# FOCUS ON EUROPEAN ECONOMIC INTEGRATION

Stability and Security.

Q2/14

This publication presents economic analyses and outlooks as well as analytical studies on macroeconomic and macrofinancial issues with a regional focus on Central, Eastern and Southeastern Europe.

# Contents

*Opinions expressed by the authors of studies do not necessarily reflect
the official viewpoint of the Oesterreichische Nationalbank or of the Eurosystem.*

# Call for Entries:
# Olga Radzyner Award 2014 for Scientific Work on European Economic Integration

In 2000, the Oesterreichische Nationalbank (OeNB) established an award to commemorate Olga Radzyner, former Head of the OeNB's Foreign Research Division, who pioneered the OeNB's CESEE-related research activities. The award is bestowed on young economists for excellent research on topics of European economic integration and is conferred annually. In 2014, four applicants are eligible to receive a single payment of EUR 3,000 each from an annual total of EUR 12,000.

Submitted papers should cover European economic integration issues and be in English or German. They should not exceed 30 pages and should preferably be in the form of a working paper or scientific article. Authors shall submit their work before their 35th birthday and shall be citizens of any of the following countries: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia or Ukraine. Previous winners of the Olga Radzyner Award, ESCB central bank employees as well as current and former OeNB staff are not eligible. In case of co-authored work, each of the co-authors has to fulfill all the entry criteria.

Authors shall send their submissions either by electronic mail to *eva.gehringer-wasserbauer@oenb.at* or by postal mail – with the envelope marked "Olga Radzyner Award 2014" – to the Oesterreichische Nationalbank, Foreign Research Division, Otto-Wagner-Platz 3, POB 61, 1011 Vienna, Austria. Entries for the 2014 award should arrive by September 19, 2014, at the latest. Together with their submissions, applicants shall provide copies of their birth or citizenship certificates and a brief CV.

For detailed information, please visit the OeNB's website at *www.oenb.at/en/About-Us/Research-Promotion/Grants/Olga-Radzyner-Award.html* or contact Ms. Eva Gehringer-Wasserbauer in the OeNB's Foreign Research Division *(write to eva.gehringer-wasserbauer@oenb.at* or phone +43-1-40420-5205).

# Call for Applications: Visiting Research Program

The Oesterreichische Nationalbank (OeNB) invites applications from external researchers for participation in a Visiting Research Program established by the OeNB's Economic Analysis and Research Department. The purpose of this program is to enhance cooperation with members of academic and research institutions (preferably postdoc) who work in the fields of macroeconomics, international economics or financial economics and/or pursue a regional focus on Central, Eastern and Southeastern Europe.

The OeNB offers a stimulating and professional research environment in close proximity to the policymaking process. Visiting researchers are expected to collaborate with the OeNB's research staff on a prespecified topic and to participate actively in the department's internal seminars and other research activities. They will be provided with accommodation on demand and will, as a rule, have access to the department's computer resources. Their research output may be published in one of the department's publication outlets or as an OeNB Working Paper. Research visits should ideally last between three and six months, but timing is flexible.

Applications (in English) should include
- a curriculum vitae,
- a research proposal that motivates and clearly describes the envisaged research project,
- an indication of the period envisaged for the research visit, and
- information on previous scientific work.

Applications for 2014 should be e-mailed to *eva.gehringer-wasserbauer@oenb.at* by November 1, 2014.

Applicants will be notified of the jury's decision by mid-December. The following round of applications will close on May 1, 2015.

# Recent Economic Developments and Outlook

# Developments in Selected CESEE Countries:

## Economic Recovery Increasingly Driven by Domestic Demand[1,2]

## 1 Regional Overview

Economic recovery proceeds but risks increased as of late

Economic conditions in Central, Eastern and Southeastern Europe (CESEE) started to recover in early 2013 and continued to do so throughout the review period. The CESEE economies thus developed very much in line with the euro area and other countries in Eastern Europe (e.g. in the Baltics) as well as other emerging market regions, where growth also picked up slightly in the second half of 2013. Most of the CESEE region covered in this report benefited from improving sentiment in Europe, more benign economic activity in the euro area and an incipient recovery of domestic demand. Only Turkey and more importantly Croatia lagged behind. Yet the recovery thus remains uneven and continues to be fragile. One risk at the current juncture relates to the future impact on emerging markets of the U.S. Fed's tapering of quantitative easing. Against this backdrop, especially Russia and Turkey have already been experiencing capital outflows and currency depreciation since mid-2013. These developments were exacerbated by rising political risks that climaxed in the context of the geopolitical tensions around Crimea. A further escalation of the conflict, including full-fledged economic and financial sanctions on the part of the EU vis-à-vis Russia, could severely affect economic conditions in the region. So far, however, the impact on the CESEE countries has been contained and limited to Russia. The region has relatively limited direct export linkages with Ukraine, and gas exports from Russia so far seem to run smoothly. Furthermore, the impact on CESEE financial markets has remained limited so far and also restricted to the Russian economy, which seems to have been affected substantially already, though (negative rating outlooks, weaker currency, deteriorating sentiment).

Following slow but steady improvements throughout 2013, quarterly year-on-year growth in the CESEE region averaged 0.7% and 0.8% in the third and fourth quarter, respectively. From this perspective, growth accelerated in all countries of the region, except for Croatia and Turkey. Slovenia, the Czech Republic and Romania even reported growth rates of above 1% in the final quarter of 2013. When looking at annual year-on-year growth rates, the pick-up in economic activity becomes even more apparent. Again with the exception of Croatia and Turkey, all countries displayed a clear upward growth trend.

A somewhat more positive economic momentum can also be observed for developments in 2013 as a whole. Growth picked up somewhat, or was at least less negative than in 2012, in most countries.

The improvement was underpinned by strengthened domestic demand. Gross capital formation in particular performed well as fixed investments increased and the inventory cycle started to turn. This is especially true for the EU Member States of the region, many of which reported substantial increases in this area.

Table 1

## Real GDP Growth

| | 2012 | 2013 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|
| | *Period-on-period change in %* | | | | | |
| Slovakia | 1.8 | 0.9 | 0.3 | 0.3 | 0.3 | 0.4 |
| Slovenia | −2.5 | −1.1 | 0.1 | 0.2 | 0.4 | 1.2 |
| Bulgaria | 0.6 | 0.9 | 0.3 | 0.2 | 0.5 | 0.3 |
| Croatia | −1.9 | −1.0 | 0.0 | −0.3 | −0.2 | −0.4 |
| Czech Republic | −1.0 | −0.9 | −1.3 | 0.3 | 0.3 | 1.8 |
| Hungary | −1.7 | 1.1 | 1.1 | 0.3 | 0.8 | 0.5 |
| Poland | 2.0 | 1.6 | 0.4 | 0.6 | 0.7 | 0.5 |
| Romania | 0.5 | 3.5 | 0.6 | 0.8 | 1.6 | 1.5 |
| Turkey | 2.5 | 4.0 | 1.6 | 2.1 | 0.9 | 0.5 |
| Russia | 3.4 | 1.3 | 0.2 | 0.4 | 0.6 | 0.9 |
| CESEE average[1] | 2.3 | 1.8 | 0.5 | 0.8 | 0.7 | 0.8 |
| Euro area | −0.7 | −0.4 | −0.2 | 0.3 | 0.1 | 0.2 |

*Source: Eurostat, national statistical offices.*

[1] Average weighted with GDP at PPP.

Evidently, unmet investment needs could finally be addressed after two years of stagnating capital formation or even disinvestment.

Several pieces of evidence can explain this development: Improving forecasts of external economic activity might have prompted exporters across the region to start modernizing and expanding production in anticipation of future business opportunities. Furthermore, the end of the EU's multiannual financial framework 2007–2013 encouraged public investment as countries sought support for as many

Chart 1

## GDP Growth and Its Main Components

*Percentage points, GDP growth in %*
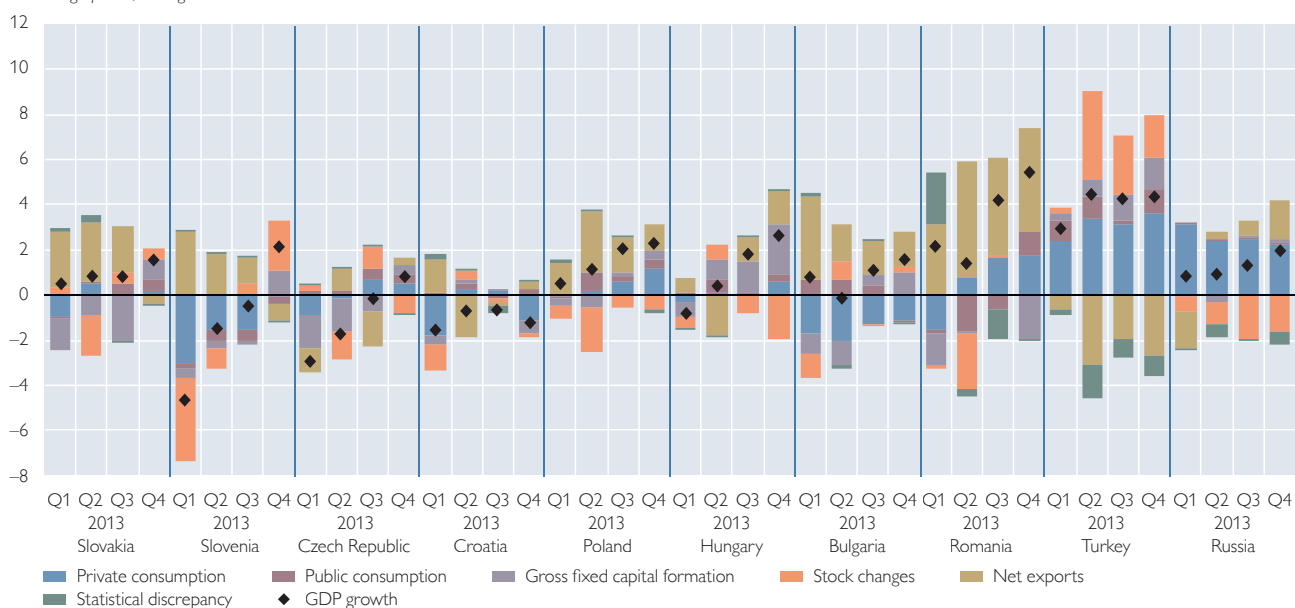


Source: Eurostat, national statistical offices.

EU-funded projects as possible in order to increase the absorption rate of the funds allocated.

The export-oriented industrial sector of the region generally developed very positively as well, with the exception of Russia and Croatia. In the other CESEE countries, industrial production increased from around $-0.5\%$ on average in January 2013 to around 6.5% on average in January 2014. Romania even registered double-digit growth rates. This was mirrored by value added in industry, which started to contribute positively to growth in nearly all countries under observation. Against this backdrop, capacity utilization was on the rise, reaching up to 75% or 80% in the first quarter of 2014 in most countries. The increase was especially strong in Poland, Hungary and Slovakia but also in Slovenia.

However, the most important factor for the pick-up in capital formation was probably improving sentiment in the region as well as throughout Europe. The Economic Sentiment Indicator (ESI) of the European Commission for example rose to 100.5 points on average in March 2014, the highest reading since mid-2011 and in line with its long-term average, having increased by more than 8 points since early 2011. The improvement was rather broad based among all sectors of the economy, but driven above all by construction and consumer sentiment. This general picture is, in principle, confirmed by manufacturing PMI data (which, however, are only available for a few countries). The index has been showing a clear upward trend in Poland, the Czech Republic and Turkey since spring 2013 and currently stands clearly above 50, indicating an expansion. The more recent slight decrease of the index in March might be related to the developments in Ukraine, the effects of which have not yet been observed in the ESI. The PMI for Russia decreased notably in the past months, from 51.8 in October 2013 to 48.3 in March 2014.

Private consumption developed less favorably than investment. However, against the background of increasingly positive sentiment and a cautious improvement of labor market conditions, some recovery can also be observed in this area. Consumption growth was slightly positive and no longer dampened economic momentum in any country but Bulgaria and Croatia.

Seasonally adjusted unemployment rates surpassed their peaks in early 2013 and have trended downward somewhat since then in all countries but Bulgaria. In some cases, however, the improvement was only marginal and unemployment rates remained especially high in Slovakia, Bulgaria and Croatia. Meanwhile, a broad-based turn in employment growth is yet to emerge. Still, employment increased somewhat in Slovakia, the Czech Republic, Hungary, Poland and Turkey. In the latter country, employment growth moderated markedly. A strong decrease of inflation supported real wage developments throughout the region. Real wage growth was positive in most countries and in some cases even accelerated significantly.

**Net exports lose some of their importance for economic activity**

Net exports continued to drive economic growth only in a few CESEE countries (especially in Croatia, Russia and Hungary). Export activity started to accelerate in early 2013 and continued to rebound in the review period in all countries but Croatia and Turkey. However, given increasing domestic demand and the associated pick-up in imports, the contribution of net exports to GDP growth generally lost some of its recent importance. In the fourth quarter, for example, net exports negatively impacted on economic momentum for the first

time since mid-2011 in Slovakia and even for the first time since the outbreak of the crisis in Slovenia. In many countries, the growth contribution of the external sector nevertheless remained an important backbone for economic activity.

Besides the acceleration of international demand, the robust export performance also reflects gains in competitiveness. Growth of unit labor costs (ULC) in manufacturing (measured in euro) has been broadly favorable in the countries under observation already for several quarters. Only Slovenia and Croatia lost some competitive edge against the backdrop of deteriorating productivity. The other countries benefited from productivity advances as well as from some depreciation of local currencies against the euro and mostly reported declining unit labor costs.

The incipient economic recovery has so far not been accompanied by improvements in financial sector activity. Growth of domestic credit to the private sector remained anemic during the review period throughout most of CESEE, with annual growth rates (adjusted for exchange rate changes) often only at around 2% or below and even showing a downward trend in several cases. This is especially true for Slovenia, where the transfer of nonperforming assets into a bad bank in December caused the credit stock to shrink. Several other countries, particularly Hungary but also Croatia and as of late (though to a lesser extent) Romania, have faced a deleveraging of households and/or corporations, which was attributable not only to the weak economic momentum, but also in part related to domestic banking sector problems (including sectoral taxes, high NPL burdens, partly due to foreign currency loans going bad against the backdrop of currency depreciation, and/or governance problems in a few countries). Rising credit growth was still reported for Slovakia, Poland and Turkey.

It is not completely clear why credit growth has not yet started to accelerate more notably. The pick-up in domestic demand that we currently see in many countries should in general be accompanied by an increasing demand for credit, and there is actually some evidence that credit demand is rising. For example, the Emerging Markets Bank Lending Conditions Survey of the Institute of International Finance (IIF) for the fourth quarter of 2013[3] reports that loan demand continued to improve across all loan categories. Demand for consumer credit was particularly strong, reflecting policy rate cuts and a recovery in private consumption in the region, at least in Central Europe. Furthermore, overall bank lending conditions remained broadly stable in the second half of 2013 after having improved somewhat in late 2012 and early 2013.

On the other hand, the survey also finds that credit standards were tightened across all loan categories and that local and international funding conditions continued to deteriorate. The deterioration in the fourth quarter, however, was less pronounced than in the third quarter given policy rate cuts and a limited impact of international financial market volatility on domestic assets.

Nevertheless, access to both domestic and foreign sources of financing seems to be guaranteed. Deposit growth outpaced credit growth in the second half of 2013 and the credit expansion was fully covered by higher deposits in all countries except Turkey and Russia. Furthermore, the consolidated exposures of BIS-reporting banks remained broadly stable in the third quarter of 2013 (more recent data were not available at the time of writing) after having declined by

No notable momentum in the financial sector

[3] www.iif.com/download.php?id=uDX7O/1A/SA=

Chart 2

## Growth of Credit to the Private Sector

*%, year on year, adjusted for exchange rate changes*



Q2 13   Q3 13   Q4 13   Feb. 14
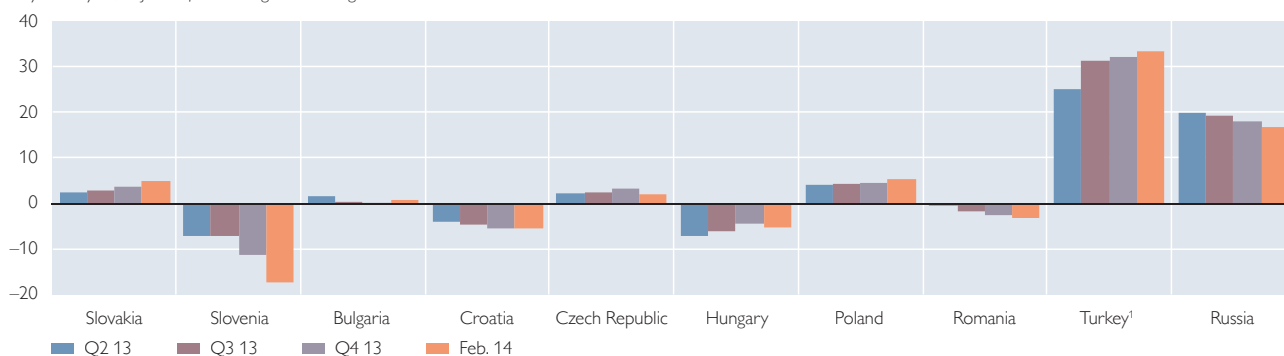
*Source: National central banks.*

[1] *Nonadjusted.*

some EUR 10 billion in the second quarter. Declining exposures between the second and the third quarter were reported especially for Croatia, Slovenia and Hungary, countries where a higher deleveraging pressure has been impacting negatively on banking sector flows already for several quarters. A substantial increase, on the contrary, was reported for Poland (by EUR 2 billion).

**Strong disinflationary tendencies in most countries of the region**

Strong disinflationary trends can be observed in most countries of the region during the review period (see chart 3). Disinflation was most pronounced in Croatia and Slovenia (more than 2 percentage points from the third quarter of 2013 until February 2014) followed by Bulgaria, Hungary and Slovakia (around 1.5 percentage points in the same period). In February, prices even started to shrink in Croatia and Slovakia. Bulgaria has been experiencing deflation since August 2013 and currently reports the lowest inflation rate by far in the EU.

Chart 3

## HICP Inflation and Its Main Drivers

*Percentage points, contribution to year-on-year change in HICP; HICP in %*



Processed food (incl. alcohol and tobacco)   Nonenergy industrial goods   Services   Energy   Unprocessed food   ◆ HICP
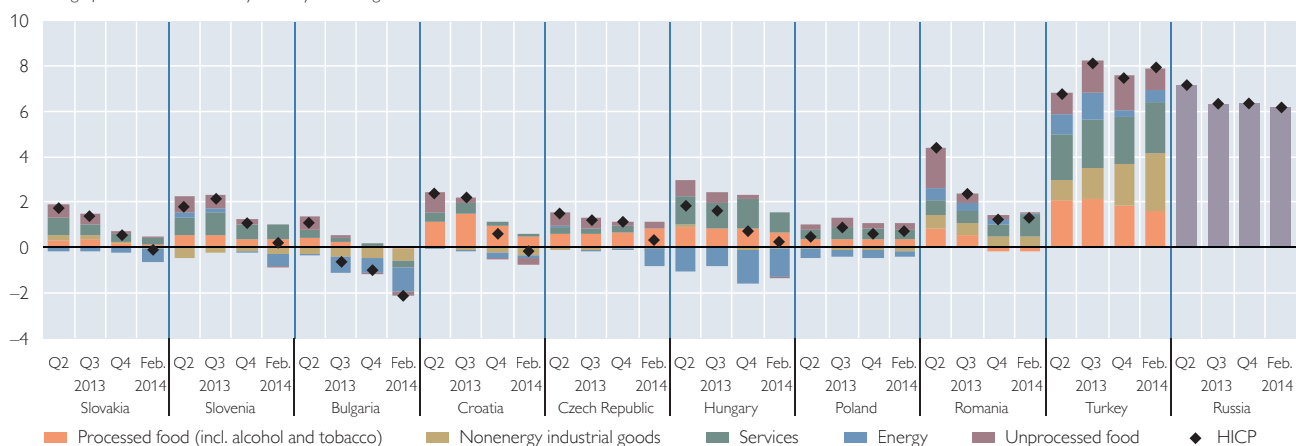
*Source: Eurostat.*

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

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Somewhat higher and more stable inflation rates were reported for Turkey and Russia. Price developments in those countries, however, have to be assessed against the backdrop of strong currency depreciation since mid-2013 (in both countries close to 20% against the euro).

Energy prices played an important role in explaining disinflation. In February, they no longer contributed to driving up prices in any country but Turkey. Price pressures from the other components of the HICP were easing as well, most notably with regard to food prices. This is especially true for Hungary, Bulgaria, Romania and Croatia, where food prices soared in 2012 on account of draughts. The ensuing base effect combined with a good harvest in 2013 led to deflation in this area in late 2013 and early 2014. In some countries, adjustments of administered prices (e.g. Czech Republic, Bulgaria, Hungary) and base effects after tax rises in the past (e.g. Czech Republic) further dampened price growth. Core inflation rates decreased less than headline inflation rates but nonetheless also demonstrated a clear downward trend (Bulgaria again reported core deflation). Uncertainty with regard to the employment situation, fiscal austerity, and subdued domestic credit dampened demand. In combination with existing excess capacities, this tempered wage demands and deprived retailers and producers of pricing power.

Against the backdrop of substantial disinflation, many central banks of the region continued to pursue a policy of monetary accommodation (see chart 4). The Hungarian central bank and the Romanian central bank cut their policy rates by a total of 100 basis points from mid-October to early April, lowering them to 2.6% and 3.5% respectively. The Czech Republic's policy rate has been standing at "technically zero" since October 2012. In November 2013, the Czech central bank decided to use the exchange rate as an additional instrument for easing monetary

*Monetary policy continues to be accommodative…*

Chart 4

## Policy Rate Developments in CESEE
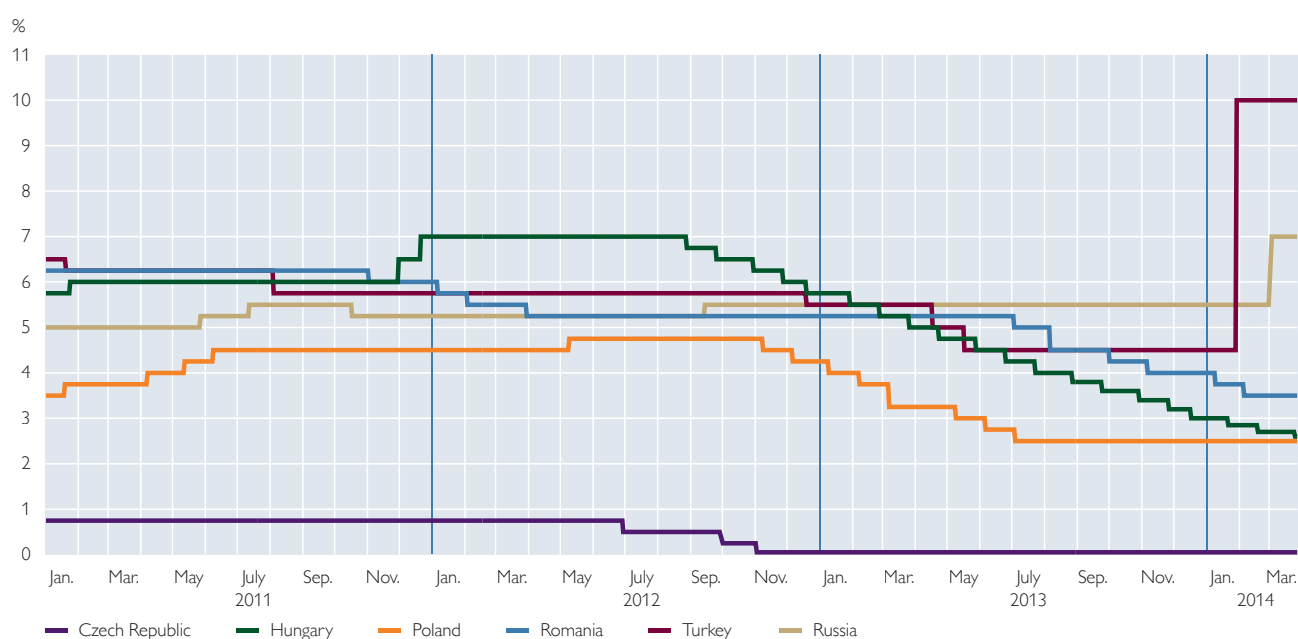


Source: National central banks.

conditions and to keep the exchange rate of the koruna against the euro at a level of close to 27 CZK per EUR. The two euro area countries, Slovenia and Slovakia, implemented the ECB's interest rate decision of November 2013.

Running counter to developments in Central Europe, Turkey and Russia increased their policy rates strongly, owing to substantial currency depreciation in the observation period. The Turkish lira lost some 6.5% against the euro between early October 2013 and early April 2014, while the Russian ruble depreciated by some 11% in the same period (see chart 5). This development was on the one hand related to broader global factors, especially the announced and finally executed tapering of quantitative easing by the U.S. Fed that put pressure on emerging markets worldwide. On the other hand, domestic political uncertainty adversely impacted on exchange rates (mass protests and corruption allegations in Turkey together with elections ahead, the conflict around Crimea in Russia). Both the Turkish lira and the Russian ruble traded at historical lows in the first quarter of 2014. Foreign currency interventions and decisive policy rate rises from 4.5% to 10% in Turkey (one-week repo rate) and from 5.5% to 7% in Russia, however, helped stabilize markets and the currencies have since recovered some of their losses.

The combined current and capital account for the region as a whole continued to be broadly balanced in the review period. On the country level, two opposing trends were at work, however: While current account surpluses improved further in most EU Member States of the country sample, external balances deteriorated somewhat in Russia and Turkey. In Russia, it was especially higher net outflows from investment income that negatively impacted on the external accounts. In Turkey, strong consumption and investment dynamics drove the trade balance deeper into the reds despite a weakening currency.

All of the EU Member States of the region reported (sometimes substantial) current account surpluses. In many cases, surpluses even increased further during

Chart 5

**Exchange Rate Developments versus the Euro**

*1.1.2013 = 100; increases indicate appreciation*



Latest observation:
April 9, 2014

Legend: EUR/BGN, EUR/HRK, EUR/CZK, EUR/HUF, EUR/PLN, EUR/RON, EUR/TRL, EUR/RUB
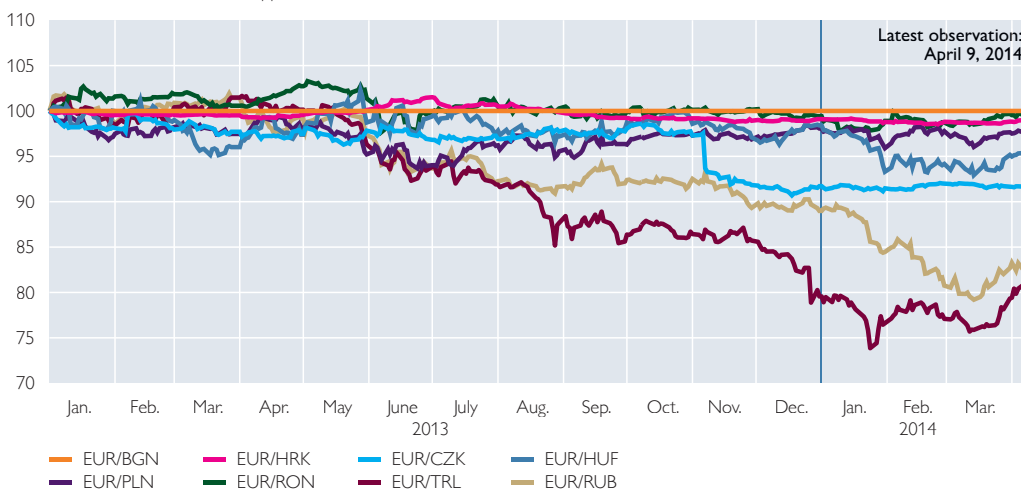
*Source: Thomson Reuters.*

Chart 6

## Combined Current and Capital Account Balance

*% of GDP, four-quarter moving sum*
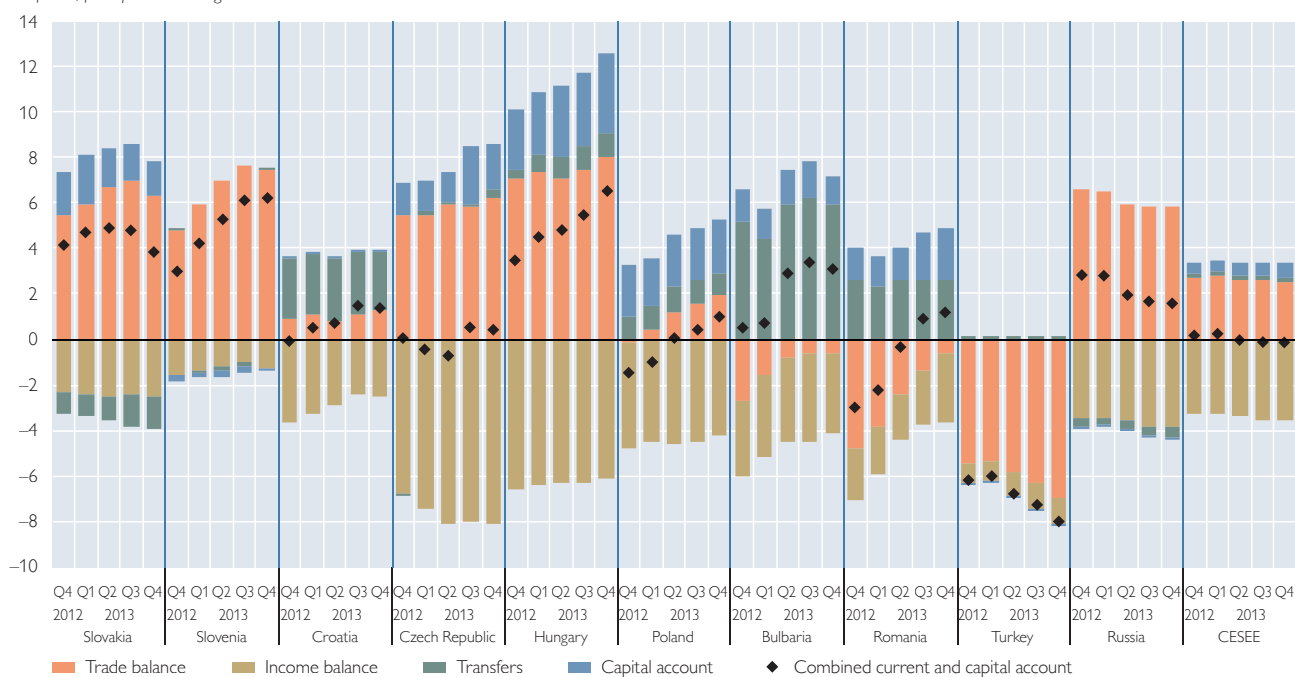


Source: Eurostat, IMF, national central banks.

the review period as a recovery of economic conditions in major export markets and partly lower import prices (e.g. for food, commodities and energy) had a positive impact on trade balances. Furthermore, the improvement of the capital account that was observed in e.g. the Czech Republic and Romania is likely to reflect the higher number of EU co-financed investment projects that were implemented as the deadline for the multiannual financial framework ending 2013 drew nearer.

Net capital flows to the ten CESEE countries as a whole decelerated markedly from 5.9% of GDP in the second quarter of 2013 to 2.6% of GDP in the fourth quarter of 2013 (four-quarter moving sums) (see chart 7). The deterioration was driven mostly by lower net portfolio inflows, while net FDI flows were somewhat lower (but still slightly positive) too. At the same time, net outflows of other investments moderated, indicating an easing of deleveraging pressure in the observation period.

*Lower but still positive capital flows to the region*

On the country level, the development was very much driven by three markets: Poland, Russia and Turkey. The net portfolio position (based on four-quarter moving sums) of those three countries deteriorated by more than EUR 42 billion between the second and the fourth quarter of 2013. 80% of this sum originated from Russia and Turkey against the backdrop of political uncertainty and tapering. In Poland, bond repayments weighted on portfolio investments.

Among the other countries, a stronger deterioration in the financial account was observed only in Bulgaria, where a substantial outflow of other investments was reported for the final quarter of 2013. In the rest of the region, financial

Chart 7

**Financial Account Balance**

*% of GDP, four-quarter moving sum*



FDI net — Portfolio investments net — Derivatives net — Other investments net — Reserve assets — ◆ Financial account

*Source: National central banks.*

account balances were roughly stable or even improved somewhat during the review period (e.g. Czech Republic, Croatia and Slovakia).
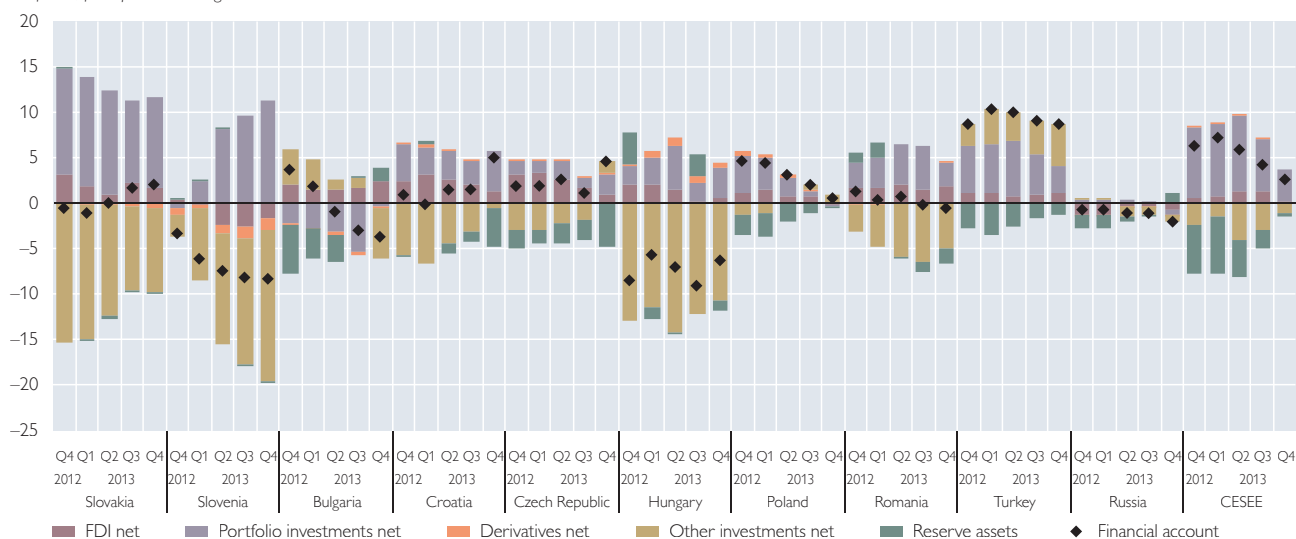
*Somewhat higher budget deficits in most countries in 2013*

Most countries under observation reported somewhat higher budget deficits in 2013 than they did in 2012, contrary to plans to reduce the fiscal deficits as outlined in the EU Stability and Convergence Programs in April 2013. The deterioration was mainly related to weak domestic demand especially in the first half of 2013 that caused revenues to underperform. The increase in the budgetary gap was most pronounced in Slovenia, where one-off factors, including those related to bank recapitalization, drove up the deficit from –4% of GDP in 2012 to –14.7% of GDP in 2013. Only Romania, Slovakia and the Czech Republic reported lower budgetary shortfalls than in 2012.

Slovakia and the Czech Republic are also the two countries in the region which had committed to reduce their deficits to below 3% of GDP under the excessive deficit procedure (EDP) by 2013. With shortfalls of 2.8% and 1.5% of GDP, this goal was clearly met, and the EDP should officially be abrogated in early summer. With that, Slovenia, Poland and Croatia remain the only CESEE EU countries still subject to an excessive deficit procedure. In the case of Slovenia, the target date for a correction had to be extended by two years, from 2013 to 2015, due to unexpected adverse economic developments, including a double-dip recession, weakening labor markets and large macroeconomic imbalances. In the case of Poland, the deadline was extended to 2015, following an initial extension from 2012 to 2014. After having deteriorated to 4.3% of GDP in 2013, the fiscal deficit is projected to turn into a surplus of some 5% of GDP in 2014, given a one-off transfer of assets. In January 2014, the EU Council found Croatia to run an excessive deficit in the evaluation round following the latter's EU accession. The deadline for a correction was set at 2016.

Box 1

## Ukraine: Challenging Political and Macroeconomic Environment

*In November 2013, public protests were triggered by the Ukrainian government's decision to suspend the process of preparations for an EU association agreement (including a deep and comprehensive free trade agreement) that the EU stood ready to sign at the Eastern Partnership summit scheduled for end-November 2013 in Vilnius. Initially peaceful protests were forcefully dissolved by the police, which prompted even larger demonstrations. Over the subsequent three months, protests and actions by authorities turned more and more violent. On February 22, president Yanukovich disappeared and parliament voted to remove the president from power. Subsequently, an interim president and a new government were approved by parliament, pending presidential elections that were set for May 25. The regime change was followed by a conflict with Russia, also because of Russian support for the secession of Crimea from Ukraine. Russia subsequently suspended the support package it had agreed in December with Yanukovich, i.e. its planned purchase of USD 15 billion Ukrainian eurobonds and a gas price discount. Moreover, pro-Russian activists started to occupy official buildings in some cities of Eastern Ukraine.*

*The political crisis and the conflict with Russia came at a time of rather adverse macro-economic conditions for Ukraine: In 2013, the economy was stagnating the second year in a row. The 2013 fiscal deficit stood at 4.5% of GDP and, on top of this, the 2013 deficit of the state-owned gas company Naftogaz reached nearly 2% of GDP. Furthermore, Ukraine's current account deficit climbed to 8.9% of GDP. High external debt service requirements and a low level of official foreign currency reserves added to the high level of external vulnerability.*

*The National Bank of Ukraine (NBU) pursued a relatively tight de facto peg against the USD from early 2009 until early 2014. Exchange rate risks materialized in the first quarter of 2014. The NBU ran down its foreign currency reserves to keep the exchange rate stable, as the hryvnia repeatedly came under pressure. As pressures further intensified in January and February this year, the NBU finally let the exchange rate float. Though administrative restrictions on foreign currency transactions were broadened during the time of the protests, foreign currency reserves declined further (to USD 15.1 billion in March 2014, covering less than two months of imports). After heavy interventions in January and February, the NBU stopped intervening on the foreign exchange market to support the hryvnia in March, while the currency continued to weaken. At the end of March, the central bank started to reduce capital controls introduced in February. From the end of 2013 to mid-April 2014 the currency lost more than 30% against the USD. Against this backdrop and pointing to the exchange rate pass-through on inflation, the NBU raised the discount rate by 300 basis points to 9.5% in mid-April.*

*The depreciation of the hryvnia will negatively impact credit quality, though the share of foreign currency loans to total loans in the household sector declined from 69% at end-2010 to 35% at end-2013 due to central bank restrictions. Yet, the remaining stock of foreign currency loans in the household sector is still considerable.*

*Given the economy's high external financing needs the new government requested support from the IMF. On March 27, the IMF announced a staff-level agreement with Ukraine on a two-year USD 14 to 18 billion Stand-By Arrangement. This forms part of a broader support package by the international community, which is set to total USD 27 billion over the next two years. The exact contribution of the IMF will be determined once all bilateral and multilateral support is accounted for. The economic program under the arrangement inter alia comprises a flexible exchange rate policy and the introduction of inflation targeting, financial sector reforms, fiscal adjustment, and an increase in retail gas and heating tariffs.*

Box 2

## Western Balkans: Emerging from Recession

*The growth performance across the Western Balkan countries improved considerably in 2013 compared to 2012 with the exception of Albania. In Bosnia and Herzegovina, Montenegro, FYR Macedonia and Serbia, real GDP growth figures moved into positive territory. As most CESEE countries covered in this report, Western Balkan countries benefited from booming exports, particularly Serbia, while at the same time import growth decelerated in most cases, leading to positive contributions of net exports to GDP growth. Domestic demand generally remained weak, suppressed by persistently high unemployment rates, low or declining real wage growth and restrictive lending conditions. Albania's real GDP declined in the first three quarters of 2013 but turned positive in the final quarter of 2013.*

*With unemployment rates (annual averages, based on Labour Force Surveys) between 15.6% (Albania) and 31% (Kosovo), labor markets continue to be one of the main concerns in the region. However, Bosnia and Herzegovina, FYR Macedonia and Serbia recorded slightly declining unemployment rates in 2013 compared to 2012. Particularly in the case of Albania, the labor market was affected by a sizable number of migrants returning home from the crisis-hit countries Greece and Italy. These developments were also reflected in the inflow of remittances: According to the World Bank, remittances to Albania declined by 2 percentage points of GDP in the first half of 2013.*

*In 2013 stronger export and weaker import growth generally narrowed the trade gap leading to a smaller current account deficit particularly in Serbia. Only in Albania did the shortfall of the current account increase somewhat in 2013 (to around 10.5% of GDP). With 15% of GDP, the current account deficit is still at an elevated level in Montenegro (2012: −18.7% of GDP) while FYR Macedonia recorded the smallest current account deficit in the region with 1.9% of GDP. In 2013, net FDI inflows increased in all countries compared to 2012 but in Montenegro.*

*Credit growth to the nonbank private sector continued to be weak or even negative in most Western Balkan countries. Noticeably, in Montenegro credit growth was positive in 2013 (+5.2%) after years of contraction. However, in the last quarter of 2013, credit growth declined by almost 2% again. Elevated and still increasing levels of nonperforming loans pose one of the greatest challenges for financial stability to the region. In 2013, Albania and Serbia reached NPL ratios of more than 20%. With about 8% to 10% Kosovo and FYR Macedonia showed the lowest NPL levels. In all Western Balkan countries efforts to tackle the problem of high NPL levels are underway.*

*Not only in the CESEE countries but also in the Western Balkans, inflation slowed down in the course of 2013 and in early 2014. In Serbia, inflation dropped from double-digit rates in the first and second quarter of 2013 to 2.0% in the final quarter of 2013 and stayed low in the first months of 2014, thus reaching the lower bound of the inflation target with 4% ±1.5 percentage points of the Serbian central bank. In Albania, the lower bound of the inflation target (3% ±1 percentage point) was reached as well. Bosnia and Herzegovina has experienced accelerating deflation since August 2013 (price decrease of 1.6% in February 2014). In Montenegro, inflation was also very low in recent months (fourth quarter of 2013: 0.2%, January and February 2014: −0.5% and −0.6%, respectively). Low inflation rates were largely driven by a sharp drop of food and beverage prices as well as clothing prices but were also due to low price increases of imported goods. The Serbian central bank continued its monetary easing cycle and cut the key policy rate in three steps, from 11% in June 2013 to 9.5% in December 2013. Albania also cut its key interest rate in three steps (from 3.5% in October 2013 to 2.75% in February 2014).*

*Regarding the fiscal stance, developments were uneven across the region. Comparing 2013 with 2012, budget deficits are expected to deteriorate significantly in Albania and Kosovo and modestly Bosnia and Herzegovina. In the other countries, deficits remained broadly unchanged or even decreased somewhat (Serbia). Public debt levels are increasing in*

*all countries but in Bosnia and Herzegovina. The increase will be particularly pronounced in Albania, bringing the debt level to 70% of GDP (2012: about 60% of GDP).*

*Over the last months, progress was made on the way to EU membership. Most importantly, Serbia started official EU accession negotiations in January 2014, and Albania can be expected to become an EU candidate country in the near future. In contrast, some internal problems in Bosnia and Herzegovina were an obstacle for the disbursement of EU funds, leading to a cut of IPA (Instrument for Pre-Accession Assistance) for the year 2013 by 50%. In February 2014, the IMF granted Bosnia and Herzegovina more time in order to meet reform commitments under the sixth review of the Stand-By Arrangement (SBA). In early 2014, the IMF approved a 36-month arrangement of about EUR 330 million under the Extended Fund Facility for supporting the reform program in Albania and concluded the second post-program monitoring with FYR Macedonia. In Kosovo, the fifth SBA review took place at the end of 2013. There are no financial arrangements with Montenegro and Serbia.*

## 2 Slovakia: Temporary Slowdown in 2013 but Back to Faster Speed in 2014

*Turning point to a more balanced growth composition*

Despite an improving momentum in the second half of the year, Slovakia's GDP growth declined to 0.9% in 2013. Net exports remained the main growth driver. After a significant expansion of car production in 2012, the car industry – a key sector in the economy – is getting close to its maximum capacity. Thanks to a rise in real disposable income and consumer confidence, private consumption was showing signs of recovery. Positive growth rates have been reported since the second quarter of 2013. Public consumption growth turned positive after two years of decline due to slower consolidation. Gross fixed capital formation decreased substantially in 2013, but finally started to increase in late 2013 after seven negative quarters. As many new sections of motorways are planned for 2014, government investment is expected to grow further this year. Taking these factors into account, a more balanced growth composition is expected for 2014.

*Trade surplus hits record high in 2013*

The current account surplus peaked at 2.4% of GDP in 2013. This was mainly due to a record high surplus in the trade balance (6.1% of the GDP) while the service balance delivered a slightly positive contribution too. Although inflows strengthened in the second half of 2013, at 1.8% of GDP net FDI in 2013 was markedly lower than a year before.

*Significant decrease in inflation but no risk for long-lasting deflation*

The significant decrease in inflation was caused mainly by a continued fall of energy and commodity prices as well as weak demand. The HICP is currently among the lowest in the European Union and entered negative territory in February 2014 (–0.1% year on year). However, because of a brightening economic outlook in Slovakia, deflation is not expected to be persistent. A slow rise of the price level is projected over the coming months.

*Labor market remains comparatively weak*

The employment rate has been stagnating at close to 60%, and with 14.3% in the last quarter of 2013, the unemployment rate remains one of the highest in the EU. Despite a slight decrease in unemployment in early 2014, GDP growth is not yet sufficiently high to kick-start a substantial turn in the labor market. On a positive note, robust growth in manufacturing production and an unchanged labor market situation suggest improving labor productivity in manufacturing (with 11.2% in the fourth quarter of 2014 and a growing trend).

*Revenue-based fiscal consolidation*

The budget deficit in 2013 decreased to below 3% of GDP. Thus, Slovakia met its commitment within the excessive deficit procedure to remove its excessive deficit in 2013. This achievement was mainly fueled by one-off measures (e.g. sale of emergency oil reserves or a levy on business operations in regulated industries). However, higher-than-budgeted revenue elements (e.g. VAT collection) as well as lower-than-budgeted expenditures (e.g. public investments) also contributed to the better outcome.

In 2013, the gross public debt level increased to 55.4% of GDP. Hence, it exceeded not only the first threshold (set at 50% of GDP) but also the threshold of 53% of GDP defined under the constitutional Fiscal Responsibility Act. At this stage, the regulation demands for additional fiscal policy sanctions (e.g. the salaries of the cabinet members had to be frozen in the 2014 budget). Forecasts for 2014 suggest debt levels to rise further to slightly above the next threshold at 57% of GDP, which is close to the Maastricht level, even though some one-off measures will be undertaken in 2014. The planned sale of telecom shares and use of this extra revenue for debt reduction would decrease the debt level by approximately 0.2% of GDP.

Table 2

## Main Economic Indicators: Slovakia

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| *Year-on-year change of the period total in %* | | | | | | | | | |
| GDP at constant prices | 3.0 | 1.8 | 0.9 | 1.9 | 0.4 | 0.5 | 0.8 | 0.9 | 1.5 |
| Private consumption | –0.5 | –0.2 | –0.1 | –0.4 | –0.8 | –1.6 | 0.9 | 0.1 | 0.3 |
| Public consumption | –4.3 | –1.1 | 1.4 | –1.1 | –0.9 | –0.3 | 0.4 | 2.8 | 2.5 |
| Gross fixed capital formation | 14.2 | –10.5 | –4.3 | –6.6 | –10.9 | –7.9 | –4.8 | –9.8 | 4.0 |
| Exports of goods and services | 12.2 | 9.9 | 4.5 | 13.3 | 8.2 | 4.9 | 4.4 | 1.9 | 6.6 |
| Imports of goods and services | 9.7 | 3.3 | 2.9 | 7.0 | 4.5 | 2.5 | 1.9 | –0.4 | 7.4 |
| *Contribution to GDP growth in percentage points* | | | | | | | | | |
| Domestic demand | 1.0 | –4.1 | –0.8 | –3.4 | –3.1 | –2.0 | –2.1 | –1.2 | 2.1 |
| Net exports of goods and services | 2.0 | 5.9 | 1.7 | 5.2 | 3.6 | 2.5 | 2.6 | 2.1 | –0.4 |
| Exports of goods and services | 9.8 | 8.8 | 4.3 | 11.0 | 7.6 | 4.7 | 4.4 | 1.7 | 6.6 |
| Imports of goods and services | –7.8 | –2.9 | –2.6 | –5.8 | –4.0 | –2.3 | –1.7 | 0.3 | –7.0 |
| *Year-on-year change of the period average in %* | | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | 0.7 | 1.0 | –1,0 | 0.5 | 2.2 | 0.1 | –1.1 | –1.5 | –1.4 |
| Unit labor costs in manufacturing (nominal, per hour) | 2.6 | –6.6 | –2.4 | –11.4 | –4.0 | 1.6 | –0.5 | –3.1 | –7.0 |
| Labor productivity in manufacturing (real, per hour) | 2.7 | 12.6 | 7.9 | 15.5 | 10.8 | 7.1 | 6.1 | 7.4 | 11.1 |
| Labor costs in manufacturing (nominal, per hour) | 5.4 | 5.1 | 5.3 | 2.3 | 6.4 | 8.8 | 5.6 | 4.1 | 3.3 |
| Producer price index (PPI) in industry | 4.5 | 1.9 | –1.0 | 1.8 | 2.0 | 0.5 | –0.7 | –1.5 | –2.3 |
| Consumer price index (here: HICP) | 4.1 | 3.7 | 1.5 | 3.8 | 3.6 | 2.2 | 1.7 | 1.4 | 0.5 |
| *Period average levels* | | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 13.7 | 14.0 | 14.3 | 13.7 | 14.5 | 14.6 | 14.1 | 14.1 | 14.3 |
| Employment rate (%, 15–64 years) | 59.3 | 59.7 | 59.9 | 60.1 | 59.4 | 59.8 | 59.8 | 60.0 | 59.8 |
| Key interest rate per annum (%) | 1.2 | 0.9 | 0.5 | 0.8 | 0.8 | 0.8 | 0.6 | 0.5 | 0.3 |
| *Nominal year-on-year change in the period-end stock in %* | | | | | | | | | |
| Broad money (including foreign currency deposits) | 0.7 | 6.6 | 5.9 | 1.9 | 6.6 | 5.5 | 6.1 | 5.6 | 5.9 |
| *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | | |
| Net foreign assets of the banking system | –3.8 | –3.1 | 0.5 | 2.7 | –3.1 | 0.4 | –5.9 | –6.5 | 0.5 |
| Domestic credit of the banking system | 9.4 | –7.1 | 0.7 | –4.5 | –7.1 | –10.9 | –7.0 | –2.2 | 0.7 |
| *of which: claims on the private sector* | 6.9 | –0.1 | 5.1 | 0.5 | –0.1 | 1.8 | 2.8 | 3.4 | 5.1 |
| *claims on households* | 3.9 | 3.9 | 4.1 | 3.7 | 3.9 | 3.9 | 4.1 | 4.1 | 4.1 |
| *claims on enterprises* | 2.9 | –4.0 | 1.0 | –3.2 | –4.0 | –2.1 | –1.3 | –0.7 | 1.0 |
| *claims on the public sector (net)* | 2.5 | –6.9 | –4.4 | –5.1 | –6.9 | –12.7 | –9.8 | –5.6 | –4.4 |
| Other assets (net) of the banking system | –4.9 | 16.7 | 4.6 | 3.8 | 16.7 | 16.0 | 19.0 | 14.3 | 4.6 |
| *% of GDP, ESA 95* | | | | | | | | | |
| General government revenues | 34.1 | 33.7 | 35.9 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 38.9 | 38.2 | 38.7 | .. | .. | .. | .. | .. | .. |
| General government balance | –4.8 | –4.5 | –2.8 | .. | .. | .. | .. | .. | .. |
| Primary balance | –3.2 | –2.7 | –0.8 | .. | .. | .. | .. | .. | .. |
| Gross public debt | 43.6 | 52.7 | 55.4 | .. | .. | .. | .. | .. | .. |
| *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 46.2 | 44.8 | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | 27.0 | 28.3 | .. | .. | .. | .. | .. | .. | .. |
| *% of GDP (based on EUR), period total* | | | | | | | | | |
| Trade balance | 1.5 | 5.0 | 6.1 | 3.9 | 5.3 | 7.8 | 9.1 | 4.6 | 3.4 |
| Services balance | –0.5 | 0.4 | 0.2 | 0.5 | 0.5 | –0.3 | 0.2 | 0.9 | –0.1 |
| Income balance (factor services balance) | –4.2 | –2.3 | –2.5 | –2.4 | –2.4 | –2.6 | –2.4 | –2.3 | –2.5 |
| Current transfers | –0.5 | –0.9 | –1.5 | –1.2 | –1.1 | –0.6 | –1.6 | –2.0 | –1.7 |
| Current account balance | –3.8 | 2.2 | 2.4 | 0.8 | 2.3 | 4.4 | 5.3 | 1.2 | –1.0 |
| Capital account balance | 1.3 | 1.9 | 1.4 | 1.5 | 3.0 | 1.0 | 1.3 | 0.8 | 2.6 |
| Foreign direct investment (net) | 2.9 | 3.2 | 1.8 | –0.2 | 7.7 | –0.9 | –3.3 | 5.0 | 5.8 |
| *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | | |
| Gross external debt | 76.7 | 75.6 | 82.7 | 73.3 | 75.6 | 80.8 | 84.5 | 86.2 | 82.7 |
| Gross official reserves (excluding gold) | 1.0 | 0.9 | 0.9 | 0.9 | 0.9 | 1.0 | 1.2 | 0.9 | 0.9 |
| *Months of imports of goods and services* | | | | | | | | | |
| Gross official reserves (excluding gold) | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 |
| *EUR million, period total* | | | | | | | | | |
| GDP at current prices | 68,974 | 71,096 | 72,134 | 18,782 | 18,119 | 16,710 | 18,036 | 18,996 | 18,393 |

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

### 3  Slovenia: Banking Sector Stabilization Provides Respite for Continuing Reforms

In mid-December 2013, the government recapitalized the three largest state-owned banks and two banks under orderly liquidation with the amount of EUR 3.2 billion (9.1% of GDP). Subsequently, the two largest banks transferred NPLs worth EUR 3.3 billion to the bank asset management company (at a discount of 69%). The third-largest bank is expected to transfer further EUR 1.1 billion worth NPLs at a discount of around 53% once the European Commission approves its restructuring plan. As a result, the share of NPLs in banks' credit portfolios is estimated to have fallen from 21% to around 12%. Out of five further private banks with a potential future capital shortfall, three foreign-owned subsidiaries have already made up for the deficit. The fourth bank was given until end-April to find private investors, otherwise the government would provide the necessary capital backstop. The deadline for the fifth domestic bank has been extended until end-2014. As a further element of the consolidation of the banking sector, the government has committed itself to fully privatize the second and third largest bank by end-2014 and reduce its stake in the biggest bank to a blocking minority in the medium term. In order to prevent a further accumulation of NPLs a new legislative framework for corporate restructuring was put into place in December 2013. This is aimed at preventive restructuring of viable companies with an unsustainable debt overhang already at an early stage and at improving the efficiency of insolvency proceedings.

After two years of negative annual growth rates, GDP grew by 2.1% year on year in the final quarter of 2013. The rebound was primarily attributable to the turnaround in domestic demand. Investments expanded for the first time since 2008, and the decline in consumption moderated as well. Nonetheless, the biggest contribution to domestic demand growth stemmed from the moderation of destocking. Export growth held up well, mirroring improved export expectations in the preceding quarters. However, the strong acceleration of import growth caused net real exports to reduce the overall GDP growth rate for the first time since late 2008. Given stubbornly high unemployment, declining real wages, weak consumer confidence, the ongoing steep decline in credit to the private sector and the need for continued fiscal restraint, the growth outlook remains weak.

Slovenia recorded a budget deficit of 14.7% of GDP in 2013, boosted by one-off measures, mostly the costs of bank recapitalization (deficit of 3.7% excluding one-offs). The deficit is expected to decrease to 3.9% in 2014 (or 3.3% excluding further bank recap) and to 3.3% in 2015. The structural balance is estimated to improve by only around 0.7 percentage points over 2013–2014 and to worsen again by 0.5 percentage points in 2015. This falls short of the June 2013 EU Council Recommendation to Slovenia, so that the country may miss the 2015 deadline for correcting its excessive deficit. On a separate note, according to the latest assessment by the European Commission, Slovenia "continues to experience excessive macroeconomic imbalances which require specific monitoring and continuing strong policy action." More specifically, weak corporate governance, the high level of state involvement in the economy, losses in cost competitiveness, corporate debt overhang and the increase in government debt call for very close monitoring. Bank restructuring, privatization and enhanced supervision require further determined action as well.

Table 3

## Main Economic Indicators: Slovenia

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | 0.7 | –2.5 | –1.1 | –3.0 | –3.3 | –4.6 | –1.4 | –0.5 | 2.1 |
| Private consumption | 0.8 | –4.8 | –2.7 | –6.8 | –5.8 | –5.3 | –2.7 | –2.8 | 0.0 |
| Public consumption | –1.6 | –1.3 | –2.0 | –1.8 | –2.4 | –1.4 | –2.4 | –2.4 | –1.9 |
| Gross fixed capital formation | –5.5 | –8.2 | 0.2 | –7.3 | –12.3 | –2.3 | –1.7 | –1.1 | 5.9 |
| Exports of goods and services | 7.0 | 0.6 | 2.9 | 0.1 | 0.8 | 1.5 | 2.2 | 4.0 | 3.7 |
| Imports of goods and services | 5.6 | –4.7 | 1.3 | –7.1 | –6.0 | –2.3 | –0.3 | 2.8 | 4.9 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | –0.3 | –6.3 | –2.4 | –8.2 | –8.3 | –7.4 | –3.3 | –1.7 | 2.9 |
| Net exports of goods and services | 1.0 | 3.8 | 1.3 | 5.1 | 5.0 | 2.8 | 1.8 | 1.1 | –0.7 |
| Exports of goods and services | 4.7 | 0.4 | 2.2 | 0.1 | 0.6 | 1.2 | 1.6 | 3.0 | 2.9 |
| Imports of goods and services | –3.6 | 3.4 | –0.9 | 5.0 | 4.4 | 1.6 | 0.2 | –1.9 | –3.6 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | –0.9 | 1.0 | –1.2 | 0.4 | 1.1 | –0.6 | –0.6 | –0.8 | –2.9 |
| Unit labor costs in manufacturing (nominal, per hour) | 0.3 | 4.8 | 2.4 | 4.0 | 5.2 | 7.3 | –3.5 | 2.1 | 4.0 |
| Labor productivity in manufacturing (real, per hour) | 1.5 | –1.8 | –1.8 | –1.1 | –3.3 | –2.7 | –2.2 | –2.5 | 0.4 |
| Labor costs in manufacturing (nominal, per hour) | 1.9 | 2.9 | 0.6 | 2.8 | 1.7 | 4.4 | –5.7 | –0.5 | 4.4 |
| Producer price index (PPI) in industry | 4.6 | 0.9 | 0.0 | 0.6 | 0.6 | 0.7 | 0.2 | –0.2 | –0.6 |
| Consumer price index (here: HICP) | 2.1 | 2.8 | 1.9 | 3.2 | 3.0 | 2.7 | 1.8 | 2.2 | 1.1 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 8.4 | 9.0 | 10.3 | 9.3 | 9.7 | 11.2 | 10.5 | 9.5 | 9.8 |
| Employment rate (%, 15–64 years) | 64.4 | 64.1 | 63.3 | 64.3 | 64.2 | 62.4 | 63.0 | 64.5 | 63.2 |
| Key interest rate per annum (%) | 1.2 | 0.9 | 0.5 | 0.8 | 0.8 | 0.8 | 0.6 | 0.5 | 0.3 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 3.0 | –0.7 | 0.2 | 0.4 | –0.7 | 0.6 | –0.8 | 0.6 | 0.2 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | 6.5 | 3.9 | 19.8 | –5.4 | 3.9 | 10.5 | 19.0 | 18.8 | 19.8 |
| Domestic credit of the banking system | –3.1 | –2.7 | –13.8 | 7.5 | –2.7 | –8.1 | –15.9 | –18.3 | –13.8 |
| *of which: claims on the private sector* | –3.8 | –7.2 | –22.9 | –5.2 | –7.2 | –9.9 | –10.3 | –10.4 | –22.9 |
| *claims on households* | 0.8 | –0.8 | –1.5 | –0.6 | –0.8 | –1.1 | –1.1 | –1.2 | –1.5 |
| *claims on enterprises* | –4.6 | –6.4 | –21.4 | –4.6 | –6.4 | –8.9 | –9.1 | –9.2 | –21.4 |
| *claims on the public sector (net)* | 0.7 | 4.5 | 9.1 | 12.7 | 4.5 | 1.8 | –5.6 | –7.8 | 9.1 |
| Other assets (net) of the banking system | –0.4 | –2.0 | –5.8 | –1.7 | –2.0 | –1.7 | –3.9 | 0.1 | –5.8 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 43.5 | 44.4 | 44.7 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 49.9 | 48.4 | 59.4 | .. | .. | .. | .. | .. | .. |
| General government balance | –6.4 | –4.0 | –14.7 | .. | .. | .. | .. | .. | .. |
| Primary balance | –4.5 | –1.8 | –12.1 | .. | .. | .. | .. | .. | .. |
| Gross public debt | 47.1 | 54.4 | 71.7 | .. | .. | .. | .. | .. | .. |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 85.1 | 83.7 | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | 30.6 | 30.4 | .. | .. | .. | .. | .. | .. | .. |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | –2.6 | –0.3 | 1.8 | 0.7 | 0.3 | 1.6 | 2.6 | 2.7 | 0.2 |
| Services balance | 4.1 | 5.1 | 5.7 | 5.8 | 4.7 | 6.2 | 6.0 | 6.3 | 4.3 |
| Income balance (factor services balance) | –1.4 | –1.6 | –1.2 | –2.2 | –0.5 | –0.9 | –1.3 | –1.3 | –1.4 |
| Current transfers | 0.4 | 0.1 | 0.1 | –0.8 | 1.0 | –1.0 | 0.2 | –0.9 | 1.8 |
| Current account balance | 0.4 | 3.3 | 6.3 | 3.5 | 5.5 | 6.0 | 7.6 | 6.7 | 4.9 |
| Capital account balance | –0.2 | –0.3 | –0.1 | –0.3 | –0.6 | –0.1 | –0.4 | –0.3 | 0.4 |
| Foreign direct investment (net) | 1.8 | 0.5 | –1.6 | 0.9 | –1.9 | –0.8 | –7.4 | –0.2 | 2.2 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 110.9 | 115.7 | 112.2 | 114.2 | 115.7 | 116.1 | 116.1 | 113.7 | 112.2 |
| Gross official reserves (excluding gold) | 1.8 | 1.7 | 1.6 | 1.7 | 1.7 | 1.5 | 1.6 | 1.8 | 1.6 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 36,150 | 35,319 | 35,275 | 9,049 | 8,717 | 8,124 | 9,044 | 9,141 | 8,966 |

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

## 4 Bulgaria: Signs of an Economic Turnaround amid Continuing Deflation Trends

**Moderate economic expansion in the second half of 2013…**

After sluggish economic performance in the first half of 2013, real GDP expanded (year on year) by 1.3% in the second half of the year. Net exports (spurred by continuing strong export growth) remained the main growth driver, but investment also contributed positively to GDP growth for the first time since the third quarter of 2012. As a result, domestic demand ceased to put a strain on GDP growth. Unless suppressed by the continuing decline in private consumption whose downward trend has recently moderated, however, domestic demand would be even more supportive. From a production-side perspective, the turnaround was decisively supported by gross value added in industry, while activities linked to household consumption contributed negatively. The turnaround seems to have carried on in 2014 as both business and consumer sentiment indicators have shown a clear improvement since end-2013 (though they are still fairly below the levels recorded before 2009).

**…but legacies of the crisis still weigh on the recovery**

Despite these promising developments, credit conditions have remained tight. Although lending to households did not shrink in the second half of 2013 (for the first time since early 2010), we see a continuation of near-zero growth of credit to private nonbanks (not least on the back of elevated NPL ratios of more than 14%). Labor market conditions have continued to be challenging too. The unemployment rate stood at more than 13% at the end of 2013, and the share of long-term unemployment has increased to nearly 60%, making the country susceptible to hysteresis effects.

**Continuing deflationary tendencies given the rollback of electricity tariffs and subdued domestic demand**

Deflation has continued in the review period, and the annual HICP reached its hitherto strongest drop of –2.1% in February 2014. This prolonged price decline can mainly be explained by receding costs of housing and utilities (due to last year's rollback of electricity tariffs), transport and healthcare. Another reason is a negative base effect coming from food prices that increased strongly in 2012 while the harvest in 2013 was abundant.

The expansion of unit labor costs also clearly lost momentum in the second half of 2013. This can be traced back to labor productivity gains returning to more vigorous levels and labor costs either advancing at a similar rate (in manufacturing) or at a significantly smaller rate (in the total economy) than in the first half of the year.

**Respectable surplus in the current account balance**

Export growth continued to outperform import growth in the second half of 2013 (not least due to improving ULC conditions) because of subdued domestic demand. As a result, the current account balance improved substantially and recorded a surplus of nearly 2% of GDP by the end of 2013 (the largest surplus in the last decade).

**Budgetary target clearly met in 2013**

Despite a comparatively strong expansion in public consumption in 2013, the general government budget deficit widened from 0.8% of GDP in 2012 to only 1.5% of GDP in 2013, which is fairly below the deficit target of 2% (as defined by the new Socialist-led government in 2013). Several changes in social legislation of 2013 will only materialize in 2014 (such as the increase in minimum wages by nearly 10%). At the same time, the 2014 budget counts on a sharp rise in tax revenue (up by nearly 9% against 2013). It thus remains to be seen whether the government will be able to keep the budget deficit at 1.8% of GDP in 2014.

Table 4

## Main Economic Indicators: Bulgaria

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | 1.8 | 0.6 | 0.9 | 0.4 | 0.9 | –0.1 | 1.1 | 1.6 |
| Private consumption | 1.5 | 3.7 | –2.3 | 3.8 | 2.1 | –2.3 | –3.0 | –2.2 | –1.7 |
| Public consumption | 1.6 | –0.5 | 2.5 | 0.0 | 0.0 | 4.0 | 4.3 | 3.7 | –0.7 |
| Gross fixed capital formation | –6.5 | 4.8 | –0.1 | 2.9 | –1.5 | –9.8 | –1.2 | 1.8 | 5.4 |
| Exports of goods and services | 12.3 | –0.4 | 8.9 | –0.8 | –1.3 | 11.9 | 4.6 | 9.5 | 10.2 |
| Imports of goods and services | 8.8 | 3.3 | 5.7 | 2.4 | –0.9 | 5.7 | 2.0 | 8.4 | 6.7 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | 0.0 | 3.1 | –1.1 | 2.2 | 0.8 | –2.8 | –1.7 | –0.5 | 0.0 |
| Net exports of goods and services | 1.8 | –2.5 | 2.0 | –2.1 | –0.2 | 3.7 | 1.7 | 1.5 | 1.6 |
| Exports of goods and services | 7.1 | –0.3 | 6.0 | –0.6 | –0.8 | 8.0 | 3.1 | 6.9 | 6.0 |
| Imports of goods and services | –5.2 | –2.2 | –3.9 | –1.5 | 0.6 | –4.3 | –1.5 | –5.4 | –4.4 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | 2.2 | 4.4 | 5.4 | 5.1 | 5.1 | 7.7 | 7.9 | 3.8 | 1.9 |
| Unit labor costs in manufacturing (nominal, per hour) | –1.3 | 3.2 | 2.0 | 3.0 | 3.8 | 0.0 | 5.1 | 3.4 | 0.0 |
| Labor productivity in manufacturing (real, per hour) | 4.5 | 2.5 | 2.3 | 1.8 | 1.9 | 5.0 | –1.1 | 0.9 | 5.0 |
| Labor costs in manufacturing (nominal, per hour) | 3.5 | 5.7 | 4.6 | 4.8 | 5.8 | 5.0 | 4.0 | 4.4 | 5.0 |
| Producer price index (PPI) in industry | 9.3 | 4.4 | –1.5 | 5.0 | 5.8 | 1.7 | –0.9 | –3.1 | –3.6 |
| Consumer price index (here: HICP) | 3.4 | 2.4 | 0.4 | 3.0 | 2.8 | 2.1 | 1.1 | –0.7 | –1.0 |
| EUR per 1 BGN, + = BGN appreciation | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 11.4 | 12.4 | 13.0 | 11.6 | 12.5 | 13.8 | 13.0 | 12.1 | 13.2 |
| Employment rate (%, 15–64 years) | 58.4 | 58.8 | 59.5 | 60.6 | 59.4 | 57.7 | 59.5 | 61.1 | 59.6 |
| Key interest rate per annum (%)[1] | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| BGN per 1 EUR | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 12.2 | 8.4 | 8.9 | 8.7 | 8.4 | 8.9 | 7.7 | 8.1 | 8.9 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | 7.9 | 7.5 | 4.9 | 10.1 | 7.5 | 5.7 | 6.2 | 3.3 | 4.9 |
| Domestic credit of the banking system | 7.3 | 2.4 | 3.2 | 1.7 | 2.4 | 3.9 | 1.2 | 4.0 | 3.2 |
| *of which: claims on the private sector* | 3.9 | 2.6 | 0.3 | 3.7 | 2.6 | 2.0 | 0.6 | 0.2 | 0.3 |
| *claims on households* | –0.2 | –0.3 | 0.0 | –0.5 | –0.3 | –0.4 | –0.3 | –0.2 | 0.0 |
| *claims on enterprises* | 4.1 | 3.0 | 0.3 | 4.2 | 3.0 | 2.4 | 0.8 | 0.4 | 0.3 |
| *claims on the public sector (net)* | 3.4 | –0.2 | 3.0 | –2.0 | –0.2 | 1.9 | 0.7 | 3.8 | 3.0 |
| Other assets (net) of the banking system | –3.0 | –1.4 | 0.8 | –3.1 | –1.4 | –0.8 | 0.3 | 0.7 | 0.8 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 33.6 | 35.0 | 37.2 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 35.6 | 35.8 | 38.7 | .. | .. | .. | .. | .. | .. |
| General government balance | –2.0 | –0.8 | –1.5 | .. | .. | .. | .. | .. | .. |
| Primary balance | –1.3 | 0.1 | –0.7 | .. | .. | .. | .. | .. | .. |
| Gross public debt | 16.3 | 18.4 | 18.9 | .. | .. | .. | .. | .. | .. |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 107.9 | 106.6 | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | 25.5 | 24.4 | .. | .. | .. | .. | .. | .. | .. |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | –5.6 | –8.7 | –5.9 | –4.8 | –7.7 | –5.3 | –8.0 | –3.6 | –6.6 |
| Services balance | 6.0 | 6.0 | 5.3 | 13.5 | 2.2 | 1.0 | 4.6 | 13.4 | 1.2 |
| Income balance (factor services balance) | –4.7 | –3.3 | –3.5 | –4.0 | –3.6 | –4.2 | –3.1 | –4.6 | –2.2 |
| Current transfers | 4.4 | 5.2 | 6.0 | 3.5 | 4.5 | 3.6 | 12.0 | 4.8 | 3.5 |
| Current account balance | 0.1 | –0.8 | 1.9 | 8.3 | –4.6 | –4.9 | 5.5 | 10.0 | –4.1 |
| Capital account balance | 1.3 | 1.4 | 1.2 | 1.5 | 3.0 | 0.2 | 1.3 | 1.5 | 1.5 |
| Foreign direct investment (net) | 3.1 | 2.0 | 2.4 | 3.5 | –3.1 | 4.2 | 2.2 | 3.8 | –0.3 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 94.3 | 94.6 | 93.5 | 96.2 | 94.6 | 94.3 | 93.8 | 93.9 | 93.5 |
| Gross official reserves (excluding gold) | 30.6 | 34.9 | 33.3 | 35.2 | 34.9 | 32.1 | 33.4 | 34.3 | 33.3 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 5.6 | 6.0 | 5.7 | 6.0 | 6.0 | 5.6 | 5.8 | 5.9 | 5.7 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 38,505 | 39,927 | 39,940 | 11,066 | 10,863 | 8,389 | 9,809 | 10,768 | 10,974 |

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

[1] *Not available in a currency board regime.*

## 5 Croatia: Another Year of Recession Passed

**Economic contraction caused by weak household consumption and investments**

Although some indicators in the first half of 2013 raised hopes for an end of recession, the Croatian economy continued to contract in the second half of the year. Overall, the loss of GDP amounted to 1.0% in 2013. The contraction was driven by a decline of investments and household consumption, related to the adverse labor market situation as well as negative credit growth rates. The only positive contribution stemmed from government consumption. The contribution of net exports accounted for almost zero, as negative export developments were compensated by declining imports in line with subdued domestic demand. On the production side, the biggest declines were registered in manufacturing and construction.

**Current account posts surplus for the first time**

In 2013, the current account was positive for the first time, posting a surplus of 1.3% of GDP. This development was driven by an increase in the service balance (due to an increase in tourism revenues) and a narrowing of the income deficit as profits of foreign companies plunged. However, the deficit of the goods balance amounted to 14.4% of GDP, which is a slight deterioration compared to 2012, caused by falling exports. On the financing side, net FDI dropped by around 50% year on year to 1.3% of GDP. By contrast, net portfolio investments increased slightly to 4.3% of GDP. Gross external debt rose to 105.3% of GDP, thus aggravating Croatia's fragile position further. Due to the movements in international capital markets Hrvatska narodna banka (HNB) had to intervene in the foreign exchange market in January 2014 to counter depreciation pressures on the dinar.

**Credit contraction decelerates, economy falls into deflation in early 2014**

As in 2012, credit growth was negative but the contraction of credit to the private sector decelerated to 1.0% (compared to 4.1% in 2012). The share of non-performing loans in total loans continued to rise in the second half of 2013, amounting to 11.6% at the year's end. Accordingly, the pre-tax return on assets dropped to 0.3% for the whole year (compared to 0.9% in 2012). With the exception of the tourism-months, inflation decreased over the whole year with prices increasing only 0.5% year on year by the end of 2013. In February 2014, the economy fell into deflation with a price level decrease of 0.2% on a year-to-year basis. The disinflationary development was mainly driven by declining prices of energy and unprocessed food, whereas core inflation started to decrease from October onward but remained in positive territory until February 2014, with a rate of 0.4% on a yearly basis.

**European Commission opens excessive deficit procedure in response to deteriorating fiscal situation**

Croatia reported a somewhat declining, though still elevated fiscal deficit of 4.9% of GDP in 2013. Gross public debt crossed the 60%-of-GDP ceiling and amounted to 67.1% at the end of 2013. As expected the EU opened an excessive deficit procedure (EDP) in January, demanding Croatia to push the budget deficit below 3% of GDP until 2016. The rating agencies reacted to the worsening fiscal situation by lowering Croatia's sovereign rating from "BB+" to "BB" (S&P in January 2014) and revising the outlook from "stable" to "negative" (Fitch in February 2014; Moody's in March 2014), respectively.

Table 5

## Main Economic Indicators: Croatia

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | –0.2 | –1.9 | –1.0 | –1.8 | –2.2 | –1.5 | –0.7 | –0.6 | –1.2 |
| Private consumption | 0.4 | –3.0 | –1.0 | –3.6 | –4.2 | –2.8 | 0.4 | 0.3 | –1.8 |
| Public consumption | –1.4 | –0.8 | 0.5 | –0.3 | –2.0 | 0.3 | 1.4 | –0.9 | 1.2 |
| Gross fixed capital formation | –3.4 | –4.7 | –1.0 | –4.8 | –4.6 | –2.3 | 0.9 | 0.3 | –3.3 |
| Exports of goods and services | 1.7 | 0.9 | –1.8 | 0.6 | 4.3 | –4.3 | 1.4 | –1.3 | –3.8 |
| Imports of goods and services | 2.1 | –2.5 | –1.7 | –4.6 | –2.2 | –6.5 | 5.5 | –1.6 | –4.4 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | –0.1 | –3.3 | –1.0 | –4.8 | –4.5 | –3.0 | 1.1 | –0.5 | –1.6 |
| Net exports of goods and services | –0.1 | 1.4 | –0.1 | 2.2 | 2.5 | 1.5 | –1.8 | –0.2 | 0.4 |
| Exports of goods and services | 0.7 | 0.4 | –0.8 | 0.3 | 1.6 | –1.4 | 0.6 | –0.8 | –1.5 |
| Imports of goods and services | –0.8 | 1.1 | 0.7 | 1.9 | 0.9 | 2.9 | –2.4 | 0.6 | 1.9 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| Unit wage costs in manufacturing (nominal, per hour) | 1.0 | 2.0 | 3.4 | –3.3 | 2.9 | 0.3 | 4.3 | 8.2 | 1.6 |
| Labor productivity in manufacturing (real, per hour) | 1.6 | 2.0 | –1.4 | 6.0 | 1.1 | 6.8 | –3.0 | –6.1 | –1.5 |
| Gross wages in manufacturing (nominal, per hour) | 2.4 | 3.6 | 2.4 | 2.5 | 4.1 | 7.1 | 1.2 | 1.6 | 0.1 |
| Producer price index (PPI) in industry | 6.4 | 7.0 | 0.5 | 7.9 | 7.3 | 4.1 | 1.1 | –0.6 | –2.7 |
| Consumer price index (here: CPI) | 2.2 | 3.3 | 2.3 | 4.1 | 4.4 | 4.2 | 2.4 | 2.2 | 0.6 |
| EUR per 1 HRK, + = HRK appreciation | –2.0 | –1.1 | –0.8 | –0.1 | –0.4 | –0.4 | –0.4 | –1.0 | –1.3 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 13.9 | 16.3 | 17.6 | 15.0 | 18.5 | 18.4 | 17.0 | 16.9 | 18.0 |
| Employment rate (%, 15–64 years) | 52.4 | 50.7 | 49.2 | 52.5 | 48.7 | 47.5 | 49.8 | 50.2 | 49.1 |
| Key interest rate per annum (%) | 6.0 | 7.0 | 7.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| HRK per 1 EUR | 7.4 | 7.5 | 7.6 | 7.5 | 7.5 | 7.6 | 7.6 | 7.5 | 7.6 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 1.6 | 3.2 | 2.9 | 2.1 | 3.2 | 4.4 | 3.4 | 5.1 | 2.9 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | –4.2 | 6.3 | 5.7 | 1.7 | 6.3 | 7.8 | 4.8 | 5.5 | 5.7 |
| Domestic credit of the banking system | 8.8 | –0.8 | –3.0 | 3.7 | –0.8 | –0.5 | –1.5 | 0.4 | –3.0 |
| *of which: claims on the private sector* | 4.9 | –4.1 | –1.0 | –0.5 | –4.1 | –4.2 | –3.2 | –1.0 | –1.0 |
| *claims on households* | 0.5 | –0.7 | –0.9 | –1.0 | –0.7 | –0.6 | –1.4 | –0.2 | –0.9 |
| *claims on enterprises* | 4.4 | –3.4 | –0.2 | 0.5 | –3.4 | –3.6 | –1.8 | –0.8 | –0.2 |
| *claims on the public sector (net)* | 3.9 | 3.3 | –2.0 | 4.3 | 3.3 | 3.7 | 1.6 | 1.4 | –2.0 |
| Other assets (net) of the banking system | –3.0 | –2.4 | 0.3 | –3.3 | –2.4 | –2.9 | 0.2 | –0.8 | 0.3 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 40.3 | 40.8 | 41.0 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 48.1 | 45.7 | 45.9 | .. | .. | .. | .. | .. | .. |
| General government balance | –7.8 | –5.0 | –4.9 | .. | .. | .. | .. | .. | .. |
| Primary balance | –5.2 | –2.0 | –1.9 | .. | .. | .. | .. | .. | .. |
| Gross public debt | 52.0 | 55.9 | 67.1 | .. | .. | .. | .. | .. | .. |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 91.8 | 91.1 | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | 41.3 | 41.0 | .. | .. | .. | .. | .. | .. | .. |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | –13.9 | –13.8 | –14.4 | –12.4 | –11.6 | –15.3 | –17.9 | –13.2 | –11.4 |
| Services balance | 14.0 | 14.7 | 15.7 | 36.0 | 3.9 | 1.9 | 15.3 | 38.3 | 4.3 |
| Income balance (factor services balance) | –3.6 | –3.7 | –2.5 | –4.0 | –1.2 | –3.4 | –2.9 | –2.4 | –1.6 |
| Current transfers | 2.6 | 2.6 | 2.5 | 2.3 | 2.7 | 2.8 | 3.2 | 2.3 | 1.9 |
| Current account balance | –0.9 | –0.1 | 1.3 | 22.0 | –6.2 | –14.0 | –2.3 | 25.0 | –6.8 |
| Capital account balance | 0.1 | 0.1 | 0.1 | 0.0 | 0.3 | –0.1 | 0.1 | 0.1 | 0.1 |
| Foreign direct investment (net) | 2.4 | 2.5 | 1.3 | 1.8 | 3.3 | 5.9 | –0.5 | –0.3 | 0.7 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 103.9 | 102.7 | 105.3 | 104.7 | 102.7 | 102.8 | 105.0 | 103.1 | 105.3 |
| Gross official reserves (excluding gold) | 25.3 | 25.7 | 29.8 | 26.1 | 25.7 | 25.8 | 28.0 | 26.9 | 29.8 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 7.2 | 7.2 | 8.5 | 7.3 | 7.2 | 7.3 | 7.9 | 7.6 | 8.5 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 44,187 | 43,693 | 43,318 | 11,919 | 10,975 | 9,976 | 10,901 | 11,769 | 10,671 |

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

## 6 Czech Republic: On a Broadly Favorable, Though Still Delicate Growth Trajectory

**Strong boost in the final quarter of 2013 against the backdrop of ČNB foreign exchange interventions**

Following a protracted recession, the Czech economy seems to be gathering steam. The hitherto frail recovery was given a surprisingly strong boost in the last quarter of 2013. In the third quarter the rather large negative growth contribution of net exports was overcompensated by the positive impact of stock changes and to some extent public consumption. Gross fixed capital formation and private consumption played only a negligible role. In contrast, the strong GDP growth in the last quarter was driven by net exports, to a lesser degree by private consumption and, most notably, by strong gross fixed capital formation. Apart from improving sentiment indicators and the recuperating euro area, a major stimulus to GDP growth was provided by the ČNB . In early November the ČNB decided to weaken the koruna by approximately 5% against the euro and to keep the new level of about 27 CZK/EUR at least until early 2015. The intervention not only helped exporters but also encouraged investment and consumption in the fourth quarter in anticipation of higher import prices.

The labor market has been improving at a very gradual pace. The average employment rate increased to somewhat above 68% in the second half of 2013. The unemployment rate decreased in parallel, but very moderately, and averaged 6.9%.

**Current account slides into a nondramatic deficit**

The historical surpluses of the trade balance recorded in the first half of 2013 declined to about 3.5% of GDP in the second semester on the back of invigorated imports. The negative income balance stemmed mainly from FDI as a result of dividend payments to nonresidents. The cumulative current account balance deteriorated and posted a deficit of approximately 2.5% of GDP. Overall net FDI in the second half of 2013 was slightly negative (–0.2% of GDP).

**Exchange rate intervention interrupted the disinflationary trend**

HICP annual inflation slowed further down between July and December 2013 and stood just above the lower tolerance boundary of ČNB's target (2% ± 1 percentage point). A noteworthy positive contribution to inflation was delivered just by food, alcohol and tobacco and fuel and energy prices. Despite low inflation in the last quarter (1.1%) monthly figures unveil that the weakened exchange rate in the wake of ČNB's intervention fed through to prices rather quickly. Annual HICP inflation rose from 0.8% in October to 1.5% in December, interrupting the long-term disinflationary trend. However, inflation dived again in the first two months of 2014 (0.3%) owing to a fall in administered energy prices in combination with base effects on the back of past increases in indirect taxes. Against the backdrop of not yet completely averted deflation risk and exhausted standard monetary policy measures (the policy rate has remained at "technical zero" since November 2012) the ČNB has not ruled out a further extension of the intervention period.

**New government expected to stick to fiscal discipline**

In line with the EDP commitment to remove the excessive budget deficit by 2013, the latter came in at 1.5% of GDP in 2013, rendering an abrogation of the EDP likely. The new center-left coalition government which emerged from the early election at end of October was appointed only in late January 2014. Despite the pledge of the new administration to ramp up spending particularly on infrastructure projects and due to the envisaged increase in public sector wages, the budget deficit is expected to hover around 3% of GDP in the foreseeable future.

Table 6

## Main Economic Indicators: Czech Republic

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | 1.8 | –1.0 | –0.9 | –1.5 | –1.1 | –2.9 | –1.7 | –0.1 | 0.8 |
| Private consumption | 0.5 | –2.1 | 0.1 | –2.2 | –2.8 | –1.7 | –0.2 | 1.3 | 1.0 |
| Public consumption | –2.7 | –1.9 | 1.6 | –1.5 | –1.0 | 1.1 | 0.8 | 2.6 | 1.9 |
| Gross fixed capital formation | 0.4 | –4.5 | –3.5 | –5.0 | –6.9 | –6.8 | –6.6 | –3.2 | 1.7 |
| Exports of goods and services | 9.5 | 4.5 | 0.2 | 3.9 | 3.6 | –5.3 | 0.5 | 2.8 | 2.8 |
| Imports of goods and services | 7.0 | 2.3 | 0.6 | –0.4 | 3.1 | –4.5 | –0.9 | 5.2 | 2.5 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | –0.1 | –2.7 | –0.6 | –4.6 | –1.5 | –1.9 | –2.7 | 1.4 | 0.5 |
| Net exports of goods and services | 1.9 | 1.7 | –0.3 | 3.1 | 0.4 | –1.0 | 1.0 | –1.5 | 0.3 |
| Exports of goods and services | 6.4 | 3.3 | 0.1 | 2.8 | 2.6 | –4.4 | 0.4 | 2.1 | 2.2 |
| Imports of goods and services | –4.4 | –1.6 | –0.4 | 0.3 | –2.1 | 3.4 | 0.6 | –3.7 | –1.8 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | 0.1 | 2.0 | . . | 1.1 | 1.5 | –0.4 | –0.4 | 0.4 | . . |
| Unit labor costs in manufacturing (nominal, per hour) | –3.3 | 2.5 | . . | 3.0 | 2.9 | 1.4 | 1.3 | 2.0 | . . |
| Labor productivity in manufacturing (real, per hour) | 6.6 | –0.6 | . . | –0.6 | –5.5 | –0.2 | –2.3 | –6.5 | . . |
| Labor costs in manufacturing (nominal, per hour) | 3.2 | 2.0 | . . | 2.3 | –2.8 | 1.2 | –1.0 | –4.7 | . . |
| Producer price index (PPI) in industry | 3.7 | 2.4 | 0.7 | 2.2 | 0.9 | 0.8 | 0.2 | 0.3 | 1.4 |
| Consumer price index (here: HICP) | 2.1 | 3.5 | 1.4 | 3.4 | 2.9 | 1.7 | 1.5 | 1.2 | 1.1 |
| EUR per 1 CZK, + = CZK appreciation | 2.9 | –2.2 | –3.2 | –2.7 | 0.4 | –1.9 | –2.2 | –3.0 | –5.7 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 6.8 | 7.1 | 7.0 | 7.0 | 7.2 | 7.5 | 6.8 | 7.0 | 6.8 |
| Employment rate (%, 15–64 years) | 65.7 | 66.6 | 67.7 | 67.1 | 67.0 | 66.8 | 67.8 | 68.0 | 68.3 |
| Key interest rate per annum (%) | 0.8 | 0.5 | 0.1 | 0.5 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| CZK per 1 EUR | 24.6 | 25.1 | 26.0 | 25.1 | 25.2 | 25.6 | 25.8 | 25.9 | 26.7 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 2.8 | 4.8 | 5.8 | 4.0 | 4.8 | 5.1 | 4.6 | 5.8 | 5.8 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | –0.8 | 5.4 | 5.6 | 5.1 | 5.4 | 6.1 | 3.7 | 4.2 | 5.6 |
| Domestic credit of the banking system | 7.9 | 1.5 | 3.5 | 3.0 | 1.5 | 2.7 | 1.7 | 3.1 | 3.5 |
| *of which: claims on the private sector* | 4.1 | 1.9 | 2.8 | 2.4 | 1.9 | 2.5 | 1.8 | 2.1 | 2.8 |
| *claims on households* | 2.2 | 1.6 | 1.4 | 1.7 | 1.6 | 1.5 | 1.5 | 1.7 | 1.4 |
| *claims on enterprises* | 1.9 | 0.3 | 1.3 | 0.7 | 0.3 | 1.0 | 0.3 | 0.4 | 1.3 |
| *claims on the public sector (net)* | 3.7 | –0.4 | 0.8 | 0.7 | –0.4 | 0.2 | –0.1 | 0.9 | 0.8 |
| Other assets (net) of the banking system | –4.3 | –2.1 | –3.3 | –4.1 | –2.1 | –3.7 | –0.9 | –1.5 | –3.3 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 40.0 | 40.3 | 40.9 | . . | . . | . . | . . | . . | . . |
| General government expenditures | 43.2 | 44.5 | 42.4 | . . | . . | . . | . . | . . | . . |
| General government balance | –3.2 | –4.2 | –1.5 | . . | . . | . . | . . | . . | . . |
| Primary balance | –1.8 | –2.7 | –0.1 | . . | . . | . . | . . | . . | . . |
| Gross public debt | 41.4 | 46.2 | 46.0 | . . | . . | . . | . . | . . | . . |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 38.5 | 40.0 | . . | . . | . . | . . | . . | . . | . . |
| Debt of households and NPISHs (consolidated) | 30.0 | 32.4 | . . | . . | . . | . . | . . | . . | . . |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | 2.4 | 3.9 | 4.9 | 3.4 | 2.2 | 5.9 | 6.4 | 3.6 | 3.6 |
| Services balance | 1.5 | 1.6 | 1.4 | 1.8 | 1.2 | 1.6 | 1.4 | 1.0 | 1.4 |
| Income balance (factor services balance) | –6.7 | –6.8 | –8.0 | –9.0 | –7.2 | –7.3 | –8.6 | –8.7 | –7.5 |
| Current transfers | 0.1 | –0.1 | 0.4 | –0.5 | 0.6 | 0.9 | –0.6 | –0.3 | 1.5 |
| Current account balance | –2.7 | –1.3 | –1.4 | –4.3 | –3.2 | 1.1 | –1.4 | –4.3 | –1.0 |
| Capital account balance | 0.4 | 1.4 | 1.9 | 0.7 | 4.5 | 0.0 | 0.0 | 5.5 | 2.0 |
| Foreign direct investment (net) | 1.2 | 3.2 | 0.9 | 2.7 | 3.4 | 3.0 | 1.0 | –0.6 | 0.2 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 46.8 | 50.8 | 54.0 | 50.3 | 50.8 | 51.1 | 52.1 | 50.7 | 54.0 |
| Gross official reserves (excluding gold) | 19.7 | 21.9 | 27.1 | 20.3 | 21.9 | 22.5 | 21.9 | 22.3 | 27.1 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 3.4 | 3.6 | 4.4 | 3.3 | 3.6 | 3.7 | 3.6 | 3.7 | 4.4 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 155,452 | 152,911 | 149,441 | 38,605 | 39,849 | 35,115 | 37,492 | 38,034 | 38,800 |

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

## 7 Hungary: Loose Monetary Policy Supports Cyclical Recovery

**GDP growth solidifies**

GDP growth accelerated further in the second half of 2013, reaching 2.7% year on year in the fourth quarter. The structure of growth became more balanced as domestic demand continued to recover. Investment growth picked up sharply on the back of accelerated absorption of EU funds and easing lending conditions, reflecting key interest rate cuts and the Funding for Growth Scheme (FGS) for SMEs. Private consumption was supported by the sharp fall in inflation, wage increases, accelerating employment growth and decreasing unemployment. Public sector wage increases and the purchase of goods and services fueled government consumption. Export growth accelerated sharply reflecting strong external demand, improving cost competitiveness and new export capacities going on line. As import growth picked up less strongly, the contribution of net real exports became positive again.

**Budget deficit to remain narrowly below 3%**

The budget deficit amounted to 2.2% of GDP in 2013, well below the 2.7% target. The Commission expects the deficit to be at or slightly below 3% in 2014–2015, given additional spending measures, rising interest expenditure and only modest private consumption growth in nominal terms. The structural balance is set to worsen substantially in 2014 (from –1.1% to –2.4% of GDP) and to improve only marginally in 2015 (–2.3%) Thus it will fail to approach the medium-term objective of –1.7%, and government debt will likewise remain stuck slightly below 80% of GDP. In the assessment of the European Commission, "Hungary continues to experience macroeconomic imbalances, which require monitoring and decisive policy action." The highly negative net international investment position, high public and private sector debt levels, a fragile financial sector (including the high share of NPLs and foreign currency loans and an adverse operating environment) and deteriorating export performance are among the major risk factors.

**Speed of rate cutting slowed, Funding for Growth Scheme prolonged**

Referring to substantial spare capacity and sustainably low inflation, the MNB continued to reduce its policy rate during the reference period (albeit in smaller steps) despite increasing financial market volatility, bringing it to 2.6% by end-March. Disinflation has been supported by a third wave of utility price cuts effective from November 1, 2013, low imported inflation and the negative output gap. The reduction in the interest rate differential has, however, made Hungarian asset prices and the currency more susceptible to changes in global investor sentiment, as suggested by the underperformance of the local government bond market and the forint compared to some of the regional peers during the first quarter of 2014.

Monetary easing has continued through the FGS as well. The MNB decided in September 2013 to prolong (until end-2014) and expand the volume (to a total of close to 10% of GDP) and the coverage of the scheme. According to first indications, however, the utilization of the first new tranche lags behind expectations. The MNB expects a strengthening of loan demand from the second quarter of 2014 in line with the usual seasonality of investments and better knowledge about new EU funding opportunities for the 2014–2020 program period.

As to the issue of households' foreign currency loans, the government has so far refrained from a new round of rescue measures (apart from the parliament-initiated extension of the exchange rate cap scheme to delinquent borrowers and to larger loan contracts). The exact design of any new support measures will be known only after the Supreme Court delivers its verdict on the general legal framework for foreign currency loans and on potential possibilities for interference with private contracts.

Table 7

## Main Economic Indicators: Hungary

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | 1.6 | −1.7 | 1.1 | −1.7 | −2.7 | −0.8 | 0.5 | 1.8 | 2.7 |
| Private consumption | 0.4 | −1.6 | 0.2 | −4.0 | −0.9 | −0.5 | 0.2 | 0.1 | 1.1 |
| Public consumption | 0.0 | −1.2 | 1.3 | −1.7 | 0.3 | 0.5 | 2.8 | 0.1 | 1.7 |
| Gross fixed capital formation | −5.9 | −3.7 | 5.9 | −0.9 | −6.7 | −5.2 | 5.4 | 8.3 | 10.4 |
| Exports of goods and services | 8.4 | 1.7 | 5.3 | 2.1 | −1.5 | 2.2 | 3.6 | 6.4 | 8.8 |
| Imports of goods and services | 6.4 | −0.1 | 5.3 | −0.6 | −0.9 | 1.7 | 6.0 | 5.8 | 7.6 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | −0.5 | −3.3 | 0.7 | −4.1 | −2.1 | −1.3 | 2.2 | 0.8 | 1.2 |
| Net exports of goods and services | 2.1 | 1.6 | 0.4 | 2.4 | −0.6 | 0.6 | −1.8 | 1.1 | 1.5 |
| Exports of goods and services | 7.2 | 1.5 | 5.0 | 1.9 | −1.4 | 2.2 | 3.5 | 6.0 | 7.9 |
| Imports of goods and services | −5.1 | 0.1 | −4.6 | 0.5 | 0.8 | −1.5 | −5.2 | −4.9 | −6.5 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | 2.2 | 2.9 | 4.0 | 2.9 | 2.9 | 3.6 | 4.9 | 3.3 | 4.1 |
| Unit labor costs in manufacturing (nominal, per hour) | 4.5 | 6.5 | 1.3 | 5.2 | 9.7 | 4.8 | 1.2 | 0.4 | −1.2 |
| Labor productivity in manufacturing (real, per hour) | 1.4 | 0.8 | 1.6 | 2.4 | −1.9 | −1.6 | 1.2 | 2.1 | 4.5 |
| Labor costs in manufacturing (nominal, per hour) | 6.0 | 7.4 | 2.8 | 7.7 | 7.6 | 3.2 | 2.4 | 2.5 | 3.2 |
| Producer price index (PPI) in industry | 4.2 | 4.2 | 0.6 | 4.5 | −1.5 | 0.6 | −0.1 | 1.6 | 0.3 |
| Consumer price index (here: HICP) | 3.9 | 5.7 | 1.7 | 6.0 | 5.5 | 2.7 | 1.9 | 1.6 | 0.7 |
| EUR per 1 HUF, + = HUF appreciation | −1.4 | −3.5 | −2.6 | −2.9 | 7.1 | 0.1 | −0.5 | −5.0 | −4.8 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 11.0 | 11.0 | 10.3 | 10.5 | 10.8 | 11.8 | 10.3 | 9.9 | 9.2 |
| Employment rate (%, 15–64 years) | 55.8 | 57.2 | 58.5 | 58.2 | 57.8 | 56.6 | 58.3 | 59.2 | 59.7 |
| Key interest rate per annum (%) | 6.0 | 6.8 | 4.4 | 6.9 | 6.2 | 5.5 | 4.7 | 4.0 | 3.3 |
| HUF per 1 EUR | 279.3 | 289.3 | 296.9 | 283.1 | 283.4 | 296.6 | 295.6 | 298.0 | 297.6 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 5.9 | −3.3 | 6.5 | −4.1 | −3.3 | 5.5 | 4.5 | 3.1 | 6.5 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | 17.8 | 5.1 | 6.6 | 3.9 | 5.1 | 14.4 | 10.3 | 1.0 | 6.6 |
| Domestic credit of the banking system | −3.1 | −11.8 | 0.4 | −8.8 | −11.8 | −5.2 | −4.4 | 5.8 | 0.4 |
| of which: claims on the private sector | −0.6 | −13.7 | −4.6 | −13.6 | −13.7 | −6.0 | −6.5 | −2.9 | −4.6 |
| claims on households | −0.5 | −7.3 | −2.3 | −8.2 | −7.3 | −2.0 | −2.7 | −1.6 | −2.3 |
| claims on enterprises | −0.1 | −6.3 | −2.3 | −5.3 | −6.3 | −3.9 | −3.7 | −1.3 | −2.3 |
| claims on the public sector (net) | −2.6 | 1.8 | 4.9 | 4.8 | 1.8 | 0.8 | 2.1 | 8.7 | 4.9 |
| Other assets (net) of the banking system | −8.7 | 3.4 | −0.5 | 0.7 | 3.4 | −3.7 | −1.3 | −3.7 | −0.5 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 54.3 | 46.6 | 47.6 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 50.0 | 48.7 | 49.8 | .. | .. | .. | .. | .. | .. |
| General government balance | 4.3 | −2.1 | −2.2 | .. | .. | .. | .. | .. | .. |
| Primary balance | 8.4 | 2.2 | 2.0 | .. | .. | .. | .. | .. | .. |
| Gross public debt | 82.1 | 79.8 | 79.2 | .. | .. | .. | .. | .. | .. |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 97.1 | 97.8 | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | 33.6 | 31.6 | .. | .. | .. | .. | .. | .. | .. |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | 3.1 | 3.6 | 4.4 | 4.0 | 1.8 | 4.6 | 4.0 | 5.3 | 3.8 |
| Services balance | 3.2 | 3.5 | 3.6 | 4.4 | 2.4 | 3.4 | 4.0 | 4.7 | 2.3 |
| Income balance (factor services balance) | −6.5 | −6.6 | −6.1 | −6.0 | −6.8 | −5.7 | −6.6 | −5.8 | −6.0 |
| Current transfers | 0.6 | 0.4 | 1.1 | 0.1 | 2.2 | 0.2 | 1.0 | 0.6 | 2.3 |
| Current account balance | 0.4 | 0.9 | 3.0 | 2.5 | −0.3 | 2.4 | 2.3 | 4.8 | 2.4 |
| Capital account balance | 2.3 | 2.7 | 3.5 | 2.3 | 4.1 | 2.7 | 3.3 | 2.4 | 5.3 |
| Foreign direct investment (net) | 1.0 | 2.1 | 0.6 | 3.1 | 4.8 | 1.7 | −3.7 | −2.3 | 6.5 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 134.8 | 128.5 | 118.7 | 135.3 | 128.5 | 127.1 | 125.9 | 119.3 | 118.7 |
| Gross official reserves (excluding gold) | 38.1 | 34.8 | 34.4 | 36.0 | 34.8 | 36.2 | 34.7 | 31.3 | 34.4 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 5.4 | 4.8 | 4.7 | 4.9 | 4.8 | 5.0 | 4.8 | 4.3 | 4.7 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 98,872 | 97,129 | 98,066 | 25,520 | 26,834 | 21,747 | 24,449 | 25,132 | 26,738 |

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

## 8 Poland: Economic Growth Becoming More Balanced

**Export-led recovery translates into domestic demand growth**

In 2013, annual GDP growth amounted to 1.6%, with exports contributing 2.0 percentage points (ppts) and domestic demand subtracting 0.1. Weak total final demand caused imports to roughly stagnate, implying a net export contribution of 1.7 ppts. In parallel, the current account deficit fell to only 1.3% of GDP. Annual GDP growth accelerated from 0.5% in the first quarter to 2.3% in the final quarter.

Export growth, the increase in public consumption, the substantial rise of average retirement pensions and the acceleration of wage growth coupled with disinflation helped improve sentiment, invigorate private consumption growth and trigger fixed-investment expansion in the second half of 2013. In parallel, the share of profitable companies rose substantially. Finally, employment growth set in, sufficiently strong to lower unemployment rates despite a strong increase in the labor force. Credit growth is generally subdued, only consumption loan growth clearly accelerated.

**Interest rate policy on hold**

External price competitiveness of manufacturing has improved in year-on-year terms, as strong productivity gains exceeded accelerated wage growth so that unit labor costs declined, and the złoty has been slightly weaker than a year earlier since mid-2013. The złoty was roughly stable against the euro from October to March at close to 4.20 per euro. In February, annual headline inflation stood at 0.7% (both HICP and national CPI). Headline was close to core inflation, as the decline in energy prices and the rise in unprocessed food prices offset each other. The Polish Monetary Policy Council, pursuing an inflation target of 2.5% (CPI), has maintained the reference rate at 2.5% since July 2013 and recently issued forward guidance to remain on hold until the end of the third quarter.

**One-off surplus in 2014, and moderate structural improvement**

The general government deficit in 2013 amounted to 4.3% of GDP, higher than envisaged in the convergence program of April 2013 (3.5%), as weaker economic growth and steeper disinflation caused the revenue-to-GDP ratio to decline strongly. In response to ECOFIN decisions to extend the deadline for correcting the excessive deficit to 2014 and 2015 and to require Poland to take corrective action by October 1, 2013, and April 15, 2015, respectively, the Polish authorities adopted measures to improve the fiscal balance in 2014 by 10 ppts so that the European Commission expects a surplus of 5.0% of GDP. This, however, includes 8.8% of GDP one-off revenue due to changes in the pension system that will not count under the new ESA 2010 rules (coming into force in autumn 2014). These changes consist in transferring about 50% of the private pension funds' (OFEs) assets (state bonds) and liabilities (future pay-outs) to the public pay-as-you-go social insurance fund (ZUS). This transfer (one-off revenue) will lower explicit general government gross debt to 50% of GDP by end-2014. Participants may opt to continue to put part of their future contributions into OFEs; unless they do so by June, contributions will by default flow into notional individual pension accounts in ZUS. Permanent measures on the revenue side amount to 0.6 ppts (e.g. refraining from the envisaged cut in VAT rates and fees for the use of digital frequencies). Permanent measures on the expenditure side comprise a partial public wage freeze (0.15 ppts) and pension-related cuts: abolition of early retirement scheme (0.2 ppts), further gradual increase of retirement age to 67 years (0.1 ppts) and lower interest payments given changes in the pension system (0.3 ppts). The European Commission expects the deficit for 2014 without one-off revenues at 3.8% of GDP and the structural deficit at 2.9% of GDP.

Table 8

## Main Economic Indicators: Poland

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | 4.5 | 1.9 | 1.6 | 0.8 | 0.5 | 1.2 | 2.0 | 2.3 |
| Private consumption | 2.6 | 1.2 | 0.8 | 0.4 | 0.7 | –0.1 | 0.3 | 0.9 | 2.2 |
| Public consumption | –1.7 | 0.2 | 2.0 | 1.3 | 1.2 | –0.3 | 4.8 | 1.5 | 2.1 |
| Gross fixed capital formation | 8.5 | –1.7 | –0.4 | –2.3 | –5.1 | –2.7 | –3.3 | 0.8 | 1.5 |
| Exports of goods and services | 7.7 | 3.9 | 4.3 | 2.6 | 4.1 | 1.3 | 3.4 | 6.5 | 6.0 |
| Imports of goods and services | 5.5 | –0.7 | 0.7 | –2.6 | –1.2 | –1.6 | –2.1 | 3.2 | 3.3 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | 3.6 | –0.1 | –0.1 | –0.8 | –1.4 | –0.9 | –1.5 | 0.5 | 1.1 |
| Net exports of goods and services | 0.9 | 2.1 | 1.7 | 2.5 | 2.2 | 1.4 | 2.6 | 1.6 | 1.2 |
| Exports of goods and services | 3.3 | 1.8 | 2.0 | 1.2 | 1.7 | 0.6 | 1.6 | 3.1 | 2.6 |
| Imports of goods and services | –2.4 | 0.3 | –0.3 | 1.3 | 0.5 | 0.8 | 1.0 | –1.5 | –1.4 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | 1.4 | 0.7 | . . | 0.8 | 0.7 | 2.6 | 1.7 | 1.9 | . . |
| Unit labor costs in manufacturing (nominal, per hour) | 0.7 | 1.7 | 0.2 | 1.5 | 5.9 | 2.8 | 0.5 | –1.0 | –1.5 |
| Labor productivity in manufacturing (real, per hour) | 3.9 | 2.7 | 3.3 | 4.9 | –2.9 | 1.2 | 1.2 | 3.4 | 7.3 |
| Labor costs in manufacturing (nominal, per hour) | 4.6 | 4.5 | 3.4 | 6.4 | 2.8 | 4.1 | 1.7 | 2.3 | 5.6 |
| Producer price index (PPI) in industry | 7.3 | 3.3 | –1.2 | 2.8 | 0.1 | –0.5 | –1.9 | –1.1 | –1.3 |
| Consumer price index (here: HICP) | 3.9 | 3.7 | 0.8 | 3.9 | 2.8 | 1.3 | 0.5 | 0.9 | 0.6 |
| EUR per 1 PLN, + = PLN appreciation | –3.0 | –1.6 | –0.3 | 0.3 | 7.5 | 1.8 | 1.3 | –2.6 | –1.8 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 9.8 | 10.2 | 10.5 | 10.0 | 10.2 | 11.4 | 10.6 | 9.9 | 9.9 |
| Employment rate (%, 15–64 years) | 59.3 | 59.7 | 60.0 | 60.2 | 60.0 | 58.7 | 59.8 | 60.7 | 60.8 |
| Key interest rate per annum (%) | 4.2 | 4.6 | 2.9 | 4.8 | 4.5 | 3.7 | 3.0 | 2.5 | 2.5 |
| PLN per 1 EUR | 4.1 | 4.2 | 4.2 | 4.1 | 4.1 | 4.2 | 4.2 | 4.2 | 4.2 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 12.5 | 4.5 | 6.2 | 7.6 | 4.5 | 6.6 | 7.0 | 6.1 | 6.2 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | 6.4 | 3.3 | –2.8 | 4.7 | 3.3 | 6.2 | 0.9 | –1.5 | –2.8 |
| Domestic credit of the banking system | 14.0 | 1.0 | 8.1 | 4.3 | 1.0 | 4.0 | 6.6 | 7.7 | 8.1 |
| *of which: claims on the private sector* | 13.1 | 2.3 | 4.2 | 5.0 | 2.3 | 3.5 | 3.6 | 3.9 | 4.2 |
| *claims on households* | 7.4 | 0.2 | 2.7 | 0.9 | 0.2 | 1.6 | 1.5 | 2.7 | 2.7 |
| *claims on enterprises* | 5.7 | 2.1 | 1.5 | 4.1 | 2.1 | 1.8 | 2.1 | 1.3 | 1.5 |
| *claims on the public sector (net)* | 0.9 | –1.3 | 3.9 | –0.7 | –1.3 | 0.5 | 3.0 | 3.8 | 3.9 |
| Other assets (net) of the banking system | –7.9 | 0.2 | 0.9 | –1.4 | 0.2 | –3.6 | –0.5 | –0.1 | 0.9 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 38.4 | 38.3 | 37.5 | . . | . . | . . | . . | . . | . . |
| General government expenditures | 43.5 | 42.2 | 41.8 | . . | . . | . . | . . | . . | . . |
| General government balance | –5.1 | –3.9 | –4.3 | . . | . . | . . | . . | . . | . . |
| Primary balance | –2.4 | –1.1 | –1.7 | . . | . . | . . | . . | . . | . . |
| Gross public debt | 56.2 | 55.6 | 57.0 | . . | . . | . . | . . | . . | . . |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 37.3 | 41.0 | . . | . . | . . | . . | . . | . . | . . |
| Debt of households and NPISHs (consolidated) | 33.4 | 35.7 | . . | . . | . . | . . | . . | . . | . . |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | –2.7 | –1.4 | 0.6 | –0.4 | –1.0 | –0.2 | 1.3 | 1.1 | 0.1 |
| Services balance | 1.1 | 1.2 | 1.4 | 1.1 | 1.0 | 1.4 | 1.8 | 1.1 | 1.2 |
| Income balance (factor services balance) | –4.6 | –4.6 | –4.2 | –5.3 | –4.0 | –4.2 | –4.9 | –5.0 | –3.0 |
| Current transfers | 1.2 | 1.0 | 1.0 | 0.8 | 0.9 | 0.4 | 2.3 | 0.5 | 0.8 |
| Current account balance | –5.0 | –3.7 | –1.3 | –3.8 | –3.1 | –2.5 | 0.5 | –2.2 | –1.0 |
| Capital account balance | 2.0 | 2.2 | 2.3 | 2.6 | 2.3 | 0.9 | 3.5 | 2.4 | 2.4 |
| Foreign direct investment (net) | 2.4 | 1.1 | –0.2 | 0.9 | 1.6 | 1.2 | –0.5 | 0.5 | –1.9 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 67.5 | 72.7 | 70.8 | 73.7 | 72.7 | 72.5 | 70.7 | 72.2 | 70.8 |
| Gross official reserves (excluding gold) | 19.4 | 20.6 | 19.1 | 20.8 | 20.6 | 21.0 | 20.3 | 19.6 | 19.1 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 5.0 | 5.3 | 5.0 | 5.3 | 5.3 | 5.5 | 5.3 | 5.1 | 5.0 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 370,414 | 381,518 | 388,811 | 95,181 | 107,523 | 90,939 | 94,244 | 95,183 | 108,444 |

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

## 9 Romania: Relatively High GDP Growth, Improving External Position

Growth speeds up
in the second half of
2013

Economic growth accelerated in the second half of 2013, bringing the full-year figure to 3.5%, the highest growth rate since 2008. Growth was driven by an outstandingly good agricultural output and a remarkable export performance. However, with imports picking up, the growth contribution of net exports declined since mid-2013. In contrast to the first half of the year, domestic demand contributed positively to growth due to recovering private consumption, which was supported by moderate real wage growth. Yet, declining public consumption and above all shrinking gross fixed capital investments cloud the overall favorable growth picture somewhat. Moreover, agricultural output is rather volatile and cannot be seen as a sustainable growth driver. Furthermore, the banking sector is still burdened with a high share of nonperforming loans in total loans, and private sector credit growth remained negative in nominal terms.

Combined current
and capital account
balance in surplus

Romania's current account balance improved notably in 2013, as the deficit came down to 1.1% of GDP. The improvement was mainly driven by a retreating trade deficit, as export growth was supported by falling unit labor costs in the manufacturing sector and import growth was weak due to subdued domestic demand. It should also be noted that the surplus in the capital account increased noticeably in the second half of the year mainly due to a better absorption of EU structural and cohesion funds. As a result, the combined current and capital account even posted a surplus of 1.2% in 2013. This surplus, together with positive net FDI and portfolio inflows, more than compensated for net outflows in the category other investments, which were related to orderly cross-border bank deleveraging and IMF repayments. In sum, financial account dynamics resulted in a markedly falling external debt stock. Against the backdrop of the improving external position, financial market stress in some emerging economies had only limited impact on Romanian financial markets.

Romania's precautionary support program with the IMF and the EU remained broadly on track, as the general government budget deficit target was missed only by a small margin, while most other end-December performance criteria and structural benchmarks were met. In 2013 the budget deficit, which was affected by increased co-financing expenditure to support EU fund absorption, fell to 2.3% of GDP. In line with the program, the budget plan targets a deficit of 2.2% of GDP for 2014, taking inter alia into account again higher co-financing expenditure, an increase in minimum wages as well as another targeted increase in public sector salaries. Revenue-side measures include an excise rate hike for energy products, which was, however delayed by three months. Foregone earnings due to the delay will be compensated by some expenditure freezes.

Annual consumer price inflation (CPI) fell further to 1.6% in December almost dropping to the lower bound of Banca Națională a României's (BNR) inflation target band of 2.5% ±1 percentage point. Declining food prices due to the bumper harvest, a cut in the VAT rate for some bakery products as of September 2013 as well as a negative output gap were among the main factors behind this decline. Disinflation continued in early 2014, as inflation declined to 1.1% in February. The BNR cut its key policy rate further in November, January and February by 25 basis points each time, to 3.5%. The central bank expects inflation to remain below the target band for a while before picking up again in the second half of 2014.

Table 9

## Main Economic Indicators: Romania

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | 2.4 | 0.5 | 3.5 | –0.6 | 0.8 | 2.1 | 1.4 | 4.2 | 5.4 |
| Private consumption | 1.5 | 1.4 | 1.3 | 1.6 | 0.3 | –0.2 | 0.4 | 1.9 | 2.8 |
| Public consumption | 0.6 | 1.0 | –1.5 | 1.7 | –0.7 | 0.9 | –5.8 | –6.9 | 3.8 |
| Gross fixed capital formation | 7.7 | 4.2 | –3.4 | 7.8 | –2.7 | –9.5 | –2.2 | –2.1 | –2.6 |
| Exports of goods and services | 12.0 | –1.8 | 13.1 | –4.1 | –2.6 | 7.4 | 8.2 | 20.3 | 16.8 |
| Imports of goods and services | 10.6 | –0.3 | 2.3 | –1.5 | –2.1 | –0.1 | –3.6 | 7.9 | 5.1 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | 2.6 | 1.0 | –0.9 | 0.1 | 0.5 | –3.1 | –6.8 | 0.8 | 1.0 |
| Net exports of goods and services | –0.2 | –0.5 | 4.4 | –0.7 | 0.1 | 4.2 | 6.3 | 3.0 | 3.5 |
| Exports of goods and services | 4.1 | –0.6 | 5.5 | –1.6 | –1.0 | 4.1 | 3.7 | 7.5 | 6.0 |
| Imports of goods and services | –4.3 | 0.1 | –1.1 | 0.9 | 1.0 | 0.0 | 2.6 | –4.5 | –2.5 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | –8.1 | 5.2 | 2.1 | 8.1 | 7.7 | 4.5 | 2.1 | 1.7 | 1.0 |
| Unit labor costs in manufacturing (nominal, per hour) | 1.6 | 7.1 | –1.6 | 7.4 | 3.6 | 1.2 | –1.3 | –3.8 | –2.6 |
| Labor productivity in manufacturing (real, per hour) | 5.1 | 0.2 | 7.2 | 0.0 | 2.2 | 5.7 | 6.7 | 8.5 | 7.8 |
| Labor costs in manufacturing (nominal, per hour) | 7.2 | 7.3 | 5.4 | 7.4 | 5.9 | 7.0 | 5.3 | 4.4 | 5.0 |
| Producer price index (PPI) in industry | 7.1 | 5.3 | 2.1 | 5.6 | 5.5 | 5.2 | 2.8 | 0.7 | –0.5 |
| Consumer price index (here: HICP) | 5.8 | 3.4 | 3.2 | 4.2 | 4.7 | 4.8 | 4.4 | 2.4 | 1.3 |
| EUR per 1 RON, + = RON appreciation | –0.7 | –4.9 | 0.9 | –5.9 | –4.2 | –0.8 | 0.7 | 1.9 | 1.7 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 7.7 | 7.3 | 7.6 | 7.0 | 7.2 | 7.8 | 7.8 | 7.3 | 7.5 |
| Employment rate (%, 15–64 years) | 58.5 | 59.5 | 59.7 | 60.8 | 59.3 | 58.1 | 60.2 | 61.0 | 59.5 |
| Key interest rate per annum (%) | 6.2 | 5.3 | 4.8 | 5.3 | 5.3 | 5.3 | 5.3 | 4.7 | 4.1 |
| RON per 1 EUR | 4.2 | 4.5 | 4.4 | 4.5 | 4.5 | 4.4 | 4.4 | 4.4 | 4.5 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 6.6 | 2.7 | 8.8 | 5.7 | 2.7 | 4.2 | 5.0 | 4.8 | 8.8 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | –1.6 | 6.7 | 13.6 | 1.4 | 6.7 | 9.2 | 11.2 | 13.6 | 13.6 |
| Domestic credit of the banking system | 11.4 | 0.1 | –5.4 | 8.7 | 0.1 | –2.1 | –7.4 | –11.7 | –5.4 |
| *of which: claims on the private sector* | 6.8 | 1.5 | –3.3 | 4.4 | 1.5 | –0.1 | –1.2 | –3.4 | –3.3 |
| *claims on households* | 1.1 | 0.1 | –0.5 | 0.9 | 0.1 | –0.4 | –0.6 | –1.1 | –0.5 |
| *claims on enterprises* | 5.7 | 1.4 | –2.7 | 3.6 | 1.4 | 0.3 | –0.6 | –2.3 | –2.7 |
| *claims on the public sector (net)* | 4.7 | –1.4 | –2.2 | 4.3 | –1.4 | –2.0 | –6.2 | –8.3 | –2.2 |
| Other assets (net) of the banking system | –3.2 | –4.1 | 0.6 | –4.4 | –4.1 | –2.9 | 1.3 | 2.9 | 0.6 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 33.9 | 33.7 | 32.7 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 39.4 | 36.7 | 35.0 | .. | .. | .. | .. | .. | .. |
| General government balance | –5.5 | –3.0 | –2.3 | .. | .. | .. | .. | .. | .. |
| Primary balance | –3.9 | –1.2 | –0.5 | .. | .. | .. | .. | .. | .. |
| Gross public debt | 34.7 | 38.0 | 38.4 | .. | .. | .. | .. | .. | .. |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 51.1 | 52.4 | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | 21.4 | 21.0 | .. | .. | .. | .. | .. | .. | .. |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | –5.6 | –5.6 | –2.4 | –5.7 | –4.8 | –2.0 | –2.7 | –2.7 | –2.1 |
| Services balance | 0.3 | 0.9 | 1.8 | 1.0 | 1.3 | 2.2 | 2.0 | 2.2 | 1.5 |
| Income balance (factor services balance) | –1.7 | –2.3 | –3.1 | –1.5 | –1.5 | –3.1 | –2.6 | –3.1 | –3.9 |
| Current transfers | 2.5 | 2.6 | 2.6 | 1.6 | 2.3 | 3.0 | 3.7 | 1.7 | 2.4 |
| Current account balance | –4.5 | –4.5 | –1.1 | –4.6 | –2.7 | 0.0 | 0.4 | –1.9 | –2.1 |
| Capital account balance | 0.5 | 1.5 | 2.3 | 0.8 | 1.8 | 1.1 | 1.9 | 3.1 | 2.6 |
| Foreign direct investment (net) | 1.4 | 1.7 | 1.8 | 2.6 | 1.4 | 1.5 | 2.9 | 0.0 | 2.9 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 75.2 | 75.9 | 67.9 | 76.5 | 75.9 | 75.7 | 73.6 | 71.6 | 67.6 |
| Gross official reserves (excluding gold) | 25.3 | 23.8 | 22.9 | 24.8 | 23.8 | 24.3 | 24.0 | 24.1 | 22.9 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 6.7 | 6.3 | 6.4 | 6.5 | 6.3 | 6.5 | 6.6 | 6.6 | 6.4 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 131,289 | 131,267 | 142,117 | 35,847 | 38,504 | 27,389 | 33,280 | 38,626 | 43,348 |

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

## 10  Turkey: Mounting Political Risk Adds to Economic Vulnerability

**Public investment and domestic demand spur growth in 2013**

The Turkish economy continued to expand robustly in the second half of 2013, leading to an annual growth rate of real GDP of 4%, almost twice as high as the figure for 2012. Growth was driven primarily by domestic demand, in particular private consumption remained strong and gross fixed capital formation rebounded notably. The latter was supported by high public expenditure on infrastructure projects, strongly boosting construction activity. Also public consumption ticked up again in the final quarter. However, economic activity showed decreasing dynamics in the third and fourth quarter in seasonal and calendar adjusted terms. Further, confidence indicators fell sharply around the turn of the year and only recovered partly in March.

**External imbalances remain high**

In line with strong household consumption and investment, import growth was vivid and increased in particular in the fourth quarter (9.3% year on year). At the same time, exports declined in the second half of the year. The contribution of net exports to GDP growth was thus negative in 2013 as a whole. Stagnating exports along with strong import growth over the entire year – both developments are still influenced among other factors by the normalization in the gold balance – caused the current account deficit to widen (after a temporary contraction in the third quarter) to –7.9% of GDP by year-end 2013. Financing continues to be heavily reliant on short-term capital inflows. In 2013, FDI net inflows covered roughly 15% of the deficit, portfolio investments amounted to about 36%.

Substantial currency depreciation over the second half of 2013 added to a rise in inflation up to 7.5% at the end of the year. This implies an overshooting of the 5% target, and inflation continued to rise in recent months, reaching 8.4% in March. Unemployment remained high at around 9% owing to slow rehiring of previously laid-off workers in an environment of heightened uncertainty, tighter monetary policy and persistent structural weaknesses. Strong GDP growth in 2013 helped to keep the fiscal deficit (1.6% of GDP) and public debt (36% of GDP) at low levels. The finance minister ruled out fiscal slippage related to elections in 2014. Local elections at the end of March brought a clear victory for the ruling AKP party. Presidential elections will be held on August 10.

**Strong pressure on the lira from external and domestic factors**

In 2013, Fed tapering and rising political risks related to the government's response to the Gezi park protests and more recently to corruption allegations put the lira repeatedly under substantial pressure. On January 24, the lira reached an all-time low of 2.34 TRY/USD (3.19 TRY/EUR). The cumulative depreciation between mid-May 2013 and January 24, 2014, amounted to 28.2% against the USD and 36.1% against the EUR. Following a decisive interest rate hike by the CBRT on January 28, the currency stabilized and regained roughly 6% against both, USD and EUR. On January 28, the CBRT decided to raise the main policy rate (one-week repo) from 4.5% to 10%. As bank funding was done at the overnight lending rate of 7.75% prior to the interest rate decision, the effective rate hike was only 225 basis points.

The CBRT has taken further macroprudential measures to curb high credit growth. In October, credit card limits were introduced and provisioning rates for consumer, export and SME loans were changed. In combination with higher interest rates, credit growth has decelerated in recent weeks, still outpacing the 15% target and remaining considerably above deposit growth.

## Main Economic Indicators: Turkey

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| | *Year-on-year change of the period total in %* | | | | | | | | |
| GDP at constant prices | 8.5 | 2.5 | 4.0 | 1.5 | 1.3 | 2.9 | 4.5 | 4.3 | 4.4 |
| Private consumption | 7.9 | −0.7 | 4.6 | −0.2 | −0.2 | 3.4 | 5.1 | 4.7 | 5.3 |
| Public consumption | 4.4 | 6.4 | 5.9 | 5.5 | 8.5 | 7.6 | 7.8 | 1.7 | 6.8 |
| Gross fixed capital formation | 17.6 | −1.9 | 4.3 | −3.3 | −1.7 | 1.5 | 3.4 | 6.0 | 6.4 |
| Exports of goods and services | 6.5 | 17.8 | 0.1 | 14.1 | 16.1 | 5.1 | 0.1 | −2.3 | −1.5 |
| Imports of goods and services | 9.6 | 0.6 | 8.5 | 2.9 | 6.4 | 7.1 | 11.8 | 5.8 | 9.3 |
| | *Contribution to GDP growth in percentage points* | | | | | | | | |
| Domestic demand | 9.1 | −1.8 | 7.1 | −1.2 | −1.2 | 3.8 | 9.1 | 7.1 | 8.0 |
| Net exports of goods and services | −1.0 | 3.6 | −2.1 | 2.4 | 2.0 | −0.7 | −3.1 | −2.0 | −2.7 |
| Exports of goods and services | 1.4 | 3.8 | 0.0 | 3.0 | 3.6 | 1.2 | 0.0 | −0.6 | −0.4 |
| Imports of goods and services | −2.4 | −0.2 | −2.2 | −0.7 | −1.5 | −1.8 | −3.1 | −1.4 | −2.3 |
| | *Year-on-year change of the period average in %* | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| Unit wage costs in manufacturing (nominal, per hour) | 6.2 | 13.5 | 10.4 | 13.3 | 12.2 | 8.1 | 11.9 | 10.7 | 10.9 |
| Labor productivity in manufacturing (real, per hour) | 3.2 | −1.3 | 1.4 | −1.2 | −1.8 | 0.3 | 0.0 | 1.8 | 3.4 |
| Gross wages in manufacturing (nominal, per hour) | 9.7 | 11.9 | 12.0 | 12.0 | 10.1 | 8.5 | 11.8 | 12.7 | 14.6 |
| Producer price index (PPI) in industry | 12.3 | 6.1 | 5.7 | 3.6 | 3.3 | 3.9 | 4.2 | 7.6 | 6.9 |
| Consumer price index (here: HICP) | 6.5 | 9.0 | 7.5 | 9.1 | 6.8 | 7.4 | 6.8 | 8.2 | 7.5 |
| EUR per 1 TRY, + = TRY appreciation | −14.5 | 0.9 | −8.6 | 8.5 | 6.4 | −0.1 | −3.7 | −13.5 | −15.5 |
| | *Period average levels* | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 9.0 | 8.4 | 8.9 | 7.9 | 8.5 | 9.6 | 8.1 | 8.9 | 9.1 |
| Employment rate (%, 15–64 years) | 48.4 | 48.9 | 49.5 | 49.9 | 49.5 | 47.9 | 50.8 | 50.3 | 49.1 |
| Key interest rate per annum (%)[1] | 6.1 | 5.7 | 4.8 | 5.8 | 5.7 | 5.5 | 4.8 | 4.5 | 4.5 |
| TRY per 1 EUR | 2.3 | 2.3 | 2.5 | 2.3 | 2.3 | 2.4 | 2.4 | 2.6 | 2.8 |
| | *Nominal year-on-year change in the period-end stock in %* | | | | | | | | |
| Broad money (including foreign currency deposits) | 15.2 | 10.5 | 21.1 | 8.8 | 10.5 | 13.6 | 15.4 | 19.0 | 21.1 |
| | *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | |
| Net foreign assets of the banking system | 0.6 | 1.4 | −5.9 | 0.1 | 1.4 | 1.1 | −1.0 | −2.7 | −5.9 |
| Domestic credit of the banking system | 19.0 | 16.9 | 31.9 | 14.4 | 16.9 | 18.5 | 22.0 | 29.5 | 31.9 |
| *of which: claims on the private sector* | 25.0 | 18.7 | 33.5 | 15.2 | 18.7 | 21.0 | 27.0 | 33.1 | 33.5 |
| *claims on households* | 8.4 | 5.9 | 8.3 | 5.3 | 5.9 | 7.0 | 8.1 | 8.8 | 8.3 |
| *claims on enterprises* | 16.6 | 12.7 | 25.1 | 9.9 | 12.7 | 14.0 | 18.9 | 24.3 | 25.1 |
| *claims on the public sector (net)* | −6.0 | −1.8 | −1.6 | −0.8 | −1.8 | −2.5 | −5.0 | −3.6 | −1.6 |
| Other assets (net) of the banking system | −4.4 | −7.7 | −4.8 | −5.7 | −7.7 | −6.0 | −5.5 | −7.8 | −4.8 |
| | *% of GDP, ESA 95* | | | | | | | | |
| General government revenues | 36.6 | 37.8 | 39.1 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 37.4 | 38.9 | 40.7 | .. | .. | .. | .. | .. | .. |
| General government balance | −0.8 | −1.1 | −1.6 | .. | .. | .. | .. | .. | .. |
| Primary balance | 2.5 | .. | .. | .. | .. | .. | .. | .. | .. |
| Gross public debt | 39.9 | 36.2 | 36.3 | .. | .. | .. | .. | .. | .. |
| | *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | 44.3 | 47.7 | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| | *% of GDP (based on EUR), period total* | | | | | | | | |
| Trade balance | −11.5 | −8.3 | −9.8 | −7.8 | −7.1 | −8.7 | −11.2 | −9.5 | −9.6 |
| Services balance | 2.6 | 2.9 | 2.8 | 4.6 | 2.6 | 1.2 | 2.8 | 4.6 | 2.5 |
| Income balance (factor services balance) | −1.0 | −0.9 | −1.1 | −0.9 | −0.7 | −1.0 | −1.6 | −0.9 | −1.0 |
| Current transfers | 0.2 | 0.2 | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.2 |
| Current account balance | −9.7 | −6.1 | −7.9 | −3.9 | −5.0 | −8.3 | −9.8 | −5.8 | −7.8 |
| Capital account balance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Foreign direct investment (net) | 1.8 | 1.2 | 1.2 | 0.7 | 0.8 | 1.1 | 0.8 | 1.4 | 1.5 |
| | *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | |
| Gross external debt | 42.4 | 41.9 | .. | 42.7 | 41.9 | 44.0 | 44.3 | 44.0 | .. |
| Gross official reserves (excluding gold) | 10.9 | 12.4 | 13.0 | 12.4 | 12.4 | 13.2 | 12.7 | 13.0 | 13.0 |
| | *Months of imports of goods and services* | | | | | | | | |
| Gross official reserves (excluding gold) | 4.0 | 4.7 | 4.8 | 4.6 | 4.7 | 5.0 | 4.8 | 4.9 | 4.8 |
| | *EUR million, period total* | | | | | | | | |
| GDP at current prices | 554,990 | 612,718 | 617,011 | 166,958 | 156,550 | 150,448 | 160,233 | 159,251 | 147,079 |

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

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

## 11 Russia: Crimean Crisis Raises Uncertainty for Already Sluggish Economy

Russian economic growth once again declined (to 1.3% in 2013) and might further level off due to the impact of uncertainty and economic sanctions, triggered by the crisis in Crimea. The factors slowing down economic activity in the second half of 2013 remained the same as in the previous six months. Against the backdrop of the slight decline of the average annual oil price in 2013, over the whole year gross capital formation decreased by about 6%, while fixed investment stagnated. This implies that large-scale destocking continued, although at a somewhat lower pace in the fourth quarter. With real export growth accelerating and real import growth decelerating in 2013, the contribution of net exports to GDP increased somewhat. Due to a relatively tight fiscal policy, government consumption remained flat.

The only growth driver left is private consumption, buoyed by rising wages and pensions and by the continuing, but weakening, retail credit boom. Near record-low unemployment (5.6% in February 2014), stubbornly elevated inflation, and shrinking current account surpluses substantiate the view that the Russian economy is near full capacity. The Economy Ministry estimates GDP growth to have approached zero in the first quarter of 2014 (year on year).

After coming to 6.5% at end-2013 and thus missing the Bank of Russia's (CBR) annual target of 5% to 6%, CPI inflation slightly declined to 6.2% in February 2014. This was probably on account of the government's freezing of administrative price adjustments, while the ruble's steady depreciation over 2013 sharply accelerated in January-February 2014. This accelerated depreciation (no less than 10% from end-2013 to end-February 2014) was largely caused by the U.S. monetary authorities' tapering actions, coupled with Russia's renewed growth slowdown.

Then, in the three weeks since the outbreak of the Crimean crisis at the end of February, the ruble declined by another 2% to 3% before bouncing back in late March. The CBR contributed to this restabilization by strongly intervening in the market and by raising the key interest rate by 150 basis points to 7.0%. The forex sale (about EUR 8 billion) was substantially larger than provided for by the monetary authority's automatic intervention mechanism, which had been scaled back step by step in recent years.

In 2013 the total outflow of private capital from Russia came to EUR 47.2 billion (about 3% of GDP), which exceeded that of 2012 (EUR 42.5 billion). According to expert estimates, it further accelerated to about EUR 45 billion to EUR 50 billion in the first quarter of 2014. As at end-February 2014, the Russian credit boom continued; retail lending, which had overheated last year, lost some momentum. Largely due to the economic slowdown, the general government budget balance deteriorated to −1.3% of GDP in 2013.

Given the sluggish state of the global economy, the slightly lower oil price, and Russia's all-but-closed output gap, the current account surplus declined to 1.6% of GDP. Driven mostly by the accumulation of external liabilities by enterprises, the country's gross external debt has been rising lately, but continues to be relatively modest (33.5% of GDP at end-2013). At the same time, forex reserves (excluding gold), still ample, have been shrinking in absolute terms in recent months (mid-March 2014: ca. EUR 322 billion or about 21% of GDP).

Table 11

## Main Economic Indicators: Russia

| | 2011 | 2012 | 2013 | Q3 12 | Q4 12 | Q1 13 | Q2 13 | Q3 13 | Q4 13 |
|---|---|---|---|---|---|---|---|---|---|
| *Year-on-year change of the period total in %* | | | | | | | | | |
| GDP at constant prices | 4.3 | 3.4 | 1.3 | 3.0 | 2.0 | 0.8 | 1.0 | 1.3 | 2.0 |
| Private consumption | 6.7 | 7.9 | 4.7 | 7.4 | 7.2 | 5.7 | 4.4 | 4.7 | 4.1 |
| Public consumption | 1.4 | 4.6 | 0.5 | 4.5 | 3.9 | 0.6 | 0.4 | 0.4 | 0.4 |
| Gross fixed capital formation | 9.1 | 6.4 | –0.1 | 5.9 | 3.4 | –0.5 | –1.3 | 0.1 | 0.5 |
| Exports of goods and services | 0.3 | 1.4 | 4.2 | 1.2 | 1.3 | 0.0 | 3.7 | 7.4 | 5.6 |
| Imports of goods and services | 20.3 | 8.8 | 3.7 | 10.1 | 7.9 | 7.3 | 3.4 | 5.3 | –0.1 |
| *Contribution to GDP growth in percentage points* | | | | | | | | | |
| Domestic demand | 7.9 | 5.2 | 1.2 | 5.3 | 3.7 | 2.5 | 1.2 | 0.6 | 0.8 |
| Net exports of goods and services | –4.0 | –1.6 | 0.4 | –2.1 | –1.5 | –1.6 | 0.4 | 0.7 | 1.8 |
| Exports of goods and services | 0.1 | 0.4 | 1.3 | 0.4 | 0.4 | 0.0 | 1.2 | 2.1 | 1.7 |
| Imports of goods and services | –4.1 | –2.0 | –0.9 | –2.5 | –1.9 | –1.6 | –0.8 | –1.4 | 0.0 |
| *Year-on-year change of the period average in %* | | | | | | | | | |
| Unit labor costs in the whole economy (nominal, per hour) | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| Unit labor costs in industry (nominal, per person) | 9.0 | 7.6 | 7.9 | 6.3 | 6.6 | 9.2 | 8.3 | 8.5 | 5.5 |
| Labor productivity in industry (real, per person) | 4.4 | 4.8 | 2.4 | 4.8 | 4.5 | 0.7 | 2.5 | 2.5 | 3.5 |
| Average gross earnings in industry (nominal, per person) | 13.8 | 12.6 | 10.3 | 11.4 | 11.4 | 9.9 | 11.0 | 11.2 | 9.2 |
| Producer price index (PPI) in industry | 17.8 | 6.8 | 3.4 | 7.9 | 6.8 | 4.3 | 2.5 | 4.4 | 2.3 |
| Consumer price index (here: CPI) | 8.5 | 5.1 | 6.8 | 6.1 | 6.6 | 7.2 | 7.2 | 6.3 | 6.4 |
| EUR per 1 RUB, + = RUB appreciation | –1.5 | 2.4 | –5.7 | 2.9 | 4.4 | –1.5 | –3.7 | –8.0 | –9.1 |
| *Period average levels* | | | | | | | | | |
| Unemployment rate (ILO definition, %, 15–64 years) | 6.6 | 5.5 | 5.5 | 5.1 | 5.2 | 5.8 | 5.4 | 5.3 | 5.5 |
| Employment rate (%, 15–64 years) | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| Key interest rate per annum (%) | 5.3 | 5.3 | 5.5 | 5.3 | 5.5 | 5.5 | 5.5 | 5.5 | 5.5 |
| RUB per 1 EUR | 40.9 | 39.9 | 42.3 | 40.0 | 40.3 | 40.2 | 41.4 | 43.4 | 44.3 |
| *Nominal year-on-year change in the period-end stock in %* | | | | | | | | | |
| Broad money (including foreign currency deposits) | 20.9 | 12.1 | 15.7 | 15.0 | 12.1 | 15.1 | 16.3 | 16.8 | 15.7 |
| *Contributions to the year-on-year change of broad money in percentage points* | | | | | | | | | |
| Net foreign assets of the banking system | 9.9 | –0.3 | 2.7 | 0.8 | –0.3 | 4.5 | 1.8 | 2.3 | 2.7 |
| Domestic credit of the banking system | 19.7 | 15.4 | 17.5 | 19.5 | 15.4 | 17.0 | 18.1 | 18.2 | 17.5 |
| *of which: claims on the private sector* | 24.5 | 17.9 | 16.9 | 21.5 | 17.9 | 19.9 | 18.2 | 19.1 | 16.9 |
| *claims on households* | 6.4 | 8.2 | 7.4 | 8.8 | 8.2 | 8.4 | 8.2 | 8.1 | 7.4 |
| *claims on enterprises* | 18.1 | 9.7 | 9.6 | 12.7 | 9.7 | 11.5 | 10.1 | 11.0 | 9.6 |
| *claims on the public sector (net)* | –4.8 | –2.6 | 0.6 | –2.0 | –2.6 | –2.9 | –0.1 | –0.9 | 0.6 |
| Other assets (net) of the banking system | –8.7 | –3.0 | –4.6 | –5.3 | –3.0 | –6.4 | –3.5 | –3.7 | –4.6 |
| *% of GDP, ESA 95* | | | | | | | | | |
| General government revenues | 37.3 | 37.1 | 36.1 | .. | .. | .. | .. | .. | .. |
| General government expenditures | 35.7 | 36.7 | 37.3 | .. | .. | .. | .. | .. | .. |
| General government balance | 1.5 | 0.4 | –1.3 | .. | .. | .. | .. | .. | .. |
| Primary balance | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| Gross public debt | 9.0 | 10.0 | 10.5 | .. | .. | .. | .. | .. | .. |
| *Year-on-year change of the period total (based on EUR) in %* | | | | | | | | | |
| Debt of nonfinancial corporations (consolidated) | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| Debt of households and NPISHs (consolidated) | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| *% of GDP (based on EUR), period total* | | | | | | | | | |
| Trade balance | 10.4 | 9.1 | 8.6 | 7.6 | 8.2 | 10.0 | 8.4 | 8.0 | 8.3 |
| Services balance | –1.9 | –2.4 | –2.8 | –3.0 | –2.3 | –2.2 | –2.7 | –3.7 | –2.5 |
| Income balance (factor services balance) | –3.2 | –3.5 | –3.8 | –2.9 | –3.6 | –2.4 | –5.2 | –4.0 | –3.6 |
| Current transfers | –0.2 | –0.3 | –0.4 | –0.5 | –0.4 | –0.3 | –0.3 | –0.6 | –0.6 |
| Current account balance | 5.2 | 2.8 | 1.6 | 1.1 | 1.9 | 5.0 | 0.2 | –0.3 | 1.6 |
| Capital account balance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Foreign direct investment (net) | –0.8 | –1.2 | –0.7 | 0.4 | 1.0 | –5.2 | 1.9 | 0.7 | –0.7 |
| *% of GDP (rolling four-quarter GDP, based on EUR), end of period* | | | | | | | | | |
| Gross external debt | 30.5 | 31.0 | 33.5 | 30.8 | 31.0 | 34.3 | 34.1 | 33.5 | 33.5 |
| Gross official reserves (excluding gold) | 25.7 | 23.7 | 21.6 | 24.5 | 23.7 | 23.6 | 22.9 | 22.4 | 21.6 |
| *Months of imports of goods and services* | | | | | | | | | |
| Gross official reserves (excluding gold) | 14.2 | 12.5 | 11.5 | 12.9 | 12.5 | 12.7 | 12.2 | 11.9 | 11.5 |
| *EUR million, period total* | | | | | | | | | |
| GDP at current prices | 1,366,840 | 1,557,572 | 1,574,075 | 407,459 | 429,937 | 364,671 | 386,266 | 403,652 | 419,487 |

*Source: Bloomberg, national statistical offices, national central banks, wiiw, OeNB.*

# Outlook for Selected CESEE Countries:

## Moderate but Firming Growth[1,2]

### 1 CESEE-7[3]: Both External and Domestic Demand Will Pick Up

In the CESEE-7 region, economic growth will accelerate to 2.5% in 2014, following a rather weak 1.3% expansion of GDP in 2013. Growth will strengthen further over the projection horizon on the back of recovering domestic demand and against the backdrop of gradually improving external conditions. Apart from Croatia, all countries in the region will post positive growth rates in 2014. Two years ahead, in 2016, Bulgaria, the Czech Republic, Poland and Romania will grow at or above 3%, while the growth rate recorded by Hungary and Croatia will stay closer to 2%. As the growth differential to the euro area will range from 1.1 to 1.4 percentage points in this period, the catching-up process of the CESEE-7 region will resume at a moderate pace.

**Strain from fiscal policy recedes**

We expect economic growth to gain traction over the projection horizon. Higher growth is fostered by a slightly accelerating recovery in external demand and improved domestic conditions as a result of strongly reduced external imbalances and past fiscal consolidation efforts. Looking ahead, only Croatia is expected to pursue consolidation further, as it is under an excessive deficit procedure (EDP). In Bulgaria, expansive election-related fiscal policy changes in the previous year imply a more cautious stance this year. While Romania will show some consolidation under the precautionary support program, the growth impact will nevertheless be limited. A notable slackening compared with previous consolidation efforts is expected to be seen in the Czech Republic under the new government. The elections in Hungary are likely to have caused some slippage in 2014, but this will not lead to a tighter stance in the remainder of the year. This translates into a neutral fiscal policy compared with the recent past. Still, the growth contribution of public

Table 1

**GDP Projections for 2014 to 2016**

| | GDP | GDP forecasts | | | Imports | Import forecasts | | |
|---|---|---|---|---|---|---|---|---|
| | 2013 | 2014 | 2015 | 2016 | 2013 | 2014 | 2015 | 2016 |
| | *Annual growth in %* | | | | | | | |
| CESEE-7 | 1.3 | 2.5 | 2.9 | 3.1 | 2.5 | 5.0 | 6.4 | 6.7 |
| Bulgaria | 0.8 | 1.8 | 2.5 | 3.5 | 5.7 | 4.7 | 4.6 | 4.6 |
| Croatia | −0.8 | −0.6 | 0.7 | 1.7 | −1.8 | −1.1 | 2.0 | 2.0 |
| Czech Republic | −0.9 | 2.5 | 2.7 | 3.3 | 0.6 | 5.6 | 7.4 | 7.4 |
| Hungary | 1.2 | 2.0 | 2.4 | 2.4 | 5.3 | 4.7 | 4.9 | 5.0 |
| Poland | 1.5 | 3.0 | 3.4 | 3.4 | 1.9 | 5.2 | 6.9 | 7.7 |
| Romania | 3.5 | 2.5 | 2.7 | 2.9 | 2.3 | 5.0 | 6.9 | 7.5 |
| Russia | 1.3 | 0.5 | 1.0 | 2.0 | 6.0 | −2.0 | 2.0 | 3.0 |

*Source: OeNB, BOFIT, Eurostat, Rosstat.*

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[1] *Compiled by Julia Wörz with inputs from Stephan Barisitz, Markus Eller, Mathias Lahnsteiner, Isabella Moder, Thomas Reininger, Tomáš Slačík and Zoltan Walko.*

[2] *Cutoff date for all projections: April 4, 2014. The projections for the CESEE-7 countries were prepared by the OeNB, those for Russia were prepared by the Bank of Finland in cooperation with the OeNB. Lithuania is not covered by our projections, but is included in the CESEE-7 aggregate based on the IMF World Economic Outlook (WEO) of April 2014.*

[3] *CESEE-7: Bulgaria, Croatia, the Czech Republic, Hungary, Lithuania, Poland, Romania.*

consumption will decline over the projection horizon in the Czech Republic, Hungary and Poland, while it will flatten in Bulgaria and Romania. Croatia is an exception due to rather severe consolidation under the EDP.

In addition, low inflation leaves room for a rather accommodative monetary policy stance. In response to utility price cuts, Bulgaria has experienced some deflation recently, which is expected to be short lived, however. Given a record harvest in 2013, the low price base in Romania will possibly lift inflation some- what in 2014, but this effect will be temporary. In Hungary, recent and forthcoming utility price cuts will keep inflation low. In the Czech Republic, inflation may rise in 2014 beyond the inflation target due to base effects. However, the central bank is set to return to its inflation target in 2015. In other words, in particular the Czech Republic and Hungary will maintain a loose policy stance this year, but Bulgaria and Croatia will remain accommodative, too. The Romanian central bank has recently lowered interest rates and is not expected to reverse this move in the short run.

In all three years, firming domestic and external demand will be a key growth driver (see chart 1). In particular private consumption will experience a strong pickup already in 2014 and thus lead the recovery. The growth contribution of private consumption will rise gradually in all countries apart from Bulgaria. There, some base effects materializing this year will temporarily (i.e. in 2014) reduce the growth contribution. Still mired in recession, Croatia will show a further decline, and hence a negative growth contribution, of private consumption in 2014 and 2015. In sharp contrast, in the Czech Republic and Romania, real wage growth spurs consumption growth.

**Exports and private consumption will lead the recovery, followed by investments**

Chart 1

## GDP and GDP Components, Projections for 2014–2016

*Contribution of GDP components in percentage points; annual growth in %*



Private consumption | Public consumption | Gross fixed capital formation | Change in inventories
Exports of goods and services | Imports of goods and services | ◆ GDP growth
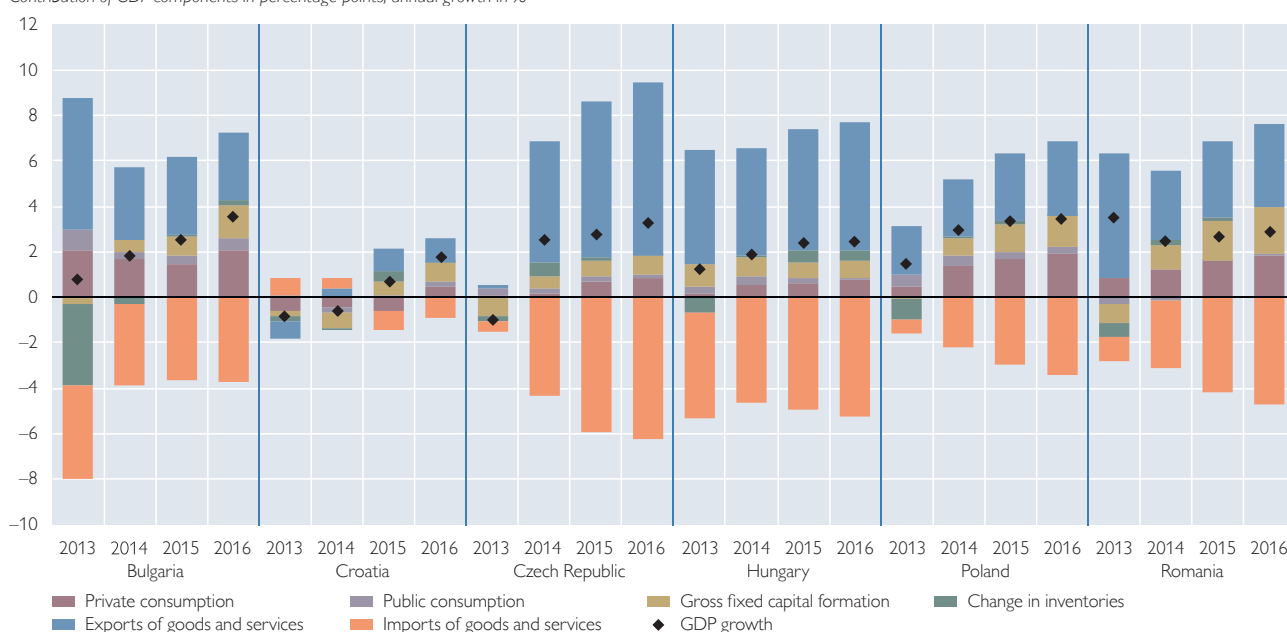
*Source: OeNB.*

As the region is finally emerging from a prolonged period of destocking and low or negative investment, a growing need for inventory buildup and replacement investments has emerged. In 2014 and 2015, the use of remaining and yet-to-be-disbursed EU funds from the 2007–2013 multiannual financial framework will also add to public investment growth. In Hungary, the Funding for Growth Scheme will lift gross fixed capital formation in 2014 notably above the level it would have attained in the absence of such a program, but a base effect from the previous year causes investments to recede slightly in year-on-year terms. In addition to these cyclical effects, gross fixed capital formation will – albeit with a small time lag – satisfy production needs for external and internal demand. Overall growth in gross fixed capital formation will accelerate notably over the three-year horizon and therefore emerge as an increasingly important growth driver. An additional boost will come from increased EU funds utilization, which is expected to rise continuously until 2016.

Thanks to a moderate but steady recovery in the external environment, export growth will likewise attain solid growth rates again. This will, in 2014, result in a sizeable positive contribution to GDP growth in almost all countries. Export growth will range from a meager 1% in Croatia to as much as 6.7% in Romania in 2014. At 6.1%, the Czech Republic likewise posts strong export growth. Croatia's recent EU accession has changed the institutional environment, with previously important CEFTA trading partners substituting away from Croatian goods. As Croatian exporters are not yet sufficiently competitive for the EU market, weak trade creation ensues – an effect that is likely to prevail for some time. In contrast, the Czech Republic has traditionally been affected most severely by changes in export demand from the euro area and is hence quick to respond to the reviving external environment. Moreover, intra-CESEE trade is becoming ever more important, adding to the dynamics. Despite posting solid export growth, Bulgaria, Hungary and Romania will show a modest, temporary growth slowdown this year compared with 2013, which is primarily related to statistical effects. The rather weak performance in 2012 has resulted in a sizeable base effect in 2013. In 2014, the growth contribution of exports will range between 0.4 percentage points in Croatia and 5.3 percentage points in the Czech Republic. In most countries, weakening currencies will support dynamic export growth up to 2016. In Hungary, a large new production capacity for automotive goods has been established, boosting Hungary's supply potential. Over 2015 and 2016, export growth will accelerate further to above 7% in the Czech Republic and Romania and to almost 7% in Poland. In Croatia, export growth will be at 2.5% in 2016, whereas it will reach between 4% and 5% in the remaining countries under review.

All countries (Croatia probably less so) are well integrated into wider European production chains[4] and hence show a strong export-import link. Combined with reviving domestic demand, imports accelerate at a fast pace as well. In consequence, the growth contribution of net exports will recede in the period from 2014 to 2016 and turn slightly negative in three countries by 2016 (Bulgaria, Poland and Romania).

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[4]  See for example the "IMF Multi-Country Report: German-Central European Supply Chain – Cluster Report," IMF Country Report No. 13/263 from August 2013.

The risks to our CESEE-7 projections show a considerable downward bias arising foremost from political uncertainties related to Russia and Ukraine. A further escalation of recent tensions in these two countries would entail severe negative spillovers to the CESEE-7 region, both directly – given their strong dependence on energy imports from Russia, other trade and financial linkages as well as potentially higher global oil prices – and indirectly through the implications of such a scenario for developments in the euro area and in other emerging markets. Lower-than-expected growth in China and Turkey and a general increase in global uncertainty would dampen growth prospects in the CESEE-7 countries. Further downside risks relate to the euro area, where additional fiscal consolidation and stronger-than-expected deleveraging by euro area banks (both in the euro area and in the CESEE-7) might result from a possible negative outcome of the forth-coming asset quality review and stress testing exercise covering EU banks. This would, in turn, lower external demand from the euro area and impact negatively on domestic demand in the CESEE-7 region. We do not expect any adverse conse-quences from the U.S. Fed's tapering of quantitative easing in the region, as capital inflows have been very moderate in recent years and all countries have substantially reduced their precrisis imbalances. Hence, apart from indirect effects through global repercussions, a less accommodative monetary policy outside the euro area is not expected to pose a risk for the region.

Upside risks emanate from a successful completion of the asset quality review in the euro area, which might lead to rising credit availability over the projection horizon, and, more generally, from stronger-than-expected growth in the euro area.

*Downside risks have risen considerably*

## 2 Developments in Bulgaria, the Czech Republic, Hungary, Poland and Romania

After another year of relatively benign GDP growth in Bulgaria of 0.8% in 2013 (seasonally and working day adjusted), we forecast a moderate acceleration to 1.8% in 2014. The gradual recovery process should continue in 2015 and 2016, with growth reaching 2.5% and 3.5%, respectively.

Resurging private investment and private consumption are the main drivers of this recovery. In addition, slightly positive GDP growth contributions stem from stock replenishment (after a long period of destocking) and public consumption (though not as significant as in 2013). On the other hand, net exports are expected to put a certain strain on GDP growth, as the expansion of domestic demand will also stimulate additional imports. However, despite improved external conditions, exports are not poised for an exceptional takeoff during the forecasting horizon (e.g. because the euro as the Bulgarian anchor currency is expected to appreciate) and the negative contribution of net exports will thus be kept in check.

In 2014, domestic demand is expected to resurge on the back of last year's social legislation changes, most of which materialize this year, such as the increase of minimum wages by nearly 10% (effective from January 1, 2014) or the renewed indexation of pensions (that, after a three-year freeze, rise by a weighted average of productivity and inflation). Moreover, the decline in price levels evident since August 2013 should stimulate private consumption as long as it is only a temporary deflation episode, which can to a large extent be explained by the rollback of electricity tariffs in 2013 and should therefore expire later this year.

*Bulgaria: Moderate recovery will gain momentum gradually*

A more pronounced economic recovery during the forecasting horizon is basically hampered by still unsettled legacies of the crisis. Unemployment (more than half of which is currently accounted for by long-term unemployment) is expected to remain elevated due to structural factors. There are no clear signs that the credit cycle will turn soon; credit for both enterprises and households could experience a prolonged period of stagnation, also on the back of fairly high nonperforming loan (NPL) ratios. It is also questionable whether the downward trend for net FDI inflows can be stopped as long as intercompany lending remains in the doldrums.

On the positive side, the incumbent government tries to implement several growth-promoting policies during the forecasting horizon, including extra public investment spending and measures targeting education, vocational training, resource efficiency, SME assistance or the promotion of EU-funded projects. However, given rather optimistic tax revenue projections and additional social spending, the public sector will be forced to remain fiscally prudent to keep the budget deficit below the targeted 2% of GDP ceiling and/or to rebuild some fiscal buffers.

**Croatia: Recovery delayed by another year**

As both the third and the fourth quarter of 2013 again posted negative year-on-year growth rates, we have to revise our forecast for 2014 downward considerably, namely by 1.6 percentage points to –0.6%. We therefore anticipate a recession for the seventh consecutive year. Moreover, we expect consumption to remain in negative territory for several reasons: First, labor market conditions have worsened further recently. Additionally, deleveraging is still under way. Also, we assume public consumption to contribute negatively to overall growth in view of the current austerity plans of the government aimed at bringing the public deficit below the 3% of GDP mark until 2016 in accordance with the EDP. Despite the accessibility of EU funds, we assume that investments will decline, especially because of continued credit contraction and the high level of NPLs. Overall, EU accession has not yet resulted in sufficient restructuring in the economy.

In our forecast, the only positive contribution to growth in 2014 will be from net exports, since we expect exports to rise in line with the recovery in the euro area and further favorable developments in the tourism industry. The positive contribution of net exports is also supported by decreasing imports given suppressed domestic demand.

From 2015 onward, we expect a gradual recovery on the back of increasing domestic demand. We project GDP to grow by 0.7% and to be supported by investments materializing from EU funds as well as by a pickup in credit growth, and a slightly positive contribution of net exports traceable to a stronger rise of exports than imports. Private consumption will, however, remain in negative territory. Further ahead, growth should accelerate to 1.7% in 2016, as preceding investment will start to pay off, new investments will be made and private consumption will finally turn positive again due to improving labor market conditions. As imports will pick up simultaneously to domestic demand, we expect the contribution of net exports to be only marginal.

Apart from the risks outlined for the region as a whole, domestic risk factors are skewed to the downside. Planned austerity measures could affect growth more strongly than currently anticipated, or, even worse, spill over to private consumption and drag it down further. Also, the pickup of investments from 2015 onward could be weaker than expected relating to problems in EU funds utilization or ongoing frictions in the credit market.

Spurred by eased monetary and fiscal conditions, recovering export demand and improving consumer and investor sentiment, the Czech economy is expected to expand by 2.5% in 2014, while GDP growth should gradually strengthen thereafter (+2.7% in 2015 and +3.3% 2016). The contribution of both domestic demand and net exports is forecast to increase over the projection horizon.

The frail recovery was given a surprisingly strong boost in the last quarter of 2013 (1.9% quarter on quarter), not only by net exports on the back of the recuperating euro area but, most notably, also by strong gross fixed capital formation and, to a lesser extent, by private consumption. All three major contributing channels were stimulated by the ČNB's decision in early November to intervene against the Czech koruna. The depreciation by approximately 5% not only helped exporters but most likely also encouraged investors and consumers to bring their investment and consumption decisions forward in anticipation of higher import prices. This effect may have continued to some extent also into early 2014. The ČNB, which intends to intervene against the exchange rate until early 2015, hopes that the intervention will boost the Czech economy through various channels also in the medium run. The rise in import prices might redirect households' demand toward domestic goods and services. At the same time, Czech exporters' higher profitability resulting from the weaker exchange rate could raise their willingness to invest, keep and even create jobs and increase wages. These factors would, in turn, boost households' purchasing power and consumption.

Our forecast does not really account for these indirect effects as they are based on certain behavioral assumptions which may or may not materialize. Nevertheless, we believe that as the short-term impact of exchange rate devaluation subsides, private consumption will increasingly benefit from improvements in real disposable income due to moderately accelerating wage growth (including pensions and minimum wages), the low inflation environment and the stabilization in the labor market over the forecast horizon. Consumer sentiment seems to confirm this, which – some setbacks notwithstanding – has now been rising significantly for nearly a year.

In a striking divergence from the austerity focus of the last (elected) administration, the new coalition government signals a strong pro-growth orientation in combination with fiscal prudence. Growth in government consumption is likely to remain strong over the forecasting period, due to, inter alia, the government's plans to support active employment policies or to the envisaged increase in the public sector wage bill. Gross fixed capital formation is forecast to strengthen not only on account of rebounding public investment, but also owing to the prospect of economic revival in the euro area and firming private consumption. In addition, in the first three quarters of 2014, gross fixed capital formation will benefit from the base effect triggered by strong declines in investment activity over the same period in 2013. On the other hand, the recovery in investment activity will be partially dampened by still rather feeble corporate credit growth. Low inflation, solidifying external demand and the weaker exchange rate will lift the contribution of net exports to growth. At the same time, however, this effect will be counteracted by the gradual recovery in import-intensive domestic demand.

Beyond the downward risks from the external environment, in particular related to developments in Russia and Ukraine, also domestic risks are tilted to the

*Czech Republic: Recovery under way*

downside. The beneficial effects of the weakened exchange rate could prove more short lived than implied by our baseline forecast.

**Hungary: Policy-supported growth**

In 2013, Hungarian GDP grew at a faster pace than expected (1.2%), largely due to a stronger-than-expected increase in investments and public consumption and a bigger contribution of net real exports as exports had expanded more dynamically than projected in fall. For 2014, we expect growth to pick up speed and come to 2%. Private consumption will be supported by improving consumer confidence, easing credit supply conditions, rising real wages and employment growth. The latter will be traceable mostly to the expansion of the public works scheme, the increasing number of frontier workers and a move of workers from the gray economy into official employment. The increase in real wages comes on the back of substantial wage hikes in parts of the public sector (education and healthcare sectors) and strengthening wage growth in the private sector, combined with the significant decline in inflation (not least owing to further administrative cuts in household utility prices).

Investment growth is expected to slow somewhat following the base effect-supported expansion in 2013. Gross fixed capital formation will nonetheless remain strong on the back of increasing capacity utilization rates, improving business confidence, higher absorption of EU funds and easing credit supply conditions. Additional support comes from the extension of the MNB's Funding for Growth Scheme and substantial policy rate cuts. Public consumption is expected to receive some uplift from the election cycle in 2014 (parliamentary elections in April, local elections in the fall). We expect export growth to ease slightly more strongly than import growth and, by extension, the contribution of net real exports to be roughly zero. After two years of contraction, we expect stock changes to be roughly neutral for the overall growth rate.

In 2015 and 2016, we project growth to accelerate to around 2.4%. Private consumption is expected to strengthen further on the back of better access to credit, alongside with wage and employment growth. Investment growth may fall back somewhat in 2015 as the MNB's Funding for Growth Scheme is discontinued, but post a cyclical recovery in 2016, supported by the easing of credit constraints, by EU funds and increasing capacity utilization. Government consumption is likely to expand at a decreasing pace given the tight limits for fiscal policy. Exports should accelerate at a faster pace than imports, so that net real exports are likely to make a somewhat more positive contribution to GDP growth.

An upside risk to these projections arises from potential further policy measures to lower households' debt servicing burden (following the April 2014 parliamentary elections), which may support disposable income growth beyond expectations.

**Poland: Export-led recovery turns into balanced growth**

In Poland, annual average growth in 2014 will amount to roughly 3%. The current upswing has been clearly export led, with export growth having accelerated to 5.1% in 2013 (after 3.3% in the previous year). This is even more remarkable as extra-euro area imports continued to contract in the euro area and German imports remained subdued at about 1%, but accelerated in the fourth quarter of 2013. Poland's continued robust export performance reflects geographical reorientation as well as high cost competitiveness, given favorable ULC developments in the manufacturing sector and the hitherto absence of marked reappreciation of the złoty. Moreover, we assume that the impressive Polish export growth figure

for 2013 to some extent already reflects early effects of the solid recovery of both total euro area imports and German imports as forecast for 2014. Taking into account such early effects and recent downward revisions of economic growth in Russia, we expect only a modest further acceleration of Polish export growth in 2014 to 5.6%, which is rather on the conservative side given the projected improvement in the euro area.

Overall, roughly half of total final demand growth will come directly from exports, while the other half will stem from domestic demand that will be largely induced by exports. The translation of foreign demand into investment will gain in importance during 2014. First, inventory change will cease to be negative as some restocking takes place. Second, the positive outlook for foreign and domestic demand, the favorable liquidity position of enterprises and the already high capacity utilization rates of manufacturing imply that current demand impulses by exports will lead to gross fixed capital formation by the private sector, as signaled already by business sentiment indicators. Moreover, the narrowing window to get disbursements from the EU multiannual fiscal framework 2007–2013 may foster semi-public sector fixed investment. Both exports and investment will help private consumption gain momentum, via confidence channels and the labor market, and will be additionally supported by low inflation.

As a result, both exports and strengthening domestic demand will increase imports, with import growth accelerating more strongly than export growth, while still remaining at a lower level. The contribution of net exports to GDP growth will decrease but remain positive.

In 2015, we expect GDP to augment by 3.4%. As before, export growth will be underpinned by both euro area and German imports, whose growth will once again pick up considerably. The translation of the foreign stimulus into domestic growth will ensure that a balanced growth structure is maintained. Both foreign and domestic demand will contribute, roughly in equal proportions, to total final demand. On the back of improvements in the labor market, private consumption will gain in importance, both directly and as a factor stimulating private investment. Private consumption growth will, however, still remain below GDP growth, signaling a sound growth structure. Gross fixed capital formation growth will accelerate. In addition to the factors prevailing already in 2014, household residential investment will play a larger role. As a result, imports will continue to expand more dynamically than exports, so that the former will outpace the latter on average in 2015 and the contribution of net exports to GDP growth will turn neutral.

Posting the highest postcrisis growth rate in 2013 (3.5%), Romanian economic activity is expected to slow down to 2.5% in 2014. Growth in 2013 was to a large extent driven by a bumper harvest, with agriculture delivering a growth contribution of 1.1 percentage points. Yet, agricultural output is rather volatile and cannot be seen as a sustainable growth driver.

**Romania: Exports remain robust, domestic demand strengthens**

While export growth will remain robust thanks to the euro area recovery, we only expect a slow and gradual strengthening of domestic demand. Increasing private consumption will be driven by rising disposable income made possible by targeted public sector wage hikes and moderate real wage growth in the private sector. Romania's export performance is likely to have a positive impact on the labor market and on wage growth. However, given sizeable and still growing nonperforming loans and cross-border deleveraging of foreign banks, a pickup of

credit growth is not yet in sight, which will only allow for a gradual recovery of private consumption. In light of the ongoing fiscal consolidation under the precautionary support program, we do not expect major growth impulses from public consumption.

Growth in gross fixed capital formation will be supported by a continuously improving absorption of EU structural and cohesion funds. Moreover, the euro area recovery will have a positive impact on economic agents' confidence and, in turn, on investment activity. The brightening of the external environment will also help lift FDI inflows. Once the credit cycle turns, we expect growth of private consumption and gross fixed capital formation to pick up speed in 2015 and 2016. Strengthening domestic demand will result in a rebound of imports, which will almost neutralize the contribution of export growth in 2014 and result in net exports becoming negative from 2015.

## 3 Russia: Crimean Crisis Puts Russian Recovery at Risk

In Russia, business activity will slow further to ½% in 2014 despite a pickup in global economic growth and world trade, as investments are being postponed because of the Crimean crisis. GDP growth of 1.3% in 2013 undershot forecasts by a margin stemming from a tangible slowdown in domestic demand. Amid a continuation of the global economic recovery, growth in Russia will probably pick up again slightly, but remain at low levels (2015: 1%; 2016: 2%).

We expect economic growth to slow further this year (to between 0% and 1%) and thus to almost stagnate. Growth is supported by recoveries in the global economy and in world trade, but is constrained by a slight decline of the oil price. In any case, these impacts are secondary compared with the rise in uncertainty triggered by the events in Crimea, even if the repercussions remain relatively contained both with respect to market reactions and possible sanctions and counter-sanctions. This uncertainty will reduce private investments. As a result of base effects related to the 2014 Olympic winter games in Sochi, public investments declined strongly in the second half 2013 and continue to be low in the first half of 2014. If this marked contraction in fixed capital formation of state-owned companies and the state seen in 2013 can be halted, investments will possibly recede only moderately in 2014 as a whole. Growth in private consumption will slow sub-stantially, in part due to the weakening ruble. No increase in public consumption is likely and export growth will be tepid. Imports will contract slightly in 2014 (by around 2%) as the slide of the ruble in early 2014 has been steeper than that during 2013.

In 2015 and 2016, Russian economic growth will recover a bit as global growth is firming. This weak recovery will be driven by private consumption in 2015, and, in 2016, in equal measure, by gross fixed capital formation and private consumption. However, growth in Russia will remain at about 1½% per annum owing to the lingering impact of the geopolitical tensions and to the projected gradual decline of the oil price (by 10% to 11% over the forecast period 2014–2016). Even this rate of economic expansion will only be reached provided geopolitical tensions remain contained and do not mount further. After their dip in 2014, imports should return to low single-digit year-on-year growth rates. Import growth should not face strong headwinds given that the ruble is not expected to depreciate substantially in real terms. After all, Russian inflation is

running well above the inflation rates of the country's main trading partners. The nominal exchange rate of the ruble will gradually decline as the current account surplus disappears and the direction of net capital flows remains outbound.

Yet, this forecast is subject to exceptional downside risks. The fallout of the events in Crimea could be more pronounced than assumed in our forecast, particularly with regard to investor reactions. Also, tensions between Russia and Ukraine could intensify and trigger even more capital flight and sanctions. Even without these complications, domestic uncertainty surrounding private and public capital formation already poses significant risks to the forecast. If the above risks were to materialize, Russian economic growth in 2014 could fall well short of our forecast. Lower-than-forecast world economic growth would impact Russian exports of energy and other basic commodities. Marked depreciation episodes of the ruble, provoked, for instance, by higher-than-expected capital outflows, would fuel inflation, depress consumption and curtail imports more strongly than forecast.

Substantial stimulus measures that might yet be undertaken in Russia pose upside risks. The government has plenty of leeway to take on additional government debt. If necessary, economic stimulus could also be given through the banking sector, particularly via state-owned credit institutions.

# Studies

# Finance, Potential Output and the Business Cycle: Empirical Evidence from Selected Advanced and CESEE Economies

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*Traditional approaches to separate the underlying trend of potential output from cyclical developments mostly rely on the concept of nonaccelerating inflation output and are thus unable to detect upswings caused by the financial cycle, which often appear to be unsustainable in the long run. In this study, we therefore propose to extend the structural unobserved components model developed by Harvey (1989) and Harvey and Jaeger (1993) by including information on the financial cycle, i.e. private credit and house price developments, to explain the cyclical deviations from potential GDP. Thus, we are able to calculate "finance-neutral" potential output and corresponding "finance-augmented" output gaps, which take the effect of financial variables into account. We apply this novel concept to four advanced economies (AT, IE, NL, US) and four economies in Central, Eastern and Southeastern Europe (BG, EE, PL, SK) in a comparative manner. Our results show a considerable impact of the financial cycle on business cycle developments in most of the economies under review, both advanced and emerging. Remarkably, our finance-augmented output gaps exhibit a considerably higher explanatory power for the variation of observed unemployment rates in corresponding economies than standard approaches (such as the HP filter). In other words, our results considerably strengthen the case for considering the financial sector in business cycle measurement.*

The global financial crisis challenged the conventional view on potential output and emphasized the important implications of finance for understanding cyclical fluctuations. The concept of potential output typically refers to the maximum level of economic activity that can be sustained over the long term. It cannot be observed directly but has to be estimated by using a variety of approaches, from statistical filters to structural models. Such estimates are a core element of the modern consensus on rule-based economic policymaking: The difference between actual and potential output – the output gap – informs policymakers about the current state of the business cycle, allowing them to intervene in a stabilizing manner. However, potential output estimates do have a major drawback: they perform badly in real time. It is well documented, for instance, that the major approaches overestimated potential output growth in the euro area prior to the crisis (ECB, 2011; Marcellino and Musso, 2011).[2]

As has been noted by Borio et al. (2013), a common thread tying together the various concepts of potential output is the idea of sustainability. This means that

only a certain level of output is possible without generating unwelcome side-effects, which, sooner, or later, will lead to some form of correction. The most common undesirable side-effect of economic booms or unsustainable output in mainstream economics is inflation. Therefore, the conventional structural approaches to estimate potential output (mainly used for policymaking) all assume some form of Phillips curve, making sustainable output equal to nonaccelerating inflation output. From that, it follows that policymakers should not fear corrections to their current growth path as long as inflation remains low and stable, as was the case in advanced economies in the "Great Moderation" boom phase prior to the global financial crisis.

This consensus in macroeconomics was severely challenged by the global financial crisis, though. It is becoming increasingly clear that certain cyclical activities pass the radar of Phillips-type sustainability, such as housing bubbles and unsustainable developments in the financial sector. Indeed, housing bubbles can generate huge business cycles without creating any inflation as reflected by the average household consumer basket (which is the common notion of inflation). This follows from the fact that housing bubbles and "ordinary" inflation (as we want to call it) are of a different nature. While the obvious sustainability criterion for a wage-driven increase in consumption is "ordinary" inflation, the sustainability criterion for a credit-driven increase in investment is, at least among others, asset price inflation. Mainstream models do not distinguish between the two sets of prices, they just control for "ordinary" inflation. This is not much of a problem as long as the two sets of inflation rates are moving in a similar direction, which is, however, not always the case.

The global financial crisis is a case in point. Hume and Sentance (2009) propose two explanations for the decoupling of asset and output inflation. First, the financial upturn of the 2000s had a relatively limited impact on effective demand. Second, in cases where the demand effect was larger, inflation pressure was dampened by a deterioration of external balances (instead of reaching domestic capacity constraints). Borio et al. (2013) discuss four additional reasons why output inflation could remain low and stable against the backdrop of soaring asset price inflation, namely (i) financial booms which coincide with positive supply shocks, (ii) increases in potential output in prolonged economic upturns (as measured by conventional approaches), (iii) capital inflows leading to currency appreciation, and finally, (iv) the existence of sectoral misallocation rather than "aggregate" capacity constraints. Corresponding to our discussion on the Phillips curve above, we may add two further factors. First, inflation expectations remained well anchored throughout the 1990s and 2000s not least due to credible central banks (Bernanke, 2012), and second, changes in wage-setting institutions may have led to a lower unemployment elasticity of wages.

Hence, to improve our understanding of potential output and the corresponding output gaps, we have to take macrofinancial linkages into account (Borio et al., 2013), as the crisis has shown that a focus on inflation developments alone is too narrow to distinguish between structural and cyclical developments. The relationship between finance and growth crucially depends on the time perspective. On the one hand, there is a large body of literature that postulates a positive long-run relationship between finance and growth, which is based on the hypothesis that financial intermediation improves the efficiency of resource

allocation.[3] On the other hand, the financial cycle literature argues that waves of booms and busts affect the economy in the short to medium run. The common notion refers to a self-enforcing but unstable circle between financing constraints, asset prices and economic activity.[4] The recent literature largely confirms the existence of the financial cycle and its importance for understanding the business cycle (for valuable surveys see Taylor, 2012; Borio, 2012).

It is evident that conventional univariate statistical filters (such as the Hodrick-Prescott (HP) filter) do not provide an appropriate alternative in this context. In principle, they could attenuate periodic signals at any frequency (the literature suggests 1 to 8 years for the business cycle and 8 to 30 years for the financial cycle, as measured from peak to peak). In practice, however, the frequency is likely to change from one cycle to another, making it again difficult for policymakers to estimate potential output in real time. In addition, without any identifying restriction, the filtered series does not allow for any economic interpretation.

The existence of a tremendous real-time uncertainty on estimations of potential output is an obvious problem for stabilization policy (Friedman, 1947).[5] Thus, improving the measurement and estimation of potential output to reduce uncertainty is crucial for decision-makers in central banks, governments and institutions. In this paper we address this issue by explicitly considering information on the financial cycle for estimating potential output and cyclical fluctuations. Our basic underlying hypothesis states that the current measurement of potential output ignores the cyclical effects of finance and thus considers effective demand created by financial cycles as sustainable output.

This paper provides first-time comparative evidence on the finance-neutral potential output as pioneered by Borio et al. (2013) by applying the concept to more countries, namely two sets of advanced (AT, IE, NL, US) and emerging EU economies (BG, EE, PL, SK). We also use a more general statistical framework, namely a variant of the Kalman filter following Harvey (1989) and Harvey and Jaeger (1993) which nests the extended HP filter suggested by Borio et al. (2013) as a special case. We show that our finance-augmented estimates of the cyclical components are able to explain a considerably higher share of the variation of the unemployment rates in the respective economies than the conventional HP filter, which considerably strengthens the case for considering the financial sector when measuring business cycles. Our work is in the spirit of Comin and Gertler (2006), who highlighted the empirical importance of medium-term cycles as well as the problem that conventional filters tend to sweep these oscillations into the trend.[6]

Our findings provide important input to the current discussion on the problems of stabilization policy, including not only monetary policy, but also fiscal interventions and macroprudential measures to smooth the financial cycle (in order to avoid corresponding busts and deep recessions). Our approach is appealing

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[3] *See Levine (2005) for a comprehensive survey of this literature.*

[4] *See Minsky (1978) for a classical exposition.*

[5] *In his discussion of Lerner's book, Milton Friedman laid down his two famous institutional arguments against Keynesian demand management, one being the difficulty to act timely, the other (and mostly forgotten) being the difficulty to identify and predict the state of the economy in real time.*

[6] *They explained the persistence of short-run shocks by endogenous productivity in an otherwise standard New Keynesian dynamic stochastic general equilibrium (DSGE) model.*

because it neither changes nor extends existing policy rules, but instead keeps them simple and makes them more robust in real time. Moreover, in contrast to the existing consensus, our results imply the need for a symmetric countercyclical economic policy response to the financial cycle.

The paper is structured as follows. Section 1 explains the empirical approach and the data used in our study. Section 2 shows our empirical results and discusses related implications for both advanced and emerging economies, while the final section concludes and discusses the findings in the context of previous literature.

## 1 Methods and Data

### 1.1 Empirical Approach

We aim at decomposing actual real GDP series by separating the underlying trend of potential output from cyclical developments, both unobserved in practice. For this purpose, we set up a structural time series model to decompose the observed series of real GDP into unobserved components.[7] In particular, we extend the structural unobserved components model proposed by Harvey (1989) and Harvey and Jaeger (1993) to decompose the real GDP time series into a trend, a cyclical component, and an irregular component, by taking into account the developments of financial variables. Therefore, following Harvey and Jaeger (1993), we express the logarithm of real GDP $y_t$ as

$$y_t = \mu_t + \psi_t + \varepsilon_t, \qquad\qquad t = 1,\ldots,T, \quad (1)$$

where $\mu_t$ is potential (trend) output, $\psi_t$ denotes the cyclical component of output and $\varepsilon_t$ is the irregular component. In its most general form, potential output is assumed to follow a local linear trend, i.e.

$$\mu_t = \mu_{t-1} + \beta_{t-1} + \eta_t, \qquad\qquad \eta_t \sim NID(0,\sigma_\eta^2), \quad (2)$$

$$\beta_t = \beta_{t-1} + \zeta_t, \qquad\qquad \zeta_t \sim NID(0,\sigma_\zeta^2), \quad (3)$$

where $\beta_t$ denotes the slope of potential output. The disturbances $\eta_t$ and $\zeta_t$ allow for stochastic shifts in the trend and in the slope of the trend. The cyclical component as a mixture of sine and cosine waves can be written as

$$\psi_t = \rho\cos\lambda_c\psi_{t-1} + \rho\sin\lambda_c\psi_{t-1}^* + \kappa_t, \qquad \kappa_t \sim NID\left(0,\sigma_\kappa^2\right), 0 \le \rho \le 1 \quad (4)$$

$$\psi_t^* = -\rho\sin\lambda_c\psi_{t-1} + \rho\cos\lambda_c\psi_{t-1}^* + \kappa_t^*, \qquad\qquad \kappa_t^* \sim NID(0,\sigma_\kappa^2). \quad (5)$$

Here, $\rho$ is a dampening factor constrained to be between zero and one, and $\lambda_c$ denotes the frequency of the cycle, measured in radians, constrained to lie between zero and $\pi$. Following Harvey and Jaeger (1993), we assume that the two disturbances $\kappa_t$ and $\kappa_t^*$ have the same variance ($\sigma_\kappa^2$). Therefore, the cyclical component of GDP is modeled by means of a stochastic sine-cosine wave. This structural component renders several advantages related to the fact that we can extract its

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[7] *See Harvey (1989) and Durbin and Koopman (2001) for in-depth treatments of state space models and the Kalman (1961) filter. The nontechnical discussion provided in this section is mainly based on these textbooks.*

properties and give an economic meaning to them, as shown by Harvey (1989) and Harvey and Jaeger (1993).[8, 9]

Importantly, this model nests the widely used Hodrick-Prescott (1997) filter as a special case. Restricting the parameters to $\sigma_\zeta^2 / \sigma_\varepsilon^2 = \lambda$ (where $\lambda$ is the smoothing parameter of the HP filter) and $\sigma_\eta^2 = \psi_t = 0$, the cyclical component of the HP filter can be retrieved as the smoothed irregular component. In this sense, we build upon the pioneering approach by Borio et al. (2013), but apply a more general statistical framework which models both the trend and the cyclical component explicitly. In order to facilitate a comparison with the extended HP filter used by Borio et al. (2013), however, we set $\sigma_\eta^2 = 0$ in our estimations to allow the trend to be only smoothly changing (i.e. the model does not permit stochastic level shifts in trend output).[10]

In order to be able to explain some variation of the cyclical component by the financial cycle, we adapt equation (4) in the following manner.

$$\psi_t = \gamma_1 HOUSE_t + \gamma_2 CREDIT_t + \rho \cos \lambda_c \psi_{t-1} + \rho \sin \lambda_c \psi_{t-1}^* + \kappa_t, \qquad (4a)$$

where $HOUSE_t$ refers to the growth rate of real house prices, and $CREDIT_t$ is the growth rate of real credit. It should be noted that in this formulation the financial variables are allowed to exert a direct effect only on the business cycle component, i.e. the output gap. Consequently, any influence of credit and house price developments on potential output can only be indirect.

Once the model is written in state space form, estimation can be carried out by means of maximum likelihood estimation via the Kalman (1961) filter and the prediction error decomposition. Following estimation of the parameters, the cyclical components are retrieved as the smoothed estimates of $\psi_t, \hat{\psi}_t$.

For each country in our sample, we subsequently estimate the smoothed cyclical and trend components given by the HP filter with $\lambda = 1600$, and those from the model described in equations (1) to (5). We then estimate variants of the model given by equations (1) to (4a) and (5) that include either real credit or real house prices, as well as a version that includes both financial variables, and retrieve the (smoothed) cycles and trends from those models.

## 1.2 Data Sources

Real GDP data are taken from the International Monetary Fund's IFS database. For advanced economies we measure credit as total credit to the nonfinancial sector (incl. cross-border credit), using the long series on credit to private nonfinancial

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[8] In particular, it is easy to define several of the characteristics of the cycle such as the expectations concerning the period (as a function of the estimate of the frequency), the amplitude, and the phase of the cycle (see Harvey, 1989, pp. 38–39, for further details).

[9] We are aware that maximum-likelihood estimations via the Kalman filter can be subject to the pile-up problem (Stock and Watson, 1998, who propose to use median unbiased estimation instead). However, our estimations of the Harvey-Jaeger model using a Kalman filter without financial explanatory variables are quite similar to Hodrick-Prescott estimations, where the signal-to-noise ratio is restricted to $\lambda$. In this sense, there seems to be no pile-up problem. The volatility of the trend is reduced when we include our financial explanatory variables in the model. They increase the estimated volatility of the cycle, as a result of which the volatility associated with the trend decreases. Therefore, we conclude that the specific behavior of the volatilities of the trend and cyclical components in our model including the growth rates of real house prices and real credit is driven by the information added by our financial indicators rather than by the pile-up problem.

[10] The model which allows for shifts in trend output (i.e. which does not set $\sigma_\eta^2=0$) will be implemented for an extended country sample in the near future.

sectors provided by the Bank of International Settlements.[11] A detailed description of the dataset can be found in Dembiermont et al. (2013). As the BIS dataset does not provide credit data for most CESEE countries, we measure credit as domestic banks' claims on the resident nonbanking sector (excl. state and local governments) for these countries.[12] Our house price dataset for the CESEE countries is described in Steiner (2013), Huynh-Olesen et al. (2013) and Hildebrandt et al. (2012). For the other countries in our dataset we use data from the BIS property price statistics[13] and residential property price data provided by the ECB. We deflate all credit and house price series using IMF consumer price data. See table 1 in the appendix for a detailed overview of the data sources for all countries.

## 2 Empirical Results

### 2.1 Advanced Economies

Chart 1 shows real GDP, real house prices and real credit for Austria, Ireland, the Netherlands and the United States as index values (Q4 2007 = 100). Four stylized facts emerge: (i) Not all countries exhibited a financial cycle that peaked around 2007. For instance, the increase in Austrian house prices even accelerated after the crisis emerged. (ii) The upswing of the financial cycle in Ireland, the Netherlands and the United States started in the second half of the 1990s and accelerated further in the 2000s (showing exponential house price trends and rising credit growth). (iii) Interestingly, house prices seem to peak earlier and more sharply than credit, especially in the United States and Ireland. (iv) At first sight, interdependencies between the financial cycle (i.e. house prices and private credit) and real GDP developments seem rather heterogeneous across countries.

Our empirical results are depicted in charts 2 to 5. For each country, we estimated four different versions of the Kalman filter, one without additional explanatory variables (Harvey and Jaeger (H/J) baseline), one including credit, one including house prices, and one allowing *both variables* to exert influence on the cyclical component of GDP (top left). The latter (our preferred measure of the finance-neutral potential output) is subsequently compared to the official estimates of potential output growth by the OECD and/or the European Commission for the respective economies (top right). In the bottom half, we decompose the actual GDP growth rates into growth contributions from potential output (shaded area) and the cyclical share (the remaining difference to actual GDP growth), comparing the HP filter (left) and the "house/credit" model (right).

Several stylized facts can be highlighted. First, in all four countries, a strong boom period preceding the global financial crisis is clearly visible. In the United States, Ireland, and the Netherlands, the estimated output gaps are considerably larger, however, when the Kalman filter takes financial developments into account, while the estimates for Austria are hardly affected by the additional explanatory variables. Thereby, the considerably negative output gaps at end-2012

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[11] *The dataset is available online at www.bis.org/statistics/credtopriv.htm.*

[12] *Although the definition of this credit variable is narrower than the definition of the total credit variable provided by the BIS, the correlation coefficient between the two variables is very high.*

[13] *The dataset is available online at www.bis.org/statistics/pp.htm.*

Chart 1

**Real GDP, House Prices and Real Credit in Advanced Economies**

**United States**

*Index: Q4 07 = 100*
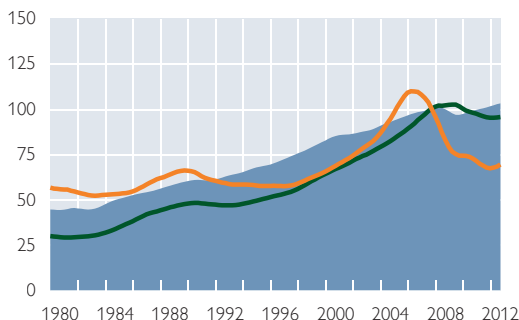
**Ireland**

*Index: Q4 07 = 100*
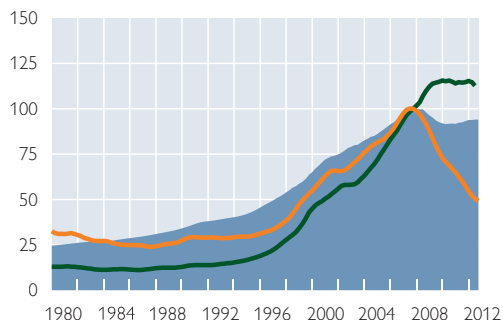
**Austria**

*Index: Q4 07 = 100*
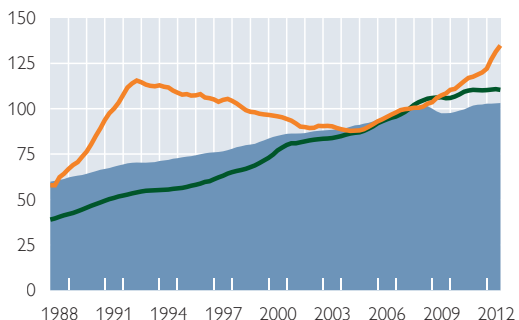
**Netherlands**

*Index: Q4 07 = 100*



    Real GDP    Real house prices    Real credit
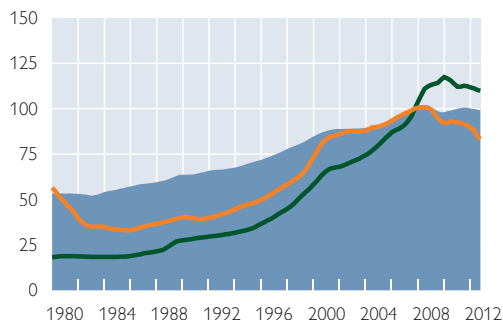
*Source: OeNB.*

may reflect the slow deleveraging of households and financial sectors in the corresponding countries. Second, particularly in those countries where the financial cycle played an important role for cyclical components (i.e. IE, NL, US), the growth rate of finance-neutral potential output is by far less volatile than the one suggested by the HP filter, as shown in the two lower panels for each country. Third, the OECD estimate of potential output growth is the closest estimate to our house/credit model in all four countries, while the estimates by the European Commission seem to follow a standard HP filter quite closely. Fourth, the considerable reduction of potential output growth according to our model (particularly in IE and NL) is likely to be caused by the capital channel (lower investment induced by the recession and financial constraints), the labor input channel (permanent destruction of human capital as a result of long periods of unemployment, hysteresis effects), as well as the total factor productivity (TFP) channel, once again because of lower investment and adverse effects on human capital by the recession. Finally, we also confirm the existence of "unfinished recessions" as outlined in Borio et al. (2013) in the first half of the 2000s for the United States, Ireland and the Netherlands. In those time periods, conventional approaches suggested a negative value for the output gap in the corresponding economies, while they may still have been in a boom phase according to finance-augmented cyclical components.

Chart 2

## United States

**Cyclical Components of GDP**
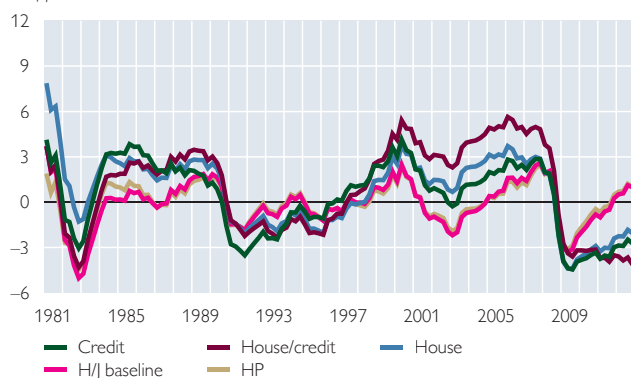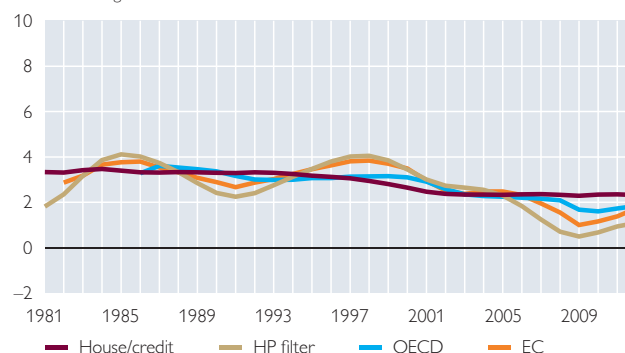
*% of potential GDP*



Legend: Credit — House/credit — House — H/J baseline — HP

**Potential/Trend GDP**

*Potential GDP growth in %*



Legend: House/credit — HP filter — OECD — EC

**GDP Growth Decomposition: HP Filter**

*Growth rate in %*



Legend: Trend HP — Real GDP

**GDP Growth Decomposition: House/Credit**

*Growth rate in %*



Legend: Trend house/credit — Real GDP
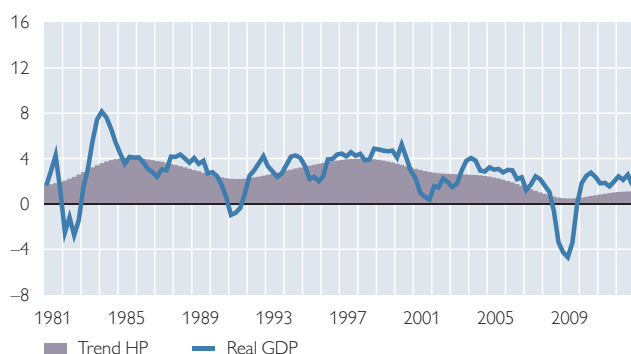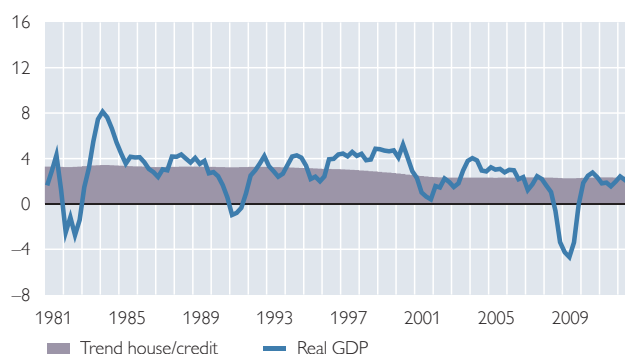
*Source: OeNB.*

In greater detail, the estimates for the United States (chart 2) show a financial boom in the late 1980s as well as in the 2000s, following a relatively moderate financial bust in the early 1990s. In 2012, at the end of our sample, the U.S. economy shows signs of recovery and positive GDP growth rates supported by developments in the housing market; however, ongoing balance sheet adjustments make it still impossible to catch up to the potential level, i.e. the growth rate is not sufficient to close the output gap. The slowdown of potential output growth in the early 2000s that is evident from the bottom right panel (suggested by the house/credit model) is confirmed by Fernald (2012) and somehow coincides with the estimates of the OECD, while both the HP filter as well as the European Commission's estimates show a considerably higher volatility of potential output growth.[14]

The financial cycle in the Netherlands (chart 3) started in the mid-1990s driven by extensive growth rates of both credit and house prices. Following an "unfinished recession" in the early 2000s, the second financial boom was comparably weak and ended with the global financial crisis. The Dutch housing market is characterized

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[14] *The main arguments for the pronounced boom/bust cycle in the United States is extensively discussed in Borio et al. (2013) and Borio (2012). Thus, for brevity reasons, we refrain from a more detailed discussion of the underlying causes and mechanisms.*

Chart 3

## Netherlands

**Cyclical Components of GDP**
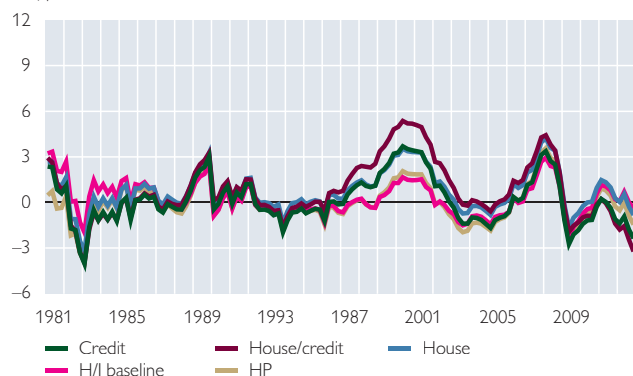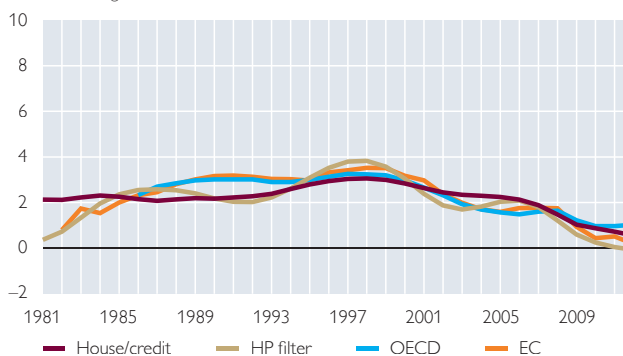
*% of potential GDP*



Credit — House/credit — House — H/J baseline — HP

**Potential/Trend GDP**

*Potential GDP growth in %*



House/credit — HP filter — OECD — EC

**GDP Growth Decomposition: HP Filter**

*Growth rate in %*



Trend HP — Real GDP

**GDP Growth Decomposition: House/Credit**

*Growth rate in %*



Trend house/credit — Real GDP
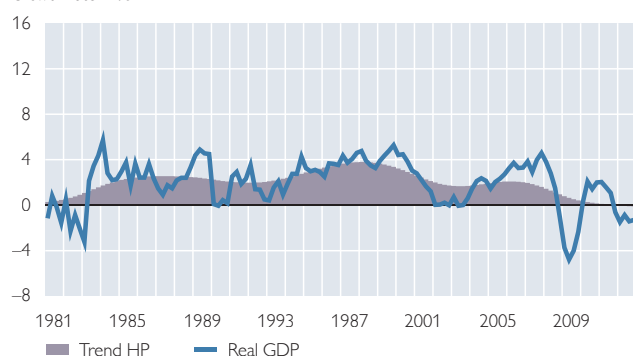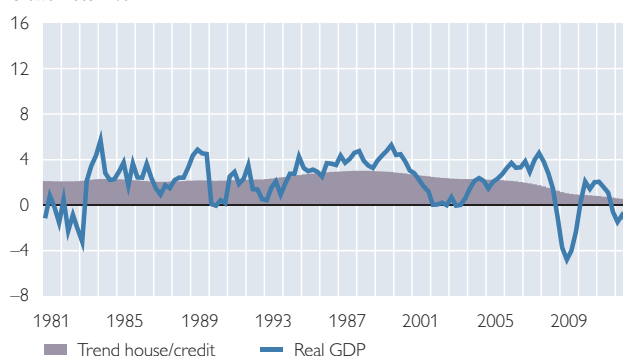
*Source: OeNB.*

by highly interventionist public policies, as explained by Vandevyvere and Zenthöfer (2012). Direct and indirect government intervention, generous mortgage interest deductibility and low taxation of home ownership, combined with a relatively rigid supply, led to a considerable increase in house prices, starting in the mid-1990s. Thus, innovations and liberalizations in mortgage financing played a more important role in the Netherlands than in other European countries. The considerable expansion of the debt capacity of Dutch households enabled them to take up larger amounts of debt, leading to high levels of leveraged housing wealth and even further price increases. Our evidence suggests that financial rebalancing in the Netherlands was still unfolding at the end of 2012.

Compared with the Netherlands, the influence of the financial cycle is even more pronounced for the Irish economy (chart 4). Until the early 1990s, Ireland was a relatively poor economy characterized by low-skilled manufacturing. During the 1990s, deregulation and other policy initiatives led to a rapid shift to high-skilled manufacturing, high growth in the service sector, rapid growth of the population, and finally to a housing and property boom (Kitchin et al., 2012). While the first years of this rapid growth period were characterized by export-led growth dominated by FDI inflows, the last years of the expansion involved a property boom financed by Irish banks which, in turn, were borrowing from

Chart 4

## Ireland

**Cyclical Components of GDP**
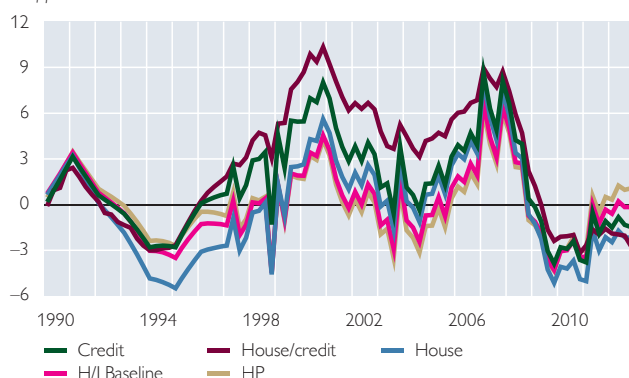
*% of potential GDP*



Legend: Credit · House/credit · House · H/J Baseline · HP

**Potential/Trend GDP**

*Potential GDP growth in %*



Legend: House/credit · HP filter · OECD · EC

**GDP Growth Decomposition: HP Filter**

*Growth rate in %*



Legend: Trend HP · Real GDP

**GDP Growth Decomposition: House/Credit**

*Growth rate in %*



Legend: Trend house/credit · Real GDP
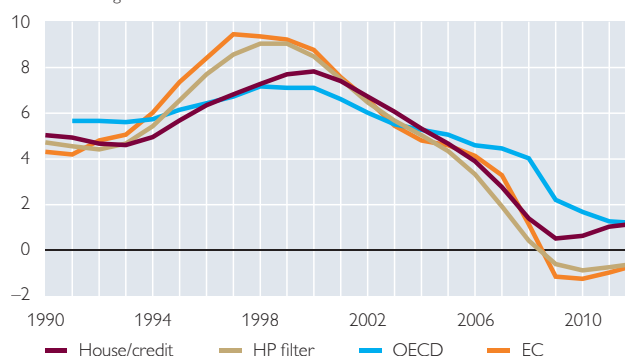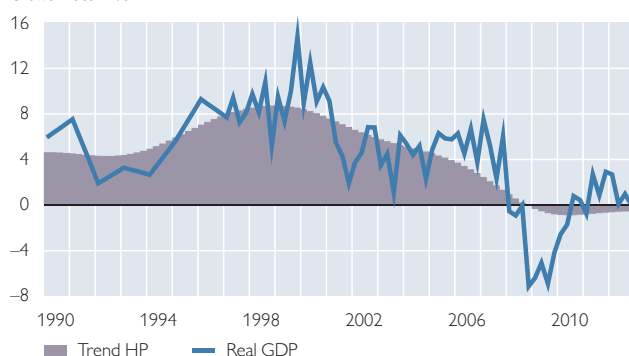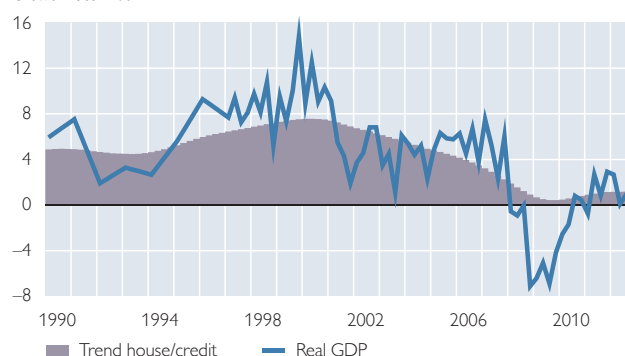
*Source: OeNB.*

European banks. The global crisis finally led to the burst of the property bubble, and many Irish banks with toxic property loans on their balance sheets were on the brink of bankruptcy, ultimately leading to the IMF-EU bailout in November 2010. While conventional univariate filters would suggest a recession in Ireland from 2003 to 2005, our extended house-credit model suggests an extensive boom period already starting in 1996, with the output gap staying positive up to the beginning of 2009. The final years of the boom, starting in 2005, seem to be caused by the property boom and extensive credit growth. Unsurprisingly, the high growth rates underpinned by the construction boom were not sustainable during the crisis, when the bust led to a severe recession.

Our estimates for Austria, on the contrary, do not suggest a sizeable financial cycle since the late 1980s. Not even the long, but rather gradual decline in house prices in the 1990s caused a substantial increase in negative output gaps at that time. During the crisis, the slow growth of credit constituted a drag on the economy, increasing the 2012 output gap by more than a percentage point (as compared to the HP filter). Potential output growth again proved to be more stable than the HP filtered series, suggesting a potential growth rate of below 1.5% for the Austrian economy at the end of 2012. A recent study by Schneider (2013) argues that the decreasing undervaluation of Austrian house prices since

Chart 5

## Austria

**Cyclical Components of GDP**
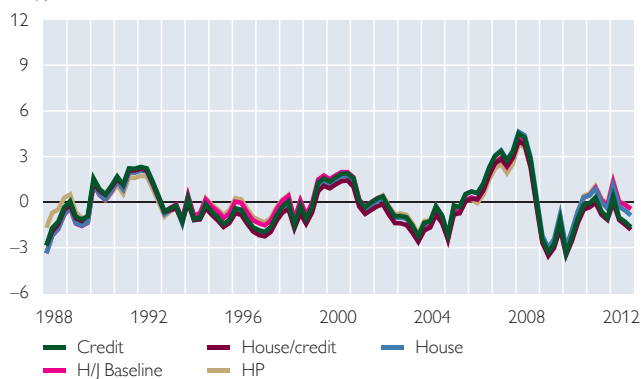
*% of potential GDP*



Legend: Credit — House/credit — House — H/J Baseline — HP

**Potential/Trend GDP**

*Potential GDP growth in %*



Legend: House/credit — HP filter — OECD — EC

**GDP Growth Decomposition: HP Filter**

*Growth rate in %*



Legend: Trend HP — Real GDP

**GDP Growth Decomposition: House/Credit**

*Growth rate in %*



Legend: Trend house/credit — Real GDP
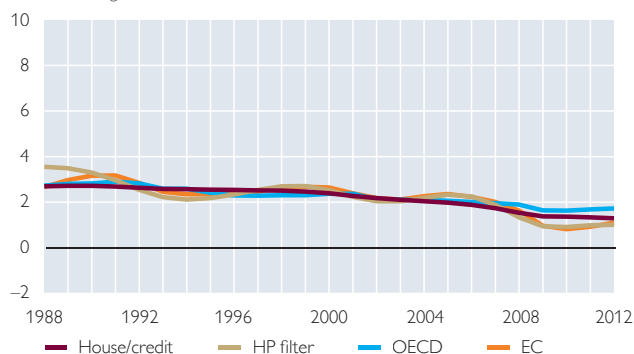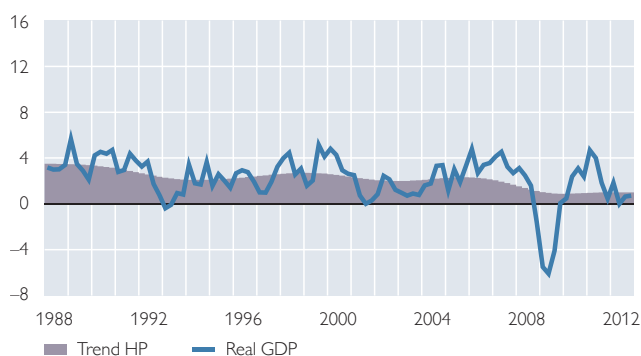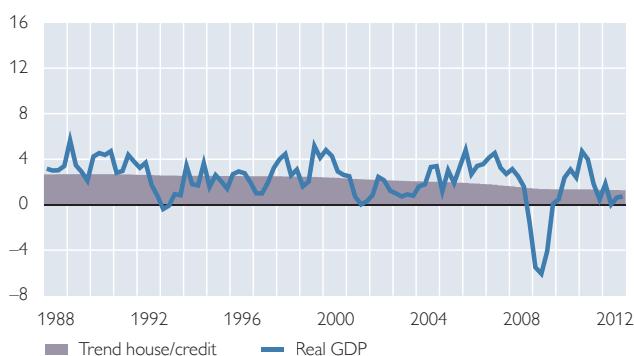
*Source: OeNB.*

2010 – mainly driven by the strong house price increases in Vienna – are not debt financed, and thereby consistent with our estimates of relatively higher negative output gaps for the "credit" model than for the "house/credit" model driven by low credit growth despite the recent rise in house prices.

### 2.2 Countries in Central, Eastern and Southeastern Europe (CESEE)

While the empirical impact of the financial cycle on business cycle fluctuations is quite substantial for most advanced economies, the effect might be different and also quite heterogeneous for economies in Central, Eastern and Southeastern Europe (CESEE), as these economies have been on a convergence path during the last decade and are at highly different stages of economic development. Further-more, countries like Estonia or Slovakia have already introduced the euro, and Bulgaria operates a currency board with a fixed exchange rate, while the Polish złoty is still floating. Thus, even when only considering the exchange rate regime, we would expect that countries in CESEE differ widely according to their vulner-ability to external shocks and capital flow reversals. A further distinct feature of financial systems in CESEE is the high share of foreign banks in total banking assets, which averages 82% in CESEE, as compared to only 37% in Latin America (Backé et al., 2010). Before the crisis, financial deepening was welcomed from the

perspective of many policymakers, as economic theory suggests a positive relationship between credit-to-GDP levels and economic development. Nevertheless, the developments prior to the crisis led to a lively policy debate whether private credit growth was excessive in the CESEE region (for empirical contributions see, for instance, Backé et al., 2007; Égert et al., 2007; Backé and Wójcik, 2008; Eller et al., 2010; Backé et al., 2010; Lahnsteiner, 2013), although an assessment of equilibrium credit seems quite difficult in emerging economies, as they are still converging to a steady state. Indeed, the correction in private credit since 2008 in some economies may suggest some overshooting in the indebtedness levels in the run-up to the crisis (Lahnsteiner, 2013).

Although developments in housing markets have not attracted as much attention in the literature, a number of studies have examined the determinants of house prices in CESEE, and further, tried to assess house price sustainability (see, for instance, Hildebrandt et al., 2012; Huynh-Olesen et al., 2013; Steiner, 2013). Huynh-Olesen et al. (2013) find a relatively strong relationship between house prices and fundamentals (such as disposable income of households), but they also give evidence that the years prior to the crisis were characterized by a decoupling of house prices from these fundamentals in almost all CESEE economies. The correction during the crisis years, however, might also have been excessive in several CESEE economies, as house prices were below the level suggested by fundamentals in most countries in 2011.

These heterogeneous developments are also obvious in our case studies for Bulgaria, Estonia, Poland and Slovakia. While the boom-bust cycle was most pronounced in Estonia (along with Latvia and Lithuania), it was also quite severe in Bulgaria (and similarly, in Romania). In Poland, such a pattern is hardly observable. The obvious acceleration in the financial cycle around 2004 (when the countries joined the EU) is also evident in the case of Slovakia. However, the recent slowdown in private credit growth has not yet affected GDP growth as sharply as in other countries in the region.[15] The developments in both financial and housing markets are also mirrored in the impact on the corresponding GDP growth rates. While Poland even managed to avoid recession in the technical sense, Estonia, for instance, faced a very sharp contraction of GDP. Bulgaria was still struggling with sluggish growth rates at end-2012, even though it started to recover rather shortly after the crisis in Estonia and the Slovak Republic.

Despite those differences, the empirical results shown in chart 6 strongly resemble the findings from the previous section. The four CESEE economies show a considerable boom period prior to the crisis, whereas the estimated output gaps for Estonia, Bulgaria and Slovakia are substantially larger when financial variables are taken into account. On the contrary, similar to our results for Austria, the estimates for Poland are hardly affected by the additional explanatory variables. Once again and similar to the advanced economies, the growth rate of finance-neutral potential output appears considerably more stable than the one suggested by the HP filter or the official estimates by the OECD and the European Commission, respectively. Compared to the advanced economies, however, two
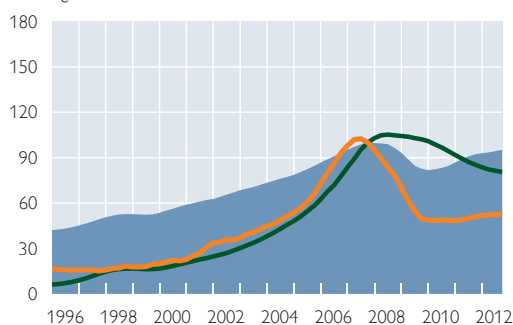
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[15] *We do not include house prices in the case of the Slovak Republic due to the short time series.*

Chart 6

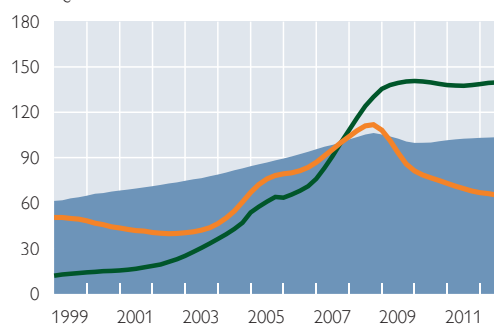**Real GDP, House Prices and Real Credit in CESEE Economies**
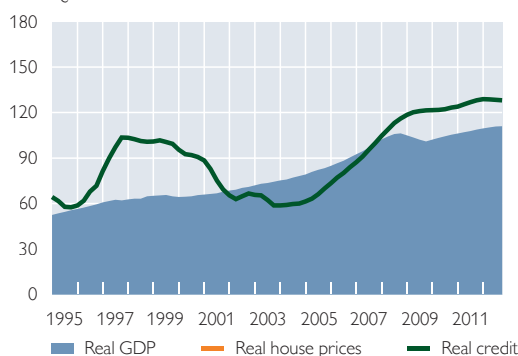
**Estonia**

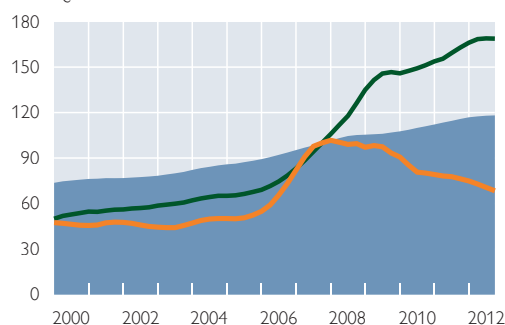*Index: Q4 07 = 100*

**Bulgaria**

*Index: Q4 07 = 100*

**Slovakia**

*Index: Q4 07 = 100*

**Poland**

*Index: Q4 07 = 100*

Real GDP    Real house prices    Real credit

*Source: OeNB.*

major differences stand out. First, the differential between the estimated output gaps is even more pronounced in absolute terms (i.e. percentage points) than in the case of the advanced economies. Second, while we observed unfinished recession phenomena in three advanced countries, none of the economies in CESEE shows a similar pattern, as the boom phases started considerably later, when most countries in the region joined the EU in 2004.

In the early 2000s, Estonia's real GDP growth was considerably higher than output growth in other CESEE countries (chart 7).[16] However, while growth was primarily driven by exports in many CESEE countries, Estonia's boom was mostly caused by an acceleration of domestic demand, particularly by a private investment boom in real estate. The investment boom was supported by capital inflows, both directly (FDI) and indirectly (cross-border loans to domestic branches of foreign banks). Both private credit as well as house prices further accelerated in the mid-2000s, when the composition of capital flows shifted to loans, and the two series peaked around 2007 and 2008. Private external debt exceeded 100% of GDP at the end of 2007, and current account deficits increased dramatically, amounting to 18% of GDP in 2007. Due to the fixed exchange rate, these capital

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[16] *The following discussion of the causes and consequences of the recent financial crisis for Estonia is mainly based on Brixiova et al. (2010).*

inflows resulted in inflation and real exchange rate appreciations, leading to a loss of competitiveness. Due to increased demand for houses but limited supply, house prices also started to increase dramatically along with private credit. While house prices were characterized by overshooting as a result of widespread speculation prior to the crisis, they may have been subject to undershooting during the correction phase (Brixiova et al., 2010). Accordingly, our results suggest that Estonia still exhibited a considerably negative output gap exceeding –10% of potential GDP at end-2012 once we control for house and credit developments. Interestingly, it seems that the lion's share of the negative output gap is due to credit developments (as credit growth is still negative), while real house prices have started to recover, albeit very sluggishly. Remarkably, our model suggests a much higher potential output for Estonia than the remaining models (including official estimates by the OECD and the European Commission).[17]

Chart 7

## Estonia

**Cyclical Components of GDP**
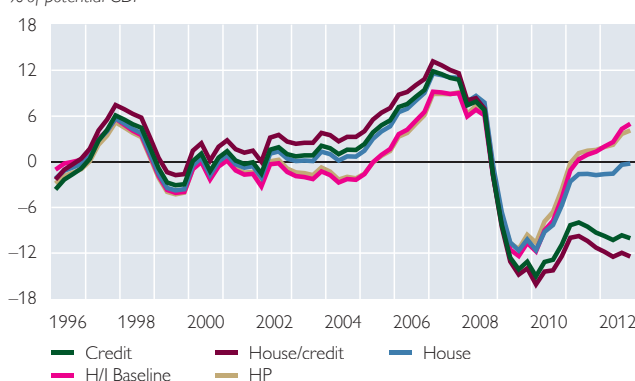
% of potential GDP

**Potential/Trend GDP**

Potential GDP growth in %

**GDP Growth Decomposition: HP Filter**

Growth rate in %

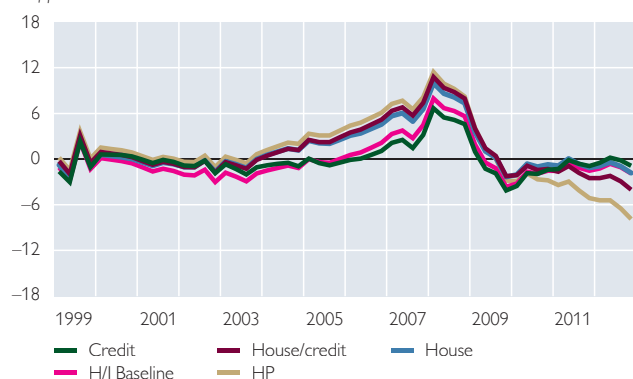**GDP Growth Decomposition: House/Credit**

Growth rate in %

Source: OeNB.

[17] The suggested considerable spare capacity in the Estonian economy, however, might also be due to our model specification, which does not specifically allow for level shifts in potential output reflecting, as may have been the case in Estonia, migration movements, and thus, a shrinking labor force. Technically, as described in the method section, we set $\sigma_\eta^2 = 0$ in equation (2) for the sake of simplicity. More sophisticated models including shifts in potential output (and other extensions in the specification) are planned to be implemented.
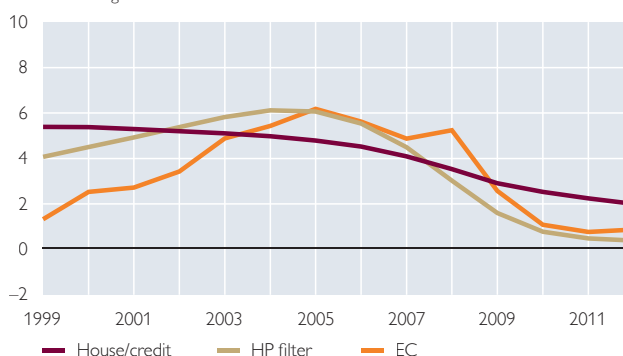
Chart 8

## Bulgaria

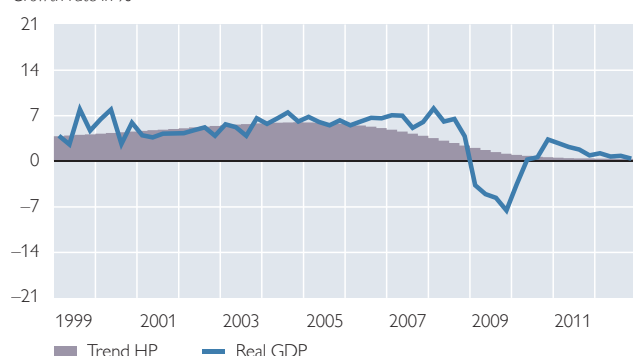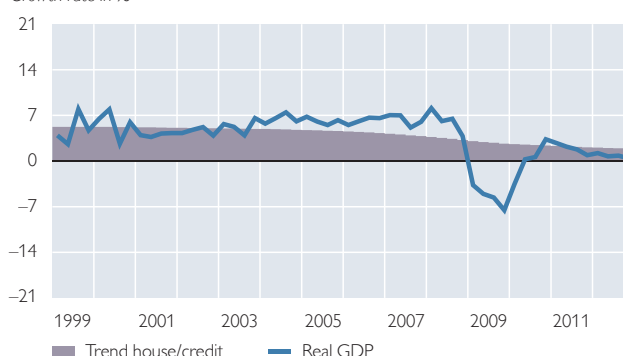**Cyclical Components of GDP**

*% of potential GDP*



Credit
House/credit
House
H/J Baseline
HP

**Potential/Trend GDP**

*Potential GDP growth in %*



House/credit
HP filter
EC

**GDP Growth Decomposition: HP Filter**

*Growth rate in %*



Trend HP
Real GDP

**GDP Growth Decomposition: House/Credit**

*Growth rate in %*



Trend house/credit
Real GDP

*Source: OeNB.*

Bulgaria (chart 8) also experienced a considerable boom-bust cycle, although it was not as severe as in the Baltic states. While real house prices also decreased by approximately 40% after the crisis, real private credit still increased substantially until 2009 and virtually stagnated thereafter. While Bulgaria attracted even more net capital inflows than Estonia in the period 2003 to 2007, the composition was quite different. FDI accounted for more than three-quarters of total net inflows in Bulgaria, but not even for half of the inflows to Estonia. Thus, the composition of Bulgarian capital inflows largely relying on FDI made the "sudden stop" less severe for Bulgaria. Nevertheless, also Bulgaria experienced a substantial boom-bust cycle with a severe recession during the global crisis. While both official estimates (European Commission) and univariate filters (HP) suggest almost zero potential GDP growth since 2010, our model implies a still positive potential growth rate of roughly 2% at end-2012, despite a substantial decrease starting around 2006.

While the Slovak Republic (chart 9) recovered from the crisis relatively quickly, our results still point to a nonnegligible impact of the financial cycle on GDP developments. The raw series for private credit mirrors the change of government in 1998, when a reform-oriented coalition came into office. Reforms included the restructuring of enterprises and banks as well as large-scale privatizations
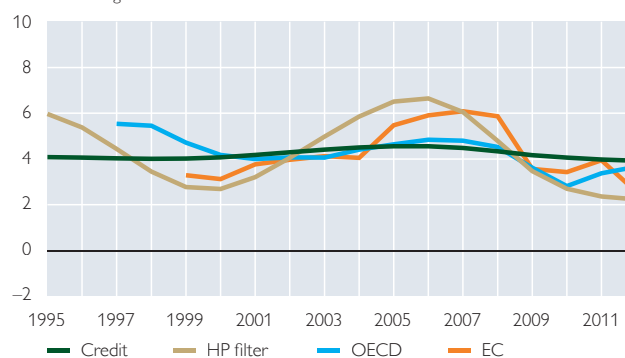
Chart 9

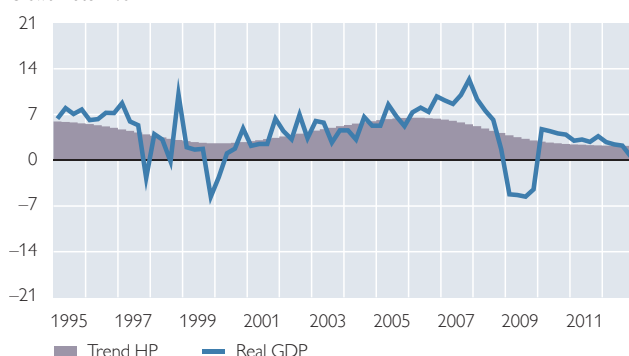## Slovakia

**Cyclical Components of GDP**
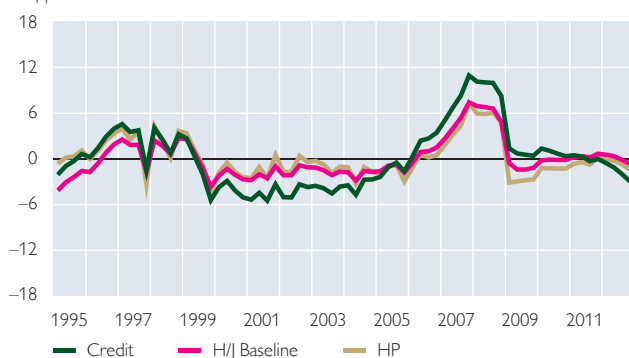
*% of potential GDP*



Credit — H/J Baseline — HP

**Potential/Trend GDP**

*Potential GDP growth in %*



Credit — HP filter — OECD — EC

**GDP Growth Decomposition: HP Filter**

*Growth rate in %*



Trend HP — Real GDP

**GDP Growth Decomposition: House/Credit**

*Growth rate in %*



Credit — Real GDP
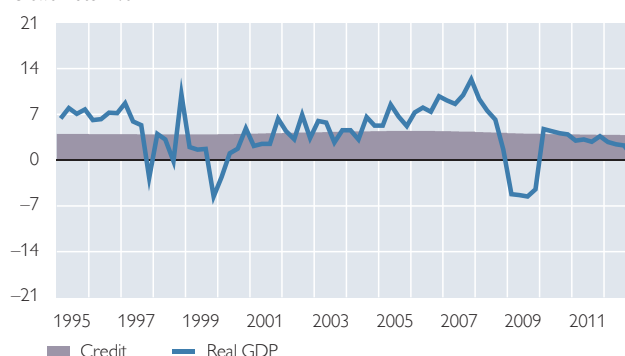
Source: OeNB.

open to foreign investors. A side-effect of this process was a substantial deleveraging in terms of private credit, opening the path towards EU membership (European Commission, 2011). Interestingly, GDP growth was not much affected during the reform years, but economic development accelerated after EU accession. Private credit doubled in four years, and Slovakia experienced buoyant GDP growth, even exceeding 10% before the crisis. Relative to other approaches, our results suggest a larger negative output gap before EU accession, and subsequently, a substantially larger positive output gap in the boom phase prior to the crisis.

Poland's resilience during the crisis is remarkable from several perspectives (chart 10). Pre-crisis credit growth was rather low compared with other CESEE economies, possibly (among other things) given Poland's history of nonperforming corporate loans in the late 1990s and early 2000s (IMF, 2007). However, net capital inflows were also lower than in other countries, not least due to the flexible exchange rate. Nevertheless, those capital inflows led to a substantial appreciation of the złoty before 2008, and a sharp depreciation during the crisis, when capital flows reversed. These exchange rate developments dampened the boom and stabilized the economy during the downturn, as the depreciating exchange rate increased Poland's competitiveness. The exchange rate, however, is not the only explanation why the country suffered less from capital outflows. Poland may
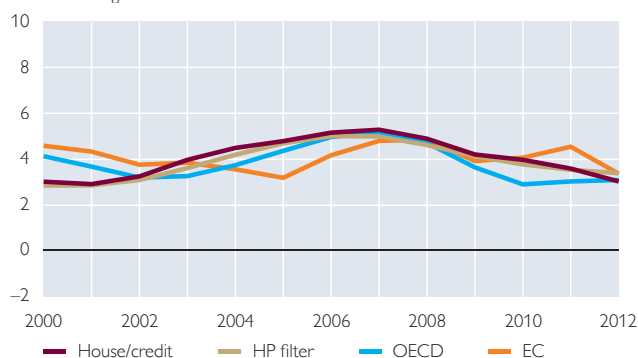
Chart 10

## Poland

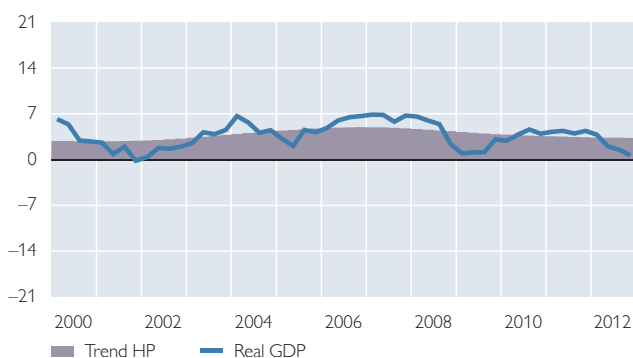**Cyclical Components of GDP**
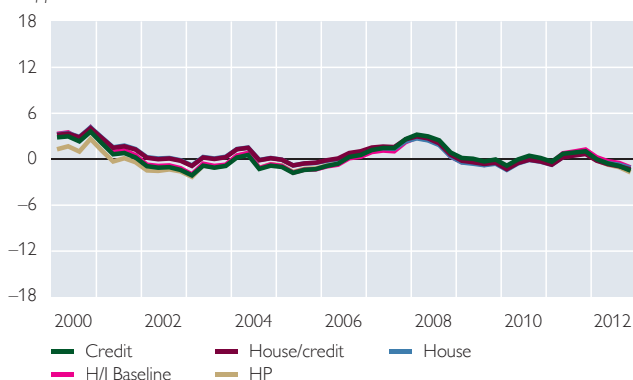
% of potential GDP



Credit — House/credit — House
H/J Baseline — HP

**Potential/Trend GDP**

Potential GDP growth in %



House/credit — HP filter — OECD — EC

**GDP Growth Decomposition: HP Filter**

Growth rate in %



Trend HP — Real GDP

**GDP Growth Decomposition: House/Credit**

Growth rate in %



Trend house/credit — Real GDP
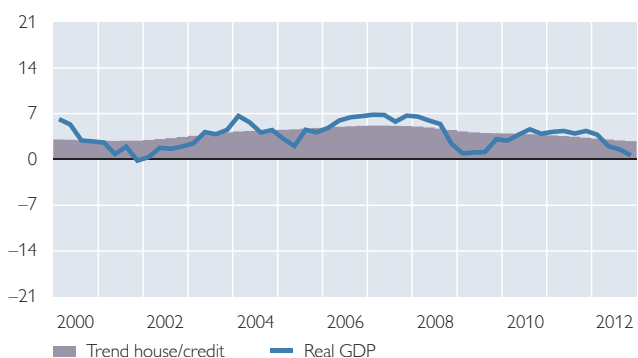
*Source: OeNB.*

in fact have benefited in particular from the Vienna Initiative, which encouraged Western European lenders to maintain their exposures to CESEE. Moreover, a larger domestic market as compared to other CESEE economies made Poland less dependent on external developments, and a strong countercyclical fiscal policy helped to avoid a recession in the technical sense. The results from our models are therefore not surprising: Traditional approaches (such as the HP filter) show no significant deviation from our estimated output gaps, and even the swings in potential output growth develop more or less similar over time.

### 2.3 Discussion

The empirical results suggest that the measurement of potential output needs to take a much broader view of sustainability. To verify our empirical results, we conduct a simple plausibility check by testing whether our model is able to replicate some standard propositions of structural models. More precisely, we analyze the simple correlation between cyclical components of standard filters (HP filter) and the Kalman filter "house/credit" model and the corresponding (annual) unemployment rates in our country sample.[18] While we did not use information from the labor

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[18] *Annual data for unemployment rates are taken from the AMECO database by the European Commission.*

## Cyclical Deviations and Unemployment Rates (I)

**United States (1990-2012)**



*Unemployment rate in %* / *Cyclical component in % of potential GDP*

R² = 0.3391

R² = 0.6465

**Netherlands (1990-2012)**



*Unemployment rate in %* / *Cyclical component in % of potential GDP*

R² = 0.3259

R² = 0.4415
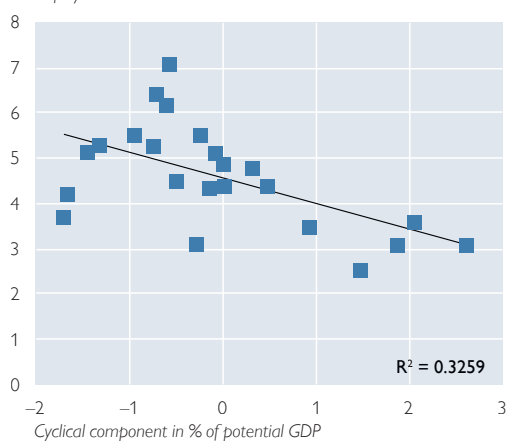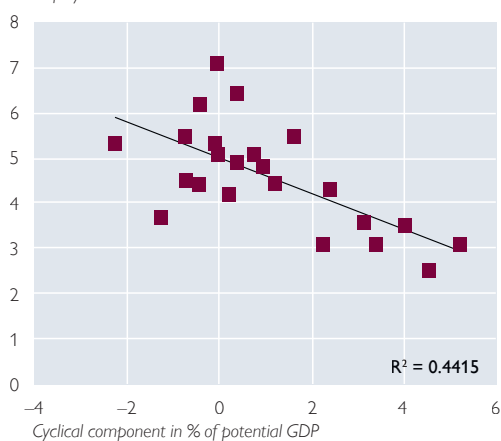
**Ireland (1990-2012)**



*Unemployment rate in %* / *Cyclical component in % of potential GDP*

R² = 0.0841

R² = 0.8413

■ HP filter

■ Kalman filter – house/credit
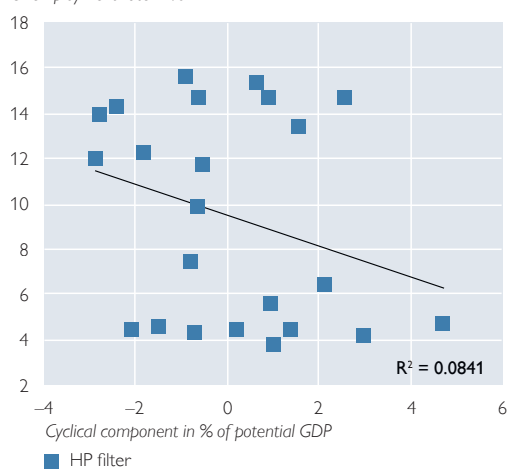
*Source: OeNB.*

Chart 12

## Cyclical Deviations and Unemployment Rates (II)

**Estonia (1995-2012)**

Unemployment rate in %



R² = 0.6655

Cyclical component in % of potential GDP

Unemployment rate in %



R² = 0.6128

Cyclical component in % of potential GDP
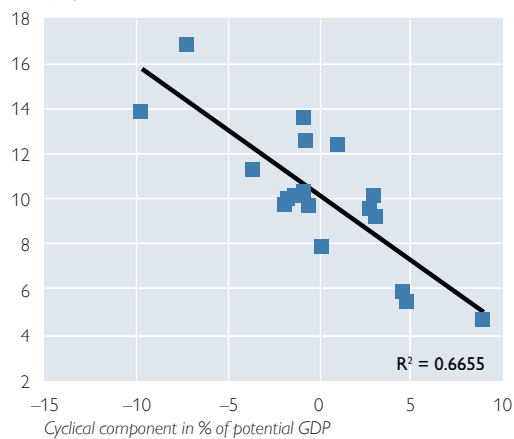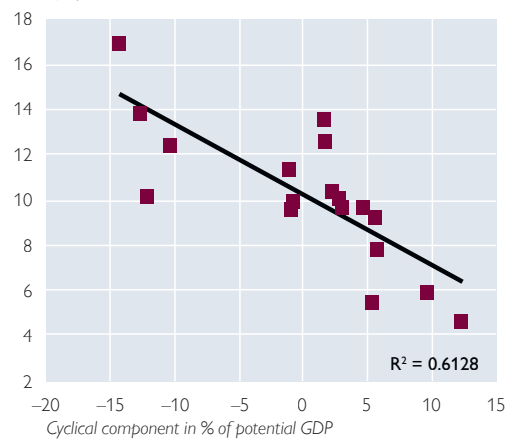
**Bulgaria (1997-2012)**

Unemployment rate in %



R² = 0.1095

Cyclical component in % of potential GDP

Unemployment rate in %



R² = 0.2682

Cyclical component in % of potential GDP
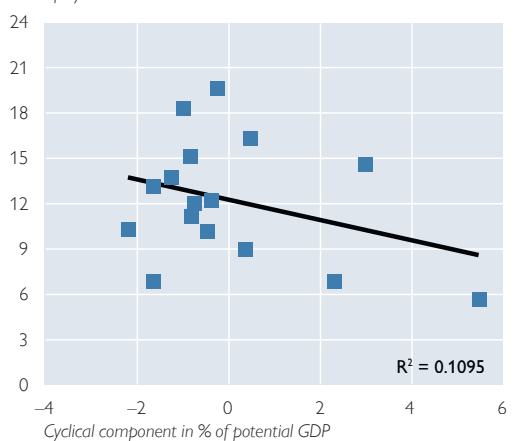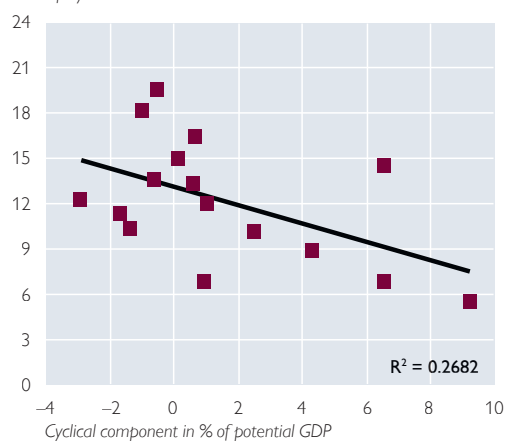
**Slovakia (1995-2012)**

Unemployment rate in %



R² = 0.4811

Cyclical component in % of potential GDP

■ HP filter

Unemployment rate in %



R² = 0.8034

Cyclical component in % of potential GDP

■ Kalman filter – house/credit
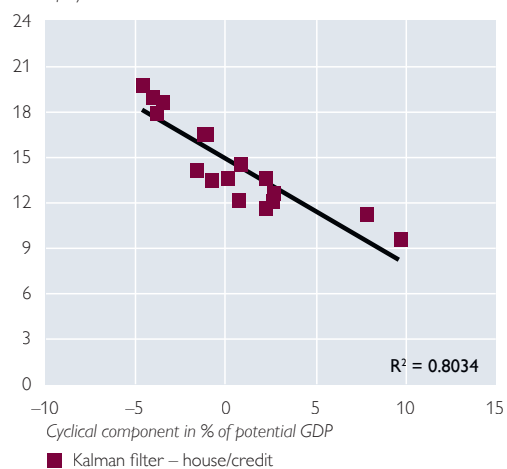
*Source: OeNB.*

market to estimate the output gaps, the explanatory power in a bivariate correlation analysis between unemployment rates and output gaps should increase if the inclusion of financial cycle variables improves the measurement of cyclical fluctuations. Chart 11 displays scatter plots illustrating a simplified form of Okun's law (defined in levels of the unemployment rate). In particular, it shows the scatter plots for three advanced economies where the financial cycle significantly determined cyclical fluctuations (i.e. excluding Austria). In the left-hand panels, unemployment rates are linked to standard HP-filtered output gaps, while the right-hand panels show the alternative model, i.e. the Kalman filter including credit growth and house prices. Each dot represents a yearly observation, i.e. an annual average of both the unemployment rate and the corresponding cyclical component of GDP.

In all three countries, the correlation between unemployment rates and output gaps substantially increases when the cyclical components consider developments in credit growth and house prices. In the United States, the coefficient of determination almost doubles from 34% to 65%. The same pattern is observable in the Netherlands, though the increase is not as pronounced as in the United States. The most striking example, however, is the case of Ireland, which probably experienced the most pronounced boom and bust in terms of the financial cycle. While the connection of HP-filtered output gaps and unemployment rates is almost non-existent, the inclusion of credit growth and house prices increases the explanatory power of this bivariate link to 84%. Thus, the omission of financial cycle variables in business cycle measures may lead to severely biased output gap estimations.[19] The same pattern is observable for CESEE economies (chart 12), i.e. the increase in explanatory power is quite distinctive in the case of Slovakia and also considerable for Bulgaria. Estonia is the only country where the explanatory power marginally decreases when considering financial sector variables. As discussed in the previous section, this may be due to a specific restriction in our model (we do not yet allow for level shifts in trend output) that may be particularly relevant for Estonia (where a large part of the workforce left the country).

Our approach to measure cyclical fluctuations might also be of considerable value for calculating structural budget balances, as public finances in Europe are very much affected by automatic stabilizers.[20] A very simple analysis linking public budget balances and output gaps in a scatter plot and comparing the explanatory power of the HP filter with that of the house/credit model shows that the connection between public deficits and output gaps increases significantly when the latter takes financial variables into account.[21] Thus, the explicit consideration of financial cycle variables might also lead to a better understanding of cyclical vs. structural adjustment in the current phase of rebalancing both in the euro area and in CESEE. In particular, differing estimates for the cyclical components shed new light on the debate on the speed of austerity in crisis countries and might also lead to a

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[19] While we compared the output gaps of our Kalman house/credit model with an ordinary HP filter, the results are qualitatively similar when compared to the other benchmark model, i.e. the Harvey/Jaeger (1993) model excluding credit growth and house prices.

[20] One has to keep in mind that fiscal policy variables reflect both (i) automatic stabilizers and (ii) discretionary policy measures, i.e. deliberate changes in the fiscal policy stance. Nevertheless, improved measures of cyclical components should lead to a higher correlation with overall public budget balances, although it only reflects the cyclical component (i.e. automatic stabilizers) of fiscal policy.

[21] For brevity reasons, we do not report these scatter plots in this paper.

reassessment of public deficit objectives in the current bust phase in these countries. More specifically, structural adjustment needs might in fact be considerably lower than estimated so far.

## 3 Conclusion

In this study, we proposed to extend the structural unobserved components model developed by Harvey (1989) and Harvey and Jaeger (1993) by including information on the financial cycle. We include the growth rates of private credit and house prices in the state equation corresponding to the cyclical component of GDP to explain cyclical deviations from potential GDP that are driven by the financial cycle. Our paper builds on earlier work by Borio et al. (2013), who extend the common HP filter with information on the financial cycle. Our approach nests the HP filter as a special case and applies this novel concept to four advanced (AT, IE, NL, US) and four CESEE economies (BG, EE, PL, SK). In a comparative manner, we are able to calculate finance-augmented output gaps which take the effect of financial variables into account.

Our results show a substantial impact of the financial cycle (i.e. house prices and private credit) on business cycle fluctuations, particularly before and during the global financial crisis. On the one hand, this finding confirms the importance of incorporating financial information in the estimation of potential output and the corresponding output gaps. More specifically, potential output growth is estimated to be more stable than shown by conventional approaches, and indeed more consistent with the grounding idea of potential output, i.e. the sustainability of economic development. On the other hand, in some countries, traditional approaches (such as the HP filter) are essentially in line with our estimation, leading to the conclusion that even in the recent crisis there were some countries (e.g. Austria, Poland) that did not experience pronounced boom-bust cycles. As pointed out by Borio et al. (2013), incorporating finance variables to estimate potential output and corresponding cyclical deviations allows us to indicate boom periods caused by financial developments even if inflation remains low and stable. By including additional information, it is also possible to estimate output gaps more robust in real time.[22]

This study reported some first results from a still ongoing research agenda and leaves several possibilities for future research. First, while we included private credit and house prices as explanatory variables in an otherwise univariate filter, there are several other variables which could reasonably be considered to capture the financial cycle, including (i) long-term interest rates or (ii) equity prices. Particularly in emerging market economies, (iii) cross-border capital flows might also be relevant, as a domestically driven credit boom is not threatened by the "sudden stop" of capital flows, which might cause a financial bust.[23] However, even variables such as the (iv) inflation rate, the (v) unemployment rate or (vi) current account balances could be taken into account to improve the explanatory power of

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[22] *We did not compare the performance of the various approaches in real time in this paper. However, preliminary results show that our "finance-augmented" output gaps are much more robust than traditional approaches. This finding is also confirmed in Borio et al. (2013).*

[23] *A further important distinction would be whether cross-border loans are primarily financed by parent banks (leading to more stable funding resources) or rather by wholesale funding.*

the model and to reduce the underlying uncertainty of measuring output gaps. Such a framework would somehow represent a hybrid approach between statistical filters and production function approaches, although it would still be purely data-driven. Furthermore, several nonlinearities could be considered in such a context, i.e. it seems likely that the effect of the variables deepens with increasing distance from a sustainable equilibrium, or that the impact differs in boom (upturn) and bust (downturn) periods. These suggestions also lead us to the main limitation of our study. The results are based on a reduced form "ad hoc" approach rather than on a theoretical model showing the underlying transmission channels and mechanisms of how finance interacts with the real economy. Nevertheless, the results presented in this paper show that neglecting financial variables in business cycle measurement might lead to severe measurement errors and large ex post revisions. Our approach is able to indicate unsustainable developments despite low and stable inflation rates in boom phases, and also enhances our understanding of cyclical vs. structural adjustments in bust/recession phases, which is of high importance in the current recovery phase. A thorough understanding of the financial cycle and its impact on business cycle fluctuations is necessary to conduct monetary, fiscal and also macroprudential policies in a stabilizing and efficient manner.

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## Appendix

Table 1

### Data Sources

| | Real GDP | Credit | House prices | Estimation from |
|---|---|---|---|---|
| Austria | IMF | BIS | OeNB (Q3 86) | Q4 86 |
| Bulgaria | IMF (Q1 90) | IMF (Q4 91) | BIS (Q1 93) | Q2 97 |
| Estonia | IMF (Q1 93) | IMF (Q1 92) | OeNB (Q2 94) | Q3 94 |
| Ireland | IMF | BIS | ECB | – |
| Netherlands | IMF | BIS | ECB | Q2 79 |
| Poland | IMF (Q1 81) | IMF (Q4 85) | OeNB (Q4 98) | Q1 99 |
| Slovak Republic | IMF (Q1 93) | IMF (Q1 93) | OeNB (Q1 02) | Q2 93 |
| United States | IMF | BIS | BIS | Q2 79 |

*Source: OeNB.*

*Note: The time series start in Q1 79 unless indicated otherwise or at the date given in brackets. All time series*
*end in Q4 12. OeNB refers to the house price data described in Huynh-Olesen et al. (2013), Hildebrandt*
*et al. (2012) and Steiner (2013).*

# How Did CESEE Households Weather the Crisis? Evidence from the OeNB Euro Survey

Majken Corti,
Thomas Scheiber[1]

*During the crisis period from 2008 to 2013 household disposable income deteriorated significantly in Central, Eastern and Southeastern Europe (CESEE), forcing households to adjust their consumption plans. Against this background, the present paper sheds some light on households' consumption smoothing behavior based on microdata supplied by the OeNB Euro Survey for ten countries in CESEE. We find that households reacted to stagnating and in some countries falling income mostly by cutting back on everyday consumption and reducing or postponing large expenditures, while other households coped by reducing the amounts they were setting aside as savings or by drawing on existing savings, overdrawing their current accounts and increasing work hours. Moreover, we find that macroeconomic forecasts by the European Commission, the wiiw and the OeNB are broadly in line with economic sentiment among CESEE households. Finally, Euro Survey results revealed that not all households were able to borrow as much as they would have liked to and that the share of households planning to take out a loan fell between 2008 and 2013.*

During the financial and economic crisis the financial situation of CESEE households deteriorated significantly. Stagnating and in some countries falling disposable income forced households to adjust their consumption plans quite substantially, not least because social security systems in CESEE are still less advanced than in many Western European countries. Against this background this short study presents OeNB Euro Survey[2] data in order to explore three issues.

First, how did CESEE households weather the crisis? In order to shed some light on households' strategies for cushioning the decline in disposable income, the 2013 fall wave of the OeNB Euro Survey included questions on households' actual consumption smoothing behavior during the crisis period from 2008 to 2013.

Second, due to the weak recovery in the main export markets of the CESEE countries, recovery decisively hinges on the pick-up of domestic demand, i.e. private investment and private consumption. The expected rebound of private consumption is partly related to households' expectations regarding their financial situation and the national economy. Are recent macroeconomic forecasts warranted in light of the microeconomic evidence on the financial situation of CESEE households? Drawing from earlier work by Beckmann and Moder (2013) on the leading properties of household sentiment, the present short study discusses the improvement in household expectations regarding the national economy evident in the 2013 fall wave. We find that the macroeconomic forecasts of the European Commission, the wiiw and the OeNB are broadly in line with household economic sentiment.

Finally, given that the crisis was preceded by a credit boom in some CESEE countries the assessment of households' financial situation requires a closer look at household deleveraging. The legacy of the crisis might reduce households' ability

and/or willingness to borrow for the purpose of smoothing consumption over the life cycle. Presented Euro Survey evidence allows some insights into whether actual levels of household debt correspond to the desired level of household debt. Furthermore, OeNB Euro Survey data allow a first look at borrowing constraints households are faced with – to provide a starting point for further research.

This study is structured as follows: Section 1 shows the impact of the crisis on the financial situation of households based on macroeconomic indicators. Section 2 presents survey evidence as to what extent the economic and financial crisis has affected CESEE households. In particular, this section will discuss a comprehensive set of strategies employed by households to cushion the effects of the crisis-induced decline in disposable income on consumption, savings and leisure. Section 3 briefly discusses improved household sentiment regarding the national economy as observed in fall 2013. Section 4 compares actual and desired levels of household debt as well as CESEE households' plans for borrowing and presumed access to credit; section 5 summarizes and concludes.

## 1 Financial Situation of CESEE Households Deteriorated Substantially between 2008 and 2013

During the five years preceding the economic and financial crisis real GDP growth was quite impressive, ranging from 2.7% in Hungary to 8.5% in Bosnia and Herzegovina in average annual terms (see table 1). CESEE households profited from this development through rising real income and employment. Higher real incomes led to both higher private consumption expenditures and larger savings. Several years of rising household income and the expectation of being better off in the future may have influenced households' willingness to borrow against future income. Bank loans to CESEE households soared with two-digit growth rates for several years – partly because the stock of outstanding credit to households started from low levels (Backé and Zumer, 2005; Barisitz, 2005). Nevertheless, the rapid credit growth in the region during these years would have been impossible without the market entry of foreign banks with cheap funding and rather aggressive business models (EIB, 2013). Central banks and financial supervisory authorities responded, in part already before 2008, by tightening monetary policy and intro-ducing macroprudential measures in order to mitigate the ongoing credit boom and to contain the associated buildup of vulnerabilities, in particular with respect to foreign currency lending to unhedged households (EIB, 2013; IWF, 2012).

In the course of the economic and financial crisis the financial situation of CESEE households deteriorated substantially. According to the EBRD's Transition Report 2011 households in the CESEE region were hit much harder by the crisis than those in Western Europe. Compared to precrisis levels private consumption declined on average in seven out of ten CESEE countries between 2009 and 2013. The slump in private consumption growth was particularly pronounced for house-holds in Southeastern Europe, where real income on average stagnated or even decreased over the five observed years.[3] Consequently, average annual growth

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[3] *The EBRD's Transition Report 2011 stressed that cross-country comparisons of Western Europe and CESEE based on macroeconomic indicators tend to lead to an underestimation of the impact of the crisis on the transition region, in particular in countries that are dependent on remittances or exhibit a high proportion of informal employment.*

Box 1

## The OeNB Euro Survey – Comprehensive Information on the New OeNB Website

*The mission of the OeNB includes the economic analysis of the countries of Central, Eastern and Southeastern Europe (CESEE). To this end, the OeNB regularly conducts a survey of households in CESEE: The OeNB Euro Survey provides a unique and comprehensive source of information about the foreign currency assets and liabilities of households in CESEE, as well as respondents' economic opinions, expectations and experiences.*

*The harmonized design of the survey allows comparisons not only across countries, but also across sociodemographic groups. The microdata supplied by the OeNB Euro Survey complement aggregate statistics and allow us to move the level of analysis from macroeconomic data to responses obtained directly from households. The analysis affords useful insights into the determinants of household behavior, e.g. euroization, thus providing important input for macroprudential monitoring as well as academic discussion.*

*Surveys are conducted twice a year, in spring and in autumn, in the following ten countries: EU Member States: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania. Non-EU Member States: Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Serbia.*

*Further information on the OeNB Euro Survey and a new set of selected results can be found on the OeNB's website under:*
*http://www.oenb.at/en/Monetary-Policy/Surveys/OeNB-Euro-Survey.html*

Table 1

## Main Economic Indicators of the Household Sector

| | BG | CZ | HR | HU | PO | RO | AL | BiH | FYROM | RS |
|---|---|---|---|---|---|---|---|---|---|---|
| *Average annual change in %* | | | | | | | | | | |
| GDP at constant prices (2004–2008) | 6.5 | 5.5 | 4.1 | 2.7 | 5.4 | 6.8 | 6.1 | 8.5[1] | 5.0 | 5.5 |
| GDP at constant prices (2009–2013) | –0.4 | –0.5 | –2.4 | –0.9 | 2.7 | –0.3 | 2.8 | –0.5 | 1.5 | –0.1 |
| Private consumption (2004–2008) | 7.1 | 3.6 | 3.8 | 1.2 | 4.5 | 12.0 | 7.5 | 6.5[1] | 7.2[1] | 6.8 |
| Private consumption (2009–2013) | –0.5 | –0.2 | –2.4 | –2.2 | 2.0 | –1.4 | 2.2 | –1.0 | 0.3 | –1.7 |
| Compensation per employee (real, whole economy, 2004–2008) | 4.3 | 2.9 | 1.6 | 2.1 | 1.1 | 13.0 | . . | . . | –0.9 | . . |
| Compensation per employee (real, whole economy, 2009–2013) | 3.4 | 0.2 | –0.4 | –2.9 | 1.7 | –3.4 | . . | . . | 1.1 | . . |
| Monthly net wages (real, 2009–2013) | . . | . . | . . | . . | . . | . . | 1.4 | 0.4 | . . | –0.3 |
| *Average level 2009–2013* | | | | | | | | | | |
| Unemployment rate (LFS, %, 15–64 years) | 10.8 | 7.0 | 13.8 | 10.9 | 9.8 | 7.5 | 13.8 | 27.4 | 31.3 | 23.9[2] |
| *Average annual change in %* | | | | | | | | | | |
| Deposits of households and NPISH (2004–2008) | 26.5 | 8.7 | 11.6 | 9.5 | 10.2 | 34.4 | 13.2 | 22.2 | 21.6 | 40.9 |
| Deposits of households and NPISH (2009–2013) | 11.4 | 4.6 | 4.3 | –0.4 | 10.3 | 9.4 | 11.0 | 9.6 | 12.2 | 17.9 |
| Loans to households and NPISH (2004–2008) | 49.5 | 30.0 | 18.6 | 26.8 | 31.0 | 71.1[1] | 60.8 | 27.5 | 45.8 | 72.0 |
| Loans to households and NPISH (2009–2013) | 0.7 | 6.5 | –0.2 | –2.1 | 8.6 | 0.8 | 1.1 | 1.1 | 6.6 | 9.5 |

*Source: European Commission, Eurostat, national statistical offices, wiiw.*

[1] *The average growth rate refers to the period 2005–2008.*
[2] *Average level 2011–2013.*

*Note: LFS = labor force survey; NPISH = nonprofit institutions serving households.*

rates of household deposits at banks slowed remarkably and even turned negative in Hungary. Furthermore, average annual growth of loans to households came to a halt in six out of ten countries – reflecting deleveraging needs of both households and banks (IMF, 2014). In the Czech Republic, FYR Macedonia[4], Poland and Serbia the effect was less pronounced with average annual growth of household borrowing falling below 10%.

## 2 How Did Households React to the Decline in Disposable Income?

In the 2013 fall wave of the OeNB Euro Survey respondents were asked how much, if at all, the economic crisis had affected their households since 2008.[5] Chart 1 shows that roughly 40% of respondents in Central and Eastern Europe admit to have been affected a "great deal" or "fair amount," whereas the share for Southeastern European households ranges from 70% to 90%. Households in FYR Macedonia were hit less hard by the crisis (41%). This result is in line with the macroeconomic development of FYR Macedonia.

The question on how households subjectively perceived the impact of the crisis, the results of which are shown in chart 1, had already been asked in fall 2010 in the EBRD's Life in Transition Survey II. The fall 2013 Euro Survey revealed that, compared with the EBRD results, the proportion of respondents who stated that the crisis had affected them "a great deal" or "a fair amount" had decreased by 17 percentage points on average in FYR Macedonia and Hungary, while in the

Chart 1

**How Much, If At All, Has the Economic Crisis Affected Your Household Since 2008?**
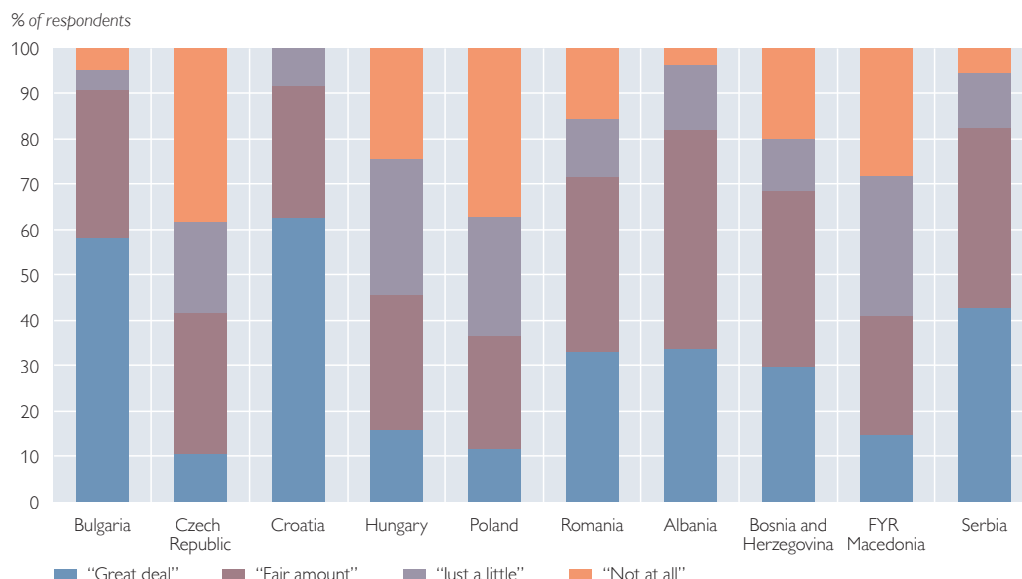


*Source: OeNB Euro Survey.*

*Note: Respondents who answered "Don't know" or indicated "No answer" have been excluded.*

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[4] *Former Yugoslav Republic of Macedonia.*

[5] *Note that data of the 2013 fall wave for Croatia might be flawed due to a change in the interviewer team. Since mainly inexperienced interviewers were deployed in the latest survey wave the share of rather poor and unemployed respondents turned out disproportionally high.*

remaining countries the share of households affected by the crisis had increased (+12 percentage points on average), in particular in Albania (+24 percentage points) and Croatia (+36 percentage points).

Based on economic theory one would expect that a household which has been hit by an adverse disposable income shock in combination with high uncertainty will react by reducing consumption and/or amounts set aside as savings. If households perceive the income shock to be temporary, economic agents will – in absence of credit constraints – try to smooth consumption by borrowing against future income (or drawing on savings). If households regard the reduction in disposable income as permanent, an adjustment of household expenditure will result – ceteris paribus – in a lower consumption level over the whole life cycle. By contrast, households which are affected by higher uncertainty but experience no disposable income shock may increase their (precautionary and/or buffer-stock) savings in order to insure themselves against a potential higher risk of an adverse income shock (Carroll et al., 1992), reinforcing business cycle swings as a result.

When asked what measures households took as a result of a decline in income or other economic difficulties during the crisis, respondents were allowed to give multiple answers (see chart 2).

The most frequent answer involved reduced consumption. On average 81% of households that indicated that they had been affected by the economic crisis reduced everyday consumption. Interestingly, variation across countries is rather small. Three in four affected households reported a reduction or postponement of large expenditures. As expected only few households (CESEE average: 2.7%) were forced to move; only Albanian households recorded a significantly higher share (16%).

As an alternative to cutting back on expenditures a household may want to smooth its consumption over time, either by reducing amounts set aside for new savings out of disposable income or by drawing on prior savings. Survey results show that respondents more frequently chose to reduce new savings (51%) than to dissave or sell assets (29%). In Croatia and Serbia both measures of consumption smoothing turned out to be of similar importance. Interestingly, across almost all countries surveyed these two consumption smoothing strategies are less frequently mentioned than measures for reducing consumption. This may be related to two stylized facts concerning CESEE households which limit the scope for consumption smoothing. First, the ability to save out of current income is rather low; and second, several households have no savings at all.

Most of the measures discussed so far reflect the income effect associated with a decrease in disposable household income. Yet, on average, 26% of CESEE households also substituted leisure for additional working hours to counteract the initial decline in disposable income. In particular, households in Albania, Bulgaria, Croatia and Hungary increased working hours or took up additional work in order to cushion the impact of the crisis on their financial situation. Furthermore, in these four countries financial help from family and friends supplemented households' disposable income more frequently than in the remaining countries surveyed (16% on average). Interestingly, financial help from family and friends seems to be more important for CESEE households' finances than social benefits.[6]

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[6] The EBRD's Transition Report 2011 presented evidence that the (successful) access to unemployment protection is better in Western Europe than in CESEE EU Member States and much better than in (potential) candidate countries.

Chart 2

## How Has the Household Reacted to Lower Disposable Income?

**Reduced Consumption Expenditures, Savings or Help**

*% of respondents who admit having been affected by the economic crisis since 2008*



Reduced everyday expenses | Reduced or postponed larger expenditures | Was forced to move
Reduced money set aside for savings | Utilized savings or sold possession | Reduced help to friends or relatives
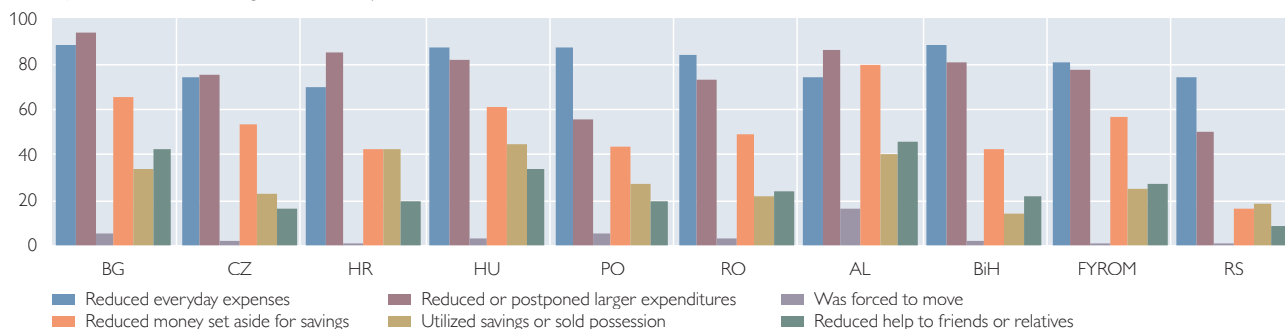
**Postponed Payments or Increased Borrowing**

*% of respondents who admit having been affected by the economic crisis since 2008*



Delayed payment of loan installments | Delayed payment of rent | Delayed payment of other bills
Took out a bank loan | Overdrew bank account | Borrowed money from other source
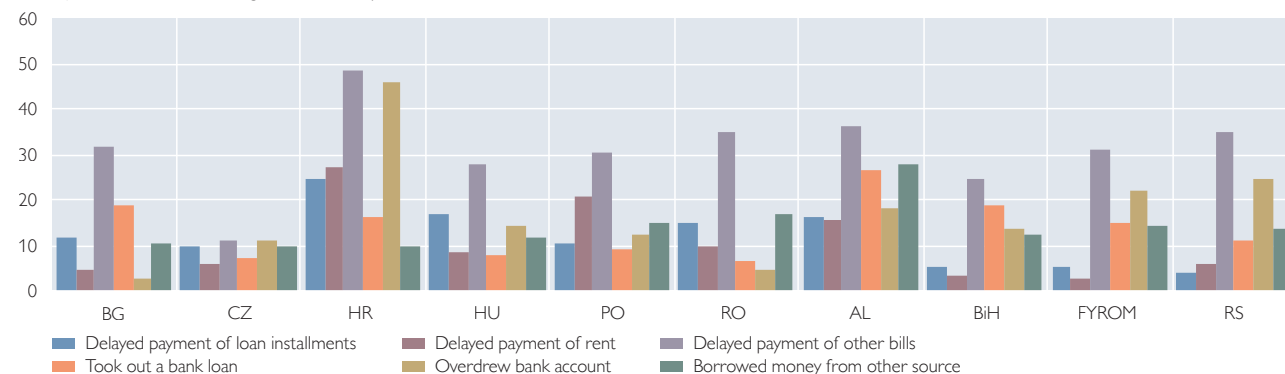
**Increased Work Hours, Received Financial Help or Social Benefits**

*% of respondents who admit having been affected by the economic crisis since 2008*



Increased work hours or took up additional work | Received financial help from family or friends | Received social benefits
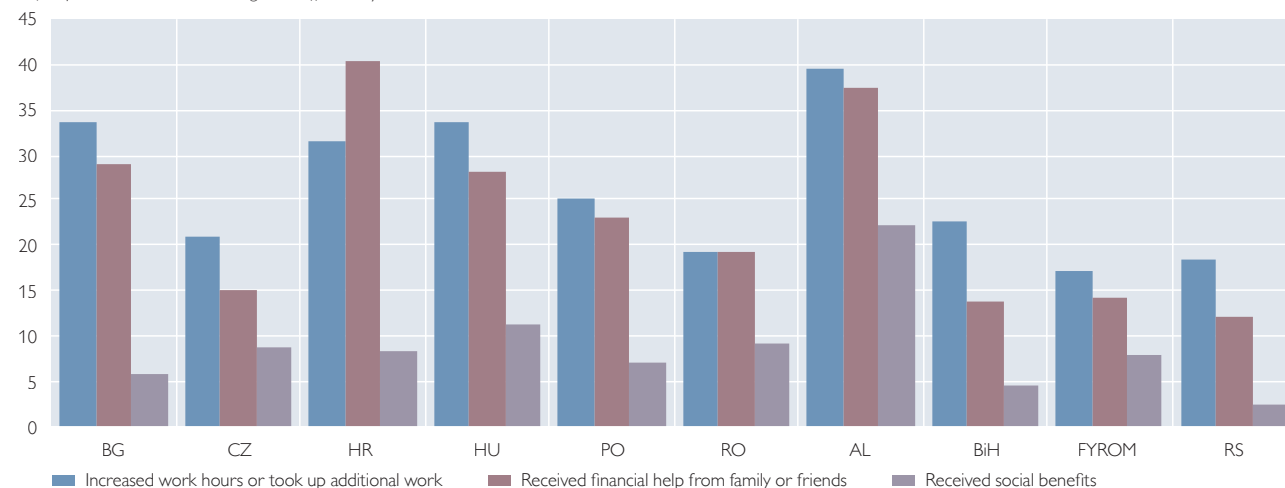
*Source: OeNB Euro Survey (fall 2013).*

*Note: Respondents who answered "Don't know" or indicated "No answer" have been excluded.*

Despite substantial differences across countries, it is possible to sum up that in general households reacted to the crisis and the subsequent reduction in disposable income mainly by reducing consumption and smoothing consumption through

direct or indirect borrowing against future income. Against the background of these findings one may expect that rising disposable income will translate into both rising consumption expenditures and savings in the course of the ongoing recovery. This expectation is supported by research findings published by Beckmann et al. (2013), who examined the determinants of households' savings based on OeNB Euro Survey data and showed that the life-cycle hypothesis holds for CESEE households.

## 3 Survey Data on CESEE Households' Expectations Broadly Support Recent Macroeconomic Outlooks for 2014

Current forecasts by the European Commission, the wiiw and the OeNB[7] stress the importance of private consumption for continued recovery in the CESEE region. All three institutions expect only moderate real GDP growth for 2014. Although private consumption growth should accelerate compared to 2013, growth rates will be still below average precrisis levels (table 1) and less dynamic than real GDP growth (see chart 3). Private consumption growth estimates range from 0.4% in the Czech Republic to 2.5% in FYR Macedonia. In Croatia and Serbia private consumption is expected to shrink again in 2014.

Are these forecasts warranted in light of the microeconomic evidence on the financial situation of CESEE households? Using evidence from the OeNB Euro Survey, Beckmann and Moder (2013) find a positive correlation between households' expectations regarding the national economy and actual future GDP and consumption growth. Hence survey answers on household sentiment might complement recent macroeconomic forecasts.

Chart 4 shows that households' expectations regarding the national economy are still in the negative territory for all countries, except for Albania. Compared to autumn 2012, the fall 2013 wave showed quite a substantial improvement of economic sentiment in the Czech Republic, Hungary, Poland and Albania, whereas

Chart 3

**Growth Outlook for Real GDP and Private Consumption in CESEE**

*Annual change in %*



Real GDP in 2013    Real GDP in 2014    Private consumption in 2013    Private consumption in 2014

*Source: European Commission winter forecast, wiiw March 2014 forecast.*

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[7]  *For details see the OeNB's Outlook for Selected CESEE Countries in this issue.*

How Did CESEE Households Weather the Crisis?
Evidence from the OeNB Euro Survey

Chart 4

## Consent to the Statement:
## "Over the Next Five Years the Economic Situation of My Country Will Improve"
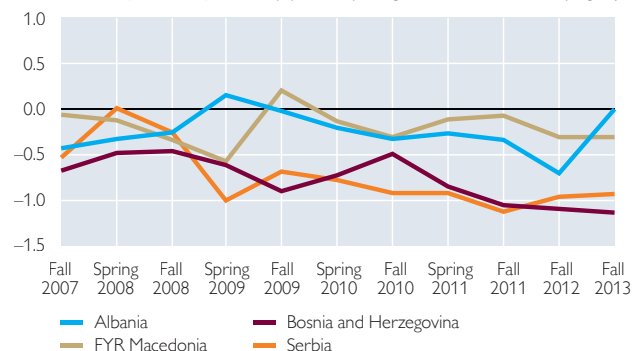
**EU Member States**

*Normalized sample means per country (–2.5: fully disagree, 0: neutral, +2.5: fully agree)*

**(Potential) Candidate Countries**

*Normalized sample means per country (–2.5: fully disagree, 0: neutral, +2.5: fully agree)*



Legend (EU Member States): Bulgaria, Czech Republic, Croatia, Hungary, Poland, Romania
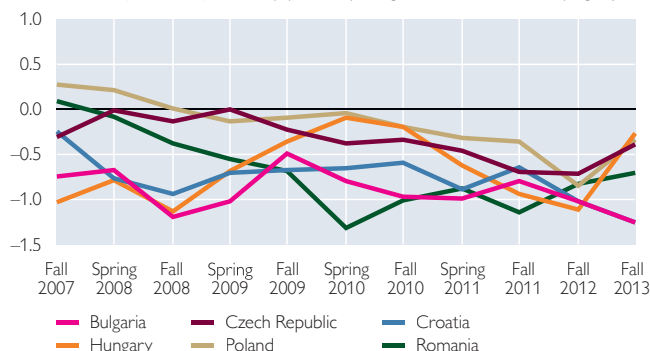
Legend (Potential Candidate Countries): Albania, Bosnia and Herzegovina, FYR Macedonia, Serbia

Source: OeNB Euro Survey.

Note: Respondents were asked whether they agreed or disagreed with the statement above on a scale from 1 ("fully agree") to 6 ("fully disagree"). Respondents who answered "Don't know" or indicated "No answer" have been excluded. This question was not asked in spring 2012 and spring 2013.

sentiment deteriorated further in Bosnia and Herzegovina and particularly in Croatia and Bulgaria.[8]

Summing up, CESEE households' expectations and macroeconomic forecasts of private consumption point in the same direction in eight out of ten countries. The exceptions are Bosnia and Herzegovina and Bulgaria, where respondents expect things to get worse while the forecasts predict an increase in growth rates for private consumption.

## 4 Will Private Sector Deleveraging Put a Brake on Future Private Consumption?

Some CESEE countries experienced a credit-financed boom in the run-up to the crisis and consequently need to adjust leverage ratios of banks, companies and/or households (European Commission, 2014; IMF, 2014; Vincelette et al., 2013). Thus, apart from a recovery of disposable income, private consumption expenditures will also hinge on the current household debt burden and households' ability and/or willingness to borrow in order to smooth consumption over the life cycle. OeNB Euro Survey data allow a closer look at the household debt burden and the significance of borrowing constraints.

### Household Debt Burden Still Elevated in Some CESEE Countries

The share of households that have taken out a loan varies considerably across CESEE countries, in part reflecting different stages in financial deepening (see chart 5, left-hand panel). Concerning the self-reported debt position, two-thirds of indebted households in the Czech Republic, Croatia, Poland and FYR Macedonia report that they have the right amount of debt and do not anticipate any problems

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[8] Chart A1 in the annex shows a similar pattern for households' expectations regarding their financial situation. Note that Beckmann and Moder (2013) found that CESEE households are more optimistic about their own financial situation than about the outlook for the whole economy.
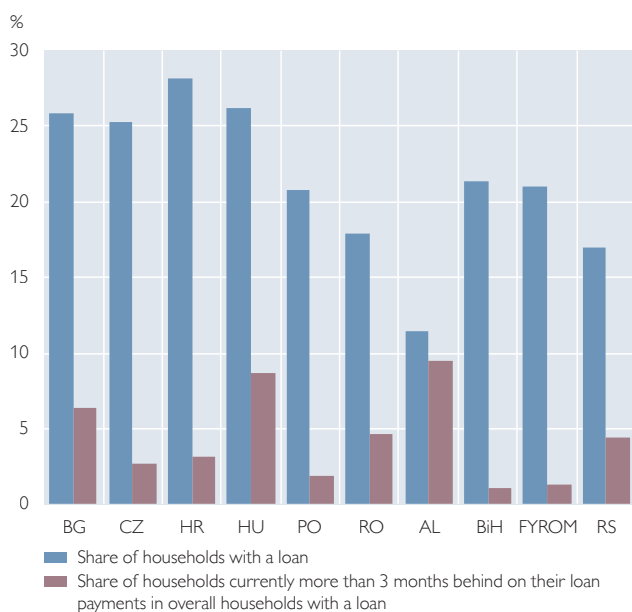
with their debt (see chart 5, right-hand panel).[9] By contrast, almost half of Bulgarian and Hungarian households with a loan admitted having too much debt at the moment and that they might experience difficulties paying it off. Furthermore, around 40% of Albanian, Bosnian, Romanian and Serbian households consider their household debt level to be too high. This self-assessment is partly reflected in the share of nonperforming loans.[10]

Beckmann et al. (2012) studied the determinants of loan arrears of CESEE households. Using OeNB Euro Survey data on the reasons behind households' financial difficulties, the authors showed that income shocks exert a strong and significant impact on loan delinquency rates in CESEE economies. Against the background of widespread foreign currency lending in the region, the authors further-more confirmed an additional – though weaker – impact of foreign currency borrowing on higher loan delinquency rates in depreciation countries.[11]

Chart 5

**Current Debt Stock of CESEE Households**

**Households with Loans and Current Loan Arrears**

%



- Share of households with a loan
- Share of households currently more than 3 months behind on their loan payments in overall households with a loan
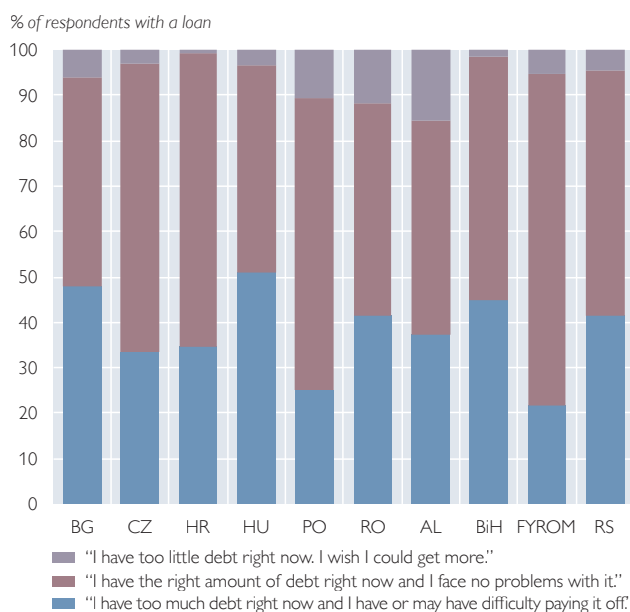
**Self-Assessment of the Current Debt Position**

% of respondents with a loan



- "I have too little debt right now. I wish I could get more."
- "I have the right amount of debt right now and I face no problems with it."
- "I have too much debt right now and I have or may have difficulty paying it off."

Source: OeNB Euro Survey.

Note: Respondents who answered "Don't know" or indicated "No answer" have been excluded. Figures of the left-hand panel are averages of spring wave and fall wave 2013. Figures of the right-hand panel refer to fall 2013.

[9] The question on the self-assessment of the current debt position originates from a survey on debt literacy from Lusardi and Tufano (2009). The wording of the question has been adopted literally. For comparison purposes, Lusardi and Tufano found that in November 2007, before the financial crisis hit the U.S. economy, 26% of respondents in the U.S. said that they were having or might experience difficulties paying off debt, while 61% reported having the right amount and 20% too little debt. Another 11% were unable to judge whether they had too much or too little debt – compared to less than 2% on average for CESEE.

[10] Loans are referred to as nonperforming if households are more than three months behind with their loan payments. The ratio of nonperforming loans derived from survey answers is highly correlated with nonperforming loan ratios from national supervisory statistics ($R^2 = 0.93$).

[11] See also EBRD (2011).

**Do Households Face Borrowing Constraints?**

The survey results illustrated in chart 5 (right-hand panel) indicate that some indebted CESEE households wish their debt level were higher. This implies that not all households were able to borrow the amount of money they intended to in the past. Looking forward, one might ask whether households' intentions to take out a loan might be frustrated by borrowing constraints. Although there is no direct survey evidence pointing to the prevalence of credit constraints, household responses indicate that not every household that needs credit actually gets it.

Chart 6 (left-hand panel) shows that the share of households planning to take out a loan has decreased substantially since 2008. Three out of five households that are still planning to take out a loan within the next 12 months assumed in fall 2013 that they would "probably" or "almost certainly" have the possibility to borrow a significant amount from a bank (see chart 6, right-hand panel).[12, 13] Interestingly, they assigned similar probabilities to obtaining a significant amount of money from family or friends. Due to a lack of historical data on this question, this first glimpse at the data does not allow a final assessment of the extent of credit constraints and their dampening impact on the recovery of private consumption in CESEE countries.

Chart 6

**Planned Loans and Presumed Access to Credit**

**"Do you plan to take out a loan within the next 12 months?"**

*% of respondents*



Average for 2008    Average for 2013
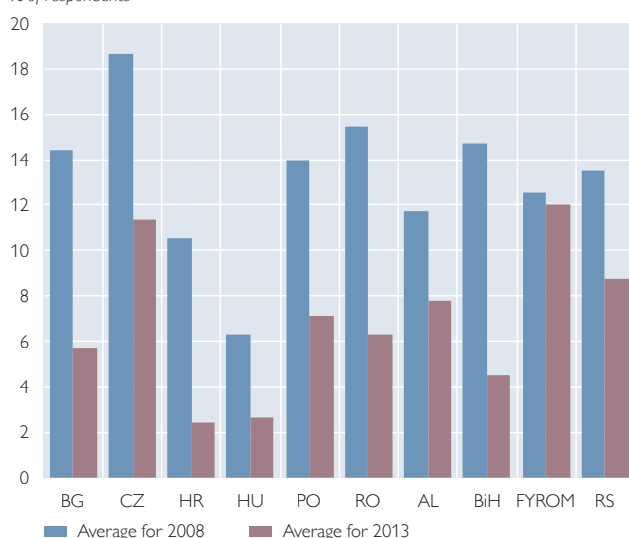
**"Do you have the possibility to borrow a significant amount of money?"**

*% of respondents who plan to take out a loan*
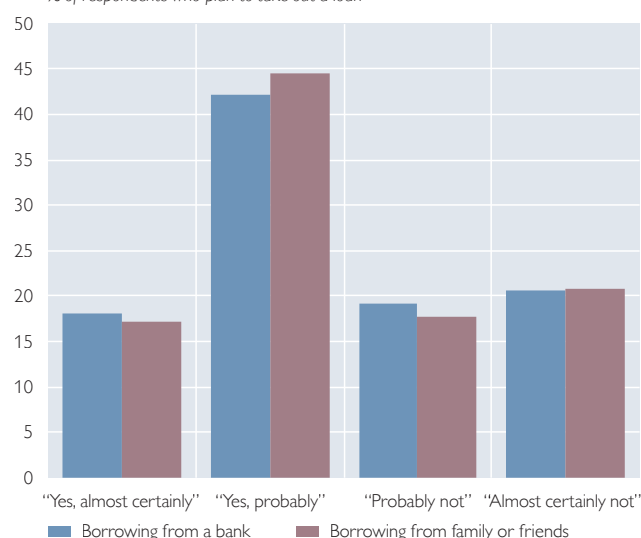


Borrowing from a bank    Borrowing from family or friends

*Source: OeNB Euro Survey.*

*Note: Respondents who answered "Don't know" or indicated "No answer" have been excluded. Figures of the right-hand panel refer to fall 2013.*

[12] *Pessimistic views on the ability to borrow a significant amount from a bank prevail in Bulgaria and Croatia, which coincides with continued deleveraging in these countries. By contrast, three out of four households in the Czech Republic and Poland expect that a bank would grant them a loan of significant amount, which reflects improving financing conditions in the Czech Republic and continued favorable financing conditions in Poland (see CESEE-7 forecast in the OeNB's Outlook for Selected CESEE Countries in this issue).*

[13] *The wording of the question on borrowing possibilities was inspired by similar questions in the EBRD Life in Transition Survey II and the Household Finance Survey 2008 of the Banco de España.*

## 5 Summary

Over the last five years (2008 to 2013) CESEE households were forced to adjust their consumption plans quite substantially as disposable income stagnated and in some countries even fell (in aggregate terms). In order to shed some light on the measures taken by households to cushion the decline in disposable income, the 2013 fall wave of the OeNB Euro Survey included some questions on households' actual consumption smoothing behavior during the crisis period from 2008 to 2013.

The strategy most frequently employed by households affected by the economic crisis was cutting back on everyday consumption followed by reducing or postponing large expenditures. Alternatively, some households saved smaller amounts of their disposable income and, less frequently, households reported to have drawn on their savings. These results suggest that CESEE households had only limited scope for consumption smoothing. Several households' ability to save out of current income was rather limited or they did not have any savings at all. Furthermore, CESEE households reported that when they borrowed against future income in order to smooth consumption, they mainly did so by overdrawing their current accounts. Finally, one in four households indicated having substituted leisure for additional working hours to counteract the initial decline in disposable income.

Against the background of these findings one may expect that rising disposable income in the course of the ongoing recovery will translate into both rising consumption expenditures and savings. Recent macroeconomic forecasts expect private consumption growth to resume in some CESEE countries in 2014, in particular in countries with improving financing conditions. These expectations seem warranted based on information derived from the OeNB Euro Survey. Overall, our analysis shows that a relatively optimistic macroeconomic outlook on private consumption for a specific country coincides with national survey results pointing to improved economic sentiment, a manageable household debt burden and a higher perceived likelihood that a bank would grant a household a significant loan.

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## Annex

Chart A1

### Consent to the Statement: "Over the Next Twelve Months I Expect the Financial Situation of My Household to Get Better"

**EU Member States**

*Normalized sample means per country (–2.5: fully disagree, 0: neutral, +2.5: fully agree)*
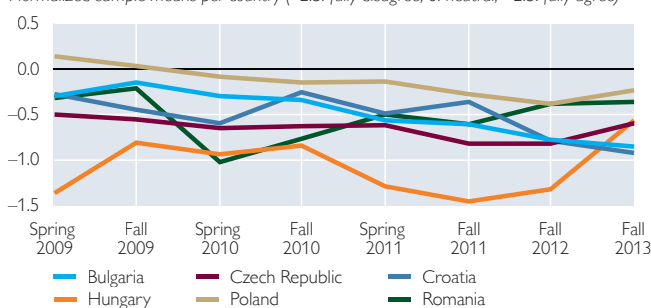
**(Potential) Candidate Countries**

*Normalized sample means per country (–2.5: fully disagree, 0: neutral, +2.5: fully agree)*
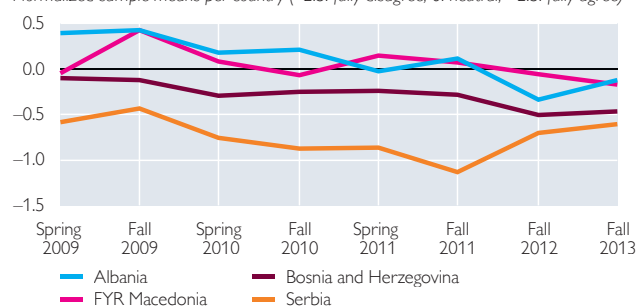


*Source: OeNB Euro Survey.*

*Note: Respondents were asked whether they agree or disagree with the statement above on a scale from 1 ("fully agree") to 6 ("fully disagree"). Respondents who answered "Don't know" or indicated "No answer" have been excluded. This question was not asked in spring 2012 and spring 2013.*

# CESEE-Related Abstracts from Other OeNB Publications

The abstracts below alert readers to studies on CESEE topics in other OeNB publications. Please see *www.oenb.at* for the full-length versions of these studies.

## The Pecking-Order of Deleveraging in the Euro Area and Austria, and Its Implications for CESEE

Judith Eidenberger, Stefan W. Schmitz, Katharina Steiner

Bank deleveraging is often used synonymously for a reduction of credit supply to the real economy which hampers economic growth. We investigate this hypothesis empirically, with a view to identifying a pecking order of deleveraging – i.e. the increase in the capital-to-assets ratio – in the euro area and Austria and its implications for CESEE. We focus on the postcrisis period from October 2008 to February 2014 and complete the picture with a precrisis analysis starting in June 2003.

In the postcrisis period, we find the pecking order of deleveraging to have been similar in the euro area and in Austria and the process to have been positive from a macroprudential perspective. Deleveraging was mainly driven by a decrease in capital, which contributed 88% in the euro area and 73% in Austria. Yet the other part of the decrease reflects the decrease of total assets, which was driven by reductions in interbank lending and external assets, while funding for the real economy increased in the euro area and in Austria.

With specific regard to the deleveraging of Austrian banks in CESEE, the pecking order also mirrors the pattern established in the euro area and Austria. It was also driven by capital increases (99%). The small reduction of total assets in the sample was due to reductions of interbank lending, cash and central bank reserves; funding for households and nonfinancial corporations increased slightly. Similar to the euro area and Austria, the banks' sovereign exposure increased, too. At the disaggregate level, however, Austrian banks reduced their activities in some countries during the past five years. But these reductions did not translate into decreases of funding for households and nonfinancial corporations.

To be published in *Financial Stability Report 27.*

## Macrofinancial Developments in Ukraine, Russia and Turkey from an Austrian Financial Stability Perspective

Tina Wittenberger, Daniela Widhalm, Mathias Lahnsteiner, Stephan Barisitz

Recent bouts of international financial market volatility and adverse geopolitical developments have put the spotlight on Ukraine, Russia and Turkey. While Austrian banks benefited from a benign macrofinancial environment in Russia and Turkey, in particular with regard to the swift recovery from the 2008–2009 crisis, they are burdened by legacy issues of the last credit boom in Ukraine. By discussing macrofinancial developments in Ukraine, Russia and Turkey, this study sets the scene for a more in-depth analysis of Austrian banks' activities in these countries.

To be published in *Financial Stability Report 27.*

## Capital Market Development in CESEE Countries and the Need for Further Reform

Krisztina Jäger-Gyovai

Capital markets in CESEE continue to be less developed than capital markets in more advanced economies. Unhedged foreign currency borrowing and dependence on external funding have been among the key vulnerabilities in CESEE

during the global economic crisis. Therefore, there is a need for better developed local capital markets in the region, additional local sources of domestic funding, and a reduction in foreign exchange exposure in domestic financial markets. International initiatives, such as the "Vienna Initiative" or the EBRD Local Currency and Capital Markets Development Initiative, support local capital market development in the region. Well-developed capital markets are not only a crucial component for generating economic output, but also foster more stable growth through the ability of diversified financial sources to offset a slowdown of economic activity caused by the credit crunch.

To be published in *Financial Stability Report 27.*

## Intra-EU Export Market Shares Almost Untouched by the Economic Crisis

Before the global recession, export growth outperformed economic growth across the EU. The economic crisis hit almost all EU countries through a steep fall in exports, especially exports of goods. Yet, as shown in this article, intra-EU export market shares were left broadly unchanged by the crisis. From a regional perspective, CESEE countries gained market shares in the period 2004–2012 at the expense of major old EU countries (the U.K., France and Italy). From a product perspective, service market shares developed broadly in line with goods market shares. At the same time, service-oriented countries were able to compensate losses in goods market shares by expanding service market shares. Austria managed to keep its market share position almost constant, benefiting most from trade links with Germany. At the product level, Austria strengthened its exports of high-technology good products.

To be published in *Monetary Policy & the Economy Q2/14.*

Klaus Vondra

## Foreign Currency Borrowing and Knowledge about Exchange Rate Risk

Foreign currency borrowing is widespread in many regions of the world. This raises the question whether unhedged borrowers do not understand the exchange rate risk emanating from such loans. Employing household-level microdata from eight Central and Eastern European countries we study how agents' knowledge about how exchange rate risk affects the currency denomination of loans. Results show, first, that a majority of respondents is aware that depreciations increase loan instalments. Second, we find that knowledge about the exchange rate risk lowers the demand for foreign currency borrowing. To assess the causal effect of literacy on loan demand we utilize information on agents' exchange rate expectations. Overall, results suggest that financial literacy exerts a strong impact on the choice of the loan currency. However, from an aggregate perspective, a misunderstanding of the underlying risks is not the main cause of foreign currency borrowing.

Published as OeNB Working Paper 188.

Elisabeth Beckmann,
Helmut Stix

# Event Wrap-Ups

# 75th Anniversary East Jour Fixe on "Ten Years After the 2004 EU Enlargement: Achievements and Next Steps"

Compiled by
Maria Silgoner[1]

The 75th East Jour Fixe of the OeNB, scheduled for April 24 and 25, 2014, was designed to assess the 10th anniversary of the 2004 EU enlargement round, in which the EU added 10 new members, eight of which were from Central, Eastern and Southeastern Europe (CESEE). At the same time, the year 2014 marks an anniversary for another two other epoch-making historical events, which both had important political implications for the CESEE region: In 2014, we commemorate the start of World War I 100 years ago, and the fall of the iron curtain 25 years ago.

The 75th Anniversary East Jour Fixe was part of a two-day conference organized jointly with the Austrian Federal Ministry for Europe, Integration and Foreign Affairs, the Austrian Federation of Industries (IV), the Institute for Human Sciences (IWM) and The Vienna Institute for International Economic Studies (wiiw).[2] More than 300 participants had registered for the event.

All the participating institutions have a longstanding dedication to and interest in the CESEE region. Their different responsibilities, interests and approaches made it possible to cover a broad range of topics, and to investigate past achievements

Chart 1

**Economic Output: 2013 vs. 2008**

*2008 = 100*
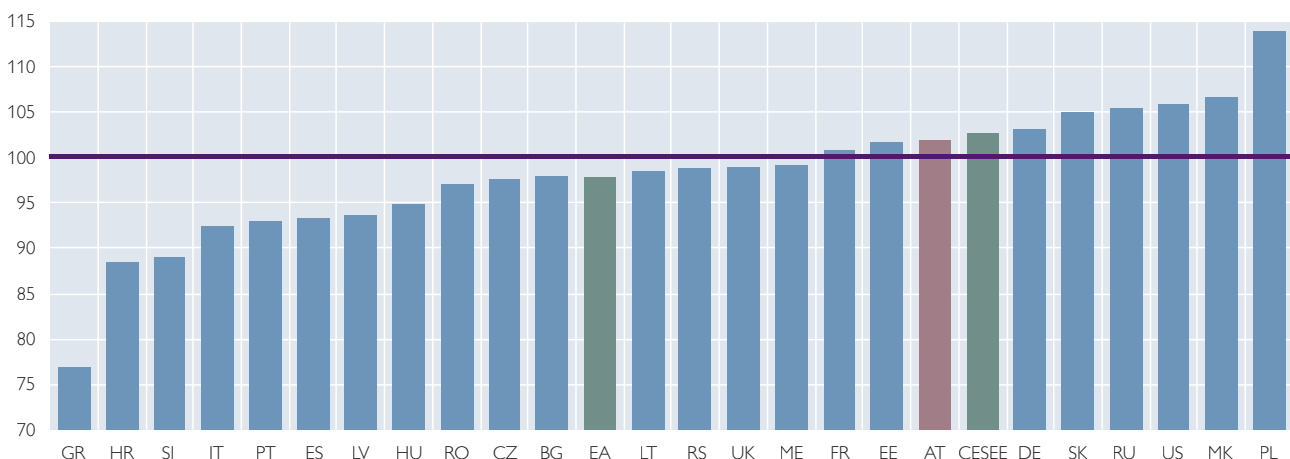


*Source: IMF, Eurostat.*

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[1]  *Oesterreichische Nationalbank, Foreign Research Division. Compiled on the basis of notes taken by Andreas Breitenfellner, Markus Eller, Krisztina Jäger-Gyovai, Isabella Moder and Anita Roitner.*

[2]  *For the detailed program of the conference, see www.oenb.at/en/Calendar/Archive/2014/Conference-24-04-2014.html; for a video documentation of all sessions, see http://wiiw.ac.at/ten-years-after-the-2004-eu-enlargement-achievements-and-next-steps-e-211.html.*

and lessons learned not only from an economic, but also from a historical and political science perspective.

In his opening remarks, *OeNB Governor Ewald Nowotny* emphasized that the single biggest enlargement round of EU in history was a win-win success story for the ten acceding countries and for the EU, especially for Austria, which has strong trade and investment links to the region. At the same time, he cautioned that the past decades have also shown that as the catching-up process is neither automatic nor irreversible, countries must be well prepared for entry to ensure that membership benefits are sustainable. The past crisis, which developed from an economic and financial crisis toward a debt crisis, is almost over in monetary terms, but has left Europe with the challenge of huge unemployment. Many countries have yet to reattain their 2008 GDP levels. This is also true for several CESEE countries, even though the region remains the fastest growing in Europe.

## First Conference Day: The Prospects for European Integration

The first conference day (organized by the wiiw) started with a very topical panel discussion on the frictions in Eastern Europe *("Overcoming New Chasms in the EU's Neighborhood").* The highly controversial contributions diverged especially in the assessment of the appropriate EU approach to the Ukraine-Russia conflict. While some speakers called for a clear EU entry perspective for Ukraine, which would support its independence and would allow the country to loosen its ties to Russia, others considered exactly this approach as dangerous and as a menace to Russia that would exacerbate the crisis further. The classical transition model of the CESEE region is not going to work in Ukraine, given its high energy and economic dependence from Russia. All speakers agreed that we were observing a major turning point in the attitude of Russia toward the West. The EU was ill-prepared to respond to these new frictions, especially given the lack of a common foreign policy.

The second session focused on the Western Balkans *("Towards Stability in the Western Balkans").* The speakers agreed that the goal of reaching stability in the region was only half met. EU membership offers market access, but not an automatic guarantee of security or of a stable democracy. Economic development is conditional on domestic policies, institution building and a commitment for change in the countries themselves. The example of Croatia shows that conditions may actually deteriorate immediately after EU accession, given that opening borders toward the EU implies closing of borders toward non-EU countries due to internal market regulations. The EU perspective is important for the small countries in the Western Balkans, but Europe currently lacks a uniform approach toward assessing the readiness of countries.

The next panel discussed the intellectual failures that led to complacency in the EU before the crisis *("The Economic Crisis and How to Resuscitate Convergence in Europe").* The results of these failures were – as was argued – unsustainable (debt) growth, a lack of stabilization functions and rebalancing mechanisms in the euro area, and a nonintegrated governance of integrated financial markets. The crisis response was labeled late and weak, with the effect that the EU was more divided after the crisis than before, both politically and economically, leaving a lost decade and a wasted generation. While the euro area has diverged since the crisis, the "new" Member States have managed to converge in per capita terms toward

the EU average, although the lower pace of catching-up could signal a "middle income trap." The panel agreed that the EU needed a new grand bargain, initiated by a convention and enshrined in a new treaty, that opens the way for two-speed integration using enhanced cooperation to cope with unavoidable heterogeneity.

### Evening Panel: Returning to Europe

The first day of the conference concluded in Palais Niederösterreich with a high-level panel discussion *("Returning to Europe: Ten Years of EU Integration in Central Eastern Europe — Achievements, Lessons Learned, Challenges Ahead").* In his introductory statement, Foreign Minister Sebastian Kurz stressed the need to develop the European project further und pointed to the vital role of Austria as a partner for the Western Balkans. Georg Kapsch, President of the IV, valued Eastern enlargement as the most successful project of the EU in the last 20 years, benefiting the acceding countries and Austria and its businesses. The panelists agreed that the EU is still the most attractive "club of countries" worldwide, in spite of growing euroscepticism and a certain enlargement fatigue. The loss of euphoria is to a large extent the result of unrealistic promises ahead of EU accession. While some speakers expressed doubts whether the success story of the last decade could be continued in the future, others emphasized the still strong growth prospects in the region. Best conditions for prosperous development would include low indebtedness, a highly educated labor force and a high degree of flexibility.

### 75th Anniversary East Jour Fixe

The second conference day started with the 75th Anniversary East Jour Fixe. Chief economists, heads of research and other high-level central bank representatives of ten CESEE countries discussed economic, monetary and financial strategies and challenges in two panel rounds. In her introductory statement, *Doris Ritzberger-Grünwald,* Director of the OeNB's Economic Analysis and Research Department sketched out the major policy alignment discussions over the last decade, such as "real versus nominal convergence criteria" or "waiting versus training room ERM II." Her summary assessment was that from today's perspective we would decide several issues differently. She also emphasized the longstanding technical cooperation of the OeNB, which evolved from informal seminars into the broad-scale training program provided by the Joint Vienna Institute (JVI), as well as the intense collaboration with the central banks in the CESEE region. While the OeNB's interest in the region originated from historical and regional ties, it is now linked to Austrian banks' CESEE activities.

Against the backdrop of different macroeconomic adjustment experiences during the crisis, the first panel round discussed *"Exchange Rate Strategies and Competitiveness."* Konstantins Benkovskis, Head of the Monetary Research and Forecasting Division at Latvijas Banka, reported policy simulations by Latvijas Banka that show that a fixed exchange rate was clearly the superior setting in Latvia in order to guarantee price stability and reduce output volatility. Mariella Nenova-Amar, Director of Economic Research and Forecasting at the Bulgarian National Bank, added that a fixed exchange rate regime in the form of a currency board arrangement (CBA) needed to be backed by other economic policy areas in order to function properly. In Bulgaria, for instance, the CBA has been supported by budgetary surpluses that were accumulated during the precrisis boom years and could be used during

the crisis. Prudent banking supervision has been equally important. Aurelijus Dabušinskas, Director of the Economics Department at Lietuvos bankas, endorsed this view but also stressed that euroization of lending was an unavoidable consequence of a CBA, having caused foreign currency risk premia to shoot up quite strongly during past crisis situations in Lithuania and other hard currency peg countries. Martin Šuster, Director of the Research Department at Národná banka Slovenska, elaborated on Slovakia's mixed experience of being part of the euro area during the crisis. While the country had clearly benefited from the sheltering function of the euro in 2008–2009, it later had to contribute to the costs for the stabilization of euro area periphery. Lubos Komarek, Director of the External Economic Relations Division at Česká národní banka and the panel's single representative of a country with a flexible exchange rate regime, pointed out that the flexible exchange rate had largely helped to stabilize the Czech economy. During the 2009 crisis, for instance, the depreciation of the koruna helped to ease monetary conditions. More recently, when the ČNB was confronted with the zero lower bound constraint, it proved to be advantageous to resort to an additional monetary instrument in the form of flexible exchange rates. Šuster noted in this context that the recent foreign currency interventions of the ČNB implied substantial cross-country spillovers for Slovakia and called for a higher degree of policy coordination.

The second central bank panel *("Challenges for Financial Stability")* was chaired by Helene Schuberth, Head of the Foreign Research Division of the OeNB, who emphasized that macroprudential policies were becoming the third leg of policy, next to monetary and fiscal policy. The first panelist, Ryszard Kokoszczynski, Deputy Director General of Research of Narodowy Bank Polski, accented the early and strict macroprudential and microprudential measures introduced in Poland before and during the crisis that supported the confidence of foreign investors. On the question of whether Poland would enter the Single Supervisory Mechanism (SSM), he noted the lack of symmetry between the responsibilities and benefits within the SSM and the high number of unresolved technical issues. István Kónya, Head of Research of Magyar Nemzeti Bank, stressed that Hungary had been particularly affected by the financial crisis. He summarized the past successful and less successful measures to reduce risks and the high stock of households' foreign currency loans. Banks practically stopped offering foreign currency loans to households 2010. A major progress was the consolidation of microprudential and macroprudential regulatory activities under central bank responsibility. Florian Neagu, Head of the Macroprudential Risk Division of Banca Națională a României, reported that the debt-to-income cap and loan-to-value ratio were the most effective monetary and macroprudential measures against the real estate bubble in Romania. His four lessons from the crisis are: (1) without good coordination across countries, the effectiveness of domestic measures is low; (2) focus on the debtor perspective, not on the creditor perspective, to investigate credit growth; (3) macroprudential measures work better than classical monetary policy tools; (4) study the linkage between business and credit cycles. Karsten Staehr, Research Supervisor at Eesti Pank, noted that the house price and credit boom in Estonia was caused mainly by foreign capital inflows. In his view, the fixed exchange rate regime was associated with fewer costs in the recent crisis, given that the latter was a symmetric shock to the euro area. Interestingly, competitiveness seems to have no effect on the current account balance in Estonia. The last speaker, Tatjana

Suler Stavt, Assistant Director in the Financial Stability Department of Banka Slovenije, gave a short summary of Slovenia's way into the European Union.

The 75th East Jour Fixe finished with a statement by *Gertrude Tumpel-Gugerell,* former Member of the Executive Board of the ECB and former Vice Governor of the OeNB. She recalled the expectations a decade ago, when two continents moved nearer to each other, that European integration would bring stability, growth and employment in the CESEE region. These hopes were not fully met, given a lack of proper institutions and regulations. The small countries in CESEE recovered relatively quickly from the crisis, helped by relatively low levels of public debt and the lack of a bank-sovereign feedback loop. But financial fragmentation would continue to weigh on growth as investors become more selective. Tumpel-Gugerell wound up by presenting the vision that at the next ten-year anniversary, the distinction between "old" and "new" EU members would have ceased to exist.

The ten central bank representatives of the CESEE countries resumed their meeting in the afternoon, discussing with Doris Ritzberger-Grünwald and a group of OeNB staff members further avenues of research for the CESEE region. Apparently, there are some common strands and trends of research, such as the increasing importance of microdata, the use and further development of GVAR models, and the attempt to better understand financial cycles (versus the real economy). The major outcome of the meeting was that research cooperation between central banks of the region and the OeNB should be intensified and institutionalized. Especially the capacity constraints affecting central bank research departments require collaboration to be able to meet the increasing demand.

## Nationalism, Integration and Disintegration in the Past and Now

The last half-day of the conference was organized by the IWM. A first session *("European Integration and Nationalism: Two Steps Forward, One Step Back")* investigated whether enlargement was one of the causes for the revival of nationalism. Speakers pointed out the failure to develop a European identity. The merits of European integration were strongly emphasized by the winners, leaving the less favored population at unease. The examples of Hungary and Turkey share the experience of a return of nationalism, antidemocratic tendencies and mismanagement that destroyed past liberal achievements and isolate the countries from the EU.

The last session *("A Century of European Disintegration and Integration: 1914–2014")* went further back in history, investing the successive and sometimes overlapping periods of integration and disintegration. The peculiar aspect of European integration is that the EU is neither a nation state ("there are no European tanks") nor an empire; nonetheless, its very structure makes small nation states economically viable. While most major regional questions were solved in wars, the Eastern question was ultimately solved smoothly within the European integration process. By contrast, the Russia-Ukraine conflict is an example of unpeaceful solutions to a question.

In addition to official debates, the two conference days provided a welcome opportunity for informal discussions and networking among central bankers, government officials, business and financial sector managers, researchers and journalists. Both media coverage and the positive feedback from participants confirmed the success of the approach to investigate the decade since EU enlargement from various angles.

# IMF Spring 2014 "Regional Economic Issues" Report for CESEE Recommends:

## Safeguarding the Recovery as the Global Liquidity Tide Recedes

The recent recovery of the euro area economies has also fueled growth in most Central, Eastern and Southeastern European countries. As outlined in the IMF's Spring 2014 Regional Economic Issues[1] report for CESEE,[2] the region – excluding the two largest economies, Russia and Turkey[3] – is projected to grow by 2.3% in 2014 (compared with 1.2% in 2013). Growth in the CESEE countries will, however, be weaker than previously expected.

While recovery is underway, it is strongly dependent on exports and on external demand. At the same time, improvements in domestic conditions have been uneven, and growth is threatened by an unusual constellation of risks:

External funding conditions have become more volatile since mid-2013. Foreign bank funding has continuously been reduced. In the third quarter of 2013, portfolio flows to CESEE (excluding Russia and Turkey) turned negative for the first time since 2009. Further downside risks comprise increasing geopolitical tensions, protracted weak growth in the euro area and global financial market volatility. The escalation of the crisis in Ukraine has introduced new risks for the region.

### Funding Structures and Vulnerabilities

The increased volatility of external financial conditions represents a threat to the CESEE economies as they are highly reliant on external funding and hence strongly susceptible to external funding shocks, given above all their high stocks of external debt and sizable refinancing needs as well as their strong reliance on relatively few common creditors. In addition, a significant degree of financial euroization in the region further increases the risks stemming from large foreign currency exposures. Moreover, the outlook is clouded by increased foreign investor participation in local bond markets and the extended role of foreign institutional investors in these markets.

Both public and private sectors in CESEE countries rely on external borrowing. The main foreign creditors are EU Member States, with the relative importance of Western creditors being linked to geographic proximity. The REI report finds higher bond market rates in advanced economies, higher investor risk aversion and tighter global liquidity conditions to contribute to increasing spreads and lower funding flows to CESEE countries.

Summarized by
Christina Lerner

[1] Regional Economic Issues (REI) reports, published biannually by the IMF, cover analytical issues of interest to policymakers, academics and the broader public in the relevant region. The CESEE REI Spring 2014 has a special focus on funding structures and risks.

[2] CESEE refers to Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, the Slovak Republic, Slovenia, Turkey, and Ukraine.

[3] The two largest economies – Russia and Turkey – have shown divergent growth patterns from the rest of CESEE: In Russia, growth decelerated sharply to 1.3% in 2013 and seems to mirror a considerable slowdown in growth potential. In Turkey, recovery gained momentum in 2013, but large exchange rate adjustments, recent monetary tightening and macroprudential measures will contain domestic demand and hence GDP growth going forward.

### Policy Priorities

As regards the policies to be pursued, the CESEE REI report states that many countries in the region lack policy space: fixed exchange rate regimes, elevated fiscal deficits and above-target inflation impede policy flexibility. Furthermore, there are still crisis legacies to be addressed, such as high levels of nonperforming loans.

The REI report recommends that, as growth becomes more robust, most countries should:

- Diversify funding sources and deepen the local investor base, in order to reduce the countries' susceptibility to external funding shocks.
- Strengthen fiscal positions: Rebuilding fiscal space contributes to lowering vulnerabilities and provides room for policy support. Stronger policies and buffers would help mitigate external shocks and also unlock higher growth potential.
- Boost growth through structural reforms: Enhancing competitiveness in the tradable sector and reducing labor market rigidities would help CESEE countries to better cope with external shocks, particularly in light of low exchange rate flexibility.

# Statistical Annex

# Statistical Annex

This section provides tables detailing selected economic indicators for Albania, Bosnia and Herzegovina, FYR Macedonia,[1] Kosovo, Montenegro, Serbia and Ukraine, i.e. CESEE countries not covered in the Recent Economic Developments and Outlook section.

## Conventions used

x   =  No data can be indicated for technical reasons
. .  =  Data not available at the reporting date
Discrepancies may arise from rounding.

Table 1

### Gross Domestic Product

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *Annual real change in %* | | | | | | |
| Albania | 5.9 | 7.5 | 3.3 | 3.8 | 3.1 | 1.5 | 1.0 |
| Bosnia and Herzegovina | 6.0 | 5.6 | −2.7 | 0.8 | 1.0 | −1.2 | 0.8 |
| Kosovo | × | 7.2 | 3.5 | 3.2 | 4.5 | 2.5 | 4.0 |
| FYR Macedonia | 6.1 | 5.0 | −0.9 | 2.9 | 2.8 | −0.4 | 3.0 |
| Montenegro | 10.7 | 6.9 | −5.7 | 2.5 | 3.2 | −2.5 | 2.5 |
| Serbia | 5.4 | 3.8 | −3.5 | 1.0 | 1.6 | −1.5 | 2.4 |
| Ukraine | 7.9 | 2.3 | −14.8 | 4.1 | 5.4 | 0.2 | 0.0 |

*Source: wiiw.*

Table 2

### Industrial Production

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *Annual real change in %* | | | | | | |
| Albania | −12.7 | 29.9 | −1.2 | 19.9 | −10.1 | 16.5 | −13.0 |
| Bosnia and Herzegovina | 6.4 | 7.3 | −6.5 | 4.4 | 3.5 | −4.4 | 6.4 |
| Kosovo[1] | × | × | −1.5 | −5.6 | 19.2 | −10.0 | 5.0 |
| FYR Macedonia | 3.7 | 5.5 | −7.7 | −4.3 | 6.9 | −2.7 | 3.2 |
| Montenegro | 0.1 | −2.0 | −32.2 | 17.5 | −10.3 | −7.1 | 10.6 |
| Serbia | 3.7 | 1.1 | −12.6 | 1.0 | 2.5 | −2.2 | 6.3 |
| Ukraine | 7.6 | −5.2 | −21.9 | 11.2 | 8.0 | −0.5 | −4.3 |

*Source: wiiw.*

[1]  *According to gross value added data.*

[1]   *Former Yugoslav Republic of Macedonia.*

Table 3

## Average Gross Wages – Total Economy

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *Annual change in %* | | | | | | |
| Albania | 25.2 | 25.3 | 5.2 | –3.6 | 4.9 | 7.7 | 4.0 |
| Bosnia and Herzegovina | 9.8 | 16.7 | 8.1 | 1.1 | 4.6 | 1.3 | 0.1 |
| Kosovo[1] | × | × | 22.8 | 12.7 | 14.4 | –1.1 | 1.5 |
| FYR Macedonia | 4.8 | 8.7 | 14.1 | 1.0 | 1.2 | 0.2 | 1.2 |
| Montenegro | 31.7 | 22.5 | 5.6 | 11.2 | 1.0 | 0.7 | –0.1 |
| Serbia | 22.0 | 17.9 | –3.3 | 7.5 | 11.1 | 8.9 | 5.7 |
| Ukraine | 29.7 | 33.7 | 5.5 | 17.5 | 17.6 | 14.9 | 7.9 |

*Source: wiiw.*

[1] *Average net monthly wages.*

Table 4

## Unemployment Rate[1]

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *%* | | | | | | |
| Albania | 13.4 | 13.1 | 13.7 | 14.0 | 14.0 | 13.4 | 15.6 |
| Bosnia and Herzegovina | 29.0 | 23.4 | 24.1 | 27.2 | 27.6 | 28.0 | 27.5 |
| Kosovo | × | 47.5 | 45.4 | 45.1 | 44.8 | 30.9 | 31.0 |
| FYR Macedonia | 34.9 | 33.8 | 32.2 | 32.0 | 31.4 | 31.0 | 29.0 |
| Montenegro | 19.3 | 17.2 | 19.3 | 19.6 | 19.7 | 19.7 | 20.0 |
| Serbia | 18.1 | 13.6 | 16.1 | 19.2 | 23.0 | 23.9 | 23.6 |
| Ukraine | 6.4 | 6.4 | 8.8 | 8.1 | 7.9 | 7.5 | 7.2 |

*Source: wiiw.*

[1] *Labor force survey, period average.*

Table 5

## Industrial Producer Price Index

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *Period average, annual change in %* | | | | | | |
| Albania | 3.5 | 6.5 | –1.6 | 0.3 | 2.6 | 1.1 | –0.5 |
| Bosnia and Herzegovina | × | 8.6 | –3.2 | 0.9 | 3.7 | 1.5 | –2.6 |
| Kosovo | × | × | 3.8 | 4.7 | 5.7 | 1.7 | . . |
| FYR Macedonia | 2.5 | 10.3 | –7.2 | 8.7 | 11.9 | 1.4 | –1.4 |
| Montenegro | 8.5 | 14.0 | –3.9 | –0.9 | 3.2 | 1.9 | 1.6 |
| Serbia | 5.9 | 12.4 | 5.6 | 12.7 | 14.2 | 5.6 | 3.6 |
| Ukraine | 19.5 | 35.5 | 6.5 | 20.9 | 19.0 | 3.7 | –0.1 |

*Source: wiiw.*

Table 6

## Consumer Price Index

|  | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
|  | *Period average, annual change in %* | | | | | | |
| Albania | 2.9 | 3.4 | 2.3 | 3.6 | 3.4 | 2.0 | 2.0 |
| Bosnia and Herzegovina | 1.5 | 7.5 | –0.4 | 2.1 | 3.7 | 2.0 | 0.2 |
| Kosovo | x | 9.4 | –2.4 | 3.5 | 7.3 | 2.5 | 1.8 |
| FYR Macedonia | 2.3 | 8.3 | –0.8 | 1.6 | 3.9 | 3.3 | 2.8 |
| Montenegro | 4.2 | 7.4 | 3.4 | 0.5 | 3.1 | 4.1 | 2.2 |
| Serbia | 7.0 | 13.5 | 8.6 | 6.8 | 11.0 | 7.8 | 7.8 |
| Ukraine | 12.8 | 25.2 | 15.9 | 9.4 | 8.0 | 0.6 | –0.3 |

*Source: wiiw.*

Table 7

## Trade Balance

|  | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
|  | *% of GDP* | | | | | | |
| Albania | –26.9 | –27.4 | –26.5 | –23.5 | –24.5 | –20.7 | –17.6 |
| Bosnia and Herzegovina | –36.7 | –37.8 | –27.4 | –25.4 | –27.5 | –32.7 | .. |
| Kosovo | x | –42.3 | –41.2 | –40.8 | –43.1 | –42.2 | .. |
| FYR Macedonia | –19.8 | –26.2 | –23.3 | –20.5 | –22.1 | –23.6 | –20.1 |
| Montenegro | –57.6 | –65.6 | –44.3 | –40.8 | –40.4 | –44.1 | –41.6 |
| Serbia | –24.8 | –26.0 | –17.1 | –16.4 | –16.9 | –18.5 | –12.2 |
| Ukraine | –7.4 | –8.9 | –3.7 | –5.9 | –9.6 | –10.7 | –10.4 |

*Source: wiiw, European Commission.*

Table 8

## Current Account Balance

|  | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
|  | *% of GDP* | | | | | | |
| Albania | –10.5 | –15.6 | –15.3 | –11.5 | –13.4 | –10.1 | –10.4 |
| Bosnia and Herzegovina | –10.6 | –13.9 | –6.3 | –5.7 | –9.7 | –9.6 | –9.0 |
| Kosovo | x | –11.7 | –9.3 | –12.0 | –13.8 | –7.7 | –6.7 |
| FYR Macedonia | –7.1 | –12.8 | –6.8 | –2.0 | –2.5 | –3.0 | –1.9 |
| Montenegro | –39.5 | –49.8 | –27.9 | –22.9 | –17.7 | –18.7 | –15.2 |
| Serbia | –17.7 | –21.6 | –6.6 | –6.7 | –9.1 | –10.7 | –4.8 |
| Ukraine | –3.7 | –7.1 | –1.5 | –2.1 | –6.1 | –7.8 | –8.7 |

*Source: wiiw.*

Table 9

## Net FDI Inflows

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *% of GDP* | | | | | | |
| Albania | 6.1 | 7.5 | 8.2 | 8.9 | 8.2 | 7.7 | 9.7 |
| Bosnia and Herzegovina | 11.8 | 5.4 | 1.4 | 2.4 | 2.7 | 2.2 | 2.3 |
| Kosovo | × | × | 7.3 | 8.5 | 8.3 | 4.6 | . . |
| FYR Macedonia | 8.5 | 6.0 | 2.2 | 2.3 | 4.5 | 1.0 | 3.2 |
| Montenegro | 25.5 | 21.2 | 36.9 | 18.5 | 12.4 | 15.3 | 10.5 |
| Serbia | 8.8 | 6.2 | 4.9 | 3.6 | 6.2 | 1.0 | 2.4 |
| Ukraine | 7.1 | 5.9 | 4.1 | 4.6 | 4.3 | 4.3 | 2.0 |

*Source: wiiw.*

Table 10

## Reserve Assets Excluding Gold

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *End of period, % of GDP* | | | | | | |
| Albania | 18.1 | 18.3 | 18.5 | 20.8 | 20.3 | 19.8 | 20.0 |
| Bosnia and Herzegovina | 30.4 | 25.2 | 25.3 | 25.7 | 24.3 | 24.7 | 26.6 |
| Kosovo | × | × | 14.4 | 14.8 | 12.0 | 16.8 | . . |
| FYR Macedonia | 23.5 | 20.3 | 21.3 | 21.0 | 24.1 | 25.7 | 22.9 |
| Montenegro | 9.7 | 7.0 | 5.8 | 5.3 | 5.3 | 5.9 | 6.1 |
| Serbia | 33.1 | 24.2 | 35.5 | 34.1 | 36.5 | 34.8 | 32.8 |
| Ukraine | 20.8 | 17.8 | 21.2 | 23.6 | 19.4 | 12.1 | 9.6 |

*Source: wiiw.*

Table 11

## Gross External Debt

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | *End of period, % of GDP* | | | | | | |
| Albania | 28.7 | 37.6 | 41.3 | 46.2 | 54.3 | 57.2 | 57.9 |
| Bosnia and Herzegovina[1] | 18.0 | 17.0 | 21.5 | 25.3 | 25.8 | 27.8 | 28.5 |
| Kosovo | × | × | 28.6 | 31.4 | 29.9 | 30.9 | 30.8 |
| FYR Macedonia | 47.6 | 49.2 | 56.4 | 58.2 | 64.9 | 69.4 | 69.8 |
| Montenegro[1] | 17.2 | 15.6 | 23.5 | 29.4 | 32.9 | 41.1 | 44.8 |
| Serbia | 60.2 | 64.6 | 77.7 | 84.9 | 76.7 | 86.9 | 79.5 |
| Ukraine | 52.2 | 58.6 | 85.8 | 83.1 | 80.5 | 72.1 | 72.8 |

*Source: wiiw.*

[1] *Gross external public debt.*

Table 12

## General Government Balance

|  | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
|  | *% of GDP* | | | | | | |
| Albania | –3.5 | –5.5 | –7.0 | –3.1 | –3.6 | –3.4 | –4.7 |
| Bosnia and Herzegovina | 1.1 | –2.2 | –4.4 | –2.5 | –1.3 | –2.0 | –2.5 |
| Kosovo | × | × | 4.1 | –1.3 | –0.2 | –0.5 | –2.0 |
| FYR Macedonia | 0.6 | –0.9 | –2.7 | –2.4 | –2.5 | –3.9 | –4.0 |
| Montenegro | 6.7 | 1.7 | –3.6 | –3.0 | –5.4 | –4.2 | –4.0 |
| Serbia | –1.9 | –2.6 | –4.5 | –4.7 | –4.9 | –6.5 | –4.8 |
| Ukraine | –1.1 | –1.5 | –4.1 | –6.0 | –1.7 | –3.5 | –4.2 |

*Source: wiiw.*

Table 13

## Gross General Government Debt

|  | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
|  | *% of GDP* | | | | | | |
| Albania | 53.8 | 55.1 | 59.3 | 57.8 | 58.6 | 60.9 | 70.0 |
| Bosnia and Herzegovina | 29.8 | 30.8 | 36.2 | 39.3 | 40.5 | 43.9 | 43.0 |
| Kosovo[1] | × | × | 6.2 | 6.1 | 5.3 | 5.6 | 6.3 |
| FYR Macedonia | 32.3 | 27.9 | 31.7 | 34.8 | 35.0 | 36.0 | 36.0 |
| Montenegro | 27.5 | 29.0 | 38.2 | 40.9 | 46.0 | 54.0 | 58.5 |
| Serbia | 30.9 | 29.2 | 34.7 | 44.5 | 48.5 | 59.8 | 62.2 |
| Ukraine | 12.3 | 20.0 | 34.8 | 39.9 | 35.1 | 35.4 | 38.8 |

*Source: wiiw.*

[1] *Public debt (national definition).*

Table 14

## Broad Money

|  | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
|  | *End of period, annual nominal change in %* | | | | | | |
| Albania (M2) | 12.9 | 7.2 | 6.8 | 12.5 | 9.2 | 5.0 | 2.3 |
| Bosnia and Herzegovina (M2) | 19.2 | 4.1 | 2.2 | 7.2 | 5.8 | 3.4 | . . |
| Kosovo (M4) | × | 23.6 | 11.2 | 12.9 | 8.8 | 7.1 | 17.3 |
| FYR Macedonia (M3) | 29.3 | 11.2 | 6.0 | 12.2 | 9.7 | 4.4 | 5.3 |
| Montenegro (M2) | 72.9 | –41.5 | –7.0 | 3.4 | 2.1 | 8.4 | 4.9 |
| Serbia (M2) | 42.5 | 9.8 | 21.5 | 12.9 | 10.3 | 9.4 | 4.7 |
| Ukraine (M3) | 51.7 | 30.2 | –5.5 | 22.7 | 14.7 | 12.8 | 17.6 |

*Source: wiiw, European Commission.*

Table 15

## Official Key Interest Rate

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| *End of period, %* | | | | | | | |
| Albania (one-week repo rate) | 6.25 | 6.25 | 5.25 | 5.00 | 4.75 | 4.00 | 3.00 |
| Bosnia and Herzegovina[1] | × | × | × | × | × | × | × |
| Kosovo[2] | × | × | × | × | × | × | × |
| FYR Macedonia (CB bills)[3] | 4.77 | 7.00 | 8.50 | 4.11 | 4.00 | 3.73 | 3.25 |
| Montenegro[2] | × | × | × | × | × | × | × |
| Serbia (two-week repo rate)[4] | 10.00 | 17.75 | 9.50 | 11.50 | 9.75 | 11.25 | 9.50 |
| Ukraine (discount rate) | 8.00 | 12.00 | 10.25 | 7.75 | 7.75 | 7.50 | 6.50 |

*Source: wiiw.*

[1] Currency board.
[2] Unilateral euroization.
[3] Monthly weighted average interest rate on Central Bank Bills auctions (28 days).
[4] 2002–05: Weighted average interest rates on securities used in open market operations by Narodna banka Srbije.

Table 16

## Exchange Rate

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| *Period average, national currency per EUR* | | | | | | | |
| Albania | 123.63 | 122.80 | 132.06 | 137.79 | 140.33 | 139.04 | 140.26 |
| Bosnia and Herzegovina | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| Kosovo | × | × | × | × | × | × | × |
| FYR Macedonia | 61.18 | 61.27 | 61.27 | 61.52 | 61.53 | 61.53 | 61.58 |
| Montenegro | × | × | × | × | × | × | × |
| Serbia | 79.98 | 81.47 | 93.94 | 102.90 | 101.96 | 113.13 | 113.09 |
| Ukraine | 6.92 | 7.71 | 10.87 | 10.53 | 11.09 | 10.27 | 10.61 |

*Source: wiiw.*

# Notes

# Periodical Publications

See *www.oenb.at* for further details.

### Geschäftsbericht (Nachhaltigkeitsbericht)
German | annually

### Annual Report (Sustainability Report)
English | annually

This report informs readers about the Eurosystem's monetary policy and underlying economic conditions as well as about the OeNB's role in maintaining price stability and financial stability. It also provides a brief account of the key activities of the OeNB's core business areas. The OeNB's financial statements are an integral part of the report.

*http://www.oenb.at/en/Publications/Oesterreichische-Nationalbank/Annual-Report.html*

### Konjunktur aktuell
German | seven times a year

This online publication provides a concise assessment of current cyclical and financial developments in the global economy, the euro area, Central, Eastern and Southeastern European countries, and in Austria. The quarterly releases (March, June, September and December) also include short analyses of economic and monetary policy issues.

*http://www.oenb.at/Publikationen/Volkswirtschaft/Konjunktur-aktuell.html*

### Monetary Policy & the Economy
English | quarterly

This publication assesses cyclical developments in Austria and presents the OeNB's regular macroeconomic forecasts for the Austrian economy. It contains economic analyses and studies with a particular relevance for central banking and summarizes findings from macroeconomic workshops and conferences organized by the OeNB.

*http://www.oenb.at/en/Publications/Economics/Monetary-Policy-and-the-Economy.html*

### Fakten zu Österreich und seinen Banken
German | twice a year

### Facts on Austria and Its Banks
English | twice a year

This online publication provides a snapshot of the Austrian economy based on a range of structural data and indicators for the real economy and the banking sector. Comparative international measures enable readers to put the information into perspective.

*http://www.oenb.at/en/Publications/Financial-Market/Facts-on-Austria-and-Its-Banks.html*

### Financial Stability Report
English | twice a year

The Reports section of this publication analyzes and assesses the stability of the Austrian financial system as well as developments that are relevant for financial stability in Austria and at the international level. The Special Topics section provides analyses and studies on specific financial stability-related issues.

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### Focus on European Economic Integration
English | quarterly

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*http://www.oenb.at/en/Publications/Economics/Focus-on-European-Economic-Integration.html*

### Statistiken – Daten & Analysen
German | quarterly

This publication contains analyses of the balance sheets of Austrian financial institutions, flow-of-funds statistics as well as external statistics (English summaries are provided). A set of 14 tables (also available on the OeNB's website) provides information about key financial and macroeconomic indicators.

*http://www.oenb.at/Publikationen/Statistik/Statistiken---Daten-und-Analysen.html*

## Statistiken – Daten & Analysen: Sonderhefte    German | irregularly
## Statistiken – Daten & Analysen: Special Issues    English | irregularly

In addition to the regular issues of the quarterly statistical series "Statistiken – Daten & Analysen," the OeNB publishes a number of special issues on selected statistics topics (e.g. sector accounts, foreign direct investment and trade in services).

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*http://www.oenb.at/en/Publications/Economics/Economics-Conference.html*

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## European Economic Integration    English | annually

The OeNB's annual Conference on European Economic Integration (CEEI) deals with current issues with a particular relevance for central banking in the context of convergence in Central, Eastern and Southeastern Europe as well as the EU enlargement and integration process. For an overview see:

*http://www.oenb.at/en/Publications/Economics/Conference-on-European-Economic-Integration-CEEI.html*
The proceedings have been published with Edward Elgar Publishers, Cheltenham/UK, Northampton/ MA, since the CEEI 2001.

*www.e-elgar.com*

## Publications on Banking Supervisory Issues    German, English | irregularly

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*http://www.oenb.at/en/Publications/Financial-Market/Publications-of-Banking-Supervision.html*

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