Developments in Selected Countries[1]

1 Introduction

In the first half of 2006, economic growth accelerated or remained stable at relatively high levels in the countries of Central and Eastern Europe (CEE) and Southeastern Europe (SEE) (CEE encompasses the ten countries Czech Republic, Hungary, Poland, Slovakia, Slovenia, Bulgaria, Romania, Croatia, Turkey and Russia; SEE encompasses Bulgaria, Croatia, Romania and Turkey).[2] GDP growth rates ranged between 4.2% (Hungary) and 7.4% (Romania), thus significantly above the rate of expansion in the euro area (2.4%). In general, output growth was more dynamic in the acceding and candidate countries and in Russia than in the five Central European new EU Member States (NMS-5; the Czech Republic, Hungary, Poland, Slovakia and Slovenia), though GDP growth reached outstanding levels also in the Czech Republic and Slovakia.

Growth in the region determined more and more by domestic demand

With the exception of Hungary, where domestic demand contracted during the first half of 2006, GDP growth was increasingly driven by domestic demand across the region. Among the components of GDP growth, gross fixed capital formation grew significantly more strongly than consumption in most countries, supported by FDI inflows, favorable domestic credit conditions and – in some countries – the increased inflow of EU funds. Hungary, where investment growth slumped on account of weaker highway and residential investments, and Romania and Russia, where both consumption and capital formation registered impressive growth rates of around 10% year on year, represented exceptions. The dynamics of consumption remained below the overall GDP growth rate in the NMS-5 as well as in Bulgaria and Croatia. Notwithstanding the shift to domestic demand, the contribution of net exports to GDP growth was positive in the NMS-5, although in some countries, such as the Czech Republic or Slovakia, only marginally so. Export growth was underpinned by the economic recovery in major trading partners and by sustained competitiveness, which is suggested by roughly stable or even rising market shares in world imports despite adverse terms-of-trade effects. In Hungary, Poland and Slovakia, the export expansion was also underpinned by a deceleration of unit labor cost growth in manufacturing in euro terms compared to the euro area during the first half of 2006. Although the recovery of domestic demand fueled imports, the growth rate of imports lagged behind export growth in the NMS-5. By contrast, the contribution of net exports was deeply negative in Southeastern European countries, in particular in Bulgaria, and in Russia. The export growth rate halved in Turkey and remained stable at a relatively low level in Russia. This development was accompanied by a decline in Turkey's share in world imports, while Russia's share benefited from the increase in the prices of its major export commodities (particularly oil). In the five non-EU countries covered in this report, import growth, powered by vigorous domestic demand, outpaced the growth rate of exports.

[1] *Compiled by Tomáš Slačík and Zoltan Walko with input from Stephan Barisitz, Balázs Égert, Johann Elsinger, Ingrid Haar-Stöhr, Silvia Kirova, Thomas Reininger, Josef Schreiner, Tomáš Slačík and Zoltan Walko. Draft version reviewed by Peter Backé and Stephan Barisitz. Final version approved by Doris Ritzberger-Grünwald. The analysis is based on information and data from various sources.*

[2] *A more detailed breakdown is: Central Europe – the Czech Republic, Hungary, Poland, Slovakia, Slovenia; Southeastern European acceding countries – Bulgaria, Romania; Southeastern European candidate countries – Croatia, Turkey; and the Eastern European country Russia.*

Table 1

Gross Domestic Product (Real)

Annual change in %

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
Czech Republic	1.9	3.6	4.2	6.1	5.9	6.9	7.1	6.2
Hungary	3.8	3.4	5.2	4.1	4.5	4.3	4.6	3.8
Poland	1.4	3.9	5.3	3.4	3.9	4.3	5.2	5.5
Slovakia	4.1	4.2	5.4	6.1	6.3	7.4	6.3	6.7
Slovenia	3.5	2.7	4.2	3.9	3.6	3.7	5.1	4.9
Bulgaria	4.9	4.5	5.7	5.5	4.6	5.5	5.6	6.6
Romania	5.2	5.2	8.4	4.1	2.4	4.3	6.9	7.8
Croatia	5.6	5.3	3.8	4.3	5.2	4.8	6.0	3.6
Turkey	7.9	5.8	8.9	7.4	7.7	9.5	6.5	7.5
Russia	4.8	7.4	7.2	6.4	6.6	7.9	5.4	7.5

Source: Eurostat, national statistical offices, wiiw.

The labor market remains a challenge despite some encouraging signs…

Strong economic activity went hand in hand with a tightening of labor market conditions in several but not in all reviewed countries. In particular, double-digit unemployment rates in Poland and Slovakia have declined substantially, but the unemployment rate diminished from already lower levels also in other countries. Bulgaria's joblessness dropped to single-digit values. The only exceptions were the Czech Republic, Hungary, Turkey and Russia, where the unemployment rate stood at around 7% to 9% in mid-2006, unchanged from a year earlier. Although the improvement in the unemployment rate is partially cyclical, there is also evidence of structural improvements. For example, lower unemployment rates were accompanied by an increase in employment and activity rates in the majority of countries, and the share of long-term unemployment in total unemployment decreased in some CEE/SEE countries. However, employment and participation rates in most countries remain below the level of the euro area, calling for further policy action to better exploit existing labor reserves and lift output.

… and rather modest real wage growth in most countries

Regardless of improving labor market conditions in a number of countries, real wage growth stayed rather modest during the first half of 2006 in most analyzed countries. Real wages advanced strongly only in Russia (+15%) and somewhat less in Romania, the Czech Republic and Hungary. However, anecdotal evidence suggests the development of bottlenecks in certain areas of the labor market in some of the NMS-5, which may become the source of stronger wage pressure in the future. According to a recent World Bank report, such bottlenecks have emerged primarily in high-skill segments in sectors like construction, medical care, transport services and information technology. Moreover, it may well be that nominal wages are adapting to increased inflation with a time lag, as suggested by the acceleration of nominal wage growth during the second quarter of 2006 in several countries.

Food and energy prices dominate price developments in the region

Inflation quickened across most of the region during the first nine months of 2006, with price pressures rising most in Turkey and Hungary. Bulgaria, Romania, Russia and Croatia were exceptions to this general trend. In Croatia, inflation was range-bound between about 3% and 4%, while it gradually eased in Romania and Russia. Inflation levels in September 2006 were generally higher in the acceding and candidate countries and in Russia than in the

NMS-5. In the latter and in Turkey, particularly higher prices for unprocessed food contributed a great deal to the increase in headline inflation during the first nine months of 2006. For more than half the year, rising energy prices pushed up headline inflation but eased somewhat in late summer. In addition, higher prices for these commodities are also likely to have translated into some upward pressure on core inflation (inflation excluding energy and unprocessed food prices). The upward pressure was triggered by higher prices for processed food and by increased transport costs. By contrast, in Romania the energy and unprocessed food component chiefly contributed to disinflation. Adjustments of regulated prices and indirect tax increases added to inflation in Slovakia, Bulgaria, Croatia and, in the wake of fiscal tightening, in Hungary. Inflationary pressure stemming from tax increases on alcohol and tobacco in Romania was offset by falling food prices. It should be noted that energy prices have a considerably bigger weight in the consumer price basket in all analyzed countries than in the euro area (12% to 19% versus 9%). The weight of unprocessed food prices also tends to be slightly higher in the NMS-5 than in the euro area, while it is considerably higher in Bulgaria, Romania, Croatia and Turkey. As a result, above-average price movements in these product groups tend to have a larger impact on overall inflation in CEE and SEE countries. Apart from these factors, a weakening of the Hungarian and, in particular, the Turkish currency during May and June 2006 appears to have contributed to higher price pressures in these two countries. To a smaller extent this may also have played a role in Poland, and possibly Slovakia and Romania.

Table 2

Harmonised Consumer Price Index (HICP)

Annual change in %

	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006
Czech Republic	−0.1	2.6	1.6	1.6	2.2	2.4	2.5	2.4
Hungary	4.7	6.8	3.5	3.5	3.2	2.4	2.7	4.6
Poland	0.7	3.6	2.2	1.8	1.2	0.9	1.4	1.5
Slovakia	8.4	7.5	2.8	2.2	3.7	4.2	4.6	4.8
Slovenia	5.7	3.7	2.5	2.3	2.6	2.3	3.1	2.5
Bulgaria	2.3	6.1	5.0	4.8	6.6	8.0	8.3	6.7
Romania	15.3	11.9	9.1	9.0	8.5	8.7	7.2	5.9
Croatia[1]	1.8	2.1	3.4	3.5	4.0	3.5	3.8	. .
Turkey	25.6	10.1	8.1	7.8	7.3	7.6	9.2	10.6
Russia[1]	13.6	11.0	12.5	12.5	11.2	10.8	9.6	. .

Source: Eurostat, national statistical offices, wiiw.

[1] *CPI.*

Massive credit growth is characteristic of most countries of the region

Strong economic growth was supported by continued favorable domestic financing conditions and robust credit growth in most analyzed countries. The growth rate of domestic credit to households and nonbank corporations (HICP/CPI deflated) accelerated in all CEE and SEE countries during the first half of 2006 except in Bulgaria. Credit growth was particularly marked in Romania, Turkey and Russia (at around 30% to 40% year on year in the second quarter of 2006), but it was considerable also in most of the NMS-5 and

Croatia (18% to 24%). Credit expansion in Poland continued to lag behind that in the other countries, but still accelerated rapidly to reach 11% year on year by the second quarter of 2006. The rate of expansion was lower in Bulgaria (8%), where the central bank's measures over the past three years to slow credit growth showed up in a deceleration of domestic banks' lending activity. Strengthening credit expansion was also evident when measured in terms of annual economic output.[3] Intensive credit activity, which has now lasted for several years in many CEE and SEE countries, has been widely debated among monetary authorities and international financial organizations concerned about implications for macroeconomic and financial stability. Strong credit expansion has been linked to widening current account deficits, rising inflation, an increase in the banking sector's reliance on foreign capital inflows and a potential deterioration of banks' portfolio quality in the future. Over the past few years, monetary authorities in Bulgaria, Romania and Croatia have repeatedly addressed this issue by taking appropriate monetary and prudential measures. However, available data suggest that so far, these measures have brought the desired effect only in Bulgaria while they might still prove successful in Croatia and Romania.[4] Russia has witnessed a continued powerful expansion of nonbanks' and banks' foreign liabilities. Foreign currency lending remains a distinctive feature of credit activity in several analyzed countries and represents an additional credit risk to banks in the form of indirect currency risk. Among the countries covered in this report, the share of foreign currencies in total lending to households and corporations is highest in Croatia, Slovenia, Hungary, Bulgaria and Romania. The increasing role of foreign currencies is less of a concern in Slovenia, where euro adoption at the beginning of 2007 will eliminate most of the currency risk. Similarly, a tight peg (currency board) like in Bulgaria mitigates such risks as long as such a monetary regime remains fully credible. By contrast, their heavy reliance on foreign capital inflows to finance large external deficits makes Hungarian and – to a somewhat lesser extent – Romanian banks vulnerable to a possible deterioration in their clients' debt servicing capability in reaction to a weakening of domestic currencies or a further increase in interest rates in the euro area. The monetary authorities of Hungary, Poland, Croatia and Romania have specifically addressed the issue of foreign currency lending, although also in these cases monetary policy instruments are subject to limitations.[5]

Balance of payments reflects changes in domestic demand and bank lending

Strengthening domestic demand and accelerating bank lending had a visible impact on the external accounts of CEE and SEE countries. During the first half of 2006, the deficit of the goods and services balance increased from already elevated levels in all four SEE countries and in Slovakia, while Poland maintained a negligible deficit and the surplus in the Czech Republic decreased. In Hungary and Slovenia, which posted comparably weaker domestic demand growth, the goods and services balance improved modestly and registered a small surplus. In Russia, favorable terms-of-trade effects outweighed the

3 Expressed as the absolute change in the outstanding value of credit compared to the same period of the previous year in percent of the cumulative value of GDP over the corresponding four quarters.

4 For a more detailed discussion on this issue as well as on the effects of the implemented measures, see Financial Stability Report 12 of the OeNB.

5 For details see Financial Stability Report 12 of the OeNB.

impact of strong domestic demand, leading also to an improvement in the already sizeable goods and services surplus. All ten countries showed a deficit of their combined income, transfer and capital account balances (with the exception of Bulgaria), which was especially large in the Czech Republic and Hungary. As a result, all countries (with the exception of Russia) recorded a deficit on their combined current and capital accounts. Except in Hungary and Turkey, the deterioration in the external balance was accompanied by an increase in the investment rate, but the savings rate deteriorated in all countries but Croatia. On a positive note, however, the expansion of net FDI inflows accelerated in these countries (except in the Czech Republic, which registered exceptionally high FDI in the first half of 2005), and covered a substantial portion of the deficit, except in Croatia and Turkey. The external financing requirement after adjusting for net FDI was substantial in the latter two countries, but it was also relatively large in Bulgaria, Romania and Hungary (at 2% to 4% of GDP).

Risks associated with heavy reliance on non-FDI capital inflows, exacerbated by insufficient economic policy credibility, became evident especially in Hungary and Turkey during the retrenchment of international risk appetite during March and May to June 2006. Heavy capital outflows from the domestic equity and bond markets caused the exchange rate in both countries to depreciate sharply, especially in Turkey. The currencies of Poland and Slovakia, which relied less on non-FDI capital inflows, but which were hit by political uncertainties, experienced comparably smaller losses. Particularly the Hungarian forint and, much more so, the Turkish lira continue to trade at significantly weaker levels than in early March 2006.[6]

The monetary authorities have reacted to developments by tightening policy

In response to robust economic growth, strong credit dynamics, rising inflation, widening external imbalances, and in Hungary, Slovakia and Turkey also to the increase in country risk premia that financial markets required, several central banks in the region lifted policy rates during the first half of 2006. The policy tightening was most substantial in Turkey (+425 basis points since the start of the rate hiking cycle), Hungary (+200 basis points) and Slovakia (+175 basis points), followed by Romania (+125 basis points) and the Czech Republic (+50 basis points). By comparison, the ECB has raised its key interest rate in four steps by 100 basis points since December 2005. The interest rate differential to the euro area is thus highest in Turkey (1,425 basis points) while it remains negative in the Czech Republic (75 basis points below that of the euro area).

Public finances capitalize on favorable cyclical conditions but could reap higher benefits

The conduct of monetary policy is complicated by fiscal policy in most CEE and some SEE countries. All new Central European EU Member States but Slovenia are subject to the EU Excessive Deficit Procedure (EDP). The reported fiscal overperformance in 2005 – the Czech Republic, Poland and Slovakia recorded a deficit below 3% of GDP in their April 2006 fiscal notifications – held out hope of a quicker return to sustainable public finances. However, such hopes were partly dashed when fiscal outcomes in 2005 were revised in Slovakia (–3.1% of GDP) and the Czech Republic (–3.6% of GDP) in their October 2006 fiscal notifications. In the Czech Republic and above all

[6] *See Financial Stability Report 12 of the OeNB.*

in Hungary, the deficit not only exceeded the envisaged Maastricht benchmark but also climbed markedly compared to the deficit in 2004. Based on the European Commission's 2006 autumn forecast, the deficit is expected to improve in 2006 in Poland (2.2% of GDP and 4.2% of GDP, respectively, if pension reform costs are included), remain approximately stable in the Czech Republic and deteriorate slightly in Slovakia (3.4% of GDP) and Slovenia (1.6% of GDP). In Hungary, the budget deficit should peak at –10.1% of GDP this year, since the measures the government has finally taken should start to kick in in 2007.

In Romania the government has had to increase its deficit target for 2006 to –2.5% of GDP mainly due to additional expenditures on infrastructure, whereas Bulgaria seems to be firmly on its way to a 3% surplus in 2006, as agreed with the IMF. Also, Croatia has further consolidated its deficit target for 2006 (3.0%, down by 0.2 percentage points) by cutting investment. Moreover, Turkey has signaled an impressive fiscal consolidation effort by aiming at a 6.5% surplus. In Russia the budget surplus remains high (8.8% of GDP in January to August 2006), although the non-oil deficit has risen since 2004 according to IMF calculations.

In summary, despite some progress it seems that a more proactive policy stance that takes advantage of the current favorable cyclical conditions to reduce budget deficits more ambitiously and to move along with necessary structural adjustments would be appropriate, given that the long-term sustainability of public finances has been deemed to be at risk by the European Commission in several countries covered in this report. In the same vein, according to a recent analysis prepared by the World Bank,[7] privatization and liberalization in strategic sectors saw little progress. Likewise, important public finance and administration reforms have stalled in the NMS-5 over the past two years, except in Hungary, where the administration has recently launched a new consolidation effort. By contrast, reforms have been stepped up over the past year in the two acceding countries Bulgaria and Romania to secure accession to the EU on January 1, 2007, albeit under significant outside pressure. Structural reforms have been further advanced in Croatia and Turkey as well, in tandem with EU membership negotiations.

Croatia's and Turkey's negotiations for EU accession are under way

Negotiations for EU accession with Croatia and Turkey started after the European Council gave its green light in October 2005. Thus far, 13 (Croatia) and 4 (Turkey) of 35 chapters have been screened. However, in both countries only the chapter on science and research has been opened up to this point, and has also been successfully completed in both cases.

Bulgaria and Romania to join the EU in 2007

After the European Commission concluded in the Monitoring Report at end-September that Bulgaria and Romania would be ready to join the EU on January 1, 2007, the decision was approved also by the Council of the European Union on October 17, 2006. The outstanding obstacles are thus on-time ratifications by remaining Member States and the European Parliament's endorsement. While the European authorities commended both countries for reforms undertaken and the progress achieved, the Accession Treaty provides for special safeguard measures. These may be called upon if the remaining

[7] *World Bank EU-8 Quarterly Economic Report, September 2006.*

issues (particularly in the economic realm, internal market issues, the fight against corruption and organized crime) are not adequately tackled.

While Slovenia is preparing for euro adoption, political jitters overshadow reform prospects and the introduction of the single currency in some CEE countries

Whereas Slovenia will adopt the euro as a frontrunner among the new Member States (NMS) on January 1, 2007, the political setting has meanwhile become less conducive to euro adoption, fiscal consolidation and structural reforms in a number of Central European NMS. In the wake of political upheavals, envisaged dates for the introduction of the single currency have been questioned or shifted back in some NMS. Domestic politics has been stalled in the Czech Republic following the continuing deadlock in parliament as a result of elections in June 2006. Four months of political bargaining failed to produce a viable government, and the odds of early elections have risen. While the political stalemate has not yet had an immediate adverse impact on financial markets or economic developments in the Czech Republic, it is not surprising that the previous euro adoption target date of 2010 has been called into question. In Slovakia, the new government of leftist and far-right populist parties has announced modifications of some of the reforms introduced during 2004 to 2005 by its predecessor. At the same time, the government has promised that its measures would not derail the country from the envisaged fiscal consolidation path and has also stuck to the euro adoption target date of 2009. In Hungary, the announced fiscal tightening measures along with upsetting details from an internal party speech by the prime minister have provoked repeated mass demonstrations since mid-September. In the heated political climate and amid waning popular support for the government (manifested also in the poor showing of the coalition parties in local elections early October), it remains to be seen whether the envisaged fiscal consolidation measures and structural reforms will be implemented with the necessary rigor. Against the backdrop of recent fiscal outcomes, the government has dropped its previous euro adoption target date of 2010. The political situation has been unstable in Poland as well, where the ruling three-party coalition broke up during budget talks in late September but was reinstalled in early October. The government has set no official euro adoption target date so far, after the previous target date had been dropped some time ago.

Slovenia has not only consistently received the best rating among the countries covered in this report, but was also upgraded by Moody's as well Standard&Poor's within the review period. Moody's also upgraded Slovakia and Romania, Standard&Poor's upgraded Bulgaria and Russia. The latter rating agency, on the other hand, decided to downgrade Hungary in June (see table 3).

Table 3

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt

Currency	Moody's Current rating[1]	Last change (former rating)	Standard&Poor's Current rating[2]	Last change (former rating)
Czech koruna	A1	Nov. 2002 (Baa1)	A–	Nov. 1998 (A)
Hungarian forint	A1	Nov. 2002 (A3)	BBB+	June 2006 (A–)
Polish zloty	A2	Nov. 2002 (Baa1)	BBB+	May 2000 (BBB)
Slovak koruna	A1	Oct. 2006 (A2)	A	Dec. 2005 (A–)
Slovenian tolar	Aa2	July 2006 (Aa3)	AA	May 2006 (AA–)
Bulgarian lev	Baa3	Mar. 2006 (Ba1)	BBB+	Oct. 2006 (BBB)
Romanian leu	Baa3	Oct. 2006 (Ba1)	BBB–	Sep. 2005 (BB+)
Croatian kuna	Baa3	Jan. 1997	BBB	Dec. 2004 (BBB–)
Turkish lira	Ba3	Dec. 2005 (B1)	BB–	Aug. 2004 (B+)
Russian ruble	Baa2	Oct. 2005 (Baa3)	BBB+	Sep. 2006 (BBB)

Source: Bloomberg.

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

2 Czech Republic: Strong Growth Continues but Political Stalemate Delays Reforms Further

Domestic demand becomes main driver of continuing robust growth

After a strong performance in 2005, the growth pace of the Czech economy accelerated further to 6.6% in the first half of 2006 despite a slight slowdown of the dynamics in the second quarter. Compared to 2005, however, the composition of growth changed: the contribution of net exports weakened substantially and growth predominantly stemmed from domestic demand.

The contribution of domestic demand components was fairly balanced. On the one hand, private consumption picked up and reached the highest rate of growth since end-2003. This was the consequence of moderately rising employment and, more importantly, improving real disposable incomes in the wake of income tax cuts in January 2006, constantly growing real wages, increases of average pensions and minimum wages. Also, households benefited from the continued availability of credit at relatively low interest rates. On the other hand, public consumption contracted because of base effects (purchase of fighter planes in 2005). Investment, particularly swelling inventories, reemerged as a big contributor to economic growth. The bulk of fixed capital formation stemmed from the reviving construction industry and investments flowing into machinery and equipment. By the same token, the substantial increase of stocks reflected the great number of unfinished construction projects as well as the buildup of stocks in retail trade in anticipation of strengthening demand. Powerful domestic demand and high energy prices caused import growth to accelerate, almost entirely eliminating the previously large contribution of net exports to growth in the first half of 2006.

On the supply side, the automobile industry has kept on playing a crucial role whose dominance is likely to deepen further after completion of an investment project being carried out by the Korean car producer Hyundai.

Still no tangible improvement on the labor market

As in the previous two years, labor productivity growth in industry continued to outpace wage increases in this sector (by about 2 percentage points in the first half of 2006). However, despite marginally falling unit labor costs, robust GDP growth failed to appreciably improve the mixed situation on the labor market. The unemployment rate stayed at around 8%. Particularly the percentage of long-term unemployed (more than half) remained persistently high.

Balance of payments deteriorates slightly

The surplus of foreign trade with goods and services recorded in 2005 for the first time in a decade rose further in the first six months of 2006. Trade with vehicles and machines contributed most to this result.[8] On the other hand, sizeable energy and commodity price hikes augmented the import bill. The deficit on the income account, largely determined by repatriated profits of foreign-owned companies, almost returned to the record level of 2004 after it had dropped somewhat in 2005. Thus, this deficit was the major driving factor behind the 1 percentage point deterioration of the current account deficit to 3.1% of GDP after an extensive recovery in 2005. Approximately the same amount flowed out of the economy in the form of portfolio investments. The capital account balance remained only faintly positive, and the foreign reserves of Česká národní banka (ČNB) did not record any perceivable change. Therefore, the Czech Republic's external financing requirement in the first half of 2006 was almost fully covered by net FDI inflows,[9] other investments as well as by net errors and omissions. Total gross foreign debt dropped slightly to 37% of GDP in the first half of 2006 compared to end 2005 (almost 39%). By contrast, the net external position worsened over the same period, as net foreign assets shrank from over 15% of GDP by more than 2 percentage points.

Inflation well under control supported also by appreciating koruna

Whereas in 2005 the Czech economy did not show any signs of extensive inflationary pressure, the inflation rate did pick up in the first three quarters of 2006, particularly due to high and rising energy prices and corresponding administered price adjustments. HICP inflation thus crept up from 1.9% year on year in December 2005 to 2.4% in January 2006 and has hovered around that level ever since (2.4% in September 2006). CPI inflation has been a bit higher, but still remains below the middle of the ČNB's target range of 3% ±1 percentage point, which took effect in January 2006.[10] Above all, decreasing prices of clothing, footwear and food along with a nominal-effective appreciation of the koruna helped curb inflation. Even though the nominal appreciation trend of the Czech currency has almost come to a halt due to the political stalemate since the parliamentary elections at the beginning of June, the koruna has still gained about 3% against the euro since January and is currently trading at around 28.3 CZK/EUR. Nevertheless, to counteract potential inflationary pressure stemming from the booming economy and the second-round effects of high energy prices, the ČNB raised its key interest rate in two steps by 50 basis points from 2.0% in October. Thus, the negative spread to the ECB's key interest rate has in the meantime increased to 75 basis points, which might be another reason for the slowdown of the koruna

[8] *Chiefly due to production increases of Škoda Auto and full capacity use of the joint car production plant TPCA in Kolín.*

[9] *FDI inflows were almost completely made up of reinvested earnings and equity whereas intercompany lending played only a minor role.*

[10] *The ČNB uses the CPI rather than the HICP as a basis for its inflation target.*

Table 4

Main Economic Indicators: Czech Republic

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	1.9	3.6	4.2	6.1	5.9	6.9	7.1	6.2
Private consumption	2.2	6.0	2.6	2.3	2.6	2.4	3.7	3.8
Public consumption	6.7	7.1	−3.2	0.7	4.5	−1.0	0.8	−3.4
Gross fixed capital formation	5.1	0.4	4.7	3.6	3.8	4.4	6.8	5.3
Exports of goods and services	2.1	7.2	21.1	10.6	10.9	10.1	17.6	10.2
Imports of goods and services	5.0	8.0	18.2	4.9	6.3	4.8	15.5	10.2
	Contribution to GDP growth in percentage points							
Domestic demand	4.2	4.8	3.6	1.8	2.6	2.7	5.6	6.5
Net exports	−2.8	−1.6	−0.1	4.7	3.5	4.5	1.1	−0.8
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	3.9	7.7	9.4	6.8	7.8	8.2	12.4	7.0
Gross average wage of industry (nominal)	6.7	5.9	7.1	4.6	5.0	4.3	6.2	8.4
Unit labor cost of industry (nominal)	2.7	−1.7	−2.1	−2.1	−2.6	−3.6	−5.5	1.2
Producer price index (PPI) of industry	−0.5	−0.4	5.7	3.0	1.4	0.0	0.3	1.3
Consumer price index (here: HICP)	1.4	−0.1	2.6	1.6	1.6	2.2	2.4	2.5
EUR per 1 CZK, + = CZK appreciation	10.6	−3.2	−0.2	7.1	6.4	6.2	4.9	6.2
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	7.4	7.9	8.4	8.0	7.8	7.8	8.0	7.1
Employment rate (15−64 years)	65.4	64.7	64.1	64.8	65.2	65.2	64.8	65.3
Key interest rate per annum (%)	3.6	2.3	2.2	2.0	1.8	2.0	2.0	2.0
CZK per 1 EUR	30.8	31.8	31.9	29.8	29.7	29.3	28.6	28.4
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	−7.6	5.2	10.3	6.4	6.2	8.1	12.5	12.2
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	8.5	1.2	2.9	5.2	7.9	9.5	11.4	3.1
Domestic credit of the banking system	−1.1	7.7	7.1	0.7	−1.0	0.9	3.0	6.5
of which:								
claims on the private sector	*−9.6*	*0.9*	*6.0*	*8.6*	*9.3*	*10.0*	*11.5*	*11.8*
claims on households	*1.9*	*3.3*	*4.4*	*5.4*	*5.6*	*6.0*	*6.5*	*6.5*
claims on enterprises	*−11.4*	*−2.5*	*1.5*	*3.2*	*3.8*	*4.1*	*5.0*	*5.3*
claims on the public sector (net)	*8.4*	*6.8*	*1.2*	*−7.9*	*−10.4*	*−9.1*	*−8.5*	*−5.3*
Other domestic assets (net) of the banking system	−15.0	−3.7	0.3	0.5	−0.6	−2.4	−1.9	2.6
	% of GDP, ESA 95							
General government revenues	39.5	40.7	41.5	40.5				
General government expenditures	46.3	47.3	44.4	44.1				
General government balance	−6.8	−6.6	−2.9	−3.6				
Primary balance	−5.5	−5.5	−1.7	−2.5				
Gross public debt	28.5	30.1	30.7	30.4				
	EUR million, period total							
Merchandise exports	40,713	43,053	54,071	63,003	15,489.8	17,082.4	17,923.5	18,499.2
Merchandise imports	43,034	45,235	54,910	61,662	15,515.8	17,068.8	16,964.0	18,156.0
	% of GDP, period total							
Trade balance	−2.9	−2.7	−1.0	1.3	−0.1	0.1	3.7	1.2
Services balance	0.9	0.5	0.4	0.6	0.9	0.3	0.1	0.4
Income balance (factor services balance)	−4.7	−4.6	−5.7	−4.8	−4.9	−3.7	−3.4	−7.4
Current transfers	1.2	0.6	0.2	0.7	0.1	0.7	0.0	−0.4
Current account balance	−5.5	−6.2	−6.0	−2.1	−4.1	−2.7	0.3	−6.1
Capital account balance	0.0	0.0	−0.5	0.2	0.0	0.3	0.4	−0.2
Foreign direct investment (net)	11.1	2.1	3.6	8.1	5.7	4.3	3.2	2.2
	EUR million, end of period							
Gross external debt	25,738	27,624	33,212	38,818	37,672	38,818	38,092	39,488
Gross official reserves (excluding gold)	22,483	21,189	20,746	24,864	24,664	24,864	24,362	23,721
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.4	4.9	4.0	4.3	4.2	3.9	3.9	3.5
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	80,054	80,936	87,285	100,033	25,335	26,514	26,099	28,743

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

appreciation in recent months. For end-2007 the ČNB expects annual inflation to range between 3.3% and 4.7%.

The highly competitive and robustly growing banking market in the Czech Republic experienced a shift in the property structure, as Raiffeisen International acquired eBanka from the biggest Czech insurance company, Česká pojišťovna, in October. The merger of both banks should be completed by 2008.

Worsening fiscal balance and challenging prospects ahead

After a recent data revision, the general government deficit did not amount to an encouraging 2.6% of GDP in 2005 as originally published. In fact, according to the revised data, the deficit was a whole percentage point higher. Hence, not only did the deficit exceed the Maastricht threshold but, despite the robust growth, it also deteriorated substantially compared to 2.9% in 2004. Despite solid GDP growth and domestic demand, the general government deficit is not expected to improve markedly in 2006. According to the European Commission's autumn forecast, it should amount to about 3.5% of GDP chiefly due to tax cuts and increased social spending.[11] The latter includes additional expenditures on pensions and health care, areas that have still not been sufficiently reformed. In the light of these updated fiscal projections and owing to the untackled overhaul of the pension and health care systems and to additional cofinancing needs of EU-funded projects after EU entry, the Czech budget deficit seems to be rather persistent. Against this backdrop, the country's previously announced euro adoption target year of 2010 has been officially postponed to an unspecified later date. A clearer picture of fiscal consolidation and the timelines of monetary integration will presumably only evolve once the current political impasse has been overcome.

3 Hungary: Finally Facing Reality

Economic growth beginning to slow

GDP growth during the first half of 2006 was at around the same level as in 2005, but the dynamics slowed markedly from the first to the second quarter. During the first half of 2006, economic growth stemmed primarily from net exports. Export growth was supported by improved economic activity in Hungary's major trading partners, while import growth was restrained by the contraction of domestic demand. This was caused by large destocking and a significant deceleration of investment activity, in particular in the areas of housing and highway construction. Although the growth rate of domestic consumption more than doubled during the first half of 2006 compared to full-year 2005, it still remained significantly below overall GDP growth. With real wage dynamics having decelerated and employment remaining stable, this acceleration was primarily driven by the acceleration of real credit growth to households.

Inflation pressures building up

Hungary's inflation performance during the first nine months of 2006 was rather disappointing. The cut in the highest VAT rate, which became effective on January 1, 2006, dampened headline HICP inflation less than the originally expected 1.4 percentage points, as the inflation rate decreased by only 1 percentage point between December 2005 (3.3%) and February 2006

[11] *In early 2006, the last of a scheduled series of corporate income tax-rate cuts reduced the rate from 26% to 24%. (See World Bank EU-8 Quarterly Economic Report, September 2006).*

(2.3%). Since then, inflation has edged up gradually to reach 4.7% by August 2006. This increase stemmed partly from energy and to a lesser extent from unprocessed food prices. However, inflation excluding these two items also accelerated considerably (from 1.0% to 2.4%). Core inflation developments can be attributed primarily to the diminishing role of retail competition, the depreciation of the forint, the increase in processed food prices and the secondary effect of higher energy prices (e.g. in the form of higher transport costs), and the growth of unit labor costs also seems to have picked up in the second quarter. In September 2006, inflation was pushed up further to 5.9% by the hike in the middle VAT rate from 15% to 20% and by an increase in excise taxes. Magyar Nemzeti Bank (MNB) expects inflation to ease to around 5% by the end of 2007 (after peaking at around 8% in the first half of 2007) and to fall slightly below 4% by end-2008.

Frontloaded fiscal adjustment: government embarks on significant budget deficit reduction

In response to the deterioration in the twin deficit situation since 2002 and to repeated calls from the EU Council, the Hungarian government has embarked on a significant reduction of the general government budget deficit over the next three years. According to the updated convergence program of September 2006, the 2006 budget deficit will reach 10.1% of GDP,[12] following a modest upward revision of the 2005 deficit to 7.8%. The deficit is expected to be cut to 6.8% in 2007, to 4.3% in 2008 and to 3.2% of GDP in 2009 by reducing the expenditure ratio by 5.6 percentage points of GDP and increasing the revenue ratio by 1.3 percentage points. However, compared to the previous convergence program update released in December 2005,[13] the government is now planning a less ambitious reduction in the expenditure ratio. Among the revenue-increasing measures, the increase in the middle VAT rate, an increase in social security contributions and a rise in the corporate and personal income tax burden stand out. Among the expenditure-reducing measures, employment cuts and a wage freeze in the public sector as well as a freeze of the nominal level of expenditures in all but a few areas in 2007 and 2008 (combined with the freeze of unspent funds and reserves) are most notable. To make the fiscal correction a lasting one, the government has also put forward a timetable for urgent structural reforms in the areas of public administration, health care, pension and education systems and price subsidy schemes. While welcoming the new program, the European Commission highlighted substantial risks to implementation. Therefore, it called on the authorities to rigorously execute the envisaged structural reforms, strictly enforce expenditure controls and strengthen the institutional framework of the budgetary process. Rigorous implementation is likely to be a challenge in view of widespread social resistance against tightening measures, as highlighted by the political unrest since mid-September 2006. So far the government has stuck with its reform plans despite the political developments, and the turmoil has not had a lasting negative impact on the forint and the local-currency bond spreads, either. However, it remains to be seen whether this resistance of the economy will continue,

[12] *Including the costs of the pension reform and of investment expenditure, which had previously been booked outside the budget.*

[13] *The convergence program update of December 2005 included a planning horizon until 2008 only. Therefore, this comparison takes into account only target values until 2008.*

Table 5

Main Economic Indicators: Hungary

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	3.8	3.4	5.2	4.1	4.5	4.3	4.6	3.8
Private consumption	10.8	8.3	3.8	1.5	2.0	1.7	2.7	2.5
Public consumption	5.8	6.2	1.6	−0.2	−0.6	−0.5	2.2	1.9
Gross fixed capital formation	10.2	2.9	8.0	6.6	8.7	3.1	9.7	−3.6
Exports of goods and services	3.9	6.1	15.8	10.8	11.2	12.6	18.2	15.1
Imports of goods and services	6.6	9.3	13.5	6.5	8.9	8.2	14.2	8.4
	Contribution to GDP growth in percentage points							
Domestic demand	6.0	6.2	4.3	0.8	2.9	0.9	1.4	−2.1
Net exports	−2.3	−2.9	1.3	3.7	1.9	3.9	3.8	6.7
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	4.9	8.4	9.7	10.1	12.3	10.7	16.3	9.0
Gross average wage of industry (nominal)	12.6	9.3	10.0	7.2	6.7	7.0	8.3	7.7
Unit labor cost of industry (nominal)	7.3	0.8	0.3	−2.6	−5.0	−3.3	−6.9	−1.2
Producer price index (PPI) of industry	−1.1	2.5	3.6	2.9	2.6	4.0	4.9	6.5
Consumer price index (here: HICP)	5.2	4.7	6.8	3.5	3.5	3.2	2.4	2.7
EUR per 1 HUF, + = HUF appreciation	5.6	−4.2	0.7	1.5	1.3	−2.3	−3.8	−6.4
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	5.9	5.9	6.1	7.2	7.3	7.3	7.7	7.2
Employment rate (15−64 years)	56.2	57.0	56.8	56.9	57.3	57.1	56.7	57.3
Key interest rate per annum (%)	9.1	8.6	11.4	7.1	6.5	6.0	6.0	6.0
HUF per 1 EUR	242.9	253.5	251.7	248.0	245.6	251.8	254.6	266.8
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	10.1	14.2	11.7	13.7	13.9	14.3	16.6	16.5
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	2.2	−1.1	−1.9	0.6	3.1	−0.7	−0.0	−1.5
Domestic credit of the banking system	12.3	22.4	17.9	15.2	12.3	17.3	19.1	22.2
of which:								
claims on the private sector	*15.4*	*18.7*	*21.7*	*16.6*	*14.8*	*17.7*	*19.1*	*21.3*
claims on households	*6.3*	*10.6*	*9.8*	*7.3*	*7.3*	*8.1*	*8.5*	*9.4*
claims on enterprises	*9.1*	*8.1*	*11.9*	*9.2*	*7.6*	*9.6*	*10.6*	*11.9*
claims on the public sector (net)	*−3.1*	*3.7*	*−3.8*	*−1.3*	*−2.5*	*−0.4*	*−0.0*	*0.9*
Other domestic assets (net) of the banking system	−4.5	−7.1	−4.2	−2.1	−1.5	−2.2	−2.5	−4.2
	% of GDP, ESA 95							
General government revenues	42.2	41.9	42.3	42.1				
General government expenditures[1]	51.2	49.1	48.8	49.9				
General government balance[1]	−9.0	−7.2	−6.5	−7.8				
Primary balance[1]	−5.1	−3.3	−2.3	−3.9				
Gross public debt[1]	55.6	58.0	59.4	61.7				
	EUR million, period total							
Merchandise exports	36,821	37,907	44,779	50,120	12,533.2	13,664.9	13,475.4	14,219.3
Merchandise imports	39,024	40,805	47,232	51,580	13,227.1	13,982.8	13,764.4	14,285.4
	% of GDP, period total							
Trade balance	−3.2	−3.9	−3.0	−1.7	−3.0	−1.4	−1.4	−0.3
Services balance	0.8	0.1	0.3	0.8	1.2	0.4	0.2	1.6
Income balance (factor services balance)	−5.5	−5.0	−6.1	−6.2	−5.8	−5.7	−7.3	−8.2
Current transfers	0.8	0.8	0.3	0.2	−0.3	0.8	1.0	−0.1
Current account balance	−7.1	−8.1	−8.5	−6.8	−8.0	−5.9	−7.5	−7.0
Capital account balance	0.3	−0.0	0.3	0.8	0.3	1.2	0.6	0.2
Foreign direct investment (net)	4.1	0.6	3.4	4.7	3.1	10.2	9.1	0.4
	EUR million, end of period							
Gross external debt	38,559	46,041	55,150	66,298	64,581	66,298	72,447	73,617
Gross official reserves (excluding gold)	9,887	10,108	11,671	15,678	14,530	15,678	17,781	16,576
	Months of imports of goods and services							
Gross official reserves (excluding gold)	2.6	2.5	2.5	3.1	2.8	2.9	3.4	3.0
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	69,660	73,508	81,283	87,869	22,897	23,314	20,423	21,048

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

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

especially as the government's standing in opinion polls has worsened recently and social unrest might continue.

External financing requirement fuels rise in net foreign debt

The slowdown of domestic demand during the first half of 2006 had a positive impact on Hungary's external balance, with the balance of goods and services turning into a minor surplus. The gradual decline in Hungary's goods and services deficit over the past few years reflects an improvement in competitiveness as a result of declining unit labor costs in manufacturing, despite substantial nominal wage increases in the first half of the decade, and the relative stability of the nominal effective exchange rate. However, a significant widening of the income deficit (mainly on account of larger profit repatriation by foreign direct investors) and a decline in the capital account surplus caused the deficit of the combined current and capital account to widen to 6.9% of GDP in the first half of 2006 from 5.8% in the same period of the previous year. Almost three-quarters of the financing requirement were covered by FDI, which consisted almost completely of intercompany lending, the rest by portfolio and other investments. Although the coverage of the deficit by net FDI inflows improved, the net FDI result stemmed primarily from smaller FDI outflows and increased inflows of intercompany loans (which are recorded as a part of FDI). Consequently, net foreign debt reached almost 40% of GDP in mid-2006, while gross foreign debt amounted to 84% of GDP.

Policy rate hikes underpin forint

Given high economic imbalances and weak policy credibility, Hungarian bond and equity prices were affected more by the retrenchment of the international risk appetite in March and in May to June 2006 than prices in neighboring countries. The increase in the required risk premium on forint assets and the deterioration in the inflation outlook on the back of currency weakness (the forint lost around 8% of its value against the euro between mid-February and early October 2006) have been among the reasons for the MNB to hike interest rates in four steps between June and September 2006, raising them by a total of 175 basis points to 7.75%. In addition, the inflationary effect of the corrective fiscal measures and the central bank's desire to anchor inflation expectations and to avoid an erosion of the real interest rate level have increasingly impacted on monetary policy decisions.

4 Poland: Growth as a Window of Opportunity for Fiscal Policy

Export-induced labor market performance boosts domestic demand …

In the first half of 2006, real GDP growth in Poland was 5.4% year on year, thus considerably higher than in 2005. Despite the substantial acceleration of both private consumption and gross fixed capital formation growth, the contribution of real exports to GDP growth continued to outpace that of domestic demand, since exports have an increasingly large share in total demand and since their annual growth rate more than doubled compared to the first half of 2005. Although real import growth accelerated more than real export growth in response to the upswing in total demand, the contribution of net exports to GDP growth in the first half of 2006 remained positive.

The sound export performance benefited from the cyclical upswing in euro area import demand and from the favorable dynamics in the global economy and in the CIS countries. Furthermore, the wage elasticity of the export sector with respect to exchange rate changes helped buffer the adverse impact of the sizeable nominal appreciation of the zloty and helped preserve price competitiveness. Production in the export sector boosted employment growth both in manufacturing and in the whole economy. The decline of the unemployment rate, which amounted to 4 percentage points year on year in the second quarter of 2006, was mainly driven by the increase in the employment rate, which contributed 3 percentage points to this decline, and to a lesser extent also by a decline in the activity rate (due to a growing number of students and emigration). The higher employment rate improved both the wage bill and consumer confidence, and, together with hikes in social transfers (according to existing indexation rules), vigorous household credit growth and disinflation, lifted real private consumption growth.

The positive external and improving domestic sales outlook strengthened fixedinvestment growth. In addition, the decline in nominal unit labor costs in industry, the high profitability and liquidity of nonfinancial corporations, the fact that real short-term interest rates were below annual GDP growth, the increasing absorption of transfers from EU structural funds and the robust expansion of housing loans bolstered the powerful rise in investment. After years of stagnation or even decline, the year-on-year growth of domestic credit to nonfinancial corporations accelerated throughout the first half of 2006 both in nominal and in PPI-deflated terms. Higher investment growth, in turn, also enhanced labor market performance (see above). Following the increase in employment, nominal wage growth accelerated both in manufacturing and in the whole economy. At the same time, the annual nominal appreciation of the zloty in euro terms continued, albeit declining from nearly 13% on average in 2005 to about 5% in the first half of 2006. Thanks to strong productivity advances, nominal unit labor costs in industry continued to shrink, compensating for the further appreciation of the zloty. However, a further rise in wage growth combined with further currency appreciation may pose an upcoming challenge for price competitiveness and external trade. Ever since the appreciation trend came to a halt at the end of February, the zloty has been traded within a range of 3.8 to 4.0 PLN/EUR with considerable short-term volatility, and it stood at 3.87 PLN/EUR on October 27.

Strong productivity advances keep inflation low despite supply-side shocks

The decline in nominal unit labor costs in industry decisively contributed to very low levels of the various core inflation rates. Annual headline HICP inflation fell from about 3% in the first half of 2005 to about 1% in the first half of 2006, despite the rise in international energy prices. This is by far the lowest inflation rate in the region. Hardly any signs of demand-side inflationary pressures are discernible in the recent development of consumer prices. However, inflation increased slightly in the third quarter due to the impact of drought on agricultural production. Nevertheless, annual inflation stood at 1.4% in September 2006, still substantially below the inflation target of the central bank (2.5% ±1 percentage point). Drought damage, stepped-up domestic demand and higher wage growth may lead to inflationary pressure or to higher imports. The central bank's inflation projection published on October 26 foresees inflation close to the target value at the beginning of 2007 and slightly below the target value in the second half of 2007. For the time being, the Monetary Policy Council has maintained the main policy rate at 4.0% since March 2006. Meanwhile, short-term real interest rates in ex post

Table 6

Main Economic Indicators: Poland

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	1.4	3.9	5.3	3.4	3.9	4.3	5.2	5.5
Private consumption (excl. NPISH)	3.4	1.9	4.3	2.0	2.3	2.8	5.2	4.9
Public consumption (incl. NPISH)	1.5	4.7	3.1	4.9	3.1	5.2	3.1	−1.0
Gross fixed capital formation	−6.3	−0.1	6.4	6.5	6.5	10.1	7.4	14.4
Exports of goods and services	4.8	14.2	14.0	8.1	6.1	11.8	21.7	13.0
Imports of goods and services	2.6	9.3	15.2	4.8	1.2	14.7	19.9	11.7
	Contribution to GDP growth in percentage points							
Domestic demand	0.9	2.8	6.1	2.2	2.0	5.4	4.5	5.1
Net exports	0.5	1.1	−0.8	1.1	1.9	−1.1	0.7	0.4
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	7.4	11.4	13.5	2.9	3.3	7.2	10.4	10.2
Gross average wage of industry (nominal)	3.7	3.0	4.5	3.2	3.2	4.4	4.3	4.9
Unit labor cost of industry (nominal)	−3.4	−7.5	−7.9	0.3	−0.1	−2.6	−5.5	−4.8
Producer price index (PPI) of industry	1.1	2.7	7.1	0.7	−0.2	−0.4	0.6	2.3
Consumer price index (here: HICP)	1.9	0.7	3.6	2.2	1.8	1.2	0.9	1.4
EUR per 1 PLN, + = PLN appreciation	−4.7	−12.4	−2.9	12.6	10.1	8.1	5.0	4.6
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	20.3	19.9	19.3	18.0	17.6	17.0	16.3	14.3
Employment rate (15−64 years)	51.5	51.2	51.7	52.8	53.7	53.7	52.6	53.9
Key interest rate per annum (%)	8.8	5.6	5.8	5.3	4.8	4.5	4.3	4.0
PLN per 1 EUR	3.9	4.4	4.5	4.0	4.0	3.9	3.8	3.9
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	2.0	1.5	6.9	11.8	12.2	12.1	10.9	10.2
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	0.9	0.1	4.2	5.0	6.6	7.4	5.8	1.5
Domestic credit of the banking system	6.6	4.8	3.5	5.3	5.5	5.5	7.5	8.6
of which:								
claims on the private sector	*2.9*	*3.4*	*4.0*	*5.6*	*7.1*	*6.7*	*8.9*	*8.9*
claims on households	*2.6*	*2.4*	*4.6*	*5.8*	*6.4*	*6.0*	*7.6*	*7.5*
claims on enterprises	*0.3*	*1.0*	*−0.6*	*−0.1*	*0.7*	*0.7*	*1.4*	*1.4*
claims on the public sector (net)	*3.7*	*1.4*	*−0.5*	*−0.3*	*−1.5*	*−1.2*	*−1.5*	*−0.2*
Other domestic assets (net) of the banking system	−5.5	−3.3	−0.8	1.5	0.1	−0.8	−2.3	0.0
	% of GDP, ESA 95							
General government revenues	41.0	39.9	38.7	40.8				
General government expenditures[1]	44.2	44.6	42.6	43.3				
General government balance[1]	−3.2	−4.7	−3.9	−2.5				
Primary balance[1]	−0.4	−1.9	−1.3	0.1				
Gross public debt[1]	39.8	43.9	41.8	41.9				
	EUR million, period total							
Merchandise exports	49,324	53,814	65,841	76,879	19,222.0	21,252.0	21,722.0	22,639.0
Merchandise imports	57,036	58,890	70,393	79,290	19,833.0	22,047.0	22,075.0	23,289.0
	% of GDP, period total							
Trade balance	−3.7	−2.7	−2.2	−1.0	−1.0	−1.1	−0.6	−1.0
Services balance	0.4	0.2	0.4	0.6	0.2	0.7	0.4	0.5
Income balance (factor services balance)	−0.9	−1.7	−4.5	−3.5	−3.3	−3.5	−3.2	−4.4
Current transfers	1.6	1.9	2.2	2.3	2.5	1.6	1.1	3.0
Current account balance	−2.6	−2.1	−4.1	−1.6	−1.5	−2.3	−2.2	−1.9
Capital account balance	−0.0	−0.0	0.4	0.3	0.2	0.3	0.6	0.3
Foreign direct investment (net)	2.0	2.0	4.6	2.2	2.8	1.4	5.4	1.9
	EUR million, end of period							
Gross external debt	81,045	84,818	94,881	111,585	107,287	111,585	114,242	115,942
Gross official reserves (excluding gold)	27,367	26,000	25,904	34,536	32,844	34,536	34,952	35,356
	Months of imports of goods and services							
Gross official reserves (excluding gold)	4.9	4.6	3.9	4.6	4.2	4.7	4.5	4.2
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	209,723	191,261	204,878	244,165	59,981	69,722	62,563	63,789

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

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

terms[14] increased slightly to about 3% in September as a consequence of persistent disinflation.

Smaller fiscal deficit in 2006, but fiscal policy risks to become procyclical in 2007

The updated convergence program of January 2006 envisaged a public deficit target for 2006 of 2.6% of GDP (or 4.6% including the net costs of the pension reform) that was smaller than the program's target value for 2005, but higher than the actual 2005 deficit of 2.5% of GDP (4.4% including pension reform costs). Public debt stood at 42.0% of GDP (47.3% including pension reform costs) at the end of 2005. Some budget execution signs in 2006 suggest that the deficit may be smaller than targeted, namely about 2% of GDP. The autumn forecast of the European Commission foresees a deficit of 2.2% of GDP 4.2% including pension reform costs). The undershooting of the target seems to stem not only from buoyant revenue increases, but also from cautious expenditure policies. For 2007 and 2008, the convergence program envisages a moderate narrowing of the public deficit to 2.2% and 1.9% of GDP, respectively (4.1% and 3.7% of GDP including pension reform costs). The budget draft for 2007 foresees a slightly higher public deficit of 2.4%. The main rule of current fiscal budgeting is a nominal anchor (fiscal deficit equal to PLN 30 billion), with the aim of achieving a decline of the deficit-to-GDP ratio by relying on nominal GDP growth while sticking to the deficit anchor. However, if the deficit in 2006 turns out to be substantially smaller than initially envisaged, this approach may imply aiming for a procyclical increase in the nominal budget deficit in 2007, which might be partially avoided only if budget execution remains prudent. Alternatively, a more ambitious fiscal consolidation strategy corresponding to the EU Council decisions in the framework of the EDP could be adopted. The Polish authorities have, at present, not set any specific target date for euro adoption.

FDI inflows surpass the small current account deficit, external debt-to-GDP ratio decreases

Both the very small deficit of the goods and services balance and the considerable deficit of the income balance widened only marginally in the first half of 2006 compared to the first half of 2005. The moderate annual rise in the current account deficit in this period resulted primarily from smaller net inflows of transfers. Net FDI inflows mounted and more than compensated the current account deficit. Thus, gross external debt (as a percentage of rolling four-quarter GDP) declined from 45.7% at end-2005 to 45.3% in mid-2006. Net external debt stood at only 15% at end-2005.

5 Slovakia: Brisk Economic Activity Continues amid Rising Inflation

Robust economic growth on the back of domestic demand, surge in industrial production

Real GDP expanded by 6.5% in Slovakia in the first half of 2006. Growth was mainly driven by strong domestic demand, with private consumption profiting from the vigorous expansion of household credit, robust real wage growth and increasingly positive labor market developments, as reflected by the decrease of the quarterly unemployment rate from 15.4% in the last quarter of 2005 to 13.6% in the second quarter of 2006 and by higher employment growth rates (4.5% in the second quarter). Public consumption also expanded dynamically in the first half of 2006, while fixed capital formation has been driven to a considerable extent by foreign direct investment. In particular, two big

[14] *As measured by the CPI-deflated key interest rate per month compounded over the past 12 months.*

production facilities have been or are being completed in the car industry in 2006. PSA Peugeot Citroën already took up production in June, while Kia planned to open its factory in November. Apart from being a driving force behind fixed capital formation, these direct investment projects have also had an impact on external trade, which was heavily characterized by the import of investment goods destined for the new plants. As the auto projects are now being finished, the growth of investment activity moderated in the second quarter. Imports lost momentum as well, while export growth remained steady and buoyant, resulting in a positive growth contribution of net exports. Exports can be expected to develop in an even more dynamic fashion once car production is fully running, thereby further strengthening the contribution of the external sector to GDP growth.

New government regears economic policy

In recent years, Slovakia has introduced a series of economic reforms most prominently exemplified by the introduction of a flat rate of 19% for personal and corporate income tax as well as for value added tax in 2004. The new coalition government formed after the June 2006 parliamentary elections has announced reversals or modifications of some of the earlier reforms. Its program focuses on the construction of a "social market economy." Measures to this end include lowering the tax burden on population strata with low and middle incomes by increasing the tax-free personal income tax base and by amendments to the flat VAT rate in selected commodities, taxing persons with above-average incomes more, increasing the minimum wage, halting strategic privatizations, and reforming the labor code to provide stronger employee protection. The program also includes expenditure streamlining in public administration, measures to lower tax and custom duty evasion and improved procurement procedures. Overall, changes in expenditures and revenues are planned to roughly offset each other, so that medium-term fiscal consolidation, as laid out in Slovakia's 2005 convergence program, would remain broadly on course. In this vein, the new government also confirmed the goal set out by the previous administration to fulfill the Maastricht criteria with a view to adopting the euro in 2009.

Political uncertainty exerts temporary pressure on Slovak koruna

In the first few weeks after the elections in June, the Slovak koruna came under depreciation pressure. For the first time since the country's entry into the exchange rate mechanism II (ERM II) in November 2005, the koruna traded above its central parity of 38.455 SKK/EUR: After hitting 37.110 SKK/EUR in April, the koruna softened to 38.768 SKK/EUR in mid-July. In late June and in July, Národná banka Slovenska (NBS) sold approximately EUR 3 billion to stabilize the exchange rate near the central parity. This measure together with hikes in the key interest rate and the confirmation of the new government that it would stick to January 2009 as the planned entry date into the euro area supported the currency, and depreciation pressure dissipated. In fact, after the approval of the state budget for 2007 on October 11, the koruna appreciated to 36.616 SKK/EUR, its historically strongest value until the cutoff date for data. The currency traded 2.6% stronger in mid-October than at the beginning of the year.

Budgetary outcome 2006 should be better than expected

On the back of robust economic activity, the targeted budget deficit for 2006 of 4.2% of GDP (including the costs of 1.3% of GDP for the pension reform launched in 2005) could be undershot. This is in line with the European

Table 7

Main Economic Indicators: Slovakia

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	4.1	4.2	5.4	6.1	6.3	7.4	6.3	6.7
Private consumption	5.2	0.2	4.2	7.0	7.5	6.4	6.5	5.7
Public consumption	5.2	3.9	2.0	0.5	3.2	–1.2	6.7	5.5
Gross fixed capital formation	0.3	–2.3	5.0	13.8	16.9	19.5	16.1	6.9
Exports of goods and services	4.7	15.9	7.9	13.5	19.2	16.3	18.0	18.4
Imports of goods and services	4.6	7.6	8.8	15.5	16.5	20.5	20.8	15.1
	Contribution to GDP growth in percentage points							
Domestic demand	4.3	–1.3	6.2	8.0	4.6	11.9	8.6	4.4
Net exports	–0.2	6.1	–0.7	–1.8	2.1	–4.6	–2.2	2.8
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	6.5	4.9	3.9	0.8	1.8	4.1	10.8	10.9
Gross average wage of industry (nominal)	7.3	7.3	10.1	7.1	4.7	6.7	2.4	8.2
Unit labor cost of industry (nominal)	0.7	2.3	6.1	6.3	2.8	2.5	–7.6	–2.4
Producer price index (PPI) of industry	2.0	8.3	3.4	4.7	5.6	6.7	9.5	9.6
Consumer price index (here: HICP)	3.5	8.4	7.5	2.8	2.2	3.7	4.2	4.6
EUR per 1 SKK, + = SKK appreciation	1.4	2.9	3.6	3.7	3.5	2.5	2.2	3.3
	Period average levels							
Unemployment rate (ILO definition, %, 15–64 years)	18.7	17.6	18.2	16.2	15.7	15.4	15.0	13.6
Employment rate (15–64 years)	56.8	57.7	57.0	57.7	58.0	58.5	58.3	59.3
Key interest rate per annum (%)	7.9	6.4	4.9	3.2	3.0	3.0	3.1	3.8
SKK per 1 EUR	42.7	41.5	40.0	38.6	38.7	38.5	37.5	37.7
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	8.7	5.5	4.0	5.0	4.5	4.3	2.2	4.5
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	13.5	7.7	–2.6	–5.8	–8.5	–7.9	8.1	16.6
Domestic credit of the banking system	–6.5	7.8	10.2	12.1	12.2	13.6	3.9	4.4
of which:								
claims on the private sector	*4.9*	*5.5*	*4.0*	*8.1*	*9.3*	*11.4*	*15.2*	*16.6*
claims on households	*1.4*	*2.2*	*4.0*	*5.3*	*5.5*	*6.1*	*8.0*	*8.9*
claims on enterprises	*3.5*	*3.2*	*0.0*	*2.8*	*3.8*	*5.4*	*7.2*	*7.8*
claims on the public sector (net)	*–11.4*	*2.3*	*6.1*	*4.0*	*2.9*	*2.2*	*–11.3*	*–12.2*
Other domestic assets (net) of the banking system	1.7	–10.0	–3.6	–1.3	0.8	–1.4	–9.7	–16.5
	% of GDP, ESA 95							
General government revenues	35.6	35.7	35.9	34.0				
General government expenditures[1]	43.3	39.4	38.9	37.1				
General government balance[1]	–7.7	–3.7	–3.0	–3.1				
Primary balance[1]	–4.1	–1.2	–0.8	–1.4				
Gross public debt[1]	43.3	42.7	41.6	34.5				
	EUR million, period total							
Merchandise exports	15,281	19,370	22,264	25,738	6,532	7,262	7,131	7,982
Merchandise imports	17,540	19,935	23,513	27,716	6,730	8,227	7,756	8,571
	% of GDP, period total							
Trade balance	–8.7	–1.9	–3.7	–5.2	–2.1	–9.5	–6.3	–5.5
Services balance	1.9	0.7	0.6	0.7	1.0	0.3	0.5	1.5
Income balance (factor services balance)	–1.9	–0.4	–1.0	–4.2	–3.4	–6.1	–1.7	–5.5
Current transfers	0.8	0.7	0.4	0.0	–0.3	0.2	–0.1	1.1
Current account balance	–7.9	–0.8	–3.6	–8.6	–4.7	–15.1	–7.6	–8.4
Capital account balance	0.4	0.3	0.3	–0.0	–0.0	–0.1	–0.1	0.0
Foreign direct investment (net)	16.5	2.2	3.3	4.1	2.9	4.5	4.9	10.2
	EUR million, end of period							
Gross external debt	12,576	14,323	17,446	22,932	22,035	22,932	23,567	24,779
Gross official reserves (excluding gold)	8,497	9,338	10,605	12,578	12,684	12,578	13,121	12,322
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.1	4.9	4.8	4.9	5.0	4.1	4.6	3.9
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	26,042	29,239	33,878	38,140	9,663	10,214	9,847	10,713

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

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

Commission's autumn forecast of 3.4% of GDP for the 2006 deficit. As a case in point, revenues from corporate income tax, which are an important component of the country's tax revenues, already stood at 100.7% of the annual plan in September. Even though the budgetary outcome could be better than envisaged, the IMF still considers the fiscal stance slightly expansionary in 2006. In 2007, fiscal policy should be broadly neutral. The draft budget includes a deficit of 2.9% of GDP (including the costs of the pension reform of 1.3% of GDP). Inter alia, it provides for higher spending on health care, education and agriculture in accordance with the government program. A reduction in state employee numbers and an across-the-board 10% cut in ministries' disposable funds are planned. According to the central bank, the draft budget is realistic, but will not contribute to curbing inflationary pressures in the economy.

Inflationary pressures are picking up

Inflation pressures have been increasing in the Slovak economy throughout 2006. Even though annual inflation declined by 0.5 percentage points in September compared to August, benefiting mainly from lower fuel and telecom service prices, the country still has one of the highest inflation rates (4.5%) in Central Europe. Inflationary pressures throughout the year originated from rising energy prices, price adjustments in the health sector and a turnaround in food price development from deflation to inflation. Core inflation has already been on an upward path for a few months (2.6% in September). This development can be traced particularly to employment, wage and productivity developments. In the first quarter of 2006, unit labor costs in the whole economy were 3.9% higher than in the same period of 2005. To contain inflation and inflation expectations, the NBS has raised its key interest rate by a cumulative 175 basis points from January to mid-October 2006. Still, inflation will not reach the central bank's target of below 2.5% in 2006, as the central bank is currently projecting 3.9% inflation for 2006. For 2007, the inflation target is below 2%, while the current central bank projection is 2.8%.

Slight improvement of the combined current and capital account

Declining imports and increasingly dynamic exports have let the trade balance improve substantially since the fourth quarter of 2005. However, this positive development only led to a minor improvement in the combined current and capital account, as profit repatriation has been increasing throughout the year. The resulting deficit of 8% of GDP was almost entirely covered by FDI. The trade balance can be expected to improve further once the new car producers start exporting on a grand scale. Total gross foreign debt remained stable at around 60% of GDP.

6 Slovenia: The Start of a New Era – A Balanced Economy in the Run-Up to Euro Adoption

Robust GDP expansion fueled by domestic demand

Slovenia's GDP growth accelerated to 5% year on year during the first half of 2006. Among the domestic demand components, gross fixed capital formation, especially in machinery and equipment and residential investment, grew most strongly. Gross fixed capital formation was supported by the acceleration of credit growth to households and enterprises. In addition, robust growth rates of investment in machinery and equipment continued to represent a rebound following stagnation during the first three quarters of 2005, while housing investment was aided by the release of funds from the National Housing Savings Scheme. Consumption growth lagged behind the growth rate of overall GDP. Within this total, the growth rate of private consumption remained broadly unchanged at around 3.5%, despite faster real household income growth and quickening real credit growth to households. Export growth during the first half of 2006 picked up slightly compared to full-year 2005. However, import growth accelerated more quickly, reflecting stepped-up gross fixed capital formation, and caused the contribution of net real exports to overall growth to decrease.

Inflation to stabilize at around 2.5%

Between December 2005 and September 2006, inflation fluctuated in a range of 2.0% to 3.4% year on year, with relatively large volatility in some months, depending mainly on the volatility of energy prices and the change in the seasonal pattern in some product categories. In September 2006, inflation stood at 2.5%, while the 12-month average inflation rate in the period from October 2005 to September 2006 was 2.6%. According to the 2006 autumn forecast of the European Commission, inflation should stabilize at around 2.5% over the next two years. Uncertainties about the forecast relate mainly to the development of regulated prices and excise duties, oil price developments and the liberalization of the electricity and natural gas market for households (from mid-2007) as well as the possible increase in VAT rates in 2008.

Current account deficit remains moderate

The deficit on the combined current and capital account amounted to 0.6% of GDP during the first half of 2006, modestly down from 1% in the same period of 2005. The deficit stemmed from the income and the transfer balances and was partly offset by a widening surplus on the balance of goods and services despite the ongoing deterioration of the terms of trade. Slovenia continued to register net FDI outflows during the first half of 2006, reflecting the ongoing expansion of Slovenian companies into neighboring countries and increased intercompany lending to foreign subsidiaries. The combined current and capital account deficits were thus mainly financed by other investment. Net foreign debt continued to rise gradually during the first half of 2006, reaching 13.4% of rolling four-quarter GDP by June 2006, primarily as a result of the increased net indebtedness of the banking sector and the decline in the net external lender position of the central bank and of the general government. In a similar vein, gross foreign debt climbed to 76.3% of GDP.

Solid public finances

Fiscal policy in Slovenia continues to stand on a relatively solid footing. According to the European Commission's autumn forecast, the budget deficit of the general government is expected to reach 1.6% of GDP in 2006, slightly up from the downward revised deficit of 1.4% in 2005. Cash-flow figures for the consolidated general government[15] for the first half of 2006 showed a deficit of 0.5% of GDP, which was a significantly better outcome than during the same period of 2005 (2.6%). In mid-September, the government decided to reduce the personal income tax rates from the beginning of 2007. The corporate income tax rate will also be lowered from 25% to 23% from the same date and then further by a percentage point a year until 2010 to a final 20%. These measures, if approved by parliament, will complement the gradual

[15] *The consolidated general government does not include all state and local government funds and agencies (for example the Capital Fund and the Restitution Fund), which form part of the general government sector.*

phasing out of the payroll tax, which started in 2006. The government also pledged to initiate a hike in VAT rates in 2008 if these tax cuts prove to bring Slovenia off the fiscal consolidation path.

Euro adoption: a win-win situation if challenges are mastered

In line with the decision of the EU Council of July 11, 2006, Slovenia will become the 13th member of the euro area on January 1, 2007. This will bring benefits, such as the elimination of any remaining element of exchange rate uncertainty for a broad range of business relations, enhanced price and cost transparency, reduced transaction and information costs and further scope for economic and financial integration with the euro area. While giving up monetary policy independence completely, Slovenia will benefit from the credible monetary policy framework of the Eurosystem to maintain price stability. Drawing on the experience of previous instances of euro adoption, some economic policy challenges can reasonably be expected for Slovenia for the period ahead.

Minimizing changeover-related price increases...

First, looking at the immediate future, minimizing changeover-related price increases upon introduction of the euro represents one of the biggest – if not the biggest – economic challenge. To gradually prepare consumers for the valuation of prices in euro and to provide for the best possible monitoring of retailers' pricing behavior, the dual display of prices has been compulsory since March 1, 2006, and will remain obligatory until the end of June 2007, albeit allowing for a number of exceptions. In addition, Slovenia's consumer association, in cooperation with the statistical office, has been monitoring retail price developments of specific goods and services. During the period between May and August 2006, exceptional price increases were restricted to a handful of goods and services (e.g. parking in the capital, certain fruits and vegetables, coffee).

... and the perception thereof

In addition to containing actual price increases during the changeover, it will also be essential to keep the perception of price increases limited. First, when euro notes and coins were introduced in the euro area in early 2002, the perception of the public in most countries was that prices had increased substantially, despite the fact that the inflationary impact registered officially by Eurostat was estimated to be within the range of 0.12% to 0.29%. Second, fears and perceptions of price increases related to euro adoption are widespread in Slovenia: According to the April 2006 Eurobarometer survey, 65% of respondents in Slovenia were afraid that euro adoption would give rise to inflation. This figure compares to an average of 46% for the ten new Member States, and to 49% for Slovenia in the survey conducted in September 2005. Against this psychological background and taking into account the increase in inflation during the first nine months of 2006 as well as the strong economic growth recorded during the first half of 2006, it will be essential to prevent exaggerated perceptions of price increases from having an impact on wage and price formation in the next few months.

Emphasis on fiscal, wage and structural policies

A second risk in connection with euro adoption may result from the full loss of monetary independence. However, monetary policy has operated with considerably limited autonomy already during Slovenia's stay in ERM II. At the same time, authorities and social partners have proved their ability to align fiscal and wage policies in order to achieve a policy mix conducive to achieving and maintaining low inflation and a balanced external position. Preserving

Table 8

Main Economic Indicators: Slovenia

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	3.5	2.7	4.2	3.9	3.6	3.7	5.1	4.9
Private consumption	1.3	3.4	3.1	3.3	3.4	2.8	3.5	3.3
Public consumption	3.2	1.6	2.9	3.1	3.2	3.9	3.3	4.1
Gross fixed capital formation	0.9	7.1	5.9	3.7	1.6	8.2	9.1	8.7
Exports of goods and services	6.7	3.1	12.5	9.2	9.5	8.8	14.9	8.6
Imports of goods and services	4.8	6.7	13.2	5.3	5.9	7.2	13.5	8.0
	Contribution to GDP growth in percentage points							
Domestic demand	2.4	4.9	5.0	1.4	1.2	2.9	4.1	4.5
Net exports	1.1	−2.2	−0.8	2.4	2.3	0.8	1.0	0.4
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	5.6	3.5	6.4	5.9	5.4	9.8	10.4	7.5
Gross average wage of industry (nominal)	9.9	7.6	7.1	5.8	5.3	5.9	6.5	5.8
Unit labor cost of industry (nominal)	4.1	4.0	0.7	−0.1	−0.0	−3.5	−3.6	−1.6
Producer price index (PPI) of industry	5.3	2.6	4.4	2.8	2.0	1.8	1.6	2.4
Consumer price index (here: HICP)	7.5	5.7	3.7	2.5	2.3	2.6	2.3	3.1
EUR per 1 SIT, + = SIT appreciation	−3.5	−3.4	−2.2	−0.2	0.2	0.1	0.1	−0.0
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	6.5	6.8	6.5	6.7	6.5	7.4	7.0	5.9
Employment rate (15−64 years)	63.4	62.6	65.3	66.0	66.6	66.0	65.9	68.9
Key interest rate per annum (%)	8.4	7.0	4.6	4.0	4.0	4.0	3.8	3.5
SIT per 1 EUR	225.9	233.8	239.1	239.6	239.5	239.5	239.5	239.6
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)[1]	22.8	12.7	5.1	6.6	5.0	7.1	6.5	7.5
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	11.0	3.3	−8.1	−10.4	−10.0	−10.1	−14.5	−15.2
Domestic credit of the banking system	12.2	8.1	14.0	19.7	18.9	21.3	24.3	25.6
of which:								
claims on the private sector	*9.1*	*8.0*	*11.5*	*16.6*	*16.8*	*18.3*	*23.8*	*26.4*
claims on households	*1.6*	*1.5*	*2.7*	*4.4*	*4.5*	*4.9*	*6.3*	*7.1*
claims on enterprises	*7.5*	*6.5*	*8.8*	*12.3*	*12.2*	*13.4*	*17.5*	*19.3*
claims on the public sector (net)	*3.2*	*0.1*	*2.4*	*3.0*	*2.2*	*3.0*	*0.6*	*−0.8*
Other domestic assets (net) of the banking system	−0.4	1.3	−0.8	−2.7	−3.9	−4.0	−3.3	−2.9
	% of GDP, ESA 95							
General government revenues	45.5	45.2	45.1	45.8				
General government expenditures	48.0	48.0	47.4	47.2				
General government balance	−2.5	−2.8	−2.3	−1.4				
Primary balance	−0.2	−0.7	−0.5	0.3				
Gross public debt	29.1	28.5	28.7	28.0				
	EUR million, period total							
Merchandise exports	11,082	11,417	12,933	14,599	3,592.9	3,871.4	4,024.6	4,277.8
Merchandise imports	11,347	11,960	13,942	15,625	3,831.8	4,388.2	4,227.3	4,381.7
	% of GDP, period total							
Trade balance	−1.1	−2.2	−3.9	−3.7	−3.4	−7.4	−3.0	−1.4
Services balance	2.6	2.2	2.6	3.1	3.4	3.5	3.1	3.3
Income balance (factor services balance)	−0.7	−0.9	−1.2	−1.0	−0.9	−1.4	−0.6	−1.1
Current transfers	0.3	0.1	−0.3	−0.3	0.1	−0.4	−1.2	−0.0
Current account balance	1.0	−0.8	−2.8	−2.0	−0.9	−5.6	−1.8	0.9
Capital account balance	−0.7	−0.7	−0.4	−0.4	−0.3	−0.8	−0.2	−0.3
Foreign direct investment (net)	6.6	−0.6	0.9	−0.2	0.0	1.6	−1.2	0.5
	EUR million, end of period							
Gross external debt	11,483	13,259	15,271	19,566	18,448	19,566	20,508	21,606
Gross official reserves (excluding gold)	6,702	6,798	6,464	6,824	6,800	6,824	6,840	6,484
	Months of imports of goods and services							
Gross official reserves (excluding gold)	6.1	5.9	4.8	4.6	4.4	4.1	4.3	3.9
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	23,695	24,857	26,144	27,373	6,938	6,995	6,788	7,578

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

[1] *The methodology for calculating broad money and its components were changed for data from the beginning of 2005 (thus affecting year-on-year rates from the beginning of 2006).*

past success will, however, necessitate further significant efforts. For example, although available information suggests that unit labor cost dynamics decelerated during the first half of 2006, the marked acceleration of the growth of the compensation per employee to almost 7% year on year during the second quarter of 2006 calls for vigilance. It will also be important to make public expenditures more flexible and to ensure the long-term sustainability of public finances despite significant pressures from population aging. Similarly, lifting long-term economic growth prospects by increasing labor market participation and flexibility, raising productivity and improving the regulatory environment for businesses will be demanding, as the recent consultations with the IMF have highlighted.

Room for further interest rate convergence seems limited

The full convergence of interest rates to the euro area level represented an economic policy challenge in some current euro area member states. Available evidence suggests that this issue may not be as prominent in Slovenia as it would seem at first sight, despite the significant acceleration of real credit growth over the past three years. First, harmonized long-term interest rates in Slovenia have been at around the euro area level already since April 2006. Second, short-term interest rates in Slovenia have converged significantly to the euro area level since the end of the third quarter of 2005. Full convergence of 12-month interest rates was achieved by early May 2006. The difference in 3- and 1-month interest rates stood at around 15 and 30 basis points, respectively, in mid-October and in September 2006, as Banka Slovenije continued to cut interest rates until July 2006 and followed the ECB rate hike in August but not in October 2006. This pattern of interest rate developments resembled previous cases of euro adoption, when long-term interest rates converged relatively early while the convergence of short-term interest rates was concentrated on the past few months or weeks of the run-up to euro adoption. Third, the comparison of interest rates charged by Slovenian banks in business relations with households and nonfinancial corporations reveals that in some business lines, interest rates both on tolar- and euro-denominated loans are already lower than in the euro area.

7 Bulgaria: Strong Growth, Solid Fiscal Policy and Widening External Imbalances

Domestic demand continues to drive strong economic growth

Real GDP grew by 6.1% year on year in the first half of 2006 and accelerated during this period, reaching 6.6% in the second quarter of 2006. Individual consumption growth remained robust and was supported by the expansion of consumer credit especially in May and June. Gross fixed capital formation also remained very buoyant. Net exports continued to contribute negatively to GDP growth in the first half of 2006. However, as import growth slowed in the second quarter while export growth remained steady, the negative contribution of net exports to growth shrank somewhat most recently. High GDP growth helped reduce the unemployment rate (ILO definition) to 9.0% in the first half of 2006 (average). Registered unemployment in Bulgaria fell to 8.4% in September. In a longer-term perspective, the reduction of joblessness in Bulgaria is remarkable, coming down from rates of close to 20% in the late 1990s to single-digit rates lately.

Household credit growth decelerating but still rapid

Household credit growth has remained rapid and, according to the latest global financial stability report of the IMF, posted among the fastest rates worldwide in 2005. In order to constrain high and ongoing domestic demand, the central bank introduced a series of primarily prudential and administrative measures in 2004 and 2005.[16] Credit growth to nongovernment decreased from 41.8% year on year in the first half of 2005 to 24.2% year on year in the first half of 2006, while credit growth to households fell from 72.2% year on year to 38.7% year on year. Overall, the Bulgarian National Bank (BNB) expects credit growth to slow down from 32.4% in 2005 to 17.5% in full-year 2006. Against this backdrop and considering the perception that such measures are only temporarily effective, the BNB already began to gradually loosen the administrative and monetary restrictions (credit ceilings and reserve requirements) on bank lending. The strict supervisory framework introduced and applied by the BNB, though, will remain unchanged.

While data suggest that bank lending has slowed, it appears that the demand for credit to finance private consumption growth is increasingly being met by other, i.e. nonbank, channels of financial intermediation, namely by leasing companies and other financial institutions outside the domestic banking sector. Moreover, retailers are increasingly providing direct financing to consumers, and last but not least parts of the corporate sector are to a growing extent able to borrow directly from abroad. On the occasion of the conclusion of the Article IV consultation with Bulgaria and the completion of the third review under the Stand-By Arrangement in August 2006, the IMF stressed the importance of the BNB's new role in supervising the growing nonbank financial sector, a function that was conferred on the central bank at the beginning of 2006.

Current account deficit deteriorates further, but net FDI inflows cover most of the current account gap

In recent years, Bulgaria has experienced a massive and fast widening of its current account deficit. In the first half of 2006, this process continued unabatedly, and the current account gap reached 16.7% of GDP compared to 11.3% of GDP in the first half of 2005. This development in the first six months of 2006 was partly attributable to the deterioration of the balance of goods and services, whose deficit rose from 17.6% to 20% of GDP, reflecting ongoing marked consumption and investment growth as well as rising oil prices. Moreover, the income and the transfers balances also worsened somewhat. On the financial side, in the first six months of 2006, net FDI inflows nearly doubled compared to the first half of 2005 and covered about three-quarters of the current account gap.[17] Since portfolio flows remained balanced and the central bank's reserves augmented slightly, the outstanding financing requirement was covered by other investments. Looking ahead to the outlook for the whole year 2006, it is important to note that Bulgaria typically runs a surplus on nonfactor services in the tourist season. This will be crucial in offsetting to some extent the deficit in the trade balance and in reducing the current account deficit to 12.5% of GDP in 2006, as projected by IMF.

[16] *See Developments in Selected Countries, Focus on European Economic Integration 2/05 and 1/06 for more details.*

[17] *FDI amounted to 12.7% of GDP, 5 percentage points of which originated from intercompany lending.*

Table 9

Main Economic Indicators: Bulgaria

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	4.9	4.5	5.7	5.5	4.6	5.5	5.6	6.6
Individual consumption	3.4	7.1	4.9	7.4	9.4	7.1	5.4	7.4
Collective consumption	6.0	3.0	6.7	2.2	4.3	−4.7	0.1	1.2
Gross fixed capital formation	8.5	13.7	13.5	19.0	24.0	21.5	21.4	20.3
Exports of goods and services	7.2	7.9	13.0	7.2	1.1	8.9	12.9	10.2
Imports of goods and services	4.9	15.3	14.1	14.6	18.8	12.9	20.0	11.4
	Contribution to GDP growth in percentage points							
Domestic demand	4.3	12.1	9.5	14.7	19.6	12.5	18.8	12.1
Net exports	0.6	−7.6	−3.9	−9.2	−15.1	−7.1	−13.2	−5.5
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	2.7	12.6	16.9	1.9	0.7	2.7	10.1	8.5
Gross average wage of industry (nominal)	3.5	3.8	7.1	7.2	7.7	7.9	9.4	9.4
Unit labor cost of industry (nominal)	0.8	−7.8	−8.3	5.2	6.9	5.1	−0.6	0.8
Producer price index (PPI) of industry	1.4	5.0	5.9	7.0	6.7	7.9	8.4	10.0
Consumer price index (here: HICP)	5.8	2.3	6.1	5.0	4.8	6.6	8.0	8.3
EUR per 1 BGN, + = BGN appreciation	−0.1	0.0	−0.2	−0.1	0.0	0.0	0.0	0.0
	Period average levels							
Unemployment rate (ILO definition, %, 15−64 years)	18.3	13.9	12.2	10.2	9.3	10.0	9.8	9.0
Employment rate (15−64 years)	50.6	52.5	54.2	55.8	57.8	56.0	55.5	59.1
Key interest rate per annum (%)	4.0	2.7	2.6	2.1	2.0	2.0	2.2	2.5
BGN per 1 EUR	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	18.3	16.3	22.3	27.3	27.1	26.5	19.2	17.0
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	7.7	5.4	4.4	8.9	11.3	8.6	8.3	10.7
Domestic credit of the banking system	12.1	14.5	21.8	25.8	23.6	26.0	18.5	12.7
of which:								
claims on the private sector	*13.6*	*19.9*	*26.3*	*27.9*	*25.0*	*23.6*	*17.9*	*12.6*
claims on households	*3.3*	*5.9*	*10.0*	*13.0*	*13.1*	*13.1*	*11.7*	*9.2*
claims on enterprises	*10.3*	*14.0*	*16.3*	*14.9*	*11.9*	*10.5*	*6.2*	*3.5*
claims on the public sector (net)	*−1.5*	*−5.4*	*−4.5*	*−2.1*	*−1.4*	*2.4*	*0.6*	*0.0*
Other domestic assets (net) of the banking system	−1.5	−3.6	−3.8	−7.4	−7.8	−8.2	−7.6	−6.4
	% of GDP, ESA 95							
General government revenues	37.4	38.8	40.7	41.1				
General government expenditures	37.8	38.5	38.0	38.7				
General government balance	−0.4	0.3	2.7	2.4				
Primary balance	1.8	2.5	4.5	3.9				
Gross public debt	53.7	46.0	38.4	29.8				
	EUR million, period total							
Merchandise exports	6,063	6,668	7,985	9,466	2,414.8	2,666.0	2,666.7	3,032.5
Merchandise imports	7,941	9,094	10,938	13,809	3,571.9	4,031.8	3,705.2	4,164.9
	% of GDP, period total							
Trade balance	−11.3	−13.7	−15.1	−20.2	−19.3	−23.0	−20.7	−19.3
Services balance	3.1	3.1	3.5	3.2	11.3	−2.6	−4.0	3.2
Income balance (factor services balance)	2.4	1.6	1.2	1.1	0.9	0.7	−0.2	0.9
Current transfers	3.4	3.5	4.5	4.6	4.5	4.6	2.6	3.2
Current account balance	−2.4	−5.5	−5.8	−11.3	−2.5	−20.2	−22.3	−11.9
Capital account balance	0.0	−0.0	0.0	−0.0	0.0	−0.0	0.0	0.0
Foreign direct investment (net)	5.7	10.3	11.5	11.2	14.9	12.5	15.6	10.2
	EUR million, end of period							
Gross external debt	10,769	10,641	12,572	14,530	13,550	14,530	15,905	16,304
Gross official reserves (excluding gold)	4,247	4,981	6,443	6,816	6,795	6,816	6,400	7,271
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.2	5.3	5.7	4.9	4.7	4.3	4.3	4.4
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	16,589	17,727	19,594	21,448	6,010	5,939	5,019	5,875

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

Private gross external debt rises significantly

Domestic credit growth is funded abroad by the banking sector and is reflected both in the high current account deficit and in the significant increase in Bulgaria's private external debt, which amounted to 54.8% of GDP in annual terms in the second quarter of 2006 compared to 41.1% of GDP in the second quarter of 2005. By contrast, public debt has been decreasing steadily.

Fiscal surplus target of 3% of GDP for 2006 appears to be within reach

Bulgaria has been conducting a strict fiscal policy, which is the main instrument to control domestic demand. Based on national methodology, the consolidated budget in the first half of 2006 showed a surplus of 6.6% of GDP. The consolidated budget revenue-to-GDP ratio grew at a faster pace than the expenditure-to-GDP ratio. So far, budgetary developments have been in accordance with the fiscal surplus target of 3% of GDP for the full year 2006 agreed with the IMF. For 2007, the Bulgarian authorities and the IMF have tentatively envisaged a surplus target in the order of 2% of GDP, taking into account Bulgaria's prospective cofinancing needs to tap EU funds. While the 2007 budget is still under preparation, the Bulgarian parliament has already voted unanimously to cut the corporate income tax rate from the current 15% to 10% from January 1, 2007, which will be the lowest level in the EU.

Annual inflation rate drops to 5.6% in September

The increases in oil prices and hikes in indirect taxes at the beginning of 2006 added to inflation pressures in the Bulgarian economy.[18] HICP inflation increased to 8.8% in February 2006 and stayed around that level for the next four months. Thereafter, a drop in food prices contributed to a gradual fall of inflation from 7.6% in July to 6.8% year on year in August. According to the National Statistical Institute, mainly owing to a sharp slowdown in the growth of transport prices, inflation dropped further to 5.6% year on year in September. The central bank expects that annual inflation will be lower than 6% at the end of 2006 (compared to 6.5% at the end of 2005).

Bulgaria's ERM II and euro adoption strategy is unchanged. The authorities are planning to join ERM II as soon as possible after membership in the EU becomes effective, while retaining the currency board as a unilateral commitment. Bulgaria intends to fulfill the convergence criteria in time to qualify for entry into the euro area after two-year participation in ERM II.

8 Romania: Strong Growth and Falling Inflation alongside Growing External Disequilibria

Growth is picking up on the eve of EU accession

In the first half of 2006, growth of real GDP in Romania rebounded to 7.4% after a somewhat more subdued performance in 2005, a year severely affected by adverse weather conditions. The main factor driving growth was domestic demand. Both private consumption and gross fixed capital formation showed double-digit real growth rates throughout the first half year. Private consumption increased on the back of robust real wage growth, declining unemployment and the strong expansion of household credit. Investments profited from the unabated strong inflow of FDI, further reconstruction measures after the 2005 floods and infrastructure investment. At the same time, the contribution of net exports to growth deteriorated further. Export growth picked up a bit in the first half of 2006, while imports continued to rise dynamically.

[18] *See Developments in Selected Countries, Focus on European Economic Integration 1/06 for more details.*

Further successful steps on the disinflation path

The HICP inflation rate decreased to 5.5% in September and was thus 3.5 percentage points lower than at the beginning of the year. This favorable development was mainly caused by below-average growth of food prices, which have a weight of nearly 40% in the HICP basket. Slow food price growth, in turn, has largely been a consequence of the recovery of agricultural production, which had contracted substantially in 2005 due to extreme weather conditions. Nominal exchange rate developments and two policy interest rate hikes of the Banca Naţională a României (BNR) amounting to a total of 125 basis points since the beginning of the year further helped to curb inflation. New or higher taxes on alcohol and tobacco have been exerting a certain upward pressure on prices since May. The BNR's inflation target of 5% ±1 percentage point, which is to be reached in December 2006, could be achieved, depending on the further trajectory of food prices and on possible demand-related inflation pressure, inter alia also as a consequence of an easing of fiscal policy. In its August inflation report, the BNR forecast an inflation rate of 6.1% for December and thereby a marginal overshooting of the inflation target. The BNR announced that it would maintain a tight monetary stance to attain its inflation goal of 4% ±1 percentage point for 2007.

The current account balance is deteriorating further

Romania's combined current and capital account deficit grew to nearly 12% of GDP in the first half of 2006, mostly due to an increasing deficit in the trade balance. Imports have been spurred by the nominal appreciation of the leu, which amounts to 4.6% since January, and by strong consumption demand fueled by rapid credit growth. Up to now, the deficit could be financed without any problems, as it is largely (so far approximately 80%) covered by FDI inflows, which are expected to reach a new record level in 2006. Still, the high current account deficit represents an element of macroeconomic vulnerability. Gross foreign debt increased in absolute terms during the first half of 2006. As a percentage of GDP, though, a slight downward trend is observable (from 30.8% in 2005 to 29.0% in the first half of 2006).

Credit growth remains rapid

In view of the strong performance of the Romanian economy and the prospects and expectations associated with EU accession, households are increasingly engaging in consumption smoothing. As the banking sector has undergone a major restructuring in the past few years and as competition among banks has increased, the supply of financial services has also improved markedly. The BNR has already taken several measures to curb credit growth. Its main target was to slow lending denominated in foreign currency. Following up on a first set of measures taken in 2005, the BNR has raised the reserve requirement on banks' foreign currency-denominated liabilities in two steps from 30% to 40% in 2006. Up to now, this measure appears to have helped slow the growth of foreign-currency lending to the private sector, which has declined from around 30% in January to around 24% in August (year on year), while its share in total private sector credit moderated from 54% at the end of 2005 to 47% in August 2006. However, at the same time, leu-denominated credit to the private sector started to skyrocket, showing annual growth rates of over 100% in August (compared to 70% at the end of 2005). This surge was mainly due to rapidly expanding credit to households (+126% in the same period). The growth of total private sector credit increased to about 60% in August. In response to this development, the NBR also hiked the reserve

Table 10

Main Economic Indicators: Romania

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	5.2	5.2	8.4	4.1	2.4	4.3	6.9	7.8
Private consumption	5.6	8.4	14.1	9.7	8.2	6.5	11.8	14.2
Public consumption	2.7	7.7	4.9	4.4	3.7	6.2	3.4	0.8
Gross fixed capital formation	7.6	8.6	10.7	13.1	10.8	21.3	11.4	12.2
Exports of goods and services	17.1	8.4	13.9	7.6	8.4	9.8	13.0	10.5
Imports of goods and services	11.8	16.0	22.1	17.2	17.4	17.2	18.7	18.0
	Contribution to GDP growth in percentage points							
Domestic demand	4.3	8.8	12.9	9.1	6.7	8.2	11.0	12.7
Net exports	0.9	–3.6	–4.5	–5.0	–4.3	–3.9	–4.1	–4.9
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	5.4	5.2	7.1	4.4	2.8	6.5	8.8	13.6
Gross average wage of industry (nominal)	23.6	19.5	23.0	16.8	17.0	18.1	16.6	14.3
Unit labor cost of industry (nominal)	17.2	13.6	14.8	11.9	13.9	10.9	7.2	0.6
Producer price index (PPI) of industry	23.2	19.6	19.1	10.8	9.0	9.1	11.2	11.9
Consumer price index (here: HICP)	22.5	15.3	11.9	9.1	9.0	8.5	8.7	7.2
EUR per 1 RON, + = RON appreciation	–16.8	–16.8	–7.3	11.8	16.3	9.5	4.0	2.9
	Period average levels							
Unemployment rate (ILO definition, %, 15–64 years)	9.1	7.5	8.5	7.5	6.5	7.2	8.1	7.4
Employment rate (15–64 years)	57.6	57.6	57.7	57.6	57.8	57.2	57.2	59.6
Key interest rate per annum (%)	29.6	18.8	20.4	10.0	8.0	7.7	7.7	8.5
RON per 1 EUR	3.1	3.8	4.1	3.6	3.5	3.6	3.6	3.5
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	40.9	31.2	31.5	41.9	41.6	40.5	32.8	27.8
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	31.8	15.5	12.9	21.1	18.4	20.8	14.9	9.5
Domestic credit of the banking system	18.7	23.9	26.0	17.1	16.5	22.6	27.6	29.4
of which:								
claims on the private sector	*24.1*	*28.2*	*32.2*	*26.7*	*26.6*	*31.1*	*31.8*	*34.6*
claims on households	..	*10.0*	*13.1*	*13.2*	*14.3*	*16.3*	*15.9*	*17.7*
claims on enterprises	..	*18.2*	*19.1*	*13.5*	*12.3*	*14.8*	*15.8*	*16.9*
claims on the public sector (net)	*–5.3*	*–4.3*	*–6.2*	*–9.5*	*–10.1*	*–8.4*	*–4.1*	*–5.2*
Other domestic assets (net) of the banking system	–9.6	–8.3	–7.4	3.7	6.7	–2.9	–9.8	–11.1
	% of GDP, ESA 95							
General government revenues	37.6	36.6	36.8	36.7				
General government expenditures	39.6	38.1	38.3	38.2				
General government balance	–2.0	–1.5	–1.5	–1.5				
Primary balance	0.5	0.2	0.0	–0.3				
Gross public debt	25.0	21.5	18.8	15.9				
	EUR million, period total							
Merchandise exports	14,644	15,614	18,935	22,255	5,939.0	5,789.0	6,215.0	6,453.0
Merchandise imports	17,392	19,569	24,258	30,062	7,686.0	8,771.0	7,915.0	9,138.0
	% of GDP, period total							
Trade balance	–5.7	–7.6	–8.7	–9.8	–7.8	–11.6	–9.9	–12.4
Services balance	0.0	0.1	–0.3	–0.5	0.1	–0.8	0.1	0.4
Income balance (factor services balance)	–1.0	–1.2	–4.2	–2.9	–3.1	–1.4	–3.7	–3.7
Current transfers	3.4	3.1	4.9	4.6	4.1	4.1	4.2	3.9
Current account balance	–3.4	–5.5	–8.4	–8.6	–6.7	–9.7	–9.3	–12.0
Capital account balance	0.2	0.4	0.8	0.7	0.5	1.0	0.7	–2.5
Foreign direct investment (net)	2.5	3.1	8.4	6.7	6.7	6.6	10.3	6.8
	EUR million, end of period							
Gross external debt	15,417	16,311	18,120	24,474	22,982	24,474	24,717	25,226
Gross official reserves (excluding gold)	5,877	6,374	10,848	16,796	16,647	16,796	18,146	18,176
	Months of imports of goods and services							
Gross official reserves (excluding gold)	3.6	3.4	4.8	5.9	5.7	5.0	6.0	5.2
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	47,970	52,246	60,892	79,465	22,362	25,811	17,126	21,572

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

requirement on leu credits from 16% to 20% in June 2006. Although credit growth has started from a low base, it warrants close monitoring, in particular in the light of external imbalances and the risks of foreign-currency borrowing by unhedged households.

Untimely fiscal easing could aggravate external imbalances

The Romanian government increased its budget deficit target for 2006 in two successive steps from 0.5% to 2.5% of GDP. The increased deficit is due to additional spending, mainly for infrastructure investments. Some 15% of additional spending, though, is devoted to the payrolls of teachers and government officials, pensions and heating allowances. As the budget shows a surplus of 1.6% of GDP for the first eight months of 2006, a spending spree for the remainder of 2006 would seem to be in the offing. Further absorption of EU structural funds, EU budget contributions and higher investment expenditure will, according to the draft budget of the Romanian government, lead to a further deterioration of the budget deficit to 2.8% of GDP in 2007. This is at odds with the recommendations of the IMF, which has urged Romania to target a balanced budget in 2006 and small budgetary surpluses over the medium run. In the present setting of brisk GDP growth and a widening current account deficit, the announced fiscal stimulus appears to be procyclical and will make the preservation of macroeconomic stability more difficult.

9 Croatia: Stabilizing Inflation and Foreign Debt

Growth picks up despite most recent slowdown

Annualized GDP growth accelerated slightly from 4.3% in 2005 to 4.8% in the first half of 2006. In more detail, robust 6.0% year-on-year growth in the first quarter of 2006 moderated to 3.6% (year on year) in the second quarter. This considerable volatility in real GDP growth is the result of large volatility in all but one of its components: public consumption remained largely flat throughout the first half of 2006. By contrast, the year-on-year growth of private consumption and gross fixed capital formation dropped despite the continuously strong growth of credit to households and nonbank corporations. Nevertheless, investment continued to expand dynamically. The previously markedly negative growth contribution of net exports declined from –4.1 to –0.4 percentage points. Notwithstanding greater economic volatility and the slowdown in real GDP growth during the first half of 2006, the rate of (registered) unemployment fell continuously from 18.3% in January to 15.7% in August 2006. Although unemployment is still high in an international comparison, Croatia last saw such a relatively low level in 1996.

Conclusion of the third review of the Stand-By Arrangement

The IMF has recently finished its third review of the Stand-By Arrangement provided to Croatia until November 15, 2006, with an overall positive assessment of Croatia's economic development. The IMF acknowledged the efforts to stabilize external debt, achieve fiscal consolidation and implement structural reforms. However, it also criticized slow privatization advances (shipyard restructuring, sale of the telecommunication and oil companies).

Consolidation of public finances under way

The target for the general government deficit was set at 3.2% of GDP in 2006. In July 2006, the authorities passed an even more ambitious supplementary budget aiming at a 3.0% deficit. The 0.2 percentage point decrease is to be achieved by cutting investment. At the same time, both revenues and current expenditures are expected to rise by 0.5% each.

Foreign debt seems to be stabilizing

Gross foreign debt continued to increase in 2006 and reached a new record high of EUR 27.5 billion (84.6% of GDP) in the second quarter of 2006 as a result of a rise of the private sector's gross (and net) foreign indebtedness. At the same time, gross public foreign debt declined substantially over the year to June 2006, apparently because government shifted from euro bonds issued abroad to domestic euro bonds bought by domestic banks, which in turn finance themselves abroad. The latest totals released by the central bank in September show that gross foreign debt contracted to EUR 26.8 billion in August. Although the gross external indebtedness of the nonfinancial corporate sector still seems to be on the rise, public foreign debt stayed flat and bank debt decreased in August 2006.

To contain further foreign borrowing by banks, the central bank closed a loophole that had enabled commercial banks to bypass the minimum required amount of foreign currency claims as a proportion of foreign currency liabilities: Given that foreign exchange-indexed kuna deposits mostly represent liabilities to foreign depositors and could be used to finance kuna loans, foreign exchange-indexed kuna deposits now – as of October 2, 2006 – have to be included in the base of foreign currency liabilities for the 32% coverage of banks' foreign currency liabilities by corresponding liquid claims.

The current account deficit stood at 20.5% as of GDP in the first half of the year, primarily because of the massive trade deficit (26.2%), which is compensated by net exports of services during the summer months. Net foreign direct investment reached 6.9% of GDP in June and partially finances the large current account deficits, whereas other investments cover most of the remaining deficit.

Seasonal exchange rate movements and foreign exchange interventions

Owing to tourism, the usual seasonal pattern characterized exchange rate movements also throughout 2006. The exchange rate vis-à-vis the euro appreciated by some 2.1% from January to July 2006 with a slight correction in March. Along the lines of its announced intervention strategy, the Croatian central bank sold kuna on the foreign exchange market at several occasions during this period in an attempt to slow the speed of appreciation. The appreciation trend reversed in mid-August, and the kuna depreciated by 2.7% in less then two months. In September, the central bank stepped in again, this time buying domestic currency. As a result, the kuna started to appreciate from end-September, which again triggered central bank kuna sales. Overall, the exchange rate recorded a slight depreciation of 0.13% between January 2 and October 16. The exchange rate fluctuated within an interval of 2.7% (weakest value over strongest value) over the same period.

Inflation subsides below 3% as energy prices drop and seasonal factors kick in

The marked acceleration of the year-on-year consumer price inflation to around 4% by the end of 2005 persisted until July 2006, when year-on-year growth gradually subsided to 3.4% in August and to 2.8% in September 2006. The fall in the inflation rate from 4.0% in July to 2.8% in September 2006 can be largely explained by a drop in goods inflation from 2.8% to 1.8%. In particular, two factors played a crucial role in lower goods prices. First, the prices of seasonal items passed their summer peak. Second, the drop in energy prices, in particular that of crude oil, seemed to have a quick effect both on fuels and lubricants for personal transport equipment and on household liquid and solid fuels.

Table 11

Main Economic Indicators: Croatia

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	5.6	5.3	3.8	4.3	5.2	4.8	6.0	3.6
Private consumption	7.7	4.6	3.9	3.4	3.8	3.2	4.0	2.1
Public consumption	4.9	1.3	−0.3	0.8	1.0	1.4	1.0	1.8
Gross fixed capital formation	13.9	24.7	4.4	4.8	5.8	9.9	18.1	8.4
Exports of goods and services	1.2	11.4	5.4	4.6	4.9	4.9	14.0	5.2
Imports of goods and services	13.4	12.1	3.5	3.5	2.3	3.6	16.1	4.2
	Contribution to GDP growth in percentage points							
Domestic demand	12.3	7.2	3.4	4.2	3.3	5.0	10.2	4.0
Net exports	−6.7	−1.8	0.4	0.1	1.9	−0.2	−4.1	−0.4
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	7.8	3.5	4.0	6.2	6.6	6.5	8.0	1.1
Gross average wage of industry (nominal)	6.9	5.4	5.5	5.3	5.4	5.4	7.2	7.3
Unit labor cost of industry (nominal)	−0.8	1.8	1.5	−0.8	−1.2	−1.1	−0.8	6.1
Producer price index (PPI) of industry	−0.5	1.9	3.6	3.1	2.0	2.3	3.5	3.7
Consumer price index (here: CPI)	1.7	1.8	2.1	3.4	3.5	4.0	3.5	3.8
EUR per 1 HRK, + = HRK appreciation	1.0	−2.1	1.0	1.3	0.3	2.3	2.3	0.9
	Period average levels							
Unemployment rate (ILO definition, %, 15–64 years)	15.1	14.5	14.1	13.0	..	12.6	..	..
Employment rate (15–64 years)	53.4	53.4	54.7	55.0	..	55.2	..	..
Key interest rate per annum (%)	5.6	4.5	4.5	4.5	4.5	4.5	4.5	4.5
HRK per 1 EUR	7.4	7.6	7.5	7.4	7.4	7.4	7.3	7.3
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	32.4	11.3	8.3	9.5	9.9	10.3	9.9	12.6
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	9.8	−7.7	−0.5	−5.0	−6.0	−6.0	−6.8	−6.4
Domestic credit of the banking system	23.2	19.5	9.4	17.3	18.6	19.6	19.6	21.9
of which:								
claims on the private sector	*21.5*	*17.7*	*10.1*	*13.2*	*13.6*	*15.4*	*17.6*	*21.3*
claims on households	*11.3*	*11.9*	*7.5*	*9.0*	*9.6*	*10.0*	*10.2*	*11.5*
claims on enterprises	*10.2*	*5.8*	*2.6*	*4.1*	*4.0*	*5.4*	*7.4*	*9.8*
claims on the public sector (net)	*1.7*	*1.8*	*−0.7*	*4.1*	*5.0*	*4.2*	*2.0*	*0.6*
Other domestic assets (net) of the banking system	−0.5	−0.5	−0.7	−2.7	−2.7	−3.3	−3.0	−2.9
	% of GDP, ESA 95							
General government revenues	49.6	46.4	46.2	47.5				
General government expenditures	53.7	50.9	51.2	51.4				
General government balance	−4.1	−4.5	−5.0	−3.9				
Primary balance	−2.0	−2.5	−2.9	−1.6				
Gross public debt	40.1	40.9	43.7	44.2				
	EUR million, period total							
Merchandise exports	5,293	5,572	6,603	7,217	1,848.1	1,979.6	2,002.9	1,970.4
Merchandise imports	11,254	12,546	13,331	14,738	3,720.2	3,949.5	3,865.1	4,313.1
	% of GDP, period total							
Trade balance	−24.4	−26.6	−23.7	−24.3	−21.8	−25.2	−24.4	−27.8
Services balance	13.4	18.8	16.8	17.2	46.2	2.8	−0.6	15.6
Income balance (factor services balance)	−2.3	−4.1	−2.2	−3.1	−1.5	−0.6	−5.2	−6.2
Current transfers	4.7	4.7	4.2	3.8	3.1	3.7	3.8	3.4
Current account balance	−8.6	−7.1	−4.9	−6.4	26.0	−19.3	−26.4	−15.1
Capital account balance	2.1	0.3	0.1	0.2	0.0	0.5	−0.0	0.0
Foreign direct investment (net)	2.4	6.4	2.5	3.9	3.8	0.9	4.3	9.2
	EUR million, end of period							
Gross external debt	15,055	19,811	22,781	25,541	24,107	25,541	26,469	27,458
Gross official reserves (excluding gold)	5,651	6,554	6,436	7,438	6,999	7,438	8,089	8,744
	Months of imports of goods and services							
Gross official reserves (excluding gold)	4.9	5.2	4.8	5.1	4.7	4.8	5.3	5.2
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	24,456	26,221	28,405	30,959	8,593	7,826	7,631	8,412

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

Persistence of service price inflation

Notwithstanding the deceleration of overall inflation, service price inflation remained fairly persistent, as overall service price inflation grew 6.3% in September, up from 5.3% in July. For instance, house rents, services related to housing, medical and hospital services, package holidays and financial services exhibited double-digit inflation rates, and transport services and other services recorded high single-digit growth rates.

A majority of these increases was concentrated on services subject to some kind of regulation by public authorities and can be explained by the reform of the health care system and the attempt to close the gap to cost recovery levels of some public services. Rises in market-based service prices might be explained by a mixture of demand- and supply-side effects, possibly due to economic catching-up.

10 Turkey: Strong Economic Growth only Marginally Dampened by Financial Market Turbulences

Turbulences in financial markets reveal persisting macroeconomic vulnerabilities

Unsettled conditions in global financial markets in May and June 2006 considerably dampened exchange rates and equity prices in Turkey and led to a substantial increase in the risk premium on Turkey's bond market. At 230 basis points, Turkish U.S.-dollar bond yield spreads are still about 50 basis points higher than before the recent correction, whereas spreads in other emerging markets are now close to the levels seen at end-April. Hence, the extent to which the country was affected by the global reduction in risk appetite – the downward correction in asset prices was stronger and the recovery slower than in other emerging markets – highlights Turkey's persisting macroeconomic vulnerabilities. These are above all Turkey's large and growing current account deficit, which is widely seen as unsustainable, a credit boom fueled by strong capital inflows, the country's relatively short history of sound macroeconomic policies, concerns about further progress with structural reforms as well as emerging political tensions within the country.

Somewhat slower but still robust economic performance

Real GDP growth (year on year) amounted to 7% in the first six months of 2006 and is expected to slow in the full year 2006, but to still remain robust between 5% and 6%. The composition of growth remained broadly the same as in 2005. The main contributors on the demand side were consumption (7.7 percentage points) and gross capital formation (3 percentage points). Conversely, net exports reduced growth by 3.1 percentage points. On the supply side, industrial output and construction were the driving factors of growth. The unemployment rate remains high at above 10% due to significant disincentives to formal sector employment and a sharply increasing labor force potential.

Disinflation process suffered further setback in 2006, end-2006 target range out of reach

The disinflation trend observed over the past years started to slow in 2005 and reversed from the beginning of 2006 on. Inflation augmented unexpectedly in April 2006, rising to 8.8% year on year, increased further to 11.7% in July and was above 10% in August and September, mainly as a consequence of the quick pass-through of the depreciation of the Turkish lira in late spring by almost 30% vis-à-vis the euro. Against this background, Turkey will miss its 2006 end-year inflation target of 5% (±2 percentage points) by a considerable margin. The IMF forecasts end-2006 inflation of around 10%. Nevertheless, the central bank, Türkiye Cumhuriyet Merkez Bankası (TCMB), has retained its medium-term inflation target of 4% (±2 percentage points). Over the summer, inflation expectations rose substantially, and despite a recent small decline they are still significantly above the medium-term target. The TCMB faces the challenge of reestablishing credibility by convincing the public that the deviation from the inflation target is temporary and that inflation will soon return to the previously announced disinflation path.

Strong appreciation of the Turkish lira followed by a sharp decline

Up to May 2006, the Turkish lira appreciated vis-à-vis the euro, mainly due to large capital inflows. This trend was interrupted by the above-mentioned sharp depreciation of the lira, which peaked at 2.13 TRL/EUR in June 2006. Most recently (in mid-October), the Turkish currency traded at 1.84 TRL/EUR. From the beginning of 2006 to the cutoff date, the Turkish lira declined by 17.7% against the euro. The TCMB reacted by abandoning its previous course of interest rate cuts and raised the short-term policy rate in various steps by a total of 425 basis points, pushing the short-term interest rate up to 17.50%. In May and June, the TCMB also intervened in the foreign exchange market to support the lira.

Fiscal policies still on track, but further progress in structural reforms needed

Turkey has undergone an impressive fiscal consolidation effort. It is supported by the IMF (the Stand-By Arrangement ends in May 2008), which has made it politically easier to sell the goal of achieving an annual primary fiscal surplus of 6.5% of GDP to the public and within the government. Moreover, it seems that this target will be met in 2006. The strategy of targeting a high primary surplus has been critical for reducing public debt, establishing confidence and supporting the disinflation objective of the TCMB. But a fixed primary surplus target may well constrain automatic stabilizers from operating. The relatively tight fiscal stance over the past years became less strict during the recent cyclical upswing because the actual primary balance was being targeted. To prevent this procyclicality, the government has announced that it would complement the annual primary balance target with an expenditure cap within the multiyear budgeting framework. The IMF has also played an important role in ensuring investor confidence by monitoring the Turkish fiscal accounts. In the first half of 2006, the general government balance thus registered a surplus of 0.5% of GDP. One of the largest fiscal risks has been social security, where projected deficit targets have been persistently breached. Large pension deficits are expected to continue even after the 2006 social security reform.

Current account deficit widens despite sizeable depreciation and is largely financed by rapidly expanding FDI inflows

Turkey has a long history of current account deficits. A breakdown shows that high deficits in merchandise trade and net factor income are only partly offset by surpluses in the balance of services (from tourism) and net transfers. During the first half of 2006, the current account deficit widened further to 11% of GDP; no significant improvement is expected for the whole year 2006 despite the sizeable currency depreciation. The persistence of the gap may be attributed mainly to the increased price of energy imports in the first half of 2006 and declining tourism revenue. Approximately 5 percentage points of the current account deficit of 11% of GDP are financed by FDI inflows, the remainder by other investment. Although FDI inflows continue to expand rapidly and the proportion of short-term capital flows funding the current account has fallen, the spring turmoil on financial markets fully exposed the risks of financing deficits by non-FDI inflows. The main impetus behind the

Table 12

Main Economic Indicators: Turkey

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	7.9	5.8	8.9	7.4	7.7	9.5	6.5	7.5
Private consumption	2.1	6.6	10.1	8.8	10.4	16.7	8.6	10.1
Public consumption	5.4	–2.5	0.5	2.4	3.2	0.0	8.1	18.1
Gross fixed capital formation	–1.1	10.0	32.4	24.0	30.7	33.0	30.7	10.9
Exports of goods and services	11.1	16.0	12.5	8.5	3.9	10.9	3.5	4.4
Imports of goods and services	15.8	27.1	24.7	11.5	11.2	15.3	8.2	10.1
	Contribution to GDP growth in percentage points							
Domestic demand	8.8	8.9	13.9	9.1	10.3	11.9	9.4	11.2
Net exports	–0.9	–3.0	–4.6	–1.7	–2.4	–2.3	–2.7	–3.4
	Year-on-year change of the period average in %							
Labor productivity of industry (real)	8.5	7.1	7.5	6.0	6.1	8.4	4.6	10.9
Gross average wage of industry (nominal)	37.6	23.1	13.4	12.2	12.5	11.4	10.6	11.5
Unit labor cost of industry (nominal)	26.8	15.0	5.5	5.9	6.1	2.8	5.7	0.5
Producer price index (PPI) of industry	50.1	25.6	14.6	6.0	4.3	2.3	4.9	8.4
Consumer price index (here: HICP)	47.0	25.6	10.1	8.1	7.8	7.3	7.6	9.2
EUR per 1 TRY, + = TRY appreciation	–23.2	–15.4	–4.5	5.9	10.4	16.0	8.6	–6.9
	Period average levels							
Unemployment rate (ILO definition, %, 15–64 years)	10.4	10.5	10.3	9.8	9.2	9.2	11.9	8.8
Employment rate (15–64 years)	44.7	43.5	43.6	43.9	44.8	44.8	40.1	44.3
Key interest rate per annum (%)	49.6	36.1	21.9	14.8	14.3	13.8	13.5	14.0
TRY per 1 EUR	1.4	1.7	1.8	1.7	1.6	1.6	1.6	1.8
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	43.1	16.5	24.1	20.6	21.1	21.6	26.8	31.0
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	–6.9	–1.8	2.2	6.4	7.2	7.7	11.2	12.1
Domestic credit of the banking system	55.9	24.8	28.7	20.5	20.6	18.4	20.4	23.5
of which:								
claims on the private sector	*2.1*	*9.4*	*19.1*	*18.8*	*18.4*	*18.8*	*20.9*	*23.9*
claims on households	*0.1*	*3.1*	*8.0*	*8.7*	*8.7*	*9.4*	*10.3*	*11.4*
claims on enterprises	*2.0*	*6.3*	*11.1*	*10.2*	*9.7*	*9.4*	*10.7*	*12.6*
claims on the public sector (net)	*53.8*	*15.5*	*9.6*	*1.7*	*2.2*	*–0.4*	*–0.5*	*–0.4*
Other domestic assets (net) of the banking system	–5.9	–6.5	–6.9	–6.3	–6.7	–4.5	–4.9	–4.6
	% of GDP, ESA 95							
General government revenues	25.9	24.4	31.2	36.9				
General government expenditures	38.8	35.7	36.9	38.1				
General government balance	–12.9	–11.3	–5.7	–1.2				
Primary balance	7.1	5.9	5.9	8.0				
Gross public debt	93.1	85.1	76.9	69.6				
	EUR million, period total							
Merchandise exports	42,392	45,192	53,913	62,012	15,530.7	17,635.6	16,206.3	17,919.0
Merchandise imports	49,980	57,449	73,102	88,630	23,308.5	24,938.0	23,309.9	27,038.5
	% of GDP, period total							
Trade balance	–4.0	–5.7	–8.0	–9.1	–8.5	–8.9	–10.6	–12.7
Services balance	4.3	4.3	4.3	3.9	6.9	2.4	1.4	2.7
Income balance (factor services balance)	–2.5	–2.3	–1.9	–1.6	–1.2	–1.4	–1.7	–1.8
Current transfers	1.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Current account balance	–0.9	–3.3	–5.2	–6.4	–2.4	–7.5	–10.5	–11.4
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	0.5	0.5	0.7	2.5	2.1	5.8	1.5	8.3
	EUR million, end of period							
Gross external debt	124,052	114,739	119,082	145,018	. .	145,018	153,649	152,298
Gross official reserves (excluding gold)	25,562	26,616	26,436	42,820	34,686	42,820	48,152	44,626
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.4	5.0	3.9	5.2	4.0	4.6	5.7	4.6
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	190,668	214,235	241,185	292,121	91,281	82,360	67,030	71,809

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

strong pickup in FDI flows is Turkey's EU accession process, which is perceived to improve the business climate in the years to come. A significant increase in the dynamics of structural reforms could accelerate Turkey's catching-up process and could facilitate the negotiation process with the EU.

The growth potential of the Turkish banking sector is attracting foreign banks: Two Greek private banks acquired large stakes of Tekfenbank and Finansbank. But the privatization of the large state-owned Turkish banks is not on track.

Amounting to almost 110% of GDP, Turkey's gross external debt is still high compared to that of other emerging market economies. In fact, the recent depreciation of the Turkish lira has reversed the trend of a declining ratio of external debt to GDP.

11 Russia: Continuing Brisk Growth

Domestic demand remains driving force of economy, shrinking net exports detract from growth

Domestic demand (notably private consumption as well as investment) remains the driving force of the Russian economy, while contracting net exports continue to act as a drag on growth. In January to July 2006, GDP was 6.7% higher than in the corresponding period of the previous year. Gross fixed capital formation expanded particularly strongly (+10.8% in the first seven months). However, some economic sectors, above all resource extraction and transportation, seem to have reached capacity constraints, and the energy sector is struggling with a rough business climate and particularly high taxation. Looking at the supply side, in January to August retail sales expanded by 12.1% (year on year), construction augmented by 10.1%, industrial production grew by 4.3%, and agriculture shrank slightly (–1%). Unemployment (labor force survey data) remained largely stable (7.2% in August 2006).

Terms of trade improve further and twin surpluses remain very high

Notwithstanding the latest drop of oil prices in September 2006, Russia's terms of trade have continued to improve overall in recent months. This improvement and the sustained prudence of macroeconomic policies have kept Russia's twin surpluses very high. The current account surplus exceeded 13% of GDP in the first half of 2006, as high as in the first half of 2005. Net FDI inflows came to 1.7% of GDP, while net portfolio flows remained limited. These developments resulted in an increase of total reserves of 14.2 percentage points of GDP (see below). In the first three quarters of 2006, the current account surplus appears to have risen further. The federal budget surplus is fairly stable at an estimated 8.8% of GDP in January to August 2006. Despite this impressive level, IMF calculations suggest that the government's nonoil deficit has risen since 2004,[19] which would point to a degree of fiscal relaxation recently. The government's budget plan for 2007, a year of parliamentary elections, was approved by the State Duma in first reading in September 2006. It is based on a less conservative oil price assumption (USD 61 per barrel of Urals grade crude) than previous budgets and aims at a surplus of 4.8% of GDP.

Foreign exchange reserves and the stabilization fund have reached new record levels

Foreign exchange reserves (including gold) reached a new record level of EUR 209.9 billion at end-September 2006 (which corresponds to over 16 months of goods and services imports). Russia's budgetary stabilization fund

[19] *IMF Article IV projections as of October 2005 and June 2006.*

more than doubled within a year to EUR 55.7 billion at end-September, which is quite remarkable given that the authorities had used this source to prepay the rest of the country's Paris Club debt (EUR 18.7 billion) in August. This early redemption was the largest such transaction so far on record.

Some nominal appreciation has helped trim still rather high inflation

The Central Bank of Russia (CBR) – whose main monetary policy instrument continue to be foreign exchange market interventions – has allowed the ruble to nominally appreciate by 4% against the U.S. dollar from end-March to end-September 2006, whereas the ruble's exchange rate against the euro has remained largely stable (–1%). This helped reduce the inflation rate modestly to below 10% year on year (9.5% in September 2006). Inflation has been declining despite rising capital inflows in the wake of the abolition of remaining (minor) capital controls and the introduction of full ruble convertibility on July 1, 2006. Accelerating money supply growth (M2 rose by 45% in August 2006 over the corresponding month of the previous year) was largely matched by increasing money demand, reverse currency substitution and further monetization of the economy. The volume of bank loans continued its robust expansion (+30% in real terms in July year on year), although it is still at a relatively modest level (around 28% of GDP at end-2005). Following market developments, the CBR has been cutting policy interest rates; it most recently reduced the refinancing rate – from 12% to 11.5% – at the end of June 2006. In the 6 months preceding the cutoff date, the real effective exchange rate of the ruble went up by 4%, in the 12 months to mid-October 2006, it rose by 10%. The ruble's unrelenting real appreciation seems to be putting the competitiveness of some manufacturing branches under pressure. Russia is showing some symptoms of the Dutch disease, although it does not (yet) appear to have fully contracted the illness.

Stock market capitalization is second to none in emerging markets; capital flight may have reversed

Notwithstanding macroeconomic and structural pressures, financial market exuberance has continued also at the Moscow stock exchange, whose capitalization reached a record level at end-August 2006 (around EUR 735 billion – slightly higher than Russia's expanding annual GDP). In absolute terms, this capitalization has thus outstripped that of any other emerging market stock exchange. Despite its expansion, the banking sector does not fully meet the financial needs of large resource-oriented Russian corporations, which have continued to take up funds abroad. While the state has been cutting its foreign liabilities, the private sector has become the country's main debtor. Russia's gross external debt is estimated to have declined to 30% of GDP at end-September 2006. Nonfinancial enterprises account for about half of this debt, credit institutions for about a quarter, and the authorities only for the remainder. According to CBR data, Russia's traditional net private sector capital outflows (which are also a measure of capital flight)[20] have lately been reversed and have turned into net capital inflows: While in 2004, net private sector capital outflows had still come to 1.4% of GDP, 2005 witnessed a slight inflow (0.2% of GDP), which multiplied in the first three quarters of 2006 (to around 4% of pro rata GDP). The expansion of private foreign liabilities may have contributed to this reversal.

[20] *According to CBR methodology, the net outflow of private sector capital equals the net capital outflow of banks, nonfinancial corporations and households (including net errors and omissions of the balance of payments).*

Table 13

Main Economic Indicators: Russia

	2002	2003	2004	2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
	Year-on-year change of the period total in %							
GDP in constant prices	4.8	7.4	7.2	6.4	6.6	7.9	5.4	7.5
Private consumption	8.3	7.4	11.2	10.9	11.5	11.2	10.5	11.7
Public consumption	2.6	2.2	2.2	1.8	2.0	1.8	3.3	4.1
Gross fixed capital formation	2.8	12.8	11.3	10.5	10.2	12.3	5.7	13.6
Exports of goods and services	10.3	12.5	11.8	6.3	5.1	10.3	7.8	5.7
Imports of goods and services	14.6	17.7	22.0	17.3	19.4	18.6	25.7	19.1
	Contribution to GDP growth in percentage points							
Domestic demand	4.1	6.6	8.3	8.3	9.4	9.1	8.5	9.9
Net exports	0.4	0.4	−1.0	−2.3	−3.3	−1.7	−3.9	−3.3
	Year-on-year change of the period average in %							
Labor productivity of industry (real)[1]	7.0	16.5	14.0	7.3	7.1	7.5	6.9	10.2
Gross average wage of industry (nominal)[1]	27.2	25.4	5.2	21.5	21.0	22.9	20.2	20.7
Unit labor cost of industry (nominal)[1]	18.9	7.6	−7.7	13.2	12.9	14.3	12.5	9.5
Producer price index (PPI) of industry	11.7	15.6	24.0	20.7	20.6	16.2	14.8	12.7
Consumer price index (here: CPI)	16.0	13.6	11.0	12.5	12.5	11.2	10.8	9.6
EUR per 1 RUB, + = RUB appreciation	−11.9	−14.5	−3.1	1.7	2.5	8.1	7.9	3.6
	Period average levels							
Unemployment rate (ILO definition)	8.0	8.6	8.2	7.6	7.3	7.5	7.9	7.5
Employment rate	. .	. .	. .	. .	. .	. .	. .	. .
Key interest rate per annum (%)	22.7	17.3	13.5	13.0	13.0	12.9	12.0	12.0
RUB per 1 EUR	29.6	34.7	35.8	35.2	34.8	34.2	33.8	34.2
	Nominal year-on-year change of the period average stock in %							
Broad money (including foreign currency deposits)	31.2	39.2	35.5	33.9	35.8	36.8	35.0	36.1
	Contributions to the year-on-year change of broad money in percentage points							
Net foreign assets of the banking system	19.8	21.3	22.4	34.0	34.2	32.4	30.2	33.1
Domestic credit of the banking system	30.4	29.6	17.6	0.4	1.4	5.8	9.3	10.9
of which:								
claims on the private sector	*28.9*	*29.5*	*30.8*	*30.0*	*29.8*	*32.6*	*32.1*	*34.7*
claims on households	. .	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .	. .
claims on the public sector (net)	*1.5*	*0.2*	*−13.2*	*−29.6*	*−28.4*	*−26.8*	*−22.8*	*−23.7*
Other domestic assets (net) of the banking system	−19.1	−11.7	−4.5	−0.2	0.1	−1.3	−5.2	−8.6
	% of GDP							
Federal government revenues	20.3	19.5	20.5	23.7				
Federal government expenditures	18.4	17.8	16.1	16.2				
Federal government balance	1.8	1.7	4.4	7.4				
Primary balance	3.9	3.4	5.6	8.4				
Gross public debt, general government	37.0	28.6	21.7	14.9				
	EUR million, period total							
Merchandise exports	113,201	120,040	147,168	196,763	53,129.8	58,045.3	56,118.3	60,900.5
Merchandise imports	64,278	67,066	78,192	101,314	26,592.3	31,791.5	26,352.0	30,197.9
	% of GDP, period total							
Trade balance	13.5	13.9	14.6	15.5	15.8	14.2	17.6	16.5
Services balance	−2.9	−2.5	−2.3	−2.0	−2.5	−1.8	−1.4	−1.5
Income balance (factor services balance)	−1.9	−3.0	−2.2	−2.5	−3.8	−2.3	−1.6	−3.5
Current transfers	−0.2	−0.1	−0.1	−0.1	−0.2	−0.2	−0.1	0.0
Current account balance	8.5	8.2	9.9	10.9	9.4	9.8	14.5	11.6
Capital account balance	−3.5	−0.2	−0.3	−1.7	−5.3	−0.3	0.0	0.0
Foreign direct investment (net)	−0.0	−0.4	0.3	0.2	1.9	−3.7	0.7	2.5
	EUR million, end of period							
Gross external debt	143,746	148,489	159,163	222,719	189,171	222,719	226,950	226,225
Gross official reserves (excluding gold)	42,291	58,531	88,661	148,094	129,169	148,094	181,240	205,515
	Months of imports of goods and services							
Gross official reserves (excluding gold)	5.7	7.7	10.1	13.3	10.6	10.9	16.2	15.8
Memorandum item								
	EUR million, period total							
Gross domestic product in current prices	363,558	381,607	473,181	615,679	168,287	184,862	169,102	185,649

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

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

Russia's growth seems to have decoupled from the oil price

It is noteworthy that since 2004 Russia's economic growth – while impressive – has apparently no longer been able to keep pace with the steep rise of the oil price. Thus, Russian growth seems to have decoupled from the oil price. This may be due to emerging capacity bottlenecks, the challenging business climate, the rather modest investment ratio (about 18% of GDP), the rigorous siphoning off of demand by the stabilization fund (established in 2004), the prepayment of large amount of foreign debt (in 2005 and 2006) and some other factors. A substantial and sustained fall of the oil price would reveal whether Russia could resort to a path of nonoil-dependent – but still robust – economic expansion or not.

Cutoff date for data: October 27, 2006.