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Contents

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Call for Applications: Visiting Research Program

The Oesterreichische Nationalbank (OeNB) invites applications from external researchers for participation in a Visiting Research Program established by the OeNB's Economic Analysis and Research Department. The purpose of this program is to enhance cooperation with members of academic and research institutions (preferably postdoc) who work in the fields of macroeconomics, international economics or financial economics and/or pursue a regional focus on Central, Eastern and Southeastern Europe.

The OeNB offers a stimulating and professional research environment in close proximity to the policymaking process. Visiting researchers are expected to collaborate with the OeNB's research staff on a prespecified topic and to participate actively in the department's internal seminars and other research activities. They will be provided with accommodation on demand and will, as a rule, have access to the department's computer resources. Their research output may be published in one of the department's publication outlets or as an OeNB Working Paper. Research visits should ideally last between three and six months, but timing is flexible.

Applications (in English) should include

- a curriculum vitae,
- a research proposal that motivates and clearly describes the envisaged research project,
- an indication of the period envisaged for the research visit, and
- information on previous scientific work.

Applications for 2015 should be e-mailed to *eva.gehringer-wasserbauer@oenb.at* by May 1, 2015.

Applicants will be notified of the jury's decision by mid-June. The following round of applications will close on November 1, 2015.

Recent Economic Developments and Outlook

Developments in Selected CESEE Countries:

Economic Recovery Loses Steam in Adverse International Environment[1,2]

1 Regional Overview

Uneven growth in the CESEE region

In the first half of 2014, the moderate economic recovery in most of Central, Eastern and Southeastern Europe (CESEE) broadly continued. Economic growth did decelerate from 0.6% in the first quarter (period on period) to 0.1% the second quarter of 2014, but this deterioration was largely due to a notable slowdown in growth in Turkey, the region's second-biggest economy.

However, since the summer, economic dynamics have decelerated in a number of CESEE countries, as evidenced by most recent high-frequency activity and sentiment indicators (see below for more details). Two events in particular have weighed on the situation lately: the slowdown of economic activity in the euro area, which already became manifest to some extent in lower export growth of CESEE countries in the second quarter, and the geopolitical tensions surrounding the conflict in eastern Ukraine. Both had different implications for individual economies, as these economies have different interconnections and are at different stages of the business cycle. Thus, the current situation is characterized by heightened economic uncertainty and a larger degree of heterogeneity in economic dynamics across Central, Eastern and Southeastern Europe.

Still relatively positive development in Central Europe

Within the CESEE region, Central European economies fared comparatively well, with little to no slowdown in economic expansion year on year (see chart 1). In recent quarters, growth has become more broadly based, with domestic demand

Table 1

Real GDP Growth

	2012	2013	Q3 13	Q4 13	Q1 14	Q2 14
	Period-on-period change in %					
Slovakia	1.8	0.9	0.5	0.6	0.7	0.6
Slovenia	–2.6	–1.0	0.5	1.2	0.0	1.0
Bulgaria	0.6	0.9	0.5	0.3	0.3	0.5
Croatia	–2.2	–0.9	–0.1	–0.6	0.2	–0.3
Czech Republic	–1.0	–0.9	0.4	1.5	0.8	0.0
Hungary	–1.7	1.1	1.1	0.7	1.1	0.8
Poland	2.0	1.6	0.8	0.7	1.1	0.6
Romania	0.5	3.5	1.5	1.1	–0.2	–1.0
Turkey	2.5	4.1	0.9	0.5	1.7	–0.5
Russia	3.4	1.3	0.3	0.4	0.1	0.2
CESEE average[1]	2.3	1.8	0.6	0.6	0.6	0.1
Euro area	–0.7	–0.4	0.1	0.3	0.2	0.0

Source: Eurostat, national statistical offices.

[1] *Average weighted with GDP at PPP.*

Note: GDP data according to ESA 95 (except for Slovenia, where only ESA 2010 data were available).

[1] *Compiled by Josef Schreiner with input from Stephan Barisitz, Markus Eller, Antje Hildebrandt, Florian Huber, Krisztina Jäger-Gyovai, Mathias Lahnsteiner, Isabella Moder, Thomas Reininger, Zoltan Walko and Julia Wörz.*

[2] *Cutoff date: October 3, 2014 (October 21, 2014, for fiscal data). This report focuses primarily on data releases and developments from April 2014 up to the cutoff date and covers Slovakia, Slovenia, the Czech Republic, Croatia, Bulgaria, Hungary, Poland, and Romania, as well as Turkey and Russia. For statistical information on selected economic indicators for CESEE countries not covered in this section (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia and Ukraine), see the Statistical Annex in this issue.*

and especially investments playing an increasing role. This has made the respective countries somewhat more resilient to adverse events in the international environment. Apart from that, several domestic policy measures had a beneficial effect on short-term growth in some countries (e.g. Hungary and the Czech Republic; see country chapters below).

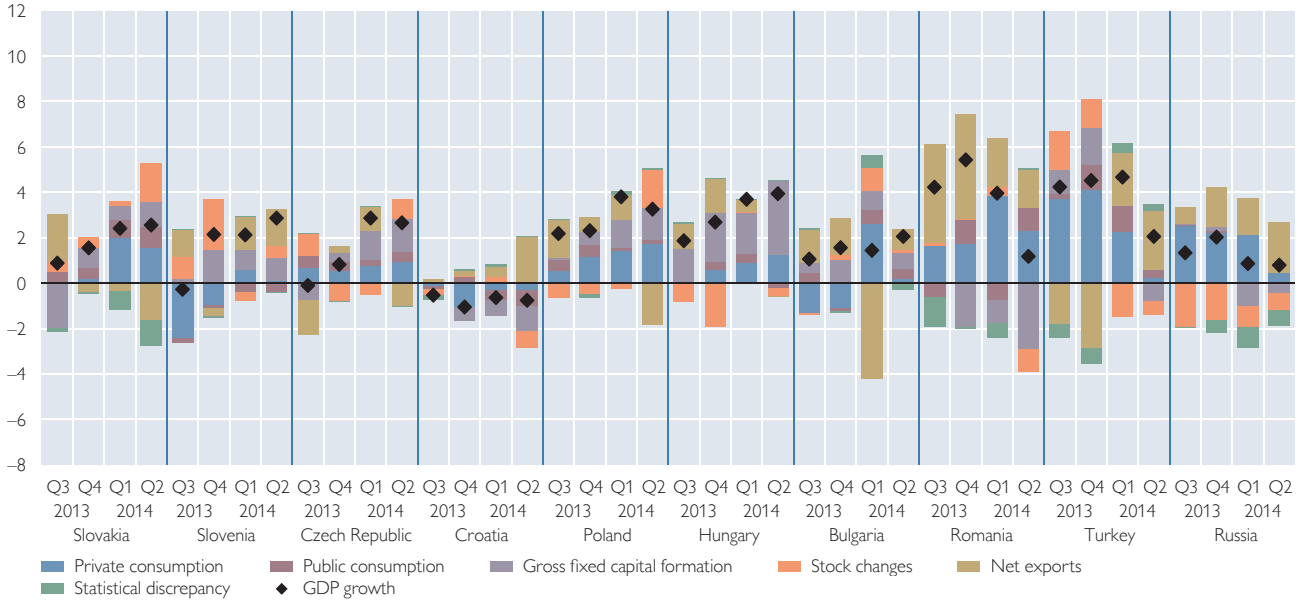
Gross fixed capital formation was an important driving force for GDP growth in all Central European countries, with private consumption bolstering growth throughout most of the region in the first half of 2014. Several factors can explain this development: Investment dynamics have been very moderate in the past years; especially throughout late 2012 and early 2013, capital formation declined in all countries. This created a substantial investment backlog. Investment dynamics were supported by an improving outlook for the international environment in late 2013 and early 2014, causing sentiment indicators to brighten (at least until early summer, when the escalation of the conflict in eastern Ukraine started to cast some shadows). Investment was further spurred by a low-interest environment against the background of an accommodative monetary policy stance at home and abroad that contributed to a moderate pickup of credit growth rates (see below). Furthermore, the end of the EU's multiannual financial framework for 2007 to 2013 encouraged public investment, as countries sought to push through as many EU-funded projects as possible to increase the absorption rate of the funds available.

Improving labor market conditions helped strengthen growth contributions from private consumption. Unemployment decreased in all countries – quite strongly in Hungary – and stood at the lowest levels in several years in summer.

Chart 1

GDP Growth and Its Main Components

Percentage points, GDP growth in %



Source: Eurostat, national statistical offices.

Note: GDP data according to ESA 95 (except for Slovenia, where only ESA 2010 data were available).

However, unemployment was still considerably higher than before the onset of the financial crisis. At the same time, employment was on the rise. Real wage growth was positive, not least because of very low inflation rates. Good wage growth in conjunction with brightening consumer sentiment also had a positive impact on consumer credit dynamics.

The contribution of net exports to growth, however, turned negative in all countries but Slovenia. After export growth accelerated in the first quarter, beginning economic weakness in the euro area put a brake on developments. At the same time, import growth was not reduced at the same pace or even kept accelerating, being fueled by robust domestic demand. Nevertheless, export growth remained firmly in positive territory, underlining a favorable competitive position that shielded the region from some of the external headwinds that arose in the review period. Especially the Czech Republic, Hungary and Slovakia reported robust productivity readings in the first half of 2014 that led to a reduction of nominal unit labor costs in manufacturing. Currency depreciation in an annual comparison further increased the competitive advantage vis-à-vis the euro area in the case of the Czech Republic and Hungary.

Noticeable growth deceleration in Russia, Turkey and Romania; recession in Croatia continues

Economic conditions in Russia, Turkey, Romania and Croatia were weaker, being marked by considerable slowdowns in economic growth or even by protracted recession. The former is especially true of Turkey and Romania, where growth declined from around 5.5% and 4.5% in the fourth quarter of 2013 to 2% and 1% in the second quarter of 2014 (year on year). Growth also weakened notably in Russia while it remained in negative territory in Croatia.

A common feature of these countries was that the growth contribution of domestic demand decreased strongly in the review period, with both consumption and investment growth decelerating noticeably. The latter was even negative throughout the first half of 2014.

Declining unemployment and steady or slightly rising employment in most of these countries did not translate into stronger consumption growth, as sentiment often remained flat. Furthermore, credit growth was negative and/or decelerating. Demand weakness was in part also linked to country specific factors. In Turkey, domestic demand growth slowed down considerably against the background of a more restrictive monetary policy implemented to curb credit expansion and stabilize the exchange rate (see below). Russia's economy suffered from deteriorating confidence, capital outflows and, more recently, economic sanctions in the context of the conflict in eastern Ukraine. Croatia has basically been stuck in recession for several years amid balance sheet weaknesses, strained labor market conditions and declining industrial production. In Romania, capital formation was impaired by problems in speeding up EU-supported investment programs. Though projects with EU cofinancing were boosted in the second half of last year, the administrative capacity has remained inadequate to ensure a smooth flow of funding.

The external sector in these countries held up comparatively well, however, and delivered important growth contributions in all countries. Export growth was positive (supported by currency depreciation in Russia and Turkey). Nevertheless, it decelerated, as demand from important export markets (euro area, also Iraq in the case of Turkey) stalled and economic uncertainty edged up. At the same time, import growth decelerated, outweighing the loss in export demand in all countries but Romania.

In terms of economics dynamics, Bulgaria takes an intermediate position between the two groups of countries outlined above. GDP growth was moderate but stable in the first half of 2014, with growth drivers shifting quickly from quarter to quarter. In June, banking sector turbulences emerged that are bound to impact on growth during the remainder of the year both directly and through credit supply and sentiment channels.

High-frequency indicators suggest a further weakening of the business cycle

The weakening outlook for the international environment and the rising degree of economic and political uncertainty in Europe suggest that the business cycle may lose further steam in the coming months. In fact, most activity and sentiment indicators have deteriorated to different extents recently. The clearest downward trend was observed in retail sales, where growth has been decelerating since the turn of the year, especially lately. In recent months, industrial production and construction output growth also embarked on a downward trend. Nevertheless, the growth rate of all three indicators has remained clearly positive so far. Looking at individual countries, however, only industrial production remained on a growth path in every country, even displaying an upward trend in Slovakia, Slovenia, Hungary and Romania. The decline in retail sales and construction dynamics was more broadly based, and several countries reported shrinking output in one or both of the sectors.

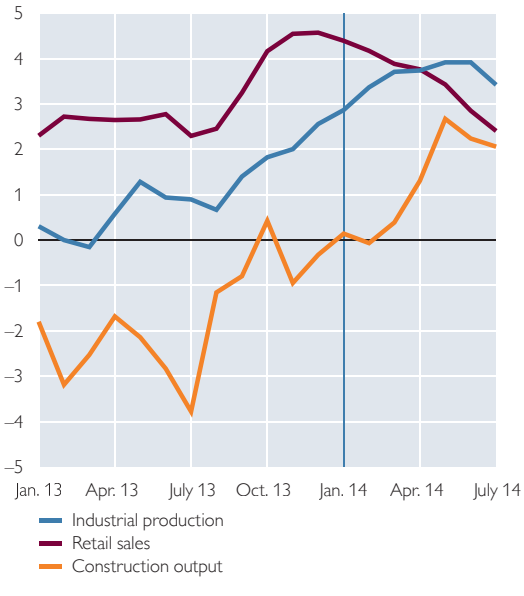
The economic sentiment indicator of the European Commission (average for CESEE EU Member States) has been declining somewhat since June, and the regional average currently stands close to its long-term average. This development was driven mostly by deteriorating consumer sentiment; retail sentiment was also somewhat lower. At the country level, especially Bulgaria, Hungary and Poland

Chart 2

Leading Indicators

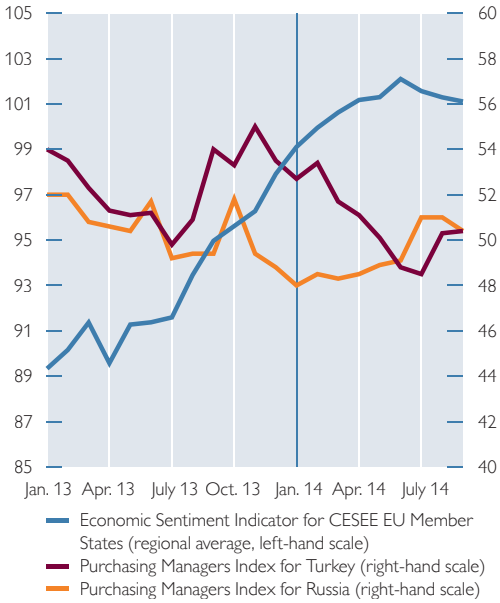
Activity Indicators (CESEE Regional Average)

Year-on-year change in %, three-month moving averages



Sentiment Indicators

Points



Source: Eurostat, wiiw, European Commission, Markit.

weighed on the regional average. The PMI for Turkey improved over the summer months after a strong decline since the turn of the year. Somewhat surprisingly, the PMI for Russia also increased in the past months and currently stands above 50 points, indicating a mild economic expansion.

Further escalation of the conflict in eastern Ukraine poses a nonnegligible risk

Direct spillovers from the conflict in eastern Ukraine and the accompanying sanctions have so far been contained, even though the recent clouding of sentiment might at least in part be due to these tensions. Since September, a fragile armistice substantially reduced but did not fully stop violence. Nevertheless, a further escalation of the conflict including tit-for-tat sanctions poses a nonnegligible risk. Exports to Russia amount to more than 2% of GDP in Poland and Hungary and to more than 3% in the Czech Republic, Slovenia and Slovakia. A prolonged economic stagnation or even recession in Russia could become a notable factor for CESEE GDP dynamics, especially if it is amplified further by adverse repercussions from the euro area, affecting e.g. sentiment and external demand. While the share of trade with Russia accounts for only 0.9% of GDP for the euro area as a whole, the respective share is higher for individual euro area countries that are important trading partners for CESEE (e.g. Germany at 1.3% of GDP).

By comparison, the Russian trade embargo for selected food items from the EU issued in August has a fairly limited impact on CESEE EU Member States. Sanctioned products represent a high share of total exports to Russia only in Poland and a somewhat smaller share in Hungary and Bulgaria. Even in these countries, however, the embargo affects only 0.1% to 0.6% of total exports. The trade ban might even help Turkey's agricultural exports to Russia, as Russian importers seek to substitute supplies from EU markets. Turkey has a substantial trade volume in goods (especially fruits and vegetables) that are covered by Russia's sanctions against the EU, so that food exports from Turkey to Russia could be stepped up quickly.

While a lower volume of exports to Russia could dampen economic dynamics somewhat, a disruption of supplies from Russia, especially of energy, would have a severe impact on CESEE countries. Most CESEE EU Member States are heavily dependent on Russian gas supplies. For example, Bulgaria, Slovakia and Hungary obtain more than 80% of their gas from Russia. The two notable exceptions from this pattern are Romania, where the share of Russian gas in total gas consumption is rather moderate, and Croatia, which does not buy gas from Russia. Furthermore, an intensification of the conflict and possible sanctions on both sides raise the specter of a general boost to oil prices (also in conjunction with ongoing conflicts in the Middle East), which would put a further brake on economic momentum in CESEE EU Member States, but also in Turkey.

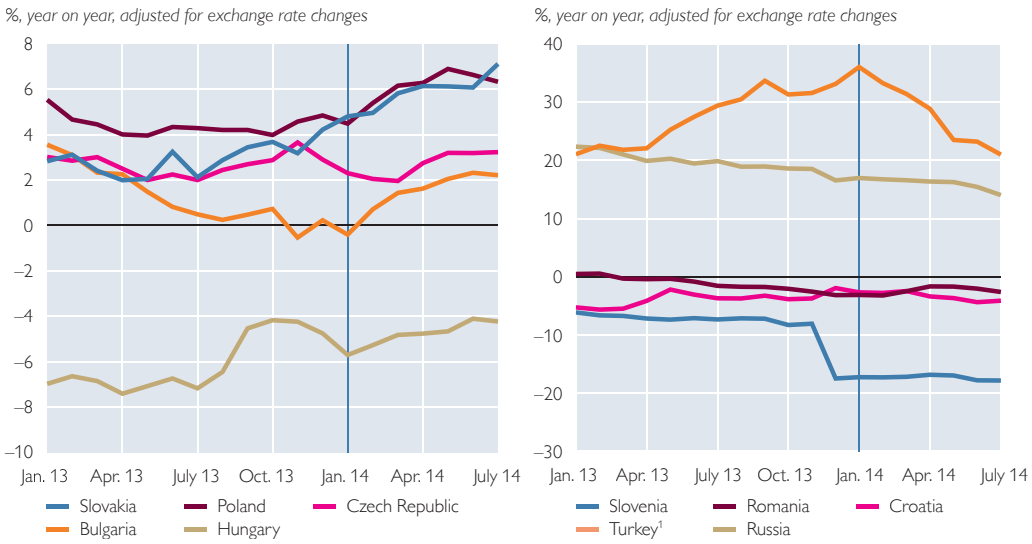
In comparison to real economic linkages, direct financial linkages of CESEE countries with Russia are less important. A further escalation of the conflict could, however, induce spillovers also to CESEE financial markets. This risk would again be most pronounced if energy supplies were affected by sanctions.

Slight improvement in financing conditions in a number of countries, but heterogeneity remains an issue

Credit dynamics were either unchanged or they improved somewhat in most countries during the review period. The latter is especially true for Poland, Slovakia, the Czech Republic and Bulgaria. In Hungary, central bank measures to support credit expansion (e.g. the Funding for Growth Scheme, see the country chapter on Hungary) had some positive effect on credit dynamics, but due to various government measures planned and taken to reduce outstanding foreign

Chart 3

Growth of Credit to the Private Sector



Source: National central banks.

[1] *Nonadjusted.*

currency debt of households and due to high sectoral taxes on banks, the credit stock continued to decline in the review period.

Lending surveys point to stable or improved credit supply and demand conditions: For example, the bank lending conditions index in Emerging Europe as collected by the Institute of International Finance[3] eased for the first time since the second quarter of 2013, with the overall index increasing noticeably by 6 points in the second quarter of 2014. The index for funding conditions even surged by 17 points, as both domestic and international funding conditions eased considerably for the first time in a year. Loan demand also increased amid a recovery in domestic demand. The demand for business loans continued to trend higher, that for consumer loans recovered after dipping temporarily in the first quarter of 2014. Notably, the demand for commercial real estate loans expanded for the first time since the first quarter of 2011 and the index for housing loan demand increased by 12 points, helped by an easing in credit standards for such loans. On the other hand, nonperforming loans (NPLs) continued to trend up, though banks expect NPLs to start declining in the coming quarters.

The CESEE Bank Lending Survey of the European Investment Bank[4] draws a somewhat less bright, but still roughly comparable picture. Banks reported a stabilization of credit demand and supply conditions, albeit at comparatively low levels. Both supply and demand are expected to improve in the next six months, however. Credit supply eased for lending to households (especially consumer credits), but continued to be tight for corporates. Banks expect an easing of supply conditions. NPLs and regulation, at both the national and international levels, remain the

[3] *http://www.iif.com/download.php?id=2venfSNbDdg=.*

[4] *http://www.eib.org/attachments/efs/economics_cesee_bls_2014_h1_en.pdf.*

most evident constraining factors affecting supply. Demand for loans improved marginally, although at a slow pace. Funding conditions are fairly favorable, with access to funding positive across all sources other than intragroup funding. Easy access to retail and corporate deposits supports a positive outlook. NPL figures deteriorated further and remain a key concern for the region's banks. However, the speed of deterioration has been decreasing.

Unlike in the larger Central European countries, credit growth remained negative in Slovenia, Romania and Croatia and continued to decelerate in Turkey and Russia. In the latter two countries, this was a welcome development, as credit expansion came down from rather high levels amid a weakening economy and substantial external imbalances in the case of Turkey. The Turkish central bank has been tightening monetary policy aggressively, with steps taken in January 2014 and several macroprudential measures effected to put a brake on the swift credit expansion (short-term dynamics, however, suggest that credit growth has started to pick up again recently). In Russia, credit growth was affected by geopolitical tensions weighing on sentiment and the outlook and impeding international refinancing possibilities. Furthermore, policy rates have been increased markedly since March 2014. In Slovenia, the banking sector is still in the process of restructuring, including the transfer of NPLs to a bank asset management company and a recapitalization of banks, which took effect at the turn of the year, as is clearly visible in the dip in lending growth in chart 3. The ongoing recession and economic uncertainty weighed on loan demand in Croatia. The Croatian central bank, however, has already taken measures to stimulate private sector lending (e.g. lowering reserve requirements provided that the released liquidity is used to grant loans to nonfinancial enterprises).

International banking groups keep up their exposures in CESEE

The exposure of international banking groups active in the region increased by some EUR 15 billion in the final quarter of 2013 and remained at roughly this level in the first quarter of 2014 (more recent data were not available at the time of writing, because the publication lag of these data is almost four months). The increase was driven predominantly by Turkey, but Poland and the Czech Republic also reported higher figures. A stronger reduction could be observed only in Russia (–EUR 8 billion between the third quarter of 2013 and the first quarter of 2014).

The EIB lending survey explored the commitment of international banking groups to CESEE and found that operations in this region remain a key strategic component of overall business strategies. CESEE operations are expected to remain profitable or to become profitable again, delivering on average higher returns on assets than overall group operations. Cross-border banks have become more selective in their country-by-country strategies, though, putting greater weight on economic prospects and reliable policy conduct.

Very moderate price pressures in most countries of the region

Price pressures stayed very moderate throughout the review period in all countries but Russia and Turkey. Bulgaria has recorded deflation for several months already, while the price level has essentially stagnated in Poland and Slovenia and for several months in Slovakia. Among the components of the HICP, it was especially energy and unprocessed food items that pushed prices down. Some upward pressure on prices came only from services and in some countries from processed food (including alcohol and tobacco). Disinflation pressure from the euro area was another factor causing weak price growth, especially in countries that peg their currencies to the euro. Core inflation rates lay above headline

inflation and in positive territory in all countries of the region. Only Bulgaria reported core deflation (see country chapter below).

The Russian trade embargo for selected food items from the countries of the EU (dairy products, meat, fish, fruit and vegetables) from August 2014 may lead to a temporary oversupply of such goods in the EU, thus possibly creating some further downward pressure on inflation. The effect will differ among Member States, depending on the consumption basket shares for which the goods account. For the EU as a whole, the respective share amounts to 10%. It is higher, though, for CESEE EU Member States, ranging from 11% in Slovenia to 21% in Romania. The price effect of the embargo should be mitigated to a certain extent, depending on the ability of domestic markets to absorb excess supply and their ability to quickly find alternative export markets. Furthermore, the European Commission announced emergency market measures to fund product withdrawals from the internal market (either for free distribution or for other destinations), green harvesting and nonharvesting of perishable fruit and vegetables most immediately impacted by the Russian measures.

Substantially higher inflation rates, i.e. rates in the high single digits, were reported for Turkey and Russia. The currencies of both countries trade substantially lower today than a year ago, and there has been a notable exchange rate pass-through on prices. In Turkey, the situation was aggravated by rising food prices after a drought in summer. As for Russia, the trade embargo (imports affected by the sanctions account for over 15% of the overall food market in Russia) is disrupting well-established trade relations and is further putting upward pressure on inflation. The Russian Ministry of Economic Development has already lifted its inflation forecast for Russia's food market in 2014 to between 12.3% and 12.7% from between 7.2% and 7.4%. As a result, the headline inflation rate is expected to reach 7.5% in 2014 instead of the previously estimated 6%.

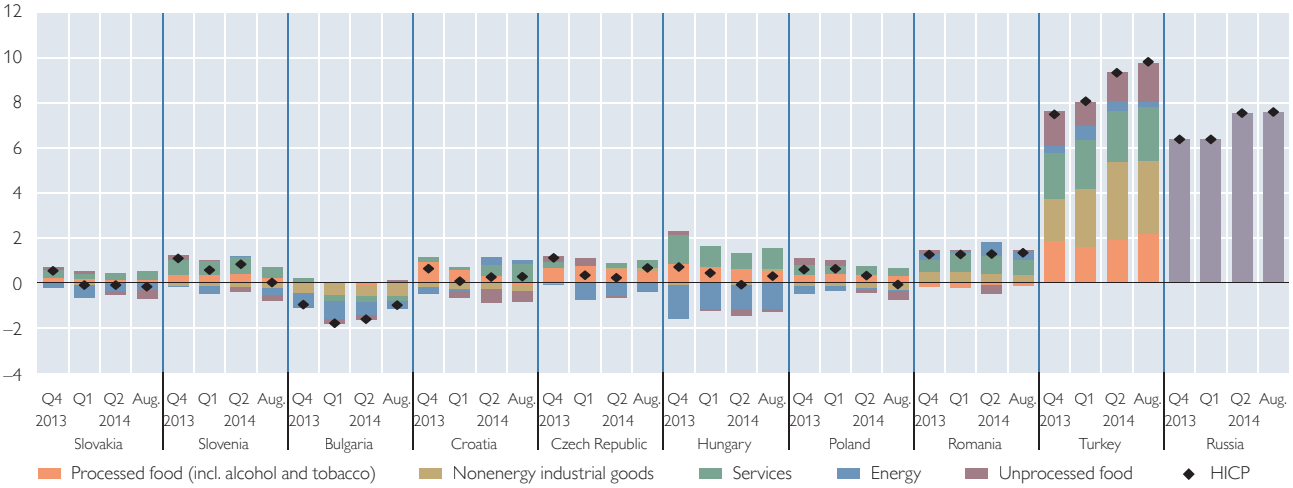
Further monetary easing in CESEE

Against the backdrop of low inflation rates or deflation, the central banks of CESEE EU Member States continued to pursue a policy of monetary accommodation.

Chart 4

HICP Inflation and Its Main Drivers

Percentage points, contribution to year-on-year change in HICP; HICP in %



Source: Eurostat.

Note: Russia: CPI. No breakdown according to COICOP available.

The Hungarian and Romanian central banks cut their policy rates by a total of 50 basis points each from early April to early October, lowering them to 2.1% and 3%, respectively. The Czech Republic's policy rate has been standing at "technically zero" since October 2012. In November 2013, the Czech central bank (CNB) decided to use the exchange rate as an additional instrument to ease monetary conditions (see Recent Developments in FEEI Q2/14). In July 2014, the CNB announced that it would continue exchange rate management at least until 2016. The two euro area countries, Slovenia and Slovakia, were subject to the ECB's interest rate decisions of June and September 2014.

Monetary policy was loosened most substantially in Turkey. The background for this move, however, was different from that in the CESEE EU countries: The Turkish lira had depreciated strongly in late 2013 and early 2014, which had prompted the Turkish central bank to hike rates aggressively. Throughout the review period, however, the exchange rate recovered as uncertainty eased, and the country saw a substantial increase in portfolio inflows in the second quarter of 2014. This led the Turkish central bank to decrease its policy rate in steps between May and July, lowering it by a total of 175 basis points to 8.25%.

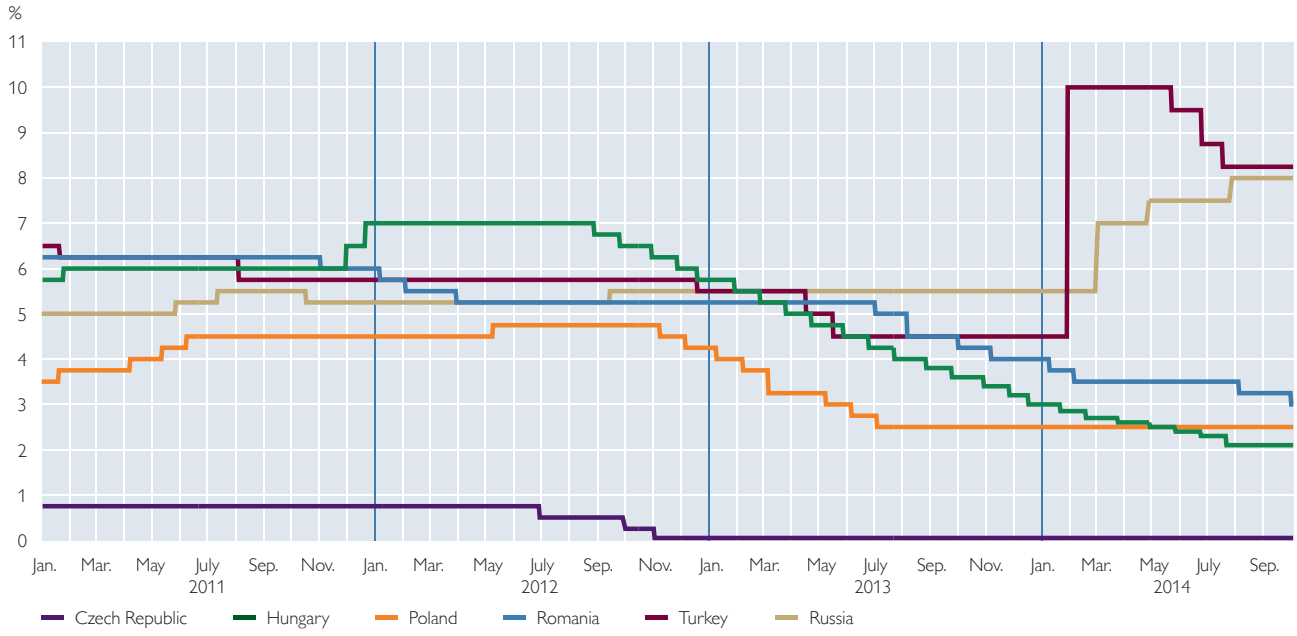
The Russian central bank was the only central bank in the region to tighten monetary policy during the review period (by a total of 100 basis points to 8%), as the conflict in eastern Ukraine led to heightened political uncertainty, currency depreciation, capital outflows and higher inflation rates.

Some further improvement in the external position of the CESEE region…

The combined current and capital account for the region as a whole improved somewhat in the review period, switching from a deficit of 0.1% of GDP at the end of 2013 (four-quarter moving sum) to a surplus of 0.6% of GDP in mid-2014. This development was driven to a substantial extent by Russia and Turkey. In both

Chart 5

Policy Rate Developments in CESEE



Source: National central banks.

countries, trade balances improved against the background of decreasing domestic demand and currency depreciation. Turkey, however, continued to report a substantial trade deficit that kept its combined current and capital account deep in the red. Higher current account surpluses were reported also for Poland and the Czech Republic, related in part to higher inflows through the capital account, even though increasing outflows of FDI income dampened this trend in the Czech Republic in the second quarter of 2014.

In the other countries of the region, external balances remained broadly unchanged or deteriorated somewhat. Remarkably for emerging economies, however, all countries posted (in most cases substantial) surpluses in the combined current and capital account.

…while Russia reports substantial capital outflows

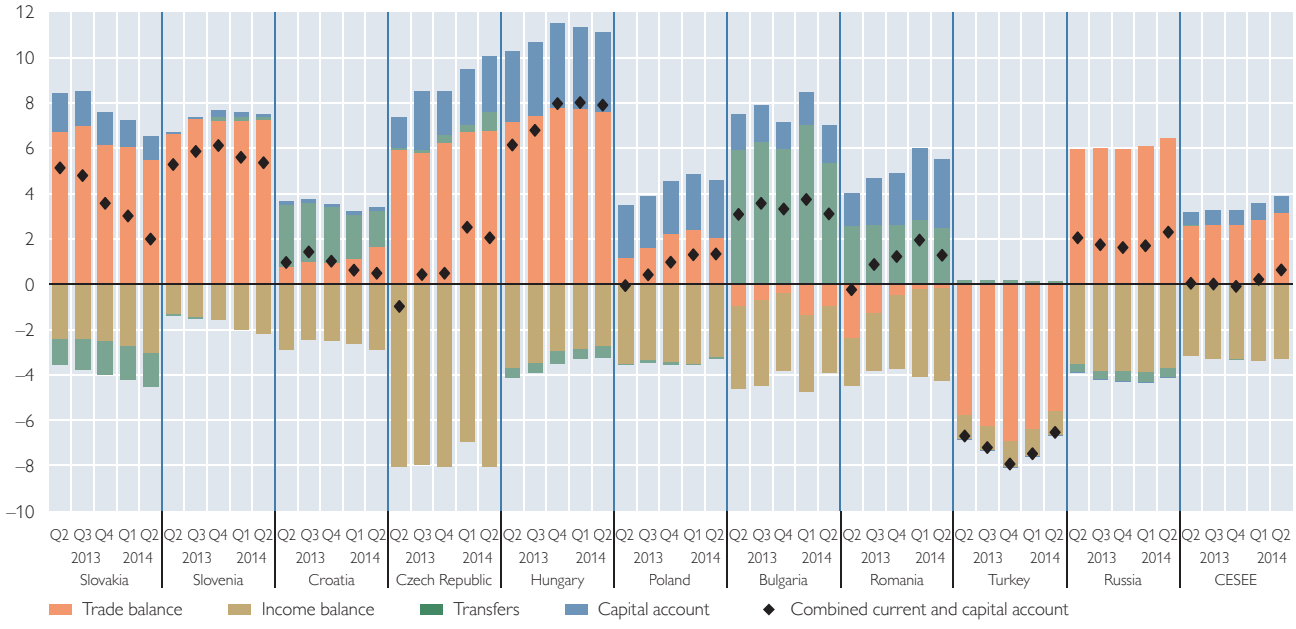
Net capital flows to the ten CESEE countries as a whole, as recorded in the financial account, decelerated markedly from 2.9% of GDP in the last quarter of 2013 to –4.8% of GDP in the second quarter of 2014 (four-quarter moving sums). The deterioration was driven by lower inflows of portfolio investments and by higher outflows from other investments. At the same time, net FDI picked up somewhat, suggesting a continuing attractiveness of many (though not all) CESEE countries covered here as an investment destination.

Regional developments were very much driven by Russia. Net outflows from the country increased by more than EUR 40 billion in the review period against the background of capital flight due to the uncertain political situation. Roughly one-third of this sum came from portfolio investments and two-thirds from other investments. As chart 7 shows, net financial flows also moderated noticeably to Croatia and Romania (by EUR 1.6 billion and EUR 4 billion) as well as to Turkey

Chart 6

Combined Current and Capital Account Balance

% of GDP, four-quarter moving sum



Source: Eurostat, IMF, national central banks.

and Poland (by some EUR 22 billion and roughly EUR 7 billion). While a financial account surplus turned into a slight deficit in Poland in the second quarter of 2014, Turkey still reported substantial net capital inflows. In fact, a rebound of inflows to Turkey could be observed after a weak start in 2014.

Except for the Czech Republic, where the financial account balance remained broadly unchanged, some improvement was reported for the other countries of the region (mostly around 2% of GDP), as FDI recovered (Slovenia, Slovakia) and as outflows from other investment moderated (Bulgaria, Hungary, Slovakia). Higher portfolio inflows also played a role in some countries (Bulgaria, Slovenia). It needs to be noted, however, that the financial account remained in substantial deficit in Hungary and Slovenia, thus largely (Hungary) or fully (Slovenia) offsetting the surplus in the combined current and capital account balances.

Only three CESEE countries remain in excessive deficit; ESA 2010 brings some changes to public sector deficits and debt ratios

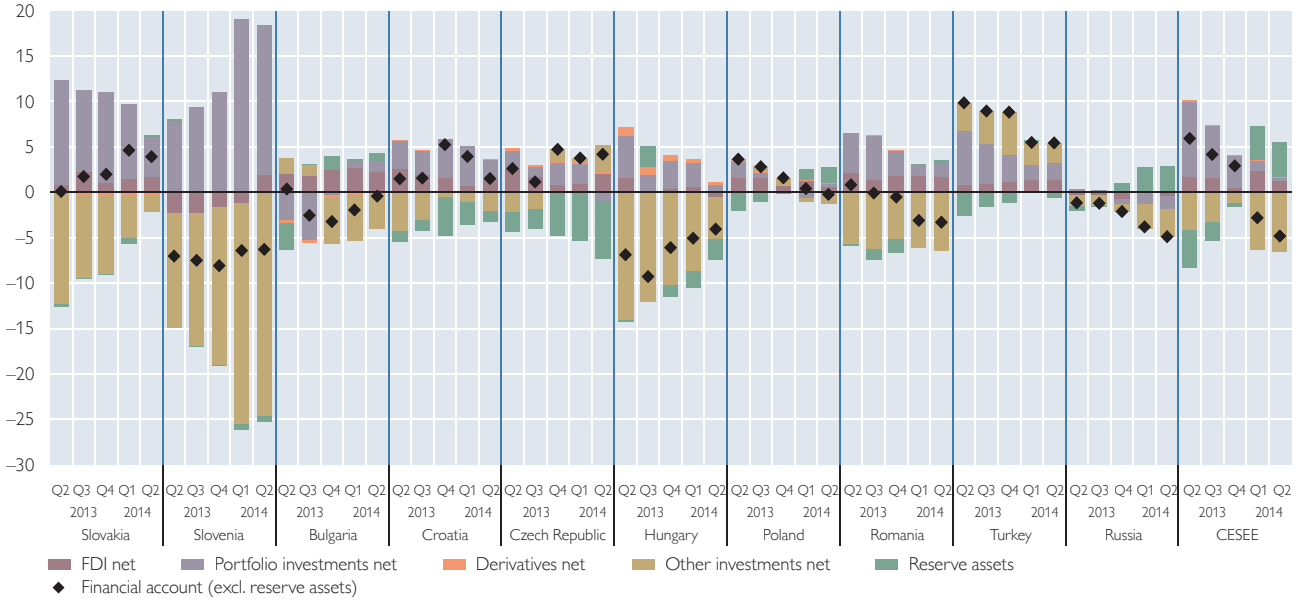
Excessive deficit procedures (EDPs) were abrogated for two CESEE countries during the review period. In 2013, the Czech Republic and Slovakia managed to bring down their public deficits in a sustainable way to below 3% of GDP. This left Slovenia, Poland and Croatia as the only CESEE EU countries still subject to an excessive deficit procedure. The target dates for a correction currently stand at 2015 for Slovenia and Poland and at 2016 for Croatia.

In October, Eurostat published the notification figures for public deficits and debt for EU countries. These differed from the figures released in spring due to a methodological change in the European System of National Accounts (switch from ESA 95 to ESA 2010). Two effects are at play: First, the recognition of research and development as well as expenditure on weapon systems as investment (in addition to some other, quantitatively less important changes) increases GDP, while it also implies some changes for the composition of GDP. The effect amounts

Chart 7

Financial Account Balance

% of GDP, four-quarter moving sum



Source: National central banks.

to 2.3% for the EU. For most CESEE EU Member States, however, the effect was smaller; only in the Czech Republic did GDP increase by 3.1%. Second, ESA 2010 also has an impact on the absolute value of debt and deficits. The main methodological changes relate to a reclassification of positions subsumed under general government and a change in the recording of lump sum payments in relation to transfers of pension funds. Depending on the relative size of these changes and the change in GDP, debt ratios went up, down or remained the same. The most fundamental change was observed in Croatia, where the debt-to-GDP ratio increased by 8.6 percentage points.

Box 1

Ukraine: Conflict Squeezes Foreign Exchange Market, Drags Country into Deep Recession:[1]

The conflict in the eastern parts of the country dragged the Ukrainian economy down into recession in the first half of 2014, with GDP shrinking by 3%. The output contraction will accelerate in the second half of the year, with the impact of the conflict increasingly reflected by short-term indicators from mid-2014. After industrial production declined by only 5% in the first half of 2014, it plummeted by 12.1% in July and 21.4% in August. The deterioration was mainly driven by the production outfalls in the heavily industrialized eastern regions Lugansk and Donetsk, where the heavy fighting between Ukrainian and pro-Russian forces was concentrated during the summer months. The cease-fire announced in early September 2014 has remained fragile. Tensions with Russia have mounted sharply not only because Russia has annexed Crimea and because it supports separatist forces in eastern Ukraine, but also because of the ongoing gas conflict and because of pressure from Moscow not to implement any parts of the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, which was ratified in September. The provisional application of the DCFTA was postponed until end-2015.

Following the sizeable depreciation of the hryvnia in early 2014, the situation in the foreign exchange market stayed tense, while deposit outflows from the banking system continued and high foreign currency demand met low supply. The hryvnia repeatedly came under considerable pressure, prompting the central bank to raise its key policy rate (currently at 12.5%), to tighten existing administrative measures, introduce new measures and to conduct regular forex auctions. In mid-September, the currency bottomed out at UAH 14.4 against the U.S. dollar before recovering in late September. The 36% depreciation (vis-à-vis the U.S. dollar) since the beginning of the year affects unhedged foreign currency debtors. In the household sector, the share of foreign currency loans increased to 45% of total loans due to the exchange rate valuation impact.

As a consequence of declining domestic demand and the weakening of the hryvnia, which has helped exports, the current account deficit shrank markedly. In the first half of 2014, the current account deficit amounted to 3.6% of GDP compared to 6.8% in the first half of 2013. The depreciation also caused inflation to rise from 0.5% at end-2013 to 17.5% in September 2014.

Despite the very difficult environment, the Ukrainian authorities have implemented policies broadly as agreed under the IMF Stand-by Arrangement so far. The positive conclusion of the first review enabled the disbursement of a further USD 1.4 billion tranche. The IMF revised its baseline scenario downward and pointed to large downside risks and related additional funding needs. The next review is scheduled to start in the second half November 2014 after the parliamentary elections in late October.[2]

[1] *Author: Mathias Lahnsteiner.*

[2] *For further data, see Statistical Annex.*

Box 2

Western Balkans:[1,2] Floods in May Ravage Bosnia and Herzegovina as well as Serbia

In the first half of 2014, economic growth weakened in all Western Balkan countries compared to 2013 except in FYR Macedonia. Economic developments in Bosnia and Herzegovina as well as in Serbia were overshadowed by the floods in late May that put a severe drag on overall economic developments. Serbia's economic growth was negative in this period. For Bosnia and Herzegovina, no growth figures have been released yet for the second quarter of 2014, but first estimates suggest real GDP growth to have turned negative there, too. The international community has provided immediate emergency help for the countries hit by the floods, also with the intention of stabilizing the economy. In Montenegro, real GDP growth was weak in the first half of 2014. Demand components have not yet been released, but sluggish growth is mainly the result of the drag on net exports caused by declining industrial production over this period. Economic growth also was subdued in Albania over the first six months of 2014 and even turned negative in the second quarter of 2014. A detailed breakdown of quarterly growth figures has not become available yet. In contrast, GDP growth was strong in FYR Macedonia, coming to about 4% in the first half of 2014. A noteworthy development is that growth drivers have changed and have moved away from state-led construction to private consumption as a result of higher wages and weak inflation. Kosovo does not compile quarterly GDP figures. However, the Central Bank of the Republic of Kosovo (CBK) saw higher consumption growth in the first half of 2014 compared to the same period of 2013 on the back of wage and salary hikes in the public sector and higher remittances. 2013 data have been revised in the process of bringing the national accounts in line with Eurostat standards. FYR Macedonia revised GDP growth down from 3.1% to 2.2%, Montenegro from 3.5% to 3.3%. The revision in Serbia was only minor.

Mirroring GDP dynamics, industrial production weakened throughout most of the Western Balkans. In Bosnia and Herzegovina as well as Serbia, the floods weighed on industrial production, resulting in negative growth rates in the second quarter of 2014 (after positive growth in the first quarter). In Montenegro, industrial production decreased at double-digit rates in the first half of 2014 primarily in the electricity, mining and gas industries. In FYR Macedonia, industrial production decelerated in the utility sectors as well, but this was more than compensated by higher manufacturing output. Albanian industrial production also weakened in the course of the first half of 2014. More recent July and August data showed that industrial production declined in Montenegro and Serbia as well as in Bosnia and Herzegovina (only in August). For Albania, no monthly data on industrial production is available (Kosovo has neither monthly nor quarterly data).

In the first half of 2014, the trade gap widened in Bosnia and Herzegovina and in Serbia due to higher imports of construction materials and lower exports of agricultural goods. In addition to these flood-related effects, Serbian exports were also affected by the temporary halt of production at a vehicle manufacturing site. With the exception of FYR Macedonia, the trade balance also worsened in the rest of the region. On the back of a poorer trade performance, the current account deficits increased or remained almost constant in all of these countries. Montenegro showed the largest current account deficit, about 15% of GDP in the first half of 2014 (2013: 14.6%). In contrast, the current account deficit stayed below 2% of GDP in FYR Macedonia in the first half of 2014, driven by an improvement of the merchandise trade balance and an increase of transfers. Thus, the heterogeneous external balances of the region persisted also in the review period.

[1] *Author: Antje Hildebrandt.*

[2] *The Western Balkans comprise the EU candidate countries Albania, FYR Macedonia, Montenegro and Serbia, as well as the potential candidate countries Bosnia and Herzegovina, and Kosovo. The designation "Kosovo" is used without prejudice to positions on status, and in line with UNSC 1244 and the opinion on the Kosovo Declaration of Independence.*

In line with restrained economic growth, the dynamics of lending to the nonbank private sector remained weak in Albania, Montenegro and Serbia, with rates running below 2% in the first half of 2014. In contrast, FYR Macedonia exhibited high credit growth of more than 9%. Albania and Serbia saw credit growth picking up somewhat in July and August from the first half of 2014, whereas credit growth turned negative in Montenegro. In the first half of 2014, NPLs increased slightly in all countries compared to 2013. With an NPL ratio of more than 24%, Albania had the highest rate; at the other end of the spectrum, Kosovo had the lowest rate of NPLs at around 8%.

Inflationary pressure stayed very subdued in the region. Inflation rates declined in the course of the year in almost all Western Balkan countries. Bosnia and Herzegovina as well as Montenegro registered negative inflation rates throughout the first half of 2014. Inflation turned negative in the second quarter of 2014 in FYR Macedonia. In Kosovo, the price dynamics decelerated to below 0.5% in the first half of 2014 from 1.8% in 2013. In the second quarter of 2014, inflation stood at 1.6% in Albania and at 1.8% in Serbia, so that both countries missed their inflation targets (3% ±1 percentage point in Albania and 4.5% ±1.5 percentage points in Serbia). Overall, subdued inflation rates were largely the result of declining agricultural prices (both domestic and imported goods), low commodity prices and weak aggregated demand. Most countries saw a slight pickup of price dynamics in July and August 2014 mostly because food prices rose. With an inflation rate of 2.0% in August, Albania was even within its inflation target range again. By contrast, prices in Montenegro fell further, dropping by more than 1% in July and August 2014. Motivated by the subdued inflationary environment, the National Bank of Albania cut its key interest rate by 25 basis points to 2.5% in May. The Albanian lek remained broadly stable against the euro. In Serbia, the key interest rate was cut in two steps, from 9.5% to 8.5%, in the second quarter of 2014. In the first nine months of 2014, the Serbian dinar lost 4% of its value against the euro, which prompted the National Bank of Serbia to intervene in the forex market several times.

Serbia faces the most challenging fiscal situation in the region. In September 2014, the Serbian government announced an austerity package providing e.g. for a cut in pensions and public sector wages and for a reduction of subsidies for state-owned enterprises. Its implementation has not started yet. The budget deficit for 2014 is expected to exceed the target by a considerable margin and could reach more than 8% of GDP. Despite solid GDP growth, the budget deficit is expected to come in somewhat above target also in the FYR Macedonia (related to higher spending in the forefront of elections). Because of the unexpected need for funds in the wake of the flooding, both regions in Bosnia and Herzegovina as well as the central government had to revise their budgets. In contrast, Albania expects to meet its – rather loose – budget deficit target of slightly more than 6% of GDP. For Kosovo and Montenegro, the 2014 budgets are largely on track.

Albania moved one step forward toward EU membership: The country was granted EU candidate status in June 2014. A month later, the EU and Kosovo initialed the Stabilisation and Association Agreement. No progress was made in the accession process of Bosnia and Herzegovina. Albania as well as Bosnia and Herzegovina lag behind in fulfilling the obligations agreed on with the IMF. Although the IMF concluded the first review under the Extended Fund Facility with Albania in June 2014, the second review of the arrangement held in September was not concluded. The disbursement of the next tranche of the loan was postponed, as there are still some outstanding issues concerning the budget for 2015, structural reforms as well as Bank of Albania governance issues. The IMF also announced that it would not conclude the eighth review of the Stand-by-Arrangement with Bosnia and Herzegovina, since the country has not implemented the agreed policies yet. Currently, Serbia is holding talks on a new arrangement with the IMF.

2 Slovakia: GDP Growth Revives on the Back of Recovering Domestic Demand

Domestic demand becomes key driver of economic growth

After slowing down for four consecutive years, GDP growth picked up again in the first half of 2014, substantially outpacing euro area dynamics. Following two years of contraction, domestic demand recovered, complementing the strong export sector, which has been a key element in Slovak economic performance in recent years. Investment has been growing robustly since the final quarter of 2013, and private consumption growth also accelerated in the review period, driven by improved labor market conditions and higher real wages. Public consumption gained steam as well. Since the fourth quarter of 2013, imports have increased considerably faster than exports, which has dampened overall GDP growth, as the contribution of net exports to growth has slipped into moderately negative territory. Looking forward, car industry plants in Slovakia are planning new investments that will increase output over the medium term and that will help exports regain momentum.

Inflation hits new all-time lows in the first half of 2014

Reflecting subdued energy and food prices as well as an appreciation of the euro, inflation turned marginally negative in January 2014 and has stayed in marginally negative territory since then. Russian import sanctions as well as favorable agricultural conditions in 2014 may put further downward pressures on food prices, while reviving consumption is expected to have some upward impact on price dynamics.

Positive changes in labor market but serious challenges remain

In the second quarter of 2014, some signs of positive labor market developments emerged. After a prolonged period of stubbornly high unemployment, the second quarter brought a fall in the unemployment rate to 13.2%, which is 0.9 percentage points lower than in the previous year. Accelerating nominal wage growth, in conjunction with inflation developments, translated into substantial real wage growth (around 6% in the second quarter of 2014). The employment rate rose by 0.9 percentage points to 60.7% in the second quarter of 2014 from a year earlier, which is the highest level since the second quarter of 2009. Despite these positive changes, a reduction of the still high jobless rate, especially among the younger population, remains a key challenge. Furthermore, the structural composition of unemployment remains unfavorable, with a high share (about two-thirds) of long-term unemployed persons and large regional disparities in unemployment.

Slovakia exits the EDP but surpasses the third limit of the constitutional debt brake

The fiscal position has improved significantly in recent years, with the general government deficit declining from 7.5% of GDP in 2010 to 2.6% of GDP in 2013. This enabled the country to exit the EDP in 2014. The European Commission found that the structural balance improved on average by 1.5% of GDP per year over the period 2010 to 2013. Nevertheless, Slovakia must reinforce the budgetary measures to ensure full compliance with the preventive arm of the Stability and Growth Pact. This will also help to rein in a continued increase in public debt ratios. At the end of 2013, the gross public debt level overshot the constitutional debt brake threshold of 55% of GDP. As a consequence, the Slovak government was obliged to set aside 3% of total state budget expenditures during 2014 and to present a budget without a nominal expenditure increase for 2015. However, the transition to ESA 2010 accounting standards in October brought about a revision of the government debt ratio in 2013 to slightly below 55% of GDP. While the expenditure cuts have already been implemented in the 2014 budget, this provides some leeway for the 2015 budget.

Table 2

Main Economic Indicators: Slovakia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	3.0	1.8	0.9	0.5	0.8	0.9	1.5	2.4	2.5
Private consumption	–0.5	–0.2	–0.1	–1.6	0.9	0.1	0.3	3.4	2.7
Public consumption	–4.3	–1.1	1.4	–0.3	0.4	2.8	2.5	4.4	5.3
Gross fixed capital formation	14.2	–10.5	–4.3	–7.9	–4.8	–9.8	4.0	3.6	6.2
Exports of goods and services	12.2	9.9	4.5	4.9	4.4	1.9	6.6	9.6	3.4
Imports of goods and services	9.7	3.3	2.9	2.5	1.9	–0.4	7.4	10.8	5.5
	Contribution to GDP growth in percentage points								
Domestic demand	1.0	–4.1	–0.8	–2.0	–2.1	–1.2	2.1	3.6	5.3
Net exports of goods and services	2.0	5.9	1.7	2.5	2.6	2.1	–0.4	–0.4	–1.6
Exports of goods and services	9.8	8.8	4.3	4.7	4.4	1.7	6.6	9.4	3.4
Imports of goods and services	–7.8	–2.9	–2.6	–2.3	–1.7	0.3	–7.0	–9.8	–5.0
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	0.7	1.0	–1.0	0.4	–1.1	–1.7	–1.6	1.9	2.8
Unit labor costs in manufacturing (nominal, per hour)	2.1	–7.2	–2.1	1.4	0.5	–2.3	–7.3	–4.5	–0.1
Labor productivity in manufacturing (real, per hour)	2.7	12.6	8.0	6.9	6.2	7.4	11.2	6.0	4.7
Labor costs in manufacturing (nominal, per hour)	5.0	4.5	5.7	8.5	6.7	5.0	3.1	1.3	4.5
Producer price index (PPI) in industry	4.5	1.9	–1.0	0.5	–0.7	–1.5	–2.3	–3.4	–3.6
Consumer price index (here: HICP)	4.1	3.7	1.5	2.2	1.7	1.4	0.5	–0.1	–0.1
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	13.7	14.0	14.3	14.6	14.1	14.1	14.3	14.1	13.2
Employment rate (%, 15–64 years)	59.3	59.7	59.9	59.8	59.8	60.0	59.8	60.2	60.7
Key interest rate per annum (%)	1.2	0.9	0.5	0.8	0.6	0.5	0.3	0.3	0.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	0.7	6.6	5.9	5.5	6.1	5.6	5.9	7.3	6.9
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–3.8	–3.1	0.3	0.4	–5.9	–6.5	0.3	0.2	2.5
Domestic credit of the banking system	9.4	–7.1	0.7	–10.9	–7.0	–2.2	0.7	2.1	9.0
of which: claims on the private sector	6.9	–0.1	5.1	1.8	2.8	3.4	5.1	5.7	6.2
claims on households	3.9	3.9	4.1	3.9	4.1	4.1	4.1	4.4	4.7
claims on enterprises	2.9	–4.0	1.0	–2.1	–1.3	–0.7	1.0	1.3	1.5
claims on the public sector (net)	2.5	–6.9	–4.4	–12.7	–9.8	–5.6	–4.4	–3.5	2.8
Other assets (net) of the banking system	–4.9	16.7	4.8	16.0	19.0	14.3	4.8	5.0	–4.6
	% of GDP								
General government revenues	36.4	36.0	38.4	..	..	..	..	..	..
General government expenditures	40.6	40.2	41.0	..	..	..	..	..	..
General government balance	–4.1	–4.2	–2.6	..	..	..	..	..	..
Primary balance	–2.7	–2.4	–0.7	..	..	..	..	..	..
Gross public debt	43.5	52.1	54.6	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	48.3	47.3	49.4	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	27.2	28.7	30.8	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	1.5	5.0	5.9	7.8	9.1	4.6	2.6	7.2	7.2
Services balance	–0.5	0.4	0.2	–0.3	0.2	0.9	–0.1	–0.1	–0.1
Income balance (factor services balance)	–4.2	–2.3	–2.5	–2.6	–2.4	–2.3	–2.6	–3.7	–3.6
Current transfers	–0.5	–0.9	–1.5	–0.6	–1.6	–2.0	–1.7	–0.5	–1.6
Current account balance	–3.8	2.2	2.1	4.4	5.3	1.2	–1.9	2.9	1.8
Capital account balance	1.3	1.9	1.4	1.0	1.3	0.8	2.6	–0.0	0.6
Foreign direct investment (net)	2.9	3.2	1.1	–0.9	–3.3	5.0	3.0	0.8	–2.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	76.7	75.6	82.7	80.8	84.5	86.2	82.7	90.9	89.0
Gross official reserves (excluding gold)[1]	1.0	0.9	0.9	1.0	1.2	0.9	0.9	1.5	1.0
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.2	0.1
	EUR million, period total								
GDP at current prices	68,974	71,096	72,134	16,710	18,036	18,996	18,393	17,022	18,381

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

[1] *Given Slovakia's adoption of the euro, the calculation of international reserves has changed as of the beginning of 2009. Specifically, reserves no longer include foreign assets in euro and claims on euro area residents.*

3 Slovenia: New Government Faces Major Challenges Despite Moderate Pickup in Economic Activity

Center-left coalition takes up office as economy improves

Following the resignation of Prime Minister Bratušek in May 2014, parliamentary elections brought to power a new center-left government. The government intends to continue privatization, reduce public spending, increase tax efficiency, further stabilize the financial system, enhance competitiveness and promote job creation and FDI. It is not yet clear how the coalition will deal with a number of key issues (e.g. privatization, the healthcare and pension reform, fiscal consolidation), as the political will to address these issues is limited in parts of the coalition. The consent of all coalition partners, however, is needed to ensure clear majority support in parliament.

The new government entered into office in improving economic surroundings. GDP expanded by 2.5% year on year during the first half of 2014, notably above the euro area reading. Private consumption growth reentered positive territory after contracting substantially – by nearly 7% – over 2012 and 2013, amid employment gains, real wage increases and less adverse consumer sentiment. Public consumption continued to contract, while investments were up by around 5% thanks to strong construction activity related to EU funding. Net real exports also supported GDP growth, as export growth accelerated and outpaced import growth by a solid margin.

Further progress in bank restructuring

The European Commission approved the restructuring plan for the bank Abanka in August, greenlighting the second tranche of recapitalization and the transfer of bad assets to the Bank Asset Management Company. Furthermore, Slovenia has committed to merge Abanka with Banka Celje (a small bank that requested state aid in April 2014) and to submit a restructuring plan for the joint entity by end-2014. Following the reception of six nonbinding bids for Nova Kreditna Banka Maribor d.d. (NKBM), the Slovenian Sovereign Holding invited binding bids for the bank in August. Also on a positive note, the banking system posted a modest profit during the first half of 2014, owing to the halving of impairment and provisioning costs and to some extent the increase in net operating income. Despite this progress, banks are still burdened with high and again increasing NPLs, which continue to foster deleveraging, especially by nonfinancial corporations. To slow down the decline in the banking system's loan-to-deposit ratio and to stabilize the banking system's funding structure, Banka Slovenije introduced minimum requirements on changes in loans to nonbanks relative to changes in deposits by nonbanks as of end-June 2014.

Further reform measures needed

Following up on previous reforms will be necessary to make the economic recovery last. In a policy strategy paper, Banka Slovenije identified four major priorities: efficiency of the legislation and the judiciary system; deleveraging and restructuring of enterprises; restoration of banks' balance sheets and enhanced financial stability; reinforcement of the long-term stability of public finances. The central bank's detailed proposals – such as the completion of banks' balance sheet repair, bank resolution through liquidation and consolidation, enhanced supervision and risk management, comprehensive and rapid corporate restructuring, privatization of banks and nonbank enterprises including the attraction of FDI, additional durable fiscal consolidation (according to Banka Slovenije, measures in the magnitude of cumulative 1.8% of GDP over 2014 to 2015 will be required to exit the EDP in 2015) and structural reforms (healthcare, pension, education, labor market, local government) – are also reflected in the European Council's eight recommendations issued to Slovenia in June 2014.

Table 3

Main Economic Indicators: Slovenia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	0.6	–2.6	–1.0	–4.5	–1.3	–0.3	2.1	2.1	2.9
Private consumption	–0.1	–3.0	–3.9	–6.4	–3.2	–4.4	–1.6	1.1	0.2
Public consumption	–1.3	–1.5	–1.1	–1.7	–1.0	–1.0	–0.8	–1.9	–1.9
Gross fixed capital formation	–4.6	–8.9	1.9	–1.9	0.8	1.0	7.4	4.6	5.2
Exports of goods and services	7.0	0.3	2.6	1.2	1.5	3.9	3.9	4.9	5.2
Imports of goods and services	5.0	–3.9	1.4	–2.7	1.2	2.5	4.6	3.3	3.3
	Contribution to GDP growth in percentage points								
Domestic demand	–0.7	–5.5	–2.0	–7.3	–1.7	–1.5	2.6	0.7	1.3
Net exports of goods and services	1.4	2.9	1.0	2.8	0.3	1.2	–0.4	1.4	1.6
Exports of goods and services	4.5	0.2	1.9	0.8	1.1	2.8	2.9	3.7	3.8
Imports of goods and services	–3.2	2.7	–1.0	1.9	–0.8	–1.7	–3.3	–2.3	–2.2
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	–1.2	0.9	0.9	–0.3	0.4	1.1	2.4	–0.4	–1.3
Unit labor costs in manufacturing (nominal, per hour)	0.2	4.7	2.8	8.0	–3.1	2.5	4.1	0.9	0.3
Labor productivity in manufacturing (real, per hour)	1.6	–1.8	–2.1	–3.3	–2.6	–2.9	0.4	2.3	2.3
Labor costs in manufacturing (nominal, per hour)	1.9	2.9	0.6	4.4	–5.7	–0.5	4.4	3.2	2.6
Producer price index (PPI) in industry	4.6	0.9	0.0	0.7	0.2	–0.2	–0.6	–0.8	–1.2
Consumer price index (here: HICP)	2.1	2.8	1.9	2.7	1.8	2.2	1.1	0.6	0.8
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	8.4	9.0	10.3	11.2	10.5	9.5	9.8	11.0	9.5
Employment rate (%, 15–64 years)	64.4	64.1	63.3	62.4	63.0	64.5	63.2	62.5	64.5
Key interest rate per annum (%)	1.2	0.9	0.5	0.8	0.6	0.5	0.3	0.3	0.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	3.0	–0.7	0.2	0.6	–0.8	0.6	0.2	1.4	4.4
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	6.5	3.9	19.7	10.5	19.0	18.8	19.7	29.1	27.4
Domestic credit of the banking system	–3.1	–2.7	–13.8	–8.1	–15.9	–18.3	–13.8	–23.1	–19.7
of which: claims on the private sector	–3.8	–7.2	–22.9	–9.9	–10.3	–10.4	–22.9	–21.1	–22.1
claims on households	0.8	–0.8	–1.5	–1.1	–1.1	–1.2	–1.5	–1.3	–1.2
claims on enterprises	–4.6	–6.4	–21.4	–8.9	–9.1	–9.2	–21.4	–19.8	–20.8
claims on the public sector (net)	0.7	4.5	9.1	1.8	–5.6	–7.8	9.1	–2.0	2.3
Other assets (net) of the banking system	–0.4	–2.0	–5.7	–1.7	–3.9	0.1	–5.7	–4.7	–3.3
	% of GDP								
General government revenues	43.6	44.4	45.2	..	..	..	..	..	..
General government expenditures	49.8	48.1	59.7	..	..	..	..	..	..
General government balance	–6.2	–3.7	–14.6	..	..	..	..	..	..
Primary balance	–4.3	–1.7	–12.0	..	..	..	..	..	..
Gross public debt	46.2	53.4	70.4	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	97.6	95.9	85.4	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	30.6	30.5	29.6	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–2.6	–0.5	1.8	1.6	2.6	2.7	0.2	3.4	3.2
Services balance	4.0	4.8	5.4	6.0	5.7	5.9	4.2	4.2	5.1
Income balance (factor services balance)	–1.4	–1.5	–1.6	–0.7	–2.1	–2.5	–0.9	–2.6	–2.7
Current transfers	0.4	0.0	0.2	–0.8	0.3	–0.8	1.8	–0.9	0.4
Current account balance	0.4	2.8	5.8	6.0	6.5	5.4	5.4	4.2	6.0
Capital account balance	–0.2	0.1	0.3	0.4	–0.0	0.1	0.8	–0.0	–0.4
Foreign direct investment (net)	1.7	0.5	–1.7	–1.2	–7.0	0.7	0.9	0.8	5.3
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	108.8	114.6	110.5	114.7	114.6	112.3	110.5	116.8	119.9
Gross official reserves (excluding gold)[1]	1.7	1.6	1.6	1.5	1.5	1.7	1.6	2.0	2.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
	EUR million, period total								
GDP at current prices	36,869	36,006	36,144	8,292	9,275	9,307	9,269	8,571	9,583

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

[1] *Given Slovenia's adoption of the euro, the calculation of international reserves has changed as of the beginning of 2007. Specifically, reserves no longer include foreign assets in euro and claims on euro area residents.*

4 Bulgaria: Domestic Demand Decelerates After Bank Runs

After a respectable start into the year, the June bank run put a drag on the recovery

The moderate economic expansion that started in the second half of 2013 continued also in the first half of 2014 but has recently lost pace. Although real GDP growth accelerated in the course of the first half of 2014, its composition changed quite strongly. The main growth driver in the first quarter of 2014 was domestic demand, as all its components expanded vigorously, whereas net exports showed a strong negative growth contribution on the back of near-zero export growth. The second quarter, in contrast, brought a deceleration of domestic demand, especially of private consumption, while export growth resumed somewhat, keeping overall GDP on an expansionary path. The deceleration of domestic demand coincides with the deposit run on Bulgaria's third- and fourth-largest banks in June 2014 and seems to have carried over to the second half of the year, as industrial production has recently faltered, consumer sentiment has deteriorated, and lending to households is again stagnating after having expanded by about 2% in the first half of 2014.

Positive labor market trends, slowing deflation

On a positive note, unemployment has come down a bit, but its structural composition – the share of long-term and old-age unemployed persons is fairly large – has remained unfavorable. Consumer prices are still declining, though less quickly recently (the annual HICP dropped by 1.0% in August), driven until the first quarter of 2014 mainly by a decline in energy prices and more recently by a decline in prices for nonenergy industrial goods and services.

Challenging rescue of troubled banks, spillovers to the rest of the sector have been kept in check

The bank runs on Corporate Commercial Bank (CCB) and First Investment Bank (FIB) in June 2014 revealed connected lending practices, undue risk concentration and questionable institutional effectiveness (notably in respect of banking supervision and resolution). FIB and CCB are owned to a major extent by the domestic private sector and account for about 20% of the banking system's total assets. The Bulgarian National Bank (BNB) put CCB under conservatorship and opened a procedure for declaring bankruptcy, which would mark the first bank insolvency in Bulgaria since the late 1990s. Most pressing at the time of writing is the fact that legal restrictions have prevented the payout of insured deposits with CCB and the shortage of funds in the Bulgarian bank deposit guarantee fund (of about 2% of GDP). Solving this issue will be a key priority right after the early parliamentary elections on October 5.

Bulgaria's currency board arrangement has not come under pressure, as the abundant coverage of base money by gross foreign reserves (of about 180%) has remained unchanged. Spillovers to the rest of the Bulgarian banking sector have been negligible, at least based on figures for the second quarter of 2014. Profitability and banking sector capitalization are in comparatively sound shape (with a return-on-assets ratio stabilizing at 0.8% and a capital adequacy ratio rising to 21%). However, NPLs reached a new peak of 15.5% of total loans, while their coverage by provisions and reserves deteriorated from more than 70% in 2013 to just 54%.

Bank rescue impacts public finance positions, budgetary target for 2014 will not be met

Pointing to weaker-than-expected economic performance, budget revenue underperformance, and blocked financing under two EU programs, the caretaker minister of finance conceded that the targeted 2014 budget deficit of 1.8% of GDP would clearly be missed and could exceed the Maastricht ceiling of 3%. Moreover, the caretaker cabinet expects gross government debt to reach a maximum of 28.4% of GDP at year-end, up from 18.9% in 2013, partly due to the restructuring of CCB. Political parties have frequently discussed tapping the fiscal reserve account (standing at 10% of GDP in August 2014) to cover the deposit guarantee gap instead of issuing new debt.

Table 4

Main Economic Indicators: Bulgaria

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	1.8	0.6	0.9	0.9	–0.1	1.1	1.6	1.4	2.1
Private consumption	1.5	3.7	–2.3	–2.3	–3.0	–2.2	–1.7	3.8	0.3
Public consumption	1.6	–0.5	2.5	4.0	4.3	3.7	–0.7	3.3	2.6
Gross fixed capital formation	–6.5	4.0	–0.3	–5.0	–4.8	2.1	4.6	4.6	3.4
Exports of goods and services	12.3	–0.4	8.9	11.9	4.6	9.5	10.2	0.1	3.4
Imports of goods and services	8.8	3.3	5.7	5.7	2.0	8.4	6.7	5.5	2.0
	Contribution to GDP growth in percentage points								
Domestic demand	0.0	3.1	–1.1	–2.8	–1.7	–0.5	–0.0	5.5	1.1
Net exports of goods and services	1.8	–2.5	2.0	3.7	1.7	1.5	1.6	–4.2	0.9
Exports of goods and services	7.1	–0.3	6.0	8.0	3.1	6.9	6.0	0.1	2.4
Imports of goods and services	–5.2	–2.2	–3.9	–4.3	–1.5	–5.4	–4.4	–4.3	–1.5
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	2.2	4.4	5.4	7.7	7.9	3.8	1.9	1.3	0.8
Unit labor costs in manufacturing (nominal, per hour)	–1.0	2.6	2.5	2.3	5.1	3.1	–0.3	1.8	3.5
Labor productivity in manufacturing (real, per hour)	4.4	2.2	2.5	4.1	–0.7	1.5	5.5	3.3	3.6
Labor costs in manufacturing (nominal, per hour)	3.7	4.8	5.1	6.5	4.4	4.7	5.1	5.1	7.2
Producer price index (PPI) in industry	9.3	4.4	–1.5	1.7	–0.9	–3.1	–3.6	–2.8	–1.2
Consumer price index (here: HICP)	3.4	2.4	0.4	2.1	1.1	–0.7	–1.0	–1.8	–1.6
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	11.4	12.4	13.0	13.8	13.0	12.1	13.2	13.1	11.5
Employment rate (%, 15–64 years)	58.4	58.8	59.5	57.7	59.5	61.1	59.6	59.0	61.0
Key interest rate per annum (%)[1]	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	12.2	8.4	8.9	8.9	7.7	8.1	8.9	8.3	7.4
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	7.9	7.5	4.9	5.7	6.2	3.3	4.9	6.0	3.4
Domestic credit of the banking system	7.3	2.4	3.2	3.9	1.2	4.0	3.2	1.9	5.5
of which: claims on the private sector	3.9	2.6	0.3	2.0	0.6	0.2	0.3	1.3	2.1
claims on households	–0.2	–0.3	–0.0	–0.4	–0.3	–0.2	–0.0	0.1	0.1
claims on enterprises	4.1	3.0	0.3	2.4	0.8	0.4	0.3	1.2	2.1
claims on the public sector (net)	3.4	–0.2	3.0	1.9	0.7	3.8	3.0	0.6	3.3
Other assets (net) of the banking system	–3.0	–1.4	0.8	–0.8	0.3	0.7	0.8	0.5	–1.4
	% of GDP								
General government revenues	32.6	34.7	37.1	..	..	..	..	..	..
General government expenditures	34.7	35.2	38.3	..	..	..	..	..	..
General government balance	–2.0	–0.5	–1.2	..	..	..	..	..	..
Primary balance	–1.4	0.3	–0.4	..	..	..	..	..	..
Gross public debt	15.7	18.0	18.3	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	116.5	116.7	116.6	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	28.2	26.8	26.7	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–5.6	–8.7	–6.1	–5.5	–8.2	–4.0	–6.7	–10.6	–7.4
Services balance	6.0	5.7	5.7	1.3	4.9	13.8	1.7	1.7	5.6
Income balance (factor services balance)	–4.7	–3.3	–3.4	–4.0	–2.9	–4.5	–2.3	–3.9	–1.0
Current transfers	4.4	5.2	6.0	3.8	12.0	4.8	3.4	8.9	5.3
Current account balance	0.1	–1.1	2.1	–4.4	5.8	10.0	–3.9	–3.8	2.5
Capital account balance	1.3	1.4	1.2	0.2	1.3	1.5	1.5	1.5	2.0
Foreign direct investment (net)	3.1	2.2	2.4	4.0	4.2	2.6	–0.5	5.0	2.4
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	94.3	94.5	93.5	94.0	93.6	93.4	93.5	92.7	92.7
Gross official reserves (excluding gold)	30.6	34.9	33.3	32.1	33.4	34.3	33.3	32.1	32.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.6	6.0	5.7	5.6	5.8	5.9	5.7	5.4	5.5
	EUR million, period total								
GDP at current prices	38,505	39,927	39,940	8,389	9,809	10,768	10,974	8,231	9,979

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

[1] *Not available in a currency board regime.*

5 Croatia: Falling Domestic Demand Prolongs Recession

Further economic contraction on the back of negative domestic demand

The protracted recession in Croatia was prolonged into the first half of 2014, with GDP declining by 0.7%. All components of domestic demand contributed negatively to growth, most of all the decline of investments, which is related to a weakening outlook and, more recently, increased uncertainty. Household consumption was also subdued on the back of falling disposable incomes. Public consumption turned negative in light of consolidation measures. The only positive contribution came from increasing net exports, since exports rose faster than imports. The most notable contractions on the output side were registered in the construction and agricultural sectors. On the positive side, value added in the manufacturing sector is showing tentative signs of recovery. Labor market conditions remained broadly unchanged. Notably, however, youth unemployment showed a clear downward trend.

Inflation continued to fall and slipped into negative territory from February to April 2014. However, the price level started to increase again slightly from May on, with the annual HICP inflation rate climbing to 0.3% by August. Subdued price dynamics were mainly due to falling food prices, but core inflation also slowed down considerably, as the economy remains in recession.

Weak fiscal situation prompts Fitch Ratings to downgrade sovereign rating

As Croatia will probably not meet the 2014 budget deficit target of 4.5% of GDP, a budget revision was announced for late autumn. The government also plans to introduce new consolidation measures, including a cut in public sector wages and the introduction of a 12% tax on savings interest as of January 1, 2015. In the course of the EDP, Croatia has to bring down its public sector deficit to 3% of GDP by 2016. Following Standard & Poor's downgrade to "BB" in January, Fitch Ratings lowered Croatia's sovereign rating from "BB+" to "BB" in August, citing increasing risks regarding Croatia's ability to stabilize its high public debt-to-GDP-ratio in the medium term. Despite these fiscal problems, the country has been able to tap international markets. In May, Croatia successfully issued eight-year eurobonds worth EUR 1.25 billion.

With exports rising, current account balance remains in surplus

In the first half of 2014, the current account balance remained in surplus (four-quarter moving sum), with the surplus falling somewhat on the back of a decrease of net current transfers, as payments into the EU budget raised outflows, and on the back of a widening income deficit. Strongly rising exports (+9.9% in the first half of 2014 compared to the same period of 2013) increased the surplus in the goods and service balance to 1.7% of GDP (four-quarter moving sum). However, due to changes in the compilation of trade statistics in the course of EU accession, these numbers have to be treated with caution. On the financing side, net FDI flows decreased slightly to 1.5% of GDP (four-quarter moving sum) until mid-2014. Gross external debt reached 106.4% of GDP at the end of June 2014, a slight increase compared to end-2013.

Ongoing private sector credit contraction

Domestic lending to the private sector continued to contract, with a yearly decline of 3.1% as of July. In contrast, loans to the government increased strongly. The share of NPLs in total loans grew further to 12.2% in June 2014 (compared to 11.6% at end-2013). Banks' profitability, measured in terms of return on assets, increased to 0.65% in the first half of 2014.

Table 5

Main Economic Indicators: Croatia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	–0.3	–2.2	–0.9	–1.8	–0.5	–0.5	–1.1	–0.6	–0.8
Private consumption	0.3	–3.0	–1.2	–2.8	–0.0	–0.3	–1.7	–0.5	–0.5
Public consumption	–0.3	–1.0	0.5	0.2	1.3	–0.8	1.4	–2.1	–3.4
Gross fixed capital formation	–2.7	–3.3	–1.0	–2.4	0.8	0.3	–3.1	–3.6	–5.2
Exports of goods and services	2.2	–0.1	3.0	–0.8	0.7	3.7	7.4	11.4	7.9
Imports of goods and services	2.5	–3.0	3.2	–4.5	5.4	5.3	6.0	7.6	2.2
	Contribution to GDP growth in percentage points								
Domestic demand	–0.1	–3.3	–1.3	–3.1	1.3	–1.3	–2.1	–1.4	–2.8
Net exports of goods and services	–0.1	1.2	–0.0	1.7	–2.0	0.1	0.2	0.4	2.0
Exports of goods and services	0.8	–0.1	1.3	–0.3	0.3	2.2	2.7	3.6	3.0
Imports of goods and services	–0.9	1.2	–1.3	1.9	–2.3	–2.1	–2.5	–3.1	–1.0
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit wage costs in manufacturing (nominal, per hour)	0.9	2.8	2.7	–1.9	4.4	7.9	1.5	–6.4	–5.0
Labor productivity in manufacturing (real, per hour)	1.7	1.7	–1.2	6.8	–3.0	–5.8	–1.3	5.1	5.5
Gross wages in manufacturing (nominal, per hour)	2.3	4.1	1.9	4.7	1.3	1.7	0.2	–1.6	0.2
Producer price index (PPI) in industry	6.4	7.0	0.5	4.1	1.1	–0.6	–2.7	–2.7	–2.7
Consumer price index (here: CPI)	2.2	3.3	2.3	4.2	2.4	2.2	0.6	0.1	0.3
EUR per 1 HRK, + = HRK appreciation	–2.0	–1.1	–0.8	–0.4	–0.4	–1.0	–1.3	–0.9	–0.6
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	13.9	16.3	17.5	18.2	17.0	17.0	17.9	18.8	16.7
Employment rate (%, 15–64 years)	52.4	50.7	52.6	50.7	53.1	53.7	52.7	52.7	54.6
Key interest rate per annum (%)	6.0	7.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0
HRK per 1 EUR	7.4	7.5	7.6	7.6	7.6	7.5	7.6	7.7	7.6
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	1.6	3.2	2.9	4.4	3.4	5.1	2.9	3.3	2.7
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–4.2	6.3	5.7	7.8	4.8	5.5	5.7	4.5	6.1
Domestic credit of the banking system	8.8	–0.8	–3.0	–0.5	–1.5	0.4	–3.0	–2.6	–4.3
of which: claims on the private sector	4.9	–4.1	–1.0	–4.2	–3.2	–1.0	–1.0	–1.7	–3.0
claims on households	0.5	–0.7	–0.9	–0.6	–1.4	–0.2	–0.9	–0.7	–0.3
claims on enterprises	4.4	–3.4	–0.2	–3.6	–1.8	–0.8	–0.2	–0.9	–2.7
claims on the public sector (net)	3.9	3.3	–2.0	3.7	1.6	1.4	–2.0	–0.9	–1.3
Other assets (net) of the banking system	–3.0	–2.4	0.3	–2.9	0.2	–0.8	0.3	1.4	0.9
	% of GDP								
General government revenues	40.3	40.8	41.0	..	..	..	..	..	..
General government expenditures	48.1	45.7	45.9	..	..	..	..	..	..
General government balance	–7.8	–5.0	–4.9	..	..	..	..	..	..
Primary balance	–5.2	–2.0	–1.9	..	..	..	..	..	..
Gross public debt	52.0	55.9	67.1	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	..	89.0	87.2	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	..	41.4	40.6	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–13.8	–13.7	–14.6	–15.2	–17.7	–13.2	–12.3	–14.6	–16.2
Services balance	13.9	14.6	15.5	1.9	15.1	37.7	4.1	1.8	15.8
Income balance (factor services balance)	–3.6	–3.6	–2.5	–3.3	–2.9	–2.5	–1.4	–3.8	–4.0
Current transfers	2.6	2.6	2.4	2.8	3.2	1.9	1.9	0.7	1.6
Current account balance	–0.9	–0.1	0.9	–13.8	–2.3	24.0	–7.6	–15.9	–2.9
Capital account balance	0.1	0.1	0.1	–0.0	0.2	0.1	0.2	0.0	0.2
Foreign direct investment (net)	2.3	2.5	1.6	5.8	–0.4	–0.4	1.8	2.1	2.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	102.7	102.1	104.7	102.3	104.5	102.5	104.7	107.0	106.4
Gross official reserves (excluding gold)	25.0	25.6	29.6	25.7	27.3	26.7	29.6	27.9	28.6
	Months of imports of goods and services								
Gross official reserves (excluding gold)	7.2	7.2	8.2	7.3	7.7	7.5	8.2	7.7	7.8
	EUR million, period total								
GDP at current prices	44,187	43,488	43,132	9,930	10,853	11,727	10,623	9,751	10,788

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

6 Czech Republic: Continued Recovery Supported by Favorable Macroeconomic Conditions

Broadly favorable economic momentum on the back of rising investment

Despite some moderation, the Czech economy generally managed to keep up the economic momentum that had started in the final quarter of 2013. On the back of rising gross fixed capital formation, GDP grew by 2.7% in the second quarter of 2014, after growing by 2.9% in the first quarter. Export growth also accelerated markedly. This momentum was supported by favorable unit labor cost (ULC) developments in national currency, the continuing macroeconomic strength of key export markets as well as exchange rate intervention by the CNB. Recent high-frequency indicators have corroborated the positive development. Industrial production increased markedly in the second quarter, the main driving force being the automotive industry, with car production rising by 11% year on year. Against the background of rising import demand related to lively domestic demand and a comparatively high import content of exports, the growth contribution of the external sector turned negative in the second quarter, however. Modest increases in private and public consumption point to a more broadly based economic recovery spurred by domestic demand.

The stronger overall performance of the Czech economy translated into somewhat faster labor market improvements. The unemployment rate fell to 6.1% in the second quarter from 6.8% a year earlier. But the employment rate also increased, rising to 68.7% in the second quarter.

In late September, the CNB decided not to discontinue its exchange rate commitment before 2016, given very subdued price dynamics. The depreciation of the koruna vis-à-vis the euro led to a trade surplus of around 7.6% of GDP in the second quarter, falling slightly to approximately 7% in the second quarter. The current account balance returned to negative territory in the second quarter, due to a rising deficit in the income balance related to outflows from FDI income.

Inflation continued its downward trend in the aftermath of the CNB's exchange rate intervention. While still positive, inflation remained at levels well below the CNB's lower tolerance boundary (2% ±1%), falling to 0.2% in the second quarter of 2014. Core inflation remained rather stable throughout the review period. However, recent figures reveal an upward trend in inflation. The rather unexpected increase of inflation to around 0.7% in August was mainly driven by food prices and nonalcoholic beverage prices. In addition, inflation expectations as measured by analyst surveys shed some positive light on the future development of inflation, indicating a convergence of expectations with the CNB's inflation target.

The banking sector remained robust, with strong balance sheets, high-quality assets and low NPL ratios. Credit growth accelerated somewhat in the first half of 2014, rising from 1.5% to around 4% in the second quarter of 2014. By historical standards it remained muted, however. This was mainly due to continuing low credit demand and tighter lending standards. After approaching historical lows, Treasury bond yields, increased as risk appetites returned.

New government to spur consumption by raising minimum wage and lowering consumption taxes

The new center-left government, which took office in January, intends to promote domestic demand inter alia by strengthening social welfare schemes and a reform of the VAT system. Previous plans to unify the value added tax (VAT) system have been discarded in favor of a third, reduced rate of 10% for various products like books and medicines. Moreover, the new government plans to raise the minimum wage and return to full pension indexation.

Table 6

Main Economic Indicators: Czech Republic

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	1.8	–1.0	–0.9	–2.9	–1.7	–0.1	0.8	2.9	2.7
Private consumption	0.5	–2.1	0.1	–1.7	–0.2	1.3	1.0	1.5	1.9
Public consumption	–2.7	–1.9	1.6	1.1	0.8	2.6	1.9	1.1	2.2
Gross fixed capital formation	0.4	–4.5	–3.5	–6.8	–6.6	–3.2	1.7	6.2	6.8
Exports of goods and services	9.5	4.5	0.2	–5.3	0.5	2.8	2.8	12.0	8.9
Imports of goods and services	7.0	2.3	0.6	–4.5	–0.9	5.2	2.5	11.9	11.3
	Contribution to GDP growth in percentage points								
Domestic demand	–0.1	–2.7	–0.6	–1.9	–2.7	1.4	0.5	1.8	3.7
Net exports of goods and services	1.9	1.7	–0.3	–1.0	1.0	–1.5	0.3	1.1	–1.0
Exports of goods and services	6.4	3.3	0.1	–4.4	0.4	2.1	2.2	9.7	7.0
Imports of goods and services	–4.4	–1.6	–0.4	3.4	0.6	–3.7	–1.8	–8.7	–8.0
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	0.1	2.0	–0.8	–0.4	–0.4	0.4	–2.8	1.0	1.0
Unit labor costs in manufacturing (nominal, per hour)	–3.3	2.5	0.6	1.6	1.3	2.1	–2.8	–3.0	–4.0
Labor productivity in manufacturing (real, per hour)	6.6	–0.6	–1.1	–0.2	–2.2	–6.4	4.4	7.7	7.8
Labor costs in manufacturing (nominal, per hour)	3.2	2.0	–0.6	1.4	–0.9	–4.5	1.5	4.5	3.5
Producer price index (PPI) in industry	3.7	2.4	0.7	0.8	0.2	0.3	1.4	1.2	1.3
Consumer price index (here: HICP)	2.1	3.5	1.4	1.7	1.5	1.2	1.1	0.3	0.2
EUR per 1 CZK, + = CZK appreciation	2.9	–2.2	–3.2	–1.9	–2.2	–3.0	–5.7	–6.8	–5.9
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.8	7.1	7.0	7.5	6.8	7.0	6.8	6.9	6.1
Employment rate (%, 15–64 years)	65.7	66.6	67.7	66.8	67.8	68.0	68.3	68.1	68.7
Key interest rate per annum (%)	0.8	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1
CZK per 1 EUR	24.6	25.1	26.0	25.6	25.8	25.9	26.7	27.4	27.4
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	2.8	4.8	5.8	5.1	4.6	5.8	5.8	5.8	5.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–0.8	5.4	5.6	6.1	3.7	4.2	5.6	7.5	5.5
Domestic credit of the banking system	7.9	1.5	3.5	2.7	1.7	3.1	3.5	1.5	4.1
of which: claims on the private sector	4.1	1.9	2.8	2.5	1.8	2.1	2.8	1.9	2.5
claims on households	2.2	1.6	1.4	1.5	1.5	1.7	1.4	1.5	1.4
claims on enterprises	1.9	0.3	1.3	1.0	0.3	0.4	1.3	0.3	1.1
claims on the public sector (net)	3.7	–0.4	0.8	0.2	–0.1	0.9	0.8	–0.4	1.6
Other assets (net) of the banking system	–4.3	–2.1	–3.3	–3.7	–0.9	–1.5	–3.3	–3.2	–4.6
	% of GDP								
General government revenues	39.6	39.8	40.7	..	..	..	..	..	..
General government expenditures	42.5	43.8	42.0	..	..	..	..	..	..
General government balance	–2.9	–4.0	–1.3	..	..	..	..	..	..
Primary balance	–1.6	–2.6	0.1	..	..	..	..	..	..
Gross public debt	41.0	45.5	45.7	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	43.5	47.6	44.7	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	29.9	32.4	30.4	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	2.4	3.9	4.9	5.9	6.4	3.6	3.6	7.6	6.9
Services balance	1.5	1.6	1.4	1.6	1.4	1.0	1.4	2.1	1.0
Income balance (factor services balance)	–6.7	–6.8	–8.1	–7.3	–8.6	–8.7	–7.5	–2.6	–13.0
Current transfers	0.1	–0.1	0.4	0.9	–0.6	–0.3	1.5	0.5	1.7
Current account balance	–2.7	–1.3	–1.4	1.1	–1.4	–4.3	–1.0	7.7	–3.3
Capital account balance	0.4	1.4	1.9	0.0	–0.0	5.5	2.0	2.3	0.0
Foreign direct investment (net)	1.2	3.2	0.9	3.0	1.0	–0.6	0.2	3.1	5.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	46.8	50.8	54.1	51.1	52.1	50.7	54.1	52.7	55.6
Gross official reserves (excluding gold)	19.7	21.9	27.1	22.5	21.9	22.3	27.1	27.8	28.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	3.4	3.6	4.4	3.7	3.6	3.7	4.4	4.4	4.4
	EUR million, period total								
GDP at current prices	155,452	152,911	149,441	35,115	37,492	38,034	38,800	34,406	37,109

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

7 Hungary: Growth Picks Up, Domestic Demand Strengthens

GDP growth at eight-year high

GDP growth accelerated to 3.8% year on year during the first half of 2014 amid a rapid upturn of domestic demand that was in part due to short-term stimulus measures. Investment growth rose to 17% on the back of falling interest rates, the Funding for Growth Scheme (FGS) of Magyar Nemzeti Bank (the MNB), accelerated utilization of EU funds and improving business sentiment. Household consumption growth also strengthened, as falling inflation and accelerating nominal wage growth fueled real income growth, employment increased sharply (in part owing to the expansion of the public works scheme), the unemployment rate eased, consumer confidence improved strongly and deleveraging slowed. Although export growth was robust during the first half of the year, it was slightly outpaced by import growth, so that the contribution of net real exports to GDP growth was minimal.

European Council calls for additional fiscal consolidation efforts

In June 2014, the European Council called on Hungary to reinforce the budgetary measures for 2014 to avoid a breach of the debt reduction rule. Furthermore, in 2015 Hungary should significantly strengthen its budgetary strategy to ensure that it reaches its medium-term objective (a structural deficit of –1.7% of GDP; compared to the Commission's forecast of –2.2% for 2014) and compliance with the debt reduction requirements. Among its seven recommendations to Hungary, the Council also urged restoring normal lending flows to the economy, creating a more stable, balanced and streamlined tax system, strengthening labor market policies, fostering competition, improving the education system and enhancing the functioning of the energy market.

New measures to support indebted households hit banks

The MNB continued to cut the policy rate in decreasing monthly steps until July 2014. Following the cut to 2.1% in July, the council expressed its view that the level reached was consistent with the medium-term inflation target (3%) and that the policy rate was likely to stay stable for an extended period. Inflation fell to around 0% during the summer, as subdued consumption, low imported inflation, the lowering of inflation expectations and repeated cuts in regulated utility prices contained inflationary pressures. Parallel to the rate cuts, the utilization of the MNB's FGS has increased, and at the beginning of September 2014, the council decided to double the maximum refinancing volume of the current tranche (available until end-2014) to around 3.3% of GDP. Despite easing lending conditions, credit developments outside the FGS have remained weak, especially for households. Banking sector profitability and the capital position received a blow in July 2014, when Parliament passed legislation obliging banks to retroactively apply the MNB's official exchange rate for the disbursement and servicing of foreign currency loans to consumers (and hence to pay back exchange rate margins), and to compensate consumers for unilateral increases in interest rates, charges and fees relating to local and foreign currency loans unless banks can prove the fairness of these increases before court. The Bank Association has appealed to the Constitutional Court, claiming that the measures – inter alia – create legal uncertainty due to their retroactive character and the restrictive procedural regulations. The two measures are expected to cost financial institutions around 3% of GDP or nearly 30% of their capital. Moreover, the government has announced that it will table new legislation until end-2014 to convert households' foreign currency loans into domestic currency loans, presumably causing additional losses to banks, although the MNB has indicated its participation in the scheme to ward off currency depreciation.

Table 7

Main Economic Indicators: Hungary

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	1.6	–1.7	1.1	–0.9	0.5	1.9	2.7	3.7	3.9
Private consumption	0.4	–1.6	0.3	–0.7	0.3	0.2	1.3	1.6	2.3
Public consumption	–0.0	–1.2	1.2	1.8	2.7	0.2	0.1	1.8	–1.1
Gross fixed capital formation	–5.9	–3.7	5.8	–5.5	5.4	8.3	10.5	13.9	18.7
Exports of goods and services	8.4	1.7	5.3	2.2	3.6	6.4	8.9	7.7	6.7
Imports of goods and services	6.4	–0.1	5.3	1.7	6.0	5.8	7.6	7.8	7.3
	Contribution to GDP growth in percentage points								
Domestic demand	–0.5	–3.3	0.7	–1.4	2.2	0.8	1.1	3.1	4.0
Net exports of goods and services	2.1	1.6	0.4	0.6	–1.8	1.1	1.5	0.5	–0.0
Exports of goods and services	7.2	1.5	5.0	2.2	3.5	5.9	8.0	7.7	6.5
Imports of goods and services	–5.1	0.1	–4.6	–1.5	–5.2	–4.9	–6.5	–7.2	–6.5
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	2.2	2.8	4.0	4.0	4.7	3.4	3.9	3.7	2.3
Unit labor costs in manufacturing (nominal, per hour)	4.5	6.4	2.6	6.5	2.6	1.8	–0.1	–3.9	–3.6
Labor productivity in manufacturing (real, per hour)	1.4	0.8	1.1	–2.0	0.5	1.5	3.9	7.6	7.7
Labor costs in manufacturing (nominal, per hour)	6.0	7.4	3.6	4.3	3.1	3.3	3.8	3.3	3.8
Producer price index (PPI) in industry	4.2	4.2	0.6	0.6	–0.1	1.6	0.3	–0.6	–1.1
Consumer price index (here: HICP)	3.9	5.7	1.7	2.7	1.9	1.6	0.7	0.4	–0.1
EUR per 1 HUF, + = HUF appreciation	–1.4	–3.5	–2.6	0.1	–0.5	–5.0	–4.8	–3.7	–3.4
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	11.0	11.0	10.3	11.8	10.3	9.9	9.2	8.4	8.0
Employment rate (%, 15–64 years)	55.8	57.2	58.5	56.6	58.3	59.2	59.7	60.9	61.7
Key interest rate per annum (%)	6.0	6.8	4.4	5.5	4.7	4.0	3.3	2.8	2.5
HUF per 1 EUR	279.3	289.3	296.9	296.6	295.6	298.0	297.6	308.1	305.9
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	5.9	–3.3	5.5	5.6	4.6	3.3	5.5	1.0	3.7
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	17.6	5.3	6.6	14.4	10.3	1.0	6.6	4.8	8.3
Domestic credit of the banking system	–3.1	–11.8	0.2	–5.2	–4.4	5.8	0.2	–4.1	–2.5
of which: claims on the private sector	–0.6	–13.7	–4.6	–6.0	–6.5	–2.9	–4.6	–4.8	–2.1
claims on households	–0.5	–7.3	–2.3	–2.0	–2.7	–1.6	–2.3	–2.9	–1.5
claims on enterprises	–0.1	–6.3	–2.3	–3.9	–3.7	–1.3	–2.3	–1.9	–0.7
claims on the public sector (net)	–2.6	1.8	4.8	0.8	2.1	8.7	4.8	0.7	–0.4
Other assets (net) of the banking system	–8.6	3.2	–1.3	–3.6	–1.2	–3.6	–1.3	0.3	–2.0
	% of GDP								
General government revenues	44.4	46.4	47.3	..	..	..	..	..	..
General government expenditures	49.9	48.7	49.7	..	..	..	..	..	..
General government balance	–5.5	–2.3	–2.4	..	..	..	..	..	..
Primary balance	–1.3	2.3	2.2	..	..	..	..	..	..
Gross public debt	81.0	78.5	77.3	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	115.6	121.1	115.1	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	33.6	31.6	28.7	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance[1]	3.0	3.1	3.7	4.1	3.2	4.6	2.8	4.3	2.3
Services balance[1]	3.3	3.9	4.1	4.1	4.4	5.2	2.9	3.7	4.8
Primary income[1]	–4.9	–4.3	–3.0	–2.6	–3.8	–2.9	–2.5	–2.2	–3.2
Secondary income[1]	–0.6	–0.8	–0.6	–1.7	–0.4	–0.7	0.3	–1.1	–0.7
Current account balance[1]	0.8	1.9	4.2	3.9	3.4	6.2	3.4	4.8	3.2
Capital account balance[1]	2.4	2.6	3.7	2.8	3.4	2.4	6.0	2.2	3.1
Foreign direct investment (net)[1]	1.0	2.1	0.4	2.0	–3.7	–3.2	6.1	2.8	–7.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt [1]	136.9	131.0	121.7	129.8	128.6	121.9	121.7	121.5	122.4
Gross official reserves (excluding gold)[1]	38.1	34.8	34.4	36.2	34.8	31.3	34.4	36.6	36.3
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	5.5	5.1	5.0	5.4	5.1	4.6	5.0	5.3	5.2
	EUR million, period total								
GDP at current prices	98,872	97,129	97,943	21,729	24,425	25,128	26,661	22,365	24,907

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

[1] *Data based on the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).*

8 Poland: Continued Consolidation Challenges amid Balanced Growth

Impressive rebound of investment coupled with sustained trade surplus

In the first half of 2014, annual GDP growth was 3½%, with exports contributing nearly 3 percentage points and domestic demand 4 percentage points. Strong growth of total final demand caused imports to grow moderately stronger than exports, implying a negative net export contribution. In parallel, the surplus in the goods and services balance declined, but the current account deficit improved to 1% of GDP, as the deficit in the income balance contracted.

Domestic demand benefited from stronger private consumption, restocking and a large contribution of gross fixed capital formation. Higher hourly wage growth, further disinflation and employment growth sufficiently strong to lower the unemployment rate lifted the real wage sum. Together with the substantial real rise of average retirement pensions, this improved sentiment, stimulated demand for consumption loans and accelerated consumption growth. Fixed investment benefited from higher export growth and the improved domestic demand situation and outlook. While housing loans continued to grow at a moderate level, business investment financing could rely on the growing share of profitable companies, the favorable liquidity position of the corporate sector and accelerating corporate credit. Moreover, investment was supported by the ample availability of EU funds. Early in the year, one-off effects also lifted investment.

Door opened to further monetary easing

The price competitiveness of Polish manufacturing compared to the euro area was weaker year on year in the first half of 2014, as accelerated wage growth exceeded productivity gains and as the złoty was slightly stronger against the euro than a year earlier. In August, annual headline inflation was negative (–0.1% HICP, –0.3% national CPI), while core inflation stood at 0.4% (HICP) and 0.5% (CPI). Headline inflation was lower than core inflation, as energy prices and above all food prices decreased year on year. Having maintained the reference rate at 2.5% since July 2013, the Polish Monetary Policy Council (MPC), pursuing an inflation target of 2.5% (CPI), highlighted its readiness in September to cut key rates depending on incoming data.[5]

Window of opportunity for required improvements in the structural balance

In April 2014, the government's convergence program envisaged a general government surplus of 5.8% of GDP in 2014 and a deficit of 2.5% in 2015. However, these figures include the transfers of assets and liabilities from private pension funds to the public pay-as-you-go system, comprising both the one-off transfer in 2014 and annual asset transfers by people retiring within ten years, starting in 2014. Under ESA 2010, these asset transfers do not count as revenue. According to these new accounting rules, in June, the Commission assessed that Poland would meet the December 2013 Council recommendations for 2014 (headline deficit of 3.9%, structural deficit improvement by 1 percentage point to 2.8% of GDP), but not those for 2015 (headline deficit of 2.8%, structural improvement of 1.2 percentage points), with forecasts of a headline deficit of 3.1% and a structural deficit of 2.4% of GDP. On July 8, 2014, the Council saw risks to a sustainable correction of the excessive deficit by the established deadline (2015) and reiterated its recommendations for 2015. General government gross debt, as shown under ESA 2010, is set to decrease from 55.7% of GDP at end-2013 to below 50% of GDP at end-2014, as the transfer of assets impacts on the accounted debt level also under the new rules.

[5] *On October 8, after the cutoff date, the MPC cut the reference rate to 2.0% and the lombard rate from 4% to 3%, as incoming data pointed to a deceleration in economic growth and an increased risk of inflation running below the target in the medium term. However, it left the deposit rate unchanged at 1%.*

Table 8

Main Economic Indicators: Poland

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	4.5	2.0	1.6	0.4	1.2	2.2	2.3	3.8	3.3
Private consumption	2.6	1.3	0.8	–0.1	0.2	0.9	2.2	2.1	2.8
Public consumption	–1.7	0.2	2.8	–0.1	5.6	2.7	3.0	0.6	1.1
Gross fixed capital formation	8.5	–1.6	–0.2	–2.7	–3.4	0.7	2.1	10.9	8.4
Exports of goods and services	7.7	3.9	4.6	1.3	3.4	7.4	6.1	7.7	5.4
Imports of goods and services	5.5	–0.7	1.2	–1.7	–2.0	4.0	4.6	5.6	9.8
	Contribution to GDP growth in percentage points								
Domestic demand	3.6	–0.1	0.0	–1.0	–1.4	0.5	1.6	2.7	5.1
Net exports of goods and services	0.9	2.1	1.6	1.4	2.6	1.6	0.7	1.1	–1.8
Exports of goods and services	3.3	1.8	2.1	0.6	1.6	3.5	2.6	3.7	2.6
Imports of goods and services	–2.4	0.3	–0.6	0.8	1.0	–1.9	–2.0	–2.6	–4.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	1.3	1.8	0.3	2.1	2.2	0.7	–3.6	–3.1	–3.2
Unit labor costs in manufacturing (nominal, per hour)	0.6	1.8	0.1	2.6	0.5	–0.9	–1.7	–0.5	3.9
Labor productivity in manufacturing (real, per hour)	3.8	2.7	3.3	1.2	1.2	3.5	7.2	5.9	2.8
Labor costs in manufacturing (nominal, per hour)	4.4	4.5	3.3	3.8	1.6	2.6	5.3	5.4	6.8
Producer price index (PPI) in industry	7.3	3.3	–1.2	–0.5	–1.9	–1.1	–1.3	–1.1	–1.0
Consumer price index (here: HICP)	3.9	3.7	0.8	1.3	0.5	0.9	0.6	0.6	0.3
EUR per 1 PLN, + = PLN appreciation	–3.0	–1.6	–0.3	1.8	1.3	–2.6	–1.8	–0.7	0.8
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.8	10.2	10.5	11.4	10.6	9.9	9.9	10.7	9.2
Employment rate (%, 15–64 years)	59.3	59.7	60.0	58.7	59.8	60.7	60.8	60.3	61.3
Key interest rate per annum (%)	4.2	4.6	2.9	3.7	3.0	2.5	2.5	2.5	2.5
PLN per 1 EUR	4.1	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	12.5	4.5	6.2	6.6	7.0	6.1	6.2	5.2	5.2
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	6.4	3.3	–2.8	6.2	0.9	–1.5	–2.8	–4.3	–1.7
Domestic credit of the banking system	14.0	1.0	8.1	4.0	6.6	7.7	8.1	7.9	7.2
of which: claims on the private sector	13.1	2.3	4.2	3.5	3.6	3.9	4.2	5.2	4.9
claims on households	7.4	0.2	2.7	1.6	1.5	2.7	2.7	2.9	2.8
claims on enterprises	5.7	2.1	1.5	1.8	2.1	1.3	1.5	2.3	2.1
claims on the public sector (net)	0.9	–1.3	3.9	0.5	3.0	3.8	3.9	2.6	2.3
Other assets (net) of the banking system	–7.9	0.2	1.0	–3.6	–0.5	–0.1	1.0	1.6	–0.2
	% of GDP								
General government revenues	39.0	39.1	38.2	..	..	..	..	..	..
General government expenditures	43.9	42.9	42.2	..	..	..	..	..	..
General government balance	–4.9	–3.7	–4.0	..	..	..	..	..	..
Primary balance	–2.4	–1.1	–1.5	..	..	..	..	..	..
Gross public debt	54.8	54.4	55.7	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	39.3	43.6	43.0	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	33.4	35.7	35.9	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance[1]	–3.4	–1.9	0.2	–0.9	0.8	0.5	0.1	0.2	0.1
Services balance[1]	1.4	1.6	2.1	2.1	2.6	1.8	1.8	1.8	2.0
Primary income[1]	–3.5	–3.3	–3.5	–2.3	–3.9	–3.9	–3.7	–2.7	–2.6
Secondary income[1]	0.2	–0.0	–0.1	–1.1	0.1	–0.1	0.5	–0.7	–0.1
Current account balance[1]	–5.2	–3.6	–1.3	–2.3	–0.4	–1.6	–1.2	–1.5	–0.6
Capital account balance[1]	2.0	2.2	2.3	0.9	3.5	2.4	2.4	1.6	3.7
Foreign direct investment (net)[1]	2.7	1.4	0.7	1.4	1.7	1.5	–1.4	3.5	–0.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt[1]	67.6	72.8	71.2	72.7	71.1	72.5	71.2	70.6	71.6
Gross official reserves (excluding gold)[1]	19.4	20.5	19.1	21.0	20.3	19.5	19.1	18.2	17.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	5.1	5.4	5.1	5.6	5.5	5.2	5.1	4.9	4.8
	EUR million, period total								
GDP at current prices	370,414	381,792	389,758	91,042	94,401	95,476	108,840	94,981	99,234

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

[1] *Data based on the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).*

9 Romania: GDP Growth Slows as Investments Plummet, Net Exports Contribute Less

Economic activity shrinks quarter on quarter

GDP shrank in the first two quarters of 2014 quarter on quarter, bringing year-on-year growth down to 2.4% in the first half of 2014. The weak growth performance was mainly driven by plummeting investment activity. Somewhat worryingly, in the second quarter of 2014, gross fixed capital formation hit a new low in seasonally adjusted real absolute terms in the post-Lehman period and was down by about one-third compared to the precrisis level in the second quarter of 2008. Private consumption took the lead as a growth driver in the first half of 2014, as it was supported by rising disposable income, which was partly the result of the minimum wage hike in January. The recovery of private consumption also spurred import growth. As a consequence, the contribution of net exports to GDP growth declined, even though export growth – supported by still declining ULCs in the manufacturing sector – remained relatively brisk.

Balance of payments position sound overall despite small current account gap

The current account showed a small deficit in the first half of 2014, compared with an almost balanced position in the first half of 2013. The deterioration was mainly due to an increasing income deficit, in particular caused by dividend payments to foreign direct investors. The slight deterioration of the trade balance was, however, more than compensated by an increasing surplus in the services balance. In the second quarter, the surpluses in the transfers and capital account balances shrank markedly, which is mainly attributable to diminished success in attracting EU structural and cohesion funds, after some positive developments in 2013 and in the first quarter of 2014. Nevertheless, net FDI inflows kept the primary balance in positive territory.

Further disinflation and two more policy rate cuts

Annual consumer price inflation (CPI) fell further to a record low of 0.7% in June before increasing marginally to 0.8% in August, remaining considerably below the Banca Nat¸ională a României's (BNR) inflation target band of 2.5% ±1%. The BNR currently expects inflation to run below the midpoint of the target until mid-2015. Against this background, the BNR in August and September cut its key policy rate in two steps of 25 basis points each to 3%. The BNR sees the causes of low inflation in favorable supply side shocks, the negative output gap, and the impact of subdued inflation in the euro area on import prices.

Latest reviews under precautionary support program still unfinished, presidential elections upcoming

In June, teams from the IMF and the European Commission visited Romania to conduct their reviews under the two-year precautionary support program, but some issues remained outstanding. As reported, the IMF/European Commission teams inter alia had substantial reservations against the 5 percentage point cut in the social security tax that took effect on October 1, while Romanian government officials argued that the fiscal deficit target (2.2% of GDP in 2014) remained unchanged. Following the visit, talks between the Romanian authorities and the teams continued, and according to the Romanian side, there was an agreement on the postponement of the gas price liberalization for households. Under the energy price liberalization roadmap, the household gas price should have been increased by 3% at the beginning of October 2014. Efforts to soften IMF/European Commission requirements have to be seen against the background of the presidential elections upcoming in November.

Table 9

Main Economic Indicators: Romania

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	2.4	0.5	3.5	2.1	1.4	4.2	5.4	3.9	1.2
Private consumption	1.5	1.4	1.3	–0.2	0.4	1.9	2.8	6.4	3.9
Public consumption	0.6	1.0	–1.5	0.9	–5.8	–6.9	3.8	–4.6	2.7
Gross fixed capital formation	7.7	4.2	–3.4	–9.5	–2.2	–2.1	–2.6	–8.4	–12.8
Exports of goods and services	12.0	–1.8	13.1	7.4	8.2	20.3	16.8	15.0	10.7
Imports of goods and services	10.6	–0.3	2.3	–0.1	–3.6	7.9	5.1	13.0	8.7
	Contribution to GDP growth in percentage points								
Domestic demand	2.6	1.0	–0.9	–3.1	–3.5	1.1	0.9	2.9	–0.5
Net exports of goods and services	–0.2	–0.5	4.4	3.2	5.2	4.4	4.6	2.1	1.7
Exports of goods and services	4.1	–0.6	5.5	2.7	4.2	7.8	6.3	9.6	6.2
Imports of goods and services	–4.3	0.1	–1.1	0.5	1.0	–3.4	–1.7	–7.5	–4.6
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	–8.1	5.2	2.1	4.5	2.1	1.7	1.0	1.0	–1.0
Unit labor costs in manufacturing (nominal, per hour)	1.6	7.1	–1.6	1.2	–1.3	–3.8	–2.6	–2.8	–1.9
Labor productivity in manufacturing (real, per hour)	5.1	0.2	7.2	5.7	6.7	8.5	7.8	9.7	8.2
Labor costs in manufacturing (nominal, per hour)	7.2	7.3	5.4	7.0	5.3	4.4	5.0	6.7	6.1
Producer price index (PPI) in industry	7.1	5.3	2.1	5.2	2.8	0.7	–0.5	–1.1	0.6
Consumer price index (here: HICP)	5.8	3.4	3.2	4.8	4.4	2.4	1.3	1.3	1.3
EUR per 1 RON, + = RON appreciation	–0.7	–4.9	0.9	–0.8	0.7	1.9	1.7	–2.6	–0.6
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.7	7.3	7.6	7.8	7.8	7.3	7.5	7.5	7.0
Employment rate (%, 15–64 years)	58.5	59.5	59.7	58.1	60.2	61.0	59.5	59.5	61.2
Key interest rate per annum (%)	6.2	5.3	4.8	5.3	5.3	4.7	4.1	3.6	3.5
RON per 1 EUR	4.2	4.5	4.4	4.4	4.4	4.4	4.5	4.5	4.4
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	6.6	2.7	8.8	4.2	5.0	4.8	8.8	6.4	5.3
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	–1.6	6.7	13.6	9.2	11.2	13.6	13.6	12.0	14.1
Domestic credit of the banking system	11.4	0.1	–5.3	–2.1	–7.4	–11.7	–5.3	–6.5	–7.9
of which: claims on the private sector	6.8	1.5	–3.3	–0.1	–1.2	–3.4	–3.3	–2.6	–3.7
claims on households	1.1	0.1	–0.5	–0.4	–0.6	–1.1	–0.5	–0.5	–1.2
claims on enterprises	5.7	1.4	–2.7	0.3	–0.6	–2.3	–2.7	–2.1	–2.5
claims on the public sector (net)	4.7	–1.4	–2.1	–2.0	–6.2	–8.3	–2.1	–3.8	–4.2
Other assets (net) of the banking system	–3.2	–4.1	0.5	–2.9	1.3	2.9	0.5	0.9	–0.9
	% of GDP								
General government revenues	33.7	33.4	32.8	..	..	..	..	..	..
General government expenditures	39.2	36.4	35.1	..	..	..	..	..	..
General government balance	–5.5	–3.0	–2.2	..	..	..	..	..	..
Primary balance	–3.9	–1.3	–0.6	..	..	..	..	..	..
Gross public debt	34.2	37.3	37.9	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	52.2	53.2	48.4	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	21.4	21.0	19.2	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–5.6	–5.6	–2.4	–2.0	–2.7	–2.7	–2.1	–1.9	–3.2
Services balance	0.3	0.9	1.9	2.2	2.0	2.2	1.5	3.3	2.8
Income balance (factor services balance)	–1.7	–2.3	–3.1	–3.1	–2.7	–2.9	–3.7	–6.1	–3.5
Current transfers	2.5	2.6	2.6	3.0	3.7	1.7	2.4	4.1	2.2
Current account balance	–4.5	–4.5	–0.9	–0.0	0.3	–1.6	–1.9	–0.7	–1.7
Capital account balance	0.5	1.5	2.3	1.1	1.9	3.1	2.6	5.7	1.3
Foreign direct investment (net)	1.4	1.7	2.2	1.7	2.9	–0.8	4.6	1.4	2.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	75.2	75.9	67.6	75.6	73.6	71.6	67.6	65.2	64.3
Gross official reserves (excluding gold)	25.3	23.8	22.9	24.2	24.0	24.1	22.9	21.9	21.6
	Months of imports of goods and services								
Gross official reserves (excluding gold)	6.7	6.3	6.4	6.5	6.5	6.6	6.4	6.0	5.9
	EUR million, period total								
GDP at current prices	131,289	131,267	142,117	27,180	33,086	38,503	43,348	28,071	34,565

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

10 Turkey: Growth Declines in the First Half of 2014

Contribution of domestic demand to growth vanishes

Economic growth slowed to 3.3% in the first half of 2014. Following a robust expansion in the first quarter, GDP growth halved in the second quarter. In particular, domestic demand growth – which had driven the GDP expansion in 2013 – slowed in reaction to monetary policy tightening in late January, receding credit growth and high interest rates, which discouraged private gross fixed capital formation. Conversely, public investment projects were unaffected in light of the ongoing infrastructure development. Recent leading indicators suggest that economic activity might pick up again in the third quarter of 2014 compared to the previous quarter. The PMI showed a slight improvement again to 50.4 in September. However, unemployment remains high (at 10%), and the participation rate is on a declining trend. Capacity utilization stood at 74.1% in seasonally adjusted terms in September, 1 percentage point below the September 2013 value.

External imbalances recede temporarily

Net exports contributed positively to GDP growth in the first half of 2014, but mainly as a result of contracting imports (in line with weaker domestic demand). Lower export growth in the second compared to the first quarter was mainly a result of divestments of gold. Further, the military conflict in important export destinations (Iraq, but also Russia and Ukraine) dampened exports. The current account deficit moderated in the first half of 2014, falling to 6.3% of GDP from 9.0% a year earlier. This rebalancing was driven by the lower deficit in gold trade – a temporary factor caused by gold imports falling primarily due to a strong base effect – alongside weak domestic demand. Furthermore, the outlook for exports is weak. The financing of the current account deficit remains challenging. Even though portfolio investments recovered in the second quarter, this trend is unlikely to be sustained, and FDI inflows remain weak.

Macrofinancial situation has stabilized, but vulnerabilities remain elevated

Following the decisive rate hike in late January 2014 (leading to an effective increase by 225 basis points to 10%), the Turkish lira has stabilized but has remained weak, in a setting of subsequent monetary easing starting in May (in three consecutive steps by a cumulative 125 basis points to 8.25%). Inflation has accelerated again since the beginning of 2014 to reach 9.5% in August due to a lagged exchange rate pass-through and elevated food prices (partly drought related).

After having fallen in the first half of 2014, credit growth has been rising again recently and currently stands at around 20% (13-week moving average, foreign currency adjusted), still slightly below the level at the beginning of 2014, but above the central bank's targeted ceiling of 15%. The cost of private credits has fallen in recent months due to lower interest rates on consumer loans. Despite an increase in the absolute volume of NPLs, the NPL ratio remains below 3% of total loans, with a stable provision coverage ratio of almost 80%. Banks' profitability fell further in the first half of 2014, and the return on assets diminished to 1.4% at end-June (compared to 1.9% in the first half of 2013).

On August 28, former Prime Minister Erdoğan became the first president elected by the people. Changes to the government were moderate, and some focus on stabilization policies can be expected with Deputy Prime Minister Babacan, Finance Minister Şimşek and Economy Minister Zeybekci remaining in office. While domestic political risks have moderated, external political risks from military conflicts in Syria and Iraq as well as from the Russia-Ukraine crisis are high and pose additional challenges in particular to the rebalancing of the large current account deficit.

Table 10

Main Economic Indicators: Turkey

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	8.5	2.5	4.1	3.1	4.6	4.2	4.5	4.7	2.1
Private consumption	7.9	–0.7	5.1	3.1	5.6	5.6	6.1	3.2	0.4
Public consumption	4.4	6.4	6.2	7.9	8.0	1.9	6.9	9.2	2.4
Gross fixed capital formation	17.6	–1.9	4.2	0.4	3.4	5.3	7.4	–0.2	–3.5
Exports of goods and services	6.5	17.8	–0.3	3.0	–0.0	–2.4	–1.2	11.1	5.5
Imports of goods and services	9.6	0.6	9.0	7.8	12.5	5.2	10.3	0.7	–4.6
	Contribution to GDP growth in percentage points								
Domestic demand	9.4	–1.6	7.4	5.2	9.5	6.7	8.1	1.9	–0.8
Net exports of goods and services	–1.0	3.6	–2.3	–1.3	–3.3	–1.8	–2.9	2.3	2.6
Exports of goods and services	1.4	3.8	–0.1	0.7	–0.0	–0.6	–0.3	2.5	1.3
Imports of goods and services	–2.4	–0.2	–2.3	–2.0	–3.3	–1.2	–2.6	–0.2	1.3
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	..	..	..	..	..	..	..	..	..
Unit wage costs in manufacturing (nominal, per hour)	6.2	13.5	10.4	8.2	11.9	10.7	10.9	11.5	13.7
Labor productivity in manufacturing (real, per hour)	3.4	–1.7	1.6	1.5	0.1	2.0	2.8	3.3	0.9
Gross wages in manufacturing (nominal, per hour)	10.0	11.5	12.2	9.8	12.0	12.9	14.0	15.2	14.7
Producer price index (PPI) in industry	11.1	6.1	4.5	2.0	3.0	6.4	6.5	11.8	11.3
Consumer price index (here: HICP)	6.5	9.0	7.5	7.4	6.8	8.2	7.5	8.1	9.3
EUR per 1 TRY, + = TRY appreciation	–14.5	0.9	–8.6	–0.1	–3.7	–13.5	–15.5	–22.4	–17.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.0	8.4	8.9	9.6	8.1	8.9	9.1	10.3	8.9
Employment rate (%, 15–64 years)	48.4	48.9	49.5	47.9	50.8	50.3	49.1	48.0	50.8
Key interest rate per annum (%)	6.1	5.7	4.8	5.5	4.8	4.5	4.5	8.4	9.7
TRY per 1 EUR	2.3	2.3	2.5	2.4	2.4	2.6	2.8	3.0	2.9
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	15.2	10.5	21.1	13.6	15.4	19.0	21.1	19.8	16.0
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	0.6	1.4	–5.9	1.1	–1.0	–2.7	–5.9	–4.8	–2.4
Domestic credit of the banking system	19.0	16.9	31.7	18.5	22.0	29.5	31.7	31.2	26.5
of which: claims on the private sector	25.0	18.7	33.5	21.0	27.0	33.1	33.5	32.4	25.2
claims on households	8.4	5.9	8.4	7.0	8.1	8.8	8.4	6.2	4.0
claims on enterprises	16.6	12.7	25.1	14.0	18.9	24.3	25.1	26.1	21.1
claims on the public sector (net)	–6.0	–1.8	–1.7	–2.5	–5.0	–3.6	–1.7	–1.2	1.4
Other assets (net) of the banking system	–4.4	–7.7	–4.7	–6.0	–5.5	–7.8	–4.7	–6.6	–8.1
	% of GDP								
General government revenues	36.6	37.8	39.1	..	..	..	..	..	..
General government expenditures	37.4	38.9	40.7	..	..	..	..	..	..
General government balance	–0.8	–1.1	–1.6	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	39.9	36.2	36.3	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	44.3	47.7	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	..	..	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–11.5	–8.3	–9.8	–8.6	–11.1	–9.5	–9.6	–6.6	–8.6
Services balance	2.6	2.9	2.8	1.2	2.8	4.6	2.5	1.4	3.3
Income balance (factor services balance)	–1.0	–0.9	–1.1	–1.0	–1.6	–0.9	–1.0	–1.3	–1.1
Current transfers	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.1	0.1
Current account balance	–9.7	–6.1	–7.9	–8.3	–9.8	–5.7	–7.9	–6.3	–6.2
Capital account balance	–0.0	–0.0	–0.0	–0.0	–0.0	–0.0	0.0	–0.0	–0.0
Foreign direct investment (net)	1.8	1.2	1.2	1.1	0.8	1.3	1.5	1.7	0.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	42.3	41.8	45.5	43.8	44.1	43.9	45.5	46.6	49.9
Gross official reserves (excluding gold)	10.9	12.4	13.0	13.2	12.7	12.9	13.0	12.8	13.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.0	4.7	4.8	5.0	4.8	4.9	4.8	4.6	5.1
	EUR million, period total								
GDP at current prices	554,990	612,976	618,475	150,856	160,603	159,752	147,265	134,484	146,286

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

11 Russia: Economy en Route to Stagnation

Russia approaches zero growth

Russian economic growth eased to about 0.8% in the first half of 2014 (from 1.3% in the whole year of 2013) and leveled off further over the summer months under the impact of stepped-up EU and U.S. sanctions in connection with Russia's annexation of Crimea (in March) and support for the armed insurgency in eastern Ukraine (from April). Flat and lately weakening oil prices in 2014 have not helped Russian GDP growth, either. Rising uncertainty hit already weak investments, which contracted by 4.5% in the first half of 2014, while large-scale destocking went on. Private consumption continued to be the main driving force of growth, although it also continued to weaken, especially from the second quarter. The retail sales expansion moderated to 2.4% in the first seven months of 2014 (year on year). With real imports contracting and real exports expanding slightly, the contribution of net exports to GDP growth increased. Thus, for the first time in years, the contribution of domestic demand to Russian economic growth turned negative in the first half of 2014. Notwithstanding the further slowdown of growth, unemployment holds post-Soviet record-low levels (4.9% in July 2014), which supports the view that the economy is running near full capacity.

Rising uncertainty boosts capital outflows; further depreciation fuels inflation

The persistently tough investment climate, actual and expected U.S. monetary policy tapering, the tightening of Western sanctions against Russia and adverse expectations emanating from the latter have given rise to recently swelling capital outflows: Over the first half of 2014, private net capital outflows came to EUR 54.4 billion (7.7% of GDP), which is more than twice as high as in the corresponding period of the previous year and already exceeds the entire outflow of 2013. The sanctions include selective travel bans and account freezes, bans on arms trade with Russia, restrictions on the transfer of high technology for oil extraction and on the export of dual-use goods (usable for military as well as civilian purposes), and tight limits on Russian state-owned banks' and enterprises' access to EU and U.S. capital markets and bank loans. The capital flight was primarily responsible for the depreciation of the ruble, which lost 20% against the U.S. dollar and 10% against the euro in the course of the first nine months of 2014. The ruble's slide, in turn, added to inflationary pressures. The consumer price level rose by 7.6% in August 2014 (as against 6.8% in 2013), and inflation is likely to accelerate (at least in the short run), given the ongoing pass-through of depreciation and Russia's imposition in August of an import ban on Western food products.

CBR intervenes in forex market and hikes key rate by a total of 250 basis points

The ruble would have fallen more and price increases would have been higher if the Central Bank of Russia (CBR) had not taken countermeasures, including increases of the key interest rate by 150 basis points in March, by another 50 basis points in April, and again by 50 basis points in July – to 8.0%. Partly as a result of forex interventions, the CBR's international reserves declined by about USD 35 billion (or 7%) in the six-and-a-half months since the outbreak of the Crimean crisis.

While eroding, international reserves remain sizable and twin surpluses persist

In August, international reserves (excluding gold) eased to USD 465 billion (or EUR 353 billion). As at end-August 2014, retail lending growth, which had overheated in 2013, slowed to 10% (in real terms, exchange rate-adjusted, year on year). Corporate lending expanded 5% (correspondingly). The continuing relatively tight fiscal stance and the weaker-than-expected ruble are reflected in the federal budget surplus of 2.0% of GDP in January to August 2014. Russia's declining import demand produced an expanding current account surplus (4.4% of GDP in the first half of 2014, against 2.8% in the respective period of 2013).

Table 11

Main Economic Indicators: Russia

	2011	2012	2013	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
	Year-on-year change of the period total in %								
GDP at constant prices	4.3	3.4	1.3	0.8	1.0	1.3	2.0	0.9	0.8
Private consumption	6.7	7.9	4.7	5.7	4.4	4.7	4.1	3.7	0.8
Public consumption	1.4	4.6	0.5	0.6	0.4	0.4	0.4	–0.0	–0.1
Gross fixed capital formation	9.1	6.4	–0.1	–0.5	–1.3	0.1	0.5	–7.0	–2.1
Exports of goods and services	0.3	1.4	4.2	0.0	3.7	7.4	5.6	1.6	1.3
Imports of goods and services	20.3	8.8	3.7	7.3	3.4	5.3	–0.1	–4.5	–7.7
	Contribution to GDP growth in percentage points								
Domestic demand	7.9	5.2	1.2	2.5	1.2	0.6	0.8	0.2	–0.7
Net exports of goods and services	–4.0	–1.6	0.4	–1.6	0.4	0.7	1.8	1.6	2.2
Exports of goods and services	0.1	0.4	1.3	0.0	1.2	2.1	1.7	0.5	0.4
Imports of goods and services	–4.1	–2.0	–0.9	–1.6	–0.8	–1.4	0.0	1.0	1.8
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per hour)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Unit labor costs in industry (nominal, per person)	9.0	7.6	7.9	9.0	8.2	8.6	5.8	7.0	4.9
Labor productivity in industry (real, per person)	4.4	4.8	2.3	0.8	2.5	2.5	3.3	2.5	3.8
Average gross earnings in industry (nominal, per person)	13.8	12.6	10.3	9.8	10.9	11.2	9.2	9.6	8.9
Producer price index (PPI) in industry	17.8	6.8	3.4	4.3	2.5	4.4	2.3	4.2	8.2
Consumer price index (here: CPI)	8.5	5.1	6.8	7.2	7.2	6.3	6.4	6.4	7.5
EUR per 1 RUB, + = RUB appreciation	–1.5	2.4	–5.7	–1.5	–3.7	–8.0	–9.1	–16.5	–13.7
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.6	5.5	5.5	5.8	5.4	5.3	5.5	5.5	5.0
Employment rate (%, 15–64 years)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Key interest rate per annum (%)	5.3	5.3	5.5	5.5	5.5	5.5	5.5	6.0	7.4
RUB per 1 EUR	40.9	39.9	42.3	40.2	41.4	43.4	44.3	48.1	48.0
	Nominal year-on-year change in the period-end stock in %								
Broad money (including foreign currency deposits)	20.9	12.1	15.7	15.1	16.3	16.8	15.7	13.4	9.1
	Contributions to the year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	9.9	–0.3	2.7	4.5	1.8	2.3	2.7	5.1	0.3
Domestic credit of the banking system	19.7	15.4	17.5	17.0	18.1	18.2	17.5	15.9	14.2
of which: claims on the private sector	24.5	17.9	16.9	19.9	18.2	19.1	16.9	17.5	15.4
claims on households	6.4	8.2	7.4	8.4	8.2	8.1	7.4	7.0	5.9
claims on enterprises	18.1	9.7	9.6	11.5	10.1	11.0	9.6	10.5	9.6
claims on the public sector (net)	–4.8	–2.6	0.6	–2.9	–0.1	–0.9	0.6	–1.6	–1.3
Other assets (net) of the banking system	–8.7	–3.0	–4.6	–6.4	–3.5	–3.7	–4.6	–7.6	–5.3
	% of GDP								
General government revenues	37.3	37.1	36.6	. .	. .	. .	. .	. .	. .
General government expenditures	35.7	36.7	37.9	. .	. .	. .	. .	. .	. .
General government balance	1.5	0.4	–1.3	. .	. .	. .	. .	. .	. .
Primary balance	. .	. .	. .	. .	. .	. .	. .	. .	. .
Gross public debt	9.0	10.0	10.4	. .	. .	. .	. .	. .	. .
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	. .	. .	. .	. .	. .	. .	. .	. .	. .
Debt of households and NPISHs (nonconsolidated)	. .	. .	. .	. .	. .	. .	. .	. .	. .
	% of GDP (based on EUR), period total								
Trade balance[1]	10.3	9.5	8.7	10.1	8.5	8.2	8.1	11.1	10.3
Services balance[1]	–1.8	–2.3	–2.8	–2.2	–2.7	–3.7	–2.5	–2.3	–2.9
Primary income[1]	–3.2	–3.4	–3.9	–2.4	–5.2	–4.0	–3.7	–2.4	–4.5
Secondary income[1]	–0.3	–0.3	–0.4	–0.3	–0.3	–0.6	–0.5	–0.4	–0.1
Current account balance[1]	5.1	3.5	1.6	5.2	0.4	–0.1	1.4	5.9	2.8
Capital account balance[1]	0.0	–0.3	–0.0	–0.0	–0.0	–0.0	–0.0	–0.0	–0.0
Foreign direct investment (net)[1]	–0.6	0.1	–0.8	–5.3	1.9	0.7	–0.7	–1.2	–0.7
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt[1]	30.8	31.4	33.8	34.3	34.1	33.5	33.8	33.8	35.2
Gross official reserves (excluding gold)[1]	25.7	23.7	21.6	23.6	22.9	22.4	21.6	20.8	20.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)[1]	14.3	12.8	11.5	12.7	12.2	11.9	11.5	11.1	11.1
	EUR million, period total								
GDP at current prices	1,366,840	1,557,572	1,574,075	364,671	386,266	403,652	419,487	332,628	368,975

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

[1] *Data based on the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).*

Box 3

All Baltic Countries Part of the Euro Area: Lithuania to Adopt the Euro January 1, 2015[1]

On January 1, 2015, Lithuania will become a full member of the Economic and Monetary Union with the euro as the legal tender. The way to euro area membership was cleared by the positive assessment of Lithuania's economic convergence in the ECB's and European Commission's convergence reports of June 2014 and by the July 2014 EU Council Decision to welcome Lithuania into the euro area followed by the ECOFIN Council's adoption of a decision allowing the country to join the euro area on January 1, 2015. The ECOFIN Council also irrevocably fixed the conversion rate of the Lithuanian litas at its central parity within ERM II agreed on in mid-2004, which is LTL 3.45280 to EUR 1.

The currency changeover has already started. Prices will be displayed both in Lithuanian litas and in euro between the end of August 2014 and at least the end of June 2015. The dual circulation period of litas and euro, during which both currencies are legal tender, will be only 15 calendar days. While Lithuanian commercial banks will exchange litas coins and banknotes for six months following the introduction of the euro, the Lithuanian central bank will do so free of charge for an unlimited period.

The Lithuanian authorities had aspired to introduce the euro already in 2007 but, at the time, Lithuania was found to have failed the inflation criterion.[2] Since then, the country has made substantial further efforts to fulfill the requirements for euro area membership. During the economic and financial crisis, the Lithuanian economy demonstrated a high degree of flexibility, in particular in the labor market, which brought the economy back onto a growth trajectory already in the first quarter of 2010.

Experience in the Baltic neighbor countries Estonia and Latvia showed that currency changeovers can be conducted smoothly and efficiently. However, Lithuanians are concerned that prices will rise when the euro is introduced: 75% of Lithuanians expect that the euro will heat up inflation.[3] In all countries that joined the euro area between 2007 and 2011 (Estonia, Cyprus, Malta, Slovakia, Slovenia), the euro changeover indeed had a one-off impact on inflation, which, however, was small and ranged between 0.2 and 0.3 percentage points. This effect was observable during or directly after euro introduction.[4] The Lithuanian authorities have announced that they will keep a close eye on price developments before and after euro introduction to prevent unjustified price increases.

Alongside the adoption of the euro, Lithuania will join the Single Supervisory Mechanism (SSM), which means that the ECB will be responsible for the supervision of the largest banks in Lithuania. Additionally, the country has to comply with the obligations under the EU's "Two-Pack" fiscal legislation. This implies, inter alia, that the 2016 draft budget will have to be submitted by October 15, 2015.

The adoption of the euro by Lithuania will bring changes not only to the new euro area member state but also to the decision-making process within the ECB. Currently, the Governing Council comprises 6 Executive Board members and 18 governors from national central banks (NCBs) of the euro area. According to Treaty law, voting rights have to rotate once there are more than 18 NCB governors. As all members of the Governing Council attend the Governing Council meetings and have the right to speak, nothing will change in terms of the discussion. Since the Governing Council takes most decisions on a consensual basis, in a spirit of cooperation, the decision-making process is not expected to change, either.[5]

[1] *Author: Antje Hildebrandt.*

[2] *http://ec.europa.eu/economy_finance/publications/publication465_en.pdf.*

[3] *http://ec.europa.eu/economy_finance/pdf/2014/fourteenth_report_on_the_practical_preparations_en.pdf.*

[4] *http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_pub/TTNR_EURO_CHANGEOVER_INFLATION_ESTONIA_2011_05.pdf.*

[5] *For more details on the rotation system, see https://www.ecb.europa.eu/ecb/orga/decisions/govc/html/faqvotingrights.en.html.*

Outlook for Selected CESEE Countries:

Moderate but Steady Growth amid a Notable Increase of External Risks[1,2]

As projected in spring 2014, economic growth in the *CESEE-6*[3] *region* will pick up in 2014 after having hovered around 1% in the two preceding years. The moderate expansion of 2.5% will be driven by strengthening domestic demand, which had been fairly weak in 2012 to 2013. Almost all countries in the region will show a notable improvement over 2013. Croatia is the only CESEE-6 country that will remain in recession also in 2014, while Romania will post a moderation in GDP growth. In 2015 and 2016, the positive contribution of domestic demand will increase further and lead to overall GDP growth of 2.5% and 2.7%, respectively. Hence, growth will become more balanced. Despite revived export and import growth, the contribution of net exports will diminish and turn negative in all countries but Croatia. However, over the entire projection horizon export and import growth will show some moderation. Import demand will recede somewhat from 6.4% in 2014 to 5.6% in 2015 and will reach 6% in 2016.

Russia's economic growth slowed to a crawl in the first half of 2014 (+0.8%) and is likely to stagnate for the year as a whole, primarily because of growing uncertainty triggered by the Ukraine crisis, including sanctions. Uncertainty is taking its toll particularly on investment and is likely to weigh on GDP growth altogether in 2014. We have thus lowered our forecast by half a percentage point for each year. In 2015 and 2016, the Russian economy should begin to see a meager

Table 1

GDP Projections for 2014 to 2016

	GDP	GDP forecasts			Imports	Import forecasts		
	2013	2014	2015	2016	2013	2014	2015	2016
	Annual growth in %							
CESEE-6	1.2	2.5	2.5	2.7	2.6	6.4	5.6	6.0
Bulgaria	0.7	1.6	2.2	3.1	6.2	4.1	5.2	5.1
Croatia	–0.6	–0.8	0.2	1.0	3.0	2.6	0.1	1.1
Czech Republic	–0.9	2.5	2.6	2.6	0.6	7.1	5.9	6.1
Hungary	1.2	3.4	2.2	1.9	5.3	8.0	6.0	5.7
Poland	1.6	3.1	3.0	3.2	2.4	7.2	6.2	6.8
Romania	3.3	1.9	2.4	2.7	2.3	6.0	7.0	8.4
Russia	1.3	0.0	0.5	1.5	4.0	–8.0	0.0	2.5

Source: OeNB, BOFIT, Eurostat, Rosstat.

Note: CESEE-6 = Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania.

[1] *Compiled by Julia Wörz with input from Stephan Barisitz, Markus Eller, Florian Huber, Mathias Lahnsteiner, Isabella Moder, Thomas Reininger and Zoltan Walko*

[2] *Cut-off date for these projections: October 6, 2014. The projections for CESEE-6 countries were prepared by the OeNB, those for Russia were prepared by the Bank of Finland in cooperation with the OeNB. They are based on the assumption of a gradual recovery in the euro area, in line with the September 2014 ECB staff estimate (see ECB Monthly Bulletin September 2014). This implies real annual GDP growth of 0.9% in 2014, 1.6% in 2015, 1.9% in 2016 and a slight decline of the oil price over the projection horizon from about USD 107 per barrel in 2014 to about USD 103 in 2016. We assume no further escalation of the Ukraine-Russia conflict, but also no settlement.*

[3] *CESEE-6: Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania.*

and very gradual recovery as growth in global trade and the world economy pick up. Following a strong depreciation-triggered contraction in 2014, imports should stabilize in 2015 and slightly rise again in 2016. This forecast, however, presupposes that sanctions will not escalate further and will stay in place during the forecast period.

1 CESEE-6: Growth Stabilizes and Becomes More Balanced

In year-on-year terms, GDP in the CESEE-6 region expanded by 2.8% in the first half of 2014, supported by a rather accommodative policy mix. With low or even no inflationary pressure, monetary policy remained expansive – in particular in Hungary and Romania – while there was no further increase in fiscal consolidation. Hence, the recovery in domestic demand gained traction at the beginning of 2014, as predicted in our last forecast. Except in Bulgaria, export growth also accelerated markedly compared to the first half of 2013. However, most recent data paint a more mixed picture. In general, the pace of growth showed some decline in most countries from the first to the second quarter, and current leading indicators suggest that the economic expansion in the second half of the year will be more moderate, bringing the full-year growth rate to 2.5% for the region as a whole. For 2015 and 2016, we project no tangible further increase in growth. The region's GDP will expand by 2.5% in 2015 and by 2.7% in 2016.

Economic policies support domestic demand

For the remainder of 2014 and for 2015, we expect domestic economic policies to remain supportive of growth. In the Czech Republic, there will be some fiscal easing under the new government, with public sector wage increases in November 2014 and January 2015. In Hungary, the central bank's Funding for Growth Scheme continues to support gross fixed capital formation through improved access to funding for small and medium-sized enterprises. In Romania, the government has cut the social security tax by 5 percentage points and postponed the liberalization of gas prices for households. In Poland, recent decisions to increase social benefits and slow the speed of fiscal consolidation in 2015 are to be seen against the background of upcoming presidential and parliamentary elections in 2015. The situation in Bulgaria is less clear-cut, given uncertainty about potential additional consolidation needs that may arise in connection with the rescue of one of the two large banks that failed in June. Croatia is the only country where the fiscal stance will tighten, as more consolidation efforts required under the excessive deficit procedure have yet to be implemented. Overall, given the countries' generally strong commitment to reach EU fiscal targets, we do not expect a pronounced fiscal easing in the region, and the growth impetus from public consumption will remain between 0 and 0.3 percentage points (and turn negative again in Croatia).

In the remainder of 2014 and in 2015, economic growth in the CESEE-6 (with the exception of Croatia) will increasingly be driven by accelerating domestic demand alongside stable external demand (see chart 1). Private consumption will pick up notably in 2014 and 2015 in all countries, again apart from Croatia. Higher consumer spending will be supported by rising disposable incomes in an environment of low inflation supported by policy measures such as increases in minimum wages (in Bulgaria, the Czech Republic and Romania) as well as other measures to support purchasing power (e.g. pension indexation above inflation in Romania and administered price cuts in Hungary).

EU funds foster investments

In addition, in most countries, gross fixed capital formation will profit from the overlap of fund disbursements of two EU multiannual fiscal frameworks. Funds from the 2007–2013 framework can still be drawn until the end of 2015. In addition, funds from the 2014–2020 multiannual framework are already available. In general, EU fund utilization has improved. In Croatia, we expect a positive net effect from EU cofunding to materialize only in 2016. In Bulgaria, two projects have been suspended due to a dubious application of funds. In Romania, EU fund utilization in fact declined in the second quarter of 2014. Gross fixed capital formation increased strongly in Poland in the first half of 2014, mainly owing to good weather conditions and advance purchases of cars due to tax changes. Given good financing conditions for corporates, this trend will continue in the second half of the year despite relatively high interest rates. Another factor supporting investment growth in most countries could be higher defense expenditure[4] in accordance with the decision taken at the latest NATO summit to increase NATO members' military spending to 2% of GDP over the next ten years and generally stronger NATO commitments in view of the current geopolitical situation. In Romania and Hungary, supply-side effects are providing an additional push to output growth this year and in 2015, as large production capacities have become operational.

In 2016, we expect domestic demand to stabilize. In Hungary, the effects from increased production capacities will fade and the loss of policy-induced support of private consumption will dampen domestic growth drivers. In all other countries, the contribution of domestic demand will improve further, showing also a very cautious recovery for the first time since 2009 in Croatia.

Contribution of net exports turns negative despite robust external demand

In line with our external assumption for euro area growth, external demand will stabilize over the projection horizon. Compared to the first half of 2014, export growth will soften in all countries, in line with internationally weakening economic sentiment (especially in the euro area) and taking into account economic sanctions against and retaliation measures by Russia. As direct effects of existing sanctions on external demand are negligible, indirect effects through economic sentiment are more likely to be felt in all countries. The moderate downward trend in export growth will continue in 2015 and will flatten out in 2016. However, in general, export growth of 5.8% in 2014 (5.3% in both 2015 and 2016) will remain an important growth pillar. Bulgaria and Romania will show a modest temporary growth slowdown this year compared with 2013, which is likely to reflect a base effect. The strong improvement in Czech export growth in 2014 compared to the previous year seems to be related to some extent to central bank interventions to weaken the currency, a policy which will be kept until the beginning of 2016. Assuming some market-induced correction, this would result in weakening export growth and strengthening import growth (and hence a notable deterioration in the contribution of net exports) in 2016.

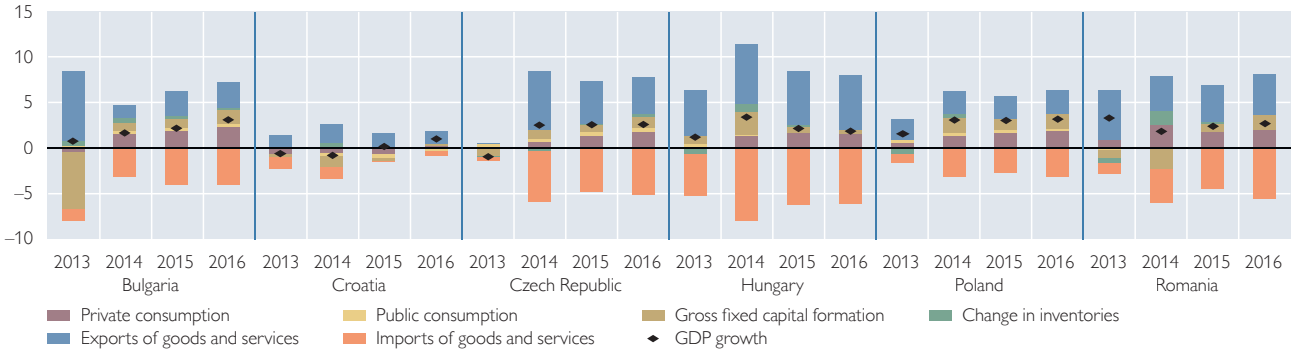
Import dynamics have been mixed in the second half of 2014, in line with country-specific demand characteristics. Compared to 2013, imports will, however, receive a notable boost. Year-on-year growth will rise from 2.6% in 2013 to 6.4% in 2014, implying a slight weakening over the first half of 2014. With the

[4] *According to the new European System of National and Regional Accounts (ESA 2010), defense spending is to be recorded as fixed-investment.*

Chart 1

GDP and GDP Components, Projections for 2014–2016

Contribution of GDP components in percentage points, annual GDP growth in %



Source: OeNB.

exception of Bulgaria and Romania, where base effects play an important role, import growth will fall in all countries and reach 5.6% in 2015 for the region as a whole. In 2016, import growth is set to accelerate somewhat to 6% in line with our projection of robust domestic demand. Hence, the contribution of net exports will turn moderately negative in 2015 in all countries apart from Croatia, where external demand will still make the sole positive contribution to GDP growth.

Downside risks dominate

The two foremost downward risks for the CESEE-6 countries stem from weaker than expected growth in the euro area and a potential stepping up of economic sanctions against and by Russia. Protracted economic slack in the euro area could feed through negatively to the CESEE-6 through lower external demand. Developments since the finalization of the September 2014 macroeconomic projection exercise (MPE) suggest that this risk is likely to materialize to some extent. Most recent hard and soft facts suggest that the assumption for euro area GDP growth underlying our baseline projection was rather too optimistic. At the same time, recent monetary policy measures by the ECB may also help to limit the extent to which this risk will materialize.

In the case of a further escalation of the Ukraine crisis,[5] the dependence of the CESEE-6 on energy imports from Russia and low substitution possibilities in the short run imply another sizeable downward risk since Russia is the most important supplier of energy for the region. Furthermore, indirect risks to CESEE-6 growth relate to unexpected shocks to global investor sentiment (e.g. due to stronger than anticipated repercussions of the Ukrainian crisis or other geopolitical events) and ensuing lower external demand, especially from the euro area. On the other hand, the direct risk from lower external demand from Russia due to trade sanctions is manageable.

[5] *We base this forecast on the assumption of no change in the status quo with respect to economic sanctions against Russia and no further retaliation measures by Russia, in particular no disruption of energy trade flows. In line with this assumption, we also presume that the military conflict in eastern Ukraine will not escalate further. While the current, unresolved situation will prevent economic sentiment from showing any significant improvement, it will not curb confidence further either.*

The effects of a sustained decline in oil prices below the assumptions underlying our baseline projection is difficult to assess given underlying deflation risks, but in the short run it is likely to pose an upside risk to growth in the CESEE-6.[6] Higher global growth poses a clear upward risk to our projection, both directly and indirectly via positive knock-on effects on euro area growth and thus on external demand. Moreover, a settlement of the conflict in eastern Ukraine or substantial progress toward a solution of the crisis before the end of the forecasting horizon would also push growth beyond our baseline projection. However, we consider the latter two events as rather unlikely.

2 Developments in Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania

Bulgaria: Financial sector turbulences and political uncertainty weigh on recovery

In light of political uncertainty and problems in the banking sector, we have revised our spring forecast downward slightly and expect Bulgaria's real GDP growth rate to come to 1.6% in 2014. The recovery process should then continue gradually in 2015 and 2016, with growth reaching 2.2% and 3.1%, respectively.

The June bank run on two of the largest domestically owned lenders, Corporate Commercial Bank (CCB) and First Investment Bank (FIB), have translated into deteriorating economic sentiment indicators. The eventual extent of the ensuing deceleration in private consumption and industrial production will very much depend on whether it will be possible to rein in uncertainties related to political instability (the early parliamentary election called for October 5, 2014, did not result in a clear majority for either of the competing party blocks) and the resolution of CCB (in particular the payment of insured deposits despite the shortage in the Bulgarian bank deposit guarantee fund). If these uncertainties are resolved, private consumption and gross fixed capital formation are likely to be strong enough to drive a gradual recovery over the forecasting horizon.

Private consumption should still benefit from last year's social legislation changes (increase of minimum wages, indexation of pensions) and from the already long-lived drop in consumer prices (although we should see a return to inflation in 2015 as the base effects of cuts in electricity tariffs abate). A recent marked improvement in capacity utilization (back to levels last observed before 2009) is indicative of a turning investment cycle. We also expect stockbuilding to continue and public consumption to contribute positively to GDP growth. The latter will, however, be smaller than in 2013. At the current stage, the 2014 budget deficit will most probably surpass the Maastricht ceiling of 3% of GDP, among other things owing to the costs related to the rescue of CCB. Despite the one-off character of this rescue, fiscal prudence will be required in 2015 and 2016 to bring the budget deficit back below the domestic target of 2% of GDP and to rebuild some fiscal buffers.

In line with our external assumptions, we expect exports to accelerate gradually over the forecasting horizon. Expansionary monetary policy in the euro area and the resulting depreciation of Bulgaria's anchor currency should also stimulate exports. However, import growth will somewhat outpace export growth, reflecting

[6] *Given very recent oil price developments, the oil price may well stabilize in 2015 at a level which is as much as 10% lower than assumed in our baseline.*

resurging domestic demand and resulting in a negative growth contribution of net exports.

Croatia: Economic stabilization in 2015 and anemic growth in 2016 on the back of external demand

In Croatia, recessionary developments in the first two quarters of 2014 are most likely to continue for the rest of the year, with the overall contraction expected to come to 0.8% (previous forecast: contraction of 0.6%). In 2014, the main drag on growth will be declining gross fixed capital formation, reflected by negative credit growth as companies deleverage further. However, part of the negative contribution of gross fixed capital formation will be offset by stock changes, which we expect to be positive after two years of destocking. Private consumption will also influence growth negatively on the back of stagnant wages in the private sector, planned wage cuts in the public sector, elevated unemployment and persistently high household indebtedness. Regarding the public sector, we expect the planned budget revision to put a strain on public consumption. The only positive contribution will stem from net exports, as the recovery of the euro area will boost exports and imports will remain subdued due to weak private consumption.

For 2015, we expect anemic growth of 0.2%. This represents a downward revision of 0.5 percentage points from our previous forecast. External demand will be the sole driver of growth, while we expect imports to remain depressed. This is in line with our forecast of another year of declining domestic demand, with especially private consumption putting a drag on growth given continued negative credit growth and a poor labor market situation. As the government has to bring down the public deficit to meet the conditions under the Excessive Deficit Procedure (EDP) by 2016, we expect public consumption to continue to affect growth negatively; however, austerity pressure might ease up in the second half of 2015 in light of the upcoming parliamentary elections in February 2016. The decline in gross fixed capital formation, which started in 2009, should moderate in 2015 and should come to an end in 2016.

From 2016 on, we forecast an export-led recovery with a growth rate of 1.0%, as net exports will continue to contribute positively to growth and the contraction of domestic demand should come to a halt. We expect gross fixed capital formation to hit the turning point and start growing again slightly on the back of reviving credit growth and the utilization of EU funds. Also, private demand should start to recover due to improving labor market conditions. Only public consumption will put a drag on growth as consolidation efforts continue.

The domestic risks to this forecast are balanced. Public consolidation measures could harm growth more strongly than currently anticipated, and private consumption could take longer to recover. On the other hand, gross fixed capital formation could pick up already in 2015 if private investment is backed by an earlier credit market recovery and if more EU funds than expected can be tapped.

Czech Republic: Growth set to stabilize at 2½% a year

On the back of continuing exchange rate interventions by Česká národní banka (CNB) and improving consumer and investor sentiment, the Czech economy is expected to grow by 2.5% in 2014. We forecast slightly higher growth rates of 2.6% for 2015 and 2016, respectively. In the coming years, domestic demand is projected to be the main driver of GDP growth.

The new government, which took office in the first quarter of 2014, is committed to a pro-growth fiscal policy mix, which should further spur domestic consumption. This policy will materialize in the form of higher government

consumption, which is expected to grow by around 1.9% in 2014, followed by increases of around 2.5% in 2015 and 2.9% in 2016. At the same time, the government pledged to stick to fiscal discipline, keeping the deficit and the debt level at current levels. Private consumption is expected to expand by 1.4% in 2014 and to rise to 2.6% and 3.6% in 2015 and 2016, respectively. Improving labor income and consumer sentiment will be supported by minimum wage and public sector wage increases in November 2014 and January 2015. This will stimulate household consumption further, which is expected to be one of the main determinants of GDP growth in the years to come. Gross fixed capital formation is projected to grow by 3.6% in 2016 after reaching 3.9% in 2014; it will be supported by higher capacity utilization, foreign direct investment inflows and capital inflows from EU funds.

To fight prevailing deflationary risks, the CNB will continue its exchange rate interventions until the beginning of 2016. However, we expect export growth to decline gradually, falling from 7.3% in 2014 to around 4.3% in 2016. The strong export performance in 2014 has been mainly supported by positive trends in traditional export markets and products (especially the automotive industry). Import growth is expected to remain strong, but will decline moderately to 6.1% in 2016. In conjunction with positive trends in private consumption and gross fixed capital formation, this shift toward domestic demand supports our expectation of a more broadly based recovery of the Czech economy, paving the way for more sustainable growth.

Hungary: Investment activity and economic policies boost growth only in the short run

The forecast of Hungarian GDP growth for 2014 as a whole has been revised upward substantially. We now expect it to reach 3.4% as solid nominal wage growth (especially in the private sector) combined with de facto stable prices (to a large extent due to administered price cuts) have bolstered households' real income. Together with improving labor market conditions, sharply improved consumer confidence, easing credit supply conditions and substantial retroactive compensation payments by banks for exchange rate margins on foreign currency loans and for unilateral hikes in interest rates and fees this will lead to a further expansion of private consumption. Private consumption growth is expected to receive a further boost in 2015 when these compensation payments will actually be paid out and – as repeatedly indicated by the government – parliament will additionally pass legislation to convert foreign currency loans into domestic currency loans. Consumption growth may decelerate somewhat in 2016 when one-off factors (e.g. administered price cuts, measures related to foreign currency loans) are set to taper off.

Public consumption growth will be held back by the need to keep the budget deficit below 3% of GDP and public debt on a steadily declining path, with the early stage in the election cycle (the next elections will not be before 2018) providing a supportive background for fiscal discipline.

Gross fixed capital formation growth is benefiting from the decline in the domestic interest rate level, the strengthening utilization of the second tranche of the central bank's Funding for Growth Scheme, and an accelerated absorption of EU funds. Also, increased capacity utilization and sharply improved business sentiment point toward a further rise in investment activity. The outlook for 2015 and 2016 is surrounded by uncertainty about the phasing out of the Funding for Growth Scheme. The odds are, however, that gross fixed capital formation growth will be substantially weaker in both years, as any remaining EU funds from the

2007 to 2013 programing period must be drawn by end-2015, leading to a "normalization" of fund inflows. The domestic interest rate cycle seems to have bottomed out, and the period of loose domestic monetary policy may come to an end toward late 2015 or early 2016 as inflation will be moving up to the central bank's target of 3%. Also, current GDP growth is substantially above the estimated potential growth rate (estimated at around 1% by both the OECD and the European Commission), which may ultimately anchor investment activity.

Although we have revised upward our forecast for export growth in 2014 on the basis of developments during the first half of 2014, we expect the pace to decelerate during the coming quarters. Despite the strengthening of euro area demand, we expect some deceleration in exports in 2015 to 2016, as the boost for exports from new production capacities in the car industry vanishes. In parallel, we expect strong import growth in 2014 on the back of domestic demand, leading to a relatively large negative contribution of net real exports. Along with the slowdown of domestic demand and exports in 2015 to 2016, import growth should decelerate as well, and net real exports should become a smaller drag on the overall GDP growth rate.

Poland: Growth drivers remain intact, but risks from Russia-Ukraine crisis cloud the outlook

In Poland, annual average growth in 2014 will amount to slightly more than 3%. The export-led recovery continues, as export growth will accelerate further to 5.6% (after 5.3% in 2013), underpinned by both the cost competitiveness of Polish manufacturing (reflecting unit labor cost and exchange rate developments) and the strong growth of German imports. This acceleration will be achieved despite the adverse impact of the economic developments in Ukraine and Russia, which is further aggravated by the Russian import ban on certain food items. Strong foreign demand continues to translate into strong fixed investment growth, which will reach nearly 8% (after a stagnation in 2013 and a contraction in 2012). The base effect, the favorable liquidity and profitability positions of enterprises, the easier availability of loan funds and the positive feedback of strengthening private consumption have been supporting investment spending. In addition, one-off factors early in the year (weather conditions boosting construction work, temporary tax allowances boosting car purchases) are lifting the growth rate of the total year. In parallel, restocking will imply a positive contribution of inventory change to GDP growth. Private consumption growth will recover markedly (2.4% after 0.8% in 2013), benefiting both from confidence channels and from improvements in the labor market. Moreover, disinflation will still have a beneficial impact. Overall, more than half of total final demand growth will come from domestic demand, and less than half from exports. Strong domestic demand growth on top of robust export growth will lift import growth to 7.2% (after only 2.4% in 2013). Thus, import growth will outpace export growth, so that the contribution of net exports to GDP growth will become moderately negative.

In 2015, we expect GDP growth to remain close to 3%. Exports will continue to be a pillar of GDP growth, but will grow slightly less than in 2014; also export growth will be slower than German import growth as a result of the further weakening of foreign demand from Ukraine and Russia. This weakening will be only partly compensated by the pick-up of imports by other euro area countries. On the domestic side, we anticipate a moderate slowing down of fiscal consolidation against the background of upcoming parliamentary and presidential elections. The government decision to increase social benefits in particular for lower-earning

households by adjusting both the pension indexation scheme and tax deductions for families with children are indicative of this; moreover, the government-approved 2015 budget draft assumes a higher deficit than currently expected for 2014. This may well contribute to public and private consumption growth as well as to fixed investment growth, while the narrowing window to get disbursements from the EU multiannual fiscal framework for 2007 to 2013 will foster semipublic-sector fixed investment. Furthermore, we assume that larger household residential investment will benefit investment further, on top of some of the factors already prevailing in 2014. Finally, we anticipate higher military purchases, which are accounted for under fixed investment according to new ESA 2010 rules. As a result, we expect fixed investment growth to decline only slightly despite the adverse base effect. Export and investment demand will maintain the positive momentum in the labor market, underpinning private consumption growth further. Overall, the growth structure will remain balanced, with domestic demand again contributing more than half to total final demand growth. Import growth will thus continue to exceed export growth, albeit to a smaller extent than in 2014, implying a slightly smaller negative contribution of net exports to GDP growth.

Romania: 2014 slump in investments to be followed by moderate pickup

Following Romania's high GDP growth of 3.3% in 2013, data for the first half of 2014 were unexpectedly weak, as Romania posted two consecutive negative quarter-on-quarter GDP growth rates (–0.2% in Q1 and –1% in Q2). In particular, plummeting gross fixed capital formation dragged down year-on-year growth to 2.4% in the first half of 2014. Against this background, we revised our forecast for 2014 down to 1.9%, which presupposes positive quarter-on-quarter growth rates in the second half of 2014. Based on the continued recovery of private consumption and an expected rebound of gross fixed capital formation, we expect GDP growth to accelerate to 2.4% in 2015 and to 2.7% in 2016.

Private consumption performed better than expected in the first half of 2014 and will remain the main growth driver. A further increase of the minimum wage in July 2014, benefiting approximately 18% of employees, has already provided a further boost to rising real disposable income and will translate into higher private consumption in the near future. In the second half of 2014, private (and public) consumption will be supported by fiscal and energy price policy measures (e.g. the reduction of the social security tax by 5 percentage points as of October 1, 2014, the postponement of the gas price liberalization) ahead of the presidential elections. Romania's sound export performance is also likely to have a positive impact on the labor market and private wage growth. Moreover, we expect lending conditions to ease gradually over the forecast horizon.

Turning to gross fixed capital formation, it should be noted that after EU fund absorption had picked up in 2013, it seems to have lost momentum in the second quarter of 2014 according to balance of payments data. We do not consider this decline in EU transfers to be permanent. An improvement would be vital to revive investment growth over the forecast horizon. While the turning point in gross fixed capital formation is difficult to project, continuously improving economic sentiment together with the decline in the domestic interest rate level should lay the basis for some impulses in this area. Improvements in the banking sector (such as a declining loan-to-deposit ratio, stabilizing nonperforming loans) suggest that the supply conditions for a revival of lending (in particular in domestic currency) also improved. A sustained euro area recovery would help Romania to attract FDI

inflows, while geopolitical tensions might negatively impact multinational companies' confidence.

Exports are forecast to maintain their positive momentum in line with our external assumptions and backed by continued declines in manufacturing unit labor costs. However, after years of weak (and most recently, negative) gross fixed capital formation growth, we do not expect a marked acceleration of export growth. As recovering domestic demand will boost import demand, net exports will make an increasingly negative contribution to overall growth.

3 Russia: Recovery Stalled by Effects of the Ukraine Crisis and Sanctions

Russian GDP growth declined to 0.8% year on year in the first half of 2014, despite transient boosts to production and consumption partly connected to the Ukraine crisis. Defense spending was stepped up, and households brought forward purchases in anticipation of higher inflation. We have slightly lowered our forecast from the previous one, given that heightened uncertainty induced especially by the Ukraine crisis as well as the related sanctions should impact on Russia's economy to such an extent that it effectively eliminates GDP expansion for 2014. Investments are bound to contract sharply, as private capital formation has been postponed; meanwhile, private consumption growth will decline further. The weaker ruble will compress imports in 2014. At the same time, we assume that financial market reactions to instability will remain limited overall and that sanctions will not escalate further (from their level of September 2014); they will stay in place during the forecast period. But uncertainty will continue to dampen private investment and will put somewhat of a drag on private consumption growth.

Given the government's low level of indebtedness and considerable fiscal resources, as well as the prominent role of state banks, Russia's authorities could in principle stimulate the economy for several years. However, such a policy shift would mean discontinuing the established, rather balanced fiscal policy that provides an anchor for the economy in unstable times. As things stand currently, a substantial government fiscal stimulus does not appear to be in the cards for the time being.

The Russian economy should start a gradual revival in 2015 and 2016, as growth in global trade and business activity are set to pick up. The oil price is assumed to decline only slightly (by about 5%) over the forecast period. To counterbalance private investment restraint, the authorities intend to boost investment by large state-owned enterprises. Giant transportation infrastructure projects funded partly by state loans could get underway in 2015. Now that Russian banks and firms have difficulties accessing Western lenders, financing will come increasingly through domestic channels. Despite the authorities' increasing emphasis on defense spending and self-sufficiency, only a relatively small amount of production capacity is likely to come on stream over the next two years. Given the time it will probably take for the unpredictable business climate to clear up, an overall (including private) investment recovery is not expected until the end of the forecast period.

Supported by some continuing real wage and pension growth, the increase in private consumption should pick up a bit again in 2015 and 2016. Yet even if the unemployment rate is currently quite low (around 5%), gains in private incomes and purchasing power are constrained by weaker corporate profitability and the likely continuing pertinence of the budget rule, high debt-servicing burdens (a

legacy of the most recent retail credit boom) and higher inflation (induced by the weakness of the ruble). The volume of Russian exports will rise very slowly, depending on the global recovery. However, Western restrictions on exports of oil technology to Russia may also impact energy production, if only marginally in the next two years.

Russia's level of imports should stabilize in real terms in 2015 and should begin to recover in 2016 – as long as the ruble's new exchange rate level remains relatively stable. Imports would thus get support from a gradual rise of the ruble's real exchange rate, as Russia's inflation rate will remain notably higher than the inflation rates of its main trading partners.

Over the long term, the conditions for economic growth and development will likely deteriorate further to the extent that plans to boost the self-sufficiency of the national economy are implemented and the authorities move away from market-oriented reforms and competition. Such a strategy, involving protectionist policies and subsidization, may result in inefficient production capacities being maintained or newly created. This could entail a decline in Russia's long-term economic trend growth rate, which BOFIT up to now has estimated at about 2% p.a.

However, at the current high level of uncertainty, the risks to the forecast this time are significant and clearly downward tilted. In particular, a further deterioration of the situation in Ukraine and intensified hostilities as well as expectations of further sanctions and the additional uncertainty these conditions generate could lead to an even further postponement of private investment than anticipated. Capital outflows and the depreciation of the ruble would regain momentum and cut imports anew. A drop in the export prices of oil and other basic commodities would impair Russia's prospects of economic recovery, depress the value of the ruble, and hit consumption and imports. On the upside, economic growth during the next two years could revive faster than we forecast if the authorities decide to move ahead with a stronger stimulus that would involve stepped-up government spending or more central bank money injected into the economy via state banks as well as centrally directed investments.

Studies

FDI in Russia from CESEE and Central Asia: A Micro-Level Perspective

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In this paper we study FDI in Russia originating from Central, Eastern and Southeastern Europe (CESEE) and Central Asia. We describe patterns of FDI and examine the determinants underlying these patterns, basing our analysis on firm-level data for the period from 1997 to 2011 obtained from Rosstat, Russia's Federal State Statistics Service. We split the investor countries under review into two subgroups, i.e. Central Eastern Europe, Baltics and Balkans (CEEBB) and Eastern Europe, Caucasus and Central Asia (EECCA). We find that Belarus and Ukraine are the largest contributors of FDI into Russia among the countries under review. However, firms established by investors from Estonia, Poland and Lithuania are more profitable than those established by investors from Belarus and Ukraine. In our empirical test of locational determinants influencing the choice of a particular Russian region as an FDI destination we, among other things, find evidence against the institutional distance argument, which maintains that FDI flows are more limited among countries that exhibit greater differences in terms of their regulatory and normative business environment.

JEL classification: D22, F15, F23
Keywords: Foreign direct investment, Russian regions, former communist countries

Economic reintegration of the countries of the former Soviet Union has become a topical issue recently with the establishment of the Eurasian Economic Union between Russia, Belarus and Kazakhstan, which will become operational in January 2015 (EEC, 2014). The "Eurasian" integration process started much earlier, soon after the dissolution of the Soviet Union in 1991, as an attempt to save the economic and business relations among the newly independent states of the Soviet Union (EEC, 2013). The early initiatives, such as the Commonwealth of Independent States (CIS), were however largely declarative in nature. The Eurasian Customs Union, which became operational in 2010, was a more tangible attempt to foster economic integration among its member states Russia, Belarus and Kazakhstan (Dragneva and Wolczuk, 2012). These three countries also form the core of the Eurasian Economic Union, which aims at enlarging its member base by including other former Soviet Union countries in the future (EEC, 2014).

The Eurasian integration can be viewed as a reaction to the integration of some former socialist countries of Central, Eastern and Southeastern Europe (CESEE) into the European Union (EU) (Dragneva and Wolczuk, 2012). The most striking example of integration pressures faced by some countries is the situation in Ukraine, where the question of closer cooperation with the EU versus Russia and the Eurasian bloc was one of the triggers of the political crisis that started in late 2013. The ensuing trade sanctions between the EU and Russia were felt in other CESEE countries as well, in particular in the Baltic states, which joined the EU as early as 2004 but at the same time retained close foreign trade relations with Russia.

In this paper we empirically address the issue of economic integration among former socialist countries in CESEE and Central Asia from the perspective of

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foreign direct investment (FDI) from these countries into Russia. Although our sample of investor countries is only responsible for a relatively small share of FDI into Russia, their investments generally represent genuine foreign investment projects with a lasting interest. In contrast, the vast majority of FDI from large investor countries like Cyprus and the British Virgin Islands often reflects round-tripping of Russian investments. Our choice of sample countries is also interesting from a historical perspective, as we analyze investment decisions among countries which share historic ties but have experienced a more recent period of economic disintegration, and partly reintegration.

FDI is a potentially important channel of shock transmission, which is however less prominently discussed than the trade and financial channels in the current debate on the effects of sanctions and countersanctions in the context of the Russia-Ukraine crisis. While we do not attempt to assess the importance of the FDI channel in this context, we can add to a better understanding of the possible impact of the current developments by analyzing the determinants of FDI into Russia for those countries that are potentially most affected by sanctions.

We conduct a micro-level descriptive analysis of the magnitude as well as the industrial and regional distribution of FDI originating from CESEE and Central Asian countries on the basis of data on foreign-owned firms in Russia. Further, we analyze the determinants of FDI in Russia originating from these countries, focusing on the relevance of institutional determinants to explain the location choice of these firms across Russia.

The paper is structured as follows: The relevant literature is reviewed in section 1. Patterns of FDI from CESEE and Central Asia in Russia are described in detail in section 2, based on firm-level data obtained from Rosstat. Section 3 describes the research design for the empirical analysis; the results are presented and discussed in section 4. Section 5 concludes.

1 Literature Review

1.1 Determinants of FDI Location

The strong growth of FDI in recent decades has inspired extensive research on determinants of FDI. The most prominent theory in this field, Dunning's eclectic (or OLI) paradigm (e.g. Dunning, 1993), suggests three primary motivations for FDI, distinguishing between foreign market-seeking investments, efficiency-seeking and resource-seeking investments (Dunning, 1977 and 1993). The more recent FDI literature has acknowledged the importance of institutions as determinants of FDI location choice. Accordingly, recent elaborations of Dunning's paradigm explicitly recognize home and host country institutions as important determinants of inward FDI (Dunning and Lundan, 2008).

1.2 Determinants of Inward FDI in Russia

There have been several studies which empirically analyze the determinants of FDI across Russia's different regions.

Brock (1998) analyzes FDI determinants during early transition (1993–1995), identifying market size and crime as important influences on FDI decisions. Broadman and Recanatini (2001) analyze determinants of FDI inflows from 1995 to 1999 using a generalized least squares estimation for panel data and an ordinary least squares estimation for cross-sectional data. They show that market size, the extent

of infrastructure development and prevailing policy frameworks explain most of the observed variations in FDI flows across Russian regions. Iwasaki and Suganuma (2005) suggest a model for the regional distribution of FDI in Russia based on panel and yearly cross-sectional data from 1996 to 2003. The authors conclude that resource endowments, market factors, degree of industrialization and infrastructure factors hold high significance and explanatory power in their empirical analysis. They further suggest that business climate and regionally favorable FDI measures may affect investment. Ledyaeva (2009) studies the determinants of FDI inflows into Russia before and after the 1998 financial crisis, using a spatial autoregressive model of cross-sectional and panel data. The important determinants of FDI inflows into Russian regions since the start of transition appear to be market size, the presence of large cities and seaports, oil and gas availability, proximity to European markets, and political and legislative risks.

Finally, the empirical model of this study is largely based on the recent study of locational determinants of FDI across Russia by Ledyaeva et al. (2013a). Using the same kind of firm-level data for the period from 1996 to 2007 and a set of explanatory variables similar to the one used in this study, Ledyaeva et al. (2013a) examine the effects of subnational variations in corruption and democratization on the location decisions of foreign investors in Russian regions. They conclude that foreign investors from less corrupt and more democratic countries tend to invest into less corrupt and more democratic Russian regions, while their counterparts from more corrupt and less democratic countries tend to locate in more corrupt and less democratic regions. In the present study we apply the framework set out in Ledyaeva et al. (2013a) to study determinants of post-socialist countries' FDI in the different Russian regions.

2 Patterns of FDI in Russia Originating from CESEE and Central Asia

We examine FDI from CESEE and Central Asia in Russia based on firm-level data taken from Rosstat (Russia's Federal State Statistics Service). For our analysis, we split the investor countries under review into two subgroups: "Central Eastern Europe, Baltics and Balkans (CEEBB)" comprises all current EU Member States and the Western Balkan countries; "Eastern Europe, Caucasus and Central Asia (EECCA)" comprises the remaining countries from the former Soviet Union in our sample.[2]

Generally speaking, FDI from former socialist countries into Russia is dwarfed by FDI from countries like Cyprus or the British Virgin Islands. In total, inward FDI stocks from our sample of countries amounted to a mere 1.1% of the total inward FDI stock in Russia in 2012.[3] It has to be mentioned, however, that a substantial part of FDI from investors such as Cyprus or the British Virgin Islands represents round-tripping of Russian investment. This can be concluded from the strong correlation of inward and outward investment flows between Russia and these countries (see Ledyaeva et al., 2013b). In contrast, FDI from our sample of

[2] *Our sample includes the following investor countries: Central Eastern Europe, Baltics and Balkans (CEEBB): Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Montenegro, Poland, Romania, Serbia, Slovakia, Slovenia; Eastern Europe, Caucasus and Central Asia (EECCA): Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.*

[3] *Source: wiiw FDI database. This figure refers to 2012, the latest year for which data are available, but the share has been constant since 2009.*

countries is likely to represent genuine foreign investment with a lasting interest. Outward FDI to Russia is economically most important for Estonia and Latvia, where it amounts to 1% to 2% of GDP. For all other countries in our sample, outward FDI to Russia ranges from 0% to 1% of GDP (Husain et al., 2014).

The full Rosstat dataset contains information on 20,165 firms with foreign capital which were registered in Russia in the period from 1997 to 2011 and which provided their balance sheet information to Rosstat in 2011. Thus, our dataset does not include firms which existed in this period but where dissolved before 2011. The dataset includes firms of two ownership types: full ownership by foreign entities and joint ventures of foreign owners (foreign entities and foreign citizens) with Russian private owners (Russian entities and citizens). The Rosstat dataset does not have a specific threshold for joint ventures; thus also minority holdings of foreign investors are included (in contrast to the wiiw FDI data). However, firms with foreign ownership of less than 10% amount to less than 5% of the full dataset.

For our analysis we only use the data on firms established by investors from CEEBB and EECCA. This yields a data sample of 2,983 firms representing about 15% of the total number of firms in the full dataset.[4] The time dynamics of established firms illustrate a rising share of CEEBB- and EECCA-owned firms over the observation period, from 11% in 1998 to 27% in 2011.[5]

The average degree of foreign ownership in our sample is 60% but the distribution is strongly skewed. For the majority of firms (52%) the degree of foreign

Table 1

Number and Revenues of CEEBB and EECCA Firms in Russia by Investing Country

Country	Number of firms, cumulated from 1997 to 2011		Share in total revenues, cumulated from 1998 to 2011	Country	Number of firms, cumulated from 1997 to 2011		Share in total revenues, cumulated from 1998 to 2011
	Absolute	%			*Absolute*	%	
Belarus*	740	24.81	29.38	Serbia	47	1.58	1.23
Ukraine*	614	20.58	17.54	Slovenia	40	1.34	4.65
Latvia	217	7.27	3.24	Hungary	27	0.91	0.32
Kazakhstan*	194	6.50	2.91	Slovakia	26	0.87	0.82
Lithuania	190	6.37	6.61	Kyrgyzstan*	19	0.64	0.05
Estonia	149	4.99	2.49	Georgia*	17	0.57	0.15
Czech Republic	145	4.86	8.84	Croatia	14	0.47	1.68
Uzbekistan*	145	4.86	3.52	Tajikistan*	10	0.34	0.01
Poland	142	4.76	10.49	Bosnia and Herzegovina	8	0.27	0.05
Armenia*	61	2.04	1.05	Turkmenistan*	6	0.20	0.00
Bulgaria	58	1.94	0.63	Montenegro	5	0.17	0.11
Azerbaijan*	53	1.78	1.07	Romania	5	0.17	0.00
Moldova*	51	1.71	3.17	Total	2,983	100	100

Source: Rosstat and authors' calculations.

Note: EECCA countries are marked with an asterisk.

[4] *This share is considerably larger than these countries' share in Russia's total inward FDI stock (see above).*

[5] *As mentioned above, the share of firms chosen for our sample in the full Rosstat dataset is relatively small compared to the shares of major single contributors of FDI into Russia: e.g. 30% of all firms in the full Rosstat dataset have been established by investors from Cyprus; the corresponding figures for the British Virgin Islands and Germany are 8% and 5%, respectively.*

ownership ranges from 10% to 50.9%, less than one-third have reported foreign ownership between 51% and 99.9%. Around 16% of the firms are 100% foreign owned, while a foreign ownership share below 10% is reported for only around 1% of all firms and can thus be seen as negligible. In table 1 we present the structure of this sample country by country.

As shown in table 1, there are two EECCA countries, Belarus and Ukraine, which stand out as the largest investors both in terms of number of firms and share in cumulative revenues. Every fourth firm in the sample is (partially) owned by Belarusian investors; taken together Belarusian firms account for almost one-third of total revenues in our sample. Interestingly, the comparable share is considerably smaller for Kazakhstan, the third member of the Eurasian Union, which has an even lower share than the most important CEEBB investor country.[6] The leading investors among the CEEBB countries include Latvia, Lithuania and Estonia, which may indicate a heritage from their Soviet past. The two other CEEBB countries with a considerable number of firms in our sample are the largest CEEBB economies: Poland and the Czech Republic.

When comparing cumulative shares, the share in the total number of firms is somewhat larger for EECCA countries (63%) than their share in total revenues (59%). This indicates that EECCA-owned firms in Russia are smaller on average than CEEBB-owned firms (see also chart 3 below). Furthermore, the lion's share of investments comes from a few countries in both groups. In the EECCA group, 90% of the cumulative revenues within the group are generated by firms with

Table 2

Number and Revenues of CEEBB and EECCA Firms in Russia by Receiving Industry

Industry	Full sample			EECCA			CEEBB		
	Number of firms, cumulated from 1997 to 2011		Share in total revenues, cumulated from 1998 to 2011	Number of firms, cumulated from 1997 to 2011		Share in total revenues, cumulated from 1998 to 2011	Number of firms, cumulated from 1997 to 2011		Share in total revenues, cumulated from 1998 to 2011
	Absolute	%		*Absolute*	%		*Absolute*	%	
Agriculture, hunting, forestry, fishing	87	2.9	0.5	57	3.0	0.5	30	2.8	0.5
Resource extraction	31	1.0	0.2	16	0.8	0.3	15	1.4	0.0
Manufacturing industries	495	16.6	24.5	291	15.2	21.6	204	19.0	28.7
Electricity, gas and water	11	0.4	0.2	7	0.4	0.3	4	0.4	0.0
Construction	258	8.7	4.9	156	8.2	3.8	102	9.5	6.6
Trade and repair	1,461	49.0	60.6	1026	53.7	65.2	435	40.5	54.0
Hotels and restaurants	36	1.2	1.3	24	1.3	1.9	12	1.1	0.3
Transport and communications	191	6.4	2.5	95	5.0	2.6	96	9.0	2.4
Financial activities	48	1.6	2.7	26	1.4	1.6	22	2.1	4.2
Real estate	321	10.8	2.6	178	9.3	2.0	143	13.3	3.4
Others	44	1.5	0.2	34	1.8	0.4	10	0.9	0.0
Total	2,983	100	100	1,910	3.0	100	1,073	100	100

Source: Rosstat and authors' calculations.

[6] *In contrast to this result, data on inward FDI stocks from the Bank of Russia (compiled according to the asset/liability principle laid down in the sixth edition of the IMF's Balance of Payments Manual – BPM6) show Kazakhstan as the largest EECCA investor in our sample. This points toward relatively low revenues of Kazakh investments in relation to the sum of invested equity, reinvested earnings and loans.*

owners from Belarus, Ukraine, Kazakhstan or Uzbekistan. In the CEEBB group concentration is slightly less than in the case of EECCA investors, with the Baltic States, Poland and the Czech Republic accounting for 71% of cumulative revenues within the group.

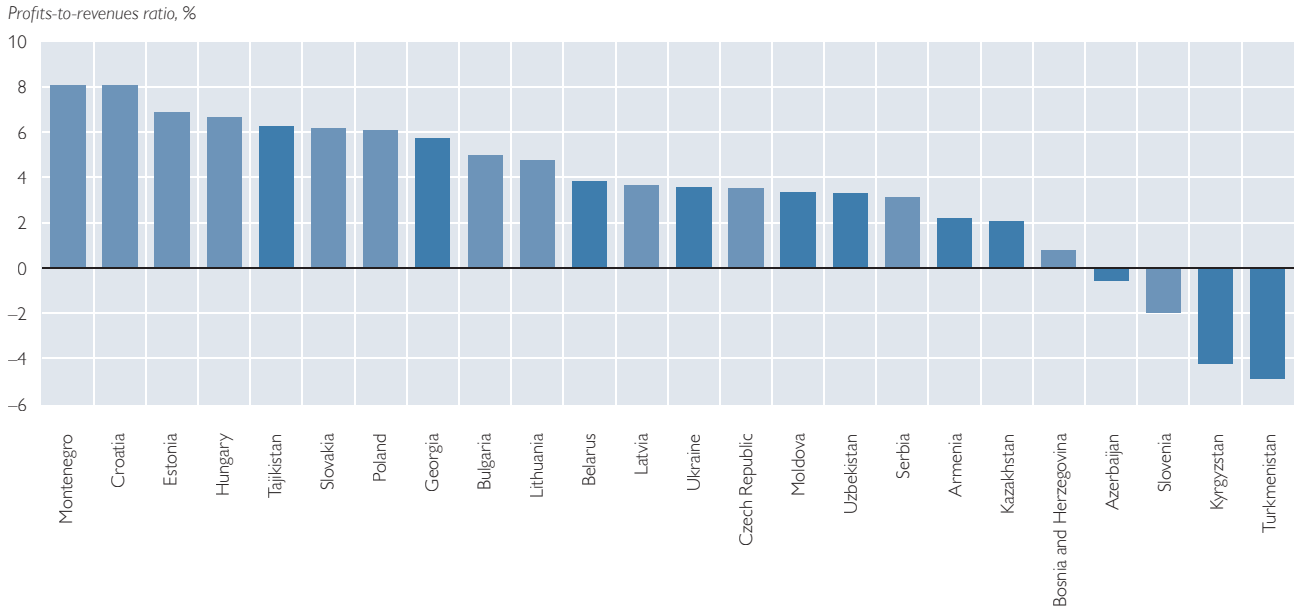
As can be seen from table 2 the industrial structure of the investments in our sample is dominated by trade and repair; nearly half of all firms, accounting for 60% of total revenues, report this as their main activity. The second largest receiving industry is manufacturing, which accounts for roughly one-quarter of cumulative revenues. Investment in the trade and repair sector seems to be slightly more attractive for EECCA firms, while investors from CEEBB countries invest more strongly in the manufacturing sector, both in terms of the number of established firms and their cumulative revenues. CEEBB investors also show more investments into Russia's real estate sector than their EECCA counterparts. With 1.6% of all firms in the sample and 2.7% of cumulative revenues, the financial sector plays a rather small role in our overall sample but is considerably more important for CEEBB firms.

Belarus is not only the leading investor country in terms of cumulative revenues and number of established firms in our sample (table 1) but also in terms of profits, followed by Poland and Ukraine. Further, Lithuanian and Czech firms show relatively high cumulative profits over the period from 1998 to 2011.

Rather than looking at cumulative profits alone, a better measure of the profitability of firms is the ratio of cumulative profits to cumulative revenues. When interpreting chart 1, one should keep in mind that the number of observations for some countries (such as Montenegro) is very small, which may create a bias. If we focus only on those investor countries with more than a hundred firms in Russia, one can conclude that Estonian-, Polish- and Lithuanian-owned firms (CEEBB

Chart 1

Average Profitability of Firms by Investor Country



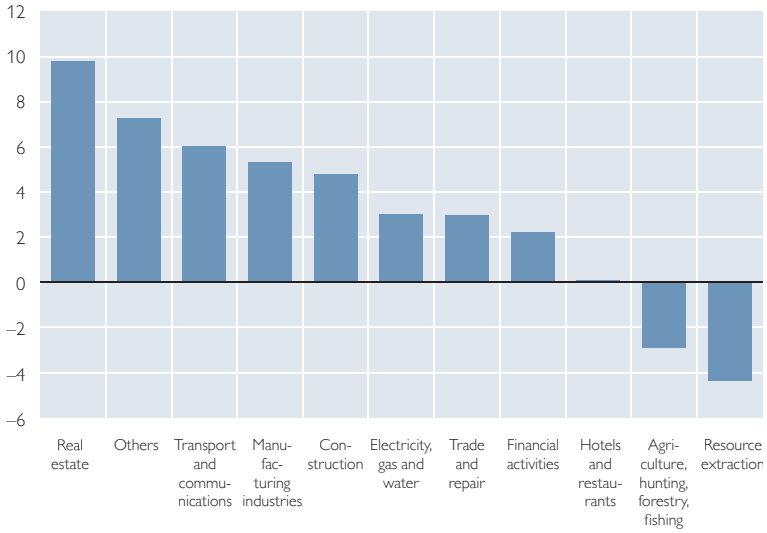
Source: Rosstat and authors' calculations.

Note: Ratio of cumulative profits to cumulative revenues, 1998–2011 average in %; the dark blue bars indicate EECCA countries.

Chart 2

Average Profitability of Firms by Receiving Industry

Profits-to-revenues ratio, %



Source: Rosstat and authors' calculations.

Note: Ratio of cumulative profits to cumulative revenues, 1998–2011 average in %.

group) are more profitable in aggregate terms than firms with owners from the largest EECCA countries Belarus and Ukraine. The weakest performers (with negative profitability) are firms with owners from the least developed EECCA countries, Kyrgyzstan and Turkmenistan, but also Slovenian firms feature in this group.

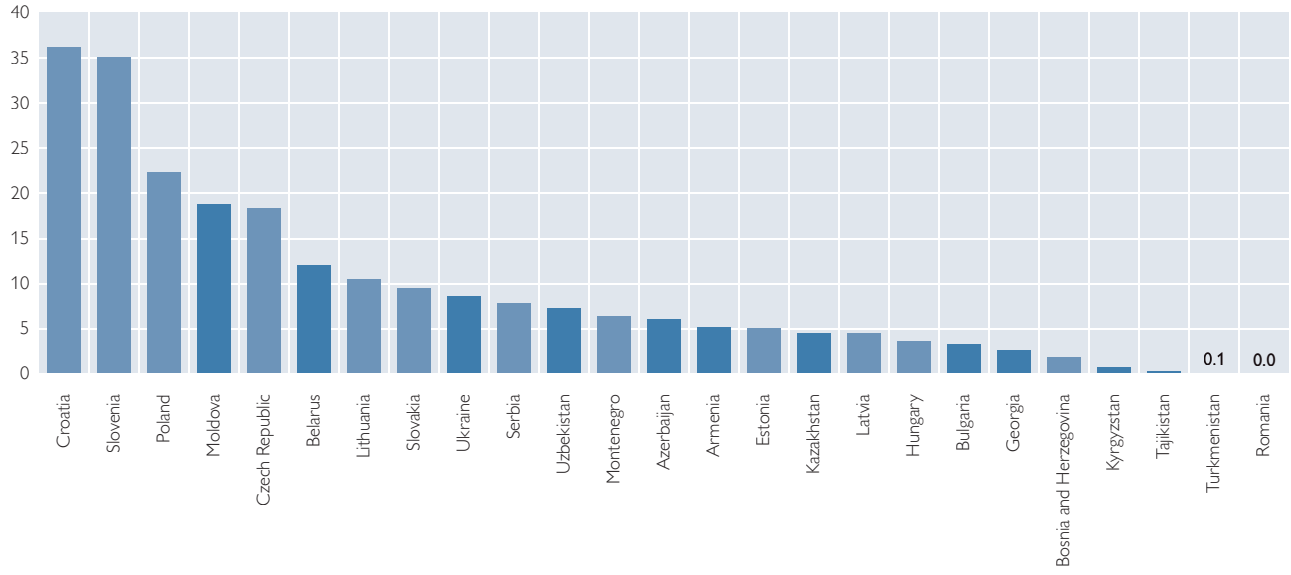
Comparing the profitability by receiving industry (chart 2) for our sample, investments in Russian real estate are the most profitable, while the performance of investments in natural resource-based operations is the worst.

As noted previously, there are differences in the average firm size between the two groups of investor countries (CEEBB and EECCA), and also within the groups (see chart 3). The average firm size in terms of revenues in the CEEBB group is EUR 11 million and, in the EECCA group, EUR 6 million. At the same time, there is larger variance in the CEEBB group, as the largest and smallest country averages are found for investments from this group.

Chart 3

Average Firm Size by Investor Country

EUR million



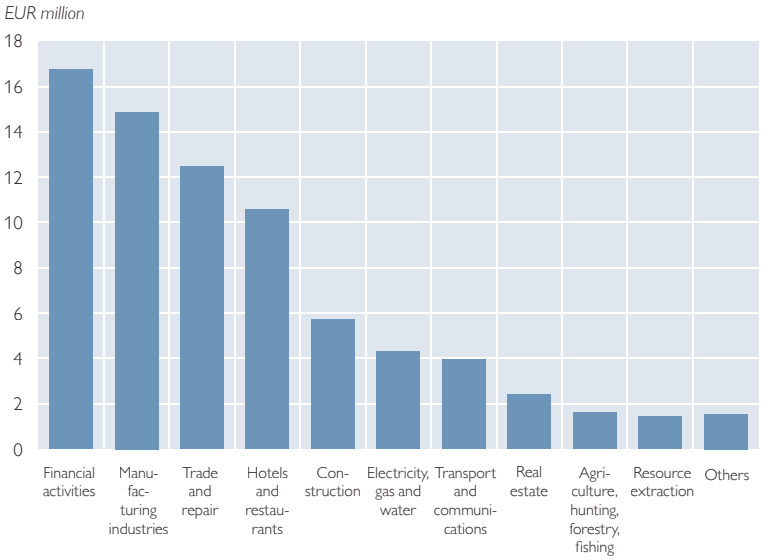
Source: Rosstat and authors' calculations.

Note: Average firm size is measured by cumulative revenues in 1998–2011 in EUR million divided by the number of established firms in 1997–2011 for each country; the dark blue bars indicate EECCA countries.

When analyzing the average firm size by receiving industry (chart 4), we observe that the volume of investment is largest in the financial activities category. At the same time the number of investments in this industry is only a fraction of those in the manufacturing or trade and repair sectors (table 2). Somewhat surprisingly, the average size of firms with foreign ownership is considerably larger in the labor-intensive hotel and restaurant sector than in the capital-intensive resource extraction sector. This may indicate that it is easier for foreign firms to enter the service sector, and to expand their operations there, than in the resource extraction sector, which is under closer political and regulatory control (see also Karhunen et al., 2014).

Chart 4

Average Firm Size by Receiving Industry



Source: Rosstat and authors' calculations.

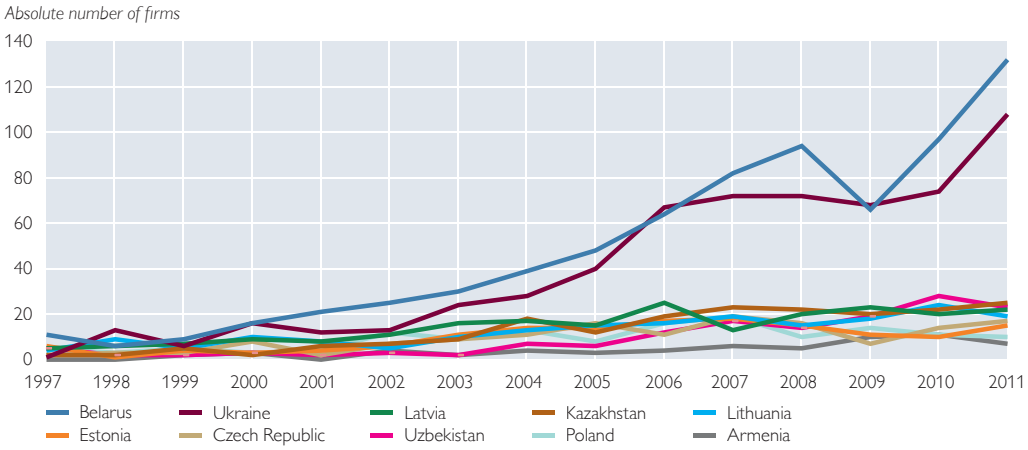
Note: Average firm size is measured by cumulative revenues in 1998–2011 in EUR million divided by the number of established firms in 1997–2011 for each industry.

Chart 5 shows the increasing importance of Belarus and Ukraine as sources of FDI into Russia. The number of firms with Belarusian ownership increased steadily until the global financial crisis in 2008, which caused a drop in 2009. In 2010, FDI into Russia recovered again, however. In the case of Ukraine, the number of firms increased until 2006, after which it remained relatively stable until 2010 and increased sharply again in 2011. For the other countries, growth dynamics have been less pronounced.

Another interesting observation relates to the amount of foreign control in foreign-owned firms in Russia. The information given in chart 6 can be analyzed

Chart 5

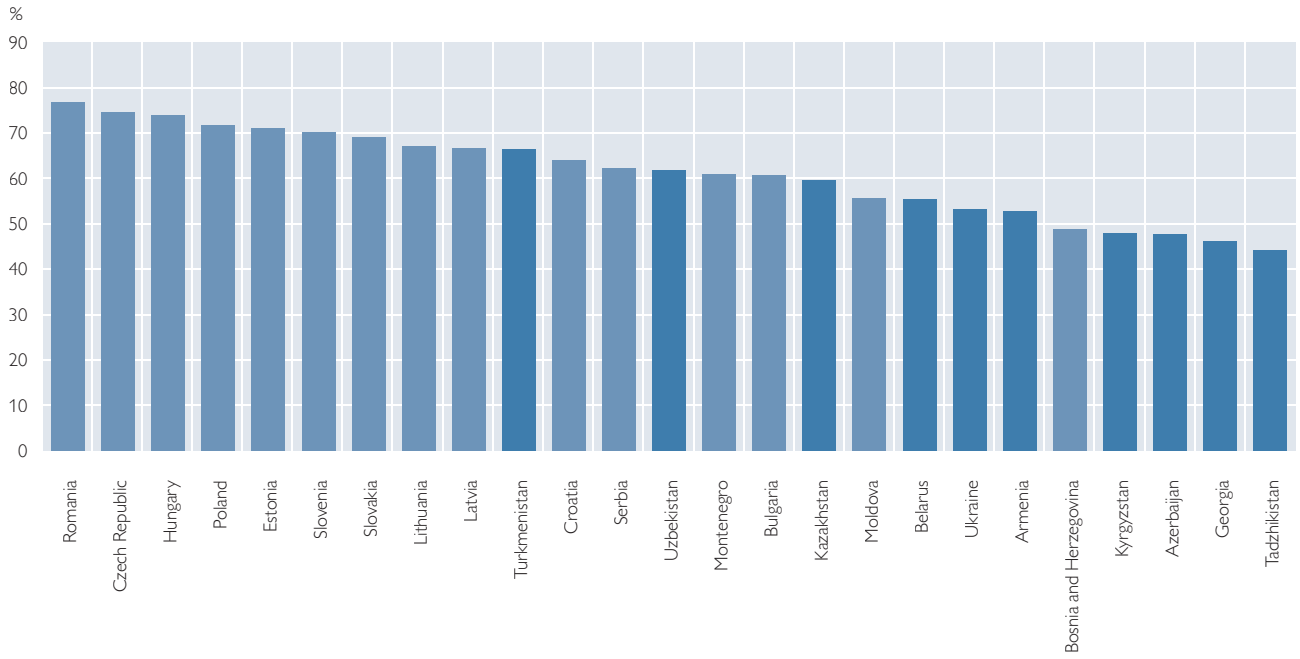
Number of Firms in Russia Owned by the Top Ten Investor Countries: 1997–2011



Source: Rosstat and authors' calculations.

Chart 6

Average Degree of Foreign Ownership by Investor Country



Source: Rosstat and authors' calculations.

Note: Degree of foreign ownership in the firms established by the respective CEEBB and EECCA investors in the period 1997–2011 in %; the dark blue bars indicate EECCA countries.

against the institutional distance argument, according to which investor countries that are more different from Russia in terms of their regulatory and normative business environment (i.e. CEEBB countries) would tend to have lower ownership shares. Interestingly, our data do not support this assumption, but provide quite the contrary evidence. The average degree of ownership is in general higher in the CEEBB group than in the EECCA group. This result can be interpreted from two perspectives. First, due to their shared socialist past, the institutional distance between the countries under examination and Russia may not be as decisive as for foreign-owned firms in the full Rosstat dataset (Karhunen and Ledyaeva, 2012). Second, the results may support the alternative theoretical explanation in the literature that higher institutional distance would lead to higher ownership shares, as a greater degree of ownership (and thereby control) would make it easier for a foreign firm to transfer its practices to a foreign business unit operating in a different institutional context (see e.g. Estrin et al., 2009). As a final observation, foreign ownership never exceeds the 90% threshold (which would indicate full ownership) for any of the investor countries.

Since we are not only interested in describing the patterns of FDI from CEEBB and EECCA countries in Russia, but also want to analyze the determinants of these patterns, we need to be able to identify differentiating features among FDI recipients. As we only analyze FDI into one host country, i.e. Russia, we need to distinguish between individual regions within Russia in the econometric analysis below. Hence, the final part of the descriptive analysis focuses on the distribution of FDI from our sample countries across Russian regions.

When looking at the regional distribution of firms for our sample as a whole (table 3), the dominance of the city of Moscow and the surrounding region as FDI

Table 3

Distribution of CEEBB and EECCA Firms by Russian Regions

Region	Number of firms, cumulated from 1997 to 2011		Region	Share in total revenues, cumulated from 1998 to 2011
	Absolute	%		%
Moscow city	1,026	34.4	Moscow city	34.8
Moscow region	205	6.9	Moscow region	14.2
Saint Petersburg	204	6.8	Saint Petersburg	5.8
Smolensk region	145	4.9	Lipetsk region	5.4
Kaliningrad region	117	3.9	Kaliningrad region	4.0
Belgorod region	93	3.1	Smolensk region	3.6
Bryansk region	77	2.6	Belgorod region	2.9
Pskov region	73	2.4	Rostov region	2.4
Rostov region	73	2.4	Bryansk region	2.0
Novosibirsk region	61	2.0	Voronezh region	1.8
Krasnodar region	52	1.7	Republic of Tatarstan	1.8
Leningrad region	46	1.5	Kemerovo region	1.8
Samara region	43	1.4	Republic of Bashkortostan	1.6
Omsk region	41	1.4	Tyumen region	1.5
Chelyabinsk region	34	1.1	Leningrad region	1.5
Others	695	23.3	Others	14.9

Source: Rosstat and authors' calculations.

Note: Cumulative number of firms for 1997–2011, cumulative revenues for 1998–2011.

destinations is obvious; together they attract over 40% of the firms in our sample and nearly 50% of the cumulative revenues. This dominance is, however, not quite as pronounced as for foreign-owned firms in the full Rosstat dataset (Ledyaeva et al., 2013a). The relatively high importance of the Smolensk and Kaliningrad regions for investors from CEEBB and EECCA can be explained by geographical factors.[7]

3 Econometric Model and Methodology

In our empirical analysis, we focus on the number of firms with foreign ownership as this number reflects the decision to invest into Russia. Moreover, our study aims to enhance our understanding of the relevant factors that motivate these investment decisions. In order to find evidence on locational determinants of FDI from CEEBB and EECCA countries into the different Russian regions we estimate the following equation for our data sample (the model is adopted from Ledyaeva et al., 2013a):

$$y_i = a_0 + a_1 MarketSize_i + a_2 MarketPot_i + a_3 Edu_i + a_4 Roads_i + a_5 Port_i + \\ + a_6 InvRisk_i + a_7 Nat\,\mathrm{Re}s_i + a_8 InstPot_i + a_9 Dem_i + a_{10} Corr_i + \varepsilon_i \quad (1),$$

where y_i is the number of firms established by investors from our sample of countries in a particular Russian region i (i =1,…,76[8]) in the period from 1997 to 2011

[7] *The Smolensk region borders on Belarus and the Kaliningrad region is a Russian enclave situated between Lithuania and Poland.*

[8] *The Russian Federation is administratively divided into federal subjects, which are commonly referred to as regions. The number of regions was 89 until 2005, after which some of them merged to form larger regions. The current number of regions is 83. Due to a data availability problem, in this study we consider only 76 Russian regions. In particular, the republics of Chechnya, Ingushetia and Kalmykia are excluded, as are the autonomous okrugs of Khanty-Mansi, Yamalo-Nenets, Chukotka and Nenets.*

(cumulative). Hence, the dependent variable in this study is a count variable which takes on only non-negative integer values. Poisson regression is appropriate for modeling the count data. However, our data is significantly overdispersed, which violates a basic assumption of the Poisson model (Hausman et al., 1984). Consequently, as recommended in the literature, we use negative binomial (NB) regression to model our data (Hausman et al., 1984). Still, we report Poisson model estimation results for comparison.

Our measure of market size *MarketSize* is the extracted first principal component of three variables (gross regional product, total population, and population density[9]) for a particular region *i*. This indicator for the market size in Russian regions was introduced previously in a study by Iwasaki and Suganuma (2005). The proportion of variance of the first principal component can reach 80% and, furthermore, its eigenvector and component loading show that this measure is suitable as a general index of market size.[10]

We also include a surrounding-market potential variable: *MarketPot* (see Blonigen et al., 2007). For a region *i*, it is defined as the sum of the market sizes (measured using the *MarketSize* variable) of the surrounding regions, defined as neighboring (but not necessarily bordering) regions whose respective capitals lie within a distance of 500 km to the capital of region *i*. Hence, we use the same distance threshold applied in Ledyaeva at al. (2013a).

Our third control variable is the educational background of the regional population: *Edu*. The educational background of the population in a region *i* is measured using a natural logarithm of the share of the population with at least a medium level of professional education compared to the share of the population with no professional education in the year 2002 (data source: 2002 Rosstat Population Census).

The fourth and fifth control variables measure the existing transport infrastructure in a particular Russian region *i*, which is assumed to have an impact on the transportation costs incurred by foreign investors. The variable *Roads* reflects the regional development of railways and highways and is measured by the average density of railways and highways in a particular region *i*. The variable *Port* is a dummy variable reflecting the presence of a seaport[11] in a particular Russian region *i* (at least one seaport = 1; no seaport = 0).

Next, we consider several indicators of investment risk and potential in Russian regions. Regional investment risk *InvRisk* is a qualitative indicator that simultaneously reflects political, economic, social, criminal, financial, ecological and legislative risks for investment activities in a particular region. The natural resources potential variable *NatRes* reflects the average weighted availability of balanced stocks of principal natural resources in a particular region *i*. The regional institutional potential variable *InstPot* reflects the level of development of principal market institutions in a given region. All three indicators are taken from the online *Expert RA* journal ranking[12] ranging from 1 to 89 for a particular Russian region *i* and are

[9] *The variables "MarketSize," "MarketPot," and "Roads" are all based on data obtained from Rosstat (see www.gks.ru) and are calculated as averages over the period from 1997 to 2010.*

[10] *One referee suggested to control for regional distance between investor country and the respective Russian regions. However, regional distance largely correlates with the market size variable. In order to avoid multicollinearity and a related bias, we decided not to include this variable.*

[11] *See http://www.searates.com/maritime/russia.html.*

[12] *See http://www.raexpert.ru (official website of the Expert RA Rating Agency).*

averaged over the period from 1997 to 2010. For *InvRisk* a value of 1 is assigned to the region with the smallest risk in Russia, and 89 is assigned to the region with the largest risk; for *NatRes* and *InstPot* a value of 1 is assigned to the region with the highest potential in Russia, and 89 is assigned to the region with the lowest potential (see footnote 8).

Finally we control for the levels of democracy and corruption in Russian regions. We measure democracy in a Russian region *i*, using a simple average of the Carnegie Moscow Center's Index of Democracy over the period from 2000 to 2004 to calculate the variable *Dem*. This index ranks Russian regions on the basis of expert evaluations of ten different dimensions. We exclude the corruption dimension here because we aim to assess the influence of corruption on firms' location decisions separately. Also, this dimension does not correlate strongly with the other dimensions of the index (see Ledyaeva et al., 2013a). The democracy index ranges from 1.7 to 4.7, with 1.7 denoting the lowest level of democracy.

Following the above consideration, corruption in a region *i* – *Corr* – is measured in terms of the corruption dimension as assessed by the Carnegie Moscow Center's Index of Democracy over the period from 2000 to 2004. The democracy index applies a 5-point scale, where 1 indicates the highest level of corruption and 5 indicates the lowest. This indicator refers mainly to state corruption in a broader sense, i.e. the interconnections between political and business elites and their interventions in the political decision-making process.

4 Estimation Results

4.1 Baseline Results

In table 4 we present the estimation results of equation (1). We estimate our model for the whole sample and also separately for the CEEBB and EECCA groups. Descriptive statistics and correlation matrix of the dependent and explanatory variables are presented in the annex.

Though, in the Poisson model, all the variables are highly statistically significant, we base our conclusions on the negative binomial model since the likelihood-ratio test of alpha indicates that our data is overdispersed and is not sufficiently described by the simpler Poisson distribution. We find that foreign investors from CEEBB and EECCA countries tend to locate in Russian regions with better transport infrastructure (represented by railway and highway roads), higher institutional potential and higher level of democracy. We further find that Russian regions with a higher level of corruption appear to be more attractive for the examined foreign investors. In general, this result indicates that foreign investors from the countries under consideration here are well-equipped to cope with and even benefit from corruption in Russia, possibly due to their long-term linkages with the Russian economy in the past. While this finding corroborates the results of an earlier study (Ledyaeva et al., 2013a) which reports that foreign investors from countries with a higher reported level of corruption tend to invest into Russian regions with a higher level of corruption. This finding does, however, not prove robust once we exclude the democracy variable, as we will see below.

We also find some differences in FDI determinants between CEEBB and EECCA investors. First, there is some evidence that while investors from EECCA tend to locate in Russian regions without seaports, investors from CEEBB are more likely to choose regions with ports. This result points to the conclusion that

Table 4

Baseline Estimations (Negative Binomial and Poisson Model)

Variable	All countries		EECCA		CEEBB	
	Poisson	*Negative binomial*	*Poisson*	*Negative binomial*	*Poisson*	*Negative binomial*
MarketSize	0.1 (0.02)***	–0.07 (0.1)	0.12 (0.02)***	–0.08 (0.13)	0.1 (0.03)***	–0.04 (0.11)
MarketPot	0.02 (0.01)***	0.04 (0.03)	0.03 (0.01)***	0.05 (0.04)	0.02 (0.01)	0.02 (0.04)
Edu	0.5 (0.14)***	0.9 (0.7)	0.48 (0.17)***	1.35 (0.77)*	0.18 (0.25)	0.66 (0.7)
Roads	0.004 (0.0002)***	0.005 (0.002)***	0.003 (0.0003)***	0.01 (0.002)***	0.01 (0.0004)***	0.004 (0.002)**
Port	–0.15 (0.07)***	–0.4 (0.3)	–0.35 (0.09)***	–0.59 (0.33)*	0.23 (0.12)*	–0.13 (0.32)
InvRisk	–0.01 (0.002)***	–0.01 (0.01)*	–0.004 (0.002)*	–0.01 (0.01)	–0.02 (0.004)***	–0.02 (0.01)**
NatRes	0.005 (0.002)***	0.005 (0.006)	0.003 (0.002)*	–0.001 (0.01)	0.01 (0.003)***	0.02 (0.01)**
InstPot	–0.02 (0.002)***	–0.03 (0.01)***	–0.02 (0.003)***	–0.04 (0.01)***	–0.0003 (0.004)	–0.02 (0.01)**
Dem	0.4 (0.06)***	0.5 (0.2)**	0.15 (0.07)**	0.19 (0.31)	0.9 (0.1)***	0.84 (0.24)***
Corr	–0.5 (0.05)***	–0.3 (0.2)*	–0.39 (0.06)***	–0.35 (0.22)*	–0.52(0.09)***	–0.34 (0.21)*
Intercept	2.8 (0.2)***	2.4 (0.85)***	3.28 (0.19)***	3.04 (1.06)***	–0.23 (0.35)	–0.08 (0.78)
No. of observations	76	76	76	76	76	76
Pseudo R^2	0.84	0.16	0.76	0.15	0.84	0.22
Likelihood-ratio test of alpha = 0	770***		829***		173.3***	

Source: Authors' estimations.

*Note: * if p < 0.10, ** if p < 0.05, *** if p < 0.01; standard errors in parentheses. Likelihood-ratio test of alpha = 0: This is the likelihood-ratio chi-square test that the dispersion parameter alpha is equal to zero. The test statistic is calculated based on the difference between the log-likelihoods from the Poisson model and the negative binomial model. The large test statistic would suggest that the response variable is overdispersed and is not sufficiently described by the simpler Poisson distribution.*

EECCA investors are more linked to local (Russian) consumers and suppliers while CEEBB investors are more oriented toward efficiency- or resource-seeking and hence favor regions with better international transport infrastructure. Second, CEEBB investors care more about regional investment risks, preferring regions with lower risks. For EECCA investors the relevant result is only marginally statistically significant in the Poisson regression and not statistically significant in the negative binomial regression. Finally, there is rather strong evidence that CEEBB investors locate in regions with less resource potential, while for EECCA investors this evidence is rather small. This may point toward the possibility that investors from EECCA are more likely to have access to profitable resource-based projects in Russia, which in general are rather strongly protected from foreign investment by state authorities.

4.2 Robustness Checking

4.2.1 Regressions without Democracy Variable

As a robustness check we also estimate our model without the democracy variable *Dem* to see if the result for the corruption variable *Corr* remains stable. The results are presented in table 5.

As we can see from the results, the coefficients of the corruption variable are not statistically significant anymore in the negative binomial model for any of the country groups. For CEEBB investors, the coefficient of the corruption variable in the negative binomial model even turns positive, indicating the expected negative relationship between corruption and foreign investment. For EECCA investors the result remains negative and statistically insignificant (p-value = 0.12). Thus, if at all, a positive relationship between corruption and foreign investment is more likely in the case of investors from EECCA countries.

Table 5

Estimations without Democracy Variable (Negative Binomial and Poisson Model)

Variable	All countries		EECCA		CEEBB	
	Poisson	*Negative binomial*	*Poisson*	*Negative binomial*	*Poisson*	*Negative binomial*
MarketSize	0.05 (0.02)***	−0.09 (0.11)	0.10 (0.02)***	−0.08 (0.13)	−0.02 (0.03)	−0.09 (0.11)
MarketPot	0.01 (0.01)	0.03 (0.04)	0.02 (0.01)**	0.05 (0.04)	−0.02 (0.01)	−0.01 (0.04)
Edu	0.82 (0.13)***	1.17 (0.66)*	0.57 (0.16)***	1.46 (0.75)*	1.03 (0.24)***	1.05 (0.75)
Roads	0.004 (0.0002)***	0.005 (0.002)***	0.004 (0.0003)***	0.005 (0.002)***	0.01 (0.0004)***	0.004 (0.002)**
Port	−0.09 (0.07)	−0.34 (0.29)	−0.32 (0.08)***	−0.58 (0.33)*	0.31 (0.12)**	0.07 (0.35)
InvRisk	−0.004 (0.002)**	−0.01 (0.01)	−0.002 (0.002)	−0.003 (0.01)	−0.01 (0.003)*	−0.01 (0.01)
NatRes	0.01 (0.002)***	0.01 (0.01)*	0.01 (0.002)**	0.00004 (0.01)	0.02 (0.003)***	0.03 (0.01)***
InstPot	−0.02 (0.002)***	−0.04 (0.01)***	−0.03 (0.002)***	−0.04 (0.01)***	−0.02 (0.003)***	−0.04 (0.01)***
Corr	−0.26 (0.04)***	−0.09 (0.17)	−0.31 (0.05)***	−0.28 (0.18)	−0.17 (0.07)**	0.17 (0.19)
Intercept	3.25 (0.15)***	3.08 (0.84)***	3.43 (0.18)***	3.37 (0.94)***	1.03 (0.27)***	0.69 (0.88)
No. of observations	76	76	76	76	76	76
Pseudo R^2	0.83	0.15	0.75	0.14	0.82	0.19
Likelihood-ratio test of alpha = 0	809***		833***		234***	

Source: Authors' estimations.

*Note: * if p < 0.10, ** if p < 0.05, *** if p < 0.01; standard errors in parentheses. Likelihood-ratio test of alpha = 0: This is the likelihood-ratio chi-square test that the dispersion parameter alpha is equal to zero. The test statistic is calculated based on the difference between the log-likelihoods from the Poisson model and the negative binomial model. The large test statistic would suggest that the response variable is overdispersed and is not sufficiently described by the simpler Poisson distribution.*

4.2.2 Regressions with Interaction Terms

In this section we run our baseline regression as specified in equation (1) for both country groups jointly, by introducing interaction terms of the explanatory variables with a regional dummy variable (1 = EECCA, 0 = CEEBB). The results are presented in table 6.

Table 6

Estimations with Interaction Terms (Negative Binomial and Poisson Model)

Variable	Poisson		Negative binomial	
	Direct coefficients	*Interaction terms with regional dummy*	*Direct coefficients*	*Interaction terms with regional dummy*
InstPot	−0.01 (0.004)***	−0.01 (0.05)	−0.03 (0.01)***	−0.01 (0.01)
NatRes	0.01 (0.003)***	−0.04 (0.003)	0.02 (0.01)**	−0.02 (0.01)*
Roads	0.004 (0.0003)***	0.0001 (0.0004)	0.003 (0.002)	0.01 (0.002)**
InvRisk	−0.02 (0.003)***	0.02 (0.004)	−0.03 (0.01)***	0.03 (0.01)**
MarketSize	0.08 (0.03)***	0.03 (0.04)	−0.02 (0.12)	−0.14 (0.16)
MarketPot	0.03 (0.01)**	−0.01 (0.02)	0.03 (0.04)	0.01 (0.06)
Edu	0.15 (0.24)	0.49 (0.29)*	0.23 (0.75)	1.53 (1.01)
Port	0.16 (0.11)	−0.52 (0.14)***	−0.14 (0.36)	−0.42 (0.48)
Dem	0.59 (0.1)***	−0.3 (0.12)**	0.72 (0.26)***	−0.28 (0.37)
Corr	−0.71 (0.09)***	0.38 (0.11)***	−0.41 (0.23)*	0.11 (0.31)
Intercept	2.19 (0.17)***		1.31 (0.68)*	
No. of observations	152		152	
Pseudo R^2	0.78		0.18	
Likelihood-ratio test of alpha = 0	1,080***			

Source: Authors' estimations.

*Note: * if p < 0.10, ** if p < 0.05, *** if p < 0.01; standard errors in parentheses. Likelihood-ratio test of alpha = 0: This is the likelihood-ratio chi-square test that the dispersion parameter alpha is equal to zero. The test statistic is calculated based on the difference between the log-likelihoods from the Poisson model and the negative binomial model. The large test statistic would suggest that the response variable is overdispersed and is not sufficiently described by the simpler Poisson distribution.*

From the results we can conclude (assuming that the results from the negative binomial model are more reliable) that both EECCA and CEEBB countries tend to invest into Russian regions with a higher level of corruption. Also, we find that EECCA investors are more averse to investment risks in Russia and locate in more resource-abundant Russian regions than CEEBB investors. All these findings confirm our conclusions drawn from the baseline estimation results (see section 4.1).

5 Conclusions

In this paper we empirically address the issue of economic integration between Russia and CEEBB and EECCA countries from an FDI perspective. This is of particular interest given the currently stark differences between the two country groups with respect to their economic integration with Russia. While economic sanctions between Russia and the EU have worsened Russia's economic relations with many CEEBB countries, some EECCA countries will experience deeper integration through the Eurasian Economic Union, and yet others – in particular Ukraine – are torn between both integration blocs. We do not wish to attempt to assess the impact of current political events on FDI flows from CEEBB and EECCA to Russia; rather we aim to describe the status quo of FDI links and explain their main determinants.

In particular, we provide a detailed statistical analysis of micro-level Rosstat data containing information about foreign firms established by investors from CEEBB and EECCA countries in Russia. In our empirical test we focus on the potential of institutional determinants to explain the location choice of firms with owners from CEEBB and EECCA countries.

Our main findings show that, in terms of the number or revenues of foreign-owned firms, FDI largely originates from two EECCA investor countries, i.e. Belarus (a member of the Eurasian Customs Union and the future Eurasian Economic Union) and Ukraine (which is currently in conflict with Russia). We further find that geography is a decisive factor as CEEBB and EECCA firms investing in Russia tend to locate quite often in the Smolensk region (which borders on Belarus) and the Kaliningrad region (a Russian enclave located in the EU) in addition to Moscow, one of the favorite destinations for Russian inward FDI in general.

Comparing the two subsamples of investor countries, CEEBB firms tend to be characterized by a higher degree of foreign ownership than EECCA firms. This leads us to conclude that the greater institutional distance between CEEBB countries and Russia induces CEEBB investors to ensure the transfer of business practice through better control over the foreign-owned firms. As such, our finding is in contrast to the institutional distance argument, which postulates a negative relationship between institutional distance and degree of foreign ownership. Further, our estimation results show that CEEBB investors care more about regional investment risk in Russia than EECCA investors.

From our econometric analysis, we conclude that Russian regions with better transport infrastructure (represented by railway and highway roads), lower investment risks, a higher institutional potential (measured by the level of development of key market institutions) and a higher level of democracy are positively associated with FDI from CEEBB and EECCA.

While these findings do not allow us to assess the impact of current economic sanctions between Russia and the EU/U.S.A. on FDI flows into Russia, they can

still serve to shape our view on the setting in which such FDI takes place. Spoken in general terms, the current political environment is likely to negatively affect FDI flows from CEEBB investors to Russia as increased uncertainty leads to a worsening investment climate. Foreign firms are likely to put their investment projects on hold, especially in sectors such as finance, which are targeted by the EU and U.S. sanctions, even if banking-related sanctions currently concern only banks with significant Russian state ownership.

A continuation of the conflict between Russia and the West would in all likelihood lead to a change in the geographical composition of Russia's inward FDI. The empirical evidence presented in this paper suggests that in particular FDI from CEEBB countries would dwindle, as CEEBB investors care strongly about regional investment risk in Russia. This would in particular impact on the Baltic countries, which are the only CEEBB countries where outward FDI to Russia plays a non-negligible role.

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Annex

Table A1

Descriptive Statistics and Correlation Matrix of the Dependent and Explanatory Variables

	Mean	Standard deviation	Minimum	Maximum	DepVar	Market Size	Market Pot	Edu	Roads	Port	InvRisk	NatRes	InstPot	Dem	Corr
DepVar	39.28	121.43	0	1026	1										
MarketSize	0.01	1.43	–0.93	10.03	**0.88**	1									
MarketPot	1.66	3.95	–6.13	14.07	–0.19	–0.28	1								
Edu	0.57	0.22	–0.21	1.31	0.39	0.42	–0.16	1							
Roads	142.6	102.96	1.61	489.23	**0.54**	0.45	0.21	0.05	1						
Port	0.21	0.41	0	1	–0.02	0	–0.25	0.33	–0.2	1					
InvRisk	40.37	20.28	4.68	80.5	–0.31	–0.31	–0.13	–0.2	**–0.57**	0.14	1				
NatRes	43.1	23.65	1.43	87.36	0.27	0.18	0.39	–0.12	**0.55**	–0.31	–0.34	1			
InstPot	39.57	22.16	1	79.43	–0.34	**–0.52**	0.19	–0.34	–0.27	–0.14	0.49	0.18	1		
Dem	2.96	0.64	1.67	4.67	0.15	0.23	–0.14	0.38	–0.06	0.17	–0.09	–0.12	–0.48	1	
Corr	2.76	0.71	1	5	–0.13	–0.19	0.2	0.08	–0.05	–0.19	–0.18	0.09	0.05	0.43	1

Source: Authors' calculations.

Note: The dependent variable (DepVar) is the number of FDI firms in a particular Russian region. Correlation coefficients greater than 0.5 are printed in boldface.

Event Wrap-Ups and Miscellaneous

76th East Jour Fixe: Using Survey Data for Economic Policy Research – A Focus on CESEE

Compiled by
Elisabeth Beckmann,
Anita Roitner,
Helmut Stix

The potential of survey data as important input to economic policy was the topic of the OeNB's 76th East Jour Fixe entitled "Using Survey Data for Economic Policy Research – A Focus on CESEE," which took place in Vienna on September 12, 2014.

In her opening remarks, *Doris Ritzberger-Grünwald,* Director of the OeNB's Economic Analysis and Research Department, highlighted the benefits of survey data but also stressed the caveats of working with these data: Survey data provide valuable information on portfolio and investment decisions and focus on the economic units that make decisions; they can therefore uncover heterogeneities that cannot be detected with macro data. Survey data, and more broadly micro data, can help separate demand from supply effects. In addition, survey data provide information which is otherwise not available, for example information on individuals' expectations, risk attitudes, beliefs, knowledge and trust. However, Ritzberger-Grünwald also stressed that survey data are complementary to and not competing with macro data. In particular, she emphasized the necessity to verify the validity of survey data – if possible by comparing results to other surveys and/or macro data.

The subsequent sessions featured six papers that analyze a broad range of highly relevant topics, providing an overview of household and firm surveys which cover several CESEE countries and the range of current methodologies of working with these data.

The first session, chaired by *Thomas Gruber,* Head of the Central, Eastern and Southeastern European Analysis Unit (Foreign Research Division, OeNB), was opened by *Martin Brown* (University of St. Gallen and Swiss Institute of Banking and Finance), who presented the paper "Euroization of Bank Deposits in Eastern Europe" (coauthored by *Helmut Stix,* OeNB). Based on OeNB Euro Survey data, the authors argue that deposit euroization is strongly related to monetary expectations. Trust in the stability of the domestic currency, in turn, is related to the assessment of current policies and institutions. Policymakers can therefore tackle deposit euroization with prudent monetary and economic decisions. However, research also shows that holding deposits in foreign currency has become a "habit" in the region. This and the fact that monetary expectations are still strongly influenced by past financial crises leads to the conclusion that a stable monetary policy is not sufficient for reducing deposit euroization. In the lively discussion that followed the talk, the question was raised whether deposit euroization might also be explained by supply effects, like the availability of savings products denominated in foreign currency; research does not support this idea, however.

The next speaker, *Dorothe Singer* (World Bank), focused on financial inclusion, which policymakers increasingly see as one of the key drivers of economic growth and poverty alleviation. The Global Financial Inclusion Database (Findex) allows a cross-country comparison of financial inclusion. It is based on a survey conducted in 2011 among households in 148 countries covering payments, savings, credit and insurance. It shows that only 52% of adults in non-EU CESEE countries have an account with a formal financial institution compared to 89% in high-income economies. There are large variations across countries, which can be explained only to

a small extent by differences in GDP per capita. Another interesting finding relates to the saving behavior among account holders across regions: 40% of all account holders in developing economies reported having saved at a formal financial institution in the past year, but only 14% did so in Europe and Central Asia, where another 14% used informal saving methods, e.g. community-based saving methods, saving through asset accumulation or "stuffing money under the mattress." The exceptionally low level of formal saving can partly be explained by the fact that the primary reason for holding an account in Europe and Central Asia is the ability to receive wages and government payment. However, other factors like trust and supply-side characteristics, like the business model of banks, may also play a role.

The second session, chaired by *Elisabeth Beckmann* (Foreign Research Division, OeNB), to some extent exemplified the diversity of topics that can be analyzed with survey data. Continuing the topic of financial inclusion of the first session, *Karolin Kirschenmann* (Aalto University School of Business) talked about the role of microfinance banks in the financial inclusion of households. Based on the example of one microfinance bank (ProCredit) in Southeastern Europe, she showed that geographical proximity to a microfinance bank affects the use of bank accounts by low-income households, demonstrating that the additional effect of a microfinance bank on financial inclusion (controlling for the presence of retail banks) is about 16 to 20 percentage points. However, as highlighted in the discussion, the analysis does not allow any conclusions regarding real or long-term effects, e.g. the trade-off between maintaining financial stability and including low-income households in the use of financial services. *Helena Schweiger* (European Bank for Reconstruction and Development) moved on to the very topical question of how conflict affects firm performance and perceptions. She based her analysis on the August 2008 conflict between Georgia and Russia and showed that in the short run, armed conflict had a significant negative impact on exports, sales and employment and a scarring effect on young firms. Despite the diversity of topics, the two presentations also shared a common thread: One aspect of how conflict affects firms is the extent to which it affects their access to finance.

The third session, chaired by *Martin Summer* (Head of the Economic Studies Division, OeNB), featured two papers that utilize firm-level survey data. Based on the Business Environment and Enterprise Performance Survey and the Banking Environment and Performance Survey, *Ralph de Haas* (European Bank for Reconstruction and Development and Tilburg University) presented an analysis of how banks' lending techniques affect funding to SMEs over the business cycle. He showed that lending to firms which have close ties to their bank (relationship lending) alleviates firms' credit constraints during a cyclical downturn but not during a boom period, with the positive impact of relationship lending being strongest for smaller firms whose financial statements are not externally audited.

Alexander Popov (European Central Bank) presented an analysis of the bank balance sheet channel using data on firms that were discouraged from taking out a loan or that were informally refused a loan in addition to information on the formal loan granting process. He showed that – consistent with previous studies – lax monetary conditions increase bank credit in general and bank credit to ex-ante risky firms in particular. This is especially true for banks with lower capital ratios. Importantly, Popov found that the results are considerably stronger

when data on these informal credit constraints are incorporated. He concluded that survey data which capture such informal constraints can therefore provide a more complete picture of the effect of monetary policy. In the ensuing discussion it was highlighted that the finding is to some extent comparable to that of micro data-based studies of the labor market. The latter have shown that the unemployment rate in some countries is considerably higher than the rate shown in aggregate statistics when those who have dropped out of the labor market (because they are too discouraged to apply) are included in the labor force.

A round-table discussion dedicated to the more practical aspects that central bankers have to deal with when using surveys and the advantages and limitations of surveys concluded the workshop. At the beginning of the discussion between five representatives from CESEE central banks, which was chaired by Doris Ritzberger-Grünwald, the representatives gave an overview of the surveys conducted by their central bank.[1] *Biswajit Banerjee,* Chief Economist of the Bank of Slovenia, opened the discussion by taking the example of the Wage Dynamics Network to highlight the problem of multi-country surveys in accurately picking up and reflecting some specific national institutional features while at the same time guaranteeing cross-country comparability of the survey questions. *Tomáš Holub,* Executive Director of the Monetary and Statistics Department of the Czech National Bank (CNB), stressed that surveys gained in importance during the crisis, e.g. for judging the threat of deflation, turning points in the cycle, disruptions in credit developments and the impact of new unconventional monetary policy. Taking the example of inflation expectation surveys among households, he also illustrated the limited reliability of these surveys for predicting, e.g., deflation as a small change in the CNB's survey question led to a significant change in expected inflation values. *István Kónya,* Head of Research at the Research Department of the central bank of Hungary, emphasized that using high-quality micro data obtained from surveys and other sources requires sufficient resources. He argued that for the analysis of, e. g., demand versus supply effects it is not only necessary to obtain individual high-quality micro datasets but also to match these with other datasets. The central bank of Hungary has successfully started cooperation with external researchers who contribute expertise and resources to the analyses of these matched micro datasets. Kónya concluded by raising the question of how cross-country cooperation could advance work toward creating and analyzing micro data for economic policy research. *Florian Neagu,* Head of the Macroprudential Risk Division of the National Bank of Romania, focused on the contribution of surveys to financial stability. He underlined the importance of surveys for "better understanding the story behind headline statistics" on the one hand and for "better calibrating" analyses of policy measures and stress tests on the other hand. He backed István Kónya in stressing the potential and challenges of combining different micro datasets. *Altin Tanku,* director of the Research Department at the Bank of Albania, pointed out that the Bank of Albania has used surveys in the analysis of economic trends and developments, finding that they facilitate a better understanding of agents' economic preferences and economic behavior, which can be used as input for policy initiatives. He agreed with the

[1] *In the interest of brevity, this information is not repeated here. The presentations are available online at: http://www.oenb.at/en/Calendar/Archive/2014/76th-East-Jour-Fixe.html.*

previous speakers about the benefits of cooperation but drew attention to the fact that cooperation will only be successful if one takes on the task of leadership. Tanku added that the Bank of Albania would welcome initiatives in this respect and would also work toward facilitating the use of data by third parties. He argued that the potential of macro data has already been exploited in many ways and that therefore micro data would continue to gain in importance. The participants of the round-table discussion concluded that the role of surveys and, more generally, micro data has grown and will continue to grow, at the same time stressing that micro data will always remain complementary to macro data.

IMF Regional Economic Issues Update October 2014 Geopolitical Tensions Taking a Toll

Compiled by
Christina Lerner

Significant Downside Risks Are Threatening Growth

The IMF's October 2014 Regional Economic Issues (REI)[1] Update for Central, Eastern and Southeastern Europe (CESEE)[2] has revised CESEE growth for 2014 down by ½ percentage point compared to the April 2014 REI, largely reflecting the effects of the tensions between Russia and Ukraine, sanctions, counter-sanctions and protracted weak growth in the euro area, CESEE's main trading partner. Growth is slowing across most of the CESEE region, with the exception of Central and Eastern Europe (CEE) and the Baltics. The IMF projects CESEE growth at 1.2% for 2014, before picking up again to 1.7% in 2015.

Diverging Macroeconomic Trends across CESEE

Private consumption has become the key growth driver in CEE (with the exception of Hungary) and in much of the Baltics and Southeastern Europe, thus contributing to the strengthening of domestic demand. As to inflation, declining world food and energy prices and disinflationary spillovers from the euro area have further enhanced the downtrend of inflation in most countries, whereas Turkey, Russia and the CIS countries have experienced high inflation. With the exception of Russia and Ukraine, external financing conditions have remained supportive for most CESEE countries. Funding by foreign banks to the CESEE region has continued to decline since late 2008, which in part reflects the unwinding of the precrisis credit boom. Foreign banks now seem to be following a more differentiated approach across countries; only countries with healthier fundamentals are seeing a resumption of foreign bank funding.

Policy Priorities: Securing a Robust Recovery and Improving Potential Growth

According to the IMF, the establishment of robust and balanced growth requires a recovery in corporate credit and investment. Given significant downside risks, CESEE countries need to reduce vulnerabilities and increase buffers. In addition, as CESEE countries are highly dependent on energy imports, they should make a concerted effort to improve their resilience to energy shocks, such as contributing to a more integrated regional energy market.

[1] *The REI is published twice a year by the IMF and covers analytical issues of interest to policymakers, academics and the broader public in the relevant region.*

[2] *The CESEE region includes Turkey and the following four subregions: Central and Eastern Europe (CEE) consists of the Czech Republic, Hungary, Poland, Slovakia and Slovenia (21% of regional GDP); Southeastern Europe (SEE) consists of Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, the former Yugoslav Republic of Macedonia, Montenegro, Romania and Serbia (8% of regional GDP); the Baltic region consists of Estonia, Latvia and Lithuania (2% of regional GDP); the CIS group consists of Belarus, Moldova, Russia and Ukraine (51% of regional GDP).*

Statistical Annex

Statistical Annex

This section provides tables detailing selected economic indicators for Albania, Bosnia and Herzegovina, FYR Macedonia,[1] Kosovo, Montenegro, Serbia and Ukraine, i.e. CESEE countries not covered in the Recent Economic Developments and Outlook section.

Conventions used

x = No data can be indicated for technical reasons
. . = Data not available at the reporting date
Discrepancies may arise from rounding.

Table 1

Gross Domestic Product

	2007	2008	2009	2010	2011	2012	2013
	Annual real change in %						
Albania	5.9	7.5	3.4	3.7	2.5	1.6	1.4
Bosnia and Herzegovina	6.0	5.6	–2.7	0.8	1.0	–1.2	2.1
Kosovo	x	7.2	3.5	3.2	4.5	2.5	3.4
FYR Macedonia	6.1	5.0	–0.9	2.9	2.8	–0.4	2.2
Montenegro	10.7	6.9	–5.7	2.5	3.2	–2.5	3.3
Serbia	5.4	3.8	–3.5	1.0	1.6	–1.5	2.6
Ukraine	7.9	2.3	–14.8	4.1	5.4	0.2	0.0

Source: wiiw.

Table 2

Industrial Production[1]

	2007	2008	2009	2010	2011	2012	2013
	Annual real change in %						
Albania	11.4	16.9	7.1	37.5	27.1	12.9	23.2
Bosnia and Herzegovina	6.3	10.3	–6.5	4.3	2.4	–3.9	5.2
Kosovo[2]	x	x	–1.5	–5.6	19.2	–10.0	5.0
FYR Macedonia	3.9	5.1	–8.7	–4.9	6.9	–2.7	3.2
Montenegro	0.1	–2.0	–32.2	17.5	–10.3	–7.0	10.7
Serbia	4.2	1.4	–12.6	1.2	2.5	–2.2	6.3
Ukraine	7.6	–5.2	–21.9	11.2	8.0	–0.5	–4.3

Source: wiiw, European Commission.

[1] *Where available according to NACE Rev. 2 classification.*
[2] *According to gross value added data.*

[1] *Former Yugoslav Republic of Macedonia.*

Table 3

Average Gross Wages – Total Economy

	2007	2008	2009	2010	2011	2012	2013
	Annual change in %						
Albania	25.2	25.3	5.2	–3.6	4.9	2.3	9.5
Bosnia and Herzegovina	9.8	16.7	8.1	1.1	4.5	1.5	0.1
Kosovo[1]	×	×	22.8	12.7	14.4	–1.1	1.5
FYR Macedonia	4.8	8.7	14.1	1.0	1.2	0.2	1.2
Montenegro	31.7	22.5	5.6	11.2	1.0	0.7	–0.1
Serbia	22.0	17.9	–3.3	7.5	11.1	8.9	5.7
Ukraine	29.7	33.7	5.5	17.5	17.6	14.9	7.9

Source: wiiw.

[1] Average net monthly wages.

Table 4

Unemployment Rate[1]

	2007	2008	2009	2010	2011	2012	2013
	%						
Albania	13.4	13.1	13.8	14.0	14.0	13.4	15.6
Bosnia and Herzegovina	29.0	23.4	24.1	27.2	27.6	28.0	27.5
Kosovo	×	47.5	45.4	45.1	44.8	30.9	31.0
FYR Macedonia	34.9	33.8	32.2	32.0	31.4	31.0	29.0
Montenegro	19.3	17.2	19.3	19.6	19.7	19.7	19.5
Serbia	18.1	13.6	16.1	19.2	23.0	23.9	22.1
Ukraine	6.4	6.4	8.8	8.1	7.9	7.5	7.2

Source: wiiw.

[1] Labor force survey, period average.

Table 5

Industrial Producer Price Index[1]

	2007	2008	2009	2010	2011	2012	2013
	Period average, annual change in %						
Albania	3.5	6.5	–1.6	0.3	2.6	1.1	–0.5
Bosnia and Herzegovina	×	8.6	–3.4	1.0	5.5	0.3	–1.8
Kosovo	×	×	3.8	4.7	5.7	1.7	3.0
FYR Macedonia	2.5	10.1	–7.2	8.7	11.9	1.4	–1.4
Montenegro	8.5	14.0	–3.9	–0.9	3.2	1.9	1.6
Serbia	5.9	12.4	5.6	13.7	12.7	6.8	2.7
Ukraine	19.5	35.5	6.5	20.9	19.0	3.6	–0.1

Source: wiiw.

[1] Where available according to NACE Rev. 2 classification.

Table 6

Consumer Price Index

	2007	2008	2009	2010	2011	2012	2013
	Period average, annual change in %						
Albania	2.9	3.4	2.3	3.6	3.4	2.0	1.9
Bosnia and Herzegovina	1.5	7.5	–0.4	2.1	3.7	2.0	0.2
Kosovo	x	9.4	–2.4	3.5	7.3	2.5	1.8
FYR Macedonia	2.3	8.3	–0.8	1.6	3.9	3.3	2.8
Montenegro	4.2	7.4	3.4	0.5	3.1	4.1	2.2
Serbia	7.0	13.5	8.6	6.8	11.0	7.8	7.8
Ukraine	12.8	25.2	15.9	9.4	8.0	0.6	–0.3

Source: wiiw.

Table 7

Trade Balance

	2007	2008	2009	2010	2011	2012	2013
	% of GDP						
Albania	–26.9	–27.6	–26.6	–23.1	–24.2	–20.8	–17.6
Bosnia and Herzegovina	–36.7	–37.8	–27.4	–25.5	–27.7	–32.5	–31.6
Kosovo	x	–41.9	–41.2	–40.8	–43.1	–41.5	–40.4
FYR Macedonia	–19.8	–26.2	–23.3	–20.5	–22.1	–23.6	–20.6
Montenegro	–57.6	–65.6	–44.3	–40.8	–40.4	–44.1	–39.9
Serbia	–24.8	–26.0	–17.1	–16.4	–16.9	–18.5	–12.4
Ukraine	–7.4	–8.9	–3.7	–5.9	–9.6	–10.7	–10.4

Source: wiiw, European Commission.

Table 8

Current Account Balance

	2007	2008	2009	2010	2011	2012	2013
	% of GDP						
Albania	–10.5	–15.7	–15.4	–11.3	–13.2	–10.2	–10.6
Bosnia and Herzegovina	–10.6	–13.9	–6.3	–5.7	–8.7	–9.4	–9.6
Kosovo	x	–11.7	–9.3	–12.0	–13.8	–7.6	–6.7
FYR Macedonia	–7.1	–12.8	–6.8	–2.0	–2.5	–3.0	–1.9
Montenegro	–39.5	–49.8	–27.9	–22.9	–17.7	–18.7	–14.6
Serbia	–17.7	–21.6	–6.6	–6.7	–9.1	–10.7	–5.0
Ukraine	–3.7	–7.1	–1.5	–2.1	–6.1	–7.8	–8.7

Source: wiiw.

Table 9

Net FDI Inflows

	2007	2008	2009	2010	2011	2012	2013
	% of GDP						
Albania	6.1	7.6	8.3	8.8	6.8	6.9	9.5
Bosnia and Herzegovina	11.8	5.4	1.4	2.4	2.7	2.2	2.2
Kosovo	x	x	7.3	8.5	8.3	4.7	5.2
FYR Macedonia	8.5	6.0	2.2	2.3	4.6	1.5	3.5
Montenegro	25.5	21.2	36.9	18.5	12.4	15.3	10.1
Serbia	8.8	6.2	4.9	3.6	6.2	1.0	2.4
Ukraine	7.1	5.9	4.1	4.6	4.3	4.3	2.0

Source: wiiw.

Table 10

Reserve Assets Excluding Gold

	2007	2008	2009	2010	2011	2012	2013
	End of period, % of GDP						
Albania	18.3	18.7	18.6	20.6	20.0	19.9	20.2
Bosnia and Herzegovina	30.4	25.2	25.3	25.7	24.3	24.7	26.3
Kosovo	x	x	14.4	14.8	12.0	17.1	17.3
FYR Macedonia	23.5	20.3	21.3	21.0	24.1	25.7	23.5
Montenegro	9.66	7.02	5.80	5.30	5.28	5.94	5.85
Serbia	33.1	24.2	35.5	34.2	36.5	34.8	33.6
Ukraine	20.8	17.8	21.2	23.6	19.4	12.1	9.6

Source: wiiw.

Table 11

Gross External Debt

	2007	2008	2009	2010	2011	2012	2013
	End of period, % of GDP						
Albania	28.7	37.9	41.5	45.6	53.5	57.4	63.3
Bosnia and Herzegovina[1]	18.0	17.0	21.5	25.3	25.8	27.8	28.2
Kosovo	x	x	28.6	31.4	29.9	30.9	30.8
FYR Macedonia	47.6	49.2	56.4	58.2	64.9	69.4	67.8
Montenegro[1]	17.2	15.6	23.5	29.4	32.9	41.1	43.0
Serbia	60.2	64.5	77.7	85.0	76.7	86.9	80.8
Ukraine	52.2	58.6	85.8	83.1	80.5	71.9	72.5

Source: wiiw.

[1] *Gross external public debt.*

Table 12

General Government Balance

	2007	2008	2009	2010	2011	2012	2013
	% of GDP						
Albania	–3.5	–5.6	–7.1	–3.1	–3.5	–3.4	–4.9
Bosnia and Herzegovina	1.2	–2.2	–4.4	–2.5	–1.3	–2.0	–2.2
Kosovo	x	x	4.1	–1.3	–0.2	–0.5	–2.0
FYR Macedonia	0.6	–0.9	–2.7	–2.4	–2.5	–3.9	–4.1
Montenegro	6.7	1.6	–3.6	–3.0	–5.4	–6.6	–3.6
Serbia	–1.9	–2.6	–4.5	–4.8	–5.0	–6.6	–5.0
Ukraine	–1.1	–1.5	–4.1	–5.8	–1.7	–3.5	–4.2

Source: wiiw.

Table 13

Gross General Government Debt

	2007	2008	2009	2010	2011	2012	2013
	% of GDP						
Albania	53.4	55.1	59.7	57.7	59.4	62.0	70.0
Bosnia and Herzegovina	29.7	30.7	36.0	39.1	40.8	44.6	42.5
Kosovo[1]	x	x	6.2	6.1	5.3	5.6	6.3
FYR Macedonia	32.3	27.9	31.7	34.8	35.0	36.0	36.0
Montenegro	27.5	29.0	38.2	40.9	46.0	54.0	56.1
Serbia	30.9	29.2	34.7	44.5	48.5	59.8	63.7
Ukraine	12.3	20.0	34.8	38.6	35.1	35.3	38.8

Source: wiiw.

[1] *Public debt (national definition).*

Table 14

Broad Money

	2007	2008	2009	2010	2011	2012	2013
	End of period, annual nominal change in %						
Albania (M2)	12.9	7.2	6.8	12.5	9.2	5.0	2.3
Bosnia and Herzegovina (M2)	19.2	4.1	2.2	7.2	5.8	3.4	7.9
Kosovo (M4)	x	23.6	11.2	12.9	8.8	7.1	17.3
FYR Macedonia (M3)	29.3	11.2	6.0	12.2	9.7	4.4	5.3
Montenegro (M2)	72.9	–41.5	–7.0	3.4	2.1	8.4	4.8
Serbia (M2)	42.5	9.8	21.5	12.9	10.3	9.4	4.7
Ukraine (M3)	51.7	30.2	–5.5	22.7	14.7	12.8	17.6

Source: wiiw, European Commission.

Table 15

Official Key Interest Rate

	2007	2008	2009	2010	2011	2012	2013
	End of period, %						
Albania (one-week repo rate)	6.25	6.25	5.25	5.00	4.75	4.00	3.00
Bosnia and Herzegovina[1]	×	×	×	×	×	×	×
Kosovo[2]	×	×	×	×	×	×	×
FYR Macedonia (CB bills)[3]	4.77	7.00	8.50	4.11	4.00	3.73	3.25
Montenegro[2]	×	×	×	×	×	×	×
Serbia (two-week repo rate)[4]	10.00	17.75	9.50	11.50	9.75	11.25	9.50
Ukraine (discount rate)	8.00	12.00	10.25	7.75	7.75	7.50	6.50

Source: wiiw.

[1] *Currency board.*
[2] *Unilateral euroization.*
[3] *Monthly weighted average interest rate on Central Bank Bills auctions (28 days).*
[4] *2002–05: Weighted average interest rates on securities used in open market operations by Narodna banka Srbije.*

Table 16

Exchange Rate

	2007	2008	2009	2010	2011	2012	2013
	Period average, national currency per EUR						
Albania	123.63	122.80	132.06	137.79	140.33	139.04	140.26
Bosnia and Herzegovina	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Kosovo	×	×	×	×	×	×	×
FYR Macedonia	61.18	61.27	61.27	61.52	61.53	61.53	61.58
Montenegro	×	×	×	×	×	×	×
Serbia	79.96	81.44	93.95	103.04	101.95	113.13	113.14
Ukraine	6.92	7.71	10.87	10.53	11.09	10.27	10.61

Source: wiiw.

Notes

Periodical Publications

See *www.oenb.at* for further details.

Geschäftsbericht (Nachhaltigkeitsbericht) — German | annually
Annual Report (Sustainability Report) — English | annually

This report informs readers about the Eurosystem's monetary policy and underlying economic conditions as well as about the OeNB's role in maintaining price stability and financial stability. It also provides a brief account of the key activities of the OeNB's core business areas. The OeNB's financial statements are an integral part of the report.
http://www.oenb.at/en/Publications/Oesterreichische-Nationalbank/Annual-Report.html

Konjunktur aktuell — German | seven times a year

This online publication provides a concise assessment of current cyclical and financial developments in the global economy, the euro area, Central, Eastern and Southeastern European countries, and in Austria. The quarterly releases (March, June, September and December) also include short analyses of economic and monetary policy issues.
http://www.oenb.at/Publikationen/Volkswirtschaft/Konjunktur-aktuell.html

Monetary Policy & the Economy — English | quarterly

This publication assesses cyclical developments in Austria and presents the OeNB's regular macroeconomic forecasts for the Austrian economy. It contains economic analyses and studies with a particular relevance for central banking and summarizes findings from macroeconomic workshops and conferences organized by the OeNB.
http://www.oenb.at/en/Publications/Economics/Monetary-Policy-and-the-Economy.html

Fakten zu Österreich und seinen Banken — German | twice a year
Facts on Austria and Its Banks — English | twice a year

This online publication provides a snapshot of the Austrian economy based on a range of structural data and indicators for the real economy and the banking sector. Comparative international measures enable readers to put the information into perspective.
http://www.oenb.at/en/Publications/Financial-Market/Facts-on-Austria-and-Its-Banks.html

Financial Stability Report — English | twice a year

The Reports section of this publication analyzes and assesses the stability of the Austrian financial system as well as developments that are relevant for financial stability in Austria and at the international level. The Special Topics section provides analyses and studies on specific financial stability-related issues.
http://www.oenb.at/en/Publications/Financial-Market/Financial-Stability-Report.html

Focus on European Economic Integration — English | quarterly

This publication presents economic analyses and outlooks as well as analytical studies on macroeconomic and macrofinancial issues with a regional focus on Central, Eastern and Southeastern Europe.
http://www.oenb.at/en/Publications/Economics/Focus-on-European-Economic-Integration.html

Statistiken – Daten & Analysen — German | quarterly

This publication contains analyses of the balance sheets of Austrian financial institutions, flow-of-funds statistics as well as external statistics (English summaries are provided). A set of 14 tables (also available on the OeNB's website) provides information about key financial and macroeconomic indicators.
http://www.oenb.at/Publikationen/Statistik/Statistiken---Daten-und-Analysen.html

Statistiken – Daten & Analysen: Sonderhefte
German | irregularly

Statistiken – Daten & Analysen: Special Issues
English | irregularly

In addition to the regular issues of the quarterly statistical series "Statistiken – Daten & Analysen," the OeNB publishes a number of special issues on selected statistics topics (e.g. sector accounts, foreign direct investment and trade in services).
http://www.oenb.at/en/Publications/Statistics/Special-Issues.html

Research Update
English | quarterly

This online newsletter informs international readers about selected research findings and activities of the OeNB's Economic Analysis and Research Department. It offers information about current publications, research priorities, events, conferences, lectures and workshops. Subscribe to the newsletter at:
http://www.oenb.at/en/Publications/Economics/Research-Update.html

CESEE Research Update
English | quarterly

This online newsletter informs readers about research priorities, publications as well as past and upcoming events with a regional focus on Central, Eastern and Southeastern Europe. Subscribe to the newsletter at:
http://www.oenb.at/en/Publications/Economics/CESEE-Research-Update.html

OeNB Workshops Proceedings
German, English | irregularly

This series, launched in 2004, documents contributions to OeNB workshops with Austrian and international experts (policymakers, industry experts, academics and media representatives) on monetary and economic policymaking-related topics.
http://www.oenb.at/en/Publications/Economics/Proceedings-of-OeNB-Workshops.html

Working Papers
English | irregularly

This online series provides a platform for discussing and disseminating economic papers and research findings. All contributions are subject to international peer review.
http://www.oenb.at/en/Publications/Economics/Working-Papers.html

Proceedings of the Economics Conference
English | annually

The OeNB's annual Economics Conference provides an international platform where central bankers, economic policymakers, financial market agents as well as scholars and academics exchange views and information on monetary, economic and financial policy issues. The proceedings serve to document the conference contributions.
http://www.oenb.at/en/Publications/Economics/Economics-Conference.html

Proceedings of the Conference on European Economic Integration
English | annually

The OeNB's annual Conference on European Economic Integration (CEEI) deals with current issues with a particular relevance for central banking in the context of convergence in Central, Eastern and Southeastern Europe as well as the EU enlargement and integration process. For an overview see:
http://www.oenb.at/en/Publications/Economics/Conference-on-European-Economic-Integration-CEEI.html
The proceedings have been published with Edward Elgar Publishers, Cheltenham/UK, Northampton/MA, since the CEEI 2001.
www.e-elgar.com

Publications on Banking Supervisory Issues
German, English | irregularly

Current publications are available for download; paper copies may be ordered free of charge.
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