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1 Introduction

In 2004, economic growth in the Czech Republic, Hungary, Poland, Slovakia and Slovenia ranged between 4.0% and 5.5%. Economic performance thus remained strong and was generally more dynamic than in 2003 . GDP in the two candidate countries, Bulgaria and Romania, as well as in Russia grew even more strongly. Croatia, however, lagged behind and furthermore reported a lower growth rate in 2004 than in 2003. Growth accelerated most in Slovenia (+2.1 percentage points) and in Romania (+3.5 percentage points).

Private consumption growth developed unevenly across the region. In Slovakia, private consumption growth soared from –0.6% in 2003 to +3.5% in 2004; in Romania and Russia, private consumption accelerated to double-digit growth rates (from around 7% in 2003 to around 11% in 2004). In several countries, namely Bulgaria, Croatia, the Czech Republic and Hungary, private consumption growth decelerated, with the strongest reduction taking place in Hungary (from 8.0% in 2003 to 3.5% in 2004).

Within the set of countries under review in this report, the growth rate of gross fixed capital formation accelerated in most countries and, in the case of Poland and Slovakia, turned from negative rates in 2003 to positive ones in 2004. Only Croatia had to cope with a noticeable slowdown of gross fixed capital formation growth (2003: +16.8%, 2004: +4.4%).

The contribution of net exports to GDP was mixed: In Bulgaria, the Czech Republic and Slovenia, the contribution of net exports to GDP growth remained negative but became smaller, whereas in the case of Romania the negative contribution became larger. In the Slovak Republic and Russia, by contrast, the contribution of net exports to GDP growth turned from positive to negative figures, while turning from a negative to a slightly positive value in Hungary and Croatia. In Poland, the positive contribution of net exports to GDP growth declined marginally.

Table 1

Gross Domestic Product (Real)

Annual change in %

	1999	2000	2001	2002	2003	2004	Q4 2004
Czech Republic	1.2	3.9	2.6	1.5	3.7	4.0	4.3
Hungary	4.2	5.2	3.8	3.5	3.0	4.0	3.8
Poland	4.1	4.0	1.0	1.4	3.8	5.4	3.9
Slovakia	1.5	2.0	3.8	4.6	4.5	5.5	5.8
Slovenia	5.6	3.9	2.7	3.3	2.5	4.6	4.3
Bulgaria	2.4	5.4	4.1	4.9	4.5	5.6	6.2
Croatia	–0.9	2.9	4.4	5.2	4.3	3.8	3.6
Romania	–1.1	2.0	5.7	5.2	5.2	8.7	9.7
Russia	6.3	9.0	5.1	4.7	7.3	7.1	6.7

Source: Eurostat, national statistical offices, wiiw.

In 2004, the inflation rate (measured by annual average changes of HICP inflation in all countries but Russia and Croatia, where reference is made to CPI inflation) surged in most countries, ranging from 2.6% in the Czech Republic to 7.4% in Slovakia among the new EU Member States (NMS) in Central Europe. Of all countries under study, only Romania and Russia reported double-digit inflation rates, with year-on-year inflation in Romania declining to single-digit rates in December 2004. As already analyzed in FEEI 2/04, the upward pressure on price levels in 2004 was largely attributable to rising international energy prices, and in the NMS also to hikes in indirect and excise tax rates and adjustments of agricultural prices related to EU membership. In most countries inflation peaked in the third quarter and began to decelerate thereafter. Price growth decelerated significantly in the first quarter of 2005, as the main inflation drivers of 2004 no longer had an impact and as no substantial second-round effects were recorded. Among other factors, the disinflation process was furthermore supported by strong currencies, falling unit labor costs in industry and a moderation of inflation expectations. In Russia, however, inflation picked up largely because of accelerating industrial producer prices as well as strong wage and private consumption growth.

Table 2

Consumer Price Index (here: HICP)

Annual change in %

	2000	2001	2002	2003	2004	Q4 2004	Q1 2005
Czech Republic	3.9	4.5	1.4	–0.1	2.6	2.7	1.4
Hungary	10.0	9.1	5.2	4.7	6.8	5.9	3.5
Poland	10.1	5.3	1.9	0.7	3.6	3.4	3.5
Slovakia	12.2	7.2	3.5	8.5	7.4	6.0	2.6
Slovenia	8.9	8.6	7.5	5.7	3.6	3.5	2.8
Bulgaria	10.3	7.4	5.8	2.3	6.1	4.7	3.8
Croatia[1]	6.4	5.0	1.7	1.8	2.1	2.3	3.1
Romania	45.7	34.5	22.5	15.3	11.9	10.0	8.9
Russia[1]	20.8	21.6	16.0	13.6	11.0	11.6	12.9

Source: Eurostat, national statistical offices, wiiw.
[1] CPI.

In 2004, budget deficits in all Central European NMS except for the Czech Republic (deficit of 3.0% of GDP) and Slovenia (deficit of 1.9%) exceeded the well-known threshold of 3% for an excessive deficit procedure under the Treaty establishing the European Community. Within this group, Hungary (–4.5% of GDP) and Poland (–4.8%) reported the largest deficits, but all countries with the exception of Poland managed to reduce their budget deficit in 2004 compared to 2003. In all countries except for Hungary, the budget deficit turned out to be lower than the deficit envisaged in the convergence program prepared by the NMS governments in May 2004 and updated in late 2004. Better-than-expected economic growth leading to revenues above targets, some spending restraint and changes in fiscal accounting were the major factors behind the positive outcome.

With regard to the exchange rage development in Central and Eastern Europe, the Polish złoty, the Hungarian forint, the Czech koruna and the Slovak koruna were on an appreciating path against the euro, with a nominal annual appreciation of around 15%, 7%, 6.5% and 6%, respectively, for the year 2004. The Romanian leu appreciated by 6% to 7% from October to the end of 2004. This trend continued into 2005 until massive capital withdrawals from the stock and fixed income markets triggered a correction in March 2005. Political uncertainty and increased risk aversion of global investors, possibly coupled in some countries with concerns about economic imbalances, led to a moderate weakening of some currencies against the euro from March onward (by between 3.3% and 7.0% in the Czech Republic, Hungary, Poland and Slovakia). By contrast, the Romanian leu remained broadly stable in this period, while the Croatian kuna has gradually appreciated since the beginning of 2005 (by around 4%), correcting the weakening which had occurred in the last quarter of 2004. In line with the other currencies in ERM II, the Slovenian tolar continues to display the remarkable stability it has shown since its entry in ERM II. The Russian ruble depreciated by some 10% against the euro from April 2004 to January 2005 but then regained territory slowly.

Stock markets in the CEECs received massive foreign investment inflows in the course of 2004, which boosted stock indices in all countries except Russia. Romania is the country with the highest gains measured by stock index changes (around 90%), followed by the Czech Republic, Hungary and Bulgaria with increases of above or slightly below 50%. The official stock index grew by around 30% in Croatia, by 25% in Slovenia and by roughly 15% in Poland and Slovakia. The continuing upward trend at the beginning of 2005 came to an end in early March 2005 when investors' global risk perception changed, leading to capital outflows also from emerging equity markets; large corrections have taken place since then. Between early March and mid-May 2005, Romania (–19.2%), Hungary (–14.8%), the Czech Republic (–13.3%), Croatia (–12.4%) and Poland (–11.4%) suffered large equity price losses.

Broadly in line with the turn in inflation developments, local currency-denominated government bond yield spreads (ten-year segment) versus euro area benchmark yields started to decrease in the Czech Republic, Hungary, Poland and Slovakia from September 2004 onward. By early March 2005, yield spreads had dropped to slightly below 300 basis points in Hungary and to around 170 basis points in Poland; they were modestly negative in the Czech Republic and Slovakia. This marked fall in yield spreads was then followed by a moderate rise (in the Czech Republic, Poland and Slovakia by 20 to 40 basis points, in Hungary by 75 basis points until late May 2005) as a consequence of the global change of investor sentiment toward emerging markets.

For the whole year of 2004, the average Emerging Markets Bond Index (EMBI) spread on sovereign euro-denominated currency debt (eurobonds) fell by 74 basis points as a result of the emerging markets' improving fundamentals, the low risk aversion of investors and the ongoing search for higher yields. Among the countries monitored in this report, Bulgaria and Romania recorded a higher-than-average fall in the spread as compared to that of the average Euro EMBI, while Poland, Hungary and Slovakia had displayed low spreads already before. Capital flowed out of other asset classes, as sentiments regarding these asset classes deteriorated since mid-March 2005. The average Euro EMBI spread widened by 30 basis points until mid-May. The spreads of Latin American and Asian issuers' eurobonds widened most, while bonds from Central and Eastern European issuers posted significantly smaller upward movements. Most likely, favorable economic developments, such as falling current account and fiscal deficits, cushioned bond market developments in the CEECs; these improvements have also been reflected in rating upgrades. In addition, the prospect of EU accession also seems to be making especially Bulgaria and Romania less vulnerable to risk spillovers from emerging markets in other regions of the world.

Both Moody's and Standard & Poor's continue to award Slovenia (Aa3/AA–) the highest rating for sovereign long-term foreign currency debt among the countries discussed in this contribution. The Czech Republic and Hungary share the second-highest rating by both agencies (A1/A–). Standard & Poor's ranks Slovakia equal to the Czech Republic and Hungary. Moody's still ranks Poland third and upgraded Slovakia to this level (A2) in January 2005. At present, both agencies rank Croatia right after the NMS (Baa3/BB) and higher than Bulgaria (Ba1/BBB–) and Romania (Ba1/BB+), since Standard & Poor's upgraded the rating for Croatia in December 2004 while Moody's lifted Romania's rating in March 2005.

Table 3

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt

Currency	Moody's			Standard & Poor's		
	Former rating	Last change	Current rating	Former rating	Last change	Current rating
CZK	Baa1	12.11.02	A1	A	05.11.98	A–
HUF	A3	12.11.02	A1	BBB+	19.12.00	A–
PLN	Baa1	12.11.02	A2	BBB	15.05.00	BBB+
SKK	A3	12.01.05	A2	BBB+	13.12.04	A–
SIT	A2	12.11.02	Aa3	A+	13.05.04	AA–
BGN	Ba2	17.11.04	Ba1	BB+	24.06.04	BBB–
HRK		27.01.97	Baa3	BBB–	22.12.04	BBB
ROL	Ba3	02.03.05	Ba1	BB	14.09.04	BB+
RUB	Ba2	08.10.03	Baa3	BB+	31.01.05	BBB–

Source: Bloomberg.
Note: CZK = Czech koruna, HUF = Hungarian forint, PLN = Polish złoty, SKK = Slovak koruna, SIT = Slovenian tolar, BGN = Bulgarian lev, HRK = Croatian kuna, ROL = Romanian leu, RUB = Russian ruble.

Bulgaria and Romania signed the EU Accession Treaty on April 25, 2005, with entry into the European Union scheduled for January 1, 2007, provided that all EU Member States ratify the treaty. Furthermore, the treaty contains safeguard clauses which allow the EU Member States to decide to postpone the accession of Bulgaria and/or Romania by one year if the countries do not comply with the implementation of the agreed reforms. In the case of Bulgaria, the decision must be unanimous, whereas in the case of Romania, the decision can be invoked by qualified majority voting if the country is found to have failed to implement reforms in specific key areas, e.g. the field of competition policy. Furthermore, the EU Member States agreed to postpone the start of negotiations with Croatia in mid-March 2005 because Croatia's efforts to fully cooperate with the International Criminal Tribunal for the Former Yugoslavia were not considered to be fully sufficient. The 25 EU Member States need to decide unanimously on the start of accession negotiations with Croatia; they have signaled that negotiations could start as soon as the remaining obstacle has been removed.

2 Czech Republic: Favorable External and Inflation Developments

In the Czech Republic real GDP growth was 4.0% year on year in 2004, slightly above growth in 2003 (3.7%). Growth accelerated from 3.8% year on year in the first quarter of 2004 to 4.3% in the last quarter. Compared to 2003, the composition of growth changed considerably. The growth rates of private and public consumption declined in the course of 2004, to 1.9% and –5.8%, respectively, in the fourth quarter, resulting in full-year growth rates of 2.5% and –3.2%, respectively (after 4.9% and 4.2% in 2003). Growth of gross fixed capital formation, in contrast, accelerated strongly to almost 10% year on year in the first three quarters of 2004, but moderated to 7.5% in the fourth quarter of 2004. The full-year growth rate of gross fixed capital formation reached 9.1%, after just 4.8% in 2003. In the second quarter of 2004, the growth rates of exports and imports jumped to around 27% year on year as remaining trade barriers with major trading partners were eliminated after EU accession. In the following quarters of 2004, growth of exports and imports moderated slightly, but full-year growth turned out to be significantly higher than in 2003. In the full year 2004, the negative contribution to GDP growth of net exports declined to just –0.5 percentage point against –1.5 percentage points in 2003. Remarkably, the contribution of net exports was strongly positive in the last quarter of 2004. According to the spring forecast 2005 of the European Commission, GDP growth is expected to remain at 4.0% in 2005 and to accelerate slightly to 4.2% in 2006.

Table 4

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	1.2	3.9	2.6	1.5	3.7	4.0	4.3
Private consumption	2.1	2.9	2.6	2.8	4.9	2.5	1.9
Public consumption	5.4	0.2	3.8	4.5	4.2	–3.2	–5.8
Gross fixed capital formation	–3.5	4.9	5.4	3.4	4.8	9.1	7.5
Exports of goods and services	5.5	16.5	11.5	2.1	7.3	20.9	22.2
Imports of goods and services	5.0	16.3	13.0	4.9	7.9	18.5	15.8
	Contribution to GDP growth in percentage points						
Domestic demand	1.3	5.0	4.9	4.2	5.3	4.6	1.7
Exports	3.4	10.8	8.5	1.7	6.0	17.7	20.0
Net exports	–0.1	–1.1	–2.2	–2.7	–1.5	–0.5	2.7

Source: Eurostat, OeNB.

In 2004, robust economic growth was not reflected in the labor market. At 8.4%, the 2004 unemployment rate (ILO definition) was even somewhat higher than that of the previous year (7.9%); the employment rate (based on the population aged between 15 and 64 years) decreased slightly from 64.7% to 64.2%. Last year, industrial production growth was outstanding, reaching almost 13% in the second quarter. For the full year, industrial production increased by 9.8% compared to just 5.9% in 2003 largely due to strong foreign demand in particular of other EU Member States. Industrial employment remained almost constant in 2004, whereas industrial labor productivity accelerated by 9.7% (2003: 7.9%). Nominal wages in the industrial sector grew faster than in 2003, but industrial unit labor cost declined by 2.5% in 2004. In 2004, industrial wages deflated by the CPI augmented by 4.9% year on year (2003: 6.0%).

After annual average HICP inflation of –0.1% in 2003, inflation increased in 2004 and reached its peak in August at 3.2% year on year. Thereafter, inflation started to decline. In April 2005, HICP inflation came in at 1.4% (after 1.2% in March, which was the lowest year-on-year rise since December 2003). The disinflation process was mainly driven by a further fall in food prices. The contin-

Table 5

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	–3.1	5.4	6.7	4.9	5.9	9.8	9.1
Labor productivity of industry (real)	3.6	9.1	6.1	6.8	7.9	9.7	9.0
Gross average wage of industry (nominal)	6.6	7.1	6.4	6.7	5.9	7.0	6.0
Unit labor cost of industry (nominal)	3.0	–1.8	0.3	–0.1	–1.9	–2.5	–2.8
Producer price index (PPI) of industry	0.9	4.8	2.9	–0.5	–0.4	5.7	8.1
Consumer price index (here: HICP)	1.8	3.9	4.5	1.4	–0.1	2.6	2.7
Exchange rate (nominal):							
CZK[1] per 1 EUR, + = EUR appreciation	2.3	–3.5	–4.3	–9.5	3.3	0.2	–3.0
EUR per 1 CZK, + = CZK appreciation	–2.2	3.6	4.5	10.6	–3.2	–0.2	3.1
	Period-average levels						
Unemployment rate (ILO definition, %)	8.8	8.9	8.2	7.4	7.9	8.4	8.2
Key interest rate per annum (%)	6.7	5.3	5.1	3.6	2.3	2.2	2.5
Exchange rate (nominal):							
CZK[1] per 1 EUR	36.89	35.60	34.07	30.81	31.84	31.90	31.13
EUR per 1 CZK	0.0271	0.0281	0.0294	0.0325	0.0314	0.0313	0.0321

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1] CZK: Czech koruna.

uous disinflation process encouraged Česká národní banka to cut its key interest rate in January and March by 25 basis points each to 2.00%; another cut in April to 1.75%, i.e. below the ECB's key rate of 2%, came as a surprise to some market participants. In line with the justification for this decision, namely an improving inflation outlook, the central bank revised its inflation forecast for the next 18 months down from between 2.0% and 3.4% to between 1.4% and 2.8%, pushing the lower threshold below the inflation target band of 2% to 4% for 2006 and beyond. This move took account of decreasing import prices due to the appreciation of the currency and a less favorable economic outlook for the country's main trading partners.

In 2004 and into early 2005, the Czech koruna appreciated sharply by around 10%, reaching its strongest nominal value in more than two and a half years at 29.3 CZK/EUR. In March, however, the currency weakened to

Table 6

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	8.9	6.5	10.8	7.1	5.2	10.3	11.5
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	13.0	8.0	8.0	7.9	1.2	2.9	3.4
Domestic credit (net) of the banking system	–3.2	–1.1	0.2	–9.7	7.7	7.1	9.4
of which: claims on the private sector	–3.8	–5.0	–5.6	–12.3	0.9	6.0	6.0
claims on households	0.1	0.3	1.1	1.7	3.3	4.4	4.3
claims on enterprises	–4.0	–5.3	–6.7	–14.0	–2.5	1.5	1.8
net claims on the public sector	0.6	3.9	5.8	2.5	6.8	1.2	3.4
Other domestic assets (net) of the banking system	–0.9	–0.4	2.6	8.9	–3.7	0.3	–1.3

Source: National central bank, OeNB.
Note: Data since 2003 according to ECB methodology.

30.5 CZK/EUR. The depreciation of the currency has apparently been due to external factors, i.e. a change in global risk assessment, whereas internal factors, such as the political crisis which led to the resignation of prime minister Stanislav Gross and the appointment of Jiří Paroubek as the new Czech premier, seem to have had only a minor impact on the markets. In mid-May, the currency stood at around 30.3 CZK/EUR.

With a budget deficit of 3.0% of GDP, the fiscal situation of the country improved compared to 2003,[1] and the 2004 deficit turned out to be significantly below the expected deficit. In its autumn forecasts, the European Commission expected the deficit to run to 4.8%; the government's convergence program of December 2004 forecast a deficit of around 5.2%, in line with the original target. For the most part, the positive outcome was influenced more by higher government revenues than by lower-than-planned expenditures. Enhanced revenues were the result of more vigorous economic growth and the possibility of rolling over unspent funds into the next year for the first time. Furthermore, the reclassification of state guarantees resulted in a reduction of the deficit by almost 1 percentage point of GDP. The government targets a deficit of 4.7% of GDP for 2005 and of 3.8% for 2006 (convergence program of December 2004). In mid-2004 the Ecofin Council decided that an excessive deficit existed and advised the Czech Republic to correct the deficit by 2008. On January 18, 2005, in its assessment of the updated convergence program, the Ecofin Council recommended the use of higher-than-planned revenues to reduce the deficit and, furthermore, emphasized the need to push forward pension and health care system reforms. The European Commission expects a budget deficit of 4.5% in 2005 and 4.0% in 2006 (2005 spring forecast). Government debt stood at 37.4% of GDP in 2004 and is forecast to come to 36.4% in 2005 and 37.0% in 2006.

Table 7

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	39.2	38.5	39.1	40.2	41.6	42.7	41.8
Expenditures	42.9	42.1	45.0	46.9	53.3	45.7	46.3
of which: interest payments	1.0	0.9	1.1	1.5	1.3	1.3	1.3
Balance	–3.6	–3.7	–5.9	–6.8	–11.7	–3.0	–4.5
Primary balance	–2.6	–2.8	–4.8	–5.2	–10.3	–1.8	–3.2
Gross public debt	16.0	18.2	27.2	30.7	38.3	37.4	36.4

Source: European Commission.

On the back of high export growth, last year's trade deficit was reduced to 0.8% of GDP (2003: –2.7%). However, the current account deficit dropped by only 1.1 percentage points to 5.2%, as the deficit on the income account increased strongly due to foreign investors' profit repatriations after large inflows of FDI in recent years. The capital account was balanced in 2003,

[1] *In 2003, however, the record high deficit of 11.7% emerged because the government had to account fully for a partially realized one-off state guarantee which amounted to 6.3% of GDP.*

Table 8

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	24,651	31,509	37,271	40,713	43,053	53,787	31,677	39,080
Merchandise exports: year-on-year change in %	*6.9*	*27.8*	*18.3*	*9.2*	*5.7*	*24.9*	*5.2*	*23.4*
Merchandise imports	26,448	34,918	40,705	43,034	45,235	54,493	32,811	39,536
Merchandise imports: year-on-year change in %	*4.1*	*32.0*	*16.6*	*5.7*	*5.1*	*20.5*	*4.4*	*20.5*
Trade balance	–1,797	–3,409	–3,434	–2,322	–2,182	–706	–1,134	–455
% of GDP	*–3.2*	*–5.6*	*–5.0*	*–3.0*	*–2.7*	*–0.8*	*–1.9*	*–0.7*
Services balance	1,130	1,536	1,706	706	416	389	328	347
Income balance (factor services balance)	–1,265	–1,490	–2,450	–3,760	–3,757	–4,393	–2,505	–3,418
Current transfers	552	403	524	934	494	191	341	171
Current account balance	–1,379	–2,960	–3,653	–4,442	–5,029	–4,518	–2,970	–3,355
% of GDP	*–2.5*	*–4.9*	*–5.4*	*–5.7*	*–6.3*	*–5.2*	*–5.0*	*–5.2*
Capital account balance	–2	–6	–10	–4	–3	–450	–2	128
% of GDP	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*–0.5*	*0.0*	*0.2*
Direct investment flows (net)	5,879	5,356	6,121	8,870	1,694	3,142	2,528	2,746
% of GDP	*10.6*	*8.9*	*9.0*	*11.3*	*2.1*	*3.6*	*4.2*	*4.3*

Source: Eurostat, national central bank, OeNB.

but turned negative, slipping to –0.5% of GDP in 2004. In 2004, the net inflow of FDI almost doubled compared to 2003 and covered almost 70% of the current account deficit. In April 2005, the sale of the government stake in Český Telekom (CT) to Spain's Telefonica was finally approved.

The country's gross external debt increased from 34.5% of GDP at the end of 2003 to 38.5% at the end of 2004.

Table 9

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (1999 including, from 2000 excluding gold)	12,771	14,043	16,269	22,483	21,189	20,746
Gross external debt	22,765	23,285	25,368	25,738	27,624	33,258
	% of GDP[1]					
Gross official reserves (1999 including, from 2000 excluding gold)	23.1	23.2	23.9	28.7	26.4	24.0
Gross external debt	41.1	38.5	37.3	32.8	34.5	38.5
	Import months of goods and services					
Gross official reserves (1999 including. from 2000 excluding gold)	4.8	4.1	4.2	5.4	4.9	4.0

Source: Eurostat, national central bank, OeNB, wiiw.

[1] Q1 2004: As a percentage of rolling four-quarter GDP.

3 Hungary: Weakening Domestic Demand Reduces Inflation Pressure

Hungarian GDP growth accelerated to 4.0% year on year in 2004, up from 3.0% in 2003. The growth rate gradually decreased during the first three quarters of 2004 and stabilized at somewhat below 4.0% in the fourth quarter. Domestic demand growth slowed down significantly from 5.5% in 2003 to

3.0% in 2004, and its structure changed significantly, with consumption growth declining (from 7.3% in 2003 to 2.2% in 2004) and investment growth accelerating (from 3.4% to 8.3%). Within domestic consumption, private consumption grew by 3.5%, while public consumption decreased compared to 2003. Consumption remained weak into the final quarter of 2004, with private consumption growth decelerating to 1.8% and public consumption contracting by 3.3% year on year. Investment growth came to a rather unexpected standstill at the end of the year, registering a growth rate of 0.3% year on year following 18.9% in the first, 10.0% in the second and 12.7% in the third quarter. Both export and import growth accelerated in full-year 2004, with import growth continuously decelerating from the second quarter, while export growth gathered strength again in the fourth quarter following a weak performance in the third quarter. As a result, net exports contributed 0.8 percentage point to the 2004 GDP growth rate, a considerable improvement following the negative contribution of 2.6 percentage points in 2003. In particular in the last quarter of 2004 GDP growth was primarily driven by net exports. In its 2005 spring forecast, the European Commission expects GDP growth to slow modestly to 3.9% in 2005 and 3.8% in 2006, with investment and net exports remaining important motors of growth. The envisaged moderate increases in real disposable income and households' slowing credit demand suggest that the deceleration of consumption activity may last, while fiscal tightening plans may continue to have a negative impact on public investment activity.

Table 10

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	4.2	5.2	3.8	3.5	3.0	4.0	3.8
Private consumption	5.6	5.5	5.7	10.2	8.0	3.5	1.8
Public consumption	1.5	1.9	6.2	5.0	5.4	–1.3	–3.3
Gross fixed capital formation	5.9	7.7	5.0	8.0	3.4	8.3	0.3
Exports of goods and services	12.2	21.0	7.8	3.7	7.6	15.7	14.0
Imports of goods and services	13.3	19.4	5.1	6.2	10.4	14.0	9.5
	Contribution to GDP growth in percentage points						
Domestic demand	5.1	4.7	1.7	5.6	5.6	3.2	0.2
Exports	7.9	14.6	6.3	3.1	6.3	13.7	12.8
Net exports	–1.0	0.5	2.1	–2.1	–2.6	0.8	3.6

Source: Eurostat, OeNB.

At the beginning of 2005, industrial output figures indeed suggested an economic slowdown, showing a deceleration of growth to 1% year on year in February 2005, down from 8.3% in 2004.

Despite the recovery of output growth, the unemployment rate (labor force survey) remained broadly unchanged (2003: 5.9%; 2004: 6.1%). Employment decreased by 0.6% year on year, and the employment rate (based on the population aged between 15 and 64 years) eased modestly to around 57%, persisting at a rather low level compared to that of the other NMS. Net real wages decreased by 1% in 2004, reversing the trend of high wage dynamics between 2001 and 2003. The slowdown resulted from the acceleration of inflation, which was coupled with a deceleration of nominal wage growth. The latter was driven by wage restraint in the public sector, but private sector nominal wage dynamics also lost momentum in the course of 2004 and early 2005.

Annual average HICP inflation rose to 6.8% in 2004 from 4.7% in 2003. After peaking at 7.8% year on year in May 2004, inflation started to decline, with disinflation accelerating in the fourth quarter of 2004 and, in particular, at the beginning of 2005. In March 2005, HICP inflation stood at 3.3% year on year before rising to 3.8% in April. In addition to base effects, disinflation has been supported by the slowdown of domestic consumption, high real interest rates, the stronger currency and the decline in unit labor cost dynamics. In parallel to falling inflation, inflation expectations have also moderated, with the market consensus expectation[2] in April 2004 anticipating year-end inflation of around 3.5% in 2005 and 2006. This is in line with the inflation target of the Hungarian central bank, 3.5% ±1 percentage point for end-2006, and its inflation projection of 3.4% for end-2006.

Table 11

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	10.1	18.5	4.1	2.9	6.3	8.3	6.6
Labor productivity of industry (real)	5.1	17.0	5.6	4.7	8.4	10.6	9.4
Gross average wage of industry (nominal)	13.4	15.0	14.5	12.6	9.3	10.0	8.8
Unit labor cost of industry (nominal)	7.9	–1.7	8.4	7.5	0.8	–0.6	–0.6
Producer price index (PPI) of industry	5.0	11.4	5.7	–1.1	2.5	3.6	2.1
Consumer price index (here: HICP)	10.0	10.0	9.1	5.2	4.7	6.8	5.9
	Exchange rate (nominal):						
HUF[1] per 1 EUR. + = EUR appreciation	5.2	2.9	–1.3	–5.3	4.3	–0.7	–5.3
EUR per 1 HUF. + = HUF appreciation	–4.9	–2.8	1.4	5.6	–4.2	0.7	5.6
	Period-average levels						
Unemployment rate (ILO definition. %)	7.1	6.4	5.8	5.9	5.9	6.1	6.3
Key interest rate per annum (%)	15.2	11.5	11.1	9.1	8.6	11.4	10.3
	Exchange rate (nominal):						
HUF[1] per 1 EUR	252.76	260.07	256.60	242.95	253.51	251.73	245.94
EUR per 1 HUF	0.00396	0.00385	0.00390	0.00412	0.00394	0.00397	0.00407

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1] HUF: Hungarian forint.

Encouraged by the decline in inflation and inflation expectations, the improvement in the structure of GDP growth and the strengthening of the currency until mid-March 2005 (+9.4% between January 2004 and February 2005), Magyar Nemzeti Bank (MNB) continued its gradual reduction of key interest rates, lowering them by a total of 525 basis points to 7.25% between the beginning of 2004 and end-May 2005. The MNB has repeatedly cited the still large external imbalance and the need for more ambitious fiscal tightening as factors which prevent bolder interest rate cuts. In addition, since mid-March 2005 – amid a diminishing global risk appetite – increased uncertainty with

[2] *Trimmed mean of the individual forecasts in the monthly Reuters poll.*

regard to portfolio capital flows, which play a significant role in financing Hungary's current account deficit, and some weakening of the Hungarian forint against the euro have called for a cautious approach to monetary easing.

Table 12

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	17.4	17.7	16.3	10.1	14.2	11.4	10.7
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	10.3	10.3	9.2	2.2	–1.0	–2.0	–1.9
Domestic credit (net) of the banking system	6.0	6.0	10.7	12.3	22.4	17.9	14.9
of which: claims on the private sector	8.8	16.2	17.2	15.4	18.7	21.8	17.4
claims on households	1.6	2.7	4.2	6.3	10.6	9.9	8.0
claims on enterprises	7.1	13.4	13.0	9.1	8.1	11.9	9.3
net claims on the public sector	–2.7	–10.2	–6.5	–3.1	3.7	–3.9	–2.5
Other domestic assets (net) of the banking system	1.1	–5.8	–3.6	–4.5	–7.2	–4.4	–2.3

Source: National central bank, OeNB.

In 2004, Hungary posted a general government budget deficit of 4.5% of GDP, excluding the costs of the pension reform. Including these costs, the deficit stood at 5.4% of GDP. The public debt ratio increased to 57.6% of GDP (60.7% including pension reform costs). The budget deficit was hence reduced compared to 2003 (6.2% excluding, 7.1% including pension reform costs), but exceeded the target set in the May 2004 convergence program (4.6% including pension reform costs). Consequently, the Ecofin Council concluded that Hungary had not taken effective action to correct its excessive deficit and in March 2005 issued a new recommendation to Hungary to take additional measures until early July 2005 to comply with its convergence program targets. According to its updated convergence program of December 2004, Hungary is targeting a budget deficit of 3.8% of GDP excluding the costs of the pension reform (4.7% including) in 2005, hence envisaging a deficit reduction by 0.7% of GDP. Nevertheless, developments over the first four months of the year suggest that without additional measures, the 2005 deficit target could be overshot. For 2006, a further deficit reduction to 3.1% (4.1%) is planned. While the 2005 target is broadly in line with the European Commission's 2005 spring forecast,

Table 13

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	..	45.3	45.0	44.1	44.5	47.5	44.0
Expenditures	..	47.6	48.7	52.6	50.8	52.0	47.8
of which: interest payments	..	5.6	4.7	4.0			
Balance	..	–2.4	–3.7	–8.5	–6.2	–4.5	–3.9
Primary balance	..	3.2	1.0	–4.5	–2.2	–0.2	0.0
Gross public debt	60.9	55.4	52.2	55.5	56.9	57.6	57.8

Source: European Commission.

Table 14

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	24,059	31,278	34,697	36,821	38,377	44,516	27,813	32,331
Merchandise exports: year-on-year change in %	*14.3*	*30.0*	*10.9*	*6.1*	*4.2*	*16.0*	*1.4*	*16.2*
Merchandise imports	26,102	34,457	37,193	39,024	41,274	46,907	30,100	34,479
Merchandise imports: year-on-year change in %	*14.8*	*32.0*	*7.9*	*4.9*	*5.8*	*13.6*	*5.1*	*14.5*
Trade balance	–2,044	–3,180	–2,496	–2,203	–2,898	–2,391	–2,287	–2,148
% of GDP	*–4.5*	*–6.3*	*–4.3*	*–3.2*	*–4.0*	*–3.0*	*–4.3*	*–3.7*
Services balance	816	1.234	1.661	587	–378	–10	–157	191
Income balance (factor services balance)	–2,713	–2,792	–3,192	–3,838	–3,682	–4,929	–2,713	–3,571
Current transfers	408	385	450	525	594	206	494	117
Current account balance	–3,531	–4,352	–3,577	–4,929	–6,364	–7,123	–4,663	–5,411
% of GDP	*–7.8*	*–8.6*	*–6.2*	*–7.1*	*–8.7*	*–8.9*	*–8.7*	*–9.3*
Capital account balance	31.2	299.9	357.9	202.3	–32.5	317.6	–70.7	187.5
% of GDP	*0.1*	*0.6*	*0.6*	*0.3*	*0.0*	*0.4*	*–0.1*	*0.3*
Direct investment flows (net)	2,872	2,334	3,992	2,889	443	2,940	–9	2,216
% of GDP	*6.4*	*4.6*	*6.9*	*4.2*	*0.6*	*3.7*	*0.0*	*3.8*

Source: Eurostat, national central bank, OeNB.

the Commission expects a deficit widening to 4.1% of GDP in 2006. The government is currently contemplating a tax reform to take effect from the beginning of 2006; it is aimed at attaining the 2006 budget deficit target and overhauling the tax system.

Despite the weakening of domestic demand, Hungary's current account deficit widened from 8.7% of GDP in 2003 to 8.9% in 2004. The deterioration in the income and transfer balances was the main reason for the deterioration of the overall deficit; the deficit on the goods and services account narrowed from 4.5% to 3.0% of GDP, supported by the deceleration of domestic demand. The capital account posted a surplus of 0.4% of GDP, reducing the country's overall external financing requirement. Net FDI inflows recovered compared to 2003 (from 0.6% to 3.7% of GDP) and covered around 40% of the overall financing requirement. In addition, the role of portfolio capital in deficit financing intensified, increasing the country's exposure to changes in international investor sentiment.

Table 15

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	10,722	12,038	12,164	9,887	10,108	11,671
Gross external debt	29,231	32,572	37,387	38,559	46,036	54,925
	% of GDP[1]					
Gross official reserves (excluding gold)	23.8	23.8	21.0	14.3	13.8	14.5
Gross external debt	64.9	64.4	64.5	55.9	62.9	68.3
	Import months of goods and services					
Gross official reserves (excluding gold)	4.3	3.6	3.4	2.6	2.5	2.5

Source: Eurostat, national central bank, OeNB, wiiw.

[1] Q1 2004: As a percentage of rolling four-quarter GDP.

The country's gross external debt continued to increase and reached 68.3% of GDP at the end of 2004, up from 62.9% a year earlier.

4 Poland: Higher Average Growth in 2004, but Deceleration in the Course of the Year

GDP growth accelerated to 5.4% in 2004 (2003: 3.8%), but decreased over the year from nearly 7% year on year in the first quarter to about 4% in the fourth quarter. Private consumption rose by 3.4%, moderately more strongly than in 2003 (3.1%) and still clearly less than GDP growth. The more robust year-on-year growth of private consumption in the first half of 2004 was probably boosted by effects related to EU accession. The main contribution to the acceleration of GDP growth in 2004 stemmed from gross fixed capital formation, which expanded (at a rate of 5.3%) for the first time after four years of contraction. Real export growth at 11.4% decelerated from the high level of 2003 (14.7%), although foreign demand was more powerful and the year-average exchange rate was roughly unchanged when deflated by industrial producer prices and significantly weaker when deflated by industrial unit labor costs. At the same time, real import growth was nearly unchanged at 8.7% (2003: 9.3%), but remained below export growth. Less dynamic export growth (combined with the impact of export production on imports) and the weaker average unit labor cost-deflated exchange rate seem to have compensated for the impact of stronger domestic demand growth on real imports. With export growth exceeding import growth, net exports improved further in 2004, contributing 1.0 percentage point to GDP growth, somewhat less than in 2003.

Table 16

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	4.1	4.0	1.0	1.4	3.8	5.4	3.9
Private consumption	5.3	2.8	2.1	3.3	3.1	3.4	1.8
Public consumption	1.0	1.1	0.6	0.6	0.2	1.4	0.5
Gross fixed capital formation	9.2	–1.9	–8.8	–5.8	–0.5	5.3	7.2
Exports of goods and services	–3.2	32.4	3.1	4.8	14.7	11.4	0.3
Imports of goods and services	1.1	15.5	–5.3	2.6	9.3	8.7	–2.1
	Contribution to GDP growth in percentage points						
Domestic demand	5.4	0.1	–1.6	0.8	2.5	4.4	3.1
Exports	–1.0	9.1	1.1	1.7	4.4	3.9	0.1
Net exports	–1.3	3.9	2.6	0.6	1.3	1.0	0.8

Source: Eurostat, national statistical office, OeNB, wiiw.

Given higher economic growth on average in 2004, year-average employment growth was recorded for the first time since 1998. Expanding by 1.3%, the employment performance implied a decline in the year-average unemployment rate (ILO definition, based on the labor force survey) to 19.3% (2003: 20.0%) despite an increase in the labor force by 0.5%. In industry, labor shedding nearly came to a halt (–0.4% against –2.5% in 2003). Coupled with robust industrial output growth, labor productivity growth (13.5%) far exceeded the slightly rising nominal wage growth (4.5%), implying an even more pronounced fall in nominal unit labor costs in industry in 2004 (7.9%) than in 2003 (7.5%).

While industrial producer prices mounted by 7.1% on average in 2004 (2003: 2.7%), their rise slowed from a peak of 9.6% year on year in May 2004 to only 2.2% year on year in March 2005, supported by the sharp fall in unit labor costs. In the whole economy, real wages (HICP deflated) declined by 1.4% year on year in the first quarter of 2005, after having been more or less stagnant in 2004 (+0.6). Inflation (HICP) peaked at 4.9% in August 2004 and started to decline thereafter. By March 2005, HICP inflation had reached 3.4% year on year, within the monetary policy target band (2.5 ±1 percentage point). In response to disinflation and an improving inflation outlook, the Monetary Policy Council of Narodowy Bank Polski lowered the key interest rate (two-week rate on central bank bills) by a total of 1 percentage point to 5.5% in two steps at the end of March and April 2005.

Table 17

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	4.7	7.8	0.6	1.4	8.6	13.1	16.6
Labor productivity of industry (real)	9.6	17.9	6.1	7.4	11.4	13.5	17.0
Gross average wage of industry (nominal)	34.1	10.9	6.9	3.7	3.0	4.5	4.8
Unit labor cost of industry (nominal)	22.3	–5.9	0.8	–3.4	–7.5	–7.9	–10.5
Producer price index (PPI) of industry	5.7	7.8	1.7	1.1	2.7	7.1	8.9
Consumer price index (here: HICP)	7.2	10.1	5.3	1.9	0.7	3.6	3.4
Exchange rate (nominal):	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PLN[1] per 1 EUR. + = EUR appreciation	8.0	–5.2	–8.4	5.0	14.1	3.0	7.6
EUR per 1 PLN. + = PLN appreciation	–7.4	5.5	9.2	–4.7	–12.4	–2.9	–7.1
	Period-average levels						
Unemployment rate (ILO definition. %)	. .	16.4	18.6	20.3	20.0	19.3	19.4
Key interest rate per annum (%)	13.7	17.9	16.0	8.8	5.6	5.8	5.3
Exchange rate (nominal):							
PLN[1] per 1 EUR	4.23	4.01	3.67	3.85	4.40	4.53	4.69
EUR per 1 PLN	0.2365	0.2495	0.2725	0.2595	0.2274	0.2207	0.2133

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1] PLN: Polish złoty.

After the real key interest rate (12-month moving average) had fallen continuously from 4.3% in December 2003 to 0.5% in August 2004, it increased to 2.9% by March 2005.[3] Both the recent increase of real interest rates and the real appreciation of the złoty by 22% (CPI-deflated) and 20% (PPI-deflated) from February 2004 to March 2005 had a tightening effect on monetary conditions. In 2004, annual average real money growth was 3.6% year on year and remained below GDP growth. Both net foreign assets and lending to households expanded, making an equally large contribution to money growth. On the other hand, net credit to government and bank lending to enterprises declined even in nominal terms. In the first quarter of 2005, this pattern was even more pronounced, as household credit expanded by 15% year on year while corporate credit contracted by 5% year on year in nominal terms, partly reflecting the

[3] *Ex post real key rate per annum as measured by the real (CPI-deflated) key rates per month compounded over the past 12 months. The similarly measured PPI-deflated key rate per annum declined from 2.1% in December 2003 to –3.8% in May before recovering to –0.9% by November and reaching 3.9% in March 2004.*

decline in unit labor costs and the resulting high profitability of the sector. At the same time, the strong currency appreciation moderated the increase of net foreign assets by 24% year on year in euro terms to only 4.5% as measured in Polish złoty.

Table 18

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	24.7	15.4	12.1	2.0	1.5	6.9	8.2
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	7.8	7.0	4.5	0.9	0.0	4.2	2.5
Domestic credit (net) of the banking system	25.1	13.5	7.2	7.1	5.2	3.7	2.8
of which: claims on the private sector	18.5	15.7	8.3	3.4	3.8	4.1	3.9
claims on households	6.2	7.0	4.2	2.8	2.5	4.7	5.7
claims on enterprises	12.3	8.7	4.1	0.5	1.3	–0.6	–1.8
net claims on the public sector	6.7	–2.1	–1.1	3.7	1.4	–0.5	–1.1
Other domestic assets (net) of the banking system	–8.3	–5.1	0.4	–6.0	–3.8	–1.0	2.9

Source: National central bank, OeNB.

According to the March 2005 fiscal notification, the public deficit was 4.8% of GDP in 2004, lower than the deficit ratios envisaged in the government's convergence programs of May (–5.7%) and December 2004 (–5.4%), which were based on real GDP growth of 5.0% and 5.7%, respectively. Thus, the deficit was only slightly higher than in 2003 (4.5%), despite the negative fiscal impact of EU accession. According to the Ecofin Council recommendation under the excessive deficit procedure in July 2004, Poland should take effective action to achieve the 2005 deficit target set in May and reach a deficit of below 3% by 2007. The December program set the deficit target for 2005 at 3.9% of GDP (against 4.2% in the May program) and at 2.2% of GDP for 2007 (against 1.5% in the May program). However, all these deficit figures are based on classifying the defined-contribution funded pension schemes inside the government sector, while the Eurostat ruling of 2004 that these schemes have to be classified outside the government sector has to be implemented by the March 2007 fiscal notification. The full reclassification would imply an upward revision of the deficit figure by about 1.8 percentage points of GDP in 2006 and 2007. Moreover, the public debt-to-GDP ratio envisaged at 47.3% in 2007 will rise as well.

Table 19

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	44.9	42.5	43.8	43.9	44.3	43.8	44.2
Expenditures	47.0	45.2	47.7	47.5	48.8	48.7	48.6
of which: interest payments	2.0	3.1	3.2	2.9	2.9	2.6	2.6
Balance	–1.4	–1.6	–3.9	–3.6	–4.5	–4.8	–4.4
Primary balance	0.6	1.6	–0.7	–0.7	–1.6	–2.2	–1.9
Gross public debt	40.1	36.8	36.7	41.2	45.4	43.6	46.8

Source: European Commission.

Accordingly, the Ecofin Council stated in its opinion on the December convergence program on February 17, 2005, that Poland should lower the deficit target for 2007.

Corresponding to further improving real net exports, the deficit in the goods and services account in the balance of payments continued to shrink to 1.9% of GDP in 2004 (2003: –2.5%). In parallel, the current account deficit contracted to 1.5% of GDP (2003: –2.2%). The current account shortfall was fully covered by a capital account surplus of 0.4% of GDP and by net direct investment inflows of 2.1% of GDP (2003: 1.9%).

Table 20

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	28,215	39,028	46,487	49,324	53,814	65,638	39,255	47,931
Merchandise exports: year-on-year change in %	*–2.5*	*38.3*	*19.1*	*6.1*	*9.1*	*22.0*	*8.4*	*22.1*
Merchandise imports	42,361	52,359	55,075	57,036	58,890	70,144	43,030	51,416
Merchandise imports: year-on-year change in %	*4.9*	*23.6*	*5.2*	*3.6*	*3.3*	*19.1*	*2.8*	*19.5*
Trade balance	–14,146	–13,331	–8,588	–7,712	–5,076	–4,506	–3,775	–3,485
% of GDP	*–9.2*	*–7.4*	*–4.1*	*–3.8*	*–2.7*	*–2.3*	*–2.8*	*–2.5*
Services balance	1,297	1,551	905	852	430	701	120	110
Income balance (factor services balance)	–948	–1,609	–1,585	–1,990	–3,189	–3,683	–2,385	–2,694
Current transfers	2,078	2,595	3,226	3,433	3,726	4,539	2,653	3,032
Current account balance	–11,719	–10,794	–6,042	–5,417	–4,109	–2,949	–3,387	–3,037
% of GDP	*–7.6*	*–6.0*	*–2.9*	*–2.7*	*–2.2*	*–1.5*	*–2.5*	*–2.2*
Capital account balance	51.0	41.0	81.0	–8.0	–40.0	803.0	–32.0	616.0
% of GDP	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.4*	*0.0*	*0.4*
Direct investment flows (net)	6,795	10,253	6,457	4,147	3,508	4,198	2,518	2,342
% of GDP	*4,4*	*5.7*	*3.1*	*2.0*	*1.9*	*2.1*	*1.8*	*1.7*

Source: Eurostat, national central bank, OeNB.

Other investment inflows (net) resulting partly from the prepayment of Paris Club debt were negative and exceeded sizeable portfolio net inflows, while gross official reserves hardly changed in absolute terms. The expansion of total gross foreign debt in percent of GDP resulted exclusively from higher official gross foreign debt.

Table 21

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	26,224	28,555	29,031	27,367	26,000	25,904
Gross external debt	65,123	74,672	81,461	81,046	84,003	92,881
	% of GDP [1]					
Gross official reserves (excluding gold)	17.0	15.8	14.0	13.5	14.0	13.2
Gross external debt	42.2	41.3	39.3	40.0	45.4	47.4
	Import months of goods and services					
Gross official reserves (excluding gold)	6.4	5.5	5.4	4.9	4.6	3.9

Source: Eurostat, national central bank, OeNB, wiiw.

[1] *Q1 2004: As a percentage of rolling four-quarter GDP.*

5 Slovak Republic: Recovery of Private Consumption

In 2004, real GDP in the Slovak Republic posted solid growth of 5.5% year on year after 4.5% in 2003. Growth in 2004 was volatile over quarters, coming in highest at the end of the year and lowest in the third quarter. The sources of growth changed substantially from 2003. In 2004, GDP growth was increasingly driven by domestic demand. Private consumption accelerated by 3.5% after a decline of 0.6% in 2003, and gross fixed capital formation turned from negative (2003: –1.5%) to positive (2004: +2.5%). Gross fixed capital formation advanced fastest in the third quarter (+5.5%) but dropped to just 0.1% growth in the last quarter of 2004. The public consumption growth rate declined from 2.7% in 2003 to 1.2% in 2004. Overall, the contribution of domestic demand to GDP growth amounted to 6.3 percentage points in contrast to a negative contribution of 2.1 percentage points in 2003. On the external side, real import growth in 2004 turned out to be only slightly lower than in 2003, whereas export growth diminished significantly from 22.5% in 2003 to 11.4% in 2004. The contribution of net exports to GDP switched from positive to negative (from 6.5 percentage points in 2003 to –0.8 percentage point in 2004). In its 2005 spring forecast, the European Commission expects a slowdown of the growth dynamics to 4.9% in 2005 and to 5.2% in 2006.

Table 22

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	1.5	2.0	3.8	4.6	4.5	5.5	5.8
Private consumption	3.2	–0.8	4.7	5.5	–0.6	3.5	4.3
Public consumption	–7.1	1.6	4.6	4.9	2.7	1.2	0.2
Gross fixed capital formation	–19.6	–7.2	13.9	–0.6	–1.5	2.5	0.1
Exports of goods and services	5.0	13.7	6.3	5.6	22.5	11.4	9.5
Imports of goods and services	–6.7	10.5	11.0	5.5	13.6	12.7	12.3
	Contribution to GDP growth in percentage points						
Domestic demand	–7.0	0.1	7.5	4.7	–2.1	6.3	8.4
Exports	3.3	9.4	4.8	4.3	17.7	10.6	9.4
Net exports	8.4	1.9	–3.7	–0.1	6.5	–0.8	–2.6

Source: Eurostat, national statistical office, OeNB.

The boom of the Slovak economy was not reflected in the labor market. The already very high unemployment rate (ILO definition) accelerated further from 17.6% in 2003 to 18.3% in 2004. The employment rate (based on the population aged between 15 and 64 years) dipped from 57.7% in 2003 to 57.0% in 2004. In industry, employment edged up by just 0.4% year on year in 2004, and labor productivity growth declined continuously in the course of the year, sinking from 7.4% in the first quarter to –1.0% in the last quarter of 2004. This resulted in an overall labor productivity growth rate of 3.9%. Weak industrial output growth was largely due to low output in the car industry related to production line upgrades. Industrial wage growth (nominal) accelerated to 10.1%, leading to a further rise of unit labor costs (+6.0%) above producer price inflation (3.4%). In 2004, industrial wages deflated by the CPI went up by 2.6% year on year (2003: –1.1%).

In 2004, the HICP still amounted to 7.4% compared to 8.5% in 2003. However, since mid-2004, the inflation rate has been declining continuously. The rate of price increase in 2004 was mainly supported by changes in administered prices and indirect taxes. These inflation drivers were much less important in 2005, leading to a pronounced slowdown in inflation in the first quarter of 2005. In addition, nominal effective exchange rate developments underpinned the moderation of inflation in 2004 and early 2005. In April 2005, the HICP inflation rate stood at 2.5% year on year. The inflation target measured by Národná banka Slovenska's HICP has been set to 3.5% ±0.5 percentage point at the end of 2005 and to below 2.5% at the end of 2006.

Table 23

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	–2.0	8.3	7.6	6.7	5.5	4.3	1.2
Labor productivity of industry (real)	1.0	11.8	6.6	6.5	4.9	3.9	–1.0
Gross average wage of industry (nominal)	7.9	9.1	10.2	7.3	7.3	10.1	9.3
Unit labor cost of industry (nominal)	6.8	–2.4	3.4	0.7	2.3	6.0	10.4
Producer price index (PPI) of industry	3.9	10.8	6.5	2.0	8.3	3.4	4.5
Consumer price index (here: HICP)	10.4	12.2	7.2	3.5	8.5	7.4	6.0
Exchange rate (nominal):							
SKK[1)] per 1 EUR. + = EUR appreciation	11.7	–3.4	1.6	–1.4	–2.8	–3.5	–4.2
EUR per 1 SKK. + = SKK appreciation	–10.5	3.6	–1.6	1.4	2.9	3.6	4.4
	Period-average levels						
Unemployment rate (ILO definition. %)	16.4	18.8	19.3	18.7	17.6	18.3	17.3
Key interest rate per annum (%)	. .	. .	8.8	7.9	6.4	4.9	4.3
Exchange rate (nominal):							
SKK[1] per 1 EUR	44.12	42.60	43.30	42.68	41.49	40.03	39.45
EUR per 1 SKK	0.0227	0.0235	0.0231	0.0234	0.0241	0.0250	0.0253

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1] SKK: Slovak koruna.

In the light of the ongoing disinflation process, Národná banka Slovenska (NBS) continued to cut its key interest rate (two-week repo tender limit rate), with reductions totaling 2 percentage points in 2004, by another 100 basis

Table 24

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	8.1	14.1	12.7	8.7	5.5	4.0	4.7
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	–4.9	6.6	2.7	13.5	7.7	–2.6	–3.9
Domestic credit (net) of the banking system	13.6	3.7	12.2	0.4	–1.9	10.2	9.9
of which: claims on the private sector	4.9	2.2	–13.9	–1.0	4.9	4.0	3.5
claims on households	1.7	2.0	1.2	1.4	2.2	4.0	4.3
claims on enterprises	3.2	0.2	–15.1	–2.3	2.7	0.0	–0.8
net claims on the public sector	8.7	1.5	26.1	1.4	–6.7	6.1	6.5
Other domestic assets (net) of the banking system	–0.5	3.8	–2.2	–5.2	–0.4	–3.6	–1.3

Source: National central bank, OeNB.
Note: Data after deduction of bad claims written off during bank consolidation.

points to 3% in March 2005. The interest rate decreases were also strongly motivated by the appreciation of the Slovak koruna. The currency appreciated sharply in 2004 and in early 2005, reaching 37.56 SKK/EUR at the beginning of March. The NBS also intervened relatively heavily on the domestic foreign exchange market to stem the appreciation pressure. In March 2005, however, the koruna started to depreciate, bottoming out at 39.84 SKK/EUR at the end of April. The currency resumed its upward trend against the euro and traded close to 39.00 SKK/EUR in mid-May. The appreciation of the Slovak koruna is largely supported by high economic growth, considerable reform progress and by the ongoing strong inflow of FDI, but also by short-term capital inflows.

One year after the implementation of a fundamental tax reform (which comprised the introduction of a 19% flat tax rate on both personal and corporate income as well as the unification of the VAT at 19%) and a simultaneous reform of the system of social benefits, the 2004 budget deficit amounted to 3.3% of GDP compared to an expected deficit of 3.8% (December 2004 convergence program). The better-than-expected outcome is largely the result of spending deferrals e.g. for co-funded EU projects and lower social security expenditures.

At the beginning of 2005, further reforms of the social system entered into force. In particular, the pay-as-you-go pension system was transformed into a multipillar system that includes a compulsory funded pillar. Moreover, in the health sector, a comprehensive system of copayments was introduced. In its spring forecast, the European Commission expects a budget deficit of 3.8% of GDP for 2005 and of 4.0% for 2006. In July 2004, the Ecofin Council decided that an excessive deficit existed and recommended that Slovakia correct the deficit by 2007. In its statement of February 17, 2005, on the updated convergence program (December 2004), the Ecofin Council assessed the program as sufficient to reduce the deficit to 3% by 2007. However, the program does not allow for any safety margins. Government debt is expected to increase from 43.6% of GDP in 2004 to 44.2% in 2005 and to 44.9% in 2006. Debt is negatively affected by the decision of an international arbitration court in Washington D.C. in December 2004 which ruled that Slovakia has to take on and honor the guarantees for the bad loans of the former Czechoslovak bank CSOR on the order of SKK 25 billion (more than EUR 600 million, or nearly 2.0% of Slovak GDP). This obligation originates from the process of property division of the former Czechoslovak Federal Republic.

Table 25

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	49.8	47.6	45.5	45.2	35.4	35.1	36.1
Expenditures	56.9	59.9	51.5	50.9	39.2	38.5	39.9
of which: interest payments	3.4	4.1	4.0	3.6	2.5	2.2	2.4
Balance	–7.1	–12.3	–6.0	–5.7	–3.7	–3.3	–3.8
Primary balance	–3.8	–8.2	–2.0	–2.1	–1.2	–1.1	–1.4
Gross public debt	47.2	49.9	48.7	43.3	42.6	43.6	44.2

Source: European Commission.

The 2004 revival of domestic demand went hand in hand with a widening of the trade and current account deficits. The trade deficit enlarged from 2.0% to 3.6% of GDP, and the current account deficit climbed from 0.8% to 3.6%. The deficit on the income account deteriorated substantially, as high FDI inflows in recent years have led to rising dividend repatriation. The capital account turned from a slight surplus (0.3% of GDP) to being balanced in 2004. In 2004, FDI inflows covered around 86% of the current account deficit.

Table 26

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	9,607	12,866	14,119	15,281	19,370	22,370	13,987	16,413
Merchandise exports: year-on-year change in %	*0.5*	*33.9*	*9.7*	*8.2*	*26.8*	*15.5*	*25.9*	*17.3*
Merchandise imports	10,633	13,838	16,494	17,539	19,935	23,553	14,343	17,106
Merchandise imports: year-on-year change in %	*–8.8*	*30.1*	*19.2*	*6.3*	*13.7*	*18.1*	*14.6*	*19.3*
Trade balance	–1,027	–971	–2,376	–2,259	–566	–1,183	–356	–693
% of GDP	*–5.4*	*–4.4*	*–10.2*	*–8.8*	*–2.0*	*–3.6*	*–1.7*	*–2.9*
Services balance	208	476	536	483	210	230	127	149
Income balance (factor services balance)	–281	–382	–350	–485	–107	–329	–120	–352
Current transfers	184	128	237	206	217	105	172	92
Current account balance	–916	–750	–1.953	–2.054	–245	–1.177	–177	–803
% of GDP	*–4.8*	*–3.4*	*–8.4*	*–8.0*	*–0.8*	*–3.6*	*–0.8*	*–3.3*
Capital account balance	148.9	99.5	87.1	113.9	89.4	15.6	63.9	–37.9
% of GDP	*0.8*	*0.5*	*0.4*	*0.4*	*0.3*	*0.0*	*0.3*	*–0.2*
Direct investment flows (net)	737	2.048	1.726	4.291	619	1.016	427	851
% of GDP	*3.9*	*9.3*	*7.4*	*16.7*	*2.1*	*3.1*	*2.0*	*3.5*

Source: Eurostat, national central bank, OeNB.

The country's gross foreign debt increased from 49.5% of GDP at the end of 2003 to 52.5% at the end of 2004.

Table 27

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	3,781	4,526	5,075	8,497	9,338	10,605
Gross external debt	. .	. .	. .	12,576	14,323	17,396
	% of GDP[1]					
Gross official reserves (excluding gold)	19.8	20.6	21.8	33.0	32.2	32.0
Gross external debt	. .	. .	. .	48.9	49.5	52.5
	Import months of goods and services					
Gross official reserves (excluding gold)	3.7	3.4	3.2	5.1	4.9	4.8

Source: Eurostat, national central bank, OeNB, wiiw.

[1] Q1 2004: As a percentage of rolling four-quarter GDP.

6 Slovenia: Smooth Participation in ERM II

GDP growth in Slovenia accelerated sharply to 4.6% year on year in 2004, from 2.5% in 2003. Output growth was particularly strong around mid-year, while it eased to 4.3% in the last quarter of 2004. Signs of an economic slowdown could be observed at the beginning of 2005, when industrial output growth plunged to 0.5% year on year in February from 5.0% in 2003. Domestic consumption growth accelerated from 2.7% in 2003 to 3.0% in 2004, with private consumption growth quickening from 2.7% to 3.5% and public consumption slowing from 2.6% to 1.7%. Private consumption was supported primarily by an increase in real disposable income (including funds disbursed from the first national housing savings scheme) and went hand in hand with powerful credit growth. Investment growth accelerated to 6.8% (from 6.3% in 2003) in a full-year comparison, but its dynamics moderated in the course of the year, so that growth came to 5.7% in the fourth quarter. The contribution of net exports to the overall GDP growth rate also improved from a negative contribution of 2.4 percentage points in 2003 to –0.3 percentage point in 2004. Both export and import growth rates accelerated sharply to around 12% to 13% year on year, with export growth surpassing import growth in the second half of the year. In its 2005 spring forecast, the European Commission expects GDP growth to slow to 3.7% in 2005, followed by a pickup to 4.0% in 2006. The slowdown in 2005 is expected to stem primarily from the weaker performance of net exports and unchanged inventories (inventories had contributed 0.8 percentage point in 2004). Consumption and investment are expected to stay robust in 2005 and 2006.

Table 28

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	5.6	3.9	2.7	3.3	2.5	4.6	4.3
Private consumption	5.9	0.4	2.3	0.3	2.7	3.5	3.2
Public consumption	2.9	2.3	3.9	1.7	2.6	1.7	2.6
Gross fixed capital formation	21.0	0.6	4.1	3.1	6.3	6.8	5.7
Exports of goods and services	1.6	13.0	6.3	6.7	3.2	12.6	13.3
Imports of goods and services	8.0	7.6	3.0	4.9	6.8	12.4	11.6
	Contribution to GDP growth in percentage points						
Domestic demand	9.4	1.5	0.9	2.3	4.9	4.9	3.8
Exports	0.9	7.1	3.7	4.1	2.0	8.0	8.5
Net exports	–3.9	2.4	1.8	1.0	–2.4	–0.3	0.5

Source: Eurostat, national statistical office, OeNB.

Strengthened economic activity in 2004 was also reflected in a decline in the unemployment rate from 6.8% in 2003 (average) to 6.5% in 2004. At the same time, employment grew by 4.4% year on year, leading to an increase in the employment rate (based on the population aged between 15 and 64 years) from 62.6% in 2003 to 65.3% in 2004. Despite tightening labor market conditions, nominal wage growth decelerated almost in parallel to the decline in inflation: real net wages in the whole economy grew by 2.0% year on year in 2004, only modestly more strongly than in 2003 (1.7%). Such wage developments have been facilitated by further progress with the deindexation of wage settlements and restraint in public sector wage growth.

Inflation (as measured by the HICP) fluctuated between 3.3% and 4.0% during 2004, showing a mildly and unevenly decelerating general trend over the year. Inflation developments remained volatile during the first quarter of 2005, with the HICP plunging to 2.3% year on year in January, the lowest level since the beginning of transition, but climbing back to 3.3% by March. Disinflation has been supported by a stable exchange rate to the euro, a deceleration of unit labor cost growth (from 4.8% year on year in 2003 to 2.2% in 2004) and favorable food price developments. Banka Slovenije attributes the most recent increase in inflation to seasonal factors and expects inflation to fall to 2.4% in the last quarter of 2005. According to Banka Slovenije's projections, however, inflation should pick up modestly to 2.6% by end-2006 and to 2.8% by end-2007, mainly because the negative output gap is set to close and then become positive.

Table 29

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	–0.5	6.3	3.1	2.5	1.4	5.0	2.4
Labor productivity of industry (real)	0.9	6.8	2.3	1.4	3.0	6.1	3.3
Gross average wage of industry (nominal)	9.3	11.7	10.8	9.9	7.6	7.1	6.8
Unit labor cost of industry (nominal)	8.3	4.6	8.4	8.3	4.4	1.0	3.3
Producer price index (PPI) of industry	2.2	7.7	8.9	5.3	2.6	4.4	5.2
Consumer price index (here: HICP)	6.1	8.9	8.6	7.5	5.7	3.6	3.5
Exchange rate (nominal):	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SIT[1] per 1 EUR. + = EUR appreciation	4.6	6.3	5.5	3.6	3.5	2.2	1.6
EUR per 1 SIT. + = SIT appreciation	–4.4	–5.9	–5.2	–3.5	–3.4	–2.2	–1.5
	Period-average levels						
Unemployment rate (ILO definition. %)	7.6	6.9	6.3	6.5	6.8	6.5	6.6
Key interest rate per annum (%)	7.2	8.1	10.5	8.4	7.0	4.6	4.0
Exchange rate (nominal):							
SIT[1] per 1 EUR	194.43	206.63	217.98	225.93	233.82	239.07	239.83
EUR per 1 SIT	0.00514	0.00484	0.00459	0.00443	0.00428	0.00418	0.00417

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1] SIT: Slovenian tolar.

Since Slovenia entered ERM II on June 28, 2004, the exchange rate of the tolar against the euro has fluctuated in a very narrow range of between 0.02% on the strong side and 0.17% on the weak side of the central rate of the euro. Toward the end of 2004 and in early 2005 the exchange rate followed a modestly appreciating trend. Following the increase in the interest rate that Banka Slovenije charges on buy/sell foreign exchange swap operations (through which it temporarily alters tolar liquidity) and in the main refinancing rate (which is linked to the former) by 25 basis points in December 2004, the bank raised this rate by another 25 basis points on April 8, 2005. The interest rate on tolar-denominated Banka Slovenije bills, which are relevant for the money market, have remained unchanged, as have money market rates, which hovered at around 4% at the end of April 2005. Despite a modest increase in backwardlooking real interest rates (i.e. nominal interest rates deflated by the contemporaneous CPI) since mid-2004, credit growth to the private sector has intensified and stood at slightly above 20% in February 2005.

Table 30

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	. .	13.7	19.2	22.8	12.7	5.1	4.4
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	. .	3.1	9.1	11.0	3.3	–8.1	–10.1
Domestic credit (net) of the banking system	. .	15.1	14.4	12.2	8.1	14.0	15.1
of which: claims on the private sector	. .	15.1	12.6	9.1	8.0	11.5	12.4
claims on households	. .	4.4	2.0	1.6	1.5	2.7	3.5
claims on enterprises	. .	10.7	10.6	7.5	6.5	8.8	8.9
net claims on the public sector	. .	0.0	1.7	3.2	0.1	2.4	2.6
Other domestic assets (net) of the banking system	. .	–4.4	–4.2	–0.4	1.3	–0.8	–0.6

Source: National central bank, OeNB.

Slovenia posted a general government budget deficit of 1.9% of GDP in 2004, slightly below the 2003 deficit and in line with the target of the May 2004 convergence program. The updated convergence program of January 2005 targeted a budget deficit of 2.1% of GDP in 2005, unchanged from the then expected 2004 level. Nevertheless, along with the March 2005 fiscal notification, the government revised the 2005 deficit target to 1.9% of GDP. In its opinion on the updated convergence program, the Ecofin Council stated in March that the government has to undertake measures, specifically with regard to the pension and health care system, to improve the long-term sustainability of public finances. Government debt stood at 29.4% of GDP at end-2004, well below the Maastricht reference value. Euro adoption at the beginning of 2007 has remained the key economic policy goal of the new center-right government which came to power in late 2004. In addition, with effect from the beginning of 2005, the government has modified the personal and corporate income tax system. The changes to the personal income tax system were aimed at reducing the burden for lower-income taxpayers and equalizing the tax burden across different sources of income. The changes in corporate income tax were aimed at broadening the tax base and making tax incentives better tar-

Table 31

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	. .	44.7	45.1	45.7	46.2	45.8	45.5
Expenditures	. .	48.2	47.9	48.1	48.2	47.7	47.6
of which: interest payments	. .	2.4	2.4	2.3	2.1	1.9	1.7
Balance	. .	–3.5	–2.8	–2.4	–2.0	–1.9	–2.2
Primary balance	. .	–1.0	–0.4	0.0	0.1	0.0	–0.5
Gross public debt	24.9	27.4	28.1	29.5	29.4	29.4	30.2

Source: European Commission.

geted. Currently, the government is considering the introduction of a flat tax (for personal and corporate income tax and VAT), which has been proposed by the Strategic Council for Economic Development, its advisory body.

Slovenia registered a current account deficit of 0.9% of GDP in 2004, up from 0.4% in 2003. The increase stemmed from the balance of goods and services turning into a small deficit, while changes in the income and transfer balance canceled each other out. The deficit on the capital account remained unchanged from 2003 at 0.7% of GDP. Net FDI inflows were insignificant (0.1% of GDP). Given relatively sizeable net portfolio capital outflows, other investment inflows were insufficient to fully cover the external financing requirement, and thus foreign exchange reserves declined by around 1% of GDP. Nevertheless, the level of central bank foreign exchange reserves at the end of 2004 was sufficient, covering around five months of imports of goods and services.

Table 32

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	8,103	9,574	10,454	11,082	11,414	12,736	8,463	9,374
Merchandise exports: year-on-year change in %	*0.2*	*18.2*	*9.2*	*6.0*	*3.0*	*11.6*	*2.3*	*10.8*
Merchandise imports	9,267	10,801	11,139	11,351	11,960	13,576	8,799	9,934
Merchandise imports: year-on-year change in %	*5.4*	*16.6*	*3.1*	*1.9*	*5.4*	*13.5*	*5.2*	*12.9*
Trade balance	–1,164	–1,227	–684	–269	–546	–840	–337	–559
% of GDP	*–5.8*	*–6.0*	*–3.1*	*–1.1*	*–2.2*	*–3.2*	*–1.8*	*–2.9*
Services balance	330	489	536	617	538	672	414	503
Income balance (factor services balance)	58	29	43	–154	–178	–101	–141	–95
Current transfers	112	126	144	142	94	31	60	9
Current account balance	–664	–583	38	335	–91	–239	–3	–143
% of GDP	*–3.3*	*–2.8*	*0.2*	*1.4*	*–0.4*	*–0.9*	*0.0*	*–0.7*
Capital account balance	–0.7	4.0	–4.0	–163.6	–165.5	–178.3	–83.4	–101.5
% of GDP	*0.0*	*0.0*	*0.0*	*–0.7*	*–0.7*	*–0.7*	*–0.5*	*–0.5*
Direct investment flows (net)	55	77	251	1.582	–115	21	–113	–88
% of GDP	*0.3*	*0.4*	*1.2*	*6.7*	*–0.5*	*0.1*	*–0.6*	*–0.5*

Source: Eurostat, national central bank, OeNB.

Table 33

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	3,159	3,436	4,908	6,702	6,798	6,464
Gross external debt	8,012	9,491	10,403	11,483	13,305	15,397
	% of GDP[1]					
Gross official reserves (excluding gold)	15.9	16.7	22.5	28.5	27.7	25.0
Gross external debt	40.2	46.1	47.6	48.8	54.1	59.5
	Import months of goods and services					
Gross official reserves (excluding gold)	3.5	3.3	4.6	6.1	5.9	4.9

Source: Eurostat, national central bank, OeNB, wiiw.
[1] Q1 2004: As a percentage of rolling four-quarter GDP.

Slovenia's gross external debt continued to rise in 2004 and reached 59.5% of GDP in December 2004 (up from 54.1% at end-2003).

7 Bulgaria: Strong Export Performance, Better Growth Structure

Real GDP grew by 5.6% in Bulgaria in 2004 (2003: 4.5%), rising from 4.5% in the first quarter to 6.2% in the fourth quarter. The structure of growth became somewhat less imbalanced, as the contribution of domestic demand to GDP growth declined to 9.5 percentage points (2003: 12.1 percentage points) despite continuing high credit growth. Domestic consumption growth moderated to 5.0% in 2004 (2003: 6.6%), mainly due to the stagnation of real (CPI-deflated) wages. However, it accelerated again in the fourth quarter, reaching 6.5% year on year. Gross fixed capital formation growth remained buoyant at 12.0% in 2004 (2003: 13.9%), slowing to 9.9% year on year in the fourth quarter. Thus, real annual import growth also remained high at 14.1% in 2004 (2003: 15.3%) and even accelerated to 16.9% year on year in the fourth quarter of 2004. As real annual export growth augmented continuously throughout the year to an average of 13.2% in 2004 (2003: 7.9%), the deterioration in net exports was less marked than in 2003, resulting in a negative contribution to GDP growth of 3.9 percentage points (2003: 7.6 percentage points).

Table 34

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	2.4	5.4	4.1	4.9	4.5	5.6	6.2
Private consumption	9.6	4.3	5.2	3.5	6.3	5.4	6.8
Public consumption	6.3	18.8	0.3	4.4	8.1	2.8	5.6
Gross fixed capital formation	18.2	25.5	22.6	8.2	13.9	12.0	9.9
Exports of goods and services	–4.6	16.6	9.9	7.2	7.9	13.2	19.8
Imports of goods and services	9.3	18.7	14.8	4.9	15.3	14.1	16.9
	Contribution to GDP growth in percentage points						
Domestic demand	11.0	8.7	9.2	4.3	12.1	9.5	10.0
Exports	–2.7	9.3	6.1	4.7	5.3	9.2	11.7
Net exports	–8.6	–3.3	–5.1	0.6	–7.6	–3.9	–3.8

Source: Eurostat, OeNB, wiiw.

Accelerating and high GDP growth improved the labor market in 2004. As the year-average participation rate picked up to 61.8% in 2004 (2003: 60.9%) and the year-average unemployment rate (ILO definition) fell to 12.2% in 2004 (2003: 13.9%),[4] total employment grew by 3.3%, which lifted the employment rate to 54.2% in 2004 (2003: 52.5%), still among the lowest rates in Europe. In parallel to the total economy, year-average employment in industry increased in 2004, enlarging at a rate of 2.4%. Combined with very high industrial output growth in 2004, labor productivity advances accelerated and remained far above nominal wage growth. Thus, in 2004, year-average nominal unit-labor costs in industry diminished by 7.9%, while producer prices advanced by 5.9%. Year-average inflation (HICP) accelerated to 6.1% in 2004 (2003: 2.3%). After infla-

[4] *Registered unemployment decreased to 13% in the first quarter of 2005, against 14.1% a year earlier.*

tion had declined from a peak of 7.6% year on year in July 2004 to a low of 3.3% in January 2005, it rose again to reach 5.1% year on year in April 2005 primarily as a result of higher food and fuel prices.

Table 35

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	–9.6	5.3	2.5	4.7	14.1	17.7	19.4
Labor productivity of industry (real)	1.2	10.0	7.6	2.2	10.9	15.0	16.1
Gross average wage of industry (nominal)	8.0	6.6	7.4	3.7	4.5	5.9	5.5
Unit labor cost of industry (nominal)	6.7	–3.1	–0.2	1.4	–5.7	–7.9	–9.1
Producer price index (PPI) of industry	3.2	17.0	3.8	1.4	5.0	5.9	6.9
Consumer price index (here: HICP)	2.6	10.3	7.4	5.8	2.3	6.1	4.7
Exchange rate (nominal):							
BGN[1] per 1 EUR. + = EUR appreciation	–0.7	–0.2	–0.2	0.1	0.0	0.2	0.3
EUR per 1 BGN. + = BGN appreciation	0.7	0.2	0.2	–0.1	0.0	–0.2	–0.3
	Period-average levels						
Unemployment rate (ILO definition. %)	. .	17.0	20.5	18.3	13.9	12.2	12.0
Key interest rate per annum (%)	4.7	3.9	4.5	4.0	2.7	2.6	2.4
Exchange rate (nominal):							
BGN[1] per 1 EUR	1.956	1.952	1.948	1.949	1.949	1.953	1.956
EUR per 1 BGN	0.5113	0.5123	0.5133	0.5130	0.5131	0.5120	0.5113

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1] *BGN: Bulgarian lev.*

Broad money increased by 22.3% on average in 2004 (2003: 16.3%), primarily boosted by very robust credit growth to households and companies, while the increase of net foreign assets played a minor role and net credit to government decreased. The growth of credit to the corporate sector continued nearly unabated at a rate of 40.6% on average in 2004 (2003: 42.7%), and the growth of credit to households accelerated to 78.5% (2003: 65.9%). In the first quarter of 2005, average corporate sector credit growth and average household credit growth amounted to 43.6% and 76.1% year on year, respectively. Thus, at the end of 2004 the growth of credit to nongovernment nonbanks also exceeded the year-end target growth rate of 30% to 35% year on year that had been envisaged in the precautionary 25-month Stand-By Arrangement with the

Table 36

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	7.9	27.4	27.8	18.3	16.3	22.3	20.6
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	–0.2	26.1	13.5	7.7	5.4	4.4	6.2
Domestic credit (net) of the banking system	2.0	6.8	15.0	12.1	14.5	21.8	19.8
of which: claims on the private sector	9.5	8.7	8.1	13.6	19.9	26.3	27.2
claims on households	2.6	1.1	2.4	3.3	5.9	10.0	11.1
claims on enterprises	6.9	7.7	5.7	10.3	14.0	16.3	16.1
net claims on the public sector	–7.4	–2.0	6.9	–1.5	–5.4	–4.5	–7.4
Other domestic assets (net) of the banking system	6.0	–5.5	–0.7	–1.5	–3.6	–3.8	–5.5

Source: National central bank, OeNB.

IMF (approved by the IMF Executive Board in August 2004), although the Bulgarian National Bank (BNB) had taken measures to tighten domestic liquidity conditions in the course of 2004.[5] Since the risk associated with rapid credit growth was again a priority topic in the context of the first review of the Stand-By Arrangement in March 2005, the BNB adopted a new package of measures aiming to cut the growth of credit to nongovernment nonbanks from 48% year on year at the end of 2004 to 25% to 30% year on year at the end of 2005. In particular, any bank whose credit growth exceeds 6%, 12%, 18% or 24% in the 3-, 6-, 12- or 24-month period, respectively, starting on April 1, 2005, will be subject to a specific set of restrictions.

The consolidated fiscal balance amounted to a surplus of 1.7% of GDP in 2004 (2003: 0.0%), overperforming with respect to both the initial 0.7% deficit target envisaged in the Pre-Accession Economic Programme (PEP) 2003 to 2006 in August 2003 and the 1% of GDP surplus target agreed with the IMF in November 2004. Stronger-than-expected economic growth, improved tax collection and reduced interest expenditure (related to the buy-back of public external debt) even left room for the government to undertake extra spending, mainly on education, health care and infrastructure projects. Overall, the consolidated budget revenue-to-GDP ratio increased from 40.7% to 41.7%, while the expenditure-to-GDP ratio decreased slightly from 40.7% to 40.0%. In mid-March 2005, the government agreed on a further tightening of the fiscal target for 2005 from a deficit of 0.5% of GDP envisaged in the PEP for 2004 to 2007 in November 2004 to a fiscal surplus of 1% of GDP, responding to the IMF's insistence during the first review of the Stand-By Arrangement that tight fiscal policy must play an active role in controlling domestic demand pressures. This change in the target was designed to compensate in particular for the 25% increase in minimum wages in January 2005, which was implemented against IMF advice.

Table 37

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	56.6	58.2	53.5	. .	. .	. .	. .
Expenditures	56.2	58.7	52.3	. .	. .	. .	. .
of which: interest payments	3.8	4.0	3.7	. .	. .	. .	. .
Balance	0.4	–0.5	1.2	–0.1	0.6	1.4	–0.5
Primary balance	4.1	3.6	4.9	2.1	2.7	3.2	1.4
Gross public debt	79.3	73.6	66.2	54.0	46.3	38.8	32.5

Source: European Commission.

In 2004, export growth according to the balance of payments accelerated more strongly than import growth, which was driven by high, albeit moderating domestic demand growth. Exports mounted by 19.9% (2003: 10.0%), imports by 20.8% (2003: 14.4%). Thus, the trade deficit continued to deteriorate, albeit at a slower pace, reaching 14% of GDP (2003: 12.4% of GDP). At the

[5] *For more detailed information on measures taken by the BNB to reduce credit growth, please see Focus on European Economic Integration 2/2004.*

same time, the current account deficit decreased to 7.4% of GDP (2003: 9.2% of GDP) due to higher surpluses in the services account (in particular thanks to tourism) and in the transfer account and owing to a lower deficit in the income account as a result of a buy-back of public external debt. Net FDI inflows in 2004 remained solid, but decreased to 8.4% of GDP (2003: 10.3% of GDP), which implied a coverage ratio of slightly more than 110% of the current account deficit, similar to that in 2003.

Table 38

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	3,734	5,253	5,714	6,063	6,668	7,994	5,004	5,807
Merchandise exports: year-on-year change in %	*–0.3*	*40.7*	*8.8*	*6.1*	*10.0*	*19.9*	*10.9*	*16.0*
Merchandise imports	4,742	6,533	7,493	7,755	8,868	10,712	6,398	7,567
Merchandise imports: year-on-year change in %	*16.3*	*37.8*	*14.7*	*3.5*	*14.4*	*20.8*	*16.6*	*18.3*
Trade balance	–1,008	–1,280	–1,779	–1,692	–2,200	–2,718	–1,394	–1,760
% of GDP	*–8.3*	*–9.3*	*–11.7*	*–10.2*	*–12.4*	*–14.0*	*–10.9*	*–12.5*
Services balance	305	547	454	486	523	723	616	831
Income balance (factor services balance)	–167	–345	–340	–285	–567	–341	–528	–287
Current transfers	282	316	562	566	613	888	451	655
Current account balance	–587	–762	–1,102	–926	–1,631	–1,447	–855	–560
% of GDP	*–4.8*	*–5.6*	*–7.2*	*–5.6*	*–9.2*	*–7.4*	*–6.7*	*–4.0*
Capital account balance	–2.3	25.4	0.0	0.0	–0.2	0.0	–0.2	0.0
% of GDP	*0.0*	*0.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Direct investment flows (net)	850	1,100	893	951	1,827	1,640	1,324	416
% of GDP	*7.0*	*8.0*	*5.9*	*5.7*	*10.3*	*8.4*	*10.3*	*3.0*

Source: Eurostat, national central bank, OeNB.

At the end of 2004, Bulgaria's gross external debt amounted to 59.3% of GDP compared to 61.4% at the end of 2003. A breakdown shows that public external debt declined to 27% of GDP from 37.9% of GDP at the end of 2003 while private external debt rose significantly, reflecting both the corporate sector's access to financing from sources other than domestic banks and the banking sector's foreign funding of domestic credit growth. In parallel, in the course of 2004, gross official foreign exchange reserves

Table 39

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	2,879	3,391	3,734	4,247	4,981	6,445
Gross external debt	10,847	11,997	12,129	10,785	10,876	11,542
	% of GDP [1]					
Gross official reserves (excluding gold)	23.7	24.7	24.5	25.6	28.1	33.1
Gross external debt	90.9	87.5	79.5	65.0	61.4	59.3
	Import months of goods and services					
Gross official reserves (excluding gold)	5.6	4.9	4.8	5.2	5.4	5.8

Source: Eurostat, national central bank, OeNB, wiiw.
[1] Q1 2004: As a percentage of rolling four-quarter GDP.

increased from 28.1% of GDP to 33.1% of GDP, covering about 5.8 months of imports of goods and services.

8 Croatia: Toward a Stabilization of External Debt?

Croatian GDP growth decelerated slightly to 3.8% in 2004 (2003: 4.3%), with growth slowing from 4.2% year on year in the first quarter of 2004 to 3.6% in the last quarter. Domestic demand was the major contributor to GDP growth in the whole year, accounting for 3.3 percentage points. At the same time, net exports made a positive contribution to growth for the first time since 2000. Moreover, in the last quarter of 2004, the contribution of domestic demand to annual GDP growth declined to only 1.2 percentage points, while that of net exports expanded to 2.4 percentage points. This resulted from the sharp decrease of gross fixed capital formation growth from 8.9% year on year in the first quarter of 2004 to 0.9% in the fourth quarter, which led to stagnant growth of real imports in the fourth quarter, whereas real export growth remained stable above 5%.

Table 40

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q42004
	Real year-on-year change in %						
Gross domestic product	–0.9	2.9	4.4	5.2	4.3	3.8	3.6
Private consumption	–2.9	4.2	4.5	7.5	4.1	3.9	3.8
Public consumption	2.8	–1.5	–6.2	–1.8	–0.3	–0.3	–0.6
Gross fixed capital formation	–3.9	–3.8	7.1	12.0	16.8	4.4	0.9
Exports of goods and services	0.7	12.0	8.1	1.3	10.1	5.4	5.8
Imports of goods and services	–3.5	3.7	9.8	8.8	10.9	3.5	0.0
	Contribution to GDP growth in percentage points						
Domestic demand	–3.0	–0.3	5.8	9.4	5.8	3.3	1.2
Exports	0.3	5.1	3.7	0.6	4.6	2.6	2.4
Net exports	2.1	3.2	–1.4	–4.2	–1.5	0.5	2.4

Source: National statistical office, OeNB.

The unemployment rate (ILO definition, based on the labor force survey) decreased to 18.2% on average in 2004 (2003: 19.5%), reflecting the decline in the total labor force, while total employment was stagnant. In the whole economy, average net wages rose by 5.9% (2003: 5.9%) in nominal terms and by 3.7% (2003: 4.1%) in real (CPI-deflated) terms. In industry, average gross wages grew by 5.6% in 2004 (2003: 5.4%). By contrast, productivity growth accelerated to 5.7% (2003: 3.5%) as a result of the 1.9% decline in industrial employment (2003: +0.6%), while industrial output growth weakened to 3.7% (2003: 4.1%). Thus, industrial unit labor costs were nearly unchanged in 2004 (–0.1) against a moderate increase in 2003 (1.8%).

Average annual inflation stood at 2.1% in 2004 (2003: 1.8%). However, headline inflation has accelerated recently, quickening to 3.9% year on year in March 2005, mainly because of rises in food and energy prices. Further upward pressure may come from the pending adjustment of regulated prices. The European Commission expects a moderate further increase in average annual inflation to 2.7% in 2005 and 2.8% in 2006 on the back of administrative price adjustments, higher indirect taxes and price dynamics in the services sector.

Table 41

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q42004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	–1.5	1.8	6.1	5.5	4.1	3.7	4.1
Labor productivity of industry (real)	1.6	4.4	7.8	7.8	3.5	5.7	6.3
Gross average wage of industry (nominal)	5.6	6.1	8.2	6.9	5.4	5.6	5.7
Unit labor cost of industry (nominal)	3.8	1.6	0.4	–0.8	1.8	–0.1	–0.6
Producer price index (PPI) of industry	2.5	9.5	3.4	–0.5	1.9	3.6	5.6
Consumer price index (CPI)[1]	4.3	6.4	5.0	1.7	1.8	2.1	2.3
Exchange rate (nominal):	0.0	0.0	0.0	0.0	0.0	0.0	0.0
HRK[2] per 1 EUR. + = EUR appreciation	6.4	0.9	–2.1	–1.0	2.1	–0.9	–1.0
EUR per 1 HRK. + = HRK appreciation	–6.0	–0.8	2.1	1.0	–2.1	0.9	1.0
	Period-average levels						
Unemployment rate (registered unemployed. %)	19.1	21.1	22.0	22.3	19.5	18.2	18.4
Key interest rate per annum (%)	7.5	6.5	5.9	5.6	4.5	4.5	4.5
Exchange rate (nominal):							
HRK[2] per 1 EUR	7.579	7.643	7.484	7.412	7.569	7.498	7.552
EUR per 1 HRK	0.1320	0.1308	0.1336	0.1349	0.1321	0.1334	0.1324

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.

[1] Retail price index until 2001, CPI since 2002.

[2] HRK: Croatian kuna.

The exchange rate regime in Croatia is a fairly tightly managed float regime, with the central bank intervening rather frequently. The Croatian kuna appreciated by 0.9% in nominal terms against the euro on average in 2004, after it had depreciated by 2.1% in 2003. Moderate appreciation pressure continued in the first months of 2005, which motivated the central bank to sell domestic currency against the euro. Broad money grew by 8.3% on average in 2004 (2003: 11.3%). While net foreign assets contracted to a lesser degree in 2004 (–1.8%) than in 2003 (–20.7), net credit to government declined by 5.5% in 2004, after it had risen by 14.9% in 2003. Moreover, the growth of credit to nongovernment nonbanks fell to 11.8% on average in 2004 (2003: 22.6%).

Due to the importance of foreign currencies in banks' assets and liabilities, interest rate management plays a rather subordinate role in the Croatian monetary policy framework. Instead, the central bank relies heavily on mandatory reserve regulations, foreign currency asset-liability ratios and other quantitative measures. In addition to a mandatory reserve ratio of 18%, Croatian banks have traditionally had to maintain a minimum coverage of their foreign currency liabilities by short-term foreign currency assets. This coverage ratio was lowered from 35% to 32% in February 2005 with the intention of improving banking sector liquidity to facilitate the domestic refinancing of government eurobonds maturing at the end of March 2005, given Croatia's commitment to the IMF to stabilize or reduce its foreign indebtedness. Furthermore, the central bank increased the so-called marginal reserve requirement ratio from 24% to 30% in February 2005 and further to 40% in May 2005. This reserve requirement ratio was introduced in July 2004 and requires banks to deposit (free of interest) a specified percent of the net increase in their foreign liabilities over the level registered in June 2004 with the central bank .

Table 42

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q42004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	2.6	14.0	30.9	32.4	11.3	8.3	8.8
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	–3.7	20.3	13.4	9.8	–7.7	–0.5	–0.3
Domestic credit (net) of the banking system	9.8	–1.2	21.1	23.2	19.5	9.4	10.5
of which: claims on the private sector	5.9	–2.0	17.0	21.5	17.7	10.1	10.7
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	3.9	0.9	4.1	1.7	1.8	–0.7	–0.3
Other domestic assets (net) of the banking system	–3.4	–5.1	–3.6	–0.5	–0.5	–0.7	–1.4

Source: National central bank, OeNB.

According to the European Commission's spring forecast, the general government posted a deficit of 5% of GDP in 2004, after the deficit had run to 6.3% of GDP in 2003. Apart from hikes of indirect tax rates, this improvement resulted to a significant extent from dividend payments by a partially state-owned company, i.e. a one-off revenue measure. Gross public debt increased to 53.8% of GDP at the end of 2004 from 51.6% at the end of 2003. The fiscal result for 2004 exceeds the 4.5% deficit target laid down in the Stand-By Arrangement with the IMF (approved by the IMF's Board of Governors in August 2004), which the authorities are treating as precautionary. Under the commitment of the Croatian government set out in the PEP for 2005 to 2007, the budget deficit of the general government is envisaged to decrease to 3.7% in 2005 and further to 3.2% in 2007. The PEP expects the continued adjustment to come primarily from measures on the expenditure side, with the expenditure-to-GDP ratio expected to sink from 52.7% in 2004 to 50.8% in 2005 and to 49.7% in 2007. These expenditure-based measures would comprise reforms in the health care system, a reduction in public employment and an enhanced financial discipline imposed on public enterprises, in particular a reduction of the sizeable direct state subsidies to state-owned shipyards. However, the 2005 spring forecast of the European Commission expects the deficit of the general government to come to 4.4% of GDP in 2005.

Table 43

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	. .	. .	. .	. .	. .	. .	. .
Expenditures	. .	. .	. .	. .	. .	. .	. .
of which: interest payments	. .	. .	. .	. .	2.0	2.0	2.2
Balance	. .	. .	. .	. .	–6.3	–5.0	–4.3
Primary balance	. .	. .	. .	. .	–4.4	–3.0	–2.1
Gross public debt	. .	. .	. .	. .	51.6	53.8	53.1

Source: European Commission.

Table 44

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	4,134	4,969	5,319	5,293	5,572	6,602	4,076	4,836
Merchandise exports: year-on-year change in %	*1.8*	*20.2*	*7.0*	*–0.5*	*5.3*	*18.5*	*4.1*	*18.7*
Merchandise imports	7,240	8,469	9,923	11,253	12,546	13,327	9,186	9,850
Merchandise imports: year-on-year change in %	*–5.5*	*17.0*	*17.2*	*13.4*	*11.5*	*6.2*	*10.8*	*7.2*
Trade balance	–3,106	–3,499	–4,604	–5,960	–6,974	–6,725	–5,110	–5,014
% of GDP	*–16.6*	*–17.5*	*–20.8*	*–24.6*	*–27.3*	*–24.3*	*–26.7*	*–24.2*
Services balance	1,545	2,470	3,303	3,285	5,047	4,906	4,656	4,525
Income balance (factor services balance)	–346	–420	–616	–574	–1.074	–618	–993	–554
Current transfers	594	959	1.099	1,152	1,245	1,160	949	880
Current account balance	–1,313	–490	–818	–2,097	–1,757	–1,277	–498	–162
% of GDP	*–7.0*	*–2.5*	*–3.7*	*–8.7*	*–6.9*	*–4.6*	*–2.6*	*–0.8*
Capital account balance	23.4	22.2	154.1	501.2	72.4	23.1	63.8	20.8
% of GDP	*0.1*	*0.1*	*0.7*	*2.1*	*0.3*	*0.1*	*0.3*	*0.1*
Direct investment flows (net)	1,315	1,141	1,327	597	1.695	667	977	568
% of GDP	*7.0*	*5.7*	*6.0*	*2.5*	*6.6*	*2.4*	*5.1*	*2.7*

Source: Eurostat, national central bank, OeNB.

The current account deficit fell to 4.6% of GDP in 2004 from 6.9% in 2003. This improvement can be traced to a lower deficit in the trade account, which amounted to 24.3% of GDP in 2004 against 27.3% of GDP in 2003, and a smaller deficit in the income account, while the surplus in the services account declined. The decrease in the trade deficit resulted from both accelerating export growth and decelerating import growth. On the other hand, net FDI inflows were markedly lower at only 2.4% of GDP in 2004 (2003: 6.6% of GDP) and thus covered only half of the current account deficit in 2004, unlike in 2003 when net FDI inflows provided for nearly full coverage. As a result, total gross foreign debt continued to rise to EUR 22 billion, which was equivalent to 82.0% of GDP at the end of 2004 (2003: 77.6%), and net foreign debt increased to 38.6% (2003: 28.6%). Public external debt declined to 26.2% of GDP from 27.3%. In fact, the level and dynamics of external debt remain the major weak spot of the Croatian economy. The authorities are aiming for a sta-

Table 45

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	3,013	3,783	5,334	5,651	6,554	6,436
Gross external debt	10,101	12,109	13,458	15,055	19,811	22,675
	% of GDP [1]					
Gross official reserves (excluding gold)	16.1	18.9	24.1	23.3	25.7	23.3
Gross external debt	54.1	60.6	60.7	62.2	77.6	82.0
	Import months of goods and services					
Gross official reserves (excluding gold)	3.9	4.3	5.3	4.9	5.2	4.8

Source: Eurostat, national central bank, OeNB, wiiw.

[1] *Q1 2004: As a percentage of rolling four-quarter GDP.*

bilization and subsequent gradual reduction of external debt, a policy objective that also represents the cornerstone of the Stand-By Arrangement with the IMF. As fiscal policy is considered to be the main policy tool to achieve this aim, uncertainties about the fiscal policy approach in recent months have led to the delay of the second review of the arrangement to June 2005, after the first review had taken place in December 2004.

9 Romania: Strong Domestic Demand Accompanied by a Widening of the Trade Deficit

Real GDP growth in Romania accelerated strongly to 8.7% year on year in 2004 compared to 5.2% in 2003. Economic growth increased from 6.2% in the first quarter to 10.0% in the third quarter and declined slightly to 9.7% in the last quarter of 2004. This strong economic performance was driven by domestic demand, with private consumption growth – largely bolstered by rapid real wage growth and strong credit expansion – coming to 11.5% (2003: 7.0%) and gross fixed capital formation climbing by 9.9%. Gross fixed capital formation boomed in the third quarter, surging by 17.3%, but growth fell back to 2.7% in the fourth quarter of 2004. Export and import growth peaked in the second quarter of 2004 at 24.6% and 25.9%, respectively, and decelerated in the third quarter and even more in the fourth quarter, slowing to 8.8% and 10%, respectively. The resulting deterioration in net exports implied a negative contribution to GDP growth of 5.8 percentage points, slightly higher than in the full year 2003.

Table 46

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	–1.1	2.0	5.7	5.2	5.2	8.7	9.7
Private consumption	–1.9	–0.7	7.4	5.1	7.0	11.5	12.8
Public consumption	. .	. .	0.8	5.7	4.3	3.4	3.6
Gross fixed capital formation	–5.5	5.6	6.5	7.7	9.1	9.9	2.7
Exports of goods and services	. .	21.3	11.6	17.4	11.5	14.1	8.8
Imports of goods and services	. .	25.5	18.3	12.2	16.2	17.9	10.0
	Contribution to GDP growth in percentage points						
Domestic demand	. .	. .	11.1	4.8	10.4	14.5	12.9
Exports	. .	. .	5.2	8.3	6.1	8.0	4.5
Net exports	. .	. .	–5.4	0.3	–5.2	–5.8	–3.2

Source: National statistical office, Eurostat, OeNB, wiiw.

The year-average unemployment rate (ILO definition) increased from 7.5% to 8.5%, and the employment rate (based on the population aged between 15 and 64 years) remained almost constant (2003: 57.6%, 2004: 57.7%). As in 2003, employment in industry (year-average) fell by around 1.6% while real industrial output increased more rapidly in 2004 (+5.4%; 8.0% in the fourth quarter) than in 2003 (+3.2%). The resulting increase in labor productivity of about 7%, however, lagged behind industrial wage growth. In the total economy, net wages deflated by the GDP deflator advanced by 6.1% in 2004 (2003: 5.0%). In industry, nominal wage growth accelerated to 23.0%, leading to a 14.8% rise in nominal industrial unit wage costs, which was, however, somewhat lower than the boost in industrial producer prices (19.1%). Producer price inflation remained nearly unchanged compared to 2003, while the year-average inflation rate came down from 15.3% in 2003 to 11.9% in 2004. In April 2005 inflation amounted to 10.0%, after having fallen to single digits in the preceding months for the first time since the beginning of transition (bottoming out at 8.7% in March 2005). The increase in inflation in April was largely caused by higher energy prices and higher taxes on tobacco and alcohol, which became effective on April 1, 2005.

Table 47

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	–7.9	6.2	8.3	4.4	3.2	5.4	8.0
Labor productivity of industry (real)	7.2	12.5	11.6	5.4	5.2	7.1	8.6
Gross average wage of industry (nominal)	44.0	41.7	51.1	23.6	19.5	23.0	22.1
Unit labor cost of industry (nominal)	34.3	25.9	35.4	17.2	13.6	14.8	12.4
Producer price index (PPI) of industry	41.6	53.8	38.7	23.2	19.6	19.1	18.0
Consumer price index (CPI)	45.8	45.7	34.5	22.5	15.3	11.9	10.0
Exchange rate (nominal):							
ROL[1] per 1 EUR. + = EUR appreciation	63.8	22.0	30.5	20.1	20.2	7.9	0.3
EUR per 1 ROL. + = ROL appreciation	–39.0	–18.1	–23.4	–16.8	–16.8	–7.3	–0.3
	Period-average levels						
Unemployment rate (ILO definition. %)	7.6	7.9	7.3	9.1	7.5	8.5	8.5
Key interest rate per annum (%)	35.0	35.0	35.0	29.6	18.8	20.3	18.5
Exchange rate (nominal):							
ROL[1] per 1 EUR	16,326.8	19,926.0	26,000.3	31,234.8	37,543.0	40,511.8	39,839.0
EUR per 100 ROL	0.00612	0.00502	0.00385	0.00320	0.00266	0.00247	0.00251

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1] ROL: Romanian leu.

Within the 12 months to May 2005, the Romanian monetary authorities reduced the key interest rate significantly step by step from 20.75% (June 2004) to 12.5% (with the latest cut in mid-April 2005). The policy measures were motivated by the continuous disinflation process but also by the need to contain the differential between domestic and international interest rates in the light of the ongoing capital account liberalization connected with the process of accession to the EU.[6] Despite declining growth rates, growth in domestic lending to the private sector remained very high in 2004, and annual growth in net foreign assets accelerated throughout the year, bringing annual money growth to more than 30% year on year. The disinflation process was supported by the currency appreciation. The Romanian leu appreciated by 6% to 7% from October 2004 to the end of 2004 to 39.390 LEU/EUR and continued to appreciate strongly in the first quarter of 2005 (end of the first quarter of 2005: 36.730 LEU/EUR), as the central bank abandoned the implicit crawling band in November 2004 and announced a more flexible exchange rate policy. The appreciation of the currency was accompanied by heavy interventions of the central bank in the foreign exchange market selling the domestic currency against the euro. The appreciation path slowed down in April to May 2005,

[6] *From mid-April 2005 onward, foreigners are allowed to make leu-denominated deposits and to repatriate gains.*

and the currency stood at 36.160 LEU/EUR at the end of May. Despite the recent inflation developments, Banca Naţională a României will stick to its inflation target of 7.0% for 2005; it announced that it would shift to an inflation targeting framework from July 1, 2005.

Table 48

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	52.0	40.4	42.5	40.9	31.2	31.5	35.9
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	10.8	38.4	44.9	31.8	15.5	12.9	17.6
Domestic credit (net) of the banking system	42.3	14.0	10.2	18.7	23.9	26.0	21.6
of which: claims on the private sector	24.3	3.6	18.3	24.1	28.2	32.2	28.2
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	17.9	10.3	–8.1	–5.3	–4.3	–6.2	–6.6
Other domestic assets (net) of the banking system	–1.0	–12.0	–12.6	–9.6	–8.3	–7.4	–3.4

Source: National central bank, OeNB.

The budget balance amounted to a deficit of 1.4% of GDP (2003: –2.0%), far below the deficit target of 3.3% envisaged in the PEP for 2003 to 2006 of August 2003 and largely in line with the deficit target of 1.3% published in the PEP for 2004 to 2007 in November 2004. The positive outcome is primarily the result of higher revenue collection due to better-than-expected economic growth.

At the end of last year, the new center-right coalition government formed in December 2004 introduced a uniform 16% flat rate for personal income (replacing the progressive rate that ranged from 18% to 40%) and corporate income (previously 25%). The sharp cut in direct tax rates will lead to revenue shortfalls. Therefore, the government introduced various measures (e.g. an increase of the dividend tax rate, a higher corporate tax rate for micro-enterprises, a higher tax rate on interest and capital income and higher taxes e.g. on alcohol and tobacco) to offset the loss of revenues. However, the budget deficit is expected to increase in the next years. In its 2005 spring forecast the European Commission assumes a higher deficit for 2005 and 2006 (2.4% and 2.6% respectively) than in its 2004 autumn forecast (2005: 1.7%, 2006: 2.2%).

Table 49

Government Budget

	1999	2000	2001	2002	2003	2004	2005f
	% of GDP						
General government							
Revenues	. .	. .	. .	. .	. .	. .	. .
Expenditures	. .	. .	. .	. .	. .	. .	. .
of which: interest payments	. .	. .	. .	2.2	1.6	1.3	1.5
Balance	. .	. .	–3.5	–2.0	–2.0	–1.4	–2.4
Primary balance	. .	. .	. .	0.2	–0.4	–0.2	–0.9
Gross public debt	. .	23.9	23.2	23.3	21.3	18.5	19.1

Source: European Commission.

In 2004, the current account deficit expanded to 7.5% against 5.7% a year earlier. This deterioration is attributable to a higher trade deficit (9.0% in 2004 compared to 7.9% in 2003) as a result of hefty demand for capital and consumer durables. The service balance turned from a surplus in 2003 into a deficit in 2004, and the shortfall on the income account doubled (in euro terms) during that period. The surplus on the capital account increased from 0.4% of GDP in 2003 to 0.9% of GDP in 2004. Net FDI inflows accelerated considerably from 3.2% of GDP in 2003 to 6.8% of GDP. Large FDI inflows are the result of the ongoing privatization process. An exceptionally large privatization project was finalized at the end of 2004 (acquisition of the majority stake of the Petrom oil company by the Austrian company OMV). Overall, net FDI inflows covered slightly more than 90% of the current account deficit (2003: 55%).

Table 50

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	7,984	11,279	12,719	14,644	15,614	18,935	11,574	13,966
Merchandise exports: year-on-year change in %	*7.7*	*41.3*	*12.8*	*15.1*	*6.6*	*21.3*	*7.7*	*20.7*
Merchandise imports	9,169	13,150	16,045	17,392	19,569	24,258	13,964	17,180
Merchandise imports: year-on-year change in %	*–5.9*	*43.4*	*22.0*	*8.4*	*12.5*	*24.0*	*10.8*	*23.0*
Trade balance	–1,185	–1,871	–3,326	–2,748	–3,955	–5,323	–2,390	–3,214
% of GDP	*–3.6*	*–4.7*	*–7.5*	*–5.7*	*–7.9*	*–9.0*	*–6.9*	*–8.1*
Services balance	–372	–260	–127	6	62	–213	40	–130
Income balance (factor services balance)	–388	–304	–316	–490	–623	–1,363	–506	–583
Current transfers	589	937	1,280	1,614	1,639	2,497	1,205	1,647
Current account balance	–1,356	–1,498	–2,489	–1,618	–2,877	–4,402	–1,651	–2,280
% of GDP	*–4.1*	*–3.8*	*–5.6*	*–3.4*	*–5.7*	*–7.5*	*–4.8*	*–5.8*
Capital account balance	41.0	38.0	106.0	97.0	188.0	505.0	172.0	191.0
% of GDP	*0.1*	*0.1*	*0.2*	*0.2*	*0.4*	*0.9*	*0.5*	*0.5*
Direct investment flows (net)	948	1,161	1,315	1,193	1,591	4,042	1,113	1,597
% of GDP	*2.9*	*2.9*	*3.0*	*2.5*	*3.2*	*6.8*	*3.2*	*4.0*

Source: National central bank, OeNB.

Table 51

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	1,520	2,655	4,445	5,877	6,374	10,712
Gross external debt (medium- and long-term)	8,757	11,113	13,507	14,691	15,683	17,547
	% of GDP[1]					
Gross official reserves (excluding gold)	4.6	6.7	10.0	12.3	12.7	18.2
Gross external debt (medium- and long-term)	26.6	27.9	30.4	30.6	31.2	29.7
	Import months of goods and services					
Gross official reserves (excluding gold)	1.7	2.1	2.9	3.6	3.4	4.7

Source: Eurostat, national central bank, OeNB, wiiw.
[1] *Q1 2004: As a percentage of rolling four-quarter GDP.*

The strong inflow of foreign capital increased gross official reserves from EUR 6.4 billion at the end of 2003 to EUR 10.7 billion at the end of 2004 and gross official reserves from 3.4 to 4.7 import months of goods and services. The ratio of medium- and long-term gross external debt to GDP decreased slightly to 29.7% in 2004 (2003: 31.2%).

10 Russia: Deteriorated Investment Climate and Competitiveness Problems Have Recently Dampened Growth

Russian GDP expanded 7.1% in real terms in 2004, which is only slightly less than in 2003 (7.3%). However, despite very high world market prices for, and ample revenues from, the country's main export commodities (oil, gas and metals), the economic expansion clearly slowed down in the fourth quarter of 2004 (6.7% year on year as against 7.7% in the fourth quarter of 2003) and further decelerated in the first quarter of 2005, when, according to preliminary estimates, GDP growth came to 4.9%. The slowdown in these two quarters was mainly reflected by industrial production, whose growth rate slackened to 3.9% in the first three months of 2005 (year on year), and by agriculture and construction performance.

Table 52

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 2004
	Real year-on-year change in %						
Gross domestic product	6.3	9.0	5.1	4.7	7.3	7.1	6.7
Private consumption	–2.9	6.0	9.3	8.3	7.4	11.0	12.0
Public consumption	3.1	4.8	–0.8	2.6	2.2	2.3	2.3
Gross fixed capital formation	6.3	31.1	10.3	2.8	12.8	10.8	9.5
Exports of goods and services	11.3	9.6	4.2	10.3	12.5	13.1	14.1
Imports of goods and services	–17.1	30.5	18.7	14.6	17.7	23.9	24.9
	Contribution to GDP growth in percentage points						
Domestic demand	–2.0	11.6	7.3	3.8	6.5	8.6	8.8
Exports	4.7	4.2	1.9	4.5	5.7	6.3	7.1
Net exports	9.1	–1.9	–2.6	0.5	0.5	–1.5	–2.1

Source: National statistical office, OeNB.

The slowdown was caused by weakening growth of gross fixed investment, which, although still fair at an estimated rate of 7.6% from January to March 2005, expanded only half as fast as in the same period of 2004. Another element was the contraction of still relatively large net exports caused by a strong acceleration of import volumes (in 2004), while export volumes grew at approximately the same pace in 2004 as in 2003. These developments may be linked to the deterioration of the investment climate triggered by the Yukos affair, the growing number of back tax claims and other recent regulatory interventions of the state bureaucracy. Lingering repercussions of the banking turbulences of the summer of 2004[7] may also have played a role. Furthermore, the competitiveness of Russian manufacturing goods is hampered by rising production costs, the continuing real appreciation of the ruble and capacity constraints.

[7] *For more detailed information on the banking turbulences, please see Focus on European Economic Integration 2/2004, p. 44.*

Table 53

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	11.6	12.0	4.9	3.7	7.0	7.4	7.2
Labor productivity of industry (real)	15.4	9.9	5.7	7.5	13.9	13.4	12.8
Gross average wage of industry (nominal)	46.7	42.1	52.0	27.2	25.4	. .	. .
Unit labor cost of industry (nominal)	27.1	29.3	43.8	18.3	10.1	. .	. .
Producer price index (PPI) of industry	59.1	46.5	19.1	11.7	15.6	24.0	28.7
Consumer price index (CPI)	85.7	20.8	21.6	16.0	13.6	11.0	11.6
Exchange rate (nominal):							
RUB[1] per 1 EUR. + = EUR appreciation	137.2	–0.8	0.4	13.5	16.5	3.7	5.8
EUR per 1 RUB. + = RUB appreciation	–57.8	0.8	–0.4	–11.9	–14.2	–3.5	–5.5
	Period-average levels						
Unemployment rate (ILO definition. %)	12.6	10.5	9.0	8.0	8.6	8.2	8.3
Key interest rate per annum (%)	57.2	33.1	25.0	22.7	17.3	13.5	13.0
Exchange rate (nominal):							
RUB[1] per 1 EUR	26.24	26.03	26.13	29.65	34.55	35.81	36.92
EUR per 1 RUB	0.0381	0.0384	0.0383	0.0337	0.0289	0.0279	0.0271

Source: Bloomberg, Datastream, national statistical office, national central bank, OeNB, wiiw.

[1] *RUB: Russian ruble.*

Robust retail sales and private consumption remained the pillar of GDP growth. Retail trade grew by 9.6% in the first quarter of 2005 (year on year); private consumption expanded by 11.0% in 2004, both boosted by surging real average wages (+10.8% in 2004). The unemployment rate (ILO definition) amounted to 8.3% in March 2005. While average inflation declined to 11.0% in 2004, monthly year-on-year inflation has been picking up again since mid-2004, reaching 13.4% in April 2005. Thus the Bank of Russia's (CBR's) goal of bringing end-year inflation down to 8.5% in 2005 appears unrealistic. The recent inflation pickup may be explained by the surge in industrial producer prices, strong wage and private consumption growth, and by periodic adjustments of administered prices. Moreover, broad money has been expanding at a high rate.

Table 54

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	63.6	60.0	44.2	31.2	39.2	35.5	32.6
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	7.5	58.5	44.3	19.8	21.3	22.4	29.4
Domestic credit (net) of the banking system	120.4	30.5	22.8	30.4	29.6	17.8	8.2
of which: claims on the private sector	43.5	36.7	35.2	28.9	29.5	30.9	29.2
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	76.9	–6.2	–12.4	1.5	0.2	–13.2	–21.0
Other domestic assets (net) of the banking system	–64.4	–29.1	–22.9	–19.1	–11.7	–4.6	–4.9

Source: National central bank, OeNB.

High money growth has been fueled by the lavish liquidity injected into the economy by continuing high current account surpluses and ongoing largely unsterilized CBR interventions to slow down the nominal appreciation of the ruble. As they have been accumulating unrelentedly, Russia's gross official reserves (including gold) reached a new record level of EUR 111 billion in early May 2005, which corresponds to more than a year of imports of goods and services. Only Japan, China, Taiwan, South Korea and Singapore possess larger forex reserves (in absolute terms). The effectiveness of the CBR's policy of curbing inflation is being persistently counteracted by the impacts of its policy of stemming the nominal appreciation of the Russian currency in order to stave off the Dutch disease. In real effective terms, the ruble rose 10% in the 12 months to March 2005.

Table 55

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
Federal government							
Revenues	12.5	15.4	17.8	20.4	19.6	20.4	17.8
Expenditures	13.8	13.2	14.8	18.5	17.8	16.1	16.3
of which: interest payments	3.4	2.4	2.6	2.1	1.7	1.2	1.4
Balance	–1.3	2.2	3.0	1.8	1.7	4.4	1.5
Primary balance	2.1	4.6	5.6	3.9	3.4	5.6	2.9
Gross public debt	86.4	56.1	42.4	36.2	26.8	. .	. .

Source: National ministry of finance, Economic Expert Group.
Note: Data on cash basis. Data for 2005 according to budget law.

On the back of high energy prices and proceeds, Russia witnessed a further widening of its twin surpluses in 2004, with the budget in the black for the fifth year in a row. Based on prudent fiscal policies, particularly on expenditure restraint, the federal government budget posted a record surplus of 4.4% of GDP in 2004. In the first two months of 2005, the fiscal position is reported to have further strengthened. Consolidated government budget performance has been moving along the same lines: Aggregated revenues and expenditures

Table 56

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1–3 2003	Q1–3 2004
	EUR million							
Merchandise exports	71,210	114,379	113,843	113,201	120,040	147,357	87,949	105,355
Merchandise exports: year-on-year change in %	*7.1*	*60.6*	*–0.5*	*–0.6*	*6.0*	*22.8*	*6.0*	*19.8*
Merchandise imports	37,168	48,934	60,138	64,278	66,508	77,326	47,923	54,769
Merchandise imports: year-on-year change in %	*–28.8*	*31.7*	*22.9*	*6.9*	*3.5*	*16.3*	*3.9*	*14.3*
Trade balance	34,042	65,444	53,705	48,923	53,532	70,030	40,026	50,585
% of GDP	*18.6*	*23.1*	*15.7*	*13.5*	*14.0*	*15.0*	*14.4*	*14.9*
Services balance	–4,034	–7,254	–10,227	–10,439	–9,773	–10,810	–7,038	–8,275
Income balance (factor services balance)	–7,291	–7,353	–4,756	–6,856	–11,543	–10,336	–8,048	–7,750
Current transfers	578	65	–912	–808	–352	–648	–410	–530
Current account balance	23,295	50,903	37,810	30,821	31,864	48,237	24,530	34,030
% of GDP	*12.7*	*18.0*	*11.0*	*8.5*	*8.3*	*10.3*	*8.9*	*10.0*
Capital account balance	–311.0	12,100.3	–10,514.7	–12,599.1	–858.7	–1,294.3	–561.0	–902.8
% of GDP	*–0.2*	*4.3*	*–3.1*	*–3.5*	*–0.2*	*–0.3*	*–0.2*	*–0.3*
Direct investment flows (net)	1,042	–500	250	–49	–1,414	1,545	838	–798
% of GDP	*0.6*	*–0.2*	*0.1*	*0.0*	*–0.4*	*0.3*	*0.3*	*–0.2*

Source: National central bank, OeNB.

of federal, regional and local governments produced a surplus of 5.9% of GDP from January to September 2004. Moreover, as of early May 2005, approximately EUR 24 billion have been transferred to the budget stabilization fund, into which oil-related revenues flow when the price of Urals grade crude fetches over USD 27 per barrel.[8] Given their liquidity drainage function, the budget and the stabilization fund constitute critical elements of Russia's stabilization policy.

The current account surplus rose to EUR 48.2 billion or over 10% of GDP in 2004 and expanded further in the first quarter of 2005 (to over EUR 16 billion as against EUR 10 billion from January to March 2004). Given the mixed business climate for foreign investors, FDI inflows have remained much lower than the country's enormous economic potential would suggest. Russia's gross external debt edged up to EUR 155.2 billion at end-2004, but declined relative to GDP to 33%. Given the very high level of official reserves (see above) and the state's punctual servicing of its liabilities, the Russian Federation became a net creditor in early 2005. At end-January the country prepaid its final debt installment to the IMF. In mid-May Russia agreed with its Paris Club creditors to prepay in 2005 at least EUR 12 billion of its Paris Club liabilities of EUR 32 billion.

Table 57

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004
	End of period, EUR million					
Gross official reserves (excluding gold)	8,387	26,139	37,026	42,291	58,531	88,661
Gross external debt	, ,	156,232	159,072	143,490	148,290	155,202
	% of GDP[1]					
Gross official reserves (excluding gold)	4.6	9.2	10.8	11.6	15.3	18.9
Gross external debt	. .	55.1	46.5	39.5	38.8	33.2
	Import months of goods and services					
Gross official reserves (excluding gold)	2.0	4.7	5.3	5.7	7.8	10.2

Source: National central bank, OeNB, wiiw.
[1] Q1 2004: As a percentage of rolling four-quarter GDP.

Since President Putin's reelection in 2004, the overall speed of structural reforms has slowed, although important progress was made in some areas (e.g. banking regulation, the introduction of deposit insurance, small business and housing reforms). In the area of social reforms, the replacement and streamlining of various in-kind benefits for citizens (e.g free municipal public transport) by financial compensation in early 2005 was organized badly, triggered mass protests and had to be watered down. In recent months, tussles between more reform-oriented and less reform-oriented members of government have displayed a remarkable degree of confusion, which does not bode well for efforts to rein in bureaucratic interference. It remains to be seen whether the most recent slowdown of GDP growth will focus minds on reform.

Cutoff date for data: May 24, 2005.

8 *Owing to the level of oil prices and forecasts that it will stay high in the medium term, the authorities decided to increase the threshold from USD 20 to USD 27 per barrel in April.*