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High Growth Continues, with Risks of Overheating on the Horizon

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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%.

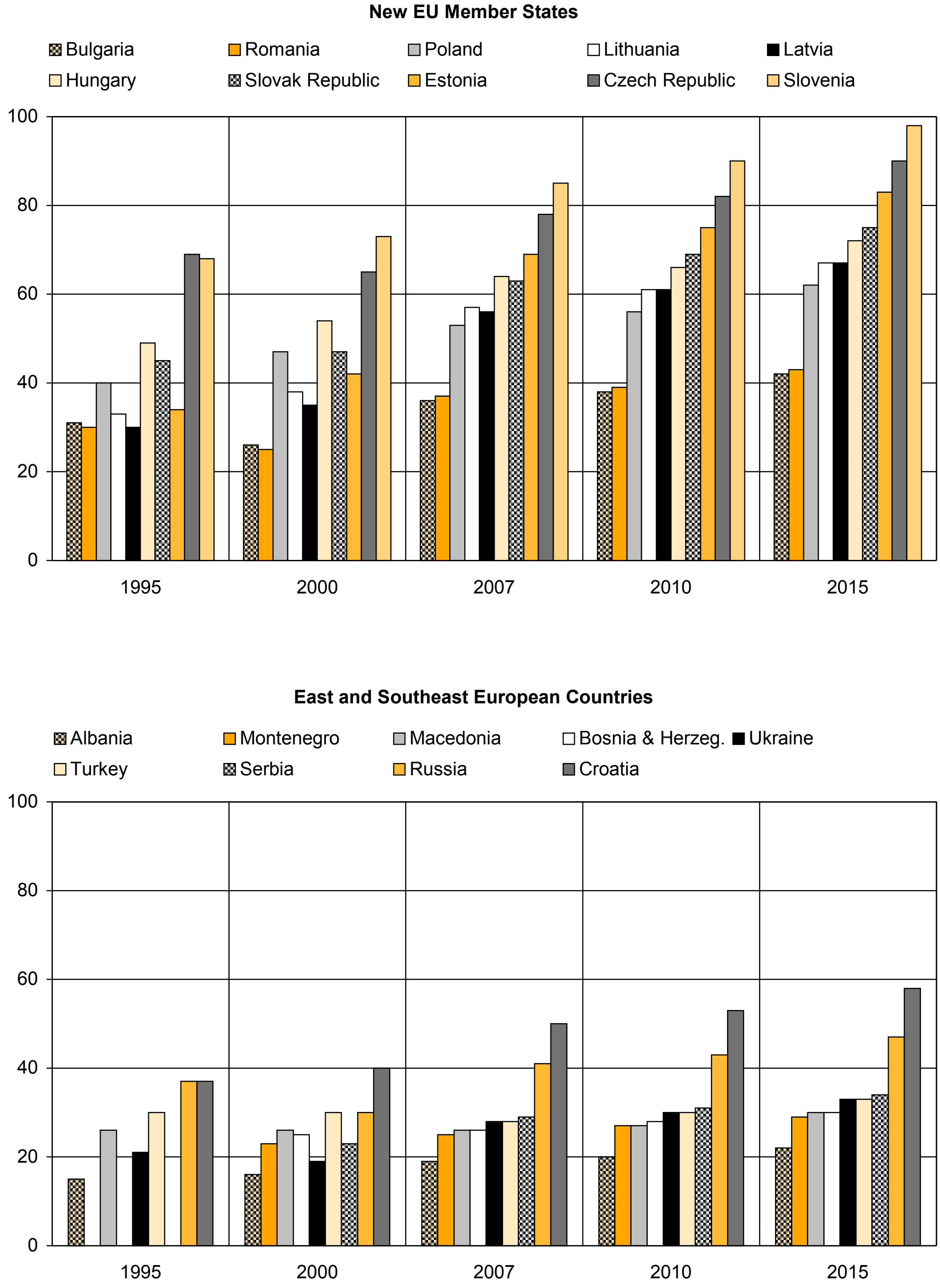
Keywords: *Central and East European new EU member states, Southeast Europe, Balkans, former Soviet Union, China, Turkey, GDP, industry, productivity, labour market, foreign trade, exchange rates, inflation, fiscal deficits, EU integration*

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

Figure I

Real per capita GDP in transition countries, at PPP

European Union (25) average = 100



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

Source: National statistics, Eurostat, wiiw estimates.

Table I

Overview developments 2005-2006 and outlook 2007-2008

	GDP real change in % against previous year				Consumer prices change in % against previous year				Unemployment, based on LFS [1] rate in %, annual average				Current account 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
Austria	*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
memo:			
D EU-15 imports from the world	*-0.6*		*11.0*
C NMS-8 imports from the world	*6.9*		*17.6*
C - D (in percentage points)	*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 cooperation 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.

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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

real change in % against preceding year

	2002	2003	2004	2005	2006 1)	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast	Index 1995=100 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 1st quarter	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: wiiw Database incorporating national statistics, forecast: wiiw 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 1st quarter	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	2007	2007	2008	Index 1995=100 2006
						1st quarter		forecast		
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 1st quarter	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]

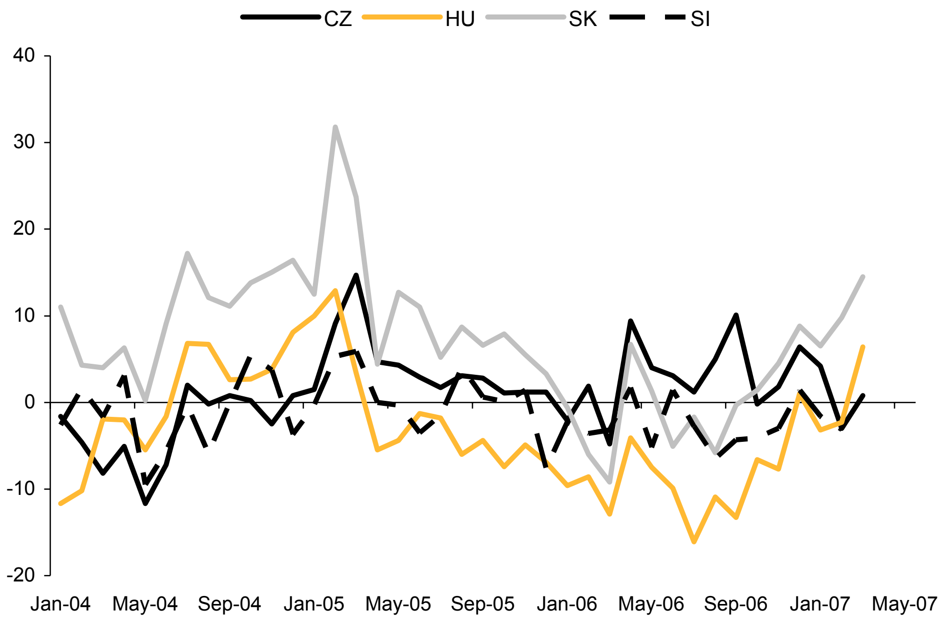
Even if very important, ULC is but one indicator of competitiveness. The changes are clearly in accord with the slowdown in export growth rates in both Romania and Bulgaria. In the case of Slovakia and Hungary, the marked expansion of exports point to other important factors governing competitiveness,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

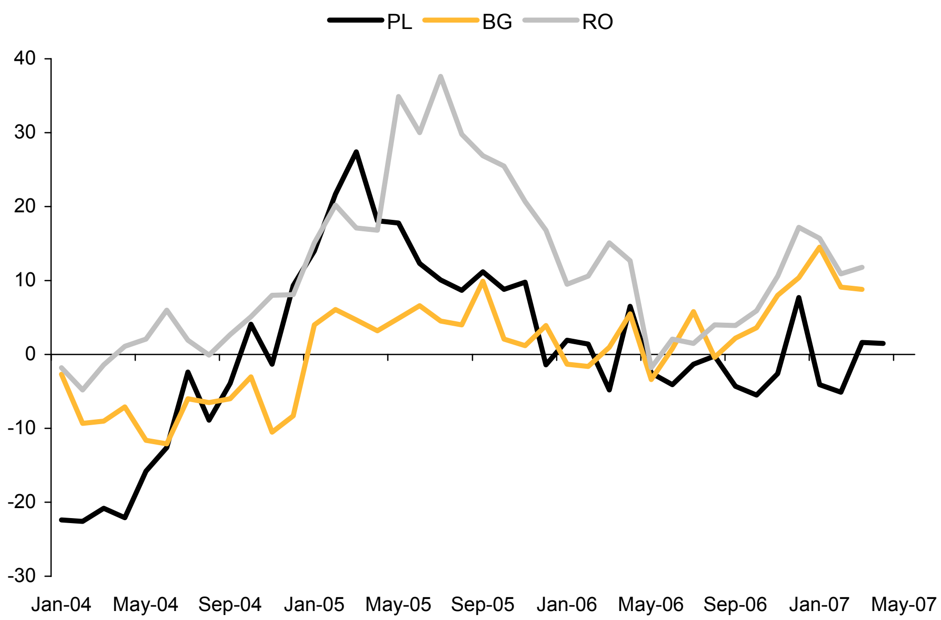
11 M. Landesmann, 'Competitiveness/Structural Convergence in Central and Eastern Europe', presentation at the OENB/SUERF Meeting, 'Central and Eastern Europe: Is Convergence on Track?', Vienna, 22 June 2007.

Figure 1

Unit labour costs in industry, 2004-2007

EUR-adjusted, year-on-year, growth in %





Source: wiiw Monthly Database incorporating national statistics.

Divergent developments in foreign trade[12]

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]	**1 Q 07 / 1 Q 06**
		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

	2004	2005	2006	2007 forecast	2004	2005	2006	2007 forecast	2006
	EUR mn				FDI net, % of CA				stock EUR mn
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) wiiw estimate.

Source: National Banks of respective countries; wiiw 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 improves[14]

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

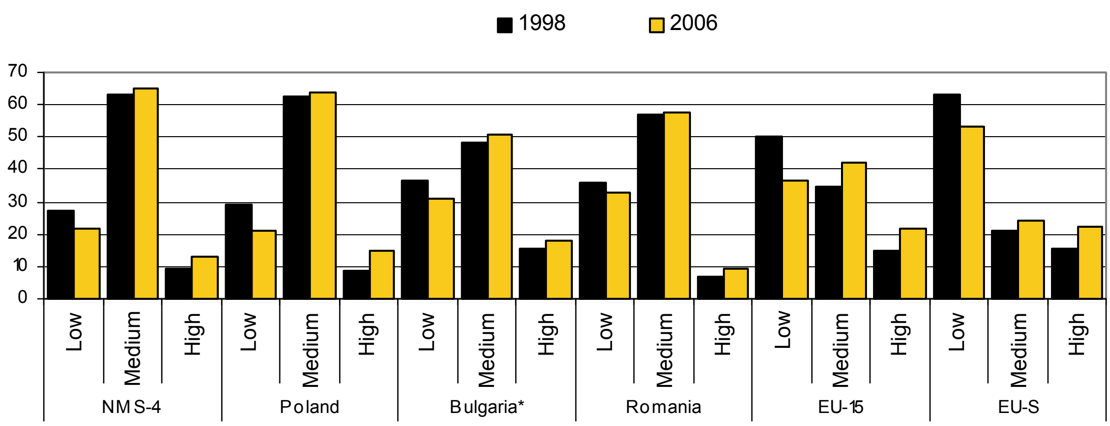
	in 1000 persons		change in % against preceding year					Index 2000=100
	2006 [1]	**2007 1Q**	**2004**	**2005**	**2006** [1]	**2006**	**2007 1Q**	**2006**
Czech Republic	4828	4865	-0.6	1.2	1.3	1.7	1.7	102.0
Hungary	3930	3906	-0.5	0.0	0.7	0.4	0.5	101.9
Poland	14594	14839	1.3	2.3	3.4	3.1	5.3	100.5
Slovak 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.

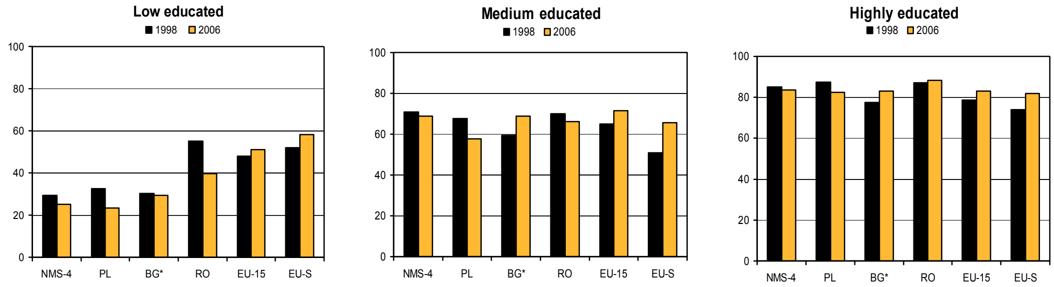
Note: NMS-4: Czech Republic, Hungary, Slovakia and Slovenia. EU-South: Greece, Portugal and Spain.

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

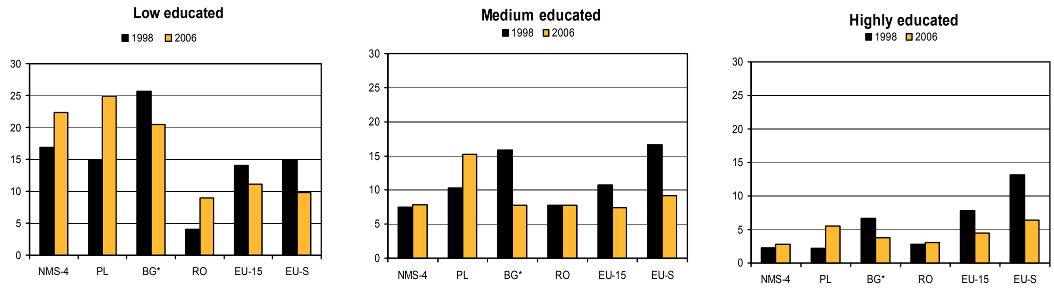


*) Bulgaria: 2000, 2005

Source: Eurostat; wiiw Database incorporating national statistics.

Figure 4

Unemployment rates, 15-64, 1998 and 2006



*) Bulgaria: 2000, 2005.

Source: Eurostat; wiiw 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	2007	2007	2008
						1st quarter		forecast	
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

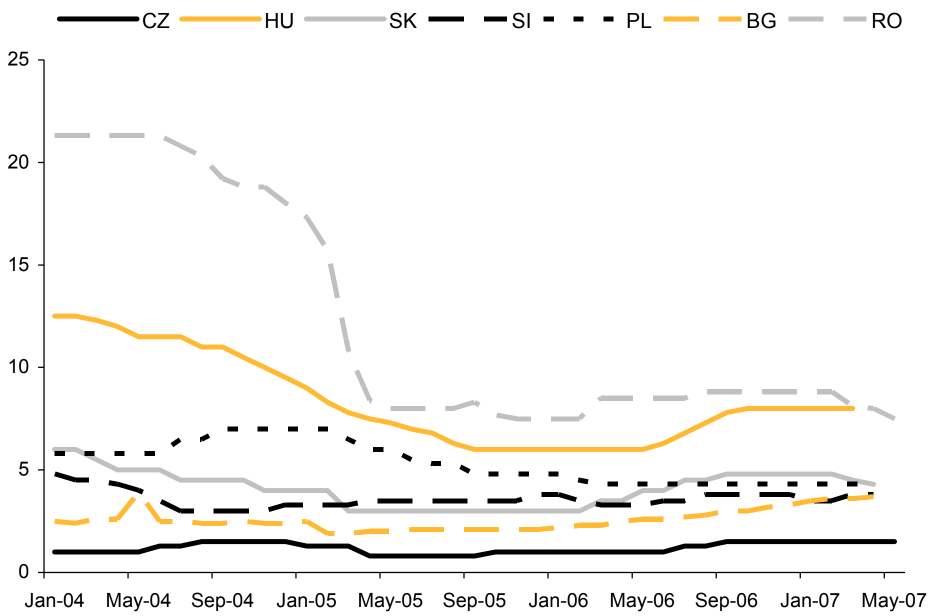
1) Preliminary.

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

Figure 5

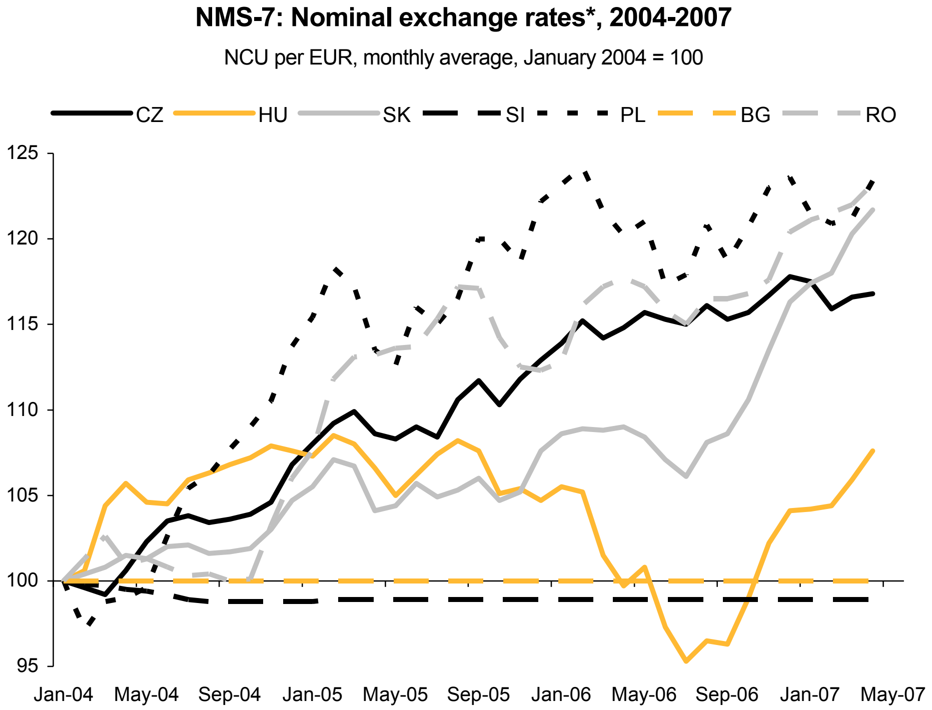
Minimum interest rates, 2004-2007

nominal NB leading rate in % p.a.



Source: wiiw Monthly Database incorporating national statistics.

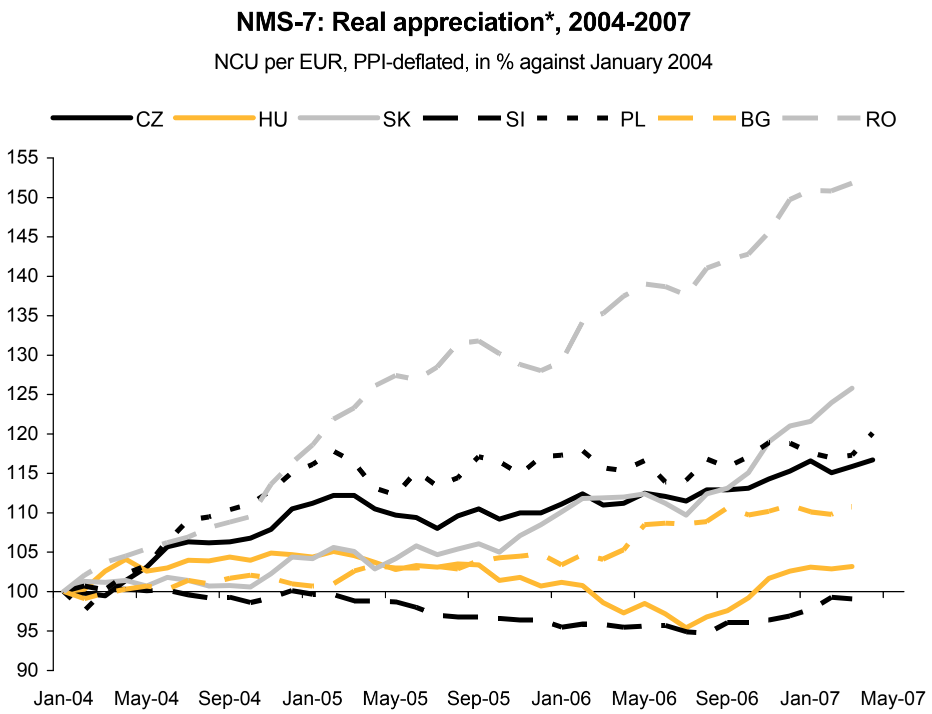
Figure 6



* Increasing line indicates appreciation.

Source: wiiw Monthly Database incorporating national statistics.

Figure 7



* Increasing line indicates appreciation.

Source: wiiw 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 Poland[16]

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

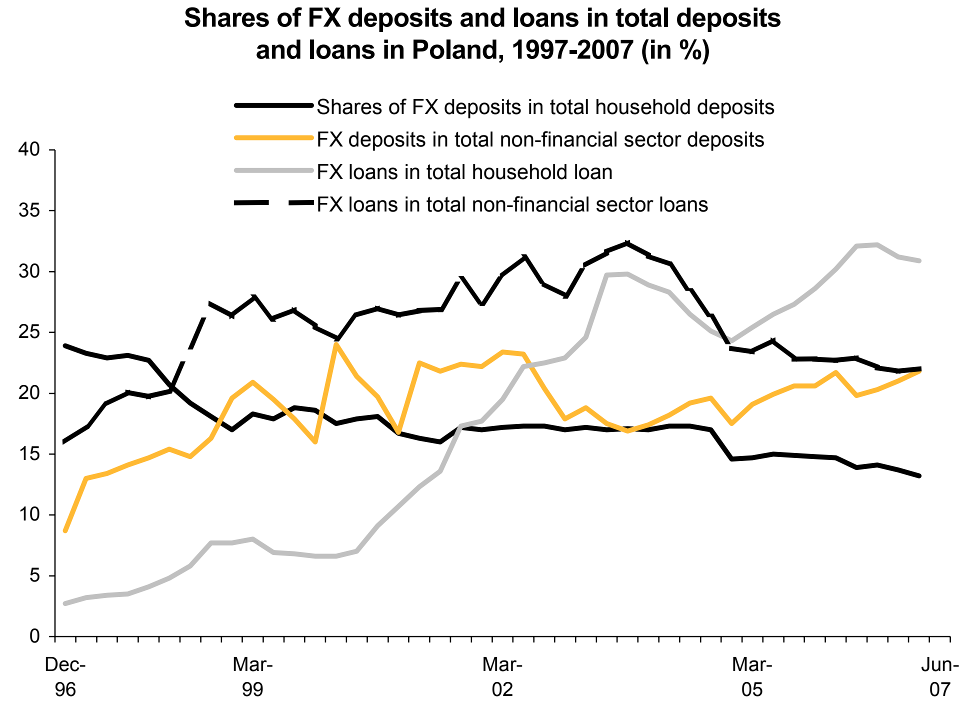
[18] Cash and liquid deposits held by firms represent either payments received (e.g. for export sales) – and not yet invested/spent - or buffers for current expenses.

[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).

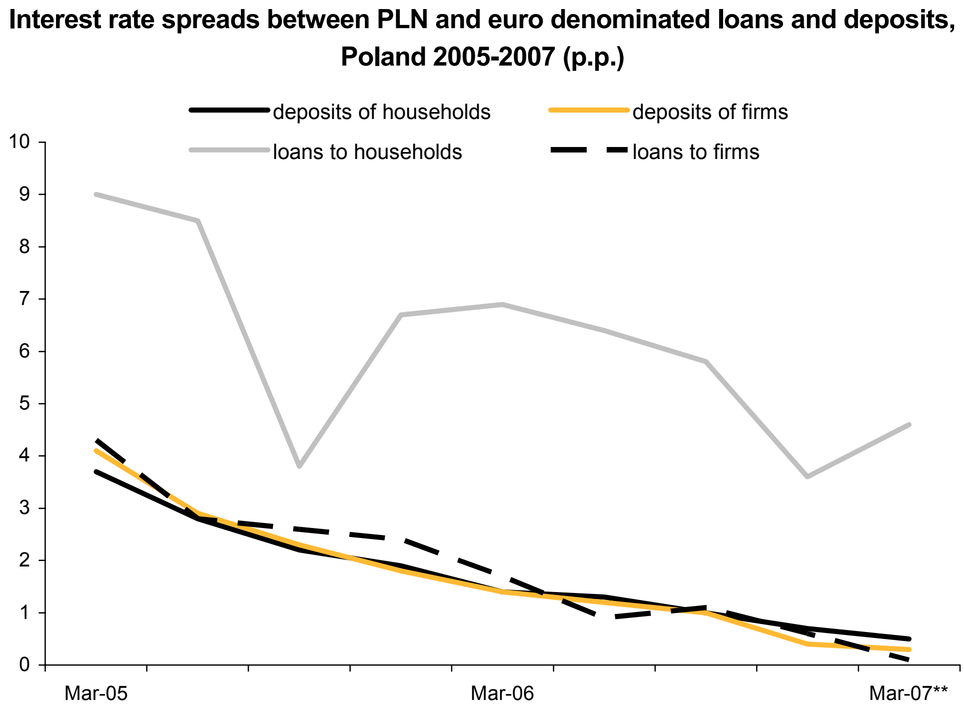
on loans/deposits denominated in HUF. Rising interest rates on HUF loans/deposits may be traced back to the hikes in policy interest rates which started in June 2006 – as well as to the weakening of the HUF vs. the euro (over the period June-October 2006).

Figure 8



Source: National Bank of Poland.

Figure 9

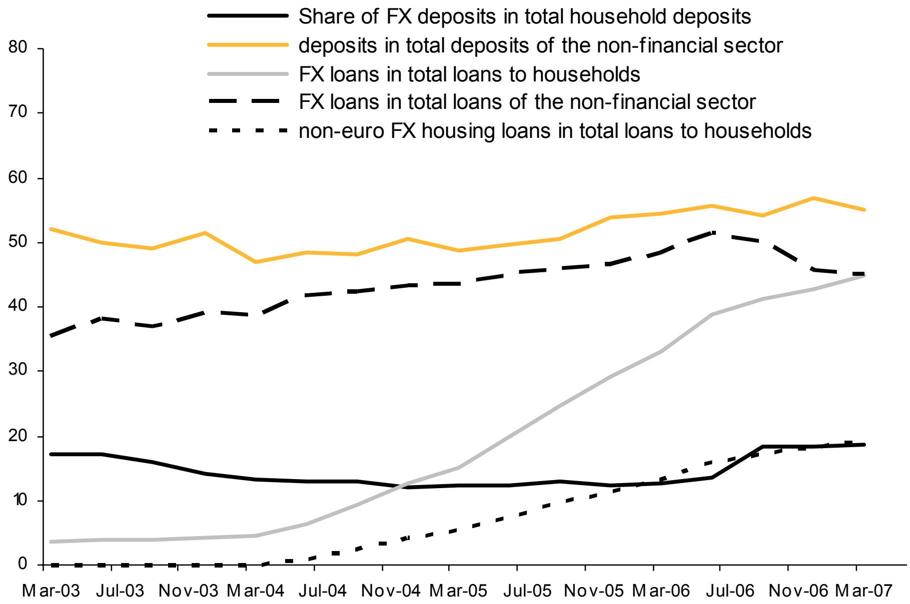


Source: National Bank of Poland

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

Shares of FX deposits and loans in total deposits and loans, Hungary, 2003-07 (in %)



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 Hungary[22]) 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.

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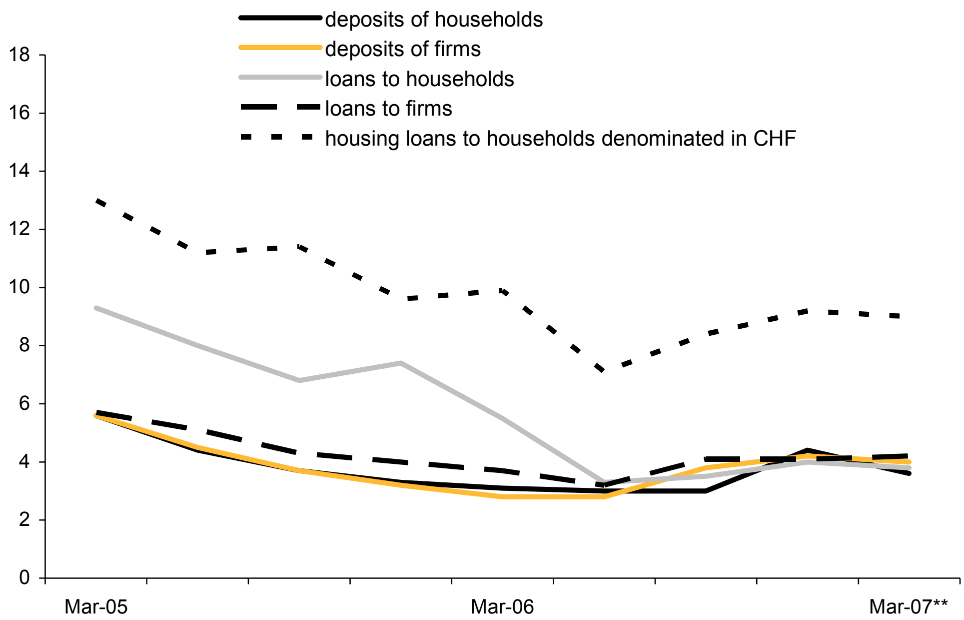
[21] It may be added that 'euroization' levels are also quite low in Slovakia, which is already a member of the Exchange Rate Mechanism II. In Slovakia, FX loans (to households and non-financial firms, combined) currently account for about 12% of the respective totals, and the FX deposits for 13% of 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 pursing 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 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 wiiw 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	2007	2007	2008
						1st quarter		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]

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[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 parties[25] 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

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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	2007	2007	2008
						1st quarter		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.