Developments in Selected Countries[1]

1 Introduction

In the five Central European new EU Member States – the Czech Republic, Hungary, Poland, Slovakia and Slovenia – GDP growth in 2005 was solid, even though it did not fully match the record 2004 figures. Moreover, growth started to accelerate in the last three quarters of 2005 after dipping in the first quarter of 2005. With a growth rate of above 4%, the five countries were again one of the growth engines of the European Union, and they were clearly more dynamic than many countries of the euro area, which recorded an aggregate growth rate of 1.3%. Growth in the acceding countries, Bulgaria and Romania, and in the two accession countries, Croatia and Turkey, as well as in Russia displayed a similar pattern as in the Central European countries: It was mostly below 2004 figures but still robust.

Considerable differences in the composition of growth across countries

In most of Central Europe, growth in 2005 was to a considerable extent driven by net exports. However, as imports may have been underrecorded due to changes in the compilation of statistics after the inclusion of these countries in the EU Single Market, the contribution of net exports may have been overstated. But even accounting for this element of uncertainty, net exports have been a key driver of growth. Private consumption, in turn, grew more slowly than overall GDP. Slovakia is a bit of an outlier, as growth was based strongly on domestic demand, including animated gross fixed capital formation, while the contribution of net exports was almost neutral. In contrast to the export-led growth in most of Central Europe, the main motor of growth in Romania and Bulgaria was private consumption, in Bulgaria joined by gross fixed capital formation, while the contribution of net exports to growth was strongly negative. Croatia, in turn, is an intermediate case, with growth mostly being supported by domestic demand, while the contribution of net exports was broadly negligible. The composition of growth in Turkey and Russia shows strong private consumption and gross fixed capital formation, while net exports display a moderately negative contribution.

Table 1

Gross Domestic Product (Real)

Annual change in %

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
Czech Republic	1.5	3.2	4.7	6.0	5.3	5.8	5.8	6.9
Hungary	3.8	3.4	4.6	4.1	3.2	4.5	4.5	4.3
Poland	1.4	3.9	5.3	3.2	2.1	2.8	3.7	4.2
Slovakia	4.6	4.5	5.5	6.0	5.1	5.1	6.2	7.6
Slovenia	3.5	2.7	4.2	3.9	2.8	5.4	3.6	3.7
Bulgaria	4.9	4.5	5.7	5.5	5.9	6.5	4.6	5.5
Romania	5.2	5.2	8.4	4.1	6.0	4.5	2.4	4.3
Croatia	5.6	5.3	3.8	4.3	1.8	5.1	5.2	4.8
Turkey	7.9	5.8	8.9	7.4	6.6	5.5	7.7	9.5
Russia	4.8	7.4	7.2	6.4	5.0	5.7	6.6	7.9

Source: Eurostat, national statistical offices, wiiw.

[1] *Compiled by Antje Hildebrandt in cooperation with Stephan Barisitz, Balázs Égert, Johann Elsinger, Silvia Kirova, Thomas Reininger, Josef Schreiner, Tomas Slacik, and Zoltan Walko. The analysis is based on information and data from a variety of sources.*

2005 was marked by lower annual average inflation rates than in 2004. However, some of the new Member States, especially the Czech Republic and Slovakia, saw inflation pick up in the last quarter of 2005 and/or in the first quarter of 2006. The monetary authorities reacted with interest rate hikes to combat the buildup of inflationary pressure. In the acceding countries, the disinflation process continued but inflation remained high, especially in Romania. Bulgaria's inflation rate in fact accelerated in recent months, driven by tax hikes, higher regulated prices and oil prices, furthermore, partly by strong domestic demand. Motivated by above-target inflation, the Banca Naţională a României (BNR) increased its key interest rate by 100 basis points in February, thus reverting its earlier interest reduction policy that had brought down key interest rates from more than 20% at the beginning of 2004 to 7.5% in late 2005. Croatia saw a rise in inflation in 2005 and at the beginning of 2006; however, price increases remained low. Turkey, by contrast, managed to bring inflation to a single-digit rate in 2005, but some price pressure built up in the first quarter of 2006. No major change was observed in Russia, where prices continued to grow at double digit rates.

Disinflation process continued in 2005 but inflationary pressure picked up somewhat in recent months

Table 2

Consumer Price Index (here: HICP)

Annual change in %

	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006
Czech Republic	−0.1	2.6	1.6	1.4	1.2	1.6	2.2	2.4
Hungary	4.7	6.8	3.5	3.5	3.6	3.5	3.2	2.4
Poland	0.7	3.6	2.2	3.6	2.2	1.8	1.2	0.9
Slovakia	8.4	7.5	2.8	2.8	2.6	2.2	3.7	4.2
Slovenia	5.7	3.7	2.5	2.8	2.2	2.3	2.6	2.3
Bulgaria	2.3	6.1	5.0	3.8	4.9	4.8	6.6	8.0
Romania	15.3	11.9	9.1	8.9	9.9	9.0	8.5	8.7
Croatia[1]	1.8	2.1	3.4	3.1	3.1	3.5	4.0	3.5
Turkey	25.6	10.1	8.1	8.8	8.7	7.8	7.3	7.6
Russia[1]	13.6	11.0	12.5	12.9	13.4	12.5	11.2	10.8

Source: Eurostat, national statistical offices, wiiw.

[1] *CPI.*

Some of the new Member States aspire to introduce the euro faster than others. Slovenia can certainly be considered one of the frontrunners: In mid-2004, the country entered ERM II and in March 2006 formally applied for a convergence examination before the summer so as to adopt the euro at the beginning of 2007. Lithuania also asked for such an examination. While Slovenia seems to be in a good position to meet the convergence criteria, inflation in Lithuania is, at present, just above the reference value and may lie more tangibly above this value over the near future. In November 2005, Slovakia was the second Central European country to enter ERM II. The three other new Member States from Central Europe – the Czech Republic, Hungary and Poland – have not yet announced that they would launch ERM II entry in the near future.

Slovenia as a frontrunner for euro adoption

An important precondition for future euro adoption is fiscal prudence. In particular, euro candidates must not have an excessive budget deficit, i.e. no EU Excessive Deficit Procedure (EDP) must have been launched against them.

Among the Central European countries, the Czech Republic, Hungary, Poland and Slovakia are currently subject to an EDP. The Czech Republic aims at bringing the deficit to below 3% of GDP in 2008, Slovakia in 2007. Both targets are in accordance with the recommendations of the EU Council. Poland, however, does not currently envisage, as urged by the EU Council, a correction of its excessive deficit by 2007, while Hungary's program to correct the deficit by 2008 has not been found sufficiently credible by the EU Council and must be substantiated by September 1, 2006.

At the same time, it is noteworthy that actual fiscal outcomes in 2005 were better in most countries than planned. In fact, in 2005 none of the five Central European countries but Hungary recorded a deficit above 3% of GDP (excluding the cost of pension reforms). It remains to be seen whether this overperformance will be a lasting one and thus possibly allow a faster lifting of the EDP for some countries than originally planned.

Bulgaria and Romania en route to EU membership

For the two acceding countries, the main focus is currently on meeting the conditions for EU membership. In its monitoring reports of end-October 2005, the European Commission commended the two countries for reform progress made in many different areas but also listed a number of shortcomings that remain. In mid-May 2006, the European Commission is expected to submit monitoring updates on the basis of which the entry date 2007 – or its postponement to 2008 – will be fixed.

Negotiations for EU accession with Croatia and Turkey

At the beginning of October 2005 the European Council furthermore decided to open negotiations for EU accession with Croatia and Turkey. The green light for negotiations with Croatia was given when the country was found to be cooperating satisfactorily with the International Criminal Court. The negotiations with Turkey are an open-ended process: the objective, accession to the EU, is clear but it cannot be taken for granted ex ante that this will be the final outcome of negotiations.

External imbalances problematic predominantly in the acceding and accession countries

Most new Member States' current account deficits decreased in 2005 compared to a year earlier. The higher deficit in Slovakia is expected to be only temporary and related to the present erection of two automobile plants, as investment goods are being imported while exports will start in 2006 to 2007. In Hungary, the current account deficit still remained high but decreased slightly compared 2004, whereas in the acceding and accession countries the already high deficit widened further in 2005, with the largest increase taking place in Bulgaria. In Bulgaria and Romania the significant current account deficits are mainly driven by the deterioration of the trade balance, as growth rates of imports outstripped the growth of exports. High import growth was partly the result of strong increases of credits to the private sector. In these countries, the monetary authorities have already taken several measures to curb credit growth. So far, however, the measures have been only partly effective. Especially in Hungary, Croatia and Turkey, the current account deficit was only covered to some extent by foreign direct investment (FDI) inflows, which led to a rise in the countries' net foreign debt in percent of GDP.

Global financial market jitters barely affected most Central, Eastern and Southeastern European countries

Increasing long-term interest rates in the U.S.A. and the euro area, combined with expectations of further interest rate rises in both of these regions and in Japan, led to a decrease in global risk appetite and to asset price losses during March 2006 not only in several emerging markets but also in Iceland

and New Zealand (where the losses were exacerbated by country-specific factors). However, these developments barely impinged on Central and Eastern Europe. Only the currencies of Hungary and Poland were noticeably affected, as these external developments were aggravated by internal factors in both countries (the still high external financing requirement combined with an inappropriate fiscal policy in Hungary, political noise in Poland). However, the currency weakening in these two countries was fairly well contained and not accompanied by a general flight of foreign capital: Initial losses in equity prices and modest increases in local currency government bond spreads against the euro area during the first half of March were reversed in the following weeks.

Rating upgrades for Slovakia, Bulgaria, Turkey and Russia

Slovenia continues to have the best rating in the group of countries under review in this report, followed by the Czech Republic and Hungary. In the review period, Slovakia, Bulgaria, Turkey and Russia received rating upgrades (see table 3).

Table 3

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt

Currency	Moody's Current rating*	Last change (former rating)	Standard & Poor's Current rating**	Last change (former rating)
Czech koruna	A1	Nov. 2002 (Baa1)	A–	Nov. 1998 (A)
Hungarian forint	A1	Nov. 2002 (A3)	A–	Dec. 2000 (BBB+)
Polish zloty	A2	Nov. 2002 (Baa1)	BBB+	May 2000 (BBB)
Slovak koruna	A2	Jan. 2005 (A3)	A	Dec. 2005 (A–)
Slovenian tolar	Aa3	Nov. 2002 (A2)	AA–	May 2004 (A+)
Bulgarian lev	Baa3	Mar. 2006 (Ba1)	BBB	Oct. 2005 (BBB–)
Romanian leu	Ba1	Mar. 2005 (Ba3)	BBB–	Sep. 2005 (BB+)
Croatian kuna	Baa3	Jan. 1997	BBB	Dec. 2004 (BBB–)
Turkish lira	Ba3	Dec. 2005 (B1)	BB–	Aug. 2004 (B+)
Russian ruble	Baa2	Oct. 2005 (Baa3)	BBB	Dec. 2005 (BBB–)

Source: Bloomberg.

*: *Aaa (best), Aa, A, Baa, Ba, B, Caa, Ca, and C (worst); each of the categories is further divided into 1, 2, and 3.*
**: *AAA (best), AA, A, BBB, BB, B, CCC, CC, C and D (worst); each of the categories is further divided into + and –.*

2 Czech Republic: Strong Economic Performance but Need for Further Reforms

Growth driven predominantly by net exports

The Czech Republic's economic performance in 2005 was one of the strongest and soundest on record. GDP growth improved substantially compared to 2004 and at 6% reached the highest annual rate since 1993. Unlike in previous years, growth was backed mainly by net exports as opposed to domestic demand. Compared with 2004, the pace of growth of both exports and imports decelerated as the positive one-off effect of EU entry faded. Notwithstanding, net exports lay at the heart of the economy's expansion. The strong increase in net exports was spawned by relatively subdued domestic demand, reflected in a much slower rise of imports. The reason for the moderate domestic demand dynamics was primarily the substantial slowdown in the growth of households' real disposable income. The latter expressed itself also in the rather moderate rise of private consumption amounting to less than half of total GDP growth. Households, whose consumption makes up more than two-thirds of total domestic spending, increased especially their transport- and household equipment-related expenditures. Also, the growth pace of fixed capital formation slackened somewhat from 2004, particularly because expenditures on residential housing contracted.

Rather limited improvement on the labor market

One of the effects that essentially contributed to the economy's strong performance was certainly the rise of overall labor productivity. Still, in the industry sector labor productivity growth almost halved compared with 2004. As a result, despite relatively moderate wage increases, unit labor costs (in industry) fell only marginally. Notably, strong growth failed to appreciably improve the mixed situation on the labor market. Although the unemployment rate, which was relatively low by EU standards, declined slightly and hovered around 8%, particularly the percentage of long-term unemployed (about half) remained persistently high. However, the employment structure witnessed some pronounced changes, as a number of entrepreneurs closed down their businesses and became employees.

Balance of payment accounts top expectations as trade balance moves into surplus

In the wake of high export growth, the balance of foreign trade with goods and services recorded a surplus for the first time in a decade. Trade with vehicles and machines contributed predominantly to this result.[2] On the other hand, sizeable price hikes of oil and related commodities extensively augmented the import bill and thus caused the overall trade balance to deteriorate. The deficit of the income account, which is largely determined by the profits of foreign-owned companies, dropped from last year's record level. The latter combined with the foreign trade surplus enabled the current account deficit to recover substantially; it decreased by more than four percentage points to low levels. Since the capital account balance was faintly positive, the Czech Republic's external financing requirement in 2005 was only about 1.9% of GDP. Mainly because of the sale of the government's stake in Ceský Telekom to Spanish Telefonica, net FDI inflows more than doubled compared to 2004 and came very close to those of the record year 2002. In addition to covering the external financing requirement, these inflows were for the most part spent

[2] *Chiefly due to production increases of Skoda Auto and the shift of the new joint car production plant TPCA in Kolin to full capacity use.*

on foreign debt securities (portfolio investment outflows) as well as a substantial accumulation of foreign reserves by Česká národní banka (ČNB).

Inflation well under control, supported also by appreciating koruna

Despite robust growth, high energy prices, and notable rises in administered prices and indirect taxes, the Czech economy did not show any signs of extensive inflationary pressure. In 2005, both the consumer price (HICP) and the producer price (PPI) inflation rate almost halved compared to 2004. Inflation gradually increased in the course of 2005, moving into the central bank's inflation target range (2% to 4% as of the turn 2005–2006).[3] Above all, decreasing prices of clothing, footwear and food along with a nominal effective appreciation of the koruna helped curb inflation. Encouraged by the continuous disinflation, the ČNB cut its key interest rate three times in early 2005. At the end of October, the ČNB council raised the leading interest rate by 25 basis points to 2.0%, where it has remained ever since, in the meantime standing 50 basis points below the ECB's key interest rate. In 2005 and into early 2006, the Czech koruna followed its earlier appreciation trend. Between January 2005 and March 2006, it gained some 12% against the euro and currently ranges at around 28.5 CZK/EUR. The underlying reason for this development appears to be chiefly the positive macroeconomic development and the continued high return on investment in the industrial and service sectors that foreign investors expect.

Fiscal balance encouraging, but prospects challenging

Following a deficit reduction to 2.9% of GDP in 2004, the general government deficit improved further last year to 2.6% of GDP (much below the 4.8% expected according to the updated convergence program of December 2005). As in 2004, this encouragingly positive outcome was brought about primarily by revenue surprises rather than lower-than-planned expenditures. Windfall revenues were the consequence of more vigorous economic growth on the one hand and rollovers of unspent funds from the previous year on the other. Yet the Czech Republic has not undergone sufficiently farreaching reforms above all with aging-related expenditures. For 2006, the Czech Republic is targeting a deficit of 3.8% of GDP. In mid-2004, the EU Council decided that the Czech Republic was in excessive deficit. At the beginning of 2006, the EU Council noted that the country was on track to reduce the deficit by 2008 as pointed out in the updated convergence program. However, in the light of the euro adoption envisaged for 2010 and additional cofinancing needs for EU-funded projects, both the OECD and the Ecofin highly recommend accelerating a major overhaul of the pension and health-care systems to keep deficit and debt under control in the long run. Moreover, to sustain the pace of growth, future governments will have to face up to other challenges, such as the high level of long-term unemployment, increasing demand for degree-level education as well as the establishment of further scope for improvement of the business environment.[4]

[3] *The ČNB uses the CPI rather than the HICP as an inflation indicator.*

[4] *See Ecofin Assessment of the updated Convergence Programme of the Czech Republic, November 2005, and OECD 2006 Economic Review – Czech Republic.*

Table 4

Main Economic Indicators: Czech Republic

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	1.5	3.2	4.7	6.0	5.3	5.8	5.8	6.9
Private consumption	2.8	4.6	3.3	2.6	2.1	2.8	2.9	2.6
Public consumption	4.5	3.8	−2.7	0.8	−1.4	0.8	4.6	−0.6
Gross fixed capital formation	3.4	4.7	5.3	3.7	3.0	3.3	4.3	4.2
Exports of goods and services	2.1	7.5	21.4	11.1	17.5	6.5	11.3	10.4
Imports of goods and services	4.9	7.9	18.4	4.8	10.4	−0.4	6.1	4.4
	Contribution to GDP growth in percentage points							
Domestic demand	4.2	4.5	4.7	0.5	0.1	−1.1	1.7	1.3
Net exports	−2.7	−1.3	0.0	5.4	5.3	6.9	4.1	5.6
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	6.8	7.9	9.7	5.4	3.9	4.0	7.6	6.1
Gross average wage of industry (nominal)	6.7	5.9	7.0	4.5	3.8	4.9	4.9	4.4
Unit labor cost of industry (nominal)	−0.1	−1.9	−2.5	−0.8	−0.1	0.8	−2.5	−1.5
Producer price index (PPI) of industry	−0.5	−0.4	5.7	3.0	6.8	4.1	1.4	0.0
Consumer price index (here: HICP)	1.4	−0.1	2.6	1.6	1.4	1.2	1.6	2.2
EUR per 1 CZK, + = CZK appreciation	10.6	−3.2	−0.2	7.1	9.5	6.3	6.4	6.2
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	7.4	7.9	8.4	8.0	8.4	7.8	7.8	7.8
Employment rate (15−64 years)	65.4	64.7	64.1	64.8	64.1	64.7	65.2	65.2
Key interest rate per annum (%)	3.6	2.3	2.2	2.0	2.3	1.8	1.8	2.0
CZK per 1 EUR	30.8	31.8	31.9	29.8	30.0	30.1	29.7	29.3
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	−7.6	5.2	10.3	6.4	5.4	5.8	6.2	8.1
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	8.5	1.2	2.9	5.2	−0.1	3.3	7.9	9.5
Domestic credit of the banking system	−1.1	7.7	7.1	0.7	2.2	0.7	−1.0	0.9
of which:								
claims on the private sector	*−9.6*	*0.9*	*6.0*	*8.6*	*7.1*	*7.8*	*9.3*	*10.0*
claims on households	*1.9*	*3.3*	*4.4*	*5.4*	*4.9*	*5.2*	*5.6*	*6.0*
claims on enterprises	*−11.4*	*−2.5*	*1.5*	*3.2*	*2.1*	*2.6*	*3.8*	*4.1*
claims on the public sector (net)	*8.4*	*6.8*	*1.2*	*−7.9*	*−4.8*	*−7.1*	*−10.4*	*−9.1*
Other domestic assets (net) of the banking system	−15.0	−3.7	0.3	0.5	3.3	1.8	−0.6	−2.4
	% of GDP, ESA 95							
General government revenues	39.9	40.7	41.4	41.1				
General government expenditures	46.7	47.2	44.2	43.7				
General government balance	−6.8	−6.6	−2.9	−2.6				
Primary balance	−5.6	−5.5	−1.7	−1.4				
Gross public debt	28.8	30.0	30.6	30.5				
	EUR million, period total							
Merchandise exports	40,713	43,053	54,071	63,003	14,590	15,841	15,490	17,082
Merchandise imports	43,034	45,235	54,910	61,662	13,719	15,359	15,516	17,069
	% of GDP, period total							
Trade balance	−3.0	−2.7	−1.0	1.4	3.8	1.9	−0.1	0.1
Services balance	0.9	0.5	0.5	0.7	0.5	1.0	0.9	0.3
Income balance (factor services balance)	−4.8	−4.7	−5.7	−4.9	−3.3	−7.2	−4.9	−3.9
Current transfers	1.2	0.6	0.2	0.7	1.7	0.4	0.1	0.7
Current account balance	−5.7	−6.3	−6.1	−2.1	2.7	−3.9	−4.1	−2.8
Capital account balance	−0.0	−0.0	−0.5	0.2	0.2	0.2	0.0	0.3
Foreign direct investment (net)	11.3	2.1	3.7	8.3	4.7	18.0	5.7	4.5
	EUR million, end of period							
Gross external debt	25,738	27,624	33,212	38,818	34,358	35,746	37,672	38,818
Gross official reserves (excluding gold)	22,483	21,189	20,746	24,864	21,101	24,701	24,665	24,864
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.4	4.9	4.0	4.3	4.1	4.3	4.2	3.9
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	78,437	80,268	86,850	98,438	22,965	24,862	25,161	25,450

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

3 Hungary: Selective Progress, but Much Remains to Be Done in the Light of Persistent Twin Deficits

GDP growth driven by net exports

Hungary posted robust economic growth at 4.1% in 2005, with most of the moderate slowdown compared to 2004 resulting from calendar effects. Growth was driven by net exports, which benefited particularly from exports to non-EU-25 countries. Growth in domestic demand turned slightly negative, which was mostly attributable to significant destocking (including unspecified items, possibly reflecting also underreported imports), but also to a deceleration of both consumption and gross fixed capital formation. The slowdown in consumption occurred despite a marked acceleration of real wage growth and a modest recovery in employment, and thus may be linked to the decline in the growth of lending to households or weak growth in households' other incomes. Investment activity continued to be supported by highway construction.

Inflation slows in the first quarter of 2006 due to VAT cut

Owing to weaker consumption growth, increased competition in the retail sector, a roughly stable exchange rate, smaller wage pressure and the fact that unlike in 2004, no one-off factors were at work, annual average inflation almost halved in 2005 compared to the year before. The inflation rate, hitting 3.3% in December, lay comfortably within the target range of Magyar Nemzeti Bank (MNB) (4.0% ±1 percentage point). The inflation rate declined sharply during the first quarter of 2006 to 2.4% by March, reflecting the impact of the cut in the highest VAT rate. Generally, the inflation environment looks fairly favorable. On the supply side, growth in unit labor costs in the whole economy is estimated by the European Commission to slow substantially in 2006 following a modest acceleration in 2005. The decline in headline inflation in 2006 should keep a lid on nominal wage pressures, although the increase in minimum wages by almost 10% in 2006 may exert upward pressure on the overall wage pyramid.[5] The further development of energy prices, however, represents a risk factor on the supply side. On the demand side, accelerating consumption growth in 2006 may slow disinflation, while the longer-term prospects will crucially depend on the policies of the government emerging from April's parliamentary elections.

Twin deficits put policy framework and currency at risk

External financing requirement falls somewhat, but remains high

Notwithstanding these positive developments, Hungary continues to face severe macroeconomic imbalances. Although modestly lower than in 2004, the deficit of the current account remained high in 2005, and there are indications that the deficit is underestimated due to unreported imports. The improvement stemmed from a smaller deficit in the goods and services balance despite adverse terms-of-trade developments, while the largest deficit generator, the income balance, continued to deteriorate. The coverage of the deficit by FDI improved compared to 2004, but this was solely attributable to a large one-off privatization deal in the fourth quarter. As a result, Hungary remains heavily dependent on debt financing, which is reflected in the continued increase in the country's net foreign debt in percent of GDP and which makes it vulnerable to changes in investors' sentiment.

[5] *Furthermore, in 2007, the envisaged cut in employers' social security contributions should ease unit labor costs.*

Credible fiscal consolidation still lacking…

Fiscal policy continues to be characterized by a weak commitment to credible consolidation. The public sector deficit increased to 6.1% of GDP in 2005 (excluding the costs of the pension reform amounting to 1.4% of GDP). The deviation from the government's original target of 3.6% was largely attributable to changes in the accounting methodology, but also to fiscal slippage of around 0.5% of GDP. For 2006 the government is targeting a deficit of around 5.0%. However, even this target looks to be at risk, especially given parliamentary elections in April and local elections in October 2006. In this context, it should be noted that starting with the first fiscal notification of 2007, Hungary will no longer be able to exclude the net costs of the pension reform from the deficit figures, which will lead to a further perceived deterioration. Also, given that the deficit including these costs will be significantly above the 3% reference value in 2006, these costs cannot be taken into account in the assessment in the framework of the EDP, either. Furthermore, considering that the convergence program remained fairly vague with respect to concrete measures on the revenue and expenditure side, the EU Council urged Hungary to present by September 1, 2006, at the latest, a revised convergence program update that identifies concrete and structural measures that are fully consistent with the medium-term fiscal adjustment path, and in the meantime to do everything necessary to reach the budgetary objectives for the 2006 to 2008 period. A fiscal correction would also be required to lend more credibility to the government's current plan of fulfilling the criteria in time for the adoption of the euro in 2010.

… making the exchange rate vulnerable

Encouraged by favorable inflation developments, the MNB continued to gradually cut its policy rate until late September 2005. Since then the policy rate has been left unchanged at 6.0%, reflecting caution in the monetary policy council about the large current account and fiscal deficits and the country's reliance on capital inflows combined with the increase in interest rates in the U.S.A. and the euro area. Hungary's vulnerability to changes in investor sentiment was demonstrated during March 2006, when global portfolio reallocations hit Hungary's currency hardest in the region, causing it to lose around 5% of its value against the euro. Investors' risk appetite, the pace of the correction of economic imbalances and the way they are brought about (i.e. by market pressure or by policy action) will remain crucial for the development of monetary policy during the next few months. Nevertheless, given that a substantial and lasting weakening of the currency would have repercussions not only for medium-term inflation but – in view of the high and increasing role of foreign currency lending to domestic households and enterprises – also for financial stability, the central bank would probably use its instruments against unwelcome exchange rate developments.

Table 5

Main Economic Indicators: Hungary

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	3.8	3.4	4.6	4.1	3.2	4.5	4.5	4.3
Private consumption	10.6	8.4	3.2	2.4	1.7	3.0	2.8	2.1
Public consumption	5.8	6.2	1.7	−0.3	0.6	−0.4	−0.8	−0.7
Gross fixed capital formation	9.3	2.5	8.4	6.6	6.8	9.4	8.7	3.1
Exports of goods and services	3.9	7.8	16.4	10.6	6.4	11.3	11.5	12.7
Imports of goods and services	6.6	11.1	13.2	5.8	4.2	3.8	7.7	7.3
	Contribution to GDP growth in percentage points							
Domestic demand	6.1	6.5	2.6	−0.3	1.1	−2.5	1.2	−0.7
Net exports	−2.3	−3.1	2.1	4.4	2.1	7.0	3.4	5.0
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	4.9	8.4	9.7	10.5	4.2	13.6	12.8	11.4
Gross average wage of industry (nominal)	12.6	9.3	10.0	7.2	6.6	8.4	6.7	7.0
Unit labor cost of industry (nominal)	7.4	0.8	0.3	−2.9	2.3	−4.5	−5.4	−3.9
Producer price index (PPI) of industry	−1.1	2.5	3.6	2.9	1.9	3.2	2.6	4.0
Consumer price index (here: HICP)	5.2	4.7	6.8	3.5	3.5	3.6	3.5	3.2
EUR per 1 HUF, + = HUF appreciation	5.6	−4.2	0.7	1.5	6.1	1.0	1.3	−2.3
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	5.9	5.9	6.1	7.2	7.1	7.1	7.3	7.3
Employment rate (15−64 years)	56.2	57.0	56.8	56.9	56.4	56.8	57.3	57.1
Key interest rate per annum (%)	9.1	8.6	11.4	7.1	8.6	7.4	6.5	6.0
HUF per 1 EUR	242.9	253.5	251.7	248.0	245.0	249.8	245.6	251.8
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	10.1	14.2	11.7	13.7	11.3	15.2	13.9	14.3
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	2.2	−1.1	−1.9	0.6	−0.7	0.6	3.1	−0.7
Domestic credit of the banking system	12.3	22.4	17.9	15.2	14.5	16.8	12.3	17.3
of which:								
claims on the private sector	*15.4*	*18.7*	*21.7*	*16.6*	*17.0*	*16.8*	*14.8*	*17.7*
claims on households	*6.3*	*10.6*	*9.8*	*7.3*	*7.0*	*7.0*	*7.3*	*8.1*
claims on enterprises	*9.1*	*8.1*	*11.9*	*9.2*	*10.0*	*9.7*	*7.6*	*9.6*
claims on the public sector (net)	*−3.1*	*3.7*	*−3.8*	*−1.3*	*−2.5*	*0.0*	*−2.5*	*−0.4*
Other domestic assets (net) of the banking system	−4.5	−7.1	−4.3	−2.1	−2.4	−2.3	−1.5	−2.3
	% of GDP, ESA 95							
General government revenues	43.6	43.4	44.1	44.5				
General government expenditures[1]	52.0	49.8	49.5	50.6				
General government balance[1]	−8.4	−6.4	−5.4	−6.1				
Primary balance[1]	−4.4	−2.5	−1.2	−2.3				
Gross public debt[1]	55.0	56.7	57.1	58.4				
	EUR million, period total							
Merchandise exports	36,821	38,377	45,083	49,794	11,127	12,594	12,492	13,581
Merchandise imports	39,024	41,275	47,534	51,344	11,405	12,942	13,134	13,863
	% of GDP, period total							
Trade balance	−3.2	−3.9	−3.0	−1.8	−1.4	−1.6	−2.8	−1.2
Services balance	0.8	−0.5	0.2	0.5	0.5	0.6	0.9	0.1
Income balance (factor services balance)	−5.5	−5.0	−6.0	−6.3	−6.3	−7.3	−5.8	−6.0
Current transfers	0.8	0.8	0.3	0.3	−0.1	0.4	−0.0	0.7
Current account balance	−7.1	−8.7	−8.6	−7.3	−7.2	−7.9	−7.7	−6.4
Capital account balance	0.3	−0.0	0.3	0.8	0.8	0.9	0.3	1.2
Foreign direct investment (net)	4.1	0.6	3.5	4.9	3.1	2.4	2.5	10.9
	EUR million, end of period							
Gross external debt	38,559	46,041	55,062	65,938	58,603	63,037	64,446	65,938
Gross official reserves (excluding gold)	9,887	10,108	11,671	15,678	13,223	14,145	14,530	15,678
	Months of imports of goods and services							
Gross official reserves (excluding gold)	2.6	2.5	2.5	3.1	2.9	2.8	2.8	2.9
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	69,660	73,508	81,219	87,801	20,263	21,362	22,879	23,295

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

[1] *Excluding the net costs of the pension reform.*

4 Poland: Strong Growth, Lower Inflation, Smaller External and Fiscal Deficits

In 2005, average annual real GDP growth in Poland was only slightly more than 3% and thus considerably weaker than in 2004. At the same time, Poland registered a sizeable positive contribution of net exports to GDP growth in 2005. However, the contribution of net exports to GDP growth has probably been somewhat overstated (see introduction). Moreover, in the course of 2005, quarterly year-on-year GDP growth and, in particular, domestic demand growth (both consumption and gross fixed capital formation) accelerated significantly. This, in turn, lifted real import growth above real export growth. While this shift led to a negative contribution of net exports to growth in the fourth quarter, the very small deficit of the goods and services balance has not yet widened.

The labor market in a virtuous circle

Improved labor market conditions have been at the center of this pickup in domestic demand. The strong export performance in 2004 following significant currency depreciation and after EU accession decisively supported the start of employment growth in the economy. As the rise in the employment rate has outpaced the increase in the participation rate since the last quarter of 2003, the unemployment rate fell by nearly 3 percentage points until the last quarter of 2005 and declined further in year-on-year terms in the first quarter of 2006. Employment in industry increased in 2005 for the first time since the start of the economic transformation. Rising employment did not trigger a more pronounced acceleration of nominal and real wage growth until the fourth quarter of 2005. The rise in the real wage bill resulting from sustained employment growth and more recently also from stronger wage growth has supported the acceleration of private consumption growth. As of March 2006, disposable incomes have gotten a further stimulus from the rise in pensions and associated benefits that occurred when the cumulated indexation surpassed a threshold. The improvement in the labor market and in real private consumption strengthened the sales expectations of the corporate sector and thus bolstered gross fixed capital formation growth. Moreover, rising transfers from EU structural funds and the recent strong growth of housing loans to households supported the financing of gross fixed capital formation. Higher investment growth, in turn, has underpinned employment growth, thus triggering a virtuous circle.

Inflation at very low levels amid stronger domestic demand

Despite the substantial improvement in the labor market and the more recent acceleration of wage growth, no wage cost pressures have emerged so far. The very strong currency appreciation had put a lid on nominal wage growth until the first quarter of 2005, with the resulting decline in nominal unit labor costs (in industry) decisively contributing to marked disinflation. The more recent increases in production and hence in labor productivity (despite employment growth) are more closely accompanied by an acceleration in wage growth, while still implying a considerable year-on-year decline in nominal unit labor costs (in industry) in the first quarter of 2006. Therefore, annual HICP inflation fell from 3.6% in the first quarter of 2005 to 0.9% in the first quarter of 2006, despite the upward pressure that resulted from the fact that the rise in international energy prices was only partially offset by the currency appreciation. Moreover, despite the recent strengthening of domestic demand, hardly any signs of demand-side inflationary pressures are discernible in the recent development of consumer prices. Conversely, favorable unit labor cost developments additionally supported investment growth on the cost side, and low and further declining inflation further strengthened private consumption growth. Currently, inflation as measured by national CPI (0.4% year on year in March 2005) is substantially below the inflation target of the central bank (2.5% ±1 percentage point). Although the nominal main policy rate was cut in several steps from 6.5% in March 2005 to 4.0% in March 2006, the real key interest rate (e.g. measured by the PPI-deflated or CPI-deflated key rates per month compounded over the past 12 months) increased as a consequence of the persistent disinflation. Both the increase of real interest rates and the nominal and real appreciation of the zloty against the euro during the 12-month period up to March 2006, albeit considerably less pronounced than previously, had a tightening effect on monetary conditions.

Fiscal performance exceeds expectations, but not yet enough

In 2005, the fiscal deficit stood at 2.5% of GDP (4.4% of GDP including the net costs of the pension reform) and thus was nearly 1.5 percentage points lower than in 2004. The rise in revenues to GDP exceeded the increase in expenditures to GDP. At the same time, the actual 2005 deficit was lower than the 2005 deficit envisaged in the convergence program of November 2004, which was set at 3.9% of GDP (5.6% of GDP including the net costs of pension reform). However, given the fact that the actual 2004 deficit had also been below target, the narrowing of the deficit from 2004 to 2005 was more or less in line with the targeted reduction envisaged in the convergence program. The updated convergence program of January 2006 envisaged only a tiny further narrowing of the deficit from 2005 to 2006. As the actual 2005 deficit was lower than assumed in the updated convergence program of January 2006, the deficit target for 2006 in fact implies a more or less unchanged deficit level. For 2007 and 2008, the convergence program envisages a moderate narrowing of the deficit to 2.2% and 1.9% of GDP (4.1% and 3.7% of GDP including all net costs of the pension reform), respectively. The reformed Stability and Growth Pact requires the achievement of a deficit (including 100% of the net costs of the pension reform) close to the reference value of 3% of GDP to enable part of these costs (namely 60% in 2007 and 40% in 2008 of forecast total net costs of about 2% of GDP) to be excluded when calculating the deficit that serves as the basis for assessing whether the reference value has been met and whether the current EDP can be abrogated. With regard to the figure including all the net costs of pension reform, the EU Council noted in March 2006 that the convergence program did not envisage the correction of the excessive deficit by 2007, as required by the EU Council recommendation of July 5, 2004. It encouraged Poland to strengthen the adjustment in 2006, in particular by allocating any higher-than-budgeted revenues or lower-than-budgeted expenditure to deficit reduction. The Polish authorities have, at present, not set any specific target date for euro adoption.

Table 6

Main Economic Indicators: Poland

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	1.4	3.9	5.3	3.2	2.1	2.8	3.7	4.2
Private consumption (excl. NPISH)	3.4	1.9	4.0	2.3	1.7	1.6	2.7	3.1
Public consumption (incl. NPISH)	1.5	4.7	3.9	2.7	3.2	2.8	1.1	3.7
Gross fixed capital formation	−6.3	−0.1	6.3	6.2	1.2	3.8	5.7	9.8
Exports of goods and services	4.8	14.2	14.0	7.2	3.9	9.7	5.6	9.2
Imports of goods and services	2.6	9.3	15.2	3.4	1.1	0.8	0.2	11.3
	Contribution to GDP growth in percentage points							
Domestic demand	0.9	2.8	6.1	1.9	1.1	−0.5	1.6	5.0
Net exports	0.5	1.1	−0.8	1.4	1.0	3.4	2.1	−0.8
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	7.4	11.4	13.5	2.9	0.2	1.1	3.3	7.2
Gross average wage of industry (nominal)	3.7	3.0	4.5	3.2	2.1	3.2	3.2	4.4
Unit labor cost of industry (nominal)	−3.4	−7.5	−7.9	0.3	1.9	2.1	−0.1	−2.6
Producer price index (PPI) of industry	1.1	2.7	7.1	0.7	3.5	0.1	−0.2	−0.4
Consumer price index (here: HICP)	1.9	0.7	3.6	2.2	3.6	2.2	1.8	1.2
EUR per 1 PLN, + = PLN appreciation	−4.7	−12.4	−2.9	12.6	18.6	13.5	10.1	8.1
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	20.3	19.9	19.3	18.0	19.1	18.3	17.6	17.0
Employment rate (15−64 years)	51.5	51.2	51.7	52.8	51.5	52.2	53.7	53.7
Key interest rate per annum (%)	8.8	5.6	5.8	5.3	6.4	5.5	4.8	4.5
PLN per 1 EUR	3.9	4.4	4.5	4.0	4.0	4.1	4.0	3.9
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	2.0	1.5	6.9	11.8	10.4	12.4	12.2	12.1
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	0.9	0.1	4.2	5.0	1.9	3.6	6.6	7.4
Domestic credit of the banking system	7.1	5.2	3.6	2.8	0.6	4.4	2.9	3.4
of which:								
claims on the private sector	*3.4*	*3.8*	*4.0*	*3.1*	*0.2*	*3.1*	*4.5*	*4.6*
claims on households	*2.8*	*2.5*	*4.7*	*4.8*	*3.6*	*5.0*	*5.4*	*5.2*
claims on enterprises	*0.5*	*1.3*	*−0.6*	*−1.7*	*−3.4*	*−1.9*	*−0.9*	*−0.6*
claims on the public sector (net)	*3.7*	*1.4*	*−0.5*	*−0.3*	*0.4*	*1.2*	*−1.6*	*−1.2*
Other domestic assets (net) of the banking system	−6.0	−3.8	−0.8	4.0	7.9	4.4	2.7	1.3
	% of GDP, ESA 95							
General government revenues	41	39.9	38.6	40.8				
General government expenditures[1]	44.2	44.6	42.5	43.3				
General government balance[1]	−3.2	−4.7	−3.9	−2.5				
Primary balance[1]	−0.4	−1.9	−1.3	−0.1				
Gross public debt[1]	39.8	43.9	41.9	42.5				
	EUR million, period total							
Merchandise exports	49,324	53,814	65,841	76,742	17,588	18,817	19,222	21,115
Merchandise imports	57,036	58,890	70,393	79,067	17,907	19,503	19,833	21,824
	% of GDP, period total							
Trade balance	−3.7	−2.7	−2.2	−1.0	−0.6	−1.2	−1.0	−1.0
Services balance	0.4	0.2	0.4	0.7	0.6	1.0	0.2	0.9
Income balance (factor services balance)	−0.9	−1.7	−4.5	−3.6	−3.6	−3.8	−3.4	−3.6
Current transfers	1.6	1.9	2.2	2.3	1.9	3.1	2.6	1.6
Current account balance	−2.6	−2.1	−4.1	−1.6	−1.8	−0.9	−1.6	−2.1
Capital account balance	−0.0	−0.0	0.4	0.3	0.7	0.1	0.2	0.3
Foreign direct investment (net)	2.0	2.0	4.6	2.5	3.8	0.9	2.9	2.4
	EUR million, end of period							
Gross external debt	81,045	84,818	94,322	109,380	97,145	103,321	106,759	109,380
Gross official reserves (excluding gold)	27,367.2	25,999.8	25,904.4	34,536.1	28,407.5	32,957	32,843.5	34,536.1
	Months of imports of goods and services							
Gross official reserves (excluding gold)	4.9	4.6	3.9	4.6	4.2	4.4	4.2	4.2
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	209,723	191,261	204,630	240,871	56,180	57,078	59,038	68,575

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

[1] *Excluding the net costs of the pension reform.*

5 Slovakia: Booming Economy Displays Some Inflationary Pressures

In 2005, economic growth in Slovakia was slightly stronger than the year before; it picked up in the course of the year. In the fourth quarter of 2005, the country reached its highest quarterly growth rate ever. The favorable economic performance was largely the result of both buoyant private consumption and animated gross fixed capital investment. Accelerating real wages, higher employment and rising credit to private households supported private consumption growth. In 2005 investment growth picked up markedly, rising by around 10 percentage points compared to previous year largely in the wake of the building of two large automotive plants (Peugeot-Citroën and Hyundai-Kia) and of road construction projects. Stock changes contributed almost 4 percentage points to GDP growth in the fourth quarter.[6] On the external side, the negative contribution of net exports to GDP growth marginally decreased in 2005 compared to the year before, while being strongly negative in the fourth quarter of 2005 on the back of strong import growth rates. However, import growth was not only accelerated by strong demand for consumer goods, but also by imports of investment goods related to FDI projects.

Slovakia enters ERM II and aspires to introduce the euro in 2009

As the seventh of the new EU Member States, the Slovak Republic entered the exchange rate mechanism II (ERM II) on November 28, 2005, with a central parity of 38.455 SKK/EUR and a standard fluctuation band of ±15%. Národná banka Slovenska (NBS) combines ERM II participation with inflation targeting. At this stage, the NBS is targeting an inflation rate below 2.5% for December 2006 and below 2% for end-2007 and end-2008 with a view to meeting the respective Maastricht criterion. Slovakia aspires to introduce the euro on January 1, 2009.

Inflation pickup gives rise to interest rate hike

One of the main economic issues is the rise in price pressure in recent months. After a low in inflation in the third quarter of 2005, prices started to increase, coming to levels above 4% year on year in the first quarter of 2006. Core inflation, which excludes the impact of changes of regulated prices and indirect taxes, started to climb as well and amounted to more than 2% at the beginning of 2006 (2005: +1.1%), indicating a more general pickup of price pressures.

The main inflation-driving factors were a 20% hike of gas prices in October, regulated price increases for heating, natural gas and electrical energy as well as higher gasoline prices. Higher housing, health care and education prices pushed inflation, too, as did the rise in excise taxes on spirits and tobacco. Apart from cost-push factors, considering the growth dynamics of credit, wages and employment, there is some risk that demand-pull inflationary pressure has been building up. Compared to many other countries of the region, credit growth to the private sector has been rather low in Slovakia until recently. Lately, however, Slovakia has seen a rise in the growth rate of private bank lending, driven by favorable credit conditions and good economic prospects. Real wage growth was solid. In the industry sector, it went hand in hand with low productivity growth. However, wage growth in the nonindustry sec-

[6] *Higher excise taxes on spirits and tobacco announced for the beginning of 2006 might have encouraged firms to frontload stockbuilding.*

tor, and thus in the sector of predominantly nontradable goods, was even stronger than in the industry sector (partly due to the backward indexation of wages to inflation) and was also coupled with relatively low productivity growth, implying some inflationary pressure. To counter inflation and inflationary expectations, the NBS increased its key interest rate by 50 basis points to 3.5% at the end of February, the first interest rate hike since 2002.

Torn between inflationary pressures and a strengthening of the currency

ERM II entry and favorable economic prospects coupled with positive investor sentiment toward the region supported the Slovak koruna. From end-November until the beginning of March, the koruna appreciated by more than 3% against the euro and temporarily even fell marginally below 37 SKK/EUR after the abovementioned interest rate move. The currency weakened slightly in March, mainly as a result of external factors (higher interest rates in the euro area and in the U.S.A.), but recovered thereafter. Tightening monetary policy to counteract rising inflationary pressure could result in stronger capital inflows and thus in a further appreciation of the currency, which could eventually harm external price competitiveness if the pass-through from the exchange rate to inflation is incomplete and/or protracted.

Current account deterioration: presumably just a temporary phenomenon

In 2005, the current account deficit more than doubled compared to the previous year. High dividend payments of foreign-owned firms had a negative effect on the income balance, while part of these profits were reinvested, thus helping to finance the current account deficit. On the back of high imports and simultaneously decelerating exports, the trade balance added to the deterioration of the current account. However, it can be expected that export growth will pick up in the years to come, as the two large automotive plants that are currently being completed will start exporting in 2006 or in early 2007.

Despite some risks, fiscal consolidation is likely to move ahead

At 2.9%, the 2005 budget deficit turned out to be smaller than envisaged in the updated convergence program of December 2005 (4.1%). Since mid-2004, Slovakia has been under the EDP. In January 2006, the EU Council commented on the updated convergence program. The country aims at bringing the deficit below 3% of GDP in 2007, which is in accordance with the EU Council's recommendations. The deficit target for 2006 is 2.9% (exclusive of the costs of the pension reform, which are estimated to come to 1.3% of GDP in 2006). However, the country has to include the net costs of the pension reform from the beginning of the first fiscal notification in 2007. Furthermore, the EU Council suggested that the country improve the structural budgetary adjustment and consequently be able to reach the medium-term objectives. The budget plans face three major uncertainties: first, parliamentary elections in June 2006, which could entail some shift in the authorities' fiscal preferences; second, the extent of EU cofinancing needs, and third, the participation rate of citizens in the second (funded) pillar of the pension system. So far, interest in shifting to the new pension system has been higher than expected. People have to decide whether to enter or not by June 30, 2006.

Table 7

Main Economic Indicators: Slovakia

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	4.6	4.5	5.5	6.0	5.1	5.1	6.2	7.6
Private consumption	5.5	−0.6	3.5	5.8	5.5	5.6	6.1	5.9
Public consumption	4.9	2.7	1.1	2.0	1.8	0.7	0.9	3.8
Gross fixed capital formation	−0.6	−1.5	2.5	12.4	5.8	10.7	16.5	15.1
Exports of goods and services	5.6	22.5	11.4	10.9	7.2	5.0	16.1	15.0
Imports of goods and services	5.5	13.6	12.7	11.2	7.9	6.9	11.6	17.7
	Contribution to GDP growth in percentage points							
Domestic demand	4.7	−2.1	6.3	6.2	5.4	6.7	2.1	10.6
Net exports	−0.1	6.5	−0.8	−0.2	−0.3	−1.6	4.1	−3.0
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	6.5	4.9	3.9	0.6	−2.7	−0.3	1.6	3.9
Gross average wage of industry (nominal)	7.3	7.3	10.1	7.3	12.2	5.7	4.9	6.8
Unit labor cost of industry (nominal)	0.7	2.3	6.1	6.6	15.3	6.1	3.2	2.8
Producer price index (PPI) of industry	2.0	8.3	3.4	4.7	2.5	4.1	5.6	6.7
Consumer price index (here: HICP)	3.5	8.4	7.5	2.8	2.8	2.6	2.2	3.7
EUR per 1 SKK, + = SKK appreciation	1.4	2.9	3.6	3.7	5.9	3.0	3.5	2.5
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	18.7	17.6	18.2	16.2	17.6	16.3	15.7	15.4
Employment rate (15−64 years)	56.8	57.7	57.0	57.7	56.9	57.4	58.0	58.5
Key interest rate per annum (%)	7.9	6.4	4.9	3.2	3.8	3.0	3.0	3.0
SKK per 1 EUR	42.7	41.5	40.0	38.6	38.3	38.9	38.7	38.5
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	8.7	5.5	4.0	5.0	5.1	6.2	4.5	4.3
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	13.5	7.7	−2.6	−5.8	−2.6	−3.9	−8.5	−7.9
Domestic credit of the banking system	−6.5	7.8	10.2	12.1	10.1	12.2	12.2	13.6
of which:								
claims on the private sector	*4.9*	*5.5*	*4.0*	*8.1*	*4.6*	*6.7*	*9.3*	*11.4*
claims on households	*1.4*	*2.2*	*4.0*	*5.3*	*4.4*	*5.0*	*5.5*	*6.1*
claims on enterprises	*3.5*	*3.2*	*0.0*	*2.8*	*0.1*	*1.7*	*3.8*	*5.4*
claims on the public sector (net)	*−11.4*	*2.3*	*6.1*	*4.0*	*5.5*	*5.4*	*2.9*	*2.2*
Other domestic assets (net) of the banking system	1.7	−10.0	−3.6	−1.3	−2.4	−2.1	0.8	−1.4
	% of GDP, ESA 95							
General government revenues	35.6	35.7	35.9	33.9				
General government expenditures[1]	43.3	39.4	38.9	36.8				
General government balance[1]	−7.7	−3.7	−3	−2.9				
Primary balance[1]	−4.1	−1.2	−0.8	−1.1				
Gross public debt[1]	43.3	42.7	41.6	34.5				
	EUR million, period total							
Merchandise exports	15,281	19,370	22,370	25,739	5,598	6,350	6,493	7,298
Merchandise imports	17,540	19,935	23,553	27,717	5,932	6,808	6,676	8,301
	% of GDP, period total							
Trade balance	−8.8	−2.0	−3.6	−5.3	−3.8	−5.0	−1.9	−10.1
Services balance	1.9	0.7	0.7	0.7	1.6	−0.0	1.0	0.3
Income balance (factor services balance)	−1.9	−0.4	−1.0	−4.3	−0.1	−6.9	−3.4	−6.3
Current transfers	0.8	0.8	0.4	0.1	0.2	0.0	−0.3	0.4
Current account balance	−8.0	−0.8	−3.5	−8.8	−2.1	−11.9	−4.7	−15.6
Capital account balance	0.4	0.3	0.3	−0.0	−0.1	0.1	−0.0	−0.1
Foreign direct investment (net)	16.6	2.3	3.4	3.8	0.9	8.2	2.9	3.1
	EUR million, end of period							
Gross external debt	12,576	14,323	17,446	22,800	21,732	21,691	22,035	22,800
Gross official reserves (excluding gold)	8,497	9,338	10,605	12,578	13,556	12,522	12,684	12,578
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.1	4.9	4.8	4.9	6.1	4.9	5.1	4.1
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	25,742	28,962	33,132	37,303	8,684	9,189	9,451	9,979

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

[1] Excluding the net costs of the pension reform.

6 Slovenia: Euro Adoption at the Doorstep

Policy mix conducive to balanced growth, declining inflation

Exports and investments are the most dynamic GDP components

GDP growth slowed down moderately in 2005 compared to 2004, but at 3.9% was still considerably stronger than in the euro area. Net exports provided the largest contribution to growth, which, however, fell considerably in the second half of the year. Exports increased most strongly to non-euro area EU Member States. Gross fixed capital formation grew most substantially among domestic components, although its growth rate decelerated considerably compared to 2004. The growth rate of investments in machinery and equipment subsided, while investments in residential buildings flourished throughout the year, supported by the increased disbursement of housing loans. Domestic consumption expanded at about the same rate as in 2004, with household and public consumption rising at a roughly equal speed.

Broad-based disinflation continues

Slovenia made considerable progress in disinflation during 2005, with annual average inflation falling to 2.5% from 3.7% in 2004. Inflation was running at an annual rate of 2.0% in March 2006, while the inflation rate excluding energy and unprocessed food stood at 1.3%. Disinflation has been supported by the stability of the exchange rate, prudence in raising regulated prices, the countercyclical adjustment of excise duties (in particular on fuel) and more intense competition in the retail sector. Building on past success represents a major policy challenge. To this end, the authorities have announced limits on increases of government-controlled prices for 2006 to 2007, with the aim of keeping overall administered price growth lower than the increase in market-based prices. Continued productivity-oriented wage setting, especially given the acceleration of unit labor cost growth over the last three quarters of 2005, ongoing fiscal consolidation and the removal of the remaining structural rigidities in the labor and goods markets will have to play an important role in containing inflation pressures further down the road. Also, potential second-round effects of the contemplated changes in VAT rates in 2007 (the direct effect is estimated to come to +0.7 to +0.8 percentage point) need to be avoided.

Outward investment activity intensifies

The deficit on current account is small and almost halved in 2005. The improvement stemmed mainly from an increase in the service surplus, but the trade deficit was also slightly smaller than in 2004, which is remarkable taking into account the marked deterioration in the terms of trade. Slovenia registered a marginal net outflow of FDI in 2005, as Slovenian companies continued to invest abroad while FDI inflows slowed down. Given a relatively large net outflow of portfolio capital (especially as domestic corporates are increasingly investing in securities abroad), the financing of the external deficit relied on other capital inflows, including increased borrowing abroad by banks.

Tax reform is slowing fiscal consolidation in 2006

Fiscal policy in Slovenia continues to stand on a relatively sound footing. The public sector deficit amounted to less than 2% in 2005, while public debt levels have remained relatively moderate. According to Slovenia's updated convergence program, the deficit will remain at the same level in 2006, mainly due to the reduction in the payroll tax rate, before gradually falling to 1% by 2008. Over the next three years, Slovenia will implement a tax reform, the major elements of which will be the gradual elimination of the payroll tax, a systemic change in the personal income tax system and changes to the corporate income tax system aimed at promoting investments in research and development. Despite the 1999 pension reform, Slovenia is still confronted with contingent liabilities on the grounds of the projected costs of an aging population.

Monetary policy is being geared to euro adoption

Since entry into ERM II, Slovenia has successfully focused monetary policy on keeping the nominal exchange rate of the tolar stable against the euro. Since early February 2006, Banka Slovenije (BS) has embarked on interest rate cuts "along the lines of nominal convergence prior to the adoption of the euro." Until end-March 2006, the main refinancing rate and the interest rate on 60-day tolar bills of the BS were reduced by 50 basis points to stand at 3.25% and 3.50%, respectively. The yield on long-term government bonds amounted to 3.8% at the end of March 2006, offering a spread of only three basis points above euro area yields.

Slovenia prepares for euro adoption

Preparations for euro adoption, which is planned for January 1, 2007, currently represent the central theme of and major challenge to economic policy in Slovenia. At the beginning of March 2006, the Slovenian authorities submitted to the EU an official request for a convergence assessment before the summer. Following the necessary procedural steps starting with the publication of the convergence reports of the European Commission and the ECB in mid-May, a final decision on Slovenia's euro adoption and, in case of a positive assessment, the irrevocable fixing of the conversion rate can be expected for mid-July 2006. Under this scenario, Slovenian authorities, businesses and households would have to undertake the final preparations for euro adoption in the second half of 2006. Following the irrevocable fixing of the conversion rate, Slovenian interest rates, especially short-term interest rates, can be expected to converge to euro area levels by the end of 2006. Given expectations of stable inflation at around 2.5% year-on-year over the next three years according to the updated convergence program, the reduction in nominal interest rates will in all likelihood lead to a decrease in real interest rates as well. This may stimulate domestic demand in an environment of already accelerating real credit growth to the private sector. In addition, as the room for maneuver for domestic monetary policy will disappear, the domestic responsibility for maintaining macroeconomic stability will shift to other economic policy areas to an even greater degree than it already has since the country's entry into ERM II in June 2004. Further fiscal consolidation, productivity-oriented wage developments, structural reforms and prudential measures in the financial sector are likely to represent core elements of a stability-oriented policy mix.

Table 8

Main Economic Indicators: Slovenia

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	3.5	2.7	4.2	3.9	2.8	5.4	3.6	3.7
Private consumption	1.3	3.4	3.1	3.3	2.9	3.8	3.4	2.8
Public consumption	3.2	1.6	2.9	3.1	2.0	3.1	3.2	3.9
Gross fixed capital formation	0.9	7.1	5.9	3.7	0.6	3.9	1.6	8.2
Exports of goods and services	6.7	3.1	12.5	9.2	8.8	9.6	9.5	8.8
Imports of goods and services	4.8	6.7	13.2	5.3	6.8	1.6	5.9	7.2
	Contribution to GDP growth in percentage points							
Domestic demand	2.4	4.9	4.5	1.6	1.6	0.6	1.4	2.9
Net exports	1.1	−2.2	−0.8	2.4	1.2	5.4	2.3	0.8
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	5.6	3.5	6.4	5.6	2.5	5.1	5.3	9.6
Gross average wage of industry (nominal)	9.9	7.6	7.1	5.8	6.0	6.0	5.3	5.9
Unit labor cost of industry (nominal)	4.1	4.0	0.7	0.2	3.4	0.8	0.0	−3.4
Producer price index (PPI) of industry	5.3	2.6	4.4	2.8	4.4	2.9	2.0	1.8
Consumer price index (here: HICP)	7.5	5.7	3.7	2.5	2.8	2.2	2.3	2.6
EUR per 1 SIT, + = SIT appreciation	−3.5	−3.4	−2.2	−0.2	−0.9	−0.3	0.2	0.1
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	6.5	6.8	6.5	6.7	6.9	5.9	6.5	7.4
Employment rate (15−64 years)	63.4	62.6	65.3	66.0	65.2	66.1	66.6	66.0
Key interest rate per annum (%)	8.4	7.0	4.6	4.0	4.0	4.0	4.0	4.0
SIT per 1 EUR	225.9	233.8	239.1	239.6	239.7	239.5	239.5	239.5
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	22.8	12.7	5.1	6.6	7.3	6.9	5.0	7.1
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	11.0	3.3	−8.1	−10.4	−10.1	−11.5	−10.0	−10.1
Domestic credit of the banking system	12.2	8.1	14.0	19.7	17.8	20.7	18.9	21.3
of which:								
claims on the private sector	*9.1*	*8.0*	*11.5*	*16.6*	*14.9*	*16.6*	*16.8*	*18.3*
claims on households	*1.6*	*1.5*	*2.7*	*4.4*	*3.8*	*4.2*	*4.5*	*4.9*
claims on enterprises	*7.5*	*6.5*	*8.8*	*12.3*	*11.1*	*12.4*	*12.2*	*13.4*
claims on the public sector (net)	*3.2*	*0.1*	*2.4*	*3.1*	*3.0*	*4.1*	*2.2*	*3.0*
Other domestic assets (net) of the banking system	−0.4	1.3	−0.8	−2.7	−0.4	−2.3	−3.9	−4.1
	% of GDP, ESA 95							
General government revenues	45.3	45.3	45.3	45.5				
General government expenditures	48	48.1	47.6	47.3				
General government balance	−2.7	−2.8	−2.3	−1.8				
Primary balance	−0.3	−0.7	−0.5	−0.1				
Gross public debt	29.7	29.1	29.5	29.1				
	EUR million, period total							
Merchandise exports	11,082	11,414	12,933	14,517	3,350	3,745	3,572	3,850
Merchandise imports	11,351	11,960	13,942	15,551	3,534	3,847	3,821	4,348
	% of GDP, period total							
Trade balance	−1.1	−2.2	−3.9	−3.8	−2.9	−1.4	−3.6	−7.1
Services balance	2.6	2.2	2.6	3.3	2.7	3.2	3.6	3.6
Income balance (factor services balance)	−0.6	−0.7	−1.0	−0.8	−0.9	−1.4	−0.3	−0.8
Current transfers	0.6	0.4	0.1	0.2	−0.8	0.2	1.3	0.2
Current account balance	1.4	−0.4	−2.1	−1.1	−2.0	0.5	1.0	−4.0
Capital account balance	−0.7	−0.7	−0.4	−0.5	−0.1	−0.4	−0.4	−0.9
Foreign direct investment (net)	6.7	−0.5	0.8	−0.1	−2.8	0.1	0.1	2.0
	EUR million, end of period							
Gross external debt	11,483	13,260	15,278	19,511	16,313	17,032	18,436	19,511
Gross official reserves (excluding gold)	6,702	6,798	6,464	6,824	6,515	6,677	6,800	6,824
	Months of imports of goods and services							
Gross official reserves (excluding gold)	6.1	5.9	4.8	4.6	4.9	4.6	4.5	4.2
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	23,695	24,857	26,144	27,373	6,369	7,071	6,938	6,995

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

7 Bulgaria: Robust Economic Growth alongside Fiscal Surpluses, High and Rising External Deficits and a Pickup in Inflation

High domestic demand fueled by credit expansion

In Bulgaria real GDP grew by 5.5% in 2005. Annual growth peaked in the second quarter, but the destructive summer floods caused economic activity to decelerate substantially in the third quarter and exports to slacken. The growth of gross fixed capital formation remained very buoyant at almost 20% in 2005, soaring in the second half of the year. Real annual import growth stayed very high. As real annual export growth decreased sharply, reaching a low in the third quarter, the deterioration in net exports was significant compared to the previous year. The underlying reason for this economic development was high domestic consumption fueled by credit expansion, which also caused the current account deficit to widen further.

Current account deficit widens to almost 12% of GDP in 2005, raising concerns

The current account deficit expanded sharply in 2005 due to the further deterioration of the trade balance on the back of rapidly rising imports and more moderate export growth. The continuing worsening of the trade balance reflected ongoing strong domestic demand for capital and consumer goods as well as rising oil prices (expenditures for energy imports doubled against 2004) and sweeping floods that disrupted exports temporarily. As in the years before, the current account displayed a seasonal pattern: The high deficit in the first, second and fourth quarters was partly offset by a huge surplus of the service balance in the third quarter stemming from revenues from tourism. In the first months of 2006, the current account deficit has apparently widened further.

The sizeable trade deficit in 2005 reflects soaring imports of investment goods, but also lastingly high imports of consumer goods driven by the rapid growth of credits, in particular to households (see below).

On the financing side, in 2005 net FDI inflows dropped, but remained comparatively high, covering about 70% of the current account deficit. While privatization in Bulgaria is gradually coming to the end, solid large and stable inflows not stemming from privatization were registered in 2005. Also, Bulgaria's gross external debt amounted to 68% of GDP compared to 64% in 2004. A breakdown shows that public external debt continued to decline, as in the past years, while private external debt rose significantly, reflecting the banking sector's foreign funding of domestic credit growth.

Credit growth is slowing down and should be reduced to 17.5% in full year 2006

Containing credit growth remains a key challenge for the Bulgarian authorities and the main issue in their discussions with the IMF. Since the beginning of 2004, the Bulgarian National Bank (BNB) has adopted a series of primarily prudential and administrative measures to keep credit growth in check and succeeded in curbing credit growth to nongovernment nonbanks from 47.7% year on year at the end of 2004 to 33.8% a year later. The measures to contain commercial banks' credit activity included tightening their reserve requirements and introducing ceilings for annual credit growth (introduced in April 2005) as well as making regulations on capital adequacy and risk exposures more stringent. In the context of the second review of the Stand-By Arrangement earlier this year, the BNB revised its credit growth projection and agreed to reduce credit expansion to 17.5% in full year 2006.

Considering the very limited room for maneuver for monetary policy under a currency board, tight fiscal policy has played an active role in controlling demand, both domestic and external. The Bulgarian government, which has run increasing budget surpluses for the last few years, agreed to further tighten fiscal policy in 2006 with the IMF and is now aiming at a fiscal surplus of 3% of GDP.

Excise duty hikes boosted inflation in February

In Bulgaria average annual HICP inflation decelerated in 2005 compared to 2004. After inflation had declined to 3.3% in January 2005, it rose gradually again to reach 6.4% year on year at end-2005. This trend continued in the first months of 2006. Inflation increased to 8.7% year on year in February and eased only slightly in March. The major factors driving up inflation in 2005 were cyclical and one-off factors, i.e. the high demand growth caused by the summer floods in 2005 combined with food price hikes and the sharp rise in energy prices. The increases in indirect taxes at the beginning of 2006 added to inflationary pressures. The government decided to sharply raise excise duties on cigarettes one year earlier than initially scheduled, arguing that it intended to harmonize indirect taxes with minimum levels in the EU early on so as to create better conditions for further nominal convergence after accession to the EU. This strategy seems reasonable, but it also introduced some added risk of further price increases. According to the central bank, average annual inflation is forecast to decline to about 6% in 2006.

Table 9

Main Economic Indicators: Bulgaria

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	4.9	4.5	5.7	5.5	5.9	6.5	4.6	5.5
Individual consumption	3.4	7.1	4.9	7.4	7.1	5.8	9.4	7.1
Collective consumption	6.0	3.0	6.7	2.2	6.4	6.5	4.3	−4.7
Gross fixed capital formation	8.5	13.7	13.5	19.0	11.2	16.9	24.0	21.5
Exports of goods and services	7.2	7.9	13.0	7.2	9.2	12.0	1.1	8.9
Imports of goods and services	4.9	15.3	14.1	14.6	10.8	15.3	18.8	12.9
	Contribution to GDP growth in percentage points							
Domestic demand	4.3	12.1	9.5	14.8	11.0	14.4	19.6	12.5
Net exports	0.6	−7.6	−4.0	−9.2	−5.1	−7.9	−15.0	−7.0
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	2.7	12.6	16.9	1.9	2.0	2.4	0.7	2.7
Gross average wage of industry (nominal)	3.5	3.8	7.1	7.2	6.4	7.0	7.7	7.9
Unit labor cost of industry (nominal)	0.8	−7.8	−8.3	5.2	4.4	4.5	6.9	5.1
Producer price index (PPI) of industry	1.4	5.0	5.9	7.1	6.2	6.9	6.7	8.4
Consumer price index (here: HICP)	5.8	2.3	6.1	5.0	3.8	4.9	4.8	6.6
EUR per 1 BGN, + = BGN appreciation	−0.1	0.0	−0.2	−0.1	−0.2	−0.3	0.0	0.0
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	18.3	13.9	12.2	10.2	11.5	10.1	9.3	10.0
Employment rate (15−64 years)	50.6	52.5	54.2	55.8	53.1	56.2	57.8	56.0
Key interest rate per annum (%)	4.0	2.7	2.6	2.1	2.2	2.0	2.0	2.0
BGN per 1 EUR	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	18.3	16.3	22.3	27.3	26.3	29.5	27.1	26.5
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	7.7	5.4	4.4	8.9	6.7	8.9	11.3	8.6
Domestic credit of the banking system	12.1	14.5	21.8	25.8	25.4	28.2	23.6	26.0
of which:								
claims on the private sector	*13.6*	*19.9*	*26.3*	*27.9*	*31.0*	*32.7*	*25.0*	*23.6*
claims on households	*3.3*	*5.9*	*10.0*	*13.0*	*11.9*	*13.7*	*13.1*	*13.1*
claims on enterprises	*10.3*	*14.0*	*16.3*	*14.9*	*19.0*	*19.0*	*11.9*	*10.5*
claims on the public sector (net)	*−1.5*	*−5.4*	*−4.5*	*−2.1*	*−5.6*	*−4.5*	*−1.4*	*2.4*
Other domestic assets (net) of the banking system	−1.5	−3.6	−3.8	−7.4	−5.8	−7.6	−7.8	−8.2
	% of GDP, ESA 95							
General government revenues	43.3	44.3	45.5	46.1				
General government expenditures	43.2	44.0	43.6	43.0				
General government balance	0.1	0.3	1.9	3.1				
Primary balance	2.3	2.4	3.7	4.8				
Gross public debt	54.0	46.1	38.6	29.9				
	EUR million, period total							
Merchandise exports	6,063	6,668	7,985	9,454	2,081	2,305	2,415	2,654
Merchandise imports	7,941	9,094	10,938	13,823	2,785	3,420	3,588	4,030
	% of GDP, period total							
Trade balance	−11.3	−13.7	−15.1	−20.4	−15.7	−22.2	−19.5	−23.2
Services balance	3.1	3.1	3.5	3.1	−1.7	4.4	11.0	−2.3
Income balance (factor services balance)	2.4	1.6	1.2	1.2	1.3	1.8	0.8	0.8
Current transfers	3.4	3.5	4.5	4.3	3.8	4.8	4.0	4.6
Current account balance	−2.4	−5.5	−5.8	−11.8	−12.3	−11.3	−3.8	−19.9
Capital account balance	0.0	−0.0	0.0	−0.0	0.0	−0.0	0.0	−0.0
Foreign direct investment (net)	5.7	10.3	11.5	8.7	8.4	7.3	10.9	7.7
	EUR million, end of period							
Gross external debt	10,769	10,641	12,572	14,530	13,120	13,589	13,550	14,530
Gross official reserves (excluding gold)	4,247	4,981	6,443	6,816	6,325	6,990	6,795	6,816
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.2	5.3	5.7	4.9	5.6	5.2	4.6	4.3
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	16,589	17,727	19,594	21,448	4,476	5,022	6,010	5,939

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

8 Romania: Weaker but still Robust Growth, Very Gradual Disinflation and Stubborn External Imbalances

GDP growth slowed in 2005 compared to the previous year but is still robust. The slowdown is mainly attributable to external shocks (unfavorable weather, heavy floods) which affected the agricultural sector. Output in agriculture declined by almost 14% year on year in 2005 after the country had seen record agricultural production in 2004. Thus, the strong output decline was also due to base effects. Growth was mainly driven by domestic demand. Private consumption was fueled by both strong wage and credit growth. Real wages in industry advanced by around 7% on average in 2005. Credit growth to the private sector remained strong, showing a rise by around 40% in 2005. Investment rose quickly due to reconstruction work after the flood, but also because of the progress made in restructuring the corporate sector. Export growth moderated, and the contribution of external demand to GDP growth remained negative, as imports expanded dynamically.

Further very small steps toward disinflation

In 2005, disinflation was very gradual and inflation remained at comparatively high levels. This trend continued in the first quarter of 2006, with year-on-year inflation just below 9%. In late 2005 and early 2006 inflation was mainly driven by increases in administered prices, volatile food prices and generally high domestic demand.

The Banca Națională a României (BNR) switched to an explicit inflation targeting strategy in August 2005, after having practiced a form of "implicit" inflation targeting for some time. With year-end inflation at 8.6%, Romania slightly overshot the 2005 target of 7.5% ±1% at year-end, which had already been revised upward from 7.0% ±1% in the second half of 2005. For 2006 and 2007, the year-end inflation targets are 5% ±1% and 4% ±1%, respectively. These goals seem ambitious, given inflation developments in the first quarter of 2006. In addition, the current floods in parts of Romania could again hamper agricultural production and push up food prices. Rising oil prices and higher-than-expected hikes in administered prices could also be obstacles for further disinflation. Currently, the BNR projects 2006 inflation to come in at 6.5%.

The current account needs attention

Standing at almost 9% of GDP in 2005, the current account deficit is mainly due to the high deficit in the trade balance. Strong domestic demand and a marked nominal appreciation of the leu against the euro (about 12% on average in 2005 compared to 2004) spurred imports, while curbing export dynamics. The appreciation of the real effective exchange rate was even stronger due to the inflation differential with Romania's main trading partners. On the back of surging imports, the trade deficit nearly doubled in the first two months of 2006 compared to the corresponding period of the previous year (in euro terms). At the same time, the FDI coverage of the current account is high at around 75% in 2005. In the short run, therefore, the financing of the deficit does not pose a serious problem. For 2006, high FDI inflows are expected, as, for instance, payments related to the privatization of Banca Comerciala Romana, which was bought by Austria's Erste Bank at the end of 2005, will be effected during the course of the year.

High inflation rate combined with a strong currency

The BNR faces conflicting objectives. In the context of inflation targeting, the exchange rate matters in as much as it impacts on inflation developments. At times, however, upward pressures on the currency may be perceived as too strong and harmful to the real economy, in particular if the exchange rate pass-through is swift and large in the case of a depreciation, whereas it is slow and incomplete if the currency appreciates. According to the BNR, there are signs of such an asymmetric pass-through in Romania.

In 2005, the BNR undertook several measures to combat inflation. Administrative measures served to moderate high growth rates of private credit. The main focus was to bring down foreign currency lending, not only for macroeconomic but also for prudential reasons. The reserve requirements for foreign currency-denominated liabilities have been raised in two steps from 30% to 40%, and a ceiling of 300% of own funds for credit institutions' foreign currency lending has been adopted. The measures have had some effect on the currency composition of household credits.

In view of strong capital inflows, the key interest rate was cut by 100 basis points to 7.5% in September 2005. After this, the leu depreciated slightly toward the end of 2005, but strengthened again in early 2006. The BNR reversed its interest rate move in February 2006 and increased the rate by 100 basis points. This step was motivated by persistent inflation pressures and the need to cope more actively with price dynamics. It remains to be seen how effective this move is, given that higher interest rates could lead to stronger capital inflows and thus upward pressure on the currency and/or to widening monetary aggregates.

Discussions between the Romanian authorities and the IMF

The Stand-By Arrangement between Romania and the IMF concluded in July 2004 has presently veered off track. According to the IMF, Romania should use monetary policy (more) actively to fight inflation. Furthermore, the IMF urges further fiscal tightening and wage moderation. In the case of fiscal policy, this means a balanced budget for 2006 and small surpluses over the medium run.

The current Stand-By Arrangement with the IMF is scheduled to expire in June. Discussions about a new agreement are still going on. After consultations in March, the Romanian authorities saw only "small differences" between the positions. Further talks are to be held before the summer and will center around the Romanian authorities' recent revision of the 2006 projected budget deficit from 0.5% to 0.9% of GDP and the planned increase in public sector wages of 12% to 15% compared to 2005 averages.

In 2005 the budget deficit was slightly lower than projected, standing at 0.4% of GDP (due to high domestic demand growth, VAT revenues were higher than expected), and was therefore in line with the deficit target of 0.7% agreed with the IMF.

Table 10

Main Economic Indicators: Romania

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	5.2	5.2	8.4	4.1	6.0	4.5	2.4	4.3
Private consumption	5.6	8.4	14.1	9.7	13.7	12.7	8.2	6.5
Public consumption	2.7	7.7	4.9	4.4	4.0	2.5	3.7	6.2
Gross fixed capital formation	7.6	8.6	10.7	13.1	5.2	8.9	10.8	21.3
Exports of goods and services	17.1	8.4	13.9	7.6	8.8	3.3	8.4	9.8
Imports of goods and services	11.8	16.0	22.1	17.2	18.4	16.1	17.4	17.2
	Contribution to GDP growth in percentage points							
Domestic demand	4.3	8.8	12.9	9.1	11.8	11.4	6.7	8.2
Net exports	0.9	−3.6	−4.5	−5.0	−5.9	−6.9	−4.3	−3.9
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	5.4	5.2	7.1	4.4	6.1	2.2	2.8	6.5
Gross average wage of industry (nominal)	23.6	19.5	23.0	16.8	15.5	16.6	17.0	18.1
Unit labor cost of industry (nominal)	17.2	13.6	14.8	11.9	8.8	14.1	13.9	10.9
Producer price index (PPI) of industry	23.2	19.6	19.1	10.8	13.5	11.6	9.0	9.1
Consumer price index (here: HICP)	22.5	15.3	11.9	9.1	8.9	9.9	9.0	8.5
EUR per 1 RON, + = RON appreciation	−16.8	−16.8	−7.3	11.8	9.4	12.3	16.3	9.5
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	9.1	7.5	8.5	7.5	8.9	7.5	6.5	7.2
Employment rate (15−64 years)	57.6	57.6	57.7	57.6	56.6	58.8	57.8	57.2
Key interest rate per annum (%)	29.6	18.8	20.4	10.0	15.8	8.6	8.0	7.7
RON per 1 EUR	3.1	3.8	4.1	3.6	3.7	3.6	3.5	3.6
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	40.9	31.2	31.5	41.9	40.8	44.8	41.6	40.5
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	31.8	15.5	12.9	21.1	23.1	22.5	18.4	20.8
Domestic credit of the banking system	18.7	23.9	26.0	17.1	12.9	15.2	16.5	22.7
of which:								
claims on the private sector	*24.1*	*28.2*	*32.2*	*26.7*	*22.7*	*25.3*	*26.6*	*31.1*
claims on households	. .	*10.0*	*13.1*	*13.2*	*9.4*	*11.8*	*14.3*	*16.3*
claims on enterprises	. .	*18.2*	*19.1*	*13.5*	*13.2*	*13.5*	*12.3*	*14.8*
claims on the public sector (net)	*−5.3*	*−4.3*	*−6.2*	*−9.5*	*−9.8*	*−10.1*	*−10.1*	*−8.4*
Other domestic assets (net) of the banking system	−9.6	−8.3	−7.4	3.7	4.9	7.1	6.7	−2.9
	% of GDP, ESA 95							
General government revenues	36.7	36.2	36.1	19.6				
General government expenditures	38.7	37.9	37.4	20.0				
General government balance	−2.0	−1.7	−1.3	−0.4				
Primary balance	0.2	0.0	0.0	0.5				
Gross public debt	23.8	20.7	18.0	15.2				
	EUR million, period total							
Merchandise exports	14,644	15,614	18,935	22,255	5,098	5,433	5,931	5,793
Merchandise imports	17,392	19,569	24,258	30,061	6,155	7,450	7,678	8,778
	% of GDP, period total							
Trade balance	−5.7	−7.6	−8.7	−9.8	−7.7	−11.5	−7.8	−11.6
Services balance	0.0	0.1	−0.3	−0.5	−0.9	−0.7	−0.0	−0.7
Income balance (factor services balance)	−1.0	−1.2	−4.2	−2.9	−2.4	−2.9	−2.3	−3.7
Current transfers	3.4	3.1	4.9	4.6	4.8	4.5	4.1	5.0
Current account balance	−3.4	−5.5	−8.4	−8.7	−6.2	−10.6	−6.1	−10.9
Capital account balance	0.2	0.4	0.8	0.7	0.6	1.0	0.5	0.9
Foreign direct investment (net)	2.5	3.1	8.4	6.6	3.5	5.7	5.2	9.9
	EUR million, end of period							
Gross external debt	15,417	16,311	18,120	24,460	20,455	22,063	22,982	24,460
Gross official reserves (excluding gold)	5,877	6,374	10,848	16,796	12,562	13,771	16,647	16,796
	Months of imports of goods and services							
Gross official reserves (excluding gold)	3.6	3.4	4.8	5.9	5.3	4.9	5.7	5.0
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	47,970	52,246	60,892	79,465	13,754	17,538	22,362	25,811

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

9 Croatia: Increasing Inflation and Foreign Debt

GDP growth was slightly higher in 2005 than in 2004 and accelerated considerably from 1.4% in the first quarter to around 4% in the remainder of 2005, chiefly due to the increasing contributions by private consumption and gross fixed capital formation. At the same time, public consumption and net exports were only of minor importance for GDP growth. Despite this performance, labor market conditions remained broadly unchanged and unemployment stayed at high levels. The general government deficit decreased by 1.1 percentage points from 2004 to 2005, mainly due to cuts in expenditures. Croatia introduced a rolling three-year budget in 2005. Croatia's 2005 Pre-Accession Economic Programme provides for further gradual fiscal consolidation.

IMF Stand-By Arrangement extended

The Stand-By-Arrangement with the IMF was extended to October 2006 following the completion of the second review in March 2006. The second review provided an overall positive assessment of Croatia's economic development and acknowledged the efforts for fiscal consolidation and structural reform, including reforms of the pension and health-care systems and of the railways, and the reduction of state subsidies. However, it also underlines slow progress with privatization and the vulnerabilities related to Croatia's external position.

Foreign debt still rising

Gross foreign debt increased slightly again in 2005 (82.4% of GDP against 80.2% in 2004) as a result of the rise in the private sector's net foreign indebtedness. At the same time, gross public foreign debt declined substantially over the last year, outpacing the drop in total public debt. This seems to be due to a shift from euro bonds issued abroad to bonds issued domestically and bought by domestic banks, which in turn finance themselves abroad. However, commercial banks use funds from abroad also to lend both to households and to nonfinancial corporations in spite of a series of administrative measures taken in 2004 and early 2005 to stem foreign borrowing. The latest measure to slow down bank lending was taken in early February 2006, when the central bank imposed a special reserve requirement of 55% to be allocated by banks on net new issues of securities. In addition, direct external borrowing by the nonfinancial corporate sector expanded rapidly as well in 2005 and in early 2006.

Inflation on the rise: Just a temporary phenomenon?

The consumer price index accelerated noticeably in 2005 compared to the previous years; in the last quarter of 2005, inflation came in at 4.0%. The reasons for these dynamics are manifold. First, oil price increases feature prominently among the explanations. Second, food prices recorded above-average increases. This would not be too surprising, given that oil price increases affect retail- and transport-intensive goods such as diary products most. However, soaring meat prices had a greater impact on food prices. Third, higher inflation rates are due to increases in administered prices. Disaggregated CPI data indicate double-digit price hikes for housing rents, water supply and medical services as well as above-average price increases for electricity. This development can be explained by health-care reforms and the attempt to close the gap to price recovery costs for some public services. Not only regulated prices but also market-based services such as education, catering, insurance and financial services recorded strong inflation rates, perhaps due to economic catching-up. In early 2006, price pressures seem to have subsided somewhat, as inflation decreased from 3.9% in January 2006 to 3.0% in March 2006 due to lower food price inflation.

The risk of a more persistent increase cannot be ruled out

However, the rate of core inflation, rising hand in hand with headline inflation from mid-2004, remained unchanged at 3.1% in December 2005 through January and February 2006. The danger of the inflation rate persisting above 3% cannot be ruled out, given possible further increases in energy prices or second-round effects triggered by recent increases. Moreover, there is a need to modernize public services and the related capital stock, which will lead to higher administered prices. Long-term pressure on inflation also comes from market-based service price inflation due to productivity gains and from rising demand for services as GDP per capita rises. However, this effect will unfold only gradually, given the low weight of services.

Monetary policy and the exchange rate

Persistent inflation pressures may pose risks because monetary policy has only limited tools in Croatia to counteract rising inflation and inflationary expectations. Price stability in Croatia is achieved by maintaining the nominal exchange rate stable against the euro in a de facto narrow band. This has a doubly stabilizing effect. First, stable nominal exchange rates anchor domestic inflation by keeping the price of imported tradable goods stable. This channel is very important in Croatia, as the weight of imported goods is thought to be unusually high in the CPI in view of the country's narrow manufacturing base and, as a result, of the large share of imported goods (reflected in structurally high trade deficits). Second, stable exchange rates provide a nominal anchor for inflationary expectations both in the tradable and the nontradable sectors.

Monetary policy and interest rate policy

At the same time, interest rate policy is very much constrained in Croatia under the country's monetary policy strategy. The central bank's key interest instrument, the discount rate, has not been changed since October 2002, (4.5%), whereas money market rates varied from 0% to roughly 10% despite the recent introduction of an interest rate corridor. However, the corridor only reflects observed money market fluctuations.

Monetary policy and currency substitution

Moreover, because of the high share of foreign exchange-denominated deposits and loans in total deposits and loans, the exchange rate cannot be used easily to stem inflation. An appreciation of the kuna would increase the net wealth of holders of foreign exchange deposits in domestic currency and would thus spur bank lending in domestic currency, which would put further pressure on inflation (if loans are used to purchase e.g. real estate). At the same time, booming lending coupled with cheaper imported goods resulting from nominal appreciation would lead to a widening of the trade deficit and would thus boost foreign debt further.

Table 11

Main Economic Indicators: Croatia

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	5.6	5.3	3.8	4.3	1.8	5.1	5.2	4.8
Private consumption	7.7	4.6	3.9	3.4	2.4	4.4	3.8	3.2
Public consumption	4.9	1.3	−0.3	0.8	−0.1	1.0	1.0	1.4
Gross fixed capital formation	13.9	24.7	4.4	4.8	0.3	3.2	5.8	9.9
Exports of goods and services	1.2	11.4	5.4	4.6	1.0	6.7	4.9	4.9
Imports of goods and services	13.4	12.1	3.5	3.5	2.1	5.8	2.3	3.6
	Contribution to GDP growth in percentage points							
Domestic demand	12.3	7.2	3.4	4.2	2.7	5.8	3.3	5.0
Net exports	−6.7	−1.8	0.4	0.1	−0.9	−0.8	1.9	−0.2
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	7.8	3.5	4.0	7.2	2.6	11.3	7.6	7.5
Gross average wage of industry (nominal)	6.9	5.4	5.5	5.3	5.6	5.0	5.4	5.4
Unit labor cost of industry (nominal)	−0.8	1.8	1.5	−1.8	3.0	−5.6	−2.1	−2.0
Producer price index (PPI) of industry	−0.5	1.9	3.6	3.1	5.0	3.2	2.0	2.3
Consumer price index (here: CPI)	1.7	1.8	2.1	3.4	3.1	3.1	3.5	4.0
EUR per 1 HRK, + = HRK appreciation	1.0	−2.1	1.0	1.3	1.4	1.2	0.3	2.3
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	15.1	14.5	14.1	. .	. .	13.4	. .	. .
Employment rate (15−64 years)	53.4	53.4	54.7	. .	. .	54.8	. .	. .
Key interest rate per annum (%)	5.6	4.5	4.5	4.5	4.5	4.5	4.5	4.5
HRK per 1 EUR	7.4	7.6	7.5	7.4	7.5	7.3	7.4	7.4
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	32.4	11.3	8.3	9.5	8.5	9.3	9.9	10.3
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	9.8	−7.7	−0.5	−5.0	−1.7	−6.4	−6.0	−6.0
Domestic credit of the banking system	23.2	19.5	9.4	17.3	12.6	18.1	18.6	19.6
of which:								
claims on the private sector	*21.5*	*17.7*	*10.1*	*13.2*	*11.4*	*12.0*	*13.6*	*15.4*
claims on households	*11.3*	*11.9*	*7.5*	*9.0*	*7.8*	*8.6*	*9.6*	*10.0*
claims on enterprises	*10.2*	*5.8*	*2.6*	*4.1*	*3.6*	*3.4*	*4.0*	*5.4*
claims on the public sector (net)	*1.7*	*1.8*	*−0.7*	*4.1*	*1.2*	*6.1*	*5.0*	*4.2*
Other domestic assets (net) of the banking system	−0.5	−0.5	−0.7	−2.7	−2.4	−2.4	−2.7	−3.3
	% of GDP, ESA 95							
General government revenues	43.3	41.6	39.9	40.8				
General government expenditures	47.4	46.1	44.9	44.7				
General government balance	−4.1	−4.5	−5.0	−3.9				
Primary balance	−2.0	−2.5	−2.9	−1.6				
Gross public debt	40.1	40.9	43.7	44.2				
	EUR million, period total							
Merchandise exports	5,293	5,572	6,603	7,244	1,524	1,891	1,871	1,958
Merchandise imports	11,254	12,546	13,331	14,727	3,093	3,976	3,720	3,938
	% of GDP, period total							
Trade balance	−24.4	−26.6	−23.7	−24.2	−23.1	−26.9	−21.5	−25.3
Services balance	13.4	18.8	16.6	17.2	0.1	14.5	46.2	2.8
Income balance (factor services balance)	−2.3	−4.1	−2.2	−3.1	−4.1	−6.7	−1.5	−0.7
Current transfers	4.7	4.7	4.2	3.8	4.4	4.1	3.1	3.7
Current account balance	−8.6	−7.1	−5.1	−6.3	−22.7	−14.9	26.3	−19.5
Capital account balance	2.1	0.3	0.1	0.2	0.0	0.0	0.0	0.5
Foreign direct investment (net)	2.4	6.5	2.5	3.8	2.6	8.2	3.6	0.8
	EUR million, end of period							
Gross external debt	15,055	19,811	22,781	25,508	23,143	24,260	24,080	25,508
Gross official reserves (excluding gold)	5,651	6,554	6,436	7,438	6,700	7,066	6,999	7,438
	Months of imports of goods and services							
Gross official reserves (excluding gold)	4.9	5.2	4.8	5.1	5.4	4.6	4.7	4.8
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	24,456	26,221	28,405	30,959	6,783	7,756	8,593	7,826

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

10 Turkey: Solid Economic Performance above Expectations, Driven by Consumption

Annual real GDP growth slowed in 2005 compared to 2004, but picked up in the second half of 2005.[7] In 2005, the growth rates of private consumption intensified markedly alongside gross fixed capital formation, which gained speed during the whole year as corporations expanded capacity. This development offset the negative contribution of net exports to growth. The composition of growth, which had become considerably more balanced in the second half of 2004 as a result of the moderate growth of domestic demand, remained broadly the same in 2005. Macroeconomic stabilization is supported by a three-year Stand-By Arrangement with the IMF, which was concluded in spring 2005 and which will be reviewed for the third time this May. This program envisages a switch toward more export-led growth over the program period.

Success story in reducing inflation, but recently noticeably above target range

HICP inflation stood at 7.1% year-on-year in December 2005, the lowest rise in more than three decades. In the first quarter of 2006, average inflation accelerated to 7.6% and was thus above the inflation target range, which came into force at the beginning of 2006, shortly after the central bank, Türkiye Cumhuriyet Merkez Bankası (TCMB), declared that it would move to an explicit inflation targeting framework. The TCMB is committed to reducing inflation to 5% by the end of this year; the target is operated with a band of ±2%. The TCMB expects that the recent sectoral cut in VAT rates in the textile, ready-to-wear and leather sectors and the continued absence of significant secondary effects of oil price increases will favorably impact inflation in the short term. At the end of April, the TCMB cut its key interest rate by 25 basis points to a historical low of 13.25%, as the underlying disinflation process remains intact. This reduction was expected and was broadly priced in by the markets. In the course of 2005, the TCMB lowered the overnight borrowing rate several times from 17.0% to 13.5%.

The Turkish lira appreciates in 2005

After a nominal depreciation in the course of 2004 until November 2004, the Turkish lira appreciated sharply against the euro in 2005. The nominal appreciation, which helped support disinflation, reached its peak at 1.61 TRL/EUR in December 2005. The TCMB has continued to dampen the speed of appreciation with frequent preannounced foreign exchange purchase auctions within the framework of its managed floating exchange rate regime. Thus, the ample capital inflows have allowed the TCMB to build up reserves in parallel to the currency appreciation.

Credit boom in housing involves inflation risks

The rehabilitation of the banks, reforms of financial regulation and supervision, the reduction of the public borrowing requirement (see below), lower real interest rates and the improvement of the overall economic situation have resulted in a large increase in bank credits to the private sector, mainly to households and for housing. If the current trend continues (and there is no indication that it will moderate soon), ongoing disinflation efforts may become more complicated.

[7] *Turkey has started to produce the first macroeconomic data series according to ESA95. Attention needs to be given to further methodological development.*

Fiscal position on track but structural improvements necessary

In 2005, the budget deficit turned out to be less pronounced than expected, which was basically attributable to more vigorous growth and declining interest rates. It has been confirmed that Turkey will meet the public sector primary surplus target of 6.5% of GNP according to the IMF definition also in 2006; however, Turkey will not fully deliver the structural improvements envisaged under the program agreed with the IMF. The overall fiscal balance, which recorded a deficit of 1.2% in ESA95 terms, benefited from declining risk premia and interest rates. The 2006 budget law envisages a narrowing of the consolidated budget deficit. In its assessment of the stabilization program, the IMF recommended deficit reduction and, furthermore, emphasized the need to push forward pension and health-care reforms. Reform measures in these areas were adopted in April 2006 and will be effective in 2007. They are part of a wider package to overhaul the country's social security system. The 2006 budget proposal has for the first time been drawn up in the context of a medium-term fiscal framework which extends the budget target through 2008.

The composition of the public debt stock improved in 2005; its external component remained stable (by comparison, private external debt increased substantially). At 49.3% of GDP, gross external debt remained constant at the end of 2005 despite the exchange rate appreciation, as the current account deficit widened. The sensitivity of external debt to exchange rate shocks is notable in light of the substantial cumulative nominal and, in particular, real appreciation of the lira in recent years. The lengthening of maturities has reduced rollover risk. However, continued reliance on floating rate paper implies an interest rate risk comparable to that of shorter-term paper. The composition of debt should improve further in 2006, as substantial amounts of foreign exchange-indexed debt will be retired.

Wider current account deficit financed mainly by FDI and portfolio inflows

In 2005, the current account deficit widened further, exclusively because of the worsening of the trade deficit in the wake of the deterioration of the terms of trade (rising oil prices) and the currency appreciation. However, import growth outstripped export growth less than earlier, moderating the dynamics of the deterioration. The slowdown of export growth is mainly due to the weakening of textile exports, which account for nearly a third of Turkey's exports, as a result of the expiration of the international Multifiber Arrangement. The decision to start accession negotiations with Turkey changed the markets' perception of the country's medium-term outlook and investment opportunities, and net FDI inflows started to take off in the second half of 2005 (privatization) and more than tripled in the year as a whole. Record capital inflows have facilitated the financing of the current account deficit, and increasing FDI inflows have started to improve their composition. Corporate tax cuts which will take effect in 2006 are expected to support FDI inflows further.

Table 12

Main Economic Indicators: Turkey

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	7.9	5.8	8.9	7.4	6.6	5.5	7.7	9.5
Private consumption	2.1	6.6	10.1	8.8	4.1	3.9	10.4	16.7
Public consumption	5.4	–2.5	0.5	2.4	4.5	4.0	3.2	0.0
Gross fixed capital formation	–1.1	10.0	32.4	24.0	10.3	20.0	30.7	33.0
Exports of goods and services	11.1	16.0	12.5	8.5	14.0	6.7	3.9	10.9
Imports of goods and services	15.8	27.1	24.7	11.5	10.6	9.1	11.2	15.3
	Contribution to GDP growth in percentage points							
Domestic demand	8.8	8.8	13.6	7.5	4.9	6.3	8.1	10.0
Net exports	–0.9	–3.0	–4.6	–1.7	0.4	–1.8	–2.4	–2.3
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	8.5	7.1	7.5	6.0	5.1	4.3	6.1	8.4
Gross average wage of industry (nominal)	37.6	23.1	13.4	12.2	12.6	12.4	12.5	11.4
Unit labor cost of industry (nominal)	26.8	15.0	5.5	5.9	7.2	7.7	6.1	2.8
Producer price index (PPI) of industry	50.1	25.6	14.6	6.0	10.9	6.7	4.3	2.3
Consumer price index (here: HICP)	47.0	25.6	10.1	8.1	8.8	8.7	7.8	7.3
EUR per 1 TRY, + = TRY appreciation	–23.2	–15.4	–4.5	5.9	–4.4	2.3	10.4	16.0
	Period average levels							
Unemployment rate (ILO definition, %, 15–64 years)	10.4	10.5	10.3	9.8	11.7	9.2	9.2	9.2
Employment rate (15–64 years)	44.7	43.5	43.6	43.9	41.3	44.8	44.8	44.8
Key interest rate per annum (%)	49.6	36.1	21.9	14.8	16.6	14.7	14.3	13.8
TRY per 1 EUR	1.4	1.7	1.8	1.7	1.7	1.7	1.6	1.6
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	43.1	16.5	24.1	20.6	18.9	20.5	21.1	21.6
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	–6.9	–1.8	2.2	6.4	5.1	5.3	7.2	7.7
Domestic credit of the banking system	55.9	24.8	28.7	20.5	21.7	21.8	20.6	18.3
of which:								
claims on the private sector	*2.1*	*9.4*	*19.1*	*18.8*	*20.0*	*18.2*	*18.4*	*18.8*
claims on households	*0.1*	*3.1*	*8.0*	*8.7*	*8.2*	*8.2*	*8.7*	*9.4*
claims on enterprises	*2.0*	*6.3*	*11.1*	*10.2*	*11.8*	*10.0*	*9.7*	*9.4*
claims on the public sector (net)	*53.8*	*15.5*	*9.6*	*1.7*	*1.7*	*3.6*	*2.2*	*–0.5*
Other domestic assets (net) of the banking system	–5.9	–6.5	–6.9	–6.3	–7.9	–6.6	–6.7	–4.5
	% of GDP, ESA 95							
General government revenues	32.3	26.9	26.6	30.6				
General government expenditures	45.2	38.2	32.3	31.8				
General government balance	–12.9	–11.3	–5.7	–1.2				
Primary balance	7.1	5.9	5.9	8.0				
Gross public debt	93.1	85.1	76.9	69.6				
	EUR million, period total							
Merchandise exports	42,392	45,192	53,913	61,843	13,689	15,154	15,530	17,470
Merchandise imports	49,980	57,449	73,102	88,289	18,440	21,871	23,301	24,677
	% of GDP, period total							
Trade balance	–4.0	–5.7	–8.0	–9.1	–8.7	–10.5	–8.5	–8.7
Services balance	4.3	4.3	4.3	3.9	1.7	3.4	6.9	2.4
Income balance (factor services balance)	–2.5	–2.3	–1.9	–1.6	–2.0	–2.0	–1.2	–1.4
Current transfers	1.4	0.4	0.4	0.4	0.3	0.5	0.4	0.4
Current account balance	–0.9	–3.3	–5.2	–6.3	–8.7	–8.6	–2.4	–7.3
Capital account balance								
Foreign direct investment (net)	0.5	0.5	0.7	2.5	0.9	0.2	2.1	5.7
	EUR million, end of period							
Gross external debt	124,159	114,823	119,111	144,157	124,091	134,828	138,539	144,157
Gross official reserves (excluding gold)	25,562	26,616	26,436	42,823	29,331	33,049	34,686	42,823
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.4	5.0	3.9	5.3	4.3	4.1	4.0	4.7
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	190,668	214,235	241,185	292,121	54,374	64,107	91,281	82,360

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

11 Russia: Oil Boom Continues

High oil prices and buoyant internal demand keep Russian growth robust in 2005

Pushed by buoyant internal demand (private consumption as well as investment) and despite the further weakening of net exports, Russian GDP growth remained robust in 2005 at more than 6%. In the course of the year, the economic expansion gathered momentum and reached almost 8% year on year in the fourth quarter, driven mostly by accelerating fixed capital formation. Higher investments have partly also spread outside the resource sector (e.g. to metallurgy, chemicals and construction), starting to fuel somewhat broader-based growth. At the same time, most of this diffusion of investments has been carried out by commodity-based conglomerates. And some sectors, notably resource extraction and transportation, seem to be struggling with capacity constraints. In the first two months of 2006. GDP growth is estimated to have slowed down to 4.1% (year on year). According to the Ministry of the Economy, the slowdown was triggered partly by the persistent real appreciation of the ruble, partly by this winter's exceptionally cold weather.

Prudent fiscal policies contribute to substantial twin surpluses

Continuing terms-of-trade gains featuring further oil and gas price rises in 2005 as well as prudent macroeconomic policies have sustained substantial and growing twin surpluses and have pushed foreign exchange reserves and the budgetary stabilization fund (established in 2004 to accumulate windfall oil-related revenues and thus to protect the budget from the effects of oil price-triggered economic volatility) to new record levels. The current account surplus was higher than in 2004; the general government budget surplus came to almost 8% of GDP of 2005. The size of the budget surplus was also caused by the tightening of resource taxation and the enforcement and collection of large back tax claims. According to preliminary estimates, in the first quarter of 2006 the current account surplus, measured in euro, increased by over a third compared to the corresponding period of the previous year. In January and February 2006, the federal fiscal surplus is estimated to have exceeded 11% of (pro rata) GDP. At end-March 2006, the foreign currency (including gold) reserves of the Central Bank of Russia (CBR) topped a new record level of EUR 170 billion (which corresponds to 15 months of goods and services imports), and the stabilization fund reached EUR 50 billion.

Despite swift expansion of foreign exchange reserves and of the stabilization fund, real appreciation pressures persist and inflation exceeds 10%

Although the stabilization fund is successfully used as the government's major sterilization instrument for liquidity created by the CBR's forex market interventions to prevent too strong a nominal appreciation of the ruble, the large and unabating inflows of foreign exchange proceeds keep the ruble under real appreciation pressures. The related problems include the specter of the Dutch disease, which continues to constitute the dilemma of Russian macroeconomic policy. Despite the rapidly rising levels of foreign exchange reserves and of the stabilization fund, the ruble's real-effective exchange rate climbed 15% from early 2005 to the end of March 2006 (compared to more than 30% since the beginning of 2003). Inflation has essentially not declined any more since early 2004 and stubbornly remains above 10%. This helps explain booming imports of manufactured goods (like automobiles or consumer electronics) and subdued industrial production growth, which came to 4% in 2005 and slowed to around 3% in the first quarter of 2006 (year on year).

Structural reforms, apart from banking, have almost ground to a halt

Despite these macroeconomic tensions and growing concerns about industrial competitiveness in the wake of real effective exchange rate developments, the authorities appear to be largely satisfied with the overall situation. This may explain why economic policymakers appear complacent and why structural reforms have almost ground to a halt in Russia. In the fall of 2005, the CBR closed the screening process for the inclusion of banks in the deposit insurance scheme, with the result that about 920 banks (about three-quarters of the total number) accounting for 99% of all private deposits were admitted to the scheme. This should raise general confidence in the banking sector and should level the playing field. Banking activity continued to expand rapidly in 2005, with banking deposits as well as credits increasing by a quarter in real terms; bank assets rose to about 45% of GDP at the end of the year. Austrian banks have also been playing an increasing role in Russia. In early February 2006, Raiffeisen International agreed to purchase Impexbank, a mid-sized privately owned bank, for around EUR 460 million.

Growing total foreign debt

Despite its expansion, the banking sector does not fully meet the financial needs of large resource-oriented Russian corporations, which are increasingly taking up funds abroad. As of early 2006, the stock of corporate sector foreign liabilities approached EUR 100 billion. Growing private external debt is responsible for the rise of Russia's total foreign debt (which came to 35.6 % of GDP at end-2005). The increase is tempered, however, by the timely and early retirement of foreign liabilities on the part of the state. As a result, the federal government's share in the country's total foreign debt has declined to about a third.

Business climate remains challenging, growth remains fragile

At end-March 2006, the CBR announced a step to liberalize capital account transactions consistent with the commitment to achieve this goal by early 2007: The remaining mandatory foreign currency selling requirements for exporters (10% of export proceeds) will be lifted and deposit requirements for nonresident portfolio investments will be halved on May 1, 2006. Notwithstanding the above-mentioned tendency toward some diversification of investment, the overall business climate remains challenging. Interventions of the tax and other authorities continue to be widespread, and the rule of law has not been fully established yet. The quality of Russian economic growth therefore remains fragile, and its sustainability beyond the current period of high commodity prices is still in question.

Cutoff date for data: April 27, 2006.

Table 13

Main Economic Indicators: Russia

	2002	2003	2004	2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005
	Year-on-year change of the period total in %							
GDP in constant prices	4.8	7.4	7.2	6.4	5.0	5.7	6.6	7.9
Private consumption	8.3	7.4	11.2	10.9	8.5	12.1	11.5	11.1
Public consumption	2.6	2.2	2.0	1.8	1.4	2.0	1.9	1.9
Gross fixed capital formation	2.8	12.8	11.3	10.4	8.2	9.7	10.1	12.2
Exports of goods and services	10.3	12.5	11.8	6.3	3.5	5.6	5.1	10.3
Imports of goods and services	14.6	17.7	22.0	17.3	15.4	14.9	19.4	18.6
	Contribution to GDP growth in percentage points							
Domestic demand	4.1	6.6	8.3	8.3	6.9	7.5	9.4	9.0
Net exports	0.4	0.4	−1.0	−2.3	−2.4	−1.8	−3.3	−1.6
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	7.5	13.9	13.4	..	−14.1	−14.3	−14.3	−14.0
Gross average wage of industry (nominal)	27.2	25.4	5.2	21.7	21.0	21.3	21.5	22.9
Unit labor cost of industry (nominal)	18.3	10.1	−7.3	..	41.0	41.6	41.7	42.9
Producer price index (PPI) of industry	11.7	15.6	24.0	20.7	23.3	23.3	20.6	16.2
Consumer price index (here: CPI)	16.0	13.6	11.0	12.5	12.9	13.4	12.5	11.2
EUR per 1 RUB, + = RUB appreciation	−11.9	−14.5	−3.1	1.7	−1.9	−1.5	2.5	8.1
	Period average levels							
Unemployment rate (ILO definition)	8.0	8.6	8.2	7.6	8.2	7.4	7.2	7.5
Employment rate	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	22.7	17.3	13.5	13.0	13.0	13.0	13.0	12.9
RUB per 1 EUR	29.6	34.7	35.8	35.2	36.5	35.4	34.8	34.2
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	31.2	39.2	35.5	33.9	31.5	30.8	35.8	36.8
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	19.8	21.3	22.4	34.0	33.5	36.0	34.2	32.4
Domestic credit of the banking system	30.4	29.6	17.6	0.4	1.4	−7.5	1.4	5.8
of which:								
claims on the private sector	*28.9*	*29.5*	*30.8*	*30.0*	*30.1*	*27.4*	*29.8*	*32.6*
claims on households	..	..	..	..	..	..	..	..
claims on enterprises	..	..	..	..	..	..	..	..
claims on the public sector (net)	*1.5*	*0.2*	*−13.2*	*−29.6*	*−28.7*	*−34.9*	*−28.4*	*−26.8*
Other domestic assets (net) of the banking system	−19.1	−11.7	−4.5	−0.2	−2.7	2.9	0.1	−1.3
	% of GDP							
Federal government revenues	20.3	19.5	20.5	23.7				
Federal government expenditures	18.4	17.8	16.1	16.2				
Federal government balance	1.8	1.7	4.4	7.4				
Primary balance	3.9	3.4	5.6	8.4				
Gross public debt, general government	37.0	28.6	21.9	20.5[1]				
	EUR million, period total							
Merchandise exports	113,201	120,040	147,168	196,763	38,269	47,319	53,130	58,045
Merchandise imports	64,278	67,066	78,192	101,314	19,570	23,360	26,592	31,792
	% of GDP, period total							
Trade balance	13.5	13.9	14.6	15.5	15.5	16.9	15.8	14.2
Services balance	−2.9	−2.5	−2.3	−1.9	−1.6	−1.8	−2.5	−1.7
Income balance (factor services balance)	−1.9	−3.0	−2.2	−2.4	−0.9	−2.5	−3.5	−2.3
Current transfers	−0.2	−0.1	−0.1	−0.2	−0.1	−0.0	−0.2	−0.3
Current account balance	8.5	8.2	9.9	11.0	12.8	12.6	9.6	9.9
Capital account balance	−3.5	−0.2	−0.3	−1.6	−0.1	−0.7	−5.3	−0.0
Foreign direct investment (net)	−0.0	−0.4	0.4	0.1	1.8	1.8	1.7	−3.7
	EUR million, end of period							
Gross external debt	143,728	148,489	159,174	219,208	161,679	179,458	178,708	219,208
Gross official reserves (excluding gold)	42,291	58,531	88,661	148,094	103,142	122,727	129,169	148,094
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.7	7.7	10.1	13.4	12.3	12.0	10.6	10.9
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	363,558	381,607	473,181	615,679	120,460	142,069	168,287	184,862

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

[1] End-September 2005.