Developments in Selected CESEE Countries:

Economic Recovery Loses Steam in Adverse International Environment[1,2]

1 Regional Overview

Uneven growth in the CESEE region

In the first half of 2014, the moderate economic recovery in most of Central, Eastern and Southeastern Europe (CESEE) broadly continued. Economic growth did decelerate from 0.6% in the first quarter (period on period) to 0.1% the second quarter of 2014, but this deterioration was largely due to a notable slowdown in growth in Turkey, the region's second-biggest economy.

However, since the summer, economic dynamics have decelerated in a number of CESEE countries, as evidenced by most recent high-frequency activity and sentiment indicators (see below for more details). Two events in particular have weighed on the situation lately: the slowdown of economic activity in the euro area, which already became manifest to some extent in lower export growth of CESEE countries in the second quarter, and the geopolitical tensions surrounding the conflict in eastern Ukraine. Both had different implications for individual economies, as these economies have different interconnections and are at different stages of the business cycle. Thus, the current situation is characterized by heightened economic uncertainty and a larger degree of heterogeneity in economic dynamics across Central, Eastern and Southeastern Europe.

Still relatively positive development in Central Europe

Within the CESEE region, Central European economies fared comparatively well, with little to no slowdown in economic expansion year on year (see chart 1). In recent quarters, growth has become more broadly based, with domestic demand

Table 1

Real GDP Growth

	2012	2013	Q3 13	Q4 13	Q1 14	Q2 14
	Period-on-period change in %					
Slovakia	1.8	0.9	0.5	0.6	0.7	0.6
Slovenia	–2.6	–1.0	0.5	1.2	0.0	1.0
Bulgaria	0.6	0.9	0.5	0.3	0.3	0.5
Croatia	–2.2	–0.9	–0.1	–0.6	0.2	–0.3
Czech Republic	–1.0	–0.9	0.4	1.5	0.8	0.0
Hungary	–1.7	1.1	1.1	0.7	1.1	0.8
Poland	2.0	1.6	0.8	0.7	1.1	0.6
Romania	0.5	3.5	1.5	1.1	–0.2	–1.0
Turkey	2.5	4.1	0.9	0.5	1.7	–0.5
Russia	3.4	1.3	0.3	0.4	0.1	0.2
CESEE average[1]	2.3	1.8	0.6	0.6	0.6	0.1
Euro area	–0.7	–0.4	0.1	0.3	0.2	0.0

Source: Eurostat, national statistical offices.

[1] Average weighted with GDP at PPP.

Note: GDP data according to ESA 95 (except for Slovenia, where only ESA 2010 data were available).

[1] *Compiled by Josef Schreiner with input from Stephan Barisitz, Markus Eller, Antje Hildebrandt, Florian Huber, Krisztina Jäger-Gyovai, Mathias Lahnsteiner, Isabella Moder, Thomas Reininger, Zoltan Walko and Julia Wörz.*

[2] *Cutoff date: October 3, 2014 (October 21, 2014, for fiscal data). This report focuses primarily on data releases and developments from April 2014 up to the cutoff date and covers Slovakia, Slovenia, the Czech Republic, Croatia, Bulgaria, Hungary, Poland, and Romania, as well as Turkey and Russia. For statistical information on selected economic indicators for CESEE countries not covered in this section (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia and Ukraine), see the Statistical Annex in this issue.*

and especially investments playing an increasing role. This has made the respective countries somewhat more resilient to adverse events in the international environment. Apart from that, several domestic policy measures had a beneficial effect on short-term growth in some countries (e.g. Hungary and the Czech Republic; see country chapters below).

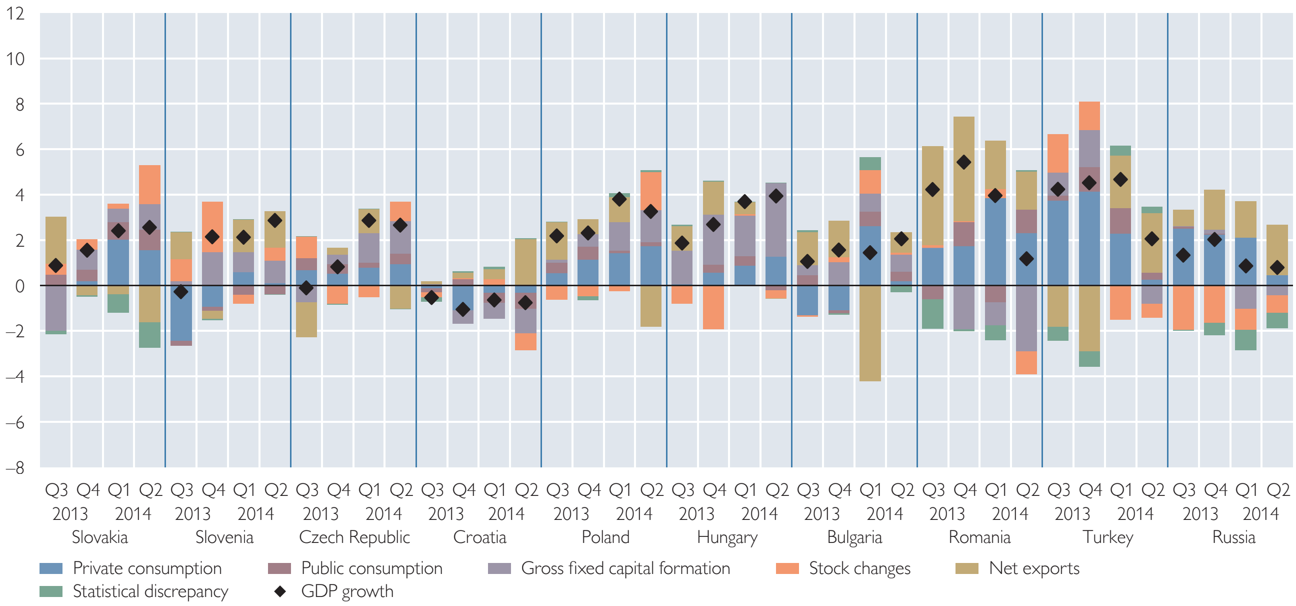
Gross fixed capital formation was an important driving force for GDP growth in all Central European countries, with private consumption bolstering growth throughout most of the region in the first half of 2014. Several factors can explain this development: Investment dynamics have been very moderate in the past years; especially throughout late 2012 and early 2013, capital formation declined in all countries. This created a substantial investment backlog. Investment dynamics were supported by an improving outlook for the international environment in late 2013 and early 2014, causing sentiment indicators to brighten (at least until early summer, when the escalation of the conflict in eastern Ukraine started to cast some shadows). Investment was further spurred by a low-interest environment against the background of an accommodative monetary policy stance at home and abroad that contributed to a moderate pickup of credit growth rates (see below). Furthermore, the end of the EU's multiannual financial framework for 2007 to 2013 encouraged public investment, as countries sought to push through as many EU-funded projects as possible to increase the absorption rate of the funds available.

Improving labor market conditions helped strengthen growth contributions from private consumption. Unemployment decreased in all countries – quite strongly in Hungary – and stood at the lowest levels in several years in summer.

Chart 1

GDP Growth and Its Main Components

Percentage points, GDP growth in %



Source: Eurostat, national statistical offices.

Note: GDP data according to ESA 95 (except for Slovenia, where only ESA 2010 data were available).

However, unemployment was still considerably higher than before the onset of the financial crisis. At the same time, employment was on the rise. Real wage growth was positive, not least because of very low inflation rates. Good wage growth in conjunction with brightening consumer sentiment also had a positive impact on consumer credit dynamics.

The contribution of net exports to growth, however, turned negative in all countries but Slovenia. After export growth accelerated in the first quarter, beginning economic weakness in the euro area put a brake on developments. At the same time, import growth was not reduced at the same pace or even kept accelerating, being fueled by robust domestic demand. Nevertheless, export growth remained firmly in positive territory, underlining a favorable competitive position that shielded the region from some of the external headwinds that arose in the review period. Especially the Czech Republic, Hungary and Slovakia reported robust productivity readings in the first half of 2014 that led to a reduction of nominal unit labor costs in manufacturing. Currency depreciation in an annual comparison further increased the competitive advantage vis-à-vis the euro area in the case of the Czech Republic and Hungary.

Noticeable growth deceleration in Russia, Turkey and Romania; recession in Croatia continues

Economic conditions in Russia, Turkey, Romania and Croatia were weaker, being marked by considerable slowdowns in economic growth or even by protracted recession. The former is especially true of Turkey and Romania, where growth declined from around 5.5% and 4.5% in the fourth quarter of 2013 to 2% and 1% in the second quarter of 2014 (year on year). Growth also weakened notably in Russia while it remained in negative territory in Croatia.

A common feature of these countries was that the growth contribution of domestic demand decreased strongly in the review period, with both consumption and investment growth decelerating noticeably. The latter was even negative throughout the first half of 2014.

Declining unemployment and steady or slightly rising employment in most of these countries did not translate into stronger consumption growth, as sentiment often remained flat. Furthermore, credit growth was negative and/or decelerating. Demand weakness was in part also linked to country specific factors. In Turkey, domestic demand growth slowed down considerably against the background of a more restrictive monetary policy implemented to curb credit expansion and stabilize the exchange rate (see below). Russia's economy suffered from deteriorating confidence, capital outflows and, more recently, economic sanctions in the context of the conflict in eastern Ukraine. Croatia has basically been stuck in recession for several years amid balance sheet weaknesses, strained labor market conditions and declining industrial production. In Romania, capital formation was impaired by problems in speeding up EU-supported investment programs. Though projects with EU cofinancing were boosted in the second half of last year, the administrative capacity has remained inadequate to ensure a smooth flow of funding.

The external sector in these countries held up comparatively well, however, and delivered important growth contributions in all countries. Export growth was positive (supported by currency depreciation in Russia and Turkey). Nevertheless, it decelerated, as demand from important export markets (euro area, also Iraq in the case of Turkey) stalled and economic uncertainty edged up. At the same time, import growth decelerated, outweighing the loss in export demand in all countries but Romania.

In terms of economics dynamics, Bulgaria takes an intermediate position between the two groups of countries outlined above. GDP growth was moderate but stable in the first half of 2014, with growth drivers shifting quickly from quarter to quarter. In June, banking sector turbulences emerged that are bound to impact on growth during the remainder of the year both directly and through credit supply and sentiment channels.

High-frequency indicators suggest a further weakening of the business cycle

The weakening outlook for the international environment and the rising degree of economic and political uncertainty in Europe suggest that the business cycle may lose further steam in the coming months. In fact, most activity and sentiment indicators have deteriorated to different extents recently. The clearest downward trend was observed in retail sales, where growth has been decelerating since the turn of the year, especially lately. In recent months, industrial production and construction output growth also embarked on a downward trend. Nevertheless, the growth rate of all three indicators has remained clearly positive so far. Looking at individual countries, however, only industrial production remained on a growth path in every country, even displaying an upward trend in Slovakia, Slovenia, Hungary and Romania. The decline in retail sales and construction dynamics was more broadly based, and several countries reported shrinking output in one or both of the sectors.

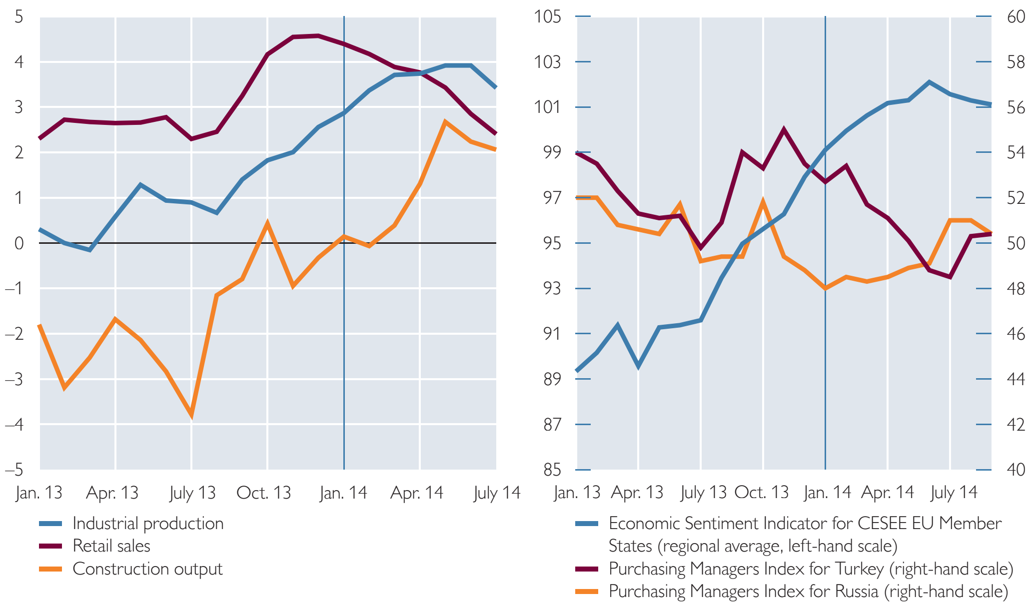
The economic sentiment indicator of the European Commission (average for CESEE EU Member States) has been declining somewhat since June, and the regional average currently stands close to its long-term average. This development was driven mostly by deteriorating consumer sentiment; retail sentiment was also somewhat lower. At the country level, especially Bulgaria, Hungary and Poland

Chart 2

Leading Indicators

Activity Indicators (CESEE Regional Average) | **Sentiment Indicators**

Year-on-year change in %, three-month moving averages | *Points*



Source: Eurostat, wiiw, European Commission, Markit.

weighed on the regional average. The PMI for Turkey improved over the summer months after a strong decline since the turn of the year. Somewhat surprisingly, the PMI for Russia also increased in the past months and currently stands above 50 points, indicating a mild economic expansion.

Further escalation of the conflict in eastern Ukraine poses a nonnegligible risk

Direct spillovers from the conflict in eastern Ukraine and the accompanying sanctions have so far been contained, even though the recent clouding of sentiment might at least in part be due to these tensions. Since September, a fragile armistice substantially reduced but did not fully stop violence. Nevertheless, a further escalation of the conflict including tit-for-tat sanctions poses a nonnegligible risk. Exports to Russia amount to more than 2% of GDP in Poland and Hungary and to more than 3% in the Czech Republic, Slovenia and Slovakia. A prolonged economic stagnation or even recession in Russia could become a notable factor for CESEE GDP dynamics, especially if it is amplified further by adverse repercussions from the euro area, affecting e.g. sentiment and external demand. While the share of trade with Russia accounts for only 0.9% of GDP for the euro area as a whole, the respective share is higher for individual euro area countries that are important trading partners for CESEE (e.g. Germany at 1.3% of GDP).

By comparison, the Russian trade embargo for selected food items from the EU issued in August has a fairly limited impact on CESEE EU Member States. Sanctioned products represent a high share of total exports to Russia only in Poland and a somewhat smaller share in Hungary and Bulgaria. Even in these countries, however, the embargo affects only 0.1% to 0.6% of total exports. The trade ban might even help Turkey's agricultural exports to Russia, as Russian importers seek to substitute supplies from EU markets. Turkey has a substantial trade volume in goods (especially fruits and vegetables) that are covered by Russia's sanctions against the EU, so that food exports from Turkey to Russia could be stepped up quickly.

While a lower volume of exports to Russia could dampen economic dynamics somewhat, a disruption of supplies from Russia, especially of energy, would have a severe impact on CESEE countries. Most CESEE EU Member States are heavily dependent on Russian gas supplies. For example, Bulgaria, Slovakia and Hungary obtain more than 80% of their gas from Russia. The two notable exceptions from this pattern are Romania, where the share of Russian gas in total gas consumption is rather moderate, and Croatia, which does not buy gas from Russia. Furthermore, an intensification of the conflict and possible sanctions on both sides raise the specter of a general boost to oil prices (also in conjunction with ongoing conflicts in the Middle East), which would put a further brake on economic momentum in CESEE EU Member States, but also in Turkey.

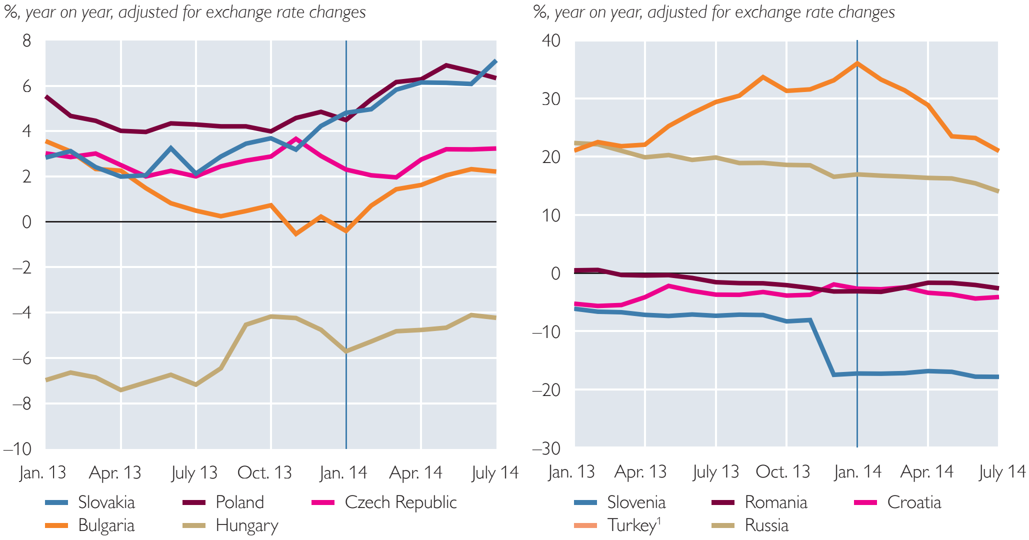
In comparison to real economic linkages, direct financial linkages of CESEE countries with Russia are less important. A further escalation of the conflict could, however, induce spillovers also to CESEE financial markets. This risk would again be most pronounced if energy supplies were affected by sanctions.

Slight improvement in financing conditions in a number of countries, but heterogeneity remains an issue

Credit dynamics were either unchanged or they improved somewhat in most countries during the review period. The latter is especially true for Poland, Slovakia, the Czech Republic and Bulgaria. In Hungary, central bank measures to support credit expansion (e.g. the Funding for Growth Scheme, see the country chapter on Hungary) had some positive effect on credit dynamics, but due to various government measures planned and taken to reduce outstanding foreign

Chart 3

Growth of Credit to the Private Sector



Source: National central banks.

[1] *Nonadjusted.*

currency debt of households and due to high sectoral taxes on banks, the credit stock continued to decline in the review period.

Lending surveys point to stable or improved credit supply and demand conditions: For example, the bank lending conditions index in Emerging Europe as collected by the Institute of International Finance[3] eased for the first time since the second quarter of 2013, with the overall index increasing noticeably by 6 points in the second quarter of 2014. The index for funding conditions even surged by 17 points, as both domestic and international funding conditions eased considerably for the first time in a year. Loan demand also increased amid a recovery in domestic demand. The demand for business loans continued to trend higher, that for consumer loans recovered after dipping temporarily in the first quarter of 2014. Notably, the demand for commercial real estate loans expanded for the first time since the first quarter of 2011 and the index for housing loan demand increased by 12 points, helped by an easing in credit standards for such loans. On the other hand, nonperforming loans (NPLs) continued to trend up, though banks expect NPLs to start declining in the coming quarters.

The CESEE Bank Lending Survey of the European Investment Bank[4] draws a somewhat less bright, but still roughly comparable picture. Banks reported a stabilization of credit demand and supply conditions, albeit at comparatively low levels. Both supply and demand are expected to improve in the next six months, however. Credit supply eased for lending to households (especially consumer credits), but continued to be tight for corporates. Banks expect an easing of supply conditions. NPLs and regulation, at both the national and international levels, remain the

[3] *http://www.iif.com/download.php?id=2venfSNbDdg=.*

[4] *http://www.eib.org/attachments/efs/economics_cesee_bls_2014_h1_en.pdf.*

most evident constraining factors affecting supply. Demand for loans improved marginally, although at a slow pace. Funding conditions are fairly favorable, with access to funding positive across all sources other than intragroup funding. Easy access to retail and corporate deposits supports a positive outlook. NPL figures deteriorated further and remain a key concern for the region's banks. However, the speed of deterioration has been decreasing.

Unlike in the larger Central European countries, credit growth remained negative in Slovenia, Romania and Croatia and continued to decelerate in Turkey and Russia. In the latter two countries, this was a welcome development, as credit expansion came down from rather high levels amid a weakening economy and substantial external imbalances in the case of Turkey. The Turkish central bank has been tightening monetary policy aggressively, with steps taken in January 2014 and several macroprudential measures effected to put a brake on the swift credit expansion (short-term dynamics, however, suggest that credit growth has started to pick up again recently). In Russia, credit growth was affected by geopolitical tensions weighing on sentiment and the outlook and impeding international refinancing possibilities. Furthermore, policy rates have been increased markedly since March 2014. In Slovenia, the banking sector is still in the process of restructuring, including the transfer of NPLs to a bank asset management company and a recapitalization of banks, which took effect at the turn of the year, as is clearly visible in the dip in lending growth in chart 3. The ongoing recession and economic uncertainty weighed on loan demand in Croatia. The Croatian central bank, however, has already taken measures to stimulate private sector lending (e.g. lowering reserve requirements provided that the released liquidity is used to grant loans to nonfinancial enterprises).

International banking groups keep up their exposures in CESEE

The exposure of international banking groups active in the region increased by some EUR 15 billion in the final quarter of 2013 and remained at roughly this level in the first quarter of 2014 (more recent data were not available at the time of writing, because the publication lag of these data is almost four months). The increase was driven predominantly by Turkey, but Poland and the Czech Republic also reported higher figures. A stronger reduction could be observed only in Russia (–EUR 8 billion between the third quarter of 2013 and the first quarter of 2014).

The EIB lending survey explored the commitment of international banking groups to CESEE and found that operations in this region remain a key strategic component of overall business strategies. CESEE operations are expected to remain profitable or to become profitable again, delivering on average higher returns on assets than overall group operations. Cross-border banks have become more selective in their country-by-country strategies, though, putting greater weight on economic prospects and reliable policy conduct.

Very moderate price pressures in most countries of the region

Price pressures stayed very moderate throughout the review period in all countries but Russia and Turkey. Bulgaria has recorded deflation for several months already, while the price level has essentially stagnated in Poland and Slovenia and for several months in Slovakia. Among the components of the HICP, it was especially energy and unprocessed food items that pushed prices down. Some upward pressure on prices came only from services and in some countries from processed food (including alcohol and tobacco). Disinflation pressure from the euro area was another factor causing weak price growth, especially in countries that peg their currencies to the euro. Core inflation rates lay above headline inflation and in positive territory in all countries of the region. Only Bulgaria reported core deflation (see country chapter below).

The Russian trade embargo for selected food items from the countries of the EU (dairy products, meat, fish, fruit and vegetables) from August 2014 may lead to a temporary oversupply of such goods in the EU, thus possibly creating some further downward pressure on inflation. The effect will differ among Member States, depending on the consumption basket shares for which the goods account. For the EU as a whole, the respective share amounts to 10%. It is higher, though, for CESEE EU Member States, ranging from 11% in Slovenia to 21% in Romania. The price effect of the embargo should be mitigated to a certain extent, depending on the ability of domestic markets to absorb excess supply and their ability to quickly find alternative export markets. Furthermore, the European Commission announced emergency market measures to fund product withdrawals from the internal market (either for free distribution or for other destinations), green harvesting and nonharvesting of perishable fruit and vegetables most immediately impacted by the Russian measures.

Substantially higher inflation rates, i.e. rates in the high single digits, were reported for Turkey and Russia. The currencies of both countries trade substantially lower today than a year ago, and there has been a notable exchange rate pass-through on prices. In Turkey, the situation was aggravated by rising food prices after a drought in summer. As for Russia, the trade embargo (imports affected by the sanctions account for over 15% of the overall food market in Russia) is disrupting well-established trade relations and is further putting upward pressure on inflation. The Russian Ministry of Economic Development has already lifted its inflation forecast for Russia's food market in 2014 to between 12.3% and 12.7% from between 7.2% and 7.4%. As a result, the headline inflation rate is expected to reach 7.5% in 2014 instead of the previously estimated 6%.

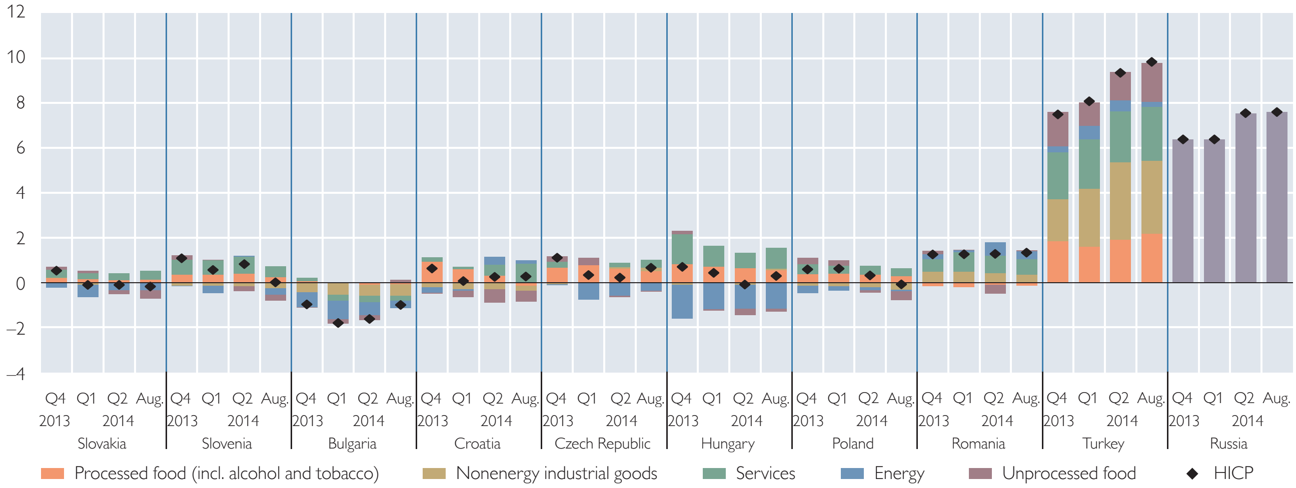
Further monetary easing in CESEE

Against the backdrop of low inflation rates or deflation, the central banks of CESEE EU Member States continued to pursue a policy of monetary accommodation.

Chart 4

HICP Inflation and Its Main Drivers

Percentage points, contribution to year-on-year change in HICP; HICP in %



Source: Eurostat.

Note: Russia: CPI. No breakdown according to COICOP available.

The Hungarian and Romanian central banks cut their policy rates by a total of 50 basis points each from early April to early October, lowering them to 2.1% and 3%, respectively. The Czech Republic's policy rate has been standing at "technically zero" since October 2012. In November 2013, the Czech central bank (CNB) decided to use the exchange rate as an additional instrument to ease monetary conditions (see Recent Developments in FEEI Q2/14). In July 2014, the CNB announced that it would continue exchange rate management at least until 2016. The two euro area countries, Slovenia and Slovakia, were subject to the ECB's interest rate decisions of June and September 2014.

Monetary policy was loosened most substantially in Turkey. The background for this move, however, was different from that in the CESEE EU countries: The Turkish lira had depreciated strongly in late 2013 and early 2014, which had prompted the Turkish central bank to hike rates aggressively. Throughout the review period, however, the exchange rate recovered as uncertainty eased, and the country saw a substantial increase in portfolio inflows in the second quarter of 2014. This led the Turkish central bank to decrease its policy rate in steps between May and July, lowering it by a total of 175 basis points to 8.25%.

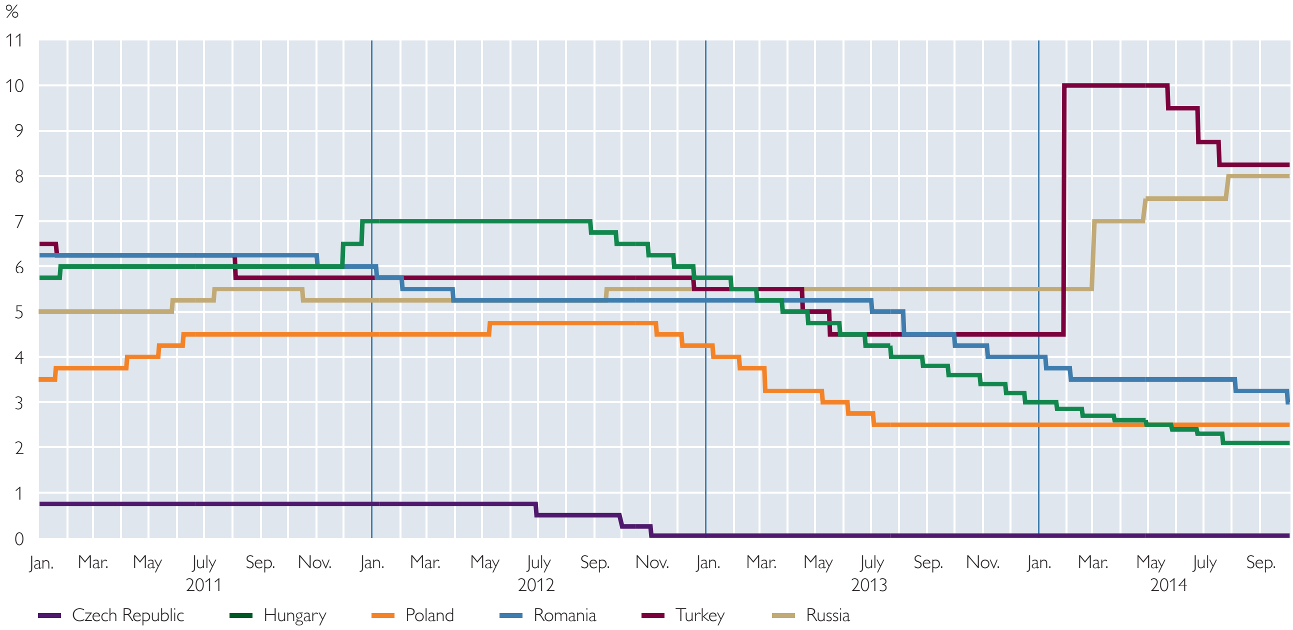
The Russian central bank was the only central bank in the region to tighten monetary policy during the review period (by a total of 100 basis points to 8%), as the conflict in eastern Ukraine led to heightened political uncertainty, currency depreciation, capital outflows and higher inflation rates.

Some further improvement in the external position of the CESEE region…

The combined current and capital account for the region as a whole improved somewhat in the review period, switching from a deficit of 0.1% of GDP at the end of 2013 (four-quarter moving sum) to a surplus of 0.6% of GDP in mid-2014. This development was driven to a substantial extent by Russia and Turkey. In both

Chart 5

Policy Rate Developments in CESEE



Source: National central banks.

countries, trade balances improved against the background of decreasing domestic demand and currency depreciation. Turkey, however, continued to report a substantial trade deficit that kept its combined current and capital account deep in the red. Higher current account surpluses were reported also for Poland and the Czech Republic, related in part to higher inflows through the capital account, even though increasing outflows of FDI income dampened this trend in the Czech Republic in the second quarter of 2014.

In the other countries of the region, external balances remained broadly unchanged or deteriorated somewhat. Remarkably for emerging economies, however, all countries posted (in most cases substantial) surpluses in the combined current and capital account.

…while Russia reports substantial capital outflows

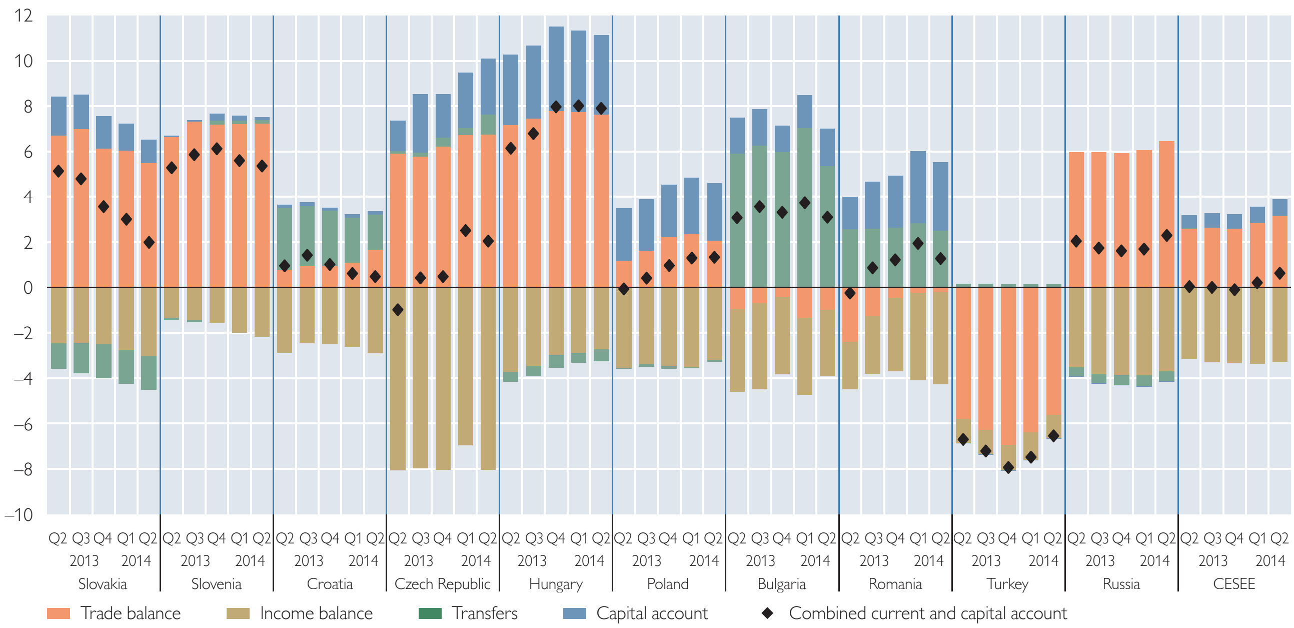
Net capital flows to the ten CESEE countries as a whole, as recorded in the financial account, decelerated markedly from 2.9% of GDP in the last quarter of 2013 to –4.8% of GDP in the second quarter of 2014 (four-quarter moving sums). The deterioration was driven by lower inflows of portfolio investments and by higher outflows from other investments. At the same time, net FDI picked up somewhat, suggesting a continuing attractiveness of many (though not all) CESEE countries covered here as an investment destination.

Regional developments were very much driven by Russia. Net outflows from the country increased by more than EUR 40 billion in the review period against the background of capital flight due to the uncertain political situation. Roughly one-third of this sum came from portfolio investments and two-thirds from other investments. As chart 7 shows, net financial flows also moderated noticeably to Croatia and Romania (by EUR 1.6 billion and EUR 4 billion) as well as to Turkey

Chart 6

Combined Current and Capital Account Balance

% of GDP, four-quarter moving sum



Source: Eurostat, IMF, national central banks.

and Poland (by some EUR 22 billion and roughly EUR 7 billion). While a financial account surplus turned into a slight deficit in Poland in the second quarter of 2014, Turkey still reported substantial net capital inflows. In fact, a rebound of inflows to Turkey could be observed after a weak start in 2014.

Except for the Czech Republic, where the financial account balance remained broadly unchanged, some improvement was reported for the other countries of the region (mostly around 2% of GDP), as FDI recovered (Slovenia, Slovakia) and as outflows from other investment moderated (Bulgaria, Hungary, Slovakia). Higher portfolio inflows also played a role in some countries (Bulgaria, Slovenia). It needs to be noted, however, that the financial account remained in substantial deficit in Hungary and Slovenia, thus largely (Hungary) or fully (Slovenia) offsetting the surplus in the combined current and capital account balances.

Only three CESEE countries remain in excessive deficit; ESA 2010 brings some changes to public sector deficits and debt ratios

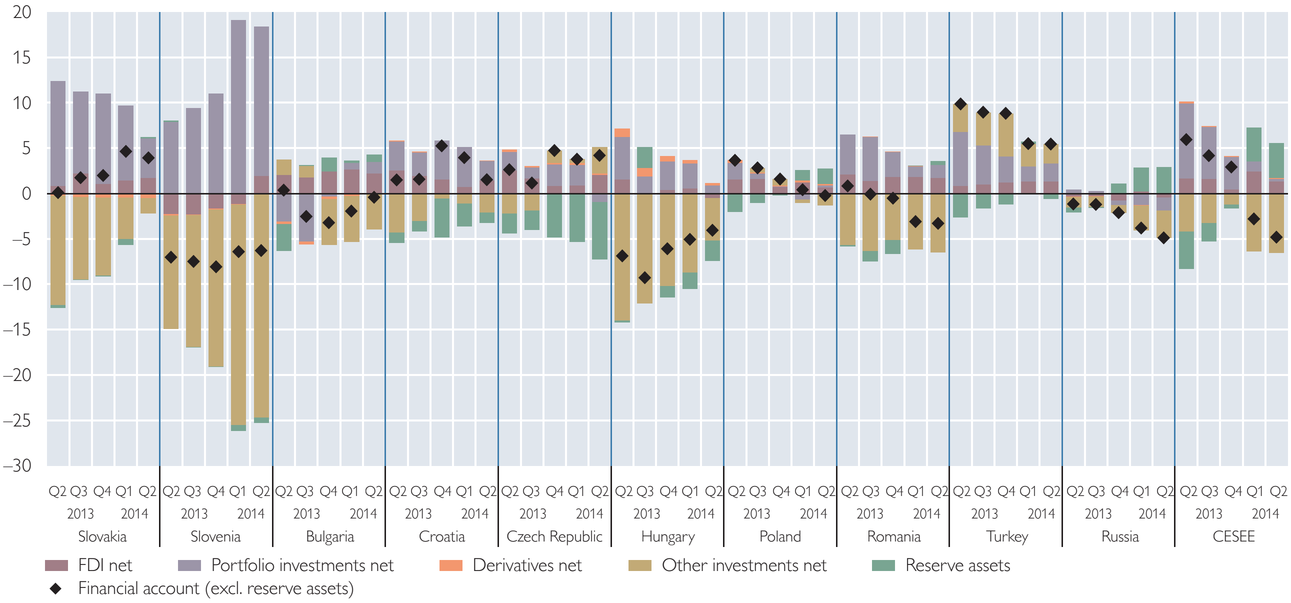
Excessive deficit procedures (EDPs) were abrogated for two CESEE countries during the review period. In 2013, the Czech Republic and Slovakia managed to bring down their public deficits in a sustainable way to below 3% of GDP. This left Slovenia, Poland and Croatia as the only CESEE EU countries still subject to an excessive deficit procedure. The target dates for a correction currently stand at 2015 for Slovenia and Poland and at 2016 for Croatia.

In October, Eurostat published the notification figures for public deficits and debt for EU countries. These differed from the figures released in spring due to a methodological change in the European System of National Accounts (switch from ESA 95 to ESA 2010). Two effects are at play: First, the recognition of research and development as well as expenditure on weapon systems as investment (in addition to some other, quantitatively less important changes) increases GDP, while it also implies some changes for the composition of GDP. The effect amounts

Chart 7

Financial Account Balance

% of GDP, four-quarter moving sum



Source: National central banks.

to 2.3% for the EU. For most CESEE EU Member States, however, the effect was smaller; only in the Czech Republic did GDP increase by 3.1%. Second, ESA 2010 also has an impact on the absolute value of debt and deficits. The main methodological changes relate to a reclassification of positions subsumed under general government and a change in the recording of lump sum payments in relation to transfers of pension funds. Depending on the relative size of these changes and the change in GDP, debt ratios went up, down or remained the same. The most fundamental change was observed in Croatia, where the debt-to-GDP ratio increased by 8.6 percentage points.

Box 1

Ukraine: Conflict Squeezes Foreign Exchange Market, Drags Country into Deep Recession:[1]

The conflict in the eastern parts of the country dragged the Ukrainian economy down into recession in the first half of 2014, with GDP shrinking by 3%. The output contraction will accelerate in the second half of the year, with the impact of the conflict increasingly reflected by short-term indicators from mid-2014. After industrial production declined by only 5% in the first half of 2014, it plummeted by 12.1% in July and 21.4% in August. The deterioration was mainly driven by the production outfalls in the heavily industrialized eastern regions Lugansk and Donetsk, where the heavy fighting between Ukrainian and pro-Russian forces was concentrated during the summer months. The cease-fire announced in early September 2014 has remained fragile. Tensions with Russia have mounted sharply not only because Russia has annexed Crimea and because it supports separatist forces in eastern Ukraine, but also because of the ongoing gas conflict and because of pressure from Moscow not to implement any parts of the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, which was ratified in September. The provisional application of the DCFTA was postponed until end-2015.

Following the sizeable depreciation of the hryvnia in early 2014, the situation in the foreign exchange market stayed tense, while deposit outflows from the banking system continued and high foreign currency demand met low supply. The hryvnia repeatedly came under considerable pressure, prompting the central bank to raise its key policy rate (currently at 12.5%), to tighten existing administrative measures, introduce new measures and to conduct regular forex auctions. In mid-September, the currency bottomed out at UAH 14.4 against the U.S. dollar before recovering in late September. The 36% depreciation (vis-à-vis the U.S. dollar) since the beginning of the year affects unhedged foreign currency debtors. In the household sector, the share of foreign currency loans increased to 45% of total loans due to the exchange rate valuation impact.

As a consequence of declining domestic demand and the weakening of the hryvnia, which has helped exports, the current account deficit shrank markedly. In the first half of 2014, the current account deficit amounted to 3.6% of GDP compared to 6.8% in the first half of 2013. The depreciation also caused inflation to rise from 0.5% at end-2013 to 17.5% in September 2014.

Despite the very difficult environment, the Ukrainian authorities have implemented policies broadly as agreed under the IMF Stand-by Arrangement so far. The positive conclusion of the first review enabled the disbursement of a further USD 1.4 billion tranche. The IMF revised its baseline scenario downward and pointed to large downside risks and related additional funding needs. The next review is scheduled to start in the second half November 2014 after the parliamentary elections in late October.[2]

[1] *Author: Mathias Lahnsteiner.*

[2] *For further data, see Statistical Annex.*

Box 2

Western Balkans:[1,2] Floods in May Ravage Bosnia and Herzegovina as well as Serbia

In the first half of 2014, economic growth weakened in all Western Balkan countries compared to 2013 except in FYR Macedonia. Economic developments in Bosnia and Herzegovina as well as in Serbia were overshadowed by the floods in late May that put a severe drag on overall economic developments. Serbia's economic growth was negative in this period. For Bosnia and Herzegovina, no growth figures have been released yet for the second quarter of 2014, but first estimates suggest real GDP growth to have turned negative there, too. The international community has provided immediate emergency help for the countries hit by the floods, also with the intention of stabilizing the economy. In Montenegro, real GDP growth was weak in the first half of 2014. Demand components have not yet been released, but sluggish growth is mainly the result of the drag on net exports caused by declining industrial production over this period. Economic growth also was subdued in Albania over the first six months of 2014 and even turned negative in the second quarter of 2014. A detailed breakdown of quarterly growth figures has not become available yet. In contrast, GDP growth was strong in FYR Macedonia, coming to about 4% in the first half of 2014. A noteworthy development is that growth drivers have changed and have moved away from state-led construction to private consumption as a result of higher wages and weak inflation. Kosovo does not compile quarterly GDP figures. However, the Central Bank of the Republic of Kosovo (CBK) saw higher consumption growth in the first half of 2014 compared to the same period of 2013 on the back of wage and salary hikes in the public sector and higher remittances. 2013 data have been revised in the process of bringing the national accounts in line with Eurostat standards. FYR Macedonia revised GDP growth down from 3.1% to 2.2%, Montenegro from 3.5% to 3.3%. The revision in Serbia was only minor.

Mirroring GDP dynamics, industrial production weakened throughout most of the Western Balkans. In Bosnia and Herzegovina as well as Serbia, the floods weighed on industrial production, resulting in negative growth rates in the second quarter of 2014 (after positive growth in the first quarter). In Montenegro, industrial production decreased at double-digit rates in the first half of 2014 primarily in the electricity, mining and gas industries. In FYR Macedonia, industrial production decelerated in the utility sectors as well, but this was more than compensated by higher manufacturing output. Albanian industrial production also weakened in the course of the first half of 2014. More recent July and August data showed that industrial production declined in Montenegro and Serbia as well as in Bosnia and Herzegovina (only in August). For Albania, no monthly data on industrial production is available (Kosovo has neither monthly nor quarterly data).

In the first half of 2014, the trade gap widened in Bosnia and Herzegovina and in Serbia due to higher imports of construction materials and lower exports of agricultural goods. In addition to these flood-related effects, Serbian exports were also affected by the temporary halt of production at a vehicle manufacturing site. With the exception of FYR Macedonia, the trade balance also worsened in the rest of the region. On the back of a poorer trade performance, the current account deficits increased or remained almost constant in all of these countries. Montenegro showed the largest current account deficit, about 15% of GDP in the first half of 2014 (2013: 14.6%). In contrast, the current account deficit stayed below 2% of GDP in FYR Macedonia in the first half of 2014, driven by an improvement of the merchandise trade balance and an increase of transfers. Thus, the heterogeneous external balances of the region persisted also in the review period.

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[2] *The Western Balkans comprise the EU candidate countries Albania, FYR Macedonia, Montenegro and Serbia, as well as the potential candidate countries Bosnia and Herzegovina, and Kosovo. The designation "Kosovo" is used without prejudice to positions on status, and in line with UNSC 1244 and the opinion on the Kosovo Declaration of Independence.*

In line with restrained economic growth, the dynamics of lending to the nonbank private sector remained weak in Albania, Montenegro and Serbia, with rates running below 2% in the first half of 2014. In contrast, FYR Macedonia exhibited high credit growth of more than 9%. Albania and Serbia saw credit growth picking up somewhat in July and August from the first half of 2014, whereas credit growth turned negative in Montenegro. In the first half of 2014, NPLs increased slightly in all countries compared to 2013. With an NPL ratio of more than 24%, Albania had the highest rate; at the other end of the spectrum, Kosovo had the lowest rate of NPLs at around 8%.

Inflationary pressure stayed very subdued in the region. Inflation rates declined in the course of the year in almost all Western Balkan countries. Bosnia and Herzegovina as well as Montenegro registered negative inflation rates throughout the first half of 2014. Inflation turned negative in the second quarter of 2014 in FYR Macedonia. In Kosovo, the price dynamics decelerated to below 0.5% in the first half of 2014 from 1.8% in 2013. In the second quarter of 2014, inflation stood at 1.6% in Albania and at 1.8% in Serbia, so that both countries missed their inflation targets (3% ±1 percentage point in Albania and 4.5% ±1.5 percentage points in Serbia). Overall, subdued inflation rates were largely the result of declining agricultural prices (both domestic and imported goods), low commodity prices and weak aggregated demand. Most countries saw a slight pickup of price dynamics in July and August 2014 mostly because food prices rose. With an inflation rate of 2.0% in August, Albania was even within its inflation target range again. By contrast, prices in Montenegro fell further, dropping by more than 1% in July and August 2014. Motivated by the subdued inflationary environment, the National Bank of Albania cut its key interest rate by 25 basis points to 2.5% in May. The Albanian lek remained broadly stable against the euro. In Serbia, the key interest rate was cut in two steps, from 9.5% to 8.5%, in the second quarter of 2014. In the first nine months of 2014, the Serbian dinar lost 4% of its value against the euro, which prompted the National Bank of Serbia to intervene in the forex market several times.

Serbia faces the most challenging fiscal situation in the region. In September 2014, the Serbian government announced an austerity package providing e.g. for a cut in pensions and public sector wages and for a reduction of subsidies for state-owned enterprises. Its implementation has not started yet. The budget deficit for 2014 is expected to exceed the target by a considerable margin and could reach more than 8% of GDP. Despite solid GDP growth, the budget deficit is expected to come in somewhat above target also in the FYR Macedonia (related to higher spending in the forefront of elections). Because of the unexpected need for funds in the wake of the flooding, both regions in Bosnia and Herzegovina as well as the central government had to revise their budgets. In contrast, Albania expects to meet its – rather loose – budget deficit target of slightly more than 6% of GDP. For Kosovo and Montenegro, the 2014 budgets are largely on track.

Albania moved one step forward toward EU membership: The country was granted EU candidate status in June 2014. A month later, the EU and Kosovo initialed the Stabilisation and Association Agreement. No progress was made in the accession process of Bosnia and Herzegovina. Albania as well as Bosnia and Herzegovina lag behind in fulfilling the obligations agreed on with the IMF. Although the IMF concluded the first review under the Extended Fund Facility with Albania in June 2014, the second review of the arrangement held in September was not concluded. The disbursement of the next tranche of the loan was postponed, as there are still some outstanding issues concerning the budget for 2015, structural reforms as well as Bank of Albania governance issues. The IMF also announced that it would not conclude the eighth review of the Stand-by-Arrangement with Bosnia and Herzegovina, since the country has not implemented the agreed policies yet. Currently, Serbia is holding talks on a new arrangement with the IMF.

2 Slovakia: GDP Growth Revives on the Back of Recovering Domestic Demand

Domestic demand becomes key driver of economic growth

After slowing down for four consecutive years, GDP growth picked up again in the first half of 2014, substantially outpacing euro area dynamics. Following two years of contraction, domestic demand recovered, complementing the strong export sector, which has been a key element in Slovak economic performance in recent years. Investment has been growing robustly since the final quarter of 2013, and private consumption growth also accelerated in the review period, driven by improved labor market conditions and higher real wages. Public consumption gained steam as well. Since the fourth quarter of 2013, imports have increased considerably faster than exports, which has dampened overall GDP growth, as the contribution of net exports to growth has slipped into moderately negative territory. Looking forward, car industry plants in Slovakia are planning new investments that will increase output over the medium term and that will help exports regain momentum.

Inflation hits new all-time lows in the first half of 2014

Reflecting subdued energy and food prices as well as an appreciation of the euro, inflation turned marginally negative in January 2014 and has stayed in marginally negative territory since then. Russian import sanctions as well as favorable agricultural conditions in 2014 may put further downward pressures on food prices, while reviving consumption is expected to have some upward impact on price dynamics.

Positive changes in labor market but serious challenges remain

In the second quarter of 2014, some signs of positive labor market developments emerged. After a prolonged period of stubbornly high unemployment, the second quarter brought a fall in the unemployment rate to 13.2%, which is 0.9 percentage points lower than in the previous year. Accelerating nominal wage growth, in conjunction with inflation developments, translated into substantial real wage growth (around 6% in the second quarter of 2014). The employment rate rose by 0.9 percentage points to 60.7% in the second quarter of 2014 from a year earlier, which is the highest level since the second quarter of 2009. Despite these positive changes, a reduction of the still high jobless rate, especially among the younger population, remains a key challenge. Furthermore, the structural composition of unemployment remains unfavorable, with a high share (about two-thirds) of long-term unemployed persons and large regional disparities in unemployment.

Slovakia exits the EDP but surpasses the third limit of the constitutional debt brake

The fiscal position has improved significantly in recent years, with the general government deficit declining from 7.5% of GDP in 2010 to 2.6% of GDP in 2013. This enabled the country to exit the EDP in 2014. The European Commission found that the structural balance improved on average by 1.5% of GDP per year over the period 2010 to 2013. Nevertheless, Slovakia must reinforce the budgetary measures to ensure full compliance with the preventive arm of the Stability and Growth Pact. This will also help to rein in a continued increase in public debt ratios. At the end of 2013, the gross public debt level overshot the constitutional debt brake threshold of 55% of GDP. As a consequence, the Slovak government was obliged to set aside 3% of total state budget expenditures during 2014 and to present a budget without a nominal expenditure increase for 2015. However, the transition to ESA 2010 accounting standards in October brought about a revision of the government debt ratio in 2013 to slightly below 55% of GDP. While the expenditure cuts have already been implemented in the 2014 budget, this provides some leeway for the 2015 budget.

Table 2

Main Economic Indicators: Slovakia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	3.0	1.8	0.9	0.5	0.8	0.9	1.5	2.4	2.5
Private consumption	–0.5	–0.2	–0.1	–1.6	0.9	0.1	0.3	3.4	2.7
Public consumption	–4.3	–1.1	1.4	–0.3	0.4	2.8	2.5	4.4	5.3
Gross fixed capital formation	14.2	–10.5	–4.3	–7.9	–4.8	–9.8	4.0	3.6	6.2
Exports of goods and services	12.2	9.9	4.5	4.9	4.4	1.9	6.6	9.6	3.4
Imports of goods and services	9.7	3.3	2.9	2.5	1.9	–0.4	7.4	10.8	5.5
	Contribution to GDP growth in percentage points								
Domestic demand	1.0	–4.1	–0.8	–2.0	–2.1	–1.2	2.1	3.6	5.3
Net exports of goods and services	2.0	5.9	1.7	2.5	2.6	2.1	–0.4	–0.4	–1.6
Exports of goods and services	9.8	8.8	4.3	4.7	4.4	1.7	6.6	9.4	3.4
Imports of goods and services	–7.8	–2.9	–2.6	–2.3	–1.7	0.3	–7.0	–9.8	–5.0
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	0.7	1.0	–1.0	0.4	–1.1	–1.7	–1.6	1.9	2.8
Unit labor costs in manufacturing (nominal, per hour)	2.1	–7.2	–2.1	1.4	0.5	–2.3	–7.3	–4.5	–0.1
Labor productivity in manufacturing (real, per hour)	2.7	12.6	8.0	6.9	6.2	7.4	11.2	6.0	4.7
Labor costs in manufacturing (nominal, per hour)	5.0	4.5	5.7	8.5	6.7	5.0	3.1	1.3	4.5
Producer price index (PPI) in industry	4.5	1.9	–1.0	0.5	–0.7	–1.5	–2.3	–3.4	–3.6
Consumer price index (here: HICP)	4.1	3.7	1.5	2.2	1.7	1.4	0.5	–0.1	–0.1
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	13.7	14.0	14.3	14.6	14.1	14.1	14.3	14.1	13.2
Employment rate (%, 15–64 years)	59.3	59.7	59.9	59.8	59.8	60.0	59.8	60.2	60.7
Key interest rate per annum (%)	1.2	0.9	0.5	0.8	0.6	0.5	0.3	0.3	0.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	0.7	6.6	5.9	5.5	6.1	5.6	5.9	7.3	6.9
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–3.8	–3.1	0.3	0.4	–5.9	–6.5	0.3	0.2	2.5
Domestic credit of the banking system	9.4	–7.1	0.7	–10.9	–7.0	–2.2	0.7	2.1	9.0
of which: claims on the private sector	6.9	–0.1	5.1	1.8	2.8	3.4	5.1	5.7	6.2
claims on households	3.9	3.9	4.1	3.9	4.1	4.1	4.1	4.4	4.7
claims on enterprises	2.9	–4.0	1.0	–2.1	–1.3	–0.7	1.0	1.3	1.5
claims on the public sector (net)	2.5	–6.9	–4.4	–12.7	–9.8	–5.6	–4.4	–3.5	2.8
Other assets (net) of the banking system	–4.9	16.7	4.8	16.0	19.0	14.3	4.8	5.0	–4.6
	% of GDP								
General government revenues	36.4	36.0	38.4	..	..	..	..	..	..
General government expenditures	40.6	40.2	41.0	..	..	..	..	..	..
General government balance	–4.1	–4.2	–2.6	..	..	..	..	..	..
Primary balance	–2.7	–2.4	–0.7	..	..	..	..	..	..
Gross public debt	43.5	52.1	54.6	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	48.3	47.3	49.4	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	27.2	28.7	30.8	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	1.5	5.0	5.9	7.8	9.1	4.6	2.6	7.2	7.2
Services balance	–0.5	0.4	0.2	–0.3	0.2	0.9	–0.1	–0.1	–0.1
Income balance (factor services balance)	–4.2	–2.3	–2.5	–2.6	–2.4	–2.3	–2.6	–3.7	–3.6
Current transfers	–0.5	–0.9	–1.5	–0.6	–1.6	–2.0	–1.7	–0.5	–1.6
Current account balance	–3.8	2.2	2.1	4.4	5.3	1.2	–1.9	2.9	1.8
Capital account balance	1.3	1.9	1.4	1.0	1.3	0.8	2.6	–0.0	0.6
Foreign direct investment (net)	2.9	3.2	1.1	–0.9	–3.3	5.0	3.0	0.8	–2.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	76.7	75.6	82.7	80.8	84.5	86.2	82.7	90.9	89.0
Gross official reserves (excluding gold)[1]	1.0	0.9	0.9	1.0	1.2	0.9	0.9	1.5	1.0
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.2	0.1
	EUR million, period total								
GDP at current prices	68,974	71,096	72,134	16,710	18,036	18,996	18,393	17,022	18,381

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

[1] *Given Slovakia's adoption of the euro, the calculation of international reserves has changed as of the beginning of 2009. Specifically, reserves no longer include foreign assets in euro and claims on euro area residents.*

3 Slovenia: New Government Faces Major Challenges Despite Moderate Pickup in Economic Activity

Center-left coalition takes up office as economy improves

Following the resignation of Prime Minister Bratušek in May 2014, parliamentary elections brought to power a new center-left government. The government intends to continue privatization, reduce public spending, increase tax efficiency, further stabilize the financial system, enhance competitiveness and promote job creation and FDI. It is not yet clear how the coalition will deal with a number of key issues (e.g. privatization, the healthcare and pension reform, fiscal consolidation), as the political will to address these issues is limited in parts of the coalition. The consent of all coalition partners, however, is needed to ensure clear majority support in parliament.

The new government entered into office in improving economic surroundings. GDP expanded by 2.5% year on year during the first half of 2014, notably above the euro area reading. Private consumption growth reentered positive territory after contracting substantially – by nearly 7% – over 2012 and 2013, amid employment gains, real wage increases and less adverse consumer sentiment. Public consumption continued to contract, while investments were up by around 5% thanks to strong construction activity related to EU funding. Net real exports also supported GDP growth, as export growth accelerated and outpaced import growth by a solid margin.

Further progress in bank restructuring

The European Commission approved the restructuring plan for the bank Abanka in August, greenlighting the second tranche of recapitalization and the transfer of bad assets to the Bank Asset Management Company. Furthermore, Slovenia has committed to merge Abanka with Banka Celje (a small bank that requested state aid in April 2014) and to submit a restructuring plan for the joint entity by end-2014. Following the reception of six nonbinding bids for Nova Kreditna Banka Maribor d.d. (NKBM), the Slovenian Sovereign Holding invited binding bids for the bank in August. Also on a positive note, the banking system posted a modest profit during the first half of 2014, owing to the halving of impairment and provisioning costs and to some extent the increase in net operating income. Despite this progress, banks are still burdened with high and again increasing NPLs, which continue to foster deleveraging, especially by nonfinancial corporations. To slow down the decline in the banking system's loan-to-deposit ratio and to stabilize the banking system's funding structure, Banka Slovenije introduced minimum requirements on changes in loans to nonbanks relative to changes in deposits by nonbanks as of end-June 2014.

Further reform measures needed

Following up on previous reforms will be necessary to make the economic recovery last. In a policy strategy paper, Banka Slovenije identified four major priorities: efficiency of the legislation and the judiciary system; deleveraging and restructuring of enterprises; restoration of banks' balance sheets and enhanced financial stability; reinforcement of the long-term stability of public finances. The central bank's detailed proposals – such as the completion of banks' balance sheet repair, bank resolution through liquidation and consolidation, enhanced supervision and risk management, comprehensive and rapid corporate restructuring, privatization of banks and nonbank enterprises including the attraction of FDI, additional durable fiscal consolidation (according to Banka Slovenije, measures in the magnitude of cumulative 1.8% of GDP over 2014 to 2015 will be required to exit the EDP in 2015) and structural reforms (healthcare, pension, education, labor market, local government) – are also reflected in the European Council's eight recommendations issued to Slovenia in June 2014.

Table 3

Main Economic Indicators: Slovenia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	0.6	–2.6	–1.0	–4.5	–1.3	–0.3	2.1	2.1	2.9
Private consumption	–0.1	–3.0	–3.9	–6.4	–3.2	–4.4	–1.6	1.1	0.2
Public consumption	–1.3	–1.5	–1.1	–1.7	–1.0	–1.0	–0.8	–1.9	–1.9
Gross fixed capital formation	–4.6	–8.9	1.9	–1.9	0.8	1.0	7.4	4.6	5.2
Exports of goods and services	7.0	0.3	2.6	1.2	1.5	3.9	3.9	4.9	5.2
Imports of goods and services	5.0	–3.9	1.4	–2.7	1.2	2.5	4.6	3.3	3.3
	Contribution to GDP growth in percentage points								
Domestic demand	–0.7	–5.5	–2.0	–7.3	–1.7	–1.5	2.6	0.7	1.3
Net exports of goods and services	1.4	2.9	1.0	2.8	0.3	1.2	–0.4	1.4	1.6
Exports of goods and services	4.5	0.2	1.9	0.8	1.1	2.8	2.9	3.7	3.8
Imports of goods and services	–3.2	2.7	–1.0	1.9	–0.8	–1.7	–3.3	–2.3	–2.2
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	–1.2	0.9	0.9	–0.3	0.4	1.1	2.4	–0.4	–1.3
Unit labor costs in manufacturing (nominal, per hour)	0.2	4.7	2.8	8.0	–3.1	2.5	4.1	0.9	0.3
Labor productivity in manufacturing (real, per hour)	1.6	–1.8	–2.1	–3.3	–2.6	–2.9	0.4	2.3	2.3
Labor costs in manufacturing (nominal, per hour)	1.9	2.9	0.6	4.4	–5.7	–0.5	4.4	3.2	2.6
Producer price index (PPI) in industry	4.6	0.9	0.0	0.7	0.2	–0.2	–0.6	–0.8	–1.2
Consumer price index (here: HICP)	2.1	2.8	1.9	2.7	1.8	2.2	1.1	0.6	0.8
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	8.4	9.0	10.3	11.2	10.5	9.5	9.8	11.0	9.5
Employment rate (%, 15–64 years)	64.4	64.1	63.3	62.4	63.0	64.5	63.2	62.5	64.5
Key interest rate per annum (%)	1.2	0.9	0.5	0.8	0.6	0.5	0.3	0.3	0.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	3.0	–0.7	0.2	0.6	–0.8	0.6	0.2	1.4	4.4
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	6.5	3.9	19.7	10.5	19.0	18.8	19.7	29.1	27.4
Domestic credit of the banking system	–3.1	–2.7	–13.8	–8.1	–15.9	–18.3	–13.8	–23.1	–19.7
of which: claims on the private sector	–3.8	–7.2	–22.9	–9.9	–10.3	–10.4	–22.9	–21.1	–22.1
claims on households	0.8	–0.8	–1.5	–1.1	–1.1	–1.2	–1.5	–1.3	–1.2
claims on enterprises	–4.6	–6.4	–21.4	–8.9	–9.1	–9.2	–21.4	–19.8	–20.8
claims on the public sector (net)	0.7	4.5	9.1	1.8	–5.6	–7.8	9.1	–2.0	2.3
Other assets (net) of the banking system	–0.4	–2.0	–5.7	–1.7	–3.9	0.1	–5.7	–4.7	–3.3
	% of GDP								
General government revenues	43.6	44.4	45.2	..	..	..	..	..	..
General government expenditures	49.8	48.1	59.7	..	..	..	..	..	..
General government balance	–6.2	–3.7	–14.6	..	..	..	..	..	..
Primary balance	–4.3	–1.7	–12.0	..	..	..	..	..	..
Gross public debt	46.2	53.4	70.4	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	97.6	95.9	85.4	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	30.6	30.5	29.6	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–2.6	–0.5	1.8	1.6	2.6	2.7	0.2	3.4	3.2
Services balance	4.0	4.8	5.4	6.0	5.7	5.9	4.2	4.2	5.1
Income balance (factor services balance)	–1.4	–1.5	–1.6	–0.7	–2.1	–2.5	–0.9	–2.6	–2.7
Current transfers	0.4	0.0	0.2	–0.8	0.3	–0.8	1.8	–0.9	0.4
Current account balance	0.4	2.8	5.8	6.0	6.5	5.4	5.4	4.2	6.0
Capital account balance	–0.2	0.1	0.3	0.4	–0.0	0.1	0.8	–0.0	–0.4
Foreign direct investment (net)	1.7	0.5	–1.7	–1.2	–7.0	0.7	0.9	0.8	5.3
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	108.8	114.6	110.5	114.7	114.6	112.3	110.5	116.8	119.9
Gross official reserves (excluding gold)[1]	1.7	1.6	1.6	1.5	1.5	1.7	1.6	2.0	2.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
	EUR million, period total								
GDP at current prices	36,869	36,006	36,144	8,292	9,275	9,307	9,269	8,571	9,583

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

[1] *Given Slovenia's adoption of the euro, the calculation of international reserves has changed as of the beginning of 2007. Specifically, reserves no longer include foreign assets in euro and claims on euro area residents.*

4 Bulgaria: Domestic Demand Decelerates After Bank Runs

After a respectable start into the year, the June bank run put a drag on the recovery

The moderate economic expansion that started in the second half of 2013 continued also in the first half of 2014 but has recently lost pace. Although real GDP growth accelerated in the course of the first half of 2014, its composition changed quite strongly. The main growth driver in the first quarter of 2014 was domestic demand, as all its components expanded vigorously, whereas net exports showed a strong negative growth contribution on the back of near-zero export growth. The second quarter, in contrast, brought a deceleration of domestic demand, especially of private consumption, while export growth resumed somewhat, keeping overall GDP on an expansionary path. The deceleration of domestic demand coincides with the deposit run on Bulgaria's third- and fourth-largest banks in June 2014 and seems to have carried over to the second half of the year, as industrial production has recently faltered, consumer sentiment has deteriorated, and lending to households is again stagnating after having expanded by about 2% in the first half of 2014.

Positive labor market trends, slowing deflation

On a positive note, unemployment has come down a bit, but its structural composition – the share of long-term and old-age unemployed persons is fairly large – has remained unfavorable. Consumer prices are still declining, though less quickly recently (the annual HICP dropped by 1.0% in August), driven until the first quarter of 2014 mainly by a decline in energy prices and more recently by a decline in prices for nonenergy industrial goods and services.

Challenging rescue of troubled banks, spillovers to the rest of the sector have been kept in check

The bank runs on Corporate Commercial Bank (CCB) and First Investment Bank (FIB) in June 2014 revealed connected lending practices, undue risk concentration and questionable institutional effectiveness (notably in respect of banking supervision and resolution). FIB and CCB are owned to a major extent by the domestic private sector and account for about 20% of the banking system's total assets. The Bulgarian National Bank (BNB) put CCB under conservatorship and opened a procedure for declaring bankruptcy, which would mark the first bank insolvency in Bulgaria since the late 1990s. Most pressing at the time of writing is the fact that legal restrictions have prevented the payout of insured deposits with CCB and the shortage of funds in the Bulgarian bank deposit guarantee fund (of about 2% of GDP). Solving this issue will be a key priority right after the early parliamentary elections on October 5.

Bulgaria's currency board arrangement has not come under pressure, as the abundant coverage of base money by gross foreign reserves (of about 180%) has remained unchanged. Spillovers to the rest of the Bulgarian banking sector have been negligible, at least based on figures for the second quarter of 2014. Profitability and banking sector capitalization are in comparatively sound shape (with a return-on-assets ratio stabilizing at 0.8% and a capital adequacy ratio rising to 21%). However, NPLs reached a new peak of 15.5% of total loans, while their coverage by provisions and reserves deteriorated from more than 70% in 2013 to just 54%.

Bank rescue impacts public finance positions, budgetary target for 2014 will not be met

Pointing to weaker-than-expected economic performance, budget revenue underperformance, and blocked financing under two EU programs, the caretaker minister of finance conceded that the targeted 2014 budget deficit of 1.8% of GDP would clearly be missed and could exceed the Maastricht ceiling of 3%. Moreover, the caretaker cabinet expects gross government debt to reach a maximum of 28.4% of GDP at year-end, up from 18.9% in 2013, partly due to the restructuring of CCB. Political parties have frequently discussed tapping the fiscal reserve account (standing at 10% of GDP in August 2014) to cover the deposit guarantee gap instead of issuing new debt.

Table 4

Main Economic Indicators: Bulgaria

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
Year-on-year change of the period total in %									
GDP at constant prices	1.8	0.6	0.9	0.9	–0.1	1.1	1.6	1.4	2.1
Private consumption	1.5	3.7	–2.3	–2.3	–3.0	–2.2	–1.7	3.8	0.3
Public consumption	1.6	–0.5	2.5	4.0	4.3	3.7	–0.7	3.3	2.6
Gross fixed capital formation	–6.5	4.0	–0.3	–5.0	–4.8	2.1	4.6	4.6	3.4
Exports of goods and services	12.3	–0.4	8.9	11.9	4.6	9.5	10.2	0.1	3.4
Imports of goods and services	8.8	3.3	5.7	5.7	2.0	8.4	6.7	5.5	2.0
Contribution to GDP growth in percentage points									
Domestic demand	0.0	3.1	–1.1	–2.8	–1.7	–0.5	–0.0	5.5	1.1
Net exports of goods and services	1.8	–2.5	2.0	3.7	1.7	1.5	1.6	–4.2	0.9
Exports of goods and services	7.1	–0.3	6.0	8.0	3.1	6.9	6.0	0.1	2.4
Imports of goods and services	–5.2	–2.2	–3.9	–4.3	–1.5	–5.4	–4.4	–4.3	–1.5
Year-on-year change of the period average in %									
Unit labor costs in the whole economy (nominal, per hour)	2.2	4.4	5.4	7.7	7.9	3.8	1.9	1.3	0.8
Unit labor costs in manufacturing (nominal, per hour)	–1.0	2.6	2.5	2.3	5.1	3.1	–0.3	1.8	3.5
Labor productivity in manufacturing (real, per hour)	4.4	2.2	2.5	4.1	–0.7	1.5	5.5	3.3	3.6
Labor costs in manufacturing (nominal, per hour)	3.7	4.8	5.1	6.5	4.4	4.7	5.1	5.1	7.2
Producer price index (PPI) in industry	9.3	4.4	–1.5	1.7	–0.9	–3.1	–3.6	–2.8	–1.2
Consumer price index (here: HICP)	3.4	2.4	0.4	2.1	1.1	–0.7	–1.0	–1.8	–1.6
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Period average levels									
Unemployment rate (ILO definition, %, 15–64 years)	11.4	12.4	13.0	13.8	13.0	12.1	13.2	13.1	11.5
Employment rate (%, 15–64 years)	58.4	58.8	59.5	57.7	59.5	61.1	59.6	59.0	61.0
Key interest rate per annum (%)[1]	. .	. .	. .	. .	. .	. .	. .	. .	. .
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Nominal year-on-year change in the period-end stock in %									
Broad money (including foreign currency deposits)	12.2	8.4	8.9	8.9	7.7	8.1	8.9	8.3	7.4
Contributions to the year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	7.9	7.5	4.9	5.7	6.2	3.3	4.9	6.0	3.4
Domestic credit of the banking system	7.3	2.4	3.2	3.9	1.2	4.0	3.2	1.9	5.5
of which: claims on the private sector	3.9	2.6	0.3	2.0	0.6	0.2	0.3	1.3	2.1
claims on households	–0.2	–0.3	–0.0	–0.4	–0.3	–0.2	–0.0	0.1	0.1
claims on enterprises	4.1	3.0	0.3	2.4	0.8	0.4	0.3	1.2	2.1
claims on the public sector (net)	3.4	–0.2	3.0	1.9	0.7	3.8	3.0	0.6	3.3
Other assets (net) of the banking system	–3.0	–1.4	0.8	–0.8	0.3	0.7	0.8	0.5	–1.4
% of GDP									
General government revenues	32.6	34.7	37.1	. .	. .	. .	. .	. .	. .
General government expenditures	34.7	35.2	38.3	. .	. .	. .	. .	. .	. .
General government balance	–2.0	–0.5	–1.2	. .	. .	. .	. .	. .	. .
Primary balance	–1.4	0.3	–0.4	. .	. .	. .	. .	. .	. .
Gross public debt	15.7	18.0	18.3	. .	. .	. .	. .	. .	. .
% of GDP									
Debt of nonfinancial corporations (nonconsolidated)	116.5	116.7	116.6	. .	. .	. .	. .	. .	. .
Debt of households and NPISHs (nonconsolidated)	28.2	26.8	26.7	. .	. .	. .	. .	. .	. .
% of GDP (based on EUR), period total									
Trade balance	–5.6	–8.7	–6.1	–5.5	–8.2	–4.0	–6.7	–10.6	–7.4
Services balance	6.0	5.7	5.7	1.3	4.9	13.8	1.7	1.7	5.6
Income balance (factor services balance)	–4.7	–3.3	–3.4	–4.0	–2.9	–4.5	–2.3	–3.9	–1.0
Current transfers	4.4	5.2	6.0	3.8	12.0	4.8	3.4	8.9	5.3
Current account balance	0.1	–1.1	2.1	–4.4	5.8	10.0	–3.9	–3.8	2.5
Capital account balance	1.3	1.4	1.2	0.2	1.3	1.5	1.5	1.5	2.0
Foreign direct investment (net)	3.1	2.2	2.4	4.0	4.2	2.6	–0.5	5.0	2.4
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	94.3	94.5	93.5	94.0	93.6	93.4	93.5	92.7	92.7
Gross official reserves (excluding gold)	30.6	34.9	33.3	32.1	33.4	34.3	33.3	32.1	32.8
Months of imports of goods and services									
Gross official reserves (excluding gold)	5.6	6.0	5.7	5.6	5.8	5.9	5.7	5.4	5.5
EUR million, period total									
GDP at current prices	38,505	39,927	39,940	8,389	9,809	10,768	10,974	8,231	9,979

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

[1] *Not available in a currency board regime.*

5 Croatia: Falling Domestic Demand Prolongs Recession

Further economic contraction on the back of negative domestic demand

The protracted recession in Croatia was prolonged into the first half of 2014, with GDP declining by 0.7%. All components of domestic demand contributed negatively to growth, most of all the decline of investments, which is related to a weakening outlook and, more recently, increased uncertainty. Household consumption was also subdued on the back of falling disposable incomes. Public consumption turned negative in light of consolidation measures. The only positive contribution came from increasing net exports, since exports rose faster than imports. The most notable contractions on the output side were registered in the construction and agricultural sectors. On the positive side, value added in the manufacturing sector is showing tentative signs of recovery. Labor market conditions remained broadly unchanged. Notably, however, youth unemployment showed a clear downward trend.

Inflation continued to fall and slipped into negative territory from February to April 2014. However, the price level started to increase again slightly from May on, with the annual HICP inflation rate climbing to 0.3% by August. Subdued price dynamics were mainly due to falling food prices, but core inflation also slowed down considerably, as the economy remains in recession.

Weak fiscal situation prompts Fitch Ratings to downgrade sovereign rating

As Croatia will probably not meet the 2014 budget deficit target of 4.5% of GDP, a budget revision was announced for late autumn. The government also plans to introduce new consolidation measures, including a cut in public sector wages and the introduction of a 12% tax on savings interest as of January 1, 2015. In the course of the EDP, Croatia has to bring down its public sector deficit to 3% of GDP by 2016. Following Standard & Poor's downgrade to "BB" in January, Fitch Ratings lowered Croatia's sovereign rating from "BB+" to "BB" in August, citing increasing risks regarding Croatia's ability to stabilize its high public debt-to-GDP-ratio in the medium term. Despite these fiscal problems, the country has been able to tap international markets. In May, Croatia successfully issued eight-year eurobonds worth EUR 1.25 billion.

With exports rising, current account balance remains in surplus

In the first half of 2014, the current account balance remained in surplus (four-quarter moving sum), with the surplus falling somewhat on the back of a decrease of net current transfers, as payments into the EU budget raised outflows, and on the back of a widening income deficit. Strongly rising exports (+9.9% in the first half of 2014 compared to the same period of 2013) increased the surplus in the goods and service balance to 1.7% of GDP (four-quarter moving sum). However, due to changes in the compilation of trade statistics in the course of EU accession, these numbers have to be treated with caution. On the financing side, net FDI flows decreased slightly to 1.5% of GDP (four-quarter moving sum) until mid-2014. Gross external debt reached 106.4% of GDP at the end of June 2014, a slight increase compared to end-2013.

Ongoing private sector credit contraction

Domestic lending to the private sector continued to contract, with a yearly decline of 3.1% as of July. In contrast, loans to the government increased strongly. The share of NPLs in total loans grew further to 12.2% in June 2014 (compared to 11.6% at end-2013). Banks' profitability, measured in terms of return on assets, increased to 0.65% in the first half of 2014.

Table 5

Main Economic Indicators: Croatia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	–0.3	–2.2	–0.9	–1.8	–0.5	–0.5	–1.1	–0.6	–0.8
Private consumption	0.3	–3.0	–1.2	–2.8	–0.0	–0.3	–1.7	–0.5	–0.5
Public consumption	–0.3	–1.0	0.5	0.2	1.3	–0.8	1.4	–2.1	–3.4
Gross fixed capital formation	–2.7	–3.3	–1.0	–2.4	0.8	0.3	–3.1	–3.6	–5.2
Exports of goods and services	2.2	–0.1	3.0	–0.8	0.7	3.7	7.4	11.4	7.9
Imports of goods and services	2.5	–3.0	3.2	–4.5	5.4	5.3	6.0	7.6	2.2
	Contribution to GDP growth in percentage points								
Domestic demand	–0.1	–3.3	–1.3	–3.1	1.3	–1.3	–2.1	–1.4	–2.8
Net exports of goods and services	–0.1	1.2	–0.0	1.7	–2.0	0.1	0.2	0.4	2.0
Exports of goods and services	0.8	–0.1	1.3	–0.3	0.3	2.2	2.7	3.6	3.0
Imports of goods and services	–0.9	1.2	–1.3	1.9	–2.3	–2.1	–2.5	–3.1	–1.0
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Unit wage costs in manufacturing (nominal, per hour)	0.9	2.8	2.7	–1.9	4.4	7.9	1.5	–6.4	–5.0
Labor productivity in manufacturing (real, per hour)	1.7	1.7	–1.2	6.8	–3.0	–5.8	–1.3	5.1	5.5
Gross wages in manufacturing (nominal, per hour)	2.3	4.1	1.9	4.7	1.3	1.7	0.2	–1.6	0.2
Producer price index (PPI) in industry	6.4	7.0	0.5	4.1	1.1	–0.6	–2.7	–2.7	–2.7
Consumer price index (here: CPI)	2.2	3.3	2.3	4.2	2.4	2.2	0.6	0.1	0.3
EUR per 1 HRK, + = HRK appreciation	–2.0	–1.1	–0.8	–0.4	–0.4	–1.0	–1.3	–0.9	–0.6
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	13.9	16.3	17.5	18.2	17.0	17.0	17.9	18.8	16.7
Employment rate (%, 15–64 years)	52.4	50.7	52.6	50.7	53.1	53.7	52.7	52.7	54.6
Key interest rate per annum (%)	6.0	7.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0
HRK per 1 EUR	7.4	7.5	7.6	7.6	7.6	7.5	7.6	7.7	7.6
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	1.6	3.2	2.9	4.4	3.4	5.1	2.9	3.3	2.7
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–4.2	6.3	5.7	7.8	4.8	5.5	5.7	4.5	6.1
Domestic credit of the banking system	8.8	–0.8	–3.0	–0.5	–1.5	0.4	–3.0	–2.6	–4.3
of which: claims on the private sector	4.9	–4.1	–1.0	–4.2	–3.2	–1.0	–1.0	–1.7	–3.0
claims on households	0.5	–0.7	–0.9	–0.6	–1.4	–0.2	–0.9	–0.7	–0.3
claims on enterprises	4.4	–3.4	–0.2	–3.6	–1.8	–0.8	–0.2	–0.9	–2.7
claims on the public sector (net)	3.9	3.3	–2.0	3.7	1.6	1.4	–2.0	–0.9	–1.3
Other assets (net) of the banking system	–3.0	–2.4	0.3	–2.9	0.2	–0.8	0.3	1.4	0.9
	% of GDP								
General government revenues	40.3	40.8	41.0	. .	. .	. .	. .	. .	. .
General government expenditures	48.1	45.7	45.9	. .	. .	. .	. .	. .	. .
General government balance	–7.8	–5.0	–4.9	. .	. .	. .	. .	. .	. .
Primary balance	–5.2	–2.0	–1.9	. .	. .	. .	. .	. .	. .
Gross public debt	52.0	55.9	67.1	. .	. .	. .	. .	. .	. .
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	. .	89.0	87.2	. .	. .	. .	. .	. .	. .
Debt of households and NPISHs (nonconsolidated)	. .	41.4	40.6	. .	. .	. .	. .	. .	. .
	% of GDP (based on EUR), period total								
Trade balance	–13.8	–13.7	–14.6	–15.2	–17.7	–13.2	–12.3	–14.6	–16.2
Services balance	13.9	14.6	15.5	1.9	15.1	37.7	4.1	1.8	15.8
Income balance (factor services balance)	–3.6	–3.6	–2.5	–3.3	–2.9	–2.5	–1.4	–3.8	–4.0
Current transfers	2.6	2.6	2.4	2.8	3.2	1.9	1.9	0.7	1.6
Current account balance	–0.9	–0.1	0.9	–13.8	–2.3	24.0	–7.6	–15.9	–2.9
Capital account balance	0.1	0.1	0.1	–0.0	0.2	0.1	0.2	0.0	0.2
Foreign direct investment (net)	2.3	2.5	1.6	5.8	–0.4	–0.4	1.8	2.1	2.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	102.7	102.1	104.7	102.3	104.5	102.5	104.7	107.0	106.4
Gross official reserves (excluding gold)	25.0	25.6	29.6	25.7	27.3	26.7	29.6	27.9	28.6
	Months of imports of goods and services								
Gross official reserves (excluding gold)	7.2	7.2	8.2	7.3	7.7	7.5	8.2	7.7	7.8
	EUR million, period total								
GDP at current prices	44,187	43,488	43,132	9,930	10,853	11,727	10,623	9,751	10,788

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

6 Czech Republic: Continued Recovery Supported by Favorable Macroeconomic Conditions

Broadly favorable economic momentum on the back of rising investment

Despite some moderation, the Czech economy generally managed to keep up the economic momentum that had started in the final quarter of 2013. On the back of rising gross fixed capital formation, GDP grew by 2.7% in the second quarter of 2014, after growing by 2.9% in the first quarter. Export growth also accelerated markedly. This momentum was supported by favorable unit labor cost (ULC) developments in national currency, the continuing macroeconomic strength of key export markets as well as exchange rate intervention by the CNB. Recent high-frequency indicators have corroborated the positive development. Industrial production increased markedly in the second quarter, the main driving force being the automotive industry, with car production rising by 11% year on year. Against the background of rising import demand related to lively domestic demand and a comparatively high import content of exports, the growth contribution of the external sector turned negative in the second quarter, however. Modest increases in private and public consumption point to a more broadly based economic recovery spurred by domestic demand.

The stronger overall performance of the Czech economy translated into somewhat faster labor market improvements. The unemployment rate fell to 6.1% in the second quarter from 6.8% a year earlier. But the employment rate also increased, rising to 68.7% in the second quarter.

In late September, the CNB decided not to discontinue its exchange rate commitment before 2016, given very subdued price dynamics. The depreciation of the koruna vis-à-vis the euro led to a trade surplus of around 7.6% of GDP in the second quarter, falling slightly to approximately 7% in the second quarter. The current account balance returned to negative territory in the second quarter, due to a rising deficit in the income balance related to outflows from FDI income.

Inflation continued its downward trend in the aftermath of the CNB's exchange rate intervention. While still positive, inflation remained at levels well below the CNB's lower tolerance boundary (2% ±1%), falling to 0.2% in the second quarter of 2014. Core inflation remained rather stable throughout the review period. However, recent figures reveal an upward trend in inflation. The rather unexpected increase of inflation to around 0.7% in August was mainly driven by food prices and nonalcoholic beverage prices. In addition, inflation expectations as measured by analyst surveys shed some positive light on the future development of inflation, indicating a convergence of expectations with the CNB's inflation target.

The banking sector remained robust, with strong balance sheets, high-quality assets and low NPL ratios. Credit growth accelerated somewhat in the first half of 2014, rising from 1.5% to around 4% in the second quarter of 2014. By historical standards it remained muted, however. This was mainly due to continuing low credit demand and tighter lending standards. After approaching historical lows, Treasury bond yields, increased as risk appetites returned.

New government to spur consumption by raising minimum wage and lowering consumption taxes

The new center-left government, which took office in January, intends to promote domestic demand inter alia by strengthening social welfare schemes and a reform of the VAT system. Previous plans to unify the value added tax (VAT) system have been discarded in favor of a third, reduced rate of 10% for various products like books and medicines. Moreover, the new government plans to raise the minimum wage and return to full pension indexation.

Table 6

Main Economic Indicators: Czech Republic

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	1.8	–1.0	–0.9	–2.9	–1.7	–0.1	0.8	2.9	2.7
Private consumption	0.5	–2.1	0.1	–1.7	–0.2	1.3	1.0	1.5	1.9
Public consumption	–2.7	–1.9	1.6	1.1	0.8	2.6	1.9	1.1	2.2
Gross fixed capital formation	0.4	–4.5	–3.5	–6.8	–6.6	–3.2	1.7	6.2	6.8
Exports of goods and services	9.5	4.5	0.2	–5.3	0.5	2.8	2.8	12.0	8.9
Imports of goods and services	7.0	2.3	0.6	–4.5	–0.9	5.2	2.5	11.9	11.3
	Contribution to GDP growth in percentage points								
Domestic demand	–0.1	–2.7	–0.6	–1.9	–2.7	1.4	0.5	1.8	3.7
Net exports of goods and services	1.9	1.7	–0.3	–1.0	1.0	–1.5	0.3	1.1	–1.0
Exports of goods and services	6.4	3.3	0.1	–4.4	0.4	2.1	2.2	9.7	7.0
Imports of goods and services	–4.4	–1.6	–0.4	3.4	0.6	–3.7	–1.8	–8.7	–8.0
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	0.1	2.0	–0.8	–0.4	–0.4	0.4	–2.8	1.0	1.0
Unit labor costs in manufacturing (nominal, per hour)	–3.3	2.5	0.6	1.6	1.3	2.1	–2.8	–3.0	–4.0
Labor productivity in manufacturing (real, per hour)	6.6	–0.6	–1.1	–0.2	–2.2	–6.4	4.4	7.7	7.8
Labor costs in manufacturing (nominal, per hour)	3.2	2.0	–0.6	1.4	–0.9	–4.5	1.5	4.5	3.5
Producer price index (PPI) in industry	3.7	2.4	0.7	0.8	0.2	0.3	1.4	1.2	1.3
Consumer price index (here: HICP)	2.1	3.5	1.4	1.7	1.5	1.2	1.1	0.3	0.2
EUR per 1 CZK, + = CZK appreciation	2.9	–2.2	–3.2	–1.9	–2.2	–3.0	–5.7	–6.8	–5.9
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.8	7.1	7.0	7.5	6.8	7.0	6.8	6.9	6.1
Employment rate (%, 15–64 years)	65.7	66.6	67.7	66.8	67.8	68.0	68.3	68.1	68.7
Key interest rate per annum (%)	0.8	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1
CZK per 1 EUR	24.6	25.1	26.0	25.6	25.8	25.9	26.7	27.4	27.4
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	2.8	4.8	5.8	5.1	4.6	5.8	5.8	5.8	5.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–0.8	5.4	5.6	6.1	3.7	4.2	5.6	7.5	5.5
Domestic credit of the banking system	7.9	1.5	3.5	2.7	1.7	3.1	3.5	1.5	4.1
of which: claims on the private sector	4.1	1.9	2.8	2.5	1.8	2.1	2.8	1.9	2.5
claims on households	2.2	1.6	1.4	1.5	1.5	1.7	1.4	1.5	1.4
claims on enterprises	1.9	0.3	1.3	1.0	0.3	0.4	1.3	0.3	1.1
claims on the public sector (net)	3.7	–0.4	0.8	0.2	–0.1	0.9	0.8	–0.4	1.6
Other assets (net) of the banking system	–4.3	–2.1	–3.3	–3.7	–0.9	–1.5	–3.3	–3.2	–4.6
	% of GDP								
General government revenues	39.6	39.8	40.7	..	..	..	..	..	..
General government expenditures	42.5	43.8	42.0	..	..	..	..	..	..
General government balance	–2.9	–4.0	–1.3	..	..	..	..	..	..
Primary balance	–1.6	–2.6	0.1	..	..	..	..	..	..
Gross public debt	41.0	45.5	45.7	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	43.5	47.6	44.7	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	29.9	32.4	30.4	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	2.4	3.9	4.9	5.9	6.4	3.6	3.6	7.6	6.9
Services balance	1.5	1.6	1.4	1.6	1.4	1.0	1.4	2.1	1.0
Income balance (factor services balance)	–6.7	–6.8	–8.1	–7.3	–8.6	–8.7	–7.5	–2.6	–13.0
Current transfers	0.1	–0.1	0.4	0.9	–0.6	–0.3	1.5	0.5	1.7
Current account balance	–2.7	–1.3	–1.4	1.1	–1.4	–4.3	–1.0	7.7	–3.3
Capital account balance	0.4	1.4	1.9	0.0	–0.0	5.5	2.0	2.3	0.0
Foreign direct investment (net)	1.2	3.2	0.9	3.0	1.0	–0.6	0.2	3.1	5.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	46.8	50.8	54.1	51.1	52.1	50.7	54.1	52.7	55.6
Gross official reserves (excluding gold)	19.7	21.9	27.1	22.5	21.9	22.3	27.1	27.8	28.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	3.4	3.6	4.4	3.7	3.6	3.7	4.4	4.4	4.4
	EUR million, period total								
GDP at current prices	155,452	152,911	149,441	35,115	37,492	38,034	38,800	34,406	37,109

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

7 Hungary: Growth Picks Up, Domestic Demand Strengthens

GDP growth at eight-year high

GDP growth accelerated to 3.8% year on year during the first half of 2014 amid a rapid upturn of domestic demand that was in part due to short-term stimulus measures. Investment growth rose to 17% on the back of falling interest rates, the Funding for Growth Scheme (FGS) of Magyar Nemzeti Bank (the MNB), accelerated utilization of EU funds and improving business sentiment. Household consumption growth also strengthened, as falling inflation and accelerating nominal wage growth fueled real income growth, employment increased sharply (in part owing to the expansion of the public works scheme), the unemployment rate eased, consumer confidence improved strongly and deleveraging slowed. Although export growth was robust during the first half of the year, it was slightly outpaced by import growth, so that the contribution of net real exports to GDP growth was minimal.

European Council calls for additional fiscal consolidation efforts

In June 2014, the European Council called on Hungary to reinforce the budgetary measures for 2014 to avoid a breach of the debt reduction rule. Furthermore, in 2015 Hungary should significantly strengthen its budgetary strategy to ensure that it reaches its medium-term objective (a structural deficit of –1.7% of GDP; compared to the Commission's forecast of –2.2% for 2014) and compliance with the debt reduction requirements. Among its seven recommendations to Hungary, the Council also urged restoring normal lending flows to the economy, creating a more stable, balanced and streamlined tax system, strengthening labor market policies, fostering competition, improving the education system and enhancing the functioning of the energy market.

New measures to support indebted households hit banks

The MNB continued to cut the policy rate in decreasing monthly steps until July 2014. Following the cut to 2.1% in July, the council expressed its view that the level reached was consistent with the medium-term inflation target (3%) and that the policy rate was likely to stay stable for an extended period. Inflation fell to around 0% during the summer, as subdued consumption, low imported inflation, the lowering of inflation expectations and repeated cuts in regulated utility prices contained inflationary pressures. Parallel to the rate cuts, the utilization of the MNB's FGS has increased, and at the beginning of September 2014, the council decided to double the maximum refinancing volume of the current tranche (available until end-2014) to around 3.3% of GDP. Despite easing lending conditions, credit developments outside the FGS have remained weak, especially for households. Banking sector profitability and the capital position received a blow in July 2014, when Parliament passed legislation obliging banks to retroactively apply the MNB's official exchange rate for the disbursement and servicing of foreign currency loans to consumers (and hence to pay back exchange rate margins), and to compensate consumers for unilateral increases in interest rates, charges and fees relating to local and foreign currency loans unless banks can prove the fairness of these increases before court. The Bank Association has appealed to the Constitutional Court, claiming that the measures – inter alia – create legal uncertainty due to their retroactive character and the restrictive procedural regulations. The two measures are expected to cost financial institutions around 3% of GDP or nearly 30% of their capital. Moreover, the government has announced that it will table new legislation until end-2014 to convert households' foreign currency loans into domestic currency loans, presumably causing additional losses to banks, although the MNB has indicated its participation in the scheme to ward off currency depreciation.

Table 7

Main Economic Indicators: Hungary

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	1.6	–1.7	1.1	–0.9	0.5	1.9	2.7	3.7	3.9
Private consumption	0.4	–1.6	0.3	–0.7	0.3	0.2	1.3	1.6	2.3
Public consumption	–0.0	–1.2	1.2	1.8	2.7	0.2	0.1	1.8	–1.1
Gross fixed capital formation	–5.9	–3.7	5.8	–5.5	5.4	8.3	10.5	13.9	18.7
Exports of goods and services	8.4	1.7	5.3	2.2	3.6	6.4	8.9	7.7	6.7
Imports of goods and services	6.4	–0.1	5.3	1.7	6.0	5.8	7.6	7.8	7.3
	Contribution to GDP growth in percentage points								
Domestic demand	–0.5	–3.3	0.7	–1.4	2.2	0.8	1.1	3.1	4.0
Net exports of goods and services	2.1	1.6	0.4	0.6	–1.8	1.1	1.5	0.5	–0.0
Exports of goods and services	7.2	1.5	5.0	2.2	3.5	5.9	8.0	7.7	6.5
Imports of goods and services	–5.1	0.1	–4.6	–1.5	–5.2	–4.9	–6.5	–7.2	–6.5
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	2.2	2.8	4.0	4.0	4.7	3.4	3.9	3.7	2.3
Unit labor costs in manufacturing (nominal, per hour)	4.5	6.4	2.6	6.5	2.6	1.8	–0.1	–3.9	–3.6
Labor productivity in manufacturing (real, per hour)	1.4	0.8	1.1	–2.0	0.5	1.5	3.9	7.6	7.7
Labor costs in manufacturing (nominal, per hour)	6.0	7.4	3.6	4.3	3.1	3.3	3.8	3.3	3.8
Producer price index (PPI) in industry	4.2	4.2	0.6	0.6	–0.1	1.6	0.3	–0.6	–1.1
Consumer price index (here: HICP)	3.9	5.7	1.7	2.7	1.9	1.6	0.7	0.4	–0.1
EUR per 1 HUF, + = HUF appreciation	–1.4	–3.5	–2.6	0.1	–0.5	–5.0	–4.8	–3.7	–3.4
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	11.0	11.0	10.3	11.8	10.3	9.9	9.2	8.4	8.0
Employment rate (%, 15–64 years)	55.8	57.2	58.5	56.6	58.3	59.2	59.7	60.9	61.7
Key interest rate per annum (%)	6.0	6.8	4.4	5.5	4.7	4.0	3.3	2.8	2.5
HUF per 1 EUR	279.3	289.3	296.9	296.6	295.6	298.0	297.6	308.1	305.9
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	5.9	–3.3	5.5	5.6	4.6	3.3	5.5	1.0	3.7
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	17.6	5.3	6.6	14.4	10.3	1.0	6.6	4.8	8.3
Domestic credit of the banking system	–3.1	–11.8	0.2	–5.2	–4.4	5.8	0.2	–4.1	–2.5
of which: claims on the private sector	–0.6	–13.7	–4.6	–6.0	–6.5	–2.9	–4.6	–4.8	–2.1
claims on households	–0.5	–7.3	–2.3	–2.0	–2.7	–1.6	–2.3	–2.9	–1.5
claims on enterprises	–0.1	–6.3	–2.3	–3.9	–3.7	–1.3	–2.3	–1.9	–0.7
claims on the public sector (net)	–2.6	1.8	4.8	0.8	2.1	8.7	4.8	0.7	–0.4
Other assets (net) of the banking system	–8.6	3.2	–1.3	–3.6	–1.2	–3.6	–1.3	0.3	–2.0
	% of GDP								
General government revenues	44.4	46.4	47.3	..	..	..	..	..	..
General government expenditures	49.9	48.7	49.7	..	..	..	..	..	..
General government balance	–5.5	–2.3	–2.4	..	..	..	..	..	..
Primary balance	–1.3	2.3	2.2	..	..	..	..	..	..
Gross public debt	81.0	78.5	77.3	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	115.6	121.1	115.1	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	33.6	31.6	28.7	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance[1]	3.0	3.1	3.7	4.1	3.2	4.6	2.8	4.3	2.3
Services balance[1]	3.3	3.9	4.1	4.1	4.4	5.2	2.9	3.7	4.8
Primary income[1]	–4.9	–4.3	–3.0	–2.6	–3.8	–2.9	–2.5	–2.2	–3.2
Secondary income[1]	–0.6	–0.8	–0.6	–1.7	–0.4	–0.7	0.3	–1.1	–0.7
Current account balance[1]	0.8	1.9	4.2	3.9	3.4	6.2	3.4	4.8	3.2
Capital account balance[1]	2.4	2.6	3.7	2.8	3.4	2.4	6.0	2.2	3.1
Foreign direct investment (net)[1]	1.0	2.1	0.4	2.0	–3.7	–3.2	6.1	2.8	–7.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt [1]	136.9	131.0	121.7	129.8	128.6	121.9	121.7	121.5	122.4
Gross official reserves (excluding gold)[1]	38.1	34.8	34.4	36.2	34.8	31.3	34.4	36.6	36.3
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	5.5	5.1	5.0	5.4	5.1	4.6	5.0	5.3	5.2
	EUR million, period total								
GDP at current prices	98,872	97,129	97,943	21,729	24,425	25,128	26,661	22,365	24,907

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

[1] *Data based on the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).*

8 Poland: Continued Consolidation Challenges amid Balanced Growth

Impressive rebound of investment coupled with sustained trade surplus

In the first half of 2014, annual GDP growth was 3½%, with exports contributing nearly 3 percentage points and domestic demand 4 percentage points. Strong growth of total final demand caused imports to grow moderately stronger than exports, implying a negative net export contribution. In parallel, the surplus in the goods and services balance declined, but the current account deficit improved to 1% of GDP, as the deficit in the income balance contracted.

Domestic demand benefited from stronger private consumption, restocking and a large contribution of gross fixed capital formation. Higher hourly wage growth, further disinflation and employment growth sufficiently strong to lower the unemployment rate lifted the real wage sum. Together with the substantial real rise of average retirement pensions, this improved sentiment, stimulated demand for consumption loans and accelerated consumption growth. Fixed investment benefited from higher export growth and the improved domestic demand situation and outlook. While housing loans continued to grow at a moderate level, business investment financing could rely on the growing share of profitable companies, the favorable liquidity position of the corporate sector and accelerating corporate credit. Moreover, investment was supported by the ample availability of EU funds. Early in the year, one-off effects also lifted investment.

Door opened to further monetary easing

The price competitiveness of Polish manufacturing compared to the euro area was weaker year on year in the first half of 2014, as accelerated wage growth exceeded productivity gains and as the złoty was slightly stronger against the euro than a year earlier. In August, annual headline inflation was negative (–0.1% HICP, –0.3% national CPI), while core inflation stood at 0.4% (HICP) and 0.5% (CPI). Headline inflation was lower than core inflation, as energy prices and above all food prices decreased year on year. Having maintained the reference rate at 2.5% since July 2013, the Polish Monetary Policy Council (MPC), pursuing an inflation target of 2.5% (CPI), highlighted its readiness in September to cut key rates depending on incoming data.[5]

Window of opportunity for required improvements in the structural balance

In April 2014, the government's convergence program envisaged a general government surplus of 5.8% of GDP in 2014 and a deficit of 2.5% in 2015. However, these figures include the transfers of assets and liabilities from private pension funds to the public pay-as-you-go system, comprising both the one-off transfer in 2014 and annual asset transfers by people retiring within ten years, starting in 2014. Under ESA 2010, these asset transfers do not count as revenue. According to these new accounting rules, in June, the Commission assessed that Poland would meet the December 2013 Council recommendations for 2014 (headline deficit of 3.9%, structural deficit improvement by 1 percentage point to 2.8% of GDP), but not those for 2015 (headline deficit of 2.8%, structural improvement of 1.2 percentage points), with forecasts of a headline deficit of 3.1% and a structural deficit of 2.4% of GDP. On July 8, 2014, the Council saw risks to a sustainable correction of the excessive deficit by the established deadline (2015) and reiterated its recommendations for 2015. General government gross debt, as shown under ESA 2010, is set to decrease from 55.7% of GDP at end-2013 to below 50% of GDP at end-2014, as the transfer of assets impacts on the accounted debt level also under the new rules.

[5] *On October 8, after the cutoff date, the MPC cut the reference rate to 2.0% and the lombard rate from 4% to 3%, as incoming data pointed to a deceleration in economic growth and an increased risk of inflation running below the target in the medium term. However, it left the deposit rate unchanged at 1%.*

Table 8

Main Economic Indicators: Poland

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	4.5	2.0	1.6	0.4	1.2	2.2	2.3	3.8	3.3
Private consumption	2.6	1.3	0.8	–0.1	0.2	0.9	2.2	2.1	2.8
Public consumption	–1.7	0.2	2.8	–0.1	5.6	2.7	3.0	0.6	1.1
Gross fixed capital formation	8.5	–1.6	–0.2	–2.7	–3.4	0.7	2.1	10.9	8.4
Exports of goods and services	7.7	3.9	4.6	1.3	3.4	7.4	6.1	7.7	5.4
Imports of goods and services	5.5	–0.7	1.2	–1.7	–2.0	4.0	4.6	5.6	9.8
	Contribution to GDP growth in percentage points								
Domestic demand	3.6	–0.1	0.0	–1.0	–1.4	0.5	1.6	2.7	5.1
Net exports of goods and services	0.9	2.1	1.6	1.4	2.6	1.6	0.7	1.1	–1.8
Exports of goods and services	3.3	1.8	2.1	0.6	1.6	3.5	2.6	3.7	2.6
Imports of goods and services	–2.4	0.3	–0.6	0.8	1.0	–1.9	–2.0	–2.6	–4.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	1.3	1.8	0.3	2.1	2.2	0.7	–3.6	–3.1	–3.2
Unit labor costs in manufacturing (nominal, per hour)	0.6	1.8	0.1	2.6	0.5	–0.9	–1.7	–0.5	3.9
Labor productivity in manufacturing (real, per hour)	3.8	2.7	3.3	1.2	1.2	3.5	7.2	5.9	2.8
Labor costs in manufacturing (nominal, per hour)	4.4	4.5	3.3	3.8	1.6	2.6	5.3	5.4	6.8
Producer price index (PPI) in industry	7.3	3.3	–1.2	–0.5	–1.9	–1.1	–1.3	–1.1	–1.0
Consumer price index (here: HICP)	3.9	3.7	0.8	1.3	0.5	0.9	0.6	0.6	0.3
EUR per 1 PLN, + = PLN appreciation	–3.0	–1.6	–0.3	1.8	1.3	–2.6	–1.8	–0.7	0.8
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.8	10.2	10.5	11.4	10.6	9.9	9.9	10.7	9.2
Employment rate (%, 15–64 years)	59.3	59.7	60.0	58.7	59.8	60.7	60.8	60.3	61.3
Key interest rate per annum (%)	4.2	4.6	2.9	3.7	3.0	2.5	2.5	2.5	2.5
PLN per 1 EUR	4.1	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	12.5	4.5	6.2	6.6	7.0	6.1	6.2	5.2	5.2
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	6.4	3.3	–2.8	6.2	0.9	–1.5	–2.8	–4.3	–1.7
Domestic credit of the banking system	14.0	1.0	8.1	4.0	6.6	7.7	8.1	7.9	7.2
of which: claims on the private sector	13.1	2.3	4.2	3.5	3.6	3.9	4.2	5.2	4.9
claims on households	7.4	0.2	2.7	1.6	1.5	2.7	2.7	2.9	2.8
claims on enterprises	5.7	2.1	1.5	1.8	2.1	1.3	1.5	2.3	2.1
claims on the public sector (net)	0.9	–1.3	3.9	0.5	3.0	3.8	3.9	2.6	2.3
Other assets (net) of the banking system	–7.9	0.2	1.0	–3.6	–0.5	–0.1	1.0	1.6	–0.2
	% of GDP								
General government revenues	39.0	39.1	38.2	..	..	..	..	..	..
General government expenditures	43.9	42.9	42.2	..	..	..	..	..	..
General government balance	–4.9	–3.7	–4.0	..	..	..	..	..	..
Primary balance	–2.4	–1.1	–1.5	..	..	..	..	..	..
Gross public debt	54.8	54.4	55.7	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	39.3	43.6	43.0	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	33.4	35.7	35.9	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance[1]	–3.4	–1.9	0.2	–0.9	0.8	0.5	0.1	0.2	0.1
Services balance[1]	1.4	1.6	2.1	2.1	2.6	1.8	1.8	1.8	2.0
Primary income[1]	–3.5	–3.3	–3.5	–2.3	–3.9	–3.9	–3.7	–2.7	–2.6
Secondary income[1]	0.2	–0.0	–0.1	–1.1	0.1	–0.1	0.5	–0.7	–0.1
Current account balance[1]	–5.2	–3.6	–1.3	–2.3	–0.4	–1.6	–1.2	–1.5	–0.6
Capital account balance[1]	2.0	2.2	2.3	0.9	3.5	2.4	2.4	1.6	3.7
Foreign direct investment (net)[1]	2.7	1.4	0.7	1.4	1.7	1.5	–1.4	3.5	–0.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt[1]	67.6	72.8	71.2	72.7	71.1	72.5	71.2	70.6	71.6
Gross official reserves (excluding gold)[1]	19.4	20.5	19.1	21.0	20.3	19.5	19.1	18.2	17.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	5.1	5.4	5.1	5.6	5.5	5.2	5.1	4.9	4.8
	EUR million, period total								
GDP at current prices	370,414	381,792	389,758	91,042	94,401	95,476	108,840	94,981	99,234

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

[1] *Data based on the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).*

9 Romania: GDP Growth Slows as Investments Plummet, Net Exports Contribute Less

Economic activity shrinks quarter on quarter

GDP shrank in the first two quarters of 2014 quarter on quarter, bringing year-on-year growth down to 2.4% in the first half of 2014. The weak growth performance was mainly driven by plummeting investment activity. Somewhat worryingly, in the second quarter of 2014, gross fixed capital formation hit a new low in seasonally adjusted real absolute terms in the post-Lehman period and was down by about one-third compared to the precrisis level in the second quarter of 2008. Private consumption took the lead as a growth driver in the first half of 2014, as it was supported by rising disposable income, which was partly the result of the minimum wage hike in January. The recovery of private consumption also spurred import growth. As a consequence, the contribution of net exports to GDP growth declined, even though export growth – supported by still declining ULCs in the manufacturing sector – remained relatively brisk.

Balance of payments position sound overall despite small current account gap

The current account showed a small deficit in the first half of 2014, compared with an almost balanced position in the first half of 2013. The deterioration was mainly due to an increasing income deficit, in particular caused by dividend payments to foreign direct investors. The slight deterioration of the trade balance was, however, more than compensated by an increasing surplus in the services balance. In the second quarter, the surpluses in the transfers and capital account balances shrank markedly, which is mainly attributable to diminished success in attracting EU structural and cohesion funds, after some positive developments in 2013 and in the first quarter of 2014. Nevertheless, net FDI inflows kept the primary balance in positive territory.

Further disinflation and two more policy rate cuts

Annual consumer price inflation (CPI) fell further to a record low of 0.7% in June before increasing marginally to 0.8% in August, remaining considerably below the Banca Naţională a României's (BNR) inflation target band of 2.5% ±1%. The BNR currently expects inflation to run below the midpoint of the target until mid-2015. Against this background, the BNR in August and September cut its key policy rate in two steps of 25 basis points each to 3%. The BNR sees the causes of low inflation in favorable supply side shocks, the negative output gap, and the impact of subdued inflation in the euro area on import prices.

Latest reviews under precautionary support program still unfinished, presidential elections upcoming

In June, teams from the IMF and the European Commission visited Romania to conduct their reviews under the two-year precautionary support program, but some issues remained outstanding. As reported, the IMF/European Commission teams inter alia had substantial reservations against the 5 percentage point cut in the social security tax that took effect on October 1, while Romanian government officials argued that the fiscal deficit target (2.2% of GDP in 2014) remained unchanged. Following the visit, talks between the Romanian authorities and the teams continued, and according to the Romanian side, there was an agreement on the postponement of the gas price liberalization for households. Under the energy price liberalization roadmap, the household gas price should have been increased by 3% at the beginning of October 2014. Efforts to soften IMF/European Commission requirements have to be seen against the background of the presidential elections upcoming in November.

Table 9

Main Economic Indicators: Romania

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	2.4	0.5	3.5	2.1	1.4	4.2	5.4	3.9	1.2
Private consumption	1.5	1.4	1.3	–0.2	0.4	1.9	2.8	6.4	3.9
Public consumption	0.6	1.0	–1.5	0.9	–5.8	–6.9	3.8	–4.6	2.7
Gross fixed capital formation	7.7	4.2	–3.4	–9.5	–2.2	–2.1	–2.6	–8.4	–12.8
Exports of goods and services	12.0	–1.8	13.1	7.4	8.2	20.3	16.8	15.0	10.7
Imports of goods and services	10.6	–0.3	2.3	–0.1	–3.6	7.9	5.1	13.0	8.7
	Contribution to GDP growth in percentage points								
Domestic demand	2.6	1.0	–0.9	–3.1	–3.5	1.1	0.9	2.9	–0.5
Net exports of goods and services	–0.2	–0.5	4.4	3.2	5.2	4.4	4.6	2.1	1.7
Exports of goods and services	4.1	–0.6	5.5	2.7	4.2	7.8	6.3	9.6	6.2
Imports of goods and services	–4.3	0.1	–1.1	0.5	1.0	–3.4	–1.7	–7.5	–4.6
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	–8.1	5.2	2.1	4.5	2.1	1.7	1.0	1.0	–1.0
Unit labor costs in manufacturing (nominal, per hour)	1.6	7.1	–1.6	1.2	–1.3	–3.8	–2.6	–2.8	–1.9
Labor productivity in manufacturing (real, per hour)	5.1	0.2	7.2	5.7	6.7	8.5	7.8	9.7	8.2
Labor costs in manufacturing (nominal, per hour)	7.2	7.3	5.4	7.0	5.3	4.4	5.0	6.7	6.1
Producer price index (PPI) in industry	7.1	5.3	2.1	5.2	2.8	0.7	–0.5	–1.1	0.6
Consumer price index (here: HICP)	5.8	3.4	3.2	4.8	4.4	2.4	1.3	1.3	1.3
EUR per 1 RON, + = RON appreciation	–0.7	–4.9	0.9	–0.8	0.7	1.9	1.7	–2.6	–0.6
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.7	7.3	7.6	7.8	7.8	7.3	7.5	7.5	7.0
Employment rate (%, 15–64 years)	58.5	59.5	59.7	58.1	60.2	61.0	59.5	59.5	61.2
Key interest rate per annum (%)	6.2	5.3	4.8	5.3	5.3	4.7	4.1	3.6	3.5
RON per 1 EUR	4.2	4.5	4.4	4.4	4.4	4.4	4.5	4.5	4.4
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	6.6	2.7	8.8	4.2	5.0	4.8	8.8	6.4	5.3
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–1.6	6.7	13.6	9.2	11.2	13.6	13.6	12.0	14.1
Domestic credit of the banking system	11.4	0.1	–5.3	–2.1	–7.4	–11.7	–5.3	–6.5	–7.9
of which: claims on the private sector	6.8	1.5	–3.3	–0.1	–1.2	–3.4	–3.3	–2.6	–3.7
claims on households	1.1	0.1	–0.5	–0.4	–0.6	–1.1	–0.5	–0.5	–1.2
claims on enterprises	5.7	1.4	–2.7	0.3	–0.6	–2.3	–2.7	–2.1	–2.5
claims on the public sector (net)	4.7	–1.4	–2.1	–2.0	–6.2	–8.3	–2.1	–3.8	–4.2
Other assets (net) of the banking system	–3.2	–4.1	0.5	–2.9	1.3	2.9	0.5	0.9	–0.9
	% of GDP								
General government revenues	33.7	33.4	32.8	. .	. .	. .	. .	. .	. .
General government expenditures	39.2	36.4	35.1	. .	. .	. .	. .	. .	. .
General government balance	–5.5	–3.0	–2.2	. .	. .	. .	. .	. .	. .
Primary balance	–3.9	–1.3	–0.6	. .	. .	. .	. .	. .	. .
Gross public debt	34.2	37.3	37.9	. .	. .	. .	. .	. .	. .
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	52.2	53.2	48.4	. .	. .	. .	. .	. .	. .
Debt of households and NPISHs (nonconsolidated)	21.4	21.0	19.2	. .	. .	. .	. .	. .	. .
	% of GDP (based on EUR), period total								
Trade balance	–5.6	–5.6	–2.4	–2.0	–2.7	–2.7	–2.1	–1.9	–3.2
Services balance	0.3	0.9	1.9	2.2	2.0	2.2	1.5	3.3	2.8
Income balance (factor services balance)	–1.7	–2.3	–3.1	–3.1	–2.7	–2.9	–3.7	–6.1	–3.5
Current transfers	2.5	2.6	2.6	3.0	3.7	1.7	2.4	4.1	2.2
Current account balance	–4.5	–4.5	–0.9	–0.0	0.3	–1.6	–1.9	–0.7	–1.7
Capital account balance	0.5	1.5	2.3	1.1	1.9	3.1	2.6	5.7	1.3
Foreign direct investment (net)	1.4	1.7	2.2	1.7	2.9	–0.8	4.6	1.4	2.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	75.2	75.9	67.6	75.6	73.6	71.6	67.6	65.2	64.3
Gross official reserves (excluding gold)	25.3	23.8	22.9	24.2	24.0	24.1	22.9	21.9	21.6
	Months of imports of goods and services								
Gross official reserves (excluding gold)	6.7	6.3	6.4	6.5	6.5	6.6	6.4	6.0	5.9
	EUR million, period total								
GDP at current prices	131,289	131,267	142,117	27,180	33,086	38,503	43,348	28,071	34,565

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

10 Turkey: Growth Declines in the First Half of 2014

Contribution of domestic demand to growth vanishes

Economic growth slowed to 3.3% in the first half of 2014. Following a robust expansion in the first quarter, GDP growth halved in the second quarter. In particular, domestic demand growth – which had driven the GDP expansion in 2013 – slowed in reaction to monetary policy tightening in late January, receding credit growth and high interest rates, which discouraged private gross fixed capital formation. Conversely, public investment projects were unaffected in light of the ongoing infrastructure development. Recent leading indicators suggest that economic activity might pick up again in the third quarter of 2014 compared to the previous quarter. The PMI showed a slight improvement again to 50.4 in September. However, unemployment remains high (at 10%), and the participation rate is on a declining trend. Capacity utilization stood at 74.1% in seasonally adjusted terms in September, 1 percentage point below the September 2013 value.

External imbalances recede temporarily

Net exports contributed positively to GDP growth in the first half of 2014, but mainly as a result of contracting imports (in line with weaker domestic demand). Lower export growth in the second compared to the first quarter was mainly a result of divestments of gold. Further, the military conflict in important export destinations (Iraq, but also Russia and Ukraine) dampened exports. The current account deficit moderated in the first half of 2014, falling to 6.3% of GDP from 9.0% a year earlier. This rebalancing was driven by the lower deficit in gold trade – a temporary factor caused by gold imports falling primarily due to a strong base effect – alongside weak domestic demand. Furthermore, the outlook for exports is weak. The financing of the current account deficit remains challenging. Even though portfolio investments recovered in the second quarter, this trend is unlikely to be sustained, and FDI inflows remain weak.

Macrofinancial situation has stabilized, but vulnerabilities remain elevated

Following the decisive rate hike in late January 2014 (leading to an effective increase by 225 basis points to 10%), the Turkish lira has stabilized but has remained weak, in a setting of subsequent monetary easing starting in May (in three consecutive steps by a cumulative 125 basis points to 8.25%). Inflation has accelerated again since the beginning of 2014 to reach 9.5% in August due to a lagged exchange rate pass-through and elevated food prices (partly drought related).

After having fallen in the first half of 2014, credit growth has been rising again recently and currently stands at around 20% (13-week moving average, foreign currency adjusted), still slightly below the level at the beginning of 2014, but above the central bank's targeted ceiling of 15%. The cost of private credits has fallen in recent months due to lower interest rates on consumer loans. Despite an increase in the absolute volume of NPLs, the NPL ratio remains below 3% of total loans, with a stable provision coverage ratio of almost 80%. Banks' profitability fell further in the first half of 2014, and the return on assets diminished to 1.4% at end-June (compared to 1.9% in the first half of 2013).

On August 28, former Prime Minister Erdoğan became the first president elected by the people. Changes to the government were moderate, and some focus on stabilization policies can be expected with Deputy Prime Minister Babacan, Finance Minister Şimşek and Economy Minister Zeybekci remaining in office. While domestic political risks have moderated, external political risks from military conflicts in Syria and Iraq as well as from the Russia-Ukraine crisis are high and pose additional challenges in particular to the rebalancing of the large current account deficit.

Table 10

Main Economic Indicators: Turkey

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	8.5	2.5	4.1	3.1	4.6	4.2	4.5	4.7	2.1
Private consumption	7.9	–0.7	5.1	3.1	5.6	5.6	6.1	3.2	0.4
Public consumption	4.4	6.4	6.2	7.9	8.0	1.9	6.9	9.2	2.4
Gross fixed capital formation	17.6	–1.9	4.2	0.4	3.4	5.3	7.4	–0.2	–3.5
Exports of goods and services	6.5	17.8	–0.3	3.0	–0.0	–2.4	–1.2	11.1	5.5
Imports of goods and services	9.6	0.6	9.0	7.8	12.5	5.2	10.3	0.7	–4.6
	Contribution to GDP growth in percentage points								
Domestic demand	9.4	–1.6	7.4	5.2	9.5	6.7	8.1	1.9	–0.8
Net exports of goods and services	–1.0	3.6	–2.3	–1.3	–3.3	–1.8	–2.9	2.3	2.6
Exports of goods and services	1.4	3.8	–0.1	0.7	–0.0	–0.6	–0.3	2.5	1.3
Imports of goods and services	–2.4	–0.2	–2.3	–2.0	–3.3	–1.2	–2.6	–0.2	1.3
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Unit wage costs in manufacturing (nominal, per hour)	6.2	13.5	10.4	8.2	11.9	10.7	10.9	11.5	13.7
Labor productivity in manufacturing (real, per hour)	3.4	–1.7	1.6	1.5	0.1	2.0	2.8	3.3	0.9
Gross wages in manufacturing (nominal, per hour)	10.0	11.5	12.2	9.8	12.0	12.9	14.0	15.2	14.7
Producer price index (PPI) in industry	11.1	6.1	4.5	2.0	3.0	6.4	6.5	11.8	11.3
Consumer price index (here: HICP)	6.5	9.0	7.5	7.4	6.8	8.2	7.5	8.1	9.3
EUR per 1 TRY, + = TRY appreciation	–14.5	0.9	–8.6	–0.1	–3.7	–13.5	–15.5	–22.4	–17.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.0	8.4	8.9	9.6	8.1	8.9	9.1	10.3	8.9
Employment rate (%, 15–64 years)	48.4	48.9	49.5	47.9	50.8	50.3	49.1	48.0	50.8
Key interest rate per annum (%)	6.1	5.7	4.8	5.5	4.8	4.5	4.5	8.4	9.7
TRY per 1 EUR	2.3	2.3	2.5	2.4	2.4	2.6	2.8	3.0	2.9
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	15.2	10.5	21.1	13.6	15.4	19.0	21.1	19.8	16.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	0.6	1.4	–5.9	1.1	–1.0	–2.7	–5.9	–4.8	–2.4
Domestic credit of the banking system	19.0	16.9	31.7	18.5	22.0	29.5	31.7	31.2	26.5
of which: claims on the private sector	25.0	18.7	33.5	21.0	27.0	33.1	33.5	32.4	25.2
claims on households	8.4	5.9	8.4	7.0	8.1	8.8	8.4	6.2	4.0
claims on enterprises	16.6	12.7	25.1	14.0	18.9	24.3	25.1	26.1	21.1
claims on the public sector (net)	–6.0	–1.8	–1.7	–2.5	–5.0	–3.6	–1.7	–1.2	1.4
Other assets (net) of the banking system	–4.4	–7.7	–4.7	–6.0	–5.5	–7.8	–4.7	–6.6	–8.1
	% of GDP								
General government revenues	36.6	37.8	39.1	. .	. .	. .	. .	. .	. .
General government expenditures	37.4	38.9	40.7	. .	. .	. .	. .	. .	. .
General government balance	–0.8	–1.1	–1.6	. .	. .	. .	. .	. .	. .
Primary balance	. .	. .	. .	. .	. .	. .	. .	. .	. .
Gross public debt	39.9	36.2	36.3	. .	. .	. .	. .	. .	. .
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	44.3	47.7	. .	. .	. .	. .	. .	. .	. .
Debt of households and NPISHs (nonconsolidated)	. .	. .	. .	. .	. .	. .	. .	. .	. .
	% of GDP (based on EUR), period total								
Trade balance	–11.5	–8.3	–9.8	–8.6	–11.1	–9.5	–9.6	–6.6	–8.6
Services balance	2.6	2.9	2.8	1.2	2.8	4.6	2.5	1.4	3.3
Income balance (factor services balance)	–1.0	–0.9	–1.1	–1.0	–1.6	–0.9	–1.0	–1.3	–1.1
Current transfers	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.1	0.1
Current account balance	–9.7	–6.1	–7.9	–8.3	–9.8	–5.7	–7.9	–6.3	–6.2
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)	1.8	1.2	1.2	1.1	0.8	1.3	1.5	1.7	0.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	42.3	41.8	45.5	43.8	44.1	43.9	45.5	46.6	49.9
Gross official reserves (excluding gold)	10.9	12.4	13.0	13.2	12.7	12.9	13.0	12.8	13.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.0	4.7	4.8	5.0	4.8	4.9	4.8	4.6	5.1
	EUR million, period total								
GDP at current prices	554,990	612,976	618,475	150,856	160,603	159,752	147,265	134,484	146,286

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

11 Russia: Economy en Route to Stagnation

Russia approaches zero growth

Russian economic growth eased to about 0.8% in the first half of 2014 (from 1.3% in the whole year of 2013) and leveled off further over the summer months under the impact of stepped-up EU and U.S. sanctions in connection with Russia's annexation of Crimea (in March) and support for the armed insurgency in eastern Ukraine (from April). Flat and lately weakening oil prices in 2014 have not helped Russian GDP growth, either. Rising uncertainty hit already weak investments, which contracted by 4.5% in the first half of 2014, while large-scale destocking went on. Private consumption continued to be the main driving force of growth, although it also continued to weaken, especially from the second quarter. The retail sales expansion moderated to 2.4% in the first seven months of 2014 (year on year). With real imports contracting and real exports expanding slightly, the contribution of net exports to GDP growth increased. Thus, for the first time in years, the contribution of domestic demand to Russian economic growth turned negative in the first half of 2014. Notwithstanding the further slowdown of growth, unemployment holds post-Soviet record-low levels (4.9% in July 2014), which supports the view that the economy is running near full capacity.

Rising uncertainty boosts capital outflows; further depreciation fuels inflation

The persistently tough investment climate, actual and expected U.S. monetary policy tapering, the tightening of Western sanctions against Russia and adverse expectations emanating from the latter have given rise to recently swelling capital outflows: Over the first half of 2014, private net capital outflows came to EUR 54.4 billion (7.7% of GDP), which is more than twice as high as in the corresponding period of the previous year and already exceeds the entire outflow of 2013. The sanctions include selective travel bans and account freezes, bans on arms trade with Russia, restrictions on the transfer of high technology for oil extraction and on the export of dual-use goods (usable for military as well as civilian purposes), and tight limits on Russian state-owned banks' and enterprises' access to EU and U.S. capital markets and bank loans. The capital flight was primarily responsible for the depreciation of the ruble, which lost 20% against the U.S. dollar and 10% against the euro in the course of the first nine months of 2014. The ruble's slide, in turn, added to inflationary pressures. The consumer price level rose by 7.6% in August 2014 (as against 6.8% in 2013), and inflation is likely to accelerate (at least in the short run), given the ongoing pass-through of depreciation and Russia's imposition in August of an import ban on Western food products.

CBR intervenes in forex market and hikes key rate by a total of 250 basis points

The ruble would have fallen more and price increases would have been higher if the Central Bank of Russia (CBR) had not taken countermeasures, including increases of the key interest rate by 150 basis points in March, by another 50 basis points in April, and again by 50 basis points in July – to 8.0%. Partly as a result of forex interventions, the CBR's international reserves declined by about USD 35 billion (or 7%) in the six-and-a-half months since the outbreak of the Crimean crisis.

While eroding, international reserves remain sizable and twin surpluses persist

In August, international reserves (excluding gold) eased to USD 465 billion (or EUR 353 billion). As at end-August 2014, retail lending growth, which had overheated in 2013, slowed to 10% (in real terms, exchange rate-adjusted, year on year). Corporate lending expanded 5% (correspondingly). The continuing relatively tight fiscal stance and the weaker-than-expected ruble are reflected in the federal budget surplus of 2.0% of GDP in January to August 2014. Russia's declining import demand produced an expanding current account surplus (4.4% of GDP in the first half of 2014, against 2.8% in the respective period of 2013).

Table 11

Main Economic Indicators: Russia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	4.3	3.4	1.3	0.8	1.0	1.3	2.0	0.9	0.8
Private consumption	6.7	7.9	4.7	5.7	4.4	4.7	4.1	3.7	0.8
Public consumption	1.4	4.6	0.5	0.6	0.4	0.4	0.4	–0.0	–0.1
Gross fixed capital formation	9.1	6.4	–0.1	–0.5	–1.3	0.1	0.5	–7.0	–2.1
Exports of goods and services	0.3	1.4	4.2	0.0	3.7	7.4	5.6	1.6	1.3
Imports of goods and services	20.3	8.8	3.7	7.3	3.4	5.3	–0.1	–4.5	–7.7
	Contribution to GDP growth in percentage points								
Domestic demand	7.9	5.2	1.2	2.5	1.2	0.6	0.8	0.2	–0.7
Net exports of goods and services	–4.0	–1.6	0.4	–1.6	0.4	0.7	1.8	1.6	2.2
Exports of goods and services	0.1	0.4	1.3	0.0	1.2	2.1	1.7	0.5	0.4
Imports of goods and services	–4.1	–2.0	–0.9	–1.6	–0.8	–1.4	0.0	1.0	1.8
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Unit labor costs in industry (nominal, per person)	9.0	7.6	7.9	9.0	8.2	8.6	5.8	7.0	4.9
Labor productivity in industry (real, per person)	4.4	4.8	2.3	0.8	2.5	2.5	3.3	2.5	3.8
Average gross earnings in industry (nominal, per person)	13.8	12.6	10.3	9.8	10.9	11.2	9.2	9.6	8.9
Producer price index (PPI) in industry	17.8	6.8	3.4	4.3	2.5	4.4	2.3	4.2	8.2
Consumer price index (here: CPI)	8.5	5.1	6.8	7.2	7.2	6.3	6.4	6.4	7.5
EUR per 1 RUB, + = RUB appreciation	–1.5	2.4	–5.7	–1.5	–3.7	–8.0	–9.1	–16.5	–13.7
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.6	5.5	5.5	5.8	5.4	5.3	5.5	5.5	5.0
Employment rate (%, 15–64 years)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Key interest rate per annum (%)	5.3	5.3	5.5	5.5	5.5	5.5	5.5	6.0	7.4
RUB per 1 EUR	40.9	39.9	42.3	40.2	41.4	43.4	44.3	48.1	48.0
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	20.9	12.1	15.7	15.1	16.3	16.8	15.7	13.4	9.1
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	9.9	–0.3	2.7	4.5	1.8	2.3	2.7	5.1	0.3
Domestic credit of the banking system	19.7	15.4	17.5	17.0	18.1	18.2	17.5	15.9	14.2
of which: claims on the private sector	24.5	17.9	16.9	19.9	18.2	19.1	16.9	17.5	15.4
claims on households	6.4	8.2	7.4	8.4	8.2	8.1	7.4	7.0	5.9
claims on enterprises	18.1	9.7	9.6	11.5	10.1	11.0	9.6	10.5	9.6
claims on the public sector (net)	–4.8	–2.6	0.6	–2.9	–0.1	–0.9	0.6	–1.6	–1.3
Other assets (net) of the banking system	–8.7	–3.0	–4.6	–6.4	–3.5	–3.7	–4.6	–7.6	–5.3
	% of GDP								
General government revenues	37.3	37.1	36.6	. .	. .	. .	. .	. .	. .
General government expenditures	35.7	36.7	37.9	. .	. .	. .	. .	. .	. .
General government balance	1.5	0.4	–1.3	. .	. .	. .	. .	. .	. .
Primary balance	. .	. .	. .	. .	. .	. .	. .	. .	. .
Gross public debt	9.0	10.0	10.4	. .	. .	. .	. .	. .	. .
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Debt of households and NPISHs (nonconsolidated)	. .	. .	. .	. .	. .	. .	. .	. .	. .
	% of GDP (based on EUR), period total								
Trade balance[1]	10.3	9.5	8.7	10.1	8.5	8.2	8.1	11.1	10.3
Services balance[1]	–1.8	–2.3	–2.8	–2.2	–2.7	–3.7	–2.5	–2.3	–2.9
Primary income[1]	–3.2	–3.4	–3.9	–2.4	–5.2	–4.0	–3.7	–2.4	–4.5
Secondary income[1]	–0.3	–0.3	–0.4	–0.3	–0.3	–0.6	–0.5	–0.4	–0.1
Current account balance[1]	5.1	3.5	1.6	5.2	0.4	–0.1	1.4	5.9	2.8
Capital account balance[1]	0.0	–0.3	–0.0	–0.0	–0.0	–0.0	–0.0	–0.0	–0.0
Foreign direct investment (net)[1]	–0.6	0.1	–0.8	–5.3	1.9	0.7	–0.7	–1.2	–0.7
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt[1]	30.8	31.4	33.8	34.3	34.1	33.5	33.8	33.8	35.2
Gross official reserves (excluding gold)[1]	25.7	23.7	21.6	23.6	22.9	22.4	21.6	20.8	20.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	14.3	12.8	11.5	12.7	12.2	11.9	11.5	11.1	11.1
	EUR million, period total								
GDP at current prices	1,366,840	1,557,572	1,574,075	364,671	386,266	403,652	419,487	332,628	368,975

Source: Bloomberg, national statistical offices, national central banks, wiiw, OeNB.

[1] *Data based on the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).*

Box 3

All Baltic Countries Part of the Euro Area: Lithuania to Adopt the Euro January 1, 2015[1]

On January 1, 2015, Lithuania will become a full member of the Economic and Monetary Union with the euro as the legal tender. The way to euro area membership was cleared by the positive assessment of Lithuania's economic convergence in the ECB's and European Commission's convergence reports of June 2014 and by the July 2014 EU Council Decision to welcome Lithuania into the euro area followed by the ECOFIN Council's adoption of a decision allowing the country to join the euro area on January 1, 2015. The ECOFIN Council also irrevocably fixed the conversion rate of the Lithuanian litas at its central parity within ERM II agreed on in mid-2004, which is LTL 3.45280 to EUR 1.

The currency changeover has already started. Prices will be displayed both in Lithuanian litas and in euro between the end of August 2014 and at least the end of June 2015. The dual circulation period of litas and euro, during which both currencies are legal tender, will be only 15 calendar days. While Lithuanian commercial banks will exchange litas coins and banknotes for six months following the introduction of the euro, the Lithuanian central bank will do so free of charge for an unlimited period.

The Lithuanian authorities had aspired to introduce the euro already in 2007 but, at the time, Lithuania was found to have failed the inflation criterion.[2] Since then, the country has made substantial further efforts to fulfill the requirements for euro area membership. During the economic and financial crisis, the Lithuanian economy demonstrated a high degree of flexibility, in particular in the labor market, which brought the economy back onto a growth trajectory already in the first quarter of 2010.

Experience in the Baltic neighbor countries Estonia and Latvia showed that currency changeovers can be conducted smoothly and efficiently. However, Lithuanians are concerned that prices will rise when the euro is introduced: 75% of Lithuanians expect that the euro will heat up inflation.[3] In all countries that joined the euro area between 2007 and 2011 (Estonia, Cyprus, Malta, Slovakia, Slovenia), the euro changeover indeed had a one-off impact on inflation, which, however, was small and ranged between 0.2 and 0.3 percentage points. This effect was observable during or directly after euro introduction.[4] The Lithuanian authorities have announced that they will keep a close eye on price developments before and after euro introduction to prevent unjustified price increases.

Alongside the adoption of the euro, Lithuania will join the Single Supervisory Mechanism (SSM), which means that the ECB will be responsible for the supervision of the largest banks in Lithuania. Additionally, the country has to comply with the obligations under the EU's "Two-Pack" fiscal legislation. This implies, inter alia, that the 2016 draft budget will have to be submitted by October 15, 2015.

The adoption of the euro by Lithuania will bring changes not only to the new euro area member state but also to the decision-making process within the ECB. Currently, the Governing Council comprises 6 Executive Board members and 18 governors from national central banks (NCBs) of the euro area. According to Treaty law, voting rights have to rotate once there are more than 18 NCB governors. As all members of the Governing Council attend the Governing Council meetings and have the right to speak, nothing will change in terms of the discussion. Since the Governing Council takes most decisions on a consensual basis, in a spirit of cooperation, the decision-making process is not expected to change, either.[5]

[1] *Author: Antje Hildebrandt.*

[2] *http://ec.europa.eu/economy_finance/publications/publication465_en.pdf.*

[3] *http://ec.europa.eu/economy_finance/pdf/2014/fourteenth_report_on_the_practical_preparations_en.pdf.*

[4] *http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_pub/TTNR_EURO_CHANGEOVER_INFLATION_ESTONIA_2011_05.pdf.*

[5] *For more details on the rotation system, see https://www.ecb.europa.eu/ecb/orga/decisions/govc/html/faqvotingrights.en.html.*