Developments in Selected Countries [1, 2, 3]

1 International Financial Turmoil Puts a Brake on the Dynamic Catching-up Process of CESEE

Growth in CESEE expected to moderate considerably in the coming months

The turmoil on international financial markets has intensified over the past weeks; the situation remains volatile, but various policy measures taken by central banks and governments around the world aim at stabilizing the situation.[4] While emerging markets were hit less hard than advanced economies for a prolonged period after the outbreak of the crisis in mid-2007, financial spillovers to this country group have increased recently. Together with the moderation in world economic activity, this development has contributed to a substantial worsening of the international economic environment for the CESEE countries covered in this report. In addition, the situation is characterized by a high degree of uncertainty surrounding current economic and financial conditions.

Up to the first half of 2008, however, the international financial turmoil had almost no direct impact on real economic developments in CESEE, as real growth came in at 6.5% year on year on average. Somewhat less favorable developments in external demand (resulting partly from lower world as well as euro area demand, especially in the second quarter of 2008) were offset to a considerable extent by a still robust performance of domestic variables. However, along with global output, growth is expected to moderate in most countries over the coming quarters (see box 2).

Inflation still elevated in most countries but on the decline owing to falling energy prices and slowing growth

Inflation has only recently started to come down somewhat from the record levels observed in the course of the year, mainly due to decreasing energy prices. Domestic inflation pressures, however, remain strong in many countries, as tightening labor markets lead to increasing wages and rising unit labor costs (ULC). The expected moderation in output growth, however, will have a certain dampening effect on prices.

Adverse impacts of the international turbulence on financial markets in the region were more pronounced than those on the real economy. Especially the SEE-2, Croatia, and Turkey (i.e. countries with stronger external and/or internal imbalances) were hit more strongly, while countries at more advanced stages of transition (notably the CEE-5) generally experienced less distortion in their financial markets (see box 1).

[1] *Compiled by Antje Hildebrandt and Josef Schreiner with input from Stephan Barisitz, Markus Eller, Johann Elsinger, Sándor Gardó, Thomas Reininger, Tomáš Slačík, Zoltan Walko, and Julia Wörz.*

[2] *Cutoff date: end-October 2008. This report focuses primarily on data releases and developments from mid-April 2008 up to the cutoff date for data.*

[3] *This report covers Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia, as well as Croatia, Turkey, and Russia. The Central, Eastern and Southeastern (CESEE) EU Member States – Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia – are referred to as the CESEE EU Member States throughout the report. Additionally, the CEE-5 group comprises the Czech Republic, Hungary, Poland, Slovakia, and Slovenia, while SEE-2 refers to Bulgaria and Romania. Croatia and Turkey are referred to as EU candidate countries.*

[4] *Central banks and governments in the countries under observation have responded to the ongoing turmoil by taking numerous policy measures, including verbal interventions stressing banking system stability, raising deposit insurance levels (to at least EUR 50,000 in CESEE, to EUR 56,000 in Croatia), supporting interbank liquidity via foreign exchange swaps (Hungary, Poland), repo auctions (Czech Republic) and guarantees (Russia, Bulgaria), lowering minimum reserve requirements (Croatia, Russia, Bulgaria), foreign exchange market interventions (Russia) and/or measures to ease the situation on government bond markets (reducing offer volumes in the Czech Republic and Hungary, buybacks in Bulgaria) (see also Financial Stability Report 16).*

Hungary is somewhat of an outlier from this pattern, as financial variables have deteriorated sharply in recent weeks. Even though the country reports one of the highest levels of gross external debt in the region, macroeconomic fundamentals are gradually recovering from a far-reaching fiscal consolidation package that was implemented in mid-2006. The current turmoil, therefore, seems to be largely based on a deterioration of international investor sentiment. Against this background and considering the prevailing nervousness on international markets, contagion risks in the region remain pronounced, as exemplified also by the recent pressure on other Central European currencies (e.g. the Czech koruna and the Polish złoty). Despite its current account surplus and its low level of gross external debt, also Russia was hit strongly by the international financial crisis, given higher political uncertainties in the context of the conflict in Georgia and decreasing energy and commodities prices on world markets that led to capital outflows and stock market turbulence.

The general risk profile of the region has clearly deteriorated since the last report. Especially countries with an unbalanced structure of economic growth (SEE-2, Russia) or high external imbalances and high external debt ratios (Bulgaria and Croatia) remain vulnerable to shocks. Risks have also risen in Romania where overheating has intensified. In the CEE-5, growth is more balanced, and both Slovakia and Slovenia are benefiting from the momentum caused by euro area entry. Overall, growth is moderating in the countries covered in this report but is expected to remain relatively solid compared with other parts of the world, unless global financial turmoil leads to a major recession in the euro area or capital flows to the region decelerate markedly. In some countries (Romania and Bulgaria in particular), an orderly moderation of GDP growth would in fact be welcome with a view to moving to a more sustainable growth path. Generally, the swift catching-up process of the past years will most probably lose speed or even come to a halt in some countries.

Repricing of risk more pronounced for countries with large current account deficits

The global market turmoil has led to a repricing of risk that is more pronounced for countries with large current account deficits (i.e. Bulgaria, Romania, and Croatia, but also in Hungary as explained above). More expensive and shorter-term external financing and, in the worst case, quantitative constraints on the access to external finance could ultimately lead to a vicious circle as regards external sustainability. Developments in the first half of 2008 show that the financing structure of current account imbalances has already worsened (rising shares of short-term financing and, in some countries, also falling FDI shares). The financing of external deficits will become increasingly challenging because of several factors: the slowdown in world economic activity and the associated decrease of FDI flows to the region, and international investors becoming more reluctant to lend funds to emerging markets with high internal and/or external imbalances. The situation could be further aggravated by banks facing rising funding costs, higher uncertainty regarding access to (i) large-scale foreign funding for domestic banks and (ii) cross-border credits for corporates, as well as risks that Western European parent banks could withdraw liquidity from CESEE subsidiaries to ease liquidity tensions in home markets or at the group level.

2 Overview of Main Developments

2.1 No Major Growth Slowdown in the First Half of 2008

Solid growth in the first half of the year but outlook deteriorating

The deceleration of economic activity observed in major economies in the course of the international financial crisis hardly affected CESEE countries in the first half of 2008. The outlook for the coming quarters, however, is increasingly clouded. Real GDP growth came in at 6.5% (year on year) on average in the first half of 2008, which represents only a minor slowdown compared with full-year 2007 (6.6%). Looking at the quarterly profile of GDP, however, average growth decelerated more markedly from 7.3% in the first quarter to 5.8% in the second quarter of 2008. This decline was mainly caused by a slump in economic activity in Turkey (which represents roughly 20% of the region's aggregate economic output), where capital formation moderated substantially in the context of elevated political uncertainty. The international financial turmoil impacted on the countries under review mainly via a worsened external environment which led to lower foreign demand growth, a continued tightening of financing conditions, and, in some countries, weakening asset markets. The continued robust development of domestic demand, however, has cushioned those adverse effects to a great extent. So far, the only countries in the region to be hit more strongly were the Baltics, where unfavorable global developments spurred an incipient adjustment of imbalances after a long boom period. According to recent forecasts, however, growth is expected to moderate substantially in the whole region.

Growth trends differ across CESEE

Different growth trends could be observed across CESEE, with the CEE-5 and Croatia lagging behind their SEE peers. In the CEE-5, growth decelerated more strongly than on average in the countries under review, dropping from 6% in 2007 to 5.4% in the first half of 2008. The most important factor in this aggregate decline was weaker economic activity in the Czech Republic, where fiscal consolidation weighed on GDP dynamics. Growth also slowed down in Slovakia (albeit from a very high level), owing to a less favorable development of the external sector. A somewhat higher growth rate could be observed only in Hungary, which is gradually recovering from a far-reaching fiscal consolidation package implemented in mid-2006. The SEE-2 was the only country group in the region

Table 1

Gross Domestic Product (Real)

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Annual change in %								
Slovenia	4.1	5.7	6.1	7.2	6.0	6.4	4.7	5.4	5.5
Bulgaria	6.2	6.3	6.2	5.5	7.3	4.9	6.9	7.1	7.1
Czech Republic	6.3	6.8	6.6	6.6	6.6	6.4	6.6	5.3	4.5
Hungary	4.1	3.9	1.3	2.7	1.2	0.9	0.8	1.7	2.1
Poland	3.6	6.2	6.5	7.2	6.4	6.4	6.1	6.3	6.0
Romania	4.2	7.9	6.1	6.1	5.7	5.7	6.6	8.2	9.3
Slovakia	6.6	8.5	10.4	8.3	9.3	9.4	14.3	8.7	7.6
Croatia	4.3	4.8	5.6	7.0	6.6	5.1	3.7	4.3	3.4
Turkey	8.4	6.9	4.6	8.1	4.1	3.3	3.6	6.7	1.9
Russia	6.4	7.3	8.1	7.4	8.0	7.3	9.5	8.5	7.5
Euro area	1.7	2.8	2.6	3.1	2.6	2.7	2.2	1.7	1.9

Source: Eurostat, national statistical offices, wiiw.

where growth picked up substantially in the first half of 2008, mainly on the back of soaring domestic demand amid continued high credit expansion and rising wages. The Croatian economy lost steam due to a slowdown in domestic consumption. While Turkey registered soft growth in the second quarter of 2008, no downturn could be observed in the first half of the year because of favorable developments in the first quarter of the year. Russia broadly sustained the dynamic development observed in 2007.

2.2 Growth Still Driven by Domestic Demand, Supported by (so far) Favorable Labor Markets

Domestic demand continued to be the driver of economic activity in the region. In the first half of 2008, private consumption growth remained broadly unchanged in most countries compared with 2007. In Bulgaria, Romania and Hungary, however, it edged up higher, while in the Czech Republic it was dampened by an increase in administered prices and indirect taxes. In Romania, Turkey and Russia, private consumption growth outpaced total GDP growth, thus indicating increased demand pressures. Public consumption was of rather minor importance throughout the region, dampening growth somewhat in Hungary, Poland and Bulgaria.

Besides a still robust development of credit to households in the first half of 2008, consumption growth benefited from benign labor market developments and rising wages. Unemployment rates throughout the region declined to the historically low level of 7.1% on average in the second quarter – and thus below the euro area average (7.3%) – with the Czech Republic and Slovenia reporting particularly low levels. Despite increasing labor demand, however, especially Slovakia and Croatia still show very high unemployment rates at 10.1% and 13.2%, respectively. Hungary was the only country were unemployment increased within the observation period, owing mainly to weak general economic dynamics. Employment also improved noticeably: While employment rates were generally on an upward path in the region (with the exception of Hungary), they did not reach the levels observed in the euro area.

GFCF growth on the decline but still above consumption growth in most CESEE countries

Growth of gross fixed capital formation (GFCF) decreased in the region, except in Romania and Croatia where it developed more swiftly than in 2007. However, GFCF growth still outpaced consumption growth in all countries but Hungary and Slovakia. During the first half of 2008, investment demand was afflicted by thinner export order books and recently declining industrial capacity utilization, mainly in line with lower international demand and industrial confidence. In many countries, FDI inflows were also below the levels observed in 2007.

In the first half of 2008, the external sector's contribution to growth was substantial only in Hungary and the Czech Republic. While growth contributions were broadly neutral in the other CEE-5, Bulgaria, and Turkey, net exports had a considerable dampening effect on growth in Romania, Croatia, and Russia. Looking at growth dynamics, external sector developments improved in the Czech Republic and Bulgaria, while they deteriorated sharply only in Croatia. Export growth decelerated in most of the CEE-5 (particularly Slovakia and Slovenia), Croatia and Turkey, whereas it gained speed in Bulgaria, Romania, Russia, but also in Poland. Import growth declined in all countries but Romania and Croatia.

External sector developments were influenced by lower international demand (the IMF, for instance, projects imports by advanced economies to more than halve in 2008 compared with 2007), currency appreciation in the CEE-5 (except Hungary) and currency depreciation in Romania and Russia.

2.3 High Commodity Prices and Buoyant Activity in Many Countries Add to Inflation Pressures until Mid-Year

Brisk economic activity in the past quarters and tightening labor markets coupled with increasing labor shortages in some CESEE countries and sectors, especially with regard to skilled labor, resulted in upward pressure on wages.

Nominal wages on the rise across CESEE

Growth rates of compensation per employee climbed in all CESEE countries (with the exception of Hungary), reaching double-digit levels in Poland and Slovakia and more than 20% in Bulgaria and Romania. Owing to rising prices, however, real wages actually grew more slowly in the CEE-5 than in 2007 and more or less stagnated in the Czech Republic, in Hungary and in Slovenia by the second quarter of 2008. Also in the SEE-2, price increases cut markedly into nominal wages. In Romania, however, real wages still rose by more than 15%. Productivity developments in the CESEE region were mixed, but in no country sufficiently high to fully offset wage increases. ULC growth in the whole economy increased in all countries (except Hungary) and reached particularly high levels in Bulgaria and Romania (17.7% and 15.3%, respectively), where it also clearly outpaced HICP inflation.

Wage and ULC developments together with rising food and energy prices throughout most of the observation period contributed to increasing inflation pressures until August, when they started to moderate gradually.

Price increases across the region reached levels of 6% and above in most countries, with Russia, Bulgaria and Turkey posting double-digit inflation rates. The situation was aggravated by an increase in administered prices and indirect taxes in several countries, e.g. Bulgaria, the Czech Republic and Poland. In Romania and Russia, the substantial and lasting currency depreciation also had a negative effect on inflation.

Table 2

Consumer Price Index (here: HICP)

	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008
	Annual change in %								
Slovenia	2.5	3.8	2.6	3.2	3.7	5.5	6.5	6.4	6.2
Bulgaria	7.4	7.6	5.3	4.7	9.0	11.2	12.4	14.0	12.5
Czech Republic	2.1	3.0	1.7	2.6	2.7	4.9	7.6	6.7	6.5
Hungary	4.0	7.9	8.8	8.5	7.3	7.1	6.9	6.8	6.3
Poland	1.3	2.6	2.0	2.3	2.4	3.7	4.5	4.3	4.4
Romania	6.6	4.9	3.9	3.9	5.1	6.8	8.0	8.6	8.2
Slovakia	4.3	1.9	2.1	1.7	1.4	2.4	3.4	4.0	4.5
Croatia[1]	3.2	2.8	1.5	2.1	2.9	4.9	6.0	6.6	7.4
Turkey	9.3	8.8	10.3	9.5	7.1	8.2	8.8	10.3	11.7
Russia[1]	9.7	9.0	7.8	7.9	8.9	11.5	12.9	14.9	15.1
Euro area	2.2	2.1	1.9	1.9	1.9	2.9	3.3	3.6	3.8

Source: Eurostat, national statistical offices, wiiw.

[1] *CPI.*

Inflation easing off somewhat most recently

In conjunction with declining oil and food prices on world markets, however, inflation started to decrease gradually in August. This was also helped by a positive base effect after strong oil price increases beginning in autumn 2007. Core inflation showed an upward trend in all countries, suggesting that commodity price shocks exacerbated existing overheating pressures.

In response to rising prices, central banks tightened monetary policy in Hungary (by 50 basis points in two steps)[5], Poland (by 25 basis points), Romania (by 75 basis points in three steps), Turkey (by 150 basis points in three steps) and Russia (by 75 basis points in three steps). Only Česká národní banka lowered its key interest rate by 25 basis points in an attempt to counteract currency appreciation. Apart from the Czech Republic, monetary conditions were tightened further in Poland and Slovakia because of currency appreciation. Inflation expectations started to decline somewhat recently, but still remain at elevated levels. The risk of second-round effects is therefore still eminent. The expected moderation in output growth, however, will have a certain dampening effect on prices.

2.4 Mixed Trends in the Development of Current and Capital Account Positions

In the first half of 2008, developments of the combined current and capital account were mixed compared with the same period in 2007, with no strong regional trends. The gaps increased substantially in Slovenia, Croatia, and to some extent also in Slovakia and Bulgaria. The deteriorations were mainly related to the goods and services balance, where weaker international demand coupled with currency appreciation in some countries hampered export growth, and adverse price developments led to a worsening in the terms of trade. Repatriations of profits also exerted some stronger drag on the income balances. Stronger improvements could be observed in Hungary, Romania, and Russia. While the lower deficit in Hungary

Table 3

Current Account Developments

	Goods and Services Balance		Income Balance		Combined Current and Capital Account		Basic Balance	
	H1 2007	H1 2008	H1 2007	H1 2008	H1 2007	H1 2008	H1 2007	H1 2008
	% of GDP							
Slovenia	−0.5	−1.6	−1.9	−2.5	−3.1	−5.7	−3.9	−5.1
Bulgaria	−23.6	−27.1	−0.7	−1.2	−22.6	−23.8	−3.0	−12.9
Czech Republic	5.9	7.2	−6.3	−8.9	−0.6	0.0	3.2	3.1
Hungary	1.2	2.0	−7.9	−7.6	−6.7	−5.0	−7.9	−0.7
Poland	−2.9	−3.5	−3.4	−3.4	−3.5	−3.7	0.3	−1.8
Romania	−16.4	−15.2	−5.3	−4.8	−16.1	−14.4	−8.7	−5.3
Slovakia	0.0	−1.1	−3.0	−4.2	−3.2	−5.0	−0.5	−3.8
Croatia	−17.2	−19.0	−4.8	−5.4	−19.0	−21.7	−6.5	−12.5
Turkey	−5.7	−6.3	−1.2	−1.2	−6.6	−7.3	−2.8	−5.7
Russia	9.4	11.4	−2.7	−3.3	6.5	8.0	6.8	9.4

Source: Eurostat, national central banks.

[5] *On October 22, 2008, Magyar Nemzeti Bank hiked interest rates by 300 basis points when the gradual weakening of the forint turned to a slump during the first three weeks of October.*

was mainly caused by an improvement in the capital account due to higher inflows of EU transfers, the better outcome in Romania and in Russia is attributable to a positive development of the goods and services balance. Russia experienced a pronounced improvement in its terms of trade due to high commodity prices until July, while in Romania currency depreciation supported export growth.

2.5 External Financing Needs Remain High in Southeastern Europe

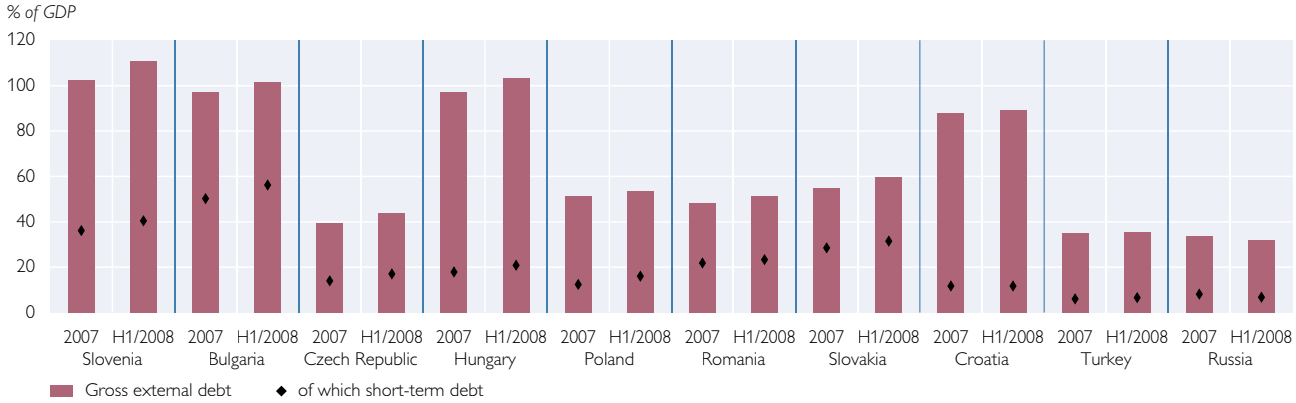
Generally, current account deficits remained at manageable levels in the CEE-5 in conformity to their more advanced stage of the convergence process. External financing needs, however, are pronounced in the SEE-2, Croatia, and Turkey.

Large variation in current account developments continues

In the Czech Republic, Hungary and Poland, basic balances (i.e. the combined current and capital account balance plus net FDI) as an indicator of external financing requirements are actually in or close to surplus. In Slovenia and Slovakia, they stood at somewhat more elevated levels. In the SEE-2, combined current and capital account deficits were substantially higher than in the CEE-5, with an even increasing trend in Bulgaria. Despite substantial net FDI inflows, also the basic balances were deeply in the red and deteriorated further in the case of Bulgaria especially due to lower net FDI inflows (predominately to the construction and real estate sector) in the first half of 2008. The same is true for Croatia, however, with the caveat that the Croatian current account shows a high degree of seasonality, with the summer months usually being positively influenced by tourism. In Turkey, external financing needs increased owing to some deterioration of the combined current and capital account and especially lower FDI inflows. Russia remains the only country with a sizeable surplus both in the combined current and capital account and in the basic balance. In the context of the current growth moderation in major Western economies, FDI flows to the region will potentially decrease in the near future, which could make it increasingly difficult to finance large current account deficits.

Chart 1

Gross External Debt



Source: Eurostat, national central banks.

2.6 Higher Ratio of Short-Term Debt Coupled with Rising Gross External Debt Levels

In the first half of 2008, gross foreign debt in the whole economy increased throughout most of the countries under review (apart from Russia), and also short-term debt trended higher. The increases in external debt levels were most pronounced in the CEE-5, ranging between 2.1% of GDP in Poland and 8.3% of GDP in Slovenia, but they were also high in Bulgaria (4.1% of GDP) and Romania (3.3% of GDP). The development was driven by a rise in (mostly short-term) indebtedness of banks in most countries with the exception of Poland, where borrowing by the corporate sector played the dominant role. While for most countries higher external indebtedness was less of a problem given their comparatively low debt levels, debt stayed at around 90% of GDP in Croatia and at above 100% of GDP in Hungary, Slovenia, and Bulgaria. Short-term debt as a percentage of total gross external debt increased in most countries (by between 0.9 percentage points in Slovakia and 5.8 percentage points in Poland), with the exception of Romania and Croatia (where it stayed constant) as well as Russia (where it decreased by 2.9%). Especially high levels were reported for Bulgaria and Slovakia (over 50%), Romania (around 45%) and the Czech Republic and Slovenia (around 35%).

2.7 External Competitiveness Weakening in Most Countries

A deterioration of international competitiveness is one of the potential driving factors for the increase in the current account deficits of the SEE-2 and Turkey.

High nominal ULC growth in industry in all countries except Turkey and Croatia

Growth of ULC in industry accelerated in all CEE-5 countries in the first half of 2008. Looking at ULC measured in euro, this development was even more pronounced in the Czech Republic, Poland, and Slovakia owing to substantial currency appreciation. In all countries of the region, higher ULC growth can be related to both weaker productivity developments and accelerating wage growth. In Bulgaria, growth of ULC in industry picked up substantially in the first half of 2008, reaching around 20% year on year. Again, this can be linked to higher wage growth as well as weaker productivity. Although no acceleration could be observed in Romania, ULC dynamics remained at elevated levels at around 11% year on year, but were dampened by currency depreciation, as industrial ULC measured in euro registered zero growth. In Turkey and Russia, no major changes in ULC dynamics could be observed compared with 2007, but ULC growth remained high especially in Russia. Currency depreciation against the euro, however, dampened negative consequences for competitiveness (at least vis-à-vis the euro area) in both countries. Croatia was the only country in the region where productivity growth accelerated in the first half of 2008. This led to somewhat slower industrial ULC growth than in 2007.

In the euro area, industrial ULC growth also picked up somewhat, although the increase was less pronounced than in the CEE-5 and in Bulgaria. In connection with an appreciation of the local currencies of Poland, Slovakia, and the Czech Republic, this development led to some appreciation of the real exchange rate deflated by industrial ULC against the euro in the above-named countries. A lasting weakness of the Romanian leu coupled with a decreasing ULC differential contributed to some real depreciation in the country. The same is true for Russia and Turkey. Despite deteriorating competitiveness indicators, no decline in export market shares could be observed in most countries until the first quarter of 2008.

Table 4

Wages, Productivity and Unit Labor Cost

	Nominal Wages in Industry				Productivity in Industry				Unit Labor Cost in Industry (in local currency)			
	2006	2007	Q1 2008	Q2 2008	2006	2007	Q1 2008	Q2 2008	2006	2007	Q1 2008	Q2 2008
	Annual change in %											
Slovenia	5.5	6.7	8.3	9.7	7.9	5.5	1.5	3.5	−2.3	1.1	6.7	6.0
Bulgaria	10.8	20.1	25.0	24.0	8.2	9.5	3.1	5.3	2.5	9.7	21.3	17.8
Czech Republic	6.1	8.6	11.6	8.5	9.4	6.6	3.4	4.5	−3.0	1.8	7.9	3.9
Hungary	8.6	8.4	7.9	7.3	11.5	9.3	7.2	4.6	−2.6	−0.8	0.6	2.5
Poland	5.2	8.7	10.4	11.2	9.5	6.0	5.1	5.1	−4.0	2.6	5.0	5.8
Romania	15.7	21.6	18.5	24.5	11.3	9.5	8.8	10.6	4.0	11.0	9.0	12.6
Slovakia	6.7	6.4	8.4	8.7	11.3	10.0	4.4	4.5	−4.1	−3.3	3.9	4.0
Croatia	7.5	5.5	7.6	7.2	2.7	2.5	4.7	5.2	4.7	3.0	2.7	1.9
Turkey	11.5	9.4	8.9	10.3	6.7	2.6	3.7	2.4	4.5	6.6	5.0	7.7
Russia	21.4	26.0	27.6	28.1	10.1	4.7	5.9	5.6	10.3	20.4	20.5	21.3
Euro area	3.5	2.8	3.5	3.2	4.1	3.2	2.2	0.8	−0.6	−0.4	1.3	2.4

Source: ECB, Eurostat, national statistical offices, wiiw.

Table 4 continued

Wages, Productivity and Unit Labor Cost

	Euro per Local Currency (annual average)				Unit Labor Cost in Industry (in euro)			
	2006	2007	Q1 2008	Q2 2008	2006	2007	Q1 2008	Q2 2008
	Annual change in %							
Slovenia	−0.0	−0.0	0.0	0.0	−2.3	1.1	6.7	6.0
Bulgaria	0.0	0.0	0.0	0.0	2.5	9.7	21.3	17.8
Czech Republic	5.1	2.1	9.7	13.9	1.9	3.9	18.4	18.3
Hungary	−6.1	5.1	−2.7	0.1	−8.6	4.3	−2.1	2.6
Poland	3.2	3.0	8.7	11.5	−0.8	5.6	14.2	18.1
Romania	2.7	5.7	−8.3	−10.2	6.8	17.4	−0.1	1.1
Slovakia	3.7	10.2	3.9	7.5	−0.6	6.6	7.9	11.8
Croatia	1.1	−0.2	1.1	1.3	5.8	2.8	3.9	3.2
Turkey	−7.3	1.3	2.5	−8.6	−3.1	8.0	7.6	−1.5
Russia	3.2	−2.6	−5.1	−5.6	13.9	17.3	14.3	14.5
Euro area	..	..	..	..	−0.6	−0.4	1.3	2.4

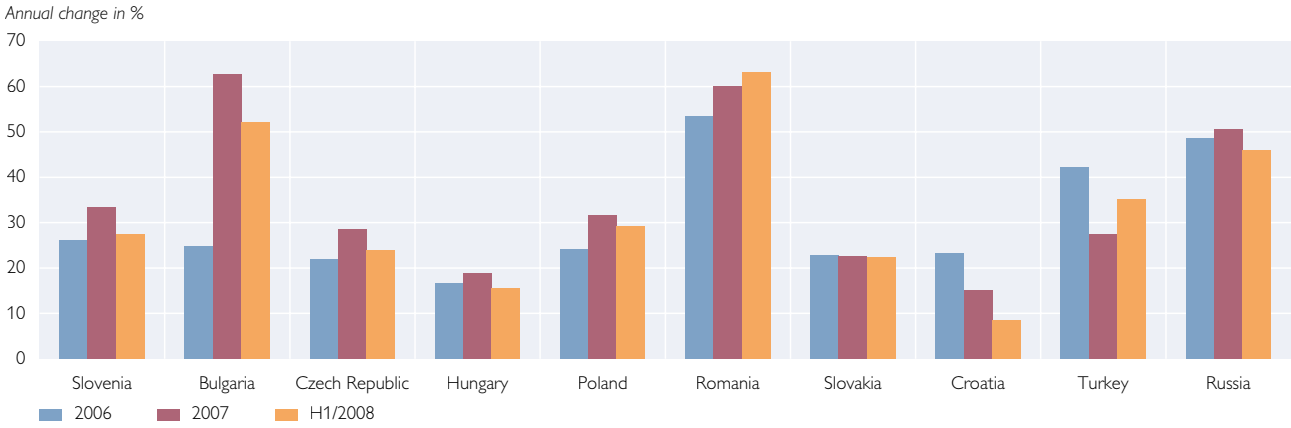
Source: ECB, Eurostat, national statistical offices, wiiw.

2.8 Strong Credit Expansion in the SEE-2 and Russia until June with Recent Moderation in All Countries

While private sector credit expansion in the CEE-5 stayed at levels roughly in line with the historical experience of successful catching-up countries in the second half of the 20th century, stronger increases could be observed in the SEE-2 and Russia.

Chart 2

Domestic Credit to Nonbanks and the Nongovernment Sector



Source: Eurostat, national central banks.

Credit expansion during the observation period still dynamic in most countries

In the first half of 2008, private sector credit grew at rates of around 20% to 30% year on year in the Czech Republic, Poland, Slovenia and Slovakia, coming down somewhat from the levels observed in 2007. Hungary and especially Croatia posted the lowest credit expansion rates. While in Hungary this was mainly due to decelerating growth of credit to the corporate sector in the second quarter of 2008, in line with a deterioration in industrial confidence in the context of weak economic dynamics, in Croatia decisive measures taken by the national authorities contributed to a moderation of credit expansion. In the SEE-2, credit growth remained high at over 50% in Bulgaria and over 60% in Romania and even accelerated in the latter country. The acceleration in Turkey represents somewhat of a normalization after extraordinarily slow credit growth in 2007. At around 50%, credit growth remained high in Russia. Latest available data on credit developments indicate that the deceleration of credit expansion (which was already observable in the second quarter in many countries) gained speed in recent months. This is presumably related to tightening credit standards and the increasingly tight liquidity situation since mid-September, which will probably further curb credit growth in the months to come.

2.9 Foreign Currency Lending still High in Some Countries, but Signs of Moderation in Recent Weeks

Foreign currency lending remains widespread in Hungary, Croatia and the SEE-2, but no increase in the share of foreign currency loans in total loans could be observed in most countries.

In Slovakia, the share of foreign currency loans in total lending decreased more sharply than in the other countries, possibly due to the planned introduction of the euro. In the other CEE-5 as well as in Croatia and Russia, the currency composition of private credit remained broadly unchanged in the first half of 2008. The foreign currency share, however, increased in Romania and above all in Bulgaria. Generally, foreign currency loans were especially widespread in Croatia, Bulgaria, Romania, and Hungary, where they made up substantially more than

50% of total private sector credit. In the other countries, these loans remained at more moderate levels at less than 25%.

High foreign currency exposure increases the risk of adverse balance sheet effects in the case of currency depreciation. Such risks are especially pronounced for households, as they are usually not hedged against adverse exchange rate movements. Household exposure to foreign currency credit is particularly strong in Hungary and Romania (more than 50% of total credit to households), but also in Poland and Bulgaria (29.8% and 24%, respectively). Tightening liquidity conditions in recent weeks presumably also put a brake on foreign currency lending, in a context of a general moderation of credit dynamics (some subsidiaries of Western European banks in CESEE e.g. announced to curtail foreign currency lending in the region).

2.10 Credit Expansion only partly Financed by Deposits

Domestic deposit growth (measured as the year-on-year change in the deposit stock as a percentage of GDP) could not keep up with domestic credit expansion in any country under review, which contributed to a decline in net foreign assets in the first half of 2008.

Net foreign assets of the banking sector declining in all countries except Croatia

Furthermore, deposit growth decelerated in several countries including the Czech Republic, Slovakia, Bulgaria, Croatia, and Russia. Subsequently, net foreign assets declined throughout the whole region (especially in Bulgaria, Romania, and Slovenia), with the exception of Croatia, partly at faster rates than observed in 2007. For financing credit expansion, other assets played some role only in Slovakia (mainly capital and reserves) and Hungary (mainly debt securities). In the first half of 2008, banks' reliance on net foreign liabilities was rather pronounced in most countries (ranging between –9.6% of GDP in Slovakia and –21% in Slovenia), with the exception of Poland and the Czech Republic, indicating that up to the end of the second quarter of 2008, banks in the countries under review apparently did not face difficulties in obtaining financing from abroad, a situation which has most probably changed in recent weeks.

High credit growth is an essentially positive element of the catching-up process, as it implies financial deepening. However, this does not mean that any credit growth rate is appropriate. In countries with very high credit growth rates, it is advisable that national authorities together with the banking sector (and their supervisory partner authorities in the home countries of foreign-owned banks) take decisive measures to dampen credit growth. The challenge is to tighten credit standards even further (and to refrain from circumvention activities) on the one hand, while on the other hand refraining from overreacting by cutting limits and stopping credit expansion entirely. More generally, the banking sector has to continue its efforts to improve risk and liquidity management.

Ratio of CESEE countries' private sector credit stock to GDP roughly in line with estimated equilibrium ranges

The ratio of the domestic private sector credit stock to GDP in CESEE remains well below the euro area average and mostly also below estimated equilibrium ratios. To a large extent, this reflects lower GDP per capita levels (at PPP). Latest estimates[6] showed that private sector credit levels in Bulgaria and Croatia are

[6] *Eller, M., P. Backé, B. Égert, and T. Zumer. 2008. Paper presented at the 11th Conference of the ECB-CFS Research Network on The Market for Retail Financial Services: Development, Integration, and Economic Effects, that took place in Prague on October 20 and 21, 2008.*

already well within the estimated equilibrium range by the first quarter of 2008, while private sector credit levels in the other countries reviewed continued to be in the lower part of the equilibrium range (Hungary, Slovenia and Croatia) or even marginally below the equilibrium range (Czech Republic, Slovakia, Poland, and Romania). As the ratios are close to equilibrium in most CESEE countries, future credit growth will (have to) be more moderate, in line with further improvements in underlying fundamentals (catching-up, macrostability, financial sector development). The recent slowdown of credit growth in some CESEE countries seems to signal a shift toward a more sustainable path. At the current juncture, the policy challenge is to ensure that this process takes place in an orderly fashion, as a sudden credit crunch could put serious strain on the economies of the region.

2.11 Abrogation of Excessive Deficit Procedures in Several Countries

EDPs abrogated for the Czech Republic, Poland, and Slovakia

In June and July 2008, excessive deficit procedures (EDP) were abrogated for the Czech Republic, Poland, and Slovakia, as the excessive deficits were corrected. These countries had been under an EDP since May 2004. Thus, Hungary is the only CESEE country under an EDP at the moment. In the case of Romania, the European Commission published a recommendation on economic and budgetary policy in mid-June, advising the government to pursue a more prudent fiscal policy, as the current expansionary fiscal strategy entailed the risk of breaching the deficit threshold of 3% of GDP, which could trigger an EDP by the EU.

Box 1

Financial Market Developments in Central, Eastern and Southeastern Europe: Caught up in the Global Financial Market Turbulence

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

Since the cutoff date for the last FEEI issue in April 2008, the global financial market turmoil that has been ongoing since mid-2007 has deepened and intensified markedly, especially starting from mid-September 2008. Risk propagation through international financial market linkages has become prominent. Until mid-September, CESEE financial markets weathered the turbulence relatively well, but were hit hard in the latest wave of market corrections, in some respects harder than other emerging market regions. However, developments were not homogeneous across CESEE, with countries and financial market segments being affected to different extents. On this note, countries in Central Europe (Czech Republic, Hungary, Poland, Slovakia) were hit less hard by the turmoil than those in Southeastern (Bulgaria, Croatia, Romania) or Eastern Europe (Russia).[1] In addition, countries with the largest economic im balances and/or insufficient policy credibility were affected the most. The performance of different financial market indicators suggests that market participants increasingly consider country-specific signs of vulnerability. However, the case of Hungary shows that higher global risk aversion has also contributed to problems in countries where fundamentals have improved more recently but vulnerabilities are perceived to be high in the present context – even though in the past risks had been more pronounced and fundamentals much worse without triggering a distinct market reaction.

[1] *Beyond the countries covered in this report, a noticeable impact of the financial turmoil was seen also in other CESEE countries: Ukraine was hit particularly hard by spillovers from the global financial turmoil, and the Baltic countries were not spared either (although developments within the Baltic region were not homogeneous).*

With the exception of Romania, Russia, Hungary, and Turkey, money market spreads against the euro area remained broadly stable or even narrowed in the CESEE region over the review period (April 30, 2008, to October 28, 2008). Money market rates in the Czech Republic and Slovakia were below euro area levels over the whole period and even became increasingly negative in Slovakia. Spreads were up by a moderate 50 basis points on their end-April levels in Poland, also reflecting an interest rate hike by 25 basis points in June. By contrast, spreads widened markedly in Romania, up by some 650 basis points, driven by monetary tightening, rising risk premia given the country's high external imbalances and tight liquidity conditions ahead of payment deadlines for banks (minimum reserves) and foreign companies operating in Romania. Turkish money market spreads were 480 basis points up on their end-April level, in light of a sizeable rise in spreads due to monetary tightening and increased political noise. Similarly, Hungarian money market spreads were up by some 400 basis points on end-April, mainly driven by a policy rate hike by 300 basis points on October 22, 2008. Russian spreads widened by 730 basis points on account of banking stability concerns, while Croatian spreads recorded an increase of 210 basis points, partly owing to tighter mandatory reserve regulations starting with the new reserve requirement calculation period on October 9, 2008. Spreads remained fairly stable in Bulgaria over the review period after having increased strongly during the final quarter of 2007.

So far, the global financial turmoil has had a rather limited impact on interest rate spreads on local currency government bonds in CESEE against the euro area, although market pressures have increased recently. Global emerging market bond spreads widened on average by some 65 basis points over the review period (JPM GBI-EM). By contrast, spreads on Bulgarian and Slovak local currency-denominated government bonds were up only 27 and 40 basis points, respectively, on their end-April levels, while spreads on Czech and Romanian local currency-denominated government bonds both rose by some 70 basis points, largely in line with developments in global emerging markets. Somewhat more pronounced increases were observed in Poland (+110 basis points) and Russia (+161 basis points). Hungary (+410 basis points) and Turkey (+620 basis points) were the worst performers. Some countries even took measures to ease bond market tensions, mainly via central bank purchases of government bonds (from the market), reduction of offer volumes (e.g. Hungary) or buybacks (e.g. Bulgaria).

The spreads on Czech and Slovak euro-denominated sovereign eurobonds widened much less (+125 to 150 basis points) over the review period than the average emerging market spread (300 basis points, JPM Euro EMBI Global Index). But also Polish eurobond spreads grew less (+195 basis points) than the average. By contrast, spreads on Bulgarian, Hungarian and Croatian (euro-denominated) eurobonds recorded a pronounced increase by 325 to 370 basis points. Common to all countries is the significantly faster widening of euro-denominated sovereign eurobond spreads since the beginning of September 2008, with the most pronounced increases observed in Romania and Turkey. In addition to another fall in global investors' risk appetite and (outlook) downgrades by international rating agencies (e.g. Bulgaria, Hungary, Poland, Romania), rising domestic political and/or economic risks throughout the region have presumably played a role in this development. Finally, spreads on Russian U.S. dollar-denominated eurobonds widened by 650 basis points over the review period. This increase is much higher than that observed for the overall market (+540 basis points, JPM EMBI Global Index); the widening has been fairly pronounced since the beginning of September.

Despite temporary declines, sovereign 5-year credit default swap (CDS) spreads trended upward continuously over the review period, in particular from the beginning of September 2008. Czech and Slovak CDS spreads were affected the least, widening by 180 basis points and 170 basis points, respectively, which was most likely attributable to rating upgrades for both countries in early 2008, still relatively solid economic fundamentals, and the euro changeover in Slovakia. More prominent increases were observed in Poland (+210 basis points) as well as Hungary and Croatia (+360 basis points each), while CDS spreads rose particularly sharply (by over 400 basis points) in countries with more pronounced economic imbalances, i.e. Russia, Romania, Turkey, and Bulgaria. A comparison with other emerging economies leads

to no clear conclusion, as developments in some of them were better than in many CESEE countries (e.g. Hong Kong: +50 basis points), while those in others were in line with (e.g. Brazil: +376 basis points, Mexico: +380 basis points, South Africa: +400) or worse than (e.g. Indonesia: +755 basis points, Argentina: +3,100 basis points) those in the CESEE region.

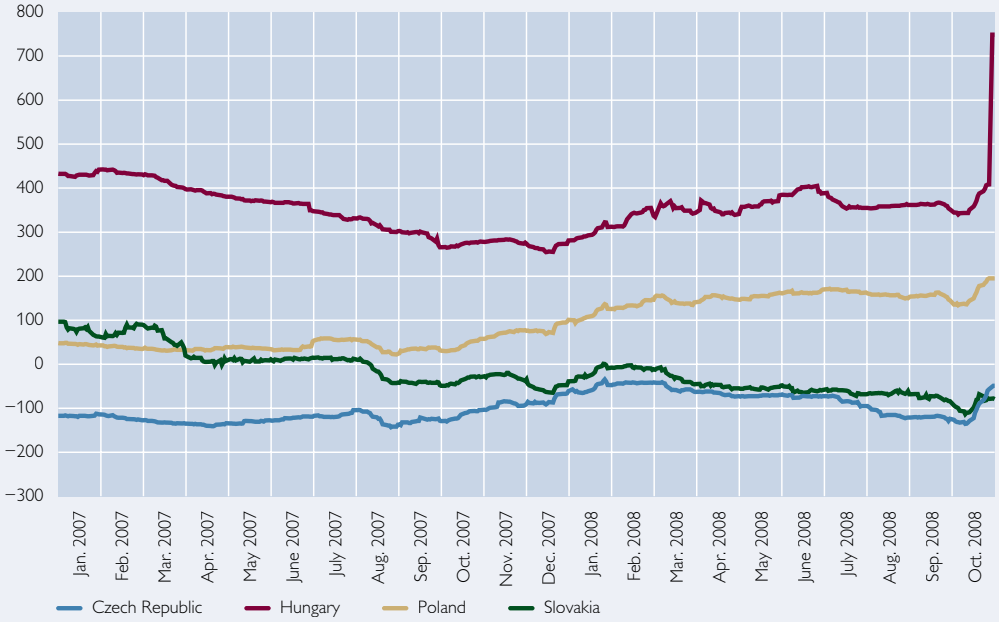
Although CESEE stock markets tended to follow developments in global equity markets, until mid-September they weathered the turmoil fairly well by international comparison. Since then, however, CESEE equity markets have come under increased pressure as a result of deteriorating investor confidence toward emerging markets. In the period under review, the MSCI EMEE index (covering the Czech Republic, Hungary, Poland, and Russia) dropped by 65%, while the DJ Industrial Average index fell by "only" 29% and the EURO STOXX index decreased by 41%. The CESEE region performed worse than other emerging market economies, as emerging Asia, Latin America, the Middle East and Africa all suffered somewhat smaller losses (around 50% on average). Developments within the CESEE region diverged considerably over the review period. The Slovak stock exchange remained practically unscathed in light of fairly positive investor sentiment ahead of the country's euro area entry in 2009, whereas the downward correction was severe in Russia (−73%) given increased political noise, heightened liquidity pressures on the Russian interbank market, the related capital flight and a considerable drop in global commodity prices. Against the background of economic overheating and widening external imbalances, the Romanian, Bulgarian, and Czech stock indices lost some 55% to 60% over the period under review, while Hungary suffered equity price losses of some 50%. Stock markets in Poland, Turkey, and Croatia were affected the least (more in line with major European markets), recording a slump of 43% on average.

Most CESEE currencies were little affected by the international financial market turmoil over the review period, even though in recent weeks developments were characterized by high exchange rate volatility and increased regional downward pressures. The latest developments even prompted some central banks to intervene on foreign exchange markets (e.g. Croatia, Romania, Russia). All in all, only the Romanian leu, the Hungarian forint and the Polish złoty suffered higher losses (2%, 4% and 7%, respectively) against the euro since end-April 2008. In case of the latter two, however, this came after a prolonged period of strong appreciation. Particularly in Hungary, downward pressures on the currency eased following the abolition of the fluctuation band in late February 2008, despite high exchange rate volatility. By mid-September, the forint even strengthened above its pre-crisis level on the back of improved fundamentals, while also serving as a target currency for carry trades. However, the forint came increasingly under pressure thereafter, in particular given external financing concerns (that led to a financial package by the IMF, the EU, and the World Bank). The Russian ruble gained 7.2% versus the euro in the period under review, while it depreciated by 15% against the U.S. dollar, thus depreciating by 4.4% against its currency basket. All other CESEE currency quotes were stronger than at end-April. The Turkish lira, which appreciated considerably during the summer months on account of monetary tightening and waning political uncertainty, lost some of these exchange rate gains during the latest wave of the turmoil, but still quoted some 2.5% stronger than at the end of April. The Czech koruna and the Slovak koruna largely withstood regional downward pressures, as well. In the Czech Republic, this is most likely the result of the koruna's capacity as a funding currency of carry trades and the ensuing unwinding of some of these trades during the market turmoil. In Slovakia, market expectations regarding a possible revaluation of the koruna's ERM II central rate against the euro helped strengthen the currency sharply in the course of May 2008. Following the revaluation of the central rate by 17.6% with effect from May 29, the exchange rate remained close to the new central rate, which in early July also became the official conversion rate.

Chart 1a

3-Month Money Market Spreads against the Euro Area

Basis points *Cutoff date: October 28, 2008*

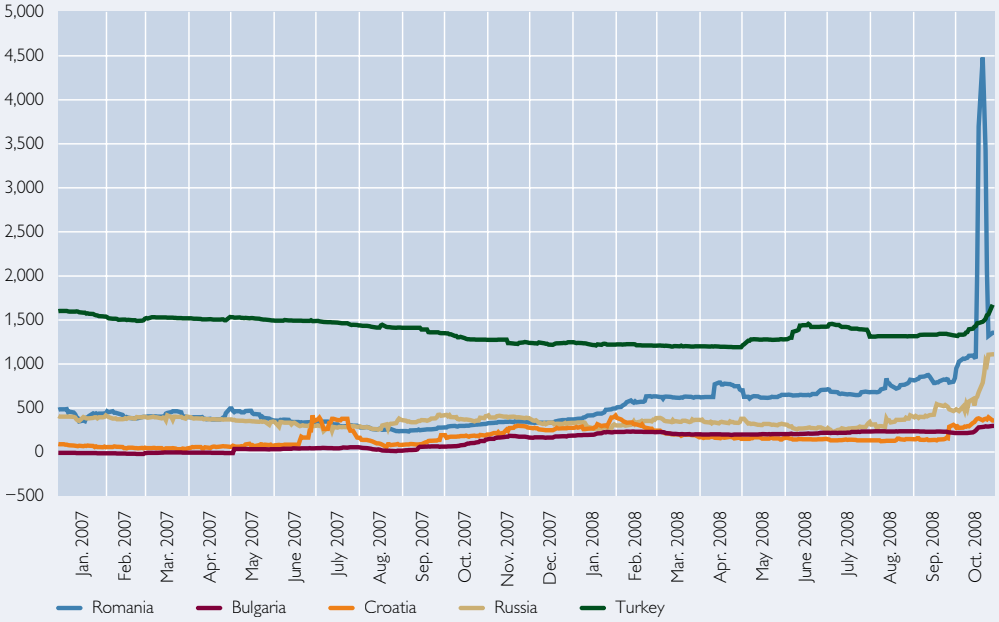


Source: Datastream, OeNB.

Chart 1b

3-Month Money Market Rate Spreads against the Euro Area

Basis points *Cutoff date: October 28, 2008*

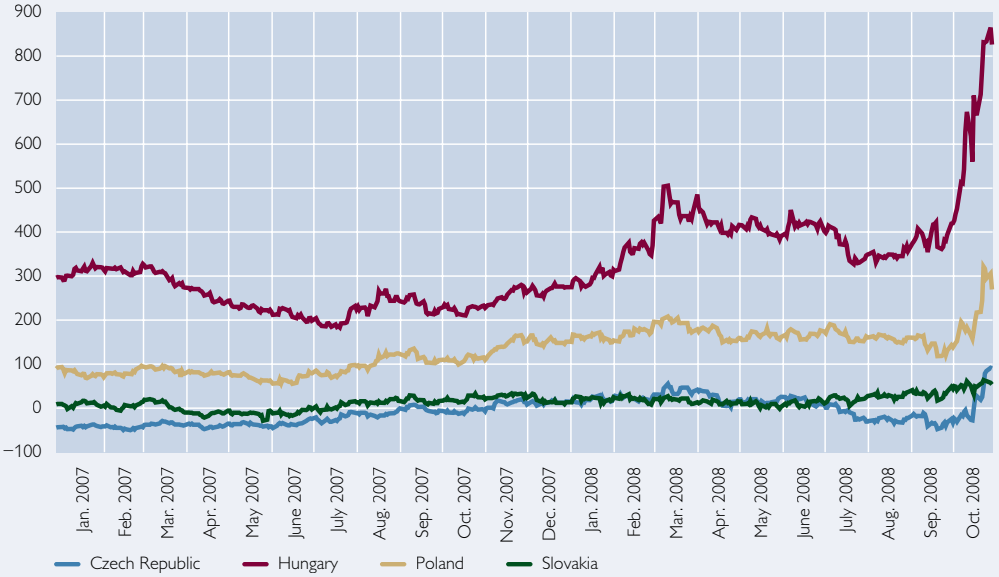


Source: Datastream, OeNB.

Chart 2a

Local Currency Government Bond Yield Spreads against the Euro Area

Country subindices of JPM GBI-EM, basis points *Cutoff date: October 28, 2008*

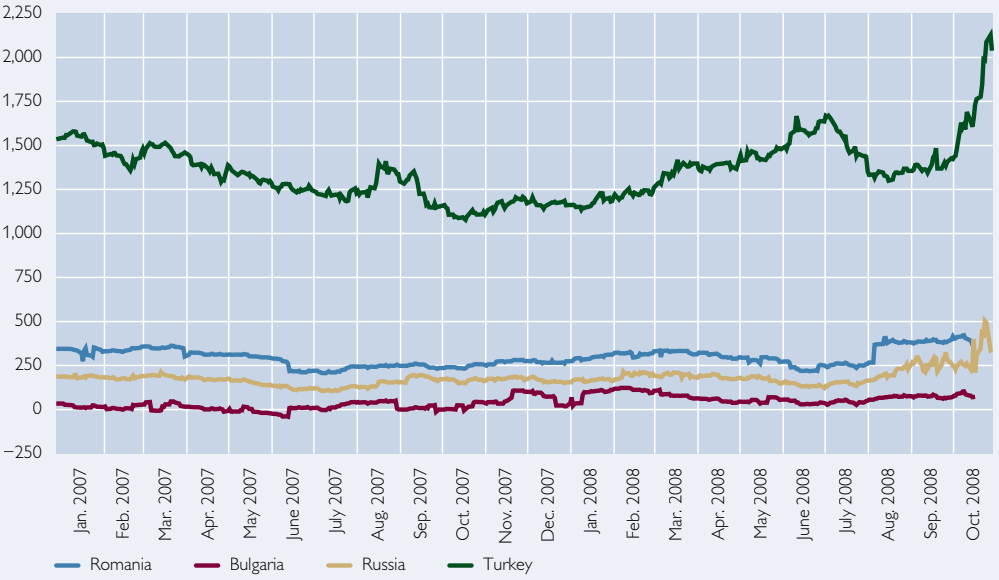


Source: Bloomberg, OeNB.

Chart 2b

Local Currency Government Bond Yield Spreads against the Euro Area

Country subindices of JPM GBI-EM for Russia and Turkey, Eurostat data for Bulgaria and Romania, basis points[1] *Cutoff date: October 28, 2008*



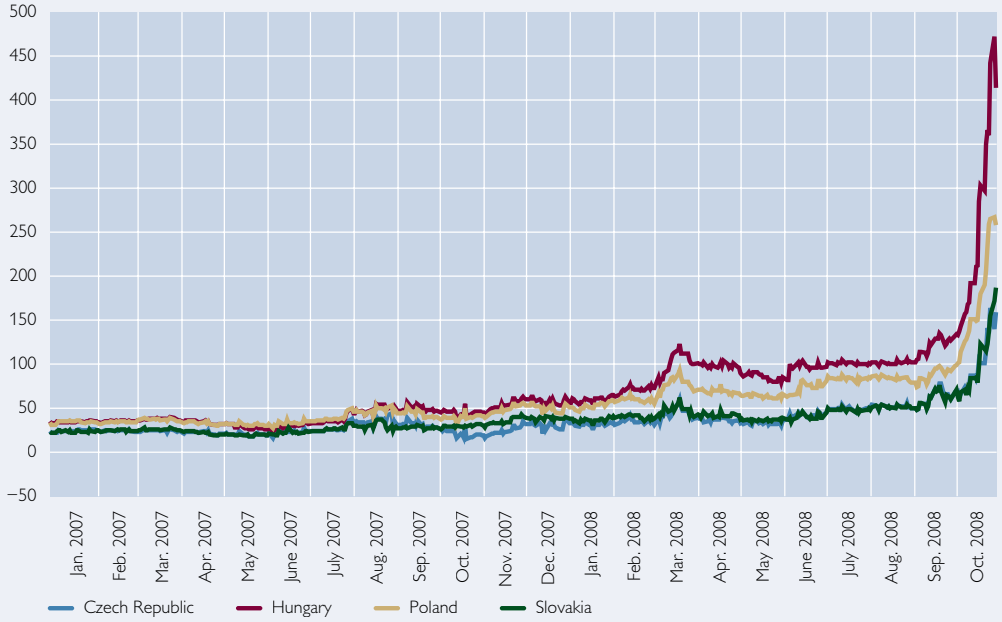
Source: Bloomberg, Eurostat, OeNB.

[1] The last observation for Bulgaria and Romania is October 15, 2008.

Chart 3a

Euro-Denominated Eurobond Yield Spreads

JPM Euro EMBI Global *Cutoff date: October 28, 2008*

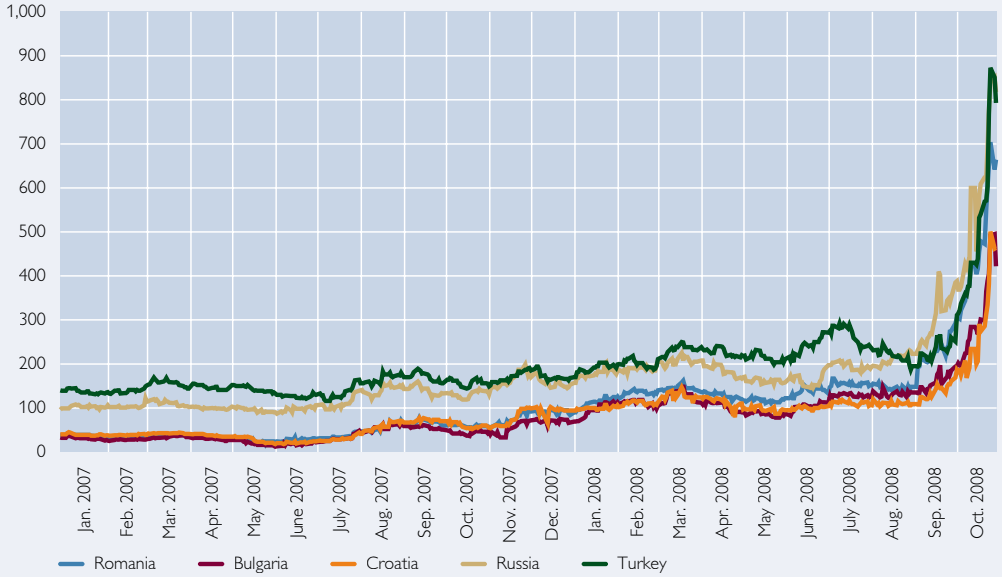


Source: Bloomberg, OeNB.

Chart 3b

Euro-Denominated Eurobond Yield Spreads

JPM Euro EMBI Global, for Russia JPM EMBI Global *Cutoff date: October 28, 2008*

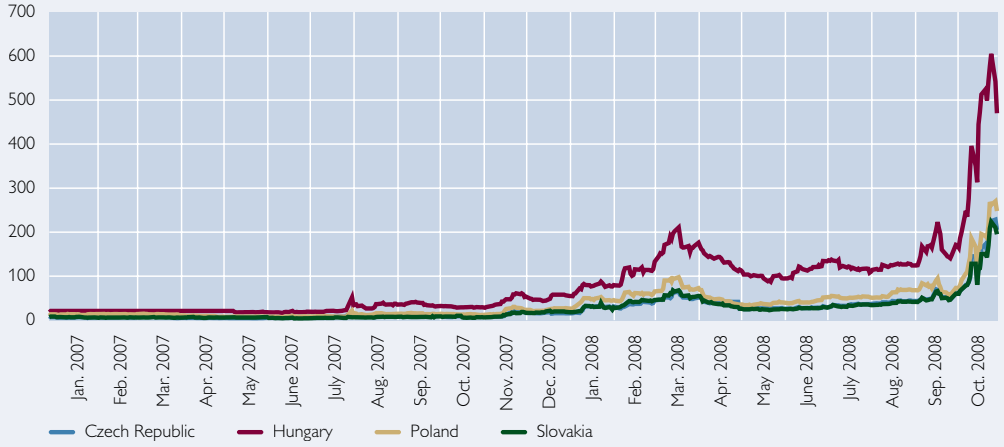


Source: Bloomberg, OeNB.

Chart 4a

Sovereign 5-Year Credit Default Swap Spreads

Basis points *Cutoff date: October 28, 2008*

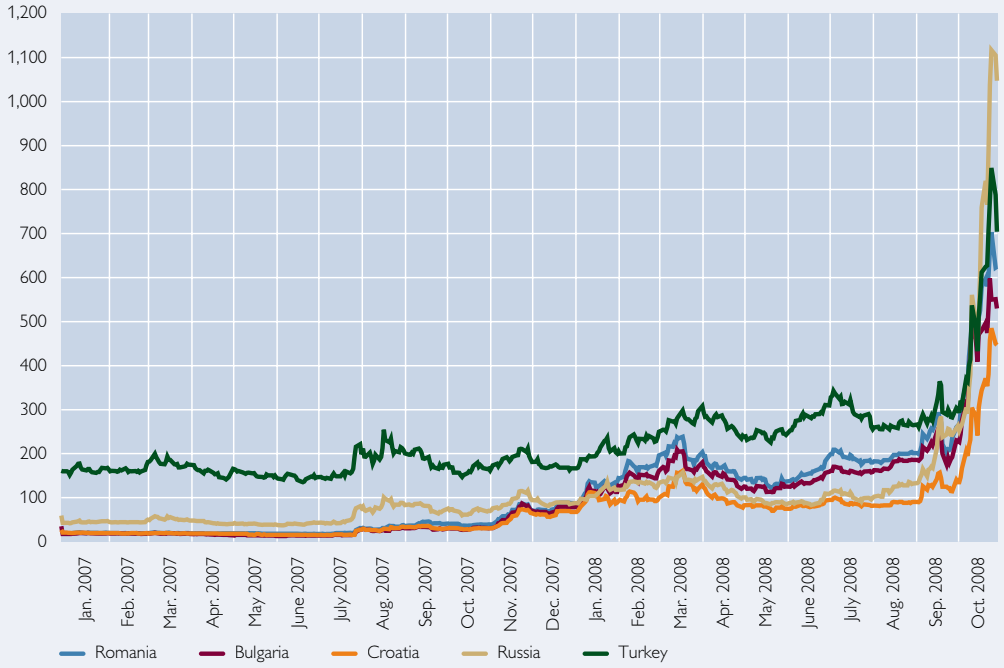


Source: Datastream, OeNB.

Chart 4b

Sovereign 5-Year Credit Default Swap Spreads

Basis points *Cutoff date: October 28, 2008*



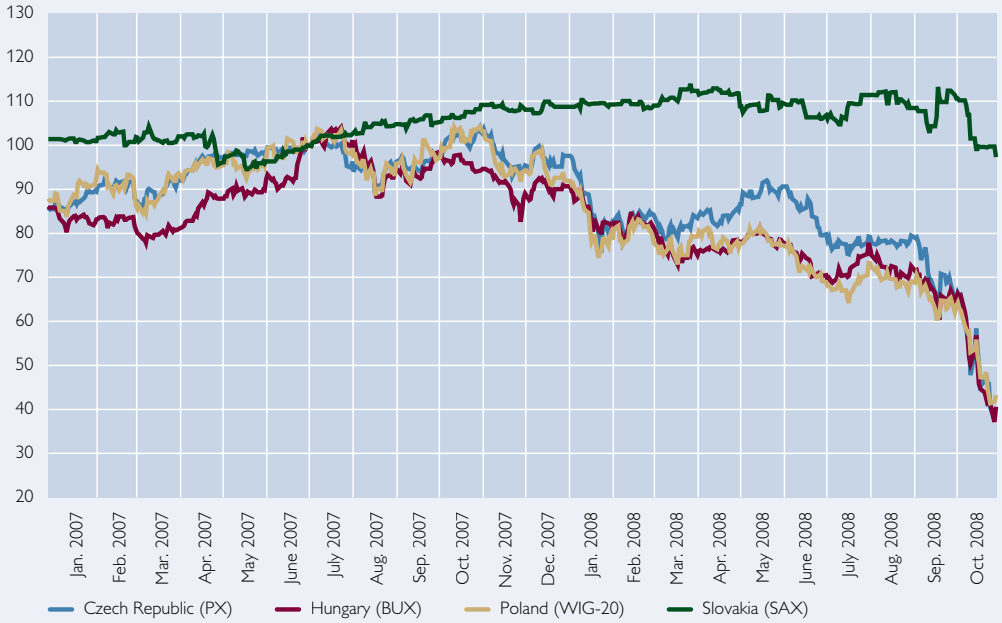
Source: Datastream, OeNB.

Note: Data for Bulgaria and Russia are based on USD.

Chart 5a

Stock Market Developments

June 29, 2007 = 100 *Cutoff date: October 28, 2008*

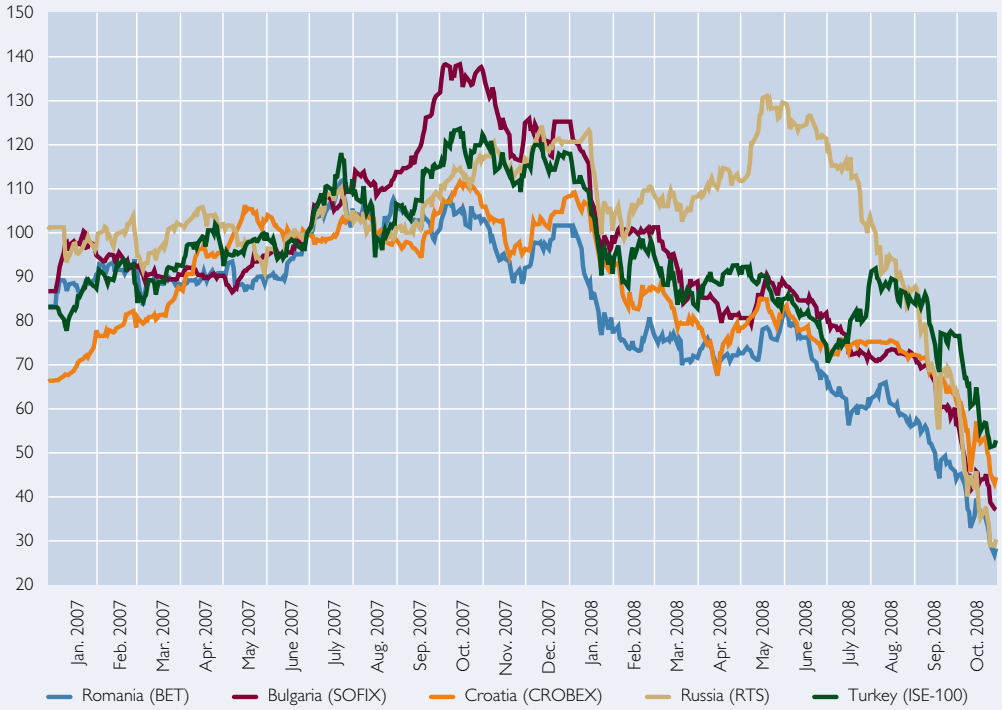


Source: Datastream, OeNB.

Chart 5b

Stock Market Developments

June 29, 2007 = 100 *Cutoff date: October 28, 2008*

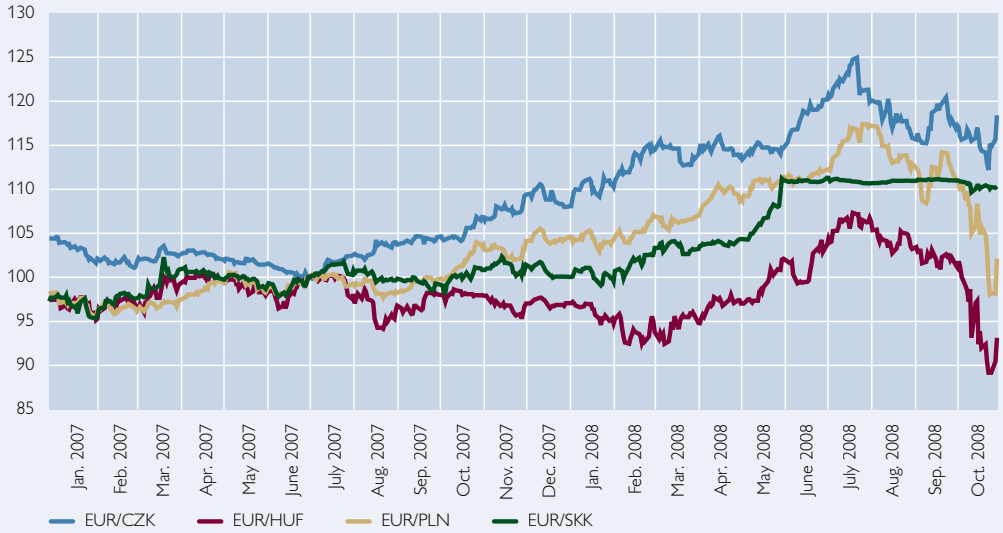


Source: Datastream, OeNB.

Chart 6a

Exchange Rate Developments against the Euro[1]

June 29, 2007 = 100 *Cutoff date: October 28, 2008*



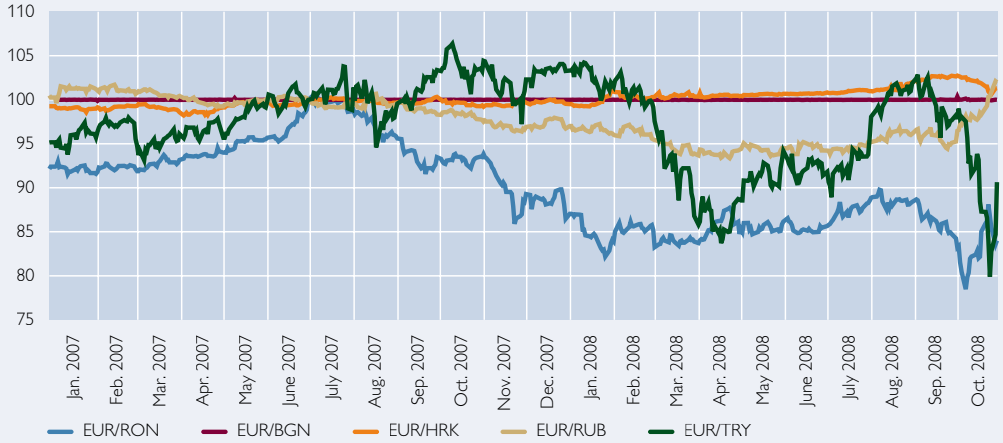
Source: Eurostat, OeNB.

[1] An increase in value means a nominal appreciation.

Chart 6b

Exchange Rate Developments against the Euro[1]

June 29, 2007 = 100 *Cutoff date: October 28, 2008*



Source: Eurostat, OeNB.

[1] An increase in value means a nominal appreciation.

2 Slovenia: Inflation Slowing along Weakening but Solid Output Growth

Real GDP growth decelerated slightly in the first half of 2008

Real GDP grew by 5.5% year on year in the first half of 2008, slightly slower than in full-year 2007. Domestic demand was the main driver of growth. Thanks to strong construction activity in both the housing and non-housing segments, GFCF continued to expand dynamically, but at a slower pace than in full-year 2007. The sharp deceleration from the first to the second quarter 2008 was in line with weakening credit activity, thinner export order books, some decline in industrial capacity utilization and potentially also linked to the ebbing of strong investment activity related to Slovenia's EU presidency in the first half of 2008. Compared with full-year 2007, domestic consumption growth picked up slightly owing to strengthening public consumption, but remained well below overall GDP growth. The dynamics of both exports and imports slowed sharply compared with 2007 on account of somewhat weaker domestic demand and sharply decelerating foreign demand. The contribution of net exports to growth remained broadly unchanged at around –1 percentage point.

Turnaround in inflation trends?

Following a substantial strengthening of price pressures in the second half of 2007 and early 2008, inflation picked up further in the second and third quarter of 2008, hitting almost 7% in July, but then fell back to 5.6% by September. Thus, the inflation differential to the euro area average narrowed from around 3 percentage points in the first quarter of 2008 to 2 percentage points in September. While the increase in headline inflation between April and July was mostly attributable to rising energy and unprocessed food prices, the subsequent decline in inflation was also to a large extent driven by these two items. Core inflation was on a falling trend from April 2008, coming in at 4.5% in September, which is, however, still elevated in a euro area context. Most notably, price pressures in the processed food segment (which played a major role in the acceleration in inflation from mid-2007) eased gradually in recent months, but were still high at 7.3% in September. Despite the favorable trend in core inflation, caution is warranted, given the pickup in ULC growth at the level of the whole economy (excluding agriculture) that was primarily attributable to accelerating nominal labor cost growth. Banka Slovenije expects annual average inflation to come to 6.1% in 2008, 3.5% in 2009 and 2.8% in 2010.

So far no significant impact of the international financial crisis

A significant worsening of the terms of trade led to a larger deficit on the goods and services balance during the first half of 2008. This, together with a widening deficit on the income balance and on the current transfers balance, caused the combined current and capital account deficit to deteriorate markedly to 5.7% of GDP. Net FDI inflows were positive, but only very small (0.6% of GDP). It should be noted, however, that two factors shelter Slovenia from some of the risks generally associated with large current account deficits: euro area membership and the fact that the country's current account deficit is toward other euro area members.[7] Hence, the difficult global financial market environment has so far had a very limited impact only on Slovenia. However, risk premia have increased, which raises the cost of financing the rising external deficit.

Parliamentary elections bring change in government

The Social Democratic party, which emerged as the winner of parliamentary elections held late in September, is likely to form a coalition with two other center-left parties and the Pensioners' Party. In terms of economic policy, however, no significant changes have been announced so far.

[7] *In fact, Slovenia had a positive current account position toward non-euro area countries in 2007.*

Table 5

Main Economic Indicators: Slovenia

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	4.1	5.7	6.1	7.2	6.0	6.4	4.7	5.4	5.5
Private consumption	2.7	4.0	3.1	2.4	2.1	4.7	3.3	3.5	2.6
Public consumption	3.2	4.4	1.4	0.7	0.4	1.7	2.7	2.9	2.8
Gross fixed capital formation	2.5	8.4	17.2	21.2	21.8	18.7	8.6	16.9	9.0
Exports of goods and services	10.1	12.3	13.0	14.9	13.0	15.1	9.3	6.8	7.8
Imports of goods and services	6.7	12.2	14.1	14.4	16.2	18.2	8.6	9.7	7.3
	Contribution to GDP growth in percentage points								
Domestic demand	2.2	5.9	7.4	7.3	8.6	8.9	4.9	8.0	5.4
Net exports of goods and services	1.9	−0.1	−1.0	0.3	−2.1	−2.2	0.0	−2.3	0.3
Exports of goods and services	6.4	8.2	9.2	10.5	9.1	10.5	6.7	5.1	5.9
Imports of goods and services	4.4	8.3	10.2	10.2	11.2	12.7	6.6	7.4	5.6
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	5.9	7.9	5.5	7.8	6.2	5.1	3.0	1.5	3.5
Gross average wage of industry (nominal)	5.8	5.5	6.7	5.6	5.8	6.6	8.6	8.3	9.7
Unit labor cost of industry (nominal)	−0.1	−2.3	1.1	−2.0	−0.4	1.4	5.4	6.7	6.0
Producer price index (PPI) of industry	2.8	2.4	7.1	4.5	5.0	8.2	10.7	10.2	10.8
Consumer price index (here: HICP)	2.5	2.5	3.8	2.6	3.2	3.7	5.5	6.5	6.4
EUR per 1 SIT, + = SIT appreciation	−0.2	−0.0	−0.0	−0.1	−0.0	−0.0	−0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	6.7	6.1	5.0	5.8	4.7	4.5	4.8	5.1	4.2
Employment rate (15−64 years)	66.0	66.6	67.8	66.0	68.3	69.0	67.7	67.1	68.3
Key interest rate per annum (%)	4.0	3.5	3.8	3.5	3.8	4.0	4.0	4.0	4.0
SIT per 1 EUR	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)[1]	6.6	8.4	22.5	18.4	21.2	25.2	25.0	13.2	10.9
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−10.4	−15.6	−21.4	−19.5	−18.0	−22.8	−25.3	−17.7	−16.8
Domestic credit of the banking system	19.7	24.7	36.6	30.6	33.9	38.6	42.9	34.8	32.7
of which: claims on the private sector	*16.6*	*26.8*	*36.0*	*29.9*	*32.7*	*38.8*	*42.3*	*36.6*	*35.3*
claims on households	*4.4*	*7.0*	*8.0*	*7.3*	*7.5*	*8.2*	*9.1*	*8.4*	*7.9*
claims on enterprises	*12.3*	*19.8*	*28.0*	*22.6*	*25.2*	*30.6*	*33.2*	*28.2*	*27.4*
claims on the public sector (net)	*3.0*	*−2.1*	*0.6*	*0.7*	*1.2*	*−0.2*	*0.7*	*−1.8*	*−2.6*
Other domestic assets (net) of the banking system	−2.7	−0.6	7.4	7.3	5.3	9.5	7.3	−5.8	−5.0
	% of GDP, ESA 95								
General government revenues	44.5	44.1	43.2	..	..	..	..	..	..
General government expenditures	46.0	45.3	43.3	..	..	..	..	..	..
General government balance	−1.5	−1.2	−0.1	..	..	..	..	..	..
Primary balance	0.1	0.2	1.2	..	..	..	..	..	..
Gross public debt	27.6	27.3	24.1	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	12.9	16.6	16.1	18.7	16.7	18.2	11.5	7.3	7.4
Merchandise imports	12.1	16.3	17.9	18.7	22.3	20.1	11.7	11.9	11.2
	% of GDP (based on EUR), period total								
Trade balance	−3.6	−3.8	−5.0	−3.2	−4.5	−4.4	−7.5	−5.8	−6.6
Services balance	3.0	2.8	3.1	2.7	4.0	3.9	1.8	3.9	5.3
Income balance (factor services balance)	−1.0	−1.3	−2.2	−1.9	−1.8	−2.3	−2.6	−2.6	−2.5
Current transfers	−0.3	−0.6	−0.9	−1.0	−0.4	−1.2	−1.0	−1.9	−1.1
Current account balance	−2.0	−2.8	−4.9	−3.4	−2.7	−4.1	−9.2	−6.4	−4.8
Capital account balance	−0.4	−0.4	−0.2	0.2	−0.3	−0.4	−0.1	−0.0	−0.2
Foreign direct investment (net)	−0.2	−0.7	−0.2	−1.6	−0.2	−1.2	1.9	1.7	−0.4
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	72.6	78.9	102.4	91.0	94.2	97.3	102.4	107.7	110.7
Gross official reserves (excluding gold)	24.2	17.5	2.0	2.7	2.6	2.3	2.0	2.1	1.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.6	3.1	0.3	0.5	0.4	0.4	0.3	0.3	0.3
	EUR million, period total								
Gross domestic product in current prices	28,252	30,454	33,542	7,679	8,537	8,730	8,596	8,525	9,353

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

[1] *The methodology for calculating broad money and its components was changed for data from the beginning of 2005.*

3 Bulgaria: Economic Vulnerabilities Intensified despite some Mitigating Factors

Solid real GDP growth coupled with tighter external refinancing conditions

The impact of the ongoing and recently aggravating global financial crisis remained limited in Bulgaria up to the cutoff date for data – at least in terms of economic growth. Real GDP growth came to 7% year on year in the first half of 2008, driven mainly by a robust expansion of GFCF but also private consumption.[8] Nevertheless, recent financial market indicators point to higher economic vulnerabilities, as reflected in a decline of the equity index, higher risk premia, or in the remarkable decrease of the banking system's net foreign assets as a contribution to the year-on-year change of broad money, indicating tighter external refinancing conditions. Given heightened liquidity pressures, the Bulgarian National Bank (BNB) eased the minimum reserve requirement on October 21.[9]

Bulgaria is faced with external imbalances and strong inflationary pressure

The combined current and capital account deficit remained high at about 25% of GDP in the first half of 2008, which was primarily attributable to a further widening of the trade deficit. Beyond that, net inward FDI was significantly lower than expected in the first half of 2008, which can be almost fully ascribed to a decline of FDI in the construction and real estate sectors.[10] As a result, net FDI inflows covered only 44% of the combined current and capital account deficit in the first half of 2008 – a substantial deterioration compared with the same period in 2007. The higher vulnerability to external shocks is also reflected in a rise of net external debt from 28% of GDP at end-2007 to 36% in June 2008, with the share of private sector and short-term external debt increasing further.

Strong inflationary pressures persisted from mid-2007 as a consequence of the food and energy price shock, strong domestic demand, a tightening labor market, and administered price adjustments. Bulgaria had the second-highest consumer price inflation rate in the EU (HICP rate: 13.2% on average in the first half of 2008). After peaking in June at 14.7% year on year, HICP inflation slowed considerably to 11.4% in September, helped by a favorable base effect. The BNB expects inflation to moderate on an annual basis in the second half of 2008 given the recent stabilization of food and energy prices, and to reach about 8% by year-end.

Labor productivity gains declined substantially in the first half of 2008. As a consequence of tightening labor market conditions, wage growth – which had been high already – gained further momentum and translated into strongly expanding nominal ULC in industry.

Vulnerabilities are contained by a strong fiscal position and comparatively high foreign exchange reserves

Higher-than-expected growth and inflation pushed up government revenues and improved the surplus of the consolidated general government balance to 7% of (projected) GDP by the end of August. The central bank's foreign reserves (excluding gold) came to 43% of GDP at end-September – the highest share in the CESEE region – and more than 100% of the country's entire short-term external debt burden.

[8] *Domestic demand is still driven by credit growth (although real growth of private sector credit decelerated from 45.6% at end-2007 to 32.5% at end-June 2008) and by wage dynamics (about +10% year on year in the first half of 2008).*

[9] *From that date on, 50% of commercial banks' cash on hand is recognized as reserve assets and commercial banks get easier access to the reserves they keep with the BNB.*

[10] *This decline was due to the exit of Western European buyers from Bulgaria's real estate market (Source: Raiffeisen Research, Strategy Bulgaria, September 2008).*

Table 6

Main Economic Indicators: Bulgaria

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	6.2	6.3	6.2	5.5	7.3	4.9	6.9	7.1	7.1
Private consumption	6.1	9.5	5.3	7.8	6.1	5.2	2.8	6.5	5.4
Public consumption	2.5	−1.3	3.1	−2.0	−0.1	−0.4	11.2	−4.4	2.0
Gross fixed capital formation	23.3	17.6	21.7	35.9	24.7	19.7	14.0	15.5	28.6
Exports of goods and services	8.6	8.7	5.2	3.7	5.3	5.4	6.0	9.2	5.1
Imports of goods and services	13.1	14.0	9.9	14.7	11.1	9.3	5.7	5.8	13.7
	Contribution to GDP growth in percentage points								
Domestic demand	13.5	12.3	11.2	16.1	12.9	8.8	8.5	6.0	15.4
Net exports of goods and services	−5.1	−6.4	−5.6	−11.5	−6.6	−4.1	−1.9	0.1	−9.8
Exports of goods and services	5.4	5.6	3.4	2.5	3.8	3.7	3.5	6.1	3.5
Imports of goods and services	10.5	12.0	9.1	14.1	10.4	7.9	5.4	6.0	13.3
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	3.4	8.2	9.5	8.4	8.9	10.9	9.7	3.1	5.3
Gross average wage of industry (nominal)	8.1	10.8	20.1	17.6	19.5	20.0	22.8	25.0	24.0
Unit labor cost of industry (nominal)	4.6	2.5	9.7	8.5	9.8	8.2	11.9	21.3	17.8
Producer price index (PPI) of industry	7.0	9.4	8.8	7.4	6.8	8.8	12.1	14.3	14.0
Consumer price index (here: HICP)	6.0	7.4	7.6	5.3	4.7	9.0	11.2	12.4	14.0
EUR per 1 BGN, + = BGN appreciation	−0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	10.2	9.0	7.0	8.0	6.9	6.7	6.2	6.6	5.9
Employment rate (15−64 years)	55.8	58.6	61.7	59.7	61.6	62.7	62.9	62.6	63.9
Key interest rate per annum (%)[1]	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	27.3	21.3	29.0	28.1	28.5	29.4	29.7	30.2	27.4
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	8.9	14.7	10.4	19.2	11.4	8.3	4.1	1.8	0.4
Domestic credit of the banking system	25.8	13.0	25.3	14.4	22.3	28.0	34.2	37.8	35.3
of which: claims on the private sector	*27.9*	*16.4*	*34.2*	*22.3*	*31.3*	*37.6*	*43.3*	*45.5*	*44.6*
claims on households	*13.0*	*9.4*	*12.0*	*9.2*	*11.1*	*12.7*	*14.5*	*15.4*	*15.2*
claims on enterprises	*14.9*	*7.0*	*22.2*	*13.1*	*20.2*	*24.9*	*28.8*	*30.2*	*29.4*
claims on the public sector (net)	*−2.1*	*−3.4*	*−8.9*	*−7.9*	*−9.0*	*−9.6*	*−9.1*	*−7.8*	*−9.2*
Other domestic assets (net) of the banking system	−7.4	−6.4	−6.6	−5.5	−5.3	−6.9	−8.6	−9.3	−8.4
	% of GDP, ESA 95								
General government revenues	41.0	39.4	41.2	..	..	..	..	..	..
General government expenditures	39.2	36.4	37.8	..	..	..	..	..	..
General government balance	1.8	3.0	3.4	..	..	..	..	..	..
Primary balance	3.5	4.4	4.4	..	..	..	..	..	..
Gross public debt	29.2	22.7	18.2	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	18.6	26.9	12.2	8.5	8.3	12.2	19.2	25.7	23.6
Merchandise imports	26.9	26.7	18.5	19.5	18.4	17.2	19.1	21.6	31.8
	% of GDP (based on EUR), period total								
Trade balance	−20.2	−22.0	−25.5	−27.3	−25.1	−22.3	−27.5	−26.1	−30.6
Services balance	3.7	3.7	3.8	−1.0	5.5	11.4	−1.4	−2.1	4.4
Income balance (factor services balance)	0.3	−2.1	−1.1	−0.2	−1.2	−2.7	−0.1	0.8	−2.9
Current transfers	3.7	2.7	1.2	1.2	1.2	0.9	1.3	2.0	4.1
Current account balance	−12.4	−17.8	−21.5	−27.3	−19.5	−12.7	−27.7	−25.4	−24.9
Capital account balance	1.1	0.7	1.2	0.5	0.6	0.9	2.6	2.7	0.2
Foreign direct investment (net)	14.7	23.1	20.5	15.7	23.0	22.3	19.9	6.9	14.4
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	69.8	80.7	97.3	81.1	83.9	92.2	97.3	99.5	101.4
Gross official reserves (excluding gold)	31.1	32.9	38.8	32.1	33.5	39.8	38.8	37.8	39.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.9	4.8	5.5	4.6	4.8	5.7	5.5	5.3	5.5
	EUR million, period total								
Gross domestic product in current prices	21,882	25,238	28,899	5,771	6,720	8,050	8,358	6,894	8,152

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

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

4 Czech Republic: Deceleration of Growth Dynamics Has Materialized

Economic growth on a gradual moderation path

In the first six months of 2008, real GDP in the Czech Republic grew by 4.9% year on year. The fourth quarter of 2007 was thus the last of 11 consecutive quarters in which GDP expanded by at least 6%, and growth has been gradually losing momentum since. The slowdown was attributable to a significant deceleration of domestic demand growth, which had been the main driver of economic performance over the past two years. Private consumption cooled down particularly as a consequence of an overall decline in disposable household income due to a fiscal reform package[11] and higher inflation. Gross capital formation growth almost came to a halt owing to lower investment and a substantial stock reduction, both in anticipation of a global economic slowdown. As a result, the contribution of domestic demand to GDP growth dropped by two-thirds compared with 2007, while net exports again assumed the role of a growth engine.

Labor market improvement has reached its limits

Despite the economic slowdown, unemployment declined further in the first half of 2008, reaching the lowest levels in more than a decade. Moreover, the extended period of robust growth in combination with social transfer reforms seems to have helped reduce long-term unemployment. However, the potential for further cutting long-term unemployment appears rather limited given persistent regional structural mismatches. As a consequence, emerging labor shortages started to show in accelerating wages and ULC in the whole economy, which are, however, likely to decline somewhat owing to the downturn in economic activity.

Past terms-of-trade improvements spurred foreign trade in the first half of 2008

The surplus of trade in goods and services rose significantly in the first half of 2008, particularly in the first quarter, probably still thanks to the improvement of the country's terms of trade over the course of 2007. As a result, there was no need for external financing of the current and capital account balance, while net FDI inflows remained strong despite some slowdown. Given the steep appreciation of the Czech koruna in the first half of 2008, however, export prices declined more sharply than import prices. The deterioration of the terms of trade along with lower demand in the EU, particularly for cars, might soon weigh on the development of the trade balance.

Inflation on a downward trajectory since its peak in January

Inflation started accelerating strongly in the last quarter of 2007, primarily due to global hikes in food and oil prices, and peaked in January 2008 in response to one-off effects of the fiscal reform package and a further deregulation of administered prices. Since February, however, inflation has been on a downward path on account of weakening domestic demand; food price growth has slowed down noticeably. As inflation expectations also remained contained, Česká národní banka lowered its key interest rate by 25 basis points to 3.5% on August 8. This rate cut was, however, also strongly motivated by the strong appreciation of the currency until the second half of July.

Financial crisis spillovers limited so far but likely to intensify, particularly in the real sector

Except for the stock market, the immediate impact of the global malaise on the financial system in the Czech Republic has been limited so far. However, the recent accentuation of the financial crisis is likely to cause GDP growth to decelerate more markedly than previously expected, thus affecting the outlook for fiscal revenues and possibly also the successful fiscal consolidation.

[11] *The package consisted, inter alia, of an increase in the lower VAT rate, some excise taxes and regulated rents, as well as the introduction of healthcare fees and lower social transfers.*

Table 7

Main Economic Indicators: Czech Republic

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	6.3	6.8	6.6	6.6	6.6	6.4	6.6	5.3	4.5
Private consumption	2.5	5.4	5.9	7.0	6.4	6.1	4.2	2.6	3.3
Public consumption	2.9	−0.7	0.5	−0.7	−0.8	−0.8	3.7	0.5	2.0
Gross fixed capital formation	1.8	6.5	5.8	5.1	5.8	4.5	7.5	4.6	4.1
Exports of goods and services	11.6	15.8	14.6	15.8	14.1	15.6	13.1	13.0	14.1
Imports of goods and services	5.0	14.2	13.8	15.8	14.1	15.2	10.9	11.2	9.6
	Contribution to GDP growth in percentage points								
Domestic demand	1.7	5.6	5.8	6.0	6.5	6.0	4.7	3.4	0.4
Net exports of goods and services	5.1	1.2	0.8	0.5	0.1	0.3	2.0	2.3	4.5
Exports of goods and services	9.5	13.7	13.7	15.0	12.8	14.0	13.1	13.4	13.7
Imports of goods and services	4.4	12.4	12.9	14.5	12.7	13.7	11.1	11.2	9.2
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	6.8	9.4	6.6	9.2	7.2	4.4	5.6	3.4	4.5
Gross average wage of industry (nominal)	4.6	6.1	8.6	9.3	8.6	8.4	8.0	11.6	8.5
Unit labor cost of industry (nominal)	−2.1	−3.0	1.8	0.1	1.3	3.9	2.3	7.9	3.9
Producer price index (PPI) of industry	3.0	1.6	4.0	3.1	4.1	3.9	5.0	5.6	5.1
Consumer price index (here: HICP)	1.6	2.1	3.0	1.7	2.6	2.7	4.9	7.6	6.7
EUR per 1 CZK, + = CZK appreciation	7.1	5.1	2.1	2.0	0.4	1.4	4.5	9.7	13.9
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	8.0	7.2	5.4	6.1	5.3	5.2	4.9	4.7	4.3
Employment rate (15−64 years)	64.8	65.3	66.1	65.5	66.0	66.3	66.5	66.1	66.6
Key interest rate per annum (%)	2.0	2.2	2.9	2.5	2.5	3.1	3.4	3.6	3.8
CZK per 1 EUR	29.8	28.3	27.8	28.0	28.3	27.9	26.8	25.6	24.8
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	6.4	12.4	14.4	13.2	14.5	14.7	15.3	14.9	12.5
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	5.2	1.2	−1.6	−3.2	−0.5	−0.8	−2.0	−2.3	−4.5
Domestic credit of the banking system	0.7	9.2	15.7	14.5	15.2	16.7	16.2	14.9	13.1
of which: claims on the private sector	*8.6*	*11.9*	*14.3*	*12.1*	*12.9*	*15.1*	*16.8*	*17.4*	*16.5*
claims on households	*5.4*	*6.7*	*7.7*	*6.9*	*7.4*	*7.9*	*8.5*	*8.9*	*8.5*
claims on enterprises	*3.2*	*5.2*	*6.6*	*5.2*	*5.5*	*7.2*	*8.2*	*8.5*	*8.0*
claims on the public sector (net)	*−7.9*	*−2.7*	*1.4*	*2.4*	*2.4*	*1.6*	*−0.5*	*−2.6*	*−3.4*
Other domestic assets (net) of the banking system	0.5	2.0	0.3	1.8	−0.3	−1.2	1.1	2.3	3.9
	% of GDP, ESA 95								
General government revenues	41.4	41.0	40.8	..	..	..	..	..	..
General government expenditures	44.9	43.6	42.4	..	..	..	..	..	..
General government balance	−3.6	−2.7	−1.6	..	..	..	..	..	..
Primary balance	−2.4	−1.5	−0.4	..	..	..	..	..	..
Gross public debt	29.7	29.4	28.7	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	16.1	20.6	18.1	19.9	17.2	18.9	16.6	16.6	20.5
Merchandise imports	11.6	20.7	15.8	17.6	15.1	16.8	14.3	18.0	18.1
	% of GDP (based on EUR), period total								
Trade balance	2.0	2.0	3.4	5.5	3.0	2.3	2.9	4.7	4.3
Services balance	1.2	1.4	1.6	1.5	2.0	1.8	1.2	2.7	1.9
Income balance (factor services balance)	−4.8	−5.6	−6.3	−3.2	−7.5	−7.5	−6.6	−4.3	−12.9
Current transfers	0.2	−0.4	−0.5	−0.4	−0.8	−0.6	−0.2	0.1	0.2
Current account balance	−1.3	−2.6	−1.8	3.4	−3.3	−3.9	−2.8	3.2	−6.4
Capital account balance	0.2	0.3	0.6	0.3	0.0	0.4	1.5	0.8	1.3
Foreign direct investment (net)	9.4	2.8	4.5	4.2	3.5	3.7	6.3	2.4	6.0
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	39.3	38.2	39.6	37.2	37.6	37.8	39.6	40.0	43.7
Gross official reserves (excluding gold)	24.8	20.9	18.4	20.2	19.1	18.7	18.4	17.8	17.0
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.3	3.4	3.0	3.3	3.1	3.0	3.0	2.9	2.8
	EUR million, period total								
Gross domestic product in current prices	100,223	113,508	128,005	29,314	31,927	32,147	34,617	34,844	38,691

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

5 Hungary: Hit Hard by the International Turmoil

Hungary's external vulnerability made headlines in mid-October. As investors fled the market (according to the country's prime minister, Hungary was subject to speculative attack), the local currency bond market collapsed for the second time in 2008, the Hungarian forint weakened significantly and its volatility increased sharply. Therefore, Magyar Nemzeti Bank (MNB) and the Hungarian government decided to take coordinated measures so as to improve liquidity conditions in the interbank and government bond markets and to bolster investor confidence. Hungary also received assurance of international support from the IMF, the ECB and the EU. Concerns were fueled by the country's large and rising external debt and its growing (albeit rather moderate compared with regional peers) short-term component, the sharp rise in risk premia since mid-2007 and the substantial exposure of households and enterprises to the risks associated with foreign currency loans. In this environment, the decline in the deficit of the combined current and capital account to 5% of GDP in the first half of 2008 (almost fully covered by net FDI) was not enough to assuage investors.

Growth recovery in the first half of 2008 due to temporary factors

The Hungarian economy expanded by almost 2% the first half of 2008, with a recovery from the first to the second quarter. However, real GDP excluding agriculture grew by 1% only in the first half of 2008, and even slowed to 0.5% in the second quarter. On the expenditure side, growth was driven by net exports, but export growth decelerated and its margin over import growth continued to narrow. Private consumption growth was anemic and investment activity again contracted on account of declining construction activity.

MNB hikes key rate by 300 basis points to ward off downward pressure on the currency

Inflation hovered at between 6.6% and 7.0% in the period from March to July, before falling back to 5.6% by September. Energy prices were a major contributor to this pattern, while the contribution of unprocessed food prices decreased markedly. Price pressure in the processed food segment rose continuously until July, but accounted for the bulk of the decline in core inflation during August and September. In order to minimize the risks of inflation expectations being stuck at elevated levels (and also taking account of unabated growth of private sector nominal wages by around 8% to 10% year on year[12]), the MNB kept policy rates high. At the same time, monetary conditions were tightened additionally by the appreciation of the forint against the euro by around 14% between early April and mid-July 2008. When the gradual weakening of the forint accelerated sharply in the first three weeks of October (around –15%), the MNB's Monetary Council hiked interest rates by 300 basis points in an emergency meeting on October 22. Among other things, this measure was taken to shelter the currency for the following two days, when the market and the stock exchange were closed due to a national holiday. In its latest forecast in August, the MNB expected inflation to fall to its 3% target by around mid-2010, with the risks being symmetric. However, the inflation forecast will likely be adjusted in the next projection.

Fiscal plans revised in light of the global financial crisis

In response to the current situation, the government submitted a revised budget draft to parliament in mid-October in which it lowered its 2008 budget deficit projection from 3.8% of GDP to 3.4% (suggesting that the actual outcome might be even lower) and reduced the 2009 target from 3.2% to 2.9%. The main economic assumptions underlying the budget were also modified (the 2009 growth forecast was slashed from 3.0% to 1.2% and the inflation forecast was revised from 4.3% to 3.9%). Over and above additional spending cuts the government also put off the tax cuts announced earlier.

[12] *It should be noted, however, that ULC in industry (which are more relevant for external competitiveness) grew by only 1.5% year on year during the first half of 2008; still, they did not contract as they had in the period from 2005 to 2007.*

Table 8

Main Economic Indicators: Hungary

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	4.1	3.9	1.3	2.7	1.2	0.9	0.8	1.7	2.1
Private consumption	3.4	1.7	−0.3	0.2	−0.6	−0.6	−0.2	0.4	1.3
Public consumption	2.4	4.3	−6.2	−10.9	−7.4	−2.2	−4.0	−6.4	0.7
Gross fixed capital formation	5.3	−2.5	0.1	0.5	−0.8	−2.6	2.6	−5.4	−2.2
Exports of goods and services	11.5	19.0	14.2	17.4	14.6	14.9	10.4	13.9	11.1
Imports of goods and services	6.8	14.7	12.0	12.8	13.1	13.5	9.1	10.2	11.2
	Contribution to GDP growth in percentage points								
Domestic demand	1.3	1.2	−0.4	−0.3	−0.2	−0.5	−0.5	−1.8	1.9
Net exports of goods and services	3.6	3.7	2.4	4.6	1.9	1.8	1.6	4.7	0.5
Exports of goods and services	9.6	17.0	14.5	18.0	14.7	15.0	11.0	16.4	12.7
Imports of goods and services	6.0	13.4	12.1	13.4	12.8	13.2	9.4	11.7	12.2
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	10.1	11.5	9.3	9.8	8.5	10.6	8.5	7.2	4.6
Gross average wage of industry (nominal)	7.2	8.6	8.4	8.9	9.5	7.7	7.6	7.9	7.3
Unit labor cost of industry (nominal)	−2.6	−2.6	−0.8	−0.8	1.0	−2.6	−0.8	0.6	2.5
Producer price index (PPI) of industry	2.9	6.7	−0.1	3.4	−0.8	−2.8	0.1	5.2	5.6
Consumer price index (here: HICP)	3.5	4.0	7.9	8.8	8.5	7.3	7.1	6.9	6.8
EUR per 1 HUF, + = HUF appreciation	1.5	−6.1	5.1	0.9	7.5	9.4	2.9	−2.7	0.1
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	7.2	7.5	7.4	7.5	7.0	7.3	7.8	8.0	7.7
Employment rate (15−64 years)	56.9	57.3	57.3	56.9	57.6	57.7	57.1	56.1	56.5
Key interest rate per annum (%)	7.1	6.8	7.8	8.0	8.0	7.7	7.5	7.5	8.3
HUF per 1 EUR	248.0	264.3	251.3	252.3	248.3	251.8	252.9	259.3	248.0
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	13.8	16.2	9.8	11.1	7.9	8.5	11.4	13.8	13.3
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	0.6	−2.2	−5.6	−4.6	−4.8	−5.9	−7.2	−8.9	−9.1
Domestic credit of the banking system	15.3	23.6	17.9	21.1	15.3	15.3	19.9	26.3	24.0
of which: claims on the private sector	*16.6*	*21.7*	*14.4*	*15.7*	*11.6*	*13.3*	*16.9*	*23.8*	*21.8*
claims on households	*7.3*	*9.4*	*8.1*	*8.8*	*7.6*	*7.5*	*8.5*	*10.9*	*10.2*
claims on enterprises	*9.3*	*12.3*	*6.3*	*6.9*	*4.1*	*5.8*	*8.3*	*12.8*	*11.6*
claims on the public sector (net)	*−1.3*	*1.9*	*3.5*	*5.4*	*3.7*	*1.9*	*3.0*	*2.6*	*2.3*
Other domestic assets (net) of the banking system	−2.0	−5.2	−2.5	−5.4	−2.6	−0.8	−1.3	−3.6	−1.7
	% of GDP, ESA 95								
General government revenues[1]	42.1	42.6	44.6	..	..	..	..	..	..
General government expenditures[1]	49.9	51.9	50.1	..	..	..	..	..	..
General government balance[1]	−7.8	−9.2	−5.5	..	..	..	..	..	..
Primary balance[1]	−3.7	−5.3	−1.4	..	..	..	..	..	..
Gross public debt[1]	61.6	65.6	66.0	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	11.6	17.5	17.1	19.9	17.7	19.2	12.5	14.9	12.5
Merchandise imports	9.5	16.5	12.6	14.7	14.0	13.5	8.8	12.6	11.3
	% of GDP (based on EUR), period total								
Trade balance	−2.5	−2.3	0.3	−0.1	0.4	0.2	0.7	1.6	1.0
Services balance	1.3	1.4	1.0	0.7	1.3	1.6	0.5	0.3	1.1
Income balance (factor services balance)	−5.7	−6.2	−7.3	−7.2	−8.6	−6.7	−6.7	−7.7	−7.5
Current transfers	−0.6	−0.5	−0.5	0.1	−0.8	−1.6	0.3	−1.1	−1.2
Current account balance	−7.5	−7.5	−6.4	−6.4	−7.7	−6.6	−5.2	−6.9	−6.6
Capital account balance	0.8	0.6	1.1	0.2	0.5	2.3	1.3	3.3	0.5
Foreign direct investment (net)	5.0	3.2	1.6	1.0	−3.2	5.5	2.9	2.1	6.3
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	75.0	90.5	97.2	92.8	96.6	94.9	97.2	99.0	103.4
Gross official reserves (excluding gold)	17.7	18.2	16.2	18.3	17.7	16.6	16.2	16.4	16.6
	Months of imports of goods and services								
Gross official reserves (excluding gold)	3.1	2.8	2.5	2.8	2.7	2.5	2.5	2.5	2.5
	EUR million, period total								
Gross domestic product in current prices	88,809	90,006	101,086	22,672	25,470	25,586	27,358	23,744	27,731

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

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

6 Poland: Roadmap for Euro Adoption Proposed

Growth slowdown set in after a strong first half of the year

Real GDP growth decelerated to 6.1% in the first half of 2008, from 6.5% in full-year 2007. Private consumption growth remained below total GDP growth despite strong employment and real wage growth, partly because real growth of gross social benefits was subdued. The deceleration in GDP growth resulted from slower GFCF growth, which was still high at 15% owing to several factors: The financial situation of the corporate sector remained favorable, the level of real interest rates was moderate, real growth of credit to nonfinancial corporations stayed high and the absorption of EU funds accelerated further. Export growth picked up despite the slowdown of euro area import growth and the rise of manufacturing ULC as well as a strong nominal appreciation of the Polish złoty against the euro (by 10% on average in the first half of 2008 year on year). Notwithstanding these developments, import growth declined, probably reflecting slower GFCF growth. Thus, the growth contribution of net exports became less negative. However, export growth in the second quarter was lower than in the first quarter of 2008, and available data on industrial output, retail sales and exports indicate that growth will slow down further in the third quarter. The recent intensification of the global financial crisis is likely to imply a more pronounced deceleration of GDP growth, even though the depreciation of the złoty against the euro (following a peak around mid-2008) may help dampen negative growth effects.

Stable external position

As export growth remained below import growth in nominal euro terms, the deficit in the goods and services balance widened in the first half of 2008 compared with the same period one year earlier. Thanks to the capital account surplus, however, the deficit of the combined capital and current account remained almost unchanged. Net FDI inflows covered only one-half of this deficit, and the remaining net inflows on the financial account lifted gross external debt and raised official foreign exchange reserves.

MPC keeps key rates on hold at end-September amid weaker growth outlook and disinflation expectations

HICP inflation accelerated to 4.5% in July and then declined to 4.1% by September, while national CPI inflation – the indicator in which the inflation target is defined – even reached 4.8% before decreasing to 4.5% in September. At the end of September 2008, the Polish Monetary Policy Council (MPC) held the view that the high, albeit declining, annual growth of food and fuel prices and the accelerating energy prices were the main reasons why inflation would remain above the upper limit for deviations of Narodowy Bank Polski's CPI target (2.5% ±1 percentage point). National core inflation, which excludes food, fuel and energy prices, continued to accelerate, reaching 2.9% in September 2008. In its press release of September 24, the MPC held the view that wage and underlying inflationary pressures would ease in the medium term, given the slowdown in economic growth, previous rate hikes and earlier złoty appreciation. Thus, the MPC kept the key rate unchanged. Before that, the MPC had hiked the rate by a total of 200 basis points in several steps since April 2007 (roughly in line with the rise in core inflation).

Government pushes for euro adoption

While until recently, Polish officials had avoided indicating any target date for euro adoption, the government officially approved a euro adoption roadmap on October 28, 2008. According to this roadmap, Poland would enter ERM II in the first half of 2009 (after reaching agreement on the necessary constitutional changes), fulfil the convergence criteria in 2011, and introduce the euro on January 1, 2012.

Table 9

Main Economic Indicators: Poland

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	3.6	6.2	6.5	7.2	6.4	6.4	6.1	6.3	6.0
Private consumption (excl. NPISH[1])	1.9	4.8	5.2	6.9	5.0	5.3	3.7	5.6	5.6
Public consumption (incl. NPISH)	5.2	5.8	0.7	0.8	1.0	0.8	0.1	−1.1	−1.6
Gross fixed capital formation	6.5	15.6	20.4	26.2	20.8	19.8	18.5	14.9	15.5
Exports of goods and services	8.0	14.6	9.0	11.7	6.5	9.3	8.8	13.2	7.2
Imports of goods and services	4.7	17.4	10.9	12.8	10.8	11.4	9.0	12.6	7.3
	Contribution to GDP growth in percentage points								
Domestic demand	2.5	7.3	7.5	7.9	8.4	7.6	6.4	6.5	6.5
Net exports of goods and services	1.1	−1.2	−1.0	−0.7	−2.0	−1.2	−0.3	0.0	−0.3
Exports of goods and services	3.0	5.4	3.6	4.7	2.7	3.8	3.4	5.5	3.0
Imports of goods and services	1.9	6.6	4.7	5.4	4.7	5.0	3.7	5.5	3.2
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	2.9	9.5	6.0	9.6	5.1	4.5	4.8	5.1	5.1
Gross average wage of industry (nominal)	3.2	5.2	8.7	8.3	8.5	8.8	9.3	10.4	11.2
Unit labor cost of industry (nominal)	0.3	−4.0	2.6	−1.2	3.2	4.1	4.3	5.0	5.8
Producer price index (PPI) of industry	0.7	2.2	2.2	3.1	2.0	1.6	2.2	3.0	2.5
Consumer price index (here: HICP)	2.2	1.3	2.6	2.0	2.3	2.4	3.7	4.5	4.3
EUR per 1 PLN, + = PLN appreciation	12.6	3.2	3.0	−1.3	3.9	4.3	5.2	8.7	11.5
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	18.0	14.1	9.7	11.4	9.7	9.1	8.6	8.2	7.2
Employment rate (15−64 years)	52.8	54.5	57.0	55.4	56.8	57.8	58.1	58.1	58.9
Key interest rate per annum (%)	5.3	4.1	4.4	4.0	4.3	4.6	4.9	5.4	5.8
PLN per 1 EUR	4.0	3.9	3.8	3.9	3.8	3.8	3.7	3.6	3.4
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	13.0	12.6	15.9	18.1	16.7	15.4	13.8	13.3	15.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	5.5	1.7	−5.7	−0.9	−5.2	−7.3	−8.8	−11.5	−10.6
Domestic credit of the banking system	5.2	12.0	20.8	20.7	21.0	21.1	20.3	21.6	23.4
of which: claims on the private sector	5.5	10.9	20.8	17.5	20.0	22.4	23.0	23.0	22.7
claims on households	5.6	8.6	13.8	12.3	13.3	14.6	14.9	14.8	14.7
claims on enterprises	−0.1	2.3	7.0	5.2	6.7	7.8	8.1	8.2	8.0
claims on the public sector (net)	−0.3	1.2	−0.0	3.2	1.0	−1.3	−2.7	−1.4	0.7
Other domestic assets (net) of the banking system	2.3	−1.1	0.8	−1.7	0.9	1.6	2.2	3.2	2.2
	% of GDP, ESA 95								
General government revenues[2]	39,0	40,0	40,4	..	..	..	..	..	..
General government expenditures[2]	43,3	43,8	42,4	..	..	..	..	..	..
General government balance[2]	-4,3	-3,8	-2,0	..	..	..	..	..	..
Primary balance[2]	-1,5	-1,1	0,6	..	..	..	..	..	..
Gross public debt[2]	47,1	47,6	45,2	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	17.9	20.3	12.8	13.4	12.7	13.1	12.0	21.3	20.4
Merchandise imports	13.4	23.9	17.9	19.5	19.7	16.7	16.2	21.2	21.9
	% of GDP (based on EUR), period total								
Trade balance	−0.9	−2.0	−3.7	−3.4	−4.1	−3.5	−3.6	−3.4	−4.5
Services balance	0.2	0.2	0.9	0.9	0.7	0.6	1.4	0.6	0.3
Income balance (factor services balance)	−2.2	−2.8	−3.0	−3.2	−3.5	−2.4	−3.1	−3.3	−3.5
Current transfers	1.6	1.9	2.0	2.1	2.2	2.2	1.6	1.1	1.8
Current account balance	−1.2	−2.7	−3.7	−3.6	−4.6	−3.1	−3.7	−4.9	−6.0
Capital account balance	0.3	0.6	1.1	0.6	0.7	1.1	1.8	1.6	1.9
Foreign direct investment (net)	2.3	3.0	3.6	4.7	2.8	4.1	2.9	3.0	1.0
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	45.9	47.3	51.2	48.2	49.5	49.4	51.2	52.7	53.3
Gross official reserves (excluding gold)	14.1	12.9	13.8	13.1	13.5	13.3	13.8	14.5	14.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.5	3.7	3.8	3.7	3.7	3.6	3.8	4.0	4.1
	EUR million, period total								
Gross domestic product in current prices	244,775	272,199	309,303	68,894	74,065	76,109	90,235	82,232	90,540

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

[1] *Nonprofit institutions serving households.*
[2] *Including the net costs of the pension reform.*

7 Romania: Medium-Term Sustainability Put to a Serious Test

Real GDP growth accelerated strongly in the first two quarters of 2008 compared with full-year 2007. In this respect, the global financial turbulence has not had a significant impact yet, but risks from intensified overheating and concerns about macrofinancial risks have increased noticeably. Romania is considered to be one of the more vulnerable countries in the region; the country's high internal and external imbalances are reflected in comparatively sharp increases of risk premia, a plunging stock market and a pronounced depreciation of the Romanian leu.

Unbalanced growth structure aggravates economic vulnerabilities

In the first half of 2008, the contribution of domestic demand to GDP growth remained substantial. Total consumption growth was higher than overall GDP growth (by more than 4 percentage points). Private consumption growth was supported by the still dynamic expansion of lending to households (+68% on average in the first half of 2008 in real terms), by the acceleration of real gross wage growth (around +15% on average in the first half of 2008) as well as favorable labor market developments. GFCF expanded by more than 30% year on year, largely driven by buoyant growth in the construction sector (+33% year on year). Export growth picked up, supposedly helped by the depreciation of the currency vis-à-vis the euro that started in mid-2007, and even outpaced import growth in the second quarter of 2008. Overall, however, the contribution of net exports to GDP growth turned out to be negative again.

High external imbalances are among the key issues of concern despite some improvement

Even though the goods and services balance improved somewhat in the first half of 2008 compared with the same period of 2007, the combined current and capital account is still deeply in the red. Higher FDI inflows in the second quarter of 2008 (boosted by privatizations) raised the FDI coverage ratio to 63.1% in the first half of 2008, compared with 45.8% in the same period of 2007. These inflows still cover the external deficit only partially.

In the first seven months of 2008, inflation peaked at more than 9% year on year in July, particularly due to higher administered prices, before moderating somewhat in August and September (at around 8.1% and 7.3%, respectively) owing to decelerating price increases for fuel and food – the main inflation drivers over the previous months. Core inflation (excluding volatile and administered prices) dropped, as well, but stayed at an elevated level, indicating demand-driven inflationary pressure and high inflation expectations, among other things. Notably, nominal ULC (whole economy) rose by more than 18% in the first half of 2008 compared with the first half of 2007, as wage growth outpaced productivity increases. Furthermore, the Romanian government hiked minimum wages as of October 2008 and raised public sector wages considerably. To combat inflationary pressures, Banca Naţională a României (BNR) continued to increase its policy rate (by a total of 0.75 percentage points to 10.25% from April). The BNR revised upward its inflation forecast from 6.0% to 6.6% year on year for end-2008 (and from 3.5% to 4.2% for end-2009). To tackle another source of vulnerability – the high and rising share of foreign currency loans – the BNR raised the penalty rate for banks that fail to keep adequate minimum reserves in leu.

Fiscal policy unsupportive of counteracting economic strains

Large uncertainties are surrounding fiscal policy in Romania. The European Commission expects some loosening of the fiscal stance for 2008, and available information points to lavish fiscal spending in the run-up to the parliamentary elections November. Moreover, the decision to hike pensions by 20% also underlines that fiscal policy does not contribute to dealing with the risks the country faces regarding its large internal and external imbalances.

Table 10

Main Economic Indicators: Romania

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	4.2	7.9	6.1	6.1	5.7	5.7	6.6	8.2	9.3
Private consumption	9.9	12.5	11.0	12.3	12.3	10.1	10.1	15.5	13.4
Public consumption	8.1	−2.4	5.5	6.3	6.8	4.9	4.8	3.0	3.1
Gross fixed capital formation	12.7	19.3	28.9	23.5	28.4	32.2	28.1	33.2	30.0
Exports of goods and services	7.7	10.6	8.7	12.0	3.5	4.8	14.9	24.6	26.9
Imports of goods and services	16.1	22.4	26.1	28.5	22.7	24.7	28.6	35.2	24.4
	Contribution to GDP growth in percentage points								
Domestic demand[1]	10.2	17.5	20.9	22.3	22.3	20.7	19.4	27.9	19.1
Net exports of goods and services	−5.9	−9.6	−14.9	−16.2	−16.6	−15.0	−12.8	−19.7	−9.8
Exports of goods and services	3.2	4.6	3.9	6.9	1.7	2.0	5.4	14.9	13.1
Imports of goods and services	9.2	14.2	18.8	23.1	18.3	17.0	18.2	34.6	22.9
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	4.4	11.3	9.5	12.6	8.5	8.8	8.0	8.8	10.6
Gross average wage of industry (nominal)	16.9	15.7	21.6	20.7	21.7	20.9	22.8	18.5	24.5
Unit labor cost of industry (nominal)	12.0	4.0	11.0	7.2	12.2	11.1	13.7	9.0	12.6
Producer price index (PPI) of industry	10.8	11.7	8.1	9.4	7.5	6.1	9.3	14.4	17.2
Consumer price index (here: HICP)	9.1	6.6	4.9	3.9	3.9	5.1	6.8	8.0	8.6
EUR per 1 RON, + = RON appreciation	11.8	2.7	5.7	5.4	7.3	9.6	0.9	−8.3	−10.2
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	7.5	7.6	6.7	7.4	6.8	6.3	6.4	6.6	5.9
Employment rate (15−64 years)	57.6	58.8	58.8	57.2	59.6	60.5	57.9	57.7	59.7
Key interest rate per annum (%)	11.7	8.5	7.5	8.4	7.6	6.8	7.3	8.5	9.7
RON per 1 EUR	3.6	3.5	3.3	3.4	3.3	3.2	3.4	3.7	3.7
	Nominal year-on-year change of the period average stock in %								
Money plus quasi money	41.3	28.2	27.8	26.8	25.8	26.2	31.9	36.8	38.7
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	17.4	1.5	−6.0	−2.8	−3.8	−5.3	−11.3	−8.6	−10.9
Domestic credit of the banking system	9.9	31.1	39.7	33.3	34.4	36.7	52.6	60.7	62.6
of which: claims on the private sector	*25.6*	*36.1*	*42.2*	*39.1*	*39.4*	*41.0*	*48.6*	*57.1*	*58.8*
claims on households	*13.2*	*19.0*	*23.3*	*21.5*	*21.1*	*22.5*	*27.4*	*31.6*	*32.5*
claims on enterprises	*12.4*	*17.1*	*19.0*	*17.6*	*18.3*	*18.5*	*21.2*	*25.5*	*26.3*
claims on the public sector (net)	*−15.7*	*−4.9*	*−2.6*	*−5.8*	*−5.0*	*−4.3*	*3.9*	*3.6*	*3.7*
Other domestic assets (net) of the banking system	13.9	−4.5	−5.8	−3.7	−4.8	−5.1	−9.4	−15.3	−13.0
	% of GDP, ESA 95								
General government revenues	32.3	33.1	34.4	..	..	..	..	..	..
General government expenditures	33.5	35.3	36.9	..	..	..	..	..	..
General government balance	−1.2	−2.2	−2.5	..	..	..	..	..	..
Primary balance	−0.1	−1.4	−1.8	..	..	..	..	..	..
Gross public debt	15.8	12.4	12.9	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	17.6	16.4	12.8	12.1	11.0	12.3	15.8	14.6	22.2
Merchandise imports	24.0	25.5	24.5	33.4	25.5	23.1	18.4	12.5	17.5
	% of GDP (based on EUR), period total								
Trade balance	−9.8	−12.1	−14.6	−17.6	−16.4	−12.5	−13.7	−16.5	−16.1
Services balance	−0.4	0.0	0.0	1.0	0.2	−0.3	−0.4	0.3	1.7
Income balance (factor services balance)	−2.9	−3.3	−3.9	−5.6	−5.1	−3.2	−3.0	−4.7	−5.0
Current transfers	4.5	4.9	4.1	5.1	4.9	4.5	2.7	6.0	4.3
Current account balance	−8.6	−10.4	−14.5	−17.1	−16.3	−11.5	−14.4	−14.9	−15.0
Capital account balance	0.7	−0.0	0.7	0.4	0.7	0.7	0.9	0.6	0.5
Foreign direct investment (net)	6.6	8.9	5.7	9.0	6.1	5.2	4.3	6.8	10.9
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	38.9	41.9	48.1	43.7	45.4	47.5	48.1	49.1	51.4
Gross official reserves (excluding gold)	21.1	21.8	20.9	21.3	20.8	22.2	20.9	20.2	19.5
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.8	5.9	5.6	5.6	5.4	5.8	5.6	5.4	5.1
	EUR million, period total								
Gross domestic product in current prices	79,739	97,898	121,212	20,360	26,553	34,354	39,946	23,516	29,851

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

[1] *Including statistical discrepancy.*

8 Slovakia: Growth Moderating to Still High Levels and Inflation Rising Somewhat in the Run-up to Euro Adoption

Economic growth returning to more sustainable levels

After an extraordinary surge toward the end of 2007, economic growth lost steam in the first half of 2008, coming in at 8.7% and 7.6% in the first and second quarter, respectively. This moderation can be traced to a declining growth contribution of the external sector. Export growth slowed given the appreciation of the Slovak koruna until May, weaker international demand and unfavorable base effects. Also stock changes exerted a substantial drag on growth, after a large-scale build-up of inventory toward the end of 2007. By contrast, the contribution of domestic demand remained broadly stable in the first two quarters and even increased when compared with full-year 2007. Private consumption profited from rising employment, dynamic real wage growth and robust credit growth. After a weaker development in the first quarter of 2008, GFCF growth recovered in the second quarter on the back of investment in both machinery and construction.

Gradual improvement of the current account comes to a halt

Following the large-scale build-up of predominately FDI-financed industrial capacity in previous years, the repatriation of profits increasingly weighs on the income balance of the balance of payments. Especially in the second quarter, the deterioration of the income balance put a brake on the gradual improvement of the combined capital and current account observed in 2007. Moreover, export growth moderated. However, import growth decelerated as well, which kept trade in goods roughly balanced in the first half of 2008, with the worsening in the second quarter being caused by adverse developments in the terms of trade, among other things. The rise in the combined capital and current account deficit in the second quarter of 2008 was increasingly financed by (short-term) other investments, while FDI coverage declined to around 30%.

Inflation accelerating amid rising domestic price pressures

Inflation increased slightly compared with previous months, coming in at 4.5% in September. The price hikes were caused, in roughly equal parts, by industrial goods, services, food, and energy. Also core inflation accelerated, reaching 4.3% year on year. Especially the rise in (whole-economy) ULC owing to a pick-up in wage growth indicates higher cost pressures on prices that could further intensify, given existing risks of second-round effects and tight labor market conditions. Despite the comparatively high unemployment rate, a further mobilization of labor in the short term seems difficult because of the high level of structural unemployment (long-term unemployment stands at over 70%) and pronounced regional disparities combined with low regional mobility. Národná banka Slovenska forecasts inflation to reach 4.0% year on year at the end of 2008.

Risks posed by financial turmoil lower owing to euro adoption

Up to the cutoff date for data, turbulence on international financial markets affected Slovakia only indirectly via lower export demand from important trading partners, and had relatively little impact on financial markets. External and exchange rate risks remained comparatively contained, as the EU Council adopted a decision allowing Slovakia to adopt the euro as its currency on January 1, 2009, following the convergence reports of the ECB and the European Commission from May 7. The irrevocable conversion rate was set at 1 EUR = 30.1260 SKK. This corresponds to the official central rate of the koruna in ERM II after the central parity had been revalued twice (by 8.5% in March 2007 and by 17.6% in May 2008). The revaluations were supported by ongoing improvements in underlying fundamentals. Since then, the koruna has traded steadily at a value of about 0.5% above the new parity.

Table 11

Main Economic Indicators: Slovakia

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	6.6	8.5	10.4	8.3	9.3	9.4	14.3	8.7	7.6
Private consumption	6.5	5.6	7.1	6.3	7.8	8.3	5.9	8.3	5.7
Public consumption	3.5	10.1	0.7	3.5	−3.5	2.2	0.8	0.6	8.9
Gross fixed capital formation	17.6	8.4	7.9	11.0	5.9	6.5	8.9	2.4	9.6
Exports of goods and services	13.9	21.0	16.0	22.7	18.1	8.5	16.0	12.4	8.7
Imports of goods and services	16.1	17.7	10.4	14.5	13.2	3.0	11.6	14.2	9.0
	Contribution to GDP growth in percentage points								
Domestic demand	8.7	6.8	6.1	2.8	4.9	4.6	11.6	8.9	7.5
Net exports of goods and services	−2.1	2.3	5.4	7.5	4.8	5.5	4.1	−0.9	0.2
Exports of goods and services	11.5	18.6	15.8	21.0	17.3	8.4	17.1	13.0	9.0
Imports of goods and services	13.6	16.3	10.3	13.4	12.4	3.0	13.0	13.9	8.7
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	0.6	11.3	10.0	9.8	10.8	10.1	9.2	4.4	4.5
Gross average wage of industry (nominal)	7.3	6.7	6.4	8.1	6.2	6.1	5.5	8.4	8.7
Unit labor cost of industry (nominal)	6.6	−4.1	−3.3	−1.6	−4.1	−3.6	−3.4	3.9	4.0
Producer price index (PPI) of industry	4.7	8.4	2.1	3.4	1.6	1.1	2.2	4.9	6.2
Consumer price index (here: HICP)	2.8	4.3	1.9	2.1	1.7	1.4	2.4	3.4	4.0
EUR per 1 SKK, + = SKK appreciation	3.7	3.7	10.2	9.1	11.7	12.7	7.5	3.9	7.5
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	16.2	13.4	11.2	11.7	11.2	11.3	10.4	10.5	10.1
Employment rate (15−64 years)	57.7	59.4	60.7	60.1	60.4	60.7	61.6	61.3	61.7
Key interest rate per annum (%)	3.2	4.0	4.4	4.7	4.3	4.3	4.3	4.3	4.3
SKK per 1 EUR	38.6	37.2	33.8	34.3	33.8	33.6	33.4	33.1	31.4
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	5.0	5.5	14.8	15.2	16.7	14.9	12.5	10.8	7.6
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−5.8	15.9	−1.7	1.1	−3.7	−3.1	−1.1	1.2	−5.7
Domestic credit of the banking system	12.1	3.9	14.4	11.6	13.9	15.8	16.1	16.8	14.4
of which: claims on the private sector	8.1	16.1	15.0	15.1	13.9	15.4	15.4	17.0	16.9
claims on households	5.3	8.7	7.3	7.6	7.1	7.1	7.3	7.4	7.8
claims on enterprises	2.8	7.3	7.7	7.5	6.8	8.3	8.1	9.5	9.1
claims on the public sector (net)	4.0	−12.1	−0.5	−3.5	0.0	0.4	0.7	−0.2	−2.5
Other domestic assets (net) of the banking system	−1.3	−14.3	2.1	2.5	6.5	2.2	−2.5	−7.3	−1.1
	% of GDP, ESA 95								
General government revenues[1]	35.3	33.5	34.7	..	..	..	..	..	..
General government expenditures[1]	38.1	37.2	36.9	..	..	..	..	..	..
General government balance[1]	−2.8	−3.6	−2.2	..	..	..	..	..	..
Primary balance[1]	−1.1	−2.2	−0.8	..	..	..	..	..	..
Gross public debt[1]	34.2	30.4	29.4	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	15.3	29.3	26.9	38.1	29.8	20.3	22.0	18.0	21.2
Merchandise imports	17.4	27.7	21.4	27.7	25.5	15.5	18.3	16.7	21.5
	% of GDP (based on EUR), period total								
Trade balance	−5.0	−4.6	−1.2	0.4	−1.8	0.0	−3.0	1.3	−2.0
Services balance	0.7	1.4	0.7	0.3	1.3	0.9	0.4	−0.6	−0.6
Income balance (factor services balance)	−4.1	−3.7	−4.3	0.3	−5.9	−5.6	−5.3	−0.8	−7.3
Current transfers	0.0	−0.1	−0.6	−1.0	−0.7	−0.9	0.1	−1.3	−1.3
Current account balance	−8.4	−7.0	−5.4	−0.1	−7.2	−5.6	−7.9	−1.4	−11.3
Capital account balance	−0.0	−0.1	0.6	1.0	0.3	0.1	1.1	0.9	2.3
Foreign direct investment (net)	4.1	6.8	3.6	−0.8	5.7	4.6	4.1	−1.2	3.4
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	59.6	54.8	54.9	56.5	54.9	53.6	54.9	54.8	59.7
Gross official reserves (excluding gold)	32.7	21.6	22.4	25.4	25.5	23.8	22.4	21.1	20.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.9	3.0	3.1	3.5	3.5	3.3	3.1	2.9	2.8
	EUR million, period total								
Gross domestic product in current prices	38,482	44,628	54,868	12,190	13,445	14,368	14,865	14,288	16,145

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

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

9 Croatia: Slower but Solid Growth, Widening External Imbalances

Economic growth moderating amid slowing private consumption

Having reached one of the highest growth rates in a decade in 2007 (+5.6%), the Croatian economy lost some of its momentum in the first half of 2008 (+3.8%). This slowdown was mainly attributable to a moderate expansion of private consumption, which can be largely explained by a marked deceleration of credit growth and an inflation-driven slowdown in real net wage growth. Public consumption eased off somewhat after the election year 2007. In contrast, GFCF growth accelerated substantially, primarily driven by strong construction activity. Finally, slower export growth coupled with an unabatedly strong import propensity led to a sharp increase in the negative contribution of net exports to growth.

Supply-side factors drive inflation to a 14-year high in July, reversal more recently

Inflationary pressures continued to pick up in 2008, mainly driven by food and energy prices, and peaked in July at 8.4% year on year, the highest level recorded since September 1994. Inflation came down to 6.4% by September 2008, against the background of easing food and energy prices and a strong base effect. Hrvatska narodna banka (HNB) forecasts an average inflation of 7% for 2008. In order to contain inflationary pressures, the HNB continued to further restrain credit growth (by implementing restrictive administrative and prudential measures), but it also tightened minimum reserve regulations by excluding banks' vault cash from qualifying as minimum reserves. With this step (effective as of October 9, 2008) the HNB primarily aimed at sterilizing excess liquidity created by the public bid Hungary's oil company MOL submitted for a 31% stake in its Croatian counterpart INA, in a deal worth some EUR 1.3 billion, which was feared would create additional inflationary pressures. However, in mid-October the HNB abolished the marginal reserve requirement applied since August 2004, thereby partly offsetting the restrictive measures taken before, so as to boost banks' foreign exchange liquidity against the background of tighter global credit conditions.

Sustained capital inflows cause appreciation pressures

The MOL-INA deal, continued strong external borrowing by the corporate sector, and a good tourism season generated a strong demand for Croatian kuna and led to a relatively strong appreciation against the euro particularly from mid-August (despite the tightly managed float), which is expected to be supportive of the disinflation process. Thus far, the kuna remained largely unaffected by the global financial market turbulence. Negative global investor sentiment was, however, felt strongly on the stock market, and risk premia grew considerably.

External imbalances continue to widen

In a more fragile global environment, FDI inflows slowed somewhat in the first half of 2008, reaching 9.2% of GDP (the MOL-INA deal will materialize only in the second half of 2008), down from 12.4% of GDP in the corresponding period of 2007. At the same time, the country's external imbalances continued to widen. The combined capital and current account deficit reached some 22% of GDP in the first half of 2008, up from 19% of GDP in the same period of 2007, mainly owing to a widening trade deficit (that was driven primarily by a higher energy bill), but also to a higher deficit on the income balance on account of increased profit repatriation (mainly dividend and interest income). Given the above, Croatia's foreign debt rose by some EUR 2 billion in the first half of 2008, reaching around 90% of rolling four-quarter GDP, with corporations' external borrowing continuing to be the driving force. Croatia's foreign exchange reserves increased to EUR 9.9 billion by mid-2008, corresponding to a five-month import cover.

Table 12

Main Economic Indicators: Croatia

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	4.3	4.8	5.6	7.0	6.6	5.1	3.7	4.3	3.4
Private consumption	3.4	3.5	6.2	7.1	6.5	6.2	5.0	4.3	2.2
Public consumption	0.8	2.2	3.4	2.8	2.7	4.4	3.7	0.5	3.2
Gross fixed capital formation	4.9	10.9	6.5	11.2	5.8	5.7	4.0	9.8	12.6
Exports of goods and services	4.6	6.9	5.7	3.0	8.9	7.3	2.1	3.8	4.6
Imports of goods and services	3.5	7.3	5.8	3.7	6.4	7.0	6.0	7.0	8.1
	Contribution to GDP growth in percentage points								
Domestic demand	4.2	5.9	6.4	8.2	6.7	4.3	6.6	7.1	6.5
Net exports of goods and services	0.1	−1.1	−0.8	−1.2	−0.1	0.7	−2.9	−2.8	−3.2
Exports of goods and services	2.2	3.4	2.9	1.2	4.1	4.9	1.0	1.5	2.2
Imports of goods and services	2.2	4.5	3.7	2.4	4.2	4.2	3.9	4.3	5.3
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	6.2	2.7	2.5	4.4	3.7	1.4	0.3	4.7	5.2
Gross average wage of industry (nominal)	5.3	7.5	5.5	6.2	5.1	5.9	4.9	7.6	7.2
Unit labor cost of industry (nominal)	−0.8	4.7	3.0	1.7	1.4	4.5	4.6	2.7	1.9
Producer price index (PPI) of industry	3.1	2.9	3.4	2.0	2.5	3.8	5.5	7.7	8.8
Consumer price index (here: CPI)	3.4	3.2	2.8	1.5	2.1	2.9	4.9	6.0	6.6
EUR per 1 HRK, + = HRK appreciation	1.3	1.1	−0.2	−0.3	−1.0	0.1	0.5	1.1	1.3
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	13.0	11.5	9.6	11.4	9.3	8.6	9.9	10.2	..
Employment rate (15−64 years)	55.0	55.6	57.2	55.4	56.9	58.9	57.4	56.0	..
Key interest rate per annum (%)	4.5	4.5	4.5	4.5	4.5	4.5	4.5	8.9	9.0
HRK per 1 EUR	7.4	7.3	7.3	7.4	7.4	7.3	7.3	7.3	7.3
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	9.5	14.0	17.9	20.0	20.1	17.5	14.6	15.0	12.9
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−5.0	−3.1	9.6	6.2	11.5	10.5	9.9	9.2	7.4
Domestic credit of the banking system	17.3	20.8	17.2	20.6	18.0	16.9	13.9	12.8	11.2
of which: claims on the private sector	13.2	20.2	19.6	22.3	22.2	18.8	15.9	13.8	11.5
claims on households	9.0	11.1	11.0	11.9	11.9	10.5	9.8	9.3	8.3
claims on enterprises	4.1	9.2	8.7	10.5	10.3	8.2	6.1	4.6	3.2
claims on the public sector (net)	4.1	0.6	−2.4	−1.7	−4.2	−1.8	−1.9	−1.0	−0.3
Other domestic assets (net) of the banking system	−2.7	−3.8	−8.9	−6.8	−9.4	−9.8	−9.2	−7.0	−5.7
	% of GDP, ESA 95								
General government revenues	..	37.8	36.4	..	..	..	..	..	..
General government expenditures	..	40.3	38.0	..	..	..	..	..	..
General government balance	−4.0	−2.5	−1.6	..	..	..	..	..	..
Primary balance	−1.8	−0.3	0.4	..	..	..	..	..	..
Gross public debt	43.7	40.8	37.7	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	9.3	17.2	8.6	1.9	16.8	12.4	4.1	8.8	7.3
Merchandise imports	10.6	14.0	10.8	8.8	12.0	10.2	12.0	13.9	15.5
	% of GDP (based on EUR), period total								
Trade balance	−24.0	−24.4	−25.2	−25.4	−27.1	−22.4	−26.0	−27.0	−29.9
Services balance	17.0	16.7	16.8	1.2	16.4	41.7	3.9	1.0	17.4
Income balance (factor services balance)	−3.1	−3.4	−3.0	−2.4	−6.9	−1.9	−1.0	−2.9	−7.6
Current transfers	3.8	3.2	2.8	2.9	2.9	2.5	2.8	2.3	2.7
Current account balance	−6.3	−7.9	−8.6	−23.8	−14.8	20.1	−20.4	−26.5	−17.4
Capital account balance	0.2	−0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Foreign direct investment (net)	4.1	7.5	9.2	14.9	10.2	5.1	7.5	11.1	7.6
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	82.3	85.6	87.8	86.2	86.8	85.2	87.8	90.7	89.2
Gross official reserves (excluding gold)	23.8	25.5	24.8	27.2	25.6	24.0	24.8	25.6	25.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.1	5.3	5.2	5.7	5.4	5.1	5.2	5.3	5.2
	EUR million, period total								
Gross domestic product in current prices	31,272	34,214	37,494	8,494	9,314	10,330	9,355	9,506	10,378

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

10 Turkey: Economic Momentum Weakening amid Political Uncertainty and Rising External Vulnerabilities

After a surprisingly strong performance in the first quarter of 2008, real GDP growth moderated to less than 2% year on year in the second quarter, its lowest rate in six years. This slowdown was attributable to weak domestic demand, as private consumption and particularly GFCF growth (slowdown in construction activity) decelerated sharply in the second quarter amid political uncertainty caused by the pending Constitutional Court (CC) decision on the status of the ruling AKP party and possibly also by tight monetary conditions as well as fiscal policy. As a result, import growth slowed markedly, thus leading again to a positive contribution of net exports to growth. Even though tensions between the CC and the military persist, the verdict announced on July 30 not to ban the AKP helped regain investor confidence. However, output performance continued to be subdued during the summer (industrial production remained weak, while capacity utilization in the manufacturing sector decreased), which pointed to an extended period of economic slowdown even before global financial market turbulence intensified in September. Declining demand from major European export markets implied a further reduction in real export growth. This weakening coupled with already low domestic demand increases the downside risks to growth expectations.

Financing of widening external deficit remains a source of concern

The large combined current and capital account deficit widened in the first half of 2008, while the coverage by FDI inflows declined to one-fifth (compared with almost three-fifth in the same period of 2007) mainly as a result of political uncertainty. Corporate borrowing accounted for the lion's share of external deficit financing. The share of short-term external debt in total gross external debt increased between end-March 2008 and June (driven by the private sector), which added further to concerns about the financing of the external deficit. Additionally, the financing conditions worsened given the global financial turmoil.

Inflation starting to respond to weaker economic environment

After peaking at 12.2% in July, monthly inflation rates started to fall, reaching 11.1% by September. Soaring oil and food prices as well as domestic factors that contributed with some lag to high inflation in the first half of 2008 have diminished recently. Single-digit inflation rates seem possible for the year as a whole, but the inflation target of 4% ±2 percentage points for December 2008 is out of reach. In an effort to anchor inflation expectations, Türkiye Cumhuriyet Merkez Bankası at the end of July raised its 2009 inflation target to 7.5% (±2 percentage points) with a targeted decline by 1 percentage point in each of the two consecutive years. Furthermore, the central bank reversed its monetary stance and raised its main policy rate from 15.25% in May to 16.75% in July 2008. As regards upside inflation risks, the depreciation of the Turkish lira since September may – if it prevails – pass through more noticeably to inflation.

Increasing vulnerability to external shocks

The current global financial crisis and the political uncertainty starting in March 2008 have increased the country's vulnerability to external shocks. Euro-denominated eurobond yield spreads and credit default swap premia have widened since August 2007, by somewhat larger amounts than in other, comparable emerging market economies, given Turkey's high external borrowing requirement. In the second quarter of 2008, the exposure was driven by a substantial increase in short-term foreign loans to the private sector. In addition, the real economy will be influenced by the global slowdown (also from tightening global liquidity), on top of already subdued domestic dynamics.

Table 13

Main Economic Indicators: Turkey

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	8.4	6.9	4.6	8.1	4.1	3.3	3.6	6.7	1.9
Private consumption	7.9	4.6	4.1	3.4	1.8	6.5	4.6	7.6	2.8
Public consumption	2.5	8.4	6.5	7.0	13.5	4.2	2.7	5.6	−3.7
Gross fixed capital formation	17.4	13.3	5.5	4.5	3.9	4.7	8.7	11.9	−1.5
Exports of goods and services	7.9	6.6	7.3	13.3	9.8	4.6	3.3	12.2	2.3
Imports of goods and services	12.2	6.9	10.7	8.2	5.1	14.0	15.5	12.8	0.7
	Contribution to GDP growth in percentage points								
Domestic demand	9.9	7.3	5.9	7.5	3.4	5.8	7.2	7.6	1.6
Net exports of goods and services	−1.5	−0.4	−1.4	0.5	0.7	−2.5	−3.6	−1.0	0.3
Exports of goods and services	1.8	1.5	1.7	2.9	2.2	1.1	0.8	2.8	0.5
Imports of goods and services	3.3	1.9	3.0	2.4	1.5	3.6	4.4	3.8	0.2
	Year-on-year change of the period average in %								
Labor productivity in manufacturing (real)	6.0	6.7	2.6	5.1	0.5	1.1	4.0	3.7	2.4
Gross average wage in manufacturing (nominal)	12.2	11.5	9.4	8.0	8.9	10.9	9.9	8.9	10.3
Unit labor cost in manufacturing (nominal)	5.9	4.5	6.6	2.8	8.4	9.8	5.7	5.0	7.7
Producer price index (PPI) of industry	6.0	9.3	6.4	10.1	6.6	3.6	5.3	8.4	16.0
Consumer price index (here: HICP)	8.1	9.3	8.8	10.3	9.5	7.1	8.2	8.8	10.3
EUR per 1 TRY, + = TRY appreciation	5.9	−7.3	1.3	−13.3	2.5	8.1	8.8	2.5	−8.6
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	..	8.6	8.7	9.8	7.8	8.1	9.0	10.5	8.0
Employment rate (15−64 years)	..	45.9	45.8	43.6	47.2	47.6	44.9	43.3	47.4
Key interest rate per annum (%)	14.8	15.6	17.2	17.5	17.5	17.5	16.5	15.4	15.6
TRY per 1 EUR	1.7	1.8	1.8	1.8	1.8	1.8	1.7	1.8	2.0
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	21.1	41.3	18.7	23.3	17.0	18.3	16.7	17.8	19.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	6.1	10.0	9.1	10.7	11.6	9.8	4.5	1.4	−0.6
Domestic credit of the banking system	21.6	39.3	15.5	17.3	11.0	15.2	18.7	20.3	23.3
of which: claims on the private sector	19.3	31.7	16.7	19.8	15.2	15.2	16.7	18.4	21.2
claims on households	8.7	11.0	6.4	7.5	5.6	5.8	7.0	8.1	8.5
claims on enterprises	10.6	20.7	10.2	12.3	9.6	9.4	9.7	10.3	12.7
claims on the public sector (net)	2.2	7.6	−1.1	−2.5	−4.2	−0.1	1.9	1.9	2.1
Other domestic assets (net) of the banking system	−6.7	−8.0	−5.9	−4.7	−5.6	−6.7	−6.5	−3.9	−2.9
	% of GDP, ESA 95								
General government revenues	..	13.6	19.6	..	..	..	..	..	..
General government expenditures	..	13.7	20.9	..	..	..	..	..	..
General government balance	−0.6	−0.1	−1.2	..	..	..	..	..	..
Primary balance	6.0	5.5	4.0	..	..	..	..	..	..
Gross public debt	52.3	46.1	38.8	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	14.6	17.8	12.9	14.5	15.7	10.7	11.0	23.5	13.4
Merchandise imports	22.4	19.1	10.2	8.6	5.3	11.3	15.7	22.2	17.0
	% of GDP (based on EUR), period total								
Trade balance	−6.9	−7.8	−7.1	−6.7	−7.3	−7.3	−6.9	−6.5	−8.8
Services balance	3.2	2.6	2.1	0.9	1.7	4.2	1.2	0.8	1.8
Income balance (factor services balance)	−1.2	−1.3	−1.1	−1.5	−1.1	−1.0	−0.9	−1.0	−1.3
Current transfers	0.3	0.4	0.3	0.3	0.3	0.4	0.3	0.3	0.2
Current account balance	−4.6	−6.1	−5.7	−6.9	−6.4	−3.7	−6.3	−6.5	−8.0
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	1.9	3.6	3.1	6.2	1.7	2.4	2.6	1.9	1.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	36.8	37.3	34.9	38.0	37.8	36.0	34.9	33.2	35.6
Gross official reserves (excluding gold)	11.0	11.1	10.4	12.1	11.5	11.0	10.4	9.6	9.5
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.2	4.8	4.6	5.1	5.0	4.9	4.6	4.3	4.1
	EUR million, period total								
Gross domestic product in current prices	388,302	418,088	480,391	102,034	116,743	133,446	128,168	123,500	122,162

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

11 Russia: Financial Turmoil Trumps Macroeconomic Fundamentals

Buoyant economic growth coupled with severe liquidity and stock market crisis

A recent sharp oil price decline, the aggravation of the U.S. and global financial crisis, and the flare-up of political risk in connection with the conflict in Georgia led to accelerated capital outflows from Russia, a deep plunge of the Moscow stock exchange,[13] and a severe liquidity crisis in the banking sector in September and October 2008. The vulnerability of the Russian financial system was heightened by its dependence on debt-creating capital inflows, by the widespread, but risky practice of pledging corporate shares to raise credit, and by sharply rising corporate debt levels.[14] Notwithstanding the financial turmoil, Russian economic growth has – so far – remained buoyant. Given strongly rising oil prices in early 2008, real GDP expansion continued at 8.0% year on year in the first half of 2008, but eased in the second quarter and in the summer, largely because of mounting capacity constraints in an economy that already shows signs of overheating.

Growth again driven by internal demand and still unbalanced

Growth remained unbalanced, with domestic demand contributing almost 12 percentage points, and net exports removing 6 percentage points in the first half of 2008. Strong domestic demand and real effective exchange rate developments kept real imports growing much faster than real exports. The latter continue to suffer from bottlenecks in oil extraction and transportation and from very high taxation of oil firms. Despite expanding imports, Russia's combined current and capital account surplus reached 8% of GDP in the first nine months of the year. Competitiveness continues on a downward trend: While labor productivity grew by above 5% in the second quarter of 2008 (in real terms, year on year), industrial ULC rose by over one-fifth in the same period (in nominal terms).

Budget remains in surplus and inflation high

The high oil price in the first half of the year and higher-than-expected economic growth boosted fiscal performance. The federal budget surplus attained 8.7% of GDP in the period from January to August 2008. Fueled by rising prices of food, energy and housing, administered price adjustments as well as rising wages, CPI inflation remained relatively high (September: 15% year on year) despite repeated monetary tightening measures by the Central Bank of the Russian Federation (CBR), e.g. increases of reserve requirements and of key reference rates. The informal end-2008 inflation target was raised to 11.8% in July.

Russian authorities put together major financial package to shore up markets

Lavish export proceeds briefly pushed Russian foreign currency reserves (including gold) above the record EUR 400 billion mark at the beginning of September 2008. Foreign exchange reserves (including gold) declined to EUR 385 billion in mid-October as a result of substantial CBR interventions to prop up the Russian ruble, following accelerating capital outflows brought about by higher political risk as well as the financial meltdown. In the two months until October 5, 2008, the nominal exchange rate declined by 11% against the U.S. dollar, while rising slightly (by 2%) against the euro. The real effective exchange rate continued to rise steadily, coming to 4.6% at end-September 2008 (year on year). With some hesitation, the authorities in late September and early October put together a strong package (estimated at a total of about EUR 150 billion) to inject liquidity and shore up markets. But a number of banks, particularly small and medium-sized institutions, have witnessed stepped-up deposit withdrawals lately. So far, the authorities bailed out three medium-sized banks.

[13] *Trading was suspended on several occasions.*

[14] *Small and medium-sized domestically-owned private banks seemed to be exposed the most to potential financial problems; state-owned and foreign-owned banks are likely to have potent financial backers.*

Table 14

Main Economic Indicators: Russia

	2005	2006	2007	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
	Year-on-year change of the period total in %								
GDP in constant prices	6.4	7.3	8.1	7.4	8.0	7.3	9.5	8.5	7.5
Private consumption	11.2	11.0	12.6	12.2	12.6	12.7	13.0	13.9	12.0
Public consumption	1.3	2.5	5.0	5.7	5.4	4.0	5.0	2.3	2.3
Gross fixed capital formation	10.6	17.7	20.8	22.0	23.6	17.9	20.6	19.4	12.9
Exports of goods and services	6.5	7.3	6.4	3.7	5.3	4.3	11.3	14.4	5.4
Imports of goods and services	16.6	21.9	27.3	28.4	28.9	26.4	26.1	27.3	22.6
	Contribution to GDP growth in percentage points								
Domestic demand	8.2	10.6	13.6	12.4	13.9	13.0	14.7	11.0	12.2
Net exports of goods and services	−2.2	−3.9	−7.0	−7.5	−7.5	−7.2	−5.8	−4.9	−6.9
Exports of goods and services	2.4	2.7	2.4	1.4	2.0	1.4	4.4	5.4	1.9
Imports of goods and services	4.5	6.6	9.3	9.0	9.5	8.6	10.2	10.3	8.9
	Year-on-year change of the period average in %								
Labor productivity of industry (real)[1]	8.6	10.1	4.7	5.8	5.6	3.6	3.7	5.9	5.6
Gross average wage of industry (nominal)[1]	21.1	21.4	26.0	25.8	24.5	24.8	28.5	27.6	28.1
Unit labor cost of industry (nominal)[1]	11.5	10.3	20.4	18.9	17.9	20.5	23.9	20.5	21.3
Producer price index (PPI) of industry	20.6	12.5	14.3	8.9	13.3	13.7	20.7	25.7	26.4
Consumer price index (here: CPI)	12.6	9.7	9.0	7.8	7.9	8.9	11.5	12.9	14.9
EUR per 1 RUB, + = RUB appreciation	1.7	3.2	−2.6	−1.8	−2.0	−2.4	−4.0	−5.1	−5.6
	Period average levels								
Unemployment rate (ILO definition)	7.6	7.2	6.1	7.0	6.0	5.6	5.8	6.7	5.6
Employment rate	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	13.0	11.6	10.3	10.6	10.4	10.0	10.0	10.2	10.5
RUB per 1 EUR	35.2	34.1	35.0	34.5	34.9	35.0	35.7	36.3	36.9
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	33.9	37.0	44.7	42.4	48.6	43.9	43.8	43.1	32.2
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	34.0	30.8	31.3	29.3	33.6	30.6	31.7	29.8	21.1
Domestic credit of the banking system	0.4	11.8	22.8	20.5	24.5	22.5	23.4	25.9	20.6
of which: claims on the private sector	*30.0*	*36.4*	*45.6*	*42.5*	*45.4*	*46.2*	*47.6*	*45.3*	*42.3*
claims on households	*8.8*	*12.0*	*12.7*	*12.8*	*12.8*	*12.7*	*12.5*	*11.9*	*11.4*
claims on enterprises	*21.2*	*24.4*	*32.9*	*29.8*	*32.6*	*33.5*	*35.1*	*33.4*	*30.9*
claims on the public sector (net)	*−29.6*	*−24.6*	*−22.8*	*−22.1*	*−20.9*	*−23.7*	*−24.2*	*−19.3*	*−21.7*
Other domestic assets (net) of the banking system	−0.2	−5.9	−9.4	−7.4	−9.5	−9.2	−11.2	−12.7	−9.6
	% of GDP								
General government revenues	39.7	39.7	40.2	..	..	..	..	..	..
General government expenditures	31.6	31.3	34.1	..	..	..	..	..	..
General government balance	8.2	8.4	6.1	..	..	..	..	..	..
Primary balance	9.1	9.2	..	..	..	..	..	..	..
Gross public debt, general government	14.9	9.0	..	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	33.8	22.6	6.7	−2.3	2.1	4.0	22.0	34.5	31.0
Merchandise imports	29.7	28.5	24.6	27.1	26.9	27.0	19.2	23.1	23.0
	% of GDP (based on EUR), period total								
Trade balance	15.5	14.1	10.1	11.3	10.3	9.0	10.2	13.7	11.9
Services balance	−1.8	−1.4	−1.5	−1.3	−1.5	−1.8	−1.4	−1.3	−1.5
Income balance (factor services balance)	−2.5	−3.0	−2.4	−1.2	−4.0	−2.4	−2.1	−2.0	−4.4
Current transfers	−0.1	−0.2	−0.3	−0.2	−0.1	−0.3	−0.4	−0.2	−0.0
Current account balance	11.0	9.6	5.9	8.7	4.8	4.4	6.2	10.3	6.0
Capital account balance	−1.7	0.0	−0.8	−0.3	0.1	0.0	−2.4	−0.0	0.1
Foreign direct investment (net)	−0.0	0.7	0.7	4.8	−3.6	0.1	1.7	1.1	1.7
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	36.0	30.4	33.8	32.2	34.3	34.3	33.8	30.5	32.0
Gross official reserves (excluding gold)	24.0	28.5	33.8	30.6	34.9	33.1	33.8	32.0	33.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)	13.4	16.2	18.6	17.1	19.2	18.0	18.6	17.7	18.7
	EUR million, period total								
Gross domestic product in current prices	616,304	787,591	940,840	195,837	222,298	251,980	270,725	243,429	278,246

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

[1] *Due to breaks in the time series data are only indicative.*

Box 2

CESEE not Spared from Global Downturn

Momentum Moderating, but Growth Differential to the Euro Area Remains Considerable; Risks Tilted to the Downside

Following a prolonged period of economic expansion which lasted well into the first half of 2008, clear signs of economic moderation became visible in CESEE countries in the third quarter. In line with a weakening of external demand, especially owing to the slowdown of economic activity in the euro area, and tighter external financing conditions, important leading indicators have deteriorated sharply since the end of the second quarter, pointing to a pronounced deceleration of growth in the second half of 2008 and in 2009. This is very much in line with the forecasts for Western industrialized countries, albeit still on a much higher level reflecting the ongoing catching-up process in the region.

Industrial output growth was still robust in the first half of 2008 (+5.5% year on year on average for the region), but turned negative in August (−0.7% year on year on average for the region). Such a steep decline was already indicated in May, when industrial confidence measured by the European Commission's Business and Consumer Survey decreased noticeably in a number of CESEE countries. By October, industrial confidence reached especially low levels in the CEE-5. Besides industrial output and industrial confidence, also recent changes in the growth of credit to nonfinancial corporations and changes in capacity utilization point to weakening industrial dynamics. The level of capacity utilization, however, remains comparatively high by historical standards.

Export orders recently fell below long-term average levels, which clearly documents a worsening of external demand conditions. According to data collected by the European Commission's Business and Consumer Survey, export expectations for the fourth quarter of 2008 declined as well, and in the Czech Republic, Hungary and a number of other CESEE countries, a majority of exporters already expects export orders to decline over the coming months. A quick recovery of external demand therefore seems highly improbable.

When compared with the first half of 2008, also growth rates of retail sales declined somewhat. This drop, however, was far less pronounced than the decrease in industrial output; in August, retail sales still grew at a robust rate (5.2% year on year on average) in the CESEE countries. However, consumer sentiment deteriorated substantially over the past months and stood at especially low levels in Hungary and some other CESEE countries. This should be seen against the backdrop of a slower expansion of consumer credit and less favorable labor market prospects than in the past. All these factors are expected to weigh on consumer spending in the near future.

Recent projections of economic growth for important CESEE countries clearly reflect the worsening sentiment and leading indicators. In 2008, the Czech Republic, Poland, and Russia are expected to grow at a substantially slower pace than in 2007. The moderation is anticipated to extend well into 2009, with some recovery by year-end. Forecasts are somewhat different for Hungary: Growth is seen to accelerate slightly in 2008, albeit from a very low level. According to the most recent forecasts by the European Commission and the wiiw, however, growth will weaken in 2009. Generally, the deterioration of economic conditions in these countries is reflected more clearly now than in previous forecasts, as projections were revised mostly (and in some cases considerably) downward. However, it has to be kept in mind that compiling forecasts takes several weeks, and therefore the most recent (mainly negative) global developments are not considered.

Weaker growth forecasts reflect lower expected demand from Western Europe, which in turn is seen to dampen exports and investment, diminishing capital inflows as well as eroding real disposable incomes in the CESEE countries owing to still high inflation and debt servicing cutting into consumption. This applies in particular to those countries with a high share of foreign currency lending that recently experienced a sizeable appreciation of the nominal exchange rate.

Risks to the growth outlook are significant and tilted to the downside. The main risks include a deterioration of external financing conditions in the wake of the international financial turmoil, a stronger-than-expected weakening of external demand and the possibility of disruptive exchange rate developments.

Table 1

Real GDP Growth in 3 CEE EU Member States and Russia

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

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