Developments in Selected Countries[1, 2]

1 Introduction

Robust economic growth across the region; rising inflationary pressure and striking external imbalances in some countries

Economic performance remained dynamic in Central, Eastern and Southeastern Europe (CESEE)[3] in the first half of 2007. Economic growth generally gained further momentum in the first half of 2007, increasing the growth differential of the group comprising the Czech Republic, Hungary, Poland, Slovakia and Slovenia to the euro area to 3.3 percentage points despite the good growth performance of the single currency area. The European Commission recently even revised upward its forecast for 2007 for most of the above-mentioned EU Member States. In fact, growth may have peaked in the countries covered in this report. Bottlenecks on the supply side, fiscal consolidation intentions and possibly lower FDI inflows are some reasons why economic growth is generally expected to slow down somewhat in the coming years. Overall, the region was not unaffected by the worldwide increase in inflationary pressure in recent months. Apart from unfavorable developments of world market prices for energy and food, dynamic domestic demand and, in some countries, wage pressures pushed up price levels as well. In particular, the EU newcomers Bulgaria and Romania have to cope with high and growing external imbalances. With inflation picking up and external disequilibria increasing, it appears that at least some countries are entering a period of new economic challenges.

The first half of 2007 continues with dynamic economic expansion

The first half of 2007 in the CESEE Member States covered in this report was mostly characterized by dynamic economic performance, with real GDP growth rates ranging between approximately 6% and 9%, far above euro area growth (2.9% year on year). Only Hungary's growth performance was significantly lower for specific reasons.

Domestic demand becomes an even bigger contributor to growth

As in 2006, domestic demand was in general the main contributor to economic growth in the CESEE Member States in the first half of 2007, whereas the growth of gross fixed capital formation (GFCF) outpaced that of private consumption. Poland, Slovenia, Bulgaria as well as Romania even registered GFCF growth rates of close to or above 20% year on year. Growth in the construction sector, driven by the building-up of new production capacities and by infrastructure projects, was to a considerable extent responsible for these dynamic investment activities.[4] As in the last reporting period, domestic demand was again strongly supported by rising real wages, continued robust or even increasing real credit growth, improvements on most labor markets and partly by high FDI inflows. It is noteworthy that stocks in the Czech Republic, Hungary and Romania contributed more than 2 percentage

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[2] *Cut-off date: November 9, 2007. This report focuses on data releases and developments from end-April 2007 up to the cut-off date.*

[3] *One set of countries covered in this report – Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia – is made up of Central, Eastern, and Southeastern European (CESEE) EU Member States, and is referred to as CESEE Member States throughout the report. The second set of countries comprises Croatia and Turkey (referred to as candidate countries), as well as Russia.*

[4] *In these countries real growth in the construction sector was around 30% in the first half of 2007.*

Table 1

Gross Domestic Product (Real)

Annual change in %

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
Slovenia	4.4	4.0	5.2	5.0	4.7	5.6	5.5	7.2	5.9
Bulgaria	6.6	6.2	6.1	5.5	6.4	6.7	5.7	6.2	6.6
Czech Republic	4.6	6.5	6.4	6.6	6.5	6.3	6.1	6.4	6.0
Hungary	4.8	4.1	3.9	4.9	3.7	3.9	3.3	2.7	1.2
Poland	5.3	3.5	5.8	5.2	5.5	5.8	6.4	6.9	6.8
Romania	8.5	4.2	7.7	6.9	7.8	8.3	7.7	6.0	5.6
Slovakia	5.4	6.0	8.3	6.7	6.7	9.8	9.6	9.0	9.4
Croatia	4.3	4.3	4.8	6.0	3.6	4.7	4.8	7.0	6.6
Turkey	8.9	7.4	6.1	6.7	8.3	4.8	5.2	6.9	3.9
Russia	7.1	6.4	6.7	5.0	7.0	6.8	7.7	7.9	7.8

Source: Eurostat, national statistical offices, wiiw.

points to GDP growth in the first half of 2007. In the two EU candidate countries[5] Croatia and Turkey as well as in Russia, domestic demand also remained the main economic driver. However, private consumption declined significantly in Turkey, as did GFCF growth, developments which were related to a restrictive monetary policy.

Weaker import growth in the euro area – weaker export growth in the CEE neighboring countries

A large share of the CESEE Member States' exports of goods and services go to the euro area. Obviously, the weakening of import growth in the euro area in the first half of 2007 compared to 2006 negatively affected the export growth of euro area trading partners: Most of the countries faced a slowdown of their export growth rates.[6] Additionally, in most cases the growth of imports decelerated or accelerated less than the growth of exports. These developments resulted in a further increase of the negative contribution of net exports to GDP growth overall.[7] In Croatia (almost balanced contribution) and Turkey (positive contribution), the outcome improved compared to 2006 due to higher export growth rates combined with more moderate import growth. In Russia, however, higher import growth rates (above 25% year on year in the first half of 2007) along with lower export growth resulted in a more negative outcome in 2007.

Inflation mostly on the rise

Most CESEE Member States faced stronger inflationary pressure in the second and third quarters of 2007. Over this period, inflation rates only declined in Hungary, admittedly from a high level, and in Slovakia. Especially in September 2007, prices picked up. Bulgaria and Romania saw the strongest increase with rates (year on year) hitting above 10% and 6%, respectively. For comparison, inflation accelerated in the euro area as well, quickening from 1.7% in August 2007 to 2.1% in September 2007 (both year on year). Like in most CESEE Member States, inflation picked up in Croatia and Russia, whereas Turkey's disinflation process continued.

5 *While the Republic of Macedonia is also an EU candidate country, it is not covered in this report.*

6 *Only Slovenia registered higher export growth rates in the first half of 2007 compared to 2006.*

7 *The contribution of net exports to GDP growth was positive in the first half of 2007 only in Hungary and Slovakia. In Slovakia, moreover, the contribution grew further compared to 2006.*

Table 2

Consumer Price Index (here: HICP)

Annual change in %

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007
Slovenia	3.7	2.5	2.5	2.3	3.1	2.5	2.3	2.6	3.2	3.7
Bulgaria	6.1	6.0	7.4	8.7	8.6	6.7	5.7	5.3	4.7	9.0
Czech Republic	2.6	1.6	2.1	2.4	2.5	2.4	1.1	1.7	2.6	2.7
Hungary	6.8	3.5	4.0	2.4	2.7	4.6	6.4	8.8	8.5	7.3
Poland	3.6	2.2	1.3	0.9	1.4	1.5	1.3	2.0	2.3	2.4
Romania	11.9	9.1	6.6	8.7	7.2	5.9	4.8	3.9	3.9	5.1
Slovakia	7.5	2.8	4.3	4.2	4.6	4.8	3.5	2.1	1.7	1.4
Croatia [1]	2.1	3.4	3.2	3.5	3.8	3.2	2.2	1.5	2.1	2.9
Turkey	10.1	8.1	9.3	7.6	9.2	10.6	9.7	10.3	9.5	7.1
Russia [1]	11.0	12.5	9.8	10.8	9.6	9.6	9.2	7.9	8.1	..

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

What were the key factors behind these inflation developments? First, price movements were caused by exogenous factors, more specifically by upward movements of world market prices for energy and food. Second, developments related to the process of income convergence presumably had an impact on inflation (strong domestic demand as a result of dynamic wage growth and strong credit growth). Finally, more country-specific factors (such as tax changes) pushed up prices. By contrast, the nominal appreciation of the exchange rate helped curb price pressure in some countries.[8]

Higher food and energy prices key to rise in inflation

Apart from increasing prices for energy, higher food prices were the main factor leading to price hikes across the region, especially in the third quarter of 2007, but also in the euro area and other countries. According to the HWWI's Index of World Market Prices of Commodities, global food prices increased by around 30% year on year (in euro terms) in September 2007. Various arguments are put forward to explain world food prices; the most common one cites increasing world demand for specific food items (such as meat or dairy products).

Supply-side bottlenecks help labor markets and put upward pressure on wages

In addition to worldwide developments, dynamic growth in the economies of the region put further upward pressure on prices. More and more countries are confronted with the phenomenon of bottlenecks on the supply side, in particular on the labor market. Strong economic expansion as well as significant worker emigration gave rise to labor shortages in some sectors and countries, exerting upward pressure on wages.[9] In the first half of 2007, nominal wages in the industrial sector increased by between close to 6% (Slovenia) and more than 20% (Romania) year on year. In the CESEE Member States, wage hikes were (partially considerably) higher than in the same period a year earlier (see also below). Among the non-EU countries, Croatia and Turkey registered

[8] *For a more in-depth analysis of exchange rate movements, see box 1.*

[9] *However, the labor market has benefited from both developments. Unemployment rates declined in most countries of the region. The two countries with the highest unemployment rates, Poland and Slovakia, registered the largest improvements. Unemployment rates (ILO definition) fell by almost 5 and 3 percentage points, respectively, in the first half of 2007 compared to the same period of 2006, but Bulgaria's and Slovenia's unemployment rates declined substantially as well.*

lower industrial wage dynamics in the first half of 2007 compared to 2006, whereas Russia saw wages in the industrial sector increase by more than 25% year on year.

Rising levels of capital utilization in the industrial sector

Bottlenecks on the supply side were also reflected in high and rising levels of industrial capacity utilization. Most CESEE Member States reached capacity utilization levels of more than 80% on average in the first nine months of 2007, with the Czech Republic topping out at 88% and Slovenia and Hungary both registering around 85%. Overall, the level of capacity utilization was higher than in the corresponding period of 2006 in all countries. In Croatia and Turkey, (overly) high capacity utilization in industry did not seem to create problems, whereas Russia has already reached capacity constraints in some sectors, especially the energy sector.

Growth of credit to the private sector puts further pressure on prices

In most countries, stronger private consumption supported by dynamic real growth of credit to the private sector put further pressure on inflation as well. Real growth of credit to the private sector grew especially dynamically in Bulgaria and Romania (on average in the first half of 2007: around 35% and 45% year on year), but was also robust in the rest of the CESEE Member States (around 20% year on year). Only Hungary saw a low real growth rate (first half of 2007: on average 2.5%, year on year). In the remaining countries, Croatia and in particular Russia, real growth of private credit stayed strong in 2007, whereas in Turkey, it declined from around 40% (average of 2006) to an average of 15% in the first half of 2007 (year on year).

Some countries react to rising inflation pressure with monetary tightening

Largely on the back of rising inflationary pressure, Česká národní banka and Narodowy Bank Polski increased their main policy rates several times in the reporting period. Motivated by low inflation rates and the need to curb capital inflows in the first quarter of 2007, Banca Naţională a României (BNR) decreased its policy rate twice, most recently in June 2007. However, at the end of October 2007, the BNR raised its key policy rate by 50 basis points to counteract inflationary pressure and currency weakening. Furthermore, the Bulgarian National Bank increased reserve requirements to limit credit growth. In contrast, Magyar Nemzeti Bank, Hungary's central bank, lowered its key interest rate, as inflation pressure in the country eased. Among the non-EU Member States, Turkey lowered its policy rate from a relatively high level, also motivated by the continued disinflation process.

Combined current and capital accounts are negative across the region

The CESEE Member States show one common characteristic of their external balances: All countries register a deficit in the combined current and capital account balance, though with major differences in levels.[10] The deficit (weighted average) of the Czech Republic, Hungary, Poland, Slovakia as well as Slovenia was around 3.4% of GDP. Bulgaria and Romania posted deficits of more than 20% (Bulgaria) and 16% (Romania) of GDP, respectively, in the first half of 2007. The deficit in the first half of 2007 was lower than one year earlier in the Czech Republic, Hungary and especially in Slovakia, whereas it widened considerably in Slovenia (from –1% of GDP to –3.4% of GDP) as

[10] *Furthermore, the structure of the current account continues to differ substantially. In the Czech Republic, Hungary, Poland, Slovakia as well as in Slovenia, deficits are largely driven by the income balance (as a result of earlier FDI inflows that are now entailing reinvested earnings, profits and dividends). In Bulgaria and Romania, however, the deficits mainly originate from highly negative trade balances, as is the case in Croatia and Turkey.*

Table 3

Inflation: Assessment and Key Factors

	Assessment		Key Factors	
	Price stability	Inflation level	Inflation targets (end 2007)	Change of the key interest rate
Slovenia	↓	○	euro area monetary policy framework	euro area interest rates
Bulgaria	↓	●	no target	..
Czech Republic	↓	○	inflation target of 3% ±1 percentage point (CPI)	increase by 75 basis points in three steps
Hungary	↓	■	combined exchange rate (wide band)and inflation target: 3% ±1 percentage point (medium-term)	decrease by 50 basis points in two steps
Poland	↓	○	inflation target of 2.5% ±1 percentage point (national headline CPI)	increase by 50 basis points in two steps
Romania	↓	●	inflation target of 4% ±1 percentage point	decrease by 50 basis points in two steps followed by an increase of 50 basis points
Slovakia	⟷	○	inflation target of < 2%	..
Croatia	↓	○	no target	..
Turkey	↑	■	no explicit target	decrease by 75 basis points in two steps
Russia	↓	●	no explicit target	..

Source: Eurostat, national central banks, OeNB.

Note: The table refers to the review period (end of April 2007 until beginning of November 2007).

↑: improvement. ↓: deterioration. ■: intermediate risk

⟷: no significant change. ○: moderate risk. ●: high risk

well as Bulgaria and Romania. Over the period, the current account deficits of Croatia and Turkey remained quite high, but shrank marginally compared to the same period of 2006, easing to below 20% of GDP (Croatia) and 10% of GDP (Turkey), respectively.[11] The surplus in Russia, the only country with a positive current account balance, dropped by around 4 percentage points to 8.7% of GDP.

FDI inflows still important for covering external deficits

Despite a decline of the coverage ratio in most of the countries, FDI inflows remained an important source of deficit financing. In countries with a high combined current and capital account deficit (Bulgaria, Romania, Croatia and Turkey), financing requirements from other sources than FDI were quite high; this also applied to Hungary and Slovenia, as both countries registered net FDI outflows caused by the drop in FDI inflows combined with ongoing FDI outflows.

Competitive edge narrows in Bulgaria, Romania and Russia; unit labor costs accelerate strongly

As already described, industrial sector wages in the CESEE Member States grew dynamically in the first half of 2007. Only in Slovenia and Slovakia (as well as in Croatia) did productivity growth outpace wage increases. Thus most of the countries faced higher unit labor costs (ULC) in the first half of 2007 compared to the first half of 2006 (both in local currency and in euro terms). The picture differs quite substantially from 2006 developments, when Romania was the only country among the CESEE Member States to post a significant

[11] *It is noteworthy that in Bulgaria as well as in Croatia developments of the combined current and capital account show strong seasonal patterns.*

Table 4

External Equilbria: Assessment and Key Factors

	Assessment		Key Factors				
	Development of the combined current and capital account[1]	Level of the combined current and capital account	Main source of the deficit/surplus	Coverage of combined current and capital account by net FDI, % of GDP		Gross external debt, % of GDP	
				2007 (first half)	2006 (first half)	2007 (first half)[2]	2006 (first half)[2]
Slovenia	↓	○	income account	–19.9	–89.2	95.6	78.2
Bulgaria	↓	●	trade account	72.1	112.1	81.7	75.1
Czech Republic	↑	○	income account	313.8	88.1	38.1	48.1
Hungary	↑	○	income account	–51.3	63.5	98.1	82.1
Poland	↓	○	income account	119.5	127.6	48.7	45.5
Romania	↓	●	trade account	39.3	80.5	28.2	31.9
Slovakia	↑	○	income account	64.9	95.2	55.6	61.3
Croatia	↓	○	trade account	60.1	37.5	85.9	84.5
Turkey	↓	●	trade account	53.1	45.1	51.0	48.1
Russia	↓	○	trade account	–5.7	–20.3	33.8	32.5

Source: Eurostat, national central banks, OeNB.

Note: The table refers to the review period (end of April 2007 until beginning of November 2007).

↑: Improvement. *↓: Worsening.* *■: Intermediate risk.*
⟷ :No significant change. *○: Moderate risk.* *●: High risk.*

[1] Comparing the first half of 2007 with the first half of 2006.

[2] % of GDP (rolling four-quarter GDP, euro basis), end of period.

Table 5

Wages, Productivity, Unit Labor Costs

Annual change in %

	Nominal Wages in Industry			Productivity in Industry			Unit Labor Cost in Industry (local currency)			Euro per Local Currency (annual average)			Unit Labor Cost in Industry (euro)		
	2006	H1 2006	H1 2007	2006	H1 2006	H1 2007	2006	H1 2006	H1 2007	2006	H1 2006	H1 2007	2006	H1 2006	H1 2007
Slovenia	5.5	6.1	5.7	8.8	7.9	7.7	–3.1	–1.7	–1.9	0.0	0.0	0.0	–3.1	–1.6	–1.9
Bulgaria	10.8	9.4	18.6	8.2	9.3	7.5	2.5	0.1	10.3	0.0	0.0	0.0	2.5	0.1	10.3
Czech Republic	6.8	6.4	8.8	8.6	10.6	8.3	–1.7	–3.8	0.5	5.1	5.6	1.2	3.3	1.5	1.7
Hungary	8.5	8.1	9.2	11.7	12.3	9.2	–2.9	–3.7	0.0	–6.1	–5.1	4.1	–8.9	–8.7	4.2
Poland	5.2	4.6	8.4	9.5	10.3	7.3	–4.0	–5.1	1.0	3.2	4.8	1.2	–0.8	–0.6	2.2
Romania	15.7	15.4	21.2	11.3	11.3	10.5	4.0	3.7	9.7	2.7	3.5	6.3	6.8	7.2	16.6
Slovakia	6.7	5.3	7.1	11.3	10.8	10.7	–4.1	–4.9	–3.2	3.7	2.8	10.3	–0.6	–2.3	6.8
Croatia	7.5	7.2	5.7	5.7	1.8	7.5	1.7	5.3	–1.7	1.1	1.6	–0.6	2.8	6.9	–2.3
Turkey	11.5	11.4	8.5	6.7	7.5	2.5	4.5	3.6	5.8	–7.3	0.3	–5.5	–3.1	4.0	–0.1
Russia	21.4	20.4	25.2	8.3	8.5	6.4	12.1	10.9	17.6	3.3	5.8	–1.9	15.8	17.3	15.4
Memorandum item: Euro area	2.5	2.5	2.8	4.6	4.1	3.5	–2.0	–1.5	–0.7	..	..	..	–2.0	–1.5	–0.7

Source: ECB, Eurostat, national statistical offices, wiiw.

increase in ULC. One can argue, however, that these ULC increases are not threatening the competitiveness of this country group yet: These countries' market shares are growing, and the countries are undergoing a process of technological upgrading (see also issue 1/2007 of this publication). Furthermore, the terms of trade have improved in most countries, and trade balances are positive or register a more or less moderate deficit. However, the picture differs in the two newest EU Member States, Bulgaria and Romania, where ULC increased at double-digit rates, harming competitiveness. Compared to the other EU Member States, their trade balances are already deeply in the red.

In Croatia and Turkey, ULC (in euro terms) declined in the first half of 2007, in Croatia mainly due to high productivity increases combined with moderate wage growth. In Turkey, productivity growth was low, but ULC developments were supported by a depreciation of the currency. Russia posted impressive wage increases, leading to a significant rise of ULC.

Fiscal balances in 2007 expected to improve mainly due to good growth performance and, in Hungary, because of consolidation efforts

According to the 2007 October fiscal notification, budgetary deficit ratios for 2007 in the CESEE Member States are expected to be lower than in 2006 in Slovenia, Hungary, Poland and Slovakia, with the biggest deficit reduction expected to take place in Hungary. The deficit ratio is forecast to increase in the Czech Republic (by 0.5 percentage points) and in Romania (by 1 percentage point). In Bulgaria, the budget surplus will decline somewhat to 2.5% of GDP. Comparing the October 2007 fiscal notifications with the updates of the (2006) convergence programs, all countries now expect a lower fiscal deficit (or higher surplus) for 2007, with the exception of Romania. The revisions mainly stem from stronger than expected economic growth, but also from fiscal reforms or methodological changes. In Bulgaria, the increased surplus can be largely ascribed to efforts to contain imbalances and address external vulnerabilities.

In 2006 fiscal policy was procyclical in Hungary, Slovenia, Slovakia and Romania according to the European Commission's Autumn 2007 forecast. In the Czech Republic and Poland, fiscal policy was roughly neutral, in Bulgaria tighter.[12] For 2007, the forecast of the Commission would imply a loosening in the Czech Republic, Bulgaria and Romania (and to a smaller extent in Slovenia), while the fiscal stance is expected to be tightened substantially in Hungary and to a smaller extent also in Poland and Slovakia.

Excessive deficit procedure ongoing in the Czech Republic, Hungary, Poland and Slovakia

The state of the excessive deficit procedures (EDP) in October 2007 was marked by a renewed recommendation of the EU Council (following a first recommendation in July 2007) to the Czech Republic to take the necessary measures to bring its budget deficit below the threshold of 3% by the end of 2008. According to the country's convergence program (submitted in March 2007), a deficit of 4% of GDP was expected for 2007 and of 3.5% of GDP for 2008, but the latest forecast predicts lower deficits as a result of a reform package adopted to accelerate the process of fiscal consolidation (also see the

[12] *No cyclically adjusted fiscal data are available for Croatia, Turkey or for Russia. The fiscal stance is measured as the arithmetic average of the cyclically adjusted primary balance on the basis of trend GDP and on the basis of potential GDP.*

country report). As a reminder,[13] Hungary, Poland and Slovakia are under an EDP as well. Poland and Slovakia have been given time to reduce their deficits by the end of 2007, Hungary by the end of 2009.[14]

The candidate countries Croatia and Turkey continue to negotiate EU accession

Following publication of Croatia's and Turkey's latest Pre-Accession Economic Programmes in the fourth quarter of 2006, joint conclusions on these programs (and on the program submitted by the Republic of Macedonia) were issued in June 2007 as a result of the ministerial dialogue meeting between the economics and finance ministers of the EU and the EU candidate countries. The conclusion on Croatia's third Pre-Accession Economic Programme for 2007 to 2009 is that the country is on track to fully meeting the Copenhagen economic criteria for accession. The policy mix of fiscal restraint and stability-oriented monetary policy is considered to be appropriate. However, an even stronger fiscal adjustment could be needed to address external vulnerabilities which have arisen recently. The conclusion on Turkey's sixth Pre-Accession Economic Programme for 2007 to 2009 is generally that the program is sound and coherent in view of the medium-term macroeconomic, fiscal and structural reforms. Furthermore, the program provides guidance for meeting the Copenhagen accession criteria. However, fiscal and structural measures as well as their budgetary effects are not always presented sufficiently. The next Pre-Accession Economic Programmes for both countries are expected in late 2007.

European Commission publishes progress reports on Croatia and Turkey in November 2007

In early November 2007, the European Commission published the annual updates of the progress reports on enlargement strategies and the main challenges in the upcoming years for Croatia and Turkey. So far, negotiations in Croatia have been opened on 14 chapters, and 2 chapters were provisionally closed (science and research, education and culture). For Turkey, negotiations on 4 chapters have been opened (science and research, industrial policy, statistics, financial control) but only 1 chapter (science and research) has already been (provisionally) closed. In the progress report on Croatia, the European Commission concludes that accession negotiations are on the right track and that reforms are advancing well. However, some improvements are still required in several areas, such as in the field of administrative and judiciary management. The progress report on Turkey is less positive. The country does not yet sufficiently meet the political criteria for EU membership. Furthermore, the Commission noted some slowing down in implementing reforms.

Partial easing of political noise across the region

In Poland's election in late October, the center-right Civic Platform won against the conservative Law and Justice Party. Markets welcomed the outcome, as the winning party is considered to be more reform- and EU-oriented. On November 9, 2007, president Lech Kaczyński designated Donald Tusk, the leader of the Civic Platform, as Prime Minister. Now, a coalition with the smaller PSL, the Polish Peasant Party, is in the offing, which will have a majority in the parliament. Poland will thus experience a phase of

[13] *For more details, see issue 1/2007 of this publication.*

[14] *In case a country exceeds the reference value (budget deficit of 3% of GDP), the cost of implementing pension reforms will be considered under certain circumstances when assessing developments of deficit figures relevant for the EDP.*

cohabitation between this coalition and the President of the Republic, who is a member of the Law and Justice Party.

In Romania, the attempt by parliament to impeach the country's popular president failed, but frictions between the government and the president persist. The Bulgarian and Hungarian governments are confronted with low popularity among the general public because they have taken restrictive fiscal policy measures (social spending cuts, restrictive wage policy). The coalition government in the Czech Republic has a very narrow majority only in parliament. In Croatia, parliamentary elections will take place on November 25, 2007. Turkey held parliamentary and presidential elections in the summer of 2007; the conflict with Kurds in Northern Iraq has most recently moved to the top of the political agenda. In Russia, upcoming elections (parliamentary in December 2007, presidential in March 2008) have further reduced economic reform momentum.

Upgrading of the Czech Republic's rating

Only one country's long-term foreign-currency rating – that of the Czech Republic – has been changed since the publication of the last report on developments in selected countries. The upgrading by Standard & Poor's was largely motivated by the country's implementation of public sector reforms.

Table 6

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt

Currency	Moody's		Standard & Poor's	
	Current rating[1]	Last change (former rating)	Current rating[2]	Last change (former rating)
Slovenian tolar	Aa2	Jul 2006 (Aa3)	AA	May 2006 (AA–)
Bulgarian lev	Baa3	Mar 2006 (Ba1)	BBB+	Oct 2006 (BBB)
Czech koruna	A1	Nov 2002 (Baa1)	A	Oct 2007 (A–)
Hungarian forint	A2	Dec 2006 (A1)	BBB+	June 2006 (A–)
Polish zloty	A2	Nov 2002 (Baa1)	A–	Mar 2007 (BBB+)
Romanian leu	Baa3	Oct 2006 (Ba1)	BBB–	Sep 2005 (BB+)
Slovak koruna	A1	Oct 2006 (A2)	A	Dec 2005 (A–)
Croatian kuna	Baa3	Jan 1997	BBB	Dec 2004 (BBB–)
Turkish new lira	Ba3	Dec 2005 (B1)	BB–	Aug 2004 (B+)
Russian ruble	Baa2	Oct 2005 (Baa3)	BBB+	Sep 2006 (BBB)

Source: Bloomberg.

[1] *Aaa (best), Aa, A, Baa, Ba, B, Caa, Ca, and C (worst); each of the categories is further divided into 1, 2, and 3, except for the best and worst category, with 1 being the best and 3 the worst subcategory.*

[2] *AAA (best), AA, A, BBB, BB, B, CCC, CC, C and D (worst); each of the categories is further divided into + and –.*

Box 1

CESEE Financial Markets only Marginally Affected by Recent International Turbulences

The CESEE countries covered in this report on recent economic developments have been affected to differing degrees by the international financial market turbulence since mid-July 2007. In general, countries with the largest economic imbalances and/or insufficient policy credibility as well as countries which had previously experienced strong capital inflows coupled with particularly high asset valuation were affected more than others. The adverse international developments impacted different financial market segments to a different extent, though country-specific factors (such as exchange rate regimes or market liquidity) imply that the degree of information content in capital market data varies across countries. In general, CESEE markets tended to follow the negative global investor sentiment, but performed relatively well compared to other emerging markets, especially when simultaneous adverse local factors (such as political uncertainty) were also at work. Asset price losses, if any, and the increase in risk premiums were well contained in the region, which may reflect investors' increased differentiation between emerging market economies and an "EU bonus" in investor judgment for several countries of this region. Having said this, the correction of overly large economic imbalances remains imperative in a relatively fragile international environment that is characterized by a more permanent reassessment of risks. This view is supported by the uneven recovery in some market segments in different countries after the turmoil peaked (mid-July 2007 to mid-August 2007).

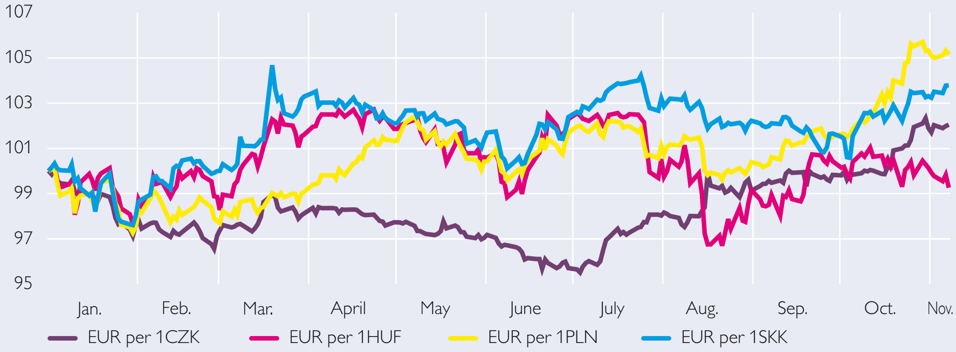
International financial market turbulences affected the Hungarian, Romanian and Turkish currencies most

CESEE currencies were affected by the international financial market turbulence primarily during the period from mid-July to mid-August. The Turkish lira, the Hungarian forint and the Romanian leu suffered most, losing around 6.6%, 5.6% and 3.7% against the euro, respectively, between July 20 and August 16, 2007. Adverse country-specific factors, like political uncertainty or large economic imbalances, made these countries vulnerable to contagion. Moreover, these countries had undergone particularly sizeable nominal appreciation during the year prior to the crisis. The Polish złoty and the Slovak koruna lost around 2%, while the Croatian kuna was practically unaffected. While the Russian ruble gained around 1.4% versus the euro, it lost about 1% against the U.S. dollar, its major reference currency, and thus remained roughly stable against its currency basket. In an international comparison, the exchange rate losses in the CESEE countries were significantly smaller than the losses of selected other emerging market currencies during

Chart 1a

Exchange Rate Developments against the Euro in 2007

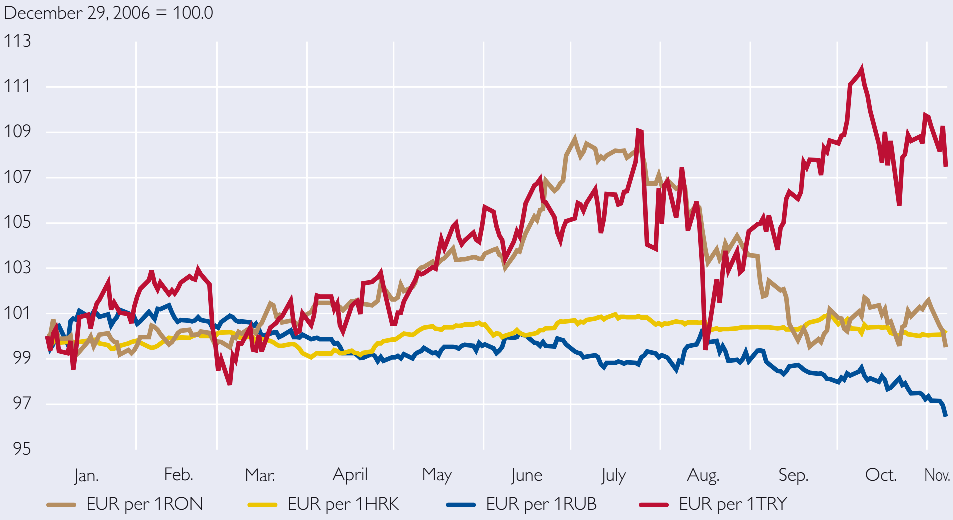
December 29, 2006 = 100.00



Source: Eurostat, OeNB.

Chart 1b

Exchange Rate Developments against the Euro in 2007



Source: Eurostat, OeNB.

the turmoil (e.g. the Brazil real, the Thai baht), but also smaller than those of the New Zealand dollar and the Icelandic króna.

The Czech koruna was a notable exception among the CESEE currencies, as it has gradually appreciated since early July 2007. This is likely to have been the result of its capacity as a funding currency of carry trades and the ensuing unwinding of these trades during the market turbulences. Between mid-August and October 2007, the Polish złoty and the Turkish lira more than recovered the losses suffered. The Hungarian forint and the Slovak koruna also recovered partially, but were trading about 2% and 1%, respectively, weaker against the euro in October 2007 than in mid-July. The Romanian leu continued to weaken until late September, before stabilizing at a level that was nearly 7% weaker than in mid-July.

Developments of money market rate spreads…

Money market rate spreads to the euro (three-month rates) trended downward in Hungary, Poland and Slovakia as well as in Croatia and Turkey between mid-July and October. The spreads increased to a limited extent in the Czech Republic and Romania, and more significantly in Bulgaria and Russia. In countries where the spread decreased, this was the result of a rise in money market rates in the euro area, which was not or not fully reflected in local money market rates, with money market rates even declining over this period in Hungary as well as in Croatia and Turkey. In October, three-month money market rates in the Czech Republic and in Slovakia were lower than in the euro area.

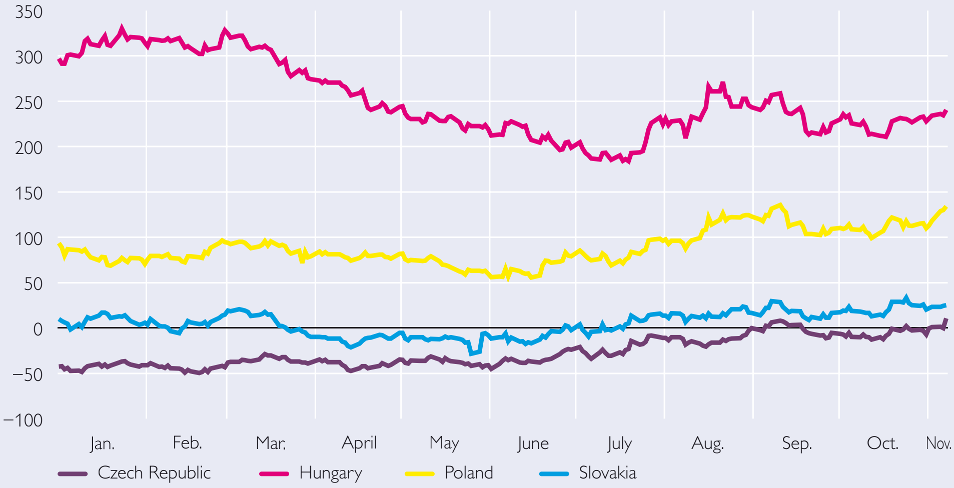
… and of long-term interest rate spreads on local currency government bonds

Long-term interest rate spreads on CESEE local currency government bonds against the euro area were not strongly affected by the international financial market turbulence. Emerging market bond spreads increased by almost 60 basis points from mid-July to mid-August (on the basis of the J. P. Morgan Emerging Markets Government Bond Index, GBI-EM). By contrast, the spreads in Czech and Slovak local currency-denominated government bonds remained roughly stable (against euro area government bonds) in this period. The increase in the Polish and Russian spreads (around 40 basis points) was also smaller than that of the broad market. Out of the six CESEE countries included in the J. P. Morgan GBI-EM, only spreads on Turkish (+180 basis points) and Hungarian (+75 basis points) government bonds increased more than the emerging market average. After a second wave of spread widening in early September, followed again by a narrowing, spread levels in October were still around 5 to 10 basis points above the mid-July levels

Chart 2a

Local Currency Government Bond Yield Spreads against the Euro Area

Country subindices (J. P. Morgan GBI-EM) in basis points for 2007

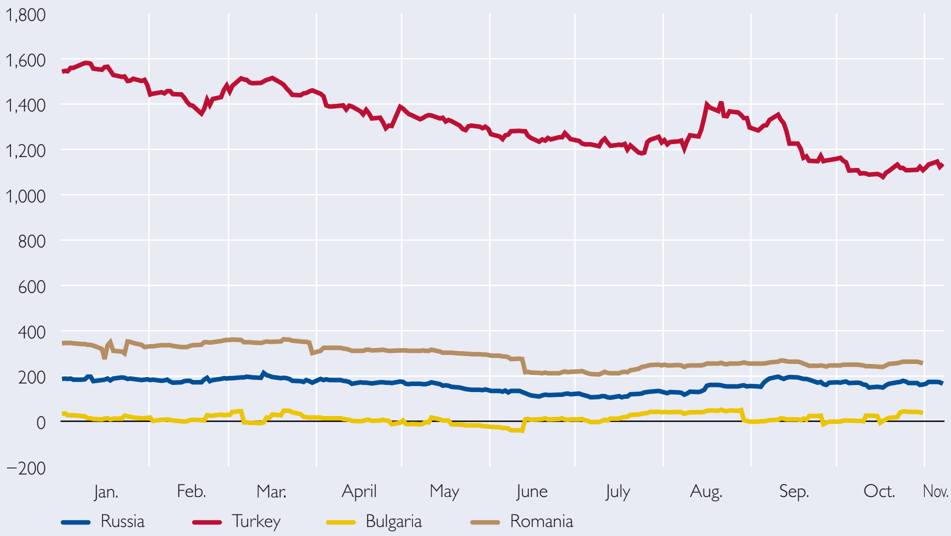


Source: Bloomberg, OeNB.

Chart 2b

Local Currency Government Bond Yield Spreads against the Euro Area

Country subindices of J. P. Morgan GBI-EM for Russia and Turkey, Eurostat data for Bulgaria and Romania, in basis points for 2007



Source: Bloomberg, Eurostat, OeNB.

in the Czech Republic and Slovakia, around 30 basis points in Hungary and Poland and 40 basis points in Russia. Turkey (where spreads had decreased substantially since mid-September) represented an exception, with spreads some 120 basis points lower in October than in mid-July. In terms of the total return in euro terms, between mid-July and October only Hungarian and Russian government bonds showed losses, with Hungary underperforming the overall emerging market index. By contrast, Czech and Polish as well as Turkish government bonds performed substantially better than the overall index.

Spreads on euro-denominated sovereign eurobonds

The increase in the spreads on euro-denominated sovereign eurobonds issued by the Czech Republic, Poland and Slovakia were significantly smaller (10 to 15 basis points) than the increase in the average market spread (26 basis points, Euro EMBI Global) during the period of turbulence from mid-July to mid-August. The spread on Hungarian eurobonds rose somewhat less (20 basis points) than the average market spread, while the increase in Romanian eurobond spreads roughly matched the market average. Only the spreads on Bulgarian, Croatian and Turkish eurobonds widened more than the average emerging market spread (by 45 basis points in Turkey and 30 to 35 basis points in the other two countries). Spreads on Russian U.S. dollar-denominated eurobonds widened by 50 basis points, less than the overall (U.S. dollar) eurobond market (70 basis points, EMBI Global). Between mid-August and October, euro-denominated sovereign eurobond spreads decreased by up to 10 basis points in most CESEE countries covered in this box, by around 20 basis points in Bulgaria and by 25 basis points in Turkey, compared to a decline by 10 basis points for the market average, while spreads on U.S. dollar-denominated sovereign eurobonds in Russia declined by 25 basis points compared to 50 basis points for the market average. As a result, in October eurobond spreads were about 15 to 25 basis points higher than in mid-July, except in the Czech Republic and Slovakia (only about 5 basis points higher).

Equity price losses in most CESEE countries slightly higher than U.S. or euro area averages

Equity price losses in the Czech Republic, Hungary, Poland, and Romania as well as Russia were somewhat larger (11% to 13%) than the losses registered in the U.S.A. or the euro area average (8% to 10%) between mid-July and mid-August 2007. However, the losses in these five countries were comparable to or smaller than those of other emerging markets and to some extent driven by the underperformance of local blue chips in the first half of 2007 (e.g. oil companies). Only Turkish equity prices decreased more substantially (by around 16%), partly as a result of rising political uncertainty ahead of parliamentary and presidential elections, but still in line with the performance of other emerging markets. The equity markets in the other countries of the region (Bulgaria, Slovakia, and Croatia) did significantly better than those in the U.S.A. and the euro area (though these markets are generally regarded as less liquid). Most of those CESEE countries which had registered more pronounced losses recovered between mid-August and October, with Czech, Turkish and Russian stocks having a positive return between mid-July and October.

Up to October 2007, CESEE financial markets weathered international turbulences quite well

Overall, and especially during the peak from mid-July to mid-August, CEESE financial markets have weathered relatively well the international financial market turbulences that started in mid-July 2007 and were accompanied by a tightening of global liquidity conditions and the repricing of risk. Any asset price losses and increases in risk premiums were well contained. In line with previous expectations, the countries with the largest economic imbalances and/or insufficient policy credibility as well as countries which had previously experienced strong capital inflows coupled with particularly high asset valuations were affected most (Hungary, Romania, Bulgaria, Croatia, Turkey and Russia). However, it should be borne in mind that country-specific factors may compromise the information content of capital market data and conceal underlying market pressure. The performance of some market indicators (e.g. exchange rate in Romania, money market rate spreads in Bulgaria, eurobond spreads in Romania and Croatia) suggests that market participants take into account country-specific signs of vulnerability, which may be an indication that a fresh wave of international market turbulence could exert additional pressure on these countries. Therefore, correcting existing economic imbalances, in particular external imbalances, in the near future remains imperative to prevent a loss of investor confidence in a relatively fragile international environment that is characterized by a more permanent reassessment of risks.

2 Slovenia: Mixed Performance Following Euro Adoption

GDP growth strengthened further following euro adoption

Slovenia's GDP growth accelerated further during the first half of 2007 following an already strong expansion in 2006. Year-on-year output growth reached 6.5% during the first half year, up from 5.2% in full-year 2006. Economic growth was driven by domestic demand, in particular by investment growth. Investment activity was particularly strong in transport equipment, nonresidential and residential construction. Investment activity most likely received support from an acceleration of credit growth – in the first half of 2007, credits to the private sector expanded by an average of around 24% year on year – increased FDI inflows, high and rising industrial capacity utilization rates, preparations for Slovenia's EU presidency during the first half of 2008, and the approaching end of the transitional period of lower VAT rates at the end of 2007 for housebuilding and repairs. The dynamics of consumption eased for several reasons: The growth rate of private consumption remained stable at slightly above 3% year on year in the first half of 2007, even though net real wages increased faster following the tax reform, credit growth accelerated and employment posted gains, and public consumption growth slowed significantly, even declining in the second quarter of 2007. Net real exports made a greater negative contribution to GDP growth, as faster import growth outpaced even faster export growth.

Deficit of the combined current and capital account widened again

Mirroring the deterioration in net real exports and the slight worsening of the terms of trade, Slovenia's deficit on the combined current and capital account more than tripled compared to the same period of 2006, rising to 3.4% of GDP in the first half of 2007. Most of the worsening was caused by the performance of the goods and services balance. In addition, the income deficit rose by almost 1 percentage point, mostly on account of rising income payments on FDI and other investment liabilities. Slovenia continued to post minor net FDI outflows during the first half of 2007. Portfolio capital outflows jumped to more than 11% of GDP, primarily because Slovenian banks invested their liquidity from expiring Banka Slovenije bills in foreign securities, but also because the nonbank private sector increased its investments abroad. As a result, Slovenia relied heavily on "other capital" inflows during the first half of 2007 (around 20% of GDP), overwhelmingly through the increase in external liabilities of Banka Slovenije, which refinanced expiring Banka Slovenije bills by taking out debt from the Eurosystem. This development was also reflected in Slovenia's net foreign debt position, which had risen to 17.5% of GDP by mid-2007, up from 11% at the end of 2006. Within the net foreign debt position, private sector net foreign debt decreased, whereas the public sector's net foreign position deteriorated noticeably as a result of a eurobond issue by the government and the aforementioned rise in the central bank's external liabilities. However, it must be borne in mind that both Slovenia's combined current and capital account deficit and its net external debt are to other euro area countries, and as such do not represent a foreign currency risk.

Inflation on the rise

According to official estimates, the impact of the euro changeover on consumer price inflation amounted to around 0.25 to 0.3 percentage points (see issue 1/2007). Nevertheless, inflation accelerated quite significantly in the first half of 2007 to reach 4.0% in July 2007 before easing back to 3.4% to 3.6% in August and September, respectively (year on year). In October 2007, inflation picked up again and came to 5.1% year on year. It is difficult to make out clearly the underlying sources of the pickup in inflation during the first ten months of 2007. On the one hand, according to the European Commission (Autumn Forecast 2007), while euro changeover effects appeared limited initially, some abnormal price increases have been reported since the expiration of the dual display of prices in mid-2007. In addition, anecdotal evidence reports that competition in the retail sector is quite low, as retailing food chains have just started to enter the country. Furthermore, year-on-year industrial producer price (PPI) inflation (domestic sales prices) rose sharply from the beginning of 2007 and was consistently above HICP inflation. However, within the domestic sales prices of industry, upward pressure on consumer goods was modest (at around 2% year on year). While prices under the direct control of the government exhibited a year-on-year inflation rate slightly below the HICP during the first eight months of 2007, they rose substantially more quickly since end-2006 than the overall price index. In addition, the prices of alcoholic beverages and tobacco were adversely influenced by the hike in excise taxes in July 2007. On the other hand, ULC growth in the whole economy remained well-contained during the first half of 2007 despite tightening labor market conditions, and no additional consumption-driven price pressure seems to have emerged over the past few quarters. Meanwhile, the government has pledged to curb inflation by introducing stricter control of regulated prices, particularly utility prices, by adjusting fuel taxes to compensate for the rise in oil prices (as far as minimum taxes allow) and by asking the state competition regulators to investigate prices charged by the main local food retailers. At the beginning of October, Banka Slovenije revised its forecast for annual average inflation (year on year) both in 2007 and 2008 to 3.3% from a previous 2.7% (in both years).

2007 budget deficit to be significantly smaller than originally envisaged

According to most recent data, the 2006 budget deficit was revised down from 1.4% of GDP to 1.2% of GDP. In its 2006 update of the stability program, the government penciled in a deficit of 1.5% for 2007. However, in its fiscal notification of October 2007, the government expects a substantially smaller deficit in 2007 of around 0.6% of GDP. The government explained the improvement mostly as a result of lower than planned expenditures, but also of revenue performance in excess of the original target. Considering the robust performance of the economy, the revision has not come as a surprise. The government has also revised down its deficit target for 2008 to 0.6% of GDP, from a deficit target of 1.6% contained in the 2006 stability program update, while the shortfall is expected to decrease to 0.3% of GDP in 2009.

Table 7

Main Economic Indicators: Slovenia

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.4	4.0	5.2	5.0	4.7	5.6	5.5	7.2	5.9
Private consumption	2.6	3.4	3.3	3.1	3.4	3.6	3.0	3.0	3.4
Public consumption	3.4	2.2	3.8	4.4	3.5	3.0	4.2	1.1	−0.7
Gross fixed capital formation	7.9	1.5	11.9	8.6	8.5	14.6	15.2	21.7	21.4
Exports of goods and services	12.5	10.5	10.0	14.9	9.4	6.9	9.5	14.3	13.6
Imports of goods and services	13.4	7.0	10.4	13.8	9.0	8.4	10.7	14.6	17.0
	Contribution to GDP growth in percentage points								
Domestic demand	5.4	1.9	5.8	4.4	4.6	7.0	7.3	7.9	8.9
Net exports of goods and services	−0.9	2.0	−0.4	0.6	0.2	−1.0	−1.4	−0.2	−2.4
Exports of goods and services	7.4	6.8	6.8	9.7	6.4	4.8	6.6	10.2	9.7
Imports of goods and services	8.3	4.8	7.2	9.1	6.2	5.9	8.0	10.4	12.1
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	6.4	5.9	7.9	9.6	6.2	8.9	7.0	8.5	6.9
Gross average wage of industry (nominal)	7.1	5.8	5.5	6.5	5.8	4.3	5.4	5.6	5.8
Unit labor cost of industry (nominal)	0.7	−0.1	−2.3	−2.9	−0.4	−4.3	−1.5	−2.7	−1.1
Producer price index (PPI) of industry	4.4	2.8	2.4	1.6	2.4	2.8	2.7	4.5	5.0
Consumer price index (here: HICP)	3.7	2.5	2.5	2.3	3.1	2.5	2.3	2.6	3.2
EUR per 1 SIT, + = SIT appreciation	−2.2	−0.2	0.0	0.1	0.0	−0.1	0.0	−0.1	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	6.5	6.7	6.1	7.0	6.0	5.7	5.7	5.8	4.7
Employment rate (15−64 years)	65.3	66.0	66.6	65.9	67.1	67.2	66.0	66.0	68.3
Key interest rate per annum (%)	4.6	4.0	3.5	3.8	3.5	3.4	3.5	3.5	3.8
SIT per 1 EUR	239.1	239.6	239.6	239.5	239.6	239.6	239.6	239.6	239.6
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)[1]	5.1	6.6	8.4	8.1	9.5	7.9	8.3	18.4	21.2
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−8.1	−10.4	−15.6	−14.6	−15.3	−16.2	−16.3	−19.5	−18.0
Domestic credit of the banking system	14.0	19.7	24.7	22.6	24.4	24.9	26.7	30.6	33.9
of which: claims on the private sector	*11.5*	*16.6*	*26.8*	*23.8*	*26.3*	*27.3*	*29.5*	*29.9*	*32.7*
claims on households	*2.7*	*4.4*	*7.0*	*6.3*	*7.0*	*7.2*	*7.5*	*7.3*	*7.5*
claims on enterprises	*8.8*	*12.3*	*19.8*	*17.5*	*19.3*	*20.1*	*22.1*	*22.6*	*25.2*
claims on the public sector (net)	*2.4*	*3.0*	*−2.1*	*−1.1*	*−1.9*	*−2.3*	*−2.8*	*0.7*	*1.2*
Other domestic assets (net) of the banking system	−0.8	−2.7	−0.6	0.2	0.3	−0.8	−2.1	7.3	5.3
	% of GDP, ESA 95								
General government revenues	44.2	44.5	44.1	..	..	..	..	..	..
General government expenditures	46.5	46.0	45.3	..	..	..	..	..	..
General government balance	−2.3	−1.5	−1.2	..	..	..	..	..	..
Primary balance	−0.5	0.1	0.2	..	..	..	..	..	..
Gross public debt	27.6	27.4	27.1	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	13.3	12.9	16.7	19.4	13.9	15.9	17.7	18.8	13.2
Merchandise imports	16.6	12.1	16.2	19.3	14.1	15.4	16.2	18.1	18.3
	% of GDP (based on EUR), period total								
Trade balance	−3.8	−3.7	−3.8	−3.0	−1.5	−3.4	−7.1	−2.8	−4.3
Services balance	2.6	3.1	3.0	3.0	3.3	2.8	2.7	2.8	2.6
Income balance (factor services balance)	−1.2	−1.0	−1.2	−1.1	−1.0	−1.2	−1.3	−1.9	−1.8
Current transfers	−0.3	−0.3	−0.6	−1.3	−0.1	−1.0	0.0	−1.0	−0.5
Current account balance	−2.7	−2.0	−2.5	−2.4	0.7	−2.8	−5.6	−2.9	−4.0
Capital account balance	−0.4	−0.4	−0.4	−0.1	−0.3	−0.4	−0.7	0.3	−0.1
Foreign direct investment (net)	0.9	−0.2	−1.0	−0.9	−0.8	0.1	−2.2	−1.2	−0.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	58.5	71.0	80.3	75.9	78.2	78.4	80.3	92.6	95.6
Gross official reserves (excluding gold)	24.6	24.7	18.0	24.4	22.7	19.9	18.0	2.7	2.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.8	4.6	3.1	4.4	4.0	3.5	3.1	0.5	0.4
	EUR million, period total								
Gross domestic product in current prices	26,230	27,634	29,742	6,848	7,632	7,590	7,671	7,640	8,389

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

[1] *The methodology for calculating broad money and its components was changed for data from the beginning of 2005.*

3 Bulgaria: Noticeable Macroeconomic Imbalances Accompany High and Rising Inflation

Domestic demand continues to drive strong economic growth

In the first half of 2007, real GDP growth remained robust at 6.4% year on year, driven by private domestic demand, which was fueled by rapid credit growth (real credit to the private sector increased on average by more than 35% year on year in the first half of 2007). Growth of GFCF soared particularly strongly (+30% year on year in the first half of 2007). Private consumption was buoyant as well, also supported by strong wage growth. In the second quarter of 2007 compared to the first quarter of 2007, however, growth of private consumption and of GFCF slowed down somewhat. One reason seems to be that the construction sector, which is one of the main drivers of investment growth, is possibly reaching capacity constraints. The negative contribution of net exports to GDP growth increased further in the first half of 2007 compared to the first half of 2006 (and to the entire year 2006). However, the negative contribution of net exports to GDP growth was smaller in the second quarter of 2007 than in the first quarter of 2007, above all because exports performed better and import demand was lower.

Substantial drop in unemployment, divergent wage dynamics in the public and private sector

Strong economic growth helped reduce the unemployment rate (ILO definition) to an average level of 7.5% in the first half of 2007 compared to 9.4% in the same period of 2006. Wage growth in industry was strong in the first half of 2007, outpacing productivity increases by about 10% and thus translating into higher ULC. In contrast to rapid wage growth in the industrial sector, the government has pursued a somewhat more restrictive wage policy with the aim of preserving macroeconomic stability. In July 2007, nominal wages in the public sector were boosted by 10%. Still, this has opened the door to public pay disputes (e.g. schoolteachers went on strike demanding doubling their current pay to keep apace with wages in the private sector). Pension policies were less prudent, as pensions were raised twice by 10% in July and again in October 2007.

Abrupt rise in the growth of credit to the private sector prompts central bank to raise minimum reserve requirements

After dipping temporarily in 2006, real growth of credit to the private sector resurged in the course of 2007 and reached 50% year on year at the end of July 2007, largely driven by the removal of administrative credit restrictions in early 2007, by a so-called reimport of credit portfolios[15] as well as by new lending activities. The abrupt increase of credit growth prompted the Bulgarian National Bank (BNB) to tighten monetary requirements by adjusting the reserve requirement level again. The central bank raised the minimum required reserves from 8% to 12% as of September 2007 with the intention of ensuring good credit quality in the future, but also of dampening domestic demand growth and its impact on the external accounts.

FDI inflows largely cover higher combined current and capital account deficit

In first half of 2007, the massive and fast widening of the combined current and capital account deficit, which Bulgaria has witnessed for the last few years, continued unabatedly. The combined current and capital account gap reached almost 23% of GDP compared to 16% of GDP in the first half of 2006. This development is largely attributable to a deterioration of the trade balance, in turn reflecting ongoing strong private consumption and exceptionally high

[15] *Comprising credit portfolios which had been shifted abroad, in particular to parent banks, in response to credit ceilings.*

Table 8

Main Economic Indicators: Bulgaria

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	6.6	6.2	6.1	5.5	6.4	6.7	5.7	6.2	6.6
Private consumption	5.9	6.1	7.5	5.2	8.2	9.0	7.5	9.1	6.4
Public consumption	3.8	2.3	2.2	4.1	3.1	0.9	1.4	−2.4	−0.3
Gross fixed capital formation[1]	13.5	23.3	17.6	17.1	16.0	11.7	23.8	35.9	24.9
Exports of goods and services	12.8	8.6	8.9	12.7	10.0	8.4	5.4	2.2	5.7
Imports of goods and services	14.5	13.1	15.1	20.8	12.2	14.7	13.9	13.2	10.7
	Contribution to GDP growth in percentage points								
Domestic demand	7.8	13.2	13.1	13.2	9.3	15.3	14.0	14.4	13.7
Net exports of goods and services	−3.3	−5.1	−7.2	−9.6	−4.2	−6.0	−9.0	−11.3	−6.3
Exports of goods and services	7.6	5.4	5.8	8.0	6.9	5.7	3.1	1.5	4.0
Imports of goods and services	10.9	10.5	12.9	17.6	11.1	11.7	12.2	12.8	10.3
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	15.2	3.4	8.2	10.1	8.5	9.0	5.0	6.3	8.7
Gross average wage of industry (nominal)	6.3	8.1	10.8	9.4	9.4	11.7	12.7	17.6	19.5
Unit labor cost of industry (nominal)	−7.8	4.6	2.5	−0.6	0.8	2.5	7.3	10.6	9.9
Producer price index (PPI) of industry	5.9	7.0	9.4	8.4	10.0	10.7	8.3	7.4	6.8
Consumer price index (here: HICP)	6.1	6.0	7.4	8.7	8.6	6.7	5.7	5.3	4.7
EUR per 1 BGN, + = BGN appreciation	−0.2	−0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	12.2	10.2	9.0	9.8	9.0	8.9	8.4	8.0	6.9
Employment rate (15−64 years)	54.2	55.8	58.6	55.5	59.1	60.3	59.8	59.7	61.6
Key interest rate per annum (%)	2.6	2.1	2.6	2.2	2.5	2.7	3.1	3.5	3.7
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 of the period average stock in %								
Broad money (including foreign currency deposits)	22.3	27.3	21.3	19.2	17.0	22.3	26.1	28.1	28.5
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	4.4	8.9	14.7	8.3	10.7	16.0	22.6	19.2	11.4
Domestic credit of the banking system	21.8	25.8	13.0	18.5	12.7	12.2	9.4	14.4	22.3
of which: claims on the private sector	*26.3*	*27.9*	*16.4*	*17.9*	*12.6*	*17.3*	*17.7*	*22.3*	*31.3*
claims on households	*10.0*	*13.0*	*9.4*	*11.7*	*9.2*	*8.8*	*8.3*	*9.2*	*11.1*
claims on enterprises	*16.3*	*14.9*	*7.0*	*6.2*	*3.5*	*8.5*	*9.4*	*13.1*	*20.2*
claims on the public sector (net)	*−4.5*	*−2.1*	*−3.4*	*0.6*	*0.0*	*−5.2*	*−8.3*	*−7.9*	*−9.0*
Other domestic assets (net) of the banking system	−3.8	−7.4	−6.4	−7.6	−6.4	−5.9	−5.9	−5.5	−5.3
	% of GDP, ESA 95								
General government revenues	42.0	41.6	40.3	..	..	..	..	..	..
General government expenditures	39.7	39.6	37.1	..	..	..	..	..	..
General government balance	2.3	2.0	3.2	..	..	..	..	..	..
Primary balance	4.0	3.6	4.6	..	..	..	..	..	..
Gross public debt	37.9	29.2	22.8	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	19.7	18.6	26.6	28.4	31.8	32.1	15.6	6.2	8.8
Merchandise imports	20.3	26.9	25.2	33.0	21.9	25.8	22.1	18.7	17.5
	% of GDP (based on EUR), period total								
Trade balance	−14.9	−20.2	−21.5	−20.6	−19.3	−18.9	−26.5	−27.0	−24.4
Services balance	3.3	3.7	2.9	−3.5	3.5	10.9	−1.1	−2.0	4.8
Income balance (factor services balance)	1.2	0.7	0.2	0.3	0.7	−0.3	0.0	0.1	−0.4
Current transfers	3.7	3.7	2.6	2.3	2.6	3.2	2.2	1.6	1.3
Current account balance	−6.6	−12.0	−15.8	−21.4	−12.5	−5.1	−25.4	−27.3	−18.5
Capital account balance	0.8	1.0	0.7	0.4	0.8	0.7	0.9	0.1	0.4
Foreign direct investment (net)	11.3	14.5	15.9	15.0	20.5	11.6	16.9	14.3	17.7
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	63.7	69.0	80.1	72.3	75.1	78.6	80.1	80.1	81.7
Gross official reserves (excluding gold)	32.4	31.1	33.1	28.6	31.3	32.5	33.1	32.2	33.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.7	4.9	4.8	4.3	4.7	4.8	4.8	4.7	4.8
	EUR million, period total								
Gross domestic product in current prices	19,874	21,882	25,100	5,102	5,954	7,026	7,018	5,877	6,637

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

[1] *National source.*

investment growth. On the financial side, in the first half of the year, net FDI inflows, an important source of financing in Bulgaria, remained strong and covered about 70% of the combined current and capital account gap.

Continued significant increase in private gross external debt

As part of the high current account deficit has been financed by nonequity inflows, Bulgaria's net external debt has risen further. Also, gross foreign debt has picked up somewhat. While private gross external debt amounted to roughly 70% of GDP in annual terms in the first half of 2007 compared to 58.6% of GDP for the same period in 2006, public sector debt has been decreasing steadily.

HICP inflation resurges to double-digit level in August and September 2007 on the back of rising food prices and strong wage growth

In Bulgaria, average HICP inflation increased to 7.4% in 2006 because excise duties and oil prices increased sharply. After the HICP rate had dropped to 4.5% year on year in May, it resurged to above 9% year on year in August and further to 11.0% year on year in September 2007, the highest monthly inflation level since May 2001. This rise reflected strong domestic demand, wage hikes, rising food prices, partly as a result of unfavorable weather conditions, as well as higher oil prices. Food price inflation speeded up notably from 4.2% in May to 25.6% in September (year on year). The BNB has revised its inflation forecast upward significantly and estimates year-end inflation to come to 6.6% in 2007 (up from 4.4% earlier).

Fiscal surplus target of around 3% of GDP for 2007 appears to be within reach

Fiscal policy remains the key tool to control domestic demand and to counter external imbalances under the currency board arrangement. In 2006, the budget surplus came in at 3.3% of GDP. According to the fiscal notification published in October 2007, the surplus for 2007 is expected to come in at 2.5% of GDP, noticeably more than originally planned in the convergence program (0.8% of GDP) and in general in accord with, but somewhat lower than what was agreed with the IMF (surplus of 3% of GDP) during the regular annual Article IV consultation in October 2007. Revising the target upward was motivated by signs of overheating and increased external vulnerabilities.

4 Czech Republic: Gradual Deceleration of Growth Dynamics

Domestic demand keeps on driving economic activity

Economic activity in the Czech Republic remained strong in the first half of 2007 despite some slowdown compared to 2006. While the pace of growth appears to be losing some momentum, its sources have not substantially changed. Like in 2006, the economy again grew predominantly on the back of domestic demand. The increase in domestic demand in the first half of 2007 can be ascribed to a large extent to inventory accumulation and, most importantly, to private consumption of almost 7% year on year. The latter was fueled by falling unemployment rates, real wage growth, unprecedentedly high consumer confidence as well as the continued fast real expansion of credit to the private sector (of slightly more than 18% year on year on average in the first half of 2007). In contrast, the growth rate of GFCF almost halved in the first six months of 2007 year on year. The contribution of net exports to GDP growth turned slightly negative in the first half of 2007, as export growth declined more than import growth did.

Deepening labor market mismatches

On the back of long-term robust growth, unemployment fell further in the course of 2007 to levels unseen since the mid-1990s. In parallel, however, structural mismatches on the labor market seem to be deepening (as corroborated by persistent long-term unemployment), implying that the scope for further unemployment reductions might be limited. The mounting anecdotal evidence on shortages of skilled labor is starting to be reflected in accelerating wage growth. In the second quarter of 2007, nominal ULC in industry (in local currency) increased after having fallen for more than four years.

Combined capital and current account balance improves on the back of a soaring trade surplus

Reflecting improving terms of trade, the surplus of foreign trade in goods and services (as a percentage of GDP) almost doubled in the first half of 2007 compared to the same period of 2006. This result was brought about primarily by the increased surplus in trade with vehicles and machines, particularly owing to production rises in the car industry. At the same time, the appreciation of the Czech koruna against the U.S. dollar and relatively contained oil prices (in the first half of 2007) lowered the import deficit in oil and raw materials. As a result, the combined current and capital account deficit was lower than in 2006 despite the continued high income deficit, which was chiefly ascribable to the repatriation of profits by foreign-owned companies. Since robust net FDI inflows exceeded the total financing need and other capital outflows, the remaining FDI inflows increased foreign reserves by 0.4% of GDP.

Is inflation taking off?

In 2006, annual average HICP inflation had risen by a little more than 2%, partly because of the nominal appreciation of the koruna and a significant drop in the oil price toward the end of the year. However, the widening negative interest rate spread between the Czech Republic and the euro area boosted koruna-denominated carry trade. The appreciation trend was thus reversed, and the koruna lost against the euro in the first six months of 2007. Hence, currency depreciation against the euro along with rising food and tobacco prices, adjustments of administered prices as well as inflation pressures emanating from the tightening labor market gradually caused inflation to accelerate. The pickup in inflation, combined with anticipated monetary tightening in the Czech Republic (at least relative to the euro area) and possibly some unwinding of carry trades in the context of global financial market turmoil, triggered a new and fairly strong appreciation trend of the koruna. The currency fully recovered its losses of the first half of the year and reached an all-time high against the euro at the end of October 2007. Despite this strong appreciation, inflation climbed to 2.8% in September 2007. Moreover, the CPI,[16] the actual target index of Česká národní banka (ČNB), came to 2.8% in September, close to the midpoint of its target of 3%[17] (±1 percentage point). For December 2007, the ČNB forecasts inflation of 3.8%. According to the ČNB, major country-specific downside risks to this forecast are lower than assumed inflation expectations, whereas upside risks lurk in the strong economic performance. Against this backdrop, the key interest rate was raised in three steps from 2.5% to 3.25% between May and August.

First attempts at fiscal consolidation

After the general government deficit improved somewhat in 2006 to 2.9% of GDP owing to robust economic growth, a deficit of 3.4% of GDP is expected

[16] *The CPI has been on average 0.2 to 0.3 percentage points higher than the HICP since 2003. The main reasons for this discrepancy are (1) the use of different weights in the indices, (2) the treatment of purchases of goods by foreigners and (3) the treatment of imputed rents.*

[17] *In January 2010, the current target effective since January 2006 will be replaced by a new target for CPI growth of 2% (±1 percentage point), which is supposed to better reflect the long-term development of the Czech economy.*

Table 9

Main Economic Indicators: Czech Republic

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.6	6.5	6.4	6.6	6.5	6.3	6.1	6.4	6.0
Private consumption	3.0	2.5	4.4	3.8	4.1	4.0	5.6	7.1	6.4
Public consumption	−3.1	2.3	1.1	3.8	−0.5	−1.1	2.4	0.2	−1.6
Gross fixed capital formation	3.9	2.3	7.6	6.8	7.5	7.8	8.1	4.0	4.2
Exports of goods and services	20.7	11.8	15.9	21.2	13.0	12.7	17.1	15.3	13.8
Imports of goods and services	17.9	5.0	15.2	19.6	12.7	11.8	17.1	16.1	13.9
	Contribution to GDP growth in percentage points								
Domestic demand	3.6	1.7	5.8	4.9	6.4	5.9	6.2	6.6	6.0
Net exports of goods and services	0.7	5.3	0.4	1.5	0.3	0.5	−0.5	−0.4	−0.1
Exports of goods and services	14.7	9.7	13.7	17.8	11.2	10.7	15.5	14.7	12.6
Imports of goods and services	14.1	4.4	13.3	16.3	10.9	10.2	16.0	15.1	12.7
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	9.4	6.8	9.4	13.6	7.6	7.7	8.6	9.3	7.2
Gross average wage of industry (nominal)	7.1	4.6	6.1	6.3	6.4	5.2	6.3	9.1	8.6
Unit labor cost of industry (nominal)	−2.1	−2.1	−3.0	−6.4	−1.1	−2.3	−2.1	−0.2	1.3
Producer price index (PPI) of industry	5.7	3.0	1.6	0.4	1.3	2.5	2.2	3.1	4.1
Consumer price index (here: HICP)	2.6	1.6	2.1	2.4	2.5	2.4	1.1	1.7	2.6
EUR per 1 CZK, + = CZK appreciation	−0.2	7.1	5.1	4.9	6.2	4.8	4.5	2.0	0.4
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	8.4	8.0	7.2	8.0	7.1	7.1	6.6	6.1	5.3
Employment rate (15−64 years)	64.2	64.8	65.3	64.8	65.3	65.4	65.6	65.5	66.0
Key interest rate per annum (%)	2.2	2.0	2.2	2.0	2.0	2.3	2.5	2.5	2.5
CZK per 1 EUR	31.9	29.8	28.3	28.6	28.4	28.3	28.0	28.0	28.3
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	10.3	6.4	12.4	12.5	12.2	12.5	12.6	13.2	14.5
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	2.9	5.2	1.2	11.4	3.1	−4.2	−4.6	−3.2	−0.5
Domestic credit of the banking system	7.1	0.7	9.2	3.0	6.5	12.7	14.1	14.5	15.2
of which: claims on the private sector	*6.0*	*8.6*	*11.9*	*11.5*	*11.8*	*12.1*	*12.1*	*12.1*	*12.9*
claims on households	*4.4*	*5.4*	*6.7*	*6.5*	*6.5*	*6.8*	*6.9*	*6.9*	*7.4*
claims on enterprises	*1.5*	*3.2*	*5.2*	*5.0*	*5.3*	*5.3*	*5.3*	*5.2*	*5.5*
claims on the public sector (net)	*1.2*	*−7.9*	*−2.7*	*−8.5*	*−5.3*	*0.6*	*1.9*	*2.4*	*2.4*
Other domestic assets (net) of the banking system	0.3	0.5	2.0	−1.9	2.6	4.0	3.2	1.8	−0.3
	% of GDP, ESA 95								
General government revenues	42.2	41.3	40.7	..	..	..	..	..	..
General government expenditures	45.1	44.9	43.6	..	..	..	..	..	..
General government balance	−3.0	−3.5	−2.9	..	..	..	..	..	..
Primary balance	−1.8	−2.4	−1.8	..	..	..	..	..	..
Gross public debt	30.4	30.2	30.1	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	25.6	16.5	20.1	22.9	17.4	17.3	22.8	19.1	15.8
Merchandise imports	21.4	12.3	20.2	24.1	19.4	16.1	21.5	16.6	12.2
	% of GDP (based on EUR), period total								
Trade balance	−0.9	1.3	1.4	3.5	0.9	0.5	0.8	5.2	3.0
Services balance	0.4	0.6	0.4	0.1	0.4	0.8	0.1	0.6	1.0
Income balance (factor services balance)	−5.6	−4.8	−5.7	−2.8	−6.8	−6.4	−6.6	−3.7	−7.3
Current transfers	0.2	0.7	−0.2	0.0	−0.3	−0.3	−0.3	−0.4	−0.7
Current account balance	−6.0	−2.1	−4.2	0.9	−5.7	−5.3	−6.0	1.6	−3.9
Capital account balance	−0.5	0.2	0.3	0.3	−0.2	0.3	0.7	0.3	0.0
Foreign direct investment (net)	3.6	8.1	3.2	1.7	2.6	4.9	3.5	3.2	3.7
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	37.6	39.2	38.9	37.4	38.0	38.1	38.9	37.8	38.1
Gross official reserves (excluding gold)	23.5	24.7	20.8	23.6	22.2	21.9	20.8	20.2	19.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.0	4.3	3.4	4.0	3.7	3.7	3.4	3.3	3.1
	EUR million, period total								
Gross domestic product in current prices	88,430	100,576	113,670	25,967	28,771	28,941	29,992	29,165	31,822

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

for 2007 according the fiscal notification of October 2007. The higher deficit, which nevertheless remains below the previous forecast of –4% of GDP according to the update of the convergence program released in March 2007, is chiefly due to higher social transfers approved before the 2006 elections. However, the coalition government, which has been in office since the beginning of 2007, was determined to accelerate the process of fiscal consolidation and managed to push through a reform package despite a weak parliamentary majority and despite lengthy internal wrangling over details. The key items of the package are the introduction of some direct payments for health care, lower and flat personal income taxes, corporate income tax cuts, and increases of the preferential VAT rate and of some excise taxes. On the expenditure side, the government envisages some slashing of social and health care benefits. As a result, the Ministry of Finance expects the deficit to fall to 2.9% of GDP in 2008 and further to 2.3% of GDP by 2010, which is considerably below the forecasts according to the update of the convergence program published in March 2007 (2008: –3.5% of GDP, 2009: –3.2% of GDP). A more thorough overhaul of the pension and health care systems is still under discussion, and a proposal is expected in the months to come.

5 Hungary: GDP Growth at 11-Year Low in the First Half of 2007

Domestic demand continues to expand only little

GDP growth slowed sharply during the first half of 2007 to a meager 1.9% year on year, down from almost 4% in full-year 2006. The slowdown intensified in the course of the period, and the growth rate reached only little more than 1% (year on year) in the second quarter of 2007. While net real exports remained the driving force of growth, the significant decrease in their contribution to GDP growth was one of the reasons for the deceleration of output dynamics. Domestic demand continued to expand only very sluggishly during the first half of 2007. In a breakdown, consumption growth slumped as a result of the fiscal tightening, declining real wages and roughly stable employment, a significant easing of real credit growth (the real growth of credit to the private sector averaged just 2.5% year on year in the first half of 2007), and the ongoing weakness of consumer sentiment. Investment activity improved somewhat compared to 2006, but still remained anemic. In particular, public sector investment activity contracted on a year-on-year basis, whereas manufacturing investment rebounded sharply, inter alia because industrial capacity utilization improved and an FDI-related one-off project was undertaken in the tire industry. Inventory building has gradually intensified since the beginning of 2007 to become the major element of domestic demand in the first six months of 2007.

Government finances on a consolidation path

According to the latest figures, the 2006 general government budget deficit came in at 9.2% of GDP. In the 2006 update of the convergence program, the government penciled in a deficit of 6.8% of GDP for 2007. However, reflecting better than expected revenue performance and lower than expected expenditures (mainly interest expenditures) in the course of the year, the budget deficit for the entire year 2007 was revised down to 6.4% of GDP in the October 2007 fiscal notification. In its draft budget plans for 2008, the government targets a further deficit reduction to 4.1% of GDP in 2008, slightly below the 4.3% target that had been set out in the 2006 convergence program update. The government has also made progress in some important structural reforms in the course of 2007, which are seen as necessary to secure the sustainability of fiscal consolidation beyond 2008. In particular, in late September 2007, the government coalition reached a political agreement about a comprehensive reform of the health insurance system, which is to be introduced from January 1, 2008. The government has also decided measures that parliament is expected to adopt in 2008, namely to introduce three-year budgetary planning from 2009 onward, to set targets for the primary budget balance and to introduce limits on the increase in public debt. Furthermore, progress has been made on multiparty negotiations on the reform of fiscal institutions (for example the establishment of an independent budget office), which require a qualified parliamentary majority.

Narrowing deficit on combined current and capital account

During the first half of 2007, the deficit of the combined current and capital account fell to below 6% of GDP. The improvement stemmed from a sharp widening of the surplus on the goods and services balance. This reflected the weakness of domestic demand, still favorable export conditions and a slight improvement in the terms of trade. By contrast, the surplus on the transfer balance and on the capital account narrowed moderately. The deficit on the income balance, which is the source of the combined current and capital account deficit, widened as a result of increased FDI profit repatriation, of outflows related to portfolio equity income and of interest payments on foreign debt. Large net FDI outflows were registered as a result of a one-off transaction. Therefore, the major financing item was "other investments," mainly borrowing by the private sector (roughly evenly split between banks and other sectors).

Inflation decreases gradually from relatively high levels

Following the rapid and substantial pickup until early 2007, inflation peaked at almost 9.0% year on year in the first quarter of 2007 and then gradually decreased to 6.4% year on year in September 2007. Inflation excluding energy and unprocessed food prices stagnated at slightly above 7.0% until August before easing back to 5.8% in September. Magyar Nemzeti Bank (MNB) has revised its inflation projection upward for 2007 and 2008 and downward for 2009 and now expects inflation to fall to around 6% by year-end 2007, to 3.7% by end-2008, and to 2.4% in the last quarter of 2009. The negative output gap and weak domestic consumption support disinflation, while adverse energy and food price developments will likely slow the disinflation process in the remainder of 2007 and in 2008. The moderation of wage growth from currently rather high levels will be key, and preventing the expected acceleration of food and energy price inflation from feeding through to inflation expectations and wages remains a challenge. According to the MNB, the risks to the inflation outlook relate mainly to the development of inflation expectations and wages, the magnitude of the disinflationary effect of weak domestic consumption, and the timing and magnitude of the recovery of consumption.

MNB on a cautious rate cutting cycle

Following a period of a steady policy rate between October 2006 and late June 2007, the MNB responded to the improvement in inflationary developments by cutting its key policy rate by 25 basis points at the end of June 2007. Given the uncertainties surrounding the inflation outlook and the major shakeup on the global financial markets since mid-July 2007, the MNB took a

Table 10

Main Economic Indicators: Hungary

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.8	4.1	3.9	4.9	3.7	3.9	3.3	2.7	1.2
Private consumption	3.1	3.7	1.5	2.6	1.7	1.4	0.3	0.4	−0.9
Public consumption	1.8	2.4	2.1	5.4	2.4	−3.2	3.6	−6.4	−8.8
Gross fixed capital formation	7.6	5.3	−2.1	9.9	−3.6	−4.4	−4.8	2.0	0.8
Exports of goods and services	15.7	11.5	17.9	18.4	15.8	17.2	20.1	17.6	14.6
Imports of goods and services	14.1	6.9	12.4	15.5	9.5	10.4	14.5	14.9	14.1
	Contribution to GDP growth in percentage points								
Domestic demand	4.4	1.4	0.4	3.0	−0.5	−0.3	−0.2	1.0	0.5
Net exports of goods and services	0.4	3.5	4.7	2.3	5.5	5.7	4.8	2.8	1.0
Exports of goods and services	11.9	9.7	16.1	16.7	14.3	15.2	18.0	18.0	14.7
Imports of goods and services	11.6	6.2	11.4	14.3	8.7	9.6	13.2	15.2	13.7
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	9.7	10.1	11.5	16.1	8.5	11.0	10.5	9.9	8.5
Gross average wage of industry (nominal)	10.0	7.2	8.6	8.3	7.8	9.0	9.4	8.9	9.5
Unit labor cost of industry (nominal)	0.3	−2.6	−2.6	−6.7	−0.6	−1.9	−1.0	−0.9	1.0
Producer price index (PPI) of industry	3.6	2.9	6.7	4.9	6.5	9.7	5.9	3.4	−0.8
Consumer price index (here: HICP)	6.8	3.5	4.0	2.4	2.7	4.6	6.4	8.8	8.5
EUR per 1 HUF, + = HUF appreciation	0.7	1.5	−6.1	−3.8	−6.4	−10.8	−3.2	0.9	7.5
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	6.1	7.2	7.5	7.7	7.2	7.5	7.5	7.5	7.0
Employment rate (15−64 years)	56.8	56.9	57.3	56.7	57.3	57.6	57.6	56.9	57.6
Key interest rate per annum (%)	11.4	7.1	6.8	6.0	6.0	7.0	8.0	8.0	8.0
HUF per 1 EUR	251.7	248.0	264.3	254.6	266.8	275.4	260.3	252.3	248.3
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	11.8	13.8	16.2	16.6	16.4	17.2	14.6	11.2	8.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−1.9	0.6	−2.2	0.0	−1.5	−4.7	−2.5	−4.6	−4.8
Domestic credit of the banking system	17.9	15.3	23.6	19.1	22.1	29.4	23.4	21.1	15.3
of which: claims on the private sector	*21.6*	*16.6*	*21.7*	*19.1*	*21.3*	*25.8*	*20.6*	*15.7*	*11.6*
claims on households	*9.8*	*7.3*	*9.4*	*8.5*	*9.4*	*10.4*	*9.2*	*8.8*	*7.6*
claims on enterprises	*11.8*	*9.3*	*12.3*	*10.6*	*11.9*	*15.3*	*11.3*	*6.9*	*4.1*
claims on the public sector (net)	*−3.8*	*−1.3*	*1.9*	*0.0*	*0.9*	*3.7*	*2.8*	*5.4*	*3.7*
Other domestic assets (net) of the banking system	−4.2	−2.0	−5.2	−2.5	−4.3	−7.6	−6.4	−5.3	−2.5
	% of GDP, ESA 95								
General government revenues[1]	42.4	42.1	42.6	..	..	..	..	..	..
General government expenditures[1]	48.9	49.9	51.9	..	..	..	..	..	..
General government balance[1]	−6.5	−7.8	−9.2	..	..	..	..	..	..
Primary balance[1]	−2.1	−3.7	−5.3	..	..	..	..	..	..
Gross public debt[1]	59.4	61.6	65.6	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	18.1	11.9	17.9	20.7	14.2	15.7	20.9	19.0	16.0
Merchandise imports	15.8	9.3	16.3	22.4	12.8	12.5	18.0	14.3	13.5
	% of GDP (based on EUR), period total								
Trade balance	−3.0	−1.7	−1.0	−2.0	−0.6	−1.8	0.1	0.8	0.8
Services balance	0.3	1.2	1.4	0.0	1.7	2.2	1.6	0.8	1.6
Income balance (factor services balance)	−6.0	−6.5	−7.3	−7.0	−8.4	−7.0	−6.8	−7.6	−9.1
Current transfers	0.3	0.2	0.4	1.2	0.0	0.5	0.1	0.9	0.1
Current account balance	−8.4	−6.8	−6.5	−7.8	−7.3	−6.0	−5.1	−5.2	−6.6
Capital account balance	0.3	0.8	0.8	0.6	0.2	0.9	1.3	0.2	0.1
Foreign direct investment (net)	3.3	4.9	3.1	8.4	1.1	5.7	−1.8	0.7	−6.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	66.9	74.5	91.4	80.7	82.1	85.6	91.4	93.2	98.1
Gross official reserves (excluding gold)	14.2	17.6	18.2	19.8	18.4	18.5	18.2	18.3	17.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)	2.5	3.1	2.8	3.4	3.1	3.0	2.8	2.8	2.8
	EUR million, period total								
Gross domestic product in current prices	82,441	88,860	89,852	20,204	22,291	22,225	25,133	22,792	25,592

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

[1] *Including the net costs of the pension reform.*

cautious approach to easing interest rates before implementing a further rate cut of 25 basis points at end-September. However, the forint weathered rather well the global financial market turbulence during April and May as well as since mid-July 2007, probably owing to the improvement in Hungary's external and internal imbalances and the relatively high, albeit slowly eroding risk premia against the euro. At the end of October 2007, the currency stood at 251.41 HUF per 1 EUR, 1.74% weaker than at the end of April 2007.[18]

6 Poland: Investment-Driven Growth Reduces Unemployment Rate Significantly

Investment boom

Real GDP growth accelerated to nearly 7% in the first half of 2007. Domestic demand remained strong, with GFCF growth more than doubling to 25% year on year in the first half of 2007 compared to the corresponding period a year before. Apart from the favorable outlook for domestic sales, the high profitability and liquidity of the corporate sector, this buoyancy of investment growth is attributable to the accelerated expansion of credit to both companies and households (the real growth of credits to the private sector was on average above 26% in the first half of 2007 year on year) as well as the growing absorption rate of EU funds. In the first half of 2007, the sharply higher contribution of investment to GDP growth even exceeded that of private consumption, which rose, too, albeit only moderately. Private consumption growth remained below real GDP growth in the first half of 2007, despite strong employment and dynamic wage growth. As a result of stronger domestic demand, real import growth remained nearly unchanged at a high level, although real export growth roughly halved. This led to the largest negative contribution of net exports to GDP growth since 1999, namely about 2 percentage points in the first half of 2007.

Economic growth boosts employment, but industry ULC are on the rise

Annual employment growth in the whole economy accelerated further to more than 5% in the first half of 2007. At the same time, the labor force remained nearly unchanged, contrary to 2006, when it had declined by about 1.5% (see issue 1/2007 of this publication). The combination of a constant participation rate and a sharply higher employment rate implied an annual decline of the unemployment rate (ILO methodology) from above 14% in the second quarter of 2006 to below 10% in the second quarter of 2007. In parallel, nominal average wage growth roughly doubled in the industry sector (to somewhat more than 8%). Up to the first quarter of 2007, annual labor productivity growth in industry (along with a strong increase in employment) was high enough to more than offset accelerating wage growth, so that nominal ULC declined. However, in the second quarter of 2007, production growth slowed considerably, which led to a year-on-year rise in nominal industry ULC (both in national currency and in euro terms).

Moderate widening of goods and services deficit as well as income deficit

In the first half of 2007, both the trade deficit and the surplus on services roughly doubled compared to the first half of 2006, implying only a moderate increase in the deficit of the goods and services balance from 1.1% to 1.6% of GDP. At the same time, the negative income balance widened by about the same amount from 4.1% to 4.6% of GDP. As a result of the higher absorption

[18] *For more details see box 1.*

of EU funds, the capital account surplus increased. Thus, the combined capital and current account deficit augmented only by 0.7 percentage points in the first half of 2007 (to 3.4% of GDP) and continued to be outpaced by net FDI inflows.

Inflation accelerates, but still remains below target

Both annual national headline CPI inflation and HICP inflation accelerated in the third quarter of 2007 to 2.0% and 2.4% year on year, respectively. While food prices increased by 5% year on year, the rise in consumer energy prices was still below average, as the recent jump of world energy prices had not yet been fully transmitted. Inflation in September (2.3%) is still slightly below the Monetary Policy Council's (MPC's) inflation midpoint target of 2.5% (national headline CPI, target range of ±1 percentage point). In view of tighter labor market conditions in particular, the MPC raised its key interest rates by 25 basis points each at the end of April (as already reported in issue 1/2007 of this publication), June and August 2007 to 4.75%, increasing the interest rate differential to the euro area from 25 to 75 basis points. This, in turn, constituted some stimulus for nominal currency appreciation in the course of 2007.[19] According to the MPC assessment of end-September, the probability of inflation exceeding the midpoint target in the medium term had decreased to a certain degree due to recent interest rate hikes, but it was still higher than the probability of inflation running below target. At the same time, the MPC added the global economic environment to its list of factors that would help limit inflation in the medium term. Apart from the labor market, the MPC cited the situation of public finances as the most important factor that will affect the shape of monetary policy in 2008.

Reduction of the fiscal deficit to 3% of GDP in 2007 expected

The revised figure for the general government deficit in 2006 is 3.8% of GDP (against 3.9% in spring 2007). The updated convergence program of November 2006 envisaged a revenue-based reduction of the public deficit in 2007 to 3.4% of GDP, while the expenditure-to-GDP ratio was roughly unchanged despite strong increases in national cofinancing requirements of EU-funded projects. In the fiscal notification of October 2007, the authorities expect the 2007 general government deficit to reach 3.0% of GDP. Before the parliamentary elections held on October 21, 2007, the government decided on an update of the convergence program that envisaged a public deficit of 3% of GDP in 2008. Apart from the indexed hike in social transfers, this figure took into account the impact of election-related decisions of early September 2007, in particular the increase of basic salaries of public health care workers and the rise in the annual parental tax exemption per child. The Civic Platform (PO) party, which won the relative majority in the elections, announced that it would probably introduce budget changes that aim at a lower public deficit.

[19] *From end-2006 to end-September 2007, the currency strengthened by around 5.6% against the euro.*

Table 11

Main Economic Indicators: Poland

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
Year-on-year change of the period total in %									
GDP in constant prices	5.3	3.5	5.8	5.2	5.5	5.8	6.4	6.9	6.8
Private consumption (excl. NPISH)	4.3	1.9	5.2	5.2	4.9	5.5	5.1	7.0	5.3
Public consumption (incl. NPISH)	3.1	5.3	2.4	4.6	1.5	1.1	2.5	−0.5	0.8
Gross fixed capital formation	6.4	6.5	16.7	7.7	14.8	19.8	19.3	28.0	22.1
Exports of goods and services	14.0	8.0	15.1	22.0	12.6	14.8	12.2	11.6	7.9
Imports of goods and services	15.2	4.7	15.4	20.9	10.7	15.3	15.5	15.0	13.8
Contribution to GDP growth in percentage points									
Domestic demand	6.1	2.4	6.0	4.8	4.8	6.2	7.8	8.3	9.5
Net exports of goods and services	−0.8	1.1	−0.2	0.4	0.6	−0.3	−1.3	−1.3	−2.5
Exports of goods and services	4.7	3.0	5.6	7.6	4.8	5.6	4.4	4.7	3.3
Imports of goods and services	5.4	1.8	5.8	7.2	4.2	5.9	5.7	6.0	5.7
Year-on-year change of the period average in %									
Labor productivity of industry (real)	13.5	2.9	9.5	10.4	10.2	9.9	7.7	9.6	5.1
Gross average wage of industry (nominal)	4.5	3.2	5.2	4.3	4.9	6.0	5.5	8.3	8.5
Unit labor cost of industry (nominal)	−7.9	0.3	−4.0	−5.5	−4.8	−3.5	−2.0	−1.2	3.2
Producer price index (PPI) of industry	7.1	0.7	2.2	0.6	2.3	3.4	2.6	3.1	2.0
Consumer price index (here: HICP)	3.6	2.2	1.3	0.9	1.4	1.5	1.3	2.0	2.3
EUR per 1 PLN, + = PLN appreciation	−2.9	12.6	3.2	5.0	4.6	1.6	1.8	−1.3	3.9
Period average levels									
Unemployment rate (ILO definition, %, 15−64 years)	19.3	18.0	14.1	16.3	14.3	13.2	12.4	11.4	9.7
Employment rate (15−64 years)	51.7	52.8	54.5	52.6	53.9	55.6	55.7	55.4	56.8
Key interest rate per annum (%)	5.8	5.3	4.1	4.3	4.0	4.0	4.0	4.0	4.3
PLN per 1 EUR	4.5	4.0	3.9	3.8	3.9	4.0	3.8	3.9	3.8
Nominal year-on-year change of the period average stock in %									
Broad money (including foreign currency deposits)	6.9	11.8	11.9	10.9	10.2	12.8	13.7	18.0	−2.8
Contributions to the year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	4.5	5.5	1.7	6.7	2.7	−0.9	−1.5	−0.9	−5.2
Domestic credit of the banking system	3.5	5.2	12.0	7.3	8.4	14.8	17.1	20.7	21.0
of which: claims on the private sector	*4.0*	*5.5*	*10.9*	*8.7*	*8.6*	*11.7*	*14.1*	*17.5*	*20.0*
claims on households	*4.5*	*5.6*	*8.6*	*7.4*	*7.3*	*9.3*	*10.3*	*12.3*	*13.3*
claims on enterprises	*−0.6*	*−0.1*	*2.3*	*1.3*	*1.3*	*2.4*	*3.8*	*5.2*	*6.7*
claims on the public sector (net)	*−0.5*	*−0.3*	*1.2*	*−1.4*	*−0.2*	*3.1*	*3.0*	*3.2*	*1.0*
Other domestic assets (net) of the banking system	−0.5	2.3	−1.1	−1.8	−0.1	−0.9	−1.6	−1.7	0.9
% of GDP, ESA 95									
General government revenues[1]	36.9	39.0	40.0	..	..	..	..	..	..
General government expenditures[1]	42.6	43.3	43.8	..	..	..	..	..	..
General government balance[1]	−5.7	−4.3	−3.8	..	..	..	..	..	..
Primary balance[1]	−2.9	−1.5	−1.1	..	..	..	..	..	..
Gross public debt[1]	45.7	47.1	47.6	..	..	..	..	..	..
Year-on-year change of the period total (based on EUR) in %									
Merchandise exports	22.3	16.8	21.5	23.6	21.0	21.1	20.4	14.7	12.3
Merchandise imports	19.5	12.6	24.8	26.1	22.9	25.5	24.6	16.8	17.5
% of GDP (based on EUR), period total									
Trade balance	−2.2	−1.0	−2.0	−1.3	−1.9	−2.4	−2.4	−2.1	−3.5
Services balance	0.4	0.6	0.6	0.5	0.5	0.6	0.9	1.2	1.2
Income balance (factor services balance)	−4.5	−3.5	−4.2	−3.4	−4.8	−4.0	−4.7	−4.2	−5.0
Current transfers	2.2	2.2	2.4	1.1	3.0	3.3	2.1	2.1	2.4
Current account balance	−4.1	−1.6	−3.2	−3.1	−3.2	−2.4	−4.1	−3.1	−4.9
Capital account balance	0.4	0.3	0.6	0.6	0.3	0.7	0.8	0.6	0.7
Foreign direct investment (net)	4.6	2.2	3.0	5.7	1.2	2.5	2.5	5.5	2.6
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	46.2	45.8	46.6	46.0	45.5	46.2	46.6	47.7	48.7
Gross official reserves (excluding gold)	12.6	14.1	13.0	13.9	13.7	14.0	13.0	13.2	13.6
Months of imports of goods and services									
Gross official reserves (excluding gold)	3.9	4.6	3.7	4.4	4.2	4.1	3.7	3.7	3.8
EUR million, period total									
Gross domestic product in current prices	205,197	244,775	271,644	63,209	64,314	66,126	77,995	68,723	73,565

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

[1] Including the net costs of the pension reform.

7 Romania: Booming Domestic Demand and further Widening of the Current Account Deficit Signal Danger of Economic Overheating

Some slowing of economic growth, further acceleration of the negative contribution of net exports to GDP growth

At just 5.8% in the first half of 2007, year-on-year real GDP growth was noticeably below the 2006 result. The slowdown was largely the result of a drought-induced deterioration of agricultural output. Domestic demand expanded strongly, like in previous years. Private sector demand was driven by a remarkably high increase of private credits (the real growth of credits to the private sector was on average around 45% year on year in the first half of 2007). Private consumption growth was twice as high as total GDP growth, also driven by rapid wage growth. Compared with 2006, the growth of public consumption picked up in the first half of 2007, as did GFCF growth. Investment activities were also backed by credit growth and focused on the construction sector, which benefited from infrastructure projects and new production plants (also due to FDI inflows). Stock changes added more than 2 percentage points to GDP growth in the first half of 2007. On the external side, the situation worsened further compared to 2006. Export growth declined in the first half of 2007 and was particularly weak in the second quarter, whereas import growth remained strong (above 20% year on year in the first half of 2007). The negative contribution of net exports to GDP growth reached almost 14 percentage points.

Labor market improves, but competitiveness weakens

On the back of GDP growth developments, the unemployment rate declined in the first half of 2007 compared to the previous year. Improvements on the labor market and first signs of labor shortages went hand in hand with increasing wages in the industrial sector. Furthermore, an expansionary public wage policy led the way to dynamic wage growth in other sectors of the economy. In the first half of 2007, nominal wage growth in industry outpaced productivity increases by around 10 percentage points, leading to a significant acceleration of ULC compared to 2006, both in local currency and, due to currency movements, even more so in euro terms, to more than 16% year on year. This development weakened Romania's competitive edge.

Combined current and capital account deficit rises further

In the first half of 2007, the trade balance deteriorated further compared to the first half of 2006, largely triggered by a strong import surge. The deficit of the combined current and capital account enlarged by almost 6 percentage points in the first half of 2007 compared to the same period a year earlier. In the first half of 2007, net FDI inflows covered about 40% of the deficit (compared to 80% a year earlier). This is largely due to the fact that in 2006 several large privatization projects were carried out, while no such major projects were on the agenda in the first half of 2007.

Inflation rises again from historically low levels

With rates of just below 4% year on year, inflation reached record low levels in the first and second quarter of 2007. Thereafter, however, inflation started to pick up again to 5.0% year on year in August 2007 and even to 6.1% year on year in September 2007. Apart from strong domestic demand (supported by very dynamic wage and credit growth), higher prices for food because of the drought-related bad harvest in the summer of 2007 and unfavorable food price developments in the world markets accounted for a large extent of the rise in price pressure. In the first half of 2007, the nominal appreciation of the Romanian leu against the euro helped curb price increases,

Table 12

Main Economic Indicators: Romania

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	8.5	4.2	7.7	6.9	7.8	8.3	7.7	6.0	5.6
Private consumption	14.6	9.8	13.9	12.0	14.0	15.3	13.8	12.1	11.4
Public consumption	–4.2	8.5	2.5	3.3	0.7	1.3	4.1	6.4	6.9
Gross fixed capital formation	11.1	12.5	16.1	11.3	14.4	17.3	18.0	17.2	19.4
Exports of goods and services	13.9	8.1	10.6	12.9	10.5	10.6	8.6	12.9	2.4
Imports of goods and services	22.2	16.6	22.8	21.8	19.1	24.4	25.3	23.8	20.8
	Contribution to GDP growth in percentage points								
Domestic demand	12.8	8.3	14.4	12.2	14.1	15.5	15.0	14.2	18.9
Net exports of goods and services	–5.7	–6.0	–9.8	–8.7	–8.9	–10.2	–10.7	–12.1	–15.4
Exports of goods and services	5.5	3.3	4.5	6.9	5.0	4.3	3.0	7.2	1.2
Imports of goods and services	11.2	9.3	14.3	15.6	13.9	14.5	13.8	19.3	16.6
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	7.1	4.4	11.3	9.0	13.7	11.8	10.7	12.6	8.5
Gross average wage of industry (nominal)	23.0	16.8	15.7	16.6	14.3	15.0	16.8	20.7	21.7
Unit labor cost of industry (nominal)	14.8	11.9	4.0	7.0	0.5	2.9	5.5	7.2	12.2
Producer price index (PPI) of industry	19.1	10.8	11.7	11.2	11.9	12.8	11.1	9.4	7.5
Consumer price index (here: HICP)	11.9	9.1	6.6	8.7	7.2	5.9	4.8	3.9	3.9
EUR per 1 RON, + = RON appreciation	–7.3	11.8	2.7	4.0	2.9	–0.5	4.6	5.4	7.3
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	8.5	7.5	7.6	8.1	7.4	7.4	7.5	7.4	6.8
Employment rate (15–64 years)	57.7	57.6	58.8	57.2	59.6	60.9	57.4	57.2	59.6
Key interest rate per annum (%)	20.0	11.7	8.5	8.0	8.5	8.8	8.8	8.4	7.6
RON per 1 EUR	4.1	3.6	3.5	3.6	3.5	3.5	3.5	3.4	3.3
	Nominal year-on-year change of the period average stock in %								
Money plus quasi-money [1]	31.4	41.3	28.2	34.7	28.8	26.5	24.1	26.8	25.8
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	12.7	17.4	1.2	9.2	1.7	–3.0	–1.6	–2.8	–3.4
Domestic credit of the banking system	28.9	9.9	31.1	30.7	31.7	34.6	27.9	33.2	34.4
of which: claims on the private sector	*32.0*	*25.6*	*36.1*	*32.0*	*34.7*	*38.0*	*38.7*	*39.1*	*39.4*
claims on households	*13.1*	*13.2*	*19.0*	*16.2*	*17.9*	*20.3*	*20.8*	*21.5*	*21.1*
claims on enterprises	*18.9*	*12.4*	*17.1*	*15.8*	*16.8*	*17.7*	*17.8*	*17.6*	*18.3*
claims on the public sector (net)	*–3.1*	*–15.7*	*–4.9*	*–1.3*	*–3.0*	*–3.4*	*–10.8*	*–5.9*	*–5.0*
Other domestic assets (net) of the banking system	–10.2	13.9	–4.2	–5.2	–4.5	–5.0	–2.2	–3.6	–5.1
	% of GDP, ESA 95								
General government revenues	31.2	32.4	33.2	..	..	..	..	..	..
General government expenditures	32.7	33.8	35.0	..	..	..	..	..	..
General government balance	–1.5	–1.4	–1.9	..	..	..	..	..	..
Primary balance	–0.1	–0.3	–1.0	..	..	..	..	..	..
Gross public debt	18.8	15.8	12.4	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	21.3	17.6	16.4	21.4	18.6	9.5	17.1	14.4	8.2
Merchandise imports	24.0	24.0	25.5	27.9	23.1	22.8	28.3	30.9	26.1
	% of GDP (based on EUR), period total								
Trade balance	–8.7	–9.8	–12.1	–9.9	–12.6	–11.2	–13.8	–16.0	–17.4
Services balance	–0.3	–0.4	0.0	0.5	0.6	–0.1	–0.6	1.1	–0.1
Income balance (factor services balance)	–4.2	–2.9	–3.2	–4.1	–4.2	–2.9	–2.2	–5.7	–4.8
Current transfers	4.9	4.5	4.9	5.5	5.0	4.3	5.1	5.2	4.5
Current account balance	–8.4	–8.6	–10.4	–7.9	–11.1	–9.8	–11.6	–15.3	–17.8
Capital account balance	0.8	0.7	0.0	0.7	–2.4	0.3	0.9	0.4	0.7
Foreign direct investment (net)	8.4	6.6	9.4	11.3	6.5	7.1	12.1	7.7	5.3
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt[3]	29.7	30.7	28.2	29.8	31.9	27.9	28.2	27.9	28.2
Gross official reserves (excluding gold)	17.8	21.1	21.9	21.9	20.9	20.6	21.9	21.4	20.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.8	5.8	5.9	6.0	5.7	5.5	5.9	5.6	5.4
	EUR million, period total								
Gross domestic product in current prices	60,917	79,704	97,297	17,113	21,599	26,257	32,329	20,259	26,456

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

[1] Until 11/2004 national definition.

[2] Until 11/2004 general government gross.

[3] Only medium- and long-term debt.

but the currency started to weaken in July and August 2007[20] in the wake of the global subprime mortgage crisis combined with unfavorable developments of the country's external position (i.e. the further widening of the trade balance).

Turning point in monetary policy: Interest rate hike at the end of October 2007

Motivated by these developments, Banca Națională a României (BNR) decided at the end of October to raise the benchmark interest rate by 50 basis points to 7.5% after cutting the key policy rate by a total of 50 basis points in two steps (May and June 2007). The BNR has set an inflation target of 4% ±1 percentage point for 2007, but signaled that inflation is likely to exceed the upper band at the end of the year. In the November 2007 inflation report, the BNR expects inflation to reach 5.7% at the end of the year and 4.3% at the end of 2008 (according to the previous inflation report: end-2007: 3.9% year on year, end-2008: 3.7% year on year). The revisions are above all the result of unfavorable developments of food prices, currency movements and the loosening of fiscal policy. According to the BNR, the main risks to these forecasts are higher public spending in the forefront of the upcoming elections, pension hikes, dynamic wage growth and uncertainties about the behavior of investors in the face of risks in emerging markets.

Renewed fiscal loosening in the last months of the year?

In 2006, the fiscal deficit stood at slightly below 2% of GDP. For 2007, the Romanian government forecasts a budget deficit of 2.9% of GDP (according to the October 2007 fiscal notification), which is marginally higher than indicated in its first convergence program of December 2006. In the latest announcements, however, the Ministry of Finance expects the deficit to be around 1.5 percentage points lower. From January to September 2007, the general fiscal budget registered a slight surplus, but rising public infrastructure spending toward the end of the year is expected to result in deficit. In the setting of booming (substantially credit-financed) domestic demand, a widening of the combined current and capital account and accelerating inflationary pressure, all of which are signs of an overheating economy, fiscal policy and (public) wage policy should be tighter than it has recently been in order to help stabilize the economy.

8 Slovakia: Dynamically Expanding Economy, Broadly Balanced Growth

Swift GDP growth continues in the first half of 2007

Real GDP growth in the first half of 2007 accelerated to more than 9% year on year, putting Slovakia at the forefront of its Central European peers. Growth is well balanced between domestic and external demand. The pickup of economic activity since mid-2006, however, has to be attributed to the very solid performance of net exports. Production capacities have been built up on a large scale in export-oriented industries (e.g. automobiles, electronics), often financed by FDI inflows. This contributed to a robust industrial performance as well as to a rapid expansion of exports. Private consumption remained the second pillar of growth and profited from higher real wages, improved labor

[20] *The currency gained more than 6% against the euro on average in the first months of 2007 compared to the same period of 2006 and traded at 3.12 RON per 1 EUR at the end of June 2007. Affected by the international financial market turbulence, the Romanian leu started to weaken against the euro and stood at 3.41 RON per 1 EUR in late September. The currency strengthened somewhat again to 3.33 RON per 1 EUR the end of October 2007. For more details see box 1.*

market conditions and the swift growth of credits to the private sector (real growth of credits to the private sector averaged around 18% year on year in the first half of 2007). The expansion of GFCF moderated somewhat from the same period of last year, while being characterized by buoyant investment activity in machinery and transport equipment.

Labor market improves, first signs of tightening in some sectors

Strong GDP growth helped bring about a further remarkable improvement of labor market conditions, as exemplified by falling unemployment and rising employment rates as well as increasing vacancies throughout the last few quarters (especially in industry and construction). With inflation declining (see below), real wage increases in the first half of 2007 picked up. The share of long-term unemployment in total unemployment is high (close to 75%) and is decreasing only at a very slow pace. Thus, a further rise in labor demand in the future will pose a challenge to policymakers.

Sound productivity developments support international competitiveness

With industrial output expanding rapidly, industrial productivity has been posting double-digit growth since the beginning of 2006, which, in combination with reasonable wage increases, led to a noticeable decrease in industry ULC in the first two quarters. In euro terms, given the nominal exchange rate appreciation in the second half of 2006 and early 2007, industry ULC have been broadly stable in the last two years. After falling moderately, ULC picked up slightly most recently (second quarter of 2007). Nominal appreciation came to a halt after the revaluation of the central parity of the currency in ERM II in March (see issue 1/2007 of this publication). Since then, the Slovak koruna has broadly stabilized and has traded at levels of about 4% to 6% above the new central parity. ULC developments in the recent past have thus been consistent with ensuring Slovakia's competitive position. Competitiveness is further supported by the improvement of the terms of trade and especially by the positive development of the trade balance.

Trade in goods fuels improvement of the combined current and capital account

The deficit of the combined current and capital account decreased substantially in the first half of 2007 compared to the first half of 2006. This development has to be traced back to the solid performance of the trade balance. Despite an appreciation of the koruna, exports of goods accelerated markedly in the first two quarters of 2007 while import growth lost some speed. External trade disaggregated by product groups reveals that exports increased most strongly in the category consumption goods (including cars) while imports of capital goods decelerated markedly. This development mirrors the industrial development of Slovakia. The buildup of production capacities up to the second half of 2006 stimulated imports of capital goods. As these capacities went onstream, exports of consumer goods were bolstered. As profit repatriation acted as a drag on the income balance, the current account deficit did not decrease to the same extent as the trade deficit did. FDI coverage remained broadly stable at around 75% in the first two quarters of 2007.

Energy and service prices support disinflation

After the HICP inflation peak of 5% year on year in August 2006, price level growth decelerated markedly to a historical low of 1.2% year on year in July as well as in August 2007. The process of disinflation can be explained, to a considerable extent, by lower energy prices, which were mainly due to the lower world energy prices until the summer of 2007, but to some extent also to nominal appreciation. In addition, disinflation in service prices has helped overall disinflation. Disinflation of industrial goods can be attributed partly to

Table 13

Main Economic Indicators: Slovakia

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	5.4	6.0	8.3	6.7	6.7	9.8	9.6	9.0	9.4
Private consumption	4.2	7.0	6.1	6.5	5.7	6.3	6.0	6.5	7.1
Public consumption	2.0	−0.6	4.1	7.8	6.6	1.2	2.3	2.4	1.1
Gross fixed capital formation	5.0	17.5	7.3	13.8	3.6	6.7	7.0	7.7	6.3
Exports of goods and services	7.9	13.8	20.7	17.7	18.1	23.8	22.6	24.1	18.0
Imports of goods and services	8.8	16.6	17.8	19.6	14.0	22.9	15.3	17.7	14.1
	Contribution to GDP growth in percentage points								
Domestic demand	6.3	8.8	6.7	8.2	4.7	9.5	4.5	4.0	6.2
Net exports of goods and services	−0.9	−2.8	1.7	−1.9	2.9	0.3	5.2	5.6	3.4
Exports of goods and services	6.4	11.5	18.5	15.3	15.9	21.0	21.4	23.0	17.4
Imports of goods and services	7.3	14.2	16.8	17.2	13.0	20.7	16.2	17.5	14.0
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	3.9	0.6	11.3	10.6	10.9	12.7	11.0	9.9	11.5
Gross average wage of industry (nominal)	10.1	7.3	6.7	2.4	8.2	7.4	8.5	8.1	6.2
Unit labor cost of industry (nominal)	6.0	6.6	−4.1	−7.4	−2.4	−4.7	−2.2	−1.6	−4.8
Producer price index (PPI) of industry	3.4	4.7	8.4	9.5	9.6	8.5	6.1	3.4	1.6
Consumer price index (here: HICP)	7.5	2.8	4.3	4.2	4.6	4.8	3.5	2.1	1.7
EUR per 1 SKK, + = SKK appreciation	3.6	3.7	3.7	2.2	3.3	2.2	7.1	9.1	11.7
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	18.3	16.3	13.4	15.0	13.6	12.9	12.1	11.7	11.2
Employment rate (15–64 years)	57.0	57.7	59.4	58.3	59.3	59.9	60.2	60.1	60.4
Key interest rate per annum (%)	4.9	3.2	4.0	3.1	3.8	4.5	4.8	4.7	4.3
SKK per 1 EUR	40.0	38.6	37.2	37.5	37.7	37.8	35.9	34.3	33.8
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	4.0	5.0	5.5	2.2	4.5	6.7	8.6	15.1	16.7
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−2.6	−5.8	15.9	8.1	16.6	20.8	18.2	1.1	−3.7
Domestic credit of the banking system	10.2	12.0	3.9	3.9	4.4	4.0	3.5	11.6	13.9
of which: claims on the private sector	*4.0*	*8.0*	*16.0*	*15.2*	*16.6*	*15.8*	*16.5*	*15.1*	*13.9*
claims on households	*4.0*	*5.3*	*8.7*	*8.0*	*8.9*	*9.0*	*9.0*	*7.6*	*7.1*
claims on enterprises	*0.0*	*2.8*	*7.3*	*7.2*	*7.8*	*6.8*	*7.5*	*7.5*	*6.8*
claims on the public sector (net)	*6.1*	*4.0*	*−12.1*	*−11.3*	*−12.2*	*−11.9*	*−13.0*	*−3.5*	*0.0*
Other domestic assets (net) of the banking system	−3.6	−1.3	−14.3	−9.7	−16.5	−18.1	−13.0	2.4	6.5
	% of GDP, ESA 95								
General government revenues[1]	35.4	35.3	33.5	..	..	..	..	..	..
General government expenditures[1]	37.8	38.1	37.2	..	..	..	..	..	..
General government balance1	−2.4	−2.8	−3.7	..	..	..	..	..	..
Primary balance[1]	−0.2	−1.1	−2.2	..	..	..	..	..	..
Gross public debt[1]	41.4	34.2	30.4	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	14.9	15.6	29.6	27.9	25.3	29.7	34.5	37.5	30.8
Merchandise imports	17.9	17.9	29.3	30.7	25.6	33.7	27.7	27.4	25.8
	% of GDP (based on EUR), period total								
Trade balance	−3.7	−5.2	−5.6	−6.2	−5.6	−4.7	−6.0	−0.4	−2.7
Services balance	0.6	0.7	1.2	1.2	0.9	1.3	1.4	0.3	1.3
Income balance (factor services balance)	−5.2	−4.2	−3.8	−1.2	−6.0	−5.9	−1.9	0.3	−6.0
Current transfers	0.4	0.0	−0.1	−0.1	1.1	−1.1	−0.3	−1.0	−0.7
Current account balance	−7.9	−8.7	−8.3	−6.3	−9.6	−10.3	−6.9	−0.9	−8.1
Capital account balance	0.3	0.0	−0.1	−0.1	0.0	−0.1	−0.1	1.0	0.3
Foreign direct investment (net)	7.3	4.1	6.9	4.9	10.2	8.0	4.4	−0.8	5.8
	% of GDP (rolling four-quarter GDP. based on EUR), end of period								
Gross external debt	51.5	60.2	55.6	60.3	61.3	55.2	55.6	57.2	55.6
Gross official reserves (excluding gold)	31.3	33.0	21.9	33.6	30.5	23.5	21.9	25.7	25.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.8	4.9	2.9	4.8	4.2	3.2	2.9	3.4	3.4
	EUR million. period total								
Gross domestic product in current prices	33,878	38,115	44,000	9,847	10,713	11,228	12,212	12,071	13,337

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

[1] *Including the net costs of the pension reform.*

cars, pharmaceuticals (due to a reduction in the VAT rate) and electronics. In September 2007, inflation accelerated slightly to 1.7% year on year on the back of higher energy and food prices. Národná banka Slovenska (NBS) has left its key interest rate unchanged since the end of April 25, 2007. According to the 2007 October forecast, the NBS expects 1.6% inflation in December 2007, which is marginally higher than the July forecast because price increases for food and energy are higher than expected. According to the NBS, demand-pull inflationary pressures seem low, but the risk of higher wage increases still persists. Overall, the inflation target of an HICP inflation rate of below 2% in December 2007 should be reached. For 2008, the NBS projects a moderate increase of inflation to 2.3%, while most observers expect inflation to range between 2% (IMF) and 2.5% (European Commission).

Lower budget deficit in 2007 alongside tightened fiscal accounting standards

The general government deficit for 2006 had to be revised upward to 3.7% of GDP from 3.4%, the figure reported in a previous release. The increase was mainly caused by a downward correction of interest revenues and the inclusion of the Slovak state television and radio in general government. Both measures added a combined 0.3 percentage points to the 2006 deficit. The revision was lower than originally expected, as Eurostat did not recommend a reclassification of the national highway company (NDS) in general government. However, the final decision is still forthcoming. The above-mentioned changes will only marginally affect the budgetary outcome for 2007. Due to better than expected economic developments, the October 2007 fiscal notification envisages a deficit of only 2.5% of GDP for 2007 (2.7% if NDS is included).[21] This is 0.4 percentage points lower than the original target of 2.9% of GDP (according to the update of the convergence program of 2006).

9 Croatia: Buoyant Economic Growth Based on Booming Domestic Demand

Robust economic growth draws on powerful domestic demand

In line with regional trends, the Croatian economy made a strong start into the year 2007, with economic growth reaching 6.8% year on year in the first half of 2007. Private consumption growth picked up substantially, based on strong wage and credit growth (the real growth of credit to the private sector was on average almost 30% year on year in the first half of 2007) and considerably improving labor market conditions. Similarly, public consumption accelerated further, ahead of parliamentary elections on November 25, 2007. Although GFCF growth decelerated somewhat, it was also fueled by strong credit growth and remained an important pillar of economic growth. At the same time, exports of goods and services increased by more than 6% year on year thanks to a good start into the tourist season, as compared to import growth of slightly more than 5% year on year. Consequently, although the contribution of net exports to growth remained negative, it improved noticeably compared to the first half of 2006.

Increasing inflationary pressures

Partly due to base effects, inflation (CPI) in the first half of 2007 remained moderate at an average of below 2% year on year. Against the background of a pickup in the prices for food (representing a weight of some 28% in the basket of goods) and energy in the third quarter of 2007, however, some inflationary

[21] *Including pension reform costs of 1.2% of GDP.*

pressures became visible, with consumer price inflation reaching almost 4% year on year in September 2007. Excluding these two items, inflation hovered between 3% and 3.5% in the first three quarters, even falling to 3% in September thanks to a stable exchange rate and despite booming domestic demand. According to a statement of Hrvatska narodna bank (HNB), inflation is expected to lie between 2.5% and 3% year on year on average in 2007. Developments of prices for energy and food are the main risks to this forecast.

External imbalances prevail

Against the background of brisk domestic demand, the combined current and capital account deficit continued to widen in absolute terms in the first half of 2007, but decreased slightly relative to GDP compared to the first half of 2006. This decrease came in spite of a further widening of the already high trade deficit, which was, however, to a large extent counterbalanced by a higher surplus in the services balance as a result of higher than expected tourism revenues. At the same time, a lower deficit in the income balance fully made up for the lower surplus of current transfers. Net FDI inflows reached around 12% of GDP in the first half of 2007 and were up substantially compared to the same period of 2006. Thanks to huge capital increases in the banking sector, 75% of total FDI inflows were equity investments (including reinvested earnings), which covered around one-half of the combined current and capital account deficit. Given continued debt financing needs, Croatia's foreign debt increased to 86% of rolling four-quarter GDP at end-June 2007, against 84.5% at the end of the first half of 2006. Much as in 2006, the share of "other sectors" (primarily nonfinancial corporations) in total external debt increased sharply, while at the same time the banking sector's share decreased at about the same rate, to a large extent implying a shift to direct cross-border borrowing by the corporate sector (borrowing by domestic banks which refinanced themselves by taking out foreign debt).

Further tightening of credit policy

In light of the unabated strong momentum of credit growth and the central bank's determination to curb loan growth funded by foreign liabilities, the HNB continued to tighten credit policy on several occasions in the first nine months of 2007. In particular, it fine-tuned the administrative measures which came into force at the beginning of 2007 (see issue 1/2007 of this publication). One set of amendments came into force on June 20, 2007, and includes the splitting of the calculation base for purchasing compulsory HNB bills into two separate parts, i.e. household and corporate placements on the one hand and off-balance sheet items on the other hand. In a second step, in July 2007 the HNB reduced banks' maximum allowable placement growth (i.e. without triggering the compulsory purchase of low-yielding HNB bills) to a monthly 0.5% for the second half of the year. Finally, as of October 1, 2007, the calculation base for the subscription of compulsory HNB bills was broadened by also including lending by legal persons controlled by Croatian banks.

HNB interventions counteract kuna appreciation

The Croatian currency moved around a fairly stable 7.35 HRK per 1 EUR in the first months of 2007, but in light of the strong tourism season and after the sale of a 32.5% stake in Hrvatski Telekom via an IPO in September 2007, appreciation pressures aggravated. In an attempt to halt the appreciation of the Croatian kuna, the HNB intervened three times on the foreign exchange market in 2007 with a total of some EUR 500 million. At the same time,

Table 14

Main Economic Indicators: Croatia

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	4.3	4.3	4.8	6.0	3.6	4.7	4.8	7.0	6.6
Private consumption	4.8	3.4	3.5	4.0	2.1	3.9	4.1	7.1	6.5
Public consumption	−0.3	0.8	2.2	1.0	1.8	1.5	4.4	2.8	2.7
Gross fixed capital formation	5.0	4.9	10.9	18.1	8.4	9.3	9.2	11.2	5.8
Exports of goods and services	5.7	4.6	6.9	14.0	5.2	2.2	11.1	3.0	8.9
Imports of goods and services	4.6	3.5	7.3	16.1	4.2	5.5	5.0	3.7	6.4
	Contribution to GDP growth in percentage points								
Domestic demand	4.4	4.2	5.9	10.2	4.0	6.4	3.3	8.2	6.7
Net exports of goods and services	−0.1	0.1	−1.1	−4.2	−0.4	−1.8	1.6	−1.2	−0.1
Exports of goods and services	2.8	2.2	3.4	5.2	2.4	1.5	4.8	1.2	4.1
Imports of goods and services	2.9	2.2	4.5	9.4	2.7	3.2	3.2	2.4	4.2
	Year-on-year change of the period average in %								
Labor productivity of industry (real)	4.0	6.2	2.7	5.6	−1.9	3.7	3.5	7.7	7.3
Gross average wage of industry (nominal)	5.5	5.3	7.5	7.2	7.2	6.1	9.4	6.3	5.2
Unit labor cost of industry (nominal)	1.5	−0.8	4.7	1.5	9.3	2.4	5.7	−1.3	−2.0
Producer price index (PPI) of industry	3.6	3.1	2.9	3.5	3.7	2.7	1.7	2.0	2.5
Consumer price index (here: CPI)	2.1	3.4	3.2	3.5	3.8	3.2	2.2	1.5	2.1
EUR per 1 HRK, + = HRK appreciation	1.0	1.3	1.1	2.3	0.9	0.8	0.2	−0.3	−1.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	14.1	13.0	11.5	..	12.1	..	10.9	..	..
Employment rate (15–64 years)	54.7	55.0	55.6	..	54.5	..	56.8	..	..
Key interest rate per annum (%)	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
HRK per 1 EUR	7.5	7.4	7.3	7.3	7.3	7.3	7.4	7.4	7.4
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	8.3	9.5	14.0	9.9	12.6	15.9	17.3	20.0	20.1
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	−0.5	−5.0	−3.0	−6.8	−6.4	−1.8	2.2	6.2	11.5
Domestic credit of the banking system	9.4	17.3	20.8	19.6	21.9	21.6	20.2	20.6	18.0
of which: claims on the private sector	*10.1*	*13.2*	*20.2*	*17.6*	*21.3*	*21.1*	*20.9*	*22.3*	*22.2*
claims on households	*7.5*	*9.0*	*11.1*	*10.2*	*11.5*	*11.3*	*11.2*	*11.9*	*11.9*
claims on enterprises	*2.6*	*4.1*	*9.2*	*7.4*	*9.8*	*9.8*	*9.7*	*10.5*	*10.3*
claims on the public sector (net)	*−0.7*	*4.1*	*0.6*	*2.0*	*0.6*	*0.5*	*−0.7*	*−1.7*	*−4.2*
Other domestic assets (net) of the banking system	−0.7	−2.7	−3.8	−3.0	−2.9	−3.9	−5.1	−6.8	−9.4
	% of GDP, ESA 95								
General government revenues	41.2	39.6	39.2	..	..	..	..	..	..
General government expenditures	45.3	43.4	41.5	..	..	..	..	..	..
General government balance	−4.1	−3.8	−2.2	..	..	..	..	..	..
Primary balance	−2.0	−1.6	−0.1	..	..	..	..	..	..
Gross public debt	43.2	43.7	40.7	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	16.1	14.0	17.2	32.8	5.2	13.6	20.1	1.9	16.1
Merchandise imports	8.7	11.6	14.0	25.0	8.7	13.9	11.0	8.8	11.8
	% of GDP (based on EUR), period total								
Trade balance	−24.0	−24.0	−24.4	−24.0	−27.6	−22.6	−23.5	−25.4	−27.2
Services balance	16.5	17.0	16.7	−0.6	15.2	43.7	3.8	1.3	16.3
Income balance (factor services balance)	−2.3	−3.1	−3.3	−4.5	−6.5	−1.8	−0.6	−2.6	−6.4
Current transfers	4.1	3.8	3.2	3.8	3.5	2.9	2.9	2.9	2.8
Current account balance	−5.8	−6.4	−7.7	−25.3	−15.3	22.2	−17.5	−23.8	−14.5
Capital account balance	0.1	0.2	−0.4	−2.1	0.0	0.1	0.2	0.1	0.1
Foreign direct investment (net)	4.2	4.1	7.5	6.6	9.1	3.9	10.5	14.4	8.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	79.9	82.3	85.4	82.9	84.5	81.5	85.4	85.6	85.9
Gross official reserves (excluding gold)	22.4	23.8	25.5	25.2	26.7	24.2	25.5	27.2	25.6
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.8	5.1	5.3	5.3	5.6	5.1	5.3	5.7	5.4
	EUR million, period total								
Gross domestic product in current prices	28,693	31,272	34,214	7,725	8,504	9,451	8,534	8,494	9,314

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

despite lower volumes of marginal reserve requirements as a result of banks' decreasing foreign liabilities, Croatia's foreign exchange reserves increased by about EUR 500 million to EUR 9.2 billion in the first half of 2007, corresponding to an import cover of some 5.5 months.

2007 budget revised

Revenue overperformance (mainly VAT, corporate and personal income tax, property tax) considerably improved Croatia's fiscal accounts in the first half of 2007. Against this background, parliament adopted a revised 2007 budget in July, cutting the consolidated general government deficit target to 2.6% of GDP from the previous 2.8%.[22] However, only a small fraction of extra revenue is being used for budget consolidation, with the lion's share being spent on health care, education and agriculture. Based on these developments, the European Commission forecasts an ESA 95 budget deficit of 2.2% of GDP for 2007 (unchanged compared to 2006, despite the improved cyclical position of the economy).

10 Turkey: More Balanced but Somewhat Weaker Economic Growth

Growth again mainly driven by domestic demand but also supported by exports

In the first half of 2007, real economic growth stood at 5.3% year on year, a bit below GDP growth in the previous year. Growth was substantially weaker in the second quarter than in the first quarter of 2007, largely because private consumption growth turned negative. In the first half of 2007, the composition of growth changed somewhat from 2006, as the neutral contribution of net exports turned positive (the acceleration of export growth outpaced the increase of import growth). The weakening of private consumption in the first half of 2007 was caused partly by the tighter monetary stance and the contraction of lending growth in an environment of high interest rates. Real growth rates of credits to the private sector declined from an average of around 40% year on year in 2006 to about 15% year on year on average in the first half of 2007. Consequently, GFCF growth was rather moderate in the first half of 2007.

Still no improvement on the labor market

The unemployment rate remained high at around 10% (ILO definition), as in the last few years. The employment rate stayed rather stable, with notable increases in the service sector and decreases in the agricultural sector. In the first half of 2007, previously high labor productivity growth lost substantial momentum in the manufacturing sector, whereas nominal wage growth remained robust, leading to increasing ULC (in local currency). However, due to currency movements, ULC in manufacturing declined marginally in euro terms.

Continued high deficit of the combined current and capital account

In the first half of 2007, the combined current and capital account deficit declined compared to the first half of 2006, sinking by almost 2 percentage points to below 10% of GDP. This development was largely attributable to an improvement of the trade balance. FDI inflows were fairly buoyant, reflecting the payoff of reform efforts that have fostered a more open, investment-friendly business climate. Net FDI inflows, largely driven by the privatization process, covered more than one-half of the combined current and capital account gap in the first half of 2007. In addition, the abundance of global liquidity provided

[22] *Cash flow data based on national methodology. Not directly comparable with ESA 95 figures.*

ample financing, and portfolio inflows financed nearly one-third of the deficit. The partial debt financing of the still high deficit of the combined current and capital account pushed net external debt to slightly above 50% of GDP at end-June 2007 (31% private, 20% public debt).

Inflation comes down but remains above target

Domestic demand developments supported the disinflation process. Furthermore, lower price increases for durable goods and services as well as a cut in VAT on some processed foods helped curb inflation. Notwithstanding high oil prices and elevated food prices, annual inflation fell further in the third quarter of 2007, also supported by a strong lira. In October 2007, inflation picked up again (largely as a result of higher food prices) and reached 7.7% year on year. Overall, inflation remains above the official inflation target[23] of 4% (±2 percentage points) for end-year 2007. The central bank, Türkiye Cumhuriyet Merkez Bankası (TCMB), cut the benchmark rate by 25 basis points in mid-September and by 50 basis points in mid-October, bringing the rate to 16.75%. In the accompanying announcement, the TCMB noted that the lagged effect of monetary tightening is helping to drive inflation lower, and that the likelihood of hitting the 4% medium-term target remains high. On the back of factors not under the control of the TCMB (such as tax adjustments, increasing food, energy and administered prices), the TCMB revised its inflation forecast for end-2007 upward to between 6.7% and 7.9%.

Appreciation of the Turkish lira

The Turkish lira recovered after the sharp depreciation in May and June 2006. There was only a slight and short episode of exchange rate weakening in August 2007 as a consequence of the turbulences on the U.S. subprime market (see box 1). As the lira started to appreciate again once the risk appetite in global markets had begun to recover, the TCMB announced the increase of the size of its discretionary interventions in the first half of October to ease appreciation pressures on the lira. With this measure, the lira started to weaken against the euro, further supported by the mentioned interest rate cut as well as concerns that the conflict with Kurdish rebels could escalate, so that the lira traded at around 1.7 TRY per 1 EUR at the end of October 2007 (around 8% stronger against the euro than at the end of April 2007).[24]

Fiscal performance deteriorated but remains a cornerstone in the reform process

The primary surplus outturn in 2007 is expected to be around 4.25% of GNP (IMF definition), which is more than 2 percentage points below an earlier target due to higher than expected expenditures and also below the 2006 outcome (primary surplus of 5.8% of GNP). As agreed with the IMF during the 7th review of the Stand-By Arrangement in October 2007, the intended primary surplus target of 6.5% of GNP can be reduced by 1 percentage point to 5.5%, which would still be consistent with reducing the debt ratio to safer levels. For 2008, the IMF urged the Turkish government to reach a primary surplus of at least 5.5% of GNP. In ESA 95 terms, according to the European Commission (2007 Autumn Forecast), the general government deficit for 2007 is expected to be –0.7% of GDP (compared to a surplus of 0.4% achieved in 2006).

[23] *In January 2006, the Turkish central bank changed from explicit to implicit inflation targeting.*

[24] *However, the currency was weaker in first three quarters of 2007 (on average) compared to the same period a year earlier due to the strong depreciation in May and June 2006.*

Table 15

Main Economic Indicators: Turkey

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	8.9	7.4	6.1	6.7	8.3	4.8	5.2	6.9	3.9
Private consumption	10.6	9.1	5.0	8.0	11.2	1.8	0.1	1.8	−0.7
Public consumption	0.5	2.4	9.6	10.1	18.3	14.8	0.7	9.0	7.3
Gross fixed capital formation	32.4	24.0	14.0	32.1	14.0	11.3	4.4	3.0	10.0
Exports of goods and services	12.5	8.5	8.5	6.8	9.1	11.5	6.2	14.7	12.7
Imports of goods and services	24.7	11.5	7.1	10.0	13.7	3.6	1.0	4.3	8.4
	Contribution to GDP growth in percentage points								
Domestic demand	13.9	9.1	5.8	9.0	11.9	1.6	2.8	8.6	5.3
Net exports of goods and services	−4.2	−1.6	0.0	−2.0	−3.1	2.3	1.8	3.2	0.3
Exports of goods and services	3.9	2.8	2.8	2.4	3.0	3.3	2.2	5.2	4.3
Imports of goods and services	8.2	4.4	2.8	4.4	6.1	1.1	0.4	2.0	3.9
	Year-on-year change of the period average in %								
Labor productivity in manufacturing (real)	7.5	6.0	6.7	5.1	9.9	6.5	5.2	4.8	0.3
Gross average wage in manufacturing (nominal)	13.4	12.2	11.5	11.3	11.5	11.1	12.1	8.1	8.9
Unit labor cost in manufacturing (nominal)	5.5	5.9	4.5	6.0	1.4	4.4	6.5	3.2	8.5
Producer price index (PPI) of industry	14.6	6.0	9.3	4.9	8.4	12.6	11.4	10.1	6.6
Consumer price index (here: HICP)	10.1	8.1	9.3	7.6	9.2	10.6	9.7	10.3	9.5
EUR per 1 TRY, + = TRY appreciation	−4.5	5.9	−7.3	8.6	−6.9	−14.4	−14.1	−13.3	2.5
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	10.3	10.2	9.9	11.9	8.8	9.1	9.6	11.4	8.9
Employment rate (15−64 years)	43.6	43.5	43.2	40.1	44.3	45.0	43.5	41.0	44.5
Key interest rate per annum (%)	21.9	14.8	15.6	13.5	14.0	17.4	17.5	17.5	17.5
TRY per 1 EUR	1.8	1.7	1.8	1.6	1.8	1.9	1.9	1.8	1.8
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	24.1	21.1	41.3	41.8	46.7	42.2	35.6	23.3	17.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	2.1	6.1	10.0	9.7	10.1	9.3	10.8	10.7	11.6
Domestic credit of the banking system	28.9	21.6	39.3	41.5	44.2	40.2	32.5	17.3	11.0
of which: claims on the private sector	*19.2*	*19.3*	*31.7*	*30.7*	*33.8*	*33.5*	*29.0*	*19.8*	*15.2*
claims on households	*7.9*	*8.7*	*11.0*	*10.9*	*12.0*	*11.6*	*9.6*	*7.5*	*5.6*
claims on enterprises	*11.2*	*10.6*	*20.7*	*19.8*	*21.8*	*21.9*	*19.4*	*12.3*	*9.6*
claims on the public sector (net)	*9.7*	*2.2*	*7.6*	*10.8*	*10.4*	*6.7*	*3.5*	*−2.5*	*−4.2*
Other domestic assets (net) of the banking system	−6.9	−6.7	−8.0	−9.5	−7.6	−7.2	−7.7	−4.7	−5.6
	% of GDP, ESA 95								
General government revenues	15.9	27.0	27.1	..	..	..	..	..	..
General government expenditures	21.6	27.4	26.7	..	..	..	..	..	..
General government balance	−5.8	−0.3	0.4	..	..	..	..	..	..
Primary balance	5.9	8.8	8.0	..	..	..	..	..	..
Gross public debt	76.9	69.6	60.7	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	19.3	15.0	17.8	18.9	19.4	19.2	14.4	14.4	15.3
Merchandise imports	27.2	21.9	18.9	27.1	27.2	16.1	8.2	8.5	6.2
	% of GDP (based on EUR), period total								
Trade balance	−8.0	−9.3	−10.4	−10.8	−13.7	−9.3	−8.5	−9.8	−10.8
Services balance	4.3	4.2	3.3	1.4	3.1	6.1	1.9	1.4	2.6
Income balance (factor services balance)	−1.9	−1.6	−1.7	−1.8	−1.8	−1.4	−1.7	−2.1	−1.3
Current transfers	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.3	0.3
Current account balance	−5.1	−6.2	−8.3	−10.8	−12.0	−4.2	−7.7	−10.1	−9.3
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	0.7	2.5	4.7	1.7	8.5	3.0	5.8	8.7	2.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	49.0	49.0	49.9	49.9	48.1	49.2	49.9	50.5	51.0
Gross official reserves (excluding gold)	11.0	14.7	14.6	15.8	14.2	14.7	14.6	15.9	15.4
	Months of imports of goods and services								
Gross official reserves (excluding gold)	3.9	5.2	4.8	5.6	4.9	4.9	4.8	5.2	5.1
	EUR million, period total								
Gross domestic product in current prices	241,185	292,121	316,247	67,246	72,425	93,057	83,519	70,077	82,091

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

11 Russia: Overheating with Triple Surpluses?

GDP growth accelerates to almost 8% in the first half of 2007 on the back of newly buoyant investment growth …

Real GDP expanded by almost 8% year on year in the first half of 2007, which is an acceleration compared to the entire year of 2006. The driving force of this acceleration was a near-doubling of the growth rate of GFCF to above 20% year on year. Private consumption growth, already strong, also gained some further momentum. Domestic demand continued to be fueled by rapid credit expansion (the growth of real credit to the private sector amounted on average to more than 40% year on year in the first half of 2007). However, an expanding share of domestic demand is being drained by surging imports, which rose by more than a quarter in real terms in the first six months of 2007. Real export growth continued to weaken, producing an increasingly negative contribution of net exports to GDP growth.

… despite some signs that the economy might be at risk of overheating

The unemployment rate (ILO definition) declined in recent months to below 6% in September 2007, a historically low level since the early stages of transition. Some economic sectors, above all resource extraction and transportation, appear to have reached capacity constraints, and the energy sector continues to struggle with a challenging business climate. The continuing credit boom, surging imports, falling joblessness, emerging capacity constraints, rising inflationary pressures (see below), and the fact that GDP growth has been persistently overshooting trend growth in recent years, would all suggest the Russian economy is at risk of overheating. On the other hand, the most recent acceleration of investment may weaken such a conclusion.

Shrinking combined current and capital account surplus alongside increasing capital inflows …

The import surge, also fueled by the continuing real appreciation of the Russian ruble and by rapidly growing real wages, as well as sluggish export growth against the backdrop of the temporary stabilization of the (high) Urals oil price contributed to the shrinkage of the combined current and capital account surplus to 7% of GDP in the first half of 2007 (as against 12.7% of GDP in the first six months of 2006). Moreover, Russia witnessed a strong expansion of the financial account surplus, facilitated by the full liberalization of capital flows from mid-2006. Driven by some large IPOs (particularly those of the leading state-owned banks Sberbank and Vneshtorgbank) as well as by expectations of further nominal exchange rate appreciation and by rising confidence, total net private capital inflows into Russia rose to 6.5% of GDP in the first three quarters of 2007 (as against 3.7% in the corresponding period of the previous year). Foreign borrowing by banks and companies witnessed high growth rates.

… but interruption of liquidity to banks during the international financial turmoil of August 2007

However, these data conceal the fact that following a steep expansion in the first two quarters, net private capital inflows dried up and even temporarily reversed in the third quarter. This was triggered by the repercussions of the U.S. subprime crisis on Russia.[25] The sudden interruption of capital inflows in August tightened refinancing conditions, particularly for medium-sized and smaller banks, and pushed up interest rates on the interbank loan market. The Central Bank of the Russian Federation (CBR) intervened by supplying liquidity, which it did through repo operations, through cutting reserve requirements and through broadening the list of securities that credit institutions can use as collateral when borrowing from the central bank. Net

[25] *For more details see box 1.*

capital inflows appear to have resumed in October 2007, but the situation remains fragile.

Ample liquidity as well as seasonal factors have fueled inflation …

The strong capital inflows of the first half of 2007, the above-mentioned overheating pressures, utility price adjustments, seasonal factors (bad weather conditions triggering bad harvests in Russia as well as food price increases on world markets more generally) plus the most recent liquidity infusion contributed to pushing CPI inflation (year on year) from 7.4% in March to 9.3% in September 2007. Therefore, it now looks highly unlikely that the CBR will reach its informal inflation goal of 7% to 8% (for end-2007). The CBR recently excluded the use of nominal appreciation to curb inflation. President Putin and some members of the government indicated that inflation should be addressed through administrative measures. However, these statements have to be viewed in the context of the immediate preelection situation.[26]

… while pushing foreign currency reserves and the Stabilization Fund to new record heights

During the peak of the turmoil in late August 2007, the CBR intervened on the forex market to defend the ruble – for the first time since 2002. Foreign exchange reserves dipped marginally, but since then have touched new record levels again (mid-October: EUR 304 billion, which corresponds to about 20 months of goods and services imports). The country's Stabilization Fund (which holds part of the reserves) almost doubled within a year to reach EUR 99.5 billion at end-September 2007. Strongly expanding private sector foreign liabilities that overcompensated falling government external debt led to an increase of total Russian gross external debt to EUR 283 billion, or around one-third of GDP in mid-2007. With overall structural and institutional reforms continuing at a sluggish pace against the backdrop of the upcoming polls, no new reform impulses will be forthcoming until 2008.

Fiscal policy has remained prudent

Federal budget revenues were buoyed by high energy prices and swift economic growth, while expenditures were held back due to the lack of administrative rules in connection with the new budget law and new state procurement regulations. Therefore, in the first nine months of 2007, the federal budget produced a surplus of 7.1% of GDP, which is considerably higher than the planned surplus of 4.8% for the entire year according to the budget law. However, once the legal bottleneck has been overcome and given the upcoming elections, budget spending is expected to take off and to produce an outcome approximating the planned one. (In 2006, the surplus had come to 7.5% of GDP.) In any case, for the time being, Russia can boast of "triple surpluses" (current account, financial account and fiscal), providing a measure of security against macroeconomic or financial risks.

[26] *Duma elections are due in December 2007; presidential elections will follow in March 2008.*

Table 16

Main Economic Indicators: Russia

	2004	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
	Year-on-year change of the period total in %								
GDP in constant prices	7.1	6.4	6.7	5.0	7.0	6.8	7.7	7.9	7.8
Private consumption	11.6	12.2	10.9	9.2	10.4	11.4	12.4	11.8	12.0
Public consumption	2.1	2.2	4.2	3.2	5.5	4.7	3.4	4.4	4.5
Gross fixed capital formation	12.6	8.3	13.9	5.6	14.7	13.7	17.4	19.9	22.9
Exports of goods and services	11.8	6.4	7.2	8.9	6.4	6.1	7.4	3.4	5.2
Imports of goods and services	23.3	17.0	21.7	22.9	21.7	19.1	23.2	25.5	25.8
	Contribution to GDP growth in percentage points								
Domestic demand	8.8	8.4	9.7	6.4	10.0	9.5	12.2	13.2	12.8
Net exports of goods and services	−1.4	−2.3	−3.9	−2.9	−3.9	−3.6	−5.0	−6.8	−6.6
Exports of goods and services	4.1	2.3	2.6	3.4	2.4	2.0	2.9	1.3	1.9
Imports of goods and services	5.5	4.7	6.5	6.3	6.3	5.6	7.9	8.2	8.5
	Year-on-year change of the period average in %								
Labor productivity of industry (real)[1]	14.0	7.3	8.3	6.9	10.2	8.8	7.4	7.3	5.6
Gross average wage of industry (nominal)[1]	5.2	21.1	21.4	20.1	20.6	22.6	22.0	25.9	24.5
Unit labor cost of industry (nominal)[1]	−7.7	12.8	12.1	12.4	9.5	12.7	13.6	17.3	17.9
Producer price index (PPI) of industry	24.0	20.7	12.4	14.8	12.7	13.8	8.7	8.6	13.1
Consumer price index (here: CPI)	11.0	12.5	9.8	10.8	9.6	9.6	9.2	7.9	8.1
EUR per 1 RUB, + = RUB appreciation	−3.1	1.7	3.3	7.9	3.6	1.8	0.0	−1.8	−2.0
	Period average levels								
Unemployment rate (ILO definition)	8.2	7.6	7.2	7.8	7.4	6.7	6.8	7.0	6.1
Employment rate	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	13.5	13.0	11.6	12.0	12.0	11.5	11.1	10.6	10.4
RUB per 1 EUR	35.8	35.2	34.1	33.8	34.2	34.2	34.1	34.5	34.9
	Nominal year-on-year change of the period average stock in %								
Broad money (including foreign currency deposits)	35.5	33.9	37.0	35.0	36.1	37.4	39.1	42.3	48.5
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	22.4	34.0	30.9	29.2	32.1	31.8	30.2	29.9	34.7
Domestic credit of the banking system	17.6	0.4	11.7	9.3	10.9	11.6	14.4	19.3	23.2
of which: claims on the private sector	*30.8*	*30.0*	*36.4*	*32.1*	*34.7*	*38.3*	*39.4*	*41.4*	*44.2*
claims on households	*6.9*	*8.8*	*12.0*	*10.8*	*11.6*	*12.4*	*12.8*	*12.8*	*12.9*
claims on enterprises	*23.9*	*21.2*	*24.4*	*21.3*	*23.0*	*25.9*	*26.6*	*28.6*	*31.3*
claims on the public sector (net)	*−13.2*	*−29.6*	*−24.6*	*−22.8*	*−23.7*	*−26.6*	*−25.0*	*−22.1*	*−21.0*
Other domestic assets (net) of the banking system	−4.5	−0.2	−5.8	−4.2	−7.6	−6.0	−5.5	−6.9	−9.4
	% of GDP								
General government revenues	36.6	39.7	39.7	..	..	..	..	..	..
General government expenditures	31.7	31.6	31.3	..	..	..	..	..	..
General government balance	4.9	8.2	8.4	..	..	..	..	..	..
Primary balance	6.1	9.1	9.2	..	..	..	..	..	..
Gross public debt, general government	21.7	14.9	9.0	..	..	..	..	..	..
	Year-on-year change of the period total (based on EUR) in %								
Merchandise exports	22.6	33.7	22.9	46.4	28.6	18.0	7.1	−1.8	2.7
Merchandise imports	16.6	29.6	28.9	31.7	32.1	26.3	27.1	27.5	26.0
	% of GDP (based on EUR), period total								
Trade balance	14.5	15.5	14.1	18.1	16.2	13.7	9.8	11.6	10.8
Services balance	−2.3	−2.0	−1.5	−1.3	−1.4	−1.8	−1.5	−1.3	−1.6
Income balance (factor services balance)	−2.2	−2.5	−2.9	−1.6	−4.4	−3.0	−2.5	−1.0	−3.6
Current transfers	−0.1	−0.1	−0.1	0.0	0.1	−0.3	−0.3	−0.2	−0.1
Current account balance	9.9	10.9	9.6	15.2	10.5	8.7	5.6	9.2	5.5
Capital account balance	−0.3	−1.7	0.0	0.0	0.0	0.0	0.0	−0.4	0.1
Foreign direct investment (net)	0.3	0.2	1.1	1.2	3.8	0.8	−0.9	4.7	−3.3
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	33.4	36.0	30.4	34.2	32.5	28.6	30.4	31.7	33.8
Gross official reserves (excluding gold)	18.6	24.0	31.1	24.9	27.7	27.4	31.1	30.6	35.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	10.1	13.3	17.6	14.0	15.6	15.6	17.6	17.0	19.2
	EUR million, period total								
Gross domestic product in current prices	475,479	616,014	785,586	167,314	185,145	212,106	221,020	190,564	219,384

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

[1] *Due to breaks in the time series data are only indicative.*

Box 2

Economic Outlook for Central and Eastern European Countries

The OeNB compiles semiannual forecasts of economic developments in the Czech Republic, Hungary and Poland as well as Russia. Taken together, the 3 CEE Member States already account for more than 60% of the 12 CESEE EU Member States' overall GDP and are thus representative of trends in this region of the EU.[27] Among the CEE Member States, economic growth is expected to decelerate in the Czech Republic and in Hungary in 2007 compared to 2006, whereas growth will pick up in Poland. In 2008, economic growth will be stronger only in Hungary; the Czech Republic and Poland are expected to register weaker growth rates.

Table 1

GDP Growth in Three Central and Eastern European EU Member States and Russia: Forecast of October 2007

year on year change at constant prices

	2004	2005	2006	2007[1]	2008[1]
Czech Republic	4.6	6.5	6.4	5.4	5.1
Hungary	4.8	4.1	3.9	2.0	2.5
Poland	5.3	3.5	5.8	6.5	5.7
Russia	7.1	6.4	6.7	7.0	6.2

Source: Eurostat, national statistical offices, OeNB, Suomen Pankki.

[1] Forecast.

In the Czech Republic, the growth rates of private consumption are expected to pick up in 2007, driven by a sizeable increase in gross disposable income. Considering the slowdown of GFCF in the first half of this year, GFCF growth in 2007 is expected to be below that of 2006. Export and import growth rates will decline slightly in 2007 compared to 2006. The contribution of net exports to GDP growth is expected to be about neutral. For 2008, private consumption growth is expected to slow down in the wake of a recently accorded reform package which includes, inter alia, higher VAT and excise taxes and lower social transfers. The negative effects on private consumption will be mitigated by employment increases. Due to the reform package, public consumption growth will be slightly negative. GFCF growth is expected to pick up. On the external side, a slowdown both of import and export growth is expected. The contribution of net exports to GDP will again be about neutral.

In Hungary, both private and public consumption will contract in 2007. This can largely be explained with the fiscal consolidation program, which includes, inter alia, an employment cut and a wage freeze in the public sector, an increase in health care contributions and the elimination of some tax exemptions. Real net disposable income is expected to decrease, even if no significant moderation of gross nominal wages in the private sector is assumed. The dynamics of public consumption in the first half of 2007 are considerably below previous expectations, due to a particularly strong decline of social transfers in kind. After declining in 2006, GFCF growth is expected to recover marginally in 2007. The deceleration of export growth will be accompanied by a slowdown of import dynamics, especially as domestic demand continues to contract. The contribution of net exports is expected to remain positive, but significantly smaller than in 2006. For 2008,

[27] These forecasts are based on preliminary global growth projections and technical assumptions about oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem in broad macroeconomic projection exercises. These assumptions are central to the current outlook for two reasons: first, the sizeable export links of these three EU countries with the euro area, and second, the fact that Russia is one of the world's largest oil-producing nations and that energy sources account for some 60% of the country's total exports. (In the case of Russia, the forecast is established in collaboration with Suomen Pankki, Finland's central bank.)

economic growth in Hungary is expected to pick up moderately. Private consumption will grow marginally as a result of a modest recovery of employment and a stabilization (or minor increase) of real wages. GFCF growth is expected to augment. On the external side, export growth will moderate slightly, and import dynamics are expected to remain roughly stable as a result of deceleration in export growth coupled with a gradual recovery of domestic demand. The contribution of net exports will erode further, but will remain positive.

In Poland, the domestic demand boom is expected to continue in 2007, driven by private consumption and GFCF. Private consumption is rising on the back of high employment growth combined with robust real wage growth and the high growth of credit to households. On the back of buoyant demand, (still) high profitability, robust credit growth and a further increase in the absorption of structural funds, GFCF growth is expected to accelerate further. Export growth is anticipated to decline, while import growth will moderate less strongly. Thus, the contribution of net exports will become more negative. For 2008, GDP growth will moderate somewhat, as domestic demand growth is expected to decline. With real wage growth forecast to slow, private consumption growth will diminish. The deceleration of private consumption growth will be moderated mainly by social reforms (for more details see the country report on Poland). GFCF growth is expected to decelerate from very high levels in 2007, as profitability will come down, credit growth will be dampened and the increase of the absorption of structural funds will slow. Export growth will weaken slightly, while import growth will slow moderately. Overall, the contribution of net exports will stay negative.

Regarding possible sources of risk to these forecasts, deviations from the underlying assumptions for external factors, like import growth of the main trading partners and oil price developments, constitute one source of risk. Additionally, some uncertainty remains about the emergence of bottlenecks on the labor market (in particular in the Czech Republic and in Poland), which could lead to an acceleration of real wages, higher inflation and, finally, to tighter than expected monetary policy. In Poland, reforms were adopted before elections took place; thus, there remains some uncertainty about whether they will be changed again. Furthermore, the region depends largely on foreign capital inflows. The recent developments on the financial markets could have a deeper impact on the region than they had up until now (see box 1). In Hungary, public expenditures represent a source of some uncertainty: With elections coming up in 2010, it is unclear how long restraint in public sector investment and wages will last.

In Russia, the economic situation and prospects for 2007 and 2008 are quite good. Annual real growth of private consumption has remained high in recent years and is forecast to continue at a slightly weaker, but still robust rate, due the confluence of buoyant (preelection) rises in real income and the somewhat weaker expansion of lending. Credit growth may be curbed somewhat in late 2007 and in 2008 by a tighter liquidity situation in the banking sector stemming from repercussions of the most recent financial turbulences.

There is pressure to loosen fiscal policy in Russia, given the upcoming elections. Thus, government consumption is expected to speed up somewhat in 2007 and in 2008. GFCF is predicted to continue growing at a robust pace in 2007 and 2008, driven by huge projects in the energy sector and increased public investment. Rapid economic growth and the further real appreciation of the Russian ruble will sustain high import growth which, however, is expected to decline somewhat. Import demand growth is expected to ease because the upward pressure on the ruble will presumably weaken somewhat once the strong rise of oil prices experienced in recent years levels off as expected and because the economic expansion will lose some momentum. Rapidly rising imports are not yet considered to pose a threat to Russia's external balances.

Given the persisting dependence of the Russian economy on the extraction and export of raw materials, the oil price remains a key risk factor for Russian growth. If the oil price *were to drop sharply, Russia's current account balance could run into the red in one or two years from now and economic growth could suffer. However, there are now some buffers that can cushion the decline. Furthermore, the stability of the capital inflows is not guaranteed. Another risk factor consists of a possible excessively quick appreciation of the real exchange rate, triggered by accelerating inflows of energy proceeds and/or capital inflows. The rapid expansion of domestic lending, which has been going on for some years now, will also trigger risks if the number of problem loans swells further. Recently, nonperforming household credits have been proliferating swiftly, albeit from a low point of departure. Another risk could be a stronger curbing of credit growth. Finally, the political uncertainty brought on by the presidential elections in the spring of 2008 could also spill over into economic risks to growth expected toward the end of the forecast period.*