

Developments in Selected Countries¹

1 Introduction

Slovenia adopts euro in January 2007 after meeting the convergence criteria

After having fulfilled the convergence criteria in a sustainable manner, Slovenia was the first country among the new EU Member States to adopt the euro at the beginning of 2007. The changeover to the single currency went smoothly and quickly, and public surveys suggest a high level of acceptance of the euro among the Slovenian population. According to preliminary information by Eurostat, the introduction of the euro had only a temporary and limited impact on consumer price inflation in Slovenia during and after the changeover period.

Newcomers to the EU: Bulgaria and Romania

On January 1, 2007, Bulgaria and Romania joined the European Union. While their combined population accounts for some 6% of the population in the EU-27, their economic weight in the EU is much lower, accounting for about 1% of total GDP at market exchange rates and around 2% of GDP at PPP. In the run-up to EU accession, the two countries had undertaken major efforts and made substantial progress in meeting EU membership criteria. Still, at the time of accession, some structural and institutional weaknesses remained to be resolved in various areas (e.g. internal market issues, jurisdiction, corruption and organized crime). The Treaty of Accession provides for special safeguard clauses to be triggered in case the reforms are considered insufficient. Given that after accession, the reform process seems to have slowed down in some key areas in both countries, the European Commission has an important role in that it monitors the countries' progress with respect to achieving full compliance with the EU membership criteria. The European Commission will publish a new report on the progress made by Bulgaria and Romania in June 2007.

Croatia and Turkey engaged in EU accession negotiations

The accession process of Croatia and Turkey continues. While most of the 35 negotiation chapters of the *acquis* screening process have been completed for Croatia, about half of the chapters have been screened for Turkey. By now, six chapters of accession negotiations have been opened with Croatia and two with Turkey. Of these, two chapters have been closed provisionally with Croatia ("Science and Research" and "Education and Culture"), while one chapter has been tentatively closed with Turkey ("Science and Research").² The Republic of Macedonia is an EU candidate country as well. However, accession negotiations with this country have not started yet.

General economic performance in CESEE remains fairly favorable

In the second half of 2006 and into early 2007, the economic performance of the ten Central, Eastern and Southeastern European (CESEE) countries covered in this report³ has been characterized by dynamic output growth and improving labor market conditions. The competitive position of the region as a whole has been preserved, as solid wage growth (and exchange rate appreciation) has been offset by vibrant productivity increases, with unit labor costs (ULC) in industry (in euro terms) growing fast only in Romania and Russia. Inflation developments have been varied but rather benign in most

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² In December 2006, the EU Council decided to postpone negotiations with Turkey on eight chapters owing to disputes over the status of Cyprus.

³ Czech Republic, Hungary, Poland, Slovakia, Slovenia (also referred to as Central and Eastern Europe), Bulgaria, Croatia, Romania, Turkey (Southeastern Europe), as well as Russia.

Table 1

Gross Domestic Product (Real)

Annual change in %

	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Slovenia	4.4	4.0	5.2	3.8	3.9	5.0	4.7	5.6	5.5
Bulgaria	6.6	6.2	6.1	5.4	6.0	5.5	6.4	6.7	5.7
Czech Republic	4.2	6.1	6.1	6.0	6.7	6.4	6.2	5.9	5.8
Hungary	4.9	4.2	3.9	4.3	4.8	4.9	3.8	3.8	3.2
Poland	5.3	3.5	5.8	4.1	4.5	5.2	5.5	5.8	6.4
Romania	8.4	4.1	7.6	2.4	4.2	6.7	7.7	8.2	7.6
Slovakia	5.4	6.0	8.3	6.3	7.5	6.7	6.7	9.8	9.6
Croatia	4.3	4.3	4.8	5.2	4.8	6.1	3.6	4.7	4.8
Turkey	8.9	7.4	6.1	7.7	9.5	6.7	8.3	4.8	5.2
Russia	7.1	6.4	6.7	6.6	8.0	5.0	7.0	6.8	7.7

Source: Eurostat, national statistical offices, wiiv.

countries. Except for Russia, which ran sizeable surpluses, the countries in the region recorded combined current and capital account deficits, which have widened in many cases in the course of 2006 owing to both strong capital formation and consumption growth. Fiscal performance continues to be very diverse. Budget balances were broadly steady or improved somewhat in 2006 in most of the ten countries, also helped by robust GDP growth. Still, more consolidation efforts are needed in the region.

Real GDP growth in the ten countries under review ranged from about 4% to somewhat more than 8% in 2006, which is markedly above the euro area growth rate (2.7%) and in most of the ten countries also higher than in 2005. Per capita income convergence continued: In 2006, Slovenia already reached nearly 80% of the euro area average and, like the Czech Republic (72%), moved ahead of Portugal with regard to GDP per capita in PPP terms.

What were last year's main drivers of economic activity? A glance at the sources of growth indicates that domestic demand was the main contributor to GDP growth across the region except in Hungary, which saw a major decline of private consumption growth, largely related to tighter fiscal policy. Average annual growth picked up noticeably in 2006 in Poland, Romania and Slovakia. In general, private consumption was supported by robust real wage increases, real credit growth to the private sector⁴ and improvements on the labor market. The other main component of domestic demand, gross fixed capital formation, was aided primarily by strong FDI inflows, favorable credit conditions as well as by higher inflows, and a better absorption, of EU structural funds. However, investment growth moderated in Slovakia, Bulgaria and Turkey in 2006; but even in these cases capital formation growth remained strong or at least fairly robust. Only Hungary registered a contraction of gross fixed capital formation, which was largely the result of fiscal tightening. Overall, gross fixed capital

Robust economic growth continues and is increasingly driven by domestic demand

⁴ The increase in real credit to the private sector ranged between close to 10% in Hungary and around 47% in Romania (year-on-year change in December 2006, deflated by the December 2006 inflation rate). Compared with December 2005, credit growth rates declined only in Bulgaria, Hungary and Turkey. Real credit to the private sector in the euro area grew by about 9% in 2006. Comparisons of credit growth rates need to take into account that credit-to-GDP levels in CESEE were low until a few years ago, which means that catching-up effects have played a role in recent credit developments.

formation grew more strongly than consumption in all countries but Hungary, and consumption expanded less than overall GDP in the CEECs as well as in Croatia and Turkey.

The contribution of net exports to GDP growth turned out to be positive (or marginally negative) in Central and Eastern Europe (CEE), Croatia and Turkey, but strongly negative (almost hitting 10 percentage points) in Bulgaria and Romania. In Russia, the contribution of net exports to growth was also negative but more moderate. Compared with 2005, an increase in the contribution of net exports to growth was registered only in Hungary and, in particular, in Slovakia (as well as in Turkey). Export growth picked up in most of CEE in 2006 and reached very high rates in Slovakia (+20%) and Hungary (+18%). In Southeastern Europe and Russia, export growth was steady or accelerated slightly. Import growth speeded up in all countries (except Turkey), accelerating markedly in the Czech Republic, Poland and Romania. Import growth in 2006 ran at particularly brisk rates of more than 20% in Romania and Russia, partly reflecting high demand for Western European durable consumer goods.

From 2005 to 2006, the average level of capacity utilization in industry increased in all new EU Member States covered in this report, except in Slovakia. The decline in capacity utilization in Slovakia is related to new automobile production plants that opened in the third quarter of 2006⁵ and appears to be only of temporary nature, as capacity constraints increased again in the last quarter of 2006. Capacity utilization accelerated the most in Bulgaria and Romania – namely by more than 4 percentage points to about 68% and 77%, respectively. The Czech Republic, Hungary and Slovenia reached capacity utilization levels of more than 80% on average in 2006.

Labor market improves
in 2006

Compared with 2005, labor market conditions improved in part significantly in 2006 in most of the countries under review. Unemployment (ILO definition) fell most markedly in Poland and Slovakia, albeit from high levels. It appears that robust economic growth and considerable gross FDI inflows have eventually fed through more strongly to the labor market. In some cases (e.g. Poland), however, unemployment statistics have improved, also owing to increased labor migration after EU accession. In several countries, e.g. in the Czech Republic, Slovakia, Poland and Romania, the tightening of labor markets combined with rapid economic expansion, and in some cases with stark regional differences,⁶ has already put upward pressures on wages.

Rising wages
accompanied by
improved productivity:
What is the impact on
competitiveness?

Nominal wages in the industry sector picked up strongly in the two newest EU Member States, Bulgaria and Romania, hitting growth rates of around 10% and 16% year on year in 2006.⁷ In the CEECs, nominal wage growth turned out to be more moderate (unweighted average of 6½% year on year), but increases were higher (or only marginally lower) than in 2005. However, in all five CEECs under review, wage increases in industry were more than matched by productivity increases, thus leading to a decline in ULC (in nominal

⁵ After having reached nearly 80% in the first and second quarters of 2006, the capacity utilization level declined below 70% in the third quarter.

⁶ In the Czech Republic, for example, joblessness ranges between 2% in Prague and above 18% in the coal mining regions.

⁷ In Russia, wages increased by even more than 20% (year on year).

terms and in local currency). In the remaining countries – Bulgaria, Croatia, Romania, Turkey and Russia – productivity improvements could not keep up with wage rises. Consequently, ULC in industry went up in 2006, though to rather varying degrees: Moderate increases were recorded in Croatia at 1.7%, while Russia posted strong ULC growth at 12.1%.

A somewhat different picture emerges when taking account of exchange rate movements, measuring ULC in euro terms. In this case, the competitive position is measured as ULC changes in euro terms relative to developments in the euro area.⁸ It was rather stable in Poland, Slovakia and Slovenia, while deteriorating somewhat in the Czech Republic. Hungary, in turn, improved its relative ULC position, helped by the depreciation of the forint against the euro in 2006 (in annual average terms). Croatia's and Bulgaria's ULC positions weakened somewhat, while Turkey retained its competitive edge, given the currency's marked weakening in the first half of 2006.⁹ In Romania and, even more so, in Russia, competitiveness worsened tangibly in ULC terms. A country's market shares in euro area imports is another measure of competitiveness; in 2006, this measure has been stable or on the rise in all countries under review.¹⁰ For the time being, this situation provides some comfort, particularly as terms of trade have deteriorated in most countries (except Russia). At the same time, lagged negative effects on export performance cannot be excluded, in particular for countries with fast-rising ULC in euro terms.

Table 2

Wages, Productivity, Unit Labor Costs

Annual change in %

	Nominal wages in industry		Productivity in industry		ULC in industry (in local currency)		EUR per local currency (annual average)		ULC in industry (in local currency)	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
Slovenia	5.8	5.5	5.9	8.8	-0.1	-3.1	-0.2	-0.0	-0.3	-3.1
Bulgaria	8.1	10.8	3.4	8.2	4.6	2.5	-0.1	0.0	4.4	2.5
Czech Republic	4.6	6.8	6.8	8.6	-2.1	-1.7	7.1	5.1	4.9	3.3
Hungary	7.2	8.5	10.1	11.7	-2.6	-2.9	1.5	-6.1	-1.2	-8.9
Poland	3.2	5.2	2.9	9.5	0.3	-4.0	12.6	3.2	12.9	-0.8
Romania	16.8	15.7	4.4	11.3	11.9	4.0	11.8	2.7	25.2	6.8
Slovakia	7.3	6.7	0.6	11.3	6.6	-4.1	3.7	3.7	10.6	-0.6
Croatia	5.3	7.5	6.2	5.7	-0.8	1.7	1.3	1.1	0.5	2.8
Turkey	12.2	11.5	6.0	6.7	5.9	4.5	5.9	-7.3	12.1	-3.1
Russia	21.1	21.4	7.3	8.3	12.8	12.1	1.7	3.3	14.7	15.8
Memo item:										
Euro area	1.5	2.5	2.8	4.6	-1.2	-2.0	..	..	-1.2	-2.0

Source: Eurostat, national statistical offices, wiiv.

⁸ By comparison, in the euro area ULC in industry (in nominal terms) fell by around 2% in 2006 year on year. ULC in the euro area are especially relevant in this context, given that the euro area is the main trading partner of the country group under review.

⁹ See Focus on European Economic Integration 2/06.

¹⁰ Market share gains were particularly strong in 2006 in Poland and in Russia, in the latter case owing to the fact that the high oil price in the first seven months of the year raised oil export revenues.

Inflation rates remain largely stable or decrease in 2006 but vary more in early 2007

In 2006, inflation was largely stable or declined in the countries under review, with the exception of Hungary (and Turkey), while displaying a somewhat more varied, but still fairly amenable, picture in early 2007. Lower oil prices since late summer 2006, nominal exchange rate appreciation in many countries and, in some cases, favorable food price developments have helped contain price dynamics. Inflation remained fairly low in the Czech Republic and Poland in 2006, and picked up somewhat in early 2007. In Slovenia, too, inflation was kept at relatively low levels. On the back of currency appreciation, in the last quarter of 2006 and the first quarter of 2007 inflation in Slovakia moderated to similar levels as in the Czech Republic, Poland and Slovenia. Since mid-2006, the inflation rate in Hungary has moved up markedly, peaking at 9% year on year in February and March 2007. This rise was primarily attributable to increased indirect taxes and higher administered prices, both being part of a fiscal consolidation package.

Romania's disinflation continued to proceed gradually, reaching inflation rates below 4% in the first quarter of 2007, the lowest level since the beginning of the transformation process. Bulgaria, after recording inflation rates in the upper single digits in 2006, succeeded in reducing inflation to 4½% in February and March 2007, helped by base effects. In both cases, price developments were presumably also positively affected by EU accession.

Inflation in Turkey picked up to around 10% in 2006 and early 2007. At the same time, the pass-through of the large depreciation in the spring of 2006 remained relatively contained. Russia's inflation declined gradually, reaching single-digit territory in 2006. Still, inflation in Russia again proved to be rather persistent and it may be difficult to further trim it.

Currencies appreciate across the region in the second half of 2006

On the back of continued favorable economic prospects, the currencies of the new EU Member States have generally gained against the euro, in particular since mid-2006. Currency appreciation from mid-2006 to mid-April 2007 moved within a range of around 13% (Hungary and Slovakia) to some 6% to 7% (Poland and Romania, respectively) to around 2% (Czech Republic¹¹). In

Table 3

Consumer Price Index (here: HICP)

Annual change in %

	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007
Slovenia	2.5	2.5	2.3	2.6	2.3	3.1	2.5	2.3	2.6
Bulgaria	6.0	7.4	6.9	7.8	8.7	8.6	6.7	5.7	5.3
Czech Republic	1.6	2.1	1.6	2.2	2.4	2.5	2.4	1.1	1.7
Hungary	3.5	4.0	3.5	3.2	2.4	2.7	4.6	6.4	8.8
Poland	2.2	1.3	1.8	1.2	0.9	1.4	1.5	1.3	2.0
Romania	9.1	6.6	9.0	8.5	8.7	7.2	5.9	4.8	3.9
Slovakia	2.8	4.3	2.2	3.7	4.2	4.6	4.8	3.5	2.1
Croatia ¹	3.4	3.2	3.5	4.0	3.5	3.8	3.2	2.2	1.5
Turkey	8.1	9.3	7.8	7.3	7.6	9.2	10.6	9.7	10.3
Russia ¹	12.5	9.8	12.5	11.2	10.8	9.6	9.6	9.2	7.9

¹ CPI.

Source: Eurostat, national statistical offices, wiw.

¹¹ Interestingly, the Czech koruna depreciated by almost 2% against the euro in the first three-and-a-half months of 2007, after having appreciated in the second half of 2006.

Slovenia the tolar was stable against the euro until it was replaced by the single currency, while in Bulgaria (which continues to operate a currency board arrangement) the exchange rate to the euro also remained unchanged. Owing to financial turbulences affecting the Turkish economy, the lira depreciated by more than 25% in the first half of 2006, but the currency appreciated again by around 9% from mid-2006 to mid-April 2007. In Croatia and Russia, in turn, currency fluctuations to the euro remained rather limited.

Over the last months, several new governors were appointed to head the central banks in the region. In Hungary, András Simor became governor with effect from March 2007, succeeding Zsigmond Járai. That same month, the term of the Slovenian central bank governor Mitja Gaspari expired. After the Slovenian parliament had rejected two nominees proposed by the president, the president did not present a new nominee in time for parliament's regular April session. Banka Slovenije is currently represented in the Governing Council of the ECB by its deputy governor. At the beginning of 2007, Sławomir Skrzypek was appointed president of Narodowy Bank Polski, replacing Leszek Balcerowicz.

In all countries under review but Russia, the combined current and capital accounts were in deficit in 2006. Deficits turned out to be higher in all countries than a year earlier, except in Hungary and Slovakia. Sizeable income balance deficits, driven by the high profitability of foreign-owned companies, have played an important role in this context, especially in CEECs (apart from Slovenia). External imbalances are particularly high in Bulgaria and Romania: The large deficits (slightly more than 10% of GDP in Romania and even above 15% in Bulgaria) are mainly attributable to a worsening of the trade balance, as export growth could not keep up with import growth in a setting of buoyant domestic demand. However, the deficit was largely covered by net FDI inflows in Romania and fully covered in Bulgaria.

During the latter part of 2006 and in early 2007, no major monetary policy changes occurred in the ten countries covered here, apart from Slovenia's accession to the euro area. Since the fall of 2006, interest rates have been on hold in the Czech Republic and Hungary, but also in Turkey. Most recently, Poland increased its key rate by 25 basis points, citing first signs of rising inflationary pressures. Slovakia and Romania, in turn, lowered interest rates by 50 and 125 basis points, respectively, in early 2007. The rate cuts were motivated by declining inflation, but also helped contain appreciation pressures on the Slovak koruna and the Rumanian leu.

As in earlier years, fiscal outcomes in the ten countries under review were very varied in 2006, ranging from a very high deficit in Hungary to a sizeable surplus in Bulgaria and, even more so, in Russia. Fiscal positions worsened in Hungary (where the deterioration was considerable but still contained by a consolidation program implemented in mid-2006), but also in Slovakia (partly due to rising pension reform costs)¹² and Romania (which went on a spending spree at end-2006). The remaining countries registered at least moderate

Personnel changes in several central banks

Combined current and capital account positions in deficit throughout the region, except in Russia

Monetary policy developments in other countries

Fiscal performance varies widely

¹² After the expiry of a transitional arrangement, pension reform costs relating to the creation of a mandatory funded pillar have to be allocated to the general government budget since the beginning of this year. This is particularly relevant for Poland, Hungary and Slovakia (see also country sections below).

improvements in their fiscal balances, supported by strong growth. Croatia continued with its gradual fiscal consolidation strategy, while Turkey reached a small surplus for the first time in many years and Russia recorded another high budgetary surplus.

European Commission closely monitors fiscal policy of EU member and candidate countries

EU Member States are obliged to submit so-called stability or convergence programs¹³ (and annual updates) to the Council of the European Union (EU Council) and the European Commission. These programs, which contain as their core element the respective country's budgetary position and its medium-term fiscal framework, are assessed by the European Commission and evaluated by the EU Council. In a similar vein, EU candidate countries submit Pre-Accession Economic Programmes, on which the EU and the respective candidate country adopt joint opinions.

Central Europe: Slovenia submits first stability program, other countries still post excessive deficits

Slovenia's public finances, as set out in the country's first stability program, were generally considered prudent by the EU Council, while it was sensed that the country's efforts to reduce the structural deficit over the medium term could be more ambitious.

Among the countries discussed in this report, the Czech Republic, Hungary, Poland and Slovakia have been subject to an Excessive Deficit Procedure (EDP) since 2004. That year, the EU Council gave Poland and Slovakia time until 2007 to correct the excessive deficit, while the respective deadline was set to 2008 for the other two countries. Last year, the deadline for Hungary was shifted to 2009. Based on the most recent updates of the convergence programs, the EU Council concluded that Slovakia and Hungary are on track to meet these deadlines, provided that policy plans are fully implemented. This is particularly crucial for Hungary, which has had an ambitious medium-term consolidation program in place since mid-2006 to substantially reduce the deficit from around 9% of GDP recorded in 2006. As for Poland, the measures taken were assessed to be insufficient to meet the 2007 deadline (deficit target for 2007: 3.4% of GDP) and the EU Council issued a recommendation to Poland to take the necessary measures to bring the excessive deficit situation to an end in 2007. The Czech Republic's program, which was submitted only in March 2007 and contains a deficit target of 4% of GDP for 2007 and 3½% for 2008, still awaits assessment by the EU Council.

Bulgaria and Romania submit their first convergence programs after EU accession

Bulgaria and Romania submitted their first convergence programs in December 2006. In its convergence program (which was complemented by an explanatory note in January 2007), Bulgaria expects to achieve a budgetary surplus of 2% this year and 1.5% of GDP in the next two years.¹⁴ Overall, the EU Council provides a positive assessment of Bulgaria's budgetary position. By contrast, the evaluation of Romania's program is rather disapproving: With planned deficits of nearly 3% of GDP in 2007 and 2008, the EU Council particularly criticizes the procyclical nature of the fiscal program in a setting of already high external imbalances.

¹³ Euro area members are required to submit stability programs, while the other EU Member States have to submit convergence programs (and annual updates).

¹⁴ Moreover, vis-à-vis the IMF, Bulgaria recently pledged to increase its surplus target to 2.3% of GDP in an effort to contain the country's external imbalances.

Croatia and Turkey recently tabled new Pre-Accession Economic Programmes. The Croatian program foresees a further reduction of fiscal deficits from 2.2% in 2006 to 1.5% in 2009, while not always being very specific on the underlying measures taken to achieve these targets. A similar picture emerges for Turkey and its pledge of continued fiscal restraint, following up on its performance in recent years.¹⁵ However, the program remains rather generic on how to achieve this objective and how to contain medium-term fiscal risks. Joint conclusions on these programs (and on the program submitted by the Republic of Macedonia) will be issued in the context of the ministerial dialogue meeting between the economics and finance ministers of the EU and the candidate countries in May 2007.

**Croatia and Turkey
present Pre-Accession
Economic Programmes**

Over the last months, some countries in the region have been affected by political turbulence. In Hungary, the sharp divide between the two main political camps has persisted. The governments of Poland and the Czech Republic are based on fragile coalitions. In Slovakia, the coalition has been stable, but continues to include two smaller parties from the fringes of the political spectrum. In Romania, the President of the Republic was impeached by parliament in mid-April 2007 after massive disputes between the President and the Prime Minister. The upcoming presidential and parliamentary elections in Turkey and Russia might also lead to some uncertainties. While these political jitters have not affected economic performance so far, they could easily put a drag on growth in the medium term.

**Political noise across the
region**

Within the review period, Standard & Poor's upgraded Poland's long-term foreign-currency rating as economic growth gained momentum. Moody's, in turn, downgraded Hungary's rating. This step was motivated by the tense fiscal situation in the country, which is seen as a major challenge.

**Upgrading of Poland,
downgrading of Hungary**

Table 4

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt

Currency	Moody's		Standard & Poor's	
	Current rating*	Last change (former rating)	Current rating**	Last change (former rating)
Slovenian tolar	Aa2	Jul 2006 (Aa3)	AA	May 2006 (AA-)
Bulgarian lev	Baa3	Mar 2006 (Ba1)	BBB+	Oct 2006 (BBB)
Czech koruna	A1	Nov 2002 (Baa1)	A-	Nov 1998 (A)
Hungarian forint	A2	Dec 2006 (A1)	BBB+	Jun 2006 (A-)
Polish zloty	A2	Nov 2002 (Baa1)	A-	Mar 2007 (BBB+)
Romanian leu	Baa3	Oct 2006 (Ba1)	BBB-	Sep 2005 (BB+)
Slovak koruna	A1	Oct 2006 (A2)	A	Dec 2005 (A-)
Croatian kuna	Baa3	Jan 1997	BBB	Dec 2004 (BBB-)
Turkish new lira	Ba3	Dec 2005 (B1)	BB-	Aug 2004 (B+)
Russian ruble	Baa2	Oct 2005 (Baa3)	BBB+	Sep 2006 (BBB)

Source: Bloomberg.

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

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

¹⁵ Under Turkey's Stand-By Arrangement with the IMF, both parties reached an understanding that Turkey may maintain a primary surplus target of at least 6.5% of GNP through 2008.

Economic Outlook for Central and Eastern European Countries

The OeNB compiles semiannual forecasts of economic developments in Poland, Hungary, the Czech Republic as well as Russia. Taken together, the 3 EU Member States account for more than 60% of the 12 new EU Member States' overall GDP and are thus representative of trends in this EU region.¹

In the **three new EU Member States discussed** here, year-on-year real GDP growth in **2007** is predicted to accelerate slightly to 6% in Poland, while it will decelerate to about 5% in the Czech Republic and to below 3% in Hungary.

Three New EU Member States and Russia: Forecast of March 2007

Annual change at constant prices in %

GDP	2003	2004	2005	2006	2007 ¹	2008 ¹
Czech Republic	3.6	4.2	6.1	6.1	5.1	4.6
Hungary	4.1	4.9	4.2	3.9	2.7	3.0
Poland	3.9	5.3	3.5	5.8	6.0	5.5
Russia	7.4	7.1	6.4	6.7	6.4	6.0

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

¹ Forecast.

In the **Czech Republic**, growth rates of (private and public) consumption and gross fixed capital formation will slow down slightly but remain at solid levels. Real income will continue to increase, while employment is expected to rise only moderately. There are signs of a slowdown in growth of consumer lending. Export and import growth rates will decline by around 4 percentage points. The contribution of net exports to GDP growth is expected to be about neutral.

In **Poland**, private consumption will go up on the back of high employment growth combined with high nominal wage growth. ULC and inflation are expected to increase only moderately, while credit growth will remain considerable. The growth of gross fixed capital formation will be supported by high profitability, conducive financing conditions and further improvements in the absorption of structural funds. Import growth is expected to slow down to a lesser extent than export growth, so that the negative contribution of net exports will increase. However, the positive evolution of domestic demand will more than compensate the negative contribution of net exports.

In **Hungary**, private and public consumption growth will decline, which is largely attributable to the fiscal consolidation program. Real net disposable income is expected to decrease, even assuming no significant moderation of gross nominal wages in the private sector. After declining in 2006, gross fixed capital formation growth is expected to recover marginally in 2007. The deceleration of export growth will be accompanied by a slowdown of import dynamics, especially as domestic demand continues to contract. The positive contribution of net exports to GDP growth will be somewhat higher than in 2006.

In **2008**, economic developments in the **Czech Republic** will essentially hinge on the extent to which the government will be able to push its reform package through parliament. Assuming full implementation, private consumption would be boosted by the planned reduction of income tax to 15%, but could be impaired by the intended increase of the VAT rate from 5% to 9% and by substantial cuts in social transfers. Gross fixed

¹ These forecasts are based on preliminary global growth projections and technical assumptions about oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem by means of broad macroeconomic projection exercises. These assumptions are central to the current outlook for two reasons: first, the sizeable export links of the three new EU countries with the euro area, and second, the fact that Russia is one of the world's largest oil-producing nations and that energy sources account for some 60% of the country's total exports. The forecast for Russia is prepared by the OeNB in collaboration with Suomen Pankki – Finlands bank.

capital formation will augment in particular owing to the construction of an automotive parts production plant. Exports and imports will continue to grow at roughly the same speed as in 2007.

In **Poland**, a moderate rise in ULC and a slight increase in inflation are expected to dampen private consumption. Employment growth is expected to slacken, and credit growth will be dampened slightly. Gross fixed capital formation will decrease owing to lower profitability, monetary tightening and a slower increase in the absorption of structural funds. Export growth will remain stable, while import growth will slow down, which will result in a less negative contribution of net exports to GDP growth.

Economic growth in **Hungary** is expected to pick up moderately in 2008. Private consumption will grow marginally as a result of a modest recovery of employment and the stabilization (or minor increase) of real wages. Public consumption will continue to decline, whereas gross fixed capital formation is expected to pick up. On the external side, export growth will moderate slightly despite some acceleration of euro area import demand. A modest increase of domestic demand will cause import growth to rise, so that the contribution of net exports is expected to be less positive than in 2006 and 2007.

Regarding possible sources of **risk** to these forecasts, sizeable deviations from the built-in assumptions for external factors are possible, e.g. for import growth of the countries' main trading partners and for oil price developments. Exchange rate developments represent a further risk factor to the forecasts. Additionally, some uncertainty remains about the implementation of fiscal reforms. In Poland, in particular, growth of domestic demand hinges upon solid further employment growth. However, there are some signs of labor shortage in the Polish economy which might have a moderating effect on domestic demand growth.

In **Russia**, the economy is projected to grow at a robust pace in **2007** and **2008**, largely due to high consumption and investment growth. Private consumption is expected to expand robustly owing to continued buoyant rises in real income and strong lending growth. Government consumption is expected to speed up further over the following two years. Gross fixed capital formation is predicted to continue growing strongly, driven by huge projects in the energy sector and increased public investment. Rapid economic growth and further real appreciation of the ruble will sustain strong import growth. Exports are expected to expand at approximately the same pace as in 2006.

Regarding **risk** factors for Russian growth, oil price developments remain the key factor, given the persisting dependence of the Russian economy on the extraction and export of raw materials. Another risk factor consists in the possibility of an excessively quick appreciation of the real exchange rate, triggered by accelerating inflows of energy proceeds and/or capital inflows. Such a quick appreciation could have repercussions for Russia's competitiveness, with the Dutch disease looming. Furthermore, political uncertainty brought on by elections to the lower house of parliament, the Duma, in late 2007 and the 2008 presidential election pose an additional risk to the projection.

2 Slovenia Successfully Completed the Euro Changeover

GDP growth strengthens ahead of euro adoption

Slovenia's GDP growth accelerated from 4% in 2005 to 5.2% in 2006, with economic activity being particularly strong in the second half of the year. Economic growth was driven by domestic demand. Real net exports made a small negative contribution to growth, after having been a strong growth-supporting factor in 2005. Within domestic demand, gross fixed capital formation posted the highest growth and provided the largest contribution to growth. Investment activity, which strengthened considerably in the second half of 2006, was strong in machinery and equipment as well as construction. It was supported by public investment in motorway construction, rapid and accelerating growth credit to households and enterprises (with real growth credit to the private sector edging up to almost 23% by end-2006), and possibly by the payroll tax cut in early 2006. Consumption growth was slightly stronger than in 2005 on account of strengthening public consumption, while private consumption increased at roughly the same rate as in 2005. Export growth remained stable in 2006 despite rather favorable external conditions, while import growth accelerated on the back of strong domestic demand.

Deficit on combined current and capital account widens, net FDI outflow continues

Slovenia's deficit on the combined current and capital account amounted to 3% of GDP, slightly up from 2005. This deficit stemmed primarily from the income balance, but also from the balance on goods and services, the transfer balance and the capital account. The widening of the deficit in 2006 was almost evenly attributable to the goods and services balance, the income balance and transfers. Slovenia registered larger net FDI outflows than in 2005, mainly on account of smaller FDI inflows into the country, while Slovenian companies continued to expand into neighboring countries.

Small inflationary effect of the euro changeover

Annual average inflation remained stable at 2.5% in 2006. Preventing inflation from accelerating after the euro changeover represented a major economic policy challenge around the turn of the year, given that the inflation rate had fluctuated between 1.5% and 3.4% year on year during the first three quarters. In fact, the Slovenian Statistical Office registered unusual systematic price increases in some goods and services categories (mainly in restaurants, bars, for personal services, furniture and textiles) in December 2006. These price increases contributed to the rise in the overall inflation rate from 2.4% in November to 3% in December and in the core inflation rate (excluding energy and unprocessed food prices) from 2% to 2.6%. Encouragingly, however, price pressures eased at the beginning of 2007, with inflation falling to 2.3% in February, before edging up again to 2.6% in March (owing to developments in energy and unprocessed food prices). According to preliminary information by Eurostat, the total impact of the euro changeover on consumer price inflation in Slovenia during and after the changeover period may have been around 0.3 percentage point. This is in line with the experience of the first-wave changeover. Given that "teuro"¹⁶ fears proved largely unfounded, inflation expectations – as measured by the European Commission's monthly consumer survey – also receded rapidly during the first quarter of 2007, thus almost fully reversing the sharp increase between mid-2005 and end-2006.

¹⁶ *Teuro* (a combination of "euro" and the German word for expensive, *teuer*) refers to the widely-held suspicion that many retailers took advantage of the introduction of the euro to push up prices.

Similarly, ULC growth (in the whole economy) decelerated to about 1% (preliminary data) in 2006 and consumption-driven inflationary factors were contained, which bodes well for the inflation outlook. At the same time, however, net real wage growth (in the whole economy) has accelerated since September 2006 (to 5.5% year on year in January 2007). This development needs to be monitored. According to Banka Slovenije's March 2007 projection, annual average inflation should climb to 2.7% in 2007 and remain at that level in 2008. Wage developments or a possible increase in VAT rates (to compensate for lower personal and corporate income tax revenues) are seen as the major country-specific upward risks to the forecast.

As a result of successful convergence over the past years, Slovenia joined the euro area at the beginning of 2007. With regard to monetary developments in the country, the final months of 2006 were characterized by a continued exchange rate stability against the euro and the convergence of short-term interest rates (long-term interest rates had converged to euro area levels significantly earlier). Interest rate convergence over the second half of 2006 was achieved as short-term interest rates in the euro area went up more pronouncedly than those in Slovenia. As a result, real interest rates (in ex-post terms) increased slightly in Slovenia, but this seems to have been insufficient to cool credit demand, as also evidenced by real growth of credit to the private sector picking up in 2006.

The budget deficit amounted to 1.4% of GDP in 2006, which was almost the same as in 2005 and slightly lower than predicted both in the European Commission's Autumn 2006 forecast and in Slovenia's 2006 December stability program (both 1.6%). The decline in the deficit ratio was supported by a strengthening of economic activity. However, the negative impact of the payroll tax cut on budget revenues may also have been counterbalanced by spending cuts. According to the stability program, the deficit ratio should stay at 1.5% and 1.6% of GDP in 2007 and 2008, respectively, before falling back to 1% in 2009. This means that consolidation is backloaded and is expected to result from a significant decrease in both revenue and expenditure ratios. Despite a more favorable macroeconomic outlook, the program envisages the 1% deficit target to be reached one year later than expected in the previous program. This delay is attributed to a major railway project, Slovenia's EU presidency in the first half of 2008 and to the country's entry into the Schengen area. In addition, the consolidation path will not meet the target set in the revised Stability and Growth Pact, which specifies an annual improvement in the structural balance by 0.5% of GDP for euro area and ERM II members until their medium-term budgetary objective is reached. As a result, the EU Council has urged Slovenia to take advantage of the favorable economic conditions, speed up the achievement of the medium-term budgetary objective and improve the long-term sustainability of public finances in particular by strengthening the ongoing pension reform with additional measures.

**Slovenia becomes
13th euro area member**

**Budget outcome proved
better than expected in
2006, but may
worsen in 2007**

Table 5

Main Economic Indicators: Slovenia									
	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	4.4	4.0	5.2	3.8	3.9	5.0	4.7	5.6	5.5
Private consumption	2.6	3.4	3.3	3.4	2.7	3.1	3.4	3.6	3.1
Public consumption	3.4	2.2	3.8	2.4	2.2	4.4	3.5	3.0	4.2
Gross fixed capital formation	7.9	1.5	11.9	-2.1	7.0	8.6	8.5	14.6	15.2
Exports of goods and services	12.5	10.5	10.0	10.7	10.9	14.9	9.4	6.9	9.5
Imports of goods and services	13.4	7.0	10.4	7.1	10.7	13.8	9.0	8.4	10.7
Contribution to GDP growth in percentage points									
Domestic demand	5.3	1.9	5.6	1.4	4.2	4.3	4.5	6.7	6.9
Net exports of goods and services	-0.9	2.0	-0.4	2.2	-0.3	0.6	0.2	-1.0	-1.4
Exports of goods and services	7.4	6.8	6.8	7.0	7.1	9.7	6.4	4.8	6.6
Imports of goods and services	8.3	4.8	7.2	4.8	7.4	9.1	6.2	5.9	8.0
Year-on-year change of period average in %									
Labor productivity of industry (real)	6.4	5.9	8.8	5.4	9.8	10.2	7.2	9.9	8.1
Gross average wage of industry (nominal)	7.1	5.8	5.5	5.3	5.9	6.5	5.8	4.3	5.4
ULC of industry (nominal)	0.7	-0.1	-3.1	-0.0	-3.5	-3.4	-1.3	-5.1	-2.5
PPI of industry	4.4	2.8	2.4	2.0	1.8	1.6	2.4	2.8	2.7
CPI (here: HICP)	3.7	2.5	2.5	2.3	2.6	2.3	3.1	2.5	2.3
EUR per 1 SIT, + = SIT appreciation	-2.2	-0.2	-0.0	0.2	0.1	0.1	-0.0	-0.1	-0.1
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	6.5	6.7	6.1	6.5	7.4	7.0	6.0	5.7	5.7
Employment rate (15-64 years)	65.3	66.0	66.6	66.6	66.0	65.9	67.1	67.2	66.1
Key interest rate p. a. (%)	4.6	4.0	3.5	4.0	4.0	3.8	3.5	3.4	3.5
SIT per 1 EUR	239.1	239.6	239.6	239.5	239.5	239.5	239.6	239.6	239.6
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits) ¹	5.1	6.6	8.3	5.0	7.1	8.0	9.3	7.9	8.2
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	-8.1	-10.4	-15.6	-10.0	-10.1	-14.5	-15.2	-16.2	-16.3
Domestic credit of the banking system	14.0	19.7	27.1	18.9	21.3	24.3	25.5	28.3	29.9
of which:									
claims on the private sector	11.5	16.6	26.8	16.8	18.3	23.8	26.4	27.3	29.6
claims on households	2.7	4.4	7.0	4.5	4.9	6.3	7.1	7.2	7.5
claims on enterprises	8.8	12.3	19.8	12.2	13.4	17.5	19.3	20.1	22.1
claims on the public sector (net)	2.4	3.0	0.3	2.2	3.0	0.6	-0.8	1.1	0.4
Other domestic assets (net) of the banking system	-0.8	-2.7	-3.2	-3.9	-4.0	-1.8	-1.1	-4.3	-5.5
% of GDP (ESA 95)									
General government revenues	45.1	45.6	44.8	..	..	..	..	..	..
General government expenditures	47.4	47.0	46.3	..	..	..	..	..	..
General government balance	-2.3	-1.5	-1.4	..	..	..	..	..	..
Primary balance	-0.5	0.2	0.2	..	..	..	..	..	..
Gross public debt	28.9	28.4	27.8	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	13.3	12.9	16.4	11.0	12.1	19.4	13.9	15.8	16.7
Merchandise imports	16.6	12.1	15.9	12.4	15.3	19.3	14.1	15.2	15.1
% of GDP (based on EUR), period total									
Trade balance	-3.8	-3.7	-3.7	-3.4	-7.3	-3.0	-1.5	-3.4	-7.0
Services balance	2.6	3.1	2.9	3.4	3.5	3.0	3.3	2.8	2.4
Income balance (factor services balance)	-1.2	-1.0	-1.2	-0.9	-1.4	-1.1	-1.0	-1.2	-1.3
Current transfers	-0.3	-0.3	-0.6	0.1	-0.4	-1.3	-0.1	-1.0	0.0
Current account balance	-2.7	-2.0	-2.6	-0.9	-5.6	-2.4	0.7	-2.8	-5.9
Capital account balance	-0.4	-0.4	-0.4	-0.3	-0.8	-0.1	-0.3	-0.4	-0.7
FDI (net)	0.9	-0.2	-1.0	0.0	1.6	-0.9	-0.8	0.0	-2.4
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	58.5	71.0	80.3	67.6	71.0	75.9	78.2	78.4	80.3
Gross official reserves (excluding gold)	24.6	24.7	18.0	24.9	24.7	24.4	22.7	19.9	18.0
Months of imports of goods and services									
Gross official reserves (excluding gold)	4.8	4.6	3.1	4.7	4.6	4.4	4.0	3.5	3.1
EUR million, period total									
GDP at current prices	26,230	27,634	29,742	7,006	7,081	6,848	7,632	7,590	7,671

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

¹ The methodology for calculating broad money and its components was changed for data as of January 2005 (thus affecting year-on-year rates as of January 2006).

3 Bulgaria: Alongside Strong Growth, External Imbalances Deepen despite Rising Fiscal Surpluses

Real GDP in Bulgaria grew by 6.1% in 2006, mainly driven by robust private consumption and buoyant gross fixed capital formation as well as supported by an expansion of credit to households and companies. Real growth of credit to the private sector came to around 17% at end-2006, which was slower than a year earlier but still fairly vibrant.¹⁷ Export growth decelerated considerably in the second half of 2006, while imports continued to grow strongly. Thus, the negative contribution of net exports to GDP growth rose to almost 10 percentage points for full-year 2006. Positively, imports mainly consisted of investment goods and intermediate goods, thus supporting the industrial sector.

Strong economic growth continues to bear fruit for the labor market. Compared with 2005, employment increased by 4.2% in 2006, whereas the annual unemployment rate (ILO definition) declined to 9% in 2006. In addition to growing labor utilization, Bulgaria's labor productivity in industry improved substantially, almost fully offsetting nominal wage growth. Bulgaria has been pursuing prudent wage policies for some years, with a view to preserving international competitiveness.

In the context of the currency board arrangement which has been in place for ten years, sustaining a sound competitive position is crucial for taming external vulnerabilities. This is particularly important as the combined current and capital account deficit is expected to widen to 15% of GDP in 2006. The high external deficit is essentially fueled by a large trade deficit. As in previous years, the external deficit was fully covered by net FDI inflows, which amounted to 16% of GDP. While becoming more concentrated, net FDI grew by 50% in 2006 compared with 2005. At end-2006, industry accounted for 29% in the total FDI stock, the financial intermediation sector for 18% and real estate and construction (which grew fast in 2005 and 2006) for 23%. Bulgaria's net foreign debt-to-GDP ratio has been broadly stable over the past few years, amounting to 11.6% of GDP at end-2006. However, this aggregate picture conceals a significant increase in the private sector's net foreign debt, as banks have increasingly refinanced domestic lending through foreign funds and also nonbanks have increasingly reverted to direct borrowing abroad. This rise was compensated by a substantial improvement in the public sector's net foreign position (build-up of central bank reserves). It is noteworthy that net foreign debt is much lower than gross foreign debt (76.5% of GDP), mainly because of high central bank reserves and, to some extent, because of commercial banks' asset holdings abroad.

Average HICP inflation increased to 7.4% in 2006. This rise was caused by higher oil prices and a substantial increase in excise duties as part of a frontloaded harmonization with EU tax rates and administered prices. The HICP inflation rate dropped to 4.5% in February and March 2007. Apart from base effects, lower energy prices, a moderation of food prices and possibly the entry into the Single Market have had dampening effects on inflation. Bulgaria's

Domestic demand continues to drive strong economic growth

Robust wage growth largely offset by productivity improvements

Combined current and capital account deficit deteriorates further, but is fully covered by net FDI inflows

Annual inflation rate peaked in 2006 but dropped in February and March 2007

¹⁷ A sectoral disaggregation of gross fixed capital formation, which would shed further light on the most actively investing branches, is not yet available for 2006.

Table 6

Main Economic Indicators: Bulgaria									
	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	6.6	6.2	6.1	5.4	6.0	5.5	6.4	6.7	5.7
Individual consumption	4.9	7.4	7.4	9.4	7.1	5.4	7.4	7.4	7.4
Collective consumption	6.7	2.2	2.2	4.3	-4.7	0.1	1.2	1.2	1.2
Gross fixed capital formation	13.5	23.3	17.6	28.4	25.9	17.1	16.0	11.1	23.8
Exports of goods and services	12.7	8.5	9.0	2.0	10.7	12.7	10.0	8.4	5.4
Imports of goods and services	15.7	13.1	15.2	17.0	12.9	20.8	12.2	14.7	14.0
Contribution to GDP growth in percentage points									
Domestic demand	11.0	13.0	15.4	18.3	11.5	19.4	12.8	13.8	16.5
Net exports of goods and services	-4.3	-6.8	-9.3	-12.9	-5.5	-13.9	-6.4	-7.1	-10.8
Exports of goods and services	9.2	6.4	6.9	1.7	7.1	9.4	8.5	6.9	3.7
Imports of goods and services	13.6	13.2	16.2	14.6	12.5	23.4	14.8	14.0	14.5
Year-on-year change of period average in %									
Labor productivity of industry (real)	15.2	3.4	8.2	2.3	6.7	10.1	8.5	9.0	5.0
Gross average wage of industry (nominal)	6.3	8.1	10.8	8.5	9.2	9.4	9.4	11.7	12.7
ULC of industry (nominal)	-7.8	4.6	2.5	6.1	2.4	-0.6	0.8	2.5	7.3
PPI of industry	5.9	7.0	9.4	6.7	7.9	8.4	10.0	10.7	8.3
CPI (here: HICP)	6.1	6.0	7.4	6.9	7.8	8.7	8.6	6.7	5.7
EUR per 1 SIT, + = SIT appreciation	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	12.2	10.2	9.0	9.3	10.0	9.8	9.0	8.9	8.4
Employment rate (15-64 years)	54.2	55.8	58.6	57.9	56.0	55.5	59.1	60.3	59.8
Key interest rate p. a. (%)	2.6	2.1	2.6	2.0	2.0	2.2	2.5	2.7	3.1
SIT per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	22.3	27.3	21.3	27.1	26.5	19.2	17.0	22.3	26.1
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	4.4	8.9	14.7	11.3	8.6	8.3	10.7	16.0	22.6
Domestic credit of the banking system	21.8	25.8	13.0	23.6	26.0	18.5	12.7	12.2	9.4
of which:									
claims on the private sector	26.3	27.9	16.4	25.0	23.6	17.9	12.6	17.3	17.7
claims on households	10.0	13.0	9.4	13.1	13.1	11.7	9.2	8.8	8.3
claims on enterprises	16.3	14.9	7.0	11.9	10.5	6.2	3.5	8.5	9.4
claims on the public sector (net)	-4.5	-2.1	-3.4	-1.4	2.4	0.6	0.0	-5.2	-8.3
Other domestic assets (net) of the banking system	-3.8	-7.4	-6.4	-7.8	-8.2	-7.6	-6.4	-5.9	-5.9
% of GDP (ESA 95)									
General government revenues	41.4	41.4	39.9	..	..	..	..	..	..
General government expenditures	39.3	39.5	36.6	..	..	..	..	..	..
General government balance	2.2	1.9	3.3	..	..	..	..	..	..
Primary balance	4.0	3.4	4.6	..	..	..	..	..	..
Gross public debt	37.9	29.2	22.8	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	19.7	18.6	26.6	10.6	21.9	28.4	31.8	32.1	15.6
Merchandise imports	20.3	26.9	25.2	32.6	26.2	33.0	21.9	25.8	22.1
% of GDP (based on EUR), period total									
Trade balance	-14.9	-20.2	-21.5	-19.2	-22.8	-20.6	-19.3	-18.9	-26.5
Services balance	3.3	3.7	2.9	11.6	-1.8	-3.5	3.5	10.9	-1.1
Income balance (factor services balance)	1.2	0.7	0.2	0.6	0.2	0.3	0.7	-0.3	0.0
Current transfers	3.7	3.7	2.6	3.4	3.8	2.3	2.6	3.2	2.2
Current account balance	-6.6	-12.0	-15.8	-3.6	-20.7	-21.4	-12.5	-5.1	-25.4
Capital account balance	0.8	1.0	0.7	1.2	1.1	0.4	0.8	0.7	0.9
FDI (net)	11.3	14.5	15.9	20.2	12.1	15.0	20.5	11.6	16.9
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	63.3	69.1	76.5	66.9	69.1	71.6	74.1	77.5	76.5
Gross official reserves (excluding gold)	32.4	31.1	33.1	31.9	31.1	28.6	31.3	32.5	33.1
Months of imports of goods and services									
Gross official reserves (excluding gold)	5.7	4.9	4.8	5.2	4.9	4.3	4.7	4.8	4.8
EUR million, period total									
GDP at current prices	19,874	21,882	25,100	6,097	6,064	5,102	5,954	7,026	7,018

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

convergence program projects the HICP to decrease to 4% in 2007 and to 3% in 2008.

Growth of domestic credit to the private sector decelerated in 2006, but still remained dynamic and even somewhat higher than the Bulgarian National Bank (BNB) had originally projected. Lending growth to households roughly halved in the course of 2006, apparently owing to prudential and administrative measures. At the same time, cross-border lending of enterprises and inter-company loans expanded remarkably by 76% and 37%, respectively. From January 2007, the BNB lifted the quantitative restrictions on credit growth, partly owing to the success achieved in slowing credit growth and partly because enterprises had increasingly turned to less easily traceable sources of credit (leasing companies, retailers and intercompany loans). Prudential regulation (e.g. risk weights and loan-to-value ratios) remains strict, aiming to contain annual bank credit growth to the private sector in 2007 to 20%.

Bulgaria is retaining the monetary integration strategy it adopted in 2004. The country intends to apply for ERM II membership in 2007 and to fulfil the convergence criteria in the medium term so as to qualify for euro area entry between 2010 and 2012.

The general government surplus increased further and reached 3.3% of GDP in 2006. This improvement against 2005 stemmed from a considerable reduction in expenditures (–3% of GDP) which was not fully matched by a decrease in revenues. Bulgaria's convergence program contained a surplus target of 0.8% of GDP for 2007, but in view of the high current account deficit, the Bulgarian government recently agreed with the IMF on a revised fiscal surplus target of 2.3% of GDP for 2007. To put this target into perspective, it is worth noting that EU accession increases budget expenditures (membership contributions, co-financing needs). According to the IMF, the World Bank and the European Commission, Bulgaria will have to further improve the efficiency of public spending, in particular in the health care, pension and education systems. According to the EU Council's opinion on Bulgaria's convergence program, the country's medium-term budgetary position is sound. At the same time, the EU Council calls on Bulgaria to maintain a high degree of fiscal prudence to preserve stability and contain external imbalances.

4 Czech Republic: Strong Growth Continues but Appears to Have Passed Its Peak

In 2006, GDP growth in the Czech Republic continued to be robust at 6.1%, the same pace as in 2005. Output expansion peaked in the first quarter of 2006 but has slowed down a bit since. In addition, the sources of growth have changed significantly. While net foreign trade was the dominant driver in 2005, contributing more than two-thirds to GDP growth, its impact was weaker but still substantial in the first quarter of 2006. From then on, however, the contribution of net foreign trade has faded into insignificance, as import growth gathered speed in the wake of strengthening domestic demand and high energy prices. Hence, the overall contribution of net exports virtually disappeared in 2006 and the economy accelerated solely on the back of domestic demand. This surge in domestic demand can be ascribed to all its

Credit growth decelerated but is still dynamic, BNB lifts quantitative restrictions

Monetary integration plans

Fiscal surplus outperforms expectations in 2006

Domestic demand replaces net exports as the main driver of growth

components except public consumption which, owing to base effects, increased only barely (purchase of military aircraft in 2005). By contrast, private consumption posted one of the highest growth rates ever. The contribution of gross fixed investment was only slightly lower, also taking off compared with 2005 – a development which was chiefly attributable to investment in means of transport. Household consumption benefited from higher employment and real disposable incomes, while household and corporate demand was fueled by the continued fast real expansion of credit to the private sector (+18% by end-2006). Swelling inventories made up one-third of GDP growth.

Labor market improves

As a consequence of robust growth, unemployment declined in the course of 2006. This development was potentially also supported by the fact that (nominal) ULC in industry fell for the fourth year in a row as labor productivity increased at a robust pace. Nominal industrial wage growth picked up in 2006, but so did productivity growth.

Combined capital and current account balance deteriorates despite a higher trade surplus

As in 2005, the balance of foreign trade in goods and services displayed a surplus in 2006. In line with earlier years, trade in vehicles and machines contributed most to this result, particularly owing to production increases at the country's major car producers Škoda Auto and TPCA.¹⁸ By contrast, the deficit on the income account, which was chiefly ascribable to high profits of foreign-owned companies, grew further and came to more than 6% of GDP. For that reason, the combined current and capital account deficit (as a percentage of GDP) more than doubled compared with 2005. The financing need was covered by capital inflows, the lion's share of which stemmed from net FDI inflows.

Inflation easing again?

The HICP rose moderately in 2006 to an annual average of slightly more than 2%. The pressure on prices was a bit more pronounced in the first three quarters of the year, when the HICP hovered around 2.5%, particularly owing to high energy prices (until late summer) and adjustments in administered prices. In the fourth quarter of 2006, however, inflation dropped considerably, but started to pick up again from the very low levels recorded in late 2006, reaching 2.1% in March 2007. In the latter part of 2006, the declining oil price was a main driving force behind inflation relief. Moreover, throughout the year, inflation performance was supported by the nominal appreciation of the Czech koruna against the euro. Since mid-2006, the Czech currency has gained some 1.7% vis-à-vis the euro: Appreciation came to 3.5% in the second half of 2006, but some of the earlier gains have been reversed in the first months of 2007. The CPI, the actual target index of Česká národní banka (ČNB) – which has, on average, been some 0.2 to 0.3 percentage point higher than the HICP since 2003 – crept up to 2.6% in 2006. Hence, it finished within the target range of 3% (± 1 percentage point) that was introduced in January 2006.¹⁹ For December 2007, the ČNB forecasts inflation to range between 2.4% and 3.8%. According to the ČNB, major country-specific downside risks to this forecast are a stonger-than-expected exchange rate as well as the lower-than-expected inflation over the past months. Upside risks

¹⁸ Joint car production plant by Toyota, Peugeot and Citroën in Kolín.

¹⁹ The main reasons for this discrepancy are (1) different weights used in the indices, (2) the treatment of purchases of goods by foreigners and (3) the treatment of imputed rents.

Table 7

Main Economic Indicators: Czech Republic

	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	4.2	6.1	6.1	6.0	6.7	6.4	6.2	5.9	5.8
Private consumption	2.6	2.8	4.6	3.1	3.0	4.1	4.3	4.4	5.4
Public consumption	-3.2	1.0	0.3	4.9	-0.1	2.4	-1.9	-1.8	2.6
Gross fixed capital formation	4.7	1.3	7.3	1.7	3.2	6.8	7.0	8.0	7.6
Exports of goods and services	21.1	10.4	14.6	10.6	10.1	18.4	10.9	11.7	17.4
Imports of goods and services	18.2	4.8	14.2	5.9	4.9	16.4	11.3	10.9	18.1
Contribution to GDP growth in percentage points									
Domestic demand	3.5	1.7	6.0	2.5	2.5	4.7	6.6	5.5	7.0
Net exports of goods and services	0.7	4.4	0.1	3.5	4.2	1.7	-0.4	0.4	-1.2
Exports of goods and services	15.0	8.6	12.6	8.6	8.7	15.6	9.4	9.9	15.5
Imports of goods and services	14.3	4.2	12.5	5.1	4.6	14.0	9.8	9.5	16.7
Year-on-year change of period average in %									
Labor productivity of industry (real)	9.4	6.8	8.6	7.8	8.2	12.9	7.1	7.0	7.6
Gross average wage of industry (nominal)	7.1	4.6	6.8	5.0	4.3	6.3	6.5	7.5	6.8
ULC of industry (nominal)	-2.1	-2.1	-1.7	-2.6	-3.6	-5.8	-0.5	0.5	-0.8
PPI of industry	5.7	3.0	1.6	1.4	0.0	0.3	1.3	2.5	2.2
CPI (here: HICP)	2.6	1.6	2.1	1.6	2.2	2.4	2.5	2.4	1.1
EUR per 1 SIT, + = SIT appreciation	-0.2	7.1	5.1	6.4	6.2	4.9	6.2	4.8	4.5
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	8.4	8.0	7.2	7.8	7.8	8.0	7.1	7.1	6.6
Employment rate (15-64 years)	64.2	64.8	65.3	65.2	65.2	64.8	65.3	65.4	65.6
Key interest rate p. a. (%)	2.2	2.0	2.2	1.8	2.0	2.0	2.0	2.3	2.5
SIT per 1 EUR	31.9	29.8	28.3	29.7	29.3	28.6	28.4	28.3	28.0
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	10.3	6.4	12.6	6.2	8.1	12.5	12.2	12.8	12.8
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	2.9	5.2	1.2	7.9	9.5	11.4	3.1	-4.2	-4.6
Domestic credit of the banking system	7.1	0.7	9.3	-1.0	0.9	3.0	6.5	13.0	14.3
of which:									
<i>claims on the private sector</i>	6.0	8.6	11.9	9.3	10.0	11.5	11.8	12.1	12.1
<i>claims on households</i>	4.4	5.4	6.7	5.6	6.0	6.5	6.5	6.8	6.9
<i>claims on enterprises</i>	1.5	3.2	5.2	3.8	4.1	5.0	5.3	5.3	5.3
<i>claims on the public sector (net)</i>	1.2	-7.9	-2.6	-10.4	-9.1	-8.5	-5.3	0.9	2.1
Other domestic assets (net) of the banking system	0.3	0.5	2.0	-0.6	-2.4	-1.9	2.6	4.0	3.2
% of GDP (ESA 95)									
General government revenues	41.5	40.4	39.5	..	..	..	..	..	..
General government expenditures	44.4	44.0	42.5	..	..	..	..	..	..
General government balance	-2.9	-3.5	-2.9	..	..	..	..	..	..
Primary balance	-1.7	-2.4	-1.8	..	..	..	..	..	..
Gross public debt	30.7	30.4	30.4	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	25.6	16.5	20.0	15.1	15.5	23.0	17.5	17.3	22.0
Merchandise imports	21.4	12.3	19.9	13.1	12.7	24.0	19.4	15.9	20.6
% of GDP (based on EUR), period total									
Trade balance	-1.0	1.3	1.5	-0.1	0.1	3.6	0.9	0.6	0.9
Services balance	0.4	0.7	0.4	0.9	0.3	0.1	0.4	0.8	0.3
Income balance (factor services balance)	-5.7	-4.8	-6.3	-4.9	-3.7	-3.5	-7.4	-6.9	-7.1
Current transfers	0.2	0.7	-0.3	0.1	0.7	0.0	-0.3	-0.4	-0.5
Current account balance	-6.1	-2.1	-4.7	-4.1	-2.7	0.3	-6.3	-5.9	-6.4
Capital account balance	-0.5	0.2	0.3	0.0	0.3	0.3	-0.2	0.3	0.7
FDI (net)	3.6	8.1	3.9	5.7	4.3	2.5	3.3	4.8	4.8
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	38.1	39.5	39.1	39.3	39.5	37.6	38.3	38.3	39.1
Gross official reserves (excluding gold)	23.8	24.9	20.9	25.5	24.9	23.7	22.4	22.0	20.9
Months of imports of goods and services									
Gross official reserves (excluding gold)	4.0	4.3	3.4	4.4	4.3	4.0	3.7	3.7	3.4
EUR million, period total									
GDP at current prices	87,285	99,767	113,100	25,268	26,409	25,787	28,658	28,725	29,930

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

are the ongoing strong economic performance, and possibly, as suggested by the experience of the mid-1990s, rent deregulation (which was reimplemented at the beginning of 2007). The key interest rate has stayed at 2.5% since September 2006. In reaction to the fact that the target year for euro adoption was deferred from 2010 to an unspecified later date,²⁰ the ČNB has recently announced a new, lower inflation target which is supposed to better reflect the long-term development of the Czech economy. Effective from January 2010, the target for CPI growth will thus be 2% (± 1 percentage point).

**Fiscal balance remains
a problem spot**

Owing to robust economic growth, the general government deficit improved somewhat in 2006 to 2.9% of GDP. A more marked improvement was hindered by tax cuts and increased social spending. For 2007, a substantially higher deficit is expected (4% of GDP) primarily owing to higher social transfers, which are ascribable to a legislation package that was approved before the 2006 elections. The latest update of the convergence program (released in March 2007), which does not touch upon the long-debated necessary reforms of the pension, health care and social transfer systems, foresees a reduction of the deficit to 3.5% in 2008 and to 3.2% in 2009. However, now that the political deadlock after the 2006 elections, which lasted for almost eight months, has been overcome at last, it seems that the new coalition government is determined to accelerate the process of fiscal consolidation. It recently put forward a reform package whose main objective is to slow down growth in mandatory expenditures. The intended measures contain, inter alia, some cuts of social transfers, some parametric changes in the pension system and a removal of most automatic indexation schemes. On the revenue side, the government proposes the introduction of a flat personal income tax, successive reductions of the corporate income tax and an increase in the VAT rate. These adjustments of the tax system are to lead to slightly higher revenues in 2008. However, from 2009 on, the tax cuts are supposed to outweigh the higher VAT revenues, as the government expects changes in the trend and quality of mandatory expenditures to allow a gradual reduction of the tax burden without infringing on deficit targets. Owing to the fact that the government relies on the support by opposition members of parliament, the presented measures are not overly ambitious and it remains to be seen in which form the proposed package will eventually be passed by parliament, if at all.

5 Hungary: Fiscal Tightening Has Taken Its Toll

**Domestic demand
contracts in 2006**

Annual average GDP growth in Hungary slowed only modestly to 3.9% in 2006 compared with 2005. However, output dynamics weakened significantly in the course of the year. Net real exports were the driving force behind growth in 2006, as export growth accelerated on the back of stronger demand in Hungary's major export markets. Import growth accelerated at a slower pace owing to weaker domestic demand than in 2005. This slowdown in domestic demand was mainly attributable to a decrease in investment activity, with construction and investment in machinery and equipment being affected in similar ways. Encouragingly, however, the magnitude of contraction in the latter area became smaller toward the end of 2006. Domestic consumption

²⁰ See Focus on European Economic Integration 2/06.

posted a minor plus for full-year 2006, but its growth rate gradually slowed in the course of the year and was negative in the fourth quarter. This development was ascribable to the contraction of public consumption on the back of the government's fiscal consolidation efforts and the slowing of private consumption, especially in the final quarter of 2006, as real wage growth slumped amid rising inflation and growth of credit to the private sector (in real terms) decelerated by almost 6 percentage points to below 10% year on year.

The 2006 general government budget deficit came in at 9.2% of GDP.²¹ This result was much higher than originally planned (partly for technical and accounting reasons), but slightly below the revised expectations of 10.1% of GDP. Consolidation measures that took effect in the fall of 2006 are estimated to have helped reduce the deficit ratio by about 1.5 percentage points. Structural reforms are being implemented in public administration and in the health care, pension and education systems, with recent changes mainly focusing on the health care sector. In its December 2006 update of the convergence program, the Hungarian government envisages a deficit reduction to 6.8% of GDP in 2007, but according to the finance ministry's latest projections, the deficit may come in somewhat lower (6.6% of GDP), given higher tax revenues and lower debt servicing costs. In subsequent years, the deficit is to be lowered further to reach 2.7% by 2010. Thus, fiscal adjustment is frontloaded and is to be achieved primarily through a reduction in the expenditure ratio. According to the EU Council's assessment, the program is broadly consistent with the targeted correction of the excessive deficit by 2009, and thus in line with the extended deadline set by the EU Council in October 2006. According to the European Commission, risks to the budgetary outcome are represented by somewhat optimistic macroeconomic projections for 2009, by uncertainty surrounding (1) the enforcement of expenditure freezes in 2007 and 2008, (2) the effectiveness of new fiscal rules and the strengthened institutional framework of public finances and (3) the specification and implementation of structural reform steps in public administration and in the health care, pension and education systems.

Compared with 2005, the deficit of the combined current and capital account fell by 1 percentage point to slightly above 5% of GDP in 2006. At the same time, however, the negative net errors and omissions position rose by almost the same amount (to 3% of GDP in 2006 from 2.1% in 2005), which may imply that imports are still to some extent underregistered. The improvement in the combined current and capital account stemmed from a significant narrowing of the deficit during the second half of the year, reflecting fiscal and monetary tightening and favorable export conditions. The goods and services balance showed a small surplus (for the first time since 1997), despite a further deterioration in the terms of trade. The transfer balance also recorded a small surplus. Thus, the deficit of the combined current and capital account was attributable to the income deficit, which even rose against 2005. Slightly more than one-half of the combined current and capital account deficit was

Government finances on a consolidation path

Deficit on combined current and capital account narrows

²¹ About 1.5% of GDP stemmed from the net costs of the 1998 pension reform which established, inter alia, an obligatory funded pillar.

Table 8

Main Economic Indicators: Hungary

	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	4.9	4.2	3.9	4.3	4.8	4.9	3.8	3.8	3.2
Private consumption	3.1	3.9	1.6	2.3	5.6	2.7	2.0	1.7	0.0
Public consumption	1.9	1.9	-2.6	1.3	1.8	-1.6	-1.8	-4.2	-3.0
Gross fixed capital formation	7.7	5.6	-1.8	7.2	2.3	10.2	-3.3	-4.1	-4.6
Exports of goods and services	15.7	11.6	18.0	12.4	12.5	18.5	15.9	17.3	20.1
Imports of goods and services	14.1	6.8	12.6	9.1	8.4	15.7	9.7	10.7	14.7
Contribution to GDP growth in percentage points									
Domestic demand	4.5	0.7	-0.6	2.0	1.7	2.8	-1.6	-1.7	-1.5
Net exports of goods and services	0.4	3.6	4.5	2.2	3.0	2.2	5.4	5.5	4.7
Exports of goods and services	11.9	9.7	16.1	10.2	10.4	16.7	14.3	15.3	18.0
Imports of goods and services	11.6	6.1	11.6	8.0	7.4	14.5	8.9	9.7	13.3
Year-on-year change of period average in %									
Labor productivity of industry (real)	9.7	10.1	11.7	12.3	10.6	16.3	8.6	11.3	10.6
Gross average wage of industry (nominal)	10.0	7.2	8.5	6.7	7.0	8.3	7.7	8.5	9.3
ULC of industry (nominal)	0.3	-2.6	-2.9	-5.0	-3.3	-6.9	-0.8	-2.6	-1.2
PPI of industry	3.6	2.9	6.7	2.6	4.0	4.9	6.5	9.7	5.9
CPI (here: HICP)	6.8	3.5	4.0	3.5	3.2	2.4	2.7	4.6	6.4
EUR per 1 SIT, + = SIT appreciation	0.7	1.5	-6.1	1.3	-2.3	-3.8	-6.4	-10.8	-3.2
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	6.1	7.2	7.5	7.3	7.3	7.7	7.2	7.5	7.5
Employment rate (15-64 years)	56.8	56.9	57.3	57.3	57.1	56.7	57.3	57.6	57.6
Key interest rate p. a. (%)	11.4	7.1	6.8	6.5	6.0	6.0	6.0	7.0	8.0
SIT per 1 EUR	251.7	248.0	264.3	245.6	251.8	254.6	266.8	275.4	260.3
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	11.8	13.8	16.0	14.0	14.4	16.6	16.4	17.0	14.3
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	-1.9	0.6	-2.3	3.1	-0.7	0.0	-1.5	-4.7	-2.7
Domestic credit of the banking system	17.9	15.3	23.6	12.4	17.3	19.1	22.1	29.4	23.4
of which:									
claims on the private sector	21.6	16.6	21.7	14.9	17.7	19.1	21.3	25.8	20.6
claims on households	9.8	7.3	9.4	7.3	8.1	8.5	9.4	10.4	9.2
claims on enterprises	11.8	9.3	12.3	7.6	9.7	10.6	11.9	15.3	11.3
claims on the public sector (net)	-3.8	-1.3	1.9	-2.5	-0.4	0.0	0.9	3.7	2.8
Other domestic assets (net) of the banking system	-4.2	-2.0	-5.3	-1.5	-2.2	-2.5	-4.3	-7.7	-6.4
% of GDP (ESA 95)									
General government revenues ¹	42.5	42.2	43.7	..	..	..	..	..	..
General government expenditures ¹	48.9	50.0	53.0	..	..	..	..	..	..
General government balance ¹	-6.5	-7.8	-9.2	..	..	..	..	..	..
Primary balance ¹	-2.1	-3.7	-5.3	..	..	..	..	..	..
Gross public debt ¹	59.4	61.7	66.0	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	18.1	11.9	16.6	12.4	11.8	19.3	14.1	14.7	18.1
Merchandise imports	15.8	9.2	14.1	13.0	11.2	20.0	11.7	10.9	14.3
% of GDP (based on EUR), period total									
Trade balance	-3.0	-1.7	-0.5	-3.0	-1.4	-1.4	0.0	-1.3	0.6
Services balance	0.3	0.8	1.1	1.2	0.4	0.2	1.3	1.9	1.1
Income balance (factor services balance)	-6.1	-6.3	-6.8	-5.9	-5.8	-6.9	-8.2	-6.2	-6.3
Current transfers	0.3	0.2	0.3	-0.3	0.8	1.0	-0.1	0.4	0.1
Current account balance	-8.5	-6.9	-5.8	-8.1	-6.0	-7.1	-7.0	-5.2	-4.4
Capital account balance	0.3	0.8	0.8	0.3	1.2	0.6	0.2	0.9	1.4
FDI (net)	3.4	4.8	2.7	3.2	10.3	8.7	0.5	5.1	-2.3
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	67.8	75.4	92.3	74.3	75.4	82.3	84.2	87.7	92.3
Gross official reserves (excluding gold)	14.4	17.8	18.4	16.7	17.8	20.2	18.9	19.0	18.4
Months of imports of goods and services									
Gross official reserves (excluding gold)	2.5	3.1	2.9	2.9	3.1	3.4	3.1	3.0	2.9
EUR million, period total									
GDP at current prices	81,283	87,869	88,908	22,897	23,314	20,423	21,048	22,200	25,238

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

¹ Including net costs of pension reform.

financed by net FDI inflows, which were relatively large (albeit smaller than in 2006, when they were boosted by a large one-off deal). FDI outflows gathered pace in 2006.²²

Inflation in Hungary has accelerated significantly since mid-2006, with the year-on-year HICP hitting 9% in February and March 2007. Inflation pressures increased despite weak consumption and the loosening of labor market conditions and were mainly attributable to fiscal policy measures (VAT rate hike, regulated price increases, changes in price subsidy systems) and large increases in unprocessed food prices. In addition, the hefty acceleration of nominal wage growth in the private sector and the sharp increase in inflation expectations may well have contributed to inflation as well. Looking forward, Magyar Nemzeti Bank (MNB) expects inflation to gradually decelerate from the second quarter of 2007 to reach 5% by the fourth quarter of 2007 and 3% (i.e. the MNB's inflation target) by the second half of 2008. According to the MNB, the major risk to this projection are exchange rate and oil price developments (two-sided risk), wage effects of increased inflation expectations (predominantly upward risk), increases in the regulated gas price (downward risk) and the disinflationary effect of the slowdown of domestic consumption (two-sided risk). In addition, the magnitude of consumption smoothing by households in reaction to the fiscal tightening measures is also surrounded by uncertainty.

In response to the acceleration of inflation and the changes to the inflation outlook, the MNB hiked its policy rate by a total of 200 basis points over the second half of 2006.²³ The policy rate had been kept unchanged at 8% since October 2006 as the Monetary Council took a wait-and-see approach to assess the inflationary effect of the fiscal consolidation measures (notably the development of inflation expectations, wage developments and the (dis)inflationary effect of the expected slowdown of domestic demand). Against the backdrop of increased confidence of market participants in the government's fiscal policy and structural reforms, the widening of the interest rate differential against the euro (as MNB rates rose more strongly than ECB rates) and the improved climate on the international financial markets after some turbulence in May and June 2006, the Hungarian forint has strongly recovered since mid-2006, appreciating by around 13% until mid-April 2007.

Inflation cycle nearing the top

Policy rate hikes in the summer and fall of 2006 underpin Hungarian forint

6 Poland: Strong Productivity Rise alongside Growing Employment

Real GDP growth in Poland averaged 5.8% in 2006 and accelerated throughout the year. Domestic demand was supported by an expansion of bank lending to the private sector, which came to more than 20% in real terms by end-2006. Private consumption growth in 2006 was much higher than in 2005, but still remained somewhat below total GDP growth, keeping a steady pace throughout the year. Employment and wage growth as well as credit growth underpinned the expansion of private consumption and residential investment. Gross fixed

Growth, in particular investment, boosts employment; consumption growth buoyant but still below GDP growth

²² Net portfolio capital inflows were substantial, while the net inflow of other capital decreased significantly compared with previous years, mainly on account of increased investment by Hungarians abroad.

²³ See also Focus on European Economic Integration 2/06.

capital formation growth was very dynamic and gained momentum in the course of the year (approaching +20% in the second half of 2006). This was ascribable to growing EU transfers, high profitability and credit expansion to corporates as well as robust consumer and external demand. It is worth noting that manufacturing, at 72%, accounted for the lion's share in total investment outlays. In 2006 as a whole, the contribution of private consumption and gross fixed capital formation to GDP was roughly equal (about 3 percentage points each), while in the fourth quarter of 2006, the contribution of the latter was substantially higher owing to intra-year dynamics. As a result of the strong rise in total demand, real import growth was brisk in 2006 and slightly exceeded real export growth (which was also robust), thus implying a marginally negative contribution of net exports to GDP growth.

With the economy in full swing, annual employment growth in the whole economy accelerated strongly in 2006. This was the main reason why the unemployment rate (ILO definition) was by 4.5 percentage points lower in the third quarter than in 2005. About 1 percentage point of this total decline is attributable to emigration and the growing number of students, which reduced the participation rate. In parallel, nominal average wage growth picked up in 2006 and further quickened at the beginning of 2007. As production increased strongly, labor productivity in industry advanced markedly despite high employment growth. The increase in labor productivity more than offset high wage rises so that nominal ULC in industry declined not only in 2006, but also in early 2007. Looking forward, further accelerating wage growth, in particular in combination with currency appreciation, may pose a challenge for the external balance.

Goods and services deficit still remarkably low, but income deficit higher

In 2006, as in previous years, the income balance was the main reason why the combined current and capital account deficit was only moderate. The deficit in the goods and services balance remained small and widened only marginally in the first months of 2007, as import growth declined more sharply than export growth despite the strong pick-up in domestic demand. In these months, like in 2006, net FDI inflows more than compensated the current account deficit. In 2006, no major changes occurred in total gross external debt and gross official reserves, while the gradual reduction of public gross external debt continued.

Thanks to a productivity rise, inflation remains low despite supply-side shocks

Both annual headline HICP and national CPI inflation stood at only 1.3% in the fourth quarter of 2006. Annual inflation quickened in early 2007, coming to 2.4% (HICP) and 2.5% (national CPI), respectively, in March. This acceleration was almost exclusively ascribable to the drought-related rise in agricultural prices and hikes in electricity and gas prices for households. Annual inflation (as measured by the HICP excluding unprocessed food and energy and by national net CPI inflation) increased from 1.0% and 1.5%, respectively, in the fourth quarter of 2006 to 1.2% and 1.7%, respectively, in March 2007. Low inflation dynamics are partly attributable to ULC developments in the tradable sector. So far, only few signs of demand-side inflationary pressures have become discernible.

According to the April 2007 inflation report of Narodowy Bank Polski (NBP), inflation is projected to decline to 2% in the fourth quarter of 2007, to remain below the inflation target of 2.5% (as measured by the national CPI)

Table 9

Main Economic Indicators: Poland

	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	5.3	3.5	5.8	4.1	4.5	5.2	5.5	5.8	6.4
Private consumption (excl. NPISH)	4.3	1.9	5.2	2.2	2.6	5.2	4.9	5.5	5.1
Public consumption (incl. NPISH)	3.1	5.3	2.4	4.6	7.8	4.6	1.5	1.1	2.5
Gross fixed capital formation	6.4	6.5	16.7	6.4	10.1	7.7	14.8	19.8	19.3
Exports of goods and services	14.0	8.0	15.1	6.1	12.1	22.0	12.6	14.8	12.2
Imports of goods and services	15.2	4.7	15.4	1.5	15.0	20.9	10.7	15.3	15.5
Contribution to GDP growth in percentage points									
Domestic demand	6.1	2.4	5.9	2.4	5.6	4.8	4.8	6.1	7.7
Net exports of goods and services	-0.8	1.1	-0.2	1.8	-1.1	0.4	0.6	-0.3	-1.2
Exports of goods and services	4.7	3.0	5.6	2.4	4.4	7.7	4.9	5.6	4.5
Imports of goods and services	5.5	1.9	5.8	0.6	5.5	7.2	4.2	5.9	5.7
Year-on-year change of period average in %									
Labor productivity of industry (real)	13.5	2.9	9.5	3.3	7.2	10.4	10.2	9.9	7.7
Gross average wage of industry (nominal)	4.5	3.2	5.2	3.2	4.4	4.3	4.9	6.0	5.5
ULC of industry (nominal)	-7.9	0.3	-4.0	-0.1	-2.6	-5.5	-4.8	-3.5	-2.0
PPI of industry	7.1	0.7	2.2	-0.2	-0.4	0.6	2.3	3.4	2.6
CPI (here: HICP)	3.6	2.2	1.3	1.8	1.2	0.9	1.4	1.5	1.3
EUR per 1 SIT, + = SIT appreciation	-2.9	12.6	3.2	10.1	8.1	5.0	4.6	1.6	1.8
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	19.3	18.0	14.1	17.6	17.0	16.3	14.3	13.2	12.4
Employment rate (15-64 years)	51.7	52.8	54.5	53.7	53.7	52.6	53.9	55.6	55.7
Key interest rate p. a. (%)	5.8	5.3	4.1	4.8	4.5	4.3	4.0	4.0	4.0
SIT per 1 EUR	4.5	4.0	3.9	4.0	3.9	3.8	3.9	4.0	3.8
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	6.9	11.8	11.9	12.2	12.1	10.9	10.2	12.8	13.7
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	4.2	5.0	0.7	6.6	7.4	5.8	1.5	-1.8	-2.4
Domestic credit of the banking system	3.5	5.3	12.4	5.5	5.5	7.5	8.6	15.3	17.8
of which:									
claims on the private sector	4.0	5.6	11.2	7.1	6.7	8.9	8.9	12.1	14.6
claims on households	4.6	5.8	8.9	6.4	6.0	7.6	7.5	9.6	10.6
claims on enterprises	-0.6	-0.1	2.3	0.7	0.7	1.4	1.4	2.5	4.0
claims on the public sector (net)	-0.5	-0.3	1.2	-1.5	-1.2	-1.5	-0.2	3.2	3.2
Other domestic assets (net) of the banking system	-0.8	1.5	-1.2	0.1	-0.8	-2.3	0.0	-0.7	-1.7
% of GDP (ESA 95)									
General government revenues ¹	36.9	39.0	39.4	..	..	..	..	..	..
General government expenditures ¹	42.6	43.4	43.3	..	..	..	..	..	..
General government balance ¹	-5.7	-4.3	-3.9	..	..	..	..	..	..
Primary balance ¹	-2.9	-1.5	-1.5	..	..	..	..	..	..
Gross public debt ¹	45.7	47.1	47.8	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	22	17	21	14	18.3	23.5	20.3	22.1	19.5
Merchandise imports	20	13	23	10	17.2	23.3	19.4	24.2	23.1
% of GDP (based on EUR), period total									
Trade balance	-2.2	-1.0	-1.4	-1.0	-1.1	-0.6	-1.0	-1.8	-2.2
Services balance	0.4	0.6	0.7	0.2	0.7	0.4	0.5	0.7	0.9
Income balance (factor services balance)	-4.5	-3.5	-3.9	-3.3	-3.5	-3.2	-4.5	-3.7	-4.3
Current transfers	2.2	2.3	2.4	2.5	1.6	1.1	3.0	3.4	2.1
Current account balance	-4.1	-1.6	-2.3	-1.5	-2.3	-2.2	-2.0	-1.5	-3.4
Capital account balance	0.4	0.3	0.6	0.2	0.3	0.6	0.3	0.8	0.8
FDI (net)	4.6	2.2	2.9	2.8	1.4	5.4	2.6	2.3	1.6
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	46	46	47	46	46	46	46	47	47
Gross official reserves (excluding gold)	13	14	13	14	14	14	14	14	13
Months of imports of goods and services									
Gross official reserves (excluding gold)	3.9	4.6	3.8	4.5	4.6	4.4	4.2	4.2	3.8
EUR million, period total									
GDP at current prices	204,878	244,121	269,874	59,963	69,880	62,815	63,760	65,410	77,889

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

¹ Including net costs of pension reform.

until mid-2008 and then to gradually approach 3.5% (the upper tolerance limit for deviations from the inflation target) at the end of the projection horizon. The report mentioned primarily food prices and, in addition, energy prices (crude oil and fuel) and the exchange rate as major sources of uncertainty attached to its projection. Against this inflation outlook, the NBP raised its key interest rate by 25 basis points on April 25, 2007. This interest rate move came after a period of more than one year in which the Monetary Policy Council had maintained the main policy rate at 4%, which implied that the interest rate differential to the euro area decreased over this period. This, in turn, helped reduce currency appreciation in the course of 2006 and early 2007.²⁴ After the most recent interest rate move, short-term real interest rates in ex-post terms²⁵ stood at somewhat above 2%.

Fiscal policy does not envisage expenditure cuts before 2008

The public deficit in 2006 came to 3.9% of GDP,²⁶ which was lower than the original target of 4.6% (January 2006 update of the convergence program). Compared with 2005, the deficit declined somewhat, mainly as a result of growth-related higher revenues. The expenditure-to-GDP ratio was essentially stable owing to a boost in public investment expenditure, which stemmed mainly from the national co-financing requirements of EU-funded projects.

The updated convergence program of November 2006 envisages the public deficit to amount to 3.4% of GDP in 2007. This implies a further decline in the deficit by one-half percentage point compared with the final 2006 outcome. However, the deficit reduction envisaged in the convergence program is exclusively revenue-based, while the expenditure-to-GDP ratio is planned to remain roughly unchanged. Thus, in 2007, the chance to implement an expenditure reform in the context of countercyclical fiscal policy will probably be missed. Only for 2008 and 2009 does the program envisage a substantial decline in the expenditure ratio, combined with a lower revenue ratio and a further decline in the public deficit to about 3% of GDP. In its opinion on this convergence program, the EU Council concludes that it does not take sufficient action to achieve the envisaged correction of the excessive deficit by 2007 and that the planned measures should be strengthened to achieve this objective. For 2008 and 2009, the EU Council considers the envisaged progress to be appropriate, but sees considerable risks to the achievement of the budgetary targets, inter alia owing to a lack of information on the measures supporting the envisaged expenditure restraint. These measures, according to the EU Council, appear to be in an early conceptual phase.

7 Romania: Large Rise of the Current Account Deficit and Loosening of Fiscal Policy

Strong economic growth driven by buoyant domestic demand

At 7.6% in 2006, real GDP growth (year on year) in Romania was considerably stronger than in 2005. Economic activity peaked in the third quarter, with growth rates almost four times higher than in the same period of 2005, when the economy was hit hard by floods. Domestic demand expanded rapidly, thus

²⁴ From mid-2006 to mid-April 2007, the Polish currency strengthened by around 5.6% against the euro.

²⁵ As measured by the CPI-deflated key interest rate per month compounded over the past 12 months.

²⁶ The net costs of the 1999 pension reform establishing an obligatory funded pillar amounted to 2% of GDP in 2006.

being an even stronger driver of GDP growth than in 2005. Private consumption was backed by private credit and wage growth. Real credit to the private sector expanded strongly (by about 47% year on year at end-2006), as did real wages particularly in the public sector. According to the IMF, the public sector wage sum increased by about 27% in 2006 (in real terms).²⁷ Growth of gross fixed capital formation outpaced growth of private consumption. Investment grew particularly strongly in the fields of new construction, equipment and means of transport, profiting from the imminent EU accession that induced gross FDI inflows and from reconstruction work after the floods. Furthermore, stock changes added more than 2 percentage points to GDP growth in 2006. On the external side, the picture was less favorable. Export growth picked up slightly, but import growth rose much faster, supported by strong domestic demand and the continued real appreciation of the currency. The negative contribution of net exports to GDP growth increased further and reached almost double-digit levels in percentage points of GDP in 2006.

In late 2006, nominal ULC in the industry started to rise dynamically, as a sharp increase in nominal wages outpaced productivity developments, even though industrial productivity growth was strong owing to continued industrial restructuring supported by large gross FDI inflows. Public-sector wages are scheduled to rise by 14% to 19% in 2007, and as of January 2007, the minimum wage was hiked by 18%, suggesting that high wage dynamics will persist in 2007.

Strong domestic demand triggered a further widening of the trade balance, leading to a double-digit combined current and capital account deficit in 2006. In the first months of 2007, the trade balance deteriorated further on the back of a significant rise in import growth that was probably ascribable to the abolition of customs duties after EU accession. Most of the current account deficit (around 90%) was covered by net FDI inflows, which reached a record level in 2006. These substantial inflows were partly attributable to the acquisition of the majority stake in Romania's largest commercial bank, BCR, by the Austrian Erste Bank in 2005. The major part of the payment was due in 2006 (EUR 2.2 billion of a total of EUR 3.75 billion) and naturally boosted FDI. Up to now, the lion's share of FDI was channeled into takeover projects, not greenfield investments. Looking forward, it remains to be seen how dynamic gross FDI inflows will be in the coming years, as no further large-scale privatization projects are on the agenda. Interestingly, almost 40% of FDI (based on stock figures at end-2005) went into the manufacturing sector, i.e. toward export-oriented production facilities where firms have taken advantage of low labor costs. Banking and insurance as well as retail and wholesale trade each made up around 15% of the country's FDI stock. Here, the main motive of foreign activity might be to attain access to the Romanian market.

Inflation rates reached a historical low at below 4% in February and March 2007. Price increases declined mainly owing to lower food prices, a slowdown in price increases of administered goods and services, the abolition of customs

**Unit labor costs
on the rise**

**External disequilibria
are widening further**

Inflation hits record low

²⁷ In addition, private consumption was fueled by remittances from Romanians working abroad.

Table 10

Main Economic Indicators: Romania									
	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	8.4	4.1	7.6	2.4	4.2	6.7	7.7	8.2	7.6
Private consumption	14.6	9.7	13.9	10.3	6.1	11.9	13.9	15.3	13.8
Public consumption	-4.3	8.5	2.5	8.0	10.4	3.3	0.7	1.3	4.1
Gross fixed capital formation	11.1	12.6	16.1	10.6	21.0	11.2	14.4	17.3	18.0
Exports of goods and services	13.9	8.1	10.6	9.7	10.1	12.9	10.5	10.6	8.6
Imports of goods and services	22.1	16.6	22.9	16.7	16.7	21.9	19.1	24.7	25.5
Contribution to GDP growth in percentage points									
Domestic demand	14.0	10.1	17.5	7.5	8.9	15.4	16.6	18.7	18.4
Net exports of goods and services	-5.6	-6.0	-9.9	-5.1	-4.7	-8.7	-8.9	-10.5	-10.9
Exports of goods and services	5.5	3.4	4.6	3.7	3.4	7.0	5.1	4.3	3.1
Imports of goods and services	11.1	9.4	14.5	8.8	8.1	15.7	14.0	14.8	13.9
Year-on-year change of period average in %									
Labor productivity of industry (real)	7.1	4.4	11.3	2.8	6.5	9.0	13.7	11.8	10.7
Gross average wage of industry (nominal)	23.0	16.8	15.7	17.0	18.1	16.6	14.3	15.0	16.8
ULC of industry (nominal)	14.8	11.9	4.0	13.9	10.9	7.0	0.5	2.9	5.5
PPI of industry	19.1	10.8	11.7	9.0	9.1	11.2	11.9	12.8	11.1
CPI (here: HICP)	11.9	9.1	6.6	9.0	8.5	8.7	7.2	5.9	4.8
EUR per 1 SIT, + = SIT appreciation	-7.3	11.8	2.7	16.3	9.5	4.0	2.9	-0.5	4.6
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	8.5	7.5	..	6.5	7.2	8.1	7.4	7.4	..
Employment rate (15-64 years)	57.7	57.6	..	57.8	57.2	57.2	59.6	60.9	..
Key interest rate p. a. (%)	20.4	10.0	8.4	8.0	7.7	7.7	8.5	8.8	8.8
SIT per 1 EUR	4.1	3.6	3.5	3.5	3.6	3.6	3.5	3.5	3.5
Nominal year-on-year change of period average stock in %									
Money plus quasi-money	32.6	48.3	23.3	48.8	38.3	23.5	23.5	18.6	27.7
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	3.5	8.3	-11.3	6.9	-1.9	-17.8	-18.2	-6.2	-4.5
Domestic credit of the banking system	25.0	20.4	28.3	19.4	25.0	24.7	26.7	29.9	31.1
of which:									
claims on the private sector	27.6	22.8	29.5	22.5	26.0	25.5	28.1	30.8	32.9
claims on households	11.3	11.3	15.4	12.0	13.6	12.8	14.4	16.4	17.7
claims on enterprises	16.3	11.6	14.1	10.4	12.4	12.7	13.7	14.5	15.2
claims on the public sector (net)	-2.6	-2.4	-1.3	-3.1	-1.0	-0.9	-1.4	-0.9	-1.8
Other domestic assets (net) of the banking system	4.2	19.6	6.3	22.6	15.2	16.7	15.0	-5.1	1.2
% of GDP (ESA 95)									
General government revenues	31.1	32.4	30.1	..	..	..	..	..	..
General government expenditures	32.6	33.7	32.0	..	..	..	..	..	..
General government balance	-1.5	-1.4	-1.9	..	..	..	..	..	..
Primary balance	-0.1	-0.3	-1.1	..	..	..	..	..	..
Gross public debt	18.8	15.8	12.4	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	21.3	17.5	16.2	19.7	17.2	22.0	18.9	8.9	15.9
Merchandise imports	24.0	23.9	25.1	25.2	24.4	28.6	23.3	22.3	26.6
% of GDP (based on EUR), period total									
Trade balance	-8.7	-9.8	-12.1	-7.8	-11.5	-9.9	-12.6	-11.2	-13.6
Services balance	-0.3	-0.4	0.0	0.1	-0.7	0.1	1.0	0.2	-0.9
Income balance (factor services balance)	-4.2	-2.9	-3.1	-3.5	-1.1	-3.7	-4.0	-2.9	-2.4
Current transfers	4.9	4.5	4.9	4.1	4.4	4.2	4.4	3.8	6.6
Current account balance	-8.4	-8.6	-10.3	-7.0	-8.9	-9.3	-11.2	-10.1	-10.3
Capital account balance	0.8	0.7	0.0	0.5	1.0	0.7	-2.4	0.3	0.9
FDI (net)	8.4	6.6	9.3	7.7	5.8	10.3	6.8	7.0	12.3
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt ¹	29.7	30.7	28.5	30.9	30.7	29.8	29.0	28.6	28.5
Gross official reserves (excluding gold)	17.8	21.1	21.9	22.4	21.1	21.9	20.9	20.6	21.9
Months of imports of goods and services									
Gross official reserves (excluding gold)	4.8	5.8	5.9	6.2	5.8	6.0	5.7	5.6	5.9
EUR million, period total									
GDP at current prices	60,917	79,704	97,297	22,456	25,881	17,113	21,599	26,257	32,329

Source: Bloomberg, European Commission, Eurostat, IMF, national statistical offices, NCBs, wiiv, OeNB.

¹ Only medium- and long-term debt.

duties (related to EU accession), stronger competition in the retail sector and the nominal appreciation of the Romanian leu. However, the downward movement of the core inflation rate (excluding administered prices and goods with volatile prices) came to an end at the beginning of 2007. Last year, the inflation target of 5% (± 1 percentage point) was reached, with year-on-year inflation just below 5% in December. Banca Națională a României (BNR) has set its 2007 year-end inflation target to 4% (± 1 percentage point). In its most recent inflation report, the BNR estimates that the inflation rate will reach 4.6% at end-2007. After two policy rate hikes in 2006, the first quarter of 2007 marked a turning point in interest rate policy: The BNR cut its monetary policy rate in two steps from 8.75% to 7.5%. This rate cut was largely motivated by the continuous appreciation pressure on the currency and further progress with disinflation. According to the BNR, there is a certain danger that inflation could pick up, given the risk of dynamic wage growth and a relaxation of fiscal policy over the coming months. Furthermore, with effect from January 2007, the BNR removed some limits on foreign currency-denominated loans. These limits had been introduced in September 2005, restricting credit institutions' exposure to a maximum of 300% of their own funds when granting foreign currency loans to unhedged borrowers.

Against the background of strong economic growth and rising external imbalances, special attention has been paid to fiscal policy. The 2006 budget deficit reached 1.9% of GDP, which is less than the revised target of 2.5% of GDP, but much higher than the original target of 0.5% of GDP. In fact, until November 2006, the budget balance showed a surplus of more than 1% of GDP, mainly owing to expenditure restraints. In December 2006, however, a marked spending spree took place. This expenditure boom was related to infrastructure projects and the building up of capacities to handle EU funds (where efficiency improvements regarding absorption and management are still needed) as well as extra-wage payments in the public sector. In 2005, Romania launched a fundamental tax reform comprising the implementation of a flat tax on personal income, a broadening of the tax base and improvements in tax collection. Despite lower tax rates, the revenue-to-GDP ratio increased in 2005 but fell back considerably in 2006. For 2007, the Romanian government targets a deficit of 2.8% of GDP (partly owing to additional spending related to EU membership). Until 2009, the deficit is planned to be reduced to 2% of GDP. In its assessment of Romania's convergence program, the EU Council criticized the procyclical nature of fiscal policy and indicated that the progress made to achieve Romania's medium-term budget objective is insufficient and backloaded. The IMF is also critical about Romania's fiscal policy: For 2007, the IMF expects a deficit of 3.7% of GDP, arguing that budget revenue estimations are overly optimistic while expenditures do not fully take account of planned salary hikes in the public sector. Dynamic economic growth alongside a further deterioration of the current account and the risk of increasing inflation certainly calls for a more ambitious and stability-oriented fiscal policy that would dampen domestic demand and help contain external imbalances.

Fiscal loosening in the last month of 2006

8 Slovakia: Strong External Performance despite Appreciating Currency

Accelerating growth driven by exports

The Slovak economy showed a very dynamic growth performance in 2006 at +8.3%. The pick-up of economic activity, which was particularly buoyant in the second half of 2006, has to be attributed to a strong export performance which was achieved alongside an appreciating currency. While import growth in 2006 remained broadly unchanged, exports gained significant momentum. The dynamic performance of net exports made up for a slowdown in investment spending, which still remained at robust levels thanks to strong profits and FDI inflows.²⁸ Private consumption benefited from an improvement of the labor market situation, real wage growth and the rather swift real growth of private sector credit (+20% at end-2006). After a strong expansion before the June 2006 general elections, public consumption returned to significantly lower levels toward the end of the year.

Labor market improvement on the back of strong growth

Even though the unemployment rate in Slovakia is still among the highest in the EU, growth is increasingly feeding through to the labor market. In February 2007, the unemployment rate declined further to 11%. Average employment growth came to 4% in 2006. Despite the sharp decline in unemployment, nominal wage growth (in industry) was on average lower than productivity advances, causing nominal ULC to fall. High and, to a considerable extent, FDI-driven productivity developments in industry also played a role.

Strong industrial performance bolsters the external sector

Over the past few years some large FDI projects have tangibly increased the productive capacity of the Slovak economy. Industrial output increased by almost 10% in 2006. Owing to the favorable competitive position of Slovak companies, industrial sales to foreign markets grew more than three times faster than domestic sales in 2006. This development also helped contain the trade deficit and the evolution of the current account. In 2006, the deficit of the combined current and capital account decreased marginally to 8.4% of GDP. This figure has to be interpreted against the background of strong growth and high investment demand. 80% of the current account deficit was covered by net FDI inflows in 2006. In addition to the trade deficit, the income balance deficit – driven by high profits of foreign-owned firms – contributes significantly to the current account imbalance. This development was also observed in other new EU Member States. In January 2007, the trade balance went into surplus. Two large foreign companies in the motor industry started production in Slovakia in 2006. As a result, exports in the category “vehicles, aircraft, vessels and associated transport equipment” performed strongly throughout 2006 and even doubled in January 2007 against the corresponding month of 2006.

Falling energy prices ease inflationary pressure

Price developments in the second half of 2006 and in early 2007 were favorable. Inflation decreased from levels around 5% in summer 2006 to 2.1% in March 2007, with declining energy prices and nominal appreciation being the main driving forces. Moreover, added restraint on administered price adjustments (in particular in the category “housing, water, electricity, gas and

²⁸ In the first half of 2006, gross fixed capital formation grew strongly in the sectors metal products and machinery as well as transport equipment, whereas in the second half of 2006 the construction sector saw high investment growth.

other fuels”) moderated inflation in the first quarter of 2007. According to the latest forecast of Národná banka Slovenska (NBS), the inflation rate is expected to decrease to 1.5% by end-2007. This would imply that the inflation target of below 2% for December 2007 will be met. Apart from global factors (especially oil prices), the NBS sees various domestic risks to its forecast, in particular with regard to food price developments and the evolution of services prices (possible secondary effects of earlier increases in regulated prices and knock-on effects on higher-than-expected domestic demand).

In the second half of 2006, the Slovak koruna recovered from its temporary weakness following the appointment of a new government in summer, and appreciated strongly on the back of significant capital inflows, growth acceleration and renewed confidence in economic policies. Despite foreign exchange interventions by the NBS to contain appreciation pressures, the currency traded nearly 12% above its ERM II central rate by mid-March. On March 16, 2007, the central parity of the Slovak koruna against the euro in ERM II was revalued by 8.5%, which was justified by improvements in underlying fundamentals. Upon this realignment, the currency initially strengthened further so that the NBS intervened repeatedly. Moreover, the central bank reduced its key interest rate by 25 basis points both on March 27 and April 24, 2007. The rate cuts were motivated by declining inflation and the absence of demand-pull inflation pressures. This move helped stabilize the exchange rate at around 5½% to 6% above its new ERM II parity. Overall, the Slovak koruna appreciated by about 13% vis-à-vis the euro between mid-2006 and mid-April 2007. With a view to the size of the realignment in March 2007, it seems that a sizeable part of this appreciation can be explained by an enhanced economic performance, while some part was ascribable to market sentiment.

Revaluation of the central parity of the Slovak koruna

At 3.4% of GDP²⁹ the 2006 general government deficit was lower than the originally targeted 4.2% of GDP. This can be traced back to strong growth performance, positive labor market developments and lower-than-expected interest expenditure and pension reform costs. The deficit reduction was achieved despite a selective, but overall moderate, relaxation of earlier reform steps, thus implying some additional spending and some revenue reduction. The deficit target is 2.9% of GDP for 2007, and by 2009, the deficit should be below 2% of GDP. This reduction against 2006 is to be reached mainly via expenditure restraints on public-sector wages, social benefit payments (helped by a smaller number of beneficiaries) and capital expenditure. It is worth noting that the budgetary forecast is based on high GDP growth assumptions of the Ministry of Finance (7.1%, but still lower than the NBS's expectations of 8.6%). According to the European Commission, this year's budget is consistent with the planned correction of the excessive deficit by 2007. However, progress toward meeting the medium-term budgetary objective is seen as limited. The European Commission therefore recommends strengthening structural adjustments in the fiscal sphere to speed up progress toward the medium-term objective.

Budget deficit under control thanks to brisk economic activity

²⁹ The net costs of the 2005 pension reform, which established inter alia an obligatory funded pillar, amounted to 1.1% of GDP in 2006 (about one-half percentage point higher than in 2005).

Table 11

Main Economic Indicators: Slovakia									
	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	5.4	6.0	8.3	6.3	7.5	6.7	6.7	9.8	9.6
Private consumption	4.2	7.0	6.1	7.5	6.4	6.5	5.7	6.3	6.0
Public consumption	2.0	-0.6	4.1	2.2	-2.2	7.8	6.6	1.2	2.3
Gross fixed capital formation	5.0	17.5	7.3	21.0	24.4	13.8	3.6	6.7	7.0
Exports of goods and services	7.9	13.8	20.7	19.5	16.6	17.7	18.1	23.8	22.6
Imports of goods and services	8.8	16.6	17.8	17.7	21.7	19.6	14.0	22.9	15.3
Contribution to GDP growth in percentage points									
Domestic demand	6.3	8.8	6.5	5.4	13.1	8.6	3.8	9.5	4.4
Net exports of goods and services	-0.9	-2.8	1.7	0.8	-5.7	-1.9	2.9	0.3	5.2
Exports of goods and services	6.4	11.5	18.5	15.3	14.5	15.3	15.9	21.0	21.4
Imports of goods and services	7.3	14.2	16.8	14.5	20.2	17.2	13.0	20.7	16.2
Year-on-year change of period average in %									
Labor productivity of industry (real)	3.9	0.6	11.3	1.6	3.9	10.6	10.9	12.7	11.0
Gross average wage of industry (nominal)	10.1	7.3	6.7	4.9	6.8	2.4	8.2	7.4	8.5
ULC of industry (nominal)	6.0	6.6	-4.1	3.2	2.8	-7.4	-2.4	-4.7	-2.2
PPI of industry	3.4	4.7	8.4	5.6	6.7	9.5	9.6	8.5	6.1
CPI (here: HICP)	7.5	2.8	4.3	2.2	3.7	4.2	4.6	4.8	3.5
EUR per 1 SIT, + = SIT appreciation	3.6	3.7	3.7	3.5	2.5	2.2	3.3	2.2	7.1
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	18.3	16.3	13.4	15.7	15.4	15.0	13.6	12.9	12.1
Employment rate (15-64 years)	57.0	57.7	59.4	58.0	58.5	58.3	59.3	59.9	60.2
Key interest rate p. a. (%)	4.9	3.2	4.0	3.0	3.0	3.1	3.8	4.5	4.8
SIT per 1 EUR	40.0	38.6	37.2	38.7	38.5	37.5	37.7	37.8	35.9
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	4.0	5.0	5.5	4.5	4.3	2.2	4.5	6.7	8.6
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	-2.6	-5.8	15.9	-8.5	-7.9	8.1	16.6	20.8	18.2
Domestic credit of the banking system	10.2	12.0	3.9	12.2	13.6	3.9	4.4	4.0	3.5
of which:									
claims on the private sector	4.0	8.0	16.0	9.3	11.4	15.2	16.6	15.8	16.5
claims on households	4.0	5.3	8.7	5.5	6.1	8.0	8.9	9.0	9.0
claims on enterprises	0.0	2.8	7.3	3.8	5.4	7.2	7.8	6.8	7.5
claims on the public sector (net)	6.1	4.0	-12.1	2.9	2.2	-11.3	-12.2	-11.9	-13.0
Other domestic assets (net) of the banking system	-3.6	-1.3	-14.3	0.8	-1.4	-9.7	-16.5	-18.1	-13.0
% of GDP (ESA 95)									
General government revenues ¹	35.3	35.2	33.9	..	..	..	..	..	..
General government expenditures ¹	37.7	38.1	37.3	..	..	..	..	..	..
General government balance ¹	-2.4	-2.8	-3.4	..	..	..	..	..	..
Primary balance ¹	-0.2	-1.3	-2.0	..	..	..	..	..	..
Gross public debt ¹	41.5	34.5	30.7	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	14.9	15.6	29.6	19.6	22.0	27.9	25.3	29.7	34.5
Merchandise imports	17.9	17.9	29.3	14.3	26.1	30.7	25.6	33.7	27.7
% of GDP (based on EUR), period total									
Trade balance	-3.7	-5.2	-5.6	-2.1	-9.4	-6.2	-5.6	-4.7	-6.0
Services balance	0.6	0.7	1.2	1.0	0.3	1.2	0.9	1.3	1.4
Income balance (factor services balance)	-5.2	-4.2	-3.8	-3.4	-6.1	-1.2	-6.0	-5.9	-1.9
Current transfers	0.4	0.0	-0.1	-0.3	0.2	-0.1	1.1	-1.1	-0.3
Current account balance	-7.9	-8.7	-8.3	-4.7	-15.1	-6.3	-9.6	-10.3	-6.9
Capital account balance	0.3	0.0	-0.1	0.0	-0.1	-0.1	0.0	-0.1	-0.1
FDI (net)	7.3	4.1	6.9	2.9	4.5	4.9	10.2	8.0	4.4
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	51.5	60.2	55.6	59.6	60.2	60.3	61.3	55.2	55.6
Gross official reserves (excluding gold)	31.3	33.0	21.9	34.3	33.0	33.6	30.5	23.5	21.9
Months of imports of goods and services									
Gross official reserves (excluding gold)	4.8	4.9	2.9	5.2	4.9	4.8	4.2	3.2	2.9
EUR million, period total									
GDP at current prices	33,878	38,115	44,000	9,647	10,222	9,847	10,713	11,228	12,212

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

¹ Including net costs of pension reform.

9 Croatia: Moderating Inflation, but Further Rising Foreign Debt

Average annual GDP growth in Croatia accelerated slightly to nearly 5% in 2006, mainly owing to strong gross fixed capital formation.³⁰ Strong private sector credit growth, which came to 20% in real terms by end-2006 (year on year), and rising wages supported domestic demand. Quarterly GDP growth rates in 2006 were characterized by considerable fluctuations, chiefly as a result of substantial instability in all components. While public consumption remained largely flat until the third quarter of 2006 and increased significantly in the last quarter, year-on-year growth in gross fixed capital formation dropped by one-half from the first quarter to the second quarter of 2006 and then picked up again. The contribution of net exports to growth was slightly negative in 2006, though it improved over the year and became positive in the last quarter.

Robust growth driven by strong gross fixed capital formation

Supported by solid GDP growth, the unemployment rate fell in 2006, but is still at double-digit levels. Labor productivity growth in the industrial sector slowed down in 2006, whereas nominal wage growth picked up. As a result, nominal ULC increased after having declined a year earlier.

Slight improvement on the labor market

The combined current and capital account deficit came to 8.1% of GDP in 2006, a substantial increase from 2004 and 2005. This rise is ascribable to the cumulated effects of a slight deterioration of the trade, services and current transfer accounts. However, unlike in previous years, net foreign direct investment inflows reached 7.8% of GDP in 2006. This was mainly owing to the takeover of the pharmaceutical company Pliva, the recapitalization of individual banks and the ongoing privatization process of the oil company INA. Thus, the large current account deficit was fully financed by FDI inflows. At end-2006, both manufacturing and financial intermediation (excluding insurance and pension funds) each accounted for 31% of the total FDI stock, while the remaining stock mainly related to postal services and telecommunication, wholesale and retail trade as well as hotels and restaurants.

Combined current and capital account deficit increases

Year-on-year consumer price inflation accelerated to around 4% in the first half of 2006. This development was, however, reversed later in the year and in early 2007, with inflation gradually going back to 1.8% in March 2007. The reasons for this decline are a drop in energy prices and the weakening of seasonal factors which impacted on inflation earlier in 2005 and 2006. Hrvatska narodna banka expects the average inflation rate in 2007 to be at around 2.5%.

Inflation coming back to below 3%

The gross foreign debt ratio continued to increase, reaching 84.8% of GDP at end-2006, as the continued decline in gross public foreign debt (19.5% of GDP at end-2006) was not sufficient to offset the rise in the private sector's gross foreign debt. This increase in gross foreign debt is primarily attributable to the nonfinancial corporate sector that recorded an increase in its debt-to-GDP ratio by more than 5 percentage points from the last quarter of 2005 to the last quarter of 2006. The banking sector's debt ratio rose by about 1 percentage point. The net foreign debt ratio rose as well, climbing from 37.4% at end-2005 to 39.3% of GDP at end-2006.

Foreign debt remains an evergreen problem

³⁰ A sectoral disaggregation of gross fixed capital formation, which would shed light on the questions of which sectors are the most active investors, was not yet available for 2006 at the cutoff date.

Continued credit growth

In 2006, real credit growth to the private sector accelerated by almost 8 percentage points compared with 2005. Against this background, Hrvatska narodna banka introduced an instrument that penalizes excessive bank lending in addition to the regulations relating to the banking sector's foreign liabilities. As of January 1, 2007, banks are required to purchase so-called kuna-denominated compulsory one-year HNB bills which are remunerated at the rate of the Croatian kuna component of reserve requirements. The basis for the calculation of the amount of bills to be purchased is 50% of the increase in the credit volume in excess of 12% compared with the end of the preceding year. The calculation period runs from January 1 until the end of each month.

Seasonal exchange rate movements and foreign exchange interventions

In 2006, exchange rate movements were again characterized by the usual seasonal pattern reflecting tourism receipts. The exchange rate of the kuna vis-à-vis the euro appreciated until summer and depreciated by some 2.7% between August and October 2006. However, from mid-October, the currency appreciated by 1.3%, triggering two central bank interventions in November and one in December to weaken the Croatian kuna. Subsequently, the exchange rate fluctuated within a narrow range until March 2007 and then depreciated mildly until mid-April.

Gradual consolidation of public finances under way

Croatia is currently in the process of shifting fiscal accounts from government finance statistics (GFS) to ESA 95 methodology. The 2006 budget deficit target, which amounted to 2.2% of GDP in ESA 95 terms, was met. The deficit was thus noticeably smaller in 2006 than in 2005 (2.9% of GDP). This positive outcome largely resulted from higher tax revenues, given robust economic growth and more efficient tax collection, but was also related to efficiency gains on the expenditure side. The 2006 Pre-Accession Economic Programme foresees a deficit of 1.8% of GDP for 2007 and a further reduction to 1.5% of GDP by 2009 on the back of assumed strong economic growth and further fiscal consolidation efforts. However, the European Commission apparently expects a roughly steady fiscal deficit ratio for 2007 and 2008.³¹ Moreover, it sees fiscal risks, in particular as regards added expenditures on pensions, public sector wages and subsidies as well as on extra-budgetary operations.

2006 Article IV consultations by the IMF

After the last agreement with the IMF had expired in November 2006, the Croatian authorities decided not to request a follow-up arrangement. Thus, Article IV consultations are now the primary framework in which IMF surveillance takes place for Croatia. The most recent consultations convey an overall positive assessment of Croatia's economic development. However, the IMF's assessment underlines that gross external debt and current account deficits remain high, notwithstanding efforts in particular related to fiscal adjustment to tame external vulnerability. In addition, the IMF stresses the need for speedier structural reforms and for further improvements of the business climate.

³¹ A precise comparison is not possible, given that the European Commission's projections of Croatia's fiscal balances (published in November 2006) are still based on GFS methodology. The Spring 2007 forecast by the European Commission (released in May) may bring more clarity into this matter.

Table 12

Main Economic Indicators: Croatia

	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	4.3	4.3	4.8	5.2	4.8	6.0	3.6	4.7	4.8
Private consumption	4.8	3.4	3.5	3.8	3.2	4.0	2.1	3.9	4.1
Public consumption	-0.3	0.8	2.2	1.0	1.4	1.0	1.8	1.5	4.4
Gross fixed capital formation	5.0	4.9	10.9	5.8	9.9	18.1	8.4	9.3	9.2
Exports of goods and services	5.7	4.6	6.9	4.9	4.9	14.0	5.2	2.2	11.1
Imports of goods and services	4.6	3.5	7.3	2.3	3.6	16.1	4.2	5.5	5.0
Contribution to GDP growth in percentage points									
Domestic demand	4.4	4.2	5.9	3.3	5.1	10.2	4.0	6.4	3.3
Net exports of goods and services	-0.1	0.1	-1.1	1.9	-0.2	-4.2	-0.4	-1.8	1.6
Exports of goods and services	2.8	2.2	3.4	3.3	2.1	5.2	2.4	1.5	4.8
Imports of goods and services	2.9	2.2	4.5	1.4	2.3	9.4	2.7	3.2	3.2
Year-on-year change of period average in %									
Labor productivity of industry (real)	4.0	6.2	5.7	6.6	6.5	8.0	1.1	6.9	6.7
Gross average wage of industry (nominal)	5.5	5.3	7.5	5.4	5.4	7.2	7.3	6.2	9.4
ULC of industry (nominal)	1.5	-0.8	1.7	-1.2	-1.1	-0.8	6.1	-0.7	2.6
PPI of industry	3.6	3.1	2.9	2.0	2.3	3.5	3.7	2.7	1.7
CPI (here: HICP)	2.1	3.4	3.2	3.5	4.0	3.5	3.8	3.2	2.2
EUR per 1 SIT, + = SIT appreciation	1.0	1.3	1.1	0.3	2.3	2.3	0.9	0.8	0.2
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	14.1	13.0	..	..	12.6	..	12.1	..	..
Employment rate (15-64 years)	54.7	55.0	..	..	55.2	..	54.5	..	..
Key interest rate p. a. (%)	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
SIT per 1 EUR	7.5	7.4	7.3	7.4	7.4	7.3	7.3	7.3	7.4
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	8.3	9.5	14.0	9.9	10.3	9.9	12.6	15.9	17.3
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	-0.5	-5.0	-3.0	-6.0	-6.0	-6.8	-6.4	-1.8	2.2
Domestic credit of the banking system	9.4	17.3	20.8	18.6	19.6	19.6	21.9	21.6	20.2
of which:									
<i>claims on the private sector</i>	10.1	13.2	20.2	13.6	15.4	17.6	21.3	21.1	20.9
<i>claims on households</i>	7.5	9.0	11.1	9.6	10.0	10.2	11.5	11.3	11.2
<i>claims on enterprises</i>	2.6	4.1	9.2	4.0	5.4	7.4	9.8	9.8	9.7
<i>claims on the public sector (net)</i>	-0.7	4.1	0.6	5.0	4.2	2.0	0.6	0.5	-0.7
Other domestic assets (net) of the banking system	-0.7	-2.7	-3.8	-2.7	-3.3	-3.0	-2.9	-3.9	-5.1
% of GDP (ESA 95)									
General government revenues	..	..	..	..	..	..	..	..	..
General government expenditures	..	..	..	..	..	..	..	..	..
General government balance	-5.0	-3.9	-2.3	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	43.7	44.2	42.1	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	18.5	9.3	16.9	6.8	12.0	32.7	5.0	12.9	19.7
Merchandise imports	6.3	10.6	14.0	10.8	13.4	25.0	8.7	14.0	10.7
% of GDP (based on EUR), period total									
Trade balance	-23.4	-24.1	-24.4	-21.6	-25.0	-24.1	-27.6	-22.8	-23.5
Services balance	16.6	17.0	16.7	45.7	2.8	-0.6	15.3	43.8	3.8
Income balance (factor services balance)	-2.2	-3.1	-3.1	-1.3	-0.6	-5.7	-6.3	-1.2	0.1
Current transfers	4.2	3.8	3.2	3.1	3.7	3.8	3.5	2.9	2.9
Current account balance	-4.9	-6.3	-7.7	25.9	-19.1	-26.6	-15.1	22.7	-16.7
Capital account balance	0.1	0.2	-0.4	0.0	0.5	-2.1	0.0	0.1	0.1
FDI (net)	2.5	3.9	7.8	3.7	0.9	6.5	9.2	4.2	11.6
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	79.4	81.7	84.8	79.0	81.7	82.6	84.1	81.0	84.8
Gross official reserves (excluding gold)	22.4	23.8	25.5	22.9	23.8	25.2	26.7	24.2	25.5
Months of imports of goods and services									
Gross official reserves (excluding gold)	4.8	5.1	5.3	4.9	5.1	5.3	5.6	5.1	5.3
EUR million, period total									
GDP at current prices	28,693	31,272	34,214	8,678	7,886	7,725	8,504	9,451	8,534

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

10 Turkey: Export-Driven Economic Growth

Robust economic performance positive for the overall macroeconomic picture

After posting a strong performance in the years 2004 and 2005, the Turkish economy closed 2006 with slower growth of 6.1% due to a deceleration of domestic demand in the second half of the year. The composition of growth changed somewhat from 2005, with the negative contribution of net exports turning neutral on the back of weakening import growth and the positive contribution that resulted from a moderation of domestic demand. A closer look at the composition of domestic demand in 2006 shows that private consumption growth started to weaken in the second half of the year, partly because of the tighter monetary stance and the contraction of lending in an environment of higher interest rates across the board following the financial turmoil in spring and early summer 2006.³² Growth of real credit to the private sector eased from about 35% at the end of 2005 to about 25% at the end of 2006. In line with this development, gross fixed capital formation declined from high growth rates at the start of the year to a rather moderate growth rate in the last quarter of 2006. Investment went mainly into services, above all into, the financial, transportation and communication sectors. By contrast, public consumption accelerated significantly, fueled by personnel and social security expenditures. The reduction in energy prices in the second half of the year caused import growth to subside to about the same rate as export growth, leaving the contribution of net exports to GDP neutral in the year 2006.

Still no improvement on the labor market

As in the previous two years, labor productivity growth stayed high in manufacturing, and nominal wage as well as ULC growth diminished somewhat in this sector. The still rather high unemployment rate maintained the slow downward trend of the last few years. The employment rate remained stable, with notable increases in the service sector and decreases in the agricultural sector.

Combined current and capital account deficit widens

One of Turkey's persisting macroeconomic vulnerabilities is the large external imbalance that has been building up since 2002. In 2006, the combined current and capital account deficit picked up further and reached around 8% of GDP. This development was partly attributable to the deterioration of the trade balance. On the financial side, net FDI inflows nearly doubled compared to 2005 and covered about three-fifths of the current account gap. FDI was driven by the privatization process, i.a. in the banking sector.

Fiscal discipline turns long-time budget deficit into a surplus

Maintaining a disciplined fiscal policy has remained key to containing the current account deficit, supporting the disinflation process and retaining the confidence of international financial market participants. Under the current Stand-By Arrangement with the IMF, Turkey has agreed to pursue a primary surplus target of at least 6.5% of GNP through 2008. In 2006, the general government balance registered a surplus of 0.4% of GDP for the first time in many years. General government gross debt fell to about 60% of GDP. The main fiscal risks remain related to social security, where a reform law was partly annulled and postponed until 2008, to wage agreements in the public sector and to overall budget quality. As agreed with the IMF during a recent

³² See *Developments in Selected Countries, Focus on European Economic Integration 2/06*, for more details.

Table 13

Main Economic Indicators: Turkey

	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	8.9	7.4	6.1	7.7	9.5	6.7	8.3	4.8	5.2
Private consumption	10.6	9.1	5.0	10.7	18.1	8.0	11.2	1.8	0.1
Public consumption	0.5	2.4	9.6	3.2	0.0	10.1	18.3	14.8	0.7
Gross fixed capital formation	32.4	24.0	14.0	30.6	33.0	32.1	14.0	11.3	4.4
Exports of goods and services	12.5	8.5	8.5	3.9	10.9	6.8	9.1	11.5	6.2
Imports of goods and services	24.7	11.5	7.1	11.2	15.3	10.0	13.7	3.6	1.0
Contribution to GDP growth in percentage points									
Domestic demand	13.9	9.1	5.8	10.3	11.9	9.0	11.9	1.6	2.8
Net exports of goods and services	-4.2	-1.6	0.0	-2.1	-2.2	-2.0	-3.1	2.3	1.8
Exports of goods and services	3.9	2.8	2.8	1.2	3.8	2.4	3.0	3.3	2.2
Imports of goods and services	8.2	4.4	2.8	3.3	6.0	4.4	6.1	1.1	0.4
Year-on-year change of period average in %									
Labor productivity of industry (real)	7.5	6.0	6.7	6.1	8.4	5.1	9.9	6.5	5.2
Gross average wage of industry (nominal)	13.4	12.2	11.5	12.5	11.4	11.3	11.5	11.1	12.1
ULC of industry (nominal)	5.5	5.9	4.5	6.0	2.8	6.0	1.4	4.4	6.5
PPI of industry	14.6	6.0	9.3	4.3	2.3	4.9	8.4	12.6	11.4
CPI (here: HICP)	10.1	8.1	9.3	7.8	7.3	7.6	9.2	10.6	9.7
EUR per 1 SIT, + = SIT appreciation	-4.5	5.9	-7.3	10.4	16.0	8.6	-6.9	-14.4	-14.1
Period average levels									
Unemployment rate (ILO definition, %, 15-64 years)	10.3	10.2	9.7	9.4	10.6	11.9	8.8	9.1	9.1
Employment rate (15-64 years)	43.6	43.5	43.6	44.8	42.9	40.1	44.3	45.0	45.0
Key interest rate p. a. (%)	21.9	14.8	15.6	14.3	13.8	13.5	14.0	17.4	17.5
SIT per 1 EUR	1.8	1.7	1.8	1.6	1.6	1.6	1.8	1.9	1.9
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	24.1	20.4	29.0	20.9	21.4	26.5	30.9	30.7	27.9
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	2.1	6.2	11.5	7.0	7.5	11.1	11.9	10.9	12.1
Domestic credit of the banking system	28.9	20.6	21.4	20.7	18.4	20.4	23.6	21.8	19.7
of which:									
<i>claims on the private sector</i>	19.2	18.9	22.7	18.5	18.9	21.1	24.0	23.9	21.5
<i>claims on households</i>	8.0	8.7	10.5	8.8	9.5	10.3	11.4	11.0	9.3
<i>claims on enterprises</i>	11.2	10.2	12.2	9.8	9.4	10.7	12.6	12.9	12.2
<i>claims on the public sector (net)</i>	9.7	1.7	-1.3	2.2	-0.5	-0.7	-0.4	-2.1	-1.8
Other domestic assets (net) of the banking system	-6.9	-6.4	-3.8	-6.8	-4.5	-4.9	-4.6	-2.0	-3.9
% of GDP (ESA 95)									
General government revenues	..	..	..	..	..	..	..	..	..
General government expenditures	..	..	..	..	..	..	..	..	..
General government balance	-5.8	-0.3	0.4	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	76.9	69.6	60.7	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	19.3	15.0	17.5	11.9	19.5	18.8	19.2	18.9	13.9
Merchandise imports	27.2	21.9	17.7	22.5	28.2	27.0	26.3	15.9	4.9
% of GDP (based on EUR), period total									
Trade balance	-8.0	-9.3	-10.1	-8.6	-9.2	-10.8	-13.4	-9.3	-7.6
Services balance	4.3	4.2	3.3	7.3	2.6	1.4	3.1	6.2	1.9
Income balance (factor services balance)	-1.9	-1.6	-1.7	-1.2	-1.4	-1.9	-1.8	-1.4	-1.7
Current transfers	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5
Current account balance	-5.1	-6.2	-8.0	-2.1	-7.5	-10.8	-11.7	-4.1	-6.9
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FDI (net)	0.7	2.5	4.8	2.1	5.7	1.7	8.5	3.1	5.9
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	48.9	49.0	49.6	..	49.0	49.9	48.1	49.2	49.6
Gross official reserves (excluding gold)	11.0	14.7	14.6	12.7	14.7	15.8	14.2	14.7	14.6
Months of imports of goods and services									
Gross official reserves (excluding gold)	3.9	5.2	4.9	4.5	5.2	5.6	4.9	4.9	4.9
EUR million, period total									
GDP at current prices	241,185	292,121	316,247	91,281	82,360	67,246	72,425	93,057	83,519

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

review of the Stand-By Arrangement, the government imposed a freeze on certain budgetary outlays – a factor that is also important in connection with the EU accession process. The European Commission closely monitors developments related to structural reforms that will enhance the quality of medium-term fiscal discipline with regard to both macroeconomic and price stability.

Low private savings and weaker, but still dynamic domestic credit growth are reflected both in the high current account deficit and in the significant increase in Turkey's private net external debt, which amounted to nearly 30% of annual GDP at the end of 2006. By contrast, net public debt has been decreasing steadily since the crisis of 2001. However, a large fraction of public debt is indexed either to the exchange rate or to overnight interest rates and thus remains subject to interest rate or exchange rate risks.

Setback in disinflation process, inflation remains above target

With inflation at almost 10% in 2006, Turkey missed the 2006 end-year inflation target³³ of 5% (± 2 percentage points) by a considerable margin, mainly as a consequence of the passthrough of the depreciation of the Turkish lira during the spring and early summer of 2006. According to the central bank, Türkiye Cumhuriyet Merkez Bankası (TCMB), the cumulative exchange rate passthrough since May 2006 has added around 3.5 percentage points to headline inflation. Although inflation in energy and unprocessed food prices decelerated in the second half of the year, annual inflation rates remained high for these groups of consumer goods. The most recent TCMB inflation poll shows that CPI inflation expectations remain at 7.5% for end-2007, declining to 6.6% 12 months forward and 5.6% 24 months forward. This compares to an official target of 4% (± 2 percentage points) for end-2007 and beyond. Inflation increased again in March 2007, rising to more than 10% year on year, the highest level since mid-2006. The TCMB cites backward-looking price-setting behavior and the sensitivity of service prices to wage hikes as an inflationary risk.

Stable Turkish lira

After the sharp depreciation of the Turkish lira in May and the somewhat smaller depreciation in June 2006 as a consequence of financial market turbulences, the currency recovered some of the earlier losses and traded at around TRY/EUR 1.84 from August 2006. The TCMB uses discretionary interventions when market volatility increases. However, the high current account deficit continues to leave the Turkish lira vulnerable to abrupt changes in global investor sentiment. Financial markets overall have stabilized since early summer 2006, yet interest rates have remained at slightly higher levels, and bond spreads have narrowed less quickly than in many emerging markets.

11 Russia: Continuing Strong Growth and Twin Surpluses

Buoyant domestic demand and accelerating investment contrast with ongoing contraction of net exports

Real GDP in Russia expanded by 6.7% in 2006, which is slightly more than in 2005. Following a weak first quarter, economic activity strengthened in the second quarter of 2006 and remained brisk through year-end. Domestic demand continued to be the driving force of the Russian economy, supported by very rapid credit expansion (real private credit increased by around 36% at

³³ In January 2006, the Turkish central bank switched from explicit to implicit inflation targeting.

the end of 2006). Private consumption growth remained robust, and gross fixed capital formation³⁴ grew particularly strongly. Shrinking net exports increasingly acted as a drag on growth due to very high import growth rates.

Looking at the supply side, economic growth in 2006 was led by construction followed by financial services, wholesale and retail trade. Booming tertiary activities contrasted with slowing industrial production growth and the unimpressive performance of resource extraction.

Buoyed by unusually mild weather in early 2007, economic performance stood out in the first two months of 2007: Investment expanded by over one-fifth year on year, industrial activity increased by 8.6%, and retail trade grew by 13.9%. Unemployment remained largely stable. However, some economic sectors, above all resource extraction and transportation, seem to have reached capacity constraints, and the energy sector continues to struggle with a difficult business climate in which foreign investors appear to be less and less welcome. With overall structural and institutional reforms continuing at a sluggish pace against the backdrop of the upcoming elections of 2007 and 2008, the quality of Russian growth remains somewhat fragile.

Notwithstanding the weakening of oil prices since September 2006, Russia's terms of trade further improved on average in 2006 compared with the previous year. This improvement, rising capital inflows and sustained caution in macroeconomic policies have kept Russia's twin surpluses very high. The combined current and capital account surplus reached almost 10% of GDP in 2006. Even though net FDI inflows crept up to reach 1.1% of GDP, they remained modest. Foreign loans to domestic banks and corporations continued to expand swiftly. The general government budget surplus rose slightly to 8.5% of GDP. Despite this impressive level, IMF calculations suggest that the government's non-oil deficit has risen since 2004, which would point to a certain degree of recent fiscal relaxation.³⁵

The Central Bank of the Russian Federation (CBR) held firm in the face of continuing appreciation pressures, and the Russian ruble lost about 2% against the euro from mid-2006 while gaining 4% against the U.S. dollar in the same period. This, as well as the recent decline in energy prices, flanked by the substantial fiscal sterilization (see below) and the government's decision to defer adjustments of administered prices, helped reduce CPI inflation to 9% in December 2006 and was thus in line with the authorities' revised informal inflation goal (8.5% to 9%). Inflation declined further to 7.8% in February 2007 (year on year), the lowest rate witnessed since mid-1998. The CBR's informal goal for 2007 corresponds to a range of 6.5% to 8% (year-end). According to the CBR, a potential further swelling of capital inflows might strain the authorities' sterilization capacities and is currently seen as the biggest risk to achieving the informal inflation goal for 2007. Furthermore, a possible election-oriented additional relaxation of fiscal policy could also complicate policymaking. Accelerating money supply growth was so far largely matched by increasing money demand, ongoing de-dollarization and further

Booming services contrast with lackluster industrial activity and stagnating resource extraction

Strong growth performance extends into early 2007, though quality remains somewhat fragile

Favorable terms of trade and prudent macropolicies have kept twin surpluses very high

Inflation has dipped recently, but inflationary pressures persist

³⁴ A sectoral disaggregation of gross fixed capital formation, which would shed further light on the most actively investing branches, is not yet available for 2006.

³⁵ IMF estimates of November 2006.

Table 14

Main Economic Indicators: Russia

	2004	2005	2006	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Year-on-year change of period total in %									
GDP at constant prices	7.1	6.4	6.7	6.6	8.0	5.0	7.0	6.8	7.7
Private consumption	11.6	12.2	10.9	13.1	13.0	9.2	10.4	11.4	12.4
Public consumption	2.1	2.2	4.2	3.0	3.7	3.2	5.5	4.7	3.4
Gross fixed capital formation	12.6	8.3	13.9	8.9	12.1	5.6	14.7	13.7	17.4
Exports of goods and services	11.8	6.4	7.2	5.1	10.6	8.9	6.4	6.1	7.4
Imports of goods and services	23.3	17.0	21.7	17.8	19.7	22.9	21.7	19.1	23.2
Contribution to GDP growth in percentage points									
Domestic demand	8.8	8.4	9.7	8.8	9.6	6.4	10.0	9.5	12.2
Net exports of goods and services	-1.4	-2.3	-3.9	-3.0	-2.0	-2.9	-3.9	-3.6	-5.0
Exports of goods and services	4.1	2.3	2.6	1.7	4.0	3.4	2.4	2.0	2.9
Imports of goods and services	5.5	4.7	6.5	4.7	6.1	6.3	6.3	5.6	7.9
Year-on-year change of period average in %									
Labor productivity of industry (real) ¹	14.0	7.3	8.3	7.1	7.5	6.9	10.2	8.8	7.4
Gross average wage of industry (nominal) ¹	5.2	21.1	21.4	20.2	22.1	20.1	20.7	22.6	22.0
ULC of industry (nominal) ¹	-7.7	12.8	12.1	12.1	13.6	12.4	9.5	12.7	13.6
PPI of industry	24.0	20.7	12.4	20.6	16.2	14.8	12.7	13.8	8.7
CPI (here: HICP)	11.0	12.5	9.8	12.5	11.2	10.8	9.6	9.6	9.2
EUR per 1 SIT, + = SIT appreciation	-3.1	1.7	3.3	2.5	8.1	7.9	3.6	1.8	0.0
Period average levels									
Unemployment rate (ILO definition, %, 15–64 years)	8.2	7.6	7.2	7.3	7.5	7.8	7.4	6.7	6.8
Employment rate (15–64 years)	..	..	..	..	..	..	..	..	..
Key interest rate p. a. (%)	13.5	13.0	11.6	13.0	12.9	12.0	12.0	11.5	11.1
SIT per 1 EUR	35.8	35.2	34.1	34.8	34.2	33.8	34.2	34.2	34.1
Nominal year-on-year change of period average stock in %									
Broad money (including foreign currency deposits)	35.5	33.9	37.0	35.8	36.8	35.0	36.1	37.4	39.1
Contributions to year-on-year change of broad money in percentage points									
Net foreign assets of the banking system	22.4	34.0	30.8	34.2	32.2	29.2	32.1	31.8	30.2
Domestic credit of the banking system	17.6	0.4	11.7	1.4	5.8	9.3	10.9	11.6	14.4
of which:									
claims on the private sector	30.8	30.0	36.4	29.8	32.6	32.1	34.7	38.3	39.4
claims on households	6.9	8.8	12.0	8.9	10.5	10.8	11.6	12.4	12.8
claims on enterprises	23.9	21.2	24.4	20.9	22.1	21.3	23.0	25.9	26.6
claims on the public sector (net)	-13.2	-29.6	-24.6	-28.4	-26.8	-22.8	-23.7	-26.6	-25.0
Other domestic assets (net) of the banking system	-4.5	-0.2	-5.8	0.1	-1.2	-4.2	-7.6	-6.0	-5.5
% of GDP									
General government revenues	31.9	39.7	40.0	..	..	..	..	..	..
General government expenditures	27.4	31.6	31.5	..	..	..	..	..	..
General government balance	4.5	8.1	8.5	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	21.7	14.9	..	..	..	..	..	..	..
Year-on-year change of period total (based on EUR) in %									
Merchandise exports	22.6	33.7	22.9	34.0	38.8	46.4	28.6	18.0	7.1
Merchandise imports	16.6	29.6	28.9	30.2	39.7	31.7	32.1	26.3	27.1
% of GDP (based on EUR), period total									
Trade balance	14.5	15.5	14.1	15.7	14.7	18.1	16.2	13.7	9.8
Services balance	-2.3	-2.0	-1.5	-2.5	-1.9	-1.3	-1.4	-1.8	-1.5
Income balance (factor services balance)	-2.2	-2.5	-2.9	-3.8	-2.4	-1.6	-4.4	-3.0	-2.5
Current transfers	-0.1	-0.1	-0.1	-0.2	-0.3	0.0	0.1	-0.3	-0.3
Current account balance	9.9	10.9	9.6	9.3	10.1	15.2	10.5	8.7	5.6
Capital account balance	-0.3	-1.7	0.0	-5.2	-0.3	0.0	0.0	0.0	0.0
FDI (net)	0.3	0.2	1.1	1.9	-3.8	1.2	3.8	0.8	-0.9
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	33.5	36.2	29.9	33.1	36.2	34.2	32.5	28.6	29.9
Gross official reserves (excluding gold)	18.6	24.0	31.1	22.6	24.0	24.9	27.7	27.4	31.1
Months of imports of goods and services									
Gross official reserves (excluding gold)	10.1	13.3	17.6	12.7	13.3	14.0	15.6	15.6	17.6
EUR million, period total									
GDP at current prices	475,479	616,014	785,586	168,741	178,511	167,314	185,145	212,106	221,020

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

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

monetization. The volume of bank credits continued to expand robustly. The lack of full reliability of prudential data may be hiding problems of some banks with loan quality.

Foreign currency reserves (including gold) reached a new record level of EUR 260 billion in early April 2007 (which corresponds to about 19 months of goods and services imports). Russian foreign exchange reserves are the third-largest in the world (following those of China and Japan). In mid-February 2007, the CBR reported reserves to be allocated roughly as follows: 50% in U.S. dollars, 40% in euro, 10% in pounds sterling. The country's Oil Stabilization Fund³⁶ (which makes up part of the reserves) almost doubled to EUR 79 billion within a year. In line with a decision by the Duma in April 2007, the fund will be divided into a Reserve Fund (for macrostabilization purposes) and a Fund for Future Generations. Furthermore, three-year budget planning is to be introduced and separate oil and non-oil budgetary systems are to be established. Respective legal changes were passed by the Duma in mid-April 2007 and are to be successively implemented, starting next year. Russian gross external debt declined further and came to 30% of GDP at the end of 2006, as the public debt situation improved further while private liabilities expanded. For the first time in decades, gross official reserves were higher than gross external debt at the end of 2006, suggesting that the country has become a net creditor to the rest of the world.

In early February 2007, the CBR increased the weight of the euro in the dual currency basket used to steer the Russian ruble's exchange rate. The euro's share was adjusted from 40% to 45%, and the U.S. dollar's share changed accordingly, dropping from 60% to 55%. The rationale for this step was to better reflect the structure of the country's foreign trade. The Russian ruble's real-effective exchange rate had gone up by 3% since mid-2006. The currency's unrelenting real appreciation as well as strongly rising wages (nominal wage growth in industry surpassed 20% in both 2005 and 2006 and quickened further to 26.8% year on year in January 2007) and, consequently, surging ULC seem to be putting the competitiveness of various manufacturing branches under pressure. Ollus and Barisitz (2007)³⁷ shed more light on this issue by comparing sectoral import with sectoral output developments in Russian manufacturing, showing that import competition in manufacturing is strong and rising, which indicates the possibility of incipient Dutch disease.

Cutoff date for data: April 25, 2007.

Foreign exchange reserves and stabilization fund mark new highs again

Real effective exchange rate appreciation and mounting import competition point to Dutch disease threat

³⁶ See *Focus on European Economic Integration* 1/04, p. 42; for a detailed analysis, see Astrov, V. 2007. *The Russian Oil Fund as a Tool of Stabilization and Sterilization*, in this issue of *Focus on European Economic Integration*.

³⁷ Ollus, S. and S. Barisitz. 2007. *The Russian Non-Fuel Sector: Signs of Dutch Disease? Evidence from EU-25 Import Competition*. In: *BOFIT Online 2* and this issue of *Focus on European Economic Integration*.