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Reale Konvergenz: sie findet statt.

Real Convergence is Taking Place

Vor nicht allzu langer Zeit gab es noch eine heftige Diskussion darüber, ob es den – damals noch – Kandidatenländern gelingen wird, neben der nominellen Konvergenz (Angleichung von Inflation und Zinssätzen) auch schnell genug eine reale Konvergenz mit der EU 15 zu erreichen.

Nun, den CEE-Ländern ist es in den letzten Jahren erstaunlich gut gelungen, ihre Position als Industriestandort auszubauen und sich in einem mittleren Technologiesegment zu positionieren.

Mit einem jährlichen BIP-pro-Kopf-Wachstum von 4 % ist das Wohlstandsniveau in den neuen Mitgliedsstaaten (NMS) doppelt so schnell gestiegen wie in der EU-15. Die NMS haben es aber auch geschafft, ihre Exportströme völlig umzudrehen. Nicht nur, dass 60 % ihrer Exporte in die EU 15 gehen, sie haben es auch geschafft, ihren Marktanteil an den EU-Importen um 3 %-Punkte (von 6,3 % auf 9,3 %) zu steigern, was immerhin eine Steigerung des Marktanteils(!) um fast 50 % ist.

Entscheidend für den Konvergenzprozess ist aber, dass sich die Qualität der Exporte signifikant geändert hat. Die NMS-Länder haben nämlich nicht nur Marktanteile gewonnen, sondern es hat auch einen deutlichen Wandel in der Güterstruktur, von relativ niedrigpreisigen Massenprodukten zu Produkten im mittleren und höheren Technologie-Segment gegeben. Neueste Untersuchungen zeigen, dass gerade in diesem Bereich die NMS nicht nur die höchsten Marktanteilsgewinne erzielen konnten, sondern dass neben den Preisen dieser Gütergruppe aus den NMS auch die Qualität der Exporte in dieser Gütergruppe überdurchschnittlich gestiegen sind.

Die Daten deuten darauf hin, dass der Exporterfolg der NMS nicht nur in der billigeren Produktion, sondern auch in einem signifikanten Qualitätsanstieg, d. h. letztlich in einer realen Konvergenz lag.

Die Gründe für diesen Anstieg der Qualität sind auch in einer Kombination von zwei Faktoren zu suchen – zum einen haben die NMS weitgehend gut qualifizierte Arbeitskräfte, insbesondere was technische Berufsgruppen anbelangt, zum anderen hat die EU-Industrie in relativ arbeitsintensiven aber technisch anspruchsvollen Fertigungsbereichen „billigere“ Produktionsstandorte gesucht.

Keine Region der Welt hatte in den letzten Jahren relativ so hohe FDI zu verzeichnen, wie die NMS. Die kumulierten FDI's betragen in den NMS ca. 40 % des BIP's, sie sind somit höher als jene von China (25% des BIP).

All jene, die im Zuge der Beitrittsdiskussion das Gespenst der ungenügenden realen Konvergenz an die Wand gemalt haben, hat die Realität widerlegt. Die NMS haben auch im Hinblick auf die reale Konvergenz (Wohlstandsniveau, Wirtschaftsstrukturen) einen erstaunlich raschen Aufholprozess beschritten. Auch wenn der Weg der Angleichung noch nicht zu Ende ist, ein guter Teil des Weges wurde in den letzten Jahren bewältigt.

Not so long ago there was heated debate as to whether the then candidate countries will – besides nominal convergence (adjustment of inflation and interest rates) – succeed in achieving real convergence with the EU 15 within the required time frame.

In the last few years the CEE countries have made surprisingly good progress in expanding their position as a location for business and in positioning themselves in a mid-field technology segment.

With per capita GDP growth of 4 % p.a. the level of prosperity in the new member states has risen twice as fast as that of the EU 15. The new member states (NMS) have also succeeded in completely reorienting their export flows. 60 % of their exports now go to the EU 15 and they have increased their market share of EU imports by 3 percentage points from 6.3 % to 9.3 %. This represents an almost 50 % increase in market share!

The quality of exports has improved markedly, and this is crucial for the convergence process. The NMS have won additional market share and the structure of goods has changed dramatically, from relatively low-priced mass-produced articles to products in the middle and high tech segments. The most recent data show that the new member states have won the largest market share in this area and that the prices of exports relating to this category of goods from the NMS have increased, with a disproportionately strong improvement in the quality of exports in this category.

The data indicate that the export achievements of NMS are to be found in low-cost production and in a significant improvement in quality, i.e. in real convergence.

Two factors are also responsible for the improved quality – the NMS for the most part have a well-qualified workforce, especially in the technical occupational groups, and the EU's industry has been looking for “lower cost” production sites for relatively work intensive but technically demanding manufacturing segments.

In relative terms, the new member states are the region with the highest level of FDI. Cumulated FDIs in the NMS amounted to about 40 % of GDP, more than those of China (25 % of GDP).

The reality of the situation has refuted all those who, during the accession negotiations, maintained that real convergence would be insufficient. In regard to real convergence (level of prosperity, economic structures), the pace of the catching-up process in the new member states has also been quite astounding. Even if the convergence process is not yet over, a great deal has been accomplished in the last few years.

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Albania

Structural problems limit growth prospects

Area: 28,748 sq. km
Population: 3.1 mn
President: Alfred Moisiu
Prime minister: Sali Berisha
GDP (2005): EUR 6.8 bn
Per capita GDP (2005): EUR 2,170

Political situation

The new coalition government led by Prime Minister Sali Berisha of the Democratic Party has been in office for more than half a year now. Disagreements within the coalition and the tough collision course of the opposition have obstructed progress in parliament, especially since the beginning of March after alleged irregularities in connection with the abortive motion of no confidence introduced against Mrs. Topalli, spokeswoman of the Democratic Party in parliament. The performance record of the government with regard to the implementation of its political priorities, such as the fight against corruption, the containment of organised crime and the acceleration of EU integration, is consequently mixed so far. However, the negotiations on a Stabilisation and Association Agreement have been concluded. It is expected that the agreement will still be signed this spring.

Economic situation

Supported by continued strong domestic demand, which among others was reflected in a particularly strong increase in lendings of more than 70% year-on-year, economic growth is estimated at 5.5% in 2005. The economic slowdown compared with the previous years is on the one hand attributable to sales difficulties of the textile industry, which suffered under the strong competition from the Far East after the expiry of the Multifibre Agreement, and on the other hand to bottlenecks in energy supply in autumn, which required a cut in production. At 2.4% on average, inflation remained modest in 2005 in spite of higher energy costs. Possible second round effects may cause inflation to accelerate this year. However, supported by the favourable figures at the beginning of the year, the cautious policy pursued by the central bank, which tries to curb the increase in lendings by taking more restrictive measures and which continues its monetary policy aimed at a stable exchange rate of the Albanian lek, as well as the restrained fiscal policy pursued by the government in agreement with the IMF point to an only slight increase in inflation to 2.7% on average in 2006.

Since an unexpectedly good development of revenues above all in the second half of the year contributed to lowering the budget deficit to 3.3% of GDP last year, the government aims at a budget deficit of about 4% of GDP in 2006. This deficit does not yet contain possible additional tax revenue as a result of a thorough reform of tax administration, which is to contribute to restraining the shadow economy. In summer, the government is expected to decide in a supplementary budget how these revenues are to be used, with priority probably being given to the further reduction of public debt, which amounted to 55% of GDP at year-end 2005. ■

Albania – Selected Indicators

Change from previous year in %	*2002*	*2003*	*2004*	*2005*	*2006 Forecast*	*2007 Forecast*
GDP (real)	4.3	5.7	6.7	5.5	5.0	6.0
Industrial output (real)	1.8	2.7	3.1	2.0	2.5	3.5
Gross fixed capital formation (real)	–	–	–	–	–	–
Consumer prices (yearly average)	5.2	2.4	2.9	2.4	2.7	3.0
Unemployment (yearly average)	15.8	15.0	14.4	14.5	14.0	13.5
Budget balance (in % of GDP)	–6.5	–4.3	–5.0	–3.3	–4.0	–3.5
in EUR mn						
Merchandise exports	349	395	485	529	740	880
Merchandise imports	1,570	1,579	1,766	1,998	2,330	2,560
Current account	–472	–414	–349	–512	–450	–420
Current account (in % of GDP)	–9.9	–8.0	–5.7	–7.5	–6.2	–5.3
FDI (inflow, net)	143	158	275	214	250	320
Gross foreign debt (end of period)	1,258	1,257	1,346	1,460	1,600	1,720
Gross foreign debt (in % of GDP)	26.4	24.2	21.9	21.4	22.1	21.9
Import cover (in months)	5.0	4.6	4.9	4.6	4.4	4.5
Average exchange rate: ALL/EUR	132.4	137.6	127.6	124.2	126.0	126.0
Average exchange rate: ALL/USD	139.9	121.8	102.7	99.8	103.2	100.8

Sources: Bank Austria Creditanstalt Economics Department, IMF, Instat

Outlook

Economic growth will slow down a little in 2006. Due to the cautious monetary and fiscal policy, which may however result in sustained price stability, domestic demand will lose momentum. Energy problems, corruption and a not very effective public administration are aggravating the conditions for companies, whose low international competitiveness is reflected in the country's pronounced external imbalance. In 2005, the current account deficit rose to more than 7% of GDP due to difficulties to export textiles. Nevertheless, the progress in a number of privatisation projects (e. g. telecommunications, electricity supply company KESH, oil company Albpetrol) increasingly provide grounds for cautious optimism.

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Area: 45,227 sq. km
Population: 1.3 mn
President: Arnold Rüütel
Prime Minister: Andrus Ansip
GDP (2005): EUR 10.7 bn
Per capita GDP (2005): EUR 7,950

Estonia

Introduction of the euro postponed

Political situation

Estonia will not adopt the euro as planned at the beginning of 2007 because the inflation rate is too high. This official announcement was made by Finance Minister Aivar Soerd at the end of March. According to the government's estimate, the inflation rate will amount to 3.7 % in 2006. It is expected to decline to 3.2 % in 2007 provided that oil prices will decrease. As is well-known, Estonia meets the other Maastricht criteria, in particular as far as fiscal policy is concerned. The possibilities of monetary policy to combat inflation are limited owing to the fact that the national currency is pegged to the euro. The government decided to postpone the increase in excise taxes on alcohol and tobacco planned for the beginning of July 2006 and the increase in excise taxes on fuel scheduled for the beginning of 2007 to the beginning of 2008 as an immediate measure to reduce the inflationary pressure.

Economic situation

Economic growth gradually accelerated in the course of 2005, from 7.2 % in the first quarter to 11.1 % in the fourth quarter. At 9.8 %, average annual growth remained only just under the 10 % mark. Due to the boom, tax revenue was also higher than expected. Thus, the budget surplus of 1.8 % of GDP remained at the previous year's level. Exports and investments proved to be the main driving forces of growth in particular in the second half of the year. The rising demand of the neighbouring main trading partners (Finland, Sweden, Russia as well as Latvia and Lithuania) considerably contributed to an increase in exports of goods and services (21.3 %) which exceeded import growth (17.4 %). Moreover, the current account also benefited from this development. At about 10.5 % of GDP, the current account deficit was approximately 2 percentage points lower than in 2004. Gross fixed capital formation rose substantially by 13.9 % in 2005, supported by investments in the real estate sector, which resulted in a disproportionately strong increase in real estate prices. Rising by 8.1 %, private consumption remained quite robust. The increase is attributable to rising disposable income of households, on which several factors have a favourable impact: rising wage levels, increasing employment, lower income tax as well as markedly higher average old-age pensions. These are all factors which also explain the present high level of consumer confidence. The rising inflation rate marrs this favourable development. The inflation rate rose from 3 % in 2004 to 4.1 % on average in 2005, about half of the price upsurge being attributable to the development of oil prices, which left its mark on housing and transport costs. ■

Estonia – Selected Indicators

Change from previous year in %	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
					Forecast	
GDP (real)	7.2	6.7	7.8	9.8	9.5	8.5
Industrial output (real)	8.2	11.0	7.9	9.1	9.5	7.8
Gross fixed capital formation (real)	17.2	8.5	6.0	12.4	7.9	6.4
Consumer prices (yearly average)	3.6	1.3	3.0	4.1	3.5	3.1
Unemployment (yearly average)[1]	10.3	10.0	9.6	7.9	7.2	6.9
Budget balance (ESA 95, in % of GDP)	1.5	2.6	1.7	1.8	1.8	0.0
in EUR mn						
Merchandise exports	3,728	4,061	4,797	6,244	7,440	8,440
Merchandise imports	4,878	5,457	6,373	7,707	9,150	10,250
Current account	–759	–1,059	–1,122	–1,151	–1,330	–1,480
Current account (in % of GDP)	–10.2	–13.0	–12.7	–10.5	–10.0	–9.3
FDI (inflow, net)	307	797	742	2,481	1,860	1,930
Gross foreign debt (end of period)	4,490	5,594	7,340	9,652	11,230	12,990
Gross foreign debt (in % of GDP)	60.1	68.7	81.2	90.2	92.5	95.8
Import cover (in months)	1.7	1.8	1.8	1.9	0.7	0.7
Average exchange rate: EEK/EUR	15.65	15.65	15.65	15.65	15.65	15.65
Average exchange rate: EEK/USD	16.54	13.81	12.57	12.57	12.90	12.52

1) On the basis of "Labour force participation rate", Statistical Office of Estonia

Sources: Ministry of Finance of Estonia, Bank of Estonia, EBRD, Bank Austria Creditanstalt Economics Department

Outlook

The inflation rate will hardly fall below the 3 % mark by year-end 2007, in particular if oil prices should remain high. Therefore, it is questionable whether the introduction of the euro will only be postponed for one year. Data released for this year point towards a continuation of economic growth. Therefore, we have revised our growth forecasts for 2006 and 2007 upwards to about 9 %. Growth should basically continue to be broadly based, and the investment boom in particular is expected to persist for some time. The possibilities for lowering the current account deficit are limited. It should however tend to narrow slightly due to the fact that exports are increasingly gaining in importance.

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Latvia

Mixed emotions

Area: 64,589 sq. km
Population: 2.3 mn
President: Vaira Vike-Freiberga
Prime Minister: Aigars Kalvitis
GDP (2005): EUR 12.7 bn
Per capita GDP (2005): EUR 5,520

Political situation

The four-party coalition led by Aigars Kalvitis collapsed at the beginning of April, after barely 15 months in office and six months before the parliamentary elections scheduled for the autumn of 2006. A long-running dispute between the First Party and the New Era Party, fuelled partly by mutual allegations of corruption and culminating in the departure of the New Era Party from the government, was the coalition government's undoing. After again filling the vacated positions, and with its wings clipped, the government intends to continue its work until the parliamentary elections although it no longer has a majority in parliament. If it fails to receive the necessary support from the opposition there is a danger of political paralysis.

Economic situation

In 2005 economic growth in Latvia accelerated to 10.2 % from 8.5 % in 2004. This strong growth was facilitated by above-average expansion in the construction industry (+15.5 %), which was fuelled by a credit-driven real estate boom, as well as by the upturn in the services sector (+11.2 %). On the expenditure side, private consumption and investments, which also benefited from the sustained increase in lending (+54 %), were the main pillars of growth. The high consumption propensity of households was paired with rapid growth in real wages (+9 %) and the improved situation on the labour market, both a result of the growing shortage of qualified workers (migration to the EU). The ensuing wage-price spiral, however, is generating persistent inflationary pressure, together with higher inflationary expectations and other demand and supply-related factors (e. g. higher oil prices, adjustment of administered prices), which are making Latvia's plans to launch the euro in 2008 look increasingly less realistic. Against this backdrop and despite the robust growth in exports, the economy also continued to struggle with massive external imbalances, which are manifested by the stagnation of the current account deficit at a high level and the significant increase in the country's foreign debt, for lack of adequate inflows of foreign direct investment. In response to the overheated domestic economy, the Bank of Latvia in March 2006 moved to further reduce the supply of liquidity by broadening the minimum reserve base to include bank liabilities with a maturity of over two years. Nevertheless, in light of the central bank's limited room for manoeuvre in monetary policy and a procyclical fiscal policy, inflation and the current account are not expected to improve significantly in 2006. ■

Latvia – Selected Indicators

Change from previous year in %	*2002*	*2003*	*2004*	*2005*	*2006 Forecast*	*2007 Forecast*
GDP (real)	6.5	7.2	8.5	10.2	8.5	7.5
Industrial output (real)	5.8	6.5	6.0	5.7	6.5	6.0
Gross fixed capital formation (real)	13.0	12.3	23.8	20.0	15.0	13.0
Consumer prices (yearly average)	1.9	2.9	6.2	6.7	5.7	4.6
Unemployment (yearly average)	12.0	10.6	10.4	8,9	8.0	7.5
Budget balance (ESA 95, in % of GDP)	–2.3	–1.6	–1.1	–1.0	–1.5	–1.3
in EUR mn						
Merchandise exports	2,693	2,804	3,395	4,270	4,840	5,550
Merchandise imports	4,255	4,573	5,634	6,670	7,680	8,820
Current account	–656	–802	–1,426	–1,580	–1,780	–1,850
Current account (in % of GDP)	–6.6	–8.1	–12.9	–12.5	–12.2	–11.3
FDI (inflow, net)	265	228	479	395	391	356
Gross foreign debt (end of period)	7,180	7,837	10,246	12,810	15,650	18,500
Gross foreign debt (in % of GDP)	72.7	79.1	92.8	101.1	107.7	113.2
Import cover (in months)	3.1	2.7	2.7	2.8	3.0	3.0
Average exchange rate: LVL/EUR	0.58	0.65	0.67	0.70	0.70	0.70
Average exchange rate: LVL/USD	0.62	0.57	0.54	0.56	0.58	0.56

Sources: Latvijas Banka, Latvijas Statistika, Bank Austria Creditanstalt Economics Department

Outlook

While the robust economic growth and strong wage increases are making real convergence with the EU easier, this is occurring at the expense of monetary integration and the country's international competitiveness. Although the government remains committed to the original deadline of joining the euro area in 2008 despite the high inflation rate, a delay by one or two years seems likely, as neither rigorous monetary nor fiscal austerity measures can be expected for the election year 2006. On the contrary: with parliamentary elections drawing closer, the Latvian government held out the prospect of tax cuts, which ceteris paribus could lead to a prolongation of the recent inflation and current account problems.

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Lithuania

Application for membership of EMU submitted

Area: 65,301 sq. km
Population: 3.4 mn
President: Valdas Adamkus
Prime Minister: Algirdas Brazauskas
GDP (2005): EUR 20.6 bn
Per capita GDP (2005): EUR 6,010

Political situation

The four-party centre-left coalition (Social Democrats, Social Liberals, Labour Party and Farmer's Union Party) collapsed in early April after the withdrawal of the Social Liberals. The remaining three parties signed a new coalition agreement, stipulating that the government continues its work. The new coalition is left with just 71 seats out of 141 in parliament. The slim majority and the fact that even after the expulsion of the Social Liberals disagreements in the ruling three-party coalition are still strong, there are also substantial doubts whether the government will remain intact until October 2008. Having participated in the ERM-II mechanism since end-June 2004, in mid-March Lithuania officially applied for membership of Economic and Monetary Union, although the EU Commission has signalled that it could be too early. In fact, with an inflation rate of 2.8 % the price stability criterion will just be missed for the whole of 2006. In 2007 inflation will probably trend marginally higher rather than declining, and thus it seems that the decision to submit an application for EMU membership now is motivated more by tactical considerations. All other criteria are fulfilled, the EU will publish its report on Lithuania's readiness to adopt the euro in mid-May.

Economic situation

Towards the end of 2005, economic growth in Lithuania accelerated further, with GDP expanding 7.5 % in 2005 after a 7 % rise in 2004. On the whole, during the course of the year robust growth was registered in private consumption (first quarter: 5.1 % vs. fourth quarter: 15.0 %) and foreign trade (exports of goods and services, first quarter: 10.9 % versus fourth quarter: 15.6 %). On the other hand, growth in investments tapered off slightly, stagnating at around +1 % in the second half of 2005, after registering average growth of around 15 % in the first two quarters. On the supply side, the sectors that recorded the strongest growth were construction and the so-called "productive services sector" trade, hotels and restaurants, transport and communications, with both sectors growing at around 11 % during the year as a whole.

Lithuania's external position remained unchanged in 2005, with a current account deficit of again 1.4 bn euros, but progress was seen in reducing the CA deficit in relation to GDP,which improved from –7.7 % of GDP in 2004 to –7.0 % of GDP in 2005. The increase in the deficit on the balance of trade was compensated by considerably higher surpluses on the services and transfer balances, whereas the deficit on the income balance remained unchanged. As imports of goods were still roughly 1/4 higher than exports in absolute terms, the slightly stronger growth in exports (+27 %) than in imports (+25 %) was unable to reduce the trade deficit. ■

Lithuania – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	6.8	10.5	7.0	7.5	6.5	6.3
Industrial output (real)	3.1	16.1	10.3	7.3	10.5	6.5
Gross fixed capital formation (real)	11.1	18.7	25.5	7.1	10.1	8.0
Consumer prices (yearly average)	0.3	–1.2	1.2	2.7	2.8	3.0
Unemployment (yearly average)[1)]	13.8	12.4	11.4	8.5	7.5	7.0
Budget balance (ESA 95, in % of GDP)	–1.4	–1.2	–1.5	–0.5	–1.5	–1.5
in EUR mn						
Merchandise exports	6,363	6,773	7,478	9,444	11,260	13,210
Merchandise imports	7,770	8,262	9,398	11,692	13,960	16,030
Current account	–772	–1,116	–1,394	–1,456	–1,590	–1,680
Current account (in % of GDP)	–5.2	–6.8	–7.7	–7.1	–6.8	–6.5
FDI (inflow, net)	772	160	632	488	627	687
Gross foreign debt (end of period)	5,945	6,670	7,682	9,456	11,020	12,960
Gross foreign debt (in % of GDP)	39.7	40.6	42.5	46.0	47.3	50.1
Import cover (in months)	2.9	3.2	2.7	26.6	24.0	21.1
Average exchange rate: LTL/EUR	3.47	3.45	3.45	3.45	3.45	3.45
Average exchange rate: LTL/USD	3.67	3.05	2.77	2.77	2.85	2.76

1) Labour Force Survey, Statistics Lithuania

Sources: Bank Austria Creditanstalt Economics Department, Lietuvos Bankas, Statistics Lithuania

Outlook

On the whole, we expect economic growth in 2006–2007 to amount to approximately 6.5 %. Domestic demand will be dampened slightly by the higher level of interest rates. On the other hand, private consumption will benefit from the reduction of the income tax rate from 33 % to 27 % from mid-2006. Annual average inflation is projected to come in just slightly higher than the Maastricht criterion. Nevertheless, it does not seem very likely that the EU will make an exception for Lithuania. EMU membership may be delayed by more than one year due to the risk of rising inflation. But in light of the existing currency board, the stability of Lithuania's exchange rate policy is not in doubt.

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Serbia and Montenegro

New borders in the making

Area: 102,713 sq. km
Population: 8.2 mn
President: Svetozar Marovic
Prime Minister:
Vojislav Kostunica (Serbia);
Milo Djukanovic (Montenegro)
GDP (2005): EUR 20.9 bn
Per capita GDP (2005): EUR 2,560

Political situation

The referendum on the independence of Montenegro will be held on 21 May. Recent opinon polls suggest that the outcome of the referendum will be a slim majority for independence. Negotiations on Kosovo's future political status started in Vienna at the end of February. The initial rounds of negotiations have focused on decentralisation issues. Efforts will concentrate on reaching a final result in the current year; this will probably mean independence while maintaining Serbian minority rights. Events within Serbia surrounding the funeral for the late President Slobodan Milosevic, who was indicted by the war crimes tribunal in The Hague and died recently, have demonstrated the fragility of the current Serbian government without making it falter. The deadline set for extraditing the alleged war criminal Ratko Mladic for him to be handed over to the UN tribunal has been extended by one month until the end of April. However, there is still a high risk that the current negotiations on a Stabilisation and Association Agreement with the EU may be interrupted.

Economic situation

In 2005, Serbia's GDP grew by 6.3 % and Montenegro also achieved significant economic growth of 4.1 %. In both parts of the Union, growth was driven by the services sector, in Serbia supported by trade and the transport sector, and in Montenegro by good results from tourism. At 2.4 % in 2005 and 2.9 % in the first quarter of 2006, the average inflation rate in Montenegro remained under control. Combating inflation continues to be the top priority of economic policy in Serbia. A fiscal policy that is even more restrictive than in the previous year provides for a moderate increase in wages and pensions. This will help to rein in the growth of domestic demand and dampen inflation. The Serbian central bank supports the anti-inflationary course through monetary policy measures whose effectiveness is, however, limited in view of the widespread euroisation in the banking sector. Therefore the central bank, which is trying to skim off liquidity via the new instrument of Treasury savings bills for private individuals, concentrates on adjusting the minimum foreign currency reserve ratio, recently raising it to 40 %. In the first three months of 2006 the inflation rate was 14.8 %, down from 16.2 % in 2005. This decline can hardly be the result of the recent policy measures; rather, it largely reflects the absence of inflation-boosting effects from the introduction of value-added tax in the previous year. There is still little prospect of a revaluation of the dinar to control inflation – a measure which would be effective given the widespread euro-indexation of prices – because a possible adverse impact on foreign trade is to be avoided. ■

Serbia and Montenegro – Selected Indicators

Change from previous year in %	*2002*	*2003*	*2004*	*2005*	*2006 Forecast*	*2007 Forecast*
GDP (real)	4.3	2.4	8.8	6.1	5.0	5.5
Industrial output (real)	1.7	–2.7	7.5	0.7	6.0	6.5
Gross fixed capital formation (real)	–	–	–	–	–	–
Consumer prices (yearly average)	16.6	9.7	10.8	15.2	11.5	9.7
Unemployment (yearly average)	29.0	31.7	31.7	32.5	32.2	31.5
Budget balance (in % of GDP)	–4.5	–3.4	–0.3	0.9	2.4	0.9
in EUR mn						
Merchandise exports	2,549	2,696	3,250	4,020	4,870	5,760
Merchandise imports	6,680	7,011	9,152	9,200	10,390	11,200
Current account	–1,462	–1,770	–2,440	–1,810	–1,870	–1,720
Current account (in % of GDP)	–8.9	–9.8	–12.5	–8.7	–8.3	–6.8
FDI (inflow, net)	594	1,240	829	1,530	1,300	1,200
Gross foreign debt (end of period)	12,513	12,628	11,955	12,880	13,230	13,520
Gross foreign debt (in % of GDP)	76.5	69.9	61.1	61.6	58.8	53.8
Import cover (in months)	4.0	4.9	4.1	5.4	5.4	5.4
Average exchange rate: CSD/EUR	60.7	65.1	72.6	83.2	89.4	93.3
Average exchange rate: CSD/USD	64.3	57.5	58.4	67.0	73.2	74.6

Sources: Bank Austria Creditanstalt Economics Department, NBS, CBCG

Outlook

The efforts to deal with the existing macroeconomic deficits will slightly reduce growth in 2006. Nevertheless, continued capital inflows from privatisation transactions, positive effects of the structural reforms and a favourable international environment could help to achieve economic growth of about 5 %, though the downside risk is high. In Montenegro, inflation will remain moderate, whereas Serbia's high inflation rate is mainly caused by structural factors including a lack of competition. Inflation will therefore decline only slowly despite support from fiscal and monetary policies. Apart from inflation and the imbalance in foreign trade, the external debt service presents a further challenge.

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Bulgaria

Chasing records

Area: 110,994 sq. km
Population: 7.8 mn
President: Georgi Parvanov
Prime Minister: Sergei Stanishev
GDP (2005): EUR 21.4 bn
Per capita GDP (2005): EUR 2,780

Political situation

The current political agenda is dominated by Bulgaria's forthcoming accession to the EU. Top priority is being given to the reform of the economic and political areas criticised by the EU Commission, such as public administration and the judiciary, as well as the need to fight corruption. At the end of March the Bulgarian parliament adopted a resolution for an amendment to the Constitution which will promote cooperation between state-run institutions, more precisely define the separation of powers, and strengthen the independence of the judiciary. The EU Commission will decide in May when and under what conditions Bulgaria is to become a member of the EU. It is however likely that it will recommend that Bulgaria join the EU in 2007. The question of EU accession eclipsed the unsuccessful no-confidence motion that was brought by the opposition against the government based on the crisis management after the floodings. There will probably be more activity in Bulgaria's political landscape in the autumn in light of the upcoming presidential elections.

Economic situation

The Bulgarian economy maintained its strong performance in 2005 with GDP growth of 5.5 % despite negative one-off factors and structural deficits, and it only just failed to match the record growth of +5.7 % achieved in 2004. On the production side, the Bulgarian economy was driven by industrial output of +7.3 % (including construction), which generated 30.4 % in gross value added. With a growth rate of +6.6 % and a 60.3 % share of gross value added, the services sector also expanded at a disproportionately strong rate. The dynamic performance of these two sectors was reflected in the labour market. The unemployment rate declined from an average 12.7 % in 2004 to 11.5 % in 2005, the lowest level in nine years. Agriculture fell well behind these booming sectors, contracting by 8.6 % in 2005 due to adverse weather conditions. The agricultural sector consequently contributed less than 10 % to the gross value added for the first time since the beginning of the transition process.

On the demand side, growth continued to be driven by robust domestic demand. Although private consumption slowed towards the end of the year in the light of stronger inflationary pressure, slower growth in real wages and efforts by the central bank to curtail the credit boom, it expanded by as much as 7.4 % in 2005 as a whole. Investments grew even faster at 19 %, driven by the reconstruction work required after the floodings and strong inflows of foreign direct investment. Due to the government's strict fiscal policy, public consumption grew by a moderate 2.2 %. Export activity (+7.2 %) slowed markedly due to weaker exports of agricultural and textile products, and following restructurings within the steel sector, while imports continued to record strong double-digit growth (+14.6 %). The gap between exports and imports is reflected in a further deterioration of Bulgaria's net exports.

The trend will be similar in 2006, although the central bank's efforts to curb credit growth and the current rise in inflation are likely to slightly dampen private consumption. However, buoyant investment activity and stronger inventory investments in the run-up to EU accession will ensure that domestic demand remains the key growth component. The imbalance in foreign trade will persist in 2006 due to the stronger import pull in the run-up to EU accession, despite an expected revival of export activity.

Bulgaria – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	4.9	4.5	5.7	5.5	5.5	5.5
Industrial output (real)	4.7	14.1	17.1	6.7	10.9	11.3
Gross fixed capital formation (real)	8.5	13.9	13.5	19.0	15.0	13.5
Consumer prices (yearly average)	5.8	2.3	6.2	5.0	7.3	4.7
Unemployment (yearly average)	17.4	14.3	12.7	11.5	10.5	10.0
Budget balance (central government in % of GDP)	–0.6	0.0	1.7	3.2	3.0	2.0
in EUR mn						
Merchandise exports	6,063	6,668	7,985	9,454	11,000	13.000
Merchandise imports	7,755	8,868	10,938	13,824	17,000	20.000
Current account	–926	–1,630	–1,131	–2,531	–3,030	–3,000
Current account (in % of GDP)	–5.6	–9.2	–5.8	–11.8	–12.5	–11.2
FDI (inflow, net)	951	1,827	2,244	1,856	2,200	2,200
Gross foreign debt (end of period)	10,769	10,641	12,572	14,530	16,500	18,500
Gross foreign debt (in % of GDP)	65.1	60.2	64.2	67.7	68.0	69.0
Import cover (in months)	5.6	5.7	6.0	5.3	5.0	4.8
Average exchange rate: BGN/EUR	1.96	1.96	1.96	1.96	1.96	1.96
Average exchange rate: BGN/USD	2.07	1.73	1.57	1.57	1.59	1.56

Sources: BNB, NSI, Bank Austria Creditanstalt Economics Department

Current account deficit reaches record high

2005 saw a marked deterioration of Bulgaria's current account. Notwithstanding a sharp downward correction of the current account data for 2004 and 2005 as a result of methodological changes the current account deficit more than doubled in 2005 in both absolute terms and as a percentage of GDP, reaching a record level of 2.5 bn euros or 11.8 % of GDP. The deterioration is primarily attributable to a significant widening of the trade deficit. Merchandise exports grew by 18.4 %, while merchandise imports expanded by 26.4 % from a much higher base level in the light of strong demand for capital goods and price effects of energy imports. The trend will be similar in 2006, despite signs that exports are beginning to accelerate. The gap between imports and exports will probably widen further towards the end of the year due to the accelerated purchases of imports in the run-up to EU accession. This is likely to prompt a further rise in the current account deficit in 2006.

In 2005, net inflows of direct investment amounted to almost 1.9 bn euros, which corresponds to some 70 % of the current account deficit. On the financing side, the marked widening of the current account deficit was in 2005 consequently accompanied by a rise in foreign debt, which climbed to 14.5 bn euros or 67.7 % of GDP notwithstanding a significant reduction of public debt. The share of private foreign debt as a percentage of total foreign debt rose from 47.6 % in 2004 to 62.9 % at the end of 2005, and short-term foreign debt from 19.3 % to 24.5 %. Although foreign exchange reserves climbed from 6.8 bn euros in 2004 to 7.4 bn euros last year, the import cover ratio contracted from 6 to 5.3 months as a result of the strong growth of imports.

Stronger inflationary pressure

Bulgaria's rate of inflation accelerated discernibly at the beginning of 2006 to an average of 8 % yoy for the first quarter. This is the highest level in four years. The rise in prices was prompted by the sharp increase in excise taxes on alcohol and tobacco that was brought forward to 1 January 2006 with a view to preventing inflationary problems prior to the adoption of the euro. Although the gradual weakening of these one-off effects will be accompanied by an easing of the inflationary pressures in the second half of the year, the inflation rate is expected to average 7.3 % in 2006, which is above the 5 % recorded in 2005. The rise is however temporary. Bulgaria's inflation rate will start moving downward again as from 2007 despite further price and tax adjustments upon entry into the EU. The downward trend should also be supported by the more restrictive credit policy. The central bank announced that it intends to limit credit growth to 17.5 % in 2006. With a view to improving the efficiency of its minimum reserve policy, the central bank moreover expanded the definition of loans to include bonds and other debt instruments, imposed restrictions on mortgage loans, and made recommendations regarding the financial circumstances of private households for the loan-granting process.

Tight fiscal policy to continue

The general government budget ended 2005 with a record surplus of 682 mn euros or 3.2 % of GDP (2004: 1.7 % of GDP). This was attributable to the positive development of budget revenues. In this context, revenue from value-added tax, excise taxes and customs tariffs was above target on account of the robust growth of the domestic economy. Expenditure was below the level envisaged for the year. A balanced budget is planned for 2006. In light of the need to continue the rigorous austerity programme – against a background of a high current account deficit and stronger inflationary pressure – the government, in consultation with the IMF, announced that it would target a budget surplus of 3 % of GDP for 2006. Depending on the progress made in lowering the current account deficit, the government may subsequently ease its fiscal policy.

The high budget surpluses enabled the government to substantially reduce the public sector's foreign debt in 2005. Early repayments brought the level of public-sector foreign debt down from 6.6 bn euros (33.6 % of GDP) in 2004 to 5.4 bn euros (25.1 % of GDP) by the end of 2005. This is the lowest level since the beginning of the transition process. Fiscal reserves remained at high levels in 2005 despite massive repayments of foreign debt. This enabled Bulgaria again to make early debt repayments to the World Bank (191.7 mn euros) and the IMF (151.4 mn euros) in the first two months of 2006. The current year may see further debt repayments, so that public-sector foreign debt could fall to below 20 % of GDP in 2006. In light of Bulgaria's fiscal discipline, prudent debt management and imminent EU accession, the country was awarded the Investment Grade status by Moody's at the beginning of March. ■

Outlook

It is likely that the EU Commission will make a positive recommendation for Bulgaria's accession to the EU in 2007, which is expected to give a fresh impetus to the reform process. The presidential elections scheduled for the autumn could however put the ruling three-party coalition to the test. The economy is running smoothly despite adverse one-off factors and structural shortcomings in foreign trade. A rigorous fiscal policy and ongoing debt repayments are helping to improve Bulgaria's risk rating. Negative developments are the acceleration in the rate of inflation, which is however mostly a result of administrative measures and therefore only a temporary phenomenon. The imbalance in foreign trade deteriorated significantly. After rising to record levels in 2005, the current account deficit will remain in the high two-digit region in the current year before falling in 2007 due to stronger, investment-driven export capacities. Strong inflows of capital, substantial foreign exchange reserves and easier access to international financial markets at the same time facilitate the financing of the deficit.

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Croatia

Is the economy overheating?

Area: 56,538 sq. km
Population: 4.4 mn
President: Stjepan Mesić
Prime Minister: Ivo Sanader
GDP (2005): EUR 30.9 bn
Per capita GDP (2005): EUR 6,970

Political situation

As the screening process continues ahead of the opening of acquis communautaire chapters, the major topics of discussion in the political sphere are centred around policies in various areas linked to EU accession. The government at the moment finds itself in a position where it is able to rely on various partners in parliament at various times to ensure its legislative programme is adopted.

By the end of the second quarter the popularity of the government should also benefit from the payment of the first (approximately 1.2 bn kuna) of four tranches of pension debt repayments. Despite the strong fourth quarter 2005 economic growth figures and the current stable position of the government, risks to the economic growth outlook are mounting in Croatia. In the short-term, over the course of the second quarter of 2006, this should present little risk to the government. But whether this will be the case by the time general elections are due in the fourth quarter of 2007 is another issue.

Economic situation

Economic growth data for the fourth quarter of 2005 showed that the economy continued to expand robustly, at 4.8 % yoy and at 4.3 % for the whole of 2005 after recording a growth rate of only 1.8 % yoy in the first quarter of 2005. Investment activity was the main source of growth in the fourth quarter of 2005, rising to 9.9 % yoy and to 4.8 % for the whole of 2005, after having recorded a meagre growth rate of only 0.3 % yoy in the first quarter of 2005. Although inventory increases contributed 0.6 percentage points to the overall growth rate for 2005, in the second half of 2005 the run-down in the stock of inventories contributed –0.9 percentage points to growth.

Credit growth in the corporate sector accelerated 8.2 % in real terms in 2005. In the second half of the year it accelerated further to 11.8 % in real terms yoy, in part explaining the acceleration in investment activity. Over the same period credit growth in the area of households rose 17.6 % – accelerating slightly compared to the first half of the year. The deterioration in real net deposits of households slowed over the course of the fourth quarter of 2005, which was consistent with the slowing of growth in private consumption revealed by the 2005 national accounts figures. In 2005 growth of private consumption slowed to 3.4 % yoy from 3.9 % a year earlier. Last year however, government spending rose 0.8 % yoy compared to a fall of 0.3 % in 2004. Putting the investment, private and government consumption data together still leads to the same conclusion: domestic demand remains the driver of growth in Croatia.

Export success only limits worsening of external imbalance

While the domestic economy has picked up, Croatia's external imbalances, unsurprisingly, have deteriorated. In 2005 the current account deficit rose to 6.3 % of GDP from 5.1 % a year earlier. Merchandise trade data for the first two months of the year continue to show an acceleration of non-oil imports, which rose by 19.7 % yoy, compared to 11.5 % yoy in the second half of 2005. The run-down in inventories which the national accounts figures revealed in the second half of 2005 combined with the strong industrial production figures seen in the first two months of the year (+6.6 % yoy) is part of the reason behind the larger 706 mn euros February merchandise trade deficit. The other is the continued strength of retail sales which rose 5.3 % yoy in real terms in February.

Croatia – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	5.6	5.3	3.8	4.3	4.4	4.2
Industrial output (real)	5.4	4.1	3.7	5.1	5,9	5.0
Gross fixed capital formation (real)	10.1	16.8	4.4	4.8	5.5	5.0
Consumer prices (yearly average)	2.2	1.8	2.1	3.3	3.2	2.9
Unemployment (yearly average)	22.5	19.5	18.2	18.0	17.8	17.5
Budget balance (in % of GDP)	–5.1	–6.1	–4.9	–4.2	–4.5	–4.0
in EUR mn						
Merchandise exports	5,313	5,572	6,603	7,244	7,900	8,700
Merchandise imports	11,309	12,546	13,331	14,727	16,250	18,000
Current account	–2,097	–1,866	–1,447	–1,964	–2,282	–2,511
Current account (in % of GDP)	–8.3	–7.1	–5.1	–6.3	–6.8	–7.0
FDI (inflow, net)	1,195	1,788	989	1,328	1,900	1,750
Gross foreign debt (end of period)	15,055	19,811	22,781	25,508	28,400	30,750
Gross foreign debt (in % of GDP)	68.0	83.6	87.9	82.4	84.6	85.3
Import cover (in months)	5.4	5.7	5.2	4.9	4.6	4.5
Average exchange rate: HRK/EUR	7.41	7.56	7.50	7.40	7.34	7.32
Average exchange rate: HRK/USD	7.86	6.70	6.04	5.95	6.01	5.85

Sources: Bank Austria Creditanstalt Economics Department, CNB, CBS

At the same time, merchandise exports continue to perform well. When ship and oil exports are excluded from the figures to get a sense of the underlying export performance, we see merchandise exports rising in January-February 2006 by 9.1 % yoy. Given the improved survey data for the EU in the first quarter of 2006, Croatia's exporters should be able to continue recording better results into the second quarter of 2006. Nonetheless, strong domestic demand will be reflected in a higher merchandise trade deficit in the first quarter of 2006 and therefore in an increase in the current account deficit in the 12 months to March 2006 from the current 6.3 % of GDP.

Foreign debt ended the year at 25.8 bn euros of GDP, up from 22.8 bn euros at the end of 2004. That the rate of growth in foreign debt is slowing is of little consolation. For over two years the Croatian National Bank, the Ministry of Finance and the IMF have stated as a key goal the halting of the rise in the share of foreign debt to GDP. That the rate of growth has slowed is attributable to the high existing level of foreign debt rather than to a moderation in domestic demand, which, if anything in 2005 accelerated. While banks increased foreign borrowing in the first two months of 2006 by 750 mn euros to fund domestic credit activity and the government has continued to refinance its obligations in the domestic market, this does not mean fiscal policy has been calibrated to slow domestic demand.

Indeed, although the Ministry of Finance reported a budget deficit shortly above 4 % of GDP in 2005, down from 4.9 % in 2004, public debt continued to rise in 2005 to 54.0 % of GDP. In ideal economic growth conditions, which have led to initial revenue projections being exceeded and in which a strong currency and higher inflation have worked to limit the rise in public debt as a percentage of GDP, the government has still not managed to stop public debt from rising. In other words, fiscal policy continues to support domestic demand and therefore the deterioration of Croatia's external imbalances.

Inflation peaked in Q1

Inflation in January and February 2006 was slightly higher (3.9 % and 3.6 % yoy respectively) than the general trend due primarily to the impact of administered price rises: numerous local governments increased the price of water and waste disposal charges in January and February while the new recycling scheme introduced at the beginning of January has seen retailers pass on the costs to consumers in the form of higher beverage prices.

Our calculations show that core inflation in Croatia has been stable at just below 3.0 % in the four months since November 2005. With wage pressures at the aggregate level showing that real gross wages rose only 1.3 % yoy in 2005, there is little evidence that wage developments are an imminent threat to inflation. Part of the reason is that the labour market is loose, with the internationally comparable rate of unemployment slightly less than 13 % in 2005 and less than half of the labour force active, despite an acceleration of growth. As a result, we expect that the first quarter inflation figures will represent a peak in inflationary developments and that in the remainder of the year inflation will moderate. ■

Outlook

When the first quarter 2006 GDP growth figures are released at the end of June, they will almost certainly show that the economy again grew at over 4.5 % yoy. Credit growth, industrial production, seasonally adjusted retail trade data for the first two months of 2006, the construction activity index, foreign debt growth and even the employment data all point to robust growth in the first quarter. The question is how sustainable is this? By the time the second quarter 2006 growth figures are released in late September, we will have noticed a slowdown in growth, if only due to the base effect. What the second quarter of 2006 is likely to offer is more of the same in terms of strong import growth, a widening merchandise trade and current account deficit and new administrative measures from the Croatian National Bank in yet another effort to slow the growth of foreign debt accumulation. How effective they will prove is open to question. Capital inflows will remain strong, due to tourism, foreign borrowing and interest from portfolio investors, which implies a further seasonal strengthening of the currency and increase in FX reserves.

While the anecdotal evidence (less frequent T-bill auctions and lower issue sizes) suggests the Ministry of Finance is reaping the benefits of this spurt in growth through higher tax revenues, during these times of good economic growth it has not succeeded in cutting recurrent spending and continues to depend on large privatisation revenues in an effort to limit public debt. As the gap between Ministry of Finance growth forecasts and actual growth has narrowed, the scope for tax revenue surprises on the upside has narrowed. And, as growth will slow from the current 4.5–5.0 % rates in the remainder of the year, so also will revenue growth, which, since the government has not reduced recurrent spending during the good times, means that it could well be forced to exacerbate the slowdown in growth by slowing spending to meet budget deficit targets, especially in an environment of slowly, yet steadily increasing global interest rates.

Croatia's rising public and foreign debt stock implies greater exposure to external economic events and international investor sentiment. Although Croatia does benefit in terms of investor sentiment through the commencement of EU accession talks, this does not mean that it is immune to a slowdown in economic growth as global interest rates rise.

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Czech Republic

Hardly a cloud on the horizon

Area: 78,866 sq. km
Population: 10.2 mn
President: Vaclav Klaus
Prime Minister: Jiri Paroubek
GDP (2005): EUR 98.4 bn
Per capita GDP (2005): EUR 9,610

Political situation

At the beginning of February, 2 and 3 June were set as the date for the parliamentary elections. While election campaigns are still in their early stages, it is becoming clear that economic issues, especially taxation and social security, are going to be the key topics. The Social Democrats (CSSD), the senior coalition party led by Prime Minister Jiri Paroubek, aim to maintain the current tax system and continue to make gradual adjustments. Measures taken so far have included income tax reductions implemented at the beginning of 2006, which mainly benefited lower income brackets, and decisions to increase retirement pensions, the minimum subsistence level and minimum wages as well as the family allowance. After the elections the CSSD intends to substantially increase the childbirth allowance. The conservative Civic Democrats (ODS), the main opposition party, want to carry out far-reaching reforms. They are planning to introduce a flat-tax system and redesign the pension and social security systems similar to the Slovak model. Most recently, these plans have been amended and extended. New proposals include exempting food from the envisaged uniform value-added tax rate of 15 %, and granting tax exemption to self-employed persons for one year during the next legislative period. ODS promises that if it wins the election, its planned reforms would boost economic growth to a level of up to 7.5 % p.a. while also reducing the number of unemployed persons by 100,000 in the first year of their term of office, and by half over the entire legislative period.

Recent opinion polls show that there is now a considerably wider range of possibilities to form the future government, and speculation about possible coalition governments has also increased. Since the beginning of 2006, the Green Party has gained massive popular support; currently backed by 10 % of the electorate, they rank fourth. Support for the Green Party has become stronger mainly at the expense of the leading ODS (25.5 %) and of the CSSD (21 %); this means that the gap between the two latter parties is as wide as it was before. The Communists (KSCM, 12.5 %) are in third place. The only other party exceeding the five per cent mark is the Christian and Democratic Union (KDU-CSL, 6.5 %), the third party in the coalition government. Over the past few months, the KSCM has supported the Social Democrats on major legislative proposals (e. g. in the health sector and in labour law), which may suggest that the CSSD could form a minority government with indirect KSCM support. However, in view of the recent opinion poll figures this is now very unlikely.

A future major player in the automotive industry

After the investments made by Volkswagen and TPCA (Toyota, Peugeot, Citroën), Hyundai is the third large international car manufacturer to locate production facilities in the Czech Republic. Hyundai will invest between 0.8 bn euros and 1 bn euros in building a car factory at Nosovice, a town in the structurally weak region of northern Bohemia. Production is planned to start in 2008, with the plant reaching its full production capacity of about 300,000 cars per year in 2009. According to the company's plans, the workforce employed at the factory will total 3,000, with an additional 13,000 jobs being created at various suppliers and providers of services.

Czech Republic – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	1.5	3.2	4.7	6.0	5.4	4.5
Industrial output (real)	1.9	5.5	9.6	6.7	8.1	4.7
Gross fixed capital formation (real)	3.4	4.7	5.3	3.7	4.8	5.1
Consumer prices (yearly average)	1.8	0.1	2.8	1.9	2.7	2.9
Unemployment (yearly average)	9.2	9.9	9.8	8.9	8.5	8.3
Budget balance (ESA 95, in % of GDP)	–6.8	–12.5	–2.9	–2.6	–3.5	–4.0
in EUR mn						
Merchandise exports	40,713	43,055	54,091	63,001	72,010	81,160
Merchandise imports	43,034	45,239	54,932	61,658	69,920	78,610
Current account	–4,442	–5,028	–5,281	–2,080	–2,550	–3,050
Current account (in % of GDP)	–5.7	–6.3	–6.1	–2.1	–2.3	–2.5
FDI (inflow, net)	9,090	1,875	4,009	8,806	4,500	4,820
Gross foreign debt (end of period)	25,067	27,599	33,258	41,000	45,050	49,060
Gross foreign debt (in % of GDP)	32.0	34.3	38.3	41.7	41.0	40.5
Import cover (in months)	4.9	4.4	3.6	3.8	3.4	3.1
Average exchange rate: CZK/EUR	30.8	31.8	31.9	29.8	28.8	27.9
Average exchange rate: CZK/USD	32.6	28.1	25.6	23.9	23.5	22.3

Sources: Bank Austria Creditanstalt Economics Department, CNB

A memorandum on the planned investment has already been signed; the Czech Republic and Hyundai will conclude the final agreement in May.

Economic growth at an all-time high

Based on 6.9 % growth year-on-year in the fourth quarter of 2005 and the upward trends in the three preceding quarters, the Czech Republic's GDP grew by 6.0 % in 2005 as a whole, a level which marks an all-time high. Almost all of this impressive development was due to improvements in net exports. In the year as a whole, private consumption rose moderately (by 2.6 %) while the growth of gross fixed capital formation (3.7 %) was almost fully offset by stock reduction. Public consumption increased at a comparatively low rate of 0.8 % in 2005. Foreign demand ensured a sound structure of growth, with exports of goods and services rising by about 11 % while the increase in imports was less than 5 %. As a result of high energy prices, however, the unfavourable trend in the terms of trade led to a slowdown in nominal GDP growth (2005: 5.9 %) compared with the strong performance in 2004 (8.3 %). For this reason the improvement in the financial position of private households and companies was not as pronounced as the record figures in real terms would suggest.

Off to a good start in 2006

At the beginning of 2006, economic growth remained strong and may even have slightly accelerated in some areas. For example, industrial output and retail sales continued to gain momentum. The growth of output in the industrial sector more than doubled (from 6.9 % yoy in December to 15.1 % in January). Retail trade grew at a somewhat lower, yet still impressive, rate of 6.4 % in January compared with 3.7 % in December. There are indications that clearance sales and price reductions at large retail chains were among the factors driving consumption. A substantial contribution to the increase in industrial output came from the automotive sector (+40 % yoy), where the TPCA plant reached its full production capacity. Industries closely integrated with the automotive sector also achieved disproportionately strong growth: for example, output in the engineering and electric/electronic industries increased by about 20 % year-on-year.

Following the expected jump in prices at the beginning of 2006, which was mainly due to the increase in administered prices in January (1.4 % mom, 2.9 % yoy), price levels remained almost unchanged in February and March (0.1 % mom each). This suggests that there is hardly any pressure on prices on both the supply and demand sides. Declining prices for food, clothing, furniture and equipment continue to have a dampening effect on prices. The strength of the Czech currency is also curbing inflation. Having appreciated by 5 % in nominal terms in 2005 (eop), the Czech crown gained another 2 % against the euro by the end of March. The central bank has so far seen no need for action in the area of interest rates: since the end of October 2005, interest rate levels have remained unchanged, with the 2-week repo rate standing at 2 %.

Current account deficit substantially reduced

The current account deficit for 2005 was as low as about 2.1 bn euros, a significant reduction compared with the 2004 level (5.3 bn euros) both in absolute terms and as a proportion of GDP (2004: –6.1 %, 2005: –2.1 %). Most of the improvement was due to the turnaround in the balance of trade from a deficit of 840 mn euros for 2004 to a surplus of about 1,340 mn euros for 2005. The balance of transfer payments reflected the second transfer (about 230 mn euros) made by the Slovak Republic to CSOB towards the end of the year; these transfers were awarded to CSOB by an international arbitration board on the basis of the federation's breakup. The first payment was made in spring 2005. FDI inflows totalled about 8.8 bn euros in 2005, almost matching the record level of 2002 (9.1 bn euros). The privatisation of Cesky Telekom in the first half of 2005 accounted for a large portion of the total amount, but monthly inflows in the second half of the year remained relatively high as well, averaging some 500 mn euros. ■

Outlook

With the surprisingly strong increase in support among the electorate, the Green Party could tip the scales in the process of forming the future government. After all, a "grand coalition" between the CSSD and the ODS, though not explicitly ruled out, is not an attractive option for both parties. With a basically liberal outlook, the Green Party is probably closer to the ODS, making a three-party coalition including the Christian and Democratic Union more likely than a coalition in which the CSSD would be the senior partner. It seems almost certain that an ODS-led coalition government would be more likely to carry out fiscal and social-policy reforms than a coalition led by the CSSD, but it would give lower priority to joining the euro area in 2010. The Czech economy's growth prospects 2006/2007 remain good. New production capacity in the automotive industry and larger investment spending in the EU will continue to benefit Czech exports. The favourable development of foreign trade in the early part of the year (surpluses in the balance of trade and the current account) is pointing in this direction. Even if foreign demand weakens later in the year, GDP growth in the Czech Republic will not necessarily follow suit. At the current stage of the business cycle, we in any event expect a shift from foreign demand to domestic demand. Barring any external shocks, the Czech economy is not likely to be exposed to any major risks. One of these risks relates to the country's budget policy: social expenditure will rise considerably in two steps, from the middle of 2006 and from 2007 on. High GDP growth could then increase inflationary pressure. But for the time being, we maintain our forecast of just over 2.5% for the average inflation rate in 2006. On a monthly basis, price levels will remain relatively stable; it will not be before the end of 2006 that the underlying effect of higher inflation rates – driven by oil prices – at the end of the previous year will result in lower CPI increases.

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Hungary

Election promises in contrast to actual budget situation

Area: 93,033 sq. km
Population: 10.1 mn
President: László Sólyom
Prime Minister: Ferenc Gyurcsány
GDP (2005): EUR 87.8 bn
Per capita GDP (2005): EUR 8,700

Political situation

The Socialist Party of Prime Minister Gyurcsány emerged as the clear winner from the two ballots of the parliamentary elections on April 9th and 23rd. The present coalition government of the Socialists and the Alliance of Free Democrats obtained 209 of the 386 seats in the new parliament. Thus, for the first time since the political turnaround a government was confirmed in office by the electorate. The next few weeks will show under which conditions the coalition will continue and whether any changes will be made in respect of the members of the government.

In the next few months, the government will focus on further consolidating the budget. Prime Minister Gyurcsány promised a reform policy without any hardships. Therefore, it is expected that the government will continue to be rather cautious with regard to reducing the budget deficit, particularly since the local elections scheduled for the autumn will not be conducive to rapid reforms.

Economic situation

Hungary experienced another year of considerable economic growth. After being weak at the beginning of the year, economic activity picked up considerably in the course of 2005. In the final quarter, the economy grew at a seasonally adjusted rate of 1 % compared with the previous quarter, which permitted year-on-year GDP growth of 4.1 % in 2005 as a whole. Strong foreign demand was the main engine of economic growth. At more than 10 %, export growth in real terms was almost twice as high as import growth. While investments, despite declining considerably towards the end of the year, rose by 6.6 %, the decrease in public consumption due to fiscal restraint and moderate growth of private consumption accounted for the relatively small contribution of domestic demand to GDP growth.

In the first months of the current year, there have been increasing signs that Hungary's economy is continuing to grow substantially. Supported by brisk foreign demand, industrial output rose by more than 10 % in real terms from January to March. At the same time, private consumption is slightly reviving, which is shown by the most recent retail trade figures. Although parliamentary elections may have contributed to the restraint of private investors, a GDP growth of even about 5 % year-on-year is expected in the first quarter on the basis of the available key indicators.

A continuation of the favourable export trend is expected due to improved economic prospects for important EU markets. While investment activity will be less strong than last year even after the elections due to higher real interest rates, private consumption will stimulate domestic demand as a result of changes in VAT and income tax rates. Therefore, slightly stronger economic growth than in 2005 is anticipated this year.

We assume that the new government will take initial measures to consolidate the public budget already at the beginning of the second half of the year, which will still have a dampening effect in the last months of the year, but above all in 2007, as a result of the restrained development of consumption. Moreover, we expect that the global economy will support growth a little less next year. This adverse impact on economic developments will not

Hungary – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	3.8	3.4	4.6	4.1	4.2	3.8
Industrial output (real)	2.8	6.4	8.3	7.3	8.1	6.7
Gross fixed capital formation (real)	9.3	2.5	8.4	6.6	5.0	6.5
Consumer prices (yearly average)	5.3	4.7	6.8	3.6	2.1	2.7
Unemployment (yearly average)	5.8	5.9	6.1	7.2	7.1	6.8
Budget balance (ESA 95, in % of GDP)	–8.4	–6.4	–5.4	–6.1	–5.5	–4.1
in EUR mn						
Merchandise exports	36,821	38,377	45,083	49,794	55,990	61,800
Merchandise imports	39,024	41,275	47,536	51,343	57,220	62,920
Current account	–4,929	–6,382	–6,976	–6,405	–6,150	–6,130
Current account (in % of GDP)	–7.1	–8.7	–8.6	–7.3	–7.0	–6.5
FDI (inflow, net)	2,889	424	2,860	4,271	4,000	3,500
Gross foreign debt (end of period)	39,021	47,627	56,972	68,002	72,000	75,000
Gross foreign debt (in % of GDP)	56.0	64.7	70.2	77.4	82.4	79.4
Import cover (in months)	2.8	2.9	3.1	3.2	3.2	3.1
Average exchange rate: HUF/EUR	243.0	253.5	251.7	248.0	265.0	261.0
Average exchange rate: HUF/USD	258.0	224.4	202.6	199.7	216.9	208.8

Sources: Bank Austria Creditanstalt Economics Department, NBH, KSH

be completely offset by improved prospects for investments, which will benefit from more funds being allocated to Hungary within the framework of the financing limit for 2007–2013 recently accorded by the EU, so that GDP growth will probably not reach the 4 % mark next year.

How deep will the cuts be?

The question mark over future budget policy constitutes a considerable factor of uncertainly for this economic scenario. Both major parties made generous election promises during the election campaign. The implementation of all these election promises (e. g. cuts in tax rates and social security contributions, increase in pensions, higher expenditure for infrastructure development) would further aggravate the strained fiscal situation, so that the confidence of investors and thus ultimately the stability of the economy would be put to an acid test. Irrespective of the actual composition of the government, we therefore expect that the government will pursue a retrenchment policy in the next few months, since there is also pressure on the part of the EU due to the fact that a newly adapted convergence programme, which is in line with the Growth and Stability Pact, has to be drawn up by September. Due to the statements made during the election campaign it can however be expected that the government will not pursue a particularly tough consolidation course. We assume that a reduction of the budget deficit in relation to GDP by approximately one percentage point annually will be the most probable scenario. This means that, after a budget deficit of 6.1 % of GDP (already adjusted for pension costs) last year, the government is likely to adhere to its reduction of the budget deficit to 5 % of GDP in 2006. In the first three months of this year, the budget deficit was slightly higher than planned. We therefore also anticipate a slightly higher budget deficit of more than 5 % of GDP for 2006 as a whole. As a result of the presumably rather slow budget consolidation it can be expected that the introduction of the euro envisaged for 2010 may at least be delayed to 2012 due to the belated fulfilment of the Maastricht criteria.

Weaker forint checks declining inflation trend

Based on a year-on-year comparison, the inflation rate dropped to 2.3 % in March, down from 2.5 % in February and 2.7 % in January. The cut in value-added tax by 5 percentage points to 20 % at the beginning of the year dampened inflation, but it reduced inflation somewhat less than we had originally anticipated, since especially in the services sector the tax cut was probably not passed on completely to consumers.

In the short term we expect – supported by a carry-over effect – that inflation will continue to fall to below the 2 % mark. As food prices were high in the first months of the year owing to weather conditions, we expect that this group of products, weighted at almost 20 % in the basket of goods, will significantly support the declining inflation trend until the summer. In the medium term, however, inflationary risks have increased markedly. Although core inflation is at a very low level, amounting to 0.6 % year-on-year in the first quarter, it again tends to rise now for the first time in six months. In addition, the development of the inflation rate responded to the recent weakening of the forint against the euro. In March and April, the forint was quoted almost 7 % lower on average than in the same period of the prerious year.

As a result of the increase in the key interest rates in the US and in the EU, the interest rate differential to growth markets such as Hungary has narrowed, which has triggered corresponding capital movements in the markets, putting the forint under considerable downward pressure in recent months. The by regional standards not very favourable fundamentals, which are represented by the high twin deficit, i.e. budget deficit and current account deficit, make the forint particularly vulnerable, and due to the presumably rather slow budget consolidation no reversal in the trend but perhaps a stabilisation of the exchange rate can be expected. In such a scenario it is increasingly likely that the central bank will push interest rates upwards. At any rate, further interest rate reductions are not intended for the time being.

At present we forecast an average inflation rate of 2.1 % for 2006. Next year, however, once the curbing impact of the tax cut on inflation disappears, we can expect inflation to rise to at least 2.7 %, with the future fiscal policy and its influence on aggregate demand being a risk factor which is difficult to assess. ■

Outlook

Irrespective of its concrete composition, the new government will be faced with the dilemma that on the one hand it at least will have to attempt to keep the promises made during the election campaign in order not to disappoint its voters, and on the other hand take measures to consolidate the budget, which will strengthen the confidence of the markets in a sustained stable development of Hungary's economy. In our opinion, a presumably rather restrained retrenchment policy will lower the budget deficit only slowly towards the Maastricht ceiling of 3 % of GDP. Therefore, it is likely that the introduction of the euro envisaged for 2010 will be delayed. Due to the continuation of the moderate budget consolidation policy the economy will lose some momentum, but a sharp downturn is not expected. Under favourable external conditions, GDP growth of up to 4 % will be possible in the forecast period. In spite of the decline supported by the reduction in VAT, the development of inflation will be the focus of interest this year, for the inflation rate has been unintentionally boosted as a result of the depreciation of the forint in recent weeks. In the present difficult macroeconomic environment, which is characterised by a marked twin deficit, it becomes more important for the government to strike a prudent balance between fiscal policy and monetary policy, in particular with regard to interest rate decisions, in order to ensure stable economic developments.

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Poland

Cyclical upturn

Area: 312,685 sq. km
Population: 38.2 mn
President: Lech Kaczynski
Prime Minister: Kazimierz Marcinkiewicz
GDP (2005): EUR 242.8 bn
Per capita GDP (2005): EUR 6,360

Government reshuffling

Poland's internal politics is dominated by the contest between "Law and Justice" (PiS) led by the Kaczynski brothers and the "Civic Platform" (PO). The inclusion of "Self-Defence" (Samoobrona, SO) in the government is one stage of this conflict, which will presumably be rather limited in time. It ensures a majority in parliament and thus strengthens PiS by increasing its room for manoeuvre while at the same time furthering the internal disintegration process of Samoobrona. The electorate of Samoobrona will find it hard to put up with the role of its chairman Andrzej Lepper of supporting the government, particularly since the leeway for concessions is rather narrow. The call of Samoobrona for higher budgetary expenditure and less independence of the central bank and its distinctly sceptical attitude towards the EU will further exacerbate the political controversies at home and abroad. It is likely that government reshuffles or new elections will be a recurrent feature. But the economy is at such a favourable stage at present that adverse political circumstances will hardly affect the upswing in the short and medium term.

Investments are picking up

At 3.2 % in real terms, Poland recorded a somewhat slower GDP growth in 2005 than in 2004, when it joined the EU. The weaker growth was however concentrated on the beginning of the year. Since the second quarter an acceleration can be observed again, driven by investment. Although fixed capital formation adjusted for inflation "only" exceeded the figure of the previous year by 6.2 % in 2005 as a whole, it already rose by 9.9 % yoy in the fourth quarter and by an exceptionally high seasonally adjusted 5.7 % compared with the preceding quarter. Thanks to the high liquidity of companies, increasing consumer demand and continued strong exports, investments will continue to soar again this year, although perhaps somewhat dampened by uncertainties about economic policy. We expect an increase in gross fixed capital formation of 8 % in real terms in 2006. Construction projects induced by the government (and partly financed by the EU) should also keep investments high (at 9–10 %) in 2007.

Low current account deficit

Since exports rose by 16.5 % in euro terms, while imports went up by only 12.3 %, Poland's foreign trade deficit decreased by half from 4.6 bn euros in 2004 to 2.3 bn euros in 2005. The current account deficit narrowed from 8.4 bn euros or 4.1 % of GDP to 3.9 bn euros or 1.6 % of GDP. Exports of foodstuffs and chemical products rose particularly sharply. As far as imports are concerned, energy imports above all recorded an increase (caused by higher prices). After booming in 2004, when Poland joined the EU, imports of motor vehicles and plant and machinery were rather low. The high investments of 2005 were evidently mainly made by using domestic products and services. Due to further increasing consumer and investment demand, a slight widening of the current account deficit is to be expected in 2006, but it should remain below 2 % of GDP.

Inflation at a record low

At the beginning of 2006, Poland recorded the lowest inflation rate of all EU mem-

Poland – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	1.4	3.8	5.3	3.2	4.6	4.7
Industrial output (real)	1.1	8.4	12.6	4.0	8.7	7.3
Gross fixed capital formation (real)	–6.8	–0.1	6.3	6.2	8.2	9.6
Consumer prices (yearly average)	1.9	0.8	3.5	2.1	1.3	2.5
Unemployment (yearly average)	20.0	20.0	19.1	18.2	17.3	16.6
Budget balance (ESA 95, in % of GDP)	–3.3	–4.8	–3.9	–3.8	–4.2	–5.1
in EUR mn						
Merchandise exports	49,338	53,836	65,847	76,740	88,520	98,610
Merchandise imports	57,039	58,913	70,399	79,070	90,710	104,710
Current account	–5,404	–4,109	–8,401	–3,900	–5,580	–8,610
Current account (in % of GDP)	–2.6	–2.1	–4.1	–1.6	–1.9	–3.1
FDI (inflow, net)	4,371	3,660	10,070	6,920	6,910	7,430
Gross foreign debt (end of period)	81,046	83,705	94,035	105,790	109,530	114,250
Gross foreign debt (in % of GDP)	38.7	43.7	46,2	43.5	40.6	41,7
Import cover (in months)	5.7	5.3	4.0	4.8	4.2	3.7
Average exchange rate: PLN/EUR	3.85	4.40	4.53	4.02	3.82	4.02
Average exchange rate: PLN/USD	4.08	3.89	3.64	3.23	3.14	3.22

Sources: Bank Austria Creditanstalt Economics Department, Statistical Office of Poland, National Bank of Poland

ber states. Measured by the harmonised consumer price index, prices went up by only 0.9 % in January over the previous year, compared to an average increase of 2.5 % in the EU. According to Poland's national calculation, in which foodstuffs carry a greater weight, inflation amounted to only 0.4 % yoy in March 2006. Thus the inflation rate is markedly below the lower limit of the inflation target range set by the National Bank of Poland at 2.5 % +/– 1 %. The low inflation rate was attributable to the decline in prices of clothing and foodstuffs. In case of clothing, the low inflation rate is above all due to imports from China and the strong zloty at the beginning of the year. In case of foodstuffs, a decline in prices after the strong increase in 2004 and 2005 are responsible for the low inflation rate. Although a rise in inflation is to be expected in the next few months, the upward pressure on prices is likely to remain moderate as a result of sufficient production capacities and the inflation rate will probably not exceed the 2.5 % mark during 2006.

Increasing employment

After employment in the corporate sector had declined since 1999, it again started to rise for the first time (by 1.9 %) in 2005. In March 2006, it exceeded last year's figure by 2.7 %, growing most rapidly in those sectors in which the CEE countries are comparatively strong: employment rose by 8 % in the car industry, by 7 % in the production of electrical appliances and by almost 5 % in the production of furniture (where Poland is particularly strong), while employment declined in the mining (–2 %), textile and clothing industries (–5 %) and in the electricity sector (–4 %). For the first time since 2002, the unemployment rate is likely to fall below a still substantial 18 % on average in 2006. Since mid-2005, real wages have also shown an increase, rising by 4.1 % in the corporate sector in February 2006 compared to February 2005.

Contentious fiscal policy

On March 1st the EU Commission published its assessment of the January update to the Polish convergence programme. The Commissioner for Economic and Monetary Affairs, Joaquin Almunia, declared that although the fiscal results in 2004 and 2005 were better than expected, the programme is not geared towards following a path of adjustment that would be sufficient for reducing Poland's excessive deficit in 2007 or even 2008. On July 5th, 2004 the Council specified 2007 as the target year. The Commission also fears that the pension reform is being undermined because of the special treatment accorded to various groups in the population, such as the miners, and the deficits will therefore exceed the target.

At any rate, there are heated discussions on fiscal policy. Finance Minister Zyta Gilowska advocates a lowering of pension contributions from 13 % to 10 % instead of the reform of income tax promised by the PiS during the election campaign. The reduction of incidental wage costs is considered by her to be more important for future economic growth than tax relief. She aims at reducing the budget deficit by 0.5 % of GDP in 2007. It remains to be seen whether she will succeed with these proposals. Introducing the euro is at present not a priority of the Polish government, so that the intention to put the budget on a sound footing may be of secondary importance in comparison with current political considerations.

At the beginning of a growth cycle

After a lean period at the beginning of the decade, the boom of 2004, which was caused by EU accession and related advanced purchases and investments, and then somewhat weaker growth in 2005, the conditions for Poland's economy are now extremely favourable for sustained strong economic growth. Inflation and the foreign trade deficit are low and investments and employment are picking up. The interest rate level is low by Polish standards (the 3-month interbank rate stands at 4 %). Although the series of interest rate reductions has ended, strong increases are not in sight. In view of the relatively small interest-rate differential with regard to Western Europe and the US and continued political imponderables, the zloty will depreciate against the euro quite a bit in the next two years from 3.86 at year-end 2005. We expect a zloty/euro exchange rate of 3.95 at year-end 2006 and 4.10 at year-end 2007. This will strengthen the export sector. Wages are rising, which will support consumption, but their level is still low enough in order not to jeopardise Poland's competitiveness. This situation is a classical characteristic of the fact that the economy is at the beginning of a growth cycle. ■

Outlook

Without any serious adverse effects from outside, the prospects for Poland's economy are very good. We expect GDP growth of between 4 % and 5 % both in 2006 and in 2007. There should be little threat from abroad. Both foreign demand and – thanks to increasing price-setting power by Polish exporters – the terms of trade will develop favourably. In addition, Poland can expect net transfer payments from the EU in the amount of 3 %–4 % of GDP annually. Even if it utilises only half of these funds, this will strongly support growth. Even if the government does not pursue an optimum economic policy, this will hardly affect Poland's economy under these circumstances in the medium term. A long-term success would however require a stronger orientation towards the euro, the avoidance of striking a too nationalistic note and a further acceleration of the transfer of technology and management by increasingly opening the country vis-à-vis Europe and the world, thus quickly achieving a further improvement in productivity.

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Romania

In a labyrinth of reforms

Area: 238,391 sq. km
Population: 21.6 mn
President: Traian Basescu
Prime Minister: Calin Popescu-Tariceanu
GDP (2005): EUR 79.3 bn
Per capita GDP (2005): EUR 3,660

Political situation

Romania's domestic and foreign policies are currently focusing on the preparations for EU accession, with particular attention being given to the areas criticised by the EU Commission in its last progress report. These include the reform of public administration and the judiciary, as well as the need to fight corruption. Romania seems to be throwing much of its energy into the latter area, a fact which is reflected in some high-profile cases at the highest political level. In mid-May, when the EU Commission presents its new monitoring report on Romania and makes a recommendation on the application of the protective clause included in the Accession Treaty, it will be known to what extent Romania's efforts have convinced the EU Commission. However, it is very likely that the Commission will give Romania the green light for EU accession on 1 January 2007 following the country's most recent reform successes, whilst probably imposing further requirements on Romania. The ratification process in the EU member states has in the meantime been making more headway. The parliaments of 16 of the 25 member states had approved Romania's accession to the EU by mid-April.

Economic situation

The Romanian economy lost much of its momentum in 2005 despite a relatively strong final quarter. Economic growth in 2005 slowed to 4.1 % after a revised growth rate of 8.4 % in the previous year. Besides a strong base effect the slowdown is explained on the production side by weak growth in industrial output (+2.5 %) attributable to various causes such as production losses as a result of the floodings, weaker foreign demand, and more competitive imports due to the appreciation of the leu. A further reason for the slowdown was the slump in agricultural output (–13.9 %) in the wake of the severe floodings in the spring and summer of 2005. Factors which supported economic growth were – on the back of strong growth in mortgage loans and the renovation work needed after the floodings – a booming construction industry (+9.9 %) and a rapidly expanding services sector (+8.1 %). On the demand side, domestic demand remained the most important growth component in 2005. Private consumption, though slightly slower than in 2004 (+12.9 %), remained robust at +9 % in real terms on account of strong credit growth (corporates: +31.3 %, households: +80 %), strong growth in real wages (+7.4 %) and the income effects of the 2005 tax reform. The unabated high consumption propensity of the population was also reflected in the dynamic growth of retail trade, which at +17.6 % matched the growth rate of 2004. Gross fixed capital formation gained momentum partly due to the substantial progress in the restructuring and privatisation of the corporate sector, and expanded by +13 %, which should boost industrial output in 2006. Public consumption grew at a much more moderate +4.9 %. In light of the strong import pull (+17.2 %) prompted by strong domestic demand and the appreciation of the leu, coupled with weaker export growth (+7.6 %), net exports were again strongly negative in 2005.

We expect more buoyant economic growth for 2006, based on continued robust FDI-driven investment activity and stronger inventory investments in the run-up to EU accession – despite a slight slowdown in private consumption as a result of a more

Romania – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	5.1	5.2	8.4	4.1	5.6	5.5
Industrial output (real)	4.3	3.1	5.3	2.0	4.5	3.7
Gross fixed capital formation (real)	8.2	8.6	10.8	13.0	13.5	12.5
Consumer prices (yearly average)	22.5	15.3	11.9	9.0	7.5	6.2
Unemployment (yearly average)	10.2	7.6	6.8	5.8	5.7	5.5
Budget balance (in % of GDP)	–2.5	–2.2	–1.2	–0.8	–1.0	–1.5
in EUR mn						
Merchandise exports	14,675	15,614	18,935	22,255	26,000	30,000
Merchandise imports	17,427	19,569	24,258	30,061	36,000	42,000
Current account	–1,623	–3,060	–5,099	–6,891	–9,000	–10,000
Current account (in % of GDP)	–3.4	–5.8	–8.4	–8.7	–9.6	–9.3
FDI (inflow, net)	1,194	1,910	5,127	5,208	8,000	5,000
Gross foreign debt (end of period)	16,200	17,835	21,708	30,511	36,500	44,500
Gross foreign debt (in % of GDP)	33.4	33.9	35.8	38.5	39.0	41.3
Import cover (in months)	3.5	3.4	4.8	5.9	6.4	6.2
Average exchange rate: RON/EUR[1)]	31,255	37,556	40,532	3.62	3.48	3.39
Average exchange rate: RON/USD[1)]	33,055	33,200	32,637	2.91	2.83	2.71

Sources: NBR, NIS, Bank Austria Creditanstalt Economics Department *1) Redenomination of the leu as of 1 July 2005*

moderate wage policy and the central bank's measures to curb credit growth. At the same time, the imbalance of the growth components with domestic demand as the key engine of growth will persist.

Current account deficit widens

The continued dynamic expansion of domestic demand once again resulted in a high current account deficit in 2005. Last year the deficit widened to 6.9 bn euros or 8.7 % of GDP from an already significant, revised figure of 5.1 bn euros or 8.4 % of GDP in 2004. The deterioration is largely explained by the growing imbalance in the traffic of goods. Strong demand for consumer and capital goods, boosted partly by the exchange rate, was reflected in strong import growth, while exports grew at a more moderate rate. This trend is attributable to weaker demand for exports, in particular for textile, metal and chemical products, and to the reduced competitiveness of exports in light of rising unit labour costs due to the appreciation of the leu and a strong rise in wages. The pressure on the current account was mitigated by the current transfer payments (e. g. workers' remittances, EU transfers), which rose considerably in 2005 by almost 700 mn euros to 3.7 bn euros.

The financing of the current account was facilitated by net inflows of foreign direct investment totalling 5.2 bn euros. This year, inflows of FDI will probably again exceed the record level of the previous year due to significant privatisation proceeds (e. g. BCR). This is essential because the current account deficit is likely to deteriorate further in 2006 as a result of the continued strength of the leu, the more robust demand for capital goods and the anticipated effects of accelerated purchases of consumer and capital goods in the run-up to EU accession. Any financing concerns will however also be eased by the record level of foreign exchange reserves. These rose from 10.8 bn euros in 2004 to 16.8 bn euros in 2005 mainly as a result of the central bank's interventions on the foreign exchange market against the leu and continued to climb to 18.1 bn euros until the end of March 2006, primarily due to the higher minimum reserve ratio for the foreign exchange liabilities of commercial banks. The import cover ratio improved from 4.8 months in 2004 to 5.9 months in 2005 in line with the rise in foreign exchange reserves. The high financing requirement for the catching-up process also led to a marked increase in the country's foreign debt to 30.5 bn euros in 2005 (2004: 21.7 bn euros), but at 38.5 % of GDP this was not a cause of concern (2004: 35.8 %).

Inflation – a predicament

The growing inflationary pressure discernible in Romania in the final months of 2005 carried over into the beginning of 2006 – especially on account of significant adjustments to controlled prices. In response to the further increase in prices, the central bank again tightened monetary policy so as not to entirely lose sight of its ambitious inflation target of 5 % with a tolerance margin of +/–1 % at year-end 2006 and to protect the credibility of its policy. After lowering interest rates for almost two years, the central bank again raised the policy rate by 100 basis points to 8.5 % on 8 February 2006. It also announced that it would continue its far-reaching measures involving the sterilisation of excess liquidity through open market operations. In order to increase the effectiveness of interest rates as a monetary policy tool and with a view to curbing the strong expansion of foreign currency loans (and reducing the attendant inflationary pressure and risk of loan losses), the central bank raised the minimum reserve requirement on foreign exchange-denominated liabilities held by banks from 35 % to 40 % commencing with the maintenance period 24 March – 23 April. Depending on the effectiveness of these measures, further restrictive measures may be taken in the course of the year; their dampening impact on economic growth is however likely to be limited in light of the strong competition in the banking sector.

After the recent increase in interest rates, the central bank's dilemma in regard to the need to continue the disinflation process whilst avoiding any destabilising speculative inflow of capital will probably become more acute. The increase could prompt further stronger inflows of capital. While this may make it easier to combat inflation through the faster appreciation of the leu, it would also further impair Romania's ability to compete successfully on international markets. This year, too, the central bank's biggest challenge will be to find a balanced mix of monetary and exchange rate instruments to bring down inflation and maintain Romania's international competitiveness. ■

Outlook

With the EU Commission's decision in May 2006, Romania's dream of becoming a member of the EU will probably be a reality on 1 January 2007, but the reform process must continue without interruption, not only in the segments criticised by the Commission, but also in the area of macroeconomic stabilisation. In 2005, the economy turned in a performance that was below its potential, partly due to special factors, but also on account of growing structural deficits (e. g. weak industrial output, disparities in foreign trade). The downward trend in inflation has also slowed due to both supply and demand-side factors. This has created a conflict of interests for the central bank, which has to be careful not to lose sight of its inflation target, whilst maintaining Romania's international competitiveness with an eye on exchange rate developments; a situation which makes it more difficult to combat inflation. The central bank's dilemma and signs of a policy-mismatch first and foremost call for a disciplined fiscal and wage policy. The need to fine-tune the catalogue of economic measures and instruments should however not obscure the continued sound economic outlook.

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Russia

Guarantor of global energy security?

Area: 17 million sq. km
Population: 143 mn
President: Vladimir Putin
Prime Minister: Mikhail Fradkov
GDP (2005): EUR 605.7 bn
Per capita GDP (2005): EUR 4,230

15 years Yedinaya Rossiya?

"Yedinaya Rossiya" would have to remain the dominant party for at least 10–15 years so that neither "oligarchic" nor "national-isolationist" groupings can cause Russia to stray from its path toward "sovereign democracy", Vladislav Surkov, deputy head of the presidential administration said at a seminar of the pro-Putin "Yedinaya Rossiya" (United Russia) party. It may be assumed that his position paper summarises the thinking prevailing in broad sections within the Kremlin, the "Yedinaya Rossiya" party, and the Russian population – possibly a bit exaggerated in its grandeur but nonetheless pointing the way.

The "oligarchic groupings" are the politicians and economic magnates who in the first half of the 90s "replaced competition with corruption", who carried out privatisations by doubtful means and utterly disrupted the Federation's relations with the republics. "National-isolationist" groupings refers to extreme nationalists, but also to the "Rodina" (Motherland) party, the only significant opposition party besides the Communists. It is evidently intended to weaken the Rodina sufficiently by the time Putin is succeeded in 2008 so that it does not constitute an element of uncertainty. According to Surkov, the dangers currently faced by Russia come from terrorism (especially in the Caucasus), "orange techniques" as practised in the Ukraine and Georgia, and from inadequate economic competitiveness.

Sovereignty as a means of competitiveness

Surkov stressed that in order to improve the competitiveness of the economy, one would have to enhance Russia's strengths. This in particular conforms to the concept of Russia as a key energy power, he stated. Surkov is following President Putin in this respect, who, at the G8 meeting chaired by Russia, stated that his country would like to be the guarantor of global energy security.

Other areas to be developed are space exploration, the armaments industry, transport and telecommunications, Surkov said. Russian companies should also participate in the development of global information networks. The fuels-based energy sector, strategic communication, the banking sector and the defence industry must remain in Russian hands. The other sectors should be opened to foreign investors so that they can be modernised. Sovereignty should not be understood to mean a Russian stronghold, but Russia should protect its interests rather than merely act as a "security service for foreign pipelines passing through Russia". Other countries would also protect their national interests, this is part of normal business practice; and in this sense "sovereignty is the political synonym for competitiveness".

Russia should also participate in the global economy through multinational companies, Surkov continued. Gazprom already has concrete plans in this direction: according to media reports, Gazprom intends to acquire an interest in a broader range of gas supply and gas storage and gas marketing companies in the EU. Gazprom allegedly has started negotiations with its German partners E.ON and Wintershall for the acquisition of a part of their local sales operations.

New milestones

Enhancing "sovereignty" has made further progress recently: at the initiative of the

Russia – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	4.7	7.3	7.2	6.4	5.8	5.2
Industrial output (real)	7.0	7.0	7.3	4.3	5.3	5.6
Gross fixed capital formation (real)	3.0	12.8	10.8	10.5	10.8	11.8
Consumer prices (yearly average)	15.8	13.6	10.9	12.7	9.5	7.8
Unemployment (yearly average)	8.0	8.4	8.2	7.6	7.3	6.9
Budget balance (in % of GDP)	1.0	1.4	4.5	7.0	5.0	3.0
in EUR mn						
Merchandise exports	113,413	120,012	147,187	195,390	221,950	235,910
Merchandise imports	64,439	66,603	77,238	99,990	121,400	144,930
Current account	30,775	31,701	48,136	66,070	68,550	58,090
Current account (in % of GDP)	8.4	8.3	10.3	10.9	9.4	7.0
FDI (inflow)	3,658	7,026	9,380	17,810	10,870	9,330
Gross foreign debt (end of period)	161,927	160,777	165,724	189,930	196,870	200,270
Gross foreign debt (in % of GDP)	44.3	41.9	35.4	31.3	27.0	24.0
Import cover (in months)	6.3	9.0	11.5	13.5	15.6	15.1
Average exchange rate: RUB/EUR	29.7	34.7	35.7	35.2	33.9	33.8
Average exchange rate: RUB/USD	31.4	30.6	28.7	28.3	27.9	27.0

Sources: Bank Austria Creditanstalt Economics Department, Federal State Statistics Service, CBR

government, Russia's leading aircraft manufacturers are to be combined. The military and civil aircraft manufacturers Tupolev, Ilyushin, Irkut, the Yakovlev Design Bureau, Sukhoi and MiG are to be united within the "United Aircraft Manufacturing Company (Obyedinyonnaya Aviastroyitelnaya Korporaciya, OAK)". At least 75 % of the shares in the new company are to be held by the state. The United Aircraft Manufacturing Company is to become one the world's five-largest aviation companies by 2013.

The state-owned Russian foreign trade bank (Vneshtorgbank, VTB) is to go public. The VTB Group is one of Russia's fastest-growing banks and is being developed by the state into a second pillar to complement the state-owned Sberbank. Russia's second-largest bank wants to place about one quarter of its capital in London and Moscow by the first quarter of 2007; the proceeds are to be used to finance the bank's expansion abroad. VTB acquired the central bank's foreign equity interests, which include Moscow Narodny Bank in London, Ost-West-Handelsbank in Frankfurt, Eurobank in Paris and Donaubank in Vienna.

With the purchase of an 11 %–13 % interest in the diamond company Alrosa, which is currently held by minority shareholders, the Federation is to become the company's majority shareholder. It is rumoured that this will be followed by a merger with Norilsk Nickel, the world's largest producer of nickel and platinum, giving the state control over this company, too.

Our previous edition of CEE Report included an account of Lada manufacturer AvtoVAZ, Russia's largest automobile company which was recently acquired by the state-owned arms trading company Rosoboronoexport. AvtoVAZ is now expecting to receive generous state support for investments in the construction of a new assembly plant in Togliatti.

Going East

Oil and gas are however the Russian state's key tools for enhancing its position at a national and international level. 34 % of the world's gas supplies and about 13 % of global oil reserves are on Russian territory. Russia is the world's largest exporter of gas and the world's second-largest exporter of oil. In the years 2000–2004 Russia recorded the largest increase in oil production among the world's major oil producing countries. After regaining key positions in the oil industry (Yukos, Sibneft), the state is now pursuing a policy of diversification toward the East. More than 60 % of the value of Russia's energy exports are currently going to the EU. Energy supplies to the US also have considerable potential. Autumn 2005 saw the first oil shipments from the Sakhalin-1 oilfield and the first Gazprom liquid gas shipments to the US. Cooperation in conjunction with the Shtokman project is under discussion. Japan is participating in the Sakhalin-1 and Sakhalin-2 projects and has expressed interest in participating in the construction of the Eastern Siberia – Pacific Ocean oil pipeline system. An agreement concluded during Vladimir Putin's visit to China in March 2006 foresees the construction of a gas pipeline to China. According to Energy Minister Khristenko, deliveries are to commence in 2011, with delivery capacity reaching 30 to 38 billion cubic metres of gas per annum by 2020. India is also very interested in cooperating in such projects; it has been given the prospect of concrete discussions when the G8 summit takes place in St. Petersburg in July.

Substantial foreign financing

Investments and the financing of takeovers require substantial funding by Russian companies. A substantial portion of these funds is raised abroad. The foreign debt of the corporate sector consequently increased by US dollar 50 bn to US dollar 126 bn in 2005. Notwithstanding a decline in the Federation's foreign debt, partly as a result of early repayments of Paris Club debt, total foreign debt rose by US dollar 44 bn to US dollar 259 bn. Despite the unabated high level of capital exports, both legal and illegal, the country's foreign exchange reserves rose by US dollar 61 bn to US dollar 182.2 bn at the same time. As of the end of the first quarter of 2006, they totalled already as much as US dollar 206 bn. Given the strong inflow of foreign capital, the country's monetary policy is faced with the dilemma of allowing a substantial appreciation of the rouble or, as sufficient means are not available for a sterilisation, permitting a ballooning of the money supply. At present, the central bank would seem to settle for a stronger rouble. ■

Outlook

Russia's GDP grew by 6.4 % in 2005. While price-adjusted export growth weakened and amounted to only 6.3 % (with imports growing by 17.3 %) compared to 10 %–12 % in the three preceding years, private consumption expanded by 11 % and capital investment by 10.5 %. If Russia wants to implement its strategy "Guarantor of global energy security" – and by all appearances this seems to be the case – investment needs to grow even faster in light of the gradual depletion of the West Siberian oil fields. This will require considerable funding by the corporate sector to finance the investments, especially given the continuing price controls for energy and transport. The corporate sector can receive part of the necessary funds via cooperations with foreign companies, but the bulk of the money will probably be raised on the domestic and especially foreign capital markets. The rapid growth in the foreign debt of large companies is therefore likely to continue. This could adversely affect the companies' solvency if the oil price were to fall. On the other hand, there are ways in which revenues of the large companies can be boosted: by permitting prices to rise faster after the elections of 2007 and 2008 or by making funds available via the Stability Fund (which totalled US dollar 45 bn at the end of 2005). At present, developments appear to be fairly stable, however. The oil price is likely to remain high, as is investment growth. In view of the growing difficulties in increasing production of oil and gas, GDP growth is likely to weaken slightly in the coming years, but will remain at 5 %–6 %. There are no signs of any major political turbulence. "Yedinaya Rossiya" will probably remain in power for the time being – even if perhaps not for 15 years – and 2007 will see measures being taken for a relatively problem-free succession to Putin.

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Area: 49,034 sq. km
Population: 5.4 mn
President: Ivan Gasparovic
Prime Minister: Mikulas Dzurinda
GDP (2005): EUR 37.3 bn
GDP per capita (2005): EUR 6,930

Slovakia

Change of political direction despite the boom?

Political situation

Parliamentary elections in Slovakia will take place on June 17th, about three months earlier than originally planned. The ruling parties and the opposition parties agreed on this at the beginning of February in order to put an end to the government crisis after the Christian Democrats (KDH) had left the coalition government. This resulted in a precarious situation with regard to the government's parliamentary majority, since the number of MPs of the coalition partners, which besides the SDKU comprise the SMK (Hungarian Coalition Party) and 10 remaining MPs from the Alliance of the New Citizen (ANO had left the government as a party already in August 2005), declined from a total of 150 to 53. The government had to accept that it needed to stop the current privatisation process as a condition for remaining in office until new elections are held in June. This above all affects the rail cargo company ZSSK, whose privatisation will probably be delayed until October. The privatisation of the Slovak electricity utilities (Slovenske elektrarne, HSE) may also drag on for some time. The agreements for the acquisition of 66 % of the Slovak airports Bratislava and Kosice were, however, already signed with legal validity at the end of March. According to opinion polls, a change in political direction may take place in Slovakia after the parliamentary elections in June as the leftist populist Smer (Direction – Social Democracy) stands the best chance of winning the elections. This party plans to reintroduce progressive taxation, different VAT rates and higher corporate taxes. It has been leading by a considerable margin in the surveys for months, enjoying relatively stable voter approval of about 30 % to 35 %, while the (three) parties of the (former) coalition government are supported by a total of only just 30 % of the electorate. Given the most recent discontent, e. g. with the reform of the health care system, it is doubtful whether the good economic data will boost voter support for the SDKU. The Smer party led by Robert Fico, however, has recently tried to dispel fears that a possible change in political direction would also entail a radical change in economic policy.

Record growth due to investments and exports

In the fourth quarter, Slovakia's economic growth accelerated to a record level of 7.6 % yoy, up from 6.2 % in the third quarter and 5.1 % in the first and second quarters, respectively. Overall, Slovakia's economy grew at an average rate of 6 % in 2005, which is faster than the 5.5 % recorded in 2004.

The stronger growth in the second half of the year is above all attributable to buoyant investment activity and strong export growth. Gross fixed capital formation – after expanding by 10.7 % yoy in the second quarter – increased by 16.5 % and 15.1 % in the third and fourth quarters, respectively. Exports of goods and services rose at an almost identical rate (third quarter: 16.1 %, fourth quarter: 15.0 %). Partly due to strong investment activity (imports of capital goods, plant and equipment), imports in the national accounts also picked up towards the end of the year. In the fourth quarter, imports (17.7 %) outperformed exports after lagging behind export growth in the third quarter with a growth rate of 11.6 %. Stockbuilding, too, provided a significant impetus to economic growth to-

Slovakia – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	4.6	4.5	5.5	6.0	6.3	6.5
Industrial output (real)	6.9	5.0	4.2	3.7	7.4	5.5
Gross fixed capital formation (real)	–0.6	–1.5	2.5	12.4	11.9	11.2
Consumer prices (yearly average)	3.3	8.5	7.5	2.7	3.9	2.5
Unemployment (yearly average)	17.8	15.2	14.3	11.6	10.7	10.4
Budget balance (ESA 95, in % of GDP)[1]	–7.8	–3.5	–3.0	–3.1	–3.0	–2.9
in EUR mn						
Merchandise exports	15,244	19,361	22,353	25,743	31,090	35,410
Merchandise imports	17,506	19,926	23,526	27,712	32,710	36,810
Current account	–1,425	–244	–1,149	–3,268	–2,720	–1,664
Current account (in % of GDP)	–5.5	–0.8	–3.5	–8.8	–6.3	–3.5
FDI (inflow, net)	4,258	506	1,016	1,534	2,390	2,100
Gross foreign debt (end of period)	13,166	15,439	18,167	22,610	24,010	25,090
Gross foreign debt (in % of GDP)	51.2	53.3	54.9	60.6	56.0	52.2
Import cover (in months)	5.2	5.1	4.9	4.6	3.8	3.5
Average exchange rate: SKK/EUR	42.7	41.5	40.1	38.6	37.3	36.3
Average exchange rate: SKK/USD	45.1	36.6	32.2	31.0	30.3	29.0

1) Including transfers to 2nd pillar pension funds (2005: 20 %, 2006: 40 %, 2007: 60 %)

Sources: Bank Austria Creditanstalt Economics Department, National Bank of Slovakia, Statistical Office

wards the end of the year, with the inclusion in the books of investments not yet completed and the tax-related effects of accelerated purchases (increase in excise taxes on alcohol and tobacco products) possibly having an impact. Supported by favourable developments of real wages, terms and conditions for loans and higher employment levels, private consumption rose at a relatively steady rate in 2005: with a growth rate that averaged 5.8 % in 2005, private consumption was only just below the growth rate of the Slovak economy as a whole. Public consumption rose by 2 % in 2005 and thus remained at a level markedly below the average rate.

The economy remained essentially dynamic at the beginning of 2006. Both industry, retail trade and construction expanded at similar rates as at year-end 2005. Industrial output, for example, continued to be bolstered by the export-oriented sectors, particularly mechanical engineering, but also by other technological branches such as the electrical and electronics industry.

Persistently high inflation rate

At the beginning of the year, the adjustments made to administered and regulated prices resulted in an expected surge in consumer prices (2.1 % mom and 4.1 % yoy). Inflation persisted at high levels also in February and March at the level of 4.5 % yoy. The rise in prices is not only explained by energy-induced factors but also by the general upward trend of prices. This was reflected in the increase in core inflation to 2.2 % and in particular also by the upturn in prices of services. In order to counteract the demand-induced inflationary pressure resulting from strong economic growth, the central bank raised key interest rates by 50 basis points. The 2-week repo rate for instance has been 3.5 % since March 1st. In light of the time lag with which changes in monetary policy have an impact on the real economy, the central bank wanted to take action in time in order to meet the Maastricht inflation target by 2007. Until the beginning of March, the strong currency tended to check the upward price movement, as the Slovak koruna appreciated against the euro by a little less than 4 % (in nominal terms) after Slovakia's entry to ERM II in November. Since then the Slovak koruna has depreciated somewhat again (by about 2 % until the beginning of April), which indicates that the political uncertainties due to early elections may have had a slightly delayed effect.

Investment-induced external imbalance

At the turn of 2005/2006 the trade deficit expanded considerably. At about 670 mn euros, the highest monthly trade deficit so far was recorded in December. At approximately 300 mn euros, the trade deficit still remained comparatively high in January. The high deficit is not due to inadequate export levels, as exports continued to grow at a substantial rate of about 25 % (year-on-year, in euros), but rather to surging imports. The growth rate of imports of about 40 % was almost double the average growth rate of the previous months. Apart from the higher bill to be paid for imported oil products, the import boom is evidently mainly due to substantial imports of plant and equipment for car manufacturing plants which are nearing completion – PSA in Trnava and KIA in Zilina. At any rate, the recent import boom also had a considerable impact on the current account for 2005. At just under 2 bn euros, the trade deficit was almost twice as high as in 2004 and thus contributed significantly to the current account deficit of about 3.3 bn euros or 8.8 % of GDP. The deficit in the income balance had an even more significant impact. It almost increased by five times the 2004 figure (2005: 1.6 bn euros, 2004: 330 mn euros) because of higher dividend payments by companies to their owners abroad, a large part of which (about 1 bn euros) however remained in the country as reinvested earnings. Although total foreign direct investments rose to somewhat more than 1.5 bn euros in 2005, the inflow of new capital slowed down because very few significant privatisations took place in 2005. ■

Outlook

There is little doubt that Robert Fico and the Smer party will win the elections. People are making guesses as to which coalition partners the Smer will find and if it will depend on reform-minded parties or not. An alternative to a cooperation between the SDKU and the LS-HZDS (Movement for a Democratic Slovakia) – but without the participation of Vladimir Meciar – as the mainstay of a coalition government cannot be completely ruled out either. The present government has probably attained its goal of anticipating a fait accompli by Slovakia's premature entry to ERM II at the end of November 2005 and the related fiscal and economic policy for adopting the euro at the beginning of 2009. This is because the Smer has abandoned its intention to defer the introduction of the euro until 2010/11, and it is still unclear in what manner the party will scale down its other (socio-) political intentions. There is still a high probability that a future coalition will include at least one reform-minded party, so that any adjustments to economic policy will probably be moderate.

Under these circumstances, we expect economic growth of just over 6 % in the current year and in 2007. The inflation rate will remain at just about 3.5 % on average in 2006 and will only decrease to 2.5 % in 2007 unless this is prevented by developments in the international commodity markets. Private consumption is generally expected to remain relatively robust, and investments are anticipated to slow down somewhat with the completion of the car manufacturing plants. This may be compensated for by the continuing trend toward strong export growth, which will be progressively supported by additional exports of motor vehicles. As reported, car production will start in the PSA plant in Trnava in May and in the KIA plant in Zilina in December. Therefore, it is likely that the external imbalance will be eliminated in the next few years. The current account deficit is expected to again decline to about 3.5 % of GDP by 2007. In addition, a somewhat more abundant inflow of foreign direct investment is anticipated as a result of the implementation of the privatisations delayed until the autumn.

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Slovenia

More haste, less speed

Area: 20,273 sq. km
Population: 2.0 mn
President: Janez Drnovšek
Prime Minister: Janez Janša
GDP (2005): EUR 27.4 bn
Per capita GDP (2005): EUR 13,680

Political situation

The enthusiasm with which the coalition government set about introducing reforms, culminating in the presentation of a package of seventy measures last autumn aimed at improving the competitiveness of the Slovenian economy in the longer term, seems to be paralysed by spring tiredness. Government members were evidently unable to reach agreement on the implementation of the package's ambitious privatisation plans, especially in regard to Nova Ljubljanska banka, the country's largest bank. This prompted Joze Damijan, Minister for Economic Reform, to resign at the end of March after being asked to head the newly-created Reform Ministry in the autumn. It is possible that Mr. Damijan's resignation may dilute the ambitious reform goals, and the implementation of the flat tax planned for the beginning of 2007 is now also less likely – especially because the Slovenians' aversion to the planned reform measures has resulted in the government's lowest popularity ratings since it took office almost one and a half years ago. The necessity for structural reforms is undisputed, also by the EU (e. g. in regard to reaching the goals of the Lisbon process). This applies particularly to reforms within the pension system: following a number of new measures such as the adjustment of pensions to wage increases and the abolition of the possibility for government employees to postpone their retirement until a later date, the pension system has become less sustainable.

Adoption of euro on track

Although Slovenia will probably tread the path of economic reform more cautiously, it is well ahead of the other new EU member states in two important areas of European integration. In the course of 2007, the borders to the old EU member countries may be opened after Slovenia becomes a signatory to the Schengen agreement, and Slovenia will probably already join the euro area at the beginning of 2007.

In its most recent evaluation of Slovenia's convergence programme the EU Commission commended Slovenia for its progress because it has fulfilled both the budget and the debt criteria. In 2005, the budget deficit pursuant to ESA 95 amounted to an estimated 1.8 % of GDP. It was thus in line with the target thanks to a cautious spending policy and higher revenue due to EU transfer payments. A deficit of 1.7 % of GDP is envisaged for the current year, a target which can be met from a current perspective. Slovenia is ready to adopt the euro in regard to meeting the criteria of a maximum 3 % of GDP in new debt and the maximum 60 % of GDP in public debt. Total indebtedness as a percentage of GDP even fell slightly in 2005 and will remain below 30 % of GDP in the next few years. Long-term interest rates in the euro area increased slightly after the European Central Bank raised key rates in the last few months, but they fell in Slovenia following further interest rate cuts by the central bank (e. g. the interest rate on 60-day tolar bills fell from 4 % to a current 3.5 % within a few weeks), so that the interest differential to the euro area has continued to narrow. With long-term interest rates moving in the region of 3.7 % p. a., Slovenia also easily meets the convergence criterion of a current 5.4 % (average value for the three EU countries with the greatest price stability plus 2 percentage points).

Slovenia – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	3.5	2.7	4.2	3.9	4.0	3.8
Industrial output (real)	2.5	1.4	5.5	3.1	4.4	3.8
Gross fixed capital formation (real)	0.9	7.1	5.9	3.7	4.7	5.2
Consumer prices (yearly average)	7.5	5.6	3.6	2.5	2.4	2.9
Unemployment (yearly average)	6.3	6.7	6.3	6.6	6.4	6.3
Budget balance (ESA 95, in % of GDP)	–2.7	–2.7	–2.1	–1.8	–1.7	–1.5
in EUR mn						
Merchandise exports	11,082	11,417	12,933	14,474	16,000	17,600
Merchandise imports	11,347	11,960	13,942	15,471	17,050	19,000
Current account	344	–81	–544	–301	–150	–400
Current account (in % of GDP)	1.5	–0.4	–2.1	–1.1	–0.5	–1.3
FDI (inflow, net)	1,538	–118	221	–45	150	400
Gross foreign debt (end of period)	11,482	12,995	15,355	19,511	22,500	25,000
Gross foreign debt (in % of GDP)	48.5	52.2	58.7	71.3	77.7	80.9
Import cover (in months)	6.7	5.9	4.8	4.6	4.4	4.1
Average exchange rate: SIT/EUR	226.2	233.7	238.9	239.6	239.6	239.6
Average exchange rate: SIT/USD	242.7	207.1	192.4	192.7	197.3	191.7

Sources: Bank Austria Creditanstalt Economics Department, SNB, SORS

All criteria fulfilled following decline in inflation

Inflation, which has been a problem for many years, is now under control. After averaging 2.5 % in 2005, the inflation rate fell to under 2 % in March year-on-year. In order to assure Slovenia's readiness for participation in the euro area by also meeting this criterion in the future, the government is supporting this downward trend in inflation with administrative measures. The dual pricing requirement for retailers (tolar and euro) announced some months ago came into effect on 1 March to prevent excessive price increases in the months before Slovenia switches to the euro. The restraint exercised in raising controlled prices will in any event dampen inflation in the medium term. The government has published a list of low, maximum increase rates for goods and services which are subject to price controls. These include prices for electricity, train fares and motorway tolls in the current year.

Assuming that external factors (e. g. prices for raw materials) remain stable, inflation will be around 2 % in the remaining part of 2006. In the current year the inflation rate should therefore not represent an obstacle for the adoption of the euro. We expect inflation to average 2.4 % in 2006.

The exchange rate of the tolar has been moving within a very narrow range close to the parity rate of 239.64 EUR/SIT. Based on past developments and the sound fundamental data it will continue to move within a range of +/–15 % of the parity. At the end of June this year Slovenia will consequently have provided evidence of the stability of its currency after successfully participating in ERM II for two years, and as of this date the country will probably have fulfilled all the Maastricht criteria. As the EU will next assess Slovenia's state of readiness for adoption of the euro in the convergence reports published this coming October, the Slovenian government submitted an application at the beginning of March for its assessment to be brought forward to enable it soon to embark on the final preparations for the adoption of the euro (e. g. the striking of coins). Based on the positive report of the Commission and the European Central Bank we consider it very likely that the Commission will propose to the Council of Ministers around the middle of 2006 that Slovenia be accepted into the euro area. The Slovenian tolar would in that case be replaced by the euro at the beginning of 2007 at a conversion ratio probably corresponding to the current parity rate.

Buoyant growth continues

The final months of preparation for entry into the euro area are characterised by continued strong growth of the Slovenian economy. In the final quarter of 2005 GDP growth accelerated to a seasonally adjusted 1 % compared with the previous quarter (3rd quarter: +0.7 %). With a growth rate of 3.7 % year-on-year, the economy expanded by an impressive 3.9 % in 2005 as a whole. This was only slightly below the level of the previous year. In 2005, economic growth was driven by foreign demand which boosted export growth to over 9 % in real terms. However, towards the end of the year the impetus provided by foreign demand slackened off considerably: import growth rose sharply, fuelled by strong consumption (2005: +3.3 %) and a revival of investment activity – the planned cuts in the investment allowance prompted an increase in gross fixed capital formation to over 8 % year-on-year in the final quarter of 2005. In 2005 as a whole, after a weak start, gross fixed capital formation grew by almost 4 %.

We expect the economy to continue to grow strongly at 4 % in the current year, with domestic demand providing a much stronger impetus than in the previous year. The low interest rates and the new public infrastructure projects will make investments the key growth component in the current year. Driven by unabated strong demand for credit on account of low interest rates and the improved situation of the labour market, private consumption will again grow at a dynamic rate. The external sector's contribution to economic growth will be only negligible in the current year because the strong export growth in 2005 was attributable to an exceptionally strong performance of the automotive sector. For these reasons, the export growth levels of 2005 will not be maintained despite the relatively favourable international business conditions. ■

Outlook

There is little doubt that Slovenia benefited greatly from the EU enlargement in 2005. There is every indication that the country will in the next two years continue to enjoy strong economic growth similar to the 3.9 % seen in the previous year. Consumption will remain an engine of growth and investments will gain further momentum, with both components being supported by interest rates which are converging towards EU levels. The inflation rate, for many years a weakness of the Slovenian economy, has approached the EU average. In fulfilling all the Maastricht criteria, Slovenia has become eligible for participation in the euro area. The adoption of the euro at the beginning of 2007 will however also signify the end of the restraint exercised in raising prices in the public sector. Inflation will therefore probably again rise fairly rapidly to almost 3 % in 2007. Changes in taxation, primarily the introduction of a flat tax, could make it more difficult for the government to reach its fiscal targets next year, but this will not jeopardise the fulfilment of the Stability Pact. The current account deficit, which will again amount to less than 1 % of GDP in 2006 due to the positive trend in the balance of services (tourism and transportation), could widen next year through stronger growth of merchandise imports based on strong consumption and investment activity. At just over 1 % of GDP the current account deficit would however be fairly low. Slovenia's balanced economic policy is likely to continue to provide a basis for a stable framework also after the adoption of the euro. There is a growing need to address the structural challenges such as improving Slovenia's competitiveness on foreign markets and the financing of the country's social systems in the longer term if this stability is to be maintained.

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Ukraine

Difficult times on the way to parliamentary democracy

Area: 603,700 sq. km
Population: 47.3 mn
President: Viktor Yushchenko
Prime Minister: Yuriy Yekhanurov
GDP (2005): EUR 65.6 bn
GDP per capita (2005): EUR 1,390

Unstable government

Ukraine elected a new parliament on 26 March 2006. The "Party of the Regions" received the most votes (32.1 %), while 22.3 % of Ukrainians voted for the "Yulia Tymoshenko Bloc", 14.0 % for "Our Ukraine People's Union", 5.7 % for the "Socialist Party of Ukraine", and 3.7 % for the Communists. A further 40 parties who contested 450 seats fell short of the three per cent hurdle. Of the fourteen factions who held seats in parliament before the elections there are now only five.

The formation of a coalition government is anything but easy. Some groupings within "Our Ukraine" (the party of President Viktor Yushchenko led by Roman Bezsmertny) would like to see an "orange" coalition with the Yulia Tymoshenko Bloc and the Socialists led by Oleksandr Moroz. They would have 240 seats in parliament. Another grouping within "Our Ukraine" evidently wants a coalition with the "Party of the Regions" led by Yushchenko's former rival in the presidential elections, Viktor Yanukovych. Prime Minister Yuri Yekhanurov for example pointed out that the policy overlap of the two parties covers 75 % of the economic programme. Whatever the government will look like in the end, there will be a danger of political infighting between the respective groupings in the "Our Ukraine" party, which could result in the collapse of a coalition government. This political uncertainty will have economic implications: the economic groups in Donetsk and Dnepropretovsk will feel concerned and consequently invest only a little and export capital abroad, while the government will not be strong enough to take effective measures to prevent such developments.

Weak growth and even weaker investment

Aside from lower global prices for steel, the political situation in the country was already to blame for the meagre economic growth in 2005, especially on account of low investment activity. GDP, adjusted for inflation, grew by only 2.6 % despite a boom in consumption. Inflation-adjusted figures for the GDP components have not yet been released, but in nominal terms, with GDP growth of 21.3 %, private consumption grew by 31.5 %, while gross fixed capital formation expanded by only 13.6 %. Data on investment by the business sector suggest that capital investment grew by no more than 1.9 % after being adjusted for inflation. According to the National Accounts, exports of goods and services expanded by a nominal 2.8 % and imports by 16.2 %. In the first quarter of 2006, GDP growth amounted to a real 2.4 %, which corresponds to stagnation when this is adjusted for seasonal factors.

Resistance to tax?

In 2005, the revenues of the consolidated budget of the central government and the local authorities were well above the level of the previous year, climbing from 26.3 % of GDP to 32.0 % of GDP despite the marked slowdown in economic growth. The improvement is largely attributable to the abolition of tax exemptions, especially in conjunction with special economic zones, and to higher profits as disclosed in the financial statements of large companies; the latter partly a consequence of the pressure exerted by the tax authorities. Budget spending rose from 29.4 % to 33.8 % of GDP due to the many promises made in the election campaign in 2004. The deficit fell from 3.4 % to 1.8 % of GDP.

Ukraine – Selected Indicators

	2002	2003	2004	2005	2006	2007
Change from previous year in %					*Forecast*	
GDP (real)	5.2	9.4	12.1	2.6	3.0	3.5
Industrial output (real)	7.0	15.7	12.5	3.0	3.0	7.8
Gross fixed capital formation (real)	6.0	15.8	10.2	1.0	1.0	3.0
Consumer prices (yearly average)	0.8	5.2	9.0	13.5	12.6	11.3
Unemployment (yearly average)	10.1	9.1	7.8	7.5	9.0	10.0
Budget balance (in % of GDP)	0.2	0.1	–3.1	–1.9	–4.5	–3.5
in EUR mn						
Merchandise exports	19,732	20,959	26,868	27,410	29,030	31,210
Merchandise imports	18,982	21,197	23,862	28,230	35,510	37,770
Current account	3,354	2,552	5,468	2,030	–2,290	–2,760
Current account (in % of GDP)	7.5	5.8	10.5	3.1	–3.0	–3.5
FDI (inflow, net)	732	1,257	1,378	6,270	1,640	2,000
Gross foreign debt (end of period)	22,922	21,023	24,585	31,140	35,110	39,350
Gross foreign debt (in % of GDP)	51.2	47.5	47.1	47.4	46.1	50.0
Import cover (in months)	2.4	3.0	3.2	5.9	3.4	3.1
Average exchange rate: UAH/EUR	5.0	6.0	6.6	6.4	6.2	6.9
Average exchange rate: UAH/USD	5.3	5.3	5.3	5.1	5.1	5.5

Sources: Bank Austria Creditanstalt Economics Department, National Bank of Ukraine

The situation is completely different in 2006: Ukraine reached its budget targets for the first quarter, but only thanks to high revenues from customs duties and value-added tax. Revenue from corporate tax fell sharply, especially in the regions where the country's heavy industry is concentrated. While the high revenues from value-added tax reflect the boom in consumption, they are partly also the result of some window dressing: the repayment of the excess advance payments made in the previous year was slowed down. It is at present difficult to ascertain to what extent the shortfall in the tax on profits is attributable to economic problems or whether it is an indication of resistance to taxation which is partly politically motivated.

Under these circumstances it is questionable whether the target deficit of the general government budget in the amount of 12.9 bn hryvina (2.5 % of GDP) can be met in 2006. It is likely that the deficit will widen to 3.5 % of GDP, and that the deficit of the consolidated budget will rise to 4.5 % of GDP. The deficit may be even larger if the gas-related conflict with Russia were to escalate, or in the event of an ongoing political stand-off.

Smouldering gas conflict

Ukraine's gas supplies remain a source of uncertainty for a number of different reasons. Firstly, the fate of the contract negotiated on 4 January 2006 between the state-owned Naftohaz Ukrainy and Gazprom is unclear. The Ukrainian government has so far not signed the annual Russian-Ukrainian government-to-government agreement on gas supplies for 2006. This is to be taken care of by the new government; the Yulia Tymoshenko Bloc is however strictly opposed to the deal.

Secondly, according to reports in the media Aleksander Medvedev, deputy chairman of Gazprom, wants to conduct negotiations with Ukraine as from 1 July 2006 for an increase in gas prices.

Thirdly, the position taken by the gas trading company RosUkrEnergo, which plays a key role pursuant to the gas agreement signed in January (see CEE Report 2006/1), is hotly disputed. Yulia Tymoshenko and other forces in Ukraine are calling for direct relations with Gazprom and Turkmenistan, without any intermediaries. Gazprom owns 50 % of RosUkrEnergo, and the remaining half is held by Raiffeisen Investment AG as trustee.

Fourthly, Naftohaz Ukrainy is a source of friction. Various parties are accusing the company of failing to meet its payment obligations. According to the media these parties include Finance Minister Viktor Pynzenyk, Turkmenistan and RosUkrEnergo. Naftohaz Ukrainy has however denied this and has refuted the allegations.

The conflicts of interests and the disputes have remained acute. We expect the gas conflict to again flare up in July 2006 at latest.

Quo vadis hryvnia?

A renewed flaring up of the gas conflict will come at a time when Ukraine's external position has deteriorated. In 2004, exports grew by 41 % in US dollar terms, in 2005 by only 5 %. According to preliminary data, exports contracted by 5 % year-on-year in the first two months of 2006. Import growth only slowed from 28 % in 2004 to 22 % in 2005 and accelerated to 40% year-on-year at the beginning of 2006. The current account surplus shrunk from 6.9 bn US dollars in 2004 to 2.5 bn US dollars or 3.1 % of GDP in 2005.

The narrowing of the current account surplus and capital flight are beginning to put the hryvnia under pressure. In the first quarter of 2006 the central bank intervened with 1.8 bn US dollars in support of the currency. Foreign exchange reserves fell from 19.4 bn US dollars at the end of 2005 to 17.3 bn US dollars at the end of March 2006. The central bank's inflation target for 2006 is 8.5 %–9.5 %; a target of 9.5 %–10.2 % is being discussed for 2007. After peaking last year at 14.9 % yoy in August, inflation decreased to 8.6 % yoy by March 2006. However, prices for gas and electricity will be raised by 25 % on 1 May for private persons and for government institutions. The hryvnia therefore cannot afford to depreciate significantly if the inflation target is to be met. This speaks against a devaluation, in addition to which the costs of the servicing of the government's foreign debt and the gas bill – denominated in hryvnia – would rise. At present, the central bank is targeting a corridor for the hryvnia of 5.0–5.2 to the US dollar for 2006, and now 4.95–5.25 for 2007. In light of the continued political uncertainty, the threat of a gas conflict, and the strong outflows of foreign currency, it remains to be seen whether the central bank will not liberalise foreign exchange policy earlier and more significantly. Such a move is not that easy, however, as rumours of a devaluation could prompt Ukrainians to rush into the dollar. ■

Outlook

2006 will not be an easy year for Ukraine. Political tension, the gas conflict with Russia, moderate economic growth and a deterioration of the foreign trade balance depress sentiment and put the country's currency under pressure. Nevertheless: for the first time in its history, Ukraine is moving toward a parliamentary democracy – even if this is proving to be an arduous process. Party discipline may not yet be particularly pronounced and there is still a strong regional distribution of the political spectrum. But the party hotchpotch in the parliament that characterised the political landscape before March 2006 has disappeared and we are now seeing the emergence of political parties which are worthy of this name. The economy, too, will benefit from the mutual political control. The "krysha" system, which has in the past required a political "roof" ("krysha" in Russian) for every economic initiative, making corruption an indispensable lubricant, is gradually disappearing. The transition period will require strong nerves. But Ukraine is very important for Europe, not least because it plays a key role as an energy transit route. Europe should help toward facilitating and accelerating the establishment of democracy and prosperity in Ukraine by supporting the country's entry into the WTO and through the related promise of a free-trade zone, as well as by integrating Ukraine in a common European energy policy.

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Overview

Real GDP

change in %

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	5.7	6.7	5.5	5.0	6.0
Bosnia and Herzegovina	3.5	5.0	5.5	6.0	5.5
Bulgaria	4.5	5.7	5.5	5.5	5.5
Croatia	5.3	3.8	4.3	4.4	4.2
Czech Republic	3.2	4.7	6.0	5.4	4.5
Estonia	6.7	7.8	9.8	9.5	8.5
Hungary	3.4	4.6	4.1	4.2	3.8
Latvia	7.2	8.5	10.2	8.5	7.5
Lithuania	10.5	7.0	7.5	6.5	6.3
Macedonia	2.8	4.1	3.8	4.0	4.0
Poland	3.8	5.3	3.2	4.6	4.7
Romania	5.2	8.4	4.1	5.6	5.5
Russia	7.3	7.2	6.4	5.8	5.2
Serbia and Montenegro	2.4	8.8	6.1	5.0	5.5
Slovakia	4.5	5.5	6.0	6.3	6.5
Slovenia	2.7	4.2	3.9	4.0	3.8
Ukraine	9.4	12.1	2.6	3.0	3.5

Consumer prices

in %

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	2.4	2.9	2.4	2.7	3.0
Bosnia and Herzegovina	0.1	0.7	3.6	6.5	3.9
Bulgaria	2.3	6.2	5.0	7.3	4.7
Croatia	1.8	2.1	3.3	3.2	2.9
Czech Republic	0.1	2.8	1.9	2.7	2.9
Estonia	1.3	3.0	4.1	3.5	3.1
Hungary	4.7	6.8	3.6	2.1	2.7
Latvia	2.9	6.2	6.7	5.7	4.6
Lithuania	–1.2	1.2	2.7	2.8	3.0
Macedonia	1.2	–0.4	0.5	1.0	1.5
Poland	0.8	3.5	2.1	1.3	2.5
Romania	15.3	11.9	9.0	7.5	6.2
Russia	13.6	10.9	12.7	9.5	7.8
Serbia and Montenegro	9.7	10.8	15.2	11.5	9.7
Slovakia	8.5	7.5	2.7	3.9	2.5
Slovenia	5.6	3.6	2.5	2.4	2.9
Ukraine	5.2	9.0	13.5	12.6	11.3

Unemployment rate

in %

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	15.0	14.4	14.5	14.0	13.5
Bosnia and Herzegovina	40.5	40.5	41.5	42.5	40.0
Bulgaria	14.3	12.7	11.5	10.5	10.0
Croatia	19.5	18.2	18.0	17.8	17.5
Czech Republic	9.9	9.8	8.9	8.5	8.3
Estonia	10.0	9.6	7.9	7.2	6.9
Hungary	5.9	6.1	7.2	7.1	6.8
Latvia	10.6	10.4	8.9	8.0	7.5
Lithuania	12.4	11.4	8.5	7.5	7.0
Macedonia	36.7	37.2	36.5	35.0	35.0
Poland	20.0	19.1	18.2	17.3	16.6
Romania	7.6	6.8	5.8	5.7	5.5
Russia	8.4	8.2	7.6	7.3	6.9
Serbia and Montenegro	31.7	31.7	32.5	32.2	31.5
Slovakia	15.2	14.3	11.6	10.7	10.4
Slovenia	6.7	6.3	6.6	6.4	6.3
Ukraine	9.1	7.8	7.5	9.0	10.0

Budget balance*

in % of GDP

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	–4.3	–5.0	–3.3	–4.0	–3.5
Bosnia and Herzegovina	–1.3	–1.0	0.0	0.3	0.4
Bulgaria	0.0	1.7	3.2	3.0	2.0
Croatia	–6.1	–4.9	–4.2	–4.5	–4.0
Czech Republic	–4.3	–3.4	–1.9	–2.0	–2.0
Estonia	2.6	1.7	1.8	1.8	0.0
Hungary	–6.4	–5.4	–6.2	–5.5	–4.1
Latvia	–1.6	–1.1	–1.0	–1.5	–1.3
Lithuania	–1.2	–1.5	–0.5	–1.5	–1.5
Macedonia	–0.7	0.3	–1.0	–0.6	–1.0
Poland	–4.8	–3.9	–3.8	–4.2	–5.1
Romania	–2.2	–1.2	–0.8	–1.0	–1.5
Russia	1.4	4.5	7.0	5.0	3.0
Serbia and Montenegro	–3.4	–0.3	0.9	2.4	0.9
Slovakia	–3.5	–3.0	–3.1	–3.0	–2.9
Slovenia	–2.9	–2.3	–1.8	–1.7	–1.5
Ukraine	0.1	–3.1	–1.9	–4.5	–3.5

Sources: National banks, nat. statistical offices, BA-CA Economics Department

**) According to ESA 95*

Current account

in % of GDP

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	–8.0	–5.7	–7.5	–6.2	–5.3
Bosnia and Herzegovina	–24.5	–22.4	–22.5	–20.3	–17.3
Bulgaria	–9.2	–5.8	–11.8	–12.5	–11.2
Croatia	–7.1	–5.1	–6.3	–6.8	–7.0
Czech Republic	–6.3	–6.1	–2.1	–2.3	–2.5
Estonia	–13.0	–12.7	–10.5	–10.0	–9.3
Hungary	–8.7	–8.6	–7.3	–7.0	–6.5
Latvia	–8.1	–12.9	–12.5	–12.2	–11.3
Lithuania	–6.8	–7.7	–7.1	–6.8	–6.5
Macedonia	–3.3	–7.8	–1.5	–4.2	–4.5
Poland	–2.1	–4.1	–1.6	–2.1	–3.1
Romania	–5.8	–8.4	–8.7	–9.6	–9.3
Russia	8.3	10.3	10.9	9.4	7.0
Serbia and Montenegro	–9.8	–12.5	–8.7	–8.3	–6.8
Slovakia	–0.8	–3.5	–8.8	–6.3	–3.5
Slovenia	–0.4	–2.1	–1.1	–0.5	–1.3
Ukraine	5.8	10.5	3.1	–3.0	–3.5

FDI

in % of GDP

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	3.2	4.5	3.1	3.4	4.1
Bosnia and Herzegovina	4.5	4.9	5.3	2.8	4.4
Bulgaria	10.3	11.5	8.7	9.1	8.2
Croatia	6.8	3.5	4.3	5.7	4.9
Czech Republic	2.3	4.6	8.9	4.1	4.0
Estonia	9.8	8.2	23.2	15.3	14.2
Hungary	0.6	3.5	4.9	4.6	3.7
Latvia	2.3	4.3	3.1	2.7	2.2
Lithuania	1.0	3.4	2.4	2.7	2.7
Macedonia	2.1	2.9	1.7	6.9	4.9
Poland	2.3	2.1	1.8	1.6	1.6
Romania	3.6	8.4	6.6	8.5	4.6
Russia	1.8	2.0	2.9	1.5	1.1
Serbia and Montenegro	6.9	4.2	7.3	5.8	4.8
Slovakia	1.7	3.1	4.1	5.6	4.4
Slovenia	–0.5	0.8	–0.2	0.5	1.3
Ukraine	2.9	2.6	9.6	2.1	2.5

Gross foreign debt

in % of GDP

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	24.2	21.9	21.4	22.1	21.9
Bosnia and Herzegovina	57.1	52.9	50.2	44.5	39.7
Bulgaria	60.2	64.2	67.7	68.0	69.0
Croatia	83.6	87.9	82.4	84.6	85.3
Czech Republic	34.3	38.3	41.7	41.0	40.5
Estonia	68.7	81.2	90.2	92.5	95.8
Hungary	64.7	70.2	77.4	82.4	79.4
Latvia	79.1	92.8	101.1	107.7	113.2
Lithuania	40.6	42.5	46.0	47.3	50.1
Macedonia	39.2	38.2	40.3	41.6	42.1
Poland	43.7	46.2	43.5	40.6	41.7
Romania	33.9	35.8	38.5	39.0	41.3
Russia	41.9	35.4	31.3	27.0	24.0
Serbia and Montenegro	69.9	61.1	61.6	58.5	53.8
Slovakia	53.3	54.9	60.6	56.0	52.2
Slovenia	52.2	58.7	71.3	77.7	80.9
Ukraine	47.5	47.1	47.4	46.1	50.0

Exchange rate

against EUR, annual average

	2003	2004	2005	2006 Forecast	2007 Forecast
Albania	137.6	127.6	124.2	126.0	126.0
Bosnia and Herzegovina	1.96	1.96	1.96	1.96	1.96
Bulgaria	1.96	1.96	1.96	1.96	1.96
Croatia	7.6	7.5	7.4	7.3	7.3
Czech Republic	31.8	31.9	29.8	28.8	27.9
Estonia	15.65	15.65	15.65	15.65	15.65
Hungary	253.5	251.7	248.0	265.0	261.0
Latvia	0.65	0.67	0.70	0.70	0.70
Lithuania	3.45	3.45	3.45	3.45	3.45
Macedonia	61.3	61.9	61.2	61.5	62.0
Poland	4.4	4.5	4.0	3.8	4.0
Romania*	37,556	40,532	3.6	3.5	3.4
Russia	34.7	35.7	35.2	33.9	33.8
Serbia and Montenegro	65.1	72.6	83.2	89.4	93.3
Slovakia	41.5	40.1	38.6	37.3	36.3
Slovenia	233.7	238.9	239.6	239.6	239.6
Ukraine	6.0	6.6	6.4	6.2	6.9

Sources: National banks, nat. statistical offices, BA-CA Economics Department

**) Redenomination of the Leu as of 1 July 2005*