2.08	2.89	3.55	3.45	4.75	5.30

Source: Eurostat, national central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

10 Russia: Weaker Growth Despite Record Oil Prices

Russian GDP expanded 5.2% year on year (revised data) in the first quarter of 2005. For the first half of 2005, the ministry of the economy estimates GDP growth to have accelerated slightly to 5.6%, followed by 5.7% year on year in the period from January to July 2004. Despite the slight pick-up, economic expansion weakened compared to the level it had reached in the first quarter of 2004 (7.6%) and in the full year 2004 (7.2%). This slowdown was triggered by slackening growth of gross fixed capital formation and private consumption and by a further contraction of positive net exports. While the growth rates of both exports and imports decreased, import growth persistently outstripped export growth, resulting in a negative contribution of net exports to GDP growth similar in size to that in the full year 2004. The weakening of real export growth despite 2005 record oil prices resulted from the stagnation of oil and raw material production, the drastic tightening of taxation of the energy sector as well as constraints in transport capacities. In line with weaker, but still strong domestic demand growth, import growth slowed down, but remained strong. Moreover, the continuing real appreciation of the Russian ruble is undermining the competitiveness of manufactured goods exports, while enhancing imports. In addition, the pace of structural reform has recently slowed down substantially. The contraction of gross fixed investment growth in the course of 2004, which continued in the first quarter of 2005, was linked to a business climate deterioration triggered by repercussions of the Yukos affair, the proliferation of back tax claims and other regulatory interventions of state bureaucracy. However, in the second quarter of 2005 this trend reversed, yielding a year-on-year growth of 9.4% in the first half of 2005. Although private consumption growth was lower in the first quarter of 2005 than in previous quarters, it continued to be the main pillar of GDP growth, buoyed by wage and pension increases as well as expanding retail loans. Total economy gross wages (CPI-deflated) rose by 9.4% and retail trade turnover expanded by 11.3% in the first half of 2005.

Table 52

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Real year-on-year change in %							
Gross domestic product	6.3	9.0	5.1	4.7	7.3	7.2	6.4	5.2
Private consumption	–2.9	6.0	9.3	8.3	7.4	10.6	11.4	8.0
Public consumption	3.1	4.8	–0.8	2.6	2.2	2.3	2.2	4.5
Gross fixed capital formation	6.3	31.1	10.3	2.8	12.8	10.8	9.4	8.9
Exports of goods and services	11.3	9.6	4.2	10.3	12.5	12.3	13.9	6.8
Imports of goods and services	–17.1	30.5	18.7	14.6	17.7	23.5	24.5	15.2
	Contribution to GDP growth in percentage points							
Domestic demand	–2.0	11.6	7.3	3.8	6.5	7.9	7.6	6.0
Exports	4.7	4.2	1.9	4.5	5.7	5.9	7.0	3.5
Net exports	9.1	–1.9	–2.6	0.5	0.5	–1.7	–2.1	–1.6

Source: Eurostat, national statistical office, OeNB.

In line with strong economic growth, the unemployment rate decreased to 8.2% in the first quarter of 2005 and was thus by 1 percentage point lower than in the first quarter of 2004. After it had declined to around 10% year on year in the second quarter of 2004, CPI inflation turned upward to a peak of 13.6% in May 2005 and then slightly receded to 12.9% in July. Persistent inflationary pressure may be explained by the surge in industrial producer prices (24.7% in May and 20.6% in July 2005 year on year), the strong wage and consumption growth, periodic adjustments of administered prices, capacity constraints and the still high, albeit declining, growth of broad money. The Bank of Russia (CBR) revised its CPI inflation goal for December 2005 from 8.5% to a target range of 8.5% to 10.0% at the beginning of July.

Table 53

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Year-on-year change of period average levels in %							
Gross production of industry (real)	11.6	12.0	4.9	3.7	7.0	7.4	7.2	3.7
Labor productivity of industry (real)	15.4	9.9	5.7	7.5	13.9	. .	. .	. .
Gross average wage of industry (nominal)	46.7	42.1	52.0	27.2	25.4	. .	. .	. .
Unit labor cost of industry (nominal)	27.1	29.3	43.8	18.3	10.1	. .	. .	. .
Producer price index (PPI) of industry	59.1	46.5	19.1	11.7	15.6	24.0	28.7	23.3
Consumer price index (CPI)	85.7	20.8	21.6	16.0	13.6	11.0	11.6	12.9
Exchange rate (nominal):								
RUB[1]) per 1 EUR, + = EUR appreciation	137.2	–0.8	0.4	13.5	17.0	3.3	4.1	1.9
EUR per 1 RUB, + = RUB appreciation	–57.8	0.8	–0.4	–11.9	–14.5	–3.1	–4.0	–1.9
	Period average levels							
Unemployment rate (ILO definition, %)[2])	12.6	10.5	9.0	8.0	8.6	8.2	8.3	8.2
Employment rate[3])	. .	. .	. .	. .	. .	. .	. .	. .
Participation rate[4])	. .	. .	. .	. .	. .	. .	. .	. .
Key interest rate per annum (%)	57.2	33.1	25.0	22.7	17.3	13.5	13.0	13.0
Exchange rate (nominal):								
RUB per 1 EUR	26.24	26.03	26.13	29.65	34.69	35.81	36.92	36.52
EUR per 1 RUB	0.0381	0.0384	0.0383	0.0337	0.0288	0.0279	0.0271	0.0274

Source: Bloomberg, Datastream, national statistical office, national central bank, OeNB, wiiw.

[1]) RUB: Russian ruble.

[2]) Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

[3]) Ratio of employed persons to the working-age population (aged 15 to 64).

[4]) Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

Broad money growth declined from 35.5% on average in the full year 2004 to 31.5% year on year in the first quarter of 2005 and further to 30% in May 2005. Money growth has been fueled by the lavish liquidity injected into the economy by high, and further expanding, current account surpluses and ongoing CBR interventions intended to slow down the nominal appreciation of the ruble in order to stave off the Dutch disease. The growth rate of net foreign assets increased from 39% in the full year 2004 to 62% year on year in the first quarter of 2005 and to 63% in May. Combined with strong economic growth and low real interest rates, the available liquidity has fueled rapid credit expansion in recent years. Consumer credits and car loans have become increasingly available to the average Russian consumer, implying high growth rates from a very low point of departure. Credit to enterprises and households expanded by 40% year on year in nominal terms in the first quarter of 2005, similar to the increase in the full year 2004. In real terms (CPI-deflated), the growth rate declined slightly to 24% from 27% in the full year 2004. At the same time, the government stepped up its sterilization efforts by withdrawing a substantial part of the injected liquidity from the market, channeling it into the stabilization fund. This reduceed the contribution of overall domestic credit to broad money growth to only 2 percentage points in the first quarter of 2005.

Since mid-2004, the CBR has held its refinancing rate at 13% (nominal level). As CPI inflation did not decline further, but rather increased, the real key interest rate (12-month moving average) decreased continuously from 5.1% in July 2004 to 0.3% in May 2005, before rising slightly to 0.8% in July 2005.[5] The CBR aims at limiting the real (CPI-deflated) effective appreciation of the ruble to between 8% and 10% year on year by the end of 2005. In nominal terms, the average exchange rate of the ruble in June 2005 was stronger against the U.S. dollar by 1.9% and stronger against the euro by 1.6% compared to June 2004. In real terms against the euro, the ruble was stronger by 18.7% (PPI-deflated) and by 12.8% (CPI-deflated) in June 2005 compared to June 2004. The CBR gradually increased the weight of the euro in the dual currency basket from 10% to 20% in mid-March 2005, further to 30% in mid-May and to 35% in early August. During the first half of 2005, the ruble value of the currency basket was relatively stable.

Table 54

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	Nominal year-on-year change of the annual average stock in %							
Broad money (including foreign currency deposits)	63.6	60.0	44.2	31.2	39.2	35.5	32.6	31.5
	Contributions to the nominal year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	7.5	58.5	44.3	19.8	21.3	22.4	29.4	33.7
Domestic credit (net) of the banking system	120.4	30.5	22.8	30.4	29.6	17.8	8.2	1.9
of which: claims on the private sector	*43.5*	*36.7*	*35.2*	*28.9*	*29.5*	*30.9*	*29.2*	*30.6*
claims on households	. .	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*76.9*	*–6.2*	*–12.4*	*1.5*	*0.2*	*–13.2*	*–21.0*	*–28.7*
Other domestic assets (net) of the banking system	–64.4	–29.1	–22.9	–19.1	–11.7	–4.6	–4.9	–4.1

Source: National central bank, OeNB.

On the back of record energy prices and proceeds, Russia witnessed a further widening of its large twin surpluses in the first half of 2005. The general government budget surplus reached 15% of GDP in the first quarter of 2005, after a 4.5% surplus in the full year 2004. According to preliminary data, the federal budget surplus in the first half of 2005 came to 9.8% of GDP. While certainly reflecting prudent fiscal policies, and particularly expenditure restraint, the size of the 2005 surplus is also based on "improved tax administration," as the authorities put it, i.e. the enforcement and collection of large back tax claims and fines from oil companies considered delinquent (particularly Yukos). Owing to the very favorable budget situation and to mounting political and social pressures to distribute the proceeds of the oil boom more widely, the government passed a supplemental budget in June, which envisages

[5] *The ex-post real key interest rate per annum as measured by the real (CPI-deflated) key rates per month compounded over the past 12 months. The PPI-deflated key interest rate per annum, which is measured in a similar way, stood at –6.6% in July 2004 and at –5.6% in July 2005, remaining persistently negative.*

a rise in spending by about one-tenth and a reduction in the planned federal surplus from 1.5% to about 1% of GDP in 2005. Additional financial means are to be used to shore up social reforms, cover financial gaps in the pension fund and adjust the salaries of state officials. Given the budget's important liquidity drainage function, this fiscal loosening may run counter to stabilization policy and increase inflationary pressures.

Table 55

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
Federal government							
Revenues	12.5	15.4	17.8	20.4	19.5	20.5	19.2
Expenditures	13.8	13.2	14.8	18.5	17.8	16.1	18.2
of which: interest payments	*3.4*	*2.4*	*2.6*	*2.1*	*1.7*	*1.2*	*1.4*
Balance	–1.3	2.2	3.0	1.8	1.7	4.4	1.0
Primary balance	2.1	4.6	5.6	3.9	3.4	5.6	2.4
Gross public debt, general government	94.2	57.1	44.1	37.0	31.7	23.5	. .

Source: National ministry of finance, Economic Expert Group, wiiw.
Note: Data for 2005 according to revised budget law.

The current account surplus expanded to 14.0% of GDP in the first quarter of 2005, against 10.5% in the first quarter of 2004. Exceeding the surplus of EUR 21.4 billion recorded in the first half of 2004, it went up to EUR 36.1 billion in the first half of 2005 as the trade surplus reached a record level of EUR 40.3 billion in the first six months of 2005. In the first quarter of 2005, exports of goods and services (as measured in euro) grew by 32% and imports of goods and services augmented by 17% year on year. The different growth dynamics of real versus nominal exports and imports can be explained by the above-mentioned oil price surge and the corresponding further improvement of the terms of trade (by one fifth year on year at end-March 2005) for the Russian economy.

Table 56

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	71,210.2	114,378.8	113,842.6	113,201.0	120,040.0	147,356.6	29,838.4	39,411.3
Merchandise exports: year-on-year change in %	*7.1*	*60.6*	*–0.5*	*–0.6*	*6.0*	*22.8*	*3.0*	*32.1*
Merchandise imports	37,167.9	48,934.5	60,137.9	64,278.1	66,507.9	77,326.1	15,709.4	18,898.0
Merchandise imports: year-on-year change in %	*–28.8*	*31.7*	*22.9*	*6.9*	*3.5*	*16.3*	*6.5*	*20.3*
Trade balance	34,042.3	65,444.3	53,704.7	48,922.9	53,532.0	70,030.4	14,129.0	20,513.2
% of GDP	*18.6*	*23.1*	*15.7*	*13.5*	*14.0*	*15.0*	*14.5*	*17.2*
Services balance	–4,034.0	–7,254.4	–10,226.9	–10,438.6	–9,773.4	–10,809.6	–2,017.3	–1,930.1
Income balance (factor services balance)	–7,290.8	–7,352.9	–4,755.8	–6,855.6	–11,543.1	–10,472.6	–1,892.5	–1,574.8
Current transfers	577.8	65.4	–912.5	–807.7	–351.6	–648.0	0.8	–227.3
Current account balance	23,295.3	50,902.5	37,809.6	30,821.1	31,864.0	48,100.3	10,220.1	16,781.1
% of GDP	*12.7*	*18.0*	*11.0*	*8.5*	*8.3*	*10.3*	*10.5*	*14.0*
Capital account balance	–311.0	12,100.3	–10,514.7	–12,599.1	–858.7	–1,294.3	–596.9	–83.1
% of GDP	*–0.2*	*4.3*	*–3.1*	*–3.5*	*–0.2*	*–0.3*	*–0.6*	*–0.1*
Direct investment flows (net)	1,041.8	–499.6	250.3	–49.0	–1,413.6	1,591.3	549.7	1,707.5
% of GDP	*0.6*	*–0.2*	*0.1*	*0.0*	*–0.4*	*0.3*	*0.6*	*1.4*

Source: National central bank, OeNB.

Driven by growing private indebtedness and held back by shrinking public indebtedness, total gross foreign debt edged up to EUR 171 billion (35% of GDP) at end-March 2005. In July and August, Russia repaid EUR 12 billion of its Paris Club debt ahead of schedule. Despite the repayment, gross official reserves (including gold) reached a near-record level of EUR 120 billion in mid-August 2005, which corresponds to over ten months' worth of imports of goods and services.

Table 57

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
	End of period, EUR million						
Gross official reserves (excluding gold)	8,386.6	26,139.0	37,025.9	42,290.5	58,530.7	88,660.6	103,141.7
Gross external debt	. .	160,912.4	160,653.6	143,727.5	148,488.5	159,174.1	170,857.8
	% of GDP[1])						
Gross official reserves (excluding gold)	4.6	9.2	10.8	11.6	15.3	19.0	21.1
Gross external debt	. .	56.8	46.9	39.5	38.9	34.1	34.9
	Import months of goods and services						
Gross official reserves (excluding gold)	2.0	4.7	5.3	5.7	7.8	10.2	12.7

Source: National central bank, OeNB, wiiw.

[1]) Q1 05: As a percentage of rolling four-quarter GDP.

Cutoff date for data: September 6, 2005.