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FOCUS ON EUROPEAN ECONOMIC INTEGRATION

Stability and Security.

Q2/13

The OeNB's quarterly *Focus on European Economic Integration (FEEI)* presents peer-reviewed studies on macro-financial and monetary integration in Central, Eastern and Southeastern Europe (CESEE) as well as related country analyses and statistics. This publication reflects a strategic research priority of the OeNB.

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

Call for Entries: Olga Radzyner Award 2013 for Scientific Work on European Economic Integration

In 2000, the Oesterreichische Nationalbank (OeNB) established an award to commemorate Olga Radzyner, former Head of the OeNB's Foreign Research Division, who had died in a tragic accident in August 1999. The award is bestowed on young economists for excellent research on topics of European economic integration and is conferred annually. In 2013, four applicants are eligible to receive a single payment of EUR 3,000 each from an annual total of EUR 12,000.

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

Authors shall send their submissions either by e-mail to eva.gehringer-wasserbauer@oenb.at or by postal mail – with the envelope marked “Olga Radzyner Award 2013” – to the Oesterreichische Nationalbank, Foreign Research Division, Otto-Wagner-Platz 3, POB 61, 1011 Vienna, Austria. Entries for the 2013 award should arrive by September 20, 2013, at the latest. Together with their submissions, applicants shall provide copies of their birth or citizenship certificates and a brief CV.

For detailed information, please visit the OeNB's website at http://www.oenb.at/en/ueber_die_oenb/foerderung/stipendien/radzyner/teilnahme/teilnahme.jsp or contact Ms. Eva Gehringer-Wasserbauer in the OeNB's Foreign Research Division either by e-mail (eva.gehringer-wasserbauer@oenb.at) or by phone (+43-1-40420-5205).

Call for Applications: Visiting Research Program

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

The OeNB offers a stimulating and professional research environment in close proximity to the policymaking process. Visiting researchers are expected to collaborate with the OeNB's research staff on a prespecified topic and to participate actively in the department's internal seminars and other research activities. They will be provided with accommodation on demand and will, as a rule, have access

to the department's computer resources. Their research output may be published in one of the department's publication outlets or as an OeNB Working Paper. Research visits should ideally last between 3 and 6 months, but timing is flexible.

Applications (in English) should include

- a curriculum vitae,
- a research proposal that motivates and clearly describes the envisaged research project,
- an indication of the period envisaged for the research visit, and
- information on previous scientific work.

Applications for 2014 should be e-mailed to

eva.gehringer-wasserbauer@oenb.at
by November 1, 2013.

Applicants will be notified of the jury's decision by mid-December. The following round of applications will close on May 1, 2014.

Recent Economic Developments and Outlook

Developments in Selected CESEE Countries:

Economic Downturn Continues in an Adverse International Environment^{1, 2, 3}

1 Introduction

Economic dynamics in most of the CESEE countries remained very subdued during the review period. This development was largely in line with broader European developments and in fact was substantially fueled by them. Economic weaknesses in the euro area affected the region via several channels, most importantly through external demand. Developments in the euro area still had an adverse impact on sentiment, while external financing conditions tended to improve as financial markets recovered in Europe and globally.

However, domestic factors also impacted on economic conditions. The deleveraging process is still ongoing in some countries, weighing on real sector dynamics. Furthermore, most CESEE countries are still undergoing fiscal consolidation, which further dampens domestic demand. Given considerable spare capacity and unabated uncertainty about future economic developments, companies have tended to refrain from investing, which in turn had an adverse effect on labor market conditions. It should be noted, however, that developments in Russia and, to some extent in Turkey, depart from these regional trends.

Economic growth in the region decelerated substantially in 2012, coming down from 4.3% year on year in the final quarter of 2011 to 1.2% in the final quarter of 2012. Quarter-on-quarter dynamics were flat throughout the whole of 2012, when excluding Turkey and Russia. The positive growth dynamics Turkey had recorded in early 2012 largely faded in the second half of the year, so that Russia, by far the largest economy of the region, was the only country that recorded positive quarter-on-quarter growth dynamics in the review period. But year-on-year growth rates were also declining markedly in Russia toward the end of 2012.

Four of the ten countries under review here were in recession at the end of 2012, while growth in another five did not surpass 0.2%. With that, the regional differentiation of the economic momentum we observed in early 2012 and in fact throughout most of the crisis has narrowed, and countries seem to be less able at this stage to decouple from regional trends.

Net exports were the most important driving force of GDP growth in the region in the second half of 2012. In six countries, it was even the only GDP component that contributed positively to growth. External demand has thus remained a key variable in economic developments in CESEE, and clearly the recession in the euro area has been taking its toll. In fact, export growth decelerated throughout the CESEE region. In four countries, this went hand in hand with declining growth contributions of the external sector.

Growth at a standstill throughout most of CESEE

Economic dynamics mainly driven by the external sector...

¹ Compiled by Josef Schreiner with input from Stephan Barisitz, Mariya Hake, Mathias Lahnsteiner, Thomas Reiningger, Katharina Steiner, Jarmila Urvova, Zoltan Walko and Julia Wörz.

² Cutoff date: April 5, 2013, (April 22, 2013, for fiscal data). This report focuses primarily on data releases and developments from October 2012 up to the cutoff date, while selectively recalling earlier developments wherever needed to put recent developments into perspective.

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

Table 1

Real GDP Growth

	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Period-on-period change in % (seasonally and working day adjusted)</i>								
Slovakia	3.2	2.0	0.7	0.9	0.3	0.4	0.3	0.2
Slovenia	0.6	-2.3	-0.1	-0.9	-0.2	-1.1	-0.6	-1.0
Bulgaria	1.8	0.8	0.2	0.1	0.0	0.4	0.1	0.0
Czech Republic	1.9	-1.3	-0.1	0.0	-0.5	-0.6	-0.4	-0.2
Hungary	1.6	-1.7	-0.0	0.2	-1.0	-0.6	-0.4	-0.9
Poland	4.3	2.0	0.8	0.9	0.4	0.1	0.3	0.2
Romania	2.2	0.7	1.4	-0.2	-0.1	0.6	-0.2	0.2
Croatia	-0.0	-2.0	-0.4	-0.4	-0.7	-0.7	-0.6	-0.7
Turkey	8.5	2.6	1.7	0.6	0.4	1.8	0.2	0.0
Russia	4.3	3.4	1.6	2.7	0.2	-0.4	0.7	1.8
CESEE average ¹	4.6	2.3	1.3	1.5	0.2	0.2	0.4	0.8
CESEE average (excl. Russia) ¹	4.9	1.3	1.0	0.5	0.1	0.6	0.1	-0.0
Euro area	2.0	1.4	0.1	-0.3	-0.1	-0.2	-0.1	-0.6

Source: Eurostat, national statistical offices.

¹ Average weighted with GDP at PPP.

Other countries, however, reported a somewhat rising growth impetus from trade in the latter half of 2012 (e.g. Croatia, Bulgaria, and Slovenia). Thus, several factors were at play that dampened the adverse impact of softening external demand: First, weak domestic dynamics put a damper on import demand, so that import growth declined more or less uniformly throughout the region, in some cases even more strongly than export growth. At the same time, some countries (e.g. Russia and Turkey) have started to gradually reorient their regional trading patterns toward faster-growing regions outside Europe. Finally, the CESEE region still is in a comparatively favorable competitive position against the euro area, given considerable unit labor cost improvements in manufacturing in the wake of the global financial crisis in most countries.

More recently, though, a few countries have seen some decline in price competitiveness vis-à-vis the euro area. This is true especially for Turkey, Russia and Croatia, and as of late also for Hungary and Poland. It is noteworthy that substantial parts of the deterioration are related to productivity developments, with productivity growth having turned negative in Poland and Hungary and having decelerated substantially in Croatia, where industrial production slumped toward the end of 2012. In Poland and Hungary, the situation was further accentuated by some strengthening of the exchange rate in a yearly comparison.

Domestic demand played a notable role for economic dynamics only in Russia, where both private consumption and investment added noticeably to growth. A minor positive contribution of domestic demand to growth was also reported for Romania and Bulgaria. Throughout the rest of the region, domestic demand was weak and exerted a dampening influence on the economy.

Subdued real sector dynamics went hand in hand with rather anemic growth of credit to the private sector through most of the region. Some countries, particularly Hungary, but also Slovenia and Croatia, have been faced with a deleveraging of

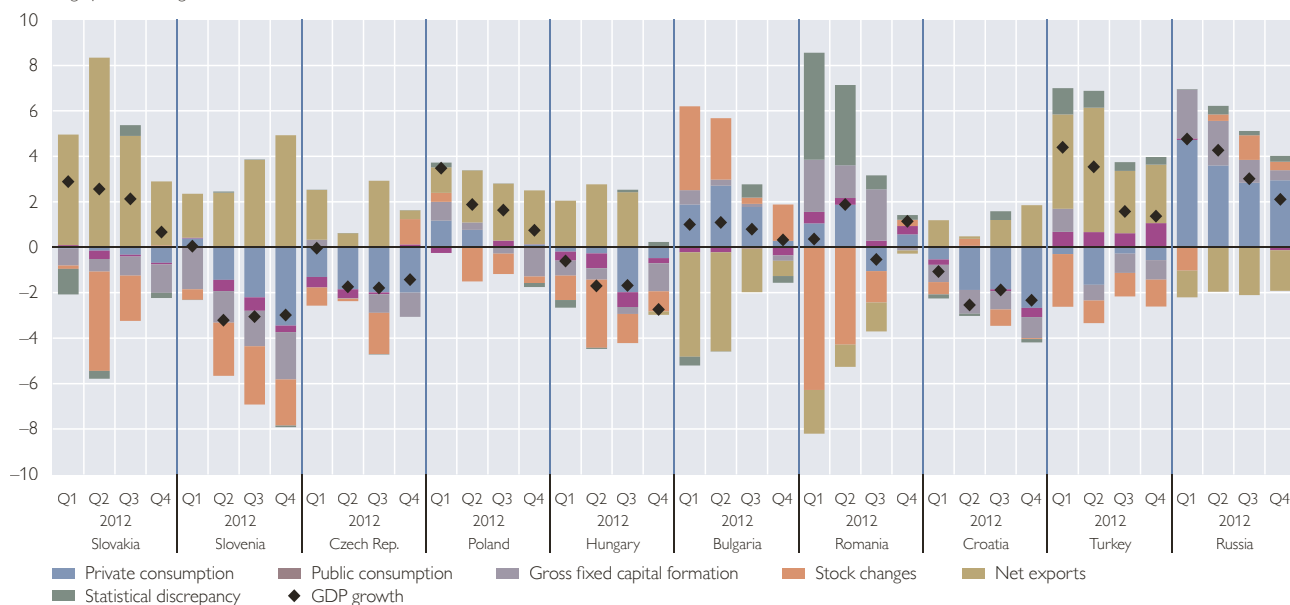
...as domestic demand remains weak

Muted credit dynamics...

Chart 1

GDP Growth and Its Main Components

Percentage points, GDP growth in %



Source: Eurostat, national statistical offices.

households and corporations. Likewise, consolidated bank exposures of BIS-reporting banks vis-à-vis some countries under review here have fallen (Hungary, Slovenia, more recently also Romania and Croatia). In some other countries of the region, cross-border exposures have fallen while consolidated exposures have remained stable or have grown slightly. This mirrors a broader change in bank funding structures toward a higher share of domestic funding sources. Considering that overall exposures have not diminished, this change should be seen separately from deleveraging processes; in particular, the macroeconomic effects of the shift to domestic funding sources, e.g. on overall credit supply, are different.⁴

At the same time, deleveraging is not a general phenomenon in the region. Countries like Poland, the Czech Republic and Slovakia have been spared, and, unlike the other countries covered here, Turkey and Russia still experienced a quite dynamic credit expansion, although it decelerated somewhat in the second half of 2012. However, credit growth in Turkey regained speed in early 2013.

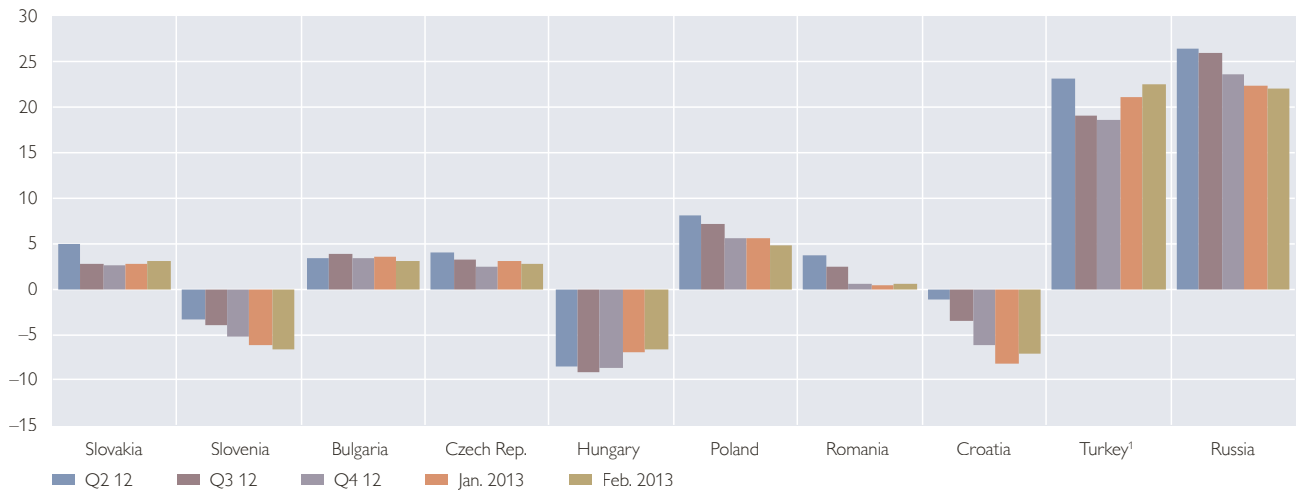
While it is notoriously difficult to disentangle the supply and demand factors of credit developments, it appears that supply as a limiting factor for credit dynamics became less important during the review period. Evidence in support of this view comes from the IIF's Emerging Markets Bank Lending Conditions Survey. The report for the fourth quarter of 2012 finds that overall lending conditions in emerging Europe improved slightly for the first time since the second quarter of 2011. This development was mainly driven by substantially improving domestic as well

⁴ Note that (quarterly) financial accounts and BIS data, which are of key importance in capturing deleveraging trends, are released with a time lag of almost four months. At the time of writing, data up to the third quarter of 2012 were available. Credit data, in turn, are available at a monthly frequency and with a shorter time lag.

Chart 2

Growth of Credit to the Private Sector

%, year on year, adjusted for exchange rate changes



Source: National central banks.

¹ Nonadjusted.

as international funding conditions, reflecting some key central banks' accommodative stance as well as reduced concerns about the euro area crisis. However, credit standards continued to tighten somewhat, as nonperforming loan ratios increased.

Low demand seems to be more important for explaining credit developments in CESEE at the current juncture than credit supply bottlenecks. This claim is also supported by the IIF survey, which reports declining credit demand in the second half of 2012. This decline is related to various factors. First, labor markets remained slack, impacting on households' credit demand. Unemployment rates have increased in nearly all CESEE countries since mid-2012 (e.g. especially in Croatia, by 3 percentage points) and were in the double digits in more than half of the region in January 2013. At the same time, youth and long-term unemployment trended upward and employment declined in most of the countries. Real wage growth also decelerated throughout most of CESEE and was negative in six out of ten countries. Furthermore, fiscal consolidation is cutting into households' debt servicing capacity and also affecting consumption. Businesses are reluctant to invest in view of unfavorable demand conditions, low capacity utilization rates and an uncertain outlook for economic growth. Sentiment indicators are also far below long-term averages, with especially pessimistic expectations among households and the construction sector.

At the same time, there is some recent evidence that the CESEE region might already have reached the trough of economic activity in late 2012 or at the beginning of 2013. At the current juncture, especially soft data point toward an admittedly rather hesitant and still uncertain turning of the economic cycle in CESEE. The economic sentiment indicator of the European Commission (which is available for EU Member States as well as for Croatia and Turkey), for example, has been increasing since November 2012, when it reached its lowest value since late 2009. In March, the average reading stood at 95 points, more than four points

...increasingly driven by low credit demand

Data on sentiment hint that a subdued recovery might set in at the beginning of 2013

above its low. Among the subindices of the indicator, the positive trend was most pronounced in construction and among consumers (both, as mentioned, from very low levels), but industrial sentiment also brightened to some degree.

In principle, the Purchasing Managers' Index (PMI) data for Poland, the Czech Republic, Turkey and Russia also confirm this picture. The index showed an upward trend from December until February. However, it softened marginally in March, when it still indicated an expansion in Russia and Turkey (values of 50.8 and 52.3) but a contraction in Poland and the Czech Republic (values of 48.0 and 49.1).

The external environment for the CESEE countries also seems to be improving somewhat. The Economic Sentiment Indicator (ESI) for the euro area increased to 90 points in March (+4.3 points since October), while the PMI improved to 46.8 (+2.8 points since July).

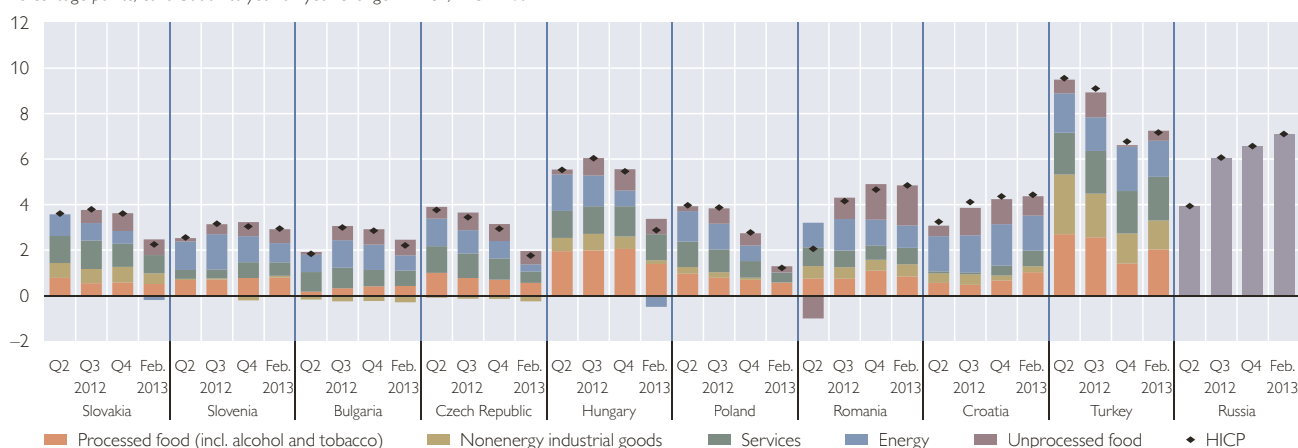
Turning to activity indicators, the picture is still somewhat blurred, and a change in trend cannot be clearly made out yet. Average growth of industrial production, for example, stopped its downward trend in December but did not gain substantial speed at the beginning of the year: the growth rate came in at only 0.2% in February. The picture is similar for construction output and retail sales: Both have recovered a bit from their lows, but are not clearly expanding yet.

Nevertheless, the most recent forecasts expect economic activity to pick up gradually starting in early 2013. Given a negative carryover effect and the weak international environment, growth for the year 2013 is set to accelerate only slightly to an average of 1.8% (after 1.7% in 2012), though. In 2014, the economic dynamics should gain some more steam, and output is projected to expand by 2.3%. With that, the recovery in the next two years will remain comparatively muted.⁵

Chart 3

HICP Inflation and Its Main Drivers

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



Source: Eurostat.

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

⁵ The figures used for calculating the regional average come from the OeNB (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Croatia and Russia) and from the European Commission (Slovakia, Slovenia and Turkey). For the detailed OeNB-Bank of Finland forecast for CESEE, see *Outlook for Selected CESEE Countries: Headwinds to Recovery because of Continued Weakness of the External Environment and Only Slow Pickup in Domestic Momentum*.

Price developments in CESEE were heterogeneous throughout the review period. While the average inflation rate for the region was roughly stable at some 5.5% to 6% (weighted average) in the second half of 2012 and in early 2013, country differences in price developments were substantial.

Moderating price pressures in most countries...

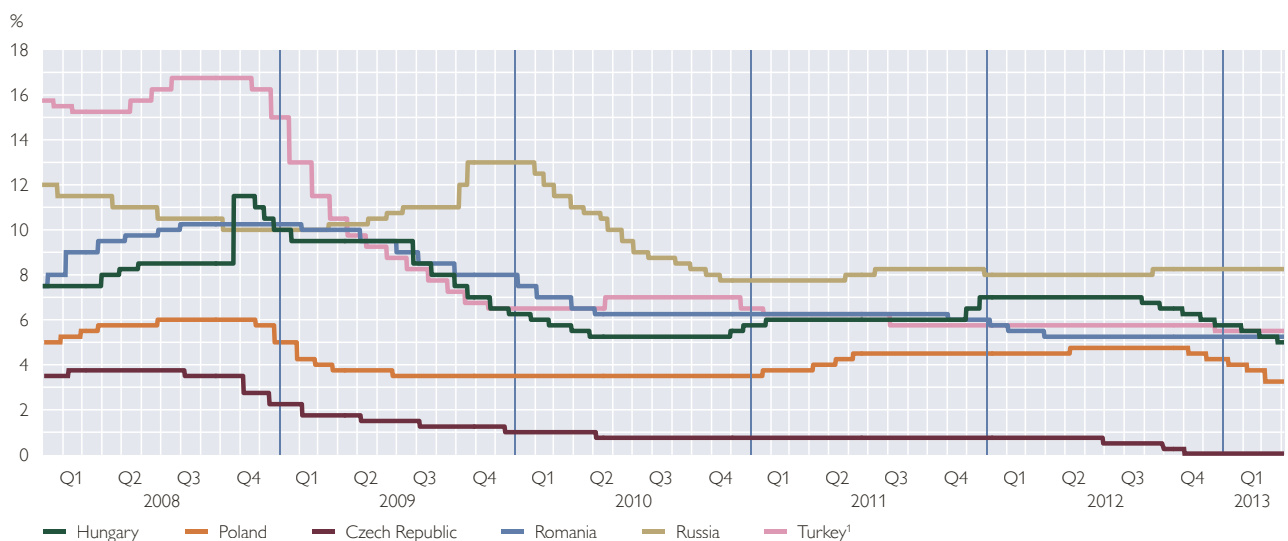
Most countries experienced disinflation during the review period, which was most pronounced in the Czech Republic, Hungary, Poland and Turkey. Inflation declined by more than 2 percentage points from the second quarter of 2012 until February 2013 in those countries. The factors behind this development include earlier tax hikes dropping out of the base in Hungary and the Czech Republic, declining price pressure from the energy component (in Hungary further accentuated by a 10% decrease in utility prices at the beginning of the year) as well as lower inflation dynamics in industrial goods in Turkey.

By contrast, price pressures in Romania and Russia increased by roughly 3 percentage points within the observation period. In both countries, pressure was strongly driven by increasing food prices. A relatively poor harvest and a low base boosted food price dynamics from the second half of 2012 onward. Additionally, hikes in administered prices in July 2012 in Romania and in July 2012 and again in early 2013 in Russia are still rippling across consumer prices.

During the review period, both the Bank of Russia (CBR) and the National Bank of Romania (BNR), have kept their main policy interest rates stable. The CBR argued that under the assumption of stable inflation expectations and in the absence of adverse food price shocks, the rate of inflation will return to the target range in the second half of 2013. The BNR, in turn, pointed out the temporary and one-off nature of the recent inflation upturn and the still considerably negative output gap, which – in conjunction with base effects kicking in during the second half of 2013 – should bring inflation back on target by year-end.

Chart 4

Policy Rate Developments in CESEE



Source: National central banks.

¹ In May 2010, the Central Bank of the Republic of Turkey replaced the borrowing rate by the one-week repo rate as a policy rate.

...provide room for
monetary loosening

Demand pressure on prices was generally low also in the other countries of the region, and core inflation rates were mostly well below headline inflation rates. Among the other central banks of the region, disinflation was well reflected in interest rate decisions. Monetary policy was loosened most aggressively in Hungary and Poland. Policy rates in both countries have been cut by a cumulative 150 basis points since October 2012 to 5% and 3.25%, respectively. The Czech Republic reduced its main interest rate by 20 basis points to a record low of 0.05%, and the central bank of Turkey cut the main interest rate by 25 basis points to 5.5%.

Favorable development
of external balances in
the second half of 2012

Combined current and capital account positions in the CESEE region had improved substantially during the global financial crisis. After some pause in 2011, external positions again improved in most CESEE countries during the observation period, in some cases substantially so. The adjustment was most pronounced in Slovenia and Turkey, where the external balances gained close to 2% of GDP from the second quarter of 2012 to the fourth quarter of 2012 (four-quarter moving sums), and in Slovakia (2.8% of GDP). Better outcomes in the trade balance largely due to low import demand reflecting weak domestic dynamics were mainly responsible for this development. A deterioration of the external position was reported only for Russia.

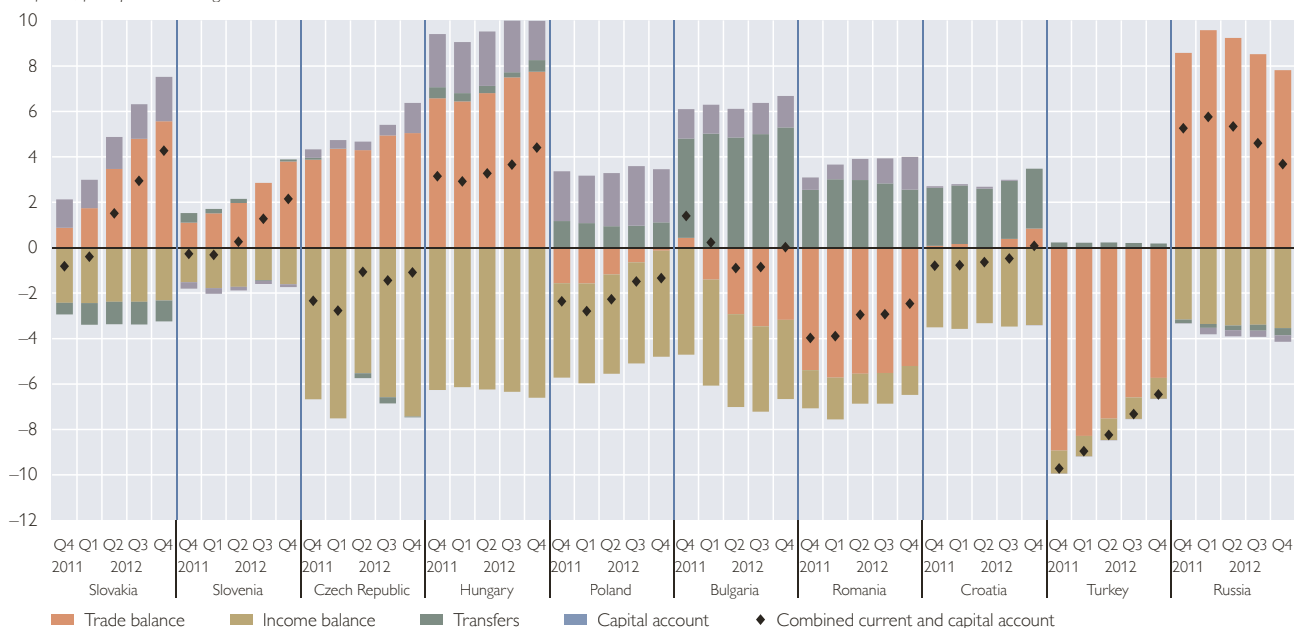
Capital flows to
CESEE gain speed with
substantial variation
across countries

Net capital flows to the ten CESEE countries as a whole accelerated strongly from -0.4% of GDP in the second quarter of 2012 (four-quarter moving sum) to 4.8% of GDP in the final quarter of 2012 (four-quarter moving sum). This development was driven to a substantial extent by flows to the bigger markets of the region, namely Turkey (rising inflows) and Russia (decreasing outflows). But some

Chart 5

Combined Current and Capital Account Balance

% of GDP, four-quarter moving sum



Source: Eurostat, IMF, national central banks.

other countries of the CESEE region also reported higher net inflows of foreign capital. This is especially true of the Czech Republic and Bulgaria.

A noticeable deterioration of the financial account balance was reported only for Croatia, Hungary and Slovenia, the economically weaker countries of the region, featuring reduced inflows in Croatia and (rising) outflows in Slovenia and particularly in Hungary.

In the Czech Republic, Hungary and Slovenia, net FDI inflows made up the largest positive component of the financial account. By contrast, (net) portfolio investment represented the financial account's largest positive component in Slovakia, Poland, Croatia, Turkey, Russia, Romania and Croatia. (Net) other investment – in particular loans – were negative in all countries under observation but Turkey and Bulgaria. Net outflows from this category were related to bank deleveraging in some countries, in particular in Hungary, Slovenia, Romania and Croatia.

Financial account developments during the review period were driven by a combination of push and pull factors, including investor sentiment. (Higher) inflows were reported especially for countries with favorable CDS developments and/or a comparatively good growth outlook, while outflows could be observed from countries faced with less benign risk assessments of international investors. Investors based their judgment on the weaker growth outlook, structural problems, and an unfavorable business environment partly due to insufficient reform efforts or a lack of policy predictability and credibility.

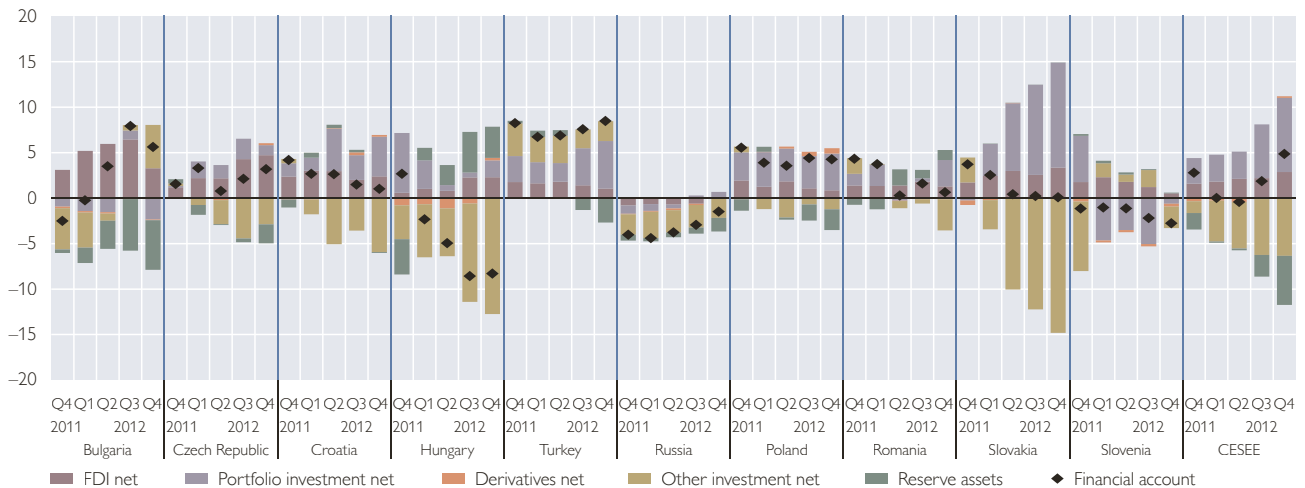
Most CESEE countries continued with fiscal consolidation efforts also in 2012. The highest declines in public deficits were reported for Romania and Slovenia (–2.7% of GDP and –2.4% of GDP, respectively) followed by Poland, Croatia and Bulgaria. In some other countries, however, budget balances stagnated or deteriorated. This is especially the case for Hungary, the Czech Republic and Russia. In the former two, the deterioration was strongly related to one-off factors, however.

Fiscal consolidation
efforts continue in 2012

Chart 6

Financial Account Balance

% of GDP, four-quarter moving sum



Source: National central banks.

In Hungary, revenues from the de facto abolition of formerly compulsory private pension funds (the pension system's "second pillar") had led to a large surplus in 2011. Without those receipts, the deficit in the country would have amounted to some 5.5% of GDP, substantially higher than the 1.9% of GDP reported in 2012. In the Czech Republic, the deficit widened by 1.1% of GDP as a result of the combined impact of two one-off operations amounting to some 1.8% of GDP. Consequently, the structural budget deficits of those two countries narrowed, just like throughout most of CESEE. In Russia, boosts in public spending in the forefront of presidential elections and a public investment program in infrastructure and the nonenergy economy along with a variety of expanded social policy schemes brought down the country's budget surplus of 1.5% of GDP in 2011 to virtually zero in 2012. Russia was also the only country whose cyclically adjusted budget balance deteriorated noticeably.

With the exception of Bulgaria, all EU Member States in the CESEE region are subject to an excessive deficit procedure (EDP). Target dates scheduled for reducing excessive deficits were set at 2012 for Poland, Hungary and Romania and at 2013 for the Czech Republic, Slovenia and Slovakia. Among the first group of countries, only Hungary and Romania managed to bring down their budget deficits to below the 3% of GDP threshold in 2012. Poland posted a deficit of 3.9% of GDP. A decision on the abrogation of the EDP will formally be taken in June. At the current juncture, it only seems safe to say that Romania has met its target in a sustainable way. In the case of Hungary, the latest forecast of the European Commission projects a rise of the deficit to 3.4% of GDP in 2013 and 2014. The sustainability of the correction in 2012 will have to be assessed against this background. Deficits are expected to exceed the 3% of GDP threshold also in the Czech Republic, Slovenia, Slovakia and Croatia in the next two years.

Croatia is about to enter the EU; Latvia submits entry request to euro area

Croatia is set to become the 28th member state of the European Union on July 1, 2013. The country finished its accession negotiations on June 30, 2011, signed the Accession Treaty on December 9, 2011, and in a referendum on January 22, 2012, a majority of the Croatian population voted in favor of EU accession. The ratification process in some EU Member States, however, is still ongoing. As of April 11, 2013, ratification was still pending in Denmark and Germany.

On March 5, 2013, Latvia formally asked the European Commission and the ECB to deliver convergence reports with the aim of joining the euro area on January 1, 2014. The respective reports will be published on June 5, 2013, with the European Commission also giving a recommendation on the introduction of the euro in Latvia. Finally, the ECOFIN will take a formal decision on the matter after consulting the European Parliament and following a discussion in the European Council.

Box 1

Ukraine: Growth Stalls, Twin Deficits Widen, but Imminent Market Pressures Ease

After growth decelerated in the first half of 2012, Ukraine's economy contracted in the second half of the year, bringing full-year GDP growth down to 0.2% from 5.2% in 2011.

Widening twin deficits also contributed to a worsening macroeconomic picture. The budget deficit increased in 2012 (from 1.8% of GDP in 2011 to 3.6% in 2012) for cyclical reasons and because of a spending boost before the parliamentary elections in October 2012. Moreover, the current account deficit rose from 6.1% of GDP in 2011 to 8.2% in 2012. Slowing domestic demand has not entailed a substantial decline in import demand so far, while export growth was negatively affected by declining global demand for steel.

Foreign exchange reserves continued to shrink in the second half of 2012 before stabilizing at very low levels in early 2013 (about three months of imports). Pressures on the de facto pegged exchange rate – and in turn on foreign exchange reserves – eased after administrative measures had been introduced in late 2012 and because households' foreign currency demand declined. Furthermore, the Ukrainian government repeatedly placed Eurobonds on international markets also to conduct repayments of loans extended by the IMF under previous Stand-By Arrangements (SBAs).

In early 2013, the Ukrainian authorities started negotiations on a new SBA. Yet, two rounds of discussion ended without reaching a final agreement. Discussions on the key building blocks of a new program, namely measures to reduce Ukraine's twin deficits, and energy sector and banking reforms will continue in the near future. The EU and Ukraine in principle agreed on the terms of an association agreement (including a deep and comprehensive free trade agreement), but it still has to be signed. At a high-level summit in February, the EU called for concrete progress in particular with respect to judicial and electoral issues until May. In parallel, the Ukrainian government has been in talks with Russia on lowering import gas prices and joining the CIS customs union, which comprises Belarus, Kazakhstan and Russia.

Western Balkans¹: Falling into Double-Dip Recession

After growth in the region had already slowed down in 2011, almost all countries drifted into recession in 2012. Serbia was hit the hardest (–1.7%), followed by Montenegro (–0.5%), Bosnia and Herzegovina (–0.7%) and FYR Macedonia (–0.3%). Positive growth could be preserved only in Albania (+1.6%) and Kosovo (+2.7%), although at a much lower level than in 2011. The deceleration in the economic momentum was broad-based and encompassed all GDP components. In particular, private consumption declined further (in Serbia) or turned negative (in FYR Macedonia) throughout most of the region (Albania was an exception). A similar picture can be seen for gross fixed capital formation, except in FYR Macedonia, where the contribution of gross fixed capital formation declined but remained in positive territory. Bosnia and Herzegovina has not released annual GDP figures for 2012 (and quarterly GDP data are not available at all for this country), but industrial production and retail sales indicators point to a decline in GDP in the second half of 2012.

External imbalances did not change substantially in 2012 compared to 2011, with current account deficits remaining rather large in most countries. While in Kosovo and Albania, the current account deficit for 2012 decreased somewhat to 7.8% of GDP (Kosovo) and 10.5% of GDP (Albania) on the back of a reduction of the trade deficit, the current account deficit in Montenegro in 2012 remained stubbornly high (17.7% of GDP). On the contrary, an increase in the trade deficit in parallel with declining transfers brought about the widening of the current account deficit in the FYR Macedonia (to 3.9%) and in Serbia (to 10.6%). On the financial account, net FDI inflows declined markedly, especially so in Serbia, FYR Macedonia and Kosovo, while remaining broadly unchanged in the other countries, so that the overall (unweighted) coverage ratio worsened to some 50% in 2012 compared to 70% in 2011 (ranging from some 8% in Serbia to 77% in Montenegro).

Despite weak real sector dynamics and initiatives to subsidize loans in the corporate sector (Serbia), credit growth² in the private sector remained positive in most countries, ranging between 3% (Bosnia and Herzegovina) and 8% (Albania). Deleveraging in Montenegro continued, though at a slower pace, with credit contracting by some 5% from 11% in 2011. Credit quality improved slightly only in Serbia, contrary to the other Western Balkan countries, where the share of nonperforming loans increased further (especially so in Albania and Montenegro). In all countries covered here, it reached levels between 11% and 23% in 2012 (except in Kosovo, where IMF estimates point to a slightly increased share of bad loans of 6.5% in total outstanding loans).³

On the back of subdued GDP momentum and despite the adverse weather conditions in some countries, annual average inflation rates decreased in 2012 in most countries and especially so in Kosovo. In the course of the year, price dynamics in the Western Balkan region decreased in the first quarter but picked up to some extent afterwards. In annual average terms, inflation ranged between 2% and 4% in most countries under review here. Only in Serbia was inflation noticeably higher at 7.2% (and also rather volatile, with December inflation coming in at 12.2% year on year).

Against this background, the Bank of Albania cut its policy rate in several steps in 2012 to a historic low of 3.75% in January 2013. The National Bank of Serbia, in turn, increased its policy rate in several steps from 9.5% in January 2012 to 11.75% in February 2013. (In the other Western Balkan countries, monetary policy is based on pegged exchange rates or – in the case of Montenegro and Kosovo – on the unilateral use of the euro as legal tender.)

¹ The Western Balkans comprise the EU candidate countries FYR Macedonia, Montenegro, and Serbia, as well as the potential candidate countries Albania, Bosnia and Herzegovina, and Kosovo. The designation of Kosovo is without prejudice to positions on status, and in line with UNSC 1244 and the opinion on the Kosovo Declaration of Independence.

² Data on credit growth are on a foreign exchange-adjusted basis.

³ This deterioration took place despite initiatives for NPL resolution launched in Montenegro in the period 2011 to 2012, i.e. the "Podgorica approach," as well as the transfer of bad loans to their foreign parent banks.

Most countries missed the general government budget targets⁴ for 2012, mainly for cyclical reasons. In FYR Macedonia and Kosovo, deficits widened to 3.8% and 2.7% of GDP, respectively, while the sharpest increase was registered in Serbia, with the deficit climbing to 6.4% in 2012 partly because of election-related extra spending. Montenegro, in turn, was able to lower the general government deficit (to 4%) on the back of an expenditure-based consolidation effort coupled with increasing fiscal revenues, while Albania kept the deficit broadly stable (at 3.4% of GDP), although at the expense of lower capital spending.

After a new two-year SBA of SDR 338.2 million had been approved in September 2012 for Bosnia and Herzegovina (initial disbursement of SDR 51 million), the first review was completed in December 2012 and another SDR 51 million were disbursed. While in FYR Macedonia, the two-year Precautionary and Liquidity Line arrangement expired in January 2013 (followed by post-program monitoring), the 20-month SBA in Kosovo amounting to SDR 91 million will be in force until end-2013. So far, the authorities have drawn upon it twice for a total of SDR 78 million, and the third review was completed by the IMF's Executive Board in April 2013. Negotiations on a renewed IMF program with Serbia are underway and are mainly conditional upon fiscal consolidation efforts as well as progress on some key structural reforms. While Montenegro began accession negotiations with the EU in December 2012, such talks have not yet started with the other two candidate countries in the Western Balkans, FYR Macedonia and Serbia. Notwithstanding a recommendation by the European Commission, the European Council did not grant Albania candidate country status in December 2012.

⁴ It should be noted that cross-country comparisons of NPL data are hampered by differences in classification rules.

⁵ No data available for Bosnia and Herzegovina.

2 Slovakia: A Record Year for the Car Industry Boosts the Economy

Car industry drives exports, net exports drive GDP growth...

Despite losing pace in 2012, Slovakia's economy remained among the top EU performers, with annual GDP growth of 2%. However, throughout the year, growth decelerated considerably, posting only 0.7% in the last quarter. Domestic demand acted as a drag on growth, with household consumption declining more and more as a result of fiscal consolidation, worsening labor market conditions and falling real wages. Investments and inventories dropped as well, mainly due to a base effect of expanding car production lines in 2011. The automobile production boosted the Slovak economy in 2012; output expanded by 26% on average, reaching as much as 44% in July 2012. However, car manufacturing also prompted the downturn of industrial production in December. Capacity utilization in the whole economy dropped to a mere 60% at the end of 2012 as a result of slowing external demand, which, however, was still sufficient to keep GDP growth in positive territory.

...making 2012 a record year for the trade and current account balance

Imports could not keep up with the pace of exports, thus bringing the 2012 trade balance to a sizeable surplus of 5.1% of GDP. The improvement of the current account amounted to 4.4 percentage points of GDP in 2012. Net FDI inflows also strengthened to 3.4% of GDP.

Average annual HICP inflation moderated somewhat to 3.7% in 2012, with the effect of a hike in the VAT rate in the previous year ending. Inflation has been propelled mainly by regulated prices and food, reflecting world price developments in commodities and the basic lack of domestic demand pressures.

No improvement in the labor market

The situation in the labor market has been worsening further, with the employment rate broadly stable at relatively low levels (under 60%), declining hours worked and a decreasing number of self-employed persons. The unemployment rate deteriorated considerably in the last quarter of 2012, rising to 14.5%. This increase possibly anticipated a reversal of labor code reforms as well as higher social contributions of the self-employed and persons working under alternative employment forms, with both measures taking effect in 2013. Combined with productivity advances that outpaced wage dynamics, unit labor costs decreased significantly in 2012, further contributing to the economy's competitiveness.

Tough consolidation year and a debt brake ahead

For 2012, Slovakia targeted a general government deficit of 4.6% of GDP. The realized deficit came in at 4.3% of GDP. Nevertheless, public debt has increased by nearly 9 percentage points of GDP. Beside the primary deficit and contributions to the European Financial Stability Facility and the European Stability Mechanism, this rise is also due to prefinancing for 2013 of about 3 percentage points of GDP to take advantage of historically low government bond yields. For 2013, a deficit of 2.9% of GDP has been budgeted for the country to come out of the EDP. The main measures to achieve this goal comprise a reintroduction of a progressive personal income tax with a second bracket and a higher corporate income tax, several changes to social contributions, a higher bank levy tax base, a temporary profit levy for regulated industries, higher car registration fees and minor spending cuts. Also, the contributions to the second pension pillar have been decreased from 9% to 4%, and a transfer back to the pay-as-you-go pillar was made possible temporarily. In 2012, the law on fiscal responsibility became effective, creating a fiscal responsibility board and imposing a system of gradual debt brakes (on the debt-to-GDP ratio), which will first apply in 2013, following the official notification that the ratio has surpassed its first threshold of 50% (the ultimate debt limit being 60%).

Table 2

Main Economic Indicators: Slovakia

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.4	3.2	2.0	2.6	3.8	2.9	2.6	2.1	0.7
Private consumption	-0.7	-0.5	-0.6	-1.0	-0.5	-0.1	-0.3	-0.6	-1.2
Public consumption	1.0	-4.3	-0.6	-4.1	-4.7	0.5	-2.1	-0.4	-0.3
Gross fixed capital formation	6.5	14.2	-3.7	17.2	18.3	-3.3	-2.5	-3.7	-5.0
Exports of goods and services	16.0	12.7	8.6	10.2	7.9	5.0	10.8	11.6	7.1
Imports of goods and services	14.9	10.1	2.8	5.4	2.7	-0.2	1.6	5.7	4.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.6	1.2	-2.9	-0.9	-0.8	-0.8	-5.5	-3.3	-1.9
Net exports of goods and services	0.7	2.0	5.2	3.5	4.6	4.9	8.3	4.9	2.8
Exports of goods and services	11.3	10.2	7.7	7.7	6.9	4.7	9.8	9.7	6.6
Imports of goods and services	-10.6	-8.1	-2.5	-4.2	-2.3	0.2	-1.4	-4.8	-3.7
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-1.4	-0.4	0.1	0.3	-1.4	-1.6	0.4	-0.2	1.8
Unit labor costs in manufacturing (nominal, per hour)	-8.8	4.3	-8.3	8.0	6.9	-5.7	-8.9	-12.6	-5.7
Labor productivity in manufacturing (real, per hour)	9.0	2.5	13.3	1.9	-0.2	11.0	14.9	15.7	11.5
Labor costs in manufacturing (nominal, per hour)	0.0	6.9	3.9	10.1	6.6	4.6	4.6	1.2	5.2
Producer price index (PPI) in industry	0.4	4.5	1.9	3.9	3.6	2.3	1.5	1.8	2.0
Consumer price index (here: HICP)	0.7	4.1	3.7	4.1	4.7	4.0	3.6	3.8	3.6
EUR per 1 SKK, + = SKK appreciation	..	..	..	..	..	..	..	..	..
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	14.4	13.6	14.0	13.2	14.0	14.1	13.7	13.7	14.5
Employment rate (%, 15–64 years)	58.8	59.5	59.7	59.9	59.5	59.6	59.8	60.1	59.4
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
SKK per 1 EUR	..	..	..	..	..	..	..	..	..
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	4.4	0.7	6.6	5.0	0.7	3.0	1.9	1.9	6.6
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	1.3	-3.8	-3.1	-5.5	-3.8	-7.2	-6.7	2.7	-3.1
Domestic credit of the banking system	9.2	9.4	-7.0	4.4	9.4	9.8	2.4	-4.5	-7.0
<i>of which: claims on the private sector</i>	3.2	6.9	-0.1	7.5	6.9	4.3	1.4	0.5	-0.1
<i>claims on households</i>	4.2	3.9	3.9	4.3	3.9	3.9	3.5	3.7	3.9
<i>claims on enterprises</i>	-1.0	2.9	-4.0	3.2	2.9	0.4	-2.1	-3.2	-4.0
<i>claims on the public sector (net)</i>	6.0	2.5	-6.9	-3.1	2.5	5.4	1.0	-5.1	-6.9
Other assets (net) of the banking system	-6.1	-4.9	16.7	6.1	-4.9	0.4	6.2	3.8	16.7
<i>% of GDP, ESA 95</i>									
General government revenues	32.3	33.3	33.1	..	..	..	..	..	..
General government expenditures	40.0	38.4	37.4	..	..	..	..	..	..
General government balance	-7.7	-5.1	-4.3	..	..	..	..	..	..
Primary balance	-6.3	-3.5	-2.5	..	..	..	..	..	..
Gross public debt	41.0	43.3	52.1	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	21.5	18.0	10.2	15.2	10.7	9.0	10.5	13.6	7.7
Merchandise imports	22.5	17.9	5.6	11.5	7.6	6.2	3.6	8.4	4.3
<i>% of GDP (based on EUR), period total</i>									
Trade balance	1.2	1.4	5.1	0.9	2.6	4.6	5.4	4.8	5.5
Services balance	-1.1	-0.5	0.4	-0.7	0.2	0.4	0.4	0.5	0.3
Income balance (factor services balance)	-3.1	-2.4	-2.3	-2.3	-2.5	-2.3	-2.2	-2.4	-2.3
Current transfers	-0.6	-0.5	-0.9	-1.1	-1.4	-0.4	-0.9	-1.2	-1.1
Current account balance	-3.7	-2.1	2.3	-3.3	-1.1	2.3	2.7	1.7	2.5
Capital account balance	1.5	1.3	1.9	1.1	1.3	0.2	2.9	1.5	3.0
Foreign direct investment (net)	0.9	1.7	3.4	1.4	5.3	4.7	0.7	-0.2	8.4
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	74.8	76.6	75.2	78.0	76.6	77.7	76.4	73.0	75.2
Gross official reserves (excluding gold) ¹	0.8	1.0	0.9	0.9	1.0	0.9	0.9	0.9	0.9
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold) ¹	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
<i>EUR million, period total</i>									
GDP at current prices	65,870	69,108	71,463	18,199	17,851	16,550	17,822	18,879	18,212

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

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

3 Slovenia: Government Determined to Tackle Crisis without International Assistance

Politics in the forefront

Political uncertainty was a dominant factor over the review period. Uncertainty surrounding the course of economic reforms diminished temporarily in late December following the constitutional court's decision to ban referendums on the laws on the bank asset management company and the state holding company, which had been passed in late October 2012. The establishment of the two institutions, which should be fully operative by September 2013 at the latest, is a key reform element to stabilize the financial sector and the economy and to ensure smooth refinancing of both the government and the banking system. In addition, a pension reform took effect at the beginning of 2013, and progress was made on labor market reform. However, the center-right government lost its parliamentary majority in late January 2013 as a consequence of corruption allegations and was finally ousted at the end of February, raising questions about the further course of fiscal consolidation and key reforms. Agreement on the formation of a new center-left government was reached in mid-March. Consolidating public finances mainly by curbing public spending (including further cuts in the public sector wage bill) while boosting the economy, among other things by promoting job creation, reducing the overindebtedness of the corporate sector, utilizing EU funds better, improving the business environment and changing insolvency legislation remain key priorities. Some changes will also be implemented to the state holding company and the bad bank law. In general, observers expect a politically rather difficult environment ahead, given the only slim parliamentary majority of the four-party coalition government.

Slight increase in the budget deficit expected for 2013 following considerable reduction in 2012

Owing mainly to a nominal wage cut in the public sector and reinforced restraint in social transfers, Slovenia succeeded in reducing the fiscal deficit in 2012 to 4.0% of GDP from 6.4% in 2011. For 2013, the European Commission expects a deficit of 5.1% of GDP, including the deficit-increasing impact of the conversion of a hybrid debt-equity instrument in the country's largest commercial bank, Nova Ljubljanska banka, into equity (0.9% of GDP). In its March 2013 EDP report, the statistical office notified a projected deficit of 4.2% of GDP for 2013, including capital injections worth 1.2% of GDP into banks. Budget execution in 2013 should be favorably influenced by a further cut in the public sector wage bill and the effects of the pension reform. However, in its Fiscal Sustainability Report of December 2012, the Commission saw Slovenia at a high sustainability risk in the medium term, mainly due to the budgetary impact of ageing costs, given that the latest pension reform will reduce pension costs only in the short term.

Economy in recession in the second half of 2012

GDP shrank by 3% year on year in the last two quarters of 2012, bringing the contraction in full-year 2012 to 2.3%. Recessionary tendencies in domestic consumption continued in the latter part of 2012. This mirrored continued savings measures implemented by the government, the ongoing contraction of credit to the household sector, very weak consumer confidence, high and increasing unemployment and declining real wages. Investment activity plummeted again in the second half of 2012, reflecting declining levels of capacity utilization, intensified deleveraging by the corporate sector and weak demand conditions. Also, destocking continued to weigh on GDP developments. On the other hand, the contribution of net exports, the single engine of growth, rose considerably in the second half of 2012. Net exports went up because the accelerating drop in imports more than offset the stagnation in exports on account of weak export demand.

Table 3

Main Economic Indicators: Slovenia

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	1.2	0.6	-2.3	0.8	-2.4	0.0	-3.2	-3.1	-3.0
Private consumption	1.3	0.9	-2.9	2.1	-0.5	0.7	-2.5	-3.8	-5.7
Public consumption	1.5	-1.2	-1.6	-1.1	-1.3	0.1	-2.4	-2.9	-1.3
Gross fixed capital formation	-13.8	-8.1	-9.3	-8.7	-3.5	-10.3	-7.6	-8.6	-10.6
Exports of goods and services	10.1	7.0	0.3	5.1	3.1	1.8	-0.3	-0.4	0.0
Imports of goods and services	7.9	5.2	-4.3	4.4	0.8	-0.8	-3.7	-5.9	-6.6
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-0.2	-0.7	-5.6	0.2	-3.8	-1.9	-5.7	-6.9	-7.8
Net exports of goods and services	1.5	1.3	3.3	0.6	1.5	1.9	2.4	3.8	4.9
Exports of goods and services	5.9	4.6	0.2	3.4	2.1	1.3	-0.2	-0.3	0.0
Imports of goods and services	-4.5	-3.4	3.1	-2.8	-0.6	0.6	2.6	4.1	4.9
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-0.6	-1.0	1.3	-2.0	0.9	1.1	1.0	2.5	0.6
Unit labor costs in manufacturing (nominal, per hour)	-1.6	0.2	5.1	0.3	4.6	0.3	11.7	2.9	6.1
Labor productivity in manufacturing (real, per hour)	5.0	1.6	-2.2	-0.4	-2.1	-2.5	-1.8	-0.1	-4.2
Labor costs in manufacturing (nominal, per hour)	3.2	1.9	2.9	-0.1	2.4	-2.3	9.7	2.8	1.7
Producer price index (PPI) in industry	2.0	4.6	0.9	4.1	3.6	1.3	0.8	0.6	0.6
Consumer price index (here: HICP)	2.1	2.1	2.8	1.5	2.6	2.5	2.5	3.2	3.0
EUR per 1 SIT, + = SIT appreciation	..	..	..	..	..	..	..	..	..
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.4	8.4	9.0	8.0	8.9	8.7	8.3	9.3	9.7
Employment rate (%, 15–64 years)	66.2	64.4	64.1	65.1	64.4	64.0	63.8	64.3	64.2
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
SIT per 1 EUR	..	..	..	..	..	..	..	..	..
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	1.6	3.0	-0.7	2.9	3.0	4.3	3.3	0.4	-0.7
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-4.0	6.5	3.9	7.8	6.5	-6.8	-4.9	-5.5	3.9
Domestic credit of the banking system	6.7	-3.1	-2.7	-2.7	-3.1	10.8	6.8	7.5	-2.7
<i>of which: claims on the private sector</i>	2.8	-3.8	-7.2	-1.5	-3.8	-3.4	-5.0	-5.2	-7.2
<i>claims on households</i>	3.9	0.8	-0.8	1.6	0.8	0.6	-0.3	-0.6	-0.8
<i>claims on enterprises</i>	-1.1	-4.6	-6.4	-3.0	-4.6	-4.0	-4.7	-4.6	-6.4
<i>claims on the public sector (net)</i>	3.9	0.7	4.5	-1.2	0.7	14.2	11.7	12.7	4.5
Other assets (net) of the banking system	-1.2	-0.4	-2.0	-2.2	-0.4	0.4	1.4	-1.6	-2.0
<i>% of GDP, ESA 95</i>									
General government revenues	44.5	44.4	45.0	..	..	..	..	..	..
General government expenditures	50.4	50.8	49.0	..	..	..	..	..	..
General government balance	-5.9	-6.4	-4.0	..	..	..	..	..	..
Primary balance	-4.3	-4.4	-1.9	..	..	..	..	..	..
Gross public debt	38.6	46.9	54.1	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	13.8	15.6	0.9	13.0	10.5	2.9	0.2	0.2	0.3
Merchandise imports	16.2	13.8	-2.3	12.0	7.1	1.6	-1.8	-3.9	-5.1
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-3.4	-2.9	-0.9	-2.3	-4.3	-2.0	-1.2	0.1	-0.8
Services balance	3.7	4.0	4.8	3.8	4.1	4.7	5.0	5.0	4.4
Income balance (factor services balance)	-1.4	-1.5	-1.6	-2.5	-0.9	-2.1	-1.4	-1.4	-1.7
Current transfers	0.3	0.4	0.1	0.0	0.7	-0.4	0.3	-0.8	1.2
Current account balance	-0.8	0.0	2.3	-1.0	-0.4	0.3	2.8	2.9	3.2
Capital account balance	0.0	-0.3	-0.1	-0.1	-0.9	0.1	0.3	0.0	-0.9
Foreign direct investment (net)	0.9	1.8	0.5	2.6	1.8	2.2	0.5	0.4	-1.0
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	114.4	111.3	115.1	117.5	111.3	116.9	115.9	114.2	115.1
Gross official reserves (excluding gold) ¹	2.0	1.8	1.7	1.8	1.8	1.6	1.7	1.7	1.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold) ¹	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
<i>EUR million, period total</i>									
GDP at current prices	35,607	36,172	35,466	9,382	8,968	8,529	9,079	9,139	8,719

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

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

4 Bulgaria: Fragile Economic Growth amid Improving Fiscal Position

Growth structure changes while labor market conditions remain slack

Against the background of lackluster global economic activity, GDP growth in Bulgaria slowed to 0.5% in the second half of 2012, bringing full-year growth to 0.8%. 2012 brought about a rebalancing of the growth structure, which had been characterized by depressed domestic demand and strong positive growth contributions by net exports in recent years. Hence, on the back of improved private consumption dynamics boosted by rising wages, domestic demand turned out to be the driving force in 2012, though its upward trend moderated in the second half of the year. On a negative note, enduring adverse labor market conditions pushed the unemployment rate to 12.4% in 2012, which is an eight-year high. The growth contribution of gross fixed capital formation returned into positive territory in 2012. However, investment dynamics remained subdued due to persistently low business confidence, relatively moderate FDI inflows and limited fiscal leeway. The pace of expansion of both imports and exports decelerated in the second half of 2012, and the contribution of net exports turned negative in 2012 for the first time since 2009.

External position roughly unchanged

Despite the fact that Bulgaria's current account improved in the second half of 2012, mirroring weaker domestic demand coupled with subdued external demand, the deficit for 2012 slipped into negative territory and came to -1.3% of GDP. The bulk of the deterioration came from the goods and services balance and was only partly countered by the narrowing of the deficit in the income balance. Nevertheless, and despite declining substantially in the second half of 2012, net FDI inflows in 2012 remained roughly at the same level as in 2011 (3.3% of GDP), thus covering the current account shortfall in 2012 by a comfortable margin. The gross foreign debt ratio slightly rose to 95% of GDP at the end of 2012, with some uptick in public sector foreign debt; private sector foreign debt levels remained broadly flat.

Price competitiveness improves, inflation decelerates after slight pickup in autumn 2012

Price competitiveness has strengthened, as the growth of unit labor costs in the manufacturing sector measured in euro remained subdued and even turned slightly negative in the last three quarters of 2012 on the back of robust labor productivity growth. The real effective exchange rate appreciation came to a halt, and the exchange rate posted a mild depreciation averaging about 4% year on year in 2012. After remaining moderate in the first half of 2012 (1.9%), annual HICP inflation increased to a peak of 3.4% in September 2012 on the back of rising prices of unprocessed foods and electricity for households before decelerating to 2.2% in February 2013. The unexpectedly high bills following the electricity price hike fueled social upheavals, which led to the resignation of the government at end-February 2013 and to early elections in May 2013. Annual core inflation remained low, sinking to 1.2% on average in 2012.

Public finances improve in 2012, weak expansionary fiscal stance ahead

With revenues from indirect taxes (especially VAT receipts) augmenting, the general government deficit narrowed from 2% of GDP in 2011 to 0.8% of GDP in 2012, which is markedly lower than the deficit target (1.3% of GDP). In anticipation of the repayment of foreign debt maturing in January 2013, the Bulgarian government in July 2012 issued new five-year benchmark Eurobonds worth EUR 950 million with a 4.25% annual coupon. The 2013 budget envisages a somewhat expansionary fiscal stance, reflecting higher public consumption, rises in pensions and an increase of minimum wages as of January 2013 (used as a basis for calculating social benefits). This deficit is to be covered by a roughly equal rise of fiscal revenues based on a somewhat optimistic GDP growth forecast of 1.9% in 2013.

Table 4

Main Economic Indicators: Bulgaria

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	0.4	1.8	0.8	1.9	0.6	1.0	1.1	0.8	0.3
Private consumption	0.1	1.5	2.6	3.1	2.4	2.7	4.3	3.2	0.4
Public consumption	1.9	1.6	-1.3	-1.4	0.9	-1.3	-1.5	-0.4	-2.0
Gross fixed capital formation	-18.3	-6.5	0.8	8.3	-12.4	3.6	1.2	0.7	-1.0
Exports of goods and services	14.7	12.3	-0.4	4.1	11.2	-3.0	3.3	-0.5	-1.7
Imports of goods and services	2.4	8.8	3.7	10.2	5.3	3.4	9.8	2.6	-0.5
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-5.2	0.0	3.5	3.8	-1.5	5.8	5.5	2.2	1.3
Net exports of goods and services	5.6	1.8	-2.7	-2.8	2.5	-4.6	-4.4	-1.9	-0.7
Exports of goods and services	7.0	7.1	-0.2	2.7	5.7	-2.1	2.2	-0.3	-1.0
Imports of goods and services	-1.4	-5.2	-2.5	-5.6	-3.1	-2.5	-6.5	-1.6	0.3
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	6.1	2.7	0.1	5.9	5.8	-0.3	-1.2	1.0	1.2
Unit labor costs in manufacturing (nominal, per hour)	-5.2	0.5	0.0	2.6	5.0	1.4	-1.2	-0.2	-0.1
Labor productivity in manufacturing (real, per hour)	12.2	6.9	3.8	5.5	3.7	2.4	4.8	3.6	4.4
Labor costs in manufacturing (nominal, per hour)	6.3	7.8	3.8	8.3	8.8	3.8	3.6	3.4	4.2
Producer price index (PPI) in industry	8.4	9.3	4.4	8.1	5.9	3.8	3.0	5.0	5.8
Consumer price index (here: HICP)	3.0	3.4	2.4	3.1	2.5	1.9	1.8	3.0	2.8
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	10.3	11.4	12.4	10.3	11.5	13.0	12.4	11.6	12.5
Employment rate (%, 15–64 years)	59.7	58.4	58.8	59.8	58.6	56.9	58.3	60.6	59.4
Key interest rate per annum (%) ¹	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	6.4	12.2	8.5	10.3	12.2	10.7	10.1	8.7	8.5
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	5.0	7.9	7.5	8.5	7.9	9.2	8.2	10.1	7.5
Domestic credit of the banking system	5.1	7.3	2.4	4.5	7.3	5.4	5.5	1.7	2.4
<i>of which: claims on the private sector</i>	1.5	3.9	2.7	2.8	3.9	3.6	4.2	3.7	2.7
<i>claims on households</i>	-0.3	-0.2	-0.3	-0.1	-0.2	-0.4	-0.4	-0.5	-0.3
<i>claims on enterprises</i>	1.8	4.1	3.0	2.9	4.1	3.9	4.7	4.3	3.0
<i>claims on the public sector (net)</i>	3.7	3.4	-0.2	1.6	3.4	1.8	1.2	-2.0	-0.2
Other assets (net) of the banking system	-3.7	-3.0	-1.4	-2.7	-3.0	-3.9	-3.6	-3.1	-1.4
<i>% of GDP, ESA 95</i>									
General government revenues	34.3	33.6	34.9	..	..	..	..	..	..
General government expenditures	37.4	35.6	35.7	..	..	..	..	..	..
General government balance	-3.1	-2.0	-0.8	..	..	..	..	..	..
Primary balance	-2.4	-1.2	0.1	..	..	..	..	..	..
Gross public debt	16.2	16.3	18.5	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	32.9	30.2	2.6	22.0	19.7	-2.9	6.1	3.0	3.9
Merchandise imports	15.4	22.3	8.9	24.5	13.1	10.2	17.3	6.2	2.6
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-7.7	-5.6	-9.1	-3.4	-8.9	-11.7	-13.0	-5.0	-7.9
Services balance	5.2	6.0	6.0	14.2	1.7	1.1	5.8	13.7	2.1
Income balance (factor services balance)	-3.1	-4.7	-3.4	-5.2	-4.4	-3.9	-2.7	-3.9	-3.2
Current transfers	4.2	4.4	5.1	3.2	3.4	7.5	6.0	3.5	4.3
Current account balance	-1.5	0.1	-1.3	8.8	-8.2	-7.0	-3.9	8.3	-4.6
Capital account balance	0.8	1.3	1.4	1.2	3.1	0.1	0.4	1.5	2.9
Foreign direct investment (net)	2.7	3.1	3.3	2.5	9.8	8.0	4.2	4.4	-2.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	102.7	94.1	94.8	94.4	94.1	95.5	96.0	96.5	94.8
Gross official reserves (excluding gold)	32.2	30.6	35.1	29.7	30.6	30.2	31.8	35.3	35.1
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	6.5	5.6	6.0	5.6	5.6	5.3	5.4	6.0	6.0
<i>EUR million, period total</i>									
GDP at current prices	36,052	38,505	39,668	10,669	10,003	8,053	9,822	11,012	1,0781

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

¹ Not available in a currency board regime.

5 Czech Republic: A Year of Records, Recession and Restraint

Net exports unable to pull the economy out of contraction...

The contraction of the Czech economy deepened further in the second half of 2012, leading to a total annual GDP decline of 1.3%. GDP growth was dragged down by a broad-based contraction of domestic demand, most notably of household consumption, which recorded a historic decline of 3.5% in 2012. This drop in demand was mainly due to ongoing fiscal consolidation, worsening labor markets and falling real wages as well as general uncertainty reflected in low though slightly improving consumer confidence. Total annual public consumption shrank, too, but its decline gradually came to a halt toward the end of 2012. Gross capital formation plunged by nearly 10% in the third quarter of 2012 and though it rebounded in the last quarter, this was solely due to restocking. Thus, the only positive GDP growth contribution came from net exports.

...even though the trade balance delivers a record surplus

The pace of both exports and imports slowed in 2012, with imports mainly driven by the import intensity of exports. Nevertheless, the difference still translated into a historical trade surplus of 3.8% of GDP for 2012. The income balance worsened, mainly because of FDI earnings dynamics. Overall, the annual current account deficit still improved to 2.4% of GDP and was more than covered by net FDI inflows of 4.7% of GDP, the highest figure in five years.

The employment rate increased slightly in the second half of 2012 to an annual average of 66.6%. However, this improvement was due mostly to the rising number of self-employed persons and persons with alternative employment forms. The total number of hours worked was cut by 1.2% to cope with the weakening economy, which was reflected in the gradually rising unemployment rate. These factors, combined with the nominal increase in compensations and a decrease in value added in manufacturing, hiked nominal unit labor costs in manufacturing by 2.9% in 2012.

CNB reaches virtual zero bound, contemplates foreign exchange interventions

Average annual HICP inflation fell to 3.5% in 2012, gradually declining throughout the year. It was mainly driven by the hike in the lower VAT rate by 4 percentage points to 10% in 2012 as well as by regulated prices (rents and energy) and higher food, housing and transport prices. As a reaction to low domestic activity and the absence of demand inflation pressures, the Czech National Bank (CNB) cut its key policy rate to a historically low “technical zero” bound of 0.05% in November 2012. Having exhausted its conventional measures, the CNB announced that it would consider intervening against the Czech koruna. At end-2012, the koruna was slightly stronger against the euro than a year earlier (25.2 EUR/CZK), having oscillated by about $\pm 2\%$ around this level in the second half of 2012.

One-off measures conceal another round of fiscal tightening

For 2012, the general government targeted a revised deficit of 3.2% of GDP. The actual deficit reached 4.4%. This overshoot was due to one-off accounting measures: church restitutions (1.5% of GDP; this liability will be settled over the next 30 years) and the temporary suspension in corrections in EU transfers for 2012. Without these one-offs, the deficit would have been 2.5% of GDP. For 2013, the Czech Republic committed itself to bringing its deficit down to 2.9% of GDP. Measures taken to achieve this goal comprise an increase of the lower and standard VAT rate by 1 percentage point (to 15% and 21%, respectively), the introduction of a temporary personal income tax surcharge for higher incomes, a temporarily lower pensions indexation and an elimination of mandatory health insurance caps. The negative budgetary effect of the introduction of the second pension pillar in 2013 has been revised down (from 0.5% to 0.1% of GDP) due to lower than expected participation.

Table 5

Main Economic Indicators: Czech Republic

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	2.5	1.9	-1.3	1.6	0.6	-0.1	-1.8	-1.8	-1.4
Private consumption	1.0	0.7	-3.5	1.0	0.4	-2.6	-3.7	-3.9	-3.9
Public consumption	0.5	-2.5	-1.0	-4.1	-3.2	-2.2	-2.0	-0.4	0.5
Gross fixed capital formation	1.0	-0.7	-1.7	-1.8	-2.4	1.5	-0.1	-3.4	-4.1
Exports of goods and services	15.5	9.4	3.8	7.0	3.2	7.4	2.4	3.6	2.2
Imports of goods and services	15.8	6.7	1.9	2.6	1.0	4.8	1.7	-0.6	1.7
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	2.0	-0.1	-2.8	-1.3	-0.9	-2.2	-2.4	-4.7	-1.8
Net exports of goods and services	0.5	2.0	1.5	2.9	1.5	2.2	0.6	2.9	0.4
Exports of goods and services	9.1	6.3	2.8	4.6	2.2	5.6	1.8	2.5	1.6
Imports of goods and services	-8.7	-4.3	-1.3	-1.7	-0.6	-3.4	-1.1	0.4	-1.2
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-0.1	0.2	3.1	-0.2	0.7	4.4	3.3	2.0	2.7
Unit labor costs in manufacturing (nominal, per hour)	-9.0	-2.3	2.9	0.8	-2.9	2.0	2.4	2.3	4.9
Labor productivity in manufacturing (real, per hour)	9.2	4.2	1.7	1.5	3.1	5.2	4.6	2.6	-5.7
Labor costs in manufacturing (nominal, per hour)	-0.6	1.8	4.6	2.3	0.1	7.4	7.1	5.0	-1.1
Producer price index (PPI) in industry	0.1	3.7	2.3	3.7	4.9	3.8	2.6	2.1	0.9
Consumer price index (here: HICP)	1.2	2.1	3.5	2.0	2.8	4.0	3.8	3.4	2.9
EUR per 1 CZK, + = CZK appreciation	4.6	2.9	-2.2	2.2	-2.0	-2.8	-3.7	-2.7	0.4
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.4	6.8	7.1	6.6	6.5	7.2	6.8	7.0	7.2
Employment rate (%, 15–64 years)	65.0	65.7	66.6	66.1	66.1	65.6	66.5	67.1	67.0
Key interest rate per annum (%)	0.8	0.8	0.5	0.8	0.8	0.8	0.7	0.5	0.1
CZK per 1 EUR	25.3	24.6	25.1	24.4	25.3	25.1	25.3	25.1	25.2
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	1.9	2.8	4.8	1.8	2.8	4.8	5.4	4.0	4.8
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	0.4	-0.8	5.4	-4.8	-0.8	3.0	6.0	5.1	5.4
Domestic credit of the banking system	4.0	7.9	1.5	10.2	7.9	5.3	5.5	3.0	1.5
<i>of which: claims on the private sector</i>	2.1	4.1	1.9	4.5	4.1	3.8	3.3	2.4	1.9
<i>claims on households</i>	2.7	2.2	1.6	2.2	2.2	2.1	2.0	1.7	1.6
<i>claims on enterprises</i>	-0.6	1.9	0.3	2.3	1.9	1.7	1.3	0.7	0.3
<i>claims on the public sector (net)</i>	1.9	3.7	-0.4	5.7	3.7	1.5	2.2	0.7	-0.4
Other assets (net) of the banking system	-2.6	-4.3	-2.1	-3.5	-4.3	-3.6	-6.0	-4.1	-2.1
<i>% of GDP, ESA 95</i>									
General government revenues	39.0	39.8	40.1	..	..	..	..	..	..
General government expenditures	43.8	43.1	44.5	..	..	..	..	..	..
General government balance	-4.8	-3.3	-4.4	..	..	..	..	..	..
Primary balance	-3.4	-1.9	-2.9	..	..	..	..	..	..
Gross public debt	37.8	40.8	45.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	21.3	13.8	4.6	10.0	5.2	8.4	3.2	4.1	2.9
Merchandise imports	24.1	12.2	2.6	7.9	2.1	5.9	2.4	-0.5	2.6
<i>% of GDP (based on EUR), period total</i>									
Trade balance	1.4	2.4	3.8	0.7	2.3	5.7	3.5	3.5	2.6
Services balance	2.0	1.5	1.3	1.7	1.0	1.6	1.2	1.4	1.0
Income balance (factor services balance)	-7.5	-6.7	-7.5	-5.1	-4.7	-5.6	-7.0	-9.5	-7.8
Current transfers	0.2	0.1	-0.0	-0.2	-0.4	0.1	-0.4	-0.5	0.6
Current account balance	-3.9	-2.7	-2.4	-3.1	-1.7	1.9	-2.7	-5.0	-3.6
Capital account balance	0.9	0.4	1.3	0.3	1.1	0.1	0.0	0.7	4.4
Foreign direct investment (net)	2.5	1.2	4.7	-3.6	4.2	3.4	5.0	4.6	5.8
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	46.9	46.6	0.0	47.7	46.6	49.8	48.7	49.7	50.5
Gross official reserves (excluding gold)	20.9	19.6	22.0	19.0	19.6	20.4	20.0	20.3	22.0
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.9	3.4	3.6	3.3	3.4	3.5	3.3	3.4	3.6
<i>EUR million, period total</i>									
GDP at current prices	150,365	156,180	152,813	39,878	39,984	36,193	38,281	38,519	39,820

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

6 Hungary: Struggling to Exit the Excessive Deficit Procedure

Stuck in recession

The Hungarian economy has slipped further into recession, with GDP contracting by 2.7% year on year in the fourth quarter of 2012. The worsening of economic output was attributable to a bigger decline of investments, which mirrored declining capacity utilization rates, the intensified contraction of credit to corporates and possibly also the increased tax burden on selected economic sectors. Furthermore, the contribution of net real exports turned marginally negative, as exports declined amid weakening external demand that was not sufficiently offset by the decline in imports. Against the background of deteriorating consumer confidence, stubbornly high unemployment and the continued sharp contraction of credit to households, consumption continued to decline, albeit less sharply than in the third quarter of 2012.

Authorities focused on efforts to exit the excessive deficit procedure

The abrogation of the excessive deficit procedure, under which Hungary has always stood since its EU entry in 2004, remains a top priority for the government. The government demonstrated renewed commitment in October and November 2012 to reduce the budget deficit and has pledged to take additional measures to meet the deficit targets of 2.7% of GDP in 2013 and 2.2% of GDP in 2014 (following a deficit of 1.9% of GDP in 2012). However, in its February forecast (i.e. prior to the surprisingly small deficit for 2012), the European Commission projected a deficit of 3.4% for both years, expecting expenditure slippages and revenue shortfalls compared to the official plans. On a more positive note, in its 2012 Fiscal Sustainability Report of December 2012, the Commission came to the conclusion that the risks to Hungary's fiscal sustainability were low in the medium- to long-term perspective, if fiscal consolidation plans are fully implemented.

Financing conditions have eased

The government's financing situation improved over the review period. Despite negative news about the suspension of negotiations on a new stand-by arrangement with the IMF/EU at the end of January 2013, the government successfully sold five- and ten-year U.S. dollar Eurobonds worth a combined USD 3.25 billion in mid-February. This represented slightly more than half of the planned Eurobond issuance for the year. In addition, the government has raised more funds than expected via the retail sale of euro-denominated bonds in the domestic market. Taking into account additional financial buffers and barring a substantial deterioration of market confidence, the government should be able to cover its relatively high gross financing needs in 2013 (around 20% of GDP) without major difficulty.

MNB continues monetary easing

In response to sharply declining headline inflation, weak demand conditions and sufficient spare capacities in the economy, the monetary council of the National Bank of Hungary (MNB) continued to cut the policy rate in monthly installments of 25 basis points to 5.0% by end-March 2013 (end-September 2012: 6.5%). HICP inflation decreased somewhat in the fourth quarter of 2012 and more substantially in January 2013 (to 2.8% year on year), partly as a result of a base effect (increase in the standard VAT rate in January 2012) and the 10% price reduction for household electricity, natural gas and purchased heat in January 2013. In addition, at the beginning of April, the MNB launched a "Funding for Growth Scheme" offering commercial banks temporary refinancing credit at zero interest rate for loans to SMEs with a maximum 2% risk premium. Refinancing from the MNB will be available for general forint-based lending to SMEs and for the conversion of foreign currency loans into forints, each with a maximum volume of HUF 250 billion (0.8% of GDP each). The details of the scheme will be coordinated with commercial banks.

Table 6

Main Economic Indicators: Hungary

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	1.3	1.6	-1.7	1.4	1.3	-0.6	-1.7	-1.7	-2.7
Private consumption	-3.0	0.5	-1.4	1.2	1.1	-0.4	-0.5	-3.7	-0.9
Public consumption	-0.7	-0.3	-2.3	-1.5	-0.8	-1.7	-3.1	-3.3	-1.1
Gross fixed capital formation	-9.5	-3.6	-3.8	-4.7	-2.4	-4.6	-3.0	-1.7	-5.6
Exports of goods and services	14.2	6.3	2.0	4.6	3.0	2.2	4.6	2.4	-1.1
Imports of goods and services	12.7	5.0	0.1	2.4	0.5	0.2	1.7	-0.3	-1.0
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-0.4	0.1	-3.5	-0.6	-0.9	-2.6	-4.5	-4.1	-2.6
Net exports of goods and services	1.8	1.5	1.7	2.0	2.2	2.0	2.8	2.4	-0.2
Exports of goods and services	11.0	5.5	1.8	3.9	2.6	2.2	4.2	2.2	-1.0
Imports of goods and services	-9.2	-4.0	-0.1	-1.9	-0.4	-0.1	-1.4	0.3	0.8
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-1.2	1.6	6.9	2.4	2.3	6.6	7.7	6.9	6.5
Unit labor costs in manufacturing (nominal, per hour)	-9.7	4.4	6.6	7.1	2.5	6.1	5.5	4.8	10.3
Labor productivity in manufacturing (real, per hour)	10.3	1.5	0.8	-1.5	3.2	-0.8	3.7	3.1	-2.1
Labor costs in manufacturing (nominal, per hour)	0.0	6.0	7.7	5.5	5.8	5.2	9.4	8.0	7.9
Producer price index (PPI) in industry	6.3	4.2	4.2	1.0	7.4	6.8	7.2	4.5	-1.5
Consumer price index (here: HICP)	4.7	3.9	5.7	3.4	4.1	5.6	5.5	6.0	5.5
EUR per 1 HUF, + = HUF appreciation	1.9	-1.4	-3.5	2.7	-9.1	-8.2	-9.4	-2.9	7.1
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	11.2	11.0	11.0	10.8	10.7	11.8	10.9	10.5	10.8
Employment rate (%, 15–64 years)	55.4	55.8	57.2	56.4	56.5	55.7	57.2	58.2	57.8
Key interest rate per annum (%)	5.5	6.0	6.8	6.0	6.3	7.0	7.0	6.9	6.2
HUF per 1 EUR	275.4	279.3	289.3	275.0	303.4	296.8	294.0	283.1	283.4
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	3.0	5.9	-3.4	5.3	5.9	1.5	0.1	-4.1	-3.4
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	4.2	17.8	5.1	16.8	17.8	10.0	10.1	3.9	5.1
Domestic credit of the banking system	6.4	-3.1	-11.8	-6.5	-3.1	0.4	-3.5	-8.8	-11.8
<i>of which: claims on the private sector</i>	3.7	-0.6	-13.7	1.6	-0.6	-1.8	-6.4	-13.6	-13.7
<i>claims on households</i>	4.6	-0.5	-7.3	2.1	-0.5	-2.0	-4.9	-8.2	-7.3
<i>claims on enterprises</i>	-0.9	0.4	-6.3	0.0	0.4	0.7	-0.9	-5.3	-6.3
<i>claims on the public sector (net)</i>	2.7	-2.6	1.8	-8.1	-2.6	2.3	2.9	4.8	1.8
Other assets (net) of the banking system	-7.7	-8.7	3.3	-5.0	-8.7	-9.0	-6.5	0.7	3.3
<i>% of GDP, ESA 95</i>									
General government revenues	45.4	53.8	46.5	..	..	..	..	..	..
General government expenditures	49.7	49.5	48.4	..	..	..	..	..	..
General government balance	-4.3	4.3	-1.9	..	..	..	..	..	..
Primary balance	-0.2	8.4	2.3	..	..	..	..	..	..
Gross public debt	81.8	81.4	79.2	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	20.3	9.1	1.8	6.3	0.8	0.0	3.4	3.1	0.7
Merchandise imports	19.5	9.2	0.9	5.8	2.2	1.6	1.2	0.6	0.4
<i>% of GDP (based on EUR), period total</i>									
Trade balance	3.3	3.4	4.2	2.6	2.6	4.2	5.5	4.5	2.6
Services balance	3.0	3.2	3.5	4.0	2.5	3.2	3.8	4.5	2.4
Income balance (factor services balance)	-5.7	-6.3	-6.5	-6.0	-6.0	-6.6	-7.3	-6.1	-6.1
Current transfers	0.4	0.5	0.5	0.7	1.0	-0.8	0.2	0.3	2.0
Current account balance	1.1	0.8	1.6	1.4	0.0	-0.1	2.2	3.3	0.9
Capital account balance	1.8	2.3	2.7	2.9	2.9	1.9	2.1	2.3	4.2
Foreign direct investment (net)	0.8	0.6	2.3	-1.9	5.2	2.1	-2.2	3.7	5.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	143.2	132.7	126.6	138.5	132.7	133.1	136.2	133.1	126.6
Gross official reserves (excluding gold)	34.8	37.7	34.5	38.3	37.7	35.1	36.7	35.8	34.5
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.2	5.3	4.8	5.5	5.3	4.9	5.0	4.9	4.8
<i>EUR million, period total</i>									
GDP at current prices	96,562	99,763	97,919	25,902	25,542	21,392	23,721	25,560	27,246

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

7 Poland: Monetary Policy Council Lowers Policy Rates to Record Low Nominal Level

Domestic demand contracts during second half of 2012; export growth is weak but positive

Poland posted GDP growth of 2.0% in 2012, with foreign demand contributing 1.1 percentage points and domestic demand only 0.1 percentage points. Weak final demand led to a decrease in import absorption, which lifted GDP growth by 0.9 percentage points, implying a net export contribution of 1.9 percentage points. Growth continued to slow down in the second half of 2012, with both private consumption and gross fixed investment contracting.

GDP growth started to decelerate after foreign demand growth slowed sharply. Together with the fading out of major public investment projects, this deceleration caused fixed investment growth to fall. Thus, the volume of hours worked stagnated in early 2012 and then started to fall, while nominal wage growth in the whole economy slowed down in parallel. Coupled with somewhat elevated inflation, this slowdown implied that real hourly wages and the real wage sum in the whole economy contracted throughout 2012. Consumer confidence continued to deteriorate. Private consumption and residential investment were particularly affected.

Slower-growing exports and contracting imports led to a decline in the current account deficit in 2012. At the same time, however, net FDI inflows were smaller, too, while the capital account surplus remained unchanged. The current account deficit, however, was again nearly fully covered by non-debt creating inflows. Annual increases in manufacturing unit labor costs remained subdued until the third quarter before picking up in the fourth quarter, when (working-day adjusted) production slumped. Still, unit labor costs grew less than in the euro area in national currency terms. However, in euro terms, the annual increase was considerably higher than in the euro area in the fourth quarter of 2012 as a result of strong nominal currency appreciation year on year in that quarter.

Strong disinflation triggers easing cycle

The exchange rate against the euro stood at PLN 4.18 at end of March 2013, after the zloty had lost about half of the 4% appreciation it had undergone during the second half of 2012. In February 2013, annual inflation was 1.2% (HICP) and 1.3% (national CPI), respectively, while core inflation amounted to 1.3% (HICP) and 1.1% (CPI). Core inflation declined from April (from 3.4% and 2.7%, respectively), headline inflation from June (from 4.2% and 4.3%) amid contracting domestic demand coupled with expectations of further disinflation. The Polish Monetary Policy Council, pursuing an inflation target of 2.5% (CPI), cut the reference rate to 4.75% by monthly steps of 0.25 percentage points between early November and early February and delivered an additional cut of 0.5 percentage points to 3.25% in early March 2012.

Cyclically adjusted primary deficit expected to move into surplus in 2013

After headline and primary deficit were lowered by 2.9 percentage points of GDP, respectively, in 2011, both deficits declined further by 1.1 percentage points to -3.9% and -1.2% of GDP, respectively, in 2012. The decline in 2012 resulted from expenditure cuts only, while the revenues-to-GDP ratio did not rise, given the slowdown of growth and disinflation. As the cost of the systemic pension reform would only have to be taken into account if the Commission and the Council assess that the correction of the excessive deficit (due in 2012) was successful, i.e. only if the fiscal deficit were “slightly above 3%,” it is probable that Poland will stay in the excessive deficit procedure for another year. For 2013, the Commission staff projected a marginal further decline of headline and primary deficit in its winter forecast.

Table 7

Main Economic Indicators: Poland

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.9	4.3	2.0	4.1	4.6	3.7	2.0	1.6	1.1
Private consumption	3.1	2.5	0.5	2.5	1.4	1.7	1.1	-0.2	-0.7
Public consumption	4.1	-1.7	0.0	-5.0	0.1	-1.0	-0.1	0.3	0.8
Gross fixed capital formation	-0.4	9.0	0.6	9.0	10.9	5.4	2.2	-1.3	-0.8
Exports of goods and services	12.1	7.7	2.4	8.9	5.2	4.0	1.9	1.2	2.7
Imports of goods and services	13.9	5.5	-1.9	5.3	1.2	1.7	-2.9	-3.9	-2.1
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	4.6	3.4	0.1	2.7	3.1	2.7	-0.3	-0.8	-0.9
Net exports of goods and services	-0.7	0.9	1.9	1.4	1.5	1.1	2.3	2.4	2.0
Exports of goods and services	4.8	3.3	1.1	3.8	2.1	1.9	0.9	0.5	1.1
Imports of goods and services	-5.5	-2.4	0.9	-2.4	-0.5	-0.8	1.4	1.8	0.9
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	1.0	0.6	0.0	1.6	0.1	1.7	1.3	2.0	0.0
Unit labor costs in manufacturing (nominal, per hour)	-9.2	0.3	1.3	2.1	-2.5	-0.4	0.2	1.0	4.6
Labor productivity in manufacturing (real, per hour)	11.3	4.3	3.1	1.5	8.2	5.0	4.1	5.3	-1.7
Labor costs in manufacturing (nominal, per hour)	1.3	4.6	4.5	3.7	5.5	4.6	4.3	6.4	2.8
Producer price index (PPI) in industry	1.8	7.3	3.3	6.8	8.2	5.8	4.6	2.8	0.1
Consumer price index (here: HICP)	2.7	3.9	3.7	3.7	4.2	4.2	4.0	3.9	2.8
EUR per 1 PLN, + = PLN appreciation	8.4	-3.0	-1.6	-3.4	-10.3	-6.8	-7.0	0.3	7.5
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	9.7	9.8	10.2	9.5	9.9	10.6	10.0	10.0	10.2
Employment rate (%, 15–64 years)	59.3	59.7	59.7	60.2	59.9	58.8	59.7	60.2	60.0
Key interest rate per annum (%)	3.5	4.2	4.6	4.5	4.5	4.5	4.6	4.8	4.5
PLN per 1 EUR	4.0	4.1	4.2	4.2	4.4	4.2	4.3	4.1	4.1
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	8.8	12.5	4.5	10.2	12.5	9.1	11.0	7.6	4.5
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	3.0	6.4	3.4	2.5	6.4	1.9	8.6	4.7	3.4
Domestic credit of the banking system	10.3	14.0	1.0	14.1	14.0	13.1	10.5	4.3	1.0
<i>of which: claims on the private sector</i>	8.0	13.1	2.3	13.5	13.1	11.6	10.1	5.0	2.3
<i>claims on households</i>	8.3	7.4	0.2	9.0	7.4	6.0	4.8	0.9	0.2
<i>claims on enterprises</i>	-0.2	5.7	2.1	4.5	5.7	5.6	5.3	4.1	2.1
<i>claims on the public sector (net)</i>	2.3	0.9	-1.3	0.6	0.9	1.5	0.4	-0.7	-1.3
Other assets (net) of the banking system	-4.5	-7.9	0.2	-6.4	-7.9	-5.9	-8.1	-1.4	0.2
<i>% of GDP, ESA 95</i>									
General government revenues	37.6	38.4	38.4	..	..	..	..	..	..
General government expenditures	45.5	43.4	42.3	..	..	..	..	..	..
General government balance	-7.9	-5.0	-3.9	..	..	..	..	..	..
Primary balance	-5.2	-2.3	-1.1	..	..	..	..	..	..
Gross public debt	54.8	56.2	55.6	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	22.9	11.4	5.2	10.7	6.6	5.9	1.2	5.0	8.9
Merchandise imports	25.0	11.4	1.7	9.5	4.0	6.2	-2.8	-0.4	4.3
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-2.5	-2.7	-1.4	-2.6	-2.7	-2.4	-1.8	-0.5	-1.0
Services balance	0.7	1.1	1.3	1.2	0.7	1.2	1.7	1.2	1.0
Income balance (factor services balance)	-3.6	-4.2	-4.5	-5.0	-3.9	-4.5	-4.3	-5.0	-4.1
Current transfers	0.8	1.2	1.1	0.8	0.6	0.5	2.0	0.8	1.0
Current account balance	-4.6	-4.5	-3.5	-5.7	-5.3	-5.2	-2.4	-3.5	-3.2
Capital account balance	1.8	2.2	2.2	1.6	3.7	1.5	2.5	2.6	2.3
Foreign direct investment (net)	0.7	2.0	0.9	3.9	2.0	-0.8	2.2	0.7	1.2
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	66.9	67.2	72.3	66.8	67.2	70.8	72.1	73.6	72.3
Gross official reserves (excluding gold)	18.7	19.4	20.5	18.8	19.4	19.2	20.9	20.8	20.5
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.1	5.0	5.3	4.9	5.0	4.9	5.3	5.3	5.3
<i>EUR million, period total</i>									
GDP at current prices	354,693	369,253	381,684	90,388	97,375	87,581	91,151	94,783	108,170

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

8 Romania: Low Growth and Elevated Inflation; Budget Deficit below 3% of GDP

Severe drought hits
GDP dynamics

In the second half of 2012, a severe drought had a large negative impact on growth dynamics, in particular in the third quarter, when GDP contracted. Romania recorded full-year GDP growth of 0.7% in 2012, which represents a noticeable deceleration compared to 2011. However, agriculture delivered a negative contribution of 1.4 percentage points to GDP growth, which means that GDP growth excluding the volatile agricultural output was broadly in line with the 2011 growth rate. It is also noteworthy that the GDP growth structure changed in the fourth quarter: While the contribution of net exports turned marginally positive, the contribution of gross fixed capital formation became mildly negative. After taking a hit in the third quarter, private consumption was again an important growth driver in the final quarter.

Inflation rate currently
above central bank
target range

Consumer price inflation (CPI) went up markedly in the second half of 2012 and in early 2013, reaching 5.7% in February. The increase is mainly the result of a rise in food prices due to the drought and of hikes in administered prices. Despite the current elevated inflation levels, the National Bank of Romania (BNR) left its key policy rate unchanged at 5.25%, as it expects inflation to return to the upper bound of the target band (2.5% \pm 1 percentage point) at end-2013. The BNR sees the persistently negative output gap as the main disinflation driver.

Budget deficit below 3%
of GDP, precautionary
international support
program extended by
three months

In 2012, the budget deficit fell below 3% of GDP in ESA (European System of Accounts) terms, i.e. on an accrual basis. However, the IMF pointed out that Romania missed the cash deficit target under the precautionary Stand-By Arrangement (SBA), mainly due to suspensions of reimbursements for some EU-funded projects, as the Romanian audit authorities had discovered irregularities. The 2013 budget targets a deficit of 2.4% of GDP in ESA terms. The budget plan allows public sector wages to be restored to the (nominal) level seen before the 25% cut implemented in 2010 and pensions to be raised by 4%. On the revenue side, the main measures are cuts in tax deductions, new taxes for agricultural producers, and a mandatory turnover tax of 3% on small enterprises, which previously were taxed according to their income.

In March, the IMF agreed to extend the SBA by three months to end-June 2013. The program was scheduled to expire in March. The extension is intended to give Romania enough time to implement the necessary measures to complete the combined seventh and eighth reviews under the SBA. Corrective measures on structural reforms, arrears and the 2013 budget were regarded as necessary during the last IMF/EC review. The Romanian authorities signaled that they would be interested in negotiating a new program.

Current account deficit
declines; net FDI inflows
continue their
downtrend

In the second half of 2012, the current account deficit was 27% lower than in the same period of 2011. The full-year figure also decreased notably, mainly driven by the decline in the income deficit. As a percentage of GDP, the sizeable trade deficit stayed unchanged, because weak external demand and rising unit labor costs in the manufacturing sector impeded a reduction, while the nominal exchange rate of the leu vis-à-vis the euro depreciated only slightly during the observation period. At the same time, the surpluses in the current transfers and services balances improved only slightly. Net FDI inflows continued their downward trend in the second half of 2012. At 1.2% of GDP for the whole year, net FDI inflows covered only 31% of the current account deficit. The composition of capital inflows shifted to portfolio inflows, while other investments recorded a net outflow in 2012.

Table 8

Main Economic Indicators: Romania

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	-1.2	2.2	0.7	4.1	1.6	0.4	1.9	-0.5	1.1
Private consumption	-0.3	1.2	1.0	3.1	0.2	1.3	2.5	-1.0	1.5
Public consumption	-4.6	1.1	1.5	3.9	9.7	3.0	1.8	2.2	-0.0
Gross fixed capital formation	-2.0	7.3	5.0	10.6	7.3	11.3	5.4	7.4	-0.6
Exports of goods and services	14.2	11.0	-3.1	9.2	4.6	-2.1	-0.4	-5.1	-4.9
Imports of goods and services	12.4	10.3	-0.8	11.8	6.1	0.9	1.1	-1.7	-3.8
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-1.1	2.6	1.5	6.0	3.5	-2.2	-0.4	1.2	0.8
Net exports of goods and services	-0.0	-0.5	-0.8	-2.9	-1.2	-1.9	-1.0	-1.0	0.1
Exports of goods and services	4.0	3.7	-1.2	3.4	1.5	-1.2	-0.2	-2.0	-1.6
Imports of goods and services	-4.1	-4.1	0.4	-6.4	-2.7	-0.7	-0.8	1.0	1.8
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	-1.7	-2.5	6.9	-1.9	-0.9	5.4	5.8	8.4	7.1
Unit labor costs in manufacturing (nominal, per hour)	-7.8	1.8	6.4	2.0	8.9	8.7	7.7	6.8	2.8
Labor productivity in manufacturing (real, per hour)	15.1	5.1	0.6	5.3	-0.2	-1.4	0.6	0.3	2.8
Labor costs in manufacturing (nominal, per hour)	6.7	7.2	7.0	7.4	8.6	7.1	8.3	7.1	5.6
Producer price index (PPI) in industry	4.3	7.1	5.3	7.0	6.1	4.8	5.2	5.6	5.5
Consumer price index (here: HICP)	6.1	5.8	3.4	4.2	3.4	2.7	2.1	4.2	4.7
EUR per 1 RON, + = RON appreciation	0.7	-0.7	-4.9	-0.1	-1.1	-3.0	-6.6	-5.9	-4.2
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.6	7.7	7.3	7.5	8.0	7.9	7.2	7.0	7.2
Employment rate (%, 15–64 years)	58.8	58.5	59.5	59.1	57.9	58.0	60.0	60.8	59.3
Key interest rate per annum (%)	6.5	6.2	5.3	6.3	6.1	5.6	5.3	5.3	5.3
RON per 1 EUR	4.2	4.2	4.5	4.3	4.3	4.4	4.4	4.5	4.5
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	6.9	6.6	2.7	6.8	6.6	10.2	8.5	5.7	2.7
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	0.9	-1.6	6.7	0.7	-1.6	5.7	-1.3	1.4	6.7
Domestic credit of the banking system	13.8	11.4	0.1	12.7	11.4	13.3	15.6	8.7	0.1
<i>of which: claims on the private sector</i>	5.2	6.8	1.4	7.1	6.8	10.4	6.7	4.4	1.4
<i>claims on households</i>	1.0	1.1	0.1	0.9	1.1	3.3	1.7	0.9	0.1
<i>claims on enterprises</i>	4.2	5.7	1.4	6.1	5.7	7.1	5.0	3.6	1.4
<i>claims on the public sector (net)</i>	8.6	4.7	-1.4	5.7	4.7	2.9	8.9	4.3	-1.4
Other assets (net) of the banking system	-7.8	-3.2	-4.0	-6.6	-3.2	-8.9	-5.8	-4.4	-4.0
<i>% of GDP, ESA 95</i>									
General government revenues	33.3	33.8	33.5	..	..	..	..	..	..
General government expenditures	40.1	39.4	36.4	..	..	..	..	..	..
General government balance	-6.8	-5.6	-2.9	..	..	..	..	..	..
Primary balance	-5.3	-3.9	-1.1	..	..	..	..	..	..
Gross public debt	30.5	34.7	37.8	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	28.5	21.1	-0.5	18.6	10.9	0.0	2.0	-3.3	-0.5
Merchandise imports	20.4	21.6	-0.5	21.9	14.7	1.9	0.6	-1.3	-2.9
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-4.8	-5.6	-5.6	-5.0	-5.7	-4.6	-7.4	-5.6	-4.9
Services balance	-0.4	0.3	0.4	-0.1	0.8	-0.3	0.2	0.5	1.0
Income balance (factor services balance)	-1.6	-1.7	-1.3	-0.9	-1.1	-1.6	-1.8	-1.0	-0.8
Current transfers	2.8	2.5	2.6	2.1	3.0	4.4	2.7	1.6	2.0
Current account balance	-4.0	-4.5	-3.9	-4.0	-3.0	-2.1	-6.3	-4.5	-2.6
Capital account balance	0.2	0.5	1.5	0.1	0.6	1.5	1.8	0.7	1.8
Foreign direct investment (net)	1.9	1.4	1.3	1.1	2.4	0.3	1.4	2.6	0.7
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	74.5	75.3	75.3	76.2	75.3	76.0	75.9	75.9	75.3
Gross official reserves (excluding gold)	26.1	25.3	23.7	26.0	25.3	26.3	25.1	24.7	23.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	7.7	6.7	6.3	7.0	6.7	6.9	6.6	6.5	6.3
<i>EUR million, period total</i>									
GDP at current prices	124,084	131,139	131,439	36,191	38,097	25,916	31,111	36,410	38,003

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

9 Croatia: Stubborn Recession Continues

Lack of domestic demand is a persistent drag on growth

In the second half of 2012, the Croatian economy continued to contract, resulting in a 2.0% decline in real GDP in 2012. Since the end of 2008, real GDP has fallen by about 11% cumulatively. Private consumption has declined since the first quarter of 2012 because of falling gross real wages in the whole economy, fiscal consolidation measures (VAT increase in March 2012) and the incipient balance sheet repair of households. Furthermore, the labor market situation became even more unfavorable, with unemployment rising by 4 percentage points to 18.5% in the course of 2012 and the employment ratio declining by almost 3 percentage points to 48.7% at the end of 2012. Gross fixed capital formation has continued to fall; it has contracted since 2009, thus denting the growth potential of the Croatian economy. The external sector continued to provide a slight positive contribution to GDP growth in 2012. While export dynamics remained subdued (also in a regional comparison), imports developed even more weakly and in fact contracted. In terms of sector output, the downturn was relatively broad-based. On a positive note, the tourist season in summer 2012 was rather good.

Balanced current account on the back of higher tourism revenue

The current account was in balance in 2012 after recording a small deficit of about 1% of GDP in the previous two years. The slight improvement was mainly driven by a somewhat rising surplus in the services account thanks to the good tourism season. The deficit in the trade balance remained broadly unchanged and price competitiveness did not improve, given rising unit labor costs in manufacturing related to a strong decline in hours worked from the second quarter of 2012 onward. On the financing side, (net) FDI inflows remained at the moderate level of 2011, while portfolio investments increased somewhat. Despite the improvement of the current account position, Croatia's external position remains vulnerable, considering that gross external debt stood at 102.3% of GDP at the end of 2012. To mitigate exchange rate fluctuations, the Croatian National Bank (HNB) has continued to intervene in the foreign exchange market, in the review period mostly by sales of foreign currency.

Following three years of moderate price dynamics, inflation picked up in the course of 2012 despite falling domestic demand. The inflationary pressures can be traced to a VAT hike in March 2012, increases in administrative prices and rising energy and food prices. At the beginning of 2013, inflation remained elevated (5.2% in January 2013), but is expected to ease somewhat in the coming months.

Croatia loses investment grade rating

On the fiscal front, public finances remained under pressure in 2012, given deteriorating economic activity and, relatedly, underperforming budget revenues. Nevertheless, the budget deficit narrowed somewhat to 4.6% of GDP, and the Croatian government is targeting a further reduction to 3.4% (according to the national methodology) of GDP in 2013. The European Commission, however, expects the deficit to rise to 5.0% and is urging further consolidation, especially the implementation of measures on the expenditure side. Gross public debt has rapidly increased since 2008 and is expected to hit 60% of GDP by 2014 according to the European Commission.

Particularly in view of the economic downturn, the relatively high external vulnerability and insufficient reforms to eliminate structural rigidities in the economy, Croatia lost its investment grade rating. S&P lowered Croatia's long- and short-term sovereign foreign currency debt rating to BB+/B from BBB-/A-3 (outlook stable) at end-2012. Moody's downgrade of Croatia to Ba1 (outlook stable) followed in February 2013.

Table 9

Main Economic Indicators: Croatia

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	-2.3	-0.0	-2.0	0.8	-0.3	-1.1	-2.5	-1.9	-2.3
Private consumption	-1.3	0.2	-2.9	0.3	0.2	-0.9	-3.1	-3.4	-4.2
Public consumption	-2.1	-0.6	-0.8	0.8	-1.1	-1.1	0.3	-0.4	-2.0
Gross fixed capital formation	-15.0	-6.4	-4.6	-7.8	-5.2	-3.9	-5.1	-4.4	-4.9
Exports of goods and services	4.8	2.0	0.4	6.7	-3.9	3.9	-4.1	0.1	3.2
Imports of goods and services	-2.8	1.3	-2.1	0.9	-3.3	0.1	-4.0	-2.8	-1.6
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-5.2	-0.3	-3.1	-2.6	-0.2	-1.8	-2.5	-3.8	-4.0
Net exports of goods and services	2.9	0.3	1.1	3.2	-0.1	1.2	0.1	1.2	1.9
Exports of goods and services	1.8	0.8	0.2	3.5	-1.4	1.2	-1.6	0.0	1.2
Imports of goods and services	1.1	-0.5	0.9	-0.3	1.4	-0.1	1.8	1.1	0.7
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit wage costs in manufacturing (nominal, per hour)	2.1	1.4	7.3	2.8	-0.7	8.9	6.5	5.1	8.7
Labor productivity in manufacturing (real, per hour)	-3.4	1.4	2.3	1.7	5.9	-2.6	4.3	5.1	1.6
Gross wages in manufacturing (nominal, per hour)	-1.1	2.7	9.5	4.6	5.2	6.0	11.1	10.4	10.4
Producer price index (PPI) in industry	4.3	6.4	7.0	6.3	6.4	6.1	6.8	7.9	7.3
Consumer price index (here: CPI)	1.0	2.3	3.4	2.0	2.4	1.5	3.4	4.1	4.6
EUR per 1 HRK, + = HRK appreciation	0.7	-2.0	-1.1	-2.8	-1.7	-2.0	-1.8	-0.1	-0.4
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	12.1	13.9	16.3	12.6	14.3	16.8	14.9	15.0	18.5
Employment rate (%, 15–64 years)	54.0	52.4	50.7	53.2	51.5	49.8	51.7	52.5	48.7
Key interest rate per annum (%)	6.0	6.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0
HRK per 1 EUR	7.3	7.4	7.5	7.5	7.5	7.6	7.5	7.5	7.5
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	3.0	1.6	3.2	0.6	1.6	2.6	3.3	2.1	3.2
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-0.2	-4.2	6.3	-4.5	-4.2	-3.9	1.5	1.7	6.3
Domestic credit of the banking system	8.1	8.8	-0.8	9.1	8.8	9.5	6.0	3.7	-0.8
<i>of which: claims on the private sector</i>	5.5	4.9	-4.1	3.9	4.9	5.8	2.7	-0.5	-4.1
<i>claims on households</i>	1.7	0.5	-0.7	1.6	0.5	1.0	0.1	-1.0	-0.7
<i>claims on enterprises</i>	3.7	4.4	-3.4	2.3	4.4	4.7	2.6	0.5	-3.4
<i>claims on the public sector (net)</i>	2.6	3.9	3.3	5.2	3.9	3.8	3.3	4.3	3.3
Other assets (net) of the banking system	-4.9	-3.0	-2.4	-3.9	-3.0	-3.1	-4.2	-3.3	-2.4
<i>% of GDP, ESA 95</i>									
General government revenues	40.1	40.4	35.7	..	..	..	..	..	..
General government expenditures	45.3	46.1	40.3	..	..	..	..	..	..
General government balance	-5.2	-5.7	-4.6	..	..	..	..	..	..
Primary balance	-3.1	-3.5	-2.0	..	..	..	..	..	..
Gross public debt	42.2	46.7	53.6	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	18.1	7.8	0.1	13.2	-1.9	2.2	-7.9	0.2	6.4
Merchandise imports	-0.5	7.5	-0.7	5.6	0.1	2.0	-3.0	-1.4	-0.3
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-12.9	-13.9	-13.7	-13.3	-13.2	-15.1	-15.5	-12.8	-11.6
Services balance	13.0	13.9	14.6	34.6	3.6	1.7	14.0	35.5	3.9
Income balance (factor services balance)	-3.5	-3.5	-3.4	-2.9	-1.6	-5.1	-4.0	-3.4	-1.3
Current transfers	2.4	2.6	2.6	2.4	2.7	2.7	2.8	2.2	3.0
Current account balance	-1.1	-0.9	0.1	20.7	-8.5	-15.9	-2.6	21.5	-6.0
Capital account balance	0.1	0.1	-0.0	0.0	0.2	0.0	0.1	-0.1	-0.0
Foreign direct investment (net)	1.0	2.4	2.4	4.7	1.5	3.1	2.5	1.2	3.0
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	104.6	103.1	102.3	104.9	103.1	103.9	106.0	103.7	102.3
Gross official reserves (excluding gold)	24.0	25.2	25.6	25.5	25.2	25.7	26.5	25.9	25.6
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	7.2	7.2	7.2	7.3	7.2	7.2	7.4	7.3	7.2
<i>EUR million, period total</i>									
GDP at current prices	44,432	44,379	43,915	11,994	11,034	9,972	10,920	11,995	11,028

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

10 Turkey: Economy Slows Markedly in Second Half of 2012

Sharp drawdown of inventories

Domestic demand contracted further in the second half of 2012 as a result of falling investment and pronounced destocking. In the last quarter of 2012, the rate of inventory depletion was the largest since the economic downturn in the first quarter of 2009. Private consumption also continued to contract, but at a slightly diminishing rate, and the unemployment rate showed an upward trend, especially in the final quarter of 2012. Nevertheless, job creation remained strong and the employment rate remained at a historically high level of almost 50%. Recent indicators suggest a recovery of economic momentum. Capacity utilization rose in seasonally adjusted terms in February and March to reach 74%, industrial production edged up slightly in January, and the PMI indicated an expansion (53.3). Credit growth also started to pick up again in December. While the annual growth rate was rather stable at the 15% target rate of the Central Bank of the Republic of Turkey (CBRT) between September and November, it has been exceeding the target since the beginning of December again.

External rebalancing fades out

The narrowing of the current account deficit continued in the second half of 2012 despite softening export growth and a slight recovery in import demand. By the end of the year, the current account deficit had shrunk to just below 6% of GDP. But in line with lower gold exports and the continued resurgence of import growth, the adjustment seems to have halted since January 2013. Following strong capital inflows, the current account has been more than fully financed since November. However, the annualized coverage of the deficit by FDI has fallen further to below 17% by the end of January, while the reliance on short-term capital inflows has increased.

CBRT remains innovative in its monetary policy

In order to reduce a potential adverse impact of volatile capital flows on macroeconomic and financial stability, the Central Bank of the Republic of Turkey (CBRT) has been refining its “reserve option mechanism” (ROM) since June 2012. This unorthodox tool, which is used to complement frequent adjustments to the interest rate corridor, allows banks to hold a certain fraction of their Turkish lira reserve requirements in foreign exchange. The amount of foreign exchange that can be held per unit of Turkish lira is stipulated by a “reserve option coefficient” (ROC), which varies between 1.4 and 2.3 depending on the fraction of reserves to which it is applied. This contributed to the USD 20 billion increase in the CBRT’s foreign exchange reserves in the course of 2012 to USD 100 billion at the end of the year and alleviated appreciation pressure. Since July 2012, the lira has remained broadly stable against the dollar and the euro.

Headline inflation declines noticeably in the course of 2012

On the back of softening food prices, year-end inflation fell to 6.2%, thus coming close to the CBRT’s target of 5.5%. Annual average inflation in 2012 was 9.0%. Core inflation also fell in the second half of 2012, but the gap between core and headline inflation narrowed significantly, thus limiting the policy leeway. Furthermore, fiscal policy was recently adding to price dynamics: A fiscal impulse was financed by indirect tax hikes in late 2012. Increases in special consumption taxes on fuel products, motor vehicles and alcohol added 1.1 percentage points to headline inflation.

The budget deficit of 2.3% of GDP in 2012 was above the end-year fiscal target of 1.5%. While total revenue was in line with plans, spending slippage caused the deviation from the target. The primary surplus deteriorated a bit in 2012, and the public debt-to-GDP ratio continued its declining trend (36.7% of GDP in 2012).

Table 10

Main Economic Indicators: Turkey

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	9.2	8.8	2.2	8.7	5.3	3.3	2.9	1.6	1.4
Private consumption	6.7	7.7	-0.7	7.5	3.3	-0.4	-1.3	-0.4	-0.8
Public consumption	2.0	4.7	5.7	10.3	-3.7	5.5	4.4	5.5	7.1
Gross fixed capital formation	30.5	18.0	-2.5	14.7	-0.9	0.7	-2.7	-4.2	-3.8
Exports of goods and services	3.4	7.9	17.2	11.9	5.9	15.0	24.0	15.0	15.0
Imports of goods and services	20.7	10.7	0.0	6.2	-8.2	-5.1	0.4	2.0	3.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	13.8	9.4	-2.1	6.9	1.2	-2.6	-3.0	-1.6	-1.5
Net exports of goods and services	-4.0	-1.0	3.7	1.0	3.6	4.6	5.0	2.7	2.6
Exports of goods and services	0.8	1.7	3.7	2.5	1.3	3.1	5.1	3.2	3.3
Imports of goods and services	-4.8	-2.7	0.0	-1.5	2.3	1.5	-0.1	-0.5	-0.8
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit wage costs in manufacturing (nominal, per hour)	2.4	5.3	13.0	6.5	9.0	16.0	12.1	12.8	11.2
Labor productivity in manufacturing (real, per hour)	8.7	4.4	-0.6	4.3	1.1	-1.7	0.7	-0.5	-0.9
Gross wages in manufacturing (nominal, per hour)	11.8	10.0	12.3	11.2	10.2	14.0	12.9	12.2	10.2
Producer price index (PPI) in industry	6.2	12.3	6.1	13.8	15.3	9.9	8.0	3.6	3.3
Consumer price index (here: HICP)	8.6	6.5	9.0	6.4	9.2	10.5	9.6	9.1	6.8
EUR per 1 TRY, + = TRY appreciation	8.3	-14.5	0.9	-20.2	-19.7	-8.4	-2.7	8.5	6.4
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	10.9	9.0	8.4	8.4	8.3	9.6	7.5	7.9	8.5
Employment rate (%, 15–64 years)	46.3	48.4	48.9	49.9	48.4	46.3	49.9	49.9	49.5
Key interest rate per annum (%) ¹	6.8	6.1	5.7	5.9	5.8	5.8	5.8	5.8	5.7
TRY per 1 EUR	2.0	2.3	2.3	2.5	2.5	2.4	2.3	2.3	2.3
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	18.6	15.2	10.5	22.1	15.2	10.3	9.3	8.8	10.5
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	-7.5	0.6	1.4	-1.1	0.6	-2.7	-3.2	0.1	1.4
Domestic credit of the banking system	30.2	19.0	16.9	26.5	19.0	18.9	17.5	14.4	16.9
<i>of which: claims on the private sector</i>	27.9	25.0	18.7	31.8	25.0	21.6	18.0	15.2	18.7
<i>claims on households</i>	8.4	8.4	5.9	10.2	8.4	7.1	5.5	5.3	5.9
<i>claims on enterprises</i>	19.5	16.6	12.7	21.5	16.6	14.5	12.5	9.9	12.7
<i>claims on the public sector (net)</i>	2.4	-6.0	-1.8	-5.3	-6.0	-2.7	-0.5	-0.8	-1.8
Other assets (net) of the banking system	-4.2	-4.4	-7.7	-3.2	-4.4	-5.9	-5.1	-5.7	-7.7
<i>% of GDP, ESA 95</i>									
General government revenues	36.7	39.4	37.4	..	..	..	..	..	..
General government expenditures	39.4	41.3	39.7	..	..	..	..	..	..
General government balance	-2.6	-2.0	-2.3	..	..	..	..	..	..
Primary balance	1.6	2.0	1.7	..	..	..	..	..	..
Gross public debt	42.4	39.1	36.7	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	16.1	12.9	23.3	17.4	12.3	17.7	30.3	26.7	18.7
Merchandise imports	39.4	24.6	6.7	21.3	9.3	5.4	8.3	8.2	5.0
<i>% of GDP (based on EUR), period total</i>									
Trade balance	-7.7	-11.5	-8.4	-11.5	-10.5	-9.2	-9.3	-7.8	-7.2
Services balance	2.1	2.6	3.0	4.8	2.3	1.2	2.9	5.0	2.7
Income balance (factor services balance)	-1.0	-1.0	-0.8	-0.9	-0.8	-1.1	-0.9	-0.8	-0.6
Current transfers	0.2	0.2	0.2	0.2	0.3	0.2	0.2	0.1	0.2
Current account balance	-6.4	-9.7	-6.0	-7.4	-8.6	-8.9	-7.2	-3.5	-4.9
Capital account balance	-0.0	-0.0	-0.0	0.0	0.0	-0.0	-0.0	-0.0	-0.0
Foreign direct investment (net)	1.0	1.8	1.1	2.1	2.1	1.2	1.8	0.7	0.7
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	39.6	42.4	41.7	40.8	42.4	42.3	44.8	42.4	41.7
Gross official reserves (excluding gold)	11.0	10.9	12.4	11.4	10.9	10.7	11.6	12.4	12.4
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	4.9	4.0	4.7	4.4	4.0	3.9	4.2	4.6	4.7
<i>EUR million, period total</i>									
GDP at current prices	551,485	554,990	612,756	143,132	137,018	138,767	150,857	166,683	156,449

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

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

11 Russia: Growth Levels Off

Domestic demand-driven GDP growth decelerates as capital formation momentum slows

Following a rather dynamic economic expansion at the beginning of 2012, GDP growth decelerated in the second, third and fourth quarters. This produced an annual growth figure of 3.4% for 2012, down from 4.3% in 2011, which was somewhat below expectations. The main driving force of the expansion in the second half of 2012 was private consumption, boosted by rapid increases in wages and pensions, while net exports continued to deliver a negative, although declining, contribution to economic activity. The slowdown in growth was largely triggered by the sharply decelerating expansion of gross fixed capital formation throughout the year, as businesses became more cautious about future prospects. With average Urals grade crude oil prices being just 1.1% higher in 2012 than in 2011, oil price changes no longer played a substantial role in stimulating the Russian economy.

According to preliminary data, in the first two months of 2013, GDP was up by only about 1% year on year. In the view of the Bank of Russia (CBR), the output gap has shrunk to near zero. This view is supported by the decrease of the unemployment rate, which in August 2012 reached a post-Soviet record low of 5.0%.

Prices surge mainly because of the poor harvest of 2012 and administrative tariff adjustments

CPI inflation increased to 6.6% at end-December 2012, which is clearly above the monetary authority's annual inflation objective of 5% to 6%. At end-February 2013, the rise in prices accelerated to 7.3%. Persisting high inflation is mainly due to first, the food price hikes stemming from a poor harvest in 2012 and second, a carryover effect of delayed increases of municipal tariffs in mid-2012 as well as further adjustments of administered prices in January 2013. High credit growth, including a retail lending boom, may also have impacted on price dynamics. Thus, while temporary and seasonal factors certainly play a role in inflation developments, core inflation was 5.7% in February 2013. Against this backdrop, the CBR increased its key interest rates by 25 basis points in September and its deposit rate by another 25 basis points in December 2012. In recent months, given weakening economic growth, government officials have suggested that the CBR should loosen its monetary stance somewhat.

High oil price keeps the federal budget in balance and the current account in surplus

In January 2013, total loans grew by 12% year on year in real terms. Correspondingly, retail loans expanded by 30%. Thus, credit growth decelerated marginally from mid-2012, partly because economic activity as a whole slowed in the second half of 2012 and partly because of the CBR's efforts (monetary tightening, moral suasion and the tightening of prudential regulations). The steady oil price and robust private consumption kept the federal budget almost in balance (deficit: 0.1% of GDP) in 2012. The sluggish state of the global economy combined with still brisk Russian domestic demand caused the country's current account surplus to shrink from 5.3% of GDP in 2011 to 3.7% a year later.

Gross external reserves remain sizeable despite continuing capital outflows

Private net capital outflows continued in 2012, even though they contracted to EUR 43.4 billion (or about 2.8% of GDP). At 30.6% of GDP at end-2012, Russia's gross external debt remains at a manageable level, and at 23.5% of GDP, the CBR's gross reserves (excluding gold) remain substantial, even if these two numbers have been slowly diverging. According to the CBR, the Cyprus crisis and remedial measures will not have an important impact on the Russian banking sector.

Table 11

Main Economic Indicators: Russia

	2010	2011	2012	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.5	4.3	3.4	5.0	5.1	4.8	4.3	3.0	2.1
Private consumption	5.5	6.3	6.7	7.8	7.9	9.0	6.9	5.5	5.7
Public consumption	-1.5	0.8	-0.2	0.7	0.3	0.4	-0.1	-0.2	-0.8
Gross fixed capital formation	5.9	10.2	6.0	10.4	14.1	15.5	9.7	4.6	1.4
Exports of goods and services	7.0	0.3	1.4	-1.5	1.2	4.2	-2.0	1.8	1.4
Imports of goods and services	25.8	20.3	9.5	17.9	14.8	13.0	5.6	10.5	9.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	7.1	7.9	5.0	9.3	7.7	5.9	5.8	4.9	3.6
Net exports of goods and services	-2.0	-4.0	-1.8	-4.4	-2.9	-1.2	-1.9	-2.1	-1.8
Exports of goods and services	2.3	0.1	0.4	-0.5	0.4	1.5	-0.7	0.5	0.4
Imports of goods and services	-4.3	-4.1	-2.2	-3.9	-3.3	-2.7	-1.3	-2.6	-2.2
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit labor costs in industry (nominal, per person)	2.2	9.3	8.4	8.6	9.4	9.2	8.8	7.2	8.3
Labor productivity in industry (real, per person)	11.8	4.1	4.0	4.7	3.0	5.5	3.7	3.9	2.9
Average gross earnings in industry (nominal, per person)	14.7	13.8	12.6	13.7	12.7	15.2	12.9	11.4	11.5
Producer price index (PPI) in industry	12.3	17.8	6.8	17.0	13.9	8.0	4.5	7.9	6.8
Consumer price index (here: CPI)	6.9	8.6	5.1	8.2	6.8	3.9	3.9	6.1	6.6
EUR per 1 RUB, + = RUB appreciation	9.6	-1.5	2.4	-3.9	-0.8	1.2	1.1	2.9	4.4
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.5	6.6	5.5	6.2	6.3	6.3	5.3	5.1	5.2
Employment rate (%, 15–64 years)	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	8.0	8.1	8.1	8.3	8.2	8.0	8.0	8.0	8.3
RUB per 1 EUR	40.3	40.9	39.9	41.2	42.1	39.5	39.8	40.0	40.3
<i>Nominal year-on-year change in the period-end stock in %</i>									
Broad money (including foreign currency deposits)	24.6	20.9	12.1	20.4	20.9	20.1	20.1	15.0	12.1
<i>Contributions to the year-on-year change of broad money in percentage points</i>									
Net foreign assets of the banking system	5.8	9.9	-0.4	11.2	9.9	6.7	10.5	0.8	-0.4
Domestic credit of the banking system	22.1	19.7	15.4	17.0	19.7	21.1	22.4	19.5	15.4
<i>of which: claims on the private sector</i>	12.4	24.5	17.9	23.7	24.5	24.8	26.9	21.5	17.9
<i>claims on households</i>	3.1	6.4	8.2	5.8	6.4	7.8	8.9	8.8	8.2
<i>claims on enterprises</i>	9.3	18.1	9.7	17.9	18.1	17.1	18.0	12.7	9.7
<i>claims on the public sector (net)</i>	9.7	-4.8	-2.6	-6.7	-4.8	-3.7	-4.5	-2.0	-2.6
Other assets (net) of the banking system	-3.3	-8.7	-2.9	-7.8	-8.7	-7.8	-12.9	-5.3	-2.9
<i>% of GDP, ESA 95</i>									
General government revenues	33.9	37.4	36.9	..	..	..	..	..	..
General government expenditures	37.4	35.9	36.5	..	..	..	..	..	..
General government balance	-3.4	1.5	0.4	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	..	..	..	..	..	..	..	..	..
<i>Year-on-year change of the period total (based on EUR) in %</i>									
Merchandise exports	39.8	24.2	9.7	22.0	29.2	21.3	10.5	8.8	0.8
Merchandise imports	37.4	23.7	12.4	13.8	19.3	17.0	11.2	15.4	7.6
<i>% of GDP (based on EUR), period total</i>									
Trade balance	9.9	10.5	9.6	9.0	10.7	12.8	10.2	7.5	8.3
Services balance	-1.9	-1.9	-2.3	-2.3	-1.9	-1.8	-2.1	-3.0	-2.2
Income balance (factor services balance)	-3.2	-3.2	-3.3	-2.9	-3.0	-2.2	-4.6	-2.8	-3.5
Current transfers	-0.2	-0.2	-0.3	-0.3	-0.2	-0.2	-0.1	-0.5	-0.4
Current account balance	4.6	5.3	3.7	3.5	5.6	8.6	3.4	1.2	2.3
Capital account balance	0.0	-0.0	-0.3	-0.0	-0.0	-1.0	-0.0	-0.0	-0.0
Foreign direct investment (net)	-0.6	-0.8	0.0	0.2	-1.7	0.3	-1.5	0.4	0.8
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	31.8	30.6	30.6	30.7	30.6	29.5	31.1	30.5	30.6
Gross official reserves (excluding gold)	28.9	25.7	23.5	26.9	25.7	24.7	25.5	24.4	23.5
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	16.3	14.2	12.8	14.8	14.2	13.5	13.9	13.1	12.8
<i>EUR million, period total</i>									
GDP at current prices	1,150,057	1,362,744	1,567,113	355,897	377,404	348,992	376,767	408,804	432,550

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

Outlook for Selected CESEE Countries:

Headwinds to Recovery because of Continued Weakness of the External Environment and Only Slow Pickup in Domestic Momentum^{1,2}

1 CESEE-7:³ New Sources of Growth Have Yet to Be Found

The slowdown in economic growth the CESEE-7 region experienced in 2012 will carry over to 2013 so that GDP will expand by only 1.1%, just marginally above the growth rate recorded last year. We expect growth dynamics to accelerate gradually during the course of 2013 and beyond, with GDP growth picking up to reach 2.4% in 2014 and 2.9% in 2015. Given an uptick in import growth combined with an only moderate revival of external demand, the growth contribution of net exports in all countries apart from the Czech Republic will diminish over the forecasting horizon. In the Czech Republic and Hungary, growth drivers will be fairly balanced between external and domestic demand; in all other countries, the moderate recovery will be spurred mainly by domestic demand. Overall, economic growth will remain below potential, and the growth differential to the euro area will be in the approximate order of 1.5 percentage points over the forecasting horizon.

The risks to our CESEE-7 projections remain tilted to the downside and relate to developments in individual euro area countries (e.g. a prolonged political

Table 1

GDP and Import Projections for 2013 to 2015

	GDP				Imports			
	2012	2013	2014	2015	2012	2013	2014	2015
	Year-on-year growth in %							
CESEE-7	1.0	1.1	2.4	2.9	0.3	1.5	6.0	7.3
Bulgaria	0.7	1.3	2.1	2.6	3.8	5.0	5.8	6.2
Czech Rep.	-1.2	0.0	1.6	2.4	2.1	2.1	6.5	8.8
Hungary	-1.8	-0.1	1.3	1.5	0.1	0.5	4.9	5.0
Poland	2.2	1.5	3.0	3.5	-1.8	-0.5	5.9	7.6
Romania	0.9	1.4	2.2	2.5	-0.8	3.1	6.3	7.8
Croatia	-2.0	-0.5	0.9	1.7	-2.0	-1.5	1.5	4.9
Russia	3.4	3.4	3.4	3.0	9.0	5.0	5.0	6.0

Source: OeNB, BOFIT, Eurostat, Rosstat.

Note: CESEE-7 = Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania; seasonally-adjusted data for 2012.

¹ Compiled by Julia Wörz with input from Stephan Barisitz, Martin Feldkircher, Mariya Hake, Mathias Lahnsteiner, Thomas Reininger, Katharina Steiner, Jarmila Urvova and Zoltan Walko.

² The OeNB and the Bank of Finland Institute for Economies in Transition (BOFIT) compile semiannual forecasts of economic developments in selected CESEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and Croatia). These forecasts are based on a broad range of information, including country-specific time series models for Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania (for technical details, see Crespo Cuaresma et al. 2009. *Simple but Effective: The OeNB's Forecasting Model for Selected CESEE Countries*. In: *Focus on European Economic Integration Q4/09*. 84–95). The projections for Russia were prepared by the Bank of Finland and are based on a SVAR model. Latvia and Lithuania are not covered in the OeNB projections, but are included in the CESEE-7 aggregate based on the IMF World Economic Outlook (WEO) projections of April 2013. The cutoff date for all projections was April 2, 2013.

³ Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania.

impasse in Italy or a collapse of economic activity in Cyprus exceeding the expected magnitude) and a resulting possible further fall in external demand from the euro area. Further, this might lead to a deterioration of global financial market conditions, which could in turn translate into an increased risk aversion vis-à-vis CESEE countries. The predictability and credibility of policy frameworks will remain key to shielding countries from contagion effects, should risk aversion increase again internationally. In contrast, improvements in funding conditions on the back of stronger-than-expected domestic deposit growth or higher capital inflows as well as lower-than-expected inflation in recent months pose upside risks.

We expect economic growth to pick up hesitantly during 2013, after having slowed down in the course of 2012. Region-wide GDP growth will amount to 1.1% in 2013. Thus, in line with the weaker external environment as compared to our October 2012 projections, we revise our growth projections downward over the entire horizon, especially for 2013. The pronounced downward revision by 1.1 percentage points for 2013 is due not only to changes in our assumptions on the external environment (mostly related to our assumption on GDP growth in the euro area⁴), but also to a considerable extent to the extremely weak carryover effect from last year. In fact, the pronounced slowdown in economic activity during the second half of 2012 implied a negative carryover in the Czech Republic and in Hungary as well as a markedly reduced positive carryover effect compared to that in 2012 in Poland. Still, all CESEE-7 countries will record positive growth rates in 2013. Further, the positive growth differential vis-à-vis the euro area will remain in an order of 1.5 percentage points. Several dampening factors observed in 2012 will prevail. We do not expect labor market conditions to improve significantly, nor do we see an end to household deleveraging. However, we anticipate a slight recovery of credit conditions, as banks' funding conditions are expected to remain reasonably good (as they were in the first months of 2013) and as risk aversion is expected to remain steady or abate somewhat further.

Very moderate recovery in the course of 2013

The regional differentiation in growth dynamics will remain largely unchanged from 2012, especially in 2013. We envisage some reduction in the growth dispersion between individual countries toward the end of the horizon. The Baltic states and Poland will continue to outperform the region as a whole despite the projected temporary slowdown in economic activity to 1.5% in 2013 in Poland. Bulgaria and Romania will post growth rates similar to that of Poland in 2013 and will grow somewhat less strongly in 2014 and 2015. We also expect the Czech Republic to recover from its recent weakness. Hungary is projected to settle on a lower growth path over the projection horizon.

Turning to the prospects for the CESEE-5⁵ in greater detail, growth will increasingly be driven by domestic demand, while the contribution of net exports to economic growth will soften in all countries (chart 1). In Bulgaria and Romania, net exports will continue to act as a drag on overall growth. Hungary and the Czech Republic will show a moderate rise in the positive contribution of net

Growth drivers shift toward domestic demand

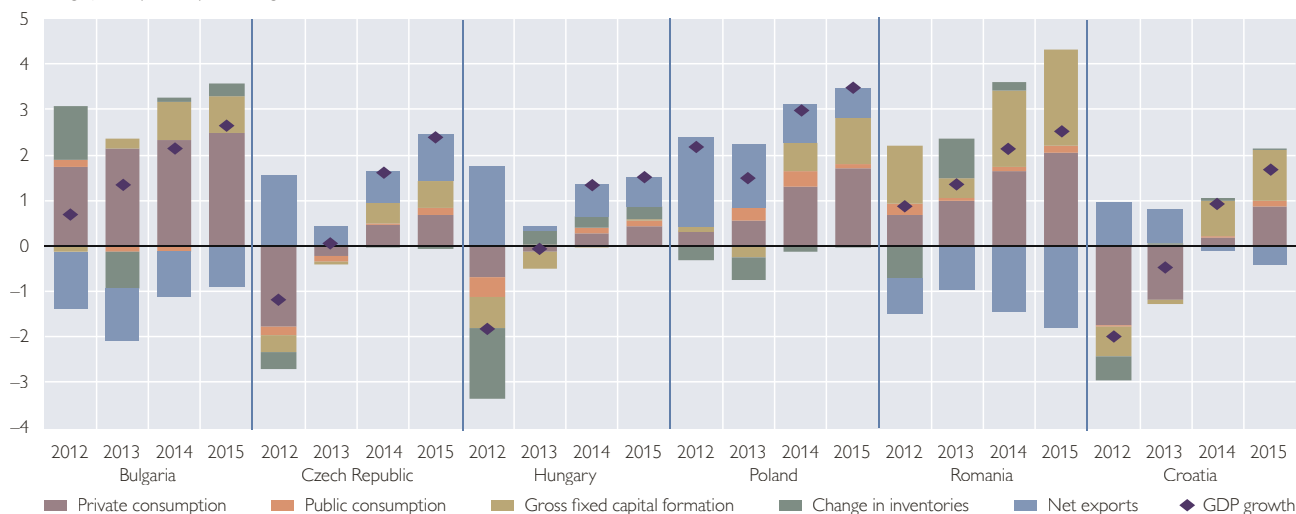
⁴ Our projections rest on technical assumptions and results from the ECB's March 2013 macroeconomic projection exercise (see ECB Monthly Bulletin March 2013 for more details).

⁵ CESEE-5: Bulgaria, the Czech Republic, Hungary, Poland and Romania. As these are the CESEE EU Member States for which we carry out our model-based forecasting, we present developments in this sub-region in greater detail, both in a comparative perspective (in this section) and in a country-by-country account (next section).

Chart 1

GDP and GDP Components – Projections for 2013 to 2015

Percentage points; year-on-year GDP growth in %



Source: OeNB.

exports that is just in line with their overall GDP expansion, thus keeping external and internal growth drivers balanced in all three years. In Poland, we expect the positive net contribution of external demand to fade over the projection horizon. Thus, despite a gradual recovery of external demand, net exports will lose importance as a pillar of growth because on the one hand, import demand from the euro area will be insufficient to trigger strong export growth in the region and on the other hand, CESEE-5 imports are expected to rise in line with exports on the back of slowly improving domestic demand conditions. In Poland, we expect imports to fall less slowly in 2013.

Overall, the gradual recovery will be driven by a resumption of domestic demand growth in all countries. This moderate recovery of internal demand rests on different factors in individual countries: In Romania and Bulgaria, increases in public wages and pensions will play an important role in 2013; minimum wage increases will also support domestic demand in Hungary. In all three countries, compensatory tax measures, the burden of which will be carried mostly by the corporate sector, will contain the effects of higher wage costs on public budgets. In the Czech Republic and in Romania, a slowdown in consolidation efforts in 2013 implies some weak impetus from public consumption. Nevertheless, as a general trend, consolidation is ongoing in all countries, precluding any notable growth impetus from public consumption over the entire horizon. The consolidation effort might be temporarily broken by the election cycle in some countries; we already saw some stimulus ahead of elections in early 2013 in Bulgaria and expect the same in 2014 for the Czech Republic and Hungary.

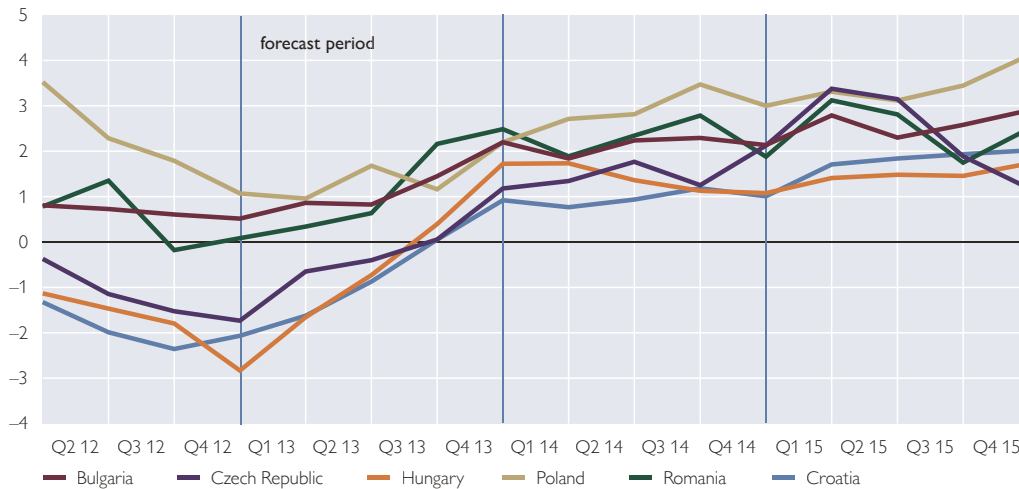
While we assume that a turnaround in growth dynamics occurred at the beginning of 2013 (chart 2), a long-standing weakness in investment growth has reduced potential growth. This weakness is related to the ongoing structural shift in the region's overall growth model away from predominantly FDI-financed invest-

Growth potential reduced by low investment

Chart 2

Quarterly Profile of GDP Projections

Year-on-year change in %



Source: OeNB.

ments toward new sources of financing. Growth in gross fixed capital formation will remain subdued or even negative in 2013, and we do not expect it to revive already in 2013 in any country except Hungary. The weak overall performance of gross fixed capital formation in 2013 is compounded by a negative base effect in Poland related to investment spending for the 2012 European football championship. With investment decisions no longer being postponed and capacity utilization rising, gross fixed capital formation will pick up throughout the region starting in early 2014. In all countries, investments co-financed by the EU continue to play an important role in gross fixed capital formation.

Economic growth will firm somewhat in 2014 and 2015, reaching 2.4% and 2.9%, respectively. In 2014, domestic demand should continue to firm somewhat and should contribute positively to overall GDP growth in all countries. Gross fixed capital formation and private consumption will constitute the main growth drivers. In particular, supply-side constraints on credit growth should ease further in view of gradually improving investor confidence (as incorporated in our external assumptions); precautionary savings should decline as well. However, labor market conditions will not change substantially, preventing a more animated recovery. Furthermore, the general fiscal stance will remain tight in 2014 as well, implying that public consumption will not provide an impetus. We expect no major changes with respect to the growth drivers for 2015.

The downward risks to this outlook have risen somewhat again recently as a result of new risks in the external environment. Developments in the euro area, including a prolonged political impasse in Italy or a stronger-than-expected collapse of economic activity in Cyprus, may translate into lower business and consumer confidence in the euro area, which we did not include in our baseline. This would primarily impact indirectly on the CESEE region through a slower-than-expected recovery (or even a further fall) of external demand and a general decline in consumer and business sentiment, which would further postpone decisions

International developments imply slight increase in downside risks

to invest in the region. Furthermore, global financial market conditions could worsen again in response to continued problems in individual euro area countries; this could also translate into increased risk aversion vis-à-vis CESEE countries. Finally, global growth could be impacted negatively by the U.S. fiscal situation, as our baseline does not incorporate the budget sequestration that came into effect after negotiations between Republicans and Democrats broke down in February. In such an uncertain external environment, the predictability and credibility of policy frameworks will remain key to shielding countries from contagion effects should risk aversion increase again internationally.

However, there are also some upside risks to our projections: further improvements in funding conditions on the back of stronger-than-expected deposit growth (hence a faster transition to a new growth model than envisaged) or higher capital inflows as well as lower-than-expected inflation and hence increased real incomes.

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

Bulgaria: Some fiscal expansion adds to recovery of domestic demand

Following a marked deceleration of real GDP growth in Bulgaria to 0.7% in 2012, down from 1.9% in 2011, we forecast a moderate acceleration of growth to 1.3% in 2013. The process of gradual recovery should continue in 2014 and 2015, with growth reaching 2.1% and 2.6%, respectively. In 2013, the positive contribution of domestic demand will continue, though at a slower pace than in 2012. Private consumption should benefit from the rise in personal incomes, i.e. the increase of minimum wages, while pensions will rise at different rates that average out to 9%. Furthermore, energy prices are set to decline by around 6% in the first half of 2013. This will, in turn, enhance public revenues through higher tax collection volumes, thus providing more favorable conditions for the expansionary fiscal stance envisaged in the 2013 budget (which is to be seen against the background of the parliamentary elections scheduled for the second quarter). On the downside, however, adverse labor market conditions coupled with ongoing deleveraging in the household sector – mostly driven by demand on the back of lower interest rates – increase households' uncertainty and their propensity to save. This might put a strain on the increase of private consumption. After having contracted strongly for several years in a row, gross fixed capital formation is predicted to shrink further, although at a declining pace, counterbalanced somewhat by an expansion of EU-linked investments. The combination of slowly accelerating domestic demand with upward pressure on imports and an even more gradual increase of exports will leave the negative contribution of net exports to GDP growth in 2013 broadly unchanged.

Going forward, we expect Bulgarian real GDP growth to pick up gradually in 2014 and 2015, with the growth structure remaining broadly unchanged from 2013. On the back of the recovery of the Bulgarian labor market, supported by the expiration of labor market restrictions in other EU countries as of the beginning of 2014, increased EU funding as well as the deferral of investments over the past few years, especially in the business sector, domestic demand will remain the main growth driver. Due to base effects, the growth of public consumption will be negative. Finally, despite the further improvement of external demand, the negative

contribution of net exports will remain broadly unchanged, as the moderate growth of domestic demand will keep imports at a comparatively high level.

We expect the Czech economy to stagnate in 2013 after having contracted in 2012. GDP growth will resume in 2014, coming to 1.6%, and will quicken to 2.4% in 2015. The growth structure in 2013 is forecast to be similar to that in 2012, when the economy was driven solely by net exports. In 2013, the contribution of net exports should just cover the negative contribution of domestic demand, which will be less pronounced than last year. Household demand will still be dragged down by the prospect of a weakening labor market accompanied by uncertainty and feeble growth of nominal disposable income eroded by inflation. Though not as extensive as in the past two years, fiscal consolidation will curtail domestic demand as well. Gross fixed capital formation will not resume until 2014, given underutilized capacities, the still paralyzed construction sector, a lack of domestic demand and the expected bottoming out of external demand in the first half of 2013. Exports slowed gradually throughout 2012 as a result of falling external demand and will continue to weaken in 2013 even if the Czech Republic's major trading partners are among the more resilient EU economies. However, these economies' growth is also projected to slow down in 2013. A lack of domestic demand implies weak import growth, which is driven predominantly by the import intensity of exports.

In 2014, a parliamentary election year, fiscal consolidation measures already implemented (and any additional measures) are expected to put much less of a strain on the Czech economy than in the previous years. The resulting resurgence of household consumption, though moderate, and no further postponement of investment decisions from previous years should shift domestic demand back to positive territory. Domestic demand continues to be dampened by the general uncertainty emanating not only from the external environment, but also from domestic political turmoil. For example, political instability at the end of 2012 left it unclear until the last days of the year which VAT rates would apply in 2013. The growth contribution of domestic demand in 2014 is expected to be approximately equal to that of net exports, which will be fueled by cautiously recovering exports in line with the gradual recovery of the external environment in 2014. Both trends, i.e. the strengthening of domestic consumption and investment as well as steady improvements in external demand, are expected to be even more pronounced in 2015.

Beyond the downside risks emanating from the external environment, any prolonged domestic political instability would add a further negative bias to our projections for the Czech Republic. While the financial markets hardly ever take note of Czech politics, these politics might have a further adverse effect on the private sector's expectations and confidence if the current discord continues or even intensifies after the elections.

Following a contraction by 1.8% in 2012, Hungarian GDP is expected to stagnate in 2013. A slow and gradual recovery should resume in 2014, but the prospects are held back by the decline in the country's output potential over the past few years. As for the outlook for 2013, we expect a smaller contraction of domestic demand than in the previous years. Private consumption should benefit from the substantial rise in minimum wages (+5.4%) in 2013 and the planned wage increase for teachers toward end-2013 combined with the sharp deceleration in

Czech Republic: External and domestic uncertainty drives down growth below potential

Hungary: Continued deleveraging and lack of investment lower growth potential

inflation on the back of utility price cuts and the favorable effect of the Job Protection Plan. At the same time, there is no end in sight for the deleveraging of households, and unemployment remains stubbornly high while consumer confidence is well below its historical average. We expect investment to contract again, albeit less than in previous years. Corporate sector deleveraging, an often changing regulatory environment and additional taxes on selected economic sectors will likely hold back investment decisions; moreover, there is also some free capacity in the economy. With export growth slowing down further and import growth accelerating somewhat in view of slightly improved domestic utilization and modest restocking, net real exports should contribute only very little to the overall growth rate in 2013.

The more favorable growth outlook for 2014 is underpinned by expectations that the credit cycle might slowly turn around, especially as monetary policy is widely expected to soften, which will promote the revival of credit. There are also signs that overall economic policy might soften ahead of the elections in spring 2014 (one-off 13th pension payment, additional measures to reduce the foreign exchange exposure of households and corporates), which could have some positive first-round effects on growth. Finally, export growth should recover from 2014 onward, but along with strengthening import growth, the contribution of net real exports will increase only to a limited extent. Our growth outlook for 2015 remains tentative, given considerable economic policy uncertainty following the elections.

Poland: 2013 dip in
growth linked to
investment cycle

We forecast Polish GDP growth to fall to 1.5% in 2013, down by more than half a percentage point from the previous year's growth because annual average growth in 2012 had still benefited from the carryover of the high growth rate of 4.3% in 2011. We forecast a significant acceleration of growth to 3.0% in 2014 and a further uptick to 3.5% in 2015. The economic slowdown in Poland that started in the first quarter of 2012 will bottom out in the first quarter of 2013, as indicated by current surveys and sentiment indicators. Foreign demand (especially from Germany) will act as the main pillar of growth, as euro area imports will stop contracting and will expand marginally, with German imports growing at an above-average rate. The gradual increase in export orders and the improvement of sentiment will translate into domestic demand, in particular stock building and gross fixed capital formation, only later in the year. Turning to domestic demand, extensive public nonresidential investment (linked to the 2012 European football championship and to a large extent funded by the EU) in the previous year implies a negative base effect in the first half of 2013, exacerbating the decline of gross fixed capital formation. Moreover, mortgage lending for households' residential building ground to a halt by the turn of the year, implying a weak contribution to gross fixed capital formation growth in the first half of 2013. Private business investment will resume only after export orders have led to a sufficient increase in capacity utilization toward the end of 2013. During last year's slowdown, employment reductions and negative real wage developments increased households' uncertainty and their propensity to save, hence dampening private consumption growth substantially. However, private consumption will be lifted temporarily in the first part of the year by a shift of (EU-linked) payments for farmers, while the significant decline of inflation to about 1% will have a stimulating effect on private consumption as well as public consumption in the second half of this year. The

combination of stagnating domestic demand and only slowly accelerating exports will not be sufficient to prevent imports from contracting further, albeit less than in 2012. As a result, the positive contribution of net exports to GDP growth will remain roughly unchanged.

In 2014, the acceleration of GDP growth to 3% will be driven by both the further quickening of euro area demand (and hence higher export growth) and by moderately expanding domestic demand. Consumption growth will benefit especially from low inflation – which will further be supported by the expiration of the temporary VAT increase at the beginning of the year – and from the loosening of macroprudential regulation for consumer loans. Gross fixed capital formation will show positive annual average growth again on the back of revived foreign demand and private consumption demand. Fixed investment, including residential building, will benefit from recent (and possibly further) cuts in key interest rates. Pent-up demand, the strong export-import link, the change in the inventory cycle related to the improved outlook plus some currency appreciation will lift imports to such an extent that the positive growth contribution of net exports will moderately decline despite substantially accelerated export growth.

We forecast only moderate growth for the Romanian economy over the forecast horizon. GDP growth will accelerate slightly from 1.4% in 2013 to 2.2% in 2014 and 2.5% in 2015. Our forecast is based on the assumption that the harvest will not be as bad in 2013 as in 2012, so that a positive base effect from agricultural production will back GDP growth this year. Looking at the demand side, private consumption, gross fixed capital formation and inventory restocking will propel growth. Export growth is projected to accelerate in 2014 and 2015 alongside the better growth performance of the euro area. Yet net exports will continue to deliver negative contributions, as imports are anticipated to grow faster than exports due to firming domestic demand, a rise in unit labor costs and the high import content of exports. Fiscal consolidation will continue, but at a reduced speed. The structural budget deficit is set to decline further in 2013 and 2014, but to a smaller extent than in previous years. Accompanied by certain revenue-side measures, some elements of the 2013 budget will moderately support private consumption. In particular, the 2013 budget allows restoring public sector wages to pre-crisis levels and includes a 4% increase in pensions. However, the banking sector is burdened with high and still rising nonperforming loans. In addition, tight lending standards for consumer loans together with a further need to repair households' balance sheets will restrain household consumption. We expect investment to augment only moderately in 2013. After gross fixed capital formation growth suffered a notable setback in the final quarter of 2012, January's construction output figure does not point to a quick rebound. The difficult external environment will hold back a rise in FDI, which has been very low in recent years. Assuming that efforts to increase the absorption of EU funds finally prove moderately successful and that the external environment improves, we expect a notable acceleration of gross fixed capital formation growth in 2014 and 2015.

Romania: Utilization of EU funds remains key

3 Croatia: Investment and Structural Reforms Crucial for Future Growth

Given the slowdown in growth toward the end of 2012, we revise our October 2012 forecast for Croatian annual GDP growth for 2013 down to –0.5% from

0.5%. The downward pressure on GDP growth exerted by the lack of domestic demand will overshadow the expected slight improvement in economic conditions in the second half of 2013 following Croatia's EU accession on July 1, 2013. We expect GDP to expand by 0.9% in 2014 and by 1.7% in 2015.

Positive growth effects from EU accession will materialize only slowly

Fiscal consolidation needs will not provide any leeway for stimulating growth in 2013 by public measures. In particular, private consumption is expected to remain suppressed, given the continued rise in unemployment paired with an unchanged unfavorable employment situation. The relatively high price level fueled by tourism and remittances along with the ongoing need to restructure households' finances additionally weigh on private consumption. Considering these adverse conditions and the fragile external environment with suppressed exports, investment will not meet previous expectations either. Net exports are expected to make a slightly positive contribution to GDP growth. As a consequence, Croatian EU accession might not produce positive effects immediately but rather only over the medium to long term.

Weak export performance given low competitiveness

In 2014, GDP is projected to rebound to 0.9% annual growth. While ongoing fiscal consolidation will rule out any growth impulse from the public sector, domestic demand will regain some ground. Among the demand components, much-needed forward-looking investments in the private sector can be expected to contribute most to GDP growth, as some stimulus from EU funds will finally materialize. These developments will additionally feed into positive import growth, whereas the export potential will remain subdued and stock building will continue. Therefore, the contribution of net exports to GDP growth can be expected to be marginally negative.

Looking further ahead, growth should revive moderately to reach 1.7% in 2015. Preceding investment will start to pay off, as domestic and external demand are expected to improve – the latter being conditional on the outlook of Croatia's main trading partners.

Downside risks prevail as structural reform needs are high

The risks to the outlook are slightly tilted to the downside, because private investment might fall short of expectations either because of deteriorating external demand conditions as a result of developments in the euro area or due to an insufficient implementation of the planned structural reforms.

4 Russia: Economic Growth Set to Continue before Levelling off

Our GDP growth forecast for Russia amounts to 3.4% for both 2013 and 2014; growth is projected to slow to about 3% in 2015. The forecast is based on an expected gradual slide of the oil price in the course of the forecast period, while the global economy and trade are anticipated to revive starting in 2013. Imports will increase by 5% in 2013 and 2014; import growth is set to accelerate somewhat in 2015. Faster import growth will contribute to the slight slowdown of economic growth forecast for 2015.

Lower oil price dampens GDP growth

In the second half of 2013, economic expansion in Russia is expected to revive from the slow rate of the second half of 2012 (less than 3%) to 3.4% for 2013 as a whole. Besides the meager carryover effect from 2012, downward pressure from the projected decline of the oil price will take its toll. On the other hand, the global economy and trade are forecast to start recovering. Russia's fiscal stance is not scheduled to ease as much as was assumed in the previous forecast, while government expenditure will still increase at a notable pace. In 2014, growth will

retain its pace, as the global economy will revive but the oil price will continue to decline slightly. In 2015, growth will head for 3%, boosted by the oil price as well as an uptick in import growth.

Private consumption is expected to increase at a slowing rate but still relatively briskly. Constrained by tighter profitability, the corporate sector is anticipated to keep wage increases roughly in line with the rise of productivity, whereas the pre- and post-election hikes of public sector wages should be moderate. The heated rise of consumer credit (particularly until mid-2012) will continue to cool down somewhat. Public consumption will continue to support growth, although this spending will be eroded by high inflation. The expansion of corporate fixed investment is expected to revive from the sluggish rate of late 2012. Capacity utilization, which has recovered to pre-crisis boom levels, combined with production growth as well as increased wear-and-tear of capital since the recession, has created new capacity needs. The surrounding global uncertainties should abate gradually. Russia's export volumes will continue to grow slowly. With exports of oil products shrinking and gas exports edging up very slowly, crude oil exports should grow minimally during the forecast period. Nonenergy exports (accounting for slightly less than 40% of all revenues from goods and services exports) should take up part of the slack.

We forecast import growth to proceed at a less heated pace following the strong post-slump rebound. Imports are projected to grow by around 5% in 2013 and 2014. Thereafter, the cumulative impact of the appreciation of the ruble's real exchange rate should gradually begin to lift the rate of import growth. Russia's WTO membership will also start to provide some support to import growth.

Our forecast is subject to upside and downside risks. The price of oil could rise or fall faster than assumed, and global upside and downside risks related to Russia's export volumes could also change. Moreover, exports of basic nonenergy commodities could respond better than anticipated to the projected global recovery. Private consumption will exceed the forecast if the current line of wage increases in selected parts of the public sector spread more widely throughout the public sector. Growth in imports could exceed our forecast if the demand emphasis shifted more toward imported goods because domestic inflation continuously exceeds the rise of import prices.

New capacity needs
revive investment

Risks are fairly balanced
and very much tied to
actual oil price
developments

Studies

Residential Property Prices in Central, Eastern and Southeastern European Countries:

The Role of Fundamentals and Transition-Specific Factors

Duy T. Huynh-Olesen,
Katharina Steiner,
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The large movements in residential property prices in emerging markets observed over the past decade have raised interest in housing market developments. Within a cointegration framework applied to an unbalanced panel, we assess the relationship between residential property price developments, economic fundamentals and transition-specific factors in Central, Eastern and Southeastern European (CESEE) EU countries from 1999 to 2011.² Our results show that demand-side fundamentals (disposable income, population, interest rates) and transition-specific factors related to housing demand (such as funding through remittances and credit growth) as well as construction costs on the supply side have been particularly important in residential property price movements. Nevertheless, these factors cannot fully explain residential property price movements, i.e. we find evidence that house prices moved above the level indicated by those factors in the years preceding the crisis. The sharp correction of residential property prices that took place following the outbreak of the financial crisis reversed these overshoots and brought house prices back to – and in some countries even below – the level indicated by the explanatory factors. This suggests that residential property prices are likely to rebound somewhat when economic conditions improve.

JEL classification: C23, P20, R3

Keywords: Housing markets, residential property prices, Central, Eastern and Southeastern Europe, cointegration framework

Since 1999, residential property prices (henceforth simply referred to as house prices) in many Central, Eastern and Southeastern European (CESEE) EU countries have gone through a dramatic rise and a slump, often causing devastating effects on the real side as well as on the financial side of many economies in the region. A feature of many housing booms is the emergence of seemingly plausible fundamental explanations to describe the upward movement in house prices. Looking back, the appreciation of house prices in many CESEE countries was to some extent driven by fundamentals, such as rising disposable income and better access to credit, but in light of the sharp declines in some countries it is evident that these house price increases were not sustainable, which raises several questions. What are the factors underlying the observed developments and can they be explained by transition-specific factors, such as pronounced credit growth? To what extent have house prices decoupled from economic fundamentals?

These questions are of particular relevance as history has shown that property price developments were often the reason for severe financial and economic crises (e.g. in the second half of the 1980s and early 1990s in Finland, Norway and

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² In this study we focus on Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

Sweden, or in 2007 in the U.S.A.). Most recently, the slump in house prices had major implications, causing fluctuations in employment, economic growth and financial stability particularly in the Baltic countries, but also in Western European countries such as Ireland and Spain. Thus, policymakers and central bankers have a key interest in an assessment of potential risks originating from excessive house price developments. Therefore, different methods have been applied to evaluate signs of house price misalignments. This includes simply defining a benchmark for excessive developments based on historical data, comparing the affordability of house prices, or relating house prices to alternatives to owner-occupied housing.

In this paper we establish a relationship between house prices, housing market fundamentals and transition-specific factors with a particular focus on financial market developments to derive signs of price misalignments. The fundamentals are identified from the stock-flow model, which underlies many empirical studies of house prices. The empirical literature on housing market dynamics in CESEE countries is still limited compared with studies on advanced and other emerging economies (e.g. Glindro et al., 2008 and Beidas-Strom et al., 2009), although some recent papers have investigated and provided empirical facts on the particular characteristics and determinants of residential property markets in CESEE countries (e.g. Égert and Mihaljek, 2007; Ciarlone, 2012; and Hildebrandt et al., 2012).

We follow the existing empirical work and analyze the fundamentals of house prices within a panel data cointegration framework. We contribute to the literature by (1) accounting for demand- and supply-side factors related to house price movements with a particular focus on the role of foreign banks, credit and tax incentives for the external financing of house purchases, (2) analyzing the current state of the misalignment of house prices in the CESEE region and (3) briefly looking at the short-run dynamics of house prices.

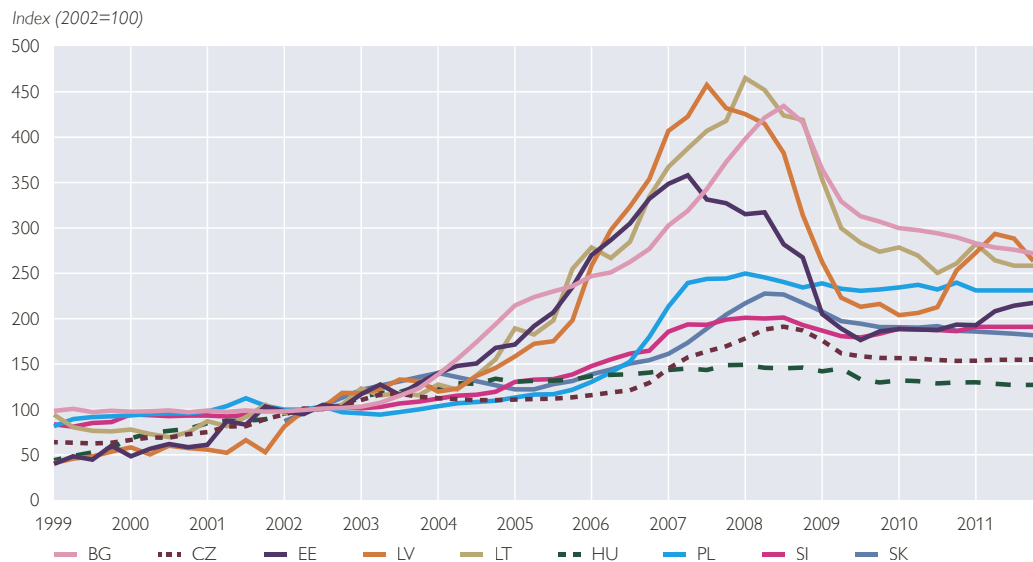
This paper is organized as follows. Section 1 sets the scene by reviewing house price developments in CESEE countries in recent years. In section 2, we outline the theoretical framework and discuss the linkages between house price developments and fundamentals. Section 3 discusses the empirical strategy, followed by the description of the data in section 4. Our main results and robustness checks are presented in sections 5 and 6. Section 7 concludes.

1 The Rise and Fall of House Prices in Most CESEE Countries

House prices in most CESEE countries went through an upsurge in the early 2000s, which came to a halt at the outbreak of the global financial and economic crisis in 2007. Since then, nominal house prices have fallen in the Czech Republic, Slovenia, Slovakia, Poland and particularly in the Baltics and Bulgaria (chart 1). The declines were a by-product of unbalanced macroeconomic developments impacting the demand and supply conditions in the housing market (see Hildebrandt et al., 2012). In Hungary house prices were on a steady upward movement until the end of 2007 and have fallen slightly since then. Only in Latvia and Estonia have house prices resumed their positive growth since 2010, but this development is likely to be due to a shift toward high-end properties bought by foreigners. Besides residential housing, the crisis also hit the commercial property market, exposing, *inter alia*, overcapacities of offices or shopping areas.

Chart 1

Nominal House Prices

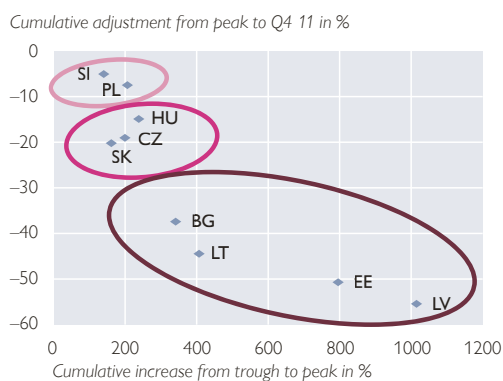


Sources: See sources provided in table A1.

Note: Romania is not included in the chart because the time series was too short.

Chart 2

House Price Cycles from 1999 to 2011



Sources: See sources provided in table A1.

Note: Based on quarterly data. Romania is not included in the chart because the time series was too short.

Looking at the period 1999 – 2011, the CESEE countries with the highest cumulated growth of house prices were also those countries where the largest declines took place, although the declines only reversed part of the cumulated growth. For example in Latvia, house prices increased more than tenfold from 1999 to mid-2007. The downward movement that ensued brought house prices back to their 2005 level. Chart 2 shows the relationship between the cumulative growth and decline of house prices before and after the individual house price peak in each CESEE country. We can distinguish between three groups of countries:

first, those which experienced large corrections in house prices, i.e. the Baltic countries and Bulgaria, second, countries that saw relatively less pronounced price developments (the Czech Republic, Slovakia and Hungary), and third, countries that experienced a surge in house prices but have not seen a significant fall in prices so far (Poland and Slovenia). The Baltic countries and Bulgaria experienced a cumulative adjustment between –55% (Latvia) and –37% (Bulgaria). The adjustment following the house price peak was somewhat less pronounced but still high in Slovakia, Hungary and the Czech Republic (between –20% and –15%). Poland and Slovenia show the least pronounced house price adjustments, with a fall in

house prices of between –8% and –5% from the time when prices reached their peak to the end of 2011.

In general, some of the house price appreciation is related to distorted house prices at the beginning of transition. The socialist system in the CESEE countries was based on low housing costs, centralized production and state or enterprise control over housing allocation (Tsenkova, 2011). The privatization and restitution of residential property after the collapse of the socialist system in the early 1990s fueled the expansion of homeownership but took place at prices far below market prices (Dübel et al., 2006). Hence, the rapid house price growth in CESEE countries may also have reflected the normalization toward market prices.³

2 The Impact of Demand and Supply on House Prices

The stock-flow model as presented by Meen (2001) and applied e.g. by Steiner E. (2010), which has been used in a vast range of empirical house price studies, considers the main fundamental factors related to housing demand (real permanent income, house prices, demographics and the user cost of homeownership⁴) and housing supply (the existing housing stock, investment, construction costs and house prices). It models both, the stock of housing and the flow of residential investment, from a demand and supply perspective. In the context of this paper, the model serves to show the fundamental factors related to demand and supply.

The demand for housing stock is derived from the life-cycle framework underlying the stock-flow model. Accordingly, an agent's demand for housing (hs_d) depends on the house price (p), the user cost of homeownership (uc) and the permanent household income (y) (equation 1).

$$hs_{d,t} = f \left(\underset{-}{p_t}, \underset{-}{uc_t}, \underset{+}{y_t} \right) \quad (1)$$

Higher prices and user cost of homeownership lead to lower demand, while rising income and expectations thereof usually raise the demand for living and recreation space, i.e. the housing stock, which in turn drives up house prices.⁵ User cost of homeownership is often proxied by the after-tax interest rate as outlined in DiPasquale and Wheaton (1994), but the application of market rates is also often considered.

Turning to the supply side of the housing market, the flow of residential investment for new homes (inv) depends on construction costs (cc) (e.g. labor costs, material costs, the cost of finance) and house prices (p) (equation 2).

³ Égert and Mihaljek (2007) provide anecdotal evidence of initial undershooting in CESEE. Cubeddu et al. (2012) find evidence of a correction of initial undershooting for Chile during the 2000s.

⁴ The user cost of homeownership, as defined by Poterba (1984), includes maintenance costs, financing costs (i.e. interest expenditures adjusted for tax reliefs), the depreciation of house prices and the expected capital gain of homeownership.

⁵ Purchase affordability of housing has to be considered as well. Typical measures of affordability relate house prices e.g. to wages or income. It has to be added that if house prices rise more than disposable income, demand for housing and thus house prices can be expected to decline. In CESEE countries, the affordability of houses declined in the run-up to the house price peak before improving thereafter. However, other factors, such as high indebtedness of households, additionally weigh on affordability (Hildebrandt et al., 2012).

$$inv_t = f(cc_t, p_t) \quad (2)$$

- +

Higher house prices will support residential investment, while higher construction costs will weigh on investment. The housing stock increases if residential investment in a given period is higher than the depreciation and *vice versa*. Formally, this writes:

$$hs_{s,t} = inv_t + (1-d)hs_{t-1} \quad (3)$$

If markets cleared quickly, demand would equal supply at all times ($hs^* = hs_d = hs_s$). However, due to market imperfections⁶ this only applies in the very long run; in the short run house prices are likely to deviate from the equilibrium level. Following the stock-flow model, sustainable house price developments should reflect the development of the demand- and supply-side fundamentals. These considerations serve as a theoretical benchmark for our empirical setting outlined in section 3 and provide guidance on the expected signs of the coefficients. In addition to the fundamentals identified by the stock-flow model, the dynamics of house prices and their link to economic activity depend on many local factors, e.g. as discussed by Beidas-Strom et al. (2009), Egert and Mihaljek (2007), and Hildebrandt et al. (2012),⁷ who discuss detailed data and stylized facts on CESEE residential property market characteristics. Therefore, we test for additional factors, such as external demand for housing, credit (in particular foreign currency credit) and the role of foreign banks, which relate to transition-specific characteristics of CESEE.

3 Empirical Methodology

While the qualitative discussion in section 2 gives insight into the demand for and the supply of housing affecting house prices, this section presents the empirical specification related to the stock-flow model. We first relate house prices to the demand-side fundamentals: household disposable income and the user cost of homeownership. We add the size of the population to model aggregate demand since we analyze country-wide developments. Second, we add transition-specific demand-side variables and, third, supply-side factors. We estimate our empirical model by applying a cointegration framework, which is warranted by the statistical properties of the data, in particular stationarity and the indication of cointegration. Therefore, we start by analyzing the time series properties of the data. The results of the panel unit root tests show that all variables are integrated of order one except for the interest rate, which is stationary in levels. Then the test put forward in Kao (1999) confirms cointegration relationships among the variables being I(1). Therefore, we can establish an error correction framework to

⁶ On the supply side, the lack of transparency, long institutional procedures and simply the time to start and finish building projects determine the gradual adjustment of supply. On the demand side, lack of market transparency, particularly in emerging markets with underdeveloped market structures making the search for homes a time-consuming process, set the environment for a gradual adjustment of demand (DiPasquale and Wheaton, 1994).

⁷ Global factors, such as declining real interest rates and global business cycles may also play an increasing role in housing market cycles as argued by Girouard et al. (2006). Their indirect impact on demand and supply shifters is considered in this section.

analyze (1) the long-run determinants of house prices for the panel of ten CESEE countries (results shown in table 1) and (2) to calculate equilibrium house prices for each country, which can be compared to the actual house prices in each country (results shown in chart 3). Finally, we briefly touch upon the short-run dynamics provided in annex C.

More specifically, the empirical strategy we pursue in our analysis follows the framework proposed by Kao and Chiang (2000) to address the endogeneity problem which arises when relating I(1) variables with each other. More specifically, we estimate the parameters of the model, impose common dynamics across countries using the panel dynamic OLS (PDOLS) estimator and allow for country-fixed effects. Formally, the specification of the PDOLS estimator writes as follows

$$y_{it} = X_{it}'\beta + \sum_{s=-q}^S \Delta X_{it+s}'\delta_{i,s} + \lambda_i + \varepsilon_{it} \quad (4)$$

where y_{it} is the log of real house prices for country $i = 1, \dots, N$ (cross-section units) at time $t = 1, \dots, T$ (time index), q indicates the number of lags and S the number of leads, X_{it} is a matrix of demand-side fundamentals (the log of real gross household disposable income, the real interest rate⁸ and the log of population), other transition-specific and supply-side variables, Δ indicates first differences, β and δ represent the slope coefficients of the explanatory variables and λ is the vector of country-fixed effects. ε_{it} is an error term. The intuition behind the PDOLS estimator is that leads, lags and the contemporaneous value of the first difference of the regressors account for possible endogeneity and, hence, addresses the econometric hurdles that arise when estimating models with I(1) variables in levels.

The misalignment of house prices \widehat{ec}_{it} is derived as the unexplained part of house prices, i.e. the part of the house prices which cannot be explained by demand-side fundamentals, transition-specific and supply-side factors.⁹ That is

$$\widehat{ec}_{it} = y_{it} - X_{it}'\hat{\beta} - \lambda_i \quad (5)$$

The short-run specification is estimated country by country to allow for country-specific coefficients reflecting that differences in institutional settings foster different dynamics. Formally, this writes

$$\Delta y_{it} = \phi_i (\widehat{ec}_{it}) + \sum_{j=0}^J \Delta X_{it-j}'\gamma_{ij} + \mu_{it} \quad (6)$$

where γ_{ij} represent the country-specific slope coefficients. The first differences of the explanatory variables enter the equation with J lags. The country-specific error-correcting speed of adjustment term is indicated by ϕ_i . A negative sign of ϕ_i

⁸ To take into account the importance of loans in foreign currency, the interest rate we apply is a weighted interest rate according to the share of loans in domestic and foreign currency.

⁹ The inferred misalignment indicator only represents the misalignment of observed house prices from the chosen explanatory variables. Since we do not strictly estimate the demand equation as dictated by the model, the misalignment indicator might also include any effect from omitted variables.

suggests that the system is mean reverting to its long-run equilibrium derived from equation (4). μ_{it} is an error term.

Based on the estimation strategy outlined above, we (1) estimate the benchmark long-run model including the demand-side fundamentals (income, user cost of homeownership and population), (2) add one-by-one additional transition-specific and supply-side variables and (3) identify an “extended model” reflecting fundamentals, transition-specific and supply-side factors selected on the basis of the correct sign, the largest size of the coefficient and the highest significance. Then we derive the misalignment as outlined by equation (5) using the benchmark and the extended model. Finally, we add the lagged error-correction term in the short-run benchmark specification (equation 6), which signifies the gradual adjustment process in housing markets (see annex C). Only trending time series enter the equation in logs, which is not the case for real interest rates.¹⁰ To summarize, given that we are working with a relatively homogeneous group of transition economies, there are good reasons to believe in common coefficients, where the country-fixed effects allow for different levels of house prices across countries in the long run despite common coefficients.

To better motivate the choice of the PDOLS estimator, we briefly discuss its properties by comparing it to a similar estimator, the pooled mean group (PMG) estimator. Our empirical framework bears many similarities to the PMG estimator as proposed by Pesaran et al. (1999), such as that it also assumes homogeneous long-run dynamics and heterogeneous short-run dynamics. A number of recent studies analyzing house price dynamics in the long run have employed the PMG estimator (e.g. Kholodilin et al., 2007). The main difference between the PMG estimator and the PDOLS estimator is that the elasticities are inferred from country-by-country estimations of long-run equations. Applying this estimator to our data, we find that in some cases the estimated elasticities have the opposite sign of what we expected, e.g. for some countries higher household income leads to lower house prices and higher interest rates lead to higher house prices. Since we cannot reconcile these findings with economic theory, we use the PDOLS estimator. Section 6 outlines the robustness checks applied to strengthen the validity of our results. In addition, compared to the PMG estimator, the PDOLS estimator allows for fixed effects in the sense that some of the regressors are systematically correlated with an unobserved country-specific fixed effect. We are not aware of any tests that could support or reject the assumptions of fixed effects in the framework of the PDOLS estimator. To provide us with some idea of the plausibility of fixed effects, we test for random effects in an ordinary panel data model. Using the Hausmann test, we reject the null of random effects in the panel data. Admittedly, this is not a formal test of the PDOLS estimator, but it provides some indication that fixed effects are not completely ruled out.

¹⁰ We deviate from the stock-flow model in two dimensions. First, the housing stock is not included due to missing data. Second, due to negative real interest rates in some countries the real interest rate enters the model in levels and not in logarithms, thereby violating the efficiency conditions of the stock-flow model. Nevertheless, it has been the practice in many applications to overlook these two shortcomings and we follow the same approach.

4 Data

The data we have collected for the ten CESEE countries in some cases start as early as 1999, allowing us to exploit the cross-country and time dimension of the data, which is important considering that short time series might fail to reflect broad movements of house prices (Maeso-Fernandez et al., 2004). Compiling lengthy, comparable cross-country house price time series implies difficulties caused by the heterogeneity of the market within and across countries and its lack of transparency. Data quality largely depends on the distribution of reported transactions, i.e. whether they refer to new or existing buildings. It also depends on the type of dwelling or the location. Another crucial issue is whether prices refer to transaction or selling prices (Hildebrandt et al., 2012). While the ECB and the BIS provide various house price series, cross-country comparability is not ensured for all time series due to different methods of collecting data across countries.¹¹ In general, the various indices of house prices (e.g. for the capital city and the whole country) show very similar dynamics for the ten CESEE countries, though at different price levels. We apply quarterly, seasonally-adjusted price indices reflecting real house price developments in the whole country as collected by Hildebrandt et al. (2012). Most empirical studies apply real house prices (e.g. Égert and Mihaljek, 2007; Andrews, 2010; and Ciarlone, 2012). Their application facilitates the cross-country comparability of the data taking account of cross-country inflation differentials over time.

Data on house price indices for the whole country are mostly available only from the early 2000s, while other house price time series, e.g. for the capital city or house price level data for the whole country, are in many cases available at least from 1999 onward. These different time series often show similar dynamics for each country, which we exploit to extrapolate the time series for the whole country using the available growth rates of other house price data. Annex A provides more detailed information on the different house price time series. Information on the variables used as proxies for the fundamentals and the respective transition-specific variables entering the estimation equation is available in annex A (table A3). Some proxies are used in the final estimation equations shown in table 1, whereas others are applied for robustness checks as outlined in section 6 and indicated in table A3.

As we are also interested in the impact of credit financing conditions on house price developments, we collect time series to proxy the impact of foreign capital inflows, credit and interest rates, accounting for domestic and foreign currency lending to households. In addition, we calculate the cost of financing considering tax deductibility of interest rates to account for the impact of such policy measures on housing demand and thus house prices. There are good reasons to believe that the after-tax interest rate is a better proxy for the user cost of homeownership than the before-tax interest rate (Poterba, 1984). For some of the countries the inflation-adjusted after-tax interest rate is calculated, which we will use in some of the estimations below; however it is not available for all countries of the sample in sufficient length (e.g. Lithuania and Bulgaria). Details on the calculation of the after-tax interest rate are provided in annex B.

¹¹ Eurostat has published a handbook on how to compile residential property price indices, while the BIS provides a collection of various house price time series on its website.

5 Results

5.1 Long-Run Estimations

Table 1 presents the estimation results of the long-run specification. Our main benchmark model relates the log of real house prices to the demand-specific fundamentals, namely the log of real household disposable income, the real interest rate, and the log of the population between the age of 16 and 64. In the first four columns we compare the pooled estimator, the PMG estimator, the traditional fixed-effect estimator and the PDOLS estimator applied to the benchmark specification. For all models, all slope coefficients have the expected sign and are significant. The coefficient of real disposable income in the pooled regression is somewhat low, but this is likely due to the simple nature of the pooled regression and the endogeneity problem discussed by Kao et al. (1999). The advantage of the PDOLS estimator is that it allows for fixed effects instead of conducting country-by-country estimations and it additionally handles possible endogeneity. Applying the PDOLS estimator yields more plausible coefficient

Table 1

Estimation Results of the Long-Run Specification

	OLS pooled (1)	PMG (2)	FE (3)	PDOLS (4)	PDOLS (5)	PDOLS (6)	PDOLS (7)	
Demand-side fundamentals	Interest rate, weighted	-0.066 *** (-0.004)	-0.04 *** (-0.007)	-0.0299 *** (-0.0027)	-0.025 *** (-0.005)	-0.02 *** (-0.006)	-0.019 *** (-0.004)	
	Household income	0.07 *** (-0.01)	2.371 *** (-0.134)	1.275 *** (-0.0629)	1.544 *** (-0.097)	1.526 *** (-0.108)	1.38 *** (-0.116)	1.068 *** (-0.119)
	Population, aged 15 to 64	0.16 *** (-0.018)	79.223 *** (-10.395)	4.8751 *** (-0.7073)	6.508 *** (-1.138)	8.356 *** (-1.386)	12.257 *** (-1.719)	1.654 (-1.134)
Transition-specific demand-side factors	Interest rate, weighted, after tax				-0.017 *** (-0.005)			
	External demand					0.254 *** (-0.062)		
	Household loans						0.189 *** (-0.022)	
	Foreign currency loans to households							
Supply-side factors	Foreign liabilities							
	Construction costs							
	Gross value added, construction sector							
	Residential investment							
	Building permits							
Constant	-2.634 *** (-0.269)		-73.339 *** (-10.718)	-98.245 *** (-17.302)	-126.396 *** (-21.06)	-168.115 *** (-23.602)	-25.629 (-17.173)	
Adjusted R-squared	0.4697		0.8733	0.9009	0.9108	0.8975	0.934	
Observations	432	415	432	406	310	308	388	
Fixed effects	no	no	yes	yes	yes	yes	yes	
Cointegration test	n.a.	n.a.	-2.118 ***	4.410 ***	-2.772 ***	-2.542 ***	-1.982 **	

Source: Authors' calculations.

Note: Dependent variable: log house prices. *: significant at the 10% level, **: significant at the 5% level, ***: significant at the 1% level. Standard errors in parentheses. Cointegration test refers to the Kao (1999) panel data cointegration test.

Table 1 continued

Estimation Results of the Long-Run Specification

	PDOLS (8)	PDOLS (9)	PDOLS (10)	PDOLS (11)	PDOLS (12)	PDOLS (13)	PDOLS (14)	
Demand-side fundamentals	Interest rate, weighted	-0.027 *** (-0.005)	-0.022 *** (-0.006)	-0.015 *** (-0.005)	-0.028 *** (-0.005)	-0.042 *** (-0.008)	-0.024 *** (-0.004)	-0.005 (-0.006)
	Household income	1.566 *** (-0.112)	1.647 *** (-0.147)	1.102 *** (-0.128)	1.61 *** (-0.104)	1.402 *** (-0.141)	0.853 *** (-0.096)	0.638 *** (-0.178)
	Population, aged 15 to 64	8.605 *** (-1.257)	8.703 *** (-1.888)	4.354 *** (-1.219)	8.899 *** (-1.321)	7.621 *** (-1.731)	5.601 *** (-0.972)	9.2 *** (-2.109)
Transition-specific demand-side factors	Interest rate, weighted, after tax							
	External demand							0.153 ** (-0.067)
	Household loans							0.179 ** (-0.069)
	Foreign currency loans to households	0.029 ** (-0.012)						
Supply-side factors	Foreign liabilities		0.075 **					
	Construction costs		(-0.037)	0.707 *** (-0.134)				0.49 ** (-0.195)
	Gross value added, construction sector				0.335 *** (-0.08)			
	Residential investment					0.029 (-0.055)		
	Building permits						0.289 *** (-0.023)	
Constant	-130.042 *** (-19.101)	-131.904 *** (-28.632)	-69.161 * (-18.197)	-135.1 *** (-20.124)	-115.141 *** (-26.31)	-85.916 *** (-14.75)	-161.159 ** (-35.985)	
Adjusted R-squared	0.921	0.913	0.9345	0.9045	0.9109	0.9337	0.956	
Observations	384	273	373	406	258	392	271	
Fixed effects	yes	yes	yes	yes	yes	yes	yes	
Cointegration test	-1.982 **	-3.042 ***	-6.361 ***	-2.294 **	-1.340 *	-6.692 ***	-2.175 **	

Source: Authors' calculations.

Note: Dependent variable log house prices. *: significant at the 10% level, **: significant at the 5% level, ***: significant at the 1% level. Standard errors in parentheses. Cointegration test refers to the Kao (1999) panel data cointegration test.

estimates (equation 4 to 14). The last row of the table shows the Kao panel data cointegration test statistics, which for all models is consistent with cointegration.¹²

The results for the demand-specific fundamentals are as follows. The coefficient of disposable household income is greater than 1 in most equations, implying that a 1% to 1.6% rise in household disposable income translates into a 1% increase in house prices in the long run. While empirical research usually finds the elasticity of house prices with respect to income to be close to unity (ECB, 2003), Égert and Mihaljek (2007) report first evidence of higher income elasticities in transition economies than in advanced economies. This is supported by our findings and could be explained by two features. First, households raised their expectations of rising future income in view of improved living standards related to the catching-up process in the CESEE countries and EU accession. In turn, higher income expectations could have led to increased household demand for residential

¹² In annex C we present the short-run specification of the benchmark model.

property.¹³ Second, housing transactions during the initial phase of privatization following the socialist era took place at prices below market prices. A normalization of house prices is likely to have supported the finding that households spend an increasing share of their income on housing. However, the size of the coefficient diminishes in the extended model, indicating that other explanatory factors than the main fundamentals are of importance too.

The coefficients of the real interest rate and the population have the expected negative signs in all our models. Higher interest rates raise the costs of external financing, thereby dampening demand for house purchases and thus house prices. However, caution is warranted in the interpretation of the results as the interest rate alone might not be sufficient to describe the share of loan servicing costs, i.e. noninterest fees and structural breaks in general financing conditions are not covered. We also see in the third row of table 1 that a growing population increases the demand for living space and supports house price growth.

In model 5 we substitute the real interest rate with the real after-tax interest rate. It shows similar estimation results as the real interest rate. In general we would have preferred to use the after-tax interest rate since this is a better proxy for the user cost of homeownership, but since we were not able to collect the information for all countries we used the real interest rate throughout this exercise for reasons of comparability.¹⁴

A *transition-specific feature* of the region under analysis is the importance of remittances driven by expatriates moving back to the CESEE countries and by citizens living and working (temporarily) abroad and buying second homes, i.e. *external demand*. In model 6 we add remittances as an explanatory transition-specific variable, which turns out to have the expected positive impact on house prices. Remittances often serve as external financing for house purchases or renovations in the CESEE countries, as qualitatively discussed by Égert and Mihaljek (2007).

Considering the rise in the share of credit-financed housing in CESEE countries during the past 15 years, the interplay between housing loans and housing markets deserves particular attention.¹⁵ Especially the *liberalization of financial markets and the reduction of credit constraints* in CESEE countries, which took place against the background of foreign banks penetrating the markets and fierce competition lowering the financing costs of homeownership, can be assumed to have raised the sensitivity of house prices to interest rates (ECB, 2003). Therefore, we add financial variables to model the relationship between credit financing and house price movements in columns 7 to 9 of table 1.

The estimation presented in column 7 shows that total lending to households indeed supported the housing market. Foreign currency loans to households also turn out to have the expected positive significant sign (column 8). However, the

¹³ Due to constraints related to data on income expectations, we can only capture expected future income indirectly via housing loans in the empirical estimations.

¹⁴ Another reason for bringing the after-tax interest rate into the analysis is that housing policies aimed at increasing the user cost of homeownership (and transaction costs) tend to dampen speculative behavior in the market while maintaining long-term incentives for owner-occupied housing investment, such as (counter-cyclical) taxes on capital gains of real estate transactions (OECD, 2003). These taxes were often missing in boom phases, as they did in the transition economies of CESEE.

¹⁵ The stock of outstanding housing loans increased from 7% of GDP in 2004 to 20% in 2011 (unweighted average).

coefficient is smaller in magnitude, which shows it was the generally improved borrowing conditions that supported demand for housing and thus house price growth. Egert and Mihaljek (2007) talk about a “self-reinforcing cycle” between credit growth and house price growth as already highlighted in OECD (2003). Declining interest rates foster the external financing of housing, pushing up house prices. In turn, rising house prices do not only require households to take up higher volumes of housing loans, but also allow them to take out higher loans due to the expectation that the underlying collateral would appreciate.¹⁶ Thus, it is rather difficult to establish the causal direction of the relationship between credit and house prices (ECB, 2003). We also see that foreign liabilities of domestic banks, serving as a proxy for parent bank funding of foreign subsidiaries, have moved in parallel with house prices. The results shown in column 9 suggest that the inflow of funding from foreign parent banks indeed supported the housing market in the run-up to the crisis. Likewise, it has also amplified the downturn in housing markets since the outbreak of the crisis.

In models 10 to 13 of table 1 we add, one-by-one, different *supply-side variables*. The results are somewhat mixed. In model 10, real construction cost is added; the coefficient is significant and the sign is positive, as expected. While higher construction costs (of new homes) might just be passed on to the buyer and thus raise house prices, rising construction costs might also indirectly impact house prices via demand. When construction costs increase it becomes more attractive to buy an already existing house, which in turn would foster demand for the existing housing stock and thus house price growth in this market segment.

On the other hand, value added in the construction sector and residential investment can be expected to increase the supply of properties and thus weigh on house prices. The coefficients of value added and residential investments have positive signs (model 12), which are inconsistent with the demand equation, but consistent with the supply equation. This shows that the supply effects dominate the demand effects. An additional explanation with respect to value added in the construction sector is that construction value added covers any kind of construction, including civil engineering works. This factor could explain why value added shows the opposite sign than expected. Regarding residential investment, theory assumes that residential investment only takes the form of investment in new construction. In the CESEE countries, a high share of residential investment goes into the renovation of existing properties, which would not increase the stock but only improve it (which could also be the case for value added in construction). Given that our house price indices are not quality adjusted, an improvement of the existing housing stock is likely to support house prices.¹⁷ The number of granted building permits is also seen to have a positive effect on house prices (model 13). As with the other supply-side variables, this finding shows that the supply effect dominates the demand effects, since an increase in house prices

¹⁶ In addition, (expectations of) house price appreciation loosening borrowing constraints may affect consumer spending through wealth effects. Empirical evidence on this relationship has been provided e.g. by Benito et al. (2006) and Ciarlone (2012).

¹⁷ Residential investment and household income co-move to a high extent and caution is warranted since the results might be affected by possible multicollinearity. The same accounts for household income and household loans. However, estimating the respective equations (7 and 12) without household income does not significantly affect the results of the coefficients in terms of their significance, only their size turns out to be slightly bigger.

has led to increased investments and, hence, to an increase in the number of building permits. It also has to be considered that restrictions on urban land use or the availability of land for housing construction together with poor property records or poor space planning in general restrict the housing market in CESEE countries.¹⁸

In the last column of table 1 we combine the significant variables with the expected sign into our extended model. All variables in the extended model still have the expected sign, although the significance of the interest rate has disappeared and the size of the coefficient of income changes has been reduced a lot. On the one hand, these changes are likely to reflect the complexity of the model and the relatively small number of observations. It should also be mentioned that some variables are not available for Slovakia and Bulgaria, which implies that the model is not estimated for these countries. On the other hand, a theoretical implication is that other variables than the fundamentals are of high importance in determining house prices (e.g. credit). Nevertheless, caution is warranted when comparing the two misalignment indicators inferred from the benchmark model and the extended model.

5.2 Misalignment between Housing Prices and the Equilibrium Level

The *country-specific misalignment indicators* inferred from the benchmark and extended model of the long-run specification are shown in chart 3. The misalignment shows the part of house price movements which cannot be explained by the demand and supply fundamentals and additional transition-specific demand-side factors. Section 3 (equation 5) outlines the notion of misalignment in more detail.

On the one hand, house price growth in most countries until 2007–2008 was higher than macroeconomic developments would have justified, as the misalignment indicators show, i.e. the values above the zero line – the equilibrium – in chart 3. On the other hand, the fall in house prices seen afterwards was also much faster than warranted by the model in a number of countries (indicated by downward trending lines below the zero line). By the end of 2011 most of the excessive house price growth had been offset by an equally strong decline, e.g. in Estonia. In Poland the adjustment reflects the improvement of fundamentals rather than the adjustment of house prices. More recently, imbalances started to accumulate in Lithuania due to underlying factors; in particular, the affordability of houses declined, reflecting the still weak growth of disposable income. The relatively strong fall in house prices (see chart 2) in Slovakia brought the valuation of houses into deep negative territory, according to the model, which seems surprising. This should be seen against the backdrop of relatively strong income growth in recent years combined with a relatively flat movement of house prices in Slovakia. According to the extended model, houses in the Czech Republic and Lithuania are more undervalued than shown in the benchmark model, reflecting that the additional explanatory variables in the extended model have improved relative to house prices. In addition, in Lithuania houses were overvalued according to the benchmark model, but according to the extended model, house prices at end-2011 were broadly in line with the underlying values, showing the importance of

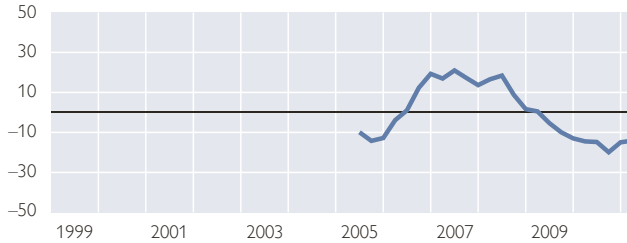
¹⁸ Although indicators of the EBRD or the World Bank could serve as crude proxy for the quality of (local) administration, the limited variation of these indices over time impedes their application in this empirical setting.

Chart 3

House Price Mismalignments in CESEE Countries

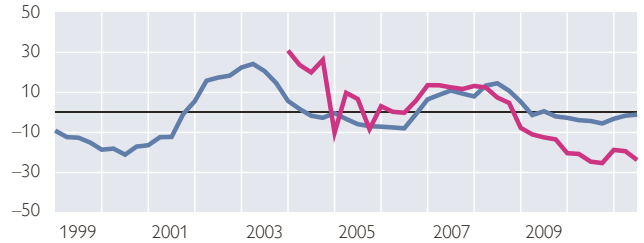
Bulgaria

Deviation from the long-run average in %



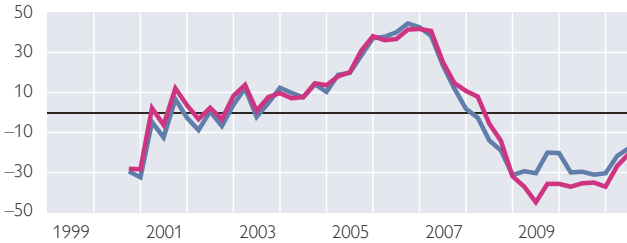
Czech Republic

Deviation from the long-run average in %



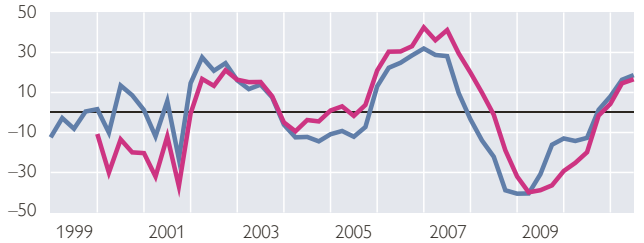
Estonia

Deviation from the long-run average in %



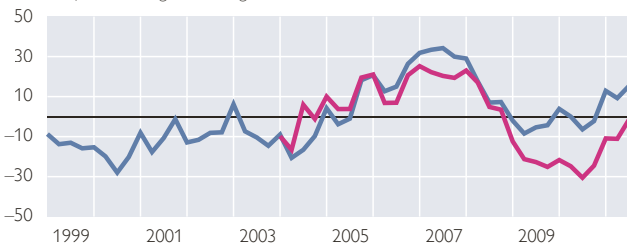
Latvia

Deviation from the long-run average in %



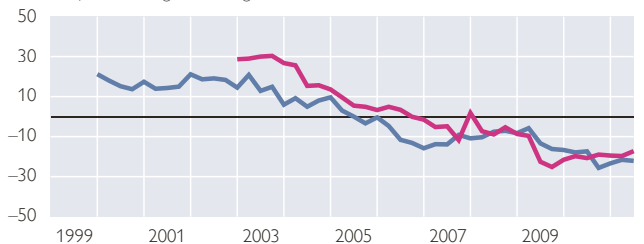
Lithuania

Deviation from the long-run average in %



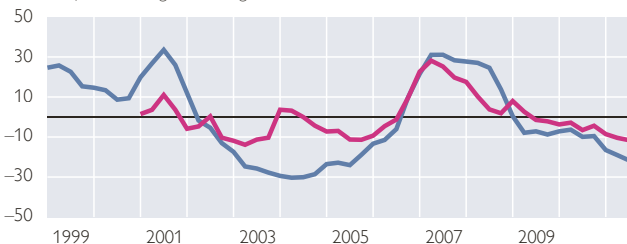
Hungary

Deviation from the long-run average in %



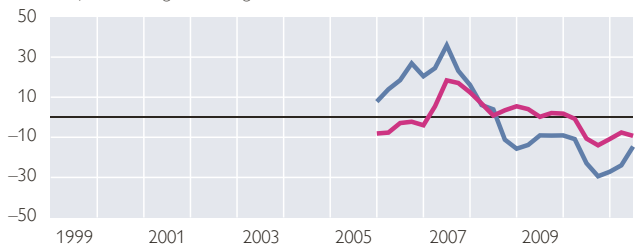
Poland

Deviation from the long-run average in %



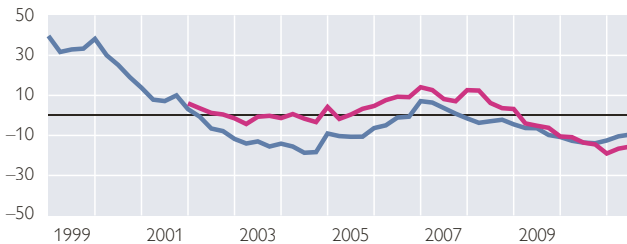
Romania

Deviation from the long-run average in %



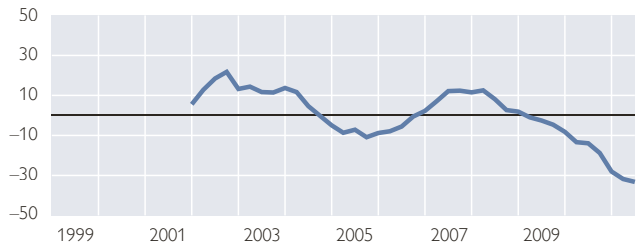
Slovenia

Deviation from the long-run average in %



Slovakia

Deviation from the long-run average in %



Source: Authors' calculations.

Note: The solid blue line denotes the misalignment based on the benchmark model, the red line indicates the misalignment based on the extended model. The solid horizontal black line indicates the equilibrium. No misalignment measure based on the extended model for Bulgaria and Slovakia was calculated due to missing data.

accounting for the transition-specific variables, i.e. credit and remittances. In general, some caution is warranted when interpreting these figures, since the misalignment refers to the misalignment of house prices that cannot be explained by variables other than those entering the respective models. For example macro-prudential regulation could also have an impact.¹⁹ Moreover, the equilibrium level is subject to uncertainty and may not give a comprehensive picture of the level of misalignment.

6 Robustness Checks

In order to check the robustness of our results shown in the previous section, we (1) interchange the dependent variable with another house price index series and (2) test the model by using alternative proxies for the explanatory variables. First, uncertainties related to the heterogeneity of house price data collection methods outlined in section 4 lead us to test the robustness of the results applying house price indices for the capital city instead of those for the whole country. Table 2 shows the original results from table 1 together with the results testing the other house price index series for the baseline and the extended model. The results turn out to be similar, although the significance of the coefficients is lower for the extended model (14') applying house price indices for the capital city.

Table 2

Robustness Check Testing Different House Price Data Series

Estimation results of the long-run specification

		PDOLS (4)	PDOLS (4')	PDOLS (14)	PDOLS (14')
Dependent house price variable		(whole country)	(capital city)	(whole country)	(capital city)
Demand-side fundamentals	Interest rate, weighted	-0.025 *** (-0.005)	-0.033 *** (-0.004)	-0.005 (-0.006)	-0.002 (-0.005)
	Household income	1.544 *** (-0.097)	1.387 *** (-0.073)	0.638 *** (-0.178)	0.982 *** (-0.178)
	Population, aged 15 to 64	6.508 *** (-1.138)	10.397 *** (-1.256)	9.2 *** (-2.109)	1.622 (-2.114)
Transition-specific demand-side factors	External demand			0.153 ** (-0.067)	0.027 (-0.067)
	Household loans			0.179 ** (-0.069)	0.044 (-0.069)
Supply-side factors	Construction costs			0.49 ** (-0.195)	0.474 ** (-0.195)
	Constant	-98.245 *** (-17.302)	-157.448 *** (-19.095)	-161.159 ** (-35.985)	-27.29 (-36.07)
	Adjusted R-squared	0.9009	0.895	0.956	0.997
	Observations	406	373	271	271
	Fixed effects	yes	yes	yes	yes

Source: Authors' calculations.

Note: The house price index for the capital city is based on transaction prices (asking prices for Slovakia, Poland and Romania) of new and existing homes in the capital city (Bulgaria: large cities).

¹⁹ We put less emphasis on macroprudential policy measures, although the importance of these policies has become greater, particularly after the outbreak of the crisis, in the wake of which numerous measures have been taken to curb the negative repercussions of the housing market volatility observed in recent years. For a comprehensive discussion we refer to Vandebussche et al. (2012), who find that some macroprudential policies implemented in CESEE countries in recent years tend to reduce house price volatility.

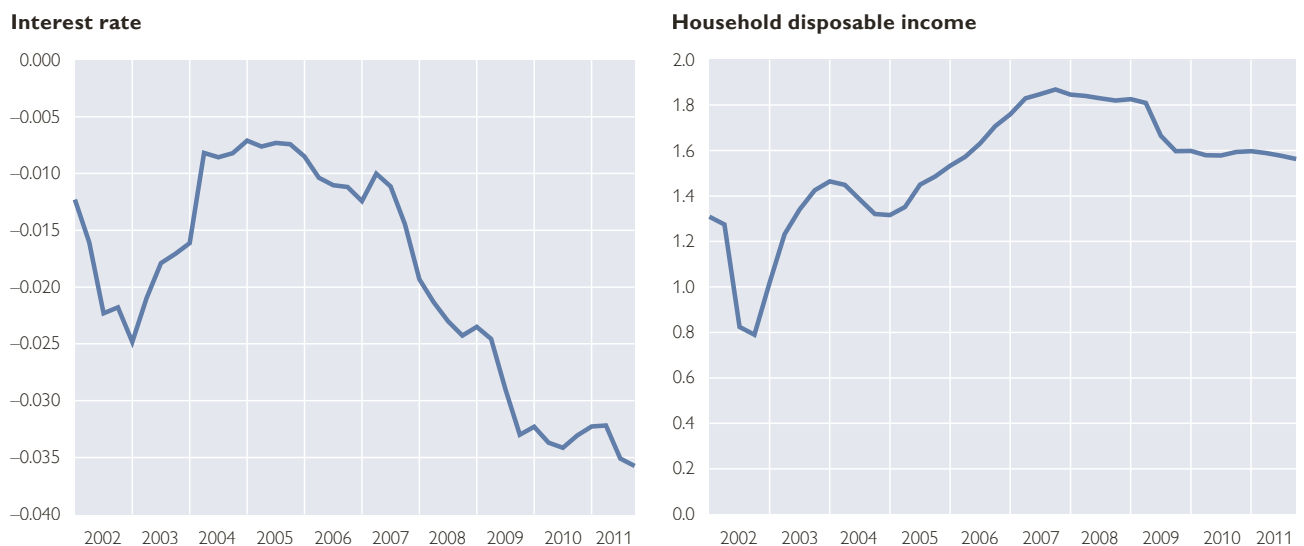
Second, we apply different proxy variables to test the robustness of the explanatory variables. For example, we apply real gross household disposable income as a fundamental demand-side factor shown in table 1, because it is very closely related to the decision of households to buy property. In turn, we exchange this explanatory variable for real GDP per capita, an alternative proxy variable. The coefficient of real GDP also turns out to have the expected positive sign with a relatively similar size of the coefficient, which supports the robustness of our results. The same procedure is applied to selected other demand and supply fundamentals and transition-specific demand variables.²⁰ Overall, the results applying the different proxies as explanatory variables show that the signs of the coefficients and their size are similar to those reported in table 1.

In addition, we have cross-checked whether the estimations of the benchmark model differ if we split the sample into two subsamples: those countries which experienced an outright boom-bust (Bulgaria and the Baltics) and the other remaining countries. We find that the elasticities are numerically bigger for the boom-bust countries compared to the benchmark model presented in the paper. As expected we also find smaller numerical elasticities for the other countries. The conclusions regarding the misalignment of house prices remain broadly unchanged.

To see whether house price elasticities have changed since the onset of the crisis, we run a series of recursive estimations. The coefficients of disposable income and the interest rate derived from this exercise are shown in chart 4. The chart shows the coefficient estimates for the sample ending in the quarter indicated on the horizontal axis. We see that interestingly, house prices have

Chart 4

Coefficients of Recursive Estimates of the Benchmark Model



Source: Authors' calculations.

Note: The charts show the coefficient estimates for the sample ending in the quarter indicated on the horizontal axis. The PDOLS estimator was applied to the benchmark model.

²⁰ Annex A, table A3, shows descriptive information on the alternative proxies applied. The results for the various proxies used for robustness checks are available upon request.

become more sensitive to changes in the interest rate since the beginning of 2006, while we do not observe any significant structural breaks around the time of EU accession. In the right-hand panel of the chart we report the coefficients of disposable income. House prices became more sensitive to changes in income in the run-up to the crisis. Our interpretation of this finding is that the boom years in the region bolstered demand, and growth contributed to improving the income prospects of many households. This could have led households to purchase properties on the margin of what they could afford due to expectations of rising future income.²¹

7 Conclusions

House prices in CESEE countries went through a significant rise in the years before the crisis, with nominal house prices increasing up to tenfold in some countries. The upward movement came to a halt at the outbreak of the crisis, and house prices declined rapidly in the countries where house prices had increased most strongly. In this paper, we assess these developments and relate them to fundamentals and transition-specific factors that characterize the CESEE countries. For financial stability reasons we are particularly interested in those factors that are related to banking sector developments. We apply the stock-flow model to motivate the choice of fundamental factors, which are mainly related to demand for housing: gross disposable income, interest rates and population. These explanatory variables enter our benchmark specification. In addition, we add further demand-side factors related to external demand for housing (remittances) and credit financing of house purchases (loans to households, foreign currency loans to households, foreign liabilities of banks and after-tax interest rates). We also account for the supply side by analyzing the role of construction costs, gross value added, residential investment and the number of building permits for house price changes. The estimation results are based on a panel data cointegration framework, which allows us to also consider the misalignment of observed house prices with the development of the fundamental factors.

Despite the sensitivity of the results to the estimation specifications, we find a relatively strong relationship between house prices and fundamentals, as suggested for transition economies by former research. In particular, the disposable income of households turns out to be a major factor related to house prices. In the initial phase of our sample, i.e., after the privatization of housing, prices were below market prices. Subsequently, house prices normalized and households began to spend an increasing share of their income on housing. Since the early 2000s, the complete overhaul of the banking sectors in CESEE countries increased the borrowing opportunities at lower interest rates. This supported demand for housing too, as indicated by the results. According to our estimation results it was, however, not necessarily the access to foreign currency loans in itself that supported the housing market, but rather the generally improved borrowing conditions. The results also suggest that the inflow of funding from foreign parent banks to local subsidiaries pushed house prices further up in the run-up to the crisis.

²¹ We restrict our attention to estimations in which we assume the coefficients to be fixed, while the evidence presented in chart 5 suggests that the coefficients might be time varying. This avenue is left for future research.

Because of their severe macroeconomic effects house price movements will remain of key interest to policymakers. Our findings concerning the influence of borrowing conditions on house prices illustrate this fact in a quite obvious way. Furthermore, the negative correlation of after-tax interest rates and house prices makes the deductibility of housing credit expenditures and repayments an instrument for policymakers to influence housing market developments.

We also find evidence that the surge in house prices was associated with a decoupling from the development of fundamentals in almost all CESEE countries covered in our sample. The correction after 2008 has removed these misalignments and, in fact, in 2011 house prices in most countries were below the level suggested by the fundamentals. This indicates that house prices are likely to rebound somewhat once fundamentals and credit conditions improve.

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Annex A

Annex A provides detailed information on the quarterly house price data and explanatory variables.

Table A1

National Indices of Real House Prices (2005=100)

Country	Geographical area	Type of dwellings	Statistical concept	Unit	Treatment	Minimum	Maximum	Mean	Number of observations	Time span of original time series	Extrapolated time span	Source
						<i>of the real house price index</i>						
Bulgaria	big cities (27 district centers)	existing apartments	transaction price per square meter	log, index	deflation using CPI	34.4	118.6	64.1	60	Q1 97–Q4 11, quarterly data	–	ECB (NSO)
Czech Republic	whole country	existing apartments	transaction price per square meter	log, index	deflation using CPI	58.2	104.2	80.3	56	Q1 04–Q4 11, quarterly data	Q1 98–Q4 03	CZSO
Estonia	whole country	existing and new apartments	transaction price per square meter	log, index	deflation using CPI	14.3	106.3	45.3	68	Q3 03–Q4 11, quarterly data	Q2 94–Q2 03	ECB (NSO)
Hungary	whole country	n.a.	transaction price per square meter	log, index	deflation using CPI	38.8	110.6	86.9	56	Q1 98–Q4 11, quarterly data	–	FHB Banking Group
Latvia	whole country	existing and new apartments	transaction price per square meter	log, index	deflation using CPI	13.7	104.5	45.5	52	Q1 00–Q4 11, quarterly data	Q1 99–Q4 99	ECB (NSO)
Lithuania	whole country	existing and new apartments	transaction price per square meter	log, index	deflation using CPI	21.0	108.0	47.2	68	Q4 98–Q4 11, quarterly data	Q1 94–Q3 98	ECB (NSO)
Poland	big cities	existing apartments	transaction price per square meter	log, index	index calculated from price level data, deflation using CPI	44.0	114.3	70.6	53	Q4 02–Q4 11, quarterly data	Q4 98–Q3 02	ECB (NSO)
Romania	capital city	existing and new dwellings	asking price per square meter	log, index	extrapolation with the trend growth rate, deflation using CPI	64.9	141.2	106.0	24	Q4 06–Q4 11, quarterly data	Q1 06–Q3 06	REAS
Slovakia	whole country	existing and new dwellings	asking price per square meter	log, index	index calculated from price level data, interpolation for 2002 – 2004 based on annual data, deflation using CPI	75.6	114.0	93.4	40	Q1 02–Q4 11, quarterly data	–	Národná banka Slovenska
Slovenia	whole country	existing dwellings	transaction price per square meter	log, index	deflation using CPI	33.3	101.4	68.5	67	Q1 03–Q4 11, quarterly data	Q2 95–Q4 02	ECB (NSO)

Source: Authors' calculations.

Table A2

Real House Price Data Used for Extrapolating the National House Price Indices

Country	Geographical area	Type of dwellings	Statistical concept	Unit	Treatment	Correlation coefficient with the house price index for the whole country	Time span	Source
Czech Republic	capital city	existing apartments	transaction price per square meter	log, index	deflation using CPI	0.997	Q1 98–Q4 11, quarterly data	CZSO
Estonia	whole country	existing and new dwellings	transaction price per square meter	log, national currency	deflation using CPI, index calculated from price level data	0.998	Q2 94–Q4 11, quarterly data	BIS, NSO
Latvia	capital city	existing and new apartments	asking prices per square meter	log, national currency	deflation using CPI, averages based on monthly data, index calculated from price level data	0.939	Q1 99–Q4 11, quarterly data	NCB
Lithuania	whole country	existing apartments	transaction or asking price per square meter	log, national currency	deflation using CPI, index calculated from price level data	0.818	Q1 94–Q4 11, quarterly data	Oberhaus
Poland	whole country	existing and new apartments	transaction price per square meter	log, national currency	deflation using CPI, index calculated from price level data	0.668	Q4 98–Q4 11, quarterly data	NSO
Romania	extrapolation of the data using the trend growth rate of the house price index for the whole country shown in table A1							
Slovenia	capital city	existing and new apartments	n.a.	log, national currency	deflation using CPI, index calculated from price level data	0.987	Q2 95–Q4 11, quarterly data	Slonep

Source: Authors' calculations.

Note: For Bulgaria, Hungary and Slovakia, there are no house price time series available that are longer than those for the whole country.

Table A3

Explanatory Variables

Variable	Description	Unit	Treatment	Mini- mum	Maxi- mum	Mean	Num- ber of obser- vations	Source
Demand side, fundamental factors								
Interest rate, weighted	weighted real interest rate	%	deflation using CPI, compilation of the weighted interest rate based on interest rates on domestic currency loans to households for house purchase and on interest rates on foreign currency loans (up to 2006: loans to households; 2006–2011: loans to households for house purchase); weighted according to the share of foreign currency loans to total household loans; quarterly data	–48.5	25.7	4.7	569	OeNB, NCBs, ECB, IMF
<i>Interest rate</i>	<i>real bank lending rate</i>	%	<i>deflation using CPI, IFS Code (60P), government bond yield for PL (Code 60P) as no data are available</i>	–51.0	25.7	4.9	575	<i>IMF (IFS)</i>
Household income	real gross disposable income per capita	log, in nc	deflation using CPI, seasonal adjustment, quarterly data	–2.1	5.1	0.6	567	Eurostat
<i>Real GDP</i>	<i>real gross domestic product per capita</i>	<i>log, in nc</i>	<i>deflated, seasonal adjustment, quarterly data</i>	6.1	13.3	8.6	643	<i>Eurostat</i>
Population, aged 15 to 64	population aged 15 to 64 years	log, number of persons	linear interpolation of annual data	13.7	17.1	15.3	730	Eurostat
<i>Population, aged 25 to 44</i>	<i>population aged 25 to 44 years</i>	<i>log, number of persons</i>	<i>linear interpolation of annual data</i>	12.8	16.2	14.4	459	<i>Eurostat</i>
Demand side, additional transition-specific factors								
External demand	private remittances as a share of GDP	log, %	seasonal adjustment, quarterly data	–1.3	2.2	0.6	359	Eurostat
Household loans	loans to households and NPISH as a share of GDP, end of period	log, %	foreign currency component adjusted for exchange rate movements (at January 2008 exchange rates), quarterly data	0.6	5.4	3.6	587	OeNB, ECB, NCBs
<i>Domestic currency loans to households</i>	<i>loans denominated in domestic currency to households as share of GDP, end of period</i>	<i>log, %</i>	<i>quarterly data</i>	–2.6	5.2	3.1	592	<i>OeNB, ECB, NCBs</i>
Foreign currency loans to households	household loans denominated in foreign currency to households as a share of GDP, end of period	log, %	adjusted for exchange rate movements (at January 2008 exchange rates), quarterly data	–6.7	5.2	1.3	565	OeNB, ECB, NCBs
<i>Foreign currency housing loans</i>	<i>housing loans denominated in foreign currency to households as share of GDP, end of period</i>	<i>log, %</i>	<i>adjusted for exchange rate movements (at January 2008 exchange rates), quarterly data</i>	–9.0	5.0	1.6	257	<i>OeNB, ECB, NCBs</i>
Foreign liabilities	foreign liabilities of commercial banks as a share of GDP	log, %	based on immediate-borrower basis, quarterly data	1.8	8.3	4.2	341	IMF (IFS)
Supply-side factors								
Construction costs	real construction costs for residential buildings	log, index (2007=100)	deflated, seasonally adjusted, quarterly data	3.1	4.9	4.4	495	Eurostat (Haver Analytics)
<i>Wages in construction</i>	<i>real wages in construction</i>	<i>log, index (2007=100)</i>	<i>deflated, seasonally adjusted, quarterly data</i>	2.8	5.3	4.4	480	<i>Eurostat</i>
Gross value added, construction	real gross value added in construction as a share of GDP	log, %	deflated, seasonally adjusted, quarterly data	–0.1	6.3	1.9	680	Eurostat
Residential investment	real gross fixed capital formation (housing) as a share of GDP	log, %	deflated, seasonally adjusted, quarterly data	–0.5	5.4	2.1	360	Eurostat
Building permits	new building permits	log, index (2007=100)	seasonally adjusted, quarterly data	1.8	5.2	3.9	485	Eurostat (Haver Analytics)

Source: Authors' calculations.

Note: The variables in italics are used as alternative proxy variables for robustness checks. The summary statistics are shown in logarithms to allow for the cross-country comparability of the data.

Annex B

Construction of the After-Tax Interest to Represent Financing Conditions and Tax Deductibility

Taxation and regulatory policies influence not only prices and ownership rates but also macroeconomic developments. Tax incentives stimulate ownership (Springler and Wagner, 2010). This results in a higher level of house prices and may also result in a greater cyclical volatility of house prices. Even though tax incentives do not cause volatility in house prices by themselves, they interact with and magnify the shocks that impinge on house prices (variations in disposable incomes, demographic changes, etc.; see van den Noord, 2003).

To be able to analyze the correlation between price developments and prevailing taxation rules it makes sense to construct time series to represent tax deductibility and to estimate the financing cost of housing investment to the extent by which they are affected by the personal income tax system. To quantify governments' involvement in housing markets for the CESEE countries, we expand the model by Fukao and Hanazaki (1986). They assume a typical price of one unit of housing P (it is six times the disposable income of an average production worker (APW)). By incorporating marginal tax rates we get the after-tax nominal interest rates $i_a(t)$. As the duration of tax relief is limited, the $i_a(t)$ are time dependent.

As the following relationship holds

$$\int_0^{\infty} i_f P e^{-(i-\pi)t} dt = \int_0^{\infty} i_a(t) P e^{-(i-\pi)t} dt \quad (7)$$

(with the inflation rate π and the unit of housing P), we obtain the nominal after-tax interest rate i_f . For further information see van den Noord (2005). The theoretical model suggests that price volatility would be largest when tax breaks for owner-occupied homes are largest. Pearson's correlation coefficient between the after-tax interest rates and house price changes against 2004 is -0.324 (authors' calculation).

For calculating the after-tax interest rate, information on tax interest deductibility, tax credits and imputed income from housing is taken into account.²² Wealth taxes and capital gains taxes are not included. The formulas applied for incorporating the rules within the specific country are available upon request.

The relevant information on countries' tax regulation and tax deductibility was taken from the European Tax Handbooks (IBFD, 2001 to 2010). Furthermore, for data on marginal rates of income tax plus employees' social security contributions and personal income tax we use OECD Series (OECD, a, b). To derive the unit of housing we needed data on disposable income. We took data (OECD, a) of the net income after taxes of a married couple with two children and one earner. Disposable income is gross wage earnings minus total payments to general government plus cash transfer from general government for two children.

²² Property real estate taxes are not included in the calculation. Property taxation plays a minor role when comparing taxation differences among countries.

Annex C

The Short-Run Dynamics of House Prices in CESEE Countries

The model estimated in the main text is a long-run specification of house prices and is essentially the first step of the Engle-Granger (1984) procedure. For illustrative purposes we show the estimation results of the short-run specification, i.e. equation 6, below (table C1). We focus on the benchmark model only because the number of observations drops significantly for the extended model. In the model, we include only the contemporaneous changes on the right-hand side, due to poorer fit when we include more lags. Several features are worth mentioning. First, the negative sign of the country-specific coefficient of the error-correction term indicates that there is indeed evidence of a correction back to the long-run equilibrium, although the coefficient is insignificant in most countries. The low values of the slope-coefficients indicate that this adjustment is very slow, though. It is only slightly faster and significant in Estonia, Bulgaria, and faster, but insignificant in Latvia, where the speed of adjustment takes a pace of about one-tenth of the disequilibrium per quarter. The insignificance of the error-correction term might just reflect the fact that the time series applied in the estimations are relatively short, although one would have expected a significant negative coefficient given that we find evidence of cointegration. In addition, it is likely that the strong house price increases and the following adjustment reflected the catching-up process of the economies and that this effect more than offset the error-correction mechanism.

Second, in all countries changes in disposable income have a significant positive impact on the change in house prices. The largest coefficient estimates are found for the Baltic countries. Despite the fact that Bulgaria – just like the Baltic

Table C1

Estimation Results of the Short-Run Specification Based on the Baseline Model Specification

	Bulgaria (1)	Czech Republic (2)	Estonia (3)	Latvia (4)	Lithuania (5)	Hungary (6)	Poland (7)	Romania (8)	Slovakia (9)	Slovenia (10)
error- correction _{t-1}	-0.104 * (-0.055)	-0.067 * (-0.043)	-0.186 ** (-0.087)	-0.186 * (-0.127)	-0.137 * (-0.071)	0.012 * (-0.04)	-0.047 * (-0.033)	0.05 * (-0.104)	-0.069 * (-0.046)	-0.052 * (-0.035)
Δhouse price _{t-1}	0.537 *** (-0.142)	0.363 *** (-0.123)	-0.063 *** (-0.153)	0.006 *** (-0.165)	0.067 *** (-0.124)	0.033 *** (-0.089)	0.169 *** (-0.093)	0.149 *** (-0.191)	0.668 *** (-0.087)	0.09 *** (-0.137)
Δinterest rate, weighted _t	-0.013 *** (-0.004)	-0.005 *** (-0.005)	-0.026 *** (-0.01)	-0.021 *** (-0.01)	-0.016 *** (-0.01)	-0.005 *** (-0.003)	0.003 *** (-0.006)	-0.003 *** (-0.011)	-0.009 *** (-0.003)	-0.011 *** (-0.006)
Δhouse- hold income _t	0.619 ** (-0.235)	0.779 ** (-0.215)	3.649 ** (-1.124)	1.955 ** (-0.512)	2.372 ** (-0.431)	1.124 ** (-0.132)	1.068 ** (-0.135)	0.789 ** (-0.232)	1.148 ** (-0.211)	1.341 ** (-0.389)
Δpopula- tion, 15–64 _t	15.326 ** (-6.958)	2.857 ** (-4.098)	64.407 ** (-34.242)	-6.477 ** (-16.713)	-4.716 ** (-5.296)	9.309 ** (-14.332)	0.449 ** (-5.763)	17.93 ** (-70.832)	11.464 ** (-8.757)	1.534 ** (-5.009)
adjusted R-squared	0.6215	0.3242	0.2675	0.2058	0.402	0.6775	0.5804	0.4219	0.6983	0.2003
observ- ations	23	49	43	49	49	46	49	21	37	49

Source: Authors' calculations.

Note: Dependent variable first difference of house prices. *: significant at the 10% level, **: significant at the 5% level, ***: significant at the 1% level. Standard errors in parentheses.

countries – also experienced very large cumulated house price growth, the coefficient of disposable income for Bulgaria is the smallest among the countries. Third, declining interest rates are associated with increasing house prices in most countries, except for Poland, where we get the unexpected sign. Finally, we see that the coefficient of the change in population is very large for many countries. We do not put too much weight on this finding since it is likely attributable to the fact that population data are available only on an annual frequency and the interpolation that we conducted might have shaped the results.

Trust in the EU in CESEE:

Did the Crisis and EU Integration Have an Impact? Evidence from the OeNB Euro Survey

The economic and financial crisis of 2008–09 and the ongoing sovereign debt crisis since 2010 have undermined EU citizens’ trust in national and European government institutions in many European countries. Against this background we look at trust in the EU in Central, Eastern and Southeastern Europe (CESEE) on the basis of results obtained from the OeNB Euro Survey. While we find that trust in the EU differs largely across the CESEE countries of the sample, the results are broadly comparable to average levels obtained for euro area countries over the same period. A comparison of pre-crisis and post-crisis levels of citizens’ trust in the EU reveals a certain divide: While trust in the EU declined significantly in the EU Member States of the sample during the sovereign debt crisis, an increase was found for most of the non-EU countries over the same period. A number of major EU integration steps in the latter group of countries may explain this increase. We conclude that prudent communication policies remain key in fostering not only citizens’ general trust in European institutions, but also their understanding of necessary policy measures both in normal times and in particular in crisis times.

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JEL classification: D02, E65, G01, H12, Z13

Keywords: Trust in the European Union, sovereign debt crisis, survey data; Central, Eastern and Southeastern Europe

According to Nobel laureate Kenneth Arrow, trust is an asset. “Without trust, cooperations break down, financing breaks down and investment stops. [...] if there is no trust, there is no progress” (Arrow, 1972). Sapienza and Zingales (2012) present survey evidence for the U.S.A. showing that the global recession following the collapse of Lehman Brothers was inter alia caused by a sharp loss in trust in the financial sector and the economic system in general. Against this background, it is of crucial importance to European policymaking that the citizens of Europe have sufficient trust in EU institutions. A lack of trust may have negative repercussions for European integration as a whole. For the (potential) candidate countries trust in the EU is essential given their strong economic links with EU Member States, their EU integration perspective and the important role of the euro in the region. Therefore, their political and economic future cannot be seen separately from EU policies.

The economic and financial crisis of 2008–09 and the ongoing sovereign debt crisis since 2010 have undermined EU citizens’ trust in national and European government institutions in many European countries, in particular in the euro area periphery countries which have been most exposed to the crisis, i.e. Greece, Ireland, Portugal and Spain (see Roth et al., 2011). Roth et al. (2011) find that declining trust in the EU can be mainly explained by the deteriorated economic environment during the crisis.² Furthermore, citizens’ perception of poor crisis management by the European institutions may have also played a role. The lack of tools to address systematically macroeconomic imbalances as well as the political

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² Unemployment and debt over GDP are found to be the central explanatory variables for declining trust in EU institutions during the crisis period (see Roth et al., 2011).

“muddling-through approach” have called into question the capability of the EU to come up with sustainable solutions (see European Commission, 2012).

Against this background we look at trust in the EU in Central, Eastern and Southeastern Europe (CESEE)³ on the basis of results obtained from the OeNB Euro Survey. First, we show the different levels of trust in the EU that can be identified in CESEE and how these levels of trust compare to levels of trust observed in the euro area. To this end we analyze the results of seven waves of the OeNB Euro Survey over the period from 2009 to 2012 and compare them to those obtained from euro area countries, thus putting them into perspective. Second, we make use of the time dimension of the Euro Survey (1) to study whether the sovereign debt crisis has affected citizens’ trust in the CESEE region and also (2) to analyze the survey evidence against the background of Croatia’s upcoming EU accession and a number of important integration steps made by other countries of the sample. Third, we explain what “trust in the EU” actually measures by reporting correlations of *trust in the EU* with other variables measuring trust, economic sentiment and expectations from the OeNB Euro Survey. Given our particular sample of countries and the role of the euro as a safe haven currency in some of these countries, we specifically look at the relationship between trust in the EU and trust in the euro. Finally, we present socio-demographic breakdowns to understand which groups of the population tend to support the EU.

1 Levels of Trust in the EU Differ Substantially across CESEE but Are Largely in Line with Euro Area

Since spring 2009, the OeNB Euro Survey⁴ has contained a question on respondents’ trust in the EU. The wording of this question is as follows: “I would like to ask you a question about how much trust you have in certain institutions. Please tell me on a scale from 1 (trust completely) to 5 (do not trust at all) whether you trust the European Union.” Chart 1 shows the percentage of respondents who answered that they trusted completely or had some trust in the EU in seven survey waves from spring 2009 to fall 2012.⁵

The levels of trust measured by the OeNB Euro Survey differ substantially across CESEE countries. Among the EU Member States of the sample, the lowest average trust levels (just below 30%) over the observation period are found for Hungary and the Czech Republic. Higher levels are registered for Poland and Romania. In Bulgaria, almost half of the respondents answered that they completely or somewhat trust the EU. Among the respondents in candidate and potential candidate countries, Albanians by far have the highest level of trust in the EU, followed by respondents in FYR Macedonia and Bosnia and Herzegovina. Low levels of trust in the EU can be found for Croatia and Serbia.

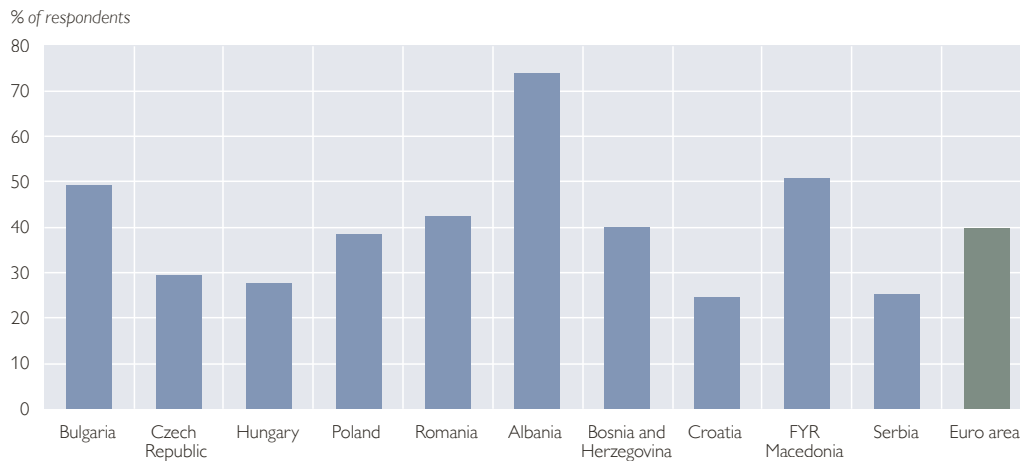
³ The country sample covered by the OeNB Euro Survey comprises five EU Member States (Bulgaria, the Czech Republic, Hungary, Poland and Romania) and five (potential) candidate countries (Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and Serbia).

⁴ The OeNB Euro Survey is carried out twice a year (consisting of a spring wave and a fall wave). The survey typically provides evidence on the use of the euro in the countries covered, including households’ foreign currency (euro) cash holdings, savings deposits or foreign currency loans, their motives as well as on households’ economic sentiment. For a detailed description of the OeNB Euro Survey, see Dvorsky, Scheiber and Stix (2008).

⁵ Results available on ceec.oenb.at

Chart 1

Trust in the EU



Source: OeNB Euro Survey 2009–2012, Standard Eurobarometer 71–78.

Note: Respondents of the OeNB Euro Survey were asked “I would like to ask you a question about how much trust you have in certain institutions. Please tell me on a scale from 1 (trust completely) to 5 (do not trust at all) whether you trust the European Union.” Figures show the percentage share of respondents who “trust completely” or “somewhat trust” the EU. Respondents answering “Don’t know” and “No answer” are excluded. Percentages for CESEE countries refer to OeNB Euro Survey data and are averages across seven survey waves. Respondents of the Standard Eurobarometer were asked “I would like to ask a question about how much trust you have in certain institutions. Please tell me if you tend to trust or tend not to trust the European Union.” The entry for the euro area refers to the Standard Eurobarometer 71–78 and represents the population weighted average across eight survey waves. Including Estonia from 2011 onwards.

A comparison of the results on trust in the EU obtained from the OeNB Euro Survey with those of similar surveys carried out in the euro area reveals that the reported trust levels from the CESEE region do not differ largely from those observed in the euro area. The only exception in this context is Albania, where reported trust levels are considerably higher than those found for any of the euro area countries. The European Commission’s Eurobarometer survey, which is carried out twice a year, contains a question on trust in the EU which is broadly comparable⁶ to that of the OeNB Euro Survey, asking whether people “tend to trust the European Union” or whether they “tend not to trust” (see European Commission, 2009–2012). The average level of trust in the EU obtained from the Eurobarometer for euro area countries across eight survey waves is largely in line with the levels found for CESEE countries (see chart 1, right-hand bar). Furthermore, there are sizeable differences across countries also within the euro area (see table A2 in the annex).

2 What Does “Trust in the EU” Measure and Is It Associated with Other Variables?

The OeNB Euro Survey question on respondents’ trust in the EU refers to the interviewee’s confidence in the “EU as an institution.” Obviously, the scope of the question is rather broad and therefore the variable could measure a wide range of influencing factors.

⁶ Comparing results for the countries covered by both surveys, the Eurobarometer and the OeNB Euro Survey, they seem to be broadly in line.

The EU consists of several supranational institutions, i.e. the European Parliament, the European Commission, the European Council, the Council of the European Union, the European Court of Justice, the Court of Auditors and the European Central Bank (ECB). It is unclear whether there are differences in the way respondents view specific institutions.⁷ In addition, respondents most likely do not actually think of all these institutions when they answer the question about trust in the EU; on the contrary, they may also associate the EU with the euro or other institutions, such as the International Monetary Fund (IMF). All these factors would, in turn, influence their level of trust in the EU.

2.1 Association of Trust in the EU with Trust in National Institutions

Some of the European institutions have clear counterparts at the national level, e.g. national parliaments or national governments.⁸ Hence the question arises whether trust in national institutions fosters or hinders trust in the EU. Answers from the literature are ambiguous. On the one hand, analyzing individual-level data, Muñoz et al. (2012) find that trust in national institutions positively influences trust in European institutions, as a result of both an underlying orientation toward institutional trust and the transfer of support for the national government from the national to the EU level (*congruence hypothesis*). This suggests that citizens use their opinions based on domestic information as a proxy for trust at the European level because of limited information on politics at the European level (Roth et al., 2011). On the other hand, at the country level Muñoz et al. (2012) find that the relationship is negative (*compensation hypothesis*): Living in a country with highly trusted (mistrusted) and well-performing (badly-performing) institutions hinders (fosters) trust in the European institutions.

As our sample contains both EU members and nonmembers, these hypotheses cannot be directly applied to all the countries in our sample. Nevertheless, it is very informative to look at correlations between trust in the EU and trust in national institutions; this should also help understand the possible differences between the two groups of countries.

According to the correlations found in the data of the OeNB Euro Survey, trust in the EU is positively correlated with other measures of trust in a range of both public and private institutions. This indicates that all these variables to some extent capture a general propensity to trust or distrust. Looking at the correlations in more detail shows that trust in the EU is correlated both with trust in national governments and trust in national non-policymaking institutions, proxied by trust in the police (see table 1). These findings to some extent support the congruence hypothesis. Interestingly, positive correlations are found not only for the aggregate across countries, but also for each individual country of the sample including those who are not members of the EU. There is a particular strong association of trust in the EU with trust in domestically- and foreign-owned banks, which could be interpreted as a proxy for trust in private institutions.

However, Arnold et al. (2012) show that once country-level characteristics are accounted for, these relationships lose their significance. They demonstrate that

⁷ Arnold et al. (2012) find that individuals across Europe evaluate the institutions of the EU through a single attitude dimension of political trust rather than through separate evaluations.

⁸ For Euro Survey results on trust in national governments, see chart A1 in the annex.

Table 1

Correlation Coefficients of Trust in the EU with Other Variables

	Trust in the EU	Trust in the government	Trust in the police	Trust in domestically-owned banks	Trust in foreign-owned banks	Expect domestic economy to improve	Expect euro to be stable
Trust in the government	0.370						
Trust in the police	0.374	0.554					
Trust in domestically-owned banks	0.452	0.445	0.504				
Trust in foreign-owned banks	0.549	0.392	0.419	0.683			
Expect domestic economy to improve	0.226	0.335	0.250	0.267	0.234		
Expect euro to be stable	0.262	0.104	0.109	0.144	0.190	0.190	
Expected date of euro introduction in years	-0.170	-0.118	-0.125	-0.099	-0.113	-0.146	-0.131

Source: OeNB Euro Survey, 2009–2012.

Note: The figures show the Spearman correlation coefficient. For an explanation of the variables, see table A1 in the annex.

the degree of corruption at the country level drives the relationship between trust in national and European institutions. The authors explain that corruption erodes trust in the national political system and lowers the perceived costs of ceding sovereignty to supranational bodies.

We cannot replicate the in-depth analysis by Arnold et al. (2012) for the OeNB Euro Survey country sample. However, on the basis of correlations at the country level between trust indicators and the corruption perception index of Transparency International (Transparency International, 2012), we can provide some preliminary indication that these results might also hold for CESEE countries.

2.2 Association of Expected Economic Performance and Trust in the EU

There is clear evidence from the literature that policymaking institutions will be assessed by their ability to foster beneficial economic results (see e.g. Blind, 2006). As a case in point, Roth et al. (2011) find that unemployment leads to a fall in trust in national and European institutions, especially during times of crisis and in particular in the EU-15 countries. In a similar vein, they detect that an increase in debt over GDP reduces trust both in national governments as well as in the EU in all 27 EU Member States. The authors conclude that solving the euro area crisis, helping the countries to lower their debt levels and increasing their employment rates would most likely stabilize citizens' trust in institutions.

The OeNB Euro Survey contains a question on respondents' expectations as regards the domestic economy.⁹ The results show some positive correlation between an expected improvement in the country's economic performance and respondents' trust in the EU. A somewhat stronger correlation is found between citizens' trust in their national governments and an expected improvement in the economic performance (see table 1).

⁹ Respondents are asked whether they agree or disagree on a scale from 1 (fully agree) to 6 (disagree) with the following statement: "Over the next five years, the economic situation in my country will improve".

2.3 Association of Trust in the Euro and Trust in the EU

Finally, citizens' confidence in the euro as a stable and trustworthy currency plays a crucial role for the future of European integration and for the political legitimacy of the euro (see Banducci et al., 2003; Bordo and Jonung, 2003). It may be assumed that trust in the euro is associated with trust in European institutions. In addition, for those countries in our sample which are not EU members, the euro plays an important role as a safe haven currency (Stix, 2010).

Roth et al. (2012) analyze the evolution of public support for the euro throughout the financial and sovereign debt crisis in twelve euro area countries and compare it with the development of trust in European institutions. They conclude that trust in the euro was hardly affected by the crisis, whereas there was a dramatic fall in trust and support for the EU, and in particular for the ECB¹⁰ (see table A2 in the annex). Furthermore, Roth et al. (2012) find that in some EU Member States outside the euro area, namely in Denmark, Sweden and the U.K., the public attitude toward the euro has become significantly more critical.¹¹

Given the important role of the euro in some CESEE households' portfolios, an association between trust in the EU and trust in the euro can be expected to hold for this region. Looking at Euro Survey results for CESEE as a whole, a positive – though rather weak – correlation between “trust in the EU” and “trust in the euro” can be found.¹² However, correlation coefficients for individual countries render a differentiated picture: For each of the five EU Member States, the respective correlation coefficient is around or slightly above 0.3. Furthermore, higher (lower) trust in the EU is associated with an earlier (later) expected adoption of the euro. This corroborates the above finding. For the EU Member States, it can be argued that the decrease of trust both in the EU and in the stability of the euro is related to hesitant EU crisis management and intense media coverage. By contrast, for the non-EU members of the Euro Survey sample the two variables are found to be hardly correlated at all. A possible explanation could be that in this region – in contrast to the EU Member States – trust in the euro is associated with the role of the euro as a safe haven asset, i.e. for respondents in non-EU Member States the euro is a safe haven asset irrespective of their trust in the EU institutions.

3 Trust in the EU over the Past Four Years

As the OeNB Euro Survey results on trust in the EU capture seven waves from spring 2009 to fall 2012, we can take a closer look at whether the levels of trust have changed markedly in the course of the sovereign debt crisis, thus pointing to a possible impact of the crisis on trust levels.

Chart 2 displays differences in trust levels found for each country, comparing the average levels observed in the three waves from spring 2009 to spring 2010 with those observed in the four waves from fall 2010 to fall 2012. Interestingly,

¹⁰ Ehrmann et al. (2012) give three explanations for the level of trust in the ECB having fallen throughout the crisis: (1) the sharp deterioration of the economic situation during the crisis, (2) the overall fall in public trust in the European project, possibly because citizens saw Europe as being unable to prevent or solve the global crisis, and (3) the fact public opinion associated the ECB with the troubles of the financial sector.

¹¹ As regards the CESEE EU Member States that have not yet introduced the euro, Roth et al. (2012) find a comparably sharp loss of trust in the euro only for the Czech Republic.

¹² Since its launch in fall 2007, the OeNB Euro Survey has included questions about the expected stability and trustworthiness of the domestic currency and the euro (for Euro Survey results on trust in currencies, see e.g. Beckmann and Scheiber, 2012).

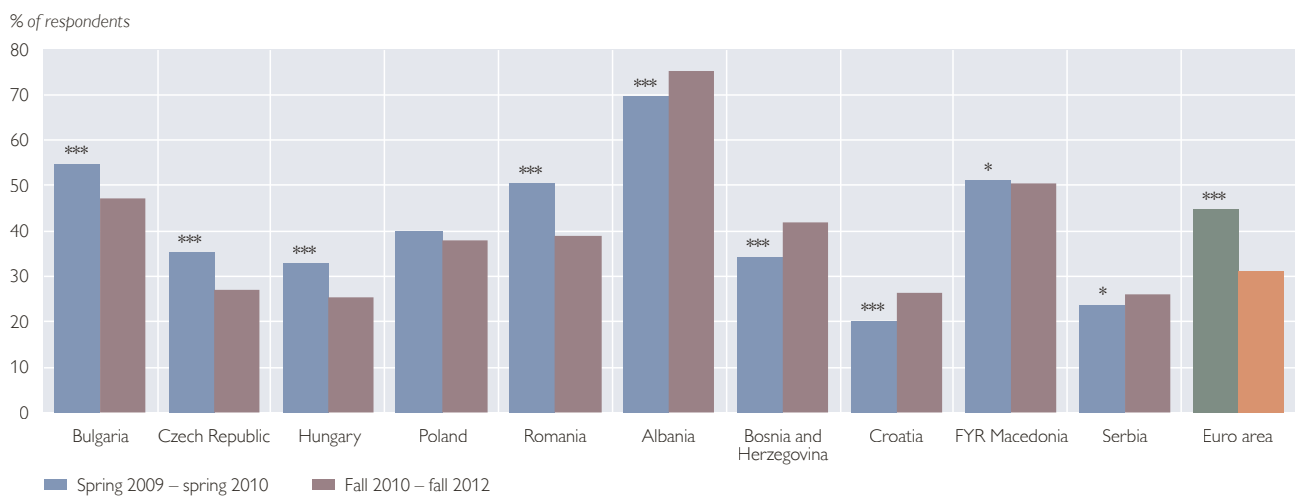
a clear dividing line seems to exist between EU Member States on the one hand and the non-EU member countries on the other.

3.1 Trust in the EU Declined in Member States during Sovereign Debt Crisis

In four of the five EU Member States of the sample, respondents' trust in the EU recorded a significant decline over the crisis period. This decline is in line with the Eurobarometer findings on the euro area countries (see chart 2, right-hand bar).

Chart 2

Trust in the EU and the Impact of the Sovereign Debt Crisis



Source: OeNB Euro Survey 2009–2012, Standard Eurobarometer 71–78.

Note: Respondents of the OeNB Euro Survey were asked "I would like to ask you a question about how much trust you have in certain institutions. Please tell me on a scale from 1 (trust completely) to 5 (do not trust at all) whether you trust the European Union." Figures show the average percentage share of respondents who "trust completely" or "somewhat trust" the EU for the respective time period. Respondents answering "Don't know" and "No answer" are excluded. Respondents of the Standard Eurobarometer were asked "I would like to ask a question about how much trust you have in certain institutions. Please tell me if you tend to trust or tend not to trust the European Union." The figures for the euro area refer to the Standard Eurobarometer 71–78 and represent the population weighted averages for the respective time period. Including Estonia from 2011 onwards. ***, **, and * indicate that the difference between the two time periods is significant at the 1%, 5%, and 10% level, respectively.

First, the unfavorable economic development related to the crisis may explain this loss in trust found for EU Member States. Roth et al. (2011), as mentioned earlier, find that recessions, in particular rising unemployment, weaken trust in governmental institutions both at the national as well as at the European level. In a similar vein, Rohrschneider and Loveless (2006) find from individual-level data that in the fairly "new" EU Member States of Central and Eastern Europe dissatisfaction with European institutions is even more strongly driven by economic concerns than in the "old" EU Member States. Second, this decrease in trust can be possibly attributed to citizens' rather negative perception of the EU's crisis management in recent years. Another factor potentially influencing trust in European institutions is that some euro area countries and two of the five EU Member States in our sample¹³ received support under EU-IMF programs. It is beyond the scope of the current paper and the available data from the Euro Survey to investi-

¹³ Romania received an EU-IMF Stand-By Arrangement (SBA) from May 2009 to May 2011, followed by an EU-IMF precautionary program. Hungary was under an EU-IMF SBA from November 2008 to November 2010.

gate whether such programs rather foster or undermine trust in the EU in the respective countries.

3.2 Trust in the EU Increased in Some Candidate and Potential Candidate Countries during 2009–12

By contrast, in four of the five non-EU Member States confidence in the EU increased significantly over the period of the sovereign debt crisis. While respondents may have approved of the EU's crisis management, it can be assumed that major steps in the integration process achieved since 2009 have also positively affected trust in the EU in candidate and potential candidate countries. Chart 2 seems to support this hypothesis for Albania, Bosnia and Herzegovina, Croatia and Serbia, although reported trust levels differ substantially between individual countries.

Table 2

Overview of Major EU Integration Steps

	Status	Major integration steps achieved since early 2009
Albania	Potential candidate	April 2009: application for EU membership December 2010: visa liberalization October 2012: candidate status recommended
Bosnia and Herzegovina	Potential candidate	June 2008: Stabilization and Association Agreement signed December 2010: visa liberalization
Croatia	Acceding country	October 2005: launch of accession negotiations December 2011: Accession Treaty signed
FYR Macedonia	Candidate country	October 2009: opening of accession negotiations recommended December 2009: visa liberalization
Serbia	Candidate country	Since 2009: application of European Partnership for Serbia December 2009: visa liberalization March 2012: candidate status granted

Source: European Commission (2013).

As table 2 shows, Croatia is the most advanced country in terms of EU integration, with EU accession scheduled for July 2013. Accordingly, the level of citizens' trust in the EU has increased significantly over the past five years. In this context, it is important to note that Croatia – as well as Serbia – traditionally displayed exceptionally low levels of trust in the EU as compared to the other CESEE countries (see e.g. Dvorsky, Scheiber and Stix, 2010). However, despite these low levels of trust according to the OeNB Euro Survey, Croatians obviously differentiate between their confidence in the EU on the one hand and their approval of Croatia's EU entry on the other hand, given the results of the referendum held on January 22, 2012, in which more than 66% of the Croatian electorate voted in favor of EU accession. These findings are in line with research by Arnold et al. (2012) showing that trust in EU institutions on the one hand and general support for EU membership and further integration on the other hand are two separate dimensions.

The levels of trust in the EU reported for potential candidate countries – whose perspective to join the EU is more distant – are substantially higher and have increased significantly over the past five years.

Additional explanations for the comparatively high levels of confidence in European institutions found for some countries, specifically for EU Member States, might be related to the compensation hypothesis or other factors at the country level as discussed above (Muñoz et al., 2012; Arnold et al., 2012).

4 Who Trusts the EU – Socio-Demographic Evidence

Previous research has shown that the propensity to trust or distrust differs significantly across socio-demographic groups. The following section analyzes whether this result also holds for the OeNB Euro Survey. Studying trust in the EU across socio-demographic groups may also provide important insights for policymakers as to which groups have a particularly skeptical or an exceptionally positive attitude toward the EU.

Table 3 breaks down the results of the Euro Survey by age groups in line with previous research on trust, replies from the youngest age group (14 to 34-year olds) are clearly above the respective country average for all countries. The share of respondents who completely or somewhat trust the EU declines with age in all countries except Albania, with particularly high deviations from the respective average for Serbia and FYR Macedonia.

Breaking down the results by income shows that the reported level of trust in the EU for respondents reporting high incomes is above the respective average in

Table 3

Trust in the EU by Socio-Demographic Groups

	Bulgaria	Czech Republic	Hungary	Poland	Romania	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	Serbia
% of respondents										
Average	49.3	29.4	27.6	38.4	42.3	73.7	39.8	24.6	50.6	25.3
Age										
14 to 34 years	53.6	35.6	30.8	41.0	44.4	71.9	43.4	28.2	56.8	32.7
35 to 54 years	49.8	27.4	26.4	37.4	41.6	75.3	38.9	24.5	50.5	24.6
55 years and over	42.8	24.3	26.2	35.7	40.6	74.0	37.2	20.9	41.6	17.7
Net household income										
Low income	42.0	23.9	24.0	37.6	42.3	73.4	38.2	21.0	49.1	18.6
Medium income	52.1	30.1	29.7	38.3	43.3	75.0	40.0	26.6	50.0	28.5
High income	53.5	35.8	31.4	43.2	47.8	75.5	39.8	28.4	52.2	34.8
Current employment status										
Self-employed	53.1	33.1	24.8	43.0	44.7	76.8	46.6	30.7	58.8	30.5
Employed	49.9	29.4	29.1	39.5	42.9	74.3	37.9	24.8	49.5	27.4
Unemployed	46.3	29.1	22.5	32.8	41.4	70.8	38.9	20.7	51.4	20.1
Student	61.4	40.1	38.3	41.9	47.4	73.1	47.5	34.0	60.4	41.4
Retired	41.8	23.2	26.3	32.6	40.3	74.6	39.3	21.6	39.4	16.6
Education										
Low	41.8	23.2	26.3	32.6	40.3	74.6	39.3	21.6	39.4	16.6
Medium	61.4	40.1	38.3	41.9	47.4	73.1	47.5	34.0	60.4	41.4
High	46.3	29.1	22.5	32.8	41.4	70.8	38.9	20.7	51.4	20.1

Source: OeNB Euro Survey, 2009–2012.

Note: Respondents were asked “I would like to ask you a question about how much trust you have in certain institutions. Please tell me on a scale from 1 (trust completely) to 5 (do not trust at all) whether you trust the European Union.” Figures show the percentage of respondents who “trust completely” or “somewhat trust” the EU in the respective socio-demographic group. The percentages are averages across survey waves for the indicated time period. Respondents answering “Don’t know” and “No answer” are excluded.

most countries. By contrast, even more substantial, albeit negative deviations from the respective country average level of trust in the EU can be found for people who report to have a low income. This phenomenon is particularly pronounced for the Czech Republic, Bulgaria and Serbia.

Grouping respondents by employment categories renders the following picture: Self-employed interviewees have a higher propensity to trust the EU (with Hungary being the only exception in this context), while unemployed respondents have substantially lower-than-average confidence in the EU. These results are broadly in line with research by Arnold et al. (2012), who find that a higher occupational status tends to make citizens more supportive of EU institutions.

Finally, the breakdown of results by respondents' education reveals that trust in the EU is highest in the category "medium education." Interestingly, trust levels below the respective country averages were found for both, respondents with a low level of education and those with high education. In line with this result, Arnold et al. (2012) provide evidence that higher levels of education decrease trust in the EU at the individual level. The authors explain that higher education may raise the awareness of the shortcomings of European institutions and make citizens more hesitant, or even unwilling, to trust them.

An interesting case is Albania, where the reported level of trust in the EU is by far the highest in the region. Furthermore, in contrast to all other countries, the levels of trust in the EU vary only weakly across respondents' socio-demographic attributes. Understanding in detail why trust in the EU seems to be a general and broadly based feature of the Albanian society would be an interesting case study for future research.

5 Summary and Conclusions

Results from the OeNB Euro Survey provide evidence on CESEE citizens' trust in the EU, complementing evidence on euro area countries, and render the following picture:

While trust in the EU differs largely across the CESEE countries of the sample, the results are broadly comparable to average levels obtained for euro area countries over the same period. Furthermore, trust in the EU is positively correlated with trust in national governments. This indicates some preliminary support for the congruence hypothesis, which suggests that because of limited information on policies at the European level, citizens use their opinions on their national government as a proxy for trust at the European level.

Euro Survey results regarding the correlation between "trust in the EU" and "trust in the euro" are highly differentiated: For each of the five EU Member States a positive correlation can be found. For the EU Member States, it can be argued that the decrease of trust both in the EU and in the stability of the euro is related to people's perception of the EU's crisis management and intense media coverage. By contrast, for the non-EU members of the Euro Survey sample the two variables are found to be hardly correlated at all. A possible explanation could be that in this region – in contrast to the EU Member States – trust in the euro is associated with the role of the euro as a safe haven asset.

A comparison of pre-crisis and post-crisis levels of citizens' trust in the EU reveals a similar divide: While trust in the EU declined significantly in the EU Member States of the sample during the sovereign debt crisis, an increase was

found for most of the non-EU Member countries over the same period. A number of major EU integration steps in the latter group of countries may explain this increase. Furthermore, the comparatively high levels of confidence in European institutions in (potential) candidate countries might be related to the compensation hypothesis – which suggests that living in a country with weakly trusted and badly-performing institutions will be associated with high individual trust in the EU – or to other factors at the country-level.

With regard to socio-demographic characteristics, our results are in line with previous research: Young respondents, respondents with medium education and respondents with high income have a higher propensity to trust the EU.

To conclude, prudent communication policies remain key in fostering not only citizens' general trust in European institutions, but also their understanding for necessary policy measures both in normal times and in particular in crisis times.

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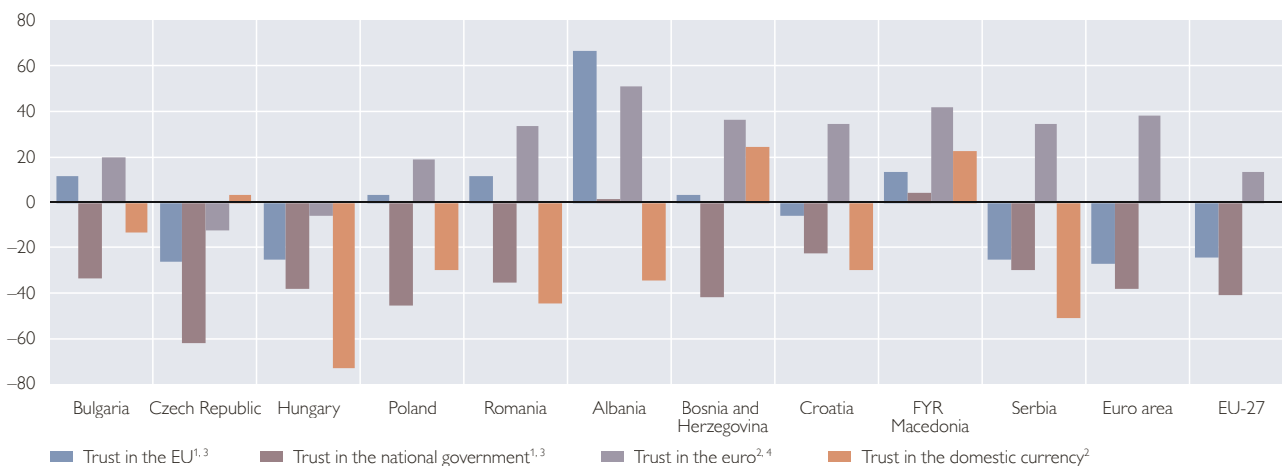
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Annex

Chart A1

Trust in the EU, the National Government, the Euro and the Domestic Currency

Balance statistics



Source: OeNB Euro Survey of fall 2012, Standard Eurobarometer 78.

¹ Respondents of the OeNB Euro Survey were asked "I would like to ask you a question about how much trust you have in certain institutions. Please tell me on a scale from 1 (trust completely) to 5 (do not trust at all) whether you trust ... the European Union/the national government or cabinet of ministers." Balance statistics are calculated as the percentage share of respondents answering category 1 or 2 minus the percentage share of respondents answering category 4 or 5. Respondents answering "Don't know" and "No answer" are excluded.

² Respondents of the OeNB Euro Survey were asked whether they agreed or disagreed on a scale from 1 (strongly agree) to 6 (strongly disagree) to the following statement: "Over the next five years the euro/domestic currency will be a very stable and trustworthy currency." Balance statistics are calculated as the percentage share of respondents answering categories 1 to 3 minus the percentage share of respondents answering categories 4 to 6. Respondents answering "Don't know" and "No answer" are excluded.

³ Respondents of the Standard Eurobarometer were asked "I would like to ask a question about how much trust you have in certain institutions. Please tell me if you tend to trust or tend not to trust... the European Union/national government." The figures for the euro area and the EU-27 are population-weighted averages.

⁴ Respondents of the Standard Eurobarometer were asked "What is your opinion on the following statement? Please tell me whether you are for it or against it: A European economic and monetary union with one single currency, the euro." The figures for the euro area and the EU-27 are population-weighted averages. No data available for trust in the domestic currency for the euro area and the EU-27.

Table A1

Variable Description

Variable	Description
OeNB Euro Survey	
Trust in the EU	Categorical variable derived from the question: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it. 1 means "I trust completely", 2 means "I somewhat trust", 3 means "I neither trust nor distrust", 4 means "I somewhat distrust" and 5 means "I do not trust at all": the European Union.
Trust in the government	Categorical variable derived from the question: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it. 1 means "I trust completely", 2 means "I somewhat trust", 3 means "I neither trust nor distrust", 4 means "I somewhat distrust" and 5 means "I do not trust at all": government/cabinet of ministers.
Trust in the police	Categorical variable derived from the question: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it. 1 means "I trust completely", 2 means "I somewhat trust", 3 means "I neither trust nor distrust", 4 means "I somewhat distrust" and 5 means "I do not trust at all": police.
Trust in domestically-owned banks	Categorical variable derived from the question: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it. 1 means "I trust completely", 2 means "I somewhat trust", 3 means "I neither trust nor distrust", 4 means "I somewhat distrust" and 5 means "I do not trust at all": domestically-owned banks.
Trust in foreign-owned banks	Categorical variable derived from the question: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it. 1 means "I trust completely", 2 means "I somewhat trust", 3 means "I neither trust nor distrust", 4 means "I somewhat distrust" and 5 means "I do not trust at all": foreign-owned banks.
Expect domestic economy to improve	Categorical variable derived from the question: I am going to read you some general statements and would like to know whether you agree or disagree. Please indicate your judgment on a scale from 1 (strongly agree) to 6 (strongly disagree): Over the next five years, the economic situation of [MY COUNTRY] will improve.
Expect the euro to be stable	Categorical variable derived from the question: I am going to read you some general statements and would like to know whether you agree or disagree. Please indicate your judgment on a scale from 1 (strongly agree) to 6 (strongly disagree): Over the next five years, the euro will be very stable and trustworthy.
Expect the domestic currency to be stable	Categorical variable derived from the question: I am going to read you some general statements and would like to know whether you agree or disagree. Please indicate your judgment on a scale from 1 (strongly agree) to 6 (strongly disagree): Over the next five years, the [LOCAL CURRENCY] will be very stable and trustworthy.
Expected date of euro introduction in years	Respondents of the OeNB Euro Survey were asked: When, in which year, do you think the euro will be introduced in [YOUR COUNTRY]?
Standard Eurobarometer	
Trust in the EU	Respondents of the Standard Eurobarometer were asked: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it: the European Union.
Trust in the national government	Respondents of the Standard Eurobarometer were asked: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it: the (NATIONALITY) government.
Support for the single currency, the euro	Respondents of the Standard Eurobarometer were asked: What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it: a European economic and monetary union with one single currency, the euro.

Table A2

Trust in the EU, National Government and the Euro

	Euro area	EA-4 (IE, EL, ES, PT)	EA-8 (BE, DE, FR, IT, LU, NL, AT, FI)	EU-27
Trust in the EU¹	% of respondents			
Average 2009–2012	40	39	40	40
Spring 2009–spring 2010	45	47	44	44
Fall 2010–fall 2012	31	25	33	33
Fall 2012	31	22	33	33
Trust in the national government, fall 2012 ¹	29	12	33	27
Trust in the euro, fall 2012 ²	66	62	67	53

Source: Standard Eurobarometer 71–78.

¹ Respondents of the Standard Eurobarometer were asked “I would like to ask you a question about how much trust you have in certain institutions. Please tell me if you tend to trust or tend not to trust... the European Union/national government.” The entries for different aggregates and time periods are population-weighted averages. Including Estonia from 2011 onwards.

² Respondents of the Standard Eurobarometer were asked “What is your opinion on the following statement? Please tell me, whether you are for it or against it: A European economic and monetary union with one single currency, the euro.” The entries for different aggregates are population-weighted averages. Including Estonia.

CESEE-Related Abstracts from Other OeNB Publications

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

Measuring Financial (In)Stability in Emerging Europe: A New Indexed-Based Approach

The importance of assessing financial stability in emerging Europe has increased rapidly since the recent financial crisis. Against this background, in the present paper we contribute to the existing literature in a twofold way: First, by using a broad range of indicators from money, bond, equity and foreign exchange markets, we develop a comprehensive financial instability index (FII) that gauges the level of financial market stress in some key Central, Eastern and Southeastern European (CESEE) countries. In a second step, we perform a panel estimation to investigate which macroprudential indicators that cover both internal and external imbalances explain the evolution of our FII over the past more than 15 years. Our analysis suggests that both the levels and changes of some indicators (such as credit growth and the level of private sector indebtedness) play an important role for financial stability. Moreover, we find that the impact of some key indicators on financial (in)stability is nonlinear and varies over time depending on market sentiment.

To be published in *Financial Stability Report 25*.

Petr Jakubík,
Tomáš Slačik

The Cross-Border Movement of Euro Banknotes and Austria's TARGET2 Liabilities

In the public and academic discussion on the payment system TARGET2, the high claims and liabilities of some euro area countries have mostly been associated with the financial crisis. The implicit assumption that TARGET2 balances would be close to zero without the financial crisis is both theoretically and empirically wrong, though. This study looks into the payment mechanisms that have caused the TARGET2 liabilities of the Oesterreichische Nationalbank (OeNB) to rise to a substantial level over the past ten years. The increase can be attributed to a structurally induced inflow of banknotes to the OeNB, which is partly due to tourism but above all to the physical shipment of euro cash from countries outside monetary union into Austria. This central bank money, which comes to Austria as cash, leaves the country in cashless form, causing an equivalent increase in the OeNB's TARGET2 liabilities. Structurally induced in- and outflows of central bank money (in cashless form or as banknotes) can be observed in other euro area countries, too. Understanding these flows is essential for a correct interpretation of TARGET2 balances during and after the current crisis.

Published in *Monetary Policy & the Economy Q4/12*.

Clemens Jobst,
Martin Handig,
Doris Schneeberger

Event Wrap-Ups

Turkish-Austrian Economic Relations in a European and International Context

Compiled by
Julia Wörz

Turkish-Austrian economic relations were at the center of a conference jointly organized by the Oesterreichische Nationalbank (OeNB) and the Central Bank of the Republic of Turkey (CBRT) held on the OeNB's premises in Vienna on March 18, 2013.

In his opening remarks, *OeNB Governor Ewald Nowotny* emphasized Turkey's enormous growth record over the past years. Since 1995, Turkey's GDP has almost doubled whereas Austria's GDP – still surpassing growth in the euro area by a margin – has expanded at less than half that pace over the same time period. However, Turkey's growth performance was all but even over the past decades. Nowotny recalled the severe financial crisis in 2001, which he witnessed in his position as vice president of the European Investment Bank that he held at that time. He pointed out how well Turkey has learned the lessons from the then massive lending and currency mismatch in the banking sector, demonstrating the importance and effectiveness of comprehensive reform and discipline. Today, Turkey's banking sector is extremely healthy, representing a good example for other countries. Nowotny further highlighted the fruitful cooperation between Austria and Turkey in the new IMF constituency and the strength of FDI ties between Austria and Turkey and their potential to support technological upgrading, thus fostering catching up in per capita incomes. He also mentioned Turkey's successful export re-orientation toward fast-growing destinations. This process underlines the bridge function of the Turkish economy and puts Turkey at the crossroads between the dynamic economies of Asia and Europe.

CBRT Governor Erdem Başçı thanked the OeNB for hosting the event and focused in his speech on the following three issues: First, he reflected on the growing share of emerging countries in world exports and in particular the increase in trade among emerging countries themselves, which has reduced the impact of lower demand from advanced economies. At the same time global decision making has moved from the G7 to the G20 level and is reflected in the increased recognition of emerging countries in international organizations. Second, turning to financial stability, Başçı said that the challenges and potential adverse consequences of strong capital flows to emerging markets cannot be addressed by capital controls. Rather, capital accounts have to be kept open and risks should be managed by careful macroprudential policies. In Turkey, the approach currently pursued by the authorities combines such policies with careful interest rate management, also keeping a close view on exchange rate developments and credit growth. Başçı mentioned in this context Turkey's membership in the Financial Stability Board, where it currently chairs the regional consultative group for the Middle East and North Africa (MENA), one of six regional groups. Third, Başçı referred to the rotation scheme in the joint IMF constituency as a symbolic yet very promising solution. Referring to bilateral economic relations with Austria, he identified a large unexploited potential for bilateral trade, mentioning also strong FDI links. Austria is the number one investor in Turkey, with a focus on the energy sector, which makes the outlook for further business cooperation between the two countries appear very promising.

In the panel discussion, Austrian-Turkish economic relations were reviewed from several different angles. *CBRT Vice Governor Murat Çetinkaya* reflected on

Turkey's immediate growth prospects and expressed his expectations of a rebalancing of growth drivers based on the following factors: well-anchored inflation expectations, strong fundamentals as the pull factor behind capital inflows, low exchange rate volatility, a low and declining debt-to-GDP ratio and strong employment growth arising from increasing labour force participation. Further, he pointed toward ongoing financial deepening, the high profitability of the Turkish banking sector, its strong capitalization and good asset quality. With respect to the cooperation between Austrian and Turkish business partners, he saw the greatest potential in finance, pointing out Turkish investors' appetite for EU assets. A total of 16 Turkish banks are currently active in the EU, two of them in Austria.

Professor Aykut Kibritçioğlu from *Ankara University* gave a detailed comparison of Austrian and Turkish trade patterns and pointed out a large unexploited potential for bilateral trade. To date, bilateral trade is mostly inter-industry in nature, thus keeping the potential for further growth limited. Further, FDI can also substitute for and hence crowd out trade. Finally, he did not identify any empirical evidence for a positive influence of immigration flows (predominantly from Turkey to Austria) on trade. Hence, high-level support in order to enhance trade relations is needed, and there is a strong role for business agencies and joint green investments.

Ambassador Ayşe Sezgin confirmed the importance of political support in order to boost bilateral trade up to its potential. Referring to shifts in global economic and political balances and the increasing recognition of emerging economies in global decision taking, she expressed the view that Turkey's accession to the EU will be unlike any previous enlargement, but therefore all the more interesting. Given its impressive growth record – Turkey will become Europe's second largest economy in 2050 – and its role as an energy and transit hub between producer and consumer markets, Turkey is to be considered as a truly global player. Consequently, if Europe wants to remain a dynamic world region, European integration must become deeper and wider.

The last speaker, *Supervisory Board Chairman of Vienna Insurance Group, Wolfgang Ruttenstorfer*, shared his views on the prospects for Austrian companies. After having taken advantage of being the first to move into the then newly accessible markets in Central and Eastern Europe and in light of limited scope for further expansion in this region with the privatization process coming to an end, Austrian firms now have to take strategic decisions where to move next. Two important markets are well within reach for Austrian companies: Russia and Turkey, with Turkey representing an interesting hub for the Caspian Sea and the Middle East. While large firms can afford to enter both markets, smaller firms will have to decide on one. Turkey's healthy banking sector, its comparatively high level of human capital and its relatively liberal business environment add to the country's attractiveness for foreign investors.

The discussion that followed the experts' contributions revealed a vivid interest – in particular of Turkish business people based in Vienna – in strong business ties between Turkey and Austria.

IMF April 2013 World Economic Outlook: Hopes, Realities and Surveys

Compiled by
Christina Lerner

In its April 2013 World Economic Outlook (WEO), the IMF sees a stabilization of economic activity in advanced economies and a pickup in growth in emerging market and developing economies. Subtitled “Hopes, Realities and Surveys,” the report states that after a slowdown in 2012, financial conditions have eased and global market confidence has improved. In advanced economies, two main tail risks to the global recovery could be averted: the danger of a euro area break-up and of a sharp fiscal contraction in the U.S.A. However, the road to recovery remains bumpy, and prospects remain divergent: What was a two-speed recovery, i.e. strong economic growth in developing economies but weak economic performance in advanced economies, is now becoming a three-speed recovery. Emerging and developing economies are still growing strongly, the U.S.A. is performing better than forecast, but the euro area is still experiencing negative growth.

World output is projected to increase by 3.3% in 2013 and 4% in 2014, while euro area growth is forecast to contract by 0.3% in 2013 and to increase by 1.1% in 2014. The analogous projections for Central, Eastern and Southeastern European (CESEE) countries are +2.2% (2013) and +2.8% (2014). Growth in the U.S.A. is forecast to be 1.9% in 2013 and 3% in 2014.

Since the October 2012 WEO, acute crisis risks in the euro area have diminished, inflation pressure has moderated and confidence in the viability of monetary union has increased. However, financial conditions remain vulnerable: The highly fragmented transmission of monetary policy and the weak credit intermediation in the euro area periphery are still hindering recovery. Domestic rebalancing from the public to the private sector is being held back by deleveraging, tight credit conditions and economic uncertainty. Events in Cyprus could lead to even more sustained financial market fragmentation. Hence, the main short-term risks now evolve around balance sheet weaknesses, financial fragmentation and insufficient progress toward a stronger economic and monetary union. However, the IMF recognizes that some institutional progress has been made in creating a roadmap for a banking union in the EU.

The WEO stresses that healthy banks are important to support recovery: Completing bank recapitalization and dealing with nonperforming assets are considered the crucial conditions in this regard. The IMF’s policy advice for the euro area hence focuses on further progress on banking union, including bank resolution and deposit protection, fiscal integration and on arresting the decline in demand. Given moderating inflation pressure, monetary policy should remain very accommodative.

Emerging Europe has experienced a sharp growth slowdown in 2012, reflecting spillovers from the euro area crisis and domestic policy tightening in the largest economies. Southeastern Europe is forecast to experience the most tepid recovery. Given the strong economic linkages between the euro area and the CESEE countries, prolonged stagnation in the euro area countries represents the key downside risk: Emerging Europe’s principal export market, the euro area, will remain weak, starting to grow only in the second half of 2013. The distorted credit transmission represents a further obstacle to the more robust revival of economic activity in the euro area’s periphery. However, growth in emerging Europe is projected to pick up in 2012 and 2013, with positive impulses from improved financial market sentiment and easing external financing conditions.

Statistical Annex

Statistical Annex

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

Conventions used

x = No data can be indicated for technical reasons

. . = Data not available at the reporting date

Discrepancies may arise from rounding.

Table 1

Gross Domestic Product

	2006	2007	2008	2009	2010	2011	2012
	<i>Annual real change in %</i>						
Albania	5.4	5.9	7.5	3.3	3.8	3.1	1.6
Bosnia and Herzegovina	5.5	6.0	5.6	-2.8	0.7	1.0	-0.7
FYR Macedonia	5.0	6.1	5.0	-0.9	2.9	2.8	-0.3
Montenegro	8.6	10.7	6.9	-5.7	2.5	3.2	-0.5
Serbia	5.2	6.9	5.5	-3.1	1.0	1.6	-1.7
Ukraine	7.3	7.9	2.3	-14.8	4.1	5.2	0.2

Source: *wiiw*.

Table 2

Industrial Production

	2006	2007	2008	2009	2010	2011	2012
	<i>Annual real change in %</i>						
Albania	12.1	-9.7	8.7	10.6	18.6	10.0	..
Bosnia and Herzegovina	11.5	6.4	7.3	1.5	3.7	6.4	-5.2
FYR Macedonia	3.6	3.7	5.5	-7.7	-4.3	3.3	-6.6
Montenegro	1.0	0.1	-2.0	-32.2	17.5	-10.3	-7.1
Serbia	4.7	3.7	1.4	-12.6	2.5	2.1	-2.9
Ukraine	6.2	7.6	-5.2	-21.9	11.2	7.6	-1.8

Source: *wiiw*.

¹ Former Yugoslav Republic of Macedonia.

Table 3

Average Gross Wages – Total Economy

	2006	2007	2008	2009	2010	2011	2012
	<i>Annual change in %</i>						
Albania	9.2	25.2	25.3	5.2	-3.6	6.6	6.0
Bosnia and Herzegovina ¹	11.5	6.4	7.3	1.5	3.7	6.4	-5.2
FYR Macedonia	8.0	4.8	8.7	14.1	1.0	1.2	0.2
Montenegro	15.6	31.7	22.5	5.6	11.2	1.0	0.7
Serbia	24.4	22.0	17.9	-3.3	7.5	11.1	8.9
Ukraine	29.2	29.7	33.7	5.5	17.5	17.6	14.9

Source: wiiw.

¹ Net wages.

Table 4

Unemployment Rate

	2006	2007	2008	2009	2010	2011	2012
	%						
Albania ¹	13.8	12.9	12.7	13.9	13.5	13.3	13.3
Bosnia and Herzegovina ¹	44.1	42.5	40.6	42.4	42.8	43.9	44.5
FYR Macedonia ²	36.0	34.9	33.8	32.2	32.0	31.4	31.0
Montenegro ²	29.6	19.3	17.2	19.3	19.6	19.7	20.0
Serbia ²	20.9	18.1	13.6	16.1	19.2	23.0	24.0
Ukraine ²	6.8	6.4	6.4	8.8	8.1	7.9	7.5

Source: wiiw.

¹ Registered, end of period.² Labor force survey, period average.

Table 5

Industrial Producer Price Index

	2006	2007	2008	2009	2010	2011	2012
	<i>Period average, annual change in %</i>						
Albania ¹	0.8	3.5	6.5	-1.6	0.3	2.6	1.5
Bosnia and Herzegovina ²	3.4	4.6	6.9	-3.1	0.0	4.2	0.8
FYR Macedonia	7.3	2.5	10.3	-6.5	8.7	11.1	4.6
Montenegro	3.6	8.5	14.0	-3.9	-0.9	3.2	1.9
Serbia	13.3	5.9	12.4	5.6	12.7	14.2	5.5
Ukraine	9.6	19.5	35.5	6.5	20.9	19.0	3.6

Source: wiiw, national sources.

¹ Manufacturing industry.² Federation of Bosnia and Herzegovina.

Table 6

Consumer Price Index

	2006	2007	2008	2009	2010	2011	2012
	<i>Period average, annual change in %</i>						
Albania	2.4	2.9	3.4	2.3	3.6	3.4	2.0
Bosnia and Herzegovina	6.2	1.5	7.5	-0.4	2.1	3.7	2.1
FYR Macedonia	3.2	2.3	8.3	-0.8	1.6	3.9	3.3
Montenegro	3.0	4.2	7.4	3.4	0.5	3.1	4.1
Serbia	11.7	7.0	13.5	8.6	6.8	11.0	7.2
Ukraine	9.1	12.8	25.2	15.9	9.4	8.0	0.6

Source: *wiiw*.

Table 7

Trade Balance

	2006	2007	2008	2009	2010	2011	2012
	<i>% of annual GDP</i>						
Albania	-23.1	-26.9	-27.4	-26.5	-23.5	-24.2	-20.7
Bosnia and Herzegovina	-34.2	-36.9	-37.9	-27.6	-25.5	-27.7	..
FYR Macedonia	-19.1	-19.8	-26.2	-23.3	-20.5	-22.4	-23.7
Montenegro	-45.0	-57.6	-65.6	-44.3	-40.8	-40.4	-42.1
Serbia	-21.4	-24.8	-26.0	-17.7	-17.0	-17.1	-18.1
Ukraine	-4.8	-7.4	-8.9	-3.7	-6.1	-8.4	-11.7

Source: *wiiw*.

Table 8

Current Account Balance

	2006	2007	2008	2009	2010	2011	2012
	<i>% of annual GDP</i>						
Albania	-6.6	-10.5	-15.6	-15.3	-11.5	-12.8	-10.5
Bosnia and Herzegovina	-7.9	-10.6	-13.9	-6.3	-5.7	-8.7	-9.0
FYR Macedonia	-0.4	-7.1	-12.8	-6.8	-2.0	-3.0	-3.9
Montenegro	-31.3	-39.5	-49.8	-27.9	-22.9	-17.7	-17.7
Serbia	-10.1	-17.7	-21.6	-7.2	-7.4	-9.2	-10.6
Ukraine	-1.5	-3.7	-7.1	-1.5	-2.2	-6.3	-8.2

Source: *wiiw*.

Table 9

Net FDI Inflows

	2006	2007	2008	2009	2010	2011	2012
	<i>% of annual GDP</i>						
Albania	3.5	5.9	6.9	7.9	8.9	7.7	7.5
Bosnia and Herzegovina	6.1	13.3	5.3	1.4	1.5	2.1	3.5
FYR Macedonia	6.6	8.5	6.1	2.0	2.2	4.5	1.5
Montenegro	21.9	21.2	18.9	35.8	17.8	12.0	13.7
Serbia	14.3	6.4	5.6	4.7	3.1	5.9	0.8
Ukraine	5.3	6.5	5.5	4.0	4.2	4.3	3.8

Source: wiiw.

Table 10

Reserve Assets Excluding Gold

	2006	2007	2008	2009	2010	2011	2012
	<i>End of period, % of annual GDP</i>						
Albania	18.5	18.1	18.3	18.5	20.8	20.0	19.8
Bosnia and Herzegovina	28.0	30.5	25.3	25.4	25.8	24.4	23.7
FYR Macedonia	25.1	23.5	20.3	21.3	21.0	24.0	23.5
Montenegro	8.0	9.7	7.0	5.8	5.3	5.3	5.8
Serbia	37.9	33.1	24.2	35.5	34.1	36.9	34.2
Ukraine	19.3	20.8	17.8	21.2	24.4	20.1	12.5

Source: wiiw.

Table 11

Gross External Debt

	2006	2007	2008	2009	2010	2011	2012
	<i>End of period, % of annual GDP</i>						
Albania	26.2	28.6	37.4	41.0	44.2	49.6	54.0
Bosnia and Herzegovina ¹	20.9	18.0	17.0	21.6	25.4	25.9	27.8
FYR Macedonia	47.9	47.6	49.2	56.4	58.2	64.6	68.6
Montenegro	23.5	17.2	15.6	23.5	29.4	32.9	39.4
Serbia	60.9	60.2	64.6	77.7	84.9	77.5	85.5
Ukraine	48.2	52.2	58.6	85.8	86.0	83.4	76.3

Source: wiiw.

¹ Gross external public debt.

Table 12

General Government Balance

	2006	2007	2008	2009	2010	2011	2012
	<i>% of GDP</i>						
Albania	-3.3	-3.5	-5.5	-7.0	-3.1	-3.5	-3.4
Bosnia and Herzegovina	2.8	1.2	-2.2	-4.4	-2.5	-1.3	-3.0
FYR Macedonia	-0.5	0.6	-0.9	-2.7	-2.4	-2.5	-3.8
Montenegro	2.7	6.7	0.4	-5.7	-4.9	-5.4	-4.0
Serbia	-1.6	-2.0	-2.6	-4.5	-4.7	-5.0	-6.4
Ukraine	-0.7	-1.1	-1.5	-4.1	-6.0	-1.8	-3.6

Source: *wiiw*.

Table 13

Gross General Government Debt

	2006	2007	2008	2009	2010	2011	2012
	<i>% of annual GDP</i>						
Albania	56.0	53.9	55.1	59.8	58.2	58.0	59.4
Bosnia and Herzegovina	21.9	29.7	30.8	36.2	39.6	40.7	43.1
FYR Macedonia	38.8	32.3	27.9	31.7	34.8	35.0	36.0
Montenegro	32.6	27.5	29.0	38.2	40.9	45.9	51.0
Serbia	37.3	30.9	29.2	34.7	44.5	48.7	63.0
Ukraine	14.8	12.3	20.0	34.8	39.9	36.3	36.8

Source: *wiiw*.

Table 14

Broad Money

	2006	2007	2008	2009	2010	2011	2012
	<i>End of period, annual nominal change in %</i>						
Albania (M2)	7.4	9.6	7.4	8.7	4.5	6.6	4.9
Bosnia and Herzegovina (M2)	21.1	23.5	13.5	-1.6	7.8	5.6	4.6
FYR Macedonia	25.0	29.3	11.2	6.0	12.2	9.7	4.4
Montenegro (M2)	82.9	71.9	-14.3	..	..	..	..
Serbia (M3)	38.3	42.5	9.8	21.5	12.9	10.3	9.4
Ukraine	34.5	51.7	30.2	-5.5	22.7	14.7	12.8

Source: *European Commission, wiiw*.

Table 15

Official Key Interest Rate

	2006	2007	2008	2009	2010	2011	2012
	<i>End of period, %</i>						
Albania (refinancing base rate)	5.5	6.3	6.3	5.3	5.0	4.8	4.0
Bosnia and Herzegovina ¹	x	x	x	x	x	x	x
FYR Macedonia ²	5.7	4.8	7.0	8.5	4.1	4.0	3.7
Montenegro ⁴	x	x	x	x	x	x	x
Serbia (two-week repo rate) ³	14.0	10.0	17.8	9.5	11.5	9.8	11.3
Ukraine (refinancing rate) ⁵	8.5	8.0	12.0	10.3	7.8	7.8	7.5

Source: Eurostat, Bloomberg, wiiv, IMF.

¹ Currency board.

² Monthly weighted average interest rate on Central Bank Bills auctions (28 days).

³ 2002–05: Weighted average interest rates on securities used in open market operations by Narodna banka Srbije.

⁴ Unilateral euroization.

⁵ Average.

Table 16

Exchange Rate

	2006	2007	2008	2009	2010	2011	2012
	<i>Period average, national currency per EUR</i>						
Albania	123.08	123.63	122.80	132.06	137.79	140.33	139.04
Bosnia and Herzegovina	1.96	1.96	1.96	1.96	1.96	1.96	1.96
FYR Macedonia	61.19	61.18	61.27	61.27	61.52	61.53	61.53
Montenegro	x	x	x	x	x	x	x
Serbia	84.19	79.98	81.47	93.94	102.90	101.96	112.98
Ukraine	6.34	6.92	7.71	10.87	10.53	11.09	10.27

Source: wiiv, national sources, Thomson Reuters.

Notes

Periodical Publications

See www.oenb.at for further details.

Geschäftsbericht (Nachhaltigkeitsbericht) Annual Report (Sustainability Report)

German
English

This report reviews the OeNB's mandate, responsibilities and organization as well as the monetary policy of the Eurosystem, economic conditions and developments both in the financial markets and in financial market supervision during the reporting year. Furthermore, it contains the OeNB's financial statements, Intellectual Capital Report and Environmental Statement.

Konjunktur aktuell

German

This online report provides a concise assessment of the current state of the global economy and the economic situation in the euro area, Central, Eastern and Southeastern Europe (CESEE) and Austria. Furthermore, it analyzes major developments in financial markets and the performance of Austrian banks. The report is published in January, March, April, June, September, October and December; issues published at the end of a quarter additionally contain brief analyses of special economic and monetary policy topics.

Monetary Policy & the Economy

English

Monetary Policy & the Economy provides analyses and studies on central banking and economic policy topics and is published at quarterly intervals.

Fakten zu Österreich und seinen Banken Facts on Austria and Its Banks

German
English

This semiannual publication provides a snapshot of Austria's economy based on a range of real and financial variables, which are also put into an international perspective.

Financial Stability Report

English

This semiannual report contains analyses of Austrian and international developments with an impact on financial stability and studies designed to offer in-depth insights into specific financial stability-related topics.

Focus on European Economic Integration

English

This quarterly publication presents peer-reviewed studies on macrofinancial and monetary integration in Central, Eastern and Southeastern Europe (CESEE) as well as related country analyses and statistics. This publication reflects a strategic research priority of the OeNB.

Statistiken – Daten & Analysen

German, English summaries

This quarterly publication contains analyses of Austrian financial institutions, cross-border transactions and positions as well as financial flows. 14 tables provide information about macroeconomic, financial and monetary indicators. In addition, this series includes special issues on selected statistics topics published at irregular intervals.

Research Update

English

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German, English

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These proceedings contain contributions to the OeNB's annual Conference on European Economic Integration (CEEI), which focuses on Central, Eastern and Southeastern European issues and the ongoing EU enlargement process.

Publications on Banking Supervision

German, English

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