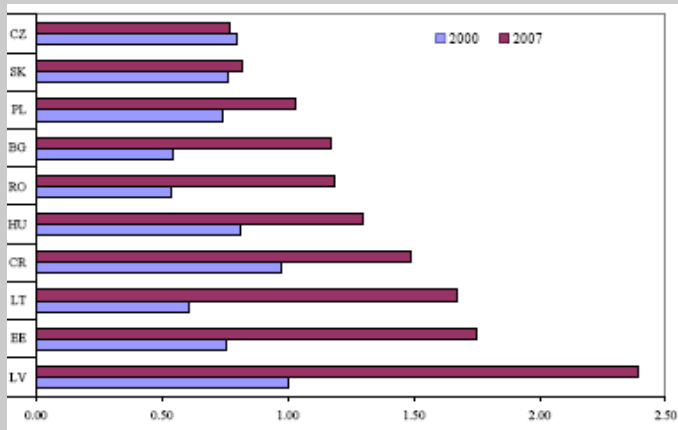
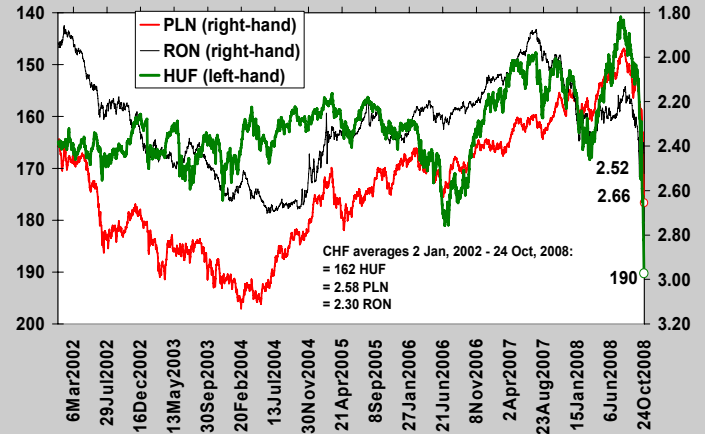


Figure 13. Loan-to-deposit ratio in the EU10



Source: Rosenberg C., Tirpák M. Determinants of Foreign Currency Borrowing in the NMS of the EU, IMF Working Paper, July 2008.

Figure 14. HUF, RON, and PLN exchange rates against CHF in Jan 2002-24 Oct, 2008



Note: reverse scale - decline denotes LCU depreciation
Source: EBC data, staff calculations.

As argued below, weaker demand abroad and the ongoing financial turbulence will contribute to slowing output growth in the EU10. This will put pressure on fiscal balances, in many countries after years of running pro-cyclical fiscal policy. It is important for the authorities to begin reversing the pro-cyclical tendencies in fiscal policies. At the same time, governments should be careful not to widen fiscal deficits by more than investors will be ready to finance and deem sustainable at a time of more negative investor sentiment. Governments should also be careful not to adjust spending by cutting social transfers indiscriminately at a time when slower growth will clearly weigh on living standards, especially in the poorer countries and more disadvantaged regions. At a time when citizens are coming under pressure from the increased share of outlays on food in household budgets (given the earlier increase in food prices) and weaker economic activity, governments will be well advised to sustain, and where needed, better target social safety nets.

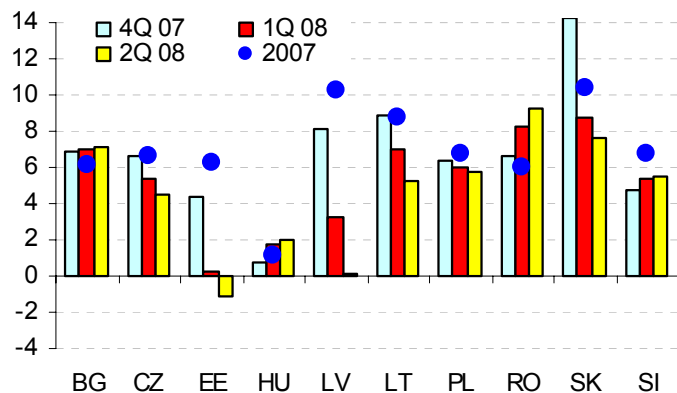
There may be some scope for monetary easing in some countries to alleviate the impact of the turbulence should liquidity issues begin to emerge. Such issues have not appeared thus far. Scope for monetary easing will be larger in countries that have been able to control better inflation thus far.

The global slowdown will put economic fundamentals at test and will penalize the slow reformers of the past the most. The time of low borrowing costs, high foreign investment, rising tax revenues and higher living standards will now have to be replaced by some painful decisions to reform public finances; increase labor force participation rates, particularly by penalizing early retirement; improving productivity by modernizing education; reducing red tapes and improving governance and investment climate.

Output and Demand

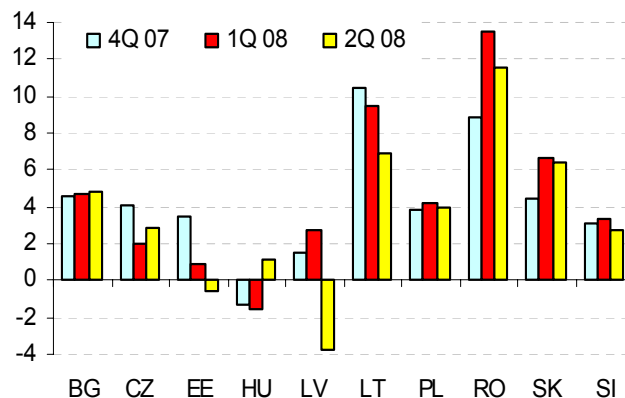
The pace of economic activity has slowed this year in all countries of the region except Romania, reflecting a combination of weak external demand and sluggish domestic spending (Figure 15). The latter is due to the surge in consumer price inflation earlier in the year and the tighter financial conditions that led to slow growth in consumer credit. The slowdown in activity among the EU10 has been led by outright contractions in output in Estonia and Latvia, as measured on a seasonally adjusted basis. From a year earlier, real GDP contracted by 1.4 percent in the second quarter in Estonia and growth was barely positive in Latvia, in both countries reflecting a broad-based decline in activity following an earlier period of overheating. The slowdown has been more moderate in Lithuania so far.

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