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1 Introduction

In the first three quarters of 2004, economic growth in the new EU Member States in Central Europe (the Czech Republic, Hungary, Poland, Slovakia, Slovenia) ranged from 3.7% year on year in the Czech Republic to 5.9% year on year in Poland. In these five countries, the weighted average growth rate of 4.9% was again clearly higher than the average growth rate in the euro area (1.9%). By contrast, Bulgaria, Romania and Russia outperformed most or all of these five new Member States with growth rates of 5.8%, 8.1% and 7.0%, respectively, while Croatia lagged behind most of them with a growth rate of 3.9%.

Compared to the full year 2003, most countries posted higher GDP growth. In the Central European new Member States, the growth acceleration of 1.4 percentage points was equal to that in the euro area. Poland and Slovenia showed the strongest acceleration within this group, with 2.2 and 2.0 percentage points, respectively. However, Romania posted the largest rise in GDP growth among all the countries under study (3.2 percentage points). Only three countries, i.e. the Czech Republic, Croatia and Russia (the latter from a high starting level, though), had slightly lower growth rates than in 2003.

Table 1

Gross Domestic Product (Real)

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Annual change in %						
Czech Republic	1.2	3.9	2.6	1.5	3.7	3.5	3.9
Hungary	4.2	5.2	3.8	3.5	3.0	4.3	4.2
Poland	4.0	4.0	1.0	1.4	3.8	6.9	6.1
Slovakia	1.5	2.0	3.8	4.6	4.5	5.4	5.5
Slovenia	5.6	3.9	2.7	3.3	2.5	3.9	4.7
Bulgaria	2.4	5.4	4.1	4.9	4.3	5.3	6.0
Croatia	–0.9	2.9	4.4	5.2	4.3	4.2	3.8
Romania	–1.2	2.1	5.7	5.0	4.9	6.1	7.0
Russia	6.3	9.0	5.1	4.7	7.3	7.5	7.3

Source: Eurostat, national statistical offices, wiiw.

Looking at growth dynamics from the demand side, country groups may be distinguished according to patterns of change (compared to 2003) observed in domestic and net foreign demand's contribution to overall GDP growth.

– Despite a considerably larger contribution by domestic demand than in 2003, GDP growth in Russia decreased slightly, because the contribution of net exports switched from positive to negative.
– In the other two countries that experienced a slight slowdown in GDP growth, i.e. the Czech Republic and Croatia, the contribution of net exports was less negative than in 2003, but this was more than offset by a reduction in the positive contribution of domestic demand, implying a more balanced growth structure.
– The negative contribution of net exports was also less pronounced in Bulgaria, Hungary and Slovenia, where GDP growth accelerated. In Bulgaria, the positive contribution of domestic demand declined. This decline, however, did not offset the growth-enhancing change in the contribution of net exports. In Hungary and Slovenia, the contribution of domestic demand remained nearly unchanged. Thus, in parallel to growth acceleration, the growth structure for these three countries was more balanced as well.

– Finally, in Poland, Slovakia and Romania, the contribution of net exports was less positive (Poland), eroded to zero (Slovakia) or remained negative at the same level (Romania), while the simultaneous increase in the positive contribution of domestic demand led to an acceleration of GDP growth.

In all those countries (with the exception of Russia) where the contribution of domestic demand increased, i.e. Poland, Slovakia and Romania, growth of gross fixed capital formation accelerated to a larger extent than consumption growth. Moreover, in Hungary, where the contribution of domestic demand was nearly unchanged, and in the Czech Republic, where it declined, growth of gross fixed capital formation accelerated significantly, too, while consumption growth declined. In Bulgaria, where the contribution of domestic demand declined, growth of fixed capital formation decelerated to a smaller extent than consumption growth. Thus, for most countries a relative shift from consumption to investment growth can be observed for 2004. The exceptions are Slovenia, where both consumption and investment growth increased slightly, and Croatia and Russia, where gross fixed capital formation growth decreased (substantially in Croatia and moderately in Russia) from high levels, while consumption growth was nearly unchanged (Croatia) or increased (Russia).

The fact that in most countries the contribution of net exports to growth was less negative or less positive than in 2003 means that the dynamic of change in net exports was generally lower and the levels of external balance or imbalance tended to change to a lesser extent than before. The exceptions are Romania, where the negative contribution was unchanged, and Russia, where both the direction and the size of the contribution of net exports changed, from moderately positive to more considerably negative. In all those countries (with the exception of Croatia) where the contribution of net exports was less negative or unchanged, this was based on export growth acceleration, while import growth accelerated less or, in some cases, decelerated. Even among the three countries where the contribution of net exports was less positive or turned negative (Poland, Slovakia, Russia), there was one country, namely Poland, where export growth accelerated, too.

The level of net exports' contribution achieved in the first three quarters of 2004 as a result of the above-mentioned changes was positive only in Poland, while it was most negative in Bulgaria (despite its significant reduction), in Romania and in Russia. Thus, in Poland there was an improvement in the level of real net exports (decreasing deficit), as opposed to a significant further deterioration in the level of real net exports in Bulgaria and Romania, where the deficit increased, and a moderate deterioration in Russia, where the surplus decreased. It is worth noting that the most negative contribution of net exports can be found precisely in those three countries (apart from Poland) where GDP was highest, i.e. Bulgaria, Romania and Russia. Indeed, in these countries the contribution of domestic demand was very high, ranging from 9.0 to 11.0 percentage points, which implies a significantly imbalanced growth structure.

The changes in the level of real net exports are generally also reflected in the balance of goods and services in the balance of payments statistics, albeit to a lesser extent (in nominal terms, as percentage points of GDP), with Poland showing an improvement, and Bulgaria and Romania a further deterioration of this balance in the first three quarters of 2004 compared to the same period in 2003. However, in the case of Russia, the deterioration in real terms is not reflected, as the nominal balance has further improved, which may be explained by the high price level of important export goods.[1]

Finally, taking a look at the level of the balance of goods and services (in percentage points of GDP) in the first three quarters of 2004, Bulgaria and Romania showed the highest deficit levels, reaching 6.6% and 8.6%, respectively. Russia and Slovenia, by contrast, recorded a surplus which reached the impressive level of 12.4% in Russia and came close to balance in Slovenia. In Bulgaria and Romania, other subbalances led to a lower deficit in the current account balance than implied by the balance of goods and services alone (4.0% and 5.9% of GDP, respectively), while in the Czech Republic and Hungary the negative income balance increased the deficit from –0.2% and –3.2% of GDP, respectively, in the balance of goods and services to –5.5% and –9.1%, respectively, in the current account balance.

Price developments have been quite heterogeneous throughout the region. Among the new Member States in Central Europe, inflation rates (as measured by year-on-year changes of consumer prices in the third quarter of 2004) ranged from 3.0% in the Czech Republic to 7.0% in Hungary and 7.2% in the Slovak Republic. Of all the countries under study, Croatia had the lowest inflation rate (1.9%), while Romania (11.9%) and Russia (11.0%) were the only countries with double-digit inflation.

There were strong upward pressures on prices in 2004. In addition to rising international energy prices, hikes in indirect tax rates and adjustments of agricultural prices in the new Member States related to EU accession put upward pressure on prices. Moreover, in some countries, there was a delayed inflationary effect of the nominal depreciation that had taken place up to the first quarter. In Bulgaria, the rise in international energy prices was exacerbated by adjustments to regulated energy prices. Food prices also sharply increased in the country, partly as a result of drought damages. While the subindices of the HICP (Harmonised Index of Consumer Prices) indicate that demand side-driven inflationary pressure has played a limited role in the new Member States, it seems that demand-side pull effects as well as strong credit expansion and – in Russia – increases in net foreign assets have contributed to overall inflation in Bulgaria, Romania and Russia to a larger extent.

Compared to the annual average inflation in 2003, there was a significant inflation acceleration in four out of the nine countries under review (the Czech Republic, Hungary, Poland, Bulgaria). However, despite the upward pressures on prices, inflation went down in four countries (Slovakia, Slovenia, Romania, Russia). In Slovakia, the relatively low level of core inflation (about 2%) pulled down headline inflation, which was influenced by hikes in administered prices and tax changes. Moreover, the favorable base effect (due to sizeable hikes in administered prices in 2003) and the activities of retail trade companies helped to more than offset the upward pressures. Inflation also declined in Slovenia,

[1] *For other countries, there are deviations, too. The Czech Republic and Hungary posted a moderately negative contribution of net exports, but their balance of goods and services actually improved. In Slovakia, the contribution of net exports was close to zero, but the balance of goods and services deteriorated.*

on the back of lower unit labor cost advances, which resulted from the gradual de-indexation of the economy.

The inflation rates in October and November generally signal disinflation in most countries, except Russia. In particular, the Czech Republic, Hungary and Poland as well as Bulgaria seem to have already passed the inflation peak. In Romania, single-digit inflation could be reached for the first time since the start of the transition process.

Table 2

Consumer Price Index (here: HICP)

	2000	2001	2002	2003	Q1 2004	Q2 2004	Q3 2004
	Annual change in %						
Czech Republic	3.9	4.5	1.4	–0.1	2.0	2.5	3.0
Hungary	10.0	9.1	5.2	4.7	6.8	7.4	7.0
Poland	10.1	5.3	1.9	0.7	1.8	3.4	4.7
Slovakia	12.2	7.2	3.5	8.5	8.2	8.0	7.2
Slovenia	8.9	8.6	7.5	5.7	3.7	3.8	3.6
Bulgaria	10.3	7.4	5.8	2.3	6.4	6.7	6.8
Croatia[1]	6.4	5.0	1.7	1.8	1.9	2.3	1.9
Romania[1]	45.7	34.5	22.5	15.3	13.6	12.3	11.9
Russia[1]	20.8	21.6	16.0	13.6	10.8	10.3	11.1

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

As far as the quality of *sovereign long-term foreign currency debt* is concerned, both Moody's and Standard & Poor's continue to award Slovenia the highest rating among the countries discussed in this contribution. The Czech Republic and Hungary share the second-highest rating by both agencies. Moreover, in December, Standard & Poor's upgraded its rating for Slovakia to be equal to that of the Czech Republic and Hungary. Moody's still ranks Poland third, closely followed by Slovakia, whose outlook, however, was described as positive in October. At present, both agencies rank Croatia right after the new Member States and higher than Bulgaria and Romania, since Standard & Poor's upgraded the rating for Croatia in December. However, both Bulgaria and Romania could improve their ratings in recent months as well; Moody's upgraded the former in November and Standard & Poor's upgraded the latter in September.

Table 3

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt

Currency	Moody's			Standard & Poor's		
	Former rating	Last change	Current rating	Former rating	Last change	Current rating
CZK	Baa1	12.11.02	A1	A	05.11.98	A–
HUF	A3	12.11.02	A1	BBB+	19.12.00	A–
PLN	Baa1	12.11.02	A2	BBB	15.05.00	BBB+
SKK	Baa3	12.11.02	A3	BBB+	13.12.04	A–
SIT	A2	12.11.02	Aa3	A+	13.05.04	AA–
BGN	Ba2	17.11.04	Ba1	BB+	24.06.04	BBB–
HRK	. .	27.01.97	Baa3	BBB–	22.12.04	BBB
ROL	B1	11.12.03	Ba3	BB	14.09.04	BB+
RUB	Ba2	08.10.03	Baa3	BB	27.01.04	BB+

Source: Bloomberg.

2 Czech Republic: Economic Growth Gains Momentum

Real GDP growth was 3.7% year on year in the first nine months of 2004, much like growth in the full year 2003 (3.7%). However, the similar growth rates mask considerable changes in the structure of growth. In particular, in the first three quarters of 2004, private consumption growth decreased to only 2.7% year on year (after 4.9% in the full year 2003) and public consumption even declined by 2.6% (after rising by 4.2% in 2003). On the other hand, the growth rate of gross fixed capital formation accelerated steadily from the last quarter of 2002, coming to about 10% in the first three quarters of 2004 after 4.8% in 2003. With export growth of 19.8% exceeding import growth of 19% year on year in the first three quarters of 2004, the deterioration of real net exports slowed down, implying a smaller negative contribution of net exports to GDP growth of 1.5 percentage points (against 3 percentage points in 2003). In the second quarter of 2004, both real export growth and real import growth jumped to about 26% (from 10.4% and 11.3%, respectively, in the first quarter of 2004) and decreasing only moderately to 22.7% and 19.3%, respectively, in the third quarter of 2004. The higher level of export and import growth may be traced partly to the effects of EU accession.

Table 4

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	1.2	3.9	2.6	1.5	3.7	3.5	3.9
Private consumption	2.1	2.9	2.6	2.8	4.9	3.4	2.6
Public consumption	5.4	0.2	3.8	4.5	4.2	−1.3	−0.8
Gross fixed capital formation	−3.5	4.9	5.4	3.4	4.8	9.3	10.5
Exports of goods and services	5.7	16.8	11.8	2.7	5.5	10.4	26.0
Imports of goods and services	5.0	16.2	12.9	4.9	8.1	11.3	25.8
	Contribution to GDP growth in percentage points						
Domestic demand	1.1	4.6	4.4	3.7	3.8	4.7	4.9
Exports	3.6	11.1	8.7	2.2	4.5	8.7	21.0
Net exports	0.1	−0.7	−1.8	−2.2	−3.0	−1.8	−2.9

Source: Eurostat, OeNB.

After outstanding growth of industrial production in the second quarter of 2004 (+12.6%), the growth rate came down to 8.8% in the third quarter of 2004, which was partly due to the slightly lower export growth. After an annual decline of industrial employment since the end of 2001, industrial employment increased by 0.5% year on year in the second quarter of 2004 and 1.0% year on year in the third quarter. However, in the second quarter of 2004, the total unemployment rate (ILO definition) was again higher than in the same period of the previous year, coming to 8.2% against 7.5%. For the third quarter, some improvement in the labor market compared to the same period of 2003 is evident in the registered unemployment rate. Despite slightly higher nominal wage growth, nominal industrial unit wage costs continued to fall in year-on-year terms in the first three quarters of 2004 (–1.7%). However, inflation of industrial producer prices rose to 4.9% year on year in that period, from –0.4% in 2003, inter alia because of higher oil prices and the Czech koruna's depreciation against the euro by 2% from September 2003 to March 2004. After peaking in

October at 8.6% year on year, industrial producer price inflation declined to 8.2% in November, supported by the Czech koruna's renewed appreciation by 5.4% against the euro from March to November. Following inflation (HICP) of –0.1% in 2003 and of 1.0% in December 2003 (year on year), the inflation rate accelerated to 3.2% in August 2004 and then decreased to 2.5% by December 2004. The harmonization of excise duties and VAT with EU law, the increase in agricultural prices (partly related to EU accession), the growth in regulated prices and the sharp increase in fuel prices were the major factors behind the price development in 2004. The rise in VAT rates in May still affected price increases at the end of 2004, especially in the service sector.

Table 5

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	−3.1	5.4	6.7	4.9	5.9	8.7	12.6
Labor productivity of industry (real)	3.6	9.1	6.1	6.8	7.9	9.0	12.0
Gross average wage of industry (nominal)	6.6	7.1	6.4	6.7	5.9	8.7	6.3
Unit labor cost of industry (nominal)	3.0	−1.8	0.3	−0.1	−1.9	−0.2	−5.2
Producer price index (PPI) of industry	0.9	4.8	2.9	−0.5	−0.4	1.8	5.0
Consumer price index (here: HICP)	1.8	3.9	4.5	1.4	−0.1	2.0	2.5
Exchange rate (nominal):							
CZK[1] per 1 EUR, + = EUR appreciation	2.3	−3.5	−4.3	−9.5	3.3	3.9	1.8
EUR per 1 CZK, + = CZK appreciation	−2.2	3.6	4.5	10.6	−3.2	−3.8	−1.7
	Period average levels						
Unemployment rate (ILO definition, %)	8.8	8.9	8.2	7.3	7.8	8.7	8.2
Key interest rate per annum (%)	6.7	5.3	5.1	3.6	2.3	2.0	2.0
Exchange rate (nominal):							
CZK[1] per 1 EUR	36.89	35.60	34.07	30.81	31.84	32.86	32.02
EUR per 1 CZK	0.0271	0.0281	0.0294	0.0325	0.0314	0.0304	0.0312

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

Although the inflation pick-up was primarily supply side-driven, Česká národní banka (ČNB) decided to increase the key interest rate from 2.00% to 2.50% in the summer of 2004 in order to contain second-round effects. After the real key interest rate (12-month moving average) had fallen continuously from 1.4% in December 2003 to –1.1% in August 2004, it came to –0.4% in November 2004.[2] While the decline of real interest rates eased monetary conditions, the real appreciation by 2.5% (CPI-deflated) and 6.7% (PPI-deflated) during the 12-month period up to November had a tightening impact. The increase in annual money growth in the first three quarters of 2004 was accompanied by a marked shift from contraction to expansion in lending to the corporate sector, while household lending growth remained high and net general government credit growth slowed sharply.

After the budget deficit had reached a record high of 12.6% of GDP in 2003 (as the government had to account fully for a partially realized one-off state guarantee), the update of the government's Convergence Program of December 2004 points to a deficit of 5.2% including two one-off operations and of about 4% excluding these operations in 2004 against a deficit of 5.3% expected in the

[2] *Ex post real key rate per annum as measured by the real (CPI-deflated) key rates per month compounded over the past 12 months. The similarly measured PPI-deflated key rate per annum declined from 1.5% in December 2003 to –5.6% in November 2004.*

Table 6

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	8.9	6.5	10.8	7.1	5.2	8.8	11.5
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	13.0	8.0	8.0	7.9	1.2	−2.6	3.4
Domestic credit (net) of the banking system	−3.2	−1.1	0.2	−9.7	7.7	12.3	9.3
of which: claims on the private sector	*−3.8*	*−5.0*	*−5.6*	*−12.3*	*0.9*	*4.1*	*6.0*
claims on households	*0.1*	*0.3*	*1.1*	*1.7*	*3.3*	*4.0*	*4.2*
claims on enterprises	*−4.0*	*−5.3*	*−6.7*	*−14.0*	*−2.5*	*0.1*	*1.8*
net claims on the public sector	*0.6*	*3.9*	*5.8*	*2.5*	*6.8*	*8.2*	*3.3*
Other domestic assets (net) of the banking system	−0.9	−0.4	2.6	8.9	−3.7	−0.9	−1.3

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

May 2004 program. The Convergence Program expects the public debt-to-GDP ratio to have risen from 37.8% at end-2003 to 38.6% (against 38.4% in the May program) at end-2004. According to the Ecofin recommendation under the excessive deficit procedure in July 2004, the Czech Republic should take effective action to achieve the 2005 deficit target set in May and should reach a deficit below 3% by 2007. In line with the national budget law, the December program sets the deficit target for 2005 at 4.7% of GDP, much like the target in the May program and the figure in the European Commission's autumn forecast. It expects the debt-to-GDP ratio to decline to 38.3% at end-2005.

Table 7

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	39.2	38.5	39.1	40.2	41.9	41.9	41.6
Expenditures	42.9	42.1	45.0	46.9	54.5	46.7	46.3
of which: interest payments	*1.0*	*0.9*	*1.1*	*1.5*	*1.3*	*1.2*	*1.4*
Balance	−3.6	−3.7	−5.9	−6.8	−12.6	−4.8	−4.7
Primary balance	−2.6	−2.8	−4.8	−5.2	−11.3	−3.6	−3.3
Gross public debt	16.0	18.2	25.3	28.8	37.8	37.8	39.4

Source: European Commission.

In the first three quarters of 2004, the trade deficit amounted to 0.7% of GDP, against a deficit of 1.9% in the same period of 2003. However, the current account deficit in the first three quarters of 2004 was larger than the year before, reaching 5.5% of GDP, up from 4.9% of GDP. The worsening of the current account was caused by the development of the income balance (increasing flows of repatriated and reinvested profits) as well as by the reduction of the surplus in the transfer balance. In the same period, net foreign direct investment (FDI) inflows remained unchanged on the previous year at a level of 4.7% of GDP, covering 85% of the current account deficit. Upcoming privatization projects are likely to ensure strong inflows of FDI in the near future. For

Table 8

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	24,651	31,509	37,271	40,713	43,080	21,355	25,239
Merchandise exports: year-on-year change in %	*6.9*	*27.8*	*18.3*	*9.2*	*5.8*	*5.3*	*18.2*
Merchandise imports	26,448	34,918	40,705	43,034	45,250	21,910	25,567
Merchandise imports: year-on-year change in %	*4.1*	*32.0*	*16.6*	*5.7*	*5.1*	*4.3*	*16.7*
Trade balance	−1,797	−3,409	−3,434	−2,322	−2,170	−555	−328
% of GDP	*−3.2*	*−5.6*	*−5.0*	*−3.0*	*−2.7*	*−1.4*	*−0.8*
Services balance	1,130	1,536	1,706	706	416	239	249
Income balance (factor services balance)	−1,265	−1,490	−2,450	−3,760	−3,656	−1,286	−1,792
Current transfers	552	403	524	934	487	171	135
Current account balance	−1,379	−2,960	−3,653	−4,442	−4,923	−1,432	−1,736
% of GDP	*−2.5*	*−4.9*	*−5.4*	*−5.7*	*−6.1*	*−3.6*	*−4.2*
Direct investment flows (net)	5,879	5,356	6,121	8,870	2,094	1,691	1,792
% of GDP	*10.6*	*8.9*	*9.0*	*11.3*	*2.6*	*4.2*	*4.3*

Source: Eurostat, national central bank, OeNB.

example, the government plans to sell 51% of its stake in Český Telecom (ČT) in 2005.

During the first three quarters of 2004, gross official reserves declined both in absolute terms and in import months of goods and services (from 5.0 to 4.4).

Table 9

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (including gold)	12,771	14,158	16,400	22,614	21,340	21,784
Gross external debt	22,765	23,285	25,368	25,738	27,599	28,758
	% of GDP[1]					
Gross official reserves (including gold)	23.1	23.4	24.1	28.8	26.6	26.6
Gross external debt	41.1	38.5	37.3	32.8	34.4	35.1
	Import months of goods and services					
Gross official reserves (including gold)	4.8	4.2	4.2	5.4	5.0	4.5

Source: Eurostat, national central bank, OeNB, wiiw.
[1] Q2 2004: As a percentage of rolling four-quarter GDP.

3 Hungary: Strong Gross Fixed Capital Formation and High External Deficit

Hungarian GDP grew by 4.1% year on year during the first nine months of 2004 (full-year 2003: 3.0%), with the growth rate gradually easing to 3.7% by the third quarter. Domestic consumption grew by 2.8% during the January to September period, sharply down from 7.3% in 2003. The main reason for this slowdown was the stagnation of real wages and employment. Although off the highs seen in the first quarter of 2004, gross fixed capital formation remained the domestic demand component that delivered the highest contribution to GDP growth in the first nine months of 2004, rising by 13.2% year on year. Particularly strong investment growth marked the largest sectors: manufacturing (26.6%), transport, storage and communications (26.4%) and real estate, renting and business activities (20.3%). Although export and import growth rates were roughly halved from the second to the third quarter, they grew by 15.4% and 16.0% year on year, respectively, during the first nine months. Thus, net exports deteriorated further, implying a negative contribution of 1.2 percentage points to the GDP growth rate during the first nine months of 2004, which was less than the negative contribution of 2.6 percentage points in 2003.

Table 10

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	4.2	5.2	3.8	3.5	3.0	4.3	4.2
Private consumption	5.6	5.5	5.7	10.2	7.6	3.7	5.0
Public consumption	1.5	2.0	6.2	5.0	6.7	0.5	–1.5
Gross fixed capital formation	5.9	7.7	5.0	8.0	3.4	18.9	10.0
Exports of goods and services	12.2	21.0	7.8	3.7	7.6	18.0	18.7
Imports of goods and services	13.3	19.4	5.1	6.2	10.4	16.7	20.4
	Contribution to GDP growth in percentage points						
Domestic demand	5.1	4.7	1.7	5.6	5.6	3.8	6.8
Exports	7.9	14.6	6.3	3.1	6.3	15.4	15.9
Net exports	–1.0	0.5	2.1	–2.1	–2.6	0.4	–2.6

Source: Eurostat, OeNB.

The slowdown of economic activity impacted on the labor market. The unemployment rate rose to 6.1% in the period from August to October 2004 from 5.6% in the same period of 2003. In the same period, the employment rate dropped by 0.6 percentage point to 50.7%. Deteriorating labor market conditions supported wage moderation in the private sector, where nominal gross wage growth slowed down to 8.7% year on year in the third quarter of 2004 from 11.5% in the first quarter. Wage dynamics in the public sector were significantly slower in September (3.3%), though they showed some acceleration from the middle of the year.

In line with expectations, HICP inflation peaked in May 2004 at 7.8% year on year. Since then price pressure has eased gradually, and the inflation rate dropped to 5.7% in November. Disinflation has been supported by falling import prices on the back of the strengthening of the currency and the moderation of inflation expectations. Wage restraint in the private sector despite the sharp rise in prices between mid-2003 and mid-2004 has also been beneficial, as it implied a stagnation of CPI-deflated wages and, thereby, supported the weakening of private consumption growth. Moreover, nominal unit wage costs in industry even declined in year-on-year terms. The Hungarian central bank (Magyar Nemzeti Bank, MNB) expects a sharp drop in inflation to below 5% during the first quarter of 2005, when the effect of indirect tax increases at the beginning of 2004 will drop out of the calculation. Thereafter, disinflation is expected to slow down, mainly on the back of lower food and oil price inflation, while core inflation will remain roughly unchanged. The MNB expects an inflation rate of 4.4% in December 2005, which would be slightly above the midpoint of the inflation target band of 4% ±1 percentage point. According

Table 11

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	10.1	18.5	4.1	2.9	6.3	10.3	10.3
Labor productivity of industry (real)	5.1	17.0	5.6	4.7	8.4	12.8	12.3
Gross average wage of industry (nominal)	13.4	15.0	14.5	12.4	9.4	11.8	10.2
Unit labor cost of industry (nominal)	7.9	−1.7	8.4	7.4	1.0	−0.9	−1.9
Producer price index (PPI) of industry	5.0	11.4	5.7	−1.1	2.5	4.9	4.8
Consumer price index (here: HICP)	10.0	10.0	9.1	5.2	4.7	6.8	7.4
Exchange rate (nominal):							
HUF[1] per 1 EUR, + = EUR appreciation	5.2	2.9	−1.3	−5.3	4.3	6.7	0.5
EUR per 1 HUF, + = HUF appreciation	−4.9	−2.8	1.4	5.6	−4.2	−6.3	−0.5
	Period average levels						
Unemployment rate (ILO definition, %)	7.0	6.4	5.7	5.8	5.9	6.1	5.9
Key interest rate per annum (%)	15.2	11.5	11.1	9.1	8.6	12.5	11.8
Exchange rate (nominal):							
HUF[1] per 1 EUR	252.76	260.07	256.60	242.95	253.51	260.00	252.16
EUR per 1 HUF	0.00396	0.00385	0.00390	0.00412	0.00394	0.00385	0.00397

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

to the MNB, inflation should fall further in 2006, to 3.9% in December, against a target band of 3.5% ±1 percentage point.

Encouraged by the easing of price pressures, the improvement in the structure of GDP growth and the strengthening of the currency during 2004 (+7.6% year on year against the euro in nominal terms in December 2004), the MNB cut interest rates by a total of 300 basis points from the beginning of 2004. At the end of 2004, the policy rate stood at 9.5%. On the other hand, the large current account deficit and the insufficient fiscal tightening in the course of 2004 have reduced the scope for monetary easing in the view of the MNB. The expected decline in inflation and government promises for fiscal tightening have led to general market expectations of further rate cuts at the beginning of 2005.

Table 12

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	17.4	17.7	16.3	10.1	14.2	12.3	11.4
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	10.3	10.3	9.2	2.2	−1.0	−0.5	−2.0
Domestic credit (net) of the banking system	6.0	6.0	10.7	12.3	22.4	20.1	18.9
of which: claims on the private sector	*8.8*	*16.2*	*17.2*	*15.4*	*18.7*	*25.9*	*24.0*
claims on households	*1.6*	*2.7*	*4.2*	*6.3*	*10.6*	*11.5*	*10.8*
claims on enterprises	*7.1*	*13.4*	*13.0*	*9.1*	*8.1*	*14.4*	*13.3*
net claims on the public sector	*−2.7*	*−10.2*	*−6.5*	*−3.1*	*3.7*	*−5.8*	*−5.1*
Other domestic assets (net) of the banking system	1.1	−5.8	−3.6	−4.5	−7.2	−7.3	−5.4

Source: National central bank, OeNB.

The government failed anew to deliver its fiscal promises in 2004, and the budget deficit is estimated at around 5.1% to 5.3% of GDP, compared to the original target of 3.8% in the 2003 Preaccession Economic Program, which had been raised to 4.6% in the March 2004 fiscal notification. However, due to a larger than expected surplus in December, the preliminary deficit matched the government's forecast of September 2004. In its recommendation of July 2004 under the excessive deficit procedure, the Ecofin Council invited the Hungarian authorities to take effective action to reach the deficit targets laid down in the Convergence Program of May 2004 (deficit reduction from 4.6% of GDP in 2004 to 4.1% in 2005 and 2.7% in 2008). By contrast, the Convergence Program of December 2004 targets a deficit reduction to 4.7% in 2005, and also the targets for the remaining program horizon have been adjusted upward. Thus, the Ecofin Council in January 2005 formally decided that Hungary had taken no effective action in response to the Council recommendation of July 5, 2004, within the period laid down in that recommendation. Moreover, both the MNB and the European Commission forecast a deficit ratio for 2005 above the target ratio in the December 2004 program (5.5% and 5.2% of GDP, respectively). Apart from economic risk factors (e.g. higher interest expenditures, lower VAT revenues, higher deficit outside the central government), the political cycle (national and regional elections in 2006) may also negatively affect fiscal developments.[3]

Table 13

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	. .	0.0	44.3	43.4	43.6	0.0	42.5
Expenditures	. .	47.6	48.7	52.6	49.8	48.7	47.6
of which: interest payments	. .	*5.6*	*4.8*	*4.1*	. .	. .	. .
Balance	. .	−3.0	−4.4	−9.2	−6.2	−5.5	−5.2
Primary balance	. .	2.6	0.4	−5.1	−2.1	−1.1	−1.2
Gross public debt	60.9	55.4	53.5	57.2	59.1	59.7	59.5

Source: European Commission.

The worsening trend in the current account has not ended yet. During the first nine months of 2004 the deficit amounted to 9.1% of GDP, up from 8.8% in the same period of 2003. While the trade balance improved year on year (by 1.9% of GDP), the deterioration on the other balances (services, incomes and transfers) outweighed this effect. In part linked to EU transfers, the capital account balance improved by 0.5% of GDP compared to the first nine months of 2003, leading to a modest improvement in the country's overall external financing requirement (current plus capital account). Net FDI inflows intensified during the first nine months of 2004 and covered nearly 40% of the current account deficit.

[3] *All the deficit and debt figures in this paragraph are based on a classification which excludes the funded pension pillar from the government sector. Classifying it as belonging to the government sector would imply a downward revision of the deficit and debt figures, with the deficit in 2004 and 2005 decreasing by about 1.0 percentage point of GDP.*

Table 14

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	24,059	31,278	34,697	36,821	38,161	18,164	21,296
Merchandise exports: year-on-year change in %	*14.3*	*30.0*	*10.9*	*6.1*	*3.6*	*−2.2*	*17.2*
Merchandise imports	26,102	34,457	37,193	39,024	41,132	19,737	22,327
Merchandise imports: year-on-year change in %	*14.8*	*32.0*	*7.9*	*4.9*	*5.4*	*2.4*	*13.1*
Trade balance	−2,044	−3,180	−2,496	−2,203	−2,971	−1,573	−1,031
% of GDP	*−4.5*	*−6.3*	*−4.3*	*−3.2*	*−4.1*	*−4.4*	*−2.7*
Services balance	816	1,207	1,625	591	−170	4	−371
Income balance (factor services balance)	−2,713	−2,792	−3,192	−3,835	−3,930	−2,065	−2,281
Current transfers	408	385	450	547	583	349	100
Current account balance	−3,531	−4,380	−3,613	−4,900	−6,488	−3,285	−3,583
% of GDP	*−7.8*	*−8.7*	*−6.2*	*−7.1*	*−8.9*	*−9.3*	*−9.5*
Direct investment flows (net)	2,872	2,334	3,992	2,734	775	181	840
% of GDP	*6.4*	*4.6*	*6.9*	*4.0*	*1.1*	*0.5*	*2.2*

Source: Eurostat, national central bank, OeNB.

Nevertheless, the country's net foreign debt continued to increase until mid-2004 before falling back slightly to 31.7% of (rolling four-quarter) GDP at the end of September 2004.

Table 15

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (excluding gold)	10,722	12,038	12,164	9,887	10,108	10,517
Gross external debt	29,231	32,572	37,387	38,559	46,504	50,134
	% of GDP[1]					
Gross official reserves (excluding gold)	23.8	23.8	21.0	14.3	13.8	13.9
Gross external debt	64.9	64.4	64.5	55.9	63.5	66.3
	Import months of goods and services					
Gross official reserves (excluding gold)	4.3	3.7	3.4	2.6	2.5	2.4

Source: Eurostat, national central bank, OeNB, wiiw.
[1] Q2 2004: As a percentage of rolling four-quarter GDP.

4 Poland: Strong Currency as a Challenge

GDP growth accelerated to 5.9% year on year in the first three quarters of 2004, against 3.8% in the full year 2003. However, annual growth decreased from 6.9% in the first quarter to 4.8% in the third quarter. In the first three quarters of 2004, private consumption grew at 3.7% year on year, only moderately more strongly than in the full year 2003 (3.1%) and still clearly less than GDP. The main contribution to the acceleration of GDP growth stemmed from gross fixed capital formation, which expanded (at a rate of 3.8%) for the first time after three years of contraction. At 16%, real export growth slightly exceeded the high level of 2003, with the third quarter witnessing a remarkable acceleration of annual growth to 20.4% from 11.3% in the second quarter. However, real import growth accelerated even more strongly both in the first three quarters of 2004 (compared to growth in 2003) and in the third quarter (compared to annual growth in the second quarter), while still remaining below export growth. EU entry effects as well as more powerful foreign demand (combined with the impact of export production on imports) increased export and import growth. The fact that domestic demand speeded up faster than foreign demand explains why import growth exceeded export growth acceleration. While net exports still improved further in the first three quarters of 2004, benefiting from the weaker average exchange rate level in year-on-year terms, their contribution to GDP growth (0.8 percentage point) was smaller than in 2003 (1.3 percentage points). In the third quarter, the contribution of net exports was equal to zero, probably reflecting also the recent currency appreciation.

Table 16

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	4.0	4.0	1.0	1.4	3.8	6.9	6.1
Private consumption	5.3	2.8	2.1	3.3	3.1	3.9	3.8
Public consumption	1.0	1.1	0.6	0.6	0.4	1.3	2.5
Gross fixed capital formation	9.2	2.7	−8.8	−5.8	−0.9	3.5	3.6
Exports of goods and services	−3.2	23.2	3.1	4.8	14.7	16.0	11.3
Imports of goods and services	1.1	15.6	−5.3	2.6	9.3	11.3	8.3
	Contribution to GDP growth in percentage points						
Domestic demand	5.4	−0.1	−1.7	0.8	2.5	5.4	4.7
Exports	−1.0	9.7	0.9	1.3	4.4	5.0	3.8
Net exports	−1.4	4.2	2.7	0.5	1.3	1.3	0.9

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

Coming to 19.1%, the unemployment rate (ILO definition) was slightly lower in the second quarter than a year earlier (19.4%). Similarly, the registered unemployment rate decreased to 19.1% in the third quarter from 19.5% a year earlier, reflecting stronger economic growth. Correspondingly, in the first three quarters of 2004, labor shedding in industry nearly came to a halt (–0.5% year on year) and labor productivity growth (15.6%) exceeded the slightly rising nominal wage growth (5.3%) by far, implying an even more pronounced fall in nominal industrial unit wage costs (8.9%) than in 2003. However, industrial producer price inflation rose to 7.3% year on year in that period from 2.7% in 2003, inter alia because of higher oil prices and the zloty's 10% depreciation against the euro from August 2003 to February 2004. After a peak in May (9.6% year on year), industrial producer price inflation fell to 6.7% in November, supported by the zloty's reappreciation by 14% against the euro from February to November. Inflation (HICP) rose from a low of 0.7% year on year in August 2003 to 4.9% in August 2004. This was mainly a result of higher energy prices and an increase in food prices (which was partly EU accession-related), while the increase of other manufactured goods prices still remained nearly negligible, despite the increase in industrial producer prices. By November 2004, HICP inflation had declined to 4.5% year on year. In an effort to contain the surge of inflationary expectations and to achieve the target corridor of 1.5% to 3.5%, the Monetary Policy Council raised the key interest rate (two-week rate on central bank bills) by a total of 1.25 percentage points to 6.5% in three steps between the end of June and the end of August, after it had stood at 5.25%

Table 17

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	4.7	7.8	0.6	1.4	8.6	18.7	16.6
Labor productivity of industry (real)	9.6	17.9	6.1	7.4	11.4	19.6	17.0
Gross average wage of industry (nominal)	34.1	10.9	6.9	3.7	3.0	6.6	4.8
Unit labor cost of industry (nominal)	22.3	−5.9	0.8	−3.4	−7.5	−10.9	−10.5
Producer price index (PPI) of industry	5.7	7.8	1.7	1.1	2.7	4.4	8.9
Consumer price index (here: HICP)	7.2	10.1	5.3	1.9	0.7	1.8	3.4
Exchange rate (nominal):							
PLN[1] per 1 EUR, + = EUR appreciation	8.0	−5.2	−8.4	5.0	14.1	14.0	7.6
EUR per 1 PLN, + = PLN appreciation	−7.4	5.5	9.2	−4.7	−12.4	−12.3	−7.1
	Period average levels						
Unemployment rate (ILO definition, %)	. .	16.1	18.3	19.9	19.6	20.7	19.1
Key interest rate per annum (%)	13.7	17.9	16.0	8.8	5.6	5.3	5.3
Exchange rate (nominal):							
PLN[1] per 1 EUR	4.23	4.01	3.67	3.85	4.40	4.78	4.69
EUR per 1 PLN	0.2365	0.2495	0.2725	0.2595	0.2274	0.2094	0.2133

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

for about a year. Taking into account the zloty's strong appreciation, there were no further interest rate hikes in 2004.

After the real key interest rate (12-month moving average) had fallen continuously from 4.3% in December 2003 to 0.5% in August 2004, it increased to 1.2% in November 2004.[4] While the decline of real interest rates eased monetary conditions, the real appreciation by 10.8% (CPI-deflated) and 11.6% (PPI-deflated) during the 12-month period up to November had a tightening effect. In the first half of 2004, annual real money growth remained below GDP growth. While lending to households made the largest contribution to money growth, bank lending to enterprises stagnated in nominal terms and declined

Table 18

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	24.7	15.4	12.1	2.0	1.5	5.3	7.1
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	7.8	7.0	4.5	0.9	0.0	2.8	5.3
Domestic credit (net) of the banking system	25.1	13.5	7.2	7.1	5.2	6.2	4.6
of which: claims on the private sector	*18.5*	*15.7*	*8.3*	*3.4*	*3.8*	*4.9*	*4.4*
claims on households	*6.2*	*7.0*	*4.2*	*2.8*	*2.5*	*3.9*	*4.7*
claims on enterprises	*12.3*	*8.7*	*4.1*	*0.5*	*1.3*	*1.0*	*−0.2*
net claims on the public sector	*6.7*	*−2.1*	*−1.1*	*3.7*	*1.4*	*1.3*	*0.2*
Other domestic assets (net) of the banking system	−8.3	−5.1	0.4	−6.0	−3.8	−3.7	−2.8

Source: National central bank, OeNB.

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

in real terms. Without the increase of net foreign assets real money would have stagnated, and this increase stemmed only from the statistical effect of the year-on-year depreciation of the zloty in that period.

The December 2004 update of the government's convergence program expects a deficit of 5.4% of GDP in 2004 (based on real GDP growth of 5.7%) against a deficit ratio of 5.7% anticipated in the May 2004 program (based on assumed real GDP growth of 5.0%). A substantial part of the deficit widening from 2003 to 2004 resulted from the fiscal impact of EU accession. The December program expects the public debt-to-GDP ratio to have risen from 45.4% at end-2003 to 45.9% (against 49.0% in the May program) at end-2004. According to the Ecofin recommendation under the excessive deficit procedure in July 2004, Poland should take effective action to achieve the 2005 deficit target set in May and reach a deficit of below 3% by 2007. In line with the draft national budget, the December program sets the deficit target for 2005 at 3.9% of GDP against 4.2% in the May program and the European Commission's autumn forecast of 4.1%. It expects the debt-to-GDP ratio to rise to 47.6% at end-2005.[5]

Table 19

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	44.9	42.5	43.8	43.9	43.7	45.6	45.7
Expenditures	47.0	44.2	47.7	48.1	47.6	51.3	49.9
of which: interest payments	*2.0*	*2.1*	*3.0*	*2.9*	*3.1*	*3.1*	*3.1*
Balance	–1.4	–0.7	–3.8	–3.6	–3.9	–5.6	–4.1
Primary balance	0.6	1.4	–0.8	–0.7	–0.8	–2.5	–1.0
Gross public debt	40.1	36.8	36.7	41.1	45.4	47.7	49.8

Source: European Commission.

Corresponding to further improving real net exports, the deficit in the goods and services balance in the balance of payments shrank further to 1.6% of GDP in the first three quarters of 2004 from 2.7% a year earlier. This can be attributed inter alia to the substantially weaker level of the real (unit wage cost-deflated) exchange rate in the first three quarters of 2004, owing to both the depreciation of the average nominal exchange rate by 6.5% year on year (despite the appreciation since the end of February) and the nominal fall of industrial unit wage costs by 9% year on year. The current account deficit, which shrank in parallel, declining to 1.5% of GDP from 2.5% a year earlier, was fully covered by net direct investment inflows at 1.6% of GDP.

Significant portfolio net inflows outpaced net other investment outflows and led to an increase in gross official reserves. However, the rise in the ratio to GDP (in percentage points) of both reserves and gross external debt in the first half of 2004 was not only due to increased absolute levels; about half of the rise was the result of the depreciation of the average nominal year-on-year exchange rate in that period.

[5] *All deficit and debt figures in this paragraph are based on classifying the defined contribution pension schemes (open pension funds) inside the government sector. According to Eurostat rulings in 2004, a reclassification has to be implemented by 2007, which would imply an upward revision of the deficit and debt figures (permanent deficit increase by about 1.5 percentage points of GDP).*

Table 20

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	28,215	39,028	46,487	49,324	53,813	25,215	31,392
Merchandise exports: year-on-year change in %	*−2.5*	*38.3*	*19.1*	*6.1*	*9.1*	*6.8*	*24.5*
Merchandise imports	42,361	52,359	55,075	57,036	58,890	27,836	33,729
Merchandise imports: year-on-year change in %	*4.9*	*23.6*	*5.2*	*3.6*	*3.3*	*0.1*	*21.2*
Trade balance	−14,146	−13,331	−8,588	−7,712	−5,077	−2,621	−2,337
% of GDP	*−9.2*	*−7.4*	*−4.1*	*−3.8*	*−2.7*	*−2.9*	*−2.6*
Services balance	1,297	1,551	905	861	434	−76	380
Income balance (factor services balance)	−948	−1,609	−1,585	−1,993	−3,191	−1,793	−1,718
Current transfers	2,078	2,595	3,226	3,434	3,724	1,661	1,785
Current account balance	−11,719	−10,794	−6,042	−5,410	−4,110	−2,829	−1,890
% of GDP	*−7.6*	*−6.0*	*−2.9*	*−2.7*	*−2.2*	*−3.1*	*−2.1*
Direct investment flows (net)	6,795	10,253	6,457	4,144	3,499	1,917	1,844
% of GDP	*4.4*	*5.7*	*3.1*	*2.0*	*1.9*	*2.1*	*2.1*

Source: Eurostat, national central bank, OeNB.

Table 21

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (excluding gold)	26,224	28,555	29,031	27,367	26,000	28,871
Gross external debt	65,121	74,671	81,461	81,045	83,939	92,607
	% of GDP[1]					
Gross official reserves (excluding gold)	17.0	15.8	14.0	13.5	14.0	15.8
Gross external debt	42.2	41.3	39.3	40.0	45.4	50.6
	Import months of goods and services					
Gross official reserves (excluding gold)	6.4	5.5	5.4	4.9	4.6	4.6

Source: Eurostat, national central bank, OeNB, wiiw.
[1] Q2 2004: As a percentage of rolling four-quarter GDP.

5 Slovak Republic: Positive Developments after the Tax Reform

In the first three quarters of 2004 the Slovak economy boomed, with GDP growth coming to 5.4% year on year, after 4.2% in the full year 2003. Foreign demand was partially replaced by domestic demand, which may reflect first positive effects of the tax reform of January 2004. Private consumption grew by 3.2% (after a decline by 0.6% in 2003) and gross fixed capital formation confirmed the turnaround (+3.4%) after two years of decline. Public consumption continued to grow moderately at 1.8%. Despite the revival of domestic demand, real import growth (12.9%) was slightly lower than in 2003, as export growth slowed down from the high rate of 22.5% in 2003 to 16.1% year on year in the first half of 2004 and to 12.2% in the first three quarters of 2004. In the third quarter, the year-on-year export growth was relatively low (5%), which was mainly due to new production upgrades at Volkswagen Bratislava. However, trade data according to customs statistics show a continuation of fast export growth after July, which indicates that the full-year figure should improve again. In contrast to previous years, net exports deteriorated in the first three quarters of 2004, implying a slightly negative contribution to annual GDP growth.

Table 22

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	1.5	2.0	3.8	4.6	4.5	5.4	5.5
Private consumption	3.2	−0.8	4.7	5.5	−0.6	3.1	2.9
Public consumption	−7.1	1.6	4.6	4.9	2.7	−2.6	4.7
Gross fixed capital formation	−19.6	−7.2	13.9	−0.6	−1.5	0.9	3.5
Exports of goods and services	5.0	13.7	6.3	5.6	22.5	15.8	16.4
Imports of goods and services	−6.7	10.5	11.0	5.5	13.6	12.0	17.0
	Contribution to GDP growth in percentage points						
Domestic demand	−7.0	0.1	7.5	4.7	−2.1	1.8	5.5
Exports	3.3	9.4	4.8	4.3	17.7	13.8	14.8
Net exports	8.4	1.9	−3.7	−0.1	6.5	3.5	0.0

Source: Eurostat, national statistical office, OeNB.

Despite high economic growth, the unemployment rate (ILO definition) increased to 19.1% in the first half of 2004, from 17.8% a year earlier, and industrial employment declined by 0.6% year on year. As a result, industrial labor productivity growth increased to 6.7%, from 4.7% in 2003. While industrial wage growth accelerated more strongly, reaching 9.5%, the implied further rise of unit wage costs remained below producer price inflation. Higher wage growth in combination with moderate disinflation led to a real wage growth of 1.3% (after a decline in 2003) and supported private consumption.

Following the tax reform of January 2004, which inter alia comprised the increase of lower VAT rates for some goods at the uniform level of 19%, and owing to a further liberalization of administered prices, inflation (HICP) declined only modestly from 9.3% in December 2003 to 8.3% year on year

Table 23

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	−2.0	8.3	7.6	6.7	5.5	6.5	5.7
Labor productivity of industry (real)	1.0	11.8	6.6	6.5	4.9	7.5	5.9
Gross average wage of industry (nominal)	7.9	9.1	10.2	7.3	7.3	10.8	8.3
Unit labor cost of industry (nominal)	6.8	−2.4	3.4	0.7	2.3	3.1	2.2
Producer price index (PPI) of industry	3.9	10.8	6.5	2.0	8.3	2.9	2.8
Consumer price index (here: HICP)	10.4	12.2	7.2	3.5	8.5	8.2	8.0
Exchange rate (nominal):							
SKK[1] per 1 EUR, + = EUR appreciation	11.7	−3.4	1.6	−1.4	−2.8	−2.9	−2.8
EUR per 1 SKK, + = SKK appreciation	−10.5	3.6	−1.6	1.4	2.9	3.0	2.9
	Period average levels						
Unemployment rate (ILO definition, %)	16.3	18.8	19.3	18.7	17.6	19.5	18.6
Key interest rate per annum (%)	. .	. .	8.8	7.9	6.4	5.9	5.0
Exchange rate (nominal):							
SKK[1] per 1 EUR	44.12	42.60	43.30	42.68	41.49	40.56	40.08
EUR per 1 SKK	0.0227	0.0235	0.0231	0.0234	0.0241	0.0247	0.0250

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

in July 2004. However, inflation went down to 6.0% in November, as inflation expectations remained under control, indicated by the fact that core inflation was relatively stable during the whole period, coming to 2.0% year on year in November.

The monetary policy strategy of Národná banka Slovenska (NBS) is based on inflation and monetary indicators, but also takes account of exchange rate developments (managed floats). To contain the appreciation of the Slovak koruna against the euro, the NBS cut the key interest rate (two-week repo tender limit rate) four times (in March, April, June and November) by a total of 2.0 percentage points to 4.0%, and it intervened on the foreign exchange market. As a result, the nominal appreciation against the euro could be limited to below 4% year on year in November, with the real (PPI-deflated) appreciation being about 0.5 percentage point higher. In the first three quarters, real money growth was slightly negative, as net foreign assets declined (partly owing to the valuation effect of the appreciation) and the growth of lending to the corporate sector decreased. By contrast, growth of both lending to households and net government credit markedly accelerated.

Table 24

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	8.1	14.1	12.7	8.7	5.5	4.4	2.5
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	–4.9	6.6	2.7	13.5	7.7	–3.8	–2.4
Domestic credit (net) of the banking system	13.6	3.7	12.2	0.4	–1.9	13.8	10.9
of which: claims on the private sector	*4.9*	*2.2*	*–13.9*	*–1.0*	*4.9*	*6.1*	*6.5*
claims on households	*1.7*	*2.0*	*1.2*	*1.4*	*2.2*	*3.5*	*4.0*
claims on enterprises	*3.2*	*0.2*	*–15.1*	*–2.3*	*2.7*	*2.6*	*2.5*
net claims on the public sector	*8.7*	*1.5*	*26.1*	*1.4*	*–6.7*	*7.7*	*4.4*
Other domestic assets (net) of the banking system	–0.5	3.8	–2.2	–5.2	–0.4	–5.7	–6.1

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

In January 2004 a far-reaching tax reform was implemented, comprising the introduction of a flat income tax rate at a uniform level of 19% and the unification of the VAT rate at 19%. Simultaneously, the system of social benefits was reformed. The December 2004 update of the government's convergence program expects a deficit of 3.8% of GDP in 2004 (based on real GDP growth of 5.0%) against a deficit ratio of 4.0% expected in the May 2004 program (based on assumed real GDP growth of 4.1%). This fiscal performance, which was better than expected, is attributable to tax revenues being above the target after the tax reform. This is particularly true for personal and corporate income tax. Budgetary expenditures, however, were roughly at the target level, largely due to lower transfers to the EU budget than expected. The December program expects the public debt-to-GDP ratio to have risen from 42.8% at end-2003 to 43.0% at end-2004 (against 45.1% in the May program). According to the Ecofin recommendation under the excessive deficit procedure in July 2004, Slovakia should take effective action to achieve the 2005 deficit target set in May and reach a deficit below 3% by 2007. In line with the national budget law, the December program sets the deficit target for 2005 at 3.8% of GDP as compared to 3.9% in the May program and the European Commission's autumn forecast of 4.0%. It expects the debt-to-GDP ratio to rise to 44.2% at end-2005.[6]

Table 25

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	49.8	47.6	45.5	45.2	35.6	34.6	34.5
Expenditures	56.9	59.9	51.5	50.9	39.2	38.3	38.3
of which: interest payments	*3.4*	*4.1*	*4.0*	*3.6*	*2.5*	*2.3*	*2.4*
Balance	−7.1	−12.3	−6.0	−5.7	−3.7	−3.9	−4.0
Primary balance	−3.8	−8.2	−2.0	−2.1	−1.2	−1.6	−1.6
Gross public debt	47.2	49.9	48.7	43.3	42.6	44.2	45.2

Source: European Commission.

As a result of recovering domestic demand, the trade balance and current account deficits increased to 2.5% and 2.9% of GDP, respectively, in the first three quarters of 2004, against deficits of 1.7% and 0.8% of GDP, respectively, a year earlier. However, net capital inflows increased as well. New greenfield investment (especially Hyundai) led to net FDI inflows of 3.5% of GDP in the first three quarters of 2004, against 2.0% a year earlier. At the same time, portfolio investment showed net inflows of 3.7% of GDP, against net outflows of 1.8% a year earlier.

Table 26

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	9,607	12,866	14,119	15,281	19,365	9,044	10,861
Merchandise exports: year-on-year change in %	*0.5*	*33.9*	*9.7*	*8.2*	*26.7*	*25.5*	*20.1*
Merchandise imports	10,633	13,838	16,494	17,539	19,934	9,281	11,192
Merchandise imports: year-on-year change in %	*−8.8*	*30.1*	*19.2*	*6.3*	*13.7*	*13.5*	*20.6*
Trade balance	−1,027	−971	−2,376	−2,259	−569	−237	−331
% of GDP	*−5.4*	*−4.4*	*−10.2*	*−8.8*	*−2.0*	*−1.7*	*−2.1*
Services balance	208	476	536	483	210	56	107
Income balance (factor services balance)	−281	−382	−350	−485	−107	−127	−316
Current transfers	184	128	237	206	217	126	23
Current account balance	−916	−750	−1,953	−2,054	−249	−182	−516
% of GDP	*−4.8*	*−3.4*	*−8.4*	*−8.0*	*−0.9*	*−1.3*	*−3.3*
Direct investment flows (net)	737	2,048	1,726	4,272	488	487	777
% of GDP	*3.9*	*9.3*	*7.4*	*16.6*	*1.7*	*3.5*	*4.9*

Source: Eurostat, national central bank, OeNB.

[6] *The deficit and debt figures for 2005 are based on a classification which excludes the funded pension pillar introduced in 2005 from the government sector. Classifying it as belonging to the government sector would imply a downward revision of the deficit and debt figures, with the 2005 deficit decreasing by 0.4 percentage point of GDP.*

The country's gross foreign debt increased slightly from 49.5% of GDP at the end of 2003 to 49.7% of annual (rolling four-quarter) GDP at end-June 2004.

Table 27

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (including gold)	3,410	4,391	4,748	8,824	9,717	10,165
Gross external debt	. .	. .	. .	12,576	14,323	15,394
	% of GDP[1]					
Gross official reserves (including gold)	17.8	20.0	20.4	34.3	33.5	32.8
Gross external debt	. .	. .	. .	48.9	49.5	49.7
	Import months of goods and services					
Gross official reserves (including gold)	3.3	3.3	3.0	5.3	5.2	4.9

Source: Eurostat, national central bank, OeNB, wiiw.
[1] *Q2 2004: As a percentage of rolling four-quarter GDP.*

6 Slovenia: Falling Inflation Supported by a Stable Exchange Rate

GDP growth in Slovenia amounted to 4.5% year on year during the first nine months of 2004, with the growth rate gradually increasing in the course of the year. Within domestic demand, the expansion of gross fixed capital formation was the most dynamic (+6.9%), despite a gradual deceleration. Supported by the acceleration of public consumption growth, domestic consumption strengthened in the course of 2004, growing by 3.0% during the first nine months. Following a slowdown in the second quarter, private consumption growth picked up in the third quarter and reached 3.8% year on year, supported by a similar development of wages. During the first nine months of 2004, exports and imports grew at the same pace (+11.6%). As a result, the negative contribution of net exports to GDP growth diminished to 0.3% during the period from January to September 2004, after having stood at 2.2% for both the same period of 2003 and the full year 2003. In fact, net exports added 0.9 percentage points to the GDP growth rate in the third quarter.

Table 28

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	5.6	3.9	2.7	3.3	2.5	3.9	4.7
Private consumption	5.9	0.4	2.3	0.3	2.7	3.8	3.1
Public consumption	2.9	2.3	3.9	1.7	2.6	0.2	1.6
Gross fixed capital formation	21.0	0.6	4.1	3.1	6.3	7.9	6.5
Exports of goods and services	1.6	13.0	6.3	6.7	3.2	9.1	13.7
Imports of goods and services	8.0	7.6	3.0	4.9	6.8	10.2	14.5
	Contribution to GDP growth in percentage points						
Domestic demand	9.4	1.5	1.0	2.3	4.7	4.7	5.6
Exports	0.9	7.1	3.5	3.9	1.9	5.5	8.2
Net exports	–3.9	2.4	1.7	1.0	–2.2	–0.8	–0.9

Source: Eurostat, national statistical office, OeNB.

Strengthening economic activity was also reflected by a decline in the unemployment rate to 6% in the third quarter of 2004 from 6.6% a year earlier. At the same time, the employment rate rose from 52.6% to 56.7%. Tightening labor market conditions were reflected in the slight increase in nominal wage growth rates between the first and third quarters of 2004 (from 5.7% to 5.9% year on year, while inflation marginally declined (from 3.7% to 3.6%). However, productivity gains largely compensated for the wage increases, and unit wage costs in the industry in fact stagnated during the first half of 2004 (+0.4% year on year), compared to an increase by 4.4% in 2003.

The inflation rate (HICP) bottomed out in March 2004 at 3.5% year on year. After this point, inflation was rather volatile. Owing to administered price increases and rising oil prices, price growth accelerated until mid-year to 3.9% before falling back to 3.4% in October. In November inflation picked up again, reaching 3.8% on the back of higher food and energy prices. The increase in inflation was anticipated by Banka Slovenije, which had raised its inflation forecast for the fourth quarter to 3.5% in October 2004 (from 3.2%). The Slovenian central bank expects disinflation to resume in 2005, with the rate falling to 2.5% in the last quarter. According to Banka Slovenije, disinflation should be supported by weaker growth in administered prices (including the impact of excise tax changes on fuel), a favorable composition of GDP growth, exchange rate stability and wage increases lagging behind productivity gains.

Table 29

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	−0.5	6.3	3.1	2.5	1.4	4.0	7.4
Labor productivity of industry (real)	0.9	6.8	2.3	1.4	3.0	5.6	8.4
Gross average wage of industry (nominal)	9.3	11.7	10.8	9.9	7.6	8.0	6.6
Unit labor cost of industry (nominal)	8.3	4.6	8.4	8.3	4.4	2.3	−1.7
Producer price index (PPI) of industry	2.2	7.7	8.9	5.3	2.6	3.3	4.3
Consumer price index (here: HICP)	6.1	8.9	8.6	7.5	5.7	3.7	3.8
Exchange rate (nominal):							
SIT[1] per 1 EUR, + = EUR appreciation	4.6	6.3	5.5	3.6	3.5	2.8	2.5
EUR per 1 SIT, + = SIT appreciation	−4.4	−5.9	−5.2	−3.5	−3.4	−2.7	−2.5
	Period average levels						
Unemployment rate (ILO definition, %)	7.4	6.7	6.2	6.3	6.7	6.8	6.8
Key interest rate per annum (%)	7.2	8.1	10.5	8.4	7.0	5.6	4.6
Exchange rate (nominal):							
SIT[1] per 1 EUR	194.43	206.63	217.98	225.93	233.82	237.65	238.86
EUR per 1 SIT	0.00514	0.00484	0.00459	0.00443	0.00428	0.00421	0.00419

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

Since Slovenia entered ERM II on June 28, 2004, the exchange rate of the tolar against the euro has fluctuated in a very narrow range of between 0.03% and 0.17% on the weak side of the fluctuation band. Apart from some foreign exchange intervention between June 28 and July 1, 2004, intended to signal that the trend depreciation was over, Banka Slovenije intervened only once on the foreign exchange market at the end of July. The Slovenian central bank left its key policy rates unchanged from the point Slovenia joined ERM II until mid-December 2004. On December 23, however, it increased two of its rates (buy/sell foreign exchange swap rate and main refinancing rate) by 25 basis points, while leaving the interest rates on its money market-relevant tolar-denominated bills unchanged. Correspondingly, money market rates have been stable at around 4% since late June 2004. While the current interest rate level helps to discourage speculative capital inflow, backward-looking real interest rates are low at around 0.5% as measured by the differential between the 12-month interbank rate and the year-on-year CPI rate. The growth of credit to the private sector gathered pace in the course of 2004, reaching nearly 15% in CPI-deflated terms in October (December 2003: 10.7%).

Table 30

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	. .	13.7	19.2	22.8	12.7	5.8	5.8
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	. .	3.1	9.1	11.0	3.3	−5.3	−7.1
Domestic credit (net) of the banking system	. .	15.1	14.4	12.2	10.4	15.7	14.1
of which: claims on the private sector	. .	*15.1*	*12.6*	*9.1*	*8.0*	*10.4*	*11.3*
claims on households	. .	*4.4*	*2.0*	*1.6*	*1.5*	*2.0*	*2.4*
claims on enterprises	. .	*10.7*	*10.6*	*7.5*	*6.5*	*8.4*	*8.9*
net claims on the public sector	. .	*0.0*	*1.7*	*3.2*	*2.4*	*5.3*	*2.8*
Other domestic assets (net) of the banking system	. .	−4.4	−4.2	−0.4	−1.0	−4.6	−1.3

Source: National central bank, OeNB.

Despite the upward revision of the 2004 budget deficit projection (due to methodological changes and subdued VAT revenues), fiscal policy in Slovenia continues to be relatively well contained. The European Commission expects a deficit of around 2% of GDP in 2005 and 2006. At slightly below 31% of GDP, the public debt ratio is well within the Maastricht limit.

Table 31

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	. .	44.7	45.1	45.7	46.2	45.2	44.6
Expenditures	. .	48.2	47.9	48.1	48.2	47.5	46.8
of which: interest payments	. .	*2.4*	*2.4*	*2.3*	*2.1*	*2.0*	*1.9*
Balance	. .	−3.5	−2.8	−2.4	−2.0	−2.3	−2.2
Primary balance	. .	−1.0	−0.4	0.0	0.1	−0.3	−0.2
Gross public debt	24.9	27.4	28.1	29.5	29.4	30.9	30.8

Source: European Commission.

During the first nine months of 2004, Slovenia registered a current account deficit of 0.1% of GDP, practically unchanged as compared to the period of January to September 2003. The increase in the trade deficit could be compensated by a larger services balance surplus and a smaller income balance deficit. Both the volume of FDI inflows and outflows increased modestly, but net FDI registered an outflow of 0.6% of GDP, unchanged from the first nine months of 2003.

Table 32

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	8,103	9,574	10,454	11,082	11,414	5,643	6,177
Merchandise exports: year-on-year change in %	*0.2*	*18.2*	*9.2*	*6.0*	*3.0*	*2.2*	*9.5*
Merchandise imports	9,267	10,801	11,139	11,351	11,960	5,927	6,561
Merchandise imports: year-on-year change in %	*5.4*	*16.6*	*3.1*	*1.9*	*5.4*	*4.9*	*10.7*
Trade balance	−1,164	−1,227	−684	−269	−546	−284	−383
% of GDP	*−5.8*	*−6.0*	*−3.1*	*−1.1*	*−2.2*	*−2.4*	*−3.0*
Services balance	330	489	536	617	538	307	335
Income balance (factor services balance)	58	29	43	−154	−178	−125	−79
Current transfers	112	126	144	142	94	28	59
Current account balance	−664	−583	38	335	−91	−75	−68
% of GDP	*−3.3*	*−2.8*	*0.2*	*1.4*	*−0.4*	*−0.6*	*−0.5*
Direct investment flows (net)	55	77	251	1,582	−115	−22	−88
% of GDP	*0.3*	*0.4*	*1.2*	*6.7*	*−0.5*	*−0.2*	*−0.7*

Source: Eurostat, national central bank, OeNB.

Owing to the small deficit on the current account, the deficit on the capital account (0.6% of GDP) and net FDI outflow, net foreign debt continued to rise, but still reached only 4.3% of GDP in September 2004.

Table 33

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (excluding gold)	3,159	3,436	4,908	6,702	6,798	6,476
Gross external debt	8,012	9,491	10,403	11,483	13,305	14,349
	% of GDP[1]					
Gross official reserves (excluding gold)	15.9	16.7	22.5	28.5	27.7	25.7
Gross external debt	40.2	46.1	47.6	48.8	54.1	56.9
	Import months of goods and services					
Gross official reserves (excluding gold)	3.5	3.3	4.6	6.1	5.9	5.2

Source: Eurostat, national central bank, OeNB, wiiw.
[1] *Q2 2004: As a percentage of rolling four-quarter GDP.*

7 Bulgaria: More Balanced Credit Activity in the Country? When?

In the first three quarters of 2004, real GDP in Bulgaria grew by 5.7% year on year, up from 4.3% in the full year 2003. Annual growth in the third quarter was 5.8%. At the same time, the structure of growth became less imbalanced, as domestic consumption growth continuously decreased to 4.3% year on year in the first three quarters against 6.5% in the full year 2003 due to higher inflation and the resulting stagnation in real (CPI-deflated) wages. By contrast, high gross fixed capital formation growth at 12.4% year on year in the first three quarters of 2004 was only slightly lower than in the full year 2003 (13.8%). Given the investment boom in sectors such as tourism, textiles, machinery, transport and vehicles, real annual import growth remained high (albeit declining from quarter to quarter) at 13.6% in the first three quarters of 2004, after having come to 14.8% in the full year 2003. As real annual export growth continuously increased to 12% in the first three quarters of 2004 (full-year 2003: 7.9%), the deterioration in net exports was less pronounced than in 2003, resulting in a negative contribution to GDP growth of 3.9 percentage points (full-year 2003: 7.2 percentage points).

Table 34

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	2.4	5.4	4.1	4.9	4.3	5.3	6.0
Private consumption	9.6	4.3	5.2	3.5	6.4	5.5	4.9
Public consumption	6.3	18.8	0.3	4.4	7.3	2.9	0.3
Gross fixed capital formation	20.8	15.4	23.3	8.5	13.8	21.4	6.3
Exports of goods and services	−4.6	16.6	9.9	7.2	7.9	8.0	10.9
Imports of goods and services	9.3	18.7	14.8	4.9	14.8	17.7	11.3
	Contribution to GDP growth in percentage points						
Domestic demand	11.0	8.7	9.2	4.3	11.5	16.8	9.9
Exports	−2.7	9.3	6.1	4.7	5.3	5.7	8.1
Net exports	−8.6	−3.3	−5.1	0.6	−7.2	−11.6	−4.0

Source: Eurostat, OeNB, wiiw.

Corresponding to high growth, the unemployment rate (ILO definition) decreased to 12% in the second quarter of 2004 from 13.7% in the same period of 2003; the registered unemployment rate was 11.9% in November 2004 compared to 13.2% in November 2003. Very high industrial output growth in the first half of 2004 and only slightly higher industrial employment implied labor productivity advances far above wage growth. Thus, in the first half of 2004, nominal industrial unit wage costs decreased by 9% year on year, while producer prices increased by 4.5% year on year. After a peak in producer price inflation of 8.1% year on year in July, caused by climbing oil prices and raw

Table 35

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	−9.6	5.3	2.5	4.7	15.3	16.2	19.0
Labor productivity of industry (real)	1.2	10.0	7.6	2.2	12.0	15.8	18.0
Gross average wage of industry (nominal)	8.0	6.6	7.4	3.7	4.5	5.9	6.6
Unit labor cost of industry (nominal)	6.7	−3.1	−0.2	1.4	−6.7	−8.5	−9.6
Producer price index (PPI) of industry	3.2	17.0	3.8	1.4	5.0	1.9	7.1
Consumer price index (here: HICP)	2.6	10.3	7.4	5.8	2.3	6.4	6.7
Exchange rate (nominal):							
BGN[1] per 1 EUR, + = EUR appreciation	−0.7	−0.2	−0.2	0.1	0.0	−0.1	0.1
EUR per 1 BGN, + = BGN appreciation	0.7	0.2	0.2	−0.1	0.0	0.1	−0.1
	Period average levels						
Unemployment rate (ILO definition, %)	. .	16.9	20.3	18.2	13.7	13.4	12.0
Key interest rate per annum (%)	4.7	3.9	4.5	4.0	2.7	2.5	3.0
Exchange rate (nominal):							
BGN[1] per 1 EUR	1.956	1.952	1.948	1.949	1.949	1.949	1.952
EUR per 1 BGN	0.5113	0.5123	0.5133	0.5130	0.5131	0.5124	0.5130

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiw.
[1] *BGN: Bulgarian lev.*

material prices, the producer price increase moderated to 7.3% year on year in November 2004. In parallel, CPI inflation accelerated from 5.6% year on year in December 2003 to 7.6% in July and then fell to 4.5% year on year in November. In addition to higher oil and industrial producer prices, the acceleration of inflation from 2.3% in 2003 to 6.6% year on year in the first three quarters of 2004 was also driven by the rise in food prices (8.2% year on year) and the adjustments to regulated prices (electricity, natural gas, heating costs).

Money growth was driven primarily by credit growth to households and companies, while the increase of net foreign assets played a minor role and net credit to government decreased. Compared to the peak of annual growth rates in the first quarter of 2004 (household credit: 83%, corporate sector credit: 43%), credit expansion slowed down slightly to annual growth rates of 76% and 38%, respectively, in October, perhaps as a result of a number of measures taken to contain credit growth: First, the Bulgarian National Bank (BNB) required even small (mostly consumer) loans to be registered with the BNB; second, the Ministry of Finance transferred fiscal reserves from commercial banks to the BNB; third, recommended by the IMF, the BNB extended the coverage of minimum reserve requirements to include deposits with a maturity of over two years, albeit at the reduced rate of 4% (against the standard rate of 8%). However, credit growth to the nongovernment sector was still higher in October at a rate of 40% year on year in real (CPI-deflated) terms than the growth rate of 30% to 35% recommended by the IMF. Thus, the BNB introduced new minimum reserve requirements as of December 6, 2004. First, banks have to set aside 8% of all funds attracted, and second, banks' cash will be fully excluded when calculating the amount of the minimum reserve to be maintained with the central bank.

Table 36

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	7.9	27.4	27.8	18.3	16.3	21.3	24.5
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	−0.2	26.1	13.5	7.7	5.4	2.7	4.1
Domestic credit (net) of the banking system	2.0	6.8	15.0	12.1	14.5	20.6	23.3
of which: claims on the private sector	*9.5*	*8.7*	*8.1*	*13.6*	*19.9*	*24.4*	*26.3*
claims on households	*2.6*	*1.1*	*2.4*	*3.3*	*5.9*	*8.5*	*9.8*
claims on enterprises	*6.9*	*7.7*	*5.7*	*10.3*	*14.0*	*15.8*	*16.6*
net claims on the public sector	*−7.4*	*−2.0*	*6.9*	*−1.5*	*−5.4*	*−3.8*	*−3.1*
Other domestic assets (net) of the banking system	6.0	−5.5	−0.7	−1.5	−3.6	−1.9	−2.9

Source: National central bank, OeNB.

After the budget was balanced in 2003, a surplus in the consolidated budget (national definition) of 4.7% of GDP was achieved in the first three quarters of 2004, against 3.4% in the same period of 2003; this result is attributable to an increase in the revenue ratio by 0.6 percentage points to 42% and a decrease in the expenditure ratio by 0.7 percentage points to 37.3% of GDP. The European Commission's autumn forecast expects a fiscal balance surplus of 0.5% of GDP for the full year 2004 and a deficit of 1.0% of GDP for 2005, while the government plans a deficit of 0.5% of GDP, taking into account the 2005 tax reform. This reform comprises a cut in the corporate tax rate from 19.5% to 15%, a reduction in the income tax rate in each tax bracket by 2% (and 5% in the highest tax bracket) and an increase in the tax-exempt income from 120 lev to 130 lev. In addition, part of the package is to raise excise taxes on alcohol and tobacco products to counter the resulting revenue shortfall.

Table 37

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	56.6	58.2	53.5	. .	. .	. .	. .
Expenditures	56.2	58.7	53.3	. .	. .	. .	. .
of which: interest payments	*3.8*	*4.0*	*3.7*	. .	. .	. .	. .
Balance	0.4	−0.5	0.2	−0.8	−0.1	0.5	−1.0
Primary balance	4.1	3.6	3.9	1.4	2.0	2.6	1.0
Gross public debt	79.3	73.6	66.2	53.2	46.2	38.1	35.3

Source: European Commission.
Note: Gross debt excluding social security and local government debt.

In the first three quarters of 2004, the current account deficit was lower at 3.9% of GDP than in the same period of 2003 (5.5% of GDP). While the trade deficit deteriorated to 12.4% of GDP over that period from 10.9% a year earlier, the improvement in all the other current account subbalances fully compensated for this deterioration. In particular, the balance of services posted a higher surplus of 5.9% of GDP against 4.8% a year earlier, caused by rising tourism revenues. Besides, net FDI inflows decreased to 2.9% of GDP in the first three quarters of 2004, covering about 74% of the current account deficit, against 7.2% of GDP covering about 123% of the current account deficit a year earlier.

Table 38

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	3,734	5,253	5,714	6,063	6,668	3,252	3,618
Merchandise exports: year-on-year change in %	*−0.3*	*40.7*	*8.8*	*6.1*	*10.0*	*15.0*	*11.3*
Merchandise imports	4,742	6,533	7,493	7,755	8,868	4,192	4,918
Merchandise imports: year-on-year change in %	*16.3*	*37.8*	*14.7*	*3.5*	*14.4*	*17.3*	*17.3*
Trade balance	−1,008	−1,280	−1,779	−1,692	−2,200	−941	−1,300
% of GDP	*−8.3*	*−9.3*	*−11.7*	*−10.2*	*−12.5*	*−12.0*	*−15.0*
Services balance	305	547	454	486	523	81	177
Income balance (factor services balance)	−167	−345	−340	−285	−441	−320	−200
Current transfers	282	316	562	566	613	258	355
Current account balance	−587	−762	−1,102	−926	−1,505	−922	−968
% of GDP	*−4.8*	*−5.6*	*−7.2*	*−5.6*	*−8.5*	*−11.8*	*−11.2*
Direct investment flows (net)	759	1,100	893	951	1,235	645	1,004
% of GDP	*6.2*	*8.0*	*5.9*	*5.7*	*7.0*	*8.2*	*11.6*

Source: Eurostat, national central bank, OeNB.

At end-September 2004, Bulgaria's gross external debt came to 63.4% of rolling four-quarter GDP, which was 15.3% higher in absolute terms than at the end of 2003 (59.3% of GDP). During that period, gross official reserves increased from 28% of GDP to 31% of rolling four-quarter GDP, or 5.6 import months of goods and services.

Table 39

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (excluding gold)	2,879	3,391	3,734	4,247	4,981	5,784
Gross external debt	10,864	12,038	12,046	10,769	10,476	11,937
	% of GDP[1]					
Gross official reserves (excluding gold)	23.7	24.7	24.5	25.6	28.2	31.3
Gross external debt	89.3	87.8	79.0	64.9	59.3	64.5
	Import months of goods and services					
Gross official reserves (excluding gold)	5.6	4.9	4.8	5.2	5.4	5.7

Source: Eurostat, national central bank, OeNB, wiiw.
[1] Q2 2004: As a percentage of rolling four-quarter GDP.

8 Croatia: Toward the Stabilization of External Debt?

After expanding by 4.3% year on year in 2003, GDP in Croatia rose by 3.9% during the first nine months of 2004. Domestic demand was the major contributor to growth. Private consumption grew by 3.9% (after 4.1% in 2003) and added 2.3 percentage points to the GDP growth rate. Gross fixed capital formation growth slowed down markedly from 16.8% in 2003 to 5.5% in the period from January to September 2004, and its growth even came to a standstill in the third quarter (+0.5% year on year). Export and import growth rates roughly halved in the period from January to September (compared to the full year 2003) to reach 5.2% and 4.7% year on year, respectively. As a result, the contribution of net exports to GDP growth was roughly balanced (–0.1 percentage point), compared to a negative contribution of 1.5 percentage points in 2003, which was reflected also in the improvement of the current account balance.

Table 40

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	−0.9	2.9	4.4	5.2	4.3	4.2	3.8
Private consumption	−2.9	4.2	4.5	7.5	4.1	3.9	3.8
Public consumption	2.8	−1.5	−6.2	−1.8	−0.3	−1.6	0.7
Gross fixed capital formation	−3.9	−3.8	7.1	12.0	16.8	8.9	7.7
Exports of goods and services	0.7	12.0	8.1	1.3	10.1	6.4	3.9
Imports of goods and services	−3.5	3.7	9.8	8.8	10.9	5.9	5.4
	Contribution to GDP growth in percentage points						
Domestic demand	−3.0	−0.3	5.8	9.4	5.8	5.1	5.4
Exports	0.3	5.1	3.7	0.6	4.6	2.4	1.7
Net exports	2.1	3.2	−1.4	−4.2	−1.5	−0.9	−1.5

Source: National statistical office, OeNB.

The European Commission expects the unemployment rate to have increased slightly to 14.7% (of the civilian labor force) from 14.5% in 2003, in line with the modest weakening of output growth. Wages in the industry grew at a broadly unchanged rate of around 5.5% during the first half of 2004. Nevertheless, as productivity growth accelerated, industrial unit wage costs were lower year on year during the first quarter of 2004 and increased only slightly in the second quarter.

Inflation remains well contained in Croatia. Average inflation for the first nine months of 2004 stood at 2.1% year on year, unchanged from 2003. The stability of the exchange rate, favorable unit labor cost developments and the moderation of domestic consumption growth are the major factors behind this development. On the other hand, higher prices for housing, energy and transport exerted upward pressure on inflation during 2004. The European Commission expects a modest increase in inflation to 2.7% in 2005 and to 2.8% in 2006 on the back of administrative price adjustments, higher indirect taxes and price increases in the services sector.

Table 41

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	−1.5	1.8	6.1	5.5	4.1	5.4	2.3
Labor productivity of industry (real)	1.6	4.4	7.8	7.8	3.5	7.8	4.5
Gross average wage of industry (nominal)	5.6	6.1	8.2	6.9	5.4	5.5	5.3
Unit labor cost of industry (nominal)	3.8	1.6	0.4	−0.8	1.8	−2.1	0.7
Producer price index (PPI) of industry	2.5	9.5	3.4	−0.5	1.9	0.1	3.2
Consumer price index (CPI)[1]	4.3	6.4	5.0	1.7	1.8	1.9	2.3
Exchange rate (nominal):							
HRK[2] per 1 EUR, + = EUR appreciation	6.2	0.7	−2.2	−0.8	2.1	0.4	−1.4
EUR per 1 HRK, + = HRK appreciation	−5.8	−0.7	2.2	0.9	−2.1	−0.4	1.4
	Period average levels						
Unemployment rate (registered unemployed, %)	19.1	21.1	22.0	22.3	19.5	19.1	18.0
Key interest rate per annum (%)	7.5	6.5	5.9	5.6	4.5	4.5	4.5
Exchange rate (nominal):							
HRK[2] per 1 EUR	7.580	7.635	7.471	7.407	7.563	7.614	7.437
EUR per 1 HRK	0.1319	0.1310	0.1339	0.1350	0.1322	0.1313	0.1345

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

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

[2] *HRK: Croatian kuna.*

Hrvatska narodna banka's exchange rate regime is a managed float regime, with the central bank intervening if it deems intervention necessary. During the last three quarters of 2004, the Croatian kuna was stronger against the euro by about 1% to 1.5% year on year in nominal terms. This development came on top of the usual seasonal strengthening of the exchange rate caused by net inflows from tourism in spring and summer.

The general government is expected to have posted a deficit of 4.5% of GDP in 2004, following 6.3% in 2003. According to the European Commission, this improvement was brought about by one-off measures on the revenue side (dividend payments from a partially state-owned company). The European Commission expects fiscal consolidation to continue in the next two years, with the deficit falling to 3.9% of GDP in 2005 and to 3.6% in 2006. The adjustment

Table 42

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	2.6	14.0	30.9	32.4	11.3	9.3	7.5
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	−3.7	20.3	13.4	9.8	−7.7	−1.3	−0.5
Domestic credit (net) of the banking system	9.8	−1.2	21.1	23.2	19.5	10.8	8.3
of which: claims on the private sector	*5.9*	*−2.0*	*17.0*	*21.5*	*17.7*	*10.4*	*9.6*
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*3.9*	*0.9*	*4.1*	*1.7*	*1.8*	*0.4*	*−1.3*
Other domestic assets (net) of the banking system	−3.4	−5.1	−3.6	−0.5	−0.5	−0.1	−0.3

Source: National central bank, OeNB.

is expected to come primarily from measures on the expenditure side, such as savings in health insurance, the reduction in public employment and an enhanced financial discipline of public enterprises.

Table 43

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	. .	. .	. .	. .	. .	. .	. .
Expenditures	. .	. .	. .	. .	. .	. .	. .
of which: interest payments	. .	. .	. .	. .	. .	. .	. .
Balance	. .	. .	. .	−5.0	−6.3	−4.5	−3.9
Primary balance	. .	. .	. .	−2.9	−4.2	−2.3	−1.7
Gross public debt	. .	. .	. .	50.4	51.6	52.8	52.4

Source: European Commission.

The external imbalance continues to be the major risk factor for the Croatian economy. However, the current account deficit fell to 1.5% of GDP during the first nine months of 2004, from 2.6% in the same period of 2003. Nevertheless, due to seasonal factors, the full-year deficit is expected to be significantly above the figure of the first three quarters and is estimated by the central bank at around 5% of GDP (2003: 6.8%). During the first three quarters of 2004, the improvement stemmed from the trade balance, supported by weakening domestic demand, and also from a decline in the income deficit. By contrast, the surpluses on the services balance (mainly in tourism) and on transfers were smaller than in the period from January to September 2003. Although net FDI was only at a moderate level (3.1% of GDP), it more than covered the current account deficit in the first nine months of 2004.

The relatively high current account deficit and the rise in external debt until mid-2004 are also crucial for Croatia's relations with the IMF. Stabilizing and subsequently reducing overall external debt represents a cornerstone of the Stand-by Agreement, which was concluded in August 2004. For this purpose, in July 2004 Hrvatska narodna banka introduced a 24% unremunerated reserve

Table 44

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	4,205	4,976	5,341	5,212	5,483	2,702	3,121
Merchandise exports: year-on-year change in %	*3.6*	*18.3*	*7.3*	*−2.4*	*5.2*	*7.6*	*15.5*
Merchandise imports	7,374	8,477	9,961	11,084	12,337	5,864	6,522
Merchandise imports: year-on-year change in %	*−3.8*	*15.0*	*17.5*	*11.3*	*11.3*	*10.9*	*11.2*
Trade balance	−3,168	−3,502	−4,620	−5,872	−6,854	−3,163	−3,401
% of GDP	*−17.0*	*−17.5*	*−20.8*	*−24.2*	*−26.8*	*−26.1*	*−26.0*
Services balance	1,556	2,543	3,254	3,236	4,965	1,192	1,127
Income balance (factor services balance)	−340	−441	−587	−572	−1,060	−906	−478
Current transfers	605	963	1,086	1,125	1,215	625	586
Current account balance	−1,348	−436	−866	−2,082	−1,734	−2,252	−2,166
% of GDP	*−7.2*	*−2.2*	*−3.9*	*−8.6*	*−6.8*	*−18.6*	*−16.6*
Direct investment flows (net)	1,385	1,159	1,575	618	1,604	857	421
% of GDP	*7.4*	*5.8*	*7.1*	*2.5*	*6.3*	*7.1*	*3.2*

Source: Eurostat, national central bank, OeNB.

requirement for new foreign borrowing by commercial banks (compared to the level of foreign liabilities over June 2004). In fact, gross external debt declined to 78.2% of GDP by September 2004, from 79.0% in June. By contrast, in response to the moderation of lending growth to households and enterprises and in order to ensure the smooth replacement of maturing foreign government bonds by domestically issued ones, the central bank reduced the reserve requirement rate from 19% to 18% in October 2004. In this respect, however, it should be borne in mind that the sharp deceleration in growth of lending to households and enterprises during 2003 in part probably reflected financial disintegration in response to the central bank's imposition of credit ceilings in early 2003. In addition, the growth of lending to households and enterprises has not further decreased during 2004 (remaining broadly stable over the first ten months of 2004 at about 11.5% year on year), and it may increase once the base effect falls out of the index in early 2005.

Table 45

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (excluding gold)	3,013	3,783	5,334	5,651	6,554	6,389
Gross external debt	9,932	11,880	12,838	14,694	18,645	20,936
	% of GDP[1]					
Gross official reserves (excluding gold)	16.1	18.9	24.0	23.3	25.7	24.1
Gross external debt	53.2	59.4	57.8	60.7	73.0	79.0
	Import months of goods and services					
Gross official reserves (excluding gold)	3.9	4.3	5.3	5.0	5.3	4.9

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

[1] *Q2 2004: As a percentage of rolling four-quarter GDP.*

9 Romania: Boosting Tax Competition in (Central and Eastern) Europe

GDP growth in Romania accelerated strongly to 8.1% year on year in the first three quarters of 2004 (full-year 2003: 4.9%), with annual real GDP growth increasing from 6.1% in the first quarter to 10.0% in the third quarter of 2004. This acceleration was driven by domestic demand, as domestic consumption growth increased to 9.4% in the first three quarters of 2004 (full-year 2003: 6.9%) and gross fixed capital formation boomed at a growth rate of 13.7% (after a rise of 9.2% in the full year 2003), with annual growth rising from 7.3% in the first quarter to 17.4% in the third quarter of 2004. After both export and import growth had jumped in year-on-year terms in the second quarter of 2004, export growth fell back while import growth remained high in the third quarter. Thus, in the first three quarters of 2004, export growth of 16.2% year on year was clearly lower than import growth of 20.2% year on year. The resulting further deterioration in net exports implied a negative contribution to GDP growth of about 3 percentage points, similar to that in the full year 2003.

Table 46

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004[1]	Q2 2004[1]
	Real year-on-year change in %						
Gross domestic product	−1.2	2.1	5.7	5.0	4.9	6.1	7.0
Private consumption	−1.1	−0.8	6.9	5.2	7.3	8.4	9.5
Public consumption	. .	. .	3.9	−9.4	5.0	4.1	7.5
Gross fixed capital formation	−4.8	5.5	10.1	8.2	9.2	7.3	12.9
Exports of goods and services	. .	23.4	12.1	17.6	11.1	10.2	24.5
Imports of goods and services	. .	27.1	18.4	12.0	16.3	12.4	25.8
	Contribution to GDP growth in percentage points						
Domestic demand	. .	. .	8.8	4.1	7.7	7.7	10.1
Exports	. .	. .	4.0	5.9	3.9	4.8	9.6
Net exports	. .	. .	−3.1	0.9	−2.8	−1.6	−3.1

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

Both participation and total employment rates fell, while the unemployment rate (ILO definition) increased in the first half of 2004 year on year, despite strong economic growth. However, the rate of registered unemployment was 6.1% at the end of the third quarter of 2004 against 6.9% a year earlier. In the first three quarters of 2004, industrial production went up by 4.5%, while industrial employment fell by 2%. The resulting increase in labor productivity by about 6.5% lagged behind industrial wage growth, which came to around 23%. Thus, nominal industrial unit wage costs increased by 15.7% year on year, which, however, was lower than the rise in industrial producer prices (19.5%). The producer price inflation rate remained nearly unchanged compared to 2003, although nominal depreciation against the euro declined from 16.8% in 2003 to 9.6% year on year in the first three quarters of 2004, which resulted in a significant real appreciation. However, consumer price inflation decelerated from an annual average of 15.3% in 2003 to 12.6% year on year in that period. In November 2004, for the first time since the start of the

Table 47

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	−7.9	6.2	8.3	4.4	3.2	5.7	3.0
Labor productivity of industry (real)	7.2	12.5	11.6	5.4	5.2	8.4	5.5
Gross average wage of industry (nominal)	44.0	41.7	51.1	23.6	19.5	24.0	23.2
Unit labor cost of industry (nominal)	34.3	25.9	35.4	17.2	13.6	14.4	16.8
Producer price index (PPI) of industry	41.6	53.8	38.7	23.2	19.6	18.0	19.4
Consumer price index (CPI)	45.8	45.7	34.5	22.5	15.3	13.6	12.3
Exchange rate (nominal):							
ROL[1] per 1 EUR, + = EUR appreciation	63.8	22.0	30.5	20.1	20.2	13.9	8.6
EUR per 1 ROL, + = ROL appreciation	−39.0	−18.1	−23.4	−16.8	−16.8	−12.2	−7.9
	Period average levels						
Unemployment rate (ILO definition, %)	6.9	7.2	6.7	8.4	7.1	8.9	7.7
Key interest rate per annum (%)	35.0	35.0	35.0	29.6	18.8	21.1	21.3
Exchange rate (nominal):							
ROL[1] per 1 EUR	16,326.8	19,926.0	26,000.3	31,234.8	37,543.0	40,550.0	40,664.0
EUR per 100 ROL	0.00612	0.00502	0.00385	0.00320	0.00266	0.00247	0.00246

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

transition process, the inflation rate came down to a single-digit figure (9.9% year on year).

Against the background of the continuing disinflation process, the central bank lowered the reference rate by 50 basis points to 20.75% in June. This decision was followed by six further reductions of the reference rate, with the last rate cut taking place on January 17, 2005, when the rate was reduced by 0.5 percentage point to 16.5%. By contrast, growth in domestic lending to the private sector remained very high (60% year on year in the first three quarters against 58% in the full year 2003), and annual growth in net foreign assets accelerated throughout the year so that annual money growth came to 30% year on year in that period, fueling domestic demand. For several years, the authorities have been following a managed float strategy in their exchange rate policy, with a focus on both the external balance and disinflation. In July

Table 48

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	52.0	40.4	42.5	40.9	31.2	26.2	28.9
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	10.8	38.4	44.9	31.8	15.5	6.1	11.8
Domestic credit (net) of the banking system	42.3	14.0	10.2	18.7	23.9	28.4	26.3
of which: claims on the private sector	*24.3*	*3.6*	*18.3*	*24.1*	*28.2*	*34.5*	*33.3*
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*17.9*	*10.3*	*−8.1*	*−5.3*	*−4.3*	*−6.1*	*−7.0*
Other domestic assets (net) of the banking system	−1.0	−12.0	−12.6	−9.6	−8.3	−8.2	−9.2

Source: National central bank, OeNB.

2005, the Romanian leu will be redenominated by slashing four zeros off the currency.

After the general government deficit came to 2.1% of GDP in 2003, the official projections for the budget deficit 2004 were revised downward from 2.1% to 1.6% in August 2004, mainly because of a better-than-expected revenue collection as a result of strong economic activity and, as the IMF remarks, improvements in tax administration and in avoiding tax evasion. At the end of December 2004, the new coalition government, which was formed in December 2004, under the newly elected President Traian Basescu introduced a flat 16% income tax rate (replacing the personal income tax with rates ranging from 18% to 40%) and a 16% corporate tax rate (previously 25%), both effective from January 1, 2005. The government named the following official aims of these tax rate cuts: to boost economic activity, to attract FDI and to reduce the shadow economy. The official deficit target for 2005 is 1.5% of GDP, the European Commission's autumn forecast expects a deficit of 1.7%.

Table 49

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
General government							
Revenues	. .	. .	. .	. .	. .	. .	. .
Expenditures	. .	. .	. .	. .	. .	. .	. .
of which: interest payments	. .	. .	. .	. .	. .	. .	. .
Balance	. .	−4.4	−3.5	−2.0	−2.0	−1.6	−1.7
Primary balance	. .	. .	. .	1.0	0.2	0.0	−0.1
Gross public debt	. .	23.9	23.2	23.3	21.8	21.8	22.2

Source: European Commission.

In the first three quarters of 2004, the current account deficit stood at 5.9% of GDP against 4.8% a year earlier. This deterioration is attributable to a higher trade deficit (8.2% of GDP in the first three quarters of 2004 against 7% a year earlier), as a result of strong demand for capital goods and consumer durables. Over this period, net FDI inflows increased from 3.2% to 4.1% of GDP, or almost EUR 1.6 billion, covering 70% of the current account deficit in the first three quarters of 2004.

Table 50

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	7,984	11,279	12,719	14,644	15,614	7,501	9,014
Merchandise exports: year-on-year change in %	*7.7*	*41.3*	*12.8*	*15.1*	*6.6*	*8.5*	*20.2*
Merchandise imports	9,169	13,150	16,045	17,392	19,569	9,058	11,052
Merchandise imports: year-on-year change in %	*−5.9*	*43.4*	*22.0*	*8.4*	*12.5*	*10.7*	*22.0*
Trade balance	−1,185	−1,871	−3,326	−2,748	−3,955	−1,557	−2,038
% of GDP	*−3.6*	*−4.7*	*−7.5*	*−5.7*	*−7.9*	*−7.7*	*−9.1*
Services balance	−372	−260	−127	6	62	−38	−82
Income balance (factor services balance)	−388	−304	−316	−490	−623	−416	−411
Current transfers	589	937	1,280	1,614	1,639	721	914
Current account balance	−1,356	−1,498	−2,489	−1,618	−2,877	−1,290	−1,617
% of GDP	*−4.1*	*−3.8*	*−5.6*	*−3.4*	*−5.8*	*−6.4*	*−7.2*
Direct investment flows (net)	948	1,161	1,315	1,193	1,591	785	1,156
% of GDP	*2.9*	*2.9*	*3.0*	*2.5*	*3.2*	*3.9*	*5.2*

Source: National central bank, OeNB.

The strong inflow of foreign (portfolio) capital increased gross official reserves from 3.7 import months of goods and services at the end of the second quarter to 4.5 at the end of the third quarter, amounting to 17.7% of rolling four-quarter GDP. Medium- and long-term gross external debt increased to 32% of GDP at the end of the third quarter.

Table 51

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (excluding gold)	1,520	2,655	4,445	5,877	6,374	7,746
Gross external debt (medium- and long-term)	8,757	11,113	13,507	14,691	15,684	16,515
	% of GDP[1]					
Gross official reserves (excluding gold)	4.6	6.7	10.0	12.3	12.7	14.8
Gross external debt (medium- and long-term)	26.6	27.9	30.4	30.7	31.4	31.7
	Import months of goods and services					
Gross official reserves (excluding gold)	1.7	2.1	2.9	3.6	3.4	3.7

Source: Eurostat, national central bank, OeNB, wiiw.
[1] Q2 2004: As a percentage of rolling four-quarter GDP.

10 Russia: Slowdown of Growth amid Uncertainty over Economic Policy

Real GDP growth in Russia came to 7.0% year on year in the first three quarters of 2004, after 7.3% in the full year 2003. Following annual GDP growth rates of 7.5% in the first quarter and 7.4% in the second quarter, growth slowed to 6.4% in the third quarter. The expansion of the aggregate production index of five base sectors of the Russian economy (industry, construction, transportation, agriculture and retail sales) slowed to 6.6% in the first eleven months of the year, from 7.3% in the full year 2003. The slowdown in the first three quarters of 2004 as compared to the full year 2003 reflected weaker export volume and stronger import volume growth, resulting in a deterioration of net exports that implied a negative contribution to GDP growth of nearly 2 percentage points in the first three quarters of 2004 after positive contributions in 2002 to 2003. Moreover, investment growth lost some momentum in the third quarter (10.6% year on year), while private consumption, buoyed by real (CPI-deflated) wage rises of 12% year on year, continued to steam ahead (13.1% year on year). While the still robust GDP expansion benefited from persistently high and even rising oil and raw material prices, the slowdown may have been brought about by uncertainties about the direction of government policies in the resource sector in connection with the escalation of the Yukos affair, more general questions relating to overall structural reform policies, which seem to have lost momentum in recent months, and repercussions of the bank alert of the summer of 2004, which gave rise to temporary credit bottlenecks. Deposit and loan growth resumed in the fall of the year, but the events left their trace in a somewhat dampened expansion of banking activities.

Table 52

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Real year-on-year change in %						
Gross domestic product	6.3	9.0	5.1	4.7	7.3	7.5	7.3
Private consumption	−2.9	6.0	9.3	8.7	7.8	11.8	12.4
Public consumption	3.1	4.8	−0.8	2.6	2.2	2.5	2.6
Gross fixed capital formation	6.3	31.1	10.3	3.0	12.9	14.1	12.5
Exports of goods and services	11.3	9.6	4.2	9.6	13.7	12.6	8.5
Imports of goods and services	−17.1	30.5	18.7	14.6	19.5	24.1	20.0
	Contribution to GDP growth in percentage points						
Domestic demand	−2.0	11.6	7.3	4.1	6.8	8.3	9.4
Exports	4.7	4.2	1.9	4.2	6.3	6.3	4.2
Net exports	9.1	−1.9	−2.6	0.3	0.5	−0.9	−2.4

Source: Eurostat, national statistical office, OeNB.

Despite the slowdown of investment expansion in recent months, industrial restructuring and modernization are continuing, being reflected in industrial output growth coupled with industrial employment decline in year-on-year terms. Notwithstanding strong wage increases (24% year on year), the annual rise in nominal industrial unit wage costs of 9% remained far below that of producer prices of 21.5% in the first half of 2004. The unemployment rate (ILO definition) declined to 7.5% in October 2004 from 8.3% a year earlier. Average inflation (CPI) declined from 13.6% in 2003 to 10.7% year on year in the first three quarters of 2004. However, since June 2004 the monthly annual inflation rate has been picking up again from 10.2% to 11.7% in November. The recent inflation pick-up may be explained by the considerable increase of industrial producer prices, by strong real wage and private consumption growth, and by periodic adjustments of regulated prices and tariffs. Moreover, broad money has been expanding at a very high real rate.

Table 53

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

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Year-on-year change of period average levels in %						
Gross production of industry (real)	11.6	12.0	4.9	3.7	7.0	7.6	7.1
Labor productivity of industry (real)	10.6	14.6	5.7	7.5	13.9	14.2	13.3
Gross average wage of industry (nominal)	46.7	42.1	52.0	27.2	25.4	24.9	23.1
Unit labor cost of industry (nominal)	32.6	24.0	43.8	18.3	10.1	9.3	8.6
Producer price index (PPI) of industry	59.1	46.5	19.1	11.7	15.6	19.0	24.2
Consumer price index (CPI)	85.7	20.8	21.6	16.0	13.6	10.8	10.3
Exchange rate (nominal):							
RUB[1] per 1 EUR, + = EUR appreciation	137.2	−0.8	0.4	13.5	16.5	5.4	−0.6
EUR per 1 RUB, + = RUB appreciation	−57.8	0.8	−0.4	−11.9	−14.2	−5.2	0.6
	Period average levels						
Unemployment rate (ILO definition, %)	12.6	10.5	9.0	8.0	8.7	9.3	7.9
Key interest rate per annum (%)	57.2	33.1	25.0	22.7	17.3	14.3	13.8
Exchange rate (nominal):							
RUB[1] per 1 EUR	26.24	26.03	26.13	29.65	34.55	35.83	34.85
EUR per 1 RUB	0.0381	0.0384	0.0383	0.0337	0.0289	0.0279	0.0287

Source: Bloomberg, Datastream, national statistical office, national central bank, OeNB, wiiw.
[1] RUB: Russian ruble.

High money growth has been fueled by both credit growth to the nongovernment sector and a net foreign assets increase. However, nongovernment credit growth has been continuously declining from 46% year on year in April to 35% year on year in November, while net foreign assets have been rising from 29% year on year in March to 58% year on year in November. As a result of the unrelenting buildup of gross official reserves (based on the high current account surplus) and the limited sterilization instruments of the monetary authorities, there is a lot of liquidity in the banking sector. The effectiveness of the central bank's policy of curbing inflation is being persistently counteracted by the impact of its policy of stemming nominal appreciation tendencies of the ruble in order to stave off Dutch disease. In real terms, the ruble was 5% stronger in September than a year earlier against a basket of currencies of Russia's main trading partners.

Table 54

Monetary Developments

	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
	Nominal year-on-year change of the annual average stock in %						
Broad money (including foreign currency deposits)	63.6	60.0	44.2	31.2	39.2	39.9	38.4
	Contributions to the nominal year-on-year change of broad money in percentage points						
Net foreign assets of the banking system	7.5	58.5	44.3	19.8	21.3	18.0	19.2
Domestic credit (net) of the banking system	120.4	30.5	22.8	30.4	29.6	25.8	24.5
of which: claims on the private sector	*43.5*	*36.7*	*35.2*	*28.9*	*29.5*	*32.1*	*32.9*
claims on households	. .	. .	. .	. .	. .	. .	. .
claims on enterprises	. .	. .	. .	. .	. .	. .	. .
net claims on the public sector	*76.9*	*−6.2*	*−12.4*	*1.5*	*0.2*	*−6.4*	*−8.4*
Other domestic assets (net) of the banking system	−64.4	−29.1	−22.9	−19.1	−11.7	−3.9	−5.2

Source: National central bank, OeNB.

On the back of high oil prices and economic growth, Russia witnessed a further widening of its twin surpluses in the first three quarters of 2004, with the budget in the black for the fifth year in a row. The federal government budget is estimated to have posted a surplus of 4.9% of GDP in the period from January to September and of 3.8% in the period from January to October. The general government budget is projected to reach a surplus of over 3% of GDP in 2004. The budgetary situation also reflects a prudent fiscal stance and successful tax reforms since 2001. Moreover, approximately EUR 14 billion have already been transferred to the Budgetary Stabilization Fund, into which oil-related budget revenues flow when the price of Urals grade crude fetches over USD 20/barrel. Given their liquidity drainage function, the budget and the Stabilization Fund constitute critical elements of stabilization policy.

Table 55

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
Federal government							
Revenues	12.5	15.4	17.8	20.3	19.4	20.1	17.8
Expenditures	13.8	13.2	14.8	18.5	17.7	17.0	16.3
of which: interest payments	*3.4*	*2.4*	*2.6*	*2.1*	*1.7*	*. .*	*1.4*
Balance	−1.3	2.2	3.0	1.8	1.7	3.1	1.5
Primary balance	2.1	4.6	5.6	3.9	3.4	. .	2.9
General government							
Revenues	33.6	36.8	37.2	37.6	36.6	37.0	35.3
Expenditures	36.7	33.7	34.5	37.0	35.5	33.9	33.6
of which: interest payments	*. .*	*. .*	*2.7*	*2.1*	*1.7*	*1.3*	*1.4*
Balance	−3.1	3.1	2.7	0.6	1.1	3.1	1.7
Primary balance	. .	. .	5.4	2.7	2.8	4.4	3.1
Gross public debt	86.4	56.1	42.4	36.2	26.8	. .	. .

Source: National ministry of finance, Economic Expert Group, IMF.
Note: Federal government: Data on cash basis. Data for 2004–05 according to budget law.
General government: Data on commitment basis.

The Russian current account surplus came to EUR 29.3 billion, or over 9% of GDP, in the first three quarters of 2004 (against EUR 24.4 billion or 8.3% of GDP in the same period of 2003). Given the rather difficult business climate for foreign investors, FDI inflows are much lower than the country's enormous economic potential would suggest. Net FDI inflows dwindled to only EUR 120 million in the first three quarters of 2004. (They had come to EUR 840 million in the corresponding period of 2003.) Foreign investors' reluctance has been heightened by the authorities' unrelenting pursuit of the country's largest private oil firm, Yukos (which now faces liquidation), and of its founder, and by what is seen by many international observers as an arbitrary enforcement of the rule of law. This is bound to weaken property rights and undermine confidence.

Table 56

Balance of Payments

	1999	2000	2001	2002	2003	H1 2003	H1 2004
	EUR million						
Merchandise exports	71,210	114,379	113,843	113,201	120,040	56,881	65,691
Merchandise exports: year-on-year change in %	*7.1*	*60.6*	*−0.5*	*−0.6*	*6.0*	*6.2*	*15.5*
Merchandise imports	37,168	48,934	60,138	64,278	66,508	30,673	34,575
Merchandise imports: year-on-year change in %	*−28.8*	*31.7*	*22.9*	*6.9*	*3.5*	*1.7*	*12.7*
Trade balance	34,042	65,444	53,705	48,923	53,532	26,208	31,116
% of GDP	*18.6*	*23.1*	*15.7*	*13.4*	*13.9*	*15.1*	*14.6*
Services balance	−4,034	−7,254	−10,227	−10,439	−9,773	−3,865	−4,572
Income balance (factor services balance)	−7,291	−7,353	−4,756	−6,856	−11,543	−4,182	−5,074
Current transfers	578	65	−912	−808	−352	−206	−217
Current account balance	23,295	50,903	37,810	30,821	31,864	17,955	21,252
% of GDP	*12.7*	*18.0*	*11.0*	*8.5*	*8.3*	*10.3*	*9.9*
Direct investment flows (net)	1,042	−500	250	−49	−1,414	1,475	1,324
% of GDP	*0.6*	*−0.2*	*0.1*	*0.0*	*−0.4*	*0.8*	*0.6*

Source: National central bank, OeNB.

Russia's gross external debt slightly increased to EUR 158.0 billion at the end of June 2004, but declined to 37.2% relative to GDP. Meanwhile, the monetary authorities' gross official reserves topped EUR 86 billion at end-November 2004, a new record level which corresponds to more than a year of imports of goods and services.

Table 57

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	Q2 2004
	End of period, EUR million					
Gross official reserves (excluding gold)	8,387	26,139	37,026	42,291	58,531	69,471
Gross external debt	. .	156,232	159,072	143,490	148,290	157,960
	% of GDP[1]					
Gross official reserves (excluding gold)	4.6	9.2	10.8	11.6	15.2	16.4
Gross external debt	. .	55.1	46.5	39.4	38.6	37.2
	Import months of goods and services					
Gross official reserves (excluding gold)	2.0	4.7	5.3	5.7	7.8	9.0

Source: National central bank, OeNB, wiiw.
[1] Q2 2004: As a percentage of rolling four-quarter GDP.

Whereas structural reforms had already slowed down in the run-up to parliamentary and presidential elections, only few new reform initiatives have emerged, unfortunately, since the re-election of President Putin in March 2004. This fact may be partly connected to a degree of complacency on the part of the government, given the overall favorable economic environment. In the political sphere, a general tendency toward the centralization of power in the hands of the executive branch can be discerned. Regional governors will no longer be elected by the population, but appointed by the president. Further enterprise privatization has become more difficult since a number of large state-owned firms have been declared strategic enterprises that can only be privatized by presidential permission. In the summer of 2004 the authorities passed a social reform measure by providing for the replacement of in-kind social benefits with monetary compensation from the beginning of 2005. In December a new housing code was enacted which aims at facilitating the further privatization of apartments and the formation of a mortgage market.

Cutoff date for data: January 7, 2005.