

# Recent Economic Developments

# Developments in Selected CESEE Countries:

## Multispeed Recovery in CESEE<sup>1,2,3</sup>

### 1 Introduction

Recovery is gaining ground in the region ...

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

... but there are still vast differences between countries ...

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

... as underlined by financial markets data

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

<sup>1</sup> Compiled by Josef Schreiner with input from Stephan Barisitz, Markus Eller, Jarko Fidrmuc, Sándor Gardó, Antje Hildebrandt, Mathias Lahnsteiner, Thomas Reiningger, Zoltan Walko and Julia Wörz.

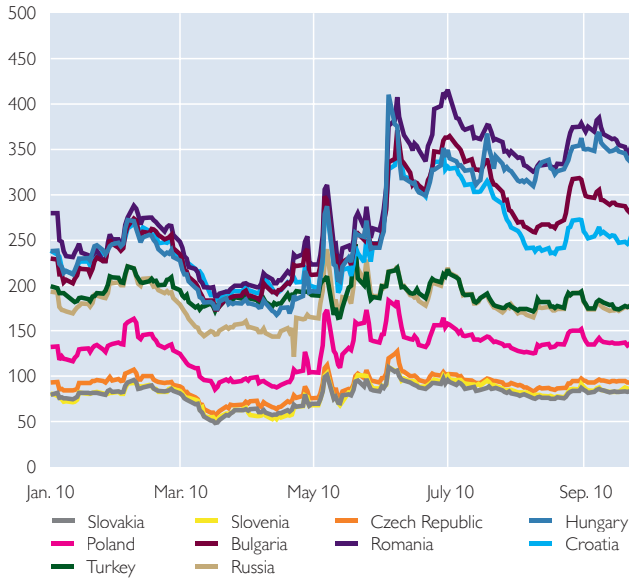
<sup>2</sup> Cut-off date: October 8, 2010 (October 22, 2010, for fiscal data). This report primarily focuses on data releases and developments from March 2010 to the cut-off date, while selectively recalling earlier developments where this appears necessary to put recent developments into perspective.

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

## Selected Financial Market Indicators

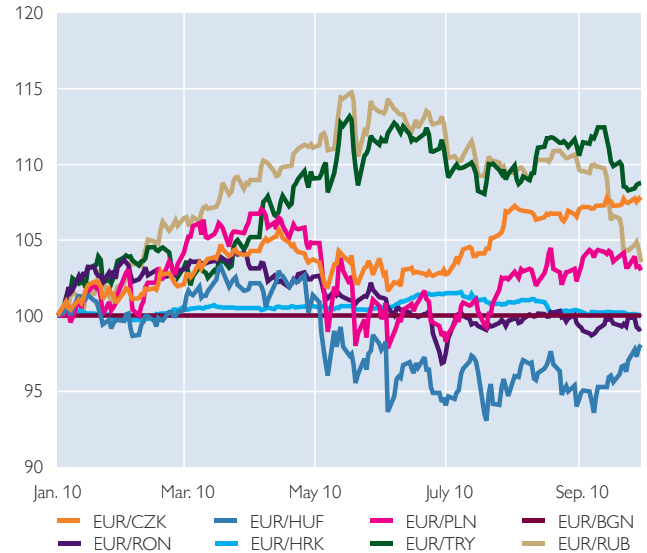
### CDS Premiums

Basis points



### Exchange Rates

Index: January 1, 2010 = 100



Source: Thomson Financial.

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

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

GDP readings are improving throughout the region

<sup>4</sup> A more detailed analysis of macrofinancial developments in the region will be published in the OeNB's Financial Stability Report 20 in December.

Table 1

**Real Gross Domestic Product**

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

Source: Eurostat, national statistical offices.

<sup>1</sup> Weighted average.

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

Dynamics driven to a substantial extent by the external sector ...

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

... and a turn in the inventory cycle

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

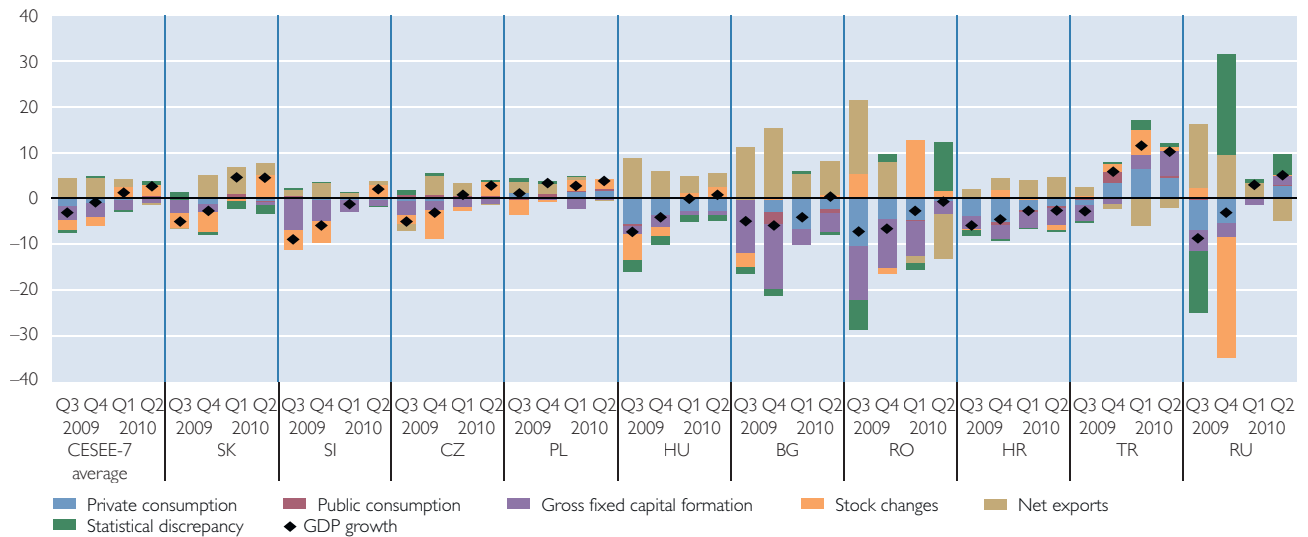
No distinctive growth contribution from domestic demand in most countries

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

Chart 2

## GDP Developments

Percentage points, GDP growth in %



Source: Eurostat, national statistical offices.

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

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

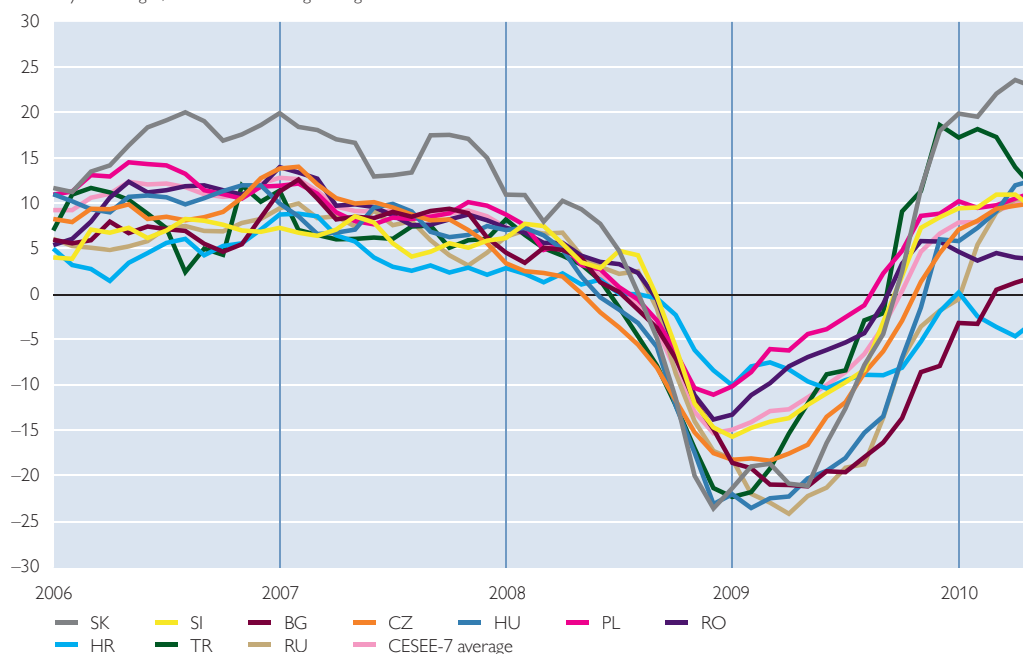
Industrial sector performing especially well

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

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

### Industrial Production

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



Source: Eurostat, wiiv.

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

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

<sup>5</sup> For the detailed OeNB forecast for CESEE, see box 2.

Gradually improving economic outlook for CESEE; regional differences remain

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

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

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

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

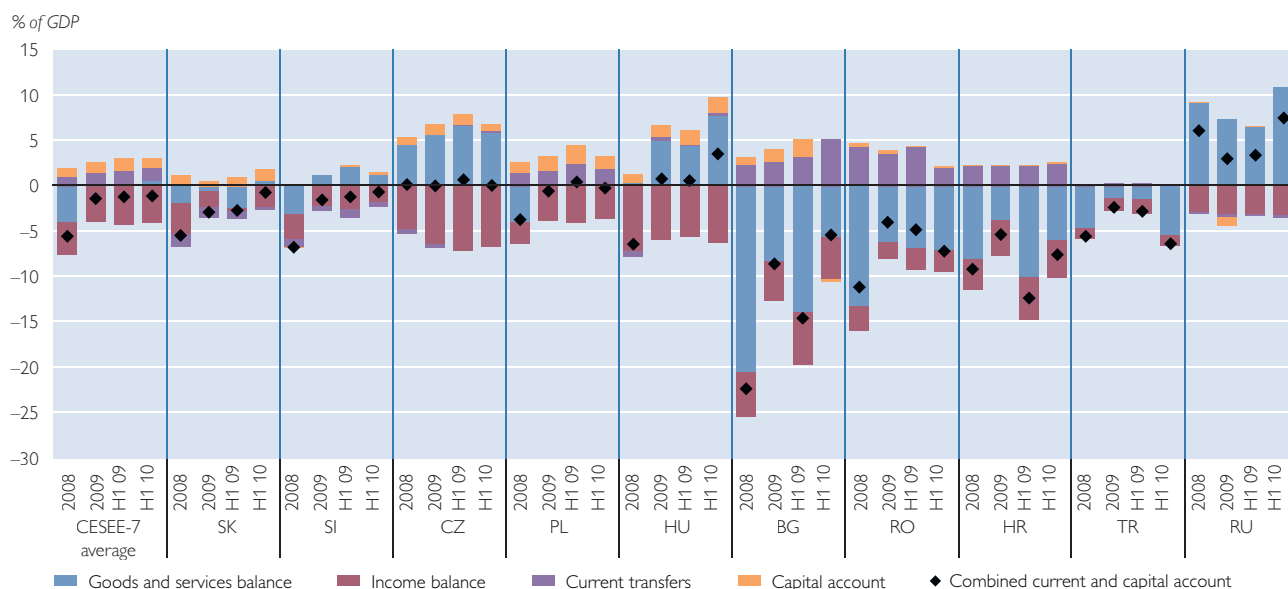
A look at saving/investment balances also points in this direction. The reduction in current account deficits was driven mainly by a decline in investment with some additional help by the saving rate only in Bulgaria, Hungary and Croatia. However, after a series of negative quarters, capital formation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

External adjustment has probably reached its peak ...

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

Chart 4

### Current and Capital Account of the Balance of Payments



Source: National central banks.

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

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

#### Gross external debt mostly flat

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

#### Recovery of labor market conditions around the corner?

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

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

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

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

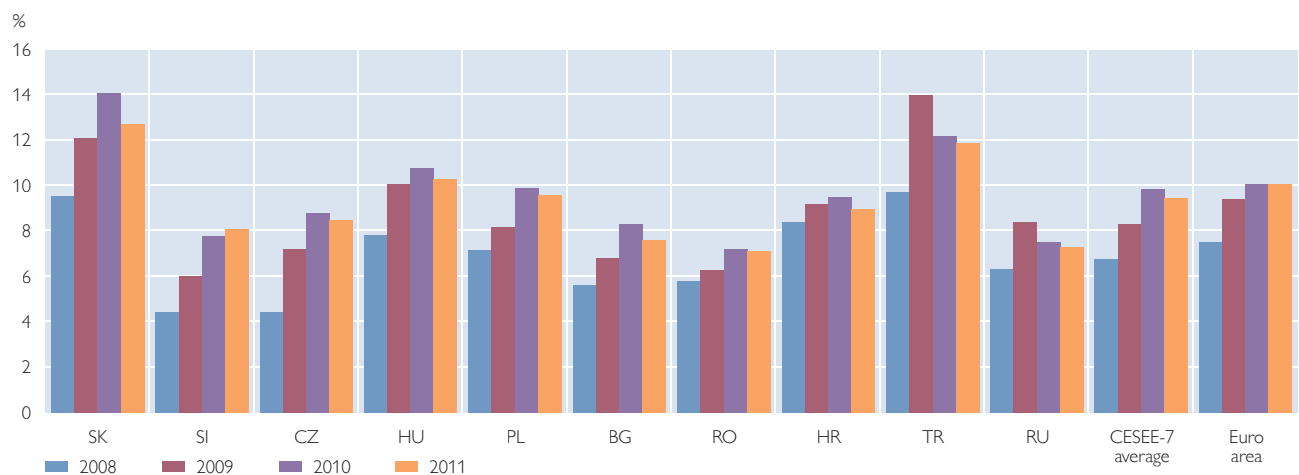
In a similar vein, the gradual recovery in general economic conditions was not strong enough to push up wages. Nominal wage growth at the whole economy level was mostly flat with some notable increases only in Bulgaria and Russia. Moderate, but still clearly positive inflation rates pushed real wage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

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

Cyclical surge in productivity boosts competitiveness

Chart 5

## Unemployment Rates



Source: Eurostat, forecasts: IMF.

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

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

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

Table 2

### Development of Unit Labor Costs in Industry

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

Source: Eurostat, national statistical offices, wiiv.

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

Credit dynamics were dampened but have recently appeared to rebound

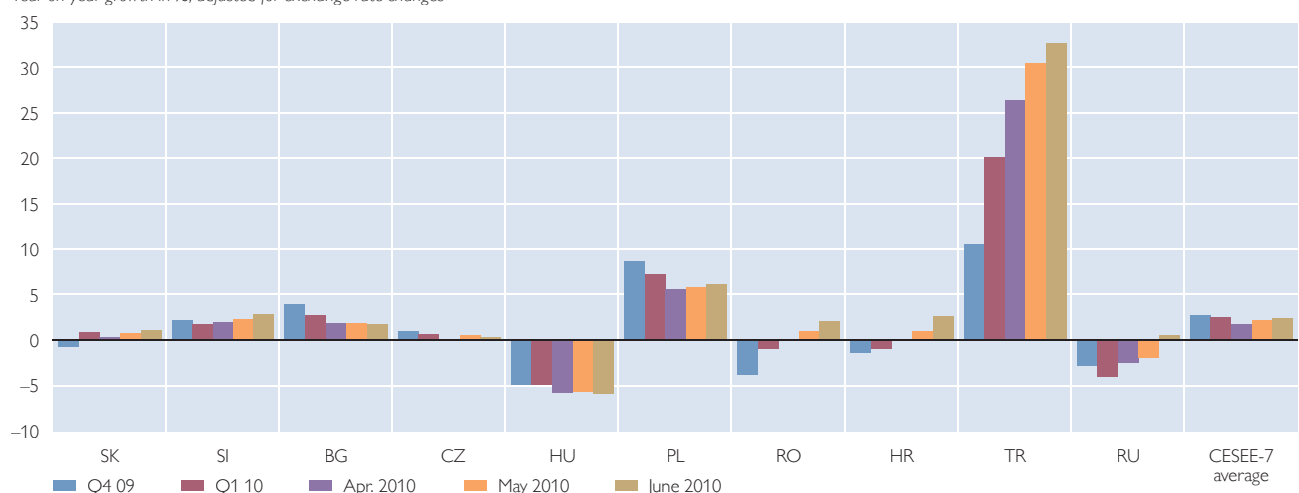
An interesting feature of current credit developments is that household credit is growing at more or less robust annual rates (sometimes in the double digits) while corporate credit growth mostly remains in the red. Low credit demand in the corporate sector is likely related to still low levels of capacity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

Corporate credit growth weaker than household credit growth

Chart 6

### Growth of Credit to the Private Sector

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



Source: National central banks.

Note: Turkey: nonadjusted rate.

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

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

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

Nonperforming loan ratios still elevated

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

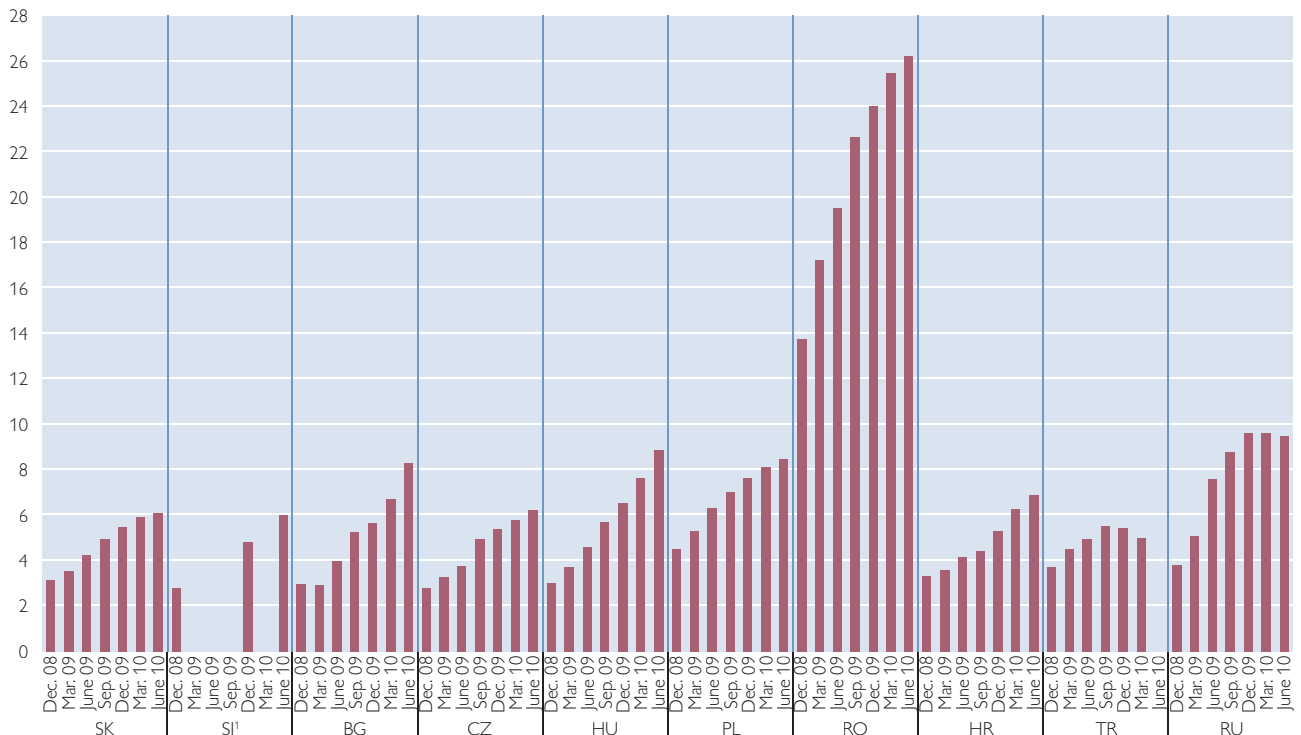
Some pickup in generally moderate inflation

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

Chart 7

## Nonperforming Loans

% of total credit



Source: National central banks.

<sup>1</sup> Until 2009, Slovenia published nonperforming loan details only at annual frequency. Since 2010, details have been available biannually.

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

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

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

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

Governments are slowly embarking on a fiscal consolidation path

Table 3

**Consumer Price Index (HICP)**

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

Source: Eurostat, national statistical offices, wiw.

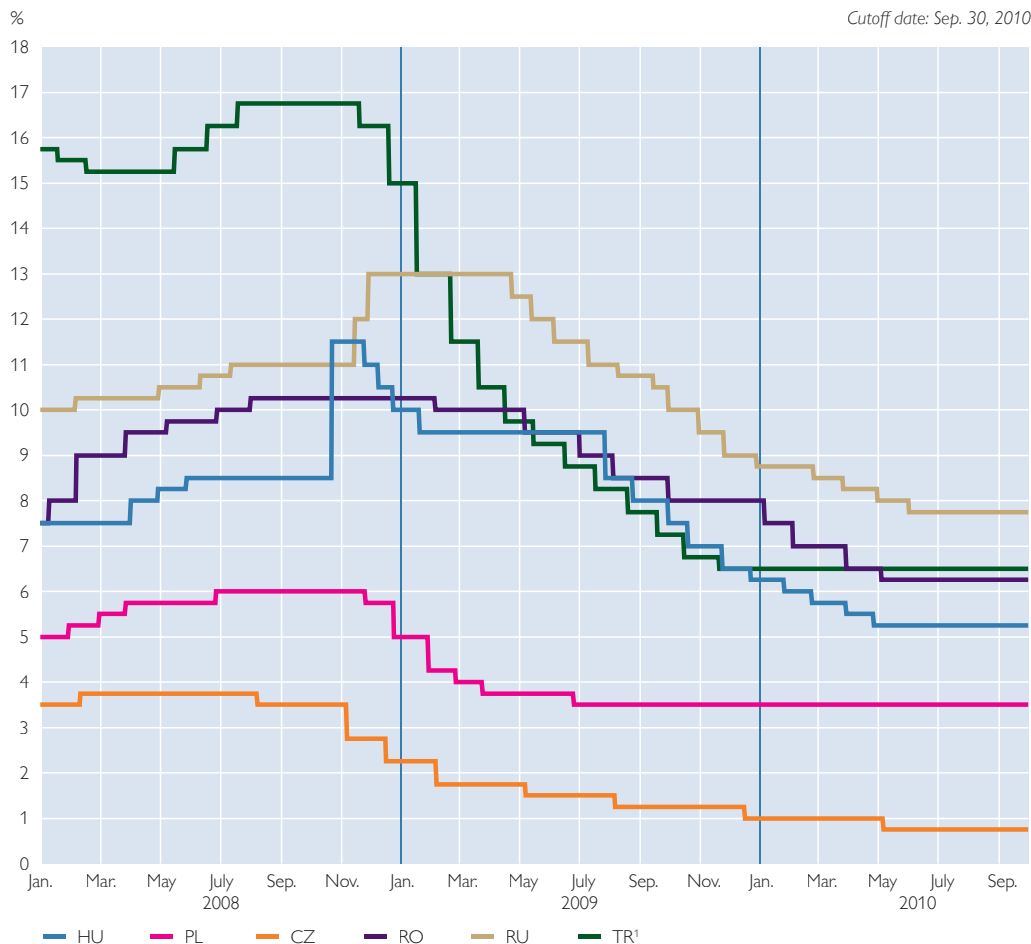
<sup>1</sup> CPI.

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

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

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

Chart 8

**Policy Rate Developments in CESEE**


Source: National central banks.

<sup>1</sup> In May 2010, the Central Bank of Turkey replaced the borrowing rate with the one-week repo rate as the new policy rate.

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

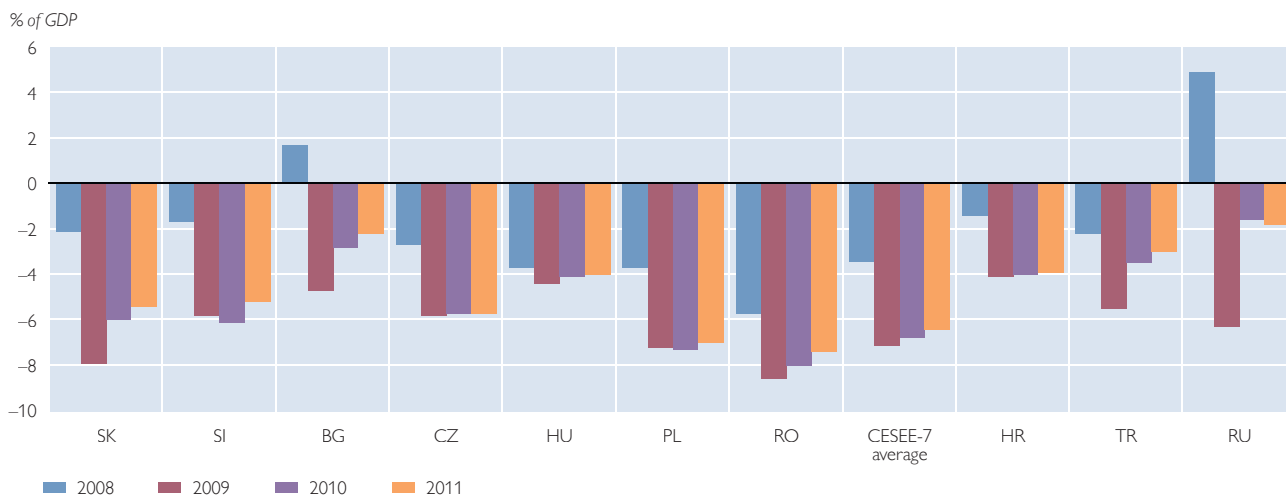
According to recent forecasts, the bulk of consolidation will take effect in 2012 and the years thereafter, as deficits in the CESEE-7 are projected to remain broadly unchanged in 2010 (with the notable exception of Bulgaria) and 2011. As regards the non-EU Member States of the country sample, the deficits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

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

EU accession  
negotiations continue

Chart 9

### General Government Deficits



Source: Eurostat, European Commission.

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

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

Box 1

#### Estonia to Become 17<sup>th</sup> Member of the Euro Area in 2011

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

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

Table 1

### Comparison of Estonian and Euro Area Indicators

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

Source: Eurostat.

<sup>1</sup> 2000 and 2009 data.

<sup>2</sup> Eurostat definition.

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

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

Box 2

### OeNB-BOFIT Outlook for CESEE Countries: Growth Driven by Net Exports and Restocking, Domestic Demand to Remain Weak<sup>1</sup>

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 1

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

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

Source: OeNB September 2010 forecast, Eurostat.

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

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

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

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

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

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

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

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

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

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

Table 2

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

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

Source: BOFIT September 2010 forecast, Eurostat.

### OeNB Projections for Croatia: Weak Domestic Demand Slows Economic Recovery

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

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

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

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

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

Table 3

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

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

Source: OeNB September 2010 forecast, Eurostat.

## 2 Slovakia: Fragile Revival Based on External Demand

Output growth fueled by exports and public consumption

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

FDI in electronics industry improve industrial structure

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

Soaring wages

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

Inflation remains low

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

Expanding budget deficit

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

Table 4

## Main Economic Indicators: Slovakia

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

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

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

### 3 Slovenia: Gradual Recovery under Way

GDP growth bounces back in the second quarter of 2010

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

Current account improvement in the first half of 2010

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

Inflation up due to food prices and excise tax increases

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

Parliament approved supplementary budget to keep 2010 deficit

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

Table 5

**Main Economic Indicators: Slovenia**

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

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

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

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

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

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

External imbalances are corrected further, external competitiveness starts to strengthen

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

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

In June 2010, the amendment of the State Budget Act for 2010 revised the targeted general government deficit for 2010 upward, from 2.8% to 3.8% of GDP. Assuming a – compared to currently available forecasts rather optimistic – real GDP growth rate of 1% for 2010, this amendment accounted for an unexpectedly strong decline in revenues from VAT and excise duties and incorporated additional spending for healthcare and social activities. The authorities also decided to further substantially reduce the fiscal reserve account (FRA) to finance the deficit. In line with a cash budget deficit target of 4.8% of GDP, the FRA is expected to shrink from 11% to about 6% of GDP during 2010. In July 2010 the Ecofin opened an Excessive Deficit Procedure (EDP) for Bulgaria as the deficit in 2009 was qualified to be excessive. Under the EDP, the government has committed itself to reducing the deficit-to-GDP ratio to below 3% until 2011, which requires a consolidation effort of at least  $\frac{3}{4}$ % of GDP in 2011. Accordingly, the budget proposal for 2011 currently discussed in parliament targets a deficit ratio of 2.6%, assuming a real GDP growth rate of 3.6% for 2011.

Table 6

**Main Economic Indicators: Bulgaria**

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

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

<sup>1</sup> Not available in a currency board regime.

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

Positive real GDP growth in the first half of 2010

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

Some signs of labor market improvement

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

Stronger currency against the backdrop of improved investor confidence

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

Accelerating inflation

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

Fiscal consolidation top priority of new government

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

Table 7

**Main Economic Indicators: Czech Republic**

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

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

## 6 Hungary: Government to Boost Economy while Pursuing Fiscal Consolidation

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

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

Monetary policy on hold since April 2010

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

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

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

Table 8

**Main Economic Indicators: Hungary**

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

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

## 7 Poland: Gradually Heading for Balanced Growth

Favorable conditions for the take-off of fixed investment growth

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

Foreign exchange intervention to curb zloty's re-appreciation

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

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

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

Table 9

## Main Economic Indicators: Poland

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

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

## 8 Romania: Still in Recession, Painful Fiscal Adjustment

Output stabilization  
only temporary

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

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

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

VAT rate hike triggers  
pickup in inflation

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

Current account deficit  
increased despite  
recession and good  
export performance

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

Table 10

**Main Economic Indicators: Romania**

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

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

## 9 Croatia: Weak Economy Increasingly Challenging Public Finances

Depressed domestic demand weighs on economic recovery

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

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

Despite partial improvements external vulnerabilities remain

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

Deteriorating public finances tied with sizeable financing needs

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

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

Table 11

## Main Economic Indicators: Croatia

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

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

## 10 Turkey: Buoyant Domestic Demand and Rising External Imbalances

Private consumption surpassed pre-crisis level

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

Widening external deficit and chronically high unemployment

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

Recent inflation hikes perceived as temporary

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

Reversal of liquidity measures has started

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

Table 12

## Main Economic Indicators: Turkey

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

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

## 11 Russia: Summer Heat Wave Temporarily Slowed down Recovery

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

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

... but was somewhat dampened by the summer heat wave

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

Russia's external balances improved in the first half year

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

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

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

Fiscal stimulus in response to crisis to be withdrawn?

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

Table 13

**Main Economic Indicators: Russia**

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

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

