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Research Report

High Growth Continues, with Risks of Overheating on the Horizon

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special issue on economic prospects for
Central, East and Southeast Europe

Vladimir Gligorov, Sándor Richter et al.

High Growth Continues, with Risks of Overheating on the Horizon

*Vladimir Gligorov,
Sándor Richter et al.*

**High Growth
Continues, with
Risks of Overheating
on the Horizon**

Please note:

Starting with the next issue, the wiiw Research Reports series **Special issue on economic prospects for Central, East and Southeast Europe** will be renamed **wiiw Current Analysis and Forecast**.

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Summary

The 1st of May 2007 marked the third anniversary of the accession of the new member states (NMS) to the European Union: the economic balance of the first three years is a clear success for the whole EU. Over the period 2001-2003 GDP in the NMS had increased by 3.1% per year on average; over the period 2004-2006, however, it expanded by 5.3% per year – an increase of the annual growth rate by 2.2 percentage points. In part, this growth acceleration is attributable to the more favourable international environment and the distinctly better growth performance in the 'old' EU; nevertheless the NMS substantially increased their lead in terms of growth over the EU-15: up from 1.7 p.p. in 2001-2003 to 3.1 p.p. in 2004-2006. The catching-up process to the level of development of the 'old' EU has thus accelerated. The aggregate figures for the group show that in 2001-2003 the NMS reduced the gap in per capita GDP in relation to the EU average by 2.7 p.p., and the pace of catching up was nearly a third faster, 3.8 p.p., in the post-accession period. In the field of investments the difference between the pre- and post-accession period was even more spectacular: while in 2001-2003 both the EU-15 and the NMS recorded an only marginal expansion, in 2004-2006 investment growth in the NMS was 4.7 p.p. higher than in the 'old' EU member states. The NMS also became more attractive targets for FDI. And their export growth rates nearly doubled after EU accession: import growth lagged behind export growth, yielding better trade balances. The stronger economic growth reduced unemployment: the aggregate unemployment rate in the NMS declined by 1.7 p.p. in the post-accession period. However, three macroeconomic stability indicators – inflation, current account status and fiscal balance – reveal a more differentiated and less favourable picture than those measuring changes in the real economy.

Given the expected continuation of the favourable international environment, the period of high growth in the NMS will continue in 2007 and 2008, except for Hungary. Nevertheless, in all but two countries (the Czech Republic and Hungary) growth rates in 2008 will be somewhat lower than, or only as high as, in 2007, thus hinting at constraints on further growth acceleration. Household consumption remains the engine of growth in the Czech Republic, Poland, Bulgaria and Romania, as well as in the Baltic States. Investments will boom in Poland, Slovenia, Bulgaria, Romania and the Baltic States. Supply-side constraints on a very rapid expansion of the economy will be felt in more and more countries of the region, especially in terms of the tight labour market. There are clear signs of overheating in Bulgaria, Romania and the Baltic States where the external balance has been deteriorating and no turnaround is in sight. Only in Slovakia does very high growth seem to be sustainable at least over the next two years. Inflation will remain relatively low. This is the outcome of the contradicting effect of inflationary pressures from an increasingly tight labour market and its consequences, and the considerable appreciation of the national currencies. High export growth will reflect the favourable international environment and the growing import demand of the region's main trading partner countries, as well as the continuing competitiveness of the NMS.

Economic developments in the future member states (FMS) of the EU – the candidate and potential candidate countries of the Balkans – continue to surprise positively. All countries report respectable growth rates of their GDPs, and the growth looks sustainable. Industrial production, a weak sector traditionally, grows faster than GDP, except in Montenegro. Tourism – an important sector in the Balkans – is attracting investments, private as well as public. In general, investments are proving to be an important driver of growth, though consumption is still the dominant contributor. In addition, exports are growing rather fast though so are imports too. These positive

developments are supported by the belief in the political and policy stability in these countries. Though external and internal imbalances, i.e. in the labor markets, are still quite large, price stability does not seem threatened. Even in countries such as Turkey or Serbia, where exchange rates and prices are more volatile, the risks of serious crisis are rather low. In addition to macroeconomic stability, the underlying political stability seems to have improved as well. Though no breakthrough has been achieved in the longstanding political problems, progress in democratization is bringing the security and political risks down.

Though economies are doing better in the FMS, public and corporate governance as well as structural reforms are not necessarily contributing decisively to that. The most commonly used indices of progress in reforms, business climate and public governance, do not give a consistent picture and certainly do not unequivocally report improvement. The prospects of EU integration have improved during the German presidency and will add to the positive outlook. Growth should stay between 5% and 6%, investments and exports should grow even faster and macroeconomic stability should be sustained in the medium run.

Russia's economic growth accelerated in 2007, driven by booming consumption and investments (including FDI). More expenditures on state-sponsored priority programmes and industrial policy measures focusing on public-private partnership projects should foster restructuring and innovations. The wiiw forecast reckons with ongoing reliance on energy revenues and an average annual GDP growth of 5.3% in the coming years. With more money and power consolidation at home, Russian self-confidence will grow further – and this may lead to more conflicts with the West.

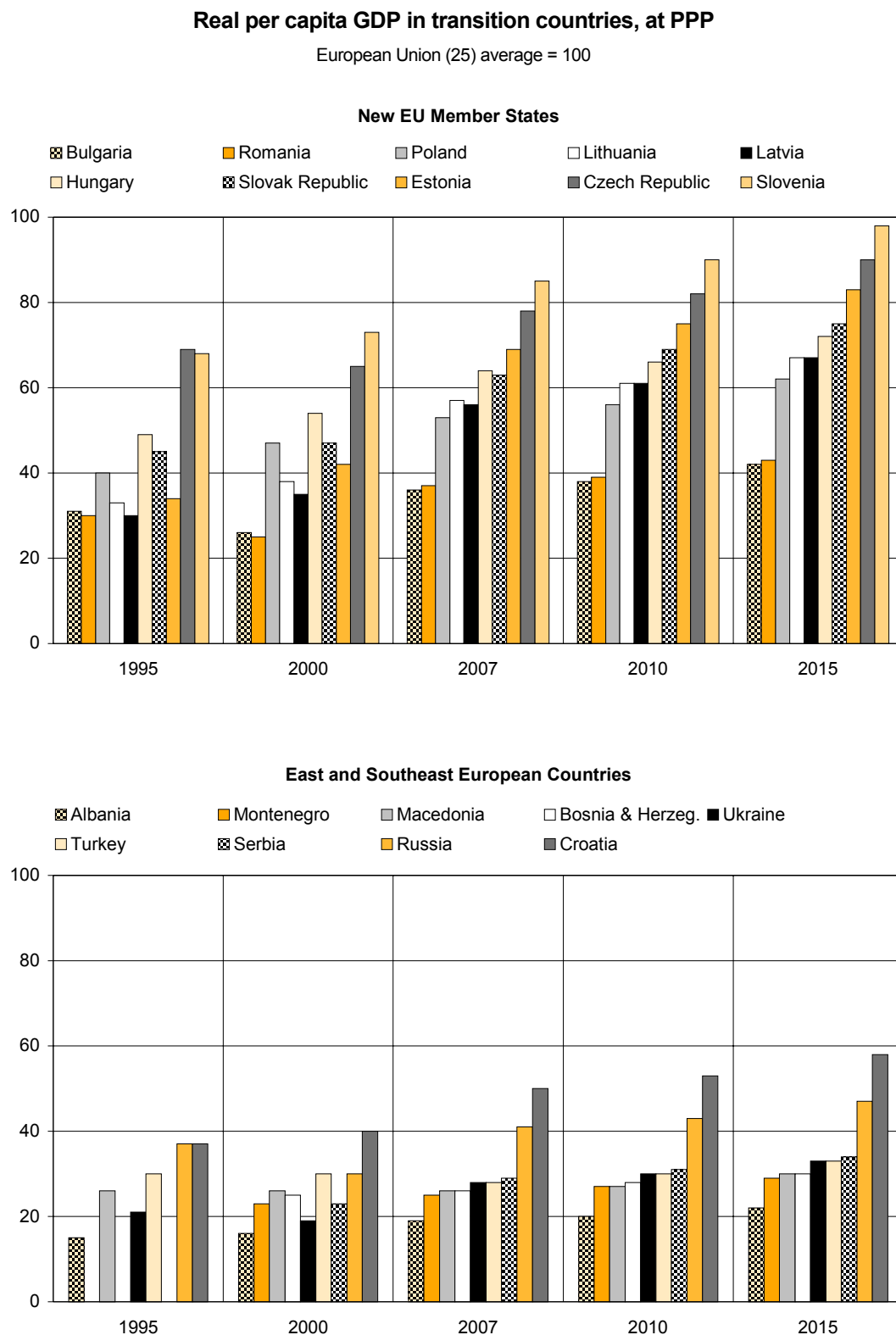
In Ukraine, strong consumer demand, vigorous investment activity and solid exports have all contributed to impressive GDP growth of 7.9% in January-May 2007. Rising consumption and housing construction are increasingly driven by expanding consumer credit, not least due to the growing presence of foreign banks. However, we expect economic growth for the year as a whole to be somewhat lower, between 6.5% and 7%. Imports growing faster than exports will translate into a rising current account deficit, possibly up to 4% of GDP in 2007 and even higher next year. The prospects for greater political stability in the country remain bleak.

GDP grew by 11.1% in China in the first quarter of 2007, faster than expected by most experts. Obviously, the official efforts to contain growth have so far not been successful. The economy was driven by a rebound of investment and by a ballooning trade surplus, but supported by a certain acceleration of consumer demand as well. Recent data point to a continuation of the rapid expansion, which may result in a growth rate for the whole year between 10.5% and 11%.

Keywords: *Central and East European new EU member states, Southeast Europe, Balkans, former Soviet Union, China, Turkey, GDP, industry, productivity, labour market, foreign trade, exchange rates, inflation, fiscal deficits, EU integration*

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

Figure I



Remark: Projection assuming a 3 percentage points growth differential with respect to the EU-15 after 2007

Source: National statistics, Eurostat, wiw estimates.

Table I

Overview developments 2005-2006 and outlook 2007-2008

	GDP				Consumer prices				Unemployment, based on LFS ¹⁾				Current account			
	real change in % against previous year				change in % against previous year				rate in %, annual average				in % of GDP			
	2005	2006	2007 forecast	2008 forecast	2005	2006	2007 forecast	2008 forecast	2005	2006	2007 forecast	2008 forecast	2005	2006	2007 forecast	2008 forecast
Czech Republic	6.5	6.4	5	5.2	1.9	2.5	3	2.8	7.9	7.1	6.3	6	-1.6	-3.1	-4.3	-4.4
Hungary	4.1	3.9	2.7	3.1	3.6	3.9	7.0	3.5	7.2	7.5	7.7	7.7	-6.9	-5.8	-4.6	-3.8
Poland	3.6	6.1	6	5.5	2.1	1.0	2.3	2.5	17.8	13.9	11	10	-1.7	-2.3	-3.0	-3.5
Slovak Republic	6.0	8.3	8.5	8	2.7	4.5	3	2	16.2	13.3	11	10	-8.6	-8.3	-4.7	-4.1
Slovenia	4.0	5.2	5	5	2.5	2.5	2.6	2.3	6.6	6.0	5.8	5.5	-2.0	-2.5	-2.2	-1.5
NMS-5 ²⁾³⁾	4.5	5.9	5.4	5.2	2.4	2.1	3.3	2.7	14.1	11.5	9.7	9	-3.1	-3.5	-3.6	-3.7
Bulgaria	6.2	6.1	6	6	5.0	7.3	5	5	10.1	9.0	7.5	7	-12.0	-15.8	-16.5	-15.0
Romania	4.1	7.7	6.0	5.5	9.0	6.6	4.0	4.5	7.1	7.2	7	7	-8.7	-10.3	-13.0	-11.6
Estonia	10.5	11.4	9.5	8.4	4.1	4.4	5.5	5	7.9	5.9	5	4.5	-10.5	-14.8	-13.8	-11.5
Latvia	10.6	11.9	8.9	8	6.7	6.8	7.5	7	8.7	6.8	6	5.5	-12.6	-21.1	-19.5	-19.0
Lithuania	7.6	7.5	7	6.5	2.7	3.8	5	5	8.3	5.6	4.5	4	-7.2	-10.8	-11.1	-10.4
NMS-10 ²⁾³⁾	4.8	6.5	5.7	5.5	3.6	3.2	3.7	3.3	9.7	10.0	8.7	8.1	-4.6	-5.7	-6.2	-6.0
EU-15 ³⁾	1.6	2.8	2.7	2.5	2.1	2.2	.	.	7.9	7.4	6.9	6.5	0.01	-0.15	.	.
EU-25 ²⁾³⁾	1.9	3.1	3.0	2.8	2.1	2.2	2.0	1.9	8.8	8.0	.	.	-0.18	-0.40	.	.
EU-27 ²⁾³⁾	1.9	3.2	3.0	2.8	2.3	2.3	2.0	2.0	8.7	7.9	7.2	6.7	-0.27	-0.51	.	.
Croatia	4.3	4.8	5	5	3.3	3.2	2.8	2.3	12.7	11.1	10.8	10.3	-6.3	-7.6	-7.7	-7.1
Macedonia	3.8	3.1	4	4	0.5	3.2	3	3	37.3	36.0	35	35	-1.4	-0.4	-1.9	-1.8
Turkey	7.4	6.1	5.5	6.5	8.2	9.6	7.5	5	10.3	9.9	9.5	9	-6.4	-7.9	-6.9	-6.3
Albania ⁴⁾	5.6	4.9	5	5.5	2.4	2.4	2.5	3	14.2	13.9	14	13.5	-7.4	-7.6	-8.5	-6.6
Bosnia and Herzegovina ⁴⁾⁵⁾	5.5	6.2	6	6	3.0	7.2	3.7	2	44.2	31.1	30	30	-21.3	-11.4	-10.9	-9.2
Montenegro	4.0	6.5	5	5	2.3	3.0	3	3	30.3	30.0	30	30	-8.9	-29.4	-15.2	-15.2
Serbia	6.2	5.7	5	5	16.2	11.6	8	6	20.8	20.9	22	23	-8.5	-11.4	-12.5	-11.5
Russia	6.4	6.7	6.9	5.2	12.5	9.8	8	7	7.2	7.2	7	6.5	11.0	9.6	6.6	5.3
Ukraine	2.6	7.1	6.5	6	13.5	9.1	10	9	7.2	6.8	6.5	6.4	3.1	-1.5	-3.8	-4.9
China	10.4	10.7	10.5	10	1.8	1.5	2.8	2	.	.	.	.	7.2	9.5	8.5	6.6

Note: NMS: The New EU Member States.

1) LFS - Labour Force Survey. - 2) wiiw estimate. - 3) Current account data include flows within the region. - 4) Unemployment rate by registration, end of period. - 5) From 2006 data based on first LFS April 2006.

Source: wiiw (June 2007); Eurostat; forecasts for EU-15 and the Baltic States: European Commission (Spring 2007); wiiw.

Table III

Central and East European new EU member states (NMS-10): an overview of economic fundamentals, 2006

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovak Republic	Slovenia	NMS-10 ¹⁾	EU-15	EU-27 ²⁾
GDP in EUR at exchange rates, EUR bn	25.10	113.62	13.07	89.88	16.03	23.75	271.59	97.15	43.93	29.7	723.85	10796.26	11539.74
GDP in EUR at PPP, EUR bn	67.31	195.99	21.90	161.49	30.53	46.62	492.89	194.26	81.27	42.04	1334.31	10548.10	11907.03
GDP in EUR at PPP, EU-25=100	0.6	1.7	0.2	1.4	0.3	0.4	4.2	1.7	0.7	0.4	11.5	90.6	102.2
GDP in EUR at PPP, per capita	8740	19090	16300	16040	13340	13740	12930	9000	15080	20930	13059	27021	24117
GDP in EUR at PPP per capita, EU-25=100	35	76	65	64	53	55	52	36	60	83	52	108	96
GDP at constant prices, 1990=100	111.2	131.5	155.0	138.6	116.4	113.7	158.4	119.6 ³⁾	138.7	150.0	142.8	138.3	139.2
GDP at constant prices, 2000=100	137.3	128.2	170.2	128.4	165.9	156.1	123.4	142.2	135.5	124.6	130.9	111.3	113.2
Industrial production real, 1990=100	85.4	119.5	110.1	216.8	70.6	68.2	185.6	82.2 ³⁾	133.5	110.4	148.8	.	127.3
Industrial production real, 2000=100	161.1	147.2	168.7	143.2	150.4	176.8	143.2	134.0	143.4	123.2	143.7	.	109.5
Population - thousands, average	7699	10267	1343	10064	2289	3394	38132	21584	5390	2009	102171	390196	493499
Employed persons - LFS, thousands, average	3110	4828	646	3930	1087	1499	14594	9313	2301	961	42270	171010	213768
Unemployment rate - LFS, in %	9.0	7.1	5.9	7.5	6.8	5.6	13.9	7.2	13.3	6.0	10.0	7.9	8.7
General gov. expenditures, EU-def., in % of GDP	37.2	42.5	33.2	52.5	37.0	33.6	43.6	32.9	37.3	46.3	41.8	47.4	47.2
General gov. revenues, EU-def., in % of GDP	40.8	39.5	37.0	43.4	37.4	33.3	39.6	31.2	33.9	44.8	38.4	45.1	44.8
Price level, EU-25=100 (PPP/exch. rate)	37	58	60	56	52	51	55	50	54	71	54	102	97
Compensation per employee ⁴⁾ , monthly, in EUR	317	970	853	1012	544	654	758	673	721	1664	751	3211	2755
Compensation per employee, monthly, EU-27=100	11.5	35.2	30.9	36.7	19.8	23.7	27.5	24.4	26.2	60.4	27.3	116.6	100.0
Exports of goods in % of GDP	47.7	66.6	58.6	65.0	30.0	47.3	34.3	26.6	75.7	57.3	46.9 ⁵⁾	29.6 ⁵⁾	30.6 ⁵⁾
Imports of goods in % of GDP	69.2	64.5	75.2	65.5	54.5	61.3	35.8	38.7	81.3	61.0	51.3 ⁵⁾	29.9 ⁵⁾	31.3 ⁵⁾
Exports of services in % of GDP	15.9	9.3	21.2	11.9	13.2	12.1	6.0	5.7	9.8	11.9	8.7 ⁵⁾	8.9 ⁵⁾	8.9 ⁵⁾
Imports of services in % of GDP	13.0	8.3	14.9	10.7	9.8	8.5	5.4	5.7	8.6	8.9	7.5 ⁵⁾	8.0 ⁵⁾	8.0 ⁵⁾
Current account in % of GDP	-15.8	-3.1	-14.8	-5.8	-21.1	-10.8	-2.3	-10.3	-8.3	-2.5	-5.7 ⁵⁾	-0.2 ⁵⁾	-0.5 ⁵⁾
FDI stock per capita in EUR	2047	5719	9232	6170	2515	2462	2361	1432	3338	3133	3019	.	.

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

1) wiiw estimates. - 2) wiiw estimates, except: employed persons, budget and compensation per employee. - 3) 1989=100, which in the Polish case is the appropriate reference year. - 4) Gross wages plus indirect labour costs, whole economy, national account concept. - 5) Data include flows within the region.

Source: wiiw, AMECO, Eurostat.

Table III

Southeast Europe: an overview of economic fundamentals, 2006

	Croatia	Macedonia	Turkey	Albania	Bosnia and Herzegovina	Montenegro	Serbia	NMS-10 ¹⁾	EU-15	EU-27 ²⁾
GDP in EUR at exchange rates, EUR bn	34.22	4.96	318.59	7.31	9.18	1.93	25.46	723.85	10796.26	11539.74
GDP in EUR at PPP, EUR bn	55.06	13.28	504.07	14.71	20.89	3.86	53.63	1334.31	10548.10	11907.03
GDP in EUR at PPP, EU-25=100	0.5	0.1	4.3	0.1	0.2	0.03	0.5	11.5	90.6	102.2
GDP in EUR at PPP, per capita	12400	6510	6910	4670	6330	6180	7210	13059	27021	24117
GDP in EUR at PPP per capita, EU-25=100	49	26	28	19	25	25	29	52	108	96
GDP at constant prices, 1990=100	113.4	100.6	186.1	154.4	461.1 ³⁾	.	.	142.8	138.3	139.2
GDP at constant prices, 2000=100	132.4	110.3	131.0	139.0	134.9	119.9	136.4	130.9	111.3	113.2
Industrial production real, 1990=100	85.0	54.6	204.2	54.5	.	.	.	148.8	.	127.3
Industrial production real, 2000=100	132.5	103.3	133.2	152.4	161.4	115.4	111.7	143.7	.	109.5
Population - thousands, average	4442	2040	72974	3150	3843	625	7440	102171	390196	493499
Employed persons - LFS, thousands, average	1586	570	22330	932 ⁴⁾	811 ⁵⁾	180	2631	42270	171010	213768
Unemployment rate - LFS, in %	11.1	36.0	9.9	13.9 ⁴⁾	31.1 ⁵⁾	30.0	20.9	10.0	7.9	8.7
General gov. expenditures, nat. def., in % of GDP	49.0 ⁶⁾	34.9	26.7 ^{6/7)}	28.3	41.5 ⁶⁾	27.6	42.6 ⁶⁾	41.8 ⁷⁾	47.4 ⁷⁾	47.2 ⁷⁾
General gov. revenues, nat. def., in % of GDP	44.9 ⁶⁾	34.3	27.1 ^{6/7)}	25.1	44.1 ⁶⁾	29.4	41.2 ⁶⁾	38.4 ⁷⁾	45.1 ⁷⁾	44.8 ⁷⁾
Price level, EU-25=100 (PPP/exch. rate)	62	37	63	50	44	50	47	54	102	97
Average gross monthly wages, EUR at exchange rate	906	376	651 ⁸⁾	227 ⁹⁾	444	377	378 ¹⁰⁾	751 ⁸⁾	3211 ⁸⁾	2755 ⁸⁾
Average gross monthly wages, EUR at PPP	1458	1009	1030 ⁸⁾	456 ⁹⁾	1011	754	796 ¹⁰⁾	27.3 ⁸⁾	116.6 ⁸⁾	100.0 ⁸⁾
Exports of goods in % of GDP	24.6	38.5	22.7	8.6	29.3	26.6	20.3	46.9 ¹¹⁾	29.6 ¹¹⁾	30.6 ¹¹⁾
Imports of goods in % of GDP	49.1	59.2	32.9	31.7	66.4	73.5	39.7	51.3 ¹¹⁾	29.9 ¹¹⁾	31.3 ¹¹⁾
Exports of services in % of GDP	24.9	9.7	6.0	16.3	9.7	22.4	6.6	8.7 ¹¹⁾	8.9 ¹¹⁾	8.9 ¹¹⁾
Imports of services in % of GDP	8.2	9.3	2.8	17.2	4.4	11.2	6.8	7.5 ¹¹⁾	8.0 ¹¹⁾	8.0 ¹¹⁾
Current account in % of GDP	-7.6	-0.4	-7.9	-7.6	-11.4	-29.4	-11.4	-5.7 ¹¹⁾	-0.2 ¹¹⁾	-0.5 ¹¹⁾
FDI stock per capita in EUR	4577	1028	822	575	676	1943	1119	3019	.	.

Note: NMS-10: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia. PPP: Purchasing power parity - wiiw estimates for Albania, Bosnia and Herzegovina, Montenegro, Serbia.

1) wiiw estimates. - 2) wiiw estimates, except: employed persons, budget and compensation per employee. - 3) 1995=100. - 4) Employment and unemployment by registration, end of year. - 5)

Figures based on the first LFS April 2006. - 6) Year 2005; for Serbia year 2004. - 7) EU definition: expenditures and revenues according to ESA'95, excessive deficit procedure. - 8) Gross wages plus indirect labour costs, whole economy, national account concept. - 9) Public sector. - 10) Including various allowances. - 11) Data include flows within the region.

Source: wiiw, AMECO, Eurostat.

Part A: The new EU member states

*Sándor Richter**

The first three years in the EU – a clear economic success

Membership in the EU – a preliminary balance

1 May 2007 marked the third anniversary of the accession of ten new member states (NMS) to the European Union (EU): five central European, three Baltic and two Mediterranean countries. In this section stock is taken of the new member states' first three years in the EU by comparing various macro-economic indicators in the three years prior to accession in 2004 and the three years thereafter.¹

Table 1

GDP growth rates			
in %			
	average 2001-2003		average 2004-2006
A EU-15	1.4		2.2
B NMS- 8	3.1		5.3
<i>Austria</i>	0.9		2.5
B-A (percentage points)	1.7		3.1
Estonia	8.6	Latvia	10.4
Lithuania	7.9	Estonia	10.0
Latvia	7.2	Lithuania	7.5
Hungary	4.2	Slovakia	6.6
Slovakia	3.8	Czech R.	5.5
Slovenia	2.9	Poland	4.9
Czech R.	2.7	Slovenia	4.6
Poland	2.1	Hungary	4.3

Source: wiiw Database incorporating national statistics, Eurostat.

In terms of *economic growth*, the post-accession period was a clear success. Over the period 2001-2003 GDP in the NMS-8 increased by 3.1% on average; however, over the period 2004-2006 it rose by 5.3%: an increase of 2.2 percentage points (p.p.) (see Table 1). In part, this is attributable to the distinctly better growth performance in the 'old' EU in the second period compared to the first; nevertheless the NMS-8 substantially increased its lead in terms of growth over the EU-15: up from 1.7 p.p. in 2001-2003 to 3.1 p.p. in 2004-2006. This improvement in growth performance

* V. Astrov, V. Gligorov, P. Havlik, G. Hunya, M. Landesmann, K. Laski, J. Pöschl and L. Podkaminer as well as the authors of the country reports provided valuable comments on this overview.

¹ The comparison was made for the NMS-8 (5 Central European and 3 Baltic countries). With regard to data availability, the years 2001-2003 were taken as the three-year period prior to accession, and the years 2004-2006 as the three-year period after accession, even though strictly speaking the first four months of 2004 belong to the pre-accession period.

encompassed all but one member of the group.² Both the best and worst NMS performers achieved higher average growth rates in 2004-2006 than in 2001-2003 (Latvia 10.4% vs. Estonia 8.6%, and Hungary 4.3% vs. Poland 2.1%)

In the field of investments (gross fixed capital formation) the difference between the pre- and post-accession period is even more spectacular (Table 2). In 2001-2003 both the EU-15 and the NMS-8 recorded only marginal expansion of investments whereas in 2004-2006 the performance improved in both the EU-15 and the NMS-8. That notwithstanding, investment growth in the NMS-8 was 4.7 p.p. greater than in the 'old' member states. As with GDP growth, both the best and worst performers among the NMS achieved substantially higher average growth rates in 2004-2006 than in 2001-2003. Only Lithuania recorded a marginally lower growth rate in the second period.

Table 2

Investment growth rates (gross fixed capital formation)			
in %			
	average 2001-2003		average 2004-2006
A EU-15	0.3		3.6
B NMS-8	0.3		8.3
B-A (in percentage points)	0.0		4.7
Estonia	15.0	Latvia	21.9
Lithuania	12.8	Estonia	15.3
Latvia	12.3	Lithuania	12.2
Hungary	5.7	Slovakia	9.8
Czech R.	4.0	Poland	9.8
Slovakia	3.4	Slovenia	7.0
Slovenia	2.7	Czech R.	4.4
Poland	-5.5	Hungary	3.8

Source: wiiw Database incorporating national statistics, Eurostat.

The NMS became more attractive targets for FDI in the post-accession period (Table 3). In current euro prices, close to € 25 billion more was invested in the NMS 8 in the three years after accession than in the three years before. Assuming an annual 2 % euro inflation, foreign capital investment increased, in constant prices, by about 36% after accession. The majority of FDI projects in the NMS originated in 'old' EU.

Export growth rates nearly doubled after accession to the EU, thus indicating the accelerated rate at which the NMS-8 opened up to the world economy (Table 4). Nevertheless, a very similar rate of acceleration was recorded for EU-15 exports over both periods. The difference between the (lower) EU-15 and the (higher) NMS-8 export growth rates remained practically unchanged before and after accession. This hints at the important role that external factors played in 'enhancing' NMS-8 export sales data. In both periods, NMS-8 import growth lagged behind export growth, thus yielding better trade balances.

² Lithuania's average growth performance was 0.4 p.p. weaker in the post-accession period.

Table 3

FDI inflows			
EUR billion			
	cumulated 2001-2003		cumulated 2004-2006
A EU-15	1,331.7		1,285.8
B NMS-8	55.8		80.4
Czech R.	17.2	Poland	29.1
Poland	14.8	Czech R.	18.1
Hungary	9.5	Hungary	14.6
Slovakia	8.1	Slovakia	7.5
Slovenia	2.4	Estonia	4.4
Estonia	1.7	Lithuania	2.9
Lithuania	1.4	Latvia	2.4
Latvia	0.7	Slovenia	1.4

Note: 2006 estimate

Source: wiiw FDI Database incorporating national statistics, Eurostat.

The growth of NMS household consumption, the largest component in GDP, also accelerated in the post-accession period, yet less than that of investments or exports (Table 5). This means that during the first three years of association, the sources of economic growth underwent a shift to the detriment of consumption.

Table 4

Exports of goods, growth rates ¹⁾			
in %			
	average 2001-2003		average 2004-2006
A EU-15 exports to the world	0.7		8.9
B NMS-8 exports to the world	10.0		18.7
B – A (in percentage points)	9.3		9.8
<i>memo:</i>			
<i>D EU-15 imports from the world</i>	-0.6		11.0
<i>C NMS-8 imports from the world</i>	6.9		17.6
<i>C - D (in percentage points)</i>	7.5		6.6
Exports to the world by individual NMS			
Lithuania	15.5	Estonia	23.6
Slovakia	14.6	Czech R.	20.7
Poland	11.3	Slovakia	19.9
Czech Republic	11.0	Latvia	19.9
Latvia	7.7	Poland	19.5
Hungary	6.6	Lithuania	18.4
Slovenia	6.3	Hungary	15.5
Estonia	4.0	Slovenia	14.3

Note: 1) Export in current euro prices. Data for EU-15 and NMS-8 add up total foreign trade (to/from the world) of goods by individual Member States.

Source: Eurostat Database (balance of payments statistics).

Table 5

Consumption of households, growth rates

in %

	average 2001-2003		average 2004-2006
A EU-15	1.7		1.8
B NMS-8	4.0		4.4
B-A (In percentage points)	2.4		2.6
Hungary	8.4	Lithuania	13.3
Estonia	8.1	Latvia	11.8
Latvia	7.6	Estonia	10.2
Lithuania	6.6	Slovakia	5.8
Slovakia	3.5	Poland	3.9
Czech R.	3.5	Czech R.	3.3
Poland	2.6	Slovenia	3.2
Slovenia	2.3	Hungary	2.7

Source: wiiw Database incorporating national statistics, Eurostat.

Stronger economic growth reduced unemployment in the NMS 8 in the first three post-accession years (Table 6). The change is less spectacular than in the fields of GDP, investment and export growth, yet it is nonetheless appreciable. The aggregate unemployment rate in the NMS-8 declined by 1.7 p.p in the post-accession period. On average it still remained twice as high as in the EU-15, but the gap closed by two p.p. compared to the pre-accession period. Taking the NMS individually, the picture becomes much more mixed than in the case of other macro-economic indicators. Whereas five NMS managed to reduce their unemployment rates to a considerable extent, Hungary and the Czech Republic (two countries with traditionally low unemployment rates) recorded higher unemployment after accession than in the three years before.

Table 6

Unemployment rates

LFS, in %

	average 2001-2003		average 2004-2006
A EU-15	7.5		7.8
B NMS-8	14.7		13.0
B-A (in percentage points)	7.2		5.2
Hungary	5.8	Slovenia	6.3
Slovenia	6.5	Hungary	6.9
Czech R.	7.7	Czech R.	7.8
Estonia	11.0	Estonia	7.8
Latvia	11.9	Lithuania	8.4
Lithuania	14.5	Latvia	8.6
Slovakia	18.4	Slovakia	15.9
Poland	19.2	Poland	16.9

Source: wiiw Database incorporating national statistics, Eurostat.

Table 7

Inflation			
Changes in consumer prices, in %			
	average 2001-2003		average 2004-2006
A EU-15	2.1		2.1
B NMS-8	3.4		3.0
B-A (in percentage points)	1.3		0.9
Lithuania	0.1	Poland	2.2
Czech R.	2.2	Czech R.	2.4
Latvia	2.4	Lithuania	2.6
Poland	2.7	Slovenia	2.9
Estonia	3.6	Estonia	3.8
Slovakia	6.3	Hungary	4.8
Hungary	6.4	Slovakia	4.9
Slovenia	7.2	Latvia	6.6

Source: wiiw Database incorporating national statistics, Eurostat.

Three macro-economic stability indicators – inflation, current account status and fiscal balance – reveal a more differentiated picture than those measuring changes in the real economy (see Table 10 for summary).

Table 8

Current account position			
in % of GDP			
	average 2001-2003		average 2004-2006
A EU-15	0.2		0.2
B NMS-8	-4.3		-4.8
B-A (in percentage points)	-4.5		-5.0
Slovenia	0.1	Slovenia	-2.4
Poland	-2.5	Poland	-2.7
Lithuania	-5.6	Czech R.	-4.2
Czech R.	-5.7	Hungary	-7.0
Hungary	-7.0	Slovakia	-8.3
Slovakia	-7.3	Lithuania	-8.7
Latvia	-7.5	Estonia	-12.8
Estonia	-9.4	Latvia	-16.1

Source: wiiw Database incorporating national statistics, Eurostat.

Half of the 8 NMS recorded an increase in consumer price inflation after accession (Table 7). In the case of the Czech Republic and Estonia, however, deterioration is marginal and the level of inflation has remained low in both countries. The deterioration is considerable in the case of the other two Baltic States; in Lithuania, however, even after post-accession deterioration, inflation is well below 3%. The higher level of inflation in the Baltic States must be seen in the context of their very rapid (and in the wake of EU accession accelerated) economic growth. In the other four NMS-8

economies, inflation dropped after accession to the EU. In the light of the substantially accelerated economic growth, the overall development of inflation in the NMS 8 can be deemed a success.

External equilibrium measured in the terms of the current account position improved in only one NMS (Czech Republic); in all the others, it deteriorated or remained unchanged (Table 8). This only partly reflects real economy transactions. In terms of foreign trade balances (goods), of the 5 Central European NMS only Slovenia registered deterioration.³ The reason for this is that in the current account an ever-increasing role is played by profits realized by foreign owned enterprises in those countries. Those profits then appear to their full extent as debits in the current account. A considerable portion of those profits is reinvested; however, it appears in the capital account as part of the FDI inflows. Current account deterioration was relatively mild in three Central European NMS, yet marked in the Baltic States, especially in Latvia and Estonia, where the current account deficit was already rather high in the pre-accession period. In the Baltic States, foreign trade deficits also increased to a considerable extent.

The general government position improved in all but one country: Hungary (Table 9). Hungary's fiscal problems are clearly political in nature (government over-expenditures related to elections from 2000 onwards) and are not attributable to EU-membership. The degree of improvement in the other 7 NMS was considerable. In 2001-2003, only 3 of the NMS 8 met the Maastricht criterion pertaining to the budget deficit/GDP ratio; by 2004-2006 5 already fulfilled the criterion, while one NMS was only 0.1 p.p. above the 3% threshold.

Table 9

General government balance

in % of GDP

	average 2001-2003		average 2004-2006
A EU-15	-2.1		-2.2
B NMS-8	-5.4		-4.2
B-A (in percentage points)	-3.3		-2.0
Estonia	0.7	Estonia	2.8
Latvia	-2.0	Latvia	-0.3
Lithuania	-2.3	Lithuania	-0.8
Slovenia	-3.1	Slovenia	-1.7
Poland	-5.5	Slovakia	-2.9
Slovakia	-5.7	Czech R.	-3.1
Czech R.	-6.4	Poland	-4.7
Hungary	-6.8	Hungary	-7.8

Note: According to the Excessive Deficit Procedure

Source: Eurostat

Finally, as figures in Table 11 illustrate, the catching up process in the NMS-8 (up to the level of development of the 'old' EU-member states) accelerated in the post-accession period. The

³ Calculated from Table 7 in Vladimir Gligorov, Leon Podkaminer et al., 'Private Consumption and Flourishing Exports Keep the Region on High Growth Track', *wiiw Research Reports*, No. 335, February 2007, p. 18.

aggregate figures for the group show that in 2001-2003 the NMS-8 reduced the gap in per capita GDP by 2.7 p.p., and the pace was nearly a third faster, 3.8 p.p. in the post-accession period. It is important to point out that owing to Poland's weight in the group and that country's relatively modest, yet nonetheless accelerating catching-up process, aggregate data do not reveal the astonishing performance attained by the smaller NMS. In only six years Estonia managed to outstrip Poland, Hungary and Slovakia and caught up close to 20 p.p. in terms of per capita GDP. Less spectacular, but still rapid catching up was recorded in the other two Baltic States. In the post-accession period, 5 of the 8 NMS achieved a swifter pace of catching up than in the pre-accession period 2001-2003; the other 3 NMS displayed an opposite trend. Nevertheless, the pace of acceleration was substantially more rapid. The percentage points that the 5 NMS gained by accelerating the catching-up process after accession amounted to 13.3 p.p. overall while the percentage points that the 3 NMS lost through deceleration of the catching-up process following accession amounted to 3 p.p.. In more concrete terms, Slovenia and the Czech Republic already have a higher per capita GDP than Portugal, and Slovenia has also achieved the level of Greece (see Annex Table I for details).

Table 10

Change of selected stability indicators in 2004-2006 compared to 2001-2003

	Inflation (CPI, period average)	External equilibrium (Current account position in % of the GDP, period average)	Budget (General government position in % of the GDP, period average)
Czech Republic	–	+	+
Hungary	+	unchanged	–
Poland	+	–	+
Slovakia	+	–	+
Slovenia	+	–	+
Estonia	–	–	+
Latvia	–	–	+
Lithuania	–	–	+

Key to table: improvement +; deterioration –

Source: Tables 7, 8 and 9.

In conclusion, NMS' overall performance in the post-accession period has been clearly better than in the final three years before accession. But what role did EU-membership play in this improvement, and to what degree is that success explained by other factors?

As for the external conditions, the international environment in the post-accession period was friendlier than before. In 2001-2003 world trade increased by 8%, in 2004-2006 by close to 30%, while the main NMS-8 export market, the EU-15, also expanded more dynamically. However, as seen above, the NMS-8 managed to consolidate their lead in terms of growth over the EU-15. Furthermore, energy prices were substantially higher in the post-accession period, yet that did not affect growth in the NMS 8.

These favourable external conditions melded with the benefits arising out of the abolition of the last remaining trade barriers after accession. Although EU export markets had already been long open to the NMS-8 – except in respect of relatively small segments of agricultural and food products – accession brought about the removal of all border controls by the 'old' EU. Easier cross-border co-

operation with other new EU members have boosted intra-NMS trade and exports to non-EU destinations.

The ever-increasing investment activities may well have reflected greater confidence (and lower risks) that the countries associated with full membership. The NMS-8 put behind them the troublesome years of transition and the process was largely guided by the seamless adoption of the *acquis communautaire*. Foreign and domestic investor confidence in the predictability of the NMS-8 institutional and economic policy environment arising out of EU-membership increased markedly in later years. This stood in contrast to the pre-accession period when, despite tangible progress towards membership, possible failure of the enlargement process could not always be completely ruled out.

Table 11a

GDP per capita at PPP (EU-15 = 100)					
	level 2001	level 2003		level 2004	level 2006
EU-15	100	100	EU-15	100	100
NMS-8 average	46.2	48.9	NMS-8 average	50.6	54.4
Latvia	33.8	37.9	Latvia	40.2	49.4
Lithuania	36.6	43.2	Poland	44.8	47.8
Estonia	40.0	47.1	Lithuania	45.1	50.9
Poland	42.0	43.0	Estonia	49.5	61.4
Slovak Republic	44.4	48.5	Slovak Republic	50.1	55.9
Hungary	51.9	55.8	Hungary	56.5	58.8
Czech Republic	60.1	64.9	Czech Republic	66.4	70.6
Slovenia	67.4	71.0	Slovenia	73.6	78.2

Table 11b

Ranking by pace of catching up catching up in p.p.			
	2001-2003		2004-2006
Estonia	7.1	Estonia	11.9
Lithuania	6.6	Latvia	9.2
Czech Republic	4.8	Lithuania	5.8
Slovak Republic	4.1	Slovak Republic	5.8
Latvia	4.0	Slovenia	4.5
Hungary	3.9	Czech Republic	4.2
Slovenia	3.6	NMS-8	3.8
NMS-8	2.7	Poland	2.9
Poland	1.0	Hungary	2.3

Source: wiiw Database incorporating national statistics, Eurostat.

Finally, the NMS-8 have since attained maturity in terms of FDI involvement in their economies. This is manifest in improved trade performance, enhanced management culture and increased competitiveness. Even if not linked directly to the date of accession, these issues are all closely related to the institutional anchor of EU membership and may well have contributed to increased confidence and investment.

Liberalization in migration matters (applicable to three 'old' EU countries only) may explain in part the reduction in unemployment, especially in Poland, the Baltic States and Slovakia. Transfers from the EU budget were higher in the post-accession period compared to the pre-accession period; yet, given the phasing-in process, the relatively small amounts transferred so far do not suffice to explain the better results that the NMS-8 achieved in the post-accession period.

Global environment: external conditions remain favourable

2006 was a good year for the world economy. Global economic growth amounted to 5.4%. World trade expanded close to 9% last year. Rising oil prices coupled with rapid global economic growth initially raised fears of inflationary pressures only to recede when oil prices dropped in the second half of the year.⁴ Economic performance in the European Union (EU) registered 3% growth in 2006, with expansion in the eurozone being the best in six years: 2.7%. The engine of growth in the EU was domestic demand, with investment in machinery and equipment taking the lead. Private consumption only expanded at a moderate pace. Net exports supported growth, especially in the last quarter of 2006.⁵

Global growth is expected to remain strong in both 2007 and 2008, yet somewhat less robust than in 2006. The envisaged slowdown in growth by about half a percentage point will be mainly due to a more pronounced decline in the US growth rate: down from 3.3 to 2.2%. It is assumed that the EU and Japan will record the same (or only marginally lower) growth rate in 2007 as in the previous year. Emerging market and developing countries are expected to maintain their rapid rates of expansion, albeit somewhat below the levels achieved in 2006, supported by major increases in commodity prices and favourable global financial conditions.⁶ In world trade, less buoyant activities in global manufacturing will yield a robust rate of growth, albeit 1.5 p.p. lower than in the previous year.⁷ Oil markets will remain tight in 2007.

The risks that the global economy faces in the current year include the possibility of a marked drop in the US growth rate owing to problems in the domestic housing sector; an increase in financial volatility leading to investors pulling back from risky assets; and a re-mergence of inflationary pressures in the event of oil prices suddenly rising.⁸

Survey data in the European Union hint at the continuation of robust growth. The European Commission's spring 2007 forecast assumes 2.9% in the EU and 2.6% in the eurozone. Whereas growth in consumption will lag behind that of GDP, the rate of investment growth is expected to expand vigorously; it will be backed by solid corporate profitability, a high rate of capacity utilization, favourable financial conditions and the challenges posed by the rapid development of new technologies. Employment will increase by 1.4%, accompanied by a substantial 0.7 p.p. decline in the unemployment rate: down to 7.2%. Both the government deficit/GDP ratio and the government debt/GDP ratio are expected to improve over the current year. Consumer-price inflation in the EU-27 and the eurozone will amount to 2.2% and 1.9%, respectively. As in the previous year, the current account deficit/GDP ratio in the EU-27 will remain negligible.

⁴ World Economic Outlook April 2007, IMF.

⁵ Economic forecast Spring 2007, European Commission.

⁶ World Economic Outlook April 2007, IMF., Economic forecast Spring 2007, European Commission

⁷ Economic forecast Spring 2007, European Commission.

⁸ World Economic Outlook April 2007, IMF.

The risks on which the EU forecast is predicated are for the most part on a par with those that global development faces as outlined above. EU-specific risks might possibly include: a more buoyant upswing in consumer spending than expected owing to a rise in employment; wage pressures as a consequence of tightening labour markets; and a boost to consumer confidence which might ultimately give rise to inflationary pressures in late 2007 and 2008.⁹

After years of low growth, Germany, the prime export market for the NMS, shifted into high gear in 2006. GDP growth will hover around 2.5%, both this year and next. In 2007 import growth will remain strong 8.5%, albeit substantially lower than in 2006: 11.1%.¹⁰

Economic growth in the NMS and its sources

2006 was an exceptionally good year for the NMS in terms of economic growth (see Table 12). Slovakia, Estonia and Latvia recorded their most rapid expansion since transition began; their growth rates were more characteristic of the Asian 'tiger' economies than those of Central Europe. The Czech Republic, Poland, Romania, Bulgaria and Lithuania maintained robust growth. The only outlier was Hungary, where economic growth was less than 4% as a consequence of the austerity package introduced in the middle of 2006.

Table 12

Gross domestic product										Index
real change in % against preceding year										1995=100
	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008	2006
Czech Republic	1.9	3.6	4.6	6.5	6.4	6.6	6.1	5	5.2	138.0
Hungary	4.4	4.2	4.8	4.1	3.9	4.9	2.7	2.7	3.1	156.3
Poland	1.4	3.9	5.3	3.6	6.1	5.5	7.4	6	5.5	160.6
Slovak Republic	4.1	4.2	5.4	6.0	8.3	6.7	9.0	8.5	8	160.5
Slovenia	3.4	2.7	4.4	4.0	5.2	5.0	7.2	5	5	154.5
NMS-5 ²⁾	2.3	3.9	5.0	4.5	5.9	5.7	6.5	5.4	5.2	154.6
Bulgaria	4.5	5.0	6.6	6.2	6.1	5.5	6.2	6	6	131.7
Romania ³⁾	5.1	5.2	8.5	4.1	7.7	6.9	6.0	6.0	5.5	133.2
Estonia	8.0	7.1	8.1	10.5	11.4	11.7	9.8	9.5	8.4	223.0
Latvia	6.5	7.2	8.7	10.6	11.9	13.1	11.2	8.9	8.0	218.6
Lithuania	6.9	10.3	7.3	7.6	7.5	8.5	8.3	7	6.5	196.2
NMS-10 ²⁾	3.1	4.4	5.8	4.8	6.5	6.2	6.6	5.7	5.5	152.9

1) Preliminary. - 2) wiiw estimate. - 3) From 2003 FISIM adjusted.

Source: wiiw Database incorporating national statistics, forecast: wiiw and European Commission (Spring Report 2007) for Baltic States.

The first quarter of 2007 brought about a considerable acceleration of economic growth in Poland, Slovakia and Slovenia. In the same period remarkable deceleration was registered in Estonia,

⁹ Economic forecast Spring 2007, European Commission.

¹⁰ Economic forecast Spring 2007, European Commission.

Latvia, Romania and Hungary, with the Czech Republic recording a more modest pace. Earlier trends continued in Bulgaria and Lithuania.

As for the sources of economic growth, a differentiated picture emerges across countries (see Table 15).

At one extreme we have Slovakia with an outstanding mix of sources of growth. Half of the country's growth came from consumption and a quarter from investment, with net exports contributing a considerable amount. This trend seems to have continued in the first quarter of 2007. The increase in consumption is expected to grow at a somewhat slower pace than GDP (see Table 13). Although investment could increase more dynamically, it still keeps pace with the GDP expansion (see Table 14). In the first quarter of 2007, the net export position was strongly positive; the Slovak growth path can thus be seen to be broadly based and appears sustainable.

Bulgaria and Romania are at the other extreme. In both countries, the extremely rapid economic growth has yielded an unfortunate mix that clearly hints at the process's unsustainability. In Bulgaria and Romania alike, consumption is the main driving force of rapid GDP growth and for years net exports have been deteriorating at breakneck speed. The only good news is that in both countries investments have increased much more rapidly than GDP. While the scramble towards consumption is understandable given the low standard of living in both countries, the deterioration of their net export position offers a clear warning.

The Czech Republic, Poland and Slovenia are now also among the rapidly growing countries. The mix of growth components is more or less balanced, without any specific deterioration of net exports. In Poland and Slovenia, investments turned out to be significant sources of growth in the first quarter of the year.

Table 13

Consumption of households											
real change in % against preceding year											
	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008 forecast	Index 1995=100 2006	in % of GDP 2006
Czech Republic	2.2	6.0	2.9	2.4	4.4	3.8	6.7	6	5	139.6	47.6
Hungary	10.6	8.3	2.9	3.7	1.4	2.6	0.6	-0.3	1	154.9	52.2
Poland	3.4	2.0	4.4	2.0	5.2	5.4	6.9	6	5	160.7	61.2
Slovak Republic	5.2	0.1	3.8	7.2	6.3	6.6	6.5	7	5	164.4	56.7
Slovenia	1.3	3.5	2.8	3.6	3.3	3.2	3.4	3	3	137.4	52.9
Bulgaria	4.0	6.3	5.3	5.5	7.1	5.7	8.1	7	7	137.3	77.2
Romania	5.3	8.5	14.5	9.7	14.1	12.0	12.1	10	8	177.1	68.7
Estonia	10.9	6.8	7.0	7.9	15.8	16.1	18.3	16	14	230.9	51.0
Latvia	7.4	8.2	8.8	11.6	20.0	17.4	.	17	15	235.2	64.4
Lithuania	5.8	10.3	12.2	9.9	13.5	14.9	12.2	12	12	220.0	65.6

1) Preliminary.

Source: wiw Database incorporating national statistics, forecast: wiw and European Commission (Spring Report 2007) for Baltic States.

Hungary, the only NMS that is not a member of the club of rapidly growing countries, is a special case. The components of growth in 2006 and the first quarter of 2007 reflect the impact of the austerity package. Consumption growth decelerated and went into decline in the first quarter, whereas net exports improved on a spectacular scale; both phenomena are in keeping with the country's convergence programme. The sole unintended effect of the stabilization measures has been the drop in investments. A revival in investment is an important prerequisite for returning to a growth path with substantially more dynamic expansion.

As for the outlook in the current year, high GDP growth will continue to be a regional characteristic, with the exception of Hungary. Slovakia will probably manage to exceed the rate of expansion it achieved in 2006, remaining in top form in terms of components of growth, with consumption increasing dynamically (albeit somewhat below GDP expansion), investments booming and net exports improving. Slovenia will follow a pattern similar to Slovakia in terms of growth components, but overall GDP expansion will ensue at a slower pace.

Table 14

Gross fixed capital formation											
real change in % against preceding year											
	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008 forecast	Index 1995=100 2006	in % of GDP 2006
Czech Republic	5.1	0.4	3.9	2.3	7.6	6.8	1.5	2	4	134.4	25.2
Hungary	10.2	2.2	7.6	5.3	-2.1	9.9	-2.3	3	4	197.8	21.8
Poland	-6.3	-0.1	6.4	6.5	16.5	7.6	29.6	22	18	203.0	19.9
Slovak Republic	0.3	-2.3	5.0	17.5	7.3	13.8	7.7	8	7	181.1	26.4
Slovenia	0.9	7.0	7.9	1.5	11.9	8.6	21.6	10	7	218.7	25.8
Bulgaria	8.5	13.9	13.5	23.3	17.6	17.1	35.9	25	20	294.6	26.2
Romania ²⁾	8.2	8.5	11.1	12.6	16.1	11.3	17.2	14	10	191.2	24.6
Estonia	24.1	7.0	13.5	12.7	19.7	18.9	18.3	16	12	322.3	33.8
Latvia	13.0	12.3	23.8	23.6	18.3	19.5	.	16	14	627.3	34.4
Lithuania	10.9	14.1	15.5	9.2	11.9	10.5	22.5	13	11	318.7	23.1

1) Preliminary. - 2) From 2003 new GDP accounting methodology (FISIM reallocation).

Source: wiiw Database incorporating national statistics, forecast: wiiw and European Commission (Spring Report 2007) for Baltic States.

Poland will maintain its growth momentum, with consumption expanding in accord with GDP growth. That notwithstanding, investments will boom and the price to be paid will be a modest deterioration in the country's net export position.

The picture is less rosy for the Czech Republic. Although GDP growth will decelerate in 2007 by about 1.4 p.p., that is no reason for concern. More worrisome will be the unfavourable shift in components of growth. Consumption growth will outstrip GDP growth, while investment growth will slow down considerably. The first quarter results already point to a deterioration in the net export position.

Within the framework of the country's austerity programme, the Hungarian economy will hit rock bottom this year in terms of economic growth, attaining only about half of the GDP growth rate achieved by the NMS-5 as a group. Consumption will decline slightly, investments will grow modestly and the net export position will improve in a spectacular manner.

Table 15

Contributions (percentage points) to the GDP growth rates

	2000	2001	2002	2003	2004	2005	2006	2006 I Q	2007 I Q
Czech Republic									
GDP growth rate (%)	3.6	2.5	1.9	3.6	4.6	6.5	6.4	6.6	6.1
Consumption	0.8	1.9	2.6	4.7	0.8	1.7	2.4	2.6	3.1
Gross fixed investment	1.4	1.8	1.5	0.1	1.0	0.6	1.9	1.6	0.4
Trade balance	0.0	-1.1	-2.2	-0.9	1.3	4.8	1.2	2.3	-0.4
Other items*	1.4	-0.1	0.0	-0.3	1.5	-0.6	0.9	0.1	3.0
Hungary									
GDP growth rate (%)	5.2	4.1	4.4	4.2	4.8	4.2	3.9	4.9	2.7
Consumption	.	3.7	6.8	5.8	2.1	2.5	1.2	2.9	-0.6
Gross fixed investment	.	1.3	2.5	0.5	1.7	1.2	-0.5	1.6	-0.4
Trade balance	.	1.6	-2.0	-2.5	0.5	2.9	3.7	2.0	2.2
Other items*	.	-2.5	-2.9	0.4	0.5	-2.4	-0.5	-1.6	1.5
Poland									
GDP growth rate (%)	4.3	1.2	1.4	3.9	5.3	3.6	6.1	5.5	7.4
Consumption	2.3	1.8	2.5	2.2	3.4	2.2	3.9	4.8	4.8
Gross fixed investment	0.7	-2.3	-1.3	0.0	1.2	1.2	3.0	0.9	3.6
Trade balance	1.0	2.6	0.5	1.1	-0.7	1.1	-0.5	0.2	-1.1
Other items*	0.3	-0.9	-0.3	0.6	1.4	-0.9	-0.3	-0.4	0.1
Slovenia									
GDP growth rate (%)	4.1	2.7	3.4	2.7	4.4	4.0	5.2	5.0	7.2
Consumption	0.9	2.0	1.4	2.2	2.1	2.3	2.5	2.5	2.2
Gross fixed investment	0.5	0.1	0.2	1.7	1.9	0.4	2.8	1.9	5.2
Trade balance	2.7	1.7	1.0	-2.1	-0.6	2.0	-0.2	0.8	0.0
Other items*	0.0	-1.1	0.8	0.9	1.0	-0.7	0.1	-0.2	-0.2
Slovak Republic									
GDP growth rate (%)	0.7	3.2	4.1	4.2	5.4	6.0	8.3	6.7	9.0
Consumption	1.2	4.0	4.0	0.9	2.7	3.8	4.3	5.1	4.2
Gross fixed investment	-2.9	3.4	0.1	-0.6	1.3	4.4	1.9	3.1	1.9
Trade balance	0.2	-4.9	-0.3	5.4	-0.9	-2.6	1.5	-1.8	4.6
Other items*	2.2	0.7	0.3	-1.5	2.3	0.4	0.6	0.3	-1.7
Bulgaria									
GDP growth rate (%)	5.4	4.1	4.5	5.0	6.6	6.2	6.1	5.5	6.2
Consumption	5.0	3.9	3.7	5.1	4.9	4.7	5.7	4.6	6.5
Gross fixed investment	2.4	3.9	1.6	2.6	2.7	4.8	4.2	3.4	8.3
Trade balance	-0.5	-3.4	1.4	-4.3	-2.7	-4.2	-5.9	-7.5	-9.8
Other items*	-1.5	-0.3	-2.2	1.6	1.7	0.9	2.1	5.0	1.2
Romania									
GDP growth rate (%)	2.1	5.7	5.1	5.2	8.5	4.1	7.7	6.9	6.0
Consumption	1.3	5.5	4.2	7.0	8.8	8.3	10.3	10.0	11.0
Gross fixed investment	1.0	1.9	1.6	1.8	2.4	2.8	3.8	1.8	3.1
Trade balance	-2.4	-3.4	0.9	-3.9	-4.9	-4.9	-7.6	-7.0	-8.8
Other items*	2.2	1.7	-1.6	0.3	2.2	-2.1	1.2	2.1	0.7

*Other items include change in stocks and statistical discrepancies

Source: wiiw estimates incorporating national sources.

In Bulgaria and Romania economic growth will be slightly slower than in the previous year, yet still rapid and devoid of balance. In both countries, the growth in domestic demand will be substantially more rapid than that of GDP. Consumption in Romania will grow about 4 p.p. more rapidly than GDP; in Bulgaria it will keep pace with GDP. The investment boom will continue in both countries. First quarter data, however, predict a dramatic deterioration in both countries' net export position.

In the Baltic states, both consumption and gross fixed investment rates have been delinked from GDP growth, thus hinting at the unsustainability of the current extremely high growth rate (see more on that on p. 31).

Rapid expansion of industrial output

Industrial production expanded dynamically in the NMS-5 group, well above the rate of GDP growth (see Table 16). A considerable acceleration in industrial growth can be seen in Slovakia, where the foreign owned manufacturing cluster has shifted into the top gear this year in terms of exports. A real surprise has been the industry's outstanding first quarter performance in Slovenia, a country with a traditionally modest rate of industrial expansion. In the NMS-5 group only Hungary registered a setback in the rate of output growth that still remained surprisingly dynamic despite the stabilization measures and the resultant shrinking domestic demand.

Table 16

	Gross industrial production									
	real change in % against preceding year									
	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008 forecast	Index 1995=100 2006
Czech Republic	1.9	5.5	9.6	6.7	9.7	14.8	12.4	8	9	156.6
Hungary	2.8	6.4	7.4	7.0	10.1	13.3	8.8	8	9	241.4
Poland ²⁾	1.1	8.3	12.6	3.7	11.3	12.3	13.1	10	10	197.9
Slovak Republic	6.7	5.3	4.2	3.6	9.9	9.5	15.2	14	10	167.5
Slovenia	2.4	1.4	4.8	3.3	6.5	7.1	9.3	7	6	137.7
NMS-5 ³⁾	2.1	6.7	9.9	4.9	10.4	12.6	12.3	9.4	9.4	187.5
Bulgaria ⁴⁾	6.5	14.1	13.8	8.4	5.8	7.3	7.3	7	7	126.0
Romania	4.3	3.1	5.3	2.0	7.1	4.7	7.6	6	6	119.0
Estonia	8.2	10.9	10.5	9.2	7.0	8.7	8.2	6.5	6	229.3
Latvia	8.4	9.1	6.0	5.6	4.0	8.5	1.3	2.5	2	184.2
Lithuania	3.1	16.1	10.8	7.1	7.3	12.4	-1.0	1	4	198.0
NMS-10 ³⁾	2.9	6.8	9.4	4.7	9.4	11.0	10.7	8.4	8.5	171.7

1) Preliminary. - 2) Sales; quarterly data refer to enterprises with more than 9 employees. - 3) wiiw estimate. - 4) Quarterly data refer to enterprises with more than 10 employees.

Source: wiiw Database incorporating national statistics, forecast: wiiw

Romania recorded faster industrial growth in the first quarter of the current year compared to the corresponding period in the previous year. Of the Baltic states, only Estonia managed to maintain the growth momentum achieved in 2006, but in the first quarter of 2007 a sharp downward turn was

to be seen in industrial output growth in Latvia and Lithuania in particular, while GDP in both countries continued to expand very rapidly.

Table 17

Labour productivity in industry

real change in % against preceding year

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	Index 1995=100 2006
Czech Republic ²⁾	5.8	9.5	10.5	8.2	9.2	13.6	10.3	219.2
Hungary ³⁾	4.6	10.2	10.7	11.2	11.9	16.4	9.5	301.2
Poland ⁴⁾	6.6	9.7	11.7	3.9	9.5	10.5	9.5	250.7
Slovak Republic	6.5	4.7	3.8	0.5	11.3	10.8	10.0	181.5
Slovenia	5.6	3.6	6.2	5.2	8.3	9.9	8.4	183.8
Bulgaria ⁵⁾	5.2	10.3	12.8	8.8	5.6	10.1	6.6	159.4
Romania	5.0	5.4	11.8	6.2	10.6	8.6	12.8	192.0
Estonia	10.3	11.8	10.2	9.1	11.1	.	.	290.4
Latvia	7.7	6.4	6.9	5.0	3.4	.	.	142.3 ⁶⁾
Lithuania	5.9	5.9	9.0	7.5	6.7	.	.	204.2

1) Preliminary. - 2) Enterprises with 20 and more employees. Calculated with sales. - 3) Enterprises with more than 5 employees. - 4) 2006 and quarterly data refer to enterprises with more than 9 employees. - 5) Quarterly data refer to enterprises with more than 10 employees. - 6) 2000=100.

Source: wiiw Database incorporating national statistics.

Forecasts for both 2007 and 2008 point to modest (around one percentage point) deceleration in industrial output growth for the NMS-5 and the NMS-10 alike. A considerable change compared to 2006 is expected for Slovakia (acceleration) and Lithuania and Latvia (deceleration).

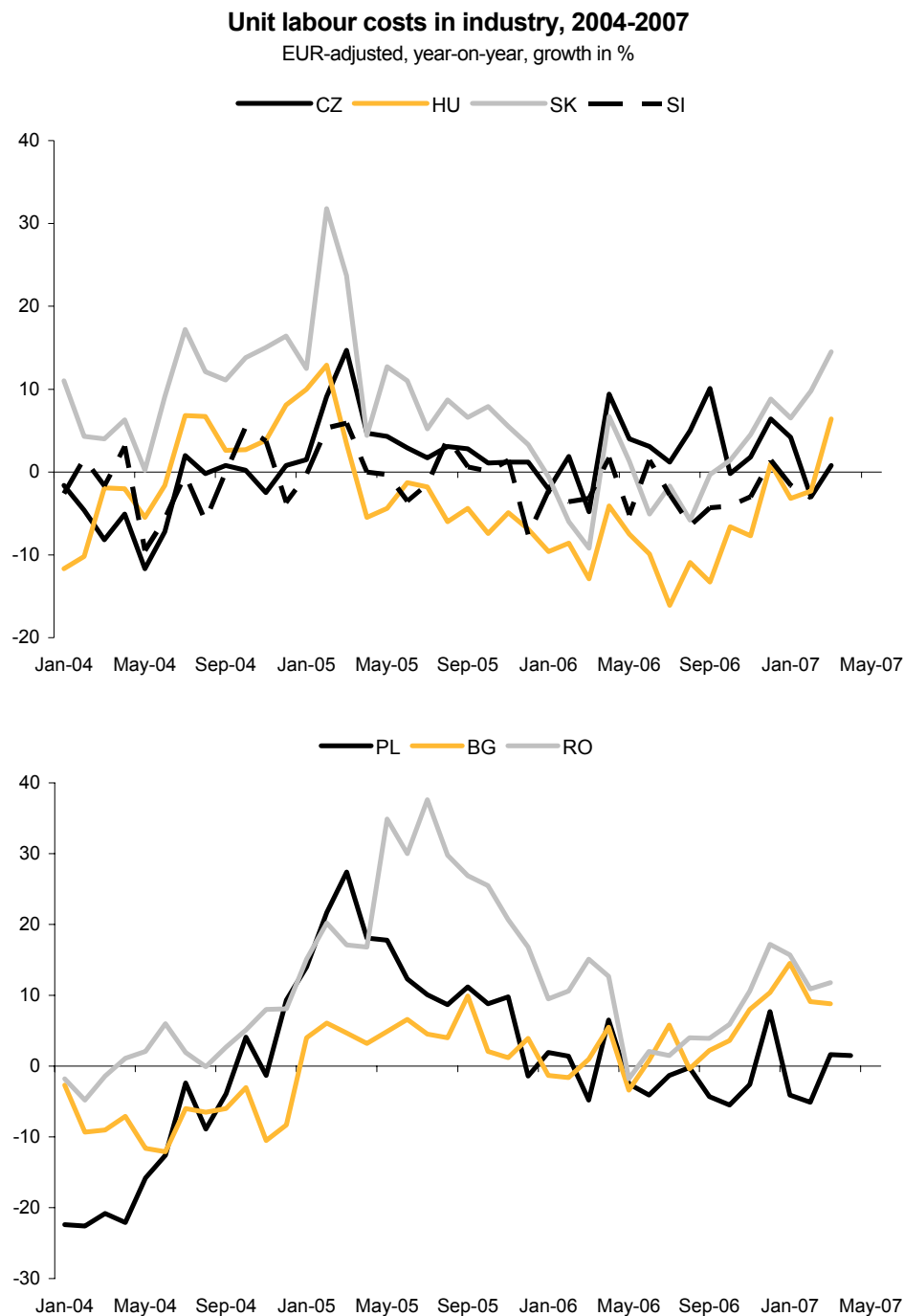
Rising unit labour costs pose no threat to competitiveness

In the period April 2006 to April 2007, unit labour costs (ULC) in industry increased substantially in Slovakia, Hungary, Romania and Bulgaria. In Poland and the Czech Republic they remained roughly at the level recorded in May 2006, albeit with some fluctuations (see Figure 1). Productivity in industry increased at double digit or close to double digit rates in the period concerned in the NMS-5 and Romania (but not Bulgaria), see Table 17. Thus, increasing unit labour costs are primarily the outcome of strong appreciation of national currencies in the countries concerned; in Romania, the process was further enhanced by very high wage rises. However, compared to the 'old EU' the NMS have maintained their cost competitiveness, especially in those manufacturing branches where foreign investors are heavily represented (such as electrical and transport equipment).¹¹

Even if very important, ULC is but one indicator of competitiveness. The changes are clearly in accord with the slowdown in export growth rates in both Romania and Bulgaria. In the case of Slovakia and Hungary, the marked expansion of exports point to other important factors governing competitiveness, probably related to upgrading the quality of commodity exports.

¹¹ M. Landesmann, 'Competitiveness/Structural Convergence in Central and Eastern Europe', presentation at the OENB/SUERF Meeting, 'Central and Eastern Europe: Is Convergence on Track?', Vienna, 22 June 2007.

Figure 1



Source: wiiw Monthly Database incorporating national statistics.

Divergent developments in foreign trade¹²

Customs statistics show diverging trends in foreign trade in goods. In Hungary, Slovakia and Slovenia, export growth rates increased steadily over the period 2005-2006 and in the first quarter of

¹² This section deals with transactions in goods captured by customs statistics. It does not cover transactions in non-factor services. Moreover, it is concerned with the transactions measured at current prices (euro). The contributions of external trade to GDP growth, discussed earlier, correspond to trade in both goods and non-factor services (expressed at constant prices).

2007 (see Table 18). An unambiguous decline in the export growth rate over the same period is to be observed in Romania and all the three Baltic states, as well as in Poland and Bulgaria over a shorter time horizon. In Estonia and Lithuania, the extent of decline has been dramatic; it can be interpreted as a sign of deteriorating competitiveness.

Table 18

Foreign trade of the new EU member states

(based on customs statistics)

		2004	2005	2006 ¹⁾	2007 1Q	2005	2006 ¹⁾	<u>1 Q 07</u> <u>1 Q 06</u>
		EUR mn				change in %		
Czech Republic	Exports	53995	62738	75645	21075	16.2	20.6	17.5
	Imports	54824	61441	74078	19757	12.1	20.6	16.1
	Balance	-829	1297	1566	1318	.	.	.
Hungary	Exports	44630	50093	58442	16032	12.2	16.7	18.4
	Imports	48550	52996	60418	16321	9.2	14.0	15.0
	Balance	-3920	-2903	-1977	-289	.	.	.
Poland	Exports	60014	71740	87880	23244	19.5	22.5	13.7
	Imports	71812	81530	100371	26282	13.5	23.1	14.2
	Balance	-11798	-9791	-12491	-3037	.	.	.
Slovakia ²⁾	Exports	22427	25771	33273	9789	15.8	29.1	37.0
	Imports	23686	27748	35733	9868	18.2	28.8	27.0
	Balance	-1259	-1978	-2460	-79	.	.	.
Slovenia	Exports	12786	14397	16722	4703	12.6	16.1	18.0
	Imports	14146	15804	18260	4958	11.7	15.5	15.8
	Balance	-1360	-1408	-1539	-255	.	.	.
NMS-5	Exports	193852	224738	271961	74843	16.0	21.0	18.7
	Imports	213018	239520	288861	77185	12.5	20.6	16.5
	Balance	-19166	-14782	-16900	-2342	.	.	.
Bulgaria	Exports	7985	9466	11983	2837	18.6	26.6	6.2
	Imports	11620	14668	18375	4570	26.2	25.3	16.1
	Balance	-3635	-5201	-6392	-1732	.	.	.
Romania	Exports	18935	22255	25851	7102	17.5	16.2	14.2
	Imports	26281	32569	40746	11148	23.9	25.1	30.1
	Balance	-7346	-10313	-14895	-4047	.	.	.
Estonia	Exports	4769	6183	7639	1877	29.7	23.5	3.5
	Imports	6703	8204	10564	2624	22.4	28.8	8.9
	Balance	-1934	-2021	-2926	-747	.	.	.
Latvia	Exports	3204	4110	4684	1255	28.3	14.0	20.8
	Imports	5670	6925	9052	2498	22.1	30.7	33.2
	Balance	-2467	-2815	-4368	-1244	.	.	.
Lithuania	Exports	7478	9490	11240	2785	26.9	18.4	6.2
	Imports	9958	12498	15371	3893	25.5	23.0	13.4
	Balance	-2480	-3008	-4131	-1107	.	.	.
NMS-10	Exports	236222	276242	333357	90698	17.0	20.7	32.4
	Imports	273250	314383	382969	101917	15.1	21.8	37.7
	Balance	-37028	-38141	-49612	-11219	.	.	.

1) Preliminary. - 2) From 2005 data refer to trade excluding value of goods for repair.

Source: wiiw Database incorporating national statistics.

The three countries with accelerating export growth also managed to outstrip their respective import growth rates in the first quarter of 2007 (Slovakia 10 p.p., Slovenia 4.2 p.p., Hungary 3.4 p.p.). A modest positive gap of 1.4 p.p. was registered by the Czech Republic, while Poland was seen to be lagging behind, even if only marginally. The balance of payments statistics, however, show Poland to be lagging much farther behind (see country table). The difference between export and import growth rates turned out to be unfavourable for the Baltic states and Bulgaria and Romania. In the case of Bulgaria and Romania, the yawning gap between export and import growth rates (-9.9 p.p. and -15.9 p.p., respectively) may be explained, at least to some extent, by changes in the registration of trade flows following EU accession and related methodological changes in the compilation of trade statistics.

Current account – growing deficits attributable to foreign firms' profits

In our forecast for the current account/GDP ratio (CA/GDP ratio) for the NMS-5, we project a modest and gradual deterioration: from -3.1% in 2005 to -3.7% in 2008 (see Overview developments in Table I). The average figure masks diverging tendencies (see individual country tables for first quarter 2007 data). In Hungary the consequences of the austerity programme such as a less dynamic increase in consumption-related imports, sluggish investment and rapidly expanding exports are reflected in the improving CA/GDP ratio. In Slovakia, the comparatively high deficit in both 2005 and 2006 was partly caused by high profits accruing to foreign owned enterprises. This will also remain an important factor in the future. Despite the surplus in the first quarter of 2007 and the very dynamic expansion of exports, the CA/GDP ratio in Slovakia will come close to -5%, worst in the NMS-5 group, albeit only about half as high as the previous year. In Slovenia the growing gap between export and import growth will permit an improvement in the CA/GDP ratio that was favourable anyhow. The opposite holds true for the Czech Republic and Poland, where the export/import growth rate gap has been closing and the profits earned by foreign owned companies increasing; this has resulted in a modest deterioration in the CA/GDP ratio in both countries.

In many NMS, deterioration of the current account is explained not by worsening trade balances or unfavourable changes in customary income positions, but by the ever greater role played by profits earned by foreign owned enterprises which appear in their full volume as debit in the current account. A considerable part of these profits are reinvested, but this appears in the capital account as part of the FDI inflows.

The NMS will receive substantially more transfers from the EU budget from 2007 onwards than in their first three years of membership. For the NMS-5 and the Baltic states, these transfers will amount to about 2% of their GDP in 2007, double that of 2006. In 2008 and 2009 it will rise to around 3% of GDP. The overwhelming proportion of this inflow will, however, appear in the capital account in the balance of payments statistics, and not in the current account.¹³ This, again, diminishes the relevance of the current account position as a benchmark for evaluating the external equilibrium of the countries concerned.

In Bulgaria and Romania, the two newcomers to the EU, the current account position was bad in 2006 and the situation is expected to get worse this year. In Romania, imports will grow much more slowly than exports even if this partly attributable to methodological changes. Interest payments, stagnant remittances from abroad and profits accruing to foreign owned firms are the other

¹³ World Bank EU8+2, Regular Economic Report, May 2007 p. 29.

explanatory factors behind the high and worsening CA/GDP ratio. Although abundant capital inflows will cover the bulk of the deficit in Romania and about half of it in Bulgaria, they will also simultaneously cause national currencies to appreciate further and impact negatively on the foreign trade balance. External imbalances will increase the vulnerability of both the Romanian and Bulgarian economies.

Foreign Direct Investment (FDI) – a counterweight to trade deficit

FDI in Bulgaria and Romania is booming, with inflows reaching historic highs in 2006. This is partially due to privatization, but also to new investment projects in financial services, trade and real estate. EU membership is a stability anchor for foreign investors attracted by improving business conditions and soaring consumption. FDI contributes to the expansion of productive capacities and efficiency improvements, as well as to a decline in unemployment; the foreign trade deficits of these countries, however, continue to rise.

The FDI inflows into the other NMS altogether were marginally lower in 2006 than in preceding years; substantial declines in some countries were offset by considerable increases in others (see Table 19). In three countries, Poland, Latvia and Lithuania, FDI inflows reached an all-time high; they also surged in Slovakia. The decline of FDI in the other three NMS (the Czech Republic, Hungary and Estonia) was to be anticipated given that the 2005 peak was known to have been largely due to major privatization deals.

Table 19

	FDI inflow to NMS								2006 stock EUR mn
	2004	2005	2006	2007 forecast	2004	2005	2006	2007 forecast	
	EUR mn				FDI net, % of CA				
Czech Republic	4009	9354	4760	5000	68	572	104	81	58813
Hungary	3633	6099	4874	4000	40	69	47	43	62096
Poland	10292	7703	11093	12000	111	126	124	103	90000 ¹⁾
Slovakia	2441	1694	3324	3000	93	48	83	112	18000 ¹⁾
Slovenia	665	445	303	400	31	-11	-38	-29	6300 ¹⁾
NMS-5	21041	25295	24354	24400	77	129	86	82	235209
Bulgaria	2736	3103	4105	4000	172	121	100	87	15723
Romania	5183	5213	9082	7000	101	76	91	46	30891
Estonia	776	2349	1282	1300	48	160	24	24	12390
Latvia	513	582	1303	1300	30	30	35	32	5745
Lithuania	623	826	1426	1300	30	37	47	37	8333
NMS-10	30871	37368	41552	39300	80	107	79	63	308291

Note: CA means current account deficit. FDI net is defined as inflow minus outflow.

1) wiw estimate.

Source: National Banks of respective countries; wiw forecasts.

Foreign exchange inflows through FDI also play a considerable role in securing the external equilibrium of the recipient NMS by counterbalancing foreign exchange outflows due to deficits in the

current account. Last year the Czech Republic, Poland and Bulgaria managed to receive amounts of FDI (net) higher than their current account deficits. The opposite was the case in Hungary, Slovakia, Romania and all three Baltic states; the coverage of current account deficit through net FDI was especially weak in the Baltic states and Hungary. Slovenia proved to be a special case as FDI outflows were greater than FDI inflows, thus creating a negative net FDI position.

In 2007 FDI coverage of the current account deficit will be substantially smaller than in the previous year in Bulgaria and Romania, as well as to some extent in the Czech Republic. It will remain low in Hungary and the Baltic states, and be negative in Slovenia. It is only Slovenia where we expect coverage to improve this year.

Labour market situation improves¹⁴

Labour market conditions in the NMS have continued to improve in 2007. For the first time unemployment in the NMS-5 dropped to single digits (9.7%) and was some 3 p.p. lower than in the first quarter of 2006. Forecasts point to a further decline, except in Hungary where the austerity measures will take effect (Table 20 and 21). The unemployment rate dropped most in Poland and Slovakia – the two countries hardest hit by unemployment in the past couple of years. Unemployment continued to decline in the Czech Republic, Slovenia, Bulgaria and Estonia; it has remained almost unchanged in Hungary and Latvia. It is worth noting that in six out of ten reporting countries, the unemployment rates are almost the same as the average rate in the old EU countries – or even below that level.

The drop in the unemployment rate is largely attributable to rising employment on the back of the strong GDP growth and partially due to an increase in migrant labour, particularly from the Baltic States. Migration also seems to have had a positive impact on the labour market situation in Poland and probably in Romania as well. Despite these general improvements, some structural features of unemployment remain unchanged or have even deteriorated. Regional disparities in the NMS are still widening and interregional mobility is low. Thus, in a number of countries labour shortages in some regions or branches co-exist with high unemployment in other regions. In the NMS, labour shortages occurred much earlier than might have been expected after years of almost jobless growth and high unemployment. High unemployment had persisted for a long period of time, resulting in a large proportion of long-term unemployed who in principle are unemployable as their skills have eroded, they lack any motivation to work and their level of education is low.

The demand for labour is particularly strong in those countries reporting the lowest rates of unemployment, i.e. the Baltic States; however, demand is also strong in Bulgaria and even in Slovakia where unemployment is still high. In early 2007 employment continued to rise in all NMS and growth was remarkable in Poland, Bulgaria and the Slovak Republic. This is also reflected in rising employment and activity rates throughout the region. Employment rates range from a low of 55% in Poland to 68% in Estonia. Together with Slovenia and Latvia, Estonia's employment rate already exceeds the EU-15 average of 66%.

Lack of skilled labour is reported for most countries, not only in the automotive industry in the Czech Republic and Slovakia in particular, but also in segments of the high-skill service sector such as health-care personnel, architects, civil engineers and IT experts. These developments may also be

¹⁴ This section was written by Hermine Vidovic, wiiw.

partly attributed to the large inflow of FDI. In attracting skilled workers from abroad to fill the vacancies, the Czech Ministry of Labour and Social Affairs already launched a programme entitled 'Selecting qualified workers from abroad' as far back as 2003, offering permanent residence permits to those who had lived and worked in the country for two and a half years (a similar programme is being considered by Polish authorities). Almost all countries face labour shortages in the construction sector, particularly the Baltic States, but Poland as well, where nearly every second firm is unable to fill its vacancies. One of the solutions is to recruit workers from Ukraine and Belarus – and more recently from Uzbekistan and Tajikistan. A similar situation is reported for Romania, where large numbers of workers have left for Western Europe attracted by higher wages. In all these countries, employers blame labour shortages as being the limiting factor on the expansion of production.

In the Baltic States, but also in Bulgaria (which suffers from labour shortages in many sectors) and Romania as well, the lack of labour coupled with noticeable productivity increases has been the main cause of (extraordinary) wage increases. As for Poland, only wages in the construction sector have responded to the shortage situation to date; average wage increases have otherwise remained moderate. Available data point to an increase in the wage bill in industry in Slovakia and the Czech Republic, where only recently workers at the Skoda car plant went on strike for higher pay.

An analysis of labour market developments with respect to different skill types (see Figure 2) shows that the NMS have a supply structure which differs from that of the EU-15: the NMS have a significantly smaller proportion of people with low levels of education as well as a lower proportion of people with the highest levels of education.

Table 20

Unemployment, LFS definition, annual averages

	in 1000 persons					rate in %			
	2006 ¹⁾	2007 1Q	2004	2005	2006 ¹⁾	2006 1Q	2007 1Q	2007 forecast	2008 forecast
Czech Republic	371	311	8.3	7.9	7.1	8.0	6.0	6.3	6
Hungary	317	316	6.1	7.2	7.5	7.7	7.5	7.7	7.7
Poland	2344	1894	19.0	17.8	13.9	16.1	11.3	11	10
Slovak Republic	353	303	18.1	16.2	13.3	14.9	11.5	11	10
Slovenia	61	58	6.3	6.6	6.0	6.9	5.7	5.8	5.5
NMS-5 ²⁾	3447	2883	14.9	14.1	11.5	13.1	9.7	9.7	9.0
Bulgaria	306	273	12.0	10.1	9.0	9.7	8.0	7.5	7.0
Romania	728	.	8.0	7.1	7.2	.	.	7	7
Estonia	41	36	9.6	7.9	5.9	6.4	5.3	5	4.5
Latvia	80	80	10.4	8.7	6.8	7.8	6.9	6	5.5
Lithuania	89	89	11.4	8.3	5.6	6.4	5.6	4.5	4
NMS-10 ²⁾	4690	.	10.3	9.7	10.0	.	.	8.7	8.1

1) Preliminary. - 2) wiiw estimate.

Source: wiiw Database incorporating national statistics, forecast: wiiw and European Commission (Spring Report 2007) for Baltic States.

Despite the NMS having a low number of people with the lowest levels of education in their labour forces, the employment and unemployment rates (see Figures 3 and 4) place those countries in a

much worse position in the labour market compared to the same group of workers in the EU-15 labour markets (a gap of 20 to 30 p.p. in employment rates and about 10 p.p. in unemployment rates). On the other hand, the employment rates of the medium- and highly educated do not differ much between the NMS and the EU-15.

Table 21

Employment, LFS definition, annual averages

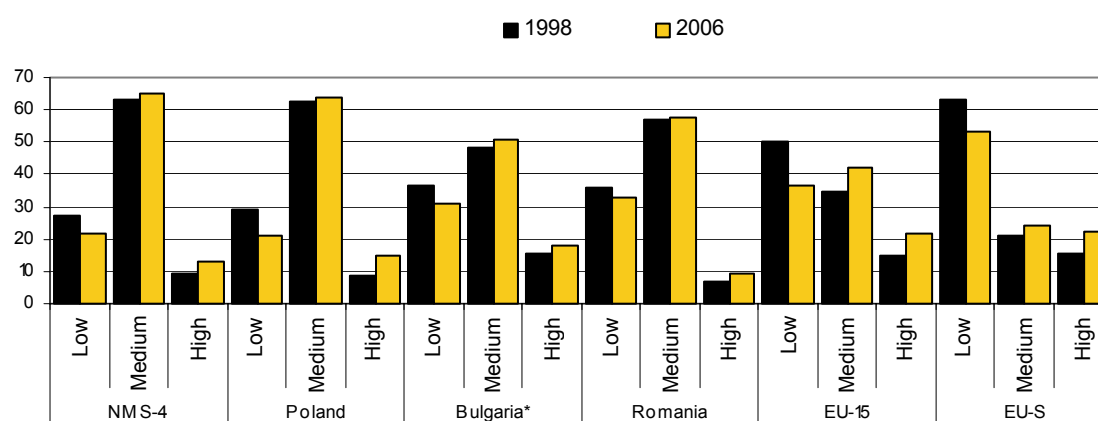
	in 1000 persons		change in % against preceding year					Index 2000=100 2006
	2006 ¹⁾	2007 1Q	2004	2005	2006 ¹⁾	2006 1Q	2007 1Q	
Czech Republic	4828	4865	-0.6	1.2	1.3	1.7	1.7	102.0
Hungary	3930	3906	-0.5	0.0	0.7	0.4	0.5	101.9
Poland	14594	14839	1.3	2.3	3.4	3.1	5.3	100.5
Slovak Republic	2301	2327	0.3	2.1	3.8	3.7	3.1	109.5
Slovenia	961	958	5.1	0.6	1.3	1.3	1.3	106.7
NMS-5 ²⁾	26615	26894	0.7	1.7	2.6	2.0	3.5	101.9
Bulgaria	3110	3135	3.1	2.0	4.4	3.6	6.6	111.3
Romania	9313	.	-0.7	-0.1	1.8	0.9	.	100.9 ³⁾
Estonia	646	647	0.2	2.0	6.4	6.8	1.9	112.9
Latvia	1087	1084	1.1	1.8	4.9	4.1	2.6	115.5
Lithuania	1499	1499	-0.1	2.6	1.7	2.7	1.0	107.2
NMS-10 ²⁾	42270	.	0.5	1.3	2.6	2.0	.	.

1) Preliminary. - 2) wiiw estimate. - 3) 2002=100.

Source: wiiw Database incorporating national statistics.

Figure 2

Educational structure of working-age population, 15-64, 1998 and 2006



*) Bulgaria: 2000, 2006.

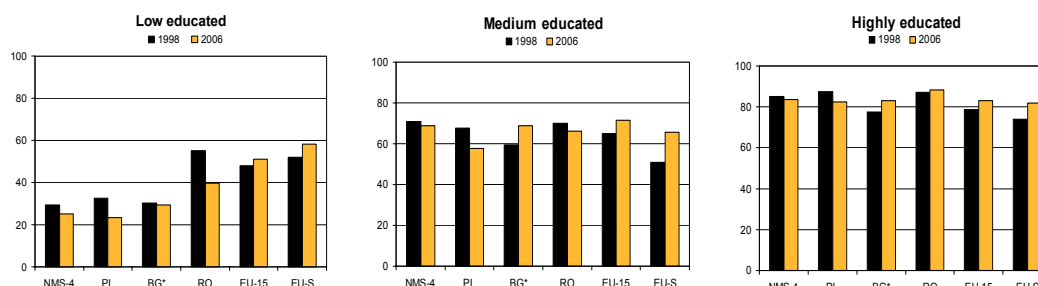
Note: NMS-4: Czech Republic, Hungary, Slovakia and Slovenia. EU-South: Greece, Portugal and Spain.

Source: Eurostat, wiiw database incorporate national statistics.

At the high-skill end of the labour market, an interesting phenomenon is to be seen: in this segment of the labour market there are clear signs of the situation being much tighter in the NMS than in the EU-15, with high and rising employment and very low unemployment rates even in periods of very poor overall labour market performance (such as in Poland in the early 2000s). The situation is even tighter where 25-35 year age group is concerned.

Figure 3

Employment rates, 15-64, 1998 and 2006

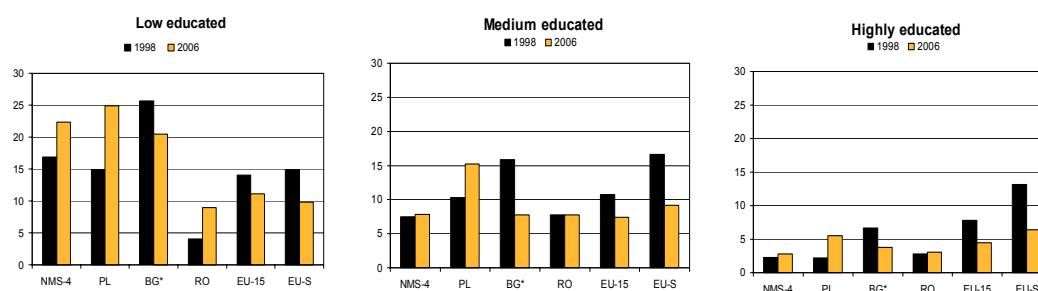


*) Bulgaria: 2000, 2005

Source: Eurostat; wiw Database incorporating national statistics.

Figure 4

Unemployment rates, 15-64, 1998 and 2006



*) Bulgaria: 2000, 2005.

Source: Eurostat; wiw Database incorporating national statistics.

Inflation – currently low, but increasing pressures ahead

In January this year Slovenia, the first among the new member states, successfully introduced the euro. That the country landed softly in the eurozone is indicated by the CPI in the first quarter of the year compared to the corresponding period in the last pre-euro year: a difference of a mere 0.2% (see Table 22).

The Czech Republic and Slovakia managed to reduce consumer price inflation in the first quarter of this year. While the Czech Republic has been a low inflation country for years, this does not apply to Slovakia, where back in 2006 the inflation rate stood at 4.5% and the current rapid economic growth could easily trigger higher inflation without the counterbalancing effect of a strong nominal appreciation of the national currency. Poland, another member of the low inflation club in the region, registered a modest acceleration in consumer price rises in the first quarter; however, this occurred at a fairly low level of inflation. Hungary is again a special case in the NMS-5 group as a series of

administrative price rises were introduced within the context of the austerity package in order to diminish public expenditures on subsidies. In all three Baltic states, consumer price inflation in the first quarter of the current year was higher than in the corresponding period in 2006.

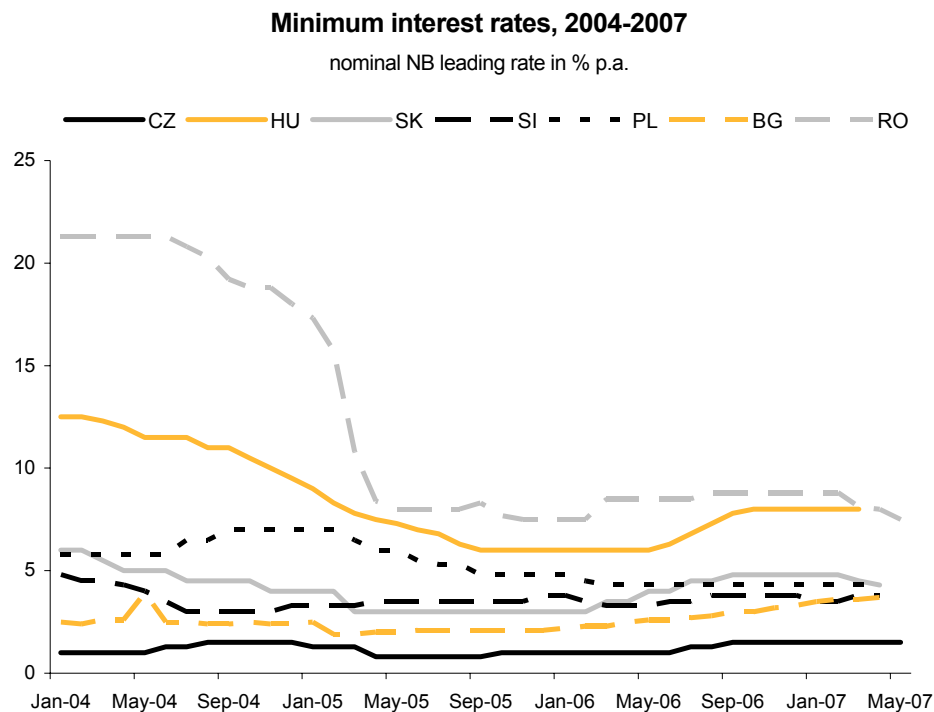
Table 22

Consumer price inflation									
change in % against preceding year									
	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008
Czech Republic	1.8	0.1	2.8	1.9	2.5	2.8	1.6	3	2.8
Hungary	5.3	4.7	6.8	3.6	3.9	2.5	8.5	7.0	3.5
Poland	1.9	0.8	3.5	2.1	1.0	0.6	2.0	2.3	2.5
Slovak Republic	3.3	8.5	7.5	2.7	4.5	4.3	2.8	3	2
Slovenia	7.5	5.6	3.6	2.5	2.5	2.2	2.4	2.6	2.3
Bulgaria	5.8	2.3	6.1	5.0	7.3	8.0	5.2	5	5
Romania	22.5	15.3	11.9	9.0	6.6	8.6	3.8	4.0	4.5
Estonia	3.6	1.3	3.0	4.1	4.4	4.4	5.2	5.5	5
Latvia	1.9	2.9	6.2	6.7	6.8	7.0	7.6	7.5	7
Lithuania	0.3	-1.2	1.2	2.7	3.8	3.3	4.4	5.0	5.0

1) Preliminary.

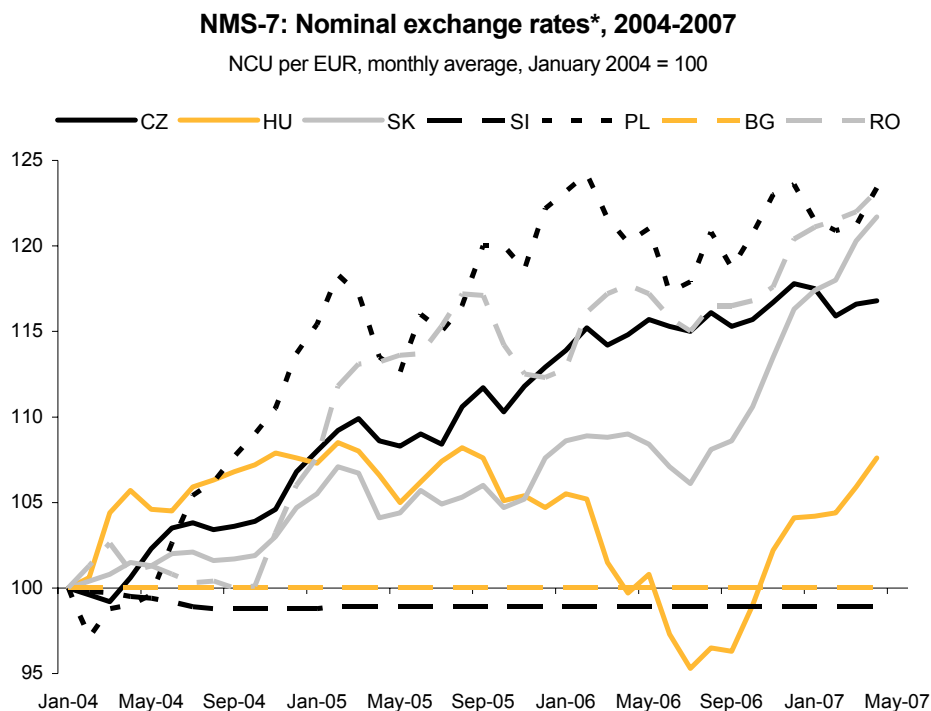
Source: wiiw Database incorporating national statistics, forecast: wiiw and European Commission (Spring Report 2007) for Baltic States.

Figure 5



Source: wiiw Monthly Database incorporating national statistics.

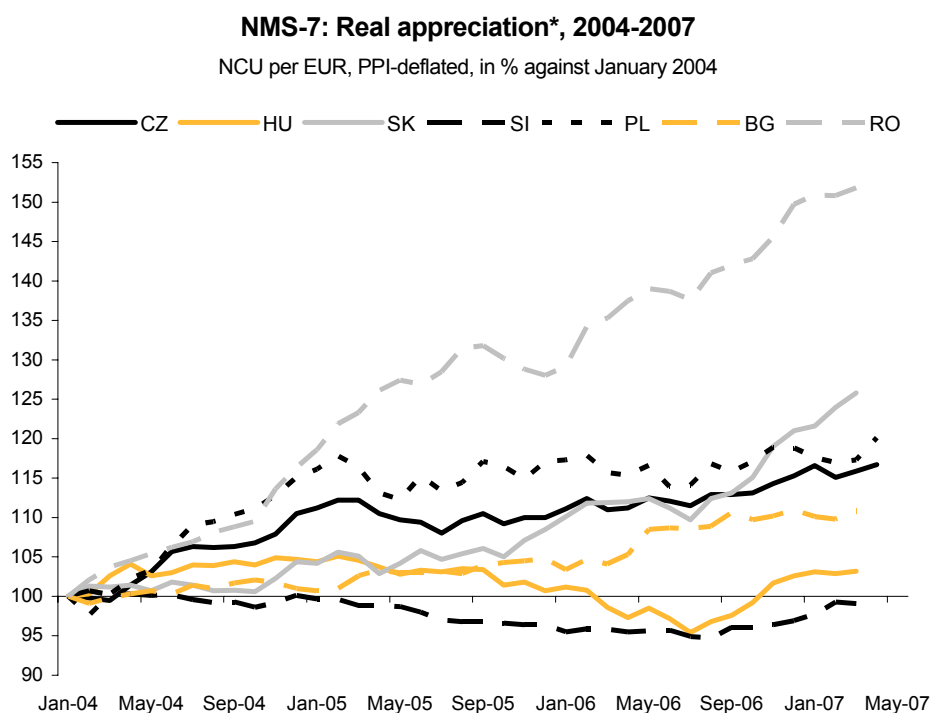
Figure 6



* Increasing line indicates appreciation.

Source: wiw Monthly Database incorporating national statistics.

Figure 7



* Increasing line indicates appreciation.

Source: wiw Monthly Database incorporating national statistics.

Accession to the EU did not bring about a price shock in Bulgaria and Romania. On the contrary, inflation in the first quarter of 2007 was substantially lower than in the corresponding period in the last pre-accession year. In Romania, this development was supported by nominal appreciation.

Taking the consumer price inflation reference value for price stability according to the Maastricht criterion (currently 3.0%)¹⁵ only the Czech Republic, Poland Slovakia (and certainly Slovenia) met the Maastricht criterion in the first quarter of 2007. With regard to our forecast for CPI inflation for 2007, the Czech Republic and Slovakia are seen to be on the verge of non-compliance. Given its aspirations to introduce the euro as early as 2009, Slovakia will have to make every effort to remain on the safe side of inflation up until 2008.

Inflationary pressure may become still stronger in the course of the current year in those countries with: (a) high rates of GDP growth (Poland, Slovakia, Romania and the Baltic states); (b) increasingly frequent labour shortages (Poland, Czech Republic and Hungary); and (c) high rates of capacity utilization (Czech Republic, Hungary, Slovakia and Poland). Lower energy prices and a strong euro against the dollar will ease this pressure; nevertheless, the most effective weapon against (imported) inflation remains nominal appreciation. It has been strong throughout the first quarter of the year and is expected to remain so throughout 2007 and 2008.

On spontaneous euroization and delayed EMU membership in the Czech Republic, Hungary and Poland¹⁶

Sooner or later, all new EU member states (NMS) will be obliged to enter the eurozone. Slovenia already fulfilled this task in January 2007, Malta and Cyprus will introduce the euro in 2008. However, as far as the three largest NMS (Poland, Hungary and the Czech Republic) are concerned, this is unlikely to occur before 2012 – possibly even later. Even if they wanted to, the Hungarian authorities cannot realistically hope for an earlier switch, whereas the Polish and Czech authorities do not seem to be all that keen on surrendering their monetary sovereignty at too early a juncture. Technically, the entry into the eurozone requires that the Maastricht criteria be met.¹⁷ While none of the three countries meets all of the criteria simultaneously, Hungary's situation is arguably the most difficult. Hungary fails to meet four of the five criteria (relating to the public sector deficit, public debt, inflation and interest rates). Eliminating the large deficit in the Hungarian public sector will be a major undertaking. By way of contrast, Poland and the Czech Republic will not find it very difficult to get their public sector deficits under control. Unlike Hungary, neither country has recently run up an excessive deficit. Moreover, high GDP growth (that is expected to continue in the medium term) will reduce the deficit/GDP ratios in both countries, without necessitating any dramatic cuts in social spending. All in all, Hungary's entry into the eurozone is likely to lag behind that of the other two countries. It would appear paradoxical that despite all this, Hungary is still much more 'euroized' than Poland.

Before comparing the internal roles played by the euro in Hungary and Poland, it may be worth reflecting on the significance of the euro in the Czech Republic. At present, no reliable estimates of

¹⁵ European Central Bank.

¹⁶ This section was written by L. Podkaminer. The indicators reported here were calculated from the original statistics of the national banks of the Czech Republic, Hungary, Poland.

¹⁷ As evidenced by the recent refusal to admit Estonia and Lithuania into the eurozone, the Maastricht criteria are at present interpreted literally. Back in 1998, a much more liberal interpretation was applied (to secure the entry of Greece or Belgium).

the stocks of euro-denominated assets and liabilities are available for the latter country. As far back as March 2004, the Czech National Bank stopped reporting on the stocks of assets and liabilities denominated in foreign currencies. However, even then the stocks of deposits and assets denominated in foreign currencies were pretty low – and declining. The share of foreign exchange (FX) loans in total loans to households was but a fraction of 1%, whereas the share of FX loans in total loans to the non-financial sector stood at about 12%. As for the share of FX deposits, households accounted for about 7% and the non-financial sector for about 30%. (The latter fact has limited bearing because normally the non-financial sector does not hold significant amounts of deposits, regardless of their denomination. Moreover, as a rule in the non-financial sector, persistently high debts are also incurred in the form of bank loans).¹⁸ That Czech households and firms alike should prefer to borrow in the domestic currency (and – in the case of households – to hold deposits in the domestic currency as well) is not all that surprising. The interest rate differentials (between the rates applied to the CZK and FX denominated loans/deposits) have been very low. At least since September 2003, the interest rates on CZK loans to firms may have been lower than the rates on the FX loans. Apparently, Czech firms have had little reason to run up debts denominated in foreign currencies. FX deposits would make more sense (as the interest on those deposits is slightly higher than on the CZK deposits). However, given the consistent nominal appreciation of the domestic currency, tying down funds in the form of FX deposits could hardly be deemed rational. Furthermore, since the beginning of 2005, all interest rate spreads have continued to fall. At the same time, since the trend towards appreciation has continued, the Czech Republic has no reason to attach greater importance to the role of foreign exchange than it did at the beginning of 2004. Indeed, it is more likely that its role has diminished still further.¹⁹ It is perhaps no accident that the Czech National Bank no longer reports on the stocks of FX loans/deposits.

In Poland, the shares of the foreign-denominated loans and deposits are generally higher than in the Czech Republic; only the share of FX deposits in the non-financial sector is lower. This may reflect a much higher degree of openness in the Czech economy: the much more important role played by foreign trade transactions relative to domestic sales. The share of FX deposits in the household sector has been declining consistently since 1996 (see Figure 8). This is a natural trend given: (a) the long-term shift towards nominal appreciation of the PLN (that started in the biennium 1995-1996); and (b) the positive interest rate differentials (PLN vs. euro or USD).

Up until March 2004 the large positive interest rate differentials in Poland played a major role in increasing the FX shares in the total loans of households and firms alike. Since then the share of FX loans in total loans to firms has gradually contracted. As can be seen in Figure 9, in more recent times the interest rate differentials between PLN and FX loans to firms have been very small – and have dropped consistently. The advantages of borrowing in FX have been eroded. However, the share of FX loans in total loans to households has stabilized. This may well reflect the fact that despite the drop, the interest rate spreads on loans to households are still significant.²⁰

In terms of recent trends in interest rate spreads Hungary differs radically from both the Czech Republic and Poland. As can be seen in Figure 11, the spreads in question are quite large. Moreover, the spreads have been rising since mid-2006 – primarily because the rise in interest rates

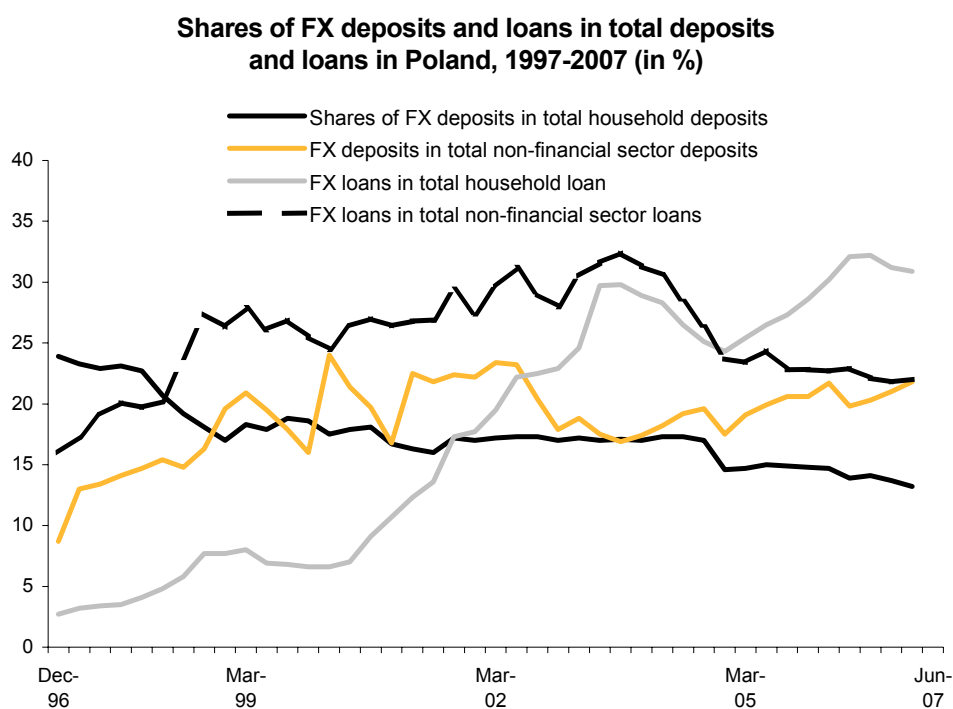
¹⁸ Cash and liquid deposits held by firms represent either payments received (e.g. for export sales) – and not yet invested/spent – or buffers for current expenses.

¹⁹ A recent World Bank estimate puts the share of FX loans to the private sector at 10.4% in 2006.

²⁰ The spreads in question are even larger for the very popular housing loans denominated in Swiss francs (CHF).

on loans/deposits denominated in HUF. Rising interest rates on HUF loans/deposits may be traced back to the hikes in policy interest rates which started in June 2006 – as well as to the weakening of the HUF vs. the euro (over the period June-October 2006).

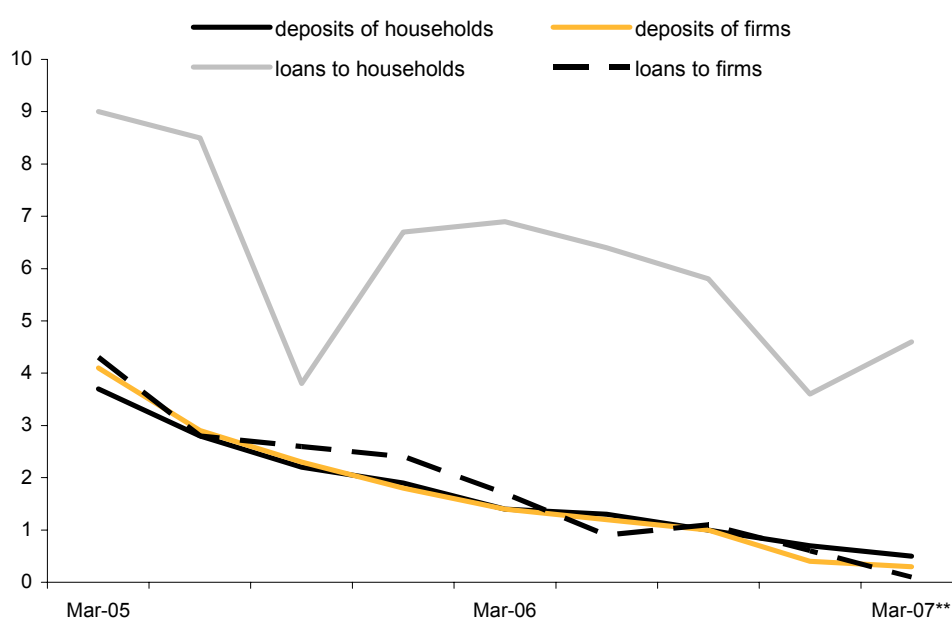
Figure 8



Source: National Bank of Poland.

Figure 9

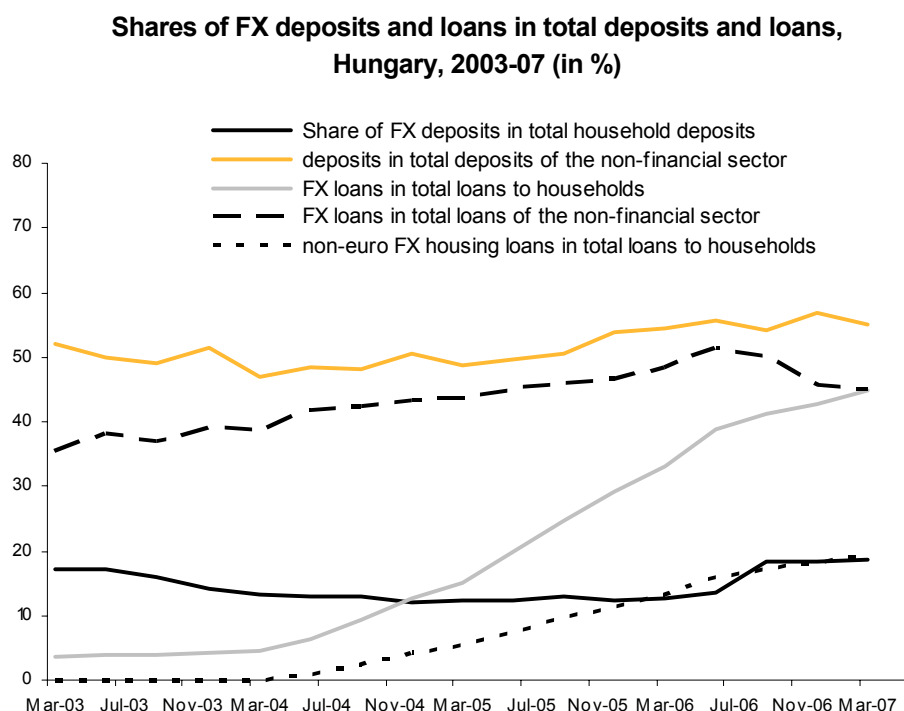
Interest rate spreads between PLN and euro denominated loans and deposits, Poland 2005-2007 (p.p.)



Source: National Bank of Poland

Given the very high interest rate spreads, it is not surprising that both Hungarian households and firms tend to borrow in foreign (rather than domestic) currency (see Figure 3). Interestingly enough, close to 20% of the total stock of loans in the household sector relates to housing loans drawn in foreign currencies other than euro – presumably in CHF. (Interest rate spreads between HUF- and CHF-denominated housing loans are particularly broad, see Figure 11.).

Figure 10



Source: National Bank of Hungary.

Hungary appears to be much more 'euroized' than Poland – and most probably still more so than the Czech Republic.²¹ At the same time, the prospects of Hungary entering the eurozone seem much further away than those of the other two countries. This paradox is apparent rather than real. In actual fact, it is to be expected that the level of 'euroization' tends to be low in a country displaying an inflation rate (and interest rates) roughly the same as those in the eurozone and whose exchange rate vs. the euro is reasonably stable. In such a country, the gains from borrowing (or keeping huge deposits) in euros must perforce be negligible. Conversely, in a country with high inflation/interest rates, 'euroization' is likely to happen either spontaneously (as in the case of Hungary²²) or through administrative action (as in the case of Montenegro, for example). It may be added, that although beneficial – in the short term at least – to the parties involved (banks lending in FX, as well as their customers), spontaneous 'euroization' may well be a risky proposition in a longer-term perspective.

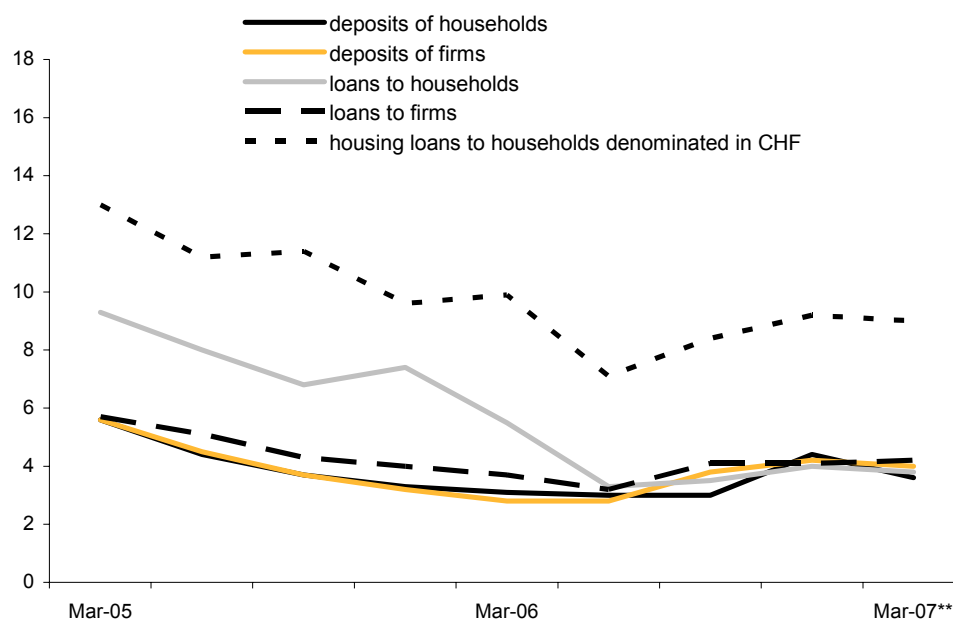
²¹ It may be added that 'euroization' levels are also quite low in Slovakia, which is already a member of the Exchange Rate Mechanism II. In Slovakia, FX loans (to households and non-financial firms, combined) currently account for about 12% of the respective totals, and the FX deposits for 13% of the total.

²² Spontaneous 'euroization' has been typical of the post-Yugoslav countries (including Slovenia as well). Memories of innumerable currency/banking crises in those countries are still deeply engrained and public confidence in the domestic currency is correspondingly limited. The levels of 'euroization' (akin to Hungary's) are also quite high in Bulgaria and Romania which have gone through periods of very high inflation in the 1990s, as well as in the Baltic countries.

First, it may induce appreciation of the domestic currency well beyond levels consistent with economic fundamentals. In practical terms, this may result in the domestic tradable sector suffering a loss in competitiveness and trade/current account deficits increasing. In due time, corrective measures (such as devaluation of the exchange rate) may prove inevitable. Such a move might possibly deliver a hard blow first to those customers with heavy FX debts (households and firms alike) and then their creditors.

Figure 11

**Interest rate spreads between HUF and FX denominated loans and deposits,
Hungary, 2003-2007 (p.p.)**



Source: National Bank of Hungary

Public finances – deficits below and above the 3% benchmark

Periods of strong economic growth are ideal for improving public finance balances, especially when they are essential to meeting the Maastricht criteria for general government position/GDP ratio (a deficit not higher than 3% of GDP).

In Slovakia the deficit/GDP ratio increased slightly in 2006 despite the robust expansion of the country's economy (see Table 23). This was on account of the increased budgetary expenditures initiated by the new Slovak government to fulfil at least some of its pre-election promises to address social tensions that have emerged following the radical reforms introduced by the previous government. Helped by the booming economy, by 2008 the country's deficit/GDP ratio will have been reduced to below the requisite level of 3%, thus removing one obstacle in Slovakia's path to introducing the euro in 2009. The Czech Republic will not be able to sustain the less than 3% deficit/GDP ratio it achieved last year. In all likelihood, the revenue-reducing effect of the planned reforms in taxation will not be matched by additional revenues from cuts in various social benefits and public health-care expenditures. Throughout 2007 and 2008 Poland has every prospect of

adhering to its deficit/GDP reducing policy that it has been pursuing since 2003, but even then it will most likely still remain above the 3% threshold in 2008.

Table 23

General government budget balance in % of GDP ¹⁾									
	2000	2001	2002	2003	2004	2005	2006 ²⁾	2007 forecast	2008 forecast
Czech Republic	-3.7	-5.7	-6.8	-6.6	-2.9	-3.5	-2.9	-4.2	-3.5
Hungary	-3.0	-4.1	-8.9	-7.2	-6.4	-7.8	-9.2	-6.3	-4.0
Poland	-3	-5.1	-5	-6.3	-5.7	-4.3	-4.0	-3.3	-3.2
Slovak Republic	-11.8	-6.5	-7.7	-2.8	-2.4	-2.8	-3.4	-3.0	-2.8
Slovenia	-3.8	-4.1	-2.5	-2.8	-2.3	-1.5	-1.4	-1.5	-1.4
Bulgaria	-0.6	-0.6	-0.7	0.0	1.7	3.2	3.7	3	2.5
Romania	3.2	-2.1	-2.0	-1.5	-1.5	-1.4	-1.9	-3.5	-4.0
Estonia	-0.2	-0.3	0.4	2	2.3	2.3	3.8	3.5	3
Latvia	-2.8	-2.1	-2.3	-1.6	-1.0	-0.2	0.4	-0.3	0
Lithuania	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.3	0.0	0.5

1) EU definition: net lending (+) or net borrowing (-) according to ESA'95, excessive deficit procedure. - 2) Preliminary.

Source: Eurostat; wiiw forecasts.

Hungary suffered an extremely high public deficit in 2006. It was the regrettable consequence of irresponsible economic policy driven by political cycles, further to being aided and abetted by all the major political parties since 2001. After the spring elections in 2006, the incoming 'new-old' government had no choice but to break with the policy (which had been of its own making prior to the elections). The austerity package and a wave of public finance reforms (partly launched, partly in the pipeline) already took effect in 2006, without which the deficit would have been even higher. The full impact will be felt in 2007 and 2008, thus by 2009 the general government deficit/GDP ratio will have come close to the Maastricht criterion. Nevertheless, the reforms have been extremely unpopular. There is every risk that political considerations pertaining to the next elections will slow down the reforms and the final stage of the deficit reduction programme will not materialize.

Of the two EU entrants in 2007, Romania failed to capitalize on the benevolent impact of a booming economy on the fiscal deficit. From a low level in 2005, the deficit/GDP ratio increased in 2006. It is expected to increase further in 2007 and 2008 in the light of the relaxed fiscal policy being pursued by the Romanian government, which justifies its policy by the need to fund infrastructure investments and meet the co-financing requirement of EU-supported projects. Bulgaria has maintained a fiscal surplus since 2004; last year it amounted to close on 4% of the GDP. This surplus will decrease over the next two years, indicating the adoption of a more relaxed fiscal policy in Bulgaria.

Baltic States: is the end of the economic miracle in sight?²³

In the first quarter of 2007 economic growth slowed down slightly in the Baltic States compared to the corresponding period in 2006. Given the patent signs of overheating over the past two years, this could be considered good news. However, the fact that domestic demand continued to accelerate at

²³ This section was written by Sebastian Leitner, wiiw.

the beginning of 2007 merely served to compound the macroeconomic imbalances looming large in all three countries, especially Latvia. The rate of growth in both household consumption and gross capital formation has largely outstripped that of overall economic growth.

The economic boom over the past five years in the Baltic countries has led to dramatically tighter labour markets. The uninterrupted rise in employment led to a drop in unemployment rates in the first quarter of 2007: 5.3% in Estonia, 6.9% in Latvia and 5.6% in Lithuania. Part of this drop in unemployment, however, is attributable to a rise in emigration following accession to the European Union; although this was most prominent in Lithuania, it was also to be observed in Estonia and Latvia. As a consequence of strong demand growth and labour supply constraints, real wage increases have been high in recent years. In all three countries real wage growth surpassed 10% in 2006: the upward trend continued in the first quarter of 2007: 18.5% in Estonia, 23.5% in Latvia and 22.9% in Lithuania. Under these circumstances, governments will have to do their utmost to avoid further wage pressures. However, the Lithuanian parliament envisages a rise in the minimum wage from its current level (35%) to 60% of the average monthly gross wage. In all Baltic States, a subsequent drop in competitiveness has become apparent in the tradable goods sector. Not only are current account deficits on the rise, but gross industrial production has also forfeited its dynamism of old. While industrial output growth in Estonia is still high (7.0% in 2006 and 8.2% in the first quarter of 2007), it slowed down in Latvia to a mere 4% in 2006 and 1.3% in the first quarter of 2007. In Lithuania where industrial production still grew by 7.3% in 2006, growth ground to a halt in the first quarter of 2007: -1.0%. Since producer prices picked up sharply in Estonia and Latvia (7% and 17.7%, respectively, in the first quarter of 2007), employers in the industry and construction sectors in both countries have emphasized the need to open up the labour market to migrant workers also from the CIS and so curtail wage increases.

Another consequence of nominal wage rises outstripping productivity growth by far is that consumer inflation rates have increased in all three Baltic countries. In Latvia, in particular, where consumer prices have increased by more than 6% since 2004, they rose still further to 7.6% in the first quarter of 2007. This is a disturbing trend given that the Latvian currency is pegged to the euro. A similar, but less severe development is to be observed in Estonia and Lithuania. Since consumer price growth is likely remain high for some years to come, the introduction of the euro, which had been a declared short-term aim in Estonia and Lithuania dating back to 2006, has had to be postponed. According to current projections, a more realistic date for the Baltic States' entry into the eurozone would be 2011.

In Latvia, the soaring current account deficit is the clearest indicator of an overheated economy. In all likelihood, the deficit in 2007 will not be much lower than the previous year, when it reached the alarming figure equivalent to 21.1% of GDP. Domestic demand is fuelled by the rapid rise in loans to private households. In June 2007 the National Bank of Latvia raised its discount rate to 6% in an endeavour to curb internal demand. However, the net effect might be minimal given that the exorbitant credit growth taking place there, but also in Estonia and Lithuania, is due to households taking up euro-denominated mortgage loans. Both countries operate currency boards, thus effectively eliminating the scope for influencing the money market. The banking sector in the Baltic States is predominantly foreign-owned; thus, few risks are incurred by channelling capital to households for investment in housing. Moreover, the demand for credit is governed more by developments in euro interest rates than by conditions prevailing on domestic money markets. With inflation rates rising in the Baltic countries, real interest rates have dropped even lower.

As the central banks in the Baltic States do not have much of an influence on the money market, governments ultimately resort to fiscal policy to curb domestic demand. In 2006 Estonia achieved a budget surplus of 3.8% owing to unexpectedly high tax revenues; in 2007 the surplus is once again expected to exceed 3%. Lithuania is also trying to take steam out by means of a balanced budget in 2007 and a surplus of 0.5% the year thereafter. Latvia is in dire need to apply the brakes, yet the government is loath to do so. It does not plan to balance the budget until 2008 and a budget surplus is expected to emerge only in later years. The measures taken by the Latvian government may well not suffice to curb domestic demand and inflation, not to speak of current account deficits. As a consequence, Standard & Poor's downgraded its sovereign ratings for Latvia in May from A- to BBB+ arguing that the overheated economy may be prone to a hard landing.

Clearly, the current situation in the Baltic economies is unsustainable. The rise in inflation rates, most evident in Latvia, together with the fixed exchange rate regimes, have recently brought about a marked real appreciation of the Baltic currencies. In all likelihood, the drop in industrial output growth rates in Latvia and Lithuania and the slowdown in export growth in Estonia and Lithuania are the outcome of the countries' obvious loss in competitiveness. The Baltic governments should thus do their utmost to curb domestic demand.

Summary of the outlook for 2007-2008

According to the latest wiw forecast, the period of high growth in the region will continue in 2007 and 2008, except for Hungary which has no chance of attaining the growth rate of the other NMS-5 countries before 2009. Nevertheless, in all but two countries (the Czech Republic and Hungary) growth rates in 2008 will be somewhat lower than, or only as high as, the current year, thus hinting at constraints on further acceleration or the mere maintenance of the current pace of growth (see Table 24).

Household consumption will remain the engine of growth in the Czech Republic, Poland, Bulgaria and Romania, as well as in the Baltic States. Investments will boom in Poland, Bulgaria, Romania and the Baltic States. Supply-side constraints on a very rapid expansion of the economy will be felt in more and more countries of the region, especially in terms of the labour market. There are clear signs of overheating in Bulgaria, Romania and the Baltic States where the external balance has been deteriorating and no turnaround is in sight. Only in Slovakia does very high growth seem to be sustainable at least over the next two years.

Inflation will remain relatively low. This is the outcome of the contradicting effect of increasing inflationary pressures from an increasingly tight labour market and its consequences, on the one hand, and the considerable nominal appreciation of the national currencies, on the other.

High export growth rates will reflect the favourable international environment and the growing import demand of the region's main trading partner countries, as well as the continuing competitiveness of the NMS. Overheating in Romania, Bulgaria and the Baltic States will become a serious concern given the dynamic growth in imports and the deterioration in net exports.

Table 24

Overview of wiiw forecasts for selected NMS in 2007 and 2008

changes in % *)

		Czech Republic		Hungary		Poland		Slovakia		Slovenia		Bulgaria		Romania	
		2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
Gross domestic product	February 2007	5	5	2.7	3.1	5.3	5	7	7	4.5	4.4	6	5.5	6.5	6
	June 2007	5	5.2	2.7	3.1	6.0	5.5	8.5	8	5	5	6	6	6.0	5.5
Consumption of households	February 2007	4.5	4	-0.3	1	5	4	7	5	3	3	6	5.5	10	8
	June 2007	6	5	-0.3	1	6	5	7	5	3	3	7	7	10	8
Gross fixed capital formation	February 2007	6	4	3	4	15	10	10	8	7	7	15	15	12	10
	June 2007	2	4	3	4	22	18	8	7	10	7	25	20	14	10
Gross industrial production	February 2007	8	8	8	9	8	7	12	10	5	4.5	5	6	6	6
	June 2007	8	9	8	9	10	10	14	10	7	6	7	7	6	6
LFS - unemployment rate in %, annual average	February 2007		6.5	7.9	7.8	14	13	12	11	6	6	8	7	7	7
	June 2007	6.3	6	7.7	7.7	11	10	11	10	5.8	5.5	7.5	7	7	7
Consumer prices	February 2007	2.5	3	6.3	3.5	1.8	2	3	2	2.6	2.3	5	5	6	6
	June 2007	3	2.8	7.0	3.5	2.3	2.5	3	2	2.6	2.3	5	5	4.0	4.5
General governm. budget, % of GDP	February 2007	-3.6	-3.2	-6.5	-4	-3.3	-3.2	-3.0	-2.9	-1.6	-1.5	1	1	-3.0	-3.0
	June 2007	-4.2	-3.5	-6.3	-4.0	-3.3	-3.2	-3.0	-2.8	-1.5	-1.4	3	2.5	-3.5	-4.0
Current account, % of GDP	February 2007	-4.4	-4.0	-4.9	-4.1	-2.0	-2.0	-4.9	-5.1	-2.2	-1.5	-13.5	-13.3	-12.7	-11.0
	June 2007	-4.3	-4.4	-4.6	-3.8	-3.0	-3.5	-4.7	-4.1	-2.2	-1.5	-16.5	-15	-13.0	-11.6
Exports of goods & services, BOP	February 2007	.	.	13.2	12.0	15.5	9.6	.	.	.	.	14.9	11.8	20.9	16.0
	June 2007	12.4	15.5	13.3	12.1	16.6	14.9	35.2	22.6	10.8	9.6	10.2	9.7	18.4	17.1
Imports of goods & services, BOP	February 2007	.	.	9.8	9.7	16.3	11.4	.	.	.	.	14.4	11.3	21.1	15.7
	June 2007	13.7	14.9	9.6	9.7	19.1	19.3	25.8	22.9	10.1	10.0	14.3	12.3	25.6	15.7
Average exchange rate NCU/EUR															
	February 2007	28	27.5	255	250	4.05	4.0	35.0	33.5	1	1	1.956	1.956	3.50	3.55
	June 2007	28	27.5	251	250	3.9	3.9	34.5	33.5	1	1	1.956	1.956	3.36	3.40

Note: *) Real change in % against previous year, unless otherwise indicated.

Source: wiiw forecasts.

Country reports

Anton Mihailov

Bulgaria: populist pressures on the rise

Strong economic growth continued in the first quarter with GDP rising by 6.2% year-on-year underpinned by robust performance in manufacturing and services. Buoyant domestic demand remained the main growth driver: gross fixed capital formation surged by an impressive 35.9% year-on-year while private consumption increased by 8.1% compared to the same period of 2006. By contrast, net exports made a highly negative contribution to GDP growth in the first quarter.

The closure of two nuclear reactors at the Kozloduy power plant at the end of 2006 (a controversial condition for EU accession that had been pressed on Bulgaria almost a decade ago, before the reversal in global public attitude towards nuclear energy) had the effect of a one-time negative shock on industrial output and will have a lasting negative impact on exports as Bulgaria will no longer be in the position of a net exporter of electricity. This outcome was clearly visible in the dynamics of Bulgaria's total exports, which slowed down considerably in the first quarter, both in value and in volume terms. However, the other short-term repercussions of the closure seem to be waning as the rest of the economy adjusted to its effects.

The situation in the labour market continued to improve steadily with the LFS rate of unemployment dropping to 8.0% in the first quarter. LFS data also suggest a robust rise in the level of employment (by 6.6% year-on-year). The shrinking pool of unemployed is largely made up of low-skilled job seekers with little chance of entering gainful employment. Labour shortages are becoming a chronic feature of many sectors of the Bulgarian economy, exerting an upward pressure on real wages, which have been on the rise. While so far there were no visible spillovers on domestic prices, this may only be a matter of time if the present wage rise continues.

In early 2007, the National Statistical Institute reported revised national accounts for the period 2002-2005. These revisions were the result of methodological changes (such as fully applying EU statistical standards in the balance of payments methodology and in the distribution of financial intermediation services in the national accounts) and also reflected the final statistical data for 2005. The revised data considerably changed the picture of Bulgaria's economic growth – indeed, the growth trend – in this period (see Table BG). In the light of the new figures, GDP growth peaked in 2004 and decelerated slightly thereafter, including in 2006 when it increased by 6.1%.

With the euphoria of EU accession subsiding and the farewell shake-hand with the IMF (the final precautionary agreement expired in March 2007), Bulgarian politicians seem to be regaining new appetite for policy activism. Regrettably, they seem to be bowing to a wave of rising populist pressures – mirroring the overall upward pressure on wages – both within the ruling tripartite coalition dominated by the Socialist Party and generally in the country. Incomes policy – whose tightness until now had been one of the pillars of macroeconomic stability and national competitiveness – seems to be the first line of defence that is giving way. Succumbing to the threat of a strike by public transport employees in Sofia in the run-up to the first election of Bulgarian members of the European Parliament in May, the authorities agreed to an increase in their wages

Table BG

Bulgaria: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008 forecast
Population, th pers., end of period	7845.8	7801.3	7761.0	7718.8	7679.3	.	.	.	.
Gross domestic product, BGN mn. nom.	32401.6	34627.5	38822.6	42797.4	49090.6	9978.6	11493.4	53500	59000
annual change in % (real)	4.5	5.0	6.6	6.2	6.1	5.5	6.2	6	6
GDP/capita (EUR at exchange rate)	2101	2263	2551	2827	3260	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	6100	6760	7330	7890	8740	.	.	.	.
Gross industrial production									
annual change in % (real) ²⁾	6.5	14.1	13.8	8.4	5.8	7.3	7.3	7	7
Gross agricultural production									
annual change in % (real)	5.3	-9.9	6.6	-6.0	0.6	.	.	.	.
Construction output total									
annual change in % (real)	2.7	5.6	35.2	1.0	.	.	.	.	.
Actual final consump. of househ., BGN mn. nom.	25630.2	27444.4	30155.5	33556.4	37897.3	8418.5	9452.5	.	.
annual change in % (real)	4.0	6.3	5.3	5.5	7.1	5.7	8.1	7	7
Gross fixed capital form., BGN mn. nom.	5908.5	6694.4	7969.4	10346.5	12878.3	2345.2	3386.2	.	.
annual change in % (real)	8.5	13.9	13.5	23.3	17.6	17.1	35.9	25	20
LFS - employed persons, th. avg.	2739.6	2834.8	2922.5	2980.0	3110.0	2940.5	3135.4	3200	3300
annual change in %	1.5	3.5	3.1	2.0	4.4	3.6	6.6	3	3
Reg. employees in industry, th pers., avg.	666.8	689.5	695.8	693.0	694.3	700.6	705.3	.	.
annual change in %	1.3	3.4	0.9	-0.4	0.2	-2.5	0.7	.	.
LFS - unemployed, th pers., average	592.4	448.7	399.7	334.2	305.7	315.2	272.7	260	240
LFS - unemployment rate in %, average	17.8	13.7	12.0	10.1	9.0	9.7	8.0	7.5	7
Reg. unemployment rate in %, end of period	16.3	13.5	12.2	10.7	9.1	10.8	8.9	8.0	7.5
Average gross monthly wages, BGN	257.6	273.3	292.4	323.7	354.6	329.0	384.0	410	450
annual change in % (real, gross)	1.5	3.7	0.8	5.4	2.1	1.9	10.9	10	5
Consumer prices, % p.a.	5.8	2.3	6.1	5.0	7.3	8.0	5.2	5	5
Producer prices in industry, % p.a.	1.2	4.9	6.0	6.9	9.4	8.4	7.4	6	5
General governm. budget, nat. def., % GDP									
Revenues	38.7	40.6	40.8	42.0	40.8	43.9	44.0	.	.
Expenditures	39.3	40.6	39.1	38.9	37.2	39.6	39.3	.	.
Deficit (-) / surplus (+), % GDP	-0.7	0.0	1.7	3.2	3.7	4.3	4.7	3	2.5
Public debt in % of GDP ³⁾	53.2	46.2	38.8	29.9	23.0	24.9	20.8	20	16
Base rate of NB, % p.a., end of period	3.4	2.9	2.4	2.1	3.3	2.3	3.6	.	.
Current account, EUR mn	-402.5	-972.3	-1306.9	-2621.9	-3977.9	-1093.6	-1501.7	-4500	-4500
Current account in % of GDP	-2.4	-5.5	-6.6	-12.0	-15.8	-21.4	-25.6	-16.5	-15
Gross reserves of NB excl. gold, EUR mn	4247.1	4981.0	6443.0	6815.7	8309.0	6399.6	8343.4	.	.
Gross external debt, EUR mn	10768.9	10640.6	12658.5	15089.6	19669.9	16112.2	20294.1	.	.
Gross external debt in % of GDP	65.0	60.1	63.8	69.0	78.4	.	.	.	.
FDI inflow, EUR mn	980.0	1850.5	2735.9	3103.3	4104.5	789.6	770.8	4300	4500
FDI outflow, EUR mn	28.9	23.3	-165.6	249.1	121.8	22.8	10.1	.	.
Exports of goods, BOP, EUR mn	6062.9	6668.2	7984.9	9466.3	11982.6	2672.3	2837.3	13200	14500
annual growth rate in %	6.1	10.0	19.7	18.6	26.6	28.4	6.2	10	10
Imports of goods, BOP, EUR mn	7940.9	9093.8	10938.4	13876.1	17372.7	3725.7	4322.1	20000	22500
annual growth rate in %	6.0	14.5	20.3	26.9	25.2	33.0	16.0	15	13
Exports of services, BOP, EUR mn	2455.0	2728.7	3262.1	3564.1	3990.2	551.1	651.5	4400	4800
annual growth rate in %	1.1	11.1	19.5	9.3	12.0	4.5	18.2	10	9
Imports of services, BOP, EUR mn	1949.6	2176.0	2605.8	2745.2	3270.1	728.0	779.7	3600	4000
annual growth rate in %	-7.1	11.6	19.8	5.3	19.1	29.0	7.1	10	11
Average exchange rate BGN/USD	2.077	1.733	1.575	1.574	1.559	1.627	1.493	.	.
Average exchange rate BGN/EUR (ECU)	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956
Purchasing power parity BGN/USD	0.582	0.555	0.574	0.588	0.613	.	.	.	.
Purchasing power parity BGN/EUR	0.675	0.655	0.681	0.701	0.729	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) Different methodology for quarterly data. - 3) According to ESA'95. excessive deficit procedure.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

that is hardly justifiable on economic grounds. Concomitantly, the government significantly softened the regulations preventing loss-making state-owned firms from raising their wages. These policy acts – constituting a typical situation of moral hazard – provoked a wave of new demands for wage increases, in the first place, by unionized public sector employees, which will be difficult to arrest given the weakened credibility of the authorities. Undoubtedly, there will be repercussions on wage formation in the private sector as well. In turn, it can be expected that the ensuing income rises will have a negative effect on both inflation and the current account balance. The demands for wage hikes are not the only source of populist pressure on fiscal spending. Other claims have also been on the rise, in particular, for pension hikes but also from farmers, for compensations due to unfavourable weather conditions.

While these medium-term risks remain, there has been no immediate fallout on the fiscal stance as higher spending was more than offset by continuing windfall gains in fiscal revenue. In January-April, the consolidated general government revenue was up by 17.6% year-on-year while expenditure was up by 8.9%, resulting in a surplus which was 45% higher than a year earlier. This was a somewhat unexpected outcome as it had been widely believed that the changeover in the administration of VAT after EU accession would have negative implications on tax collection. The sources of the current windfall are still unclear so it remains to be seen how the fiscal situation will develop through the year. In April, the Bulgarian government retired ahead of schedule the remainder of the country's debt to the IMF, paying back SDR 204.8 million (some BGN 450 million), which was the third and last operation on advanced debt repayment to the IMF.

On the negative side, the current account deficit continued to expand, both in absolute and in relative terms, under the combined effect of several factors such as the rise in real wages, the deceleration of export growth and a renewed surge in domestic credit. After the lifting of credit restrictions at the end of 2006, the credit expansion has resumed but at more moderate rates than those seen a couple of years ago. In retrospective, the empirical evidence indicates that bank lending to the corporate sector was rather sensitive to these administrative controls (in mid-2006, net new bank lending to the corporate sector went to a standstill), whereas lending to households was less affected. This sensitivity now works in the reverse direction, with corporate lending recovering much faster than lending to households. Despite its widening, the current account deficit is almost fully covered by inward FDI, mitigating to a certain extent the short-term risks associated with it.

Nevertheless, the current account deficit, together with the persistently high (by EU standards) inflation, remain the main stumbling blocks on Bulgaria's road towards adopting the euro. Upon EU accession, Bulgaria voiced its intention for a fast-track entry to the euro zone, in particular, by entering ERM-2 already in 2007, with a view to acceding to the EMU around 2010-11. While in principle endorsing Bulgaria's intention to join ERM-2, the ECB seems a bit hesitant about fast-track entry to the euro zone on the grounds that Bulgaria needs a longer catch-up period during which fast economic growth will be accompanied by higher inflation. Obviously, the timing of EMU accession will be subject to further discussions.

The short-term outlook for the Bulgarian economy is little changed from the previous quarter. Both in 2007 and 2008, GDP is expected to grow at around 6% per annum, bringing about a further rise in employment and a fall in the rate of unemployment. With labour shortages becoming more acute, cost-push inflation in the form of wage pressure is becoming the key pro-inflationary factor in the country. Under the present coalition government, the considerable wage rises already experienced

in the first quarter are set to continue and therefore no major progress in disinflation can be expected in the short run. Despite the pressures for higher public spending, the general government budget will remain in surplus but its magnitude is difficult to predict. If public revenues remain as buoyant as they were in the first quarter, the surplus may be comparable to that recorded in 2006, but this is something to follow over the course of the year. With real wages rising, export revenues dampened by the discontinuation of electricity exports and FDI continuing to surge, no options for curbing the current account deficit are in sight in the short run.

Leon Podkaminer

The Czech Republic: stagnant investment augurs overall growth slowdown

GDP growth, which had accelerated until the fourth quarter of 2005, has been slowing down since. Although, at over 6%, growth in the first quarter of 2007 looks again impressive, the slowdown appears to be associated with rather unfavourable longer-term changes in the composition of final demand. Throughout 2005 growth was driven primarily by foreign trade (in goods and non-factor services), contributing 4.8 percentage points to the overall GDP growth rate of 6.5%; household consumption contributed a further 1.2 p.p. (and the government consumption 0.5 p.p.) while gross fixed capital formation a mere 0.6 p.p. Throughout 2006 the contribution of foreign trade was diminishing. In the first quarter of 2007 that contribution was already negative (-0.6 p.p.). Private consumption has gradually become the main driver of growth (its contribution advanced from 2.1 p.p. in the whole of 2006 to 3.1 p.p. in the first quarter of 2007). Gross fixed capital formation, which grew remarkably throughout 2006, sagged suddenly in the first quarter of 2007, contributing a mere 0.3 p.p. to overall growth. However, it is the performance of inventories which is most intriguing. Inventories increased strongly already in 2006 (generating 1.1 p.p. of the overall GDP growth). The further rise in inventories, presently registered, turns out to be the major factor behind overall GDP growth (contributing an unprecedented 3.1 p.p.). Quite obviously, such a massive accumulation of inventories cannot be sustained for very long. In case there is no further growth in inventories, the quarterly GDP growth rate would – *ceteris paribus* – fall to 3%. If part of the inventories turns out to be excessive, which cannot be ruled out, their liquidation would then depress the overall growth even more. Unfortunately, the official statistics are mute on the nature of rising inventories. However, some evidence on the construction sector (volumes of dwellings under construction, new orders for other types of construction activities, etc.) suggests that the levels of works in progress is about normal (by the standards of the past few years). Thus the rising inventories may rather represent unsold stocks of products and stockpiling supplies of raw materials. Should this be the case, the eventual halt (or reversion) of the inventory accumulation is likely to come sooner rather than later. Moreover, it would have a more disturbing character compared to a situation when a large share of inventories represents investment projects awaiting completion.

The sudden, and wholly unanticipated, strong slowdown in growth of gross fixed capital formation in the first quarter of 2007 is quite remarkable as it comes at a time when gross value added in the corporate sector is reported to be rising substantially and when, simultaneously, loans and credits to the non-financial corporate sector have been expanding very rapidly (at about 20% year-on-year).²⁴

²⁴ Gross fixed investment (rising 1.5% in the first quarter of 2007) comprises investment by business as well as by private households (primarily dwellings) and by the government (transport infrastructure, public buildings etc). Investment by

Clearly, it is not a shortage of funds that limits investment in fixed domestic assets. Rather, one might speculate about a worsening of medium-term sales' prospects as deterring investment. This could be a natural development given the accumulation of inventories. Alternatively, the reasons for the falling propensity to invest may have something to do with firms' growing interest in moving their activities abroad and/or rising repatriation of profits. The possible diversion of investment and funds from the domestic to foreign markets should not come as a big surprise. After all, much of the Czech economy is actually owned/controlled by foreign parties²⁵ which are unlikely to have become local patriots.

Rising private consumption will continue to be a firm pillar of growth in both 2007 and 2008. The strong increase in private consumption is firmly supported by a strengthening wage bill. This trend is combined with rising demand for labour, rising employment (also of foreign migrant workers) and falling unemployment. The tightening labour market, with increasing incidence of labour shortages, will be strengthening the employees' position vis-à-vis their employers. It may be important though to observe that this is not really threatening high profits, at least not in the near future. In actual fact, owing to strong gains in labour productivity and rising levels of utilization of the production capacities, gross operating surpluses (*cum* mixed income of the household sector) have been rising faster than employees' compensation. Thus the current strengthening of wages can be seen as a return to the proportions between wages and profits that were there in the past.²⁶ Nonetheless, concerns about the medium-term consequences of rising wages are legitimate – especially given the slowdown of investment in fixed productive assets. One does not need to fear so much the negative consequences of eroding profit margins; these are high enough. But one can expect a somewhat higher acceleration of wage hikes which may be fuelled simultaneously by rising unit labour costs and stronger consumer demand.

The weak growth of gross fixed investment (and a possible stagnation of the stock of inventories) will most probably somewhat reduce the demand for imports of investment goods and intermediate inputs. The general stabilization of prices (at levels lower than in 2006) of imported energy expected in 2007 will also help to reduce imports – though the consumer demand for imports of goods and services is likely to remain robust. At the same time growth of exports is expected to remain quite strong even if the domestic (i.e. actually predominantly foreign-owned) export-oriented manufacturing firms have to mobilize reserves to achieve rates of growth of sales as recorded in 2005 or 2006. A new surge in export activities, in 2008 and beyond, may have to await the completion of new FDI projects. All in all, foreign trade will continue to generate surpluses of the same order as in recent years. However, the contribution of trade to overall GDP growth is forecasted to be close to zero in both 2007 and 2008.

The tightening labour market and high levels of capacity utilization are cited as reasons for concern at the Czech National Bank. Although at the moment inflation is still quite low, the CNB

business may be proxied by the volume of machinery and equipment installed. That volume *fell* by about 4% in real terms.

²⁵ The share of foreign-owned firms in industrial output (sales) is over 60%. They account for about 90% of manufacturing exports.

²⁶ For example in 2003, when employees' compensation constituted 47.9% of the gross value added (against 47.0% in 2006).

Table CZ

Czech Republic: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year	10200.8	10201.7	10206.9	10234.1	10266.6	.	.	.	.
Gross domestic product, CZK bn. nom. ²⁾	2464.4	2577.1	2817.4	2994.4	3220.3	742.6	816.1	3480	3760
annual change in % (real) ²⁾	1.9	3.6	4.6	6.5	6.4	6.6	6.1	5	5.2
GDP/capita (EUR at exchange rate) ²⁾	7841	7933	8652	9824	11067	.	.	.	.
GDP/capita (EUR at PPP - wiiw) ²⁾	14580	15390	16600	17430	19090	.	.	.	.
Gross industrial production									
annual change in % (real) ³⁾	1.9	5.5	9.6	6.7	9.7	14.8	12.4	8	9
Gross agricultural production									
annual change in % (real)	-4.4	-7.6	14.9	-4.8	.	.	.	.	.
Construction industry									
annual change in % (real)	2.5	8.9	9.7	4.2	6.6	0.5	29.0	.	.
Consumption of households, CZK bn. nom. ²⁾	1248.1	1317.4	1400.0	1445.8	1532.0	349.7	376.8	.	.
annual change in % (real) ²⁾	2.2	6.0	2.9	2.4	4.4	3.8	6.7	6	5
Gross fixed capital form., CZK bn. nom. ²⁾	677.8	687.5	727.2	746.1	812.9	179.9	185.3	.	.
annual change in % (real) ²⁾	5.1	0.4	3.9	2.3	7.6	6.8	1.5	2	4
LFS - employed persons, th. avg. ⁴⁾	4764.9	4733.2	4706.6	4764.0	4828.1	4785.2	4864.9	.	.
annual change in %	0.8	-0.7	-0.6	1.2	1.3	1.7	1.7	1.3	1.3
LFS - employed pers. in industry, th. avg. ⁴⁾	1463.1	1424.7	1409.0	1422.0	1493.3	1476.3	1515.7	.	.
annual change in %	-0.1	-2.6	-1.1	0.9	5.0	5.4	2.7	.	.
LFS - unemployed, th pers., average	374.1	399.1	425.9	410.2	371.3	414.1	311.2	.	.
LFS - unemployment rate in %, average ⁴⁾	7.3	7.8	8.3	7.9	7.1	8.0	6.0	6.3	6
Reg. unemployment rate in %, end of period	9.8	10.3	9.5	8.9	7.7	8.8	7.3	7	6.5
Average gross monthly wages, CZK ⁵⁾	15866	16917	18041	18992	20207	18918	20399	.	.
annual change in % (real, gross)	5.4	6.5	3.7	3.3	3.8	4.1	6.2	4.4	4.4
Consumer prices, % p.a.	1.8	0.1	2.8	1.9	2.5	2.8	1.6	3	2.8
Producer prices in industry, % p.a.	-0.5	-0.4	5.7	3.0	1.6	0.3	3.2	2.5	2
General governm. budget, EU-def., % GDP ⁶⁾									
Revenues	39.5	40.7	41.5	40.4	39.5	.	.	38.0	38.0
Expenditures	46.3	47.3	44.4	44	42.5	.	.	42.2	41.5
Deficit (-) / surplus (+)	-6.8	-6.6	-2.9	-3.5	-2.9	.	.	-4.2	-3.5
Public debt, EU-def., in % of GDP ⁶⁾	28.5	30.1	30.7	30.4	30.4	.	.	31.4	32.2
Discount rate, % p.a., end of period	1.8	1.0	1.5	1.0	1.5	1.0	1.5	.	.
Current account, EUR mn	-4442	-5028	-4651	-1638	-3561	616.5	477.4	-5400	-6000
Current account in % of GDP	-5.6	-6.2	-5.3	-1.6	-3.1	2.4	1.6	-4.3	-4.4
Gross reserves of NB incl. gold, EUR mn	22614	21340	20884	25054	23882	24570	23826	.	.
Gross external debt, EUR mn	25738	27624	33212	39379	44263	38607	.	.	.
Gross external debt in % of GDP	32.2	34.1	38.1	39.5	39.2	.	.	.	.
FDI inflow, EUR mn	9090	1875	4009	9354	4760	541.2	1079.5	.	.
FDI outflow, EUR mn	221	183	824	-12	1073	88.1	142.3	.	.
Exports of goods, BOP, EUR mn	40713	43055	54091	62781	75684	17939.7	21352	86000	100000
annual growth rate in %	9.2	5.8	25.6	16.1	20.6	24.9	19.0	14	16
Imports of goods, BOP, EUR mn	43034	45239	54517	60797	73283	16856.6	19847.6	84000	97000
annual growth rate in %	5.7	5.1	20.5	11.5	20.5	25.7	17.7	14	16
Exports of services, BOP, EUR mn	7502	6880	7761	9478	10603	2365.1	2387.9	11000	12000
annual growth rate in %	-5.3	-8.3	12.8	22.1	11.9	20.9	1.0	5	5
Imports of services, BOP, EUR mn	6796	6464	7245	8254	9384	2111.9	2200	10000	11000
annual growth rate in %	9.3	-4.9	12.1	13.9	13.7	28.2	4.2	5	5
Average exchange rate CZK/USD	32.74	28.23	25.70	23.95	22.61	23.79	21.40	.	.
Average exchange rate CZK/EUR (ECU)	30.81	31.84	31.90	29.78	28.34	28.59	28.04	28	27.5
Purchasing power parity CZK/USD	14.27	13.89	14.03	14.08	14.15	.	.	.	.
Purchasing power parity CZK/EUR	16.57	16.41	16.63	16.79	16.43	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) According to new calculation. - 4) From 2002 weighted according to census 2001. - 5) Enterprises with more than 20 employees, including part of the Ministry of Defence and the Ministry of the Interior. - 6) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.

forecasting model, as of April 2007, predicts inflation ranging between 3.2% and 4.2% by December 2007 and between 2.7% and 4.1% by December 2008.²⁷ The CNB responded accordingly, by raising its interest rates (first by 0.5 p.p. in September 2006, and by a further 0.25 p.p. on 31 May 2007). The market rates have been on the rise as well – but still remain quite low. Yields on ten-year government bonds are still lower than in the euro area. Despite this the Czech currency does not weaken nominally vs. the euro. The CNB decisions look traditionally cautious. Nonetheless they will not be conducive to any faster rise in gross fixed investment, or in consumer credit.

The political situation remains unstable because the liberal-conservative government installed in December 2006 has a fairly shaky parliamentary backing. Despite this it has recently tabled a proposal for a fiscal reform which is likely to prove controversial. The draft reform stipulates substantial cuts in various social benefits and in spending on public health care – but a rise in the lower (i.e. applied to foodstuffs) of the country's two VAT rates (from 5% to 9%). The corporate income tax rate is to be gradually reduced from the current 24% to 19% by the year 2010. A flat tax rate of 15% (on a broader base) is to replace the present progressive personal income tax system (with rates ranging between 12% and 32%). There is little doubt that on the whole the reform will serve well primarily the relatively well-off population strata. At the same time it will probably do very little (if anything) to support a sustainable consolidation of public finances. Despite strong GDP growth (and other favourable conditions: low level of public debt, low long-term interest rates) the general government deficit is now expected to surpass 4% of the GDP in 2007. This is a clear breach of the Convergence Programme. This outcome is blamed on the high growth of mandatory social spending. However, this is inaccurate. One cannot ignore the fact that it is the revenue side which has been contracting, relative to the GDP, very fast in recent years.²⁸ Given the plans to cut taxes even further, one cannot expect the deficit to fall below 3% of the GDP also in 2008 and even in 2009.

The stubborn persistence of the public sector's fiscal deficits is one the chief reasons for the Czech authorities' cautiousness concerning the prospects of adoption of the euro. The current (as of October 2006) official position (co-authored by the CNB and the government) stipulates the postponement of the *potential* entry into the euro area beyond the originally planned horizon of 2009-10. But there are other concerns such as over allegedly low flexibility of the Czech labour market and the persistent differences (vs. the euro area) in the price levels. All in all, the Czech authorities simply do not seem convinced that an early adoption of the common European currency will be particularly beneficial.

Summing up, GDP growth in 2007 will be lower than in 2005-06, primarily on account of weak growth of gross fixed investment and a possible stagnation (or downward adjustments) in the level of inventories. After the adjustment in inventories and the inauguration of fresh production capacities in manufacturing, growth may accelerate again in 2008. Private consumption, fuelled by rising employment and wages, will be the main force behind growth in both 2007 and 2008.

²⁷ See www.cnb.cz/forecast. The same source predicts GDP growth in 2007 ranging between 4.9% and 6.5%, followed by 3.8-6.8% for 2008. Interestingly, the inflation forecasts excluding the first-round impacts of rising indirect taxes are much lower (e.g. 2.1-3.5% by March 2008). It appears that the CNB essentially fights an inflation driven by higher taxes rather than higher demand or higher costs.

²⁸ Between 2004 and 2007 the overall general government revenue/GDP ratio has fallen by 3.4 percentage points, but the expenditure/GDP ratio by 2.3 p.p.

Growth in exports and imports will be less impressive in 2007 – also because of emerging supply-side bottlenecks. But the contribution of foreign trade to GDP growth is likely to be neutral in both 2007 and 2008. The consolidation of public finances will proceed very slowly with the entry into the euro area delayed until 2011, at the earliest.

Sándor Richter

Hungary: shrinking deficits, lower growth

Amidst the austerity measures introduced in the second half of 2006 and early 2007, economic growth continued its gradual deceleration that had started already in the first quarter of last year. The 2.7% expansion in the first quarter of 2007 is the weakest among the NMS-10. That growth slowdown represents the 'collateral damage' of the economic policy measures aimed at diverting Hungary from its mid-2001 to mid-2006 growth path that has led to unsustainable fiscal imbalances. Signs of a transition to a more balanced growth path are clearly visible: both the foreign trade and the budget deficits have been shrinking, and the HUF/EUR exchange rate, after volatilities and depreciation in 2006, returned to its longer-run level of 245-250 by April-May this year.

Taking advantage of the favourable external environment due to more robust EU growth in general and the upturn in Germany in particular, the highly specialized Hungarian industry managed to maintain its dynamic expansion. The 8.8% growth rate of industrial output in the first quarter disguises a stagnation of domestic sales and a 17% expansion of sales on foreign markets.

Exports have been the main engine of growth. In the first quarter of 2007 they expanded by 18.2%, in euro terms, 3.5 percentage points more rapidly than imports (customs statistics). The foreign trade deficit more than halved compared to the respective period of 2006.

According to investment statistics, in the first quarter investment in new assets recovered from the decline in the previous year, even if growth was marginal compared to the respective period in 2006 (gross fixed capital formation, a broader category used in national accounts, slightly declined). Due to the decelerating pace of highway construction and the decline in outlays for housing, construction-related investments dropped by 7.3% while investment in machinery and equipment increased by a spectacular 15.5%. The over 50% expansion of manufacturing sector investments is promising for the future.

As envisaged in the convergence programme, government consumption declined strongly, and consumption of households hardly changed in the first quarter, resulting in a 1.7% drop in total consumption.

Indicators for employment and wages reflect the impact of the government's efforts to reduce the fiscal deficit. The number of employed in the whole economy remained almost unchanged, with employment in the business sector increasing by 1.5% and that in the public sector (employing 27% of all employees in Hungary) declining by 4.2% in the first quarter. The gap between the incomes earned in the two sectors has been growing as well. In the first quarter net earnings in the public sector decreased by 1.2%, while in the business sector they expanded by 2.6%. With unemployment unchanged, labour shortage in certain branches has become a problem. According

to a recent survey 21% of firms employing more than 250 persons report difficulties in meeting their demand for labour. Skilled workers and engineers with foreign language skills are the most demanded professions.

Inflation accelerated in early 2007 and reached its climax in March with 9% (month to month) following considerable price rises for household energy, public transport and pharmaceutical products as a consequence of abolished or redesigned price subsidies for the products concerned. Price rises for food products were unexpectedly high. All in all consumer price inflation proved to be higher than envisaged in the convergence programme. The higher than expected CPI inflation along with a stronger than projected exchange rate allowed the Monetary Council to leave the base rate unchanged until 26 June, when it was reduced from 8% to 7.75%.

As a consequence of the first wave of austerity measures in the second half of 2006, the fiscal balance began to improve and the 2006 general government deficit/GDP ratio turned out to be less (9.2%) than predicted in the government's convergence programme (10.1%). That was the result of the strict observation of expenditure plans coupled with higher than forecasted revenues from various (partly new, partly raised) taxes and fees. As a result of more rigorous regulations and control a certain 'whitening' of the shadow economy has begun. In the first four months of 2007 the fiscal deficit continued to turn out better than planned. Helped by the somewhat higher than envisaged inflation, revenues from fees, indirect taxes and personal income taxes have been continuously higher than originally planned. Moreover, this year even expenditures (in healthcare) have so far been lower than foreseen in the convergence programme.

The fiscal deficit remains the key question of any forecast for Hungary in 2007. In earlier reports wiiw reckoned with a lower (6.5%) general government deficit/GDP ratio for this year than the government's target in the convergence programme (6.8%). In May the government revised its 2007 forecast for some macroeconomic indicators, among others for the fiscal deficit as well. The most recent target figure for the general government deficit/GDP ratio is 6.4%. Considering the higher inflation as well as the strong exchange rate and the lower yields that are expected to diminish interest expenditures, wiiw has marginally revised its forecast for the deficit/GDP ratio to 6.3%.

The decline in household consumption is expected to be smaller (wiiw forecast: 0.2%) than that foreseen in the May forecast of the government (0.6%). Though real household incomes will fall this year, we expect that households will response by 'smoothing' their consumption expenditures. This assumption is supported by the strong increase in household credits in 2006 and in the first months of 2007. In the business sector an upturn in long-term credits in late 2006 hints at a turnaround in investments. High capacity utilization and lively foreign demand also support a moderate recovery of investment after the decline in 2006. The government's May forecast reckons with more dynamic growth of exports than that of imports, with the difference in the growth rates amounting to 2.6 percentage points. The wiiw forecast predicts that the gap between export and import growth rates will be bigger, 3.4 p.p., and as a consequence the balance of trade and services is assumed to close with a surplus this year. The wiiw sticks to its earlier GDP growth forecast of 2.7% for this year, that is 0.5 p.p. higher than the May forecast of the government (this target remained as originally set out in the convergence programme).

Table HU

Hungary: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., end of period	10142.4	10116.7	10097.5	10076.6	10064.0	10072	10059	10060	10060
Gross domestic product, HUF bn, nom. ²⁾	17180.6	18940.7	20717.1	22055.1	23752.7	5143.2	5750.8	25800	27500
annual change in % (real) ²⁾	4.4	4.2	4.8	4.1	3.9	4.9	2.7	2.7	3.1
GDP/capita (EUR at exchange rate) ²⁾	6961	7376	8144	8815	8925	.	.	.	.
GDP/capita (EUR at PPP - wiiw) ²⁾	12710	13230	13930	14690	16040	.	.	.	.
Gross industrial production									
annual change in % (real)	2.8	6.4	7.4	7.0	10.1	13.3	8.8	8	9
Gross agricultural production									
annual change in % (real)	-4.1	-4.5	22.9	-8.5	-2.9	.	.	.	.
Construction industry									
annual change in % (real)	17.5	2.2	6.8	18.8	-1.6	8.6	3.3	.	.
Consumption of households, HUF bn, nom. ²⁾	9078.8	10232.2	11006.5	11835.6	12394.9	2872.9	3087.2	.	.
annual change in % (real) ²⁾	10.6	8.3	2.9	3.7	1.4	2.6	0.6	-0.3	1
Gross fixed capital form., HUF bn, nom. ²⁾	3958.3	4177.3	4650.7	5016.7	5185.8	897.4	957.0	.	.
annual change in % (real) ²⁾	10.2	2.2	7.6	5.3	-2.1	9.9	-2.3	3	4
LFS - employed persons, th, avg.	3870.6	3921.9	3900.4	3901.5	3930.1	3885.3	3905.5	.	.
annual change in %	0.1	1.3	-0.5	0.0	0.7	0.4	0.5	.	.
Reg. employees in industry, th pers., avg. ³⁾	817.9	801.8	785.4	762.9	752.2	751.9	748.4	.	.
annual change in %	-1.9	-2.0	-2.0	-2.9	-1.4	-2.6	-0.5	.	.
LFS - unemployed, th pers., average	238.8	244.5	252.9	303.9	316.8	323.6	316.3	.	.
LFS - unemployment rate in %, average	5.8	5.9	6.1	7.2	7.5	7.7	7.5	7.7	7.7
Reg. unemployment rate in %, end of period	8.0	8.3	9.1	9.3	9.2	9.6	10.3	.	.
Average gross monthly wages, HUF ³⁾	122482	137187	145520	158343	171239	171796	183960	.	.
annual change in % (real, net)	13.6	9.2	-1.0	6.3	3.5	5.7	-7.0	-3	1
Consumer prices, % p.a.	5.3	4.7	6.8	3.6	3.9	2.5	8.5	7.0	3.5
Producer prices in industry, % p.a.	-1.8	2.4	3.5	4.3	6.5	4.7	3.5	5	4.5
General governm.budget, EU-def., % GDP ⁴⁾									
Revenues	42.3	41.9	42.5	42.2	43.7	.	.	.	.
Expenditures	51.2	49.1	48.9	50.0	53.0	.	.	.	.
Deficit (-) / surplus (+)	-8.9	-7.2	-6.4	-7.8	-9.2	.	.	-6.3	-4.0
Public debt, EU-def., in % of GDP ⁴⁾	54.0	58.0	59.4	61.7	66.0	.	.	.	.
Base rate of NB, % p.a., end of period	8.5	12.5	9.5	6.0	8.0	6.0	8.0	.	.
Current account, EUR mn	-4929.2	-5933.0	-6915.5	-6090.6	-5196.9	-1455.3	-1101.9	-4700	-4200
Current account in % of GDP	-7.0	-7.9	-8.4	-6.9	-5.8	-7.2	-4.8	-4.6	-3.8
Reserves total, excl. gold, EUR mn	9887.4	10108.3	11670.9	15678.4	16349.2	17781.0	16949.7	.	.
Gross external debt, EUR mn	38559.3	46041.1	55150.1	66239.6	82104.5	72395.7	86111.1	.	.
Gross external debt in % of GDP	54.5	61.6	67.0	74.6	91.3	.	.	.	.
FDI inflow, EUR mn	3185.1	1887.5	3633.3	6099.4	4874.2	2230.4	481.4	.	.
FDI outflow, EUR mn	295.7	1463.4	892.1	1874.5	2442.4	461.2	511.2	.	.
Exports of goods, BOP, EUR mn	36820.7	37906.9	44779.1	50119.9	58415.9	13474.4	16060.4	66300	74300
annual growth rate in %	6.1	2.9	18.1	11.9	16.6	19.3	19.2	13.5	12
Imports of goods, BOP, EUR mn	39024.1	40804.5	47232.3	51579.9	58833.1	13764.4	15932.1	64700	71200
annual growth rate in %	4.9	4.6	15.8	9.2	14.1	20.0	15.7	10	10
Exports of services, BOP, EUR mn	7820.0	8122.5	8769.5	10313.0	10676.3	2112.1	2539.3	11960	13400
annual growth rate in %	-0.6	3.9	8.0	17.6	3.5	-8.0	20.2	12	12
Imports of services, BOP, EUR mn	7233.1	8074.6	8532.5	9584.5	9657.7	2073.5	2399.2	10400	11200
annual growth rate in %	16.6	11.6	5.7	12.3	0.8	-3.7	15.7	8	8
Average exchange rate HUF/USD	258.00	224.44	202.63	199.66	210.51	211.53	192.61	.	.
Average exchange rate HUF/EUR (ECU)	242.97	253.51	251.68	248.05	264.27	254.40	252.35	251	250
Purchasing power parity HUF/USD	114.72	119.60	124.05	124.90	127.83	.	.	.	.
Purchasing power parity HUF/EUR	133.11	141.31	147.12	148.89	147.09	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (from 2001 FISIM adjustment, estimate of illegal economy, real change based on previous year prices etc.) - 3) Enterprises with more than 5 employees. - 4) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.

While meeting the 2007 general government deficit target seems to be secured, the consistent implementation of the government programme to reduce the deficit below 3% by 2009 is far from certain. The attainment of the deficit level needed to introduce the euro requires a series of structural reforms in the public sector. But in the past twelve months the popularity of the socialist-liberal government has dropped to a historical low, with all reforms, whether implemented or still in their planning stage, being in the continuous political crossfire of the opposition. Nevertheless, the main opposition party FIDESZ has cautiously avoided the presentation of an alternative programme for addressing the chronic ills of the public sector yet and sticks to its view that Hungary's problems can be solved without austerity measures. As the progress of reforms is slower than planned, the government tries to set limits to its own inclination to excessive spending. From 2008 no budget draft can be submitted to the parliament stipulating a primary deficit. Regulations still to be introduced will put a cap on ministerial expenditures for three years and ban the financing of the municipalities' operational costs from credit.

There is no new official target date for the introduction of the euro but the target itself has remained an anchor of economic policy for the medium run. There is a consensus among the political parties that Hungary needs the euro and that it should be introduced as soon as possible. A more exact schedule for the euro introduction will probably not be announced before 2008.

Leon Podkaminer

Poland: growth turns euphoric

In the first quarter of 2007 Poland's GDP growth accelerated further. At a 7.4% rate, growth is now the highest in over ten years. Private consumption contributed 4.8 percentage points (p.p.) to that rate, gross fixed investment another 3.6 p.p., while the contribution of foreign trade was negative (-1.1 p.p.). Growth in private consumption is supported by the rising national wage bill (up 8.6% in real terms) and also by the continuing expansion of loans to the household sector. The stock of such loans rose by 35% in real terms (end-March 2007 over end-March 2006).

Growth of gross fixed investment has been fast accelerating for the past four quarters. The growth rate of investment recorded in the first quarter of 2007 (close to 30%) to some degree reflects also the unusually mild weather which permitted uninterrupted construction activities throughout the last winter.²⁹ But the importance of the weather must not be overestimated. Construction firms were busy because the demand for their output was extraordinarily strong. Besides, larger firms (employing over 50 persons) increased their fixed assets investments by 47% in real terms. Purchases of machinery, equipment and means of transport accounted for two thirds of these investments. 60% of larger firms' investments made in the first quarter of 2007 will extend industrial production capacities.

There are good grounds to expect the strong investment expansion to continue in the coming quarters, especially in branches supplying capital goods as well as in the construction sector itself. The reasons for this are manifold. First, the economy is currently (second quarter of 2007) running at record levels of utilization of productive capacities. The average (employment-weighted) level of

²⁹ In the first quarter of 2007 the gross output of the construction sector rose phenomenally, by over 50%, and the sector's real gross value added by 40% – dwarfing the industry's 9%.

capacity utilization in the corporate sector has reached over 86%.³⁰ Second, profitability has been very high and generally rising across all sectors and branches. Net profits of the entire corporate sector rose from PLN 12 billion in the first quarter of 2006 to PLN 19 billion in the same period of 2007. All liquidity indicators for the corporate sector are looking very good, with record low numbers of firms in financial distress. Currently about 95% of firms fully observe their credit obligations.³¹ Only some 7% of firms polled signal liquidity problems while 40% of firms judge their own money balances to be much in excess of current needs. Quite obviously, the financing of investment outlays is generally not a problem, at least to the bulk of (larger-scale) enterprises. Smaller and medium-sized firms lacking large own liquid resources (and also the bulk of the construction firms) continue to have quite an easy access to cheap credit. Third, firms are generally very satisfied with the strength of demand: only about 5% of firms report insufficient demand (vs. 10% one year ago). Demand is generally expected to remain very strong. The volumes of new orders placed (also in branches supplying investment goods) are record high. All in all, the conditions for a further expansion of investment activities are highly favourable. It may be worth adding that the expansion of investment in the business sector is accompanied by strongly rising public investment into infrastructure, in part financed from EU funds.³² Moreover, housing construction is entering a period of rather turbulent growth. The number of housing construction permits issued rose by over 50%, the number of dwellings under construction by 66%. The construction boom is supported by a fast rise in housing loans extended to the household sector. Within one year the stock of such loans jumped by close to 60%. No doubt the loan expansion has also been fuelling a genuine real estate price bubble in (and around) the larger urban centres.

The high levels of capacity utilization coincide with intensifying shortages of labour. A rising number of firms report difficulties in finding properly qualified employees, 28% of them report more or less permanent vacancies. Shortage of labour is quoted as a barrier to growth by about 11% of firms (up from 2% a year ago), with the construction sector (and also horticulture) suffering the most. Nearly half of the construction firms cannot find the workers needed. As even migrant workers from Ukraine become difficult to come by, some desperate employers have started recruiting workers in Central Asia. No doubt some firms' (and sectors') ambitious plans on expanding employment (and hence production) will be frustrated. The standard short-term response to the symptoms of labour shortages involves, first of all, wage hikes. So far the growth of average wages has been generally quite moderate, trailing behind the fast rising labour productivity. Only in construction did the average wage respond to the excess demand for labour, rising twice as fast as in other activities. Continuing gains in unit labour costs support low consumer price inflation. Producer price inflation is also low in most industries (except in construction). Nonetheless, as the elaborate forecasting model at the National Bank of Poland envisages the *possibility* of inflation rising to 3% by the end of 2008, the NBP decided to raise its interest rates by 0.25% in April and June.³³ This will push up the market interest rates. The interest rate differentials vs. the euro area (and the US dollar) will increase further

³⁰ Capacity utilization in the construction sector as well as in industrial firms delivering primarily capital goods approaches 90%, in export-oriented firms it is close to 87%.

³¹ See the report on the business climate in the second quarter of 2007 (accessible on the web page of the National Bank of Poland, www.nbp.pl/publikacje/koniumktura).

³² Poland (jointly with Ukraine) will host the 2012 European Football Cup. This will boost additional multi-billion investments in infrastructure, stadiums, hotels etc.

³³ The NBP's current GDP growth rate prediction for the first quarter of 2008 ranges (with 90% probability) between about 1% and 7%. Of course, that much could be said without a recourse to any econometrics.

Table PL

Poland: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., end of period	38219	38191	38174	38157	38122	38149	38115	.	.
Gross domestic product, PLN mn, nom. ²⁾	808578	843156	924538	983302	1057855	242379	267077	1147100	1240400
annual change in % (real) ²⁾	1.4	3.9	5.3	3.6	6.1	5.5	7.4	6	5.5
GDP/capita (EUR at exchange rate) ²⁾	5485	5020	5341	6401	7122	.	.	.	.
GDP/capita (EUR at PPP - wiiw) ²⁾	9990	10220	11070	11700	12930	.	.	.	.
Gross industrial production (sales)									
annual change in % (real)	1.1	8.3	12.6	3.7	11.3	12.3 ³⁾	13.1 ³⁾	10	10
Gross agricultural production									
annual change in % (real)	-1.9	-0.8	7.5	-4.2	-1.8	.	.	.	.
Construction output total									
annual change in % (real)	-0.3	0.9	-7.0	1.5	12.0 ³⁾	2.2 ³⁾	51.1 ³⁾	.	.
Consumption of households, PLN mn, nom. ²⁾	532615	545136	585983	610362	647905	160353	175013	.	.
annual change in % (real) ²⁾	3.4	2.0	4.4	2.0	5.2	5.4	6.9	6	5
Gross fixed capital form., PLN mn, nom. ²⁾	151472	153758	167158	179180	210460	29813	39443	.	.
annual change in % (real) ²⁾	-6.3	-0.1	6.4	6.5	16.5	7.6	29.6	22	18
LFS - employed persons, th, avg. ⁴⁾	13782.0	13616.8	13794.8	14115.3	14594.0	14098.0	14839.0	.	.
annual change in %	-3.0	0.6	1.3	2.3	3.4	3.1	5.3	.	.
Reg. employees in industry, th pers., avg.	2670.5	2639.1	2663.1	2665.4	2481.8 ³⁾	2477.0 ³⁾	2556 ³⁾	.	.
annual change in %	-5.3	-1.2	0.9	0.1	2.3 ³⁾	1.5 ³⁾	3.2 ³⁾	.	.
LFS - unemployed, th pers., average ⁴⁾	3431.0	3328.5	3230.3	3045.3	2344.3	2701.0	1894.0	.	.
LFS - unemployment rate in %, average ⁴⁾	19.9	19.6	19.0	17.8	13.9	16.1	11.3	11	10
Reg. unemployment rate in %, end of period ⁴⁾	18.0	20.0	19.1	17.6	14.9	17.8	14.4	13	12.5
Average gross monthly wages, PLN	2097.8	2185.0	2273.4	2360.6	2477.2	2539.6 ³⁾	2737.8 ³⁾	.	.
annual change in % (real, gross)	0.7	3.4	0.7	1.8	4.0	4.3 ³⁾	5.9 ³⁾	5	5
Consumer prices, % p.a.	1.9	0.8	3.5	2.1	1.0	0.6	2.0	2.3	2.5
Producer prices in industry, % p.a.	1.0	2.6	7.0	0.7	2.3	0.6	3.3	1.5	2
General governm.budget, EU-def., % GDP ⁵⁾									
Revenues	39.3	38.4	37.0	39.1	39.6	.	.	40.2	39.2
Expenditures	44.3	44.7	42.7	43.5	43.6	.	.	43.5	42.4
Deficit (-) / surplus (+)	-5.0	-6.3	-5.7	-4.3	-4.0	.	.	-3.3	-3.2
Public debt, EU-def., % of GDP ⁵⁾	39.8	47.1	45.7	47.1	47.8	.	.	42.1	41.5
Discount rate of NB % p.a., end of period	7.5	5.8	7.0	4.8	4.3	4.3	4.3	4.4	.
Current account, EUR mn	-5399	-4108	-8670	-4130	-6273	-1396	-1833	-8700	-11000
Current account in % of GDP	-2.6	-2.1	-4.3	-1.7	-2.3	-2.2	-2.7	-3.0	-3.5
Gross reserves of NB excl. gold, EUR mn	27367	26000	25904	34536	35235	34952	36488	.	.
Gross external debt, EUR mn	81045	84818	94881	112112	126715	115468	.	.	.
Gross external debt in % of GDP	38.6	44.2	46.5	45.9	46.7	.	.	.	.
FDI inflow, EUR mn	4371	4067	10292	7703	11093	3384	2433	.	.
FDI outflow, EUR mn	228	269	636	2493	3319	15	257	.	.
Exports of goods, BOP, EUR mn	49338	53836	65847	77562	93268	21728	24944	108200	124400
annual growth rate in %	6.0	9.1	22.3	17.8	20.2	23.3	14.8	16	15
Imports of goods, BOP, EUR mn	57039	58913	70399	79804	97164	22080	26170	115600	138700
annual growth rate in %	3.5	3.3	19.5	13.4	21.8	23.4	18.5	19	20
Exports of services, BOP, EUR mn	10545	9850	10815	13077	16329	3464	4242	19600	22500
annual growth rate in %	-3.4	-6.6	9.8	20.9	24.9	32.5	22.5	20	15
Imports of services, BOP, EUR mn	9690	9408	10033	11541	14561	3185	3794	17500	20100
annual growth rate in %	-3.3	-2.9	6.6	15.0	26.2	39.0	19.1	20	15
Average exchange rate PLN/USD	4.08	3.89	3.65	3.23	3.10	3.19	2.97	.	.
Average exchange rate PLN/EUR (ECU)	3.86	4.40	4.53	4.03	3.90	3.83	3.89	3.9	3.9
Purchasing power parity PLN/USD	1.83	1.83	1.85	1.85	1.84	.	.	.	.
Purchasing power parity PLN/EUR	2.12	2.16	2.19	2.20	2.15	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices; revision in government sector, shadow economy, etc.). - 3) Enterprises with more than 9 employees. - 4) From 2003 according to census May 2002. - 5) According to ESA'95 excessive deficit procedure; forecast wiiw estimate.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.

– despite inflation in Poland being lower than in the US and the euro zone. This will be favouring a renewed appreciation of the Polish zloty vs. the euro and the dollar (after having weakened somewhat in the first months of 2007).

Exports performed quite well in the first quarter of 2007, possibly aided by the exchange rate movements. Exporters were predominantly satisfied with the exchange rate levels. The share of unprofitable exports has been very low by historical standards (less than 5%). Things may get worse if the zloty starts strengthening again. Nevertheless, exporting firms are quite optimistic about further expansion. That optimism is well founded in a strong rise of export orders. On the import side one observes even more brisk dynamics. Generally, this is not a sign of falling competitiveness of domestic products vs. foreign imports. Rather, this is a consequence of the strong expansion of domestic demand necessitating, e.g., large imports of capital goods and other products whose domestic supply becomes insufficient.

Despite the outstanding growth performance, the public sector deficits remain quite large. Moreover, the government is bent on further cuts in taxes. This will prolong the process of fiscal consolidation. But this is not necessarily an unwelcome development as the authorities are unenthusiastic – to say the least – about the euro adoption.

Summing up, strong investment and consumption will be pulling up GDP growth in 2007-08. Trade has ceased to contribute positively to growth, though the expansion of exports will continue. Not much should happen on fiscal matters, inflation should remain moderate and the exchange rate generally stable.

Gábor Hunya

Romania: growth slowdown, expanding external imbalance

Economic growth, while decelerating in the first quarter of 2007, was still fairly strong at 6% against the same period of 2006. Increasing overheating and external instability constitute a serious macroeconomic challenge: domestic demand expanded by close to 15% whereas the worsening of the external balance diminished the GDP by almost 9%. Despite the external imbalance the currency keeps appreciating and inflation falling. Fixed capital formation rose by 30.6% and construction output by 17.2% in the first quarter of the year, to a large extent due mild weather. Investments were made primarily in new constructions such as roads and urban real estate development while investments in equipment hardly increased. At the same time, the growth of the services sector – which contributes 60% to the GDP – decelerated as a sign of consolidation following years of rapid expansion in the wake of the privatization of this sector.

Manufacturing growth benefits from the investments made in the past two years and is undergoing rapid structural change. In the first four months of the year, output increased by 8.1% and labour productivity was 12% higher than one year earlier. The once very strong clothing industry is one of the main losers, together with petroleum refining and machine building. Expanding branches include, next to construction materials, the production of household electronics and cars. These changes are also reflected in the export structure. The currently sluggish investments in machinery and

equipment and modest manufacturing sector FDI suggest that restructuring in manufacturing will continue without generating accelerated growth in the coming year.

The fiscal policy was relaxed in mid-2006 and the 2007 government target foresees a 2.8% deficit to GDP ratio according to the Romanian methodology and 3.2% according to EU methodology. In Romania the fiscal deficit is usually registered in December while during the year the budget is in surplus. 2007 deviates from this rule: in the first quarter the general government budget recorded a deficit of 0.7% of GDP (national methodology). The relaxation was explained by the financial needs of infrastructure development and the co-financing of EU projects, but also wages in the public sector expanded more strongly than envisaged by the government.

The deterioration of the foreign trade balance in the first quarter of 2007 was worse than expected: the deficit amounted to more than 14% of GDP. As known from the experience of other NMS in 2004, EU accession triggers a sudden increase in imports part of which is due to methodological changes. Also in the case of Romania it was imports from the EU that soared, by 41%, in the first quarter of the year while exports to this area rose by a modest 13%.

Further to commodity trade, a deficit on the current account is produced by increasing profits of the foreign sector as well as by interest payments. The increase in these items could only partially be compensated by remittances. In lack of large privatization revenues, FDI will be lower in 2007 than a year earlier. Portfolio and other capital inflows are of increasing significance in financing the current account deficit, or at least National Bank reserves will grow at a much slower pace than previously. The National Bank has given up its endeavour to curtail the credit expansion: the reference interest rate has been decreased by one percentage point during 2007, to 7.5% in May, back to the level of early 2006, and administrative restrictions have been abolished. This resulted in no surge of credits but in lower interest margins.

There has been a prolonged constitutional and governmental crisis in Romania that has set back the reform process. Measures to fight corruption and to operate the agricultural payment system have been delayed. On 27 June the European Commission presented its report on the progress of Romanian (and Bulgarian) reforms after EU accession. It did not suggest the application of safeguard clauses on the country, but left it dependent on the results of another assessment in October. This year much of the EU funds coming to Romania are still those related to pre-accession programmes. The exception is agriculture, which may lose – according to the safeguard clause – 25% of the envisaged EUR 742 million for 2007, and even the payment of the reduced fund may be postponed to next year.

The 2007 wiiw forecast for economic growth has been corrected half a percentage point downward in light of the first quarter data: 6% growth in 2007 and 5.5% in 2008. Both figures are lower than the prognosis of the Romanian government which has also been adjusted downwards (to 6.5% and 6.3% respectively) and also below those of the European Commission and the IMF. More modest optimism can be justified by the performance of agriculture and the external deficits. Agriculture has always been the dark horse of growth forecasts for Romania. The 2007 harvest looks worse than last year due to continuing drought and the bad shape of the irrigation system. This may cause lower GDP growth this year than our current forecast which may in turn be compensated next year.

Table RO

Romania: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year	21794.8	21733.6	21673.3	21623.8	21584.4	.	.	.	.
Gross domestic product, RON mn, nom. ²⁾	151475.1	197564.8	246468.8	288047.8	342418.0	60985.7	68498.6	388000	438000
annual change in % (real) ²⁾	5.1	5.2	8.5	4.1	7.7	6.9	6.0	6.0	5.5
GDP/capita (EUR at exchange rate) ²⁾	2224	2420	2806	3676	4501	.	.	.	.
GDP/capita (EUR at PPP - wiiw) ²⁾	6060	6510	7400	8030	9000	.	.	.	.
Gross industrial production									
annual change in % (real)	4.3	3.1	5.3	2.0	7.1	4.7	7.6	6	6
Gross agricultural production									
annual change in % (real)	-3.5	7.5	18.0	-13.1	0.7	.	.	.	.
Construction output total									
annual change in % (real)	10.0	9.8	9.2	9.5	19.3	20.9	30.6	.	.
Consumption of households, RON mn, nom. ²⁾	102671.0	128150.4	167244.7	196354.2	235136.7	46739.0	54086.9	.	.
annual change in % (real) ²⁾	5.3	8.5	14.5	9.7	14.1	12.0	12.1	10	8
Gross fixed capital formation, RON mn, nom. ²⁾	32283.6	42293.0	53850.3	66503.8	84260.3	9972.6	12787.2	.	.
annual change in % (real) ²⁾	8.2	8.5	11.1	12.6	16.1	11.3	17.2	14	10
LFS - employed persons, th, avg. ³⁾	9234.3	9222.5	9157.6	9146.6	9313.3	9028.6	.	.	.
annual change in %	.	-0.1	-0.7	-0.1	1.8	0.9	.	.	.
Reg. employees in industry, th pers., avg.	1891.0	1848.0	1741.0	1672.0	1610.0	.	.	.	.
annual change in %	-0.5	-2.3	-5.8	-4.0	-3.7	-4.0	-4.4	.	.
LFS - unemployed, th pers., average ³⁾	845.3	691.8	799.5	704.5	728.4	762.5	.	.	.
LFS - unemployment rate in %, average ³⁾	8.4	7.0	8.0	7.1	7.2	7.8	.	7	7
Reg. unemployment rate in %, end of period	8.4	7.4	6.3	5.9	5.2	6.2	4.9	5	5
Average gross monthly wages, RON	532.1	663.8	818.3	968.0	1150.0	1072.7	1286.7	.	.
annual change in % (real, net)	2.4	10.8	10.6	14.3	9.6	5.9	14.3	.	.
Consumer prices, % p.a.	22.5	15.3	11.9	9.0	6.6	8.6	3.8	4.0	4.5
Producer prices in industry, % p.a.	23.0	19.5	19.1	10.5	11.6	10.9	9.4	8	8
General governm.budget, EU-def., % GDP ⁴⁾									
Revenues	37.6	32.1	31.1	32.4	30.1	.	.	.	.
Expenditures	39.6	33.6	32.6	33.7	32.0	.	.	.	.
Deficit (-) / surplus (+)	-2.0	-1.5	-1.5	-1.4	-1.9	.	.	-3.5	-4.0
Public debt, EU-def., % of GDP ⁴⁾	23.8	21.5	18.8	15.8	12.4	.	.	.	.
Discount rate, % p.a., end of period	20.4	20.4	18.0	7.5	8.8	8.5	8.1	.	.
Current account, EUR mn	-1623	-3060	-5099	-6888	-9973	-1358	-3055	-15000	-15000
Current account in % of GDP	-3.3	-5.8	-8.4	-8.7	-10.3	-7.9	-15.1	-13.0	-11.6
Gross reserves of NB excl. gold, EUR mn	5877	6374	10848	16799	21310	18146	21530	.	.
Gross external debt, EUR mn	16200	17835	21504	31093	41422	.	43634	.	.
Gross external debt in % of GDP	33.4	33.9	35.4	39.1	42.6	.	.	.	.
FDI inflow, EUR mn	1212	1946	5183	5213	9082	1965	1312	7000	7000
FDI outflow, EUR mn	18	36	56	-24	31	33	-3	.	.
Exports of goods, BOP, EUR mn	14675	15614	18935	22255	25850	6218	7102	29700	34200
annual growth rate in %	15.4	6.4	21.3	17.5	16.2	22.0	14.2	15	15
Imports of goods, BOP, EUR mn	17427	19569	24258	30061	37609	7910	10290	47000	54100
annual growth rate in %	8.6	12.3	24.0	23.9	25.1	28.5	30.1	25	15
Exports of services, BOP, EUR mn	2468	2671	2903	4102	5513	1264	1772	7440	9300
annual growth rate in %	8.6	8.2	8.7	41.3	34.4	60.0	40.2	35	25
Imports of services, BOP, EUR mn	2463	2609	3116	4451	5507	1177	1599	7160	8590
annual growth rate in %	2.5	5.9	19.4	42.8	23.7	29.5	35.9	30	20
Average exchange rate RON/USD	3.3055	3.3200	3.2637	2.9137	2.8090	2.9624	2.5820	.	.
Average exchange rate RON/EUR (ECU)	3.1255	3.7556	4.0532	3.6234	3.5245	3.5641	3.3818	3.36	3.40
Purchasing power parity RON/USD	0.9893	1.1811	1.2962	1.3917	1.4816	.	.	.	.
Purchasing power parity RONEUR	1.1473	1.3955	1.5371	1.6590	1.7627	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (from 2003 FISIM adjusted and real change based on previous year prices). - 3) From 2002 break in methodology. - 4) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.

The wiiw forecast concerning the current account deficit has usually been more pessimistic than the government's prognosis. That attitude has been justified by facts in the past few years including the current one. For 2007 we again forecast much stronger growth of imports than of exports. The deficit is the result of high capital inflows which trigger currency appreciation. As a positive side-effect, inflation declines. The question is how long the widening external imbalance will be sustainable, particularly in case of turbulence on international markets. The wiiw forecast indicates some likelihood of an adverse development. For 2008 we expect increasing inflation and some currency depreciation together with a further slowdown of economic growth. Economic policy will remain lax, with reforms being delayed and fiscal control weakening as the absence of a government with strong parliamentary majority and presidential support seems to be lasting.

With adequate policies the country could soon fulfil the Maastricht criteria of which it misses only the inflation target. However, setbacks may occur if the current fiscal relaxation goes on and the government-controlled gas prices rise in 2008. The National Bank's caution concerning the introduction of the euro is justified; it envisages to join the ERM II not before 2012 and to adopt the euro two years later. In the short term priority will be given to real convergence and to achieving a sustainable exchange rate at a much lower current account deficit (and, eventually, a balanced current account).

Zdenek Lukas

Slovakia: a new European citadel of car manufacturing?

One year ago the Social-Democratic Party Smer, led by Robert Fico and his allies, took power; it followed eight years of pro-reform centre-right coalition governments. Despite post-election fears that the social democrats would radically change the liberal economic policy that was backed by the booming economy, any changes have been of a largely cosmetic nature. As a result, the economic fundamentals established by the earlier policy makers have continued to shape the current economic events. Nevertheless, the ruling government has pursued a socially balanced policy that was coupled with increased budgetary expenditures focused on poor people, young families and pensioners. Likewise, budgetary spending on agriculture and on the Government Office were raised overproportionately. The rapidly expanding economy and hence high budgetary revenues make it easy to finance these items. However, spending on establishing a 'knowledge economy' – i.e. money on education and research & development – has so far increased less than total budgetary expenditures on average. Changes in the flat-tax system have been modest, focusing on lowering the VAT rate on medicines and on higher taxation of considerably above-average wages. Foreign direct investors have not been affected by the recent tax amendments. This is good news because foreign investment and its economic impact have been the main driving force behind the country's strong (and sustainable) economic expansion and its acceleration observed in the past few years.

On the supply side, the GDP expansion in the first quarter of 2007 followed mostly from growth in gross value-added in industry and in services (transport, post, telecommunications), both rising by 19%. Construction is also contributing to GDP growth: its output rose by 21% in the first quarter, mostly driven by new construction, modernization and reconstruction.

Table SK

Slovak Republic: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year	5378.8	5379.0	5382.2	5386.7	5390.0	.	.	.	.
Gross domestic product, SKK bn, nom. ²⁾	1111.5	1212.7	1355.3	1471.1	1636.3	368.8	414.6	1830	2020
annual change in % (real) ²⁾	4.1	4.2	5.4	6.0	8.3	6.7	9.0	8.5	8
GDP/capita (EUR at exchange rate) ²⁾	4839	5434	6288	7077	8150	.	.	.	.
GDP/capita (EUR at PPP - wiiw) ²⁾	10990	11500	12360	13410	15080	.	.	.	.
Gross industrial production									
annual change in % (real)	6.7	5.3	4.2	3.6	9.9	9.5	15.2	14	10
Gross agricultural production									
annual change in % (real)	1.5	-2.4	5.6	-6.0	.	.	.	.	.
Construction industry									
annual change in % (real)	4.1	6.0	5.7	14.7	14.8	14.3	21.4	.	.
Consumption of households, SKK bn, nom. ²⁾	634.3	676.9	754.4	829.8	927.2	221.5	241.9	.	.
annual change in % (real) ²⁾	5.2	0.1	3.8	7.2	6.3	6.6	6.5	7	5
Gross fixed capital form., SKK bn, nom. ²⁾	303.5	302.8	327.1	394.6	432.1	89.1	98.6	.	.
annual change in % (real) ²⁾	0.3	-2.3	5.0	17.5	7.3	13.8	7.7	8	7
LFS - employed persons, th, avg.	2127.0	2164.6	2170.4	2216.2	2301.4	2257.5	2326.6	.	.
annual change in %	0.2	1.8	0.3	2.1	3.8	3.7	3.1	.	.
LFS - employed pers. in industry, th, avg.	640.9	634.1	641.3	649.1	666.4	653.4	687.1	.	.
annual change in %	1.9	-1.1	1.1	1.2	2.7	1.8	5.2	.	.
LFS - unemployed, th pers., average	486.9	459.2	480.7	427.5	353.4	395.8	303.0	.	.
LFS - unemployment rate in %, average	18.5	17.4	18.1	16.2	13.3	14.9	11.5	11	10
Reg. unemployment rate in %, end of period	17.5	15.6	13.1	11.4	9.4	11.4	8.9	8	7
Average gross monthly wages, SKK ³⁾	13511	14365	15825	17274	18761	17315	18511	.	.
annual change in % (real, gross)	5.8	-2.0	2.5	6.3	3.3	2.7	4.2	4	3
Consumer prices, % p.a.	3.3	8.5	7.5	2.7	4.5	4.3	2.8	3	2
Producer prices in industry, % p.a.	2.1	8.3	3.4	4.7	8.4	9.5	3.4	5	4
General governm.budget, EU-def., % GDP ⁴⁾									
Revenues	35.7	37.5	35.4	35.2	33.9	.	.	.	.
Expenditures	43.3	40.3	37.8	38.0	37.3	.	.	.	.
Deficit (-) / surplus (+)	-7.7	-2.8	-2.4	-2.8	-3.4	.	.	-3.0	-2.8
Public debt, EU-def., in % of GDP ⁴⁾	43.3	42.4	41.5	34.5	30.7	.	.	.	.
Discount rate, % p.a., end of period	6.5	6.0	4.0	3.0	4.8	3.5	4.5	.	.
Current account, EUR mn ⁵⁾	-2043	-1747	-2656	-3288	-3640	-622	20	-2500	-2500
Current account in % of GDP	-7.8	-6.0	-7.8	-8.6	-8.3	-6.3	0.2	-4.7	-4.1
Gross reserves of NB incl. gold, EUR mn	8824	9717	10954	13067	10145	13657	12437	.	.
Gross external debt, EUR mn	12655	14654	17421	22705	24449	23580	24317 ^{II}	.	.
FDI inflow, EUR mn	4397	1914	2441	1694	3324	316 ^{II}	241 ^{II}	.	.
FDI outflow, EUR mn	12	219	-17	126	294	40 ^{II}	33 ^{II}	.	.
Exports of goods, BOP, EUR mn ⁵⁾	15270	19359	22248	25743	33273	7145	9825	46000	57000
annual growth rate in %	8.2	26.8	14.9	15.7	29.2	28.5	37.5	38	24
Imports of goods, BOP, EUR mn ⁵⁾	17517	19924	23485	27713	35733	7771	9876	45000	55500
annual growth rate in %	6.2	13.7	17.9	18.0	28.9	31.3	27.1	26	23
Exports of services, BOP, EUR mn ⁵⁾	2958	2912	3000	3542	4313	596 ^{II}	666 ^{II}	4800	5300
annual growth rate in %	6.4	-1.5	3.0	18.1	21.7	13.4	11.7	11	10
Imports of services, BOP, EUR mn ⁵⁾	2474	2703	2785	3285	3783	526 ^{II}	661 ^{II}	4700	5600
annual growth rate in %	10.3	9.2	3.0	18.0	15.2	10.5	25.7	24	19
Average exchange rate SKK/USD	45.34	36.77	32.26	31.02	29.72	31.17	26.24	.	.
Average exchange rate SKK/EUR (ECU)	42.70	41.49	40.05	38.59	37.25	37.46	34.37	34.5	33.5
Purchasing power parity SKK/USD	16.21	16.59	17.19	17.09	17.24	.	.	.	.
Purchasing power parity SKK/EUR	18.80	19.60	20.38	20.37	20.13	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted). - 3) From 2006 including wages of armed forces. - 4) According to ESA'95, excessive deficit procedure. - 5) Calculated from USD.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.

Slovakia has remained one of top growing economies in Europe. Growth even speeded up in the first quarter of 2007, when GDP rose by 9% as compared to 6.7% in the corresponding period of 2006. As a result of rising industrial investment, in particular FDI and stepped-up infrastructure investment, gross fixed capital formation increased by 7.7%. Rising real wages and credits to private households fuelled private consumption, up 6.5%. Since the second half of 2006 real exports have gained momentum, driven in particular by foreign demand for cars, steel, refinery products and electronics. Although the strong domestic demand was partly covered by rising imports, foreign trade contributed positively to overall GDP growth. Despite the appreciation of the domestic currency, the export goods manufactured by the new FDI-led companies have been sufficiently competitive to withstand the appreciation. With increasing repatriation of profits of FDI and a widening foreign trade deficit, the current account deficit deteriorated in 2006, accounting for 8.3% of the GDP. According to preliminary data, the current account for January to March 2007 ended in a modest surplus (EUR 20 million, or 0.2% of GDP).

As a result of the lively investment activity, gross industrial output expanded by 15.3% in the first four months of 2007. Industrial employment (LFS data) rose by some 5%, while industrial labour productivity was up by around 10%. At the same time nominal wages rose by some 8%, and unit labour costs (ULCs) dropped by about 2% in SKK terms. Taking into account the appreciation of the Slovak koruna by above 8% in the reference period, ULCs rose by some 6% in euro terms. Nevertheless, the competitiveness of Slovak tradable goods continues to rely on the wage rates, which in euro terms are relatively low: gross monthly wages averaged some EUR 540 in the first quarter of 2007, i.e. at least one fifth lower than in other Central European competitors (Czech Republic, Hungary, Poland). The National Bank of Slovakia (NBS) is fighting appreciation through foreign exchange intervention. The latest one (in April 2007) in the amount of EUR 700 million resulted in a marginal depreciation.

The foreign investment enterprises in the automotive industry (Volkswagen, PSA Peugeot Citroen and KIA in association with Hyundai) are the flagships of the Slovak economy and are important driving forces for other industrial sectors. Car production soared by 93% in the first four months of 2007 as compared to the same period a year earlier; in particular in the newcomer factories (PSA and KIA) production is rising more and more rapidly. Foreign investment enterprises operating in machinery & equipment and in electrical & optical equipment also registered high rates of production growth (15% and 19% respectively).

With an annual production of more than 1 million cars envisaged for the end of the current decade, Slovakia is becoming the world's biggest car producer per capita. Car production is expected to account for more than half of manufacturing output and over 60% of total exports in 2008.

FDI inflows doubled to EUR 3.3 billion in 2006, after a fall to EUR 1.7 billion in 2005. The highest number of investors has targeted the car, electro-technical and machinery industries as well as services. The largest projects, two new car factories (PSA Peugeot-Citroen and KIA Hyundai), are both located in western Slovakia and account for strong pro-employment effects. As foreign investors are focusing on the more developed western regions, the eastern parts of the country with high unemployment are falling behind. So far there are only two large foreign investment enterprises (with the concomitant employment effects) in eastern Slovakia, US Steel Košice (the largest flat-rolled steel producer in Central Europe) and the German automobile gear box manufacturer Getrag

Ford Košice-Kechnec. As for the year 2007, we expect a substantial slowdown of the FDI inflow as compared to the record level of 2006.

Since 2006 the accelerating economic growth has supported growth in employment as the demand for labour has been on the rise. Total employment (LFS) increased by 3.1% in the first quarter of 2007, chiefly due to industrial employment rising by 5.2%. The unemployment rate (LFS) fell by 3.4 percentage points, to 11.5% in the first quarter of 2007. Whereas the standard of living is rising on the country average, the gap between rich and poor remains wide. At the end of March 2007, more than 7% of the Slovak population were living below the poverty line. The wealthiest region is Bratislava, followed by the Žilina district in the north-west. Purchasing power is lowest in southern-central Slovakia and in districts in the remote east (with the exception of Košice city). Infrastructure is unbalanced and links between the eastern and western parts of the country are underdeveloped. Therefore, the fast completion of the motorway system between the west (Bratislava) and the east (Košice) has been one of the government's priorities. The main bottlenecks in construction are the technical preparation of the project and the negotiations with owners of the land needed for the motorway. There is the risk that Slovakia may not be able to make full use of the more than EUR 3 billion granted by the EU up until 2013. Several deadlines having been postponed, a realistic target date for the completion of the motorway now seems to be 2015.

On the road to the euro, Slovakia was admitted into the ERM-II already on 26 November 2005. The central exchange rate parity was set at SKK 38.46 to the euro, with a +/-15% fluctuation band. Since joining the ERM-II the Slovak koruna has appreciated by 12%, reaching SKK 34.50 to the euro in February 2007. Based on economic fundamentals as well as on mutual agreements with the EU administration and the European Central Bank, on 19 March 2007 the NBS appreciated the central exchange rate parity of the Slovak koruna by 8.5% to SKK 35.44 to the euro. The standard fluctuation band of +/-15% around the central rate parity continues to be observed. So far the policy makers have been relatively successful on their way towards meeting the Maastricht criteria. Slovakia aims to keep its budget deficit below 3% of GDP (the maximum threshold for the euro adoption). There should be no problem in meeting the Maastricht criterion related to inflation, although developments on the world oil markets might represent some risks. The new government has repeatedly confirmed its ambitious target of adopting the euro by 2009.

The vigorous external and domestic demand, fuelled by accelerating export growth and rising real wages, will keep GDP growth at a high level, reaching above 8% this year. The strong (and sustainable) expansion of industrial output in the coming years, mainly in car manufacturing, will contribute most to the GDP growth. Consumer price inflation will most probably meet the Maastricht criterion. In the wake of rising labour demand the unemployment rate will go down further. Increasing budget tax revenues thanks to robust GDP growth will result in reducing the budget deficit to below 3% of GDP in 2007. The foreign trade balance will be in surplus owing to the strong expansion of industrial exports. By contrast, increasing repatriation of profits by FDI companies, expanding domestic demand partly covered by imports as well as high prices for imported fuels will slow down the improvement in the external position. In addition, the strong domestic currency will encourage imports. All in all, the current account deficit will slightly diminish in the years to come.

Slovenia: impressive growth performance

The strong performance of the Slovenian economy prevailing in 2006 has continued in 2007. GDP growth accelerated further, to 7.2% in the first quarter of the year, the best result since 1999. Similar to previous years the rise in GDP was backed by robust domestic demand. Growth of gross fixed investment speeded up sharply, by 21%, with the strongest increases observed in construction and transport equipment. Private consumption rose by about 3%, while growth of government consumption slowed down slightly, to 2.2%. The contribution of foreign trade to GDP growth was neutral. High investment translated into 35% growth in construction, particularly residential building/motorway construction, favoured by good weather conditions.

Industrial output expanded significantly and was up 10% in the first four months of the year, the best performance since the country's independence. The fastest growth was registered for capital goods production (+14.6%), while both the production of intermediate and consumer goods performed below average. Output of manufacturing exceeded the average industrial growth, with the most favourable results achieved in the manufacture of wood and wood products, basic metals, chemicals, as well as machinery and equipment. Slight improvements are recorded in the manufacture of food and beverages and in the production of textiles and textile products – two branches suffering from production losses over the past couple of years. On the negative side, the production of transport equipment decreased and output of leather and leather products continued to fall.

The situation on the labour market continued to improve and in the first quarter of 2007 the LFS unemployment rate fell to 5.7%, much below the EU average rate. Employment according to that measure increased by 1.3%, while the national accounts statistics reported an employment growth by 2.4% in the first quarter of 2007. The fastest rise in the number of employed was observed in construction, business activities and other services; after years of job cuts, a slight employment increase was also registered in manufacturing. In June the Economic and Social Council decided to increase the quota for work permits for foreigners from 18,500 to 24,500. This step became necessary due to labour shortages in the transport, construction, tourism and metallurgy sectors.

Foreign trade grew dynamically in the first quarter of 2007: exports and imports rose by 18% and 17%, respectively, and the trade deficit narrowed as compared to the same period in 2006. In services trade, imports (starting from a low level) grew faster than exports, but these developments caused only a minor reduction in the services trade surplus. A recent Slovenian analysis has shown that between 1995 and 2006 the country's regional trade structure changed significantly³⁴: over that period the importance of the EU-15 as a trading partner declined, while trade with the new EU member states gained momentum. At the same time the share of external trade with the successor states of the former Yugoslavia (almost half of which is accounted for by Croatia) rose only slightly. In the first quarter of 2007 the current account experienced some modest deterioration, primarily the result of a worsening of the income balance due to growing payments of dividends, profits and interests. The deficit of current transfers narrowed against the first quarter of 2006. As in the past two years, Slovenia has remained a net exporter of FDI, with most investments directed

³⁴ *Slovenian Economic Mirror*, March 2007, p. 16.

Table SI

Slovenia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year	1995.7	1996.8	1997.0	2001.1	2008.5	.	.	.	.
Gross domestic product, EUR-SIT mn, nom. ²⁾	22347.9	24259.5	26171.7	27625.4	29736.3	6844.3	7650.9	32000	34400
annual change in % (real) ²⁾	3.4	2.7	4.4	4.0	5.2	5.0	7.2	5	5
GDP/capita (EUR at exchange rate) ²⁾	11862	12458	13148	13805	14808	.	.	.	.
GDP/capita (EUR at PPP - wiw) ²⁾	16040	16840	18150	19220	20930	.	.	.	.
Gross industrial production annual change in % (real) ³⁾	2.4	1.4	4.8	3.3	6.5	7.1	9.3	7	6
Gross agricultural production annual change in % (real)	13.4	-12.4	17.3	0.2	-5.7	.	.	.	.
Construction output, in effect. working time annual change in % (real) ⁴⁾	-3.4	-1.7	2.5	3.0	15.3	1.6	35	.	.
Consumption of households, EUR-SIT mn, nom. ²⁾	12115.9	13217.9	14034.5	14854.3	15722.7	3549.7	3855.9	.	.
annual change in % (real) ²⁾	1.3	3.5	2.8	3.6	3.3	3.2	3.4	3	3
Gross fixed capital form., EUR-SIT mn, nom. ²⁾	5055.6	5646.2	6412.7	6748.7	7683.6	1637.5	2055.3	.	.
annual change in % (real) ²⁾	0.9	7.0	7.9	1.5	11.9	8.6	21.6	10	7
LFS - employed persons, th, avg. annual change in %	910	897	943	949	961	946	958	.	.
	-0.7	-1.4	5.1	0.6	1.3	1.3	1.3	.	.
Reg. employees in industry, th pers., avg. ⁵⁾	246.1	242.2	239.7	239.3	235.5	234.9	236.8	.	.
annual change in % ⁵⁾	1.1	-1.6	-1.0	-1.7	-1.6	-2.5	0.8	.	.
LFS - unemployed, th pers., average	62.0	64.8	64.0	67.0	61.0	70	58	.	.
LFS - unemployment rate in %, average	6.4	6.7	6.3	6.6	6.0	6.9	5.7	5.8	5.5
Reg. unemployment rate in %, end of period	11.3	11.0	10.1	10.2	8.6	10.1	8.1	8	7.5
Average gross monthly wages, EUR-SIT ⁶⁾	982	1057	1117	1157	1213	1175	1238	.	.
annual change in % (real, net) ⁶⁾	2.1	1.8	2.1	3.5	2.5	3.1	5.2	.	.
Consumer prices, % p.a.	7.5	5.6	3.6	2.5	2.5	2.2	2.4	2.6	2.3
Producer prices in industry, % p.a.	5.1	2.5	4.3	2.7	2.3	1.6	4.5	2.2	2
General governm.budget, EU-def., % GDP ⁷⁾									
Revenues	45.5	45.3	45.1	45.6	44.8	.	.	.	.
Expenditures	48.0	48.0	47.4	47.0	46.3	.	.	.	.
Deficit (-) / surplus (+), % GDP	-2.5	-2.8	-2.3	-1.5	-1.4	.	.	-1.5	-1.4
Public debt in % of GDP ⁷⁾	29.1	28.6	28.9	28.4	27.8	.	.	.	.
Discount rate % p.a., end of period	7.3	5.0	3.3	3.8	3.8	3.3	3.8	.	.
Current account, EUR mn	247.2	-195.7	-719.7	-547.5	-756.2	-163.5	-174.7	-700	-500
Current account in % of GDP	1.0	-0.8	-2.7	-2.0	-2.5	-2.4	-2.3	-2.2	-1.5
Gross reserves of NB excl. gold, EUR mn ⁸⁾	6701.5	6798.2	6464.0	6824.1	5341.7	6840.4	836.8 ⁸⁾	.	.
Gross external debt, EUR mn	11524	13225	15343	19614	23895	21704	26404 ¹⁾	.	.
Gross external debt in % of GDP	48.7	53.2	58.4	71.0	79.7	.	.	.	.
FDI inflow, EUR mn	1721.7	270.5	665.2	444.9	303.4	44.6	174.1	.	.
FDI outflow, EUR mn	165.8	421.3	441.0	503.4	590.3	108.4	281.8	.	.
Exports of goods, BOP, EUR mn	11081.6	11417.1	12932.8	14599.2	17031.7	4028.2	4771.3	19000	20800
annual growth rate in %	6.0	3.0	13.3	12.9	16.7	19.4	18.4	12	9
Imports of goods, BOP, EUR mn	11346.6	11959.9	13941.6	15625.1	18152.5	4232.1	4936.6	20000	22000
annual growth rate in %	1.9	5.4	16.6	12.1	16.2	19.3	16.6	10	10
Exports of services, BOP, EUR mn	2439.5	2464.9	2782.6	3209.7	3537.8	728.6	782.4	3800	4200
annual growth rate in %	12.0	1.0	12.9	15.3	10.2	19.5	7.4	7	10
Imports of services, BOP, EUR mn	1819.7	1924.7	2095.0	2354.1	2653.0	521.8	585.1	2900	3200
annual growth rate in %	10.8	5.8	8.8	12.4	12.7	16.8	12.1	10	12
Average exchange rate EUR-SIT/USD	1.003	0.864	0.803	0.804	0.797	0.832	0.763	.	.
Average exchange rate EUR-SIT/EUR (ECU)	0.944	0.975	0.997	1.000	1.000	1.000	1.000	1	1
Purchasing power parity EUR-SIT/USD	0.602	0.610	0.609	0.603	0.594	.	.	.	.
Purchasing power parity EUR-SIT/EUR	0.698	0.721	0.722	0.718	0.707	.	.	.	.

Note: Slovenia has introduced the Euro from 1 January 2007. For statistical purposes all time series in SIT as well as the exchange rates and PPP rates have been divided by the conversion factor 239.64 (SIT per EUR) to EUR-SIT. The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) From July 2005 new methodology. - 4) From 2004 construction put in place; units with at least 20 employees. - 5) From January 2005 data from Statistical Register of Employment, years before from Monthly Report on Earnings. - 6) From January 2005 including legal persons with 1 or 2 employees in private sector. - 7) According to ESA'95, excessive deficit procedure. - 8) From January 2007 (Euro introduction) only the foreign currency reserves nominated in non-euro currency are included.

Source: wiw Database incorporating national statistics; Eurostat; wiw forecasts.

towards the successor states of the former Yugoslavia, ranging from investments in manufacturing to insurance companies. Gross foreign indebtedness has risen significantly in the past few years, to almost 80% of the country's GDP by the end of 2006.

On 1 January Slovenia entered the euro zone as the first of the new member states joining the EU in 2004. The changeover to the euro is estimated to have caused only a small increase in inflation, about 0.2 percentage points. The average annual consumer price inflation stood at 2.6% in May; however prices in some sub-categories rose considerably faster than average, such as those for services in restaurants and coffee shops, furniture and furnishings and cosmetic products. With production straining capacity limits, producer prices soared by 4.4% during the first four months of 2007.

The appointment of a new governor of the Bank of Slovenia has become the main political topic in recent months. Despite the successful introduction of the euro, the centre-right government led by Janez Janša rejected a second six-year term for Mitja Gaspari (proposed by President Janez Drnovšek, a former centre-left leader). In the second round Deputy Governor Andrej Rant, who is currently heading the bank, also failed to get the necessary votes in the parliament. Recently a new candidate, former Minister of Finance Marko Kranjec, has been proposed by the president and is very likely to become the next governor.

GDP growth in 2007 and 2008 will remain above 4%. Private consumption will probably rise by around 3% thanks to more pronounced wage growth than in the past few years and the effects of the reduced personal income tax rates (the highest rate was lowered from 50% to 41%). However, rising interest rates could be a limiting factor for household borrowing for consumption purposes. Investment growth will continue due to enhanced housing construction favoured by a reduced VAT rate up to the beginning of 2008 (thereafter it is to be raised again as agreed in the transitional agreement with the EU). An additional impetus should come from investments in motorway construction. Inflation prospects are generally moderate, but the effects of the liberalization of the electricity and natural gas market, envisaged to become effective from 1 July, are still uncertain. Experience gained in other EU countries has shown mixed results concerning price developments after the implementation of the electricity directive; as for natural gas prices, the impact of liberalization was hard to assess due to their close linkage to oil prices. In 2008 a (possible) change in the VAT rate might contribute to an increase in inflation. Maintaining a moderate level of the trade deficit together with a modest rise in the services trade surplus, the current account should gradually improve over the coming years. Given the relatively high GDP growth, the situation on the labour market should further improve. There are no signs of a deterioration of either the general government deficit or the general government debt. Slovenia's main foreign policy challenge, however, will be the EU presidency in the first half of 2008.

Part B: The countries of Southeast Europe

Vladimir Gligorov *

Future Member States (FMS): better than expected

Introduction

Recovery in the Balkans, where all the EU-candidate countries (actual and potential) are located, is still good for a positive surprise, despite the region often being known for its negative surprises in the past. With a number of unresolved problems that previously tended to precipitate crises, it is refreshing to observe that stability has proved to be much more resilient than recent history warrants. The economies of the region have continued to grow; in some cases that growth has even accelerated. For the most part, regional cooperation has continued to improve and the EU integration process has continued unabated, notwithstanding several hiccoughs. The business climate has also improved and reforms, though still rather gradual, have enjoyed relatively wide, albeit cautious support. Short-term and medium-term prospects are good, even though serious political and policy challenges lie ahead for these countries and the region as a whole. If these developments are sustained, the image of the region may change very much for the better by the time Croatia (as the first among these countries) joins the EU around 2010. The region as a whole can still make it into the EU by 2015 or couple of years later. At least one major political problem still remains to be solved in the short run: the independence of Kosovo.

Growth with stability

This diverse group of countries has benefited from increased stability; GDP growth has varied between 5 and 6% (see Table 1). The year 2007 has started even better than for most other

Table 1

	Gross domestic product											
	real change in % against preceding year											
											Index	Index
											1990=100	2000=100
	2002	2003	2004	2005	2006 ¹⁾	2006	2007	2007	2008	2006	2006	
						1st quarter		forecast				
Croatia	5.6	5.3	4.3	4.3	4.8	6.0	7.0	5	5	113.4	132.4	
Macedonia	0.9	2.8	4.1	3.8	3.1	2.2	7.0	4	4	100.6	110.3	
Turkey	7.9	5.8	8.9	7.4	6.1	6.7	.	5.5	6.5	186.1	131.0	
<i>Candidate countries</i>	7.5	5.7	8.3	7.0	5.9	6.5	.	5.4	6.3	174.2	130.5	
Albania	4.3	5.8	6.2	5.6	4.9	.	.	5	5.5	.	139.0	
Bosnia & Herzegovina	5.5	3.0	6.0	5.5	6.2	.	.	6	6	.	134.9	
Montenegro	1.7	2.4	4.2	4.0	6.5	6.8	6.6	5	5	.	119.9	
Serbia	4.2	2.5	8.4	6.2	5.7	7.0	8.7	5	5	.	136.4	
<i>Potential candidate countries</i>	4.5	3.1	7.3	5.8	5.8	.	.	5.2	5.3	.	135.7	

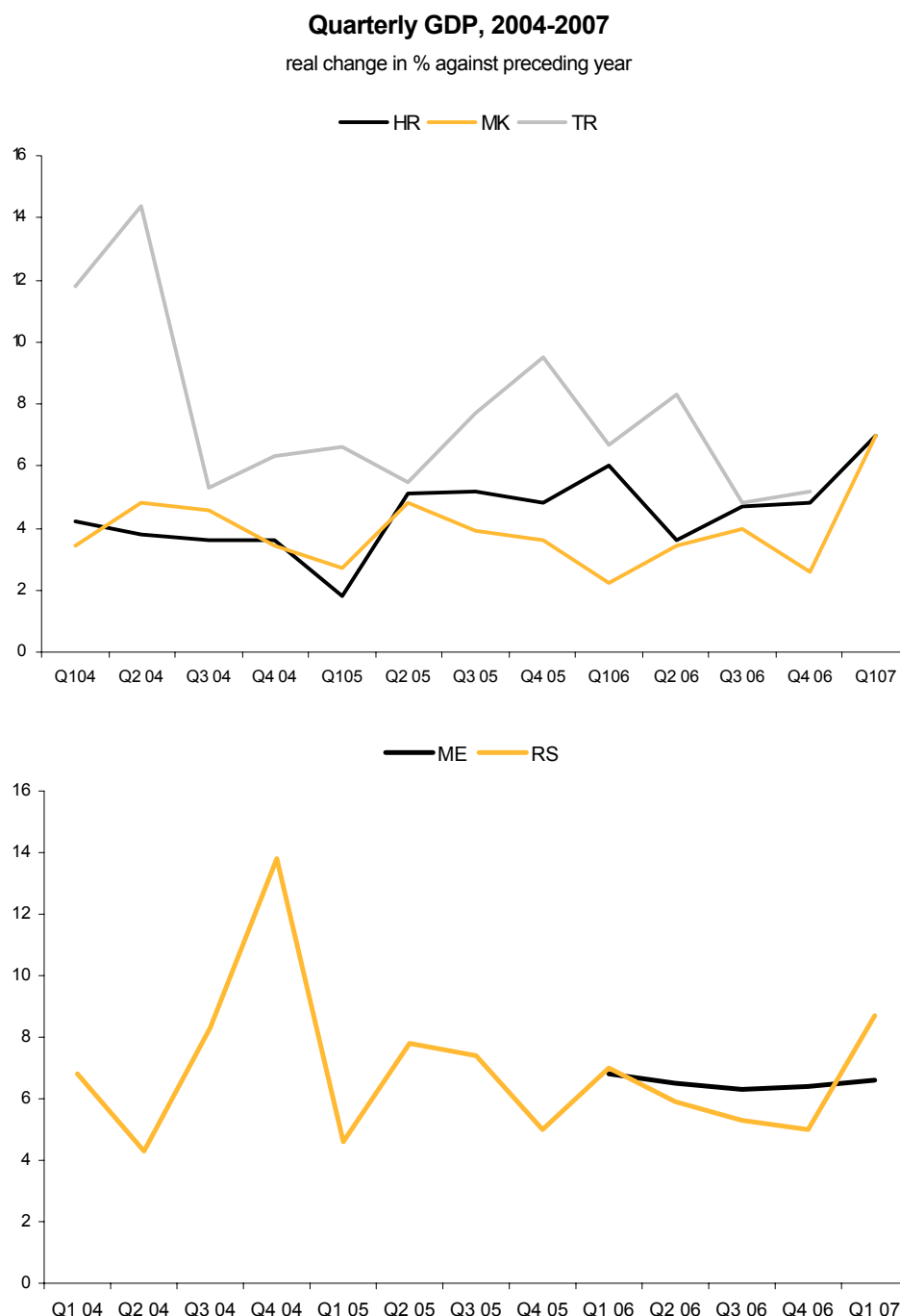
1) Preliminary.

Source: wiw Database incorporating national statistics, forecast: wiw.

* P. Havlik and wiw staff provided comments.

countries - at least as much as one can tell from the preliminary data. With GDP data not available in some cases, indirect indications are that the rates of growth achieved previously have been maintained. In Serbia, Croatia and Macedonia, the first quarter showed a GDP growth rate of 8.7% and 7% respectively, while in Montenegro it was 6.6% (see Figure 1).

Figure 1



Note: Candidate countries: HR (Croatia), MK (Macedonia), TR (Turkey); potential candidates: AL (Albania), BA (Bosnia and Herzegovina), ME (Montenegro), SR (Serbia).

Source: wiiw Monthly Database incorporating national statistics.

Table 2

		Foreign trade								
		(based on customs statistics)								
		2002	2003	2004	2005	2006 ¹⁾	2007 1Q	2005	2006	1 Q 07 1 Q 06
		EUR mn					change in %			
Croatia	Exports	5187	5468	6453	7065	8253	2006	9.5	16.8	1.8
	Imports	11325	12546	13343	14935	17094	4260	11.9	14.5	7.7
	Balance	-6137	-7079	-6890	-7870	-8841	-2254	.	.	.
Macedonia	Exports	1181	1209	1348	1641	1912	535	21.7	16.5	42.6
	Imports	2111	2039	2358	2595	2997	791	10.0	15.5	30.7
	Balance	-931	-831	-1010	-954	-1085	-256	.	.	.
Albania	Exports	359	396	487	530	631	182	8.9	19.0	26.1
	Imports	1589	1643	1849	2111	2430	660	14.2	15.1	22.1
	Balance	-1231	-1247	-1363	-1581	-1800	-478	.	.	.
Bosnia and Herzegovina	Exports	1068	1188	1441	1934	2640	698	34.2	36.5	26.6
	Imports	4115	4253	4758	5715	5818	1475	20.1	1.8	41.1
	Balance	-3046	-3066	-3317	-3781	-3178	-776	.	.	.
Montenegro ²⁾	Exports	210	271	452	434	500	.	-3.9	15.0	.
	Imports	593	630	869	940	1180	.	8.3	25.0	.
	Balance	-383	-359	-416	-506	-680	.	.	.	.
Serbia	Exports	2193	2441	2853	3617	5092	1385	26.8	40.8	40.6
	Imports	5919	6603	8679	8470	10448	2894	-2.4	23.3	30.8
	Balance	-3726	-4162	-5826	-4853	-5356	-1509	.	.	.

1) Preliminary. - 2) From 2004 including trade with Serbia & Kosovo.

Source: wiiw Database incorporating national statistics.

Table 3

Foreign financial position											
EUR bn, end of period											
	Gross external debt ¹⁾			Reserves of National Bank (excluding gold) ²⁾			Current account				
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2007 forecast	2008 forecast
Croatia	22.8	25.5	29.0	6.4	7.4	8.7	-1.4	-2.0	-2.6	-2.8	-2.8
Macedonia	1.5	1.8	1.8	0.7	1.0	1.3	-0.3	-0.1	0.0	-0.1	-0.1
Turkey	129.3	135.7	164.4	29.0	40.6	48.5	-12.5	-18.5	-25.3	-25.0	-27.0
Albania	1.2	1.4	1.5	1.0	1.2	1.4	-0.3	-0.5	-0.6	-0.7	-0.6
Bosnia & Herzegovina	2.1	2.2	2.1	1.8	2.1	2.8	-1.4	-1.7	-1.0	-1.1	-1.0
Montenegro	0.5	0.5	0.6	.	.	.	-0.1	-0.2	-0.6	-0.3	-0.4
Serbia	10.4	13.1	14.9	3.0	4.8	8.8	-2.3	-1.8	-2.9	-3.7	-3.7

1) Gross external public debt for Bosnia & Herzegovina and Montenegro. Macedonia medium- and long-term debt. - 2) Albania: refer to total foreign assets including gold.

Source: wiiw Database incorporating national statistics, forecast: wiiw.

Growth has continued to be fuelled by consumption, both private and public. In most countries, wages and salaries increased in real terms throughout the first half of the current year. Furthermore, whatever data on investments are available, they point to acceleration, e.g., in Serbia by 25% in

2007, in Croatia and Macedonia over 10% in the first quarter. Indeed, an important turn-around may be afoot with investment taking over as the main driver of growth rather than consumption.

Table 4

FDI inflow									
EUR million									
	2000	2001	2002	2003	2004	2005	2006 ¹⁾	2006 ¹⁾	2006
							in % CA		stock
Croatia	1139	1503	1197	1785	990	1425	2838	108	20333
Macedonia	189	493	83	84	126	80	279	1479	2100 ¹⁾
Turkey	1053	3612	1203	1537	2326	8080	16027	63	60008
Albania	155	232	143	158	278	224	259	47	1812
Bosnia and Herzegovina	159	133	282	338	534	421	338	32	2600 ¹⁾
Montenegro	.	.	.	44	53	393	644	113	1215 ²⁾
Serbia ³⁾	55	184	504	1208	777	1265	3504	121	8317

1) wiiw estimate. - 2) Cumulated inflows from 2001. - 3) Until 2004 FDI net. FDI stock refers to cumulated inflows from 1997.

Note: CA means current account deficit.

Source: wiiw Database incorporating national banks statistics.

Another important indicator of an improved economic environment is continued rapid growth of exports (see Table 2). In Albania, Serbia, Macedonia and Bosnia and Herzegovina exports are expected to grow faster than imports for the year as a whole, while in other countries imports are outpacing the relatively rapid export growth. None the less, given that this region has mostly relied on imports for quite a long time, growing exports are indicators of improved economic structure in terms of production and increased reliance on markets.

Table 5

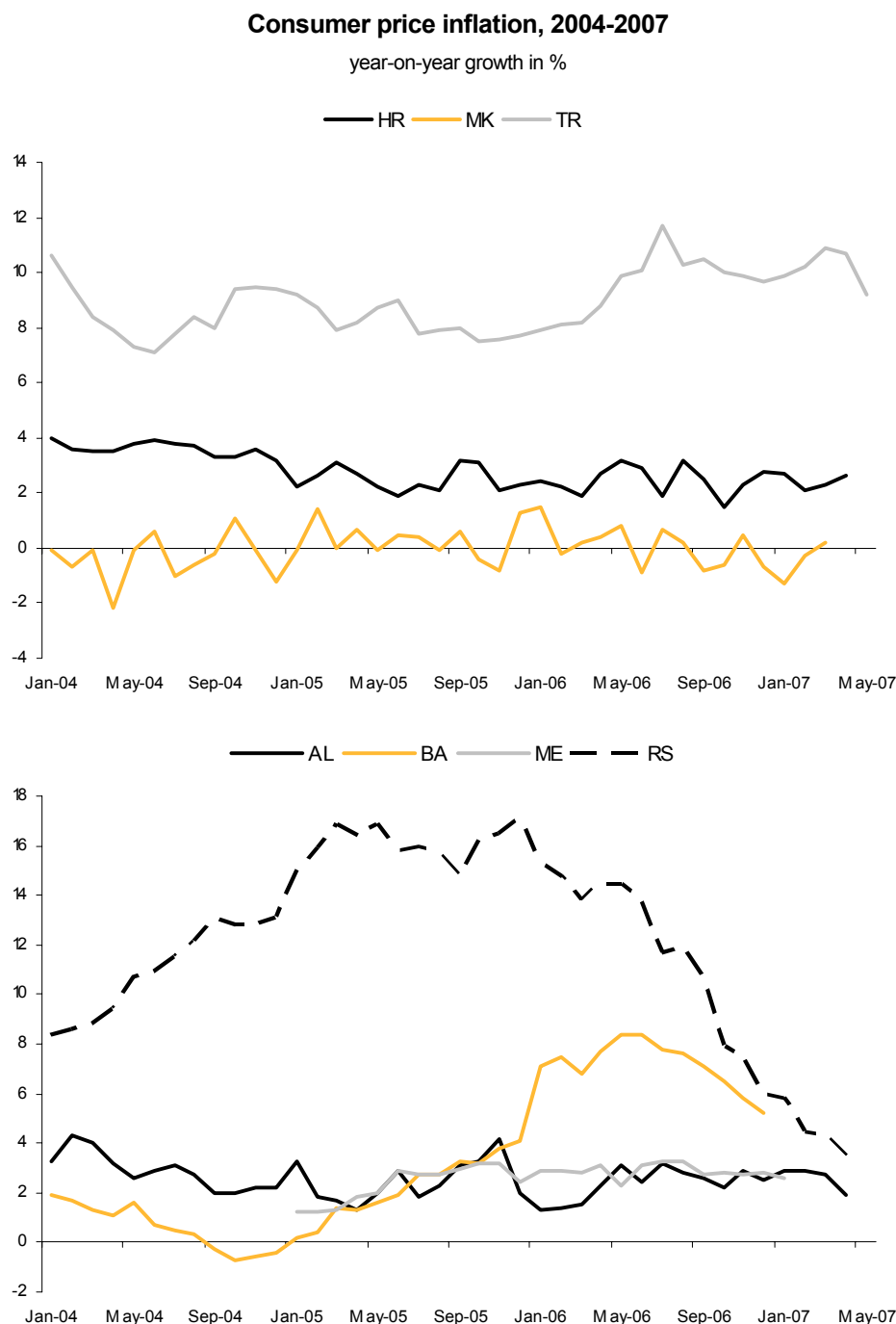
Consumer price inflation									
change in % against preceding year									
	2002	2003	2004	2005	2006 ¹⁾	2006	2007	2007	2008
						1st quarter		forecast	
Croatia	1.7	1.8	2.1	3.3	3.2	3.5	1.6	2.8	2.3
Macedonia	1.8	1.2	-0.4	0.5	3.2	2.7	1.0	3	3
Turkey ²⁾	45.0	25.3	8.6	8.2	9.6	8.1	10.3	7.5	5
Albania	5.2	2.2	3.0	2.4	2.4	1.4	2.8	2.5	3
Bosnia & Herzegovina ³⁾	1.3	1.1	0.8	3.0	7.2	7.1	.	3.7	2
Montenegro	16.0	6.7	2.4	2.3	3.0	2.9	2.5	3	3
Serbia	16.6	9.9	11.4	16.2	11.6	14.8	4.8	8	6

1) Preliminary. - 2) From 2004 new methodology. - 3) Costs of living.

Source: wiiw Database incorporating national statistics, forecast: wiiw.

Foreign investments also increased throughout the previous year: they continue to flow into the region though not at the same pace (see Tables 3 and 4). In addition to investments in privatization projects, which are still the foreign investors' main targets, an increasing numbers of greenfield investments have emerged. There are early signs of increased interest in investments in production to supply these growing markets and economies.

Figure 2



Source: wiiw Monthly Database incorporating national statistics.

All these indications of the regional economies' improved performance are accompanied by growing signs of improved stability. Even in the past, inflation did not pose a threat to stability (see Tables 5 and 6). Stability has since been strengthened by the continuing deceleration of inflation in Serbia (see Figure 2). Until the middle of last year, Serbia was very much an outlier with inflation running at close to 20%. Since then, a sharp appreciation of the local currency, combined with a much more restrictive monetary policy, has managed to bring the inflation rate down to single digits. Turkey alone still poses some significant risks to price stability.

Table 6

Producer prices in industry

change in % against preceding year

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008
Croatia	-0.4	1.9	3.5	3.0	2.9	3.5	1.9	2.5	2.4
Macedonia	-0.9	-0.3	0.9	3.2	4.5	5.6	0.9	2	3
Turkey ²⁽³⁾	48.3	23.8	13.1	7.6	9.3	4.9	11.2	7.5	5
Albania ²⁾	5.1	1.8	12.2	4.9	0.7	0.7	.	2	2.5
Montenegro	14.5	4.5	5.8	2.1	3.6	0.9	3.0	3	3
Serbia	8.8	4.6	9.1	14.2	13.3	14.3	5.5	8	6

1) Preliminary. - 2) In manufacturing industry. - 3) Wholesale prices.

Source: wiw Database incorporating national statistics, forecast: wiw.

A more important development is that stability and growth have proved to be much more resilient to political shocks and instabilities than in the past. In a number of countries, political instability of one kind or another has not translated into either nominal or real economic instability. Although no solution has been found to any of the key problems that were a drag on the economy in the past, growth has remained strong and prices have remained stable or have been stabilized.

Productivity and employment

Productivity has continued to be the source of growth rather than increased employment (see 'Figure 3). In a number of countries, employment has continued to decline despite strong growth. However, in an increasing number of countries, employment is also starting to pick up and some unemployment rates have dropped somewhat. It is hard to be more precise about these facts, given the quality of the employment and unemployment data and for want of reliable data on labour mobility, especially when it relates to outward migration. The indirect indications are, however, that the situation in the labour market is improving (see Table 7).

Table 7

Unemployment

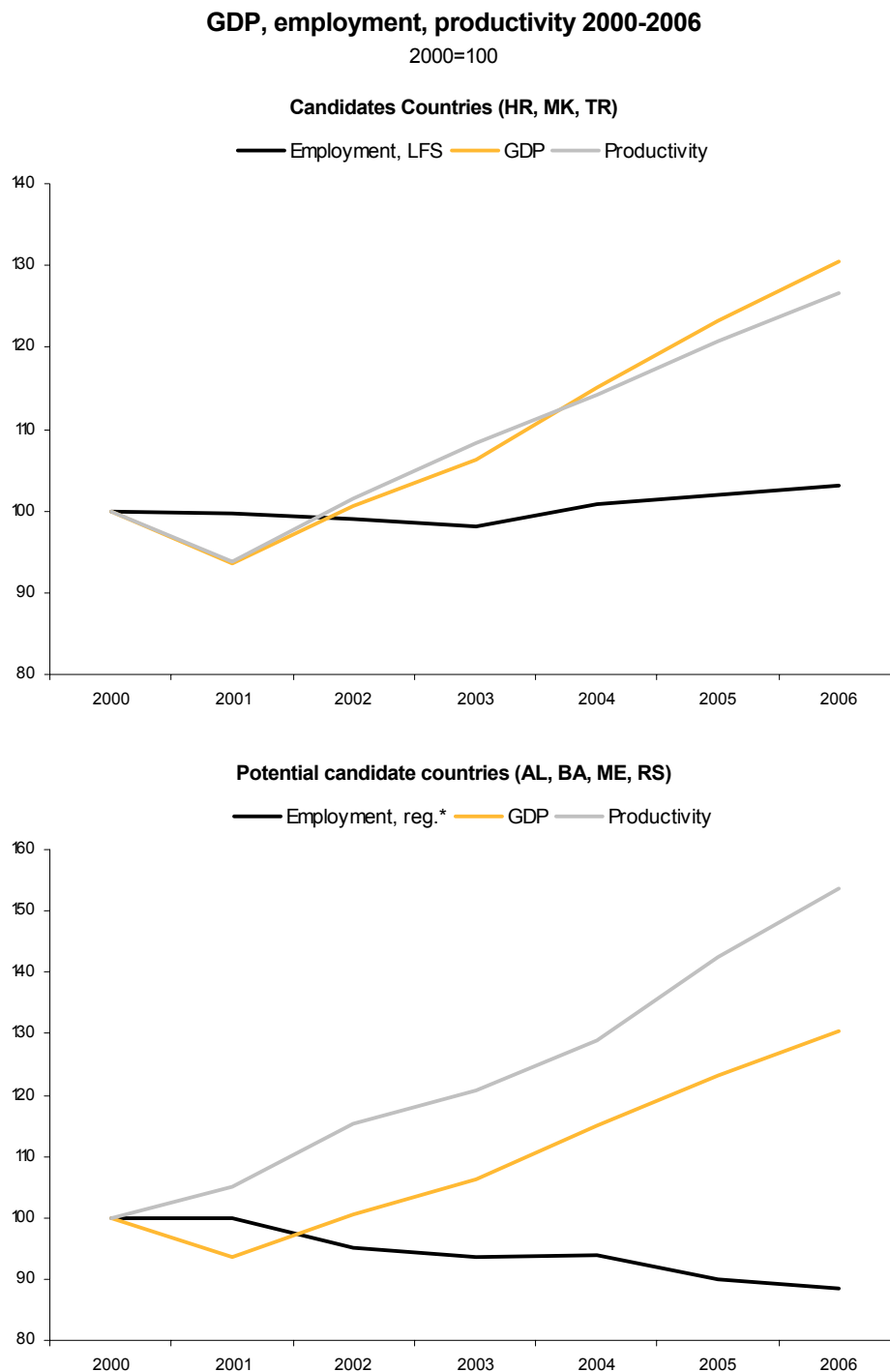
LFS definition, annual average

	in 1000 persons						rate in %				
	2001	2002	2003	2004	2005	2006 ¹⁾	2004	2005	2006 ¹⁾	2007 forecast	2008
Croatia	277	266	256	250	229	199	13.8	12.7	11.1	10.8	10.3
Macedonia	263	263	316	309	324	321	37.2	37.3	36.0	35	35
Turkey	1967	2464	2493	2498	2520	2446	10.3	10.3	9.9	9.5	9
Albania ²⁾	181	172	163	157	155	150	14.4	14.2	13.9	14	13.5
Bosnia & Herzegovina ²⁽³⁾	422	442	460	486	508	367	43.2	44.2	31.1	30	30
Montenegro ⁴⁾	58	58	.	72	78	77	27.7	30.3	30.0	30	30
Serbia ⁵⁾	433	460	500	665	720	693	18.5	20.8	20.9	22	23

1) Preliminary. - 2) Registered unemployment, end of period. - 3) From 2006 data based on the first LFS, April 2006. - 4) From 2004 according to ILO and Eurostat LFS definition and census 2003. - 5) From 2004 according to census 2002 and revisions based on ILO and Eurostat methodology

Source: wiw Database incorporating national statistics, forecast: wiw.

Figure 3



* Serbia data are based on LFS.

Source: wiw Monthly Database incorporating national statistics.

This is supported by steady industrial growth and rapid growth in the construction sector. In many countries, the tourist industry is also doing much better: something that also helps the labour market. Industrial production growth is outpacing GDP growth in a number of countries. This is partly due to the fact that decline has been sharper previously. Manufacturing, however, is posting higher growth rates than industry as a whole; this should be an indication of a growing market for local products

rather than exports. There are still few signs of large-scale reindustrialization, but the figures are increasingly encouraging (see Table 8 and Figure 4).

Table 8

Gross industrial production											
real change in % against preceding year											
	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008	Index 1990=100 2006	Index 2000=100 2006
Croatia ²⁾	5.4	4.1	3.7	5.1	4.5	6.4	8.0	6	5	85.0	132.5
Macedonia ³⁾	-4.8	4.1	-2.2	7.1	2.5	0.5	11.6	5	5	54.6	103.3
Turkey	9.5	8.7	9.8	5.5	5.8	2.8	7.9	6	9	204.2	133.2
Albania ⁴⁾	-5.1	29.0	14.1	1.3	1.5	.	.	2	3	54.5	152.4
Bosnia and Herzegovina ⁵⁾	5.7	5.1	12.1	10.8	11.5	9.8	10.7	11	10	.	161.4
Montenegro	0.6	2.4	13.8	-1.9	1.0	4.4	-5.3	3	3	.	115.4
Serbia	1.8	-3.0	7.1	0.8	4.7	5.7	4.8	5	5	.	111.7

1) Preliminary. - 2) Enterprises with more than 20 employees. - 3) Enterprises with more than 10 employees. From 2004 new methodology and new weighting system. - 4) Gross value added. - 5) wiiw estimates based on weighted averages for the two

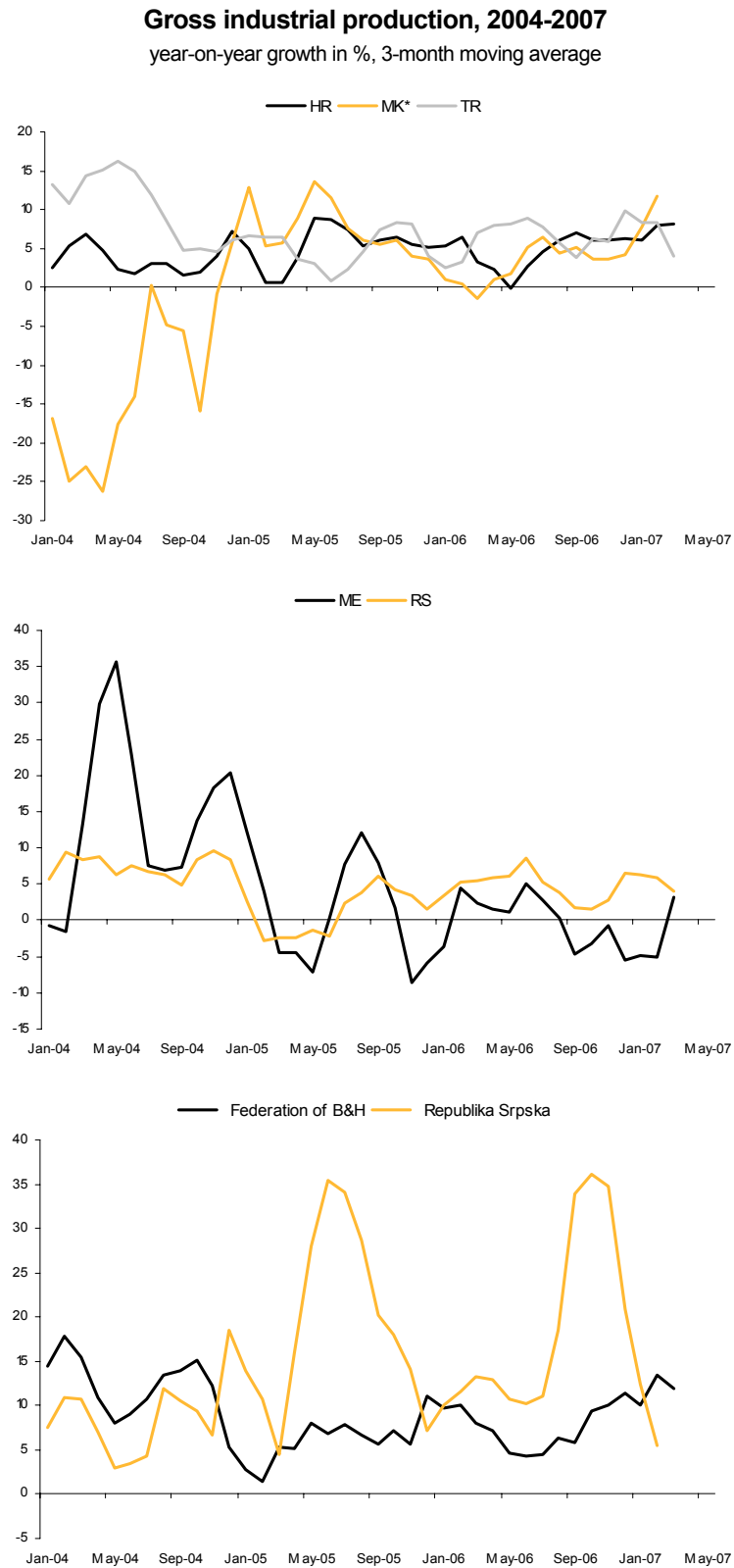
Source: wiiw Database incorporating national statistics, forecast: wiiw.

It is not yet clear how important the increased openness of the intra-regional markets has become. Though CEFTA has yet to start operating in full force, the expectation is that it will contribute further to the accessibility of local markets. To the extent that growth of industrial production has been limited by the extent of the market, this barrier is now being steadily eroded. In addition to that, growing investments in infrastructure are bringing markets closer to producers: probably one of the reasons for the continued improvement in industrial production.

As far as can be determined from the scant data on restructuring in industry, it seems that a technological change is also taking place (see Figure 5 and Table 9). Many of the inherited industrial plants have not been resuscitated and will probably remain dormant in the future. Thus, whatever industrial production is started, it is mostly on the basis of new investments and new technologies. That probably also explains the slow rate of reindustrialization, because existing companies have not proved useful and new investments need larger and more stable markets in order to justify the relatively high initial costs.

Reliance on new production capacities and enhanced productivity of labour becomes essential given the relatively high wages in most of these countries. Although employment is low and unemployment high, wages are also comparatively high. All the indications are that wages are higher in these countries than in comparable countries at the same level of development. For instance, despite better economic performance throughout the transition period, wages in Bulgaria and Romania have remained lower than in the other Balkan countries, with the exception of Albania. This is due in part to the existence of other sources of income. In the past, the other sources of income have mostly been remittances, which have remained the crucial factor and will remain so in the future. In addition, however, income from property is proving important in many cases. The relatively rapid growth in real estate prices has opened up that source of income and has supported a matching growth in credit. As a consequence, the minimum wages that are acceptable for the labour in demand in the region are somewhat higher than in countries with a comparable level of GDP *per capita*.

Figure 4



* From 2005 new methodology.

Source: wiiw Monthly Database incorporating national statistics.

Figure 5

Labour productivity in industry, 2004-2007

year-on-year in %, 3-month moving average

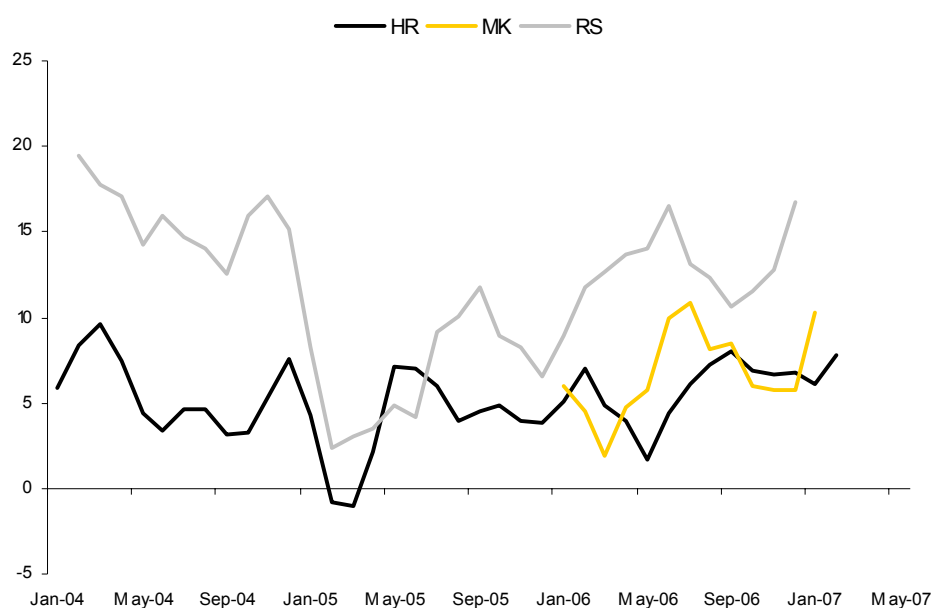


Table 9

Labour productivity in industry

real change in % against preceding year

								Index 1990=100 2006	Index 2000=100 2006
	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007		
Croatia ²⁾	9.6	7.7	5.7	3.6	5.8	7.0	7.8	210.8	149.9
Macedonia ³⁾	1.9	10.1	4.6	11.9	6.3	.	.	165.5	139.8
Turkey ⁴⁾	10.2	7.4	8.2	5.6	6.2	.	.	.	142.0
Albania	.	.	.	.	.	.	.	.	.
Bosnia and Herzegovina	4.2	17.3	14.4	11.6	.	.	.	.	.
Montenegro ⁵⁾	5.3	6.0	.	.	.	.	.	.	.
Serbia	12.7	10.9	12.5	9.0	13.5	11.7	.	.	181.1

1) Preliminary. - 2) Enterprises with more than 20 employees. - 3) Enterprises with more than 10 employees. - 4) In manufacturing industry. - 5) Excluding small enterprises.

Source: wiiw Database incorporating national statistics.

With high wages and the low value of existing capital stock, substitution occurs in favour of capital and technology. This keeps the wages high, but also gives rise to various structural reasons for unemployment. Rates of unemployment are still high or very high, despite their being on a downward trend, except in Serbia. The demand for skilled labour is also increasing, as is the demand for investments in education. The acquisition of skills through learning-by-doing type is taking place on a large scale, but the demand for better education is increasing apace, hence

educational reform features prominently on the agenda in many countries. Public investment in human capital is also on the increase, as are the numbers of private schools, training facilities and universities.

Trade and external balances

Exports are growing, but so are imports. Trade deficits are thus still quite high (see Table 2 and Figure 6). To the extent that they are “covered” by foreign investments, these deficits may not be problematic assuming that they are sustainable, i.e. they will not lead to an adjustment in relative prices. Furthermore, the rapid growth of credit together with increased investments in productive capacities should prove a stabilizing factor as they tend to improve both the perception and allocation of risk.

The rapid growth in construction is financed to an unknown extent by private transfers, especially remittances. This has probably had a greater effect on domestic production rather than on demand for imports; hence, it should also prove to be a stabilizing factor. In the past, remittances were mostly used to finance consumption which, in turn, tended to support imports in the absence of domestic production. That is probably still true in many cases, but to an increasing degree private transfers are being used to invest in private housing and small businesses. That tends to increase the demand for domestically produced goods and services, in addition to increasing the domestic supply of goods and services.

The growth in commodity exports is still limited to few sectors. As in other communist countries, in a number of Balkan countries steel-mills were built everywhere and generated major losses. Through the growing demand for iron and steel these capacities have recently become productive and are proving to be the driving forces of export growth. This certainly applies to Serbia, as well as to Bosnia and Herzegovina and Macedonia. Capacities also lie unutilized in Croatia and Montenegro, but privatization and restructuring have proved difficult there.

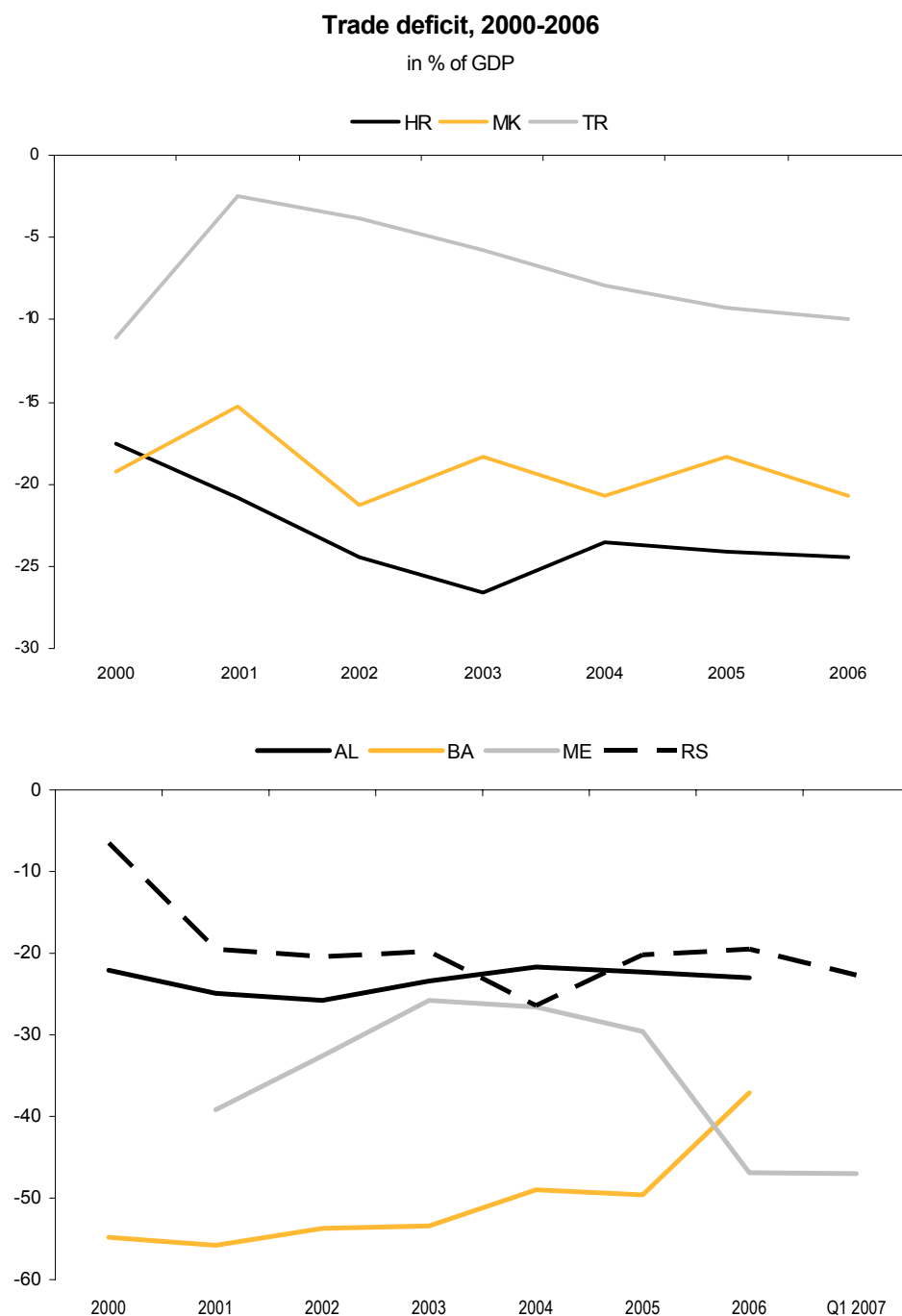
Apart from steel and some other extraction, agriculture is also a traditional export sector. It is certainly important in Serbia and Macedonia, but in Turkey as well. In these countries, as well as in Croatia, textiles and apparel are still being exported and in terms of employment they are still important industries. Unlike Turkey, which is increasing its exports of manufactured goods, there are only a few industrial goods, albeit growing in numbers, that are being exported. None of the rapid growth industries that have proved to be sources of significant exports elsewhere have been built in this region (as already mentioned, Turkey is an exception). The automotive industry has studiously avoided this region, as have other producers of all types of machinery.

Along the coast, tourism is growing fairly swiftly; these exports perhaps take on the greatest importance in countries such as Croatia, Montenegro and Albania. Tourism is also important in Turkey, but not to that extent. Even landlocked countries, such as Macedonia, Serbia and Bosnia and Herzegovina, are recording growing exports of tourist services. In most cases, however, the services balance is also turning negative because growing incomes lead to growing consumption of leisure and holidays that local people often spend abroad.

Current accounts are also reporting continued high deficits - in most cases even worsening deficits (see Figure 7). The extreme case is Montenegro which has seen a dramatic increase in its current

account deficit owing to massive inflows of foreign investments. Current accounts, however, have deteriorated in both Croatia and Serbia, while they have improved in Bosnia and Herzegovina and Macedonia. In most cases, worsening current accounts have not led to an increase in foreign debt to GDP ratios (except in Croatia and Serbia), because of the acceleration of the GDP growth.

Figure 6



In two countries, however, the foreign debt to GDP ratio continues to deteriorate. In Croatia this has long been the case. Although the foreign debt to GDP ratio exceeded 85% at the beginning of this

year, it fails to worry Croatia's creditors, yet continues to worry its central bank. At the end of last and the beginning of this year, the central bank imposed a ceiling on the commercial banks' credit activities equivalent to 12% per year. As a consequence, credit growth dropped to 20% in the first half of this year. This has also led to a deceleration in the accumulation of foreign debt.

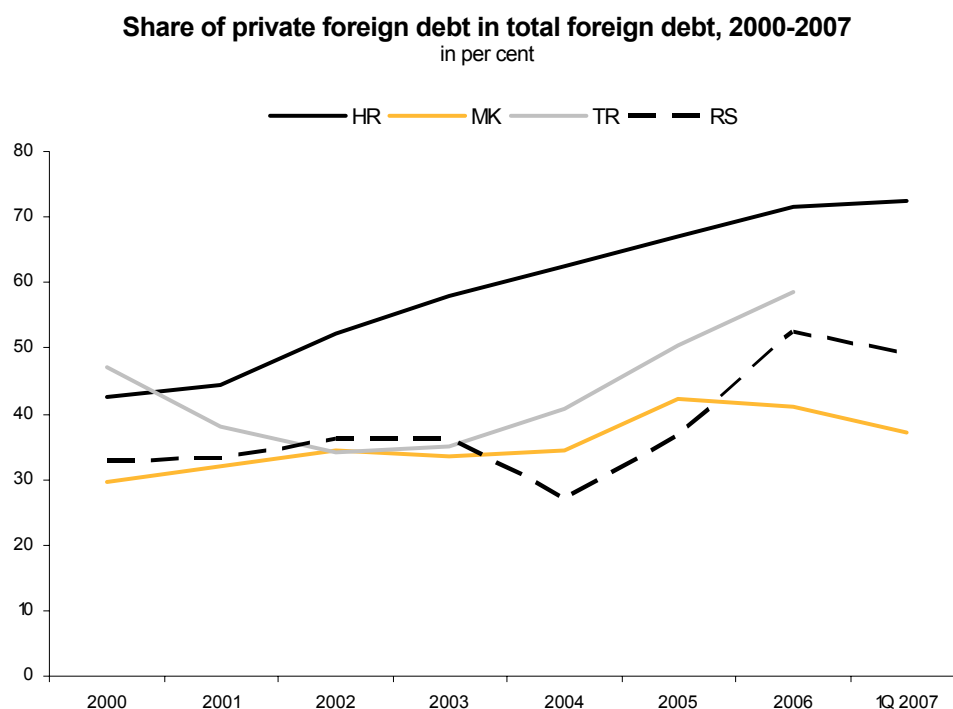
Figure 7



In Serbia, on the other hand, foreign debt continues to grow as a consequence of a high and growing current account deficit. At the end of the first quarter of 2007, Serbia's foreign debt to GDP

ratio stood at 60%. It is expected to exceed 62% by the end of the current year even though GDP growth in euros is expected to be around 11%. It is hard to determine the direction in which Serbia's debt to GDP ratio is heading because of the volatility of GDP and prices; however, it would not be unrealistic to say that given the way it has been developing over the past couple of years, it can hardly stabilize at less than 150%. It also seems to be growing by more than 4 percentage points per year and that growth will accelerate with the further decline in inflation.

Figure 8

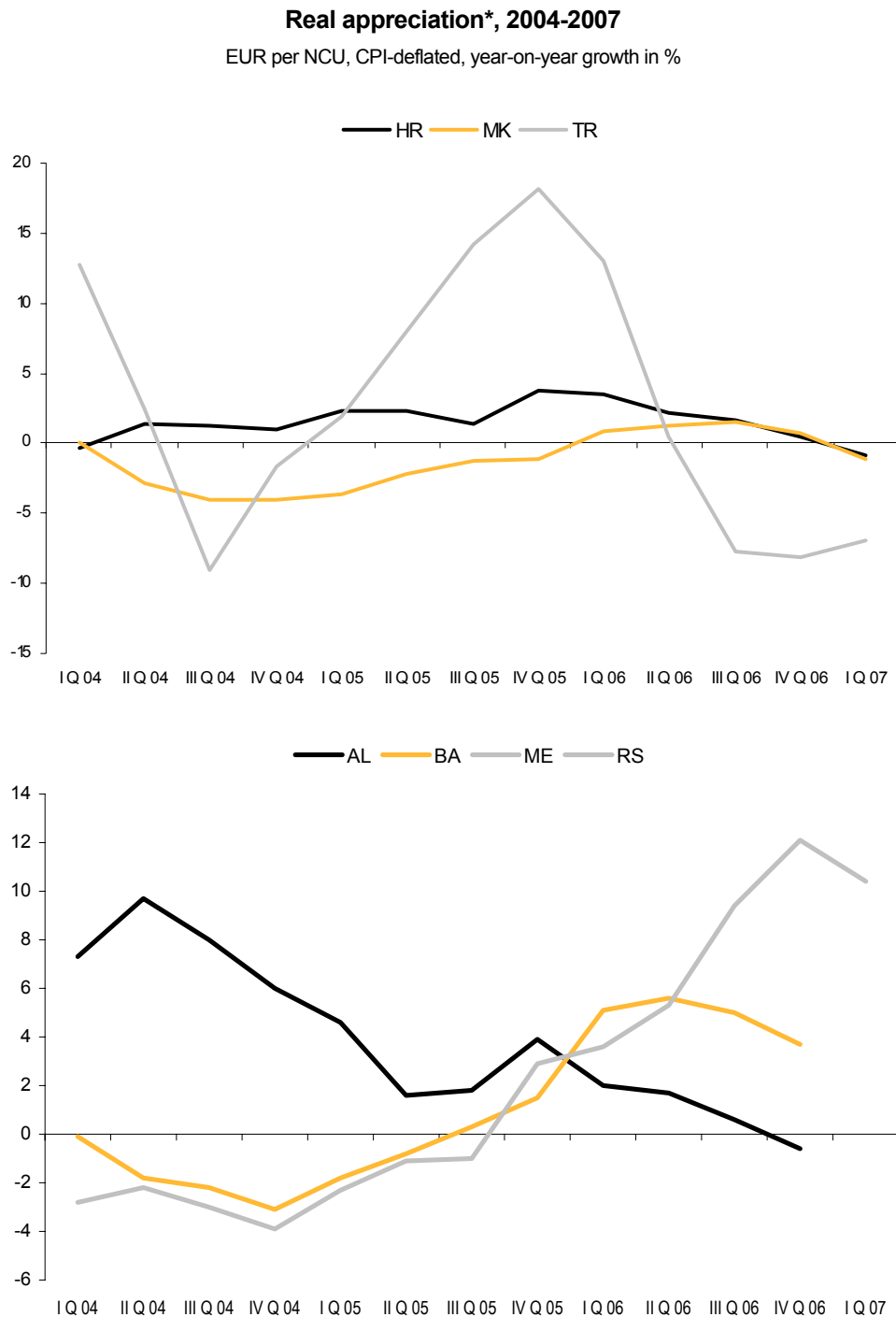


Source: National Banks of the respective countries.

Not only in Croatia and Serbia, but in all the other cases too, it is the share of private foreign debt in total foreign debt that is increasing (see Figure 8). Public debt is declining in a number of cases nominally and certainly in terms of GDP. Indeed, in some cases, governments have decided to draw down funds from increased privatization revenues and pay back some of their foreign debts ahead of time. Serbia, for instance, has paid back all its debt to the IMF and Macedonia has cleared some of its debt with the Club of Paris.

In both Serbia and Macedonia, the development of the external balances offers prima facie evidence of an overvalued exchange rate. Serbia may be getting into a situation similar to that of Croatia several years back. The latter country dealt with what according to all indications was an overvalued exchange rate by relying on its growing exports of services and adjustments in the labour market. This has resulted in Serbia accruing a high foreign debt which may require further labour market adjustment in the future. In the case of Croatia, the aim was to stabilize prices: indeed, they have been stable for over a decade now. Serbia is also trying to stabilize prices with an overvalued exchange rate, but it is only at the very beginning of the adjustment process (see Figure 9). Improvements in the services sector, however, will not have the same effect on exports as in Croatia, because Serbia does not enjoy the comparative advantages of tourism. Indeed, in the past couple of years, its balance of services has been negative - unlike Croatia where it has been markedly positive.

Figure 9



* Increasing line indicates real appreciation. Serbia: based on end-of-month exchange rates.

Source: wiw Monthly Database incorporating national statistics.

In the other countries, foreign debt does not have the tendency to grow compared either to the GDP or to exports. This is partly the consequence of the way the trade deficit is financed; in some cases, viz Bosnia and Herzegovina, there are still significant public transfers. In the case of Turkey, the

public debt to GDP ratio continues to drop owing to high primary surpluses in the fiscal balance. Private debt, on the other hand, is growing rather rapidly, but from a very low level in most countries.

Public finances and stability

Most of the countries in this group rely on fixed exchange rates. Serbia and Turkey are the exceptions. In all cases, fiscal policy is of key importance, albeit to different degrees. In the past, it also used to be the key cause of instability; partly because it was sensitive to political, electoral and other shocks and partly because of the underlying social pressures. In a number of cases, it was also isolated somewhat from the political process and was thus mostly concerned with consolidating and lending support to the shaky exchange rate (see Table 10). In recent times, fiscal policy has changed in a number of respects.

Table 10

General government budget balance, in % of GDP ¹⁾

	2000	2001	2002	2003	2004	2005	2006 ²⁾	2007 forecast	2008 forecast
Croatia	-6.5	-6.7	-5.0	-6.2	-4.9	-4.1	-3.0	-3	-2.5
Macedonia	2.3	-6.3	-5.0	-1.1	0.0	0.3	-0.6	-1	-1
Turkey	.	.	.	-11.3	-5.8	-0.3	0.4	-2.6	-2.1
Albania	-7.5	-6.9	-6.0	-4.9	-5.1	-3.4	-3.2	-3	-4
Bosnia and Herzegovina	-6.5	-3.3	-0.1	0.8	1.7	2.6	2	0	0
Montenegro ³⁾	-6.0	-3.1	-2.8	-3.1	-2.1	-1.8	1.8	0	0
Serbia	.	-1.5	-3.3	-4.0	-1.4	1.4	-0.6	-2	-2

1) National definition; for Turkey EU definition: net lending (+) or net borrowing (-) according to ESA'95, excessive deficit procedure; for Croatia IMF definition. - 2) Preliminary. - 3) Central government budget deficit.

Source: wiiw Database incorporating national statistic, wiiw forecasts.

Most of the countries in the region have undergone a process of democratization and can be considered relatively stable democracies, notwithstanding certain deficiencies. It will also be very interesting to see whether elections continue to weaken (as before) or strengthen the fiscal policy stance and structure of public revenues and expenditures. In the past, Croatia was a country that had difficulties in curbing public expenditures. Before elections, the incumbent government used to grant more rights and increase wages and pensions. The incoming government would thus have to embark on a fiscal consolidation programme immediately after taking office. This year is an election year in Croatia; however, it seems that there will be fewer attempts to sway the voters through increased public expenditures. Some deterioration in the fiscal balance could be conceivably expected, although it is not planned; in any event, it will be nowhere near to what it was previously.

Populism

Populism is on the rise in transition countries now member states of the EU, e.g., in Poland, Romania and Bulgaria. In the future member states, the picture is somewhat different. A contrast between the pre-election debates in Serbia and Croatia may be illustrative of the regional trends.

In Serbia, the pre-election debate, at least when it comes to economic issues, was concentrated on fiscal measures that would help one or the other group of voters. Also, public investment and public ownership was promoted as being more in the public interest than private sector development. Finally, big anti-corruption scandals were uncovered by the incumbent government. The parties were mostly competing in promises of tax and investment favours with hardly any mention of fiscal or structural reforms. The budget that came out after the election is a fair reflection of that.

In Croatia, however, the pre-election debate does centre around two broadly different programmes, none of which in fact contains the populist themes. The opposition, broadly speaking from the left, argues for structural reforms centred on an industrial policy that aims to support growth of industrial production. The programme also supports investments in science and education. A major new fiscal measure is the proposed introduction of the capital gains tax.

The leading, right-wing, party that is heading the governing coalition, on the other hand, favours lower taxes and structural reforms that are business-friendly.

Taking these two examples as two extreme cases, it could be argued that most of the other countries are closer to that side where Croatia is rather than where Serbia is. That is an illustration of the increased political stability in this group of countries.

Unlike Croatia, Serbia did engage in massive pre-election increases in public spending. The elections were held at the end of January 2007 and the government increased spending to such an extent that in the fourth quarter public expenditures accounted for a 7.4% deficit in that quarter's GDP. Most of these expenditures were wage increases for public sector employees. In addition, the government promised various tax privileges if it were re-elected. It promised massive increase in public investments. All of that implied a significant increase in overall public spending. The budget for 2007 that was eventually adopted in mid-June of 2007 incorporated most of these promises, representing a 28% nominal increase in expenditures over the previous year's budget. This is also because there are presidential and local elections scheduled for later in the year and votes will still have to be bought.

Serbia's budget deficit

Serbia's current central budget envisaged a deficit of 0.6% of GDP. The projection for the general government budget deficit is 0.4% of GDP. However, if off budget expenditures are included, the deficit goes up to about 2.5% of GDP. This is without the guarantees that will be granted, which would bring the general government budget deficit to close to 4% of GDP. That is higher than in all the other countries considered here.

Most of this increase consists of higher wages and of public investments. Both are reversible in principle, though not in practice, at least not easily. The rise in wages should trigger more spending on pensions as they are tied to wages at least at very low levels. If growth remains at around 5% per year and if inflation continues to decelerate, fiscal consolidation may prove to be a tough sell in the next budget because it should be introduced in the parliament at the time of local and possibly presidential elections. Thus, relatively large budget deficits will probably characterize the fiscal policy of the current government.

Most other countries have moved on from this type of crude intervention in the election process. For instance, in Turkey, which is notoriously sensitive to political shocks, current political tensions and the upcoming elections seem to have been of little consequence to budgetary policy. Indeed, the economy's reactions to current political developments that involved massive demonstrations and

threats of a military coup have been rather mild. This is the added evidence of growing economic stability and resistance to short-term political challenges.

In most other countries another change can be detected. In the past, concern over fiscal consolidation used to lead to savings in public investments. Thus, consolidation policies were not really very popular. Croatia was the first country to buck the trend; the previous government, the one that lost the election in 2004, increased investments in infrastructure quite dramatically, mostly to support tourism. The current government has maintained that policy, albeit at a lower level. Montenegro has also started investing in infrastructure, mainly to support its tourist industry as well. Serbia has followed suit and intends to invest even more over the next few years. Finally, the most conservative country when it comes to public investments, Macedonia, decided to allow a minor fiscal deficit last year and is planning to invest in human capital and institutional development this year, even if it means that the fiscal deficit will rise to 1% of GDP.

Public investments

Data on public investments are not readily available. In some cases, they are not to be found in the budget because the public sector is not consolidated within the general budget and because there are official transfers, increasingly from the EU. The shift towards more public investments can be estimated to be between 22% of GDP in a country such as Macedonia and 4% in Croatia some years back. It is realistic to forecast that public investments will go as far up as 5% to 6% of GDP. This is on the assumption that there will be an increase in the development type of investments and also assuming that the public sector will not be privatized as quickly as was previously planned.

In addition to the change in the approach to public financing, the countries have adopted various changes in their taxation systems. In most countries, corporate income tax rates have gone down significantly. They range from 10% in Albania and in Republika Srpska, to 13% in Serbia and 30% in the Federation of Bosnia and Herzegovina (the other entity in Bosnia and Herzegovina). Contrary to that, there is growing discussion about introducing capital gains taxes, which are mostly unknown in the region. The idea was introduced by the opposition during the pre-election debate in Croatia; the issue, however, has also been taken up in other countries.

Tax rates

Most countries have moved towards a more flat system of tax rates. That is understood to mean relatively low rates for personal and corporate income taxes. In addition, for instance in Macedonia, VAT rate should be similar to the rate of income taxes, 10% from next year. Similar ideas have been floated in Bosnia and Herzegovina, where the corporate income tax is much lower, 10%, in the Republic than in the Federation, 30%. Though the flat tax idea is becoming ever more popular, it is generally understood to mean low rates of direct taxes, while most of the revenues are collected from indirect taxes. In addition, the rates of contributions to social security funds are rather high, though the pension funds are mostly running big deficits and rely to a significant extent on the transfers from the budget. Thus, low taxes means just low tax burden on profits rather than on wages. Given that public expenditures are between 40% and 50% of the GDP, with Macedonia at the lower end of the scale and Albania being an exception with a much lower rate, the overall tax burden cannot be low.

Privatization and foreign investments

Foreign investments are projected to go down in most countries in this group. The one country which is relying on significant increases in greenfield foreign investments is Macedonia. Republika Srpska has also announced that it expects dramatic increases in foreign investments, especially in its energy sector. All the other countries have privatization plans, but there have been no reports of significant new investments in new businesses. Also, inflows due to privatization will not be as large as last year; the next round of large privatizations may have to be delayed due to technical reasons and reasons of public finance.

One of the reasons for possible slow-down of privatizations is the growing unpopularity of foreign investments. In Montenegro, parliament stopped the planned privatization of a steel-mill and thermo-plant. The opposition argued only partly on the grounds that it would lead to Russian oligarch Oleg Deripaska owning almost 40% of all the industrial assets in the country; there was also strong criticism of the process of privatization, which is also true for Croatia. The opposition also stressed the general dissatisfaction with the foreign ownership and the corruption surrounding privatization. Similar complaints about corruption have been expressed elsewhere for some time now, but they seem to be gaining political influence. Of course, foreign investments will continue to play a very important role (see Table 11 for dependence on foreign capital flows).

Table 11

Net capital flows								
EUR mn								
	Croatia				Macedonia			
	2003	2004	2005	2006	2003	2004	2005	2006
Capital inflow transfer	4213	2385	3860	5423	199	344	410	311
Capital transfer	72	23	51	-147	-6	-4	-2	-1
FDI	1678	708	1230	2670	84	126	78	279
Portfolio	869	245	-1077	-193	3	12	189	66
Other capital (loans)	1593	1409	3744	3093	118	210	144	-34
Financial derivatives	.	.	-88	.	.	.	.	.
Destination of capital inflow	3101	1447	2807	4030	177	350	399	319
Current account	1866	1404	1985	2617	132	334	66	19
Increase reserves	1236	43	822	1412	45	16	334	300
Errors & omissions	-1112	-938	-1053	-1394	-23	6	-11	8
	Albania				Bosnia & Herzegovina			
	2003	2004	2005	2006	2003	2004	2005	2006
Capital inflow transfer	318	416	439	569	1333	1461	1744	1254
Capital transfer	139	106	99	178	411	348	330	272
FDI	158	270	221	251	338	533	420	338
Portfolio	-20	5	-2	27	.	.	.	.
Other capital (loans)	41	35	120	113	584	581	994	644
Financial derivatives	.	.	.	.	.	.	.	.
Destination of capital inflow	449	522	597	760	1600	1789	2094	1660
Current account	360	288	492	554	1439	1443	1717	1044
Increase reserves	88	234	105	207	162	346	378	616
Errors & omissions	131	106	157	195	268	327	350	406

Table 11 contd.

Table 11 (contd.)

	Montenegro				Serbia			
	2003	2004	2005	2006	2003	2004	2005	2006
Capital inflow transfer	-42	36	366	587	2229	2485	3798	7441
Capital transfer	.	.	.	-14	.	.	.	670
FDI	39	51	381	467	1208	777	1247	3487
Portfolio	1	6	5	-4	.	.	.	.
Other capital (loans)	-82	-20	-20	139	1021	1708	2551	3284
Financial derivatives	.	.	.	.	.	.	.	.
Destination of capital inflow	43	97	328	632	2072	2668	3421	7216
Current account	102	120	154	568	1257	2308	1790	2906
Increase reserves	-59	-22	174	64	815	360	1631	4310
Errors & omissions	85	61	-38	45	-157	183	-377	-225

	Turkey			
	2003	2004	2005	2006
Capital inflow transfer	6528	11473	31323	32683
Capital transfer	.	.	.	.
FDI	1100	1635	7203	14999
Portfolio	2179	6358	10817	5900
Other capital (loans)	3249	3480	13303	11784
Financial derivatives	.	.	.	.
Destination of capital inflow	10727	13206	33080	31298
Current account	7083	12484	18522	26207
Increase reserves	3644	722	14558	5091
Errors & omissions	4198	1734	1753	-1386

Source: wiiw Database incorporating national bank statistics, Eurostat for Turkey.

In Serbia, the new government announced that it does not plan to continue with the privatization of the public sector. It may decide to sell minority shares in the oil and energy sectors and will perhaps put the national air carrier up for sale, but even that is doubtful. The ever growing number of scandals involving public officials and private companies has diminished public support for privatization. The government, the parties and the ministers, on the other hand, have expressed interest in maintaining control over the public companies, which in Serbia produce about 45% of GDP and employ a large number of people. Similar sentiments have been voiced by the prime minister of the Republika Srpska, while privatization is by no means popular in the Federation of Bosnia and Herzegovina.

Public governance and business climate

This reform fatigue that is setting in at a time when the economies in the region are actually doing much better than any time since the start of the transition process, raises the issue of their overall progress towards reform and the quality of public governance and the business climate. A set of indicators for the advance of transition are published by the European Bank for Reconstruction and Development (EBRD) in its annual *Transition Report*. Table 12 gives the most recent assessments for all the candidates and potential candidate countries, as well as one member state of the EU from the Balkan region: Bulgaria.

Progress is measured on a scale from 1 to 4, with 4 and 4+ or 4.33 indicating that the level of the developed market economies has been achieved. Several observations can be made on the basis of this table. On the whole, the duration of the transition process does make a difference. The countries in the Western Balkans have shown less progress than Bulgaria, which has just joined the EU. Croatia is an exception as it does not seem to be lagging far (if at all) behind Bulgaria and it lies ahead of all the other countries in the region.

The other FMS countries are lagging behind Croatia and the other countries in the region. This is attributable to the fact that their transition started later and in a rather more difficult overall setting. Clearly, Bosnia and Herzegovina is not moving all that fast on most structural reforms: an outcome of its complicated and rather dysfunctional overall constitutional set up. In the case of Serbia, transition only started in 2001 and was delayed after the assassination of the prime minister in early 2003. On the other hand, Montenegro started to change before Serbia, but reforms have been slow and uneven due to the country's unclear constitutional position: it was a *de facto* independent country, but remained part of the federation or the state union of Serbia and Montenegro until May 2006.

Table 12

Transition indicators, 2006

	large scale privatization	small scale privatization	restructuring	price liberaliz- ation	foreign trade and exchange rate regimes	compe- tition policy	Banking reform and interest rate liberalization
Albania	3.00	4.00	2.33	4.33	4.33	2.00	2.67
B&H	2.67	3.00	2.00	4.00	3.67	1.67	2.67
Bulgaria	4.00	4.00	2.67	4.33	4.33	2.67	3.67
Croatia	3.33	4.33	3.00	4.00	4.33	2.33	4.00
Macedonia	3.33	4.00	2.67	4.33	4.33	2.00	2.67
Montenegro	3.33	3.00	2.00	4.00	3.33	1.00	2.67
Serbia	2.67	3.67	2.33	4.00	3.33	1.67	2.67
	stock- exchange and other non- banking financial services	other infrastru- cture reform	Telecommuni- cations	railroads	electricity	Roads	water and waste-water
Albania	1.67	2.00	3.00	2.00	2.67	2.00	1.67
B&H	1.67	2.33	2.33	3.00	3.00	2.00	2.00
Bulgaria	2.67	3.00	3.33	3.33	3.67	2.67	3.00
Croatia	3.00	3.00	3.67	2.67	3.00	3.00	3.33
Macedonia	2.33	2.33	3.00	2.00	3.00	2.33	2.33
Montenegro	1.67	2.00	3.00	1.00	2.33	2.00	2.00
Serbia	2.00	2.00	2.33	2.33	2.33	2.67	1.67

Source: EBRD (2007).

It is also clear that the advancement in terms of the macroeconomic stability indicators is better than in terms of structural indicators. Thus, price liberalization is generally judged to be quite advanced, though this assessment could be challenged in the case of Serbia, for instance, where close to 50 per cent of all prices are directly or indirectly controlled by the State. Similarly, external relations are

more liberal than internal relations, a somewhat unusual situation. In all the other respects, the region is still at an early stage of transition.

Though EBRD indicators are widely used to assess progress in transition, other indicators are used even more to assess the progress in terms of those reforms that affect investors and business in general. One such index is provided by the World Bank in its annual publication, *Doing Business: How to Reform*, which covers the whole world. In the most recent issue (2007), it offers a picture somewhat different to that in Table 12. The results can be found in Table 13, which gives the overall ranking of all the countries treated here compared to 175 countries covered by the World Bank report. In terms of overall ranking, Serbia has improved its position from 95th in 2006 to 68th in 2007. Montenegro's position worsened, dropping from 64th to 70th over the same period, Bosnia and Herzegovina was 91st in 2006 and 95th in 2007 and Croatia was 124th in 2006 and 134th in 2007. Turkey went from being 84th to 91st, Albania worsened its position ranking 120th in 2007 compared to 115th in 2006, while Macedonia improved its position slightly by moving from 94th to 92nd country in the world.

Table 13

Doing business indicators, 2007

	Overall	starting business	dealing with licenses	employing workers	registering property	getting credit
Albania	120	121	161	113	76	48
Bosnia and Herzegovina	95	141	160	95	139	7
Croatia	124	100	170	130	109	117
Macedonia	92	76	86	117	87	48
Montenegro	70	83	154	76	106	83
Serbia	68	60	157	73	110	33
Turkey	91	53	148	146	54	65
	protecting investors	paying taxes	trading across borders	enforcing contracts	closing a business	
Albania	162	125	101	99	89	
Bosnia and Herzegovina	83	111	56	117	69	
Croatia	156	58	92	28	80	
Macedonia	83	79	127	72	123	
Montenegro	19	97	80	115	43	
Serbia	60	64	51	76	103	
Turkey	60	65	79	70	138	

Source: The World Bank (2007).

Compared to the EBRD ranking, it is clear in the World Bank ranking that Croatia is doing much more poorly. The discrepancies are even starker if specific categories are compared. Croatia does best in the category 'enforcing contracts', though this is the area where the EU has expressed most concern in its annual reports on candidate countries including Croatia. The World Bank also judges that it is very difficult to obtain credits in Croatia, while the EBRD gives the country high marks for its overall banking reform and generally finds its financial sector to be quite satisfactory. Altogether, the perception of Croatia as reflected in the World Bank's report is completely at odds with that of the EBRD report.

Similar discrepancy surfaces in the case of Serbia, though in the opposite direction. While EBRD suggests that Serbia is at the very beginning of transition, The World Bank ranks it way above Croatia and also suggests that quite significant improvement has taken place between 2006 and 2007 reports (which in effect means between 2005 and 2006 in real time). The only worsening that The World Bank's report notices is that in firing workers, as the new law is rather less favourable to the employers. These discrepancies are somewhat hard to reconcile. It seems, for instance, that Serbia is much more "business friendly" than Croatia, although its institutional development is well behind Croatia's. Similarly, Montenegro, which fares worse than Bosnia and Herzegovina in the EBRD report, is practically on a par with Serbia and way ahead of Bosnia and Herzegovina, which in turn does considerably better than the dismal record of Croatia. Turkey does practically as well as Macedonia and Bosnia and Herzegovina, which is surprising too.

Table 14

Indices of corruption and freedom					
	CPI, 2006	Heritage, 2007	Fraser, 2006	Freedom House, 2007	Global Competitive-ness Report
Albania				partly free (3,3)	98
Bosnia and Herzegovina	93	115		partly free (3,3)	89
Croatia	69	109	74	free (2,2)	51
Macedonia	105	71	102	partly free (3,3)	80
Montenegro				partly free (3,3)	87
Serbia	90			free (3,2)	87
Turkey	60	83	83	partly free (3,3)	59

Other indices provide a consistent picture of a region with countries that face problems with their institutional development, but not necessarily a consistent picture of their ranking within the region. The indicator of corruption that is widely used, the Corruption Perception Index (CPI) of Transparency International of 2006 ranks Croatia 69th and gives it a score of 3.4 on a scale from 1 to 10 (10 being the best). Serbia has a score of 3 and is ranked 90th, together with Gabon and Suriname, while Bosnia and Herzegovina scores 2.9 and is ranked 93rd, together with Armenia, Syria and Eritrea, for instance. Montenegro and Albania are not scored and ranked. Turkey does better than all the other countries while Macedonia is the worst. Judging by this index, the countries are quite corrupt.

The *Global Competitiveness Report* published the World Economic Forum, which is widely used as a summary index of a wide range of indicators of institutional, technological and policy advance, ranks Croatia 51st and Turkey the 59th out of 125 countries in the 2007 report. Serbia and Montenegro are ranked together as 87th and Bosnia and Herzegovina is very close to them as the 89th country in the world. Macedonia is somewhere in between these two groups of countries while Albania is the worst performer. Thus, by this index, Croatia is well ahead of all the other countries in terms of overall economic and institutional development.

Three institutes rank countries according to the measure of freedom they enjoy in economic and political terms. Freedom House ranks countries in terms of political and civic freedom and categorizes them as free, partly free and not free. The first figure in table 3 stands for political and the last figure for the civic freedom. The index ranges from 1 to 5 (with the score of 1 being the best).

Croatia is categorized as free in both categories, while Serbia is taken to be a free country overall, though not in terms of political freedom. All the other countries are considered to be partly free. As for the other two indices of economic freedom, the Fraser Institute ranked Croatia 74th while it puts Turkey at 83rd and Macedonia at 102nd place out of 130 countries in 2006. The Heritage Foundation, however, rated Croatia 109th out of 161 countries in 2007 and Bosnia and Herzegovina 115th while the only other two ranked, Turkey and Macedonia, did much better in 2007.

Thus, it seems there is some inconsistency in the way the countries under consideration here are seen by the institutions that track progress in institutional development. One way to make sense of these diverging assessments is to hypothesize that perhaps those rankings that include indicators of the level of development directly, i.e. the *Global Competitiveness Index* and the EBRD index, tend to rank Croatia higher than those, such as the World Bank business index, that look at formal business indicators or reflect current business perceptions. That would explain the relatively high ranking of Serbia by the business indicators since it is a country that has only recently opened up its economy and is currently attracting a lot of investor and business interest. In all these cases, the relatively high levels of corruption do not seem to be a major impediment to investment and business activities in general. This is essentially in line with the state of affairs that prevailed in the other transition countries about 7 to 10 years ago. It is apparently also the state of affairs prevailing in the new EU member states in the Balkans, Bulgaria and Romania, which do not necessarily score better in terms of various indices of corruption and institutional development, but do attract a lot of business interest.

On the basis of these indices it can be concluded that these countries clearly face problems related to both public and corporate governance. It is, however, hard to determine whether these deficiencies are a barrier to growth and development or whether they will prove to be so in the future.

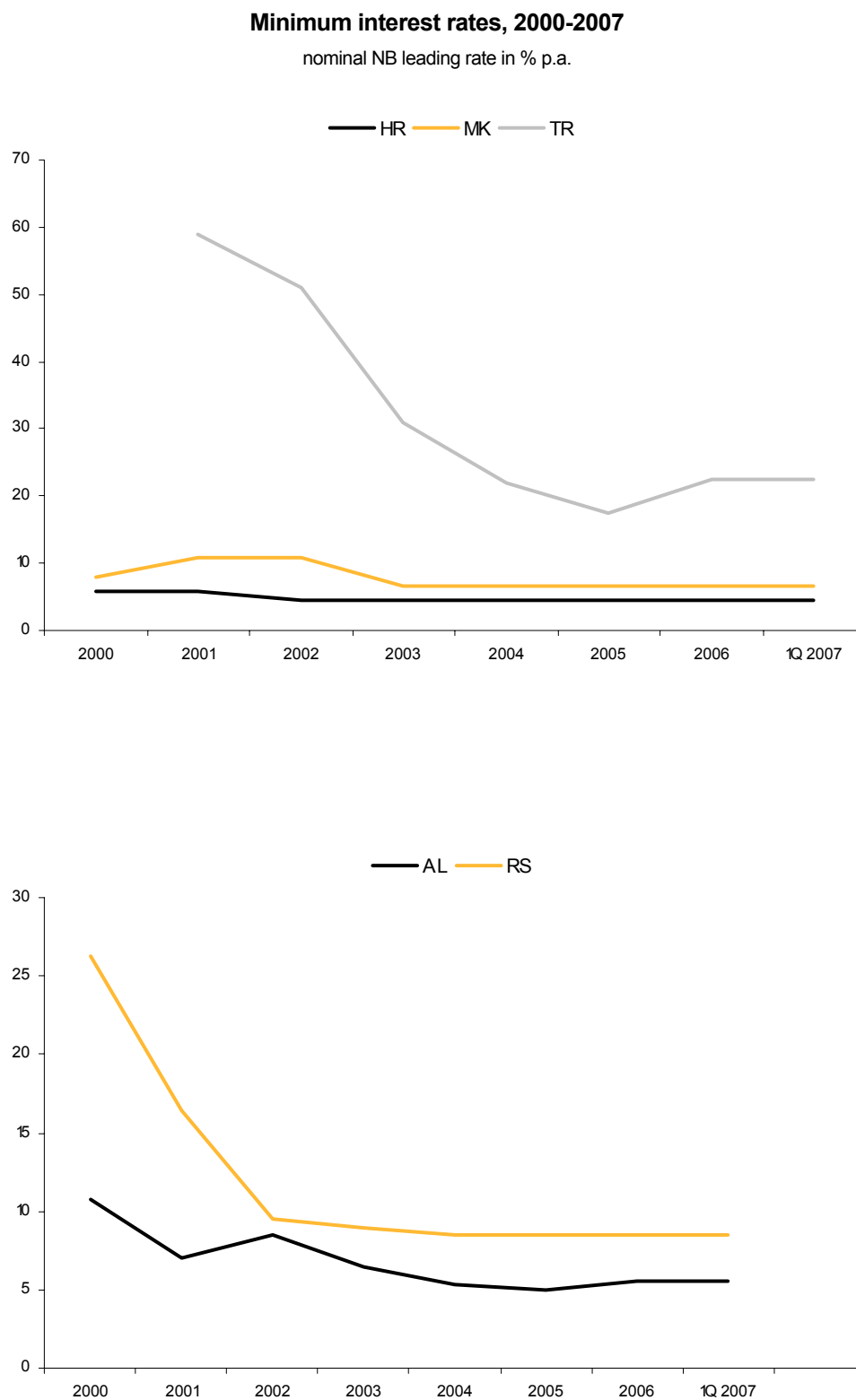
Markets are not worried

Increased stability with significant growth supported bullish markets until quite recently. A sign of possible trouble ahead was the political crisis in Serbia in mid-May. The possibility of the nationalist Radical Party coming into power sent the Belgrade stock exchange into a spin. The crisis was short-lived and markets recovered quickly, but then started to post losses until the second half of June. Similarly, the markets in the region became volatile and started losing ground (see Figures 11 to 13). This is in line with the performance of the other stock exchanges in transition countries, with the exception of Slovenia, where the markets continue to be strong.

The reasons for the increased volatility and risk in the stock exchanges are certainly linked to the general reassessment of risks that is going on in most world markets. More interesting, however, are the reasons specific to each market. As has already been said, the Belgrade stock exchange seems to be reconsidering the new government's policy and is apparently not all that enamoured with it. No specific market unease can be detected, so the correction probably reflects the expectation that interest rates may have to be hiked, whereupon the stock market will suffer.

Similar reasons seem to be at play in other stock exchanges in the region. A rather long and steep rise in the price of equity has been matched by a continuous drop in falling interest rates: an indication of improvements in the investors' risk assessment (see Figure 10). Major increases in the value of stocks have occurred after the resolution of each major political crisis or uncertainty. Thus, stock

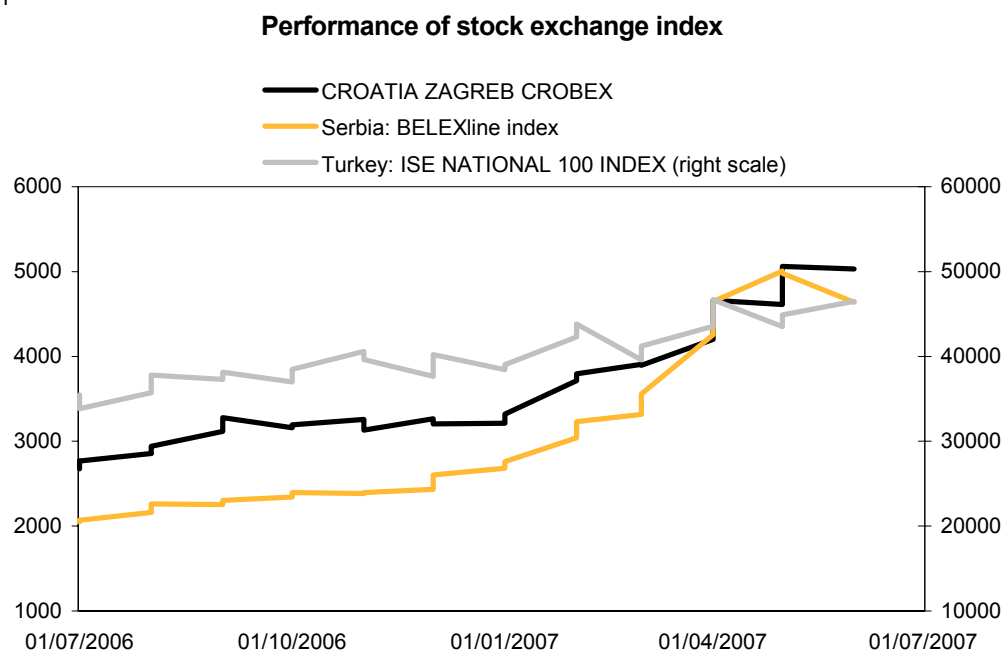
Figure 10



Source: wiw Monthly Database incorporating national statistics.

prices in Montenegro have increased several times since the country gained independence in May 2006. Only since the spring of this year have stocks started to lose in value. Similarly, after the Serbian elections and the democratic parties' victory over the nationalists, the stock market reacted very positively, only to start worrying when the assessment of the election results of the elections were doubted. In Bosnia and Herzegovina, growing political tensions and uncertainties about the course taken by political reform have ultimately impacted negatively on the markets' performance. Lastly, the high hopes of speedy reforms after the elections in Macedonia last year supported the performance of the stock exchange until data on the performance of the economy injected more realism into the markets.

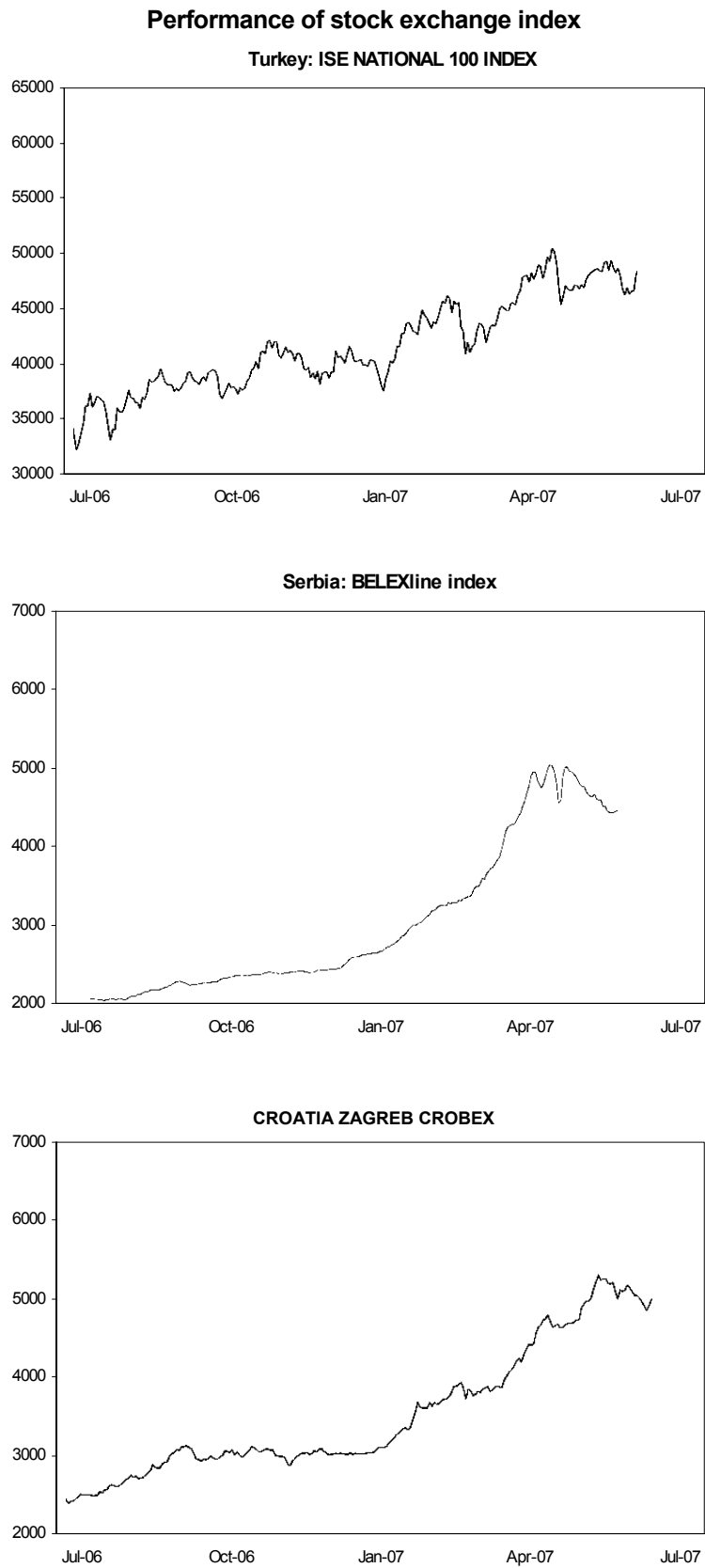
Figure 11



Source: Bloomberg

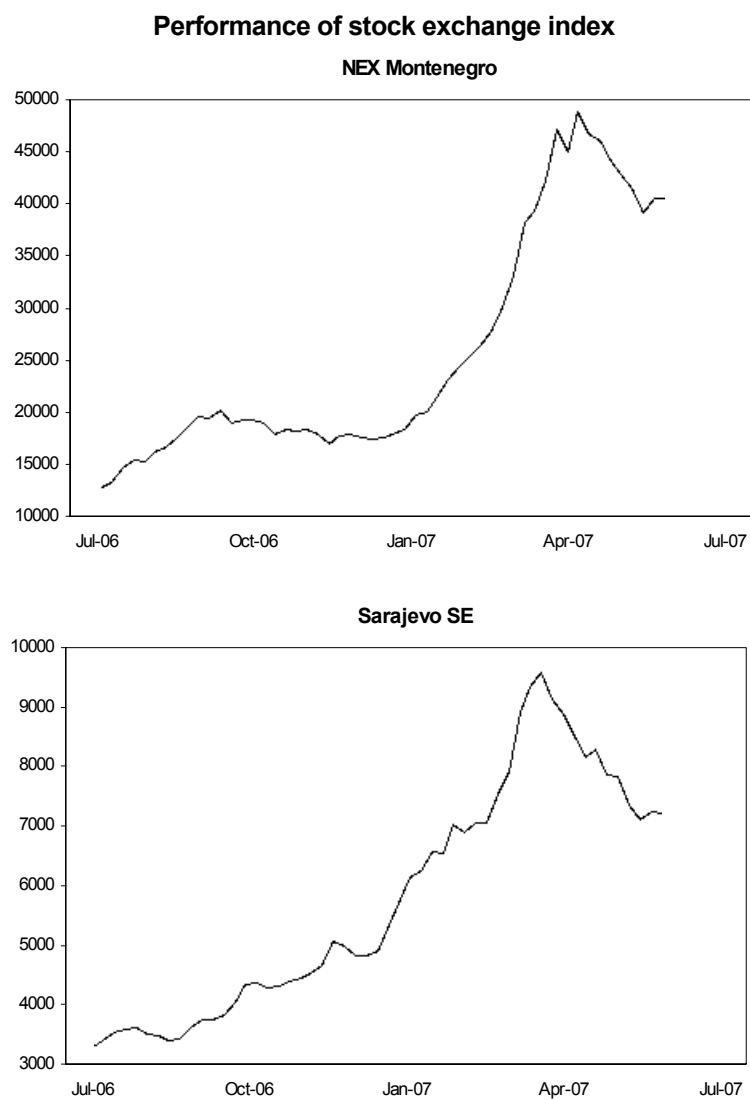
None the less, given the amount of political uncertainty that has accumulated of late, especially in relation to the issue of the final status of Kosovo, the markets are not unduly worried. The increased volatility, which is also evident in the Turkish markets, suggests that future expectations are somewhat more uncertain than they were only a few months ago. This, however, is no indication that major challenges will have to be addressed in the near future. This is supported by the monetary data, which still shows rather low monetization despite recent fast growth of credit and significant gains in the financial markets in general (see Table 15).

Figure 12

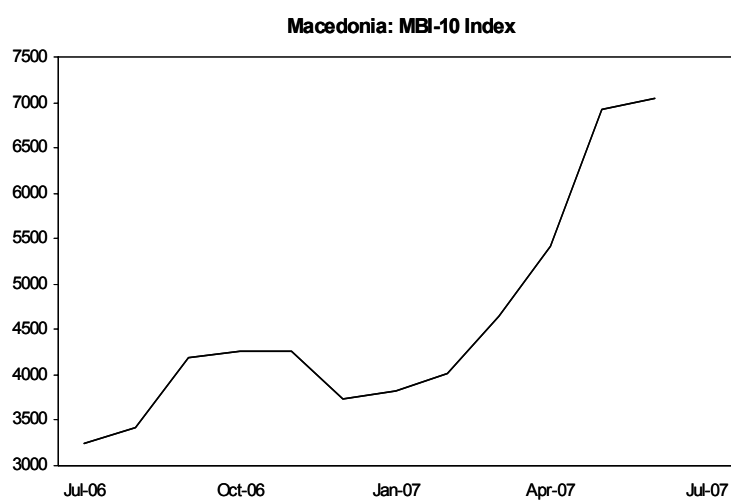


Source: Bloomberg (www.bloomberg.com)

Figure 13



Source: Stock Exchange Monitor (www.sem-on.net)



Source: Macedonian Stock Exchange (www.mse.com.mk)

Table 15

		Money supply, end of period													
		2000	2001	2002	2003	2004	2005	2006 ¹⁾	2000	2001	2002	2003	2004	2005	2006 ¹⁾
Croatia	GDP	152.5	165.6	181.2	198.4	215.0	231.3	250.6	100	100	100	100	100	100	100
	Currency outside banks	6.6	8.5	9.7	10.6	11.0	12.2	14.6	4.4	5.1	5.3	5.3	5.1	5.3	5.8
	M1, Narrow money	18.0	23.7	30.9	33.9	34.6	38.8	48.5	11.8	14.3	17.0	17.1	16.1	16.8	19.4
	Broad money	73.1	106.1	116.1	128.9	139.9	154.6	182.5	47.9	64.0	64.1	65.0	65.1	66.8	72.8
Macedonia	GDP	236.4	233.8	244.0	251.5	265.3	284.2	303.3	100	100	100	100	100	100	100
	Currency outside banks	9.5	14.1	14.1	14.2	14.2	14.4	16.2	4.0	6.0	5.8	5.6	5.3	5.1	5.3
	M1, Narrow money	22.4	25.3	26.4	27.3	27.6	29.7	34.7	9.5	10.8	10.8	10.8	10.4	10.4	11.5
	Broad money	43.7	71.6	65.0	76.7	89.7	103.9	129.5	18.5	30.6	26.6	30.5	33.8	36.6	42.7 ^{ix}
Albania	GDP	533.0	590.3	628.5	694.0	752.4	822.0	900.0	100	100	100	100	100	100	100
	Currency outside banks	99.2	119.1	130.8	125.2	138.1	149.7	163.3	18.6	20.2	20.8	18.0	18.4	18.2	18.1
	M1, Narrow money	124.0	142.9	152.7	144.7	172.8	227.7	247.5	23.3	24.2	24.3	20.9	23.0	27.7	27.5
	Broad money	328.1	394.3	416.7	448.4	507.2	578.0	674.3	61.6	66.8	66.3	64.6	67.4	70.3	74.9
Bosnia and Herzegovina	GDP	10.7	11.6	12.8	13.4	14.7	15.8	18.0	100	100	100	100	100	100	100
	Currency outside banks	0.7	1.7	1.7	1.6	1.7	1.7	2.0	6.1	14.4	13.5	11.9	11.4	11.0	11.0
	M1, Narrow money	1.4	2.7	3.0	3.1	3.5	4.1	5.1	13.1	23.2	23.4	23.2	24.1	26.0	28.2
	Broad money ²⁾	2.5	4.7	5.1	5.5	6.8	8.1	10.1	23.0	40.3	39.5	40.9	46.5	51.1	56.1
Serbia	GDP	397.7	783.9	1020.1	1171.6	1431.3	1750.0	2139.8	100	100	100	100	100	100	100
	Currency outside banks	10.9	25.3	43.7	43.0	45.2	53.7	68.4	2.7	3.2	4.3	3.7	3.2	3.1	3.2
	M1, Narrow money	27.0	58.2	93.8	99.5	111.2	144.9	200.0	6.8	7.4	9.2	8.5	7.8	8.3	9.3
	Broad money ³⁾	65.2	125.4	191.5	244.9	323.1	459.4	634.5	16.4	16.0	18.8	20.9	22.6	26.3	29.7
Turkey	GDP	124.6	178.4	277.6	359.8	430.5	487.2	576.3	100	100	100	100	100	100	100
	Currency outside banks	3.2	4.8	7.2	10.1	12.4	18.2	24.6	2.6	2.7	2.6	2.8	2.9	3.7	4.3
	M1, Narrow money ⁴⁾	8.2	11.1	14.3	21.6	29.5	61.9	72.2	6.6	6.2	5.1	6.0	6.8	12.7	12.5
	Broad money	58.8	107.7	136.7	155.5	192.7	260.6	319.8	47.2	60.4	49.2	43.2	44.8	53.5	55.5

1) Preliminary. - 2) Money M2 (M1+quasi money). - 3) Excluding frozen foreign currency saving deposits of households. - 4) Until 2004 excluding foreign currency sight deposits.

Source: wiiw Database incorporating national statistics; National bank statistics for Albania, Bosnia and Herzegovina, Serbia and Turkey.

Security and EU integration

Starting in the second half of last year and continuing into the current year, the stability of the Balkans has been challenged by the attempts to settle the Kosovo issue. This has also initiated a major change in the strategic make-up of the Balkans. This is essentially linked to the greater role being assumed by Russia in the region. That has arisen at the same time as the confusion in the EU not only over the Kosovo issue, but also over the issue of EU enlargement in the Balkans in general. Finally, the diminution of the 'soft' power held by the USA has been dramatically illustrated by that country's inability to close the Kosovo issue through the adoption of a UN resolution based on the plan proposed by the Special Envoy of the Secretary-General, Mr. Martti Ahtisaari. This has led to a stalemate in Bosnia and Herzegovina and to an impasse in the Security Council. Both bear consequences for security and the EU integration process in the Balkans.

Kosovo: politics and economics

The population is around 2 million of which about 90% is ethnic Albanian. After the NATO intervention in 1999, it has been under UN administration, i.e., the United Nations Interim Administration Mission in Kosovo (UNMIK). Its mandate is based on the Security Council resolution 1244 from 1999. It entrusts the responsibility for security to NATO. UNMIK represents Kosovo abroad while it is obliged to transfer internal sovereignty to Kosovo. The latter has been largely accomplished. It remains to delegate external sovereignty, which is what the current process of negotiations in the Security Council is about.

Clearly, UNMIK, as an interim administration, cannot remain in Kosovo indefinitely. The proposal that was sent to the Security Council by the Special Envoy of the Secretary General Martti Ahtisaari in March of this year envisages independence for Kosovo with monitoring by the EU and NATO. That would be embedded in the process of Kosovo's integration into the EU. Already, Kosovo is tracking the Stabilisation and Association Process that applies to all future member states from the Balkans (except Turkey). It should be speeded up once the Security Council decides on the international status of Kosovo. At the moment, the decision on a new resolution has stalled as Russia, a permanent Security Council member, does not support Mr Ahtisaari's proposal.

The decision is seen as urgent because of the economic and security problems that Kosovo or rather its citizens face. The country's GDP was put by the IMF at EUR 2.3 billion in 2006. That is just over EUR 1000 per capita. Consumption, however, is much higher, close to EUR 3 billion. To get an idea how the Kosovo economy functions, it is the best to start with the external balance. In 2006, imports were about EUR 1.5 billion while exports of goods were about EUR 100 million and exports of services about EUR 150 million or together around 260 million. Transfers were close to EUR 800 million in 2006; of that around EUR 230 million in remittances. The latter figure is very probably an understatement as errors and omissions are put at over EUR 450 million.

Budget revenues were over EUR 700 million and expenditures 630 million in 2006. This is said by the IMF to be an exceptional year. The expectation is that public spending will be around EUR 750 million in the medium run. Of that, about 150 million is projected to go to public investments. The bulk of the rest goes to wages and salaries, goods and services and on subsidies and transfers. Most of the revenues come from the VAT, mostly on imports, and from aid and other types of budget support. To get an indication of how weak the economy is, it is enough to notice that VAT on imports collects 5 times more than from domestic sources. Other tax revenues are also mostly on imports, as they come mostly from excises.

From these few figures it can be concluded that not much of a production of goods and services is to be found in Kosovo. Indeed, according to the available data, labour participation was below 50% and the unemployment rate was around 40% in 2007. Among women, labour participation was around 25% and the unemployment rate was above 60%. Undoubtedly, social pressure must be considerable.

Politically, the legitimacy of the elected officials is being tested in the current process of state and institution building. The permanent feature of Kosovo political dynamics is the recurrent de-legitimization of the governing institutions once they are seen as incapable of normalizing the international position of the country. One after another leadership structure has been thrown out of office by popular revolt since the mid-1960s. The current political leaders face the same prospect in the upcoming elections if they do not deliver on the expected international recognition of the independence of Kosovo.

The increased role of Russia has coincided with a lull in the EU integration efforts in the Balkans. After accepting Macedonia as a candidate country and with the accession of Bulgaria and Romania a foregone conclusion that was came into being on 1 January 2007, the EU lost momentum. Hardly any new initiatives were launched until the European Council met in the second half of June 2007. Shortly before that, the EU restarted negotiations with Serbia on the Stabilization and Association Agreement (SAA), which it had already initialled with Montenegro. The German EU presidency might ultimately prove beneficial to the region, as it opens up the path towards a revision of the existing Nice Treaty: a step that should make it possible for Balkan countries to join the EU when they are ready. It is thus expected that all the potential candidate countries will have negotiated their SAAs with the EU by the end of 2007. Macedonia should start negotiating in the first half of 2008 and the others could do likewise a year later. The actual process of enlargement could start with Croatia joining in 2010 and all the other countries by 2015 - or perhaps a couple of years later (see Table 16 for the current forecast). The process as a whole should have a stabilizing effect and support the continuance of economic growth which, in turn, would reinforce the process of ever closer integration and eventual accession to full membership in the EU. This should apply to Turkey as well if the current process of democratization, political stabilization and economic development continues without any major set backs into the second half of the next decade.

The problem with this scenario is twofold. On one hand, it is not clear how the NATO enlargement process will proceed. The expectations are that Croatia, Albania and Macedonia will be invited to join in 2008. Montenegro should be the next to follow. The remaining two countries, Serbia and Bosnia and Herzegovina, will have to decide whether they are ready to join once the Kosovo issue has been settled. The alternative is to enter into closer cooperation with Russia.

Russia's current strategy in the region is difficult to discern. Russia has a clear interest in keeping open the Balkan security problems, which are centred around Kosovo and Bosnia and Herzegovina, in order to capitalize on the indecision currently displayed by the EU and the diminished authority of the USA. It also intends to extend its strategy of exerting control over the supply of energy as a powerful economic and political tool. It has shown interest in investing in pipelines, power plants, oil companies and similar business ventures. This is not a strategy designed exclusively; it is strategy that aims at increasing the importance of Russia in both Europe, Central Asia and the Middle East.

Table 16

SEE EU Accession Forecast

	SAA	Negotiations	EU	Euro
Bulgaria	1995 (EA)	1999	2007	2009
Romania	1995 (EA)	1999	2007	2012
Croatia	2005	2005	2010	2012
Macedonia	2004	2008	2013	2015
Albania	2006	2009	by 2015	by 2017
Bosnia and Herzegovina	2007	2009	by 2015	by 2017
Serbia	2007	2009	by 2015	by 2017
Montenegro	2007	2009	by 2015	since 2002
Kosovo	2007	2010	after 2015	since 2002
Turkey	.	2005	2015-2020	After 2020

The short-term consequence of Russia's incursion into Balkan affairs is the greater risk of insecurity. The rest is uncertain. The economic and political influence of Russia in the Balkans is rather limited. The energy sector is important, but the rest of the economy and foreign trade is very much oriented towards the EU. Investments and budgetary support also hail from the EU. Finally, migration flows almost exclusively towards the West. Indeed, with the accession of Bulgaria and Romania, all the other candidate and potential candidate countries are fenced in by the EU and/or NATO. It is inconceivable that Serbia and Albania will be the only states to stay out of the EU. This is probably the reason why the economies in the region do not seem all that anxious about the possibility of a major crisis erupting in connection with the Kosovo issue.

Prospects

Prospects for both growth and stability are basically favourable (see Table 17 for a summary). There are some specific problems in each of the countries under consideration here, but investments seem to be on the rise as well as exports while the expansion of consumption is showing no sign of slowing down. In addition, public consumption is going to continue to increase as development needs become even more urgent. External constraints will not be binding in the medium run, though some countries may have to adjust their policies to take care of growing foreign debts. Finally, reindustrialisation should continue and that will have positive effects on the already slowly improving labour markets.

Security will be a concern, especially because of the complex process of dealing with Kosovo's increasing independence, but violent conflicts seem ever more remote. Security should be reinforced by the process of EU integration which should finally see all the countries in this region having contractual relations with the EU by the end of this year. Thus, there are some chances that FMS will continue to positively surprise in the future too.

Table 17

Overview of wiiw forecasts for Southeast Europe in 2007 and 2008

changes in % ^{*)}

		Croatia		Macedonia		Turkey		Albania		Bosnia & Herzegovina		Montenegro		Serbia	
		2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
Gross domestic product	February 2007	4.4	4.4	4	4	5.5	6.5	5	5.5	5.7	5.5	5	5	5	5
	June 2007	5	5	4	4	5.5	6.5	5	5.5	6	6	5	5	5	5
Gross industrial production	February 2007	4.4	4.5	5	5	6	9	2	3	11	11	3	3	5	5
	June 2007	6	5	5	5	6	9	2	3	11	10	3	3	5	5
LFS - unemployment rate in %, annual average	February 2007	11	10.5	35	35	9.5	9	14	14	30	30	30	30	23	24
	June 2007	10.8	10.3	35	35	9.5	9	14	13.5	30	30	30	30	22	23
Consumer prices	February 2007	3	2.9	3	3	7	5	2	2	4	2	3	3	10	10
	June 2007	2.8	2.3	3	3	7.5	5	2.5	3	3.7	2	3	3	8	6
General governm. budget, % of GDP	February 2007	-3	-2.5	-1	-1	-1.8	.	-3	-4	0	0	-1	-1	-2	-2
	June 2007	-3	-2.5	-1	-1	-2.6	-2.1	-3	-4	0	0	0	0	-2	-2
Current account, % of GDP	February 2007	-8.1	-7.3	-1.9	-1.8	-8.4	-7.6	-8.5	-6.5	-17.5	-15.8	-15.0	-15.0	-9.9	-9.5
	June 2007	-7.7	-7.1	-1.9	-1.8	-6.9	-6.3	-8.5	-6.6	-10.9	-9.2	-15.2	-15.2	-12.5	-11.5
Exports of goods & services, BOP	February 2007	.	.	.	.	19.0	19.3	14.8	14.3	22.2	20.5	.	.	15.0	9.6
	June 2007	7.9	8.7	20.5	19.8	19.8	19.8	9.6	15.0	20.3	20.9	21.3	22.6	28.7	21.5
Imports of goods & services, BOP	February 2007	.	.	.	.	15.3	17.2	4.9	5.2	1.8	3.2	.	.	20.2	19.7
	June 2007	9.3	11.0	19.6	19.0	14.9	17.6	6.3	5.3	19.0	15.9	20.3	20.8	25.4	23.9
Average exchange rate NCU/EUR	February 2007	7.4	7.4	62	62	1.89	1.80	122	122	1.956	1.956	1	1	87	90
	June 2007	7.4	7.4	62	62	1.8	1.7	125	125	1.956	1.956	1	1	82	84

Note: *) real change in % against previous year, if not otherwise indicated.

Source: wiiw forecasts.

Albania: becoming a flat tax country

The Albanian government has approved a flat tax regime of 10%. Conservative Prime Minister Sali Berisha declared this move to be a fiscal revolution for Albania which now allegedly features one of the lowest tax rates in the world. This is believed to be a strong weapon in the fight against the informal sector, a carrot for increased FDI penetration and above all a magic bullet for economic prosperity, to generate double-digit economic growth rates. However, current GDP growth prospects are only at about 5%. The lack in energy supply is the main obstacle to higher growth rates.

The government's decision in favour of the flat tax was made by the end of May 2007. The 10% flat tax is supposed to replace the current personal income tax, which is a progressive tax, rising from 1% to 20%, as well as the current profit tax of 20% (i.e. corporate tax). The income tax is not a pure flat tax as it exempts the first 10,000 lek for incomes below 30,000 lek. The new income tax will become effective from July 2007, while the new profit tax will be in place from January 2008.

Given the traditionally low willingness of Albanians to pay taxes it is debateable whether the tax reform will have any effect at all. However, if it does have any impact, it will most probably increase economic inequality in the country. It is also quite likely that tax revenues will fall to a certain extent. Cutting the nominal corporate tax into half might have considerable consequences for the government budget. This is especially what the IMF fears. Thus the head of the IMF mission to Albania had discouraged the government from introducing the flat tax; instead the IMF expressed its strong interest in prioritizing the country's energy problem.

In order to overcome the chronic energy crisis, investments in the order of EUR 1 billion are needed as estimated by the new management of the Albanian energy corporation (KESH). This is to overhaul the existing system as well as to invest in thermal power plants, which should help to reduce Albania's dependency on hydropower generation and electricity imports. The management also expects further power cuts of about four hours daily or more following the summer. The lack of rain, enormous losses in the distribution network, together with consumers' unwillingness to pay their energy bill are the main obstacles to a proper electricity supply in Albania. Moreover, regional energy prices are rising and import capacities are allegedly limited.

Interestingly enough, the huge amount of energy imports in the past several months has had an impact on the euro exchange rate of the Albanian lek (ALL). After years of nominal appreciation against the euro, the strong increase in foreign currency spending to afford the import of energy has exerted a depreciating pressure. However, in nominal effective annual terms, the lek depreciated only by an average of 0.1% over the first quarter of 2007. This is because the lek is still appreciating against the US dollar. In any case, a more relaxed exchange rate regime might support the Albanian industry and its exports.

Currently it is mainly domestic demand that drives economic growth. The construction sector in particular is booming. Nevertheless, according to the Ministry of Economy half of the Albanian businesses are in a state of bankruptcy because they have created a scheme of debt dependency among each other. Especially in the construction sector barter transactions are not uncommon. As important steps transactions are to be formalized through the banking system and legal procedures

Table AL

Albania: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., end of period	3102.8	3119.5	3135.0	3150.0	3150	.	.	.	.
Gross domestic product, ALL mn, nom.	628527	694018	752367	822035	900000	.	.	970000	1050000
annual change in % (real)	4.3	5.8	6.2	5.6	4.9	.	.	5	5.5
GDP/capita (EUR at exchange rate)	1535	1622	1884	2106	2321	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	3740	3940	4100	4420	4670	.	.	.	.
Gross industrial production									
annual change in % (real) ²⁾	-5.1	29.0	14.1	1.3	1.5	.	.	2	3
Gross agricultural production									
annual change in % (real) ²⁾	2.1	3.2	6.2	0.9	3.5	.	.	3.5	3
Construction output total									
annual change in % (real) ²⁾	21.5	23.6	7.7	15.1	10	.	.	11	12
Consumption of households, ALL mn, nom.	455952	508108	.	.	.	.	.	.	.
in % of GDP	72.5	73.2	.	.	.	.	.	.	.
Gross fixed capital form., ALL mn, nom.	143914	160210	.	.	.	.	.	.	.
in % of GDP	22.9	23.1	.	.	.	.	.	.	.
Reg. employment total, th pers., end of per.	920.1	926.2	931.2	932.0	932.0	931.0	.	.	.
annual change in %	0.1	0.7	0.5	0.1	0.0	0.0	.	.	.
Reg. unemployed, th pers., end of period	172.4	163.0	157.0	155.0	150.0	151.8	.	.	.
Reg. unemployment rate in %, end of period	15.8	15.0	14.4	14.2	13.9	14.0	.	14	13.5
Average gross monthly wages, ALL ³⁾	19659	21325	24393	26808	27900	27333	.	.	.
annual change in % (real, gross) ³⁾	8.1	6.0	11.2	7.3	2.6 ^{4x}	3.3	.	.	.
Consumer prices, % p.a.	5.2	2.2	3.0	2.4	2.4	1.4	2.8	2.5	3
Producer prices in manufacturing ind., % p.a.	5.1	1.8	12.2	4.9	0.7	0.7	.	2	2.5
General government budget, nat. def., % GDP									
Revenues	24.6	24.1	24.5	24.8	25.1	.	.	.	.
Expenditures	30.6	29.0	29.6	28.3	28.3	.	.	.	.
Deficit (-) / surplus (+), % GDP	-6.0	-4.9	-5.1	-3.4	-3.2	.	.	-3	-4
Public debt in % of GDP ⁴⁾	60.1	54.7	55.6	56.9	55.6	.	.	.	.
Refinancing base rate, % p.a., end of period	8.5	6.5	5.3	5.0	5.5	5.0	5.5	.	.
Current account, EUR mn ⁵⁾	-445.6	-360.4	-287.8	-492.0	-553.6	-128.8	-183.2	-660	-550
Current account in % of GDP	-9.4	-7.9	-4.9	-7.4	-7.6	.	.	-8.5	-6.6
Gross reserves of BoA incl. gold, EUR mn ⁶⁾	813.0	812.7	1005.2	1201.6	1362.6	1221.5	1372.2	.	.
Gross external debt, EUR mn	1184.4	1105.0	1218.0	1373.5	1467.3	.	.	.	.
Gross external debt in % of GDP	24.9	21.9	20.7	20.7	20.1	.	.	.	.
FDI inflow, EUR mn ⁵⁾	142.9	157.8	278.4	224.2	258.6	56.8	88.2	.	.
FDI outflow, EUR mn	.	.	-9.0	-1.7	-8.2	.	-2.0	.	.
Exports of goods, BOP, EUR mn ⁵⁾	350.5	397.9	485.6	530.2	630.6	144.4	182.0	700	800
annual growth rate in %	3.0	13.5	22.0	9.2	18.9	18.9	26.0	11	14
Imports of goods, BOP, EUR mn ⁵⁾	1574.5	1578.3	1762.3	2006.9	2316.0	515.2	629.5	2500	2500
annual growth rate in %	5.9	0.2	11.7	13.9	15.4	29.4	22.2	8	0
Exports of services, BOP, EUR mn ⁵⁾	619.6	637.8	807.5	967.3	1193.6	276.8	274.2	1300	1500
annual growth rate in %	4.0	2.9	26.6	19.8	23.4	35.8	-0.9	9	15
Imports of services, BOP, EUR mn ⁵⁾	624.9	711.8	848.0	1107.7	1257.8	312.7	303.9	1300	1500
annual growth rate in %	25.9	13.9	19.1	30.6	13.6	37.2	-2.8	3	15
Average exchange rate ALL/USD	140.2	121.9	102.8	99.9	98.1	102.2	95.7	.	.
Average exchange rate ALL/EUR (ECU)	132.4	137.5	127.7	124.2	123.1	123.0	125.3	125	125
Purchasing power parity ALL/USD, wiiw ⁷⁾	46.9	47.9	49.5	49.7	50.4	.	.	.	.
Purchasing power parity ALL/EUR, wiiw ⁷⁾	54.3	56.6	58.7	59.3	61.2	.	.	.	.

1) Preliminary. - 2) According to gross value added. - 3) Public sector only. - 4) Based on IMF data. - 5) Until 2003 calculated from USD with the average exchange rate. - 6) Refer to total foreign assets of Bank of Albania. - 7) wiiw estimates incorporating data of World Development Indicators 2006.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

for bankruptcy recognition are to be introduced. As part of the fiscal package, the government also approved a law that bans cash transactions of more than EUR 2228 for businesses. Approved cash transactions will be limited to 10% of a company's total transactions during the taxable period; or 10% of the total turnover of the business. Moreover all salary transactions have to go via the banking system, or they will not be recognized as expenditures in the balance sheets.

This is good news for Albania's financial sector, which has recently attracted substantial FDI inflows. After the takeover of the country's banking market leader, the Albanian Savings Bank, by Austrian Raiffeisen in 2004, French Société Générale has acquired a majority share in Banka Popullor only recently, in April 2007. Also the insurance market is increasingly a target of FDI, in particular from Austria. The Vienna Insurance Group (Wiener Städtische) plans to acquire 60% of the Sigma insurance company, one of the top three insurance companies in Albania and also active in Kosovo and Macedonia. An insurance company of similar size and market coverage, SIGAL, became part of the Austrian UNIQA insurance group in March 2007. UNIQA has an option of acquiring a majority ownership in SIGAL in the medium term (as of January 2010). Now the Albanian government plans to sell its 51% stake in the state-owned INSIG insurance company. Thus more FDI is expected to trickle into the financial sector of Albania in the time to come. In this respect Albania is following the experience of the other Southeast European countries, where FDI in the financial sector acted as a door opener for FDI in other sectors as well.

The overall growth prospects of the Albanian economy appear to be rather favourable given the expected improvements in physical and institutional infrastructure. Strong domestic demand growth fuelled by remittances from Albanians working abroad is at the core of the country's economic performance. However, an improved business climate should also attract more FDI to the export sector, making this sector an engine of economic growth too. It remains to be seen whether the introduction of a flat tax regime can be supportive in this respect.

Zlatko Bosnić

Bosnia and Herzegovina: solid economic growth and political unease – par for the course

Economic activities continue to expand in Bosnia and Herzegovina (BiH). Expansion is most evident in certain manufacturing sectors, construction, trade and other services. The country has benefited from the high demand on international markets for metallurgical products. This has had an impact on exports which are growing rapidly, even when compared to imports. Nonetheless, the gap in the trade balance, EUR 3.4 billion (2006), is inordinate for a country with a GDP of EUR 9.2 billion. On the other hand, the gap has lessened compared to previous years: a clear sign of improvement. Whereas in the period 2002-2003 exports covered only one quarter of imports, by 2006 the ratio stood at EUR 2.7 to 6.1 billion or 44%. In that year exports increased by 29%, although not all of that was real growth. Following the introduction of the VAT on 1 January 2006, a higher proportion of trade flows came into play in statistics. The figures for the period January- May 2007 point to a boom in machinery imports, as a result of which imports have expanded faster than exports (31% versus 20%, year-on-year).

As for the high trade deficits, some well-known as well as some less well-known sources have been contributory factors. Remittances from abroad are a comparatively well known source, but only in so far as they enter the country through official channels. Unregistered revenue from tourists (and quasi-tourists) plays a significant role. The same holds true for household and company borrowings (registered and unregistered) from abroad. The inflow of foreign direct investments has been modest; it is currently declining rather than rising.

FDI has never been a really strong factor in BiH. Despite this, in certain segments of the corporate sector foreign-owned enterprises play a major or even dominant role; this is particularly the case in commercial banking. Some foreign investors were fortunate enough to have paid only a modest entrance fee; hence, they do not rank high in FDI statistics. Were the number of foreign investors to be far greater, primarily in manufacturing, the country's export performance would be stronger, as the experience of many other countries has shown. Foreign investors still face manifold stumbling blocks – a host of different government bodies at different levels are intent upon justifying their existence and are eager to conserve a plethora of regulations to support them in their aspirations. Investors from neighbouring countries (Austria, Croatia and Slovenia) find their way around more easily, as is confirmed by the data. For those investors who have sussed out the rules of the game, BiH offers good business opportunities. Of course, even those investors suffer from the country being split into two economic spaces: a problem that has never been overcome. If a company is active in both parts of the country, it faces double the trouble on account of income tax issues, divergent rules and administrative constraints.

In both economic and other terms, BiH is a highly decentralized country. Its citizens are busy expanding their economic activities; this is plain to see in both the main cities (Sarajevo, Banja Luka, Mostar and Tuzla) and rural areas. New businesses and production plants are cropping up everywhere. Only the territories close to the eastern and south-eastern border are poor and still lag behind. The rural population falls into two categories: those who are participating in their country's new prosperity and the many who have not yet managed to do so. The latter group either lives off remittances from abroad – as distinct from social security payments – or eke out a living through subsistence farming. Possibly close to half of the population are smallholders working tiny plots of land. It is thus puzzling to see that the country is a large net importer of processed and unprocessed agricultural products: exports of agricultural produce and products amounted to EUR 55 million over the period January-May 2007 compared to imports over the same period amounting to EUR 432 million. A large proportion of the population suffer from some kind of social exclusion; for example, they have little chance of being offered a job or their access to public utilities is limited. Most people no longer live where they lived before the war; they are the victims most severely hit by social exclusion. BiH citizens are sometimes criticized for their lack of mobility – the exception being that many people are bent on finding a livelihood outside the country. However, even moving from one canton to another can cause a lot of problems; for example, it impinges on claims under the social security system. In fact, matters get much worse if an individual decides to move from one entity to the other. These factors contribute to unemployment. Information on the extent of unemployment is slowly improving. Undoubtedly, registration figures fail to provide a complete picture. LFS figures from April 2006 indicate an unemployment rate of some 30%. Some experts are convinced that even this figure is exaggerated. Of course, a high proportion of unregistered labour means that only a small proportion of the people are paying into the social security scheme. 533,000 persons were registered as unemployed in April 2007: some 17,000 more than the previous year.

Table BA

Bosnia and Herzegovina: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year	3828	3832	3843	3844	3843	.	.	.	.
Gross domestic product, BAM mn, nom.	12829	13443	14678	15791	17950	.	.	19700	21300
annual change in % (real)	5.5	3.0	6.0	5.5	6.2	.	.	6	6
GDP/capita (EUR at exchange rate)	1714	1794	1953	2100	2388	.	.	.	.
GDP including NOE, BAM mn, nom. ²⁾	16170	16954	17980	19320	20900	.	.	.	.
GDP/capita, incl. NOE (EUR at PPP - wiw)	5290	5460	6240	6190	6330	.	.	.	.
Gross industrial production									
annual change in % (real) ³⁾	5.7	5.1	12.1	10.8	11.5	9.8	10.7	11	10
Net agricultural production, total									
annual change in % (real)	7.9	-7.5	20.3	-3.1	.	.	.	.	.
LFS - employed persons, th, avg. ⁴⁾	.	.	.	.	811	.	.	.	.
Reg employees total, th pers., end of period	637.7	634.0	638.4	642.4	652.8	643.1	661.1	.	.
annual change in %	1.9	-0.6	0.7	0.6	1.6	1.9	2.8	.	.
LFS - unemployed, th pers., average ⁴⁾	.	.	.	.	366.8	.	.	.	.
LFS - unemployment rate in %, average ⁴⁾	.	.	.	.	31.1	.	.	30	30
Reg. unemployment rate in %, end of period	40.9	42.0	43.2	44.2	44.8	44.5	44.7	.	.
Average gross monthly wages, BAM	660	717	748	798	869	840	.	.	.
annual change in % (real, net) ⁵⁾	-0.6	7.3	3.6	3.5	1.4	1.3	.	.	.
Consumer prices, % p.a. ⁶⁾	1.3	1.1	0.8	3.0	7.2	7.1	.	3.7	2
General governm.budget, nat.def., % GDP									
Revenues	40.0	44.8	43.4	44.1	.	.	.	.	.
Expenditures	40.1	44.0	41.7	41.5	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-0.1	0.8	1.7	2.6	2	.	.	0	0
Public debt in % of GDP	34.8	30.6	28.1	31.7	.	.	.	.	.
Current account, EUR mn ⁷⁾	-1252.7	-1438.7	-1443.1	-1716.5	-1043.7	-113.5	.	-1100	-1000
Current account in % of GDP	-19.1	-20.9	-19.2	-21.3	-11.4	.	.	-10.9	-9.2
Gross reserves of CB excl. gold, EUR mn	1260.0	1421.7	1767.8	2145.3	2761.2	2269.3	.	.	.
Gross external public debt, EUR mn	2193.4	2052.3	2061.4	2217.9	2074.5	2169.1	.	.	.
Gross external public debt in % of GDP	33.4	29.9	27.5	27.5	22.6	.	.	.	.
FDI inflow, EUR mn	281.8	337.6	534.0	420.6	337.8	86.3	.	.	.
FDI outflow, EUR mn	.	.	1.2	1.0	.	.	.	.	.
Exports of goods, BOP, EUR mn ⁷⁾	1168.6	1303.0	1677.0	2087.3	2687.3	563.3	.	3300	4000
annual growth rate in %	-7.9	11.5	28.7	24.5	28.7	31.5	.	23	21
Imports of goods, BOP, EUR mn ⁷⁾	4692.2	4974.1	5354.5	6092.9	6093.1	1133.7	.	6400	6800
annual growth rate in %	2.5	6.0	7.6	13.8	0.0	-1.0	.	5	6
Exports of services, BOP, EUR mn ⁷⁾	552.0	636.3	696.1	767.2	888.0	159.5	.	1000	1200
annual growth rate in %	-0.7	15.3	9.4	10.2	15.7	16.1	.	13	20
Imports of services, BOP, EUR mn ⁷⁾	320.2	339.2	349.3	371.5	402.3	62.0	.	430	460
annual growth rate in %	6.3	5.9	3.0	6.4	8.3	9.9	.	7	7
Average exchange rate BAM/USD	2.077	1.734	1.576	1.573	1.559	1.628	1.493	.	.
Average exchange rate BAM/EUR (ECU)	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.96	1.96
Purchasing power parity BAM/USD, wiw ⁸⁾	0.689	0.686	0.632	0.681	0.708	.	.	.	.
Purchasing power parity BAM/EUR, wiw ⁸⁾	0.798	0.811	0.750	0.812	0.859	.	.	.	.

1) Preliminary. - 2) GDP figures including the Non-Observed Economy (NOE) are based on IMF estimates. - 3) wiw estimates based on weighted averages for the two entities (Federation BH and Republika Srpska). - 4) Data based on the first LFS April 2006. - 5) wiw calculation. - 6) Costs of living. - 7) Converted from the national currency. - 8) Rough estimates based on World Bank and wiw; price level presumably higher.

Source: wiw Database incorporating national statistics, IMF; wiw forecasts.

In 2006, BiH households saw consumer prices leap by 7.2%: a side-effect of introducing VAT. Given that an index for the country as a whole is being worked on, the price index for each of the two entities (Federation of BiH and Republika Srpska) shows a one-off leap that started a few months prior to VAT being introduced only to end soon thereafter. Both before and after that leap, no inflationary pressure was to be discerned; hence, we can expect low inflation for 2007. ITA (the countrywide Indirect Tax Authority) revenues expanded comfortably. The poorer segments of society had to sacrifice a large share of their incomes to pay for increased prices of food, accommodation and public utilities.

The introduction of VAT hit the poorer segment of the population hard, while richer households may well have increased their rate of consumption. The marked increase in bank loans to households would seem to point in that direction. Nevertheless, it is unlikely that household consumption was the major engine of GDP growth in 2006. Investment – in construction and new machinery – should have contributed to growth; exports undoubtedly did. The BiH Office of Statistics is currently working on a pioneer project directed towards the calculation of GDP expenditure categories. The Office will publish its findings later this year; the figures will relate to 2005 and 2006. This marks a first step towards charting hitherto unknown territory. Other uncharted areas remain: for example, the lack of reliable population figures. In that respect, one will have to wait until the first post-war census in 2011, to which support is being lent by EUROSTAT.

Large parts of the population are uneasy about the present state of affairs – for a variety of reasons. For some the reasons are poverty and recent losses in real incomes, others complain the persistent political *impasse*. The new BiH Council of Ministers, chaired by Nikola Špirić, is kept busy with internal squabbles; to date, it has produced little of substance. Whereas the EU and their BiH counterparts have managed to conclude the technical sections of the SAA, the political section has become the main hindrance. The EU is eager to see progress, but the whole thing has been spoilt by the dispute that has erupted over police reform: more an issue of wording than actual reform. In political terms, readiness to cooperate in BiH has reached an all-time low by post-war standards: a scary development for most people.

The BiH population will ultimately pay the bill for the lack of progress on reforms and integration. Their hope for a European style of life will materialize later than it would have otherwise. Preparing for accession to the EU calls for a tremendous effort, as well as much careful planning. BiH is far from being up-to-date in terms of adequate institutional structure. Should the EU decide to interpret and apply the rules strictly, it could take ages before BiH is ripe for membership. Were the open issues in the Balkans – especially the problem relating to the status of Kosovo – to be settled, it would certainly be a helpful move even where cooperation within the country and progress are concerned. At the economic level, private initiative is proving effective; the economy is likely to continue growing.

Hermine Vidovic

Croatia: economic growth path remains unchanged

The first quarter of 2007 witnessed a substantial expansion of GDP (7%). Buoyant domestic demand was the main driver of growth: gross fixed capital formation rose by 11.2% and private

consumption surged by 7% (reporting the highest growth since 2002). The latter was backed by rising wages and increased household lending. Growth of construction output slowed somewhat in the first quarter of the year. Consumer price inflation diminished as compared to a year earlier, averaging 2.5% during the first five months of 2007. The external imbalances continued to widen.

Industrial production rose by 8% during the first quarter of 2007, of which mining and quarrying by 14% and manufacturing by 10%. Within the latter, the production of office machinery and computers and the manufacture of radio, TV and communication equipment was rising rapidly; also the output of food and beverages performed particularly well. Only three out of 23 reporting branches recorded an output decline. Labour productivity rose by 7.8% during the first quarter of the year, even along with a small employment increase. Growth of construction decelerated to 6.5% in the first quarter; about half of the total is accounted for by motorway construction, which developed less dynamically than in previous years. The slowdown of production is also reflected by a decreasing number of building permissions.

Final data from the Labour Force Survey indicate an 0.8% employment increase in 2006 against a year earlier and a further decline in the unemployment rate to 11.1%. Labour market data, available both from registration and the Croatian Pension Insurance Institute, show a 2.7% increase in employment in the first three months of 2007. At the same time unemployment continued its downward trend (due to rising employment from the register), but was still high, at 15.9% in April.

On the external side, imports were again growing faster than exports during the first four months of 2007, with exports up by 6% and imports by 10% in euro terms (based on customs statistics). This resulted in a further deterioration of the trade deficit to EUR 3.3 million, a 13.5% increase as against the same period in 2006. After a strong rise in 2006, shipbuilding (Croatia's major single exporter) reported a substantial contraction of exports, as did the manufacture of coke and refined petroleum products. On the positive side, exports of machinery and equipment, basic metals and wood products expanded by more than one third. Exports to EU countries grew below average, those to Italy, Croatia's main trading partner, even registered a significant decline. In trade with the successor states of the former Yugoslavia, both exports and imports performed most dynamically in trade with Bosnia and Herzegovina. Considering the further deterioration of the merchandise trade deficit, on the one hand, and the rise in tourist overnight stays, on the other, the current account deficit may have reached about EUR 2 billion during the first quarter of the year. As for FDI, 2006 saw a record inflow worth EUR 2.8 billion, mostly due to the sale of the pharmaceutical company Pliva to the US-based company Barr.

The restrictive measures set by the Croatian National Bank (CNB) to curb the growth of foreign debt (credit growth limit of 12% a year on commercial banks) yielded some results, at least with respect to the limitation of bank credits. Overall, from December 2006 foreign debt rose by EUR 640 million and reached EUR 29.6 billion by March 2007, equal to 86% of the GDP. The bulk of the increase was borne by enterprises, accounting for one third of total debt, while foreign debt of the government was further reduced and bank debt increased only modestly. In June modified measures to restrict credit growth were introduced by the CNB.

Table HR

Croatia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year	4443	4442	4439	4442	4442	.	.	.	.
Gross domestic product, HRK mn, nom.	181231	198422	214983	231349	250590	56721	62561	270500	290600
annual change in % (real)	5.6	5.3	4.3	4.3	4.8	6.0	7.0	5	5
GDP/capita (EUR at exchange rate)	5507	5906	6462	7038	7704	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	9380	9930	10680	11380	12400	.	.	.	.
Gross industrial production ²⁾									
annual change in % (real)	5.4	4.1	3.7	5.1	4.5	6.4	8.0	6	5
Gross agricultural production									
annual change in % (real)	7.7	-15.9	11.9	-8.7	.	.	.	.	.
Construction industry, hours worked ²⁾									
annual change in % (real)	12.8	22.8	2.0	-0.8	9.3	15.9	6.5	.	.
Consumption of households, HRK mn, nom.	108027	115081	123123	131671	140261	33453	36391	.	.
annual change in % (real)	7.7	4.6	4.8	3.4	3.5	4.0	7.1	4.5	4
Gross fixed capital form., HRK mn, nom.	44105	56662	60512	65008	74792	17131	19530	.	.
annual change in % (real)	13.9	24.7	5.0	4.8	10.9	18.1	11.2	8	7
LFS - employed persons, th, avg.	1528	1537	1563	1573	1586	.	.	.	.
annual change in %	.	0.6	1.7	0.7	0.8	.	.	.	.
Reg. employees in industry, th pers., avg.	281.0	282.6	281.7	278.9	284.1	280.5	281.1	.	.
annual change in %	-2.2	0.6	-0.3	-1.0	1.9	0.8	0.2	.	.
LFS - unemployed persons, average	266.0	256.0	249.5	229.0	198.5	.	.	.	.
LFS - unemployment rate in %, average	14.8	14.3	13.8	12.7	11.1	.	.	10.8	10.3
Reg. unemployment rate in %, end of period	21.3	18.7	18.5	17.8	17.0	18.1	16.6	16	15.5
Average gross monthly wages, HRK	5366	5623	5985	6248	6634	6454	6854	.	.
annual change in % (real, net)	3.1	3.8	3.7	1.6	1.9	1.5	3.6	.	.
Consumer prices, % p.a.	1.7	1.8	2.1	3.3	3.2	3.5	1.6	2.8	2.3
Producer prices in industry, % p.a.	-0.4	1.9	3.5	3.0	2.9	3.5	1.9	2.5	2.4
General governm.budget, IMF-def., % GDP									
Revenues	46.3	45.1	45.4	44.9	.	.	.	.	.
Expenditures	51.4	51.3	50.2	49.0	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-5.0	-6.2	-4.9	-4.1	-3.0	.	.	-3	-2.5
Public debt in % of GDP% ³⁾	50.7	51.2	52.0	52.7	50.0	.	.	53	54
Discount rate % p.a., end of period	4.5	4.5	4.5	4.5	4.5	4.5	4.5	.	.
Current account, EUR mn	-2095.3	-1865.7	-1404.2	-1984.9	-2617.4	-2053.3	.	-2800	-2800
Current account in % of GDP	-8.6	-7.1	-4.9	-6.3	-7.6	.	.	-7.7	-7.1
Gross reserves of NB excl. gold, EUR mn	5651.3	6554.1	6436.2	7438.4	8725.3	8088.5	9519.8	.	.
Gross external debt, EUR mn	15054.8	19810.6	22780.7	25540.8	28975.1	26542.8	29610.3	.	.
Gross external debt in % of GDP	61.5	75.5	79.4	81.7	84.7	.	.	.	.
FDI inflow, EUR mn	1196.8	1784.5	990.4	1424.9	2837.6	527.6	.	.	.
FDI outflow, EUR mn	601.3	106.1	281.9	194.5	167.6	25.5	.	.	.
Exports of goods, BOP, EUR mn	5293.1	5571.7	6603.1	7216.6	8433.6	2004.8	.	9200	10200
annual growth rate in %	-0.5	5.3	18.5	9.3	16.9	32.7	.	9	11
Imports of goods, BOP, EUR mn	11253.4	12545.9	13330.9	14738.3	16797.5	3865.2	.	18500	20700
annual growth rate in %	13.4	11.5	6.3	10.6	14.0	25.0	.	10	12
Exports of services, BOP, EUR mn	5832.3	7565.9	7636.7	8052.6	8533.2	663.2	.	9100	9700
annual growth rate in %	6.4	29.7	0.9	5.4	6.0	1.6	.	7	7
Imports of services, BOP, EUR mn	2547.5	2632.9	2867.8	2734.9	2820.2	706.4	.	2950	3100
annual growth rate in %	16.9	3.4	8.9	-4.6	3.1	9.0	.	4.5	5
Average exchange rate HRK/USD	7.86	6.70	6.04	5.95	5.84	6.11	5.62	.	.
Average exchange rate HRK/EUR (ECU)	7.41	7.56	7.50	7.40	7.32	7.34	7.36	7.4	7.4
Purchasing power parity HRK/USD, wiiw	3.75	3.81	3.82	3.84	3.83	.	.	.	.
Purchasing power parity HRK/EUR, wiiw	4.35	4.50	4.54	4.58	4.55	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) Enterprises with more than 20 employees. - 3) Including guarantees.

Source: wiiw Database incorporating national statistics; IMF; wiiw forecasts.

The next parliamentary elections will be held in November this year. Recent opinion polls show the Social Democrats in the lead, closely followed by the ruling HDZ. Only recently Zoran Milanović was elected new president of the Social Democrats, succeeding long-time leader Ivica Račan, who died in April this year. However, for the upcoming elections Ljubo Jurčić, a former minister of economy, will be the top candidate for prime minister.

Croatia's goal to join the EU as a full member in 2009 – i.e., before the European Parliamentary elections – is very ambitious. By contrast, members of the European Parliament stressed that 'the current EU institutional framework (Nice Treaty) needs to be reformed before any further enlargements take place'. So far, Croatia has opened six chapters, out of which two ('science and research' and 'education and culture') have been closed provisionally. Another six chapters should be opened by the end of June. None of the eleven chapters with opening benchmarks has been opened for negotiation.³⁵ From 2007 onwards Croatia is being eligible for Pre-Accession Assistance (IPA), replacing programmes such as PHARE or SAPARD. Out of the EUR 139 million earmarked for 2007, about one third each is earmarked for regional development, transition assistance and institution building.

Economic prospects have changed little against our previous forecast. Provided that Croatia does not slip into a severe debt crisis, the economic outlook will remain favourable. Driven mainly by domestic demand, GDP should grow by around 5% annually in the period 2007-2009. Household consumption is expected to remain quite strong. Rising employment and wages as well as bank lending will support consumption. Growing imports, responding to rising domestic demand, will reduce the overall contribution of trade to GDP growth. Apart from the increase in employment, improvements on the labour market should continue in the form of falling unemployment rates. Given the continued widening of the trade deficit, the current account deficit will remain at high levels, thus implying a further increase in foreign debt.

Vladimir Gligorov

Macedonia: promising figures

This year has started better than most other recent years. GDP increased by 7% in the first quarter over the same period last year. After a long period of primary concern with stability, the new government, elected in 2006, seems bent on promoting growth. At the moment, the growth that has been recorded is more due to the fact that the improved regional environment is lifting the Macedonian economy too. The government's programme does target structural reforms, but their effects should be expected only in the coming years.

The reported growth, which is probably the fastest for any quarter in recent history, is mostly the consequence of the improved performance of the external sector. Exports increased by over 40% in the first quarter, almost twice as much as imports. Investments are also reported to have grown by almost 11%, though this is only investment in machinery and equipment. Overall domestic trade has

³⁵ Opening benchmarks, for example strategies or action plans, are a new tool. Their purpose is to improve the quality of negotiations by providing incentives for the candidate countries to undertake necessary reforms at an early stage. For details see European Commission (2006), 'Enlargement Strategy and Main Challenges 2006-2007 including annexed special report on the EU's capacity to integrate new members' (COM 2006) 649.

increased by 13.6%, which indicates that consumption is also contributing significantly to growth of GDP.

On the supply side, industrial production has posted a strong growth of 11.6%, which is rather high historically, but is still from a very low level. Similarly, banking services have grown by 12.5%, but their contribution to GDP is of course rather limited. More importantly, agriculture does not seem to be doing all that well, with only 3.5% growth in the first quarter. Finally, construction has expanded by 5.8%, which is not really impressive by regional standards.

Public expenditures have been lower than in the first quarter of last year while revenues have increased by almost 20%. In addition, the government decided to pay back some of the foreign debt ahead of time and use the foreign investments from 2006 in that way. Macedonia's external financial position has improved significantly in the past couple of years due to an increased inflow of remittances and some significant privatizations last year. Foreign reserves at the central bank have doubled, from around EUR 660 million at the end of 2004 to over EUR 1300 million at the end of the first quarter of this year.

Apart from increased receipts from foreign investments, this also reflects the improvement in the current account. Unlike most other countries in the region, Macedonia had almost a balanced current account last year and has reported a surplus of close to EUR 40 million in the first quarter of 2007. Given that the trade deficit was around EUR 200 million in the first quarter, inflows of remittances have certainly been quite significant. That is an indication of the improved perception of the country risk, which used to be one of the chief problems of Macedonia in the past.

Political stability has improved after last year's elections, though the largest Albanian party – which did not get into the government – boycotted the parliament for about half a year. The smaller Albanian party, however, is member of the coalition government. There is a conflict of two principles that has created this problem. On the one hand, there are a number of ethnic Macedonian and ethnic Albanian parties in Macedonia and they tend to form cross-ethnic competing coalitions. On the other hand, the constitutional agreement, called the Ohrid agreement, requires that the majority of each ethnic community has to vote for certain laws in order for those to be adopted. Thus, if a minority party from one of the ethnic communities is in the governing coalition, by virtue of being in an electoral coalition with the majority party from the other community, the laws that require majority of the votes from both communities cannot be passed without the consent of the majority ethnic party, which is in opposition. Therefore the parliamentary and the government coalitions may not be the same. That can create problems in the functioning of both the parliament and the government, as it did in Macedonia.

Still, it is a sign of the increased political stability that this problem was solved through negotiations, in which there was, as usual, international mediation. Thus, both internal players in Macedonia show growing democratic maturity, but the persistent role of the international actors also illustrates the need for this country to be well integrated with the international structures. When it comes to the EU, Macedonia is a candidate country and is expecting to start negotiations for full membership during the Slovenian presidency in the first half of next year. That process is absolutely crucial for its stability and development. In addition, Macedonia expects to be among the countries that will be invited to join NATO at the next round of its enlargement, perhaps as soon as next year.

Table MK

Macedonia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007	2008
Population, th pers., mid-year ²⁾	2020.2	2026.8	2032.5	2036.9	2040	.	.	.	.
Gross domestic product, MKD mn, nom.	243970	251486	265257	284226	303305	.	.	325000	348000
annual change in % (real)	0.9	2.8	4.1	3.8	3.1	2.0	7.0	4	4
GDP/capita (EUR at exchange rate)	1981	2025	2128	2277	2430	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5200	5330	5660	6100	6510	.	.	.	.
Gross industrial production									
annual change in % (real) ³⁾	-4.8	4.1	-2.2	7.1	2.5	0.5	11.6	5	5
Gross agricultural production									
annual change in % (real)	-2.3	4.5	6.8	0.3	0.5	.	.	.	.
Construction output, value added									
annual change in % (real)	0.6	13.3	7.4	-4.2	0.7	.	.	.	.
Consumption of households, MKD mn, nom.	188179	191873	209075	222890	.	.	.	.	.
annual change in % (real)	12.5	-1.5	8.0	.	.	.	.	.	.
Gross fixed capital form., MKD mn, nom.	40448	42110	47286	48868	.	.	.	.	.
annual change in % (real)	17.6	1.1	10.9	.	.	.	.	.	.
LFS - employed persons, th. avg.	561.3	545.1	523.0	545.3	570.4	559.7	.	.	.
annual change in %	-6.3	-2.9	-4.1	4.3	4.6	6.1	.	.	.
Reg. employees in industry, th pers., avg. ⁴⁾	110.9	106.7	101.5	125.7	.	.	.	.	.
annual change in % ⁴⁾	-9.5	-3.8	-4.9	-3.1	.	-3.8	-2.2	.	.
LFS - unemployed, th pers., average	263.5	315.9	309.3	323.9	321.3	318.1	.	.	.
LFS - unemployment rate in %, average	31.9	36.7	37.2	37.3	36.0	36.2	.	35	35
Reg. unemployment rate in %, end of period	.	.	.	.	.	.	.	.	.
Average gross monthly wages, MKD	19025	19950	20771	21330	23036	22558	23138	.	.
real growth rate, % (net wages)	5.0	3.6	4.4	6.4	4.0	4.8	5.0	.	.
Consumer prices, % p.a.	1.8	1.2	-0.4	0.5	3.2	2.7	1.0	3	3
Producer prices in industry, % p.a.	-0.9	-0.3	0.9	3.2	4.5	5.6	0.9	2	3
General governm. budget, nat.def., % GDP ⁵⁾									
Revenues	34.9	33.4	33.2	35.5	34.3	.	.	.	.
Expenditures	40.0	34.5	33.2	35.3	34.9	.	.	.	.
Deficit (-) / surplus (+), % GDP	-5.0	-1.1	0.0	0.3	-0.6	.	.	-1	-1
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	10.7	6.5	6.5	6.5	6.5	6.5	6.5	.	.
Current account, EUR mn ^{6) 7)}	-379.9	-132.1	-334.2	-65.5	-18.9	-36.6	39.7	-100	-100
Current account in % of GDP	-9.5	-3.2	-7.7	-1.4	-0.4	.	.	-1.9	-1.8
Gross reserves of NB, excl. gold, EUR mn	692.8	718.4	665.2	1041.4	1329.2	1130.1	1322.3	.	.
Gross external debt, EUR mn ⁸⁾	1513.2	1439.4	1475.7	1849.1	1782.5	1752.1	1711.7	.	.
Gross external debt in % of GDP	37.8	35.1	34.1	39.9	36.0	.	.	.	.
FDI inflow, EUR mn ⁷⁾	82.6	83.8	126.5	80.3	279.5	242.4	15.2	.	.
FDI outflow, EUR mn ⁷⁾	0.1	0.3	0.9	2.2	0.2	0.1	-1.9	.	.
Exports of goods, BOP, EUR mn ⁷⁾	1180.8	1207.8	1347.2	1640.2	1910.5	374.3	534.3	2300	2750
annual growth rate in %	-8.5	2.3	11.5	21.7	16.5	1.9	42.8	20	20
Imports of goods, BOP, EUR mn ⁷⁾	2034.8	1959.4	2243.1	2490.6	2935.2	-596.1	-730.4	3530	4220
annual growth rate in %	8.3	-3.7	14.5	11.0	17.9	16.2	22.5	20	20
Exports of services, BOP, EUR mn ⁷⁾	268.8	289.6	328.6	379.3	479.4	.	.	580	700
annual growth rate in %	-1.6	7.8	13.4	15.4	26.4	.	.	20	20
Imports of services, BOP, EUR mn ⁷⁾	292.3	298.7	372.4	406.5	459.3	.	.	530	610
annual growth rate in %	-0.8	2.2	24.7	9.2	13.0	.	.	15	15
Average exchange rate MKD/USD	64.74	54.30	49.41	49.29	48.79	51.07	46.70	.	.
Average exchange rate MKD/EUR (ECU)	60.98	61.26	61.34	61.30	61.19	61.23	61.18	62	62
Purchasing power parity MKD/USD, wiiw	20.03	19.69	19.46	19.19	19.20	.	.	.	.
Purchasing power parity MKD/EUR, wiiw	23.23	23.27	23.08	22.87	22.84	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) 2006 wiiw estimate. - 3) Enterprises with more than 10 employees, from 2004 new methodology, from 2007 new methodology and weighting system. - 4) From 2005 re-weighted data with information from pension and invalid insurance funds. Quarterly data are unweighted. - 5) Refers to central government budget and extra budgetary funds. - 6) Including grants. - 7) Converted from USD with the average exchange rate. - 8) Medium- and long-term debt.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

The prospects are better than they have been in many years. This year's growth may top 4% and if that turns out to be the case, next year it could even accelerate if negotiations with the EU and NATO membership materialize. The government is also determined to introduce structural reforms and is working hard to increase foreign investors' interests. So far these are only intentions, but an improved economic environment may help in their realization.

Vladimir Gligorov

Montenegro: fast growth

The growth acceleration that started last year has continued in the first quarter of 2007 – not in industry though. While GDP expanded by 6.6%, industrial production contracted by 5.3% in comparison with the first quarter of 2006. This is partly because growth of industrial production was rather strong last year, but it is also a continuation of the decline in industrial production in the second half of last year. Growth in Montenegro is mostly due to services, i.e., financial services and tourism.

On the demand side, there has been a significant worsening of the trade balance and also of the current account. This is just the other side of the large inflows of foreign investments, or rather investments from abroad. Most of these investments go into real estate, but also into privatization. In addition, domestic investments are also growing, as the high growth of equities at the stock exchange indicates. Finally, private consumption is rising as well because of the growing wealth of real estate owners and somewhat increased employment and compensations. Public consumption, on the other hand, is not expanding all that much and it seems that fiscal consolidation has been fully achieved in Montenegro. This was the weak point for many years, but the ministry of finance has finally succeeded in balancing the budget.

Recently there has been dissatisfaction with the fast process of privatization, in particular to foreigners and especially to Oleg Deripaska, who already owns the aluminium plant, which is the largest exporter in Montenegro. He intended to buy the power plant and a number of other state-owned assets, but the parliament failed to approve these deals. The smaller coalition partner in the government voted with the opposition against the government-sponsored privatizations. This was partly because of the very large share of the country's assets that Mr. Deripaska would thus acquire (he would have owned about 40% of the assets in Montenegro), but it is also partly a sign of social protest. As of this moment, the further process of privatization is very much in doubt.

Unlike in other post-Yugoslavia countries, political stability was never a serious issue in Montenegro. It was not easy to achieve independence, but the risk of political, not to mention violent, conflicts was always rather low. That does not mean that it is easy to take political decisions. At the moment the public is debating the new constitution and it has proved to be difficult to reach a consensus on some of the key issue connected with the national identity and the rights of the minorities.

The constitutional problems are not having significant political, let alone economic consequences, but the adoption of the constitution is important for the process of EU integration. Montenegro has initialled a Stabilization and Association Agreement with the EU and is expecting to sign it in autumn.

Table ME

Montenegro: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population th pers., mid-year ²⁾	617	620	622	623	625	.	.	.	.
Gross domestic product, EUR mn, nom. ³⁾	1301.5	1392.0	1565.0	1735.0	1932.0	.	433.9	2100	2300
annual change in % (real)	1.7	2.4	4.2	4.0	6.5	6.8	6.6	5	5
GDP/capita (EUR at exchange rate)	2109	2244	2516	2784	3091	.	.	.	.
GDP/capita (EUR at PPP - wiw)	4910	4990	5350	5680	6180	.	.	.	.
Gross industrial production ⁴⁾									
annual change in % (real)	0.6	2.4	13.8	-1.9	1.0	4.4	-5.3	3	3
Net agricultural production	.	.	.	.	.	.	.	.	.
annual change in % (real)	5.9	1.0	3.8	-0.9	.	.	.	.	.
Construction industry	.	.	.	.	.	.	.	.	.
annual change in % (real)	.	.	.	.	.	.	.	.	.
Consumption of households, EUR mn, nom. ⁵⁾	1067.3	1024.8	1137.3	.	.	.	.	.	.
real growth rate, % ⁵⁾	6.4	.	.	.	.	.	.	.	.
Gross fixed capital form., EUR mn, nom. ⁵⁾	198.9	200.8	286.1	.	.	.	.	.	.
real growth rate, % ⁵⁾	-16.1	.	.	.	.	.	.	.	.
LFS - employed persons, th, Oct ⁶⁾	220.6	.	187.3	178.8	179.6	.	.	.	.
annual change in %	2.9	.	.	-4.5	0.5	.	.	.	.
Reg. employees in industry, th pers., avg.	35.8	34.1	.	.	.	.	.	.	.
annual change in %	-2.3	-5.0	.	.	.	.	.	.	.
LFS - unemployed, th pers., average ⁶⁾	57.7	.	71.8	77.8	77.0	.	.	.	.
LFS - unemployment rate in %, Oct. ⁶⁾	20.7	.	27.7	30.3	30.0	.	.	30	30
Reg. unemployment rate in %, end of period ⁷⁾	.	32.9	29.3	25.2	20.5	25.2	20.3	20	18
Average gross monthly wages, EUR ⁸⁾	251	271	303	326	377	464	418	.	.
annual change in % (real, net)	.	9.3	9.1	6.7	12.0	.	13.0	.	.
Consumer prices, % p.a.	16.0	6.7	2.4	2.3	3.0	2.9	2.5	3	3
Producer prices in industry, % p.a.	14.5	4.5	5.8	2.1	3.6	0.9	3.0	3	3
Central governm. budget, nat.def., % GDP ⁹⁾									
Revenues	17.7	24.2	23.8	24.8	29.4	.	.	.	.
Expenditures	20.5	27.4	25.9	26.6	27.6	.	.	.	.
Deficit (-) / surplus (+), % GDP	-2.8	-3.1	-2.1	-1.8	1.8	.	.	0	0
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	.	.	.	.	.	.	.	.	.
Current account, EUR mn ¹⁰⁾	-163.4	-102.1	-119.6	-154.0	-568.2	-131.2	-175.8	-320	-350
Current account in % of GDP	-12.6	-7.3	-7.6	-8.9	-29.4	.	-40.5	-15.2	-15.2
Gross reserves of NB, excl. gold, EUR mn	.	.	.	.	.	.	.	.	.
Gross external public debt, EUR mn	893.6	461.5	488.6	513.3	630.0	.	.	.	.
Gross external public debt in % of GDP	68.7	33.2	31.2	29.6	32.6	.	.	.	.
FDI inflow, EUR mn	.	43.8	52.7	392.7	644.3	.	.	.	.
FDI outflow, EUR mn	.	5.1	2.1	11.5	177.6	.	.	.	.
Exports of goods, BOP, EUR mn ¹¹⁾	322.6	270.6	452.1	460.6	514.5	105.7	134.7	590	680
annual growth rate in %	37.1	-16.1	.	1.9	11.7	.	27.4	15	15
Imports of goods, BOP, EUR mn ¹¹⁾	747.3	629.9	868.6	974.3	1420.1	258.0	338.5	1700	2040
annual growth rate in %	3.4	-15.7	.	12.2	45.8	.	31.2	20	20
Exports of services, BOP, EUR mn	171.7	191.3	249.5	329.8	433.5	33.7	50.9	560	730
annual growth rate in %	14.3	11.4	30.4	32.2	31.5	.	51.0	30	30
Imports of services, BOP, EUR mn	71.7	79.7	101.4	134.3	217.1	46.7	44.6	270	340
annual growth rate in %	34.3	11.1	27.2	32.5	61.7	.	-4.5	25	25
Average exchange rate USD/EUR	0.94	1.13	1.24	1.24	1.26	1.20	1.31	.	.
Purchasing power parity USD/EUR, wiw ¹²⁾	0.37	0.38	0.40	0.41	0.41	.	.	.	.
Purchasing power parity EUR/EUR, wiw ¹²⁾	0.43	0.45	0.47	0.49	0.50	.	.	.	.

Note: From 2002 the term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) From 2003 according to census November 2003; 2006 wiw estimate. - 3) Including non-observed economy. - 4) Excluding small private enterprises and arms industry. - 5) Unrevised data. - 6) From 2004 according to census 2003 and revisions based on ILO and Eurostat methodology. - 7) In % of unemployed plus employment (excluding individual farmers). - 8) Quarterly wage data refer to employees who received wages (previously wages were divided by all registered employees in enterprises). - 9) Revenues excluding grants, expenditures excluding net lending. - 10) Including all transactions with Serbia. - 11) From 2004 trade with Serbia and Kosovo based on customs statistics (before on ITRS). - 12) Estimate based on a 45% price level (EU-25=100) in 2003 and extrapolation with GDP deflator.

Source: wiw Database incorporating national statistics; wiw forecasts.

For further progress in this process, it will be necessary to complete the state building process. At the moment it is not easy to see what a compromise would look like, but Montenegrins have proved to be able to reach compromises when it turned out to be necessary.

The country is also seeking membership in NATO. It has very good relations both with the United States and with Russia. Unlike Serbia, it has no territorial problems within itself or with its neighbours. Its stability is not threatened, but the added anchor of NATO would be useful to this very small country.

Economic prospects are favourable. Montenegro's tourist sector will continue to grow. Similarly, the development of other services has great potential. The main problem is high unemployment, which is the consequence of the collapse of industrial production and of government employment. Also, Montenegro accepted large inflows of refugees and its labour market has difficulty in handling the increased supply of labour. However, with political and macroeconomic stability achieved, sustained high growth rates are achievable. The only worry is the external account, but that may become an issue in a few years down the road. The other cloud is the decline in support for reforms; that may slow down further liberalization which has proved crucial so far.

Vladimir Gligorov

Serbia: reforms on hold

The first half of this year has been quite good in economic, though not in political terms. Both these developments have led to low interest in and thus low expectations of a speed-up in reforms. There is some chance that a more ambitious programme of reforms will be introduced after the planned presidential and local elections at the end of this year.

GDP has been reported by the central bank to have grown by 7% in the first quarter. One contributing factor has been fast growing exports. The government is also counting on fast growth of investments, 21.5% in real terms for the whole year, though so far the data on the development are not available. Retail trade has increased by almost 31% in the first four months of this year over the same period last year. Also, wages have gone up by just over 24% in real terms in the same period. Thus, consumption has clearly contributed the most to the GDP growth so far.

Industrial production has continued to grow more slowly than the GDP. Within it, manufacturing is actually doing better, as it posted an 8.6% growth in the first four months. Indirect evidence suggests, however, that services have continued to contribute more to GDP growth. Data on agricultural production come as a rule much later, but the early indications are that it may do worse than last year due to rather unfavourable weather conditions. Construction posted an over 9% growth in the first quarter. There are some suggestions that most of it is happening in the big cities only, i.e., in the three largest cities: Belgrade, Nis and Novi Sad. This would be in line with what has been observed in most other transition countries.

Table RS

Serbia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year ²⁾	7500	7481	7463	7450	7440	.	.	.	.
Gross domestic product, RSD mn, nom.	1020117	1171564	1431313	1750000	2139800	.	499000	2427000	2701000
annual change in % (real)	4.2	2.5	8.4	6.2	5.7	7.0	8.7	5	5
GDP/capita (EUR at exchange rate)	2242	2408	2643	2833	3424	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5380	5530	6150	6670	7210	.	.	.	.
Gross industrial production ³⁾									
annual change in % (real)	1.8	-3.0	7.1	0.8	4.7	5.7	4.8	5	5
Gross agricultural production									
annual change in % (real)	-2.1	-11.4	26.0	-3.4		.	.	.	.
Construction output total									
annual change in % (real) ⁴⁾	-7.4	10.8	3.5	2.0	9.3	.	.	.	.
Consumption of households, RSD mn, nom.	819739	885658	998540	1221531	1475003	.	.	.	.
annual change in % (real)	.	.	.	.	.	.	.	.	.
Gross fixed capital form., RSD mn, nom.	120502	188875	253333	301962	383907	.	.	.	.
annual change in % (real)	.	.	.	.	.	.	.	.	.
LFS - employed persons, th. Oct ⁵⁾	3000.2	2918.6	2930.8	2733.4	2630.7	.	.	.	.
annual change in %	-3.4	-2.7	0.4	-6.7	-3.8	.	.	.	.
Reg. employees in industry, th pers., avg.	648.1	605.3	562.2	536.1	493.3	508.7	470 ¹⁾	.	.
annual change in %	-8.0	-6.6	-7.1	-4.7	-8.0	-5.7	-8.4 ¹⁾	.	.
LFS - unemployed, th pers., Oct ⁵⁾	459.6	500.3	665.4	719.9	693.0	.	.	.	.
LFS - unemployment rate in %, Oct ⁵⁾	13.3	14.6	18.5	20.8	20.9	.	.	22	23
Reg. unemployment rate in %, end of period ⁶⁾	30.5	31.9	26.4	27.1	27.9	.	.	29	30
Average gross monthly wages, RSD	13260	16612	20555	25514	31745	28202	35047.7	.	.
annual change in % (real, net)	29.9	13.6	10.1	6.4	11.4	10.9	18.6	.	.
Consumer prices, % p.a.	16.6	9.9	11.4	16.2	11.6	14.8	4.8	8	6
Producer prices in industry, % p.a.	8.8	4.6	9.1	14.2	13.3	14.3	5.5	8	6
General governm. budget, nat.def., % GDP									
Revenues	39.9	40.3	41.2	.	.	.	.	.	.
Expenditures	43.2	44.2	42.6	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-3.3	-4.0	-1.4	1.4	-0.6	.	.	-2	-2
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	9.5	9.0	8.5	8.5	8.5	8.5	.	.	.
Current account, EUR mn ⁷⁾	-1323.4	-1256.9	-2308.0	-1790.2	-2906.1	-680.5	-1149.0	-3700	-3700
Current account in % of GDP	-7.9	-7.0	-11.7	-8.5	-11.4	.	-18.5	-12.5	-11.5
Gross reserves of NB, excl. gold, EUR mn	2076.8	2728.2	3008.0	4753.7	8841.3	5142.0	8598.4	.	.
Gross external debt, EUR mn	10768	10858	10355	13064	14885	12616	14858	.	.
Gross external debt in % of GDP	64.0	60.3	52.5	61.9	58.5	.	.	.	.
FDI inflow, EUR mn ⁷⁽⁸⁾	504.1	1208.3	777.1	1265.3	3504.3	161.0	665.4	.	.
FDI outflow, EUR mn ⁷⁾	.	.	.	17.9	16.8	-7.5	2.9	.	.
Exports of goods, BOP, EUR mn ⁷⁽⁹⁾	2347.6	2937.9	3283.8	3998.9	5155.7	1041.1	1381.3	6450	7750
annual growth rate in %	15.5	25.1	11.8	21.8	28.9	.	32.7	25	20
Imports of goods, BOP, EUR mn ⁷⁽⁹⁾	5773.5	6497.1	8487.9	8255.3	10107.8	2142.3	2793.6	12600	15700
annual growth rate in %	25.3	12.5	30.6	-2.7	22.4	.	30.4	25	25
Exports of services, BOP, EUR mn ⁷⁽⁹⁾	794.9	919.7	1188.2	1316.3	1674.8	306.5	441.7	2340	2930
annual growth rate in %	16.0	15.7	29.2	10.8	27.2	.	44.1	40	25
Imports of services, BOP, EUR mn ⁷⁽⁹⁾	657.0	740.9	1047.4	1321.2	1724.1	338.2	451.6	2240	2690
annual growth rate in %	59.1	12.8	41.4	26.1	30.5	.	33.5	30	20
Average exchange rate RSD/USD	64.40	57.58	58.38	66.71	66.82	72.61	60.86	.	.
Average exchange rate RSD/EUR (ECU)	60.68	65.05	72.57	82.91	84.06	87.18	80.19	82	84
Purchasing power parity RSD/USD, wiiw	21.80	24.00	26.30	29.50	32.90	.	.	.	.
Purchasing power parity RSD/EUR, wiiw	25.30	28.30	31.20	35.20	39.90	.	.	.	.

Note: The new ISO code for the Serbian dinar is RSD. From 2004 the term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) wiiw estimate in 2005 and 2006. - 3) From 2004 according to NACE and new weighting system. - 4) Gross value added. - 5) From 2004 according to census 2002 and revisions based on ILO and Eurostat methodology. - 6) Until 2003 jobseekers, rate in per cent of labour force excluding farmers. - 7) Converted from USD with the average exchange rate. - 8) Until 2004 FDI net. - 9) From 2006 including trade with Montenegro.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

Because of the prolonged political crisis after the parliamentary elections, held in late January, foreign investments, which are still mainly linked to privatizations, have not repeated the stellar performance of the last year. Net foreign direct investments have been put by the government at USD 873 million, which is about EUR 650 million, but some of that money is for the deals done last year. Serbia is supposed to pay a bit less than EUR 500 billion for the acquisition of the Telecom in the Republika Srpska in Bosnia and Herzegovina, so that the net result for the year as a whole may turn out to be rather modest.

In mid-May the government was finally formed. The coalition included the Democratic Party (around 22% of the votes) – which was in opposition in the past three years but is headed by the President of the Republic, Boris Tadić –, the Democratic Party of Serbia (together with the Peoples Party around 17% of the votes) headed by the previous and the current Prime Minister, Vojislav Koštunica, and the small party G17 Plus (around 7% of the votes) headed by the former minister of finance and now minister of economy, Mladjen Dinkić. The single largest party is the Radical Party (close to 30% of the votes), which is considered to be too nationalist and also openly against EU integration, and was left out of the government; it will have to remain in opposition.

This distribution of votes made it difficult for the coalition to be formed. The incumbent prime minister, Mr. Koštunica, threatened to go into coalition with the Radical Party if he was not re-elected. In the end, his request was accepted and he retained the post of prime minister. This, however, does not address the root causes of the political instability in Serbia. Basically, the government is committed to fight off the independence of Kosovo, which it considers a province of Serbia and which has been under UN protection since the end of the NATO intervention in 1999. At the same time, it is essential for Serbia's stability to continue to strengthen its ties with the EU, which in turn supports independence of Kosovo and is indeed poised to take over most of the UN and NATO responsibilities there. In addition, the progress in EU integration depends on the cooperation with the Hague Tribunal, which means that the Serbian government will have to come up with the most wanted indictees, Radovan Karadžić and Ratko Mladić. On any of these issues, the government can collapse.

After the formation of the new government, the EU resumed the negotiations for the Stabilization and Association Agreement that had been discontinued last year because of Serbia's lack of cooperation with the Hague Tribunal. The Serbian government on its part arrested two out of the five remaining indictees. At the same time the process of Kosovo independence has stalled in the UN Security Council giving the Serbian government the much needed time to try and strengthen its political position. It has chosen a two-pronged strategy as far as anyone can tell. On the one hand, it is trying to speed up the process of EU integration.

On the other hand, it has decided to shelve further reforms for the time being. This is clear from the budget that was adopted at the end of June. This is the budget for 2007 to be sure; again because of the political crisis, the budget was not adopted at the end of last year and could not be adopted earlier this year since there was no government. As a consequence, the budget essentially legalizes the fiscal inertia created during the long period of temporary financing. Therefore no reforms are envisaged in this budget. Worse than that, no corrections of the strong pre-election expansion of expenditures is contemplated. According to the central bank, the fiscal deficit was 7.4% of the GDP in the last quarter of 2006. Most of the increase in spending went to wages and salaries, which has

not been reversed. Thus, the budget counts with more than 20% real growth of wages with only 5% growth in productivity in 2007.

The prospects for consolidation and reforms later this year or next year depend very much on the outcome of the presidential and local elections that should take place at the end of the year. Presidential elections might not even be held, though they were planned. If the nationalist opposition does well in the local elections, which is almost certain, the prospects for reforms will be bleak. At the moment, business sentiment does not reveal any expectations of political or economic shocks. The stock exchange has become somewhat risk averse, but that is in line with similar developments in the stock markets throughout the region.

Given the growing confidence of the business community, short-term and medium-term prospects are favourable, political risks and instability notwithstanding. Further than that, much will depend on the way that growing imbalances especially on the external account are handled.

Michael Landesmann and Julia Wörz

Parliamentary elections and Turkey's economy

On 3 May, parliamentary elections were fixed for 22 July 2007. The previous due date for these elections was 4 November 2007, but the ruling AKP party decided to call for an early election date in the wake of the outbreak of a political and constitutional conflict between the secular and the moderate Islamic forces in the previous weeks. Immediate cause was the tussle between the opposing forces over the election of a new President for which the AKP had nominated the current foreign minister Abdullah Gül. In the first round of the presidential vote in parliament Mr Gül had received 357 votes out of 361 present which were 10 votes short of the necessary 367 to be elected as president in the first two rounds of the election. Following this vote the main opposition party CHP applied to the Constitutional Court, arguing that it was unconstitutional to start voting with only 361 MPs present (the opposition parties had made a decision to leave the voting chamber). On 1 May the Constitutional Court ruled in favour of the CHP's demand, which meant that the first round of voting that had taken place on 27 April was illegitimate and would have to be repeated and that the presence of 367 MPs in the assembly was necessary before any voting could start. Furthermore, before that ruling, there had been an intervention by the military with the Turkish General Staff releasing a statement expressing their concerns regarding increasing threats to secularism. This statement was seen as an ominous sign of the military getting involved in the political dynamic of the country, and the European Commission reacted critically to this intervention.

Surrounding the elections for the Presidency there were also large street demonstrations organized by the secular forces objecting to an 'Islamic' candidate for president, which had also taken place previously when there was the possibility that the current prime minister Recep Tayyip Erdogan (whose right-hand man Abdullah Gül is) was a potential presidential candidate. With the strategy of an early parliamentary election, the AKP attempts to take over the initiative as current opinion polls indicate that they would win such an election and they would then attempt to pass in parliament a number of constitutional changes such as moving towards direct elections of the president of the Republic. In such a case, Mr Erdogan might become the official candidate of the AKP. Anybody familiar with the political scene in Turkey knows that behind the 'secular' vs. 'Islamic' divide are also

economic interests which object to the way the economic reform process is going on. They resist the relinquishing of power over state-owned assets and fear a reduction of national control through the rapprochement with the EU and the eventual implementation of the *acquis communautaire*.

Current economic developments and the formulation of the economic policy agenda have to be seen against the background of these political developments and, as political stability might re-emerge in the wake of a decisive AKP election victory (which seems likely at the moment, but election forecasts have often proven wrong as was recently the case in the French parliamentary elections) there would again be a resumption of more predictable economic outcomes. Should the outcome of the elections not clear the situation, either through a decisive election win or through a non-acceptance of the losing side (backed by the military) of the election outcome, then the future path not only in economic terms but also in terms of the already complex Turkey–EU relationship will be much more difficult to evaluate. Given this rather complex context in which an economic assessment has to be attempted, we shall adopt the scenario in this article that political stability will be re-established after the July election.

Let us now move on to an assessment of the economic situation: In our February Report we pointed to the slowdown of economic growth in the last quarter of 2006 which was brought about by a tight monetary policy stance of the Turkish Central Bank. This had developed in the wake of the financial market turbulence of April/May 2006 and led to a high interest rate regime (with interest rates remaining at close to 20%) as the Central Bank perceived the economy drifting far away from the inflationary target (4% annual inflation) they had set themselves. The yearly GDP deflator had moved from 5.4% in 2005 to 11.5% in 2006 (average annual rates) and given that the deflationary strategy was an important pillar of the overall economic strategy (together with a – successful – reduction of public debt) the Central Bank reacted to this re-emergence of inflationary dangers with a succession of strong interest rate hikes. As was to be expected, high interest rates together with an expectation of a trend tendency of a nominally appreciating currency (typical of a catching-up economy) stimulated further capital inflows and hence reduced – as in many emerging market economies – control over liquidity. Furthermore, strong inflows of capital put further pressure on the exchange rate which, in Turkey's context of a large current account deficit, was not the direction in which external economic equilibrium could be achieved. In fact, some moderate success is starting to set in on the inflation front: annualized consumer price inflation (CPI) came down from 10.7% in April to 9.2% in May, and producer price inflation (PPI) fell from 9.7% to 7.1% over the same period. The estimation is that CPI inflation by end-of-year 2007 will come down to 6.5%. Commentators argue that the stickiness in inflation rates (in the context of an appreciating currency) in spite of a significant slowdown of consumer demand is due to asymmetric pass-through effects in the wake of exchange rate movements (i.e. not passing on the cost benefits of a currency appreciation to the consumers) as well as inertia in price setting behaviour in the services sector. Hence, the tough monetary policy stance is bringing inflation down, but only very gradually. Given the Central Bank's inflation target commitment, the high interest rate regime is likely to stay.

Given that domestic demand has been slowing down, there has been some success in switching demand towards net exports (in spite of currency appreciation; see below). Hence industrial production growth was a respectable 7.9% in the first quarter of 2007, with particularly strong growth in the manufacture of other transport equipment, electrical machinery and metals, while the production of transport equipment (more domestic market-oriented) slowed down considerably. In view of the conscious policy-stance of maintaining a deflationary stance, we predict a further mild

slowing down of industrial production in the coming months, and recent reports regarding a very dry summer do not bode well with regard to agricultural harvests; tourism income is, however, expected to be well above last year's relatively low returns. Nonetheless, the general view is that GDP growth in 2007 as a whole will lie in a respectable range between 5.5% and 6.0%. As a successful anti-inflation drive benefits consumers' real income expectations, domestic spending can pick up again and Turkey is projected to move back on its 6-7% per annum growth path in 2008.

On the fiscal side, there has been the long-run success story of bringing down the gross public debt to GDP ratio from 93% in 2002 to 60.5% in 2006 and the expectation is that it will further decline to 56.6% in 2007. Declines in real tax revenues in the first four months (declines in corporate tax rates, declining VAT revenues from slower domestic consumer demand) were more than compensated by whopping privatization revenues. The high interest rates impose a high burden on interest expenditure on public debt and these have increased by 12% over the first four months of 2007. Given also the higher non-interest spending in an election year, the primary surplus (which cannot include income from privatization) is projected to amount to about 5.5% of GDP in 2007 (down from 6.1% in 2006) and the overall budget deficit to GDP ratio is expected to rise to 2.6% in 2007 (there was a surplus of 0.4% in 2006).

Regarding external trade, the first quarter of 2007 brought dynamic developments in exports for the Turkish economy. The depreciation episode of the Turkish lira in mid-2006 favoured exports of goods, which rose by 14% (in euro terms) compared to the first quarter of 2006. Imports expanded by about 7% over the same period. The moderate growth in imports is caused by falling consumer and restrained capital imports, especially in the automobile sector which has lost momentum, while demand for imported intermediates – triggered by strong export growth – remained roughly constant. Strong export growth and sluggish import demand have led to an improvement in the goods trade deficit in the first four month of 2007 with a corresponding positive effect on the current account. Also, the export to import ratio (in goods trade) rose considerably and reached about 66% in the first four months of 2007 (from 61% in the same period last year).

The strong demand for exports arises not only from the exchange rate developments but also from good fundamentals, such as high labour productivity growth in manufacturing and the qualitative upgrading of the products produced. Motor vehicles, iron and steel, mineral fuels and oils and also clothing have contributed most strongly to the dynamism in exports. In particular the textile and clothing sector has recovered well, implying that the Turkish textiles and especially clothing industry – due to improvements in quality and complying with the importance of time-to-market – is able to withstand the strongly increased competition from China following the quota removal in 2005. Another important factor behind the strong export performance is to be found in the recovery of demand in the EU members, particularly in Germany. Germany is Turkey's largest single trading partner with a share of around 14%. Recent changes in the geographical composition also show that exports to the Middle East and Western Balkans were growing strongest, reinforcing Turkey's position as a hub for the region. On the import side, Russia's share is still increasing due to strong energy prices, however again, imports from partners within Southeast Europe and the Middle East evolve most dynamically.

The internationalization of the Turkish economy through trade is progressing, the trade-to-GDP ratio has reached 56% in 2006 (up from 50% in 2001). In contrast to these favourable developments in goods trade, trade in services developed more sluggishly with exports being subject to strong

fluctuations arising from tourism. The prospect for travel exports are positive for 2007, thus a recovery of this sector is expected. A possible drain on the current account may arise from the deterioration of the income balance following profit repatriation and interest payments for investments.

Nevertheless, the favourable developments in external trade together with the exchange rate dynamics have resulted in a slight reduction in the current account deficit, which had reached an unsustainably high level in 2006. For 2007, we expect a moderate improvement in the current account, even though the deficit is expected to remain at a high level for the next few years.

The most striking point to note from the capital account is the surge in FDI inflows in the first quarter of 2007. Net FDI made up 49% of total net capital inflows in the first quarter of 2007. With EUR 7 billion, half of the 2006 volume of FDI inflows was already reached by end of March 2007. Following mega-deals in the communication sector in 2006 (takeovers of Türk Telekom and Teksim, a Turkish mobile phone provider) the investment boom is driven more recently by record purchases of real estate by non-residents. Despite the dampening of the housing boom in mid-2006, the demand for real estate especially in Istanbul has recovered strongly, leading to fast rising property prices. Another sector responsible for the strong interest in Turkey as a location for FDI is the banking sector. The interest of foreign banks in local establishments is driven by cost-saving motives (saving on brokerage costs) as well as by market-seeking behaviour. The Turkish market, with its fast growing, young, relatively qualified labour force is an attractive destination for foreign investors. The increased presence of foreign (especially Western European) banks and brokerage offices in Turkey is expected to accelerate the ongoing consolidation and restructuring process in the highly fragmented Turkish finance and insurance market. Another driving force behind increased interest in investment in Turkey – apart from the attractions of the local market – is posed by the geopolitical situation, with investments from the Middle East and by Middle Eastern – especially Saudi Arabian – firms being redirected to Turkey, which is perceived as a safer destination in the short to medium run.

Table TR

Republic of Turkey: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year ²⁾	69302	70231	71152	72065	72974	.	.	.	.
Gross domestic product, TRY mn, nom.	277574	359763	430511	487202	576322	107769	.	653600	730900
annual change in % (real)	7.9	5.8	8.9	7.4	6.1	6.7	.	5.5	6.5
GDP/capita (EUR at exchange rate)	2782	3022	3405	4030	4370	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5650	5740	6140	6470	6910	.	.	.	.
Gross industrial production									
annual change in % (real)	9.5	8.7	9.8	5.5	5.8	2.8	7.9	6	9
Gross agricultural production									
annual change in % (real)	6.9	-2.5	2.0	5.6	2.9	.	.	.	.
Construction industry									
annual change in % (real)	-5.6	-9.0	4.6	21.5	.	.	.	.	.
Consumption of households, TRY mn, nom.	184420	239586	284631	328561	382757	79698	.	.	.
annual change in % (real)	2.1	6.6	10.1	8.8	5.2	8.1	.	5	6
Gross fixed capital form., TRY mn, nom.	46043	55618	76722	95307	121093	21371	.	.	.
annual change in % (real)	-1.1	10.0	32.4	24.0	14.0	32.1	.	8	15
LFS - employed persons, th, avg.	21354	21147	21791	22046	22330	20903	21574 ^{1-H}	.	.
LFS - employed pers. in agricult. th, avg.	7458	7165	7400	6493	6088	5304	5444 ^{1-H}	.	.
LFS - employed pers. in industry th, avg. ³⁾	4912	4811	5017	5456	5674	5248	5434 ^{1-H}	.	.
LFS - employed pers. in services th, avg.	8984	9171	9374	10097	10568	10351	10696 ^{1-H}	.	.
LFS - unemployed, th pers. average	2464	2493	2498	2520	2446	2735	2717.5 ^{1-H}	.	.
LFS - unemployment rate in %, average	10.3	10.5	10.3	10.3	9.9	11.5	11.4	9.5	9
Reg. unemployment rate in %, average	1.9	2.5	.	.	.	.	.	.	.
Average gross wages, manuf. industry (TRY/Hour)	2.68	3.30	3.74	4.20	4.68	.	.	.	.
annual change in % (real)	-5.4	-1.9	2.5	1.9	0.9	1.0	.	1	.
Consumer prices, % p.a. ⁴⁾	45.0	25.3	8.6	8.2	9.6	8.1	10.3	7.5	5
Producer prices in manufacturing, % p.a. ⁴⁾	48.3	23.8	13.1	7.6	9.3	4.9	11.2	7.5	5
General governm. budget, EU-def., % GDP ⁵⁾									
Revenues	.	.	15.9	27.0	27.1	.	.	26.1	25.3
Expenditures	.	.	21.6	27.4	26.7	.	.	28.7	27.4
Deficit (-) / surplus (+)	.	-11.3	-5.8	-0.3	0.4	.	.	-2.6	-2.1
Public debt, EU-def., in % of GDP ⁵⁾	93.0	85.1	76.9	69.6	60.5	.	.	57.0	55.0
Discount rate % p.a., end of period ⁶⁾	51.0	31.0	22.0	17.5	22.5	16.5	22.5	18	15
Current account, EUR mn	-1667	-7083	-12484	-18522	-25297	-7246 ⁷⁾	-6909 ⁷⁾	-25000	-27000
Current account in % of GDP	-0.9	-3.3	-5.2	-6.4	-7.9	-10.8	.	-6.9	-6.3
Gross reserves of CB, excl. gold, EUR mn	25562	26616	26436	42823	46200	48152	50682	.	.
Gross external debt, EUR mn	123678	114220	118045	143094	156774	152041	.	.	.
Gross external debt in % of GDP	64.1	53.8	48.7	49.3	49.2	.	.	.	.
FDI inflow, EUR mn	1203	1537	2326	8080	16027	947 ⁷⁾	7003 ⁷⁾	.	.
FDI outflow, EUR mn	177	439	693	875	744	-150 ⁷⁾	939 ⁷⁾	.	.
Exports of goods, BOP, EUR mn	42380	45183	53889	62017	73180	16262 ⁷⁾	18608 ⁷⁾	89000	109000
annual change in %	10.3	6.6	19.3	15.1	18.0	19	14.4	22	22
Imports of goods, BOP, EUR mn	49983	57504	73102	88953	105184	23496 ⁷⁾	25216 ⁷⁾	121000	143000
annual change in %	17.5	15.0	27.1	21.7	18.2	27	7.3	15	18
Exports of services, BOP, EUR mn	15113	15881	18519	21113	19443	2888 ⁷⁾	3007 ⁷⁾	22000	24000
annual growth rate in %	-13.9	5.1	16.6	14.0	-7.9	4	4.1	14	10
Imports of services, BOP, EUR mn	6923	6617	8165	9268	8806	1917 ⁷⁾	2103 ⁷⁾	10000	11000
annual growth rate in %	-5.3	-4.4	23.4	13.5	-5.0	4	9.7	8	10
Average exchange rate TRY/USD	1.5236	1.4987	1.4293	1.3480	1.4407	1.3330	1.4110	1.4	1.3
Average exchange rate TRY/EUR (ECU)	1.4397	1.6949	1.7771	1.6771	1.8090	1.6026	1.8492	1.8	1.7
Purchasing power parity TRY/USD	0.6115	0.7549	0.8315	0.8768	0.9424	.	.	.	.
Purchasing power parity TRY/EUR	0.7084	0.8920	0.9861	1.0452	1.1434	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) SIS projections. - 3) Industry including construction. - 4) From 2004 new methodology. - 5) According to ESA'95, excessive deficit procedure. - 6) CBRT interest rate - overnight, lending. - 7) Converted from USD with the average exchange rate.

Source: CBRT-EDDS (Central Bank of Turkey, Electronic Data Distribution System), SIS (State Institute of Statistics), SPO (State Planning Organization), UT (Undersecretary of Treasury), Eurostat; wiiw forecasts and European Commission (Spring Report 2007).

Part C: Russia and Ukraine; China

Country reports

Peter Havlik

Russian Federation: booming domestic demand prevents overall growth slowdown

Contrary to most expectations, Russian economic growth apparently accelerated in 2007. In the first quarter of the year, the GDP increased by nearly 8% as the boom in domestic demand exceeded earlier forecasts. Both private consumption and especially investments expanded at double-digit rates, driven by rapidly growing real wages and incomes (consumption) and by record capital inflows (including FDI). As expected, real exports remain nearly flat while imports continue to surge. In terms of contributions to GDP growth, private consumption, with its share in GDP meanwhile exceeding 60%, has become a major driving force. The contribution of real net exports to GDP growth has again been negative; the export surplus is rapidly diminishing and the estimated trade balance at constant 2003 prices will turn into the red in 2007. Still, the GDP growth forecast for the current year had to be revised upwards – albeit slightly.

Domestic demand supports the extraordinary construction boom (housing in particular, but newly launched infrastructure projects as well) and that of retail trade. A growing part of retail sales represents imported goods: imports of passenger cars, for example, reached a record level in the first quarter of 2007. However, also the domestic industry seems to benefit as the output of manufacturing expanded by more than 12% in January-April 2007 compared to the same period of the previous year. And there is some evidence that not only domestic industrial sales are recovering: in the first quarter of the year non-energy export revenues increased by nearly 20% in US dollar terms and, for the first time in many years, their share in total export revenues went up (from 33% of the total in the first quarter of 2006 to 38% in the corresponding period of 2007). This is certainly a welcome development in view of stagnating exports of energy (natural gas in particular) and meagre extraction growth. Yet whether this signals a reversal of trend is doubtful – especially given the ongoing competitiveness losses that result from rapidly rising unit labour costs as wages are growing much faster than productivity and the rouble appreciates (in real effective terms by another 5% in the first quarter of 2007).

Indeed, the prevention of excessive rouble appreciation has been one of the key challenges for the Central Bank of Russia (CBR). The appreciation pressure is strong given the huge inflows of foreign exchange – despite some relief provided by the Stabilization Fund, which accumulates part of energy-related export revenues. Fund assets are currently being invested mainly in USD- and EUR-denominated sovereign bonds. Net inflows of foreign capital reached USD 41 billion in 2006, and more than USD 60 billion in January-April 2007. The CBR foreign exchange reserves exceeded USD 400 billion in June 2007 (about one quarter of which represents the Stabilization Fund) and are now the third highest in the world (after China and Japan). The managed peg exchange rate regime (the rouble is pegged to a basket of USD and EUR with the share of the latter gradually increasing) and the full liberalization of capital account transactions (since June 2006) require massive currency interventions. As a result, the money supply is growing fast (M2 increased by nearly 50% in 2006

Table RU

Russia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., end of period ²⁾	144964	144168	143474	142754	142192	142600	142100	141500	141000
Gross domestic product, RUB bn, nom.	10830.5	13243.2	17048.1	21620.1	26781.1	5661.8	6566.2	31000	35000
annual change in % (real)	4.7	7.3	7.2	6.4	6.7	5.0	7.9	6.9	5.2
GDP/capita (EUR at exchange rate)	2514	2641	3310	4290	5516	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	6940	7510	8280	9040	9880	.	.	.	.
Gross industrial production									
annual change in % (real)	3.1	8.9	8.3	4.0	3.9	3.0	8.4	6	5.0
Gross agricultural production									
annual change in % (real)	1.5	1.3	3.0	2.4	2.8	1.3	1.9	.	.
Construction output total									
annual change in % (real)	2.7	14.4	10.1	10.5	14.5	-0.1	23	.	.
Consumption of households, RUB bn, nom.	5400.3	6540.1	8405.6	10628.9	12910.9	2783.1	3332.6	.	.
annual change in % (real)	8.5	7.5	12.1	12.8	11.2	9.6	11.9	15	10
Gross fixed capital form., RUB bn, nom.	1939.3	2432.3	3130.5	3848.4	4795.6	679.0	922.4	.	.
annual change in % (real)	2.8	12.8	12.6	8.3	13.9	5.7	19.8	14	12
LFS - employed persons, th, avg.	66659	66432	67275	68169	68799	67704	68567	.	.
annual change in %	2.4	-0.3	.	1.3	0.9	1.0	1.3	.	.
Reg. employment in industry, th pers., avg.	15135	14934	14775	14469	.	.	.	.	.
annual change in %	-1.2	-1.3	-1.1	-2.1	.	.	.	.	.
LFS - unemployed, th pers., average	5698.3	5959.2	5674.8	5262.8	5309.3	5729.0	5333.3	.	.
LFS - unemployment rate in %, average	7.9	8.2	7.8	7.2	7.2	7.8	7.2	7	6.5
Reg. unemployment rate in %, end of period	2.1	2.3	2.6	2.5	2.3	2.6	2.3	.	.
Average gross monthly wages, RUB	4360.3	5498.5	6739.5	8554.9	10736.0	9395.0	11922.3	.	.
annual change in % (real, gross)	16.2	10.9	10.6	12.6	13.5	10.3	18.4	.	.
Consumer prices, % p.a.	16.0	13.6	11.0	12.5	9.8	10.9	7.8	8	7
Producer prices in industry, % p.a.	11.8	15.6	24.0	20.7	12.4	14.8	8.6	9	8
General governm.budget, nat.def., % GDP									
Revenues	32.5	31.3	31.9	39.7	39.7	35.1	.	40	41
Expenditures	31.6	29.9	27.4	31.5	31.3	22.5	.	36	38
Deficit (-) / surplus (+), % GDP	0.9	1.3	4.5	8.1	8.5	12.6	.	4	3
Public debt, nat.def., in % of GDP ³⁾	37.0	28.6	21.7	14.9	9.0	.	.	.	.
Refinancing rate of NB % p.a., end of per.	21	16	13	12	11	12	10.5	.	.
Current account, EUR mn ⁴⁾	30788	31330	47457	67368	75776	25339	16678.5	60000	55000
Current account in % of GDP	8.4	8.2	10.0	11.0	9.6	12.6	6.7	6.6	5.3
Gross reserves of NB, excl. gold, EUR mn	42290	58531	88663	148094	244190	164781	247719	300000	.
Gross external debt, EUR mn	147067	148776	157423	216553	255866	226590	.	.	.
Gross external debt in % of GDP	40.3	39.0	33.1	35.3	32.6	.	.	.	.
FDI inflow, EUR mn ⁴⁾	3660	7041	12422	10258	23047	6176.3	.	.	.
FDI outflow, EUR mn ⁴⁾	3736	8606	11085	10255	14422	4099.5	.	.	.
Exports of goods, BOP, EUR mn ⁴⁾	113468	120265	147357	195894	243792	55929	53406	250000	260000
annual growth rate in %	-0.2	6.0	22.5	32.9	24.5	46.0	-4.5	3	4
Imports of goods, BOP, EUR mn ⁴⁾	64470	67304	78327	100787	132106	25740	32166	155000	175000
annual growth rate in %	7.4	4.4	16.4	28.7	31.1	31.2	25.0	17	13
Exports of services, BOP, EUR mn ⁴⁾	14393	14359	16373	19767	24337	4808	5119	25000	25500
annual growth rate in %	12.7	-0.2	14.0	20.7	23.1	32.1	6.5	3	2
Imports of services, BOP, EUR mn ⁴⁾	24848	23997	27131	31688	36312	6981	7106	40000	43000
annual growth rate in %	8.2	-3.4	13.1	16.8	14.6	25.1	1.8	10	8
Average exchange rate RUB/USD	31.35	30.69	28.81	28.30	27.34	28.10	26.33	26	26
Average exchange rate RUB/EUR (ECU)	29.65	34.69	35.81	35.22	34.08	33.84	34.46	34	34
Purchasing power parity RUB/USD, wiiw	9.27	10.35	12.09	13.99	15.78	.	.	.	.
Purchasing power parity RUB/EUR, wiiw	10.74	12.20	14.32	16.72	19.03	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) Resident population. - 3) wiiw estimate. - 4) Converted from USD to EUR at the official cross exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

and by another 5% in the first quarter of 2007), in particular of household deposits and credits to companies in foreign currency. The rapid money supply growth makes the meeting of the CBR inflation target extremely difficult. Still, consumer price inflation dropped for the first time to single digits in 2006 and a gradual disinflation is expected to continue: the CBR target of 8% annual CPI inflation for 2007 seems to be within reach.

Revenues of the state budget jumped to nearly 40% of GDP in both 2005 and 2006 and the budget has been enjoying huge surpluses (around 8% of GDP). Thanks to windfall gains from high world market energy prices, the Russian government was able not only to repay nearly all of outstanding external debts but also to increase salaries in the public sector as well as pensions. Besides, several national development projects (infrastructure, housing, health sector, education and agriculture) were initiated. The recently (May 2007) adopted three-years budget plan for the period 2008-2010 reflects some important changes in economic policies. First, the future budget revenues will depend less on energy proceeds (apart from the Stabilization Fund, which has been renamed Reserve Fund and will be maintained at 10% of GDP; another part of windfall proceeds from oil and gas exports will be accumulated in the newly established Development Fund). As a result, the share of budget revenues in GDP will decline by about 5 percentage points between 2006 and 2010. Second, government expenditures will increase (even as a share of GDP) with state-sponsored priority programmes to benefit most. In this way, the current government budget surpluses will be eliminated almost completely. The long-discussed controversial idea of Industrial Policy (IP) has apparently gained official blessing. The government-sponsored IP should offer targeted support to various public-private partnership projects in the automotive, aviation and other high-tech industries. Whether the creation of a more favourable climate for foreign investors (as promised by President Putin at the June 2007 Economic Summit in St. Petersburg) will become a part of the government's IP remains to be seen.

Rising state expenditures, surging capital-related foreign exchange inflows (with the concomitant money supply expansion) and the strong growth of consumer demand will keep inflationary pressures alive. However, the main challenges for the Russian economy in the medium and long run are whether it succeeds in replacing energy exports as the key growth engine by other drivers, and how it will deal with the acute demographic crisis (the population is projected to decline by nearly 10 million in the coming decade). The officially endorsed development scenario (presented by the Ministry of Economic Development and Trade at the mentioned Economic Summit) relies on innovation and high-tech developments supported by the Industrial Policy referred to above. Growing investments in transport infrastructure, education, health and R&D should help to generate an average annual GDP growth rate of 6.6% over the next decade. The wiiw forecast for the coming years is closer to the official 'intermediate' scenario which reckons with ongoing reliance on the (modernized) energy sector, possibly with a few high-tech niches, and average annual growth of 5.3%. Such a growth slowdown appears inevitable, at least in the coming couple of years, before any (uncertain) modernization efforts bear fruit.

Needless to say, both scenarios implicitly assume stepped-up reforms – which have stalled in the past few years. Economic policy decisions have been overshadowed by politics, especially by the looming issue of Putin's successor in 2008. EU–Russian relations have deteriorated recently. The EU is concerned mainly with energy supplies; the future contractual relations with Russia are unclear after the expiry of the current Partnership and Cooperation Agreement (PCA) in November (and the start of EU negotiations is blocked by Poland). With growing economic strength, Russian external

policies are becoming also more assertive. In particular, the Kremlin is gaining confidence that it can regain its foothold in the former Soviet republics (or at least prevent a more intensive involvement of the EU in this region). The strategy seems to bear some fruit, for example in Belarus, Kazakhstan and Ukraine, but also elsewhere as the influence of Russian investments is rapidly increasing. Meanwhile, Gazprom, Rosneft and other large state-owned (or state-controlled) corporations are going global while consolidating their control over domestic assets and strategic resources. Russian energy and metals giants acquire assets abroad, not least in the former Soviet republics. Simultaneously, the inflows of FDI to Russia are rapidly rising, thanks to both returning Russian offshore capital and the country's improved credit rating. The repeatedly delayed WTO accession still seems to be imminent – despite worsening relations with the West and remaining bottlenecks (e.g. with Georgia, Estonia). Broadly speaking, the economic outlook remains positive with both consumption and investments (including FDI) growing rapidly. With more money and power consolidation at home, Russian self-confidence will grow further – and this may lead to more conflicts with the West.

Vasily Astrov

Ukraine: external surpluses are over

Strong consumer demand, vigorous investment activity and solid exports have all contributed to impressive GDP growth of 7.9% in January-May 2007. Over the same period, industrial output expanded by 12.1% and construction by 11.5% (in value-added terms). Real retail trade turnover – a proxy for private consumption – was up by 26.2% in January-April. Similarly to last year, the strong consumer demand was partly backed by a respectable 14% gain in real wages. However, their role behind consumption growth has been generally diminishing, as the government of Prime-Minister Viktor Yanukovich (in office since August 2006) allowed only a modest wage growth in the public sector, and rising consumption is increasingly driven by expanding consumer credit. Between January and May alone, the latter expanded by 28.6% in nominal terms – much faster than credit extended to businesses (+16.2%). The lending boom is not least due to the growing presence of foreign banks which have easy access to external funds: as of 1 May, their share reportedly reached some 29% of Ukraine's banking sector capital.

The strong demand for consumer goods is partly spilling over into imports (in particular those of durables), but is also benefiting consumer-oriented branches of the economy such as retail trade and food-processing. Besides, the rapid expansion of consumer credit appears to have boosted housing construction: the latter was up by 45% in the first quarter of 2007 (year-on-year). Overall, investment in fixed assets over the same period rose by 32.2%, reflecting, among other things, an 80% growth in metallurgy which has been increasingly investing in energy-saving technologies following the 'gas price shock' last year. Finally, the solid growth of goods exports (+24.5% in euro terms in January-April, according to the customs statistics) nearly matched the growth of imports and was due to both high world prices for metals and chemicals and the strong demand for Ukrainian machinery and equipment in the CIS countries. (As a result of the latter, Ukraine's total exports to Russia grew by an astonishing 56%.)

However, the currently observed pace of economic growth will probably not be sustained for the year as a whole. In particular, the high figure of exports in the first quarter is largely due to the low

statistical base reflecting the low steel prices at the beginning of 2006 – in sharp contrast to much of the rest of the year. Therefore, we expect export growth in 2007 to slow down to around 10%. At the same time, the growth of imports (+25% in January-April) is likely to largely keep its momentum – the combined effect of the booming imports of investment and consumer goods and the higher prices of imported energy (particularly for natural gas). As a result, net exports will be a higher drag on GDP growth for the year as a whole. Also, following the severe drought in May, grain output is likely to be disappointing (and grain export quotas are once again on the government's agenda). In addition, the rapid growth of investments in the first quarter (and of construction in particular) may have benefited from the mild winter. All in all, we expect economic growth to reach between 6.5% and 7% this year and to decline only marginally in 2008.

An unpleasant side-effect of the current boom is, however, the widening of the external imbalances. In 2006, Ukraine's current account (-1.5% of GDP) turned out to be in the red for the first time since 1998 for the year as a whole. Given imports growing far ahead of exports, a further current account deterioration seems unavoidable, possibly up to 4% of GDP this year and even higher in 2008. In addition to the negative trade developments, the current account will also be increasingly affected by the interest payments on foreign loans and FDI-related profits. However, this development should not represent a real reason for concern, given the similar patterns observed earlier in the Central European new EU member states: their current account deficits were typically offset by inflows of FDI and resulted largely from large-scale imports of FDI-related investment goods needed for modernization. In 2006, FDI inflows into Ukraine (EUR 4.1 billion) were three times the size of its current account deficit, and they should be sufficient to finance it again this year, in view of the upcoming ambitious privatisation deals (such as of Ukrtelekom and the Odessa Port Plant) and the looming WTO accession. In June 2007, President Yushchenko signed into law the remaining WTO-related bills (such as on food safety, export duties on scrap metal and seeds, VAT on agricultural producers, and intellectual property rights), and the last remaining bilateral deal on market access – with Kyrgyzstan – was reached in May.

Against the background of high capital inflows, the National Bank is having no problems in defending the *de facto* hryvnia peg to the US dollar. On the contrary, its foreign exchange reserves had been persistently on the rise and reached nearly USD 25 billion by the end of May. Also, the UAH and USD interest rates are gradually converging,³⁶ pointing to the prevailing expectations of (at least) exchange rate stability. Another possible manifestation of growing confidence in the domestic currency is the replacement of hard-currency deposits by hryvnia, which started in May. In fact, the National Bank might let the currency appreciate somewhat in case it decides to adopt inflation targeting – an option currently under discussion. However, it remains to be seen whether inflation targeting as a monetary policy concept would be all that instrumental, given the high degree of the country's economic openness and major risks to price stability emanating primarily from the supply side (such as further energy price hikes). So far this year, domestic energy tariff adjustments have been largely avoided,³⁷ resulting in consumer price inflation of a mere 1.9% between January and

³⁶ The spread between them stands currently at 2 percentage points for both deposits and credits (in average weighted terms).

³⁷ The current gas tariffs charged to households depend on the volumes consumed and start from around USD 62 per thousand cubic metres (th cm) – much below the border price Ukraine has been paying for its gas imports since the start of the year (USD 130 per th cm). However, any domestic price hikes will be almost certainly delayed until after the parliamentary elections on 30 September (see below).

Table UA

Ukraine: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., end of period	48003.5	47622.4	47280.8	46929.5	46646.0	46831.7	46559.6	46300	46000
Gross domestic product, UAH mn, nom.	225810	267344	345113	424741	537667	105423	132252	630000	728000
annual change in % (real)	5.2	9.6	12.1	2.6	7.1	4.1	8.0	6.5	6
GDP/capita (EUR at exchange rate)	931	928	1100	1411	1814	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4630	5130	5920	6250	6870	.	.	.	.
Gross industrial production									
annual change in % (real)	7.0	15.8	12.5	3.1	6.2	0.6	12.5	8	7
Gross agricultural production									
annual change in % (real)	1.2	-11.0	19.7	-0.1	0.4	4.0	5.0	.	.
Construction output total									
annual change in % (real)	-5.8	26.5	17.2	-6.6	9.8	5.0	16.1	.	.
Consumption of households, UAH mn, nom.	124560	146301	180956	238961	315317	66695	.	.	.
annual change in % (real)	9.5	11.5	13.5	16.6	14.4	20.2	.	.	.
Gross fixed capital form., UAH mn, nom.	43289	55075	77820	93357	129037	21494	.	.	.
annual change in % (real)	3.4	22.5	20.5	-0.3	18.7	19.9	.	20	15
LFS - employed persons, th, avg.	20091.2	20163.3	20295.7	20680.0	20730.4	20432.9	.	.	.
annual change in %	0.6	0.4	0.7	1.9	0.2	.	.	.	.
Reg. employees in industry, th pers., avg. ²⁾	3578.1	3416.0	3408.3	3415.8	3361.9	3378.2	3303.3	.	.
annual change in %	-6.1	-4.5	-0.2	0.2	-1.6	-1.0	-2.2	.	.
LFS - unemployed, th pers., average	2140.7	2008.0	1906.7	1600.8	1515.0	1744.5	.	.	.
LFS - unemployment rate in %, average	9.6	9.1	8.6	7.2	6.8	7.9	.	6.5	6.4
Reg. unemployment rate in %, end of period	3.8	3.6	3.5	3.1	2.5	3.2	2.8	2.4	2.3
Average gross monthly wages, UAH ²⁾	376.4	462.3	589.6	806.2	1041.4	918.3	1161	.	.
annual change in % (real, gross)	20.0	16.7	17.0	20.4	18.4	23.8	14.7	.	.
Consumer prices, % p.a.	0.8	5.2	9.0	13.5	9.1	9.7	10.2	10	9
Producer prices in industry, % p.a.	3.0	7.6	20.5	16.7	9.5	8.4	16.6	15	8
General government budget, nat. def., % GDP									
Revenues	27.4	28.2	26.5	31.6	32.1	31.2	33.3	.	.
Expenditures ³⁾	26.7	28.4	29.7	33.4	32.8	30.8	28.5	.	.
Deficit (-) / surplus (+), % GDP	0.7	-0.2	-3.2	-1.8	-0.7	0.4	4.8	-2.6 ⁴⁾	.
Public debt in % of GDP	33.5	29.0	24.7	17.7	15.0	.	.	.	.
Refinancing rate of NB % p.a., end of period	7.0	7.0	9.0	9.5	8.5	9.5	8.5	.	.
Current account, EUR mn ⁵⁾	3360	2559	5560	2030	-1289	-638	-915.8	-4000	-6000
Current account in % of GDP	7.5	5.8	10.6	3.1	-1.5	-3.7	-4.6	-3.8	-4.9
Gross reserves of NB excl. gold, EUR mn ⁶⁾	4088	5348	6977	16058	16587	13921	16813.7	.	.
Gross external debt, EUR mn	12247	19055	22528	33504	41219	33901	.	.	.
Gross external debt in % of GDP	27.3	42.9	43.1	50.4	48.7	.	.	.	.
FDI inflow, EUR mn ⁵⁾	734	1261	1380	6263	4148	877	740	.	.
FDI outflow, EUR mn ⁵⁾	-5	12	3	221	-106	-1	.	.	.
Exports of goods, BOP, EUR mn ⁵⁾	19770	21013	26906	28093	31048	6822	8240	34000	37400
annual growth rate in %	3.6	6.3	28.0	4.4	10.5	5.0	20.8	10	10
Imports of goods, BOP, EUR mn ⁵⁾	19018	20555	23895	29004	35188	7949	9620	42200	47300
annual growth rate in %	0.9	8.1	16.3	21.4	21.3	38.9	21.0	20	12
Exports of services, BOP, EUR mn ⁵⁾	4958	4615	6325	7503	9000	1833	1880	10100	11100
annual growth rate in %	11.2	-6.9	37.0	18.6	19.9	28.3	2.6	12	10
Imports of services, BOP, EUR mn ⁵⁾	3743	3934	5329	6054	7305	1651	1760	8900	10700
annual growth rate in %	-6.3	5.1	35.5	13.6	20.7	28.4	6.6	22	20
Average exchange rate UAH/USD	5.327	5.333	5.319	5.125	5.050	5.050	5.050	5	5
Average exchange rate UAH/EUR (ECU)	5.030	6.024	6.609	6.389	6.335	6.067	6.617	6.5	6.5
Purchasing power parity UAH/USD, wiiw	0.943	0.997	1.117	1.301	1.495	.	.	.	.
Purchasing power parity UAH/EUR, wiiw	1.013	1.091	1.228	1.443	1.672	.	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary. - 2) Excluding small enterprises. - 3) From 2004 including lending minus repayments. - 4) Central budget deficit passed by Parliament in December 2006. - 5) Converted from USD. - 6) Useable.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

May. However, producer price inflation accelerated sharply (to 9.8% over the same period) due to the high price dynamics for Ukraine's major export commodities, and will increasingly spill over into consumer prices.

Both financial markets and the country's economy in general have so far been virtually unaffected by a new spiral of political crisis triggered by the dissolution of the Verkhovna Rada (Parliament) by President Yushchenko on 2 April 2007. The move is to be seen as the President's response to the continuous expansion of the ruling parliamentary coalition (controlled by Mr Yushchenko's political rival Mr Yanukovych), which was gradually approaching a two-thirds majority – enough to enact constitutional amendments shifting still further powers from the president to the parliament. Although the president's right to dissolve the Rada under these circumstances was questionable at best (the Constitutional Court has been unable to judge on the issue), the subsequent months have witnessed prolonged negotiations which have resulted in a compromise on early parliamentary elections scheduled for 30 September 2007.

Ironically, the new elections are unlikely to substantially shift the balance of 'orange' and 'anti-orange' forces in the Rada. Nor will they mend the existing political tensions and the country's deep split between the pro-European West and the pro-Russian East. The party of Mr Yanukovych is almost certain to win again and has good chances of forming a new government. The prospect of Mr Yanukovych staying in office may be not a bad piece of news for the business environment and probably partly explains the remarkable resilience of the economy to the political turbulence so far. The only tangible outcome of the early elections could be a somewhat smaller fragmentation of the country's political landscape and further consolidation of influence within the two political poles: by Ms Tymoshenko within the 'orange' camp (at the expense of President Yushchenko) and by Mr Yanukovych within the opposite camp. Both politicians are widely seen as the key contenders in the next presidential elections scheduled for 2009.

Waltraut Urban

China: growth picking up again

In the first quarter of 2007, the Chinese GDP expanded at a rate of 11.1%, faster than in the previous quarter (10.4%) and than in 2006 on average (10.7%). Growth was also higher than expected by most experts – including the government – and the official efforts to prevent overheating have not been successful so far. Growth was driven by a rebound of investment and by a ballooning trade surplus, but supported by a certain acceleration of consumer demand as well. Monthly data available for April and May point to a continuation of the rapid development which may result in a growth rate of the Chinese economy for the whole year between 10.5% and 11%. In 2008, growth will remain strong, but perhaps slow down a bit, taking into account the delayed impact of government measures to cool down the economy and measures taken by important Chinese trading partners to contain the Chinese trade surplus.

The growth rate of fixed asset investment, after reaching a peak in the middle of last year, had decelerated thereafter, reaching a rate of 24% (in nominal terms) for the year 2006 as a whole. This was considered a consequence of emerging over-capacities, but various government measures to cool down 'excessive' investment could play a role as well. In March 2007, investments started to

rebound, yet their growth rate in the first quarter of 2007 (23.7%) was still below that in the first quarter of 2006 (27.7%). However, investment in *urban areas*, covering more than 80% of total investment in fixed assets and for which data are available on a monthly basis, shows a further acceleration throughout April and May. Also, the total planned investment for new projects rose by 6% in May, reversing the decline during the first four months of the year.³⁸ Investments bounced back particularly in energy-intensive sectors such as non-ferrous metal mining, metallurgy, construction materials and chemicals, all showing growth rates of fixed-asset investment in the first quarter of more than 50%.³⁹ These sectors were already targeted last year by the Chinese authorities by restrictive measures such as tighter rules governing land and cash supplies as well as environmental standards, because of the fear of creating over-capacities and putting particular strain on energy consumption and the environment in general.⁴⁰ But, obviously, these industries have managed to utilize their capacities for increased exports and high profits have provided the necessary cash for further expansion. Therefore, tightening measures reiterated by the Chinese government recently, should put an emphasis on the enforcement of environmental and energy laws rather than financial restrictions in order to become effective. At the same time, this would support China's goal of raising the energy efficiency by 20 % and cutting emissions of key pollutants by 10% until 2010.

Export growth accelerated and import growth decelerated, widening the already huge trade surplus substantially. In the first quarter of 2007 Chinese exports expanded by 27.8%, reaching USD 252.1 billion, while imports rose by 18.2%, to USD 205.6 billion. The resulting trade surplus of USD 46.5 billion was twice as high as in the same period of last year; it even increased further in April and May to reach USD 88 billion for the first five months of the year, making a significant contribution to the economy's overall growth and, at the same time, increasing the chance that the trade surplus for the whole year may exceed last year's record size. Exports (in value terms) rose particularly fast in commodities such as steel and ferroalloys, up by 120% and 70% respectively, partly due to soaring metal prices.⁴¹ The government measures to curb exports (such as the announcement of a further reduction of tax rebates for certain groups of exporters) may in the short run have even been counter-productive as they probably induced a forward shift of the exports concerned.

The corresponding large bilateral trade deficits (mainly with the USA and the EU) have provoked various counter actions, including complaints to the World Trade Organization (WTO), anti-dumping procedures, and high-level consultations about exchange rate adjustments, subsidies and the protection of intellectual property rights: With the Chinese trade surplus rising further, the USA and the EU will take an increasingly tougher stance which may result in a certain dampening effect on the Chinese trade surplus later on.

In order to accommodate the growing requests by the USA to give market forces a greater role in determining the value of the Chinese currency, the fluctuation band versus the US dollar was widened as of end of May by the Chinese authorities. Now, the yuan can gain or lose 0.5% of its value against the US dollar on any trading day (the earlier range was 0.3%). Between the first

³⁸ *China Daily*, 18 June 2007.

³⁹ People's Bank of China (PBC), *China Monetary Policy Report, Quarter One*, 2007, p. 47.

⁴⁰ See W. Urban, "China: undamped growth of the economy", *wiiw Research Reports*, No. 328, July 2006, p. 101.

⁴¹ People's Bank of China (PBC), *China Monetary Policy Report, Quarter One*, 2007, p. 47.

quarters of 2006 and 2007, the yuan appreciated (on average) by 3.4% against the US dollar, but depreciated by 5.3% against the euro.

The inflow of foreign direct investment was strong, reaching USD 15.9 billion in the first quarter, up 12% from the same period last year. Cumulated investment over the first five months of the year amounted to USD 25.3 billion, up 10% from last year. This indicates an acceleration of FDI inflows also if compared to the whole year 2006. However, end-of-year FDI data and quarterly and monthly FDI data, respectively, are not strictly comparable, as the latter exclude direct investment in the financial sector, which is playing an increasing role in China.⁴² Most relevant for foreign investors, the National People's Congress (NPC), a kind of Chinese parliament, has approved a new 'Law on Corporate Income Tax' in March this year. According to this law, to take effect on 1 January 2008, corporate income tax will be unified at a rate of 25%, within a five-year transition period, for domestically as well as foreign-owned enterprises.⁴³ However, foreign direct investment qualifying as 'high-tech' investment will continue to pay the lower tax rate of 15%. The NPC also adopted the much-debated 'Law on Protecting Property', affording private property the same protection as state-owned property, but only 'if it was acquired legally'. This amendment was made with a view to exempting from protection, for instance, property that was unlawfully privatized or acquired through corruption. However, given the high degree of uncertainty in the Chinese legal system, this clause could be used for other purposes as well.

The strong rise in foreign currency reserves continued in the first quarter. China's foreign currency reserves, the world's largest since February last year, stood at USD 1202 billion at the end of March 2007 – with an incredible USD 140 billion added alone in the first three months of this year. About USD 60 billion of that increment can be attributed to the foreign trade surplus and the net inflow of FDI. According to the People's Bank of China, China's central bank, the remaining USD 80 billion represented currency purchased through swap contracts with domestic commercial banks and repatriation of Initial Public Offering (IPO) earnings by Chinese companies which recently have listed on bourses outside Mainland China (e.g. in Hong Kong). Speculative foreign currency flows are not believed to have increased.⁴⁴ Most of China's foreign currency reserves are invested in US treasury bonds. But, in order to diversify the assets and improve the gains, China has decided to set up a 'state investment company' – following the example of many oil exporting countries – which in a first step should have a portfolio of USD 200-300 billion to invest. Even before being formally established, this new investment arm of the Chinese government moved to acquire a 10% stake in the US-based private equity investor Blackstone Group, for a price of USD 3 billion. The deal will be completed after Blackstone's listing on the stock market on 22 June 2007.

In China, quarterly data on aggregate private consumption are not published. Retail trade turnover – which may be used as a proxy for consumer demand – expanded much faster than last year in nominal terms during the first quarter of 2007. But as inflation picked up as well, retail trade in real terms (deflated with the retail trade index) grew only slightly faster (12.8%) as compared to the same period of last year (12.2%), and approximately at the same pace as in the year 2006 as a whole

⁴² In 2006, for instance, USD 8.9 billion were invested in the financial sector.

⁴³ So far, the official rate for foreign investment enterprises has been 15% while that for Chinese enterprises 33% – though the effective rates has often been considerably lower.

⁴⁴ Bank of Finland, Institute for Economies in Transition, *BOFIT Weekly* 16, 20 April 2007.

Table CN

China: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008 forecast
Population, mn pers., end of period	1284.5	1292.3	1299.9	1307.6	1315.5	.	.	.	.
Gross domestic product, CNY bn, nom.	12033.3	13582.3	15987.8	18308.5	20940.7	4339.0	5028.7	23800	26700
annual change in % (real)	9.1	10.0	10.1	10.4	10.7	10.4	11.1	10.5	10
GDP/capita (USD at exchange rate)	1132	1270	1486	1706	1997	.	.	.	.
GDP/capita (USD at PPP - wiiw)	5475	6161	6933	7822	8893	.	.	.	.
Industrial value added ²⁾									
annual change in % (real)	9.9	12.5	11.1	11.4	12.5	12.7	13.2	.	.
Agricultural value added									
annual change in % (real)	2.9	2.5	6.0	5.2	5.0	4.5	4.4	.	.
Retail trade turnover, CNY bn	4813.6	5251.6	5950.1	6717.7	7641.0	1844.0	2118.8	.	.
annual change in % (real)	10.6	9.2	10.5	12.1	12.9	12.2	12.8	.	.
Total investment in fixed assets, CNY bn	4350.0	5556.7	7047.7	8877.4	10987.0	1390.8	1752.6	.	.
annual change in % (nominal)	16.8	27.7	26.8	26.0	24.0	27.7	23.7	.	.
Employment total, mn pers., end of period	737.4	744.3	752.0	758.3	.	.	.	.	.
annual change in %	1.0	0.9	1.0	0.8	.	.	.	.	.
Staff and workers, mn pers., end of period ³⁾	105.6	104.6	105.8	108.5	111.6	107.9	110.3	.	.
annual change in %	-2.2	-0.7	0.8	2.6	2.9	3.1	2.2	.	.
Unemployment rate (urban) in %, end of per. ⁴⁾	4.0	4.5	4.2	4.2	4.1	.	.	4.3	4.5
Average gross annual wages, CNY ⁵⁾	12422	14040	16024	18364	20846	18776.8	22195	.	.
annual change in % (real) ⁶⁾	15.5	12.0	10.5	12.8	.	.	.	.	.
Retail prices, % p.a.	-1.8	-0.1	2.8	0.8	0.8	0.6	2.1	.	.
Consumer prices, % p.a.	-0.8	1.2	3.9	1.8	1.5	1.2	2.7	2.8	2
General government budget, nat.def., % GDP									
Revenues	15.7	16.0	16.5	17.3	18.0	.	.	.	.
Expenditures	18.3	18.1	17.8	18.4	19.4	.	.	.	.
Deficit (-) / surplus (+), % GDP	-2.6	-2.2	-1.3	-1.1	-1.3	.	.	-1.0	.
Refinancing rate of NB % p.a., end of per. ⁷⁾	2.7	2.7	3.3	3.3	3.3	2.9	3.6	.	.
Current account, USD bn	35.4	45.9	70.0	161.0	250	.	.	270	250
Current account in % of GDP	2.4	2.8	3.6	7.2	9.5	.	.	8.5	6.6
Gross reserves of NB excl. gold, USD bn	286.4	403.3	609.9	818.9	1066.3	875.1	1202.0	.	.
Gross external debt, USD bn	171.7	194.0	223.0	280.0	323.0	.	.	.	.
Gross external debt in % of GDP	11.8	11.8	11.5	12.5	12.3	.	.	.	.
FDI inflow, gross, USD bn ⁸⁾	52.8	53.3	60.6	72.4	78	14.2	15.9	.	.
FDI outflow, gross, USD bn ⁸⁾	2.8	1.8	2.1	12.3	18	.	.	.	.
Exports of goods total, USD bn ⁹⁾	325.6	438.4	593.4	762.0	969.1	197.3	252.1	.	.
annual change in %	22.3	34.6	35.4	28.4	27.2	26.6	27.8	.	.
Imports of goods total, USD bn ⁹⁾	295.3	412.8	561.3	660.1	791.6	174.0	205.6	.	.
annual change in %	21.2	39.9	36.0	17.6	20.0	24.8	18.2	.	.
Trade balance of goods, USD bn ⁹⁾	30.3	25.5	32.1	101.9	177.5	23.3	46.5	.	.
Average exchange rate CNY/USD	8.277	8.277	8.277	8.206	7.972	8.035	7.761	7.5	7.1
Average exchange rate CNY/EUR	7.753	9.366	11.276	10.261	10.015	9.658	10.167	.	.
Purchasing power parity CNY/USD, wiiw ¹⁰⁾	1.711	1.706	1.774	1.790	1.790	.	.	.	.
Purchasing power parity CNY/EUR, wiiw	1.982	2.016	2.104	2.134	2.202	.	.	.	.

Note: CNY: ISO code for the Chinese yuan.

1) Preliminary. - 2) Including construction. - 3) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives, shareholding ownership and foreign invested enterprises. - 4) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 5) 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. - 6) Staff and workers cost of living index is used as deflator for calculating real wage. - 7) Overnight rate. - 8) Quarterly FDI data exclude investments in the financial sector. - 9) According to customs statistics. - 10) Purchasing power parity, ICP-method; see Ren Ruoen, The Vienna Institute Monthly Report 1996/2.

Sources: China Statistical Yearbook; China Monthly Statistics; China Daily etc.; wiiw forecasts.

(12.9%). In April 2007, retail trade turnover accelerated and reached a year-on-year growth rate (in real terms) of 13.3%; provisional data point to a similar growth rate in May. Demand rose particularly fast for product groups such as furniture, construction and decoration material, jewellery, and cars. In fact, the rise in retail trade turnover is surprisingly low, given the strong increase in incomes this year. According to official figures, in the first quarter of 2007 real per capita income of urban households rose by 19.2% and that of rural households by 15.2% year-on-year. Also, minimum wages were raised in many provinces as well.

Consumer price inflation began to rise already at the end of last year; it hit the 3% mark in March and reached 3.4% in May 2007. This was mainly due to the rapid rise in food prices (in May food prices increased by 8.3%). Some important items such as pork (25%) and eggs (37%) showed extremely high price hikes, which were at least partly attributable to rising feed prices, in particular of maize, the price of which was pushed up by its extended use for bio-fuel production. The so-called core inflation, excluding items with strongly fluctuating prices such as petrol and food, is said to be around 1% only. Supply measures such as the marketing of 'strategic reserves' of pork, for instance, and a watchful eye on bio-fuel production therefore seem more adequate than a tightening of the money supply to contain current inflationary pressures. Furthermore, the good summer harvest is expected to increase supply and ease price pressure, e.g. on maize. But in June, state-administered electricity prices will be raised and a new, refined oil pricing system – which will gradually phase out oil subsidization – is planned to take effect soon. Both measures will press on inflation later in the year (the PBC wants to keep inflation below 3% this year).

The monetary authorities battled hard to keep money growth in check, despite the rising inflow of liquidity from the widening current account surplus and a strong demand for bank loans. The reserve requirements for commercial banks were raised already five times this year and the reference interest rates were raised twice. As of 26 June, the reserve ratio for commercial banks stood at 11.5% and the reference interest rate for 12-month commercial loans reached 6.25%. However, the rate for 12-month deposits stood at 3.06%, below the rate of inflation in May (3.4%). Given the same target for money growth (M2) as last year (16%), actual money growth was 17.3% in the first quarter, but came down to 16.7% in May.

Excess liquidity and low or even negative real interest rates on saving deposits have among other factors helped to continue the bull run at the Shanghai and Shenzhen stock exchanges. After rising 130% in 2006, the Shanghai composite index gained 48% in the first five months of this year, raising fears of a bubble building up. There are currently 100 million stock accounts in China, with 20 million new share trading accounts being opened in 2007. The price/earnings ratio at the Shanghai exchange now stands at 40, compared to 15 in Hong Kong, and daily turnovers have skyrocketed. With a view to dampening this development, the Chinese authorities have raised the stamp tax on stock trades from 0.1% to 0.3%. This led to an immediate fall of stock prices on 30 May 2007, and although stock prices have largely recovered soon thereafter, the all-time maximum reached on 29 May has not been exceeded yet (as of 16 June 2007), indicating a certain calming down of the bull run.

On the supply side, agricultural value-added rose at a rate of 4.4%, at a similar pace as in the first quarter of 2006. But industrial value-added, growing by 13.2%, expanded half a percentage point faster compared to the same period last year; growth in the services sector was even one percentage point higher than in the first quarter of 2006. However, data for large industrial

enterprises, which are available on a monthly basis, show a similar growth rate of value-added in April and May as in 2006. Within the industrial sector, the fastest growing industries include transport equipment, non-metallic mineral products, smelted and pressed ferrous metals (in particular steel) and chemicals, as well as electrical machinery and equipment, fuelled by fast growing investment and surging exports.

To sum up, China's overall economic growth in 2007 will reach between 10.5% and 11%, depending on the effectiveness of government measures to cool down the economy and on the trading partners' success to put a cap on China's huge trade surplus. Development of the world economy, in particular of the US economy, will have a significant impact as well. The expansion of fixed asset investment will remain fast, although to a certain extent contained by government restrictions. The trade surplus will probably be even larger than last year. Private consumption may accelerate further, driven by high income growth. On the supply side, industrial production will continue to expand strongly but services will gain in relative importance.

Appendix

**Selected Indicators of
Competitiveness**

Table A/1

GDP per capita at current PPPs (EUR), from 2007 at constant PPPs

	1991	1995	2000	2004	2005	2006	2007	2008	2009	2010	2015
	projection assuming 5% p.a. GDP growth and zero population growth p.a.										
Bulgaria	4764	4782	5319	7330	7887	8743	9267	9824	10315	10830	13823
Cyprus	11111	12744	16531	19897	20857	22148	22990	23886	25081	26335	33611
Czech Republic	9149	10048	13018	16595	17426	19090	20045	21087	22141	23248	29672
Estonia	5688	5249	8245	12193	14052	16303	17852	19351	20319	21335	27229
Hungary	7289	7524	10527	13933	14685	16036	16469	16980	17829	18720	23892
Latvia	6882	4576	7002	9919	11410	13338	14525	15687	16471	17295	22073
Lithuania	8172	5070	7627	11125	12219	13735	14696	15651	16434	17255	22023
Malta	9965	12297	15700	16631	17398	18626	19185	19722	20709	21744	27751
Poland	4531	6167	9383	11065	11703	12926	13701	14455	15178	15937	20340
Romania	4116	4644	5003	7398	8029	9000	9540	10065	10568	11097	14162
Slovak Republic	6023	6825	9524	12355	13409	15079	16360	17669	18553	19480	24862
Slovenia	9523	9779	14613	18154	19215	20933	21979	23078	24232	25444	32474
NMS-12	5596	6317	8648	11121	11871	13148	13858	14579	15308	16073	20514
Croatia	5979	5682	8103	10679	11384	12395	12953	13536	14212	14923	19046
Macedonia	4316	4026	5141	5656	6101	6509	6770	7040	7392	7762	9906
Turkey	4199	4608	5998	6136	6468	6907	7287	7761	8149	8557	10921
Albania	1861	2247	3313	4101	4415	4670	4904	5173	5432	5704	7280
Bosnia & Herzeg.	.	.	4990	6238	6193	6330	6709	7112	7468	7841	10007
Montenegro	.	.	4636	5352	5681	6182	6492	6816	7157	7515	9591
Serbia	.	.	4682	6147	6673	7208	7569	7947	8344	8762	11182
Russia	8133	5679	5973	8278	9035	9878	10559	11108	11664	12247	15631
Ukraine	5792	3276	3771	5924	6249	6873	7320	7759	8147	8554	10918
	projection assuming 2% p.a. GDP growth and zero population growth p.a.										
Austria	18378	19684	25235	28024	28852	30810	31426	32054	32695	33349	36820
Germany	17589	18669	22457	25226	25817	27609	28161	28724	29299	29885	32995
Greece	10822	10993	14619	18481	19730	21313	21739	22174	22617	23070	25471
Portugal	10527	11737	16146	16379	16814	17631	17984	18344	18710	19085	21071
Spain	12465	13565	18525	21939	22985	24432	24921	25419	25928	26446	29199
USA	21389	23374	30556	33595	35198	37150	37893	38650	39423	40212	44397
EU(15) average	15966	17181	22063	24654	25418	27021	27561	28113	28675	29248	32292
EU(25) average	14300	15471	20096	22715	23494	25074	25852	26653	27479	28331	33003
EU(27) average	13629	14771	19145	21792	22569	24117	24889	25685	26507	27355	32021
European Union (25) average = 100											
	1991	1995	2000	2004	2005	2006	2007	2008	2009	2010	2015
Bulgaria	33	31	26	32	34	35	36	37	38	38	42
Cyprus	78	82	82	88	89	88	89	90	91	93	102
Czech Republic	64	69	65	73	74	76	78	79	81	82	90
Estonia	40	34	42	54	60	65	69	73	74	75	83
Hungary	51	49	54	61	63	64	64	64	65	66	72
Latvia	48	30	35	44	49	53	56	59	60	61	67
Lithuania	57	33	38	49	52	55	57	59	60	61	67
Malta	70	79	78	73	74	74	74	74	75	77	84
Poland	32	40	47	49	50	52	53	54	55	56	62
Romania	29	30	25	33	34	36	37	38	38	39	43
Slovak Republic	42	45	47	54	57	60	63	66	68	69	75
Slovenia	67	68	73	80	82	83	85	87	88	90	98
NMS-12	39	41	43	49	51	52	54	55	56	57	62
Croatia	42	37	40	47	48	49	50	51	52	53	58
Macedonia	30	26	26	25	26	26	26	26	27	27	30
Turkey	29	30	30	27	28	28	28	29	30	30	33
Albania	13	15	16	18	19	19	19	19	20	20	22
Bosnia & Herzeg.	.	.	25	27	26	25	26	27	27	28	30
Montenegro	.	.	23	24	24	25	25	26	26	27	29
Serbia	.	.	23	27	28	29	29	30	30	31	34
Russia	57	37	30	36	38	39	41	42	42	43	47
Ukraine	41	21	19	26	27	27	28	29	30	30	33
Austria	129	127	126	123	123	123	122	120	119	118	112
Germany	123	121	112	111	110	110	109	108	107	105	100
Greece	76	71	73	81	84	85	84	83	82	81	77
Portugal	74	76	80	72	72	70	70	69	68	67	64
Spain	87	88	92	97	98	97	96	95	94	93	88
USA	150	151	152	148	150	148	147	145	143	142	135
EU(15) average	112	111	110	109	108	108	107	105	104	103	98
EU(25) average	100	100	100	100	100	100	100	100	100	100	100
EU(27) average	95	95	95	96	96	96	96	96	96	97	97

Sources: National statistics, Eurostat, wiw estimates.

Table A/2

Indicators of macro-competitiveness, 1999-2006

EUR based, annual averages

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.
Czech Republic								
Producer price index, 2000=100	95.3	100.0	102.8	102.3	101.9	107.7	110.9	112.7
Consumer price index, 2000=100	96.2	100.0	104.7	106.6	106.7	109.7	111.8	114.5
GDP deflator, 2000=100	98.5	100.0	104.9	107.8	108.8	113.7	113.5	114.8
Exchange rate (ER), CZK/EUR	36.88	35.61	34.08	30.81	31.84	31.90	29.78	28.34
ER nominal, 2000=100	103.6	100.0	95.7	86.5	89.4	89.6	83.6	79.6
Real ER (CPI-based), 2000=100	105.6	100.0	93.4	84.7	89.1	88.7	83.1	78.8
Real ER (PPI-based), 2000=100	104.2	100.0	94.2	85.1	88.8	86.1	81.5	80.0
PPP, CZK/EUR	16.33	16.37	16.76	16.57	16.41	16.63	16.79	16.43
Price level, EU(25)=100	44	46	49	54	52	52	56	58
Average monthly gross wages, CZK	12797	13614	14793	15866	16917	18041	18992	20207
Average monthly gross wages, EUR (ER)	347	382	434	515	531	565	638	713
Average monthly gross wages, EUR (PPP)	784	832	883	957	1031	1085	1131	1230
GDP nominal, CZK mn	2080797	2189169	2352214	2464432	2577110	2817362	2994396	3220259
Employed persons - LFS, th., average ¹⁾	4764.1	4731.6	4750.2	4764.9	4733.2	4706.6	4764.0	4828.1
GDP per employed person, CZK	436766	462670	495182	517205	544481	598598	628547	666983
GDP per empl. person, CZK at 2000 pr.	443352	462670	472166	479645	500256	526302	553757	581231
Unit labour costs, CZK, 2000=100	98.1	100.0	106.5	112.4	114.9	116.5	116.6	118.2
Unit labour costs, ER adj., 2000=100	94.7	100.0	111.2	129.9	128.5	130.0	139.4	148.4
Unit labour costs, PPP adj., Austria=100	29.30	31.09	34.09	38.73	37.66	38.81	40.90	42.63
Hungary								
Producer price index, 2000=100	89.6	100.0	105.2	103.3	105.8	109.5	114.2	121.6
Consumer price index, 2000=100	91.1	100.0	109.2	115.0	120.4	128.6	133.2	138.4
GDP deflator, 2000=100	91.1	100.0	108.4	116.9	123.6	129.0	132.0	136.8
Exchange rate (ER), HUF/EUR	252.80	260.04	256.68	242.97	253.51	251.68	248.05	264.27
ER, nominal 2000=100	97.2	100.0	98.7	93.4	97.5	96.8	95.4	101.6
Real ER (CPI-based), 2000=100	104.7	100.0	92.4	84.8	86.1	81.8	79.5	83.3
Real ER (PPI-based), 2000=100	104.0	100.0	94.9	91.0	93.2	91.5	90.3	94.7
PPP, HUF/EUR	114.50	122.35	126.47	133.11	141.31	147.12	148.89	147.09
Price level, EU(25)=100	45	47	49	55	56	58	60	56
Average monthly gross wages, HUF	77187	87645	103553	122482	137187	145520	158343	171239
Average monthly gross wages, EUR (ER)	305	337	403	504	541	578	638	648
Average monthly gross wages, EUR (PPP)	674	716	819	920	971	989	1063	1164
GDP nominal, HUF mn	11393499	13150766	15270126	17180604	18940742	20717110	22055093	23752721
Employed persons - LFS, th., average ²⁾	3809.3	3856.2	3868.3	3870.6	3921.9	3900.4	3901.5	3930.1
GDP per employed person, HUF	2990969	3410291	3947503	4438744	4829481	5311535	5652978	6043796
GDP per empl. person, HUF at 2000 pr.	3281843	3410291	3640600	3798669	3906399	4116511	4284182	4418948
Unit labour costs, HUF, 2000=100	91.5	100.0	110.7	125.5	136.6	137.5	143.8	150.8
Unit labour costs, ER adj., 2000=100	94.1	100.0	112.1	134.3	140.2	142.1	150.8	148.4
Unit labour costs, PPP adj., Austria=100	26.03	27.79	30.72	35.78	36.72	37.92	39.55	38.09
Poland								
Producer price index, 2000=100	92.8	100.0	101.6	102.6	105.3	112.7	113.4	116.1
Consumer price index, 2000=100	90.8	100.0	105.5	107.5	108.4	112.2	114.5	115.7
GDP deflator, 2000=100	93.3	100.0	103.5	105.9	106.2	110.6	113.6	115.2
Exchange rate (ER), PLN/EUR	4.227	4.011	3.669	3.856	4.398	4.534	4.025	3.895
ER, nominal, 2000=100	105.4	100.0	91.5	96.1	109.6	113.0	100.4	97.1
Real ER (CPI-based), 2000=100	113.9	100.0	88.6	93.3	107.6	109.5	97.3	95.2
Real ER (PPI-based), 2000=100	108.9	100.0	91.1	94.2	105.3	103.8	95.7	94.8
PPP, PLZ/EUR	1.999	2.074	2.121	2.118	2.160	2.188	2.202	2.146
Price level, EU(25)=100	47	52	58	55	49	48	55	55
Average monthly gross wages, PLN ³⁾	1697	1894	2045	2098	2185	2273	2361	2477
Average monthly gross wages, EUR (ER)	401	472	557	544	497	501	586	636
Average monthly gross wages, EUR (PPP)	849	913	964	991	1011	1039	1072	1154
GDP nominal, PLN mn	665688	744378	779564	808578	843156	924538	983302	1057855
Employed persons - LFS, th., average ⁴⁾	14757	14526	14207	13782	13617	13795	14115	14594
GDP per employed person, PLN	45110	51245	54872	58669	61921	67021	69662	72486
GDP per empl. person, PLN at 2000 pr.	48364	51245	53023	55421	58283	60580	61338	62945
Unit labour costs, PLN, 2000=100	95.0	100.0	104.4	102.4	101.4	101.6	104.1	106.5
Unit labour costs, ER adj., 2000=100	90.1	100.0	114.1	106.6	92.5	89.8	103.8	109.7
Unit labour costs, PPP adj., Austria=100	39.37	43.91	49.40	44.87	38.30	37.88	43.02	44.48

1) From 2002 according to census 2001. - 2) From 1999 according to census 2001. - 3) From 1999 broader wage coverage. - 4) From 2003 according to census 2002.

(Table A/2 ctd.)

(Table A/2 ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.
Slovak Republic								
Producer price index, 2000=100	90.2	100.0	106.5	108.7	117.8	121.8	127.5	138.2
Consumer price index, 2000=100	89.3	100.0	107.1	110.6	120.0	129.0	132.5	138.5
GDP deflator, 2000=100	91.2	100.0	105.0	109.9	115.1	122.0	124.9	128.3
Exchange rate (ER), SKK/EUR	44.12	42.59	43.31	42.70	41.49	40.05	38.59	37.25
ER, nominal, 2000=100	103.6	100.0	101.7	100.3	97.4	94.0	90.6	87.5
Real ER (CPI-based), 2000=100	113.8	100.0	97.0	94.5	86.3	79.2	75.9	71.6
Real ER (PPI-based), 2000=100	110.1	100.0	96.6	92.7	83.7	79.9	76.9	71.7
PPP, SKK/EUR	17.91	18.30	18.70	18.80	19.60	20.38	20.37	20.13
Price level, EU(25)=100	41	43	43	44	47	51	53	54
Average monthly gross wages, SKK	10728	11430	12365	13511	14365	15825	17274	18761
Average monthly gross wages, EUR (ER)	243	268	286	316	346	395	448	504
Average monthly gross wages, EUR (PPP)	599	625	661	719	733	776	848	932
GDP nominal, SKK mn	852169	941314	1020595	1111484	1212665	1355262	1471131	1636263
Employed persons - LFS, th., average	2132.1	2101.7	2123.7	2127.0	2164.6	2170.4	2216.2	2301.4
GDP per employed person, SKK	399685	447882	480574	522559	560226	624430	663808	710986
GDP per empl. person, SKK at 2000 pr.	438328	447882	457541	475642	486819	511811	531493	554289
Unit labour costs, SKK, 2000=100	95.9	100.0	105.9	111.3	115.6	121.2	127.4	132.6
Unit labour costs, ER adj., 2000=100	92.6	100.0	104.1	111.0	118.7	128.9	140.5	151.6
Unit labour costs, PPP adj., Austria=100	23.22	25.20	25.87	26.83	28.20	31.18	33.44	35.31
Slovenia								
Producer price index, 2000=100	92.9	100.0	108.9	114.5	117.3	122.4	125.7	128.5
Consumer price index, 2000=100	91.8	100.0	108.4	116.5	123.1	127.5	130.7	133.9
GDP deflator, 2000=100	94.9	100.0	108.7	117.3	124.0	128.1	130.0	133.0
Exchange rate (ER), EUR-SIT/EUR	0.8080	0.8556	0.9063	0.9440	0.9752	0.9968	1.0000	0.9998
ER, nominal, 2000=100	94.4	100.0	105.9	110.3	114.0	116.5	116.9	116.9
Real ER (CPI-based), 2000=100	100.9	100.0	99.9	98.8	98.5	99.3	99.3	99.0
Real ER (PPI-based), 2000=100	97.4	100.0	98.4	97.0	98.3	98.5	100.6	103.0
PPP, SIT/EUR	0.5954	0.6170	0.6528	0.6980	0.7213	0.7219	0.7185	0.7073
Price level, EU(25)=100	74	72	72	74	74	72	72	71
Average monthly gross wages, EUR-SIT	723	800	895	982	1057	1117	1157	1213
Average monthly gross wages, EUR (ER)	895	935	988	1041	1083	1120	1157	1213
Average monthly gross wages, EUR (PPP)	1214	1296	1372	1407	1465	1547	1610	1715
GDP nominal, SIT mn	16354	17945	20028	22348	24259	26172	27625	29736
Employed persons - LFS, th., average	886	901	916	910	897	943	949	961
GDP per employed person, EUR-SIT	18458	19917	21865	24558	27045	27754	29110	30943
GDP per empl. person, EUR-SIT at 2000 pr.	19457	19917	20111	20943	21810	21664	22394	23265
Unit labour costs, EUR-SIT, 2000=100	92.5	100.0	110.9	116.8	120.6	128.3	128.7	129.8
Unit labour costs, ER adj., 2000=100	98.0	100.0	104.7	105.9	105.8	110.2	110.1	111.1
Unit labour costs, PPP adj., Austria=100	64.89	66.55	68.66	67.57	66.40	70.40	69.17	68.29
Bulgaria								
Producer price index, 2000=100	85.1	100.0	103.8	105.0	110.1	116.7	124.8	136.5
Consumer price index, 2000=100	90.7	100.0	107.4	113.6	116.2	123.4	129.6	139.0
GDP deflator, 2000=100	93.7	100.0	106.7	111.4	113.3	119.2	123.9	133.8
Exchange rate (ER), BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
ER, nominal, 2000=100	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real ER (CPI-based), 2000=100	108.2	100.0	95.2	91.8	91.5	88.1	85.7	81.6
Real ER (PPI-based), 2000=100	112.7	100.0	97.5	95.8	91.8	88.6	86.7	83.0
PPP, BGN/EUR	0.5922	0.6156	0.6431	0.6747	0.6552	0.6807	0.7010	0.7293
Price level, EU(25)=100	30	31	33	34	34	35	36	37
Average monthly gross wages, BGN	201	225	240	258	273	292	324	355
Average monthly gross wages, EUR (ER)	103	115	123	132	140	150	166	181
Average monthly gross wages, EUR (PPP)	339	365	373	382	417	430	462	486
GDP nominal, BGN mn	23790	26753	29709	32402	34628	38823	42797	49091
Employed persons - LFS, th., average	2875.3	2794.7	2698.8	2739.6	2834.8	2922.5	2980.0	3110.0
GDP per employed person, BGN	8274	9573	11008	11827	12215	13284	14362	15785
GDP per empl. person, BGN at 2000 pr.	8828	9573	10317	10621	10777	11144	11596	11800
Unit labour costs, BGN, 2000=100	97.1	100.0	99.2	103.4	108.1	111.9	119.0	128.1
Unit labour costs, ER adj., 2000=100	97.1	100.0	99.2	103.4	108.1	111.9	119.0	128.1
Unit labour costs, PPP adj., Austria=100	16.39	16.96	16.59	16.82	17.29	18.22	19.06	20.08

(Table A/2 ctd.)

(Table A/2 ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.
Romania								
Producer price index, 2000=100	65.2	100.0	138.1	169.9	203.0	241.8	267.2	298.2
Consumer price index, 2000=100	68.6	100.0	134.5	164.8	190.0	212.5	231.7	246.9
GDP deflator, 2000=100	69.3	100.0	137.4	169.6	210.3	241.8	271.5	299.7
Exchange rate (ER), RON/EUR	1.6296	1.9956	2.6027	3.1255	3.7556	4.0532	3.6234	3.5245
ER, nominal, 2000=100	81.7	100.0	130.4	156.6	188.2	203.1	181.6	176.6
Real ER (CPI-based), 2000=100	116.7	100.0	99.1	99.2	105.4	103.8	87.0	81.1
Real ER (PPI-based), 2000=100	120.1	100.0	95.5	92.7	93.8	86.9	73.5	67.1
PPP, RON/EUR	0.5109	0.7161	0.9548	1.1473	1.3955	1.5371	1.6590	1.7627
Price level, EU(25)=100	31	36	37	37	37	38	46	50
Average monthly gross wages, RON	192	284	422	532	664	818	968	1150
Average monthly gross wages, EUR (ER)	118	142	162	170	177	202	267	326
Average monthly gross wages, EUR (PPP)	376	397	442	464	476	532	583	652
GDP nominal, RON mn	54573.0	80377.3	116768.7	151475.1	197564.8	246468.8	288047.8	342418.0
Employed persons - LFS, th., average ⁵⁾	10535.0	10508.0	10440.0	9234.3	9222.5	9157.6	9146.6	9313.3
GDP per employed person, RON	5180	7649	11185	16404	21422	26914	31492	36767
GDP per empl. person, RON at 2000 pr.	7472	7649	8138	9670	10186	11130	11600	12269
Unit labour costs, RON, 2000=100	69.3	100.0	139.7	148.2	175.5	198.0	224.7	252.4
Unit labour costs, ER adj., 2000=100	84.8	100.0	107.1	94.6	93.3	97.5	123.8	142.9
Unit labour costs, PPP adj., Austria=100	25.85	30.62	32.33	27.79	26.92	28.66	35.78	40.43
Estonia								
Producer price index, 2000=100	95.3	100.0	104.4	104.8	105.0	108.1	110.3	115.1
Consumer price index, 2000=100	96.2	100.0	105.8	109.6	111.0	114.4	119.1	124.3
GDP deflator, 2000=100	94.9	100.0	105.3	109.3	111.8	114.2	121.9	129.3
Exchange rate (ER), EEK/EUR	15.647	15.647	15.647	15.647	15.647	15.647	15.647	15.647
ER, nominal, 2000=100	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real ER (CPI-based), 2000=100	102.1	100.0	96.6	95.2	95.8	95.0	93.2	91.3
Real ER (PPI-based), 2000=100	100.6	100.0	96.9	95.9	96.3	95.8	98.0	98.5
PPP, EEK/EUR	8.141	8.230	8.687	8.854	8.794	8.917	9.149	9.340
Price level, EU(25)=100	52	53	56	57	56	57	58	60
Average monthly gross wages, EEK ⁶⁾	4440	4907	5510	6144	6723	7287	8073	9400
Average monthly gross wages, EUR (ER)	284	314	352	393	430	466	516	601
Average monthly gross wages, EUR (PPP)	545	596	634	694	764	817	882	1006
GDP nominal, EEK mn	81776	92938	108218	121372	132904	146694	173062	204556
Employed persons - LFS, th., average	579.3	572.5	577.7	585.5	594.3	595.5	607.4	646.3
GDP per employed person, EEK	141163	162337	187326	207297	223631	246337	284923	316503
GDP per empl. person, EEK at 2000 pr.	148748	162337	177962	189667	200087	215798	233731	244695
Unit labour costs, EEK, 2000=100	98.7	100.0	102.4	107.2	111.2	111.7	114.3	127.1
Unit labour costs, ER adj., 2000=100	98.7	100.0	102.4	107.2	111.2	111.7	114.3	127.1
Unit labour costs, PPP adj., Austria=100	35.91	36.54	36.90	37.55	38.29	39.19	39.42	42.90
Latvia								
Producer price index, 2000=100	99.4	100.0	101.7	102.7	106.0	115.1	124.1	136.9
Consumer price index, 2000=100	97.5	100.0	102.5	104.4	107.5	114.1	121.8	130.1
GDP deflator, 2000=100	97.3	100.0	101.7	105.4	109.1	116.8	128.7	142.9
Exchange rate (ER), LVL/EUR	0.6237	0.5600	0.5627	0.5826	0.6449	0.6711	0.7028	0.7028
ER, nominal, 2000=100	111.4	100.0	100.5	104.0	115.2	119.8	125.5	125.5
Real ER (CPI-based), 2000=100	112.1	100.0	100.2	103.9	114.0	114.1	114.4	109.4
Real ER (PPI-based), 2000=100	107.4	100.0	99.9	101.9	109.9	107.7	109.4	103.9
PPP, LVL/EUR	0.2787	0.2820	0.2867	0.2954	0.3062	0.3241	0.3451	0.3689
Price level, EU(25)=100	45	50	51	51	47	48	49	52
Average monthly gross wages, LVL	141	150	159	173	192	211	246	302
Average monthly gross wages, EUR (ER)	226	267	283	297	298	314	350	430
Average monthly gross wages, EUR (PPP)	506	530	555	586	629	651	712	820
GDP nominal, LVL mn	4265.0	4685.7	5219.9	5758.3	6392.8	7434.5	9059.1	11264.7
Employed persons - LFS, th., average	968.5	941.1	962.1	989.0	1006.9	1017.7	1035.9	1086.8
GDP per employed person, LVL	4404	4979	5426	5822	6349	7305	8745	10365
GDP per empl. person, LVL at 2000 pr.	4525	4979	5335	5526	5818	6256	6798	7252
Unit labour costs, LVL, 2000=100	103.7	100.0	99.2	104.2	110.2	112.3	120.4	138.8
Unit labour costs, ER adj., 2000=100	93.2	100.0	98.8	100.2	95.7	93.7	95.9	110.6
Unit labour costs, PPP adj., Austria=100	32.22	34.76	33.84	33.40	31.34	31.26	31.47	35.52

5) Methodological break in 2001/2002. - 6) From 1999 excluding compensations from Health Insurance Fund.

(Table A/2 ctd.)

(Table A/2 ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.
Lithuania								
Producer price index, 2000=100	86.2	100.0	97.0	94.3	93.8	99.4	110.9	119.1
Consumer price index, 2000=100	99.0	100.0	101.3	101.6	100.4	101.6	104.3	108.3
GDP deflator, 2000=100	99.4	100.0	99.4	99.6	98.5	101.4	107.4	115.0
Exchange rate (ER), LTL/EUR	4.2712	3.6990	3.5849	3.4605	3.4528	3.4528	3.4528	3.4528
ER, nominal, 2000=100	115.5	100.0	96.9	93.6	93.3	93.3	93.3	93.3
Real ER (CPI-based), 2000=100	114.4	100.0	97.8	96.1	98.9	99.8	99.3	97.8
Real ER (PPI-based), 2000=100	128.4	100.0	101.1	99.8	100.6	97.1	91.0	88.8
PPP, LTL/EUR	1.7638	1.7112	1.6676	1.6607	1.6049	1.6375	1.7067	1.7589
Price level, EU(25)=100	41	46	47	48	46	47	49	51
Average monthly gross wages, LTL	987	971	982	1014	1073	1149	1290	1500
Average monthly gross wages, EUR (ER)	231	262	274	293	311	333	373	434
Average monthly gross wages, EUR (PPP)	560	567	589	611	668	702	756	853
GDP nominal, LTL mn	43667	45674	48585	51971	56804	62587	71200	81991
Employed persons - LFS, th., average	1456.5	1397.8	1351.8	1405.9	1438.0	1436.3	1473.9	1499.0
GDP per employed person, LTL	29981	32675	35941	36967	39502	43575	48307	54697
GDP per empl. person, LTL at 2000 pr.	30177	32675	36172	37130	40112	42961	44991	47563
Unit labour costs, LTL, 2000=100	110.1	100.0	91.4	91.9	90.0	90.0	96.5	106.1
Unit labour costs, ER adj., 2000=100	95.4	100.0	94.3	98.2	96.4	96.5	103.3	113.7
Unit labour costs, PPP adj., Austria=100	29.98	31.58	29.37	29.76	28.71	29.25	30.82	33.18
Croatia								
Producer price index, 2000=100	91.2	100.0	103.6	103.2	105.1	108.8	112.1	115.3
Consumer price index, 2000=100	94.2	100.0	104.9	106.7	108.6	110.9	114.6	118.2
GDP deflator, 2000=100	95.5	100.0	104.0	107.8	112.1	116.4	120.1	124.1
Exchange rate (ER), HRK/EUR	7.5796	7.6350	7.4690	7.4068	7.5634	7.4952	7.4002	7.3226
ER, nominal, 2000=100	99.3	100.0	97.8	97.0	99.1	98.2	96.9	95.9
Real ER (CPI-based), 2000=100	103.5	100.0	95.3	94.9	97.0	96.2	93.9	92.0
Real ER (PPI-based), 2000=100	104.4	100.0	95.5	94.6	95.3	93.4	93.5	94.2
PPP, HRK/EUR	4.1789	4.2423	4.3255	4.3488	4.4983	4.5353	4.5752	4.5513
Price level, EU(25)=100	55	56	58	59	59	61	62	62
Average monthly gross wages, HRK	4551	4869	5061	5366	5623	5985	6248	6634
Average monthly gross wages, EUR (ER)	600	638	678	724	743	799	844	906
Average monthly gross wages, EUR (PPP)	1089	1148	1170	1234	1250	1320	1366	1458
GDP nominal, HRK mn	141579	152519	165640	181231	198422	214983	231349	250590
Employed persons - LFS, th., average	1492.0	1553.0	1469.0	1528.0	1536.5	1562.5	1573.0	1586.0
GDP per employed person, HRK	94892	98209	112757	118607	129139	137589	147075	158001
GDP per empl. person, HRK at 2000 pr.	99339	98209	108400	110039	115229	118185	122450	127273
Unit labour costs, HRK, 2000=100	92.4	100.0	94.2	98.4	98.4	102.1	102.9	105.1
Unit labour costs, ER adj., 2000=100	93.1	100.0	96.3	101.4	99.4	104.0	106.2	109.6
Unit labour costs, PPP adj., Austria=100	58.64	63.30	60.08	61.56	59.30	63.25	63.46	64.11
Macedonia								
Producer price index, 2000=100	90.3	100.0	102.0	101.1	100.8	101.7	104.9	109.7
Consumer price index, 2000=100	94.5	100.0	105.5	107.4	108.7	108.2	108.8	112.3
GDP deflator, 2000=100	92.4	100.0	103.6	107.1	107.5	108.9	112.5	116.0
Exchange rate (ER), MKD/EUR	60.62	60.73	60.91	60.98	61.26	61.34	61.30	61.19
ER, nominal, 2000=100	99.8	100.0	100.3	100.4	100.9	101.0	100.9	100.8
Real ER (CPI-based), 2000=100	103.6	100.0	97.2	97.5	98.7	101.4	103.0	101.8
Real ER (PPI-based), 2000=100	105.9	100.0	99.5	99.9	101.3	102.8	104.0	104.1
PPP, MKD/EUR	21.61	22.69	23.02	23.23	23.27	23.08	22.87	22.84
Price level, EU(25)=100	36	37	38	38	38	38	37	37
Average monthly gross wages, MKD ⁷⁾	16468	17958	17886	19025	19950	20771	21330	23036
Average monthly gross wages, EUR (ER)	272	296	294	312	326	339	348	376
Average monthly gross wages, EUR (PPP)	762	791	777	819	857	900	933	1009
GDP nominal, MKD mn	209010	236389	233841	243970	251486	265257	284226	303305
Employed persons - LFS, th., average	545.2	549.8	599.3	561.3	545.1	523.0	545.3	570.4
GDP per employed person, MKD	383348	429919	390185	434620	461351	507189	521274	531736
GDP per empl. person, MKD at 2000 pr.	414910	429919	376587	405687	429253	465791	463366	458274
Unit labour costs, MKD, 2000=100	95.0	100.0	113.7	112.3	111.3	106.8	110.2	120.3
Unit labour costs, ER adj., 2000=100	95.2	100.0	113.4	111.8	110.3	105.7	109.2	119.4
Unit labour costs, PPP adj., Austria=100	33.98	35.87	40.08	38.46	37.29	36.40	36.97	39.58

7) Until 1999 wiw estimate.

(Table A/2 ctd.)

(Table A/2 ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.
Albania								
Producer prices, manufact.ind., 2000=100	93.9	100.0	92.8	97.5	99.3	111.4	116.8	117.7
Consumer price index, 2000=100	99.9	100.0	103.1	108.5	110.9	114.2	116.9	119.8
GDP deflator, 2000=100	96.0	100.0	103.4	105.6	110.2	112.5	116.4	121.5
Exchange rate (ER), ALL/EUR	146.96	132.58	128.47	132.36	137.51	127.67	124.19	123.08
ER, nominal, 2000=100	110.8	100.0	96.9	99.8	103.7	96.3	93.7	92.8
Real ER (CPI-based), 2000=100	108.8	100.0	96.0	96.0	99.5	91.6	88.9	87.9
Real ER (PPI-based), 2000=100	113.2	100.0	105.7	103.0	105.7	89.5	86.7	89.4
PPP, ALL/EUR	51.487	52.550	53.716	54.280	56.649	58.658	59.250	61.178
Price level, EU(25)=100	35	40	42	41	41	46	48	50
Average monthly gross wages, ALL ⁸⁾	12708	14963	17218	19659	21325	24393	26808	27900
Average monthly gross wages, EUR (ER)	86	113	134	149	155	191	216	227
Average monthly gross wages, EUR (PPP)	247	285	321	362	376	416	452	456
GDP nominal, ALL mn	480581	532977	590282	628527	694018	752367	822035	900000
Reg. employment total, th., average ⁹⁾	1075	1067	1066	920	923	929	932	932
GDP per employed person, ALL	447009	499675	553946	683075	751765	810111	882382	965665
GDP per empl. person, ALL at 2000 pr.	465504	499675	535689	647047	682316	720303	758297	795113
Unit labour costs, ALL, 2000=100	91.2	100.0	107.3	101.5	104.4	113.1	118.1	117.2
Unit labour costs, ER adj., 2000=100	82.2	100.0	110.8	101.6	100.6	117.4	126.0	126.2
Unit labour costs, PPP adj., Austria=100	22.32	27.28	29.79	26.59	25.88	30.76	32.46	31.81
Bosnia and Herzegovina								
Producer price index, 2000=100	.	.	.	.	.	.	.	.
Consumer price index, 2000=100	95.3	100.0	103.2	104.5	105.7	106.5	109.7	117.6
GDP deflator, 2000=100	96.0	100.0	103.6	108.6	110.5	104.7	116.1	124.2
Exchange rate (ER), BAM/EUR	1.96	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	100.0
Real ER (CPI-based), 2000=100	102.9	100.0	99.0	99.8	100.6	102.0	101.1	96.4
Real ER (PPI-based), 2000=100	.	.	.	.	.	.	.	.
PPP, BAM/EUR	0.741	0.751	0.766	0.798	0.811	0.750	0.812	0.859
Price level, EU(25)=100	38	38	39	41	41	38	41	44
Average monthly gross wages, BAM	503	539	598	660	717	748	798	869
Average monthly gross wages, EUR (ER)	257	276	306	337	367	382	408	444
Average monthly gross wages, EUR (PPP)	678	718	781	827	884	997	983	1011
GDP nominal, BAM mn	9752.0	10713.0	11599.0	12829.0	13443.0	14678.1	15790.7	17950.0
Reg. employees total, th., average	641.1	635.7	633.1	631.7	635.9	636.2	640.4	647.6
GDP per employed person, BAM	15211	16852	18321	20310	21142	23070	24657	27717
GDP per empl. person, BAM at 2000 pr.	15840	16852	17683	18698	19133	22041	21243	22309
Unit labour costs, BAM, 2000=100	99.3	100.0	105.7	110.4	117.2	106.1	117.4	121.8
Unit labour costs, ER adj., 2000=100	99.3	100.0	105.7	110.4	117.2	106.1	117.4	121.8
Unit labour costs, PPP adj., Austria=100	27.87	28.21	29.40	29.86	31.16	28.74	31.28	31.74
Montenegro								
Producer price index, 2001=100	.	.	100.0	114.5	119.7	126.6	129.3	134.0
Consumer price index, 2000=100	83.2	100.0	121.8	141.2	150.7	154.3	157.9	162.6
GDP deflator, 2000=100	.	100.0	122.0	125.5	131.0	141.4	150.7	157.6
PPP, EUR/EUR	.	0.36	0.43	0.43	0.45	0.47	0.49	0.50
Price level, EU(25)=100	.	36	43	43	45	47	49	50
Average monthly gross wages, EUR	.	151	176	251	271	303	326	377
Average monthly gross wages, EUR (PPP)	.	419	410	585	602	644	666	755
GDP nominal, EUR mn	.	1022.2	1244.8	1301.5	1392.0	1565.0	1735.0	1932.0
Reg. employment total, th., average ¹⁰⁾	145.6	140.8	141.1	140.1	142.7	143.5	144.3	150.8
GDP per employed person, EUR	.	7262	8821	9290	9756	10908	12020	12812
GDP per empl. person, EUR at 2000 pr.	.	7262	7229	7405	7446	7716	7976	8131
Unit labour costs, EUR, 2000=100	.	100.0	117.3	163.3	175.2	188.9	197.0	223.3
Unit labour costs, PPP adj., Austria=100	.	17.19	19.88	26.93	28.39	31.18	31.97	35.47

8) Excluding private sector. - 9) From 2002 according to census 2001. - 10) Excluding individual farmers.

(Table A/2 ctd.)

(Table A/2 ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.
Serbia								
Producer price index, 2000=100	49.4	100.0	187.7	204.2	213.6	233.1	266.1	301.5
Consumer price index, 2000=100	55.7	100.0	193.3	225.4	247.7	275.9	320.6	357.8
GDP deflator, 2000=100	55.3	100.0	188.0	234.8	263.0	296.4	341.2	394.3
Exchange rate (ER), RSD/EUR	11.74	15.04	59.46	60.68	65.05	72.57	82.91	84.06
ER, nominal, 2000=100	78.0	100.0	395.3	403.5	432.5	482.5	551.3	558.9
Real ER (CPI-based), 2000=100	137.5	100.0	209.0	186.7	185.7	190.0	190.8	177.2
Real ER (PPI-based), 2000=100	151.6	100.0	213.0	198.7	204.8	214.3	224.0	210.1
PPP, RSD/EUR	6.4	11.3	20.8	25.3	28.3	31.2	35.2	39.9
Price level, EU(25)=100	55	75	35	42	44	43	42	47
Average monthly gross wages, RSD ¹¹⁾	1992	3799	8691	13260	16612	20555	25514	31745
Average monthly gross wages, EUR (ER)	79	72	146	219	255	283	308	378
Average monthly gross wages, EUR (PPP)	311	336	418	524	587	659	725	796
GDP nominal, RSD mn	210232	397656	783897	1020117	1171564	1431313	1750000	2139800
Employed persons - LFS, th., average	3103	3094	3106	3000	2919	2931	2733	2631
GDP per employed person, RSD	67758	128538	252414	340014	401414	488362	640225	813398
GDP per empl. person, RSD at 2000 pr.	122622	128538	134245	144836	152601	164763	187639	206273
Unit labour costs, RSD, 2000=100	55.0	100.0	219.0	309.8	368.3	422.1	460.1	520.7
Unit labour costs, ER adj., 2000=100	114.9	100.0	193.6	268.3	297.5	305.7	291.6	325.5
Unit labour costs, PPP adj., Austria=100	16.70	14.60	27.87	37.58	40.97	42.86	40.21	43.92
Russia								
Producer price index, 2000=100	68.2	100.0	119.1	133.0	153.8	190.7	230.2	258.7
Consumer price index, 2000=100	82.8	100.0	121.6	141.1	160.2	177.9	200.1	219.7
GDP deflator, 2000=100	72.6	100.0	116.5	134.7	153.5	184.4	219.8	255.1
Exchange rate (ER), RUB/EUR	26.239	26.029	26.130	29.647	34.686	35.814	35.218	34.079
ER, nominal, 2000=100	100.8	100.0	100.4	113.9	133.3	137.6	135.3	130.9
Real ER (CPI-based), 2000=100	119.5	100.0	84.4	84.2	88.4	84.0	75.0	67.6
Real ER (PPI-based), 2000=100	141.7	100.0	85.3	86.1	87.6	74.7	63.6	57.3
PPP, RUB/EUR	6.035	8.343	9.518	10.740	12.200	14.320	16.720	19.030
Price level, EU(25)=100	23	32	36	36	35	40	47	56
Average monthly gross wages, RUB	1523	2223	3240	4360	5499	6740	8555	10736
Average monthly gross wages, EUR (ER)	58	85	124	147	159	188	243	315
Average monthly gross wages, EUR (PPP)	252	266	340	406	451	471	512	564
GDP nominal, RUB mn	4823234	7305646	8943582	10830535	13243240	17048100	21620100	26781100
Employed persons - LFS, th., average	62945	65070	65123	66659	66432	67275	68169	68799
GDP per employed person, RUB	76626	112273	137334	162477	199350	253410	317154	389266
GDP per empl. person, RUB at 2000 pr.	105513	112273	117901	120598	129841	137444	144324	152583
Unit labour costs, RUB, 2000=100	72.9	100.0	138.8	182.6	213.8	247.6	299.3	355.3
Unit labour costs, ER adj., 2000=100	72.3	100.0	138.2	160.3	160.5	180.0	221.2	271.4
Unit labour costs, PPP adj., Austria=100	10.49	14.59	19.88	22.42	22.07	25.20	30.47	36.57
Ukraine								
Producer price index, 2000=100	82.8	100.0	108.7	112.0	120.5	145.2	169.4	185.5
Consumer price index, 2000=100	78.0	100.0	112.0	112.9	118.8	129.5	147.0	160.4
GDP deflator, 2000=100	81.2	100.0	109.9	115.6	124.9	143.8	172.5	203.9
Exchange rate (ER), UAH/EUR	4.393	5.029	4.814	5.030	6.024	6.609	6.389	6.335
ER, nominal, 2000=100	87.4	100.0	95.7	100.0	119.8	131.4	127.0	126.0
Real ER (CPI-based), 2000=100	109.9	100.0	87.3	92.4	107.3	110.2	95.9	89.1
Real ER (PPI-based), 2000=100	101.2	100.0	89.1	89.8	100.6	93.7	81.1	77.0
PPP, UAH/EUR	0.7680	0.9170	0.9874	1.0127	1.0907	1.2277	1.4429	1.6720
Price level, EU(25)=100	17	18	21	20	18	19	23	26
Average monthly gross wages, UAH	178	230	311	376	462	590	806	1041
Average monthly gross wages, EUR (ER)	40	46	65	75	77	89	126	164
Average monthly gross wages, EUR (PPP)	231	251	315	372	424	480	559	623
GDP nominal, UAH mn	130442	170070	204190	225810	267344	345113	424741	537667
Employed persons - LFS, th., average	20048.2	20175.0	19971.5	20091.2	20163.3	20295.7	20680.0	20730.4
GDP per employed person, UAH	6506	8430	10224	11239	13259	17004	20539	25936
GDP per empl. person, UAH at 2000 pr.	8010	8430	9299	9725	10620	11827	11905	12719
Unit labour costs, UAH, 2000=100	81.2	100.0	122.5	141.8	159.4	182.6	248.0	299.9
Unit labour costs, ER adj., 2000=100	92.9	100.0	128.0	141.7	133.1	138.9	195.2	238.1
Unit labour costs, PPP adj., Austria=100	10.58	11.44	14.44	15.55	14.35	15.26	21.09	25.16

11) Until 2000 wiiw estimate.

(Table A/2 ctd.)

(Table A/2 ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.
Austria								
Producer price index, 2000=100	96.2	100.0	101.5	101.1	102.7	107.7	110.0	113.2
Consumer price index, 2000=100	97.7	100.0	102.7	104.5	106.0	108.2	110.7	112.4
GDP deflator, 2000=100	98.3	100.0	101.8	103.2	104.6	106.4	108.4	110.1
Exchange rate (ER), EUR-ATS/EUR	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000
PPP, EUR-ATS/EUR	1.0644	1.0394	1.0540	1.0560	1.0375	1.0294	1.0319	1.0281
Price level, EU(25)=100	106	104	105	106	104	103	103	103
Average monthly gross wages, EUR (ER)	2334	2390	2428	2483	2532	2580	2622	2690
Average monthly gross wages, EUR (PPP)	2193	2299	2303	2351	2440	2507	2541	2616
GDP nominal, EUR-ATS mn	200025	210392	215878	220841	226243	235819	245103	256667
Employed persons - LFS, th., average ¹²⁾	3669.2	3685.7	3711.2	3762.1	3793.5	3744.0	3824.4	3928.3
GDP per employed person, EUR-ATS	54515	57083	58169	58701	59640	62986	64089	65338
GDP per empl. person, EUR-ATS at 2000 pr.	55478	57083	57162	56872	57016	59180	59120	59351
Unit labour costs, EUR, 2000=100	100.5	100.0	101.4	104.3	106.1	104.1	105.9	108.2
Unit labour costs, ER adj., 2000=100	100.5	100.0	101.4	104.3	106.1	104.1	105.9	108.2
Unit labour costs, PPP adjusted	0.52	0.52	0.53	0.54	0.55	0.54	0.55	0.57

12) From 2004 new methodology.

ER = Exchange Rate, PPP = Purchasing Power Parity, Price level: PPP / ER.

EUR-ATS: ATS divided by fixed parity before 1999 (1€ = 13.7603 ATS). EUR-SIT: SIT divided by fixed parity (1 € = 239.64 SIT).

For the 10 new EU member states, Croatia and Macedonia PPPs are taken from Eurostat. For the rest of the countries PPPs have been estimated by wiiw using the OECD benchmark PPPs for 2002 and extrapolated with GDP price deflators. PPPs for Albania, Bosnia and Herzegovina, Montenegro and Serbia are estimated by wiiw.

Sources: National statistics; WIFO; Eurostat; Purchasing power parities and real expenditures, 2002 benchmark year, OECD 2005; wiiw estimates.

Table A3

Indicators of macro-competitiveness, 1999-2006

annual changes in %

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.	2000-06 average
Czech Republic									
GDP deflator	2.8	1.5	4.9	2.8	0.9	4.5	-0.2	1.1	2.2
Exchange rate (ER), CZK/EUR	2.0	-3.4	-4.3	-9.6	3.3	0.2	-6.6	-4.8	-3.7
Real ER (CPI-based)	1.1	-5.3	-6.6	-9.4	5.3	-0.5	-6.4	-5.1	-4.1
Real ER (PPI-based)	0.4	-4.0	-5.8	-9.7	4.4	-3.0	-5.3	-1.8	-3.7
Average gross wages, CZK	8.4	6.4	8.7	7.3	6.6	6.6	5.3	6.4	6.7
Average gross wages, real (PPI based)	7.4	1.4	5.7	7.8	7.0	0.9	2.2	4.7	4.2
Average gross wages, real (CPI based)	6.2	2.4	3.8	5.4	6.5	3.7	3.3	3.8	4.1
Average gross wages, EUR (ER)	6.3	10.2	13.5	18.6	3.2	6.4	12.8	11.8	10.8
Employed persons (LFS) ¹⁾	-2.1	-0.7	0.4	0.8	-0.7	-0.6	1.2	1.3	0.3
GDP per empl. person, CZK at 2000 pr.	3.5	4.4	2.1	1.1	4.3	5.2	5.2	5.0	3.9
Unit labour costs, CZK at 2000 prices	4.8	1.9	6.5	6.1	2.2	1.4	0.1	1.4	2.8
Unit labour costs, ER (EUR) adjusted	2.7	5.6	11.2	17.4	-1.1	1.2	7.2	6.5	6.7
Hungary									
GDP deflator	8.4	9.7	8.4	7.8	5.8	4.4	2.3	3.7	6.0
Exchange rate (ER), HUF/EUR	4.9	2.9	-1.3	-5.3	4.3	-0.7	-1.4	6.5	0.6
Real ER (CPI-based)	-3.5	-4.5	-7.6	-8.2	1.6	-5.1	-2.8	4.8	-3.2
Real ER (PPI-based)	-0.8	-3.9	-5.1	-4.2	2.5	-1.9	-1.3	4.8	-1.3
Average gross wages, HUF	13.9	13.5	18.2	18.3	12.0	6.1	8.8	8.1	12.1
Average gross wages, real (PPI based)	8.4	1.7	12.3	20.4	9.4	2.5	4.3	1.5	7.3
Average gross wages, real (CPI based)	3.5	3.4	8.2	12.3	7.0	-0.7	5.0	4.1	5.6
Average gross wages, EUR (ER)	8.6	10.4	19.7	25.0	7.3	6.8	10.4	1.5	11.3
Employed persons (LFS) ²⁾	0.6	1.2	0.3	0.1	1.3	-0.5	0.0	0.7	0.4
GDP per empl. person, HUF at 2000 pr.	3.6	3.9	3.8	4.3	2.8	5.4	4.1	3.1	3.9
Unit labour costs, HUF at 2000 prices	10.0	9.3	13.9	13.4	8.9	0.7	4.6	4.8	7.8
Unit labour costs, ER (EUR) adjusted	4.9	6.2	15.3	19.8	4.4	1.4	6.1	-1.6	7.1
Poland									
GDP deflator	6.0	7.2	3.5	2.3	0.4	4.1	2.7	1.4	3.1
Exchange rate (ER), PLN/EUR	7.7	-5.1	-8.5	5.1	14.1	3.1	-11.2	-3.2	-1.2
Real ER (CPI-based)	1.6	-12.2	-11.4	5.3	15.4	1.7	-11.2	-2.1	-2.5
Real ER (PPI-based)	1.3	-8.2	-8.9	3.5	11.8	-1.4	-7.9	-0.9	-2.0
Average gross wages, PLN ³⁾	10.6	11.6	8.0	2.6	4.2	4.0	3.8	4.9	5.6
Average gross wages, real (PPI based)	30.3	3.5	6.3	1.6	1.5	-2.8	3.1	2.6	2.2
Average gross wages, real (CPI based)	28.3	1.3	2.4	0.7	3.3	0.5	1.7	3.9	2.0
Average gross wages, EUR (ER)	27.8	17.6	18.1	-2.4	-8.7	0.9	17.0	8.5	6.8
Employed persons (LFS) ⁴⁾	-3.9	-1.6	-2.2	-3.0	0.6	1.3	2.3	3.4	0.1
GDP per empl. person, PLN at 2000 pr.	8.7	6.0	3.5	4.5	3.3	3.9	1.3	2.6	3.6
Unit labour costs, PLN at 2000 prices	1.7	5.3	4.4	-1.9	0.8	0.1	2.6	2.3	1.9
Unit labour costs, ER (EUR) adjusted	-5.6	11.0	14.1	-6.6	-11.6	-2.9	15.5	5.7	3.1
Slovak Republic									
GDP deflator	7.5	9.7	5.0	4.6	4.7	6.0	2.4	2.7	5.0
Exchange rate (ER), SKK/EUR	11.4	-3.5	1.7	-1.4	-2.8	-3.5	-3.6	-3.5	-2.4
Real ER (CPI-based)	1.9	-12.2	-3.0	-2.6	-8.7	-8.3	-4.1	-5.6	-6.4
Real ER (PPI-based)	6.2	-9.1	-3.4	-4.0	-9.8	-4.5	-3.8	-6.7	-5.9
Average gross wages, SKK	7.2	6.5	8.2	9.3	6.3	10.2	9.2	8.6	8.3
Average gross wages, real (PPI based)	2.8	-3.8	1.6	7.0	-1.8	6.5	4.3	0.2	1.9
Average gross wages, real (CPI based)	-3.0	-4.9	1.0	5.8	-2.0	2.5	6.3	3.9	1.7
Average gross wages, EUR (ER)	-3.7	10.4	6.4	10.8	9.4	14.1	13.3	12.5	11.0
Employed persons (LFS)	-3.0	-1.4	1.0	0.2	1.8	0.3	2.1	3.8	1.1
GDP per empl. person, SKK at 2000 pr.	3.4	2.2	2.2	4.0	2.3	5.1	3.8	4.3	3.4
Unit labour costs, SKK at 2000 prices	3.7	4.3	5.9	5.1	3.9	4.8	5.1	4.1	4.7
Unit labour costs, ER (EUR) adjusted	-6.9	8.0	4.1	6.6	6.9	8.6	9.1	7.9	7.3
Slovenia									
GDP deflator	6.4	5.4	8.7	7.9	5.7	3.3	1.5	2.3	4.9
Exchange rate (ER), EUR-SIT/EUR	4.0	5.9	5.9	4.2	3.3	2.2	0.3	0.0	3.1
Real ER (CPI-based)	-0.9	-0.9	-0.1	-1.1	-0.3	0.8	0.0	-0.3	-0.3
Real ER (PPI-based)	1.2	2.6	-1.6	-1.5	1.4	0.3	2.1	2.4	0.8
Average gross wages, EUR-SIT	9.6	10.6	11.9	9.7	7.5	5.7	3.6	4.8	7.7
Average gross wages, real (PPI based)	7.3	2.8	2.8	4.4	4.9	1.3	0.9	2.5	2.8
Average gross wages, real (CPI based)	3.3	1.6	3.3	2.1	1.8	2.0	1.1	2.3	2.0
Average gross wages, EUR (ER)	5.4	4.5	5.7	5.3	4.1	3.4	3.3	4.8	4.4
Employed persons (LFS)	-1.7	1.7	1.7	-0.7	-1.4	5.1	0.6	1.3	1.2
GDP per empl. person, EUR-SIT at 2000 pr.	7.2	2.4	1.0	4.1	4.1	-0.7	3.4	3.9	2.6
Unit labour costs, EUR-SIT at 2000 prices	2.2	8.1	10.9	5.4	3.3	6.4	0.2	0.9	5.0
Unit labour costs, ER (EUR) adjusted	-1.7	2.1	4.7	1.2	0.0	4.1	-0.1	0.9	1.8

1) From 2002 according to census 2001. - 2) From 1999 according to census 2001. - 3) From 1999 broader wage coverage. - 4) From 2003 according to census 2002.

(Table A/3 ctd.)

Table A3 (ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.	2000-06 average
Bulgaria									
GDP deflator	3.7	6.7	6.7	4.4	1.8	5.2	3.9	8.0	5.2
Exchange rate (ER), BGN/EUR	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real ER (CPI-based)	-2.2	-7.6	-4.8	-3.5	-0.3	-3.8	-2.7	-4.7	-4.0
Real ER (PPI-based)	-4.1	-11.3	-2.5	-1.7	-4.1	-3.5	-2.2	-4.2	-4.3
Average gross wages, BGN	9.7	11.7	6.9	7.3	6.1	7.0	10.7	9.5	8.4
Average gross wages, real (PPI based)	6.7	-5.0	3.0	6.1	1.1	0.9	3.6	0.1	1.4
Average gross wages, real (CPI based)	6.9	1.2	-0.4	1.4	3.7	0.8	5.4	2.1	2.0
Average gross wages, EUR (ER)	10.6	11.7	6.9	7.3	6.1	7.0	10.7	9.5	8.4
Employed persons (LFS)	-5.3	-2.8	-3.4	1.5	3.5	3.1	2.0	4.4	1.1
GDP per empl. person, BGN at 2000 pr.	8.0	8.4	7.8	2.9	1.5	3.4	4.1	1.8	4.2
Unit labour costs, BGN at 2000 prices	1.6	3.0	-0.8	4.3	4.6	3.5	6.4	7.7	4.0
Unit labour costs, ER (EUR) adjusted	2.4	3.0	-0.8	4.3	4.6	3.5	6.4	7.7	4.0
Romania									
GDP deflator	47.8	44.2	37.4	23.4	24.0	15.0	12.3	10.4	23.3
Exchange rate (ER), ROL/EUR	63.1	22.5	30.4	20.1	20.2	7.9	-10.6	-2.7	11.7
Real ER (CPI-based)	13.2	-14.3	-0.9	0.0	6.2	-1.4	-16.2	-6.7	-5.1
Real ER (PPI-based)	12.2	-16.8	-4.5	-2.9	1.1	-7.3	-15.5	-8.7	-8.0
Average gross wages, ROL	45.7	47.8	48.6	26.1	24.8	23.3	18.3	18.8	29.1
Average gross wages, real (PPI based)	0.9	-3.7	7.6	2.5	4.4	3.5	7.0	6.5	3.9
Average gross wages, real (CPI based)	0.0	1.5	10.5	2.9	8.2	10.2	8.5	11.4	7.5
Average gross wages, EUR (ER)	-10.7	20.7	13.9	5.0	3.8	14.2	32.3	22.1	15.6
Employed persons (LFS) ⁵⁾	-0.6	-0.3	-0.6	.	-0.1	-0.7	-0.1	1.8	0.0
GDP per empl. person, ROL at 2000 pr. ⁵⁾	0.1	2.4	6.4	.	5.3	9.3	4.2	5.8	5.5
Unit labour costs, ROL at 2000 prices ⁵⁾	45.6	44.4	39.7	.	18.4	12.8	13.5	12.3	22.8
Unit labour costs, ER (EUR) adjusted ⁵⁾	-10.7	17.9	7.1	.	-1.4	4.5	27.0	15.5	11.4
Estonia									
GDP deflator	4.5	5.4	5.3	3.8	2.3	2.1	6.8	6.1	4.5
Exchange rate (ER), EEK/EUR	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real ER (CPI-based)	-2.9	-2.0	-3.4	-1.5	0.6	-0.8	-1.9	-2.1	-1.6
Real ER (PPI-based)	-0.3	-0.6	-3.1	-1.0	0.4	-0.6	2.4	0.5	-0.3
Average gross wages, EEK ⁶⁾	10.4	10.5	12.3	11.5	9.4	8.4	10.8	16.4	11.3
Average gross wages, real (PPI based)	11.8	5.4	7.6	11.1	9.2	5.3	8.5	11.6	8.4
Average gross wages, real (CPI based)	6.9	6.3	6.1	7.6	8.0	5.2	6.4	11.5	7.3
Average gross wages, EUR (ER)	11.4	10.5	12.3	11.5	9.4	8.4	10.8	16.4	11.3
Employed persons (LFS)	-4.5	-1.2	0.9	1.4	1.5	0.2	2.0	6.4	1.6
GDP per empl. person, EEK at 2000 pr.	5.0	9.1	9.6	6.6	5.5	7.9	8.3	4.7	7.4
Unit labour costs, EEK at 2000 prices	5.1	1.3	2.4	4.6	3.7	0.5	2.3	11.2	3.7
Unit labour costs, ER (EUR) adjusted	6.0	1.3	2.4	4.6	3.7	0.5	2.3	11.2	3.7
Latvia									
GDP deflator	4.4	2.8	1.7	3.6	3.6	7.0	10.2	11.1	5.6
Exchange rate (ER), LVL/EUR	-5.7	-10.2	0.5	3.5	10.7	4.1	4.7	0.0	1.7
Real ER (CPI-based)	-6.8	-10.8	0.2	3.7	9.7	0.1	0.3	-4.3	-0.3
Real ER (PPI-based)	-2.4	-6.9	-0.1	1.9	7.9	-2.0	1.5	-5.0	-0.5
Average gross wages, LVL	5.8	6.1	6.3	8.8	11.3	9.6	16.5	23.0	11.5
Average gross wages, real (PPI based)	10.2	5.4	4.6	7.7	7.8	0.9	8.1	11.6	6.5
Average gross wages, real (CPI based)	3.3	3.4	3.7	6.8	8.1	3.2	9.2	15.2	7.0
Average gross wages, EUR (ER)	12.2	18.1	5.8	5.1	0.5	5.3	11.2	23.0	9.6
Employed persons (LFS)	-1.8	-2.8	2.2	2.8	1.8	1.1	1.8	4.9	1.7
GDP per empl. person, LVL at 2000 pr.	6.6	10.0	5.7	3.6	5.3	7.5	8.7	6.7	6.8
Unit labour costs, LVL at 2000 prices	-0.8	-3.6	0.6	5.0	5.7	1.9	7.2	15.3	4.5
Unit labour costs, ER (EUR) adjusted	5.2	7.4	0.1	1.5	-4.5	-2.1	2.4	15.3	2.7
Lithuania									
GDP deflator	-0.6	0.7	-0.6	0.2	-1.1	3.0	5.9	7.1	2.1
Exchange rate (ER), LTL/EUR	-4.9	-13.4	-3.1	-3.5	-0.2	0.0	0.0	0.0	-3.0
Real ER (CPI-based)	-4.6	-12.6	-2.2	-1.8	3.0	0.9	-0.5	-1.5	-2.2
Real ER (PPI-based)	-7.1	-22.1	1.1	-1.3	0.9	-3.5	-6.3	-2.4	-5.1
Average gross wages, LTL	6.2	-1.7	1.2	3.2	5.8	7.2	12.2	16.3	6.2
Average gross wages, real (PPI based)	4.4	-15.2	4.3	6.2	6.3	1.1	0.6	8.3	1.4
Average gross wages, real (CPI based)	5.4	-2.7	-0.1	2.9	7.1	5.9	9.2	12.1	4.8
Average gross wages, EUR (ER)	11.7	13.5	4.4	6.9	6.0	7.2	12.2	16.3	9.4
Employed persons (LFS)	-8.8	-4.0	-3.3	4.0	2.3	-0.1	2.6	1.7	0.4
GDP per empl. person, LTL at 2000 pr.	7.8	8.3	10.7	2.6	8.0	7.1	4.7	5.7	6.7
Unit labour costs, LTL at 2000 prices	-1.5	-9.2	-8.6	0.6	-2.1	0.0	7.1	10.0	-0.5
Unit labour costs, ER (EUR) adjusted	3.6	4.8	-5.7	4.2	-1.9	0.0	7.1	10.0	2.5

5) In 2002 no comparable growth rates available due to methodological break in employment. Average 2000-2006 is calculated without 2002.

- 6) From 1999 excluding compensations from Health Insurance Fund.

(Table A/3 ctd.)

Table A3 (ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.	2000-06 average
Croatia									
GDP deflator	3.8	4.7	4.0	3.6	4.0	3.9	3.2	3.4	3.8
Exchange rate (ER), HRK/EUR	6.2	0.7	-2.2	-0.8	2.1	-0.9	-1.3	-1.0	-0.5
Real ER (CPI-based)	3.1	-3.3	-4.7	-0.5	2.3	-0.9	-2.4	-2.0	-1.7
Real ER (PPI-based)	2.9	-4.2	-4.5	-1.0	0.8	-2.0	0.2	0.8	-1.5
Average gross wages, HRK	10.2	7.0	3.9	6.0	4.8	6.4	4.4	6.2	5.5
Average gross wages, real (PPI based)	7.4	-2.5	0.3	6.5	2.8	2.8	1.4	3.2	2.0
Average gross wages, real (CPI based)	5.7	0.7	-0.9	4.3	2.9	4.3	1.0	2.9	2.2
Average gross wages, EUR (ER)	3.7	6.2	6.3	6.9	2.6	7.4	5.7	7.3	6.1
Employed persons (LFS)	-3.4	4.1	-5.4	4.0	0.6	1.7	0.7	0.8	0.9
GDP per empl. person, HRK at 2000 pr.	2.6	-1.1	10.4	1.5	4.7	2.6	3.6	3.9	3.6
Unit labour costs, HRK at 2000 prices	7.4	8.2	-5.8	4.4	0.1	3.8	0.8	2.2	1.9
Unit labour costs, ER (EUR) adjusted	1.1	7.4	-3.7	5.3	-2.0	4.7	2.1	3.2	2.4
Macedonia									
GDP deflator	2.8	8.2	3.6	3.4	0.3	1.3	3.3	3.1	3.3
Exchange rate (ER), MKD/EUR	-0.7	0.2	0.3	0.1	0.5	0.1	-0.1	-0.2	0.1
Real ER (CPI-based)	1.1	-3.5	-2.8	0.4	1.2	2.7	1.6	-1.1	-0.3
Real ER (PPI-based)	-1.2	-5.6	-0.5	0.4	1.3	1.5	1.2	0.1	-0.2
Average gross wages, MKD	2.9	9.0	-0.4	6.4	4.9	4.1	2.7	8.0	4.9
Average gross wages, real (PPI based)	3.0	-1.5	-2.4	7.3	5.2	3.2	-0.5	3.3	2.0
Average gross wages, real (CPI based)	3.6	3.1	-5.6	4.5	3.6	4.5	2.2	4.6	2.4
Average gross wages, EUR (ER)	3.6	8.8	-0.7	6.3	4.4	4.0	2.8	8.2	4.8
Employed persons (LFS)	1.0	0.8	9.0	-6.3	-2.9	-4.1	4.3	4.6	0.6
GDP per empl. person, MKD at 2000 pr.	3.3	3.6	-12.4	7.7	5.8	8.5	-0.5	-1.1	1.4
Unit labour costs, MKD at 2000 prices	-0.4	5.2	13.7	-1.3	-0.9	-4.1	3.2	9.2	3.4
Unit labour costs, ER (EUR) adjusted	0.4	5.0	13.4	-1.4	-1.4	-4.2	3.3	9.4	3.3
Albania									
GDP deflator	1.8	4.1	3.4	2.1	4.4	2.1	3.5	4.4	3.4
Exchange rate (ER), ALL/EUR	-12.9	-9.8	-3.1	3.0	3.9	-7.2	-2.7	-0.9	-2.5
Real ER (CPI-based)	-12.2	-8.1	-4.0	0.0	3.6	-7.9	-2.9	-1.1	-3.0
Real ER (PPI-based)	-15.8	-11.7	5.7	-2.5	2.6	-15.3	-3.1	3.1	-3.3
Average gross wages, ALL	10.4	17.7	15.1	14.2	8.5	14.4	9.9	4.1	11.9
Average gross wages, real (PPI based)	7.5	10.5	24.0	8.6	6.5	2.0	4.8	3.3	8.3
Average gross wages, real (CPI based)	10.0	17.7	11.6	8.5	6.1	11.1	7.3	1.6	9.0
Average gross wages, EUR (ER)	26.8	30.5	18.8	10.8	4.4	23.2	13.0	5.0	14.8
Registered employment, total ⁷⁾	-1.9	-0.8	-0.1	-0.1	0.3	0.6	0.3	0.0	0.0
GDP per empl. person, ALL at 2000 pr.	15.4	7.3	7.2	4.4	5.5	5.6	5.3	4.9	5.7
Unit labour costs, ALL at 2000 prices	-4.4	9.7	7.3	9.4	2.9	8.4	4.4	-0.7	5.8
Unit labour costs, ER (EUR) adjusted	9.8	21.6	10.8	6.2	-1.0	16.7	7.3	0.1	8.6
Bosnia and Herzegovina									
GDP deflator	8.1	4.1	3.6	4.8	1.7	-5.3	10.9	7.0	3.7
Exchange rate (ER), BAM/EUR	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real ER (CPI-based)	-5.0	-2.9	-1.0	0.8	0.8	1.3	-0.8	-4.7	-0.9
Real ER (PPI-based)	.	.	.	.	.	.	.	.	.
Average gross wages, BAM	10.8	7.2	10.9	10.4	8.6	4.3	6.7	8.9	8.1
Average gross wages, real (PPI based)	.	.	.	.	.	.	.	.	.
Average gross wages, real (CPI based)	4.9	2.2	7.5	9.0	7.5	3.5	3.6	1.6	4.9
Average gross wages, EUR (ER)	10.8	7.2	10.9	10.4	8.6	4.3	6.7	8.9	8.1
Registered employees, total	.	-0.8	-0.4	-0.2	0.7	0.1	0.7	1.1	0.1
GDP per empl. person, BAM at 2000 pr.	.	6.4	4.9	5.7	2.3	15.2	-3.6	5.0	5.0
Unit labour costs, BAM at 2000 prices	.	0.7	5.7	4.4	6.2	-9.4	10.7	3.7	3.0
Unit labour costs, ER (EUR) adjusted	.	0.7	5.7	4.4	6.2	-9.4	10.7	3.7	3.0
Montenegro									
GDP deflator	.	.	22.0	2.8	4.4	7.9	6.6	4.6	7.9
Average gross wages, EUR	.	.	16.8	42.6	7.8	11.7	7.8	15.6	16.5
Average gross wages, real (PPI based)	.	.	.	24.5	3.2	5.6	5.6	11.6	.
Average gross wages, real (CPI based)	.	.	-4.1	23.0	1.1	9.1	5.4	12.2	7.4
Registered employment, total	.	-3.3	0.2	-0.7	1.8	0.6	0.6	4.5	1.2
GDP per empl. person, EUR	.	.	21.5	5.3	5.0	11.8	10.2	6.6	9.9
GDP per empl. person, EUR at 2000 pr.	.	.	-0.4	2.4	0.6	3.6	3.4	1.9	1.9
Unit labour costs, ER (EUR) adjusted	.	.	17.3	39.3	7.2	7.8	4.3	13.4	14.3

7) From 2002 according to census 2001.

(Table A/3 ctd.)

Table A3 (ctd.)

	1999	2000	2001	2002	2003	2004	2005	2006 prelim.	2000-06 average
Serbia									
GDP deflator	.	81.0	88.0	24.9	12.1	12.7	15.1	15.6	32.4
Exchange rate (ER), RSD/EUR	.	28.2	295.3	2.1	7.2	11.6	14.2	1.4	32.5
Real ER (CPI-based)	.	-27.3	109.0	-10.7	-0.5	2.3	0.5	-7.2	3.7
Real ER (PPI-based)	.	-34.0	113.0	-6.7	3.1	4.6	4.5	-6.2	4.8
Average gross wages, RSD	.	90.7	128.8	52.6	25.3	23.7	24.1	24.4	48.5
Average gross wages, real (PPI based)	.	-5.9	21.9	40.2	19.8	13.4	8.7	9.8	14.7
Average gross wages, real (CPI based)	.	6.2	18.4	30.9	14.0	11.1	6.8	11.5	13.9
Average gross wages, EUR (ER)	.	-8.8	102.2	49.5	16.9	10.9	8.6	22.7	25.0
Employed persons (LFS)	.	-0.3	0.4	-3.4	-2.7	0.4	-6.7	-3.8	-2.3
GDP per empl. person, RSD at 2000 pr.	.	4.8	4.4	7.9	5.4	8.0	13.9	9.9	7.7
Unit labour costs, RSD at 2000 prices	.	81.9	119.0	41.4	18.9	14.6	9.0	13.2	37.9
Unit labour costs, ER (EUR) adjusted	.	-13.0	93.6	38.6	10.9	2.7	-4.6	11.6	16.0
Russia									
GDP deflator	72.4	37.7	16.5	15.7	14.0	20.1	19.2	16.1	19.7
Exchange rate (ER), RUB/EUR	137.2	-0.8	0.4	13.5	17.0	3.3	-1.7	-3.2	3.8
Real ER (CPI-based)	29.2	-16.3	-15.6	-0.2	5.0	-5.0	-10.7	-9.9	-7.8
Real ER (PPI-based)	48.3	-29.4	-14.7	0.9	1.8	-14.8	-14.9	-9.8	-12.1
Average gross wages, RUB	44.8	46.0	45.7	34.6	26.1	22.6	26.9	25.5	32.2
Average gross wages, real (PPI based)	-8.9	-0.4	22.4	20.4	9.1	-1.2	5.2	11.7	9.3
Average gross wages, real (CPI based)	-22.0	20.9	19.9	16.0	11.0	10.4	12.8	14.3	15.0
Average gross wages, EUR (ER)	-38.9	47.2	45.2	18.6	7.8	18.7	29.1	29.7	27.3
Employed persons (LFS)	7.7	3.4	0.1	2.4	-0.3	1.3	1.3	0.9	1.3
GDP per empl. person, RUB at 2000 pr.	-1.2	6.4	5.0	2.3	7.7	5.9	5.0	5.7	5.4
Unit labour costs, RUB at 2000 prices	46.5	37.2	38.8	31.6	17.1	15.8	20.9	18.7	25.4
Unit labour costs, ER (EUR) adjusted	-38.2	38.3	38.2	15.9	0.1	12.1	22.9	22.7	20.8
Ukraine									
GDP deflator	27.4	23.1	9.9	5.1	8.0	15.2	20.0	18.2	14.1
Exchange rate (ER), UAH/EUR	58.7	14.5	-4.3	4.5	19.8	9.7	-3.3	-0.8	5.4
Real ER (CPI-based)	30.9	-9.0	-12.7	5.8	16.1	2.8	-13.0	-7.1	-3.0
Real ER (PPI-based)	20.3	-1.2	-10.9	0.9	11.9	-6.9	-13.4	-5.1	-3.8
Average gross wages, UAH	16.0	29.6	35.2	21.0	22.8	27.6	36.7	29.2	28.8
Average gross wages, real (PPI based)	-11.5	7.3	24.4	17.5	14.1	5.9	17.2	18.0	14.7
Average gross wages, real (CPI based)	-5.4	1.1	20.7	20.0	16.7	17.0	20.5	18.4	16.2
Average gross wages, EUR (ER)	-26.9	13.3	41.2	15.8	2.5	16.3	41.4	30.3	22.2
Employed persons (LFS)	-12.8	0.6	-1.0	0.6	0.4	0.7	1.9	0.2	0.5
GDP per empl. person, UAH at 2000 pr.	14.5	5.2	10.3	4.6	9.2	11.4	0.7	6.8	6.8
Unit labour costs, UAH at 2000 prices	1.3	23.2	22.5	15.7	12.5	14.5	35.8	20.9	20.5
Unit labour costs, ER (EUR) adjusted	-36.2	7.6	28.0	10.7	-6.1	4.4	40.5	21.9	14.4
Austria									
GDP deflator	0.6	1.8	1.8	1.4	1.3	1.7	1.9	1.6	1.6
Exchange rate (ER), EUR-ATS/EUR	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Average gross wages, EUR-ATS	2.3	2.4	1.6	2.3	2.0	1.9	1.6	2.6	2.0
Average gross wages, real (PPI based)	3.1	-1.5	0.1	2.7	0.4	-2.8	-0.5	-0.3	-0.3
Average gross wages, real (CPI based)	1.7	0.0	-1.1	0.5	0.6	-0.2	-0.7	1.1	0.0
Average gross wages, EUR (ER)	3.2	2.4	1.6	2.3	2.0	1.9	1.6	2.6	2.0
Employed persons (LFS) ⁸⁾	1.2	0.4	0.7	1.4	0.8	0.0	2.1	2.7	1.2
GDP per empl. person, EUR-ATS at 2000 pr.	2.1	2.9	0.1	-0.5	0.3	2.4	-0.1	0.4	0.8
Unit labour costs, EUR-ATS at 2000 prices	0.2	-0.5	1.4	2.8	1.7	-0.5	1.7	2.2	1.3
Unit labour costs, ER (EUR) adjusted	1.1	-0.5	1.4	2.8	1.7	-0.5	1.7	2.2	1.3

8) From 2004 new methodology.

Note: In terms of real exchange rates a minus sign means real appreciation.

ER = Exchange Rate, PPI = Producer price index, CPI = Consumer price index.

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