Developments in Selected Countries

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1 Introduction

In the first quarter of 2004, economic growth in the new Member States of the European Union in Central Europe (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) ranged from a low of 3.1% year on year in the Czech Republic to a high of 6.9% year on year in Poland. At the same time, the growth levels of the current accession countries[1] (Bulgaria, Croatia and Romania) lay within this range, while at 7.4% year on year Russia's growth rate was outstanding. By contrast, in full-year 2003 economic growth in all the Central European new Member States was slower than in the current accession countries.

Annual GDP growth in the first quarter of 2004 was higher than the average annual growth in recent quarters, except in the Czech Republic, Croatia and Russia, where the growth rate remained constant.

Table 1

Gross Domestic Product (Real)

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Annual change in %						
Czech Republic	0.5	3.2	2.6	1.5	3.1	3.3	3.1
Hungary	4.2	5.2	3.8	3.5	2.9	3.6	4.2
Poland	4.0	4.0	1.0	1.4	3.8	4.7	6.9
Slovak Republic	1.5	2.0	3.8	4.4	4.2	4.7	5.5
Slovenia	5.6	3.9	2.7	3.4	2.3	2.5	3.7
Bulgaria	2.4	5.4	4.1	4.9	4.3	4.9	5.3
Croatia	–0.9	2.9	4.4	5.2	4.3	3.3	4.2
Romania	–1.2	2.1	5.7	5.0	4.9	4.6	6.1
Russia	6.3	9.0	5.1	4.7	7.3	7.6	7.4

Source: Eurostat, national statistical offices, wiiw.

Looking at growth dynamics from the demand side, the new Member States show a pattern that may be broadly characterized by the following common features: First, compared to previous periods, private consumption growth in the first quarter of 2004 slowed toward the longer-term trend level. This means that the Czech Republic and Hungary saw a downward correction from quite a high growth level, partly as a result of fiscal consolidation measures. In Poland and Slovenia, household consumption growth accelerated from rather low levels, while in Slovakia it resumed at a moderate pace after last year's contraction. Second, compared to previous periods, growth of gross fixed capital formation in the first quarter of 2004 accelerated or resumed (in countries like Poland and Slovakia, which had suffered from investment contraction). The level of investment growth, however, is still comparatively low in Poland and Slovakia. In general, demand for capital goods was supported by the dynamic development of exports as well as advanced profitability in industry, as unit labor costs had decreased, or increased, at rates below those of producer price inflation for quite a while. Third, taking both private consumption and fixed capital formation developments, the contribution of total domestic demand to GDP growth augmented – with the exception of Hungary, where the investment take-off was not able to fully compensate the slowdown in consumption. Fourth, real export

[1] *In view of the European Council's unconditional decision of June 2004 to enter into accession negotiations with Croatia, in this contribution the term "accession country" refers not only to Bulgaria and Romania, but also to Croatia, regardless of the fact that accession negotiations have not yet been formally opened.*

growth accelerated in all countries under observation, except in Poland and the Slovak Republic, where growth rates slowed down moderately from very high levels in the previous year to still considerably high levels in the reporting period. Fifth, the combination of high or higher export growth and the sizeable weight of exports in total real GDP, ranging from 63% (Slovenia) to 93% (Czech Republic), had the effect that the contribution of exports to GDP growth was above that of total domestic demand. The only exception was Poland with its export weight of no more than 32%, which to a large extent reflects the fact that Poland is the largest economy among these countries.

However, these common features – and, in particular, also the few exceptions mentioned – caused import growth and thus the contribution of net exports to growth to develop along different lines. In the Czech Republic and Slovenia, both higher domestic demand and higher export growth pushed up import growth by so much that the contribution of net exports to growth continued to be negative. In the Czech Republic, the negative contribution of net exports was even more pronounced than in previous quarters. However, it is interesting to note that in both countries the deterioration of real net exports was not reflected in the goods and services balance of the balance of payments, which actually improved by even turning into a slight surplus. Import growth accelerated also in Hungary, driven by higher export growth. However, the parallel weakening of domestic demand contained this acceleration so that the contribution of net exports to growth was close to zero. By contrast and despite the strengthening of domestic demand, in Poland and Slovakia lower export growth slowed down import growth by so much that the contribution of net exports continued to be positive. Moreover, this development was reflected in the balance of payments. All in all, the five new Member States in Central Europe are either following a relatively balanced growth path or are on their way toward more balanced growth.

Turning to the current accession countries, Bulgaria shows a growth pattern that is, at first glance, somewhat similar to the main features of development in the Czech Republic, with a corrective slowdown in consumption growth being more than compensated by faster investment growth and the resulting increase in domestic demand growth leading to higher import growth and deteriorating net exports. However, this development was far more pronounced in Bulgaria, with booming investment demand (on the back of increased profitability and stepped-up lending) and a highly negative contribution of net exports to growth, which was also reflected in a further deterioration of the goods and services balance in the balance of payments on top of an already high deficit. By contrast, in Croatia and Romania growth dynamics differ considerably from the common features sketched out above for the new Member States in Central Europe. As the result of a slowdown in gross fixed capital formation, which more than compensated the further increase in consumption growth from an already high level in Romania, growth in domestic demand has not increased. At the same time, export growth has declined. The combination of weaker or constant growth in domestic demand and lower export growth slowed import growth. However, this slowdown did not suffice to keep net exports from deteriorating further. This development was also reflected in a further worsening of the goods and services balance in the balance of payments against the backdrop of an already high deficit. All in all, the three accession countries are still struggling to find a sustainable basis for growth.

In Russia, the domestic demand boom, driven by both private consumption and gross fixed capital formation, led to a significant acceleration of real import growth against a moderate deceleration of real export growth. However, given the very low base level of imports, even the marked excess of import over export growth rates led to an only moderate deterioration of net exports, equivalent to a small decline of the sizeable net export surplus.

Price developments have been quite heterogeneous throughout the region. Among the new Member States in Central Europe, inflation rates (as measured by year-on-year changes of consumer prices in the second quarter of 2004) ranged from 2.5% in the Czech Republic to 8.0% in the Slovak Republic. In the current accession countries, inflation (as measured by year-on-year changes of consumer prices in the first quarter of 2004) ranged from 1.9% in Croatia to 13.6% in Romania, while it stood at 10.8% in Russia.

In the Czech Republic, Hungary and Poland, annual inflation went up in the first and second quarters of 2004, compared to the average annual price changes in recent quarters. In addition to rising energy prices, hikes in indirect tax rates related to EU accession and higher food prices, which were partly related to accession as well, were the main causes. Apart from the lagged effect of a wage-driven consumption boom in Hungary, demand-side driven inflation is hardly noticeable.

By contrast, inflation decreased in the Slovak Republic, where the relatively low level of core inflation (below 3%) pulled down headline inflation, which was influenced by hikes in administered prices and tax changes. Inflation also declined in Slovenia, on the back of lower unit labor cost advances which resulted from the gradual deindexation of the economy.

While inflation rates have come down over recent quarters also in Romania and Russia, they markedly augmented in Bulgaria as a result of tax changes, drought-related increases of food prices and the strong credit expansion.

In assessing the quality of sovereign long-term foreign currency debt by rating agencies, both Moody's and Standard & Poor's have awarded Slovenia the highest rating among the countries monitored in this contribution. The Czech Republic and Hungary share the second-highest rating, while Poland

Table 2

Consumer Price Index (HICP)

	2000	2001	2002	2003	Q4 2003	Q1 2004	Q2 2004
	Annual change in %						
Czech Republic	3.9	4.5	1.4	–0.1	0.8	2.0	2.5
Hungary	10.0	9.1	5.2	4.7	5.4	6.8	7.4
Poland	10.1	5.3	1.9	0.7	1.4	1.8	3.4
Slovak Republic	12.2	7.2	3.5	8.5	9.4	8.2	8.0
Slovenia	8.9	8.6	7.5	5.7	5.0	3.7	3.8
Bulgaria	10.3	7.4	5.8	2.3	4.7	6.4	6.7
Croatia[1]	6.4	5.0	1.7	1.8	1.8	1.9	. .
Romania[1]	45.7	34.5	22.5	15.3	14.8	13.6	. .
Russia[1]	20.8	21.6	16.0	13.6	12.5	10.8	. .

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

and Slovakia are ranked third. Moody's has not changed its ratings of any of the observed countries for the last ten months, while Standard & Poor's has upgraded several countries (Slovakia, Slovenia, Bulgaria and Russia) during 2004. These upgrades reflect better economic performance as well as a more prudent fiscal policy and, in the case of Bulgaria, the prospect of EU membership in 2007.

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	Baa3	12.11.02	A3	BBB	02.03.04	BBB+
SIT	A2	12.11.02	Aa3	A+	13.05.04	AA–
BGN	B1	05.06.03	Ba2	BB+	24.06.04	BBB–
HRK	. .	27.01.97	Baa3	. .	17.01.97	BBB–
ROL[1]	B2	17.06.02	Ba3	BB–	17.09.03	BB
RUB	Ba2	08.10.03	Baa3	BB	27.01.04	BB+

Source: Bloomberg.

Note: The date format used is day/month/year.

[1] *After the cutoff date for this analysis, Standard & Poor's raised Romania's foreign currency rating from BB to BB+.*

Developments after Enlargement

In June 2004, the new Member States of the European Union participated in the EU parliamentary elections. The voter turnout of this EU-wide election was disappointingly low. In the Slovak Republic, only 16.8% of all eligible voters cast their ballot. Hungary, with a voter turnout of 38.5%, reported the highest turnout among the new Member States in Central Europe (EU-25 average: 45.7%).

Since their EU accession on May 1, 2004, the new members are heading toward the next milestone of European integration: the adoption of the euro. The authorities in the new Member States have announced target years for euro adoption ranging from 2006 (Estonia) to 2010 (Hungary). Before adopting the euro, the countries have to fulfill the Maastricht convergence criteria, which require – inter alia – participation in the Exchange Rate Mechanism II (ERM II) without severe tensions for at least two years before compliance with the Maastricht criteria is examined. At the end of June 2004, Estonia, Lithuania and Slovenia already entered ERM II.

2 Czech Republic: Weakest Growth Rate among the New EU Member States

With economic growth coming to 3.1% in the first quarter of 2004, just as in full-year 2003, economic performance in the Czech Republic exceeded the average growth of the EU-15, but lagged behind that of the other new Member States. The deterioration of net exports continued to have a negative impact on growth, reducing GDP growth by nearly 4 percentage points in the first quarter. Household consumption growth slowed down, but remained above GDP growth, whereas government consumption even contracted. Gross fixed capital formation increased strongly, partly because investors in the building and con-

Table 4

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Real year-on-year change in %						
Gross domestic product	0.5	3.2	2.6	1.5	3.1	3.3	3.1
Private consumption	1.7	2.6	2.6	2.8	4.9	3.8	3.9
Public consumption	2.3	−9.8	3.8	4.5	2.2	2.0	−1.6
Gross fixed capital formation	−1.0	0.3	5.4	3.4	7.4	8.5	9.5
Exports of goods and services	6.1	16.9	11.5	2.3	5.9	7.0	8.3
Imports of goods and services	5.4	16.6	13.0	4.9	7.9	9.6	11.3
	Contribution to GDP growth in percentage points						
Domestic demand	0.4	4.0	4.7	4.2	5.7	7.3	6.9
Exports	4.2	12.2	9.1	2.0	5.2	6.6	7.7
Net exports	0.1	−0.8	−2.1	−2.7	−2.6	−4.0	−3.8

Source: Eurostat, OeNB.

struction sector anticipated the rise in VAT from 5.0% to 19.0% effective from May, and rushed to beat this increase.

In the first half of 2004, industrial production rose sharply by 10.8% (first half of 2003: 5.6%), largely driven by an upswing in export demand which was predominantly realized by foreign-owed firms, as they account for over 70% of industrial exports. In the first half of 2004, labor productivity in the industrial sector increased more strongly than the average industry wage. Despite the upswing in industrial production, industrial employment declined in the first half of 2004. The unemployment rate (ILO definition) was about 1 percentage point higher in the first quarter of 2004 than the year before.

Table 5

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	6.3	8.7
Labor productivity of industry (real)	3.6	9.1	6.1	6.8	8.3	8.5	9.5
Gross average wage of industry (nominal)	6.6	7.1	6.4	6.7	5.9	6.6	8.8
Unit labor cost of industry (nominal)	3.0	−1.8	0.3	−0.1	−2.2	−1.8	−0.7
Producer price index (PPI) of industry	0.9	4.8	2.9	−0.5	−0.4	0.4	1.8
Consumer price index (HICP)	1.8	3.9	4.5	1.4	−0.1	0.8	2.0
Exchange rate (nominal):							
CZK[1] per 1 EUR, + = EUR appreciation	2.3	−3.5	−4.3	−9.5	3.3	4.0	3.9
EUR per 1 CZK, + = CZK appreciation	−2.2	3.6	4.5	10.6	−3.2	−3.9	−3.8
Period average levels							
Unemployment rate (ILO definition, %)	8.8	8.9	8.2	7.3	7.8	8.1	8.7
Key interest rate per annum (%)	6.7	5.3	5.1	3.6	2.3	2.0	2.0
Exchange rate (nominal):							
CZK[1] per 1 EUR	36.89	35.60	34.07	30.81	31.84	32.10	32.86
EUR per 1 CZK	0.0271	0.0281	0.0294	0.0325	0.0314	0.0312	0.0304

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

While prices remained almost constant in 2003, HICP inflation jumped from 1.0% year on year in December 2003 to 2.0% in January 2004 and accelerated further to about 3% year on year in the period from May to July. In the first half of 2004, average HICP inflation was around 2.2%. These price developments were largely attributable to the harmonization of excise duties and VAT with EU law, to an increase in regulated prices and to the sharp rise in fuel prices. At the end of August, Česká národní banka (ČNB), the Czech central bank, decided to raise the key interest rate by 25 basis points to 2.50%, the second interest rate increase in 2004, after a hike from 2.00% to 2.25% in June, which in turn had been the first change since August 2003.

Table 6

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	5.9	8.9
	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	−5.7	−2.6
Domestic credit (net) of the banking system	−3.2	−1.1	0.2	−9.7	7.7	13.5	12.4
of which: claims on the private sector	*−3.8*	*−5.0*	*−5.6*	*−12.3*	*0.9*	*3.6*	*4.2*
claims on households	*0.1*	*0.3*	*1.1*	*1.7*	. .	. .	. .
claims on enterprises	*−4.0*	*−5.3*	*−6.7*	*−14.0*	. .	. .	. .
net claims on the public sector	*0.6*	*3.9*	*5.8*	*2.5*	*6.8*	*9.8*	*8.2*
Other domestic assets (net) of the banking system	−0.9	−0.4	2.6	8.9	−3.7	−1.9	−0.9

Note: Data since 2003 according to ECB methodology.

The exceptionally high budget deficit in 2003 was attributable to the fact that the government had to account for a realized one-off state guarantee, which totaled 6.3% of GDP. Since only a very small proportion of this guarantee actually had to be paid in cash, the resulting cash deficit came to around 7.3% of GDP, which still indicates a deterioration of the fiscal deficit. The financial framework for the period from 2004 to 2007 provides for gradually reducing the deficit to 3.5% by 2007. Gross public debt is expected to increase to 44% by that time. The implementation of fiscal reforms is strongly exposed due to the weak political backing for the government and to political uncertainties.[2] After the resignation of Prime Minister Spidla in reaction to the weak support for his party in this year's elections to the European Parliament, the implementation of fiscal reform plans is one of the main challenges for new Prime Minister Stanislav Gross, given that parliamentary elections will take

Table 7

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	44.1	44.8	45.9	44.3	49.9	50.0	49.5
Expenditures	47.8	48.9	51.9	51.0	63.6	55.6	54.4
of which: interest payments	*1.0*	*1.0*	*1.1*	*1.7*	. .	. .	. .
Balance	−3.7	−4.5	−6.4	−6.4	−13.6	−5.6	−4.9
Primary balance	−2.6	−3.0	−4.9	−5.0	−12.9	−4.6	−3.9
Gross public debt	14.9	18.2	25.2	28.9	39.7	40.5	41.8

Source: European Commission, Eurostat, national ministry of finance (2003–2005: Convergence program May 2004), OeNB.

[2] *Due to the deterioration of the fiscal position and the uncertain outlook for fiscal consolidation, Standard & Poor's downgraded its long-term local currency sovereign credit rating for the Czech Republic from A+ to A at the beginning of September 2004.*

place in 2006. Another major challenge for the Czech authorities is to get under way with reforms of the pension and health care systems – an essential precondition for reducing the budget deficit beyond 2007.

In the first half of 2004, the rise in exports (+21.6%), which was particularly strong vis-à-vis the European transition countries and the CIS, surpassed import growth (+20.2%), which implied a lower trade deficit than in the first half of 2003. However, in the first quarter of 2004, the current account deficit was larger than the year before, partly because increasing flows of repatriated and reinvested profits of foreign firms drove up the income balance deficit, but mainly because of the sharp contraction of the surplus in the transfer balance. Net FDI inflows, by contrast, considerably exceeded the current account deficit.

Table 8

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	24,651	31,509	37,271	40,713	43,080	10,544	11,400
Merchandise exports: year-on-year change in %	*6.9*	*27.8*	*18.3*	*9.2*	*5.8*	*7.0*	*8.1*
Merchandise imports	26,448	34,918	40,705	43,034	45,250	10,677	11,427
Merchandise imports: year-on-year change in %	*4.1*	*32.0*	*16.6*	*5.7*	*5.1*	*5.3*	*7.0*
Trade balance	−1,797	−3,409	−3,434	−2,322	−2,170	−133	−28
% of GDP	*−3.5*	*−5.6*	*−5.0*	*−3.0*	*−2.7*	*−0.7*	*−0.1*
Services balance	1,130	1,536	1,706	706	416	102	55
Income balance (factor services balance)	−1,265	−1,490	−2,450	−3,760	−3,656	−518	−584
Current transfers	552	403	524	934	487	296	48
Current account balance	−1,379	−2,960	−3,653	−4,442	−4,923	−253	−509
% of GDP	*−2.7*	*−4.9*	*−5.4*	*−5.7*	*−6.2*	*−1.3*	*−2.6*
Direct investment flows (net)	5,879	5,356	6,121	8,870	2,094	861	915
% of GDP	*11.4*	*8.9*	*9.0*	*11.3*	*2.6*	*4.6*	*4.7*

Source: Eurostat, national central bank, OeNB.

Table 9

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (including gold)	12,771	14,158	16,400	22,614	21,340	22,076
Gross external debt	22,765	23,285	25,368	25,738	27,599	26,382
	% of GDP[1]					
Gross official reserves (including gold)	24.8	23.4	24.1	28.8	26.8	27.5
Gross external debt	44.1	38.5	37.3	32.8	34.7	32.9
	Import months of goods and services					
Gross official reserves (including gold)	4.8	4.2	4.2	5.4	5.0	5.1

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

In the first quarter of 2004, gross official reserves increased slightly, while gross external debt markedly declined as a result of net FDI inflows being above the current account deficit.

The privatization process in the Czech Republic has not yet been completed. In the medium term, a number of major privatization projects are still on the agenda, such as the sale of Český Telecom (ČT) and of the electricity producer České energetické závody (ČEZ), which will ensure privatization-related FDI inflows in the coming years.

3 Hungary: On the Road to More Sustainable Growth

Following 2.9% economic growth in full-year 2003, GDP in Hungary grew by 4.2% year on year in the first quarter of 2004. Annual GDP growth has accelerated continuously since mid-2003, although the annual growth of consumption (private and public) decelerated, as expected, from 6.5% in the first half to 5.5% in the second half of 2003 and to 2.8% in the first quarter of 2004, owing to fiscal tightening measures and the slackening of net real wage growth. In the first quarter of 2004, the main domestic contribution to GDP growth stemmed from gross fixed capital formation, which picked up sharply, albeit from a very weak base period. Starting from a lower base level, exports grew somewhat more strongly than imports, so that real net exports had no effect on the GDP growth rate. Thus, after having reduced GDP growth by nearly 3 percentage points in 2003, the year-on-year deterioration of net exports has now come to a halt.

Table 10

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Real year-on-year change in %						
Gross domestic product	4.2	5.2	3.8	3.5	2.9	3.6	4.2
Private consumption	5.6	5.5	5.6	10.4	. .	. .	. .
Public consumption	1.5	1.9	4.4	2.2	. .	. .	. .
Gross fixed capital formation	5.9	7.7	5.0	8.0	3.0	4.7	18.9
Exports of goods and services	12.2	21.0	7.8	3.7	7.2	17.0	17.4
Imports of goods and services	13.3	19.4	5.1	6.2	10.3	13.4	16.6
	Contribution to GDP growth in percentage points						
Domestic demand	5.1	4.6	1.7	5.5	5.7	1.7	4.3
Exports	7.9	14.5	6.2	3.1	6.1	13.8	14.8
Net exports	–1.0	0.5	2.1	–2.0	–2.8	1.9	0.0

Source: Eurostat, OeNB.

Despite the recovery of economic activity, the unemployment rate stood at 5.8% in the second quarter of 2004, unchanged from the same period in the previous year. At the same time, real net wages (deflated by the CPI) stagnated in year-on-year terms in the first half of 2004, compared to a growth rate of 9.3% in 2003. This was the result of weakening nominal wage growth in the public sector and an only modest acceleration of wage dynamics in the private sector during the first half of 2004 while inflation was picking up.

Following inflation (HICP) of 4.7% on average in 2003 and of 5.7% year on year in December 2003, price growth accelerated to 7.6% in May 2004 but went down again to 7.2% in July. The hike in VAT rates and regulated prices at the beginning of 2004, higher fuel and food prices and the weakening of the forint in the second half of 2003 were the major factors behind this acceleration, though some lagged effects of the strong domestic consumption seen over the past two years may have exerted some pressure as well. The inflation target of Magyar Nemzeti Bank (MNB), the Hungarian central bank, consists in achieving an inflation rate of 4% ± 1 percentage point in December 2005. In the

Table 11

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	10.0	10.6
Labor productivity of industry (real)	5.1	17.0	5.6	4.7	8.4	11.6	13.2
Gross average wage of industry (nominal)	13.4	15.0	14.5	12.4	9.4	9.6	11.8
Unit labor cost of industry (nominal)	7.9	–1.7	8.4	7.4	1.0	–1.8	–1.2
Producer price index (PPI) of industry	5.0	11.4	5.7	–1.1	2.5	5.5	4.9
Consumer price index (HICP)	10.0	10.0	9.1	5.2	4.7	5.4	6.8
Exchange rate (nominal):							
HUF[1] per 1 EUR, + = EUR appreciation	5.2	2.9	–1.3	–5.3	4.3	8.5	6.7
EUR per 1 HUF, + = HUF appreciation	–4.9	–2.8	1.4	5.6	–4.2	–7.8	–6.3
	Period average levels						
Unemployment rate (ILO definition, %)	7.0	6.4	5.7	5.8	5.9	5.5	6.0
Key interest rate per annum (%)	15.2	11.5	11.1	9.1	8.6	11.0	12.5
Exchange rate (nominal):							
HUF[1] per 1 EUR	252.76	260.07	256.60	242.95	253.51	259.82	260.00
EUR per 1 HUF	0.00396	0.00385	0.00390	0.00412	0.00394	0.00385	0.00385

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

MNB's view, disinflation should be effected through the tightening of fiscal and income policy, the continuation of a cautious monetary policy stance and the passing of the adverse base effects from the index in late 2004 and early 2005.

Following the tightening of monetary policy by a total of 600 basis points in the second half of 2003, the MNB reduced its key policy rate only gradually by 150 basis points to 11.0% by mid-August 2004. On the one hand, the strengthening of the forint since the beginning of the year, the more favorable GDP growth composition and the surpassing of the peak in the inflation cycle supported this easing of monetary policy. On the other hand, in the MNB's view, risks to the inflation forecast (uncertainty about the outlook for fiscal policy, private sector wage and consumption growth as well as fuel and food prices) continue to call for a cautious monetary approach.

The government intends to cut the budget deficit in 2004 to 4.6% of GDP (ESA) from the disappointing 5.9% registered in 2003. However, despite the

Table 12

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	14.4	12.3
	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	–0.6	0.1
Domestic credit (net) of the banking system	6.0	6.0	10.7	12.3	22.3	23.7	20.2
of which: claims on the private sector	*8.8*	*16.2*	*17.2*	*15.4*	*18.6*	*22.0*	*25.9*
claims on households	*1.6*	*2.7*	*4.2*	*6.3*	*10.6*	*11.5*	*11.5*
claims on enterprises	*7.1*	*13.4*	*13.0*	*9.1*	*8.0*	*10.5*	*14.4*
net claims on the public sector	*–2.7*	*–10.2*	*–6.5*	*–3.1*	*3.7*	*1.7*	*–5.7*
Other domestic assets (net) of the banking system	1.1	–5.8	–3.6	–4.5	–7.1	–8.7	–8.0

Source: National central bank, OeNB.

freezing of expenditures worth around 1% of GDP, the deficit (on a cash flow basis) had already reached 90.5% of the annual target at the end of July, which is sharply above the speed of deficit accumulation seen in previous years. While the government has committed itself to further savings, if necessary, politics (the replacement of Prime Minister Medgyessy in September and the election of a new Socialist Party chairman in October) will constitute a challenge when it comes to fulfilling this commitment.

Table 13

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	. .	45.4	44.4	44.1	44.5	44.2	43.4
Expenditures	. .	48.4	49.1	53.4	50.4	48.8	47.5
of which: interest payments	. .	*5.6*	*4.9*	*4.1*			
Balance	. .	−3.0	−4.4	−9.3	−5.9	−4.6	−4.1
Primary balance	. .	2.6	0.2	−5.2	−2.0	−0.5	−0.2
Gross public debt	60.9	55.4	53.5	57.1	59.1	59.4	57.9

Source: European Commission, Eurostat, national ministry of finance (2003–2005: Convergence program May 2004), OeNB.

The worsening trend in the current account has not yet ended, contrary to the recent developments of real net exports. In the first quarter of 2004, the deficit amounted to 9.5% of GDP. In the period from January to April, the deficit was 23% higher, in euro terms, than in the comparable period of the previous year. This deterioration stemmed mainly from a strong increase in the deficit in the services balance, which had traditionally been in surplus. On a positive note, net FDI returned to positive territory, covering around 30% of the current account deficit.

Table 14

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	24,059	31,278	34,697	36,821	38,161	8,947	10,263
Merchandise exports: year-on-year change in %	*14.3*	*30.0*	*10.9*	*6.1*	*3.6*	*-0.5*	*14.7*
Merchandise imports	26,102	34,457	37,193	39,024	41,132	9,547	10,671
Merchandise imports: year-on-year change in %	*14.8*	*32.0*	*7.9*	*4.9*	*5.4*	*1.0*	*11.8*
Trade balance	−2,044	−3,180	−2,496	−2,203	−2,971	−599	−408
% of GDP	*−4.5*	*−6.3*	*−4.3*	*−3.2*	*−4.1*	*−3.4*	*−2.3*
Services balance	816	1,207	1,625	591	−170	−132	−384
Income balance (factor services balance)	−2,713	−2,792	−3,192	−3,835	−3,930	−904	−1,017
Current transfers	408	385	450	547	583	148	104
Current account balance	−3,531	−4,380	−3,613	−4,900	−6,488	−1,488	−1,705
% of GDP	*−7.8*	*−8.7*	*−6.2*	*−7.1*	*−8.9*	*−8.5*	*−9.5*
Direct investment flows (net)	2,872	2,334	3,992	2,734	775	−69	327
% of GDP	*6.4*	*4.6*	*6.9*	*4.0*	*1.1*	*−0.4*	*1.8*

Source: Eurostat, national central bank, OeNB.

The country's net foreign debt continued to increase, from 26% of GDP at the end of 2003 to 28% of annual GDP at end-March 2004, with the position of the private sector improving modestly.

Table 15

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (excluding gold)	10,722	12,038	12,164	9,887	10,108	10,067
Gross external debt	29,231	32,572	37,387	38,425	44,093	45,685
	% of GDP					
Gross official reserves (excluding gold)	23.8	23.8	21.0	14.3	13.8	13.7
Gross external debt	64.9	64.4	64.5	55.7	60.2	62.0
	Import months of goods and services					
Gross official reserves (excluding gold)	4.3	3.7	3.4	2.6	2.5	2.4

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

4 Poland: In Need of Fixed Capital Formation

GDP growth accelerated to 6.9% year on year in the first quarter of 2004, against 3.8% in full-year 2003. Being clearly below GDP growth, private consumption growth was only moderately stronger than in 2003. Gross fixed capital formation expanded for the first time after three years of contraction. However, its growth rate was still modest and remained below that of private consumption despite high profitability in industry. The strong weakening of the zloty may have induced the delay of several import-intensive fixed investments. By contrast, the build-up of inventories was very strong, lifting investment growth to 21.8% and the contribution of domestic demand to GDP growth from 3.5 to 5.7 percentage points. This increase in the build-up of stocks may include a significant number of half-finished investment goods and thus indicate higher fixed capital formation growth in future periods. Slowing down from very high levels, export growth still remained substantial. As import growth decelerated in tandem, despite the pick-up in domestic demand, the contribution of net exports to growth continued to be positive.

Table 16

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Real year-on-year change in %						
Gross domestic product	4.0	4.0	1.0	1.4	3.8	4.7	6.9
Private consumption	5.3	2.8	2.1	3.3	3.1	3.9	4.0
Public consumption	1.0	1.1	0.6	0.6	0.4	1.2	1.0
Gross fixed capital formation	9.2	2.7	−8.8	−5.8	−0.9	0.1	3.5
Exports of goods and services	−3.2	23.2	3.1	4.8	14.7	16.4	10.4
Imports of goods and services	1.1	15.6	−5.3	2.6	9.3	8.9	6.5
	Contribution to GDP growth in percentage points						
Domestic demand	5.4	−0.1	−1.7	0.8	2.5	2.9	5.7
Exports	−1.0	9.8	0.9	1.3	4.4	4.9	3.3
Net exports	−1.4	4.2	2.7	0.5	1.3	1.8	1.2

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

Coming to 20.7% in the first quarter of 2004, the unemployment rate (ILO definition) remained very high – even slightly higher than a year earlier (20.5%) – despite the GDP growth acceleration; however, the continuously high unemployment rate corresponded to the low fixed investment growth rates. Despite very high output growth, labor shedding in industry continued, albeit at a lower pace. Although unit labor costs (ULC) continued to fall substantially, inflation of industrial producer prices significantly rose to 9.9% in May (and 8.6% in July) because of higher oil prices and the strong depreciation of the zloty by 10% against the euro from August 2003 to February 2004. Inflation (HICP) rose from a low of 0.7% year on year in August 2003 to 4.6% year on year in July 2004, mainly as a result of higher energy prices and an increase in food prices (which was partly EU accession-related), while the increase of other manufactured goods prices still remained nearly negligible. In an effort to contain the surge of inflationary expectations and second-round effects and to achieve the target corridor of 1.5% to 3.5%, the Monetary Policy Council raised the key interest rate (two-week rate on central bank bills) by a total of 1.25 percentage points to 6.5% in three steps from the end of June, after it had stood at 5.25% for about a year.

Table 17

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	11.8	18.7
Labor productivity of industry (real)	9.6	17.9	6.1	7.4	11.4	14.2	19.6
Gross average wage of industry (nominal)	34.1	10.9	6.9	3.7	3.0	4.5	6.6
Unit labor cost of industry (nominal)	22.3	−5.9	0.8	−3.4	−7.5	−8.5	−10.9
Producer price index (PPI) of industry	5.7	7.8	1.7	1.1	2.7	3.4	4.4
Consumer price index (HICP)	7.2	10.1	5.3	1.9	0.7	1.4	1.8
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	15.7	14.0
EUR per 1 PLN, + = PLN appreciation	−7.4	5.5	9.2	−4.7	−12.4	−13.5	−12.3
	Period average levels						
Unemployment rate (ILO definition, %)	. .	16.1	18.3	19.9	19.6	19.3	20.7
Key interest rate per annum (%)	13.7	17.9	16.0	8.8	5.6	5.3	5.3
Exchange rate (nominal):							
PLN[1] per 1 EUR	4.23	4.01	3.67	3.85	4.40	4.62	4.78
EUR per 1 PLN	0.2365	0.2495	0.2725	0.2595	0.2274	0.2163	0.2094

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

Real key interest rates[3] fell continuously to 0.6% in July (from 6.3% a year earlier) in CPI-deflated terms and to –3.0% (from 4.9% a year earlier) in PPI-deflated terms. The combination of past depreciation and declining real interest rates eased monetary conditions substantially, even though the zloty appreciated by 6% from February to August. However, bank lending to enterprises nearly stagnated in nominal terms and declined in real terms, while lending to households made the largest contribution to the year-on-year growth of broad money in the second half of 2004. Net foreign assets were the second-largest contributor to broad money growth, but this was primarily a statistical effect of the depreciation.

The government's convergence program presented in May 2004 envisages a deficit of 5.7% in 2004.[4] Despite assumed higher growth, the planned revenue

[3] *As measured by the 12-month moving average of the nominal key interest rate deflated by the change in the price index level during the respective 12-month period.*

[4] *This figure does not take into account the potential impact of this year's Eurostat framework ruling on the deficit definition according to ESA 95 with respect to fiscal costs arising from the introduction of a funded pension system. The ruling could increase the deficit-to-GDP ratio on a permanent basis by more than 1 percentage point.*

Table 18

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	4.9	5.3
	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	1.3	2.8
Domestic credit (net) of the banking system	25.1	13.5	7.2	7.1	5.2	7.4	6.2
of which: claims on the private sector	*18.5*	*15.7*	*8.3*	*3.4*	*3.8*	*4.7*	*4.9*
claims on households	*6.2*	*7.0*	*4.2*	*2.8*	*2.5*	*3.5*	*3.9*
claims on enterprises	*12.3*	*8.7*	*4.1*	*0.5*	*1.3*	*1.2*	*1.0*
net claims on the public sector	*6.7*	*−2.1*	*−1.1*	*3.7*	*1.4*	*2.7*	*1.3*
Other domestic assets (net) of the banking system	−8.3	−5.1	0.4	−6.0	−3.8	−3.8	−3.7

Source: National central bank, OeNB.

ratio remained nearly unchanged compared to 2003, given cuts in income and corporate tax rates. By contrast, noninterest payments were set to rise substantially; the authorities attributed a substantial part of the expenditure-driven deficit widening to the fiscal impact of EU accession. However, in the first seven months of 2004, the central government's deficit was about 16% below the level observed in the same period of 2003. A better-than-scheduled fiscal outcome for 2004 could help to prevent the public debt-to-GDP ratio from rising to the level of nearly 52% envisaged in the convergence program (according to ESA 95). That debt level would correspond to close to 59% according to the national definition, which includes government guarantees, inter alia, and is relevant for the constitutional ceilings of 50%, 55% and 60%, the surpassing of which will require the implementation of increasingly drastic fiscal consolidation measures in the years to come.

Table 19

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	40.3	42.1	42.3	42.2	50.9	50.6	50.4
Expenditures	44.1	42.6	44.2	44.9	55.0	56.3	54.6
of which: interest payments	*3.2*	*3.3*	*3.4*	*3.7*	. .	. .	. .
Balance	−2.0	−1.8	−3.5	−3.6	−4.1	−5.7	−4.2
Primary balance	1.2	0.8	0.5	0.0	−1.0	−2.8	−1.1
Gross public debt	42.5	36.6	36.7	41.2	45.3	49.0	51.9

Source: European Commission, Eurostat, national ministry of finance (2003–2005: Convergence program May 2004), OeNB.

Corresponding to the improvement of real net exports, the deficit in the goods and services balance in the balance of payments shrank further both in the first quarter and in the first half of 2004. This can be attributed mainly to the substantial weakening of the ULC-based real exchange rate, owing to both nominal depreciation and the nominal decrease of industrial ULC. The current account deficit, which shrank in parallel, was fully covered by net direct investment inflows in the first half of 2004.

Table 20

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	28,215	39,026	46,489	49,325	53,814	12,097	14,451
Merchandise exports: year-on-year change in %	*−2.5*	*38.3*	*19.1*	*6.1*	*9.1*	*8.3*	*19.5*
Merchandise imports	42,361	52,359	55,074	57,036	58,892	13,624	15,365
Merchandise imports: year-on-year change in %	*4.9*	*23.6*	*5.2*	*3.6*	*3.3*	*3.0*	*12.8*
Trade balance	−14,146	−13,333	−8,585	−7,711	−5,078	−1,527	−914
% of GDP	*−9.2*	*−7.4*	*−4.1*	*−3.8*	*−2.7*	*−3.4*	*−2.1*
Services balance	1,297	1,542	909	857	428	−252	37
Income balance (factor services balance)	−948	−1,612	−1,584	−1,987	−2,741	−647	−597
Current transfers	2,078	2,595	3,226	3,435	3,730	781	782
Current account balance	−11,719	−10,808	−6,034	−5,406	−3,661	−1,645	−692
% of GDP	*−7.6*	*−6.0*	*−2.9*	*−2.7*	*−2.0*	*−3.7*	*−1.6*
Direct investment flows (net)	6,795	10,253	6,457	4,149	3,424	1,215	612
% of GDP	*4.4*	*5.7*	*3.1*	*2.0*	*1.9*	*2.7*	*1.4*

Source: Eurostat, national central bank, OeNB.

After temporarily falling below the 2003 average of EUR 27.3 billion at end-2003 and rising again to a peak of EUR 29.3 billion at the end of February 2004, gross official reserves remained rather stable at the average level of the first half of 2004 (EUR 28.4 billion).

Table 21

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (excluding gold)	26,224	28,555	29,031	27,367	25,846	28,856
Gross external debt	65,365	69,465	71,900	84,743	104,734	106,560
	% of GDP[1]					
Gross official reserves (excluding gold)	17.0	15.8	14.0	13.5	14.0	15.8
Gross external debt	42.4	38.4	34.6	41.8	56.6	58.2
	Import months of goods and services					
Gross official reserves (excluding gold)	6.4	5.5	5.4	4.9	4.5	5.0

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

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

5 Slovak Republic: Skyrocketing Economy

In the first quarter of 2004 the Slovak economy boomed, with GDP growth coming to 5.5% year on year after 4.2% in full-year 2003. This development was primarily traceable to a continuing strong rise in real exports, which grew at the lower, but still high rate of 15.8%. Moreover, domestic demand began to rise again, with private consumption growing at 3.1% and gross fixed capital formation showing the first signs of a revival (0.9%) after two years of decline. Public consumption, by contrast, contracted by 2.3%. Despite lower export growth, real import growth remained at the high level of 12.0%, given the recovery of domestic demand. However, with export growth still exceeding import growth, net exports continued to contribute positively to GDP growth (3.6 percentage points), albeit less than in full-year 2003.

Table 22

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Real year-on-year change in %						
Gross domestic product	1.5	2.0	3.8	4.4	4.2	4.7	5.5
Private consumption	3.2	−0.8	4.7	5.3	−0.4	−2.1	3.1
Public consumption	−7.1	1.6	4.6	4.7	2.9	10.4	−2.3
Gross fixed capital formation	−19.6	−7.2	13.9	−0.9	−1.2	−1.8	0.9
Exports of goods and services	5.0	13.7	6.3	5.5	22.6	26.1	15.8
Imports of goods and services	−6.7	10.5	11.0	5.2	13.8	11.9	12.0
	Contribution to GDP growth in percentage points						
Domestic demand	−7.0	0.1	7.5	4.4	−2.2	−6.0	1.9
Exports	3.3	9.4	4.8	4.3	17.8	21.6	13.9
Net exports	8.4	1.9	−3.7	0.0	6.4	10.7	3.6

Source: Eurostat, national statistical office, OeNB.

Despite high economic growth, industrial employment declined by 1.3% in the first half of 2004. Although construction and service sector employment expanded slightly, the unemployment rate (ILO definition) increased by 1 percentage point to 19.5% in the first quarter of 2004. As a result of this development, industrial labor productivity growth increased. As industrial wage growth accelerated, too, the ULC continued to increase and CPI-deflated industrial wage growth turned positive as well.

Table 23

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	4.2	6.5
Labor productivity of industry (real)	1.0	11.8	6.6	6.5	4.9	3.8	7.5
Gross average wage of industry (nominal)	7.9	9.1	10.2	7.3	7.3	8.9	10.8
Unit labor cost of industry (nominal)	6.8	−2.4	3.4	0.7	2.3	4.9	3.1
Producer price index (PPI) of industry	3.9	10.8	6.5	2.0	8.3	8.4	2.9
Consumer price index (HICP)	10.4	12.2	7.2	3.5	8.5	9.4	8.2
Exchange rate (nominal):							
SKK[1] per 1 EUR, + = EUR appreciation	11.7	−3.4	1.6	−1.4	−2.8	−1.2	−2.9
EUR per 1 SKK, + = SKK appreciation	−10.5	3.6	−1.6	1.4	2.9	1.2	3.0
	Period average levels						
Unemployment rate (ILO definition, %)	16.3	18.8	19.3	18.7	17.6	17.5	19.5
Key interest rate per annum (%)	. .	. .	8.8	7.9	6.4	6.2	5.9
Exchange rate (nominal):							
SKK[1] per 1 EUR	44.12	42.60	43.30	42.68	41.49	41.18	40.56
EUR per 1 SKK	0.0227	0.0235	0.0231	0.0234	0.0241	0.0243	0.0247

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

In January 2004 a far-reaching tax reform was implemented. First, a flat income tax set at a uniform level of 19% was introduced. Second, the VAT was unified at 19% as well. Simultaneously, the system of social benefits was reformed. First analyses indicate that the tax reform actually improved the economic incentives, although its negative effects severely burdened the middle-income population.

Following the tax reform and a further liberalization of administered prices, inflation (HICP) accelerated to a peak of 8.4% year on year in February, but inflationary expectations remained strong also afterwards, with a possible overheating in the economy and seasonal effects causing new rises in inflation in May and July. Still, average inflation in the second quarter declined to 8.0% after 8.2% in the first quarter of the reporting year.

The monetary policy strategy of Národná banka Slovenska (NBS), the Slovak central bank, is based on inflation and monetary indicators, but also takes account of exchange rate developments (managed float). While leaving the main key interest rate (two-week repo tender limit rate) unchanged in the first eight months of 2003, the NBS cut it twice by a total of 0.5 percentage point in the remaining months of 2003 and three times by a total of 1.5 percentage points during 2004, to a level of 4.5% in mid-August. These rate cuts have been mainly viewed as being connected to the appreciation of the Slovak koruna since 2003.

Table 24

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	5.3	4.4
	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	–4.3	–3.8
Domestic credit (net) of the banking system	13.6	3.7	12.2	0.4	–1.9	10.6	13.8
of which: claims on the private sector	*4.9*	*2.2*	*–13.9*	*–1.0*	*4.9*	*5.9*	*6.1*
claims on households	*1.7*	*2.0*	*1.2*	*1.4*	*2.2*	*3.1*	*3.5*
claims on enterprises	*3.2*	*0.2*	*–15.1*	*–2.3*	*2.7*	*2.8*	*2.6*
net claims on the public sector	*8.7*	*1.5*	*26.1*	*1.4*	*–6.7*	*4.7*	*7.7*
Other domestic assets (net) of the banking system	–0.5	3.8	–2.2	–5.2	–0.4	–1.0	–5.7

Note: Data after deduction of bad claims written off during bank consolidation.

Fiscal development was better than expected in 2003, given the surprisingly good development of exports. As a result, the budget deficit (according to ESA 95) came to 3.6% of GDP, against an initial target of 5% of GDP. However, the government's convergence program presented in May 2004 expects a slightly higher budget deficit of 4% of GDP in 2004. Regarding implementation, the central government posted a small surplus in the first quarter compared to a sizeable deficit a year earlier. Key measures of the healthcare and pension reforms were approved by parliament in the second half of 2003 – a fact which will provide significant support to the fiscal reform package.

Table 25

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	51.3	50.1	47.7	43.2	37.4	37.4	38.4
Expenditures	59.2	63.6	54.3	50.4	40.9	41.5	41.8
of which: interest payments	*3.4*	*4.1*	*4.0*	*3.8*	. .	. .	. .
Balance	–7.8	–12.3	–6.0	–5.7	–3.6	–4.0	–3.4
Primary balance	–4.5	–9.4	–2.7	–3.4	–1.2	–1.5	–0.6
Gross public debt	43.8	49.9	48.7	43.3	42.8	45.1	46.4

Source: European Commission, Eurostat, national ministry of finance (2003–2005: Convergence program May 2004), OeNB.

Buoyant, mainly supply side-driven exports since 2003 caused a marked improvement in the current account balance. Both in the first quarter and in the first four months of 2004, the current account balance was positive, mainly as a result of the trade balance performance. In 2002, FDI inflows based on large-scale privatization deals reached 16.2% of GDP, but this indicator fell to 1.8% in 2003. In the first quarter of 2004, results were roughly at the level of the comparable period in 2003. However, there is still some potential for new increases especially in view of an announced investment project by Hyundai.

Table 26

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	9,607	12,866	14,119	15,263	19,363	4,197	5,015
Merchandise exports: year-on-year change in %	*0.5*	*33.9*	*9.7*	*8.1*	*26.9*	*23.5*	*19.5*
Merchandise imports	10,633	13,838	16,494	17,538	19,934	4,363	5,001
Merchandise imports: year-on-year change in %	*−8.8*	*30.1*	*19.2*	*6.3*	*13.7*	*13.0*	*14.6*
Trade balance	−1,027	−971	−2,376	−2,275	−571	−166	15
% of GDP	*−5.4*	*−4.4*	*−10.2*	*−8.9*	*−2.0*	*−2.6*	*0.2*
Services balance	208	476	536	483	208	15	49
Income balance (factor services balance)	−281	−382	−350	−485	−107	−27	15
Current transfers	184	128	237	206	221	61	53
Current account balance	−916	−750	−1,953	−2,070	−248	−117	131
% of GDP	*−4.8*	*−3.4*	*−8.4*	*−8.1*	*−0.9*	*−1.8*	*1.7*
Direct investment flows (net)	737	2,048	1,726	4,151	516	326	337
% of GDP	*3.9*	*9.3*	*7.4*	*16.2*	*1.8*	*5.0*	*4.4*

Source: Eurostat, national central bank, OeNB.

The country's gross foreign debt decreased from 49.7% of GDP at the end of 2003 to 47.7% of annual GDP at end-March 2004, given the strong improvement in the position of the private sector.

Table 27

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (including gold)	3,410	4,391	4,748	8,824	9,717	10,019
Gross external debt	. .	. .	. .	12,576	14,323	14,282
	% of GDP[1]					
Gross official reserves (including gold)	17.8	20.0	20.4	34.3	33.7	33.5
Gross external debt	. .	. .	. .	49.0	49.7	47.7
	Import months of goods and services					
Gross official reserves (including gold)	3.3	3.3	3.0	5.3	5.2	5.3

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

6 Slovenia: ERM II Participation – The New Monetary Policy Challenge

After the economy had expanded by 2.3% in 2003, GDP growth accelerated to 3.7% year on year in the first quarter of 2004. Rising by 8% year on year, gross fixed capital formation delivered the largest domestic contribution to GDP growth. Private consumption grew at an unchanged rate of 3.7%, public consumption growth decelerated sharply and real net exports delivered a negative contribution of 1.2 percentage points to the overall growth rate, after weaker net exports had reduced growth by about 2 percentage points in 2003.

Table 28

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Real year-on-year change in %						
Gross domestic product	5.6	3.9	2.7	3.4	2.3	2.5	3.7
Private consumption	5.9	0.4	2.3	0.4	2.9	3.6	3.7
Public consumption	2.9	2.3	3.9	2.5	1.9	1.9	0.6
Gross fixed capital formation	21.0	0.6	4.1	2.6	5.4	5.5	8.0
Exports of goods and services	1.6	13.0	6.3	6.8	3.1	4.1	8.8
Imports of goods and services	8.0	7.6	3.0	4.8	6.4	6.9	10.4
	Contribution to GDP growth in percentage points						
Domestic demand	9.4	1.5	1.0	2.4	4.3	4.4	4.9
Exports	0.9	7.1	3.5	3.9	1.9	2.6	5.6
Net exports	−3.9	2.4	1.7	1.0	−2.0	−2.0	−1.2

Source: Eurostat, national statistical office, OeNB.

In the first half of 2004, average net wages in the total economy (deflated by the CPI) rose by 1.7% year on year. This was slightly below the 2003 average, although labor market conditions were somewhat tighter, with the unemployment rate declining to 6.8% in the first quarter of 2004 from 7% one year earlier. Further progress has been achieved in the deindexation of wages by concluding a wage agreement for the private sector as well. Since the fourth quarter of 2003, the annual increase in industrial unit labor costs has been clearly below industrial producer price inflation.

The inflation rate fell to a record low of 3.5% in March 2004. Further deindexation, the slowing down of the tolar's depreciation rate, the restraint in raising regulated prices, temporary anti-inflationary changes to the fuel tax regime and – until mid-2003 – the slowdown of economic activity supported disinflation. However, inflation picked up to between 3.8% and 3.9% between May and July 2004, with inflation rising in a few categories only (primarily clothing, energy, and recreation and culture), while easing in the majority of categories. Banka Slovenije, the Slovenian central bank, forecasts inflation to come to 3.2% year on year in the fourth quarter of 2004.

On June 27, 2004, Slovenia entered ERM II. The central rate was fixed at the then prevailing market rate of SIT/EUR 239.64, and a standard fluctuation band of ±15% around the central rate was agreed upon. Since then, the exchange rate has fluctuated in a narrow range of between 0.07% and 0.17% on the weak side of the central rate. In the run-up to ERM II entry and encouraged by the decline in inflation, Banka Slovenije has continued to frequently cut various key interest rates by between 200 and 250 basis points in total since the

Table 29

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	4.9	4.0
Labor productivity of industry (real)	0.9	6.8	2.3	1.4	3.0	6.5	5.5
Gross average wage of industry (nominal)	9.3	11.7	10.8	9.9	7.6	7.0	7.9
Unit labor cost of industry (nominal)	8.3	4.6	8.4	8.3	4.4	0.5	2.2
Producer price index (PPI) of industry	2.2	7.7	8.9	5.3	2.6	2.3	3.3
Consumer price index (HICP)	6.1	8.9	8.6	7.5	5.7	5.0	3.7
Exchange rate (nominal):							
SIT[1] per 1 EUR, + = EUR appreciation	4.6	6.3	5.5	3.6	3.5	3.0	2.8
EUR per 1 SIT, + = SIT appreciation	−4.4	−5.9	−5.2	−3.5	−3.4	−2.9	−2.7
	Period average levels						
Unemployment rate (ILO definition, %)	7.4	6.7	6.2	6.3	6.7	6.7	6.8
Key interest rate per annum (%)	7.2	8.1	10.5	8.4	7.0	6.2	5.6
Exchange rate (nominal):							
SIT[1] per 1 EUR	194.43	206.63	217.98	225.93	233.82	236.14	237.65
EUR per 1 SIT	0.0051	0.0048	0.0046	0.0044	0.0043	0.0042	0.0042

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

beginning of 2004. Money market rates fell in tandem and the three-month interest rate differential between Slovenia and the euro area halved between January and August 2004, coming to 1.9 percentage points at end-August. Real interest rates (as measured by the differential between the 12-month interbank rate and the year-on-year CPI rate) fell from 2% in February 2004 to 0% by July, while domestic credit growth continued to accelerate, in particular lending to enterprises.

Table 30

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	8.0	5.8
	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	−2.4	−5.3
Domestic credit (net) of the banking system	. .	15.1	14.4	12.2	11.2	14.4	15.7
of which: claims on the private sector	. .	*15.1*	*12.6*	*9.1*	*8.7*	*9.6*	*10.4*
claims on households	. .	*4.4*	*2.0*	*1.6*	*2.2*	*1.6*	*2.0*
claims on enterprises	. .	*10.7*	*10.6*	*7.5*	*6.5*	*8.0*	*8.4*
net claims on the public sector	. .	*0.0*	*1.7*	*3.2*	*2.4*	*4.8*	*5.3*
Other domestic assets (net) of the banking system	. .	−4.4	−4.2	−0.4	−1.8	−4.1	−4.6

Source: National central bank, OeNB.

Fiscal policy in Slovenia has remained on a solid footing. The government aims at a general government budget deficit of 1.9% of GDP (ESA 95 definition) this year, slightly above last year's 1.8% deficit. According to the government's convergence program presented in May 2004, deficit reduction will be resumed in 2005 with a deficit of 1.8%, and the deficit ratio is envisaged to drop below 1% in 2007. Parliamentary elections will be held at the beginning of October 2004.

Table 31

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	43.0	42.5	43.1	43.3	44.0	45.1	44.0
Expenditures	45.1	45.6	45.8	45.8	45.8	47.0	45.7
of which: interest payments	*2.3*	*2.2*	*2.2*	*2.4*	*. .*	*. .*	*. .*
Balance	−2.1	−3.0	−2.7	−1.9	−1.8	−1.9	−1.8
Primary balance	0.2	−0.9	−0.5	−0.1	−0.3	−0.3	−0.4
Gross public debt	25.1	26.7	26.9	27.8	28.6	29.1	29.5

Source: European Commission, Eurostat, national ministry of finance (2003–2005: Convergence program May 2004), OeNB.

Following a balanced current account in 2003, Slovenia registered a small surplus of 0.8% of GDP during the first quarter of 2004 (Q1 2003: –0.4%). By the end of April, however, a deficit had emerged, which – at EUR 25 million – was double that of April 2003, owing to a widening of the trade deficit. The FDI account continued to register a net outflow of capital.

Table 32

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	8,071	9,506	10,420	11,098	11,427	2,763	2,985
Merchandise exports: year-on-year change in %	*−0.4*	*17.8*	*9.6*	*6.5*	*3.0*	*2.9*	*8.0*
Merchandise imports	9,230	10,722	11,100	11,363	11,971	2,915	3,087
Merchandise imports: year-on-year change in %	*4.7*	*16.2*	*3.5*	*2.4*	*5.3*	*5.0*	*5.9*
Trade balance	−1,159	−1,216	−680	−265	−544	−151	−102
% of GDP	*−6.2*	*−5.9*	*−3.1*	*−1.1*	*−2.2*	*−2.7*	*−1.7*
Services balance	329	486	534	629	541	140	138
Income balance (factor services balance)	57	28	43	−176	−73	−23	2
Current transfers	111	124	143	142	93	9	8
Current account balance	−661	−579	38	330	17	−25	46
% of GDP	*−3.5*	*−2.8*	*0.2*	*1.4*	*0.1*	*−0.4*	*0.8*
Direct investment flows (net)	55	76	252	1,611	−109	−64	−22
% of GDP	*0.3*	*0.4*	*1.2*	*6.9*	*−0.4*	*−1.1*	*−0.4*

Source: Eurostat, national central bank, OeNB.

The ongoing increase in the country’s gross foreign debt has turned Slovenia into a net debtor since end-2003. Nevertheless, at the end of March 2004 net foreign debt was negligible at 0.9% of annual GDP.

Table 33

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (excluding gold)	3,159	3,436	4,908	6,702	6,798	6,791
Gross external debt	8,012	9,491	10,403	11,483	12,994	13,491
	% of GDP[1]					
Gross official reserves (excluding gold)	16.8	16.7	22.5	28.5	27.8	27.3
Gross external debt	42.7	46.1	47.6	48.8	53.1	54.3
	Import months of goods and services					
Gross official reserves (excluding gold)	3.6	3.4	4.6	6.1	5.9	5.8

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

7 Bulgaria: High Current Account Deficit Leads to Attempts to Restrain Credit Growth

Real GDP in Bulgaria grew by 5.3% year on year in the first quarter of 2004, up from 4.3% in full-year 2003. A very high growth in domestic demand and increasingly negative net exports continued to characterize the economy. In the first quarter, growth of domestic consumption (private and public) moderated to 5.2% year on year, roughly matching the level of GDP growth, compared to 6.6% in full-year 2003 and 7.0% in the fourth quarter. Gross fixed capital formation boomed at a growth rate of 21.4%, fueled by enhanced profitability and credit expansion. This investment boom caused imports to grow by 17.7% and thus outpace export growth by an even higher rate than previously. The resulting deterioration in net exports reduced GDP growth by 11.5 percentage points, after dampening growth by 7.2 percentage points in full-year 2003.

Table 34

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003[1]	Q1 2004[1]
	Real year-on-year change in %						
Gross domestic product	2.4	5.4	4.1	4.9	4.3	4.9	5.3
Private consumption	9.6	4.3	5.2	3.5	6.4	6.5	4.9
Public consumption	6.3	18.8	0.3	4.4	7.3	10.2	6.9
Gross fixed capital formation	20.8	15.4	23.3	8.5	13.8	10.0	21.4
Exports of goods and services	–4.6	16.6	9.9	7.2	7.9	5.3	8.0
Imports of goods and services	9.3	18.7	14.8	4.9	14.8	13.9	17.7
	Contribution to GDP growth in percentage points						
Domestic demand	11.4	8.7	9.2	4.3	11.5	13.5	16.8
Exports	–2.8	9.3	6.1	4.7	5.3	3.1	5.7
Net exports	–8.9	–3.3	–5.1	0.6	–7.2	–8.6	–11.5

Source: Eurostat, OeNB, wiiw.
[1] In this column, public consumption covers only collective consumption.
Private consumption in this column additionally includes the difference between public and collective consumption.

The remarkable labor productivity advances in industry since 2002 have been based on the expansion of production and not on further labor shedding. This trend contributed to a decrease in the unemployment rate (ILO definition) to 13.4% in the first quarter of 2004, down from 15.6% a year earlier. Industrial unit labor costs continue to decline if measured on the basis of gross production, while remaining roughly constant on the basis of gross value added. Thus, the rise in industrial producer prices, while moderating, implied a substantial increase in corporate sector profitability.

Inflation (HICP) accelerated from an annual average of 2.3% in 2003 to 6.7% year on year in the second quarter of 2004, on account of a drought-related jump in food prices, increases in excise taxes (on alcohol and tobacco) at the beginning of 2004, and particularly the continuing credit boom.

Table 35

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	–9.6	5.3	2.5	4.7	15.3	17.2	17.0
Labor productivity of industry (real)	1.2	10.0	7.6	2.2	12.0	15.2	16.6
Gross average wage of industry (nominal)	8.0	6.6	7.4	3.7	4.5	6.1	5.9
Unit labor cost of industry (nominal)	6.7	–3.1	–0.2	1.4	–6.7	–7.9	–9.2
Producer price index (PPI) of industry	3.2	17.0	3.8	1.4	5.0	4.5	1.9
Consumer price index (HICP)	2.6	10.3	7.4	5.8	2.3	4.7	6.4
Exchange rate (nominal):							
BGN[1] per 1 EUR, + = EUR appreciation	–0.7	–0.2	–0.2	0.1	0.0	0.0	–0.1
EUR per 1 BGN, + = BGN appreciation	0.7	0.2	0.2	–0.1	0.0	0.0	0.1
	Period average levels						
Unemployment rate (ILO definition, %)	. .	16.9	20.3	18.2	13.7	12.7	13.4
Key interest rate per annum (%)	4.7	3.9	4.5	4.0	2.7	2.6	2.5
Exchange rate (nominal):							
BGN[1] per 1 EUR	1.96	1.95	1.95	1.95	1.95	1.95	1.95
EUR per 1 BGN	0.5113	0.5123	0.5133	0.5130	0.5131	0.5130	0.5124

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

[1] *BGN: Bulgarian lev.*

Domestic demand growth was partly driven by strong growth in credit to the private sector (households and enterprises), which have accelerated since the first quarter of 2001. In the first quarter of 2004, nominal private credit grew by about 50% year on year, with claims on the corporate sector expanding by more than 40% and claims on households by around 80%. However, despite the monetary expansion of recent years, monetization in Bulgaria (measured by the ratio of broad money to nominal GDP) is still comparatively low at 42.5%.

Table 36

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	20.5	21.3
	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	3.8	2.7
Domestic credit (net) of the banking system	2.0	6.8	15.0	12.1	14.5	18.2	20.6
of which: claims on the private sector	*9.5*	*8.7*	*8.1*	*13.6*	*19.9*	*22.7*	*24.4*
claims on households	*2.6*	*1.1*	*2.4*	*3.3*	*5.9*	*7.6*	*8.5*
claims on enterprises	*6.9*	*7.7*	*5.7*	*10.3*	*14.0*	*15.1*	*15.8*
net claims on the public sector	*–7.4*	*–2.0*	*6.9*	*–1.5*	*–5.4*	*–4.4*	*–3.8*
Other domestic assets (net) of the banking system	6.0	–5.5	–0.7	–1.5	–3.6	–1.5	–1.9

Source: National central bank, OeNB.

In order to reduce the level of liquidity in the banking system, the Ministry of Finance transferred fiscal reserves from commercial banks to Balgarska Narodna Banka (BNB), the Bulgarian central bank. On May 20, 2004, heeding an IMF recommendation, the BNB extended the coverage of minimum reserve requirements to include deposits of over two years with effect from July 1, 2004, albeit at the reduced rate of 4% (against the standard rate of 8%). The minimum reserve rate is the main remaining monetary policy tool within the framework of the Currency Board Arrangement (CBA), which has been in place in Bulgaria since mid-1997.

Table 37

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	. .	. .	. .	38.7	38.6	37.5	37.1
Expenditures	. .	. .	. .	39.4	39.4	38.2	37.7
of which: interest payments	. .	. .	. .	. .	. .	. .	. .
Balance	. .	−0.5	0.2	−0.7	−0.8	−0.7	−0.6
Primary balance	. .	. .	. .	1.5	1.5	1.7	2.1
Gross public debt	. .	73.6	66.2	56.2	50.5	45.8	42.7

Source: 2000–2001: European Commission, 2002–2005: Preaccession Economic Program 2003.
Note: Gross debt excluding social security and local government debt.

While the Preaccession Economic Program (PEP) presented in autumn 2003 provided for a fiscal deficit target of 0.7% of GDP for 2004, this target was lowered to 0.4% of GDP in April in accordance with IMF recommendations to contain the external deficit, given that the actual fiscal result for 2003 was not a deficit of 0.8% of GDP as expected in the PEP, but a balanced budget. In the first half of 2004, the budget surplus came to about 5% of this period's GDP and was thus higher than in the comparable period of 2003 (4% of GDP), since revenues grew at a faster pace than expenditures in real terms. At the end

Table 38

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	3,734	5,253	5,714	6,063	6,668	1,635	1,718
Merchandise exports: year-on-year change in %	*−0.3*	*40.7*	*8.8*	*6.1*	*10.0*	*20.5*	*5.1*
Merchandise imports	4,742	6,533	7,493	7,755	8,868	1,926	2,227
Merchandise imports: year-on-year change in %	*16.3*	*37.8*	*14.7*	*3.5*	*14.4*	*17.3*	*15.7*
Trade balance	−1,008	−1,280	−1,779	−1,692	−2,200	−290	−509
% of GDP	*−8.3*	*−9.3*	*−11.7*	*−10.2*	*−12.5*	*−7.8*	*−12.3*
Services balance	305	547	454	486	523	−58	−34
Income balance (factor services balance)	−167	−345	−340	−285	−441	−154	−133
Current transfers	282	316	562	566	613	127	175
Current account balance	−587	−762	−1,102	−926	−1,505	−375	−502
% of GDP	*−4.8*	*−5.6*	*−7.2*	*−5.6*	*−8.5*	*−10.0*	*−12.2*
Direct investment flows (net)	759	1,100	893	951	1,235	258	327
% of GDP	*6.2*	*8.0*	*5.9*	*5.7*	*7.0*	*6.9*	*7.9*

Source: Eurostat, national central bank, OeNB.

of July, the Bulgarian government approved a 0.5%-of-GDP deficit target for the election year 2005.

In the first quarter of 2004, the current account deficit climbed to 12.2% of GDP – a rise that was attributable exclusively to the significant weakening of the trade balance due to differences between domestic and foreign real demand growth and the further rise in oil prices. However, price competitiveness did not deteriorate, as the real exchange rate based on industrial unit labor costs slightly depreciated in 2003 and at the beginning of 2004. In the first quarter of 2004, net FDI inflows covered about 60% of the current account gap – significantly less than in 2002 and 2003.

In the first quarter of 2004, gross external debt increased markedly, reflecting both the current account deficit in excess of net FDI inflows and the weakening of the euro against the U.S. dollar. Foreign currency reserves remained constant at EUR 5.0 billion, corresponding to about 5.5 months of import cover.

Table 39

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (excluding gold)	2,879	3,391	3,734	4,247	4,981	5,038
Gross external debt	10,864	12,038	12,046	10,769	10,476	11,168
	% of GDP[1]					
Gross official reserves (excluding gold)	23.7	24.7	24.5	25.6	28.2	27.9
Gross external debt	89.3	87.8	79.0	64.9	59.3	61.9
	Import months of goods and services					
Gross official reserves (excluding gold)	5.6	4.9	4.8	5.2	5.4	5.5

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

Structural reforms have continued, albeit at a slower pace. Bank privatization has been completed, and the long-delayed sale of Bulgaria Telecom Company was finalized in June 2004, leading to a rise in net FDI by about 10% year on year in the first quarter of 2004. Looking ahead, the completion of key privatization projects by end-2004, including the sale of Bulgartabak, the reform of the energy and railway sectors and of the health and education systems, the enactment of judicial reforms and the improvement of state administration will be important further areas of structural and institutional change.

8 Croatia: Toward the Stabilization of External Debt?

Economic activity in Croatia remained strong in the first quarter of 2004, with real GDP growth amounting to 4.2%, after 4.3% in full-year 2003. Gross fixed capital formation slowed considerably, but still rendered almost the same contribution to GDP growth as private consumption, which remained more or less stable. At the same time, public consumption contracted even more strongly. Although import growth slowed down to below the export growth rate, the higher base level of imports implied a further deterioration of net exports, which dampened GDP growth by about 1 percentage point, after it had reduced growth by 1.5 percentage points in full-year 2003.

As of January 2004, Hrvatska narodna banka (HNB), the Croatian central bank, changed its methodology of calculating the inflation rate. The Retail Price

Table 40

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Real year-on-year change in %						
Gross domestic product	−0.9	2.9	4.4	5.2	4.3	3.3	4.2
Private consumption	−2.9	4.2	4.5	7.5	4.1	3.6	3.9
Public consumption	2.8	−1.5	−6.2	−1.8	−0.3	−0.1	−1.6
Gross fixed capital formation	−3.9	−3.8	7.1	12.0	16.8	14.8	8.9
Exports of goods and services	0.7	12.0	8.1	1.3	10.1	12.3	6.4
Imports of goods and services	−3.5	3.7	9.8	8.8	10.9	13.1	5.9
	Contribution to GDP growth in percentage points						
Domestic demand	−3.0	−0.3	5.8	9.4	5.8	6.3	5.1
Exports	0.3	5.1	3.7	0.6	4.6	4.8	2.4
Net exports	2.1	3.2	−1.4	−4.2	−1.5	−3.0	−0.9

Source: National statistical office, OeNB.

Index (RPI) and the Cost of Living Index (COLI) were replaced by the Consumer Price Index (CPI), which is in line with Eurostat standards. The main differences are in the number and classification of items, the weighting scheme, the formula used and the adjustment for quality changes. The biggest discrepancy can be observed in 2002, when CPI inflation was 0.6 percentage point below RPI inflation.

After year-on-year CPI inflation came to 1.8% in full-year 2003 and 1.9% in the first quarter of 2004, it rose to 2.5% in June 2004, mainly driven by higher prices of energy and (mostly administered or regulated) services. However, CPI inflation slowed down in July to 1.9%, with the changes in oil prices (30.3% year on year) being the remaining inflation-driving factor.

Table 41

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	−1.5	1.8	6.1	5.5	4.1	1.3	5.4
Labor productivity of industry (real)	1.6	4.4	7.8	7.8	3.5	−0.1	7.8
Gross average wage of industry (nominal)	5.6	6.1	8.2	6.9	5.4	3.5	5.6
Unit labor cost of industry (nominal)	3.8	1.6	0.4	−0.8	1.8	3.6	−2.1
Producer price index (PPI) of industry	2.5	9.5	3.4	−0.5	1.9	0.6	0.1
Consumer price index (CPI)[1]	4.3	6.4	5.0	1.7	1.8	1.8	1.9
Exchange rate (nominal):							
HRK[2] per 1 EUR, + = EUR appreciation	6.2	0.7	−2.2	−0.8	2.1	2.5	0.4
EUR per 1 HRK, + = HRK appreciation	−5.8	−0.7	2.2	0.9	−2.1	−2.4	−0.4
	Period average levels						
Unemployment rate (registered unemployed, %)	19.1	21.1	22.0	22.3	19.5	18.9	19.1
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	7.58	7.64	7.47	7.41	7.56	7.62	7.61
EUR per 1 HRK	0.1319	0.1310	0.1339	0.1350	0.1322	0.1312	0.1313

[1] Retail price index until 2001, CPI since 2002.
[2] HRK: Croatian kuna.

The HNB discount rate has been at a low of 4.5% since September 2002. The Croatian kuna appreciated from about 7.7 HRK/EUR in early 2003 to about 7.45 HRK/EUR in mid-2003 and then depreciated back to 7.7 HRK/EUR. By mid-2004, the kuna had appreciated again to 7.35 HRK/EUR, reflecting the usual tourism peak in the summer season. The HNB's exchange rate regime is a managed float regime, with the HNB intervening if it deems intervention necessary. However, interventions have become less frequent recently: after 22 and 16 official interventions, respectively, in 2001 and 2002, the HNB conducted only 9 in 2003 and 9 from January until mid-August 2004.

Table 42

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	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	11.6	9.3
	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	−2.6	−1.3
Domestic credit (net) of the banking system	9.8	−1.2	21.1	23.2	19.5	14.6	10.8
of which: claims on the private sector	*5.9*	*−2.0*	*17.0*	*21.5*	*17.7*	*13.0*	*10.4*
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*3.9*	*0.9*	*4.1*	*1.7*	*1.8*	*1.7*	*0.4*
Other domestic assets (net) of the banking system	−3.4	−5.1	−3.6	−0.5	−0.5	−0.5	−0.1

Source: National central bank, OeNB.

In 2003, the general government deficit in Croatia stood at 5.5% of GDP, as in 2002. The deficit of the consolidated central government climbed to 2.9% in 2003 because of higher-than-expected expenditure increases. The 2004 consolidated central government budget provides for a deficit of 2.7% of GDP. In the first four months of 2004, the corresponding deficit was more than 60% higher than in the comparable period of 2003, as revenues (+7%) grew at a slower pace than expenditures (+13%), primarily because of a strong increase in capital expenditures. After exploding from 26% of GDP in 1998 to 39.5% of GDP in 2000, public sector debt went up only slightly to 43% of GDP in 2003. 61% of public sector debt was denominated in foreign currencies.

Table 43

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
Consolidated central government							
Revenues	47.7	43.8	42.8	39.6	42.0	. .	. .
Expenditures	49.7	48.8	45.2	41.6	44.9	. .	. .
of which: interest payments	*1.5*	*1.7*	*1.8*	*1.8*	*1.9*	. .	. .
Balance	−2.0	−5.0	−2.4	−2.0	−2.9	. .	. .
Primary balance	−0.3	−2.3	−0.8	−0.1	0.7	. .	. .
Gross public debt	33.0	39.5	40.6	41.1	43.2	. .	. .

Source: National ministry of finance.

The deficit of the trade balance has been widening from the early 1990s to reach a record low at 26.9% of GDP in 2003. Exports gained momentum, but were not able to fully compensate the constantly high import growth. However, the increasingly positive balance of services based on tourism and rising transfers from Croatians abroad kept the annual current account deficit in single digits over the last few years. In the first quarter of 2004, the current account deficit stood at 19.3% of GDP as against 17.4% of GDP a year earlier. FDI inflows roughly matched the current account deficits from 1999 to 2003, with the exception of the year 2002.

Table 44

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	4,205	4,976	5,341	5,212	5,464	1,375	1,502
Merchandise exports: year-on-year change in %	*3.6*	*18.3*	*7.3*	*−2.4*	*4.8*	*14.5*	*9.3*
Merchandise imports	7,374	8,477	9,961	11,084	12,329	2,717	2,945
Merchandise imports: year-on-year change in %	*−3.8*	*15.0*	*17.5*	*11.3*	*11.2*	*11.5*	*8.4*
Trade balance	−3,168	−3,502	−4,620	−5,872	−6,865	−1,342	−1,442
% of GDP	*−17.0*	*−17.5*	*−20.8*	*−24.2*	*−26.9*	*−23.2*	*−23.3*
Services balance	1,556	2,543	3,254	3,236	4,965	251	191
Income balance (factor services balance)	−340	−441	−587	−543	−1,055	−222	−219
Current transfers	605	963	1,085	1,123	1,214	304	277
Current account balance	−1,348	−436	−867	−2,056	−1,741	−1,010	−1,194
% of GDP	*−7.2*	*−2.2*	*−3.9*	*−8.5*	*−6.8*	*−17.4*	*−19.3*
Direct investment flows (net)	1,385	1,159	1,575	617	1,598	274	195
% of GDP	*7.4*	*5.8*	*7.1*	*2.5*	*6.3*	*4.7*	*3.2*

Source: Eurostat, national central bank, OeNB.

Gross external debt as a percentage of GDP has been on a steady rise from around 20% in the mid-1990s to 75.7% at the end of the first quarter of 2004. It augmented significantly in 2003 because of the results of the public and the private (banking and corporate) sectors. In order to contain the private sector credit boom, which is based on foreign liabilities incurred by banks, the monetary authorities tightened the liquidity belt at the beginning of 2003: Commercial banks whose loan portfolio was growing by more than 4% quarter on quarter were required to buy low-interest HNB bills worth twice as much as their lending above the 4% threshold. Also, banks were ordered to hold 35% of their foreign exchange-denominated liabilities in liquid foreign exchange-denominated assets, and reserve requirements were tightened as well.

Table 45

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (excluding gold)	3,013	3,783	5,334	5,651	6,554	6,179
Gross external debt	9,932	11,880	12,841	14,710	18,652	19,629
	% of GDP[1]					
Gross official reserves (excluding gold)	16.1	18.9	24.0	23.3	25.7	23.8
Gross external debt	53.2	59.4	57.9	60.7	73.1	75.7
	Import months of goods and services					
Gross official reserves (excluding gold)	3.9	4.3	5.3	5.0	5.3	5.2

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

In 2003, privatization was mostly shaped by a single sale, that of a minority stake in the oil firm INA to Hungarian MOL for some EUR 446 million. The new conservative government elected in November 2003 announced that it would step up efforts to complete the privatization process by 2006. Upcoming privatizations concern Croatia Telecom and the sale of further stakes of INA. The remaining two state-owned banks, an insurance company, nearly 150 hotels, numerous agricultural firms and shipyards are still awaiting privatization.

9 Romania: On the Road toward Sustainable Economic Expansion?

Following economic growth rates of 4.9% in 2003, real GDP increased by 6.1% year on year in the first quarter of 2004. As in 2003, export growth and private consumption growth were the most important contributors to GDP growth. Strong household consumption was fueled by vigorous consumer credit growth and increasing wages, real net wages rising by 9.7% year on year in the first quarter of 2004. The robust growth of domestic consumption (private and public) continued to exceed the level of GDP growth, increasing further to 8.1% year on year, from 6.9% in full-year 2003 and 6.8% in the fourth quarter. By contrast, growth of gross fixed capital formation declined to 7.3%. Net exports of goods and services continued to deteriorate and thus dampened GDP growth, albeit to a smaller degree than in full-year 2003.

Table 46

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004[1]
	Real year-on-year change in %						
Gross domestic product	–1.2	2.1	5.7	5.0	4.9	4.6	6.1
Private consumption	–1.1	–0.8	6.9	5.2	7.3	7.2	8.4
Public consumption	. .	. .	3.9	–9.4	5.0	5.1	4.1
Gross fixed capital formation	–4.8	5.5	10.1	8.2	9.2	11.0	7.3
Exports of goods and services	. .	23.4	12.1	17.6	11.1	17.6	10.2
Imports of goods and services	. .	27.1	18.4	12.0	16.3	23.8	12.4
	Contribution to GDP growth in percentage points						
Domestic demand	. .	. .	8.8	4.1	7.7	8.0	7.7
Exports	. .	. .	4.0	5.9	3.9	5.1	4.8
Net exports	. .	. .	–3.1	0.9	–2.8	–3.4	–1.6

Source: Eurostat, OeNB, wiiw.

[1] *In this column, public consumption covers only collective consumption.*
Private consumption in this column additionally includes the difference between public and collective consumption.

In the first half of 2004, industrial output increased by 4.2% year on year, with growth slowing down in the second quarter. As in 2003, labor productivity was enhanced by labor shedding in the first quarter, while high wage growth continued to induce nominal unit labor cost growth. The resulting substantial increases in industrial producer prices still exceed inflation (HICP). This may undermine the impressive success of efforts directed at disinflation, i.e. tighter monetary policy and fiscal consolidation. (Inflation was brought down from 45.8% to 15.3% between 1999 and 2003.) Nevertheless, inflation slowed to 12.3% year on year in May 2004. After the key policy rate (reference rate) had been held constant at 21.25% since the beginning of the year, it was cut to 20.75% in June and to 20.00% in July. In two steps, the reference rate was further reduced to 18.75% in August, in response to the continued disinflation process. The authorities have announced a gradual shift to an inflation targeting strategy beginning in 2005.

Table 47

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	0.9	5.7
Labor productivity of industry (real)	7.2	12.5	11.6	5.4	5.2	3.1	8.4
Gross average wage of industry (nominal)	44.0	41.7	51.1	23.6	19.5	19.8	24.0
Unit labor cost of industry (nominal)	34.3	25.9	35.4	17.2	13.6	16.1	14.4
Producer price index (PPI) of industry	41.6	53.8	38.7	23.2	19.6	19.2	18.0
Consumer price index (CPI)	45.8	45.7	34.5	22.5	15.3	14.8	13.6
Exchange rate (nominal): ROL[1] per 1 EUR, + = EUR appreciation	63.8	22.0	30.5	20.1	20.2	18.8	13.9
EUR per 1 ROL, + = ROL appreciation	−39.0	−18.1	−23.4	−16.8	−16.8	−15.8	−12.2
	Period average levels						
Unemployment rate (ILO definition, %)	6.9	7.2	6.7	8.4	7.1	6.8	. .
Key interest rate per annum (%)	35.0	35.0	35.0	29.6	18.8	19.7	21.1
Exchange rate (nominal): ROL[1] per 1 EUR	16 326.75	19 926.00	26 000.25	31 234.75	37 543.00	39 735.00	40 550.00
EUR per 1 ROL	0.0001	0.0001	0.0000	0.0000	0.0000	0.0000	0.0000

[1] ROL: Romanian leu.

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

Credit to the private sector is booming, with growth further accelerating to 47% in CPI-deflated terms in the first quarter of 2004 from 37% in full-year 2003. However, the growth of credits to households has slowed down over the past months, as Banka Naţională a României, the central bank of Romania,

Table 48

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	28.1	26.2
	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	11.6	6.2
Domestic credit (net) of the banking system	42.3	14.0	10.2	18.7	23.9	25.6	28.3
of which: claims on the private sector	*24.3*	*3.6*	*18.3*	*24.1*	*28.2*	*33.7*	*34.5*
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*17.9*	*10.3*	*−8.1*	*−5.3*	*−4.3*	*−8.1*	*−6.2*
Other domestic assets (net) of the banking system	−1.0	−12.0	−12.6	−9.6	−8.3	−9.1	−8.2

Source: National central bank, OeNB.

has introduced stricter rules on granting credits to private households. Regarding exchange rate policy, the authorities have followed a managed float strategy with a focus on both the external balance and disinflation for several years. In July 2005, the national currency, the leu, will be redenominated by slashing four zeros off the currency.

Table 49

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	. .	. .	. .	36.4	37.0	36.7	35.7
Expenditures	. .	. .	. .	38.6	39.5	39.9	38.9
of which: interest payments	. .	. .	. .	. .	. .	. .	. .
Balance	. .	−4.4	−3.5	−2.2	−2.5	−3.2	−3.2
Primary balance	. .	. .	. .	0.3	−0.6	−1.4	−1.5
Gross public debt	. .	23.9	23.2	22.7	22.3	22.7	24.2

Source: 2000–2001: European Commission, 2002–2005: Preaccession Economic Program 2003.

Within the 24-month Stand-By Arrangement approved in July by the IMF, which provides Romania with SDR 250 million, the target for the general fiscal deficit in 2004 was reduced to 2.1% of GDP. Both this new target and the actual deficit in 2003 (2.0% of GDP) are below the deficit values envisaged in the Preaccession Economic Program presented in autumn 2003 (PEP 2003). For the years 2005 to 2008, the authorities forecast a gradual deficit increase reaching 2.7% by 2008. In the first quarter of 2004, the central government deficit of 1.5% of GDP was below that in the comparable period of 2003 (2.4%), despite forthcoming parliamentary elections in November 2004. According to the medium-term fiscal plan, in 2005, the corporate tax rate will be reduced from 25% to 19%, the upper-income tax rate from 40% to 38% and the lower-income tax rate from 18% to 14%. Excise tax rates are expected to be raised in order to bring them into line with European Union practices. On the expen-

Table 50

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	8,487	10,366	11,385	14,637	15,614	3,778	4,329
Merchandise exports: year-on-year change in %	*2.2*	*22.1*	*9.8*	*28.6*	*6.7*	*14.3*	*14.6*
Merchandise imports	9,744	12,050	14,354	17,400	19,569	4,191	4,933
Merchandise imports: year-on-year change in %	*−10.8*	*23.7*	*19.1*	*21.2*	*12.5*	*8.7*	*17.7*
Trade balance	−1,257	−1,684	−2,969	−2,763	−3,955	−413	−604
% of GDP	*−3.8*	*−4.2*	*−6.7*	*−5.8*	*−7.9*	*−4.5*	*−6.0*
Services balance	−395	−246	−115	−53	72	17	4
Income balance (factor services balance)	−411	−285	−282	−531	−592	−76	−94
Current transfers	626	860	1,143	1,614	1,639	323	425
Current account balance	−1,437	−1,355	−2,223	−1,733	−2,836	−149	−269
% of GDP	*−4.4*	*−3.4*	*−5.0*	*−3.6*	*−5.7*	*−1.6*	*−2.7*
Direct investment flows (net)	1,025	1,048	1,174	1,131	1,562	376	407
% of GDP	*3.1*	*2.6*	*2.6*	*2.4*	*3.1*	*4.1*	*4.1*

Source: National central bank, OeNB.

diture side, policymakers intend to reduce subsidies to loss-making firms and to follow a prudent wage policy in the public sector.

In 2003, the current account deficit reached 5.7% of GDP, while the trade deficit came to 7.9%. In the first half of 2004, the trade deficit worsened even further, reflecting the strong demand for both capital and consumer durable goods. As a result, the current account deficit of the first half of 2004 reached EUR 1.6 billion (first half of 2003: EUR 1.3 billion). As net inflows of FDI amounted to EUR 1.2 billion in the first half of 2004 (first half of 2003: EUR 0.8 billion), they may cover a larger part of the current account gap in full-year 2004 than in recent years, owing to large privatization projects, a more stabilized macroeconomic situation and, above all, the prospect of EU membership.

In the first quarter of 2004, gross official reserves increased, slightly raising the rather moderate level of import cover despite strong import growth.

Table 51

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (excluding gold)	1,520	2,655	4,445	5,877	6,374	6,725
Gross external debt (medium- and long-term)	8,735	11,044	13,507	14,648	15,396	15,809
	% of GDP[1]					
Gross official reserves (excluding gold)	4.6	6.7	10.0	12.3	12.7	13.2
Gross external debt (medium- and long-term)	26.5	27.7	30.4	30.6	30.8	31.1
	Import months of goods and services					
Gross official reserves (excluding gold)	1.6	2.3	3.2	3.5	3.5	3.6

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

On the structural side, Romania still has to cope with the phenomenon of soft budget constraints – and the resulting accumulation of substantial arrears, which is most widespread among state-owned enterprises and reflected, in particular, by the low collection rate of large utilities. The authorities are taking several measures to limit the accumulation of arrears, for example the acceleration of bankruptcy procedures and a more forceful restructuring of large state-owned, loss-making companies. Privatization is being stepped up: In July, a strongly debated privatization project was finally brought to a conclusion after repeated delays, when the Austrian OMV acquired the majority stake of the biggest Romanian company, the Petrom oil company.

10 Russia: Bank Alert and Continued Uncertainty over Yukos Affair against Backdrop of Strong Fundamentals and Growth

Real GDP growth accelerated to 7.3% in 2003 and, according to preliminary data, amounted to 7.4% year on year in the first half of 2004. Growth continued to benefit from high and rising oil and raw material prices, political stability under President Putin and the cumulative positive effect of economic reforms. In the first quarter of 2004, real export growth and private consumption growth on the back of strong wage and pension increases were the demand components that delivered the highest contribution to GDP growth with 6.3 and 6 percentage points, respectively. Notwithstanding its very high real growth rates of 14.1% year on year in the first quarter and 12.6% in the first half of 2004, gross fixed capital formation contributed considerably less to overall GDP growth (1.8 percentage points), given its still relatively low weight. Although the import volume is still far below that of exports, import growth exceeded export growth by so much that a deterioration of net exports resulted, dampening GDP growth in the first quarter by about 1 percentage point.

Table 52

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	Real year-on-year change in %						
Gross domestic product	6.3	9.0	5.1	4.7	7.3	7.6	7.4
Private consumption	−2.9	6.0	9.3	8.7	7.8	8.4	11.8
Public consumption	3.1	4.8	−0.8	2.6	2.2	1.9	2.5
Gross fixed capital formation	6.3	31.1	10.3	3.0	12.9	13.8	14.1
Exports of goods and services	11.3	9.6	4.2	9.6	13.7	16.1	12.6
Imports of goods and services	−17.1	30.5	18.7	14.6	19.5	20.4	24.1
	Contribution to GDP growth in percentage points						
Domestic demand	−2.0	11.6	7.3	4.1	6.8	7.0	8.3
Exports	4.7	4.2	1.9	4.2	6.3	7.7	6.3
Net exports	9.1	−1.9	−2.6	0.3	0.5	0.8	−0.9

Source: Eurostat, national statistical office, OeNB.

Industrial restructuring and modernization have been gathering momentum. Despite strong wage increases in industry, the rise in unit labor costs remained below that of producer prices in the first quarter of 2004. The unemployment rate (ILO definition) slightly declined to 7.9 % in June 2004 from 8.0% a year earlier. Given still buoyant increases of official reserves, limited sterilization instruments, swiftly expanding bank loans and periodic adjustments of regulated prices and tariffs, inflation (CPI) has only been declining slowly, reaching 10.5% in July 2004.

Table 53

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

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	7.6
Labor productivity of industry (real)	10.6	14.6	5.7	7.5	13.9	14.3	14.2
Gross average wage of industry (nominal)	46.7	42.1	52.0	27.2	25.4	26.6	24.9
Unit labor cost of industry (nominal)	32.6	24.0	43.8	18.3	10.1	10.8	9.3
Producer price index (PPI) of industry	59.1	46.5	19.1	11.7	15.6	12.6	19.0
Consumer price index (CPI)	85.7	20.8	21.6	16.0	13.6	12.5	10.8
Exchange rate (nominal):							
RUB[1] per 1 EUR, + = EUR appreciation	137.2	-0.8	0.4	13.5	16.5	9.8	5.4
EUR per 1 RUB, + = RUB appreciation	−57.8	0.8	−0.4	−11.9	−14.2	−8.9	−5.2
	Period average levels						
Unemployment rate (ILO definition, %)	12.6	10.5	9.0	8.0	8.3	8.0	8.9
Key interest rate per annum (%)	57.2	33.1	25.0	22.7	17.3	16.0	14.3
Exchange rate (nominal):							
RUB[1] per 1 EUR	26.24	26.03	26.13	29.65	34.55	34.90	35.83
EUR per 1 RUB	0.0381	0.0384	0.0383	0.0337	0.0289	0.0287	0.0279

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

[1] *RUB: Russian ruble.*

While the Central Bank of Russia aims at steadily reducing inflation, it also focuses on stemming appreciation tendencies of the ruble in order to avoid the "Dutch disease." But the two goals are partly inconsistent, which gives rise to recurring difficulties.

Table 54

Monetary Developments

	1999	2000	2001	2002	2003	Q4 2003	Q1 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	39.7	39.9
	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	16.5	18.1
Domestic credit (net) of the banking system	120.4	30.5	22.8	30.4	29.6	30.9	25.7
of which: claims on the private sector	*43.5*	*36.7*	*35.2*	*28.9*	*29.5*	*34.3*	*32.1*
claims on households	..	..	..	..	..	..	..
claims on enterprises	..	..	..	..	..	..	..
net claims on the public sector	*76.9*	*−6.2*	*−12.4*	*1.5*	*0.2*	*−3.4*	*−6.4*
Other domestic assets (net) of the banking system	−64.4	−29.1	−22.9	−19.1	−11.7	−7.8	−3.9

Source: National central bank, OeNB.

Russia easily maintained its twin surpluses in 2003, with the government budget showing a surplus for the fifth year in a row. The federal government's budget posted a surplus of 1.7% of GDP, the consolidated budget (comprising all three regional levels of government) showed a surplus of 1.4% (2002: 0.9%) and the enlarged government overall balance (used by the IMF) came to a surplus of 1.1%. In the first five months of 2004, the federal government surplus is estimated at 1.8% of GDP. The sustained surplus position can be attributed to high oil revenues and economic growth, but also to successful tax reforms since 2001 (introduction of a personal income flat tax rate at 13%, reduction of corporate income tax rates and scrapping of a number of tax exemptions). In early 2004, the fiscal authorities established a stabilization fund into which oil-related budget revenues flow when the price of Urals grade crude fetches over USD 20 per barrel. This fund is expanding quickly and reached RUB 199 billion (EUR 5.7 billion) at end-May 2004.

Table 55

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
Federal government							
Revenues	12.5	15.4	17.8	20.3	19.4	17.9	17.2
Expenditures	13.8	13.2	14.8	18.5	17.7	17.4	16.1
of which: interest payments	*3.4*	*2.4*	*2.6*	*2.1*	*1.7*	..	..
Balance	−1.3	2.2	3.0	1.8	1.7	0.5	1.0
Primary balance	2.1	4.6	5.6	3.9	3.4	..	..
Gross public debt	..	..	..	..	..	..	..

Note: Data for the period from 2004 to 2005 according to budget law.
Source: Economic Expert Group.

Following a current account surplus of EUR 32 billion or 8.3% of GDP in 2003, on the back of a sizeable trade surplus, the current account surplus came to a preliminary 9% of GDP in the first half of 2004. Given the rather difficult business climate for foreigners, FDI inflows are much lower than the country's enormous economic potential would suggest. Despite the launching of some important oil extraction projects, there was actually a net outflow of FDI in 2003, which continued in the first months of 2004. Foreign investors' reluctance has not been eased by the authorities' unrelenting pursuit of the country's largest oil firm, Yukos, and its founder and what appears to be a selective enforcement of the rule of law. This may weaken property rights.

Table 56

Balance of Payments

	1999	2000	2001	2002	2003	Q1 2003	Q1 2004
	EUR million						
Merchandise exports	71,210	114,379	113,843	113,201	120,040	28,963	29,838
Merchandise exports: year-on-year change in %	*7.1*	*60.6*	*−0.5*	*−0.6*	*6.0*	*16.0*	*3.0*
Merchandise imports	37,168	48,934	60,138	64,278	66,508	14,752	15,360
Merchandise imports: year-on-year change in %	*−28.8*	*31.7*	*22.9*	*6.9*	*3.5*	*4.7*	*4.1*
Trade balance	34,042	65,444	53,705	48,923	53,532	14,211	14,479
% of GDP	*18.6*	*23.1*	*15.7*	*13.4*	*13.9*	*16.7*	*14.4*
Services balance	−4,034	−7,254	−10,227	−10,439	−9,773	−1,928	−2,012
Income balance (factor services balance)	−7,291	−7,353	−4,756	−6,856	−11,441	−1,310	−2,072
Current transfers	578	65	−912	−808	−333	−144	14
Current account balance	23,295	50,903	37,810	30,821	31,984	10,828	10,408
% of GDP	*12.7*	*18.0*	*11.0*	*8.5*	*8.3*	*12.7*	*10.4*
Direct investment flows (net)	1,042	−500	250	−49	−2,508	729	−262
% of GDP	*0.6*	*−0.2*	*0.1*	*0.0*	*−0.7*	*0.9*	*−0.3*

Source: National central bank, OeNB.

Russia's gross external debt slightly grew to EUR 152.9 billion at end-March 2004, but declined to 38.2% relative to GDP. Meanwhile, gross official reserves (excluding gold) rose to EUR 65.2 billion or a comfortable 9.5 import months worth of goods and services.

Table 57

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q1 2004
	End of period in EUR million					
Gross official reserves (excluding gold)	8,387	26,139	37,026	42,291	58,531	65,187
Gross external debt	. .	158,775	161,734	143,490	147,073	152,896
	% of GDP[1]					
Gross official reserves (excluding gold)	4.6	9.2	10.8	11.6	15.2	16.3
Gross external debt	. .	56.0	47.3	39.4	38.3	38.2
	Import months of goods and services					
Gross official reserves (excluding gold)	2.0	4.7	5.3	5.7	7.8	9.5

Source: National central bank, OeNB, wiiw.

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

In the run-up to the parliamentary and presidential elections in December 2003 and March 2004, respectively, the implementation of structural reforms generally slowed down somewhat. However, banking reforms have seen more dynamics recently. After much hesitation, a deposit insurance law was finally enacted in December 2003. According to this law, all credit institutions were given a deadline until end-June 2004 to apply for participation in the deposit insurance scheme. Now the Central Bank of Russia is engaged in an examination and screening process to determine which banks are "fit" to join. This may be the first serious review Russian banks have experienced in years.

In this situation, two smaller banks' licenses were revoked in connection with money laundering charges in May 2004, which apparently gave rise to concerns among depositors, who started to withdraw money from credit institutions. Although the Central Bank of Russia reacted in mid-June by easing money market liquidity, a medium-sized bank stopped servicing its clients in early July. The reinforced unrest provoked notable withdrawals even from Russia's largest private bank, triggering a wider liquidity crisis. The authorities responded by sharply cutting all reserve requirements, promoting the takeover of the insolvent middle-sized bank by a state-owned one and by passing a special law in mid-July providing for a limited interim guarantee of all existing bank deposits of private individuals. The measures appear to have calmed down the situation for the time being. Given the currently robust overall economic situation, banks are far from where they were prior to the 1998 meltdown, but the fragility of confidence has been clearly exposed.

Cutoff date for data: August 30, 2004.