

# Current Analyses and Forecasts | 6 | July 2010

Economic Prospects for Central, East and Southeast Europe

*Vasily Astrov, Mario Holzner, Kazimierz Laski,  
Leon Podkaminer et al.*

**Will Exports Prevail over Austerity?**

A large, stylized letter 'F' is centered within a circular graphic. The top half of the circle is yellow, and the bottom half is light gray. The letter 'F' is white, with a yellow top bar and a gray stem and crossbar.



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## **Will Exports Prevail over Austerity?**



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### Executive summary

- The mild improvement in the international environment has helped to uplift the mood among the exporters of Central, East and South-East Europe (CESEE). In 2010, exports are likely to be the main growth driver throughout the region, contributing to an improvement in external balances.
- In subsequent years, investments and household consumption will gradually pick up. In most of the economies, previously postponed investments will be finally put into effect and household consumption will show signs of life after the 2009 crisis.
- Generally, countries with flexible exchange rate regimes and a stronger industrial base appear to be benefiting most from the current rebound in international trade. They are expected to record growth above the regional average (yet still below pre-crisis levels).
- Among the CESEE countries, the CIS countries are expected to register the strongest performance over the forecast period. This upswing will be mainly driven by the recovery in global commodity prices (especially for oil and steel) and competitiveness gains due to currency devaluations.

- Central European NMS have also improved their external competitiveness – via devaluation and/or cuts in employment (e.g. in Slovakia). On account of their solid industries, they profit most from the ongoing recovery in global trade. However, their growth prospects are constrained by the anaemic growth performance in their main export market - the eurozone.
- Prospects of recovery are weakest in the Baltic states and the countries of South-East Europe. Their general reliance on fixed exchange rates has prevented an improvement in external competitiveness. Furthermore, their weak industrial sectors remain an obstacle to export-led growth.
- Most CESEE countries (particularly the NMS) have been recently shedding labour and unemployment is on the rise – a belated consequence of the crisis. In the West Balkans, significant employment cuts have been mostly averted (except in Serbia), but they might well come to the fore in the near future. Labour market deterioration - in tandem with the on-going 'credit crunch' - is suppressing consumer demand almost everywhere (except in the CIS and Turkey).
- The recent surge in the CESEE budget deficits reflects primarily the recession-induced shortfalls in tax revenues rather than a rise in expenditures. However, funding deficits under the current (post-Greek crisis) conditions is becoming costlier, thus raising the issue of budget deficit sustainability. The fiscal consolidation measures being envisaged might well increase the drag on domestic demand in many CESEE countries (first and foremost the NMS).
- A permanent tightening of financial conditions and a sustained need for deleveraging will most likely result in slower capital accumulation in the CESEE countries in the years ahead. Furthermore, as a consequence of the crisis, persistently low employment levels might result in human capital losses. The slower growth rates forecast will also have an impact on the region's long-term prospects of convergence with the EU-15. As a result of the crisis, the average CESEE country might lose close on a decade in the process of catching up on incomes.

### Country summaries

The **Bulgarian** government has grossly mishandled the crisis thus prolonging and deepening the economic slump in the country. The most damaging procyclical fiscal step has probably been the curbing of public investment. The economy fell into a largely self-inflicted vicious circle of economic downswing and swelling fiscal imbalance. The short-term outlook for the Bulgarian economy remains skewed towards the downside and GDP will stagnate at best in 2010.

A muted recovery in the **Czech Republic** in 2010 hinges on the performance of foreign demand. The economy has remarkable buffers that permit the active pursuit of a more expansionary fiscal policy. Under these conditions, the quest for fiscal consolidation and a certain passiveness on the monetary front affords the economy still greater insulation from fiscal risks and those posed by monetary instability, yet leaves it at the mercy of foreign trade developments. Growth could accelerate in 2011 as fiscal policy will probably relax.

After the deep recession in 2009, signs of an incipient upturn are to be seen in **Hungary**. Recovery is driven by net exports, resulting in a considerable increase in the trade surplus. In the forecast period 2010-2012, it is assumed that economic growth will slowly accelerate, initially driven for the most part by net exports. From 2011 onwards, however, the driving forces will also be modest expansion of consumption and a more articulate expansion of investments. Limited scope for government-initiated demand management in the domestic market and the possible negative impacts of fiscal consolidation in Hungary's main export markets pose a downside risk to growth.

In **Poland**, the current trends related to exchange rates, foreign trade, consumption and gross capital formation will continue. Growth in 2011 could accelerate still more, were external demand to grow stronger. Should the zloty strengthen radically, trade - the engine behind much of Poland's growth - may slow down. That notwithstanding, the major factors governing Poland's extraordinary growth performance in 2009 (healthy financial positions held by households, firms and banks) would help sustain recovery.

The GDP growth forecast for **Romania** has been revised to -1% in 2010 due to the negative effects of the recent fiscal austerity on consumption and investment. The shaken political power of the ruling coalition hinders reforms that are necessary to raise the efficiency of public services. With IMF support in place and exports recovering, external financing will remain adequate to avoid a more severe crisis.

GDP growth in **Slovakia** has been largely the result of a revival in external demand supported by improved competitiveness. Apart from the depreciation of the Slovak currency (i.e. the euro), the export expansion has been driven by a strong fall in unit labour costs coupled with rising labour productivity and falling producer prices. An increase in the unemployment rate to an average level of 15% (LFS) is the shadow side of those developments. If the euro remains weak and ULCs low, GDP growth may expand by above 3% in 2010. The main challenges for the new government relate to rising unemployment and the escalating general government budget deficit (about 7% of GDP in 2010).

GDP growth in **Slovenia** in 2010 will at best be slightly positive on account of a moderate rise in foreign demand. Given the shift to fiscal consolidation, public investments will need some time to recover and private consumption will only rise gradually as disposable income will be held back by further job reductions this year and probably stagnation in 2011. The key to potential recovery lies in the degree of recovery in Slovenia's main trading partners: Germany and Italy, in particular.

As expected, in both **Latvia** and **Lithuania** GDP will continue to decline throughout 2010, falling by 3.5% and 1.5%, respectively. Domestic demand is shrinking after the local housing and credit-driven consumption bubbles burst, which led to a dramatic surge in unemployment and a sharp decline in real wages. Both households and enterprises are in the process of deleveraging. Not least owing to the massive austerity measures adopted by both governments, deflationary pressures are strong. GDP growth will only pick up slowly: in Latvia by 0.7% in 2011 and 2% in 2012, and in Lithuania, by 1.5% in 2011 and 2.5% in 2012. In **Estonia** similar developments are to be observed; the outlook,

however, is somewhat rosier. The introduction of the euro on 1 January 2011 may bring about a stabilization of private investments and FDI inflows. Since private demand will remain rather sluggish throughout the forecast period, Estonia – like its Baltic neighbours – is clinging to the hope of a sustained revival of external demand. GDP is expected to grow by 0.5% in 2010, while an upswing of 2.5% is expected for 2011 and 3.5% for 2012.

2010 will be another year of recession in **Croatia**. Fiscal constraints and high foreign indebtedness constitute a major obstacle to financing public investment projects. Employment will continue to contract, possibly triggering a further decline in household consumption. The expectations are that GDP growth, might only rebound in 2011, provided foreign demand for both goods and services increases.

**Macedonia** is hoping for export-led recovery; that should speed up growth to 2% this year and 3 or 4% in the medium term. That scenario, however, seems a touch optimistic. Recovery among the country's main trading partners is going to be slower than previously expected and access to some of the markets, such as Serbia, may prove more difficult owing to loss of competitiveness. Overall, stability has been preserved, but growth remains elusive.

In **Turkey**, the global crisis provoked a fast decline in GDP, 14.5% in the first quarter of 2009. Thereafter, a swift change in trend followed suit thanks to three factors: a substantial currency depreciation, business-stimulating policies of both the government and the central bank, and the corporate sector's strong 'animal spirits', to use J.M. Keynes' terminology. The 11.7% GDP increase in the first quarter of 2010 has offset most of the previous decline. It followed from a massive increase in private investment and consumption expenditures. Growth may remain substantial, provided Turkish policy makers succeed in avoiding strong real appreciation of the currency.

For **Albania**, we expect final consumption to stagnate in 2010, while investment will only register a minimal increase. This minuscule increase may come about as a result of the heavy rains boosting hydro-generated energy exports, while exports of manufactures may also increase on account of exchange rate depreciation. Our forecast of a GDP growth rate of 1.7% for 2010 derives from the improvements in the current account. On the assumption that the international environment will start to improve slightly in both 2011 and 2012, a very modest improvement in household consumption and private investment can be expected. We thus forecast a growth rate of around 2% in 2011 and 3% in 2012. These rates represent only about one half of Albania's potential growth rate in the medium term.

**Bosnia and Herzegovina** experienced a relatively modest GDP decline, but the recovery may remain modest as well. In recent months, manufacturing has benefited from the rise in metal prices, but the contraction of the construction sector continues and the relative weight of both sectors is insufficient to give the economy a vigorous push in one or the other direction. The times of easy funding of huge current account deficits may be over, and this is likely to dampen the growth of both investment and consumption.

In **Montenegro**, prospects for the near future are rather gloomy. In the medium term, however, the country may continue to attract investments in tourism and other tradable services. The country expects a recovery rate of 4% in the medium term. That may be on the optimistic side because the country's recovery hinges on recovery in the EU which may well prove disappointing. In the ultimate analysis, growth may prove elusive, but stability should not be threatened.

In **Serbia**, prospects point to a slow rate of recovery mostly driven by improvements in the trade balance. That, however, has its limits because the tradable sector is rather small and, given declining investments, export capacity in the short term, it also has its limits. The government intends to sell Telecom and invest the money in infrastructure in the hope that this will lead to a rise in foreign investments in the tradable sector. As wages are quite low in euro terms, better and cheaper access to external markets could support a speed-up in growth. The risk, however, is that the pressure to support current consumption may lead to revenue from privatization being spent rather than invested. In any event, slow recovery, if not stagnation, over the medium term seems the most probable outlook.

The **Russian** economy started to recover from the crisis in late 2009. The crisis has not been seized as an opportunity to overhaul economic policies; the strategic goal of economic diversification and modernization is slipping out of reach. Fragile signs of recovery include a modest increase in output, a rise in export revenues, the stabilization of inflation and the exchange rate appreciation in early 2010. The current forecast reckons with both private consumption and investment growing faster than GDP; the latter will grow by around 4% per year over the period 2010-2012. The current account surplus will drop to below 3% of GDP by 2012. Annual CPI inflation will remain in single digits and the budget deficit will gradually revert to a surplus once again. Demographics are mitigating the adverse effects of the crisis on employment as the supply of domestic labour is shrinking.

In **Ukraine**, export-led economic recovery is underway, fuelled by the pick-up in global steel prices and the recent competitiveness gains due to the marked currency depreciation. At the same time, domestic demand remains weak, contributing to ongoing disinflation. For 2010, we expect GDP growth close to 4%, with gradual acceleration in the years ahead. Viktor Yanukovich's victory in the presidential elections and the subsequent formation of a pro-Yanukovich government have put an end to the stalemate which had persisted over the past few years, albeit partly at the cost of a certain curtailment of political freedom.

**Kazakhstan's** economy is expected to grow by 3% in 2010; growth will speed up to 5% in 2011 only to slow down somewhat to 4.5% in 2012. The oil sector will continue to be the main source of growth. Internal demand, however, will gain in importance owing to rapidly rising wages in the wake of economic revival and an increase in public wages and social expenditures envisaged by the government. In 2010, the Kazakh banks will still be licking their wounds; there will be no significant revival in credit market activity. Over the period 2011-2012, the loans market will start growing again, albeit not at as high a rate as prior to 2008.

In **China**, GDP rose 11.9% in the first quarter of 2010; that, however, should be seen in the light of the depressed levels the year previous. Assuming a prolonged pro-growth fiscal policy and a continuing recovery of the world economy, we expect the GDP to grow at a rate of about 9.5% in both 2010 and 2011. Current global economic developments, together with China's overheated real estate market and rising inflation, pose the major challenges.

### **Special section: Longer-term growth prospects of CEE countries**

The CEE economies are adjusting to the effects of the crisis in the West. Those adjustments, however, are slowing down the economies' growth and suppressing the speed of 'real convergence'. Unless the 'old' EU starts growing appreciably faster than in the past 10-15 years, long-term growth in the CEE countries will not be very spectacular.

The secular weakness of growth in the EU/euro area has its roots in the basic paradigms of EU economic policy-making. Not only does the acceleration of growth depend on changes in those paradigms, but the very preservation of the EU, which is exposed to ever stronger centrifugal forces, may also be at stake. It is in the best political and economic interests of the NMS to help avert such an eventuality, while helping to make the Union's architecture more resilient and conducive to faster growth. It is argued that the principle '*one size fits all*' on which this policy rests supports deflationary/stagnation tendencies in low-inflation/low-growth countries and bolsters booms/inflation in high-inflation/high-growth countries. Diverging trends in unit labour costs, external competitiveness and external balances are the other side of the ECB single monetary policy. Under a common currency, the emerging intra-euro-area divergences cannot be neutralized effectively. Germany has been running increasing external surpluses; its partners increasing deficits. Worse still, the German policy has supported this trend as it allegedly helps to reduce unemployment. The '*beggar-thy-neighbour*' policy turns out to be harmful to Germany itself because it suppresses domestic demand more than it helps advance external surpluses. The external surpluses represent the spiralling debt of the external deficit countries. As that debt proves unserviceable, the German government is forced to take it over in order to save the country's financial institutions. The intensity of the centrifugal forces within the euro area (and generally in the EU) should be dampened by closer coordination of the member states' fiscal and wage policies. In particular, it may be useful to demand that growing labour productivity be matched by wages at the national level. In addition, it should be possible to institute '*excessive external surplus procedures*' against countries that generate large net exports at the expense of cuts in domestic consumption. We also argue that, until the mechanisms are in place to limit the divergences in unit labour costs and external imbalances, it is advisable for the NMS to retain their own currencies and floating exchange rate regimes.

**Keywords:** Central and East European new EU member states, Southeast Europe, future EU member states, Balkans, former Soviet Union, China, Turkey, economic forecasts, employment, competitiveness, exchange rates, inflation, foreign trade, fiscal policy

**JEL classification:** G01, G18, O52, O57, P24, P27, P33, P52

Table I

## Overview 2008-2009 and outlook 2010-2012

	GDP					Consumer prices					Unemployment, based on LFS <sup>1)</sup>					Current account				
	real change in %					change in %					rate in %, annual average					in % of GDP				
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
			Forecast	Forecast				Forecast	Forecast				Forecast	Forecast				Forecast	Forecast	
Bulgaria	6.0	-5.0	0	2.5	3	12.0	2.5	3	3	3	5.6	6.8	9.0	8.5	8	-24.0	-9.4	-5.2	-4.3	-4.6
Czech Republic	2.5	-4.2	1.0	2.5	3.5	6.3	0.6	1.5	2.0	2.5	4.4	6.7	8.5	8.0	7.5	-0.7	-1.1	-0.7	-1.3	-1.2
Estonia	-3.6	-14.1	0.5	2.5	3.5	10.6	0.2	1.5	3	4	5.5	13.8	18	16	15	-9.4	4.6	2.9	1.4	0.0
Hungary	0.6	-6.3	0.8	2.5	3	6.0	4.0	4.4	3.5	3	7.8	10.0	11.5	10.5	9.3	-7.0	0.2	-1.2	-2.2	-2.3
Latvia	-4.5	-18.0	-3.5	0.7	2	15.2	3.3	-3	1	2	7.5	17.1	20	18	17	-13.0	9.4	4.5	2.2	-0.5
Lithuania	2.8	-15.0	-1.5	1.5	2.5	11.1	4.2	0.0	1.0	2.0	5.8	13.7	18	17	16	-11.9	3.8	0	-0.7	-2.1
Poland	5.0	1.7	2.7	3.5	3.5	4.2	4.0	2.5	2.5	2.5	7.1	8.2	11	10	8.5	-5.1	-1.6	-2.0	-2.7	-3.9
Romania	7.3	-7.1	-1	1.5	3	7.9	5.6	5	4	4	5.8	6.9	8.5	8	6	-11.6	-4.5	-5.8	-6.8	-7.5
Slovakia	6.2	-4.7	3	4	4	3.9	0.9	1	2	2	9.5	12.0	15	14	13	-6.6	-3.2	-2.8	-4.4	-4.8
Slovenia	3.5	-7.8	0.5	2	2.5	5.5	0.9	1.5	2	2	4.4	5.9	8	7.5	7	-6.2	-1.0	-0.8	-1.6	-2.3
<b>NMS-10 <sup>2)3)</sup></b>	<b>4.2</b>	<b>-3.6</b>	<b>1.2</b>	<b>2.7</b>	<b>3.3</b>	<b>6.3</b>	<b>3.4</b>	<b>2.7</b>	<b>2.7</b>	<b>2.8</b>	<b>6.5</b>	<b>8.5</b>	<b>10.8</b>	<b>10.0</b>	<b>8.6</b>	<b>-6.9</b>	<b>-1.6</b>	<b>-2.1</b>	<b>-2.9</b>	<b>-3.7</b>
<i>EU-15 <sup>3)</sup></i>	<i>0.5</i>	<i>-4.2</i>	<i>0.9</i>	<i>1.6</i>	<i>.</i>	<i>3.3</i>	<i>0.3</i>	<i>1.5</i>	<i>1.7</i>	<i>.</i>	<i>7.1</i>	<i>9.0</i>	<i>9.8</i>	<i>9.8</i>	<i>.</i>	<i>-0.5</i>	<i>-0.2</i>	<i>-0.3</i>	<i>-0.2</i>	<i>.</i>
<i>EU-27 <sup>3)</sup></i>	<i>1.0</i>	<i>-4.1</i>	<i>0.9</i>	<i>1.7</i>	<i>.</i>	<i>3.7</i>	<i>0.7</i>	<i>1.3</i>	<i>1.6</i>	<i>.</i>	<i>7.0</i>	<i>8.9</i>	<i>10.0</i>	<i>9.8</i>	<i>.</i>	<i>-1.0</i>	<i>-0.3</i>	<i>-1.4</i>	<i>-1.3</i>	<i>.</i>
Croatia	2.4	-5.8	-1.5	2	2.5	6.1	2.4	2	2.5	2	8.4	9.1	10.5	10	9	-9.2	-5.4	-4	-6	-7
Macedonia	4.8	-0.7	1	2	3	8.3	-0.8	0	3	3	33.8	32.2	33	33	33	-13.1	-7.3	-6	-6	-7
Turkey	0.7	-4.7	6.3	4.5	4.0	10.4	6.3	8.5	7.5	7.0	11.0	14	13	12	12	-5.7	-2.3	-4.5	-4.6	-4.6
<b>Candidate countries <sup>2)3)</sup></b>	<b>0.9</b>	<b>-4.7</b>	<b>5.6</b>	<b>4.3</b>	<b>3.9</b>	<b>10.0</b>	<b>5.9</b>	<b>7.9</b>	<b>7.1</b>	<b>6.6</b>	<b>11.6</b>	<b>14.3</b>	<b>13.5</b>	<b>12.5</b>	<b>12.4</b>	<b>-6.1</b>	<b>-2.6</b>	<b>-4.5</b>	<b>-4.7</b>	<b>-4.8</b>
Albania	7.8	4.2	1.7	2.2	3	3.4	2.2	3	2	2	13.1	13.1	15	14	14	-15.5	-15.1	-12.7	-13.0	-13.2
Bosnia & Herzegovina	5.7	-3.2	0	1	3	7.5	-0.4	0.5	1	1	23.4	24.0	27	27	27	-15.1	-7.5	-8	-8	-8
Montenegro	6.9	-5.3	-1	2	3	7.4	3.4	1	3	3	17.2	19.1	20	20	20	-50.7	-29.8	-16	-17	-17
Serbia	5.5	-3.0	1	2	3	11.7	8.6	6	4	4	13.6	16.1	22	22	22	-18.2	-5.5	-9	-10	-10
<b>Potential candidate countries <sup>2)3)</sup></b>	<b>6.0</b>	<b>-1.9</b>	<b>0.8</b>	<b>1.8</b>	<b>3.0</b>	<b>9.1</b>	<b>5.2</b>	<b>4.0</b>	<b>2.9</b>	<b>2.9</b>	<b>15.6</b>	<b>17.1</b>	<b>21.3</b>	<b>20.9</b>	<b>20.9</b>	<b>-18.9</b>	<b>-8.8</b>	<b>-9.6</b>	<b>-10.4</b>	<b>-10.4</b>
Kazakhstan	3.3	1.2	3	5	4.5	17.1	7.3	7	6.5	6	6.6	6.6	6.2	6	6	5.2	-3.1	1.1	-2.1	-2.2
Russia	5.6	-7.9	4.0	4.2	4.4	14.1	11.8	6.5	7	7	6.3	8.4	8.5	8	8	6.2	4.0	4.5	3.3	2.7
Ukraine	2.3	-15.1	3.8	4.5	6	25.2	15.9	10.5	9	8	6.4	8.8	8.7	8.2	7.8	-7.1	-1.5	0.5	0.0	-0.4
China <sup>4)</sup>	9.6	8.7	9.5	9.5	10	5.9	-0.7	3.5	3	2	4.2	4.3	4.3	4.2	4.2	9.4	6.1	3.7	5.2	5.2

Note: NMS: The New EU Member States.

1) LFS - Labour Force Survey. - 2) wiiw estimate. - 3) Current account data include flows within the region (this is not the case for EU-15 and EU-27 in 2010-2011). - 4) Registered urban unemployment rate, end of period.

Source: wiiw (June 2010), Eurostat. Forecasts by wiiw and European Commission (Economic Forecast, Spring 2010) for EU-15.

Table II

## Central and East European new EU member states (NMS-10): an overview of economic fundamentals, 2009

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Slovenia	NMS-10 <sup>1)</sup>	EU-15	EU-27 <sup>2)</sup>
GDP in EUR at exchange rates, EUR bn	33.88	137.21	13.73	93.09	18.77	26.75	310.08	115.87	63.33	34.89	847.6	10938.6	11808.7
GDP in EUR at PPP, EUR bn	73.69	198.17	19.16	149.49	26.28	43.90	540.10	236.88	91.93	41.84	1421.5	10356.1	11805.7
GDP in EUR at PPP, EU-27=100	0.6	1.7	0.2	1.3	0.2	0.4	4.6	2.0	0.8	0.4	12.0	87.7	100.0
GDP in EUR at PPP, per capita	9800	18900	14300	14900	11700	13100	14200	10600	17000	20500	13900	26100	23600
GDP in EUR at PPP per capita, EU-27=100	42	80	61	63	50	56	60	45	72	87	59	111	100
GDP at constant prices, 1990=100	119.1	137.0	137.4	130.8	100.4	108.5	181.0 <sup>3)</sup>	127.4	157.5	155.3	158.0	137.9	140.4
GDP at constant prices, 2000=100	147.0	133.6	143.0	121.8	143.2	150.6	141.0	151.0	154.3	129.2	140.5	110.6	113.6
Industrial production real, 2000=100 <sup>4)</sup>	140.8	132.7	131.6	128.6	126.9	158.8	157.5	119.5	154.9	111.7	141.7	91.1	94.4
Population - thousands, average	7592	10490	1340	10022	2255	3340	38150	21482	5418	2043	102133	397249	500523
Employed persons - LFS, thousands, average	3254	4934	596	3782	983	1416	15868	9244	2366	981	43423	173857	217823
Unemployment rate - LFS, in %	6.8	6.7	13.8	10.0	17.1	13.7	8.2	6.9	12.0	5.9	8.5	9.0	8.9
General gov. revenues, EU-def., in % of GDP	36.9	40.3	43.6	45.8	34.0	34.1	37.4	32.1	34.0	44.4	38.4	44.4	43.9
General gov. expenditures, EU-def., in % of GDP	40.7	46.1	45.4	49.8	42.9	43.0	44.5	40.4	40.8	49.9	44.1	51.2	50.7
General gov. balance, EU-def., in % of GDP	-3.9	-5.9	-1.7	-4.0	-8.9	-8.9	-7.1	-8.3	-6.8	-5.5	-5.8	-6.8	-6.8
Public debt, EU def., in % of GDP	14.8	35.4	7.2	78.3	36.1	29.3	51.0	23.7	35.7	35.9	42.5	75.9	73.6
Price level, EU-27=100 (PPP/exch. rate)	46	69	72	62	71	61	57	49	69	83	60	106	100
Compensation per employee, monthly, in EUR <sup>5)</sup>	392	1175	1125	1008	833	817	775	633	1092	1983	845	3325	2808
Compensation per employee, monthly, EU-27=100	14.0	41.8	40.1	35.9	29.7	29.1	27.6	22.5	38.9	70.6	30.1	118.4	100.0
Exports of goods in % of GDP	34.8	58.8	47.4	63.2	27.4	44.1	32.3	25.1	62.7	46.4	42.5 <sup>6)</sup>	25.5 <sup>6)</sup>	26.7 <sup>6)</sup>
Imports of goods in % of GDP	46.9	53.8	51.0	58.8	33.9	47.0	33.3	31.0	60.8	48.2	43.1 <sup>6)</sup>	25.7 <sup>6)</sup>	26.9 <sup>6)</sup>
Exports of services in % of GDP	14.4	10.6	23.0	14.0	14.5	10.1	6.7	6.1	7.1	12.4	9.2 <sup>6)</sup>	9.3 <sup>6)</sup>	9.4 <sup>6)</sup>
Imports of services in % of GDP	9.8	9.9	13.4	12.4	8.4	7.9	5.6	6.4	9.1	9.5	8.0 <sup>6)</sup>	8.1 <sup>6)</sup>	8.2 <sup>6)</sup>
Current account in % of GDP	-9.4	-1.1	4.6	0.2	9.4	3.8	-1.6	-4.5	-3.2	-1.0	-1.6 <sup>6)</sup>	-0.2 <sup>6)</sup>	-0.3 <sup>6)</sup>
FDI stock per capita in EUR	4670	8049	8407	6410	3628	2895	3323	2408	6300	5400	4300	.	.

NMS-10: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. PPP: Purchasing power parity.

1) wiiw estimates. - 2) wiiw estimates and Eurostat. - 3) 1989=100, which in the Polish case is the appropriate reference year. - 4) EU-15 and EU-27 working day adjusted. - 5) Gross wages plus indirect labour costs, according to national account concept. - 6) Data for NMS-10, EU-15 and EU-27 include flows within the region.

Source: wiiw, Eurostat, AMECO.

Table III

## Southeast Europe and selected CIS countries: an overview of economic fundamentals, 2009

	Croatia	Macedonia	Turkey	Albania	Bosnia and Herzegovina	Montenegro	Serbia	Kazakhstan	Russia	Ukraine
GDP in EUR at exchange rates, EUR bn	45.38	6.63	441.0	8.94	12.25	3.00	31.45	78.30	884.99	84.17
GDP in EUR at PPP, EUR bn	63.66	16.33	765.9	21.11	25.54	6.30	63.44	144.93	1695.84	233.30
GDP in EUR at PPP, EU-27=100	0.5	0.1	6.5	0.2	0.2	0.05	0.5	1.2	14.4	2.0
GDP in EUR at PPP, per capita	14400	8000	10700	6600	6600	10000	8700	9100	12000	5100
GDP in EUR at PPP per capita, EU-27=100	61	34	45	28	28	42	37	39	51	22
GDP at constant prices, 1990=100	112.7	112.1	167.2	192.6	.	.	.	143.3	102.5	102.5
GDP at constant prices, 2000=100	132.9	123.0	138.0	167.0	141.4	139.7	147.9	206.4	152.5	152.5
Industrial production real, 2000=100	124.4	105.5	120.9	190.0	184.3	76.7	103.0	101.7	134.9	139.0
Population - thousands, average	4429	2050	75200	3190	3843	630	7320	15880	141902	46053
Employed persons - LFS, thousands, average	1605	630	21200	1110	859	214	2616	7903	69285	20192
Unemployment rate - LFS, in %	9.1	32.2	14	13.1	24.0	19.1	16.1	6.6	8.4	8.8
General gov. revenues, nat. def., in % of GDP	38.5	33.2	22.5 <sup>1)</sup>	25.4	42.0	45.5	39.5	21.8	34.8	29.8
General gov. expenditures, nat. def., in % of GDP	41.6	36.0	28.0 <sup>1)</sup>	32.2	45.0	49.0	43.7	24.8	41.1	33.9
General gov. balance, nat. def., in % of GDP	-3.2	-2.8	-5.5 <sup>1)</sup>	-6.8	-3.0	-3.5	-4.2	-3.1	-6.3	-4.1
Public debt, nat. def., in % of GDP	37.7	32.0	45.5 <sup>1)</sup>	55.0	33.4	38.0	32.6	10.1	8.3	33.0
Price level, EU-27=100 (PPP/exch. rate)	71	41	58	42	48	48	50	54	52	36
Average gross monthly wages, EUR at exchange rate	1051	488	662 <sup>2)</sup>	242	615	643	470	329	426	175
Average gross monthly wages, EU-27=100	37.4	17.4	23.6 <sup>2)</sup>	8.6	21.9	22.9	16.7	11.7	15.2	6.2
Exports of goods in % of GDP	16.9	29.0	17.8	8.4	23.8	9.9	19.0	40.2	24.7	34.4
Imports of goods in % of GDP	33.3	52.4	21.9	34.2	51.7	55.5	34.2	26.3	15.6	38.4
Exports of services in % of GDP	18.6	9.3	5.3	19.2	8.1	22.7	7.9	4.0	3.4	11.8
Imports of services in % of GDP	6.1	8.9	2.7	17.9	3.7	9.9	7.9	9.2	5.0	9.6
Current account in % of GDP	-5.4	-7.3	-2.3	-15.1	-7.5	-29.8	-5.5	-3.1	4.0	-1.5
FDI stock per capita in EUR	5736	1500	1243	800	1500	5233	2000	3157	1200	789

PPP: Purchasing power parity according to Eurostat, wiiw estimates for Albania, Bosnia and Herzegovina, Montenegro, Serbia.

1) EU definition: expenditures and revenues according to ESA'95, excessive deficit procedure. - 2) Gross wages plus indirect labour costs, according to national account concept.

Source: wiiw, Eurostat, AMECO.



*Kazimierz Laski and Leon Podkaminer*

## **Long-term growth prospects in Central and Eastern Europe hinge on changes in the basic paradigms of EU economic policy-making\***

### **1 CEE long-term growth depends on what happens to the West**

The short-term economic fortunes of the Central and Eastern European (CEE) countries have become inextricably tied up with the economic fortunes of the western segment of the Continent. That dependence is fairly straightforward when one considers the levels of CEE exports to the 'old' EU and the levels of their trade and current account balances with the latter. Growth acceleration in the 'old' EU supports faster growth in CEE countries. But – as demonstrated by developments in 2009 – crises in the 'old' EU are capable of pushing, via plummeting exports, the CEE countries into a severe recession. The medium-term economic fortunes of the CEE countries also depend on what happens in the West. Accumulating CEE current account deficits are mirrored in the countries' growing debts to banks, firms and other agents located in the West. Servicing these debts will depend not only on the CEE countries' ability to do so, but – in the medium term – also on the prosperity of the creditor countries. Of course, the CEE countries which have already joined the European Union (and those seeking EU membership) have become dependent on policies enacted and pursued at the EU level. Finally, there is a functional dependence: some policies and practices designed at the EU level (such as the principles enshrined in the Stability and Growth Pact) have to be observed by the individual member countries, including the NMS far into the future (if not indefinitely). Moreover, even the authorities of countries which do not aspire to EU membership (Russia) or cannot realistically expect to be admitted anytime soon (Ukraine and Turkey) may well be emulating some of the concepts embodied in EU policy-making.

For some time, the dependence on (and integration with) the West has served the CEE countries quite well. Their GDP growth has been generally higher than in the 'old' EU, resulting in 'real convergence'. However the quality of CEE growth has left much to be desired. Unemployment rates have remained stubbornly high in many cases. Thus, over the period 2002-2007 the average unemployment rate was 16.7% in Poland, 15.9% in Slovakia, 11.7% in Bulgaria and close to 10% in the Baltic countries. Income inequality levels have generally increased, often sharply (though generally they have yet to surpass those in Western Europe). Worse still, in most instances, CEE growth has become 'import-fed'; i.e. it has incurred high and rising current account deficits that have caused foreign debts to snowball. Not surprisingly, profoundly deep recessions followed hot on the heels of the extremely rapid growth recorded in the Baltic states, Romania and Bulgaria. The crisis which broke out in 2008 in the highly developed countries in the West has pushed the erstwhile 'convergence leaders' into particularly painful crises<sup>1</sup>. Last but not least, despite being higher than in

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<sup>1</sup> Likewise, the apparent success of the erstwhile 'cohesion' countries (Portugal, Ireland, Greece and Spain – PIGS) proves now to have been a mirage. Actual real convergence of these countries had taken place before their EU accession (see Laski and Römisch, 2003).

the 'old' EU, growth in the NMS was actually quite unimpressive by historical standards. The '*great leaps forward*' experienced in the post-war period (1950-1970) in both the West and Japan, as well as the more recent instances (in East Asia) were incomparably faster and more sustainable than those to be observed in the CEE countries over the past 10-15 years, one reason being that growth in the 'old' EU itself had been rather stagnant.

In the short term, the CEE economies will adjust themselves – as best they can – to the effects of the crisis in the West. As discussed in a recent wiiw report<sup>2</sup>, these adjustments will necessarily slow down their growth still further as well as generally suppress the speed of 'real convergence', at least in the short-to-medium term. However, even if growth in the 'old' EU were to return and follow the patterns of the past 10-15 years, it is unlikely to be impressive. The long-term growth in the CEE countries will continue to be disappointing – and will be subject to repeated setbacks and even crises.

The secular weakness of growth in the EU/euro area is rooted in the basic paradigms of EU economic policy making. Not only does the acceleration of growth depend on changes in those paradigms, but the very preservation of the EU, which is currently subject to ever stronger centrifugal forces, may also be at stake. It is in the best political and economic interests of the NMS to help avert such an eventuality, while helping to make the Union's architecture more resilient and conducive to faster growth.

## **2 Are we all Keynesians now?**

The outbreak of the financial crisis in 2008 – and the ease with which it engulfed the 'old' part of the EU – can be interpreted as conclusive evidence of the inadequacy of much of the fundamental economic paradigm, on which the economic architecture of the European Union has been built. Liberalized, integrating and deepening private financial and capital markets in Europe have failed to minimize and allocate risks efficiently. Financial and capital markets proved capable of generating and accumulating risks instead of reducing and spreading them. Banks and other financial sector institutions engaged on a massive scale in irresponsible practices that were tolerated – or even supported – by 'market forces' (and ignored by the supervisors/regulators). Unleashing the latter forces was – in no small measure – due to the influential doctrine that the financial market tends to be 'efficient' of its own accord (i.e. when free of administrative interference). Significantly, akin to the Asian crisis of the late 1990s, the crisis – at least in Europe – has been generated solely by 'market forces' running amok – and not by governments being fiscally irresponsible. Prior to the crisis, the EU national governments had in general displayed great prudence. The behaviour of Greece was very much the exception. Most European governments (including those of Spain and Ireland) had been consistently reducing public debt/GDP ratios, lowering the deficit/GDP ratios or generating handsome surpluses. Portugal's fiscal deficit had also been lower than 3% of its GDP. Net general government borrowing was 1.4% of the EU GDP in 2006, followed by 0.8% in 2007<sup>3</sup>. The abrupt rise

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<sup>2</sup> See M. Landesmann and V. Gligorov, 'Redirecting the growth model in Central and Eastern Europe: Policy Issues', in *wiiw Current Analyses and Forecasts*, No. 5, February 2010.

<sup>3</sup> All numbers quoted in this text come from (or are based on) EU sources (e.g. EU Commission 2010b) or wiiw databanks.

in public debt levels in a number of countries in 2009 has come about in part from the governments being forced to assume huge unserviceable debts created by private financial market agents and institutions. To date, public money amounting to about 2.5% of the EU GDP has been injected into the financial sector – primarily in the form of recapitalization<sup>4</sup>. The possibility of the private sector first engaging in wild speculations only to end up in mass insolvency is ruled out in contemporary mainstream economic theory (as demonstrated recently, for example, by de Grauwe, 2008 and Goodhart, 2009). Consideration of such an eventuality had, however, featured quite prominently in the original writings of J.M. Keynes and some of his followers (such as Minsky, 1986). Fortunately enough, when the hour of need came, policy-makers did not resort to inaction that would have been consistent with the mainstream paradigms, but responded to the unfolding disaster with forceful measures that smacked of Keynes. It must be admitted, however, that in some countries, such as Germany, it took a while before steps were ultimately taken.

The extraordinary actions taken by governments and monetary authorities in Europe, whose numbers were even joined by the European Central Bank (ECB), averted a full-scale economic catastrophe. However, while these actions are commonly acknowledged to be essentially Keynesian, it still cannot be claimed that ‘we are all Keynesians now’<sup>5</sup>. These actions were pragmatic responses to a crisis, much of which ran counter to what had been previously preached and legislated. Nothing much may have changed in the decision makers’ minds. Numerous statements emanating from the ECB and the EU Commission make this point crystal clear. It may be worth quoting the opinion of Professor Jürgen Stark, currently a member of the ECB Board and its former Chief Economist: *‘There is no doubt that the exceptional fiscal policy measures and monetary policy reactions to the crisis have helped to stabilize confidence and the euro area economy. Following the substantial budgetary loosening, however, the fiscal exit from the crisis must be initiated... to be followed by ambitious multi-year fiscal consolidation. This is necessary to underpin the public’s trust in the sustainability of public finances. The Stability and Growth Pact constitutes the mechanism to coordinate fiscal policies in Europe. ... Sound and sustainable public finances are a prerequisite for sustainable economic growth and a smooth functioning of Economic and Monetary Union.’* (ECB, 2010, p. 7).

The revival of pre-crisis instincts is not only manifest in statements of this kind. Discussions about appropriate ‘exit strategies’ as well as hurried attempts to consolidate public finances are already underway in many EU countries, including the CEE NMS. Ample evidence attests to this. According to the European Commission’s 2010 Spring Economic Forecast, EU public consumption is projected to rise by about 1% in 2010 and hover around zero in 2011 (unlike previous years when it used to rise by more than 2% on average). The general government’s primary deficit in the euro area is projected to fall from 3.6% of the euro area GDP in 2010 to 2.9% in 2011. For the EU as a whole, the corresponding numbers are 4.2% and 3.5%. Interestingly enough, according to the forecasts

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<sup>4</sup> Moreover, guarantees to the financial sector of over 24% of the EU GDP have been approved, of which almost 8% of the GDP has actually been granted. These guarantees represent contingent liabilities – potential additions to public debt (see European Commission, 2010b, p. 25, ECB 2010, p.15).

<sup>5</sup> This famous statement (actually part of a quote attributed to Milton Friedman) was made by US President Richard Nixon in 1971.

fiscal stringency in the United States will be very much a symbolic gesture, with the primary deficit/GDP ratio dropping from 7.2% in 2010 to 6.8% in 2011. Public consumption in the USA does not show any signs of restraint: it is expected to rise by 2.3% and 2.7% in 2010 and 2011, respectively. These fiscal characteristics should be seen in the real context: GDP growth is expected to remain weak in Europe – and to rise fairly high in the USA.

The strength of the drives towards fiscal consolidation differs across the NMS. The EU Commission (in its Spring Forecast) envisaged radical reductions in the cyclically adjusted primary fiscal balance in Bulgaria, Hungary, Estonia and Slovenia over the period 2010-2011. Strangely enough, the public debt levels in those self-same countries (except Hungary) were quite low; the projected GDP growth rates were likewise fairly low. The forecast in respect of other countries (Poland, the Czech Republic, Slovakia and Romania) was that financial consolidation would be more sluggish, despite generally higher public debt levels. No wonder the GDP recovery in the latter countries was expected to be definitely faster than in the former. Finally, little progress on fiscal consolidation was forecast for Latvia and Lithuania where real growth was expected to remain subdued. Although the EU Commission's Spring Forecast is already in need of substantial revision (as new facts emerge and also because the new governments that have been formed in some countries are likely to pursue fiscal policies different to those of their predecessors), it may be useful to take a look at the EU Commission's projected rates of growth for public consumption in the NMS. It transpires that countries that permit a measured expansion of public consumption definitely fare better in growth terms than those which do not. Continuing contractions of public consumption (in Bulgaria, Hungary and the Baltic states) are associated with a weak pace of recovery.

Plainly, even before the global storm is really over, the orthodox 'intellectual' opposition to Keynesian economics seems to be gaining the upper hand once more – at least among the influential decision-makers. Is Keynes only relevant today when circumstances are exceptional? We would claim otherwise. While some Keynesian prescriptions have proved invaluable precisely under such circumstances, they may be equally essential during 'normal' times. In particular, what is termed 'sound macro-policy' as conducted in 'normal' times may in fact have led to disappointing results – anaemic or stagnant long-term growth in Europe that has prevailed since the early 1990s. That might change for the better with policies becoming 'more Keynesian'. Moreover, the 'sound macro-policy' (as understood and practised in the EU) actually paved the way for the external (trade and current account) imbalances across the Union that contributed to the crisis. The overall EU economic policy framework seems to be in need of substantial repair. That repair must acknowledge, among other things, the inadequacy of the Stability and Growth Pact (SGP) as a mechanism for fiscal policy coordination in Europe. Of course, the repair of the coordination mechanism requires a depth of analysis that goes far beyond the current economic policy paradigms – and even beyond Keynes as well.

### **3 The single monetary policy unleashes centrifugal forces in the euro area**

The litany of complaints and objections aimed at the common monetary policy pursued by the ECB is quite lengthy. The ECB has been accused of deficiencies in terms of democratic legitimacy,

accountability and transparency. Unlike the US central bank (the FED), the ECB displays no sensitivity towards real-economy developments (e.g. levels of or trends in unemployment). The ECB focuses narrowly on inflation (the desirable level of which remains rather vaguely specified as 'lower but close to 2%'); it adheres to a patently exotic and outdated monetarist criterion (the 4.5% rate of growth of money assumed as a norm consistent with inflation of up to 2%). Furthermore, its policy tends to lack balance: it is very swift to tighten things up even if the signs of rising inflation are largely imagined, but very slow to relax things, even if the threat of inflation is no longer to be seen. Moreover, the 2% upper limit for acceptable inflation seems rather too restrictive (and in terms of euro area practice, it is unattainable anyway). While rejecting any outside 'interference' in its goals or operating practices (the pretext being the maintenance of its credibility), the ECB feels obliged to censure fiscal, social, 'structural' or even wage policies of individual member countries. Until recently the ECB did not even care about the financial stability of the euro area banking system<sup>6</sup>.

The above objections are surely valid, yet they can be constructively addressed, even while leaving the gist (if not quite the letter) of the relevant EU treaties intact. However, addressing a fundamental flaw inherent in the design of the ECB and its policy may require more far-fetched modifications. Carrying through these modifications could well call for a more radical overhaul of the European politics, far beyond the narrow monetary domain. The future will show whether it is realistic to expect such changes. In any event, it may be important to realize that the fundamental flaws in the design of the common European currency project incur the possibility of derailing not only the project itself, but also the whole European Union (as we know it). Of course, the failure of the euro project – and ultimately the disintegration of the EU – could have rather disastrous consequences, not least (but primarily) for the NMS – and not so much for the most developed 'big and old' EU members.

### 3.1 'One size fits all'?

The original sin of the common monetary policy lies in its being defined as applying uniformly to a vast area comprising countries that had differed greatly in many aspects before switching over to the common currency. The mutual nominal convergence process (the fulfilment of the Maastricht criteria) could not – and did not – eliminate the deeply rooted differences in the ways the national economies functioned. Conditions defined in the theory of Optimum Currency Areas were not met. Most prosaically, different national inflation rates (and the rates of growth of nominal wages and unit labour costs) refused to leave their entrenched paths and mutually align themselves. Inflation in traditionally low-inflation Germany remained low – or at least lower than inflation in the traditional high-inflation countries such as Greece, Italy and others. The common monetary policy abstracts from the variations in inflation rates across the euro area. The policy responds to the *average* inflation calculated for the whole area and determines the desirable policy interest rates needed to control that average euro-area inflation rate. Of course, the interest rate suitable for controlling such an average inflation rate may be unsuitable for controlling inflation in each and every individual euro

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<sup>6</sup> During the run-up to the outbreak of the crisis in 2008 (and thereafter) a number of central banks worldwide – starting with the FED – promptly responded to the prospect of a global systemic financial crisis with radical cuts in their interest rates. The ECB used the occasion to *raise* its rates. In July 2008 the ECB interest rates were raised by 0.25 percentage points. The ECB interest rate policy did not start responding to the crisis until October 2008.

area country. For low-inflation countries, the ECB policy rates may be too high, while they may be too low for the high-inflation countries. The principle of 'one-size-fits-all' may work well in the world of modern 'unisex' fashion, but not necessarily in real-life economics. Specifically, the fiction of one ('optimal') currency area with one inflation rate being served by one monetary policy leads to higher (and positive) real interest rates in low-inflation countries and lower (not infrequently negative) real interest rates in high-inflation countries. Other things being equal, expansion of lending to the real economy decelerates (or stagnates) in low-inflation countries and accelerates in high-inflation countries. Consequently, real growth in low-inflation (thus presumably slow-growth) countries gets slower, while the opposite happens in high-inflation (thus presumably fast-growth) countries.

The common monetary policy acts pro-cyclically as it strengthens the trend towards stagnation (-cum-deflation) in weak-growth/low-inflation countries and accelerates growth (-cum-inflation) in countries that are close to a general boom. Overall, the common monetary policy has the potential to *enlarge* the cross-country differentials in inflation and growth rates. That potential has materialized in the euro area: low-inflation Germany has remained a low inflation (and low-growth) country; high-inflation Spain and Ireland have gone through a decade of high inflation and exuberant (credit-driven) real growth<sup>7</sup>.

The differential real-economy and price effects of the uniform monetary policy may have also helped to generate high fiscal deficits, at least in some countries. Low (or negative) real interest rates on public debt have facilitated public debt servicing in the high-inflation countries. This may have induced some of them (e.g. Greece) to pursue a rather lax fiscal policy. Servicing public debt in low-inflation countries has been much more troublesome, thus encouraging those countries to undertake renewed attempts at fiscal consolidation. Those attempts, however, did not always succeed (as proven in 2003 when the French and German governments initiated a 'reinterpretation' of the SGP). The reason for the difficulties of implementing fiscal consolidation in low-inflation countries is straightforward: fiscal austerity under overall stagnant growth/very low inflation is almost certain to have a negative impact on both real growth *and* the fiscal position.

### **3.2 The other side of the (euro) coin: diverging competitiveness trends and the rise of external imbalances within the euro area**

The policy-induced divergence in inflation rates nurtures more or less automatically diverging trends in average wages across the euro area. As is to be expected, nominal wages in high-inflation

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<sup>7</sup> A question arises as to the conditions under which the uniform monetary policy may not produce these destabilizing effects. The conditions, however, are well known from the theory of optimal currency areas (OCA). Of course the euro area is not – and never was – such an OCA. The so-called 'endogenous OCA theory' which claimed that an area comprising differing countries would become an OCA upon the introduction of a common currency turned obviously inadequate. The conduct of the ECB policy could become easier, if inflation rates throughout the euro area converged to a common, possibly not too low a value. Otherwise, the ECB might perhaps be given 'dictatorial' powers over discriminating lending in/to individual countries. Making the ECB a genuine central bank (and not only an institution presiding over the determination of policy interest rates for the whole area) is quite certain to encounter just as much resistance as, for example, the idea of setting up of a super-ministry of finance for the euro area (with the national finance ministries being reduced to departments of the super-ministry).

countries naturally tend to rise faster than in low-inflation countries, especially when real growth in the former countries is more rapid. Under a common currency the diverging price and nominal wage developments tend to erode the high-inflation countries' competitiveness vis-à-vis the low-inflation countries. Devaluation of the nominal exchange rate, which had been the winning strategy for securing the competitiveness of the Italian economy, for example, has been of no avail since 1997.<sup>8</sup> Certainly, rising wages in high-inflation countries need not anticipate losses in external competitiveness against the countries with stagnant (or less rapidly increasing) domestic prices and wages. Under conceivable conditions, labour productivity growth (especially in sectors producing tradable goods) might swiftly outstrip the rate at which wages increase. The unit labour costs in the tradable sector of such a high-inflation country might even decline or rise less than in a low-inflation country, thus even strengthening the competitive position of the high-inflation country.<sup>9</sup> Of course, should productivity keep increasing at more or less equal speeds across the euro area, the low-inflation countries would inevitably tend to gain at the expense of the high-inflation countries. Under the current conditions prevailing in Europe, the differential developments in wages have proved to be quite essential to developments in relative unit labour costs – and in mutual competitive positions. As expected, Germany has been out-competing Italy and Spain (and most other members of the euro area) on unit labour costs. This, in turn, is well reflected in the growing external imbalances – with Germany becoming a country with a huge external (trade and current account) surplus, while most of its other euro area partners<sup>10</sup> (except Austria and the Netherlands) are slipping into high and rising external deficits.<sup>11</sup> These trends temporarily weakened somewhat in 2009 when Germany's partner economies went into recession.

### 3.3 Germany's revenge for unfairly high real interest rates

The tendency of Germany to outcompete others on unit labour costs has *not* been entirely due to the free operation of market forces. In actual fact, all along (at least since 1995) successive German governments have actively pursued policies that focused on promoting cuts in unit labour costs. Germany has gone through successive waves of 'labour market reforms' aimed at enhancing the market's 'flexibility'. Under stagnant overall GDP growth and high unemployment levels, increased

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<sup>8</sup> The lira/DM exchange rate rose continually from 200 in 1971 to about 1000 in 1988. On average it kept depreciating about 10% annually in nominal terms. That development was associated with Italy's rapid real growth ('real convergence') combined with huge current account and trade *surpluses*, still recorded as late as 1998. Under the euro, Italy's surpluses turned into snowballing deficits while real growth has come to a standstill. Conversely, under steadily improving productivity (and chronic trade surpluses) the DM kept appreciating in nominal terms vis-à-vis the basket of currencies that later became the euro. In 1971 the DM/ECU rate stood at about 3.7 and in 1988 at about 2. Steady nominal appreciation of the DM (3.5% p.a. against the ECU/EUR basket) helped to keep the German trade surpluses in check. With fixed mutual exchange rates (after 1997) and the growing liberalization of capital movements throughout the early 1990s, German unit cost gains translated into growing trade surpluses.

<sup>9</sup> This is not a purely hypothetical situation – but actually that of China.

<sup>10</sup> Austria and the Netherlands are the two countries, whose economies have emulated that of Germany. They have also effectively maintained the pegging of their currencies to the DM since the mid-1970s and mid-1980s, respectively.

<sup>11</sup> Early differential developments in unit labour costs and external imbalances across the euro area are documented and analysed in e.g. Bibow (2006) and Flassbeck (2007), more recently in e.g. Bibow (2009), Busch (2010) and Podkaminer (2008, 2010). With some delay the problem has been acknowledged 'in Brussels' (see EU Commission, 2010a).

labour market flexibility is a polite term for greater licence to revoke workers' traditional rights and to 'downscale' the labour codes that had safeguarded employees' working conditions and living standards. The reforms provided, inter alia, for the 'inducement' of employees to become 'one-person companies' selling their services to their former employers, while the latter no longer had to pay into the mandatory social security schemes or care about anything else. Transfer payments to both low-income employees and the unemployed were curtailed – apparently to increase the labour supply (as if there were a labour shortage, not high unemployment). Besides, in its capacity as the employer of a large segment of the workforce active in the public service sectors, the German government has sought to economize on wages and employment levels. This has had a direct influence on wage negotiations between the trade unions and the federations of private sector employers. That the government mediated in these negotiations and demanded 'moderation' (from the trade unions) goes without saying. High unemployment – and the prospects of production being 'outsourced' to low-wage countries – helped to reduce wage aspirations. All these policies contributed to suppressing the growth of real (and even nominal) wages – despite the steady rise in labour productivity. Finally, these policies were capped by fiscal measures that lowered the non-wage labour costs borne by firms as well as the taxation of company revenues. In exchange, the indirect tax burden on domestic consumption (and imports in particular) has been raised. One direct consequence has been the external hyper-competitiveness of the German economy. However, the country is paying quite a high price for all this. Depressed wages result in depressed domestic consumption also of services which do not need to compete externally. All this helps to compound the overall stagnation/deflation character of growth. Indeed, average GDP growth in Germany (over the period 1999-2008) falls short of an unimpressive 1.4% – against 2% for the whole euro area. Germany's partners (taken together) grew much more rapidly, although they too were not very impressive either. However, the differences in the sources of growth are striking. Foreign trade generated most of the growth in Germany (0.9 percentage points out of the overall 1.4%). In the entire euro area (including Germany) the contribution of foreign trade to growth was symbolic (0.2 p.p.). Growth in Germany's partners in the euro area was *reduced* by foreign trade developments. The German '*beggar thy neighbour*' policy does indeed work; however, it has turned out to be a '*beggar thyself*' policy.

### **3.4 Further consequences unpalatable to (almost) everybody**

The German wage and unit labour cost developments have had a number of further consequences, of which the emergence of huge external imbalances across the euro area is but the first, being the most obvious and the most visible of all. On closer analysis, those consequences can be shown to be harmful not only to Germany's euro area partners, but also to Germany itself. One must realize that Germany's GDP gains may actually represent its partners' GDP *losses*. This follows from the principle of effective demand. Germany's increases in export surplus is an effort to widen its internal market by gaining access to external markets; if successful, the total (domestic plus external) demand increases, as does GDP. But following the same principle, the import surplus in other EU countries limits their total demand and their GDP. This is inevitable because a negative trade balance represents deductions from GDP – part of the domestic income is spent on net imports rather than on domestic production. As in similar cases, this initial loss in the form of an autonomous

increase in imports would be compounded by a loss of employment not only on the part of those who have produced goods subsequently replaced by imports, but also on the part of those who were involved in their production indirectly or supplied them with consumer goods. Secularly, the rising external deficits mean that growth in domestic output is continually depressed below the level that could be achieved under balanced external accounts.

While actually representing a loss, the trade deficit allows current domestic consumption-cum-gross capital formation (i.e. domestic absorption) to exceed domestic production. However, when a country's actual absorption is in excess of its own production (viz. Greece), it implies incurring foreign debt of whatever kind (or sale of domestic real assets to foreign parties, for example, via privatization). Sustained and rising external deficits are tantamount to accumulating net external debt. Mirroring the situation of a deficit country, a chronic surplus country (such as Germany) produces more than it can actually use (its domestic absorption is lower than domestic production). In effect, the surplus country accumulates claims against its partners; in essence, it is lending to them – one way or another<sup>12</sup>.

A 'normal' chronic deficit country (unlike the USA which – for specific reasons – seems to be quite exceptional, at least for some time now) cannot accumulate foreign debt indefinitely, even if willing to do so. Sooner or later, it will become obvious that such a country is going to be unable to service its foreign debt, whereupon it will normally be refused any additional credit. After a decade of sustained and rising external deficits, several euro area countries (that have failed to emulate German wage and fiscal policies) are now close to becoming bad credit risks. Those countries will now have to pay dearly, one way or another, for the years of domestic consumption-cum-investment in excess of their domestic production.

The debt crisis of countries outcompeted by Germany backfires on Germany itself. In the ultimate analysis, a large portion of the debt that has accumulated on account of the high-debt crisis is owed, one way or another, to Germany<sup>13</sup>. Attempts to service that debt would require that the countries that have lost competitiveness and have followed an import-fed growth path suddenly become major net exporters. Of course, those countries may be able to suppress domestic consumption and investment. But would this automatically make their tradable goods (assuming they exist) and services attractive – in price/cost terms – to potential foreign buyers? Where are such importers to be found? Surely not in Germany whose formidable competitive advantages will not disappear anytime soon. Ultimately, Germany may have to swallow some losses on these debts. More precisely, the German government may be forced to recapitalize German commercial banks and other financial market institutions owning large portions of bad foreign debt. Parts of Germany's past

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<sup>12</sup> This is abstracted from the variations in the internal compositions of countries' external debts and claims. While the government, firms, banks and households may participate in the national foreign debt (claims) in differing proportions, in the final (macro) analysis, the overall totals are what really matters. The actual composition of debt may matter when it comes to detailed designs for remedying the crisis.

<sup>13</sup> *'The financing of current account deficits seems to have remained mainly intra-euro area during the financial crisis...All things considered, it is likely that euro-area current account deficit countries have been important beneficiaries of German capital outflows before and during the financial crisis'* (EU Commission, 2010a, p. 16).

current account surpluses (and handsome profits earned by German private-sector exporters) will end up as increments to the German *public* debt.

### 3.5 The illusion of orderly ‘rebalancing’

The idea that diverging competitiveness trends within the euro area may have disturbing consequences only dawned on the EU Commission in 2008. The more recent Commission Report (EU Commission 2010a) finally acknowledges the problem. However, it fails to recognize the fundamental root causes of its development. Worse still, the Report’s *main* policy suggestions seem either somewhat irrelevant or actually counter-productive. ‘Rebalancing’, meaning the reduction of inter euro-area trade and current-account imbalances, is to be achieved essentially through the efforts of high-deficit countries which ‘...need both to regain competitiveness and address the sources of persistent weakness in domestic savings’ (Report, p. 38). As far as the latter goal is concerned, not much can in practice be achieved, if countries continue to run large external deficits – i.e. *not before* ‘rebalancing’. As long as those countries continue to be offered competitively priced foreign goods (and cheap foreign credits to purchase those goods), they will run up external deficits. Only by regaining competitiveness (by whatever means) can these countries raise domestic savings. As far as the former task is concerned, ‘Reforms of labour markets should naturally be top of the agenda to improve the functioning of competitiveness adjustment’ (Report, p. 41). In plain English, the policies of the deficit countries should be to bring about wage *deflation* which would eliminate the unit labour cost advantages that Germany has laboriously accumulated over the past 10-15 years. Because of the impossibility of nominal exchange rate adjustments, ‘internal devaluation’ – or deflation – remains the only viable route to regaining competitiveness. However, bearing in mind that nominal unit labour costs in Germany have hardly changed since 1999, while rising about 25-27% in the euro area (Busch 2010), the Report’s advice is hardly constructive on practical grounds. Moreover, it is rather destructive on economic grounds. Massive (and/or long-lasting) deflation of wages (even if successfully imposed on labour) followed by equally massive deflation of prices would first of all throw the economy into a deep and prolonged depression associated with a drop in domestic consumption and investment. (Interest rates would have to become very high in real terms). The depression of investment may not help to maintain whatever export potential the deficit countries still possess. This is the danger currently facing Greece and the Baltic states. Besides, the levels of unemployment and overall misery that would, of course, have to be engineered in order to coerce labour into accepting double-digit rates of decline in nominal (and real) wages would have to be enormous. Finally, even if successfully completed, ‘rebalancing’ on this scale would at best make the country concerned similar in character to Germany: i.e. excessively dependent on exports and otherwise displaying anaemic growth. Worse still, the ‘rebalancing efforts’ may induce others (including Germany) to tighten *their* wage policies still further. Achieving victory through an iron wage policy may be difficult or impossible for countries lacking German standards of discipline and determination.

The Commission Report does not see anything wrong with the competitiveness gains made in Germany – even though (as argued above) they have been achieved at the expense of domestic wages, consumption and investment. ‘*The policy response to intra-euro-area macroeconomic*

*imbalances should obviously not include a call for reduced competitiveness in surplus countries...Strong competitiveness in all euro-area Member States, including surplus countries, is in the interest of the euro area as a whole.'* (p. 38). What the surplus countries may try to do is '*...to tackle structural impediments to domestic demand...*' (p. 38)<sup>14</sup>.

For the time being, the EU is neither a surplus nor a deficit entity as far as net exports outside the EU are concerned. Hence, deficit countries within the EU can cut their import surpluses, if – and only if – surplus countries within the EU cut their export surpluses. This calls for an increase in the *relative* competitiveness of deficit countries and a decrease in that of surplus countries. It is merely a matter of simple arithmetic. Another possibility exists: the deficit countries could become as competitive as the surplus countries (with Germany in the lead) in relation to the world *outside* the EU. The only place where an EU surplus of such magnitude can find a market is the US, which is already suffering from an unsustainable import surplus. As the Financial Times wrote: '*...a decision to turn the eurozone into a huge Germany would – and should – be seen as an act of mercantilist warfare upon the US. How long would the latter put up with the hypocrisy of surplus countries that blame borrowers for the deficits their own surpluses make inevitable? Not much longer, would be my guess, at least now that the US government has become the world's borrower of last resort...*'<sup>15</sup>

### 3.6 Euro area accession of the NMS: risks underestimated

When joining the EU, the NMS made a pledge to join the euro area: of course, after dutifully fulfilling the Maastricht criteria. (Unlike the UK, the NMS were not granted derogation. But they do not seem to have sought derogation). Two of the CEE NMS (Slovenia and Slovakia) have already become members of the euro area; Estonia is to join in 2011. The benefits of adopting a joint European currency are pretty obvious (though often exaggerated) and do not require any extended exegesis. Countries that give up their *own* fixed-exchange rate regimes gain unequivocally because, shielded by the power of the ECB, they are no longer potential targets of eventual speculative attacks. The advantages gained by switching over to the euro are less obvious in the case of countries that have had floating exchange rates. Clearly, those countries no longer have to bear with market-driven exchange rate fluctuations that could destabilize things. On the other hand, those countries do not lose a measure of control over their national monetary policy and inflation: they continue to influence domestic interest rates<sup>16</sup>. Although national monetary policy (e.g. of the inflation-targeting kind) may

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<sup>14</sup> On pp. 45–46 the Report shortly lists macroeconomic challenges and imbalances underlying divergent competitiveness developments in individual euro countries. For Germany these are '*weak infrastructure investment and domestic demand/high saving rate; underdeveloped competition in service sector/unbalanced growth structure; insufficient wage differentiation*'. It is rather difficult to see how the government could help develop competition in the services sector or promote sufficient (whatever that may mean) wage differentiation – and especially how these developments could reduce Germany's external surpluses. Weak infrastructure investment is, of course, due to the government's attempts to satisfy the restrictions of the Stability and Growth Pact and strengthen the 'export front'. Weak domestic demand is, of course, part and parcel of the overriding policy of minimizing unit labour costs through the suppression of wages. With the lessening share of wages in the GDP and taxation becoming less progressive, higher saving rates are only to be expected.

<sup>15</sup> FT.com, Martin Wolf, 17 June 2010.

<sup>16</sup> Under free capital movements, the national monetary policy is effectively possible, provided the exchange rate is floating (this is the so-called 'impossible trinity' doctrine stating that it is impossible to have independent monetary

be unable to prevent directly high capital inflows and the associated strong nominal appreciation that could imply increases in unit labour costs and losses in the external competitiveness, it may also discourage such developments by trying to suppress domestic interest rates (and inflation). They could try making financial capital inflows potentially less profitable. Of course – as is well known – floating exchange rates tend to behave unpredictably (at least in the short term); this fact can restrict financial (or speculative) inflows seeking large rapid returns with a minimum of risk. Finally, the experience of the CEE countries, which have retained flexible exchange rates (Poland, the Czech Republic, Hungary and Romania), has shown that periods of intensified capital inflows (and some currency appreciation) are invariably followed by periods of intensified capital outflows (and some currency depreciation). 2009 has shown that flexible exchange rates can mitigate the impact of a crisis. The periods of rising and falling unit labour costs (in euro terms) alternate. While it imposes certain costs and does not rule out the possibility of appreciation lasting too long or being occasionally too strong, this is definitely a better situation than that all too often observed in countries which have adopted fixed exchange rates (including those in the euro area)<sup>17</sup>.

In the fixed exchange rate countries, the losses (or gains) in competitiveness appear to be accumulating over time, without ever (thus far) correcting themselves. The accompanying external imbalances also tend to accumulate over time. The imbalances may undergo temporary correction on account of deep domestic recessions (as is to be currently observed in the Baltic states and Bulgaria). Those recessions, however cannot and do not (and are even unlikely to) eliminate (through deflation in wages and prices) huge real overvaluation levels of their currencies. As soon as lending to those countries resumes, they are certain to start developing large external imbalances once again.

The Maastricht inflation criterion (long perceived as an irrelevant nuisance<sup>18</sup>) is in fact sorely needed. Fairly soon after adopting the euro, a country that cannot meet the criterion is sure to end up badly. Such a country would most likely experience a credit boom. With both interest rates falling abruptly to the levels prevailing in the euro area and domestic inflation still running along its earlier trajectory, the economy is likely to overheat, especially as the elimination of the exchange rate risks would attract high capital inflows. Greece is a good example of a country 'suffering' from a sudden drop in interest rates (upon adopting the euro), with inflation still running high in tandem with rapid real appreciation. Of course, should the resultant credit boom expand export capacities and enhance

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policy, fixed exchange rate and free capital movements). Of course, free capital movements are one of the 'four basic freedoms' on which the EU is founded (and one of the two taken most seriously).

<sup>17</sup> Even better outcomes could be expected with the policy that controlled inflation while at the same time steering the exchange rates to safeguard the desired degrees of external competitiveness. Such a policy was successfully pursued for a long time in Slovenia (and in Italy prior to the establishment of the Exchange Rate Mechanism). Running such a policy requires effective restrictions on capital flows – outlawed under the EU Treaties.

<sup>18</sup> In particular, the inflation criterion was viewed as absurd and actually harmful as it was incompatible with fast real growth, which was claimed to require higher inflation. It was even claimed to justify real appreciation (in otherwise chronic current account deficit countries). The latter claims were derived from popular misinterpretations of the so-called Balassa-Samuelson Effect. Around the year 2000 it was proposed to ignore the Maastricht criteria – and introduce the euro unilaterally (without asking anybody's permission). Alternatively, the criteria were to be eased for the NMS. Fortunately, neither proposal was accepted.

labour productivity, things may end well. Experience, however, tells a different tale. The credit booms following the adoption of the euro fuel consumption and imports of consumer goods, as well as boost real estate dealings and speculative investments. At the same time, they fuel rapid growth in wages and prices. In short, experience shows that booms of this kind tend to end with the countries pricing themselves out of international competition.

Fulfilment of the Maastricht inflation criterion, though necessary, is not sufficient to guarantee a measure success *after* adopting the euro. First of all, the parity at which the domestic currency is exchanged into euros may be 'too strong' – as evidenced in Portugal whose economy has remained stagnant since 1999. Secondly, the initial undervaluation of the parity (although generally desirable) is not a guarantee of success either. Italy's lira/euro parity was significantly undervalued even in 1997 (after the collapse of the first version of the Exchange Rate Mechanism the lira, like most other European currencies, was strongly devalued against the DM). Within the EMU, undervaluation 'reserves' were soon depleted as inflation in Italy was consistently higher than in Germany, while German labour productivity rose faster than that of Italy. In effect, price levels in Italy have risen rapidly relative to Germany, while the relative p.c. GDP has been declining ever since<sup>19</sup>.

For an NMS (or any other EU country) to fare *reasonably* well while participating in the euro area, it is necessary to be able to match *permanently* Germany's performance on unit labour costs. It is not sufficient to perform well against Germany on any specific date (or even over an extended period of time). What is needed is the ability and determination to emulate, for example, Germany's wage and fiscal policies *indefinitely* into the future – no matter what those policies may entail. In any case, faring *reasonably* well under the euro system in its present form is likely to imply at best a rather *weak* overall growth based on expansion of net exports. A better alternative for the NMS may be to retain a national monetary policy and a *depreciable* currency – and then try to follow a path to *rapid and externally balanced* growth.

### 3.7 Some constructive (but unrealistic?) proposals to defuse centrifugal forces

The euro-area countries that are unable or unwilling to emulate the Germany's restrictive policies with any degree of success may sooner or later find it expedient simply to withdraw their membership and reintroduce their former currencies. Such decisions may be facilitated by a severance of financial transfers (or lending) needed to service the snowballing foreign debts. Currently, the prospects of such a radical development happening seem remote: the European Council recently decided unanimously to set up a relief fund to provide the necessary support to countries in need. The details of the fund's mode of operation have still to be worked out. However, it must be understood that saving some countries that currently may need to be saved does little (if anything) to tackle the fundamental reasons for their present plight. Countries, whose governments or private sectors (or both) are saved from bankruptcy by using foreign money, do not become externally competitive through such measures. Either they remain stagnant indefinitely or – if granted new credits – they will resume running external deficits and accumulating foreign debt once again. It is hard to imagine how such a development can be prevented. In due time, those countries

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<sup>19</sup> See Podkaminer (2010).

would need yet another bail-out package financed by those who can afford it (i.e. Germany). Arguably, this is not a situation that is likely to be tolerated indefinitely. At some point, transfers and new credits will not be forthcoming (or domestic stagnation will become intolerable), and this or that country may default on its foreign debt and leave the euro area. Of course, the costs of all this would be high to both the country deciding to leave and those staying on (as well as the creditors). The likelihood of this possibly triggering the disintegration of the European Union as a whole cannot be dismissed. It is in the best interest of the NMS to preserve the EU while, of course, making it more functional and growth-friendly in practice – not merely in lofty proclamations and irrelevant ‘strategies’.

Countless are the proposals on how to correct – and reinforce – the overall architecture of the EU (and of the euro area in particular). The most consistent and comprehensive proposals stem from De Grauwe (e.g. 2009). In essence, his vision stipulates the transformation of the present *monetary* union into a de facto political union, with a centralized fiscal authority ruling – inter alia – over cross-country fiscal transfers (which would, of course, have to be much higher than the current symbolic 1% of the EU GDP). Certainly, it is rather unlikely that this vision will materialize anytime soon. If anything, one fear may be that premature attempts at fiscal centralization might actually derail political unification (which is what seems to be happening in De Grauwe’s native Belgium)<sup>20</sup>. A less ambitious proposal might, for example, suggest that countries with external surpluses be requested to draw up (and implement) consolidation programmes aimed at strengthening domestic demand. Failure to bolster domestic demand (or to reduce abnormal savings) could be subject to ‘*excessive external surplus procedures*’ with clearly defined penalties for misbehaviour. Another modest proposal may require member states to enter into binding agreements on avoiding *beggar-thy-neighbour* tax and wage policies which could generate unfair advantages in mutual trade. The ‘*race to the bottom*’ in tax (and wage) policies would have to be stopped. Arguably, all countries might also agree on broad guidelines for national wage policies (for example, stipulating that wages should be allowed to rise in line with labour productivity – no more, *but also no less*)<sup>21</sup>. Agreeing on such guidelines means more policy coordination at the EU level. That co-ordination is badly needed. In principle, it is feasible, even without having to institute an ‘EU economic government’. A labour-productivity driven wage policy, with the individual countries’ average nominal wages increasing in line with average labour productivity (augmented by a common ECB target pertaining to inflation) would result in national inflation rates approximating the common target inflation rate. Importantly, such a policy would help narrow divergences within the euro area. It would then be possible to run the *one size fits all* monetary policy, without provoking centrifugal forces within the euro area.

Finally, other hitherto unutilized possibilities exist for accelerating overall growth in both the euro area and in the EU. Drawing on those possibilities may help defuse the centrifugal tension generated to date under the rules currently being followed. Those possibilities are discussed below.

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<sup>20</sup> More recently, his proposals have been scaled down considerably (De Grauwe, 2010).

<sup>21</sup> Policy linking growth in wages to growth in labour productivity has enjoyed a long tradition in Germany and Austria.

#### 4 The EU economy needs to run budgetary deficits: fiscal deficits may be a secular necessity

##### 4.1 Efficient operation of automatic stabilizers may require fiscal deficits in excess of 3% of GDP

While it was generally admitted, *after* the crisis broke out back in 2008, that fiscal deficits may have served the purpose of providing ‘stimulus’ when the slump developed, the mood among politicians and their economic ‘experts’ already seems to be changing, even though recovery (at least in Europe) is still weak and fragile. The outbreak of the Greek public debt crisis has played a role in all of this. Each day resounds once more to the battle cry of ‘fiscal consolidation’. Suspended when events seemed to be spinning out of control, the SGP is being resurrected. Over the period 2009-2010 excessive deficit procedures were initiated for all euro area member countries (and all others except Estonia and Sweden). All these countries are expected to reduce their fiscal deficits to below the 3% of the GDP mark by 2014, at the latest. Interestingly, some non-euro member countries do not seem to be in a rush to embark on fiscal consolidation. The recent (spring) EU Commission’s economic forecasts envisage that very high levels of net lending to the general government will still persist in 2011 (in the UK 11.1% of the GDP, in Poland 7.6%, in Lithuania 9.7%, in Latvia 12.2%). The numbers are not much different to those projected for Japan and the USA (9.1% and 13.1%, respectively). Clearly, neither Japan nor the USA qualifies for euro area membership. Nor would they have they qualified before the crisis as both countries had run up high fiscal deficits for a number of years and had amassed public debts much larger in proportion to their GDP than that of the euro area. (Ironically, threats to fiscal sustainability are obviously taken very seriously in the euro area which has been much more prudent in fiscal terms than Japan or the US. Moreover, the ‘financial markets’ value the latter two countries as lower risks: Japan and the US face no problems over selling their debt – despite the fact that the yields offered are rather symbolic).

Of course, there is no good reason for the 3% deficit/GDP mark being considered the ‘norm’ and not, for example, 2% or 5%<sup>22</sup>. During the cyclical (or accidental) deceleration of growth, people (including even the present EU Commission apparatchiks) reckon with *rising* (or emerging) fiscal deficits automatically reducing the speed or extent of GDP and employment losses on account of decelerated growth. It is now acknowledged that the operation of ‘fiscal stabilizers’ has beneficial effects. Clearly, attempts at suppressing the deficits emerging (or rising) under growth deceleration may be counterproductive as far as both real growth and fiscal positions are concerned. As there is no evidence that fiscal deficits emerging as the result of the operation of automatic stabilizers must *not* exceed the 3% mark, it seems rather unwise to insist, *unconditionally*, on observing that mark in times of slower (or otherwise weak) growth. The siren calls coming from various corners (including the EU Commission) and urging the need to adopt ‘*exit strategies*’ must be closely analysed.

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<sup>22</sup> The 3% deficit/GDP ratio may be linked with the 60% debt/GDP limit on assumption that inflation is 2% and GDP growth about 3%. This applied ‘numerology’ fails in the euro area practice if only because the area’s GDP had grown on average at close to 2% per year (2002-07).

At this juncture, it should be recalled that the SGP (despite having been relaxed somewhat in the period 2004-2005) still insists on something more than simply not trespassing on the 3% deficit/GDP mark. A deficit of up to 3% is still permitted under certain conditions – in particular in times of unfavourable cyclical developments. The SGP still ‘... *lays down the obligation for Member States to adhere to the medium-term objective for their budgetary positions of “close to balance or in surplus” (CTBOIS) ...*’<sup>23</sup>

#### **4.2 ‘Close to balance or in surplus?’ Not part of economic reality**

Over the past few decades, all major countries (and a decisive majority of the minor ones) have run fiscal deficits most of time. This also applies to the major EU economies. In 37 years (1970-2007) the UK ran deficits in 30 years, Germany in 31. The average deficit/GDP ratios equalled 2.8% and 2.1%, respectively. Shorter harmonized long-run time series are available for France and Italy (30 and 32 years, respectively). Neither country recorded a single year without a deficit. The average deficit/GDP ratios were 2.9% and 7.4%, respectively. Facts are similar for other ‘old’ EU countries. The Netherlands is an exception. In 19 years – out of the total of 38 – the budget was balanced or showed a surplus; in 18 years it showed a deficit. Even in that country, however, the arithmetic mean for the budget deficit/GDP ratios over the whole period was 2.4%. In the period 1961-2007, the United States only posted a budget surplus four times and ran as many as 43 budget deficits; the average budget deficit for the whole period ran to 2.6% of GDP. Of 10 CEE NMS, only two countries ran predominantly ‘*close to balance or in surplus*’ fiscal policies in 8 reasonably normal years (2000-2007). In Bulgaria (whose statistical reporting is now subject to doubt) a surplus was reported in 5 years and in Estonia in 8. The average surplus/GDP ratios were purportedly 0.7% and 0.9%, respectively. The two remaining Baltic states ran deficits consistently (although the average deficit/GDP ratios were low: about 1%). Incidentally, it is interesting to note that all of the four ‘fiscally relatively prudent’ NMS have run huge current account deficits (all have fixed exchange rates) and ended up with massive levels of foreign debt and huge *fiscal* deficits in 2009-10. Undoubtedly, the old twin-deficits doctrine that stipulates a functional *positive* association between current account and fiscal balances does not apply here. Low fiscal deficits (or even handsome fiscal surpluses) peacefully coexisted with gigantic current account deficits for extended periods of time. The remaining six NMS have run fiscal deficits each year. Average deficit/GDP ratios vary between 2.2% (Slovenia) and 6.6% (Hungary). The average ratios for Poland, Slovakia, the Czech Republic are all around 4% (less than that for Romania). As can be seen, in real life running deficits is a regular long-term affair rather than an exception.

Were the budget only to play the role of a stabilizer of economic fluctuations, the data would suggest that for decades finance ministers took reckless decisions, irrespective whether governments changed from left to right and vice versa. It is strange that the world has existed for so long while remaining unaware of the need to respect the *close to balance or in surplus* requirement? Or, perhaps it is necessary to consider whether other rational reasons obtain for the regularity of budget

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<sup>23</sup> Council Regulation No. 1055/2005 amending the Growth and Stability Pact. *Official Journal of the European Union*, 7 July 2005, L. 174/1.

deficit policies. In our view, such reasons are to be found both in the domain of public finance and at the level of national economy as a whole.

#### 4.3 What happens when the private sector intends to save more than it intends to invest?

Each generation enjoys the benefits of public infrastructure funded by past public investments and, in turn, it invests in similar infrastructure (and human capital) that will serve future generations. A constant public debt to GDP ratio could be considered an acceptable and fair inter-generational compromise<sup>24</sup>. However, a budget deficit might prove necessary even when public investment is of no consequence. The propensity of the private sector (firms and households taken together) to save measured in terms of the ratio of private saving to GDP (the 'saving rate') may happen to be lower than the sector's propensity to invest (the GDP share of private investment in gross fixed assets, eventually augmented by inventories). This situation is not uncommon (for example, it prevailed in the USA over the period 1998- 2008 as well as in many NMS – primarily the Baltic states); it implies that the private sector is a net borrower. Lending which makes up for the excess of private investment over private savings tends to come from abroad. It is natural to expect that in such a situation, the public sector's financial balance (i.e. its fiscal deficit) does not add all that much to the demand for foreign loans (even though this has been happening in the USA for many years).

For some countries to be able to borrow externally, other countries must have banks, firms and other institutions that are able and willing to lend. Those lender countries have private sectors that save *more* than they intend to invest domestically in real gross fixed assets. Those countries include Japan, China and Russia, as well as Germany<sup>25</sup>. The role that a government's fiscal policy could usefully play in countries with excessively thrifty private sectors is radically different. Generally, those governments should be prepared to run sufficiently high fiscal *deficits*. The reason for this conclusion follows from a rather elementary understanding of national accounting. When the private sector's propensity to save is higher than its propensity to invest, a budget deficit provides the private sector with an opportunity for additional sales – and additional employment – above the level determined by the level of private investment. Without a budget deficit (and/or an export surplus), the private sector's efforts to achieve the desired level of savings would not succeed and thus lead to a decline in GDP and employment down to the level determined by the volume of private investment and net exports.

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<sup>24</sup> If nominal GDP grows over a given time on average by a certain percentage annually, the nominal public debt should grow by the same percentage. This condition is met, if the budget *deficit* constitutes on average a fixed part of GDP. Secularly balanced budgets in a growing economy would not only imply a drop in the public debt 'burden' for future generations. It would also deprive future generations of the services provided by roads, schools, hospitals, and a healthy and educated labour force, part of which would not have come into existence without previous generations having practised deficit spending.

<sup>25</sup> The high excess of savings over investment in China, for instance, is inseparable from the high excess of investment over savings in the USA, for example. However, it is misleading to talk about the Chinese 'savings glut' as the *reason* for the US growing trade deficits vis-à-vis China. The US trade deficits *create* the excess of China's savings over its domestic investment: without the US trade deficits, the Chinese GDP (and savings) would be far smaller, *ceteris paribus*.

This core economic principle explains why the budget deficit was a fairly regular phenomenon in the area of roughly balanced external accounts which generally prevailed under the Bretton Woods system and thereafter during the era of floating exchange rates. It is currently the basic reason why it is rational for countries with high current account surpluses (i.e. with private sector savings in excess of their investment needs) to run large fiscal deficits. Japan – but Germany as well – runs such deficits. Renewed attempts to suppress these deficits do not do any good and at best slow down overall growth. Instead of trying to suppress the fiscal deficit (or engaging in the promotion of net exports and lending to ‘the rest of the world’), the policy may try to address the reasons behind the excess of private savings over private investment. Deflationary tendencies may well be simultaneously responsible for too large a volume of savings and too low a level of investments. However, the structure of private sector income may be conducive to high savings (for example, via rising inequality in disposable incomes in the household sector). Alternatively, downsizing or privatization of services traditionally provided by the public sector (health and pensions) may also induce a higher propensity to save – without the requisite rise in the propensity to invest. Apart from this, some secular decline in the private propensity to invest can be expected – with some secular rise in the private propensity to save. The latter may derive from demographic changes (ageing). The former may be contingent on technological change. The productivity of fixed assets is likely to improve secularly owing to the progress of technology – small amounts of real assets invested are capable of producing more output. This trend may be temporarily interrupted by major inventions (such as ‘electricity’ which calls for high initial investment in the construction of power stations, transmission grids, etc). In the long term, as the supply of goods produced by the private sector can be expected to outstrip the demand for the same, the low private sector investment may need to be progressively supported by the investment of public funds (for example, in infrastructure and environmental protection, as well as in human capital). Of course, that would imply appropriately high levels of secular fiscal deficits.

#### **4.4 Countries with high external surpluses may need to increase their fiscal deficits**

As already discussed, high external surpluses impose definite current and prospective costs on high external deficit countries. Accumulation of external deficits in the form of excessive external debt will sooner or later tend to backfire on the surplus country. Even if external debt is owed primarily to the private sector in the external surplus country (for example, its financial sector), a default on the part of the indebted country will raise the public sector debt in the external surplus country. This is the current situation in Germany which is facing the prospect of having to subsidize Greece (and possibly others) in order to prevent losses accruing to German financial institutions that have been providing credit for the purchase of German exports.

It would have been much more rational for all parties concerned (including the German ministry of finance) to mop up its private sector’s excessive savings by increasing fiscal deficit (raising domestic consumption and investment serving useful purposes) instead of pursuing a *beggar-thy-neighbour* policy. One final outcome, higher public debt, would have been very much the same, yet on all other counts sufficiently high fiscal deficits would have served both Germany and its EU partners better.

What has been said above does not mean that budget deficits cannot have any negative effects. Public debt service (like any public good financed with taxes) *potentially* imposes a burden on all households, while the public debt service may mainly benefit households holding government bonds. Another problem is the rate of interest on public debt. If that rate is higher than the growth rate of nominal GDP, a rising share in the GDP will accrue – over the long term – to the wealthy holders of the public debt via interest payments. However, a rising share in incomes on the part of wealthy households does not increase the effective demand for consumer goods sufficiently to compensate for the taxes (also levied on low-income households), out of which interest payments are made. One of the objectives of the policy should be to prevent a situation in which the interest rate exceeds the growth rate of nominal GDP. The ECB should not indulge in excessive austerity. Moreover, the ECB might be instructed and authorized to abandon its aversion to direct lending to governments in the euro area (or even to governments in non-euro area countries).<sup>26</sup>

The reduction of budget deficits is possible and, in many cases, necessary. However, it must wait until the economy has returned to normal growth. It is no accident that the rare periods of successful fiscal consolidation in the past were also periods of satisfactory or high growth. Practically, the only means of reducing the budget deficit is to ‘grow out’ of it. This is not a coincidence. When an economy enjoys strong growth, government revenues increase and government expenditures related to unemployment and social welfare decrease. If the minister of finance does not use the improvement of the budgetary situation to launch new projects, the budget deficit shrinks: i.e. the government borrows less. At the same time, the lending needs of the private sector also diminish. Assuming a constant propensity to save among private households and business, this is caused by increased residential building and, foremost, greater business investment. These expenditures absorb private savings within the private sector and reduce their outflow beyond the private sector. Under these conditions, the reduction of deficit spending does not give rise to deflationary and contractionary tendencies and hence may be successful.

### 4.5 Public debt: an asset rather than a burden

For the private sector, public sector debts represent assets rather than real burdens. Otherwise governments would not be able to float their bonds on financial markets. Of course, the demand for (and yields on) bonds issued by various governments vary. Interestingly enough, the highly indebted countries (such as Japan and the USA) do not seem to have faced serious problems over demand for their debt. (In Japan most of the public debt is owned domestically, while the US debt is sought internationally as being the most secure). Moreover, the costs of servicing their debts have been quite low. In 2009 the ratio of interest payments on public debt to the public debt itself stood at about 2.8% (in the USA and the UK), 1.4% in Japan – but as much as 3.6% in the euro area (and in Germany as well). Public debt is demanded not only – and not primarily – because it offers returns

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<sup>26</sup> The ECB has recently bought some (tiny) amounts of the euro area government debt only to claim that it had not done so because the purchase was followed by offsetting liquidity-reducing operations. All the same, Mr. Axel Weber, the head of the German Bundesbank (and the likely next ECB President), has openly criticized the recent ‘unorthodox’ actions of the ECB. Direct purchases of government debt by the ECB (and by national banks of the euro area) are not allowed under the present EU treaties.

(although they, of course, are always welcome), but because it offers security that no other form of financial investment (not even bank deposits) can guarantee. That security is highly valued generally and also plays an important role as far as the expansion of private investment is concerned. Banks, for example, gladly accept good government bonds as collaterals for the loans they extend to firms.

Much of the official aversion to fiscal deficits which permeates the EU economic framework seems to derive from the notion that rising public debt may sooner or later become unsustainable (i.e. impossible or too difficult to service). Of course, the high costs of servicing public debt are important in this context because they have the potential to ‘snowball’ the debt, even if primary deficits are moderate. One critical question should be asked here. Why is it so much more costly to service the public debt in the euro area than in Japan or the USA? Of course, many factors contribute to variations in the costs of servicing public debt. The size of the debt (in relation to the GDP) does not seem to be all that important. Public debt/GDP ratios in Estonia and Bulgaria were very low (in 2009 7.2% and 14.8%, respectively), but the implied interest rates were 4.1% and 5.4%. What might really count is not only the (large) size of the economy in question, but most probably also its ability to run *national* monetary policy and ensure it is properly coordinated with *national* fiscal policy. The UK, Japan and the USA are just such countries – the euro area and Germany are not, despite the large size of their economies. The euro area does not have one single fiscal policy and the ECB monetary policy is unable to address the needs of individual euro area member states. Specifically, the simplest answer to the question why interest on debt is low in Japan or the USA seems to be that the Japanese and the US governments can – and do – *target* low returns on their debt, while the euro area governments lack that option. The US Treasury Department spends in excess of its own financial resources by crediting bank accounts of private sector beneficiaries (and expanding its own debit accounts with the banks). This amounts to being compelled to generate funds that could force interest rates down to zero. It is only (shortly) *afterwards* that the US Treasury Department (in cooperation with the FED) issues and floats its debt in quantities sufficient to keep interest rates at levels considered proper.<sup>27</sup>

It would be desirable, were the leading euro area governments also able to lower interest rates on their new debt issues. (An ‘*EU Special Purpose Vehicle*’ proposed recently may lower interest rates on new debt issues – yet without giving the governments fuller control over the rates). Governments (acting in concert) should be given more power to create money without having to seek buyers for their debt in advance. That, however, would most probably require some major modifications to the eurosystem’s mode of operation (and that of the ECB). Those modifications may necessitate revising some EU Treaties. Ultimately, the ECB should be allowed (and actually persuaded) to ‘print money’ with which the euro area governments (or the EU Commission) could fund their legitimate and worthy ‘deficit spending’ projects – without increasing the size of their interest-bearing public debts. Much of the recent ‘*quantitative monetary easing*’ in the USA and the UK boils down to just about that very practice. Used with moderation, ‘printing money’ need not give rise to runaway inflation. Instead, it could help accelerate overall growth – even in countries which hitherto could only subsist by resorting to *beggar-thy-neighbour* (and *beggar-thyself*) policies.

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<sup>27</sup> See e.g. Wray (1990).

## Summary and conclusions

In the short term, the CEE economies are adjusting to the effects of the crisis in the West. Those adjustments, however, are slowing down the economies' growth and suppressing the speed of 'real convergence'. Unless the 'old' EU starts growing appreciably faster than in the past 10-15 years, long-term growth in the CEE countries will not be very spectacular.

The secular weakness of growth in the EU/euro area has its roots in the basic paradigms of EU economic policy-making. Not only does the acceleration of growth depend on changes in those paradigms, but the very preservation of the EU, which is exposed to ever stronger centrifugal forces, may also be at stake. It is in the best political and economic interests of the NMS to help avert such an eventuality, while helping to make the Union's architecture more resilient and conducive to faster growth. This text attempts to identify some of the key flaws in the current EU economic arrangements and puts forward some suggestions for modest improvements. One issue relates to the way in which monetary policy has been defined and pursued in the euro area. It is argued that the principle '*one size fits all*' on which this policy rests supports deflationary/stagnation tendencies in low-inflation/low-growth countries and bolsters booms/inflation in high-inflation/high-growth countries. Whereas Germany has fallen victim to this policy, in a number of other countries policy fed credit and import booms. Diverging trends in unit labour costs, external competitiveness and external balances are the other side of the ECB single monetary policy. Under a common currency, the emerging intra-euro-area divergences cannot be neutralized effectively. Germany has been running increasing external surpluses; its partners increasing deficits. Worse still, the German policy has supported this trend as it allegedly helps to reduce unemployment. The '*beggar-thy-neighbour*' policy turns out to be harmful to Germany itself because it suppresses domestic demand more than it helps advance external surpluses. Weak overall growth in Germany is the result. The external surpluses represent the spiralling debt of the external deficit countries. As that debt proves unserviceable, the German government is forced to take it over in order to save the country's financial institutions. The intensity of the centrifugal forces within the euro area (and generally in the EU) should be dampened by closer coordination of the member states' fiscal and wage policies. In particular, it may be useful to demand that growing labour productivity be matched by wages at the national level. In addition, it should be possible to institute '*excessive external surplus procedures*' against countries that generate large net exports at the expense of cuts in domestic consumption. We also argue that, until the mechanisms are in place to limit the divergences in unit labour costs and external imbalances, it is advisable for the NMS to retain their own currencies and floating exchange rate regimes.

The Stability and Growth Pact is also in need of modification. The 3% fiscal deficit/GDP mark may prevent the efficient operation of automatic stabilizers that *today* are rightly considered vital under cyclical growth slowdowns. Furthermore, the Pact's insistence that in the medium term the budgetary positions should be *close to balance or in surplus* is not consistent with economic reality. Attempts to observe that requirement are doomed to failure whenever the private sector's propensity to save is larger than its propensity to invest in real (fixed) productive assets. Under balanced external accounts, a permanent fiscal deficit may be a secular necessity. Problems related to rising public debt may also need to be addressed. For the euro area these problems could be rendered far less serious than is often believed.

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## Will exports prevail over austerity?

### 1. International environment: a mirror-image of the radical sign $\nabla$ – the symbol of recovery

With the EU having suffered the deepest and longest recession in its history, experts around the world are discussing the shape of the current recovery in the advanced economies hit hard by the crisis. The analysts are undecided whether the development of GDP growth will be V-shaped as it was during the recession in the mid-1970s. A quick and robust upturn, however, is assumed to be most unlikely. The more fearful pundits, albeit a minority, suggest that recovery will be shaped like a W: double-dip recession reminiscent of the early 1980s and 1990s. In the jumble of letters, others suggest a shape combining a U and an L, similar to the sluggish recovery in the 2001 recession. Both the IMF in its World Economic Outlook (April 2010) and the European Commission in its Spring Forecast (May 2010) have come to a consensus and rejected all shapes based on the alphabet. The Commission expects the GDP growth trajectory for the eurozone to be more like a mirror image of the radical sign  $\nabla$ : a deep drop, then an uptick or slight rebound followed by a flatter lower rate of growth than before the crisis. In fact, growth in the eurozone is expected to be lower than 1% in 2010 and only some 1.5% in 2011. The US is expected to do slightly better, while China is back almost to double-digit growth (see Figure 1).

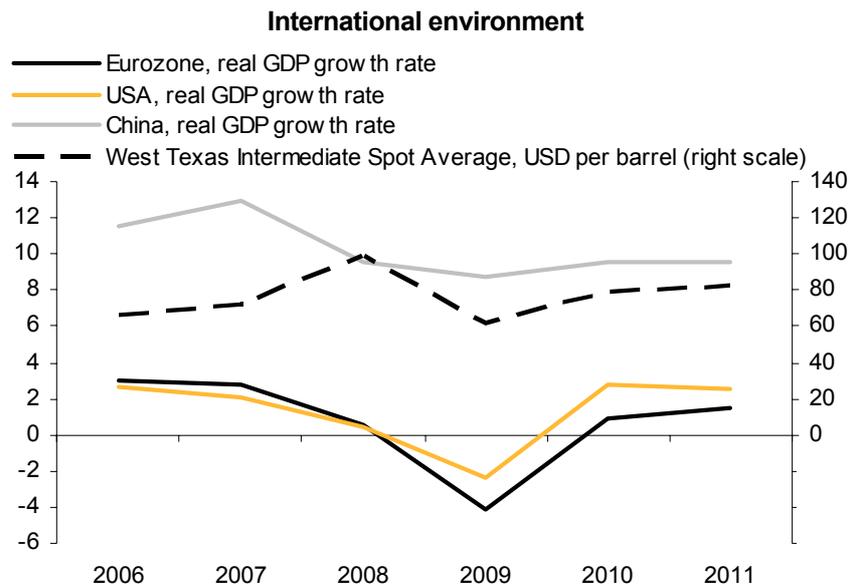
Unfortunately, of the three major global markets mentioned above, the main sales market and source of capital inflows for the economies of Central, Eastern and South-East Europe (CESEE) is the weak eurozone. Moreover, apart from its poor prospects of recovery, important downside risks for growth in the eurozone loom large. Most of the costs incurred by the massive bailout of a deregulated European financial sector will not be covered by those owning capital via inflation, since the European Central Bank will adhere to its nominal inflation target. European tax payers and recipients of transfers will have to foot the bill via higher taxes and cuts in government spending. Depending on the severity and parallel dynamics of those cuts throughout Europe, it will mean an additional drag on the development of domestic consumption and investment. In that sense, the forecasts for the CESEE countries presented in this report contain certain downside risks.

In any event, it is now generally agreed that all the countries covered in this report have been affected by the negative consequences of the international financial crisis. A permanent change in financing conditions and a sustained need for deleveraging will result in slower capital accumulation. Post-crisis growth will be lower than pre-crisis growth. One group of countries (the countries of South-East Europe and the Baltic states) that has mainly relied on massive capital inflows as an engine of growth is expected to suffer even more. The countries of Central Europe and Turkey that have established a solid export base in manufactures might suffer less as they can hope to gain from the rebound in international trade driven by growth in the emerging markets. Finally, the CIS

\* The research on this overview was completed on 1 July 2010. Peter Havlik, Kazimierz Laski, Michael Landesmann, Robert Stehrer and the authors of the individual country reports provided useful comments on the earlier draft.

countries, which have based their economies for the most part on commodity exports, are very much at the mercy of movements in international commodity prices. Current forecasts predict a nominal increase in oil prices of about 30% in USD terms for the whole of 2010 compared to the low prices in 2009. Of the countries of interest in the forecast period 2011-2012, the CIS countries should enjoy the best prospects for growth and recovery. Nevertheless, the mirror-image of the radical sign  $\nabla$  still symbolises the most likely growth pattern for the region as a whole.

Figure 1



Source: European Commission, Economic Forecast Spring 2010, wiiw, EIA.

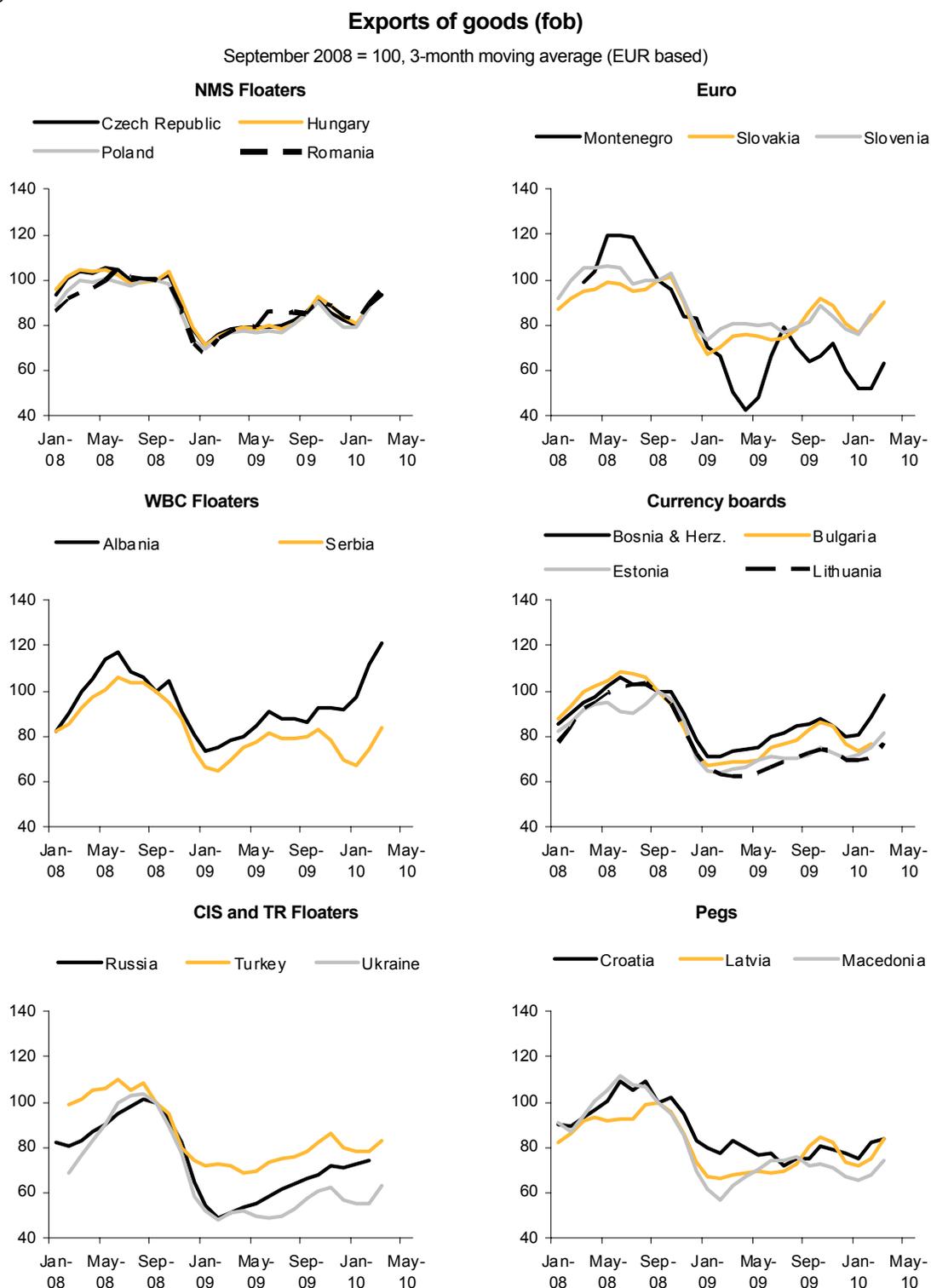
## 2. Foreign demand: only the fittest will profit from the trade rebound

In the CESEE countries, the rebound in international trade after the shock of contraction in late 2008 and early 2009 is also beginning to take shape. The mild improvement in the international environment has helped to uplift the mood among local exporters. It is thus an issue of whether a country has a substantial tradable sector and whether it can produce at competitive prices in order to profit from the resuscitation of international trade. In the section below, we analyse the latest developments in external trade and competitiveness. Box 1 focuses on the nexus between the industrial base and economic growth forecast for 2010.

### 2.1 External trade: exports on the rise

In the most recent months, foreign demand for goods produced in the CESEE countries has picked up markedly. It seems as though the export slump that characterised most of 2009 has finally come to an end - at least momentarily. The latest figures for March and April 2010 in particular reveal a return to about 80 - 90% of pre-crisis export levels (see Figure 2). Generally speaking, transport equipment, metals, energy products, chemicals, machinery and equipment are currently among the region's most successful export goods.

Figure 2



Source: wiiw Monthly Database incorporating national and Eurostat statistics.

The two outliers on the high side are Albania and Bosnia and Herzegovina. In both countries, exports recently reverted to pre-crisis levels<sup>28</sup> in euro terms. In the case of Albania, this is mainly attributable to the heavy spring rains when the volume of electricity exports generated by the hydro-power plants exploded. For Bosnia and Herzegovina, price improvements on the international metal markets were decisive as metals accounts for almost a third of the country's (limited) exports. The countries on the low side include Macedonia, Montenegro and Ukraine. The first two countries have fixed exchange rate regimes. Despite being engaged in the export of metals, they have been unable to profit thus far from the increasing commodity prices. In fact, they have suffered major losses in terms of price competitiveness. Their exports in the first months of 2010 failed to surpass pre-crisis levels in many respects - in the order of two thirds and one half of former amounts, respectively. Although Ukrainian exports have gained from a major currency devaluation and rising metal prices, export levels in early 2010 on average did not even reach 60% of the pre-crisis levels. This might be due to the fact that the prices for Russian gas imports to Ukraine rose by no less than a quarter in January 2009, with gas being the single most important energy source for Ukrainian industry. However, given the most recent political changes in Kyiv and the subsequent rapprochement between the two countries relations, the price for Russian gas imports was reduced by as much as 30% in April 2010. This should increase Ukraine's cost competitiveness and markedly enhance its export performance in the remaining quarters of 2010.

As for the choice of exchange rate regime (see Box 2 below), it is interesting to note that in early 2010 countries with an average fixed exchange rate regime lagged behind their peers with flexible exchange rate regimes by about five percentage points in comparison to pre-crisis export levels. However, decisive factors for the overall growth effect are not only the dynamic manner in which a country's export sector evolves, but also the strength of its industrial base. Those factors determine the impact that exports and import-substitution have on GDP growth. Box 1 addresses this topic.

Box 1

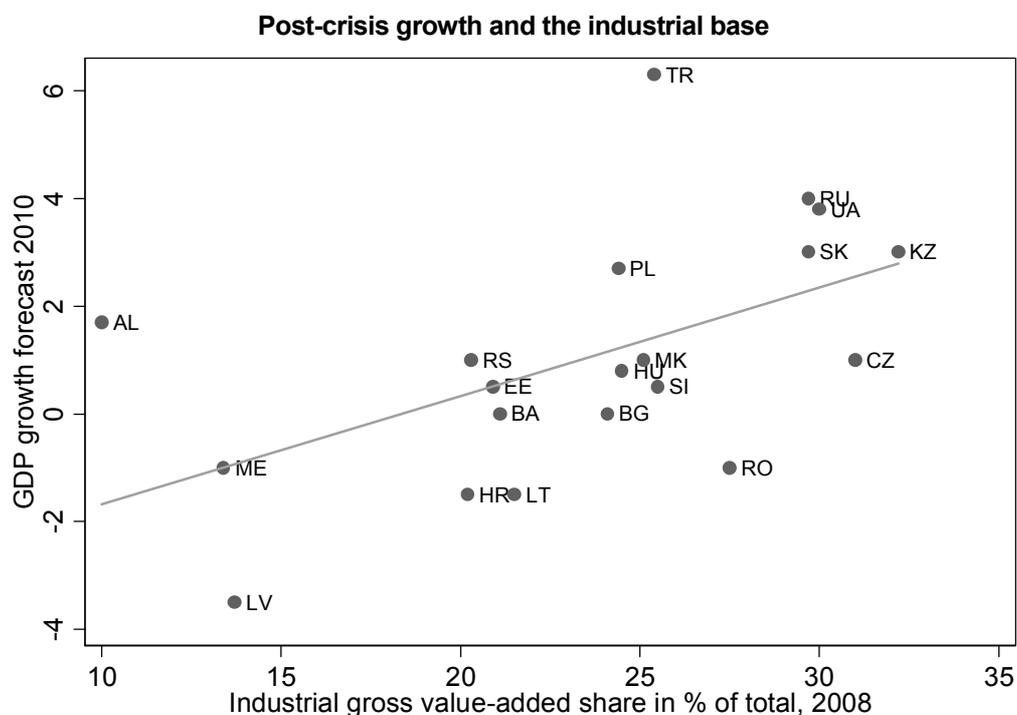
### **Industrial base and economic growth: the benefits of a larger tradable sector**

A strong industrial base is one of the preconditions for a country gaining from an upswing in international trade. It allows the country to increase exports and substitute imports, thereby contributing positively to economic growth. The countries of Central Europe, the CIS member states and Turkey have a long tradition of running a large industrial sector. Countries from Central Europe and Turkey are mainly specialised in manufacturing, while the CIS countries also have a strong mining and energy segment in their industry sectors. In both cases, a range of tradable goods can be offered on the world markets. By way of contrast, industry in the countries of South-East Europe and the Baltic states is much less developed; the structure of their economies is focused more on the production of non-tradables. In the current post-crisis environment of depressed capital flows, these countries will have to reduce their huge current account deficits by simply maintaining a lower level of economic activity as against improving their trade balances. This is best illustrated by comparing the GDP growth forecast for 2010 with the share of industry in gross value-added in

<sup>28</sup> Throughout this text we define pre-crisis levels as relating to either September 2008 or the third quarter of 2008, when the global financial crisis started.

2008 (see Figure 3). The positive relationship between the projected growth rate and the size of the industrial base is evident.

Figure 3



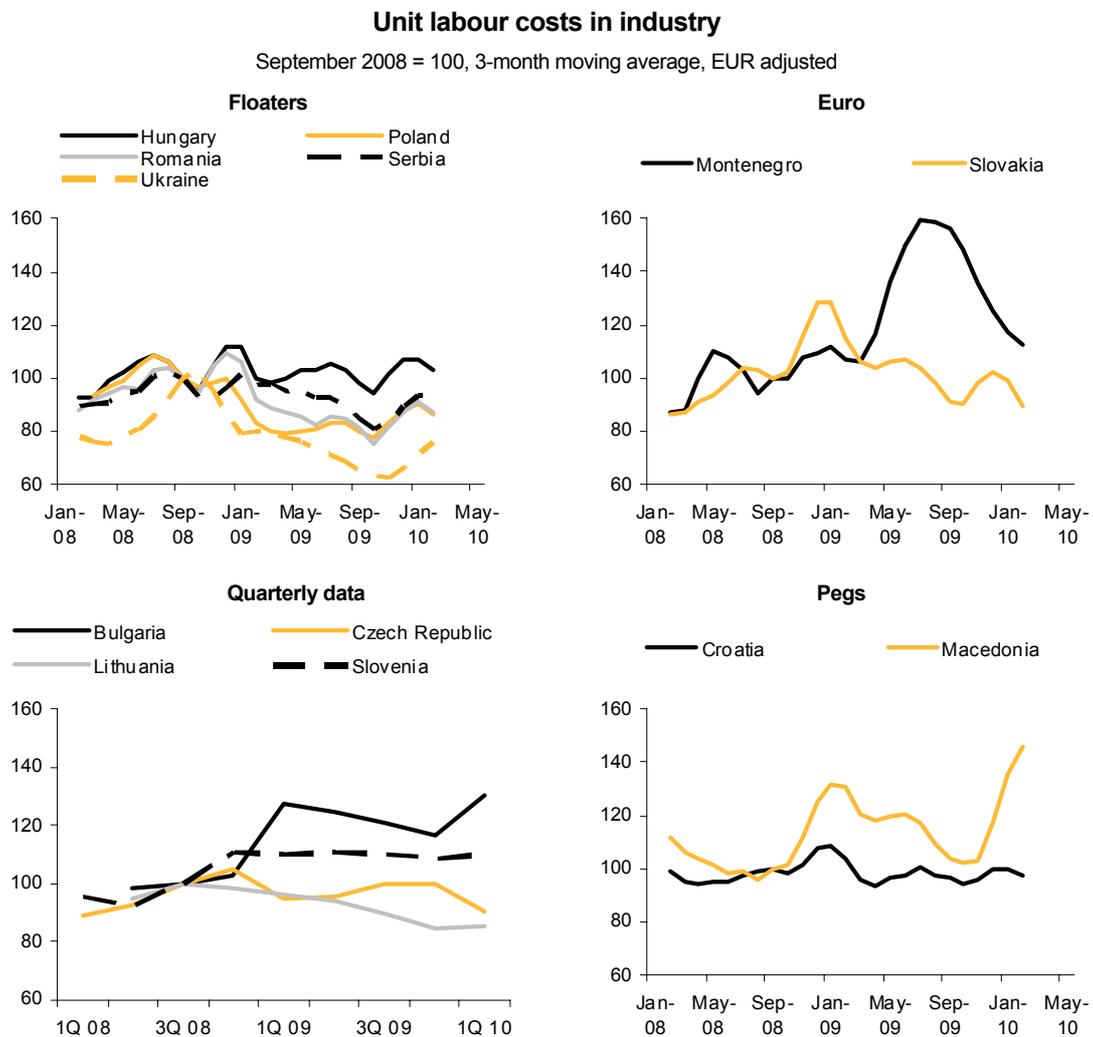
A simple ordinary least squares regression (OLS) supports in statistical terms this positive relationship for a cross-section of the 20 countries analysed. The result proves to be quite robust. In an extended regression, after including the 2009 growth rate and a dummy variable for the exchange rate regime as control variables, the coefficient for the industry share remains significant - at the 5% significance level. Thus, it can be said that for the sample of countries analysed a higher share of industry of one percentage point in gross value-added results in an economic growth rate some 0.2 percentage points higher. The fit of this very simple model is surprisingly good. About 51% of the variance in the data is explained by the model.

## 2.2 Competitiveness: devalue or decapitate

An important factor for the development of exports from the region is the development of cost competitiveness. This can be analysed by reviewing the evolution of unit labour costs (ULCs): an indicator that combines change in labour productivity and wages in euro terms - and thus captures the effect of the exchange rate as well (see Figure 4). On average, the industrial competitiveness of the countries analysed has not changed substantially throughout the crisis and post-crisis period. However, the differences between the countries are sizeable. Those countries that by virtue of their flexible exchange rate regimes ("Floaters" in Figure 4) quickly devalued were able to reduce their ULCs in euro terms by the first quarter 2010 to about 90% of the pre-crisis level. By contrast, the

fixed exchange rate regime countries saw their ULCs soar on average over the same period to about 120% of the pre-crisis level. This is the result of a combination of some wages still rising and reduced labour productivity due to the crisis-driven drop in industrial output, as well as a time lag in the shedding of labour that, in many cases, is only just beginning. In this context, the main exception is Slovakia that by March 2010 had managed to reduce its ULCs to 84% of the pre-crisis level - a result that is mainly attributable to an export-driven output boom and heavy employment lay-offs. In fact, average nominal wages in the Slovak industry rose sharply by almost 8% year-on-year in the first quarter 2010. Available data from the Baltics (Lithuania) also show a similar trend in ULC terms: something exceptional for countries with fixed exchange rate regimes. In that instance, the main driving force seems to be a combination of massive wage cuts and even more massive labour lay-offs.

Figure 4



Source: wiiw Monthly Database incorporating national and Eurostat statistics, own calculations.

A more typical ULC development for fixed exchange rate regime countries can be observed in Slovenia, Montenegro and Bulgaria - and especially Macedonia. In the first quarter of 2010, those countries recorded a ULC level that in one country was 10%, in two countries 30% and in another even 60% higher compared to the pre-crisis period<sup>29</sup>. Not being able to devalue, average wages in all four countries continued to rise throughout the first quarter of 2010: in Montenegro and Bulgaria as much as 7% year-on-year. Industrial output continues to decline or at least stagnate in all four countries. Apart from Bulgaria, the countries were initially reluctant to shed labour and Macedonia even registered a tiny increase in employment. The rise in ULCs thus comes as a combination of declining (or at best stagnating) productivity and increasing wages – a clearly unsustainable development.

The most extreme example of a CESEE economy reducing its ULCs in euro terms is the flexible exchange rate country, Ukraine. A radical devaluation in late 2008 saw wages fall in euro terms throughout 2009. In its wake and despite a renewed rise in wages in the initial months of 2010, strong output-led productivity gains further reduced the ULCs in the first quarter 2010 to levels of around 75% of the pre-crisis period. Albeit in most cases far less radical, most other flexible exchange rate countries have experienced a similar development - with devaluation at least stabilising wages in euro terms and subsequent improvements in productivity without any above-average increases in unemployment.

### **3. Labour markets slightly improving in the CIS and Turkey, but tightening in the new member states (NMS) – with consequences for household demand**

The impact on labour markets of the recession in most CESEE countries and the slowdown in economic growth in Albania, Kazakhstan and Poland was delayed somewhat. In the early stages of the crisis, companies were reluctant to implement large-scale lay-offs, given the uncertainty with respect to both the duration and depth of the economic crisis. As a result the rise in unemployment in 2009 was generally relatively mild, although the Baltic states, where the crisis started back at the beginning of 2008 (i.e. earlier than elsewhere in the region), were a major exception.

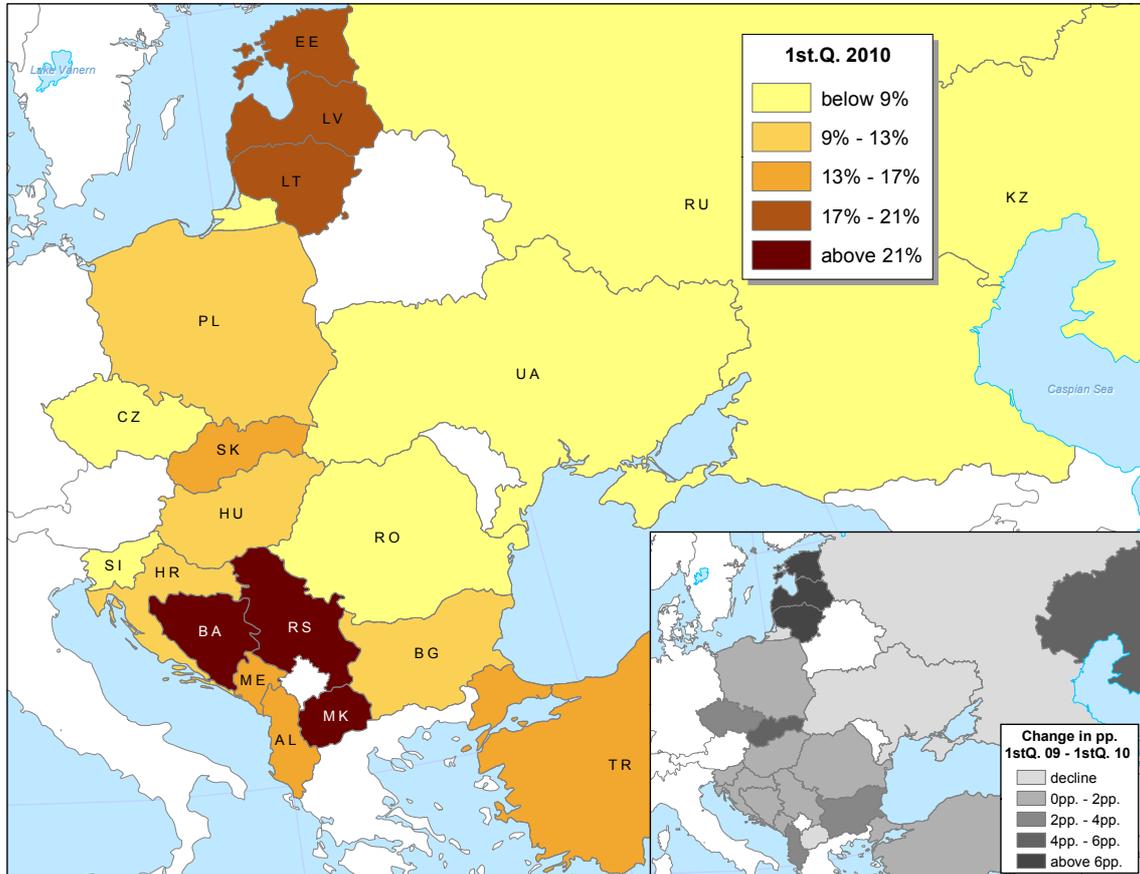
The above notwithstanding, the first quarter of 2010 witnessed a significant surge in unemployment. As shown in Figure 5, unemployment rose almost everywhere. Only Russia, Ukraine, Kazakhstan and Turkey recorded a drop in unemployment against a background of a more robust economic recovery. By way of contrast, in all other CESEE countries – even those that recorded solid economic growth in the first quarter of 2010, such as Poland and Slovakia – unemployment rose. In some cases, the increase was truly dramatic: for instance, by 3-4 p.p. in Bulgaria, Romania and Slovakia (year-on-year). On the one hand, the tightening labour markets in the NMS may be due to the fact that their economic prospects – given their close trade ties – hinge crucially on the future in the eurozone and the EU in general, whose current prospects appear rather bleak. Protracted near-stagnation prompts firms to cut their staff, which might otherwise have been retained, had the crisis turned out to be more short-lived.

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<sup>29</sup> In industry. For the evolution and levels of ULCs at the *macroeconomic level*, see Annex indicators of competitiveness.

Figure 5

**Unemployment rate (LFS)\***



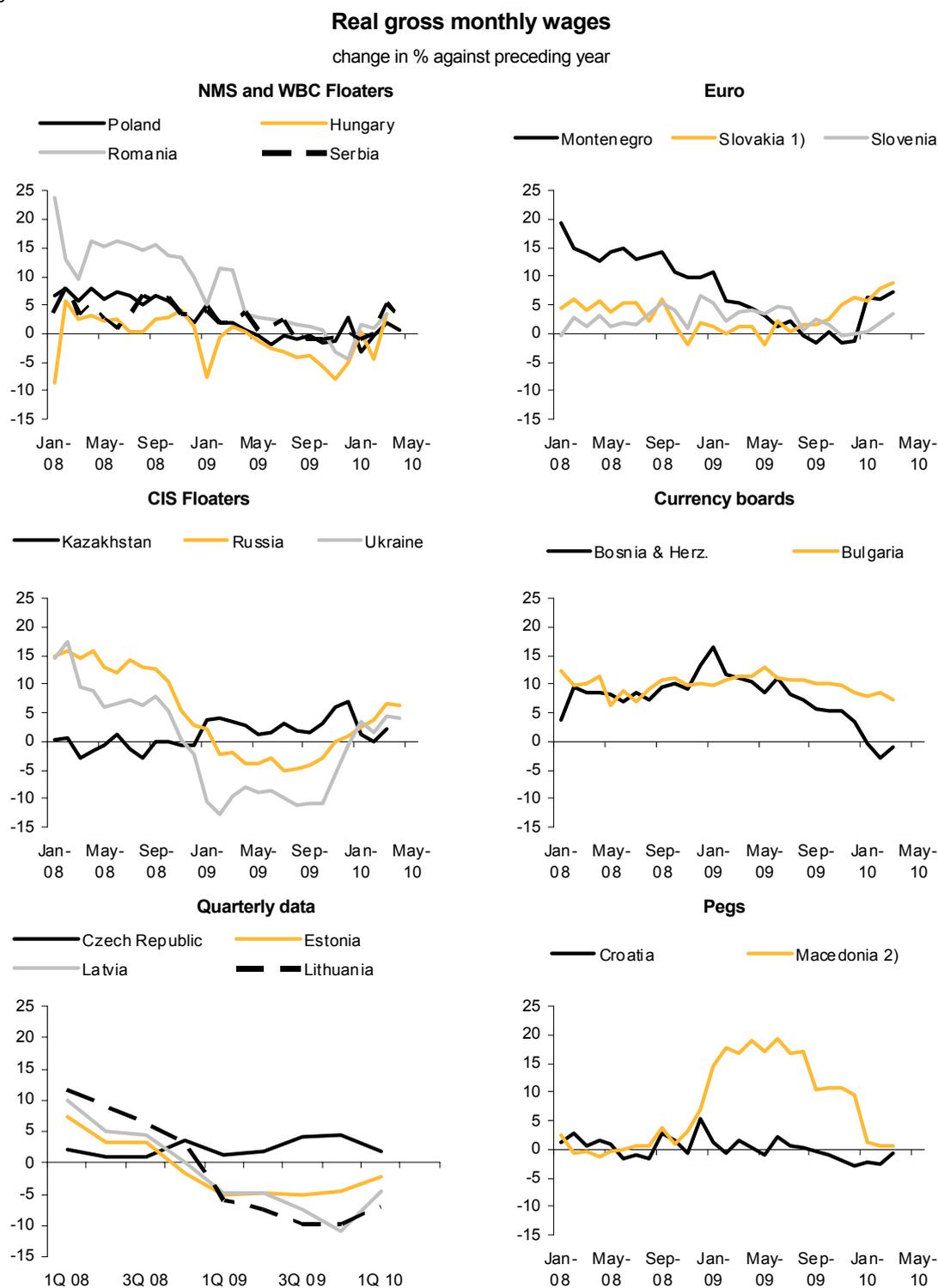
\* Albania, Bosnia and Herzegovina, Montenegro, Romania, Serbia, Ukraine: registered unemployment

Source: wiiw Database incorporating national & Eurostat statistics

The divergent labour market trends across the CESEE countries may be partly related to the differences in their wage dynamics – see Figure 6. In Russia and Ukraine (but also in the Baltic states and Hungary), real wages almost invariably fell throughout 2009 and have only just started recovering this year. In Russia and Ukraine, the downward adjustment of real wages in response to the drop in demand in 2009 was facilitated by persistently high inflation. In addition, nominal wage cuts in those countries were easy to implement, since a substantial part of wages is paid in the form of various bonuses or other one-time income, and in some instances, it takes the form of ‘shadow’ payments (the latter are of course not captured by the official statistics).<sup>30</sup> Given this situation, firms confronted with a drop in demand for their products could generally reduce their wage bill without resorting to massive layoffs; this partly explains why the rise in unemployment in those countries has been surprisingly modest. For example, in Ukraine the increase of unemployment rate was only 2 p.p. despite the dramatic 15% contraction in real GDP.

<sup>30</sup> For more, see e.g. Kuznetsov A. and R. Kapelyushnikov, ‘The Russian labour market: whence stability?’ in: wiiw Monthly Report, Nr. 2, 2010, pp. 12-17.

Figure 6

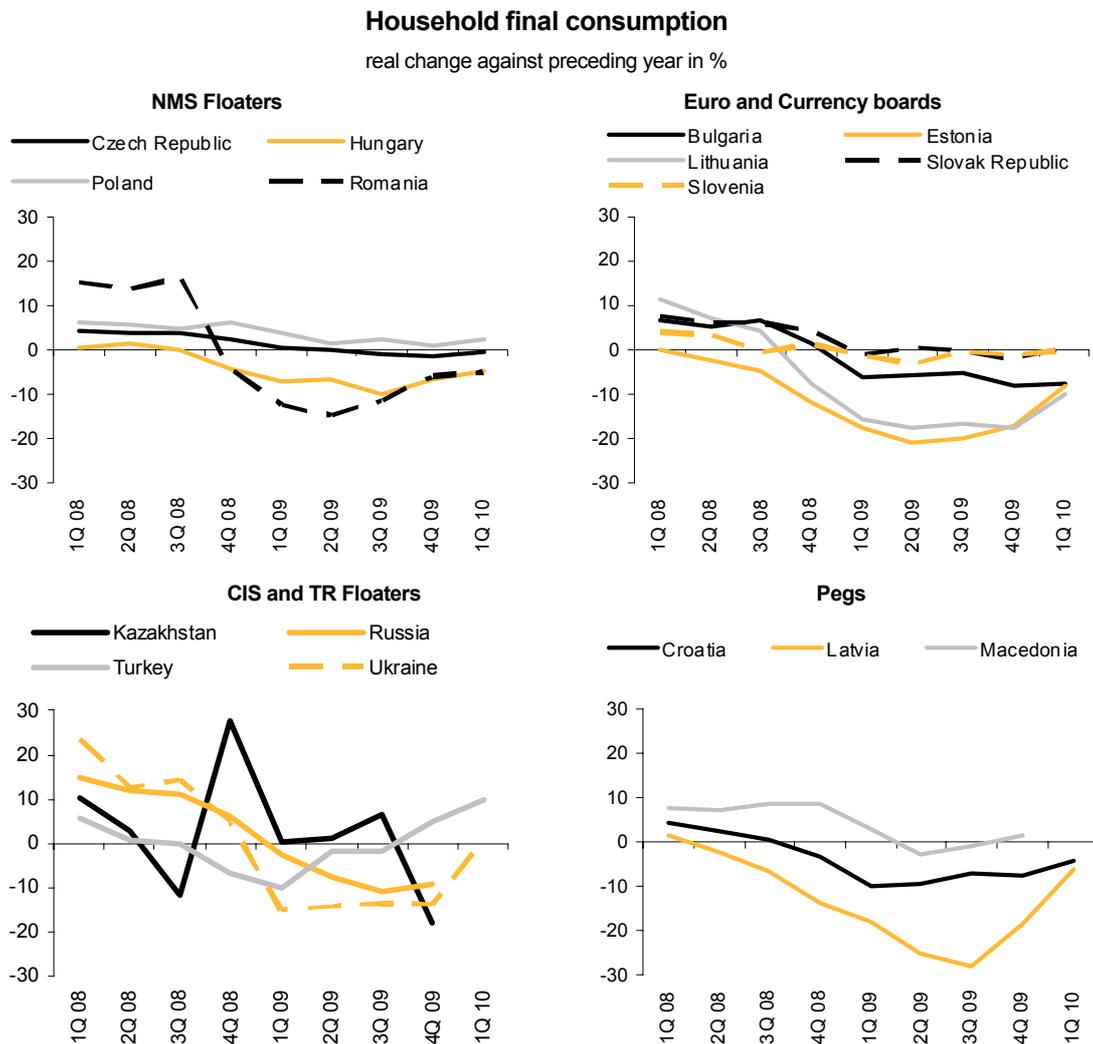


1) Slovakia: wages in industry. - 2) Macedonia: from 2009 including allowances for food and transport.

Source: iwiw Monthly Database incorporating national and Eurostat statistics.

In the NMS, however, the average real wages have been either stagnating or even continuing to grow (particularly in Bulgaria) ever since the crisis began. Given the relatively low – and declining – inflation and the more formalized labour contracts in the NMS, real wage adjustments would have required nominal wage cuts which are generally more difficult to implement. Under such circumstances, it may be easier for firms to reduce staff (especially lower paid less qualified workers) rather than wages. Among the NMS, only in the Baltic states (and Hungary) did wages fall markedly. In the case of Estonia and Lithuania, the drop primarily reflected the radical wage cuts in the public sector.

Figure 7



Source: National statistics, Eurostat.

Finally, in the Western Balkans, neither wages nor jobs appear to have shrunk substantially, at least thus far, although Croatia and Serbia are important exceptions. This is partly attributable to the relatively mild economic recession that has prevailed in those countries (except in Croatia), while

Albania has consistently posted positive economic growth. Furthermore, the relatively favourable labour market *dynamics* in the Western Balkans is to be seen against the background of very high unemployment *levels* overall, exceeding 20% in most post-Yugoslavia countries. Under these circumstances, the recently unemployed may opt to quit the labour force altogether.<sup>31</sup> At the same time, the limited scale of labour market adjustment to date and the relatively gloomy economic outlook in the Western Balkans hint at the possibility of still worse to come.

The trends in real wages and employment are important determinants of both competitiveness and consumer demand. From this point of view, the patterns observed in the NMS and Western Balkans, on the one hand, and in the CIS countries and Turkey, on the other, are quite different.<sup>32</sup> In the NMS (and potentially in the Western Balkans), the combination of marginally rising or stagnating wages and steeply rising unemployment levels is likely to result in household incomes either stagnating or declining. Stagnating household incomes – together with restricted access to consumer credit and the planned fiscal consolidation (which often envisages cuts in public sector wages, pensions and other social payments) – should, if indeed implemented, dampen private consumption in 2010. Indeed, the first quarter 2010 provided evidence of suppressed consumer demand in the NMS (except Poland, where it grew marginally) – see Figure 7.

In the CIS and Turkey, the combination of recovering wages and receding unemployment should be more supportive of private consumption, even if access to credit may not improve substantially in the short term. In Kazakhstan, the recent hikes in public pay should also contribute to growth in household consumption. Although retail sales (a proxy for private consumption) in the first quarter 2010 in both Russia and Ukraine pointed to stagnation, they have been picking up on a monthly basis and are likely to post a reasonable surplus for the year as a whole.

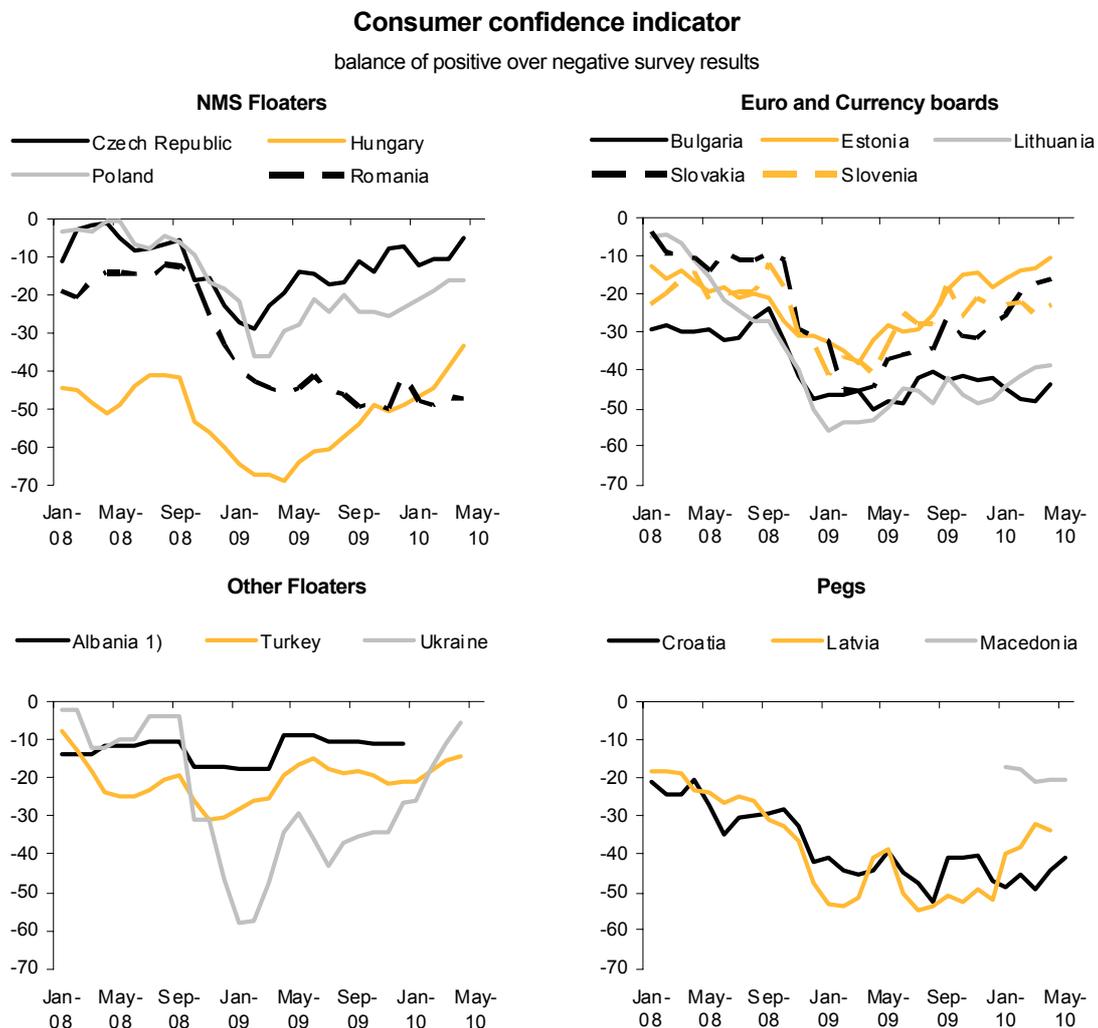
A possible indicator of trends relating to future private consumption is the consumer confidence index (see Figure 8). The latter is compiled according to the Eurostat methodology and in essence represents a net balance of positive and negative responses to a survey on consumer expectations. As can be seen from Figure 8, after a dip in the spring and summer of 2009, consumer confidence in most CESEE countries generally improved in the first months of 2010 - in some cases quite steeply (Ukraine, Hungary, Turkey and Estonia). However, in Romania, Bulgaria and Croatia, consumer confidence has been virtually stagnant at a rather low level over the past 18 months, while in Slovenia the improvement recorded over the summer months of 2009 has since come to a standstill. This pattern of consumer sentiments largely (though not entirely) squares with labour market trends and the governments' consolidation plans. One feature of the consumer confidence index common to all CESEE countries (for which the index is available) is that, even despite improvements in some countries, confidence remains firmly below zero – pointing to prevalent negative expectations.

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<sup>31</sup> The declining statistically registered labour force in these countries partly reflects the growing informal sector, but also emigration, for example. The latter eased somewhat after the Schengen visa requirements were abolished for Macedonian, Montenegrin and Serb citizens as of December 2009.

<sup>32</sup> For details, see Annex 'Indicators of competitiveness'.

Figure 8



1) Albania: quarterly data.

Source: Eurostat, national statistics.

#### 4. Investment demand: the tough times are over?

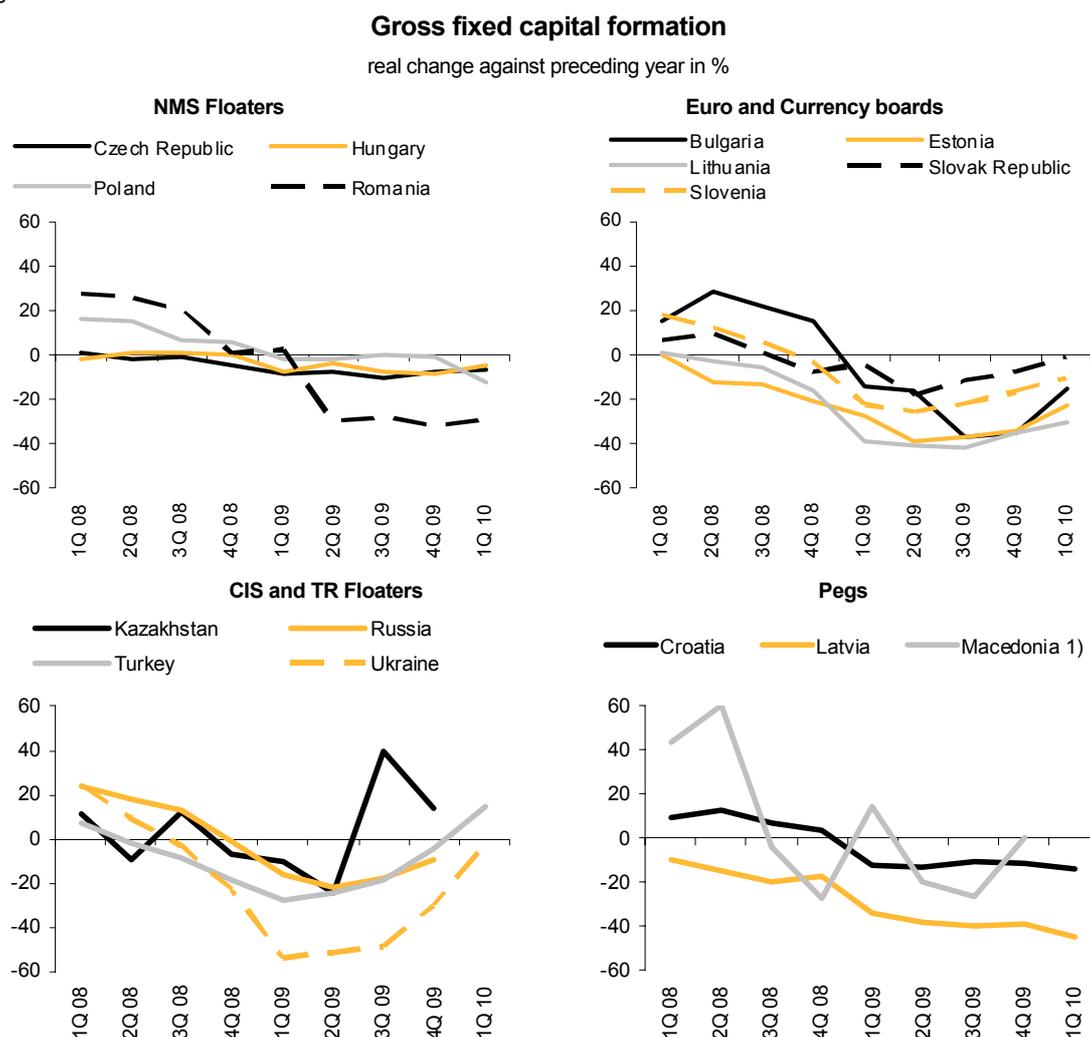
In periods of recession and concern over an uncertain future, the impact on capital investment is pronounced. This is especially true of the economic situation currently prevailing in the CESEE countries. The section below provides an analysis of the two main components of gross capital formation (GCF): gross fixed capital formation (GFCF) and changes in inventories.

##### 4.1 Gross fixed capital formation: reversal of the negative trend and growth next year?

In almost all parts of the region, GFCF has been reduced year-on-year - at least ever since the first quarter of 2009. Investment in items such as buildings, infrastructure, machinery and equipment

registered double-digit contraction rates throughout 2009 (see Figure 9). In the CIS and Turkey, in particular, a slower rate of decline can be seen to have set in as of the third quarter of 2009. However, Kazakhstan and Turkey are the only countries to have experienced substantial positive investment growth in more recent times, whereas Slovakia and Macedonia reached the turning point of zero growth. For the other countries in Central and Southeastern Europe, the negative trend is either mildly slowing down or still persisting in the latest quarters.

Figure 9



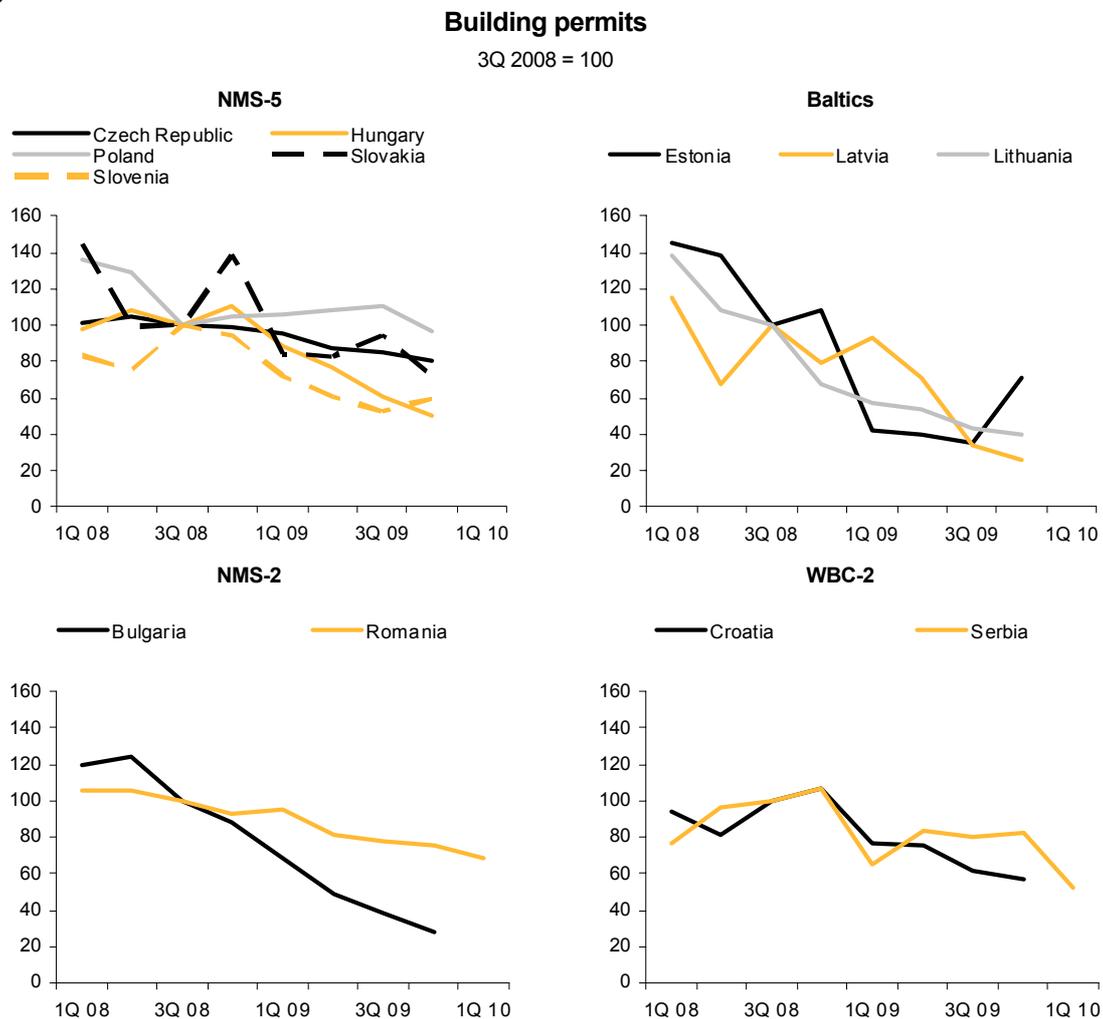
1) Macedonia: gross capital formation.

Source: National statistics, Eurostat.

For most of those countries, investment in new buildings and infrastructure is unlikely to provide an escape route anytime soon. According to the data available, the index of building permits pointed firmly south throughout the fourth quarter 2009 and the first quarter 2010 (see Figure 10). At the end of 2009, on average the countries had achieved building permit levels equivalent to only about 50% -

70% of the pre-crisis period. Poland alone registered a relatively stable and robust development in terms of building permits. Latvia and Bulgaria only reached about a quarter of their pre-crisis levels. This trend has since been confirmed by developments in real construction output growth in the first quarter 2010. For the most part, annual contraction rates in the construction sector in all countries have run to two-digits. In most cases, recent developments point to a worsening of the situation compared to the dynamics of the previous year. Once again the leaders in the negative race are the Baltic states with contraction rates ranging from 34% to 43%. Moreover, even the Czech Republic recorded a dramatic 32% decline in the first quarter 2010. Only to a certain extent can these dramatic slumps throughout the region be attributed to a particularly harsh winter; they point to more fundamental problems in the CESEE construction sector.

Figure 10

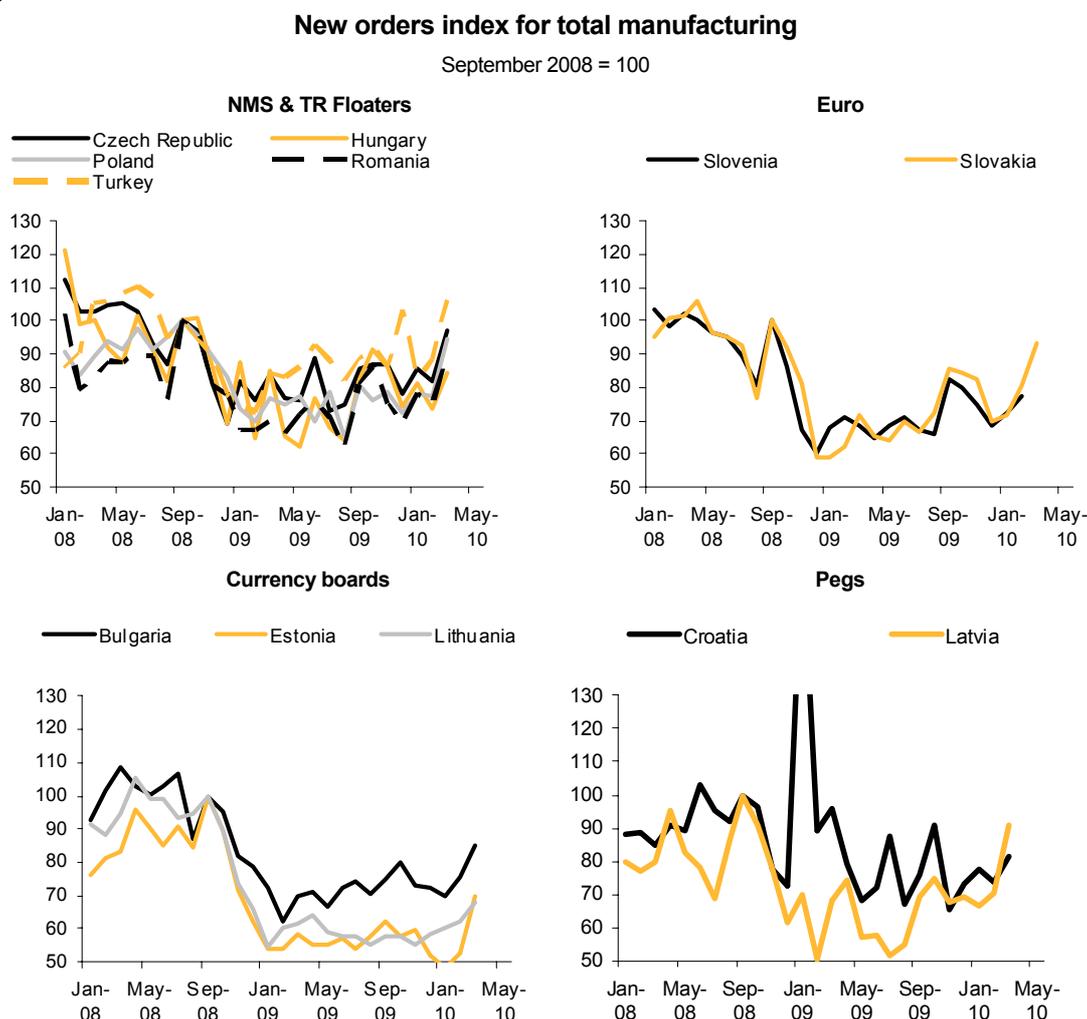


Source: Eurostat, national statistics and own calculations.

Investment in machinery and equipment might be a more likely source for an increase in GFCF in the period to come. In those manufacturing branches that customarily work on commission the index

of new orders has been showing an upward trend in recent months (see Figure 11). Thus, as demand picks up, it can be expected that investment activities will either start decreasing at a slower pace or even increasing slightly. New orders have already surpassed pre-crisis levels in Turkey and by March 2010 the countries of Central Europe had almost reached them. In most of the other countries, this trend is less pronounced; in Estonia and Lithuania it has yet to be seen whether a trend reversal in new orders gains momentum. The short-lived hike in the value of new orders in Croatia in early 2009 is directly related to the commissioning of a number of state-subsidised ships at Croatia's largest shipyard, whose order book was empty at the beginning of that year.

Figure 11

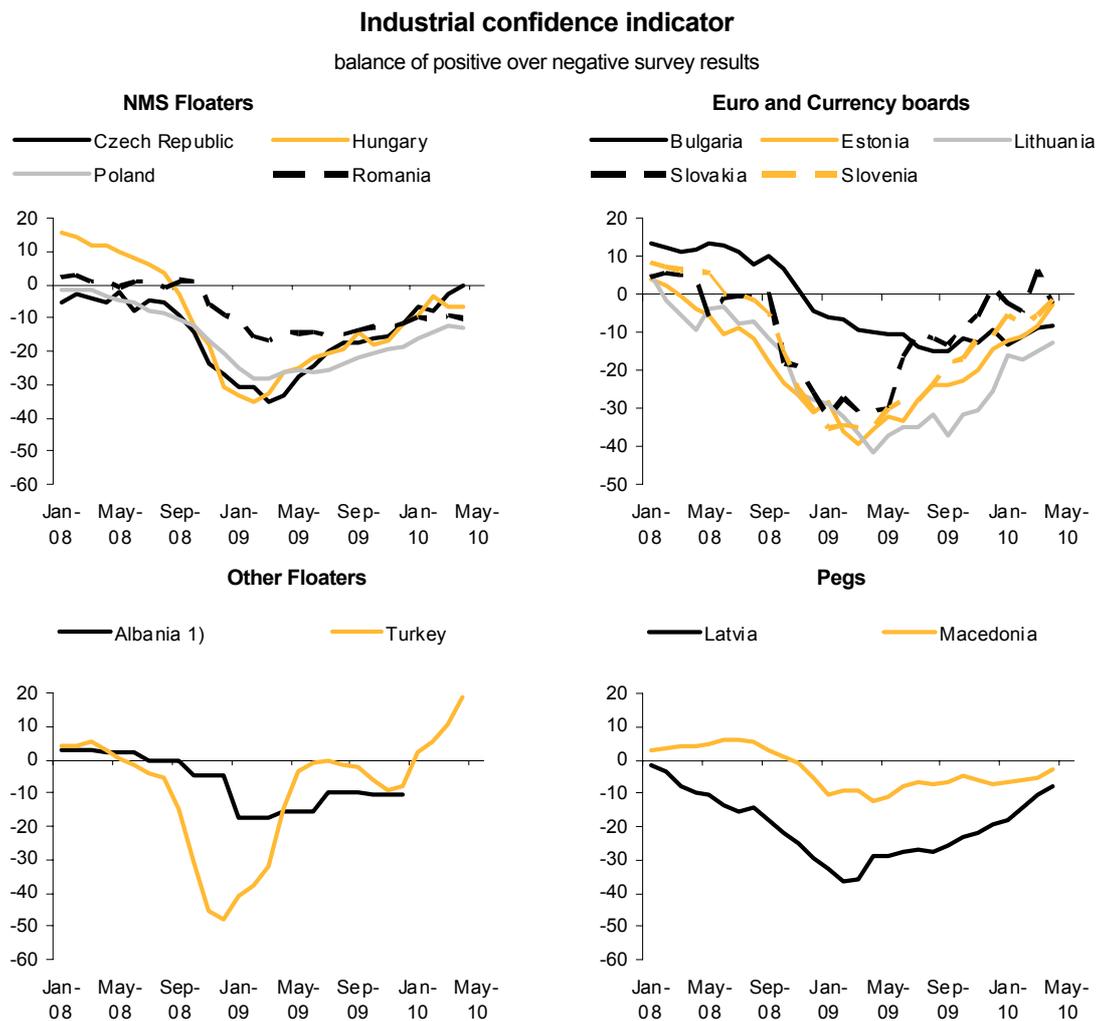


Source: Eurostat and own calculations.

However, it needs more than new orders to re-launch the investment process. The industrial confidence indicator provides a broader picture of expectations in the main manufacturing sectors. The indicator is based on deducting the assessment of stocks of finished products from the

assessment of orders booked and then adding the production expectations for the months ahead. None the less, most of the respondents in the countries of interest have rather pessimistic views in common. Though negative in almost all countries, the trend has been pointing north since around March 2009 (see Figure 12). Nevertheless, in the first months of 2010 developments appeared somewhat indecisive. Turkey is the only country in our sample that showed a majority of optimists in more recent months, while in Slovakia optimism and pessimism more or less balance each other out. Although Lithuania is doing worst in our sample, even there things are looking up.

Figure 12



1) Albania: quarterly data.

Source: Eurostat, national statistics.

Overall, it appears that the mood for investment in some sectors is improving throughout the region. However, it is to be expected that in most of the countries, GFCF growth will still decline or come close to stagnation throughout 2010, while for 2011 and 2012 that particular GDP component can be

expected to act as a driving force for an incipient, albeit fragile recovery. In the NMS this will be assisted by growing transfers from the EU.

## 4.2 Changes in inventories: stocks are running low, time for replacement?

One item in national accounts that is often neglected attracts a great deal of attention in periods of recession: changes in inventories.<sup>33</sup> Changes in inventories comprise changes in both stocks of outputs that are still held by the producers and stocks of products acquired from others that are intended to be used for intermediate consumption or re-sale. When international trade collapsed in 2009 and given the gloomy outlook, demand was met by depleting inventories rather than embarking on new production; this led to de-stocking on a major scale. This dumping of inventories acted as an additional drag on GDP growth, in addition to reflecting the uncertainty surrounding future needs for raw materials and semi-finished goods for further processing.

Table 1

<b>Change in inventories</b>							
EUR mn at PPP							
	<b>3Q 08</b>	<b>4Q 08</b>	<b>1Q 09</b>	<b>2Q 09</b>	<b>3Q 09</b>	<b>4Q 09</b>	<b>1Q 10</b>
Bulgaria	1014.8	497.0	105.1	182.6	230.2	514.3	103.0
Czech Republic	665.4	735.3	1080.9	-387.8	-176.1	-1881.6	1178.1
Estonia	86.7	-88.7	-145.5	-303.3	-78.0	49.7	-26.2
Hungary	457.7	433.3	100.5	-1311.3	-1072.3	-67.3	-629.8
Latvia	139.2	-233.3	192.2	-240.0	105.0	-323.1	258.2
Lithuania	325.9	-567.1	-1253.5	-653.3	-122.7	-599.8	254.2
Poland	3255.4	-845.1	-2099.3	-1055.2	-296.9	-1553.1	534.8
Romania	-605.6	98.1	-3867.1	490.8	1042.3	1064.1	-491.1
Slovakia	1270.6	-216.9	-195.7	-818.1	-270.6	-1471.4	-317.2
Slovenia	494.0	407.8	11.2	-225.2	41.0	-47.7	95.2
Croatia	-675.7	49.1	985.4	648.5	-772.8	395.3	1039.0
Turkey	16530.6	-5914.6	-12152.7	-4041.9	8580.6	-7594.0	-1934.1
Kazakhstan	796.2	324.8	2393.5	295.1	-330.0	-270.5	.
Russia	45638.1	-22819.0	-8916.9	-10410.2	6946.0	-33700.9	.
Ukraine	6490.4	-4941.2	-2629.1	-2376.8	3479.6	-639.4	.

Source: Eurostat and national statistics.

For the sample of countries where this type of data is available, we find a lot of idiosyncrasy in the inventory cycle changes (see Table 1). Nevertheless, the following general picture can be drawn. Up to the third quarter 2008 almost all the countries increased their inventories. With the onset of the

<sup>33</sup> It has to be noted that estimates of the changes in inventories depend heavily on the valuation method applied in the respective national accounts. This sets certain limits on the comparability of the data.

crisis in the following two quarters, about half of the countries started reducing their stocks. In the second quarter of 2009, the vast majority of countries dumped their inventories, a process that also went on during the last quarter of 2009. The latest NMS data for the first quarter 2010 show a mixed picture, with a slight majority of the countries starting to re-stock their inventories. This was particularly pronounced in the Czech Republic, whereas in Hungary in the first quarter of 2010 stocks were still quite substantially reduced.

It is fair to assume that in most countries, stocks are now held at rather low levels. Especially Estonia, Lithuania, Poland, Slovakia, Romania and Turkey have depleted their stocks over many quarters. Slovakia has been doing so for the past six consecutive quarters. Restocking inventories could thus be a modest, and in some cases important (e.g. Russia), source of GDP growth in the quarters to come.

## **5. Government demand: anaemic growth in tandem with the Greek crisis prompts a rush to fiscal consolidation**

The fiscal policy pursued in the CESEE countries (with the exception of Hungary) prior to the financial crisis can hardly be blamed for the impact that the crisis has had on those countries' economies. Over much of the past decade, most CESEE countries undertook serious efforts to consolidate their budgets. By 2008, only in Poland, Hungary, Romania, Albania, Latvia and Lithuania did the size of the budget deficit exceed the 'magical' Maastricht threshold of 3% of GDP,<sup>34</sup> while three countries – Russia, Bulgaria and Montenegro – actually recorded budget surpluses (see Figure 13). Several factors contributed to making the CESEE governments keep their fiscal deficits in check. In the 'currency board' countries (Estonia, Lithuania, Bulgaria and Bosnia and Herzegovina), fiscal prudence was a 'built-in' rule whereas, for example, in Slovakia, which joined the eurozone in 2009, the country's earlier lax fiscal policy had been constrained by the Maastricht criteria for euro adoption (budget deficit not exceeding 3% of GDP and public debt stock below 60% of GDP). More generally, the relatively restrictive fiscal stance was due to the economic policy-making paradigms prevailing in many CESEE countries. It reflected a deliberate departure from the 'Communist' past and followed the mainstream (until recently) economic policy recipes.<sup>35</sup> Even in Russia, where the government had run high fiscal surpluses on the strength of the 'oil bonanza' during the past decade, the badly needed investment in both crumbling infrastructure and human capital (let alone in economic modernization and diversification away from the energy sector) had been largely foiled by fears of inflation and misappropriation of funds (corruption).

Before the crisis, fiscal expansion had been generally bolstered by rising government tax revenues in the context of solid GDP growth. In the last few years before the crisis, Hungary had been practically the only CESEE country whose economy was (nearly) stagnating and whose public debt to GDP ratio was generally on the rise and exceeded 60% of GDP. The introduction of a fiscal stimulus package in

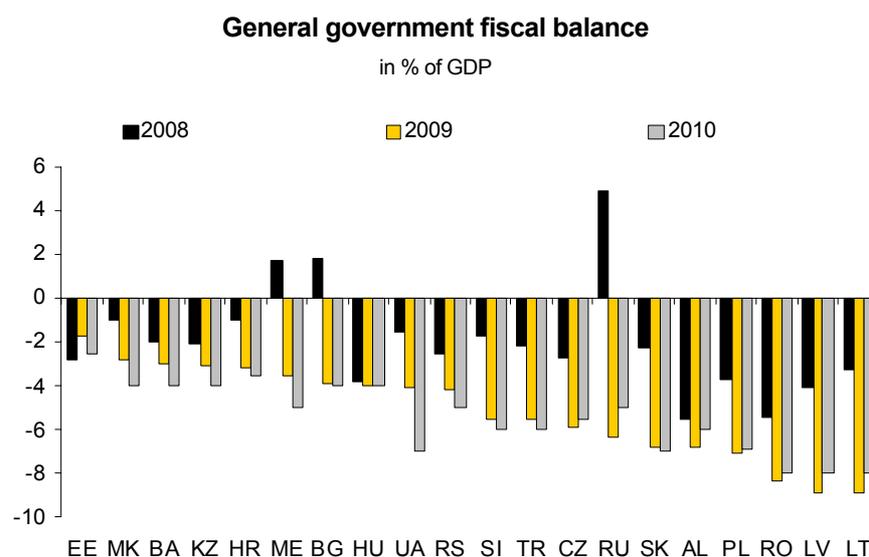
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<sup>34</sup> In Latvia and Lithuania, whose budgets in previous years had been almost balanced, the rapid deterioration in fiscal performance in 2008 reflected the economic slump, which had set in at the beginning of the year.

<sup>35</sup> For more discussion, see Special Topic by K. Laski and L. Podkaminer 'Long-term growth prospects in Central and Eastern Europe hinge on changes in the basic paradigms of EU economic policy-making'.

Hungary was out of the question at the time because the economic stagnation itself was largely the result of radical budgetary cuts undertaken in 2006 in response to the speculative attacks on the forint as a consequence of a policy mismatch. In turn, the rather disappointing growth performance in Macedonia was at least brought about in part by over-restrictive fiscal policy.

Figure 13



Source: wiw Database incorporating national and Eurostat statistics.

The economic recession in most CESEE countries (except Albania, Kazakhstan and Poland) in the wake of the global crisis could have provided a reason for counter-cyclical fiscal policy. However, in some CESEE countries, the fiscal prudence of previous years appears to have done little to secure the governments' access to capital markets during the crisis. In fact, in the countries where the recession proved to be particularly severe (such as Latvia and Ukraine, whose GDP fell between 15-18% in 2009) and where the need for an active fiscal policy was painfully obvious, governments were hardly able to borrow on the capital markets, at least during the initial stages of the crisis – despite their very low public debt to GDP ratios (9% in Latvia and 12% in Ukraine at the end of 2007). Ironically and in sharp contrast to previous IMF policy, it was the IMF and its funds within the framework of the agreed 'stand-by' loan (initially with the purpose of facilitating the repayment of external debts) that became an important source of budget deficit financing in Ukraine. Similarly, in Latvia and Romania, the IMF and EU rescue packages were to a large extent channelled into covering budget deficits.

In many other CESEE countries, the governments did not face borrowing constraints of this kind. In the ultimate analysis, the countries that had been running fiscal surpluses prior to the crisis (Bulgaria, Russia, Montenegro and Estonia) could in theory resort to funds they had accumulated. By way of contrast, Estonia and the two other Baltic states, for example, undertook radical budget cuts. In Bulgaria, fiscal restraint was complemented by an ill-conceived re-shuffling of budget expenditures, which worked pro- and not counter-cyclically.

All in all, large-scale fiscal stimulation packages in response to the crisis were put in place in only a few CESEE countries – notably Poland, Russia, Kazakhstan and Turkey. In both latter countries public investments in infrastructure (and tax cuts in Turkey) helped mitigate the depth of the recession, although in Russia a large part of the sizeable fiscal stimulus was either consumed or squandered. In other countries, the measures implemented were generally more limited. In Poland, private consumption was boosted by an increase in pensions, and in Kazakhstan by hikes in civil servants' wages. In the Czech Republic, public consumption actually went up counter to the declared policy, while Slovakia – similar to Germany, for example – launched a car-scrappage scheme (though with only limited success). Slovenia pursued active labour market policy by partially subsidizing full-time work and partially reimbursing wages. In Macedonia, thanks to the expansionary fiscal policy, economic recession has been almost averted, while in Montenegro the fiscal spending that drew down accumulated reserves succeeded in restoring faith in the banking system and rescued the ailing aluminium industry.

As exemplified by Figure 13, in 2009 nearly all CESEE countries, had much higher budget deficits than the year before. The only exception was Estonia, where fiscal austerity was followed by efforts to comply with the Maastricht fiscal criteria on the eve of adopting the euro (set for the beginning of 2011). Given the generally limited scale of the anti-crisis measures adopted in most CESEE countries, the surge in their budget deficits reflected primarily the recession-induced shortfalls in tax revenues rather than greater budget expenditures. From the sustainability point of view, this is fairly good news: economic recovery – once in full swing – should lead to a recovery in government revenues and *ceteris paribus* to a contraction in budget deficits.

However, the recent problems faced by Greece as it tried to (re-)finance its public debt and the resultant crisis centred on the euro cast new light on the fiscal situation in the CESEE countries – and almost everywhere else in Europe.<sup>36</sup> Financing budget deficits of the scale to be observed in those countries under the current (post-Greek crisis) conditions is becoming more costly (if indeed at all possible), thus raising the issue of budget deficits sustainability. Meanwhile, neither the real growth performance of most CESEE countries nor their inflation rates appear to be high enough to generate a sufficient increase in nominal tax revenues that would enable them to 'grow out' of their budget problems or 'inflate them away'. Currently, an ongoing and relatively strong economic recovery is to be observed in only a few countries (Kazakhstan, Poland, Russia, Slovakia, Turkey and Ukraine), most of which (except Ukraine) are not the most 'problematic' cases from the fiscal point of view. In turn, in the majority of CESEE countries, growth remains anaemic, while the Baltic states, Bulgaria, Romania, Croatia and some other South-East European countries are still in recession.

Against this backdrop, it is hardly surprising that nearly all the NMS (except Estonia) and Croatia have announced short-term measures to reduce their budget deficits in 2010-2011. In some countries (the Czech Republic, Slovakia and Romania), these plans are being drawn up by the newly established right-of-centre coalition governments. In Bosnia and Herzegovina, Hungary,

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<sup>36</sup> For more discussion, see Special Topic by K. Laski and L. Podkaminer 'Long-term growth prospects in Central and Eastern Europe hinge on changes in the basic paradigms of EU economic policy-making'.

Latvia, Romania and Ukraine, the pressure to reduce budget deficits is being exerted by the IMF or the EU, which have provided 'stand-by' loan packages (although Bosnia and Herzegovina and Ukraine currently appear largely immune to IMF pressure). Finally, in Bulgaria, efforts at fiscal consolidation (after a 4% budget deficit in 2009) are to be viewed against the background of the country's ambitions to join the European Exchange Rate Mechanism (ERM2).<sup>37</sup>

The details of the planned austerity packages (wherever available) reveal that for the most part they are focused on expenditures. The measures envisaged or already adopted include a 'freeze' in public-sector wages and social benefits (Slovenia), cuts in public sector-wages (Lithuania, Romania) or public-sector employment (Croatia), or both (Hungary), lower government investments (Slovenia), cuts in pensions and other social benefits (Croatia, the Czech Republic and Lithuania) and raising the age of retirement (Croatia and Lithuania). In some instances, these measures also square well with the medium-term structural budget reforms. On the revenue side, the measures announced include higher indirect taxation (the Czech Republic, Hungary, Poland and Romania), hikes in compulsory social contributions (the Czech Republic) and measures against tax evasion (Romania).

In Hungary, the fiscal consolidation measures are probably the most justified, at least in the short term. To date, within the CESEE region, Hungary has been the country most visibly affected by the repercussions of the Greek crisis. This may not come as a surprise, given that of all the CESEE countries Hungary has the highest public debt to GDP ratio (78% at the end of 2009). None the less, it is well below the levels observed, for example, in Greece, Portugal, Spain, Italy, the United Kingdom or Belgium. On the other hand, the health of public finances in some CESEE countries hinges on the viability of the domestic banking sector. Furthermore, the recent introduction of state guarantees for private loans in Slovenia and the 'bail-out' packages enacted throughout the eurozone, to which both Slovenia and Slovakia are required to contribute as euro countries, are pushing up public debts in those countries.<sup>38</sup>

The currently observed dependence of the CESEE government budget deficits on borrowing and the related concerns over the terms of the loans (spreads) leaves them little choice but to pursue fiscal consolidation. This undermines consumer demand which is already weak and thus jeopardizes economic recovery. At least in those CESEE countries where confidence by the public in the domestic currency is relatively strong and the degree of euroization or dollarization (such as the Czech Republic and Poland – even if they are currently facing no difficulties to borrow) is relatively low, it could be argued that at least partial monetization of budget deficits might be a better option. It would enable the countries to avoid painful fiscal consolidation or at least reduce the scale thereof without threatening price stability. Clearly, this would require a statutory revision of the currently independent status of their national banks.

In the medium and long term, however, the sustainability of public finances might call for profound structural reforms, especially in the health sector and pension schemes. Such reforms are on the

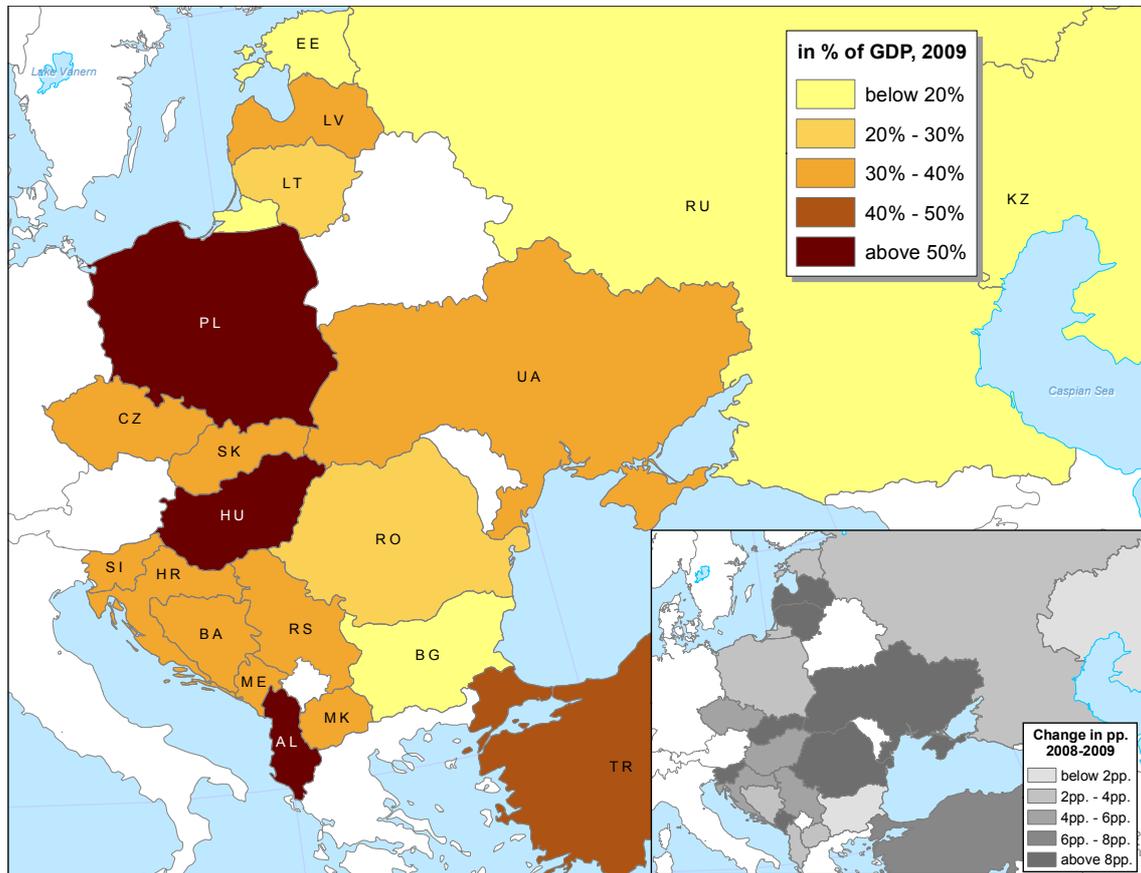
<sup>37</sup> However, Bulgaria's accession to ERM2 initially planned for the beginning of 2011 has been postponed.

<sup>38</sup> As of end-June, Slovakia is still rejecting to contribute to the 'special purpose' euro fund.

agenda, for example, in the Czech Republic, Hungary, Slovakia, Romania and Ukraine, while other countries, such as Croatia and Serbia, are planning to downsize their public administrations.

Figure 14

**Public debt, 2009**

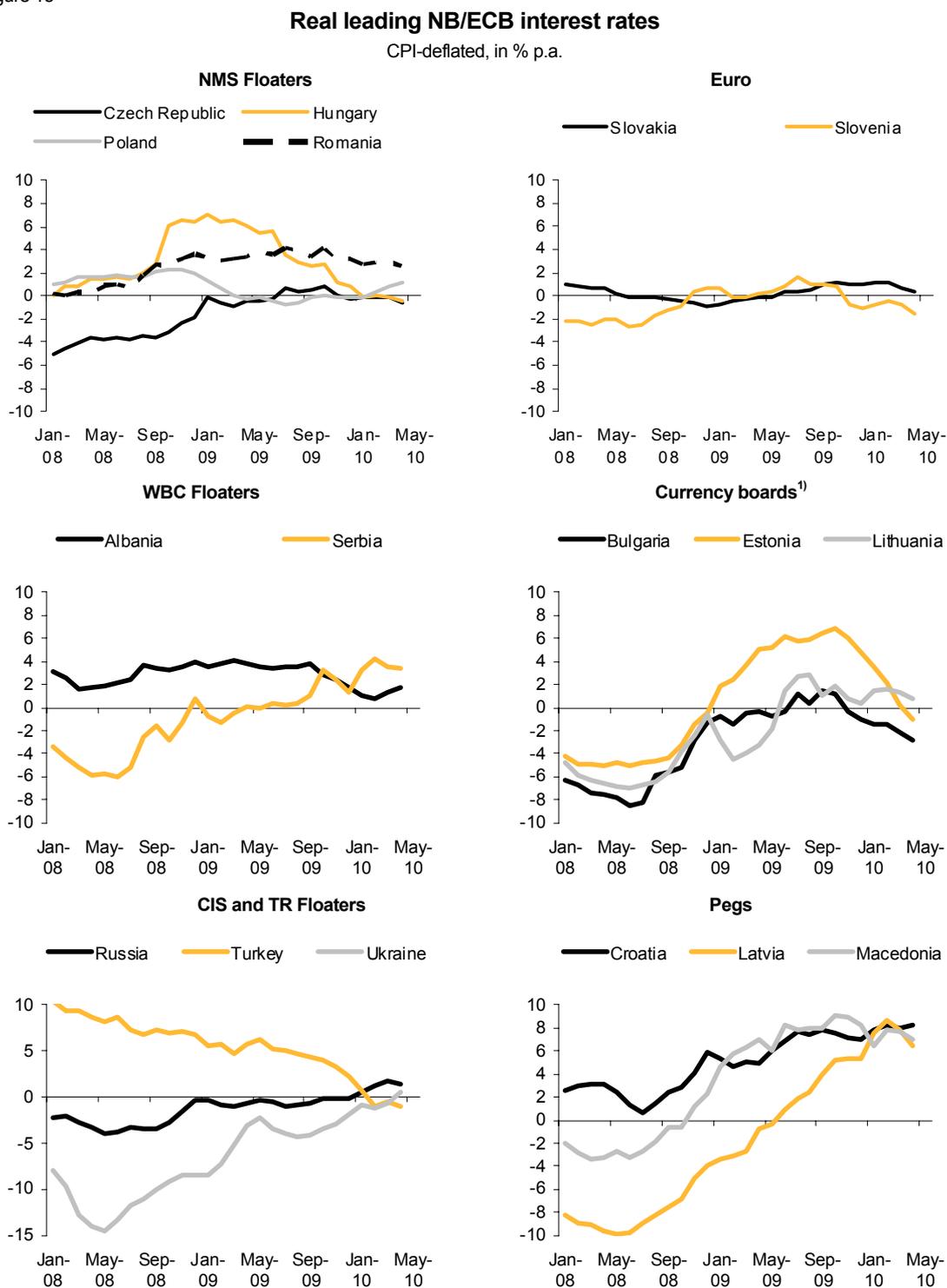


Source: wiiw Database incorporating national & Eurostat statistics

**6. Monetary sector: Real interest rates are no longer rising, yet in some cases they remain prohibitively high**

The 'credit crunch' which followed on the banks' restricted access to external financing and the sharp deterioration in overall business confidence after September 2008 was one of the main reasons for the economic downturn in the CESEE countries. Simultaneously, mainly on account of disinflation, real interest rates have been generally on the rise – see Figure 15. The outliers from this general pattern, however, are Turkey and Poland: in both countries, real interest rates have declined. In Turkey, the central bank has been lowering its policy rate in order to discourage short-term capital inflows and excessive appreciation. In Poland, evidence suggests that businesses are able to finance their investments out of profits and thus hardly need to take out new loans.

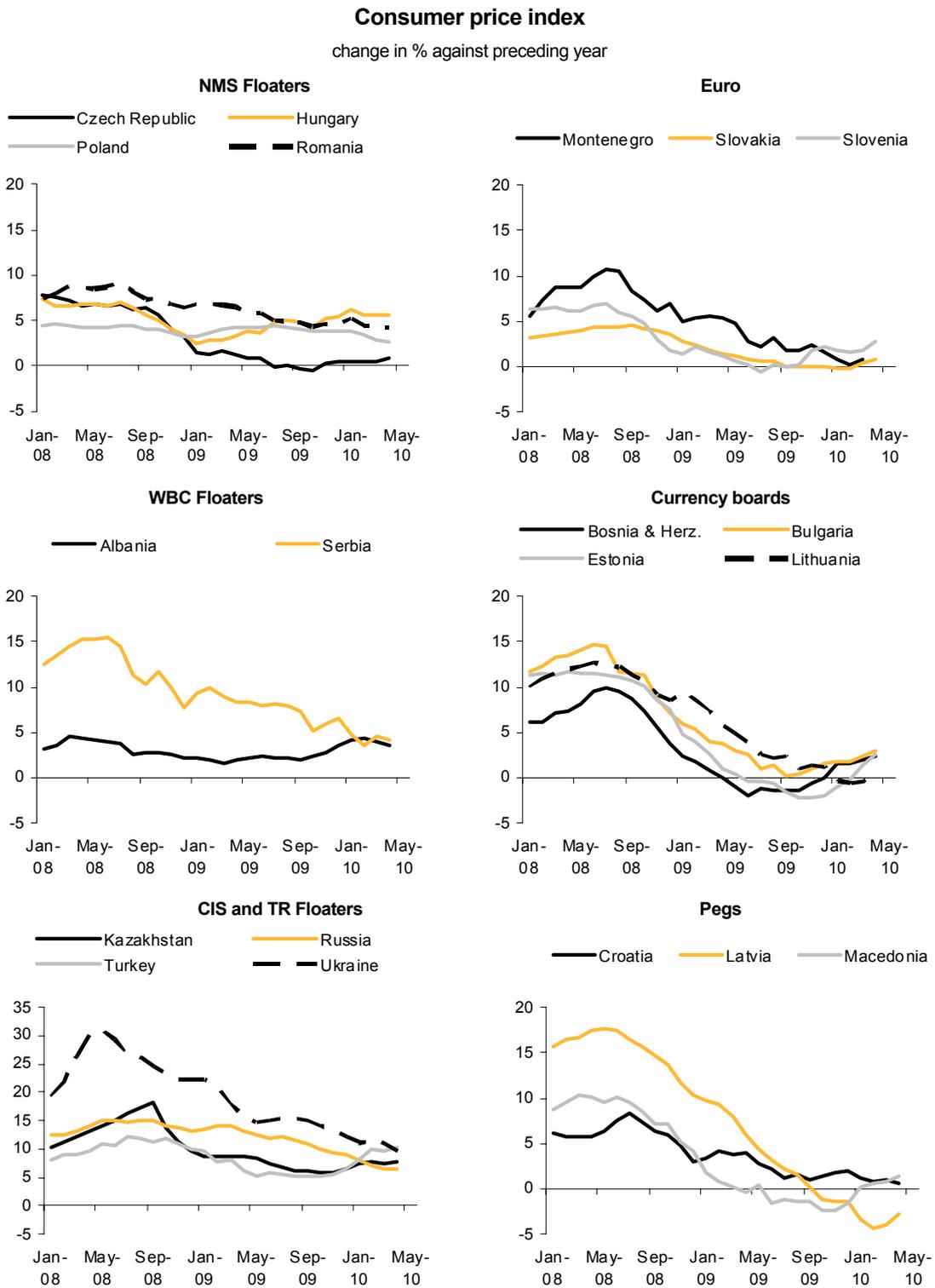
Figure 15



1) For Estonia: 1-month interbank lending rate (Talibor); for Lithuania: 1-month interbank lending rate (Vilibor); for Bulgaria: average interbank LEONIA rate of previous month.

Source: wiw Monthly Database incorporating national and Eurostat statistics.

Figure 16



Source: wiiw Monthly Database incorporating national and Eurostat statistics.

To some extent, the upward correction in real interest rates was sorely needed – especially in those cases where they started from strongly negative territory. For instance, in the Baltic states, Bulgaria, Ukraine and Serbia, real interest rates prior to the crisis had been markedly negative, generating unhealthy credit booms and, inter alia, housing market bubbles. By spring 2010, they had generally somewhat and re-entered negative territory, while they are currently low or close to zero in the majority of CESEE countries. However, in Croatia, Macedonia and Latvia, they appear to persist at a stubbornly high level: 6-8 p.a. in real terms. In Russia and Ukraine, real interest rates on bank loans are similarly high – and much higher than the relatively low policy rates set by the national banks presented in Figure 15.

In Russia and Ukraine, the high real interest rates stem, at least in part, from the legacy of high inflation in the past and the nature of the monetary response to the current economic crisis. While the ECB and the US Federal Reserve, for example, (but also the Czech and the Turkish national banks) responded to the weakening of domestic demand by lowering the policy interest rate, the national banks of Russia and Ukraine (as well as Hungary, Romania and Kazakhstan) initially tightened their monetary policy in an attempt to offset the sharp capital outflows (no capital controls were imposed). Subsequently, even as domestic demand was plunging in the wake of the crisis, those banks were reluctant to ease their stance because of the strong (and in some cases increased) inflationary pressures – see Figure 16.

In Russia, Ukraine and Kazakhstan, which were forced to abandon their exchange rate pegs in the early days of the crisis, currency depreciation and the related increases in the price of imported goods slowed down the pace of disinflation. A similar development was to be observed in Turkey which pursues a flexible exchange rate regime. However, in Hungary and Poland, whose currencies also depreciated rather sharply, the pick-up in inflation was marginal and was mostly the result of other factors such as hikes in administrative prices and indirect taxes (viz. the VAT hike in Hungary in July 2009). By way of contrast, in most other CESEE countries – especially those with fixed exchange rate regimes – inflation generally dropped, whereby Macedonia, Estonia, Latvia, and Bosnia and Herzegovina even recorded deflation over vast stretches of 2009.

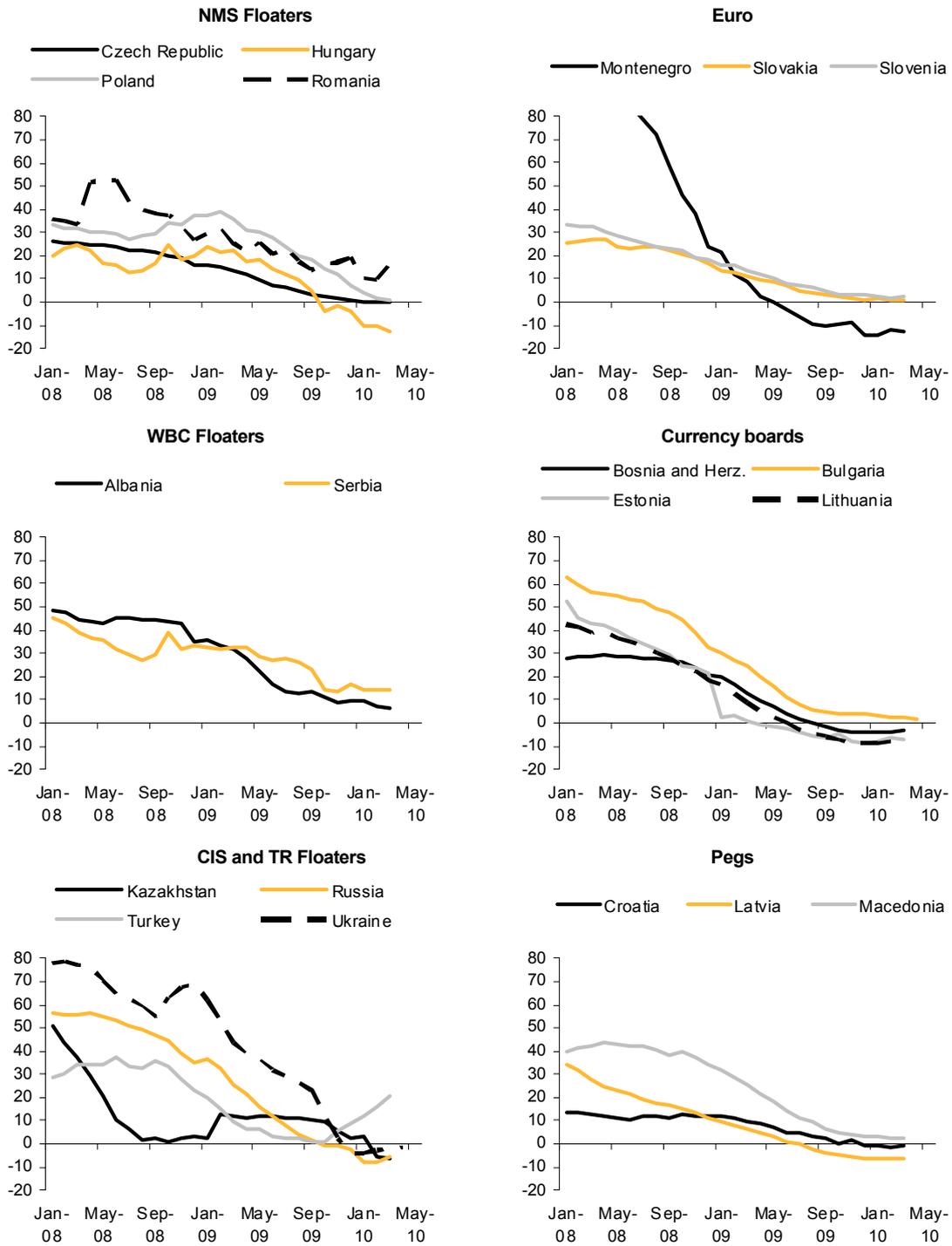
However, since the start of 2010, inflation rates in CESEE countries have generally started to converge. On the one hand, the traditionally low-inflation countries have recorded slightly higher inflation. The latter has been driven primarily by the administrative price hikes, whereas deflationary pressures have hardly subsided. In Albania, Macedonia, Bulgaria, Slovenia and (notably) Turkey, consumer prices have been picking up. As a result, by April 2010, Latvia was the only country still recording consumer price deflation on an annual basis. However, only in Turkey has the acceleration of inflation been pronounced; it can be attributed to a pick-up in consumer demand, although inflation is likely to fall in the second half of 2010.

On the other hand, in countries with traditionally high inflation (such as Russia, Ukraine and Serbia), it has been declining as the ‘cost-push’ effect of early devaluations has faded away, while domestic demand remained very weak. In response, the national banks of those countries cut their policy rates, although the real impact on the money supply has been limited given the weak transmission channel.

Figure 17

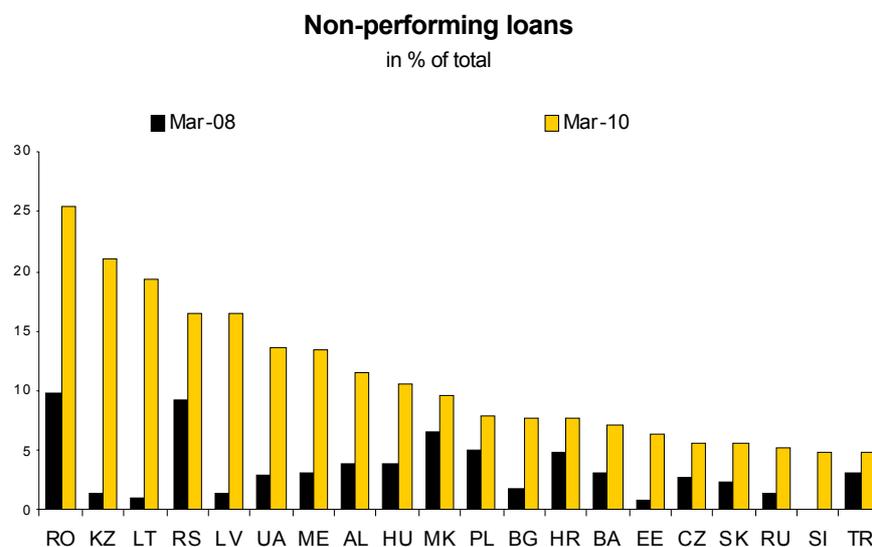
**Bank loans to non-financial private sector**

change in % against preceding year



Source: National Bank of respective country.

Figure 18



*Note:* Non-performing loans defined as credits more than 90 days overdue or classified as sum of substandard (more than 90 days overdue), doubtful (more than 180 day overdue) and loss.

EE: loans more than 60 days overdue. HU: loans for corporate sector only. UA: doubtful and loss credits. RU: referring to debt service, therefore not fully comparable with other countries.

Latest available data for ME, LT, HR as of December 2009, for PL and SI as of February 2010, for TR as of April 2010.

*Source:* National Bank of respective country.

Whether expansion of the monetary base translates into greater money supply depends on the banks' lending activity. So far, the developments in this respect have not been very encouraging. As demonstrated by Figure 17, the growth of bank loans to the non-financial private sector has been slowing down continuously almost everywhere. In spring 2010 in nearly all CESEE countries, the dynamics of the nominal stock of outstanding credit was either stagnant or (in the Baltic states, Hungary, Russia, Kazakhstan and Montenegro) even negative in year-on-year terms. Only Turkey, Romania and Serbia recorded impressive double-digit credit growth. In Turkey this represents a remarkable turnaround after the country came close to a stand-still in autumn 2009, while in Romania and Serbia credit expansion has been decelerating similar to other CESEE countries. Moreover, in Serbia the high credit growth rate is at least partly due to the statistical valuation effect; it is thus somewhat misleading. The 'second wave' of exchange rate depreciation in Serbia, which occurred in autumn 2009, inflated the value of euro-denominated and euro-indexed loans (76% of total loans at the end of 2009) expressed in national currency terms.<sup>39</sup> By the same token in Ukraine, where US dollar-denominated loans account for 54% of total loans and where the currency depreciated as well, the only marginal statistically reported decline of credit understates the true extent of the credit crunch. In addition, the persistently high inflation has to be taken into account in Ukraine, which means that in real terms the credit contraction was even more pronounced. Another reason why the statistics on credit growth may be a poor indicator of de facto credit availability is that

<sup>39</sup> The high share of foreign-currency-denominated loans in many CESEE countries (typically US dollar in the CIS countries and euro in the Baltic states, Hungary and South-East Europe) is the legacy of lower interest rates and the implicit (*ex post* irrational) belief in exchange rate stability.

absence of change in the volume of credit, for example, implies that borrowers are only able to re-finance their debt principal; if they were able to re-finance the interest, it would require an increase in the outstanding credit stock – which obviously has little to do with real credit expansion.

Generally, the freeze on lending activities is due to the reluctance of potential borrowers to accept tough loan terms (high interest rates, high collateral requirements, etc.) which themselves reflect banks' perceptions of the high risks involved. The latter should not come as a surprise against a backdrop of weak economic growth, uncertainties and ever-mounting numbers of bad loans – see Figure 18. In March 2010, the share of non-performing loans had reached double digits in Albania, Montenegro, Ukraine, Latvia, Serbia, Lithuania and Kazakhstan and even more so in Romania, where they made up 25.5% of total loans.<sup>40</sup> Simultaneously, the pressure to restructure bad loans has been generally strong; it has been greatly helped by the legislative bans on evicting the non-performers who have taken out mortgages.

## **7. External balances: improved current accounts slow down the increase in external indebtedness**

The divergent patterns of growth among the CESEE countries prior to the crisis gave rise to widely different developments in terms of their external balances. In Central European NMS such as the Czech Republic, Slovakia, Poland and Hungary which succeeded in developing strong export sectors, economic growth had been reasonably balanced, while trade and current account deficits had been generally on the decline. Some of them (such as the Czech Republic) even recorded rising trade surpluses. In contrast, in the Baltic states, large parts of South-East Europe and (increasingly) Ukraine, economic growth had been primarily driven by booming domestic demand, which typically led to imports outstripping exports and a widening of trade and current account deficits. Those deficits were only partially covered by the inflows of FDI and to a large extent by external borrowing. In fact, it was domestic credit expansion – driven not least by the high, and in some cases increasing, share of foreign-owned banks which enjoyed easy access to funds from their parent banks prior to the crisis – which was the primary source of the booming domestic demand, especially the demand for consumer durables and housing. External borrowing was overwhelmingly accounted for by the private sector (corporations and banks), while public borrowing was relatively modest, given the fairly restrictive fiscal stance in most CESEE countries. Public debts were perceived to pose a greater danger to financial stability than borrowing by the private sector; they were thus watched more closely.

The global liquidity squeeze – particularly in the aftermath of the collapse of Lehman Brothers in September 2008 – and the accompanying sharp rise in the degree of risk aversion among international financial investors compounded the problems associated with re-financing the external debts (let alone new borrowing) of many CESEE countries. However, in a number of countries, the servicing of external debts was facilitated by stabilization loans provided either by the IMF (Bosnia and Herzegovina, Serbia and Ukraine) or jointly by the IMF and the EU (Hungary, Latvia and Romania). The active role of the IMF in providing stabilization packages to the region is also to be

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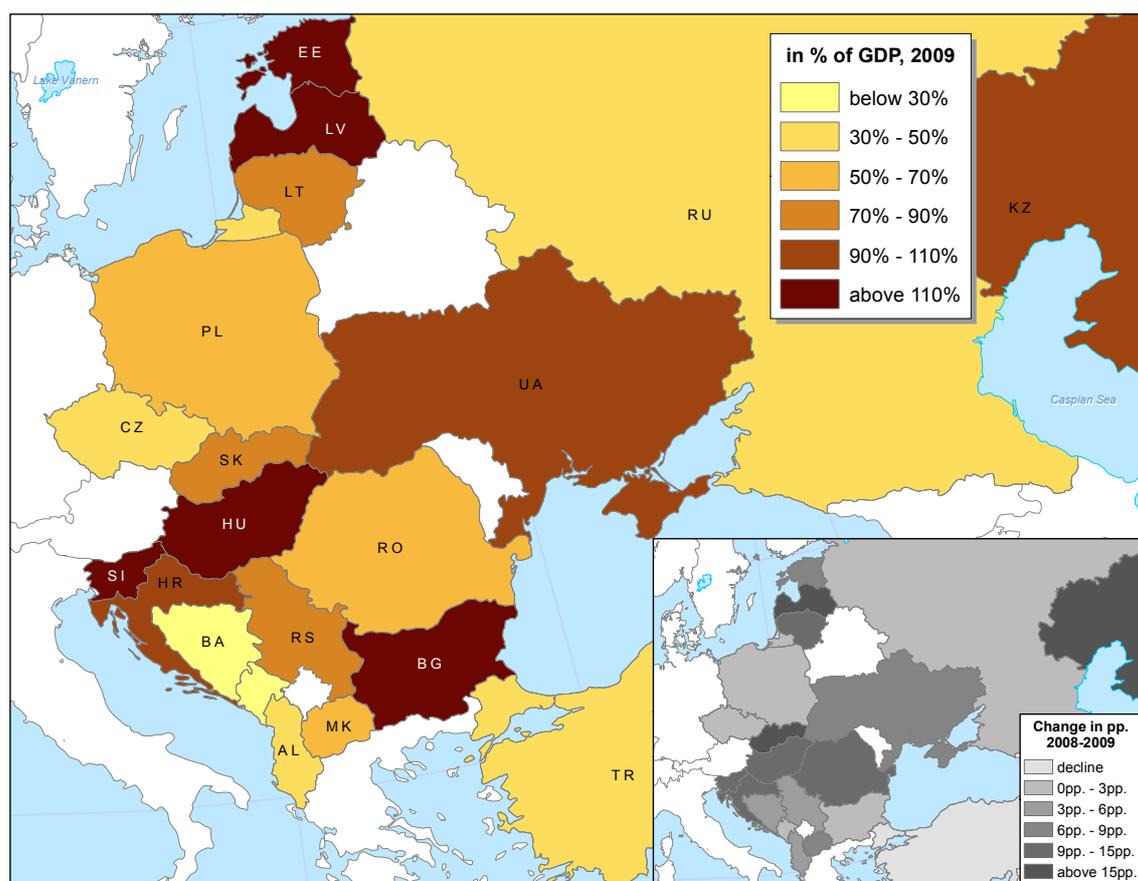
<sup>40</sup> It should be kept in mind, however, that in Romania and Serbia, non-performing loans started rising from an already high base (10-11% in September 2008).

seen in conjunction with the so-called ‘Vienna Initiative’, pursuant to which foreign banks operating in the CESEE countries were committed to not withdrawing from the region. On the contrary, in a number of countries, they re-capitalized their subsidiaries, accounting for a bulk of FDI inflows into the region. (Of course, the FDI inflows into the CESEE banking sector were essentially channelled to cover bank losses and thus hardly helped to create *new* capacities in the non-banking sector in the recipient countries.)

Thanks to the relatively high roll-over ratios in the private sector and the sharp increase in public borrowing (especially from the IMF and the EU), not only did the overall external debt stocks in most CESEE countries not fall, but they actually even increased somewhat in euro terms during 2009 (except in Estonia, Latvia and Russia). The increase was particularly strong as a share of GDP, all the more so given the economic recession observed almost everywhere in the region and the currency depreciations (in Poland, Czech Republic, Hungary, Romania and particularly Ukraine), which squeezed the value of the respective countries’ GDPs in euro (dollar) terms – see Figure 19. Turkey was the only country whose gross external debt as a share of GDP declined in 2009.

Figure 19

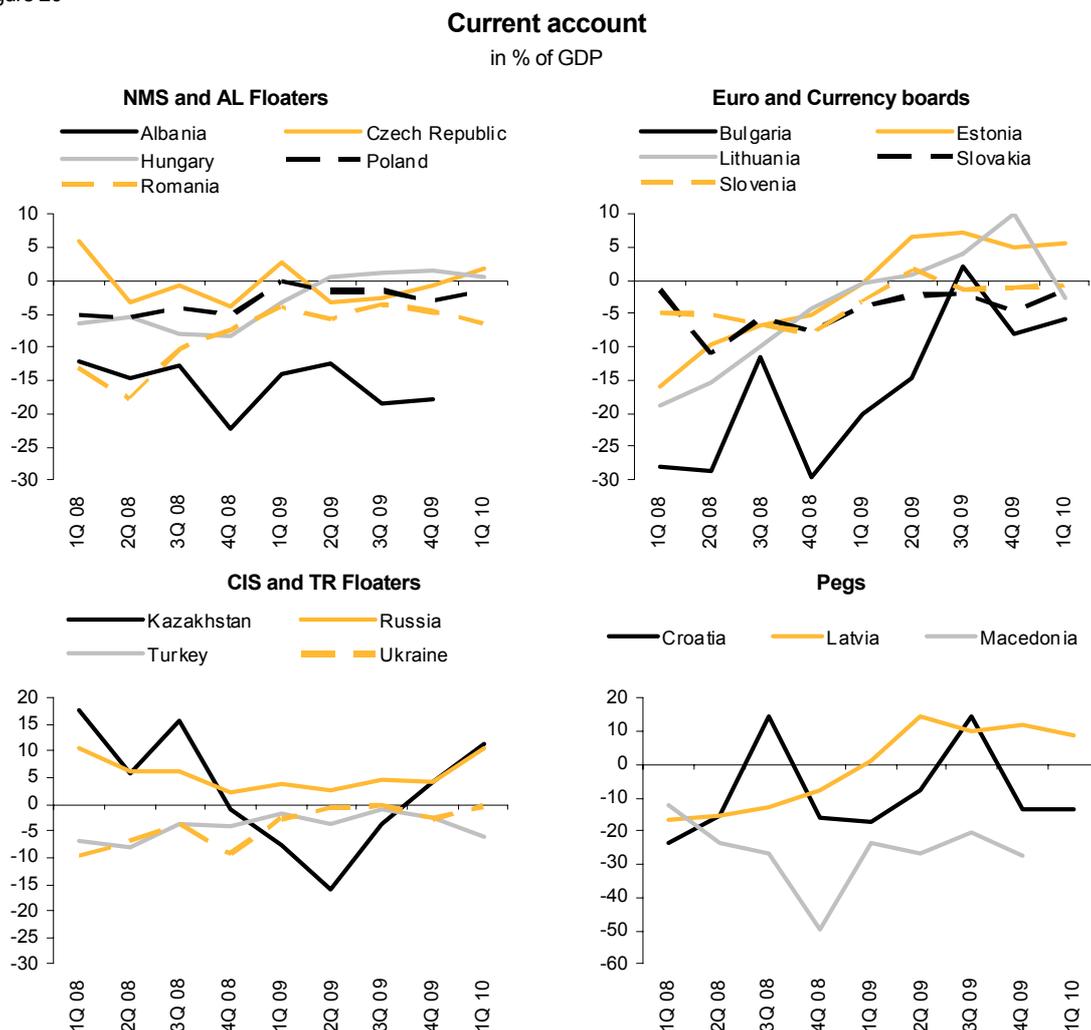
**Gross external debt, 2009**



Source: wiw Database incorporating national & Eurostat statistics

The increase in the level of external debt should not come as a surprise given the fact that most CESEE countries are still recording current account deficits, albeit on a smaller scale than prior to the crisis. In most CESEE countries, exports have been growing ahead of imports that have been constrained by depressed domestic demand (and are still falling in a few countries such as Croatia and Serbia). As a result, net exports have been on the rise, assisted in a number of cases by the above described recent competitiveness gains. Furthermore, lower FDI-related profits, which are recorded as outflows in the income balance of the balance-of-payments, have also contributed to improving current accounts.

Figure 20

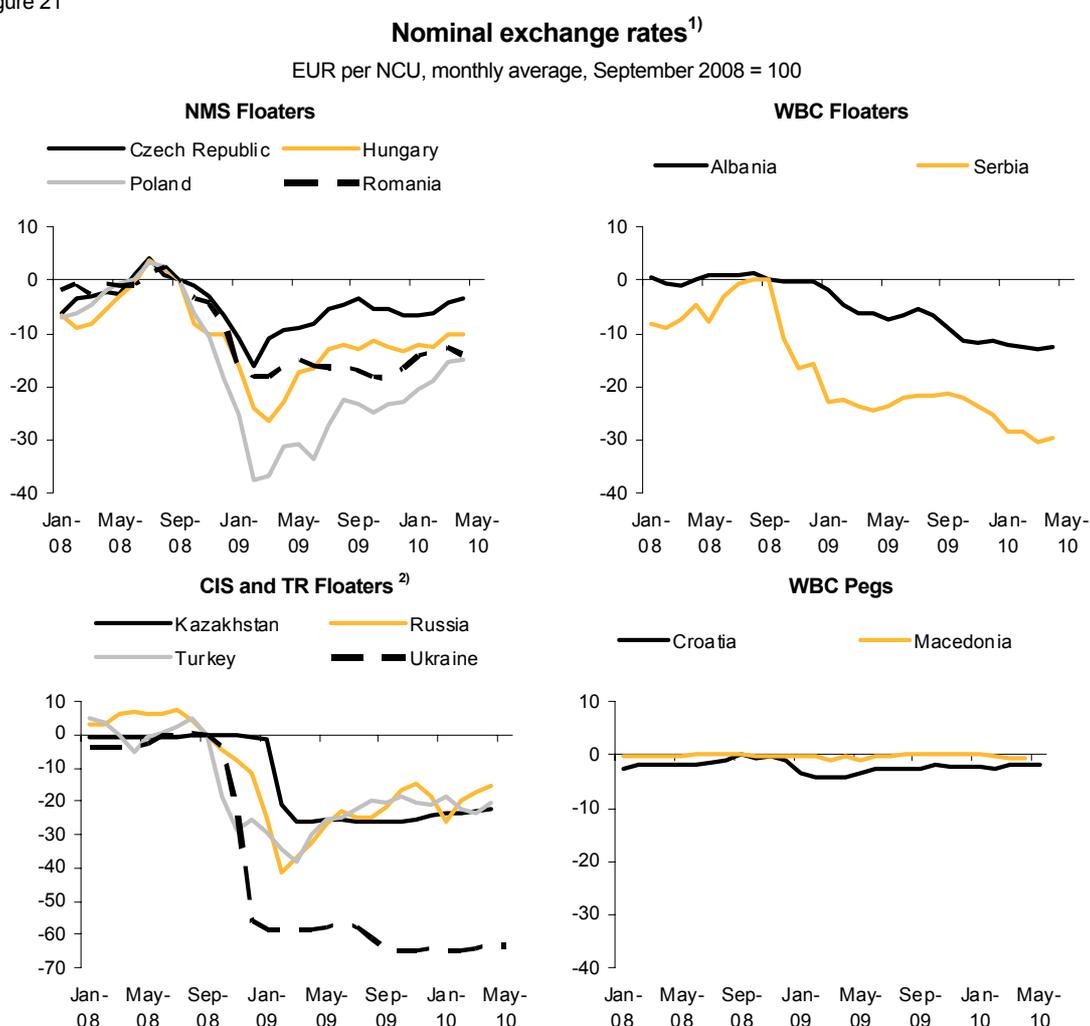


Source: wiiw Database incorporating national and Eurostat statistics.

Figure 20 suggests that the improvement in external balances was particularly marked in the Baltic states (where they turned from double-digit deficits to solid surpluses), as well as in Hungary and Ukraine (where they are now close to balance). This is due to the pronounced GDP recession, aided in the case of Ukraine by the strong currency depreciation. The current accounts of other NMS have

improved too (especially in Bulgaria and Romania), but generally less so than in the Baltic states and Ukraine; they remain firmly in negative territory. In the Central European NMS, adjustment in external balances was less of an issue since, even before the crisis, their growth path had been accompanied by current account deficits that were not excessively large and already declining. However, the persistently high deficits in Romania and Bulgaria (and some other Balkan countries) may not be sustainable. In these countries, a ‘Baltic’ or ‘Ukrainian’ scenario (a sharp cut in external funding followed by painful downward adjustments in exchange rates and/or wages) cannot be entirely ruled out, although the planned budget consolidation – first and foremost in Romania – should dampen import demand and improve external sustainability. Finally, the improvement in the current accounts in energy-exporting Russia and Kazakhstan is a reflection of the higher energy prices on world markets. Russia is the only CESEE country that has consistently run current account surpluses (both before and during the crisis); it has thus remained a net creditor to the rest of the world.

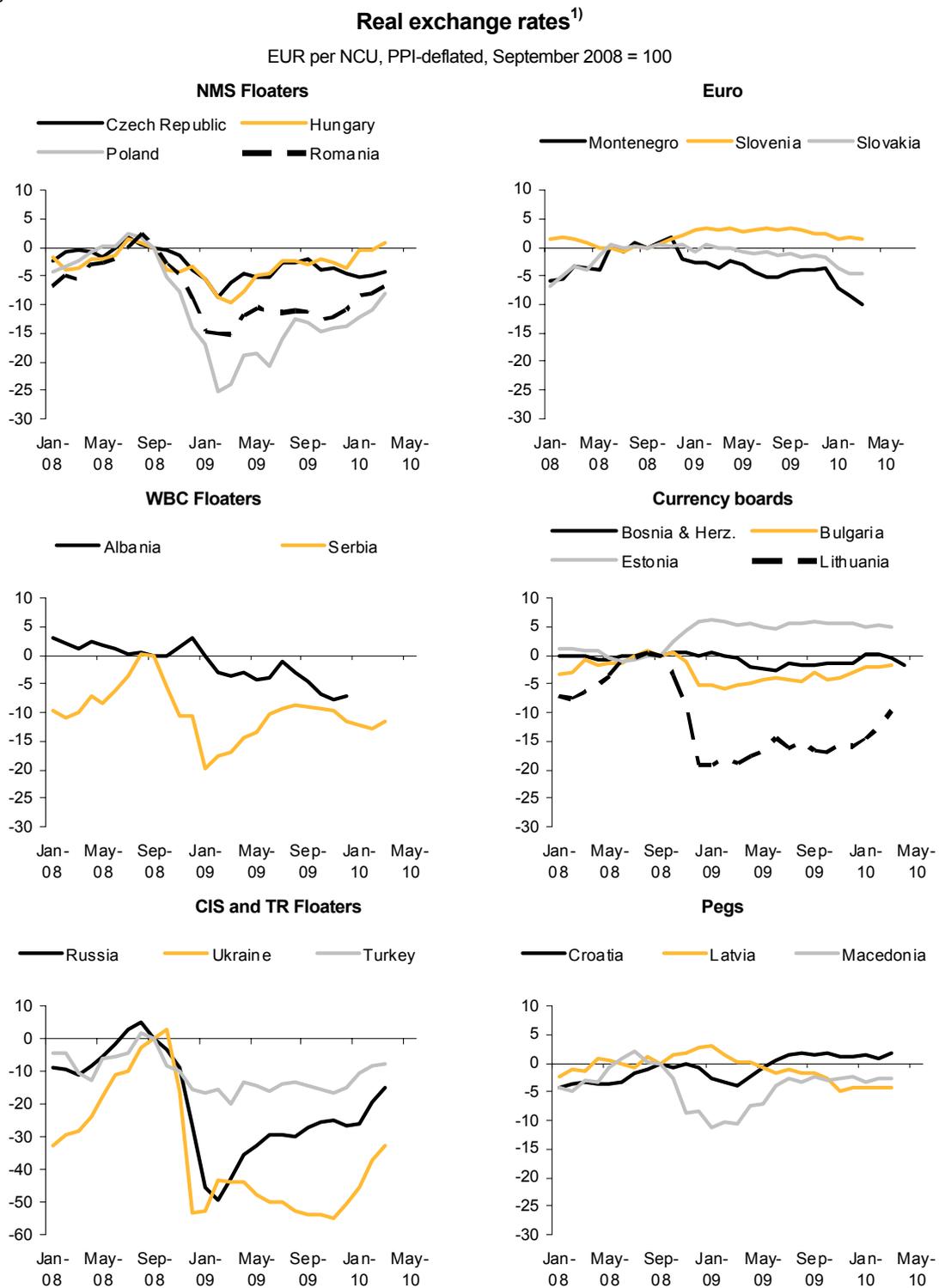
Figure 21



1) Values above 0 indicate appreciation relative to September 2008. – 2) CIS & TR Floaters: USD per NCU.

Source: wiiw Monthly Database incorporating national and Eurostat statistics.

Figure 22



1) Values above 0 indicate appreciation relative to September 2008.

Source: wiiw Monthly Database incorporating national and Eurostat statistics.

The recent Greek crisis is likely to dampen the CESEE countries' prospects of adopting the euro in the near future, as risk aversion is likely to increase both within the eurozone and within the CESEEs. The potential candidates for eurozone membership may now be afraid of completely losing their exchange rate and monetary policy autonomy, something that could prove instrumental in mitigating the external shocks. This is certainly true of those CESEE countries which had been rather sceptical about joining the eurozone from the very beginning: Poland and the Czech Republic (both on flexible exchange rates). In other CESEE countries (Latvia, Lithuania and Hungary), compliance with the Maastricht criteria set for the adoption of the euro has become more of a problem owing to the crisis, particularly when it comes to the size of the budget deficit.<sup>41</sup> Currently, Estonia is the only country right on track to introducing the euro as of January 2011, while Bulgaria is aiming to join the ERM2, two years of membership in which are a pre-requisite for adopting the euro. Given the macroeconomic adjustments that Bulgaria might well have to implement in the near future, the wisdom of that step appears questionable under the current circumstances.

Box 2

**Impact of exchange rate regime: a greater degree of flexibility helps in crisis**

The choice of exchange rate regime appears to have a considerable impact on the path of recovery in the event of a recession. A flexible exchange rate regime permits rapid depreciation of both the nominal and (subsequently) the real exchange rate. This may bring about a swift improvement in international competitiveness. Countries with a fixed exchange rate regime have to undergo a slow and painful process of cutting wage bills almost invariably in association with reductions in employment. Of the 20 CESEE countries exactly half of them maintain a flexible exchange rate regime. The other half have done one of three things: they have adopted the euro (Montenegro, Slovakia and Slovenia), established a currency board vis-à-vis the euro (Bosnia and Herzegovina, Bulgaria, Estonia and Lithuania) or pegged their currency to the euro within a very narrow band (Croatia, Latvia and Macedonia). It is interesting to note that the three countries that had pegged their exchange rates before the crisis (Kazakhstan, Russia and Ukraine), dropped the peg in the wake of the crisis and devalued substantially. It can be shown that those countries that allowed their currencies to depreciate during the crisis enjoy better prospects for growth in 2010 (see Figure 23), the sole exception being Romania, whereas most of the countries with a fixed exchange rate regime are expected to experience further decline or stagnation in 2010.

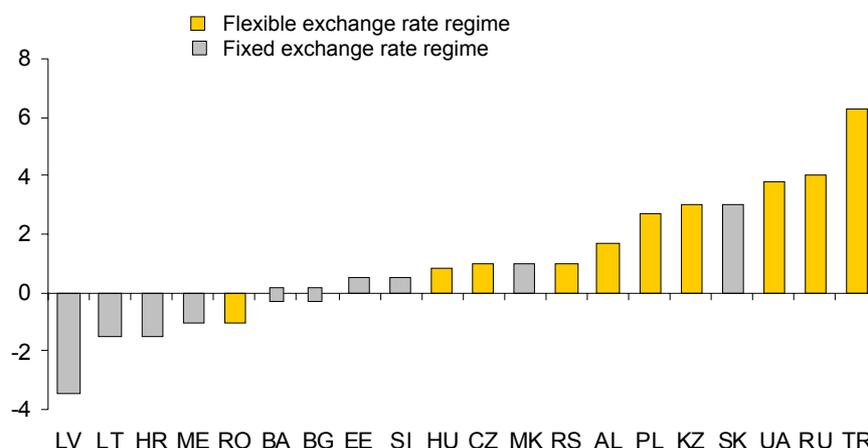
A simple OLS regression supports statistically the positive relationship between a flexible exchange rate regime and growth for a cross-section of the 20 countries analysed. However, the result is not fully robust. In an extended regression, after the inclusion of the 2009 growth rate and the 2008 share of industry in gross value-added as control variables, the coefficient for a floating exchange rate regime only remains significant at the 10% significance level. Still, it can be said that for the sample of countries analysed, a flexible exchange rate regime adds approximately 1.6 percentage points of expected GDP growth in 2010. The fit of this very simple model is surprisingly good. About 51% of the variance in the data is explained by the model.

<sup>41</sup> Hungary currently does not comply with the Maastricht criteria on public debt and inflation either.

Figure 23

**Post-crisis growth and the exchange rate regime**

GDP growth forecast 2010



Source: wiiw.

Box 3

**FDI expected to recover modestly in 2010<sup>42</sup>**

After a year of stagnation in 2008, FDI inflows to the CESEE countries dropped by half in 2009. The decline of FDI inflows in the NMS was more severe than in the SEE and CIS countries. Launching a new take-off in FDI in 2010 and afterwards is contingent upon economic growth. The three forms of FDI - equity, reinvested earnings and other capital that mainly includes intra-company loans - will behave differently. Under conditions of slack demand, expansion of capacities will not be necessary to a large extent. As to reinvested earnings, this will depend on the profit expectations from the previous year and the manner in which the investors plan to use their profits. Decisions of that kind are usually taken in the second quarter of the year; as yet they do not feature in the balance of payments. The expectations are that profits will be fairly low, but companies, in particular banks, will invest in strengthening their subsidiaries' capital base. As for other investments, some loans that subsidiaries provided to their parent companies may be returned.

Although first quarter data can be a misleading indicator of annual trends, it is still worth pointing out that in the first three months of 2010, FDI inflows into Bulgaria turned negative and declined sharply in Romania compared to the first quarter of 2009. At the same time, inflows recovered in the Czech Republic and Poland. Expectations concerning the Western Balkans are on the whole negative. As to the CIS, a resumption of FDI activities in Russia is most likely as the economy is recovering strongly.

<sup>42</sup> This section was drafted by Gábor Hunya. For details, see: Gábor Hunya (concept and analysis) and Monika Schwarzappel (database and layout), wiiw Database on Foreign Direct Investment in Central, East and Southeast Europe, 2010: FDI in the CEECs Hit Hard by the Global Crisis, wiiw, Vienna, May 2010

Table 2

**FDI inflows, first quarter 2009 and 2010**

EUR mn

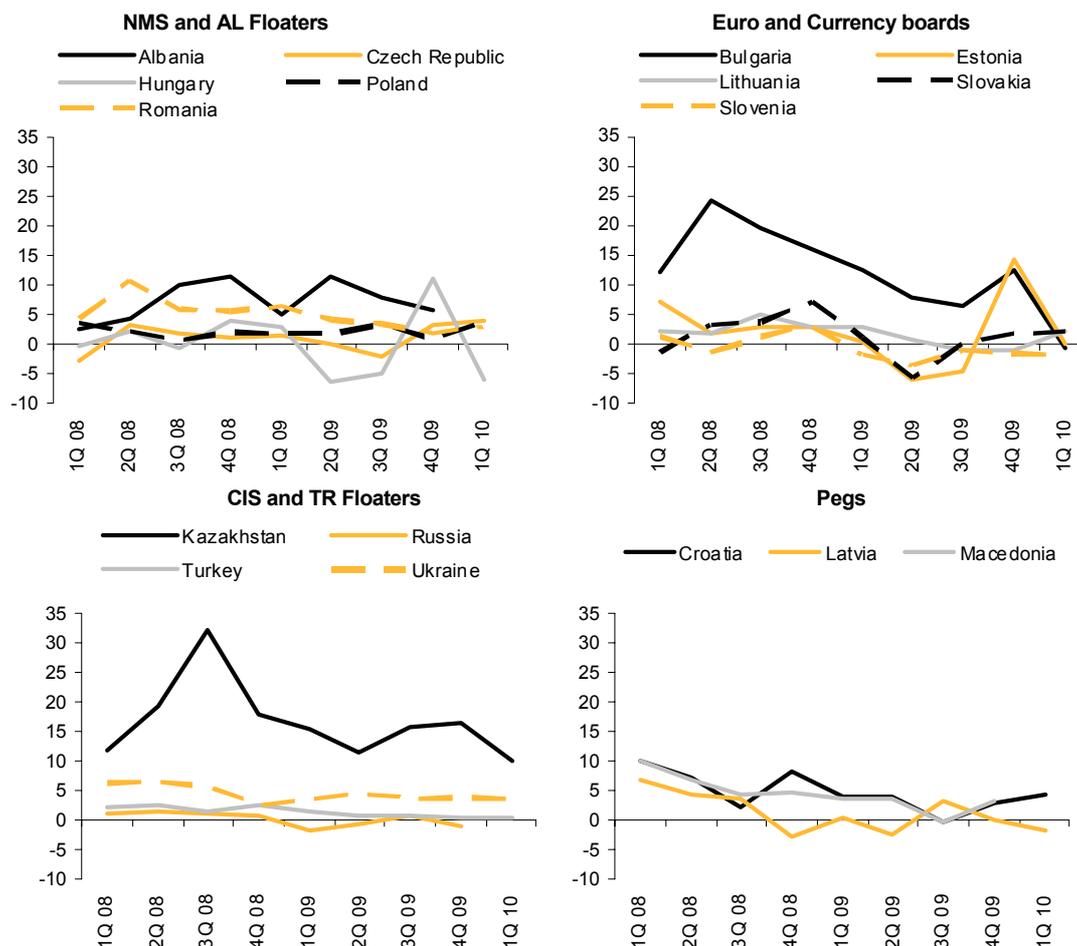
	<u>1Q 2009</u>	<u>1Q 2010</u>
Bulgaria	926	-22
Czech Republic	814	2062
Poland	1536	3527
Romania	1475	754
Slovenia	-5	-17

Source: National banks of individual countries.

Figure 24

**FDI net**

in % of GDP



Source: National statistics, Eurostat.

On the whole, wiiw expects FDI inflows to increase in the CESEE region by 14% in 2010. Three countries may well enjoy a strong revival in terms of FDI – the Czech Republic, Poland and Russia. Furthermore, Hungary, Slovakia and Ukraine are also expected to contribute to the take-off. In most NMS, the upswing in foreign investment activity is expected to be powered by increases in export demand. However, inflows into other countries, including Romania, Bulgaria and especially the Western Balkans (-38%), may well be lower, mainly on account of a drop in domestic demand for goods and services provided by foreign subsidiaries.

## **8. Summary and outlook: fragile recovery driven first by exports and then by investments**

Adding up all the nuts and bolts (and screws) analysed in the sections above leads us to the aggregate GDP growth forecasts for each individual CESEE country as described in Table 3. If we take the simple average of the actual and forecast growth rates over the period 2007-2012 for the 20 CESEE economies analysed, the shape of the curve is close to that of a runaway rollercoaster approaching the end of the ride. Overheated real growth rates in excess of 7% in 2007 were followed by a severe cooling-down to some 3.5% in 2008 and a steep drop to no less than -6% in 2009. Drawing on the available data and information relating to the first few months of 2010, we expect a minor rebound in the order of 1% for the whole year. In a rather optimistic scenario, our average forecasts predict a pick-up of growth to about 2.5% in 2011 and approximately 3.5% in 2012.

The weighted averages for the forecast period 2010-2012 foresee a stepwise increase in growth up from 1.2% in 2010 through 2.7% to 3.3% for the NMS-10 in 2012 (Table 3), substantially higher growth rates of 5.6%, 4.3% and 3.9% for the EU candidate countries (notably on account of the considerable weight and good performance that Turkey represents in this group) and a sluggish triad of 0.8%, 1.8% and 3% for the potential EU candidate countries. In our selection of CIS countries, growth hovers around 4% for all three years with a slight tendency to increase. Analysing the forecasts on the basis of two indicators of international trade competitiveness - the level of industrial development and the exchange rate regime – and using simple averages once more, the following picture emerges. Compared to the less industrialised countries with fixed exchange rate regimes, the more industrialised economies with flexible exchange rates that were less overheated before the crisis and have since passed through a somewhat milder recession, fare better in our forecasts: by 2.5 percentage points in 2010, 1.5 percentage points in 2011 and about 1 percentage point in 2012, respectively.

The composition of the GDP growth forecast for 2010-2011 reflects those general trends (see Figure 25). We expect an improvement in net exports to be the main (if not sole) GDP growth driver in 2010 in the vast majority of countries. However, as indicated above, whether the countries will actually benefit from the international trade rebound depends on the flexibility of their exchange rate regimes, the size of their industrial base and their competitiveness in general. Some countries simply cannot export enough at competitive prices to avert further recession or stagnation in 2010. This holds particularly true for several countries in South-East Europe and the Baltic states. Russia, Poland and

Turkey are the three major exceptions to the net exports trend. They are the largest economies and thus depend less on foreign trade. In the forecast period, we expect them to generate growth mainly on their internal markets via household and government final consumption, as well as via gross capital formation. This does not necessarily mean that the three countries will not benefit from the international trade rebound. Although Russia, for instance, does not export more in real terms and thus displays a slightly negative net export contribution in the growth forecast for 2010, oil prices have improved the trade surplus and government revenues, while larger receipts from commodity exports are expected to fuel (via state revenues) domestic consumption and investment. Once again a large industrial base yields benefits.

Table 3

<b>Gross domestic product</b>						
real change in % against preceding year						
	<b>2007</b>	<b>2008</b>	<b>2009 <sup>1)</sup></b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
					<b>Forecast</b>	
Bulgaria	6.2	6.0	-5.0	0	2.5	3
Czech Republic	6.1	2.5	-4.2	1.0	2.5	3.5
Estonia	7.2	-3.6	-14.1	0.5	2.5	3.5
Hungary	1.0	0.6	-6.3	0.8	2.5	3
Latvia	10.0	-4.5	-18.0	-3.5	0.7	2
Lithuania	9.8	2.8	-15.0	-1.5	1.5	2.5
Poland	6.8	5.0	1.7	2.7	3.5	3.5
Romania	6.3	7.3	-7.1	-1	1.5	3
Slovakia	10.6	6.2	-4.7	3	4	4
Slovenia	6.8	3.5	-7.8	0.5	2	2.5
<i>NMS-10 <sup>2)</sup></i>	6.4	4.2	-3.6	1.2	2.7	3.3
<i>EU-15</i>	2.7	0.5	-4.3	0.9	1.6	.
<i>EU-27</i>	3.1	1.0	-4.2	0.9	1.7	.
Croatia	5.5	2.4	-5.8	-1.5	2	2.5
Macedonia	5.9	4.8	-0.7	1	2	3
Turkey	4.7	0.7	-4.7	6.3	4.5	4.0
<i>Candidate countries <sup>2)</sup></i>	4.8	0.9	-4.7	5.6	4.3	3.9
Albania	6.0	7.8	4.2	1.7	2.2	3
Bosnia and Herzegovina	6.2	5.7	-3.2	0	1	3
Montenegro	10.7	6.9	-5.3	-1	2	3
Serbia	6.9	5.5	-3.0	1	2	3
<i>Potential candidate countries <sup>2)</sup></i>	6.8	6.0	-1.9	0.8	1.8	3.0
Kazakhstan	8.7	3.3	1.2	3	5	4.5
Russia	8.1	5.6	-7.9	4.0	4.2	4.4
Ukraine	7.9	2.3	-15.1	3.8	4.5	6

1) Preliminary. - 2) wiiw estimate.

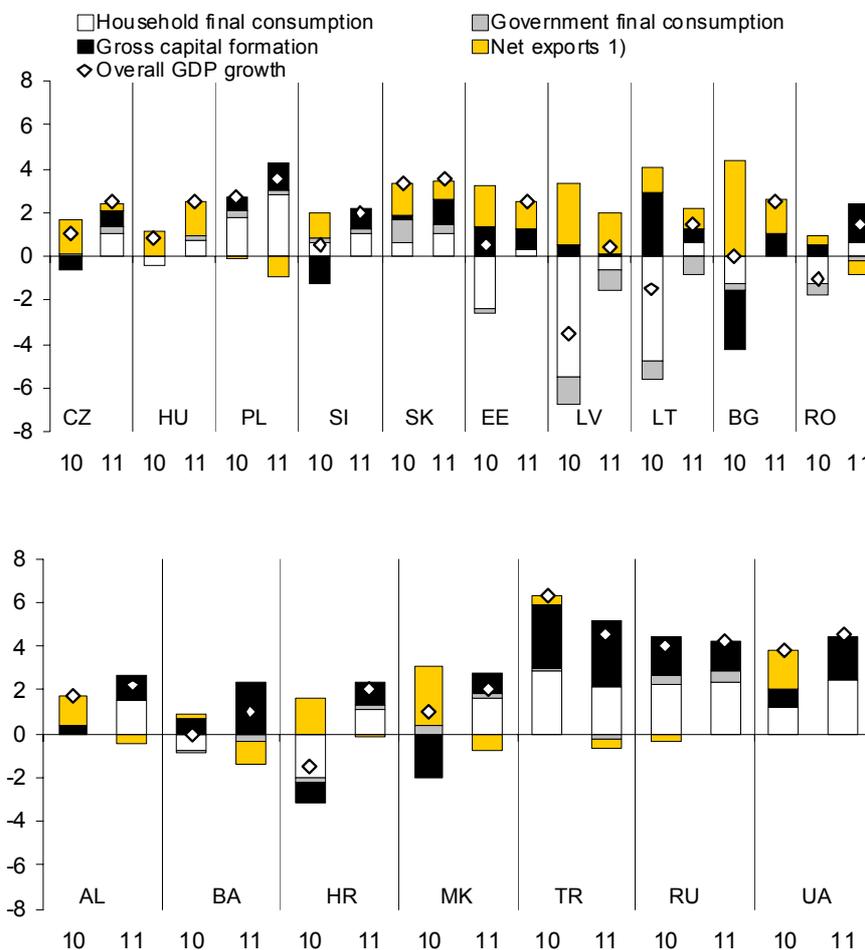
Source: wiiw Database incorporating national and Eurostat statistics. Forecasts by wiiw.

By 2011 we expect all the CESEE countries to overcome negative growth or avert a standstill. In most of the economies, long postponed investments will be finally made and household consumption will show signs of life after the crisis. By 2012 those figures should improve even more, if our rather optimistic assumptions regarding the international environment and fiscal consolidation hold. The downside risks are rooted in the unknown, but much feared negative effects of parallel austerity packages throughout the European Union - the main export market for the CESEE countries. If those effects prove worse than currently assumed, it would result in our countries of interest recording lower export growth in 2010 and a drop in investment and domestic consumption growth the year thereafter.

Figure 25

### Contributions to GDP growth 2010 and 2011

in percentage points, adds up to GDP growth rate



1) Balance of goods and NFS.

Source: wiiw Database incorporating national and Eurostat statistics; own calculations.

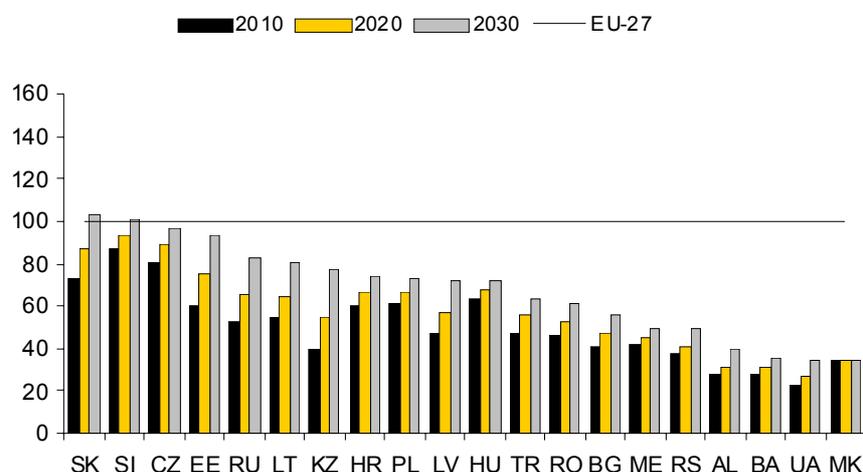
In any event, we expect slower growth after the crisis than before owing to a permanent change in financing conditions and a sustained need for deleveraging which will result in slower capital accumulation over the years ahead. Furthermore, as a consequence of the crisis, the CESEE labour markets will remain depressed over the medium term. This might induce a hysteresis effect with a display of permanently high unemployment rates attributable to the loss of skills acquired on the job. Post-crisis growth can be expected to be particularly low in those countries that experienced high growth rates fuelled by capital inflows during the pre-crisis period and dramatic employment cuts in the post-crisis period.

Figure 26

**GDP per capita in % of EU-27 average, at constant PPPs**

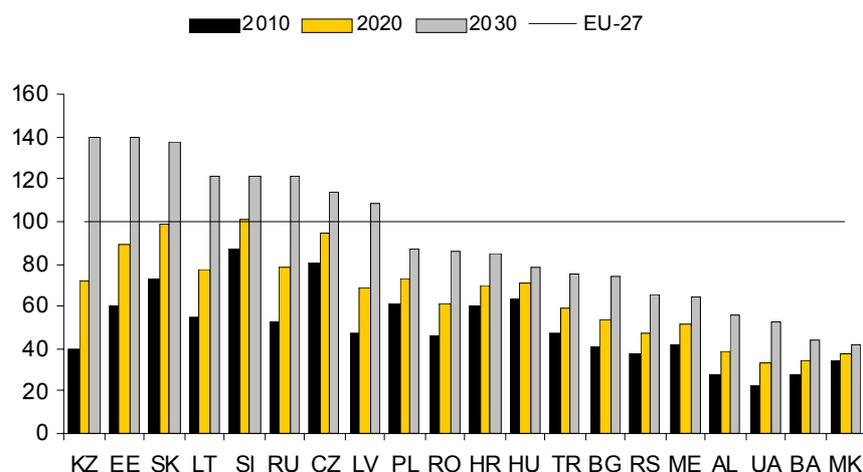
**Baseline Scenario**

Projection assuming a 50% of the average growth differential with respect to EU-27 compared to the period 2000-2008



**Optimistic Scenario**

Projection assuming the average growth differential with respect to EU-27 as the period 2000-2008



Source: wiw.

Slower growth rates will also have an impact on the pace of long-term convergence between the CESEE countries and the EU-15. In Figure 26 we present the outcome of two convergence scenarios for the period till 2030, in percentage terms of the average EU-27 GDP per capita at PPP. In the lower part of the diagram, we extrapolate growth from 2013 onwards, using the average pre-crisis (2000-2008) growth differential between each CESEE country and the EU-27 average. In the upper part, we extrapolate from the same year onwards using only half of the pre-crisis growth differential. The difference in both scenarios is substantial. In the former “optimistic” scenario, the average CESEE country could reach about 90% of the average EU-27 GDP per capita level by 2030. However, in the latter “baseline” scenario, the average CESEE country barely reaches 70% of the EU-27 level. Thus, the average difference between the two scenarios is more than 20 percentage points for 2030. This difference is much higher in those countries, where pre-crisis growth was aggressive and ended with bubble burst (viz. the Baltic states with about 40 percentage points less and Kazakhstan with more than 60 percentage points less); it is much lower in those countries where growth was already anaemic prior to the crisis (such as Macedonia or Hungary with only 7 percentage points less). While in the optimistic scenario Slovenia and Slovakia would reach the average EU-27 GDP per capita level as early as 2020, in the second scenario they would only surpass that level in 2030. In general, it can be said that under the assumptions of the baseline scenario (which we consider as were realistic) the average CESEE country will lose almost a decade in the process of catching up with the EU during to the crisis. To the extent that growth up until 2030 can be estimated at all, the two scenarios presented can be seen as an upper and a lower bound estimate with our conjecture that the  $\surd$  baseline scenario is somewhat more realistic.



*Anton Mihailov*

## **Bulgaria: In the trap of macroeconomic mismanagement**

The Bulgarian government has grossly mishandled the crisis thus prolonging and deepening the economic slump in the country. While most of Europe was turning the corner in the first quarter of 2010, Bulgaria's GDP plunged by 3.6% year-on-year, making it one of the worst performing economies on the continent in this period. Given the openness of Bulgaria's economy and its relatively healthy position before the crisis hit, the origins of this dismal outcome seem to be mostly of domestic nature.

The crisis triggered a drastic macroeconomic adjustment away from the previous pattern of growth which was led by domestic demand. For 2009 as a whole, domestic absorption contracted by 14.4% (against a GDP decline by 5.0%) and in the first quarter of the year, domestic absorption plunged by a further 8.8%. At the same time exports started to recover already in the last months of 2009 and this continued in 2010: in the first quarter, real exports of goods and services (national accounts definition) grew by 7.6% year-on-year.

While – given the large current account deficit – a switch towards more reliance on export-led growth was up to a point a needed macroeconomic correction, the disproportionate contraction in final domestic demand has to a great extent contributed to the bleak macroeconomic picture in the country. Thus despite the robust recovery in exports in the first quarter, the manufacturing industry remained in recession, with quarterly manufacturing sales dropping by 3% year-on-year. Construction was the worst affected sector with total construction output dropping by 26.7% in the first three months, after a 15.3% annual drop recorded in 2009.

There was a slight surge in consumer price inflation in the first quarter but it was largely due to rises in administrative prices. In turn, the rise in producer prices mostly reflects price movement in international markets. Overall, there do not seem to be major inflationary pressures. During the crisis, the rate of unemployment rose from the low of 5.8% (recorded in August 2008) to 10.3 (in February 2010). However, it is widely believed that the peak of unemployment has been reached and that situation in the labour market will start improving.

Final domestic demand (particularly fixed investment) was adversely affected by more difficult access to credit due to stringent screening by banks. Overall, credit activity generally remains stagnant but there has been no net withdrawal of funds by banks from the economy: the stock of credit to the non-government sector in March 2010 was 2.6% higher than a year earlier. Therefore more difficult access to credit can only explain part of the drop in domestic demand.

The continuing sharp contraction in domestic demand and, in particular, in private consumption (real retail sales dropped by 12.3% in the first quarter after a decline by 8.9% in 2009 as a whole) is all the more surprising given the fact that wage incomes never stopped to grow through the crisis: real average monthly wages in 2009 increased by some 9% and continued to grow at roughly the same rate in the first quarter of 2010. Consequently, at the end of March 2010, the stock of total household deposits was by 13.4% higher than a year earlier. Overall, the continuing decline in final domestic demand seems to be driven by an ongoing sharp drop in confidence by both consumers and investors which affects negatively their behaviour.

If one takes for granted that the currency board requires a fiscal balance (in a weaker formulation, this should hold over the cycle), the authorities have zero degree of freedom as regards the balance but do have room for manoeuvre as regards the composition of revenue and spending. A skilful restructuring of revenue and, especially, spending in times of crisis can in principle produce a robust countercyclical effect. However, it is in this territory that the government produced a series of blunders by introducing measures which were counterproductive as regards their declared fiscal goals, turned out to be procyclical (rather than countercyclical) and ultimately affected negatively the overall fiscal balance.

The fact is that since taking office in July 2009, the government has never come up with a coherent strategy and policies of dealing with the crisis. The only explicitly stated policy objective – fast entry into ERM2 – was obviously unrealistic and was announced at the wrong time, especially in view of the collateral damage of the Greek debt crisis.

Fiscal policy in this period has translated into a series of hectic and inconsistent measures, which more often than not led to wasteful outcomes. Probably the most damaging – and procyclical – fiscal step has been the curbing of public investment which started in mid-2009 and continued in 2010 as well (in the first quarter, public investment expenditure financed from local sources was 8% below the level of the same period of 2009). Another irrational step has been the withholding of payments due from the budget, especially to firms involved in public procurement, in a misguided attempt to curtail the cash fiscal deficit (which is an irrelevant measure in the context of ESA'95). The substitution of policy stimulus with cash austerity resulted in overcooling of the economy: these steps did next to nothing in terms of the overall fiscal position but had a damaging effect on economic activity and investor confidence.

At the same time, the initially declared policy of fiscal stringency was de facto abandoned in 2010 and degenerated into lavish populist spending in spheres with no countercyclical effect. Fearing a loss of popular support, the government has put on hold the envisaged reforms in the health care and pension systems as well as in education, prolonging wasteful public spending in these areas. There was no attempt (as of May 2010) to curb the growth of wages which notably outpaced productivity growth during the crisis.

But probably it is policy incoherence itself and the ever changing policy signals and measures that have had the most damaging effect on investor and consumer confidence. The absence of a clear

policy direction and the unpredictability of the economic environment have translated into growing precautionary savings rather than spending, prolonging the current economic slump. These detrimental developments also act as further deterrent to FDI, amplifying the negative effects of the crisis. Coupled with the withdrawal of policy stimulus and the discontinuation of public investment projects, this led to erosion of the tax base by margins that exceeded by far the drop of output.

The aggregate fiscal outcomes in the first quarter of 2010 were disastrous. Compared to the same period of the previous year, consolidated general government revenue dropped by 19.2%, a disproportionate plunge vis-à-vis the fall in GDP. The main factor behind this was the sharp fall in tax revenue, largely due to an eroding tax base and poor tax collection. At the same time public expenditure ballooned by 17.0% (despite the cuts in public investment), an obviously unsustainable expansion even if the economy were growing. As a result, the overall fiscal balance for this quarter was a staggering negative 12% of GDP.

There was also one farcical development in this period. When the government reported ESA'95 fiscal balance for 2009, the deficit was unexpectedly downgraded from the initial estimate of 1.9% to 3.9%. No explication of this revision was given and some analysts have suggested that, faced with the prospect of a large deficit in 2010, the government might have over-reported in the 2009 accrual balance some committed long-term spending which will be due in 2010, so that to shift the responsibility to the previous government. The irony is that as a result of this reported 2009 deficit number, which exceeds the Maastricht threshold, the European Commission has invoked an excessive budget deficit procedure against Bulgaria, despite the harsh cash austerity measures undertaken in 2009.

At present the government is contemplating a major revision of the budget for 2010 with a view to reversing the negative trends, mostly by spending cuts. However, for the time being the economy remains in a largely self-inflicted vicious circle of an economic downswing and a swelling fiscal imbalance. If macroeconomic mismanagement continues, a further deterioration of the situation cannot be excluded.

The short-term outlook for the Bulgarian economy remains skewed towards the downside. The continuing slump in domestic demand seems to outweigh the recovery in exports and as long as this will be the case, one could not possibly expect a recovery in aggregate output. Even if there will be a change towards a more supportive policy stance, the negatives already accumulated in the first months of the year would pool back the outcome for GDP growth in 2010 as a whole. In the years after, the re-orientation towards an export-led model of growth should continue but this would not be sufficient to achieve high rates of GDP expansion. As long as domestic demand remains subdued, no major resurgence of inflation can be expected. The one positive outcome of the crisis has been the notable reduction in the current account deficit; the latter can be expected to remain in the lower range in the foreseeable future.

Table BG

**Bulgaria: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011 Forecast	2012
Population, th pers., average	7699.0	7659.8	7623.4	7591.7	.	.	7560	7540	7520
Gross domestic product, BGN mn, nom.	49361.0	56519.8	66728.1	66256.3	13961.1	14050	68000	72000	76500
annual change in % (real)	6.3	6.2	6.0	-5.0	-3.5	-3.6	0	2.5	3
GDP/capita (EUR at exchange rate)	3300	3800	4500	4500	.	.	.	.	.
GDP/capita (EUR at PPP)	8600	9400	10400	9800	.	.	.	.	.
Consumption of households, BGN mn, nom.	34554.3	38826.5	45200.7	43047.9	10260.3	9530.0	.	.	.
annual change in % (real)	9.5	5.3	4.9	-6.4	-6.4	-7.3	-2	0	2
Gross fixed capital form., BGN mn, nom.	12805.2	16832.5	22253.9	16420.1	3615.7	3170.2	.	.	.
annual change in % (real)	14.7	21.7	20.4	-27.0	-14.1	-14.9	-10	4	8
Gross industrial production <sup>2)</sup>									
annual change in % (real)	6.0	9.6	0.6	-17.4	-17.6	-3.8	3	6	10
Gross agricultural production									
annual change in % (real)	-0.1	-21.0	33.0	-0.4	.	.	.	.	.
Construction industry <sup>3)</sup>									
annual change in % (real)	23.9	27.9	-3.3	-14.5	-6.4	-25.9	.	.	.
Employed persons - LFS, th, average	3110.0	3252.6	3360.7	3253.6	3262.8	3011.3	3050	3100	3150
annual change in %	4.3	4.6	3.3	-3.2	-0.8	-7.7	-6.3	1.6	1.6
Unemployed persons - LFS, th, average	305.7	240.2	199.7	238.0	222.2	341.0	.	.	.
Unemployment rate - LFS, in %, average	9.0	6.9	5.6	6.8	6.4	10.2	9.0	8.5	8
Reg. unemployment rate, in %, end of period	9.1	6.9	6.3	9.1	6.9	10.1	.	.	.
Average gross monthly wages, BGN	360.3	431.2	524.5	591.8	563.0	619.0	.	.	.
annual change in % (real, gross)	3.7	10.4	8.3	9.8	10.6	9.0	.	.	.
Consumer prices (HICP), % p.a.	7.4	7.6	12.0	2.5	5.1	1.9	3	3	3
Producer prices in industry, % p.a.	12.0	7.7	10.9	-6.5	-3.4	4.0	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	39.5	41.5	39.1	36.9	.	.	.	.	.
Expenditures	36.5	41.5	37.3	40.7	.	.	.	.	.
Net lending (+) / net borrowing (-)	3.0	0.1	1.8	-3.9	.	.	-4	-3	-2
Public debt, EU-def., in % of GDP	22.7	18.2	14.1	14.8	12.7	14.9	19	21	22
Base rate of NB % p.a., end of period <sup>4)</sup>	3.3	4.6	5.8	0.6	3.5	0.2	.	.	.
Current account, EUR mn	-4647.0	-7756.0	-8199.0	-3196.0	-1249.0	-427.0	-1800	-1600	-1800
Current account in % of GDP	-18.4	-26.8	-24.0	-9.4	-17.8	-5.9	-5.2	-4.3	-4.6
Exports of goods, BOP, EUR mn	12012.0	13512.0	15203.0	11785.0	2681.3	3009.2	13500	14800	16200
annual growth rate in %	26.9	12.5	12.5	-22.5	-26.6	12.2	14.6	9.6	9.5
Imports of goods, BOP, EUR mn	17575.0	20758.0	23800.0	15890.0	3822.8	3633.4	16800	18000	19700
annual growth rate in %	26.7	18.1	14.7	-33.2	-29.5	-5.0	5.7	7.1	9.4
Exports of services, BOP, EUR mn	4187.0	4760.0	5375.0	4879.0	794.2	715.0	5300	5700	6200
annual growth rate in %	17.5	13.7	12.9	-9.2	-2.7	-10.0	8.6	7.5	8.8
Imports of services, BOP, EUR mn	3264.0	3586.0	4045.0	3326.0	795.5	658.1	3500	3800	4200
annual growth rate in %	18.9	9.9	12.8	-17.8	-16.3	-17.3	5.2	8.6	10.5
FDI inflow, EUR mn	6221.0	9046.0	6696.0	3213.0	926.0	-21.9	1500	1300	1000
FDI outflow, EUR mn	141.0	207.0	484.0	-98.0	21.7	19.3	.	.	.
Gross reserves of NB excl. gold, EUR mn	8309.1	11215.9	11927.6	11942.8	10928.6	11182.1	.	.	.
Gross external debt, EUR mn	20690.9	29016.8	37100.1	37705.8	36834.6	37146.6	.	.	.
Gross external debt in % of GDP	82.0	100.4	108.7	111.3	108.7	106.8	.	.	.
Average exchange rate BGN/EUR	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956
Purchasing power parity BGN/EUR	0.745	0.787	0.847	0.899	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 10 and more employees. - 3) Private enterprises with 5 and more employees, all enterprises in public sector. -

4) The BNB basic interest rate is not a policy rate but a monthly reference rate computed by the BNB as the average interbank LEONIA rate of previous month (valid from 2005).

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.



*Leon Podkaminer*

## **The Czech Republic: Fragile recovery**

The dismal year 2009 ended with GDP falling less steeply in the fourth quarter than earlier. Although the pace of contractions of private consumption and inventories even accelerated, on a number of counts things were clearly improving. Strong positive growth in public consumption was sustained, despite the officially declared intention to carry through a determined consolidation of public finances. The fall in fixed capital formation became more moderate, though the very strong fall in the volume of newly installed machinery and equipment continued. Most importantly, after a year of sustained massive contraction, exports of goods and services resumed growth. Growth of exports was still accompanied by falling imports.

In the first quarter of 2010 export growth accelerated further. In current euro terms, exports of goods jumped by 18%, definitely ahead of imports which rose by 16%. Strengthening foreign demand for the products of Czech manufacturing (which account for over 90% of total exports) pulled up industrial production (by 7.5% in real terms). However, because of protracted deflation in industrial production prices, the sales of industry (at current prices) were up by mere 2.5% vs. the same period of 2009. Export sales rose by over 8% while the domestic sales of industrial goods contracted further in both nominal and real terms. The average wage in larger industrial firms (employing over 50 persons) went up quite nicely (5.8% nominally, or 5.1% in real terms). But these firms reduced overall employment massively (by 11%). Labour productivity and unit labour costs improved strongly. Provisional data for April indicate that the above tendencies have been continuing, but they may become slightly less intensive. Importantly, the producer price index seems to have stabilized (after 16 months of trending downwards).

While the performance of industry gives rise to muted optimism, the situation in the construction sector continues to be bad. In real terms the volume of construction output declined by 22% (in residential construction by 27%). Although this can be partly attributed to particularly harsh weather conditions in January and February, there is no doubt that the demand for construction is still weak. In the first quarter of 2010 the larger construction firms reduced employment (by 7%), while raising average wages by 1.8% in real terms.

In the first quarter of 2010 the GDP grew for the first time since the third quarter of 2008. The fall of private consumption nearly stopped, while the growth of public consumption slowed down strongly. Gross fixed capital formation has continued to decline at high speed, the decline in inventories has stopped. Actually, inventories have risen, contributing 0.6 percentage points to the overall growth. Real growth of exports of goods and services has accelerated further. Also imports started to grow

strongly – for the first time since the third quarter of 2008. The contribution of foreign trade to the GDP growth (+1.9 p.p.) was lower than in the last quarter of 2009 (+2.9 p.p.).

The steady decline in output levels throughout 2009 was followed, with some delay, by falling average numbers of hours worked and employment. Even though this put a brake on the growth of average wages (not very effective yet in the case of the corporate sector), labour productivity has declined resulting in unit labour costs increasing somewhat. Continuing deflation in producer prices strengthened – during 2009 – the rise in real unit labour costs (or in the share of wages in nominal output). That indicated the presence of ‘profit squeeze’. Ongoing gradual recovery of output in 2010 will not prevent further downward adjustments in employment levels. It is estimated that with the GDP rising by 1-2% in 2010, the dishoarding of employment will only be concluded sometime in 2011. In the meantime the losses on labour productivity (and unit labour costs) suffered by firms in 2009 will have been reduced to the levels justifying renewed growth in employment. Consequently, growth in the total economy’s wage bill is likely to be subdued in 2010. This will probably restrict growth of household consumption, at least temporarily. It may be remarked that also other types of household income are likely to remain depressed. Mixed income and especially the property income received fell quite dramatically in 2009: not only the employees are affected by the recession. Although these incomes will not fall as dramatically in 2010, they may not fully recover from the losses suffered earlier. Higher taxes and mandatory social security contributions that are part of the fiscal consolidation package officially enforced will, if carried through mercilessly, further erode the real purchasing value of the household sector’s disposable income. Under such conditions even a falling household saving rate may not prevent a fall in households’ real consumption.<sup>43</sup>

Inventories – whose strong contraction was the main source of output decline in 2009 – are hoped to recover in 2010. However, growth in fixed investment is not likely to accelerate. Firms’ financial position is still weak, the levels of unused capacities quite high and prospects of higher consumer demand rather bleak. Moreover, even though the Czech National Bank’s policy has been very relaxed, the commercial banks’ interest rates on loans to the business sector are not – given deflationary producer price tendencies – very encouraging. Indeed, the stock of loans to the corporate sector has been generally declining. Also the stock of loans to households, which increased moderately in the first half of 2009, has been contracting recently. Overall, the stagnant stock of debt of the entire non-financial private sector reflects that sector’s weak demand for credit, and its own weak growth outlook. It may be added that the commercial banking sector’s position is very good: the sector earns handsome profits on its assets (whose quality is reportedly very high). Czech banks continue their ‘safety first’ policies. The capital adequacy ratio even increased in 2009, reaching 14.1%, liquidity has been more than satisfactory. Besides, the total values of loans made continue to fall short of those of the deposits accepted, minimizing the need for external financing.

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<sup>43</sup> The budget for 2010 enacted by the liberal-leaning caretaker government stipulates a number of ‘austerity’ measures aimed at cutting the deficit to 5.3% of GDP. Transfers to households (e.g. sickness benefits, pensions) are to be streamlined, the tax burden on households raised, the public sector’s wage bill reduced, and rates of indirect taxation increased. But taxation of the corporate sector is to become lighter,

Under simultaneous contractions in exports and imports, foreign trade proved a disappointment in 2009 – contributing negatively to the overall GDP growth. This will be changing in 2010 and beyond. The contributions of foreign trade to overall growth will become positive even if exports and imports keep rising at the same speeds. However, the size of those contributions may still be rather moderate. The demand for Czech exports may turn out to be restricted by rather weak recovery in the euro area (and in Germany in particular). Moreover, the Czech currency – which has regained some of its 2008 strength – will not prevent an undue rise in imports. On the other hand, improving industrial competitiveness may induce sizeable FDI inflows.

Overall, a muted recovery in 2010 is possible. However that recovery critically hinges on the performance of foreign demand. Although it is generally expected that in 2010 the euro area should record positive growth, its actual strength may turn out to be a disappointment. If the euro area is visited by renewed recession, the Czech Republic will not be spared another recession too. Staking one's own prosperity on foreign prosperity is not only very risky; in the Czech case it is also unreasonable. Unlike many other countries the Czech economy has remarkable buffers allowing the active conduct of a more expansionary fiscal policy. In the same vein, its commercial banking sector has also vast room for a more active policy. Under these conditions the pursuit of fiscal consolidation and a certain passivity on the monetary front certainly insulates the economy from fiscal and monetary-instability risks even further. But, by leaving the economy at the mercy of foreign trade, the policy seems to enhance the overall risks facing the whole economy all the same.

Against expectations, the parliamentary elections did not bring to power the opposition Social Democrats. The next government will be formed by a broad liberal-conservative coalition. That government cannot be expected to stray off the fiscal consolidation plans in the near future. But if those plans bring much social discontent and not real growth recovery, the fiscal plans for 2011 may get a bit less ambitious. Consequently, growth in 2011 and beyond may accelerate under the impact of domestic demand becoming stronger due to a more relaxed fiscal stance.

Table CZ

**Czech Republic: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011	2012
							Forecast		
Population, th pers., average	10269.1	10334.2	10424.3	10490.0	.	.	10550	10600	10650
Gross domestic product, CZK bn, nom.	3222.4	3535.5	3689.0	3627.2	875.9	870.6	3720	3890	4130
annual change in % (real)	6.8	6.1	2.5	-4.2	-3.6	1.1	1.0	2.5	3.5
GDP/capita (EUR at exchange rate)	11100	12300	14200	13100	.	.	.	.	.
GDP/capita (EUR at PPP)	18200	19900	20200	18900	.	.	.	.	.
Consumption of households, CZK bn, nom.	1537.2	1658.8	1803.7	1804.4	430.3	430.3	.	.	.
annual change in % (real)	5.1	4.8	3.6	-0.3	0.8	-0.4	0	2	3
Gross fixed capital form., CZK bn, nom.	796.3	890.3	883.2	822.1	189.7	174.2	.	.	.
annual change in % (real)	6.0	10.8	-1.5	-8.3	-9.4	-6.6	-3	4	6
Gross industrial production									
annual change in % (real)	8.3	10.6	-1.9	-13.4	-19.1	7.5	3	4	6
Gross agricultural production									
annual change in % (real)	-4.2	3.1	6.6	-0.3	.	.	.	.	.
Construction industry									
annual change in % (real)	6.1	7.0	-0.2	-0.8	-11.4	-32.1	.	.	.
Employed persons - LFS, th, average	4828.1	4922.0	5002.5	4934.3	4946.8	4829.2	4860	4860	4910
annual change in %	1.3	1.9	1.6	-1.4	-0.2	-2.4	-1.5	0	1
Unemployed persons - LFS, th, average	371.7	276.6	229.8	352.2	302.8	422.7	.	.	.
Unemployment rate - LFS, in %, average	7.2	5.3	4.4	6.7	5.8	8.2	8.5	8.0	7.5
Reg. unemployment rate, in %, end of period	7.7	6.0	6.0	9.2	7.7	9.7	.	.	.
Average gross monthly wages, CZK <sup>2)</sup>	20219	21694	23542	23488	22263	22748	.	.	.
annual change in % (real, gross)	3.9	4.4	2.1	3.0	0.8	1.5	1	3	3
Consumer prices (HICP), % p.a.	2.1	2.9	6.3	0.6	1.5	0.4	1.5	2.0	2.5
Producer prices in industry, % p.a.	0.1	2.6	0.4	-1.5	1.9	-3.9	.	.	.
General governm. budget, EU-def., % GDP									
Revenues	41.1	41.8	40.2	40.3	.	.	41.4	41.7	.
Expenditures	43.7	42.5	42.9	46.1	.	.	47.0	47.4	.
Net lending (+) / net borrowing (-)	-2.6	-0.7	-2.7	-5.9	.	.	-5.6	-5.7	-4.5
Public debt, EU-def., in % of GDP	29.4	29.0	30.0	35.4	.	.	39	42	45
Discount rate of NB, % p.a., end of period	1.5	2.5	1.3	0.3	0.8	0.3	0.5	2.5	2.5
Current account, EUR mn	-2745	-4090	-962	-1465	904	621	-1000	-2000	-2000
Current account in % of GDP	-2.4	-3.2	-0.7	-1.1	2.9	1.8	-0.7	-1.3	-1.2
Exports of goods, BOP, EUR mn	75706	89379	99158	80675	18921	22311	89000	96000	108000
annual growth rate in %	20.6	18.1	10.9	-18.6	-25.1	17.9	10	8	12
Imports of goods, BOP, EUR mn	73415	85038	95031	73842	17411	19889	80000	85000	94000
annual growth rate in %	20.8	15.8	11.8	-22.3	-26.1	14.2	8	6	10
Exports of services, BOP, EUR mn	11086	12311	14849	14575	3491	3526	15000	17000	19000
annual growth rate in %	16.8	11.0	20.6	-1.8	2.0	1.0	4	10	10
Imports of services, BOP, EUR mn	9494	10526	12210	13578	2956	3810	15000	17000	19000
annual growth rate in %	15.0	10.9	16.0	11.2	10.6	28.9	8	12	10
FDI inflow, EUR mn	4363	7667	4467	1935	814	2062	5000	.	.
FDI outflow, EUR mn	1172	1187	2964	960	281	663	500	.	.
Gross reserves of NB excl. gold, EUR mn	23684	23456	26377	28478	27392	29443	.	.	.
Gross external debt, EUR mn	43415	51642	59689	60069	56800	61033	.	.	.
Gross external debt in % of GDP	37.0	38.9	43.5	43.8	41.5	42.7	.	.	.
Average exchange rate CZK/EUR	28.34	27.77	24.95	26.44	27.62	25.88	26.0	25.5	25.0
Purchasing power parity CZK/EUR	17.23	17.17	17.55	18.30	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary - 2) Enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior. From 2009 all enterprises covered.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.



*Sándor Richter*

## **Hungary: New government's visions cut to size**

After the deep recession in 2009 the signs of a beginning recovery have been becoming stronger in the first months of this year. Industrial production expanded by 5.7% in January-April compared to the respective period last year. This upturn is the result of growing foreign demand: export sales of industry increased by close to 13% while still shrinking domestic markets absorbed nearly 10% less industrial products in the first quarter of this year as compared to the first quarter of 2009. The two most important branches of Hungarian industry – production of road vehicles and of computers, electronic and optical devices – registered a particularly strong expansion, but their output lags far behind the pre-crisis levels yet. In foreign trade, decline turned into growth at the end of 2009 (exports) and in January 2010 (imports) respectively. Reflecting the effect of the still hibernating domestic market, the gap between export and import growth rates remained large: it amounted to 5 percentage points in the first quarter of the year, resulting in a more than doubling of the trade surplus (to EUR 1.3 billion) compared the respective period of 2009. Other segments of the economy present a mixed picture: output indicators of transport have improved, but construction and retail trade sales have been further declining. This mixed performance is mirrored in the GDP growth rates: data suggest that the GDP decline experienced in the preceding five consecutive quarters came to halt in the first quarter of 2010. Net exports and public consumption contributed positively to the marginally small (+0.1%) GDP change in the first quarter, while consumption of households and gross fixed capital formation were further declining and yielded a negative contribution to the GDP change.

The impact of the crisis appears with a time lag in employment. There has been a dramatic, 24% increase in the number of unemployed persons compared to the first quarter of 2009, resulting in a nearly 2 percentage point increase in the unemployment rate. Employment decreased by 1.3% in the overall economy, with significant differences by sector: employment in the public sector rose by over 5% (due to temporary public employment programmes) but in the private sector it decreased by more than 5%. The deteriorating situation on the labour market is in contradiction to the developments of net wages: the latter increased by 5.6% in real terms in the first quarter. This unusual combination is the result of changes in the rules of personal income taxation (moving upwards the tax brackets for the lower tax rate). Changes in taxation (the one-off effect of the higher VAT rate) also explain the noticeably high consumer price inflation, an outlier in the current deflationary international environment.

After a landslide victory in the recent elections the Fidesz party, obtaining more than two thirds of the seats in the parliament, took over the government on 29 May with Viktor Orbán as new Prime

Minister. Fidesz is now empowered to change any law including the constitution. The Number One challenge faced by the new government without delay is that of the budget for the current and the next year.

What can be expected from the new government? Fidesz's vision of solving Hungary's economic problems has been elaborated and represented by György Matolcsy, the newly appointed Minister of Economy (responsible also for fiscal affairs as there is no longer an independent ministry of finance). The core idea is that Hungary should be catapulted to a higher growth path with the help of ample fiscal spending combined with low interest rates on loans. Dynamic growth is thought to automatically increase tax revenues and thus the problem of the budget deficit and eventually that of the public debt will be 'grown out'. Economic growth in this concept relies more than the current practice on domestic consumption, which in turn would rely more than currently on goods and services produced by domestic SMEs, a sector with firms being predominantly in Hungarian ownership.

This vision had a dramatic confrontation with reality on 4 and 5 June when high-ranking Fidesz officials announced that the Hungarian economy is on the verge of collapse and the country's fiscal stance is hardly better than that of Greece. The original purpose of this irresponsible announcement was to sell the idea that Hungary will not be able to observe the 3.8% GDP proportional general government deficit target agreed upon with the IMF and the European Commission and that the deficit may go up to 7% or more this year. The higher deficit would have created room for at least a part of the ambitious spending programmes. However, not only would the mentioned 7% deficit be far behind the 12.2% Greek deficit (EU Commission Spring Forecast), but the actual fiscal situation in Hungary is much less dramatic than indicated by the 7% deficit proposed by Fidesz. The 2010 budget, approved still under the previous government, foresaw a 3.8% (relative to the GDP) general government deficit. This figure has been coordinated with the IMF and the European Commission, the providers of the currently unused stand-by package for Hungary.<sup>44</sup> The outgoing minister of finance, just as the recently established independent Fiscal Council, have been warning several times that the target deficit cannot be achieved without additional budget consolidation measures corresponding to approximately 1 percentage point of GDP. But even without these measures the deficit would not be higher than about 5% of GDP.

Only a few months ago the wiiw still saw room for manoeuvre opening up for the new government to surpass the 3.8% deficit target so that at least a tiny part of pre-election Fidesz promises (withdrawal of the most unpopular measures of the previous government's crisis management package, further immediate radical tax cuts, no budgetary restrictions of any kind any longer) can be realized. This belief was based, first, on the assumed initial confidence towards the incoming government (no bad track record as yet), second, on the acceptance of government-initiated demand management in a series of countries under IMF surveillance in the crisis year 2009 and, last but not least, the 5-6% general government deficit assumed to emerge in other Central European countries in 2010. However, the recent dramatic developments in Greece and the menace of fiscal collapse in

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<sup>44</sup> Last summer Hungary managed to return to market-based financing of its public debt.

Portugal, Spain, Italy and Ireland have rewritten the previous assumptions concerning the receptivity of the international environment in this respect. One by one, EU member states are announcing economic policy measures aimed at decreasing their fiscal deficits in order to preserve international financial investors' confidence.

The unfortunate communication of Fidesz officials about Hungary's fiscal difficulties, comparing them to those of Greece, pushed the country suddenly into the limelight of the international media and triggered a significant weakening of the Hungarian currency and that of the euro vis-à-vis the US dollar as well as drops in the stock exchanges all over the world. The immediate consequence was that the anyhow narrow room for attaining a higher than originally planned budget deficit through clever negotiations with the IMF and the EU shrank, within hours, to zero.

Three days after the communication debacle and the sudden weakening of the forint, the Prime Minister announced in the parliament a 29 points action plan for the economy. It consists of two strong restrictive elements with the purpose of securing the deficit target. Banks, insurance and leasing companies will be charged a new special tax this and the next two years, with the aim to collect HUF 200 billion (about EUR 750 million) revenue per annum.<sup>45</sup> The other measure is a 15% reduction of the wage bill in certain segments of the public sector, to be achieved either by wage cuts or lay-offs.

Other components of the package will come into force next year and these measures are in line with the pre-election Fidesz promises for tax reductions. The personal income tax will be 16% instead of 17% and 32%; on the other hand, currently untaxed minimum wages will be taxed as well. Although details are not yet known, this change will unambiguously re-arrange the tax burden to the detriment of low-income taxpayers. As opposed to this planned rearrangement, which will only benefit the affluent upper middle class but not the economy, a positive change was initiated for SMEs. These (up to an annual turnover of EUR 1.8 million) will have to pay only 10% corporate income tax, instead of the 19% charge on all other companies. Several so-called 'small taxes' with limited macroeconomic significance will also be abolished. As many important details of the planned measures are unclear as yet, it is too early to judge whether the package will be able to secure the achievement of the 2010 and the even more ambitious 2011 fiscal deficit target (below 3% relative to the GDP).

Other effects can be assessed more easily. The banks will face a serious challenge if the new tax is really introduced. Moreover, the new government prolonged a moratorium on the eviction of non-performing debtors with a mortgage on their real estate and prohibited providing foreign exchange-denominated mortgage loans. That will, without doubt, put a brake on financial intermediation and make loans more expensive than they currently are. While the exchange rate risk is missing in the case of forint-denominated loans, a possible hike in the central bank's policy rate – as a reaction to a fiscal policy evaluated as too relaxed and/or as an attempt to strengthen the exchange rate of the forint – may push up interest rates of forint-denominated loans, dragging on the

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<sup>45</sup> Though no details have been made public, the tax will most probably be charged on financial institutions' profits.

upturn of the economy. Restrictions in the public sector may push up unemployment and/or make the best experts leave for the private sector, while the indeed low efficiency of the sector would remain unchanged. All in all, this seemingly improvised bunch of measures cannot replace a well-prepared economic strategy which reconciles the original Fidesz targets with the requirements of real life.

Nevertheless, the growth of the Hungarian economy will slowly accelerate over the next couple of years, first driven by net exports, from the next year onwards also by a modest expansion of consumption. Fiscal consolidation and the related slow growth of import demand in Hungary's main export markets Germany, Austria and Italy may drag, while rapid recovery in some extra-EU export markets may to some extent support export-driven growth. It is an important but yet unanswered question whether the new government's efforts to facilitate a boom in domestic SME activities will yield results. While tax allowances for this segment of the economy may become helpful in this respect, the special tax on domestic financial institutions may make loans, also for SMEs, more expensive. The biggest uncertainty is the effect of the planned special tax on financial intermediation, in an environment characterized by still shrinking financing for the business sector in the first quarter of the year. The current account will deteriorate over the next few years as compared to 2009 with domestic consumption slowly gaining momentum but it will remain substantially better than before the crisis. The exchange rate of the forint will slowly appreciate to the pre-elections 265-270 HUF/EUR level, in line with the new government's assumed readiness to accept reality and follow the down-to-earth economic policy of the previous caretaker government.

Table HU

## Hungary: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011 Forecast	2012
Population, th pers., average	10071.4	10055.8	10038.2	10022.3	10022	10007	10011	10005	10000
Gross domestic product, HUF bn, nom.	23755.5	25408.1	26543.3	26094.8	5948.6	6018.4	27000	28200	29600
annual change in % (real)	4.0	1.0	0.6	-6.3	-6.7	0.1	0.8	2.5	3
GDP/capita (EUR at exchange rate)	8900	10100	10500	9300	.	.	.	.	.
GDP/capita (EUR at PPP)	15000	15600	16100	14900	.	.	.	.	.
Consumption of households, HUF bn, nom.	12436.5	13254.9	13919.4	13409.3	3222.1	3200.7	.	.	.
annual change in % (real)	1.9	0.3	-0.5	-7.6	-7.2	-4.7	-0.7	1.3	2
Gross fixed capital form., HUF bn, nom.	5161.3	5380.5	5559.1	5225.3	938.6	875.1	.	.	.
annual change in % (real)	-3.6	1.6	0.4	-6.5	-7.0	-4.4	3	9	10
Gross industrial production									
annual change in % (real)	9.9	7.9	-0.2	-17.5	-22.3	4.5	6	10	10
Gross agricultural production									
annual change in % (real)	-2.9	-11.6	27.6	-9.9	.	.	.	.	.
Construction industry									
annual change in % (real)	-0.7	-14.0	-5.2	-4.3	-5.0	-10.3	1	5	10
Employed persons - LFS, th, average	3930.0	3926.2	3879.4	3781.8	3764.1	3719.3	3760	3800	3840
annual change in %	0.7	-0.1	-1.2	-2.5	-2.1	-1.2	-0.5	1	1
Unemployed persons - LFS, th, average	316.7	312.0	329.1	420.7	402.8	497.8	.	.	.
Unemployment rate - LFS, in %, average	7.5	7.4	7.8	10.0	9.7	11.8	11.5	10.5	9.3
Reg. unemployment rate, in %, end of period	9.1	10.1	10.9	13.8	12.9	14.7	.	.	.
Average gross monthly wages, HUF <sup>2)</sup>	171351	185017	198964	199775	195842	206913	.	.	.
annual change in % (real, net)	3.6	-4.6	0.8	-2.6	-2.7	5.6	.	.	.
Consumer prices (HICP), % p.a.	4.0	7.9	6.0	4.0	2.7	5.8	4.4	3.5	3
Producer prices in industry, % p.a.	6.6	0.3	4.6	4.5	7.6	-0.9	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	42.6	44.8	45.4	45.8	.	.	.	.	.
Expenditures	52.0	49.8	49.2	49.8	.	.	.	.	.
Net lending (+) / net borrowing (-)	-9.4	-5.0	-3.8	-4.0	.	.	-4.0	-4.0	-3.5
Public debt, EU-def., in % of GDP	65.6	65.9	72.9	78.3	.	.	78	79	78
Base rate of NB, % p.a., end of period	8.0	7.5	10.0	6.3	9.5	5.5	.	.	.
Current account, EUR mn <sup>3)</sup>	-6472	-6631	-7409	222	-601	102	-1200	-2300	-2600
Current account in % of GDP	-7.2	-6.6	-7.0	0.2	-3.0	0.5	-1.2	-2.2	-2.3
Exports of goods, BOP, EUR mn <sup>3)</sup>	58380	68178	72686	58806	13636	15979	64700	71200	78300
annual growth rate in %	17.5	16.8	6.6	-19.1	-27.0	17.2	10	10	10
Imports of goods, BOP, EUR mn <sup>3)</sup>	60433	67987	72735	54763	13031	14754	59700	65100	71000
annual growth rate in %	16.5	12.5	7.0	-24.7	-28.9	13.2	9	9	9
Exports of services, BOP, EUR mn <sup>3)</sup>	10876	12574	13804	13061	2891	3188	13700	14800	16300
annual growth rate in %	5.1	15.6	9.8	-5.4	1.4	10.3	5	8	10
Imports of services, BOP, EUR mn <sup>3)</sup>	9643	11524	12843	11586	2780	2667	12200	13200	14500
annual growth rate in %	4.6	19.5	11.4	-9.8	-0.04	-4.1	5	8	10
FDI inflow, EUR mn <sup>3)</sup>	15809	52328	43239	-4052	-101	-4104	.	.	.
FDI outflow, EUR mn <sup>3)</sup>	14846	48915	41794	-5059	-814	-2803	.	.	.
FDI inflow, excl. SPE, EUR mn	5609	3956	4752	1021	750	163	1500	2500	3500
FDI outflow, excl. SPE, EUR mn	3127	2643	2020	1228	183	840	1000	1200	1500
Gross reserves of NB, excl. gold, EUR mn	16384	16305	23807	30601	27915	33771	.	.	.
Gross external debt, EUR mn	81205	98841	122898	130661	128783	135492	.	.	.
Gross external debt in % of GDP	86.1	98.7	123.5	135.4	133.5	138.0	.	.	.
Average exchange rate HUF/EUR	264.26	251.35	251.51	280.33	294.10	268.68	275	270	265
Purchasing power parity HUF/EUR	157.74	161.97	163.81	174.56	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary . - 2) Enterprises with 5 and more employees. - 3) From 2006 including Special Purpose Entities (SPEs), 2010-2012 data are estimated excluding SPEs.

Source: wiw Database incorporating Eurostat and national statistics. Forecasts by wiw.



*Leon Podkaminer*

## **Poland: Solid but moderate growth**

The year 2009 was capped with a quite strong performance in the fourth quarter, when GDP grew by more than 3%, and private consumption and gross fixed investment rose by close to 2% and over 1% respectively. Foreign trade remained the strongest positive factor, contributing 2.4 percentage points (p.p.) to overall growth. Inventories declined again in 2009. The first quarter of 2010 saw a further strengthening of private (and also public) consumption, very strong recovery in the value of inventories, and foreign trade continuing to play a positive role. Overall GDP grew by 3% in the first quarter of the year. The contribution of consumption was 2 p.p., of inventories 2.1 p.p., and of foreign trade 0.7 p.p. Gross fixed capital formation fell by over 12% – its contribution to the GDP growth rate was negative (-1.8 p.p.). The fall in gross fixed capital formation is attributed to the particularly harsh weather conditions prevailing during the exceptionally long winter. The strongly increased inventories may represent outlays on fixed investment projects whose completion has been temporarily held back by weather.

Despite some decline in average employment, the total gross wage bill rose by 3.6% nominally in the first quarter of 2010, remaining roughly unchanged in real terms. But households' disposable purchasing power was strongly augmented on account of high increases in pensions, retirement pays and other mandatory social transfers. In total, pensions and other social transfers rose by 2.9% in real terms. Likewise disposable incomes out of firms' rising profits supported private consumption.

Industrial production (sales) rose by more than 10% in real terms in the first quarter of 2010. The recovery of production was particularly turbulent in branches supplying computers, electronics and optical equipment, and electric appliances. Sales of manufacturing branches supplying primarily intermediate goods rose by over 12%, indicating that a further expansion of production is forthcoming. Sales by branches supplying primarily investment goods increased by over 6% while sales of non-durable consumer goods branches rose over 4%. Sales of branches supplying durable consumer goods jumped up by over 30%. Clearly, consumer sentiments are becoming very buoyant. Sales of the construction sector declined very strongly in the first quarter, on account of the particularly harsh and prolonged winter. But construction activities have accelerated spectacularly in more recent months. Average employment in industry fell by about 3% in the first quarter of 2010, while the average nominal industrial wage rose by about 4.5%, leaving the sector with a small unit labour cost gain (coming on top of large gains registered earlier in 2009). That gain could have been larger had (the mild) deflation in producer prices stopped. It may be important to add that the fall in industrial employment (and the overall hired employment both in the corporate sector and in the national economy at large) has already come to a halt. At the end of April employment reached

levels not recorded for over a year. But they are still appreciably short of the levels reported in summer 2008.

Net post-tax profits earned by industry (corporate sector) in the first quarter of 2010 rose by 100% over the same period of 2009, reaching PLN 7.4 billion (roughly EUR 1.8 billion). The huge extraordinary losses recorded in the first quarter of 2009 (due mainly to reckless engagement in the purely speculative currency options business in 2008) which had burdened the profits in 2009 has already been written off. Other segments of the non-financial corporate sector performed similarly. The net profit earned by the whole non-financial corporate sector in the first quarter of 2010 was 88% higher than a year earlier. The recovery of profits is further strengthening the liquidity position of non-financial firms and their ability to expand activities without having to rely on outside sources of financing. The strong financial position of the non-financial corporate sector is also shown by the most recent business climate survey of the National Bank of Poland. Close to 71% of firms do not report liquidity problems, and over 89% of firms service their bank liabilities regularly. The latter indicator is still lower than a year ago when it stood at 93% (but far from its lowest value of 76% reported in 2002). Progress has been uneven though, with the liquidity position and the ability to service debts generally continuing to deteriorate in the segment of small firms and also for the producers of capital goods as well as in mining.

The stock of households' liabilities to banks rose minimally, by about 2% nominally, within the first four months of 2010 while the stock of non-financial corporations' bank liabilities fell by 2%. Overall, net domestic assets fell massively, by 4.4% (the stocks of loans to social insurance funds and other general government institutions declined very strongly). The contraction of net domestic assets happened to be associated with a strong rise in net foreign assets of the banking system, leaving the money supply (M3) unchanged during the first four months of 2010. It may be added that, despite the stagnation observed recently, the money stock is now much higher than reported a year ago.

The weakness of the expansion of loans to the non-financial corporate sector is fairly understandable: parts of that sector wallow in money and have no reason to seek extra credit. Some other parts of the non-financial corporate sector may still face difficulties rendering them high lending risks. Relatively low interest rates on new loans to the corporate sector and the banks' somewhat less restrictive lending standards appear unable to induce higher effective demand for corporate loans. Things will change to the better when a full-scale investment rush sets in. The situation with respect to loans to households (and small businesses) is slightly different. Here the demand for loans is reported as continuing to be relatively strong. However, banks have been restricting lending to households (for current consumption and mortgages) through higher interest rates and tighter standards. This may prevent, or moderate, the build-up of a bubble on the housing market.

The acceleration of overall growth (and in particular the unexpectedly strong growth of exports of goods) resulted in a fast acceleration of imports. Both exports and imports rose at the same speed in the first quarter of 2010. The resultant foreign trade deficit is still fairly small. But further acceleration of growth will bring a steady rise in the trade deficit, especially if the zloty strengthens unduly (as was the case in the first quarter of 2010). In any case the current account deficit (over EUR 1 billion in the

first quarter of 2010) is likely to increase in the course of the year. Its size will be moderate yet, both in relation to GDP and net FDI and other capital likely to continue flowing in. The excess of capital inflows over current account deficits (which has had something to do with the strengthening of the domestic currency) is reflected in the snowballing size of official gross reserves of the National Bank of Poland. By mid-May these reserves stood at EUR 66.5 billion, up from 52.7 billion at end-December 2009.

The general government deficit in 2009 is estimated at over 7% of the GDP. But that figure is likely to be corrected downwards. The deficit/GDP ratios projected for 2010 and 2011 also seem to contain 'buffers'. In any case, the government plans to reduce the ratio to less than 3% in 2012. According to the recent (February 2010) update of the Convergence Programme, the consolidation of public finances will involve higher revenues (primarily by effectively higher indirect taxation), with total expenditures to be suppressed only in 2012 (i.e. after the parliamentary elections). Currently, the relatively high government budget deficits seem to be easy to finance. Foreign and domestic demand for debt issued by the government remains very high and yields are fairly moderate. The crisis over the large fiscal deficits in southern member countries of the eurozone has not, so far at least, generated 'contagion' effects. The nomination of Marek Belka (former prime minister and twice Poland's finance minister, most recently a top executive with the IMF) to the position of President of the National Bank of Poland is likely to contribute positively to the quality of monetary policy and the country's overall financial stability.

In May parts of Poland (primarily along the Vistula, its main river) suffered severe floods caused by protracted torrential rains in the Carpathian Mountains. Losses in terms of human suffering and destroyed or damaged infrastructure, homes, livestock and agricultural production potential are enormous. The floods' macroeconomic impacts will, however, be rather negligible. Floods that hit the country back in summer 1997 were much more severe – and they affected much more developed, urbanized areas along the Odra, Poland's second largest river. Those floods notwithstanding, Poland's GDP grew by over 7% in 1997, industrial production rose close to 12%, exports by 24% (in current euro terms). The fall in gross agricultural production (by 0.2%) appears to be the only tangible trace of the deluge of 1997.

The tendencies prevailing so far with respect to exchange rates, foreign trade, consumption and gross capital formation are likely to continue. Growth in 2010 could accelerate further if external demand strengthens – as generally expected. There are, however, some unknowns as concerns the performance in 2011 and beyond. First of all, the course of the future exchange rate is hard to predict. Should the zloty strengthen radically, the trade engine generating much of Poland's recent growth may slow down. But the other important reason for Poland's extraordinary growth performance in 2009 (healthy financial positions of households, firms and banks) would anyway help to sustain recovery, especially if recession in Poland's major trading partners comes to an end.

Table PL

## Poland: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011	2012
							Forecast		
Population, th pers., average	38141.3	38120.6	38125.8	38149.9	38139	38172	38175	38150	38150
Gross domestic product, PLN bn, nom.	1060.0	1176.7	1272.8	1341.9	313.7	327.4	1410	1500	1590
annual change in % (real)	6.2	6.8	5.0	1.7	0.8	2.9	2.7	3.5	3.5
GDP/capita (EUR at exchange rate)	7100	8200	9500	8100	.	.	.	.	.
GDP/capita (EUR at PPP)	12300	13600	14100	14200	.	.	.	.	.
Consumption of households, PLN bn, nom.	652.8	701.6	773.9	813.2	207.8	218.8	.	.	.
annual change in % (real)	5.0	4.9	5.9	2.3	4.1	2.3	3	4.5	5
Gross fixed capital form., PLN bn, nom.	208.3	253.7	280.9	282.2	46.5	39.4	.	.	.
annual change in % (real)	14.9	17.5	8.2	-0.3	-1.9	-12.4	4	6	10
Gross industrial production (sales) <sup>2)</sup>									
annual change in % (real)	12.1	9.3	2.6	-3.7	-10.6	10.1	5	6	7
Gross agricultural production									
annual change in % (real)	-1.1	5.2	0.9	-3.3	.	.	.	.	.
Construction industry <sup>2)</sup>									
annual change in % (real)	15.9	16.4	9.8	4.7	3.1	-16.7	.	.	.
Employed persons - LFS, th, average	14593.6	15240.5	15799.8	15868.0	15714.3	15574.0	15720	15800	16120
annual change in %	3.4	4.4	3.7	0.4	1.3	-0.9	-0.5	0.5	2
Unemployed persons - LFS, th, average	2344.3	1618.8	1210.7	1411.1	1413.8	1839.0	.	.	.
Unemployment rate - LFS, in %, average	13.8	9.6	7.1	8.2	8.3	10.6	11	10	8.5
Reg. unemployment rate, in %, end of period	14.8	11.4	9.5	11.9	11.1	12.9	12.5	10.5	9.5
Average gross monthly wages, PLN	2475.9	2672.6	2942.2	3103.0	3248.0	3337.6	3250	3460	3710
annual change in % (real, gross)	4.0	5.5	5.9	2.1	3.2	-0.2	1.5	4	4.5
Consumer prices (HICP), % p.a.	1.3	2.6	4.2	4.0	3.6	3.4	2.5	2.5	2.5
Producer prices in industry, % p.a.	1.8	2.0	2.4	3.9	5.8	-1.4	1	2	2
General governm.budget, EU-def., % GDP									
Revenues	40.2	40.3	39.6	37.4	.	.	.	.	.
Expenditures	43.9	42.2	43.3	44.5	.	.	.	.	.
Net lending (+) / net borrowing (-)	-3.6	-1.9	-3.7	-7.1	.	.	-6.9	-5.9	-4
Public debt, EU-def., in % of GDP	47.7	45.0	47.2	51.0	.	.	53	57	56
Discount rate of NB % p.a., end of period	4.3	5.3	5.3	3.8	4.0	3.8	3.8	3.8	3.8
Current account, EUR mn <sup>3)</sup>	-7443	-14701	-18320	-5006	-95	-1158	-7000	-10000	-15000
Current account in % of GDP <sup>3)</sup>	-2.7	-4.7	-5.1	-1.6	-0.1	-1.4	-2.0	-2.7	-3.9
Exports of goods, BOP, EUR mn <sup>3)</sup>	93382	105883	120953	100172	23479	27932	108200	119000	130900
annual growth rate in %	20.4	13.4	14.2	-17.2	-22.4	19.0	8	10	10
Imports of goods, BOP, EUR mn <sup>3)</sup>	98918	118249	138691	103354	24243	28884	111600	122800	137500
annual growth rate in %	24.0	19.5	17.3	-25.5	-28.3	19.1	8	10	12
Exports of services, BOP, EUR mn <sup>3)</sup>	16349	21018	24228	20687	4551	5004	22250	24500	27400
annual growth rate in %	24.8	28.6	15.3	-14.6	-11.4	10.0	8	10	12
Imports of services, BOP, EUR mn <sup>3)</sup>	15768	17583	20745	17231	3732	4282	17800	20100	22700
annual growth rate in %	25.9	11.5	18.0	-16.9	-18.3	14.7	7	13	13
FDI inflow, EUR mn <sup>3)</sup>	15737	17241	10036	8251	1536	3527	11000	.	.
FDI outflow, EUR mn <sup>3)</sup>	7122	4018	2047	2069	157	361	2000	.	.
Gross reserves of NB excl. gold, EUR mn	35237	42675	42299	52687	43972	60650	.	.	.
Gross external debt, EUR mn	128870	159106	172832	193938	169801	205473	.	.	.
Gross external debt in % of GDP	46.6	48.6	56.4	59.3	51.9	59.7	.	.	.
Average exchange rate PLN/EUR	3.90	3.78	3.51	4.33	4.50	3.99	4.1	4.1	4.1
Purchasing power parity PLN/EUR	2.26	2.28	2.36	2.48	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 10 and more employees. - 3) From 2006 including Special Purpose Entities (SPEs).

Source: wiw Database incorporating Eurostat and national statistics. Forecasts by wiw.



*Gábor Hunya*

## **Romania: Desperate austerity**

The contraction of the economy is deeper and lasting longer than earlier expected, mainly due to suppressed private demand and investment. GDP fell by 2.6% in the first quarter of 2010 compared to the same quarter of the previous year; private consumption fell by 4.8%, public consumption by 3.2% and gross fixed capital formation collapsed by 29%. But inventories were stocked up to such an extent that capital formation became positive. Exports of goods and services increased faster than imports thus net exports also contributed positively to GDP. On the production side, particularly construction but also the services sectors reduced their activities while industry recovered. Domestic demand may contract further in the wake of the new fiscal austerity measures introduced in June which will further depress the economy during the year.

Manufacturing sector output came out of recession in the first quarter, 4% higher year on year. At the same time, employment continued to decline thus labour productivity soared by 22%. The output recovery was especially robust in the industries producing basic metals, electrical machinery and motor vehicles while the production of consumer goods declined. The recovery was export driven whereas the domestic market for most goods contracted. Domestic car sales went down further and retail sales plummeted at two-digit rates while the value of motor vehicles exports soared. Goods exports increased by 19% in the first quarter, as much as they had declined in the same period of the previous year. Imports rose only by 11% comprising mostly inputs for the export sector.

The government had to give up the implementation of the budget law for the current year which had been passed in January and had planned a deficit of 5.8% of GDP<sup>46</sup>. Revenues in the first four months were 1.2% lower and expenditures were 3.4% higher in nominal terms as compared to the same period of last year. According to the calculations of the IMF, the fiscal deficit would have soared to above 9% of GDP had no action been taken. Such a gap could not have been financed under the current programme. An amendment of the fiscal target was agreed with the IMF in May 2010 to keep the deficit below 6.8% of GDP. This is still higher by almost one percentage point than stipulated in the budget law but demanding austerity in the current circumstances.

<sup>46</sup> The reported and targeted general government budget deficits are on a cash basis according to IMF methodology. The deficit by EU definition (quoted in Table RO) includes fiscal commitments. In 2009, the deficit by EU definition was 1.1 percentage points higher than by IMF definition. Fiscal commitments are to a large extent payment arrears the government accumulated to meet the deficit target agreed with the IMF. The government promised the Fund to reduce these arrears but has been unable to meet that target.

A debate unfolded whether the fiscal deficit should be curtailed by cutting expenditures or by increasing revenues. The government, in agreement with the business sector, declared that they were against revenue-side measures and advocated general expenditure cuts in the public sector. Wages in the public sector were cut by 25%, and as of 1 July 2010 pensions and unemployment benefits had to be cut by 15%. The lowest wage in the economy of RON 600 (EUR 144) per month and the minimum guaranteed pension of RON 350 were kept intact. (Just eight months before, word was still about increasing the minimum pension to RON 500.) The measures do not apply to the state-owned companies. Their employees' wages have only been frozen. The state will also eliminate subsidies to district heating and tax allowances on companies' food stamps. Unions announced a general strike on indefinite term beginning on 31 May and affecting all main public sectors – education, healthcare and public administration – but they were not sufficiently organized to really challenge the government. Also the non-confidence vote in Parliament failed, thus the measures could have been implemented had the constitution court not voted against the reduction of pensions on 25 June. As these measures could not be implemented, the government decided to increase value-added tax from 19% to 24%.

Owing to the new measures at least the cost of borrowing can be earned for the current year. In 2010, Romania is due to pay interests and commissions on its public foreign debts amounting to approximately EUR 2 billion. Estimates indicate that thanks to the austerity measures the government will reduce expenses on public sector employees by EUR 1.3 billion in the second half of the year and earn by the increasing VAT revenues another EUR 1-1.3 billion. On the whole, the government opted for a simple solutions and not for sophisticated and more cumbersome reforms of the inefficient public administration. Cutting employment and salaries across the board without introducing structural reforms may increase bottlenecks in public services and related costs for the business sector. The austerity impact will affect the whole economy as lower government expenditures will lead to a further fall of domestic demand. The VAT surge will add to inflation and further curtail demand.

The government also decided to enforce new measures aimed at curbing tax evasion. On 1 August, the authorities will suspend the licences of customs warehouse operators and will issue new ones to those that have no debts towards the state budget and pay a guarantee. Credit institutions will have to provide the National Agency for Fiscal Administration with data about the cash flows and/or balances of the accounts they manage, and to inform it whether they leased safe-boxes to creditors. Financial Guard commissaries and Customs Authority employees will see their powers extended to fight tax evasion.

Revenue shortfalls to the budget were first of all due to the mounting financial problems of companies. Also banks have made increasing provisioning for the rapidly increasing bad debts as the insolvency of companies soared. But interest rates on new loans declined in the first half of the year while the credit volume contracted in real terms. The National Bank reported that in April 2010, 4.7% of the debts was past-due against 2.4% a year earlier. The number of debtors shrank by 3.8%, but those in default increased by 16% year on year. The share of non-performing loans (overdue by 90 days or more) in total loans increased from 18.5% in April 2009 to over 25% in January 2010 and

has stayed on that very high level through April (the highest among the CESEEs). Meanwhile the banks have increased their prudential indicator (solvency ratio) to 15% against the minimum requirement of 8%. While the banking sector seems to be able to cope with the impacts of the crisis, the domestic market oriented non-financial private sectors face more hardship to come.

Romania's external financing underwent radical changes in 2009 and further in the first quarter of 2010. The adjustment of the current account took place by a sharp improvement of the trade balance, last year by import adjustments, in 2010 by an export boom. Despite lower deficits on goods and services in the first quarter of 2010 than one year before, the current account deficit increased due to subsiding current transfers in which remittances of Romanians working abroad declined by 35%. While in 2008 remittances amounted to 3.6% of GDP, they fell to 2.9% in 2009 and may further go down to 1.6% in 2010. Remittances are missing not only in the current account but also in households' income available for private consumption. On the financial account Romania was in a dire position in 2009 when FDI and the IMF-led loan package provided by and large the only positive inflow positions. In the first quarter of 2010 portfolio investments and foreign deposits returned while direct investments declined. These items were more than enough to finance the current account deficit. The disbursed tranche of the IMF loan added, the National Bank's reserves were stocked up by EUR 3 billion. Some of these reserves were depleted in the second quarter in the absence of a new IMF tranche.

2010 growth expectations for the Romanian economy have been adjusted downwards. In April, the IMF, unisono with the Romanian government and the EU Commission, revised its forecast to +0.8% compared to the earlier estimate of 1.3%. A month later, IMF representatives predicted a slump of the economy by 0.5% compared to 2009. This is now the official government forecast as well, which underlies the budget rectification including the austerity measures. The wiiw forecast of February 2010 predicted a stagnation of GDP which is now revised to -1%. Also the growth in the coming two years has been revised downwards. The main reason for the downward adjustment is fiscal austerity not only in Romania with its negative effects on consumption in the country, but also across the EU which will curtail demand there and thus export possibilities for Romania. Unemployment is modestly rising but its rate will remain below 9% in 2010. Inflation is at about 4% annually and cannot subside mostly due to government-initiated price rises (subsidies for district heating and energy are to be phased out) and rising import prices. The current account deficit will increase to about 6% of GDP which is within the foreseeable financial limits of the country. As for 2011, most outside observers including the IMF expect a strong rebound of the Romanian economy based on optimistic international expectations. In our view, the recovery will turn out less robust. The domestic demand factors may recover only hesitantly while even a minor recovery will provoke a negative contribution of net exports.

Table RO

## Romania: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average	21588	21547	21514	21482	.	.	21460	21440	21410
Gross domestic product, RON mn, nom.	344651	416007	514654	491274	96617	96707	510700	539100	583000
annual change in % (real)	7.9	6.3	7.3	-7.1	-6.2	-2.6	-1	1.5	3
GDP/capita (EUR at exchange rate)	4500	5800	6500	5400	.	.	.	.	.
GDP/capita (EUR at PPP)	9100	10400	12000	10600	.	.	.	.	.
Consumption of households, RON mn, nom.	233135	273418	327882	301416	65913	65017	.	.	.
annual change in % (real)	12.9	12.0	9.5	-10.9	-12.3	-4.8	-2	1	2
Gross fixed capital formation, RON mn, nom.	88272	125645	164264	125826	22995	16613	.	.	.
annual change in % (real)	19.9	30.3	16.2	-25.3	2.7	-28.9	-10	5	10
Gross industrial production <sup>2)</sup>									
annual change in % (real)	9.3	10.3	2.6	-5.5	-13.0	4.1	4	5	7
Gross agricultural production									
annual change in % (real)	2.4	-17.7	21.2	-1.1	.	.	.	.	.
Construction industry <sup>2)</sup>									
annual change in % (real)	15.4	33.2	26.7	-15.0	2.7	-20.9	.	.	.
Employed persons - LFS, th, average	9291.2	9353.3	9369.1	9243.5	9038.6	.	9150	9150	9200
annual change in %	1.9	0.7	0.2	-1.3	-0.9	.	-1	0	1
Unemployed persons - LFS, th, average	728.4	640.9	575.5	680.7	666.1	.	.	.	.
Unemployment rate - LFS, in %, average	7.3	6.4	5.8	6.9	6.9	.	8.5	8	6
Reg. unemployment rate, in %, end of period	5.2	4.0	4.4	7.8	5.6	8.4	.	.	.
Average gross monthly wages, RON	1146.0	1396.0	1761.0	1887.1	1865.7	1993.7	.	.	.
annual change in % (real, net)	9.0	14.7	16.5	2.0	9.3	0.9	.	.	.
Consumer prices (HICP), % p.a.	6.6	4.9	7.9	5.6	6.8	4.6	4	3	4
Producer prices in industry, % p.a.	9.5	7.5	15.3	1.8	5.7	3.5	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	33.1	33.5	32.1	32.1	.	.	.	.	.
Expenditures	35.3	36.0	37.6	40.4	.	.	.	.	.
Net lending (+) / net borrowing (-)	-2.2	-2.5	-5.4	-8.3	.	.	-8	-7	-6
Public debt, EU-def., in % of GDP	12.4	12.6	13.3	23.7	.	.	27	31	33
Discount rate of NB, % p.a., end of period <sup>3)</sup>	8.75	7.50	10.25	8.00	10.1	7.3	.	.	.
Current account, EUR mn	-10220	-16758	-16178	-5167	-910	-1504	-7000	-9000	-11000
Current account in % of GDP	-10.5	-13.4	-11.6	-4.5	-4.0	-6.4	-5.8	-6.8	-7.5
Exports of goods, BOP, EUR mn	25953	29542	33656	29124	6601	7879	33200	36500	40900
annual growth rate in %	16.6	13.8	13.9	-13.5	-19.0	19.4	14	10	12
Imports of goods, BOP, EUR mn	37765	47365	52729	35907	8148	9048	39500	43500	49600
annual growth rate in %	25.6	25.4	11.3	-31.9	-33.9	11.0	10	10	14
Exports of services, BOP, EUR mn	5585	6885	8751	7012	1678	1341	6300	6300	6900
annual growth rate in %	36.2	23.3	27.1	-19.9	-12.6	-20.1	-10	0	10
Imports of services, BOP, EUR mn	5581	6475	8091	7367	1743	1613	6600	6600	7300
annual growth rate in %	25.4	16.0	25.0	-8.9	-2.0	-7.5	-10	0	10
FDI inflow, EUR mn	9060	7280	9501	4528	1475	754	3500	.	.
FDI outflow, EUR mn	338	206	186	158	4	38	.	.	.
Gross reserves of NB excl. gold, EUR mn	21299	25325	25977	28303	25121	32037	.	.	.
Gross external debt, EUR mn	41196	58628	72354	80200	71500	86034	.	.	.
Gross external debt in % of GDP	40.4	50.8	56.6	69.2	61.7	70.8	.	.	.
Average exchange rate RON/EUR	3.5258	3.3353	3.6826	4.2399	4.2682	4.1148	4.2	4.1	4.0
Purchasing power parity RON/EUR	1.7600	1.8621	1.9869	2.0739	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 4 and more employees. - 3) Reference rate of NB.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.



*Zdenek Lukas*

## **Slovakia: Export-driven growth, but rising unemployment**

With surprising strength and earlier than expected, the Slovak economy is recovering and returning on the path of economic growth, the highest among the NMS. The economic expansion has been largely the result of the revival in external demand supported by improved competitiveness. GDP was up by 4.8% in the first quarter of 2010 as the external sector improved. The volume of exports and imports (goods and services) expanded by 16.8% and 9.9% respectively. Gross capital formation declined by 2.2%, gross fixed capital formation almost stagnated (-0.4%). As a result, inventories declined moderately – but the speed of contraction decelerated substantially. Companies may not have been able to reactivate production in the export-oriented sectors early enough in order to meet the strong demand from abroad and thus may have partly resorted to their stocks instead of increasing production. Real wages rose modestly (by 1.6%) and unemployment increased strongly; the purchasing power declined and consumers' caution was rising. As a result, private consumption stagnated.

The main reason behind the economic expansion has been improved competitiveness. As in other eurozone countries, the weakening of the euro is having a positive impact on the economy in particular as compared to its non-euro neighbours. Among those, the Czech Republic is Slovakia's second most important trading partner after Germany, with a share of about 13% in total Slovak exports. Poland accounts for 8% of total Slovak exports. In the first quarter of 2010 the Slovak currency (i.e. the euro) depreciated by 7% year-on-year against the Czech koruna and even by 13% against the Polish zloty. Apart from the depreciation, the export expansion has been facilitated by a strong fall in unit labour costs (ULCs) coupled with rising labour productivity and falling producer prices. The outcome of this mix is boosting the country's competitiveness on non-euro markets and also, to a lesser extent, in the eurozone. However, increasing unemployment is the shadow side of rising export competitiveness. In this respect the foreign firms' behaviour contrasts strongly with that in their home countries – Germany, Italy, Austria – where various employment support schemes helped to maintain employment.

The rising competitiveness coupled with recovering external demand has stimulated growth in industry. Gross industrial output rose by 20% in the first quarter of 2010, whereas industrial employment (LFS data) dropped by 12% (about 20% of industrial jobs were shed within one year). As a result, industrial labour productivity increased by about 30%. With nominal wages up by some 8% (partly due to structural effects as less skilled and less paid jobs were cut), ULCs declined by some 20%. In addition, the mentioned euro depreciation against a basket of currencies has boosted the competitiveness of Slovak tradable goods outside the euro area (one-half of exports) even more.

Total exports rose faster than imports and the foreign trade surplus amounted to EUR 302 million in the first quarter of 2010, as compared to a deficit of EUR 240 million in the corresponding period of 2009. Notably, while total exports rose by 18%, exports to Poland and the Czech Republic expanded by 33% and 22% respectively (in euro terms).

As in the pre-crisis period, foreign investment enterprises in the automotive industry are the most important driving force of the economy. Expanding by 53% in the first four months of 2010, car output recovered significantly faster and more strongly than expected. That growth was exclusively export-driven: car sales in Slovakia dropped by more than 40% year-on-year in spring 2010. Similar to the experience of other EU countries, the car-scrapping scheme fuelled demand in Slovakia only in the first half of 2009. Robust growth in the first four months of 2010 was also observed for machinery (53%), chemical products (36%), electrical equipment (33%) and steel production (25%). However, despite the optimistic mood prevailing in manufacturing, the reported year-on-year growth has to be seen against the background of the low statistical base in the corresponding period 2009 when the sector collapsed. As opposed to industry, construction output continued to fall (by 10%) in the first four months of the year. Nevertheless, prospects are encouraging as highway construction (supported by EU transfers) could provide an important impetus to the construction industry.

Although in the course of 2009 the government had adopted several anti-crisis measures chiefly targeted at the support of household consumption and employment, the recent revival has been solely export-led. In addition, the Slovak labour market has significantly deteriorated, with the unemployment rate (LFS) rising by 4.6 percentage points year-on-year to an average level of 15% in the first quarter of 2010. In particular industry, being foreign-owned to a high degree, has been affected. The country's eastern and southeastern districts are still struggling with the highest unemployment. However, also Bratislava – where the bulk of prosperous FDI companies is located and which so far has been an 'island' of high employment – is now facing rising unemployment as these companies have started laying off staff.

The average harmonized inflation rate amounted to 0.9% in 2009 and came to a complete halt in the first quarter of 2010. That also reflects the depressed state of the economy, of consumption and retail trade. In the first five months of the year the budgetary revenues stagnated, whereas the expenditures – before the elections – rose by 26% year-on-year. If the budgetary deficit were to rise at the same rate, the general government deficit would amount to more than 7% of GDP in 2010. In the light of recent developments, the envisaged reduction of the general government deficit from 6.8% to 5.5% of GDP in 2010 and eventually to 3% in 2012 is far from certain. Apart from the current dynamics of the rising budget deficit there are other concerns such as the absence of binding limits on budgetary expenditures, the long-term sustainability of the pension system (due to the ageing population and cuts in the second, i.e. private, pillar of the pension system) and rising unemployment benefits. Past experience has shown that only several years of strong GDP growth have an effect on employment. The need for public spending will therefore remain for some time to come.

Following FDI inflows of EUR 2.4 billion in 2008, foreign direct investment came to a standstill in 2009 as some investors left the country, curbed investment or postponed planned investment.

Although the economy is recovering, there is still not much room for a revival of FDI due to unused production capacities. Starting in 2011, VW will produce its New Small Family models in Slovakia and invest here EUR 300 million. Besides, the Slovak electric utility company Slovenské elektrárne (66% of shares owned by the Italian energy company Enel) will complete the third and fourth units of the Mochovce nuclear power station. This – the biggest – private investment (EUR 2.7 billion) is to be spent up until 2013.

The economic sentiment indicator is still lower than the long-term average (by 8 percentage points), but it increased by 24 points in May 2010 year-on-year. In addition, new orders received in industry show signs of recovery. In manufacturing new orders increased by 30% year-on-year in the first quarter of 2010. It seems that there is sustained optimism in the recovery. Backed by the current expansion, industrial output may grow by more than 15% this year. That should be boosted by a recovery in FDI inflows in 2010 to about EUR 1 billion with further FDI growth in the following years.

As for sustainable economic growth in the future, the crucial point is to avoid any measures that would threaten Slovakia's regained competitiveness and thus might undermine its competitive position particularly within the EU. If the euro remains weak and ULCs low, GDP growth may expand by above 3% in 2010. Later on, provided a strong recovery of the economies of Slovakia's main trading partners, GDP growth may even accelerate. However, economic growth powered by massive consumption appetite will not return to the high rates seen a few years ago, as the purchasing power will rise only moderately. The trade surplus and an improving income balance may diminish the current account deficit to below 3% of GDP in 2010. The main challenges for the new government relate to rising unemployment and an escalating budget deficit.

Although the ruling party Smer-SD, led by Robert Fico, won (with nearly 35%) the parliamentary elections held on 12 June, it was not able to form the next government. Its previous ally, the LS-HZDS party headed by Vladimir Mečiar, did not pass the 5% threshold required to enter parliament, and its second ally, the extreme-nationalist Slovak National Party (SNS), surpassed the threshold only by a close vote. On the other side, the entire opposition centre-right block – led by the Slovak Democratic and Christian Union – Democratic Party (SDKU-DS), together with the new liberal party Freedom and Solidarity (SaS) and the Christian Democrat Movement (KDH), and with the moderate ethnic Hungarian party called the Bridge (MOST-HID) – has a majority with 79 seats in the 150-seat parliament. This block formed the new government, as the four parties' leaders rejected to cooperate with Smer-SD.

The elections being over, the most important challenge for the new cabinet is to prepare, in due time, a plausible austerity budget for 2011 and a credible programme of medium-term fiscal stabilization. Failing that, Slovakia's international rating would decline and interest rates along with costs of debt service would rise – and the growth of public debt (currently at some 40% of GDP) and of gross external debt (about 70% of GDP) would accelerate. In all likelihood the new government will be forced to cut public expenditures or increase the tax burden or both. With the centre-right oriented government the willingness to reform and to prepare a credible stabilization programme can be expected to be high.

Table SK

## Slovakia: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average	5391.4	5397.3	5406.6	5418.2	.	.	5420	5430	5440
Gross domestic product, EUR mn, nom.	55045.5	61547.1	67221.0	63331.6	14656.0	15072.0	64600	68500	73400
annual change in % (real)	8.5	10.6	6.2	-4.7	-5.7	4.8	3	4	4
GDP/capita (EUR at exchange rate)	8300	10200	12000	11700	.	.	11900	12600	13500
GDP/capita (EUR at PPP)	15000	16900	18100	17000	.	.	.	.	.
Consumption of househ., EUR mn, nom.	30815.7	33860.3	37554.9	37674.1	9249.0	9184.0	.	.	.
annual change in % (real)	5.9	7.1	6.1	-0.7	-0.9	0.4	1	2	3
Gross fixed capital form., EUR mn, nom.	14588.8	16096.5	16715.6	14943.2	3405.0	3312.8	.	.	.
annual change in % (real)	9.3	9.1	1.8	-10.5	-3.9	-0.4	1	4	5
Gross industrial production annual change in % (real)	15.0	17.2	2.3	-14.5	-22.6	20.2	15	5	7
Gross agricultural production annual change in % (real)	-2.9	-4.5	10.6	-5.9	.	.	.	.	.
Construction industry annual change in % (real)	14.9	5.7	11.9	-11.3	-13.6	-13.9	.	.	.
Employed persons - LFS, th, average	2302.3	2357.7	2433.7	2366.3	2388.2	2283.1	2310	2310	2330
annual change in %	3.9	2.4	3.2	-2.8	-0.1	-4.4	-3	0	1
Unemployed persons - LFS, th, average	355.4	295.7	255.7	323.5	281.0	407.1	.	.	.
Unemployment rate - LFS, in %, average	13.4	11.1	9.5	12.0	10.5	15.1	15	14	13
Reg. unemployment rate, in %, end of period	9.4	8.0	8.4	12.7	10.3	12.9	14	13	12
Average gross monthly wages, EUR <sup>2)</sup>	623	669	723	745	711.0	725	.	.	.
annual change in % (real, gross)	3.3	4.3	3.3	1.4	1.7	1.6	.	.	.
Consumer prices (HICP), % p.a.	4.3	1.9	3.9	0.9	2.3	0.0	1	2	2
Producer prices in industry, % p.a.	3.0	-1.4	2.5	-6.6	-5.1	-3.4	-2	2	2
General governm.budget, EU-def., % GDP									
Revenues	33.5	32.5	32.5	34.0	.	.	.	.	.
Expenditures	36.9	34.4	34.8	40.8	.	.	.	.	.
Net lending (+) / net borrowing (-)	-3.5	-1.9	-2.3	-6.8	.	.	-7	-6.5	-6
Public debt, EU-def., in % of GDP	30.5	29.3	27.7	35.7	.	.	42	45	45
Discount rate of NB, % p.a., end of period <sup>3)</sup>	4.8	4.3	2.5	1.0	1.5	1.0	.	.	.
Current account, EUR mn	-3636	-3141	-4279	-2023	-576	-247	-1800	-3000	-3500
Current account in % of GDP	-8.2	-5.7	-6.6	-3.2	-3.9	-1.6	-2.8	-4.4	-4.8
Exports of goods, BOP, EUR mn	33349	42171	47722	39715	9125	10564	44000	45000	47000
annual growth rate in %	30.0	26.5	13.2	-16.8	-21.2	15.8	10	3	5
Imports of goods, BOP, EUR mn	35817	43009	48435	38528	9172	10255	42000	43000	45000
annual growth rate in %	29.9	20.1	12.6	-20.5	-19.4	11.8	8	2	5
Exports of services, BOP, EUR mn	4322	5140	5796	4522	1027	984	4700	4800	5000
annual growth rate in %	22.0	18.9	12.8	-22.0	-18.8	-4.2	4	3	4
Imports of services, BOP, EUR mn	3790	4752	6269	5768	1422	1259	6100	6400	6800
annual growth rate in %	15.4	25.4	31.9	-8.0	5.3	-11.5	5	5	6
FDI inflow, EUR mn	3311	2108	2395	-35	394	309	1000	1500	2000
FDI outflow, EUR mn	292	149	177	311	217	-10	300	400	500
Gross reserves of NB excl. gold, EUR mn <sup>4)</sup>	9639	12280	12674	481	182	516	.	.	.
Gross external debt, EUR mn	24449	30156	37286	45328	40257	46290	.	.	.
Gross external debt in % of GDP	50.8	54.6	55.5	71.6	63.6	71.7	.	.	.
Average exchange rate EUR/EUR	1.236	1.121	1.038	1.000	1.00	1.00	1.00	1.00	1.00
Purchasing power parity EUR/EUR	0.681	0.677	0.687	0.689	.	.	.	.	.

Note: Slovakia introduced the euro on 1 January 2009. Up to and including 2008 all time series in SKK as well as exchange rates and PPP rates have been divided for statistical purposes by the conversion factor 30.126 (SKK per EUR) to a kind of statistical EUR (euro-fixed).

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) From 2006 including wages of armed forces. - 3) 2-week limit rate of NB for REPO tenders, from 2009 official refinancing operation rates for euro area (ECB). - 4) From January 2009 (euro introduction) only foreign currency reserves denominated in non-euro currencies.

Source: wiw Database incorporating Eurostat and national statistics. Forecasts by wiw.



*Hermine Vidovic*

## **Slovenia: Strenuous recovery after severe recession**

Slovenia's economic downturn continued during the first quarter of 2010 but at a slower pace than in 2009. GDP fell by 1.2% resulting from a further shrinkage of investment and stagnating household consumption; gross fixed capital formation dropped by 10%, of which investments in construction were affected most. Contrary to other eurozone countries where inventories are being rebuilt after having been cut significantly in 2009, they still contribute negatively to GDP growth in Slovenia. Government consumption increased slightly. The contribution of foreign trade to GDP growth was positive for the fifth quarter in a row as exports growth exceeded that of imports.

Industrial production stagnated during the first months of the year, but a gradual recovery has been under way in export-oriented sectors: for instance, car production and production of electrical equipment rose by 28-30% compared to the same period a year earlier. Other branches are heavily affected by high indebtedness (reporting the highest shares of non-performing assets) such as food and wood processing, the paper and metal industries and the manufacture of machinery. In construction, one of the main drivers of GDP growth in the period prior to the crisis, output dropped by 19%. Currently there are no signs of recovery in construction, particularly in residential building, as there is still a high number of unsold apartments on the market. Civil engineering, particularly the construction of road infrastructure, will be limited due to fiscal constraints. As a consequence several construction companies and supplier companies are reported to be in severe financial difficulties.

Slovenia's labour market is continuing to deteriorate at a moderate pace. Labour Force Survey data indicate employment stagnation, while national account data point to a 3.5% rate of decline during the first quarter of 2010. Employment cuts were largest in manufacturing, mining and construction. This trend is likely to continue throughout 2010 and will affect migrant workers in particular as they account for about half of the total workforce in construction. Two acts passed by the parliament in 2009 in order to combat the rapidly rising unemployment – one envisaging subsidies in the case of short-time work, the other one foreseeing up to 85% wage compensation of average earnings of the last three months for those laid off temporarily – will partly remain in force in 2010. In the first quarter the LFS unemployment rate stood at 7%, with men more affected than women. Information obtained from registration data shows a steady increase in unemployment since September 2008, putting the unemployment rate at close to 11% at the end of March 2010. At the same time inactivity has been rising as well.

In an attempt to boost liquidity and help companies squeezed by the credit crunch to acquire loans the Slovenian government passed a law providing EUR 1 billion state guarantees for companies

registered in Slovenia. Accordingly the government will take 75% of the risk, while the remaining 25% are borne by the banks. Banks will be able to use these loans as collateral for loans from the ECB. Individual loans will range from EUR 500,000 to EUR 20 million with a maturity between one and ten years. Already in 2009 the Slovenian parliament adopted a state guarantee scheme for physical persons which will be in force until the end of 2010. The latter has earmarked EUR 350 million for bank guarantees in case temporarily employed and young families cannot repay their loans. In addition the state will take over the risk for consumer loans taken by those who lost their job due to the financial and economic crisis. Bank net lending during the first quarter of 2010 was still lower than in the same pre-year period but regained momentum in March. This was primarily due to rising household borrowing, housing loans in particular, while corporate borrowing fell significantly.

According to final results Slovenia's general government deficit stood at 5.5% of the GDP in 2009 and public debt rose by more than 13 percentage points to 35.9% of the GDP, which is still low if compared with the euro area average (78%). Estimates of the Ministry of Finance suggest that anti-crisis measures, such as partially subsidising full time work, raised the general government deficit by the equivalent of the 0.7% of the GDP. The deficit and part of the debt repayment was mainly financed through the issuance of government bonds in 2009 and early 2010. Following the poor economic results during the beginning of 2010, the lower than expected tax revenues and the financial assistance for Greece the Slovenian government decided in May on a supplementary budget for 2010 and amended budgets for 2011 and 2012. The budget supplement, envisaging a deficit below 5% instead of 5.7% adopted initially should be introduced by the end of summer. The originally enacted budget documents envisage the withdrawal of the fiscal stimulus and support measures by the end of 2010. Following the expenditure based fiscal consolidation plan, the Slovenian government adopted measures including a postponement of public sector wage increases, shifting investment financing towards EU funds and a less generous indexation of social benefit rates. According to the guidelines for the supplementary 2010 budget expenditures should be cut by an additional EUR 500 million, which will affect new investments most.

At a referendum held on 6 June Slovenian voters backed a border treaty calling for an arbitration panel to settle an almost 20 year old border dispute with Croatia. According to an agreement between the prime ministers of the two countries the finding of the arbitration panel about the maritime border (Piran Bay) and some smaller border disputes will be binding. After two years of negotiations Slovenia became an OECD member at the beginning of June.

wiiw expects GDP to be slightly positive in 2010 owing to moderately rising foreign demand. In addition, first results owing to the measures set by government to encourage lending to the private sector should become visible. Given fiscal consolidation public investment will need some time to recover and will regain strength only in 2012. Private consumption will rise only gradually as disposable income is held back by further job reductions this year and probably stagnation in 2011; at the same time unemployment will continue to rise. Key to a potential recovery will be the developments in Slovenia's main trading partners, Germany and Italy in particular. More robust growth can be expected in 2011 and 2012 under the assumption of stronger export demand than in 2010, while domestic demand will recover only at a moderate pace.

Table SI

**Slovenia: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average	2006.9	2018.1	2021.3	2043.2	.	.	2045	2045	2045
Gross domestic product, EUR mn, nom.	31050.4	34568.2	37135.4	34893.9	8287.1	8234.8	35590	37030	38710
annual change in % (real)	5.8	6.8	3.5	-7.8	-8.2	-1.2	0.5	2	2.5
GDP/capita (EUR at exchange rate)	15500	17100	18400	17100	.	.	17400	18100	18900
GDP/capita (EUR at PPP)	20700	22100	22800	20500	.	.	.	.	.
Consumption of households, EUR mn, nom.	16156.1	17944.2	19296.9	18851.5	4406.9	4421.5	.	.	.
annual change in % (real)	2.9	6.7	2.1	-1.4	-1.1	0.0	0.5	1.5	2
Gross fixed capital form., EUR mn, nom.	8242.1	9571.3	10742.4	8369.0	1995.3	1766.6	.	.	.
annual change in % (real)	9.9	11.7	7.7	-21.6	-22.2	-10.1	-7	4	4
Gross industrial production									
annual change in % (real)	5.7	7.1	2.4	-17.1	-17.9	-0.1	1	3	3
Gross agricultural production									
annual change in % (real)	-7.4	3.9	-0.8	-1.7	.	.	.	.	.
Construction industry									
annual change in % (real)	15.7	18.5	15.5	-21.5	-19.2	-18.9	.	.	.
Employed persons - LFS, th, average	961	985	996	981	962	965	966	966	976
annual change in %	1.3	2.5	1.1	-1.5	-0.9	0.3	-1.5	0	1
Unemployed persons - LFS, th, average	61	50	46	61	54	74	.	.	.
Unemployment rate - LFS, in %, average	6.0	4.8	4.4	5.9	5.3	7.1	8	7.5	7
Reg. unemployment rate, in %, end of period	8.6	7.3	7.0	10.5	8.4	10.6	11	11	10.5
Average gross monthly wages, EUR	1213	1285	1391	1439	1408	1460	.	.	.
annual change in % (real, net)	2.5	4.2	2.0	2.5	3.2	1.8	.	.	.
Consumer prices (HICP), % p.a.	2.5	3.8	5.5	0.9	1.7	1.7	1.5	2	2
Producer prices in industry, % p.a.	2.3	4.4	3.9	-1.4	1.1	-1.2	-1	2	2
General governm.budget, EU-def., % GDP									
Revenues	43.2	42.4	42.6	44.4	.	.	.	.	.
Expenditures	44.5	42.4	44.3	49.9	.	.	.	.	.
Net lending (+) / net borrowing (-)	-1.3	0.0	-1.7	-5.5	.	.	-6	-4.5	-4.5
Public debt, EU-def., in % of GDP	26.7	23.4	22.6	35.9	.	.	40	42	43
Discount rate of NB, % p.a., end of period <sup>2)</sup>	3.8	4.0	2.5	1.0	1.5	1.0	.	.	.
Current account, EUR mn	-772.0	-1646.0	-2286.0	-340.0	-267.4	-60.2	-300	-600	-900
Current account in % of GDP	-2.5	-4.8	-6.2	-1.0	-3.2	-0.7	-0.8	-1.6	-2.3
Exports of goods, BOP, EUR mn	17028.0	19799.0	20048.0	16203.0	3940.2	4213.1	17250	18100	19200
annual growth rate in %	16.6	16.3	1.3	-19.2	-22.5	6.9	6.5	5	6
Imports of goods, BOP, EUR mn	18179.0	21465.0	22699.0	16825.0	4089.6	4284.7	17650	18700	20000
annual growth rate in %	16.3	18.1	5.7	-25.9	-26.6	4.8	5	6	7
Exports of services, BOP, EUR mn	3573.0	4146.0	5041.0	4318.0	927.4	915.5	4300	4550	4900
annual growth rate in %	11.2	16.0	21.6	-14.3	-11.9	-1.3	0	6	8
Imports of services, BOP, EUR mn	2580.0	3098.0	3431.0	3298.0	691.7	694.0	3330	3560	3880
annual growth rate in %	12.5	20.1	10.7	-3.9	-3.8	0.3	1	7	9
FDI inflow, EUR mn	514.0	1106.0	1313.0	-48.0	-5.1	-16.8	0	.	.
FDI outflow, EUR mn	687.0	1316.0	933.0	624.0	134.3	140.4	.	.	.
Gross reserves of NB excl. gold, EUR mn <sup>3)</sup>	5341.7	666.0	623.0	670.8	531.6	639.0	.	.	.
Gross external debt, EUR mn	24067	34783	39238	40112	37510	40688	.	.	.
Gross external debt in % of GDP	77.5	100.6	105.7	115.0	107.5	114.3	.	.	.
Average exchange rate EUR/EUR	1.000	1.000	1.000	1.000	1.000	1.000	1	1	1
Purchasing power parity EUR/EUR	0.746	0.776	0.806	0.834	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary . - 2) Main refinancing rate, from 2007 official refinancing operation rates for euro area (ECB). - 3) From January 2007 (euro introduction) only foreign currency reserves denominated in non-euro currencies.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.



*Sebastian Leitner*

## **Baltic States: Everything for the euro?**

As expected, in the Baltic States the economic hardship has not only been the deepest, but it is also lasting longer than in other countries of the CEE region, with GDP still declining in the first quarter of 2010 year-on-year. The aim to maintain the currencies pegged to the euro and to join the eurozone as soon as possible required drastic austerity measures. These triggered massive output losses and provoked a deflationary period. As households and enterprises have to reduce their debt positions built up in the boom period, domestic demand will fall further this and at least in the first half of next year. Thus the Baltics are clinging to the hope of a sustained revival of external demand of their trading partners.

### **Estonia**

In the midst of the severe economic crisis, Estonia managed to head into the eurozone by performing drastic procyclical fiscal policies that safeguarded a public deficit of only 1.7% in 2009, while GDP slumped by 14%. On 8 June 2010 the ECOFIN meeting decided to support the introduction of the euro in Estonia following the country's positive assessment in the convergence report of the European Commission and the ECB. The only pondering remark in the report was the assumption that inflationary pressures are likely to rise again when GDP growth picks up, pointing to the danger of a renewed boom-bust cycle in the Estonian economy. The formal approval of the euro introduction, to take place on 1 January 2011, will be arranged at the ECOFIN meeting on 13 July.

Although the trough of the depression has been passed, GDP still fell by 2% year-on-year in the first quarter of 2010. Domestic demand will continue to decline in the rest of the year. Private consumption is depressed by the sharp rise in unemployment and the cuts in real wages alike. However, looking at wage developments at the sectoral level, one can observe that salaries declined mostly in the public sector and even more so in the finance and real estate sectors, but remained stable in industry. This implies that, although we see a dampening of internal demand, the expected wage-induced improvement of external competitiveness in the tradable goods sector has so far not materialized. Thus the observed fall in unit labour costs is only due to the strong shedding of labour in the past two years. In the first quarter of 2010 the unemployment rate jumped to 19.8%, in the case of persons aged 15-24 even to 40%. As usual the labour market situation of the Russian-speaking population is more dramatic than that of the autochthon citizens, the former facing an unemployment rate of 28% in the first quarter of the year. Employment dropped by almost 10% within one year, driven predominantly by layoffs in manufacturing (-15%) and construction (-30%) but also in domestic trade (-11%) and education (-17%). As the share of long-term unemployed in

total unemployment is rising, the share of those receiving benefits is going to decline. At the end of May only about one third of registered unemployed persons actually received benefits. Despite the expected revival of output growth in the second half of the year and thereafter, unemployment rates will remain double-digit for several years. Since FDI and credit flows into the country will remain lower than in the boom period, the growth path of Estonia and its Baltic neighbours will depend on the economic restructuring towards the production of tradable goods, a task which, if feasible, will take some time.

As is the case with household consumption, gross fixed investments will also still be depressed during 2010. However, overall investment will be on the rise as enterprises are again accumulating inventories after the massive destocking that took place in 2009. At the same time public demand is damped by the Estonian government's eagerness to keep the budget deficit within the Maastricht limits. However, further expenditure cuts and tax increases – which were announced along with the plan to reduce the deficit in 2011 – will be difficult to enforce: the opposition has already signalled its resistance to the plans of the minority government of Prime Minister Andrus Ansip. With the aim of euro accession already attained, that resistance may become even stronger from now on.

With domestic demand on the decline, exports are to become an important growth driver in Estonia in 2010. As did most other countries of the region also Estonia has recently experienced a swift revival of goods exports, amounting to more than 20% year-on-year in the first four months of 2010. However, exports of services, accounting for one third of total exports, stagnated, reflecting the region-wide economic slump. Furthermore, external demand on the part of the main export destinations Finland and Sweden grew only slightly, while trade with Germany fell even further in the first months of the year. Although we expect a continuation of the export upswing, the impact on Estonian exports of the fiscal consolidation measures announced in Western Europe are uncertain and should not be left out of consideration. Nevertheless, since domestic demand will remain sluggish even throughout 2011, the current account surplus – amounting to 5.5% in the first quarter of 2010 – is expected to remain positive throughout 2011 and will turn negative only after domestic demand has become stronger.

All in all GDP is expected to rise slightly in the second half of 2010 resulting in a growth rate of 0.5% for the year as a whole. The announcement concerning the introduction of the euro, which was followed by an upgrading by rating agencies, may lead to a stabilization of investment activities and FDI inflows. The prospects for Estonia with 2.5% GDP growth for 2011 and 3.5% for 2012 thus look somewhat brighter than for its Baltic neighbours.

## **Latvia**

After the economic disaster in 2009, when GDP shrank by 18%, Latvia's output fell by another 6% year-on-year in the first quarter of 2010. In total, GDP is expected to decline by another 3.5% in 2010. The recession is mainly caused by the decline in household demand due to shrinking employment and falling income levels. The burst of the Latvian real estate and credit-driven consumption bubble resulted in an unemployment rate exceeding 20%. Within the two years of

depression employment fell by almost 20%, with reductions of more than 50% in construction and 22% in industrial sectors, but also 23% in public administration and healthcare. The enormous economic slump has been pushing the Latvian economy into a deflationary phase. In the first quarter of 2010 net salaries fell by nearly 13% nominally year-on-year, reflecting not only the massive wage cuts in the public sector but also a decline of salaries in the private service and tradable goods sectors. As a result producer prices declined and also consumer prices fell substantially, by 3.9% year-on-year in the first quarter of 2010. The rise in unemployment and the fall in wage levels has also led to a further worsening of banks' loan portfolios. By the end of May the rate of loans overdue more than 90 days had risen to 19%.

As is the case for households, non-performing credits of enterprises are also still on the rise and firms are in the process of deleveraging. Hence, in the first quarter of 2010, gross fixed capital formation slumped by as much as 45% year-on-year. A further reduction of investments will occur throughout the year, with the only counterbalancing aggregate being some restocking of inventories in the second half of the year.

Goods exports rose by close to 20% in euro terms in the first four months of the year. Looking at the detailed figures, the rise is quite unevenly distributed across sectors, with wood – Latvia's main export commodity – accounting for 45% of the trade revival. With falling unit labour costs the gain in external competitiveness may allow the export growth to be sustained, while the depression of domestic demand will keep the current account in surplus for a longer period.

In early June 2010, after visiting Latvia, the joint mission of the EU and IMF gave their approval for the disbursement of the next tranche of their rescue package. In total about EUR 400 million in additional financing will become available by the end of July from the IMF, the EU and the World Bank. However, IMF mission chief Mark Griffiths stated that Latvia's government will have to find as much as LVL 440 million (equivalent to 3.5% of GDP) in cost cuts in next year's budget in order to meet the terms of the bailout loan, i.e. to reduce the budget deficit to 6% of GDP in 2011. The Latvian government has announced that it is prepared to meet the requirements, aiming at tax increases while trying to prevent further cuts in public wages. However, an agreement on definitive measures is most unlikely before the parliamentary elections on 2 October. In mid-March the conservative People's Party resigned from the ruling coalition leaving the remaining minority government of Prime Minister Valdis Dombrovskis with a support of only 44 of 100 seats in parliament.

In the polls the left-wing party 'Harmony Centre', which is supported by the Russian speaking minority in particular, is in the lead. 'Harmony Centre', ruling the capital Riga since last year, advocates a move from the flat tax income system to progressive income taxation and has strongly criticized the austerity measures of the government. On the liberal and conservative side of the political spectrum two new electoral alliances were formed in the run-up to the elections. The 'Unity' alliance, running second in the polls, includes Valdis Dombrovskis' 'New Era' and two other conservative parties. The People's Party, currently the strongest party in parliament but having lost the confidence of the electorate in the past two years has formed the economic liberal alliance 'For a

good Latvia' with 'Latvia's First Party/Latvian Way' (LPP/LC). Although a victory of 'Harmony Centre' may bring about a change in the prevailing Latvian politics, it is most likely that right-wing alliances and parties will again form a coalition after the elections and continue on the path of liberal conservatism that has dominated Latvia's economic policy course since independence.

In general, Latvia's recovery from the depression will be rather sluggish in the coming three years. The consolidation path of public households and the necessary deleveraging of households and enterprises will keep domestic demand crippled, so that GDP will grow by only 0.7% in 2011 and 2% in 2012.

## **Lithuania**

Lithuanian economic activity shows a similar pattern as in the two Baltic neighbours, with GDP declining once more in the first quarter of the year, by 2.8% annually. Also here domestic demand is still depressed. Throughout 2010 household consumption is expected to fall by 7%, triggered by an unemployment rate rising to 18% and cuts in real and nominal wages by more than 6%.

Gross fixed capital investment fell even more strongly, by 30% in the first quarter of 2010, and will only pick up in the second half of the year. While consumer prices were slightly falling year-on-year in the first quarter of 2010, producer prices in industry rose by more than 6% mainly because of the revival of oil prices. Since no further hikes of indirect taxes are scheduled for the second half of the year, consumer prices are expected to remain stable throughout 2010.

The budget deficit of 8.9% in 2009 raised concerns that Lithuania might run into difficulties refinancing its rising public debt. In order to prevent the deficit from widening even further, in December last year an additional austerity package of 4% of GDP was enacted which should help to keep the deficit below 8% in 2010. In June, Prime Minister Andrius Kubilius announced plans to reduce government expenditures in the 2011 budget by a further 3%. The savings should come inter alia from extended cuts in public employee wages, a reduction of paternity leave benefits and a rise of the retirement age.

Officially, both Lithuania and Latvia still target to introduce the euro in 2014. However, the consolidation of their budgets without eradicating the plantlets of growth revival in the coming three years will be a difficult task. Hence, the allegedly 'safe haven' of the eurozone is likely to be reached at a later date.

With domestic demand declining in all sectors of the economy, also in Lithuania all hopes are directed to a rise of external demand. In the first four months of 2010 goods exports increased by 17% in euro terms. The revival of oil prices obviously had a positive impact on exports of oil and chemical products, the most important branch in Lithuania. However, other industries show a marked upswing as well. More than in Estonia and Latvia, an increase in exports could also be driven by picking up external demand from its eastern neighbours Russia and Ukraine.

In total, GDP is expected to decline by another 1.5% in 2010. Also in the following years growth will remain sluggish with only 1.5% expected in 2011 and 2.5% in 2012.

### **Can the Baltic citizens endure more austerity than others?**

In the past two years all three Baltic States have experienced the most extensive bust of all European countries, with social hardships now developing that have not been seen since the phasing-out of the transitional crisis in the first half of the 1990s. From the breakout of the crisis in 2008 to the end of 2010 GDP per capita at PPP will have dropped between 15% in Estonia and 22% in Latvia, while unemployment rates have already jumped close to 20% in all countries.

One astonishing fact is that the citizens in the Baltic countries apparently sustained, without significant opposition, the harsh austerity measures implemented throughout 2009 and set to continue in the course of budget consolidation in the coming years, whereas governments in other Eastern and Southern European countries (Greece, Romania) with substantially lower cuts in public expenditures encountered much stronger resistance. Only in early 2009, when public wage cuts were announced, protesters gathered in the streets of Riga and Vilnius. One reason for this may be that, throughout the Baltics, unions play only a minor role with density rates at or below 10%, thus their ability to organize employee protests is limited. Furthermore, since the countries gained independence from the Soviet Union, left-wing parties have generally been in a marginalized position, particularly so in Estonia and Latvia. (This may change in Latvia in October, when 'Harmony Centre' may become the strongest party in the new parliament.) That also explains why not only in the course of the crisis but also in the 15 years before, no substantial alternatives to the liberal economic and social regime evolving in the Baltic countries was formulated in the political scene.

Moreover, the strong increases in salaries in the boom period (real wages rose by 50-70% in the three Baltic countries in the five years prior to the crisis) may have appeared as windfall profits for the middle- and upper-income classes, which now makes it easier for them to cope with the experienced shortfall. However, particularly for the low- and medium-educated, the young and a large share of the Russian-speaking minority (especially in Estonia and Latvia) the liberal experiment of the Baltic States with low state intervention and currency pegs has led to social hardship and disillusionment that will last for years to come.

Table EE

**Estonia: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average	1343.5	1341.7	1340.7	1340.3	.	.	1336	1336	1335
Gross domestic product, EEK mn, nom.	206996	244504	251493	214828	52373	50541	219100	231300	249000
annual change, % (real)	10.0	7.2	-3.6	-14.1	-15	-2.3	0.5	2.5	3.5
GDP/capita (EUR at exchange rate)	9800	11600	12000	10200	.	.	.	.	.
GDP/capita (EUR at PPP)	15400	17100	16900	14300	.	.	.	.	.
Consumption of households, EEK mn, nom.	112950	132335	137499	110614	28209	26022	107200	111000	117200
annual change in % (real)	13.0	9.1	-4.8	-18.9	-17.7	-7.8	-4.5	0.5	1.5
Gross fixed capital form., EEK mn, nom.	72325	84385	73729	46967	13235	9811	45300	48100	52500
annual change in % (real)	18.6	9.0	-12.1	-34.4	-27.3	-22.8	-5	3	5
Gross industrial production									
annual change in % (real)	9.9	6.4	-5.2	-26.0	-28.5	6.2	4	7	8
Gross agricultural production									
annual change in % (real)	-2.1	12.5	-1.0	-1.7	.	.	.	.	.
Construction industry									
annual change in % (real)	27.1	16.5	-15.4	-28.4	-31.3	-34.2	.	.	.
Employed persons - LFS, th, average	646.3	655.3	656.5	595.8	612.1	553.6	570	580	590
annual change in %	6.4	1.4	0.2	-9.2	-6.8	-9.6	-4	2	2
Unemployed persons - LFS, th, average	40.5	32.0	38.4	95.1	79.0	136.9	.	.	.
Unemployment rate - LFS, in %, average	5.9	4.7	5.5	13.8	11.4	19.8	18.0	16.0	15.0
Reg. unemployment rate, in %, end of period	1.9	2.2	4.6	13.3	8.4	14.6	.	.	.
Average gross monthly wages, EEK	9407	11336	12912	12223	12147	11865	.	.	.
annual change in % (real, gross)	11.6	13.0	3.2	-5.2	-4.5	-2.6	.	.	.
Consumer prices (HICP), % p.a.	4.5	6.7	10.6	0.2	3.7	0.0	1.5	3.0	4.0
Producer prices in industry, % p.a.	4.2	8.1	8.0	0.7	4.5	-0.1	.	.	.
General governm. budget, EU-def., % GDP									
Revenues	36.5	37.4	37.1	43.6	34.6	.	.	.	.
Expenditures	34.0	34.8	39.9	45.4	46.3	.	.	.	.
Net lending (+) / net borrowing (-)	2.5	2.6	-2.8	-1.7	-11.7	.	-2.5	-2.5	-2.5
Public debt, EU-def., in % of GDP	4.5	3.8	4.6	7.2	.	.	10	13	14
Money market rate, % p.a., end of period <sup>2)</sup>	3.8	7.0	7.0	2.8	6.4	1.6	.	.	.
Current account, EUR mn	-2237.0	-2783.0	-1504.0	631.0	-12.1	177.2	400	200	0
Current account in % of GDP	-16.9	-17.8	-9.4	4.6	-0.4	5.5	2.9	1.4	0
Exports of goods, BOP, EUR mn	7761.0	8087.0	8536.0	6503.0	1497.3	1763.5	7500	8500	9600
annual growth rate in %	22.3	4.2	5.6	-23.8	-26.4	17.8	15	13	13
Imports of goods, BOP, EUR mn	10149.0	10873.0	10413.0	7008.0	1674.9	1870.5	7900	9000	10000
annual growth rate in %	28.5	7.1	-4.2	-32.7	-33.8	11.7	13	14	11
Exports of services, BOP, EUR mn	2787.0	3200.0	3531.0	3160.0	680.2	674.6	3300	3500	3700
annual growth rate in %	6.7	14.8	10.3	-10.5	-10.1	-0.8	4	6	6
Imports of services, BOP, EUR mn	1996.0	2242.0	2338.0	1841.0	450.2	357.9	1650	1800	2000
annual growth rate in %	12.6	12.3	4.3	-21.3	-14.4	-20.5	-10	9	11
FDI inflow, EUR mn	1432.0	1998.0	1317.0	1204.0	183.2	144.7	1300	.	.
FDI outflow, EUR mn	880.0	1273.0	723.0	1053.0	172.4	141.2	.	.	.
Gross reserves of NB excl. gold, EUR mn	2115.3	2235.6	2814.0	2759.0	2638.7	2686.0	.	.	.
Gross external debt, EUR mn	12903.8	17339.5	19052.1	17409.3	18501.0	16969.7	.	.	.
Gross external debt in % of GDP	97.5	111.0	118.5	126.8	134.7	121.1	.	.	.
Average exchange rate EEK/EUR	15.6466	15.6466	15.6466	15.6466	15.6466	15.6466	15.65	15.65	15.65
Purchasing power parity EEK/EUR	9.9923	10.6247	11.1035	11.2102	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) TALIBOR 1 month interbank offered rate.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.

Table LV

## Latvia: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011 Forecast	2012 Forecast
Population, th pers., average	2287.9	2276.1	2266.1	2255.1	.	.	2240	2230	2220
Gross domestic product, LVL mn, nom.	11171.7	14779.8	16274.5	13244.3	3308.5	2852.6	12400	12600	13100
annual change in % (real)	12.2	10.0	-4.5	-18.0	-17.8	-6.0	-3.5	0.7	2
GDP/capita (EUR at exchange rate)	7000	9300	10200	8300	.	.	.	.	.
GDP/capita (EUR at PPP)	12200	13900	14400	11700	.	.	.	.	.
Consumption of households, LVL mn, nom.	7184.2	9104.3	9935.6	7941.2	2033.8	1870.0	7000	7000	7200
annual change in % (real)	21.4	14.8	-5.5	-22.5	-22.3	-5.8	-9	-1	0.5
Gross fixed capital form., LVL mn, nom.	3644.1	4975.1	4777.3	2822.8	640.5	339.5	2300	2400	2500
annual change in % (real)	16.3	7.5	-15.6	-37.7	-34.1	-44.4	-15	2	2
Gross industrial production <sup>2)</sup>									
annual change in % (real)	6.5	1.1	-3.9	-16.2	-23.0	6.4	7	8	7
Gross agricultural production									
annual change in % (real)	-1.9	10.8	0.1	0.4	.	.	.	.	.
Construction industry									
annual change in % (real)	13.3	13.6	-3.1	-34.9	-29.7	-43.4	.	.	.
Employed persons - LFS, th, average	1087.1	1118.0	1124.5	983.1	1046.7	916.7	900	900	920
annual change in %	5.2	2.8	0.6	-12.6	-8.0	-12.4	-8	0	2
Unemployed persons - LFS, th, average	79.5	71.3	90.5	203.2	168.8	235.4	.	.	.
Unemployment rate - LFS, in %, average	6.8	6.0	7.5	17.1	9.4	20.4	20	18	17
Reg. unemployment rate, in %, end of period	6.5	4.9	7.0	16.0	10.7	17.3	.	.	.
Average gross monthly wages, LVL	302	398	479	461	470	431	.	.	.
annual change in % (real, net)	15.6	19.9	6.2	-5.6	-2.6	-9.2	.	.	.
Consumer prices (HICP), % p.a.	6.6	10.1	15.2	3.3	9.0	-3.9	-3	1	2
Producer prices in industry, % p.a.	10.3	16.1	11.4	-4.6	4.0	-4.8	.	.	.
General government budget, EU-def., % GDP									
Revenues	37.7	35.4	34.4	34.0	33.4	.	.	.	.
Expenditures	38.1	35.7	38.6	42.9	41.1	.	.	.	.
Net lending (+) / net borrowing (-)	-0.5	-0.3	-4.1	-8.9	-7.7	.	-8	-8	-6
Public debt, EU-def., in % of GDP	10.7	9.0	19.5	36.1	.	.	50	58	62
Refinancing rate of NB, % p.a., end of period	5.0	6.0	6.0	4.0	5.0	3.5	.	.	.
Current account, EUR mn	-3603.0	-4710.0	-3014.0	1770.0	60.1	355.9	800	400	-100
Current account in % of GDP	-22.5	-22.3	-13.0	9.4	0.1	8.8	4.5	2.2	-0.5
Exports of goods, BOP, EUR mn	4929.0	6020.0	6531.0	5138.0	1168.8	1364.8	5900	6800	7600
annual growth rate in %	14.3	22.1	8.5	-21.3	-25.4	16.8	15	15	12
Imports of goods, BOP, EUR mn	9032.0	11074.0	10603.0	6363.0	1665.1	1628.7	6300	6700	7300
annual growth rate in %	33.7	22.6	-4.3	-40.0	-35.9	-2.2	-1	6	9
Exports of services, BOP, EUR mn	2121.0	2707.0	3088.0	2730.0	679.5	599.7	2500	2650	2800
annual growth rate in %	21.7	27.6	14.1	-11.6	-2.2	-11.7	-8	6	6
Imports of services, BOP, EUR mn	1586.0	1974.0	2169.0	1569.0	379.8	326.2	1400	1600	1750
annual growth rate in %	26.3	24.5	9.9	-27.7	-23.3	-14.1	-11	14	9
FDI inflow, EUR mn	1339.0	1705.0	869.0	54.0	22.5	59.7	100	.	.
FDI outflow, EUR mn	136.0	270.0	169.0	-16.0	-6.4	0.9	.	.	.
Gross reserves of NB excl. gold, EUR mn	3346.2	3859.9	3514.0	4614.2	3163.7	5364.9	.	.	.
Gross external debt, EUR mn	18127.7	26834.6	29762.8	29159.4	28970.2	29070.5	.	.	.
Gross external debt in % of GDP	113.1	126.4	129.5	156.2	155.1	164.7	.	.	.
Average exchange rate LVL/EUR	0.6962	0.7001	0.7027	0.7057	0.7083	0.7083	0.7027	0.7027	0.7027
Purchasing power parity LVL/EUR	0.3999	0.4681	0.4999	0.5039	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 20 and more employees.

Source: wiw Database incorporating Eurostat and national statistics. Forecasts by wiw.

Table LT

**Lithuania: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009	2010	2010	2011	2012
					1st quarter		Forecast		
Population, th pers., average	3394.1	3375.6	3358.1	3339.6	.	.	3323	3306	3289
Gross domestic product, LTL mn, nom.	82792.8	98669.1	111189.8	92353.3	20882.1	20863.1	91000	93300	97500
annual change in % (real)	7.8	9.8	2.8	-15.0	-13.3	-2.8	-1.5	1.5	2.5
GDP/capita (EUR at exchange rate)	7100	8500	9600	8000	.	.	.	.	.
GDP/capita (EUR at PPP)	13100	14800	15500	13100	.	.	.	.	.
Consumption of households, LTL mn, nom.	53268.6	63508.4	72140.6	62596.1	15476.2	14033.5	58200	59400	61800
annual change in % (real)	10.6	12.0	3.6	-17.0	-15.7	-10.0	-7	1	2
Gross fixed capital form., LTL mn, nom.	20840.8	27918.8	27984.0	15609.1	3480.0	2248.0	13600	14300	15300
annual change in % (real)	19.4	23.0	-6.5	-39.1	-38.5	-30.2	-13	4	5
Gross industrial production (sales)									
annual change in % (real)	6.5	2.4	5.5	-14.6	-13.9	-4.1	5	4	6
Gross agricultural production									
annual change in % (real)	-4.1	8.2	8.8	2.3	.	.	.	.	.
Construction industry									
annual change in % (real)	21.7	22.2	4.0	-48.5	-42.8	-42.9	.	.	.
Employed persons - LFS, th, average	1499.0	1534.2	1520.0	1415.9	1433.1	1328.4	1350	1380	1400
annual change in %	1.7	2.3	-0.9	-6.8	-5.1	-7.3	-4.7	2.2	1.4
Unemployed persons - LFS, th, average	89.4	69.0	94.3	225.1	193.9	293.4	220	.	.
Unemployment rate - LFS, in %, average	5.6	4.3	5.8	13.7	11.9	18.1	18	17	16
Reg. unemployment rate, in %, end of period <sup>2)</sup>	3.7	3.3	4.4	12.5	8.2	14.3	.	.	.
Average gross monthly wages, LTL	1495.7	1802.4	2151.7	2052.4	2193.1	2031.2	.	.	.
annual change in % (real, net)	15.0	17.0	10.1	-7.0	-5.1	-6.6	.	.	.
Consumer prices (HICP), % p.a.	3.8	5.8	11.1	4.2	8.4	-0.4	0.0	1.0	2.0
Producer prices in industry, % p.a.	7.3	7.0	18.2	-13.5	-10.3	6.1	.	.	.
General govern.budget, EU-def., % GDP									
Revenues	33.1	33.8	34.2	34.1	36.5	.	.	.	.
Expenditures	33.6	34.8	37.4	43.0	46.1	.	.	.	.
Net lending (+) / net borrowing (-)	-0.4	-1.0	-3.3	-8.9	-9.6	.	-8	-7	-6
Public debt, EU-def., in % of GDP	18.0	16.9	15.6	29.3	.	.	40	45	50
Money market rate, % p.a., end of period <sup>3)</sup>	3.7	6.8	7.8	1.6	3.1	0.9	.	.	.
Current account, EUR mn	-2551.0	-4149.0	-3840.0	1022.0	-16.0	-156.0	0	-200	-600
Current account in % of GDP	-10.6	-14.5	-11.9	3.8	-0.3	-2.6	0	-0.7	-2.1
Exports of goods, BOP, EUR mn	11262.0	12509.0	16077.0	11794.0	2750.3	3039.9	13000	14500	16000
annual growth rate in %	18.7	11.1	28.5	-26.6	-24.4	10.5	10	12	10
Imports of goods, BOP, EUR mn	14600.0	16788.0	19939.0	12570.0	2921.3	3317.6	12800	13800	15500
annual growth rate in %	23.2	15.0	18.8	-37.0	-40.4	13.6	2	8	12
Exports of services, BOP, EUR mn	2879.0	2931.0	3306.0	2712.0	554.0	207.6	2200	2400	2600
annual growth rate in %	15.0	1.8	12.8	-18.0	-17.7	-62.5	-19	9	8
Imports of services, BOP, EUR mn	2018.0	2471.0	2953.0	2117.0	420.7	446.5	2250	2500	2700
annual growth rate in %	21.9	22.4	19.5	-28.3	-33.2	6.1	6	11	8
FDI inflow, EUR mn	1448.0	1473.0	1245.0	249.0	281.4	146.9	400	.	.
FDI outflow, EUR mn	232.0	437.0	229.0	157.0	113.2	20.9	.	.	.
Gross reserves of NB excl. gold, EUR mn	4307.5	5165.1	4458.4	4495.4	4173.0	4902.4	.	.	.
Gross external debt, EUR mn	14441.8	20547.2	23048.2	23051.8	22663.3	.	.	.	.
Gross external debt in % of GDP	60.2	71.9	71.6	86.2	84.7	.	.	.	.
Average exchange rate LTL/EUR	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
Purchasing power parity LTL/EUR	1.87	1.98	2.13	2.10	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) In % of working age population. - 3) VILIBOR 1 month interbank offered rate.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.



*Hermine Vidovic*

## **Croatia: Another year of recession**

Economic activities have continued to decline in 2010, but at a slower pace than in 2009: GDP fell by 2.5% in the first quarter of the year. Domestic demand developments were again the main reason for this decline. Private consumption shrank by 4.1% in real terms, mainly as a consequence of rising unemployment, declining wages and stagnating credit activities. The latest consumer confidence survey conducted by the National Bank suggests that many consumers are still postponing their purchases of consumer durables and do not intend to increase their spending in the short run. Given, among other things, the limited scope of public investments due to fiscal constraints, gross fixed capital formation contracted by 14%.<sup>47</sup> Net export growth should have contributed positively to GDP growth. Growth of industrial production, which was slightly positive in the first quarter of the year, turned negative again in April. In March domestic orders were down 60% while foreign orders had increased by one quarter compared to a year earlier.

The worsening trend on the labour market prevailing in 2009 has continued during the first months of 2010. According to the Croatian Pension Institute (HZMO) the number of employed fell by 5% during the first quarter of the year. Employment cuts were most pronounced in construction and manufacturing with the number of workers down by 12% and 8% respectively. Based on registration data the unemployment rate rose to over 18% in March, but slowed somewhat thereafter. By comparison, the unemployment rate obtained from the Labour Force Survey is at about 10%. The large discrepancy between the two measures may indicate rising informal sector activities. Nominal wages fell for the first time since the mid-1990s with above-average declines in manufacturing and construction. In the first quarter of 2010 average net wages were down by 1.7% in real terms.

Household loans fell by 3% during the first quarter of 2010, with the largest drop in any-purpose loans and car purchase loans. By contrast, corporate loans showed a slight increase during the first months of the year. The share of bad loans doubled within a year and reached 7.8% at the end of 2009, bad corporate loans accounted for 12.8% of total loans. According to the National Bank this trend is likely to continue in 2010 and may only improve in 2011 provided a resumption of economic growth.

In mid-April the Croatian government presented an economic recovery programme which is a combination of short-term and structural measures. As one of the short-term measures, tax brackets for personal income tax will be reduced from currently four to three. Tax reliefs will be abandoned

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<sup>47</sup> This was mainly felt by the construction industry, reporting an output decline by 19%.

which should help to simplify the tax administration. On the other hand, the lower rate of crisis tax (2% tax on income between HRK 3000 and 6000) introduced in August 2009 will be abolished. In addition, public sector reforms have been announced: employees will not be given holiday bonuses this year and employment is to be reduced by about 5% – the latter being a medium-term goal of the government. Plans for downsizing public administration as well as employment in state-owned companies should be elaborated by the end of 2010. Furthermore, the pension system should undergo a number of changes: for instance, access to early retirement should be limited and certain categories of privileged pensions (e.g. for war veterans) are envisaged to be cut by 10%. Tax-related measures and the reduction of pensions become effective as of 1 July 2010. The budget revision in July is expected to bring new measures made necessary by rising expenditures (for pensions in particular) and falling revenues during the first months of the year. Thus, the target of fiscal consolidation as foreseen in the initially adopted budget for 2010, envisaging a narrowing of the deficit to 2.9% of GDP, will not be met – mainly because of declining revenues that will consequently lead to a stronger rise in public debt. At the end of 2009 total public debt amounted to 34.5% of the GDP or 50.4% if including government guarantees.

The second round of the privatization of Croatia's state-owned shipyards, issued on 15 February, closed with four valid bids for the three shipyards offered – unlike the first attempt, which closed with only one offer. Three bids were submitted by local companies for Brodosplit, Brodotrogir and 3 May. For the latter also Crown Investments (Germany) submitted an offer. Restructuring of the heavily indebted and subsidized shipyards is one of the preconditions for further progress in Croatia's negotiation talks with the EU. One of the major obstacles to Croatia's joining the EU was removed when Slovenia in a referendum held on 6 June voted in favour of an arbitrage deal to settle a twenty-year old border conflict (Bay of Piran) between Croatia and Slovenia. The findings of the arbitration panel will be binding. Thus, Croatia may complete the negotiation process with the European Union at the beginning of 2011, which would imply accession in late 2012, or even only in 2013.

Data available from customs statistics indicate an increase in goods exports (4.8%), but a further contraction of imports by 10%, leading to a narrowing of the trade deficit as compared to the first quarter of 2009. A breakdown of exports by commodity groups shows an overall increase in manufacturing exports, of which most notably exports of other transport equipment (ships), chemicals and pharmaceuticals. On the import side, manufacturing imports fell by 13.4%, with car imports down by 36%; strong import declines were also registered for machinery and electrical equipment. Tourist overnight stays fell during the first months of the year, implying a reduction of the traditional surplus in services trade. Owing primarily to the diminishing trade deficit, the current account closed with a lower deficit than in previous years, at some EUR 1.4 billion. In February 2010 foreign debt stood at EUR 44 billion, about EUR 600 million less than in December 2009. The decline in external debt is largely a consequence of a reduction of banks' and government borrowing, while direct-investment related debt (borrowing of enterprises from their foreign owners) rose only modestly and enterprise borrowing remained nearly unchanged. In 2010 Croatia has to repay (refinance) close to EUR 10 billion, which is slightly less than in 2009.

GDP will decline by another 1-2% in 2010. Fiscal constraints and high foreign debt obligations represent a major obstacle to financing public investment projects. Employment will continue to contract, translating into rising unemployment or even inactivity. This may trigger a further decline in household consumption. The current account deficit will remain at the previous year's level, at about 5% of GDP, in 2010 and increase gradually thereafter. A rebound in GDP growth may be expected only in 2011 provided a strengthening of foreign demand both in goods and services. The servicing and/or restructuring of the high foreign debt will remain one of the major challenges in the near future. Prospects of joining the EU in the coming two years may help to strengthen Croatia's standing vis-à-vis foreign creditors.

Table HR

**Croatia: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011	2012
							Forecast		
Population, th pers., average	4440	4436	4435	4429	.	.	4435	4435	4435
Gross domestic product, HRK mn, nom.	286341	314223	342159	333063	77867	76504	334600	349800	365700
annual change in % (real)	4.7	5.5	2.4	-5.8	-6.7	-2.5	-1.5	2	2.5
GDP/capita (EUR at exchange rate)	8800	9700	10700	10100	.	.	10300	10800	11300
GDP/capita (EUR at PPP - wiiw)	13500	15000	15500	14400	.	.	.	.	.
Consumption of households, HRK mn, nom.	172744	188952	202194	189638	46474	45079	.	.	.
annual change in % (real)	3.5	6.2	0.8	-8.5	-9.9	-4.1	-3.5	1.5	2
Gross fixed capital form., HRK mn, nom.	74792	82386	94281	82259	19644	16079	.	.	.
annual change in % (real)	10.9	6.5	8.2	-11.8	-12.4	-13.9	-5	4	5
Gross industrial production <sup>2)</sup>									
annual change in % (real)	4.2	4.9	1.2	-9.2	-11.0	-0.5	0	3	3.5
Gross agricultural production									
annual change in % (real)	4.4	-3.9	8.0	.	.	.	.	.	.
Construction industry, hours worked <sup>2)</sup>									
annual change in % (real)	9.4	2.4	11.8	-6.5	-0.3	-18.6	.	.	.
Employed persons - LFS, th, average	1586	1615	1636	1605	1608	.	1570	1570	1590
annual change in %	0.8	1.8	1.3	-1.9	1.0	.	-2	0	1
Unemployed persons - LFS, th, average	199	171	149	160	167	174	.	.	.
Unemployment rate - LFS, in %, average	11.1	9.6	8.4	9.1	9.4	10.0	10.5	10	9
Reg. unemployment rate in %, end of period	17.0	14.7	13.7	16.7	15.0	18.4	17.5	17	16.5
Average gross monthly wages, HRK	6634	7047	7544	7711	7707	7637	.	.	.
annual change in % (real, net)	1.9	2.2	0.8	0.2	1.8	-1.7	.	.	.
Consumer prices, % p.a.	3.2	2.9	6.1	2.4	3.8	0.9	2	2.5	2
Producer prices in industry, % p.a. <sup>3)</sup>	2.9	3.4	8.4	-0.4	1.1	3.6	.	.	.
General governm.budget, nat.def., % GDP <sup>4)</sup>									
Revenues	39.2	40.3	39.4	38.5	.	.	.	.	.
Expenditures	41.6	41.5	40.3	41.6	.	.	.	.	.
Deficit (-) / surplus (+) <sup>5)</sup>	-2.6	-1.2	-1.0	-3.2	.	.	-3.5	-3	-2.5
Public debt, EU-def., in % of GDP <sup>6)</sup>	35.7	33.1	33.5	37.7	.	.	40	41	42
Discount rate of NB, % p.a., end of period	4.5	9.0	9.0	9.0	9.0	9.0	.	.	.
Current account, EUR mn	-2717.1	-3236.1	-4337.8	-2447.8	-1844.7	-1404.6	-2000	-2700	-3500
Current account in % of GDP	-6.9	-7.6	-9.2	-5.4	-17.5	-13.4	-4	-6	-7
Exports of goods, BOP, EUR mn	8463.6	9192.5	9814.0	7690.5	1928.5	2017.1	7900	8300	8900
annual growth rate in %	17.2	8.6	6.8	-21.6	-13.4	4.6	3	5	7
Imports of goods, BOP, EUR mn	16807.8	18626.5	20607.8	15088.5	3660.3	3305.7	14000	14600	15600
annual growth rate in %	14.0	10.8	10.6	-26.8	-23.6	-9.7	-7	4	7
Exports of services, BOP, EUR mn	8526.8	9114.7	10090.6	8453.9	773.4	787.8	8200	8400	8800
annual growth rate in %	5.9	6.9	10.7	-16.2	-8.6	1.9	-3	3	5
Imports of services, BOP, EUR mn	2824.2	2847.3	3132.7	2778.3	638.6	664.1	2800	2900	3000
annual growth rate in %	3.3	0.8	10.0	-11.3	-14.6	4.0	0	2	4
FDI inflow, EUR mn	2764.8	3678.6	4195.4	2096.0	437.2	434.2	1000	.	.
FDI outflow, EUR mn	208.2	266.9	988.8	918.7	28.7	-38.5	.	.	.
Gross reserves of NB excl. gold, EUR mn	8725.3	9307.4	9120.9	10375.8	8869.5	10008.1	.	.	.
Gross external debt, EUR mn <sup>7)</sup>	29273.9	32929.2	39950.2	44574.8	40308.3	44564.2	.	.	.
Gross external debt in % of GDP <sup>7)</sup>	75.1	76.8	85.5	97.8	88.8	97.2	.	.	.
Average exchange rate HRK/EUR	7.3228	7.3360	7.2232	7.3398	7.4070	7.2854	7.3	7.3	7.3
Purchasing power parity HRK/EUR	4.7861	4.7223	4.9838	5.2321	.	.	.	.	.

Note: Gross industrial production and construction output refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) Domestic output prices, from 2009 according to NACE Rev. 2. - 4) On accrual basis. - 5) Including change in arrears and non-recorded expenditures. - 6) According to ESA'95, excessive deficit procedure. - 7) From 2008 new reporting system (estimated data for non-financial enterprises).

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.



*Vladimir Gligorov*

## **Macedonia: Stability preserved**

For some time before the current crisis, Macedonia was implementing the growth model that is now being recommended to most troubled European economies: it was keeping domestic demand down and expecting external demand to spur and sustain GDP growth. Even though fiscal policy was quite prudent and the monetary policy was restrictive in order to support the fixed exchange rate and keep the inflation rate low, growth was disappointing. Shortly before the crisis erupted, the government switched towards a more active economic policy with increased public spending and a more relaxed monetary policy. It continued with that policy stance during the course of the crisis, with the fiscal deficit increasing to almost 3% of GDP and with the intention to keep relying on public spending to support recovery. This probably accounts for the relatively mild recession last year and the expected slow recovery this year. In addition, industrial production does not account for too much and thus its sharp and continuing decline has likewise not contributed too much to the recession. Also, the inflow of remittances seems to have been sustained, reflected in the slower decline of imports than of exports last year. Thus, it is only this year that exports are growing while imports continue to decline and the trade balance is improving. So, GDP growth is driven by improvements in net exports and by sustained public spending.

These sources of growth may not prove to be enduring. Though competitiveness has improved slightly, with prices falling by almost 1% last year, the hard peg to the euro is a constraint on a sharper relative exchange rate adjustment. Also, the pre-crisis change of growth strategy was accompanied by increases in wages, which cannot be easily reversed. Finally, employment even grew last year, if statistics are to be believed, and the trend may very well be continuing this year, so productivity gains cannot be expected. Thus – although growing external demand remains the hope on which expectations of a growth speed-up are based – it is in fact support for domestic demand, mostly through public spending, that is preserving the macroeconomic stability and providing for some slow recovery.

The financing of the fiscal deficit is not proving to be easy. An attempt to borrow in the international commercial market turned out to be too expensive this spring, probably because of the impact of the Greek crisis. It is not clear whether the attitude in the financial markets will change for the better given the global and EU stress on early fiscal consolidation. Unlike most other countries in the Balkans and in the South of Europe, private debts are not all that high. Credit expansion was subdued and private debt overhang is not a big problem. The banks, however, seem reluctant to increase their activities and the central bank is also not very supportive, obsessed as it is with the stability of the exchange rate. So, even though inflation is all but non-existent, the policy rate of the

central bank has been hiked to 8.5% in the first quarter of this year. This may make it difficult for both the public and the private borrowers to take loans.

The IMF is hoping for an export-led recovery which should speed up growth to 2% this year and 3% or 4% in the medium term. This seems a bit optimistic. The recovery in the main trading partners is going to be slower than previously expected and some of the markets may be more difficult to access, such as the Serbian one, due to loss of competitiveness. Overall, stability has been preserved, but growth remains elusive.

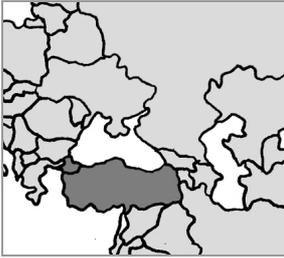
Table MK

## Macedonia: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average	2040.2	2043.6	2046.9	2050.0	.	.	2052	2054	2056
Gross domestic product, MKD mn, nom.	310915	354322	398491	406651	91366	.	411000	432000	458000
annual change in % (real)	4.0	5.9	4.8	-0.7	-0.9	.	1	2	3
GDP/capita (EUR at exchange rate)	2500	2800	3200	3200	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	6900	7700	8200	8000	.	.	.	.	.
Consumption of households, MKD mn, nom. <sup>2)</sup>	243131	273269	321020	318000	71797	.	318000	334000	351000
annual change in % (real) <sup>2)</sup>	6.0	9.8	8.1	0.2	3.9	.	0	2	2
Gross fixed capital form., MKD mn, nom.	56485	71557	86500	83000	.	.	83000	88000	94000
annual change in % (real)	11.6	13.1	4.0	-3.0	.	.	0	3	4
Gross industrial production <sup>3)</sup>									
annual change in % (real)	3.6	3.7	5.5	-7.7	-10.8	-9.4	-5	3	5
Gross agricultural production									
annual change in % (real)	4.8	-3.0	5.4	4.6	.	.	.	.	.
Construction industry									
annual change in % (real)	-11.9	9.7	-9.6	-2.1	17.4	.	.	.	.
Employed persons - LFS, th, average	570.4	590.2	609.0	629.9	618.2	.	630	640	670
annual change in %	4.6	3.5	3.2	3.4	2.9	.	0	1.5	1.5
Unemployed persons - LFS, th, average	321.3	316.9	310.4	298.9	300.8	.	.	.	.
Unemployment rate - LFS, in %, average	36.0	34.9	33.8	32.2	32.7	.	33	33	33
Reg. unemployment rate, in %, end of period	.	.	.	.	.	.	.	.	.
Average gross monthly wages, MKD <sup>4)</sup>	23036	24136	26229	29922	29540	27305	.	.	.
real growth rate, % (net wages) <sup>4)</sup>	3.9	5.5	1.9	10.5	26.1	2.8	.	.	.
Consumer prices, % p.a.	3.2	2.3	8.3	-0.8	1	0.5	0	3	3
Producer prices in industry, % p.a. <sup>5)</sup>	7.3	2.5	10.3	-6.5	-6.2	-7.5	.	.	.
General governm. budget, nat.def., % GDP <sup>6)</sup>									
Revenues	33.5	33.8	34.2	33.2	34.3	.	.	.	.
Expenditures	34.0	33.2	35.2	36.0	36.4	.	.	.	.
Deficit (-) / surplus (+)	-0.5	0.6	-1.0	-2.8	-2.1	.	-4	-2	0
Public debt, nat.def., in % of GDP	39.9	33.3	28.7	32.0	32	32.7	35	35	34
Discount rate of NB, % p.a., end of period	6.5	6.5	6.5	6.5	6.5	8.5	.	.	.
Current account, EUR mn	-23.4	-421.2	-853.3	-483.1	-345.6	-74.0	-400	-450	-500
Current account in % of GDP	-0.5	-7.3	-13.1	-7.3	-23.0	.	-6	-6	-7
Exports of goods, BOP, EUR mn	1914.0	2472.2	2684.2	1921.0	400.3	482.1	2000	2100	2300
annual growth rate in %	16.5	29.2	8.6	-28.4	-34.6	20.4	5	5	10
Imports of goods, BOP, EUR mn	2915.5	3653.3	4434.9	3472.0	846.8	778.8	3470	3600	4000
annual growth rate in %	16.6	25.3	21.4	-21.7	-14.1	-8.0	0	5	10
Exports of services, BOP, EUR mn	477.3	594.5	686.3	618.3	141.7	.	600	630	700
annual growth rate in %	14.7	24.5	15.4	-9.9	-1.6	.	0	5	10
Imports of services, BOP, EUR mn	455.0	569.4	681.9	590.2	142.7	.	600	600	700
annual growth rate in %	3.2	25.2	19.8	-13.5	-0.6	.	0	5	10
FDI inflow, EUR mn	344.8	506.0	399.9	181.0	56.7	.	150	200	200
FDI outflow, EUR mn	0.1	-0.9	-9.5	9.1	0.2	.	0	0	0
Gross reserves of NB, excl. gold, EUR mn	1311.3	1400.1	1361.0	1429.4	1116.0	1427.0	.	.	.
Gross external debt, EUR mn	2503.4	2841.1	3304.2	3839.4	3339.0	.	.	.	.
Gross external debt in % of GDP	49.3	49.1	50.9	57.8	50.2	.	.	.	.
Average exchange rate MKD/EUR	61.19	61.18	61.27	61.32	61.51	61.40	61.2	61.2	61.2
Purchasing power parity MKD/EUR	21.93	22.51	23.86	24.90	.	.	.	.	.

1) Preliminary. - 2) Including NPISHs. - 3) Enterprises with 10 and more employees. - 4) From 2009 including allowances for food and transport. - 5) Domestic output prices. - 6) Refers to central government budget and extra-budgetary funds.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.



*Josef Pöschl*

## **Turkey: Recovering and reconnecting**

Confidence in the real sector, as monitored by the Central Bank, exceeded the norm level [100] throughout the first half of 2010, soaring close to 119 in April and 115 in May. Both the IMF and OECD have raised their GDP forecasts for 2010<sup>48</sup>, while rating agencies are thinking of upgrading the country. Undeniably, Turkey contributes positively to the diversity in the economic performance of the emerging European region comprising the new EU member countries, as well as the candidate and potential candidate countries.

During the first quarter of 2010, the GDP increased by 11.7% year-on-year, in sharp contrast to the 16.5% decline one year previous. Owing to a less favourable base effect, the results of the remaining three quarters in 2010 will look less spectacular: By mid-2009, GDP recovery had already set in, as indicated in the seasonally adjusted quarter-on-quarter data.

Industrial output grew by 17% year-on-year in the first quarter of 2010. In May 2010, capacity utilization climbed close to 73%, which is not far below the level reached in the first half of 2008. Within manufacturing, transport equipment, metal industries, production of furniture, electrical machinery and refined petroleum were hit hardest by the crisis, whereas the impact was much softer in the production of food and beverages, textiles, radio and television sets. The automotive sector is now recovering. Retail sales of cars may amount to about 600,000 units in 2010. During the first four months of 2010, Otokoç (Fiat, Alfa Romeo, Lancia, Ford, Volvo), one of the major players with a market share of 8.5%, increased its vehicle sales by 24%.

In May 2010, electricity generation and consumption were up by 9% year-on-year and up by 6.5% over the period January-May: further confirmation of the ongoing economic recovery. To avoid future bottlenecks, Turkey will need to invest considerably in energy generation – some 80 billion euro over the next ten years according to spokesmen from within the industry. Turkey plans to build two nuclear power stations and complete the controversial Ilisu dam as part of the development plan for South-East Anatolia.

Unemployment is on the decline. Whereas it had come close to 16% in the first quarter of 2009, it was down to 14.5% a year later. Over the same period, employment grew by 7%.

For the first quarter of 2010, the central bank's balance of payment statistics in USD terms show an export growth of 7.5% year-on-year, whereas imports grew by 33.3%. The figures reflect the impact

<sup>48</sup> *Turkey – 2010 Article IV Consultation and Post-Program Monitoring: Preliminary Conclusions*, IMF 26 May 2010: 6.25%, *OECD Economic Outlook* No. 87, 26 May 2010: 6.8%.

of the Turkish lira having appreciated against both the US-dollar (10.1% increase of the USD-to-TRY ratio) and the euro<sup>49</sup>.

In 2009, Turkey's 500 largest exporters accounted for over 50% of total exports. Oyak Renault was the largest of all (EUR 2 billion export volume), followed by Vestel Foreign Trade, Turkey's largest producer of TV sets, and Ford Otomotiv (EUR 1.4 billion each). The larger exporters also included the car manufacturer Tofaş, a Fiat affiliate with a production capacity of about 400 thousand cars per year and a 27% share in automotive exports in 2009.

In the first quarter of 2010, the most important destinations for goods exported from Turkey were Germany with a volume of about EUR 2 billion, Italy, France, the United Kingdom, Iraq, Russia, Spain, the United States, the United Arab Emirates and Egypt. Iraq (EUR 1 billion export volume in the first quarter of 2010) is becoming an increasingly important market. In a meeting in early June, Massoud Barzani, the leader of northern Iraq, and Ümit Boyner, chairwoman of the Association of Turkish Industrialists and Businessmen (TÜSİAD), discussed ways and means of expanding trade cooperation. The prime ministers of the two countries have since signed protocols aimed at liberalizing trade. Other important export destinations in the vicinity of Turkey are Iran, Syria, Greece and Bulgaria. For Turkey, liberalization of ties with Syria was a positive experience.

To an ever-increasing degree, Turkey is discovering the major export potential offered by its neighbours. Producers of tradable goods and services are pleased with the government's effort to liberalize trade flows through bilateral agreements. Some of these agreements also support Turkish investment abroad. Turkey signed a deal of historical dimensions with Russia in May 2010. Russia will build one of the two nuclear power plants that the government is planning. (South Korea will build the other one.) The deal is not limited to trade. The two countries will drop their respective visa requirements and Turkey's tourism expects – in the context of a forthcoming economic recovery and rise in incomes – a palpable increase in the number of Russian visitors to the country (up from 2.6 million in 2009). Turkish hopes that within a few years Russian tourists could outstrip the number of German tourists (4 million in 2009) may well be exaggerated. Cooperation between the two countries' airlines, Turkey's Hava Yollari and Russia's Aeroflot, will underpin these tourism and business ties. Services provided by Turkey's construction industry were not part of the agreement, yet the sector expects new avenues to open up in the new spirit of cooperation: for example in the context of the Winter Olympics to take place in 2014 in Sochi on the Russian shores of the Black Sea. Turkish hopes of a large increase in turkey and other poultry exports may not be realized in the near future, as Russia will not relax its quotas for poultry imports.

Turkish companies are also interested in investing abroad. Members of President Dmitry Medvedev's entourage expressed the hope that Turkish companies would invest in Russia's special economic zones (industrial, innovation, tourism-recreation and port-development zones). A few Turkish companies have already adopted an active pioneering role in the Russian manufacturing

<sup>49</sup> The EUR-to-TRY ratio increased by 3.6% (av. Q1 2010/av. Q1 2009). In EUR terms, exports grew by 1.1%, imports by 25.4%. In TRY terms, exports fell by somewhat over 2%, whereas imports increased by over 20%. In April 2010, the year-on-year increase was 24% in exports and 46% in imports (in USD terms).

sector. In Iraq, the Turkish oil company TPAO has won two oil-production tenders. Central Asian countries are proving attractive to Turkish companies, with linguistic or religious proximity proving supportive in some cases. For example, some 600 Turkish companies have established business ties with Turkmenistan, and according to Turkish estimates, Turkish investment in that country amounts to a total of some EUR 5 billion.

The fiscal and monetary policy fit was perfect both before and during the crisis. Up to mid-2008, fiscal austerity offered scope for a gradual reduction of the policy rate. During the crisis months, the government let automatic stabilizers do their job; furthermore, it introduced business stimulus packages. At the same time, the central bank kept the policy rate low and started preparing an exit strategy for the period after economic recovery. The government introduced new fiscal regulations that are envisaged to enter into effect on 1 January 2011. Tax revenues rose steeply in the first quarter of 2010, thus making it easier to avoid a massive increase in government debt. Larger cuts in expenditure are unlikely, given that Turkey is going to the polls in 2011.

All this looks very fine – fine enough to make it difficult to avert real appreciation. This may not necessarily occur only on account of high inflation, which hit the 10% mark in May 2010, but is likely to fall in the second half of the year. A change is more likely to come about through nominal appreciation against the euro or the euro and the dollar. Strong real appreciation could bring about an erosion of the Turkish producers' international competitiveness and thus lead to instability in the longer term. Danger of this actually happening is evident, given that the current account is rapidly reverting to former high deficit levels under the impact of recovery. First quarter exports covered 95% of imports in 2009, but only 77% in 2010; the latter figure is not much above the full-year average for the period 2005-2009 (73%).

For 2010 we expect GDP growth to hover between 6% and 6.5% – thanks primarily to an expansion of domestic demand. The GDP will thus reach and slightly surpass the pre-crisis level. The average rate of inflation will remain significantly below 10%. In all likelihood, the economy will grow less in 2011 and 2012, since the government will have to economize after the 2011 elections at the latest, while real appreciation will slow down exports and speed up imports. In political terms, Turkey remains a fairly inhomogeneous society in many respects. The government will secure a comfortable majority in the forthcoming referendum about the reform of the judiciary system; however in the elections in 2011 the ruling AK Party will have to struggle hard, if it is to achieve as large a parliamentary majority as it has had to date. Relations with Israel have worsened, and in some respects – but not necessarily all – the rupture may be beyond repair. Within Turkish political and economic circles, the relative weight of EU is likely to decline.

Table TR

## Turkey: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009	2010	2010	2011	2012
					1st quarter		Forecast		
Population, th pers., average <sup>2)</sup>	69421	70256	71079	71897	.	.	72700	73500	74300
Gross domestic product, TRY bn, nom.	758.4	843.2	950.5	954.0	209.7	243.3	1100	1240	1380
annual change in % (real)	6.9	4.7	0.7	-4.7	-14.5	11.7	6.3	4.5	4.0
GDP/capita (EUR at exchange rate)	6000	6700	7000	6100	.	.	8000	8900	9300
GDP/capita (EUR at PPP - wiiw)	10500	11100	11400	10700	.	.	.	.	.
Consumption of households, TRY bn, nom.	534.8	601.2	663.9	683.3	155.5	181.3	.	.	.
annual change in % (real)	4.6	5.5	-0.3	-2.3	-10.1	9.9	4.0	3.0	3.0
Gross fixed capital form., TRY bn, nom.	169.0	180.6	189.1	160.6	39.7	42.9	.	.	.
annual change in % (real)	13.3	3.1	-6.2	-19.2	-27.6	14.4	10.5	13	10
Gross industrial production									
annual change in % (real)	5.8	4.5	-0.8	-5.7	-19.0	17.1	15	10	7
Gross agricultural production									
annual change in % (real)	1.3	-7.3	.	.	.	.	.	.	.
Construction industry									
annual change in % (real)	18.4	5.5	-7.5	-16.6	-18.4	.	.	.	.
Employed persons - LFS, th, avg. <sup>3)</sup>	22330	20738	21191	21288	19826	21215 <sup>H-II</sup>	22000	22300	22500
annual change in %	1.3	1.5	2.2	0.5	0.0	7.0	3	1	1
Unemployed persons - LFS, th, average <sup>3)</sup>	2446	2376	2605	3460	3276	3578 <sup>H-II</sup>	.	.	.
Unemployment rate - LFS, in %, average	9.9	10.3	11.0	14.0	15.8	14.5 <sup>H-II</sup>	13	12	12
Reg. unemployment rate, in %, average	.	.	.	.	.	.	.	.	.
Average gross monthly wages, manuf.ind., TRY <sup>4)</sup>	1301	1437	1590	.	.	.	.	.	.
annual change in % (real) <sup>4)</sup>	2.1	1.6	0	.	.	.	.	.	.
Consumer prices, % p.a.	9.3	8.8	10.4	6.3	8.4	9.3	8.5	7.5	7.0
Producer prices in industry, % p.a.	9.7	6.0	13.0	1.0	7.8	4.6	6.5	6.5	6.0
General governm. budget, EU-def., % GDP <sup>5)</sup>									
Revenues	.	19.6	21.6	22.5	.	.	22	22.5	22.5
Expenditures	.	20.6	23.9	28.0	.	.	28	27	26
Deficit (-) / surplus (+)	1.2	-1.0	-2.3	-5.5	.	.	-6.0	-4.5	-3.5
Public debt, EU-def., in % of GDP <sup>5)</sup>	46.1	39.4	39.4	45.5	.	.	48	50	51
Discount rate of NB % p.a., end of period <sup>6)</sup>	22.5	20.0	17.5	9.0	13.0	9.0	.	.	.
Current account, EUR mn	-25640	-27954	-28520	-9944	-1519	-7189	-26000	-30000	-32000
Current account in % of GDP	-6.1	-5.9	-5.7	-2.3	-1.6	-6.2	-4.5	-4.6	-4.6
Exports of goods, BOP, EUR mn	74556	84174	95730	78716	20062	20286	91000	102000	112000
annual change in %	18.4	12.9	13.7	-17.8	-14.5	1.1	15	12	10
Imports of goods, BOP, EUR mn	107255	118319	131779	96464	21034	26386	121000	136000	150000
annual change in %	19.7	10.3	11.4	-26.8	-33	25.4	25	12	10
Exports of services, BOP, EUR mn	20348	21109	23677	23507	3614	3244	22000	24000	26000
annual growth rate in %	-5.4	3.7	12.2	-0.7	2.4	-10.2	-5	10	10
Imports of services, BOP, EUR mn	9507	11372	12036	11866	2914	2909	13000	14000	15000
annual growth rate in %	2.9	19.6	5.8	-1.4	8.4	-0.2	9	6	6
FDI inflow, EUR mn	16076	16087	12421	5453	1857	1066	8000	10000	10000
FDI outflow, EUR mn	736	1537	1733	1128	273	324	1500	1500	1700
Gross reserves of CB, excl. gold, EUR mn	46251	49804	51022	49088	50436	51520	48000	49000	50000
Gross external debt, EUR mn	157626	169436	199973	188213	200476	.	185000	190000	200000
Gross external debt in % of GDP	38.7	34.5	45.2	42.5	45.3	.	.	.	.
Average exchange rate TRY/EUR	1.8090	1.7865	1.9064	2.1631	2.1618	2.0868	1.9	1.9	2.0
Purchasing power parity TRY/EUR	1.0403	1.0804	1.1711	1.24557	.	.	.	.	.

Note: Gross industrial production and construction output refer to NACE Rev. 2.

1) Preliminary. - 2) TSI projections. - 3) From 2007 according to new census. - 4) Including overtime payment. - 5) According to ESA'95 excessive deficit procedure. - 6) Overnight lending rate.

Source: National statistics (Central Bank, Turkish Statistical Institution - TSI, etc). Forecasts by wiiw.



*Mario Holzner*

## **Albania: Rainfall export growth**

The rainy first half of 2010 made the Albanian hydro power stations generate electricity for export at full throttle. While domestic consumption and investment have turned depressed, the unexpected export rebound to pre-crisis levels has slightly improved GDP growth prospects for 2010. However, for the whole forecasting period 2010-2012 we expect economic growth rates far below potential.

A showery spring 2010 has caused an electricity export miracle for Albania as the Albanian electricity corporation is overwhelmingly relying on hydro power. In the first quarter of 2010 total energy exports tripled on a year-on-year basis to more than EUR 50 million. Though a small value in international comparison, this accounts for more than a fifth of overall first quarter exports of goods. Total goods exports increased by a staggering 45%. This increase was also supported by a substantial growth of exports of raw materials and minerals as well as manufactures classified by material, which might be due to increased commodity prices. Especially the latter increase may have been supported by the 10% depreciation of the Albanian nominal and real exchange rate as compared to its peak in late 2008. Given the weather conditions in the second quarter of 2010, it can be expected that electricity exports will grow even more.

However, trade data reveal growth-dampening evidence as well. While overall imports in the first quarter of 2010 remained fairly stable year-on-year, imports of machinery and equipment dropped by more than 20%. This is the continuation of a trend that started already in the third quarter of 2009 and which reflects a substantial deceleration of gross fixed capital formation growth. This development is coherent with the slowdown in the growth of bank loans to the non-financial private sector. In March 2009 these loans were still growing by more than 30%, while the latest data from March 2010 show a meagre growth rate of some 6% only. Latest GDP data from the fourth quarter of 2009 exhibit, for the first time in years, a negative growth rate of 0.8%. The main cause for this slump is a 14% fall in the construction sector.

The most recent official bank lending survey results seem to confirm that this trend is continuing in the first and second quarter of 2010 too. Banking experts expect for the second quarter of 2010 a decrease in businesses' demand. In particular demand for investment loans has already been falling for several consecutive quarters. Interestingly enough, demand for household loans turned positive in the first quarter and is expected to grow further in the second quarter as well. The main driving force of this increase in credit demand are households' needs to finance consumption rather than to invest in real estate. It seems that households feel the need to smooth their consumption over the

business cycle as the crisis starts curbing income and employment is being reduced. Latest data from the fourth quarter of 2009 indicate a drop in total employment of nearly 8% year-on-year.

However, given the expected tightening of loan standards, dissaving to keep up household consumption will not be a viable solution for the period to come. Nevertheless one source of households' income compensation might be the increasing trend in remittances. While the first three quarters of 2009 exhibited a decline in private transfers of about 2% year-on-year, the latest available data from the fourth quarter of 2009 show a remarkable increase of 6.5%, which also increases the overall year 2009 inflow. Thus it appears that remittances act countercyclically. This is even more remarkable if one considers the long-term trend of declining remittances over the last couple of years as well as the economic situation in the two most important host countries for Albanian workers abroad, namely Greece and Italy. As rumour has it, a first wave of return migration from Greece has hit Albania but no official data are available. Nonetheless it is fair to expect household final consumption at least to stagnate in 2010 on average.

Finally, government consumption will not be a driving force for GDP in the foreseeable future either. Data on first quarter government expenditures indicate stagnation as compared to the same period of 2009. Moreover, the financing of the deficit is becoming more difficult. The government has been trying for several months, in a second attempt, to emit the country's first Eurobond ever. So far, however, it was not possible to raise the planned EUR 400 million with a maturity of up to 5 years and an interest rate of up to 7.5%. In the end it will most likely be possible to emit the bond at higher interest or to receive funds from the international financial organizations. Still, the deficit as a share in GDP will most probably drop or at least stagnate at around 6% in 2010. If international financial markets remain as risk averted as is currently the case, the Albanian government will have to drastically reduce the budget deficit in the years to come in order to keep the public debt share below 60% of GDP.

Overall we expect for the year 2010 stagnating final consumption and at best only a tiny increase in investment. This tiny increase may be following the rainfall increase in energy exports as well as an increase in manufactures exports due to exchange rate depreciation. It is that improvement of the current account that makes us forecast a GDP growth rate of 1.7% for 2010. Under the assumption that the international environment starts to improve slightly in the years 2011 and 2012 we can expect a very modest improvement of household consumption and private investment. Thus we forecast a growth rate of around 2% in 2011 and 3% in 2012. These rates are only about half of the medium-run potential growth rate of Albania.

Table AL

**Albania: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011 Forecast	2012 Forecast
Population, th pers., average	3135	3161	3177	3190	.	.	3210	3220	3240
Gross domestic product, ALL bn, nom.	882.2	966.7	1087.9	1180.0	300	300	1230	1280	1350
annual change in % (real)	5.4	6.0	7.8	4.2	3.8	-1.5	1.7	2.2	3
GDP/capita (EUR at exchange rate)	2300	2500	2800	2800	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5500	5800	6500	6600	.	.	.	.	.
Consumption of households, ALL bn, nom.	680.3	775.1	844.0	890.0	.	.	.	.	.
annual change in % (real)	4.7	10.7	6.7	1.0	.	.	0	2	3
Gross fixed capital form., ALL bn, nom.	343.9	374.9	431.7	450.0	.	.	.	.	.
annual change in % (real)	13.0	5.8	10.0	3.5	.	.	1	3	8
Gross industrial production <sup>2)</sup>									
annual change in % (real)	12.1	-10.3	9.4	4.3	6.5	.	10	2	7
Gross agricultural production <sup>3)</sup>									
annual change in % (real)	3.1	2.6	7.7	3.0	3.1	.	1	3	3
Construction output total <sup>2)</sup>									
annual change in % (real)	10.5	10.1	4.8	7.0	-3.9	.	0	2	4
Employed persons - LFS, th, June	.	1197.7	1103.0	1110.0	1114.2	.	1050	1060	1080
annual change in %	.	.	-7.9	0.6	3.2	.	-5	1	2
Employment reg. total, th pers., end of period	935.1	965.5	974.1	970.0	972.9	.	910	920	940
annual change in %	0.3	3.3	0.9	-0.4	3.6	.	.	.	.
Unemployed persons - LFS, th, June	.	184.8	166.0	167.0	.	.	190	180	170
Unemployment rate - LFS, in %, June	.	13.5	13.1	13.1	.	.	15	14	14
Reg. unemployment rate, in %, end of period	13.8	13.2	12.7	12.8	12.7	15	14	13	13
Average gross monthly wages, ALL	21842	27350	29000	31900	39396	.	.	.	.
annual change in % (real, gross)	6.7	21.6	2.6	7.6	10	.	.	.	.
Consumer prices, % p.a.	2.4	2.9	3.4	2.2	1.8	4.1	3	2	2
Producer prices in industry, % p.a.	0.8	3.5	6.5	-1.6	-1.2	.	-1	1	3
General governm.budget, nat.def., % GDP									
Revenues	26.0	26.0	26.8	25.4	.	.	23	24	25
Expenditures	29.3	29.6	32.3	32.2	.	.	29	26	27
Deficit (-) / surplus (+)	-3.3	-3.5	-5.5	-6.8	.	.	-6	-2	-2
Public debt, nat. def., in % of GDP <sup>4)</sup>	56.0	52.8	52.6	55.0	.	.	59	59	58
Base rate of NB, % p.a., end of period <sup>5)</sup>	5.5	6.3	6.3	5.3	5.8	5.3	5.3	5.3	6
Current account, EUR mn	-471.0	-831.0	-1370.3	-1345.5	-326.5	-246.6	-1120	-1210	-1400
Current account in % of GDP	-6.6	-10.6	-15.5	-15.1	-14.0	-11.4	-12.7	-13.0	-13.2
Exports of goods, BOP, EUR mn	630.6	786.3	917.5	750.7	175.7	255.0	970	1000	1110
annual growth rate in %	18.9	24.7	16.7	-18.2	-14.9	45.1	29	3	11
Imports of goods, BOP, EUR mn	2289.6	2890.4	3348.9	3054.4	692.5	674.0	3500	3600	4100
annual growth rate in %	14.1	26.2	15.9	-8.8	-5.6	-2.7	15	3	14
Exports of services, BOP, EUR mn	1156.6	1415.1	1687.8	1718.4	303.0	253.1	1800	2000	2200
annual growth rate in %	19.6	22.3	19.3	1.8	-13.9	-16.5	5	11	10
Imports of services, BOP, EUR mn	1188.0	1402.3	1618.4	1597.5	324.2	272.4	1700	1800	2100
annual growth rate in %	7.2	18.0	15.4	-1.3	-8.7	-16.0	6	6	17
FDI inflow, EUR mn	258.6	481.1	675.4	706.4	123.4	155.2	400	500	600
FDI outflow, EUR mn	8.3	11.1	55.4	26.1	4.0	1.5	10	20	30
Gross reserves of NB excl. gold, EUR mn	1329.2	1415.9	1626.1	1500.0	1593.2	.	.	.	.
Gross external debt, EUR mn <sup>6)</sup>	1445.4	1445.7	2624.3	3000.0	2701.41	.	.	.	.
Gross external debt in % of GDP	20.3	18.2	29.9	35.1	31.6	.	.	.	.
Average exchange rate ALL/EUR	123.1	123.6	122.8	132.1	128.2	138.6	140	137	127
Purchasing power parity ALL/EUR <sup>7)</sup>	51.2	52.7	52.9	55.9	.	.	.	.	.

1) Preliminary. - 2) Gross value-added. - 3) Gross value-added of agriculture, forestry and fishing. - 4) Based on IMF data. - 5) One week repo rate. - 6) Until 2007 based on IMF data. - 7) Benchmark results 2005 from Eurostat and wiiw estimates.

Source: wiiw Database incorporating national statistics and IMF. Forecasts by wiiw.



*Josef Pöschl*

## **Bosnia and Herzegovina: Downers and uppers in moderation**

Bosnia and Herzegovina (BiH) generates a high proportion of its GDP in sectors producing goods and services that are not exposed to international competition. It shares this characteristic with other economies in Southeast Europe; BiH is far from being an extreme case. Total manufacturing generates slightly over 10% of the GDP, whereas public administration in a broader sense<sup>50</sup> and trade (wholesale and retail) contribute significantly more: close to 25% and 16%, respectively. The value-added of financial intermediation and real estate together is almost equal to that of manufacturing. At the same time, the share of manufacturing in total registered employment is over 20% – and thus disproportionately high.

In more recent years prior to the crisis, the export to GDP ratio was below 30%: an extremely low figure for a small open economy. Whereas SMEs developed nicely after 1995, the number of large successful exporters has remained low. The country has failed to develop fully into a single economic space – owing to shortcomings in both the physical and institutional infrastructure. Moreover, BiH hardly offers companies easy access to large markets. Efforts to coordinate the use of existing capacities have been lacking. The leading political forces have never made it their first joint priority to remove such obstacles, so that the huge sums, which international organizations and donor countries earmarked to support BiH in the years after 1995, have yielded suboptimal results. Some major exporters from earlier times never fully recovered, while the involvement of foreign direct investors has remained low; investment in export capacities, such as those of Mittal in Zenica, remained the exception rather than the rule. The country suffers from major shortcomings, which will be difficult to overcome.

In the period January to April 2010, BiH exports amounted to EUR 1.1 billion – up by 28% year-on-year. They covered 55% of imports (EUR 2 billion). The change in the volume of imports was negligible. Quite possibly, financing imports from sources other than export revenues has become more difficult than in the past. Between 2008 and 2009, imports contracted by 25%, while the current account deficit dropped from EUR 1.9 billion to 0.9 billion. As for covering that deficit, the inflow of foreign direct investment (FDI) fell from EUR 0.73 to 0.36 billion, while the currency reserves diminished somewhat. By the end of March 2010, however, they had almost fully recovered – despite a 25% decrease in FDI compared to the first quarter of 2009.

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<sup>50</sup> Including defence, social security, education, health and social work as well as other community, social and personal services.

A large proportion of the population in BiH lives in rural areas and is engaged in farming (frequently at a subsistence level). Nevertheless, the trade balance in terms of food is markedly negative. In the period January-April 2010, exports of unprocessed agricultural products and processed food covered less than one quarter of imports. Customs and excise authorities lack the efficiency required to control the volumes and prices declared. Trade policy makes only limited use of the instruments available, such as import tariffs for livestock, meat and meat products or seasonal tariffs for certain products, as well as such mechanisms as in-country inspection. At the same time, food exports suffer from inadequate services provided by laboratories authorized to issue certificates valid for exports into the EU. Basic metals contributed most to total exports (20%) in the period January-April 2010, but wood and wood products (including furniture) generated a higher surplus over the same period (EUR 102 million compared to 95 million). The third major surplus-generating export good is electricity (EUR 75 million).

Industrial data offer a mixed picture. The Statistics Office in Republika Srpska keeps publishing positive growth figures – over 7% increase in output year-on-year for the first four months of 2010, whereas employment fell at nearly the same rate. This discrepancy follows from the fact that the increase in output is attributable to but a few industries (in particular, mining of metal ores), whereas most other industries are struggling for want of demand. The Statistics Office of the Federation of BiH reports a 2.2% increase in output and a 1% decline in employment for the same period. Producer prices for the first four months of 2010 were slightly down compared to the same period in the previous year: a drop of 0.4%, Wages, however, remained practically unchanged. In the context of the currency board regime, this is not a bad development, as it does not support fears of deteriorating competitiveness.

In contrast to a slight increase in industrial output, construction activities continued to be depressed. In April 2010, compared to April 2009, they were down by 29% in the Federation of BiH and by 19% in Republika Srpska. This was due to both low private demand and tight public budgets. Projects financed by the EU and IFIs continue to have a stabilizing effect without, however, incurring an expansionary element. Empty order books are causing trouble; one major construction company, Sarajevo Hidrogradnja, has declared its inability to pay salaries.

Consumer prices continue to show a declining trend. That holds true, at least, for products sold under competitive conditions. The 2.4% year-on-year increase in consumer prices, as reported in April 2010, is largely attributable to: (i) levies on alcohol and tobacco products (+ 30.6%) following an increase in excise tax as of 1 January 2010; and (ii) higher prices for transport (+11.5%), communications (+8.3%), education (+5.8%) and housing (+5.4%).

Privatization came close to a standstill a long time back. One of the rare exceptions is Bosnalijek, a pharmaceutical company, shares of which are held by IFC and the government of the Federation of BiH. A US investor is interested, but the case has become rather controversial. A recent attempt to privatize shares in Aluminij Mostar failed and a new tender process will follow.

Most of the micro-loan organizations operating in BiH suffered losses in 2009. According to the central bank, commercial banks are meeting the statutory level of capitalization, but some of them

could well need additional capital, should the situation get any worse. Their overall loan volume has remained more or less stable in recent months, hinting at a marginally positive trend. Money supply has also increased slightly.

In May 2010, revenues of the Indirect Taxation Office, including customs duties, increased by 12% year-on-year despite a drop in revenues from value-added tax. Nevertheless, making ends meet will be difficult in 2010; discussions on the allocation of budget revenues have intensified. In the context of the current stand-by agreement, the IMF has entered a plea for granting the central government a higher share in tax revenues. It has also urged the Federation of BiH to reduce its budget deficit, at least part of which is structural in nature. The Federation has failed to: (i) adopt a law pertaining to civil service salaries; (ii) report on the effects of having revised certain budget expenditures; (iii) launch a reform of the pension system; and (iv) redefine the system of privileged pensions. In the run-up to the general election scheduled for 3 October, politicians are afraid of disappointing some of the electorate through painful reforms. The delay in meeting previously agreed goals has led to a temporary suspension of talks on maintaining the stand-by arrangement. This will postpone the disbursement of the fourth tranche of IMF funds (about EUR 40 million). If the delay persists, problems associated with financing the public deficits will gradually intensify.

Several years ago BiH citizens with Croatian passports acquired the right to visa-free travel throughout the Schengen countries. Those with Serb passports followed suit a few months ago. As confirmed at the EU Balkan Summit on 2 June 2010, the EU will expand its visa liberalization programme later this year so as to include all BiH citizens. In order to meet the prerequisites, the country needs to build up capacities still more and strengthen the legal framework for fighting organized crime and corruption. This will involve implementing an action plan for the introduction of an electronic system for the exchange of police records and the harmonization of criminal legislation at the state level.

In their meeting on 23 April in Tallinn, the NATO foreign ministers agreed to accept the BiH application for a Membership Action Plan (MAP). In order to start the process, BiH will have to transfer ownership of all defence-related property to the central state: a controversial issue within the country. As for EU membership, Valentin Inzko, High Representative and EU Special Representative, recently mentioned that 2018 might be a possible accession date for several Balkan countries. It remains to be seen whether BiH manages to organize its first post-war census in 2011.

An official GDP growth figure for 2009 is still not available; we reckon with a relatively modest decline in GDP. We expect the economy to stagnate in 2010, followed by relatively modest GDP growth in 2011 and 2012. The main reason for this comparatively smooth performance is that most of the GDP stems from low-volatility sectors. The agents in those sectors are likely to find themselves compelled to economize on expenditures, which will have a dampening effect on aggregate demand. Hardly any of the main demand components of GDP are likely to experience a major boost over the next few years; exports, however, might prove the exception, should the global metals market enjoy a boom.

Table BA

**Bosnia and Herzegovina: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average	3843	3843	3842	3843	.	.	3843	3843	3843
Gross domestic product, BAM mn, nom. <sup>2)</sup>	19252.5	21760.2	24702.5	23950.0	.	.	24100	24600	25600
annual change in % (real) <sup>2)</sup>	6.1	6.2	5.7	-3.2	.	.	0	1	3
GDP/capita (EUR at exchange rate)	2500	2900	3300	3200	.	.	3200	3300	3400
GDP/capita (EUR at PPP - wiiw)	5700	6300	7000	6600	.	.	.	.	.
GDP by expend. approach, BAM mn, nom. <sup>2)</sup>	21366.1	24708.6	28092.6	.	.	.	.	.	.
Consumption of households, BAM mn, nom. <sup>2)</sup>	18064.3	19930.8	22437.4	21390	.	.	.	.	.
annual change in % (real) <sup>2)</sup>	4.5	6.0	5.8	-4.0	.	.	-1	0	1
Gross fixed capital form., BAM mn, nom. <sup>2)</sup>	4756.8	6446.4	7521.0	5920	.	.	.	.	.
annual change in % (real)	-9.4	28.8	10.9	-20.0	.	.	0	5	8
Gross industrial production <sup>3)</sup>									
annual change in % (real)	11.5	6.4	11.0	-3.3	-2.5	1.3	0	3	7
Gross agricultural production, total									
annual change in % (real)	3.2	-1.6	.	.	.	.	.	.	.
Employed persons - LFS, th, April	811.0	849.6	890.2	859.2	859.2	.	820	820	820
annual change in %	.	4.8	4.8	-3.5	-3.5	.	-5	0	0
Employees total - reg., th, average	653.3	686.1	705.6	697.6	702.4	691.5	650	650	650
annual change in %	1.6	5.0	2.9	-1.1	0.4	-1.6	-7	0	0
Unemployed persons - LFS, th, April	366.8	346.7	272.0	272.3	272.3	.	.	.	.
Unemployment rate - LFS, in %, April	31.1	29.0	23.4	24.0	24.0	.	27	27	27
Reg. unemployment rate, in %, end of period	44.1	42.5	40.6	42.4	41.4	42.9	44	44	44
Average gross monthly wages, BAM	869	954	1112	1204	1200	1203	.	.	.
annual change in % (real, net)	2.3	8.4	8.4	5.6	9.8	-1.5	.	.	.
Consumer prices, % p.a.	6.2	1.5	7.5	-0.4	1.6	1.7	0.5	1	1
Producer prices in industry, % p.a.	.	.	.	.	.	.	.	.	.
General governm. budget, nat. def., % GDP									
Revenues	44.6	45.2	44.1	42.0	.	.	42	43	43
Expenditures	41.7	43.9	46.1	45.0	.	.	46	45	45
Deficit (-) / surplus (+)	2.9	1.3	-2.0	-3.0	.	.	-4	-2	-2
Public debt, nat. def., in % of GDP <sup>4)</sup>	22.0	29.8	30.8	33.4	.	.	30	30	30
Base rate of NB, % p.a., end of period	.	.	.	.	.	.	.	.	.
Current account, EUR mn <sup>5)</sup>	-769.7	-1156.2	-1909.0	-924.0	-174.0	-68.6	-1000	-1000	-1000
Current account in % of GDP	-7.8	-10.4	-15.1	-7.5	.	.	-8	-8	-8
Exports of goods, BOP, EUR mn <sup>5)</sup>	2687.3	3091.5	3522.0	2920.2	655.4	811.3	3000	3200	3500
annual growth rate in %	30.5	15.0	13.9	-17.1	-20.4	23.8	3	7	9
Imports of goods, BOP, EUR mn <sup>5)</sup>	6093.0	7233.6	8344.6	6326.6	1433.8	1408.9	6400	6700	7100
annual growth rate in %	1.2	18.7	15.4	-24.2	-23.9	-1.7	1	5	6
Exports of services, BOP, EUR mn <sup>5)</sup>	903.7	1061.7	1125.6	991.7	205.4	175.5	1030	1080	1150
annual growth rate in %	13.2	17.5	6.0	-11.9	-11.6	-14.6	4	5	6
Imports of services, BOP, EUR mn <sup>5)</sup>	374.9	421.2	485.4	455.4	77.1	67.4	400	410	420
annual growth rate in %	6.4	12.3	15.2	-6.2	-1.5	-12.6	-12	2	2
FDI inflow, EUR mn <sup>5)</sup>	572.4	1517.3	726.0	360.8	32.0	17.3	300	400	700
FDI outflow, EUR mn <sup>5)</sup>	3.2	20.5	9.2	3.3	1.1	0.5	5	5	5
Gross reserves of NB excl. gold, EUR mn <sup>6)</sup>	2787.4	3424.9	3218.9	3143.8	3066.3	3131.7	3050	3050	4000
Gross external debt, EUR mn <sup>7)</sup>	2081.5	2025.4	2168.0	2677.0	2242.0	2891.4	2700	2700	2500
Gross external debt in % of GDP	21.1	18.2	17.2	21.7	.	.	.	.	.
Average exchange rate BAM/EUR	1.956	1.956	1.956	1.956	1.956	1.956	1.96	1.96	1.96
Purchasing power parity BAM/EUR <sup>8)</sup>	0.875	0.898	0.923	0.938	.	.	.	.	.

1) Preliminary. - 2) According to ESA'95 (including shadow economy, real growth rates based on previous year prices). - 3) wiiw estimates based on weighted averages for the two entities (Federation BH and Republika Srpska). - 4) Based on IMF data. - 5) Converted from national currency with the average exchange rate. - 6) Including investment in foreign securities. - 7) Gross external public debt. - 8) Benchmark results 2005 from Eurostat and wiiw estimates.

Source: wiiw Database incorporating national statistics and IMF. Forecasts by wiiw.



*Vladimir Gligorov*

## **Montenegro: Another year of negative growth**

There is a disagreement between the IMF and the government about the GDP decline last year: -6.6% as opposed to -5.3%. There is, however, no disagreement about the causes, the course, and the outcome of the crisis. Also, the government's policy has met with support by the international financial institutions, but also by the voters. The recently held local elections reaffirmed the support for the governing coalition. In addition, the European Commission is reviewing the outcome of the screening exercise and will submit its opinion on Montenegro's readiness to start negotiations for membership sometime later this year. The opinion is expected to be positive, though there is no telling when the negotiations will actually start. Finally, the negotiations for membership in NATO should end with membership in the next couple of years.

The economic news, however, is not all that good. The scale of the impact of the crisis can be debated, but there is no doubt that the impact was severe. More important is the fact that it was channelled via the banking sector, which at one point was close to collapsing. The government and the central bank needed to come up with a significant amount of financial support in order to ensure that the early run on the banks did not develop into a wholesale panic. In that, the authorities were successful and confidence has returned, but the financial sector is not without problems.

In addition, industrial production collapsed due to the fall in prices of metals, which affected the country's aluminium plant and steel-mill. The two account for much of Montenegro's industrial production. Especially important is the aluminium plant, which is a major exporter and also employs many people. The government decided to come to the rescue of aluminium production and spend a lot of money to stabilize the situation in the plant.

These significant fiscal injections into the banking and the industry sectors were possible because the budget had saved significant surpluses during the boom years. Also, foreign investments held up because they came in part from Third World countries. It is expected that foreign investments will continue this year too though the scale is uncertain. Montenegro intends to build water power plants and improve its infrastructure. These investments should help to cover the large external imbalances and the rather large fiscal deficit planned for the current year. Still, with all that, the economy should shrink by an additional 1% to 2%, though the government is forecasting a small positive growth. The outcome may depend on the results of the tourist season as that is the crux of the economy.

Policies so far have been rather accommodative. Although the ruling parties have a very liberal programme, they did not refrain from expanding public spending as much as was needed. It is,

however, to be expected that along with the recovery, the fiscal policy will change and major reforms will be attempted in order to achieve fiscal balance. That will be easier if recovery is stronger than in most countries in the region. That, in turn, depends on an increased inflow of foreign finances, which at the moment is uncertain.

The prospects for the near future are rather dim. In the medium term, however, the country may continue to be attractive for investments in tourism and other tradable services. The IMF expects a recovery rate of 4% in the medium run. That may be on the optimistic side because it depends on the recovery in the EU which may disappoint. So, growth may prove elusive, but stability should not be threatened.

Table ME

## Montenegro: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011	2012
							Forecast		
Population, th pers., average <sup>2)</sup>	624.2	626.2	628.8	630.0	.	.	631	632	633
Gross domestic product, EUR mn, nom. <sup>3)</sup>	2149.0	2680.5	3085.6	3003.0	.	.	3100	3300	3500
annual change in % (real) <sup>3)</sup>	8.6	10.7	6.9	-5.3	.	.	-1	2	3
GDP/capita (EUR at exchange rate)	3400	4300	4900	4800	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	8400	10000	10700	10000	.	.	.	.	.
Consumption of households, EUR mn, nom. <sup>3)</sup>	1660.9	2369.0	2814.8	2800	.	.	.	.	.
annual change in % (real) <sup>4)</sup>	10	8	7	-4	.	.	0	2	2
Gross fixed capital form., EUR mn, nom. <sup>3)</sup>	469.8	867.1	1180.2	1100	.	.	.	.	.
annual change in % (real) <sup>4)</sup>	8	10	8	-6	.	.	0	3	4
Gross industrial production									
annual change in % (real)	1.0	0.1	-2.0	-32.2	-13.6	-14.5	0	2	4
Net agricultural production	.	.	.	.	.	.	.	.	.
annual change in % (real)	1.9	-11.0	10.0	2.0	.	.	.	.	.
Construction output total <sup>5)</sup>	.	.	.	.	.	.	.	.	.
annual change in % (real)	28.0	23.6	20.7	5.0	.	.	.	.	.
Employed persons - LFS, th, average <sup>6)</sup>	178.4	217.4	218.8	213.6	212.5	.	215	220	220
annual change in %	-0.3	21.9	0.6	-2.4	-0.3	.	0	1	1
Unemployed persons - LFS, th, average <sup>6)</sup>	74.8	52.1	45.3	50.4	51.6	.	.	.	.
Unemployment rate - LFS, in %, average <sup>6)</sup>	29.6	19.3	17.2	19.1	19.5	.	20	20	20
Reg. unemployment rate, in %, end of period <sup>7)</sup>	20.5	16.5	14.4	15.1	14.6	16.2	.	.	.
Average gross monthly wages, EUR <sup>8)</sup>	377	497	609	643	649	695	.	.	.
annual change in % (real, net)	12.0	15.0	14.6	7.6	7.1	6.5	.	.	.
Consumer prices, % p.a.	3.0	4.2	7.4	3.4	5.3	0.6	1	3	3
Producer prices in industry, % p.a. <sup>9)</sup>	3.6	8.5	14.0	-3.9	3.6	-5.7	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	45.4	61.1	49.1	45.5	.	.	.	.	.
Expenditures	42.7	52.9	47.5	49.0	.	.	.	.	.
Deficit(-)/Surplus(+)	2.7	8.2	1.7	-3.5	.	.	-5	-3	-1
Public debt, nat. def., in % of GDP	32.6	26.3	26.8	38.0	.	.	43	44	42
Base rate of NB, % p.a., end of period	.	.	.	.	.	.	.	.	.
Current account, EUR mn <sup>10)</sup>	-531.4	-1060.8	-1564.2	-896.2	-193	.	-500	-550	-600
Current account in % of GDP	-24.7	-39.6	-50.7	-29.8	.	.	-16	-17	-17
Exports of goods, BOP, EUR mn	648.3	515.8	467.4	296.3	83.7	.	440	460	480
annual growth rate in %	40.8	-20.4	-9.4	-36.6	-22.7	.	20	5	5
Imports of goods, BOP, EUR mn	1497.7	2090.0	2549.7	1667.8	287.0	.	1180	1300	1430
annual growth rate in %	53.7	39.5	22.0	-34.6	-34.5	.	-10	10	10
Exports of services, BOP, EUR mn	418.0	672.9	750.6	680.6	55.2	.	710	780	860
annual growth rate in %	26.7	61.0	11.5	-9.3	-15.0	.	5	10	10
Imports of services, BOP, EUR mn	220.9	234.0	351.2	296.0	64.4	.	290	260	290
annual growth rate in %	64.6	5.9	50.1	-15.7	-7.6	.	-5	-10	10
FDI inflow, EUR mn	492.8	672.7	625.4	943.8	99.1	.	500	1000	1000
FDI outflow, EUR mn	26.1	115.0	73.7	32.9	10.4	.	0	50	50
Gross reserves of NB, excl. gold, EUR mn <sup>11)</sup>	172.8	259.0	216.6	175.0	202.0	165.8	.	.	.
Gross external public debt, EUR mn	504.0	462.1	481.7	540.0	.	.	.	.	.
Gross external public debt in % of GDP	23.5	17.2	15.6	18.0	.	.	.	.	.
Purchasing power parity EUR/EUR <sup>12)</sup>	0.41	0.43	0.46	0.48	.	.	.	.	.

1) Preliminary. - 2) wiiw estimate in 2009. - 3) According to ESA'95 (including shadow economy, real growth rates based on previous year prices). - 4) wiiw estimate. - 5) Gross value-added. - 6) Until 2007 as of October. - 7) In % of unemployed plus employment (excluding individual farmers). - 8) From 2007 wage data refer to employees who received wages (previously wages were divided by all registered employees in enterprises); comparable value for 2006: 433. - 9) Domestic output prices. - 10) Including all transactions with Serbia. - 11) Refer to reserve requirements of the central bank. - 12) Benchmark results 2005 from Eurostat and wiiw estimates.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.



*Vladimir Gligorov*

## **Serbia: Slow recovery with depreciation**

Unlike most other Balkan countries, Serbia's actual exchange rate regime is a managed float. As a consequence the central bank could let the dinar depreciate rather strongly from the beginning of the crisis: above 30% since August 2008. Initially, that had a stronger impact on imports, but it may be supporting the growth of exports since late 2009. In any case, exports have been growing by somewhat less than 20% while imports are still declining by just above 2% year-on-year in the first five months of 2010. This seems to be affecting industrial production, which is growing by somewhat less than 4% this year. These developments may have been enough to produce a 1% growth of GDP in the first quarter. Investments are declining, however, and so is private consumption. Public consumption, on the other hand, is increasing faster than planned and the fiscal deficit should be higher by somewhat less than 1% of GDP, mainly due to lower than envisaged revenues, for the year as a whole. The current forecast, agreed on by the government and the IMF, is for 1.5% of growth of GDP this year and 3% growth next year. This presents a downward revision from 2% in 2010 and may prove to be somewhat optimistic. Still, numbers put aside, the recovery is clearly slow and the risks are biased on the downside.

The key risk is the state of the balance sheets of the corporations. They are under pressure from declining consumption and rising costs due to exchange rate depreciation. The hardest hit is construction. That activity is depressed and there is scant chance that it might recover any time soon. Credit has dried out so it is hard to build and even harder to sell the already built apartments and offices. Similarly, falling retail trade is presenting problems for the companies in that line of business. Indeed, the whole services sector is facing tough times, and services are the major part of the economy.

Labour market problems are also mounting. Loss of employment in 2009 was quite strong and labour shedding has been continuing in the first half of this year too. Additional job losses are planned with the reduction of government employees. Furthermore, wages have been frozen since the beginning of the crisis and are declining in real terms and also in euro due to the devaluation. Similarly, real pensions are declining for the same reason. Given that the number of pensioners is not much lower than the number of employed people, the overall fall of income in real terms is quite significant.

Dinar depreciation has not speeded up inflation all that much; indeed inflation is slowing down. If it were not for the upward adjustment of administered prices and some contribution from higher import prices, deflationary pressures would be quite strong. In any case, the slowing down of inflation has

made it possible for monetary policy to be more accommodative. The central bank reduced its policy rate from somewhat below 20% before the crisis to 8% in early June 2010 and further cuts are possible if there is no spike in the rate of inflation.

Fiscal policy has been accommodative with deficits above 4% of GDP in 2009 and 2010. Not much of a fiscal stimulus can be attributed to these deficits, however, because they mostly reflect the shortfall in public revenues. As public sector wages and also pensions have been frozen and public investments cannot be increased within a short period of time, it is hard to attribute much growth support to fiscal policy. Monetary policy has been more active with the central bank reducing the reserve requirements in addition to lowering interest rates. This has had some effects on the availability of credit, but mainly for government debt. Indeed, there are some indications that the credit exposure of the, mostly foreign-owned, banks is being reduced. In early 2009 these banks signed up to the Vienna Initiative, that is to a commitment that they will not reduce their exposure to the Serbian financial market. At the beginning of this year, however, this commitment was relaxed and it was agreed, implicitly, that they could reduce their credit exposure by as much as 20%. This may be one of the reasons why the dinar exchange rate continues to depreciate in euro terms.

The prospect is for a slow recovery mostly driven by an improvement in the trade balance. That has a limit, however, because the tradable sector is rather small and with declining investments, export capacity is quite limited in the short run. The government intends to sell the Telecom and use the money to invest in infrastructure with the hope that this will lead to increased foreign investments in the tradable sector. As wages are quite low in euro terms, better and cheaper access to external markets could support a speed-up in growth. The risk is, however, that pressure to support current consumption may lead to the privatization income to be spent and not invested. In any case, in the medium run, slow recovery if not stagnation seem the most probable prospect.

Table RS

**Serbia: Selected Economic Indicators**

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011	2012
							Forecast		
Population, th pers., average	7411.6	7381.6	7350.2	7320.0	.	.	7300	7280	7250
Gross domestic product, RSD bn, nom.	1962.1	2302.2	2722.5	2953.5	.	.	3200	3400	3600
annual change in % (real)	5.2	6.9	5.5	-3.0	-4.1	0.6	1	2	3
GDP/capita (EUR at exchange rate)	3100	3900	4600	4300	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	7700	8300	9000	8700	.	.	.	.	.
Consumption of households, RSD mn, nom.	1492.7	1714.0	2023.6	.	.	.	.	.	.
annual change in % (real) <sup>2)</sup>	5.4	6	6	-2	.	.	0	2	2
Gross fixed capital form., RSD mn, nom.	412.8	552.3	632.4	.	.	.	.	.	.
annual change in % (real) <sup>2)</sup>	15.2	12	8	-5	.	.	0	3	4
Gross industrial production									
annual change in % (real)	4.7	3.7	1.1	-12.1	-15.7	2.8	2	3	3
Gross agricultural production									
annual change in % (real)	-2.6	-8.0	9.0	5.0	.	.	.	.	.
Construction output total <sup>3)</sup>									
annual change in % (real)	7.7	10.8	4.6	-17.1	-14.0	.	.	.	.
Employed persons - LFS, th, Oct <sup>4)</sup>	2630.7	2655.7	2821.7	2616.4	.	.	2510	2510	2510
annual change in %	-3.8	1.0	.	-7.3	.	.	-4	0	0
Unemployed persons - LFS, th, Oct <sup>4)</sup>	693.0	585.5	445.4	503.0	.	.	.	.	.
Unemployment rate - LFS, in %, Oct <sup>4)</sup>	20.9	18.1	13.6	16.1	.	.	22	22	22
Reg. unemployment rate, in %, end of period	28.0	25.4	24.0	24.8	25.1	26.2	.	.	.
Average gross monthly wages, RSD <sup>5)</sup>	31745	38744	45674	44147	41933	44326	.	.	.
annual change in % (real, net) <sup>5)</sup>	11.4	19.5	3.9	0.2	2.6	1.4	.	.	.
Consumer prices, % p.a.	11.7	7.0	11.7	8.6	9.4	4.3	6	4	4
Producer prices in industry, % p.a. <sup>6)</sup>	13.3	5.9	12.4	5.6	5.3	11.1	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	43.8	42.4	41.0	39.5	.	.	.	.	.
Expenditures	45.4	44.3	43.5	43.7	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-1.7	-1.9	-2.5	-4.2	.	.	-5	-3	-3
Public debt, nat.def., in % of GDP	37.3	29.8	27.9	32.6	.	31.1	35	36	36
Discount rate of NB, % p.a., end of period	8.5	8.5	8.5	8.1	8.5	8.1	8	7	7
Current account, EUR mn	-2356.0	-4614.4	-6089.7	-1743.4	-978.6	-724.9	-2700	-3100	-3100
Current account in % of GDP	-10.1	-16.0	-18.2	-5.5	.	.	-9	-10	-10
Exports of goods, BOP, EUR mn	5109.0	6382.0	7415.0	5978.0	1291.0	1470.6	6300	6900	7600
annual growth rate in %	27.4	24.9	16.2	-19.4	-22.8	13.9	5	10	10
Imports of goods, BOP, EUR mn	10090.0	13020.0	14964.0	10760.0	2755.4	2622.0	11300	12400	13600
annual growth rate in %	21.8	29.0	14.9	-28.1	-20.8	-4.8	5	10	10
Exports of services, BOP, EUR mn	1839.0	2304.0	2741.4	2500.1	568.1	537	2500	2800	3100
annual growth rate in %	39.3	25.3	19.0	-8.8	-17.4	-5.5	0	10	10
Imports of services, BOP, EUR mn	1880.0	2557.7	2913.9	2477.3	606.9	554.8	2500	2800	3100
annual growth rate in %	41.9	36.0	13.9	-15.0	-6.9	-8.6	0	10	10
FDI inflow, EUR mn	3392.4	2512.6	2017.5	1410.1	644.7	333.2	1000	1500	1500
FDI outflow, EUR mn	70	692	193	38	1.4	49.7	100	200	200
Gross reserves of NB, excl. gold, EUR mn	8857.9	9440.7	7938.5	10277.7	7864.5	10093.4	.	.	.
Gross external debt, EUR mn	14884.4	17789.4	21800.5	22787.0	21445.2	23278.4	.	.	.
Gross external debt in % of GDP	59.9	61.2	70.9	74.0	69.6	74.9	.	.	.
Average exchange rate RSD/EUR	84.19	79.98	81.47	93.92	93.8	98.6	103	110	115
Purchasing power parity RSD/EUR <sup>7)</sup>	34.42	37.66	41.04	46.55	.	.	.	.	.

1) Preliminary. - 2) wiiw estimate. - 3) Gross value-added. - 4) From 2008 extended survey as of April and October. - 5) From 2009 methodological changes of survey. - 6) Domestic output prices. - 7) Benchmark results 2005 from Eurostat and wiiw estimates.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.



*Peter Havlik*

## **Russian Federation: Consolidated yet unspectacular recovery**

Having spent nearly one year in a deep recession, the Russian economy started to recover from the crisis in late 2009. The link between energy prices and the fortunes of the Russian economy comes to the fore in both boom and bust. With a time lag of about two months, stabilization and an economic upswing followed the recovery of oil prices (the latter climbed to over USD 70 per barrel in August 2009). The GDP ceased to fall in November 2009, industrial production, the volume of goods transport and export revenues started to grow in November 2009 on an annual basis as well. Yet domestic demand still remained depressed as both retail trade and particularly investments continued to contract even in the final months of last year. The recovery in the autumn notwithstanding, GDP fell by 7.9% in 2009 – mainly due to the sharp reduction of fixed investment and a sizeable reduction of inventories. Consumer expenditures declined by more than 5% despite a modest (+2.3%) increase in real money incomes implying an increase in savings. Foreign trade, with falling exports and sharply reduced imports (in both nominal and real terms), mitigated the overall economic decline: the real contribution of foreign trade to GDP growth was positive in 2009, after several 'negative' years. CPI inflation slowed down (producer prices and the GDP deflator even fell) and the unemployment rate rose by about 2 percentage points.

Most trend features of the above-mentioned developments remained unchanged in early 2010 as the oil price continued to be above USD 70 per barrel: modest growth of GDP (+3%, year on year, in the first quarter of 2010), a stronger upswing of industry (+5.8%), goods transport (+11.5%) and, above all, export revenues (+60%). Domestic demand remained subdued with retail trade turnover and real expenditures on goods and services as a proxy for household consumption expanding by just 1% in the first quarter (despite robust growth of real disposable incomes in the same period). Most importantly, investment continued to fall while the export surplus expanded rapidly as the growth of imports was moderate. Among the positive features one has to mention the stabilization of the unemployment rate below 9% and continued disinflation (measured by the CPI; producer price inflation accelerated). Last but not least, as a by-product of rising export revenues, the rouble has been appreciating again after a short-lived depreciation during the peak of the crisis at the turn of 2008-2009.

Unfortunately, the crisis has not been used as a stimulus for a radical overhaul of economic policies; restructuring and modernization have so far been just slogans (see below). The various anti-crisis measures announced and implemented from late 2008 onwards resembled the standard rescue and fiscal packages adopted in the West. A large part of the earlier ambitious investment plans was discarded and the budget was thoroughly revised. The aim was to improve the liquidity of the banking sector and restore confidence, to support the exchange rate and domestic consumption.

The costs of the various anti-crisis measures may add up to 10% of GDP; judging by the sharp fall in consumption and in investment in particular, the effects of the adopted measures have been rather disappointing. The steep decline in investments indicates not only tightened credit, but also a deterioration of business confidence and the correction of the previous housing bubble. The share of investment (gross capital formation) fell to 20% of GDP in 2009 – a rather low figure compared to other transition countries and definitely insufficient for the urgently needed development of infrastructure and modernization of capital stocks.

From this perspective, the government's long-term strategic target of economic diversification and modernization remains high on the agenda, yet it is obviously getting out of reach. President Medvedev's priority modernization areas include energy, nuclear technologies, global information technologies and services, medical equipment and pharmaceuticals. These modernization fields are allegedly backed by specific implementation plans which also count on the participation of foreign companies and researchers. Indeed, as one of the recent foreign policy breakthroughs,<sup>51</sup> the latest (31 May to 1 June 2010) EU–Russia summit in Rostov on Don adopted a joint statement on the Partnership for Modernization with both parties pledging to encourage the sectoral dialogue and the implementation of specific joint projects. Accession to WTO (postponed once again in June 2009 on the pretext of forming a Customs Union with Belarus and Kazakhstan) was put back on the agenda again.

The recent foreign policy advances are instrumental in consolidating the earlier fragile signs of recovery which had been visible already from late summer 2009. These include a modest increase in output, rising export revenues (thanks to higher oil prices), the stabilization of inflation and a strengthening of the exchange rate. GDP growth resumed in the fourth quarter of last year, not least thanks to statistical base effects, with modest (up to 4.5% per year) growth acceleration possible in 2010-2012. The current forecast (a slight upward revision) is based on the assumption of stabilized oil prices (Urals costing around USD 70-80 per barrel) and no abrupt policy changes or external shocks. Both private consumption and investment are expected to grow faster than GDP (the latter in 2010 largely thanks to the build-up of replenished inventories). Real exports will continue to be sluggish at best since the volumes of exported oil and gas will hardly increase, while imports will grow at a faster rate, fuelled by an appreciating rouble. This implies a small negative contribution of real net exports to GDP growth in 2010 and, in nominal terms, a gradual reduction of the trade and current account surpluses. The current account surplus, expected to peak in 2010, will drop below 3% of GDP by 2012. Annual CPI inflation may remain in single digits and the budget deficit will gradually turn into a surplus again. The employment effects of the crisis have so far been rather modest. They are being mitigated by demography as the domestic labour supply is shrinking. Our previous assessment remains unchanged: labour shortages are likely to reappear soon and will definitely put a brake on economic growth already in the medium run. Chances for a successful modernization and restructuring are meagre. Needless to say, another wave of the crisis cannot be ruled out either should growth in the world economy slow down again and/or energy prices fall.

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<sup>51</sup> Other breakthroughs include the signing of a new START Treaty by presidents Obama and Medvedev in Prague, as well as marked improvements in the relations with Ukraine and Poland. Currently, Georgia (and, paradoxically, Belarus) remain almost the only sore point in Russian external relations.

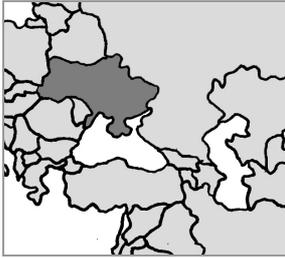
Table RU

## Russia: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average <sup>2)</sup>	142487	142115	141956	141902	141900	.	140000	139500	139000
Gross domestic product, RUB bn, nom.	26903.5	33258.1	41444.7	39063.6	8397.0	9862.0	43500	48500	53500
annual change in % (real)	7.7	8.1	5.6	-7.9	-9.4	2.9	4.0	4.2	4.4
GDP/capita (EUR at exchange rate)	5500	6700	8000	6200	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	11100	12400	13200	12000	.	.	.	.	.
Consumption of households, RUB bn, nom.	12887.9	16006.8	20009.6	21084.4	4876.5	.	.	.	.
annual change in % (real)	11.4	13.9	10.8	-7.7	-2.6	.	4.5	5	4
Gross fixed capital form., RUB bn, nom.	4980.6	6984.0	9182.6	8387.5	1345.0	.	.	.	.
annual change in % (real)	18.0	21.1	10.4	-15.7	-16.2	.	-6	6	10
Gross industrial production									
annual change in % (real)	6.3	6.3	2.1	-10.8	-14.3	5.8	5	5	5
Gross agricultural production									
annual change in % (real)	3.6	3.4	10.8	1.2	2.3	3.6	.	.	.
Construction industry									
annual change in % (real)	18.1	18.2	12.8	-16.0	-19.2	-8.5	.	.	.
Employed persons - LFS, th, average	68855.0	70570.5	70965.1	69284.9	67760.0	68028.0	69000	69000	68700
annual change in %	1.0	2.5	0.6	-2.4	-2.5	0.4	-0.4	0	-0.4
Unemployed persons - LFS, th, average	5312.0	4589.0	4791.5	6372.8	7056.0	6436.0	6400	6000	6000
Unemployment rate - LFS, in %, average	7.2	6.1	6.3	8.4	9.4	8.6	8.5	8	8
Reg. unemployment rate, in %, end of period	2.3	2.0	2.0	2.9	2.9	3.0	.	.	.
Average gross monthly wages, RUB	10633.9	13593.4	17226.3	18785.0	17448.7	19371.0	.	.	.
annual change in % (real, gross)	13.3	17.0	10.3	-2.8	-0.8	2.2	.	.	.
Consumer prices, % p.a.	9.8	9.1	14.1	11.8	13.9	7.2	6.5	7	7
Producer prices in industry, % p.a. <sup>3)</sup>	12.4	14.1	21.4	-7.2	-8.3	13.8	10	10	10
General governm.budget, nat.def., % GDP									
Revenues	39.5	40.2	38.6	34.8	36.1	35.1	.	.	.
Expenditures	31.1	34.2	33.8	41.1	33.4	32.7	.	.	.
Deficit (-) / surplus (+), % GDP	8.4	6.0	4.9	-6.3	2.7	2.5	-5	-3	0
Public debt, nat.def., in % of GDP <sup>4)</sup>	8.6	6.7	5.7	8.3	6.2	7.2	10	10	10
Base rate of NB % p.a., end of per.	11.0	10.0	13.0	8.8	13.0	8.3	.	.	.
Current account, EUR mn <sup>5)</sup>	75474	56818	70773	35224	7391	25034	50000	40000	35000
Current account in % of GDP	9.6	6.0	6.2	4.0	3.9	10.5	4.5	3.3	2.7
Exports of goods, BOP, EUR mn <sup>5)</sup>	241960	258930	321793	218221	43779	67421	250000	260000	270000
annual growth rate in %	23.7	7.0	24.3	-32.2	-40.5	54.0	15	4	4
Imports of goods, BOP, EUR mn <sup>5)</sup>	130948	163282	199148	137960	29420	33452	170000	190000	220000
annual growth rate in %	30.2	24.7	22.0	-30.7	-26.9	13.7	23	12	16
Exports of services, BOP, EUR mn <sup>5)</sup>	24791	28681	34905	30010	6389	6572	35000	38000	42000
annual growth rate in %	23.8	15.7	21.7	-14.0	-7.1	2.9	17	9	11
Imports of services, BOP, EUR mn <sup>5)</sup>	35643	42481	51495	44306	9364	9748	55000	65000	70000
annual growth rate in %	14.7	19.2	21.2	-14.0	-5.9	4.1	24	18	8
FDI inflow, EUR mn <sup>5)</sup>	23675	40237	51490	27852	7214	.	35000	45000	50000
FDI outflow, EUR mn <sup>5)</sup>	18454	33547	38273	33128	10414	.	35000	40000	45000
Gross reserves of NB, excl. gold, EUR mn	224306	318840	292483	290431	278624	313084	.	.	.
Gross external debt, EUR mn	237687	316893	339879	328733	351472	350344	.	.	.
Gross external debt in % of GDP	30.7	34.4	34.1	36.6	39.0	31.4	.	.	.
Average exchange rate RUB/EUR	34.11	35.01	36.43	44.14	44.46	41.41	39	40	41
Purchasing power parity RUB/EUR, wiiw <sup>6)</sup>	16.99	18.88	22.19	23.04	.	.	.	.	.

1) Preliminary. - 2) Resident population. - 3) Domestic output prices. - 4) wiiw estimate. - 5) Converted from USD with the average exchange rate. - 6) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.



*Vasily Astrov*

## **Ukraine: Exports to the rescue**

The second round of the presidential elections on 7 February 2010 resulted in a narrow victory of the leader of the pro-Russian opposition Party of Regions Viktor Yanukovich. This victory was followed by the break-up of the previous parliamentary coalition around Yulia Tymoshenko and the formation of a new coalition centred around Yanukovich's Party of Regions (and including two smaller parties: the Communist Party and the centrist Lytvyn Block, as well as a number of defectors from the two 'orange' factions) and of a new government headed by Mykola Azarov, a close ally of Mr. Yanukovich. Although the legal aspects of the coalition build-up appear questionable,<sup>52</sup> a speedy government formation was seen to be crucial in bringing the badly needed political stability. Indeed, the fact that the president and the prime-minister now represent the same political force has put an end to the stalemate which persisted in Ukraine over the years of the 'orange' rule, and the policy efficiency of the authorities has increased. However, the newly gained stability seems to have come at the expense of reduced political freedoms, including a tougher scrutiny of mass media.

One of the declared priorities of the new government is to resume cooperation with the IMF. The latter was suspended in November 2009 because of Ukraine's non-compliance with the IMF conditionalities attached to the USD 16.5 billion 'stand-by' loan (of which USD 10.5 billion had already been disbursed). Currently, the government is hoping for a new 2.5-year IMF package of up to USD 19 billion. However, for that, the fiscal deficit will have to be cut from 8-9% of GDP recorded last year to 6% in 2010 (the 2010 budget law adopted by the new government envisages a deficit of 5.3% of GDP). On the one hand, the fiscal situation should be helped by the ongoing economic recovery. Also, the newly granted price discount for Russian gas should reduce the losses of the state-owned Naftohaz and ultimately the burden on the state budget. However, the targeted surge in budget revenues by 28% (in nominal terms) underlying the current budget is highly questionable and relies partly on tax hikes (excise tax) and improved tax administration (e.g. of banks), which have not been legislatively enacted yet. In the first five months of 2010, the collection of tax revenues fell 8% short of the target, and the situation is unlikely to change dramatically, implying that the budget deficit for the year as a whole will probably reach at least 7% of GDP. The relatively high fiscal deficits also imply that it will not be easy for the new authorities to implement their ambitious tax reforms promised during the presidential election campaign, but seemingly postponed at least until 2011. These include, inter alia, a reduction of profit tax from 25% to 20-22% and of VAT from 20% to 17%, whereas excise taxes are to be raised further (bringing them closer to EU levels), and a 'luxury' tax is on the agenda. In addition, export subsidies of up to 3% of GDP are envisaged for next year.

<sup>52</sup> Ukraine's constitution envisages that the parliamentary coalition is formed by factions rather than individual MPs, but the constitutional court has confirmed the legitimacy of the new coalition.

Meanwhile, the need for IMF funding seems less acute given the recent turnaround in external balances. Since March 2010, Ukraine – for the first time since the crisis began – has become a net importer of capital, helped by increased political stability and the reversal of depreciation expectations, which resulted in flight *from* foreign cash by households. Overall, in January-April 2010, Ukraine recorded net capital inflows of USD 500 million – compared to *outflows* of USD 5.3 billion in the same period of last year. In addition, the current account improved further, to a surplus of around USD 100 million in January-April 2010 (from a deficit of USD 900 million in the same period of 2009), and is expected to be close to zero for the year as a whole. To contain the appreciation pressure, the National Bank has been replenishing its foreign exchange reserves, so that the hryvnia has appreciated against the US dollar only slightly, to about 7.9 UAH/USD (the appreciation against the euro, which fell against the US dollar in April-May 2010, was of course more pronounced).

In addition, the prospects for the government to raise funding elsewhere rather than from the IMF have improved. Following the speedy government formation, the yields on government (hryvnia-denominated) bonds plunged markedly: from over 20% p.a. at the end of 2009 to 10-13% p.a. currently. Given the current (CPI) inflation rate of 10-11%, this corresponds to real yields close to zero.<sup>53</sup> The CDS spreads also declined from around 10% at the start of the year to a mere 5% in mid-April, although they increased subsequently to around 7% due to the turbulence in the eurozone and the related increase in risk aversion. The 2010 budget law envisages domestic borrowings of UAH 36 billion (excluding bond issues for the purposes of bank recapitalization) and foreign borrowings of USD 4.1 billion, including the anticipated USD 2 billion from the IMF to be used for fiscal purposes.<sup>54</sup> In addition, privatization – which almost stalled in the past few years due to the persistent political stalemate – is likely to receive a boost, with stakes in Ukrtelecom and the Odessa Port plant (the second-biggest fertilizer producer) featuring on the privatization list. The 2010 budget law reckons with privatization revenues of UAH 10 billion.

In the area of foreign policy, the marked improvement of relations with Russia – manifested most visibly in the new contract granting a 30% price discount on imported Russian gas in exchange for extending the lease of the Russian naval base in Sevastopol at least until 2042 – is an encouraging development, which also reduces drastically the probability of future ‘gas wars’ between the two countries (a major concern for Europe, which receives the bulk of its gas imports from Russia via Ukraine). However, the scope of Ukraine’s advances towards Russia is potentially constrained by domestic politics and the powerful Tymoshenko-led ‘orange’ opposition, which is eager to earn political points in the run-up to the next parliamentary elections scheduled for autumn 2011. Therefore, it is unlikely that the most radical Russian advances – such as merging Ukraine’s energy monopolist Naftohaz with Russia’s Gazprom or Ukraine acceding the Russia-Belarus-Kazakhstan customs union<sup>55</sup> – will materialize in the near future, although increased cooperation in a number of areas including aviation and nuclear energy is almost certain.

<sup>53</sup> Of course, the latter applies only to domestic investors; for foreign investors, the yields are very high given the stable exchange rate outlook.

<sup>54</sup> Pending the outcome of negotiations with the IMF, the government has secured a USD 2 billion loan from Russia.

<sup>55</sup> Unlike the latter three countries, Ukraine is a WTO member.

These developments are to be viewed against the background of the economic recovery underway. Real GDP was up by 4.8% in the first quarter of 2010 (year-on-year), while industrial production increased by 12.6% in January-April. Metals industry and machine-building have been leading this growth (+22% and +28% in gross output terms, respectively) and are strongly export-oriented. Steel exports soared over the same period by 37% and those of machinery by 39% (in US dollar terms). Overall, exports of goods and services increased by 25%, while imports by only 20%. As a result, the trade deficit in goods and services in January-April 2010 halved compared to the same period of last year. This was entirely due to trade in services, whereas the trade deficit in goods actually widened. However, the latter reflected the abnormally high growth in energy imports in January-April 2010 (particularly in the *value* of oil imports), given the very low oil price in the first months of 2009 and hence the very low statistical base. In the coming months, import growth will almost certainly fall short of the growth in exports, partly due to the subsiding statistical effect, but also thanks to the 30% discount on Russian gas starting from the second quarter of 2010 onwards. The observed improvement in external competitiveness is hardly surprising given the 60% nominal depreciation of the hryvnia during the crisis which brought the real exchange rate back to levels observed in 2005-2006, when Ukraine's external accounts were largely balanced.

At the same time, domestic market-oriented sectors continue to be a drag on growth. The performance of the food-processing industry was anaemic (+1.2% in January-April 2010), while retail trade turnover – a proxy for private consumption – fell by 1.2%, albeit picking up gradually on a monthly basis. Investment activity proved to be an even bigger disappointment: in the first quarter of 2010, investments in fixed assets plunged by 12.5% and construction output by 21% year-on-year – and that starting from an already very low base (in the first quarter of 2009, they had fallen by 40% and 57% respectively). The weakness of domestic demand reflects the combination of rising unemployment, falling wages, cautious spending behaviour, still under-utilized capacities and the ongoing credit crunch in both corporate and consumer segments. Interest rates charged on loans (16-17% p.a. in hryvnia terms) remain prohibitively high and reflect the high risk perceptions of banks.

For 2010, we expect (largely export-driven) economic growth of close to 4%, with gradual acceleration in the years to come. However, even with this relatively high growth (given the circumstances), Ukraine's GDP will still be nearly 12% below the pre-crisis level. Also, domestic demand, though picking up somewhat, is likely to remain subdued at least until the end of the year. Unemployment is unlikely to recede fast, while bank lending is unlikely to recover before the re-capitalization of the banking sector has been completed. One positive consequence of the weak domestic demand is however further disinflation. In both April and May 2010, the country recorded CPI deflation (on a monthly basis), which is likely to continue over the summer months. (In Ukraine, deflation is often observed in summer due to the declining prices of food, which account for more than half of the consumer basket.) In annual average terms, consumer price inflation should not exceed 11% this year, particularly if the government opts not to raise gas tariffs for households and heating companies. Lower inflation should lead to lower nominal interest rates and reduce incentives for speculative capital inflows, thus preventing excessive currency appreciation and safeguarding external competitiveness.

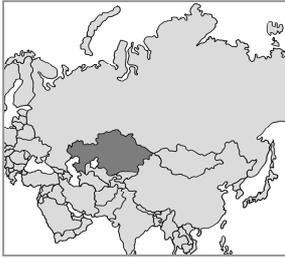
Table UA

## Ukraine: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009	2010	2010	2011	2012
					1st quarter		Forecast		
Population, th pers., average	46788	46509	46258	46053	46112	45934	45800	45600	45400
Gross domestic product, UAH mn, nom.	544153	720731	948056	914720	188037	218125	1049200	1195100	1368200
annual change in % (real)	7.3	7.9	2.3	-15.1	-20.2	4.9	3.8	4.5	6
GDP/capita (EUR at exchange rate)	1800	2200	2700	1800	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5200	5800	6000	5100	.	.	.	.	.
Consumption of households, UAH mn, nom.	319383	423174	582482	590196	131905	148068	.	.	.
annual change in % (real)	15.9	17.2	11.8	-14.2	-15.1	0.5	2	4	6
Gross fixed capital form., UAH mn, nom.	133874	198348	250158	164522	32189	33631	.	.	.
annual change in % (real)	21.2	23.9	1.9	-46.2	-53.9	-2.2	5	10	10
Gross industrial production									
annual change in % (real)	6.2	7.6	-5.2	-21.9	-31.8	10.8	6.5	7	8
Gross agricultural production									
annual change in % (real)	2.5	-6.5	17.1	-1.8	1.7	5.3	.	.	.
Construction industry									
annual change in % (real)	9.9	15.6	-15.8	-48.2	-56.5	-21.4	.	.	.
Employed persons - LFS, th, average	20730.4	20904.7	20972.3	20191.5	20005.1	20088.4	20200	20250	20300
annual change in %	0.2	0.8	0.3	-3.7	-3.4	0.4	0	0.2	0.2
Unemployed persons - LFS, th, average	1515.0	1417.6	1425.1	1958.8	2096.9	1983.8	.	.	.
Unemployment rate - LFS, in %, average	6.8	6.4	6.4	8.8	9.5	9.0	8.7	8.2	7.8
Reg. unemployment rate, in %, end of period	2.7	2.3	3.0	1.9	3.1	1.8	.	.	.
Average gross monthly wages, UAH <sup>2)</sup>	1041.4	1351.0	1806.0	1906.0	1736.0	1993.0	.	.	.
annual change in % (real, gross)	18.4	15.0	6.8	-8.9	-11.0	3.3	.	.	.
Consumer prices, % p.a.	9.1	12.8	25.2	15.9	20.4	11.2	10.5	9	8
Producer prices in industry, % p.a. <sup>3)</sup>	9.6	19.5	35.5	6.5	17.4	17.2	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	31.6	30.5	31.4	29.8	34.9	.	.	.	.
Expenditures	32.3	31.6	32.8	33.9	35.0	.	.	.	.
Deficit (-) / surplus (+)	-0.7	-1.1	-1.5	-4.1	-0.04	.	-7	-4.5	-3
Public debt, nat.def., in % of GDP	14.8	12.3	20.0	33.0	19.1	.	37	37	35
Discount rate of NB, % p.a., end of period	8.5	8.0	12.0	10.3	12.0	10.3	.	.	.
Current account, EUR mn <sup>4)</sup>	-1289	-3849	-8721	-1291	-500	-50	500	0	-500
Current account in % of GDP	-1.5	-3.7	-7.1	-1.5	-2.7	-0.3	0.5	0.0	-0.4
Exports of goods, BOP, EUR mn <sup>4)</sup>	31048	36383	46274	28958	6468	7577	33300	36600	40300
annual growth rate in %	10.5	17.2	27.2	-37.4	-30.7	17.2	15	10	10
Imports of goods, BOP, EUR mn <sup>4)</sup>	35188	44100	57270	32296	7200	8565	35500	39100	43000
annual growth rate in %	21.3	25.3	29.9	-43.6	-41.6	19.0	10	10	10
Exports of services, BOP, EUR mn <sup>4)</sup>	9000	10337	12228	9936	2176	2371	10900	12000	13200
annual growth rate in %	19.9	14.9	18.3	-18.8	-8.7	9.0	10	10	10
Imports of services, BOP, EUR mn <sup>4)</sup>	7305	8571	11039	8048	2040	1764	8000	8800	9700
annual growth rate in %	20.7	17.3	28.8	-27.1	-12.5	-13.6	0	10	10
FDI inflow, EUR mn <sup>4)</sup>	4467	7220	7457	3453	697	705 <sup>5)</sup>	4000	.	.
FDI outflow, EUR mn <sup>4)</sup>	-106	491	690	116	21	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	16587	21634	21847	17824	18647	17934	.	.	.
Gross external debt, EUR mn	41391	54421	72109	72516	75437	76275	.	.	.
Gross external debt in % of GDP	50.6	56.0	82.6	90.8	94.4	72.7	.	.	.
Average exchange rate UAH/EUR	6.335	6.918	7.708	10.868	10.065	11.068	10	10.5	10
Purchasing power parity UAH/EUR, wiiw <sup>6)</sup>	2.227	2.656	3.402	3.921	.	.	.	.	.

1) Preliminary. - 2) Excluding small enterprises. - 3) Domestic output prices. - 4) Converted from USD with the average exchange rate. - 5) FDI net. 6) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.



*Olga Pindyuk*

## **Kazakhstan: On track of steady recovery**

Kazakhstan's economy bounced off in the fourth quarter of 2009, which allowed the country to avoid recession and reach 1.2% real GDP growth that year. In the first quarter of 2010 the recovery continued and the economy grew by an astonishing 7.1% year-on-year (y-o-y). The biggest contributions to growth were made by manufacturing (18.7% growth y-o-y), mining (7.8%), and wholesale and retail trade (11.5%). At the same time, value-added continued to drop in financial services (-21.5%), construction (-8.7%), and the hotels and restaurants sector (-4.5%). The major factors behind the growth speed-up are increased commodity prices at the world markets and reviving internal demand (which is reflected in the growth of retail trade).

The oil sector will continue to be the most important source of growth during the forecast period as Kazakhstan plans to increase oil production and world demand is expected to be high. We forecast that in 2010, exports will grow by 34% in EUR terms, thus to a large extent offsetting the previous year's plunge by 36%. In 2011-2012, export growth will be moderate, as we do not envisage a significant surge of oil prices during this period.

Yet, we expect that internal demand will contribute increasingly more to the growth. We forecast that household consumption will grow by 3% in 2010 (after a 3% decline in 2009), and growth will speed up in the next years. The factors behind this trend will be faster growth in wages with a revival of the economy and an increase in public wages and social expenditures envisaged by the government (for example, starting from 1 April 2010, salaries of civil servants and students' scholarships were increased by 25%; the government plans to increase financing of active labour market policies). First signs of a revival of domestic demand can be seen in the improvement of consumers' expectations in the first quarter of 2010 (measured by the consumer confidence index). Restrained access of households to loans in the short run will limit the growth potential.

Inflationary pressures will remain relatively low during the forecast period, as growth of household consumption will be moderate and the tenge will slightly depreciate with respect to the US dollar. Thus, consumer price inflation will remain in the one-digit range (6-7% per annum). The producer price index, by contrast, will rise quite dramatically in 2010 – by about 20% p.a. – reflecting the oil prices rebound. In 2011-2012, PPI growth is expected to be in the one-digit range as we assume that world oil prices will remain relatively stable.

The government is active in pursuing an economic diversification strategy by attracting investment into infrastructure development projects (besides the oil transport infrastructure). Recently the World

Bank, the EBRD and IFC (as members of the Clean Technology Fund) agreed to provide USD 1.3 billion for the development of energy saving projects. The EBRD provided a USD 1 billion loan to support diversification projects. The effects of these efforts are not likely though to have a noticeable impact on the Kazakh economy in the short run.

We expect that by the end of 2010, when the effect of the lower base will be less pronounced, Kazakhstan's GDP will grow by 3%. In 2011, growth will speed up further to 5% and in 2012 it will slow down somewhat to 4.5%. This comes as the effects of the structural changes will not be profound yet and thus there will not be sufficient driving forces for a more rapid growth of the economy.

The 2010 budget was amended in March in order to account for increases in social expenditures, and the planned budget deficit was raised. We forecast that the 2010 budget deficit will reach its highest level in the past ten years, 4% of GDP. In order to finance the increased budget deficit, a USD 1 billion loan was taken from the World Bank. Later on, as the negative effects of the economic crisis will fade away, we expect the government's fiscal policies to become more prudent and the budget deficit gradually to decline to 2% of GDP in 2012.

According to our forecast, the current account will be positive in 2010 (1.1% of GDP), as imports are expected to recover more slowly than exports, reflecting different rates of growth of domestic and external demand. For the years to come, growth of imports will outpace that of exports, mainly due to increased investment demand. The current account is therefore expected to turn into a deficit of about 2% of GDP. Capital inflows, in particular FDI, will be high enough to finance the deficit. FDI, which has been directed primarily to the oil sector (exploration and extraction), turned out to be very resilient – in 2009, net FDI in euro terms decreased only by 12% y-o-y to EUR 9 billion (8.2% of GDP). We forecast that in 2010-2012 net FDI will be gradually increasing.

Government policy towards foreign investors in the oil sector may pose risks for the FDI forecast. After having muscled into the Kashagan oilfield project last year following a dispute with the foreign investors, the Kazakh government continues to use the same instruments to obtain a stake in the Karachaganak oil field, which remains the only major oil field in the country where the government does not have a stake yet. The companies participating in the Karachaganak Petroleum Operating (KPPO) consortium (BG, Chevron, Eni and Lukoil) have already faced a broad range of accusations including tax evasion, financial wrongdoing and environmental abuse. Recently, the accusations of fiscal fraud through an increase in costs by USD 1.3 billion have been dropped, however, two inquests still continue: one on unauthorized production of crude oil, and another one on violations of Kazakh regulations regarding employment of foreigners with threats to deport expatriate workers.

The customs union of Kazakhstan with Russia and Belarus has to be launched on 1 July 2010. Russia announced in May that it would proceed with launching a customs union with Kazakhstan only, as the issue of export duties on oil and oil products has not yet been resolved with Belarus. However, even for Russia and Kazakhstan the customs union will not be fully operational starting from July; several technical regulations and procedures still remain to be defined and adopted.

Kazakhstan managed to agree with Russia on the solutions of a number of sensitive issues: there will be a transitory period granted for imports of passenger cars and airplanes during which import duties will not be raised; and decisions in the regulatory body (Commission of the Customs Union) will be made on a consensus basis, with Kazakhstan having equal representation as Russia. However, the overall increase in import duties is still in place, bringing them mostly in line with Russia's level. These changes will have a negative impact on the Kazakh economy, creating trade diversion and hampering diversification of the economy. In total, according to calculations of ATF Bank, a Kazakh subsidiary of the Unicredit group, the non-weighted average import tariff of Kazakhstan increased from 5.8% to 9.5%, while for the weighted average import tariff the increase will be more moderate – from 4.2% to 5.4% (as duties will not be imposed on goods imported from Russia, a major trading partner of Kazakhstan). Under the new customs regime rates of 75-100% reappeared, whereas previously the maximum import duty rate in Kazakhstan was 30%. The highest increase in tariffs will be for investment goods. For example, import duties on trucks have been raised dramatically and reach up to 90% now. This increase in import duties was decided on to serve the interests of two truck producers in Russia and Belarus (KamAZ and Minsk automotive factory). Kazakh transport companies mostly import trucks from outside the newly created customs union, as Russian and Belarusian trucks do not come up to EURO 4 and EURO 5 emission standards.

The potential benefits of the customs union for Kazakhstan may be linked to increased FDI as the country has the most favourable tax regime among the three and thus can be an attractive destination for foreign investors looking for better market access opportunities. However, the overall economic effect of entering the customs union is likely to be negative for Kazakhstan, and it appears that political motives are the major reason for the country's participation in the union.

The issue of the restructuring of the two major banks (BTA and Alliance Bank) appears to be solved and the problem banks are not going to be a drag on the banking system. Nevertheless, the banking sector still faces problems as banks continue to accumulate losses because of poor asset quality. The share of non-performing loans (NPLs) in their portfolios has been growing. There are different measures of NPLs in the available statistics, but even the most moderate indicator of bad debts increased from 1% at the beginning of 2008 to 21% in March 2010. If a broader definition of NPLs is used, with certain categories of doubtful loans being considered non-performing, the share of NPLs even reaches an estimated 30%. The share of doubtful loans in total loans is estimated at 44%, which gives grounds to expect the share of NPLs to further slightly increase, as banks will proceed with admitting more bad loans in their portfolios.

Given the prevalence of high-risk assets at the market, banks have been very reluctant to issue new loans. In March 2010, the amount of loans issued was 45% lower than a year earlier, with the decline in loans to the corporate sector being even more profound. The total stock of loans in March 2010 was 6.7% lower than in March 2009. We expect that in 2010, Kazakh banks will still be licking their wounds and there will be no significant revival in credit market activity. In 2011-2012, the loans market will start growing again, though not at as high a rate as prior to 2008.

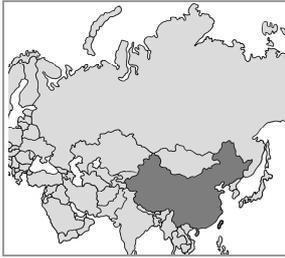
Table KZ

## Kazakhstan: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
								Forecast	
Population, th pers., average	15308	15484	15674	15880	15814	16049	16000	16100	16200
Gross domestic product, KZT bn, nom.	10214	12763	16053	16100	3055	3882	19400	21600	23900
annual change in % (real)	10.7	8.7	3.3	1.2	-2.2	7.1	3	5	4.5
GDP/capita (EUR at exchange rate)	4200	4900	5800	4900	.	.	6700	7400	7800
GDP/capita (EUR at PPP - wiiw)	8200	9000	9300	9100	.	.	.	.	.
Consumption of households, KZT bn, nom.	4547	5468	6871	7200	1629	.	7900	8800	9700
annual change in % (real)	12.7	11.0	6.3	-3	0.3	.	3	5	4
Gross fixed capital form., KZT bn, nom.	3084	3857	4309	4541	625	.	5600	6100	6800
annual change in % (real)	29.7	17.3	1.0	1.9	-11.4	.	3	6	6
Gross industrial production									
annual change in % (real)	7.0	4.5	2.1	1.7	-4.6	11.5	7	5	4
Gross agricultural production									
annual change in % (real)	7.0	8.4	-5.6	13.8	3.6	2.4	4	8	5
Construction industry									
annual change in % (real)	28.6	5.7	1.8	-4.9	-4.2	-8.7	1	5	8
Employed persons - LFS, th, average	7403.5	7631.8	7857.2	7903.4	7830.4	8029.3	8060	8140	8180
annual change in %	2.0	3.1	3.0	0.6	0.9	2.5	2	1	0.5
Unemployed persons - LFS, th, average	625.4	578.8	557.8	554.5	583.1	526.2	.	.	.
Unemployment rate - LFS, in %, average	7.8	7.3	6.6	6.6	6.9	6.2	6.2	6	6
Reg. unemployment rate, in %, end of period	1.1	0.8	0.7	0.6	0.8	1.0	.	.	.
Average gross monthly wages, KZT	40790	53238	60734	67639	62671	67839	.	.	.
annual change in % (real, gross)	10.3	17.8	-2.5	3.8	3.9	0.9	.	.	.
Consumer prices, % p.a.	8.6	10.8	17.1	7.3	8.7	7.6	7	6.5	6
Producer prices in industry, % p.a.	18.4	12.4	36.9	-22.2	-28.7	45.5	20	3	6
General governm.budget, nat.def., % GDP									
Revenues and grants	27.9	22.6	25.1	21.8	.	.	.	.	.
Expenditures and net lending	20.4	24.3	27.2	24.8	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	7.5	-1.7	-2.1	-3.1	.	.	-4.0	-3.0	-2.0
Public debt, nat. def., in % of GDP	11.3	7.2	8.3	10.1	.	.	9	8	7
Base rate of NB % p.a., end of period	9.0	9.0	10.5	7.0	9.5	7.0	.	.	.
Current account, EUR mn <sup>2)</sup>	-1525	-5355	4742	-2400	-900	2100	1200	-2500	-2800
Current account in % of GDP	-2.4	-7.0	5.2	-3.1	-5.3	11.1	1.1	-2.1	-2.2
Exports of goods, BOP, EUR mn <sup>2)</sup>	30881	35309	48905	31500	6300	9800	42300	43600	47500
annual growth rate in %	35.8	14.3	38.5	-36	-40.6	55.6	34	3	9
Imports of goods, BOP, EUR mn <sup>2)</sup>	19216	24288	26128	20636	4700	3900	24300	28100	31200
annual growth rate in %	33.1	26.4	7.6	-21	-4.1	-17.0	18	16	11
Exports of services, BOP, EUR mn <sup>2)</sup>	2237	2596	2978	3100	700	700	3400	3600	3900
annual growth rate in %	25.0	16.1	14.7	4	16.7	0.0	10	6	8
Imports of services, BOP, EUR mn <sup>2)</sup>	6947	8491	7474	7219	1600	1700	8900	9600	10400
annual growth rate in %	15.4	22.2	-12.0	-3	0	6.3	23	8	8
FDI inflow, EUR mn <sup>2)</sup>	4958	7440	9882	9000	2000	2100	10700	10800	10600
FDI outflow, EUR mn <sup>2)</sup>	-309	2369	2590	2200	200	200	2400	2300	2300
Gross reserves of NB excl. gold, EUR mn	14525	11970	13711	16184	14603	20146	.	.	.
Gross external debt, EUR mn	56252	65436	76417	77881	79326	.	.	.	.
Gross external debt in % of GDP	87.2	86.0	84.3	99.5	104.9	.	.	.	.
Average exchange rate KZT/EUR	158.27	167.75	177.04	205.67	180.88	204.86	182	182	189
Purchasing power parity KZT/EUR, wiiw <sup>3)</sup>	81.24	91.09	110.40	111.09	.	.	.	.	.

1) Preliminary. - 2) Converted from USD with the average exchange rate. - 3) Based on ICP benchmark results 2005 and wiiw estimates.

Source: National statistics (National Bank, Agency of Statistics etc). Forecasts by wiiw.



*Waltraut Urban*

## **China: Economy fast on track**

In the first quarter of 2010, the Chinese GDP expanded at a rate of 11.9%, after reaching 10.7% growth in the last quarter of 2009 and 8.7% for the year 2009 as a whole. Growth was mainly driven by investment, but consumption played a substantial role as well. Both were supported by continued stimulus measures of the Chinese government which have been part of the huge 'stimulus package' implemented in 2009 during the global financial and economic crisis. Foreign trade, which had started to grow again in December last year, recovered further, but as imports rose faster than exports China's trade surplus narrowed. After deflation had come to an end in December 2009, inflation picked up in the first months of 2010.

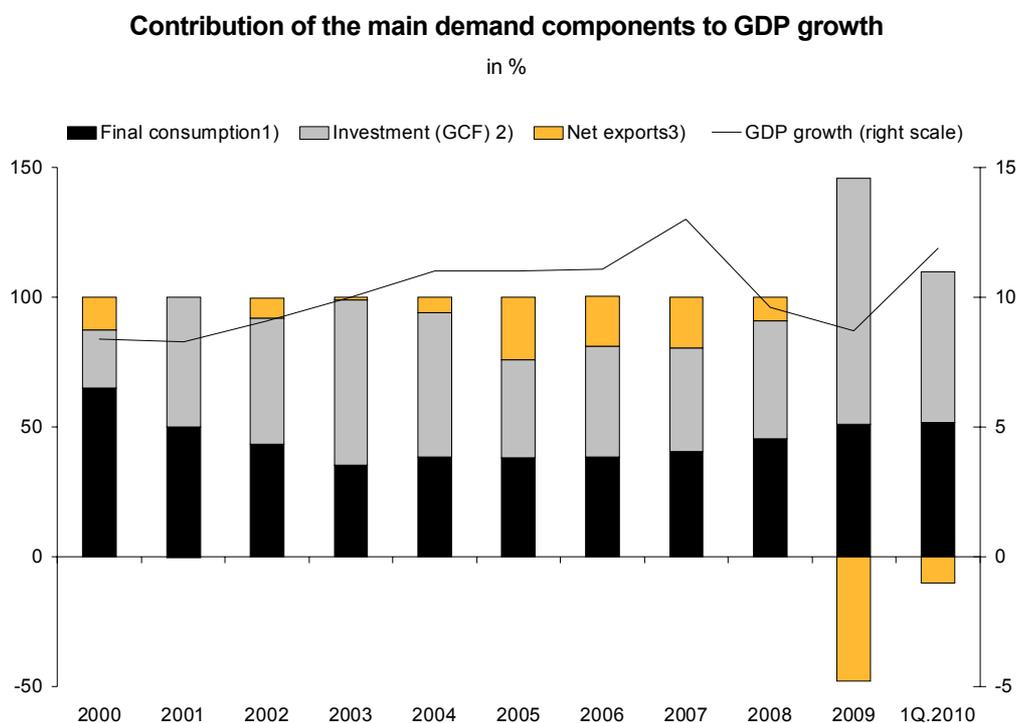
The very high GDP growth rate has to be seen in the light of the depressed year-earlier levels, when the economy hit the bottom of the crisis. But from the second quarter of 2009 onwards, the Chinese economy recovered rather quickly and because of that level effect the year-on-year growth rates for the rest of 2010 are expected to be lower than in the first quarter. Under the assumption of a prolonged pro-growth fiscal policy and a moderately tight monetary policy as pledged by the Chinese government in November last year, together with a continuous recovery of the world economy, we expect China's GDP to grow by 9.5% in 2010. This estimate is in line with current forecasts of the World Bank, the United Nations (both 9.5%) and the Asian Development Bank (9.6%), but lower than those of the IMF (10%) and the OECD (11%).<sup>56</sup> Recent estimates by Chinese researchers put GDP growth in a range between 9% and 10%. The biggest downward risks are a 'double-dip' recession of the world economy caused by sovereign debt risk, and an early budgetary consolidation in Europe as well as a still fragile recovery in the USA and Japan. As for the domestic economy, the biggest challenges come from the real estate market, rising inflation and the escalation of related labour disputes. For those reasons the Chinese government is still hesitant to phase out its support measures while fighting overheating in certain sectors and trying to restrain the real estate market.

Taking into account the above-mentioned risks, we expect the Chinese economy to grow by 9.5% in 2011 and 10% in 2012. But if the Chinese government takes its goal to switch from quantitative to more qualitative growth more seriously in the upcoming Five Year Plan 2011-2015, growth rates may be even lower.

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<sup>56</sup> World Bank, Quarterly Assessment of the Chinese Economy (17 March 2010); Asian Development Bank, Asian Development Outlook 2010 (13 April 2010); United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP), Economic and Social Survey (May 2010); IMF, World Economic Outlook (April 2010); OECD Economic Outlook (May 2010).

Figure 1



Notes: 1) Private consumption and government consumption. - 2) Gross capital formation, including fixed capital formation and change in inventories. - 3) Net exports of goods and services

Source: China Statistical Yearbook, 2009; *China Daily*, 16 April 2010.

As illustrated in Figure 1, investment was again the most important driver of GDP growth in the first quarter of 2010, but lost relative importance compared to last year when it was heavily pushed by the government.<sup>57</sup> This development is also reflected in Figure 2 which shows declining growth rates of (urban) fixed asset investment. In contrast, investment in real estate has strongly accelerated after a deep slump in the first quarter of 2009. A certain slowdown at the beginning of this year is due to several government measures taken to contain the overheated real estate market.

#### *Fighting the real estate bubble*

The real estate market in China is driven by excessive demand and property prices are reported to have skyrocketed by about 80% year-on-year in many big cities such as Shanghai and Beijing. This prompted consumer complaints and heightened concerns that an asset bubble was building up, driven by excess liquidity and speculation. An eventual bursting of such a bubble could substantially harm the Chinese economy given the fact that real estate investment comes up to one quarter of fixed asset investment which takes an average share of 40% of GDP. Accounting for some 10% of

<sup>57</sup> In 2009, the foreign sector's contribution to GDP growth was negative, for the first time since 1993, due to the global financial and economic crisis. Exports fell by 11% and imports by 6%. As a consequence, the trade balance shrank from EUR 202 billion to EUR 141 billion.

GDP, the sector is also an important employer and has a significant impact on many upstream (cement, steel, glass etc.) as well as downstream industries (furniture, home appliances, etc.). Besides, land (-use) sales are a primary source of fiscal revenue for local governments and affordable housing is considered an important element of social stability in China's current phase of rapid urbanization. The government has therefore introduced a number of measures to contain real estate demand already at the end of last year,<sup>58</sup> but has released further regulations on 16 April this year. Such measures include more stringent downpayment requirements for mortgage loans, higher loan rates, a temporary ban on lending for third or above home purchases and tighter scrutiny of developers financing. Local governments can adjust these basic rules according to the specific situation. Further on, the People's Bank of China (PBOC) has raised the reserve requirement for banks three times this year already to rein in excess liquidity, and the approval of stock issue plans of real estate companies will be handled with more care. For the future, the introduction of a property tax is discussed.

As a consequence, property sales in China's major cities dropped significantly in May this year, yet records on price developments are ambiguous with prices falling in some cities but still rising in others, where prices will probably adjust later in the year. However, many experts find especially the policies to tighten third and above home purchase difficult to implement due to the independence of China's housing registration and bank credit systems and the fact that housing systems in different cities are not linked with each other. But there is also a minority fraction which fears that house prices may fall very strongly (20-30%) and may set in motion a downward spiral. Then even high-quality mortgage loans would face limitations and 'contract violation' cases would increase markedly. Also, when housing prices plunge, demand usually hibernates and buying is suspended, which in turn will intensify the over-capacity of industries relying on property development. In this case the end of 2010 and the beginning of 2011 may see a sluggish real estate market similar to what happened in late 2008 and early 2009.<sup>59</sup> The measures to cool down the real estate market have already triggered a decline in the stock market (Figure 3). The shares of China Vanke Co., the county's biggest listed property developer, has reached the lowest value since March 2009.

#### *Rising contribution of final consumption to GDP growth*

In the longer-term perspective, China is trying to gradually rebalance its growth pattern away from excessive investment and exports towards domestic consumption, to make the economy less sensitive to external shocks. The current development seems to be in line with this goal as illustrated in Figure 1. Retail trade as a proxy for private consumption showed high and persistent growth throughout the crisis and in the first five months of this year as well (see Figure 4). This development is backed by the relatively fast rise of incomes but also supported by 'consumer subsidies' to the rural population for the purchase of household appliances and by various measures to promote car sales. These measures were introduced last year in order to compensate for the shortfall of external

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<sup>58</sup> See W. Urban, 'China: On the cusp of double-digit growth', *wiiw Current Analyses and Forecasts*, No. 5, February 2010, p. 144.

<sup>59</sup> See *China Daily*, 17 May 2010.

Selected data on China, 2007-2010

Figure 2

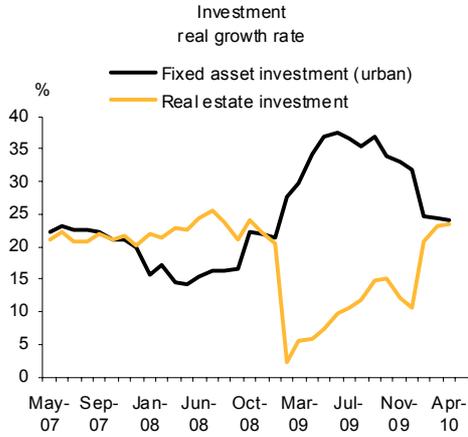


Figure 3



Figure 4

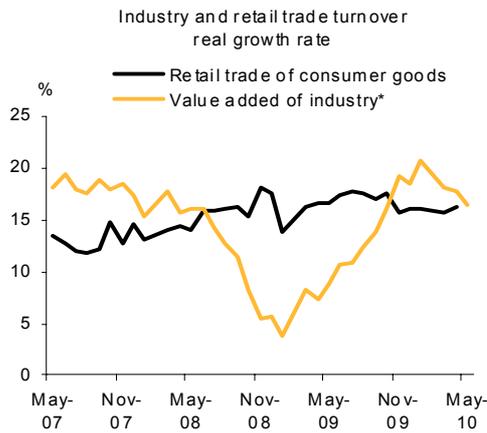


Figure 5

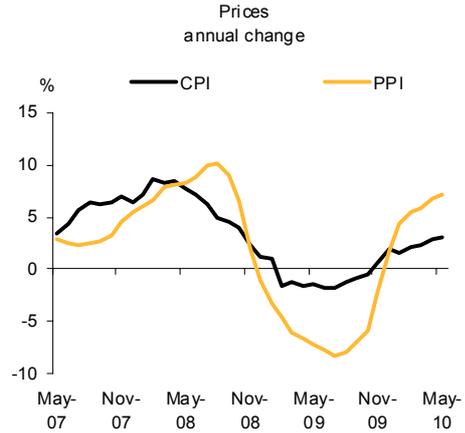
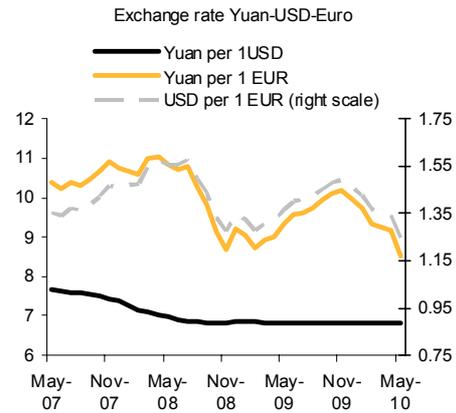


Figure 6



Figure 7



Note: \* Includes only enterprises with annual sales revenue of over yuan 5 million (euro 560,000).

Source: National Bureau of Statistics, China Monthly Statistics, iwiw calculations.

demand. In the first quarter, sales of household appliances and audio-video equipment rose by 30% and sales of motor vehicles by 40%. Consumer subsidies are expected to phase out at the end of this year, thus incomes will become the major driver of consumption again.

*Will the strike at China's Honda factory trigger a nation-wide wage race?*

In May this year, 1900 workers at the Honda Auto Parts Manufacturing Co. in Foshan, Guangdong province, went on strike for higher pay, putting Honda's four assembly plants in China to a halt as well. The action was primarily triggered by rising inflation. Workers were demanding that monthly salaries be raised from 1000-1500 yuan to 2000-2500 yuan.<sup>60</sup> The strike lasted for about three weeks and was the largest industrial action ever reported in China. Finally, the management agreed to raise wages by 600 yuan (67 euro) per month (about 24% on average), which represents a substantial increase particularly for low-wage earners, mainly migrant workers. The bargain is becoming a catalyst for wage increases in other companies of the branch, as automakers and suppliers have similar wages nationwide and profits in China's auto industry are relatively high compared to mature markets, leaving a certain room for increasing workers' benefits. Further on, the quest for higher wages is already spreading to other sectors, as the Chinese labour market is currently dried up in the industrial hubs of eastern China, for skilled as well as unskilled personnel. In the first week of June, for instance, Foxconn, a large Taiwan-funded contract electronics manufacturer, which has been in the news recently because of a string of suicides among its workers, raised wages by 30% and announced it would give its labourers in Shenzhen a second pay rise in October this year, which would push up wages by 65% altogether. Immediately after hearing about the Foxconn pay rise, thousands of workers from another big Taiwan-based electronics factory, Merry Electronics, in Shenzhen went on strike for higher pay as well. Similar walkouts have been reported in the provinces of Yunnan, Henan, Gansu, Shandong, Jiangsu and Shanghai over the past few weeks.<sup>61</sup>

The Honda strike was a landmark event also from a political point of view. It was extensively covered in the official media and the wage negotiations took place directly between the Honda management and elected workers' representatives, circumventing official trade union representatives (independent trade unions are forbidden in China), which is a sign of the government's support of the action. One reason for this could be the government's increasing awareness that low-paid workers, in particular second-generation migrant workers, represent a major potential source of social unrest, which could be partly mitigated by adequate pay rises. But higher wages are also an important step towards a more consumer-driven economy. Further on, there are certain signs that collective bargaining, which is stipulated in China's new Labour Law of 2008, will become more common now. The era of a declining proportion of GDP going to wages, which began more than 20 years ago, is probably coming to end now.<sup>62</sup>

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<sup>60</sup> From 112-168 euro to 225-280 euro. Currently, the minimum wage in Foshan comes up to 920 yuan (103 euro) per month.

<sup>61</sup> See *China Daily*, 3 June 2010.

<sup>62</sup> 14 Provinces and regions have already raised minimum wages this year, with the highest by more than 20%.

For foreign investment enterprises targeting the global market, increasing wages translate into rising production costs and could become a reason to leave China (e.g. for Vietnam, Bangladesh, Laos), particularly in branches where margins are already very low as in apparel and footwear. But companies producing for the Chinese market, such as automotives, will be compensated and attracted respectively by the larger market potential. Judging from provisional data on foreign direct investment in the first quarter of this year, based on investments in the non-financial sector only, the inflow of FDI rose by about 8% (measured in USD) compared to the same period of last year, after remaining more or less constant in 2009.

#### *Inflation – a rising concern*

After a period of deflation, prices started to rise at the end of last year. During the first months of 2010, inflation accelerated significantly and in May consumer prices were 3.1% higher than in the same period of 2009. Producer prices increased even faster, to 7.1% above the previous year's level, hinting at further price rises for final goods in the future (see Figure 5). One major factor behind this development are soaring food prices because of an extreme drought in the southwest of China, but rising costs for housing, raw materials (oil!) and wages as well. There is also widespread concern that the official CPI underestimates the actual rise in living costs.

#### *Foreign trade above pre-crisis levels again*

After expanding vigorously, Chinese exports have surpassed pre-crisis levels already in December 2009 and then again in May this year (see Figure 6). Imports rose even faster, and in March 2010 China reported a monthly trade deficit for the first time in years. In the first quarter of this year, exports rose by 21% and imports by 55% as against the same period last year. However, in April and May, the growth rates of exports and imports converged and the trade deficit turned into a substantial surplus again. Nevertheless, because of the much faster growth of the Chinese economy compared to those of its major trading partners, we expect the trade surplus and the current account surplus to be significantly smaller than last year and in the years prior to the crisis. The recent restrictions by the Chinese government on exports of highly energy-intensive and polluting products such as steel plates, aluminium products and fertilizers will have a certain dampening effect as well.

#### *More flexibility for the yuan's exchange rate*

On 19 June 2010, the People's Bank of China (PBOC) announced that it will enhance the flexibility of China's currency by abandoning the dollar peg. The announcement came one week in advance of the G20 meeting in Canada, where global imbalances and also the role of the Chinese currency in this context should be discussed. However, the PBOC ruled out a one-off revaluation of the yuan and advocates a system of managed float similar to that in the period between mid-2005 and mid-2008, reflecting market supply with reference to a basket of currencies, but moving within a narrow band ( $\pm 0.5\%$  per day). Between 2005 and 2008, the yuan had appreciated at about 20% in terms of US dollar. The system would also allow greater flexibility of the yuan's exchange rate to the euro, which has fluctuated strongly in recent times because of the dollar peg (see Figure 7). The expected gradual revaluation of the yuan will have only a moderate impact on the development of the Chinese economy in the short run. By making Chinese exports more expensive and imports

relatively cheaper, it could reduce China's current account surplus and dampen GDP growth and employment to a certain extent and will at the same time help to curb inflation and rein in excess liquidity. But the impact on the current account is not certain due to the high import content of Chinese exports and will partly depend on price elasticities and the price policy of Chinese exporters. In a longer-term view, it will reduce the country's reliance on external demand, support the upgrading of the country's industry and make Chinese investments abroad easier.

*Strong growth of industrial production*

In the first quarter of this year, industrial value-added expanded at a rate of 14.5% as comparable to the boom year 2007. But comparisons in the first quarter are flattered by depressed year-earlier levels. We therefore expect the growth rates to decline in the months to come and the average growth rate for 2010 to reach about 9.5%. A certain deceleration of growth is already visible in Figure 4, presenting growth rates of value-added for large enterprises until May 2010.

Table CN

## China: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010 1st quarter	2010	2011	2012
							Forecast		
Population, mn pers., end of period	1314.5	1321.3	1328.0	1335.0	.	.	1342	1349	1356
Gross domestic product, CNY bn, nom.	21192.4	25730.6	31405.0	33535.3	6574.0	8057.7	38000	42900	48100
annual change in % (real)	11.6	13.0	9.6	8.7	6.1	11.9	9.5	9.5	10
GDP/capita (EUR at exchange rate)	1600	1900	2300	2600	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	3900	4500	4900	5200	.	.	.	.	.
Retail trade turnover, CNY bn	7641.0	8921.0	10848.8	12534.3	2939.0	3637.0	.	.	.
annual change in % (real)	13.8	13.0	15.7	16.7	15.8	15.7	17.5	17	16
Total investment in fixed assets, CNY bn	10999.8	13732.4	17282.8	22500	2812.9	3532.0	.	.	.
annual change in % (nominal)	23.9	24.8	25.9	30.1	28.8	25.6	25	23	20
Industrial value added									
annual change in % (real)	12.9	14.9	9.5	9.5	5.3	14.5	9.5	10	11
Agricultural value added									
annual change in % (real)	5.0	3.7	5.5	4.2	3.5	3.8	.	.	.
Construction value added									
annual change in % (real)	13.7	12.8	7.1	9.5	.	.	.	.	.
Employment total -reg., mn, end of period	764.0	769.9	774.8	767.0	.	.	770	778	784
annual change in %	0.8	0.8	0.6	-1.0	.	.	0.3	1.0	0.8
Staff and workers, mn, end of period <sup>2)</sup>	111.6	114.3	115.2	115.1	113.6	.	.	.	.
annual change in %	2.9	2.4	0.8	0.4	0.6	.	.	.	.
Reg. unemploy.rate (urban), in %, end of per. <sup>3)</sup>	4.1	4.0	4.2	4.3	.	.	4.3	4.2	4.2
Average gross annual wages, CNY <sup>4)</sup>	21001	24932	29229	33029	29800	.	.	.	.
annual change in % (real) <sup>5)</sup>	12.7	13.6	11.0	14.1	14.0	.	.	.	.
Consumer prices, % p.a.	1.5	4.8	5.9	-0.7	-0.6	2.2	3.5	3	2
Producer prices in industry, % p.a.	3.0	3.1	6.9	-6.4	-4.6	5.2	.	.	.
General government budget, nat.def., % GDP									
Revenues	18.3	19.9	19.5	19.8	.	.	.	.	.
Expenditures	19.1	19.3	19.9	22.8	.	.	.	.	.
Deficit (-) / surplus (+)	-0.8	0.6	-0.4	-3.0	.	.	-2.8	-2.0	-1.0
Public debt, nat.def., in % of GDP <sup>6)</sup>	16.5	20.2	16.9	24	.	.	.	.	.
Base rate of NB % p.a., end of period <sup>7)</sup>	3.3	3.3	2.8	2.8	2.8	2.8	.	.	.
Current account, EUR bn	198.8	271.4	289.5	213.1	.	.	150	250	300
Current account in % of GDP	9.4	11.0	9.4	6.1	.	.	3.7	5.2	5.2
Exports of goods total, EUR bn <sup>8)</sup>	771.0	888.9	971.9	864.9	188.1	228.3	950	1140	1330
annual change in %	26.5	15.3	9.3	-11.0	-7.7	21.3	10	20	17
Imports of goods total, EUR bn <sup>8)</sup>	629.7	697.8	769.4	724.3	140.4	217.8	820	990	1130
annual change in %	19.3	10.8	10.3	-5.9	-20.2	55.2	13	21	14
Trade balance of goods, EUR bn <sup>8)</sup>	141.2	191.1	202.5	140.6	47.8	10.5	130	150	200
Exports of services, BOP, EUR bn	73.2	89.2	99.9	88.6	.	.	.	.	.
annual growth rate in %	23.0	21.9	12.0	-11.4	.	.	.	.	.
Imports of services, BOP, EUR bn	80.2	95.0	108.0	101.2	.	.	.	.	.
annual growth rate in %	19.7	18.4	13.7	-6.3	.	.	.	.	.
FDI inflow, EUR bn <sup>9)</sup>	62.1	101.0	100.4	65	16.7	16.9	71	.	.
FDI outflow, EUR bn <sup>9)</sup>	16.8	12.4	36.3	43	.	.	.	.	.
Gross reserves of NB excl. gold, EUR bn	810.0	1038.2	1384.0	1665.2	1468.6	1815.7	.	.	.
Gross external debt, EUR bn	245.4	253.8	266.5	268.5	.	.	.	.	.
Gross external debt in % of GDP	12.1	11.0	8.3	7.9	.	.	.	.	.
Average exchange rate CNY/USD	7.972	7.604	6.945	6.831	6.836	6.827	6.6	6.4	6
Average exchange rate CNY/EUR	10.019	10.418	10.223	9.526	8.923	9.457	9.2	9.0	8.4
Purchasing power parity CNY/USD, wiiw <sup>10)</sup>	3.462	3.615	3.943	3.828	.	.	.	.	.
Purchasing power parity CNY/EUR, wiiw <sup>10)</sup>	4.149	4.348	4.820	4.808	.	.	.	.	.

Note: CNY: ISO code for the Chinese yuan.

1) Preliminary. - 2) Staff and workers (on duty) refer to all persons working in government agencies, political and party organizations, social organizations, enterprises and institutions. - 3) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 4) Average gross annual wages of staff and workers, defined as: total wages of staff and workers on duty per average number of staff and workers on duty. - 5) Staff and workers cost of living index is used as a deflator for calculating real wage. For 2009 the consumer price index was used as a deflator. - 6) Central government debt only. - 7) Overnight rate. - 8) According to customs statistics. - 9) Net investments drawn from the Chinese balance of payments. Data for 2009 and 2010 are gross equity investments in the non-financial sector as given by the Chinese Ministry of Commerce. - 10) wiiw estimates based on the 2005 International Comparison Project benchmark (World Bank).

Source: National statistics (National Bureau of Statistics, Central Bank, China Daily etc.). Forecasts by wiiw.



## **Appendix**

### **Selected indicators of competitiveness**

Table A/1

## GDP per capita at current PPPs (EUR) from 2010 at constant PPPs and population

	1991	2000	2005	2008	2009	2010	2012	2015	2020	2025	2030
									projection <sup>1)</sup>		
Bulgaria	4400	5300	7700	10300	9700	9700	10200	10800	11800	12800	13800
Cyprus	10700	16900	20400	24000	23000	22900	24100	24700	25700	26700	27700
Czech Republic	8800	13000	17100	20200	18900	19100	20300	20900	21900	22900	23900
Estonia	5500	8600	13900	16900	14300	14400	15300	16500	18500	20700	23200
Hungary	6800	10500	14200	16100	14900	15000	15900	16200	16700	17200	17700
Latvia	6500	7000	10900	14400	11700	11300	11600	12500	14000	15800	17800
Lithuania	7200	7500	11900	15500	13100	12900	13400	14300	15900	17900	19900
Malta	9500	15900	17500	19100	18500	18700	19800	19800	19800	19800	19800
Poland	4500	9100	11500	14100	14200	14600	15600	15900	16400	17100	18100
Romania	4000	5000	7900	12000	11000	10900	11400	12000	13000	14000	15100
Slovakia	5800	9600	13500	18100	17000	17500	18900	19800	21500	23500	25500
Slovenia	8500	15200	19700	22800	20500	20600	21500	22100	23100	24100	25100
NMS-12	5400	8600	11700	14800	14000	14200	15100	15700	16700	17700	18700
Croatia	7000	9400	12700	15500	14400	14200	14900	15400	16400	17400	18400
Macedonia	4300	5100	6400	8200	8000	8100	8500	8500	8500	8500	8500
Turkey	3800	8000	9500	11400	10600	11300	12300	12700	13700	14700	15700
Albania	1500	3500	5000	6500	6600	6700	7000	7300	7800	8700	9700
Bosnia & Herzeg.	.	3900	5200	7000	6600	6600	6900	7200	7700	8200	8700
Montenegro	.	5600	6900	10700	10000	9900	10400	10700	11200	11700	12200
Serbia	.	5000	7100	9000	8700	8800	9300	9600	10200	11200	12200
Kazakhstan	.	4200	7300	9300	9100	9400	10300	11500	13600	16100	19100
Russia	7600	6600	10000	13200	12000	12500	13600	14500	16200	18200	20300
Ukraine	4600	2800	4700	6000	5100	5300	5800	6100	6600	7600	8600
China	750	2100	3400	4900	5200	5700	6800	7700	9200	11200	13600
Austria	18800	25000	28000	31000	29300	29700	30200	30200	30200	30200	30200
Germany	18100	22600	26300	29000	27200	27500	27800	27500	27000	26500	26000
Greece	12300	16000	20600	23600	22800	22100	22200	22800	23800	24800	25800
Portugal	10600	15400	17800	19700	18700	18800	18800	18500	18000	17500	17000
Spain	12800	18500	22900	25700	24100	24000	24300	24600	25100	25600	26100
USA	21500	30600	35700	38800	36900	37900	38800	38800	38800	38800	38800
EU-27 average	13700	19100	22500	25100	23600	23800	24700	24700	24700	24700	24700
<b>European Union (27) average = 100</b>											
	1991	2000	2005	2008	2009	2010	2012	2015	2020	2025	2030
Bulgaria	32	28	34	41	41	41	41	44	48	52	56
Cyprus	78	88	91	96	97	96	98	100	104	108	112
Czech Republic	64	68	76	80	80	80	82	85	89	93	97
Estonia	40	45	62	67	61	61	62	67	75	84	94
Hungary	50	55	63	64	63	63	64	66	68	70	72
Latvia	47	37	48	57	50	47	47	51	57	64	72
Lithuania	53	39	53	62	56	54	54	58	64	72	81
Malta	69	83	78	76	78	79	80	80	80	80	80
Poland	33	48	51	56	60	61	63	64	66	69	73
Romania	29	26	35	48	47	46	46	49	53	57	61
Slovakia	42	50	60	72	72	74	77	80	87	95	103
Slovenia	62	80	88	91	87	87	87	89	94	98	102
NMS-12	39	45	52	59	59	60	61	64	68	72	76
Croatia	51	49	56	62	61	60	60	62	66	70	74
Macedonia	31	27	28	33	34	34	34	34	34	34	34
Turkey	28	42	42	45	45	47	50	51	55	60	64
Albania	11	18	22	26	28	28	28	30	32	35	39
Bosnia & Herzeg.	.	20	23	28	28	28	28	29	31	33	35
Montenegro	.	29	31	43	42	42	42	43	45	47	49
Serbia	.	26	32	36	37	37	38	39	41	45	49
Kazakhstan	.	22	32	37	39	39	42	47	55	65	77
Russia	55	35	44	53	51	53	55	59	66	74	82
Ukraine	34	15	21	24	22	22	23	25	27	31	35
China	5	11	15	20	22	24	28	31	37	45	55
Austria	137	131	124	124	124	125	122	122	122	122	122
Germany	132	118	117	116	115	116	113	111	109	107	105
Greece	90	84	92	94	97	93	90	92	96	100	104
Portugal	77	81	79	78	79	79	76	75	73	71	69
Spain	93	97	102	102	102	101	98	100	102	104	106
USA	157	160	159	155	156	159	157	157	157	157	157
EU-27 average	100	100	100	100	100	100	100	100	100	100	100

1) 2010-2012 extrapolated with wiiw GDP growth forecasts (EU-15 taken from European Forecast Spring 2010). From 2013 projection assuming a 50% of the average growth differential with respect to EU-27 in the period 2000-2008.

Sources: National statistics, Eurostat, wiiw estimates.

Table A/2

## Indicators of macro-competitiveness, 1995-2012

EUR based, annual averages

	1995	2000	2005	2008	2009	2010	2011	2012
					prelim.		forecast	
<b>Bulgaria</b>								
Producer price index, 2000=100	2.8	100.0	123.3	164.9	154.3	158.3	163.5	168.7
Consumer price index, 2000=100	2.9	100.0	130.9	169.3	173.5	178.7	184.1	189.6
GDP deflator, 2000=100	3.2	100.0	123.6	161.1	168.4	172.8	178.5	184.2
Exchange rate (ER), NC/EUR	0.0868	1.9522	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
ER, nominal, 2000=100	4.4	100.0	100.2	100.2	100.2	100.2	100.2	100.2
Real ER (CPI-based), 2000=100	71.0	100.0	117.7	140.4	142.5	144.2	146.0	147.4
Real ER (PPI-based), 2000=100	64.7	100.0	114.5	134.8	130.9	132.8	135.2	136.7
PPP, NC/EUR	0.0224	0.6194	0.7152	0.8468	0.8991	0.91	0.93	0.94
Price level, EU27 = 100	26	32	37	43	46	47	47	48
Average monthly gross wages, NC	8	225	324	525	592	600	620	650
Average monthly gross wages, EUR (ER)	87	115	166	268	303	310	320	330
Average monthly gross wages, EUR (PPP)	339	362	453	619	658	660	670	690
GDP nominal, NC mn	880	26753	42797	66728	66256	68000	72000	76500
Employed persons - LFS, th., average	2984.2	2794.7	2981.9	3360.7	3253.6	3050	3100	3150
GDP per employed person, NC	295	9573	14352	19855	20364	22300	23200	24300
GDP per empl. person, NC at 2000 pr.	9353	9573	11612	12325	12093	12900	13000	13200
Unit labour costs, NC, 2000=100	3.5	100.0	118.9	181.5	208.7	198.3	203.4	210.0
Unit labour costs, ER adj., 2000=100	77.9	100.0	118.6	181.1	208.3	198.0	203.0	209.6
Unit labour costs, PPP adj., Austria=100	12.0	16.9	19.0	26.8	29.2	27.8	28.4	29.1
<b>Czech Republic</b>								
Producer price index, 2000=100	78.4	100.0	101.7	104.9	103.3	104.9	107.0	109.8
Consumer price index, 2000=100	72.1	100.0	110.4	123.3	124.1	125.9	128.4	131.7
GDP deflator, 2000=100	72.1	100.0	113.4	120.8	124.0	125.9	128.5	131.8
Exchange rate (ER), NC/EUR	34.31	35.60	29.78	24.95	26.44	26	25.5	25
ER nominal, 2000=100	96.4	100.0	83.7	70.1	74.3	73.0	71.6	70.2
Real ER (CPI-based), 2000=100	81.4	100.0	118.9	146.2	137.5	139.3	142.5	146.1
Real ER (PPI-based), 2000=100	83.0	100.0	113.1	122.6	118.3	120.8	123.8	127.0
PPP, NC/EUR	13.19	16.34	17.09	17.55	18.30	18.4	18.5	18.6
Price level, EU27 = 100	38	46	57	70	69	71	72	74
Average monthly gross wages, NC	8307	13614	18992	23542	23488	23800	24800	26200
Average monthly gross wages, EUR (ER)	242	382	638	944	889	920	970	1050
Average monthly gross wages, EUR (PPP)	630	833	1111	1341	1283	1300	1340	1410
GDP nominal, NC bn	1381	2189	2984	3689	3627	3720	3890	4130
Employed persons - LFS, th., average	4963	4732	4764	5003	4934	4860	4860	4910
GDP per employed person, NC	278291	462670	626335	737430	735097	765400	800400	841100
GDP per empl. person, NC at 2000 pr.	385990	462670	552324	610455	592820	607900	623100	638300
Unit labour costs, NC, 2000=100	73.1	100.0	116.9	131.1	134.7	133.1	135.3	139.5
Unit labour costs, ER adj., 2000=100	75.9	100.0	139.7	187.0	181.3	182.2	188.8	198.6
Unit labour costs, PPP adj., Austria=100	21.2	30.8	40.5	50.3	46.1	46.4	47.9	50.0
<b>Estonia</b>								
Producer price index, 2000=100	74.2	100.0	110.3	134.3	135.3	137.3	141.4	147.1
Consumer price index, 2000=100	62.8	100.0	119.0	146.7	147.0	149.2	153.7	159.9
GDP deflator, 2000=100	62.1	100.0	123.9	156.7	155.8	158.1	162.9	169.4
Exchange rate (ER), NC/EUR	14.819	15.647	15.647	15.647	15.647	15.65	15.65	15.65
ER, nominal, 2000=100	94.7	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real ER (CPI-based), 2000=100	72.2	100.0	107.2	121.9	121.0	120.6	122.2	124.6
Real ER (PPI-based), 2000=100	79.9	100.0	102.7	109.9	115.0	115.4	117.1	119.4
PPP, NC/EUR	5.665	8.188	9.377	11.104	11.210	11.25	11.42	11.64
Price level, EU27 = 100	38	52	60	71	72	72	73	74
Average monthly gross wages, NC	2375	4907	8073	12912	12223	11800	12200	12900
Average monthly gross wages, EUR (ER)	160	314	516	825	781	750	780	820
Average monthly gross wages, EUR (PPP)	419	599	861	1163	1090	1050	1070	1110
GDP nominal, NC mn	43283	96381	174956	251493	214828	219100	231300	249000
Employed persons - LFS, th., average	633.4	572.5	607.4	656.5	595.8	570	580	590
GDP per employed person, NC	68335	168350	288041	383081	360571	384400	398800	422000
GDP per empl. person, NC at 2000 pr.	110111	168350	232404	244406	231372	243100	244800	249100
Unit labour costs, NC, 2000=100	74.0	100.0	119.2	181.3	181.2	166.5	171.0	177.7
Unit labour costs, ER adj., 2000=100	78.1	100.0	119.2	181.3	181.2	166.5	171.0	177.7
Unit labour costs, PPP adj., Austria=100	24.6	34.7	39.1	55.0	52.1	47.9	49.0	50.5

(Table A/2 cont.)

(Table A/2 ctd.)

	1995	2000	2005	2008	2009	2010	2011	2012
					prelim.		forecast	
<b>Hungary</b>								
Producer price index, 2000=100	52.5	100.0	115.1	128.7	134.5	138.1	140.7	143.4
Consumer price index, 2000=100	49.5	100.0	132.8	158.1	164.5	171.7	177.7	183.0
GDP deflator, 2000=100	52.3	100.0	133.9	153.0	160.5	164.7	167.9	171.1
Exchange rate (ER), NC/EUR	162.65	260.04	248.05	251.51	280.33	275	270	265
ER, nominal 2000=100	62.5	100.0	95.4	96.7	107.8	105.8	103.8	101.9
Real ER (CPI-based), 2000=100	86.1	100.0	125.4	135.8	125.5	131.2	136.0	139.9
Real ER (PPI-based), 2000=100	85.6	100.0	112.3	108.9	106.1	109.8	112.3	114.3
PPP, NC/EUR	73.44	124.04	153.53	163.81	174.56	177.2	177.9	177.8
Price level, EU27 = 100	45	48	62	65	62	64	66	67
Average monthly gross wages, NC	38900	87645	158343	198964	199775	207100	217100	228100
Average monthly gross wages, EUR (ER)	239	337	638	791	713	750	800	860
Average monthly gross wages, EUR (PPP)	530	707	1031	1215	1144	1170	1220	1280
GDP nominal, NC bn	5755	13345	21989	26543	26095	27000	28200	29600
Employed persons - LFS, th., average	3623	3856	3902	3879	3782	3760	3800	3840
GDP per employed person, NC	1588649	3460739	5635932	6842102	6900107	7180900	7421100	7708300
GDP per empl. person, NC at 2000 pr.	3037571	3460739	4209060	4471962	4299132	4358700	4420600	4505800
Unit labour costs, NC, 2000=100	50.6	100.0	148.5	175.7	183.5	187.6	193.9	199.9
Unit labour costs, ER adj., 2000=100	80.8	100.0	155.7	181.6	170.2	177.4	186.8	196.2
Unit labour costs, PPP adj., Austria=100	20.2	27.5	40.4	43.7	38.7	40.4	42.4	44.2
<b>Latvia</b>								
Producer price index, 2000=100	84.8	100.0	122.5	174.8	166.8	161.9	163.3	166.5
Consumer price index, 2000=100	71.3	100.0	122.1	165.2	170.5	165.4	167.1	170.4
GDP deflator, 2000=100	71.7	100.0	128.6	196.2	194.7	188.9	190.6	194.3
Exchange rate (ER), NC/EUR	0.6818	0.5592	0.6962	0.7027	0.7057	0.703	0.703	0.703
ER, nominal, 2000=100	121.9	100.0	124.5	125.7	126.2	125.7	125.7	125.7
Real ER (CPI-based), 2000=100	63.6	100.0	88.4	109.2	111.2	106.4	105.7	105.7
Real ER (PPI-based), 2000=100	71.0	100.0	91.6	113.9	112.4	108.3	107.6	107.6
PPP, NC/EUR	0.2288	0.2863	0.3605	0.4999	0.5039	0.48	0.48	0.48
Price level, EU27 = 100	34	51	52	71	71	69	68	68
Average monthly gross wages, NC	90	150	246	479	461	410	410	420
Average monthly gross wages, EUR (ER)	131	267	353	682	653	580	580	600
Average monthly gross wages, EUR (PPP)	391	522	682	958	915	850	850	870
GDP nominal, NC mn	2615.1	4750.8	9059.1	16274.5	13244.3	12400	12600	13100
Employed persons - LFS, th., average	966.7	941.1	1033.7	1124.5	983.1	900	900	920
GDP per employed person, NC	2705	5048	8764	14473	13472	13800	14000	14200
GDP per empl. person, NC at 2000 pr.	3776	5048	6815	7376	6920	7300	7300	7300
Unit labour costs, NC, 2000=100	80.0	100.0	121.7	219.2	224.9	189.6	189.6	194.2
Unit labour costs, ER adj., 2000=100	65.6	100.0	97.8	174.5	178.2	150.9	150.9	154.6
Unit labour costs, PPP adj., Austria=100	20.6	34.5	31.9	52.7	50.9	43.2	43.0	43.7
<b>Lithuania</b>								
Producer price index, 2000=100	71.9	100.0	110.9	150.5	130.2	130.2	131.5	134.1
Consumer price index, 2000=100	68.9	100.0	104.7	127.7	133.0	133.0	134.4	137.1
GDP deflator, 2000=100	73.2	100.0	108.3	137.2	134.0	134.0	135.4	138.0
Exchange rate (ER), NC/EUR	5.1717	3.6952	3.4528	3.4528	3.4528	3.45	3.45	3.45
ER, nominal, 2000=100	140.0	100.0	93.4	93.4	93.4	93.4	93.4	93.4
Real ER (CPI-based), 2000=100	53.5	100.0	100.9	113.6	117.1	115.2	114.4	114.4
Real ER (PPI-based), 2000=100	52.4	100.0	110.5	131.9	118.4	117.2	116.7	116.6
PPP, NC/EUR	1.4209	1.7443	1.7748	2.1335	2.1039	2.08	2.07	2.07
Price level, EU27 = 100	27	47	51	62	61	60	60	60
Average monthly gross wages, NC	481	971	1276	2152	2052	1910	1950	2030
Average monthly gross wages, EUR (ER)	93	263	370	623	594	550	570	590
Average monthly gross wages, EUR (PPP)	338	557	719	1009	976	920	940	980
GDP nominal, NC mn	26925	45737	72060	111190	92353	91000	93300	97500
Employed persons - LFS, th., average	1632	1398	1474	1520	1416	1350	1380	1400
GDP per employed person, NC	16495	32721	48891	73151	65226	67400	67600	69600
GDP per empl. person, NC at 2000 pr.	22534	32721	45144	53317	48676	50300	49900	50400
Unit labour costs, NC, 2000=100	71.9	100.0	95.3	136.0	142.1	128.0	131.7	135.8
Unit labour costs, ER adj., 2000=100	51.4	100.0	102.0	145.6	152.1	137.1	141.1	145.4
Unit labour costs, PPP adj., Austria=100	14.9	31.9	30.7	40.6	40.1	36.2	37.1	38.0

(Table A/2 ctd.)

(Table A/2 ctd.)

	1995	2000	2005	2008	2009	2010	2011	2012
					prelim.		forecast	
<b>Poland</b>								
Producer price index, 2000=100	64.8	100.0	112.8	120.0	124.7	125.9	128.5	131.0
Consumer price index, 2000=100	55.0	100.0	114.4	123.9	128.8	132.1	135.4	138.7
GDP deflator, 2000=100	59.0	100.0	113.5	123.3	127.8	130.8	134.4	137.6
Exchange rate (ER), NC/EUR	3.135	4.008	4.023	3.512	4.328	4.1	4.1	4.1
ER, nominal, 2000=100	78.2	100.0	100.4	87.6	108.0	102.3	102.3	102.3
Real ER (CPI-based), 2000=100	76.4	100.0	102.7	117.5	98.2	104.3	105.2	105.7
Real ER (PPI-based), 2000=100	84.6	100.0	104.6	112.1	98.2	103.5	104.0	104.0
PPP, PLZ/EUR	1.401	2.117	2.232	2.360	2.485	2.51	2.55	2.56
Price level, EU27 = 100	45	53	55	67	57	61	62	62
Average monthly gross wages, NC	691	1894	2361	2942	3103	3250	3460	3710
Average monthly gross wages, EUR (ER)	220	472	587	838	717	790	840	900
Average monthly gross wages, EUR (PPP)	493	895	1058	1247	1249	1290	1360	1450
GDP nominal, NC bn	330	744	983	1273	1342	1410	1500	1590
Employed persons - LFS, th., average	14791	14526	14116	15800	15868	15720	15800	16120
GDP per employed person, NC	22282	51245	69661	80560	84565	89700	94900	98600
GDP per empl. person, NC at 2000 pr.	37795	51245	61375	65337	66170	68600	70600	71600
Unit labour costs, NC, 2000=100	49.5	100.0	104.1	121.9	126.9	128.2	132.6	140.2
Unit labour costs, ER adj., 2000=100	63.3	100.0	103.7	139.1	117.5	125.3	129.6	137.1
Unit labour costs, PPP adj., Austria=100	25.5	44.4	43.5	54.0	43.2	46.2	47.5	49.9
<b>Romania</b>								
Producer price index, 2000=100	8.8	100.0	254.3	345.3	351.5	369.1	383.9	403.0
Consumer price index, 2000=100	8.4	100.0	231.7	279.7	295.3	310.1	322.5	335.4
GDP deflator, 2000=100	8.4	100.0	270.2	391.0	401.9	422.0	438.9	460.8
Exchange rate (ER), NC/EUR	0.2630	1.9922	3.6209	3.6826	4.2399	4.2	4.1	4.0
ER, nominal, 2000=100	13.2	100.0	181.8	184.9	212.8	210.8	205.8	200.8
Real ER (CPI-based), 2000=100	69.0	100.0	114.9	125.7	114.2	118.9	124.5	130.1
Real ER (PPI-based), 2000=100	67.7	100.0	130.2	152.9	140.4	147.2	154.5	163.0
PPP, NC/EUR	0.0703	0.7273	1.6989	1.9869	2.0739	2.15	2.21	2.27
Price level, EU27 = 100	27	37	47	54	49	51	54	57
Average monthly gross wages, NC	28	284	968	1761	1887	1940	2040	2160
Average monthly gross wages, EUR (ER)	105	143	267	478	445	460	500	540
Average monthly gross wages, EUR (PPP)	392	391	570	886	910	900	920	950
GDP nominal, NC mn	7214	80985	288955	514654	491274	510700	539100	583000
Employed persons - LFS, th., average	.	10508	9115	9369	9244	9150	9150	9200
GDP per employed person, NC	.	7707	31702	54931	53148	55800	58900	63400
GDP per empl. person, NC at 2000 pr.	.	7707	11733	14051	13224	13200	13400	13800
Unit labour costs, NC, 2000=100	.	100.0	223.9	340.1	387.2	398.8	413.1	424.7
Unit labour costs, ER adj., 2000=100	.	100.0	123.2	184.0	181.9	189.2	200.7	211.5
Unit labour costs, PPP adj., Austria=100	.	30.6	35.6	49.3	46.1	48.0	50.7	53.1
<b>Slovakia</b>								
Producer price index, 2000=100	76.9	100.0	123.1	128.1	119.6	117.2	119.6	121.9
Consumer price index, 2000=100	67.4	100.0	132.9	146.7	148.0	149.5	152.5	155.6
GDP deflator, 2000=100	73.2	100.0	124.5	133.3	131.8	130.5	133.1	137.1
Exchange rate (ER), NC/EUR	1.2763	1.4141	1.2813	1.0377	1.0	1.0	1.0	1.0
ER, nominal, 2000=100	90.3	100.0	90.6	73.4	70.7	70.7	70.7	70.7
Real ER (CPI-based), 2000=100	81.3	100.0	132.1	166.1	172.2	170.9	171.4	171.4
Real ER (PPI-based), 2000=100	86.9	100.0	126.4	142.9	143.7	139.3	140.0	140.0
PPP NC/ EUR	0.5158	0.6044	0.6757	0.6865	0.6889	0.67	0.68	0.68
Price level, EU27 = 100	40	43	53	66	69	67	68	68
Average monthly gross wages, NC	239	379	573	723	745	760	790	830
Average monthly gross wages, EUR (ER)	187	268	448	697	745	760	790	830
Average monthly gross wages, EUR (PPP)	463	628	849	1053	1081	1130	1170	1210
GDP nominal, NC mn	19136	31152	49280	67221	63332	64600	68500	73400
Employed persons - LFS, th., average	2147	2102	2215	2434	2366	2310	2310	2330
GDP per employed person, NC	8914	14822	22246	27621	26764	28000	29700	31500
GDP per empl. person, NC at 2000 pr.	12172	14822	17869	20721	20307	21500	22300	23000
Unit labour costs, NC, 2000=100	76.7	100.0	125.4	136.3	143.2	138.1	138.4	141.0
Unit labour costs, ER adj., 2000=100	84.9	100.0	138.4	185.8	202.5	195.3	195.7	199.4
Unit labour costs, PPP adj., Austria=100	19.2	24.9	32.5	40.4	41.7	40.3	40.2	40.7

(Table A/2 ctd.)

(Table A/2 ctd.)

	1995	2000	2005	2008	2009	2010	2011	2012
					prelim.		forecast	
<b>Slovenia</b>								
Producer price index, 2000=100	75.9	100.0	117.5	130.3	128.5	127.2	129.7	132.3
Consumer price index, 2000=100	67.3	100.0	131.0	147.0	148.3	150.5	153.5	156.6
GDP deflator, 2000=100	69.0	100.0	129.8	143.4	146.2	148.4	151.4	154.4
Exchange rate (ER), NC/EUR	0.6389	0.8556	1.0000	1.0	1.0	1.0	1.0	1.0
ER, nominal, 2000=100	74.7	100.0	116.9	116.9	116.9	116.9	116.9	116.9
Real ER (CPI-based), 2000=100	98.1	100.0	101.0	104.5	104.4	104.1	104.4	104.4
Real ER (PPI-based), 2000=100	103.7	100.0	93.5	91.3	93.4	91.5	91.9	91.9
PPP, NC/EUR	0.4752	0.6113	0.7302	0.8057	0.8340	0.84	0.84	0.84
Price level, EU27 = 100	74	71	73	81	83	84	84	84
Average monthly gross wages, NC	467	800	1157	1391	1439	1470	1520	1580
Average monthly gross wages, EUR (ER)	731	935	1157	1391	1439	1470	1520	1580
Average monthly gross wages, EUR (PPP)	983	1308	1585	1727	1725	1760	1810	1880
GDP nominal, NC mn	9270	18481	28750	37135	34894	35590	37030	38710
Employed persons - LFS, th., average	882	901	949	996	981	966	966	976
GDP per employed person, NC	10510	20511	30288	37281	35581	36800	38300	39700
GDP per empl. person, NC at 2000 pr.	15240	20511	23335	25998	24337	24800	25300	25700
Unit labour costs, NC, 2000=100	78.6	100.0	127.2	137.3	151.6	152.0	154.1	157.7
Unit labour costs, ER adj., 2000=100	105.3	100.0	108.8	117.4	129.7	130.1	131.8	134.9
Unit labour costs, PPP adj., Austria=100	60.6	63.4	65.2	65.1	68.1	68.4	69.0	70.1
<b>Croatia</b>								
Producer price index, 2000=100	86.7	100.0	112.1	129.3	128.8	131.3	134.6	137.3
Consumer price index, 2000=100	79.7	100.0	114.6	129.1	132.2	134.8	138.2	140.9
GDP deflator, 2000=100	76.6	100.0	120.0	137.3	141.8	144.7	148.3	151.2
Exchange rate (ER), NC/EUR	6.7572	7.6339	7.4000	7.2232	7.3398	7.3	7.3	7.3
ER, nominal, 2000=100	88.5	100.0	96.9	94.6	96.1	95.6	95.6	95.6
Real ER (CPI-based), 2000=100	98.0	100.0	106.5	113.3	113.1	113.9	114.8	114.8
Real ER (PPI-based), 2000=100	99.9	100.0	107.6	111.8	113.8	115.4	116.6	116.6
PPP, NC/EUR	3.6769	4.2358	4.6745	4.9838	5.2321	5.28	5.33	5.33
Price level, EU27 = 100	54	55	63	69	71	72	73	73
Average monthly gross wages, NC	2887	4869	6248	7544	7711	7590	7900	8220
Average monthly gross wages, EUR (ER)	427	638	844	1044	1051	1040	1080	1130
Average monthly gross wages, EUR (PPP)	785	1149	1337	1514	1474	1440	1480	1540
GDP nominal, NC mn	115699	176690	264368	342159	333063	334600	349800	365700
Employed persons - LFS, th., average	1641.8	1553	1573	1636	1605	1570	1570	1590
GDP per employed person, NC	70470	113773	168066	209169	207490	213100	222800	230000
GDP per empl. person, NC at 2000 pr.	91945	113773	140102	152385	146285	147300	150300	152100
Unit labour costs, NC, 2000=100	73.4	100.0	104.2	115.7	123.2	120.4	122.8	126.3
Unit labour costs, ER adj., 2000=100	82.9	100.0	107.5	122.3	128.1	125.9	128.4	132.1
Unit labour costs, PPP adj., Austria=100	40.7	54.1	54.9	57.8	57.3	56.4	57.3	58.5
<b>Macedonia</b>								
Producer price index, 2000=100	83.7	100.0	104.9	127.3	119.0	119.1	122.7	126.3
Consumer price index, 2000=100	90.8	100.0	108.8	124.4	123.4	123.4	127.1	130.9
GDP deflator, 2000=100	83.4	100.0	113.0	136.1	139.9	140.0	144.2	148.5
Exchange rate (ER), NC/EUR	49.15	60.73	61.30	61.27	61.32	61.2	61.2	61.2
ER, nominal, 2000=100	80.9	100.0	100.9	100.9	101.0	100.8	100.8	100.8
Real ER (CPI-based), 2000=100	122.1	100.0	97.1	102.4	100.5	99.0	100.2	101.2
Real ER (PPI-based), 2000=100	105.5	100.0	96.8	103.3	100.2	99.4	100.9	101.8
PPP, NC/EUR	21.61	22.76	21.95	23.86	24.90	24.6	25.0	25.2
Price level, EU27 = 100	44	37	36	39	41	40	41	41
Average monthly gross wages, NC <sup>1)</sup>	14,623	17958	21330	26229	29922	29900	31400	33000
Average monthly gross wages, EUR (ER)	298	296	348	428	488	490	510	540
Average monthly gross wages, EUR (PPP)	677	789	972	1099	1202	1210	1250	1310
GDP nominal, NC mn	169521	236389	286619	398491	406651	411000	432000	458000
Employed persons - LFS, th., average	.	549.8	545.3	609.0	629.9	630	640	670
GDP per employed person, NC	.	429919	525662	654321	645578	652400	675000	683600
GDP per empl. person, NC at 2000 pr.	.	429919	465285	480906	461556	466100	468000	460500
Unit labour costs, NC, 2000=100	.	100.0	109.8	130.6	155.2	153.6	160.6	171.6
Unit labour costs, ER adj., 2000=100	.	100.0	108.7	129.4	153.7	152.4	159.4	170.2
Unit labour costs, PPP adj., Austria=100	.	35.7	36.6	40.3	45.3	45.0	46.9	49.7

1) From 2009 including allowances for food and transport.

(Table A/2 ctd.)

(Table A/2 ctd.)

	1995	2000	2005	2008	2009	2010	2011	2012
					prelim.		forecast	
<b>Albania</b>								
Producer price index, 2000=100	.	100.0	116.9	129.8	127.7	126.4	127.6	131.5
Consumer price index, 2000=100	55.0	100.0	116.9	127.4	130.2	134.1	136.8	139.5
GDP deflator, 2000=100	69.0	100.0	117.1	129.8	135.1	138.5	141.0	144.4
Exchange rate (ER), NC/EUR	119.93	132.58	124.19	122.80	132.06	140	137	127
ER, nominal, 2000=100	90.5	100.0	93.7	92.6	99.6	105.6	103.3	95.8
Real ER (CPI-based), 2000=100	66.1	100.0	112.5	114.3	107.5	102.6	105.2	113.5
Real ER (PPI-based), 2000=100	.	100.0	116.1	114.7	108.9	100.6	102.3	111.4
PPP, NC/EUR	38.38	48.90	52.10	52.94	55.90	56.6	56.8	57.1
Price level, EU27 = 100	32	37	42	43	42	40	41	45
Average monthly gross wages, NC	7376	13355	19993	29000	31900	32900	34200	35900
Average monthly gross wages, EUR (ER)	62	101	161	236	242	240	250	280
Average monthly gross wages, EUR (PPP)	192	273	384	548	571	580	600	630
GDP nominal, NC bn	230	523	815	1088	1180	1230	1280	1350
Employed persons - LFS, th., June <sup>2)</sup>	1150	1067	932	1103	1110	1050	1060	1080
GDP per employed person, NC	199874	490362	874565	986280	1063063	1171400	1207500	1250000
GDP per empl. person, NC at 2000 pr.	289839	490362	746563	759841	786777	845900	856300	865700
Unit labour costs, NC, 2000=100	93.4	100.0	98.3	140.1	148.9	142.8	146.6	152.3
Unit labour costs, ER adj., 2000=100	103.3	100.0	105.0	151.3	149.5	135.2	141.9	159.0
Unit labour costs, PPP adj., Austria=100	21.4	22.9	22.7	30.3	28.3	25.6	26.8	29.8
<b>Bosnia and Herzegovina</b>								
Producer price index, 2000=100	.	.	.	.	.	.	.	.
Consumer price index, 2000=100	.	100.0	109.7	127.2	126.7	127.3	128.6	129.8
GDP deflator, 2000=100	99.5	100.0	119.5	144.7	144.9	145.8	147.4	148.9
Exchange rate (ER), NC/EUR	.	1.96	1.96	1.96	1.96	1.96	1.96	1.96
ER, nominal, 2000=100	.	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real ER (CPI-based), 2000=100	.	100.0	98.9	105.6	104.2	102.9	102.2	101.2
Real ER (PPI-based), 2000=100	.	.	.	.	.	.	.	.
PPP, NC/EUR	.	0.7891	0.8574	0.9232	0.9377	0.93	0.93	0.92
Price level, EU27 = 100	.	40	44	47	48	48	48	47
Average monthly gross wages, NC	.	539	796	1112	1204	1200	1210	1230
Average monthly gross wages, EUR (ER)	.	276	407	569	615	610	620	630
Average monthly gross wages, EUR (PPP)	.	683	929	1205	1284	1290	1300	1340
GDP nominal, NC mn	3117.0	11689.2	17127.4	24702.5	23950.0	24100	24600	25600
Employed persons - LFS, th., April <sup>3)</sup>	.	635.7	641.5	890.2	859.2	820	820	820
GDP per employed person, NC	.	18387	26697	27748	27874	29400	30000	31200
GDP per empl. person, NC at 2000 pr.	.	18387	22345	19178	19236	20200	20400	21000
Unit labour costs, NC, 2000=100	.	100.0	121.6	197.9	213.5	202.7	202.3	199.8
Unit labour costs, ER adj., 2000=100	.	100.0	121.6	197.9	213.5	202.7	202.3	199.8
Unit labour costs, PPP adj., Austria=100	.	26.9	30.9	46.6	47.6	45.2	45.0	44.1
<b>Montenegro</b>								
Producer price index, 2001=100	.	87.3	118.0	151.2	145.3	151.5	158.1	162.8
Consumer price index, 2001=100	.	82.1	129.7	149.5	154.5	156.1	160.8	165.6
GDP deflator, 2001=100	.	83.2	123.3	163.3	167.8	175.0	182.6	188.0
Exchange rate (ER), EUR/EUR	.	1	1	1	1	1	1	1
Real ER (CPI-based), 2001=100	.	83.9	119.4	126.9	129.9	128.9	130.6	131.8
Real ER (PPI-based), 2001=100	.	.	111.1	125.2	124.9	128.8	132.5	133.7
PPP, NC/EUR	.	0.3112	0.4197	0.4573	0.4766	0.49	0.51	0.51
Price level, EU27 = 100	.	31	42	46	48	49	51	51
Average monthly gross wages, NC	.	151	326	609	643	650	680	710
Average monthly gross wages, EUR (PPP)	.	485	778	1332	1349	1320	1350	1390
GDP nominal, NC mn	.	1065.7	1815.0	3085.6	3003.0	3100	3300	3500
Employed persons - LFS, th., average	.	230.3	178.8	218.8	213.6	215	220	220
GDP per employed person, NC	.	4627	10150	14102	14059	14400	15000	15900
GDP per empl. person, NC at 2000 pr.	.	4627	6846	7185	6970	6800	6800	7000
Unit labour costs, NC, 2000=100	.	100.0	146.2	259.9	282.9	293.1	306.6	311.0
Unit labour costs, PPP adj., Austria=100	.	23.1	31.9	52.5	54.1	56.1	58.5	58.9

2) Until 2006 registered employment data. - 3) Until 2005 registered employees.

(Table A/2 ctd.)

(Table A/2 ctd.)

	1995	2000	2005	2008	2009	2010	2011	2012
					prelim.		forecast	
<b>Serbia</b>								
Producer price index, 2000=100	.	100.0	266.1	358.9	379.0	406.6	423.5	435.4
Consumer price index, 2000=100	.	100.0	320.6	428.1	464.9	492.8	512.5	533.0
GDP deflator, 2000=100	.	100.0	340.9	464.6	519.6	557.4	580.6	596.8
Exchange rate (ER), NC/EUR	.	52.55	82.91	81.47	93.92	103	110	115
ER, nominal, 2000=100	.	100.0	157.8	155.0	178.7	196.0	209.3	218.8
Real ER (CPI-based), 2000=100	.	100.0	183.1	229.4	214.0	203.2	194.6	189.7
Real ER (PPI-based), 2000=100	.	100.0	157.0	189.5	180.2	174.4	167.6	161.5
PPP, NC/EUR	.	10.23	31.72	41.04	46.55	49.4	50.7	51.1
Price level, EU27 = 100	.	19	38	50	50	48	46	44
Average monthly gross wages, NC	.	3799	25514	45674	44147	46800	49650	52670
Average monthly gross wages, EUR (ER)	.	72	308	561	470	450	450	460
Average monthly gross wages, EUR (PPP)	.	371	804	1113	948	950	980	1030
GDP nominal, NC bn	.	384	1683	2722	2954	3200	3400	3600
Employed persons - LFS, th., average	.	3094	2733	2822	2616	2510	2510	2510
GDP per employed person, NC	.	124197	615891	964822	1128825	1274900	1354600	1434300
GDP per empl. person, NC at 2000 pr.	.	124197	180652	207688	217261	228700	233300	240300
Unit labour costs, NC, 2000=100	.	100.0	461.7	718.9	664.3	669.0	695.7	716.6
Unit labour costs, ER adj., 2000=100	.	100.0	292.6	463.7	371.7	341.3	332.4	327.4
Unit labour costs, PPP adj., Austria=100	.	13.6	37.5	55.0	41.7	38.4	37.2	36.3
<b>Russia</b>								
Producer price index, 2000=100	23.1	100.0	230.2	358.3	332.6	365.8	402.4	442.7
Consumer price index, 2000=100	20.6	100.0	200.1	273.5	305.8	325.6	348.4	372.8
GDP deflator, 2000=100	21.2	100.0	219.8	342.7	350.7	375.5	401.8	424.5
Exchange rate (ER), NC/EUR	5.892	26.029	35.264	36.425	44.140	39	40	41
ER, nominal, 2000=100	22.6	100.0	135.5	139.9	169.6	149.8	153.7	157.5
Real ER (CPI-based), 2000=100	99.0	100.0	133.1	162.4	148.4	175.7	180.2	184.4
Real ER (PPI-based), 2000=100	104.2	100.0	158.1	209.6	166.7	205.3	216.9	228.2
PPP, NC/EUR	1.816	7.534	15.061	22.192	23.035	24.4	25.7	26.6
Price level, EU27 = 100	31	29	43	61	52	63	64	65
Average monthly gross wages, NC	533	2223	8555	17226	18785	20910	23490	26140
Average monthly gross wages, EUR (ER)	90	85	243	473	426	540	590	640
Average monthly gross wages, EUR (PPP)	293	295	568	776	815	860	910	980
GDP nominal, NC bn	1429	7306	21625	41445	39064	43500	48500	53500
Employed persons - LFS, th., average	64055	65070	68169	70965	69285	69000	69000	68700
GDP per employed person, NC	22301	112273	317232	584015	563811	630400	702900	778700
GDP per empl. person, NC at 2000 pr.	105270	112273	144315	170434	160771	167900	174900	183400
Unit labour costs, NC, 2000=100	25.5	100.0	299.3	510.4	590.0	628.9	678.2	719.7
Unit labour costs, ER adj., 2000=100	112.9	100.0	221.0	364.7	347.9	419.7	441.3	456.9
Unit labour costs, PPP adj., Austria=100	13.4	13.1	27.2	41.6	37.6	45.4	47.5	48.8
<b>Ukraine</b>								
Producer price index, 2000=100	34.1	100.0	169.4	300.6	320.2	353.8	385.7	416.5
Consumer price index, 2000=100	27.5	100.0	147.0	226.5	262.5	290.0	316.2	341.4
GDP deflator, 2000=100	29.0	100.0	179.1	324.5	368.7	407.5	444.1	479.7
Exchange rate (ER), NC/EUR	1.928	5.029	6.389	7.708	10.868	10	10.5	10
ER, nominal, 2000=100	38.3	100.0	127.0	153.3	216.1	198.9	208.8	198.9
Real ER (CPI-based), 2000=100	78.1	100.0	104.2	122.8	99.9	117.9	120.3	133.8
Real ER (PPI-based), 2000=100	90.6	100.0	124.1	160.6	125.9	149.6	153.0	170.1
PPP, NC/EUR	0.4029	1.2196	1.9861	3.4018	3.9208	4.28	4.60	4.87
Price level, EU27 = 100	21	24	31	44	36	43	44	49
Average monthly gross wages, NC	73	230	806	1806	1906	2150	2440	2790
Average monthly gross wages, EUR (ER)	38	46	126	234	175	220	230	280
Average monthly gross wages, EUR (PPP)	181	189	406	531	486	500	530	570
GDP nominal, NC mn	54516	170070	441452	948056	914720	1049200	1195100	1368200
Employed persons - LFS, th., average	24125	20175	20680	20972	20192	20200	20250	20300
GDP per employed person, NC	2260	8430	21347	45205	45302	51900	59000	67400
GDP per empl. person, NC at 2000 pr.	7784	8430	11921	13932	12286	12700	13300	14100
Unit labour costs, NC, 2000=100	34.4	100.0	247.7	474.8	568.3	620.1	672.0	724.8
Unit labour costs, ER adj., 2000=100	89.6	100.0	195.0	309.8	263.0	311.8	321.9	364.5
Unit labour costs, PPP adj., Austria=100	12.3	15.1	27.7	40.8	32.8	39.0	40.0	45.0

(Table A/2 ctd.)

(Table A/2 ctd.)

	1995	2000	2005	2008	2009 prelim.	2010	2011 forecast	2012
<b>Austria</b>								
Producer price index, 2000=100	97.0	100.0	110.0	125.4	116.1	116.9	118.4	120.1
Consumer price index, 2000=100	93.2	100.0	110.7	118.5	119.1	120.8	123.0	125.1
GDP deflator, 2000=100	97.5	100.0	108.5	114.8	116.9	117.7	118.4	120.0
Real ER (CPI-based), 2000=100	107.0	100.0	99.8	98.5	98.0	97.6	97.7	97.4
Real ER (PPI-based), 2000=100	104.5	100.0	102.4	102.6	98.7	98.3	98.1	97.5
PPP, NC/EUR	1.1127	1.0351	1.0583	1.0920	1.1372	1.114	1.116	1.109
Price level, EU27 = 100	117	104	106	109	114	111	112	111
Average monthly gross wages, EUR	2282	2389	2639	2913	2980	3020	3070	3140
Average monthly gross wages, EUR (PPP)	1943	2308	2494	2668	2621	2710	2750	2830
GDP nominal, NC mn	174613	207529	243585	281867	277074	282600	288300	298100
Employed persons - LFS, th., average	3670	3686	3824	4090	4078	4070	4080	4100
GDP per employed person, NC	47584	56306	63692	68916	67949	69400	70700	72700
GDP per empl. person, NC at 2000 pr.	48816	56306	58721	60028	58128	59000	59700	60600
Unit labour costs, NC, 2000=100	104.4	100.0	106.0	114.4	120.9	120.7	121.2	122.1
Unit labour costs, PPP adjusted	0.58	0.53	0.56	0.60	0.64	0.64	0.64	0.64

NC = national currency (including euro-fixed series for euro area countries - SK, SI, AT). ER = Exchange Rate, PPP = Purchasing Power Parity, Price level: PPP/ER.

PPP rates have been taken from Eurostat based on the benchmark results 2005. For Albania, Bosnia and Herzegovina, Montenegro and Serbia available data 2005-2008 have been extrapolated by wiiw with GDP deflators. Russia and Ukraine are estimated by wiiw using the OECD PPP benchmark results 2005 and extrapolation with GDP price deflators.

Real exchange rates: Increasing values mean real appreciation.

Sources: wiiw Database incorporating national and Eurostat statistics; WIFO; Eurostat; Purchasing power parities, 2005 benchmark year, OECD November 2007; wiiw estimates and forecasts.

Table A3

## Indicators of macro-competitiveness, 1995-2012

annual changes in %

	1995	2000	2005	2008	2009 prelim.	2010	2011 forecast	2012	2005-08 average
<b>Bulgaria</b>									
GDP deflator	62.7	6.7	3.7	11.3	4.5	2.6	3.3	3.2	7.8
Exchange rate (ER), EUR/NC	-25.6	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real ER (CPI-based)	17.3	8.5	3.7	8.0	1.5	1.2	1.3	1.0	5.5
Real ER (PPI-based)	9.7	13.6	3.4	4.4	-2.9	1.5	1.8	1.1	5.0
Average gross wages, NC	53.2	11.7	10.7	21.6	12.8	1.4	3.3	4.8	15.7
Average gross wages, real (PPI based)	-0.2	-5.3	2.6	9.7	20.6	-1.2	0.0	1.6	5.6
Average gross wages, real (CPI based)	-5.5	1.2	4.4	8.7	10.1	-1.6	0.3	1.8	6.9
Average gross wages, EUR (ER)	13.9	11.9	10.6	21.6	12.8	2.5	3.2	3.1	15.7
Employed persons (LFS)	2.7	-2.8	2.0	3.3	-3.2	-6.3	1.6	1.6	3.6
GDP per empl. person, NC at 2000 prices	0.2	8.4	4.2	2.6	-1.9	6.7	0.8	1.5	2.5
Unit labour costs, NC at 2000 prices	52.9	3.0	6.2	18.5	15.0	-5.0	2.5	3.3	12.9
Unit labour costs, ER (EUR) adjusted	13.7	3.2	6.1	18.5	15.0	-5.0	2.5	3.3	12.8
<b>Czech Republic</b>									
GDP deflator	10.2	1.5	-0.4	1.9	2.6	1.5	2.0	2.6	1.5
Exchange rate (ER), EUR/NC	-0.7	3.6	7.1	11.3	-5.6	1.7	2.0	2.0	6.3
Real ER (CPI-based)	5.4	5.6	6.5	14.1	-6.0	1.4	2.3	2.5	7.0
Real ER (PPI-based)	2.7	9.2	3.2	5.2	-3.5	2.1	2.5	2.6	2.8
Average gross wages, NC	18.6	6.4	5.3	8.5	-0.2	1.3	4.2	5.6	6.9
Average gross wages, real (PPI based)	10.2	-2.9	4.8	8.1	1.3	-0.2	2.1	3.0	5.9
Average gross wages, real (CPI based)	8.7	2.4	3.6	2.1	-0.9	-0.2	2.2	3.1	3.5
Average gross wages, EUR (ER)	17.8	10.2	12.7	20.8	-5.8	3.5	5.4	8.2	13.6
Employed persons (LFS)	0.7	-0.7	1.2	1.6	-1.4	-1.5	0.0	1.0	1.5
GDP per empl. person, NC at 2000 prices	5.2	4.3	5.1	0.8	-2.9	2.5	2.5	2.4	3.8
Unit labour costs, NC at 2000 prices	12.7	1.9	0.2	7.7	2.7	-1.2	1.7	3.1	3.0
Unit labour costs, ER (EUR) adjusted	11.9	5.6	7.3	19.8	-3.0	0.5	3.7	5.2	9.5
<b>Estonia</b>									
GDP deflator	31.4	4.5	5.5	6.7	-0.6	1.5	3.0	4.0	7.5
Exchange rate (ER), EUR/NC	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real ER (CPI-based)	30.0	2.1	1.9	6.7	-0.8	-0.3	1.3	2.0	3.8
Real ER (PPI-based)	25.1	0.8	-2.4	1.7	4.6	0.4	1.5	2.0	1.1
Average gross wages, NC	37.0	10.5	10.8	13.9	-5.3	-3.5	3.4	5.7	15.4
Average gross wages, real (PPI based)	9.1	5.4	8.9	5.4	-6.0	-4.9	0.4	1.7	9.4
Average gross wages, real (CPI based)	6.2	6.3	6.4	3.0	-5.5	-4.9	0.4	1.7	8.4
Average gross wages, EUR (ER)	41.9	10.5	10.8	13.9	-5.3	-4.0	4.0	5.1	15.4
Employed persons (LFS)	-6.2	-1.2	2.0	0.2	-9.2	-4.3	1.8	1.7	2.5
GDP per empl. person, NC at 2000 prices	11.5	11.3	7.3	-3.8	-5.3	5.1	0.7	1.8	3.1
Unit labour costs, NC at 2000 prices	22.9	-0.7	3.3	18.3	0.0	-8.1	2.7	3.9	11.9
Unit labour costs, ER (EUR) adjusted	27.3	-0.7	3.3	18.3	0.0	-8.1	2.7	3.9	11.9
<b>Hungary</b>									
GDP deflator	25.6	9.2	2.1	3.8	4.9	2.6	1.9	1.9	3.9
Exchange rate (ER), EUR/NC	-23.3	-2.8	1.5	-0.1	-10.3	1.9	1.9	1.9	0.0
Real ER (CPI-based)	-4.3	4.7	2.8	2.2	-7.6	4.5	3.7	2.9	2.7
Real ER (PPI-based)	-4.9	3.8	0.4	-1.6	-2.6	3.5	2.3	1.8	-0.6
Average gross wages, NC	16.8	13.5	8.8	7.5	0.4	3.7	4.8	5.1	8.1
Average gross wages, real (PPI based)	-9.4	2.2	5.5	2.8	-3.9	1.0	2.9	3.1	4.3
Average gross wages, real (CPI based)	-8.9	3.4	5.1	1.4	-3.5	-0.7	1.3	2.0	2.6
Average gross wages, EUR (ER)	-10.4	10.4	10.4	7.5	-9.9	5.2	6.7	7.5	8.2
Employed persons (LFS)	-1.9	1.2	0.0	-1.2	-2.5	-0.6	1.1	1.1	-0.1
GDP per empl. person, NC at 2000 prices	3.4	3.6	3.5	1.9	-3.9	1.4	1.4	1.9	2.4
Unit labour costs, NC at 2000 prices	12.9	9.6	5.2	5.6	4.4	2.2	3.4	3.1	5.6
Unit labour costs, ER (EUR) adjusted	-13.4	6.5	6.7	5.5	-6.3	4.2	5.3	5.0	5.6
<b>Latvia</b>									
GDP deflator	15.1	4.2	10.1	15.4	-0.8	-3.0	0.9	1.9	13.8
Exchange rate (ER), EUR/NC	-2.8	11.7	-4.5	-0.4	-0.4	0.4	0.0	0.0	-1.4
Real ER (CPI-based)	18.1	12.5	0.0	10.8	1.8	-4.3	-0.7	0.0	5.4
Real ER (PPI-based)	4.5	9.3	-1.0	4.5	-1.4	-3.6	-0.6	-0.1	5.3
Average gross wages, NC	24.5	6.1	16.5	20.5	-3.8	-11.1	0.0	2.4	22.8
Average gross wages, real (PPI based)	11.3	4.2	7.9	8.1	0.9	-8.3	-0.9	0.5	10.2
Average gross wages, real (CPI based)	-0.4	3.4	9.0	4.5	-6.8	-8.3	-1.0	0.4	12.0
Average gross wages, EUR (ER)	21.0	18.5	11.3	20.0	-4.2	-11.2	0.0	3.4	21.1
Employed persons (LFS)	.	-2.8	1.6	0.6	-12.6	-8.5	0.0	2.2	2.5
GDP per empl. person, NC at 2000 prices	.	10.0	9.0	-5.1	-6.2	5.5	0.0	0.0	4.2
Unit labour costs, NC at 2000 prices	.	-3.6	6.9	27.0	2.6	-15.7	0.0	2.4	17.8
Unit labour costs, ER (EUR) adjusted	.	7.7	2.2	26.5	2.2	-15.3	0.0	2.4	16.2

(Table A/3 ctd.)

Table A3 (ctd.)

	1995	2000	2005	2008	2009	2010	2011	2012	2005-08
					prelim.		forecast		average
<b>Lithuania</b>									
GDP deflator	41.9	0.9	6.7	9.7	-2.3	0.0	1.0	2.0	7.8
Exchange rate (ER), EUR/NC	-8.8	15.6	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Real ER (CPI-based)	23.8	14.6	0.5	7.2	3.1	-1.7	-0.7	0.0	3.1
Real ER (PPI-based)	12.5	28.8	7.1	11.2	-10.2	-1.0	-0.5	0.0	6.3
Average gross wages, NC	47.8	-1.7	11.0	19.4	-4.6	-6.9	2.1	4.1	17.0
Average gross wages, real (PPI based)	15.2	-15.1	-0.5	1.0	10.3	-7.0	1.1	2.1	5.4
Average gross wages, real (CPI based)	5.9	-2.7	8.2	7.5	-8.4	-6.9	1.1	2.1	10.6
Average gross wages, EUR (ER)	34.7	13.6	11.0	19.4	-4.6	-7.5	3.6	3.5	17.0
Employed persons (LFS)	-1.4	-4.0	2.6	-0.9	-6.8	-4.7	2.2	1.4	1.4
GDP per empl. person, NC at 2000 prices	4.8	7.6	5.0	3.7	-8.7	3.3	-0.8	1.0	5.5
Unit labour costs, NC at 2000 prices	41.1	-8.6	5.8	15.1	4.5	-9.9	2.9	3.1	10.9
Unit labour costs, ER (EUR) adjusted	28.6	5.6	5.8	15.1	4.5	-9.9	2.9	3.1	10.9
<b>Poland</b>									
GDP deflator	36.8	7.2	2.6	3.0	3.6	2.3	2.8	2.4	2.8
Exchange rate (ER), EUR/NC	-14.0	5.5	12.5	7.7	-18.8	5.6	0.0	0.0	6.6
Real ER (CPI-based)	6.9	13.9	12.5	8.3	-16.4	6.3	0.8	0.5	6.5
Real ER (PPI-based)	3.7	9.4	8.5	3.9	-12.5	5.4	0.5	0.0	3.9
Average gross wages, NC	31.6	11.6	3.8	10.1	5.5	4.7	6.5	7.2	6.7
Average gross wages, real (PPI based)	4.9	3.5	3.3	7.5	1.5	3.7	4.4	5.1	4.9
Average gross wages, real (CPI based)	3.0	1.3	1.7	5.6	1.4	2.2	3.9	4.6	4.0
Average gross wages, EUR (ER)	13.2	17.7	16.8	18.6	-14.4	10.2	6.3	7.1	13.6
Employed persons (LFS)	0.9	-1.6	2.3	3.7	0.4	-0.9	0.5	2.0	3.5
GDP per empl. person, NC at 2000 prices	13.4	6.0	1.3	1.3	1.3	3.7	2.9	1.4	1.9
Unit labour costs, NC at 2000 prices	16.0	5.3	2.5	8.7	4.1	1.0	3.4	5.7	4.7
Unit labour costs, ER (EUR) adjusted	-0.2	11.1	15.4	17.1	-15.5	6.6	3.4	5.7	11.5
<b>Romania</b>									
GDP deflator	35.3	43.3	12.2	15.3	2.8	5.0	4.0	5.0	12.9
Exchange rate (ER), EUR/NC	-25.2	-18.2	11.9	-9.4	-13.1	0.9	2.4	2.5	2.4
Real ER (CPI-based)	-3.7	16.9	19.4	-5.7	-9.2	4.1	4.8	4.5	6.9
Real ER (PPI-based)	-2.8	23.3	16.1	-1.7	-8.2	4.8	5.0	5.5	8.0
Average gross wages, NC	49.3	47.8	18.3	26.1	7.2	2.8	5.2	5.9	21.1
Average gross wages, real (PPI based)	10.5	-5.7	9.4	9.4	5.3	-2.1	1.1	0.8	10.0
Average gross wages, real (CPI based)	12.9	1.5	8.4	16.9	1.5	-2.1	1.1	1.8	13.1
Average gross wages, EUR (ER)	11.7	20.9	32.3	14.2	-6.9	3.4	8.7	8.0	24.0
Employed persons (LFS)	.	-0.3	-0.5	0.2	-1.3	-1.0	0.0	0.5	0.6
GDP per empl. person, NC at 2000 prices	.	2.7	4.6	7.2	-5.9	-0.2	1.5	3.0	5.8
Unit labour costs, NC at 2000 prices	.	43.9	13.0	17.7	13.9	3.0	3.6	2.8	14.5
Unit labour costs, ER (EUR) adjusted	.	17.7	26.5	6.6	-1.1	4.0	6.1	5.4	17.2
<b>Slovakia</b>									
GDP deflator	9.9	9.4	2.4	2.9	-1.1	-1.0	2.0	3.0	2.3
Exchange rate (ER), EUR/NC	-1.4	3.6	3.7	8.0	3.8	0.0	0.0	0.0	6.4
Real ER (CPI-based)	5.5	13.8	4.3	8.3	3.7	-0.8	0.3	0.0	7.0
Real ER (PPI-based)	3.4	10.5	2.9	4.2	0.6	-3.1	0.5	0.0	3.8
Average gross wages, NC	14.3	6.5	9.2	8.1	3.0	2.1	3.9	5.1	8.3
Average gross wages, real (PPI based)	4.9	-4.0	5.6	5.5	10.3	4.2	1.9	3.0	6.3
Average gross wages, real (CPI based)	4.0	-4.9	6.2	4.0	2.0	1.1	1.9	3.0	4.9
Average gross wages, EUR (ER)	12.8	10.3	13.2	16.8	6.9	2.1	3.9	5.1	15.2
Employed persons (LFS)	1.7	-1.4	2.1	3.2	-2.8	-2.4	0.0	0.9	2.9
GDP per empl. person, NC at 2000 prices	4.0	2.8	4.5	2.9	-2.0	5.9	3.7	3.1	4.9
Unit labour costs, NC at 2000 prices	9.9	3.6	4.5	5.1	5.1	-3.6	0.2	1.9	3.2
Unit labour costs, ER (EUR) adjusted	8.4	7.3	8.3	13.5	9.0	-3.6	0.2	1.9	9.8
<b>Slovenia</b>									
GDP deflator	15.1	5.4	1.6	3.8	2.0	1.5	2.0	2.0	2.9
Exchange rate (ER), EUR/NC	-0.5	-5.6	-0.3	0.0	0.0	0.0	0.0	0.0	-0.1
Real ER (CPI-based)	9.9	0.9	0.0	1.8	-0.1	-0.3	0.3	0.0	0.9
Real ER (PPI-based)	7.9	-2.4	-2.5	-2.3	2.4	-2.1	0.5	0.0	-1.2
Average gross wages, NC	18.4	10.6	3.6	8.3	3.4	2.2	3.4	3.9	5.7
Average gross wages, real (PPI based)	4.9	3.0	1.7	4.3	4.9	3.2	1.4	1.9	2.5
Average gross wages, real (CPI based)	4.3	1.6	1.1	2.6	2.5	0.6	1.4	1.9	2.0
Average gross wages, EUR (ER)	17.8	4.5	3.3	8.3	3.4	2.2	3.4	3.9	5.6
Employed persons (LFS)	3.6	1.7	0.7	1.1	-1.5	-1.5	0.0	1.0	1.4
GDP per empl. person, NC at 2000 prices	0.5	2.6	3.8	2.3	-6.4	1.9	2.0	1.6	3.7
Unit labour costs, NC at 2000 prices	17.8	7.8	-0.2	5.8	10.5	0.2	1.4	2.3	1.9
Unit labour costs, ER (EUR) adjusted	17.3	1.8	-0.5	5.8	10.5	0.2	1.4	2.3	1.8

(Table A/3 ctd.)

Table A3 (ctd.)

	1995	2000	2005	2008	2009	2010	2011	2012	2005-08
					prelim.		forecast		average
<b>Croatia</b>									
GDP deflator	22.8	4.6	3.3	6.3	3.3	2.0	2.5	2.0	4.3
Exchange rate (ER), EUR/NC	4.9	-0.7	1.3	1.6	-1.6	0.5	0.0	0.0	0.9
Real ER (CPI-based)	4.1	3.5	2.4	4.0	-0.2	0.7	0.8	0.0	2.2
Real ER (PPI-based)	1.6	4.8	0.1	3.6	1.8	1.4	1.0	0.0	1.0
Average gross wages, NC	34.0	7.0	4.4	7.1	2.2	-1.6	4.1	4.1	6.0
Average gross wages, real (PPI based)	33.0	-2.5	1.4	-1.2	2.6	-3.5	1.6	2.0	1.5
Average gross wages, real (CPI based)	31.3	0.7	1.0	0.9	-0.2	-3.5	1.5	2.0	2.0
Average gross wages, EUR (ER)	40.5	6.3	5.7	8.7	0.6	-1.0	3.8	4.6	6.9
Employed persons (LFS)	.	4.1	0.7	1.3	-1.9	-2.2	0.0	1.3	1.2
GDP per empl. person, NC at 2000 prices	.	-1.0	3.5	1.1	-4.0	0.7	2.0	1.2	3.0
Unit labour costs, NC at 2000 prices	.	8.1	0.9	5.9	6.5	-2.2	2.0	2.8	2.9
Unit labour costs, ER (EUR) adjusted	.	7.4	2.2	7.6	4.8	-1.7	2.0	2.8	3.8
<b>Macedonia</b>									
GDP deflator	17.1	8.2	3.8	7.3	2.8	0.1	3.0	2.9	5.7
Exchange rate (ER), EUR/NC	3.9	-0.2	0.1	-0.1	-0.1	0.2	0.0	0.0	0.0
Real ER (CPI-based)	17.0	3.6	-1.6	4.3	-1.9	-1.6	1.3	1.0	0.9
Real ER (PPI-based)	4.6	6.3	-0.9	3.7	-3.0	-0.8	1.5	0.9	1.4
Average gross wages, NC 1)	10.7	9.0	2.7	8.7	9.0	-0.1	5.0	5.1	6.0
Average gross wages, real (PPI based)	5.7	-1.5	-0.5	-1.5	16.6	-0.1	1.9	2.1	0.2
Average gross wages, real (CPI based)	-4.4	3.1	2.2	0.3	9.9	-0.1	2.0	2.0	2.4
Average gross wages, EUR (ER)	15.0	8.8	2.8	8.5	9.1	0.4	4.1	5.9	6.0
Employed persons (LFS)	.	0.8	4.3	3.2	3.4	0.0	1.6	4.7	3.9
GDP per empl. person, NC at 2000 prices	.	3.6	-0.2	1.6	-4.0	1.0	0.4	-1.6	0.8
Unit labour costs, NC at 2000 prices	.	5.2	2.8	7.0	13.6	-1.0	4.6	6.8	5.2
Unit labour costs, ER (EUR) adjusted	.	5.0	2.9	6.8	13.5	-0.8	4.6	6.8	5.2
<b>Albania</b>									
GDP deflator	10.0	4.0	2.7	4.3	4.1	2.5	1.8	2.4	3.3
Exchange rate (ER), EUR/NC	-6.7	10.8	2.8	0.7	-7.0	-5.7	2.2	7.9	1.0
Real ER (CPI-based)	-2.2	8.8	3.0	0.4	-5.9	-4.6	2.5	7.9	1.1
Real ER (PPI-based)	.	13.5	3.5	0.9	-5.0	-7.6	1.7	8.9	0.6
Average gross wages, NC 1)	58.9	10.2	5.0	6.0	10.0	3.1	4.0	5.0	11.1
Average gross wages, real (PPI based)	.	3.5	0.1	-0.4	11.8	4.2	2.9	1.9	6.9
Average gross wages, real (CPI based)	47.5	10.2	2.6	2.6	7.6	0.1	1.9	2.9	8.1
Average gross wages, EUR (ER)	48.3	22.2	8.0	6.7	2.3	-0.6	4.2	12.0	12.2
Employed persons (LFS) 2)	4.2	-0.8	0.3	-7.9	0.6	-5.4	1.0	1.9	-1.5
GDP per empl. person, NC at 2000 prices	8.8	7.5	5.4	17.1	3.5	7.5	1.2	1.1	7.8
Unit labour costs, NC at 2000 prices	46.1	2.5	-0.3	-9.5	6.2	-4.1	2.7	3.8	3.0
Unit labour costs, ER (EUR) adjusted	36.4	13.6	2.5	-8.9	-1.2	-9.5	4.9	12.0	4.0
<b>Bosnia and Herzegovina</b>									
GDP deflator	.	4.1	4.4	7.4	0.2	0.6	1.1	1.0	6.0
Exchange rate (ER), EUR/NC	.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real ER (CPI-based)	.	2.9	0.8	3.7	-1.4	-1.3	-0.7	-1.0	1.9
Real ER (PPI-based)	.	.	.	.	.	.	.	.	.
Average gross wages, NC	.	7.2	6.5	16.6	8.2	-0.3	0.8	1.7	10.4
Average gross wages, real (PPI based)	.	.	.	.	.	.	.	.	.
Average gross wages, real (CPI based)	.	2.2	3.4	8.5	8.6	-0.8	-0.2	0.6	5.7
Average gross wages, EUR (ER)	.	7.2	6.5	16.6	8.2	-0.3	0.8	1.7	10.4
Employed persons (LFS) 3)	.	-0.8	0.5	4.8	-3.5	-4.6	0.0	0.0	2.8
GDP per empl. person, NC at 2000 prices	.	16.1	3.4	0.9	0.3	5.0	1.0	2.9	2.6
Unit labour costs, NC at 2000 prices	.	-7.7	3.0	15.6	7.9	-5.1	-0.2	-1.3	7.6
Unit labour costs, ER (EUR) adjusted	.	-7.7	3.0	15.6	7.9	-5.1	-0.2	-1.3	7.6
<b>Montenegro</b>									
GDP deflator	.	.	4.3	7.7	2.8	4.3	4.4	3.0	8.4
Real ER (CPI-based)	.	.	0.1	3.6	2.4	-0.8	1.3	1.0	1.6
Real ER (PPI-based)	.	.	-2.0	7.3	-0.2	3.1	2.8	1.0	2.5
Average gross wages, NC	.	.	7.8	22.5	5.6	1.1	4.6	4.4	19.1
Average gross wages, real (PPI based)	.	.	5.6	7.5	9.9	-3.1	0.2	1.4	11.3
Average gross wages, real (CPI based)	.	.	5.4	14.1	2.1	0.1	1.6	1.4	14.3
Employed persons (LFS)	.	.	-4.5	0.6	-2.4	0.7	2.3	0.0	4.0
GDP per empl. person, NC	.	.	13.9	14.4	-0.3	2.4	4.2	6.0	12.2
GDP per empl. person, NC at 2000 prices	.	.	9.1	6.2	-3.0	-2.4	0.0	2.9	3.5
Unit labour costs, NC at 2000 prices	.	.	-1.2	15.4	8.8	3.6	4.6	1.4	15.1
Unit labour costs, ER (EUR) adjusted	.	.	-1.2	15.4	8.8	3.6	4.6	1.4	15.1

1) In 2009 wiw estimate (including allowances for food and transport). - 2) Until 2007 registered employment data. - 3) Until 2006 registered employees.

(Table A/3 ctd.)

Table A3 (ctd.)

	1995	2000	2005	2008	2009 prelim.	2010	2011 forecast	2012	2005-08 average
<b>Serbia</b>									
GDP deflator	.	77.5	15.5	12.1	11.8	7.3	4.2	2.8	12.0
Exchange rate (ER), NC/EUR	.	-52.2	-12.5	-1.8	-13.3	-8.8	-6.4	-4.3	-2.9
Real ER (CPI-based)	.	-15.7	-0.4	5.8	-6.7	-5.1	-4.2	-2.5	5.7
Real ER (PPI-based)	.	-6.8	-4.1	3.8	-4.9	-3.3	-3.9	-3.6	3.7
Average gross wages, NC	.	90.7	24.1	17.9	-3.3	6.0	6.1	6.1	22.1
Average gross wages, real (PPI based)	.	-5.9	8.7	4.9	-8.5	-1.2	1.8	3.2	9.6
Average gross wages, real (CPI based)	.	6.2	6.8	5.5	-11.0	0.0	2.0	2.0	9.4
Average gross wages, EUR (ER)	.	-8.8	8.6	15.7	-16.2	-4.3	0.0	2.2	18.6
Employed persons (LFS)	.	-0.3	-6.7	6.3	-7.3	-4.1	0.0	0.0	-0.9
GDP per empl. person, NC at 2000 prices	.	5.6	13.2	-0.7	4.6	5.3	2.0	3.0	6.8
Unit labour costs, NC at 2000 prices	.	80.7	9.6	18.7	-7.6	0.7	4.0	3.0	14.3
Unit labour costs, ER (EUR) adjusted	.	-13.6	-4.1	16.5	-19.8	-8.2	-2.6	-1.5	11.0
<b>Russia</b>									
GDP deflator	143.9	37.7	19.2	18.0	2.3	7.1	7.0	5.7	16.8
Exchange rate (ER), NC/EUR	-55.8	0.8	1.6	-3.9	-17.5	13.2	-2.5	-2.4	-0.4
Real ER (CPI-based)	27.9	19.5	11.8	5.8	-8.6	18.4	2.6	2.3	8.1
Real ER (PPI-based)	43.0	42.1	17.6	9.8	-20.5	23.1	5.7	5.2	11.7
Average gross wages, NC	119.6	46.0	26.9	26.7	9.0	11.3	12.3	11.3	26.4
Average gross wages, real (PPI based)	-34.7	-0.4	5.2	4.4	17.5	1.2	2.1	1.2	8.0
Average gross wages, real (CPI based)	-26.2	20.9	12.8	11.1	-2.5	4.5	5.0	4.0	13.5
Average gross wages, EUR (ER)	-2.9	47.2	28.9	21.8	-10.0	26.9	9.3	8.5	25.9
Employed persons (LFS)	-1.2	3.4	1.3	0.6	-2.4	-0.4	0.0	-0.4	1.3
GDP per empl. person, NC at 2000 prices	-2.9	6.4	5.0	5.0	-5.7	4.4	4.2	4.9	5.5
Unit labour costs, NC at 2000 prices	126.1	37.2	20.9	20.7	15.6	6.6	7.8	6.1	19.8
Unit labour costs, ER (EUR) adjusted	0.0	38.3	22.8	16.0	-4.6	20.6	5.1	3.5	19.3
<b>Ukraine</b>									
GDP deflator	415.8	23.1	24.6	28.6	13.6	10.5	9.0	8.0	22.6
Exchange rate (ER), NC/EUR	-80.0	-12.6	3.5	-10.3	-29.1	8.7	-4.8	5.0	-3.8
Real ER (CPI-based)	-7.4	9.9	14.9	8.4	-18.6	18.0	2.1	11.2	7.9
Real ER (PPI-based)	13.0	1.5	15.9	14.4	-21.6	18.8	2.3	11.2	10.6
Average gross wages, NC	430.7	29.6	36.7	33.7	5.5	12.8	13.5	14.3	32.3
Average gross wages, real (PPI based)	-9.9	7.3	17.2	-1.3	-0.9	2.1	4.1	5.9	10.3
Average gross wages, real (CPI based)	11.3	1.1	20.5	6.8	-8.9	2.1	4.1	5.9	15.0
Average gross wages, EUR (ER)	6.0	13.3	41.4	20.0	-25.1	25.4	4.5	21.7	27.3
Employed persons (LFS)	.	0.6	1.9	0.3	-3.7	0.0	0.2	0.2	0.8
GDP per empl. person, NC at 2000 prices	.	5.2	0.8	2.0	-11.8	3.4	4.7	6.0	4.2
Unit labour costs, NC at 2000 prices	.	23.2	35.7	31.1	19.7	9.1	8.4	7.9	27.0
Unit labour costs, ER (EUR) adjusted	.	7.6	40.3	17.7	-15.1	18.6	3.2	13.2	22.2
<b>Austria</b>									
GDP deflator	2.0	1.1	2.1	2.0	1.8	0.7	0.6	1.4	2.0
Real ER (CPI-based)	3.0	0.5	0.1	-0.4	-0.5	-0.4	0.1	-0.3	-0.3
Real ER (PPI-based)	0.0	0.0	-2.0	0.1	-3.9	-0.4	-0.2	-0.6	-0.4
Average gross wages, NC	3.0	2.6	2.3	3.2	2.3	1.3	1.7	2.3	3.1
Average gross wages, real (PPI based)	2.7	-1.3	0.2	-3.0	10.5	0.6	0.4	0.9	-0.7
Average gross wages, real (CPI based)	0.8	0.2	0.0	0.0	1.8	-0.1	-0.1	0.6	0.8
Employed persons (LFS)	0.4	0.4	2.1	1.5	-0.3	-0.2	0.2	0.5	2.2
GDP per empl. person, NC at 2000 prices	2.1	3.2	0.3	0.5	-3.2	1.5	1.2	1.5	0.6
Unit labour costs, NC at 2000 prices	0.9	-0.6	2.0	2.7	5.6	-0.2	0.5	0.8	2.5
Unit labour costs, ER (EUR) adjusted	4.6	-0.6	2.0	2.7	5.6	-0.2	0.5	0.8	2.5

NC = national currency (including euro-fixed series for euro area countries - SK, SI, AT). ER = Exchange Rate, PPI = Producer price index, CPI = Consumer price index. Positive growth of real exchange rates means real appreciation.

Sources: wiiw Database incorporating national and Eurostat statistics, wiiw estimates. Forecasts by wiiw.



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