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Stability and Security.

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The Focus on European Economic Integration (FEEI) is a channel for communicating the OeNB's ongoing research on Central, Eastern and Southeastern European (CESEE) countries, thus reflecting a strategic regional research priority of the OeNB. Contributions to the quarterly FEEI include peer-reviewed studies dealing primarily with macrofinancial and monetary integration as well as economic country analyses and cross-regional comparisons.

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Recent Economic Developments

Developments in Selected CESEE Countries:

Multispeed Recovery in CESEE[1,2,3]

1 Introduction

Recovery is gaining ground in the region …

More than two years after the breakup of Lehman Brothers, economic developments in CESEE continue to be heavily influenced by the repercussions of the international crisis. International support packages are still in place in Hungary and Romania, many countries are struggling with increasing public deficits and debt levels, labor markets are under pressure, and financial market developments in some cases are still surrounded by uncertainty. However, the region is on its way to overcome the economic drought of 2009. Given the pickup in international demand and positive impulses from the inventory cycle, the economic recovery that had started in some countries in mid-2009 was taking root in the first half of 2010, with growth dynamics improving in all countries under observation.

… but there are still vast differences between countries …

The return to growth, however, is taking place at different speeds. While some countries are experiencing nothing less than a sheer boom of economic activity (e.g. Turkey), others are still more or less stuck in stagnation (e.g. Bulgaria and Hungary) or in recession (e.g. Romania and Croatia). This only partly comes as a surprise: Just as the most vulnerable and imbalanced economies of the region were hit more strongly (and in part earlier) by the crisis, they are also slower in returning to a sustainable growth path. It has also become apparent that it is obviously the bigger countries that are currently faring better. This may be related to larger domestic markets being more resilient to financial market swings and/or less dependent on international developments. Still, the extent of the regional differences and its persistence are remarkable, e.g. as concerns the strength of growth in Turkey or its weakness in Croatia. A piece of evidence for this can be found in different vintages of forecasts for the respective countries: The European Commission in spring 2009 expected Turkey to grow by 2.2% in 2010 and revised this forecast to 4.7% in spring 2010. In its autumn World Economic Outlook, the IMF already projected growth of 6.1%. By comparison, the outlook for all CESEE EU Member States was revised upward by a meager 1 percentage point. For Croatia, the expected growth for 2010 was even revised downward, from 1.5% in spring 2009 to –1.2% in autumn 2010. Overall, economic activity in the region can therefore be considered a multispeed recovery with pronounced differences between individual countries.

… as underlined by financial markets data

Financial markets data paint a similar picture of the country group. The situation has clearly stabilized since the peak of the disruptions in late 2008 and early 2009. Risk premiums (here: CDS premiums) have declined substantially (from levels of up to 1,200 basis points in Russia in October 2008), most national currencies have recovered at least part of their losses, and rating agencies have assigned upgrades to most countries of the region. When taking an in-depth look at developments since the start of 2010, however, the regional differences lined out above again

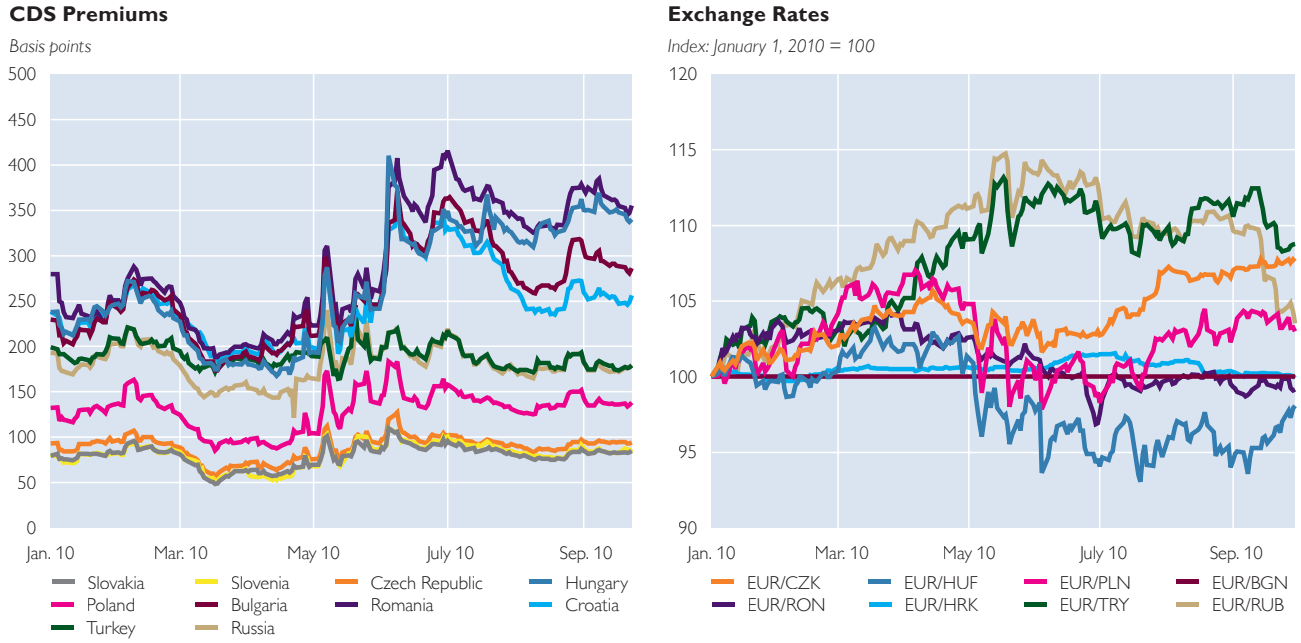
[1] *Compiled by Josef Schreiner with input from Stephan Barisitz, Markus Eller, Jarko Fidrmuc, Sándor Gardó, Antje Hildebrandt, Mathias Lahnsteiner, Thomas Reininger, Zoltan Walko and Julia Wörz.*

[2] *Cut-off date: October 8, 2010 (October 22, 2010, for fiscal data). This report primarily focuses on data releases and developments from March 2010 to the cut-off date, while selectively recalling earlier developments where this appears necessary to put recent developments into perspective.*

[3] *This report covers the Czech Republic, Bulgaria, Hungary, Poland, Romania, Slovakia and Slovenia as well as Croatia, Turkey and Russia.*

Chart 1

Selected Financial Market Indicators



Source: Thomson Financial.

become readily apparent. The CDS premiums for Croatia, Bulgaria, Romania and Hungary stand substantially above those of the other countries and also show a higher degree of volatility. In particular, they experienced an upward boost in late May and early June, triggered by developments in Hungary and Romania related to increased uncertainties concerning EU/IMF support packages and fiscal consolidation.[4] Exchange rate developments also varied greatly within the region. Both the Turkish lira and the Russian ruble appreciated by about 10% from early January until their peaks in September 2010. This appreciation of the ruble, but also its recent decline to a considerable extent reflect the development of the USD/EUR exchange rate, as the ruble is tied to a currency basket. In recent months, the Czech koruna and the Polish zloty have shown an upward trend. By contrast, the Hungarian forint and the Romanian leu traded sideways. Financial markets data confirm that while the worst is over, some countries are ahead of others in recovering from the crisis.

GDP readings are improving throughout the region

The growth readings for CESEE have improved strongly recently, from an average of –5.5% in the third quarter of 2009 to 5.1% in the second quarter of 2010, indicating a significantly stronger recovery than in the euro area. However, the aggregate masks regional heterogeneity: The dynamics were strongly influenced by the positive readings in Russia and Turkey, the two biggest economies of the region by far (together they account for nearly two-thirds of total economic output of CESEE). By contrast, annual growth remained negative or subdued in Bulgaria, Hungary, Romania and Croatia. Nevertheless, the trend of improving economic dynamics was rather broad based, encompassing also the weaker economies of the

[4] *A more detailed analysis of macrofinancial developments in the region will be published in the OeNB's Financial Stability Report 20 in December.*

Table 1

Real Gross Domestic Product

	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Annual change in % (not seasonally adjusted)							
Slovakia	6.2	–4.7	–5.7	–5.5	–4.9	–2.6	4.8	4.7
Slovenia	3.7	–8.1	–8.4	–9.4	–8.8	–5.7	–1.1	2.2
Bulgaria	6.2	–4.9	–5.3	–3.8	–4.9	–5.8	–4.0	0.5
Czech Republic	2.5	–4.1	–3.6	–5.0	–5.0	–2.9	1.0	3.0
Hungary	0.6	–6.3	–6.7	–7.5	–7.1	–4.0	0.1	1.0
Poland	5.1	1.8	0.8	1.2	1.2	3.5	2.9	4.0
Romania	7.3	–7.1	–6.2	–8.7	–7.1	–6.5	–2.6	–0.5
Croatia	2.4	–5.8	–6.7	–6.3	–5.7	–4.5	–2.5	–2.5
Turkey	0.7	–4.7	–14.6	–7.6	–2.7	6.0	11.7	10.3
Russia	5.2	–7.9	–9.3	–11.0	–8.6	–2.9	3.1	5.2
CESEE average[1]	4.1	–5.4	–8.0	–7.6	–5.5	–0.6	3.9	5.1
Euro area	0.5	–4.1	–5.3	–5.5	–3.8	–1.7	1.1	2.4

Source: Eurostat, national statistical offices.

[1] Weighted average.

region. While some of the pickup is probably attributable to the weak base for annual comparisons a year earlier, the quarterly changes in seasonally-adjusted GDP figures also support the general conclusion: According to these data, output no longer declined in any country of the region in the second quarter. Slovakia, Slovenia, the Czech Republic, Poland, Bulgaria, Romania, Turkey and Russia reported (partly substantially) positive growth (no comparable data are available for Croatia).

Dynamics driven to a substantial extent by the external sector …

Economic activity was to a substantial extent driven by improving global economic and financial conditions, which fostered foreign demand. World trade has been increasing strongly since May 2009, reaching its pre-crisis level in June 2010. Quarter-on-quarter growth in the euro area (the major trading partner of the region) turned positive in the third quarter of 2009 and increased to 1% in the second quarter of 2010. These improvements in the international environment are clearly visible in the GDP components throughout the region: Positive growth impulses often originated from the external sector. Exports gave a substantial boost to growth in most CESEE countries, providing double-digit growth contributions in Slovakia, the Czech Republic, Hungary and Romania throughout the review period. At the same time, however, the comparatively high import content of exports in CESEE also led to an uptick of imports, which often put a substantial damper on the external sector's growth contribution.

… and a turn in the inventory cycle

The second big growth driver in the review period were stock changes, the growth contributions of which turned positive in most countries in the first half of 2010 as the inventory cycle turned. Data from the European Commission's Business and Consumer Survey confirm that a majority of respondents from industry assess their current stock of finished products to be too small in the case of Slovakia, Slovenia, Bulgaria, Hungary and Romania (data only available for EU Member States). Interestingly, the picture is considerably different for the retail sector: With the exception of Bulgaria, all countries reported too large stocks.

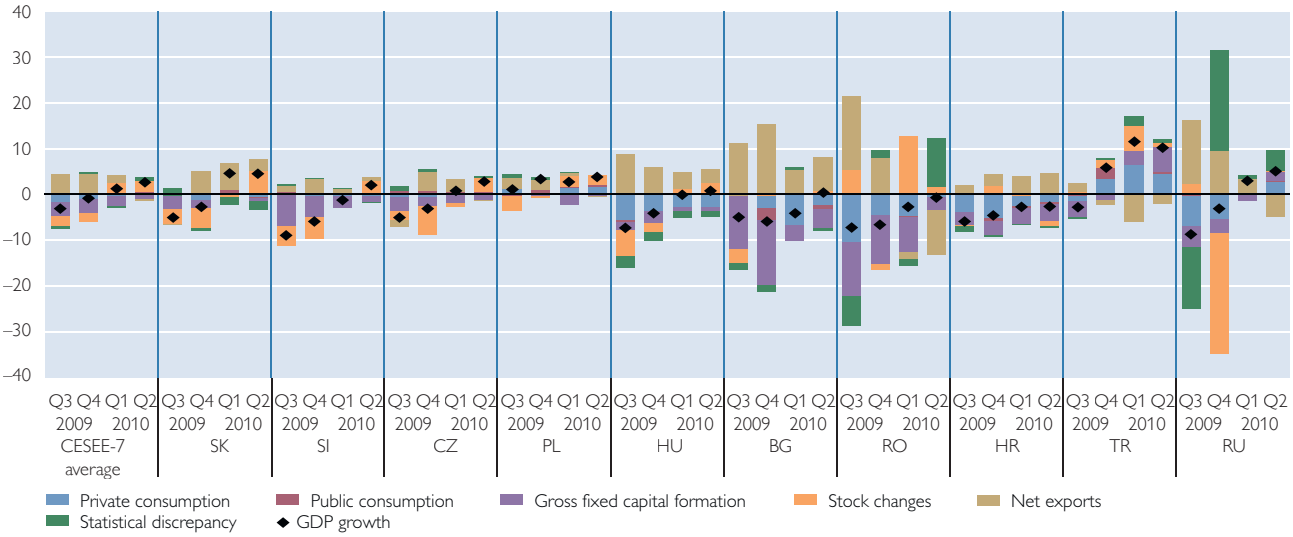
No distinctive growth contribution from domestic demand in most countries

The other GDP components have generally not boosted growth. Despite a pickup in recent quarters, annual growth of private consumption and investment

Chart 2

GDP Developments

Percentage points, GDP growth in %



Source: Eurostat, national statistical offices.

remained mostly negative. The causes of sluggish domestic demand can still be found in comparatively low levels of capacity utilization and a subsequent low need for investment as well as in weak labor market conditions, subdued wage dynamics and credit growth and the ongoing necessity of balance sheet repairs. The exceptions in this respect are the Czech Republic and Poland, where consumption made a positive, though rather small contribution to growth, and, of course, Russia and Turkey, where both components grew strongly and pushed economic activity forward. Developments have been varied across the region also in this respect.

Industrial sector performing especially well

Economic activity indicators have improved strongly in CESEE. Especially industrial production has recovered from its low in early 2009, when its annual declines were in the double digits throughout the region. The recovery gained speed in mid-2009 and in some countries turned into a downright boom. By July 2010, industrial output again expanded in all countries but Croatia, and annual growth rates were mostly at around as much as 10%. Given the composition of GDP growth, this improvement in industrial output was also due to the strong export orientation of the region.

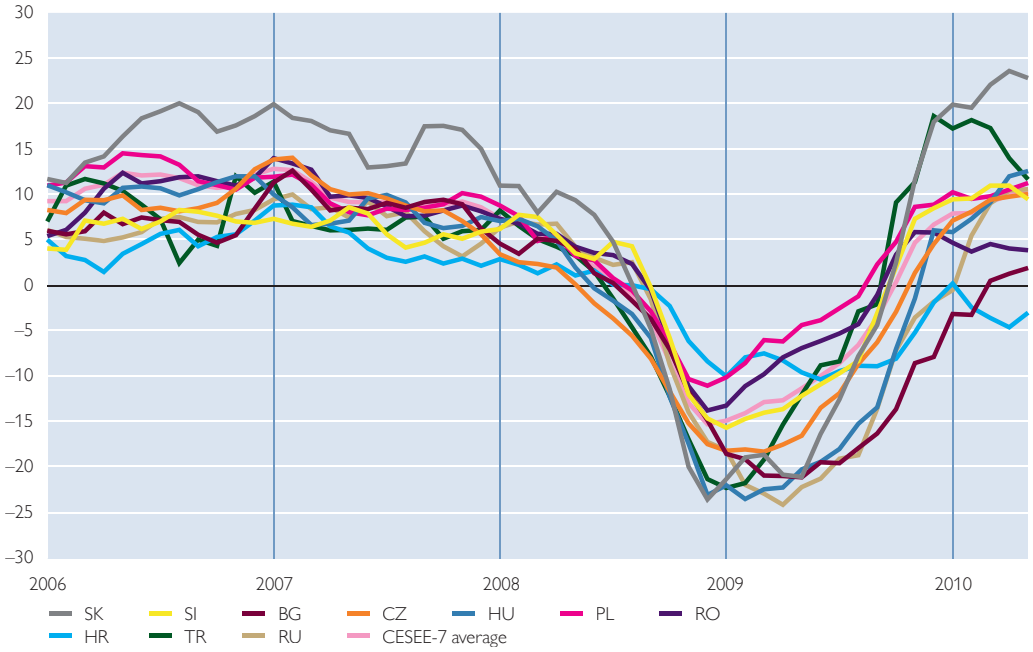
Other economic activity indicators, especially retail sales and construction output, performed less favorably, however. The contraction continued especially in construction, where production was influenced by adverse weather conditions in the first quarter. Retail trade fared somewhat better, expanding again in half of the CESEE countries, but its dynamics generally remained subdued and far below historical levels. Thus, the recovery of the industrial sector, which had been hit by the crisis early and especially hard, is progressing faster than that of other sectors. The marked improvement of the Economic Sentiment Indicator since spring 2009 was also driven to a substantial extent by industry.

Hence, with some notable exceptions (above all Turkey and Russia), the growth dynamics are generated abroad while there are only minor or no impulses at all from the domestic market. The future development of the region therefore still

Chart 3

Industrial Production

Year-on-year changes, three-month moving averages



Source: Eurostat, wiiw.

hinges on the world economy, especially the euro area, and as a result also on industrial dynamics, at least in the near term. Given the outlook for the euro area, where GDP is currently projected to grow at around 1.5% both in 2010 and 2011, CESEE is poised for a further gradual recovery. In the coming quarters, growth may be adversely impacted by slowly diminishing growth contributions from stock changes. High and rising export-driven industrial output, slowly improving capacity utilization and the availability of EU funds, however, will sooner or later trigger investment spending, which should bolster the economic cycle. In the medium term, the central question will be whether the countries can manage to channel some of the positive momentum in industry and exports into higher employment and private consumption in order to make growth more balanced and self-sustaining.

Gradually improving economic outlook for CESEE; regional differences remain

According to recent forecasts for CESEE,[5] growth is expected to come in at around 3.5% on average this year and to stay at about this level in 2011. This rate is substantially above euro area growth, but still somewhat below world output growth and substantially below growth in other emerging market regions (especially in Emerging Asia). The dynamics in CESEE are strongly driven by Russia, Turkey and Poland, the largest countries in the sample, which are also projected to grow most strongly. Therefore, average growth in the region is strongly biased to the upside. The median of growth projections, for example, would only be at around 1.5% in 2010 given negative growth in Croatia and Romania and stagnation in Bulgaria. Developments in 2011 would be only slightly better: Median growth would pick up to somewhat above 2% given a stronger recovery in Croatia, Romania and Bulgaria but a markedly lower growth reading for Turkey.

[5] *For the detailed OeNB forecast for CESEE, see box 2.*

Economic expansion is not expected to return to pre-crisis levels even in the medium run. According to IMF forecasts for the period from 2012 to 2015, the region's economy will expand by around 4% after having grown by around 6.5% in the boom years before the crisis. Nevertheless, income levels will continue to catch up to the euro area average. After temporarily dipping into negative territory in 2009, the region's growth differential vis-à-vis the euro area will increase to between 2 and 2.5 percentage points from 2011 onward.

External adjustment has probably reached its peak …

The economic downturn and the associated reduction in domestic demand led to a marked improvement of CESEE countries' external accounts in 2009. Readings for the first half of 2010 were also broadly positive, with the Central European countries reporting balanced current accounts and Hungary even a surplus. The same is true for Russia, where, however, terms of trade developments related to high oil prices played a role. More substantial deficits were observed only in Bulgaria, Croatia, Romania and Turkey. While in the former two countries, however, the adjustment in the external accounts continued in the first half of 2010, the later two reported rising deficits. In Turkey, the deterioration is consistent with relatively high domestic demand growth. In the case of Romania, it can be partly explained by lower transfers, as adverse economic conditions prohibit Romanians working abroad from sending substantial amounts of money back home (which must be seen in the light of the fact that after their country's EU entry, many Romanians went to Spain to work in the then still booming construction sector). However, the goods and services balance has contributed to the rising deficit in Romania too, as imports are still growing very dynamically, which can only partly be explained by rising exports absorbing substantial amounts of imports as inputs. At the same time, the item "statistical discrepancy" has become very sizeable in Romania.

Concerning the financial account, trends in the first half of 2010 were heterogeneous, but balances mostly improved somewhat compared to the first half of 2009. The main exceptions were Slovakia, Bulgaria and Croatia, where portfolio outflows and, in the latter two also reductions in FDI and other investments, weighed on the financial account. FDI inflows turned positive or were positive in all countries but Hungary and Russia. They even increased in the economically stronger countries of Central Europe, which testifies to CESEE remaining an attractive FDI destination even after the crisis.

… as a pickup in domestic demand seems to be in the offing

Some factors put a question mark behind the sustainability of the current adjustment of external accounts. First, some deterioration was already observed in the most recent quarter in Slovakia, Slovenia, Romania, Russia and Turkey. Second, and more importantly, the factors that drove the adjustment process were to a substantial extent related to the crisis. This is especially true for waning domestic demand, which gave a boost to goods and services balances. Demand, however, is set to start to increase again in the near to medium term.

A look at saving/investment balances also points in this direction. The reduction in current account deficits was driven mainly by a decline in investment with some additional help by the saving rate only in Bulgaria, Hungary and Croatia. However, after a series of negative quarters, capital formation is set to increase again in the near future on the back of slowly rising capacity utilization rates, the availability of EU funds and the sheer necessity of reinvestment to make up for depreciations in the capital stock. Last but not least, one also needs to consider that most CESEE

Chart 4

Current and Capital Account of the Balance of Payments

Source: National central banks.

countries are still catching-up economies with a higher investment need. The saving rate may have a mitigating effect only in some countries, e.g. Slovakia, Slovenia, the Czech Republic, Turkey and Russia, where it currently stands below its long-term average. But even in these countries, the scope for a further strong rise in savings remains questionable. Households are partly strongly indebted and still repairing their balance sheets, wage growth is mostly modest, and (planned) fiscal consolidation efforts in many countries do not point to a strong rise in disposable income, even though, considered in isolation, consolidation efforts would have a positive impact on overall savings.

Some pressure on current account balances could also emanate from the future development of external price competitiveness as the recent improvements in unit labor costs may prove to be of a mainly cyclical nature only (see below).

Gross external debt mostly flat

Gross external debt augmented strongly in 2009 owing to buoyant debt-creating flows and debt dynamics that were unfavorable especially because GDP shrank throughout most of the region. By contrast, external debt levels were mostly stable in the first half of 2010, and in some countries they even declined somewhat. Some stronger increases were observed in Romania and Slovenia only (by about 4 percentage points of GDP). In both countries, this rise was driven by governments tapping the external market for new borrowing and refinancing.

Recovery of labor market conditions around the corner?

Improving economic dynamics seem to foster a turn in labor market conditions. While unemployment rates had increased markedly from 2008 to 2009, they stabilized in the course of 2010 and stood between 7.1% in the Czech Republic and 14.4% in Slovakia in June 2010. In the latest readings, a certain downward trend was observable in some countries (e.g. the Czech Republic, Poland, Turkey and Russia), and notable further increases in unemployment occurred only in Croatia and Slovenia. This positive trend is mirrored in recent forecasts, which project unemployment to peak in 2010 and to slowly decline thereafter. Nevertheless,

unemployment will stay substantially above pre-crisis levels also in 2011, and the most vulnerable groups in the labor market will continue to be more strongly affected than the average: Youth unemployment as well as long-term unemployment is still on the rise.

Current employment data are somewhat inconclusive at this point. Both absolute employment figures and employment rates rose in the second quarter. Most of this development, however, was of a seasonal nature, as increases in employment were mostly reported for agriculture and construction. Still, there were notable improvements in industry and/or service sector employment in the Czech Republic, Poland, Slovakia and Turkey, i.e. in those countries that also lead the growth ranking and fared comparatively better in unemployment.

The rather flat development of employment (when adjusted for seasonal factors) may be explained by the general observation that hours worked currently seem to increase more strongly than employment. This can be interpreted as a reversal of trends during the crisis when part of the labor market adjustment was due to a reduction of working hours while employment declined only comparatively little (given the steep decrease in output). Companies tried to keep their labor force employed and therefore expanded flexible and/or short-time working schemes. The employment response to output rising again has been, at least in the short term, subdued. However, this strategy probably paid off for companies, as now they can expand their production more flexibly and especially without experiencing shortages of skilled workers (or at least experiencing less of them).

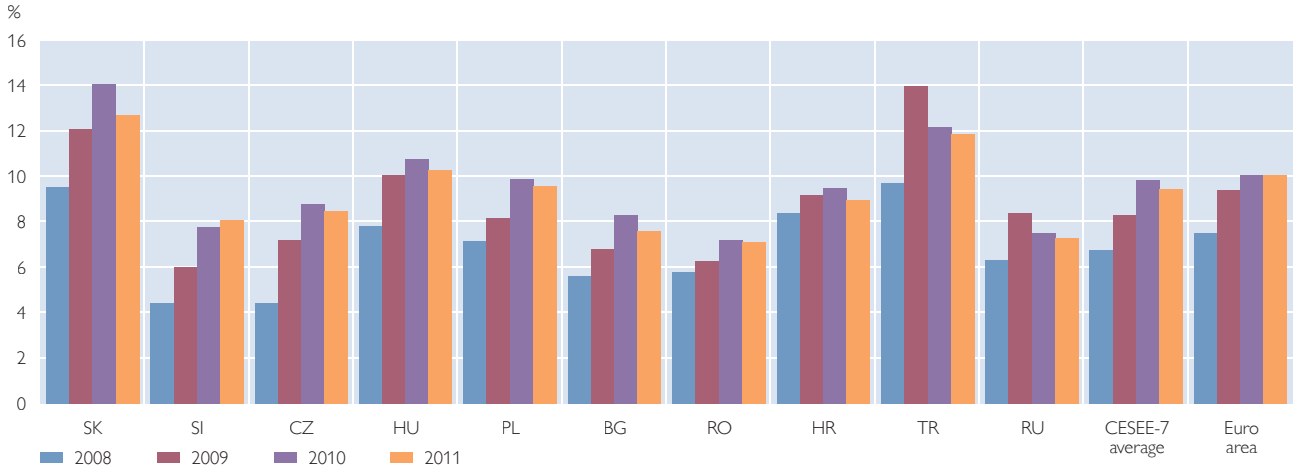
In a similar vein, the gradual recovery in general economic conditions was not strong enough to push up wages. Nominal wage growth at the whole economy level was mostly flat with some notable increases only in Bulgaria and Russia. Moderate, but still clearly positive inflation rates pushed real wage growth into negative territory (again with the exception of Bulgaria and Russia).

Cyclical surge in productivity boosts competitiveness

Concerning industrial wage developments, no clear trends could be identified. Wage growth decelerated in the second quarter of 2010 compared to the 2009 average in Bulgaria, Romania and Croatia and remained stable in the Czech

Chart 5

Unemployment Rates



Source: Eurostat, forecasts: IMF.

Republic, Poland and Hungary. In the other countries, it accelerated moderately, in Slovenia and Russia strongly. Consequently, wage increases stood within a wide range, from –0.5% in Croatia to 15.6% in Russia in the second quarter. By contrast, productivity growth picked up throughout the region. Productivity advances were huge in some cases, with readings for the second quarter mostly being in the double digits. This surge in industrial productivity is related to the strong recovery of industrial output amid a lacking response of industrial employment and therefore of a mainly cyclical nature. Companies that cut back on working hours during the crisis are currently reversing this policy, which has positive effects on productivity per person employed. When looking at the quarterly dynamics (i.e. the change from the first to the second quarter), however, this trend already seems to gradually lose speed in most countries.

At the current juncture, however, productivity increases are still high enough to compensate for wage growth in nearly all countries of the region. Only Bulgaria reports a minor increase in industrial unit labor costs (ULC). This picture does not change substantially when measuring ULC developments in euro. They decreased in most countries, despite a – in some places strong – annual appreciation of local currencies vis-à-vis the euro (given a weak base for the annual comparison due to far-reaching depreciation in early 2009). ULC picked up somewhat in Bulgaria, Poland and Russia.

To put those generally positive readings into perspective, however, one needs to note that industrial ULC also declined strongly in the euro area given roughly constant wages and rising productivity (similar to CESEE). Therefore, relative to the euro area, only Romania and Slovakia could improve their competitive edge while the price competitiveness of the other countries decreased, in particular Russia's.

Table 2

Development of Unit Labor Costs in Industry

	Nominal wages in industry				Unit labor costs in industry (in local currency)				Euro per local currency (year-on-year change in the period average)				Unit labor costs in industry (EUR)			
	2008	2009	Q1 10	Q2 10	2008	2009	Q1 10	Q2 10	2008	2009	Q1 10	Q2 10	2008	2009	Q1 10	Q2 10
	Annual change in %															
Slovenia	7.8	1.4	9.9	9.6	4.9	10.4	0.4	–6.9	0.0	0.0	0.0	0.0	4.9	10.4	0.4	–6.9
Slovakia	7.6	2.7	5.8	6.1	5.5	0.7	–22.7	–18.3	8.0	3.8	0.0	0.0	13.9	4.5	–22.7	–18.3
Bulgaria	21.4	11.4	10.0	9.2	20.0	21.9	2.4	1.4	0.0	0.0	0.0	0.0	20.0	21.9	2.4	1.4
Czech Republic	8.1	4.4	3.9	3.5	11.4	7.5	–10.9	–10.4	11.2	–5.7	6.7	4.3	23.9	1.4	–4.9	–6.5
Hungary	6.3	4.7	8.0	5.2	6.4	12.2	–6.0	–8.1	–0.2	–10.3	9.5	4.1	6.2	0.6	2.9	–4.3
Poland	8.8	4.9	4.4	4.6	7.4	2.5	–8.2	–7.7	7.6	–18.8	12.7	10.9	15.6	–16.8	3.5	2.4
Romania	21.3	11.2	12.4	8.2	14.1	0.4	–8.5	–10.3	–9.4	–13.1	3.7	0.3	3.4	–12.8	–5.1	–10.0
Croatia	6.2	1.4	0.1	–0.5	2.9	1.5	–8.0	–5.0	1.6	–1.6	1.7	1.5	4.5	–0.1	–6.4	–3.6
Turkey	10.7	8.5	11.2	. .	11.2	8.8	–4.7	. .	–6.3	–11.8	3.6	9.3	4.2	–4.0	–1.3	. .
Russia	25.0	3.2	12.6	15.6	21.5	3.2	–3.7	–0.1	–3.9	–17.4	7.4	13.7	16.8	–14.8	3.4	13.6
Memorandum item:																
Euro area	3.0	0.4	2.4	3.1	5.7	9.3	–6.5	–7.5	0.0	0.0	0.0	0.0	5.7	9.3	–6.5	–7.5

Source: Eurostat, national statistical offices, wiiw.

Credit dynamics were dampened but have recently appeared to rebound

Within the observation period, credit developments mostly remained extremely weak and the expansion of credit to the private sector stagnated in most countries. The two big exceptions from this general picture are again Poland and especially Turkey, as both countries were less affected by the crisis, showed strong GDP dynamics in the first half of 2010 and – in this respect, more importantly – also reported positive growth contributions from domestic demand, especially consumption. This should have had a positive impact on credit demand. For Turkey, it is also true that its banking sector displayed a higher degree of resilience to the crisis; credit expansion did not come to a halt even at the peak of the international financial turmoil. This might have been related to the substantial reforms that were implemented after a banking crisis in the early 2000s and a high share of state ownership. Apart from Poland and Turkey, most recent data also deliver somewhat more positive news for the other CESEE countries: The dynamics seem to be picking up slowly, as positive trends became visible in Slovenia, Romania, Croatia and Russia.

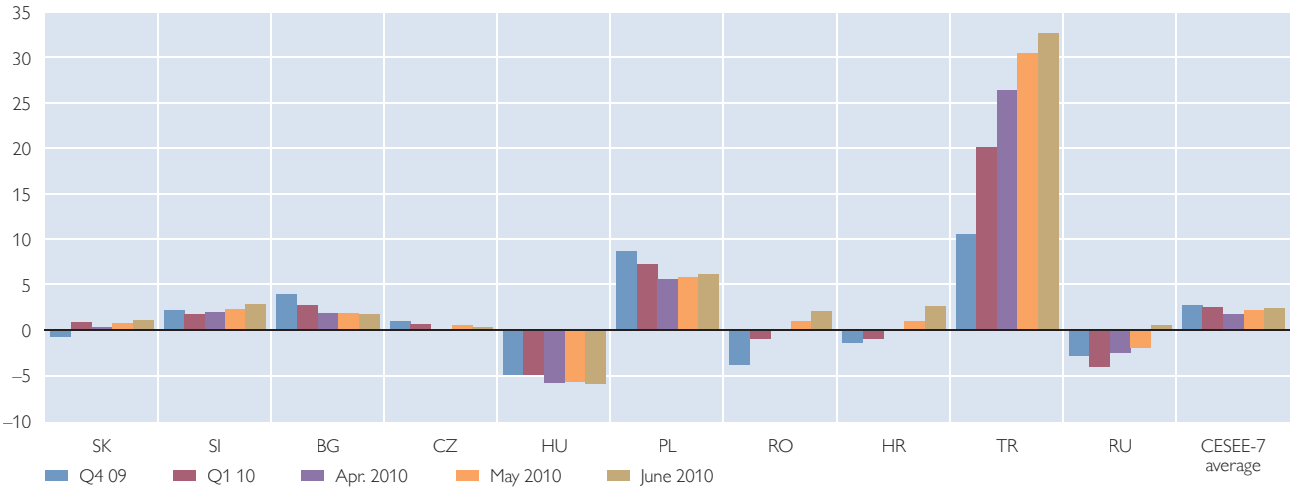
Corporate credit growth weaker than household credit growth

An interesting feature of current credit developments is that household credit is growing at more or less robust annual rates (sometimes in the double digits) while corporate credit growth mostly remains in the red. Low credit demand in the corporate sector is likely related to still low levels of capacity utilization and a simultaneously low need for investment. The comparatively positive performance of household credit, however, seems puzzling as private consumption is stagnant in many countries, and the recently observed growth in imports was mainly driven by intermediate goods as inputs for export production. Apart from households taking mortgage loans, a possible explanation for the rise of consumer loans could be that households are taking out credit to finance ongoing consumption as real wage growth has been negative in many cases and, likewise, total compensation of employees has hardly shown positive dynamics throughout the region. Further evidence for this is provided by survey data concerning the saving behavior of

Chart 6

Growth of Credit to the Private Sector

Year-on-year growth in %, adjusted for exchange rate changes



Source: National central banks.

Note: Turkey: nonadjusted rate.

households: The recent rounds of the European Commission's Business and Consumer Survey as well as the OeNB's Euro Survey (both surveys are not conducted in all countries covered in this report) found that households considered themselves not to be in a position to save at the current juncture. The European Commission's survey also reported that respondents in Hungary, Romania and Bulgaria were already drawing on their savings or running into debt.

Bank lending survey shows increasing demand but no broad-based easing of lending conditions

Recent bank lending surveys conducted in Poland and Hungary reported that household demand for loans was increasing while banks generally tightened lending standards vis-à-vis the sector in the second quarter of 2010. Unlike in Poland, where banks reported a further tightening for the third quarter, in Hungary, no further tightening measures are envisaged. In both countries, corporate loan demand was up too. The tightening cycle witnessed in this segment since 2007 has ended in Hungary, but the responses to the survey suggest that the considerably tighter credit conditions currently applied may remain in place for a longer period. In Poland, banks gradually eased some elements of lending and are expected to continue this policy in the third quarter. Asked for their rationale, Polish banks answered that their assessment of risks related to the economic outlook justified the easing of lending standards. More generally, the responses in the bank lending surveys also suggested that capital and liquidity positions of banks no longer inhibited lending, which should be true for other CESEE countries too. However, the deterioration in the quality of loan portfolios remained a major reason for tightening lending standards in Poland. Regarding borrowers' creditworthiness, Hungarian banks for the first time since the onset of the crisis reported that this factor did not necessitate tightening; neither did it contribute to an easing of standards, though.

Nonperforming loan ratios still elevated

The behavior of nonperforming loan (NPL) ratios in the region has been heterogeneous. In most countries, their increase seems to be slowing down. In Turkey and Russia, there has already been a marginal decrease. It also needs to be noted that some of the recent increases may have been related, at least in part, to statistical factors and not entirely to genuinely new borrowers sliding into trouble. Weak and, in some cases, negative total loan growth has adversely impacted the denominator of NPL ratios, while the numerator has continued to rise as loans have matured or the grace periods provided in the framework of loan restructuring have expired and some of these trouble loans have finally become nonperforming.

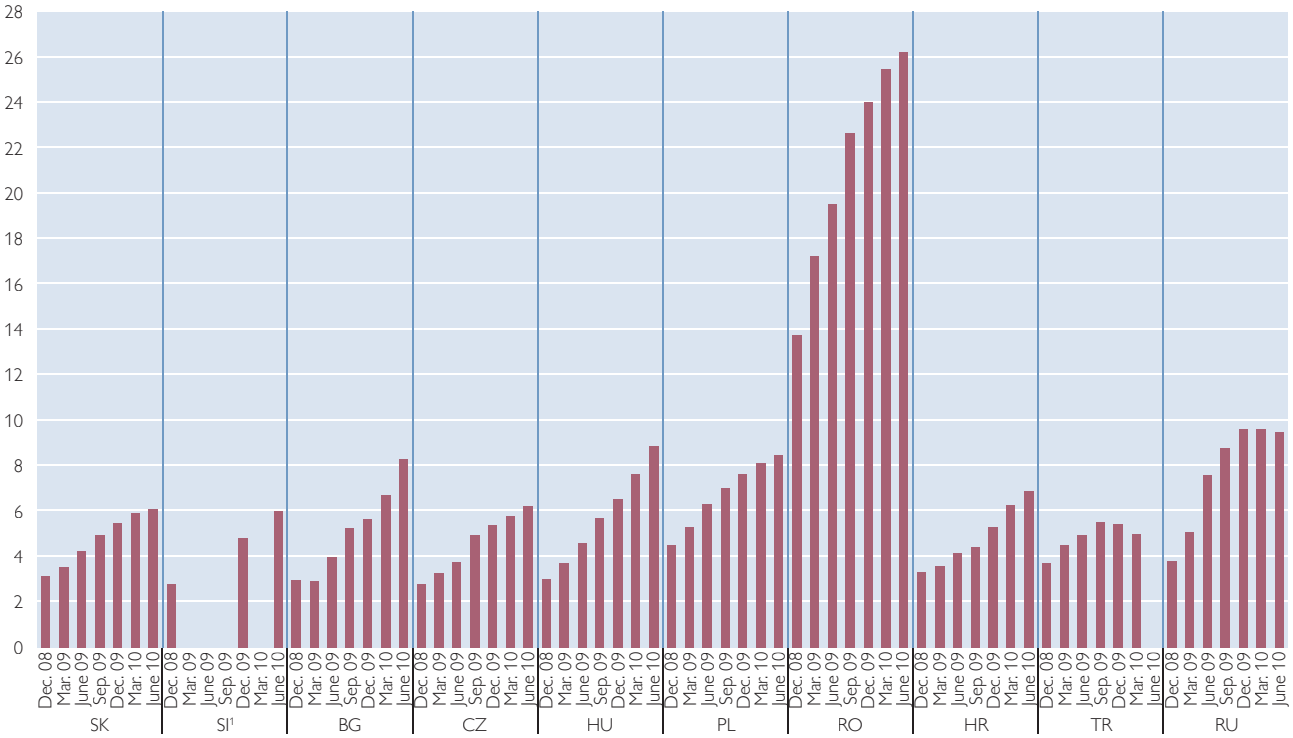
Some pickup in generally moderate inflation

Starting from very low and, in some cases, negative levels (e.g. Slovakia), inflation started to increase somewhat in recent months in most countries of the region. Higher prices for processed food (including alcohol and tobacco) as well as energy were mainly responsible for this development. An increase in the value-added tax rate (from 19% to 24%) in July gave a further boost to prices in Romania. However, price pressures emanating from cyclical developments (output gap) remained rather contained: Core inflation rates mostly increased less than headline inflation rates. Also, ULC developments at the whole economy level were mostly quite favorable; in some countries, ULC even declined year on year, on the back of falling wages and rising productivity. Moreover, exchange rate appreciation contributed to containing inflation pressures. Some countries (Hungary, Poland and Russia) even experienced disinflation in the review period. Contrary to regional trends, Hungary and Poland saw inflation rates rising in early 2009, in the case of the former this was due to an increase in the value-added tax rate, in the case of the latter due to generally comparatively sound economic developments

Chart 7

Nonperforming Loans

% of total credit



Source: National central banks.

[1] Until 2009, Slovenia published nonperforming loan details only at annual frequency. Since 2010, details have been available biannually.

and a strong depreciation of the zloty. Thus, current inflation developments are in part also attributable to base effects.

Despite the recent increase, inflation rates have generally remained on a reasonable level in most countries. Substantial price increases were limited to Romania (VAT rate hike) as well as Turkey and Russia. Still, even in these two countries, where economic dynamics were relatively strong, inflation remained contained, as annual price rises came down from early 2010 levels in the course of the year.

Given decreasing medium-term inflation risks, some central banks (of the Czech Republic, Hungary, Romania and Russia) kept cutting their policy rates in spring after having lowered them substantially already in 2009 to counteract the economic slump. Beginning in June, amid resurfacing uncertainties concerning the disinflation process and in line with the stabilization of economic conditions, monetary easing cycles ended in all countries of the region.

Governments are slowly embarking on a fiscal consolidation path

Most CESEE countries have regained positive growth (or were close to attaining it) by mid-2010. However, this improvement in economic activity has been partly attributable to a significant deterioration of government accounts. Sizeable public spending either in the form of large fiscal stimulus packages (e.g. Russia) or through the operation of automatic stabilizers has put enormous strains on public finances. This has led to a steep rise in government deficits by an average of 4 percentage points of GDP (within a range from 0.7% of GDP in Hungary to 11.2% of GDP in Russia) in 2009 compared to a year earlier. Also, there was a large expansion

Table 3

Consumer Price Index (HICP)

	2008	2009	Jan. 10	Feb. 10	Mar. 10	Apr. 10	May 10	June 10	July 10	Aug. 10
	Annual change in %									
Slovakia	3.9	0.9	–0.2	–0.2	0.3	0.7	0.7	0.7	1.0	1.1
Slovenia	5.6	0.9	1.8	1.6	1.8	2.7	2.4	2.1	2.3	2.4
Bulgaria	12.0	2.5	1.8	1.7	2.4	3.0	3.0	2.5	3.2	3.2
Czech Republic	6.3	0.6	0.4	0.4	0.4	0.9	1.0	1.0	1.6	1.5
Hungary	6.0	4.0	6.2	5.6	5.7	5.7	4.9	5.0	3.6	3.6
Poland	4.2	4.0	3.9	3.4	2.9	2.7	2.3	2.4	1.9	1.9
Romania	7.9	5.6	5.2	4.5	4.2	4.2	4.4	4.3	7.1	7.6
Croatia[1]	6.1	2.4	1.1	0.7	0.9	0.6	0.8	0.7	1.0	0.9
Turkey	10.4	6.3	8.2	10.1	9.6	10.2	9.1	8.4	7.6	8.3
Russia[1]	14.1	11.8	8.1	7.2	6.5	6.0	6.4	6.1	5.9	6.6
CESEE-7 average	5.8	3.3	3.3	3.0	2.8	2.9	2.7	2.7	2.9	3.0
Euro area	3.3	0.3	1.0	0.9	1.4	1.5	1.6	1.4	1.7	1.6

Source: Eurostat, national statistical offices, wiiw.

[1] CPI.

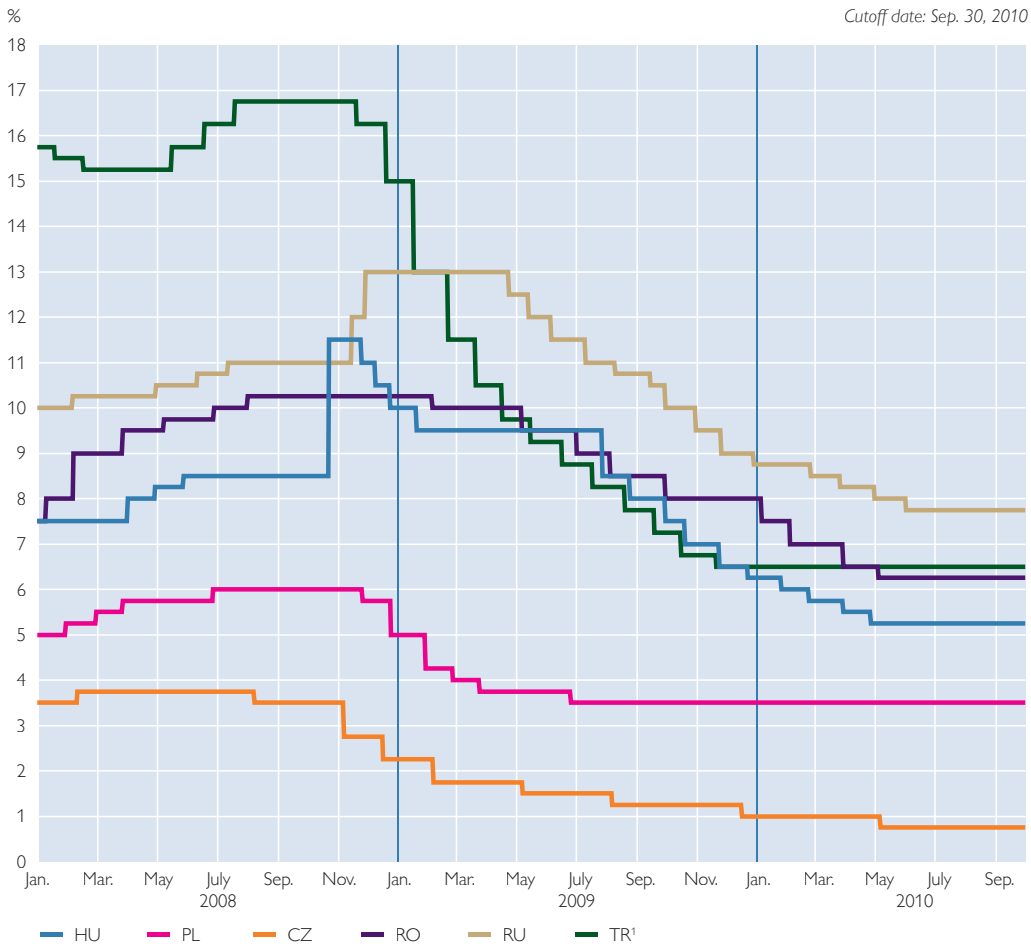
in public debt, ranging from 1.0 percentage point of GDP in Bulgaria to as much as 12.9 percentage points of GDP in Slovenia.

As the economic outlook is improving after the recession, governments are starting to embark on a fiscal consolidation path in order to safeguard the sustainability of their public finances and to meet commitments made within the framework of the excessive deficit procedure (EDP), which all EU Member States of the country group reviewed here are currently subject to. In July 2010, Bulgaria was the latest country where an excessive deficit was found to exist, after the country had to revise upward its 2009 budget deficit from 1.9% of GDP to 3.9% of GDP (as new budget data had revealed a host of unaccounted procurement deals) and to even 4.7% of GDP in October 2010. Under the EDP, strict benchmarks for reducing the budgetary gaps have been agreed upon, with the deadlines for finalizing the correction of excessive deficits stretching from 2011 in the case of Hungary and Bulgaria, to 2012 for Poland and Romania and 2013 for the Czech Republic, Slovakia and Slovenia. So far the procedures seem to be broadly on track. The European Commission has found that the required effective action has been taken in all countries (with the obvious exception of Bulgaria). It can be expected that the governments will take fiscal consolidation seriously not only due to the current EDPs but also due to markets' increased surveillance of and pressure on government policies, which has been apparent since the onset of the crisis and, especially since spring, related to developments in some euro area countries.

Dwindling revenues have pressured policymakers to increase revenues by implementing tax hikes or to cut spending to reduce the budgetary gap. For example, the Czech Republic, Hungary, Slovenia and Romania have raised tax rates (mainly value-added tax but also excise taxes) and/or cut or frozen public sector wages. Poland and Slovakia will increase their VAT rates in 2011. These moves have become crucial, especially given the absence of previously high economic growth rates that in the coming years could boost revenues to past levels. In turn, the hike of indirect tax rates may dampen the speed of recovery

Chart 8

Policy Rate Developments in CESEE



Source: National central banks.

[1] In May 2010, the Central Bank of Turkey replaced the borrowing rate with the one-week repo rate as the new policy rate.

and will probably have some negative distributional effects. Some countries (e.g. Croatia and Russia) were able to issue international bonds to cover their financing needs.

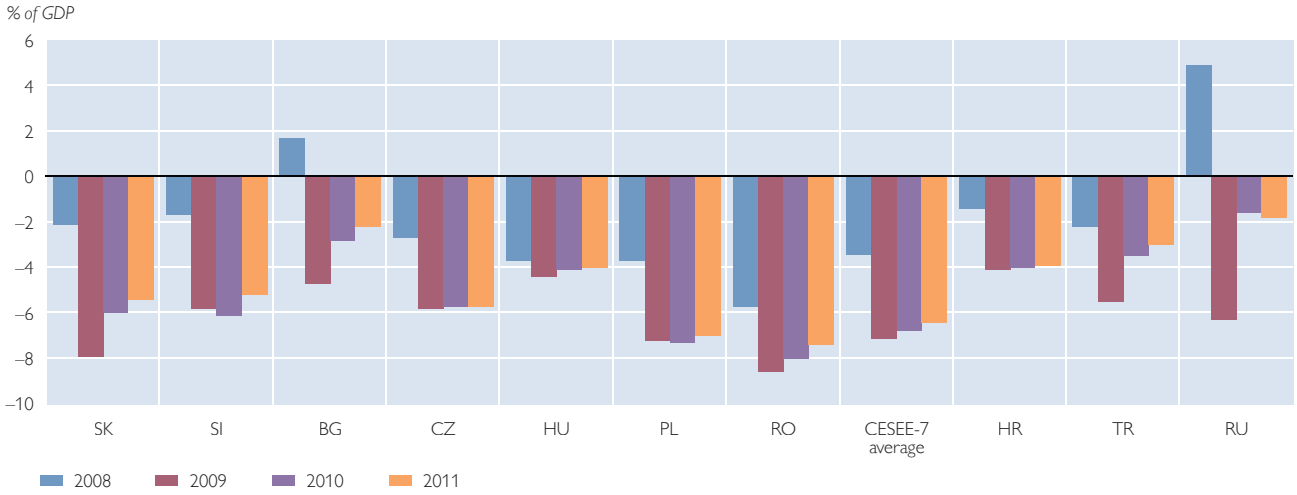
According to recent forecasts, the bulk of consolidation will take effect in 2012 and the years thereafter, as deficits in the CESEE-7 are projected to remain broadly unchanged in 2010 (with the notable exception of Bulgaria) and 2011. As regards the non-EU Member States of the country sample, the deficits will decrease strongly in Turkey and Russia already in 2010 and hover around 4% of GDP in Croatia until 2011.

EU accession negotiations continue

The EU accession negotiations with two candidate countries, Croatia and Turkey, proceeded in the review period. In the case of Croatia, further substantial progress was made after the talks had been unblocked in the wake of a rapprochement between Croatia and Slovenia in October 2009. Croatia opened three new chapters and closed five in its accession negotiations. The talks are now continuing in 33 out of 35 chapters, 22 have already been closed provisionally.

Chart 9

General Government Deficits



Source: Eurostat, European Commission.

Turkey and the EU have opened 11 negotiation chapters, but only one chapter has been closed provisionally. As Turkey has not yet met all of its statutory obligations – specifically with regard to the extension of the existing customs union with the EU to Cyprus – the opening of chapters on these matters has been delayed. Moreover, the EU will not close any other chapter provisionally unless Turkey has met all of its statutory obligations.

Slovenia, a member of the EU since 2004, made a further move toward international integration by joining the OECD on July 21, 2010.

Box 1

Estonia to Become 17th Member of the Euro Area in 2011

Following the positive assessment of Estonia's economic convergence in the ECB's and the European Commission's Convergence Reports of May 12, 2010, and the June 2010 EU Council Conclusion to welcome Estonia's entry into the euro area, the Ecofin Council adopted a decision allowing the country to join the euro area on January 1, 2011. The Ecofin Council also irrevocably fixed the conversion rate of the Estonian kroon at its central parity within ERM II agreed in June 2004, which is EEK 15.6466 to EUR 1.

In Estonia, the changeover to the euro has already started: From July 1, 2010, until the end of June 2011, dual pricing both in Estonian kroons and in euro is mandatory to enable people to get used to the new currency. Furthermore, the preliminary distribution of euro coins and banknotes to commercial banks has already begun. The dual circulation period (i.e. the period during which both the kroon and the euro are legal tender) will be short, lasting only until January 14, 2011. Estonian commercial banks will exchange legacy currency coins and banknotes until end-2011. Eesti Pank will exchange kroons and cents for euro without a specified term and free of charge.

Table 1

Comparison of Estonian and Euro Area Indicators

	Estonia		Euro area (EA-16)	
	1999	2009	1999	2009
Population (million as at Jan. 1)	1.4	1.3	311.6	329.6
Population, as a share of the total euro area population (%)	0.4	0.4	×	×
GDP, as a share of euro area GDP (%)	0.1	0.2	×	×
Per capita GDP (at PPP; euro area GDP = 100)	37.8	58.0	×	×
Labor productivity per hour worked (euro area = 100[1])	17.2	25.4	×	×
Employment rate	61.5	63.5	60.4	64.7
Unemployment rate[1, 2]	13.6	13.8	9.3	9.4

Source: Eurostat.

[1] *2000 and 2009 data.*
[2] *Eurostat definition.*

Great efforts to meet the criteria for euro area membership preceded the introduction of the euro. The Estonian economy has demonstrated a high flexibility of wages and prices and managed to adjust to external shocks under a fixed exchange rate regime for almost two decades and especially during the crisis. Despite the deep recession, Estonia fulfilled the Maastricht budget deficit criterion in 2009 by implementing radical expenditure cuts. In the second quarter of 2010, economic growth turned out positive for the first time after two years of steep declines of real GDP.

The prospect of euro area membership and Estonia's efforts to achieve this goal helped build confidence in the markets. A small and very open economy well integrated into the EU, Estonia is expected to benefit strongly from the euro. Euro area membership will reduce transaction and information costs, leading to increased trade and financial integration. Price transparency will enhance competition. Additionally, euro area membership provides a credible framework for price stability, implying lower risk premiums and lower long-term interest rates. Finally, the common currency provides a shelter against financial market turbulences, in particular in times of crisis. It will eventually lead to higher economic growth and living standards, and the positive effects will spill over to the other countries of the Baltic region.

Box 2

OeNB-BOFIT Outlook for CESEE Countries: Growth Driven by Net Exports and Restocking, Domestic Demand to Remain Weak[1]

Our GDP growth forecast of 1.3% for the CESEE-7[2] region for 2010 remains unchanged compared to our March projections, taking into account major upward (Czech Republic and Hungary) and downward revisions (Bulgaria and Romania) at the country level. Robust growth in Poland and the Czech Republic contrasts with negative GDP growth in Bulgaria and Romania in 2010. Hungary will post modest but positive growth again. Net exports and substantial

[1] *The OeNB and the Bank of Finland Institute for Economies in Transition (BOFIT) compile semiannual forecasts of economic developments in selected CESEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and Croatia). The OeNB is in charge of the projections for the EU Member States as well as Croatia, BOFIT provides the forecast for Russia. The cutoff date for all projections in this box was September 24, 2010 (Croatia: October 5, 2010). The forecasts are based on a broad range of information, including country-specific time series models for Bulgaria, the Czech Republic, Hungary, Poland and Croatia (for technical details, see Crespo Cuaresma et al., 2009. Simple but Effective: The OeNB's Forecasting Model for Selected CESEE Countries, Focus on European Economic Integration Q4/09, pp. 84–95). The forecast for Romania draws on information from various sources and expert judgment (given that the time series are as yet too short to conduct model calculations). The projections for Russia are based on an SVAR model.*

[2] *Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania. Latvia and Lithuania are not covered by our own projections, but are included in the CESEE-7 aggregate based on the most recent IMF projections. As Estonia will become a euro area member at the beginning of 2011, it is no longer covered in the CESEE-7 aggregate.*

restocking remain the principal growth drivers. In 2011, investment growth and private consumption will also strengthen in all countries, and GDP growth will pick up to 2.8%, implying a marginal downward revision of our March projection of 3.1%. The recovery will continue in 2012, accelerating slightly to 3.4%.

The gradual economic recovery in the Central and Eastern European EU Member States started in the second half of 2009 and continued into ***the first half of 2010*** *with highly dissimilar developments in individual countries. Apart from Poland, still the region's growth engine, domestic demand remained tepid and continued to contribute negatively to GDP growth. Private consumption will remain subdued as a result of the still rather bleak labor market situation and very moderate or – in the public sector often – negative wage growth. Investments are hampered by low credit growth and low levels of capacity utilization. In the Czech Republic and in Lithuania, domestic demand gained momentum in the second quarter of 2010 as a result of increasing investment activity. However, gross fixed capital formation declined in all countries in the first half of 2010 year on year due to tight credit conditions, low FDI inflows and a marked decline in private house building.*

Thus, the replenishment of stocks remains the only positive growth component that adds substantially to the ***recovery in 2010.*** *Restocking will continue in all countries over the entire projection period, albeit at a decreasing rate. Its substantial positive growth contribution in 2010 will be only temporary and will become negligible in 2011 and 2012.*

Leading indicators point toward a continued recovery. Especially the industrial sector has benefited so far from strengthening external demand and restocking. Industrial production, new orders and sales have generally already surpassed their pre-crisis levels, and capacity utilization is rising steadily from historically low levels. On the other hand, weak private consumption implies a much more protracted recovery in retail trade and the construction sector as compared to industry.

The housing boom in many CESEE-7 countries found an abrupt end in the crisis. Credit conditions will remain tight in the near future, and fiscal consolidation needs have already resulted in tax hikes and other restrictive budgetary measures in some countries. As a result, investment is expected to remain well below the longer-term pre-crisis average over the projection period, which is further reinforced by low capital utilization rates in many countries. EU-funded projects will represent an important component of investment activity, especially so in Hungary, Bulgaria and Poland.

Domestic demand will revive very hesitantly in ***2011,*** *again making a positive contribution to the still moderate growth rate of 2.8% in the region. Tight labor market conditions, falling real wages, wage cuts in the public sector in some countries and an elevated debt burden on households in several countries are factors which will dampen private consumption. With little room for maneuver, public consumption will remain weak. Investment growth will pick up somewhat as utilization rates increase, backed by large-scale projects cofinanced by the EU as well as by strengthening output growth in the export-oriented industrial sector. Thus, reviving external demand will support investment growth. Export and import growth are expected to be more dynamic, with net exports turning negative again in 2011 in all countries except for Hungary.*

The picture will remain largely unchanged in ***2012.*** *Domestic demand and investments will gain momentum, but both will remain well below their long-term pre-crisis average. Import growth is expected to be buoyant. Net exports will again make a negative contribution despite significant export growth. Restocking will come to an end in 2012 in all countries.*

The CESEE-7 region will reach its pre-crisis output level by the end of 2011. However, it should be noted that Poland, the largest economy in the region, did not experience any output loss in 2009. The Czech Republic will recover its pre-crisis GDP level in 2011, Bulgaria only in 2012, and Hungary and Romania will need more time to recover to their pre-crisis output levels.

These forecasts are subject to considerable risks related on the one hand to the substantial fiscal consolidation needed in most countries and on the other hand to developments in Western Europe. Fiscal consolidation poses a considerable downside risk to our forecast for all countries

apart from Romania and the Czech Republic, where reforms have already been passed and are thus included in our forecasts. Serious consolidation efforts would further depress nascent domestic demand; in particular, private and public consumption will be directly affected. The risks attached to the external environment are rather balanced, given our already cautious assumptions on EU and euro area GDP and import growth. As in our last forecast, uncertainty continues to prevail with respect to changes in investor confidence (i.e. the development of global risk aversion, in particular vis-à-vis emerging economies). We continue to assume that investor confidence will gradually be restored over the projection horizon. Thus, the possibility that investor risk perceptions remain below their pre-crisis levels represents an additional downside risk with negative implications for the long-term catching-up process. Given the more evident consolidation needs, downside risks have increased again compared to our March projections.

Table 1

CESEE-7: GDP Projections for 2010 to 2012 and Revisions to OeNB March Projections

	Euro-stat	OeNB			Change from March	
	2009	2010	2011	2012	2010	2011
	Year-on-year growth in %				*percentage points*	
CESEE-7	–3.3	1.3	2.8	3.4	–0.0	–0.2
Bulgaria	–5.0	–0.3	2.4	3.2	–0.6	–0.5
Czech Republic	–4.2	2.1	2.4	2.5	0.8	–0.2
Hungary	–6.3	0.8	2.2	3.0	1.0	–0.3
Poland	1.7	3.2	3.7	4.1	0.2	0.3
Romania	–7.1	–2.6	1.5	2.8	–3.4	–1.6

Source: OeNB September 2010 forecast, Eurostat.

BOFIT-OeNB Forecast for Russia: Consumption-Driven Growth to Continue

Russia will exhibit a brisk consumption-driven recovery. Growth will remain brisk throughout the 2010 to 2012 period, peaking in 2011 and slowing slightly in 2012. Still, GDP growth is forecast to stay at slightly below 5% until 2012. GDP will reach its pre-recession level of 2008 in mid-2011.

GDP started to augment again in the second half of 2009, only to slow in the first quarter of 2010, inter alia due to a harsh winter. Growth stayed at that level in the second quarter of 2010. For the second half of 2010, growth is expected to be animated, although the exceptionally hot and dry summer will shave a bit off of production volumes. Especially in 2010, growth – materializing at slightly below 5% – is supported by the world market price of oil. Rather weak growth in the first half of 2010 will (as a low base) raise the annual figure for 2011 to over 5.5%, despite a slowdown in early 2011.

Growth will be driven mainly by private consumption. The first half of 2010 saw rising real wages, very large hikes of pensions, declining unemployment, consumer confidence indicators approaching pre-crisis levels, and some revival of banks' household lending. Real wages are anticipated to grow briskly, and the public sector is assumed to stick to its plan to keep the pension and wage ratio virtually constant. Household propensity to save is not expected to rise from its current level, to which it had already risen during the crisis. Unemployment prospects are relatively uncertain, as employment decreased only by a few percentage points in the recession, thus dampening productivity strongly.

Investments are forecast to revive with a lag, partly because companies have more idle production capacity than before the crisis. In the first half of 2010, investment growth was zero. It is expected to revive in the second half of the year, but tangible investment growth will

take off only in 2011. Deleveraging and the adjustment of banks' balance sheets may have run their course, and banks look poised to expand credit prudently soon.

Public consumption is expected to still increase slightly this year due to the remaining anti-crisis measures but to remain unchanged in the period from 2011 to 2012. The public sector is practically free of debt (net), and there is no immediate need to balance public sector finances, although the government and particularly regions and municipalities have scaled down their total real expenditures this year. Significant expenditure cuts are hardly likely, as elections are approaching (Duma elections in December 2011, presidential elections in March 2012).

Russia's export volume was about 10% higher in the first half of 2010 than in the previous year, mainly as gas exports had recouped their deep losses of early 2009. Despite the rapid growth of world trade, Russia's export volume is expected to grow relatively slowly, as export volumes of crude oil, oil products and gas (55% to 58% of Russian exports of goods and services in 2009 and in the first half of 2010) are forecast to increase very modestly because of slow production growth.

According to preliminary figures, Russia's import volume was up by over 20% year on year in the first half of 2010 compared to a deep slump in the first half of 2009 (over one-third lower than in the first half of 2008). Seasonally adjusted imports in the first quarter of 2010 fell from the preceding quarter, but rose fast in the second quarter. Import growth is expected to decelerate slightly in the third quarter and to fall further from 2011 to 2012, but is still anticipated to come to over 10%. Imports will be driven by consumption growth, and from 2011, by a pickup of investments.

The forecast is based on the view of brisk but somewhat decelerating growth of the world economy and world trade, and a gradually rising world market oil price. The uncertainties surrounding the forecast are exceptionally large. All uncertainties in the global economy are directly reflected in the development of the Russian economy, particularly via energy prices as well as financial markets. A drop in the oil price could hit the Russian economy strongly, especially now, as the chances for fiscal stimulus are becoming smaller than in 2008, after which the government had spent half of its reserve funds. In the midst of uncertainty, the direction of capital flows may change easily and strongly, backed by large amounts of liquidity both globally and in the Russian banking sector. Still, positive surprises for Russia are also possible in terms of higher energy prices, foreign finance and bank lending growth. The revival of investment in Russia is subject to considerable uncertainty, which from the perspective of private investors is represented by interference by the state, i.e. politicians and officials, in corporate activities, as well as by short-term reactions to problems arising from the recession. Russian companies' inventory building is fraught with abnormal uncertainty; even in less turbulent times, changes in inventories (mostly growth) have had a considerable impact on Russia's GDP growth.

Table 2

Russia: GDP Projections for 2010 to 2012 and Revisions to BOFIT March Projections

	Rosstat	BOFIT-OeNB			Change from March	
	2009	2010	2011	2012	2010	2011
	Year-on-year growth in %				*percentage points*	
Russia	–7.9	4.9	5.6	4.7	–0.6	0.6

Source: BOFIT September 2010 forecast, Rosstat.

OeNB Projections for Croatia: Weak Domestic Demand Slows Economic Recovery

Given weak domestic demand, the Croatian economy will continue to contract in 2010, before growth picks up to 1.5% in 2011 and 2.8% in 2012.

Following a slump in GDP in 2009, economic conditions are set to remain weak in Croatia in 2010. Although the fragile recovery that started in the latter part of 2009 continued in early 2010, the economy still contracted by 2.5% year on year in the first half of 2010 on the back of still depressed domestic demand. The downward trend of the Croatian economy is set to moderate further in the second half of the year, implying a drop of approximately 1.6% in real output for 2010 as a whole and, like in Romania and Bulgaria, a rather sluggish economic recovery.

In particular, private consumption is expected to gain some momentum in the latter half of 2010 following the abolition of the crisis tax in two steps (July and November) and the reduction of the level and number of personal income tax rates as of July 2010. However, the full impact of these measures will fully materialize only in 2011. Similarly, gross fixed capital formation is seen to have bottomed out in the first half of 2010. The main impetus for recovery in investment activity should come from the private sector following the introduction of the government's three-pillar credit/financing scheme in early 2010, which is aimed at stimulating bank lending to the economy. However, like public consumption, public investment is expected to remain listless in light of increasing fiscal constraints. Against the background of firming export growth and a relatively good tourism season (arrivals were up by 12% year on year in July 2010, while nights spent increased by 5%) as well as the ongoing downward adjustment of imports, net exports are forecast to contribute positively to growth also in the second half of 2010.

We expect the economy to grow by 1.5% in 2011 and to return to the growth pattern seen before the crisis, with a positive (negative) contribution of domestic demand (net exports). Investment activity is expected to pick up on the back of resuming lending activity and improving consumer and business sentiment, while private consumption should benefit from the tax relief measures mentioned above and possibly also from incipient improvements in labor market conditions. At the same time, given the freezing of budget expenditures for 2011 and 2012 at the level of the revised 2010 budget, no major stimuli can be expected from public consumption. Given that general elections will be held in 2011, no substantial progress will be achieved with structural reforms, either. Provided the global environment is supportive, export growth is to accelerate further in 2011, but will be outpaced by import growth, given the strengthening of domestic demand.

The Croatian economy is forecast to expand by 2.8% in 2012, driven by a further strengthening of domestic demand. In particular, gross fixed capital formation is forecast to accelerate on the back of increased FDI inflows ahead of the country's prospective EU entry expected in 2013 if EU membership negotiations are completed on schedule by mid-2011 and the subsequent ratification process in the EU Member States is concluded on time. The frontloading of imports prior to EU entry is expected to result in an increasingly negative contribution of net exports, though.

Table 3

Croatia: GDP Projections for 2010 to 2012 and Revisions to OeNB March Projections

	Euro-stat	OeNB			Change from March	
	2009	2010	2011	2012	2010	2011
	Year-on-year growth in %				*percentage points*	
Croatia	–5.8	–1.6	1.5	2.8	–1.5	–0.3

Source: OeNB September 2010 forecast, Eurostat.

2 Slovakia: Fragile Revival Based on External Demand

Output growth fueled by exports and public consumption

After output declined in 2009, it started to grow by nearly 5% in the first half of 2010. The vivid expansion was driven primarily by external demand: Exports expanded by more than 16% in both quarters. Public consumption grew by 6.2% in the first quarter, but declined by 1.2% in the second quarter. This backlash took place against the background of the parliamentary elections in June 2010. Accordingly, the prospects for the economy remain surrounded by uncertainty because public consumption is likely to decline, private consumption is still largely stagnant, and import growth is catching up with that of exports. While investment growth was negative in the review period, it should return to a positive path in the near to medium term as industrial production is growing dynamically, capacity utilization is picking up again and large investment projects, especially in the electronics industry, are in the pipeline.

FDI in electronics industry improve industrial structure

Growing exports are mirrored in the trade balance, which has shown an uninterrupted surplus since the second quarter of 2009. However, the service and the income balances continue to be in deficit, causing the overall current account deficit to rise to over EUR 600 million. Finally, FDI increased again in the first half of 2010 to nearly EUR 300 million. New investment projects were announced, for instance by Samsung and Sony. As a result, the electronics industry is improving the industrial structure of Slovakia, which still has a strong focus on the automotive industry.

Soaring wages

The labor market has already reacted to the revival of the economy, with unemployment declining from the top value of over 15% in the first quarter to 14.4% in the second quarter 2010. However, labor market participation remained below the pre-crisis level of 60% of the labor force. Nominal wages in industry improved strongly in both quarters, but labor productivity also increased by more than 30% in the first half of 2010. This was made possible by strong increases in industrial production amid subdued employment. However, these figures reflect also the stagnation or even slight declines (first half of 2009) of productivity in the previous years.

Inflation remains low

HICP inflation remained low in the first half of 2010. Core inflation reached positive but comparably low values of approximately 1%. Overall average inflation was low, but different product groups showed highly different price dynamics. Prices for food, clothing, and furniture declined slightly, whereas prices for alcoholic beverages and health and education increased by more than 4% on average in the first half of 2010. Producer prices even declined in the first quarter, but they turned around and grew by 0.1% in the second quarter of 2010. The low price pressures can partially be attributed to lower energy prices, but also to competition from neighboring CESEE countries (especially Hungary and the Czech Republic).

Expanding budget deficit

Public expenditures exploded before the parliamentary elections in June 2010, and already in September, the budget deficit stood at 83% of the value projected for the whole year. The Ministry of Finance therefore revised the deficit figure from 5.5% to 7.8% of GDP. For 2011, the government approved a budget proposal targeting a deficit of 4.9% of GDP (which may be too optimistic a goal). This figure is to be achieved mainly by expenditure cuts, supported by a temporary increase of VAT by 1 percentage point to 20%, a reduction of income tax exemptions and increases of consumption taxes.

Table 4

Main Economic Indicators: Slovakia

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	10.6	6.2	–4.7	–5.7	–5.5	–4.9	–2.6	4.8	4.7
Private consumption	6.9	6.0	–0.7	–0.9	0.4	–0.3	–1.9	0.4	–1.0
Public consumption	0.1	5.3	2.8	1.3	6.9	–0.2	2.9	6.2	–1.2
Gross fixed capital formation	9.1	1.8	–10.5	–3.9	–17.7	–11.4	–7.3	–0.4	–1.9
Exports of goods and services	14.3	3.2	–16.5	–25.2	–20.3	–15.0	–5.2	16.8	16.5
Imports of goods and services	9.2	3.1	–17.6	–22.3	–22.2	–15.6	–10.3	9.9	14.4
	Contribution to GDP growth in percentage points								
Domestic demand	6.6	5.9	–6.1	–4.0	–7.1	–6.3	–6.7	0.7	4.2
Net exports of goods and services	4.7	0.2	0.5	–4.0	1.0	–0.1	4.7	5.8	2.5
Exports of goods and services	13.6	3.1	–15.8	–26.5	–20.2	–13.3	–4.7	14.0	13.8
Imports of goods and services	8.9	2.9	–16.3	–22.4	–21.2	–13.2	–9.4	8.2	11.3
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	14.3	2.7	2.5	–13.3	–5.3	7.2	22.9	36.0	29.6
Average gross earnings in industry (nominal)	6.4	7.6	2.7	3.0	1.5	1.6	4.7	5.8	6.1
Unit labor costs in industry (nominal)	–6.8	5.5	0.7	20.3	7.4	–4.9	–16.1	–22.7	–18.3
Producer price index (PPI) in industry	–1.4	2.5	–6.6	–5.1	–7.5	–8.1	–5.8	–3.4	0.1
Consumer price index (here: HICP)	1.9	3.9	0.9	2.3	1.1	0.4	0.0	0.0	0.7
EUR per 1 SKK, + = SKK appreciation	10.2	8.0	3.8	. .	. .	. .	. .	. .	. .
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	11.2	9.6	12.1	10.4	11.3	12.6	13.9	15.2	14.4
Employment rate (%, 15–64 years)	60.7	62.3	60.2	61.0	60.4	60.1	59.2	58.0	58.6
Key interest rate per annum (%)	4.4	4.0	. .	. .	. .	. .	. .	. .	. .
SKK per 1 EUR	33.8	31.3	. .	. .	. .	. .	. .	. .	. .
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	13.0	4.8	3.2	9.8	6.4	3.0	3.2	–1.2	1.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	0.7	–8.0	–1.4	–11.9	–5.5	–1.8	–1.4	3.3	3.2
Domestic credit of the banking system	13.6	12.5	23.0	27.8	28.0	26.2	23.0	9.4	9.9
of which: claims on the private sector	15.1	11.2	6.0	11.8	9.6	7.6	6.0	2.4	2.1
claims on households	6.9	7.0	3.5	6.4	5.3	4.3	3.5	3.3	3.6
claims on enterprises	8.1	4.2	2.4	5.4	4.3	3.2	2.4	–0.9	–1.5
claims on the public sector (net)	–1.5	1.3	17.0	16.0	18.4	18.6	17.0	7.0	7.8
Other assets (net) of the banking system	–1.3	0.3	–18.4	–6.1	–16.1	–21.4	–18.4	–13.9	–11.4
	% of GDP, ESA 95								
General government revenues	32.5	32.9	33.6	. .	. .	. .	. .	. .	. .
General government expenditures	34.3	35.0	41.5	. .	. .	. .	. .	. .	. .
General government balance	–1.8	–2.1	–7.9	. .	. .	. .	. .	. .	. .
Primary balance	–0.4	–0.9	–6.5	. .	. .	. .	. .	. .	. .
Gross public debt	29.6	27.8	35.4	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	27.0	13.4	–17.5	–24.0	–25.3	–18.2	–1.6	19.9	29.7
Merchandise imports	21.5	13.4	–20.6	–20.0	–29.1	–23.6	–8.9	12.4	29.2
	% of GDP (based on EUR), period total								
Trade balance	–1.2	–1.1	1.5	–2.1	1.6	3.5	2.5	2.0	2.2
Services balance	0.7	–0.7	–2.0	–2.9	–1.6	–1.7	–1.9	–1.8	–1.3
Income balance (factor services balance)	–4.3	–3.5	–1.8	0.7	–1.3	–3.0	–3.0	–2.3	–2.3
Current transfers	–0.6	–1.3	–1.1	–0.7	–1.0	–0.7	–2.1	0.4	–0.9
Current account balance	–5.4	–6.6	–3.4	–5.0	–2.4	–1.9	–4.6	–1.6	–2.2
Capital account balance	0.6	1.2	0.6	1.0	0.9	0.0	0.4	2.6	0.0
Foreign direct investment (net)	3.9	3.4	–0.8	0.1	–5.6	0.2	1.9	2.1	0.3
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	54.8	58.2	71.6	61.8	69.5	73.3	71.6	72.6	74.3
Gross official reserves (excluding gold)[1]	22.3	19.5	0.8	0.3	0.1	0.8	0.8	0.8	0.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	3.1	2.8	0.1	0.0	0.0	0.1	0.1	0.1	0.1
	EUR million, period total								
GDP at current prices	54,940	64,899	63,332	14,656	15,587	16,568	16,522	15,072	16,355

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

[1] *Given Slovakia's adoption of the euro, the concept of the calculation of international reserves has changed as at the beginning of 2009. In particular, reserves no longer include foreign assets in euro and claims on euro area residents.*

3 Slovenia: Gradual Recovery under Way

GDP growth bounces back in the second quarter of 2010

Following a contraction in GDP in six consecutive quarters, year-on-year GDP growth returned to positive territory in the second quarter of 2010. However, household consumption continued to contract, though less than in 2009. While the growth of credit to households continued its moderate recovery, the decline in total real net wages was bigger than in 2009 (even though the negative trend seems to have reversed since the beginning of 2010), and the recovery of consumer demand was held back by heightened unemployment and weak consumer confidence. The contraction of investments moderated as well, supported by increased industrial capacity utilization rates and improving business confidence. At the same time, credit to the corporate sector continued to stagnate during the first seven months of 2010, and public investment activity was held back by fiscal savings. Changes in inventories contributed 1.7 percentage points to the GDP growth rate. The contribution of net real exports amounted to 0.9 percentage points in the first half of 2010, less than half the contribution seen in 2009, with both export and import growth returning to positive territory.

Current account improvement in the first half of 2010

The deficit in the combined current and capital account narrowed to 0.7% of GDP during the first half of 2010, from 1.2% in the same period of 2009. The improvement in the balance was attributable to the current account, where the narrowing of the surplus in the goods and services balance was more than compensated for by the smaller deficits in the income and the transfer balances. The most notable development in the financial account was the slowdown in the net repayment of loans by the banking sector, possibly reflecting some easing of external financing conditions.

Inflation up due to food prices and excise tax increases

Following a rise to 2.7% in April 2010, HICP inflation fluctuated between 2.1% and 2.4% between May and August. Core inflation was substantially lower (0.1% – 0.4%), reflecting weak domestic consumption and a further decline in ULC growth at the whole economy level to 0.6% by the second quarter (which is also positive for the country's international competitive position). Administered prices continued to exert upward pressure on the overall inflation rate, as did increases in excise duties (on tobacco in April, on tobacco, electricity and gas in August).

Parliament approved supplementary budget to keep 2010 deficit

In early July 2010, parliament passed a supplementary budget for 2010 to limit the central government budget deficit at the targeted 5.1% of GDP and to incorporate the financial aid to Greece into the budget. The supplementary budget, which became necessary as budget revenues lagged behind original plans during the first half of 2010, foresaw expenditure cuts (especially in goods and services as well as investments) and a rise in excise duties on several products. In late September 2010, the government revised its 2011 central government budget deficit target from 3.8% to 4.5% of GDP and for 2012 from 2.8% to 3.6%, compared to the stability program of January 2010. For achieving the fiscal targets, the government envisages a freeze of public sector wages (i.e. suspending the last two wage hikes previously agreed with employees), pensions and social transfers. This already prompted a strike in late September, involving around half of all public sector employees. The government has also sent a draft pension bill to parliament, envisaging, inter alia, a gradual increase in the statutory retirement age, promoting work beyond that age, and extending the assessment period for the calculation of the amount of the pension.

Table 5

Main Economic Indicators: Slovenia

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	6.9	3.7	–8.1	–8.4	–9.4	–8.8	–5.7	–1.1	2.2
Private consumption	6.7	2.9	–0.8	0.2	–2.5	–0.2	–0.5	–0.4	–0.3
Public consumption	0.7	6.2	3.0	3.7	4.3	3.9	0.2	0.8	0.7
Gross fixed capital formation	12.8	8.5	–21.6	–22.8	–24.7	–22.2	–16.0	–9.8	–5.7
Exports of goods and services	13.7	3.3	–17.7	–21.4	–23.2	–18.1	–6.9	5.6	11.4
Imports of goods and services	16.7	3.8	–19.7	–22.5	–25.4	–19.3	–11.1	4.0	10.2
	Contribution to GDP growth in percentage points								
Domestic demand	9.0	4.2	–10.5	–9.9	–11.9	–10.5	–9.5	–2.2	1.5
Net exports of goods and services	–2.2	–0.5	2.2	1.4	2.3	1.5	3.6	1.0	0.8
Exports of goods and services	9.6	2.5	–13.1	–16.3	–17.6	–13.3	–4.8	3.6	7.4
Imports of goods and services	11.8	3.0	–15.3	–17.7	–20.0	–14.8	–8.4	2.7	6.6
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	6.4	3.1	–8.3	–12.6	–16.5	–8.4	5.6	9.5	17.7
Average gross earnings in industry (nominal)	6.9	7.8	1.4	0.7	0.3	1.0	3.5	9.9	9.6
Unit labor costs in industry (nominal)	0.4	4.9	10.4	15.2	20.1	10.3	–1.9	0.4	–6.9
Producer price index (PPI) in industry	4.4	3.9	–1.4	1.1	–1.6	–3.1	–2.0	–1.2	2.1
Consumer price index (here: HICP)	3.8	5.5	0.9	1.7	0.6	–0.2	1.4	1.7	2.4
EUR per 1 SIT, + = SIT appreciation	. .	. .	. .	. .	. .	. .	. .	. .	. .
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	5.0	4.5	6.0	5.4	5.7	6.3	6.6	7.3	7.3
Employment rate (%, 15–64 years)	67.8	68.6	67.5	66.7	67.6	68.3	67.5	66.3	66.5
Key interest rate per annum (%)	. .	. .	. .	. .	. .	. .	. .	. .	. .
SIT per 1 EUR	. .	. .	. .	. .	. .	. .	. .	. .	. .
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	26.0	6.9	1.7	8.0	5.7	2.8	1.7	0.2	2.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–23.1	–11.9	6.6	–10.7	–1.0	6.2	6.6	11.5	0.9
Domestic credit of the banking system	35.1	20.8	2.1	21.5	10.7	3.1	2.1	–3.2	3.9
of which: claims on the private sector	42.6	22.7	4.7	18.0	10.1	6.6	4.7	4.5	5.2
claims on households	9.0	5.0	2.7	3.6	2.6	2.5	2.7	3.4	4.3
claims on enterprises	33.6	17.7	2.0	14.3	7.5	4.2	2.0	1.2	0.9
claims on the public sector (net)	–7.5	–1.8	–2.6	3.6	0.7	–3.5	–2.6	–7.7	–1.3
Other assets (net) of the banking system	14.0	–2.0	–7.0	–2.9	–4.1	–6.5	–7.0	–8.1	–2.8
	% of GDP, ESA 95								
General government revenues	42.4	42.3	43.2	. .	. .	. .	. .	. .	. .
General government expenditures	42.4	44.1	49.0	. .	. .	. .	. .	. .	. .
General government balance	0.0	–1.8	–5.8	. .	. .	. .	. .	. .	. .
Primary balance	1.3	–0.7	–4.4	. .	. .	. .	. .	. .	. .
Gross public debt	23.4	22.5	35.4	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	16.3	1.3	–19.4	–22.6	–24.0	–21.6	–7.8	7.1	16.1
Merchandise imports	18.1	5.7	–25.7	–26.6	–32.0	–27.8	–15.3	6.1	19.3
	% of GDP (based on EUR), period total								
Trade balance	–4.8	–7.1	–2.0	–1.9	–0.3	–2.5	–3.2	–1.5	–1.8
Services balance	3.0	4.0	3.1	2.9	3.4	3.3	3.0	2.6	3.3
Income balance (factor services balance)	–2.3	–2.8	–2.2	–2.7	–2.2	–2.7	–1.3	–1.9	–1.6
Current transfers	–0.7	–0.8	–0.4	–1.9	–0.2	–0.7	0.9	–0.6	–0.4
Current account balance	–4.8	–6.7	–1.5	–3.6	0.7	–2.6	–0.6	–1.4	–0.5
Capital account balance	–0.2	–0.1	0.0	–0.1	0.5	0.0	–0.5	0.5	0.0
Foreign direct investment (net)	–0.6	1.0	–1.5	0.0	–4.6	–0.5	–0.9	–0.5	0.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	100.6	105.2	113.8	101.8	103.7	113.0	113.8	116.0	117.9
Gross official reserves (excluding gold)[1]	1.9	1.7	1.9	1.4	1.3	1.9	1.9	1.8	2.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	0.3	0.3	0.4	0.3	0.2	0.4	0.4	0.4	0.4
	EUR million, period total								
GDP at current prices	34,568	37,305	35,384	8,387	9,068	9,038	8,891	8,335	9,390

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

[1] *Given Slovenia's adoption of the euro, the concept of the calculation of international reserves has changed as at the beginning of 2007. In particular, reserves no longer include foreign assets in euro and claims on euro area residents.*

4 Bulgaria: Export-Led Recovery Gains Ground in a Fragile Environment, Burden of Crisis-Related Costs Remains

Growth turns positive thanks to favorable net export performance, but sustainability of growth remains fragile

Although real GDP contracted year on year in the first quarter of 2010 at a similar pace as in 2009, the Bulgarian economy re-entered positive growth territory in the second quarter of 2010. The main driver of this turnaround was a strong export performance (strongest year-on-year expansion since end-2006). This lifted economic activity somewhat from its past lows: New orders in the manufacturing sector in June 2010 for the first time reached a level comparable to pre-crisis figures, and industrial production has entered a renewed, albeit contained, expansion track. Construction output, on the other hand, still contracted in the first half of 2010, reflecting the continued decline in gross fixed capital formation. A stagnating seasonally-adjusted unemployment rate of about 10% since June and slowly improving consumer confidence are signals of a pending recovery of domestic demand, which may, however, be hampered by sluggish real domestic private credit growth. Accelerating economic activity is visible also on the monetary side, where money supply started to expand, albeit still at a contained pace, in the first half of 2010. At the same time, the pickup in HICP inflation continued, reaching an annual rate of 3.2% in August, primarily driven by the increase in prices for alcohol and tobacco but also food.

External imbalances are corrected further, external competitiveness starts to strengthen

The favorable net export performance contributed to a further substantial correction of the current account deficit, which, however, at a little more than 5% of GDP in the first half of 2010, was still among the highest in the region. Net FDI inflows as a percentage of GDP are still underperforming compared to pre-crisis figures; nonetheless, in the second quarter of 2010, they again fully covered the combined current and capital account deficit. There have also been signs that external competitiveness has started to strengthen somewhat: The real effective exchange rate depreciated by about 4% from the beginning of the year until end-August. The growth of unit labor costs in the industrial sector decelerated substantially in the first half of 2010, even though it remained in positive territory. This development was primarily driven by pronounced labor productivity gains, while industrial wages were still growing at a respectable annual rate of nearly 10%.

Burden of the crisis: enforced depletion of the fiscal reserve account to keep public balances in check

In June 2010, the amendment of the State Budget Act for 2010 revised the targeted general government deficit for 2010 upward, from 2.8% to 3.8% of GDP. Assuming a – compared to currently available forecasts rather optimistic – real GDP growth rate of 1% for 2010, this amendment accounted for an unexpectedly strong decline in revenues from VAT and excise duties and incorporated additional spending for healthcare and social activities. The authorities also decided to further substantially reduce the fiscal reserve account (FRA) to finance the deficit. In line with a cash budget deficit target of 4.8% of GDP, the FRA is expected to shrink from 11% to about 6% of GDP during 2010. In July 2010 the Ecofin opened an Excessive Deficit Procedure (EDP) for Bulgaria as the deficit in 2009 was qualified to be excessive. Under the EDP, the government has committed itself to reducing the deficit-to-GDP ratio to below 3% until 2011, which requires a consolidation effort of at least ¾% of GDP in 2011. Accordingly, the budget proposal for 2011 currently discussed in parliament targets a deficit ratio of 2.6%, assuming a real GDP growth rate of 3.6% for 2011.

Table 6

Main Economic Indicators: Bulgaria

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	6.4	6.2	–4.9	–5.3	–3.8	–4.9	–5.8	–4.0	0.5
Private consumption	9.0	3.4	–3.5	–8.5	–0.7	–0.5	–4.1	–8.2	–3.2
Public consumption	0.3	–1.0	–6.5	–4.4	–2.2	–0.2	–15.0	0.3	–4.9
Gross fixed capital formation	11.8	21.9	–29.0	–10.4	–23.5	–37.2	–37.5	–12.8	–13.7
Exports of goods and services	6.1	3.0	–10.3	–17.1	–15.2	–8.0	–1.0	5.7	12.9
Imports of goods and services	9.6	4.2	–21.5	–21.3	–24.6	–20.6	–19.1	–2.5	0.3
	Contribution to GDP growth in percentage points								
Domestic demand	10.7	8.0	–16.2	–13.6	–16.4	–15.0	–19.4	–9.7	–6.3
Net exports of goods and services	–4.6	–1.9	12.8	9.6	14.6	11.4	15.0	5.4	7.4
Exports of goods and services	4.0	2.0	–6.5	–11.3	–10.2	–5.5	–0.5	3.3	7.6
Imports of goods and services	8.5	3.9	–19.3	–20.9	–24.9	–16.9	–15.5	–2.1	0.3
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	7.8	1.2	–8.5	–11.4	–11.1	–9.3	–2.4	7.4	7.7
Average gross earnings in industry (nominal)	19.7	21.4	11.4	12.7	12.0	9.6	11.2	10.0	9.2
Unit labor costs in industry (nominal)	10.9	20.0	21.9	27.1	26.0	20.9	13.9	2.4	1.4
Producer price index (PPI) in industry	7.6	11.1	–6.3	–3.4	–6.9	–10.2	–4.9	4.1	8.5
Consumer price index (here: HICP)	7.6	12.0	2.5	5.1	3.1	0.8	0.9	1.9	2.9
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.0	5.7	6.9	6.4	6.4	6.7	8.0	10.2	10.1
Employment rate (%, 15–64 years)	61.7	64.0	62.6	62.6	63.3	63.1	61.2	58.8	60.2
Key interest rate per annum (%)[1]	. .	. .	. .	. .	. .	. .	. .	. .	. .
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	31.2	8.8	4.2	6.3	3.6	1.6	4.2	7.7	8.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	1.5	–12.3	1.7	–10.5	–7.1	–9.3	1.7	3.5	2.9
Domestic credit of the banking system	38.7	26.3	6.6	23.1	16.1	15.0	6.6	7.5	9.1
of which: claims on the private sector	45.3	28.4	4.1	23.0	11.6	5.6	4.1	2.9	2.2
claims on households	14.8	10.3	2.3	8.6	4.8	2.8	2.3	1.8	1.5
claims on enterprises	30.5	18.1	1.8	14.4	6.8	2.8	1.8	1.1	0.8
claims on the public sector (net)	–6.7	–2.1	2.5	0.1	4.5	9.4	2.5	4.6	6.9
Other assets (net) of the banking system	–9.0	–5.1	–4.1	–6.3	–5.4	–4.1	–4.1	–3.3	–4.0
	% of GDP, ESA 95								
General government revenues	41.5	39.1	36.9	. .	. .	. .	. .	. .	. .
General government expenditures	40.4	37.4	41.6	. .	. .	. .	. .	. .	. .
General government balance	1.1	1.7	–4.7	. .	. .	. .	. .	. .	. .
Primary balance	2.3	2.6	–3.9	. .	. .	. .	. .	. .	. .
Gross public debt	17.2	13.7	14.7	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	17.8	7.5	–23.1	–27.2	–33.1	–26.5	–1.6	14.5	38.8
Merchandise imports	24.0	9.2	–33.3	–29.7	–39.2	–36.6	–26.4	–5.5	14.4
	% of GDP (based on EUR), period total								
Trade balance	–24.9	–24.3	–11.9	–15.8	–14.3	–9.0	–9.6	–7.6	–8.9
Services balance	3.9	3.8	3.7	–0.6	2.4	12.0	–0.1	0.1	4.9
Income balance (factor services balance)	–8.2	–5.0	–4.4	–5.9	–5.7	–3.9	–2.4	–5.2	–4.1
Current transfers	2.3	2.3	2.7	2.9	3.6	2.1	2.2	5.2	5.1
Current account balance	–26.9	–23.1	–9.9	–19.4	–14.0	1.2	–10.0	–7.5	–3.0
Capital account balance	–1.9	0.8	1.4	2.5	1.4	0.8	1.0	0.8	–1.3
Foreign direct investment (net)	30.3	17.5	9.6	12.2	7.5	6.2	13.1	0.2	6.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	94.3	104.7	107.9	103.5	103.2	104.2	107.9	106.2	106.5
Gross official reserves (excluding gold)	36.4	33.7	34.1	30.7	30.7	32.4	34.1	31.9	31.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.3	5.1	7.4	5.0	5.7	6.5	7.4	7.0	6.7
	EUR million, period total								
GDP at current prices	30,772	35,431	35,043	7,299	8,821	9,517	9,406	7,346	8,628

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

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

5 Czech Republic: New Government with Strong Commitment to Fiscal Reforms

Positive real GDP growth in the first half of 2010

Real GDP accelerated in the first and second quarters of 2010, following five consecutive quarters of declining GDP growth. The recovery was largely driven by net exports in the first quarter whereas the restocking of enterprises boosted growth in the second quarter of 2010. Export growth increased in the first half of 2010 partly due to the base effect but also supported by strong growth in Germany, by far the largest export partner of the Czech Republic. Export growth went hand in hand with surging imports of intermediate goods resulting in a smaller growth contribution of net exports in the second quarter of 2010. Domestic demand gained momentum in the second quarter of 2010 as a result of improved private consumption and investment activity.

Some signs of labor market improvement

The labor market is still under strain despite some positive signs recently. The jobless rate accelerated noticeably to above 8% in the first quarter of 2010, accompanied by decreasing employment and vacancy rates, but dropped thereafter. By comparison, the unemployment rate was 5.8% in the first quarter of 2009. ULC continued to decline in 2010, with productivity growth outpacing wage increases as industrial production visibly gained momentum as from the beginning of the year but also due to the lower employment rate.

Stronger currency against the backdrop of improved investor confidence

The Czech koruna continued to gain strength in 2010, appreciating vis-à-vis the euro by 3.3% in the reference period from the beginning of April 2010 to the end of September 2010 and by 2.2% from end-September 2009 to end-September 2010 compared to the same period in the previous year. This development basically reflected improved investor sentiment. As a result of the strong export performance, the current account was in surplus in the first quarter of 2010. In the subsequent quarter, import growth started to catch up with export growth due to stronger domestic demand and the high import content of Czech industrial production turning the current account surplus into a deficit. This shortfall was almost completely covered by FDI inflows.

Accelerating inflation

Inflation started to pick up gradually at the end of 2009 and continued its upward movement in the course of 2010, reaching 1.5% in August 2010. The rise was driven largely by higher regulated prices for natural gas, rents and healthcare as well as by increased VAT (20% instead of 19%) and excise taxes on fuels, alcohol and cigarettes becoming effective at the beginning of 2010. Inflation remained still well below the inflation target of Česká nárdodní banka (CNB), which is 2% +/– 1 percentage point. Against this backdrop, the CNB cut the key interest rate to 0.75% in May 2010.

Fiscal consolidation top priority of new government

The newly elected center-right coalition government in power since mid-July 2010 is strongly committed to fiscal tightening and, in the longer term, also to reforming the pension, healthcare and education systems. Immediately after taking office, the new government agreed on freezing budget spending to reach a budget deficit of 5.3% of GDP in 2010. It aims to reduce the deficit subsequently to below 3.0% of GDP by 2013 and to achieve a balanced budget by 2016. Some key elements of the reform package taking effect in 2011 are the reduction of spending in the civil service sector by 10% (excluding education) through wage cuts and/or layoffs. In addition, the new government plans some cuts in social benefits.

Table 7

Main Economic Indicators: Czech Republic

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	6.1	2.5	–4.1	–3.6	–5.0	–5.0	–2.9	1.0	3.0
Private consumption	5.0	3.6	–0.2	0.8	0.0	–0.6	–0.8	0.3	1.1
Public consumption	0.7	1.0	4.2	3.1	3.4	5.6	4.7	2.8	0.8
Gross fixed capital formation	10.8	–1.5	–9.2	–9.4	–9.2	–11.7	–6.8	–6.5	–4.3
Exports of goods and services	15.0	6.0	–10.8	–18.8	–16.0	–9.3	2.6	13.5	14.5
Imports of goods and services	14.3	4.7	–10.6	–17.0	–15.4	–8.0	–1.7	10.7	15.2
	Contribution to GDP growth in percentage points								
Domestic demand	5.4	1.1	–4.2	–1.1	–3.9	–4.3	–7.6	–1.8	2.8
Net exports of goods and services	0.7	1.4	–0.4	–2.8	–1.5	–1.5	4.3	2.8	–0.1
Exports of goods and services	14.1	6.1	–11.3	–21.1	–17.5	–9.5	2.6	12.8	14.0
Imports of goods and services	13.3	4.7	–10.9	–18.4	–16.0	–8.0	–1.7	10.0	14.1
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	8.2	–2.8	–3.1	–12.1	–8.6	–0.8	10.4	16.6	15.5
Average gross earnings in industry (nominal)	7.1	8.1	4.4	1.5	2.6	5.9	7.4	3.9	3.5
Unit labor costs in industry (nominal)	–1.0	11.4	7.5	15.5	12.2	6.8	–2.8	–10.9	–10.4
Producer price index (PPI) in industry	2.6	0.4	–1.5	1.9	–1.1	–3.7	–3.1	–3.9	0.4
Consumer price index (here: HICP)	3.0	6.3	0.6	1.5	1.0	–0.1	0.0	0.4	0.9
EUR per 1 CZK, + = CZK appreciation	2.1	11.2	–5.7	–7.5	–7.0	–5.8	–2.2	6.7	4.3
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	5.4	4.4	6.7	5.8	6.4	7.4	7.3	8.2	7.2
Employment rate (%, 15–64 years)	66.1	66.6	65.4	65.6	65.4	65.2	65.3	64.1	64.9
Key interest rate per annum (%)	2.9	3.5	1.5	2.0	1.6	1.3	1.2	1.0	0.8
CZK per 1 EUR	27.8	25.0	26.5	27.6	26.7	25.6	25.9	25.9	25.6
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	16.1	13.6	0.2	12.3	9.1	3.2	0.2	–0.8	2.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–0.1	0.2	1.0	4.1	2.6	–0.7	1.0	0.3	3.0
Domestic credit of the banking system	15.3	11.0	4.6	8.9	9.3	6.6	4.6	4.8	5.9
of which: claims on the private sector	18.2	10.6	0.3	9.0	5.2	2.0	0.3	–0.3	–0.2
claims on households	9.1	6.5	3.8	6.2	5.4	4.6	3.8	3.2	2.9
claims on enterprises	9.2	4.1	–3.5	2.7	–0.3	–2.5	–3.5	–3.5	–3.1
claims on the public sector (net)	–2.9	0.4	4.3	–0.1	4.1	4.6	4.3	5.1	6.1
Other assets (net) of the banking system	0.9	2.4	–5.4	–0.7	–2.7	–2.7	–5.4	–5.9	–6.1
	% of GDP, ESA 95								
General government revenues	41.8	40.2	40.2	. .	. .	. .	. .	. .	. .
General government expenditures	42.5	42.9	46.0	. .	. .	. .	. .	. .	. .
General government balance	–0.7	–2.7	–5.8	. .	. .	. .	. .	. .	. .
Primary balance	0.4	–1.6	–4.5	. .	. .	. .	. .	. .	. .
Gross public debt	29.0	30.0	35.4	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	18.2	10.7	–18.5	–25.1	–25.0	–17.8	–4.4	18.2	23.9
Merchandise imports	16.0	11.5	–22.2	–26.2	–28.1	–21.2	–12.6	14.2	25.8
	% of GDP (based on EUR), period total								
Trade balance	3.4	2.8	5.0	4.8	5.7	4.9	4.6	7.4	5.8
Services balance	1.4	1.8	0.7	1.7	1.0	0.3	0.0	–0.8	–0.5
Income balance (factor services balance)	–7.2	–4.7	–6.4	–4.1	–10.0	–6.6	–4.7	–4.4	–8.9
Current transfers	–0.8	–0.5	–0.4	0.5	–0.1	–1.2	–0.7	0.0	0.5
Current account balance	–3.2	–0.6	–1.1	2.8	–3.3	–2.6	–0.8	2.2	–3.2
Capital account balance	0.6	0.8	1.1	1.8	0.5	0.6	1.7	0.2	1.0
Foreign direct investment (net)	5.1	1.0	0.7	1.7	0.0	–2.0	3.2	3.9	3.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	40.5	40.3	43.7	39.1	41.3	41.9	43.7	43.8	46.4
Gross official reserves (excluding gold)	18.4	17.8	20.8	18.8	18.9	20.0	20.8	20.9	21.5
	Months of imports of goods and services								
Gross official reserves (excluding gold)	2.9	2.9	3.9	3.2	3.4	3.7	3.9	3.8	3.8
	EUR million, period total								
GDP at current prices	127,423	147,939	137,345	31,733	34,412	35,506	35,694	33,608	36,495

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

6 Hungary: Government to Boost Economy while Pursuing Fiscal Consolidation

Economy shows modest growth in the first half of 2010, sectoral differences decrease

GDP grew moderately by 0.5% year on year during the first half of 2010, with the growth rate accelerating from 0.1% in the first quarter to 1% in the second quarter. Household consumption was dragged down by the reduction in credit to households in year-on-year terms until April 2010, by sharply higher debt servicing costs due to the weakening of the forint versus the euro and the Swiss franc, and by sustained high unemployment. Public consumption grew modestly mainly due to the extension of public work programs. Only slowly increasing industrial capacity utilization, contracting credit to corporates, depressed business confidence in services and construction, poor household finances and the reduction in public sector investments hampered investment activity. Exports revived on the back of healthy external demand, but the parallel rebound in import growth cut the contribution of net exports by more than half compared to 2009. However, net exports in absolute terms improved year on year, which translated into a rise in the surplus in the combined current and capital account balance during the first half of 2010.

Monetary policy on hold since April 2010

Since the last interest rate cut at the end of April 2010, Magyar Nemzeti Bank (MNB) has left its policy rate unchanged at 5.25% as it saw medium-term inflation risks increasing again and risk premiums on Hungarian financial assets repeatedly heightened. HICP inflation decelerated from 5.7% in March to 3.6% in August, and core inflation behaved similarly at a somewhat lower level. Apart from a base effect in July, disinflation was supported by weak domestic consumption, the negative output gap, stagnating whole economy ULC and slowing energy price inflation. By contrast, following adverse weather conditions, unprocessed food prices prevented a further drop in inflation in July and August. The MNB raised its inflation projection in August, anticipating above-target (3%) inflation rates until end-2012. The MNB expects rising energy and food prices to increasingly feed through to core inflation amid the recovery of domestic demand, while above-target inflation expectations may lead to undesired wage increases. The recurring increase in Hungary's risk premiums since May 2010 was in part caused by international factors, which were compounded by increased uncertainty about the sustainability of Hungary's financial position.

Government re-commits itself to budget deficit targets for 2010 and 2011

Following adverse market reactions to unfortunate official comments about the situation of the state finances at the beginning of June, the government committed itself to the 3.8% budget deficit target for 2010 and adopted a range of economic measures over the summer. With these measures the government intended to compensate for expenditure slippages and revenue underperformance during the first half of 2010 and start implementing election promises while keeping the budget deficit target. After the suspension of talks during the regular review of the IMF/EU credit facility, the government in early September committed itself to the 2011 budget deficit target of less than 3%. The details of the fiscal plans (including a "family-friendly" 16% flat income tax, budgetary savings and possible further "special" taxes) were to be finalized in late fall. Furthermore, the government is planning to enact additional measures in particular with respect to households facing difficulties in paying their debts, plus some changes in the pension and social systems.

Table 8

Main Economic Indicators: Hungary

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	1.0	0.6	–6.3	–6.7	–7.5	–7.1	–4.0	0.1	1.0
Private consumption	0.4	–0.5	–7.5	–7.2	–6.7	–9.7	–6.3	–4.6	–4.8
Public consumption	–7.4	–0.8	–1.1	–2.0	–0.5	–3.1	1.0	0.8	0.9
Gross fixed capital formation	1.6	0.4	–6.5	–7.0	–3.4	–6.8	–8.1	–4.4	–3.7
Exports of goods and services	16.2	5.6	–9.1	–17.8	–13.9	–6.9	3.1	13.7	16.1
Imports of goods and services	13.3	5.7	–15.4	–21.5	–22.6	–14.6	–2.0	11.6	15.4
	Contribution to GDP growth in percentage points								
Domestic demand	–1.2	0.7	–11.5	–10.0	–15.0	–13.2	–7.8	–2.0	–0.7
Net exports of goods and services	3.1	0.0	7.4	4.1	10.6	8.8	5.9	3.6	2.9
Exports of goods and services	16.7	6.6	–11.3	–24.5	–17.7	–8.4	3.6	16.5	19.1
Imports of goods and services	13.6	6.6	–18.7	–28.5	–28.2	–17.2	–2.3	12.9	16.1
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	9.4	0.2	–6.6	–15.1	–11.2	–4.5	4.8	14.5	14.5
Average gross earnings in industry (nominal)	8.3	6.3	4.7	3.9	3.6	5.9	5.3	8.0	5.2
Unit labor costs in industry (nominal)	–1.0	6.4	12.2	23.0	16.8	11.3	–0.5	–6.0	–8.1
Producer price index (PPI) in industry	0.4	4.6	4.6	7.6	6.3	4.1	0.4	–0.9	5.9
Consumer price index (here: HICP)	7.9	6.0	4.0	2.7	3.6	4.9	4.9	5.8	5.2
EUR per 1 HUF, + = HUF appreciation	5.1	–0.2	–10.3	–11.8	–13.3	–13.0	–2.7	9.5	4.1
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.4	7.9	10.1	9.7	9.6	10.4	10.5	11.9	11.2
Employment rate (%, 15–64 years)	57.3	56.7	55.4	55.1	55.6	55.5	55.5	54.5	55.3
Key interest rate per annum (%)	7.8	8.7	8.6	9.6	9.5	8.5	6.8	5.9	5.3
HUF per 1 EUR	251.3	251.7	280.5	294.1	285.9	271.3	270.9	268.7	274.6
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	11.0	8.8	3.4	8.6	11.9	7.5	3.4	0.1	3.5
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–6.8	–3.8	13.3	4.9	7.7	15.1	13.3	11.4	12.3
Domestic credit of the banking system	21.3	18.2	–4.1	14.0	13.7	0.8	–4.1	–10.5	2.8
of which: claims on the private sector	19.3	20.4	–4.7	24.0	15.2	5.3	–4.7	–16.0	2.9
claims on households	9.1	12.7	0.8	14.0	10.1	6.4	0.8	–3.8	5.4
claims on enterprises	10.1	7.6	–5.3	9.9	5.2	–0.9	–5.3	–12.0	–2.5
claims on the public sector (net)	1.9	–2.1	0.5	–10.0	–1.5	–4.5	0.5	5.5	–0.1
Other assets (net) of the banking system	–3.4	–5.6	–5.8	–10.2	–9.6	–8.4	–5.8	–0.9	–11.6
	% of GDP, ESA 95								
General government revenues	44.8	45.4	45.8	. .	. .	. .	. .	. .	. .
General government expenditures	49.8	49.1	50.2	. .	. .	. .	. .	. .	. .
General government balance	–5.0	–3.7	–4.4	. .	. .	. .	. .	. .	. .
Primary balance	–0.9	0.4	0.2	. .	. .	. .	. .	. .	. .
Gross public debt	66.1	72.3	78.4	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	17.1	6.4	–19.7	–27.4	–26.1	–19.5	–4.2	18.6	22.6
Merchandise imports	12.6	7.0	–24.9	–28.9	–31.5	–26.3	–11.7	13.1	22.9
	% of GDP (based on EUR), period total								
Trade balance	–0.1	–0.5	3.6	2.2	4.5	3.4	4.1	5.5	4.9
Services balance	1.0	0.9	1.5	0.5	1.6	2.6	1.1	2.7	2.5
Income balance (factor services balance)	–7.3	–7.2	–5.9	–5.3	–5.9	–5.1	–7.1	–5.9	–6.5
Current transfers	–0.5	–0.6	0.4	–0.3	0.5	0.7	0.4	–0.2	0.8
Current account balance	–6.9	–7.4	–0.5	–2.9	0.7	1.6	–1.5	2.0	1.7
Capital account balance	0.7	1.0	1.3	1.4	1.8	1.4	0.7	1.9	1.6
Foreign direct investment (net)	0.2	2.7	–0.2	1.7	–6.3	–1.1	4.4	–2.4	–2.0
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	102.9	117.0	145.5	126.6	134.0	140.6	145.5	147.7	145.0
Gross official reserves (excluding gold)	16.2	22.7	32.8	27.3	27.5	32.5	32.8	35.4	36.0
	Months of imports of goods and services								
Gross official reserves (excluding gold)	2.4	3.3	5.5	4.1	4.3	5.3	5.5	5.9	5.9
	EUR million, period total								
GDP at current prices	101,093	105,606	93,319	20,220	22,516	24,084	26,499	22,413	24,294

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

7 Poland: Gradually Heading for Balanced Growth

Favorable conditions for the take-off of fixed investment growth

Poland posted annual GDP growth of 3.4% in the first half of 2010 (after 1.8% in 2009); from the first quarter to the second quarter, annual growth accelerated from 2.9% to 4.0%. Real exports re-emerged as the demand component with the highest growth contribution, given the strong recovery of foreign demand and the zloty's value remaining at a still moderate level compared to its pre-crisis heights. Inventory restocking rendered a sizeable contribution to GDP growth. By contrast, fixed investment still fell in annual terms. However, the improved profitability of manufacturing, the availability of EU funds and public infrastructure projects bode well for a take-off of fixed investment. Household loan growth started to accelerate in the second quarter of 2010, driven above all by housing loans, which in turn is set to further support future fixed investment. The upswing in production translated into employment growth (both in annual and seasonally-adjusted quarterly terms) by the second quarter of 2010. The unemployment rate stood at 9.6% in the second quarter of 2010, 1.6 percentage points higher than a year earlier due to a rise in the activity rate to the highest level since 2001 (65.6%). Thus, given still moderate total wage growth, private consumption remained below GDP growth after it had been the main pillar of growth in 2009. The still moderate acceleration of domestic demand kept import growth below export growth, and the contribution of net exports to GDP growth at 0.2 percentage points.

Foreign exchange intervention to curb zloty's re-appreciation

Annual inflation decreased to 1.9% (HICP) and 2.0% (CPI) in August 2010, after a peak of 3.9% (HICP) and 3.5% (CPI) in January 2010 respectively. In parallel, core inflation continued to fall, reaching 1.4% (HICP) and 1.2% (CPI). Thus, headline inflation stood below the inflation target (2.5% CPI). Disinflation was the result of low demand pressure, a continuous fall of nominal ULC in manufacturing (as production growth exceeded wage growth by far) and partial currency re-appreciation up to April 2010 (by 14% year on year). However, after foreign exchange interventions, the zloty depreciated by 3% against the euro from April to September, when it was still 5% stronger than a year earlier. At the end of September, the Polish monetary policy council (MPC) assessed that moderate economic growth, limited wage and inflationary pressures and the risk of weakening global growth justified keeping interest rates unchanged. The MPC has thus kept the key policy rate at 3.5% since end-June 2009.

Multi-year financial plan envisages bulk of fiscal consolidation for 2012

The convergence program update of February 2010 envisaged an ESA-95 budget deficit of 6.9% of GDP in 2010, after the deficit had reached 7.2% of GDP in 2009 (including about 3% of GDP net fiscal costs of systemic pension reform), which caused the Ecofin to issue an EDP recommendation that required a correction of the deficit by 2012. In August 2010, the government adopted a multi-year financial plan for fiscal consolidation targeting a general government deficit of 5.7% of GDP in 2010. Similar to the convergence program, this plan envisages only a moderate fiscal tightening in 2011 (to 5.1% of GDP, mainly a standard VAT rate hike from 22% to 23%), while the bulk of fiscal consolidation is scheduled for 2012 (i.e. after the parliamentary elections) to achieve a deficit of 3.0% of GDP. Government gross debt is expected to peak at 54.6% of GDP at end-2012, before declining to 53.7% in 2013.

Table 9

Main Economic Indicators: Poland

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	6.8	5.1	1.8	0.8	1.2	1.2	3.5	2.9	4.0
Private consumption	4.9	5.7	2.2	4.0	1.4	2.3	1.0	2.3	2.9
Public consumption	3.7	7.4	1.9	5.6	–1.2	–1.0	4.2	2.1	2.3
Gross fixed capital formation	17.2	9.6	–0.8	–1.9	–1.5	–0.1	–0.3	–12.4	–1.1
Exports of goods and services	9.1	7.0	–9.5	–15.2	–13.7	–9.4	0.5	10.4	18.3
Imports of goods and services	13.5	8.1	–13.5	–16.9	–18.8	–13.3	–4.7	8.0	17.5
	Contribution to GDP growth in percentage points								
Domestic demand	9.2	5.8	–1.3	–1.7	–2.7	–1.9	0.9	2.2	4.1
Net exports of goods and services	–2.1	–0.8	2.3	1.5	3.1	2.4	2.1	0.6	–0.1
Exports of goods and services	3.5	2.8	–3.8	–6.3	–5.7	–3.9	0.2	3.6	6.5
Imports of goods and services	5.5	3.6	–6.1	–7.8	–8.8	–6.3	–1.9	3.0	6.6
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	5.9	1.5	2.5	–6.1	–1.0	5.4	11.9	13.7	13.5
Average gross earnings in industry (nominal)	8.7	8.8	4.9	5.9	4.2	4.4	5.1	4.4	4.6
Unit labor costs in industry (nominal)	2.6	7.4	2.5	13.4	5.2	–1.0	–6.4	–8.2	–7.7
Producer price index (PPI) in industry	2.1	2.4	3.9	5.8	4.8	2.7	2.4	–1.4	1.3
Consumer price index (here: HICP)	2.6	4.2	4.0	3.6	4.3	4.3	3.8	3.4	2.5
EUR per 1 PLN, + = PLN appreciation	3.0	7.6	–18.8	–20.6	–23.5	–21.1	–9.7	12.7	10.9
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.7	7.2	8.3	8.4	8.0	8.2	8.6	10.7	9.6
Employment rate (%, 15–64 years)	57.0	59.2	59.4	58.9	59.3	59.9	59.4	58.2	59.3
Key interest rate per annum (%)	4.4	5.7	3.8	4.4	3.7	3.5	3.5	3.5	3.5
PLN per 1 EUR	3.8	3.5	4.3	4.5	4.5	4.2	4.2	4.0	4.0
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	13.4	18.6	8.1	17.5	14.4	9.6	8.1	5.5	7.1
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–9.0	–13.6	3.2	–9.3	–6.3	–1.9	3.2	5.1	7.8
Domestic credit of the banking system	20.0	39.2	9.2	38.7	30.9	18.0	9.2	1.1	7.4
of which: claims on the private sector	22.5	30.1	6.7	29.7	23.1	16.2	6.7	0.8	6.6
claims on households	14.6	20.8	6.8	21.1	17.7	13.7	6.8	3.5	7.7
claims on enterprises	7.9	9.3	–0.2	8.6	5.4	2.5	–0.2	–2.6	–1.1
claims on the public sector (net)	–2.5	9.1	2.5	9.0	7.8	1.8	2.5	0.3	0.8
Other assets (net) of the banking system	2.4	–6.9	–4.3	–11.9	–10.2	–6.5	–4.3	–0.7	–8.1
	% of GDP, ESA 95								
General government revenues	40.3	39.5	37.2	. .	. .	. .	. .	. .	. .
General government expenditures	42.2	43.2	44.4	. .	. .	. .	. .	. .	. .
General government balance	–1.9	–3.7	–7.2	. .	. .	. .	. .	. .	. .
Primary balance	0.4	–1.5	–4.7	. .	. .	. .	. .	. .	. .
Gross public debt	45.0	47.1	50.9	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	13.3	14.2	–15.8	–20.5	–22.6	–18.9	1.1	18.0	24.9
Merchandise imports	19.5	17.2	–24.3	–26.6	–31.1	–26.7	–11.6	17.2	24.9
	% of GDP (based on EUR), period total								
Trade balance	–4.0	–4.9	–1.0	–1.1	–0.7	–1.0	–1.1	–0.8	–0.8
Services balance	1.1	1.0	1.1	1.1	1.2	0.9	1.2	0.7	0.8
Income balance (factor services balance)	–3.8	–2.4	–3.8	–3.3	–4.7	–3.4	–3.8	–3.3	–3.8
Current transfers	2.0	1.5	1.5	2.2	2.3	1.6	0.4	2.1	1.9
Current account balance	–4.7	–4.8	–2.2	–1.1	–2.0	–1.9	–3.4	–1.4	–1.8
Capital account balance	1.1	1.1	1.6	2.7	1.4	0.6	1.9	1.5	1.2
Foreign direct investment (net)	4.2	1.9	2.0	2.0	0.7	3.6	1.6	3.8	–0.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	51.0	48.0	62.7	49.1	53.2	60.1	62.7	62.7	59.7
Gross official reserves (excluding gold)	13.7	11.6	16.9	12.6	13.7	16.2	16.9	18.7	19.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	3.8	3.2	5.2	3.5	4.0	4.9	5.2	5.7	5.9
	EUR million, period total								
GDP at current prices	311,669	363,163	311,218	69,725	73,452	79,076	88,964	82,126	85,919

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

8 Romania: Still in Recession, Painful Fiscal Adjustment

Output stabilization only temporary

The Romanian economy continued to shrink in the first half of 2010 (–1.5% year on year). In the second quarter of 2010, the annual drop in real GDP decelerated; in seasonally adjusted quarter-on-quarter terms, growth was even marginally positive. Domestic demand was still on the decline in the first half of 2010, as only changes in inventories contributed positively to growth. Although export growth was higher than import growth in the first quarter, the difference in the base levels implied that the contribution of net exports to GDP growth had turned negative. This was exacerbated in the second quarter, when import growth slightly exceeded high export growth. Strong import growth was the result of both the start of inventory re-stocking and the high import content of exports. The notoriously high statistical discrepancy between the production and the expenditure side of GDP increased markedly in the second quarter and reached 10.5 percentage points. In the next few quarters, the additional fiscal consolidation measures introduced in July (including a VAT hike from 19% to 24%, a cut in public wages by 25% and a reduction in most social transfers by 15%) will have a dampening impact on domestic demand and thus also on import growth.

Multilateral support program on track, but (political) risks remain

The fiscal austerity package was agreed under the IMF/EU support program and was considered necessary to achieve the fiscal deficit targets (7.3% of GDP for 2010 and 4.9% for 2011). As the European Commission and the IMF assessed Romania's performance under the policy program as satisfactory, the EU disbursed EUR 1.15 billion and the IMF about EUR 900 million in September 2010. Total disbursements from the EU and the IMF amounted to EUR 3.7 billion and EUR 11.1 billion respectively (in total about 12.6% of annual GDP) by mid-2010. The implementation of the fiscal package prompted public protest and rising political tension, resulting in a major government reshuffle in September.

VAT rate hike triggers pickup in inflation

The annual inflation rate (CPI) jumped from 4.4% in June to 7.1% in July and rose further to 7.6% in August, mainly due to the VAT rate hike. Banca Naţionalâ României (BNR) projects inflation to reach 7.8% at end-2010 (well above the target band of 3.5% ±1 percentage point), before declining to 3.1% at end-2011 due to the persistence of the negative output gap and dissipating first-round effects of the VAT rate hike. Against the background of uncertainties concerning the resumption of disinflation, the BNR left its key policy rate unchanged at 6.25%, after it had cut the policy rate by 175 basis points from January to May.

Current account deficit increased despite recession and good export performance

The current account deficit increased by 50% year on year in the first half of 2010 and reached 7.5% of GDP, after it had narrowed markedly in 2009. The deterioration was largely due to a decrease in the current transfers surplus (reflecting a fall in remittances and a low absorption of EU structural funds). By contrast, the trade balance remained broadly unchanged compared to a year earlier, but deteriorated in the second quarter. Supported by productivity gains, ULC in industry declined by almost 10% year on year (in local currency terms) in the first half of 2010. The Romanian leu did not change substantially against the euro in comparison to 2009 levels, notwithstanding some fluctuations triggered by uncertainties about the country's performance under the policy program, and smoothed by central bank interventions. The decline in ULC and avoiding a re-appreciation helped lift exports. Net FDI inflows declined and covered only 40% of the current account deficit in the first half of 2010, after more than 100% a year earlier.

Table 10

Main Economic Indicators: Romania

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	6.3	7.3	–7.1	–6.2	–8.7	–7.1	–6.5	–2.6	–0.5
Private consumption	11.8	9.5	–10.6	–12.1	–14.6	–11.1	–5.3	–4.7	–0.4
Public consumption	–0.3	7.2	0.7	3.0	1.0	–0.4	–0.1	–1.7	–2.0
Gross fixed capital formation	30.3	16.1	–25.3	2.7	–29.7	–27.6	–31.4	–28.9	–9.5
Exports of goods and services	7.8	7.7	–5.2	–9.6	–10.4	–3.7	3.9	21.6	23.2
Imports of goods and services	27.9	7.0	–21.3	–24.8	–26.2	–20.7	–11.4	16.1	25.4
	Contribution to GDP growth in percentage points								
Domestic demand	18.3	13.3	–19.4	–22.2	–24.6	–16.6	–16.3	0.4	–1.3
Net exports of goods and services	–16.7	–2.6	16.1	21.6	22.0	16.0	8.2	–1.6	–9.8
Exports of goods and services	3.5	3.5	–2.4	–5.9	–5.3	–1.6	1.3	12.8	11.6
Imports of goods and services	20.2	6.1	–18.4	–27.5	–27.3	–17.6	–6.9	14.4	21.4
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	15.3	6.8	11.0	–2.7	7.7	14.2	24.9	22.3	20.3
Average gross earnings in industry (nominal)	21.4	21.3	11.2	16.3	9.7	10.0	9.5	12.4	8.2
Unit labor costs in industry (nominal)	5.3	14.1	0.4	20.3	2.0	–3.5	–13.4	–8.5	–10.3
Producer price index (PPI) in industry	7.5	15.4	1.9	5.7	1.4	–1.4	2.0	3.5	6.1
Consumer price index (here: HICP)	4.9	7.9	5.6	6.8	6.1	5.0	4.5	4.6	4.3
EUR per 1 RON, + = RON appreciation	5.6	–9.4	–13.1	–13.6	–13.0	–15.4	–10.5	3.7	0.3
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.7	6.1	7.2	7.2	6.6	7.2	7.8	8.4	7.2
Employment rate (%, 15–64 years)	58.8	59.1	58.6	57.4	59.2	60.4	57.4	57.0	60.1
Key interest rate per annum (%)	7.5	9.7	9.1	10.1	9.7	8.7	8.0	7.2	6.3
RON per 1 EUR	3.3	3.7	4.2	4.3	4.2	4.2	4.3	4.1	4.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	33.7	17.5	9.0	15.4	11.7	10.7	9.0	8.4	8.2
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–8.4	–10.7	5.0	–7.4	–4.6	3.7	5.0	8.8	12.6
Domestic credit of the banking system	55.9	41.5	12.6	38.7	29.5	16.8	12.6	3.0	11.4
of which: claims on the private sector	51.2	33.7	1.2	25.0	12.2	2.9	1.2	–1.7	7.3
claims on households	29.1	18.7	0.6	14.2	7.8	2.1	0.6	–1.6	2.6
claims on enterprises	22.1	15.0	0.6	10.8	4.4	0.8	0.6	–0.1	4.7
claims on the public sector (net)	4.7	7.8	11.4	13.7	17.3	13.9	11.4	4.7	4.1
Other assets (net) of the banking system	–13.8	–13.3	–8.7	–15.9	–13.3	–9.8	–8.7	–3.4	–15.8
	% of GDP, ESA 95								
General government revenues	33.5	32.1	32.1	. .	. .	. .	. .	. .	. .
General government expenditures	36.1	37.8	40.7	. .	. .	. .	. .	. .	. .
General government balance	–2.6	–5.7	–8.6	. .	. .	. .	. .	. .	. .
Primary balance	–1.9	–5.0	–7.0	. .	. .	. .	. .	. .	. .
Gross public debt	12.6	13.4	23.9	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	14.8	14.1	–13.7	–19.0	–20.8	–14.2	0.7	19.8	31.4
Merchandise imports	26.5	11.5	–32.0	–33.9	–37.6	–34.4	–21.2	12.7	27.0
	% of GDP (based on EUR), period total								
Trade balance	–14.3	–13.7	–5.9	–6.8	–6.5	–5.4	–5.2	–5.4	–6.9
Services balance	0.3	0.5	–0.3	–0.3	–0.1	–0.4	–0.4	–1.1	–0.7
Income balance (factor services balance)	–3.3	–2.6	–1.8	–2.3	–2.5	–1.4	–1.4	–2.1	–2.5
Current transfers	3.9	4.3	3.5	5.4	3.4	3.8	2.3	1.8	2.2
Current account balance	–13.4	–11.6	–4.5	–4.0	–5.7	–3.4	–4.7	–6.8	–7.9
Capital account balance	0.7	0.4	0.5	0.0	0.2	0.7	0.8	0.2	0.2
Foreign direct investment (net)	5.7	6.7	3.8	6.5	4.2	3.5	2.0	2.5	3.0
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	47.0	51.8	69.2	52.3	57.0	64.9	69.3	73.7	74.1
Gross official reserves (excluding gold)	20.3	18.8	24.4	18.4	20.1	23.1	24.4	27.4	26.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.6	5.2	7.8	5.3	6.2	7.4	7.8	8.7	8.1
	EUR million, period total								
GDP at current prices	124,624	139,578	115,855	22,636	26,708	30,828	35,683	23,510	27,407

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

9 Croatia: Weak Economy Increasingly Challenging Public Finances

Depressed domestic demand weighs on economic recovery

Following a slump in GDP by 5.8% in 2009, weak economic conditions prevailed in Croatia in the first half of 2010, when the economy contracted by 2.5% year on year. Driven by resuming export growth and the ongoing decline in imports, net exports continued to contribute positively to economic growth. This positive momentum was, however, by far offset by the negative growth contribution of domestic demand. In particular, capital formation remained depressed, given persistently low business confidence, poor FDI inflows and fiscal constraints. Similarly, despite a moderating downward trend, private consumption continued to decline in the first half of 2010 due to ongoing debt restructuring of households, limited credit availability and falling disposable incomes coupled with adverse labor market conditions.

As a result of subdued domestic demand and downward wage pressures, inflation averaged a moderate 0.9% in the first three quarters of 2010. A benign inflationary environment was also underpinned by a fairly stable kuna over the review period. In order to smooth out seasonal (tourism-related) appreciation pressures, Hrvatska narodna banka (HNB) intervened three times against the kuna in June and July 2010, injecting a total of EUR 364 million.

Despite partial improvements external vulnerabilities remain

Driven by a further improving trade balance, the current account deficit continued to narrow in the first half of 2010, while a relatively good tourism season boded well for further improvements in the second half of the year. On the financing side, FDI inflows remained moderate, covering roughly a third of the current account deficit. Given the related financing needs (and the further drop in GDP), gross external debt levels increased somewhat to 99% of GDP by mid-2010 and are set to rise further, largely driven by increasing public sector debt. At the same time, reserve accumulation continued, and by end-September 2010, foreign exchange reserves climbed to over EUR 11 billion (22% of GDP).

Deteriorating public finances tied with sizeable financing needs

Poorer-than-expected economic growth prospects, below-plan budget revenues and additional spending brought public finances increasingly under pressure by mid-2010 and made the adoption of a supplementary budget in August necessary. According to the revised 2010 central government budget, the deficit will rise to 4.2% of GDP, up from the targeted 2.5%. The cyclical shortfall in revenues has been compounded by tax reliefs, which took effect in the second half of 2010. These measures included the abolition of the crisis tax in two steps and – as part of the government's economic recovery program – the reduction of the level and number of personal income tax rates as of July 2010, and are designed to stimulate private consumption. At the same time, the government decided to freeze budget expenditures in 2011 and 2012 at the level of the revised 2010 budget. According to the government's economic and fiscal policy guidelines 2011–2013, Croatia targets a central government budget deficit of 4.1% of GDP in the election year 2011, 2.8% in 2012 and 1.5% in 2013.

Given continued strong financing needs, the government tapped domestic bond markets two times so far in 2010, with one kuna and one euro-denominated bond issue each, totaling some EUR 1.7 billion. It also issued a ten-year Eurobond worth USD 1.25 billion in international markets in July. Consequently, public debt levels are set to increase considerably in 2010, while remaining relatively low at somewhat over 40% of GDP (public guarantees excluded).

Table 11

Main Economic Indicators: Croatia

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	5.5	2.4	–5.8	–6.7	–6.3	–5.7	–4.5	–2.5	–2.5
Private consumption	6.1	0.8	–8.4	–9.9	–9.4	–6.8	–7.4	–4.1	–2.5
Public consumption	3.4	2.0	0.2	3.9	1.2	–0.6	–3.4	–1.1	–1.8
Gross fixed capital formation	6.5	8.2	–11.8	–12.4	–12.7	–10.5	–11.3	–13.9	–13.4
Exports of goods and services	4.3	1.7	–16.2	–14.2	–19.8	–17.6	–11.2	3.6	7.0
Imports of goods and services	6.5	3.6	–20.7	–20.9	–24.7	–23.5	–12.4	–4.8	–4.2
	Contribution to GDP growth in percentage points								
Domestic demand	7.1	3.5	–9.8	–13.1	–12.4	–7.0	–6.6	–5.9	–7.0
Net exports of goods and services	–1.7	–1.3	4.7	7.1	7.0	2.2	2.5	3.5	4.7
Exports of goods and services	2.0	0.8	–7.3	–4.9	–8.4	–10.9	–4.4	1.1	2.6
Imports of goods and services	3.7	2.1	–12.0	–12.0	–15.4	–13.1	–6.9	–2.4	–2.1
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	4.5	3.2	0.1	–3.5	–0.4	1.1	2.9	8.7	4.8
Average gross earnings in industry (nominal)	5.6	6.2	1.4	2.5	2.7	1.7	–1.2	0.1	–0.5
Unit labor costs in industry (nominal)	1.0	2.9	1.5	6.6	3.2	0.5	–4.0	–8.0	–5.0
Producer price index (PPI) in industry	3.4	8.3	–0.4	1.1	–0.6	–2.3	0.1	3.5	4.8
Consumer price index (here: CPI)	2.9	6.1	2.4	3.8	2.9	1.2	1.7	0.9	0.7
EUR per 1 HRK, + = HRK appreciation	–0.2	1.6	–1.6	–1.7	–1.4	–1.9	–1.4	1.7	1.5
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.8	8.6	9.3	9.7	9.1	8.9	9.6	11.5	12.7
Employment rate (%, 15–64 years)	57.2	57.8	56.6	56.5	56.5	57.1	56.4	54.9	53.5
Key interest rate per annum (%)	3.6	5.3	6.0	6.0	6.0	6.0	6.0	6.0	6.0
HRK per 1 EUR	7.3	7.2	7.3	7.4	7.4	7.3	7.3	7.3	7.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	18.3	4.3	–0.9	3.3	1.1	–1.2	–0.9	1.6	2.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	12.0	–3.6	1.5	–8.0	–7.1	–6.8	1.5	5.1	3.1
Domestic credit of the banking system	14.1	13.2	–0.5	15.7	11.2	8.7	–0.5	–0.9	4.1
of which: claims on the private sector	14.9	10.3	–0.6	9.4	5.0	1.9	–0.6	–0.5	3.2
claims on households	9.4	6.3	–1.6	4.6	1.7	0.4	–1.6	–1.8	0.1
claims on enterprises	5.5	4.0	1.0	4.8	3.3	1.5	1.0	1.4	3.0
claims on the public sector (net)	–0.8	2.9	0.1	6.3	6.2	6.7	0.1	–0.4	1.0
Other assets (net) of the banking system	–7.8	–5.4	–1.8	–4.4	–3.0	–3.1	–1.8	–2.6	–4.5
	% of GDP, ESA 95								
General government revenues	40.3	39.4	38.8	. .	. .	. .	. .	. .	. .
General government expenditures	42.8	40.8	42.2	. .	. .	. .	. .	. .	. .
General government balance	–2.5	–1.4	–3.4	. .	. .	. .	. .	. .	. .
Primary balance	–0.7	0.1	–2.3	. .	. .	. .	. .	. .	. .
Gross public debt	33.0	33.5	38.8	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	8.6	6.8	–21.6	–13.4	–23.7	–30.9	–16.5	4.6	18.6
Merchandise imports	10.8	10.7	–26.8	–23.6	–30.1	–31.1	–21.2	–9.7	–2.4
	% of GDP (based on EUR), period total								
Trade balance	–22.0	–22.8	–16.3	–16.5	–17.5	–15.0	–16.3	–12.3	–13.6
Services balance	14.6	14.7	12.5	1.3	12.2	30.7	3.6	1.2	12.3
Income balance (factor services balance)	–2.6	–3.3	–3.9	–4.3	–4.9	–2.9	–3.5	–4.7	–3.6
Current transfers	2.4	2.3	2.3	2.0	2.6	2.0	2.6	2.4	2.5
Current account balance	–7.6	–9.2	–5.4	–17.6	–7.6	14.7	–13.6	–13.4	–2.4
Capital account balance	0.1	0.0	0.1	0.0	0.0	0.0	0.3	0.1	0.1
Foreign direct investment (net)	8.2	6.8	2.6	3.9	4.1	–0.3	3.0	4.5	–0.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	76.9	84.3	98.3	85.7	89.8	93.7	98.3	98.2	99.0
Gross official reserves (excluding gold)	21.7	19.3	22.9	18.9	19.5	20.4	22.9	22.1	20.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.2	4.6	7.0	4.7	5.2	5.9	7.0	6.8	6.6
	EUR million, period total								
GDP at current prices	42,831	47,372	45,380	10,506	11,510	12,204	11,160	10,502	11,493

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

10 Turkey: Buoyant Domestic Demand and Rising External Imbalances

Private consumption surpassed pre-crisis level

Seasonally adjusted GDP rose notably in the second quarter of 2010 (3.7% quarter on quarter) and reached its pre-crisis level. However, annual growth was slightly lower in the second quarter than in the first due to a base effect. The strong recovery in private consumption since the fourth quarter of 2009 has been backed by easing lending standards, low lending rates and accelerating credit growth as well as improving employment conditions. Private consumption regained pre-crisis levels already in the first quarter. Recovery is also underway in income-sensitive spending categories. Compared to the final quarter of 2009, the contribution of public consumption to GDP growth declined notably following cutbacks in public spending on construction in the first quarter of 2010 and as a result of the advance payment of health care expenditures for 2010 in the final quarter of 2009. By contrast, fixed investment growth started only in the first quarter and further accelerated in the second quarter, with investment in consumer durables and investment goods increasing most strongly. Capital utilization continued its steady rise and reached 73.5% in September 2010. On top of private consumption and fixed investment, export re-emerged as a driver of growth in the second quarter. Due to rising labor force participation, unemployment remains high and a serious economic policy challenge.

Widening external deficit and chronically high unemployment

The weak external environment coupled with accelerating import growth led to a substantially higher current account deficit in the first three quarters of 2010 compared with a year earlier. With imports rising by 30.5% and exports expanding by only 12.9% annually from January to August 2010, the current account deficit doubled over this period and brought the 12-month rolling deficit to 8.1% of GDP in September. Strong capital inflows are set to ease the financing of the current account deficit. Portfolio investment inflows surged to USD 15 billion in the first three quarters of 2010 compared to USD 3.3 billion a year earlier, and FDI inflows reached more than USD 5 billion, compared to the current account deficit of USD 28 billion over the same period.

Recent inflation hikes perceived as temporary

Inflation in the first quarter of 2010 was driven by high food prices, while sharply falling ULC in industry dampened the inflationary pressure. In the second quarter, plummeting food prices coupled with lower import prices (as the currency appreciated) caused a quarter-on-quarter drop in the CPI. Recently, food prices have been rising again, challenging the end-year inflation target of 6.5%. The Turkish lira appreciated against the euro by 3.4% between April and end-September 2010 and by 5.7% compared to end of September 2009. Recently, the central bank established changes in daily foreign exchange auctions to fight further appreciation.

Reversal of liquidity measures has started

In mid-April the central bank announced its exit strategy from monetary easing, starting with a technical rate adjustment in May, replacing the borrowing rate (6.5%) with the one-week repo rate (7%) as the new policy rate. Rate hikes are not envisaged, but tightening continued in September through a rise in foreign and local currency reserve requirement rates (to 11% and 5.5% respectively, which reduced liquidity by 0.4% of GDP) while the spread between the borrowing and the one-week repo rate was widened. Rising tax revenues and tax adjustments will likely help the government easily undershoot the deficit target of 4.9% of GDP in 2010; in August the 12-month rolling deficit stood at 3.3%.

Table 12

Main Economic Indicators: Turkey

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	4.7	0.7	–4.7	–14.6	–7.6	–2.7	6.0	11.7	10.3
Private consumption	5.5	–0.3	–2.2	–10.1	–1.7	–1.9	5.0	8.5	6.2
Public consumption	6.5	1.7	7.8	5.1	0.5	5.2	17.9	1.0	3.6
Gross fixed capital formation	3.1	–6.2	–19.1	–27.6	–24.4	–18.5	–4.6	15.2	28.7
Exports of goods and services	7.3	2.7	–5.3	–11.5	–11.1	–5.4	7.4	–0.3	12.1
Imports of goods and services	10.7	–4.1	–14.3	–31.0	–20.6	–11.7	11.0	22.3	17.8
	Contribution to GDP growth in percentage points								
Domestic demand	5.8	–1.2	–6.5	–18.8	–9.6	–4.2	6.6	15.2	11.4
Net exports of goods and services	–1.3	1.9	2.8	6.9	3.6	1.8	–1.0	–5.7	–1.8
Exports of goods and services	1.7	0.6	–1.3	–2.7	–2.7	–1.3	1.8	–0.1	2.8
Imports of goods and services	3.0	–1.2	–4.0	–9.6	–6.2	–3.1	2.8	5.6	4.6
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	2.9	–0.2	–0.1	–13.2	–3.7	1.3	16.3	16.6	. .
Average gross earnings in industry (nominal)	10.4	10.7	8.5	7.1	9.2	7.9	9.5	11.2	. .
Unit labor costs in industry (nominal)	7.1	11.2	8.8	23.5	13.5	6.6	–5.9	–4.7	. .
Producer price index (PPI) in industry	6.0	13.0	1.0	7.8	–1.8	–2.2	1.0	4.6	6.6
Consumer price index (here: HICP)	8.8	10.4	6.3	8.4	5.7	5.3	5.7	9.3	9.2
EUR per 1 TRY, + = TRY appreciation	1.1	–6.3	–11.8	–16.3	–7.9	–15.1	–7.9	3.6	9.3
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.1	10.0	12.9	14.5	12.5	12.4	12.0	13.3	10.1
Employment rate (%, 15–64 years)	44.7	44.9	44.2	41.4	44.7	45.9	44.9	43.8	47.3
Key interest rate per annum (%)	17.2	16.0	9.2	12.6	9.6	8.0	6.7	6.5	6.5
TRY per 1 EUR	1.8	1.9	2.2	2.2	2.1	2.1	2.2	2.1	2.0
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	15.3	24.7	13.0	19.0	18.2	16.5	13.0	12.8	17.2
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	3.0	6.4	–1.2	7.1	5.8	5.1	–1.2	–6.1	–6.6
Domestic credit of the banking system	20.5	19.7	21.5	15.5	17.4	18.3	21.5	26.8	30.2
of which: claims on the private sector	18.2	15.3	9.9	8.1	5.1	5.4	9.9	15.6	22.4
claims on households	6.7	6.2	2.7	3.6	2.6	1.3	2.7	4.4	5.8
claims on enterprises	11.5	9.1	7.1	4.6	2.5	4.1	7.1	11.2	16.6
claims on the public sector (net)	2.3	4.3	11.6	7.3	12.3	12.9	11.6	11.2	7.8
Other assets (net) of the banking system	–8.3	–1.4	–7.2	–3.6	–5.0	–6.9	–7.2	–7.8	–6.4
	% of GDP, ESA 95								
General government revenues	19.6	21.6	22.5	. .	. .	. .	. .	. .	. .
General government expenditures	20.6	23.9	28.0	. .	. .	. .	. .	. .	. .
General government balance	–1.0	–2.2	–5.5	. .	. .	. .	. .	. .	. .
Primary balance	4.4	3.1	0.1	. .	. .	. .	. .	. .	. .
Gross public debt	39.4	39.4	45.5	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	12.9	13.8	–17.7	–14.7	–23.2	–26.6	–4.6	0.7	29.9
Merchandise imports	10.3	11.2	–26.6	–33.4	–32.5	–30.1	–7.2	26.4	42.8
	% of GDP (based on EUR), period total								
Trade balance	–7.2	–7.1	–4.0	–1.0	–4.6	–5.4	–4.4	–5.5	–6.9
Services balance	2.1	2.4	2.6	0.7	2.1	5.0	2.1	0.4	1.4
Income balance (factor services balance)	–1.1	–1.1	–1.3	–1.8	–1.6	–1.1	–1.0	–1.4	–1.0
Current transfers	0.3	0.3	0.4	0.4	0.3	0.3	0.5	0.2	0.2
Current account balance	–5.8	–5.5	–2.3	–1.7	–3.8	–1.2	–2.8	–6.4	–6.4
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	3.1	2.1	1.1	1.8	1.1	1.1	0.7	0.6	0.7
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	38.4	40.0	42.7	41.7	40.8	41.8	42.3	43.0	44.3
Gross official reserves (excluding gold)	10.5	10.2	11.1	10.6	10.1	11.0	11.1	11.2	11.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.6	4.3	5.4	4.6	4.6	5.3	5.4	5.4	5.6
	EUR million, period total								
GDP at current prices	472,996	499,921	440,430	96,393	107,112	122,392	114,534	116,105	137,267

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

11 Russia: Summer Heat Wave Temporarily Slowed down Recovery

GDP growth returned to 4% in the first half of 2010, driven by exports and domestic demand …

Boosted by rising oil prices, Russia's economic recovery slowly gathered momentum in the first half of 2010, but appears to have been somewhat stunted by the severe summer heat wave. The first quarter of 2010 saw annual GDP growth turn positive (+3.1%), driven by real exports, while domestic demand continued to decline, implying import growth far below export growth. Annual growth accelerated to 5.2% in the second quarter, with private consumption and investment becoming the drivers of growth, while real export growth slowed sharply and import growth accelerated along domestic demand, which turned the growth contribution of net exports negative for the first time since 2008.

… but was somewhat dampened by the summer heat wave

However, the economy in the third quarter performed more weakly than expected due to the repercussions of the heat wave that ravaged central Russia in late July and August. As a result, the country's grain harvest is expected to have shrunken by about 30% compared to 2009. Agriculture in general, manufacturing and tourism have been negatively affected. Economy ministry estimates show GDP expansion slightly below 4% in the January–August period.

Russia's external balances improved in the first half year

Bank Rossii's (BR) more flexible stance (under its continued managed floating policy) helps explain the rise of the ruble's nominal-effective exchange rate by 5% over the first eight months of 2010. This rise, the persisting output gap, and the decline of ULC in industry are largely responsible for annual CPI inflation having touched a post-Soviet low of 5.9% in July 2010, before rising again to 7.0% in September, due to the price shock triggered by the heat wave, and possibly also to accelerating M2 growth (mainly as a result of increasing net credit to government). Given the much higher average oil price and the recovery of export volumes, Russia's combined current and capital account surplus rose to 7.3% of GDP in the first half of 2010 (from 3.4% a year earlier).

Nonperforming loans remain high, but banks' liquidity is adequate, and credit squeeze may be easing

The BR continued to make use of low inflation to support the recovery, fight the credit crunch, and curb speculative upward pressure on the ruble by further gradually lowering the refinancing rate to 7.75% at end-May. Credit to the private sector (in real terms) seems to have bottomed out in the spring of 2010; from end-March to end-August 2010, the loan volume increased by 4.0%. At 9.5% of total credit, the NPL ratio remained high at mid-2010. Given rising deposit inflows in recent months, credit institutions' liquidity situation further improved, making possible the withdrawal of some BR liquidity support measures.

Fiscal stimulus in response to crisis to be withdrawn?

In light of a supplementary budget providing for further expenditures of 0.7% of GDP in June and of a possible second supplementary budget in the fall, it is not yet clear to what degree the authorities are willing to withdraw their large crisis-response fiscal stimulus. The federal budget deficit came to 2.2% of GDP in the first nine months of 2010; however, factoring in backloading and the repercussions of the heat wave, experts now expect a shortfall of about 5% of GDP in 2010 (roughly equal to the original budget plan; in 2009, the deficit stood at 5.9% of GDP). Deficit finance is partly being monetized by using the reserve fund, which shrank to EUR 30.2 billion at end-September 2010; the government inter alia launched a U.S. dollar-denominated eurobond of USD 5.5 billion in April 2010 and aims to cut next year's federal deficit to 3.6% of GDP.

Table 13

Main Economic Indicators: Russia

	2007	2008	2009	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
	Year-on-year change of the period total in %								
GDP at constant prices	8.5	5.2	–7.9	–9.3	–11.0	–8.6	–2.9	3.1	5.2
Private consumption	14.2	10.7	–7.6	–2.8	–7.9	–11.3	–8.0	0.1	4.5
Public consumption	2.7	2.8	2.0	1.7	2.0	1.7	2.6	1.8	0.7
Gross fixed capital formation	21.0	10.4	–15.7	–16.4	–22.1	–17.7	–9.3	–7.1	9.3
Exports of goods and services	6.3	0.6	–4.7	–15.4	–9.7	–3.1	7.7	18.5	3.9
Imports of goods and services	26.2	14.8	–30.4	–34.9	–39.3	–34.0	–14.8	10.7	20.8
	Contribution to GDP growth in percentage points								
Domestic demand	13.9	9.8	–14.6	–4.3	–9.7	–8.9	–34.2	–0.8	5.5
Net exports of goods and services	–6.5	–5.6	11.4	8.7	13.4	13.9	9.4	3.2	–4.7
Exports of goods and services	2.3	0.2	–1.6	–5.7	–3.2	–0.9	2.8	6.4	1.3
Imports of goods and services	8.8	5.8	–13.0	–14.3	–16.6	–14.8	–6.5	3.2	6.0
	Year-on-year change of the period average in %								
Labor productivity in industry (real)	4.6	3.1	0.1	–8.5	–4.8	1.1	12.8	16.7	15.8
Average gross earnings in industry (nominal)	26.0	25.0	3.2	4.9	2.2	0.7	5.2	12.6	15.6
Unit labor costs in industry (nominal)	20.4	21.5	3.2	14.9	7.3	–0.4	–7.0	–3.7	–0.1
Producer price index (PPI) in industry	14.0	21.8	–6.6	–8.3	–10.1	–13.1	5.0	13.9	12.4
Consumer price index (here: CPI)	9.1	14.1	11.8	13.9	12.6	11.5	9.3	7.3	6.2
EUR per 1 RUB, + = RUB appreciation	–2.6	–3.9	–17.4	–18.2	–15.7	–18.5	–17.3	7.4	13.7
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.2	6.4	8.4	9.1	8.6	7.8	8.1	8.8	7.4
Employment rate (%, 15–64 years)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Key interest rate per annum (%)	10.3	10.9	11.4	13.0	12.2	10.9	9.4	8.6	8.0
RUB per 1 EUR	35.0	36.4	44.1	44.4	43.8	44.8	43.6	41.3	38.5
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	44.2	14.6	16.4	9.3	7.1	9.1	16.4	20.5	22.2
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	29.9	15.6	10.3	15.7	11.1	5.9	10.3	5.4	9.9
Domestic credit of the banking system	24.9	15.8	16.1	12.5	14.5	19.3	16.1	19.4	18.9
of which: claims on the private sector	42.6	33.5	2.1	28.8	16.3	9.5	2.1	–1.6	6.3
claims on households	11.6	7.6	–2.8	4.7	0.5	–2.8	–2.8	–2.2	0.4
claims on enterprises	31.0	26.0	4.9	24.1	15.8	12.3	4.9	0.6	5.9
claims on the public sector (net)	–17.7	–17.7	14.0	–16.2	–1.8	9.8	14.0	21.0	12.6
Other assets (net) of the banking system	–10.6	–16.8	–10.1	–18.9	–18.6	–16.1	–10.1	–4.3	–6.7
	% of GDP, ESA 95								
General government revenues	40.2	38.6	34.8	. .	. .	. .	. .	. .	. .
General government expenditures	34.2	33.8	41.0	. .	. .	. .	. .	. .	. .
General government balance	6.0	4.9	–6.3	. .	. .	. .	. .	. .	. .
Primary balance	. .	. .	. .	. .	. .	. .	. .	. .	. .
Gross public debt	6.7	5.7	8.3	. .	. .	. .	. .	. .	. .
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	6.7	24.2	–32.4	–40.2	–38.4	–36.6	–13.1	51.8	53.7
Merchandise imports	24.6	22.7	–31.3	–26.5	–33.3	–37.7	–26.6	11.9	42.1
	% of GDP (based on EUR), period total								
Trade balance	10.0	10.6	9.0	7.6	8.4	9.9	9.5	14.1	11.0
Services balance	–1.4	–1.5	–1.6	–1.6	–1.4	–1.9	–1.5	–1.4	–1.6
Income balance (factor services balance)	–2.4	–2.9	–3.2	–2.0	–4.0	–3.1	–3.4	–2.4	–3.9
Current transfers	–0.3	–0.2	–0.2	–0.2	–0.1	–0.4	–0.3	–0.2	–0.3
Current account balance	6.0	6.1	4.0	3.9	2.8	4.6	4.4	10.2	5.2
Capital account balance	–0.8	0.0	–0.9	0.1	0.1	–3.6	0.0	0.1	0.0
Foreign direct investment (net)	0.7	1.1	–0.6	–1.6	–0.7	0.8	–1.2	–0.6	–0.6
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	34.1	. .	36.6	31.0	32.5	34.7	36.6	36.8	37.0
Gross official reserves (excluding gold)	33.4	26.1	32.6	25.6	27.6	28.9	32.6	33.6	35.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	18.6	14.2	19.2	13.9	15.2	16.3	19.2	20.4	21.1
	EUR million, period total								
GDP at current prices	948,003	1,137,006	886,266	189,207	212,112	234,724	250,224	238,853	281,826

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

Studies

Crisis Response Policies in Russia, Ukraine, Kazakhstan and Belarus – Stock-Taking and Comparative Assessment

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This study focuses on comparing and assessing the policy measures Russia, Ukraine, Kazakhstan and Belarus took in response to the impact of the U.S. subprime crisis (2007) and of the Great Recession (2008–2009). Being most dependent on cross-border capital inflows, Kazakhstan was most affected by, and reacted most intensively to, the subprime turmoil, followed by Russia. In contrast, all four countries responded to the second crisis with a panoply of fiscal, monetary, exchange rate and other measures. After sharp across-the-board devaluations in late 2008 and early 2009, and accompanying the recovery of the oil price, the currencies of the oil exporters Russia and Kazakhstan soon stabilized, whereas the currencies of the oil importers Ukraine and Belarus stayed under pressure – giving rise to intermittent interventions. Opposing – if hitherto successful – macrofinancial restabilization strategies have been conducted: Oil exporters employed their oil stabilization funds to deliver generous fiscal stimuli, whereas oil importers took recourse to IMF Stand-By Arrangements and exchange controls. With respect to the banking turmoil and restructuring since late 2007, the following can be concluded: Although measuring recapitalization costs is not unproblematic, systems dominated by state-owned banks (Russia, Belarus) appear to have fared better in precisely this time span in the sense that they have incurred less crisis-triggered recapitalization spending than systems dominated by private domestic or even foreign-owned capital (Kazakhstan, Ukraine). One of the reasons that might explain this result is the (with hindsight) excessive pre-crisis credit booms in the privately dominated banking systems, financed largely from abroad, coupled with the possibly even weaker rule of law outside the sphere of direct state control in the CIS region.

JEL classification: E52, G21, H30, P34
Keywords: Crisis response policies, fiscal stimulus, quasi-fiscal policy, Russia, Ukraine, Kazakhstan, Belarus, oil stabilization fund, macrofinancial stabilization, directed lending, related-party lending, banking regulation, recapitalization, rule of law

1 Introduction

The purpose of this study is to present, compare and assess the crisis response measures of the four CIS countries with the highest total GDP. In addition to Russia and Ukraine, these are oil-rich and FDI-intensive Kazakhstan, and highly centralized Belarus. The crisis referred to is the current global financial and economic crisis, starting with the U.S. subprime turmoil (since August 2007) and culminating in the crisis triggered by the collapse of Lehman Brothers (since September 2008).

The study starts with an overview of macroeconomic developments, policies and reforms in the four countries in the years leading up to the major 2007–2008 upheavals, which enables us to point to accumulating economic vulnerabilities. The various country-specific impacts of the crisis are briefly outlined in section 2. This leads us to the documentation of the way the authorities reacted, which forms the core part of the study in section 3. Key crisis response measures are systematically outlined for the areas of monetary and exchange rate policies, trade

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protection, fiscal policy, oil stabilization funds (if any), banking regulation, supervision and bailouts, privatization and other policy measures. Detailed information on key policy measures is included in the tables in the annex. The most important sources of comparative policy information are the national statistical agencies of Russia, Ukraine, Kazakhstan and Belarus, IMF Staff Reports 2005–2010 on the four countries, OECD Economic Surveys of Russia and Ukraine, World Bank Russian Economic Reports and the annual reports of the four national central banks. Section 4 synthetically and comparatively assesses the policy measures described and draws conclusions. Finally, the study is summarized in section 5.

2 Pre-Crisis Economic Developments and Vulnerabilities and the Impact of the Crisis from 2007 to 2009

2.1 Economic Developments and Vulnerabilities before 2007–2008: Signs of Overheating

In the years preceding the outbreak of the crisis, which intervened in the CIS region as an external shock, all four countries under discussion boasted average GDP growth rates of around 7% to 8% p.a. (see chart 1) and witnessed signs of economic overheating. These included:

Buoyant oil and commodity prices

In the two oil-producing and -exporting countries Russia and Kazakhstan (henceforth called "hydrocarbon countries" – HCCs), a key underlying force that supported domestic demand were skyrocketing oil and raw material prices (up to mid-2008); in contrast, the two oil-importing countries Ukraine and Belarus (in the following referred to as "nonhydrocarbon countries" – NHCs) had to contend with a negative net impact of high energy prices on their terms of trade and external balances.[2] However, the NHCs have, in a more limited sense, both benefited from high processed commodity prices: Ukraine's key export staple continues to be steel, while Belarus has traditionally profited from large-scale refining of relatively cheap Russian oil and from the sale of petrochemical products at world market prices (Barisitz 2007a, p. 132–133, 140) (see chart 4).

Credit booms and dollarization of loans

Credit booms unfolded in all of the four countries under observation (see chart 2). These booms partly embodied the swift expansion of foreign exchange (mostly U.S. dollar)-denominated loans, which attained 45% to 50% of total loans (before the crisis) in Ukraine and Kazakhstan. Foreign currency-denominated lending to unhedged borrowers (notably households) has been pronounced in all four countries, if somewhat less so in Russia and Belarus. Together with rising wages and profits, strong loan growth fueled surging domestic demand and high inflation (see chart 3).

Capital inflows, swelling current account deficits and external debt

Credit booms were also driven by substantial capital inflows: In the case of Russia and particularly Kazakhstan, these inflows largely consisted of syndicated loans

[2] *IMF and EBRD publications frequently divide CIS countries into "hydrocarbon countries" and "nonhydrocarbon countries" for analytical purposes (see IMF 2010, p. 34; EBRD 2009, p. 78–90)*

from international financial markets and eurobond placements, pushing up private external debt (Barisitz, 2009, p. 42–43). In Ukraine, where foreign strategic investors accounted for a higher share of banking assets, loans and refinancing from parent banks also fueled credit expansion. The surge of domestic demand contributed to deteriorating current account balances across the board, although Russia continued to register surpluses (see chart 6).

Belarus: Outlier boasting extensive government control, forced growth

In Belarus, credit growth and economic expansion have partly been driven by government instructions (directed lending, forced growth, inventory accumulation), buttressed by subsidized energy deliveries from Russia (as mentioned above), even if the latter subsidies have been steadily rolled back since early 2007, which rendered Belarus' financial situation more difficult.[3] The Belarusian economy to some degree constitutes an exception in that the authorities have held on to administrative control over a wide range of activities. The banking sector is still dominated by state-owned banks (SOBs, accounting for over three-quarters of total banking assets). Inflation grew despite tightening price controls. Also with respect to foreign exchange reserves, Belarus, equipped with a relatively low stock, has been an outlier.

Largely accommodative fiscal and monetary policies, eroding competitiveness

Pre-crisis macroeconomic policies generally tended to be accommodative. While HCCs' oil-related budget revenues surged and delivered headline surpluses, their underlying non-oil budget balances are estimated to have remained in the red.[4] Notwithstanding its relatively tight fiscal stance, Belarus' quasi-fiscal policies, prominently featuring directed credits extended by SOBs, have remained quite loose in recent years (see chart 2). Exchange rate regimes have tended toward de facto pegs to the U.S. dollar. These exerted expansionary monetary effects because of pre-crisis appreciation pressures, substantial resource revenue and/or capital inflows, sizeable – but largely unsterilized – foreign currency purchases by central banks and high rates of base money growth and liquidity expansion.[5] Resulting real appreciations put pressure on industrial competitiveness margins.[6]

[3] *For a more detailed description of the Belarusian "economic model," see Barisitz 2007b, p. 86–88.*

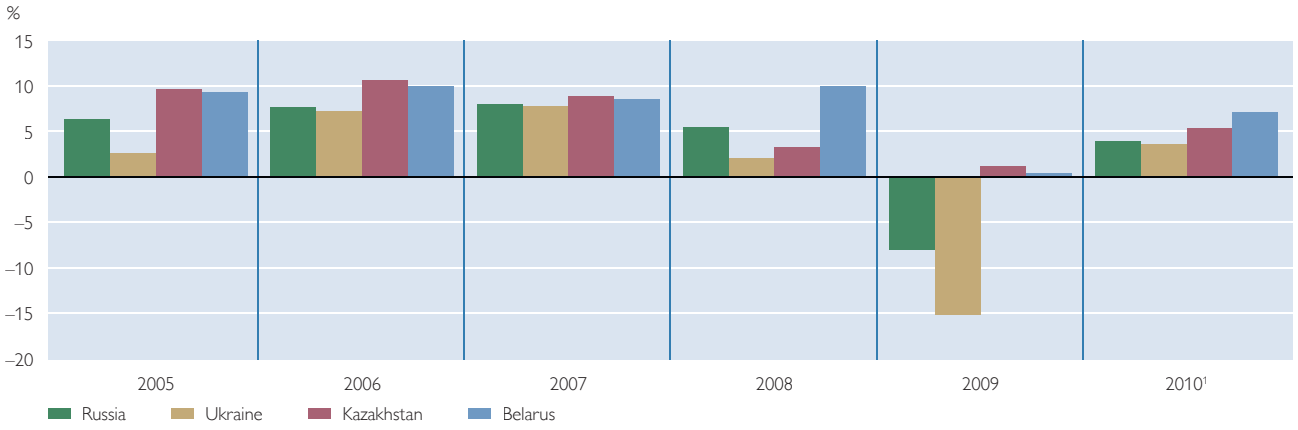
[4] *For instance, according to IMF calculations, Russia's non-oil federal budget deficits in 2006 and 2007 came to 3.9% and 3.0% of GDP, respectively, while the country's headline federal budget surpluses stood at 7.4% and 6.2% of GDP, respectively (IMF 2009a, p. 29).*

[5] *There have been sterilization operations from the fiscal side, through oil stabilization funds in Russia and Kazakhstan. These interventions have prevented even stronger appreciation pressures.*

[6] *With the exception of the Belarusian ruble, which experienced substantial nominal exchange rate reductions in the early years of the decade, real effective exchange rates of the analyzed countries' currencies increased in the period from 2000 to 2008, most strongly in the case of the Russian ruble, which rose over 80%.*

Chart 1

GDP Growth 2005–2010

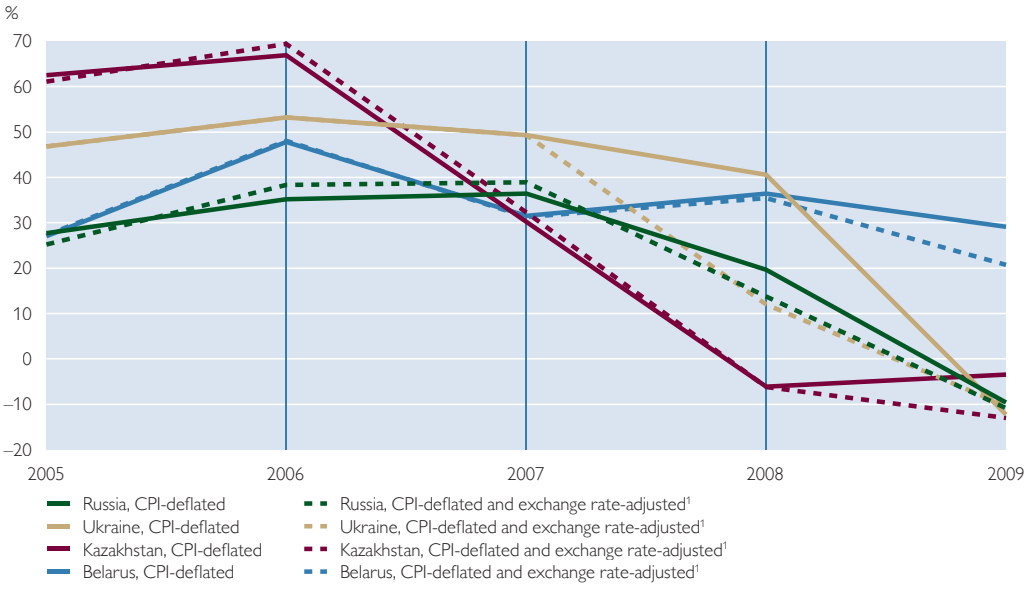


Source: National statistics, IMF.

[1] IMF forecast (World Economic Outlook October 2010).

Chart 2

Real Credit Growth (year-end)

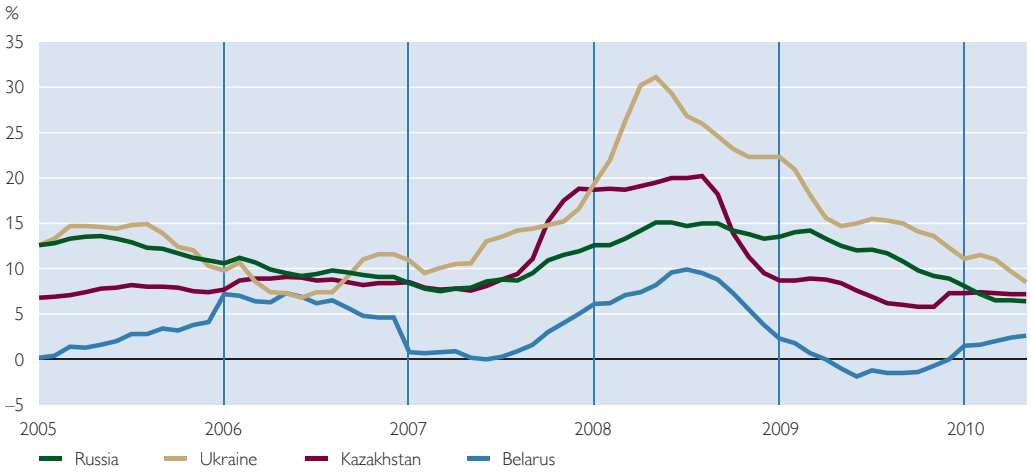


Source: National statistics, IMF.

[1] Based on the U.S. dollar exchange rate.

Chart 3

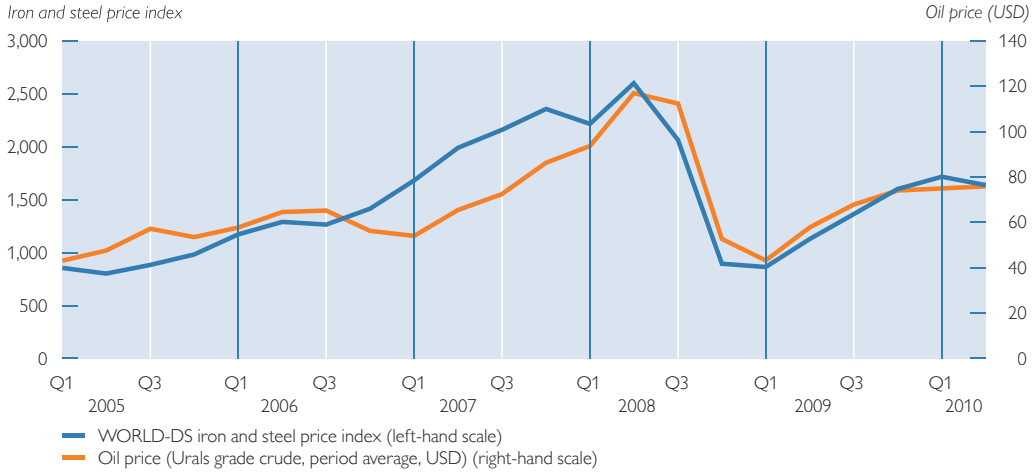
CPI Inflation (year on year)



Source: wiiw, IMF.

Chart 4

Oil and Steel Prices



Source: Thomson Reuters.

2.2 Differential Impact of the Crisis from 2007 to 2009

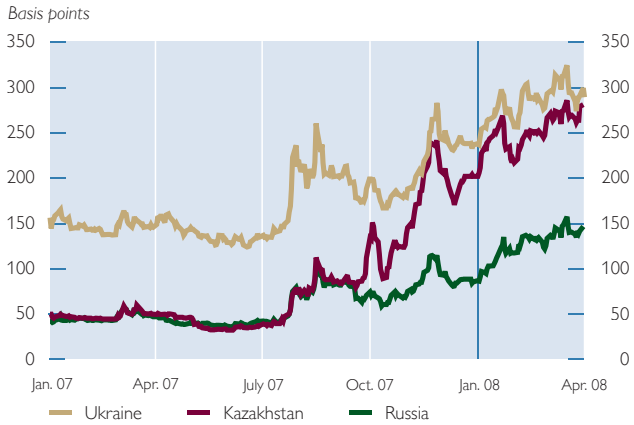
2.2.1 Repercussions of the U.S. Subprime Crisis (August 2007 to mid-2008)

The major repercussions of the U.S. subprime crisis on the four largest CIS countries embodied rising external borrowing costs and the temporary drying-up of bank and corporate funding sources from international financial markets or heightened volatility of capital inflows (capital channel). Mainly due to the particularly high degree of the Kazakh banking sector's dependence on external finance (which comprised around half of its total liabilities), against the backdrop of a low deposit base and a relative dearth of FDI in this sector, Kazakhstan was hit strongest, followed by Russia (see chart 6).

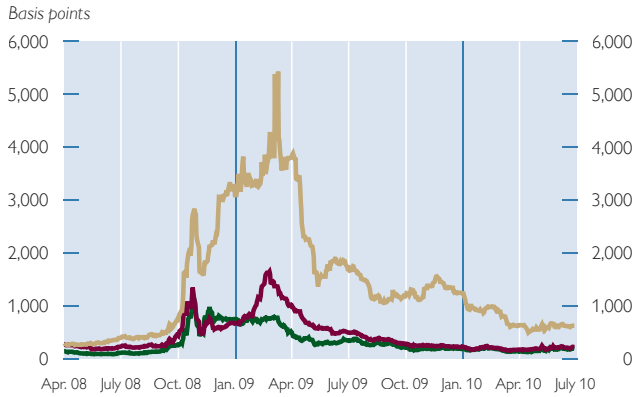
Chart 5

CDS Spreads

January 2007 to April 2008[1] (five-year maturity)



April 2008 to June 2010[1] (five-year maturity)



Source: Thomson Reuters.

[1] CDS spreads for Belarus are not available.

Thus, the Kazakh CDS premiums rose strongest (in relative terms) from mid-2007 to early 2008. Kazakhstan also witnessed a credit squeeze (month-on-month credit volume growth rates ground to a halt in the fall of 2007), a reversal of property price growth (burst of the housing bubble), and, more generally, a deterioration of asset quality (IMF, 2008a, p. 3–6). As a result, Kazakh GDP growth slumped from about 10% in the first half of 2007 to 5% in the same period of 2008 (year on year). In the last quarter of 2007, for the first time since early 2000, seasonally adjusted real GDP registered a decline related to the previous quarter (see also Jandosov, Sabyrova and Mogilevsky, 2010, p. 8). While capital inflows into Russia declined initially following the outbreak of the financial turmoil, eurobond issuances by a few large Russian state-dominated energy companies and banks soon recovered, as did recourse to the syndicated loan market. Ukraine and Belarus were hardly touched by the subprime crisis: At mid-2007, foreign strategic investors already accounted for 39% of Ukrainian banking sector assets[7]; most of these actors held open refinancing channels for their subsidiaries. The Belarusian banking sector was still quite small, mostly state-owned and -directed and less dependent on foreign financial flows.

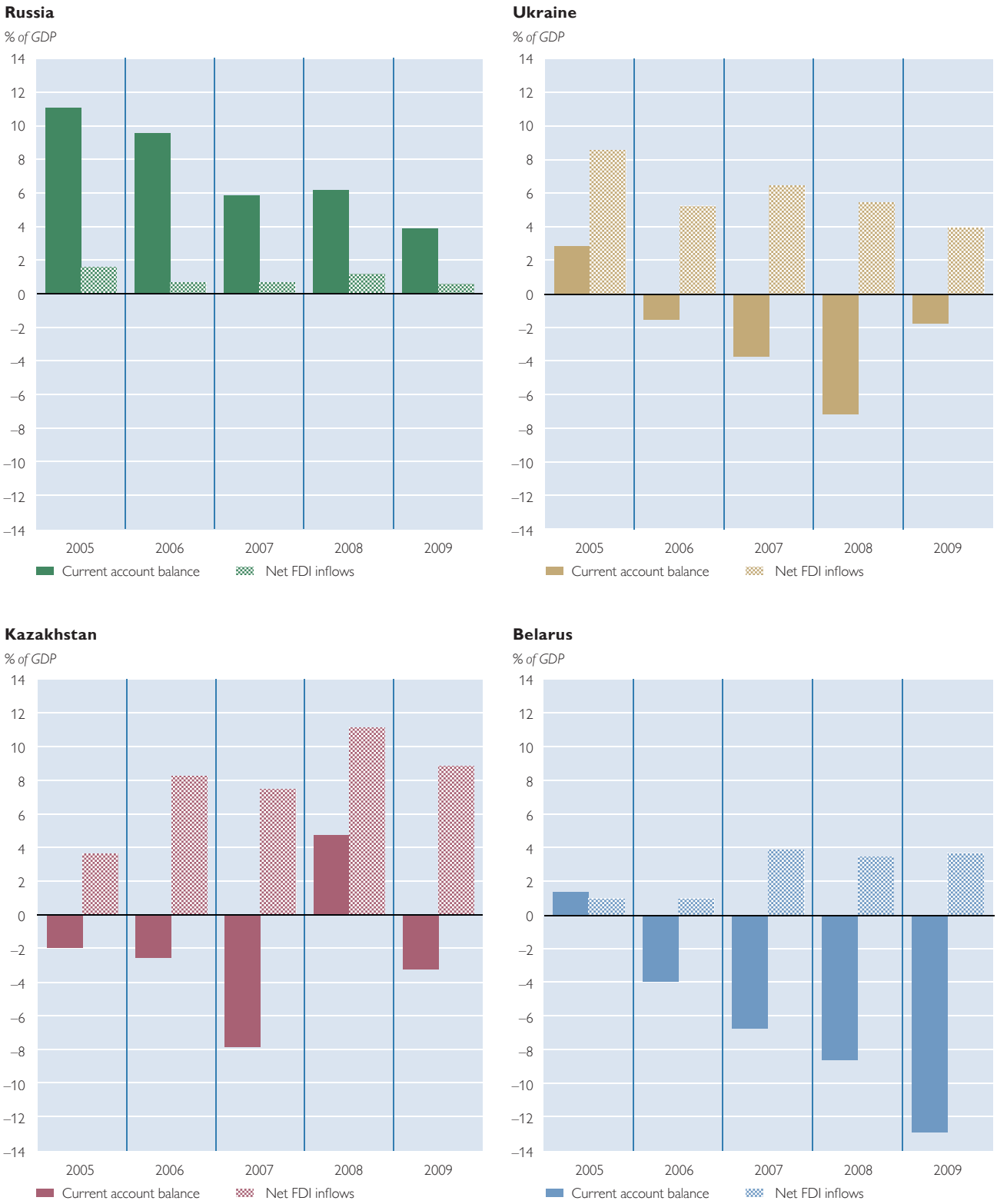
2.2.2 Heavy Impact of the Collapse of Lehman Brothers and of the Ensuing Great Recession (from September 2008)

The crisis had a heavy dual impact on all four countries: They were practically shut out of international financial markets (implying skyrocketing spreads and sharp reversals of capital inflows, see chart 5, right-hand panel) and the collapse of export demand and of oil and commodity prices contributed to plummeting GDP

[7] *In contrast to Ukraine, the other three countries observed have featured much lower shares of foreign-owned banks in total sector assets. As of end-2007, the respective shares were: 17% (Russia), 16% (Kazakhstan) and 20% (Belarus).*

Chart 6

Current Account Balance and Net FDI Inflows 2005–2009



Source: National statistics.

growth (capital and trade channels); moreover, in the case of Ukraine and Russia, these developments contributed to deep recessions (see chart 1).[8] Therefore, banks' balance sheets came under increasing strain, nonperforming assets and loans swelled and Russia, Ukraine and Belarus were also caught by a credit squeeze, like Kazakhstan beforehand (see chart 2). Only in Belarus did the authorities uphold credit growth through government programs.[9] Confidence in banks weakened again, and gave rise to renewed deposit withdrawals.

Capital outflows, decreasing export demand, declining commodity prices and, therefore, deteriorating terms of trade as well as the sagging confidence in domestic banks quickly reversed exchange rate expectations and put strong depreciation pressure on all four currencies. Initial interventions to defend exchange rates led to sharp declines of central banks' foreign currency reserves which, however, were only critical in the case of Belarus (see chart 8). While eventual devaluations could not be avoided (see chart 9), they contributed to banking turmoil via aggravating the solvency problems of unhedged borrowers. While all four countries were hit by a banking turmoil, which in some cases triggered failures of smaller and medium-sized credit institutions, only in Kazakhstan did two of the largest four banks default (on their foreign debt). As the crisis impact deepened, inflationary pressures eased (see chart 3), and unemployment rose across the board. One of the reasons Ukraine was especially hard hit by the crisis was its stubborn political instability and turmoil (since 2005), which fed into protracted uncertainties about its economic policy stance and exacerbated the lack of confidence in the domestic currency (IMF, 2009b, p. 4; Raiffeisen Research – Raiffeisen Bank Aval, 2009, p. 3). Year-on-year economic growth resumed or recovered in all four countries by the first quarter of 2010.

3 How Did the Authorities React?

3.1 Policy Response to the Impact of the Subprime Crisis

Having been most affected by the impact of the subprime crisis, Kazakhstan also made the strongest policy effort to tackle the crisis (see table 3 in the annex). This effort was centered on liquidity support by the National Bank of the Republic of Kazakhstan (NBK) and by the government. This included the government's establishment in November 2007 of a USD 1 billion (1.0% of GDP) facility of earmarked deposits with banks, to be onlent to support construction companies and SMEs. After strongly intervening in the foreign currency market to support the Kazakh tenge, using USD 6 billion (about a quarter of its international reserves), the NBK in October 2007 declared that it had pegged the Kazakh tenge to the U.S. dollar, which contributed to stabilizing the situation. Moreover, the

[8] *The fact that Russian growth performance was so much weaker than Kazakh growth performance in 2009 was probably due to Russia's much higher share of manufacturing industry in GDP and the latter's greater dependence on external demand, as opposed to Kazakhstan's less diversified economic structure (Sabyrova 2009, p. 9).*

[9] *As pointed out by Astrov (2010, p. 13), loan growth through directed credits to state-owned enterprises (SOEs) – often based on negative real interest rates – bolstered fixed investment, while wage increases in SOEs fueled private consumption in Belarus. Thus, publicly supported domestic demand largely compensated for crisis-triggered export losses and prevented a recession in Belarus. Yet this was achieved at the cost of a widening current account gap (2009: 12.9% of GDP), expanding borrowing needs and swelling foreign debt (near-doubling to 44% of GDP at end-2009).*

Kazakh Financial Supervision Agency (FSA)[10] stepped up its monitoring activities in the country's largest banks. Russia largely confined its crisis response to CBR (Bank Rossii) and government liquidity injections (see table 1 in the annex).

3.2 Policy Response to the Impact of the Collapse of Lehman Brothers and the Great Recession

Confronted with the above-mentioned substantial dual impact of the U.S. and global financial and economic crisis, all of the four largest CIS countries reacted with a broad range of policy measures. Because of their weak external positions (see chart 6 and 8) and overall difficult financial situation, the NHCs (Ukraine and Belarus) solicited and received IMF Stand-By Arrangements (SBAs)[11], while the HCCs (Russia and Kazakhstan) did not apply for international financial assistance.

3.2.1 Monetary Policy Easing, Foreign Exchange Interventions Followed by Devaluations

Once again, wide-ranging liquidity assistance was provided, e.g. Natsionalny bank Ukraini (NBU) injections of some 6% of GDP or bank deposit inflows of USD 1.4 billion (1.3% of GDP) from firms of the Kazakh state holding company Samruk-Kazyna[12]. While aiming at emergency intervention to help the financial system, these liquidity injections also probably added to depreciation pressure on domestic currencies and thus gave rise to a policy dilemma. Foreign currency interventions from September 2008 to January 2009 consumed sizeable amounts of international reserves (up to one-third in the case of Russia), but could not prevent substantial devaluations (by between 20% and 50%) in all four countries (see chart 9). The Russian and Kazakh devaluations were either stepwise or one-off, but appear to have been tightly controlled by the authorities using their bountiful reserves.[13] In the cases of Ukraine and Belarus, though, the authorities at certain points seem to have been forced to step back and allow markets a greater say in determining currency values. Still, all four countries have continued to aim at maintaining the relative stability of their currency's exchange rate against the U.S. dollar, even if Russia, managing a U.S. dollar-euro currency basket, has allowed somewhat greater flexibility since September 2008.

Once the height of the financial crisis had passed, the new exchange rate levels had been defended and inflation had started to decline, in the second quarter of 2009 monetary policy was eased in all four countries in order to further support liquidity and credit activity. While the loosening monetary policy stance has since been largely upheld in Russia and Kazakhstan (World Bank, 2010, p. 11), the Ukrainian and Belarusian authorities intermittently reversed their stances in order

[10] *Agency of the Republic of Kazakhstan on regulation and supervision of the financial market and financial organizations.*

[11] *The SBA for Ukraine took effect in November 2008, providing a total earmarked amount of USD 16.4 billion, of which USD 10.6 billion were disbursed by end-2009; a new arrangement was reached in July 2010, covering an amount of USD 14.9 billion. The SBA for Belarus was concluded in January 2009, providing for an augmented amount of USD 3.5 billion.*

[12] *Samruk-Kazyna, also known as the National Welfare Fund, is a Kazakh public entity created by the end-2008 merger of the state asset holding company Samruk and the sustainable development fund Kazyna.*

[13] *The fact that the CBR used up about one-third of its currency reserves defending the Russian ruble and managing the gradual depreciation was not necessarily a "lost" investment, since it gave banks and corporates – some of whom were saddled with high external debt – time to adjust their balance sheets.*

to counter new depreciation pressures or support new (lower) exchange rate levels (see tables in the annex). This recalls the above-mentioned dilemma which respective authorities faced by choosing a policy trade-off.

Reappreciation pressures set in for the Russian ruble and the Kazakh tenge toward the end of the first quarter of 2009, on the back of the recovery of the oil price; reappreciation pressures for the Ukrainian hryvnia and the Belarusian ruble have only emerged in late 2009 and early 2010 and partly stemmed from the recovery of Ukrainian terms of trade and the readjustment of its external balance (around mid-2009), followed by political restabilization since the change of its presidency and government in February and March 2010. However, the fragility of the world economic recovery was underlined by the impact of the Greek and euro area debt crisis of May 2010 on global confidence and commodity prices: Oil prices plunged by about one-fifth in just two weeks, before recovering again. Steel prices also dropped sharply. This put intermittent downward pressure on the Russian ruble, less so on the Ukrainian hryvnia.

3.2.2 Fiscal Policy and Oil Stabilization Funds (If Any)

Prominent fiscal stimulus packages were assembled in the HCCs. The Russian authorities, in late 2008 and in April 2009, passed supplementary budgets: The revised federal budget for 2009 produced a deficit of 5.9% of GDP (see chart 7), which corresponds to a swing of 9.5 percentage points, compared to the original budget plan.[14] While the fiscal stimulus is dominated by spending measures, revenue measures also feature prominently (see table 1 in the annex and Ponomarenko and Vlasov, 2010, p. 8–9). But, as traditional in Russia, the execution of the budget was heavily backloaded; after witnessing a surge of government spending in late 2008, in the first quarter of 2009 – during the depth of the crisis – the fiscal stimulus was withdrawn. It only made itself felt in the second half of the year, in a possibly procyclical manner. Most of the budget deficit of 2009 was financed by the Reserve Fund.[15] Although the Russian authorities announced plans to reduce the fiscal stimulus in 2010, they passed a supplementary budget providing for expenditures of 0.7% of GDP in June 2010 and earmarked an additional supplementary budget for the fall of the year. The federal budget shortfall is expected to come to about 5% of GDP in 2010.

Kazakhstan put together a comprehensive anticrisis program[16], providing for the allocation of about USD 12 billion (10% to 11% of annual GDP) over the period from 2009 to 2010 and drawing on combined efforts of the government, the NBK and the FSA. While the National Fund of the Republic of Kazakhstan (NFRK, the country's oil stabilization fund) largely provided the necessary

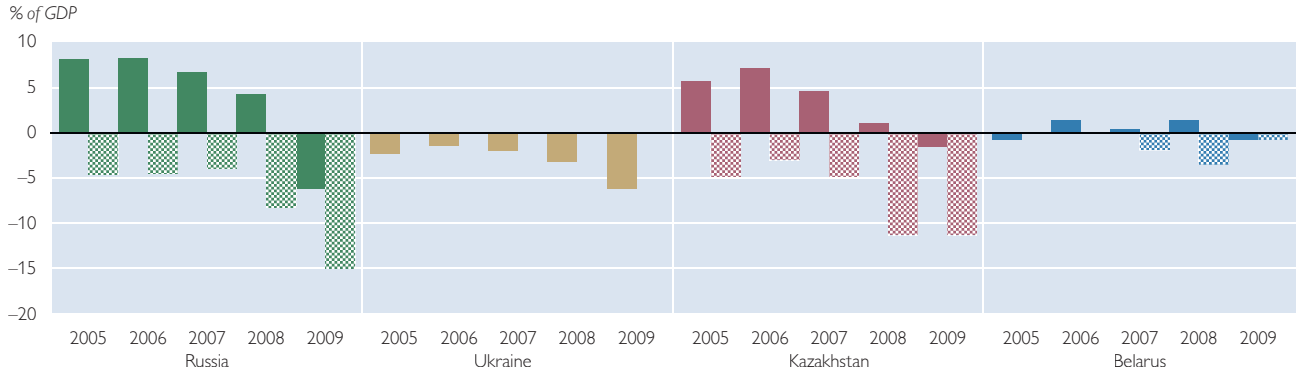
[14] *Based on OECD calculations (OECD 2009, p. 43).*

[15] *In February 2008, the Russian oil stabilization fund was split into a Reserve Fund and a National Welfare Fund. The Reserve Fund fulfills the functions of a fiscal stabilization fund, accumulating budget revenues from oil and gas, and is capped at 10% of GDP. The National Welfare Fund is earmarked to support the state pension system. While prior to the most recent crisis period, in mid-2008, the Reserve Fund came to about 8.5% of GDP, it declined to 4.9% of GDP at end-2009 and is expected to be used up in the course of 2010.*

[16] *Including the Joint Action Plan of the Government, National Bank and Financial Supervision Agency on the stabilization of the economy and financial sector for 2009–2010, adopted in late 2008 and later slightly amended, and other measures. In addition, certain budgetary adjustments (e.g. a rise in current and social expenditures in the context of declining tax revenues) are estimated to come to around USD 5 billion in 2009.*

Chart 7

General Government Budget Balances 2005–2009

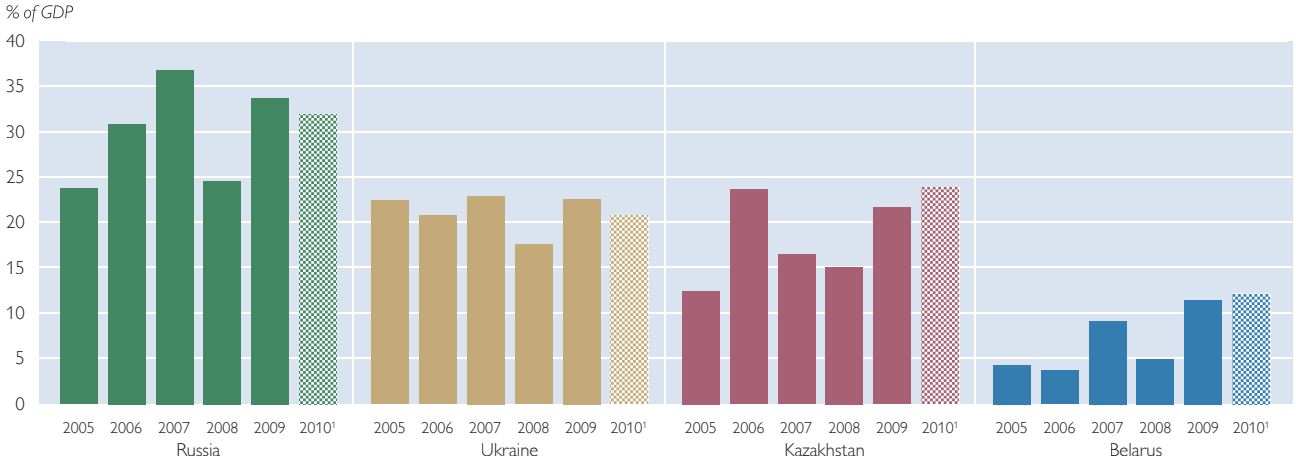


Source: National statistics.

Note: Dotted columns depict non-oil budget balances (RU, KZ) or augmented budget balances (including noncash bank restructuring measures, net lending to financial institutions and/or quasifiscal activity, BY) as calculated by the IMF.

Chart 8

Central Banks' Foreign Exchange Reserves 2005–2010



Source: National statistics.

[1] End-March.

Note: In the cases of Russia and Kazakhstan, the authorities' total foreign currency assets also include oil stabilization funds. However, the Russian fund (split between the Reserve and National Welfare Funds) cannot be clearly delimited from the CBR's foreign exchange reserves.

funds[17], Samruk-Kazyna has served as the main vehicle for crisis relief: Public support was provided to the largest (in terms of assets) four banks, to unfinished housing projects, SMEs, farms and to other hard-hit parts of the real sector (see table 3 in the annex). Like in Russia, spending measures predominate. According to preliminary estimates, overall about 59% of the 2009 fiscal package was allocated to the financial sector, 28% to the corporate sector and 13% to households (Jandosov and Sabyrova, 2009, p. 7). The Kazakh authorities also plan to

[17] *In mid-2007, the NFRK amounted to 19.8% of GDP, then stagnated at about this level until mid-2009 (20.9%), before expanding to 22.3% of GDP at end-March 2010.*

trim their budgetary stimulus in 2010, but they, too, amended their budget in March 2010 in order to deliver increases in social expenditures.

Ukraine and Belarus, recipients of IMF financial assistance (as mentioned above), appear to have followed an alternative, even opposite, strategy: The NHC did not deliver fiscal stimuli (of any appreciable size), but rather maintained a relatively tight fiscal stance (see chart 7) to support macroeconomic stability and underpin feeble confidence. Ukraine even had recourse to some unorthodox tightening measures (e.g. accumulation of VAT refund arrears, enforcement of advanced tax payments by large enterprises). However, a few months before the presidential elections of early 2010, the Ukrainian authorities abstained from adjusting low retail gas tariffs, and parliament raised minimum wages and pensions by 20% – inconsistent with the goals of the country's IMF program, which thus veered off-track. The new government in June 2010 received a bridging loan of USD 2 billion from Russia's Vneshtorgbank (VTB). In early July, a new SBA was agreed upon with the IMF (see above), a major plank of which is budgetary consolidation. While satisfying the IMF's fiscal stringency conditions, Belarus continued its long-standing policy of serving quasi-fiscal stimuli (see subsection 3.2.4).

3.2.3 Banking Regulation, Supervision and Bailouts

As a first crisis response reaction in this field and as a complement to liquidity injections, central banks tended to introduce regulatory forbearance (e.g. loosening of loan classification and provisioning requirements), which was later (in the second half of 2009) at least partly withdrawn again. Also, to some degree preemptively, deposit insurance limits were raised or blanket guarantees extended to all retail deposits. While some smaller banks that had defaulted on interbank markets were closed, the authorities saved or nationalized most smaller or medium-sized credit institutions that had gotten into trouble. Large SOBs (e.g. in Russia: Sberbank, VTB, Vneshekonombank (VEB); in Ukraine: Oschadbank (State Savings Bank)) were among the first to receive government capital injections and then were also used as instruments to keep other parts of the sector afloat (via subordinated loans, etc.) (see table 1 in the annex).

In Ukraine, after diagnostic studies carried out in response to IMF recommendations had revealed large capital deficiencies, the state as well as foreign and most – but not all – domestic private owners of ailing banks took recapitalization measures deemed necessary. Remaining credit institutions were put in receivership or entered liquidation procedures (see table 2 in the annex).[18] Up to mid-2009, public costs of bank restructuring in Ukraine were estimated at UAH 40 to 45 billion or about 5% of GDP, while total costs may have reached twice that level (IMF, 2009b, p. 22).

Bank restructuring in Kazakhstan has evolved in a much different way but entailed costs of a comparable dimension: In the framework of the authorities' anti-crisis program, in February 2009 Samruk-Kazyna recapitalized the country's largest four banks (together accounting for about two-thirds of banking assets) with a total capital injection of USD 2.5 billion (2.3% of GDP). In April 2009, however, Bank Turan Alem (BTA, the country's largest credit institution) and Alliance Bank (the fourth-largest) – in both, the state had just become a

[18] *As of end-September 2010, 4 banks were still under receivership and 18 banks in the liquidation phase.*

majority owner – defaulted on their foreign obligations of about USD 16 billion (or up to 15% of the country's external debt). In the second half of 2009, BTA and Alliance Bank reached preliminary debt restructuring agreements with their foreign creditors in which the latter accepted major haircuts (in both cases 60% and higher); these haircuts were confirmed in final arrangements reached in the spring of 2010 (see table 3 in the annex). BTA's contract, which accounts for three-quarters of the mentioned sum, corresponds to the biggest debt restructuring deal seen in emerging markets in recent years (Gorst, 2010). As of mid-2010, in Ukraine as well as Kazakhstan still deteriorating asset quality and expanding provisions will likely necessitate further restructuring and recapitalization efforts.

In Belarus the authorities provided capital injections of USD 1.5 billion (2.5% of GDP) to SOBs in December 2008, aimed at compensating losses stemming from traditional quasifiscal activities and expected from the slump. In 2009, Belarusian bank privatization continued to progress slowly, with only Belpromstroi-bank, the fifth-largest bank, sold to Sberbank (see table 4 in the annex).

3.2.4 Administrative, Trade Protection and Other Policy Measures

This subsection refers to a heterogeneous group of measures. Some countries did not withstand the temptation to raise selected tariff and/or nontariff barriers to trade. This refers e.g. to the widely publicized and controversial adjustment of Russian import duties on foreign cars and trucks in December 2008. Russian authorities are also reported to have intensified practices of granting price preferences to domestic suppliers in public procurement. Ukrainian authorities imposed a 13% import surcharge on a range of products, subsequently restricted to two (cars and refrigerators). In contrast to the HCCs, which had already liberalized their capital accounts (Russia in mid-2006, Kazakhstan in early 2007), the NHCs introduced new exchange controls on top of already existing ones: In October 2008, Ukraine imposed a set of multiple restrictions to stem crisis-triggered capital outflows (see table 2 in the annex) (IMF, 2008b, p. 8); from May 2009, Belarus took a number of administrative measures to check dollarization and curb foreign currency outflows.

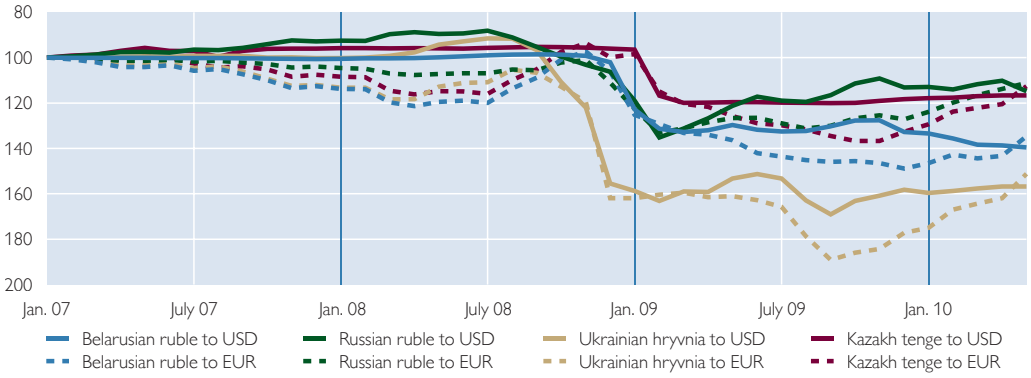
In the framework of their IMF program, the Belarusian authorities consented to refrain from further increasing directed lending financed with government deposits in credit institutions; however they continued to bolster domestic investment (mainly public residential construction and agricultural capital formation) by stepping up instructed lending through decrees under government programs procuring nongovernment financial sources (see table 4 in the annex) (IMF, 2009c, p. 7). Belarusian quasifiscal expansion has in recent years essentially taken the place and functions of fiscal stimuli. To support Russia's economic recovery (more money to finance the budget deficit and the remaining fiscal stimulus) and to facilitate corporate borrowing on international financial markets, the authorities in Moscow successfully issued eurobonds of USD 5.5 billion in April 2010 (which constitutes the country's first eurobond issuance since the crisis of 1998). Belarus followed suit and issued USD 1 billion of eurobonds in July and August 2010, largely to strengthen its foreign currency reserves. In mid-September, the Ukrainian authorities issued USD 2 billion of eurobonds to repay the bridging loan they had received from VTB. Kazakhstan plans a similar measure.[19]

[19] *The Kazakh authorities envisage a bond sale of between USD 500 million and USD 750 million soon.*

Chart 9

Exchange Rates against the U.S. Dollar and the Euro

January 07 = 100

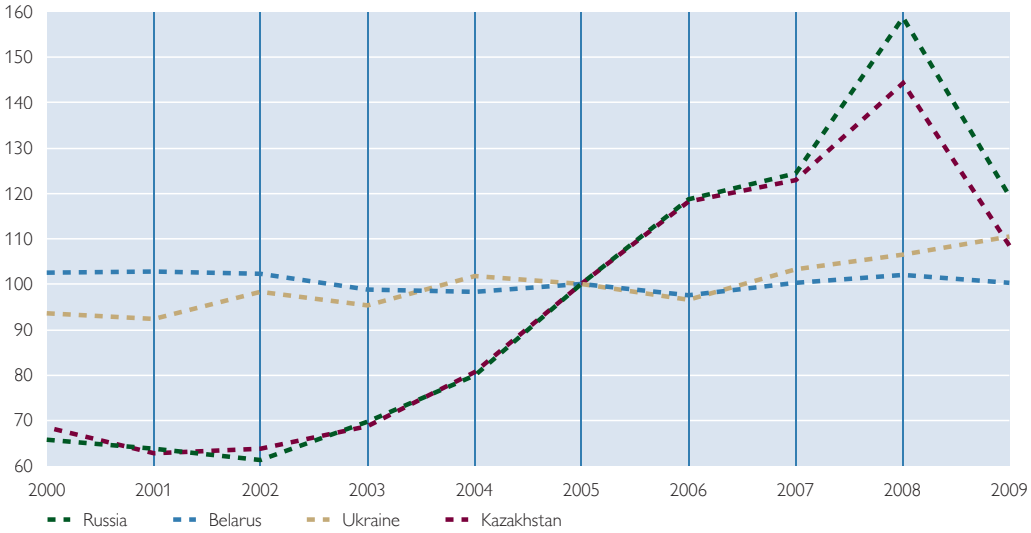


Source: Thomson Reuters.

Chart 10

Merchandise Terms of Trade[1]

2005 = 100



Source: UNCTAD Handbook of Statistics.

[1] Terms of trade correspond to "net barter t.o.t"., defined as the ratio of the export unit value index to the import unit value index (UNCTAD).

4 Comparative Assessment and Conclusions

4.1 Subprime Crisis (2007): Kazakhstan Most Affected Macrofinancially and Policywise

Being most dependent on cross-border capital inflows from international financial markets, Kazakhstan was most affected by repercussions of the U.S. subprime turmoil in terms of financial instability and shrinking GDP growth. Therefore, and since it had the means, Kazakhstan also put in place the most intensive and comprehensive policy response.

4.2 After Trough of Great Recession (early 2009), Russian Ruble and Kazakh Tenge Soon Stabilized, whereas Ukrainian Hryvnia and Belarusian Ruble Stayed under Pressure

One can detect a stylized pattern of monetary and exchange rate policy crisis response in all four countries: The period from September 2008 to January 2009 featured initial strong liquidity injections and a general loosening of monetary policy. January and February 2009 witnessed substantial devaluations of domestic currencies, accompanied – at least for a short period – by monetary tightening to defend new exchange rate levels. Then, around March 2009, the HCCs loosened their monetary policies again, and this time in a sustained manner, in order to enable or help recovery of lending.

The NHCs, in contrast, possessed only limited room for monetary loosening because they had to cope with continuing or intermittent exchange rate pressures. These pressures persisted until recently (late 2009, early 2010), when recovery gathered momentum, which may have allowed Ukrainian and Belarusian monetary authorities to ease their stances more durably (see tables in the annex). In recent months – somewhat reminding of the pre-crisis period – all four currencies (with the possible exception of the Belarusian ruble) have tended to come under appreciation pressures again. As the distinction between HCCs and NHCs suggests, differences in the terms-of-trade development between oil exporters and oil importers in the year since the first quarter of 2009[20] likely explain the differential stability of respective currencies in this period.[21]

4.3 U.S. Dollar Remains Reference Currency for CIS Currencies, with Qualifications for the Russian Ruble

One of the official goals of the four countries' currency policies has been, and remains, to render exchange rates more flexible once conditions permit. Russia continues to aim to move to inflation targeting in the medium term (although the authorities are not prepared to commit to timetables). For the time being, however, all four monetary authorities have held on to relatively stable exchange rates of their currencies to the U.S. dollar (of course disregarding the one-off or repeated discretionary devaluations). This applies with the partial exception of the exchange rate of the Russian ruble, which is officially managed with regard to a currency basket (containing the U.S. dollar with a weight of 55% and the euro with a weight of 45%) and whose nominal relationship to the U.S. currency has been more volatile since September 2008.

4.4 Opposing Policies in Pursuit of Macrofinancial Restabilization: Oil Money and Fiscal Stimuli (HCCs) versus IMF Assistance and Exchange Controls (NHCs)

Facing the crisis, the HCCs successfully upheld their capital account convertibility while they served generous fiscal stimuli, largely financed by their accumulated oil

[20] *The oil importers were also hit by successive reductions of Russian gas price subsidies.*

[21] *For lack of most recent data, chart 10 is unfortunately not fully up to date. But chart 4, depicting oil and steel price developments until mid-2010, may at least give a partial indication on where terms of trade have likely gone for countries like Russia and Ukraine (for Ukraine the indication is weaker than for Russia).*

stabilization funds.[22] The HCCs have not needed to and did not approach the IMF for financial assistance. In contrast, the crisis exacerbated the already tenuous financial situation of the NHCs, which were forced to apply for IMF assistance and to conclude SBAs.[23] Cash-strapped NHCs may have had no choice but to opt for budgetary austerity as a crisis response measure which was in any case in line with IMF recommendations, even if Ukraine failed to observe the respective conditionality. In this connection it could be argued that in a comparably fragile environment, confidence may preferably be enhanced not by injecting additional money but by demonstrating fiscal prudence.

At the same time, to stabilize their financial and economic situation, the NHCs took recourse to new exchange controls on top of their already existing restrictions; the IMF accepted the new controls as temporary measures. Disregarding this interventionism, which bore an emergency character, the pursuit (outlined above) of obviously the same underlying or final goals with exactly opposite fiscal strategies points to a remarkable dichotomy. All the more so, as both strategies hitherto seem to have worked, although not necessarily efficiently, in contributing to macrofinancial restabilization.

4.5 Surprising Results of Comparative Crisis Management Experience of State-Dominated Banking Sectors (Russia, Belarus) versus Privately Dominated Banking Sectors (Ukraine, Kazakhstan)

With respect to the banking turmoil and bank restructuring since late 2007, we arrive at the following assessment: Although it is not always easy to distinguish recapitalization costs from other costs, particularly in the countries analyzed here, SOB-dominated systems (Russia, Belarus) do appear to have fared better in precisely this time span in the sense that they have faced less crisis-triggered recapitalization needs than systems dominated by private domestic or even foreign-owned capital (Kazakhstan and Ukraine, respectively). Thus, the Russian and Belarusian banking sectors have possibly faced recapitalization costs of about 3% to 5% of GDP, whereas the Ukrainian and Kazakh sectors have been saddled with recapitalization costs of around 8% to 12% of GDP (including steep haircuts for foreign creditors in the case of insolvent Kazakh banks).[24] Enlarging this limited

[22] *Looking at selected other countries equipped with oil stabilization funds (CIS member Azerbaijan, emerging-market Kuwait, advanced economy Norway), we can see that the average size of their funds is much higher (late 2008: Azerbaijan: 25% of GDP, Kuwait: 165%, Norway 125%; for comparison: Russia: 8%, Kazakhstan: 20%). While this is certainly related to different economic structures and policy choices, it may also have to do with the fact that these countries' oil stabilization funds are older and have had more time to accumulate than those of Russia and Kazakhstan, which were established around the turn of the millennium. Of the three additional countries mentioned here, only Azerbaijan appears to have employed its fund to deliver a sizeable contribution to anticrisis fiscal stimulus measures, whereas the other two countries have not taken such actions. Generally, one may identify an ambiguous impact of oil resources over the economic cycle: While they can contribute to the downturn (via a plunge in oil prices), the subsequent turnaround and recovery can be supported by oil money (if it is set aside in time).*

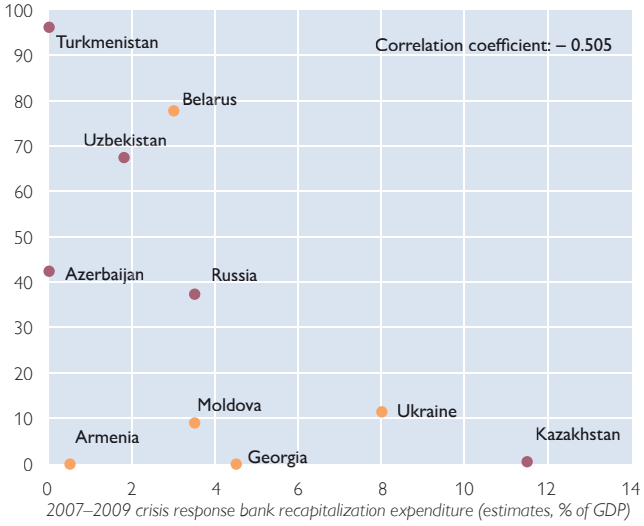
[23] *This, of course, does not exclude the possibility that countries lacking hydrocarbon resources, and therefore, oil stabilization funds, may be in a position to accumulate budgetary reserves or stabilization funds. Estonia and Bulgaria, for instance, have piled up fiscal reserves by saving parts of budget surpluses achieved in the pre-crisis period. Assuring the strength and stability of their currency board arrangements has certainly been an important incentive for fiscal thrift in the case of these two countries. Estonia and Bulgaria have since benefited by drawing on these funds to cushion the impact of the crisis.*

[24] *The estimates mentioned refer to public and private costs incurred up to late 2009. Recapitalization and nationalization costs borne by the state may, of course, be partly recouped through future reprivatization.*

Chart 11

State Control of Banking Sector and Global Crisis-Triggered Recapitalization Costs in Selected CIS Countries and Georgia

Share of state-owned banks in total banking sector assets (%, end-2008)

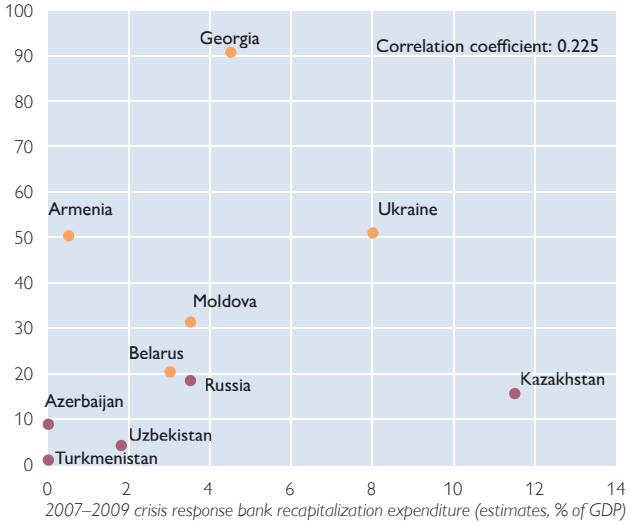


Source: Share of SOBs: EBRD; recapitalization expenditure: estimates based on IMF Staff Reports.

Note: Purple points refer to HCCs, orange points to NHCs.

Foreign Control of Banking Sector and Global Crisis-Triggered Recapitalization Costs in Selected CIS Countries and Georgia

Share of foreign-owned banks in total banking sector assets (%, end-2008)



Source: Share of foreign-owned banks: EBRD; recapitalization expenditure: estimates based on IMF Staff Reports.

Note: Purple points refer to HCCs, orange points to NHCs.

sample by some other CIS countries (both HCCs and NHCs) does not change the overall picture (see chart 11, left-hand panel). Even more surprisingly, the relationship between foreign banking sector control and crisis response recapitalization expenditure does not seem to be negative for the above sample (see chart 11, right-hand panel).[25] Note that in chart 11 we show only bivariate correlations without controlling for the impact of other relevant variables (i.e. we do not show conditional correlations). This is mostly due to a lack of respective data. We are aware of interpreting unconditional correlations with caution. In the following, we very briefly discuss the impact of potential control variables in qualitative and logical terms. Relatively low recapitalization costs in SOB-dominated systems are probably not connected to the respective countries' differing GDP growth or impacts of devaluation, since steering clear of a recession in 2009 and boasting a relatively mild depreciation (20%) did not prevent Kazakhstan from being saddled with very high recapitalization expenditures. Also, Russia's and Belarus' relatively strong devaluations did not trigger substantial recapitalization spending.

Neither do possible differences of bank size or bank concentration from country to country (as indicated e.g. by the share of the five largest credit institutions in

[25] *This may not be quite as surprising if one takes into account that foreign-owned banks contributed to credit booms and external debt accumulation in emerging Europe, as Berglöf et al. (2009, p. 23) point out. Furthermore, the overall picture does not seem to change when looking outside the CIS at other large emerging markets. In Brazil, China and India (which, together with Russia, make up the four countries of the "BRIC" group) state-owned banks claim the absolute or relative majority of total banking sector assets, with domestic privately owned and foreign-owned banks accounting for the rest. According to a recent special report of The Economist, many of the largest emerging market credit institutions "are state-controlled and most were handsomely profitable through the crisis and have good capital and funding profiles. Few have business overseas." (Foulis 2010, p. 6).*

total assets) appear to wield important influence: Again, in Russia and Belarus, recapitalization expenditure was below average despite the fact that some systemically relevant banks (notably the state-owned savings banks Sberbank and Belarusbank) were particularly large. It could be that regulatory forbearance and liquidity injections have been more generous vis-à-vis SOBs; however, the information available suggests that regulatory forbearance has also been extended to struggling private credit institutions, and there are examples of specific and substantial liquidity help being afforded to selected private banking groups (e.g. Alfagroup).

One of the reasons that might explain this result is the excessive, with hindsight, pre-crisis credit booms in the privately dominated banking systems (financed largely from abroad),[26] coupled with the possibly even weaker rule of law outside the area of direct state control in the CIS region. Or it could be that the state, as an owner of banks, has been able to more successfully control its own banks than other owners have been capable of controlling their credit institutions. Weakness of rule of law in this sense may mean insufficient (as is now recognized) pre-crisis banking supervisory and regulatory frameworks as well as inadequate enforcement of the existing banking rules and of creditor rights outside the sphere of immediate public purview due to shortcomings in the judicial system. Thus, surveillance of the domestic private sector, including connected lending activities, has probably fallen short of what would be required (Moody's Investors Service, 2010, p. 6–7).[27] The relationship between bank ownership and crisis-response recapitalization needs is certainly an issue that would merit further investigation. Such research might not be easy given data requirements (comparative data on single banks would likely be needed). Overall, while the banking sectors remain fragile in all four countries, the major shock – relating to the impact of the Great Recession – seems to have been weathered.[28]

4.6 Government Operative Economic Control – Where It Exists – Has Claimed a Prominent Role in Crisis Response Policies

The countries where state influence on corporates (as measured by the EBRD index on enterprise reform[29]) is stronger, namely Belarus and Kazakhstan, have prominently used as anticrisis tools either directed lending or onlending of government funds and the placement of state-owned enterprises' deposits in the portfolios of ailing banks. For Russia and Ukraine, these instruments are less important.

5 Summary

This study focuses on comparing and assessing the crisis response measures of the four CIS countries with the highest total GDP. These are the two oil producers Russia and Kazakhstan – here also called "hydrocarbon countries" (HCCs) – and the oil-importing countries Ukraine and Belarus – "nonhydrocarbon countries"

[26] *Excessive pre-crisis credit booms may also have been exacerbated by relatively high shares of foreign currency-denominated loans (implying heightened credit risk in case of devaluation).*

[27] *Moreover, in the case of Kazakhstan, rapid pre-crisis accumulation of NFRK assets may have engendered expectations of bank bailouts on the part of foreign lenders, who thus chose to opt for high-risk strategies.*

[28] *Of course, the degree to which banks' impaired balance sheets still need repair (in the sense of a fully realistic booking of nonperforming loans) may delay a new upswing in lending.*

[29] *The EBRD index on enterprise reform basically refers to the degree by which enterprises' budget constraints have been hardened (see Fries and Taci, 2002, p. 4, and EBRD; 2009, pp. 146, 178, 214, 242).*

(NHCs). An important distinguishing feature between HCCs and NHCs is that the former possess substantial foreign currency assets (foreign currency reserves plus oil stabilization funds), whereas the latter do not. The crisis referred to is the current global financial and economic crisis, starting with the U.S. subprime turmoil (since August 2007) and culminating in the Great Recession triggered by the collapse of Lehman Brothers (September 2008). All four countries under observation showed signs of overheating in the years leading up to the major 2007–2008 external shock.

Given its high dependence on cross-border capital inflows from international financial markets, Kazakhstan was most affected by repercussions of the U.S. subprime crisis, followed by Russia. In contrast, the bankruptcy of Lehman Brothers and the ensuing Great Recession had a heavy dual impact on all four countries: They were practically shut out of international financial markets, and the collapse of export demand and of oil and commodity prices sharply drove down growth rates and even entailed deep recessions in Ukraine and Russia. Nonperforming loans swelled, and all four countries suffered from a credit squeeze.

Kazakhstan and Russia reacted to the subprime crisis with substantial liquidity support; substantial foreign currency intervention to prop up the domestic currency confined itself to Kazakhstan during this stage. Confronted with the impact of the September 2008 crisis, all of the countries under discussion reacted with a panoply of measures, including strong liquidity injections, foreign currency interventions consuming a sizeable amount (up to one-third) of their international reserves (September 2008 to January 2009) and important devaluations of between 20% and 50%, made unavoidable by the sharp deterioration of terms of trade (January and February 2009). In their difficult financial situation, Ukraine and Belarus applied for and received IMF SBAs.

Prominent fiscal stimulus packages were prepared and served in the HCCs: In Russia, the stimulus compared to the original budget plan for 2009 reached 9% to 10% of GDP. Kazakhstan put together a comprehensive anticrisis program of 10% to 11% of GDP, comprising fiscal measures (including financial assistance to credit institutions and the real sector) and bank recapitalization. In both cases, stimulus measures were predominantly financed by the HCCs' oil stabilization funds. In contrast, the NHCs – committed to IMF programs and in pursuit of the same ultimate goals – appear to have followed an opposite strategy of fiscal austerity to support macroeconomic stability and confidence. However, as opposed to the HCCs, which upheld full capital account convertibility, the NHCs took recourse to new exchange controls on top of their already existing restrictions.

Once quarter-on-quarter economic growth returned again (around mid-2009), the Russian ruble and the Kazakh tenge soon stabilized, while the Ukrainian hryvnia and the Belarusian ruble remained under recurrent pressure – until most recently. As the distinction between HCCs and NHCs suggests, differences in terms of trade developments – with oil prices on the recovery again compared to the fall of 2008 – may help explain the differential stability of the respective currencies. As in the past, the U.S. dollar remained the reference currency for the CIS currencies, with qualifications for the Russian ruble, whose exchange rate against the U.S. dollar has been somewhat more flexible since September 2008.

With respect to the banking turmoil and restructuring since late 2007, the following can be concluded: Even though the measurement and delimitation of recapitalization costs is not unproblematic in the countries under investigation, systems dominated by state-owned banks (Russia, Belarus) appear to have fared better in precisely this time span in the sense that they have incurred less crisis-triggered recapitalization spending than systems dominated by private domestic or even foreign-owned capital (Kazakhstan, Ukraine). One of the reasons that might explain this result is the (with hindsight) excessive pre-crisis credit booms in the privately dominated banking systems (financed largely from abroad), coupled with the possibly even weaker rule of law outside the area of direct state control in the CIS region. Certainly further work would be needed to investigate this issue, which seems to give rise to more questions than answers. While banking sectors remain fragile in the region, the major shock appears to have been surmounted.

Cut-off date for information: October 1, 2010

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Annex: Key Crisis Response Policies in the Four Largest CIS Countries (2007–2010)

Table 1

Russian Crisis Response Policies

Policy category of measures[1]	**Subprime crisis** (triggered by the collapse of the U.S. subprime market; 2nd half of 2007 to 2008)	**Great Recession** (triggered by the collapse of Lehman Brothers; since September 2008)
Monetary policy easing and/ or bank/enterprise liquidity assistance	**September 2007 to April 2008:** CBR and government liquidity injections: – reduction of reserve requirements for a term of three months (October 2007 to January 2008, estimated to have provided RUB 100 billion in support); – expansion of eligible collateral for refinancing operations (October 2007, again in February 2008); – average haircuts of collateral lowered from 19% to 10%; – recycling of a portion of government cash surplus via deposit auctions, etc.	**From September 2008:** – CBR (Bank Rossii) provides wide array of liquidity facilities, including • reserve requirements cut to 0.5% (boosting bank liquidity by RUB 400 billion) until April 2009; after that, reserve requirements were lifted again; • interest rates paid to banks by CBR on deposits raised; • repo operations stepped up; • expansion of list of eligible collateral; • even uncollateralized loans granted to banks with designated credit ratings (maximum balance: end-February 2009: RUB 1900 billion; withdrawn in early 2010); • guarantees for interbank lending made by largest banks to smaller banks. – USD 50 billion of foreign currency reserves made available to Vneshekonombank (VEB) for lending to banks and enterprises to help them refinance foreign loans: USD 11 billion disbursed by end-Oct 2009; – government guarantee of bank loans to corporates (up to 70% of loans, amount available: RUB 300 billion); – short-term deposits of RUB 530 billion of budget funds with credit institutions until end-2009. **February 2009:** in defense of the devalued lower level of the exchange rate (see below), the CBR curtails liquidity support somewhat, allowing interest rates to rise to more market-based levels (thus, repo rates increase by almost 3% to about 12%). **Q2 2009:** in the light of the stabilization of the Russian ruble and of rising oil prices, monetary policy gradually eased to support banks and stimulate credit activity: – the CBR's new uncollateralized lending facility amounts to RUB 720 billion until mid-Jun 2009; – VEB collateralized lending of USD 2 billion to Alfagroup; – government switches deposits (of RUB 1.5 trillion) from central to commercial banks (on auction basis); – monetization of fiscal deficit launched via drawing on Reserve Fund; – April 2009 to end-May 2010: the CBR cuts its refinancing rate in 14 steps from 13% to 7.75 %, repo rates also come down.
Substantial foreign currency market intervention and/or domestic currency devaluation	–	**August to October 2008:** foreign currency intervention by the CBR to defend the ruble exchange rate. **November 2008 to January 2009:** substantial but stepwise devaluation against U.S. dollar/euro basket (on the whole by 28%, total cost of defense of Russian ruble: about one-third of reserves); – authorities view this as justifiable measure to give exposed banks and enterprises breathing space to accumulate enough foreign currency liquidity to meet debt service obligations; – however, policy raises short-term expectations of further ruble depreciation, encouraging dollarization; end-January 2009: the CBR declares that it will defend the new level of exchange rate within a trading band of ±10% Q3 2009: after stabilization of exchange rate, ruble appreciation tendencies on back of rising oil prices: – the CBR occasionally intervenes in the market, buying an excessive amount of foreign currency, contributing to recovery of reserves; – but it allows a greater volatility of the exchange rate than before the crisis.
Trade protection measures: tariff barriers increased	–	**January 2009:** increase of import duty on new and used foreign cars and trucks, farm machinery and machine tools, and products of ferrous metallurgy; tariff adjustments to be phased out from mid-2010.
Nontariff barriers to trade increased		Price preferences for domestic suppliers in public procurement.

[1] *Including only policy categories that refer to actually implemented measures.*

Table 1 continued

Russian Crisis Response Policies

Fiscal stimuli (discretionary measures)	End-2007 surge in government spending, including capitalization of Russia's development institutions	**Late 2008 and April 2009:** supplementary budgets passed, providing for expansionary fiscal policy in the second half of 2008, but withdrawing stimulus in Q1 2009: – budgetary expenditures tend to be heavily backloaded (38% of expenditures of 2008 executed in Q4; non-oil general government deficit contracts from some 6% of annual GDP in Q4 2008 to roughly 0.8% in Q1 2009); – **December 2008:** revenue-side anticrisis measures are adopted, comprising corporate income tax reductions, an easing of depreciation rules and the simplification of SME taxation; – **April 2009:** supplementary budget includes large increases in spending in many areas, including defense and security, strategic sectors (e.g. car industry), health, education, social assistance (increase of unemployment benefits), intergovernmental transfers; – revised 2009 federal budget produces deficit of 5.9% of GDP (= swing of 9.5 percentage points compared to original budget plan). In 2010, the government plans to introduce more modest anticrisis fiscal measures.
Oil stabilization fund (where existing) used	–	Most of the 2009 budget deficit was financed by the Reserve Fund; government purchases mortgages from banks up to RUB 200 billion, financed by National Welfare Fund.
Bank regulations/supervision softened	–	The CBR introduces regulatory forbearance by easing loan classification and provisioning requirements (as of mid-2010, to be gradually brought back in line with pre-crisis norms).
Bank recapitalization measures/ bailouts/resolution measures/ restructuring	–	**From September 2008:** – a number of small and medium-sized private banks exposed to securities markets (e.g. Globex, Kit Finance, Sobinbank, Sviaz) default on their obligations in the interbank market; they are acquired via VEB, Vneshtorgbank (VTB) or SOEs or closed, and their obligations to other banks are honored; – partly to achieve this goal, government capital (subordinated loans) is injected to VEB, VTB, Sberbank, Rosselkhozbank, Rosagroleasing; injections are discontinued in late 2009; – VEB is authorized to provide subordinated loans (to support capital positions) of up to RUB 450 billion to banks other than Sberbank; – the CBR is authorized to provide up to RUB 500 billion to Sberbank.
Deposit insurance strengthened	–	The deposit insurance limit is raised from RUB 100,000 to RUB 200,000, and 90% of deposits are insured up to RUB 700,000; the government injects RUB 200 billion from the budget into the Deposit Insurance Agency.
Other crisis response measures	–	Government capital injection of RUB 60 billion into State Mortgage Agency; guarantee by State Mortgage Agency of housing bonds and lending up to RUB 500 billion; **April 2010:** to facilitate corporate borrowing on international financial markets and create a benchmark for security price comparison, the government issued USD 5.5 billion of U.S. dollar-denominated eurobonds with maturities of five and ten years and coupon rates of 3.6% and 5.0% (historically low for Russian sovereign debt; last government eurobond issuance dates back to before crisis of 1998).
Results of impact assessments of crisis response measures, if any	–	Overall 2009 fiscal and nonfiscal "anticrisis package" estimated at 7.5% of GDP, of which 6.4% have fiscal implications for the budget (OECD, Eco Survey Russian Federation, July 2009, p. 43); according to government calculations, the fiscal stimulus mitigated Russia's 2009 GDP contraction by 2 percentage points (BOFIT Weekly, February 12, 2010).

Source: IMF Staff Reports 2007–2010: Russian Federation; OECD Economic Surveys Russia 2007, 2009; World Bank Russian Economic Reports 2007–2010; Bank Rossii Annual Reports 2007 and 2008; wiiw Current Analyses and Forecasts 2007–2010: Russia; OeNB, Focus on European Economic Integration, 2007–2010: Recent Economic Developments: Russia; OeNB, Financial Stability Reports 2009: Russia; BOFIT Weekly, February 12, 2010.

Table 2

Ukrainian Crisis Response Policies

Policy category of measures[1]	**Great Recession** (triggered by the collapse of Lehman Brothers; since September 2008)
Monetary policy easing and/or bank/enterprise liquidity assistance	**September to December 2008:** the Natsionalny bank Ukraini (NBU) injects liquidity of some 6% of GDP into the banking system (reserve requirements are almost eliminated, refinancing against expanded collateral list, etc.). **October 2008 to March 2009:** ample refinancing (total outstanding refinancing credits amount to about 7.5% of GDP). **December 2008:** in view of exchange rate pressures which could trigger balance sheet effects associated with unhedged borrowing, authorities tighten monetary policy: – the refinancing rate is raised from 16% to 20% and turns positive in real terms in spring 2009; – collateral requirements are tightened again; – to discourage deposit dollarization, reserve requirements for foreign currency deposits are increased. **June 2009:** against the backdrop of falling inflation, the NBU reduces key policy interest rates. **August to October 2009:** – however, to cut excess liquidity and support the Ukrainian hryvnia, the NBU tightens its monetary stance again; – the NBU continues providing stabilization loans to ailing banks while actively absorbing excess liquidity by selling certificates of deposit to banks. **Late 2009:** – most of OVDPs (treasury bills) issued in 2009 are bought out by the NBU; – throughout 2009, the NBU abstains from large interest rate cuts. **December 2009 to April 2010:** the NBU maintains a tight monetary stance to check depreciation pressure on the hryvnia. **April to August 2010:** following exchange rate stabilization and given declining inflation, the NBU cuts the refinancing rate in three steps to 7.75%.
Substantial foreign currency market intervention and/or domestic currency devaluation	**October to November 2008:** – NBU intervention amounts to over USD 4 billion (from reserves of USD 38 billion) and keeps the hryvnia at a repegged level of UAH 5.8/ USD 1; – however, increasing reserve losses force the NBU to step back. **November 2008:** the NBU moves to introduce a flexible exchange rate policy (in line with the country's IMF program); – at the same time, large NBU injections of hryvnia liquidity to stabilize the banking sector leak into the foreign currency market, adding pressure on exchange rate and reserves; – given possible balance sheet effects, the NBU takes action to avoid excessive exchange rate depreciation. **September 2008 to April 2009:** the hryvnia's nominal effective exchange rate depreciates by about 35%, but stabilizes in spring 2009, reflecting increasing confidence and allowing the NBU to scale back interventions. **H2 2009:** renewed downward pressure on the Ukrainian hryvnia triggers more frequent interventions and moral suasion. **March to April 2010:** the NBU intervenes to limit exchange rate volatility, prevent excessive appreciation and replenish foreign currency reserves.
New exchange controls introduced	Imposition of a set of restrictions to stem capital outflows: **– mid-Oct 2008:** ban on early withdrawal of time deposits (lifted in spring 2009); – six-day delay for investors wishing to convert hryvnia profits, revenues or sale of assets into foreign currency; – ceiling for monthly wiring of foreign currency out of the country (UAH 15,000 if no documents are presented, UAH 75,000 otherwise); – large discrepancy between official and market exchange rates (alignment of official and market rate of previous day in spring 2009 in line with IMF program); – **August to September 2009:** to dedollarize the economy, the NBU orders banks to pay interest on foreign currency deposits in national currency and bans foreign currency lending (except to exporters); – **December 2009:** parliament passes a law prohibiting foreign currency lending to households.
Trade tariff barriers increased	**March 2009:** imposition of a 13% import surcharge on a range of commodities for balance of payments reasons (nonobservance of IMF program); subsequently, the import surcharge is restricted to cars and refrigerators.
Fiscal stimuli (discretionary measures, including social policy adjustments, but not automatic stabilizers)	No fiscal stimulus (but IMF conditionality is not observed). **November 2008:** the government adopts a resolution to contain the seasonal year-end spending surge; despite efforts, economic contraction leads to a fiscal deficit of 3.2% of GDP in 2008. **December 2008:** parliament adopts the budget for 2009 which, according to IMF staff calculations, entails a deficit of 5.5% of GDP; authorities then take measures to contain the deficit to a revised level of 4% (in line with the country's IMF program): – increases of excise duties on tobacco, alcohol and diesel; – adjustments of domestic prices for gas, electricity and coal, etc. **March 2009:** parliament revokes the article from the 2009 budget law that had paved the way for the monetization of the fiscal deficit; given deeper-than-expected economic contraction; the deficit target is revised once more to 6% of GDP; – introduction of a temporary 13% import surcharge. **Mid-2009:** government deficit stands at 3% of GDP, which, however, largely reflects – increases in VAT refund arrears; – advanced tax payments by large enterprises. **October to November 2009:** unorthodox fiscal measures continue, including the government's use of USD 2 billion obtained from the IMF under a quota redistribution exercise for budgetary gas payments. The Ministry of Finance steps up the issuance of OVDPs (treasury bills): – outstanding volume triples (to UAH 85 billion) over 2009 as the government has to finance the widening fiscal gap and recapitalize ailing systemic banks; – high needs and absence of other sources to cover the budget deficit push yields upward (to 29% in October, before they level off to 25% by year-end); – most of OVDPs issued are bought out by the NBU. **November 2009:** parliament adopts Status law (minimum wage and pension law) which, according to IMF calculations, could add up to 7% of GDP to the budget deficit in 2010 and which, together with the failure to adjust retail gas tariffs, pushes the IMF program off-track. **April 2010:** Ukraine signs gas fleet treaty with Russia, providing for an around 30% discount on gas delivery prices to Ukraine; the deal is estimated to save up to USD 4 billion p.a. until 2019 (particularly central budget). **July 2010:** the budget law revises the deficit target from 5.3% to 5.0% of GDP (precondition of the new IMF program).

[1] *Including only policy categories that refer to actually implemented measures.*

Table 2 continued

Ukrainian Crisis Response Policies

Bank regulations/ supervision/accounting requirements softened	Authorities put in place a loan loss classification and provisioning framework in line with international practice. **October to November 2009:** to encourage lending, the NBU relaxes the provisioning requirements for banks; specifically, it allows banks to temporarily refrain from downgrading loan categories despite the deteriorating financial stance of borrowers, if borrowers service their loans on time. **Early 2010:** new law eases capital requirements for banks: – banks' subordinated loans may constitute up to 100% of additional capital (up from 50%); – introduction of a moratorium on collateral repossession if a borrower makes interest payments with less than two months' delay; – up to 100% of loan loss reserves is made tax deductible (previously: 10% of loan portfolio).
Bank recapitalization measures/bailouts/ resolution measures/ restructuring	**October 2008:** Prominvestbank (the country's sixth-largest bank) is put under receivership; in November, it is sold to private strategic investors, but these were unable to inject the required additional capital, therefore the bank was nationalized in December 2008; finally, Prominvestbank was successfully sold to an investor in 2009. **Spring 2009:** diagnostic studies covering 38 banks accounting for 85% of sector assets reveal large capital deficiencies; – subsequently, the two SOBs Oschadbank and Eximbank are recapitalized (UAH 15 billion and USD 1.8 billion, respectively); – shareholders of all majority foreign-owned banks inject the necessary capital of about UAH 16.5 billion (USD 2 billion) as do most domestically owned private banks (UAH 5 billion or USD 625 million); – however, for seven domestically owned private banks (accounting for 15% of total deposits), shareholders are unable to come up with the additional capital; – the NBU introduces temporary administration in these banks; – the government decides to recapitalize/restructure five of the above-mentioned seven problem banks (capital needs were calculated at about UAH 25 billion). All in all, the public cost of bank restructuring is estimated at around UAH 40 to 45 billion (about 5% of GDP). **Mid-October 2009:** 17 banks under NBU receivership, including Nadra, Ukrprom, Rodovid; two banks (Kyiv and Ukrgaz) are recapitalized by the state and exit receivership. **September 2010:** four banks are still under receivership, 18 banks are in the liquidation phase.
Privatization accelerated	**Late 2008:** the government approves an expanded list of enterprises slated for privatization in 2009. However, privatization targets are missed by a wide margin.
Other crisis response measures	**December 2008:** in order to improve the financial situation of Naftogaz Ukraini, gas prices for households are raised by 35% (i.e. to about one-third of import prices). **March 2009:** parliament revokes two articles from the 2009 budget law which paved the way for government interference with NBU refinancing decisions and facilitated the monetization of the fiscal deficit. **June 2010:** the government receives a six-month bridging loan of USD 2 billion from Vneshtorgbank (Russia). **July 2010:** the government raises household gas tariffs by 50% (effective as of August 1, 2010) and adopts a law that strengthens NBU independence (preconditions of the new IMF program). **Mid-September 2010:** the government issues USD 2 billion of eurobonds with maturities of five and ten years and coupon rates of 6.9% and 7.8%; this issue is the first successful eurobond placement by the Ukrainian sovereign since 2007; the authorities plan to use the proceeds to repay the USD 2 billion VTB loan (see above).
IMF program (if any): major anticrisis commitments realized and funds disbursed	**November 2008:** a two-year IMF SBA is approved by the IMF Executive Board, totaling USD 16.4 billion; – a more flexible exchange rate policy is thus partly realized; – the fiscal target for 2009 is revised from balance to a deficit of 4% of GDP, then to a deficit of 6%; – the first tranche of USD 4.5 billion is disbursed following approval of the SBA; **May 2009:** second and third tranches (USD 5.4 billion together) are disbursed; **November 2009:** suspension of disbursement of fourth tranche until authorities reach consensus on economic policy; **July 2010:** a new two-year IMF SBA is approved by the IMF Executive Board, totaling USD 14.9 billion. Important targets: reduction of budget deficit and public debt, strengthening of NBU independence.

Source: Lytvyn 2010; IMF Staff Reports 2007–2010: Ukraine; OECD Economic Assessment Ukraine 2007; Natsionalny bank Ukraini Annual Reports 2007 and 2008; wiiw Current Analyses and Forecasts 2007–2010: Ukraine; OeNB, Financial Stability Reports 2009: Ukraine.

Table 3

Kazakh Crisis Response Policies

Policy category of measures[1]	**Subprime crisis** (triggered by the collapse of the U.S. subprime market; 2nd half of 2007 to summer 2008)	**Great Recession** (triggered by the collapse of Lehman Brothers; since September 2008)
Monetary policy easing and/or bank/enterprise liquidity assistance	**August to October 2007:** in reaction to a sudden stop of capital inflows, the National Bank of Kazakhstan (NBK) – postpones the earlier-planned tightening of reserve requirements; – provides large-scale liquidity support to banks through repurchase agreements, foreign currency swaps, early redemption of NBK notes, easing of reserve requirements, expansion of the list of collateral accepted at refinance window. **November 2007:** the government establishes a USD 1 billion (1.1% of GDP) financing facility in form of earmarked government deposits with banks, to be onlent to assist construction companies and support SMEs. **December 2007:** the NBK raises its policy rate from 9% to 11% to help contain inflationary pressures. **H1 2008:** however, the NBK then cuts reserve requirements on foreign liabilities to support bank liquidity.	**Late 2008/H1 2009:** within the framework of the authorities' anticrisis program (see below): – about USD 1.4 billion of bank deposit inflows are registered from firms under the umbrella of the state holding company Samruk-Kazyna (SK, National Welfare Fund); – USD 1 billion is provided to banks to refinance the completion of viable construction projects and mortgages; – USD 1 billion is supplied to credit institutions for onlending to SMEs at favorable interest rates. Monetary policy is eased as economy weakens and inflation pressures decline: – the NBK initially provides direct liquidity support and cuts reserve requirements; – **January to September 2009:** to stimulate lending, the NBK, in a series of cuts, adjusts its policy interest rate by 3.5 percentage points to 7.0% (a historical low).
Substantial foreign currency market intervention and/or domestic currency devaluation	**August to October 2007:** in the context of the heavily managed float of the Kazakh tenge and in response to depreciation pressures, the NBK strongly intervenes in the foreign currency market, using USD 6 billion (25%) of its reserves. **Late 2007:** the NBK effectively pegs the tenge to U.S. dollar. **Early 2008:** intervention in foreign currency market substantially scaled back.	**January to February 2009:** sizeable foreign exchange market interventions by the NBK (USD 6 billion) to defend the exchange rate of the Kazakh tenge (KZT 120/USD 1). **February 2009:** the NBK devalues the tenge by 20% against the U.S. dollar in one step (with a ±5% band established around a central parity of KZT 150/USD 1). **March 2010:** the NBK widens the tenge exchange rate corridor to +10/–15%, providing some room for appreciation on the back of stronger export performance and increased capital inflows, – but the CBR allows greater exchange rate volatility than before the crisis.
Trade protection measures: tariff barriers increased	–	Local content rules for purchases by state-near companies are tightened. **July 2010:** as a result of the introduction of the customs union between Russia, Belarus and Kazakhstan and of unified customs tariffs, more than 30% of Kazakh customs tariff positions are to be raised (including tariffs on machinery and equipment, vehicles, fertilizers, wood, medicine and medical equipment, meat, and footwear).

[1] *Including only policy categories that refer to actually implemented measures.*

Table 3 continued

Kazakh Crisis Response Policies

Fiscal stimuli (discretionary measures, including social policy adjustments, but not automatic stabilizers)	–	The authorities' broad anticrisis program includes the Joint Action Plan, estimated to come to at least USD 12 billion (10% to 11% of GDP) over the 2009–2010 period, and additional budgetary measures. It draws on combined efforts of the government, the NBK and the FSA, with the oil stabilization fund (National Fund of the Republic of Kazakhstan – NFRK) largely providing the necessary funds, and with SK serving as the main vehicle for crisis relief. The Joint Action Plan broadly entails: – the provision of public support to the country's top four banks; – steps to aid the completion of unfinished residential construction projects and to spur housing demand; – financial assistance to the SME and farming sectors; – stepped-up public investment in infrastructure and the industrial sector. By mid-2010, approximately 80% of Joint Action Plan funds are disbursed, including direct equity support and deposits. **2009:** a new budget and tax code bring increased current/social expenditures in the context of falling revenues: – the corporate income tax rate is cut by 10 percentage points to 20% in 2009 and earmarked for a further cut by 5 percentage points in 2011; – the VAT rate is reduced by 1 percentage point to 12%; – strengthening of the social safety net: introduction of a uniform 11% rate for social tax; pension payments and child care allowances are raised.
Oil stabilization fund used	–	Funding for anticrisis program largely comes from the NFRK (see above).
Bank regulations/supervision/ accounting requirements softened	The Financial Supervision Agency (FSA) intensifies the supervision of credit institutions: – onsite inspections of largest banks are stepped up; – an FSA representative is installed at each large bank to enhance contacts with the bank management and more closely monitor operations; – strengthening of stress-testing methodologies, in close cooperation with the NBK.	Bank supervisors step up their analysis of banks' balance sheets; as a result, banks substantially adjust their provisioning levels. **October 2009:** the FSA raises banks' minimum capital requirements more than threefold to KZT 5.0 billion; an exception is made for credit institutions operating outside Almaty and Astana and not registered there: these banks have to meet minimum capital requirements of KZT 2.0 billion. **Early 2010:** the FSA decides to curb new domestic foreign exchange lending through higher provisioning requirements on loans to borrowers that do not possess effective currency hedges (10% from mid-2010, 20% from 2011); foreign loans are limited to a maximum of 30% of liabilities. **February 2010:** a new Concept for the Development of the Financial Sector is approved, aiming at countercyclical macroprudential regulation.
Bank recapitalization measures/ bailouts/resolution measures/ restructuring	–	**October 2008:** the Law on Financial Stability is passed, granting to the FSA new powers to intervene in banks and to the government new authority to acquire shares to cover capital deficiencies; these powers are subsequently used for intervention (see below); the banking resolution framework is strengthened. **February 2009:** to cushion the impact of deteriorating asset quality, and as part of authorities' anticrisis program, the government (through Samruk-Kazyna) seizes control of two banks and capitalizes two other banks (these four banks account for about two-thirds of total banking sector assets): – Bank Turan-Alem (BTA, largest credit institution in terms of total assets, 75% of equity acquired); – Halyk (second-largest, savings bank, 28%); – Kazkommertsbank (third-largest bank, 18%); – Alliance (fourth-largest, 100% acquired in December 2009), resulting in a total capital injection of USD 2.5 billion. **March 2009:** bond swap between SK, BTA and Alliance banks for about USD 5 billion (the swap in essence corresponds to collateral-free lending by SK to these credit institutions); **April 2009:** faced with increasing liquidity problems, BTA and Alliance default on their obligations to foreign creditors: – the combined foreign liabilities of the two banks come to over USD 16 billion, of which BTA owes around three-quarters; their combined debt exceeds 40% of the sector's total external debt; – authorities declare that they do not intend to guarantee loans of (nationalized) BTA, Alliance or of any other credit institution. **May 2009:** Astana-Finance defaults on its debt; restructuring of its obligations is ongoing. **Summer 2009:** BTA and Alliance sign MoUs with their foreign creditors in which these principally approve the restructuring of the two banks' foreign debt. **October and December 2009:** general-term debt restructuring agreements are signed with Alliance's and BTA's foreign creditors (agreements include steep haircuts). **November 2009:** TemirBank defaults on its foreign debt. **March 2010:** Alliance signs its final agreement, which provides for creditors to take a 33% stake in Alliance (besides SK's remaining 67%) and for the bank's debt to be cut from USD 4.5 billion to USD 1.1 billion (–76%). **End-May 2010:** BTA's final agreement is signed, providing for creditors to acquire 18.5% of BTA (besides SK's remaining 81.5%) and for the bank's debt to be reduced from USD 12.2 billion to USD 4.4 billion (–64%). **July 2010:** TemirBank completes its restructuring efforts (bank debt is reduced from USD 1.4 billion to USD 0.7 billion).

Table 3 continued

Kazakh Crisis Response Policies

Deposit insurance strengthened	The NBK increases the capital of the Kazakh Deposit Insurance Fund (KDIF). **Mid-2008:** a limit on individual deposit insurance of KZT 700,000 (USD 5,800) is introduced, which covers about 90% of household deposits.	The capital base of the KDIF is increased fourfold to KZT 100 billion (about 0.6% of GDP) and the deposit ceiling for individuals is raised from KZT 700,000 to KZT 5 million (ca. USD 33,333). However, the NBK acknowledges that the KDIF would only be sufficient to cover deposits in the event of the failure of small banks or of a limited number of medium-sized banks, but not of large banks; the KDIF has the right to borrow from the NBK.
Other crisis response measures	**November 2007:** a Memorandum of Understanding (MoU) on Financial Stability is signed by the government, the NBK and the FSA, setting out the framework for cooperation in periods of financial distress.	**2008 to 2009:** numerous memoranda are concluded between regional authorities and local companies on preserving jobs (by mid-2009 reportedly more than 5,000 enterprises with over 800,000 workers had signed memoranda with state bodies). **Mid-2009:** USD 2.4 billion earmarked for plan to further modernize the economy and employment strategy for 2010 to 2011. Reforms are introduced to ease regulatory and administrative burdens, particularly for the SME sector. Part of anticrisis policy are micro-credit programs operated through offices of Kazpost. **Early 2010:** to facilitate corporate borrowing on international financial markets, the government plans to create a benchmark for security price comparison by issuing USD 500 million of U.S. dollar-denominated securities (the last Kazakh issuance of international bonds was in 2000).
Results of impact assessments of crisis response measures (if any)		According to calculations in Jandovov, Sabyrova and Mogilevsky (2010), the Kazakh fiscal anticrisis package dampened the weakening of economic activity in 2009 by around 2.5 percentage points.

Source: Holzhacker and Sabyrova (2010); IMF Staff Reports 2007–2010: Kazakhstan; National Bank of the Republic of Kazakhstan Annual Reports 2007 and 2008; wiiw Current Analyses and Forecasts 2007–2010: Kazakhstan; OeNB, Financial Stability Reports 2010: Kazakhstan; Jandosov and Sabyrova (2009); Jandosov, Sabyrova and Mogilevsky (2010).

Table 4

Belarusian Crisis Response Policies

Policy category of measures[1]	**Great Recession** (triggered by the collapse of Lehman Brothers; since September 2008)
Monetary policy easing and/or bank/enterprise liquidity assistance	**Late 2008:** the Natsionalny bank Respubliki Belarus (NBRB) grants noncollateralized emergency loans to banks and reduces reserve requirements. **Early 2009:** to support the new exchange rate regime, the NBRB raises its interest rates (Lombard auction rate floor, overnight rate) by about 4 percentage points. **April 2009:** to support liquidity and credit activity, the NBRB cuts the interest rate on overnight liquidity support by 2 percentage points. **June 2009:** the NBRB increases the interest rate of overnight loans by 2 percentage points, while leaving the refinancing rate unchanged. **February 2010:** to promote market-based lending and dedollarization, the NBRB reduces the interest rate on overnight loans by 1 percentage point and the refinancing rate by 0.5 percentage point. **April to May 2010:** the refinancing rate is cut further by 1 percentage point to 12%.
Substantial foreign exchange market intervention and/or domestic currency devaluation	**From September 2008:** the Belarusian ruble's peg to the U.S. dollar comes under pressure, the NBRB intervenes heavily to slow depreciation, official reserves fall from USD 4.6 billion at end-August to USD 3.2 billion at end-2008 (worth 0.9 month of imports); **January 2009:** one-step devaluation to new U.S. dollar parity 20% below previous level; – new exchange rate regime includes switch to currency basket (equal weights on euro, U.S. dollar and Russian ruble); – widening of fluctuation rate band to ±5% allows exchange rate regime to better absorb shocks. The NBRB initially allows the exchange rate to appreciate against the central parity, despite the loss of reserves, in an attempt to limit currency substitution by keeping the U.S. dollar/Belarusian ruble exchange rate as stable as possible. **May to June 2009:** depreciation of the Belarusian ruble and widening of the trading band from 5% to 10%, followed by a stabilization of the market. **November to December 2009:** the need to close the financing gap and to contain the current account deficit calls for – another depreciation (by 8%) of the Belarusian ruble within a widened fluctuation band; – a recentering of the band at the exchange rate level of end-December 2009.
New exchange controls introduced	From May 2009, the authorities take a number of administrative measures to promote the dedollarization of the economy and curb foreign exchange outflows.
Fiscal stimuli (discretionary measures, but not automatic stabilizers)	No fiscal stimulus; the tight fiscal stance is viewed as necessary to check domestic demand and support macroeconomic stability (in line with the country's IMF program): – wage freeze for civil servants and workers of companies receiving public resources in 2009; – revenue shortfalls offset by spending restraint regarding nonpriority goods, services and investment, etc. In response to the shortfall of (expected) budget financing (by USD 500 million), the authorities execute a package of contingency measures.
Bank regulations softened	**September 2009:** loan classification and provisioning requirements are brought into line with best international practice (in line with FSAP recommendations).
Bank restructuring measures	**December 2008:** the authorities provide a capital injection of USD 1.5 billion (2.5% of GDP) to SOBs, aimed at compensating the losses banks expect as a result of economic shocks.
Deposit insurance strengthened	Presidential decree extends full guarantee to all household deposits.
Privatization accelerated	The authorities make tangible progress in developing legal and institutional frameworks for privatization; – privatization proceeds are higher than expected; – but bank privatization progresses slowly, with only Belpromstroibank being acquired by Sberbank (Russia) in 2009.

[1] *Including only policy categories that refer to actually implemented measures.*

Table 4 continued

Belarusian Crisis Response Policies

Other crisis response measures	**First quarter 2009:** the authorities – agree not to increase directed lending financed with government deposits in credit institutions; – do not extend a regulatory act imposing a general ceiling on monthly price increases of 0.5%; – cut the number of goods and services subject to price regulation; – stop announcing medium-term wage targets (in line with the IMF program). On the other hand, authorities continue to bolster domestic demand by – instructing lending at below market rates through decrees and resolutions under government programs using nongovernment deposit financing, which mainly boosts housing construction and agricultural capital formation. Therefore in H1 2009, gross disbursements under government programs are 40% higher than in the same period of 2008. Under pressure to meet official lending targets, banks turn to the NBRB for refinancing. The NBRB supports this credit activity using mechanisms outside its standard refinancing facilities (via ad-hoc decisions of the NBRB Board). This helps boosting fixed investment (+17% from January to August 2009 year on year) and building up inventories (contributing about 2% to GDP growth in 2008 and up to 4% in 2009). Progress is made on adjusting NBRB governance and the focus on its core functions (in line with the IMF program): **January 2010:** the Statute of the NBRB is amended; under the new statute – voting rights of government officials at the NBRB Board are revoked, allowing them to act only in an advisory capacity; – the NBRB Chairman participates in meetings of the Council of Ministers only in an advisory capacity. **July to August 2010:** the government issues USD 1 billion of eurobonds with a maturity of five years and an average coupon rate of 8.7%; the sale is to boost Belarus' foreign currency reserves.
IMF program (if any): major anticrisis commitments realized and funds disbursed	**January 2009:** a 15-month IMF SBA is approved by the IMF Executive Board, totaling USD 2.5 billion; it is augmented to USD 3.5 billion in mid-2009; – the first tranche of USD 810 million is disbursed upon SBA approval; – the second to fifth tranches, of USD 610 million each, are disbursed in May, August, November 2009 and February 2010, respectively; the program is successfully concluded in March 2010.

Source: IMF Staff Reports 2007–2010: Belarus; Natsionalny bank Respubliki Belarus Annual Reports 2007 and 2008; OeNB Financial Stability Reports 2007: Belarus; Barisitz, S.: Belarus: Economy and Banking Sector 2009–2010 Dependent on Foreign Financing, OeNB, AUSA Info No. 10/2010.

Euro Survey of Spring 2010: Sovereign Debt Crisis Left Traces in CESEE Households' Sentiment, Foreign Currency Portfolios Broadly Unchanged

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The OeNB Euro Survey's spring wave was conducted in May and June 2010 at a time of highly exceptional circumstances in the EU and in the euro area, which appear to have had a significant effect on CESEE households' trust in the euro. However, it can be assumed that the reported low trust levels were extraordinary and of only temporary nature. Nevertheless, confidence in the euro was still "ahead" of that in the respective local currencies. By contrast, trust in the EU as an institution remained rather high in almost all countries surveyed and continued to be substantially higher than trust in domestic governments. Despite worsened results from some sentiment-related questions, people did not adjust their foreign currency portfolios. The deposit substitution index (DSI) as well as the projected amount of euro cash holdings per capita remained broadly unchanged throughout the region.

JEL classification: D14, E41, E50, G01
Keywords: Euroization, global financial crisis, portfolio decision, survey data, Central, Eastern and Southeastern Europe

1 Introduction

The OeNB Euro Survey's spring wave was conducted in May and June 2010, at a time when the overall situation in the EU in general, and in the euro area in particular, was highly exceptional. The adoption of the support package for Greece in March 2010, the creation of the European Stabilization Mechanism in May 2010 and a strong commitment to accelerated fiscal consolidation contributed to restoring confidence both in the euro area and the EU in the following months. However, it can be expected that broad media coverage of these events in the CESEE region fed into changes in people's sentiment. The survey results provide a unique snapshot on CESEE households' perceptions, including possible changes in their sentiment vis-à-vis the euro as well as changes in their behavior as regards the use of the euro in their countries.

This article is structured as follows. Section 2 presents survey evidence on CESEE households' sentiment as of spring 2010, in particular on their trust in the euro and in their respective local currencies, on their trust in the EU as compared to their domestic governments as well as on their expectations regarding euro adoption. Section 3 analyzes whether the reported changes in households' sentiment entailed any changes in their actual behavior: We will examine whether people rearranged their portfolios, i.e. whether they exchanged their foreign currency holdings (both cash holdings as well as saving deposits) into local currencies or into other foreign currencies (U.S. dollar, Swiss franc). Section 4 concludes.

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2 Exceptional Circumstances in the EU Left Traces in CESEE Households' Sentiment

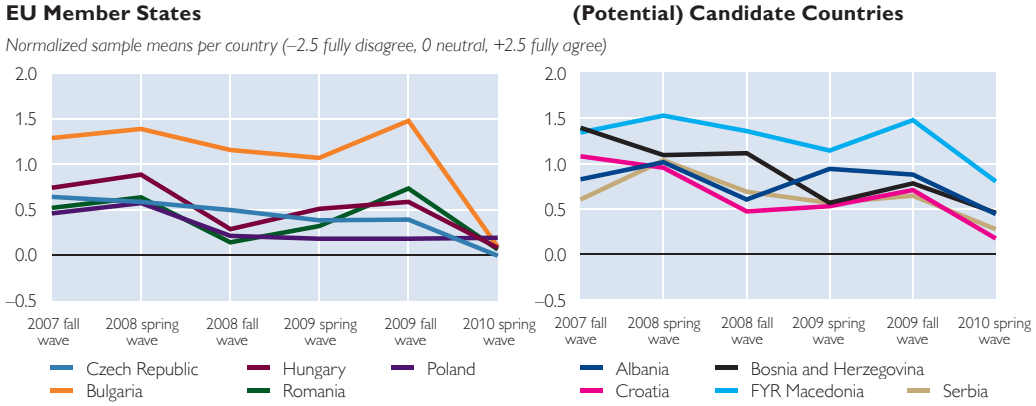
Since its launch in fall 2007, the OeNB Euro Survey has contained questions about the perceived stability and trustworthiness of the euro as well as of the respective local currencies. Previous results from the OeNB Euro Survey showed a generally very high level of confidence in the euro in all countries surveyed, especially as compared to trust in the respective local currencies (see Dvorsky, Scheiber and Stix, 2009). While the arrival of the financial crisis in the fall of 2008 had marked a temporary decline of trust in the euro and the respective local currencies in some CESEE countries, trust levels recovered in the months afterward and partly reached pre-crisis levels again.

2.1 Trust in the Euro Affected by Developments in the Euro Area

The new results obtained from the 2010 spring wave, however, reveal a significant decline of trust in the euro. This decline can be observed in nine out of ten countries surveyed and it is substantial in some countries (see chart 1). Moreover, the survey contains a forward-looking question on respondents' expectations regarding the euro's stability and trustworthiness over the next five years. Results from this question render a very similar picture as presented in chart 1, reflecting the increased uncertainty surrounding the euro area at the time the survey interviews were conducted.

Chart 1

Consent to the Statement: Currently, the Euro Is Very Stable and Trustworthy



Source: OeNB Euro Survey.

Note: Respondents were asked whether they agreed or disagreed on a scale from 1 (fully agree) to 6 (fully disagree) to the statement above.

This observed decline in trust might have been aggravated by the marked depreciation of the euro vis-à-vis the U.S. dollar in the period from mid-May to mid-June 2010.

Given the particular timing[2] of the spring wave, it can be assumed that the reported trust levels were exceptionally low and only of a temporary nature. Most

[2] *In four countries, interviews started on May 6, in the remaining countries on May 10, 2010. This means the survey was conducted virtually at the same time the European Stabilization Mechanism was adopted (May 9, 2010) and Greece received the first instalment of the EU-IMF support package (May 18, 2010).*

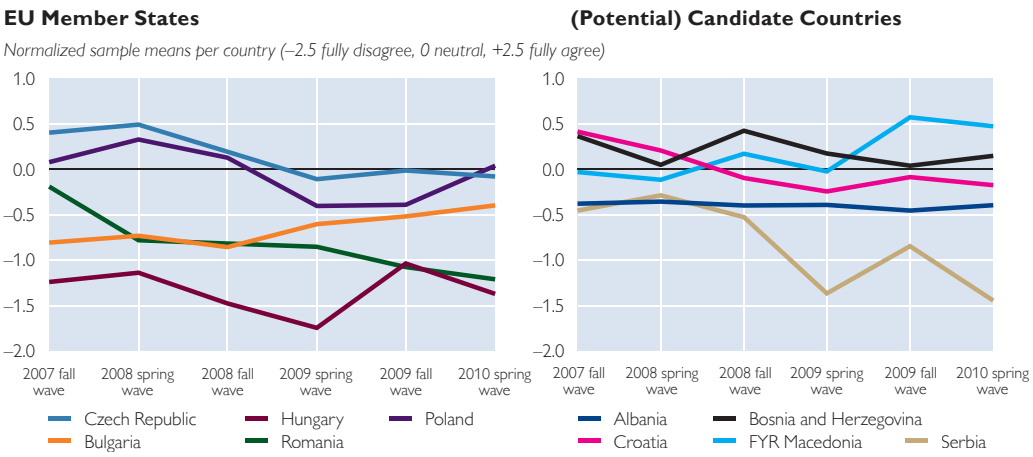
likely, a recovery of trust already took place over the summer months. More recent survey results that might confirm this hypothesis will only be available at the end of 2010, however.

2.2 Trust in the Euro Still "Ahead" of Trust in Local CESEE Currencies

Interestingly, decreased trust in the euro does not translate into short-term gains of trust in the local currencies (see chart 2). Compared over a longer time period e.g. with pre-crisis levels and neglecting smaller changes in trends and ups and downs during the recent crisis period, the loss in trust regarding the Romanian and the Serbian currencies is particularly pronounced, while trust in the Hungarian forint continued to be exceptionally low. However, according to results obtained from the forward-looking question regarding the expected stability of the local currencies over the next five years, Hungarian respondents seem to have more favorable expectations, while Romanian and Serbian respondents are very skeptical even regarding the future.

Chart 2

Consent to the Statement: Currently, the Local Currency Is Very Stable and Trustworthy



Source: OeNB Euro Survey.

Note: Respondents were asked whether they agreed or disagreed on a scale from 1 (fully agree) to 6 (fully disagree) to the statement above.

When relating the perceived stability of the local currency to actual exchange rate developments (vis-à-vis the euro), one can separate three groups of countries.

The first group consists of countries whose exchange rate has markedly depreciated against the euro since the beginning of the crisis in fall 2008: Albania, Serbia and Romania. In line with actual exchange rate movements, people's assessment of the stability of their local currency declined or remained low (in the case of Albania).

The second group of countries experienced depreciation during the crisis months but their currencies rebounded afterward: Hungary, Poland and the Czech Republic. For these countries, again, respondents' sentiment toward the local currency seems to be correlated with actual exchange rate movements.

The third group consists of countries whose exchange rate was kept stable or relatively stable during the crisis (the two currency board countries Bulgaria and

Bosnia-Herzegovina as well as FYR Macedonia and Croatia). In these countries, the assessment of the stability of the local currency remained high or even increased since the beginning of the crisis – with the notable exception of Croatia, where sentiment toward the kuna deteriorated.

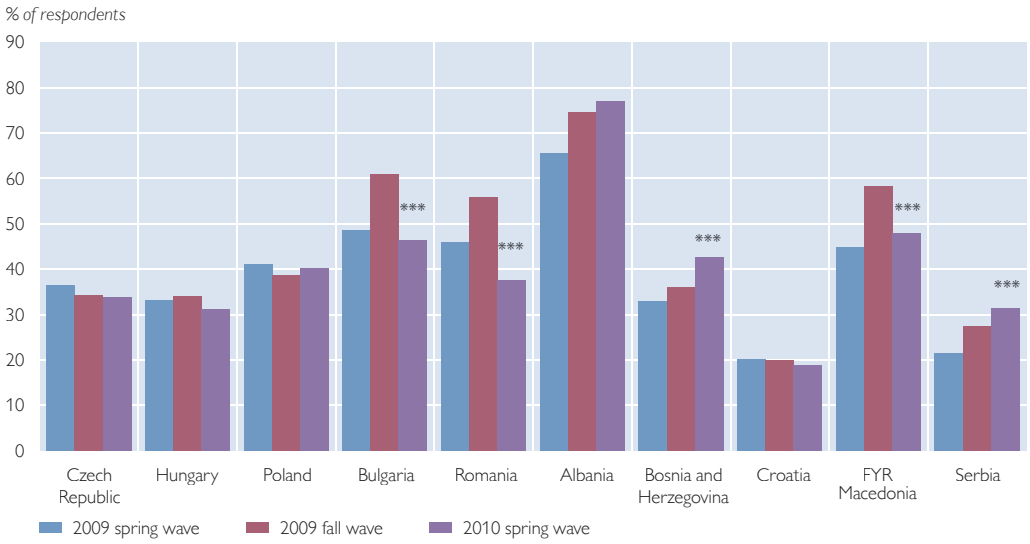
To sum up, while exchange rate developments may have played a role for people's confidence in their local currencies, the assessment of a country's overall economic situation may also have contributed to this picture: A comparison of the perceived stability of the euro with that of the local currencies reveals that the euro is still "ahead" of the respective local currencies in all countries surveyed. However, in the Czech Republic and Poland – the two countries which had shown the best economic performance throughout the region over the previous six months – the difference melted away and is now very small compared to previous waves. By contrast, in Hungary, Romania and Serbia the lead of the euro is still considerable.

2.3 Trust in the EU Remains Very High throughout the CESEE Region

While the instabilities of the euro area during spring 2010 seem to have contributed to a significant decline in trust in the euro in nine out of ten countries surveyed, the general level of trust in the EU as an institution appears to have hardly been affected. Furthermore, in all the countries concerned, the level of trust in the EU is above the level of trust in the respective domestic government (for trust in domestic governments, see annex, chart 9). Thus, it can be argued that the package of measures the EU adopted in spring 2010 to preserve financial stability in Europe was perceived as credible by CESEE households and that the EU as an institution successfully proved its ability to manage a crisis situation.

Chart 3

Trust in the European Union



Source: OeNB Euro Survey.

*Note: Respondents were asked whether they trusted the respective institution on a scale from 1 (I trust completely) and 5 (I do not trust at all). Results are based on the share of respondents answering "rather trust" (2) or "trust completely" (1). The answers "Don't know" and "No answer" are not included. *** indicate a statistically significant change in normalized sample means (at the 1% level) between the 2009 fall and the 2010 spring waves.*

Chart 3 depicts the results on respondents' trust in the EU, which generally speaking remained broadly unchanged over the past one and a half years in many countries – with the exception of Bulgaria, Romania and FYR Macedonia, where it significantly decreased as compared to the 2009 fall wave, but still remained at a comparatively high level. For Romania, this substantial loss of confidence in the EU might be related to the perception of the austerity measures under the EU-IMF balance-of-payments support program. However, in all three countries trust in the EU was still higher than trust in the respective national government.

As regards reported levels of trust in the EU, Croatia and Serbia are exceptions throughout the CESEE region. In Croatia, despite substantial progress in the country's EU accession negotiations during the six months preceding the spring wave (following the successful resolution of the border dispute with Slovenia), only below 20% of respondents said they had trust in the European Union. For Serbia, levels of trust are also reported to be still very low, albeit showing a significant increase as compared to the previous survey wave.

2.4 Dampened Expectations on Future Euro Adoption in EU Member States

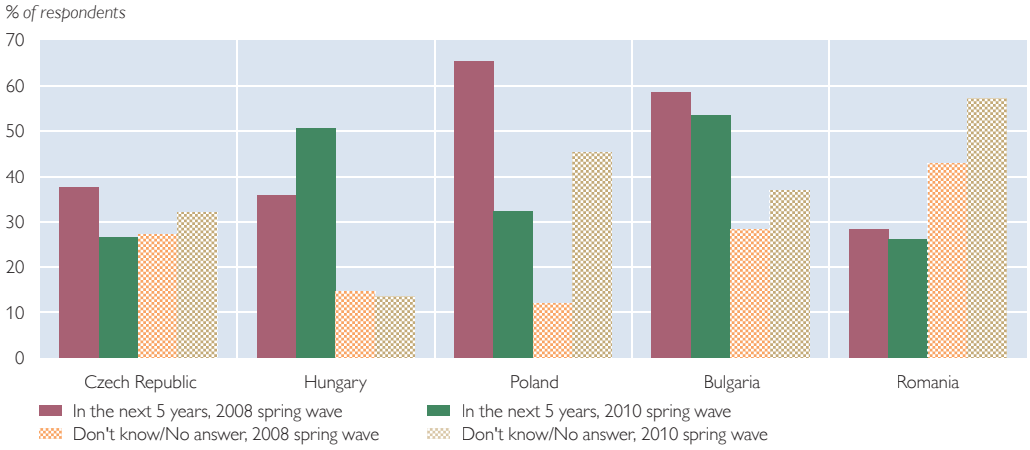
During the 2010 spring wave, people were also asked when they expected the euro to be introduced in their respective countries. When comparing results for the EU Member States surveyed to those obtained from the 2008 spring wave (see Dvorsky, Scheiber and Stix, 2008), it is quite striking that the share of respondents who expect the euro to be introduced in their countries within the next five years has decreased in four of the five Member States (see chart 4). The largest drop was recorded in Poland, where the share of respondents expecting euro introduction within the next five years more than halved against 2008 results. At the same time, the share of replies in the "I don't know/no answer" category increased substantially and reached close to 50% in Poland and even 60% in Romania, possibly reflecting the increased perception of uncertainty surrounding euro adoption in an environment of economic and financial crisis.[3] The only exception in this context seems to be Hungary, where the share of people expecting euro introduction within the next five years even increased to around 50%, with only around 10% answering they did not know. Interestingly, these results seem to be largely unrelated to the respective countries' official announcements on euro adoption plans.[4]

[3] *Contrary to previous OeNB Euro Survey results, the current results do not seem to be in line with the European Commission's most recent Eurobarometer, which draws a markedly more optimistic picture for all EU Member States covered (see European Commission, 2010a). The results are, however, not fully comparable, as the dominant mode of the Eurobarometer are telephone interviews (as opposed to the face-to-face interviews mainly used in the OeNB Euro Survey). Furthermore, the Eurobarometer questionnaire deals exclusively with euro-related questions, whereas the euro-relatead questions in the OeNB Euro Survey are part of a larger set of questions on a wide range of topics.*

[4] *While Bulgaria maintains its official target of introducing the euro "as soon as possible," Romania quotes "2015" as the official target date for euro adoption. Poland seems to pursue a more cautious policy stance, announcing ERM II entry "as soon as conditions are met." The Czech Republic and Hungary currently do not announce any official target date (see European Commission, 2010b).*

Chart 4

Trust in the European Union



Source: OeNB Euro Survey.

Note: The categories "5 years and later" and "Never", which are not shown in the chart, represent the remaining percentage share.

From people's answers to the question of when they expected the euro to be introduced in their respective countries, median years of euro adoption were calculated. A comparison of these median years derived from the 2010 and 2008 spring waves reveals that in four of the five EU Member States analyzed, people expect euro adoption later than previously (see table 1).

Table 1

Expected Date for the Adoption of the Euro in EU Member States

	Median[1] 2008	Median[1] 2010
Czech Republic	2013	2016
Hungary	2015	2015
Poland	2012	2015
Bulgaria	2011	2013
Romania	2013	2015

Source: OeNB Euro Survey.

[1] Calculated median years are based on the question: "When, in which year, do you think the euro will be introduced in your country?"

This generally worsened sentiment on the possible date of euro adoption in four out of five EU Member States surveyed probably reflects people's awareness that the consequences of the financial and economic crisis, both for the euro area and for the respective countries, might pose additional challenges to further euro area enlargement. Moreover, people may have taken note of the growing fatigue of euro area decision makers with regard to taking in new members.

3 Foreign Currency Holdings of CESEE Households Broadly Unaffected by Worsened Sentiment: Role of the Euro Remains Predominant

Given CESEE households' perceptions on the decreased trustworthiness of the euro as well as their dampened expectations regarding the future adoption of the euro by their respective countries, it might be assumed that people adjusted their behavior with respect to their foreign currency portfolios and, in particular, their euro holdings. Therefore, section 3.1 examines households' behavior with respect to savings deposits and section 3.2 takes a closer look at their foreign currency cash holdings. Evidence is available from a question on the perceived attractiveness of savings deposits and cash holdings (in both cases, foreign versus local currency). These survey results will be analyzed against the background of aggregate statistics on households' savings deposits (section 3.1) and projections on euro cash holdings per capita (section 3.2).

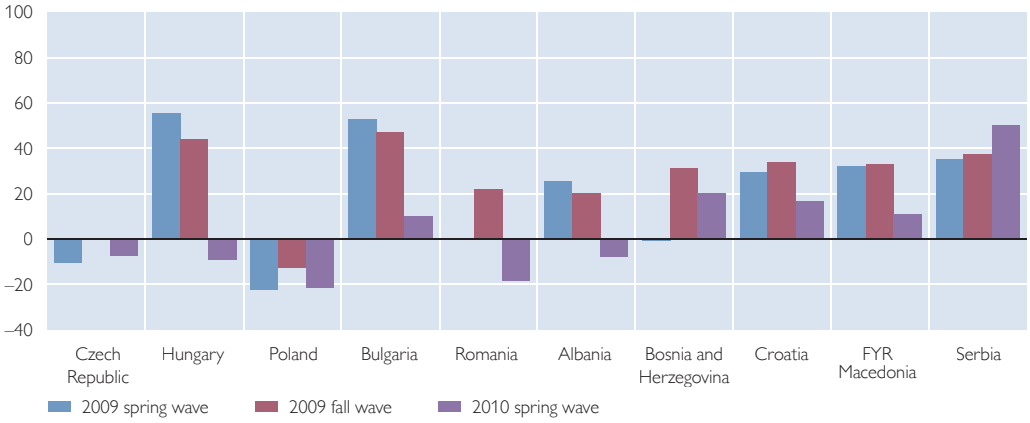
3.1 Foreign Currency Deposits: Virtually No Change

Chart 5 shows that in spring 2010 the perceived attractiveness of foreign currency deposits decreased substantially in all countries surveyed, with the only exception of Serbia. By contrast, in 2009, a majority of respondents in six countries had assessed foreign currency deposits as safer than those in local currency (see Dvorsky, Scheiber and Stix, 2009). Given the sharp decline in trust in the euro observed in the same survey wave, this U-turn, however, does not come as a surprise.

Chart 5

Attractiveness of Deposits in Foreign Currency versus Deposits in Local Currency

Balance statistics ("more attractive" minus "less attractive", percentage share)



Source: OeNB Euro Survey.

Note: Recorded answers are based on the question "How has the economic and financial crisis changed your attitude towards the following types of savings… Have they become a lot safer in terms of preserving the value of your savings?" The sample is restricted to respondents holding deposits or transaction accounts.

Did this substantial change in CESEE households' sentiment on foreign currency deposits lead to an actual change in their behavior, i.e. to a reshuffling of savings deposits from foreign currencies into the respective local currency? Chart 6 depicts the deposit substitution index (DSI) for the ten CESEE countries under observation. It shows quite clearly that the share of foreign currency-denominated

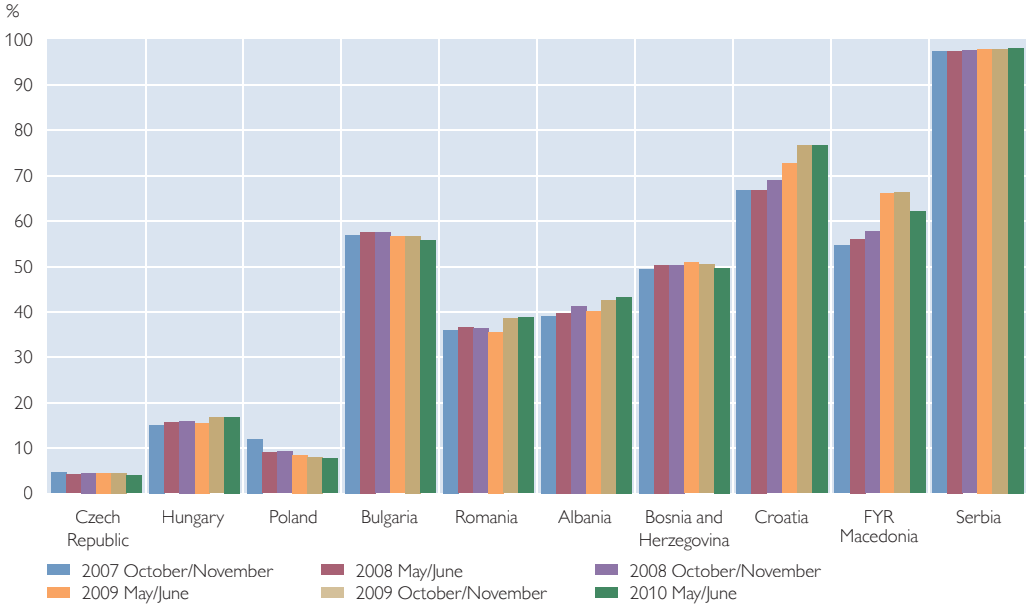
deposits in total deposits remained virtually unchanged in nine of the ten countries surveyed between October/November 2009 and May/June 2010 – only in FYR Macedonia, the DSI decreased by 4 percentage points since February 2010.

The absence of any large changes in savings behavior implies that the extent of financial euroization continues to follow the usual pattern across the CESEE region: A comparatively low level of deposit substitution prevails in the Czech Republic, Hungary and Poland, while the other countries display medium substitution levels, and the "extreme cases" of Croatia, Serbia and FYR Macedonia are at the high end of the spectrum.

Why did people not convert their foreign currency, i.e. euro, savings deposits into local currency, although at the same time they report to be increasingly skeptical as regards the preservation of the value of their savings? First, the reputation of the euro as a stable and trustworthy currency, despite its recent downturn, is still considerably higher than that of the respective local currencies in those countries where euro deposits play a significant role. Second, trust in the EU as an institution remained at a comparatively high level in all countries, and recent EU crisis management measures were obviously perceived as credible. Third, evidence from the fall of 2009 shows that higher interest rates offered for deposits in local currency did not change respondents' perception that euro deposits were more attractive than those in local currency (Stix, 2010). Finally, practical considerations, such as banking fees, agreed maturity periods or lack of time may have reduced people's readiness to convert their savings deposits.

Chart 6

Deposit Substitution Index



Source: National central banks.

Note: Deposit substitution index (DSI) = Foreign currency deposits divided by total deposits of the household sector; averages of May/June and October/November, respectively. Data on foreign currency deposits for Croatia do not include deposits indexed in foreign currency. Entries for Bosnia and Herzegovina comprise savings deposits of households and the corporate sector.

An alternative option for CESEE households would have been to convert (parts of) their euro-denominated deposits into alternative foreign currencies, such as the U.S. dollar or the Swiss franc. In particular, this might have been expected for countries where anecdotal evidence suggests a certain "tradition" or "culture" of using e.g. the U.S. dollar, such as Albania or Romania. Evidence from aggregate statistics on household deposits, however, does not point into this direction. In general, the currency composition within foreign currency-denominated savings deposits remained broadly unchanged, and if any adjustments were found, they were only small.[5]

3.2 Euro Cash Holdings Broadly Unchanged

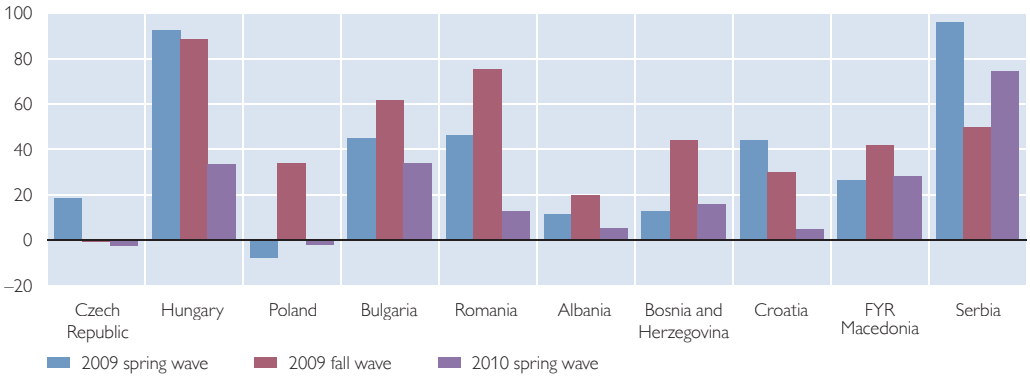
Foreign currency cash holdings – and in particular euro cash holdings – play an economically significant role throughout the CESEE region (see e.g. Scheiber and Stix, 2009). Particularly high amounts of cash holdings are typically reported from four non-EU members covered by the survey, namely Albania, Croatia, FYR Macedonia and Serbia. Reasons for this behavior can be mainly found in the past. First, people still remember past periods of instability in their countries and therefore hold foreign currency cash as a means of precaution, i.e. they "save" in foreign currency cash. Second, these countries have a certain "history" of using legacy currency cash for transactions (Deutsche mark and Austrian schilling) before the euro cash changeover. Third, network effects creating a necessity for economic agents to keep euro cash holdings contribute to the continuous use of euro cash in the countries surveyed.

Survey evidence from a direct question on the attractiveness of cash holdings might shed some light on the question whether the recent crisis situation in the EU influenced people's attitude. Chart 7 clearly shows that the special circumstances

Chart 7

Attractiveness of Foreign Currency Cash versus Local Currency Cash

Balance statistics ("more attractive" minus "less attractive", percentage share)



Source: OeNB Euro Survey.

Note: Recorded answers are based on the question "How has the economic and financial crisis changed your attitude towards the following types of savings… Have they become a lot safer in terms of preserving the value of your savings?" The sample is restricted to respondents holding deposits or transaction accounts.

[5] *Monthly statistics on the foreign currency composition of household deposits were available for the Czech Republic, Bosnia and Herzegovina, Bulgaria and Romania. We found a significant decline of euro denominated deposits versus other foreign currency deposits in May and June 2010 (from 91.3% in April to 88.8% in August) only in Romania.*

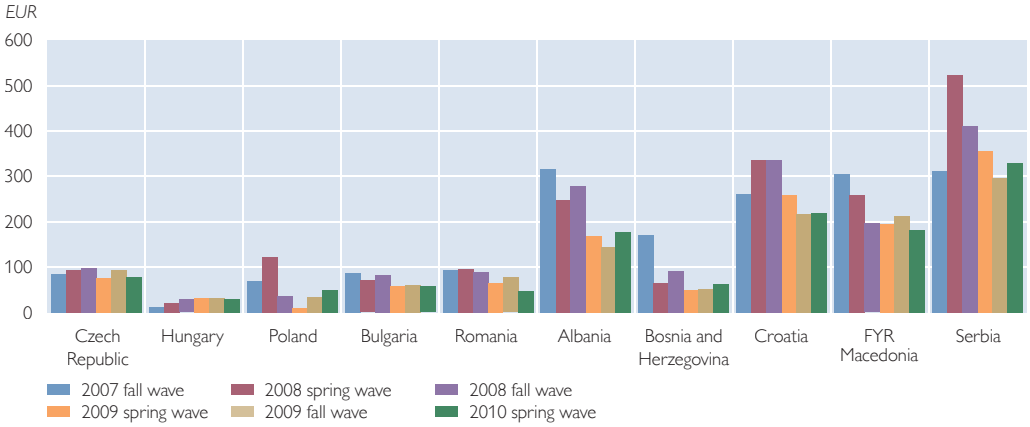
prevailing in the EU at the time of the 2010 spring wave had an impact on CESEE households' assessment of the attractiveness of euro cash holdings. In all countries surveyed, with the only exception of Serbia, respondents on average assessed foreign cash holdings to be substantially less safe than six months earlier.

Given this worsened assessment as well as the general decline in trust in the euro across the entire CESEE region at the time of the 2010 spring wave, one might have presumed that households reduced their euro cash holdings and at least partly converted them into the respective local currency.

Chart 8 reveals that this did not happen. Based on the current survey results, the projected amount of euro cash holdings per capita remained virtually unchanged in comparison to six months earlier. The only exception is Romania, where a substantial drop of euro cash holdings per capita was recorded. The country's very difficult economic situation, which is also reflected in a generally more pessimistic sentiment reported from Romania in spring 2010 as compared to the other CESEE countries, suggests that Romanian households used their cash reserves for consumption purposes.[6]

Chart 8

Projected Amount of Euro Cash Holdings per Capita



Source: OeNB Euro Survey.

Note: Projections per capita refer to the population older than 14 years.

What are the possible explanations for respondents' behavior with respect to their euro cash holdings? Why do the extraordinary circumstances prevailing in the euro area in spring 2010 not seem to have had an substantial impact on respondents' behavior? First, for some countries this may be explained by network effects, which prompt economic agents to keep euro cash holdings because other agents do so as well. Second, the euro's relatively high reputation as compared to some local currencies might have played a role. This is in line with survey evidence on deposits (section 3.1). Finally, the generally high level of trust in the EU as an institution might have contributed to this behavior.

[6] *In a similar vein, direct evidence from ad hoc questions of the 2009 fall wave of the OeNB Euro Survey confirmed that households that had withdrawn money from savings deposits during the financial crisis had to use at least parts of it for consumption purposes and did not bring it back to the banking system (see Dvorsky, Scheiber and Stix, 2010). Furthermore, monetary statistics on Romania show that the annual growth rate of total savings deposits decelerated considerably during the course of 2010.*

4 Conclusions

When the recent OeNB Euro Survey was carried out in spring 2010, circumstances prevailing in the EU and the euro area were highly unusual.

Therefore, it comes as no surprise that CESEE households' sentiment on the reputation of the euro was markedly affected. However, it can be assumed that the reported low trust levels were exceptional and of only temporary nature. Nevertheless, confidence in the euro was still "ahead" of that in the respective local currencies. By contrast, trust in the EU as an institution remained rather high in almost all countries surveyed and continued to be substantially higher than trust in domestic governments. In four out of five EU Member States surveyed, we observe that respondents expect euro adoption later than they did in 2008. This probably reflects people's awareness that the consequences of the financial and economic crisis, both for the euro area itself as well as for the other EU Member States, might pose additional challenges to further euro area enlargement.

While this generally deteriorated picture of CESEE households' sentiment would have suggested that people changed their behavior with respect to their foreign currency holdings, such a change did not take place. The deposit substitution index (DSI) as well as the projected amount of euro cash holdings per capita remained broadly unchanged throughout the region.

To sum up, despite worsened results from some sentiment questions, the results of the OeNB's Euro Survey 2010 spring wave show that the generally high level of trust in the EU as an institution remained unchanged and that people did not adjust their foreign currency portfolios in line with sentiment changes.

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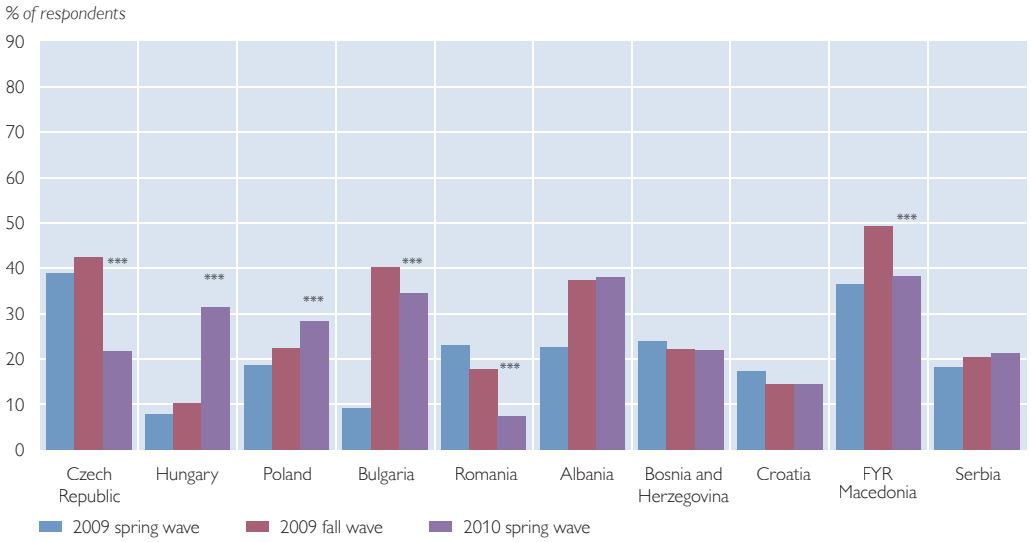
Annex

Chart 9

Trust in Government/Cabinet of Ministers



Source: OeNB Euro Survey.

*Note: Respondents were asked whether they trusted the respective institution on a scale from 1 (I trust completely) and 5 (I don not trust at all). Results are based on the share of respondents answering "rather trust" (2) or "trust completely" (1). The answers "Don't know" and "No answer" are not included. *** indicate a statistically significant change in normalized sample means (at the 1% level) between the 2009 fall and the 2010 spring waves.*

Selected Abstracts from Other OeNB Publications

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

Foreign Currency Lending in Central, Eastern and Southeastern Europe: the Case of Austrian Banks

Johannes Pann, Reinhardt Seliger, Julia Übeleis

This paper describes the exposure of Austrian banks to foreign currency loans in Central, Eastern and Southeastern Europe and the CIS and elaborates on its risks to banking sector stability. Austrian banks' foreign currency loan exposure more than doubled between 2005 and 2009, their regional subsidiaries' foreign currency loan exposure continued to be higher than the market average in this period. Our findings confirm the key importance of funding risks and do not contradict the assumption of a nonlinear relationship with regard to credit risk. However, a simple comparison of risk indicators does not unambiguously indicate an overall higher credit risk in the foreign currency loan portfolio. Most recent data suggest that Austrian banks' foreign currency loan exposure is declining. Policymakers are now called upon to use the momentum and strike a balance between restricting foreign currency lending to foster a more sustainable growth path and avoiding negative procyclical effects.

To be published in *Financial Stability Report 20*.

Russian Banks on the Route of Fragile Recovery

Stephan Barisitz, Mathias Lahnsteiner

Largely thanks to the recovery of the real economy, the situation of Russian banks has improved again. After month-on-month loan growth had quickly ground to a halt in late 2008, banks contributed to Russia's deep economic slump in 2009. The share of nonperforming loans had tripled to 10% of total loans by late 2009 and has since remained at about this level. An incipient recovery of lending made itself felt only in the second quarter of 2010. However, as the national authorities had delivered a comprehensive policy response which helped sustain or reestablish confidence, Russia did not experience any major bank run or failure. Temporary deposit withdrawals after the collapse of Lehman Brothers were followed by a rapid expansion of deposits, starting from early 2009. Following a modest crisis-triggered rise, the share of foreign currency loans declined again to about one-fifth of total loans. Banks' access to international capital markets improved from late 2009/early 2010. Profitability, having plunged to zero in mid-2009, subsequently recovered but is still modest. Thanks to recapitalization exercises, capital adequacy is satisfactory. The stabilization of the banking sector has allowed the authorities to start exiting from crisis response measures. Banks are faced with a vulnerable environment given the world economy's post-crisis fragility and Russia's undiminished dependence on the oil price and capital flows, which is exacerbated by persisting structural weaknesses. Nonetheless, the existing shock-absorbing factors are sizeable.

To be published in *Financial Stability Report 20*.

Event Wrap-Ups

OeNB Conference on European Economic Integration 2010 – Catching-Up Strategies after the Crisis

Compiled by
Jarko Fidrmuc and
Susanne Steinacher[1]

The topic of this year's Conference on European Economic Integration (CEEI) of the Oesterreichische Nationalbank (OeNB), which took place in Vienna on November 15 and 16, 2010, was "Catching-Up Strategies after the Crisis."[2] Under this caption, the CEEI 2010 discussed the post-crisis growth of, and convergence prospects for, countries in Central, Eastern and Southeastern Europe (CESEE), with a particular focus on possible changes in growth models, monetary policy, financial integration, regulatory requirements and the role of capital and exports. More than 300 participants from over 30 countries and 220 institutions followed the presentations and discussions of high-level representatives of central banks, international organizations and academia.

In his opening speech, *Ewald Nowotny,* Governor of the *OeNB* and Member of the Governing Council of the *ECB,* discussed various challenges to future economic developments. He pointed out that, after the positive trend observed in the first half of 2010, we could now see light at the end of the tunnel, although major challenges remained. In particular, fiscal stabilization would require extraordinary efforts over the next few years. Fiscal debt had increased in all CESEE countries in the last two years, although public debt levels were still lower in CESEE than in the euro area. Moreover, the fiscal crisis had underlined the importance of competitiveness, which needed to be supported by, especially, wage developments. With regard to financial stability, Nowotny stated that the euro had acted as a shelter not only for the euro area countries, but also for a broader European region. Similarly, the Basel III agreement would ensure improved financial stability. However, there were also potential risks related to these regulatory changes that might compel some banks to reduce their credit volumes in order to comply with the new regulations.

Growth Experience and Foreign Banks' Activities in CESEE

In his keynote lecture, *Vítor Constâncio,* Vice-President of the *ECB,* addressed possible catching-up strategies to be employed after the crisis. He also stressed the importance of the proper use of fiscal policy as an anticyclical instrument. Together with wage moderation, fiscal stabilization is of crucial importance for financial stability. Previous macroeconomic and financial developments were characterized by increasing vulnerability. Current account deficits had widened as a result of excessive consumption growth and a credit boom that was also supported by foreign currency loans. The policy implications of these developments were often played down. Now they have to be addressed through different adjustment policies. Some countries could allow their currencies to depreciate, while countries with

[1] *Oesterreichische Nationalbank, Foreign Research Division. On the basis of notes taken by Stephan Barisitz, Andreas Breitenfellner, Markus Eller, Martin Feldkircher, Jarko Fidrmuc, Mariya Hake, Antje Hildebrandt, Sándor Gardó, Mathias Lahnsteiner, Paul Ramskogler, Thomas Scheiber and Julia Wörz.*

[2] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of 2011. Presentations and papers, information about the speakers and the conference program are available under Services and Events at www.oenb.at.*

fixed exchange rates would have to increase their competitiveness. In the second half of his lecture, Constâncio turned to financial stability, stating that the Vienna Initiative (a coordinated effort on the part of Western European banks to recapitalize their affiliates in the CESEE countries) had helped maintain confidence in financial stability in the CESEE countries, which showed how important multilateral coordination was for achieving financial stability. Moreover, he pointed out that, while the Basel III agreement constituted a robust regulatory framework, much still remained to be done to achieve financial stability in the CESEE region.

Catching-Up Prospects after the Crisis

Under the chairmanship of *OeNB* Governor *Ewald Nowotny,* Session 1 discussed past experiences of crisis resolution and the current prospects for catching-up in CESEE. There was consensus among the speakers that CESEE will be subject to long-lasting domestic and external challenges. With lower trend growth in the EU-15, elevated risk perceptions and lower capital inflows, potential output in the region may remain below pre-crisis levels. Strategies to not only close the output gap, but also bring potential output back to a higher level will thus be crucial for the region.

Based on experience gained in the Nordic financial crisis of the early 1990s, *Seppo Honkapohja,* Member of the Board of *Suomen Pankki – Finlands Bank,* outlined the elements of a successful policy response. He stressed the importance of correcting problems in competitiveness (i.a. by allowing the exchange rate to float – where the Nordic example had proven that this was a short-term policy response and had not precluded a subsequent euro area membership for Finland) and of restoring monetary policy credibility (by adopting inflation targeting). He moreover underlined that during the Nordic crisis, a clear fiscal strategy and gradual consolidation had been vital elements in crisis resolution. Growth had been restored by focusing on labor productivity growth and investment in education, research and development, and industrial restructuring (entailing the move toward information and communications technologies in the case of Finland).

Werner Röger, head of unit at DG ECFIN *(European Commission),* drew attention to Eastern Europe's substantial convergence with Eastern and Western Europe. He also stressed the importance of total factor productivity growth. The crisis will, however, result in lastingly lower levels of productivity growth and reduced investment-to-GDP ratios, thus slowing down future convergence. By contrast, lower EU-15 growth as a result of the crisis will partially offset this effect in the medium to longer term. Thus, Röger presented a rather positive outlook for the region's catching-up prospects, also based on relatively optimistic assumptions with respect to future investment ratios.

Dariusz Rosati, professor at the *Warsaw School of Economics,* analyzed an "integration growth model (IGM)" that allowed for successful catching-up in the CESEE region. This model was characterized by institutional harmonization and convergence, by an internationalization of production and trade integration and, finally, also by international financial integration of EU Member States in Eastern and Western Europe. As an implication of these integration steps, risk premia in CESEE had fallen sharply and facilitated strong inflows of foreign capital. The latter had financed a rapid expansion of domestic credit and had made possible large and growing current account deficits, together with a real appreciation of the

domestic currencies. Thus, large imbalances and vulnerabilities had followed, in particular because capital inflows had often been biased toward the nontradable services sector, including real estate. Domestic policies had not responded adequately in terms of banking regulation, structural reforms or exchange rate regimes. Given the new, less favorable external environment, Rosati expected recovery to be sluggish and catching-up to slow down. Nevertheless, he clearly advocated sustaining the integration growth model and supplementing it with well-conceived policies in terms of financial regulation, prudent banking supervision, increased labor market flexibility and fiscal reforms as well as the adoption of the euro as soon as practically possible in each single case. At the EU level, he saw a need for the completion of the single market in services, improved governance and guarantees also for non-euro area EU members. The ensuing discussion centered on the roles played by flexible and fixed exchange rates in terms of the vulnerability to a crisis and on the role of wage flexibility in connection with international price competitiveness.

Challenges for Monetary Policy in the CESEE Region

Against the background of a still fragile economic recovery and prospects of weaker and probably more volatile economic growth in CESEE after the crisis, the first panel discussion – chaired by *Peter Mooslechner,* Director of the Economic Analysis and Research Department of the *OeNB* – brought together high-level representatives from CESEE central banks and the IMF to discuss the related challenges for monetary policy in the region. The general conclusion of this panel appeared to be that appropriate structural and fiscal policy measures were crucial for the conduct of monetary policy. At the same time, the crisis had shown that central banks – in order to properly support macroeconomic stability – would have to augment their policy instruments and to integrate financial sector stability into their price stability focus.

Marek Belka, President of *Narodowy Bank Polski,* emphasized that Poland and other CESEE countries were currently facing the challenge of preserving macroeconomic stability against strong capital inflows resulting from highly expansionary monetary policy in advanced economies. The most important risk to financial system stability in Poland relates to foreign currency lending to households; however, this type of lending has almost disappeared since the crisis, which reduces the future vulnerability of the Polish economy. Furthermore, he noted that the policy of flexible exchange rates had contributed to the generally good growth performance of Poland in the last two years, although he acknowledged that the eventual adoption of the euro remained the objective of Polish monetary policy.

Júlia Király, Deputy Governor of *Magyar Nemzeti Bank,* stressed that the crisis had prompted a reconsideration of international financial markets' risk attitude with regard to debt financing and external imbalances. In the post-crisis environment, it is an important task to develop local currency capital markets in CESEE so as to reduce the dependence on external financing sources. Király said that she was in favor of flexible inflation targeting as a monetary strategy that avoided reacting to excessive risk premium volatility with interest rate policy steps but, at the same time, also incorporated macroprudential policies to enhance systemic resilience and leaning against the financial cycle. A proper cross-border coordination of macroprudential measures is crucial in this respect.

Cristian Popa, Deputy Governor of *Banca Naţională a României,* noted that flexible inflation targeting had not prevented the build-up of external imbalances and that nominal appreciation had not been successful in containing soaring prices in the pre-crisis boom period. Popa also drew attention to a new role for central banks after the crisis, where financial sector stability would have a stronger weight in policy considerations (e.g. the provision of sufficient liquidity in the interbank market, which had not been an issue in CESEE before the crisis).

Boris Vujčić, Deputy Governor of *Hrvatska narodna banka,* found that price stability was currently an only minor issue for CESEE central banks (except for a certain probability that commodity and food prices might surge anew in the medium run), while the main focus of their attention was on sluggish credit growth and financial stability. Although Hrvatska narodna banka had relaxed its liquidity provisions for commercial banks to stimulate credit supply, credit growth in Croatia was still depressed, not least on account of a lack of demand for new loans, especially in the household sector. As regards financial sector stability, the crisis had brought about an increase in the indebtedness of the corporate sector, while it had had a favorable impact on the foreign currency exposure of banks in Croatia.

Leslie Lipschitz, Director of the *IMF Institute,* concluded that traditional monetary policy did not seem to be effective enough to avoid a resurgence of large capital inflows and external imbalances in CESEE – indeed, higher interest rates might simply exacerbate inflows. The armory required to curb renewed excesses must include serious microprudential, macroprudential and fiscal instruments, such as higher capital and liquidity requirements for banks to limit maturity transformation (especially in foreign currency) or limits on lending (or borrowing) in foreign currency to shift to domestic currency loans and hedge the exchange risk. Moreover, higher taxes on short-term real estate capital gains, transaction taxes on mortgage lending (e.g. for secondary residences) or on high loan-to-value loans might also be worth consideration.

The New Role of Growth Financing

Session 2, chaired by *Doris Ritzberger-Grünwald,* Head of the *OeNB's* Foreign Research Division, addressed the question as to whether the global financial crisis may have changed the modes of financing growth. The session brought together the views of researchers, central bankers and entrepreneurs. In the run-up to the crisis, growth in CESEE had mainly been financed by large capital inflows, which resulted in varying degrees of vulnerability. This raised concerns about the use of capital ("excessive" consumption, real estate boom) in CESEE. However, capital inflows, as well as internal and external demand, had fallen substantially during the financial crisis, which in turn raised the question as to whether we were witnessing a possible structural decline in capital inflows and, if so, what would be its long-term growth impact.

Against the background of tighter refinancing conditions, households' continued deleveraging and downside risks to internal and external demand, *Joachim Nagel,* Head of the Markets Department at the *Deutsche Bundesbank,* proposed that a more reliable model for financing sustainable future growth in CESEE be developed. This model would imply a slower but more sustainable financial deepening, as well as an enhancement of macrofinancial resilience. The main challenge was to

strengthen internal sources of growth financing, i.e. to rely more strongly on local refinancing through domestic savings and local capital markets. Furthermore, the dependency of CESEE economies on portfolio and credit flows should be reduced by way of strengthening FDI flows. Finally, the mitigation of financial risk also required a reduction of the incentives for unhedged households to take on foreign currency loans.

Reiner Martin (ECB) and *Jarko Fidrmuc (OeNB)* looked at the interlinkages between capital flows, exports and industrial production. The main question addressed was whether the long-term growth prospects of CESEE countries had deteriorated since the export boom and capital inflows had come to a sudden halt in the wake of the financial crisis. Their results showed that exports and the stock of FDI in the CESEE region were positively related to industrial production, and thus to economic growth. Output growth in Poland, Romania, Slovakia and Slovenia, in particular, had profited from exports and FDI. By contrast, portfolio investment was only weakly related to the industrial growth performance of CESEE countries. These findings implied, first, that the CESEE countries should make determined efforts to remain attractive locations for inward FDI and to enhance their export prospects, and, second, that the reduction of portfolio investment inflows appeared to be unproblematic from a long-term growth perspective.

Wolfgang Ruttenstorfer, Chief Executive Officer of *OMV,* a globally active Austrian energy company, concluded that the old story of boom and bust cycles also applied to CESEE. Macroeconomic imbalances and policy weaknesses had magnified the effects of the global financial crisis and had generated an urgent need for secure funding. The international support programs of the EU, IMF and World Bank, as well as the Vienna Initiative, had turned out to be vital for multinational enterprises like OMV to maintain their business in the CESEE region. Countries where growth had previously been driven mainly by consumption should develop a more sustainable growth path in the future by strengthening investment and capital-enhancing productivity growth. Furthermore, the public sector is called upon to enforce the build-up of the infrastructure necessary for a modern economy, to support the development of domestic capital markets, to reform legal systems and to implement better public governance and efficient administrative procedures.

Marko Voljc, Chief Executive Officer of *KBC,* a Belgian banking and insurance company that had expanded to the Visegrád countries and Bulgaria, found that the potential for the CESEE region remained intact, although the financial crisis had dampened global investors' risk appetite and put a drag on loan demand. KBC embraced the Vienna Initiative, which helped not only the CESEE economies, but also the banking and insurance sectors to weather the storm. In the future, the CESEE region will still be able to attract external capital, owing to good fundamentals and an, in parts, strong recovery. However, emerging economies' competition for capital has increased, and an attractive business environment will be a key determinant of capital inflows. But the use of capital, too, will be scrutinized more closely than before the crisis. Sustainable growth would imply a (re)direction of capital inflows to productive ends, in particular toward export-generating activities, but also sound public finances. Finally, increasing reliance on domestic funding would support these goals.

The New Role of Exports

Session 3 was chaired by *Doris Ritzberger-Grünwald,* Head of the *OeNB's* Foreign Research Division. It involved a discussion of the new role of trade and firms in the changing post-crisis economic and fiscal framework. Three academic contributions discussed various processes of adjustment at the industry or firm level.

Jože Damijan, professor of International Economics at the *University of Ljubljana,* opened the session by presenting a paper on firms' trade patterns. By exploring a dataset of Slovenian exporting firms in the period from 1994 to 2003, he showed that the pattern of exporting activities tended to be determined by uncertainty and financial constraints. Moreover, export intensity was a nonlinear function of access to finance and a firm's size. In addition, firms' financial factors, such as their equity, return on assets, access to bank finance and to internal credit markets, played a more important role in export expansion than firm productivity. The paper's policy implications included the establishment and maintenance of a sound financial system as well as a different perspective on export promotion policies.

Professor *Joseph Francois* from *Johannes Kepler University Linz* and *Julia Wörz (OeNB)* proceeded by presenting a paper on the link between trade growth and its sector composition in the period from 1995 to 2007. In their paper, they challenged the widespread assumption that income elasticity was related to trade intensity and concluded that changes in income could be mapped into changes in the industrial and country composition of trade. As a consequence, an alternative explanation of the rise and fall of trade was offered, whereby changes in the composition of trade itself (i.e. countries moving into trade-intensive sectors) tended to be more important than the nature of trade and production (i.e. global supply chains). The results for the CESEE countries confirmed a considerable structural change in the region, with an all in all positive effect on their export performance. In particular, industries in the new EU Member States showed a successful restructuring toward rapidly growing industries. Consequently, domestic restructuring remained important for the CESEE countries as global trade patterns were partly moving away from CESEE's current specialization.

The third presentation in this session was by *László Halpern* from the Institute of Economics at the *Hungarian Academy of Sciences.* He elaborated on the collapse of trade in the wake of the crisis and on firms in selected EU countries. The main result of his presentation was that countries revealed heterogeneous profiles when the effect of the crisis is analyzed. Furthermore, he presented evidence based on the European Firms in a Global Economy (EFIGE) firm-level database, showing that the response of firms to the crisis differed, depending on their size and export behavior. Hence, the main conclusion was that a sustainable recovery required both restructuring on the basis of more research and innovation and policies aimed at synchronized labor market adjustment in the EU.

Monetary Policy and Financial Stability

In his keynote lecture, *Stephen Cecchetti,* Economic Advisor and Head of the Monetary and Economic Department of the *BIS,* compared monetary conditions in Central and Eastern Europe (CEE) to those in other emerging market areas. He revealed striking differences in some financial market segments. Since the collapse of Lehman Brothers, capital inflows into Latin America and Asia had rebounded

and cross-border bank lending had risen. Net inflows of capital into the CEE region, by contrast, were still only moderate and the period of negative cross-border lending was just coming to an end. Moreover, while foreign loans outstanding in Asia and Latin America had again almost reached their pre-crisis peaks, the exposure of banks in advanced economies to CEE was still far from pre-crisis levels. Cecchetti highlighted several policy challenges associated with soaring capital inflows: Equity price rallies leading to the build-up of bubbles, the surge in foreign investors' ownership of local bonds and falling bond yields despite policy rate hikes had to be considered the most demanding policy tasks in the near future. With respect to the CEE region, Cecchetti noted that new regulatory reforms could curb the credit supply. Furthermore, in a banking system based on foreign-owned banks, there would always remain concerns about changes in the policy and/or lending strategy of the respective parent bank. Professor Cecchetti concluded that monetary policy was currently in transition and that this phase was especially prone to the risk of making errors. Since the CEE region was destined to grow faster than the euro area, a re-emergence of capital inflows could be expected. While some of these inflows could be channeled to the public sector, it was important to bear in mind that this would expose the private sector to the risk of crowding-out and that it would moreover weaken incentives for fiscal consolidation. The main challenges ahead were thus related to catching-up, namely a possible surge in capital inflows and asset prices. Existing policy frameworks had performed relatively well in the recent crisis. Consequently, there was no need to make rigorous changes to the existing framework. On the contrary, it was important to resist spillovers from the policies of other emerging markets. In particular, policymakers should continue to let exchange rates adjust freely, avoid capital controls as well as interventions regarding credit allocation and refrain from returning to financial repression.

The Catching-Up Experience of the Western Balkans

Session 4 of the CEEI 2010 was chaired by *OeNB* Governor *Ewald Nowotny* and dealt with the catching-up experience of the Western Balkan region.

To begin with, the first speaker, *Vladimir Gligorov,* senior economist at the *Vienna Institute for International Economic Studies,* outlined the stylized facts of a neoclassical growth path, which had been cut short by the global crisis in the case of the Western Balkan region. In this context, he warned that increased risks might now become a permanent feature, which would mean that neoclassical growth would lead to stagnation. Thus, the dilemma, in his view, was whether to work on the reduction of risks (and to stick to the neoclassical growth model) or to change the growth paradigm. In conclusion, Gligorov stressed the urgent need for structural reforms in the Western Balkans, which would, however, imply a slow recovery over the medium term and would also be subject to social and political risks.

The second speaker, *Boštjan Jazbec,* IMF Senior Advisor to the Governor of the *Central Bank of the Republic of Kosovo,* first highlighted the main stages of a textbook transition process, ranging from macroeconomic stabilization, price liberalization, trade liberalization, current account convertibility and privatization to the development of an institutional and legal framework. He stressed that, with a few exceptions, the institutional aspects were greatly overlooked during transition. In

this context, Jazbec raised the question as to whether the transition process should actually start with institution building, as the creation of basic market institutions took time. In the Western Balkans in particular, the institutional setting needed to be improved, given poorly defined property rights, a weak rule of law, inefficient judicial systems and fragile legal frameworks – all factors that hamper foreign investment inflows into the region. However, unlocking the region's growth potential also called for better education, more strategic infrastructure investment, the supportive role of the EU institutional framework and a learning-by-doing approach, instead of dependence on international aid and investment.

Finally, *Michael Loufir,* Head of Emerging Markets Research at the *National Bank of Greece,* underlined that before the crisis, the Western Balkan countries Serbia, FYR Macedonia and Albania had experienced a slower catching-up process that had started from a lower level than that of the EU members Bulgaria and Romania. Turning to developments since the onset of the global crisis, Loufir showed that the Western Balkan countries had been more resilient to the crisis than the EU Member States mentioned earlier. Finally, he emphasized the region's future potential, given the still low level of economic development, competitiveness (low wages and tax rates) and the prospects for EU membership, but also underscored the importance of accelerating institutional, structural and economic reforms for purposes of enhancing the convergence process.

A Political Scientist's View on Crisis Management

Wolfgang F. Danspeckgruber, founding director of the Liechtenstein Institute on Self-Determination and professor at *Princeton University,* delivered a dinner speech. From a political scientist's perspective on crisis and crisis management, he provided a panoramic view of the contemporary geostrategic landscape. Danspeckgruber maintained that, in the post-bipolar world, cost-benefit calculations of individual actors had replaced the relatively stable strategic alliances of the Cold War period. As a consequence, different actors might have diverging perceptions of crises and their potential impact. Given its global geostrategic role, the U.S.A. was finding itself in a more severe crisis caused by its overstretched defense budget, as Danspeckgruber pointed out. This made a potential transatlantic trade bloc encompassing the EU and North America – a strategic alliance that would comprise roughly 800 million inhabitants – a desirable option. This held even more true as China and India were proving to be increasingly important global actors, which would, as Danspeckgruber anticipated, be of rising significance also in the CESEE region. Finally, he advocated the accession of Turkey to the EU from both a global geostrategic and a regional economic perspective. Europe would be likely to benefit from the dynamism of the Turkish economy and an enriched cultural background.

Central Banking for the 21st Century: An American Perspective

The second conference day began with a keynote lecture by Professor *Paul A. Wachtel* (Stern School of Business, *New York University),* who started out with a discussion of the evolution of modern central banking. He traced the concept of central banks back to the 17th and 18th centuries, pointing out that modern central banking – with central banks performing the main role of acting as a lender of last resort – dated back to the 19th century. In 1907, when the FED was established, its

founders had already considered other roles for a central bank that went beyond panic avoidance and lender of last resort functions. After the post-war period with its emphasis on Keynesian thinking and the role of fiscal policy in macroeconomic policy, monetary policy had gained importance, in particular after the inflationary episodes of the 1970s. Overall, at the end of the 20th century, the key word had been central bank independence. According to this notion, a central bank was mainly responsible for monetary control. Other functions only played a minor role. The recent financial crisis had changed the views about central banking, bringing prudential and regulatory issues to the forefront. Wachtel drew attention to the various functions of central banks in the post-crisis world. The first function comprises monetary policy. Experience has shown that independent central banks achieve lower and less volatile inflation rates than those subject to government control. The second task is the supervision and regulation of individual financial institutions. In this respect, functioning as the lender of last resort plays a central role. In some countries, however, other governmental agencies are in charge of supervision and regulation, and in the case of the ECB, banking supervision is decentralized, taking place at the national level. Finally, a major responsibility is the regulation of systemic risk. The notion of central banks performing an explicit regulatory function with regard to systemic risk is new. The main aspects of a systemic risk regulator are the need to augment the oversight and supervision of large and interconnected institutions, the ability to address systemic problems that arise from smaller institutions and the need to have the authority over shadow banking. Wachtel concluded that the role of the central banks had possibly broadened after the global financial crisis. In addition, it was likely that central banks had become more political than they were before the crisis.

The New Role of Financial Integration

Session 5 was chaired by *OeNB* Governor *Ewald Nowotny* and dealt with the highly topical question of what role financial integration will play in a post-crisis setting.

Ignazio Angeloni, Advisor to the Executive Board of the *ECB,* gave an overview of various important aspects of financial integration. First, he noted that the traditional arguments in favor of financial integration (market efficiency, lower cost of capital, smooth transmission of monetary policy) were still valid today. More recently, however, the links between financial integration and financial stability had become more important. For instance, financial integration could increase market volatility by facilitating contagion across institutions and markets. Moreover, there were risks stemming from an underregulated financial sector and from a mix of banking and securitization. Angeloni also illustrated that the crisis had had disruptive effects on financial integration, which differed across financial market segments, however. Looking forward, he highlighted the powerful link between sovereign risk and financial sector risks. Government bonds played a central role in the collateralization process and, in addition, governments were the ultimate regulators and guarantors of the financial system. He concluded that a reform of euro area rules of governance was also critical for restoring financial integration.

The next speaker, *Christa Hainz* from the *Ifo Institute for Economic Research* in Munich, presented a paper analyzing firms' access to loans as well as their actual need for loans. Hainz stressed that access to loans was a major determinant of

economic growth. However, owing to a lack of data, firms' use of loans was often taken as a proxy for their access to loans in academic research. In the paper, the authors developed a direct measure for access to finance, using data from the 2005 Business Environment and Enterprise Performance Survey to determine whether a firm without a loan was indeed credit-constrained or whether it did not have demand for financing. The paper came to the conclusion that analyzing information on the use of finance was not sufficient to identify financially constrained firms. Therefore, from a policy perspective, information about the use of loans was not enough to identify the types of firms that should be supported.

The third presentation in this session was delivered by *Andrzej Stopczyński,* Director of the *Polish Financial Supervision Authority.* He discussed the need for an enhanced role of local supervisors and shareholders' oversight. Stopczyński pointed out that the supervisors' primary task was to assure the long-term stability of the banking system. In this respect, it is not enough to focus on current capital adequacy ratios and liquidity measures. In his view, the recent experiences of many countries illustrated that banking supervision should shield economies against the risk of boom-bust cycles. Inter alia, Stopczyński underscored the importance of financing credit growth through domestic savings. Currently, one of the key issues is how to motivate banks to avoid unstable booms in consumer and mortgage lending. Stopczyński concluded that local supervisors should have effective tools at their disposal to avert local lending booms.

Challenges for Banking in the CESEE Region

The second and final panel discussion of the CEEI 2010 was chaired by *Andreas Ittner,* Executive Director of Financial Stability, Banking Supervision and Statistics at the *OeNB,* and focused on "Challenges for Banking in the CESEE Region."

Piroska Nagy, EBRD Director for Country Policy and Strategy, pointed out that, for CESEE countries in their current situation of fragile recovery, strengthening competitiveness was a major point. She stressed that it was now time for banks to clean up their balance sheets before the revitalization of lending and any economic recovery could really gain momentum. To stabilize and broaden the base of financial development in CESEE, the Vienna Initiative will help focus on the establishment of local currency capital markets, in which banks should participate.

Michael Hysek, Head of the Banking Supervision Department of the *Austrian Financial Market Authority,* familiarized the audience with the significant changes that banks would soon face in the legal and supervisory frameworks. These changes will comprise better risk capture (including securitization), more stringent capital requirements, the limitation of leverage, higher liquidity standards, more intensive (where necessary, intrusive) supervision, a strengthening of cross-border supervisory cooperation and other modifications.

María Teresa Fábregas Fernández, Deputy Head of Unit in the *European Commission,* outlined a number of Commission proposals for legal and regulatory adjustments in favor of a safer, sounder and more transparent future financial sector. She also discussed possible reforms of rules regulating rating agencies.

Swedbank's crisis-triggered woes in the Baltic countries were described briefly by *Håkan Berg,* Head of Baltic Banking in this large Swedish credit institution. While Swedbank had, for a period, needed government guarantees to borrow, it

had aggressively restructured nonperforming corporate debtors in the Baltics, and in the second quarter of 2010, the bank's Baltic operations had turned profitable again.

Andreas Treichl, Chief Executive Officer of *Erste Bank Group,* stressed a particular issue that he perceived as problematic, namely the apparent lack of clarity about whether regulators actually wanted banks active in CESEE to go back to basics and emphasize bank lending financed through deposits or whether they wanted them to spread their activities to possibly risky undertakings in local capital – particularly bond – markets. He added that Erste Group would continue to dedicate itself to lending as a driving force of growth in the region.

Executive Director *Ittner* wrapped up the session by underlining that banks remained pivotal for supporting the real economy and that, therefore, cross-border banking – and probably also, to some degree, capital markets – would still be necessary for future growth in the CESEE region. However, cross-border supervisory cooperation would be indispensible for achieving and maintaining financial stability.

In addition to the official debates, the two conference days provided welcome room for informal discussions and networking between central bankers, government officials, financial sector managers, researchers and journalists. Both the media coverage and positive feedback from participants confirmed the CEEI's status as one of the leading forums for discussions of economic and monetary integration in CESEE.

Olga Radzyner Award Winners 2010

2010 marks the 11th year that the OeNB bestowed its Olga Radzyner Award on young economists from Central, Eastern and Southeastern Europe (CESEE) for excellent scientific work on European economic integration. This award commemorates Olga Radzyner, the former head of the OeNB's Foreign Research Division, who died in a tragic accident in August 1999.

Interest in the award has been rising continually over the years. In 2010, economists from 11 countries submitted 18 papers, a great number of which was of outstanding quality. The many different aspects of European economic integration covered in the contributions ranged from FDI and trade integration, financial and stock market integration, price convergence and monetary transmission channels to the international fragmentation of production.

Out of the pool of promising young CESEE economists participating in the award, a panel of OeNB reviewers selected four winners, whose papers were considered outstanding in terms of originality, overall presentation of the research question and analysis, and the use of state-of-the-art methods. On November 15, 2010, at the OeNB's Conference on European Economic Integration (CEEI), Governor Ewald Nowotny conferred this year's award upon[1]:

- *Bejtush Kiçmari* (Kosovo), statistician at the Central Bank of the Republic of Kosovo, for his thesis on the determinants of FDI inflows in six Southeastern European (SEE) countries from 2000 to 2006. Kiçmari finds that FDI inflows in SEE are mainly determined by market size, trade openness, the privatization of state-owned enterprises, market potential and macroeconomic stability.
- *Katarína Lukácsy* (Slovakia), PhD student at the Central European University in Budapest, for her paper in which she applied an innovative methodology to examine whether the size and frequency of price changes in different CPI components in Slovakia were affected by EU accession. Lukácsy shows that after EU accession, (1) the size of price increases declined, (2) the frequency of price changes rose in all sectors but services, and (3) the Slovak economy responded to monetary shocks faster and stabilized sooner than before EU accession.
- *Marjan Petreski* (FYR Macedonia), PhD student at Staffordshire University, U.K., and assistant lecturer at the University American College in Skopje, for his paper in which he examined in an elaborated manner how monetary policy responses changed under a regime switch from exchange rate targeting to inflation targeting in emerging market economies. Petreski concludes that the period of inflation targeting was characterized by a more stable economic environment and by greater independence in the conduct of monetary policy.
- *Anna Watson* (Poland), PhD student at the University of Cambridge, Corpus Christi College, U.K., for her paper in which she augmented a New-Keynesian Dynamic Stochastic General Equilibrium (DSGE) model to study the impact of trade integration and competition on real and nominal price rigidities in Europe. Watson's results imply a decline in the degree of price stickiness in the EU with deepening integration, inflation rates reacting more sensitively to terms of trade changes, and more trade integration contributing to price convergence and a greater synchronization of inflation dynamics across Europe.

[1] *Winners in alphabetical order.*

IMF Regional Economic Outlook: Europe – Building Confidence

Compiled by
Christina Lerner

The IMF's recent Regional Economic Outlook (REO) for Europe was presented at the Oesterreichische Nationalbank (OeNB) on October 20, 2010. First, *Ajai Chopra,* Acting Director of the IMF's European Department outlined the main findings of this report[1]. Second, *Helge Berger,* Deputy Division Chief of the Euro Area and EU Policies Division of the IMF's European Department, focused on the outlook and policy issues for advanced European economies. Third, *Bas Bakker,* Division Chief of the Emerging Europe Regional Division of the IMF's European Department, presented prospects and issues for emerging European economies after the crisis. In the discussion that followed, economists from the OeNB and experts from various economic institutions and commercial banks exchanged their views.

The presentation was chaired by *Franz Nauschnigg,* Head of the OeNB's European Affairs and International Financial Organizations Division. In his opening remarks, Nauschnigg pointed out that the good international cooperation, especially with and between the IMF and the EU, had helped stabilize the markets in Central, Eastern and Southeastern Europe. As spreads and interest rates declined, this joint effort eventually prevented a meltdown.

After the deepest recession in the postwar period, Europe is now recovering, as was pointed out by Chopra: With the exception of Greece and Portugal, all European countries should post positive growth next year. While advanced Europe[2] is projected to expand by 1.7% in 2010 and 1.6% in 2011, emerging Europe[3] is forecast to grow by 3.9% in 2010 and 3.8% in 2011.

In his presentation on advanced European economies, Berger stated that, despite recent strength, the outlook remains moderate and uneven. This is mainly due to well-known structural rigidities in the labor, product and services markets, which will limit the euro area's growth potential. In addition, significant risks remain, with downside risks having even increased.

In view of these risks, it will be crucial to get the policies right: Monetary policy should remain supportive and must steer carefully between the need to normalize policies on the one hand, and to ensure bank liquidity on the other. Fiscal consolidation is inevitable, but should be undertaken in a way that minimizes the negative impact on growth. As regards the fiscal governance discussion, structural reforms are needed in order to support growth and reduce trade imbalances.

Furthermore, in order to sustain the upswing, the remaining banking weaknesses should be dealt with and the gaps in the "European House" should be closed in order to build confidence. As regards European supervision and macroprudential policies, significant progress has been achieved. Their cooperative implementation remains the crucial next step.

As regards emerging Europe, Bakker pointed out that the projected expansion of 3.9% in 2010 is mainly led by exports, while domestic demand remains subdued. The recovery is uneven across regions, with CIS countries and Turkey experiencing

[1] *See www.imf.org/external/pubs/ft/reo/2010/eur/eng/ereo1010.htm for the full report.*

[2] *Advanced Europe refers to the euro area countries and the Czech Republic, Denmark, Sweden, Norway, Switzerland, Iceland and Israel.*

[3] *Emerging Europe refers to Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Turkey and Ukraine.*

the strongest growth, and countries that had deep recessions the weakest growth. However, the near-term outlook is benign: all countries will grow in 2011. There are some upside risks, but there are significant downside risks for emerging Europe, which would be particularly harmful if they materialized. Hence, there is a strong need for suitable policies to sustain the recovery and minimize risks: Substantial fiscal consolidation is needed over the next five years, as fiscal positions have weakened. Although fiscal consolidation may hurt growth in the short term, market concerns about weak public finances could be even more damaging. In addition, private sector credit growth, which has been weak since the onset of the crisis, has to be revived in order to support the recovery. In this context, it seems very important to repair bank balance sheets, which will help alleviate supply constraints.

Bakker then elaborated on the question of why the slump in emerging Europe was so deep: The seeds for the crisis were planted in the five years leading up to the crisis by buoyant growth in domestic demand, which was led by credit booms, an overheating of the economy and the buildup of large imbalances and vulnerabilities. The credit booms, which were financed by large capital flows from Western European banks, fueled a domestic demand boom. But he also emphasized that it was not just private demand that grew rapidly, as buoyant fiscal revenues were likewise used to increase public expenditure. As a consequence, asset prices and inflation surged and vulnerabilities increased sharply. The crisis was triggered by the global financial turmoil in the aftermath of Lehman Brothers' collapse, which led to a sudden stop of capital inflows and to the collapse of global trade flows.

However, a meltdown was avoided with the help of decisive domestic policy, large-scale international financial support and the presence of Western European banks that did not reduce their exposure in the region during the crisis. In addition, countercyclical policy in Western Europe, such as policy rate cuts, liquidity provision from the Eurosystem and accommodating fiscal policy, contributed further to avoiding a final breakdown of the region. However, some countries were more affected than others: Countries that had the largest imbalances and the strongest credit booms have seen the deepest recessions, whereas countries that managed to avoid excesses have seen much shallower recessions or avoided them altogether.

Among the lessons to be learnt from the crisis are the insights that credit booms can be costly and that they are especially hard to stop under fixed exchange rate regimes. There is a strong need for a more active fiscal policy, as larger surpluses in boom years can be used to lean against overheating and to build buffers for countercyclical policies during a downturn.

Statistical Annex

Statistical Annex

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

Conventions used

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

Table 1

Gross Domestic Product

	2003	2004	2005	2006	2007	2008	2009
	Annual real change in %						
Albania	5.8	5.7	5.7	5.4	5.9	7.7	3.3
Bosnia and Herzegovina	3.8	6.3	3.9	6.1	6.2	5.7	–2.9
FYR Macedonia	2.8	4.1	4.1	4.0	6.1	5.0	–0.8
Serbia	2.4	8.3	5.6	5.2	6.9	5.5	–3.0
Montenegro	2.5	4.4	4.2	8.6	10.7	6.9	–5.7
Ukraine	9.6	12.1	2.7	7.3	7.9	2.3	–15.1

Source: wiiw.

Table 2

Industrial Production

	2003	2004	2005	2006	2007	2008	2009
	Annual real change in %						
Albania	29.0	14.1	11.7	12.1	–9.7	9.4	4.3
Bosnia and Herzegovina	5.1	12.1	10.8	11.5	6.4	11.0	–3.3
FYR Macedonia	4.1	–2.2	7.1	3.6	3.7	5.5	–7.7
Serbia	–3.0	7.1	0.8	4.7	3.7	1.1	1.1
Montenegro	2.4	13.8	–1.9	1.0	0.1	–2.0	–32.2
Ukraine	15.8	12.5	3.1	6.2	7.6	–5.2	–21.9

Source: wiiw.

Table 3

Average Gross Wages - Total Economy

	2003	2004	2005	2006	2007	2008	2009
	Annual change in %						
Albania	12.0	2.8	5.0	9.2	25.2	2.2	14.1
Bosnia and Herzegovina[1]	5.1	12.1	10.8	11.5	6.4	11.0	–3.3
FYR Macedonia	4.9	4.1	2.7	8.0	4.8	8.7	14.1
Serbia	25.3	23.7	24.1	24.4	22.0	17.9	–3.3
Montenegro	7.8	11.7	7.8	15.6	31.7	22.5	5.6
Ukraine	22.8	27.6	36.7	29.2	29.7	33.7	5.5

Source: wiiw.

[1] *Net wages.*

[1] *Former Yugoslav Republic of Macedonia.*

Table 4

Unemployment Rate

	2003	2004	2005	2006	2007	2008	2009
	%						
Albania[1]	15.0	14.4	14.1	13.8	12.9	12.7	13.9
Bosnia and Herzegovina[1]	41.9	43.2	44.1	44.1	42.5	40.6	42.4
FYR Macedonia[2]	36.7	37.2	37.3	36.0	34.9	33.8	32.2
Serbia[2]	14.6	18.5	20.8	20.9	18.1	13.6	16.1
Montenegro[2]	22.7	27.7	30.3	29.6	19.3	17.2	19.3
Ukraine[2]	9.1	8.6	7.2	6.8	6.4	6.4	8.8

Source: wiiw.

[1] Registered, end of period.
[2] Labor Force Survey, period average.

Table 5

Industrial Producer Price Index

	2003	2004	2005	2006	2007	2008	2009
	Period average, annual change in %						
Albania[1]	8.7	12.2	4.9	0.8	3.5	6.5	–1.6
Bosnia and Herzegovina[2]	–0.1	2.3	–0.6	3.4	4.6	6.9	–3.1
FYR Macedonia	–0.3	0.9	3.2	7.3	2.5	10.3	–6.5
Serbia	4.6	9.1	14.2	13.3	5.9	12.4	5.6
Montenegro	4.5	5.8	2.1	3.6	8.5	14.0	–3.9
Ukraine	7.6	20.5	16.7	9.6	19.5	35.5	6.5

Source: wiiw, national sources.

[1] Manufacturing industry.
[2] Federation of Bosnia and Herzegovina.

Table 6

Consumer Price Index

	2003	2004	2005	2006	2007	2008	2009
	Period average, annual change in %						
Albania	2.4	2.9	2.4	2.4	2.9	3.4	2.2
Bosnia and Herzegovina	1.1	0.8	3.0	6.2	1.5	7.5	–0.4
FYR Macedonia	1.2	–0.4	0.5	3.2	2.3	8.3	–0.8
Serbia	9.9	11.4	16.2	11.7	7.0	13.5	8.6
Montenegro	6.7	2.4	2.3	3.0	4.2	7.4	3.4
Ukraine	5.2	9.0	13.5	9.1	12.8	25.2	15.9

Source: wiiw.

Table 7

Trade Balance

	2003	2004	2005	2006	2007	2008	2009
	% of annual GDP						
Albania	–23.3	–21.7	–22.5	–23.1	–26.9	–27.4	–26.6
Bosnia and Herzegovina	–49.5	–45.6	–45.2	–34.6	–37.2	–38.2	–27.8
FYR Macedonia	–18.3	–21.1	–18.4	–19.7	–19.8	–26.1	–23.0
Serbia	–20.4	–27.3	–21.1	–21.4	–23.1	–22.6	–15.2
Montenegro	–23.8	–24.9	–28.3	–39.5	–58.7	–67.5	–46.0
Ukraine	–8.6	5.8	–1.3	–4.8	–7.4	–8.9	–3.7

Source: wiiw.

Table 8

Current Account Balance

	2003	2004	2005	2006	2007	2008	2009
	% of annual GDP						
Albania	–6.9	–5.8	–9.0	–6.6	–10.6	–15.5	–15.5
Bosnia and Herzegovina	–19.4	–16.3	–17.1	–8.0	–10.7	–14.4	–6.8
FYR Macedonia	–4.1	–8.4	–2.6	–0.5	–7.1	–12.7	–7.2
Serbia	–7.8	–13.8	–8.8	–10.1	–16.0	–18.2	–5.5
Montenegro	–6.8	–7.2	–8.5	–24.7	–39.6	–50.7	–30.1
Ukraine	5.8	10.6	2.9	–1.5	–3.7	–7.1	–1.5

Source: wiiw.

Table 9

Net FDI Inflows

	2003	2004	2005	2006	2007	2008	2009
	% of annual GDP						
Albania	3.1	4.5	3.2	3.5	6.0	7.0	7.9
Bosnia and Herzegovina	4.6	7.0	5.6	6.2	13.5	5.0	1.5
FYR Macedonia	2.4	6.0	1.6	6.8	8.5	6.1	2.6
Serbia	6.9	4.1	6.2	14.3	6.3	5.5	4.4
Montenegro	2.6	3.0	21.0	21.7	20.8	17.9	30.6
Ukraine	2.8	2.6	8.7	5.3	6.5	5.5	4.0

Source: wiiw.

Table 10

Reserve Assets Excluding Gold

	2003	2004	2005	2006	2007	2008	2009
	End of period, % of annual GDP						
Albania	15.6	16.7	17.9	18.5	18.1	18.4	18.8
Bosnia and Herzegovina	19.3	22.0	24.7	28.3	30.8	25.5	25.6
FYR Macedonia	16.7	15.1	22.0	25.8	23.5	20.3	21.2
Serbia	15.9	15.9	23.5	38.0	32.8	23.8	32.7
Montenegro	1.8	2.0	3.4	8.0	9.7	7.0	5.8
Ukraine	12.1	13.4	23.2	19.3	20.8	17.8	21.2

Source: wiiw.

Table 11

Gross External Debt

	2003	2004	2005	2006	2007	2008	2009
	End of period, % of annual GDP						
Albania	22.0	20.8	20.9	20.2	18.5	29.6	38.2
Bosnia and Herzegovina[1]	27.7	25.5	25.3	21.1	18.2	17.2	21.8
FYR Macedonia	35.9	48.1	54.1	49.3	47.6	49.2	57.0
Serbia	62.7	54.4	64.3	63.9	61.8	65.2	72.5
Montenegro	30.6	29.3	28.3	23.5	17.2	15.6	23.5
Ukraine	42.9	43.1	48.5	48.2	52.2	58.6	85.6

Source: wiiw.

[1] Gross external public debt.

Table 12

General Government Balance

	2003	2004	2005	2006	2007	2008	2009
	% of GDP						
Albania	–4.9	–5.1	–3.5	–3.3	–3.5	–5.5	–6.8
Bosnia and Herzegovina	0.7	1.6	2.4	2.9	1.3	–2.0	–3.0
FYR Macedonia	–1.1	0.0	0.3	–0.5	0.6	–1.0	–2.8
Serbia	–1.1	0.9	1.0	–1.6	–1.9	–2.6	–4.1
Montenegro	–3.1	–2.0	–1.7	1.6	6.7	0.5	–2.3
Ukraine	–0.2	–3.2	–1.8	–0.7	–1.1	–1.5	–4.1

Source: wiiw.

Table 13

Gross General Government Debt

	2003	2004	2005	2006	2007	2008	2009
	% of annual GDP						
Albania	60.7	57.7	58.1	56.0	52.8	52.6	55.0
Bosnia and Herzegovina	30.2	25.5	25.6	22.0	29.8	30.8	33.4
FYR Macedonia	45.0	42.6	46.9	39.9	33.3	28.7	32.0
Serbia	64.3	50.7	50.5	37.3	29.8	27.9	32.6
Montenegro	47.1	44.5	38.6	32.6	26.3	26.8	38.0
Ukraine	29.3	24.7	17.7	14.8	12.3	20.0	33.0

Source: wiiw.

Table 14

Broad Money

	2003	2004	2005	2006	2007	2008	2009
	End of period, annual nominal change in %						
Albania (M2)	7.6	8.2	11.7	7.6	9.8	7.4	8.7
Bosnia and Herzegovina (M2)	4.8	21.0	17.6	21.1	25.1	13.6	–1.2
FYR Macedonia	16.0	17.0	15.0	25.0	29.3	11.2	6.0
Serbia (M3)	29.1	31.2	39.1	37.4	41.1	29.6	11.5
Montenegro (M21)	–0.3	10.6	58.7	82.9	71.9	–14.3	. .
Ukraine	46.5	32.4	54.3	34.5	51.7	30.2	–5.5

Source: European Commission, wiiw.

Table 15

Official Key Interest Rate

	2003	2004	2005	2006	2007	2008	2009
	End of period, %						
Albania (refinancing base rate)	6.5	5.3	5.0	5.5	6.3	6.3	5.3
Bosnia and Herzegovina[1]	×	×	×	×	×	×	×
FYR Macedonia[2]	6.2	10.0	8.5	5.7	4.8	7.0	8.5
Serbia (two-week repo rate)[3]	10.6	16.4	19.2	14.0	10.0	17.8	9.5
Montenegro[4]	×	×	×	×	×	×	×
Ukraine (refinancing rate)[5]	7.0	9.0	9.5	8.5	8.0	12.0	10.3

Source: Eurostat, Bloomberg, wiiw, IMF.

[1] *Currency board.*
[2] *Monthly weighted average interest rate on Central Bank Bills auctions (28 days).*
[3] *2002–2005: Weighted average interest rates on securities used in open market operations by Narodna banka Srbije.*
[4] *Unilateral euroization.*
[5] *Average.*

Table 16

Exchange Rate

	2003	2004	2005	2006	2007	2008	2009
	Period average, national currency per EUR						
Albania	137.51	127.67	124.19	123.08	123.63	122.80	132.06
Bosnia and Herzegovina	1.96	1.96	1.96	1.96	1.96	1.96	1.96
FYR Macedonia	61.26	61.34	61.30	61.19	61.18	61.27	61.32
Serbia	65.05	72.57	82.91	84.19	79.98	81.47	93.92
Montenegro	×	×	×	×	×	×	×
Ukraine	6.02	6.61	6.39	6.34	6.92	7.71	10.87

Source: wiiw, national sources, Thomson Reuters.

Notes

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