

# Developments in Selected Central, Eastern and Southeastern European Countries<sup>1,2,3</sup>

Financial and real spillovers from global crisis interrupt fast catching-up process of recent years

## 1 Introduction

Following the collapse of Lehman Brothers in September 2008, the global financial crisis has intensified markedly, risk aversion has risen substantially, especially vis-à-vis emerging economies, and the repercussions of the crisis on the real economy have magnified significantly across the globe. The remarkable resilience Central, Eastern and Southeastern Europe (CESEE) had displayed until last fall, gave way to a situation in which emerging Europe – like emerging markets in general – was hit hard by the fallout of global developments through several channels. The region suffered from a marked tightening in external financing conditions, as international investor confidence waned and stiffening global credit conditions affected the region's major creditors.<sup>4</sup> This resulted in a marked slowdown, in a few cases even a reversal, of capital inflows. In addition, as the real economy effects were transmitted across countries, the CESEE region experienced a dramatic fall in external demand and sluggish export markets. Moreover, once the downturn gained momentum, sentiment indicators began to plummet.

Capital inflows and exports had been key drivers of the favorable economic performance of the region in recent years. Credit expansion, in many CESEE countries increasingly financed by Western European parent banks extending funds to their subsidiaries in emerging Europe, had supported the growth process. Solid foreign direct investment (FDI) inflows had likewise played an important role. A substantial part of these capital inflows was used to strengthen production and export capacity, and investment in real estate increased noticeably in some countries in recent years, too.

With both these pillars of CESEE growth faltering in the fourth quarter of 2008, output growth in the region slumped. Granted, any growth model at work in emerging economies is under pressure today. Moreover, growth models differed considerably within the CESEE region. As a case in point, the degree of reliance on external funding varied widely, as did the contribution of exports to growth. Consequently, individual CESEE countries fared differently during the most recent downturn.

The CESEE region on average still performs somewhat more favorably than the euro area, but the growth differential has already narrowed substantially and could, according to current forecasts, contract to around 1 percentage point in 2009, down from 3 percentage points in recent years. On balance, the economic

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<sup>2</sup> Cutoff date: March 31, 2009 (and April 22, 2009, for fiscal data and IMF forecasts). This report focuses primarily on data releases and developments from end-October 2008 up to the cutoff date.

<sup>3</sup> This report covers Slovakia and Slovenia, Bulgaria, the Czech Republic, Hungary, Poland and Romania as well as Croatia, Turkey and Russia. In addition, the Statistical Annex (p. 94–98) provides statistical information on selected economic indicators for Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Serbia, Montenegro and Ukraine.

<sup>4</sup> For a more thorough exposition of sources and channels of financial spillovers, see e.g. Gardó, S., A. Hildebrandt and Z. Walko. 2008. *Walking the Tightrope: A First Glance on the Impact of the Recent Global Financial Market Turbulence on Central, Eastern and Southeastern Europe*. In: *Financial Stability Report 15*. OeNB. 119–140.

catching-up of CESEE will almost grind to a halt this year, marked cross-country differences notwithstanding.

The world economy is faced with its most serious crisis in many decades. Over the past few months, the downturn of the global economy has progressed at an unprecedented and almost breathtaking speed. Growth forecasts for the global economy and economic activity in advanced countries have repeatedly and substantially been revised downward; the IMF currently projects 2009 GDP growth for the world at  $-1.3\%^5$ , at  $-2.8\%$  for the United States and at  $-4.2\%$  for the euro area. The recession has reached all advanced economies and since the last months of 2008 has also been strongly feeding through to emerging countries, as the collapse of international trade amplified the negative effects resulting from the financial spillovers to emerging markets after the Lehman bankruptcy.

After September 2008, capital flows were driven increasingly by a “flight to safety,” i.e. capital was rechanneled to advanced economies, in particular to the United States. The macrofinancial risk profile of CESEE countries underwent a major reassessment. While all countries of the region were affected, those countries that displayed vulnerabilities like high external financing needs or widespread currency mismatches were particularly hit. As of mid-September 2008,

External environment for CESEE worsens dramatically, as advanced economies enter deep recession

Capital flows to emerging economies subside and global trade collapses after the demise of Lehman Brothers

Table 1

### Substantial Financial Spillovers since Lehman Brothers Collapse

Change in selected indicators between September 12, 2008, and March 31, 2009

	Local currency (GBI) bond spread vs. the euro area, basis points	Euro-EMBIG spread vs. the euro area, basis points	5-year CDS premiums, basis points	GBI Index (local currency), %	Euro-EMBIG Index (EUR), %	Equity index (local currency), %
Slovakia	31	..	73	<b>2.0</b>	..	-21.7
Bulgaria	<b>374</b>	<b>294</b>	<b>276</b>	..	-0.6	<b>-71.0</b>
Czech Republic	<b>146</b>	..	155	<b>0.4</b>	..	<b>-41.9</b>
Hungary	<b>524</b>	<b>360</b>	<b>371</b>	<b>-9.3</b>	<b>-7.0</b>	<b>-43.6</b>
Poland	<b>92</b>	217	219	<b>3.2</b>	<b>-3.7</b>	<b>-38.5</b>
Romania	<b>105</b>	<b>349</b>	<b>243</b>	..	<b>-4.2</b>	<b>-53.0</b>
Croatia	..	<b>394</b>	<b>273</b>	..	-1.1	<b>-56.6</b>
Turkey	-290	171	123	16.1	1.5	<b>-30.4</b>
Russia	<b>470</b>	<b>362</b>	<b>331</b>	<b>-3.5</b>	<b>-10.0</b>	<b>-32.1</b>
Emerging market average	56	279	236	6.0	-2.9	-23.7
Africa	..	196	166	..	1.8	..
Asia	-20	74	66	8.2	5.3	-20.4
Europe	<b>235</b>	<b>292</b>	<b>392</b>	<b>3.5</b>	<b>-3.8</b>	<b>-45.4</b>
Latin America	33	266	<b>425</b>	9.3	-2.5	-21.6
Middle East	29	..	101	6.8	..	..
Euro area	0	..	..	7.8	..	<b>-38.3</b>
U.S.A.	-20	..	..	<b>5.3</b>	..	<b>-36.1</b>

Source: Thomson Reuters, Bloomberg, authors' calculations.

Note: Bold figures indicate negative performance relative to the emerging market average. For Bulgaria and Romania, the 10-year spread is used instead of the GBI spread. For Russia, the EMBIG Index (USD-denominated eurobonds) is used instead of the Euro EMBIG Index (EUR-denominated eurobonds).

<sup>5</sup> Unless specified otherwise, percentage changes refer to the same period of the previous year.

Currencies came under considerable pressure...

financial markets in emerging Europe were on average affected more strongly than those of other emerging economies.<sup>6</sup>

Besides having a negative impact on bond and stock markets, the loss of investor confidence dealt a particular blow to currency markets. Most currencies of countries with floating exchange rates registered substantial losses against the euro between mid-September 2008 and end-March 2009, with depreciation running to more than 28% in Poland, around 20% in Turkey and Hungary, some 15% in Romania and around 10% in the Czech Republic. To put these developments into perspective, it should be recalled that all these currencies had strengthened very substantially in nominal terms until mid-2008 (the Romanian leu until mid-2007).

Depreciation was fairly gradual in the last few months of 2008 but accelerated in the first weeks of 2009 to reach its peak in mid-February (or early March in the case of Hungary), when currencies traded at values not seen for many years. It is worth mentioning that the accelerated weakening of some CESEE currencies took place in close context with international rating agencies starting to take a more pessimistic stance toward CESEE as well as with continuing downward revisions of growth forecasts. More recently, however, the situation improved somewhat, with most currencies having either stabilized or strengthened again. In fact, the Czech koruna appreciated substantially and also the zloty firmed since mid-February 2009, while the forint and the Turkish lira broadly stabilized since early March. The Russian ruble, which is pegged to a basket consisting of the U.S. dollar and the euro, weakened considerably despite substantial foreign exchange interventions, since its fluctuation band against the basket was gradually widened between November 2008 and January 2009. Since then, the ruble broadly stabilized, even firming somewhat in the second half of March. Nominal effective depreciation in the region was less pronounced than bilateral weakening versus the euro, because the single currency appreciated against the currencies of other major CESEE trading partners (especially the United Kingdom and the United States).

Besides factors affecting the whole CESEE region, exchange rate movements were apparently also driven by country-specific factors. In Poland, the depreciation of the zloty was – especially in early 2009 – fueled by the closure of foreign exchange call options, which Polish companies had sold in exchange for insurance against further zloty appreciation. In Hungary, concerns about the high external financing needs and, at times, also about political stability, weighed on the forint. In Russia, declining oil prices and the resulting terms-of-trade shock, but also increased political uncertainty in the aftermath of the war in Georgia and a lack of trust in the fragile banking system exerted pressure on the ruble.

In turn, the currencies of the hard peg countries in the CESEE region remained stable, and the tightly managed kuna softened moderately. The Slovak koruna traded steadily against the euro during the last months before Slovakia introduced the euro on January 1, 2009, as the second country of the group covered in this report (after Slovenia in 2007). The changeover to the single currency went

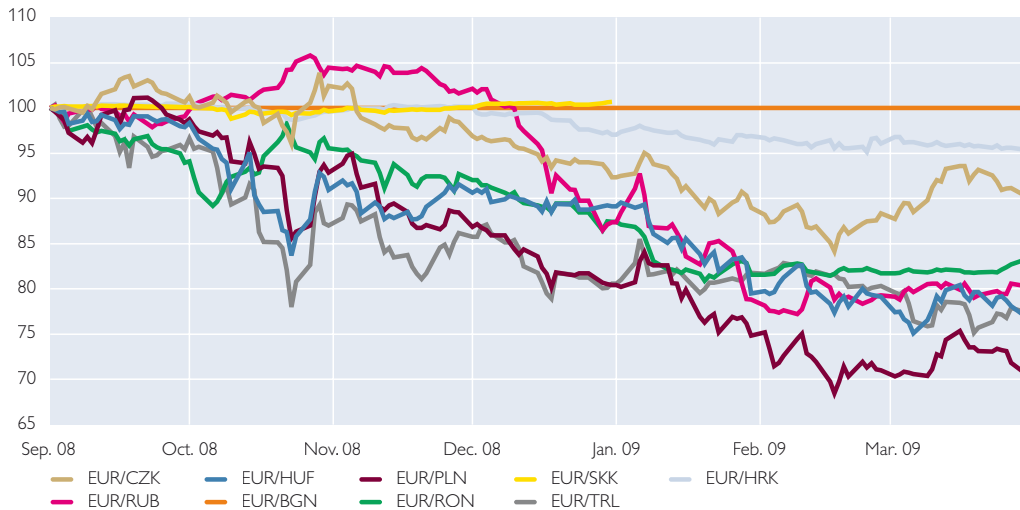
<sup>6</sup> *The unfolding impact of the crisis on financial markets in CESEE countries is reviewed in greater detail in box 1. In addition, the Financial Stability Report 17 of the OeNB further explores the repercussions of the financial crisis on financial and banking sectors in CESEE.*

Chart 1

**Exchange Rate Developments against the Euro<sup>1</sup>**

September 1, 2008 = 100

Cutoff date: March 31, 2009



Source: Thomson Reuters.

<sup>1</sup> An increase in value means a nominal appreciation.

smoothly, with a substantial share of the initial euro banknote stock delivered by the Oesterreichische Nationalbank.

As is well known, currency depreciation works in two ways: First, it bolsters competitiveness. For CESEE, this is especially relevant, as most of the countries of the region are very open and export-oriented economies. On average, exports account for more than 50% of GDP and contribute strongly to growth. In the fourth quarter of 2008, however, as global trade slumped, export growth decreased markedly and in most countries turned even negative.

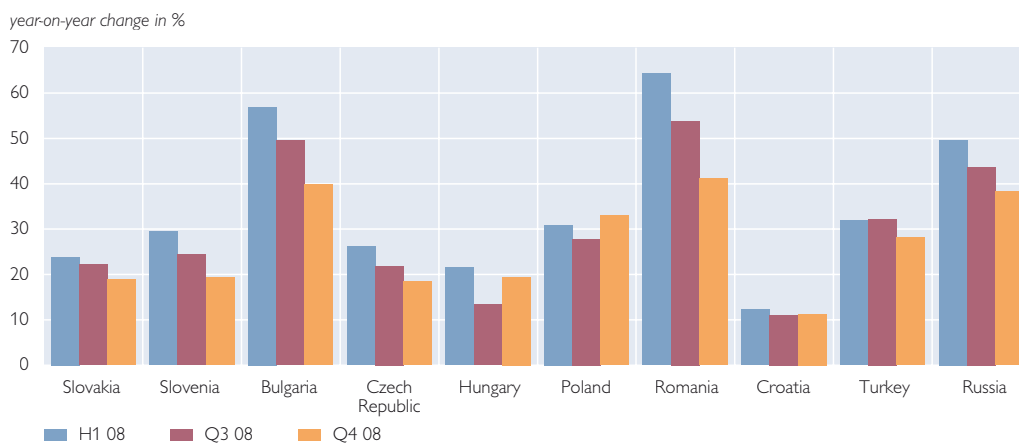
Second, depreciation increases the debt burden of economic agents that have taken out foreign currency-denominated credit without proper hedging. Foreign currency loans account for a substantial share in total loans to the nonbank non-government sector in many but not all countries of the region. Where this share is high, depreciation has a dampening effect on domestic demand, as debtors tend to cut spending in order to offset higher debt service obligations. Unhedged borrowing is usually concentrated in the household sector. Foreign currency loans are especially popular in Hungary and Croatia, where they constitute around 65% of total credit, and in Bulgaria and Romania, where they amount to around 55% of total credit. In Romania, this is somewhat mitigated by the fact that overall credit to the nonbank nongovernment sector is considerably smaller (relative to GDP) than in the other three countries. In Hungary, Romania and Croatia, but also in Poland, households' exposures to foreign currency loans are high, which is not so much the case in Bulgaria.

Another important transmission mechanism of the financial crisis is that it can restrict credit supply by banks, which has immediate consequences for debt-financed demand components. A deteriorating creditworthiness of borrowers due to (expected) insolvencies or falling asset prices or a more unfavorable outlook for sales and profits may raise risk premiums or induce banks to restrict the volume of

...with ambiguous consequences for economic activity

First signs of a credit squeeze...

### Domestic Credit to Nongovernment Nonbanks



Source: Eurostat, national central banks.

loans (beyond the reduction in credit demand that ensues from the downturn of the real economy). Moreover, to the extent that credit is foreign-funded, a decrease of cross-border capital flows may likewise depress credit supply.

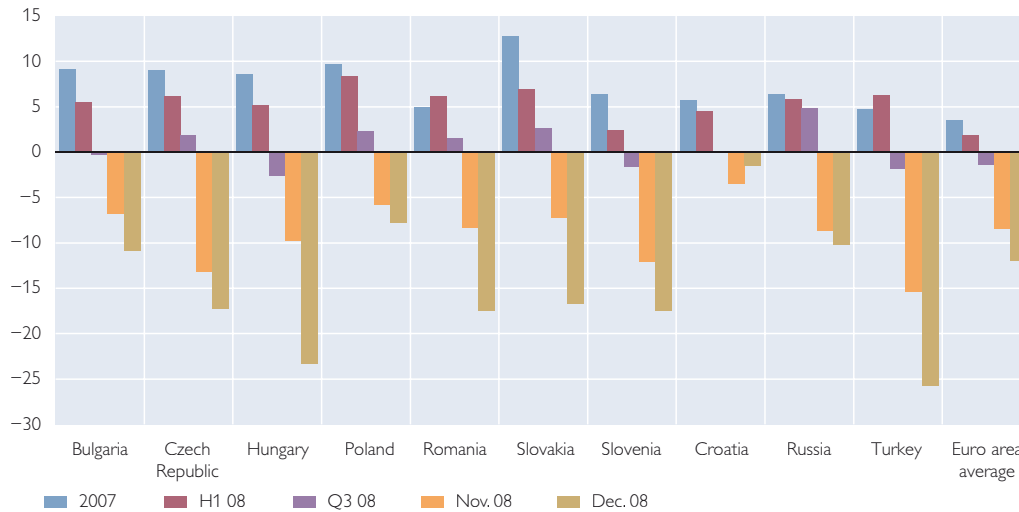
In fact, annual domestic credit growth to the nonbank nongovernment sector slowed substantially in most CESEE countries since mid-2008, with growth rates falling by more than 10 percentage points in Romania, Bulgaria, Slovenia and Russia. In Croatia, credit expansion remained broadly stable at comparatively low growth rates. An acceleration of credit expansion was observed in Hungary and Poland in local currency terms. To an important extent, this can, however, be explained by currency depreciation in an environment of widespread foreign currency-denominated credit. This also holds for Russia. Monthly data show that credit growth basically came to a standstill in a number of countries, as recorded in particular for Bulgaria, the Czech Republic, Slovakia and Slovenia toward the end of 2008.

In most countries, slower credit expansion was mainly traceable to credit developments in the corporate sector, where credit growth decelerated more markedly than in the household sector. This relates, on the one hand, to lower demand for investment credit, given the fast changing outlook for industrial production and exports. Following a pronounced weakening of external demand, the export-oriented and often rather export-dependent industrial sector of the region experienced a severe contraction, with industrial output declining by nearly 15% year on year on average in December 2008, capacity utilization sinking to long-term lows and export expectations deteriorating. In the majority of CESEE countries, industrial output declined more strongly than in the euro area as a whole. Notable exceptions are Poland and Croatia. While year-on-year output growth in industry in the euro area decelerated by around 14 percentage points between December 2007 and December 2008, the CESEE countries witnessed an average deceleration of nearly 20 percentage points, though from higher initial levels, so that toward the end of 2008, industrial production dynamics were rather similar in the two regions.

Chart 3

### Industrial Production

year-on-year change in %



Source: Eurostat, wiiv.

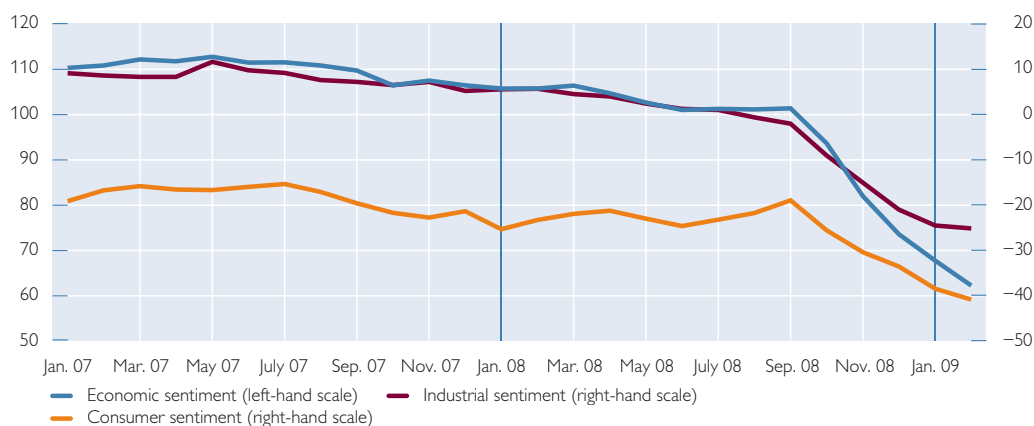
Present capacity utilization generally lies at somewhat lower levels in CESEE than in the euro area (especially in Bulgaria and Slovakia); here, too, the decline in most CESEE countries was somewhat more pronounced than the euro area average.

However, apart from falling credit demand, there is also evidence for tightening credit supply toward the end of 2008. Bank lending surveys covering the second half of 2008 in Hungary and Poland indicated that banks' willingness to lend decreased sharply. Banks had already reported in previous surveys that they would tighten lending, but – as borne out by the most recent surveys – the deepening crisis led to a much more restrictive stance than previously intended. Banks tightened their price and nonprice credit conditions and indicated that this tightening will continue during the first half of 2009, primarily due to clients' deteriorating payment ability, negative economic prospects and higher funding costs as well as difficulties in accessing funding. Although banks did not yet see a significant deterioration in their portfolios, risks are expected to materialize much more strongly over the coming quarters.

Banking sector deposits developed unevenly across countries in the fourth quarter of 2008. While annual domestic deposit growth remained broadly constant or even accelerated in Hungary, Poland and Slovakia, it decelerated in the Czech Republic, Slovenia and, above all, Bulgaria and Romania. In terms of quarterly changes, deposit growth stagnated in Slovenia and turned slightly negative in Bulgaria in the fourth quarter. The banking systems in some European non-EU countries (including Russia and Croatia) experienced temporary deposit withdrawals in October and November 2008, which stopped once the authorities were taking measures to strengthen confidence in the banking system. In addition, Russia registered a marked redollarization of deposits (and to a lesser extent of loans) in recent months, while a much more moderate shift from local currency- to euro-denominated deposits took place in Croatia.

Chart 4

**Sentiment Indicators for CESEE EU Member States**



Source: European Commission.

... and deteriorating consumer and corporate sector confidence...

A worsening of the economic outlook usually affects consumer and corporate confidence, and a deterioration in confidence has, in turn, a negative impact on economic activity. Expectations of declining profits dampen the propensity to invest, and the fear of unemployment drives up precautionary savings by households.

Recently, the interplay of these forces has been patently evident in the CESEE region, where – as elsewhere – a marked deterioration in confidence is clearly visible in the data. As the Business and Consumer Survey of the European Commission shows, general economic sentiment has declined considerably since 2007 – often from high levels. The decline turned into a slump in October 2008, and by February 2009, confidence had reached historical lows in most countries for which comparable data are available (i.e. the EU Member States), with industrial sentiment falling somewhat more sharply than consumer sentiment.

... contribute to a sharp slowdown in economic activity

In response to financial and real spillovers from the global crisis, economic activity slowed markedly in the CESEE region in the fourth quarter of 2008.<sup>7</sup> The implosion of external demand slashed CESEE exports, which had been an important driver of GDP growth in recent years, so that all countries recorded negative export growth year on year.

How did this slowdown play out in more detail? Average growth in the region declined to –0.1% in the final quarter of 2008 after 4.8% in the third quarter, with Hungary, Slovenia and Turkey reporting a contraction of economic activity. The deceleration – which was on average more pronounced in CESEE than in the euro area – was strongest in Turkey, where the economy had already started to contract considerably in the second quarter of 2008, followed by Romania, Russia

<sup>7</sup> At that time, a contraction was also observable in CESEE countries not covered in this report. With the slump having manifested itself already several quarters earlier, all three Baltic countries are now in a deep recession (in particular Latvia, but also Estonia). Some of the catch-up gains reaped in the earlier part of the decade, when the Baltic states grew very buoyantly, have thus been canceled out. Ukraine is another CESEE economy that has entered a phase of severe economic contraction. There, external imbalances, financial fragility, a massive terms-of-trade shock (as metal prices collapsed) and pronounced weaknesses in the policymaking process triggered a downward spiral resulting in double-digit negative GDP growth rates in early 2009.

and Slovenia. The deceleration was somewhat less pronounced in Croatia, yet started from lower levels. Despite the substantial slowdown of economic activity, all CESEE countries covered in this report except Turkey and Hungary still outperformed the euro area in terms of growth. Moreover, the wide range of growth outcomes in the fourth quarter – from –6.2% to +3.5% – is a remarkable aspect of recent GDP development in the region, underlining the continued intra-regional diversity in economic performance, even in the general setting of a substantial downturn.

It is noteworthy that the slowdown in economic activity in CESEE set in later – but more forcefully – than in the euro area. While in the euro area economic activity had been moderating already from the second quarter of 2008, most CESEE countries were first hit by the downturn in the final quarter of 2008. Euro area growth decelerated by 3.6 percentage points between the fourth quarter of 2007 and the fourth quarter of 2008, which contrasts with 6 percentage points recorded on average for the country group under observation in this report (see table 2).

The slowdown encompassed all GDP components and was particularly pronounced in the external sector. Exports suffered from faltering external demand, and growth rates declined to levels of between –0.2% in Romania and –8.7% in the Czech Republic. Weak domestic demand in turn put a damper on imports, with growth rates ranging from 0.4% in Poland to –23.0% in Turkey. The contribution of net exports to growth declined in the Central European countries to levels of between 0.7 percentage points (Slovenia) and –1.9 percentage points (Czech Republic). By contrast, in Southeastern Europe, the contribution of net exports to growth increased (especially in Croatia and Romania) as imports contracted more strongly than exports. Currency depreciation did not yet have a markedly positive effect on the composition of growth in countries with floating exchange rates, which is possibly related to J-curve effects (except for Romania, where depreciation had started earlier than elsewhere in the region).

Table 2

### Gross Domestic Product (Real)

	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Annual change in %</i>								
Slovakia	10.4	6.4	10.5	14.3	9.3	7.9	6.6	2.5
Slovenia	6.8	3.5	7.5	5.4	5.7	5.5	3.9	–0.8
Bulgaria	6.2	6.0	4.9	6.9	7.1	7.1	6.8	3.5
Czech Republic	6.0	3.2	5.8	5.9	4.4	4.4	4.0	0.2
Hungary	1.1	0.5	0.6	0.5	1.7	2.1	0.8	–2.3
Poland	6.7	4.8	5.7	7.2	6.2	5.8	5.2	2.3
Romania	6.2	7.1	5.8	6.8	8.2	9.3	9.2	2.9
Croatia	5.5	2.4	4.8	3.5	4.3	3.4	1.6	0.2
Turkey	4.7	1.1	3.2	4.2	7.3	2.8	1.2	–6.2
Russia	8.1	5.6	7.7	9.0	8.7	7.5	6.0	1.0
Euro area	2.6	0.8	2.6	2.1	2.1	1.4	0.5	–1.5

Source: Eurostat, national statistical offices.

On average, growth of private consumption declined at a somewhat slower pace than growth of the other components, often remaining in positive territory. This is attributable to the still comparatively robust development in Central European countries, where private consumption growth remained broadly stable and declined markedly only in Hungary. Credit for this relatively solid performance was due to the still favorable development of real wages in the fourth quarter amid declining inflation and continued employment growth in most CESEE countries.

The deterioration in gross fixed capital formation (GFCF) was more pronounced, however. All countries reported a substantial decrease in the growth rate of this component in the fourth quarter of 2008; in Hungary, Slovenia and Turkey, investments even contracted. As mentioned earlier, this development is largely traceable to the unfavorable outlook of the industrial sector of the CESEE region against the backdrop of worsening financing conditions and sluggish external demand. Residential investments also slowed in several countries, but less so than other GFCF components, presumably as numerous ongoing projects were being completed.

No quick recovery  
on the horizon

Available activity indicators point to a further deterioration in the coming quarters, which is also reflected in recent GDP forecasts for the countries of CESEE. Projections have repeatedly been revised downward and most forecasters already see a recession, not only for individual countries of the region, but also for the region as a whole. The most recent economic developments based on high-frequency data as well as the growth outlook for the region – including the OeNB projections for the Czech Republic, Hungary and Poland – are discussed in greater depth in box 2.

Economic slowdown  
has had substantial  
dampening effect on  
inflation...

The economic downturn has already had a substantial dampening effect on price increases, with inflation having decelerated markedly in most countries covered in this report. It has reached low or moderate levels in Central Europe and Croatia, while remaining more elevated in the other countries. For example, inflation is coming down fast in Bulgaria, while staying at persistently high levels especially in Russia. As at February 2009, year-on-year inflation rates ranged between 1.3% in the Czech Republic and 13.5% in Russia. Besides fading demand-pull pressure, this development can be traced back to declining prices of food and energy (especially oil) in world markets (which is in turn a consequence of the global economic slump). Accordingly, the contribution of these two components to inflation has decreased at an above-average rate in the past months, and services have again become the most important inflation component in a number of countries, especially in Central Europe. Weakening economic dynamics are clearly reflected in core inflation rates, which came down just as strongly as headline inflation. From September 2008 to February 2009, core inflation declined most markedly in Bulgaria (namely by 7.4 percentage points). Inflation expectations for the coming twelve months likewise moderated notably in all countries except Hungary. According to the Business and Consumer Survey of the European Commission, the majority of the people in Slovenia and the Czech Republic even expect price levels to remain unchanged in 2009.

... but leads to  
temporary increase  
in ULC

Favorable labor market developments together with rising skill shortages and in some countries outward migration have spurred wage growth in the region over the last few years, and the economic crisis has not yet brought about a major change of this situation. In the fourth quarter of 2008, growth of compensation

Table 3

**Consumer Price Index (here: HICP)**

	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
	Annual change in %							
Slovakia	1.9	3.9	1.4	2.4	3.4	4.0	4.5	3.9
Slovenia	3.8	5.5	3.7	5.5	6.5	6.4	6.2	3.1
Bulgaria	7.6	12.0	9.0	11.2	12.4	14.0	12.5	9.0
Czech Republic	3.0	6.3	2.7	4.9	7.6	6.7	6.5	4.4
Hungary	7.9	6.0	7.3	7.1	6.9	6.8	6.3	4.2
Poland	2.6	4.2	2.4	3.7	4.5	4.3	4.4	3.6
Romania	4.9	7.9	5.1	6.8	8.0	8.6	8.2	6.9
Croatia <sup>1</sup>	2.8	6.1	2.9	4.9	6.0	6.6	7.4	4.5
Turkey	8.8	10.4	7.1	8.2	8.8	10.3	11.7	10.9
Russia <sup>1</sup>	9.1	14.1	9.0	11.5	12.9	14.8	14.9	13.8
Euro area	2.1	3.3	1.9	2.9	3.3	3.6	3.8	2.3

Source: Eurostat, national statistical offices, wiiw.

<sup>1</sup> CPI.

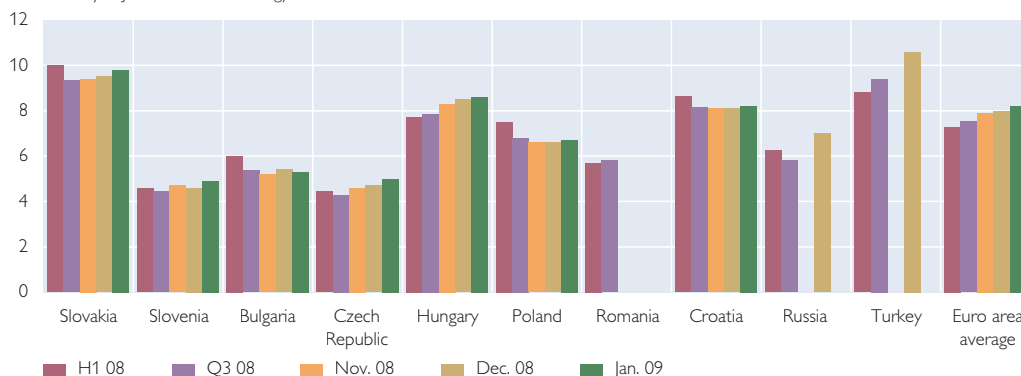
per employee in the whole economy decelerated somewhat only in Bulgaria and Romania (though remaining at levels of or even above 20% year on year), while it stayed roughly constant in the other countries. The Czech Republic even recorded a slight increase. With inflation decreasing, real wage growth accelerated in most countries. By contrast, labor productivity developed much less favorably. Declining output coupled with a lagging employment response to deteriorating economic conditions led to negative productivity growth rates in Slovenia, Poland and Hungary. Some notable, though declining, productivity advances were observed in Bulgaria and Romania only. Accordingly, ULC growth in local currency accelerated in all countries, with Hungary, Bulgaria and Romania recording the largest increases. Weakening exchange rates in the final quarter of 2008 in some countries translated into somewhat lower growth rates of ULC as measured in euro. Overall, however, the increases in all CESEE countries were still noticeably higher than those in the euro area. They were particularly high in Bulgaria and Slovenia. The pickup in ULC dynamics in the fourth quarter of 2008, however, was most likely a cyclical phenomenon. Developments in early 2009 already point toward a deceleration. Especially tax revenue data suggest a considerable decrease in wage growth in some countries. In countries with flexible exchange rates, currency depreciation will further contribute to a dampening of ULC growth in euro terms in the first quarter of 2009, as the recent firming of currencies has only partially offset their previous weakening.

Some effects of the economic downturn on labor markets started to materialize recently, though not yet in all countries. Moreover, compared to the euro area, CESEE labor markets have so far been less affected, which is most likely attributable to the robust growth performance observed in the region until the third quarter of 2008. In the last few months of 2008, monthly unemployment figures tended to slowly increase in most CESEE countries to reach levels between 4.9% (Slovenia) and 9.8% (Slovakia) in January 2009. In a number of countries (including the Czech Republic, Poland, Slovenia and Bulgaria), unemployment is still noticeably lower than in the euro area. Nevertheless, the impressively positive labor

**Downturn slowly feeding through to labor markets**

### Development of Unemployment Rates

% , seasonally adjusted, LFS methodology



Source: Eurostat, wiw.

Note: Data for Russia unadjusted.

market dynamics of the past few years had come to an end after mid-2008. Recent forecasts project accelerated rises in the unemployment rate in the countries of the region during this year. In the same vein, employment data herald the changing trends on CESEE labor markets. In the fourth quarter of 2008, employment still grew, but at declining rates, in all countries but Hungary, while employment rates started to decrease.

#### Deteriorating current account balances ...

With the exception of Romania and Turkey, the combined current and capital account deficits of the countries of the region increased somewhat in 2008 and especially in the fourth quarter. Sluggish domestic demand led to a pronounced reduction of imports of goods and services, and slumping external demand cut even more deeply into exports. This resulted in a marked deterioration of the goods and service balance in many countries, which was further aggravated by adverse developments in the terms of trade in most countries, but especially in the case of Russia.

The major exceptions in this respect are Romania and Turkey, where a positive development of the service balance in both countries and also of the trade balance in the case of Turkey caused the current account deficit of the country to decrease. In some countries, especially in Poland and Bulgaria, current transfers contributed notably to rising current account deficits. This could be traceable to a reduction in workers' remittances following the economic slowdown in the EU-15 countries, which received most of the migrants from CESEE in the middle of the decade. Moreover, there is anecdotal evidence – especially for Poland – of substantial return migration during previous quarters. In Bulgaria, the suspension of EU funds of EUR 500 million due to irregularities concerning public administration may have contributed to declining current transfers. Income balances in general remained a drag on the current account. In the fourth quarter of 2008, however, a notable reduction was observed in some countries (especially in the Czech Republic and in Poland) amid a decrease in repatriated profits, which was likely to be related to the economic slowdown.

Table 4

**Current Account Developments**

	Goods and services balance			Income balance			Combined current and capital account			Net FDI			Basic balance		
	2007	2008	Q4 2008	2007	2008	Q4 2008	2007	2008	Q4 2008	2007	2008	Q4 2008	2007	2008	Q4 2008
	<i>% of GDP</i>														
Slovakia	-0.5	-1.8	-3.7	-4.3	-3.5	-2.3	-4.8	-5.4	-6.5	3.6	3.4	7.0	-1.2	-2.0	0.5
Slovenia	-1.4	-2.6	-4.5	-2.1	-2.7	-2.8	-4.4	-6.1	-8.3	-0.8	0.7	2.4	-5.2	-5.4	-5.9
Bulgaria	-21.4	-22.5	-25.7	-1.6	-3.2	-2.7	-20.6	-23.5	-28.4	21.8	14.6	8.1	1.3	-8.9	-20.3
Czech Republic	5.0	5.0	1.0	-7.7	-7.8	-6.7	-1.2	-2.4	-5.3	4.5	4.3	4.1	3.3	1.9	-1.1
Hungary	1.4	0.9	-0.2	-7.4	-8.1	-7.9	-5.4	-7.4	-9.4	1.7	3.1	5.6	-3.7	-4.3	-3.8
Poland	-2.9	-3.6	-4.0	-3.8	-3.2	-2.4	-3.6	-4.3	-5.5	4.2	2.3	1.6	0.6	-1.9	-3.9
Romania	-14.0	-12.7	-9.6	-3.4	-4.1	-4.1	-12.8	-11.9	-9.9	5.7	6.8	5.9	-7.1	-5.1	-4.0
Croatia	-7.3	-8.2	-17.3	-2.7	-3.3	-1.9	-7.5	-9.3	-16.8	8.1	5.8	5.5	0.6	-3.4	-11.3
Turkey	-5.1	-4.7	-2.9	-1.1	-1.1	-1.2	-5.9	-5.5	-3.7	3.1	2.1	2.4	-2.8	-3.5	-1.4
Russia	8.6	9.1	4.8	-2.3	-2.9	-2.3	5.2	6.0	2.2	0.7	1.0	0.3	6.0	7.0	2.5

Source: Eurostat, national central banks.

Basic balances (i.e. the combined current and capital account balance plus net FDI), which are useful indicators of external financing needs, increased in most countries in 2008. This development was caused by deteriorating current and capital account balances in most countries, but in Bulgaria, Poland and Croatia, also lower net FDI inflows contributed to higher deficits/lower surpluses. Romania was the only country among the group that reported an improvement in its basic balance, which was due to the favorable development of the trade balance. For the other components of the financial account, developments were mixed. Higher outflows of portfolio investments were observed in the Czech Republic, Poland and to a lesser extent also in Romania. Outflows in other investments were observed in Slovenia and Bulgaria.

Intra-year developments are highly interesting in this context, as the changing capital flow dynamics after the demise of Lehman Brothers had strong effects on financial account developments in the CESEE region during the fourth quarter of 2008. Financial account positions worsened across the entire region in the final quarter of 2008, but remained in positive territory for most countries. An exception is Russia, where fourth-quarter capital outflows from the nonbank private sector amounted to about EUR 100 billion, pushing the financial account deeply into the red. Following further, yet more moderate outflows in January 2009, outflows largely ceded in February 2009. Relatively pronounced outflows were also observed in Turkey, namely to the tune of EUR 9 billion in the fourth quarter of 2008.

Meeting external financing needs has become increasingly difficult against the backdrop of the financial turmoil. To ease acute pressures, some countries called on international financial institutions (especially the IMF) and the EU for support. Hungary and Romania entered into IMF Stand-By Arrangements (as did Ukraine, Latvia, Belarus and Serbia). IMF funds were complemented by loans from the World Bank, the EBRD as well as the European Union (and in the case of Latvia,

... contributed to need for international assistance in the region

... which was supplemented by government measures to a varying extent

individual EU countries). In return, the countries concerned committed themselves to fiscal restraint, banking sector support programs and moderation, especially concerning public sector wages and pensions.

Rapidly deteriorating economic conditions and the increasingly gloomy outlook for the region prompted government action across the region. At the same time, recent developments underscored that the macroeconomic policy leeway is much more constrained in CESEE countries than in advanced industrial economies. In fact, room for maneuver is almost nonexistent in some countries, what with constraints to finance fiscal deficits, what with limits to monetary policy resulting from exchange rate commitments and/or a high degree of currency substitution. When we take a closer look at the crisis-response measures in the CESEE countries, the following picture emerges:

In accordance with the proposal of the European Commission, all CESEE EU Member States increased their deposit guarantees to the equivalent of EUR 50,000. While Hungary made a political declaration of guaranteeing deposits 100%, Slovenia and Slovakia actually implemented a full guarantee. The non-EU Member States covered in this report also implemented changes in their guarantee schemes, raising the deposit guarantee level to EUR 50,000 in Croatia, to EUR 19,400 in Russia and to EUR 23,500 in Turkey. The latter country plans to further increase this level.

The possibility of state capital injections into banks has been established throughout the region, but banks have been reluctant to draw on that form of relief. So far, recapitalizations were effected only in Romania (EximBank and CEC Bank) and in Russia. In the latter case, the amount channeled into the banking sector was substantial.

More generally, fiscal policy responses to the crisis have varied across countries. While the Czech Republic, Poland and Slovenia decided on fiscal stimulus packages of around 1% of GDP in 2009 (basically in line with the EU and the euro area average), the stimulus is larger in the case of Russia (more than 5% of GDP). At the other end of the spectrum, the net impact of measures in Bulgaria, Romania and Hungary is either neutral or even deficit-reducing, i.e. procyclical.

This variety in fiscal policy responses may be explained by the following factors: First, most of the countries of the region are small and open economies. A strong fiscal stimulus would therefore very likely lead to an increase in imports (and thus a delay in the correction of external imbalances) rather than to higher domestic demand. Second, for countries with high external financing needs, fiscal expansion might weaken investor confidence and thus complicate access to foreign funds. Third, government balances are already under stress in a number of countries, which restricts the room for increased deficit spending.

In 2008, Hungary and Romania reported a budget deficit of more than 3% of GDP. Hungary has been subject to an excessive deficit procedure since 2004. An excessive deficit procedure will be opened against Romania and presumably also against Poland. Only Bulgaria reports a fiscal surplus, which it aims to keep also in the medium run. In 2008, budget deficits increased in most countries (notably in Romania, where the procyclical loosening already seen in 2007 continued, but also in Poland and Slovenia). Only Hungary reported a lower deficit in 2008 compared with 2007, as it had to continue its consolidation efforts to maintain sol-

Table 5

**General Government Budget Balance**

	2004	2005	2006	2007	2008	2009 <sup>1</sup>
	% of GDP					
Slovakia	-2.3	-2.8	-3.5	-1.9	-2.2	-2.8
Slovenia	-2.2	-1.4	-1.3	0.5	-0.9	-3.2
Bulgaria	1.6	1.9	3.0	0.1	1.5	2.0
Czech Republic	-3.0	-3.6	-2.6	-0.6	-1.5	-2.5
Hungary	-6.4	-7.8	-9.2	-4.9	-3.4	-2.8
Poland	-5.7	-4.3	-3.9	-1.9	-3.9	-3.6
Romania	-1.2	-1.2	-2.2	-2.5	-5.4	-7.5
Croatia	-4.3	-4.0	-2.5	-1.6	-2.2	-2.5
Turkey	-4.5	-0.6	-0.1	-1.2	-1.3	-2.5
Russia	4.9	8.2	8.4	6.0	4.8	..

Source: Eurostat, wiiw, national statistics.

<sup>1</sup> As forecast by the European Commission (January 2009), which is due to release new fiscal balance data in its Spring 2009 Forecasts on May 4, 2009. Developments since January 2009 suggest that headline fiscal deficits will be revised upward in several CESEE countries.

vency, and Bulgaria achieved an increase in its budget surplus. The ongoing downturn will put pressures on general government balances during 2009.

In light of the recent economic slowdown and weakening currencies, CESEE central banks with monetary policy leeway have been faced with the challenge of finding the right balance between (1) stimulating demand by lowering interest rates and letting currencies depreciate further and (2) controlling adverse balance sheet effects of such policies on domestic demand but also on financial stability. Moreover, central banks with pegged exchange rates had to decide about how to react to shifts in risk premiums and, in the case of Russia, to substantial terms-of-trade shocks (due to the collapse of oil prices).

Against this background, the direction of monetary policy in the region was heterogeneous. In October and early November 2008, the central banks of Russia and Hungary raised their policy rates – Russia to safeguard confidence in the ruble and Hungary to stem depreciation pressures before the completion of an IMF arrangement. Once the agreement was struck, the Hungarian central bank gradually reversed previous rate hikes from late November onward. Some monetary easing was also observed in the other countries; somewhat more gradually in the Czech Republic and in Slovakia (in the latter case, with a view to keeping policy rates in line with the euro area in the run-up to the introduction of the euro at the beginning of 2009) and more noticeably in Poland and in Turkey.

In addition to deteriorating economic conditions, monetary policy decisions frequently made reference to an improving inflation outlook. Many central banks, however, still intervened to support their currencies, either verbally (e.g. the Czech Republic, Poland, Romania, Hungary) and/or through direct market interventions (e.g. Croatia, Hungary, Russia, Romania). In addition, the Polish government sold EU funds on foreign exchange markets to support the zloty, and more recently a similar step was announced by Hungary.

Against the background of the crisis, the debate on the timing of euro adoption has regained some momentum. Members of monetary union are not exposed to the risk of currency crises and in times of substantial turbulence in global finan-

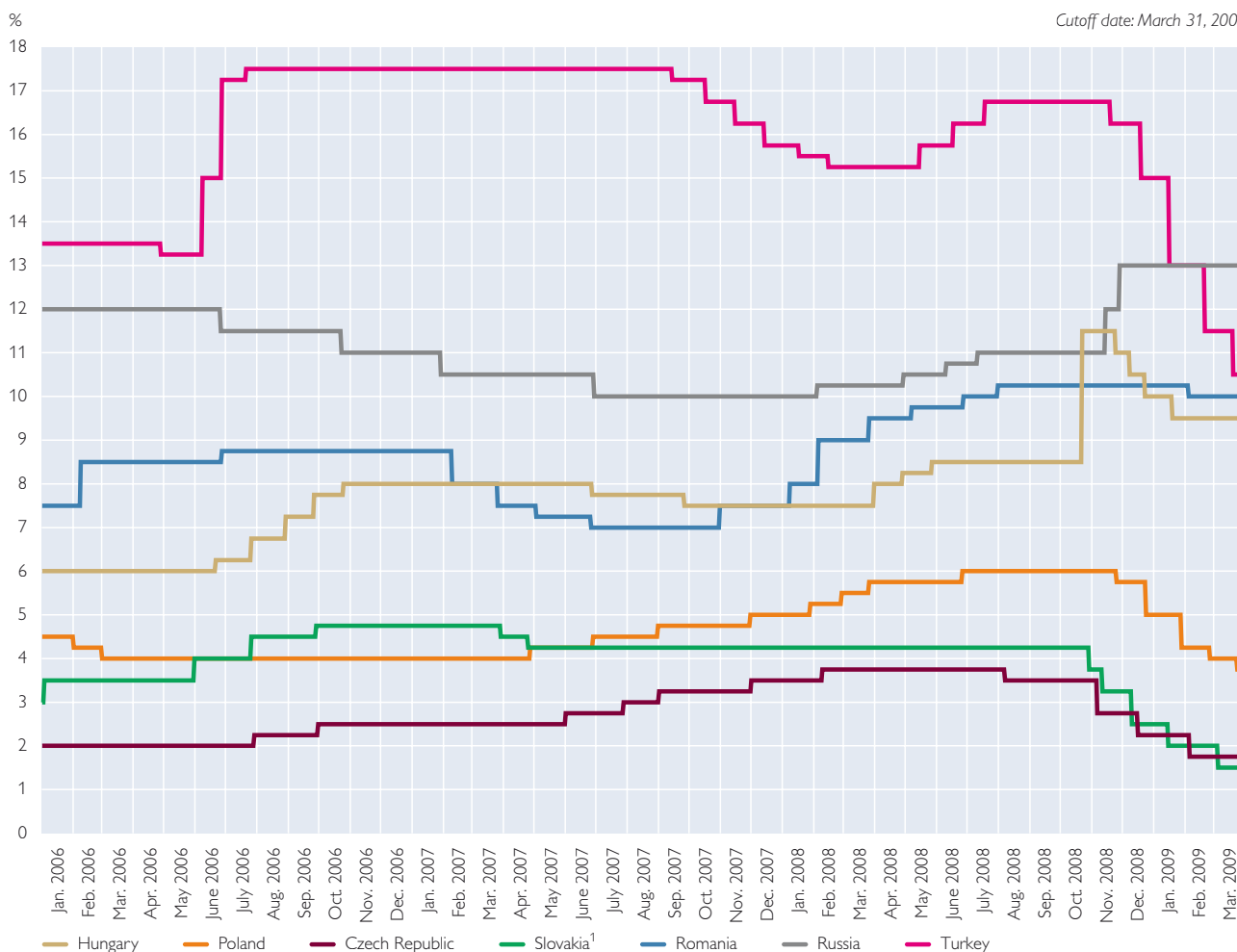
**Challenging times  
for monetary policy**

**Crisis sparked some  
renewed discussion  
about timing of euro  
adoption**

Chart 6

## Policy Rate Developments in CESEE

Cutoff date: March 31, 2009



Source: National central banks.

<sup>1</sup> As of January 1, 2009, ECB main refinancing rate.

cial markets this is a considerable advantage, from which – among CEE countries – Slovenia and now also Slovakia benefit. The idea of speeding up preparations for euro adoption to be able to introduce the common currency at an earlier stage than previously envisaged has gained in popularity in several countries, and the governments of Poland, Hungary and Bulgaria have made statements to this effect. Others have argued that joining ERM II, which is one of the preparatory steps to qualify for eventual euro area membership, is too risky given that volatility is high. The Polish government only recently hinted that it considers giving more weight to this line of reasoning in its deliberations about the monetary integration of Poland.<sup>8</sup> Another line of thought that has recently gained attention is that of retaining competitiveness in the longer run under fixed exchange rates or in a currency union. Looking ahead, this latter point may also be of relevance for Slovenia and

<sup>8</sup> See the country section on Poland for more details.

Slovakia, given that over the last few months the euro has appreciated substantially against a number of CESEE currencies.

The accession negotiations with the EU candidate countries Croatia and Turkey have been proceeding. In the case of Croatia, negotiations are now ongoing in 22 out of 35 chapters and seven chapters have already been closed provisionally. The provisional closing of another eleven chapters is blocked, however, due to an unresolved border dispute with Slovenia. As this issue lingers on, time is running out to conclude negotiations by the end of this year, as originally envisaged.

Of the eight opened negotiation chapters, Turkey and the European Union have managed to provisionally close only one chapter. As Turkey does not, as yet, meet all of its statutory obligations – specifically with regard to extending the existing customs union with the EU to Cyprus – opening chapters on these matters has been delayed. Moreover, the EU will not close any other chapter provisionally unless Turkey has met all of its statutory obligations.

To sum up, the ongoing global crisis has put the growth process in the CESEE countries to the test. At the current juncture, challenges are manifold, and the dependence of the region on global financial and economic developments remains high. The crisis has exposed some of the macrofinancial vulnerabilities in the region, while also confirming the diversity across CESEE countries in terms of performance and also, at least to some extent, in terms of crisis-response measures.

In recent months, Europe as a whole has begun to pay greater attention to economic and financial developments in CESEE countries, and in particular also to the need to be prepared to actively support individual CESEE countries. This is a reflection of Europe's increasing recognition of the fact that the intense trade, FDI and financial sector links between many Western European countries and the CESEE region are too important to take a laissez faire approach to adverse developments in individual member countries. As for policy action, the doubling of EU macrofinancial assistance for Member States in need, to a total of EUR 50 billion, is a case in point. Moreover, the additional funds Europe is providing to beef up IMF resources will also help deal with adverse developments in individual CESEE countries.

Some further progress in EU accession negotiations

Box 1

### Financial Market Developments in Central, Eastern and Southeastern Europe: Spillovers from the Global Financial Crisis

*This box reviews financial market developments in CESEE in a cross-country perspective and in comparison with developments in the euro area and in non-European emerging markets. The macroeconomic implications of financial market developments are analyzed and discussed in the main part of Recent Economic Developments in this issue.*

*After CESEE countries had been hit hard by the wave of market corrections from mid-September until end-October 2008 (see box 1 in Focus on European Economic Integration 2/08), financial market conditions remained tense over the review period (October 28, 2008, to April 10, 2009). Developments across the countries were rather divergent in most financial market segments. Among the different financial market segments, exchange rates seem to have been affected most, hitting record lows against the euro and prompting central bank interventions in many countries (see main part of the report). While money market developments differed considerably, local currency government spreads declined in the majority of countries. Euro-bond spreads and credit default swap (CDS) premiums stayed at elevated levels, while becom-*

ing more volatile. However, both segments started to show some downward tendencies in late February/early March 2009. Similarly, stock markets managed to recover somewhat in that time period, after the downward trend had decelerated the months before.

Over the review period, money market spreads against the euro area moved in quite different directions across the CESEE region, ranging from -360 basis points in Turkey to +660 basis points in Russia. The sharp contraction in Turkey is largely associated with sizeable policy interest rate cuts (-625 basis points), which by far exceeded the rate cuts of the ECB (-225 basis points). In contrast, spreads widened significantly in Russia, reflecting a liquidity squeeze on the interbank market as well as the central bank's monetary tightening aimed at supporting the ruble. Due to tightened liquidity conditions, Croatian spreads recorded an increase of 540 basis points, while spreads in Bulgaria increased by some 160 basis points. In the Czech Republic, the interest rate differential toward the euro area became positive in terms of 3-month money market rates by mid-November 2008 (after having been negative since March 2005), as the differential in key policy rates turned positive as well. In comparison with the countries already mentioned, spreads remained broadly unchanged in Poland, Hungary and – albeit at a much higher level – in Romania.

In most of the CESEE countries, local currency government bond spreads declined over the review period. Turkey's local currency bond market performed best, as spreads were down by 1,000 basis points. Spreads widened significantly only in Russia (+330 basis points) and marginally also in the Czech Republic (+20 basis points). All countries except for Turkey underperformed global developments, since spreads declined by less than the 100 basis points recorded by the JPM GBI-EM spread.

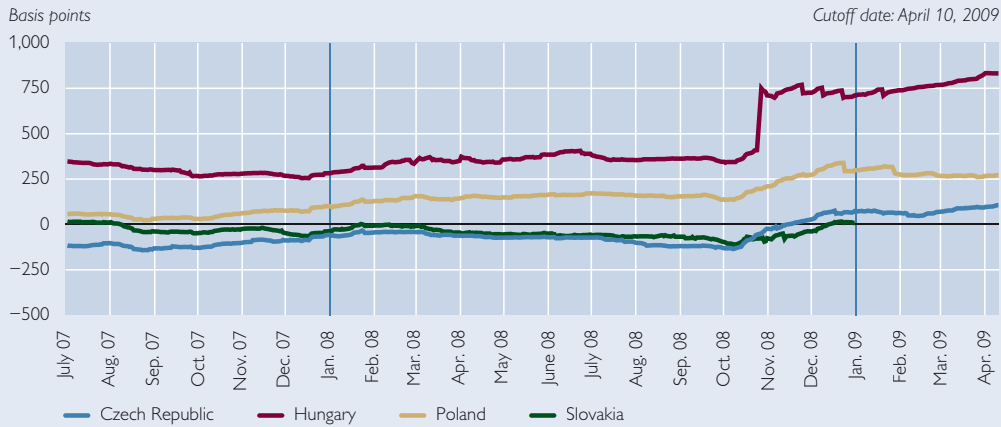
Eurobond spreads have remained at elevated levels since October 2008. Despite high volatility in some countries, most of the CESEE countries' eurobond spreads stayed almost unchanged (with changes ranging from -20 basis points in Bulgaria to +30 basis points in Hungary), while the average emerging market spread (JPM Euro EMBI Global Index) declined somewhat more noticeably (-40 basis points) over the review period. Again, Turkey represents an exception, with spreads having contracted substantially (-500 basis points). Having ranked among the countries with the highest euro-denominated eurobond spreads at end-October 2008, Turkey's spreads stood below those of Romania, Bulgaria, Croatia and Hungary at the cutoff date. Romania's spreads declined markedly as the agreement on an IMF-led multilateral financial support package was coming into reach and was then eventually announced in March 2009 (-150 basis points since end-October 2008). Finally, spreads on Russian U.S. dollar-denominated eurobonds decreased by 240 basis points, which was roughly in line with the decline observed for the overall market (JPM EMI Global Index).

Developments in CDS markets were characterized by much higher volatility over the review period (partly due to decreasing liquidity). For example, Russia's 5-year CDS (representing the most volatile in our country selection) was traded between 400 and 1,000 basis points, whereas Slovakia's 5-year CDS (being the least volatile in our sample) moved in a range from 100 to 280 basis points. While CDS premiums still trade well above pre-September 2008 levels, some downward tendencies were recently seen in all countries (since late February 2009 in the Czech Republic, Poland and Slovakia, since March in the rest of the countries). With the exception of Hungary, CDS premiums of those countries which had initially recorded the strongest increases also showed the most pronounced downward corrections in absolute terms in March and early April 2009 (Bulgaria, Croatia, Romania, Russia and Turkey). Similar to developments in the eurobond market, Romania's CDS spreads decreased notably due to the international financial support package. Russia and Turkey performed best, with CDS premiums declining by some 650 and 370 basis points from their record highs at end-October 2008. CDS of the three countries considered to be least risky (the Czech Republic, Poland and Slovakia) had been trading in a rather close range up to end-October. Since then, however, Polish CDS premiums went up markedly and Czech CDS premiums followed suit at the beginning of 2009. The Czech Republic's differential to Slovakia narrowed again in recent weeks, but Poland's CDS premiums were 100 basis points higher than Slovakia's at the cutoff date (compared with 50 basis points at end-October 2008).

From end-October 2008 to end-February 2009, CESEE stock markets recorded further losses, though on average the downward trend decelerated somewhat. In March, however, a recovery set in. When taking the whole review period into consideration, only Bulgaria (-40%), Croatia (-30%) and Slovakia (-10%) recorded equity price losses. In contrast, the most pronounced equity price gains were seen in Russia (+40%) and the Czech Republic (+20%). Hence, developments within the CESEE region diverged considerably. A global comparison reveals that, over the review period, Eastern Europe performed in line with other emerging market regions, while outperforming mature stock markets. Similarly to the MSCI EM Index, the MSCI EMEE Index (covering the Czech Republic, Hungary, Poland and Russia) increased by about 30%, whereas the DJ Industrial Average and the EURO STOXX decreased by about 5%.

Chart 1a

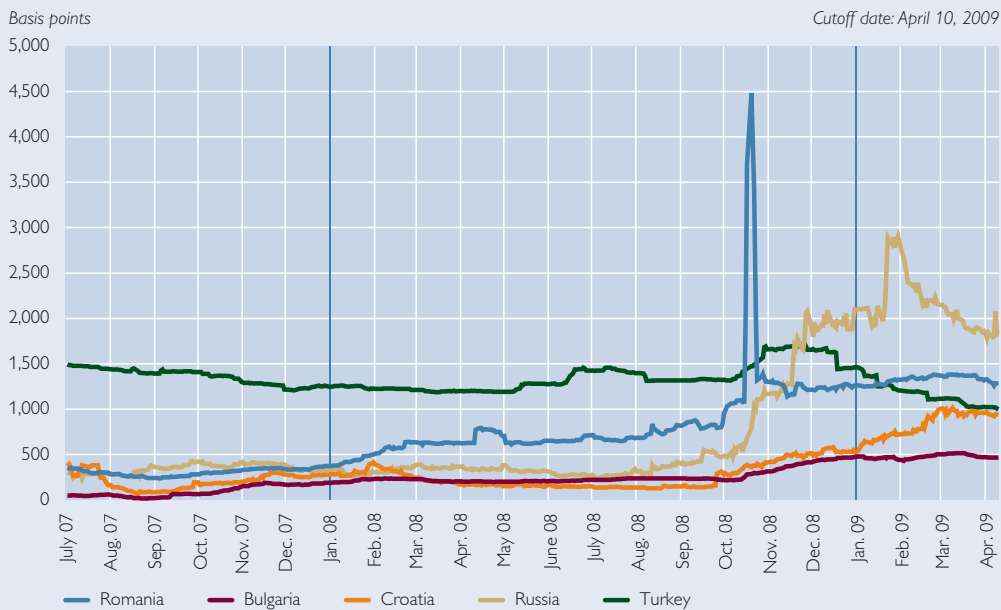
### 3-Month Money Market Spreads against the Euro Area



Source: Bloomberg.

Chart 1b

### 3-Month Money Market Rate Spreads against the Euro Area



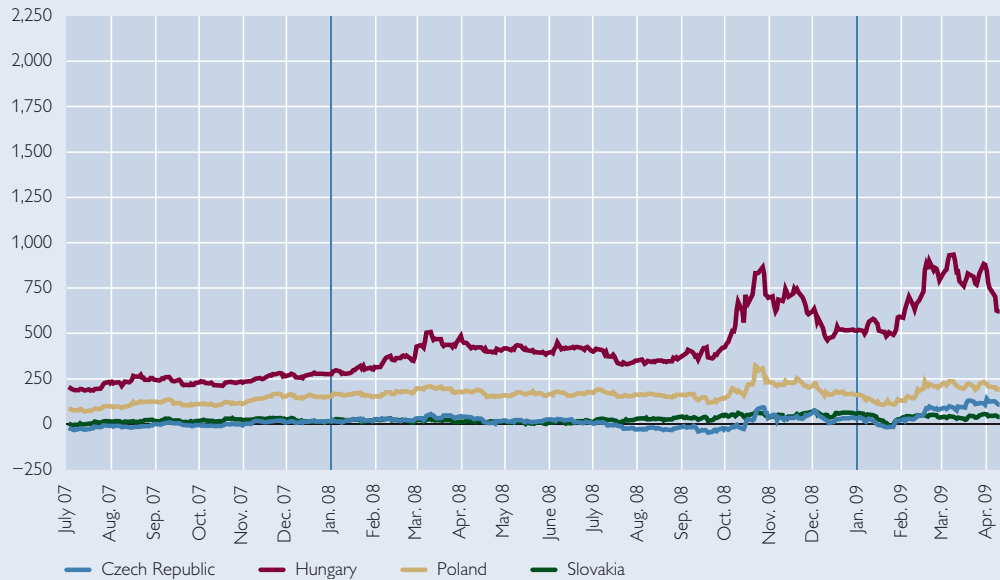
Source: Bloomberg.

Chart 2a

### Local Currency Government Bond Yield Spreads against the Euro Area

Country subindices of JPM EM-GBI, basis points

Cutoff date: April 10, 2009



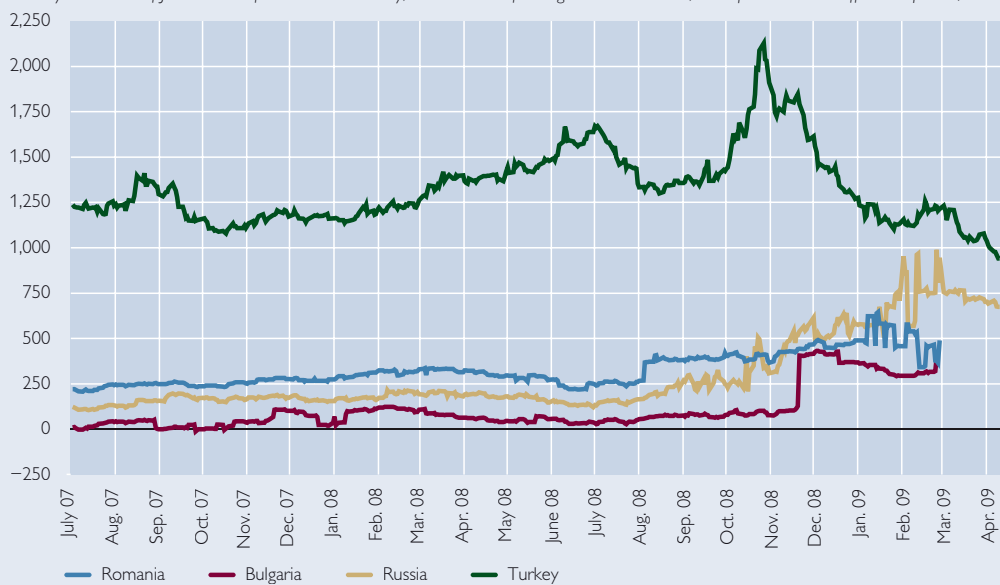
Source: Thomson Reuters.

Chart 2b

### Local Currency Government Bond Yield Spreads against the Euro Area

Country subindices of JPM GBI-EM for Russia and Turkey, Eurostat data for Bulgaria and Romania, basis points<sup>1</sup>

Cutoff date: April 10, 2009



Source: Thomson Reuters, Eurostat.

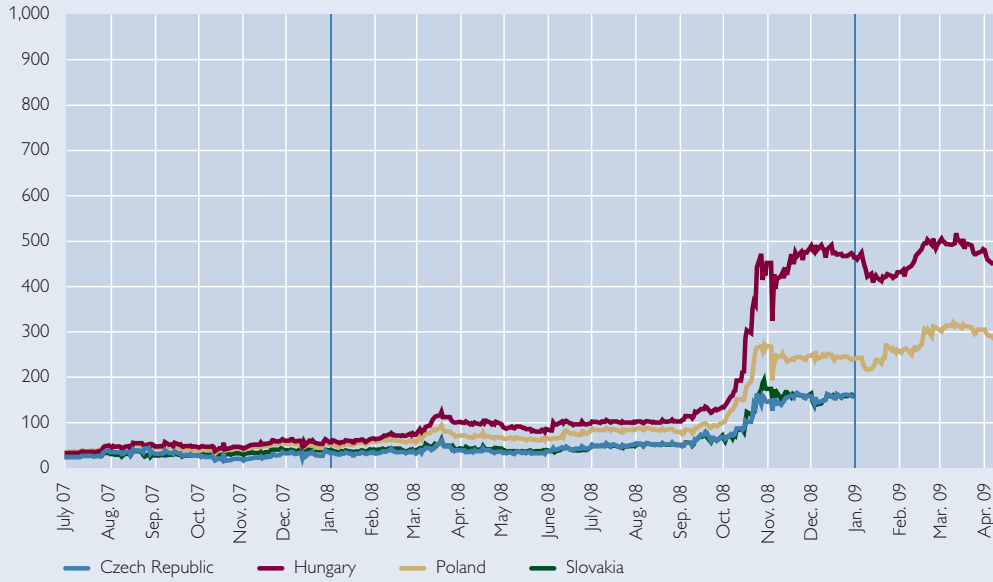
<sup>1</sup> The last observation for Bulgaria and Romania is February 27, 2009.

Chart 3a

### Euro-Denominated Eurobond Yield Spreads

JPM Euro EMBI Global, basis points

Cutoff date: April 10, 2009



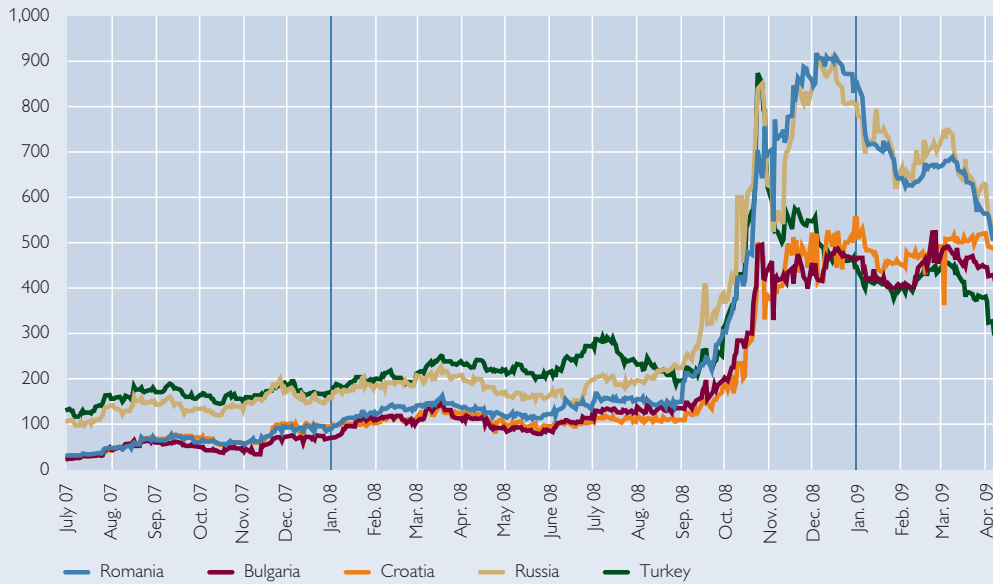
Source: Thomson Reuters.

Chart 3b

### Euro-Denominated Eurobond Yield Spreads

JPM Euro EMBI Global, for Russia JPM EMBI Global, basis points

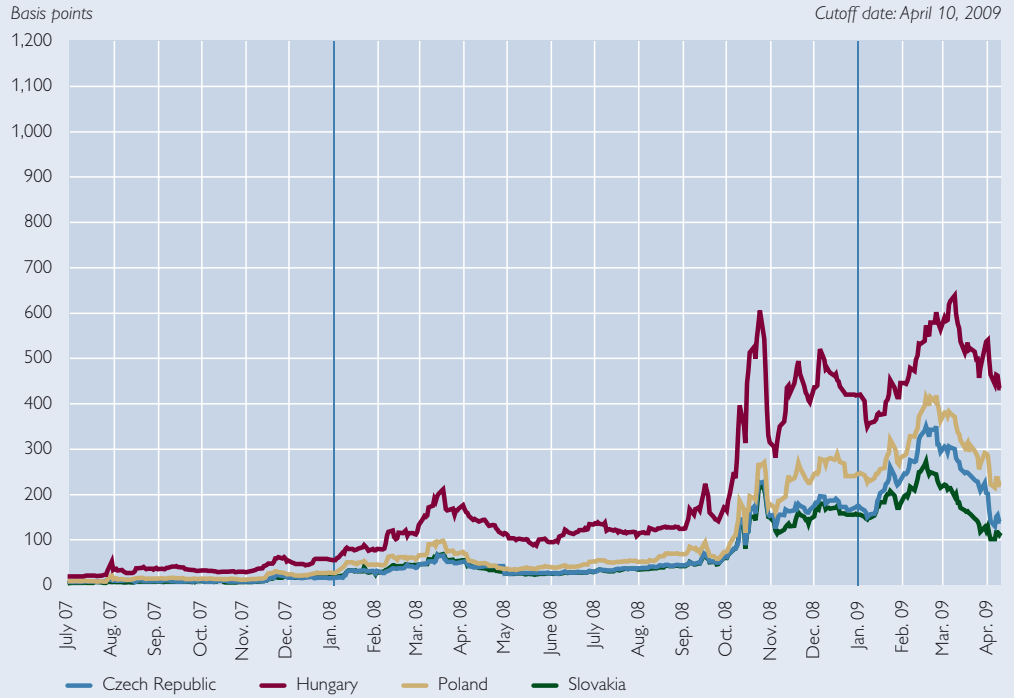
Cutoff date: April 10, 2009



Source: Thomson Reuters.

Chart 4a

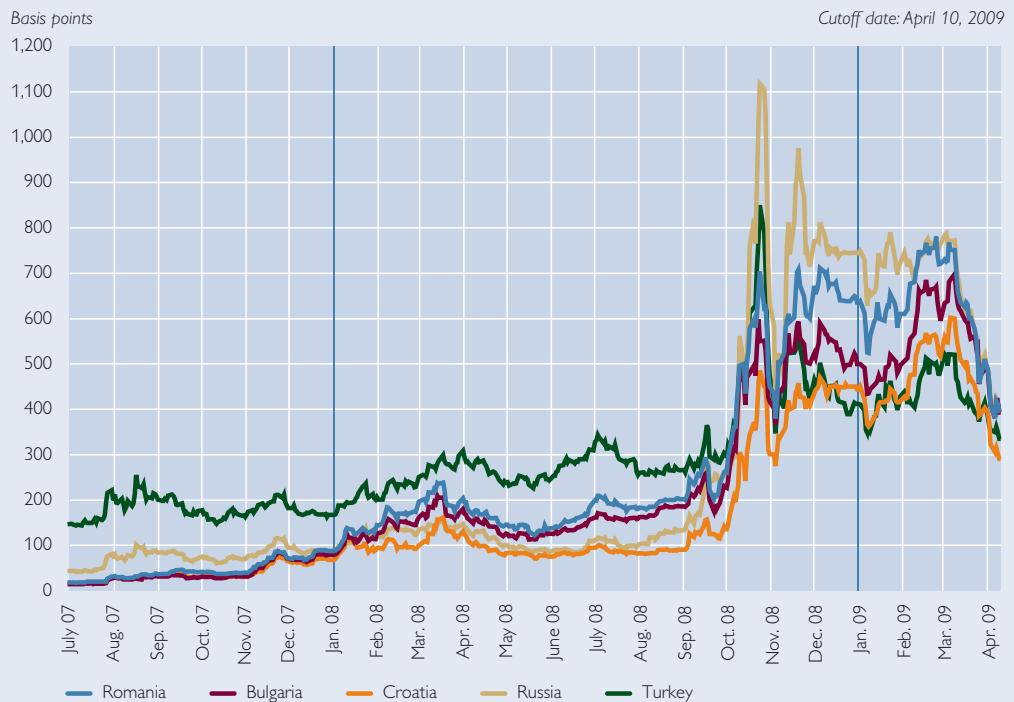
### Sovereign 5-Year Credit Default Swap Premiums



Source: Thomson Reuters.

Chart 4b

### Sovereign 5-Year Credit Default Swap Premiums



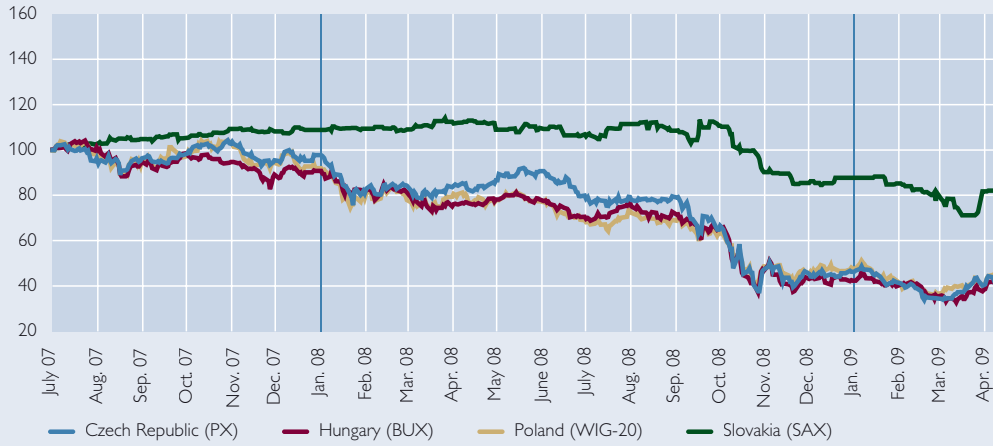
Source: Thomson Reuters.

Chart 5a

**Stock Market Developments**

June 29, 2007 = 100

Cutoff date: April 10, 2009



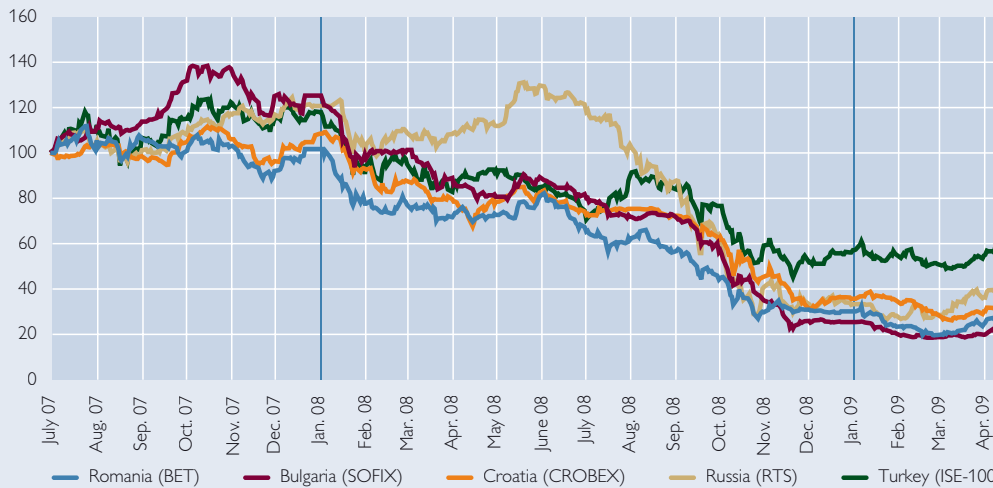
Source: Thomson Reuters.

Chart 5b

**Stock Market Developments**

June 29, 2007 = 100

Cutoff date: April 10, 2009



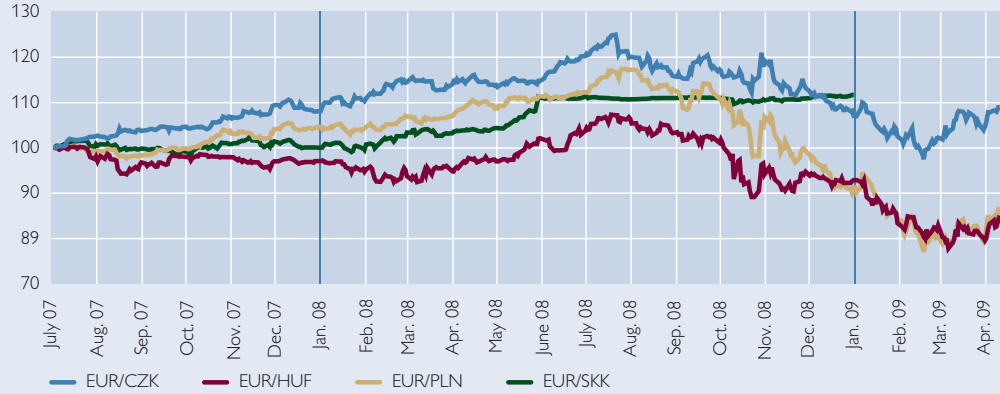
Source: Thomson Reuters.

Chart 6a

### Exchange Rate Developments against the Euro<sup>1</sup>

June 29, 2007 = 100

Cutoff date: April 10, 2009



Source: Thomson Reuters.

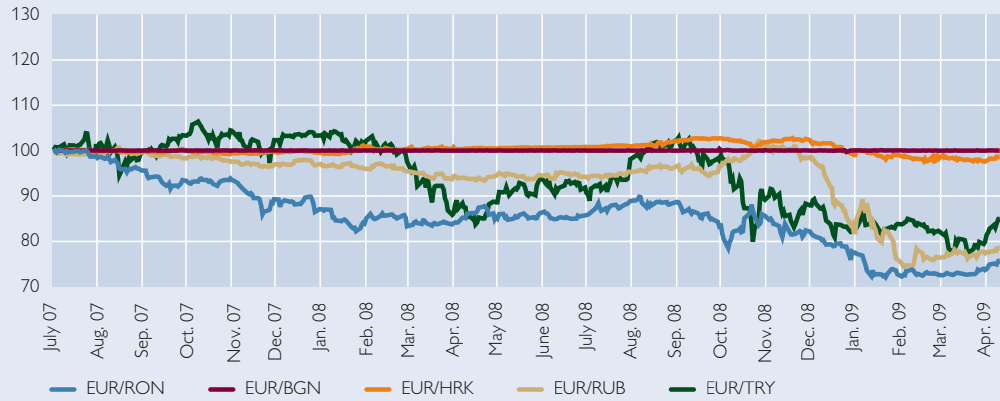
<sup>1</sup> An increase in value means a nominal appreciation.

Chart 6b

### Exchange Rate Developments against the Euro<sup>1</sup>

June 29, 2007 = 100

Cutoff date: April 10, 2009



Source: Thomson Reuters.

<sup>1</sup> An increase in value means a nominal appreciation.

**Outlook for Selected Central and Eastern European Countries<sup>1</sup>**

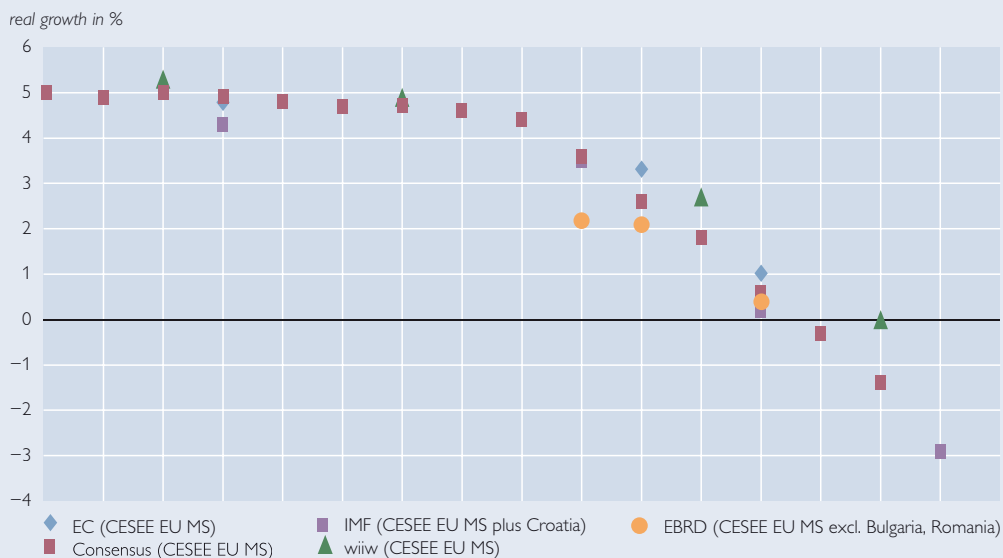
**Region Not Immune to Global Downturn: 2009 to Bring Stagnation in Poland and Recession in the Czech Republic, Hungary and Russia; Comparatively Moderate Recovery in 2010 Hinges Strongly on Improvement of External Demand**

Since the fall of 2008, the global financial crisis has intensified markedly, risk aversion has risen substantially, especially vis-à-vis emerging economies, and the repercussions of the crisis on the real economy have magnified very strongly across the globe. World-wide, forecasting institutions have undertaken repeated and very substantial downward revisions of growth projections. While forecasters started to moderately reduce their growth projections for the U.S.A. and the euro area already at the beginning of 2008, projections for CESEE countries remained broadly unchanged or were even revised upward in the case of Russia until August/September 2008, but declined sharply thereafter. The positive growth differential of about 3 percentage points between CESEE and the euro area, observed for many years, no longer figures in current projections. In 2009 and 2010, the growth differential between these two regions could amount to around 1 percentage point.

In the fourth quarter of 2008, growth decelerated markedly. Also, the development of important short-term activity indicators points to a further weakening of general economic dynamics in early 2009.

Chart 1

**CESEE EU Member States: Development of Growth Projections for 2009**



Source: Consensus Economics, EBRD, European Commission (EC), IMF, wiiw.

<sup>1</sup> The OeNB and Suomen Pankki – Finlands Bank (BOF) compile semiannual forecasts of economic developments in the Czech Republic, Hungary, Poland and Russia, with the OeNB responsible for the projections for the three Central European countries and the BOF in charge of the forecast for Russia. The forecasts are based on expert judgment and estimates of long-run elasticities. For the first time, the projections for the three Central European countries are also informed by country-specific IS-LM models, which are, however, still being developed. (A detailed description of the model is forthcoming in a future issue of the Focus on European Economic Integration, and a preliminary version of this description is available upon request from julia.woerz@oenb.at). The forecast for Russia was prepared in cooperation with the BOF and is based on a structural VAR model. All forecasts are based on preliminary global growth projections and technical assumptions about euro area import growth, oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem in the context of broad macroeconomic projection exercises. Imports of the euro area are expected to shrink substantially in 2009 and to recover moderately thereafter. The price of oil will stay broadly stable in 2009 and is expected to rise slightly in 2010. The EUR/USD exchange rate is assumed to remain unchanged over the entire projection horizon at levels recorded at the end of March 2009.

Having first turned negative in October 2008, industrial output growth contracted at an accelerating rate, which in January 2009 reached on average  $-17.1\%$  (year on year) in the EU Member States covered in the main part of the report. Output likewise declined at a more or less comparable pace in Russia and Turkey, while a less pronounced reduction was observed in Croatia. Currently, industrial production in CESEE contracts at rates comparable with those seen in the euro area, the deterioration has, however, been more pronounced in CESEE countries, as this region's industrial production growth had been higher than in the euro area before the onset of the crisis.

The weakening of the industrial sector is also reflected in declining capacity utilization rates and worsening industrial sentiment. Both indicators continued their downward trend and reached long-term lows in recent months.

The household sector, in turn, has been affected less than industry so far. Growth of retail sales turned negative in December 2008 and averaged  $-1.4\%$  in the EU Member States (excluding the Baltic states) in February 2009. According to most recent data, retail sales in Croatia and Russia still expanded in December 2008 (for Turkey no comparable data are available). While retail sales in the euro area contracted somewhat more strongly in February 2009, the deceleration over the past months was again more pronounced in CESEE. Consumer sentiment continued its downward trend and by March 2009, had sunk to levels which were even below industrial sentiment. Unemployment rates increased slowly in all CESEE countries in early 2009, thus lagging developments in a number of euro area countries, where unemployment soared recently.

Export orders in the region fell far below long-term average levels (comparable data for Croatia, Russia and Turkey are not available) and continued to go down in early 2009, which shows that recently external demand had shrunk further in key export markets, including the euro area, which receives more than 50% of all CESEE exports. Export expectations likewise declined markedly in early 2009 and reached negative levels in all countries.

The new OeNB-BOF projections were completed in early April 2009<sup>2</sup> and cover the three largest EU members in Eastern Europe, namely the Czech Republic, Hungary and Poland, which together represent more than 60% of the CESEE EU Member States' GDP, and Russia. According to these projections, the **Polish economy** is expected to stagnate in 2009 and to start growing again in 2010. The Czech Republic and Hungary, both very open economies (more so than Poland), are affected particularly strongly by the downturn in external demand, with **Hungary** falling into a steeper and longer recession owing to more pronounced macro-financial weaknesses (substantial public sector debt, high share of foreign currency loans to the nonbank private sector). The **Czech Republic** is being hit strongly by the current bust in the automotive industry, but is expected to recover sooner due to its greater leeway for anti-cyclical measures. The **Russian economy** will likewise experience negative growth in 2009 on the back of decreased oil prices reflecting weaker external demand. For all economies alike, the main growth drivers of recent years are dysfunctional at the moment. Much stiffer financing conditions as a result of the financial crisis and receding foreign capital inflows are weighing on the growth outlook. Domestic demand, which has suffered considerably in recent months, is holding up relatively well in Poland and is likely to react to stimuli from economic support programs in the Czech Republic and Russia. There is currently no room for such measures in Hungary. Some revival can be expected to come from EU-funded investment projects and the catching-up process, which, granted, has been slowed down very much by the crisis but is due to continue thereafter. An upswing in Central Europe is expected to rely heavily on a recovery of external demand, which is assumed to rise again gradually in 2010. For Russia, oil price developments remain key to the growth outlook.

Against the backdrop of the global outlook, the highly export-oriented **Czech economy** is now expected to shrink by 2.3% in 2009 compared with 2008 and to slightly recover

<sup>2</sup> The cutoff date for all data and forecasts in this box was April 3, 2009, with the exception of the IMF World Economic Outlook figures in the table, which were released on April 22, 2009.

Table 1

**Real GDP Growth in 3 CEE EU Member States and Russia**

	Latest forecast				Previous forecast	
	2006	2007	2008	2009	2008	2009
<i>Annual change in %</i>						
<b>Czech Republic</b>						
Historical data	6.4	6.5	..	..		
European Commission (November 2008)			4.4	3.6	European Commission (April 2008)	4.7 5.0
IMF (October 2008)			4.0	3.4	IMF (April 2008)	4.2 4.6
wiiw (October 2008)			4.3	4.3	wiiw (July 2008)	4.7 5.0
Consensus Forecasts (October 2008)			4.0–4.8	1.5–5.2	Consensus Forecasts (April 2008)	3.8–5.5 3.2–6.0
<b>Hungary</b>						
Historical data	3.9	1.3	..	..		
European Commission (November 2008)			1.7	0.7	European Commission (April 2008)	1.9 3.2
IMF (October 2008)			1.9	2.3	IMF (April 2008)	1.8 2.5
wiiw (October 2008)			2.0	1.0	wiiw (July 2008)	2.5 3.4
Consensus Forecasts (October 2008)			1.7–2.5	1.0–2.6	Consensus Forecasts (April 2008)	1.5–2.7 2.5–3.6
<b>Poland</b>						
Historical data	6.2	6.5	..	..		
European Commission (November 2008)			5.4	3.8	European Commission (April 2008)	5.3 5.0
IMF (October 2008)			5.2	3.8	IMF (April 2008)	4.9 4.5
wiiw (October 2008)			5.4	4.8	wiiw (July 2008)	5.5 5.3
Consensus Forecasts (October 2008)			5.0–5.4	3.3–4.6	Consensus Forecasts (April 2008)	4.7–5.8 4.1–5.5
<b>Russia</b>						
Historical data	7.3	8.1	..	..		
European Commission (November 2008)			7.1	6.0	European Commission (April 2008)	7.7 7.3
IMF (October 2008)			7.0	5.5	IMF (April 2008)	6.8 6.3
wiiw (October 2008)			..	..	wiiw (July 2008)	7.3 6.8
Consensus Forecasts (October 2008)			6.2–7.5	3.4–6.1	Consensus Forecasts (April 2008)	6.5–7.8 6.0–7.6

Source: European Commission, Consensus Forecasts, IMF, wiiw.

in 2010 (+1.4%). Private consumption and investment will suffer given the unprecedented drop of confidence indicators over the last half year, an expected marked rise in unemployment and tight financing conditions. Nevertheless, the effect of the crisis on domestic demand may remain relatively contained compared with other CEE countries.

The negative impact on both private consumption and gross fixed capital formation will be alleviated by significant monetary and fiscal stimuli. Česká národní banka lowered its key interest rate by 200 basis points to 1.75% in the 12 months up to March 2009. Fiscal stimulus measures will likely amount to about 2% of GDP and focus, in particular, on investment support as well as on the reduction of the tax burden and labor costs. Private consumption will also benefit from an increase of real disposable income thanks to lower inflation. Although net exports will certainly suffer from plunging import demand in the euro area so that a substantial contraction seems to be inevitable, the impact will be alleviated by massive fiscal measures in the euro area (particularly in the automotive sector) and also by the recently depreciated Czech koruna.

Against the backdrop of the assumed strengthening of external demand, net exports are expected to contribute positively to growth in 2010. Growth will also be supported by some revival of domestic demand. While public consumption growth will likely decelerate, private consumption is likely to pick up. Given continued tight financing conditions, we expect investment to stay broadly flat in 2010.

The global economic crisis reached **Hungary** when the country was already experiencing difficult times, leading to a pronounced slump in economic activity in the fourth quarter of 2008 (GDP fell by 2.3% year on year, exports and imports by as much as 7.8% and 8.2%, private and public consumption decreased by 4.3% each). Given the global growth outlook and a new wave of domestic fiscal tightening measures – which are in line with the commitments made in connection with the international financial support provided by the IMF and the EU<sup>3</sup> – GDP is projected to decline by 4.1% in 2009 and by 0.4% in 2010. The announced fiscal package, which involves spending cuts and an increase in indirect taxes with the aim to reduce nonwage labor costs, is further dampening the short-term growth outlook and fueling inflation in the short term, and hence reduces private spending capacity.

With respect to the individual demand components, private consumption will likely remain weak due to moderate wage growth (both in the private and the public sector), tightened financing conditions, reductions in transfers and savings measures in the pension system. Fiscal restraint will also hamper public investments. Private investments are discouraged mainly by the bleak economic outlook, deteriorated financing conditions and a declining profitability of the corporate sector, which presumably results in a contraction in investment over the projection horizon. With receding FDI, EU-funded projects will likely constitute the main pillar of investment. Exports will contract sharply in 2009 in response to lacking external demand. In this environment, the recent depreciation of the Hungarian forint cannot give the much-needed export stimulus, but puts additional pressure on the balance sheets of unhedged borrowers who have taken out foreign currency loans. Hence, there is no room for domestic economic stimuli, and the timing of a recovery will crucially depend on the recovery of export demand.

For 2010, based on the assumption of strengthening external demand, net exports will again contribute positively to growth but not outweigh a projected further decline in domestic demand. While private consumption will more or less stagnate, public consumption and investments will still decline. Hence, no growth impetus can be expected from domestic factors for 2010, and the revival of external demand will not be sufficient to lead to a recovery.

**Poland's** economy is expected to stagnate in 2009 and to start growing again in 2010, albeit at a moderate pace only. In 2009, private consumption will remain the main pillar of growth, with its growth rate still positive, but considerably smaller than in 2008. While consumer sentiment has already deteriorated markedly, the impact of the crisis on employment and retail sales will continue to lag somewhat behind the development in investment, exports and industrial output. At the same time, the personal income tax reduction that took effect at the beginning of 2009 may not boost consumption to a noticeable extent, as it mainly benefits higher-income households with a relatively high saving propensity. Moreover, credit extension to households will moderate further, and households burdened with foreign currency-denominated debt will probably restrain their consumption following the recent sharp currency depreciation.<sup>4</sup>

After two years of capacity expansion that was far stronger (roughly at double or triple growth rates) than for its regional peers, the Polish economy will see a marked contraction of fixed investment given the negative sales outlook, considerably higher unit labor costs, tighter lending conditions of banks and reduced access to cross-border loans as well as funding and home market problems of foreign parent companies. The budget envisages enhanced public investment (as a fiscal stimulus), but such spending plans were always underexecuted in previous years.

<sup>3</sup> For detailed information on the package see: <http://www.imf.org/external/country/HUN/index.htm>.

<sup>4</sup> The recent Polish request for an IMF credit line came after the cutoff date of our forecast.

The contraction of foreign demand is resulting in a veritable slump of exports. In addition, there will probably be some negative fallout from losses on foreign exchange options in the corporate sector. Given the deterioration in all three major final demand components, imports will fall even more than exports, thus putting the contribution of net exports to GDP growth in positive territory. With employment trailing output contraction, manufacturing productivity dropped sharply, so that the depreciation of the zloty in recent months mainly served to compensate for considerably increased unit labor costs rather than boosting the foreign trade balance. Assuming an unchanged exchange rate, the recently achieved currency level will strengthen net exports, once external demand picks up.

For 2010, based on the assumptions for foreign demand, a stabilization of exports, some moderate recovery in investment growth and constant subdued private consumption growth are expected. The investment-driven recovery will imply import growth exceeding export growth.

The forecast for **Russia** has been substantially scaled down in the wake of a massive deterioration in the external environment. The crash in oil prices is markedly squeezing domestic incomes, and capital can no longer be obtained on international markets. Growth in consumption is expected to fade and investment to decline markedly. Weak international demand is having a modest contractionary effect on export volumes. Import volumes will decline much more dramatically, in line with the depreciation of the ruble and soft demand. Total output growth is projected to reverse sharply into a modest decline this year (-2%) and then to gradually improve again in 2010 (+1%) based on a gradual recovery in the world economy and a moderate rise in oil prices.

Private consumption growth, largely driven by the trickle-down effects of oil and staple revenues, is slowing substantially and projected to decline slightly this year, owing to weaker wage developments and rising layoffs and unemployment. Given the authorities' sizeable anti-crisis measures already put in place and anticyclical fiscal policy, public consumption is projected to cushion the decline somewhat. Moreover, as Russian households are not highly indebted, there should be room for recovery of private consumption in 2010. With credit more expensive and harder to obtain, demand easing and company profits on the descent, volatile investment has been scaled back sharply in many branches. Public sector investment is also set to decline in the context of budget cuts in this area. Investment is thus estimated to decrease substantially in 2009, after which it should gradually resume positive growth.

The Russian export performance will continue to be determined largely by demand in the world markets and by domestic oil and raw material extraction and transport capacities (bottlenecks). After rapid growth in 2008, imports are expected to decline sharply in 2009 due to fading demand (squeezed incomes) and a weaker ruble (controlled devaluation in the period from November 2008 to January 2009 contributed to a 12% depreciation of the real effective exchange rate in the six months to end-February 2009). Furthermore, the weaker ruble may stimulate import substitution in some areas. As demand recovers, imports too should return to moderate growth in 2010.

As for risks to these projections, Russia's economic outlook depends heavily on what happens in the world economy through both oil prices and financial market developments. If the world economic crisis lasts longer and deepens, the price of oil falls further and financial markets remain in the doldrums, the situation in Russia will worsen. A renewed sustained deterioration of Russia's terms of trade would increase the downward pressure on the ruble and further destabilize the banking sector and the economy. Shrinking purchasing power due to a weaker ruble, high inflation and declining incomes could also set off popular unrest. In a worst plausible case, Russia's economic performance would be way below the one forecast here. Alternatively, a swift recovery of the world economy and a bouncing back of the oil price could set the stage for an above-forecast economic performance.

## 2 Slovakia: Euro Introduction Mitigates Spillovers from Global Financial Crisis

Fading external demand takes toll on growth

Economic growth slowed markedly from 6.6% in the third quarter to 2.5% in the fourth quarter of 2008, which translates into an annual average growth rate of 6.4%. The deceleration was broadly based and encompassed all GDP components. Exports suffered in particular as they contracted on the back of a pronounced decrease in foreign demand. With imports shrinking equally strongly, the growth contribution of net exports remained broadly constant at about -1 percentage point. Worsening export expectations and declining capacity utilization impacted adversely on investments. Private consumption growth, however, held up relatively well, which may be explained by a comparatively favorable development of unemployment, which increased only marginally in the final quarter of 2008, stable wage growth and still rather robust credit developments in the household sector. Recent forecasts project GDP growth in 2009 in a range of 0.8% to 2.7%. Thus, Slovakia is seen as one of the few CESEE countries avoiding stagnation/recession.

Annual growth of domestic credit to the nongovernment nonbank sector decelerated to 15.4% in December 2008 (from 25.3% in April) mainly due to a drastic slowdown in corporate credit growth. This is related to the slump in the export-oriented industrial sector, which was severely hit by the global slowdown. Industrial production decreased by 27% in January 2009, led by transport equipment (-48%) and electrical equipment (-44%). The latter two sectors represent the backbone of the impressive FDI-financed growth performance of the past years.

Inflation declines despite euro changeover

HICP inflation decelerated from 4.5% in September 2008 to 2.4% in February 2009, mainly on the back of lower inflationary pressure from food and energy. The introduction of the euro seems to have had little impact on general price developments so far, with only few cases of reported irregularities concerning price conversion. Národná banka Slovenska estimates the effect of euro adoption on overall HICP inflation to amount to 0.15 percentage points.

Euro somewhat shields economy from global headwinds

The short-term impact of the global financial crisis on the Slovak economy has arguably been mitigated by the euro adoption, in particular as regards exchange rate developments. While other currencies of the region weakened against the euro at double-digit rates, the Slovak koruna remained stable vis-à-vis the euro in the second half of 2008. However, over the medium term, the strong conversion rate combined with weakening currencies of key competitors (the Czech Republic, Hungary and Poland) will presumably put the competitive position of the Slovak economy under pressure. Throughout 2008, industrial ULC in Slovakia increased noticeably and at an accelerating pace. This was mainly due to a marked reduction in labor productivity growth, as the plunge in industrial output in the last months had not yet led to a notable employment response. Since this phenomenon was observed everywhere in the region, it did not have a major impact on the country's competitiveness. Moreover, in the fourth quarter of 2008, wage dynamics in industry moderated substantially, which may indicate that wages actually adjust to changing demand conditions.

As of this writing, the government has announced policy measures in the order of 0.5% of GDP with a view to dampening the real economic consequences of the crisis. A newly established economic crisis committee is in charge of coordinating the measures, which mainly focus on the labor market (e.g. temporary payroll tax relief for firms that are considered to be facing temporary liquidity problems).

Table 6

**Main Economic Indicators: Slovakia**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	8.5	10.4	6.4	10.5	14.3	9.3	7.9	6.6	2.5
Private consumption	5.8	7.0	6.1	8.2	5.8	8.3	5.6	6.0	4.6
Public consumption	10.2	-1.3	4.3	-0.2	-1.3	0.7	9.6	5.3	2.3
Gross fixed capital formation	9.3	8.7	6.8	11.1	7.0	7.5	11.8	7.3	1.4
Exports of goods and services	21.0	13.8	3.2	8.3	11.6	11.2	8.1	2.7	-7.8
Imports of goods and services	17.7	8.9	3.3	2.3	10.2	10.6	7.7	3.6	-6.7
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	6.7	6.6	6.3	5.5	13.7	9.2	6.8	6.9	2.9
Net exports of goods and services	2.2	4.6	0.0	5.6	1.2	1.0	0.7	-0.7	-1.0
Exports of goods and services	18.0	13.2	3.1	7.8	11.8	11.7	8.1	2.5	-7.7
Imports of goods and services	15.8	8.6	3.2	2.2	10.5	10.6	7.3	3.2	-6.7
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	11.3	10.0	0.6	10.1	9.2	4.4	4.5	0.8	-7.5
Gross average wage of industry (nominal)	6.7	6.4	6.8	6.1	5.5	8.4	8.7	7.8	2.8
Unit labor cost of industry (nominal)	-4.1	-3.3	6.2	-3.6	-3.4	3.9	4.0	7.0	11.2
Producer price index (PPI) of industry	8.4	2.1	6.1	1.1	2.2	4.9	6.2	6.6	6.7
Consumer price index (here: HICP)	4.3	1.9	3.9	1.4	2.4	3.4	4.0	4.5	3.9
EUR per 1 SKK, + = SKK appreciation	3.7	10.2	8.0	12.7	7.5	3.9	7.5	10.8	10.1
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15-64 years)	13.4	11.2	9.5	11.4	10.7	10.2	9.8	9.1	9.1
Employment rate (15-64 years)	59.4	60.7	62.2	60.7	61.6	61.3	61.7	63.1	62.9
Key interest rate per annum (%)	4.0	4.4	4.1	4.3	4.3	4.3	4.3	4.3	3.5
SKK per 1 EUR	37.2	33.8	31.3	33.6	33.4	33.1	31.4	30.3	30.4
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	12.8	15.1	7.6	14.9	12.6	10.8	7.6	6.4	5.8
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-1.9	-2.4	-5.8	-3.1	-1.1	1.2	-5.7	-9.9	-8.3
Domestic credit of the banking system	14.3	17.2	15.6	17.1	15.3	13.9	16.1	17.4	15.0
of which: claims on the private sector	15.5	14.9	16.2	15.4	15.4	17.0	16.9	16.5	14.6
claims on households	7.7	7.2	7.8	7.1	7.3	7.4	7.8	8.1	8.0
claims on enterprises	7.7	7.8	8.4	8.3	8.1	9.5	9.1	8.4	6.6
claims on the public sector (net)	-1.2	2.2	-0.6	1.8	-0.2	-3.1	-0.8	1.0	0.4
Other domestic assets (net) of the banking system	0.4	0.3	-2.3	0.8	-1.5	-4.4	-2.8	-1.1	-1.0
<i>% of GDP, ESA 95</i>									
General government revenues <sup>1</sup>	33.5	32.5	32.7	..	..	..	..	..	..
General government expenditures <sup>1</sup>	36.9	34.4	34.9	..	..	..	..	..	..
General government balance <sup>1</sup>	-3.5	-1.9	-2.2	..	..	..	..	..	..
Primary balance <sup>1</sup>	-2.0	-0.5	-0.9	..	..	..	..	..	..
Gross public debt <sup>1</sup>	30.4	29.4	27.6	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	29.3	26.9	13.4	20.3	22.0	18.0	21.2	19.1	-2.2
Merchandise imports	27.7	21.4	13.4	15.5	18.3	16.7	21.5	20.1	-1.9
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-4.6	-1.2	-1.1	0.0	-3.0	1.3	-2.0	-0.6	-2.8
Services balance	1.4	0.7	-0.7	0.9	0.4	-0.6	-0.6	-0.7	-1.0
Income balance (factor services balance)	-3.7	-4.3	-3.5	-5.6	-5.3	-0.8	-7.4	-3.2	-2.3
Current transfers	-0.1	-0.6	-1.3	-0.9	0.1	-1.4	-1.3	-1.1	-1.5
Current account balance	-7.0	-5.4	-6.6	-5.6	-7.8	-1.4	-11.3	-5.6	-7.5
Capital account balance	-0.1	0.6	1.2	0.1	1.1	0.9	2.4	0.5	1.1
Foreign direct investment (net)	6.8	3.6	3.4	4.6	4.1	-1.2	3.4	3.8	7.0
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	54.8	54.8	58.0	53.4	54.8	54.8	59.7	59.1	58.0
Gross official reserves (excluding gold)	21.6	22.4	18.9	23.7	22.4	21.1	20.2	19.4	18.9
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.0	3.1	2.7	3.3	3.1	2.9	2.8	2.7	2.7
<i>EUR million, period total</i>									
Gross domestic product in current prices	44,629	54,900	65,026	14,441	14,931	14,213	16,042	17,550	17,221

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

<sup>1</sup> Including the net costs of the pension reform.

### 3 Slovenia: Successive Crisis-Response Packages to Counter Economic Contraction

Drop in investment leads to negative GDP growth in the fourth quarter of 2008

GDP contracted by 0.8% in the closing quarter of 2008, after an expansion of 3.9% in the previous quarter. Among the domestic demand components, investment growth turned negative in the last three months of 2008, with the biggest downward impulse coming from construction, metal products and machinery. This reflected both the deterioration in economic prospects (especially the export outlook) and a tight credit market. By contrast, domestic consumption continued to expand, albeit at a somewhat slower pace than during the first three quarters of 2008. In particular, public consumption grew dynamically. Private consumption growth had turned rather weak already in the third quarter and remained so in the fourth, despite solid real wage growth and rising employment in the final three months of 2008, potentially reflecting mainly souring expectations. Similarly to other countries in the region, exports decreased substantially; however, as imports fell even more, net exports contributed positively to GDP growth.

Inflation differential to the euro area decreased

Mainly due to slowing inflation in energy and processed food prices, HICP inflation decelerated to 2.1% in February 2009, from around 7% in mid-2008. Given that disinflation in these two components was stronger than in the euro area, the difference between inflation in Slovenia and the euro area average decreased from 2.8 to 0.9 percentage points.

Several fiscal measures taken to dampen the impact of the crisis

In order to mitigate the impact of the global crisis on Slovenia's real economy, the authorities put together a first package in mid-December 2008 and a second in February 2009, both of which are now being implemented. The packages included a subsidy scheme for companies that shorten working hours while keeping salaries unchanged and thus abstain from layoffs, tax breaks for investment, guarantee schemes for bank loans to enterprises and measures to improve the capital adequacy of banks. Against the background of faltering growth of domestic credit to the private sector (which ran to 15% year on year in January 2009, down from around 34% in mid-2008 and 43% in December 2007), the government issued unlimited retail deposit insurance and became entitled to undertake guarantees for bank liabilities to a maximum of EUR 12 billion to support banks' refinancing. The country's biggest bank has already applied for a guarantee and two more banks are expected to follow suit. Also, the proceeds of two government bond issues (combined volume: EUR 2.5 billion) have been used to improve banking sector liquidity. Currently, the government is working on a third set of crisis-response measures. These will reportedly concentrate on enhancing competitiveness, helping workers who lose their job due to shrinking orders, implementing measures in the construction sector, subsidizing interest payments of companies, stepping up support for research and development and providing additional aid to SMEs. To incorporate these measures into the fiscal accounts, parliament passed a supplementary budget, which envisages a substantial increase in expenditures compared with 2008 (+17%) and a budget deficit of 3.4% of GDP (up from 0.9% in 2008). The revised budget is based on assumed GDP growth of 0.6%, but the government has already started work on another supplementary budget based on the government's recently updated growth forecast of -4%. Besides, the government is considering unifying financial supervision, implementing further changes in the tax system and streamlining the public sector (including measures to contain the public sector wage bill).

Table 7

## Main Economic Indicators: Slovenia

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	5.9	6.8	3.5	7.5	5.4	5.7	5.5	3.9	-0.8
Private consumption	2.9	5.1	2.2	7.1	5.4	3.7	3.5	0.7	1.1
Public consumption	4.1	2.5	3.7	2.3	3.5	2.0	3.3	4.6	5.0
Gross fixed capital formation	10.4	11.9	6.2	14.5	4.2	16.9	10.3	4.5	-5.3
Exports of goods and services	12.5	13.8	3.3	15.8	10.1	7.6	8.0	4.2	-6.2
Imports of goods and services	12.2	15.7	3.5	19.4	11.1	9.7	9.2	3.0	-6.6
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	5.8	8.2	3.8	9.8	6.6	7.4	6.5	3.2	-1.5
Net exports of goods and services	0.1	-1.5	-0.2	-2.4	-1.2	-1.6	-1.0	0.9	0.7
Exports of goods and services	8.2	9.6	2.5	10.9	7.2	5.7	5.9	3.1	-4.6
Imports of goods and services	8.1	11.1	2.7	13.3	8.4	7.3	6.9	2.3	-5.2
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	7.9	5.5	-1.0	5.1	3.0	1.6	3.6	-0.7	-8.8
Gross average wage of industry (nominal)	5.5	6.7	7.8	6.6	8.6	8.3	9.7	9.4	4.1
Unit labor cost of industry (nominal)	-2.3	1.1	8.9	1.4	5.4	6.6	5.9	10.2	14.2
Producer price index (PPI) of industry	2.4	7.1	8.1	8.2	10.7	10.2	10.8	8.0	3.9
Consumer price index (here: HICP)	2.5	3.8	5.5	3.7	5.5	6.5	6.4	6.2	3.1
EUR per 1 SIT, + = SIT appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15-64 years)	6.0	4.9	4.4	4.6	4.6	4.6	4.5	4.3	4.2
Employment rate (15-64 years)	66.5	67.8	68.6	69.0	67.7	67.1	68.3	70.1	68.8
Key interest rate per annum (%)	3.5	3.8	3.9	4.0	4.0	4.0	4.0	4.2	3.5
SIT per 1 EUR	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	8.4	22.5	9.8	25.2	25.0	13.2	10.9	7.8	7.7
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-15.6	-21.4	-15.6	-22.8	-25.3	-17.7	-16.8	-15.0	-13.1
Domestic credit of the banking system	24.7	36.6	30.5	38.6	42.9	34.8	32.7	29.7	25.4
of which: <i>claims on the private sector</i>	26.8	36.0	32.2	38.8	42.3	36.6	35.3	31.2	26.3
<i>claims on households</i>	7.0	8.0	7.2	8.2	9.1	8.4	7.9	6.8	5.7
<i>claims on enterprises</i>	19.8	28.0	25.0	30.6	33.2	28.2	27.4	24.4	20.6
<i>claims on the public sector (net)</i>	-2.1	0.6	-1.7	-0.2	0.7	-1.8	-2.6	-1.6	-0.9
Other domestic assets (net) of the banking system	-0.6	7.4	-5.5	9.5	7.3	-5.8	-4.9	-6.9	-4.6
<i>% of GDP, ESA 95</i>									
General government revenues	43.3	42.9	42.7	..	..	..	..	..	..
General government expenditures	44.6	42.4	43.6	..	..	..	..	..	..
General government balance	-1.3	0.5	-0.9	..	..	..	..	..	..
Primary balance	0.1	1.8	0.2	..	..	..	..	..	..
Gross public debt	26.7	23.4	22.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	16.6	16.3	2.4	18.2	11.4	7.4	7.7	4.0	-9.1
Merchandise imports	16.3	18.1	6.9	20.4	12.0	12.1	13.1	10.2	-6.6
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-3.7	-4.8	-7.2	-4.5	-7.4	-5.7	-7.0	-7.7	-8.2
Services balance	3.2	3.5	4.6	4.0	2.2	4.1	4.9	5.6	3.7
Income balance (factor services balance)	-1.4	-2.1	-2.7	-4.0	-1.3	-2.5	-2.4	-3.0	-2.8
Current transfers	-0.6	-0.8	-0.6	-0.9	-1.0	-1.7	-0.4	0.4	-0.7
Current account balance	-2.5	-4.2	-5.9	-5.4	-7.4	-5.9	-5.0	-4.7	-8.0
Capital account balance	-0.4	-0.2	-0.2	-0.4	-0.1	0.0	-0.2	-0.4	-0.3
Foreign direct investment (net)	-0.6	-0.8	0.7	0.0	0.5	1.7	-0.3	-0.9	2.4
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	77.6	100.8	105.0	96.1	100.8	104.7	107.9	108.1	105.0
Gross official reserves (excluding gold) <sup>1</sup>	17.2	1.9	1.7	2.2	1.9	2.0	1.7	1.7	1.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.1	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.3
<i>EUR million, period total</i>									
Gross domestic product in current prices	31,013	34,471	37,126	8,958	8,920	8,726	9,636	9,647	9,117

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

<sup>1</sup> Given Slovenia's adoption of the euro, the methodology for calculating international reserves was changed from the beginning of 2007. In particular, reserves no longer include foreign assets in euro as well as claims on euro area residents.

#### 4 Bulgaria: Crisis Hits, too, but So Far Less Hard than in Other CESEE Countries

While still running to 3.5%, economic growth halves in the fourth quarter of 2008

The global crisis reached Bulgaria via the foreign trade channel and a reduction of net foreign capital inflows. So far, the knock-on effects, while being substantial, have been somewhat less pronounced than in many other CESEE countries. However, macroeconomic imbalances that have built up over the last years – in spite of broadly prudent macroeconomic policies – still form a risk of weighing on the real economy in the course of 2009/2010.

Bulgaria ranked among the fastest growing countries in the region up to the third quarter of 2008. The decline in growth to 3.5% in the fourth quarter can be attributed to lower private consumption growth and to a strong decrease of exports. Lower domestic and foreign demand has also fed through to a marked decline of industrial output, which shrank by more than 8% in December 2008. Credit expansion (private sector credit growth has moderated substantially and largely ground to a halt – in month-on-month terms – at the end of 2008) decelerated considerably, partly resulting from tighter external financing conditions and more cautious local lending practices. As a consequence, the Bulgarian National Bank (BNB) further decreased minimum reserve requirements in December 2008 and January 2009, bringing about some easing in money market conditions.

Macroeconomic imbalances still in place

As exports of goods and services declined more strongly than imports in the fourth quarter of 2008, the current account balance did not improve and reached a deficit of about 24% of GDP for 2008 as a whole. At the same time, net FDI inflows moderated in the second half of 2008, but still covered about 70% of the full-year combined current and capital account deficit. Furthermore, external debt continued to rise. While net external debt reached 44% of GDP at end-September 2008, gross external debt stood at 107% of GDP at the end of 2008.

HICP inflation slowed substantially in the second half of 2008, falling from 14.4% year on year in July 2008 to 5.4% in February 2009. This was mainly brought about by lower energy and food price increases. While these two components accounted for more than 50% of total inflation in July 2008, their share had decreased to just 18% by February 2009.

Wage dynamics, while starting to moderate in the fourth quarter of 2008, are still at a high level. The moderation has not yet offset the marked reduction in labor productivity growth induced by the recent downturn. Thus, the already high ULC growth accelerated further toward the end of 2008.

Buffers: fiscal positions remain solid while foreign exchange reserves have diminished

After a fiscal surplus of 1.5% of GDP in 2008, Bulgaria aims to keep the surplus target of 3% also in the medium run. However, the European Commission in its assessment of Bulgaria's convergence program expects higher revenue shortfalls and hence a fiscal surplus of only about 2% of GDP for 2009 and 2010 due to lower GDP growth and a less tax-intensive composition of growth. The reserves accumulated from the budgetary surpluses of the last years (the Fiscal Reserve Account is equipped with funds of about 12% of GDP as at February 2009) work as an additional buffer to ensure a smooth refinancing of maturing public debt.

The central bank's international reserves declined by around 20% from September 2008 to the end of March 2009, which is to a considerable extent due to the easing of the minimum reserve requirement (deposits of other MFIs with the BNB declined by about 35%). Nevertheless, BNB's foreign reserves still cover gross short-term external debt by about 95% and reserve money by 193%.

Table 8

**Main Economic Indicators: Bulgaria**

	2006	2007	2008	Q3 2007	Q4 2007	Q3 2007	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	6.3	6.2	6.0	4.9	6.9	7.1	7.1	6.8	3.5
Private consumption	9.5	5.3	4.8	5.2	2.8	6.5	5.4	6.4	1.5
Public consumption	-1.3	3.1	0.1	-0.4	11.2	-4.4	2.0	0.4	1.2
Gross fixed capital formation	17.6	21.7	20.3	19.7	14.0	15.5	28.6	22.3	15.8
Exports of goods and services	8.7	5.2	2.9	5.4	6.0	9.2	5.1	3.8	-6.0
Imports of goods and services	14.0	9.9	4.9	9.3	5.7	5.8	13.7	4.2	-3.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	12.3	11.2	7.2	8.8	8.5	6.0	15.4	4.0	4.3
Net exports of goods and services	-6.4	-5.6	-2.8	-4.1	-1.9	0.1	-9.8	-1.1	-0.5
Exports of goods and services	5.6	3.4	1.9	3.7	3.5	6.1	3.5	2.6	-3.5
Imports of goods and services	12.0	9.1	4.6	7.9	5.4	6.0	13.3	3.7	-3.0
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	10.5	8.7	0.7	9.7	8.0	7.4	4.5	0.0	-9.1
Gross average wage of industry (nominal)	10.8	20.1	22.2	20.0	22.8	25.0	24.0	22.5	17.8
Unit labor cost of industry (nominal)	0.3	10.4	21.3	9.4	13.7	16.4	18.7	22.5	29.6
Producer price index (PPI) of industry	6.8	8.4	10.8	8.1	11.7	14.6	13.2	12.2	3.8
Consumer price index (here: HICP)	7.4	7.6	12.0	9.0	11.2	12.4	14.0	12.5	9.0
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	9.0	6.9	5.6	6.8	6.2	6.2	5.9	5.3	5.1
Employment rate (15–64 years)	58.6	61.7	64.0	62.7	62.9	62.6	63.9	65.0	64.3
Key interest rate per annum (%) <sup>1</sup>	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	21.3	29.0	22.8	29.4	29.7	30.2	27.4	22.2	13.3
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	14.7	10.4	-2.9	8.3	4.1	1.8	0.4	-3.4	-9.1
Domestic credit of the banking system	13.0	25.3	33.5	28.0	34.2	37.8	35.3	32.9	28.9
of which: claims on the private sector	16.4	34.2	41.7	37.6	43.3	45.5	44.6	42.2	35.6
claims on households	9.4	12.0	14.3	12.7	14.5	15.4	15.2	14.4	12.5
claims on enterprises	7.0	22.2	27.4	24.9	28.8	30.2	29.4	27.8	23.1
claims on the public sector (net)	-3.4	-8.9	-8.2	-9.6	-9.1	-7.8	-9.2	-9.3	-6.7
Other domestic assets (net) of the banking system	-6.4	-6.6	-7.8	-6.9	-8.6	-9.3	-8.4	-7.3	-6.6
<i>% of GDP, ESA 95</i>									
General government revenues	39.5	41.5	39.0	..	..	..	..	..	..
General government expenditures	36.5	41.5	37.4	..	..	..	..	..	..
General government balance	3.0	0.1	1.5	..	..	..	..	..	..
Primary balance	4.4	1.1	2.4	..	..	..	..	..	..
Gross public debt	22.7	18.2	14.1	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	26.9	12.5	13.0	12.2	19.2	25.8	22.3	17.9	-10.2
Merchandise imports	26.7	18.4	15.8	17.2	19.6	22.0	33.0	18.4	-5.3
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-22.0	-25.3	-25.9	-22.3	-27.8	-26.1	-30.8	-22.5	-24.9
Services balance	3.7	3.9	3.4	11.4	-1.4	-2.1	4.5	10.5	-0.8
Income balance (factor services balance)	-2.1	-1.6	-3.2	-3.2	-0.9	-1.6	-5.7	-2.7	-2.7
Current transfers	2.7	1.2	1.5	0.9	1.3	2.0	4.3	0.6	-0.4
Current account balance	-17.8	-21.8	-24.3	-13.2	-28.8	-27.7	-27.8	-14.1	-28.8
Capital account balance	0.7	1.2	0.8	0.9	2.6	2.7	0.2	0.4	0.4
Foreign direct investment (net)	23.3	21.8	14.6	23.9	20.8	9.5	23.9	16.7	8.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	81.7	99.8	107.4	93.9	99.8	99.4	106.0	108.8	107.4
Gross official reserves (excluding gold)	32.9	38.8	35.0	39.8	38.8	37.8	39.7	42.4	35.0
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	4.8	5.5	5.1	5.7	5.5	5.3	5.5	5.9	5.1
<i>EUR million, period total</i>									
Gross domestic product in current prices	25,238	28,899	34,118	8,050	8,358	6,894	8,152	9,515	9,557

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

<sup>1</sup> Not available in a currency board regime.

## 5 Czech Republic: Marked Downturn in Growth Dynamics

Sudden collapse of GDP growth via trade channel

In 2008, real GDP growth slowed noticeably from 4.4% in the first quarter to 0.2% in the last quarter, bringing the annual average growth rate to 3.2%. After a gradual deceleration in the first three quarters, economic growth fell abruptly in the closing quarter. In the third quarter, external trade still contributed substantially to economic expansion, while negative stock changes put a major damper on growth in the wake of a deteriorating external environment and worsening export expectations. The latter started to materialize strongly in the final quarter of 2008, in which the growth contribution of net exports turned negative. Domestic consumption and positive stock changes managed to somewhat counteract this development. After a gradual slowdown in the first nine months of the year, investment growth came almost to a halt in the final quarter, notably suffering from a sharp fall in housing construction. Industrial production decreased by more than 17% in December 2008; in the automobile sector, which is particularly important for the Czech economy, the contraction amounted to around 25%.

Economic policy environment dominated by faded inflationary and emerging recession risks

On the back of lower inflationary pressure from food and energy as well as weakening demand, inflation continuously declined since the beginning of 2008. Headline inflation adjusted for first-round effects of changes to indirect taxes, i.e. the inflation rate relevant for CNB monetary policy, dropped well below the inflation target of 3%. In response to fading inflationary risks and looming recession threats, the CNB lowered its key interest rate since November 2008 in three steps by 175 basis points to 1.75%. In addition, the economy has been provided with a fiscal stimulus amounting to almost 1% of GDP. Further fiscal measures are currently being debated in parliament, with good prospects of being approved soon, which would lift the fiscal stimulus well above 2% of GDP. These measures focus particularly on investment support as well as on the reduction of the tax burden and labor costs. Inter alia, they include shortened write-off periods or a reduction of the corporate income tax and of social insurance rates for both employers and employees.

Long-lasting labor market improvement seems over

As the labor market reacts with some lag to GDP developments, the economic slowdown started feeding through to the labor market in the closing quarter of 2008. Although unemployment has gone up only moderately so far, a further deterioration is likely. As in other countries, ULC jumped in the last quarter of 2008, due to the drop in productivity that accompanied the output slump. Although the depreciation of the Czech koruna observed in the second half of 2008 and in early 2009 offset some of the pressure, the fourth-quarter ULC increase was still more pronounced when expressed in euro (given the koruna's strong appreciation until mid-2008, which was, as of the final quarter, not completely reversed in year-on-year terms).

A deterioration of the terms of trade, which was partly caused by strong currency appreciation in the first half of 2008, along with much lower demand in the EU weighed on the trade balance, which turned negative in the closing quarter. The current account deficit rose in parallel, reaching its highest level since 2004, but was amply covered by still solid FDI inflows. Driven by the general rise in risk aversion, financial market concerns about the (real) impacts of the financial crisis and the implied negative outlook for exports and FDI, the koruna lost more than 28% of its value against the euro between its mid-2008 peak and mid-February 2009. Although it has recovered noticeably since then, exchange rate volatility has remained elevated.

Table 9

**Main Economic Indicators: Czech Republic**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	6.8	6.0	3.2	5.8	5.9	4.4	4.4	4.0	0.2
Private consumption	5.4	5.3	2.8	5.6	3.7	2.7	3.3	2.8	2.5
Public consumption	-0.7	0.4	0.9	-1.3	3.7	-0.8	2.0	2.6	-0.2
Gross fixed capital formation	6.5	6.7	3.1	5.9	6.5	4.5	4.5	3.4	0.3
Exports of goods and services	15.8	14.9	6.9	16.1	13.5	14.1	15.0	9.0	-8.7
Imports of goods and services	14.2	14.2	4.6	15.6	11.4	12.3	10.5	4.3	-6.9
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	5.6	5.2	1.1	5.3	4.1	2.3	0.2	-0.1	2.0
Net exports of goods and services	1.2	0.7	2.3	0.4	1.9	2.2	4.5	4.6	-1.9
Exports of goods and services	13.7	14.0	7.0	14.5	13.5	14.6	14.7	8.9	-9.3
Imports of goods and services	12.4	13.3	4.7	14.1	11.6	12.4	10.2	4.3	-7.4
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	9.4	6.6	0.9	4.4	5.6	3.7	4.8	4.7	-10.1
Gross average wage of industry (nominal)	6.1	8.6	8.3	8.4	8.0	11.6	8.7	7.5	5.9
Unit labor cost of industry (nominal)	-3.0	1.8	7.3	3.9	2.3	7.7	3.7	2.7	17.8
Producer price index (PPI) of industry	1.6	4.0	4.5	3.9	5.0	5.6	5.1	5.5	1.6
Consumer price index (here: HICP)	2.1	3.0	6.3	2.7	4.9	7.6	6.7	6.5	4.4
EUR per 1 CZK, + = CZK appreciation	5.1	2.1	11.3	1.4	4.5	9.7	13.9	16.0	5.8
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.1	5.3	4.4	5.1	4.9	4.5	4.3	4.3	4.5
Employment rate (15–64 years)	65.3	66.1	66.5	66.3	66.5	66.1	66.6	66.7	66.8
Key interest rate per annum (%)	2.2	2.9	3.5	3.1	3.4	3.6	3.8	3.6	3.0
CZK per 1 EUR	28.3	27.8	25.0	27.9	26.8	25.6	24.8	24.1	25.3
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	12.4	14.4	13.1	14.7	15.3	14.9	12.5	12.4	12.8
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	1.2	-1.6	-1.9	-0.8	-2.0	-2.3	-4.5	-2.0	0.9
Domestic credit of the banking system	9.2	15.7	11.8	16.7	16.2	14.9	13.1	9.2	10.3
of which: claims on the private sector	11.9	14.3	15.4	15.1	16.8	17.4	16.5	15.0	13.0
claims on households	6.7	7.7	8.2	7.9	8.5	8.9	8.5	8.1	7.3
claims on enterprises	5.2	6.6	7.2	7.2	8.2	8.5	8.0	6.9	5.7
claims on the public sector (net)	-2.7	1.4	-3.6	1.6	-0.5	-2.6	-3.4	-5.8	-2.7
Other domestic assets (net) of the banking system	2.0	0.3	3.3	-1.2	1.1	2.3	3.9	5.2	1.7
<i>% of GDP, ESA 95</i>									
General government revenues	41.2	42.0	40.9	..	..	..	..	..	..
General government expenditures	43.8	42.6	42.4	..	..	..	..	..	..
General government balance	-2.6	-0.6	-1.5	..	..	..	..	..	..
Primary balance	-1.5	0.5	-0.3	..	..	..	..	..	..
Gross public debt	29.6	28.9	29.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	20.6	18.1	10.7	18.9	16.6	17.6	20.8	15.2	-8.4
Merchandise imports	20.7	15.8	11.4	16.8	14.3	18.8	18.7	13.9	-3.4
<i>% of GDP (based on EUR), period total</i>									
Trade balance	2.0	3.4	2.8	2.4	2.9	4.9	4.2	2.9	-0.7
Services balance	1.4	1.6	2.2	1.8	1.2	2.5	2.3	2.1	1.9
Income balance (factor services balance)	-5.6	-7.7	-7.8	-9.3	-8.1	-4.1	-12.7	-7.4	-6.7
Current transfers	-0.4	-0.5	-0.3	-0.6	-0.3	0.1	0.2	-0.8	-0.7
Current account balance	-2.6	-3.2	-3.1	-5.7	-4.2	3.4	-6.0	-3.2	-6.2
Capital account balance	0.3	0.6	0.8	0.4	1.5	0.8	1.3	0.2	1.0
Foreign direct investment (net)	2.8	5.1	4.1	4.7	6.7	2.4	5.6	4.4	3.7
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	38.2	40.6	38.9	38.7	40.6	41.0	44.7	43.0	38.9
Gross official reserves (excluding gold)	20.9	18.5	17.7	18.7	18.5	18.0	17.2	17.2	17.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.4	3.0	3.0	3.0	3.0	2.9	2.8	2.8	3.0
<i>EUR million, period total</i>									
Gross domestic product in current prices	113,508	127,244	148,620	31,969	34,403	34,302	38,223	38,895	37,201

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

## 6 Hungary: Global Crisis Pushes the Economy into Recession

GDP contracts on collapsing domestic demand...

Hungary's GDP fell by 2.3% in the final quarter of 2008. On the expenditure side, domestic consumption represented a major drag on growth. This mirrored a deterioration in the labor market, sharply limited access to credit for households, and austerity measures implemented by the government in response to the financial crisis. Gross fixed capital formation posted the fourth contraction in a row, reflecting worsening economic prospects both at home and abroad and a marked deterioration in access to credit for enterprises. Exports contracted sharply in the last quarter of 2008 as a result of faltering external demand, but since the drop in imports was even bigger, net exports delivered a minor positive contribution to growth.

... but the economic downturn eases pressure on inflation

As a result of the economic downturn and helped by base effects, inflation decelerated considerably in recent months (to 2.9% year on year in February 2009, from around 7% in mid-2008). The weak economic environment seems to have helped contain the pass-through to inflation of the sharp weakening of the forint over the past few months (by around 20% versus the euro between end-September 2008 and mid-March 2009). The recession could also limit potential secondary effects of further fiscal consolidation measures (main VAT rate and excise duty hikes) envisaged to take effect from July 2009 but yet to be approved by parliament. As a result of these measures (estimated impact on headline inflation: around 1 percentage point), Magyar Nemzeti Bank (MNB) expects annual average inflation to rise to 3.7% in 2009, i.e. above its 3% medium-term target, but to return to slightly below the target in 2010 (2.8%).

International financial assistance to mitigate the impact of the crisis

Since October 2008 Hungary has been affected severely by the global financial crisis. In particular, the government bond market became illiquid at the beginning of October 2008. Lending by domestic banks came to a standstill (adjusted for valuation effects, including exchange rate changes). In order to alleviate external financing risks, not least in light of private creditors' unwillingness to fully roll over maturing external debt especially vis-à-vis the public sector, in early November 2008, the IMF, the EU and the World Bank jointly provided EUR 20 billion in financial assistance.

The authorities are extending measures in response to the financial crisis

In line with the IMF agreement, and in an attempt to restore confidence and contain public sector financing needs to available means, the government in October 2008 adopted an economic policy package, which included fiscal tightening, better fiscal governance and – in addition to liquidity-improving measures by the MNB – measures to support the banking sector. Furthermore, in April 2009, the government decided to inject, through loans, a combined EUR 1.4 billion into two major banks by mid-2009, which will be financed from the EUR 20 billion of international financial assistance. Also, the government intends to extend until end-2009 the agreement with commercial banks about the voluntary restructuring of foreign currency loans to households. It also introduced legislation to provide temporary government guarantees for mortgage payments of persons that (have) become unemployed due to the financial crisis. As the economic slowdown turned out to be more severe than previously expected, the Hungarian government decided on further corrective measures in mid-February 2009 (pending parliamentary approval) and to cap the 2009 budget deficit at 2.9% of GDP (original target: 2.6%). Also, the MNB adopted additional measures in February and March 2009 to improve the foreign currency liquidity of Hungarian banks (long-term foreign exchange swaps, announcement of the future conversion of EU funds on the market).

Table 10

**Main Economic Indicators: Hungary**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	4.1	1.1	0.5	0.6	0.5	1.7	2.1	0.8	-2.3
Private consumption	1.7	0.6	-0.7	0.3	0.7	0.4	1.2	-0.1	-4.3
Public consumption	4.3	-7.4	0.5	-2.3	-2.7	2.1	1.8	3.0	-4.3
Gross fixed capital formation	-6.2	1.5	-2.6	-1.3	4.0	-5.1	-1.9	-1.5	-2.7
Exports of goods and services	18.6	15.9	4.6	17.1	12.2	15.1	9.3	3.5	-7.8
Imports of goods and services	14.8	13.1	4.0	14.8	10.0	12.6	10.2	2.8	-8.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	1.9	-1.0	-0.1	-1.3	-1.3	-0.8	2.7	0.3	-2.4
Net exports of goods and services	3.0	2.9	0.8	2.5	2.4	3.2	-0.7	0.9	0.2
Exports of goods and services	16.6	16.2	5.3	17.0	12.8	17.9	10.7	4.1	-9.1
Imports of goods and services	13.6	13.3	4.5	14.5	10.3	14.7	11.4	3.2	-9.3
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	11.5	9.3	-0.9	10.6	8.5	6.1	3.4	-2.6	-11.0
Gross average wage of industry (nominal)	8.6	8.4	6.6	7.7	7.6	7.7	7.1	6.9	4.9
Unit labor cost of industry (nominal)	-2.6	-0.8	7.6	-2.6	-0.8	1.5	3.5	9.7	17.9
Producer price index (PPI) of industry	6.7	-0.1	5.5	-2.8	0.1	5.2	5.6	3.9	7.2
Consumer price index (here: HICP)	4.0	7.9	6.0	7.3	7.1	6.9	6.8	6.3	4.2
EUR per 1 HUF, + = HUF appreciation	-6.1	5.1	-0.1	9.4	2.9	-2.7	0.1	6.7	-4.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15-64 years)	7.5	7.3	7.8	7.3	7.8	7.6	7.7	7.8	8.1
Employment rate (15-64 years)	57.3	57.3	56.6	57.7	57.1	56.1	56.5	57.3	56.7
Key interest rate per annum (%)	6.8	7.8	8.7	7.7	7.5	7.5	8.3	8.5	10.6
HUF per 1 EUR	264.3	251.3	251.7	251.8	252.9	259.3	248.0	236.1	263.4
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	16.2	9.8	11.2	8.5	11.4	13.8	13.3	9.8	8.3
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-2.2	-5.6	-7.5	-5.9	-7.2	-8.9	-9.1	-5.5	-6.8
Domestic credit of the banking system	23.6	17.9	22.0	15.3	19.9	26.3	24.0	16.7	21.3
of which: claims on the private sector	21.7	14.4	20.4	13.3	16.9	23.8	21.8	14.7	21.5
claims on households	9.4	8.1	10.5	7.5	8.5	10.9	10.2	8.3	12.5
claims on enterprises	12.3	6.3	9.9	5.8	8.3	12.8	11.6	6.5	9.0
claims on the public sector (net)	1.9	3.5	1.6	1.9	3.0	2.6	2.3	2.0	-0.2
Other domestic assets (net) of the banking system	-5.2	-2.5	-3.2	-0.8	-1.3	-3.6	-1.6	-1.4	-6.1
<i>% of GDP, ESA 95</i>									
General government revenues <sup>1</sup>	42.7	44.8	46.5	..	..	..	..	..	..
General government expenditures <sup>1</sup>	51.9	49.7	49.8	..	..	..	..	..	..
General government balance <sup>1</sup>	-9.2	-4.9	-3.4	..	..	..	..	..	..
Primary balance <sup>1</sup>	-5.3	-0.9	0.8	..	..	..	..	..	..
Gross public debt <sup>1</sup>	65.6	65.8	73.0	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	17.5	17.1	5.8	19.2	12.5	15.1	13.8	6.1	-10.2
Merchandise imports	16.5	12.6	6.1	13.5	8.8	12.7	13.6	8.3	-8.7
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-2.3	0.3	0.1	0.2	0.7	1.6	0.5	-1.1	-0.3
Services balance	1.4	1.0	0.9	1.6	0.5	0.3	1.1	1.8	0.2
Income balance (factor services balance)	-6.2	-7.4	-8.1	-6.8	-6.8	-7.9	-7.9	-8.8	-7.9
Current transfers	-0.5	-0.5	-1.2	-1.6	0.3	-1.1	-1.1	-1.2	-1.6
Current account balance	-7.6	-6.5	-8.4	-6.6	-5.3	-7.1	-7.5	-9.3	-9.7
Capital account balance	0.6	1.1	1.1	2.3	1.3	3.4	0.5	0.5	0.3
Foreign direct investment (net)	3.2	1.7	3.1	5.6	2.9	2.1	4.5	0.3	5.6
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	90.5	97.2	113.2	94.9	97.2	100.2	105.2	107.6	113.2
Gross official reserves (excluding gold)	18.2	16.1	22.6	16.6	16.1	16.5	16.8	16.4	22.6
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	2.8	2.5	3.4	2.5	2.5	2.5	2.5	2.4	3.4
<i>EUR million, period total</i>									
Gross domestic product in current prices	89,967	101,137	105,378	25,714	27,394	23,406	26,839	28,437	26,695

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

<sup>1</sup> Including the net costs of the pension reform.

## 7 Poland: Looming Stagnation – Fiscal Policy Response Trying to Square the Circle

Growth slowdown accelerates in the fourth quarter, with private consumption remaining the main pillar of growth

Real GDP growth averaged 4.8% in 2008, falling from 6.2% in the first quarter to 2.3% in the fourth quarter, as the deteriorating external environment led to markedly lower growth of fixed investment since the summer and to the contraction of exports since the fall of 2008. Deteriorating sentiment and limited credit availability contributed to the worsening of the economic situation.

Due to pass-through effects, annual HICP inflation increased to 3.6% in February 2009 (up from 3.2% in January, but down from 4.5% in July 2008). Having assessed the medium-term inflation outlook as positive, the Narodowy Bank Polski (NBP) lowered the key interest rate by another 25 basis points to 3.75% at the end of March 2009, following four cuts from 6% as from end-October 2008.

The zloty depreciated against the euro by 34% from its peak at end-July 2008 to a low at mid-February 2009. The correction was attributable to the worsening outlook for exports and for capital inflows as well as rising risk aversion. Many companies had to start buying euro to close foreign exchange call options which they had sold in exchange for insurance against further zloty appreciation. This further weakened the zloty. From mid-February to end-March 2009, the zloty gradually recovered by 7%.

Weaker zloty helps compensate for increase in ULC

Given the high share of foreign currency-denominated debt, the depreciation of the zloty may curb domestic demand, as unhedged borrowers cut spending. Yet, the weaker zloty also supports the foreign trade balance, as the depreciation helps compensate for the downturn-driven large increase in ULC.

The current and capital account deficit increased to 5.5% of GDP in the fourth quarter of 2008. In January 2009, however, imports fell more sharply than exports and the income balance improved further, which implied a lower current account deficit year on year. By contrast, the capital account balance continued to deteriorate also in January. In 2008, net FDI inflows had covered half of the current and capital account deficit; they turned negative in December 2008, but recovered again in January 2009. While net portfolio capital inflows continued to be negative in January, other investment inflows turned positive, but were lower year on year.

Income tax reform and higher spending plans for public investment are geared at providing fiscal stimulus but intentions to cling to the deficit target put a question mark to its eventual size

The convergence program envisages a fiscal deficit of 2.5% of GDP in 2009 (2008: 3.9%), assuming 3.7% of GDP growth and a mild increase in the revenue-to-GDP ratio. The program entails fiscal stimulus measures (income tax reductions, increased public investment) estimated at 1 percentage point. In March 2009, the ministry of finance lowered its growth forecast to between 1.7% and 3.7%. The full-year deficit target of 2.5% is to remain unchanged. It remains to be seen to what extent this will reduce the originally envisaged fiscal stimulus.

The Polish government has stepped up efforts to adopt the euro by 2012, but at the time of writing, it is uncertain whether Poland will actually request to join ERM II in the near future. At end-March 2009, the NBP reiterated that Poland should join ERM II and the euro area as early as possible, once it will have mobilized sufficient political support to implement the constitutional changes needed for euro adoption. Currently, the two-thirds majority required for these changes is out of reach. The government has expressed that it will not necessarily seek agreement on constitutional changes before ERM II entry. It is currently considering whether and, if so, in what way the present setting of high exchange rate volatility and the current valuation of the zloty impinge on the time lines toward ERM II entry.

Table 11

**Main Economic Indicators: Poland**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	6.2	6.7	4.8	5.7	7.2	6.2	5.8	5.2	2.3
Private consumption (excl. NPISH <sup>1</sup> )	4.8	5.0	5.3	4.5	3.6	5.8	5.5	5.1	5.0
Public consumption (incl. NPISH)	5.8	3.7	0.0	3.1	5.2	-0.9	-1.9	1.4	1.4
Gross fixed capital formation	15.6	17.3	7.9	16.6	15.1	14.9	15.5	4.8	2.9
Exports of goods and services	14.6	9.1	5.8	8.1	9.7	11.0	8.3	6.8	-2.1
Imports of goods and services	17.4	13.5	6.2	13.9	11.2	11.1	8.5	5.6	0.4
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	7.3	9.0	5.2	8.7	8.4	6.7	6.3	5.0	3.2
Net exports of goods and services	-1.2	-2.0	-0.3	-2.7	-0.9	-0.3	-0.3	0.3	-1.0
Exports of goods and services	5.4	3.7	2.4	3.3	3.7	4.6	3.4	2.8	-0.8
Imports of goods and services	6.6	5.7	2.7	6.0	4.6	4.8	3.8	2.5	0.2
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	9.5	6.0	1.7	4.5	4.8	5.1	5.1	1.2	-4.7
Gross average wage of industry (nominal)	5.2	8.7	9.7	8.8	9.3	10.4	11.2	10.1	7.4
Unit labor cost of industry (nominal)	-4.0	2.6	7.8	4.1	4.3	5.0	5.8	8.8	12.7
Producer price index (PPI) of industry	2.2	2.2	2.6	1.6	2.2	3.0	2.5	2.2	2.5
Consumer price index (here: HICP)	1.3	2.6	4.2	2.4	3.7	4.5	4.3	4.4	3.6
EUR per 1 PLN, + = PLN appreciation	3.2	3.0	7.7	4.3	5.2	8.7	11.5	14.6	-2.9
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15-64 years)	13.9	9.6	7.2	9.3	8.6	7.6	7.3	6.9	6.9
Employment rate (15-64 years)	54.5	57.0	59.2	57.8	58.1	58.1	58.9	60.0	60.0
Key interest rate per annum (%)	4.1	4.4	5.7	4.6	4.9	5.4	5.8	6.0	5.8
PLN per 1 EUR	3.9	3.8	3.5	3.8	3.7	3.6	3.4	3.3	3.8
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	12.6	15.9	15.8	15.4	13.8	13.3	15.0	16.8	17.8
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	1.7	-5.7	-11.0	-7.3	-8.8	-11.5	-10.6	-9.6	-12.3
Domestic credit of the banking system	12.0	20.8	26.1	21.1	20.3	21.6	23.4	24.9	33.8
of which: claims on the private sector	10.9	20.8	23.9	22.4	23.0	23.0	22.7	22.2	27.3
claims on households	8.6	13.8	15.5	14.6	14.9	14.8	14.7	14.3	18.2
claims on enterprises	2.3	7.0	8.3	7.8	8.1	8.2	8.0	8.0	9.1
claims on the public sector (net)	1.2	0.0	2.2	-1.3	-2.7	-1.4	0.7	2.7	6.4
Other domestic assets (net) of the banking system	-1.1	0.8	0.7	1.6	2.2	3.2	2.2	1.5	-3.7
<i>% of GDP, ESA 95</i>									
General government revenues <sup>2</sup>	39.9	40.2	39.2	..	..	..	..	..	..
General government expenditures <sup>2</sup>	43.8	42.1	43.1	..	..	..	..	..	..
General government balance <sup>2</sup>	-3.9	-1.9	-3.9	..	..	..	..	..	..
Primary balance <sup>2</sup>	-1.2	0.4	-1.7	..	..	..	..	..	..
Gross public debt <sup>2</sup>	47.7	44.9	47.1	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	20.3	13.4	12.2	13.9	11.9	20.3	21.3	17.8	-8.4
Merchandise imports	23.9	19.5	14.1	18.2	18.8	20.6	23.2	20.5	-5.2
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-2.0	-4.0	-4.5	-3.8	-4.4	-3.6	-4.7	-4.5	-5.1
Services balance	0.2	1.1	0.9	0.9	1.5	0.6	0.9	0.7	1.1
Income balance (factor services balance)	-2.8	-3.8	-3.2	-3.2	-3.8	-3.5	-4.2	-2.7	-2.4
Current transfers	1.9	2.0	1.4	2.1	1.6	1.1	1.9	2.1	0.4
Current account balance	-2.7	-4.7	-5.4	-4.0	-5.1	-5.3	-6.0	-4.3	-6.0
Capital account balance	0.6	1.1	1.1	1.1	1.8	1.6	1.9	0.4	0.5
Foreign direct investment (net)	3.2	4.2	2.3	4.8	3.2	3.1	2.8	2.1	1.6
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	47.3	50.9	47.6	49.1	50.9	52.4	53.3	51.6	47.6
Gross official reserves (excluding gold)	12.9	13.8	11.7	13.2	13.8	14.4	14.7	13.8	11.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.7	3.8	3.3	3.6	3.8	3.9	4.0	3.8	3.3
<i>EUR million, period total</i>									
Gross domestic product in current prices	272,199	311,282	360,641	76,691	90,841	82,590	90,960	94,345	92,746

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

<sup>1</sup> Nonprofit institutions serving households.<sup>2</sup> Including the net costs of the pension reform.

GDP growth plunges and its composition changes

## 8 Romania: Turning to the IMF and the EU for Macrofinancial Assistance

Following buoyant real GDP expansion in the first three quarters, a sharp deceleration of growth was recorded in the final quarter of 2008, bringing full-year GDP growth to 7.1%. The fourth quarter 2008 entailed an abrupt shift in the composition of growth, which had hitherto been characterized by surging domestic demand and negative growth contributions by net exports. Private consumption declined by 4.5%, partly driven by a slowdown of credit growth (adjusted for exchange rate changes). Against the backdrop of worsening economic prospects and tighter financing conditions, investments grew by a mere 2.8% in the final quarter of 2008. Despite continued growth of public consumption, overall domestic demand contracted in the closing quarter, while the contribution of net exports turned positive as imports declined and exports stagnated.

The slowing economy and favorable base effects helped reduce HICP inflation from its peak of 9.1% in July 2008 to 6.4% in December. Inflation edged up to 6.9% in February 2009, presumably due to pass-through effects. Despite this increase, the Banca Națională a României (BNR) cut its key policy rate by 25 basis points to 10% in early February, citing an improved medium-term inflation outlook. The BNR forecasts inflation to fall to 4.5% by end-2009, i.e. the upper end of its inflation target range (3.5% ± 1 percentage point).

Mainly driven by improvements in the trade balance, the current account deficit declined in the second half of 2008 despite a continued rise in ULC in industry, but still amounted to 12.3% of GDP for 2008. The current account adjustment gained momentum in January 2009, as the deficit was only half as high as one year earlier. In 2008, about half of the current account gap was covered by net FDI.

Romania ranks among the countries hit hardest by the global financial market crisis, as external vulnerabilities began to materialize. Given the high share of foreign currency loans, the currency's weakness increases credit risk for banks as many foreign currency borrowers are likely to be unhedged. As from mid-January 2009, the Romanian leu stabilized against the euro (down about 35% from its July 2007 peak), amid recurrent interventions by the BNR. Expectations of international macrofinancial assistance may have contributed to exchange rate stabilization.

Stand-By Arrangement is being put in place

To preempt a further drain on foreign exchange reserves and in view of high external refinancing needs, Romania turned to the IMF and the EU for financial assistance. In March 2009, a two-year Stand-By Arrangement of EUR 12.95 billion was agreed between Romania and IMF staff (the IMF's Executive Board will deal with this matter in early May), which is part of a multilateral financial support package to which the EU (EUR 5 billion), the World Bank (EUR 1 billion), the EBRD and other multilaterals (EUR 1 billion) contribute further funds. Moreover, nine foreign banks (holding a market share of 70% of assets) pledged to continue to keep up their business in Romania and to provide additional capital to their subsidiaries if needed.

Loose fiscal policy in 2008, budget for 2009 to be revised

The program agreed with the IMF inter alia contains tighter fiscal policies. In 2008, the budget deficit rose to 5.4% of GDP. In February 2009, the parliament adopted the 2009 budget plan, which – under the assumption of +2.5% GDP growth – envisaged a reduction of the budget deficit to 2% of GDP. In the meantime, the GDP forecast for 2009 has been corrected to –4%, and the budget will need to be revised shortly to bring it in line with the cash deficit target of 4.6% (corresponding to 5.1% in ESA 95 terms) agreed with the Fund.

Table 12

**Main Economic Indicators: Romania**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	7.9	6.2	7.1	5.8	6.8	8.2	9.3	9.2	2.9
Private consumption	12.8	11.6	9.1	10.8	10.5	15.5	13.4	16.0	-4.5
Public consumption	-3.8	1.2	3.1	7.5	-4.6	5.4	-0.8	4.2	3.9
Gross fixed capital formation	19.9	28.9	19.3	32.2	28.0	33.2	30.0	24.3	2.8
Exports of goods and services	9.8	7.8	18.9	4.1	13.8	25.8	30.7	21.1	-0.2
Imports of goods and services	22.7	27.8	17.1	26.6	30.6	35.1	28.8	19.5	-10.4
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	15.3	17.8	12.0	19.1	16.6	21.6	21.9	14.0	-2.6
Net exports of goods and services	-10.2	-16.6	-6.3	-17.0	-13.7	-19.6	-13.4	-7.7	7.7
Exports of goods and services	4.3	3.5	8.5	1.7	4.9	15.4	14.7	8.8	-0.1
Imports of goods and services	14.4	20.1	14.9	18.7	18.6	35.0	28.0	16.4	-7.8
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	11.3	9.5	5.1	8.8	8.0	8.8	10.6	6.7	-5.7
Gross average wage of industry (nominal)	15.7	21.6	21.3	20.9	22.8	18.5	24.5	23.3	18.8
Unit labor cost of industry (nominal)	4.0	11.0	15.4	11.1	13.7	8.9	12.6	15.6	26.0
Producer price index (PPI) of industry	11.7	8.1	15.8	6.1	9.3	14.4	17.2	19.6	12.1
Consumer price index (here: HICP)	6.6	4.9	7.9	5.1	6.8	8.0	8.6	8.2	6.9
EUR per 1 RON, + = RON appreciation	2.7	5.7	-9.5	9.6	0.9	-8.3	-10.2	-9.6	-9.6
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15-64 years)	7.3	6.4	5.8	6.4	6.1	5.8	5.8	5.7	5.8
Employment rate (15-64 years)	58.8	58.8	59.1	60.5	57.9	57.7	59.7	60.5	58.3
Key interest rate per annum (%)	8.5	7.5	9.6	6.8	7.3	8.5	9.7	10.1	10.3
RON per 1 EUR	3.5	3.3	3.7	3.2	3.4	3.7	3.7	3.6	3.8
<i>Nominal year-on-year change of the period average stock in %</i>									
Money plus quasi money	28.2	27.8	32.6	26.2	31.9	36.8	38.7	33.3	23.4
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	1.5	-6.0	-11.2	-5.3	-11.3	-8.6	-10.9	-13.6	-11.2
Domestic credit of the banking system	31.1	39.7	57.9	36.7	52.6	60.7	62.6	59.4	50.5
of which: claims on the private sector	36.1	42.2	52.4	41.0	48.6	57.1	58.8	52.9	42.7
claims on households	19.0	23.3	28.8	22.5	27.4	31.6	32.5	28.9	23.2
claims on enterprises	17.1	19.0	23.6	18.5	21.2	25.5	26.4	24.0	19.4
claims on the public sector (net)	-4.9	-2.6	5.6	-4.3	3.9	3.6	3.7	6.5	7.9
Other domestic assets (net) of the banking system	-4.5	-5.8	-14.2	-5.1	-9.4	-15.3	-13.0	-12.5	-15.9
<i>% of GDP, ESA 95</i>									
General government revenues	33.1	34.0	33.1	..	..	..	..	..	..
General government expenditures	35.3	36.6	38.5	..	..	..	..	..	..
General government balance	-2.2	-2.5	-5.4	..	..	..	..	..	..
Primary balance	-1.3	-1.8	-4.7	..	..	..	..	..	..
Gross public debt	12.4	12.7	13.6	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	16.4	13.8	13.8	13.4	16.8	13.5	20.9	19.5	2.2
Merchandise imports	25.5	25.4	9.4	24.2	20.1	12.4	16.4	17.3	-5.9
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-12.1	-14.4	-13.3	-12.6	-14.2	-15.7	-15.1	-12.7	-11.1
Services balance	0.0	0.4	0.6	0.2	-0.1	0.3	1.1	-0.5	1.5
Income balance (factor services balance)	-3.3	-3.4	-4.1	-3.8	-2.6	-4.5	-4.5	-3.4	-4.1
Current transfers	4.9	3.9	4.4	4.2	2.8	5.7	4.1	5.2	3.2
Current account balance	-10.4	-13.5	-12.3	-11.9	-14.2	-14.2	-14.4	-11.5	-10.5
Capital account balance	0.0	0.7	0.4	0.5	0.9	0.6	0.5	0.1	0.6
Foreign direct investment (net)	8.9	5.7	6.8	6.5	3.3	6.5	10.3	4.9	5.9
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	41.9	47.6	52.9	46.3	47.6	47.4	50.6	49.1	51.4
Gross official reserves (excluding gold)	21.8	20.5	19.2	21.6	20.5	19.9	19.1	19.4	19.2
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.9	5.6	5.3	5.9	5.6	5.4	5.1	5.1	5.3
<i>EUR million, period total</i>									
Gross domestic product in current prices	97,931	123,660	136,661	34,545	39,363	24,705	31,509	38,673	41,774

Source: Bloomberg, European Commission, Eurostat, IMF, national statistical offices, national central banks, wiiw, OeNB.

## 9 Croatia: Coping with Spillovers from the Global Financial Crisis

From overheating to recession fears

Amid the global financial turmoil, the Croatian economy gradually lost momentum over the course of 2008. GDP growth decelerated from 4.3% in the first to only 0.2% in the final quarter of 2008, thus averaging 2.4% in 2008. This development came mainly on the back of a marked slowdown of private consumption, which even contracted by 3.2% in the fourth quarter of 2008, given waning consumer confidence, tighter credit and deteriorating labor market conditions (in terms of employment and unemployment figures as well as wage dynamics). Similarly, investment activity slowed considerably toward end-2008, but with a growth rate of 3.5% in the closing quarter of 2008, gross fixed capital formation, driven by robust construction activity, remained the backbone of the Croatian economy. Given plunging export and import demand, imports contracted by 7.1% and exports by 2.5% in the final quarter of 2008. Hence, the contribution of net exports shifted into positive territory in the fourth quarter of 2008.

Global financial turmoil hits Croatian financial markets

Having reached a peak in July 2008 at 8.4% year on year, inflation had moderated to 2.9% in December 2008, given easing energy and food price pressures and large base effects. Inflation, however, accelerated to 4.2% in February 2009, mainly due to tax and regulated price adjustments, but the recent depreciation of the kuna may have played some role, too. In fact, given falling investor and depositor confidence, the kuna has come under some downward pressure since October 2008. Hrvatska narodna banka (HNB) allowed for some moderate depreciation of the kuna, but to prevent a more marked weakening, it not only increased the foreign exchange component of the reserve requirement, which is to be allocated in kuna, from 50% to 75%, but also undertook outright market interventions, which decreased the country's foreign exchange reserves to EUR 8.6 billion by February 2009, down from EUR 9.8 billion in September 2008. Moreover, the HNB reduced reserve requirements from 17% to 14%, decreased the foreign currency liquidity ratio in two steps from 28.5% to 20% and raised banks' maximum allowed open foreign exchange position from 20% to 30% of own funds.

Budget 2009 revised to improve resilience

In early 2009, the government adopted a set of anti-recession measures and revised the 2009 budget, which had originally targeted a deficit of 0.9% of GDP. The new budget proposal envisages a deficit of 1.5% of GDP. With a view to financing the budget deficit and to refinancing maturing public debt, the government, in early 2009, took out a EUR 1 billion loan from domestic banks (for which the HNB relaxed liquidity provisions so that banks were able to extend this loan without recourse to additional external funding) and plans to issue a euro-bond worth at least EUR 750 million in May.

External vulnerabilities pose a challenge to the authorities

Croatia's external deficits widened considerably in 2008, with the combined current and capital account deficit reaching 9.2% of GDP. At the same time, net FDI coverage decreased and access to debt finance has become more difficult and/or expensive, while Croatia's foreign debt increased considerably to some 82% of GDP in 2008. Until the third quarter, the corporate sector continued to borrow directly from abroad, but cross-border funding for corporations largely dried up in the fourth quarter of 2008. By contrast, in the context of HNB credit restrictions, banks gradually reduced their foreign liabilities over the first three quarters of 2008, but markedly stepped up foreign borrowing in the closing quarter (+EUR 2.1 billion) in order to compensate for the decrease in domestic funding sources partly caused by temporary deposit withdrawals.

Table 13

**Main Economic Indicators: Croatia**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	4.7	5.5	2.4	4.8	3.5	4.3	3.4	1.6	0.2
Private consumption	3.5	6.2	0.8	6.2	4.8	4.2	2.3	0.4	-3.2
Public consumption	2.2	3.4	1.9	4.4	3.7	0.5	3.2	1.3	2.7
Gross fixed capital formation	10.9	6.5	8.2	5.7	4.0	9.8	12.6	6.6	3.5
Exports of goods and services	6.5	4.3	1.7	5.9	0.7	3.6	4.4	1.6	-2.5
Imports of goods and services	7.4	6.5	3.6	8.2	6.8	7.1	8.3	6.5	-7.1
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	5.8	7.1	3.5	5.4	7.0	6.9	6.2	3.8	-2.7
Net exports of goods and services	-1.2	-1.7	-1.3	-0.6	-3.6	-2.7	-3.1	-2.5	3.3
Exports of goods and services	2.9	2.0	0.8	3.6	0.3	1.3	1.9	1.0	-1.0
Imports of goods and services	4.1	3.7	2.1	4.2	3.9	4.0	4.9	3.5	-4.3
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real)	2.7	2.5	2.9	1.4	0.3	4.7	5.2	1.5	0.1
Gross average wage of industry (nominal)	7.5	5.5	7.2	5.9	4.9	7.6	7.2	7.1	6.9
Unit labor cost of industry (nominal)	4.7	3.0	4.2	4.5	4.6	2.7	1.9	5.5	6.8
Producer price index (PPI) of industry	2.9	3.4	8.6	3.8	5.5	7.7	8.8	11.3	6.7
Consumer price index (here: CPI)	3.2	2.8	6.1	2.9	4.9	6.0	6.6	7.4	4.5
EUR per 1 HRK, + = HRK appreciation	1.1	-0.2	1.6	0.1	0.5	1.1	1.3	1.8	2.1
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15-64 years)	11.2	9.6	8.4	9.3	9.1	8.8	8.4	8.1	8.2
Employment rate (15-64 years)	55.6	57.2	..	58.9	57.4	56.0	57.6	59.7	..
Key interest rate per annum (%)	4.5	4.5	9.0	4.5	4.5	8.9	9.0	9.0	9.0
HRK per 1 EUR	7.3	7.3	7.2	7.3	7.3	7.3	7.3	7.2	7.2
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	14.0	17.9	11.5	17.5	14.6	15.0	12.9	10.7	7.9
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-3.1	9.6	5.5	10.5	9.9	9.2	7.4	5.7	0.4
Domestic credit of the banking system	20.8	17.2	11.0	16.9	13.9	12.8	11.2	8.9	11.4
of which: claims on the private sector	20.2	19.6	11.9	18.8	15.9	13.8	11.5	11.0	11.3
claims on households	11.1	11.0	7.6	10.5	9.8	9.3	8.3	6.8	6.2
claims on enterprises	9.2	8.7	4.3	8.2	6.1	4.6	3.2	4.2	5.1
claims on the public sector (net)	0.6	-2.4	-0.8	-1.8	-1.9	-1.0	-0.3	-2.1	0.1
Other domestic assets (net) of the banking system	-3.8	-8.9	-5.1	-9.8	-9.2	-7.0	-5.7	-3.9	-3.9
<i>% of GDP, ESA 95</i>									
General government revenues	..	41.4	38.9	..	..	..	..	..	..
General government expenditures	..	43.0	41.1	..	..	..	..	..	..
General government balance	-2.5	-1.6	-2.2	..	..	..	..	..	..
Primary balance	-0.3	0.4	-0.3	..	..	..	..	..	..
Gross public debt	40.8	37.7	35.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	17.2	8.6	6.0	12.4	4.1	8.8	7.9	13.5	-5.3
Merchandise imports	14.0	10.8	10.6	10.2	12.0	13.9	15.7	15.8	-2.1
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-21.3	-22.0	-22.9	-19.8	-22.8	-23.6	-25.9	-21.0	-21.4
Services balance	14.6	14.7	14.7	36.8	3.4	0.9	15.1	35.2	4.1
Income balance (factor services balance)	-3.0	-2.7	-3.3	-1.6	-0.9	-2.5	-6.7	-2.0	-1.9
Current transfers	2.8	2.4	2.2	2.3	2.4	2.0	2.3	2.0	2.3
Current account balance	-6.9	-7.5	-9.3	17.7	-17.9	-23.2	-15.2	14.2	-16.8
Capital account balance	-0.3	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1
Foreign direct investment (net)	6.6	8.1	5.8	4.6	6.6	9.8	7.5	1.3	5.5
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	74.9	76.9	82.4	74.6	76.9	79.5	78.3	77.9	82.4
Gross official reserves (excluding gold)	22.3	21.7	19.3	21.0	21.7	22.4	22.0	21.1	19.3
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.3	5.2	4.6	5.1	5.2	5.3	5.2	4.9	4.6
<i>EUR million, period total</i>									
Gross domestic product in current prices	39,096	42,829	47,375	11,696	10,708	10,855	11,974	13,013	11,534

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

## 10 Turkey: A Major Downturn in Late 2008

Contraction of domestic economic activity in the fourth quarter exceeds expectations

Growth weakened throughout 2008 and turned negative in the fourth quarter of 2008 (−6.2%), yielding an annual growth rate of GDP of 1.1% in 2008. As elsewhere, the global liquidity squeeze impacted negatively on both domestic and external demand, but the downturn in Turkey began already in the second quarter of 2008 and has been much more pronounced than in the rest of the region. Tighter financing conditions and high uncertainty implied a substantial contraction of gross fixed capital formation, which intensified throughout the third and fourth quarter. Capacity utilization fell to record lows in December 2008. Industrial production contracted in almost all sectors of the economy. Private consumption also declined due to tight credit conditions, worsening consumer sentiment and increasing unemployment. Public consumption was the only component which still developed positively thanks to spending rises made possible by improved debt service dynamics. Plunging import demand helped produce a strongly positive contribution of net exports. Despite considerable regional and sectoral diversification in recent years, Turkey's export sector currently is in a weak position given the importance of the automotive sector, which has been hit especially hard by the global crisis. By end-2008, Turkey's car industry recorded a drop in orders of around 30%.

Disinflation allows for monetary easing

Inflation had fallen in the last quarter of 2008 and shrank even more in early 2009 in line with global trends. Against this background, the central bank started to lower interest rates from a high of 16.75% in July 2008 to 15% in December 2008. Three stronger rate cuts down to 10.5% followed until March 2009. The Turkish lira held up relatively well in the third quarter of 2008. Depreciation vis-à-vis the euro, however, accelerated in the fourth quarter, when risk aversion to emerging markets rose markedly. The Turkish currency stabilized again broadly only in March 2009. It is noteworthy that so far there has been only little evidence of a pass-through of exchange rate movements to inflation.

The budget deficit amounted to 1.3% of GDP in 2008. The 2009 budget deficit, which was passed in the fall of 2008, is targeted at 1.1% of GDP (in ESA 95 terms), based on an assumed GDP growth rate of +4%. To date, the government has announced four packages in support of the economy, which together correspond to about 3.5% of GDP (provided all measures are fully implemented). They are mostly aimed at supporting businesses, stimulating consumer demand and easing the credit squeeze. No support measures are being taken for the banking sector, given that the latter has weathered the crisis rather well so far. Solvency problems and systemic risks have to date been contained owing to a solid domestic deposit structure, capital buffers and the comparatively cautious credit policy of recent years.

IMF Stand-By Arrangement envisaged, but not yet agreed upon, which causes some uncertainty

The current account deficit narrowed considerably in the second half of 2008, but still leaves – especially longer-term – financing concerns. FDI inflows moderated over the same period, amid considerable portfolio outflows in the last quarter of 2008. The financial account turned negative in the fourth quarter, recording net outflows of about EUR 9 billion, after solid capital inflows in the first three quarters (having totaled more than EUR 30 billion). An external financing gap could open up if rollover rates on private sector debt should fall. Against this background, Turkey entered into talks with the IMF for a Stand-By Arrangement, which could prevent or, if need be, fill such a gap, but the negotiations were not continued before the local elections, which took place at the end of March 2009, and even now uncertainties remain.

Table 14

**Main Economic Indicators: Turkey**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	6.9	4.7	1.1	3.2	4.2	7.3	2.8	1.2	-6.2
Private consumption	4.6	4.6	0.3	6.8	6.1	6.1	1.5	-1.3	-4.6
Public consumption	8.4	6.5	1.8	4.2	2.7	5.0	-5.0	1.2	6.1
Gross fixed capital formation	13.3	5.4	-4.6	4.4	8.5	9.5	-1.2	-6.9	-17.5
Exports of goods and services	6.6	7.3	2.6	4.6	3.3	13.3	3.9	3.6	-8.2
Imports of goods and services	6.9	10.7	-3.1	14.0	15.5	14.9	2.2	-2.8	-23.1
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	7.3	6.0	-0.5	5.7	7.8	8.6	2.5	-0.5	-11.4
Net exports of goods and services	-0.4	-1.4	1.5	-2.5	-3.6	-1.4	0.2	1.6	5.2
Exports of goods and services	1.5	1.7	0.6	1.1	0.8	3.0	0.9	0.8	-2.0
Imports of goods and services	1.9	3.0	-0.9	3.6	4.4	4.4	0.7	-0.8	-7.2
<i>Year-on-year change of the period average in %</i>									
Labor productivity in manufacturing (real)	6.7	1.7	..	0.1	4.0	4.6	3.8	0.9	..
Gross average wage in manufacturing (nominal)	11.5	9.4	..	10.9	9.9	8.8	10.5	9.7	..
Unit labor cost in manufacturing (nominal)	4.5	7.6	..	10.9	5.6	4.1	6.5	8.7	..
Producer price index (PPI) of industry	9.3	6.4	12.7	3.6	5.3	8.4	16.0	15.2	11.2
Consumer price index (here: HICP)	9.3	8.8	10.4	7.1	8.2	8.8	10.3	11.7	10.9
EUR per 1 TRY, + = TRY appreciation	-7.3	1.3	-6.3	8.1	8.8	2.5	-8.6	-3.0	-14.8
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15-64 years)	..	8.6	9.4	8.7	8.6	8.8	8.7	9.4	10.6
Employment rate (15-64 years)	..	45.8	45.9	47.6	44.9	43.3	47.4	47.7	45.2
Key interest rate per annum (%)	15.6	17.2	16.0	17.5	16.5	15.4	15.6	16.7	16.4
TRY per 1 EUR	1.8	1.8	1.9	1.8	1.7	1.8	2.0	1.8	2.0
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	41.3	18.7	19.5	18.3	16.7	17.8	19.8	16.7	23.6
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	10.0	9.1	1.0	9.8	4.5	1.4	-0.6	-1.3	4.5
Domestic credit of the banking system	39.3	15.5	21.2	15.2	18.7	20.3	23.3	20.8	20.5
of which: claims on the private sector	31.7	16.7	19.7	15.2	16.7	18.4	21.2	20.6	18.8
claims on households	11.0	6.4	8.1	5.8	7.0	8.1	8.5	8.5	7.4
claims on enterprises	20.7	10.2	11.6	9.4	9.7	10.3	12.7	12.2	11.3
claims on the public sector (net)	7.6	-1.1	1.5	-0.1	1.9	1.9	2.1	0.2	1.8
Other domestic assets (net) of the banking system	-8.0	-5.9	-2.7	-6.7	-6.5	-3.9	-2.9	-2.9	-1.3
<i>% of GDP, ESA 95</i>									
General government revenues	..	18.3	18.3	..	..	..	..	..	..
General government expenditures	..	19.6	19.7	..	..	..	..	..	..
General government balance	-0.1	-1.2	-1.3	..	..	..	..	..	..
Primary balance	5.5	4.0	..	..	..	..	..	..	..
Gross public debt	46.1	38.9	35.1	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	17.8	12.9	13.8	10.7	11.0	23.4	13.3	24.8	-3.6
Merchandise imports	19.1	10.2	11.1	11.2	15.7	22.2	16.9	19.6	-11.7
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-7.8	-7.2	-7.1	-7.5	-7.0	-6.8	-8.8	-7.4	-5.2
Services balance	2.6	2.1	2.4	4.2	1.1	0.7	1.7	4.3	2.4
Income balance (factor services balance)	-1.3	-1.1	-1.1	-1.0	-0.9	-1.1	-1.3	-0.8	-1.2
Current transfers	0.4	0.3	0.3	0.4	0.3	0.3	0.2	0.3	0.3
Current account balance	-6.1	-5.9	-5.5	-3.8	-6.4	-6.9	-8.2	-3.6	-3.7
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	3.6	3.1	2.1	2.4	2.5	2.0	2.5	1.4	2.4
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	37.4	35.5	39.8	36.5	35.5	34.1	36.1	39.7	39.8
Gross official reserves (excluding gold)	11.1	10.5	10.2	11.2	10.5	9.8	9.6	10.6	10.2
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	4.8	4.6	4.3	4.9	4.6	4.3	4.1	4.4	4.3
<i>EUR million, period total</i>									
Gross domestic product in current prices	418,088	472,996	499,769	131,330	127,276	119,675	121,339	144,176	114,580

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiw, OeNB.

## 11 Russia: Fiscal Stimulus to Mitigate Spillovers from Crisis

While Russian growth was still buoyant in the first three quarters of 2008 (7.3%), the impact of the drastic worsening of the global financial crisis severely hit Russia in the fourth quarter: economic activity slowed down sharply (to +1%). Annual growth dropped to 5.6% in 2008. In January and February 2009, the economy contracted swiftly (estimated GDP drop of 8%).

During the second half of 2008, oil prices fell by more than 70%, before slightly recovering in the first quarter of 2009. This implies a major terms-of-trade shock for Russia. After the demise of Lehman Brothers, capital flows to Russia reversed and the structurally weak banking sector has been one of the main victims of the crisis, given its dependence on foreign borrowing, its direct exposure to the collapsed equity market and its segmented structure. Overnight lending rates spiked in November 2008 and January 2009, indicating a severe liquidity squeeze. A major part of the authorities' package of measures (about EUR 150 billion) went to shoring up the banking sector.

While the Central Bank of the Russian Federation (CBR) continued to intervene heavily in support of the ruble, persisting capital outflows upheld substantial downward pressures. In mid-November 2008, the CBR opted for a gradual devaluation policy, while somewhat tightening foreign exchange controls. It widened the ruble's corridor vis-à-vis its USD/EUR basket in more than 20 incremental steps. The strategy seems to have maintained devaluation expectations. It also provided room for economic agents to react by building up currency positions in view of future foreign-currency debt service obligations. Net capital outflows are estimated to have reached around EUR 100 billion in the fourth quarter of 2008, and EUR 22 billion in January 2009.

On January 23, 2009, the CBR declared the corridor widening exercise to be completed. Since then, the ruble has been fairly stable (having depreciated about 50% against the U.S. dollar and 25% against the euro from early August 2008 to mid-March 2009). The loss of international reserves has slowed down substantially (they dropped over a quarter to EUR 291 billion in the above period). Monthly capital outflows declined to EUR 3.5 billion in February 2009. The domestic credit boom slowed down sharply in recent months under the impact of the liquidity squeeze, the weakening of the ruble, the economic slump as well as the development of household deposits, which fell noticeably in October and November 2008 before broadly stabilizing thereafter (adjusted for exchange rate changes).

Inflation was subject to competing impacts from the sharp decline of M2 growth and of producer price inflation versus that of ruble depreciation. The CPI continued to increase at an elevated rate of 13.9% in February 2009. Given the devaluation, the annual rise in ULC (exchange rate adjusted) slowed down to 15% in 2008. The combined current and capital account surplus is rapidly shrinking due to terms-of-trade developments.

The federal government budget surplus fell to 4.1% of GDP in 2008 and to about 2.6% in January and February 2009. Revised fiscal plans for 2009 envisage a federal budget deficit of 7.4% of GDP (assuming a contraction of economic activity by 2.2% and an average oil price of USD 41 per barrel). The new budget plan reportedly includes crisis-response measures totaling 5.5% of GDP. The largest part of the deficit is to be financed by the country's Reserve Fund (which accounts for over 8% of GDP).

Russia hit particularly hard by plunge of oil price and capital outflows...

... leading to a devaluation of the ruble

While twin surpluses and international reserves are eroding, the latter are still sizeable

Massive fiscal stimulus to contain economic contraction

Table 15

**Main Economic Indicators: Russia**

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
<i>Year-on-year change of the period total in %</i>									
GDP in constant prices	7.7	8.1	5.6	7.7	9.0	8.7	7.5	6.0	1.0
Private consumption	11.2	13.6	11.2	14.2	13.7	12.0	13.3	12.1	7.9
Public consumption	2.4	3.4	2.5	2.4	3.5	2.7	2.4	2.6	2.4
Gross fixed capital formation	18.0	21.1	10.0	18.2	21.5	23.5	17.3	12.1	-2.0
Exports of goods and services	7.3	6.3	0.5	4.0	11.3	10.2	0.7	2.4	-8.4
Imports of goods and services	21.3	26.5	15.0	27.2	23.0	21.3	19.7	21.8	1.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	10.7	13.4	10.2	14.1	12.4	11.3	13.7	11.7	4.5
Net exports of goods and services	-3.7	-6.7	-5.8	-7.5	-4.5	-4.2	-7.4	-7.5	-3.8
Exports of goods and services	2.7	2.3	0.2	1.3	4.4	3.8	0.2	0.8	-3.3
Imports of goods and services	6.4	9.0	6.0	8.8	8.9	8.0	7.6	8.3	0.5
<i>Year-on-year change of the period average in %</i>									
Labor productivity of industry (real) <sup>1</sup>	10.1	4.7	3.3	3.6	3.7	5.9	5.6	5.3	-3.6
Gross average wage of industry (nominal) <sup>1</sup>	21.4	26.0	23.9	24.8	28.5	27.6	28.1	26.6	15.1
Unit labor cost of industry (nominal) <sup>1</sup>	10.3	20.4	19.9	20.5	23.9	20.5	21.3	20.2	19.4
Producer price index (PPI) of industry	12.5	14.3	21.4	13.7	20.7	25.7	26.4	30.2	4.7
Consumer price index (here: CPI)	9.8	9.1	14.1	9.0	11.5	12.9	14.8	14.9	13.8
EUR per 1 RUB, + = RUB appreciation	3.4	-2.6	-3.9	-2.4	-4.0	-5.0	-5.6	-4.0	-0.9
<i>Period average levels</i>									
Unemployment rate (ILO definition)	7.2	6.1	6.3	5.6	5.7	7.1	5.4	5.8	7.0
Employment rate	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	11.6	10.3	10.7	10.0	10.0	10.2	10.5	10.5	11.9
RUB per 1 EUR	34.1	35.0	36.4	35.0	35.7	36.3	36.9	36.5	36.0
<i>Nominal year-on-year change of the period average stock in %</i>									
Broad money (including foreign currency deposits)	37.0	44.7	30.2	43.9	43.8	43.1	32.2	30.3	18.6
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	30.8	31.3	22.9	30.6	31.7	29.8	21.1	24.4	17.6
Domestic credit of the banking system	11.8	22.8	19.1	22.5	23.4	25.9	20.6	16.1	15.4
of which: claims on the private sector	36.4	45.6	40.7	46.2	47.6	45.3	42.3	40.3	36.2
claims on households	12.0	12.7	11.1	12.7	12.5	11.9	11.4	11.5	9.9
claims on enterprises	24.4	32.9	29.6	33.5	35.1	33.4	30.9	28.8	26.3
claims on the public sector (net)	-24.6	-22.8	-21.6	-23.7	-24.2	-19.3	-21.7	-24.2	-20.8
Other domestic assets (net) of the banking system	-5.9	-9.4	-11.8	-9.2	-11.2	-12.7	-9.6	-10.3	-14.4
<i>% of GDP</i>									
General government revenues	39.7	40.4	38.5	..	..	..	..	..	..
General government expenditures	31.3	34.4	33.7	..	..	..	..	..	..
General government balance	8.4	6.0	4.8	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt, general government	8.9	7.2	..	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	22.6	6.7	24.2	4.0	22.0	34.4	30.5	39.5	-1.6
Merchandise imports	28.5	24.6	22.7	27.0	19.2	23.2	23.4	29.7	15.7
<i>% of GDP (based on EUR), period total</i>									
Trade balance	14.1	10.1	10.5	8.9	10.1	13.6	11.9	11.2	6.2
Services balance	-1.4	-1.5	-1.5	-1.8	-1.4	-1.3	-1.5	-1.8	-1.4
Income balance (factor services balance)	-3.0	-2.3	-2.9	-3.4	-2.1	-1.8	-4.3	-3.1	-2.3
Current transfers	-0.2	-0.2	-0.2	-0.1	-0.3	-0.2	0.0	-0.2	-0.3
Current account balance	9.6	5.3	6.0	6.4	3.6	10.4	6.1	6.2	2.1
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Foreign direct investment (net)	0.7	0.7	1.0	0.1	1.8	1.3	1.5	1.2	0.3
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	30.3	33.7	30.4	34.2	33.7	30.5	32.0	34.1	30.4
Gross official reserves (excluding gold)	28.5	33.8	25.6	33.0	33.8	31.9	33.7	33.9	25.6
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	16.2	18.6	14.0	18.0	18.6	17.7	18.7	18.7	14.0
<i>EUR million, period total</i>									
Gross domestic product in current prices	788,356	944,298	1,144,075	254,274	271,499	244,951	276,103	319,067	303,953

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, IMF, OeNB.

<sup>1</sup> Due to breaks in the time series, data are only indicative.