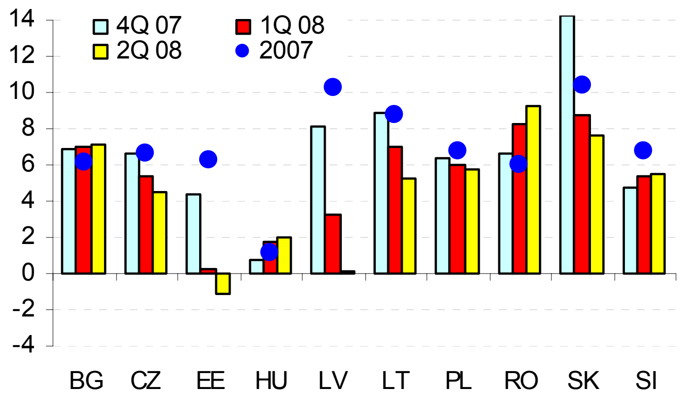
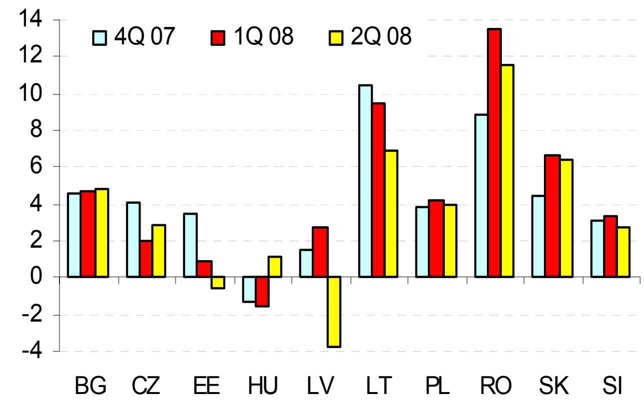
Figure 15. Real GDP growth (% change, yoy)



Source: Statistical offices.

Figure 16. Final Consumption Expenditure (% change, yoy)



Source: Eurostat.

In contrast to weaker economic expansion in the rest of the EU10, real GDP growth strengthened in Bulgaria and Romania in H1 2008. Real GDP growth rose to 7.1 percent in Bulgaria and is likely to have remained strong in the third quarter, thanks to a buoyant harvest. Growth accelerated to 9.2 percent in the second quarter in Romania, reflecting strong expansion in private consumption and investment.

The prospects for growth for 2008 as a whole are worsening as growth is likely to weaken in all countries by the end of the year. For the year as a whole, real GDP growth is likely to accelerate to about 8 percent in Romania only and somewhat pickup from a low base in Hungary this year, with real GDP growth of about 1.5 percent. Depressed sentiment indicators suggest that output will likely contract for the year as a whole in Estonia and Latvia, and slow substantially in Lithuania. A more moderate, yet sustained, slowdown appears likely in the Czech Republic, Bulgaria, Poland and Slovenia**.**

The economic outlook is rapidly changing, along with the developments in international financial markets. As of the time of this writing, it appears that economic challenges facing the EU10 are likely to multiply in 2009. Growth is likely to slow in almost all countries due to weak external demand and tight financial conditions, with projections subject to substantial uncertainty. Moreover, weakness in external demand and deteriorating financial performance of enterprises, as assessed at the time of this writing, may well result in a decline in investment growth. While further moderate slowdown appears likely in Bulgaria, Czech Republic, Poland, and Slovenia; Romania and Slovakia are estimated to face more substantial slowdown but from a higher growth rates in the past. Estonia and Latvia will likely face prolonged contraction.

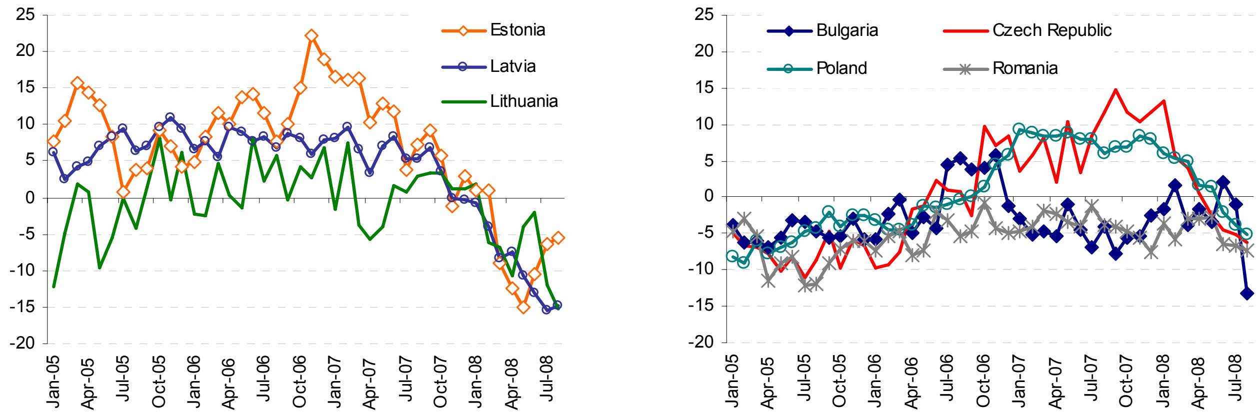
Employment

The slowdown in economic activity has had little impact on the EU10 labor markets thus far. Unemployment rates fell in all countries but Hungary through the middle of 2008. There seems to be a modest pickup in registered unemployment in the last several months in the Baltic countries, but the increase thus far is of less than one-tenth of one percent. Early indicators signal that labor markets are weakening in the Czech Republic, Slovakia and Poland.

Unemployment will likely rise in 2009 and 2010 in most EU10 countries, as the ongoing slowdown takes its toll. Ongoing or expected slowdown is likely to translate into deteriorating labor market outcomes, however, so far the response of unemployment has been delayed in part probably due to relatively high employment protection and firing costs (see Special Topic on Labor Markets in June 2007 and the 2009 Doing Business Report). This response (underscored by gloomier employment expectations recorded in economic sentiment surveys) suggests a sharp increase in joblessness is likely, especially in the Baltics (Figure 17). The likely return of migrants from the EU15 countries because of the rapidly deteriorating economy in that part of the EU may also add to unemployment.

Thus far, however, low unemployment and high inflation has fed into wage pressures in most EU10 countries. Sustained skill shortages and low internal mobility, in particular in the larger countries, are also an important factor that has added to wage pressures. Average real wages rose the fastest in the faster growing economies, led by Romania (16 percent from a year earlier), Bulgaria (11 percent) and Poland (7 percent). Real wage growth appears to have slowed to 5 percent in Latvia and 10 percent in Lithuania from 20 percent last year and is likely to slow further in the region in 2009, except maybe for Romania where a 50-percent increase has been granted to teachers likely to be followed by other public administration.

Figure 17. Employment Expectations for Three Months Ahead

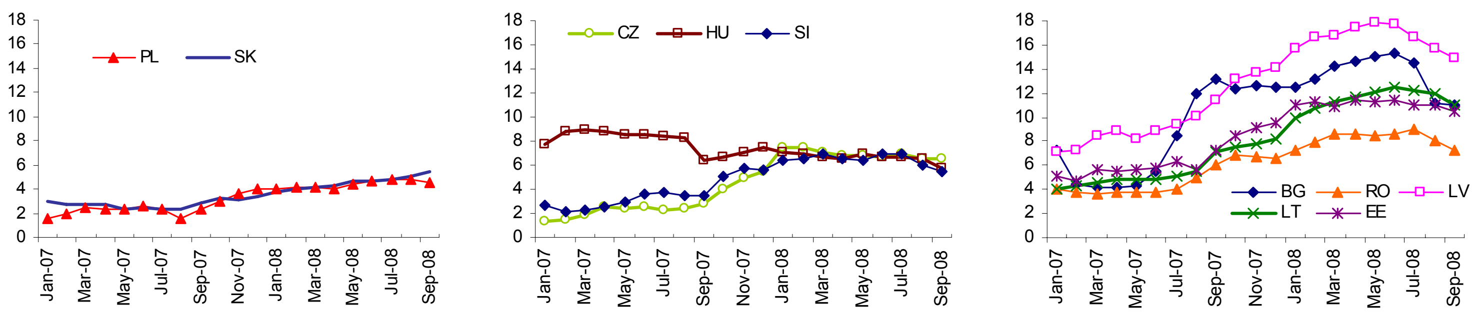


Source: European Commission. *Note:* A negative value indicates no plans to increase employment.

Inflation

Inflation has begun to decline in most countries in the region, after price increases surged in early 2008 because of higher prices for food and imported energy (Figure 18). Prospects that commodity prices will continue to fall suggest that further decreases in inflation are likely. The ongoing financial turmoil and slowing global growth are complicating policy-makers' choices even as inflation remains high.

Figure 18. Consumer Price Inflation (% change, yoy)



Source: Central Statistical Offices.

The recent slowdown in inflation has been most pronounced in those countries where increases were the largest earlier, namely in Bulgaria, Estonia and Latvia. Despite easing for the fourth month in a row, 12-month inflation in Latvia is still very high, at 14.9 percent in September. Inflation has also eased in Romania, the Czech Republic and Hungary but remains far above the central banks' target range. In Poland and Slovakia, 12-month consumer price inflation has remained little changed in recent months at about 5 percent, but core inflation has continued rising in Slovakia.

Inflation is likely to slow in 2009, reflecting the decline in commodity prices and weak domestic demand. The Baltics and the Czech Republic should see faster reductions in inflation, in the latter also due to the lag effect of sizeable strengthening of the koruna until September. Double-digit wage increases for certain categories of public employees in Romania and Slovenia, along with currency weakness in the former, and pressures to boost spending ahead of the parliamentary elections in several countries, could limit the pace of decline in inflation, however. Decreases in inflation are also likely to be moderated by the continued tight labor conditions or upward adjustments in administered prices (Bulgaria, Lithuania, Poland and Romania).