Developments in Selected Countries[1, 2]

1 Introduction

In 2007 economic activity in the Central, Eastern and Southeastern European (CESEE) region turned out to be strong again, averaging around 6%, compared to 2.6% in the euro area and 2.2% in the U.S.A.[3] Many CESEE countries even registered higher annual average growth than in 2006, but in some countries under review, growth decelerated somewhat toward the end of 2007. Domestic demand remained the main pillar of economic growth, while the growth of exports lost some of its momentum in most countries, even though economic growth in major CESEE trading partner countries held up relatively well in the second half of 2007. Against the background of global financial market turbulences since August of last year, the issue of potential spillover effects has moved to center stage. So far, however, the CESEE financial markets have not been affected by the turbulences to a larger extent than the markets of other emerging market economies (see box 1). Nevertheless, looking forward, some impact on the real economies of CESEE countries can be expected in 2008 and 2009: Economic growth will moderate somewhat compared to buoyant developments in 2007, but is widely expected to remain comparatively strong (see box 2).

Increasing price pressures have been an important issue in all countries under review: Inflation has picked up in the last months of 2007 and in the beginning of 2008, pushed up by increases in global energy and food prices, but also by domestic factors. In particular the two newest EU Member States, Bulgaria and Romania, and to a lesser extent also the two candidate countries, Croatia and Turkey, have been affected by high and rising external imbalances, which makes them vulnerable to negative external shocks. Fiscal positions have generally improved in 2007, but this development was largely driven by cyclical factors and less by consolidation efforts.

2007: A year of robust economic growth across CESEE, with gross fixed capital formation expanding strongly

The CESEE region saw another year of robust economic activity. Real GDP growth gained further momentum in 2007 in annual average terms in Slovenia, Poland, and Slovakia, as well as Croatia and Russia. In Hungary, Romania, and Turkey, economic growth turned out to be weaker in 2007 than a year earlier. In the case of Romania and Turkey, the unfavorable development was largely the result of deteriorating net exports and bad harvest, whereas in Hungary, the fiscal consolidation program left its marks. Real GDP growth was almost unchanged in Bulgaria and the Czech Republic. At 3.4 percentage points, the growth differential (measured at current prices) of the CESEE EU Member States with the euro area was slightly lower in 2007 than in 2006.

In 2007, gross fixed capital formation (GFCF) expanded more strongly than private consumption in all countries except Turkey. Some countries (notably Bulgaria, Poland, and Romania) even registered record-high GFCF growth rates

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[2] *Cutoff date: April 18, 2008. This report primarily focuses on data releases and developments from November 2007 up to the cutoff date.*

[3] *One set of countries covered in this contribution – Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia – is referred to as the CESEE EU Member States throughout the report. The CEE-5 subgroup of countries comprises the Czech Republic, Hungary, Poland, Slovakia, and Slovenia. The second set of countries covered here consists of Croatia and Turkey (referred to as EU candidate countries), as well as Russia.*

that were partly driven by the dynamic development of real credit as well as by the inflow of net FDI and EU structural funds. GFCF growth weakened significantly only in the two EU candidate countries. Among the CESEE EU Member States,[4] Slovenia, Poland, and Romania registered double-digit growth rates in construction investments year on year in 2007, whereas this type of investment shrank in Hungary. In the field of equipment investments, growth turned out to be very dynamic in Poland and Romania (at above 20% year on year), while Slovenia, Hungary, and Slovakia registered growth rates of around 10%; growth was somewhat lower in the Czech Republic. As in 2006, private consumption growth remained robust throughout the region in 2007, with the notable exception of Hungary, where private consumption even contracted as a result of the fiscal austerity package. Consumption growth was supported by rapid growth of real credit (in particular in Slovenia, Bulgaria, Poland, Romania, as well as Russia) and dynamic wage growth, which was most pronounced in Bulgaria, Poland, Romania, as well as in Russia (for more details, see below). Apart from Hungary, private consumption growth in 2007 turned out to be weaker only in Slovenia, Bulgaria, and Romania compared with 2006, although growth rates remained comparatively high in the latter two countries. Overall, domestic demand remained the main contributor to GDP growth in most of the countries under review.

Negative contribution of net exports to GDP growth in many countries of the region

With the exception of the Czech Republic, Hungary, and Slovakia, the contribution of net exports to GDP growth was negative in 2007 and even highly negative in Bulgaria, Romania, and Russia. Comparing 2007 with 2006, the contribution of net exports to GDP growth improved (at least slightly) in the Czech Republic, Poland, Slovakia, Bulgaria, as well as Croatia, despite lower export growth (except in the Czech Republic) as import growth fell more strongly. In Hungary the positive contribution of net exports declined in 2007 as export growth decelerated more strongly than import growth, whereas in Slovenia the negative contribution of net exports declined as import growth outpaced export

Table 1

Gross Domestic Product (Real)

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Annual change in %								
Slovenia	4.1	5.7	6.1	6.1	6.3	7.2	6.0	6.4	4.7
Bulgaria	6.2	6.3	6.2	7.1	6.2	5.5	7.3	4.9	6.9
Czech Republic	6.4	6.4	6.5	6.3	6.2	6.5	6.5	6.3	6.6
Hungary	4.1	3.9	1.3	3.9	3.7	2.7	1.2	0.9	0.8
Poland	3.6	6.2	6.5	6.6	6.6	7.2	6.4	6.4	6.1
Romania	4.2	7.9	6.1	8.4	7.9	6.1	5.7	5.7	6.6
Slovakia	6.6	8.5	10.4	9.0	8.2	8.3	9.3	9.4	14.3
Croatia	4.3	4.8	5.6	4.7	4.8	7.0	6.6	5.1	3.7
Turkey	8.4	6.9	4.5	6.3	5.7	7.6	4.0	3.4	3.4
Russia	6.4	7.3	8.1	7.5	8.0	7.4	8.0	7.3	9.5
Memorandum item:									
Euro area	1.6	2.7	2.6	2.5	3.1	3.1	2.5	2.6	2.2

Source: Eurostat, national statistical offices, wiiw.

[4] *No comparable data are available for Bulgaria and the non-EU Member States.*

growth. In Romania, Turkey and Russia, import growth gained more speed in 2007 compared with 2006, whereas export growth slowed down. In Romania and Russia, the negative contribution of net exports to GDP growth turned out to be much higher than in 2006 at almost 15 percentage points and 7 percentage points, respectively.

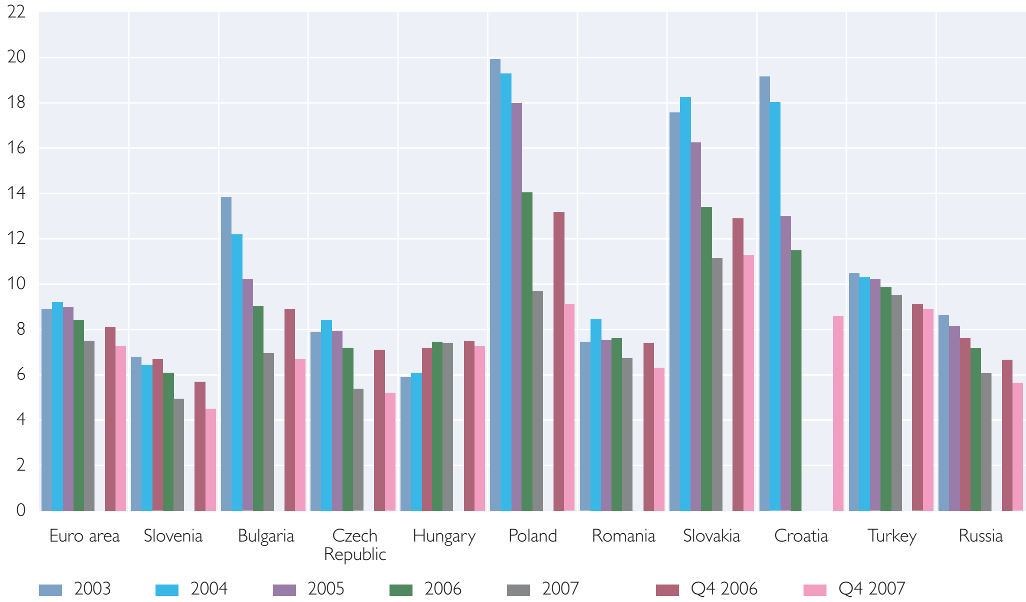
Tight labor markets become increasingly problematic in some countries

In 2007, unemployment rates in many CESEE countries reached the lowest levels recorded since the early stages of the transition process, which was primarily due to strong economic growth. While the unemployment rate in the euro area also declined to the lowest level in history, it still dropped less markedly than it did in most CESEE countries. Favorable labor market developments have led to labor shortages in some CESEE countries and sectors, especially with regard to skilled labor for which demand has increased rapidly. Tightening labor market conditions along with increasing inflation put further upward pressure on wages. In most countries, total economy compensation per employee rose more sharply in 2007 than in 2006, with nominal growth rates ranging between around 6% (Slovenia and Croatia) and above 20% (Romania) year on year. In this context, productivity growth (measured as gross value added per employee) increased most strongly in Slovakia by above 8%, while most countries saw an acceleration of around 3% to 4% year on year. Only Hungary and Poland registered lower productivity growth rates of about 2%. Overall, nominal ULC growth rates were positive in all countries in 2007, with the lowest increase being recorded in Slovakia (0.2%) and the highest in Bulgaria and Romania (above 14%).[5] In the euro

Chart 1

Unemployment Rates

ILO definition, period average



Source: Eurostat.

[5] *No comparable data are available for Russia.*

area, nominal ULC on the basis of the whole economy accelerated by 1.5% year on year in 2007 (against 1.0% in 2006).

Price pressures remain strong

Price pressures increased across the region in the last months of 2007 and early 2008, and thus became a key policy issue in most CESEE countries. As already highlighted in FEEI 2/2007, exogenous factors (i.e. rising world market prices for energy and food) had a strong impact on inflationary developments. For comparison, the euro area was also affected by worldwide price increases, as is reflected in higher inflation rates over the past months. However, the CESEE region was hit even more strongly by the unfavorable development of world market prices, given that the share of energy and food in the consumer goods basket (which is incorporated in the weights for calculating the HICP) is higher in the CESEE countries than in more advanced economies. In Romania, the weights of energy and food items add up to above 60%, while they come to around 40% in the other CESEE EU Member States except Slovenia (35%).[6] The corresponding weight in the euro area is just around 30%. Moreover, some CESEE countries were severely hit by crop failure in 2007, which put additional pressure on food prices. Thus, in the period from October 2007 to March 2008, the food and energy components clearly added more to inflation than they did in the period from April to September 2007.

Apart from these developments, country-specific factors pushed up inflation, as well. In some countries, strong consumption growth and accelerating real ULC on the basis of the whole economy also contributed to inflation. Bulgaria, Poland and Romania registered positive growth rates of real ULC whereas ULC declined in several countries, most strongly in Slovakia (1.6% year on year). In Croatia and Turkey, real ULC remained almost unchanged in 2007 compared with 2006.[7]

Table 2

Consumer Price Index (here: HICP)

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008
	Annual change in %									
Slovenia	2.5	2.5	3.8	2.5	2.3	2.6	3.2	3.7	5.5	6.5
Bulgaria	6.0	7.4	7.6	6.7	5.7	5.3	4.7	9.0	11.2	12.4
Czech Republic	1.6	2.1	3.0	2.4	1.1	1.7	2.6	2.7	4.9	7.5
Hungary	3.5	4.0	7.9	4.6	6.4	8.8	8.5	7.3	7.1	6.9
Poland	2.2	1.3	2.6	1.5	1.3	2.0	2.3	2.4	3.7	4.5
Romania	9.1	6.6	4.9	5.9	4.8	3.9	3.9	5.1	6.8	8.0
Slovakia	2.8	4.3	1.9	4.8	3.5	2.1	1.7	1.4	2.4	3.4
Croatia[1]	3.4	3.2	2.8	3.2	2.2	1.5	2.1	2.9	4.9	5.9
Turkey	8.1	9.3	8.8	10.6	9.7	10.3	9.5	7.1	8.2	8.8
Russia[1]	12.5	9.8	9.1	9.6	9.2	7.9	8.1	9.0	11.5	12.9
Memorandum item:										
Euro area	2.2	2.2	2.1	2.2	1.8	1.9	1.9	1.9	2.9	3.4

Source: Eurostat, national statistical offices, wiiw.

[1] *CPI.*

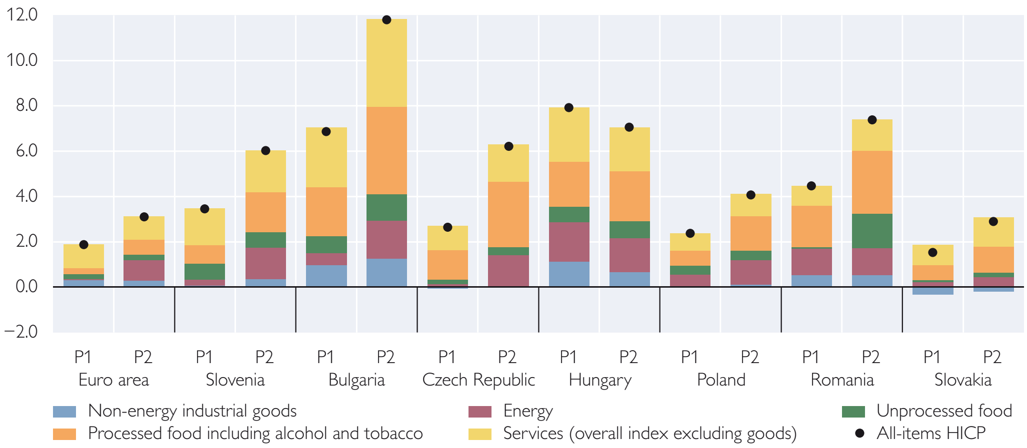
[6] *For the non-EU Member States, no comparable figures are available on the contribution of these components to HICP.*

[7] *For Russia, no comparable ULC data for the whole economy are available.*

Chart 2

Contribution to the HICP

percentage points, dots in %, year on year



Source: Eurostat.

Note: P1 stands for the period from April 2007 to September 2007, P2 for the period from October 2007 to March 2008.

Accelerating wages in 2007, however, call for some caution. Higher administered prices and VAT increases are further factors behind the pickup in inflation, e.g. in Bulgaria and the Czech Republic in 2007, and in Poland in early 2008, which is also reflected in a higher contribution of services to HICP. Regarding aggregate demand conditions relative to aggregate supply, which have a bearing on inflation pressures, it is useful to look at the development of output gaps.[8] It is noteworthy that the output gap became more positive in most countries in 2007 compared with 2006. In Romania, the output gap moderated slightly, but remained high at 3%. In contrast, Hungary's output gap fell to 0.2% in 2007 after 1.8% in 2006.[9]

High real growth rates of credit to the private sector

Domestic demand was also underpinned by strong real growth of credit to the private sector. It is particularly noticeable that all countries except Hungary featured higher real credit growth than the euro area, reflecting (at least to some extent) the process of income convergence and catching-up in terms of financial intermediation.[10] However, even when accounting for these factors, real credit growth was outstandingly dynamic in Romania, Bulgaria, and Russia. In 2007, credit growth picked up markedly in the latter two countries and Poland, whereas it dropped sharply in Hungary, Turkey, and Croatia. The slowdown in Hungary was largely the result of low growth and low consumer confidence. In Turkey, it was ascribable to tight monetary policy, while in Croatia, it was attributable to the central bank's prudential and administrative measures.

Monetary tightening

In contrast to some major central banks (e.g. the Federal Reserve, the Bank of England), several central banks in CESEE hiked their policy rates (see table 3) in the last quarter of 2007 and early 2008, largely in response to rising inflationary

[8] *No comparable data are available for the non-EU Member States.*

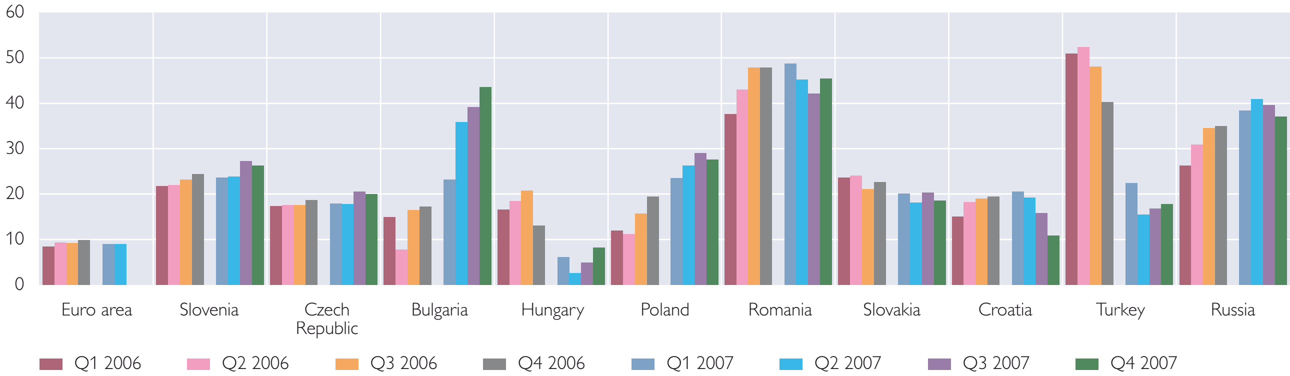
[9] *The output gap is defined as the gap between actual and potential GDP, measured as a percentage of potential GDP. For comparison, the output gap of the euro area was –0.2% in 2006 and 0.2% in 2007.*

[10] *Financial intermediation is measured as the share of credit to the private sector in relation to GDP. It is still considerably lower in CESEE than in the euro area.*

Chart 3

Domestic Credit to Nonbanks and the Nongovernment Sector, Deflated by the CPI

Annual change in %, period average



Source: National central banks, OeNB.

Table 3

Inflation: Assessment and Key Factors

	Assessment		Key Factors: Monetary Policy Issues	
	Price stability	Inflation level	Inflation targets	Change of the key interest rate
Slovenia	↓	◙	euro area monetary policy framework	euro area interest rates
Bulgaria	↓	●	no target	..
Czech Republic	↓	◙	inflation target of 3% ±1 percentage point (CPI) until end-2009	increase by 50 basis points in two steps to 3.75%
Hungary	↔	◙	inflation target: 3% ±1 percentage point (medium-term)	increase by 50 basis points in one step to 8.0%
Poland	↓	◙	inflation target of 2.5% ±1 percentage point (national headline CPI)	increase by 100 basis points in four steps to 5.75
Romania	↓	●	inflation target of 3.8% ±1 percentage point for end-2008	increase by 200 basis points in four steps to 9.5%
Slovakia	↓	○	inflation target of <2% at end 2008	no change, monetary policy rate at 4.25% since end-April 2007
Croatia[1]	↓	◙	no target	increase from 3.86% to 4.95%[1]
Turkey	↓	●	inflation target of 4% ±2 percentage points	decrease by 150 basis points in four steps to 15.25%
Russia	↓	●	no explicit target	increase by 25 basis points in one step to 10.25%

Source: Eurostat, national central banks, OeNB.

[1] *Weighted monthly averages of weighted repo rates achieved at regular reverse repo auctions of the HNB.*

Note: The table refers to the review period (beginning of November 2007 until mid-April 2008).

↑ *: improvement* ↓ *: deterioration* ◙ *: intermediate risk*
↔ *: no significant change* ○ *: moderate risk* ● *: high risk*

Table 4

External Equilbria: Assessment and Key Factors

	Assessment		Key Factors: FDI and Gross External Debt			
	Development of the combined current and capital account[1]	Level of the combined current and capital account	Coverage of combined current and capital account by net FDI in %		Gross external debt, % of GDP	
			2006	2007	2006[2]	2007[2]
Slovenia	↓	○	–20.9	–0.0	78.5	101.7
Bulgaria	↓	●	135.1	100.7	80.7	97.3
Czech Republic	↔	○	113.2	173.0	38.1	39.5
Hungary	↑	○	52.5	26.0	91.4	96.5
Poland	↔	○	113.0	148.7	46.5	50.7
Romania	↓	●	85.1	44.1	28.0	27.9
Slovakia	↑	○	95.5	74.9	54.8	54.9
Croatia	↓	◙	93.0	101.8	85.6	87.8
Turkey	↔	◙	58.0	52.5	37.3	35.0
Russia	↓	○	–10.0	–9.9	30.3	26.6

Source: Eurostat, national central banks, OeNB.

[1] *Comparing 2007 with 2006.*
[2] *% of GDP (rolling four-quarter GDP, euro basis), end of period.*

Note: The table refers to the review period (beginning of November 2007 until mid-April 2008).

↑ : *improvement* ↓ : *deterioration* ◙ : *intermediate risk*
↔ : *no significant change* ○ : *moderate risk* ● : *high risk*

pressures. A notable exception is Turkey, which has lowered the policy rate by a total of 150 basis points since the beginning of November 2007, albeit from a high level.

Substantial combined current and capital account deficit widening further in Bulgaria and Romania

In the CEE-5, the deficits of the combined capital and current accounts generally remained well contained in 2007. Interestingly, in Hungary and Slovakia the deficit ratio even declined markedly. Overall, the deficits were largely covered by net FDI inflows in the Czech Republic, Poland and Slovakia. In contrast, deficit ratios in Bulgaria and Romania continued to widen in 2007, moving further into double-digit territory. Nevertheless, Bulgaria's deficit continued to be fully covered by net FDI inflows (following substantial overcoverage in previous years), whereas in Romania the coverage ratio almost halved to 44% in 2007. Russia's surplus of the combined capital and current account shrank in 2007 due to strong import growth and more moderate export growth.

Competitiveness: ULC in industry on the rise in most countries

Among the CESEE EU Member States, ULC in industry measured in local currency declined in Hungary and Slovakia in 2007. In Slovenia the increase of ULC in industry was less than 1 percentage point higher than in the euro area (where ULC decreased slightly). The Czech Republic, Hungary, Poland, and Slovakia posted ULC increases (in euro terms) between 4.3 percentage points and 6.9 percentage points compared with the euro area. Bulgaria and, even more so, Romania registered significant increases in nominal industrial wages that came to more than 20% year on year in 2007 and were by far not matched by productivity gains. In relation to the euro area, ULC thus increased by 10 percentage points and almost 18 percentage points, respectively. Despite rising ULC, the CEE-5 posted higher market shares in world imports in 2007 than in 2006, whereas Bulgaria's market share was steady and Romania lost some market share. Croatia's

Table 5

Wages, Productivity and Unit Labor Cost

	Nominal Wages in Industry				Productivity in Industry				Unit Labor Cost in Industry (local currency)			
	2006	2007	Q3 2007	Q4 2007	2006	2007	Q3 2007	Q4 2007	2006	2007	Q3 2007	Q4 2007
	Annual change in %											
Slovenia	5.5	6.7	6.6	8.6	7.9	6.3	6.0	3.8	−2.3	0.4	0.6	4.6
Bulgaria	10.8	20.1	20.0	22.8	8.2	9.5	10.9	9.7	2.5	9.7	8.2	11.9
Czech Republic	6.1	8.6	8.6	8.1	9.4	6.5	4.4	5.1	−3.0	1.9	4.1	2.8
Hungary	8.6	8.5	7.6	7.4	11.5	9.3	10.6	8.2	−2.6	−0.7	−2.7	−0.7
Poland	5.2	8.7	8.8	9.3	9.5	6.0	4.5	4.8	−4.0	2.6	4.1	4.3
Romania	15.7	21.6	20.9	22.8	11.3	9.5	8.8	8.0	4.0	11.0	11.1	13.7
Slovakia	6.7	6.4	6.1	5.5	11.3	10.0	10.1	9.2	−4.1	−3.3	−3.6	−3.4
Croatia	7.5	5.6	6.0	5.0	2.7	5.9	4.7	3.6	4.7	−0.2	1.2	1.3
Turkey	11.5	9.4	10.9	9.9	6.7	2.6	1.1	4.0	4.5	6.6	9.8	5.7
Russia	21.4	26.0	24.8	28.5	8.3	4.6	2.0	3.4	12.0	20.5	22.4	24.2
Memorandum item:												
Euro area[1]	2.6	3.2	3.1	3.2	5.2	3.5	3.6	1.9	−2.5	−0.3	−1.1	0.5

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

[1] *Nominal wages, productivity and ULC in manufacturing.*

Table 5 continued

Wages, Productivity and Unit Labor Cost

	Euro per Local Currency (annual average)				Unit Labor Cost in Industry (euro)			
	2006	2007	Q3 2007	Q4 2007	2006	2007	Q3 2007	Q4 2007
	Annual change in %							
Slovenia	−0.0	−0.0	−0.0	−0.0	−2.3	0.4	0.6	4.6
Bulgaria	0.0	0.0	0.0	0.0	2.5	9.7	8.2	11.9
Czech Republic	5.1	2.1	1.4	4.5	1.9	4.0	5.5	7.5
Hungary	−6.1	5.1	9.4	2.9	−8.6	4.4	6.4	2.2
Poland	3.2	3.0	4.3	5.2	−0.8	5.6	8.6	9.7
Romania	2.7	5.7	9.6	0.9	6.8	17.4	21.7	14.7
Slovakia	3.7	10.2	12.7	7.5	−0.6	6.6	8.6	3.9
Croatia	1.1	−0.2	0.1	0.5	5.8	−0.4	1.3	1.9
Turkey	−7.3	1.3	8.1	8.8	−3.1	8.0	18.7	15.0
Russia	3.3	−2.7	−2.4	−4.4	15.8	17.3	19.4	18.8

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

[1] *Nominal wages, productivity and ULC in manufacturing.*

ULC remained roughly unchanged in 2007 compared with the euro area, whereas the positions of Turkey and especially Russia in terms of ULC worsened considerably. Despite increasing ULC, Turkey gained some market share in 2007 compared with 2006. Croatia's share remained almost unchanged, whereas Russia lost some of its world market share.

Fiscal notification of the CESEE EU Member States as of April 2008: Headline fiscal balances improved in 2007 but presumably mostly due to robust GDP growth

Fiscal outcomes in the CESEE EU Member States improved in most countries, but were apparently largely driven by cyclical developments (i.e. revenue overperformance). Nevertheless, in 2007, structural fiscal balances (cyclically adjusted, excluding one-off items) improved in all CESEE EU Member States (but Romania) and even substantially in Hungary. Still, at above 5% of GDP, Hungary reports the highest headline deficit among the countries covered in this contribution. Notably, the countries under excessive deficit procedure (EDP), i.e. the Czech Republic, Poland, and Slovakia, posted deficits well below 3% of GDP in 2007. In Slovenia, the only euro area country under review here, the government budget was almost balanced in 2007 after a deficit of 1.2% in 2006, while Bulgaria increased its budget surplus further to 3.4% of GDP. Only Romania saw a widening of its budget deficit by 0.3 percentage points to 2.5% of GDP in 2007.

In Croatia, the budget deficit is expected to narrow to 1.6% of GDP in 2007 (after –2.5% of GDP a year earlier). In Turkey, the fiscal balance turned from a close-to-balance position in 2006 into a deficit of 1.2% of GDP in 2007, as a result of weak tax collection and some election-related spending. In Russia, fiscal policy somewhat loosened in the election year 2007. However, the general government budget still recorded a surplus of 6.1% of GDP (2006: 8.4% of GDP). In February 2008, Russia's Stabilization Fund was split into a Reserve Fund to assist budget spending in the event of a large oil price drop and a new National Wealth Fund to finance structural reforms, as planned.

Updated stability and convergence programs assessed by the EU Council

In early 2008 the Council of the European Union assessed the updated stability and convergence programs of the EU Member States covered in this report for the period from 2007 to 2010 (until 2011 for Hungary). Hungary's program is considered to be adequate to correct the excessive deficit by 2009. In the Czech Republic (despite risks concerning the long-term sustainability of public finances) the EDP can be expected to be closed soon. The same applies to Slovakia where the program is consistent with a correction of the excessive deficit by 2007. Poland, in contrast, was considered not to have taken adequate steps to correct the deficit by 2007 as planned. The Council expressed serious concerns regarding the medium-term fiscal framework of Romania, which entails the risk of breaching the 3% limit, and criticized that budget spending was unpredictable and transparency insufficient. The Bulgarian and Slovenian programs were evaluated positively.

Croatia and Turkey – Pre-Accession Economic Programmes

In a similar vein, the candidate countries Croatia and Turkey submitted their medium-term Pre-Accession Economic Programmes (PEPs) to the European Commission in late 2007. These programs were assessed by the European Commission in April 2008. According to this assessment, the programs generally provide a relatively consistent macroeconomic and fiscal framework. Croatia intends to continue reducing its deficit in the years ahead and turn it into a small surplus by 2010, mainly based on a reduction of public spending. According to the Turkish PEP, Turkey will revert to a general government surplus target and is planning to increase the surplus in 2009 and 2010.

Accession negotiations with the EU candidate countries proceeding

Since our last report, Croatia and the European Commission have opened two more chapters, bringing the total number of chapters opened to 16 out of 35, 2 of which have already been closed provisionally. In October 2008, the European Commission is expected to publish a roadmap for concluding the (technical) negotiation process with Croatia. Turkey has so far opened five negotiation chapters (one more than in our last report); to date, one chapter has been closed provisionally.

Box 1

Walking on a Narrow Trail: An Interim Look at the Impact of Recent Global Financial Market Turbulence on Central, Eastern and Southeastern Europe[1]

Major market disruptions originating from the U.S. subprime crisis have shaken financial markets worldwide in several waves since July 2007. In the Central, Eastern and Southeastern European (CESEE) countries, the effects of the financial turbulence became noticeable in the second half of 2007, indicating that the region's financial market integration with European and global structures has deepened in recent years.

The impact of the financial turmoil on the CESEE region cannot be fully assessed yet, as the turbulence has not come to an end and many underlying data are published with some time lag. Nevertheless, a few preliminary conclusions can be drawn already at this stage. So far, the CESEE financial markets seem to have weathered relatively well the international financial market turbulence, which was accompanied by a tightening of global liquidity conditions and a repricing of risk. Still, corrections occurred in most financial market segments. The crisis hit the CESEE financial markets in several waves and peaked in mid-March 2008. Following repeated liquidity operations by major central banks worldwide and the rescue of an investment bank by the Federal Reserve, global financial market turbulence appears to have subsided somewhat in recent weeks. The CESEE financial markets seem to have calmed down to some extent, too, as is indicated e.g. by the movements in exchange rates, eurobond spreads and the credit default swap (CDS) rate (see charts below). In general, developments were, however, not homogeneous across the region, with countries and financial market segments being affected to different extents, in terms of both prices and volumes. In line with expectations, countries with certain characteristics were affected the most: those with the largest economic imbalances and/or insufficient macroeconomic policies, as well as countries that had previously experienced strong capital inflows coupled with particularly high asset valuation and buoyant demand conditions (e.g. Bulgaria, Croatia, Hungary, Romania, Turkey). Indeed, the performance of selected market indicators (such as exchange rates in Turkey and Romania or CDS spreads in Hungary) suggests that market participants are starting to take greater account of country-specific signs of vulnerability.

In the current fragile environment, risk propagation through financial market linkages might play a more prominent role than it would otherwise, and could manifest itself in rising funding costs and/or decreasing financial flows. These risks could materialize if the risk appetite for emerging markets in general or emerging Europe in particular declined further, or if the parent banks in the mostly foreign-owned CESEE banking systems were forced to cut back lending seriously. Given that the majority of foreign creditors active in the region come from just a few Western European countries (most notably Austria, France, Germany, and Italy), the risk of contagion could increase, too. However, prudential indicators are mostly rather solid and stable, pointing to some buffer in the banking systems that will help cope with unexpected shocks. Furthermore, the governance structures of (mostly foreign-owned) banks as well as the quality of the prudential and supervisory systems should mitigate the risk to some extent.

According to the latest data on the development of credit to the private sector, there is no widespread indication of a possible change in banks' lending behavior yet (as is reflected by the sustained brisk growth of credit extended by local banks). Furthermore, the available balance of payments data do not provide any strong evidence of dwindling capital inflows. Quite on the contrary: Gross capital inflows into the region even accelerated in the third quarter of 2007 and remained at elevated levels in the final quarter of 2007. On the back of increasing funding costs, however, some reduction of capital inflows is not inconceivable in the future. While a sharp decline of capital inflows cannot be fully excluded, it appears to be rather unlikely, given sizeable parent bank and/or intercompany financing as well as ongoing policy

[1] *For an in-depth discussion on this issue, see Gardó, S., A. Hildebrandt, and Z. Walko, 2008. Walking the Tightrope: A First Glance on the Impact of Recent Global Financial Market Turbulences on Central, Eastern and Southeastern Europe. OeNB. Financial Stability Report 15.*

tightening in many countries of the region. In this context, even a substitution effect in favor of relatively low-risk CESEE countries might materialize, assuming that parent companies will try to sustain business activities in the region so as to benefit from the profit-making opportunities provided by the region's catching-up potential and generally higher (risk-adjusted) returns.

Overall, countries with relatively weak macroeconomic fundamentals might come under additional pressure if global financial market turmoil persisted or deepened. A sudden stop of capital inflows may lead to major exchange rate corrections, which could have substantial balance sheet and wealth effects in countries with sizeable unhedged foreign currency positions. Therefore, correcting existing (in particular external) imbalances in the near future remains key to preventing a loss of investor confidence in a relatively fragile international environment. At the same time, increasing liquidity constraints and higher external financing costs could help the CESEE countries to contain overheating pressures, thus placing growth and convergence on a sounder footing in some countries.

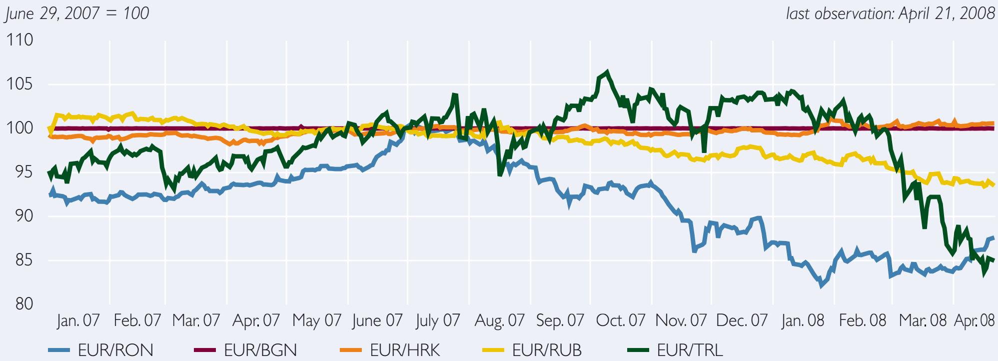
Chart 1

Exchange Rate Developments against the Euro[1]

Source: Eurostat, OeNB.
[1] An increase in value means a nominal appreciation.

Chart 2

Exchange Rate Developments against the Euro[1]

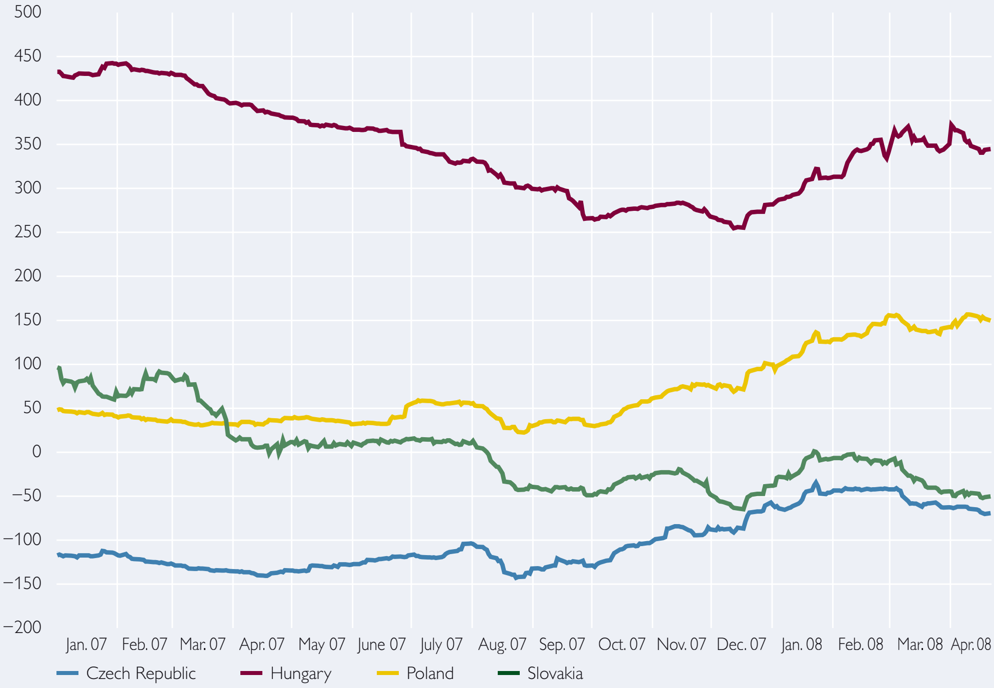


Source: Eurostat, OeNB.
[1] An increase in value means a nominal appreciation.

Chart 3

3-Month Money Market Spreads against the Euro Area

basis points *last observation: April 21, 2008*

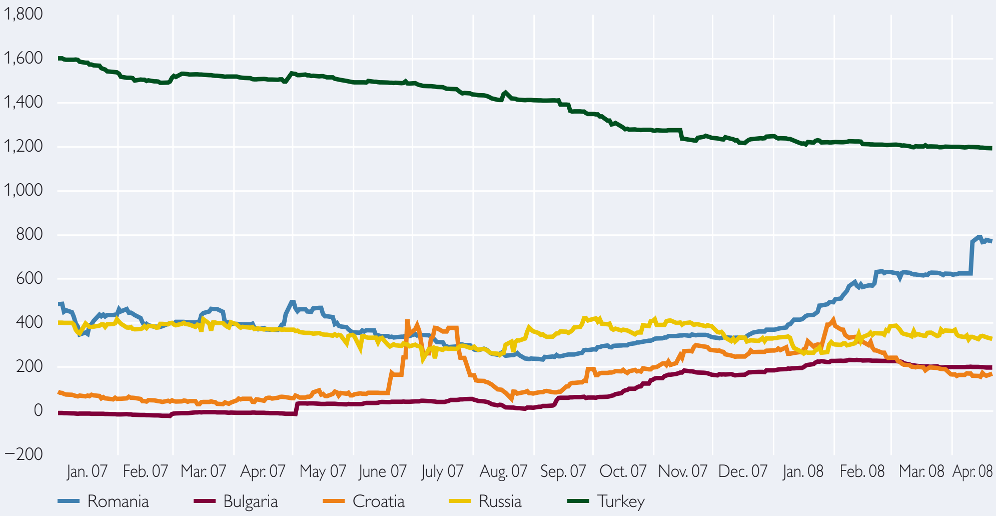


Source: Datastream, OeNB.

Chart 4

3-Month Money Market Spreads against the Euro Area

basis points *last observation: April 21, 2008*

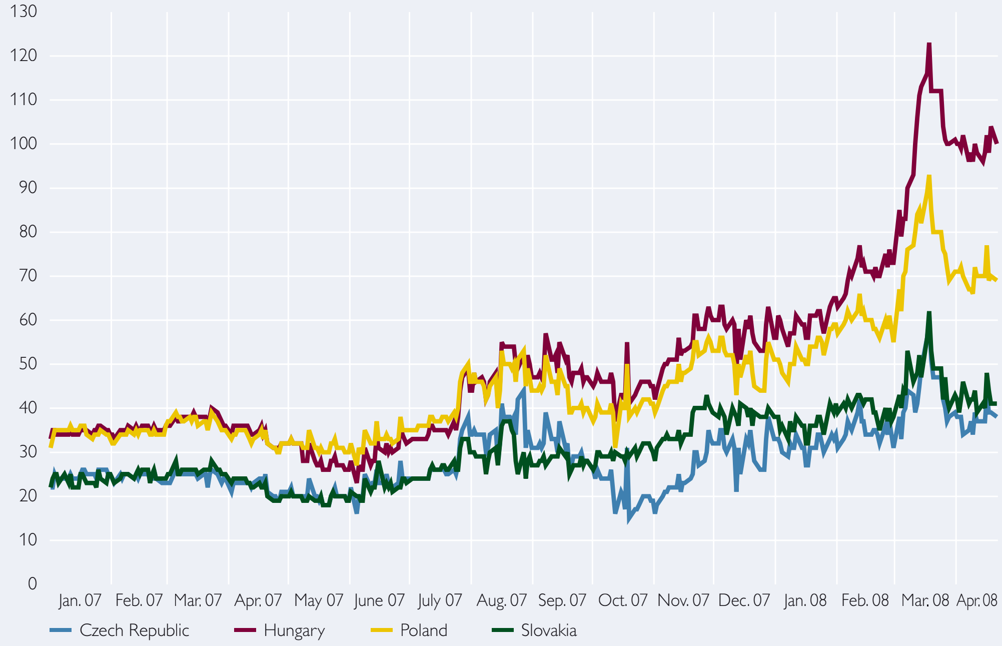


Source: Datastream, OeNB.

Chart 5

Euro-Denominated Eurobond Yield Spreads

JPM Euro EMBI global index *last observation: April 21, 2008*

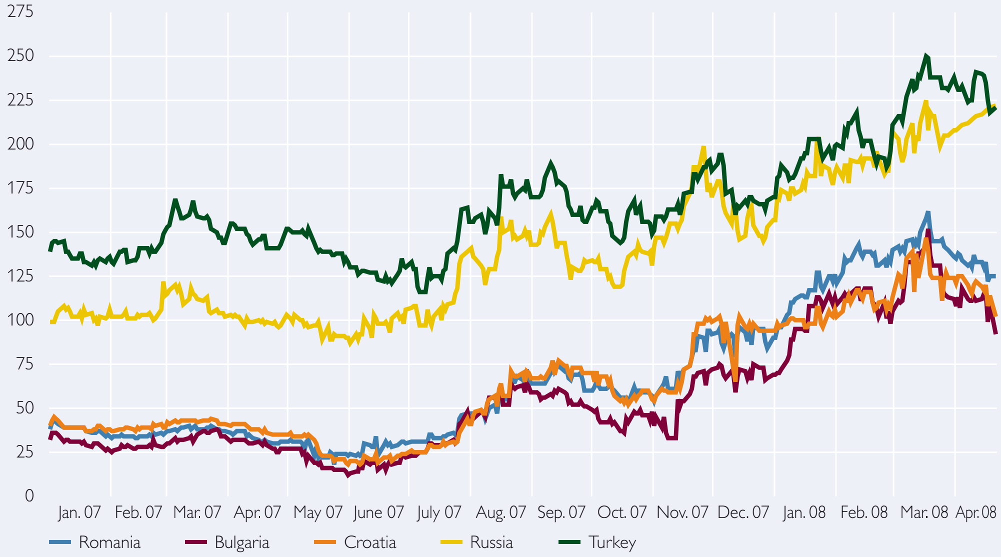


Source: Bloomberg, OeNB.

Chart 6

Euro-Denominated Eurobond Yield Spreads

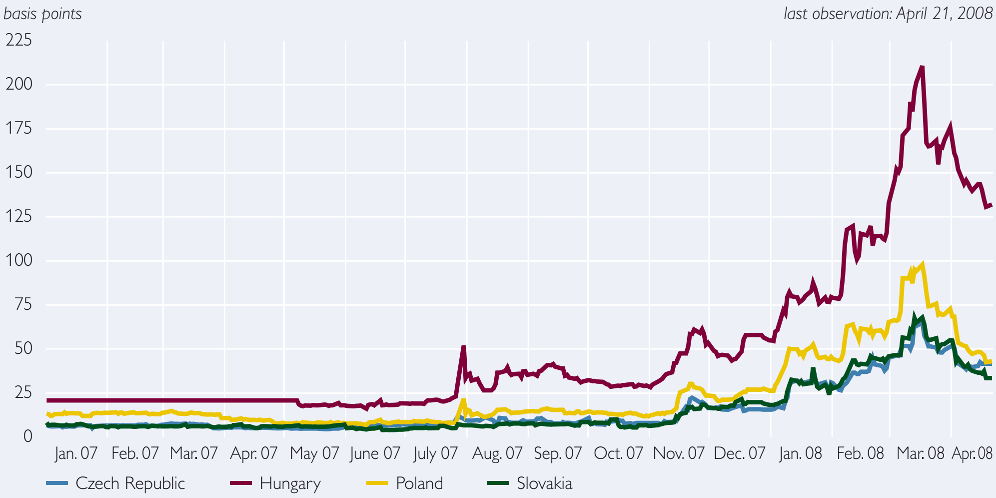
JPM Euro EMBI global index, for Russia JPM EMBI global index *last observation: April 21, 2008*



Source: Datastream, OeNB.

Chart 7

Sovereign 5-Year Credit Default Swap Spreads



Source: Datastream.

Chart 8

Sovereign 5-Year Credit Default Swap Spreads

Source: Datastream, OeNB.
Note: Data for Bulgaria and Russia are based on USD.

2 Slovenia: Janus-Faced Development after Euro Adoption

Real GDP growth peaks in 2007

Real GDP growth in Slovenia reached 6.1% year on year in 2007, the highest level since the beginning of transition. The growth momentum slowed toward year-end, though, in particular owing to a deceleration of investment growth, especially non-housing construction. Domestic demand was the main driver of growth, both in the second half of 2007 and full-year 2007. Gross fixed capital formation (GFCF) expanded strongly, which was in part due to accelerated motorway construction projects, but also supported by a further pickup in corporate lending, some rise in FDI inflows, and the expectation that the transitional period in which Slovenia was permitted to apply lower VAT rates to construction, renovation and maintenance work for residential housing would expire by end-2007 (it was extended until end-2010 in a EU Council decision of December 2007). Following a period of moderate growth (slightly above 2% year on year) in the first half of 2007, private consumption growth accelerated in the second half of 2007. This was supported by an increase in lending to households, strong employment gains, and – with a delay – a rise in real wages from the beginning of 2007 on, which was partly due to a lower tax burden. The contribution of net exports to the overall GDP growth rate was negative in 2007 largely as a result of increasing imports.

Energy and food prices drive up inflation

Following a temporary dip in inflation in the late summer of 2007, price pressures have picked up substantially again since October, with the year-on-year HICP rate reaching 6.9% in March 2008. Energy price inflation (including energy prices that are set by the government) has accelerated the most, but inflation in the food segment (including alcohol and tobacco) has also increased sharply. In the latter segment, the development was basically fueled by global food price hikes, but their effect was also magnified by the growing concentration, and thus lack of competition, in the Slovenian retail food sector in recent years. This situation may also have made it easier to relieve pent-up price pressures following the end of the dual pricing system in mid-2007.

Rising ULC call for some caution

As to underlying inflationary developments, nominal growth in unit labor costs (ULC) at the whole-economy level came to 2.8% year on year in 2007, and thus growth remained below the inflation rate despite having accelerated from 0.9 year on year in 2006. However, the increase in nominal compensation per employee calls for caution, especially considering the decline in productivity growth and the risk of second-round effects associated with the sharp increase in headline inflation and some of its most "sensitive" components (i.e., energy and food), as well as first warning strikes of employees demanding higher wages.

External balance deteriorates

Slovenia's deficit on the combined current and capital account widened to 5.0% of GDP in 2007, up from 3.2% in 2006. This development was largely attributable to a worsening of the goods and services deficit and the income deficit (mostly owing to higher interest payments on foreign debt), but also to the fact that the transfer balance moved into deficit. The external deficit was financed exclusively by foreign loans, as net FDI was nil (following modest outflows in 2005 and 2006) and portfolio investment registered large net outflows (as a result of Slovenian banks' increased investments abroad).[11]

[11] *After the adoption of the euro, Slovenia's gross official reserves decreased significantly because of the statistical treatment of international monetary reserves within the euro area. Only foreign currency reserves denominated in non-euro currency and invested in non-EMU countries are included in the country's international monetary reserves, in addition to monetary gold, reserve tranches and SDRs.*

Table 6

Main Economic Indicators: Slovenia

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.1	5.7	6.1	6.1	6.3	7.2	6.0	6.4	4.7
Private consumption	2.7	4.0	3.1	4.6	2.8	2.4	2.1	4.7	3.3
Public consumption	3.2	4.4	1.4	3.8	4.6	0.7	0.4	1.7	2.7
Gross fixed capital formation	2.5	8.4	17.2	11.0	12.3	21.2	21.8	18.7	8.6
Exports of goods and services	10.1	12.3	13.0	8.1	13.0	14.9	13.0	15.1	9.3
Imports of goods and services	6.7	12.2	14.1	10.3	12.3	14.4	16.2	18.2	8.6
	Contribution to GDP growth in percentage points								
Domestic demand	2.2	5.9	7.4	7.7	6.8	7.3	8.6	8.9	4.9
Net exports of goods and services	1.9	−0.1	−1.0	−1.4	−0.2	0.3	−2.1	−2.2	0.0
Exports of goods and services	6.4	8.2	9.2	5.6	8.8	10.5	9.1	10.5	6.7
Imports of goods and services	4.4	8.3	10.2	7.0	9.0	10.2	11.2	12.7	6.6
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	5.9	7.9	6.3	8.9	7.0	8.3	6.9	6.0	3.8
Gross average wage of industry (nominal)	5.8	5.5	6.7	4.3	5.4	5.6	5.8	6.6	8.6
Unit labor cost of industry (nominal)	−0.1	−2.3	0.4	−4.3	−1.5	−2.5	−1.1	0.6	4.6
Producer price index (PPI) of industry	2.8	2.4	7.1	2.8	2.7	4.5	5.0	8.2	10.7
Consumer price index (here: HICP)	2.5	2.5	3.8	2.5	2.3	2.6	3.2	3.7	5.5
EUR per 1 SIT, + = SIT appreciation	−0.2	−0.0	−0.0	−0.1	−0.1	−0.1	−0.0	−0.0	−0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	6.7	6.1	5.0	5.7	5.7	5.8	4.7	4.5	4.8
Employment rate (15−64 years)	66.0	66.6	67.8	67.2	66.1	66.0	68.3	69.0	67.7
Key interest rate per annum (%)	4.0	3.5	3.8	3.4	3.5	3.5	3.8	4.0	4.0
SIT per 1 EUR	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	6.6	8.4	22.5	7.9	8.3	18.4	21.2	25.2	25.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−10.4	−15.6	−21.4	−16.2	−16.3	−19.5	−18.0	−22.8	−25.3
Domestic credit of the banking system	19.7	24.7	36.6	24.9	26.7	30.6	33.9	38.6	42.9
of which: claims on the private sector	*16.6*	*26.8*	*36.0*	*27.3*	*29.5*	*29.9*	*32.7*	*38.8*	*42.3*
claims on households	*4.4*	*7.0*	*8.0*	*7.2*	*7.5*	*7.3*	*7.5*	*8.2*	*9.1*
claims on enterprises	*12.3*	*19.8*	*28.0*	*20.1*	*22.1*	*22.6*	*25.2*	*30.6*	*33.2*
claims on the public sector (net)	*3.0*	*−2.1*	*0.6*	*−2.3*	*−2.8*	*0.7*	*1.2*	*−0.2*	*0.7*
Other domestic assets (net) of the banking system	−2.7	−0.6	7.4	−0.8	−2.1	7.3	5.3	9.5	7.3
	% of GDP, ESA 95								
General government revenues	44.5	44.1	43.2	..	..	..	..	..	..
General government expenditures	46.0	45.3	43.3	..	..	..	..	..	..
General government balance	−1.5	−1.2	−0.1	..	..	..	..	..	..
Primary balance	0.1	0.2	1.2	..	..	..	..	..	..
Gross public debt	27.6	27.3	24.1	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	12.9	16.6	15.9	16.0	17.3	18.7	16.7	18.1	10.7
Merchandise imports	12.1	16.3	17.5	15.5	16.5	18.7	22.3	20.0	10.3
	% of GDP (based on EUR), period total								
Trade balance	−3.6	−3.8	−4.8	−3.3	−7.2	−3.2	−4.5	−4.4	−7.1
Services balance	3.0	2.8	3.1	3.8	2.0	2.7	4.0	3.7	1.8
Income balance (factor services balance)	−1.0	−1.3	−2.2	−2.9	−1.3	−1.9	−1.8	−2.3	−2.6
Current transfers	−0.3	−0.6	−0.9	−1.0	−0.0	−1.0	−0.4	−1.2	−1.0
Current account balance	−2.0	−2.8	−4.8	−3.3	−6.5	−3.4	−2.7	−4.2	−8.8
Capital account balance	−0.4	−0.4	−0.2	−0.5	−1.2	0.3	−0.1	−0.4	−0.4
Foreign direct investment (net)	−0.2	−0.7	−0.0	1.7	−1.9	−1.6	−0.1	−0.4	1.9
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	69.4	78.5	101.7	76.6	78.5	90.5	94.2	97.3	101.7
Gross official reserves (excluding gold)	24.2	17.5	2.0	19.5	17.5	2.7	2.6	2.3	2.0
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.6	3.1	0.3	3.5	3.1	0.5	0.4	0.4	0.3
	EUR million, period total								
Gross domestic product in current prices	28,252	30,454	33,542	7,871	7,911	7,679	8,537	8,730	8,596

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

3 Bulgaria: Strong Economic Momentum Coupled with Rising Macroeconomic Imbalances

Growth continues to be robust, based on buoyant investment activity

Following a drought-related growth dip in the third quarter of 2007, the economy regained momentum in the final quarter of 2007, with economic growth reaching 6.2% for the full-year 2007, almost the same rate as in 2006. On the expenditure side, domestic demand (in particular GFCF) remained the main pillar of growth despite a gradual slowdown over the course of 2007. In particular, private consumption growth decelerated considerably throughout 2007, coming down to +2.8% year on year in the final quarter of 2007. Domestic demand was to a large extent driven by high credit growth in both the corporate and retail segments, notwithstanding an increase in the minimum reserve requirement from 8% to 12% as of September 2007. Import growth decelerated noticeably toward year-end, so that the negative contribution of net exports declined substantially in the course of the year as export growth picked up slightly.

Labor market conditions improve considerably

Labor market conditions continued to tighten in the second half of 2007, with labor shortages becoming evident in various segments of the economy. Overall, the number of the employed increased by some 3% on average in 2007, while the unemployment rate fell to below 7%, the lowest level since the beginning of the transition process. In light of these developments and sizeable pension and public sector wage increases, wage pressures picked up in 2007. Wage dynamics accelerated to levels well above the gains in labor productivity, translating into rapidly rising nominal ULC in the whole economy of above 14% year on year in 2007 (against 4.4% year on year in 2006).

Supply- and demand-side factors triggering a strong pickup in inflation

Rapid real credit and wage growth coupled with supply-side factors (high food and energy prices) led to a substantial acceleration in inflation in the second half of 2007. During the first quarter of 2008, consumer price inflation climbed further (to 13.2% year on year in March 2008), given a strong base effect, persistently high food and energy prices, harmonization of excise taxes with EU requirements and more generous income policies (also exemplified in the increase of the minimum wage by 22% as of January 2008). Planned adjustments in regulated prices and upcoming pension and public sector wage increases (scheduled for mid-2008) might also fuel inflationary pressures.

External imbalances on the rise

Bulgaria's external imbalances continued to widen in 2007. In fact, the combined current and capital account deficit exceeded 20% of GDP last year, mainly on the back of a widening goods and services deficit, as the favorable development of real net exports was offset by sharply deteriorating terms of trade. At the same time, net FDI inflows continued to cover completely the deficit on the combined current and capital account. The country's gross external debt soared by 16.6 percentage points of GDP during 2007, mainly driven by intercompany loans and banks' foreign borrowing and despite early repayments of foreign public debt.

Table 7

Main Economic Indicators: Bulgaria

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	6.2	6.3	6.2	7.1	6.2	5.5	7.3	4.9	6.9
Private consumption	6.1	8.0	5.3	9.2	8.6	7.8	6.1	5.2	2.8
Public consumption	2.5	2.4	3.1	0.9	1.7	−2.0	−0.1	−0.4	11.2
Gross fixed capital formation[1]	23.3	17.6	21.7	21.8	31.9	35.9	24.7	19.7	14.0
Exports of goods and services	8.6	8.7	5.2	8.4	5.0	3.7	5.3	5.4	6.0
Imports of goods and services	13.1	16.2	9.9	16.1	16.2	14.7	11.1	9.3	5.7
	Contribution to GDP growth in percentage points								
Domestic demand	13.1	15.0	11.4	16.5	18.0	16.5	13.2	9.0	8.6
Net exports of goods and services	−5.1	−8.3	−5.8	−7.2	−11.3	−11.8	−6.8	−4.3	−2.0
Exports of goods and services	5.4	5.6	3.4	5.7	2.9	2.5	3.8	3.7	3.5
Imports of goods and services	10.5	13.8	9.2	12.9	14.2	14.4	10.6	8.0	5.5
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	3.4	8.2	9.5	9.0	5.0	8.4	8.9	10.9	9.7
Gross average wage of industry (nominal)	8.1	10.8	20.1	11.7	12.7	17.6	19.5	20.0	22.8
Unit labor cost of industry (nominal)	4.6	2.5	9.7	2.5	7.3	8.5	9.8	8.2	11.9
Producer price index (PPI) of industry	7.0	9.4	8.8	10.7	8.3	7.4	6.8	8.8	12.1
Consumer price index (here: HICP)	6.0	7.4	7.6	6.7	5.7	5.3	4.7	9.0	11.2
EUR per 1 BGN, + = BGN appreciation	−0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	10.2	9.0	7.0	8.9	8.4	8.0	6.9	6.7	6.2
Employment rate (15−64 years)	55.8	58.6	61.7	60.3	59.8	59.7	61.6	62.7	62.9
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	27.3	21.3	29.0	22.3	26.1	28.1	28.5	29.4	29.7
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	8.9	14.7	10.4	16.0	22.6	19.2	11.4	8.3	4.1
Domestic credit of the banking system	25.8	13.0	25.3	12.2	9.4	14.4	22.3	28.0	34.2
of which: claims on the private sector	*27.9*	*16.4*	*34.2*	*17.3*	*17.7*	*22.3*	*31.3*	*37.6*	*43.3*
claims on households	*13.0*	*9.4*	*12.0*	*8.8*	*8.3*	*9.2*	*11.1*	*12.7*	*14.5*
claims on enterprises	*14.9*	*7.0*	*22.2*	*8.5*	*9.4*	*13.1*	*20.2*	*24.9*	*28.8*
claims on the public sector (net)	*−2.1*	*−3.4*	*−8.9*	*−5.2*	*−8.3*	*−7.9*	*−9.0*	*−9.6*	*−9.1*
Other domestic assets (net) of the banking system	−7.4	−6.4	−6.6	−5.9	−5.9	−5.5	−5.3	−6.9	−8.6
	% of GDP, ESA 95								
General government revenues	41.0	39.4	41.2	..	..	..	..	..	..
General government expenditures	39.2	36.4	37.8	..	..	..	..	..	..
General government balance	1.8	3.0	3.4	..	..	..	..	..	..
Primary balance	3.5	4.4	4.4	..	..	..	..	..	..
Gross public debt	29.2	22.7	18.2	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	18.6	26.9	12.2	32.4	15.8	8.5	8.3	12.2	19.2
Merchandise imports	26.9	26.7	18.5	28.0	24.0	19.5	18.4	17.2	19.1
	% of GDP (based on EUR), period total								
Trade balance	−20.2	−22.0	−25.5	−19.8	−27.0	−27.3	−25.1	−22.3	−27.5
Services balance	3.7	3.7	3.8	11.6	−0.6	−1.0	5.5	11.4	−1.4
Income balance (factor services balance)	0.3	−2.1	−1.1	−2.2	−2.3	−0.2	−1.2	−2.7	−0.1
Current transfers	3.7	2.7	1.2	3.2	2.3	1.2	1.2	0.9	1.3
Current account balance	−12.4	−17.8	−21.5	−7.2	−27.6	−27.3	−19.5	−12.7	−27.7
Capital account balance	1.1	0.7	1.2	0.7	0.9	0.5	0.6	0.9	2.6
Foreign direct investment (net)	14.7	23.1	20.5	17.9	23.8	15.7	23.0	22.3	19.9
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	69.8	80.7	97.3	79.5	80.7	81.1	83.9	92.2	97.3
Gross official reserves (excluding gold)	31.1	32.9	38.8	32.5	32.9	32.1	33.5	39.8	38.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.9	4.8	5.5	4.8	4.8	4.6	4.8	5.7	5.5
	EUR million, period total								
Gross domestic product in current prices	21,882	25,238	28,899	7,057	7,165	5,771	6,720	8,050	8,358

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

[1] *National source.*

4 Czech Republic: Highest Economic Growth in History Mainly Driven by Domestic Demand

In the Czech Republic, real GDP grew by 6.5% year on year in 2007, thus fully keeping the pace already recorded in 2005 and 2006. Economic performance was mainly driven by robust domestic demand that was attributable to both private consumption and GFCF growth. Private consumption – fueled by rising real wages and employment – accounted for nearly one-half of GDP growth. Moreover, economic growth in the last quarter of 2007 was affected by increased healthcare consumption in anticipation of the introduction of a fee that patients have to pay when turning to a doctor as of January 2008. Net exports continued to contribute positively to GDP growth in 2007: Driven primarily by the country's major car producer Škoda Auto, exports continued to rise strongly and even outpaced import growth.

Labor market improvement gradually turns into a problem

In the course of 2007, unemployment declined to the lowest levels in a decade, as growth fed increasingly through to the labor market. However, regional structural mismatches have persisted, while the share of the long-term unemployed in total unemployment has remained high. At this stage, the scope for reducing unemployment further appears rather limited, unless labor supply can be increased. Emerging labor shortages have started to show in rising nominal wages and ULC in the whole economy (in 2007, nominal ULC climbed to +2.3% year on year from +1.5% year on year in 2006). The increase of ULC was even more pronounced in euro terms given the strong appreciation of the Czech koruna.

Inflation – a cause for concern?

Since end-2006, inflation has accelerated steadily, but it did not exceed the central bank's 3% target rate until the final quarter of 2007, when it jumped to a high owing to global food and oil price hikes. In January 2008 the HICP accelerated further and reached 7.5% year on year. In response to this adverse development, the Česká národní banka (ČNB) has raised its key interest rate in two steps to 3.75% since the beginning of November 2007. The most recent acceleration of inflation, however, is largely ascribable to policy-driven one-off effects, particularly the increase in the reduced VAT rate, in the excise duty on tobacco, and in regulated rents as well as the introduction of healthcare fees. Year-on-year inflation came in somewhat lower in February and March 2008. From mid-November 2007 to mid-April 2008, the koruna appreciated substantially against the euro, which is partly ascribable to the unwinding of carry trades and has a dampening effect on inflation according to the ČNB. In order to contain the strong appreciation of the currency, the government and the ČNB in early April 2008 agreed on a series of measures to prevent foreign exchange transactions that are connected to the privatization revenues and EU funds from the foreign exchange market.

Fiscal consolidation? Not really.

Windfall revenues due to unexpectedly robust growth reduced the fiscal deficit to 1.6% of GDP, much below the original target of 4%. In January 2008, the first part of a fiscal package came into force, comprising, inter alia, the introduction of a 15% flat tax on personal income. However, the net fiscal impact of this package is estimated to be neutral for 2008 and negative thereafter because of additional corporate tax cuts. Hence, long-term fiscal sustainability will essentially hinge on the implementation of further reform steps, particularly of the pension and healthcare systems.

Table 8

Main Economic Indicators: Czech Republic

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	6.4	6.4	6.5	6.3	6.2	6.5	6.5	6.3	6.6
Private consumption	2.3	5.5	5.6	5.0	6.3	6.8	6.3	5.7	4.0
Public consumption	2.2	0.0	0.9	−2.2	1.4	0.7	−0.3	−0.3	3.1
Gross fixed capital formation	2.3	5.5	6.1	5.2	5.2	5.3	5.2	5.5	8.0
Exports of goods and services	11.8	14.4	14.5	11.3	16.0	15.8	14.4	15.6	12.5
Imports of goods and services	5.0	13.8	13.7	10.7	16.1	15.8	14.2	15.1	10.2
	Contribution to GDP growth in percentage points								
Domestic demand	1.6	5.9	5.7	6.0	6.2	6.0	6.3	5.9	4.7
Net exports of goods and services	5.3	0.4	0.7	0.4	−0.4	0.3	0.2	0.2	2.1
Exports of goods and services	9.7	12.5	13.5	9.6	14.5	14.9	13.0	13.9	12.4
Imports of goods and services	4.4	12.1	12.8	9.2	14.9	14.6	12.8	13.7	10.3
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	6.8	9.4	6.5	7.7	8.6	9.3	7.2	4.4	5.1
Gross average wage of industry (nominal)	4.6	6.1	8.6	5.2	6.3	9.1	8.6	8.6	8.1
Unit labor cost of industry (nominal)	−2.1	−3.0	1.9	−2.3	−2.1	−0.2	1.3	4.1	2.8
Producer price index (PPI) of industry	3.0	1.6	4.0	2.5	2.2	3.1	4.1	3.9	5.0
Consumer price index (here: HICP)	1.6	2.1	3.0	2.4	1.1	1.7	2.6	2.7	4.9
EUR per 1 CZK, + = CZK appreciation	7.1	5.1	2.1	4.8	4.5	2.0	0.4	1.4	4.5
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	8.0	7.2	5.4	7.1	6.6	6.1	5.3	5.2	4.9
Employment rate (15–64 years)	64.8	65.3	66.1	65.4	65.6	65.5	66.0	66.3	66.5
Key interest rate per annum (%)	2.0	2.2	2.9	2.3	2.5	2.5	2.5	3.1	3.4
CZK per 1 EUR	29.8	28.3	27.8	28.3	28.0	28.0	28.3	27.9	26.8
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	6.4	12.4	14.4	12.5	12.6	13.2	14.5	14.7	15.3
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	5.2	1.2	−1.6	−4.2	−4.6	−3.2	−0.5	−0.8	−2.0
Domestic credit of the banking system	0.7	9.2	15.7	12.7	14.1	14.5	15.2	16.7	16.2
of which: claims on the private sector	*8.6*	*11.9*	*14.3*	*12.1*	*12.1*	*12.1*	*12.9*	*15.1*	*16.8*
claims on households	*5.4*	*6.7*	*7.7*	*6.8*	*6.9*	*6.9*	*7.4*	*7.9*	*8.5*
claims on enterprises	*3.2*	*5.2*	*6.6*	*5.3*	*5.3*	*5.2*	*5.5*	*7.2*	*8.2*
claims on the public sector (net)	*−7.9*	*−2.7*	*1.4*	*0.6*	*1.9*	*2.4*	*2.4*	*1.6*	*−0.5*
Other domestic assets (net) of the banking system	0.5	2.0	0.4	4.0	3.2	1.8	−0.3	−1.2	1.1
	% of GDP, ESA 95								
General government revenues	41.4	41.0	40.8	..	..	..	..	..	..
General government expenditures	44.9	43.6	42.4	..	..	..	..	..	..
General government balance	−3.6	−2.7	−1.6	..	..	..	..	..	..
Primary balance	−2.4	−1.5	−0.4	..	..	..	..	..	..
Gross public debt	29.7	29.4	28.7	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	16.1	20.5	17.5	17.6	22.3	19.7	16.7	18.3	15.6
Merchandise imports	11.6	20.5	15.5	16.6	21.4	17.5	15.0	16.8	13.1
	% of GDP (based on EUR), period total								
Trade balance	2.0	2.1	3.3	1.2	1.5	5.6	2.8	2.1	3.0
Services balance	1.2	1.1	1.4	1.3	0.6	1.1	1.7	1.5	1.4
Income balance (factor services balance)	−5.2	−5.7	−7.2	−6.3	−6.5	−4.3	−8.4	−8.4	−7.5
Current transfers	0.4	−0.6	−0.5	−1.0	−1.0	−0.5	−0.8	−0.5	−0.4
Current account balance	−1.6	−3.1	−3.0	−4.8	−5.4	2.0	−4.7	−5.3	−3.5
Capital account balance	0.2	0.3	0.6	0.3	0.6	0.3	0.0	0.4	1.4
Foreign direct investment (net)	9.3	3.2	4.2	4.9	3.5	4.3	3.2	4.1	5.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	39.2	38.1	39.5	37.4	38.1	37.1	37.5	37.7	39.5
Gross official reserves (excluding gold)	24.8	20.8	18.4	21.8	20.8	20.1	19.1	18.6	18.4
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.3	3.4	3.0	3.7	3.4	3.3	3.1	3.0	3.0
	EUR million, period total								
Gross domestic product in current prices	100,353	114,070	128,232	28,999	30,183	29,324	31,956	32,268	34,684

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

5 Hungary: Real GDP Growth Slowed Down Further in 2007

Real GDP growth in Hungary slowed to an 11-year low of 1.3% year on year in 2007. Economic growth in the second half of 2007 (as in full-year 2007) was carried by net exports. Domestic demand continued to contract in 2007, especially in the second half of the year. On a positive note, however, the year-on-year contraction of private and public consumption became smaller in the final quarter, and GFCF growth was moderate. Private consumption was supported by a modest recovery of real household credit growth and a deceleration in the erosion of real wage growth, mainly in the public sector. By contrast, the employment situation deteriorated toward end-2007, and household sentiment remained very weak going into 2008. Regarding investment, the decline in construction activity slowed toward the end of the year, and investment in machinery and equipment exhibited relatively solid momentum of around 10% year on year in the fourth quarter of 2007.

Inflation on the rise again, MNB tightens monetary policy

Following gradual disinflation in the first three quarters of 2007, inflation turned upward again from October 2007, and year-on-year inflation was running at 7.4% in January 2008 (mainly due to energy and food prices), before easing back to 6.7% in February and March. ULC at the whole-economy level increased by 6.8% year on year in 2007 (against –5.3% in 2006) but ULC growth continued to remain below the inflation rate. In response to the worsening inflation outlook, Magyar Nemzeti Bank (MNB) raised its policy rate by 50 basis points to 8.0% at end-March 2008. In addition, to promote the consistency of monetary policy and remove the possibility of a potential conflict between inflation and exchange rate targeting, the Hungarian forint was floated in late February 2008 (thus abolishing the previous ±15% fluctuation band around a unilaterally fixed central rate against the euro).[12] According to the MNB, Hungary would benefit from adopting the euro as soon as possible, despite clear risks involved. Several measures are required for the transition to the common currency to be smooth: further labor and product market reforms, lasting fiscal consolidation (including the strengthening of fiscal institutions), and policy measures that enhance medium-term growth prospects, most notably reducing the tax wedge or cutting back on social policies that hinder labor supply.

Resurfacing fiscal risks despite better-than-expected 2007 budget outturn

Despite a better-than-expected fiscal outcome in 2007, uncertainties about the future course of fiscal policy have intensified recently. In early April 2008 the government abolished several unpopular copayments introduced earlier, following a referendum in early March that reflected overwhelming public disapproval of these measures. While the immediate budgetary impact of the change is seen to be rather limited, the referendum outcome – in combination with the government's weak standing in opinion polls ahead of the elections in 2009 (European Parliament) and 2010 (Hungarian parliament and local government), and a tense domestic political climate – already cast a shadow over the government's future reform drive. Prospects were dimmed further in late March, when the junior coalition partner announced its withdrawal from the government as of end-April. A minority government with the tacit support of the former junior coalition partner seems to be the most likely outcome at present, which makes the reform implications mentioned above even more relevant.

[12] *The MNB had proposed to float the forint several times in recent years, but until this year could not get the necessary consent by the government to change the exchange rate regime.*

Table 9

Main Economic Indicators: Hungary

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.1	3.9	1.3	3.9	3.7	2.7	1.2	0.9	0.8
Private consumption	3.4	1.8	−0.5	1.7	0.1	0.1	−0.7	−0.9	−0.3
Public consumption	2.4	4.7	−6.3	−1.4	5.1	−9.8	−9.3	−5.5	−0.2
Gross fixed capital formation	5.3	−2.8	1.0	−5.1	−5.5	1.9	0.8	−1.8	2.7
Exports of goods and services	11.5	18.9	14.2	18.0	22.3	17.5	14.8	15.0	10.4
Imports of goods and services	6.8	14.5	12.2	12.1	17.7	13.1	13.4	13.6	9.2
	Contribution to GDP growth in percentage points								
Domestic demand	1.3	1.1	−0.3	0.2	0.8	−0.2	−0.1	−0.4	−0.4
Net exports of goods and services	3.6	3.7	2.3	5.0	4.0	4.5	1.8	1.8	1.5
Exports of goods and services	9.6	17.0	14.6	15.9	20.1	18.1	14.9	15.1	11.0
Imports of goods and services	6.0	13.2	12.3	11.0	16.0	13.6	13.1	13.3	9.5
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	10.1	11.5	9.3	11.0	10.5	9.9	8.5	10.6	8.2
Gross average wage of industry (nominal)	7.2	8.6	8.5	9.0	9.4	8.9	10.4	7.6	7.4
Unit labor cost of industry (nominal)	−2.6	−2.6	−0.7	−1.9	−1.0	−0.9	1.7	−2.7	−0.7
Producer price index (PPI) of industry	2.9	6.7	−0.1	9.7	5.9	3.4	−0.8	−2.8	0.1
Consumer price index (here: HICP)	3.5	4.0	7.9	4.6	6.4	8.8	8.5	7.3	7.1
EUR per 1 HUF, + = HUF appreciation	1.5	−6.1	5.1	−10.8	−3.2	0.9	7.5	9.4	2.9
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	7.2	7.5	7.4	7.5	7.5	7.5	7.0	7.3	7.8
Employment rate (15−64 years)	56.9	57.3	57.3	57.6	57.6	56.9	57.6	57.7	57.1
Key interest rate per annum (%)	7.1	6.8	7.8	7.0	8.0	8.0	8.0	7.7	7.5
HUF per 1 EUR	248.0	264.3	251.3	275.4	260.2	252.3	248.3	251.8	252.9
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	13.8	16.2	9.8	17.2	14.6	11.2	8.0	8.6	11.4
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	0.6	−2.2	−5.6	−4.7	−2.5	−4.6	−4.8	−5.9	−7.2
Domestic credit of the banking system	15.3	23.6	17.9	29.4	23.4	21.1	15.3	15.3	19.9
of which: claims on the private sector	*16.6*	*21.7*	*14.4*	*25.8*	*20.6*	*15.7*	*11.6*	*13.3*	*16.9*
claims on households	*7.3*	*9.4*	*8.1*	*10.4*	*9.2*	*8.8*	*7.6*	*7.5*	*8.5*
claims on enterprises	*9.3*	*12.3*	*6.3*	*15.3*	*11.3*	*6.9*	*4.1*	*5.8*	*8.4*
claims on the public sector (net)	*−1.3*	*1.9*	*3.5*	*3.7*	*2.8*	*5.4*	*3.7*	*1.9*	*3.0*
Other domestic assets (net) of the banking system	−2.1	−5.2	−2.5	−7.6	−6.4	−5.3	−2.6	−0.8	−1.3
	% of GDP, ESA 95								
General government revenues[1]	42.1	42.6	44.6	..	..	..	..	..	..
General government expenditures[1]	49.9	51.9	50.1	..	..	..	..	..	..
General government balance[1]	−7.8	−9.2	−5.5	..	..	..	..	..	..
Primary balance[1]	−3.7	−5.3	−1.4	..	..	..	..	..	..
Gross public debt[1]	61.6	65.6	66.0	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	11.9	17.9	16.2	15.7	20.9	19.6	17.3	18.6	10.4
Merchandise imports	9.3	16.3	12.1	12.5	18.0	14.2	13.2	13.4	8.1
	% of GDP (based on EUR), period total								
Trade balance	−1.7	−1.0	1.4	−1.8	0.1	1.2	1.7	1.2	1.4
Services balance	1.2	1.4	1.1	2.2	1.6	0.8	1.4	1.6	0.6
Income balance (factor services balance)	−6.5	−6.9	−7.9	−6.5	−6.5	−7.7	−9.2	−7.3	−7.3
Current transfers	0.2	0.4	0.3	0.5	0.1	0.8	0.1	−0.8	1.1
Current account balance	−6.8	−6.1	−5.0	−5.5	−4.7	−4.9	−5.9	−5.2	−4.1
Capital account balance	0.8	0.8	1.0	0.9	1.3	0.2	0.1	2.4	1.3
Foreign direct investment (net)	4.9	2.8	1.0	5.3	−2.2	0.7	−3.9	4.9	2.3
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	74.5	91.4	96.5	85.4	91.4	93.4	98.5	96.0	96.5
Gross official reserves (excluding gold)	17.6	18.2	16.2	18.5	18.2	18.4	17.7	16.7	16.2
	Months of imports of goods and services								
Gross official reserves (excluding gold)	3.1	2.8	2.5	3.0	2.8	2.8	2.8	2.6	2.5
	EUR million, period total								
Gross domestic product in current prices	88,860	89,858	100,959	22,420	24,888	22,624	25,465	25,521	27,350

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

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

6 Poland: Inflation Rises Above the Tolerance Band Set by the Monetary Authorities

Investment activity continues to dominate domestic demand

Real GDP growth accelerated to 6.5% in 2007. In the course of the year, growth moderated somewhat but remained above 6%. Private consumption growth was again below total GDP growth, despite strong employment and real wage growth. The improvement in the labor market, which is reflected also in the sharp decline of the unemployment rate, is closely linked to booming GFCF, which contributed 4 percentage points to GDP growth (thus even surpassing consumption and exports), driven by the favorable financial situation of the corporate sector, the strong expansion of real credit (which, however, stabilized in the second half of the year), as well as the growing absorption of EU funds.[13] While the contribution of exports to GDP growth weakened mainly as a result of the significant slowdown of euro area import growth, the contribution of import growth weakened, as well, despite strong domestic investment activity. Thus, the contribution of net exports to GDP growth remained slightly negative, as in 2006.

ULC in industry on the rise

Nominal ULC in industry continued to rise in annual terms from the second half of 2007 onward. In euro terms, ULC in industry increased by about 9% year on year in the second half of 2007, with roughly one-half being attributable to ULC rising in national-currency terms and the other half to currency appreciation. This notwithstanding, the trade deficit widened only moderately.

Inflation pushed up mainly by food and energy prices, but also by ULC

The pickup in inflation in 2007 was cost pushed, mainly by food and energy prices, but also by rising ULC (whole-economy nominal ULC rose by 6.1% last year against –1.0% in 2006). After a low of 1.2% in August 2007, national core inflation rose from 1.7% in December to 2.7% in March mainly as a result of hikes in regulated electricity and heating prices due to higher energy prices.[14] In March 2008, HICP inflation reached 4.4%, while national CPI inflation stood at 4.1%, hence above the upper tolerance limit for deviations from the Narodowy Bank Polski's CPI target of 2.5% ±1 percentage point.

Monetary tightening continues

Starting in April 2007, the Polish Monetary Policy Council (MPC) raised its key interest rate in several steps by a total of 100 basis points in 2007 and by 75 basis points to 5.75% in the first quarter of 2008. The rising interest rate differential to the euro area may also have contributed to nominal currency appreciation, which came to 10% year on year against the euro in March 2008. Still, in its assessment of end-March 2008, the MPC considered that its past interest rate hikes, the złoty appreciation and the impact of the global slowdown might prove insufficient to bring inflation down to the target over the monetary policy transmission horizon. At the same time, the MPC held the view that higher inflation has created a risk of second-round effects via elevated inflation expectations.

Budget deficit shrinks markedly in 2007

In 2007, the general government budget deficit-to-GDP ratio dropped by 1.8 percentage points to 2.0%, which was mainly attributable to the expenditure side: The expenditure-to-GDP ratio fell by 1.4 percentage points (to 42.4%), in particular as a result of lower spending on unemployment benefits.

[13] *In 2007, growth of GFCF was particularly strong in the areas of transport equipment (45% year on year, contributing 5.3 percentage points to GFCF growth), metal products and machinery (24.8% year on year, contributing 7.7 percentage points) as well as in housing construction work (34% year on year, contributing 4.6 percentage points).*

[14] *However, it must be borne in mind that core inflation measures are subject to substantial limitations, especially if shocks to inflation are of a persistent rather than temporary nature.*

Table 10

Main Economic Indicators: Poland

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	3.6	6.2	6.5	6.6	6.6	7.2	6.4	6.4	6.1
Private consumption (excl. NPISH)	1.9	4.8	5.2	5.2	4.8	6.9	5.0	5.3	3.7
Public consumption (incl. NPISH)	5.2	5.8	0.7	4.9	4.5	0.8	1.0	0.8	0.1
Gross fixed capital formation	6.5	15.6	20.4	18.0	16.6	26.2	20.8	19.8	18.5
Exports of goods and services	8.0	14.6	9.0	14.6	10.1	11.7	6.5	9.3	8.8
Imports of goods and services	4.7	17.4	10.9	16.6	17.5	12.8	10.8	11.4	9.0
	Contribution to GDP growth in percentage points								
Domestic demand	2.5	7.3	7.4	7.5	9.3	7.7	8.3	7.5	6.3
Net exports of goods and services	1.1	−1.1	−0.9	−0.9	−2.7	−0.5	−1.9	−1.1	−0.3
Exports of goods and services	3.0	5.4	3.6	5.5	3.7	4.8	2.7	3.8	3.4
Imports of goods and services	1.8	6.5	4.6	6.4	6.5	5.3	4.6	4.9	3.7
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	2.9	9.5	6.0	9.9	7.7	9.6	5.1	4.5	4.8
Gross average wage of industry (nominal)	3.2	5.2	8.7	6.0	5.5	8.3	8.5	8.8	9.3
Unit labor cost of industry (nominal)	0.3	−4.0	2.6	−3.5	−2.1	−1.2	3.2	4.1	4.3
Producer price index (PPI) of industry	0.7	2.2	2.2	3.4	2.6	3.1	2.0	1.6	2.2
Consumer price index (here: HICP)	2.2	1.3	2.6	1.5	1.3	2.0	2.3	2.4	3.7
EUR per 1 PLN, + = PLN appreciation	12.6	3.2	3.0	1.6	1.8	−1.3	3.9	4.3	5.2
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	18.0	14.1	9.7	13.2	12.4	11.4	9.7	9.1	8.6
Employment rate (15−64 years)	52.8	54.5	57.0	55.6	55.7	55.4	56.8	57.8	58.1
Key interest rate per annum (%)	5.3	4.1	4.4	4.0	4.0	4.0	4.3	4.6	4.9
PLN per 1 EUR	4.0	3.9	3.8	4.0	3.8	3.9	3.8	3.8	3.7
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	13.0	12.6	15.9	13.0	14.0	18.1	16.7	15.4	13.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	5.5	1.7	−5.7	−0.9	−1.5	−0.9	−5.2	−7.3	−8.9
Domestic credit of the banking system	5.2	12.0	20.8	14.8	17.1	20.7	21.0	21.1	20.4
of which: claims on the private sector	*5.5*	*10.9*	*20.8*	*11.7*	*14.1*	*17.5*	*20.0*	*22.4*	*23.0*
claims on households	*5.6*	*8.6*	*13.8*	*9.3*	*10.3*	*12.3*	*13.3*	*14.6*	*14.9*
claims on enterprises	*−0.1*	*2.3*	*7.0*	*2.4*	*3.8*	*5.2*	*6.7*	*7.8*	*8.1*
claims on the public sector (net)	*−0.3*	*1.2*	*−0.0*	*3.1*	*3.1*	*3.2*	*1.0*	*−1.3*	*−2.7*
Other domestic assets (net) of the banking system	2.3	−1.1	0.8	−0.9	−1.6	−1.7	0.9	1.6	2.3
	% of GDP, ESA 95								
General government revenues[1]	39.0	40.0	40.4	..	..	..	..	..	..
General government expenditures[1]	43.3	43.8	42.4	..	..	..	..	..	..
General government balance[1]	−4.3	−3.8	−2.0	..	..	..	..	..	..
Primary balance[1]	−1.5	−1.1	0.6	..	..	..	..	..	..
Gross public debt[1]	47.1	47.6	45.2	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	17.9	20.3	14.9	19.6	18.8	14.7	13.8	14.4	16.6
Merchandise imports	13.4	23.9	17.3	23.8	23.4	16.8	18.4	16.6	17.5
	% of GDP (based on EUR), period total								
Trade balance	−0.9	−2.0	−2.8	−2.4	−2.4	−2.1	−3.4	−3.1	−2.7
Services balance	0.6	0.6	1.2	0.6	0.9	1.2	1.2	1.3	1.0
Income balance (factor services balance)	−3.6	−4.2	−4.3	−4.0	−4.7	−4.2	−5.0	−4.1	−4.1
Current transfers	2.3	2.4	2.4	3.3	2.1	2.1	2.4	2.9	2.1
Current account balance	−1.6	−3.2	−3.7	−2.4	−4.1	−3.1	−4.8	−3.0	−3.7
Capital account balance	0.3	0.6	1.1	0.7	0.8	0.6	0.7	1.1	1.8
Foreign direct investment (net)	2.3	3.0	3.8	2.5	2.5	5.5	2.8	4.0	3.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	45.8	46.5	50.7	46.2	46.5	48.0	49.3	49.1	50.7
Gross official reserves (excluding gold)	14.1	12.9	13.9	14.0	12.9	13.1	13.6	13.3	13.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.5	3.7	3.9	4.1	3.7	3.7	3.8	3.7	3.9
	EUR million, period total								
Gross domestic product in current prices	244,775	272,243	308,011	66,143	78,186	68,630	73,729	75,673	89,979

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

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

7 Romania: Rising Internal and External Imbalances

Economic growth dropped in 2007 amid slowing consumption growth and accelerating import growth

With real GDP rising by 6.0% year on year in 2007, economic growth was considerably slower than in 2006 as a consequence of the bad 2007 harvest. Private consumption lost some of its momentum but continued to increase rapidly throughout the year, driven by dynamic real credit and wage growth as well as positive labor market developments. Following a decline in 2006, public consumption growth picked up strongly in 2007. GFCF growth surged in 2007, benefiting from robust real credit growth and a better absorption of EU funds.[15] Import growth accelerated markedly in 2007, while export growth slowed somewhat. As a result, growth became even more imbalanced: The negative contribution of net exports to GDP growth in 2007 was about 5 percentage points higher than in 2006, reaching almost 15 percentage points.

Strong wage gains outstrip productivity growth

High public sector wage increases, combined with favorable developments on the Romanian labor market, again paved the way to strong wage growth in other sectors. Nominal ULC in the whole economy increased by more than 14% year on year in 2007 (compared with 12.3% in 2006). Furthermore, in the industry sector, the rise in ULC by more than 17% in 2007 (in euro terms, annual average) seriously challenges the competitiveness of the Romanian economy. However, the reversal of exchange rate trends in the second half of 2007 and early 2008, which ushered in a strong nominal depreciation of the Romanian leu, has cushioned somewhat the effects of the loss of international cost competitiveness.

In 2007, fast import growth caused the foreign trade balance to deteriorate further compared with 2006. Importantly, the coverage by net FDI inflows of the combined capital and current account dropped sharply from 85% in 2006 to only 44% in 2007, as no major privatization projects were on the agenda.

Inflation rate accelerating further: BNR raises interest rates again

Inflation continued to accelerate in the last quarter of 2007 and even more so in early 2008 (also due to the base effect), reaching 8.7% in March 2008 on the back of both supply- and demand-side factors as well as worsening inflation expectations. Romania missed the inflation target of 4% ±1 percentage point for end-2007 by 1.6 percentage points. For 2008, the end-year target is set at 3.8% ±1 percentage point, but the Banca Națională României (BNR) expects inflation to be within the inflation target corridor by the start of the second quarter of 2009. The year-end inflation target is 3.5% ±1 percentage point for 2009. The BNR has continued hiking the policy rate by a total of 200 basis points in four steps since early November 2007.

Fiscal policy not supportive of counteracting unfavorable economic developments

The budget deficit widened to 2.5% of GDP in 2007 against 2.2% of GDP in 2006, and was not supportive of counteracting the risk of economic overheating. The rise in public expenditure was largely the result of lax public sector wage policy and higher social payments, but also of public investment bolstered by higher absorption of EU funds. The revenue ratio increased, too, but to a lesser extent. Loose fiscal policy in Romania is criticized by international institutions but also by the BNR, as it increases internal and external imbalances.

[15] *In 2007, 46% of all investments were equipment investments (including means of transport) and almost 46% new construction works; the remaining 8% of investments fall in the "other expenditures" category. Investment in new construction increased by more than 31% year on year (construction of residential construction accelerated at a slightly lower speed) and equipment investments by almost 25%.*

Table 11

Main Economic Indicators: Romania

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.2	7.9	6.1	8.4	7.9	6.1	5.7	5.7	6.6
Private consumption	9.9	12.5	11.0	12.7	13.3	12.3	12.3	10.1	10.1
Public consumption	8.1	−2.4	5.5	−3.6	−0.6	6.3	6.8	4.9	4.8
Gross fixed capital formation	12.7	19.3	28.9	21.9	21.3	23.5	28.4	32.2	28.1
Exports of goods and services	7.7	10.6	8.7	9.8	9.3	12.0	3.5	4.8	14.9
Imports of goods and services	16.1	22.4	26.1	24.0	24.9	28.5	22.7	24.7	28.6
	Contribution to GDP growth in percentage points								
Domestic demand[1]	8.5	18.5	23.0	15.9	16.3	52.5	15.3	17.8	15.7
Net exports of goods and services	−5.9	−9.6	−14.9	−10.4	−10.4	−16.2	−16.6	−15.0	−12.8
Exports of goods and services	3.2	4.6	3.9	4.0	3.3	6.9	1.7	2.0	5.4
Imports of goods and services	9.2	14.2	18.8	14.4	13.7	23.1	18.3	17.0	18.2
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	4.4	11.3	9.5	11.8	10.7	12.6	8.5	8.8	8.0
Gross average wage of industry (nominal)	16.8	15.7	21.6	15.1	16.8	20.7	21.7	20.9	22.8
Unit labor cost of industry (nominal)	11.9	4.0	11.0	2.9	5.5	7.2	12.2	11.1	13.7
Producer price index (PPI) of industry	10.8	11.7	8.1	12.8	11.1	9.4	7.5	6.1	9.3
Consumer price index (here: HICP)	9.1	6.6	4.9	5.9	4.8	3.9	3.9	5.1	6.8
EUR per 1 RON, + = RON appreciation	11.8	2.7	5.7	−0.5	4.6	5.4	7.3	9.6	0.9
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.5	7.6	6.7	7.4	7.5	7.4	6.8	6.3	6.4
Employment rate (15–64 years)	57.6	58.8	58.8	60.9	57.4	57.2	59.6	60.5	57.9
Key interest rate per annum (%)	11.7	8.5	7.5	8.8	8.8	8.4	7.6	6.8	7.3
RON per 1 EUR	3.6	3.5	3.3	3.5	3.5	3.4	3.3	3.2	3.4
	Nominal year-on-year change of the period average stock in %								
Money plus quasi-money	41.3	28.2	27.8	26.5	24.1	26.8	25.8	26.2	31.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	17.4	1.5	−6.0	−2.2	−1.6	−2.8	−3.8	−5.3	−11.3
Domestic credit of the banking system	9.9	31.1	39.7	34.6	27.9	33.3	34.4	36.7	52.6
of which: claims on the private sector	*25.6*	*36.1*	*42.2*	*38.0*	*38.7*	*39.1*	*39.4*	*41.0*	*48.6*
claims on households	*13.2*	*19.0*	*23.3*	*20.3*	*20.8*	*21.5*	*21.1*	*22.5*	*27.5*
claims on enterprises	*12.4*	*17.1*	*19.0*	*17.7*	*17.8*	*17.6*	*18.3*	*18.5*	*21.1*
claims on the public sector (net)	*−15.7*	*−4.9*	*−2.6*	*−3.4*	*−10.8*	*−5.8*	*−5.0*	*−4.3*	*3.9*
Other domestic assets (net) of the banking system	13.9	−4.5	−5.9	−5.9	−2.2	−3.7	−4.8	−5.1	−9.4
	% of GDP, ESA 95								
General government revenues	32.3	33.1	34.4	..	..	..	..	..	..
General government expenditures	33.5	35.3	36.9	..	..	..	..	..	..
General government balance	−1.2	−2.2	−2.5	..	..	..	..	..	..
Primary balance	−0.1	−1.4	−1.8	..	..	..	..	..	..
Gross public debt	15.8	12.4	12.9	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	17.6	16.4	13.2	9.5	17.1	12.1	11.0	12.3	17.2
Merchandise imports	24.0	25.5	24.4	22.8	28.3	33.4	25.5	23.1	18.1
	% of GDP (based on EUR), period total								
Trade balance	−9.8	−12.1	−14.5	−11.0	−13.7	−17.6	−16.4	−12.5	−13.4
Services balance	−0.4	0.0	0.2	−0.1	−0.4	1.0	0.2	−0.3	0.2
Income balance (factor services balance)	−2.9	−3.3	−3.6	−2.8	−1.8	−5.6	−5.1	−3.2	−2.1
Current transfers	4.5	4.9	4.0	4.3	5.1	5.1	4.9	4.5	2.4
Current account balance	−8.6	−10.4	−13.9	−9.6	−10.9	−17.1	−16.3	−11.5	−12.8
Capital account balance	0.7	−0.0	0.7	0.3	0.9	0.4	0.7	0.7	0.9
Foreign direct investment (net)	6.6	8.9	5.8	7.0	11.8	9.0	6.1	5.2	4.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt[2]	30.7	28.0	27.9	27.7	28.0	27.7	28.0	27.4	27.9
Gross official reserves (excluding gold)	21.1	21.8	20.9	20.5	21.8	21.3	20.8	22.2	20.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.8	5.9	5.6	5.5	5.9	5.6	5.4	5.8	5.6
	EUR million, period total								
Gross domestic product in current prices	79,739	97,898	121,212	26,600	32,487	20,360	26,553	34,354	39,946

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

[1] *In the first quarter of 2007, stock changes contributed 36.7 percentage points to the growth rate of GDP.*

[2] *Only medium- and long-term debt.*

8 Slovakia: Strong Economic Momentum Has a Favorable Impact on Foreign Trade and Productivity

Record growth in the fourth quarter driven to some extent by one-off effects

Real GDP growth in Slovakia accelerated to more than 10% year on year in 2007, which is well above the growth rates observed in all other EU countries. Growth was solid throughout the whole year, but exceptionally high in the fourth quarter of 2007, when economic activity expanded by 14.3% year on year. This acceleration can be explained at least partly by an outstanding increase in stock changes, which contributed 5.4 percentage points to economic growth in the final quarter of 2007. The contribution of net exports to GDP growth improved largely as a result of lower import growth and despite some slowing down of export growth.

On the production side, the economy was driven by a buoyant development of the industrial sector throughout 2007. This can be traced back to the large-scale buildup of (often FDI-financed) production capacities in export-oriented industries (e.g. automobiles, electronics) in recent years that fueled export growth. Despite repatriated profits exerting a negative effect on the income balance, the combined current and capital account position improved noticeably in 2007.

Rising productivity safeguards international competitiveness

FDI inflows in the industrial sector also positively impacted productivity developments. While nominal ULC declined given relatively moderate nominal wage growth in industry, ULC in industry increased (in euro terms) owing to the appreciation of the Slovak koruna, thus negatively affecting international competitiveness.

Labor market conditions continue to tighten

The unemployment rate declined further and employment showed robust growth rates of around 2%. Together with low geographical mobility of the workforce and a high share of the long-term unemployed (accounting for over 75% of total unemployment), this development contributed to growing labor shortages, especially of skilled workers in specific regions and labor market segments.

Inflation started to increase in the second half of 2007 and reached 3.6% year on year in March 2008. This development was, however, in line with global developments and mainly the outcome of rising food prices and, to some extent, also of energy price hikes. In contrast, nominal ULC in the whole economy increased only modestly (+0.4% year on year in 2007 against 1.7% year on year in 2006).

The general government deficit in Slovakia dropped to 2.2% of GDP in 2007. This positive development was mainly brought about by strong economic growth in the country and was almost entirely revenue driven.

Slovakia requests convergence assessment

On April 4, 2008, Slovakia submitted a request for a country examination (convergence assessment) in view of its intention to introduce the euro in 2009. By the time this report is published, the respective convergence reports of the ECB and the European Commission will have come available, the latter also containing a recommendation on Slovakia's request. A final decision will be taken by the Ecofin Council in early July, after the European Parliament has given its opinion and the European Council its deliberation.

Table 12

Main Economic Indicators: Slovakia

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	6.6	8.5	10.4	9.0	8.2	8.3	9.3	9.4	14.3
Private consumption	6.5	5.6	7.1	4.3	6.6	6.3	7.8	8.3	5.9
Public consumption	3.5	10.1	0.7	2.8	9.2	3.5	–3.5	2.2	0.8
Gross fixed capital formation	17.6	8.4	7.9	7.9	5.0	11.0	5.9	6.5	8.9
Exports of goods and services	13.9	21.0	16.0	24.0	23.1	22.7	18.1	8.5	16.0
Imports of goods and services	16.1	17.7	10.4	22.8	14.9	14.5	13.2	3.0	11.6
	Contribution to GDP growth in percentage points								
Domestic demand	8.7	6.8	6.1	8.9	2.9	2.8	4.9	4.6	11.6
Net exports of goods and services	–2.1	2.3	5.4	0.8	6.0	7.5	4.8	5.5	4.1
Exports of goods and services	11.5	18.6	15.8	21.0	21.7	21.0	17.3	8.4	17.1
Imports of goods and services	13.6	16.3	10.3	20.2	15.7	13.4	12.4	3.0	13.0
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	0.6	11.3	10.0	12.7	11.0	9.8	10.8	10.1	9.2
Gross average wage of industry (nominal)	7.3	6.7	6.4	7.4	8.5	8.1	6.2	6.1	5.5
Unit labor cost of industry (nominal)	6.6	–4.1	–3.3	–4.7	–2.2	–1.6	–4.1	–3.6	–3.4
Producer price index (PPI) of industry	4.7	8.4	2.1	8.5	6.1	3.4	1.6	1.1	2.2
Consumer price index (here: HICP)	2.8	4.3	1.9	4.8	3.5	2.1	1.7	1.4	2.4
EUR per 1 SKK, + = SKK appreciation	3.7	3.7	10.2	2.2	7.1	9.1	11.7	12.7	7.5
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	16.2	13.4	11.2	12.9	12.1	11.7	11.2	11.3	10.4
Employment rate (15–64 years)	57.7	59.4	60.7	59.9	60.2	60.1	60.4	60.7	61.6
Key interest rate per annum (%)	3.2	4.0	4.4	4.5	4.8	4.7	4.3	4.3	4.3
SKK per 1 EUR	38.6	37.2	33.8	37.8	35.9	34.3	33.8	33.6	33.4
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	5.0	5.5	14.8	6.7	8.6	15.2	16.7	14.9	12.5
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–5.8	15.9	–1.7	20.8	18.2	1.1	–3.7	–3.1	–1.1
Domestic credit of the banking system	12.1	3.9	14.4	4.0	3.5	11.6	13.9	15.8	16.1
of which: claims on the private sector	*8.1*	*16.1*	*14.9*	*15.8*	*16.5*	*15.1*	*13.9*	*15.4*	*15.4*
claims on households	*5.3*	*8.7*	*7.3*	*9.1*	*9.0*	*7.6*	*7.1*	*7.1*	*7.3*
claims on enterprises	*2.8*	*7.3*	*7.7*	*6.8*	*7.5*	*7.5*	*6.8*	*8.3*	*8.1*
claims on the public sector (net)	*4.0*	*–12.1*	*–0.5*	*–11.9*	*–13.0*	*–3.5*	*0.0*	*0.4*	*0.7*
Other domestic assets (net) of the banking system	–1.3	–14.3	2.1	–18.1	–13.0	2.5	6.5	2.2	–2.5
	% of GDP, ESA 95								
General government revenues[1]	35.3	33.5	34.7	..	..	..	..	..	..
General government expenditures[1]	38.1	37.2	36.9	..	..	..	..	..	..
General government balance[1]	–2.8	–3.6	–2.2	..	..	..	..	..	..
Primary balance[1]	–1.1	–2.2	–0.8	..	..	..	..	..	..
Gross public debt[1]	34.2	30.4	29.4	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	15.3	29.3	26.9	30.1	32.9	38.1	29.8	20.3	22.0
Merchandise imports	17.4	27.7	21.4	32.0	25.9	27.7	25.5	15.5	18.3
	% of GDP (based on EUR), period total								
Trade balance	–5.0	–4.6	–1.2	–3.1	–5.5	0.4	–1.8	0.0	–3.0
Services balance	0.7	1.4	0.7	1.4	1.6	0.3	1.3	0.9	0.4
Income balance (factor services balance)	–4.1	–3.7	–4.3	–5.8	–1.9	0.3	–5.9	–5.6	–5.3
Current transfers	0.0	–0.1	–0.6	–1.0	–0.3	–1.0	–0.7	–0.9	0.1
Current account balance	–8.4	–7.0	–5.4	–8.5	–6.1	–0.1	–7.2	–5.6	–7.9
Capital account balance	–0.0	–0.1	0.6	–0.1	–0.1	1.0	0.3	0.1	1.1
Foreign direct investment (net)	4.1	6.8	3.6	7.9	4.4	–0.8	5.7	4.6	4.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	59.6	54.8	54.9	54.4	54.8	56.5	54.9	53.6	54.9
Gross official reserves (excluding gold)	32.7	21.6	22.6	23.2	21.6	25.4	25.5	23.8	22.6
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.9	3.0	3.1	3.2	3.0	3.5	3.5	3.3	3.1
	EUR million, period total								
Gross domestic product in current prices	38,482	44,628	54,868	11,386	12,398	12,190	13,445	14,368	14,865

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

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

9 Croatia: Inflationary Pressures and External Vulnerabilities on the Rise

Strong economic growth driven by domestic consumption

In the latter half of 2007, the Croatian economy lost some of the strong momentum observed previously, with growth decelerating to below 4% in the final quarter. Nonetheless, annual average GDP growth reached a robust 5.6% in 2007, one of the highest rates in a decade. Domestic demand remained the main pillar of growth in 2007. Despite slowing down over the course of 2007, private consumption grew by a vigorous 6.2% on average in 2007, up from 3.5% in 2006, fueled by strong retail lending (despite restrictive measures implemented by the Hrvatska narodna banka (HNB)), improved labor market conditions and debt repayments to pensioners.[16] Similarly, public consumption growth accelerated markedly in view of the parliamentary elections in late 2007. While investment growth slackened toward year-end 2007, partly in view of more moderate public investment dynamics, it still came to 6.5%. Despite a marked slowdown in export growth in the final quarter of 2007, the gap between export and import growth narrowed in the full-year perspective. The contribution of net exports to growth improved slightly but remained modestly negative.

Rising inflationary pressures

Consumer price inflation accelerated sharply in the final months of 2007, reaching 5.8% year on year in December 2007, driven mainly by high food and energy prices. Core inflation picked up, also driven by rising nominal ULC for the whole economy (2.7% year on year in 2007 against 2.3% year on year in 2006). For similar reasons, inflationary pressures remained high in the first quarter of 2008, as well, with average consumer price inflation reaching 5.9% year on year.

External position deteriorating further

The acceleration of domestic demand triggered a further deterioration in Croatia's external position in 2007. In this context, the country's combined capital and current account gap increased noticeably on the back of a widening trade deficit. On the financing side, gross FDI inflows reached a record high of 9.7% of GDP, with the financial industry accounting for over 60% of total FDI inflows in 2007, following considerable capital increases in the banking sector. Croatia's gross external debt continued to rise moderately in 2007 and reached nearly 88% of GDP against the background of a marked change in the country's external debt structure. Croatian corporations increasingly rely on direct borrowing from abroad rather than the domestic banking system, given domestic borrowing constraints (administrative and prudential measures by the HNB). In light of this substitution effect, the HNB's efforts to mitigate the country's external indebtedness seem to have proved only partially effective. The share of public debt in total foreign debt has continued to decrease in 2007, a trend which might come to a halt in 2008: For the first time since 2004, the Croatian government has decided to tap international financial markets in 2008 with a eurobond issue worth some EUR 1.5 billion (partly to refinance previous bond issues).

Improvement of the fiscal balance in 2007

Croatia's fiscal balance improved in 2007, reaching an estimated deficit of 1.6% of GDP. Fiscal developments were largely underpinned by revenue overperformance, that were, however, spent on health care, education and agriculture in the run-up to parliamentary elections.

[16] *This debt accumulated because, between 1993 and 1998, pensions were not indexed to rises in wage levels, but to price level changes. As a result, the real value of the pensions declined considerably. According to a 1998 Constitutional Court ruling, the state had to assume liability for these unpaid pensions (amounting to some 6% of 2006 GDP). Pensioners were given the option to receive 50% of the money in four instalments in 2006 and 2007 or the full amount over a longer period (2008 to 2013).*

Table 13

Main Economic Indicators: Croatia

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.3	4.8	5.6	4.7	4.8	7.0	6.6	5.1	3.7
Private consumption	3.4	3.5	6.2	3.9	4.1	7.1	6.5	6.2	5.0
Public consumption	0.8	2.2	3.4	1.5	4.4	2.8	2.7	4.4	3.7
Gross fixed capital formatio^{n}	4.9	10.9	6.5	9.3	9.2	11.2	5.8	5.7	4.0
Exports of goods and services	4.6	6.9	5.7	2.2	11.1	3.0	8.9	7.3	2.1
Imports of goods and services	3.5	7.3	5.8	5.5	5.0	3.7	6.4	7.0	6.0
	Contribution to GDP growth in percentage points								
Domestic demand	4.2	5.9	6.4	6.4	3.3	8.2	6.7	4.3	6.6
Net exports of goods and services	0.1	–1.1	–0.8	–1.8	1.6	–1.2	–0.1	0.7	–2.9
Exports of goods and services	2.2	3.4	2.9	1.5	4.8	1.2	4.1	4.9	1.0
Imports of goods and services	2.2	4.5	3.7	3.2	3.2	2.4	4.2	4.2	3.9
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	6.2	2.7	5.9	3.7	3.5	7.7	7.3	4.7	3.6
Gross average wage of industry (nominal)	5.3	7.5	5.6	6.1	9.4	6.3	5.2	6.0	5.0
Unit labor cost of industry (nominal)	–0.8	4.7	–0.2	2.4	5.7	–1.3	–2.0	1.2	1.3
Producer price index (PPI) of industry	3.1	2.9	3.4	2.7	1.7	2.0	2.5	3.8	5.5
Consumer price index (here: CPI)	3.4	3.2	2.8	3.2	2.2	1.5	2.1	2.9	4.9
EUR per 1 HRK, + = HRK appreciation	1.3	1.1	–0.2	0.8	0.2	–0.3	–1.0	0.1	0.5
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	13.0	11.5	..	..	10.9	11.4	9.3	8.6	..
Employment rate (15–64 years)	55.0	55.6	..	..	56.8	55.4	56.9	58.9	..
Key interest rate per annum (%)	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
HRK per 1 EUR	7.4	7.3	7.3	7.3	7.4	7.4	7.4	7.3	7.3
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	9.5	14.0	17.9	15.9	17.3	20.0	20.1	17.5	14.6
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–5.0	–3.1	9.6	–1.8	2.2	6.2	11.5	10.5	9.9
Domestic credit of the banking system	17.3	20.8	17.2	21.6	20.2	20.6	18.0	16.9	13.9
of which: claims on the private sector	*13.2*	*20.2*	*19.6*	*21.1*	*20.9*	*22.3*	*22.2*	*18.8*	*15.9*
claims on households	*9.0*	*11.1*	*11.0*	*11.3*	*11.2*	*11.9*	*11.9*	*10.5*	*9.8*
claims on enterprises	*4.1*	*9.2*	*8.7*	*9.8*	*9.7*	*10.5*	*10.3*	*8.2*	*6.1*
claims on the public sector (net)	*4.1*	*0.6*	*–2.4*	*0.5*	*–0.7*	*–1.7*	*–4.2*	*–1.8*	*–2.0*
Other domestic assets (net) of the banking system	–2.7	–3.8	–8.9	–3.9	–5.1	–6.8	–9.4	–9.8	–9.2
	% of GDP, ESA 95								
General government revenues	..	..	..	..	..	..	..	..	..
General government expenditures	..	..	..	..	..	..	..	..	..
General government balance1)	–4.0	–2.5	–1.6	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt1)	43.7	40.8	37.7	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	9.3	17.2	8.2	13.6	20.1	1.9	16.8	10.7	4.1
Merchandise imports	10.6	14.0	10.8	13.9	11.0	8.8	12.0	10.0	12.0
	% of GDP (based on EUR), period total								
Trade balance	–24.0	–24.4	–25.2	–22.6	–23.5	–25.4	–27.2	–22.6	–26.0
Services balance	17.0	16.7	16.9	43.7	3.8	1.2	16.4	41.9	4.0
Income balance (factor services balance)	–3.1	–3.3	–2.9	–1.8	–0.6	–2.7	–6.7	–1.5	–1.0
Current transfers	3.8	3.2	2.8	2.9	2.9	2.9	2.9	2.5	2.8
Current account balance	–6.4	–7.7	–8.5	22.2	–17.5	–24.0	–14.6	20.3	–20.2
Capital account balance	0.2	–0.4	0.1	0.1	0.2	0.1	0.1	0.1	0.1
Foreign direct investment (net)	4.1	7.6	8.6	4.1	10.5	14.7	10.3	3.0	7.6
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	82.3	85.6	87.8	81.5	85.6	86.2	86.8	85.2	87.8
Gross official reserves (excluding gold)	23.8	25.5	24.8	24.2	25.5	27.2	25.6	24.0	24.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.1	5.3	5.2	5.1	5.3	5.7	5.4	5.1	5.2
	EUR million, period total								
Gross domestic product in current prices	31,272	34,214	37,494	9,451	8,535	8,494	9,314	10,330	9,355

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

[1] *Preliminary data for 2007.*

10 Turkey: Economic Slowdown in the Course of 2007

Economic growth again mainly driven by domestic demand

Real GDP grew by 4.5% in the full-year 2007, compared with 6.9% in 2006, on the back of a severe drought that resulted in negative growth of agricultural production. On the expenditure side, the composition of economic growth changed somewhat in 2007, as the contribution of net exports turned more negative (with the acceleration of import growth outpacing the increase in export growth). Real growth of credit to the private sector decelerated from around 40 percentage points on average year on year in 2006 to about 6 percentage points on average in the second half of 2007, with lending to corporates declining even more strongly. Consequently, GFCF growth, which had started to decline substantially over the course of 2006, remained weak during 2007. Interestingly, private consumption growth remained robust backed by strong wage increases but was rather volatile.

Far-reaching revision of national account statistics

In March 2008, the Turkish Statistical Institute (Turkstat) revised upward its nominal GDP figures for 2006 by more than one-third, following a revision of the statistics that were better aligned with ESA 95, which implies a stronger consideration of the informal economy, among other things. Turkstat also adjusted the real GDP growth rates of preceding years as well as key macroeconomic indicators in relation to GDP.[17] Furthermore, in early 2008, Turkstat published new population figures, which show that the number of people living in Turkey is significantly smaller than estimated before. This fact (combined with the higher GDP estimates) pushed up Turkish GDP per capita values.

External imbalances remain a source of vulnerability

In the second half of 2007, the combined current and capital account deficit increased to 5% of GDP. This development was largely attributable to a lower surplus on the services balance. Net FDI inflows were weaker and covered almost one-half of the external deficit.

Reducing inflation is one of the major challenges

Higher oil prices, a sharp rise in food prices, increases in excise taxes on alcohol and tobacco as well as nominal effective exchange rate developments and strong ULC growth in the whole economy (8.7% year on year in 2007 against 6.8% in 2006 year on year) pushed up annual headline inflation to 8.2% year on year in the final quarter of 2007 and to 8.8% in the first quarter of 2008. Inflation remained well above the upper limit of the central bank's inflation target of 4% ±2 percentage points. The Turkish lira, which appreciated by around 1% year on year in 2007, started to weaken against the euro by more than 3% year on year in March 2008, which was partly due to increased political uncertainty (court case to ban the ruling AKP).

Fiscal deficit expected to widen in 2007

According to national sources, the budget deficit is expected to increase to –1.2% of GDP in 2007 after –0.1 % of GDP in 2006, which is largely the result of weak tax collection and election-related spending.

After the final review under the stand-by arrangement (backlog of social security reforms) had been postponed in February 2008, completion of the review is scheduled to take place in early May, enabling the country to draw about USD 3.7 billion. So far, Turkey has not requested a further stand-by arrangement with the IMF.

[17] *For example, the current account deficit for 2006 was revised down from 8.3% of GDP in 2006 (old data) to 6.1% of GDP (new data), public debt in 2006 from above 60% of GDP (old data) to 46.1% of GDP (new data).*

Table 14

Main Economic Indicators: Turkey

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
Year-on-year change of the period total in %									
GDP in constant prices	8.4	6.9	4.5	6.3	5.7	7.6	4.0	3.4	3.4
Private consumption	7.9	4.6	4.6	2.9	0.6	5.6	1.6	8.2	2.9
Public consumption	2.5	8.4	2.8	11.2	2.0	4.7	2.1	3.3	1.6
Gross fixed capital formation	17.4	13.3	..	12.5	8.2	3.6	2.7	2.6	..
Exports of goods and services	7.9	6.6	6.7	4.1	7.9	12.5	9.3	4.2	2.5
Imports of goods and services	12.2	6.9	11.1	3.3	1.6	8.6	5.6	14.4	15.7
Contribution to GDP growth in percentage points									
Domestic demand	9.9	7.3	6.0	6.2	4.3	7.3	3.5	6.1	7.3
Net exports of goods and services	–1.5	–0.4	–1.6	0.1	1.4	0.2	0.4	–2.7	–3.8
Exports of goods and services	1.8	1.5	1.5	1.0	1.9	2.7	2.1	1.0	0.6
Imports of goods and services	3.3	1.9	3.1	0.9	0.5	2.5	1.7	3.7	4.4
Year-on-year change of the period average in %									
Labor productivity in manufacturing (real)	6.0	6.7	2.6	6.5	5.2	5.1	0.5	1.1	4.0
Gross average wage in manufacturing (nominal)	12.2	11.5	9.4	11.1	12.1	8.0	8.9	10.9	9.9
Unit labor cost in manufacturing (nominal)	5.9	4.5	6.6	4.4	6.5	2.8	8.4	9.8	5.7
Producer price index (PPI) of industry	6.0	9.3	6.4	12.6	11.4	10.1	6.6	3.6	5.3
Consumer price index (here: HICP)	8.1	9.3	8.8	10.6	9.7	10.3	9.5	7.1	8.2
EUR per 1 TRY, + = TRY appreciation	5.9	–7.3	1.3	–14.4	–14.1	–13.3	2.5	8.1	8.8
Period average levels									
Unemployment rate (ILO definition, %, 15–64 years)	10.2	9.9	9.5	9.1	9.6	11.4	8.9	8.9	8.9
Employment rate (15–64 years)	43.5	43.2	43.6	45.0	43.5	41.0	44.5	44.5	44.5
Key interest rate per annum (%)	14.8	15.6	17.2	17.4	17.5	17.5	17.5	17.5	16.5
TRY per 1 EUR	1.7	1.8	1.8	1.9	1.9	1.8	1.8	1.8	1.7
Nominal year-on-year change of the period average stock in %									
Broad money (including foreign currency deposits)	21.1	41.3	18.7	42.2	35.6	23.3	17.0	18.3	16.7
Contributions to the year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	6.1	10.0	9.1	9.3	10.8	10.7	11.6	9.8	4.5
Domestic credit of the banking system	21.6	39.3	15.5	40.2	32.5	17.3	11.0	15.2	18.7
of which: claims on the private sector	*19.3*	*31.7*	*16.7*	*33.5*	*29.0*	*19.8*	*15.2*	*15.2*	*16.7*
claims on households	*8.7*	*11.0*	*6.4*	*11.6*	*9.6*	*7.5*	*5.6*	*5.8*	*7.0*
claims on enterprises	*10.6*	*20.7*	*10.2*	*21.9*	*19.4*	*12.3*	*9.6*	*9.4*	*9.7*
claims on the public sector (net)	*2.2*	*7.6*	*–1.1*	*6.7*	*3.5*	*–2.5*	*–4.2*	*–0.1*	*1.9*
Other domestic assets (net) of the banking system	–6.7	–8.0	–5.9	–7.2	–7.7	–4.7	–5.6	–6.7	–6.5
% of GDP, ESA 95									
General government revenues	..	..	..	..	..	..	..	..	..
General government expenditures	..	..	..	..	..	..	..	..	..
General government balance[1]	–0.6	–0.1	–1.2	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt[1]	52.3	46.1	38.8	..	..	..	..	..	..
Year-on-year change of the period total (based on EUR) in %									
Merchandise exports	15.0	17.8	12.8	19.2	14.4	14.6	15.4	10.3	11.1
Merchandise imports	21.9	18.9	10.4	16.1	8.2	8.7	5.7	11.7	15.3
% of GDP (based on EUR), period total									
Trade balance	–7.0	–7.9	–7.2	–7.8	–6.6	–6.8	–7.5	–7.5	–7.0
Services balance	3.2	2.6	2.1	5.2	1.6	0.9	1.7	4.3	1.2
Income balance (factor services balance)	–1.2	–1.3	–1.0	–1.2	–1.3	–1.4	–1.0	–1.0	–0.9
Current transfers	0.3	0.4	0.3	0.4	0.4	0.3	0.3	0.4	0.3
Current account balance	–4.7	–6.1	–5.8	–3.3	–5.9	–7.0	–6.4	–3.7	–6.3
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	1.9	3.6	3.0	2.5	4.5	6.1	1.7	2.3	2.5
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	36.8	37.3	35.0	37.0	37.3	38.0	37.8	36.0	35.0
Gross official reserves (excluding gold)	11.0	11.1	10.4	11.1	11.1	12.1	11.5	11.0	10.4
Months of imports of goods and services									
Gross official reserves (excluding gold)	5.2	4.8	4.7	4.9	4.8	5.2	5.1	4.9	4.7
EUR million, period total									
Gross domestic product in current prices	388,302	418,088	480,391	111,568	107,220	102,034	116,743	133,446	128,168

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

[1] *Preliminary data for 2007.*

11 Russia: Impressive Economic Expansion, but Deepening CBR Policy Dilemma

Buoyed by high oil prices and accelerating investment, annual economic growth exceeded 8% in 2007

With GDP growth of more than 8% year on year, the country has reached its highest growth rate since 2000. Economic performance was buoyed by the very high world market prices for oil and metals and pushed further by accelerating internal demand. Private consumption and particularly GFCF growth was supported by a continued boom of real credit, record-low joblessness and rising real wages. The contribution of net exports to GDP growth, in contrast, decelerated strongly due to surging import growth (above 25% year on year) that was not matched by higher export growth rates, causing the negative contribution of foreign trade to virtually double compared to 2006, namely to reach 7 percentage points in 2007. Thus, Russian growth has become increasingly unbalanced. On the positive side, one-half of Russian imports in 2007 consisted of machinery and equipment, whose value expanded even faster than total imports.

Combined current and capital account surplus declines amid accelerating ULC

The import surge has been fueled by strong domestic demand, the continuing real appreciation of the Russian ruble, and sharply rising ULC. On top of brisk rises in preceding years, nominal ULC in industry are estimated to have increased by about 20% in 2007,[18] which represents an increasingly serious challenge for Russia's competitiveness. Accelerating imports and only modestly expanding exports contributed to a sizeable reduction of the combined current and capital account surplus. However, this contraction was more than offset by a strong expansion of the financial account surplus. Driven by some large IPOs as well as by expectations of nominal exchange rate appreciation and rising investor confidence, total net private capital inflows into Russia rose to 6.4% of GDP (from 4.3% in 2006), with net capital inflows by banks making up around one-half of this amount. Net FDI inflows only accounted for about one-tenth of total net private capital inflows. However, capital inflows have become much more volatile (and have even reversed temporarily) since the summer of 2007 because of repercussions of the U.S. financial crisis, which tightened external refinancing conditions, pushed up interest rates on the interbank loan market, and curtailed access to finance for many smaller banks.

Swelling private foreign liabilities led to an increase of Russia's gross external debt to 34% of GDP as of end-2007. While their expansion has slowed down in recent months, foreign currency reserves reached a new record high as of end-March 2008. These funds provide a sizeable buffer cushioning external shocks.

Runaway inflation coupled with banks' recurrent liquidity bottlenecks have deepened the CBR's policy dilemma

Strong capital inflows and brisk money supply growth, sharp food and energy price increases, possible overheating pressures, some fiscal loosening, utility price adjustments, as well as recent liquidity infusions to assist cash-starved banks contributed to pushing up inflation to almost 12% at end-2007 and 13.3% in March 2008 (year on year), the highest level since 2005. The Central Bank of the Russian Federation (CBR) is confronted with an increasingly serious dilemma of conflicting goals of monetary policy and banking soundness. This is exemplified by the CBR's attempts to combat accelerating inflation by implementing so far unsuccessful administrative measures (October 2007), hiking interest rates and raising reserve requirements (February 2008) on the one hand, while on the other hand injecting additional liquidity to banks (February 2008).

[18] *Data on ULC growth rates for the whole economy are not available.*

Table 15

Main Economic Indicators: Russia

	2005	2006	2007	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
	Year-on-year change of the period total in %								
GDP in constant prices	6.4	7.3	8.1	7.5	8.0	7.4	8.0	7.3	9.5
Private consumption	11.2	11.0	12.6	11.3	12.2	12.2	12.6	12.7	13.0
Public consumption	1.3	2.5	5.0	2.5	1.1	5.7	5.4	4.0	5.0
Gross fixed capital formation	10.6	17.7	20.8	17.5	21.3	22.0	23.6	17.9	20.6
Exports of goods and services	6.5	7.3	6.4	6.1	7.7	3.7	5.3	4.3	11.3
Imports of goods and services	16.6	21.9	27.3	19.1	22.8	28.4	28.9	26.4	26.1
	Contribution to GDP growth in percentage points								
Domestic demand	8.2	10.6	13.6	10.9	11.8	12.4	13.9	13.0	14.7
Net exports of goods and services	−2.2	−3.9	−7.0	−3.6	−4.8	−7.5	−7.5	−7.2	−5.8
Exports of goods and services	2.4	2.7	2.4	2.0	3.0	1.4	2.0	1.4	4.4
Imports of goods and services	4.5	6.6	9.3	5.6	7.8	9.0	9.5	8.6	10.2
	Year-on-year change of the period average in %								
Labor productivity of industry (real)[1]	7.3	8.3	4.6	8.8	7.4	7.3	5.6	2.0	3.4
Gross average wage of industry (nominal)[1]	21.1	21.4	26.0	22.6	22.0	25.9	24.5	24.8	28.5
Unit labor cost of industry (nominal)[1]	12.8	12.0	20.5	12.6	13.6	17.3	17.9	22.4	24.2
Producer price index (PPI) of industry	20.7	12.4	14.1	13.8	8.7	8.6	13.1	13.6	20.7
Consumer price index (here: CPI)	12.5	9.8	9.1	9.6	9.2	7.9	8.1	9.0	11.5
EUR per 1 RUB, + = RUB appreciation	1.7	3.3	−2.7	1.8	0.0	−1.8	−2.0	−2.4	−4.4
	Period average levels								
Unemployment rate (ILO definition)	7.6	7.2	6.1	6.7	6.8	7.0	6.0	5.6	5.6
Employment rate	..	..	..	..	..	..	.	..	..
Key interest rate per annum (%)	13.0	11.6	10.3	11.5	11.1	10.6	10.4	10.0	10.0
RUB per 1 EUR	35.2	34.1	35.0	34.2	34.1	34.5	34.9	35.0	35.7
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	33.9	37.0	44.6	37.4	39.1	42.3	48.5	43.9	43.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	34.0	30.9	31.8	31.8	30.2	29.8	34.2	31.2	31.9
Domestic credit of the banking system	0.4	11.7	21.6	11.6	14.4	19.3	23.2	21.3	22.4
of which: claims on the private sector	*30.0*	*36.4*	*44.5*	*38.3*	*39.4*	*41.4*	*44.2*	*45.1*	*46.6*
claims on households	*8.8*	*12.0*	*12.7*	*12.4*	*12.8*	*12.8*	*12.9*	*12.7*	*12.5*
claims on enterprises	*21.2*	*24.4*	*31.8*	*25.9*	*26.6*	*28.6*	*31.3*	*32.4*	*34.1*
claims on the public sector (net)	*−29.6*	*−24.6*	*−22.9*	*−26.6*	*−25.0*	*−22.1*	*−21.0*	*−23.8*	*−24.2*
Other domestic assets (net) of the banking system	−0.2	−5.8	−8.8	−6.0	−5.5	−6.8	−8.9	−8.7	−10.5
	% of GDP								
General government revenues	39.7	39.7	40.2	..	..	..	.	..	..
General government expenditures	31.6	31.3	34.1	..	..	..	.	..	..
General government balance	8.2	8.4	6.1	..	..	..	.	..	..
Primary balance	9.1	9.2	..	..	..	..	.	..	..
Gross public debt, general government	14.9	9.0	..	..	..	..	.	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	33.8	22.6	7.0	17.8	6.5	-2.3	2.2	4.2	22.8
Merchandise imports	29.7	28.5	24.5	25.7	26.7	27.1	26.8	26.9	19.1
	% of GDP (based on EUR), period total								
Trade balance	15.5	14.1	10.2	13.7	10.0	11.3	10.4	9.1	10.4
Services balance	−1.8	−1.4	−1.5	−1.6	−1.4	−1.3	−1.5	−1.8	−1.5
Income balance (factor services balance)	−2.5	−3.0	−2.3	−2.9	−2.6	−0.9	−3.8	−2.4	−2.1
Current transfers	−0.1	−0.2	−0.3	−0.3	−0.3	−0.2	−0.1	−0.3	−0.4
Current account balance	11.0	9.6	6.1	8.8	5.6	8.9	5.0	4.5	6.4
Capital account balance	−1.7	0.0	−0.8	−0.0	0.1	−0.3	0.1	0.0	−2.4
Foreign direct investment (net)	−0.0	1.0	0.5	0.7	−1.4	4.5	−4.0	0.1	1.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	36.0	30.3	26.6	28.2	30.3	27.9	28.9	29.3	26.6
Gross official reserves (excluding gold)	24.0	31.0	33.7	27.1	31.0	30.5	34.9	33.1	33.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)	13.4	17.7	18.5	15.6	17.7	17.1	19.2	18.0	18.5
	EUR million, period total								
Gross domestic product in current prices	616,304	788,520	940,840	213,058	216,541	195,837	222,298	251,980	270,725

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

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

Box 2

Outlook for Central and Eastern European (CEE) Countries[1]

Robust Economic Performance Expected to Continue but Growth Peak Has Passed

Economic growth in CEE countries will stay robust in the years to come; so far, the region has been relatively resilient to headwinds from financial market turbulences. Yet some economic slowdown is expected in the region (e.g. in the Czech Republic and Poland), but largely on the back of country-specific internal factors. Hungary's economic performance – which was exceptionally weak in 2007 compared with other countries of the region – is likely to remain anemic, but real GDP growth will at least gain some momentum after the strongest effects of the far-reaching fiscal stabilization program have phased out.

Table 1

Real GDP Growth in the Three CEE EU Member States

			latest forecasts			previous forecasts	
	2006	2007	2008	2009		2008	2009
	annual change in %						
Czech Republic							
OeNB (March 2008)	6.4	6.5	5.2	5.4	OeNB (September 2007)	5.1	4.8
European Commission (April 2008)			4.7	5.0	European Commission (November 2007)	5.0	4.9
IMF (April 2008)			4.2	4.6	IMF (October 2007)	4.6	..
wiiw (March 2008)			4.5	5.0	wiiw (July 2007)	5.2	..
Consensus Forecasts (April 2008)			3.8–5.5	3.2–6.0	Consensus Forecasts (September 2007)	4.1–5.5	..
Hungary							
OeNB (March 2008)	3.9	1.3	1.8	2.8	OeNB (September 2007)	2.5	3.3
European Commission (April 2008)			1.9	3.2	European Commission (November 2007)	2.6	3.4
IMF (April 2008)			1.8	2.5	IMF (October 2007)	2.7	..
wiiw (March 2008)			2.5	4.1	wiiw (July 2007)	3.1	
Consensus Forecasts (April 2008)			1.5–2.7	2.5–3.6	Consensus Forecasts (September 2007)	2.5–3.5	..
Poland							
OeNB (March 2008)	6.2	6.5	5.6	4.9	OeNB (September 2007)	5.7	5.0
European Commission (April 2008)			5.3	5.0	European Commission (November 2007)	5.6	5.2
IMF (April 2008)			4.9	4.5	IMF (October 2007)	5.3	..
wiiw (March 2008)			5.5	5.3	wiiw (July 2007)	5.5	
Consensus Forecasts (April 2008)			4.7–5.8	4.1–5.5	Consensus Forecasts (September 2007)	4.8–5.8	..

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

[1] *The OeNB compiles semiannual forecasts of economic developments in the Czech Republic, Hungary, Poland, and Russia. In the case of Russia, the forecast is established in collaboration with Suomen Pankki, Finland's central bank. The forecasts are based on preliminary global growth projections and technical assumptions about euro area import growth, oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem in the context of broad macroeconomic projection exercises. Compared with 2007, import growth of the euro area is expected to moderate in 2008 but to accelerate thereafter. The price of oil will pick up in 2008 and is expected to stay at elevated levels in 2009. The EUR/USD exchange rate is assumed to remain unchanged at the average level recorded in the two-week period ending in mid-February 2008 over the entire projection horizon.*

The OeNB's projections are well in line with those of the other economic and financial institutions. Compared with the September 2007 projections, real GDP growth forecasts were slightly revised downward for Hungary and Poland, and upward for the Czech Republic, in line with the 2007 outcome and the less favorable euro area growth projections.

According to the ECB's projections of March 2008, economic growth in the euro area is expected to slow to 1.3% to 2.1% in 2008 and to accelerate only marginally in 2009, after real GDP growth of 2.6% year on year in 2007. The ECB's growth projections for the euro area were revised downward from December 2007, reflecting, among other things, the dampening impact of the financial market turmoil. Economic forecasts for the USA and for emerging economies other than the four countries under review in this contribution follow the same line: Compared with previous forecasts, real GDP growth projections were revised downward more or less strongly for 2008 and 2009, largely on the back of ongoing global financial turbulence.

Overall, the three CEE countries have been relatively resilient to the financial market turmoil, but are likely to be affected negatively by worsening financing conditions and monetary tightening in the medium term. Furthermore, the region will be impacted by the economic slowdown in industrialized countries because of declining goods and services exports. The extent to which the CEE EU Member States depend on exports to the U.S. economy, however, is very small: Exports to the U.S.A. account for around 4% of total exports, whereas those to the euro area account for more than 50%. However, even before the beginning of the financial turbulence on world markets, most CEE countries already showed some signs of growth fatigue in 2007 partly on the back of country-specific internal factors.

For the ***Czech Republic****, we expect real GDP growth to moderate in 2008 and 2009 compared with 2007. Private consumption growth will lose steam in both years due to the reform package that will likely entail an increase in VAT and excise taxes as well as lower social transfers. Furthermore, rising inflation and monetary tightening are anticipated to have a dampening effect on private consumption. On the external side, we expect export growth to slow down somewhat owing to weaker demand in the euro area in 2008, but to revive somewhat in 2009, largely in connection with the opening of the Hyundai plant and of economic growth picking up in the euro area. Import growth will moderate as well, as soon as Hyundai's investment has been completed. Net exports will contribute positively to real GDP growth in 2008 (0.5 percentage points) and in 2009 (1.1 percentage points). Compared with the September 2007 forecast, the projection was revised slightly upward, in particular in light of a higher-than-expected positive impact of employment growth and the release of a new car model by Škoda, which pushed up expectations on export growth. These positive effects even offset the slight downward revision of GFCF growth that reflects a deterioration of confidence in industry, trade and construction, and weaker import demand of the country's main trading partners.*

Following a slump in ***Hungary's*** *growth performance in 2007, there seems to be room for real GDP growth to accelerate somewhat in 2008 and particularly in 2009. Private consumption growth will still be restrained in 2008 owing to ongoing labor market adjustment and inflation-induced moderation of real wage developments, but will pick up in 2009 backed by stronger growth in real income (lower tax burden) and some strengthening of employment. In 2009, the public sector can be expected to stimulate private consumption growth, e.g. in the form of higher public sector wages or an increase in selected transfers, given the upcoming elections to the European Parliament in 2009 and the Hungarian parliament in 2010. For 2008 and 2009, the OeNB's outlook for GFCF growth is fairly positive, supported by high capacity utilization levels in industry and, more recently, some strengthening of corporate credit activity. Furthermore, in 2009, the planned tax reform is likely to reduce the tax burden on companies. In light of the unfavorable economic outlook for Hungary's major export markets, export growth will slow down in 2008, as will import growth (export-import link), resulting in a slightly positive contribution of net exports to GDP growth. For 2009, we expect export growth to accelerate again and import growth to pick up even more owing to higher domestic* *demand, so that the contribution of external trade to GDP growth will be almost nil. The OeNB's latest growth projections were adjusted downward compared with September 2007, mainly due to worse economic prospects in the country's major trading partners. This assessment is supported by signs of lowering employment levels, accelerating inflation and deteriorating consumer and industry sentiment.*

*According to our projections, **Poland** will see further years of robust economic growth despite slowing down somewhat compared with 2007. Private consumption growth stands on a sound footing, supported by high employment growth and increasing disposable income (high nominal wage and credit growth, rising salaries for healthcare workers, changes in the tax benefit system) as well as by the envisaged tax reform scheduled to enter into force in 2009. However, higher inflation will prevent private consumption growth from accelerating strongly. After reaching a growth rate of around 20% year on year in 2007, GFCF growth will decline in 2008 and 2009, largely owing to lower profitability (reflecting rising ULC) and some tightening of monetary policy. However, GFCF growth will continue to expand dynamically, given sustained private consumption growth and increasing labor-substituting investments. On the back of lower import growth of the euro area, export growth is expected to slow down in 2008 but to regain some speed in 2009. The acceleration, however, will not be substantial as ULC will rise in the tradable sector. Overall, the contribution of net exports to GDP growth will be negative in 2008 and 2009 at around 2 percentage points. Compared with the previous forecast, the deceleration of export growth is expected to be more pronounced, given the current strong level of the currency and the expected slowdown of euro area import growth. At the same time, import growth is anticipated to turn out weaker (also reflecting a strong currency) compared with the previous forecast.*

*The main **risks to the projections** refer to deviations from the underlying assumptions for external factors, in particular import growth rates of the main trading partners as well as the actual impact of the financial market turmoil on the region. Another source of risks is country-specific factors. In Hungary, the government's defeat in the March 2008 referendum on selected structural reforms (doctor's fee, hospital fee, tuition fee) implies some risk regarding the implementation of fiscal reforms ahead of the elections in 2009 and 2010. In the Czech Republic and Poland, some uncertainty remains about bottlenecks on the labor market that might be even greater than assumed in the forecast, which could lead to higher wages and inflation. In Poland, some uncertainty remains about the implementation of fiscal reforms (e.g. the tax reform envisaged to enter into force in 2009).*

*In **Russia**, the economic situation and prospects for 2008 and 2009 remain quite favorable, despite the impact of the recent turbulences on financial markets, which have affected the country by constraining domestic banks' and enterprises' access to refinancing on international markets and thus tightening liquidity. The good prospects are mainly based on the high oil price. Annual real growth of private consumption has remained high in recent years and is forecast to continue at a slightly weaker but still robust rate, due to decelerating wage growth and a somewhat more modest expansion of lending.*

The pressure to boost federal spending has grown in tandem with sizeable and increasing fiscal oil revenues. According to Russian budgetary plans, fiscal policy is set to loosen somewhat in the coming years, which will translate into more robust government consumption up to 2009. GFCF is predicted to continue growing at a brisk pace in the coming years; investment will flow to various sectors, but is primarily driven by large energy projects and increased public infrastructure investments. Rapidly expanding domestic demand and a further real appreciation of the Russian ruble will sustain high import growth, which is, however, expected to moderate over the forecast period, as the rise of both income and the real external value of the ruble will decelerate. These developments are expected to set in once the strong increase in oil prices experienced in recent years has leveled off. Moderation notwithstanding, Russia's imports are predicted to continue expanding faster than exports, with the result that the still sizeable current account surplus will shrink swiftly.

Table 2

Real GDP Growth in Russia

	latest forecast					previous forecast	
	2006	2007	2008	2009		2008	2009
	annual change in %						
Russia							
OeNB (March 2008)	7.3	8.1	7.6	6.8	OeNB (September 2007)	6.2	5.6
European Commission (April 2008)	..		7.7	7.3	European Commission (November 2007)	7.0	6.9
IMF (April 2008)			6.8	6.3	IMF (October 2007)	6.5	..
wiiw (March 2008)			6.4	6.0	wiiw (July 2007)	5.2	
Consensus Forecasts (April 2008)			6.5–7.8	6.0–7.6	Consensus Forecasts (September 2007)	6.1–8.0	..

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

Oil price developments remain not only a major driving force, but also a key ***risk to the projection*** *for Russian growth. If the oil price were to drop sharply, Russia's current account balance might run into the red already in 2009 and economic expansion could suffer. A deepening of the international financial crisis could also weaken the financial standing of some Russian banks, curb the current credit boom and dampen internal demand. Yet the authorities do have some generous fiscal buffers (Reserve Fund and National Wealth Fund) and monetary buffers (the third-largest international reserves of the world) at their disposal, which could cushion economic decline. Moreover, if inflows of energy proceeds and/or capital were to accelerate substantially, this would involve the risk of an excessively quick appreciation of the real exchange rate.*