

Developments in Selected CESEE Countries:

Economic Activity Finally Starting to Recover^{1,2,3,4}

Moderate acceleration of economic activity...

1 Introduction

Economic activity in Central, Eastern and Southeastern Europe (CESEE) finally started to gain some momentum in the second quarter of 2013 after a protracted period of weakness. Average economic growth in the region amounted to 0.2% in the first and to 0.4% in the second quarter of 2013 (quarter on quarter, see table 1). The regional aggregate, however, was held back by Russia, which slipped into recession in mid-2013. Without Russia, growth would have accelerated from 0% in the fourth quarter of 2012 to 1% in the second quarter of 2013. The momentum was driven especially by a boom in Turkey, which started in the first quarter of 2013. In the other countries, growth rates improved only in the second quarter. A turnaround in the Czech Republic as well as a firming of growth in Poland and Romania played an important role in this respect. It needs to be noted, however, that despite some improvement, economic activity remained comparatively weak in several other CESEE countries. This is especially true for Slovenia but also for Croatia and Bulgaria.

...as domestic demand starts to pick up

In many countries, the improvement was underpinned by a pick-up in domestic demand, especially consumption, which had been a drag on economic activity in the past. Consumption improved noticeably in the second quarter and the component no longer dampened GDP growth in any country under review here but Slovenia (see chart 1).

Table 1

Real GDP Growth

	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
	Period-on-period change in % (seasonally and working day adjusted)					
Slovakia	0.4	0.3	0.2	0.1	0.2	0.3
Slovenia	-0.5	-1.3	-0.4	-1.0	-0.5	-0.3
Bulgaria	0.3	0.1	0.1	0.1	0.1	-0.1
Czech Republic	-0.4	-0.4	-0.3	-0.3	-1.3	0.6
Hungary	-1.5	-0.5	0.0	-0.5	0.6	0.1
Poland	0.4	0.0	0.3	0.1	0.2	0.4
Romania	-1.0	1.4	-0.5	1.0	0.4	0.5
Croatia	-0.9	-0.5	-0.3	-0.4	0.0	-0.2
Turkey	0.4	1.8	0.2	0.0	1.6	2.1
Russia	-0.3	0.4	1.2	0.5	-0.2	-0.3
CESEE average ¹	-0.1	0.6	0.6	0.3	0.2	0.4
CESEE average (excl. Russia) ¹	0.0	0.7	0.1	0.0	0.6	1.0
Euro area	-0.1	-0.3	-0.1	-0.5	-0.2	0.3

Source: Eurostat, national statistical offices.

¹ Average weighted with GDP at PPP.

¹ Compiled by Josef Schreiner with input from Stephan Barisitz, Markus Eller, Antje Hildebrandt, Mathias Lahnsteiner, Isabella Moder, Thomas Reiningger, Tomáš Slačik, Jarmila Urvová, Zoltan Walko and Julia Wörz.

² Cutoff date: October 4, 2013. This report focuses primarily on data releases and developments from April 2013 up to the cutoff date.

³ This report covers Slovakia, Slovenia, the Czech Republic, Bulgaria, Hungary, Poland and Romania as well as Croatia, Turkey and Russia.

⁴ For statistical information on selected economic indicators for CESEE countries not covered in this section (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia and Ukraine), see the Statistical Annex in this issue.

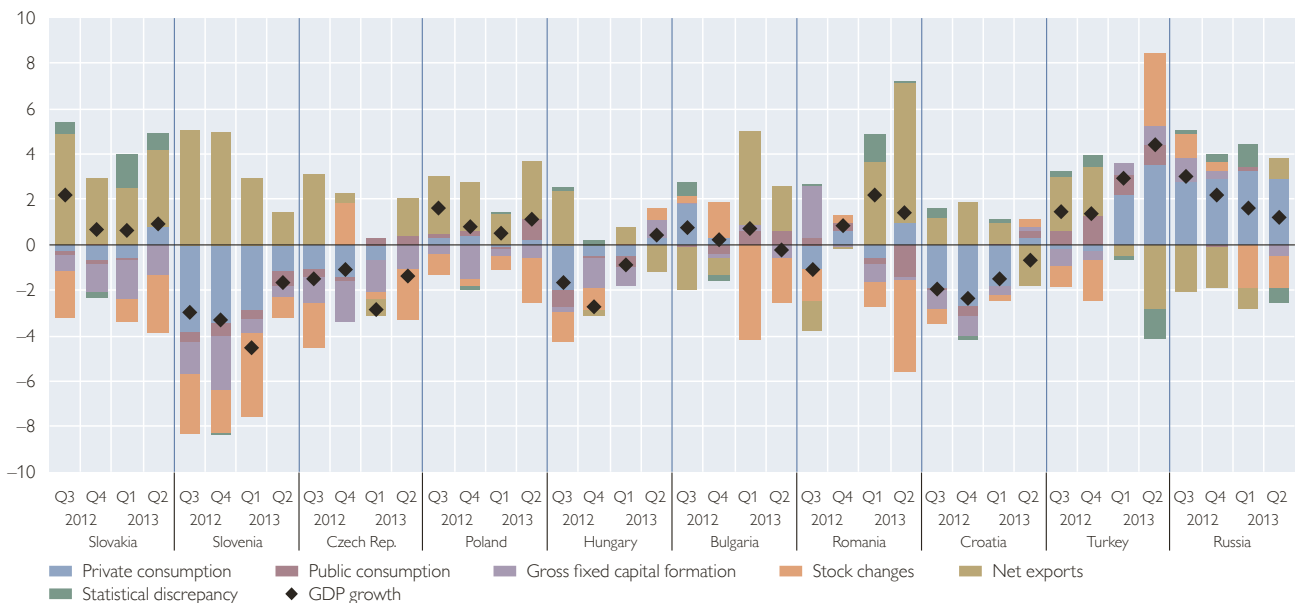
The improvement in consumption went hand in hand with a stabilization of CESEE labor markets: Seasonally adjusted unemployment rates surpassed their peaks in late 2012 or early 2013 and since then have trended downward in many countries. The general employment situation is less benign, though. Still, employment increased slightly in Bulgaria, the Czech Republic and Hungary and more noticeably in Turkey in the first half of 2013. Comparatively strong decreases were reported for Slovenia and Croatia. Furthermore, some signs of a turnaround in wage growth could also be observed in several countries. Real wage growth entered positive territory in Slovakia, the Czech Republic, Hungary and Poland in the first half of 2013 (also against the background of moderating inflation) while stronger wage losses were again observed only in Slovenia and Croatia, which was also related to more pronounced economic adjustment needs. Real wages in Turkey and Russia in turn grew strongly in the first half of 2013.

Sentiment generally brightened during the observation period. The Economic Sentiment Indicator of the European Commission (not available for Russia) for example reached 98 points on average in September, the highest reading since March 2012. Since the beginning of the year, it has been increasing by more than 6 points, and it is now slowly approaching its long-term average (of 100). The improvement was rather broad based among all sectors of the economy, but it was consumer sentiment that impacted most on the index. This general picture is, in principle, also confirmed by manufacturing PMI data (which, however, are not available for all countries). The index has been showing a clear upward trend in Poland, the Czech Republic and Turkey since spring and summer and currently stands clearly above 50, indicating an expansion. Developments have been less

Chart 1

GDP Growth and Its Main Components

Contribution in percentage points, GDP growth in %



Source: Eurostat, national statistical offices.

positive only in Russia, where the index declined to below 50 in July and remained at this level in August and September.

Brightening sentiment, however, has been reflected so far only to a limited extent in gross fixed capital formation, given the very early stage of the recovery. In the second quarter, gross fixed capital formation contributed positively to growth only in Croatia, Hungary and Turkey. Capacity utilization has been growing only slowly for the past few quarters, with notable excess capacities remaining in place according to historical averages in most countries under review here. This went hand in hand with the rather anemic development of industrial production since late 2012. Output growth of the sector hovered between 0% and 1% on average in the past few months. The region, however, was heterogeneous in this respect. While Hungary, Poland, Romania and Turkey saw accelerating industrial output, other countries (Slovakia, Bulgaria, Croatia, Slovenia, the Czech Republic) reported a deceleration or decline.

Net exports still important source of growth in many, though not all countries

Net exports remained a pillar of growth in many countries (see chart 1). This is especially true for Slovakia and Poland, where foreign demand has been a driving force of growth for several quarters, but also applies to Bulgaria, Romania and Russia. In the latter, this component's growth contribution turned positive in the review period. In some other countries the opposite was observed: Net exports started to dampen GDP growth. This is especially true for Hungary, Croatia and Turkey – countries where domestic demand started to play a more prominent role. Net exports' contribution to growth, however, decelerated strongly also in Slovenia. Looking at exports and imports separately reveals that Romania and Bulgaria recorded particularly vigorous export growth in the first half of 2013, while exports picked up tangibly also in Poland in the second quarter. In turn, export momentum remained weakest in the Czech Republic and Croatia. Imports soared in Turkey, but were much more moderate in the other countries of the region; overall, however, they fared better than in the second half of 2012.

In order to take full advantage of the moderate firming of external demand, safeguarding price competitiveness remains key. Overall, developments in manufacturing unit labor costs (ULC; measured in euro) were relatively favorable in CESEE, albeit heterogeneous across countries. Hungary, Croatia and Turkey but also Russia lost some competitive edge against the euro area despite (moderately) weakening currencies, which was related to weak productivity readings and – especially in Turkey and Russia – also to vivid labor cost increases (above 10% in the second quarter). ULC developments (in manufacturing) in the other countries were more favorable. ULCs even declined somewhat in the Czech Republic, Romania and Slovakia in the second quarter. While Romania and Slovakia benefited from robust productivity growth, declining productivity in the Czech Republic was compensated for by stagnating labor costs and a slight depreciation of the koruna in annual comparison.

Fledgling upturn still rather fragile

While the moderately positive momentum in private consumption, brightening sentiment and an improving external environment bode well for an economic recovery, the upturn is not yet broad based and rather fragile. Investments are not yet on a clear upward path and the signals derived from activity indicators remain mixed. The continuing weakness of credit expansion (see chart 2) fits this picture. The growth of domestic credit to the private sector has remained anemic during the review period throughout most of CESEE, with annual growth rates often

only at around 2% or below and not showing a clear upward trend. Robust growth rates were reported only for Turkey and Russia and to a much lesser extent for Poland. Subdued credit developments are, in general, not untypical of incipient recoveries, during which credit demand is usually low (“creditless recoveries”). However, it is also possible that credit supply bottlenecks are restraining what would otherwise be a stronger recovery of the real economy. While it is notoriously difficult to disentangle credit demand and supply factors, again, the situation in CESEE seems to differ to some extent across countries.⁵

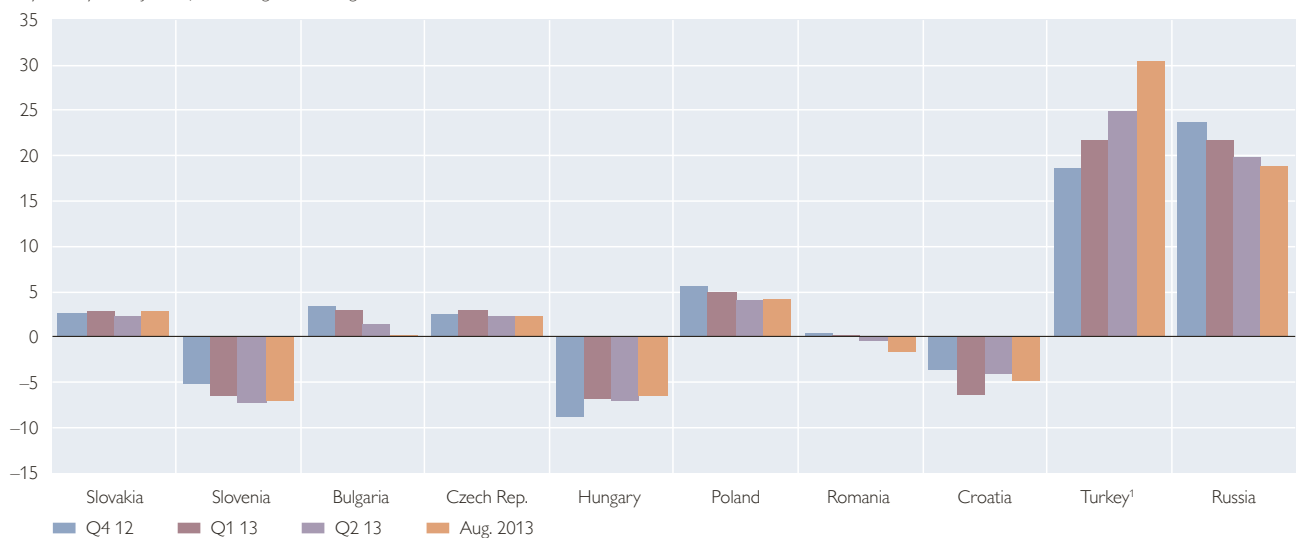
Several countries, particularly Hungary and Slovenia, but also Croatia and as of late (though to a much lesser extent) Romania, have faced a deleveraging of households and/or corporations, which was attributable not only to the weak economy, but also in part to domestic banking sector problems (including sectoral taxes, high NPL burdens, partly due to foreign currency loans going bad, and/or governance problems in a few countries). In several countries, this is also mirrored in lower consolidated exposures of BIS-reporting banks. More specifically, exposures vis-à-vis Hungary, Romania and Slovenia had been declining for several quarters already and continued to do so in the first quarter of 2013 (more recent data have not been available at the time of writing).

For the region as a whole, however, the consolidated exposures of BIS-reporting banks went up in early 2013. The highest increases could be observed in the Czech Republic and Poland, but exposures also grew in Turkey and Russia. Furthermore, surveys like the Emerging Markets Bank Lending Conditions Survey of the Institute of International Finance (IIF) show that lending conditions in emerging Europe eased in the first half of 2013. The improvement was driven by easing

Chart 2

Growth of Credit to the Private Sector

%, year on year, adjusted for exchange rate changes



Source: National central banks.

¹ Nonadjusted.

⁵ For detailed information on financial market and banking sector developments, see the OeNB's Financial Stability Report 26.

credit standards for most credit categories, growing loan demand (for consumer, housing and particularly business loans as manufacturing activity and consumption stayed relatively stable) as well as easing domestic funding conditions. International funding conditions, however, tightened toward the end of the second quarter of 2013 for the first time since the third quarter of 2012, as expectations about a tapering of asset purchases by the U.S. Federal Reserve increased financial market volatility and dampened capital flows to emerging markets (even leading to capital flow reversals in some cases). This development, however, had a notable impact only on the bigger markets of the region, namely Russia (which had been facing rather persistent net capital outflows in the recent past) and Turkey.

Growth is projected to pick up more strongly only in 2014

Against the background described above, recent forecasts expect economic activity to pick up in the course of the year but to remain slack on average in 2013. According to the IMF, annual average growth should come in at 1.7% in the CESEE region, somewhat below the previous year, given negative carryover effects and weakening economic activity in Russia. Growth, however, is set to accelerate in 2014, and the regional GDP should expand by 2.7%. All in all, the recovery will remain comparatively muted in the next two years.⁶

Fading price pressures in most countries

Price pressures moderated substantially throughout most of the region during the review period (see chart 3). Only Turkey reported a rise in the inflation rate. Disinflation was most pronounced in Bulgaria and Romania (more than 2 percentage points from the first quarter of 2013 until August) and also notable in Croatia and Hungary (above 1 percentage point in the same period). The development was driven to a substantial extent by lower contributions to inflation by energy (in part related to downward adjustments of administered prices, e.g. in Hungary and Bulgaria). In some countries, also unprocessed food prices started to exert a dampening impact on inflation given a base effect triggered by a good harvest starting to enter the market (e.g. in Romania, Croatia and Bulgaria).

Chart 3

HICP Inflation and Its Main Drivers

Contribution to year-on-year change in HICP in percentage points; HICP in %



Source: Eurostat.

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

⁶ For a detailed forecast, see the OeNB-Bank of Finland Outlook for Selected CESEE Countries on p. 38 of this issue.

Against this background, inflation was strongly driven by volatile prices for fuel and food across the region. Therefore, core inflation rates decreased much less than headline inflation. Nevertheless, core inflation was fairly benign during the review period in most countries. Core inflation rates hovered at around 2% or below in August and displayed a moderate downward trend in many countries. Uncertainty with regard to the employment situation, fiscal austerity, and subdued domestic credit dampened demand. In combination with notable excess capacities, this tempered wage demands and deprived retailers and producers of pricing power.

The main exception to this pattern was Turkey. Core as well as headline inflation rates increased noticeably during the review period and are now the highest among the countries of the region. Booming domestic demand and a depreciating currency (given political turbulences as well as the recent global financial market disruptions) contributed to elevated price pressures. Headline inflation has remained elevated also in Russia, but no disaggregated price data are available.

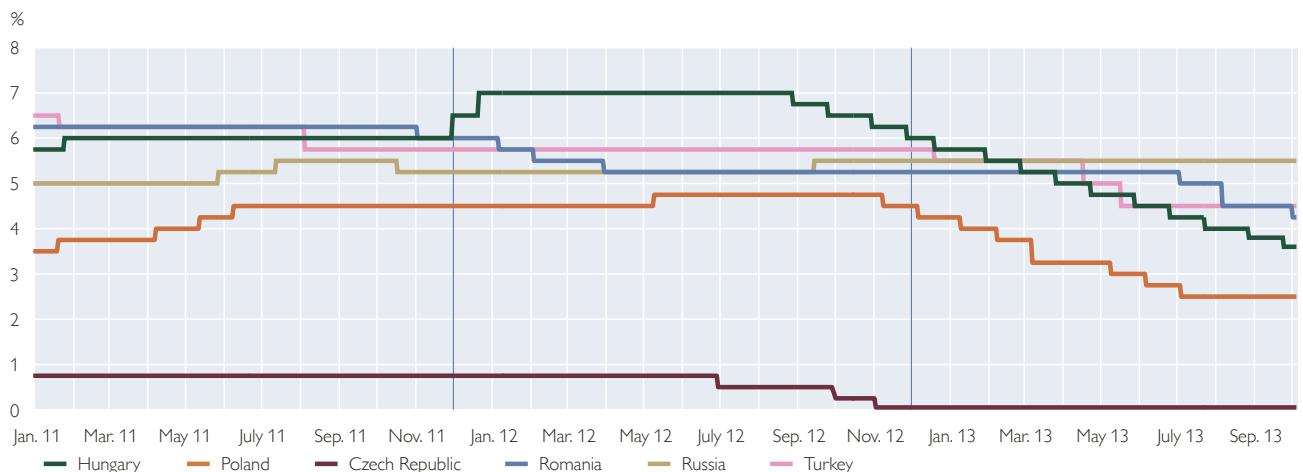
Disinflation provided room for a continuation of monetary accommodation that many central banks of the region have pursued since roughly mid-2012 (see chart 4). The Hungarian central bank cut its policy rate by a total of 140 basis points to 3.6% from mid-April to early October, the Polish and the Romanian central banks cut their rates by 75 basis points and 100 basis points to 2.5% and 4.25% respectively. The Turkish central bank reduced its one-week repo rate by 50 basis points to 4.5%, while its overnight lending rate was raised by 125 basis points to 7.75% in an effort to fight currency depreciation, which set in after the tapering announcement by the U.S. Federal Reserve in early summer. In the two euro area countries Slovenia and Slovakia, the ECB's interest rate decision of early May was implemented. The Czech Republic's policy rate has been standing at "technically zero" since October 2012.

Combined current and capital account positions improved further (in some cases substantially) in most countries of the region during the observation period and were in surplus or broadly balanced throughout most of CESEE (see chart 5). The improvement was most pronounced in Bulgaria, Romania and Slovenia, where

Further external adjustment in the first half of 2013

Chart 4

Policy Rate Developments in CESEE



Source: National central banks.

the combined current and capital account gained around 2.5% of GDP from the fourth quarter of 2012 to the second quarter of 2013 (four-quarter moving sums). It was mostly the trade balance that drove the adjustment, as external demand started to recover and imports continued to contract in some countries. In Hungary, higher surpluses in the capital account and in current transfers were a factor too, reflecting in part a refunding by the European Commission due to earlier overpayments by Hungary to the EU. Some deterioration, however, was also observed in Turkey and Russia. While this trend has already lasted for several quarters in Russia, it is of rather recent nature in Turkey. In both countries, the development was driven by a deterioration of the goods and services balances, given vivid consumption growth and weaker currencies. In Russia, a lower oil price was a further factor. It needs to be noted, though, that Russia still reported a notable current account surplus of more than 2% of GDP (four-quarter moving sum) in mid-2013.

Capital flows to CESEE decelerated somewhat

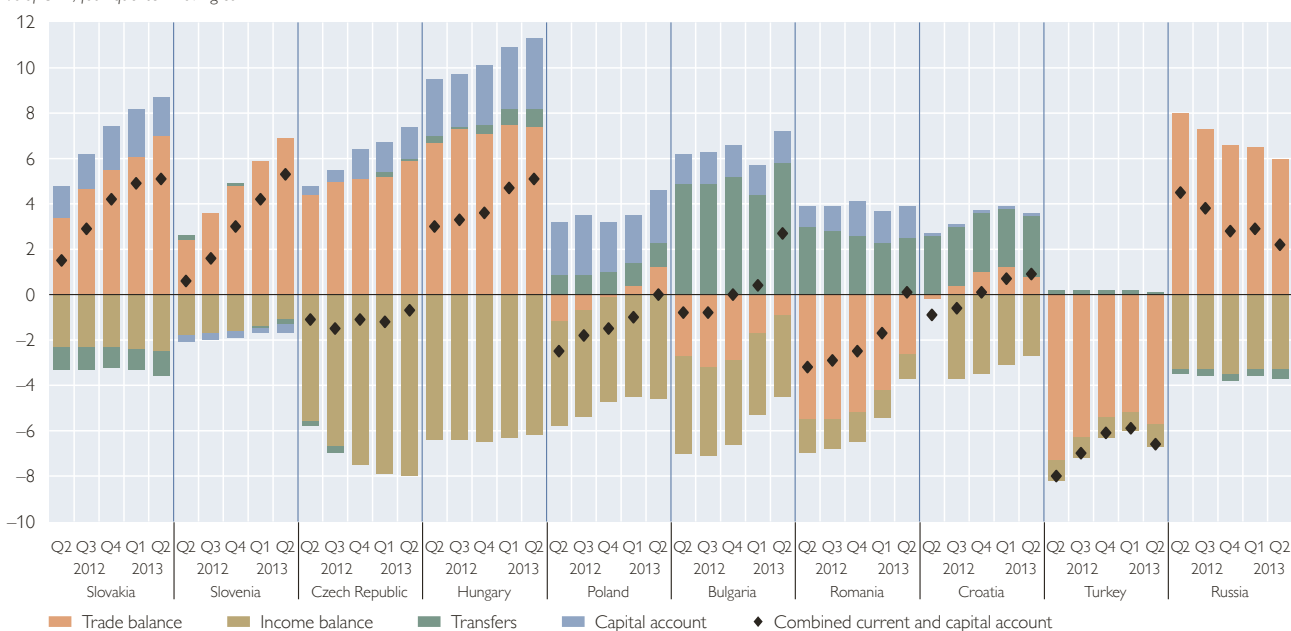
Net capital flows to the ten CESEE countries as a whole decelerated somewhat from 6.1% of GDP in the fourth quarter of 2012 (four-quarter moving sum) to 5.3% of GDP in the second quarter of 2013 (four-quarter moving sum) (see chart 6). However, the deterioration took place mainly in the second quarter and was driven mostly by other investments. In the latter component, it was especially Russia that weighed on the regional aggregate, with 85% of net outflows originating from that country. The other components of the financial account were roughly stable, some (e.g. FDI) even recorded higher inflows during the review period.

At country level, however, developments were heterogeneous. Strong deteriorations in the financial account balance were observed in Slovenia and Bulgaria (related to other investments, which, however, still recorded a small net inflow in

Chart 5

Combined Current and Capital Account Balance

% of GDP, four-quarter moving sum



Source: Eurostat, IMF, national central banks.

Bulgaria) and to a lesser extent in Poland (related to portfolio flows). The financial account balance, by contrast, improved noticeably in Hungary, Turkey and Slovakia. In the latter two countries this was at least in part related to other investments, while in Hungary it was higher portfolio inflows that had a positive impact (reflecting mostly government bond issues and increased holdings of central bank bills by foreigners). In the other countries of the region, the financial account balances remained roughly stable.

In the Czech Republic and Bulgaria, net FDI inflows made up the largest positive component of the financial account. Net portfolio investment represented the financial account’s largest positive component in the other countries of the region. (Net) other investments – in particular loans – were negative in all countries under observation but Turkey and Bulgaria. As indicated above, net outflows from this category were related to bank deleveraging in some countries, in particular in Hungary, Slovenia, Romania and Croatia.

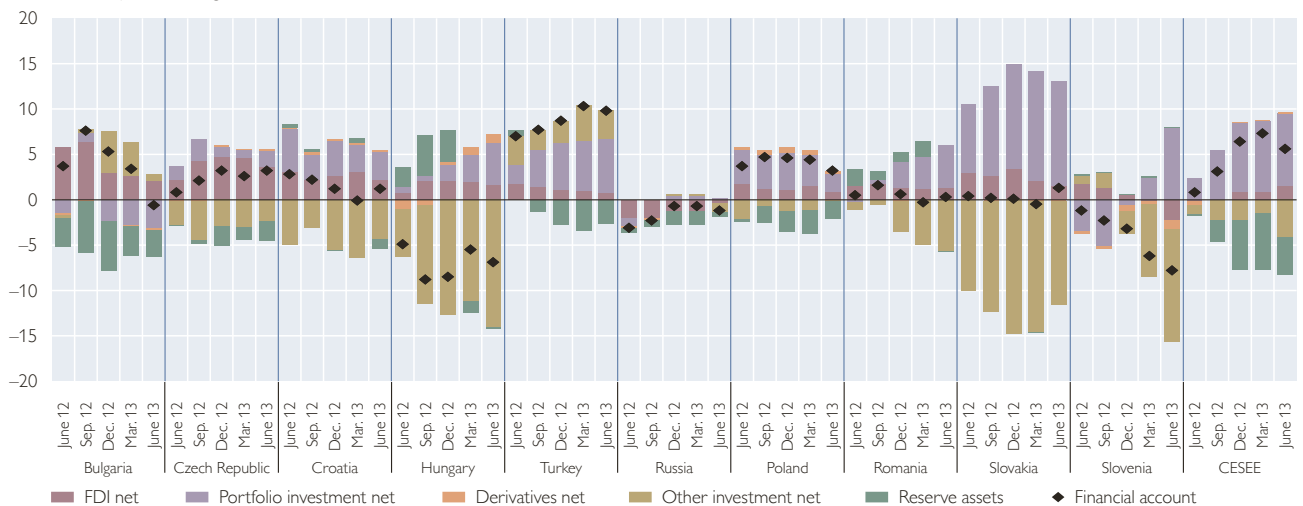
Excessive deficit procedures (EDP) were abrogated for two CESEE countries in the review period. In 2012, Hungary and Romania managed to bring down their public deficits in a sustainable way to below 3% of GDP, according to the EU. Given unfavorable forecasts, however, the EDP in Hungary was put to an end only after the Hungarian government had adopted further corrective measures in May. Poland was originally also required to remove its excessive deficit in 2012. After it had reported a budget deficit of 3.9% of GDP for 2012, however, the deadline was extended by the EU to 2014. According to the European Commission, an achievement of the target by that date would require further consolidation measures amounting to 0.4% of GDP both in 2013 and 2014. Also in Slovenia, the target date had to be extended by two years, from 2013 to 2015, due to unexpected adverse economic developments, including a double-dip recession, weakening labor markets and large macroeconomic imbalances. Furthermore, the European Commission projects public debt in Slovenia to climb above 60% of GDP in 2013 (driven by a high budget

Mixed progress on the fiscal front

Chart 6

Financial Account Balance

% of GDP, four-quarter moving sum



Source: National central banks.

deficit, partly due to bank recapitalization measures and a further contraction of GDP). In the Czech Republic and in Slovakia, two other EU Member States covered here, excessive deficits are scheduled to be removed by 2013. It is very likely that in the near future, an EDP will be opened against Croatia, which joined the EU in July 2013,⁷ given that its budget deficit in 2013 will tangibly exceed 3% of GDP.

Budgetary targets as published in the stability and convergence programs this spring show a mixed picture concerning changes in the fiscal stance in 2013. Substantial consolidation measures are planned in Slovakia and the Czech Republic in an effort to reach EDP targets. In both countries, deficits should decline to slightly below 3% of GDP in the current year. Given the fact that the Czech Republic's 2012 deficit (4.4% of GDP) was strongly affected by one-off factors (amounting to some 1.9% of GDP), meeting the target this year appears to be within reach. Achieving the deficit target could prove more challenging for Slovakia. The latest Slovakian finance ministry forecast, however, still maintains that this target is achievable. Some further consolidation is also envisaged in Romania, Turkey, Poland and Croatia. In the latter two countries, however, the public deficits will remain above 3% of GDP. Budget gaps are planned to widen somewhat in Bulgaria and Hungary (though remaining below 3% of GDP) and – in the light of substantial additional spending on bank recapitalization measures – substantially in Slovenia, despite various spending cuts and tax increases.

Box 1

Ukraine: External Risks on the Rise as Foreign Exchange Reserves Shrink

Annual GDP growth remained negative in Ukraine in the first half of 2013 (–1.2%). Annual inflation rates also stayed in negative territory in the first half of 2013, while the current account deficit amounted to 7.3% of GDP (based on the four quarters up to mid-2013) compared to 8.5% in 2012.

After stabilizing in the first half of 2013, official foreign exchange reserves shrank again more recently. At end-August, reserves stood at USD 21.7 billion, down 44% from the post-Lehman peak reached in April 2011. The current level corresponds to less than three months of imports. The most recent reduction was caused by the redemption of foreign currency debt, including to a large part repayments of loans to the IMF extended under previous Stand-By Arrangements (SBAs). Outflows were no longer compensated for by eurobond issuances, as had happened earlier this year, due to a deterioration in market conditions. Prospective debt service needs together with the persistent current account deficit indicate further pressure on reserves in the near future. The central bank pointed out that it had not intervened in the recent past on the foreign exchange market to support the hryvnia, which has been broadly stable against the U.S. dollar.

No tangible progress has been made as regards a new SBA since negotiations had ended without a final agreement in early 2013. The EU association agreement (including a deep and comprehensive free trade agreement) could be signed at the Eastern Partnership summit in Vilnius in November, if the EU sees tangible progress in all of the benchmarks set out in the December 2012 Council conclusions.

In September, Moody's cut Ukraine's government bond rating to Caa1 from B3, citing heightened concerns over Ukraine's external liquidity position, increased downside risk related to future negotiations with the IMF and increased political and economic risks due to deteriorating relations with Russia in the context of a possible signing of the association agreement. Following this step, CDS premia and eurobond spreads increased markedly.

⁷ See 73rd East Jour Fixe: Croatia – 28th EU Member State. In: Focus on European Economic Integration Q3/13.

Western Balkans:¹ Modest Recovery Clouded by Fiscal Challenges

After drifting into recession in 2012, the first half of 2013 brought a modest recovery in all Western Balkan countries on the back of either rising net exports (Montenegro and Serbia), investments (FYR Macedonia) or public consumption (Albania). For Bosnia and Herzegovina, no quarterly GDP data are yet available, but other activity indicators also point to positive GDP growth in the first half of 2013. For Kosovo, neither quarterly GDP data nor other activity indicators are available. It is also noteworthy that Montenegro revised 2012 GDP growth down from -0.5% to -2.5% , experiencing the deepest double-dip recession in the region.

In line with the slow pickup, the labor market situation seems to have stabilized in most countries, except for Bosnia and Herzegovina and Serbia, where participation and employment rates deteriorated further. Unemployment remains very high in the region, especially in Bosnia and Herzegovina, FYR Macedonia and Kosovo.

The external positions of the Western Balkan countries slightly improved during the review period. Increasing exports and either declining or stagnating imports led to reduced trade deficits in all countries. Consequently, the current account gaps narrowed everywhere except in FYR Macedonia and Kosovo, ranging between 3.4% of GDP in FYR Macedonia and 16.1% of GDP in Montenegro (in the second quarter on a four-quarter moving sum basis). On the financing side, net FDI flows increased in the first half of 2013 in all countries but FYR Macedonia and Montenegro and covered between 30% (Serbia) and 90% (Montenegro) of the current account deficits.

Despite a better economic performance, the growth of credit to the nonbank private sector² was weaker in the first half of 2013 than in 2012 in almost all countries, ranging between -0.1% in Albania and 3.6% in FYR Macedonia at the end of the second quarter of 2013. Especially bank lending to the corporate sector weakened partly due to tightened credit standards. In Montenegro, credit growth turned positive in the first half of 2013 after several years of contraction. In all countries, credit quality deteriorated further in the first half of 2013 compared to 2012, with shares of nonperforming loans in total loans reaching levels between around 7.6%³ in Kosovo and 24.4% in Albania.

Inflationary pressure was subdued across most of the region during the review period, ranging between 0.5% in Bosnia and Herzegovina and 2.2% in Albania in the second quarter of 2013. Only in Serbia did inflation remain elevated (10.4%) but it has been gradually declining since the end of 2012 and is expected to recede further toward the central bank's inflation target ($4\% \pm 1.5$ percentage points) over the coming months. In anticipation of declining price pressures, the Serbian central bank cut the key interest rate in two steps by 50 basis points (May) and by 25 basis points (June) to currently 11%. The Bank of Albania reduced its policy rate in July 2013 to 3.5%, and the inflation target of $3\% \pm 1$ percentage point is currently being met comfortably. FYR Macedonia also lowered its key interest rates in July from 3.50% to 3.25%. Overall, the interest rate cuts were motivated by lower price pressures in a context of continuously weak domestic demand.

Weak revenues, pre-election spending, e.g. in Albania, or unexpected expenditures (bankruptcy of the aluminium plant KAP, where the state guaranteed the debt), like in Montenegro, leave the Western Balkans in a challenging fiscal situation. Regarding public debt, Serbia surpassed the 60%-of-GDP level in the first quarter of 2013, and in Albania, public debt further increased to above 64% of GDP in the second quarter of 2013. In light of the latest developments, Serbia announced the introduction of another austerity package recently,

¹ The Western Balkans comprise the EU candidate countries FYR Macedonia, Montenegro, and Serbia, as well as the potential candidate countries Albania, Bosnia and Herzegovina, and Kosovo. The designation of Kosovo is without prejudice to positions on status and in line with UNSCR 1244 and the opinion of the International Court of Justice on the Kosovo Declaration of Independence.

² Data on credit growth are on a foreign exchange-adjusted basis.

³ In April 2013 according to data of the IMF.

aiming to cut the budget deficit to 2% of GDP by 2017. Noticeably, Montenegro adopted a fiscal rule limiting budget shortfalls at 3% and public debt at 60% of GDP from 2015 onwards.

In the reporting period, preparations of Western Balkans countries for EU accession moved some steps forward: Accession negotiations with Montenegro are proceeding, accession negotiations with Serbia are expected to be opened in the near future, and Albania is heading toward EU candidate country status.

In Bosnia and Herzegovina, the second (May 2013) and third (July 2013) reviews of the two-year SBA of SDR 338.2 million have taken place. So far, a total of SDR 169 million have been disbursed. The program will be completed in September 2014. Regarding Kosovo, a total of SDR 78 million of an approved SBA of SDR 91 million approved in April 2012 has been paid out so far. A tranche of SDR 4.2 million was made available after the third review in April 2013, but the country has not yet drawn upon it. The fourth review successfully took place in July 2013. After completing its financial arrangement with FYR Macedonia, the IMF concluded the first post-program monitoring with the country in June 2013. Currently, Albania, Montenegro and Serbia have no financial arrangements with the IMF.

Box 3

A Tribute to a Determined Adjustment Effort: Just Five Years after a Wrenching Fiscal Crisis, Latvia Becomes the 18th Member of the Euro Area in 2014¹

Following the positive assessment of Latvia's economic convergence in the European Commission's and the ECB's convergence reports of June 5, 2013, and the June 2013 EU Council conclusion to welcome Latvia's entry into the euro area, the Ecofin Council adopted a decision allowing the country to join the euro area on January 1, 2014. The Ecofin Council also irrevocably fixed the conversion rate of the Latvian lats at its central parity within ERM II agreed on in early 2005, which is LVL 0.702804 to EUR 1.

In the meantime, the currency changeover has started: While dual price display both in Latvian lats and in euro is recommended for a period between July 2013 and December 2014, it is mandatory for a quarter before and half a year after euro introduction so that people can get used to the new currency. The dual circulation period of lats and euro (the period during which both currencies are legal tender) will be short, lasting only until January 14, 2014. While Latvian commercial banks will exchange lats coins and banknotes for six months following the introduction of the euro, the Latvian central bank will do so free of charge for an unlimited period of time.

Latvia has taken substantial efforts to meet the criteria for euro area membership in recent years. Wages and prices have been highly flexible, and adjustments took place under a fixed exchange rate regime for almost two decades; this was a particular challenge especially during the crisis, which hit the country particularly hard and initially sparked a debate about the sustainability of the peg. In the wake of the deep downturn in the years 2008–2010, Latvia underwent a radical adjustment and austerity program supported by EU-IMF-led financial assistance. This has helped Latvia to resume robust growth and to fulfill all Maastricht criteria in a sustainable manner. With respect to future inflation developments, however, risks might be tilted to the upside, given that price level convergence is not yet complete.² In fact, Latvia turned out to be the fastest-growing economy in the EU in 2012 and is forecast to outperform all other EU countries also in 2013.

Latvia's efforts to join the euro area and the prospect of euro area membership helped build market confidence. A small and very open economy well integrated into the EU, Latvia is expected to benefit strongly from the common currency. Euro area membership will reduce transaction and information costs, leading to increased trade and financial integration.

¹ See also the 74th East Jour Fixe summary on p. 90 in this issue.

² For details see the ECB's Convergence Report, June 5, 2013.

Price transparency will support competition. Additionally, euro area membership offers a credible framework for price stability, implying lower risk premia and lower long-term interest rates. Moreover, the euro provides shelter against financial market turbulences in particular in times of crisis. At the same time, smooth participation in the euro area hinges on retaining a strong ability and willingness to adjust to shocks, just like for any other country taking part in the European currency area.

2 Slovakia: Growth Remains Moderate but Positive, Record Current Account Surplus, Incomplete Fiscal Consolidation

Net exports drive GDP even though exports hit bottom ...

The Slovak economy started to pick up slightly in the first half of 2013 in quarter-on-quarter terms. The biggest contribution came from net exports, despite the fact that both exports and imports seem to have hit bottom in early 2013 (both decreasing quarter on quarter). Household consumption turned positive after two years' decline, owing to continuously improving consumer confidence, higher gross disposable income and lower savings. Government consumption increased only slightly, due to continuing consolidation. Gross fixed capital formation decreased substantially year on year but may have reached its turning point, posting quarter-on-quarter growth for the first time in the second quarter of 2013 following five consecutive negative quarters. Investment activity was low both in the public and in the private sectors, due to fiscal consolidation, low capacity utilization and worsened financing conditions attributable to both lower profitability of corporations and tighter credit conditions (as reported in the country's bank lending survey).

...leading to yet another trade balance record

The current account surplus kept growing, reaching a cumulative surplus of 4.8% of GDP in the first half of 2013, mainly owing to the goods and services balance, which reached a record surplus of 9.5% of GDP in the second quarter. The negative income balance resulted from FDI earnings. Despite a relatively strong inflow of FDI, both from reinvested earnings and new equity capital, overall net FDI inflows turned negative due to an outflow of other FDI capital.

Labor market remains the sore spot of the economy

The situation on the labor market still shows no considerable signs of improvement. Employment broadly stagnated in the first half of 2013. The unemployment rate decreased by 0.5 percentage points in the second quarter, however, it remains among the highest in the EU. Moreover, it was the number of part-time workers that increased, while the number of full-time employees has been declining for the past four quarters. On a positive note, real wages increased again, after two years' decline, mainly due to the low inflation rate. Average annual HICP inflation has continued moderating into 2013, standing at 1.4% in August. Its decline has been mainly driven by absent demand pressures, lower global fuel prices, as well as by a decline in regulated electricity prices.

Fiscal consolidation is not yet complete, the debt brake kicks in for the first time

Slovakia is expected to bring its general government deficit down to 2.9% by 2013 under the Excessive Deficit Procedure. According to the latest finance ministry forecast, this seems achievable. Nevertheless, as the economy remains slack and with some of the consolidation measures taken so far being one-offs (e.g. weakening the private pension pillar in favor of the pay-as-you-go pillar), the sustainability of fiscal adjustment remains to some extent in question. The deficit for 2014 is planned to come in again at 2.9% of GDP. A public administration reform, entailing expenditure cuts, was launched in 2013, but some of its details are still unclear; for instance, cutting public sector employment is not part of the plan. Another area offering room for improving the fiscal position is fighting tax evasion (according to the European Commission, Slovakia has one of the largest VAT gaps in the EU). As part of this effort, in September 2013, the finance ministry has started a VAT receipts lottery. A breach of the lowest limit of the constitutional debt brake (50% of GDP) was recorded in 2012, and consequently, the finance minister had to explain this situation to parliament and present corrective measures, which, however, the Slovak fiscal council found to be insufficiently specified.

Table 2

Main Economic Indicators: Slovakia

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.4	3.2	2.0	2.9	2.6	2.1	0.7	0.6	0.9
Private consumption	-0.7	-0.5	-0.6	-0.1	-0.3	-0.6	-1.2	-1.0	1.5
Public consumption	1.0	-4.3	-0.6	0.5	-2.1	-0.4	-0.3	-0.6	-0.1
Gross fixed capital formation	6.5	14.2	-3.7	-3.3	-2.5	-3.7	-5.0	-8.4	-6.4
Exports of goods and services	16.0	12.7	8.6	5.0	10.8	11.6	7.1	4.2	4.7
Imports of goods and services	14.9	10.1	2.8	-0.2	1.6	5.7	4.2	1.6	1.3
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.6	1.2	-2.9	-0.8	-5.5	-3.3	-1.9	-3.3	-3.1
Net exports of goods and services	0.7	2.0	5.2	4.9	8.3	4.9	2.8	2.5	3.4
Exports of goods and services	11.3	10.2	7.7	4.7	9.8	9.7	6.6	4.0	4.6
Imports of goods and services	-10.6	-8.1	-2.5	0.2	-1.4	-4.8	-3.7	-1.5	-1.2
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-1.4	-0.4	0.1	-1.7	0.5	-0.2	1.9	2.8	-0.4
Unit labor costs in manufacturing (nominal, per hour)	-8.8	2.6	-7.1	-4.7	-7.5	-11.4	-4.4	2.8	
Labor productivity in manufacturing (real, per hour)	9.0	2.7	13.1	11.0	14.6	15.5	11.3	6.1	6.6
Labor costs in manufacturing (nominal, per hour)	0.0	5.4	5.1	5.8	6.0	2.3	6.4	9.0	5.6
Producer price index (PPI) in industry	0.4	4.5	1.9	2.3	1.5	1.8	2.0	0.5	-0.7
Consumer price index (here: HICP)	0.7	4.1	3.7	4.0	3.6	3.8	3.6	2.2	1.7
EUR per 1 SKK, + = SKK appreciation	..	..	..	..	..	..	..	..	..
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	14.4	13.7	14.0	14.1	13.7	13.7	14.5	14.6	14.1
Employment rate (%, 15–64 years)	58.8	59.3	59.7	59.6	59.8	60.1	59.4	59.8	59.8
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
SKK per 1 EUR	..	..	..	..	..	..	..	..	..
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	4.4	0.7	6.6	3.0	1.9	1.9	6.6	5.5	6.1
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	1.3	-3.8	-3.1	-7.2	-6.7	2.7	-3.1	0.4	-5.9
Domestic credit of the banking system	9.2	9.4	-7.1	9.8	2.4	-4.5	-7.1	-10.9	-7.0
<i>of which: claims on the private sector</i>	3.2	6.9	-0.1	4.3	1.4	0.5	-0.1	1.8	2.8
<i>claims on households</i>	4.2	3.9	3.9	3.9	3.5	3.7	3.9	3.9	4.1
<i>claims on enterprises</i>	-1.0	2.9	-4.0	0.4	-2.1	-3.2	-4.0	-2.1	-1.3
<i>claims on the public sector (net)</i>	6.0	2.5	-6.9	5.4	1.0	-5.1	-6.9	-12.7	-9.8
Other assets (net) of the banking system	-6.1	-4.9	16.7	0.4	6.2	3.8	16.7	16.0	19.0
<i>% of GDP, ESA 95</i>									
General government revenues	32.3	33.3	33.1	..	..	..	..	..	..
General government expenditures	40.0	38.4	37.4	..	..	..	..	..	..
General government balance	-7.7	-5.1	-4.3	..	..	..	..	..	..
Primary balance	-6.3	-3.5	-2.5	..	..	..	..	..	..
Gross public debt	41.0	43.3	52.1	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	21.5	18.0	10.2	9.0	10.5	13.6	7.7	2.9	5.1
Merchandise imports	22.5	17.9	5.6	6.2	3.6	8.4	4.3	-0.8	0.5
<i>% of GDP (based on EUR), period total</i>									
Trade balance	1.2	1.4	5.1	4.6	5.4	4.8	5.5	7.7	9.3
Services balance	-1.1	-0.5	0.4	0.4	0.4	0.5	0.3	-0.2	0.2
Income balance (factor services balance)	-3.1	-2.4	-2.3	-2.3	-2.2	-2.4	-2.3	-2.6	-2.6
Current transfers	-0.6	-0.5	-0.9	-0.4	-0.9	-1.2	-1.1	-0.6	-1.6
Current account balance	-3.7	-2.1	2.3	2.3	2.7	1.7	2.5	4.3	5.3
Capital account balance	1.5	1.3	1.9	0.2	2.9	1.5	3.0	1.0	1.2
Foreign direct investment (net)	0.9	1.7	3.4	4.7	0.7	-0.2	8.4	-0.9	-1.4
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	74.8	76.6	75.2	77.7	76.4	73.0	75.2	80.3	83.9
Gross official reserves (excluding gold) ¹	0.8	1.0	0.9	0.9	0.9	0.9	0.9	1.0	1.2
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold) ¹	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2
<i>EUR million, period total</i>									
GDP at current prices	65,870	69,108	71,463	16,550	17,822	18,879	18,212	16,811	18,255

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

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

3 Slovenia: Stabilization of Banking Sector Pending, Economy Stuck in Recession

Delay in banking sector consolidation

While the government originally intended to transfer the first tranche of bad loans from banks to a bank asset management company by mid-2013, the transaction was repeatedly delayed, partly due to the need for compliance with EU regulations on state aid. Following extended discussions with the ECB and the European Commission, in August 2013 Banka Slovenije commissioned a system-wide asset quality review and a bottom-up stress testing exercise for the ten largest Slovene banks. The results of these tests are expected for November, and the bad loan transfer is set to take place by end-2013. The transfer will be accompanied by capital injections for banks to help them meet minimum capital requirements. The central bank governor has already suggested that these exercises could result in an upward revision of the total value of bad assets (currently EUR 3.3 billion) and of the total costs for the 2013 budget (currently around EUR 1.5 billion). While the government had repeatedly denied speculation about Slovenia applying for EU aid, in late September the prime minister admitted the possibility that the results of the stress tests could be worse than expected and indicated that new steps would have to be decided on this basis. The urgency of the matter became clear at the beginning of September when the central bank initiated the liquidation of two smaller banks, while the government assumed guarantees worth around EUR 1 billion to cover the liabilities of the two banks.

Economy still in the doldrums

Slovenia remained stuck in recession into the first half of 2013, although the pace of decline moderated somewhat in the second quarter. Net exports remained the sole element supporting economic activity. However, the expansion of exports was modest while imports ceased to contract and the size of these components' contribution to growth decreased sharply. Household consumption continued to decline, although less than previously, mirroring declining real wages and employment, weak confidence and continued deleveraging. So did government consumption as a result of continued efforts to stem the widening of the budget deficit. Investment growth also remained negative, though much less than in 2012. This reflected cuts in public investment as part of the mid-year budget correction, negative credit growth, low levels of capacity utilization, and muted sentiment.

Banking sector recapitalization to push up 2013 budget deficit

At the beginning of July, parliament passed a revision to the 2013 budget in line with the 2013 Stability Programme update. The revision, which led to a minor increase (and reshuffle) in expenditures and a substantial decrease in revenues, was necessary to take into account a weaker macroeconomic environment, higher debt servicing costs, bank recapitalization needs and higher expenditures for public sector wages and pensions. In order to limit the increase in the deficit, investments were cut, the standard VAT rate raised (from 20% to 22%), a new lottery tax was introduced and judicial taxes and motorway registration fees were adjusted upward. The draft revision of the 2014 budget (originally passed in 2012) submitted to parliament at end-September foresees a deficit target of 3.2% of GDP (after 4% in 2013), excluding the costs of ongoing bank consolidation. A new property tax, measures against the grey economy, the suspension of previously planned cuts in the corporate income tax and the VAT hike of mid-2013 support the revenue side. On the expenditure side, expenditure for goods and services will be reduced, transfers to households roughly stabilized, investment expenditure (better utilization of EU funds) and interest expenses (due to higher government debt) increased.

Table 3

Main Economic Indicators: Slovenia

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	1.3	0.7	-2.5	-0.2	-3.5	-3.0	-3.3	-4.6	-1.7
Private consumption	1.5	0.8	-4.8	-1.2	-5.1	-6.8	-5.8	-5.2	-2.1
Public consumption	1.3	-1.6	-1.3	-0.2	-0.6	-1.8	-2.4	-1.8	-3.1
Gross fixed capital formation	-15.2	-5.5	-8.2	-6.2	-6.5	-7.3	-12.3	-3.3	-3.0
Exports of goods and services	10.2	7.0	0.6	1.7	-0.3	0.1	0.8	1.7	2.0
Imports of goods and services	7.4	5.6	-4.7	-1.4	-4.1	-7.1	-6.0	-2.3	0.0
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-0.5	-0.3	-6.3	-2.5	-6.2	-8.2	-8.3	-7.6	-3.2
Net exports of goods and services	1.8	1.0	3.8	2.3	2.7	5.1	5.0	2.9	1.5
Exports of goods and services	6.0	4.7	0.4	1.3	-0.2	0.1	0.6	1.3	1.5
Imports of goods and services	-4.3	-3.6	3.4	1.0	2.9	5.0	4.4	1.7	0.0
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-0.3	-0.9	1.0	1.4	1.1	0.3	1.0	-0.4	0.6
Unit labor costs in manufacturing (nominal, per hour)	-1.5	0.3	4.8	-0.7	11.2	4.0	5.1	6.8	-3.7
Labor productivity in manufacturing (real, per hour)	4.9	1.5	-1.8	-1.6	-1.3	-1.2	-3.2	-2.2	-2.1
Labor costs in manufacturing (nominal, per hour)	3.2	1.9	2.9	-2.3	9.7	2.8	1.7	4.4	-5.7
Producer price index (PPI) in industry	2.0	4.6	0.9	1.3	0.8	0.6	0.6	0.7	0.2
Consumer price index (here: HICP)	2.1	2.1	2.8	2.5	2.5	3.2	3.0	2.7	1.8
EUR per 1 SIT, + = SIT appreciation	..	..	..	..	..	..	..	..	..
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.4	8.4	9.0	8.7	8.3	9.3	9.7	11.2	10.5
Employment rate (%, 15–64 years)	66.2	64.4	64.1	64.0	63.8	64.3	64.2	62.4	63.0
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
SIT per 1 EUR	..	..	..	..	..	..	..	..	..
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	1.6	3.0	-0.7	4.3	3.3	0.4	-0.7	0.6	-0.8
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-4.0	6.5	3.9	-6.8	-4.9	-5.4	3.9	10.5	19.0
Domestic credit of the banking system	6.7	-3.1	-2.7	10.8	6.8	7.5	-2.7	-8.1	-15.9
<i>of which: claims on the private sector</i>	2.8	-3.8	-7.2	-3.4	-5.0	-5.2	-7.2	-9.9	-10.3
<i>claims on households</i>	3.9	0.8	-0.8	0.6	-0.3	-0.6	-0.8	-1.1	-1.1
<i>claims on enterprises</i>	-1.1	-4.6	-6.4	-4.0	-4.7	-4.6	-6.4	-8.9	-9.1
<i>claims on the public sector (net)</i>	3.9	0.7	4.5	14.2	11.7	12.7	4.5	1.8	-5.6
Other assets (net) of the banking system	-1.2	-0.4	-2.0	0.4	1.4	-1.7	-2.0	-1.7	-3.9
<i>% of GDP, ESA 95</i>									
General government revenues	44.7	44.4	45.2	..	..	..	..	..	..
General government expenditures	50.6	50.8	49.2	..	..	..	..	..	..
General government balance	-5.9	-6.4	-4.0	..	..	..	..	..	..
Primary balance	-4.3	-4.4	-1.9	..	..	..	..	..	..
Gross public debt	38.6	46.9	54.1	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	14.4	13.1	0.8	2.7	0.4	0.0	0.4	0.5	1.5
Merchandise imports	16.3	13.1	-3.0	1.3	-2.2	-4.7	-6.2	-4.7	-3.6
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-2.3	-2.6	-0.3	-1.8	-0.5	0.7	0.3	1.7	2.7
Services balance	3.6	4.1	5.1	4.9	4.9	5.8	4.7	6.1	5.8
Income balance (factor services balance)	-1.7	-1.4	-1.6	-1.7	-1.9	-2.2	-0.5	-0.9	-0.9
Current transfers	0.2	0.4	0.1	-0.3	0.3	-0.8	1.0	-1.0	0.0
Current account balance	-0.1	0.4	3.3	1.1	2.9	3.5	5.5	5.9	7.6
Capital account balance	0.2	-0.2	-0.3	-0.3	0.1	-0.3	-0.6	-0.1	-0.4
Foreign direct investment (net)	1.2	1.8	0.5	1.7	1.1	0.9	-1.9	-0.7	-7.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	114.8	110.9	115.7	116.9	115.9	114.2	115.7	115.9	115.8
Gross official reserves (excluding gold) ¹	2.0	1.8	1.7	1.6	1.7	1.7	1.7	1.5	1.6
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold) ¹	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
<i>EUR million, period total</i>									
GDP at current prices	35,485	36,150	35,319	8,519	9,034	9,049	8,717	8,127	9,029

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

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

4 Bulgaria: Suppressed Domestic Demand Prolongs Economic Stagnation

Modest economic contraction in the second quarter of 2013 amid tight credit market and weak labor market conditions

For the first time since the 2009–2010 recession, annual GDP growth turned (modestly) negative in the second quarter of 2013. This was mainly driven by sluggish domestic demand (destocking, decline in gross fixed capital formation, stagnating private consumption), while net exports contributed, in contrast to 2012, positively to GDP growth. Exports grew quite strongly in the first half of 2013 (significantly more strongly than imports), which can – at least partly – be traced to favorable base effects from weather-related disruptions in early 2012. A production-side view reveals that the slowdown in output growth can basically be explained by a negative contribution of construction and industry; the only significant positive growth contribution came from agriculture.

In line with sluggish economic activity, lending is still suppressed. Credit to nonbank corporates expanded in the first half of 2013 (with an average annual real growth rate of 2%) only half as much as a year before, and lending to households continued to shrink. The prolonged economic stagnation has also left its footprint on the labor market. The unemployment rate climbed to more than 13% in the first half of 2013; long-term unemployment accounts for more than half of this figure.

Current account turns into surplus in the first half of 2013

The current account balance turned into surplus in the first half of 2013 (a modest surplus of 1.7% of GDP, compared to a deficit of 5.45% of GDP a year before). This improvement can basically be traced to a strong upward shift in net current transfers in the second quarter of 2013 (mostly reflecting an extra absorption of EU funds), but also to vivid export growth in the first half of 2013 and less dynamic import growth as a consequence of weak domestic demand.

Rollback of electricity tariffs leads to a significant deceleration of inflation

Increases in electricity prices in the summer of 2012 contributed to mass protests, which also led to a change in government in February 2013. The new administration undertook a rollback of electricity tariffs, which contributed – together with relenting food price pressures and receding costs of healthcare, transport and communications – to a continuous disinflation process that eventually led to moderate deflation in August 2013 (for the first time since ten years, annual HICP inflation turned negative).

Unit labor costs increased quite strongly in the first half of 2013 in the whole economy, which can be traced back to a pronounced expansion of employees' compensation, coupled with meager labor productivity gains. The latter also holds true for manufacturing. However, the rise in labor costs in manufacturing lost momentum in the first half of 2013 so that the country's price competitiveness against the euro area stayed about unchanged in this sector.

Loosened fiscal stance in 2013, some fiscal tightening planned for 2014

Against the background of sluggish economic activity and underperforming tax receipts, the government revised upward this year's target for the general government budget deficit (from 1.3%) to 2% of GDP, expecting that output will not grow by more than 0.6% this year (compared to 1.9%, assumed in the original budget plan). As a consequence, the maximum amount of new government debt which can be issued in 2013 was increased. According to the budget proposal for 2014, currently being negotiated, the fiscal deficit is to be reduced to below 2% of GDP, assuming a 2014 GDP growth rate of 1.8%.

Table 4

Main Economic Indicators: Bulgaria

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	0.4	1.8	0.8	1.0	1.1	0.8	0.3	0.8	-0.2
Private consumption	0.1	1.5	2.6	2.7	4.3	3.2	0.4	0.0	0.0
Public consumption	1.9	1.6	-1.3	-1.3	-1.5	-0.4	-2.0	3.3	3.6
Gross fixed capital formation	-18.3	-6.5	0.8	3.6	1.2	0.7	-1.0	1.8	-2.6
Exports of goods and services	14.7	12.3	-0.4	-3.0	3.3	-0.5	-1.7	11.3	5.3
Imports of goods and services	2.4	8.8	3.7	3.4	9.8	2.6	-0.5	4.6	2.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-5.2	0.0	3.5	5.8	5.5	2.2	1.3	-3.2	-2.1
Net exports of goods and services	5.6	1.8	-2.7	-4.6	-4.4	-1.9	-0.7	4.1	2.0
Exports of goods and services	7.0	7.1	-0.2	-2.1	2.2	-0.3	-1.0	7.7	3.6
Imports of goods and services	-1.4	-5.2	-2.5	-2.5	-6.5	-1.6	0.3	-3.6	-1.6
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	5.8	2.2	-0.5	-0.7	-1.7	0.1	0.4	12.9	13.1
Unit labor costs in manufacturing (nominal, per hour)	-1.3	-1.2	3.4	5.7	0.6	3.3	3.8	-0.2	4.1
Labor productivity in manufacturing (real, per hour)	9.3	4.4	2.3	1.3	4.5	1.5	1.9	5.2	-0.1
Labor costs in manufacturing (nominal, per hour)	7.8	3.5	5.7	7.1	5.1	4.8	5.8	5.0	4.0
Producer price index (PPI) in industry	8.4	9.3	4.4	3.8	3.0	5.0	5.8	1.7	-0.9
Consumer price index (here: HICP)	3.0	3.4	2.4	1.9	1.8	3.0	2.8	2.1	1.1
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	10.3	11.4	12.4	13.0	12.4	11.6	12.5	13.8	13.0
Employment rate (%, 15–64 years)	59.7	58.4	58.8	56.9	58.3	60.6	59.4	57.7	59.5
Key interest rate per annum (%) ¹	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	6.4	12.2	8.4	10.7	10.1	8.7	8.4	8.9	7.7
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	5.0	7.9	7.5	9.2	8.2	10.1	7.5	5.7	6.2
Domestic credit of the banking system	5.1	7.3	2.4	5.4	5.4	1.7	2.4	3.9	1.2
<i>of which: claims on the private sector</i>	1.5	3.9	2.6	3.6	4.2	3.7	2.6	2.0	0.6
<i>claims on households</i>	-0.3	-0.2	-0.3	-0.4	-0.4	-0.5	-0.3	-0.4	-0.3
<i>claims on enterprises</i>	1.8	4.1	3.0	3.9	4.6	4.2	3.0	2.4	0.8
<i>claims on the public sector (net)</i>	3.7	3.4	-0.2	1.8	1.2	-2.0	-0.2	1.9	0.7
Other assets (net) of the banking system	-3.7	-3.0	-1.4	-3.9	-3.5	-3.1	-1.4	-0.8	0.3
<i>% of GDP, ESA 95</i>									
General government revenues	34.3	33.6	34.9	..	..	..	..	..	..
General government expenditures	37.4	35.6	35.7	..	..	..	..	..	..
General government balance	-3.1	-2.0	-0.8	..	..	..	..	..	..
Primary balance	-2.4	-1.2	0.1	..	..	..	..	..	..
Gross public debt	16.2	16.3	18.5	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	33.0	30.2	2.5	-2.9	6.2	3.0	3.5	13.0	3.3
Merchandise imports	15.4	22.3	8.1	9.2	16.0	5.7	2.1	2.9	-3.8
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-7.7	-5.6	-8.7	-11.0	-12.3	-4.8	-7.8	-5.2	-8.0
Services balance	5.2	6.0	5.9	0.9	5.6	13.5	2.1	1.0	4.4
Income balance (factor services balance)	-3.1	-4.7	-3.7	-4.1	-3.1	-4.1	-3.4	-3.9	-3.0
Current transfers	4.2	4.4	5.2	7.5	6.0	3.5	4.5	3.4	11.8
Current account balance	-1.5	0.1	-1.3	-6.8	-3.8	8.1	-4.6	-4.6	5.2
Capital account balance	0.8	1.3	1.4	0.1	0.4	1.5	3.0	-0.1	0.8
Foreign direct investment (net)	2.7	3.1	3.0	8.1	3.6	4.7	-2.9	5.5	1.8
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	102.7	94.3	94.9	95.5	96.5	96.4	94.9	93.8	92.9
Gross official reserves (excluding gold)	32.2	30.6	35.1	30.2	31.8	35.3	35.1	32.2	33.4
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	6.5	5.6	6.0	5.3	5.4	6.0	6.0	5.6	5.8
<i>EUR million, period total</i>									
GDP at current prices	36,052	38,505	39,668	8,053	9,822	11,012	10,781	8,476	9,918

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

¹ Not available in a currency board regime.

5 Croatia: Waiting for the Upswing

Domestic demand may have reached a turning point, picking up somewhat in the second quarter

Following its prolonged contraction in 2012, Croatia's GDP continued to shrink in the first quarter of 2013 (by 1.5% year on year). The only positive contributions came from net exports (due to a stronger contraction of imports than exports) and – to a much lesser extent – public consumption. In the second quarter, however, economic activity gathered some momentum as domestic demand started to improve. The economy still remained in recession, though. Private consumption picked up on the back of increasing consumer confidence due to EU accession on July 1, 2013, and a good tourism season, which also showed in a growing number of tourist arrivals in July and August. Investment improved as well and contributed positively to growth for the first time since 2008. In contrast to strong domestic demand, net exports contributed negatively to growth, mainly due to base effects on the import side. Unemployment remained elevated but decreased slightly in the second quarter to 17%.

Current account in surplus but external position remains vulnerable due to high external debt

In the first half of 2013 the current account improved further. The four-quarter moving sum of the current account surplus reached 0.9% of GDP at the end of June (compared to 0.1% of GDP in 2012). The improvement was mainly driven by a narrowing of the deficit of the income balance. Exports decreased by 1.6% and imports by 0.6% compared to the previous year. Thus, the goods and services balance worsened somewhat and amounted to 0.8% of GDP (four-quarter moving sum). In the first half of 2013, the decrease of exports was completely driven by the decline in the exports of goods, whereas services exports rose by 2.7% year on year.

On the financing side, net FDI as well as net portfolio investment were positive but decreased by around 30% year on year in the first half of 2013. With external debt amounting to 104.9% of GDP in June 2013, Croatia's external position remains fragile. Foreign debt came to EUR 11.5 billion by the end of August, which is a slight increase compared to the end of 2012. The kuna traded marginally weaker against the euro but within its long-standing range.

Rising NPLs and further contraction of credit

In the financial sector, the share of NPLs grew further and amounted to 15.1% of total loans in June 2013. The deteriorating asset quality weighs on profitability, with the average return on assets dropping from 0.7% in 2012 to 0.5% in the first half of 2013. Growth of credit to the private sector remained negative in the first two quarters of 2013 (–4.2% and –3.2% year on year, respectively).

Fiscal situation remains strained, opening of EDP probable

The fiscal situation worsened in the first half of 2013, as the budget deficit reached 3.4% of annual GDP by July, going beyond the 3%-of-GDP target for the whole year. Gross public debt, which has been rising markedly since 2008, stood at 54% of GDP at end-2012 and is projected to come close to 60% of GDP at the end of 2013. It is very likely that the EU will soon open an Excessive Deficit Procedure (EDP) for Croatia. Meanwhile, all three major rating agencies have downgraded Croatia's sovereign rating to non-investment grade. Following the downgrade by S&P at the end of 2012 and Moody's downgrade in February 2013, Fitch lowered Croatia's sovereign rating from BBB- to BB+ in September. Additionally, S&P revised its outlook from "neutral" to "negative" recently.

Table 5

Main Economic Indicators: Croatia

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	-2.3	0.0	-2.0	-1.1	-2.5	-1.9	-2.3	-1.5	-0.7
Private consumption	-1.3	0.2	-2.9	-0.9	-3.1	-3.4	-4.2	-2.9	0.5
Public consumption	-2.1	-0.6	-0.8	-1.1	0.3	-0.4	-2.0	0.3	1.3
Gross fixed capital formation	-15.0	-6.4	-4.6	-3.9	-5.1	-4.4	-4.9	-2.3	0.9
Exports of goods and services	4.8	2.0	0.4	3.9	-4.1	0.1	3.2	-4.9	0.8
Imports of goods and services	-2.8	1.3	-2.1	0.1	-4.0	-2.8	-1.6	-5.6	4.9
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-5.2	-0.3	-3.1	-1.8	-2.5	-3.8	-4.0	-2.4	1.1
Net exports of goods and services	2.9	0.3	1.1	1.2	0.1	1.2	1.9	0.9	-1.8
Exports of goods and services	1.8	0.8	0.2	1.2	-1.6	0.0	1.2	-1.6	0.3
Imports of goods and services	1.1	-0.5	0.9	-0.1	1.8	1.1	0.7	2.5	-2.1
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit wage costs in manufacturing (nominal, per hour)	2.2	1.4	7.8	9.7	7.2	5.1	9.0	0.3	9.0
Labor productivity in manufacturing (real, per hour)	-3.4	1.5	1.8	-3.3	3.6	5.0	1.3	6.9	-3.1
Gross wages in manufacturing (nominal, per hour)	-1.1	2.7	9.5	6.0	11.1	10.4	10.5	7.2	5.6
Producer price index (PPI) in industry	4.3	6.4	7.0	6.1	6.8	7.9	7.3	4.1	1.1
Consumer price index (here: CPI)	1.0	2.3	3.4	1.5	3.4	4.1	4.6	4.6	2.3
EUR per 1 HRK, + = HRK appreciation	0.7	-2.0	-1.1	-2.0	-1.8	-0.1	-0.4	-0.4	-0.4
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	12.1	13.9	16.3	16.8	14.9	15.0	18.5	18.4	17.0
Employment rate (%, 15–64 years)	54.0	52.4	50.7	49.8	51.7	52.5	48.7	47.5	49.8
Key interest rate per annum (%)	6.0	6.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0
HRK per 1 EUR	7.3	7.4	7.5	7.6	7.5	7.5	7.5	7.6	7.6
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	3.0	1.6	3.2	2.6	3.3	2.1	3.2	4.4	3.4
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-0.2	-4.2	6.3	-3.9	1.5	1.7	6.3	7.8	4.8
Domestic credit of the banking system	8.1	8.8	-0.8	9.5	6.0	3.7	-0.8	-0.5	-1.5
<i>of which: claims on the private sector</i>	5.5	4.9	-4.1	5.8	2.7	-0.5	-4.1	-4.2	-3.2
<i>claims on households</i>	1.7	0.5	-0.7	1.0	0.1	-1.0	-0.7	-0.6	-1.4
<i>claims on enterprises</i>	3.7	4.4	-3.4	4.7	2.6	0.5	-3.4	-3.6	-1.8
<i>claims on the public sector (net)</i>	2.6	3.9	3.3	3.8	3.3	4.3	3.3	3.7	1.6
Other assets (net) of the banking system	-4.9	-3.0	-2.4	-3.1	-4.2	-3.3	-2.4	-2.9	0.2
<i>% of GDP, ESA 95</i>									
General government revenues	40.1	40.4	36.8	..	..	..	..	..	..
General government expenditures	45.3	46.1	40.6	..	..	..	..	..	..
General government balance	-5.2	-5.7	-3.8	..	..	..	..	..	..
Primary balance	-3.1	-3.5	-1.1	..	..	..	..	..	..
Gross public debt	42.2	46.7	53.7	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	18.1	7.8	0.4	2.3	-7.9	0.3	7.4	-7.7	-1.2
Merchandise imports	-0.5	7.5	-0.4	4.3	-2.7	-2.8	0.0	-6.4	5.4
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-12.9	-13.9	-13.8	-16.0	-15.6	-12.3	-11.5	-15.2	-17.8
Services balance	13.0	14.0	14.7	1.7	14.3	35.8	4.0	2.0	14.9
Income balance (factor services balance)	-3.5	-3.6	-3.5	-5.3	-4.3	-3.6	-1.0	-3.5	-2.6
Current transfers	2.4	2.6	2.6	2.7	2.8	2.2	2.7	2.7	3.1
Current account balance	-1.0	-0.9	0.1	-16.9	-2.8	22.1	-5.8	-14.1	-2.3
Capital account balance	0.1	0.1	0.1	0.0	0.0	0.0	0.2	0.0	0.1
Foreign direct investment (net)	1.0	2.4	2.6	3.0	2.7	1.4	3.4	5.3	-1.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	104.7	103.4	102.1	104.1	106.5	104.1	102.1	102.3	104.9
Gross official reserves (excluding gold)	24.0	25.2	25.6	25.7	26.5	25.9	25.6	25.7	27.3
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	7.2	7.2	7.2	7.2	7.4	7.3	7.2	7.3	7.7
<i>EUR million, period total</i>									
GDP at current prices	44,432	44,379	43,915	9,972	10,920	11,995	11,028	10,016	10,977

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

6 Czech Republic: Recession is Over, Lower Inflation despite Indirect Tax Hikes

Positive second quarter growth after two years of recession

The Czech economy seems to have hit bottom in early 2013: Following a strong decline in the first quarter of 2013, GDP rose in the second quarter in quarter-on-quarter terms. Net exports delivered a negative growth contribution in the first quarter. Given strong demand, however, the situation improved in the second quarter. Gross fixed capital formation has fallen further into negative territory, owing to a continued decline in construction output, further cutbacks in public investment and still wary expectations combined with relatively low capacity utilization. Stock changes also contributed negatively to growth, partly due to the pre-stocking of tobacco products at the end of 2012, which had been triggered by an excise tax hike scheduled for 2013. The decline of household consumption has been leveling off, subtracting only 0.1 percentage points from GDP in the first half of 2013.

The average employment rate increased slightly to 67.3% in the first half of 2013, while the number of full-time equivalent employees declined. The unemployment rate decreased to 6.8% in the second quarter after rising to 7.5% in the first quarter. The participation rate hit a long-time high of 72.8% in mid-2013.

Solid current account

Notwithstanding negative export growth in the first half of 2013, the trade balance continued to record historical surpluses (of about 6% of GDP) as imports contracted even more strongly than exports. This contraction, in turn, was the result of a drop in import-intensive exports, declining domestic demand and lower energy input prices. The negative income balance mainly resulted from FDI and portfolio investment earnings. Overall, the cumulative current account balance posted a surplus of 0.5% of GDP in the first half of 2013. FDI flows in the first half were driven by two major equity capital investments in the energy sector. Overall, net FDI inflows amounted to 2% of GDP.

Considerable disinflation despite increases in indirect taxes

The HICP inflation rate halved to 1.6% in the first half of 2013. The decline was partly due to a base effect following a hike in the lower VAT rate of 4 percentage points in 2012. Both VAT rates were raised yet again in January 2013 by 1 percentage point each (to 15% and 21%, respectively); however, their contribution to inflation was not as big this time. Declining fuel and telecommunication prices, a reduction in the retail price of gas in July and still absent domestic demand pressures dragged down inflation even further. Rising food prices and higher final consumer product import prices due to a weaker currency were not able to compensate for these downward pressures. As a result, the monetary policy-relevant inflation rate (CPI adjusted for first-round effects of changes to indirect taxes) has remained way under the lower bound of the Česká národní banka's (CNB) inflation target of 2% \pm 1 percentage point (at 0.2% in September) and the policy rate has remained at its "technical zero" (0.05%) since November 2012. The koruna has depreciated, trading 4% lower on average in September 2013 than a year earlier.

New government and a new budget underway

Under the EDP, the Czech Republic has to remove its excessive budget deficit by end-2013, targeting a general government deficit of 2.8% for this year. Early parliamentary elections are scheduled for the end of October. In the meantime a caretaker government has approved a budget proposal envisaging a general government deficit of 2.9% of GDP both for 2014 and 2015. Whether these fiscal goals are endorsed by the new parliament and what policy measures will be launched to achieve the target, depends on the election outcome.

Table 6

Main Economic Indicators: Czech Republic

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	2.5	1.8	-1.0	0.1	-1.5	-1.5	-1.1	-2.9	-1.3
Private consumption	0.9	0.5	-2.1	-1.3	-2.3	-2.2	-2.8	-1.5	0.1
Public consumption	0.2	-2.7	-1.9	-2.8	-2.5	-1.5	-1.0	1.3	1.8
Gross fixed capital formation	1.0	0.4	-4.5	-1.7	-3.8	-5.0	-6.9	-6.4	-5.0
Exports of goods and services	15.4	9.5	4.5	7.8	2.6	3.9	3.6	-5.3	0.5
Imports of goods and services	15.4	7.0	2.3	5.0	1.4	-0.4	3.1	-4.8	-1.7
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	1.8	-0.1	-2.7	-2.4	-2.4	-4.6	-1.5	-2.2	-3.0
Net exports of goods and services	0.6	1.9	1.7	2.4	0.9	3.1	0.4	-0.7	1.6
Exports of goods and services	9.1	6.4	3.3	6.0	1.9	2.8	2.6	-4.4	0.4
Imports of goods and services	-8.4	-4.4	-1.6	-3.5	-1.0	0.3	-2.1	3.6	1.2
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-0.5	0.1	2.0	3.3	2.2	1.1	1.5	-0.2	-0.4
Unit labor costs in manufacturing (nominal, per hour)	-8.6	-3.3	2.5	1.7	2.6	3.0	2.9	1.3	0.8
Labor productivity in manufacturing (real, per hour)	9.9	6.6	-0.6	2.4	1.7	-0.6	-5.5	0.3	-1.6
Labor costs in manufacturing (nominal, per hour)	0.5	3.2	2.0	4.1	4.4	2.3	-2.8	1.6	-0.9
Producer price index (PPI) in industry	0.1	3.7	2.4	3.8	2.6	2.2	0.9	0.8	0.2
Consumer price index (here: HICP)	1.2	2.1	3.5	4.0	3.8	3.4	2.9	1.7	1.5
EUR per 1 CZK, + = CZK appreciation	4.6	2.9	-2.2	-2.8	-3.7	-2.7	0.4	-1.9	-2.2
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.4	6.8	7.1	7.2	6.8	7.0	7.2	7.5	6.8
Employment rate (%, 15–64 years)	65.0	65.7	66.6	65.6	66.5	67.1	67.0	66.8	67.8
Key interest rate per annum (%)	0.8	0.8	0.5	0.8	0.7	0.5	0.1	0.1	0.1
CZK per 1 EUR	25.3	24.6	25.1	25.1	25.3	25.1	25.2	25.6	25.8
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	1.9	2.8	4.8	4.8	5.4	4.0	4.8	5.1	4.6
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	0.4	-0.8	5.4	3.0	6.0	5.1	5.4	6.1	3.7
Domestic credit of the banking system	4.0	7.9	1.5	5.3	5.5	3.0	1.5	2.7	1.7
<i>of which: claims on the private sector</i>	2.1	4.1	1.9	3.8	3.3	2.4	1.9	2.5	1.8
<i>claims on households</i>	2.7	2.2	1.6	2.1	2.0	1.7	1.6	1.5	1.5
<i>claims on enterprises</i>	-0.6	1.9	0.3	1.7	1.3	0.7	0.3	1.0	0.3
<i>claims on the public sector (net)</i>	1.9	3.7	-0.4	1.5	2.2	0.7	-0.4	0.2	-0.1
Other assets (net) of the banking system	-2.6	-4.3	-2.1	-3.6	-6.0	-4.1	-2.1	-3.7	-0.9
<i>% of GDP, ESA 95</i>									
General government revenues	39.1	40.0	40.3	..	..	..	..	..	..
General government expenditures	43.9	43.3	44.7	..	..	..	..	..	..
General government balance	-4.8	-3.3	-4.4	..	..	..	..	..	..
Primary balance	-3.4	-1.9	-2.9	..	..	..	..	..	..
Gross public debt	37.8	40.8	45.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	21.3	13.8	4.6	8.4	3.2	4.1	2.9	-6.3	0.1
Merchandise imports	24.1	12.2	2.6	5.9	2.4	-0.5	2.6	-7.0	-3.5
<i>% of GDP (based on EUR), period total</i>									
Trade balance	1.4	2.4	3.8	5.7	3.5	3.5	2.6	6.0	5.9
Services balance	2.0	1.5	1.3	1.6	1.2	1.4	1.0	1.8	1.8
Income balance (factor services balance)	-7.5	-6.7	-7.5	-5.6	-7.0	-9.5	-7.8	-7.2	-7.6
Current transfers	0.2	0.1	0.0	0.1	-0.4	-0.5	0.6	0.9	-0.6
Current account balance	-3.9	-2.7	-2.4	1.9	-2.7	-5.0	-3.6	1.5	-0.5
Capital account balance	0.9	0.4	1.3	0.1	0.0	0.7	4.4	0.0	0.0
Foreign direct investment (net)	2.5	1.2	4.7	3.4	5.0	4.5	5.8	2.9	1.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	47.0	46.8	50.5	50.0	48.8	49.7	50.5	50.7	51.7
Gross official reserves (excluding gold)	20.9	19.7	21.9	20.4	20.0	20.3	21.9	22.5	21.9
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.9	3.4	3.6	3.5	3.3	3.4	3.6	3.7	3.6
<i>EUR million, period total</i>									
GDP at current prices	150,021	155,452	152,911	36,170	38,286	38,605	39,849	35,080	37,525

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

7 Hungary: Out of Excessive Deficit Procedure, MNB Supports Bank Lending

GDP back in positive territory

GDP growth came back to modestly positive territory in the second quarter of 2013. On the production side, growth was driven by agriculture and construction, which rebounded from a weak base in 2012. On the demand side, household consumption bounced back on the back of rising real incomes, improving consumer confidence and, presumably, some beneficial effect of the measures aimed at reducing households' foreign currency debt servicing burden. Investments also posted solid growth mainly due to public investment activity, while manufacturing investments declined. By contrast, net real exports dampened overall growth, as export growth lagged behind the acceleration of imports.

Excessive deficit abrogated in June 2013

Given a deficit well below 3% of GDP in 2012 and expectations that the deficit would stay below this threshold in 2013 and 2014, the EU Council closed the EDP in June 2013. The draft budget for 2014, submitted to parliament in September 2013, targets a deficit of 2.9% of GDP and – with 2014 being an election year – accommodates a considerable increase in government spending (e.g. wage hikes for teachers, further cuts in household utility and energy prices, more generous family support). According to the Hungarian Fiscal Council, the deficit target could be achieved, but there are substantial risks both on the revenue and the expenditure sides.

Also in line with the government's rhetoric about regaining economic autonomy, in August 2013 the government and the Magyar Nemzeti Bank (MNB) repaid their outstanding IMF loans (combined EUR 2.9 billion), taken out in 2008–2009, ahead of schedule. In order to beef up the MNB's foreign exchange reserves and to pre-finance eurobond maturities in January 2014, the government is considering issuing a eurobond in late 2013.

Official measures to ease credit squeeze

The MNB continued reducing its policy rate in monthly steps from 5% in March 2013 to 3.6% in September given low medium-term inflationary pressures, sufficient spare capacities and the disinflationary effect of weak domestic demand. Despite this policy and the broadening of the government's housing loan subsidies in late 2012 and early 2013, the stock of credit to the private sector continued to contract into the third quarter of 2013. Lending conditions remained tight in the second quarter of 2013, given bleak economic prospects and industry-specific risks, and despite some easing of banks' liquidity constraints. In order to ease SMEs' access to credit, the MNB started a "Funding for Growth Scheme" in June 2013. Under the scheme, the MNB provides banks with long-term refinancing at an interest rate of 0%, which banks can lend on to SMEs with a maximum all-in margin of 2.5% either for the financing of investment and working capital or for converting foreign currency loans into forint loans. Another pillar of the scheme aims at reducing Hungary's gross external debt and the outstanding stock of the MNB's two-week bills. As for households, in addition to the measures that have already been taken (early repayment of foreign currency housing loans at beneficial exchange rates, temporary exchange rate fixation, interest rate subsidies), the government in July 2013 started negotiations with banks to phase out outstanding foreign currency housing loans altogether. In early September 2013, however, the government set banks a deadline until November 1, 2013, for taking action to alleviate households' repayment burden and for assuming the resulting costs. These costs, combined with the bank levy, the transaction tax and a new one-off tax for 2013 to compensate for below-plan revenues from the financial transaction tax, are likely to push banks back into the red in 2013.

Table 7

Main Economic Indicators: Hungary

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	1.3	1.6	-1.7	-0.6	-1.7	-1.7	-2.7	-0.9	0.5
Private consumption	-3.0	0.5	-1.4	-0.2	-0.5	-3.7	-0.9	-0.9	0.6
Public consumption	-0.7	-0.3	-2.5	-2.8	-3.1	-3.3	-0.7	-2.2	-0.2
Gross fixed capital formation	-9.5	-3.6	-3.8	-4.5	-3.0	-1.7	-5.7	-6.0	4.9
Exports of goods and services	14.2	6.3	2.0	2.2	4.6	2.4	-1.1	1.1	3.0
Imports of goods and services	12.7	5.0	0.1	0.2	1.7	-0.3	-1.0	0.4	4.7
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-0.4	0.1	-3.5	-2.6	-4.5	-4.1	-2.6	-1.6	1.6
Net exports of goods and services	1.8	1.5	1.7	2.0	2.8	2.4	-0.2	0.7	-1.2
Exports of goods and services	11.0	5.5	1.8	2.2	4.2	2.2	-1.0	1.1	2.9
Imports of goods and services	-9.2	-4.0	-0.1	-0.1	-1.4	0.3	0.8	-0.4	-4.1
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-1.2	1.6	5.2	5.0	6.1	5.1	4.6	1.8	..
Unit labor costs in manufacturing (nominal, per hour)	-9.7	4.4	6.4	5.5	5.4	4.7	10.1	6.2	2.9
Labor productivity in manufacturing (real, per hour)	10.3	1.5	0.8	-0.5	3.5	2.9	-2.2	-1.2	1.2
Labor costs in manufacturing (nominal, per hour)	0.0	6.0	7.4	5.0	9.1	7.8	7.7	5.0	4.1
Producer price index (PPI) in industry	4.0	4.2	4.2	6.8	7.2	4.5	-1.5	0.6	-0.1
Consumer price index (here: HICP)	4.7	3.9	5.7	5.6	5.5	6.0	5.5	2.7	1.9
EUR per 1 HUF, + = HUF appreciation	1.9	-1.4	-3.5	-8.2	-9.4	-2.9	7.1	0.1	-0.5
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	11.2	11.0	11.0	11.8	10.9	10.5	10.8	11.8	10.3
Employment rate (%, 15–64 years)	55.4	55.8	57.2	55.7	57.2	58.2	57.8	56.6	58.3
Key interest rate per annum (%)	5.5	6.0	6.8	7.0	7.0	6.9	6.2	5.5	4.7
HUF per 1 EUR	275.4	279.3	289.3	296.8	294.0	283.1	283.4	296.6	295.6
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	3.0	5.9	-3.3	1.5	0.1	-4.1	-3.3	5.5	4.5
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	4.2	17.8	5.1	10.0	10.1	3.9	5.1	14.4	10.1
Domestic credit of the banking system	6.4	-3.1	-11.8	0.4	-3.5	-8.8	-11.8	-5.2	-4.2
of which: claims on the private sector	3.7	-0.6	-13.7	-1.8	-6.4	-13.6	-13.7	-6.0	-6.5
claims on households	4.6	-0.5	-7.3	-2.0	-4.9	-8.2	-7.3	-2.0	-2.7
claims on enterprises	-0.9	0.4	-6.3	0.7	-0.9	-5.3	-6.3	-3.9	-3.7
claims on the public sector (net)	2.7	-2.6	1.8	2.3	2.9	4.8	1.8	0.8	2.3
Other assets (net) of the banking system	-7.7	-8.7	3.4	-9.0	-6.5	0.7	3.4	-3.7	-1.4
<i>% of GDP, ESA 95</i>									
General government revenues	45.6	54.3	46.6	..	..	..	..	..	..
General government expenditures	49.9	50.0	48.6	..	..	..	..	..	..
General government balance	-4.3	4.3	-2.0	..	..	..	..	..	..
Primary balance	-0.2	8.5	2.2	..	..	..	..	..	..
Gross public debt	82.2	82.1	79.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	16.7	11.3	1.6	-0.2	3.1	2.9	0.6	1.7	2.0
Merchandise imports	17.2	10.7	1.0	1.7	0.8	0.6	1.0	0.0	3.0
<i>% of GDP (based on EUR), period total</i>									
Trade balance	2.5	3.1	3.6	3.7	5.2	4.0	1.9	5.0	4.4
Services balance	3.0	3.2	3.5	3.2	3.8	4.6	2.4	3.7	3.8
Income balance (factor services balance)	-5.7	-6.4	-6.5	-6.5	-7.0	-6.0	-6.6	-5.6	-6.6
Current transfers	0.4	0.6	0.4	-1.2	0.2	0.1	2.3	-0.1	0.9
Current account balance	0.2	0.4	1.0	-0.9	2.2	2.7	0.0	3.1	2.5
Capital account balance	1.8	2.3	2.6	1.9	2.0	2.3	3.8	2.8	3.6
Foreign direct investment (net)	0.8	0.7	2.1	2.1	-2.0	3.0	4.8	1.6	-3.5
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	143.3	133.0	126.9	133.6	136.7	133.7	126.9	125.5	124.3
Gross official reserves (excluding gold)	34.8	37.7	34.5	35.1	36.7	35.8	34.5	36.0	34.5
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.3	5.4	4.8	4.9	5.0	4.9	4.8	5.0	4.8
<i>EUR million, period total</i>									
GDP at current prices	96,562	99,763	97,837	21,390	23,694	25,515	27,238	21,824	24,590

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

8 Poland: Pension Reform to Reduce Deficit and Debt

Export growth accelerates and domestic slowdown appears to be bottoming out

In the first half of 2013, annual GDP growth amounted to 0.9%, with exports contributing 1.7 percentage points and domestic demand subtracting 1.4. Weak total final demand caused imports to decline, lifting GDP growth by 0.6 percentage points and implying a contribution of net export of 2.3 percentage points. In parallel, the current account deficit fell to only 1% of GDP in this period, from 4% in the first half of 2012. The effects of previously shrinking and uncertain euro area imports, the end of a public nonresidential construction boom and tighter lending standards still showed in the first half of 2013 in destocking, contracting fixed investment and private consumption restraint. By contrast, exports have accelerated since the fourth quarter of 2012, even before euro area imports started to rise. Supported by the stimulating impact of exports, there are signs of domestic demand contraction fading out. Disinflation has helped achieve real annual growth of wages and pensions since the first quarter. The seasonally adjusted unemployment rate declined continuously to 10.3% in August from a peak of 10.6% in April, and employment indices have shown month-on-month increases.

Złoty only moderately affected by quantitative easing tapering fears

The złoty had been roughly stable against the euro from end-January to mid-May, before falling by 4.5% until end-June after the U.S. Federal Reserve's quantitative easing tapering remarks, but gaining 2.5% afterwards until end-September. In August 2013, inflation was 0.9% (HICP) and 1.1% (national CPI), while core inflation amounted to 0.9% (HICP) and 1.4% (CPI). Headline inflation had fallen from 2.2% (2.4%) in December to a low of 0.2% in June, dragged down by lower energy prices, but then rose, because unprocessed food prices fell less than in July and August 2012. The Polish Monetary Policy Council, pursuing an inflation target of 2.5% (CPI), cut the reference rate in six steps from 4.25% in December to 2.5% in July.

Weak growth and disinflation lead to higher deficit in 2013

The 2012 deadline for correcting the excessive deficit was missed, with the general government deficit standing at 3.9% of GDP. As the annual improvement of the structural balance by 1.5% of GDP over 2010–2012 was above the required level of 1.25% and the deterioration of the Polish economy was worse than expected, the Ecofin on June 21, 2013, extended the deadline for removing the excessive deficit to 2014. At the same time, it required Poland to take corrective action by October 1, 2013, and called on the government to reduce its deficit to 3.6% of GDP in 2013 and 3.0% in 2014. The government's convergence program of April 2013 had envisaged a deficit of 3.5% of GDP in 2013 and 3.3% in 2014. However, weaker economic growth and steeper disinflation than anticipated caused the revenue-to-GDP ratio to be 1.5 percentage points lower at mid-2013 than in the first half of 2012. As a result, the budget was amended by cutting expenditures by one-third of the revenue shortfall and raising the 2013 target for the general government deficit. In early September, the government approved the draft budget for 2014 and plans to change the pension system. Accordingly, general government debt would be cut by at least 8 percentage points, and the 2014 general government deficit would be cut by 0.5 percentage points. The envisaged pension reform involves the transfer of about 50% of private pension funds (OFEs) assets and liabilities to the public pay-as-you-go social insurance fund (ZUS). The obligatory contributions of 2.8% of gross salary, which currently has to be paid to OFEs, will be raised to 2.92%, and every participant will be able to decide whether future contributions continue to go to OFEs or to the notional individual pension account in ZUS, with the latter being the default choice.

Table 8

Main Economic Indicators: Poland

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.9	4.5	1.9	3.6	2.0	1.6	0.8	0.5	1.2
Private consumption	3.1	2.6	1.2	2.2	1.7	0.4	0.7	-0.1	0.3
Public consumption	4.1	-1.7	0.2	-1.7	-0.2	1.3	1.2	-0.3	4.8
Gross fixed capital formation	-0.4	8.5	-1.7	5.2	0.7	-2.3	-5.1	-2.7	-3.3
Exports of goods and services	12.1	7.7	3.9	5.4	3.5	2.6	4.1	1.3	3.4
Imports of goods and services	13.9	5.5	-0.7	2.8	-1.5	-2.6	-1.2	-1.6	-2.1
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	4.6	3.6	-0.1	2.4	-0.3	-0.8	-1.4	-0.9	-1.5
Net exports of goods and services	-0.7	0.9	2.1	1.2	2.3	2.5	2.2	1.4	2.6
Exports of goods and services	4.8	3.3	1.8	2.5	1.6	1.2	1.7	0.6	1.6
Imports of goods and services	-5.5	-2.4	0.3	-1.3	0.7	1.3	0.5	0.8	1.0
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	1.0	1.3	1.1	1.3	1.2	1.1	0.9	2.3	..
Unit labor costs in manufacturing (nominal, per hour)	-9.1	0.3	1.3	-0.4	0.2	1.0	4.6	2.0	1.0
Labor productivity in manufacturing (real, per hour)	11.3	4.3	3.1	5.0	4.1	5.4	-1.7	2.1	0.7
Labor costs in manufacturing (nominal, per hour)	1.3	4.6	4.5	4.6	4.3	6.4	2.8	4.1	1.7
Producer price index (PPI) in industry	1.8	7.3	3.3	5.8	4.6	2.8	0.1	-0.5	-1.9
Consumer price index (here: HICP)	2.7	3.9	3.7	4.2	4.0	3.9	2.8	1.3	0.5
EUR per 1 PLN, + = PLN appreciation	8.4	-3.0	-1.6	-6.8	-7.0	0.3	7.5	1.8	1.3
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	9.7	9.8	10.2	10.6	10.0	10.0	10.2	11.4	10.6
Employment rate (%, 15–64 years)	59.0	59.3	59.7	58.8	59.7	60.2	60.0	58.7	59.8
Key interest rate per annum (%)	3.5	4.2	4.6	4.5	4.6	4.8	4.5	3.7	3.0
PLN per 1 EUR	4.0	4.1	4.2	4.2	4.3	4.1	4.1	4.2	4.2
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	8.8	12.5	4.5	9.1	11.0	7.6	4.5	6.6	7.0
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	3.0	6.4	3.3	1.9	8.6	4.7	3.3	6.2	0.9
Domestic credit of the banking system	10.3	14.0	1.0	13.1	10.5	4.3	1.0	4.0	6.6
<i>of which: claims on the private sector</i>	8.0	13.1	2.3	11.6	10.1	5.0	2.3	3.5	3.6
<i>claims on households</i>	8.3	7.4	0.2	6.0	4.8	0.9	0.2	1.6	1.5
<i>claims on enterprises</i>	-0.2	5.7	2.1	5.6	5.3	4.1	2.1	1.8	2.1
<i>claims on the public sector (net)</i>	2.3	0.9	-1.3	1.5	0.4	-0.7	-1.3	0.5	3.0
Other assets (net) of the banking system	-4.5	-7.9	0.2	-5.9	-8.1	-1.4	0.2	-3.6	-0.5
<i>% of GDP, ESA 95</i>									
General government revenues	37.5	38.4	38.3	..	..	..	..	..	..
General government expenditures	45.4	43.4	42.2	..	..	..	..	..	..
General government balance	-7.9	-5.0	-3.9	..	..	..	..	..	..
Primary balance	-5.2	-2.3	-1.1	..	..	..	..	..	..
Gross public debt	54.9	56.2	55.6	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	22.8	12.1	5.9	5.3	2.1	6.0	10.3	3.2	5.5
Merchandise imports	24.9	12.2	2.3	5.4	-2.0	0.5	5.5	-2.0	-2.2
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-2.5	-2.7	-1.4	-2.4	-1.8	-0.4	-1.0	-0.2	1.3
Services balance	0.7	1.1	1.2	1.1	1.7	1.1	1.0	1.4	1.8
Income balance (factor services balance)	-4.1	-4.6	-4.6	-4.6	-4.7	-5.3	-4.0	-4.2	-4.9
Current transfers	0.8	1.2	1.0	0.5	2.0	0.8	0.9	0.4	2.3
Current account balance	-5.1	-5.0	-3.7	-5.3	-2.8	-3.8	-3.1	-2.5	0.4
Capital account balance	1.8	2.0	2.2	1.5	2.5	2.6	2.3	0.9	3.5
Foreign direct investment (net)	1.4	2.4	1.1	-0.6	2.4	0.9	1.6	1.2	-0.2
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	66.9	67.5	72.7	70.8	72.3	73.7	72.7	72.5	70.9
Gross official reserves (excluding gold)	18.7	19.4	20.6	19.1	20.8	20.8	20.6	21.0	20.3
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.1	5.0	5.3	4.8	5.2	5.3	5.3	5.5	5.3
<i>EUR million, period total</i>									
GDP at current prices	354,693	370,414	381,518	87,432	91,383	95,181	107,523	90,939	94,244

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

9 Romania: Net Exports Drive Growth, Current Account Turns into Surplus

Pickup in exports keeps economy growing

In the first half of 2013, GDP grew by 1.8%. Despite a fairly unfavorable external environment, Romanian exports grew swiftly. Net exports delivered an extraordinarily positive growth contribution, as remarkable export growth coincided with shrinking domestic demand for imports. Private consumption growth came to a standstill, as slightly positive real wage growth was insufficient to compensate for the effects of rising unemployment, declining remittances from abroad and further tightening credit conditions. Gross fixed capital formation took a hit amid decreasing public capital expenditures, which also led to a drop in construction output. Meanwhile, private sector credit growth turned negative even in nominal terms.

Current account balance turns around

Fast export growth together with muted import demand entailed a notable improvement in the trade and services balance and enabled a shift from a current account deficit to a surplus. Export performance has been supported by additional production capacities, increasing demand from non-EU countries and a favorable development of manufacturing unit labor costs, as productivity improved and the rise in labor costs moderated. While the current account reversed, net FDI inflows declined from already low levels. Mainly as a result of foreign investments in government bonds, net portfolio inflows were positive and particularly high in the first quarter. At the same time, other investments showed considerable outflows mainly reflecting repayments to the IMF and cross-border deleveraging of foreign banks, which so far proceeded in an orderly manner.

Recent and prospective disinflation allows for interest rate cuts

Consumer price inflation (CPI) peaked in early 2013 at about 5% and has trended downward since. Also, the Banca Națională a României's (BNR) preferred core inflation rate (adjusted CORE2 inflation) went down gradually as well. In August, headline inflation fell to 3.7% mainly due to lower food prices reflecting an outstandingly good agricultural year. After a weak harvest in 2012, annual inflation rates are subject to a favorable base effect in the second half of 2013. The BNR, which has also pointed out the negative output gap, expects disinflation to continue, with inflation falling below the target of 2.5% in the first quarter of 2014. Accordingly, it cut its key policy rate by 25 basis points in July, by 50 basis points in August and by an additional 25 basis points at end-September to 4.25%.

New EU/IMF precautionary program as a policy anchor and a safeguard against external shocks

In July, the Romanian authorities reached staff-level agreement on a new precautionary support program with the IMF (already approved by the IMF Executive Board) and the European Commission, under which access would total EUR 4 billion, equally split between the IMF and the EU. After Romania managed to exit the excessive deficit procedure this year, it will proceed with gradual fiscal consolidation under the program, targeting a deficit of 2.4% of GDP in 2013 and achieving a structural deficit of not more than 1% of GDP by 2015. Moreover, the new program focuses on institutional and structural reforms, in particular in those areas where insufficient progress had been made under previous multilateral support frameworks (e.g. reforming inefficient state-owned enterprises, health-care system reform). The program also aims to address the banking sector's sizeable and still growing nonperforming loans by speeding up NPL resolution in order to revive credit growth.

Table 9

Main Economic Indicators: Romania

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	-0.9	2.3	0.4	-0.1	1.9	-1.1	0.9	2.2	1.5
Private consumption	-0.3	1.2	1.0	1.3	2.5	-1.0	1.5	-0.3	0.3
Public consumption	-4.6	1.1	1.5	3.0	1.8	2.2	0.0	-0.2	-0.5
Gross fixed capital formation	-2.3	7.3	5.2	11.3	5.4	7.4	-0.6	-5.4	-3.8
Exports of goods and services	14.2	10.9	-3.1	-2.1	-0.4	-5.1	-4.9	8.5	11.9
Imports of goods and services	12.5	10.3	-0.8	0.9	1.1	-1.7	-3.8	0.0	-1.7
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-1.1	2.6	1.5	2.1	3.1	0.1	0.4	-3.5	-6.8
Net exports of goods and services	0.0	-0.5	-0.8	-1.8	-1.0	-1.0	0.1	4.6	6.6
Exports of goods and services	4.0	3.7	-1.2	-1.1	-0.2	-1.9	-1.7	4.6	5.4
Imports of goods and services	-4.1	-4.1	0.4	-0.6	-0.8	0.9	1.8	0.0	1.2
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-1.9	-2.7	6.8	6.0	5.8	9.0	6.7	1.2	3.6
Unit labor costs in manufacturing (nominal, per hour)	-7.8	1.8	6.4	8.7	7.7	6.8	2.8	1.9	-1.3
Labor productivity in manufacturing (real, per hour)	15.1	5.1	0.6	-1.4	0.6	0.3	2.8	5.0	6.7
Labor costs in manufacturing (nominal, per hour)	6.7	7.2	7.0	7.1	8.3	7.1	5.6	7.0	5.3
Producer price index (PPI) in industry	4.3	7.1	5.3	4.8	5.1	5.6	5.5	5.2	2.8
Consumer price index (here: HICP)	6.1	5.8	3.4	2.7	2.1	4.2	4.7	4.8	4.4
EUR per 1 RON, + = RON appreciation	0.7	-0.7	-4.9	-3.0	-6.6	-5.9	-4.2	-0.8	0.7
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.6	7.7	7.3	7.9	7.2	7.0	7.2	7.8	7.8
Employment rate (%, 15–64 years)	58.8	58.5	59.5	58.0	60.0	60.8	59.3	58.1	60.2
Key interest rate per annum (%)	6.5	6.2	5.3	5.6	5.3	5.3	5.3	5.3	5.3
RON per 1 EUR	4.2	4.2	4.5	4.4	4.4	4.5	4.5	4.4	4.4
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	6.9	6.6	2.7	10.2	8.5	5.7	2.7	4.2	5.0
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	0.9	-1.6	6.7	5.7	-1.3	1.4	6.7	9.2	11.2
Domestic credit of the banking system	13.8	11.4	0.1	13.3	15.6	8.7	0.1	-2.1	-7.4
<i>of which: claims on the private sector</i>	5.2	6.8	1.5	10.4	6.7	4.4	1.5	-0.1	-1.2
<i>claims on households</i>	1.0	1.1	0.1	3.3	1.7	0.9	0.1	-0.4	-0.6
<i>claims on enterprises</i>	4.2	5.7	1.4	7.1	5.0	3.6	1.4	0.3	-0.6
<i>claims on the public sector (net)</i>	8.6	4.7	-1.4	2.9	8.9	4.3	-1.4	-2.0	-6.2
Other assets (net) of the banking system	-7.8	-3.2	-4.1	-8.9	-5.8	-4.4	-4.1	-2.9	1.3
<i>% of GDP, ESA 95</i>									
General government revenues	33.3	33.8	33.5	..	..	..	..	..	..
General government expenditures	40.1	39.4	36.4	..	..	..	..	..	..
General government balance	-6.8	-5.6	-2.9	..	..	..	..	..	..
Primary balance	-5.3	-3.9	-1.1	..	..	..	..	..	..
Gross public debt	30.5	34.7	37.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	28.5	21.2	-0.5	0.0	2.0	-3.3	-0.5	4.6	7.2
Merchandise imports	25.0	17.2	-0.5	1.9	0.6	-1.3	-2.9	-1.1	-4.2
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-6.1	-5.6	-5.6	-4.6	-7.4	-5.6	-4.9	-2.0	-2.8
Services balance	0.3	0.3	0.4	-0.3	0.2	0.5	1.0	2.1	1.9
Income balance (factor services balance)	-1.5	-1.7	-1.3	-2.6	-1.9	-0.3	-0.8	-2.0	-1.6
Current transfers	2.9	2.5	2.6	4.4	2.7	1.6	2.0	2.9	3.5
Current account balance	-4.4	-4.5	-3.9	-3.1	-6.4	-3.7	-2.7	1.1	1.1
Capital account balance	0.2	0.5	1.5	1.5	1.8	0.7	1.8	1.1	1.9
Foreign direct investment (net)	1.8	1.4	1.3	1.2	1.5	1.8	0.7	0.7	1.9
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	74.5	75.3	75.3	76.0	75.9	75.9	75.3	76.0	73.2
Gross official reserves (excluding gold)	26.1	25.3	23.7	26.3	25.1	24.7	23.7	24.2	23.9
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	7.6	6.7	6.3	6.9	6.6	6.5	6.3	6.5	6.6
<i>EUR million, period total</i>									
GDP at current prices	124,084	131,139	131,439	25,916	31,111	36,410	38,003	27,561	33,133

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

10 Turkey: Domestic Demand Revives, Demand for Lira Plummets

Upswing in domestic demand in the first half of 2013

The Turkish economy showed a strong rebound in the first half of 2013 (GDP expanded by 3.7% year on year), fueled by reviving domestic demand. The strongest demand components were household consumption and public gross fixed capital investment, the latter resulting from large state-financed investment programs related to infrastructure projects. By contrast, private gross fixed capital formation was steady in the first half of 2013 (and even contracted in the second quarter) given ample production capacity and a rise in political uncertainty both at home and in some neighboring countries. The contribution of net exports to growth turned negative in the first half of the year. On the production side, construction and wholesale as well as retail trade accounted for the largest growth contributions along with financial intermediation and agriculture. Manufacturing value added expanded only moderately. Capacity utilization is broadly steady at 74%, likewise the business confidence index has been leveling off while July industrial production increased and the August PMI moved beyond the 50 benchmark again. Private sector credit growth has continually increased since the beginning of 2013, reaching almost 30% in July (double the central bank's indicative target of 15%).

External imbalances widen again

Vivid domestic demand fostered import growth while exports faltered as a result of continued weak demand from Europe and a tightening of restrictions on gold exports to Iran. At the same time, gold imports jumped due to lower gold prices and the replenishment of stocks by Turkish companies. Consequently, the current account deficit widened considerably to 8.9% of GDP in the first half of 2013. This severely aggravated Turkey's vulnerability to capital flow volatility as became evident first in June, when the emergence of domestic political unrest coincided with a global worsening of investor sentiment toward emerging markets following the U.S. Federal Reserve's tapering announcement. Due to sizable capital outflows, the Turkish lira depreciated by 15% against the euro (and by 11.5% against the U.S. dollar) between the beginning of May and the beginning of October. On September 5, the lira reached a record level of TRY 2.07 against the U.S. dollar and remained at around TRY/USD 2 ever since.

Monetary policy relies on foreign exchange intervention and liquidity management with some corridor widening

In fighting capital outflows and stabilizing the currency, the Central Bank of the Republic of Turkey (CBRT) was reluctant to raise interest rates and relied mainly on direct interventions and liquidity instruments. Following the build-up of foreign currency stocks until early 2013 the CBRT sold foreign exchange reserves in several interventions, starting on June 11. Still, foreign exchange reserves remained above the level of end-2012. Despite some initial success this policy was not sufficient by far to halt the sharp depreciation of the lira. Eventually, the upper bound of the interest corridor was raised in two steps in July and August to 7.75% (by 125 basis points in total, not yet offsetting previous lending rate reductions between January and May), while the one-week repo and borrowing rates have been held constant at 4.5% and 3.5%, respectively.

Weak lira gives rise to inflation pressures

The strong lira depreciation in the second quarter is likely to have put upward pressure on domestic prices even though overall inflation moderated again in August, led by lower food prices. However, given the increase in the CBRT's preferred core inflation measures in August in year-on-year terms compared to July, the central bank raised its end-year inflation projection from 5.3% to 6.2% (and thus above the target rate of 5.5%).

Table 10

Main Economic Indicators: Turkey

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	9.0	8.5	2.6	4.2	3.4	1.5	1.4	2.9	4.4
Private consumption	6.7	7.9	-0.8	-0.4	-2.2	-0.3	-0.4	3.1	5.3
Public consumption	2.0	4.4	6.4	5.7	5.4	5.5	8.5	7.6	7.4
Gross fixed capital formation	29.9	17.6	-1.9	2.2	-4.4	-3.3	-1.7	2.3	3.7
Exports of goods and services	3.4	6.5	18.2	16.1	26.1	14.4	16.7	5.6	1.2
Imports of goods and services	20.7	9.6	0.7	-4.7	-1.7	3.0	6.6	7.1	11.7
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	13.7	9.1	-1.8	-1.6	-3.2	-1.2	-1.2	3.6	8.5
Net exports of goods and services	-4.0	-1.0	3.7	4.6	5.9	2.4	2.1	-0.5	-2.8
Exports of goods and services	0.8	1.4	3.8	3.3	5.4	3.1	3.7	1.3	0.3
Imports of goods and services	-4.8	-2.4	-0.2	1.3	0.5	-0.7	-1.6	-1.8	-3.1
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit wage costs in manufacturing (nominal, per hour)	2.4	5.9	13.6	16.0	12.4	13.7	12.2	8.6	11.5
Labor productivity in manufacturing (real, per hour)	8.7	3.4	-1.4	-2.2	-0.1	-1.5	-1.8	-0.2	0.4
Gross wages in manufacturing (nominal, per hour)	11.9	9.7	11.9	13.5	12.3	12.0	10.1	8.4	11.8
Producer price index (PPI) in industry	6.2	12.3	6.1	9.9	8.0	3.6	3.3	3.9	4.2
Consumer price index (here: HICP)	8.6	6.5	9.0	10.5	9.6	9.1	6.8	7.4	6.8
EUR per 1 TRY, + = TRY appreciation	8.3	-14.5	0.9	-8.4	-2.7	8.5	6.4	-0.1	-3.7
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	10.9	9.0	8.4	9.6	7.5	7.9	8.5	9.6	8.1
Employment rate (%, 15–64 years)	46.3	48.4	48.9	46.3	49.9	49.9	49.5	47.9	50.8
Key interest rate per annum (%) ¹	6.8	6.1	5.7	5.8	5.8	5.8	5.7	5.5	4.8
TRY per 1 EUR	2.0	2.3	2.3	2.4	2.3	2.3	2.3	2.4	2.4
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	18.6	15.2	10.5	10.3	9.3	8.8	10.5	13.6	15.4
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-7.5	0.6	1.4	-2.7	-3.2	0.1	1.4	1.1	-1.0
Domestic credit of the banking system	30.2	19.0	16.9	18.9	17.5	14.4	16.9	18.5	22.0
<i>of which: claims on the private sector</i>	27.9	25.0	18.7	21.6	18.0	15.2	18.7	21.0	27.0
<i>claims on households</i>	8.4	8.4	5.9	7.1	5.5	5.3	5.9	7.0	8.1
<i>claims on enterprises</i>	19.5	16.6	12.7	14.5	12.5	9.9	12.7	14.0	18.9
<i>claims on the public sector (net)</i>	2.4	-6.0	-1.8	-2.7	-0.5	-0.8	-1.8	-2.5	-5.0
Other assets (net) of the banking system	-4.2	-4.4	-7.7	-5.9	-5.1	-5.7	-7.7	-6.0	-5.5
<i>% of GDP, ESA 95</i>									
General government revenues	36.7	34.1	32.5	..	..	..	..	..	..
General government expenditures	39.4	36.3	34.8	..	..	..	..	..	..
General government balance	-2.6	-2.2	-2.3	..	..	..	..	..	..
Primary balance	1.6	1.8	1.7	..	..	..	..	..	..
Gross public debt	42.4	39.8	37.9	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	16.1	12.9	23.3	17.7	30.3	26.6	18.7	5.4	-2.2
Merchandise imports	39.4	24.6	6.6	5.2	8.1	8.0	4.8	4.5	6.9
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-7.7	-11.5	-8.3	-9.2	-9.3	-7.8	-7.1	-8.7	-11.2
Services balance	2.3	2.6	2.9	1.1	2.9	4.7	2.8	1.4	3.0
Income balance (factor services balance)	-1.0	-1.0	-0.9	-1.1	-0.9	-0.8	-0.7	-1.0	-1.6
Current transfers	0.2	0.2	0.2	0.2	0.2	0.1	0.2	0.1	0.1
Current account balance	-6.2	-9.7	-6.0	-9.0	-7.1	-3.8	-4.8	-8.2	-9.6
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	1.0	1.8	1.1	1.2	1.8	0.7	0.7	1.0	0.7
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	39.6	42.4	41.7	42.4	44.8	42.4	41.7	43.7	44.3
Gross official reserves (excluding gold)	11.0	10.9	12.4	10.7	11.6	12.4	12.4	13.2	12.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	4.9	4.0	4.7	3.9	4.2	4.6	4.7	5.0	4.8
<i>EUR million, period total</i>									
GDP at current prices	551,485	554,990	612,280	138,066	150,893	166,896	156,425	150,573	160,079

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

¹ Until April 2010: overnight borrowing rate; from May 2010: one-week repo (lending) rate.

11 Russia: Growth Continues to Sag

Plummeting investment dampens GDP expansion further

After reaching a growth rate for the entire year of 3.4% in 2012, Russian economic growth declined to 1.6% in the first quarter 2013 and further to 1.2% in the second quarter. Quarter-on-quarter readings were negative throughout the first half of 2013. Industrial production and manufacturing were flat over the first eight months. The slowdown of economic activity in the first half-year was largely triggered by plummeting investment (–10%, notably large-scale destocking, while gross fixed capital formation contracted 1.5%). While this certainly reflected heightened caution in the private corporate sector, it is also the result of shrinking state infrastructure investment. Net exports, however, started to contribute positively to growth in the second quarter.

Private consumption remains sole driving force of growth

Due to relatively tight fiscal policy, government consumption hardly increased in the first half of 2013. The only remaining driving force of growth was private consumption (+5.7%), buoyed by rapid increases of wages and pensions and by the continuing, if decelerating, retail credit boom. Unemployment continues to hover at near post-Soviet record lows (5.3% in July). Low joblessness, elevated inflation and shrinking current account surpluses also support the view that the economy is reaching full capacity.

Inflation elevated because of administered price adjustments and the ruble's recent depreciation

CPI inflation declined slightly to 6.5% at end-August 2013, which is still clearly above the Bank of Russia's (CBR) annual target of 5% to 6%. The persistence of relatively high inflation is due to the ruble's depreciation of over 6% against the U.S. dollar and of over 7% against the euro from end-April to end-August 2013 in connection with recent global financial market turbulences. The adjustment of administered prices at the beginning of 2013 also contributed to inflation. Therefore, notwithstanding the marked slowdown of economic growth, the CBR has held its key interest rates stable. However, it cut some longer-term refinancing rates that allow nonmarketable securities as collateral. Under the framework of transition to inflation targeting, the CBR in mid-September 2013 declared that the rate on one-week open market operations (5.5% in early October) would be its new key interest rate replacing the refinancing rate (8.25%) as the main policy tool.

Retail credit boom slightly decelerates

Over the first nine months of 2013, the total outflow of private capital came to EUR 36.4 billion, which is about the same amount recorded in the corresponding period of 2012. As at end-August 2013, total credit growth remained strong (+11% in real terms, year on year), with the retail lending boom slightly decelerating (+24%). Regulatory tightening by the CBR may be starting to rein in the consumer credit boom. Despite the economic slowdown the federal budget was slightly in surplus (0.9% of GDP) between January and August 2013, inter alia due to a new oil price-based fiscal rule, which places limits on spending levels. Given faltering growth, fiscal stimulus measures are being prepared, though. For instance, assets are to be borrowed from the National Welfare Fund (which as at end-August amounted to EUR 65.6 billion) to finance transportation projects.

Current account surplus shrinks

Given the sluggish state of the global economy and the lower oil price, Russia's current account surplus shrank to 3.2% of GDP between January and June 2013 (first half of 2012: 6.1%). While it has been rising lately, Russia's gross external debt remains at a relatively low level (33.7% of GDP at mid-2013), which, however, now considerably exceeds the amount of its foreign exchange reserves (excluding gold) of 22.7% of GDP.

Table 11

Main Economic Indicators: Russia

	2010	2011	2012	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.5	4.3	3.4	4.8	4.3	3.0	2.1	1.6	1.2
Private consumption	5.5	6.3	6.7	9.0	6.9	5.5	5.7	6.0	5.4
Public consumption	-1.5	0.8	-0.2	0.4	-0.1	-0.2	-0.8	0.5	-0.2
Gross fixed capital formation	5.9	10.2	6.0	15.5	9.7	4.6	1.4	0.1	-2.5
Exports of goods and services	7.0	0.3	1.4	4.2	-2.0	1.8	1.4	0.4	4.1
Imports of goods and services	25.8	20.3	9.5	13.0	5.6	10.5	9.2	4.9	1.4
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	7.1	7.9	5.0	5.9	5.8	4.9	3.6	1.5	1.0
Net exports of goods and services	-2.0	-4.0	-1.8	-1.2	-1.9	-2.1	-1.8	-0.9	0.9
Exports of goods and services	2.3	0.1	0.4	1.5	-0.7	0.5	0.4	0.2	1.3
Imports of goods and services	-4.3	-4.1	-2.2	-2.7	-1.3	-2.6	-2.2	-1.1	-0.3
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit labor costs in industry (nominal, per person)	2.2	9.3	5.6	9.3	8.7	7.3	-2.4	8.2	9.0
Labor productivity in industry (real, per person)	11.8	4.1	4.0	5.5	3.8	3.9	2.9	1.7	1.8
Average gross earnings in industry (nominal, per person)	14.7	13.8	9.6	15.3	12.8	11.4	0.2	9.9	11.0
Producer price index (PPI) in industry	12.3	17.8	6.8	8.0	4.5	7.9	6.8	4.3	2.5
Consumer price index (here: CPI)	6.9	8.5	5.1	3.9	3.9	6.1	6.5	7.2	7.2
EUR per 1 RUB, + = RUB appreciation	9.6	-1.5	2.4	1.2	1.1	2.9	4.4	-1.5	-3.7
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.5	6.6	5.5	6.3	5.3	5.1	5.2	5.8	5.4
Employment rate (%, 15–64 years)	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	5.3	5.3	5.3	5.3	5.3	5.3	5.5	5.5	5.5
RUB per 1 EUR	40.3	40.9	39.9	39.5	39.8	40.0	40.3	40.2	41.4
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	24.6	20.9	12.1	20.1	20.1	15.0	12.1	15.1	16.3
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	5.8	9.9	-0.3	6.7	10.5	0.8	-0.3	4.5	1.8
Domestic credit of the banking system	22.1	19.7	15.4	21.1	22.4	19.5	15.4	17.0	18.1
<i>of which: claims on the private sector</i>	12.4	24.5	17.9	24.8	26.9	21.5	17.9	19.9	18.2
<i>claims on households</i>	3.1	6.4	8.2	7.8	8.9	8.8	8.2	8.4	8.2
<i>claims on enterprises</i>	9.3	18.1	9.7	17.1	18.0	12.7	9.7	11.5	10.1
<i>claims on the public sector (net)</i>	9.7	-4.8	-2.6	-3.7	-4.5	-2.0	-2.6	-2.9	-0.1
Other assets (net) of the banking system	-3.3	-8.7	-3.0	-7.8	-12.9	-5.3	-3.0	-6.4	-3.6
<i>% of GDP, ESA 95</i>									
General government revenues	33.9	37.4	36.9	..	..	..	..	..	..
General government expenditures	37.4	35.9	36.5	..	..	..	..	..	..
General government balance	-3.4	1.5	0.4	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	8.4	9.0	9.6	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	39.9	24.1	8.3	15.4	10.2	8.8	0.6	-0.7	-4.8
Merchandise imports	37.4	23.8	13.9	23.3	10.8	15.4	8.7	-0.7	1.8
<i>% of GDP (based on EUR), period total</i>									
Trade balance	9.9	10.5	9.0	10.6	10.2	7.5	8.1	9.8	8.3
Services balance	-1.9	-1.9	-2.4	-2.3	-2.1	-3.0	-2.3	-2.1	-2.6
Income balance (factor services balance)	-3.2	-3.2	-3.5	-2.5	-4.7	-2.8	-3.7	-2.3	-4.8
Current transfers	-0.2	-0.2	-0.3	-0.3	-0.1	-0.5	-0.4	-0.3	-0.3
Current account balance	4.6	5.2	2.8	5.5	3.3	1.1	1.8	5.1	0.7
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	-0.6	-0.8	-1.2	-5.6	-1.5	0.4	1.1	-5.2	1.9
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	31.8	30.6	30.8	29.5	31.1	30.6	30.8	33.9	33.7
Gross official reserves (excluding gold)	28.9	25.7	23.5	24.7	25.5	24.4	23.5	23.4	22.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	16.3	14.2	12.5	13.3	13.7	12.9	12.5	12.7	12.2
<i>EUR million, period total</i>									
GDP at current prices	1,150,057	1,362,744	1,567,113	348,992	376,767	408,804	432,550	373,285	389,360

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