World Bank EU8+2 Regular Economic Report January 2007[1]

EU8+2

HIGHLIGHTS OF THE REPORT

Output growth gained further pace across the region in 2006, but is likely to moderate slightly in 2007. Real GDP growth strengthened not least in Poland, Slovakia, and Romania as dynamics improved further in the second half of the year, but the Baltic States, Slovenia, and Bulgaria also grew even more strongly than the year before. This took place in spite of an appreciation of several countries' currency against the euro and especially the dollar as well as some moderation in euro area growth. Meanwhile, oil prices declined significantly from September and further in early 2007. Growth is likely to ease somewhat in most NMS in 2007 as growth slows in the euro area and output moves closer to potential.

A tendency towards higher inflation is emerging across most countries the region. While, inflation remains well under control in Poland and the Czech Republic, other countries in the region are struggling to contain it. In the Baltic and to some degree Southeastern European countries, strong wage and credit growth are leading to overheating and significant inflationary pressures. In other countries in the region, weakening of currencies during May and June 2006 contributed to higher price pressures later in the year, particularly in Hungary. Adjustments of regulated prices and indirect tax increases added to inflation in several countries in the region. Another round of regulated price increases is expected for most EU8+2 countries In 2007, with the impact on inflation likely to be most pronounced in Hungary, the Czech Republic, Estonia, Lithuania and Romania. At the same time, the recent sharp decline in oil prices could help dampen inflationary pressures in 2007.

Fiscal policies in the region were generally pro-cyclical in 2006 and the picture is not likely to change much in 2007. Fiscal deficits increased in most countries in the region despite strong growth and buoyant tax revenues, adding to concerns about overheating (see above). Only Poland and Bulgaria managed to improve their structural fiscal balances. The fiscal easing was particularly dramatic in Hungary and Slovakia, with the deficit in the former reaching about 10% of GDP. For 2007, Hungary is planning strong fiscal consolidation, and Slovakia and Poland similarly target lower deficits. Most other countries in the region envisage (further) fiscal easing. Many of the countries are planning fiscal consolidation that will only bite in 2008-2009, but the credibility of these delayed plans is diluted by the fact that many countries will be entering new pre-election periods by then.

Current account deficits (CAD) increased in 2006 across the region, in some countries to worrisome levels. Bouyant domestic demand was associated with higher current account deficits across the region, with export growth holding up well. While external deficits remained low in Poland, the Czech Republic, and Slovenia, they were close to or exceeded 10% of GDP in other countries in the region. FDI covered the CADs of the Czech Republic, Poland and Bulgaria,

[1] Prepared by a team of World Bank economists in the region led by Thomas Laursen and including Ewa Korczyc, Paulina Hołda, Ron Hood, Stella Ilieva, Leszek Kasek, Matija Laco, Sanja Madzarevic-Sujster, Anton Marcincin, Catalin Pauna, and Emilia Skrok. This report continues the series of EU8 Quarterly Economic Reports and is the first to include the new EU member states Bulgaria and Romania. Henceforth, the new "EU8+2 Regular Economic Reports" will be produced three times a year (January/May/September) and published on the last Thursday of these months.

and most of the deficits in Hungary, Slovakia and Romania. The banking sector played the main role in financing the deficits in the Baltic States but also contributed importantly in Romania.

Enthusiasm for early euro adoption has waned somewhat. While Slovenia joined the euro-zone from January 1, 2007, most NMS are struggling to meet several of the entry conditions including those relating to inflation, budget deficits, exchange rate stability and legal compatibility and most countries have dropped specific targets dates for entering the euro-zone. Slovakia still aims at January 2009, but this could be complicated, not least by the very small margin relative to the Maastricht limit planned in the fiscal deficit for 2007. Lithuania's bid for inclusion in the euro-zone in January 2007 was rejected in the spring of 2006 owing to concerns about inflation, and Estonia and Latvia have unilaterally delayed their euro adoption plans for the same reasons. The Baltic States still aim to join the euro-zone as soon as possible but have acknowledged that this is unlikely to be before 2010. The other countries in the region have also dropped specific targets (Poland never set one) and indicated that euro adoption would not be feasible until sometime during 2011-12, at the earliest.

The rapid expansion of credit has not yet resulted in any evident weakening of banking systems in the region, but the situation warrants close monitoring. Further, in some countries an outright credit boom has contributed to large macroeconomic imbalances, potential asset market bubbles, and significant vulnerabilities that call for a more determined policy response. The overall efficiency, profitability and capitalization of banks in the EU8+2 countries are all in line with those of banks in the euro zone and non-performing loans (NPLs) do not yet show evidence of mounting vulnerabilities. The credit expansion reflects to a significant extent a natural process of financial deepening, and credit-to-GDP ratios are more or less in line with what one would expect given levels of per capita income. Foreign banks, which arguably have better management and oversight, hold an overwhelmingly dominant position in virtually all the EU8+2 countries.

However, there are important risks. An excessive growth rate of credit in some countries is contributing to overheating and large external imbalances, especially in the Baltic States and to some degree Bulgaria and Romania. The concentration of new credit in the household sector for consumption and housing contributes little to long run growth potential while creating conditions for asset price bubbles. Maturity and currency mismatches are increasing, especially in respect of foreign currency mortgage credit. Indirect ownership structures may effectively isolate some of the parent banks from their related local operations. Enhanced supervision and in some countries tighter prudential regulations are warranted, while a stronger response is called for in cases where rapid credit growth is associated with mounting macroeconomic risks—including avoiding pro-cyclical fiscal policies and considering fiscal measures to discourage household borrowing.

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External Environment

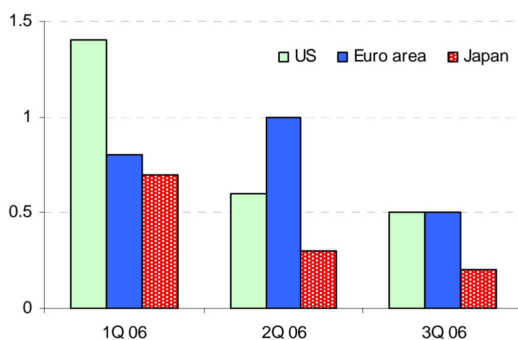
The external environment remained broadly favorable in the third quarter of 2006. While growth slowed in the euro-zone and other leading industrialized economies, oil prices declined and investor sentiment in emerging markets recovered with spreads declining to record low levels by the end of the year. With crude oil prices easing further at the beginning of 2007 and the slowdown in growth in key markets expected to level off, prospects for 2007 are good.

Economic activity slowed down in the US, Japan and the euro-zone in Q3-2006 (Chart 1, Chart 2). Output growth slowed further to 0.5% (qoq, SA[2]) in the US, with the housing downturn contributing significantly to the slowdown while both investment and consumer spending held up well. Growth in Japan also continued to weaken to 0.2% (qoq, SA), with leading indicators offering conflicting signals on the expected trend. In the euro area, growth slowed markedly in Q3 to 0.5% (qoq, SA) from 1.0% in the previous quarter, driven by the slowdown of the main economies Germany, France, and Italy.

Despite the Q3 growth deceleration, all major European business and consumer confidence indices remain upbeat (Chart 3). The ECB continued raising interest rates to 3.5% in December (Chart 4). With US interest rates on hold since mid-2006, the euro has strengthened significantly against the US dollar and weaker euro-zone industrial production and machinery orders suggest that exports may start to be affected. Positive signs are visible in the US with November job gains exceeding expectations and the weakening of home prices and continued low mortgage rates contributing to a rebound in mortgage applications. Nevertheless, a moderate slowdown in all the major economies is predicted in 2007 compared to 2006.

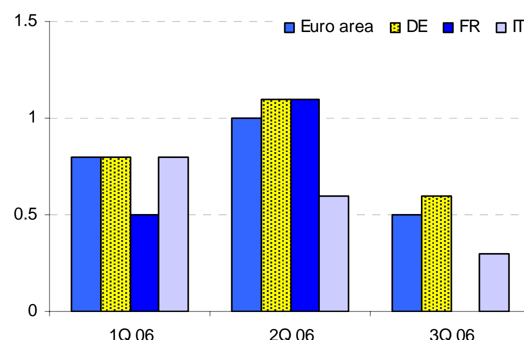
Oil prices have declined from a peak of around $75 in August to around $52 in early 2007 (Chart 5) while spreads on emerging market debt declined from around 240 basispoints in July to around 175 basispoints in early 2007 (Chart 6). The global growth slowdown, mild winters in the Northern Hemisphere, and the inability of OPEC to agree on production cutbacks led to a sharp decline in oil prices in the second half of 2006 and into 2007. Following the turbulence in May-June 2006, capital flows to emerging markets recovered strongly, with emerging market debt spreads easing and equity market indices rebounding.

Chart 1. Growth in the US, Euro-area and Japan (% q-o-q, SA)



Source: Eurostat

Chart 2. Growth in Main Euro-area Economies (% q-o-q, SA)



Source: Eurostat

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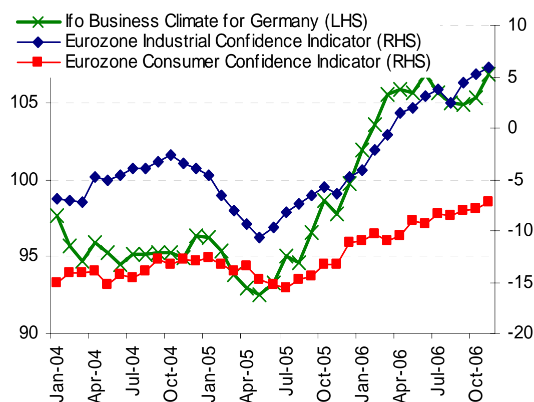
[2] SA=seasonally adjusted.

Table 1. Growth Forecasts for Euro-area, Japan and the US

	Euro area		Japan		United States	
	2006	2007	2006	2007	2006	2007
OECD	2.6	2.2	2.8	2.0	3.3	2.4
IMF	2.4	2.0	2.7	2.1	3.4	2.9
EC	2.6	2.1	2.7	2.3	3.4	2.3
WB	2.4	1.9	2.9	2.4	3.2	2.1

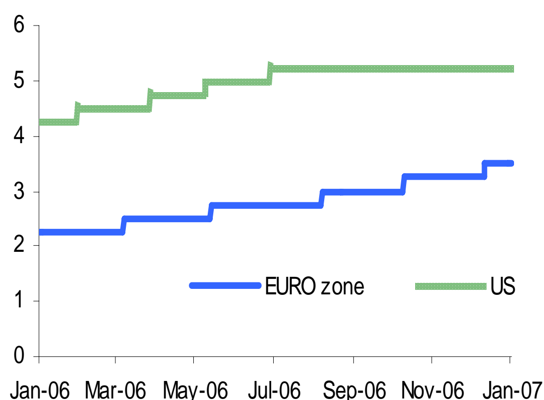
Source: OECD Economic Outlook No 80, Prelim. (working day adjusted annual growth rates); IMF World Economic Outlook September 2006; EC Autumn Forecast; WB Prospects for Global Economy

Chart 3. Business and Consumer Confidence Indicators



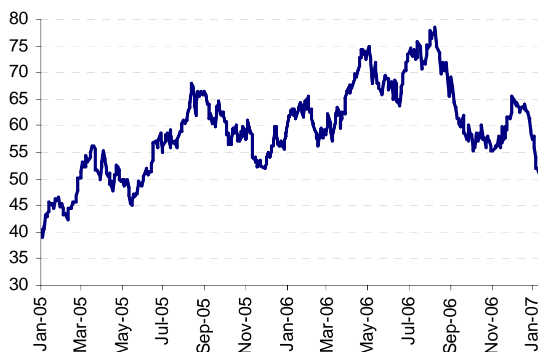
Source: IFO; EC.

Chart 4. Policy Rates in the US and euro-area (%)



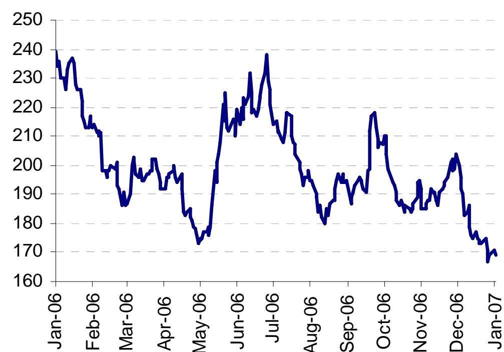
Source: ECB; FED.

Chart 5. Brent Crude Oil, USD/BBL



Source: Reuters.

Chart 6. EMBI+ Spreads (basispoints)



Source: Cbonds.

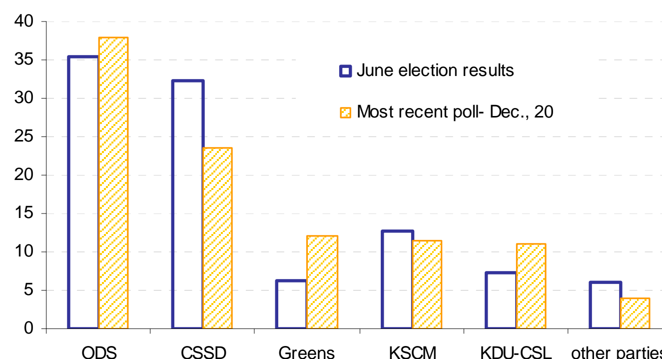
Political Background

Six elections have taken place in the region since October of last year. However, the elections have generally not strengthened the mostly weak coalition governments in the region, and with the exception of Hungary, prospects for significant progress on politically challenging reform agendas remain elusive.

As Bulgaria has realized its overarching national goal of EU accession in the beginning of 2007, the tree-party-coalition government looks stable and enjoys broad public support. However, the coalition faces the challenge to revitalize the broad reform agenda that lies ahead. The presidential elections won last fall by the incumbent president Georgi Parvanov revealed two political developments—the right-wing political parties' weakness and the growth of nationalistic ideas. Forthcoming elections of EU MPs this spring and local government elections in the fall will demonstrate how permanent these developments are.

In the Czech Republic, the political stalemate following the June general elections is finally over. The coalition government of the June election winner Civic Democratic Party (ODS), the Christian Democrats (KDU-CSL) and the Greens won the confidence vote in the Chamber of Deputies on January 19 due to the absence of two defectors from the CSSD and one abstaining MP. The three parties have agreed on a business-friendly program, which includes a flat-rate income tax, pension reform, progress in privatization and a moratorium on new nuclear power stations. CSA Czech airlines, Prague airport, Ceska Posta and Czech Railways will all be prepared for privatization. According to the coalition agreement, the public finance deficit would decline to 3% of GDP in 2008 and further to 2.6% of GDP in 2009-2010. As the CSSD has rejected cooperation with the new cabinet it will be difficult to implement major reforms requiring legislative changes. The latest approval ratings indicate that support for ODS has further strengthened, while support for CSSD has weakened (Chart 7).

Chart 7. Czech Republic: Popularity Polls (%)

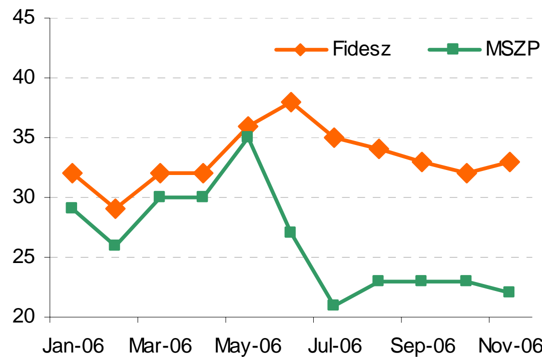


Source: ISI.

In Estonia, Toomas Hendrik Ilves (of the opposition Social Democratic Party) won the September presidential election. The three-party coalition led by PM Savisaar of the Centre party and including the Reform Party and the People's Union remains intact. Parliamentary elections are due in March 2007.

Hungarian Prime Minister Gyurcsany's position has further strengthened since the summer, improving prospects for progress in fiscal and structural reforms. If PM Gyurcsany is chosen as party leader at the MSZP congress in late February 2007, this would further consolidate his position. Nevertheless, the popularity of the ruling party remains low after it plummeted in May-June (Chart 8).

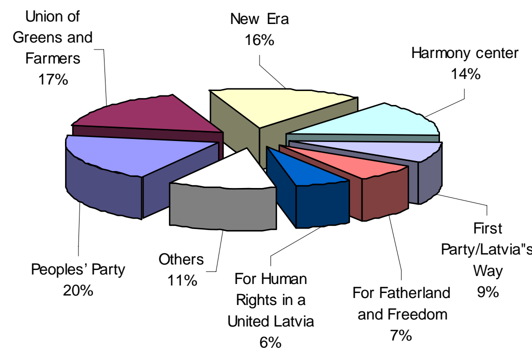
Chart 8. Hungary: Popularity Polls (%)



Source: Gallup Hungary.

In **Latvia**, the three-party ruling coalition led by PM Aigars Kalvitis won an extra six seats in the October 7 general elections and with 51 seats out of 100 was able to form a majority government (Chart 9). This is the first time a sitting government won a second term in the Baltic state's 15 years of independence. Nationalist Alliance for Fatherland and Freedom (LNNK) joined the government as the fourth partner and the coalition can now count on 59 of the 100 votes in Parliament. The ruling coalition faces a major challenge in balancing pre-election spending pledges with the need for fiscally responsible policies that target inflation and external vulnerabilities. Despite record high growth rates and increases in tax revenues, the coalition has not been able to commit to balanced budget with the 2007 draft showing a deficit of 1.4% of GDP despite the delay until 2009 of promises to cut the income tax rate from 25% to 15%. Integration to NATO and health care account for the largest shares of the additional budget expenditures planned for 2007. Further budgetary and wage pressures stem from the proposed increases in salaries for public sector employees and a hike in the monthly minimum wage from LVL90 to LVL120 in January 2007. The non-taxable minimum monthly income will increase from LVL32 to LVL50 resulting in additional spending of 14.5 million LVL.

Chart 9. Latvia: Parliamentary Election Results



Source: Latvia Central Election Commission.

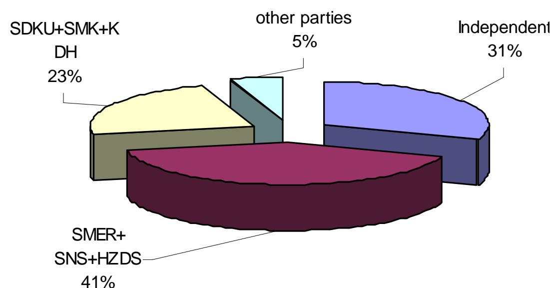
The **Lithuanian** political situation stabilized following the formation of a four-party coalition minority government in July 2006. The coalition led by PM Gediminas Kirkilas of the Social Democratic Party (LSP) and including the Peasant Nationalists (LVL), the Liberal and Centre Union (LCS) and the Civic Democracy commands only 58 of the 141 seats in the Seimas, but is supported by the conservative opposition Homeland Union (TS) with 26 seats. However, the political situation remains fragile given the long-standing tensions between the TS and the LSP.

Local elections will take place in February 2007 and general elections are scheduled for October 2008.

In **Poland**, local elections on November 12 brought no clear winner for the three-level sub-governments. The opposition Civic Platform (PO) won at the regional (most politicized) level with 27% of the votes, followed by Law and Justice (PiS) with 25% and the Left and Democrats Coalition with 14%. At the county level, PiS won 18% followed by PO with 12% and the Peasants Party (PSL) with 11.5%. At the municipal level, PiS won 16%, followed by PO (14%) and the Left and Democrats Coalition (9%). In Warsaw, Hanna Gronkiewicz-Waltz from PO, supported by the Left, defeated former PM Kazimierz Marcinkiewicz from PiS in the second round of mayoral elections on November 26. Following a serious conflict in the coalition, the PiS, LPR and Self-Defense re-joined after a one-month long divorce thus restablishing a majority government. Ms. Gilowska returned as Finance Minister, while Mr. Kluza was appointed chief of the new joint financial supervision agency.

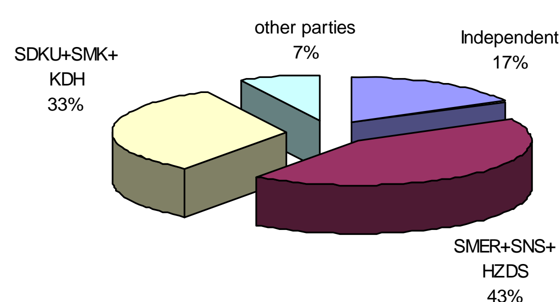
In **Slovakia** the coalition government of Prime Minister Robert Fico, elected in June 2006, is maintaining popularity above 60% by focusing more on social affairs on the back of high economic and employment growth. Local elections in December 2 brought victory to the ruling coalition (Chart 10, Chart 11).

Chart 10. Slovakia: Share of Elected Mayors of Municipalities, Towns and Town Districts by Political Party



Source: CSO; staff calculations.

Chart 11. Slovakia: Share of Elected Deputies to Municipality, Town and Local Councils by Political Party



Source: CSO; staff calculations.

In **Slovenia**, local elections in October 2006 strengthened the position of the coalition, particularly of some of its junior members. Presidential elections are scheduled for late 2007 and general elections in late 2008. The main opposition party, the centre-left Liberal Democracy of Slovenia (LDS), is still in disarray and is unlikely to provide a strong challenge to the government in the near future. The government is expected to accelerate implementation of the promised reforms in next two years, even if in a somewhat moderated form.

Romania is governed by a fragile centrist coalition – the Democratic Alliance (DA). Frequent political bickering within the coalition has hampered decision-making. President Basescu has been at loggerheads with Prime Minister Calin Tariceanu, also President of the Liberal party (the other large member of the coalition). A dissident group of liberals, under the leadership of former president Solojan, has left the party and plans to establish a Liberal Democratic party. They have stated their intention to cooperate with DA but not with the liberals. The decision in December of the small Conservative party to leave the coalition has further complicated matters for the government.

Box 1. Bulgaria and Romania in the European Union

As of January 1, 2007, Bulgaria and Romania became the 26th, respectively 27th, members of the European Union, a historic landmark in their protracted and uneven transition towards becoming fully fledged market economies. The prospects of joining the EU club constituted a solid external anchor for the transformation of the two countries, placing Bulgaria and Romania on a steady path of converging in income, competitiveness and living standards towards the EU. Celebrated with enthusiasm on the streets of Bucharest and Sofia on New Year's Eve, accession to the EU is, nevertheless, neither the beginning nor the end of the integration process. The unfinished reforms agenda remains considerable and the structural adjustment of the two countries needs to continue, especially in the areas of governance and market regulation.

Economic growth has been robust in recent years, driven by productivity gains, innovation, a better allocation of resources, and, occasionally, excess demand. The gap remains, however, large. Labor participation and employment are well below the EU-15 average. The share of the agricultural sector remains unsustainably high, while employment in services is substantially below the EU average. Disparities between the urban and the large rural sectors, as well as between regions, are widening. Around 40% of Romania's and 30% of Bulgaria's population live in rural areas. Poverty remains high and the pick up in economic activity has failed to filter through to important social groups. The attention dedicated to human capital development remains limited. The gradual opening of EU-25 labor markets to the workforce from Bulgaria and Romania is likely to widen the mismatch between supply and demand in segments of the labor market in the two countries and augment wage pressures.

The macroeconomic policy framework and outcomes have improved substantially in recent years, but vulnerabilities remain. Core inflation has been on a downward trend in Romania but rising recently in Bulgaria, and the conduct of fiscal policy has generally been prudent, especially in Bulgaria. At the same time, external imbalances have widened, and both countries run large current account deficits, fuelled by strong credit growth to the private sector. A central dilemma for policymaking over the coming years will be how to reconcile the need to further consolidate macroeconomic stability with the need to implement the substantial acquis commitments, especially in infrastructure and environment.

The consolidation of the governance and institutional framework is slower than expected and represents a main cause of concern for the EU. Progress in strengthening the justice system and fighting corruption is limited. Modernizing the public sector and reforming public administration require additional sustained effort. Rigidities in the functioning of the markets remain, affecting the transaction costs of companies and obstructing the reallocation of resources, including of labor, towards better ends. The EC will however monitor closely, including through the imposition of safeguard clauses, progress in improving the functioning of the judiciary, fighting corruption, implementing the acquis and the use of the structural and cohesion funds.

(see Annex 1 for a more in depth analysis)

Macroeconomic Developments and Prospects

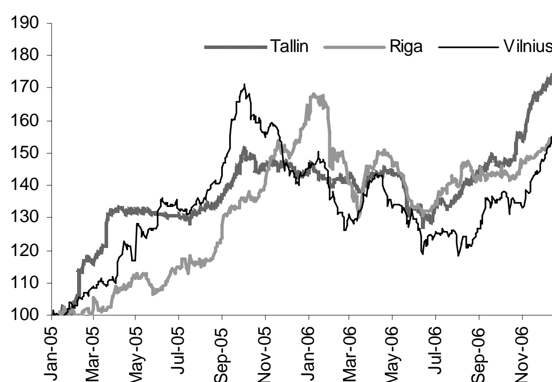
Output growth gained further steam in 2006 driven by buoyant domestic demand, but it is likely to moderate somewhat in 2007 in most countries in the region. Meanwhile, a tendency towards higher inflation is emerging across the region, although inflation remains low in Poland and the Czech Republic. Current price trends are responding as strong internal demand reasserts itself as a determining factor along with tightening of labor markets, in some countries rapid wage increases, continuing rapid credit growth, as well as adjustments to administered prices and indirect taxes. Moreover, fiscal policies in the region were mostly pro-cyclical. Current account deficits generally increased, in some countries to very worrisome levels, although they remained low in Poland and the Czech Republic. Strong FDI inflows, a positive sentiment towards emerging markets (despite the turbulence in May-June), and in some countries large inflows through the banking system supported the financing of these deficits. However, vulnerability has increased, including because of growing currency and term structure mismatches.

Market Developments

EU8+2 financial markets recovered strongly following the May-June emerging market turmoil and the short-term outlook remains positive. The early summer turbulence led to important outflows of funds from the region, especially in Hungary and Poland. However, since October, the outflow of funds from Central and Eastern Europe (CEE) stemmed and investors regained their appetite for EU8+2 instruments. While the outlook remains positive for 2007, the existence of large and growing current account imbalances in some countries, coupled at times with wider fiscal deficits, make several of the EU8+2 countries vulnerable to sudden corrections. Ongoing uncertainty regarding the growth rates and inflation dynamics in the Euro-zone and the US compound the risks.

In the **Baltic States**, stock markets renewed their strong upward trend in mid-2006. In November, the Tallin stock exchange index reached an all-time high (Chart 12).

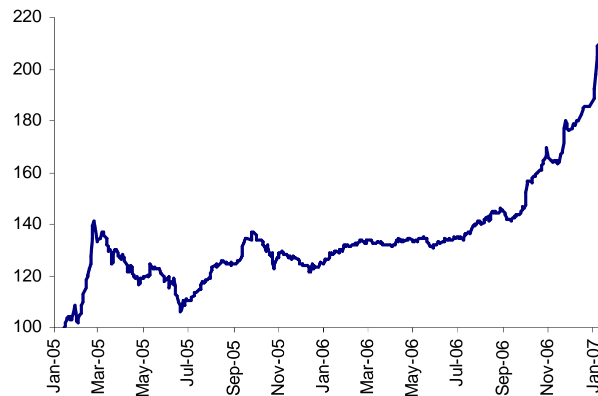
Chart 12. Baltic Stock Exchange Indices (Jan 2005=100)



Source: OMX Stock Exchanges.

In **Bulgaria**, the Sofia Stock Exchange Index, Sofix, registered record high values on the back of improved investor confidence in the wake of expected EU membership. The Sofix has almost doubled over the past two years, surging in the second half of 2006 (Chart 13). Companies in infrastructure and machinery saw growth rates of over 2000% in 2006.

Chart 13. Sofia Stock Exchange Index
(Jan 2005=100)

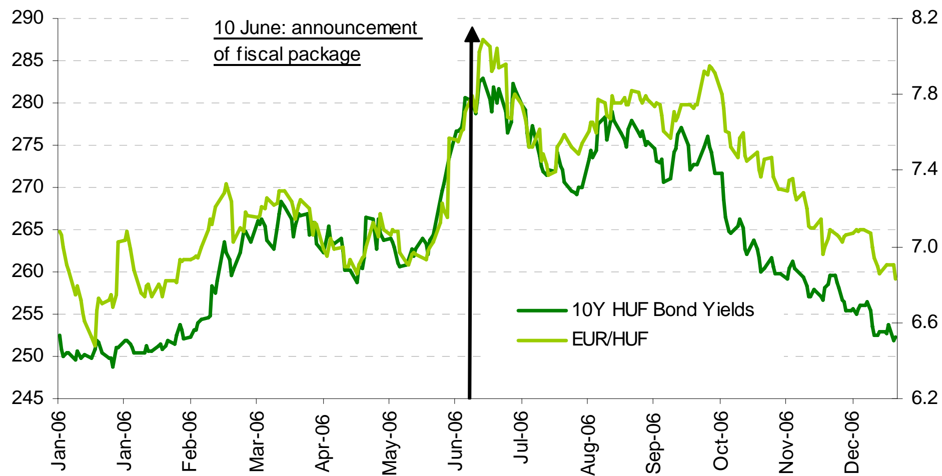


Source: ISI

In the Czech Republic, the koruna has strengthened markedly over recent months, reaching an all-time high of CZK/EUR27.44 in early January and extending its annual gain to 5% against the euro and 15% against the USD. Governor Tuma intervened verbally in December saying that he could imagine a certain weakening in the koruna after it had gone “totally crazy” in the past few weeks. The currency’s ability to shrug off unfavorable political news is probably related to the strong external position. CZK yields remain below Bund yields, while Czech hard currency spreads are extremely tight. The sentiment on the Prague Stock Exchange has continued to be positive, with the PX50 up by 52% since early 2005 although only 8% in 2006.

In Hungary, financial market recovered following the announcement of a bold structural reform agenda and the revised Convergence Program submitted to the EU on August 31. Despite skeptical reactions to the package, including from the European Commission, the market perception of Hungary improved (Chart 14). This led to a decline of government yields at the long end of the curve and caused a significant strengthening of the exchange rate. After weakening in May-June, the exchange rate fluctuated around 275-280 HUF/EUR before appreciating from October to about 255 by the beginning of January. Stricter central bank policies have supported this trend.

Chart 14. Hungary: Yields and Exchange Rate



Source: Reuters.

In **Poland**, strong fundamentals supported a strengthening of the Zloty and a bullish stock market, whose index has reached records highs. Following some weakening in the first half, the Zloty recovered ground against the euro in the second half of 2006 and appreciated strongly against the USD. Yield curves remain relatively flat, with the five year T-bonds priced at around 4.8%. The overall WIG index at end-September was 30% higher than a year before, while the construction index increased by 129% during the same period on the back on a strong revival of the sector.

In **Romania**, the RON stayed relatively flat against the euro with a mild tendency of appreciation towards the end of the year, when the exchange rate fell below RON 3.4 per Euro, on the back of continued strong foreign capital inflows. The Rasdaq stock market index gained 38% in the last 12 months, while investment in corporate and municipal bonds yielded 14-15%. Net assets of the mutual funds have grown strongly, up 64% during the year by end-October. Real estate, both residential and offices, continues to attract significant interest, despite falling returns. Moody's Investors Service upgraded Romanian government long-term and short-term foreign and local currency ratings to Baa3/P-3 with a stable outlook.

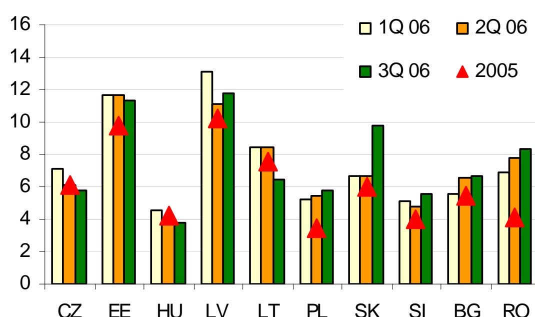
In **Slovakia**, the koruna appreciated sharply from September 2006, moving further away from the central ERM2 parity of 38.455 SK/EUR and approaching the lower bound of 32.687 SK/EUR raising speculation that an adjustment of the parity might be needed. The central bank spent some EUR 500 million in December to defend a rate of about 34.0. In contrast to most other markets in the region, the Slovak share index did not increase during 2006.

In **Slovenia**, the euro was introduced on January 1, 2007 at the central ERM2 rate of SIT239.6. The stock exchange in Slovenia is booming, but overall turnover is low.

Output Developments

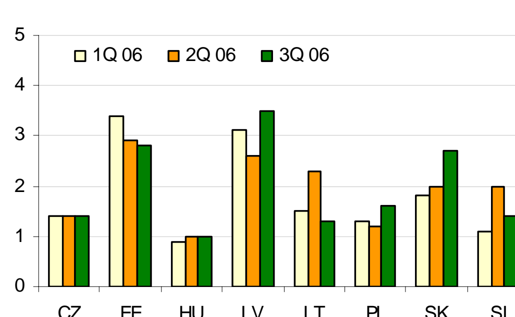
Growth remains strong throughout the region. In Q3-2006, output growth gained further strength in Poland, Slovakia, Romania, and Bulgaria, reaching nearly 6% yoy in Poland, more than 8% in Romania, and nearly 10% in Slovakia (Chart 15). Meanwhile, growth eased slightly in the Baltic States and the Czech Republic from the exceptionally high levels in the earlier part of the year. Hungary continues to lag the rest of the region with Q3 growth declining further to less than 4%. There are signs of overheating in the Baltic States where output is likely to be above potential (Box 2) and some concerns of similar developments in Bulgaria and Romania.

Chart 15. Real GDP Growth (% yoy)



Source: CSOs.

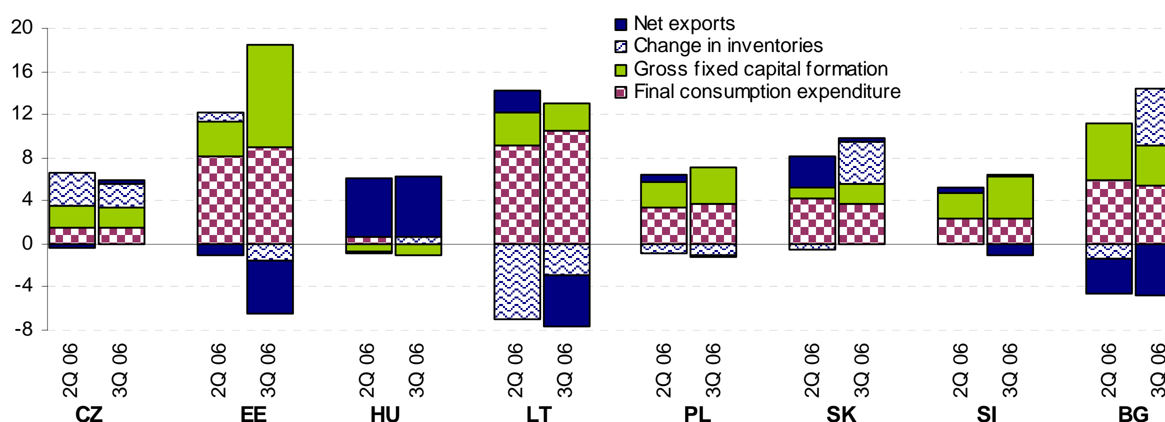
Chart 16. Real GDP Growth (%, qoq, SA)



Source: Eurostat.

Domestic demand is increasingly the main engine of growth in most countries in the region. Final consumption and gross fixed capital formation continue to dominate, with negative net exports offsetting vibrant domestic demand especially in the Baltic countries and Bulgaria (Chart 17). Domestic demand is being stimulated by rapid private sector credit expansion and wage growth. Policy actions to contain this expansion have been modest in most of the countries. Interest rates were raised in most of the EU8+2 countries in Q3, particularly in Hungary, but also in the Czech Republic and Slovakia. In most cases, excluding Hungary, Slovakia, Bulgaria and Romania, the increases have been less than the 75 basis point increase in the euro area rates over the 1Q-3Q. Romania has also tightened certain administrative controls but these are relatively ineffective in limiting credit from foreign affiliates including foreign banks. Hungary is the main exception to this picture, with growth being driven entirely by net exports.

Chart 17. Contributions to GDP Growth (% points of GDP)

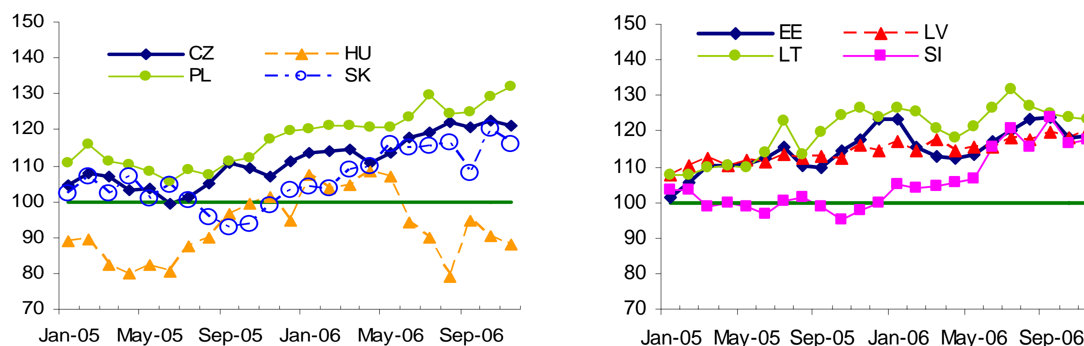


Source: CSOs; staff calculations.

Growth is likely to moderate slightly in 2007. Indicators of economic sentiment have drifted lower in the Baltic States but remain positive and output growth is likely to fall only slightly (Chart 18). In the Visegrad countries, indicators have risen recently and output growth is like to remain closer to the 2006 rates. Only the indicator for Hungary remains in negative territory (although it improved

sharply in September) and it is likely that the recently agreed fiscal consolidation and administered price increases will weigh heavily on domestic demand with output growth for 2007 expected to slow further to around 2.2 percent (Table 2).

Chart 18. Economic Sentiment Indicator



Source: EC.

Table 2. Macroeconomic Outlook

	Output growth			Inflation HICP average			Current account as % of GDP			Fiscal balance (GG), % of GDP		
	2005	**2006F**	**2007F**	**2005**	**2006F**	**2007F**	**2005**	**2006F**	**2007F**	**2005**	**2006F**	**2007F**
CZ	6.1	6.0	4.9	1.9	2.8	3.0	-2.1	-3.4	-2.4	-3.6	-3.5	-4.0
EE	9.8	11.0	8.3	4.1	4.4	4.3	-10.5	-12.4	-13.4	1.6	2.6	1.2
HU	4.2	4.1	2.2	3.6	3.5	6.2	-6.8	-7.9	-5.9	-6.1	-8.6	-5.1
LV	10.2	11.0	9.0	6.7	6.6	6.3	-12.7	-14.0	-13.7	0.2	-1.5	-1.4
LT	7.5	7.8	6.3	2.7	3.9	4.7	-7.2	-8.9	-9.2	0.0	-1.0	-1.2
PL	3.4	5.4	5.1	2.1	1.4	2.1	-1.7	-1.9	-2.5	-2.5	-1.9	-1.4
SK	6.1	7.8	7.6	2.7	4.5	3.1	-8.6	-7.8	-4.8	-2.9	-3.7	-2.9
SI	4.0	4.7	4.3	2.5	2.7	2.7	-2.0	-2.6	-2.7	-1.4	-1.6	-1.5
BG	5.5	6.0	6.0	5.0	7.4	4.0	-11.3	-14.1	-13.6	2.3	3.2	2.0
RO	4.1	7.0	6.0	9.0	5.0	5.0	-8.6	-10.5	-11.8	-0.8	-1.0	-2.8

Source: Convergence Programs (PL, LT, EE, HU, CZ, BG, SI- current account: CB)

SK - output: WB; inflation, fiscal balance: Convergence Program; current account: EC

LV - IMF; fiscal balance: MOF

RO – WB

Box 2. Overheating in the Baltic States?

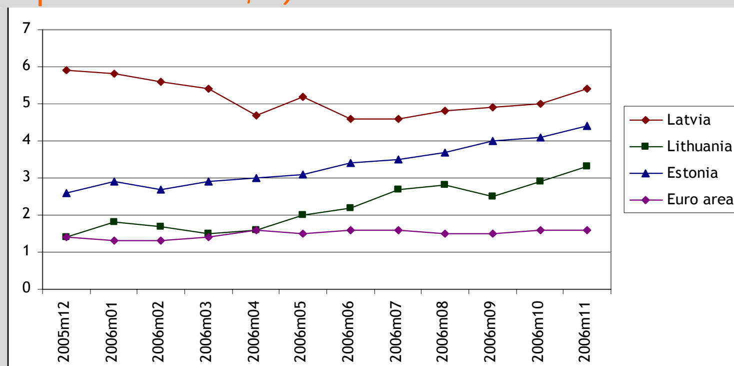
Over the last decade, strong domestic demand has been the main source of record high growth in the Baltic States. Since accession to the EU in 2004, a combination of rapidly increasing real incomes, high consumer confidence, booming credit expansion and capital inflows has contributed to additional domestic demand pressures. This has pushed output growth above its potential, putting strong upward pressure on prices and wages and raised imports leading to very high current account deficits.

Generally, overheating of an economy occurs when productive capacity with existing labor, capital, and technology is unable to keep pace with growing demand without putting sustained upward pressure on prices. Although the Baltic countries are only half way in their catching up with average EU income levels (in 2005, GDP per capita at PPP was 60% of EU-25 level in Estonia, 47% in Latvia, and 52% in Lithuania), a positive output gap (the difference between actual and potential levels of output of an economy) has emerged over the last two years in all three countries. The IMF estimates that Estonia's output gap is above 2% of GDP, Latvia's 1-2% of GDP, and Lithuania's just below 2% of GDP. Further, current growth rates exceed estimates of potential output growth that are more in the range of 6-7% thus further straining the economies. However, estimates of both the level of potential output (and the output gap) and potential growth rates need to be interpreted with caution in countries going through rapid transformation.

Signs of overheating are mostly clearly seen in rising core inflation (see figure below) and strong

real exchange rate appreciation. In addition, economic overheating tends to create asset price bubbles, evident in the booming real estate markets in the Baltic States. In labor markets, upward pressure on wages leads to higher labor unit costs undermining competitiveness. Indeed, in Q3-2006, the highest annual rises in nominal hourly labor costs in the EU25 were registered in Latvia (24%), Lithuania (20%) and Estonia (17%).

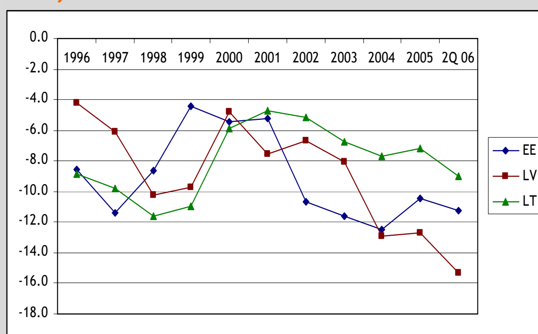
Chart 19. Core Inflation (CPI excluding energy and unprocessed food, %)



Source: Eurostat.

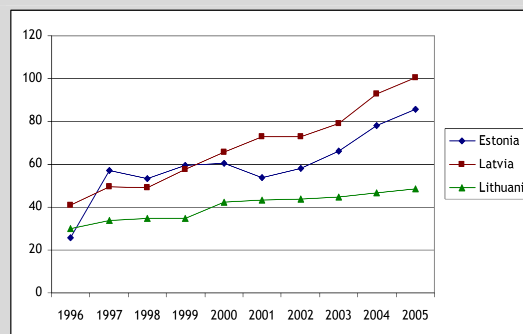
In the external sector, booming domestic demand is associated with a surge in imports, worsening of current accounts, and rising external debt (see charts below). The banking system is playing a key role through rapid credit expansion increasingly financed through bank borrowing abroad. These capital inflows are thus a critical element of the current boom cycle.

Chart 20. Current Account Balances (% of GDP)



Source: central banks; staff calculations.

Chart 21. External Debt (% of GDP)



Source: central banks; staff calculations.

Although a number of small, open economies have maintained current account deficits far exceeding 10% of GDP for extended periods (including Singapore during the 1960-70s), current account deficits cannot be sustained indefinitely. The IMF estimates that for the Baltic States, sustainable current account deficits are around 7.5% of GDP in the medium term and around 5% of GDP in the long run.

Looking ahead, there are two likely scenarios for the Baltic States: a gradual decrease in domestic demand and an **orderly adjustment** in the current account deficits or continued increases in domestic demand ultimately leading to **disorderly adjustment**. Domestic demand growth may slow gradually under the influence of increasing levels of household and corporate sector debt, rising interest rates in the euro-zone, and a lowering of expectations about permanent income, or if banks become concerned about asset quality and curtail credit expansion, leading to a gradual slowdown in growth. Alternatively, continued rapid domestic demand growth and widening current account deficits could result in a sudden loss of confidence resulting in banks pulling out, a sharp correction in asset markets, and a collapse of growth. In such a scenario, the fixed exchange rate regimes could come under considerable pressure. A proactive policy response is warranted to limit these risks:

- reversing the current pro-cyclical fiscal policies; fiscal tightening aimed at increasing

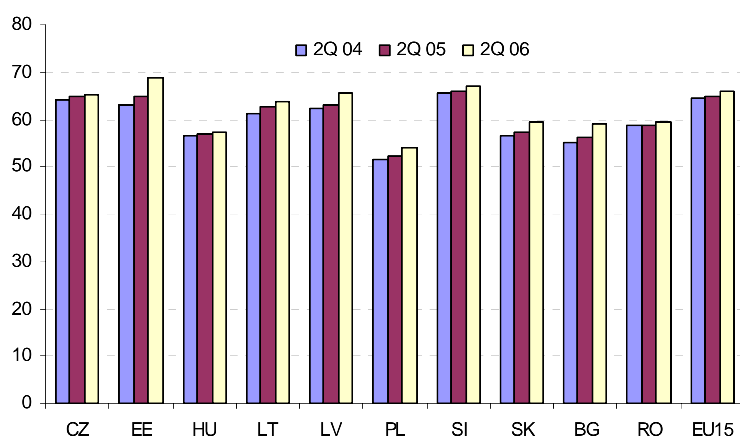
public savings and discouraging private borrowing;

- tightening supervision of financial intermediation sectors in home and host-countries (including better cross-country cooperation), including policy measures to limit excessive consumer and mortgage credit growth;
- continuing structural reforms in labor markets aimed at making labor markets more flexible with increased regional and sectoral mobility. This would also include allowing more inward migration to help loosening labor market constraints. Education systems also need to respond better to the new labor market needs;
- bolstering investor confidence by implementing credible *euro* adoption plans that include steps to tame inflation (commitment to restrain fiscal expenditures and steps to slow rapid credit expansion).

Labor Markets

The upward trend in employment continues, driven by the rapid expansion of output in most of the EU8+2 markets. Employment rates have been increasing at a solid pace in several countries in the region, notably in the Baltic States, Poland, and Bulgaria (Chart 22). The only exception to this positive trend is Hungary and Romania, where the employment rate has stayed almost flat for four consecutive quarters.

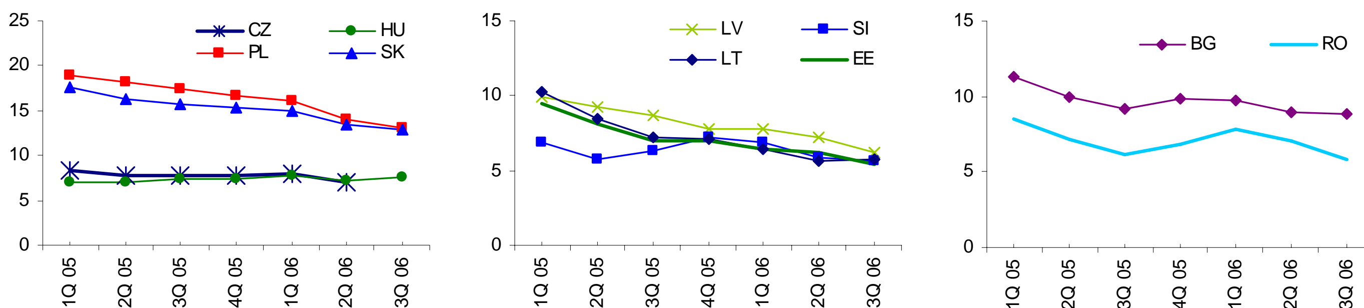
Chart 22. Employment Rates, 15-64 (LFS, %)



Source: Eurostat.

The increase in employment has been associated with a decline in unemployment rates, especially in countries with high levels of unemployment (Chart 23). In some countries, unemployment has fallen by more than the increase in employment under the influence of external migration. In Poland, the registered unemployment rate fell to 14.9% in September, while the LFS rate declined to 13% in Q3, 4.4 percentage points lower than the year before. Similar developments have been visible in other high unemployment countries, such as Bulgaria and Slovakia. The tightening of labor markets is particularly discernible in the Baltic States, where unemployment rates have reached record low levels leading to labor shortages and exerting significant pressure on wages. Unemployment levels remain moderate, at between 5.5% and 7%, in the Czech Republic and Slovenia. Romania exhibits the lowest registered unemployment, at around 5%. Hungary is the only country where unemployment is stagnant, and it may even rise as the economy slows further and planned cuts in public sector staffing are implemented.

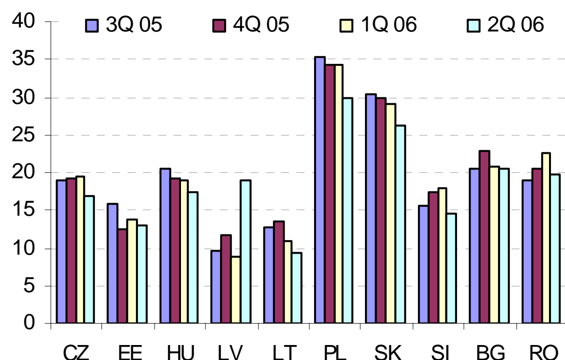
Chart 23. Unemployment Rate (LFS, %)



Source: CSOs.

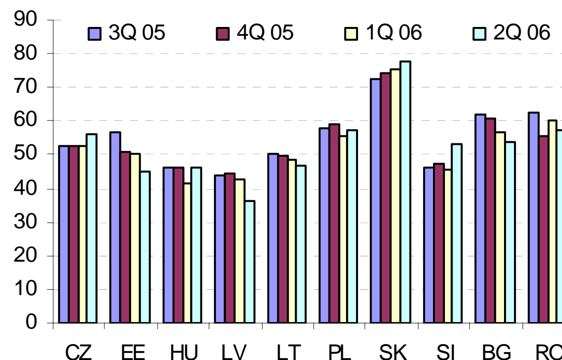
However, the benefits arising from growth and improved job opportunities do not filter through to important labor market categories. The young and the long-term unemployed are particularly affected. Youth and long-term LFS unemployment rates remain stubbornly high in the majority of the EU8+2 countries. The unemployment rate of the 15-24 years old category exceeds 25% in Poland and Slovakia, with Latvia the only country where the rate has fallen below 10% (Chart 24). Over 40% of the unemployed are long-term unemployed in all EU8+2 countries, with the exception of Latvia (Chart 25). In Bulgaria, the number of long term unemployed is declining, although it still exceeds 50%. In Slovakia, it is on the rise, approaching 80%, while in Poland and Romania it is stagnant at over 50%. These dynamics raise important questions about the relevance of education for the labor market. Many graduates appear to go directly into unemployment or out of the labor force as discouraged workers.

Chart 24.Youth Unemployment Rate (15-24 year olds, %)



Source: Eurostat.

Chart 25. Long-Term Unemployment (% of total unemployment



Source: Eurostat.

Labor and skills shortages are increasingly visible in segments of the labor markets, including manufacturing, construction and selected areas in services. This reflects not only the rapid expansion of the sectors, but also adverse demographic trends and labor migration to the EU-15 area. The number of unfilled job vacancies is on the rise in most of the countries. In Lithuania, for example, job vacancies increased to 17,000 in Q2-2006, up from 6,100 a year earlier.

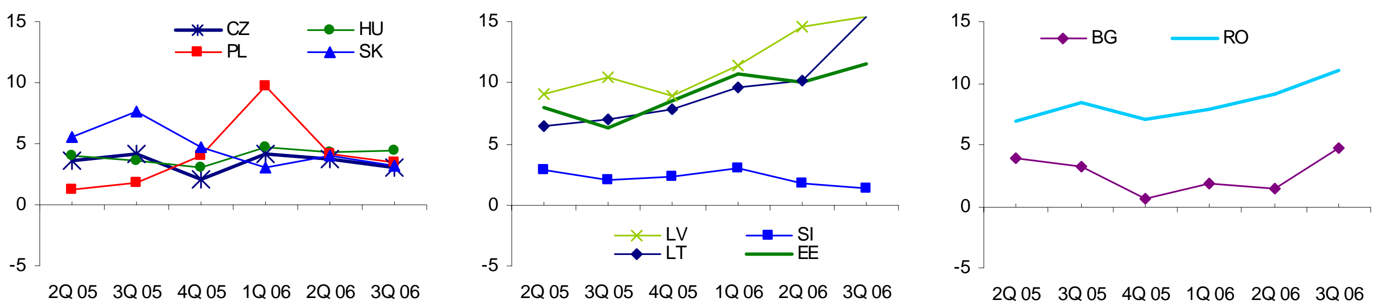
While there is limited information on the magnitude of the migration flows from EU 8+2, estimates suggest that the numbers are large and exceed initial official expectations.[3] Spurred by excess demand in segments of the labor market in the destination countries, as well as by market disequilibria in the countries of origin, labor mobility from the EU8+2 to the old member states has intensified. Studies suggest that the countries that opened their domestic markets fully, particularly Great Britain and Ireland, experienced the largest inflows of workers from the East. However, the

[3] See the EU 8 Quarterly Economic Report, Part II: Labor Migration from the New EU Member States, September 2006, for a comprehensive assessment of the dimensions and characteristics of external migration from the NMS after May 2004.

overall economic impact of the open-door policy has largely been positive. Migration occured without causing significant distorsions to host country labor markets or increases in unemployment. In many cases, migration is segmented, in response to excess demand for occupations requiring specific expertise (e.g. dentists, nurses, software programmers, workers in agriculture, etc.). Wage differentials represented a major factor in the decision to emigrate. Evidence points to the fact that the magnitude of migration flows depended not only on the imposition of certain temporary restrictions, but also on the shortages of labor in the destination country. Informal emigration from Bulgaria and Romania to Spain or Italy appears large as well, raising some concerns about labor shortages in the sending countries. These are likely to be exacerbated in the future as EU integration deepens and access to the labor markets of the other member countries is gradually liberalized.

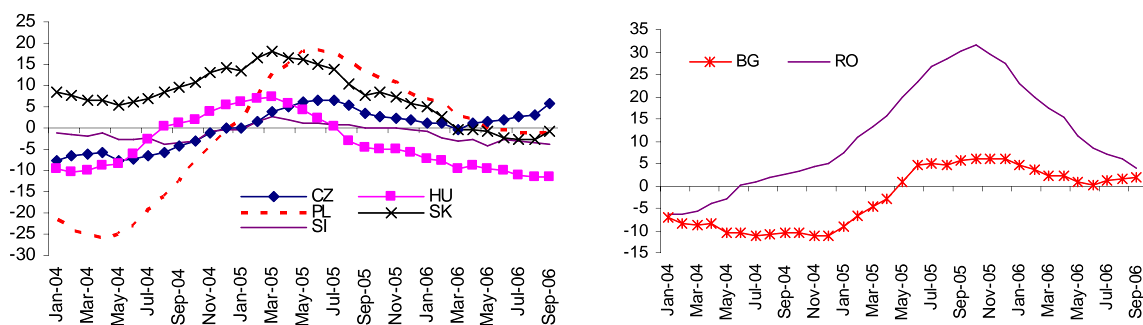
The increasing mismatch between labor demand and supply has exacerbated wage pressures. The decline in unemployment, but also strong productivity gains, have led to the acceleration of wage growth in several countries, particularly in the Baltic States, Romania and Bulgaria (Chart 26). In some countries such as the Baltic States, real wages growth outpaces productivity dynamics, fueling further inflationary pressures and affecting competitiveness. In Latvia, real wages rose by 15.4% y/y, in Estonia 11.5%, and in Lithuania 15.4% in Q3-2006, but also Romania saw rapid real wage growth at nearly 11% y/y in September. In contrast, in the Visegrad countries, Slovenia and Bulgaria real wage growth remains moderate and below productivity growth except perhaps in sectors suffering from chronic labor shortages such as construction and high-skilled services. In this latter group of countries, the growth in unit labor costs in industry has declined to around zero (Chart 27).

Chart 26. Real Wage Growth (% yoy)



Source: CSOs

Chart 27. ULC in Industry Growth (EUR, % yoy)



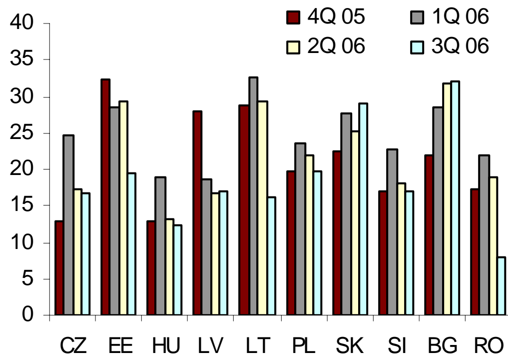
Source: WIIW.

There is evidence that, in some of the countries, wage demands are picking up further, including in the public sector, complicating the 2007 wage policy agenda and feeding into already high aggregate demand.

Foreign Trade and Balance of Payments

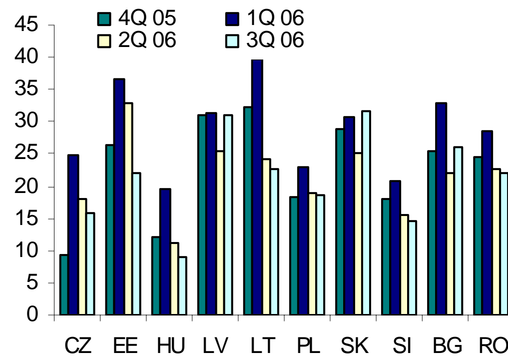
Export, and to a lesser extent import, growth rates have generally slackened. While exports continued to grow strongly in Q3-2006, growth rates are somewhat off the peaks attained earlier in the year except in Slovakia and Bulgaria (Chart 28 Chart 29). Export growth decelerated sharply in Romania and in Lithuania. This may partly reflect the real appreciation of currencies in recent years, which has been particularly strong in Romania (Chart 30). Import growth rates followed a similar pattern falling from Q1-2006 highs in all countries except Latvia and Slovakia. Terms of trade have worsened throughout the region with the exception of Lithuania and Poland (Chart 31).

Chart 28. Export of Goods (EUR, % yoy)



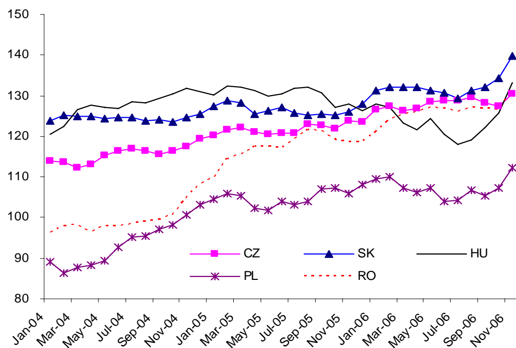
Source: CSOs; Eurostat.

Chart 29. Import of Goods (EUR, % yoy)



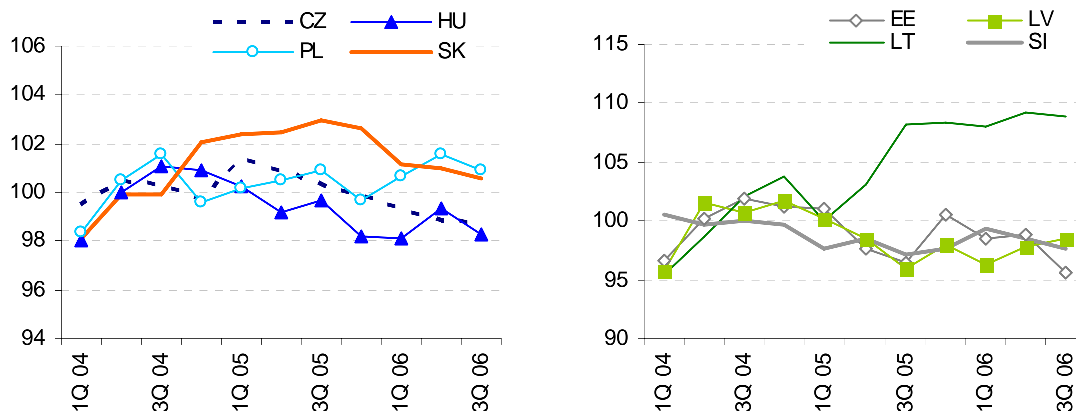
Source: CSO; Eurostat.

Chart 30. Real Effective Exchange Rates (2000 = 100)



Source: IFF.

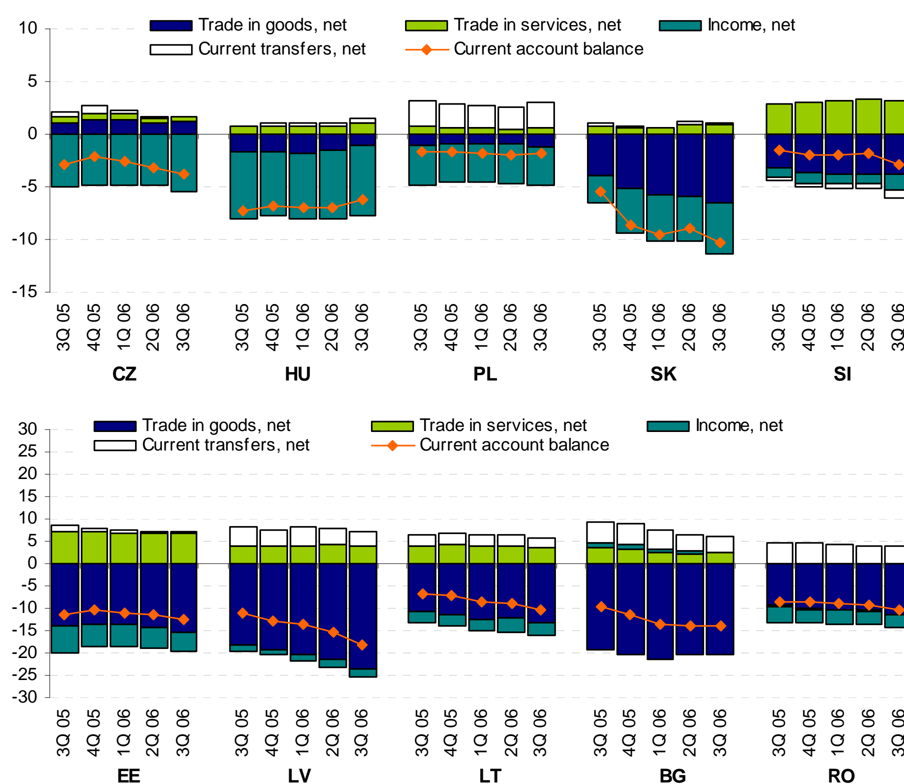
Chart 31. Terms of Trade (trade with EU25, average 2004=100)



Source: Eurostat; staff calculations.

Current account positions have weakened in most countries of the region, not least in Slovakia and Latvia. In most EU8+2 countries, current account deficits widened further in Q3- 2006, exceeding 18% of GDP in Latvia, close to 14% of GDP in Bulgaria, and 10% of GDP in Slovakia. The current account deficit narrowed only in Hungary, owing to a sharp decline in the trade deficit, but was flat in Poland during the year. In the Baltic countries, the very high external deficits are fueled mainly by trade in goods with soaring imports related to strong domestic demand (Chart 32). This is also the main driver in Slovakia, Bulgaria and Romania with buoyant imports also related to large FDI projects. The deficit remains stubbornly high in Hungary at over 6% of GDP reflecting a deteriorating income balance (which is also the largest drag on the current account in the Czech Republic, Poland and increasingly Slovakia). The largest factor is the repatriation of profits from direct investments and dividend payments. External imbalances are contained in Poland, Slovenia and the Czech Republic, the latter being the only country with a positive trade balance in the region.

Chart 32. Current Account Balance and Components (% of GDP)

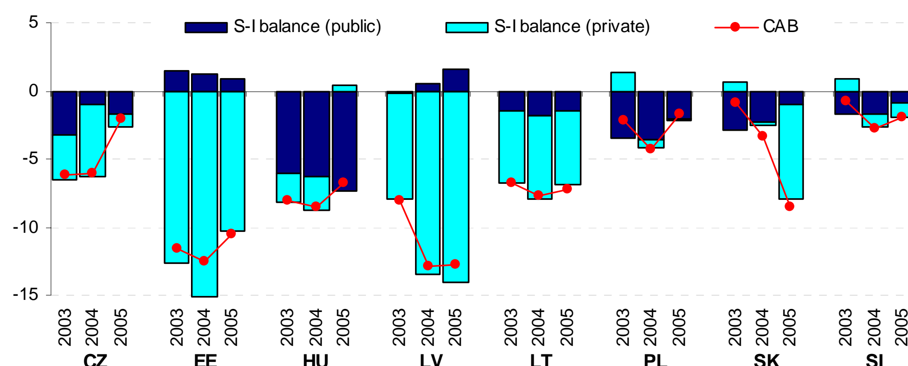


4 quarters cumulative

Source: national central banks; and staff calculations.

The largest external imbalances in the region - in the Baltic States, Slovakia, Bulgaria and Romania - are generated in the private sector. Soaring current account deficits in the Baltic countries in recent years reflects the gap between relatively flat savings and increased investment - in 2005 this was also the case of Slovakia. The main source of this savings-investment gap in these countries is in the private sector while the balance of the public sector was even positive in Estonia, Latvia, and Bulgaria (Chart 33). These imbalances translate into booming private sector credit (see also Special Topic). Meanwhile, in Hungary and Poland, the savings-investment gap is driven by the government sector.

Chart 33. Savings-Investment Gap (% of GDP)



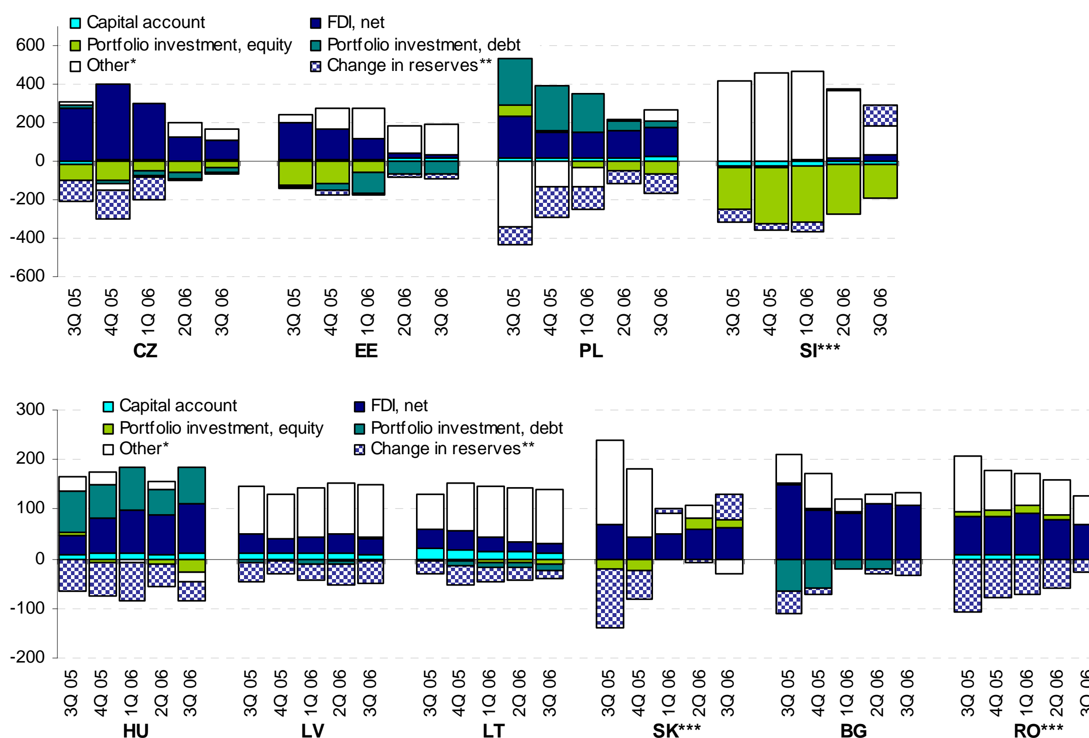
The current account balance reflects the gap between savings and investment in the economy (S-I=CAB). This gap can be divided into public and private sector gaps: (Sg-Ig)+(Sp-Ip)=CAB. However, in some countries - notably Estonia and Slovakia - there were significant statistical discrepancies in this equation.
Investment in this equation is calculated as gross fixed capital investment plus change in inventories. The former is allocated between the private and public sectors in the national statistics, and the latter was proportionally allocated as this division is not available in the national statistics.

Source: AMECO; staff calculations.

On the financing side, strong FDI flows covered the current account deficits in the Czech Republic, Poland, Bulgaria and to a large degree in Hungary, Slovakia and Romania[4] (Chart 34). In the other countries in the region, net FDI covered less than 30% of the deficit - in Estonia even as low as 12%. Debt portfolio investment remained buoyant in Hungary while it weakened significantly in Poland. In the Baltic States, foreign borrowing by banks plays an increasingly important role in financing the deficits. Most EU8+2 countries, excluding Slovakia and Slovenia, increased reserves thus partly mitigating upward pressures on exchange rates but complicating liquidity control in the Baltic States. In Slovakia, the widening current account gap was covered in part by the use of reserves in Q3-2006, a period of pressure on the exchange rate.

[4] However, at least in some countries (notably the Czech Republic and Romania) this partly reflects the inflow of privatization receipts matched by increases in reserves.

Chart 34. Financing of Current Account (% of CAD)



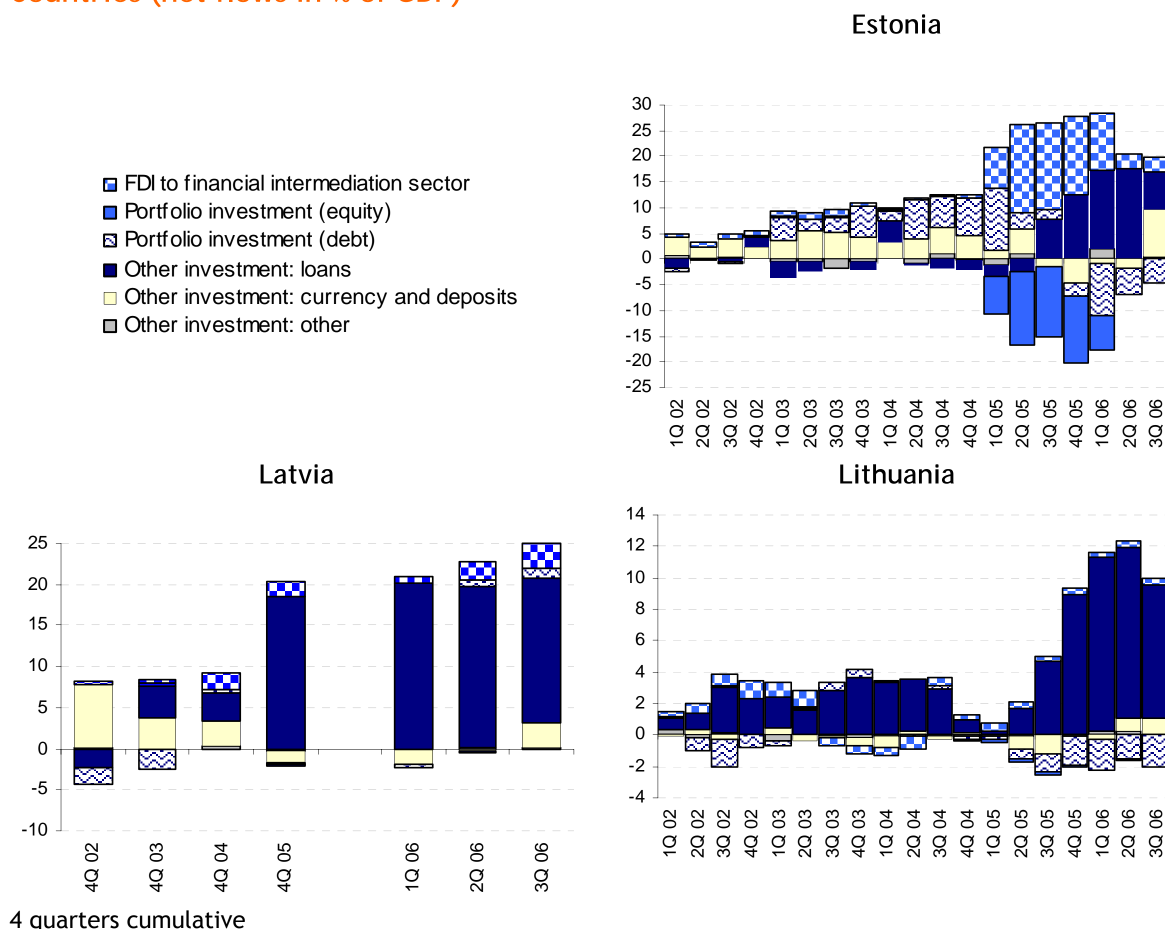
4 quarters cumulative
*financial derivatives, other investment and net errors and omissions
**negative values denote increase of reserves
***portfolio investment include equity and debt

Source: national central banks; and staff calculations.

In the Baltic countries, the banking sector plays the most important role in financing the current account deficit. Only a small part of this financing is in the form of FDI in the financial sector, except for Estonia where huge inflows reflected Hansapank sale in 2005. The vast majority of banking sector assets already belongs to or is controlled by foreign credit institutions (in Estonia reaching 99% at the end of Q1-2006) with a clear domination of Scandinavian capital. The large current account gaps are increasingly financed by institutional foreign borrowing, including parent bank funding in the form of loans and deposits (Chart 35). As the rapid lending expansion continues, the banking sector in these countries becomes more dependent on parent banks in terms of funding and liquidity.[5] Similarly in Romania, a significant part of the current account gap appears to be financed by banking sector foreign borrowing.

[5] In all Baltic countries, foreign borrowing has a significant share in banking sector liabilities: in Estonia 42.5% (end-Q1-2006), of which about 75% from non-resident parent banks; in Latvia 33% (end-H1-2006), incl. 20% from parent banks; in Lithuania 37% (end-2005), including 22% from parent banks.

Chart 35. Financing of Current Account Deficit by the Banking Sector in the Baltic Countries (net flows in % of GDP)



Source: national central banks; and staff calculations.

Box 3. Are FDI Inflows Financing Productive Investments?

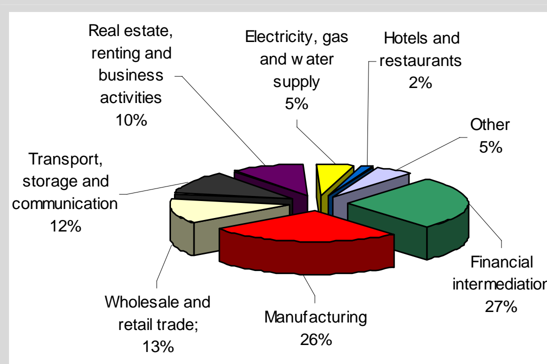
The structure of FDI in the NMS shows the highest concentration in the banking sector, the technology-intensive car industry and electrical machinery. The new EU member States have become new hubs of manufacturing for automobile production in Europe - about one tenth of inward FDI stocks in Hungary, Poland and the Czech Republic are in the automobile industry. Foreign investors have also penetrated industries with relatively stable domestic markets, e.g. food, non-alcoholic beverages, breweries and tobacco. However, textiles, clothing and leather industries are less internationalized through FDI than other activities (although in Bulgaria and Romania, most textile companies have foreign ownership). Foreign presence is also still relatively small in branches with structural difficulties and excess capacity, such as steel and shipbuilding industries, although investor sentiment towards these sectors appears to be changing recently.

Table 3. FDI Stock (% of GDP, 2005)

Country	
Bulgaria	42.1
Czech Republic	44.4
Hungary	49.5
Latvia	29.8
Croatia	32.2
Estonia	82.0
Lithuania	29.2
Poland	27.5
Romania	26.0
Slovak Republic	33.0
Slovenia	10.5

Note: National estimates may differ from presented data.
Source: IMF-IFS; CBs.

Chart 36. FDI Sectoral Composition (%, 2005)

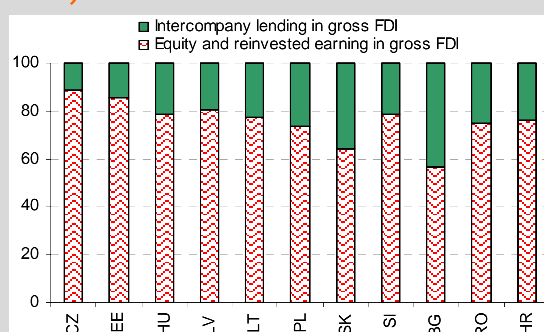


Source: national central banks..

In recent years, there has been increasing FDI activity in the service sectors, particularly in tourism, real estate industries and trade. Media, in particular publishing of dailies, as well as marketing and ICT industries are becoming important targets for foreign investors, although still with low levels of investment. Telecommunication and energy sectors have attracted a significant share of FDI as countries proceed with privatization of monopolies.

Approximately, one-third of FDI in the NMS was in the form of inter-company lending, mainly executed between financial intermediaries. The remaining two-thirds consisted of equity investment and reinvested earnings. Bulgaria and the Slovak Republic recorded a relatively large share of inter-company lending during the observed period at close to 40% of total gross FDI. Countries with emerging banking sectors and/or low credit-to-GDP ratio still have an increasing trend of inter-company lending given that foreign mother banks are relending through their domestic affiliates to profit from the higher interest rate margins that persist in recipient countries. Inter-company lending also accounts for a large portion of NMS gross external debt, ranging from 8% (Slovenia) to 21% (Estonia).

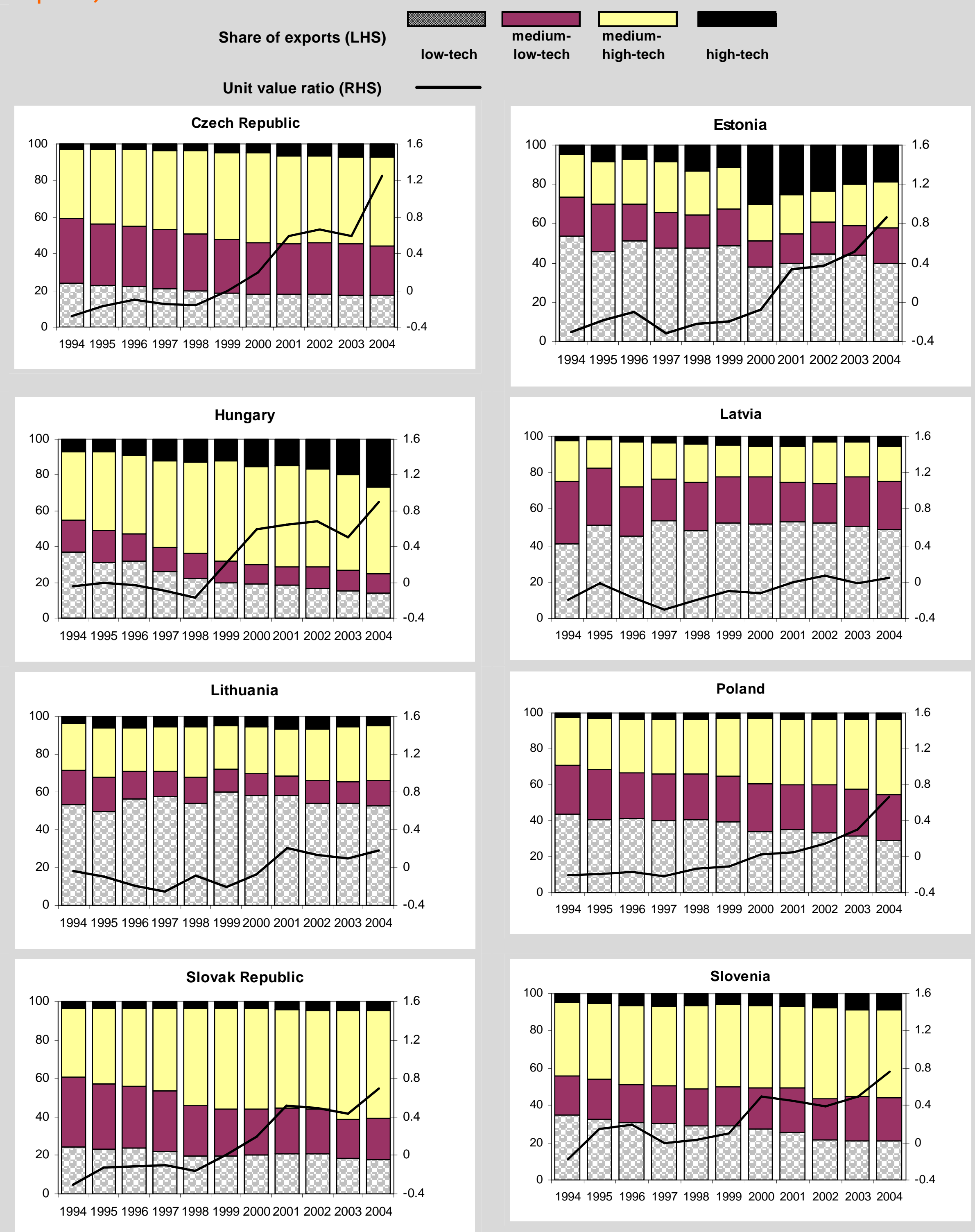
Chart 37. Structure of FDI Stock (%, 2005)



Source: IMF-IFS; national central banks.

The positive effects of past FDI inflows into the region are visible in an increasing ratio of unit value of country exports relative to world exports and a shift towards higher export product quality. The shift towards higher technology exports is particularly evident in the Visegrad countries and Slovenia. While Estonia also has a relatively high share of high-tech exports, the trend has been declining since 2000. The other two Baltic States have made little progress in moving up the technology ladder.

Chart 38. Moving up the Technology and Quality Ladder (share in % of country exports)

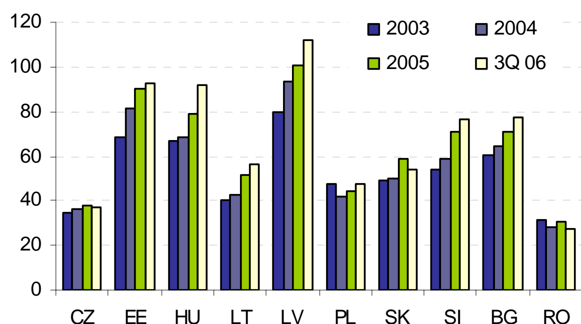


Source: Comtrade; IMF.

In most of the countries in the region, foreign borrowing to cover external imbalances has translated into higher external debt. External debt (gross) has been rising rapidly in the Baltic States (reaching over 110% of GDP at end-Q3-2006 in Latvia), Hungary, Slovenia and Bulgaria (Chart 39). In the Baltic countries, a growing share of the external debt is taken up by the banking sector (in Latvia as much as 70%). In Hungary, the growth of banks' foreign debt was matched by that of the government and gross external debt reached 90% of GDP. Also Slovenia and Bulgaria saw an increase in their foreign debt trending towards 80% of GDP while in other countries it remained

relatively stable, below 60% of GDP (Slovakia and Poland) and even 40% of GDP (the Czech Republic and Romania).

Chart 39. Gross External Debt (eop, % of GDP)

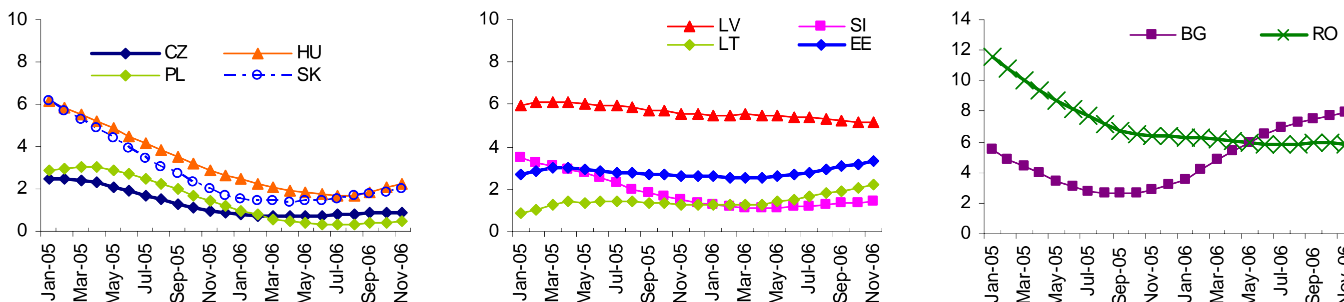


Source: Eurostat; national central banks and CSOs.

Inflation and Monetary Policy

The strong expansion of output and tightening of labor markets have been accompanied by intensified underlying price pressures. Core inflation trended higher in Estonia, Lithuania, Hungary, and Slovakia in 2006 (Chart 40). In Bulgaria, the sharp rise in excise duties on cigarettes and alcohol in January 2006 caused underling inflation to rise to 7.5% in 2006[6]. The core inflation remained stubbornly high also in Romania and Latvia in 2006 at around 6%. Only Poland and the Czech Republic managed to keep inflation well under control.

Chart 40. HICP-Core Inflation (12M moving average, %)



Source: Eurostat.

The rising inflationary pressures in most countries are related to the rapid output growth and closing of output gaps, tightening of labor markets and higher wage growth, rapid credit expansion, and pro-cyclical fiscal policies. The strong depreciation of the forint in the first half of 2006 (Chart 42) contributed to higher inflation in Hungary, while the trend towards appreciating nominal exchange rates in countries with floating exchange rate systems in the second half of the year has helped to keep recent price pressures lower than one would expect against the background of the countries' impressive growth rates (Czech Republic, Poland, Slovakia) (Chart 43).

[6] HICP-Core Inflation index contains effects of some administrative price adjustments, including tax changes (e.g. excise on tobacco and alcohol products). According to calculations of the National Bank of Bulgaria, average core inflation in 2006 would be about 4% (after excluding one-off alcohol and tobacco prices adjustments) or about 3% (after excluding all administrative price adjustments).

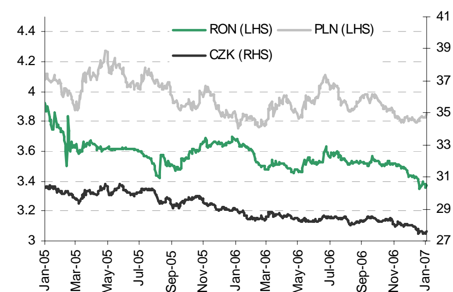
Chart 41. Slovakia: EUR Exchange Rate

Source: Reuters.

Chart 42. Hungary: EUR Exchange Rate

Source: Reuters.

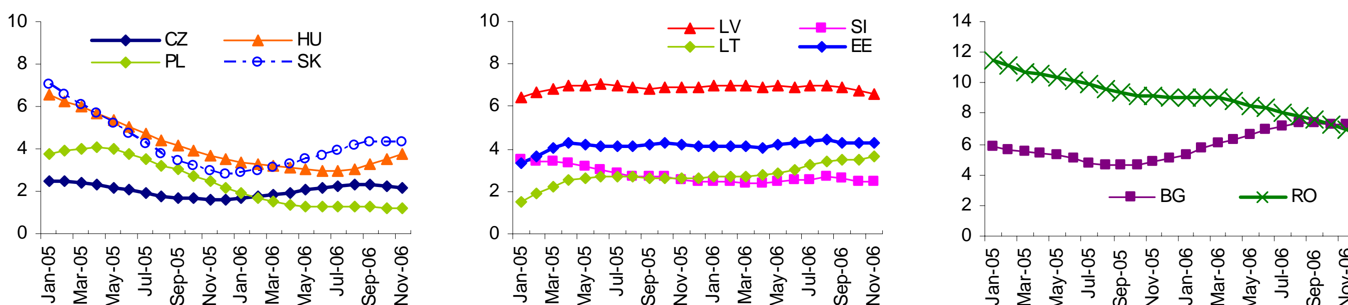
Chart 43. Czech Republic, Poland and Romania: EUR Exchange Rates



Source: Reuters.

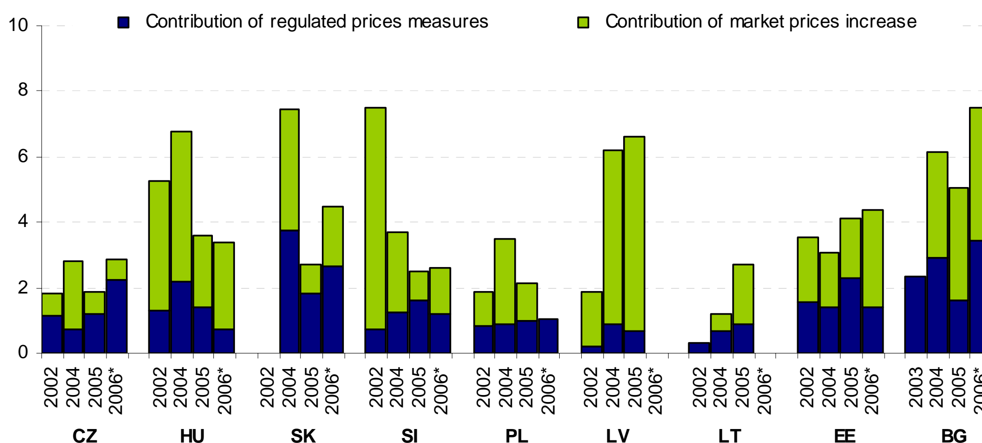
Consumer price inflation followed a similar pattern but affected also by adjustments in regulated prices and indirect taxes (Chart 44). In Lithuania, consumer price inflation accelerated further during the course of 2006 as envisaged when its bid to join the EMU from 2007 was rejected earlier in the year. In Hungary, consumer price inflation shot up sharply to 6.4% y/y in October from 3.2% y/y in July affected also by the increase in the VAT rate and regulated energy prices under the government's fiscal austerity package. Adjustments of regulated prices and increases in indirect taxes also added to inflation in the Czech Republic, Poland, Slovakia and Bulgaria (Chart 45). Falling oil prices in the second half of 2006 are likely to affect inflation only with some lag.

Chart 44.HICP (12M moving average, %)



Source: Eurostat.

Chart 45. Contribution of Regulated Prices to CPI Inflation (period average, %)



** 9M: CZ, PL.; 10M: HU, SK, SL, BUL, EE.*
Source: national central banks and CSOs; staff calculations.

Further regulated price increases are planned in several EU8+2 countries. The impact of these adjustments on inflation is likely to be most pronounced in Hungary, the Czech Republic, Estonia,

Lithuania and Romania (Table 4). In Hungary, further increases in energy prices and excises are expected to push inflation up to around 8% y/y in Q1-2007. In Lithuania, increases in gas prices may add 1.7pps to inflation in 2007 (compared to 0.9pps in 2006).[7] In Estonia, further hikes in energy prices and excise duties (including on tobacco and alcohol) may add 1.3-1.5pps to inflation in 2007-08. Further administrative price changes are also planned in Latvia (e.g. an increase in the electricity tariff by 10.4% and in the gas tariff by 36% in 2007). In Bulgaria, excise duty increases were frontloaded to 2007 and electricity and district heating prices are expected to increase in response to the planned adjustment of natural gas prices to Western European levels between 2007 and 2012. In contrast, Slovakia plans more moderate administrative price adjustments (mainly in electricity for companies), including some regulated price reduction (i.e. reduction of VAT rate for medicines or cuts in gas, water and sewage prices), which may help the country meet the inflation criterion for euro adoption.

Table 4. Administrative Price Increases and Impact on Inflation in Selected Countries (2006-2007)

Price increase/decrease (%)	CZ				HU				EE			
	2006		2007		2006		2007		2006		2007	
Changes in tax policies												
Increase of excise duty on motor fuel												
Increase of excise duty on diesel oil												
Increase of excise duty on tobacco	4.60%	Apr.	25.60%	Jan.	6%	Sep.	6-10%					
Increase of excise duty on alcoholic beverages					7%	Sep.	5%					
Other												
- increase of middle VAT rate from 15% to 20%					0.05	Sep.						
- medical equipment is taxed at 18% instead of 5%											0.12	Jan.
- increase of VAT rate for heating, peat, coal & firewood											0.12	Jan.
Other administrative price changes												
Water supply x)	3.70%		4.80%							Jan.		Jan.
Sewerage									9.60%		9.60%	
										Nov.05-		
Refuse collection	1.90%								17%	March.0		
Electricity	8.90%	Jan.	7.90%	Jan.								
										Jan.-		
Distance heating	9.70%		2.80%						50%	Apr.		
										Sep.-		
									20%	Oct.		
Heating energy, based on natural gas												
- in Tallinn									8%	Aug.	15%	Aug.
										Aug.-		Aug.-
- elsewhere									20%	Oct.	15%	Oct.
Transportation fees	2.80%		6.70%				n/a	Jan.				
Gas prices	4.80%	Jan.	-4.20%	Jan.	28%	Aug.	24%	Jan.	11%	Jan.		
	1.40%	Apr.	2.70%	Apr.xx)					50%	Oct.		
	-5.50%	Oct.										
Telephone charges	3.30%	May.	1.00%									
Postponed												
Increase of excise duty on alcoholic beverages									6%	Jul.		
									7.5-			
Increase of excise duty on tobacco									16.5%	Jul.		
Estimated effect on CPI (annual growth rate)1	*0.9*		*1.8*		*0.8*		*2.9*		*1.0*		*1.28*	
Changes in tax policies	*0.1*		*0.9*		*0.3*		*0.5*		*0.4*		*0.77*	
Other administrative price changes	*0.8*		*0.9*		*0.5*		*2.4*		*0.5*		*0.51*	

1) direct effect
1) EE in 2006 inc. increase of excise duty on tabacco introduced in July 2005
x) inc. Sewerage
xx) assumption
x) inc. Sewerage in Tallinn

Source: Czech R. - MOF; Hungary - CB; Estonia - MOF.

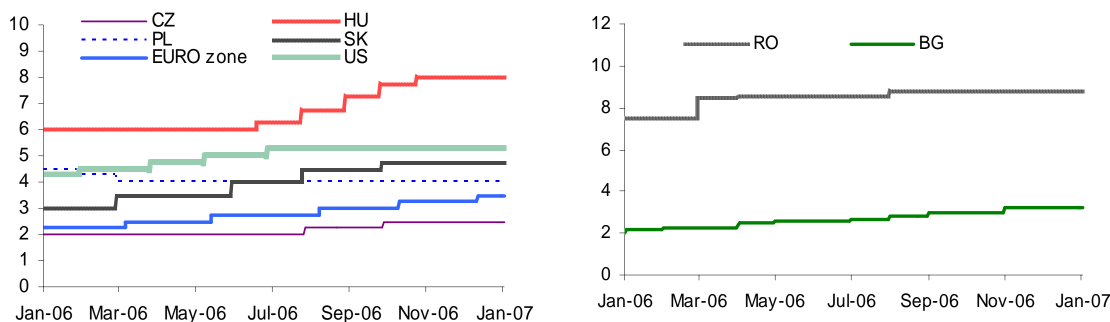
Inflation pressures are delaying euro adoption plans in the Baltic States and could cause problems also in Slovakia. According to official government projections and other sources, inflation in the Baltic States is likely to slow down only during 2008 thus probably delaying euro adoption prospects to 2010. In Slovakia, currency appreciation and the decision to cut or stabilize key prices such as gas and electricity are expected to help achieve the Maastricht inflation criteria in early 2008, but monetary policy faces a tough dilemma between securing low inflation and avoiding an excessive appreciation of the exchange rate. The key here is fiscal policy which may need to do more to not only safeguard the fiscal target but also help lower inflation.

With increasing inflationary pressures, most NMS with independent monetary policies followed the tightening cycle of the ECB (Chart 46). In Hungary, depreciation of the HUF in Q2-2006 and the risk of markedly higher inflation prompted the central bank (MNB) to raise interest rates by 200bps to 8.0% between June and October. With a strengthening HUF, the MNB opted to keep rates on hold in November and December. In Slovakia, the NBS continued its tightening cycle with increases in key

[7] Gazprom, the main supplier of natural gas to the Baltic States, has indicated that prices will be increased to Western European levels by 2008.

interest rates by 75 bps in Q3-2006 (50 bps in July and an additional 25 bps in September) but left interest rates on hold in Q4 with the koruna appreciating sharply against the euro and the regulatory decisions regarding energy prices for 2007 improving the inflation outlook. In Czech Republic, a worsening fiscal outlook prompted the CNB to tighten monetary policy by 50bps in two steps in July and September. The benchmark 2-week repo rate was raised to 2.50 %, but remained the lowest in the EU. Romania also nudged interest rates higher. Meanwhile, Poland kept interest rates unchanged following a cut earlier in the year as inflation continued well below NBP targets while concerns about 2007-08 mounted.

Chart 46. Key Central Bank Interest Rates (%)



Source: CBs.

Public Finances[8]

Fiscal deficits in several NMS widened in 2006 despite strong growth and buoyant revenues. The fiscal deficit increased most dramatically in Hungary, where it widened to 10% of GDP, but also increased significantly in Romania, Slovakia, Lithuania and Latvia (Table 5). In Romania, unbudgeted public sector wage increases added to the deficit, while Slovakia and the Czech Republic raised social spending. Estonia, Poland and Bulgaria managed to improve their fiscal positions, but only the latter two achieved a strengthening of their structural fiscal balances (while it deteriorated in Estonia and all other countries in the region). Bulgaria and Estonia were the only countries in the region where the budget was in surplus in 2006.

Budget plans for 2007 reveal a mixed picture and continuing spending pressures in most countries. Hungary plans a strong fiscal tightening, with a reduction in the general government deficit of more than 3pps of GDP, as part of its much needed medium-term fiscal consolidation and reform program. Slovakia also aims to reverse the deterioration in public finances experienced in 2006, reducing the deficit to just below the Maastricht limit of 3% of GDP in 2007 in order to be able to adopt the euro from 2009. Poland plans to continue its process of gradual fiscal consolidation, although the deficit in 2007 would remain above the Maastricht limit. A small improvement is also in the cards in Lithuania. In contrast, fiscal deficits would widen in the Czech Republic, Latvia, and Romania, while the surplus would decline in Bulgaria and Estonia.

- In *Hungary,* the fiscal austerity program is based on a mix of tax increases and spending cuts. On the revenue side, the preferential VAT rate was raised from 15% to 20%, the rate of health insurance contributions increased, tax bases broadened, and a special 4% PIT rate added to the tax burden of the richest individuals. On the spending side, savings would be achieved through reducing the number of public employees, better coordinating public operations by avoiding duplications, spreading of e-government, improving the public administration system, reforming health care (including introducing co-payments, merging public providers and improving control over pharmaceutical subsidies), old-age retirement (including raising the early retirement age and adjusting the initial pension levels) and elementary and higher education systems (including introducing tuition fees in higher education and linking subsidies to performance measures) and better targeting price subsidies (on pharmaceuticals, gas and passenger transport). At the same time, the budget

[8] The discussion in the following draws on the updates of national Convergence Programs from December 2006, unless otherwise stated. GG balance includes the cost of pension reform where relevant.

is made more transparent through inclusion of the costs of motorway construction carried out by the public company AAK and replacement of regular bailouts of the public transport companies by public sector agreements for services. Furthermore, budgets will contain a special reserve which will reach 1% of GDP in 2009.

- In *Slovakia*, the government plans to increase current expenditures and thus boost domestic consumption while restricting capital expenditure. The budget is counting on savings in public procurement and public administration, which, although welcome, are politically difficult and thus fiscally risky.

- In the *Czech Republic*, higher social transfers and tax cuts for low-income households are undermining the previous fiscal consolidation and adding a strong pro-cyclical impulse to the already booming economy.

- In *Romania*, the 2007 budget is based on optimistic revenue projections and seemingly underestimated expenditures (which do not include funds for statutory wage increases). On the other hand, the budget allocates 9.7% of GDP for fixed investments (compared with realized 3.8% of GDP in 2005 and planned 6.1% of GDP 2006), which, likely to remain unspent, could be reallocated to current spending during the course of the year.

- In *Bulgaria*, 2007 budget plans entail a sizeable pro-cyclical fiscal impulse to the economy. However, the budget provides for saving of 10% of budgeted primary spending with the purpose of achieving a surplus of at least 2% of GDP in case of heightened external risks. A contingency of 0.6% of GDP planned in the budget could provide a cushion in this regard. The corporate income tax rate was cut by 5 percentage points to 10%. This is expected to be offset to some extent by increases in excise rates and introduction of excises on coke, coal, and electricity. Further cuts in the social contribution rate (by 3 percentage points) have been postponed until mid-2007 depending on budget execution. The budget focuses on social welfare and increased capital spending and confirms reform inertia, including in public finance management and administrative capacity building.

- *Latvia* has been forced to delay planned cuts in income tax rates to at least 2009.

Poland and the Czech Republic both plan to reduce their fiscal deficits to just below 3% of GDP by 2009, while it would remain slightly above the critical threshold in Hungary (Table 6). Bulgaria and Estonia would remain in surplus over the medium term, while Lithuania would eliminate its small deficit by 2009. Romania, which also satisfies the Maastricht limit, would gradually bring back its deficit in 2008-09 following the ongoing expansion, while Slovakia plans a significant further adjustment in 2008 but a slight reversal in 2009.

Expenditure levels in the region would tend to converge somewhat over the medium term, although sizeable differences would remain. Spending levels would decline in the higher spending countries, notably Hungary, Poland and Slovenia, although remain broadly unchanged in the Czech Republic. Among the lower spending countries, spending would rise in Lithuania but decline further in Estonia and remarkably also in Slovakia. Bulgaria and especially Romania would see spending rise further from current moderate-high levels. By 2009, spending levels would range from a low of 33% of GDP in Slovakia to a high of 47% of GDP in Hungary, with most other countries clustered around 40% of GDP.

Table 5. General Government Balance (% of GDP)

	National Convergence Program					European Commission/WB*		
	2005	2006f	2007f	2008f	2009f	2006f	2007f	2008f
Headline GG balance								
Bulgaria	2.4	3.2	0.8	1.5	1.5	3.3	1.8	1.7
Czech Republic	-3.6	-3.5	-4.0	-3.5	-3.0	-3.5	-3.6	-3.2
Estonia	2.3	2.6	1.2	1.3	1.6	2.5	1.6	1.3
Hungary	-7.8	-10.1	-6.8	-4.3	-3.2	-10.1	-7.4	-5.6
Latvia	0.1	-0.4	-1.3	-0.9	-0.4	-1.0	-1.2	-1.2
Lithuania	-0.5	-1.2	-0.9	-0.5	0.0	-1.0	-1.2	-1.3
Poland	-4.3	-3.9	-3.4	-3.1	-2.9	-4.2	-3.9	-3.7
Romania	-0.8	-2.3	-2.7	-2.4	-1.9	-1.4	-2.6	-2.6
Slovakia	-3.1	-3.7	-2.9	-2.4	-1.9	-3.4	-3.0	-2.9
Slovenia	-1.4	-1.6	-1.5	-1.6	-1.0	-1.6	-1.6	-1.5
Structural budget balance								
Bulgaria	2.4	2.9	0.4	1.0	1.1	..	..	..
Czech Republic	-3.6	-3.8	-4.2	-3.6	-3.0	-3.6	-4.1	-3.8
Estonia	2.1	1.7	0.6	1.2	1.6	1.5	1.0	1.3
Hungary	-8.1	-9.7	-5.7	-3.8	-2.8	-10.3	-6.5	-5.1
Latvia	0.0	-0.9	-1.8	-1.1	-0.5	-1.3	-1.3	-0.9
Lithuania	-1.0	-2.0	-1.7	-1.0	-0.2	-1.4	-1.4	-1.2
Poland	-4.1	-3.9	-3.4	-3.1	-3.0	-4.3	-4.0	-3.7
Romania	-1.8	-3.3	-3.7	-3.4	-2.7	..	..	..
Slovakia	-2.3	-3.8	-3.0	-2.5	-1.9	-3.3	-3.3	-3.3
Slovenia	-1.2	-1.7	-1.6	-1.8	-1.0	-1.5	-1.6	-1.7
Consolidation effort								
Bulgaria	..	0.6	-2.6	0.6	0.1	..	..	..
Czech Republic	..	-0.2	-0.4	0.6	0.6	0.0	-0.5	0.3
Estonia	..	-0.4	-1.1	0.6	0.4	-0.6	-0.5	0.3
Hungary	..	-1.5	4.1	1.8	1.0	-2.1	3.9	1.3
Latvia	..	-0.9	-0.9	0.7	0.6	-1.3	0.0	0.4
Lithuania	..	-0.8	0.6	0.7	0.8	-0.2	0.3	0.2
Poland	..	0.4	0.5	0.4	0.3	0.0	0.3	0.4
Romania	..	-1.5	-0.4	0.4	0.6	..	..	..
Slovakia	..	-0.9	0.7	0.6	0.6	-0.4	-0.1	0.1
Slovenia	..	-0.5	0.1	-0.2	0.8	-0.3	-0.1	-0.1

Note: The structural balance equals the headline balance *minus* the cyclical component *minus* one-off measures. However, it includes the deficit due to the introduction of the 2nd pension pillar. Unlike the fiscal impulse, it does not adjust for the effect of EU funds. The consolidation effort equals the difference between the structural balance net of the 2nd pension pillar cost.

Source: EC (2006), Autumn Economic Forecasts; national Convergence Programs (December 2006 and January 2007); and WB staff (consolidation effort based on EC forecasts).

Capital spending plans diverge significantly in the region. Capital spending is set to rise further in Romania (where it would reach an incredible 9% of GDP) but also in the Czech Republic and Lithuania (to around 6% of GDP), while it would decline to a questionably low level in Slovakia (this may partly reflect the exclusion of highway construction from the GG budget). In most other countries in the region, capital spending would remain broadly stable at around 4% of GDP.

Social transfers would be rationalized in several countries. In particular, the high levels of social spending in Hungary, Poland, and Slovenia would be scaled back, but even in Estonia and particularly Slovakia - countries with relatively low levels of social spending – this category of spending would be compressed further. By 2009, social transfers would range from a high of 29% of GDP in Slovenia to a low of 10% of GDP in Romania (this may partly reflect classification differences).

Public wage bills would also be squeezed in a number of countries. Hungary, the Czech Republic, Poland and Slovakia all plan to reduce general government wage bills, while other countries in the region for which data is available would maintain these broadly stable. By 2009, the wage bill would range from a high of 10% of GDP in Hungary to a low of 6% of GDP in Bulgaria.

Table 6. Medium-Term Fiscal Plans (% of GDP)

Bulgaria	2005	2006	2007	2008	2009
GG Balance	2.4	3.2	0.8	1.5	1.5
Total revenue	42.4	41.5	41.8	41.8	41.7
Total expenditure	40.0	38.3	41.0	40.3	40.2
Collective consumption	9.8	9.1	9.0	9.1	9.2
Total social transfers	20.5	20.5	20.2	20.3	20.1
Interest	1.6	1.4	1.4	1.3	1.2
Subsidies	2.1	1.3	1.8	2.4	2.6
Gross fixed capital formation	3.1	4.0	4.1	4.3	4.2
Other	2.9	2.0	4.5	2.9	2.9
(compensation of employees)	6.4	5.8	6.0	6.0	5.9
Czech Republic					
	2005	2006	2007	2008	2009
GG Balance	-3.6	-3.5	-4.0	-3.5	-3.0
Total revenue	40.4	39.9	39.9	40.4	40.3
Total expenditure	44.0	43.4	43.9	43.9	43.2
Collective consumption	11.2	10.9	10.6	10.3	10.1
Total social transfers	22.7	22.6	23.0	23.0	22.5
Interest	1.2	1.2	1.4	1.5	1.5
Subsidies	1.9	1.9	1.9	1.8	1.7
Gross fixed capital formation	5.0	5.1	5.2	5.6	5.7
Other	2.2	1.8	1.8	1.7	1.7
(compensation of employees)	8.0	7.7	7.6	7.4	7.2
Estonia					
	2005	2006	2007	2008	2009
GG Balance	2.3	2.6	1.2	1.3	1.6
Total revenue	35.5	38.3	37.8	36.9	36.2
Total expenditure	33.2	35.7	36.6	35.6	34.6
Collective consumption	7.9	8.3	8.3	8.2	8.0
Total social transfers	18.7	19.2	19.4	18.2	17.3
Interest	0.2	0.2	0.1	0.1	0.1
Subsidies	0.9	1.0	1.0	1.0	1.0
Gross fixed capital formation	3.2	3.6	3.8	4.0	3.8
Other	2.3	3.4	4.0	4.1	4.4
(compensation of employees)	9.4	9.2	9.2	9.1	9.0
Hungary					
	2005	2006	2007	2008	2009
GG Balance	-7.8	-10.1	-6.8	-4.3	-3.2
Total revenue	42.2	41.9	43.1	43.0	43.4
Total expenditure	50.0	52.0	49.9	47.3	46.6
Collective consumption	9.8	10.0	9.4	8.6	8.3
Total social transfers	27.2	28.4	27.2	26.7	25.6
Interest	4.1	3.9	4.4	4.3	4.1
Subsidies	1.3	1.2	1.3	1.3	1.2
Gross fixed capital formation	4.0	4.8	3.5	3.0	3.9
Other	3.6	3.7	4.1	3.4	3.5
(compensation of employees)	12.6	12.0	11.4	10.5	10.2
Lithuania					

Table 6. Medium-Term Fiscal Plans (% of GDP)

	2005	2006	2007	2008	2009
GG Balance	-0.5	-1.2	-0.9	-0.5	0.0
Total revenue	33.0	33.3	33.9	34.5	35.9
Total expenditure	33.5	34.5	34.8	35.0	35.9
Collective consumption	7.1	6.9	6.3	6.0	5.9
Total social transfers	18.5	19.5	19.5	19.5	19.6
Interest	0.8	0.8	0.9	0.9	0.8
Subsidies	0.7	0.7	0.8	0.8	0.8
Gross fixed capital formation	3.5	3.7	4.2	4.5	5.1
Other	2.9	2.9	3.1	3.3	3.7
(compensation of employees)	na				

Latvia

	2005	2006	2007	2008	2009
GG Balance	0.1	-0.4	-1.3	-0.9	-0.4
Total revenue	36.2	37.5	38.2	38.6	39.0
Total expenditure	36.1	37.9	39.5	39.5	39.4
Collective consumption	8.7	12.7	14.2	14.4	13.9
Total social transfers	8.9	8.0	7.5	7.4	6.9
Interest	0.6	0.5	0.5	0.5	0.5
Subsidies	0.5	0.6	0.2	0.2	0.2
Gross fixed capital formation	2.3	3.0	3.7	4.3	5.1
Other	15.1	13.1	13.4	12.7	12.8
(compensation of employees)	10.1	9.5	9.2	8.9	8.7

Poland

	2005	2006	2007	2008	2009
GG Balance	-4.3	-3.9	-3.4	-3.1	-2.9
Total revenue	39.1	39.8	40.4	39.5	37.7
Total expenditure	43.4	43.7	43.8	42.6	40.6
Collective consumption	8.0	7.8	7.8	7.5	7.0
Total social transfers	26.1	25.3	24.8	24.1	23.0
Interest	2.6	2.4	2.4	2.4	2.4
Subsidies	0.6	0.9	0.9	0.9	0.9
Gross fixed capital formation	3.4	3.8	4.6	4.3	4.2
Other	2.7	3.5	3.3	3.4	3.1
(compensation of employees)	10.1	10.3	10.1	9.5	9.0

Romania

	2005	2006	2007	2008	2009
GG Balance	-0.8	-2.3	-2.7	-2.4	-1.9
Total revenue	32.8	33.9	36.5	37.2	37.9
Total expenditure	33.6	36.2	39.2	39.6	39.8
Collective consumption	8.8	8.3	8.8	8.3	8.6
Total social transfers	10.1	9.6	9.9	10.2	9.6
Interest	1.1	1.1	1.1	1.1	1.0
Subsidies	1.7	1.5	1.0	0.9	0.9
Gross fixed capital formation	3.8	6.1	9.7	9.3	8.7
Other	8.1	9.6	8.7	9.8	11.0
(compensation of employees)	n/a				

Slovakia

	2005	2006	2007	2008	2009
GG Balance	-3.1	-3.7	-2.9	-1.5	-1.9
Total revenue	33.9	32.6	31.7	32.1	31.1
Total expenditure	37.0	36.3	34.6	33.6	33.0
Collective consumption	10.9	10.8	10.2	10.0	9.9
Total social transfers	15.3	15.3	14.9	14.4	14.1
Interest	1.7	1.8	2.0	1.9	1.8
Subsidies	1.3	1.3	1.3	1.3	1.3

Table 6. Medium-Term Fiscal Plans (% of GDP)					
Gross fixed capital formation	2.1	1.8	1.4	1.2	1.1
Other	5.7	5.3	4.8	4.8	4.8
(compensation of employees)	7.3	7.3	7.0	6.8	6.7
Slovenia					
	2005	2006	2007	2008	2009
GG Balance	-1.4	-1.6	-1.5	-1.6	-1.0
Total revenue	45.8	45.1	43.6	42.7	41.7
Total expenditure	47.2	46.7	45.1	44.3	42.7
Collective consumption	7.5	7.6	7.5	7.5	7.3
Total social transfers	30.8	30.5	29.9	29.5	28.5
Interest	1.8	1.7	1.4	1.3	1.3
Subsidies	1.4	1.4	1.3	1.5	1.4
Gross fixed capital formation	3.3	3.4	3.2	2.7	2.5
Other	2.4	2.1	1.8	1.8	1.7
(compensation of employees)	na				

Source: National Convergence Programs, December 2006 and January 2007; Medium Term Outlook for Czech Republic; and WB staff (revenue for Poland, which includes also lost income due to 2nd pension pillar).

Plans for the use of EU funds structural funds in 2007-2013 vary substantially. Plans for these resources are outlined in the required National Strategic Reference Frameworks (NSRFs) and are focused on the EU strategic priorities and Lisbon objectives of sustainable growth, competitiveness and employment. However, allocations among the various strategic priorities differ significantly across the NMS with a few emphasizing the environment and others giving much greater weight to transport and infrastructure. Furthermore, there is significant variation in the share of total structural resources that would be under management of local governments in the countries (ANNEX 2).

Structural Reforms

Countries in the region continue pursuing privatization and improvements to the business climate, but the pace of further reform is slow and the pace of convergence towards EU-15 standards remains disappointing, especially in governance, institutional reform and market regulation. The declining popular support for painful reforms partly explains the slow pace of reform implementation in the above areas, and even reversals of reforms already undertaken. The situation has been complicated, in some of the countries by incessant political disputes and weak, multi-color coalition governments which struggle to overcome visible internal differences vis-à-vis the direction of critical policies.

While in most countries, public governance appears to be improving according to statistics capturing various degrees of progress in the fight against corruption, the outcomes and standards remain below EU15 levels. In particular, the functioning of the judiciary in the new entrants, Bulgaria and Romania, constitutes a source of concern for the EU. Two recent reports, the EBRD *Transition Report 2006* and the World Bank *Doing Business 2007*, find that some indicators of business regulation and competitiveness remain poor or have even worsened. These include dealing with licences, hiring or firing workers, enforcing contracts or closing a business. In addition, the pace of improvement in the delivery of public services, mainly in health, education and housing, has been slow.

Table 7.EBRD Transition Indicators (2006).										
Country	Private sector share of GDP (EBRD estimate %)	Enterprises			Markets and trade			Financial institutions		Infrastructure
		Large-scale privatization	Small-scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalization	Securities markets and non-bank financial institutions	Infrastructure reform
Bulgaria	75	4	4	3-	4+	4+	3-	4-	3-	3
Czech Republic	80	4	4+	3+	4+	4+	3	4	4-	3+
Estonia	80	4	4+	4-	4+	4+	4-	4	4-	3+
Hungary	80	4	4+	4-	4+	4+	3+	4	4	4-
Latvia	70	4-	4+	3	4+	4+	3	4-	3	3
Lithuania	75	4	4+	3	4+	4+	3+	4-	3	3
Poland	75	3+	4+	4-	4+	4+	3	4-	4-	3+
Romania	70	4-	4-	3-	4+	4+	3-	3	2	3+
Slovak Republic	80	4	4+	4-	4+	4+	3+	4-	3	3-
Slovenia	65	3	4+	3	4	4+	3-	3+	3-	3

Note: The indicators range from 1 to 4+. 4+ represents the standards of an industrialized market economy.
Source: EBRD Transition Report, 2006.

With around 65-80% of GDP already generated by the private sector, disposing of the remaining state assets, particularly in "strategic sectors", has proven a major challenge for the governments of the NMS. This comes after a period of notable advancements made in enterprise privatization, banking sector reforms, and price and trade liberalization before accession into the EU. Uncertainty related to the stability of energy supply has reached new heights and has occasionally led to calls for reviewing past privatization contracts and for a shift in approach, with some governments signaling intentions to play an increased role in regulating the sector, including in tariffs setting. The upgrade of infrastructure is also slow, signaling weak project implementation capacity, despite the generous financial support coming from the EU under the structural and cohesion funds. Recent reports suggest that the absorption rate of the 2004-06 structural and cohesion funds has been disappointing.

In Bulgaria, with the privatization of most large SOEs already completed, the focus is now on the remaining, predominantly small, enterprises, whose transfer into private ownership continues at a slow pace. A number of SOEs in the energy sector were privatized in 2006, mainly sold to foreign investors. However, only 6 out of the 24 enterprises planned for privatization in 2006 had been sold by November. In October, the Privatization Authority selected the winning bidder for DHC Plovdiv and for the re-nationalized air company, Bulgaria Air. Some of the remaining planned privatization deals, especially in transport, such as the Bulgaria Maritime Fleet, and in the defense industry, are still at an early the stage. Further:

- The National Revenue Agency, which integrated the collection of tax and social contributions, started operation on January 3, 2006 under a modern legal framework and organization, which is expected to further reduce compliance costs to businesses. Recently a new information system was put into operation, which would increase the efficiency of revenue administration.

- The start-up of the new business registration system has been postponed to July 2007. The reform of the existing system is intended to streamline the entry of new firms by transferring the responsibility for registration from the courts to a specially created agency.

- Administrative measures introduced in 2005 and 2006 aimed at slowing down bank lending were removed from January 2007.

- In education, the financing mechanism of schools was changed to a unified per capita formula which is expected to provide incentives for improving the efficiency of government spending on education and further optimization of the school network.

In the Czech Republic, the only privatization that is currently underway is of Aero Vodochody (a military jet maker). The sale of other state assets such as the Czech Airlines (CSA), the Czech Telecom, the airport operator Letistě Praha and the postal system is planned for 2007. The ODS and CSSD also reached a compromise regarding the privatization of the power utility CEZ whereby 5.5 % of CEZ shares (instead of the planned 16%) would be sold. The sale is expected some time in 2007. Further:

- Measures to improve the business environment include a new bankruptcy law that will come into force from July 1, 2007, strengthening the position of creditors, limiting possibilities of dragging bankruptcies and making it possible for the viable parts of firms to continue business activity. Also, an amendment to the trade law came into force in July 2006 allowing entrepreneurs to register directly at the trade office, including tax, social and healthcare insurance registration.

- Domestic political uncertainty undermines short-term prospects for needed pension and healthcare reforms.

In Estonia, the government agreed to terminate the privatization agreement of Eesti Raudtee (Estonian Railway) and repurchase the majority shares (66%). The repurchase was endorsed by parliament along with the state budget for 2007 and the deal amounting to 2.35m EEK (150m EUR) was sealed in early January. The decision ends a long dispute with the Baltic Rail Services (BRS), the consortium that bought the majority holding from the state when the rail company was privatized in 2001.

In Hungary, an ambitious and comprehensive public finance consolidation and reform plan, which includes the reform of central and local governments, education, healthcare and pensions, was outlined in the Convergence Program released in September. Most of the envisaged reform measures do not require a qualified majority in parliament and therefore could pass without the support from the opposition Fidesz. One notable exception is the municipal finance reform, an area where progress appears to be slow. The European Commission supports the corrective measures in principle, but has expressed reservations about the feasibility of some of the reforms. Although the implementation of the reform plan will probably take several years, some progress is already visible:

- The healthcare reform agenda appears to be the most advanced, and a number of draft laws were expected to be adopted before end-2006. In particular, these laws would strengthen the link between individuals' use of healthcare services and their payments into the social security funds.

- Education reform is also under way, with a number of laws already adopted by parliament. These should pave the way for the introduction of tuition fees from 2008.

- Pension reform is a long-term project, but changes in the rules for early retirement and disability pensions are in the pipeline for 2007.

- Public sector reform is also planned, although the reduction in public sector staff is only going to lead to budget improvements in the second half of 2007 and previous plans have been difficult to implement.

In Latvia, the government's 38.6% stake in Ventspils Nafta was sold to the oil and gas company Vitol Group in October. The government decided in October that the Hipoteku un zemes banka will not be privatized, but converted into a development bank responsible for implementing and administrating state aid programs. Progress is also being made on public financial management reforms, including the introduction of a Medium-Term Expenditure Framework.

In Lithuania, the sale of Mazeikiu Nafta (MN), the sole Baltic oil refining and transportation complex, to the Polish oil concern PKN Orlen was closed in mid-December. PKN Orlen now has an 84.36% interest in MN, having also acquired the 54% share held by Russia`s bankrupt oil company Yukos. Since the initial agreements were signed in May 2006, the Lithuanian oil complex has been dogged by problems including a halt in supplies of crude by pipeline from Russia, a shutdown of its

offshore oil terminal for repairs, and an accidental fire that significantly reduced the refining capacity of the plant in October.

In Poland, privatization has slowed down significantly, with only 10% of the annual target fulfilled by the end of October. Improvements in the quality of the business environment continue, with the Act on Economic Freedom proposing simplifications in business start-up procedures under discussion in Parliament. The Ministry of Economy hopes that a one-stop facility for firm registration could be introduced in late 2008. The Ministry of Justice is working on a comprehensive judicial reform, and while the details of the program are yet to be spelled out, it is expected that the enforcement of contracts (where Poland scores among the lowest in the region according to the World Bank Doing Business 2007 report) would be improved. Also worth noting:

- The government has decided to give the voivod (the representative of the government in the regions) the right to veto projects prepared by the regional governments to be financed from EU funds. This would obviously strengthen the role of the central government in the allocation of EU funds.

- The government has decided that high-level civil servants will be exempt from passing the Civil Service state examinations. This is widely seen as a way of politicizing senior civil service positions.

In Romania, the government has decided to stop the privatization process of the CEC Savings Bank following a “disappointing” financial offer for the bank. The government now wants to recapitalize the bank and improve its efficiency. In an unusual call, the President has asked the Ministry of Economy not to speed up the privatization process in the energy sector, especially that of the state-owned gas producer Romgaz. Privatization would only be resumed after closely analyzing the results of the privatizations carried out so far in the sector, including the sale of the oil company Petrom. Several months ago, Petrom, controlled by OMV of Austria, and natural gas distributors started price-related disputes. Petrom asked for natural gas prices higher than the ones set by the National Regulatory Authority, and natural gas distributors Distrigaz Nord and Distrigaz Sud did not sign the contracts given the price imposed by Petrom. This has led to a political and public debate about the transparency of the privatization contracts and the impact of the sales on tariffs and the quality of services offered by the utilities. Also:

- The Oversight Commission for the Private Pension System (CSSPP) initiated the procedure for authorizing voluntary pension funds and 10-15 companies are expected to submit the documentation necessary to obtain the status of fund administrator. The procedures should conclude at the end of January 2007 and the authorities should then start collecting the first contributions to the system. The law on voluntary pensions came into force in March 2006.

In Slovakia, the new government has been more cautious than initially feared in reversing some of the decisions of its predecessor. In health, the government abolished patient co-payments and removed the applicability of bankruptcy and execution legislation to healthcare providers. The decision was, however, suspended by the Constitutional Court and a final ruling is pending. Health providers are the main debtors to the Social Insurance Agency (SIA) and their arrears appear to be increasing. The government has also increased the state allowance for the first born child and is considering making the second pension pillar voluntary for new entrants to the labor market as well as allowing those who switched to return to the first pillar. The Labor Code is under discussion with labor unions with the expectation of making it more labor friendly. Further:

- Parliament has revised the Income and Value Added Tax Act. While the flat tax rate has been maintained, tax allowances will gradually decrease to zero for those earning annual incomes higher than SK 600,000 (EUR 17,000), a move tantamount to reintroducing progressive tax rates. Similarly, a reduced 10% VAT rate was introduced for medical products and devices.

- The privatization of companies deemed strategic, such as the Bratislava airport and the rail transport firm ZSSK Cargo, has been explicitly ruled out by the government. In November,

the cabinet proposed amendments to the act on regulation of network industries in order to allow increased government oversight of energy prices.

In Slovenia, substantial stakes in the state telecommunications firm, Telekom Slovenije (TS), and in the second-largest bank, Nova Kreditna Banka Maribor (NKBM), are due to be sold. The government's intention is to reduce its holdings in TS and NKBM to 25% (plus one share) each, from 74% and 90%, respectively. However, the transactions will take time, and there is only a slim chance that they will be completed before 2008. The prospects for further privatizations might be affected by the decision to prevent Belgium's KBC from acquiring a majority stake in Slovenia's largest bank, Nova Ljubljanska Banka (NLB), and by KBC's subsequent decision to dispose of its existing stake. Also:

- The government has apparently abandoned the idea of extending the flat tax to personal income. The tax reform approved in November 2006 will cut the number of tax brackets from five to three, and the top marginal rate of personal income tax from 50% to 41%. The corporate income tax rate will be reduced from the current rate of 25% to 23% in 2007 and further to 20% by 2010. The government is keeping open the option of raising the VAT rate to make up for any revenue shortfall.

- Labor market reform is expected to proceed only slowly. Trade unions oppose the government's efforts to reduce the scope for industry-wide collective bargaining and to weaken employment protection in the public sector. Negotiations between the government, employers and the unions on the social agreement through 2009 are ongoing, but expected to make slow progress.

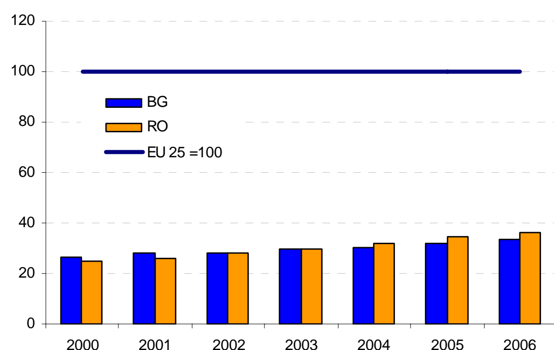
ANNEX 1. BULGARIA AND ROMANIA IN THE EUROPEAN UNION

As of January 1, 2007, Bulgaria and Romania have joined the European Union, following the recommendation of the European Commission in its September 26 Monitoring Report and the ratification of the Accession Treaties by the national parliaments of the EU-25 states. The Commission will however monitor closely progress in improving the functioning of the judiciary, fighting corruption, implementing the acquis and the use of the structural and cohesion funds. Bulgaria and Romania will report regularly on progress in addressing specific benchmarks, with submission of the first reports expected by end-March 2007. Delays in these fields could potentially lead to the activation of safeguard clauses envisaged in the Accession Treaty.

The prospects of joining the EU club constituted a solid external anchor for the transformation of the two countries throughout their uneven transition. Nevertheless, accession to the Union and the adoption of EU standards is neither the beginning nor the end of the integration process. The unfinished reform agenda remains large and the structural adjustment of the two countries needs to continue. Membership opens a broad range of opportunities, including access to generous EU funds. It also adds to the existing challenges, many coming from the commitment to implement the provisions of the acquis and cope with the rigors imposed by membership.

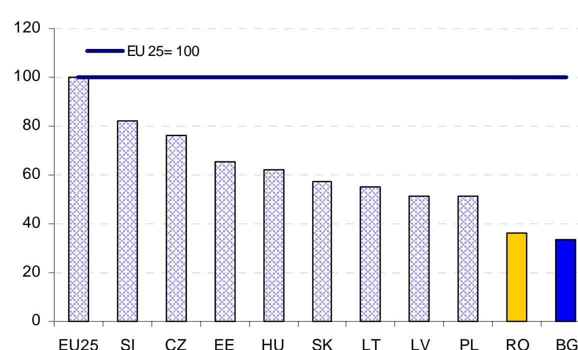
Bulgaria and Romania are steadily converging in income, competitiveness and living standards towards the EU, but the gap remains large. After a slow start, at the beginning of the transition, and uneven progress during the mid-nineties, culminating in a crisis in Bulgaria, the opening of the negotiations for accession in December 1999 brought back the momentum for reforms. Negotiations were closed in 2004, paving the way for accession in 2007. Consistent improvement in macroeconomic policies and important advances in structural reforms have placed Bulgaria and Romania on a steady path towards real and nominal convergence with the EU.

Chart 47. GDP per capita (% of EU25)



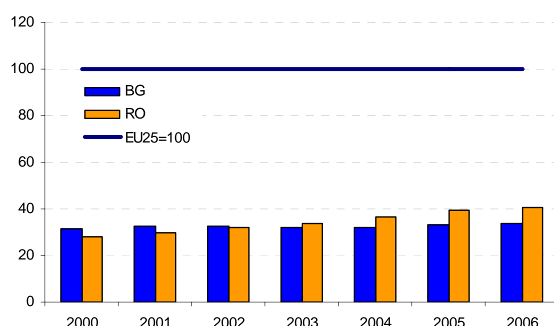
Source: Eurostat.

Chart 48. GDP per capita (PPS, 2006*)



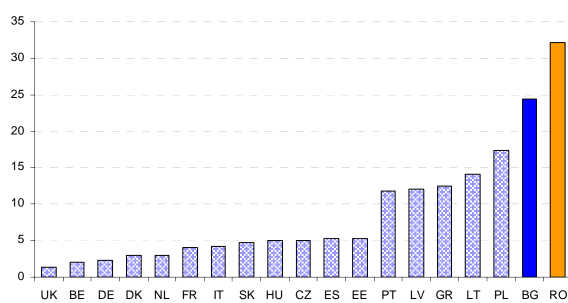
Source: Eurostat forecast.*

Chart 49. Labor Productivity (% of EU25)



Source: Eurostat.

Chart 50. Employment in Agriculture (% of total employment)

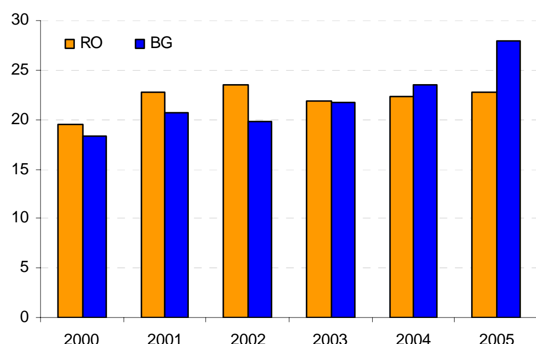


Source: CSOs.

Economic growth has been robust in recent years, driven by productivity gains, innovation, a better allocation of resources, and, occasionally, excess demand. The gradual liberalization of

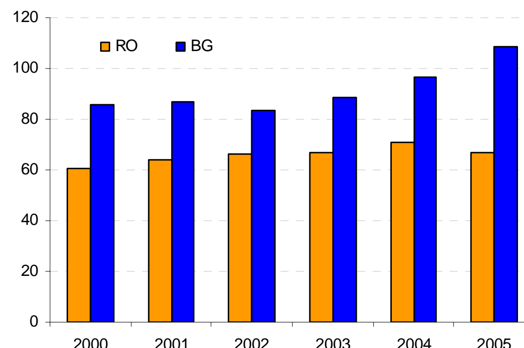
trade with the EU has led to integration with the EU single market. Currently, 56% of Bulgaria's and over 65% of Romania's trade is with the EU, figures comparable with the intra-EU trade. Driven by strong FDI inflows, estimated at 14.8% of GDP in Bulgaria and 7.2% of GDP[9] in Romania in 2006, the share of goods of higher technological complexity in the exports of the two countries has increased.

Chart 51. Investment (% of GDP)



Source: EBRD.

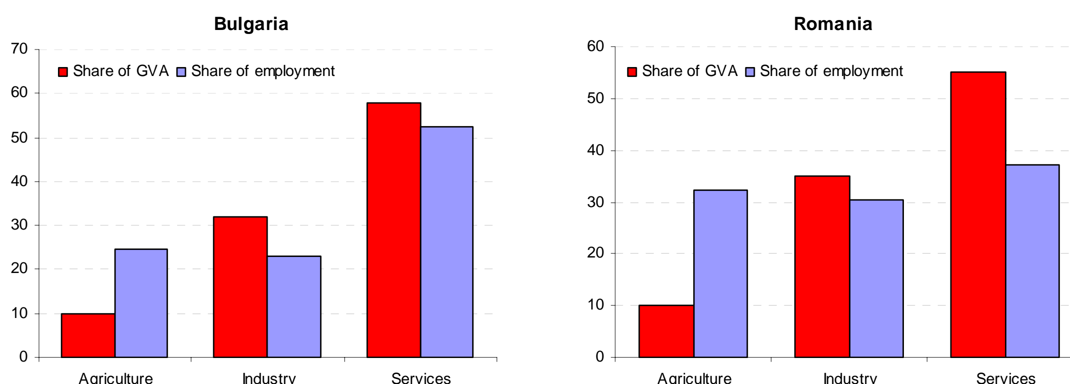
Chart 52. Trade (exports plus imports, % of GDP)



Source: EBRD.

Important and persistent rigidities in the structures of the two economies represent key challenges to sustaining the current high economic growth over the long run, and to broadening the distribution of its benefits. Labor participation and employment (55.8% in Bulgaria, 57.6% in Romania) are well below the EU-15 average (65.2%). The share of the agricultural sector remains unsustainably high, accounting for 8-11% of GDP and 25-32% employment. Employment in services is well below the EU average. Disparities between the urban and the large rural sectors, as well as between regions, are widening. Around 40% of Romania's and 30% of Bulgaria's population lives in the rural area. Poverty remains high and the pick up in economic activity has failed to filter through to important social categories.

Chart 53. Structure of GVA and Employment (2005)

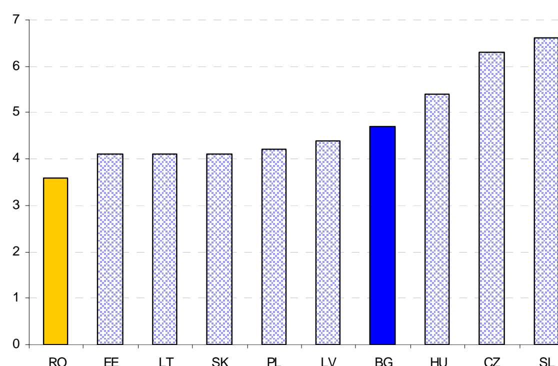


Source: Eurostat.

The gradual opening of the national EU-25 labor markets to the workforce from Bulgaria and Romania is likely to widen the mismatch between supply and demand in segments of the labor market in the two countries. A large number of Bulgarians and Romanians already work, mostly informally, in other European countries. Rough estimates suggest these include up to one million Bulgarians and between 1.5-2 million Romanians. This has raised some concerns about the resulting shortages of labor at home and upward pressure on wages. These concerns seem to start materialize as both unskilled (construction, tourism and agricultural workers) as well as skilled (IT specialists, doctors, nurses, engineers) labor shortages are increasingly visible.

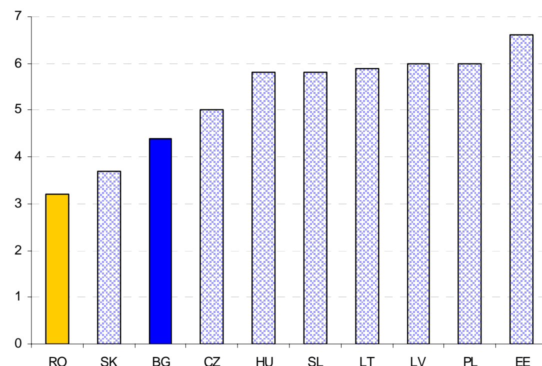
[9] Net FDI.

Chart 54. Government Expenditure on Health (% of GDP, 2004*)



Source: Eurostat ; BG, RO* national sources, 2005*

Chart 55. Government Expenditure on Education (% of GDP, 2004*)



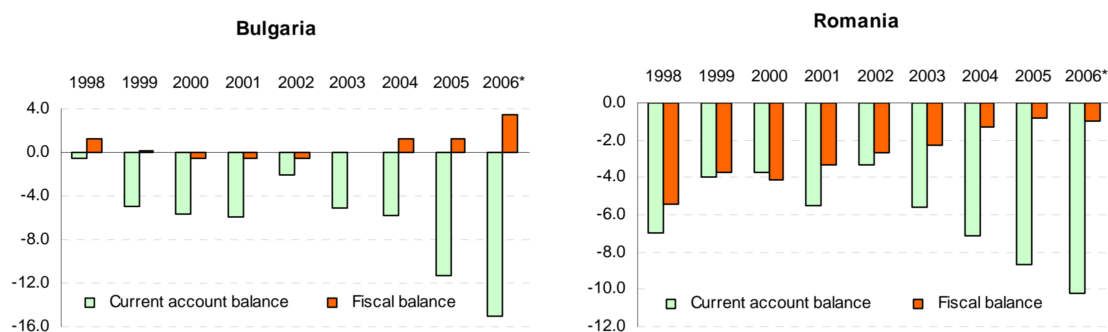
Source: Eurostat; BG, RO* national sources, 2005*

The attention dedicated to human capital development remains limited. To maintain productivity growth, enhance competitiveness, and address skills mismatches, the two countries would need to invest more, and more effectively, in building, maintaining and protecting their human capital pool in a fiscally sustainable manner. The education, health and social protection systems, in particular, require attention. Improving the efficiency and efficacy of spending on education and health by dealing with the overcapacity in the sectors and focusing on the quality of outputs should be seen as a priority of the public sector modernization agenda. Both countries score low on the Human Development Index (HDI). Bulgaria has a HDI of 0.81, while Romania scores 0.80, well behind the Czech Rep. (0.88), Hungary (0.87) or Poland (0.86). The quality of education needs improvement, as the outcome indicators of educational achievement are lower than those of the OECD and other EU members. Most health indicators are also poorer, or significantly poorer, than EU averages and life expectancy at birth is among the lowest in Europe.

Macroeconomic policy frameworks and outcomes have improved, but vulnerabilities remain. Spurred by EU aspirations, macroeconomic stabilization has continued in both countries. Inflation has been on a downward trend, driven by relatively tight incomes (reversed lately in Romania) and monetary policies (currency board in Bulgaria) and disciplined fiscal policy, particularly in Bulgaria. Both countries have succeeded to gradually reduce the main inflationary pressures, especially by cutting quasi-fiscal deficits, eliminating direct financing by central banks of budget deficits, and tightening revenue policies. However, inflation rates in both countries remain, at around 5-6%, above EU levels. Fiscal consolidation has advanced, with Bulgaria consistently running surpluses, and Romania reducing until recently the deficits of the general government budget.

At the same time, external imbalances have widened, and both countries run large current account deficits, in Romania further fuelled by strong credit growth to the private sector. Acceleration of economic growth, the opening of the capital account and improved access to credit have spurred final consumption and investment, suggesting that strong demand pressures are likely to continue. On the positive side, the increasing current account deficit is fully (Bulgaria) or mostly (Romania) covered by non-debt creating inflows (FDI) and in Bulgaria portfolio and banking sector flows remain rather limited. The situation seems to be less sound in Romania where FDI inflows reflect to some extent privatization receipts (as suggested by a significant increase in reserves) which are likely to decline in the years to come, possibly resulting in increased vulnerability. Moreover the banking sector seem to play much more important role in financing the current account deficit than in Bulgaria.

Chart 56. Fiscal and Current Account Balances (% of GDP)

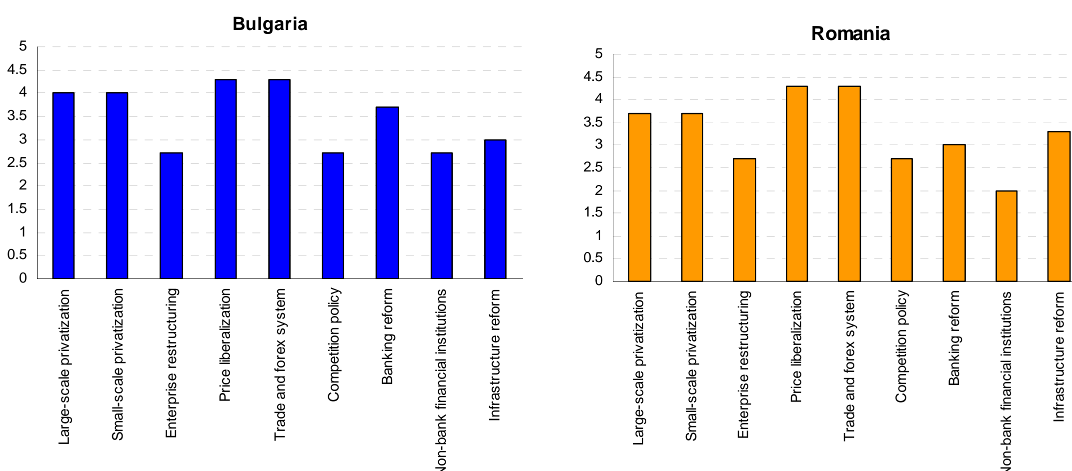


Source: World Bank.

A principal dilemma for policymaking over the coming years will be how to reconcile the need to further consolidate macroeconomic stability with the need to implement the substantial acquis commitments, especially in infrastructure and environment. This is all the more challenging given the stated intention of the two countries to join the EMU around 2010-2012. The significant costs associated with the acquis are expected to put additional pressure on spending and deficits and risk accelerating public expenditure to unsustainable levels. To prevent this, tight expenditure management controls and mechanisms, restructuring of current expenditure and a strong revenue base are required. Identifying ways to effectively bring in the private sector to share the integration costs will be key to success.

Strongly anchored to their EU commitments, structural reforms continue to advance, but reform fatigue is becoming increasingly visible. Both Bulgaria and Romania have made important strides to enhance structural adjustment. The financial sector, especially banking, has been substantially strengthened and almost fully privatized. Privatization of SOEs is almost complete in Bulgaria and has advanced decisively in Romania. Prices have been liberalized and utility tariffs are gradually being adjusted upwards towards EU levels. Competition and the business environment have been consolidated.

Chart 57. EBRD Transition Indicators (2006)



Source: EBRD Transition Report 2006.

At the same time, the unfinished reform agenda remains large, and weaknesses continue to surface. There is a clear risk of reform *fatigue*, already visible in many of the EU-8 countries. Privatization has slowed down in Romania, especially in energy generation, while the procedures and review mechanisms for appeals of past privatization are cumbersome in Bulgaria. The deregulation of the labor and product markets needs to continue. Rigidities in the functioning of the markets remain, affecting the transaction costs of companies and obstructing the reallocation of resources, including of labor, towards better ends. Despite undeniable improvement in the World

Bank *Doing Business* ranking in 2007 (Romania being presented as one of the top ten reformers out of 175 countries), both countries still rank relatively low at ease of doing business - Romania 49th and Bulgaria 54th. Both countries score particularly low at ease of operating businesses and employing workers.

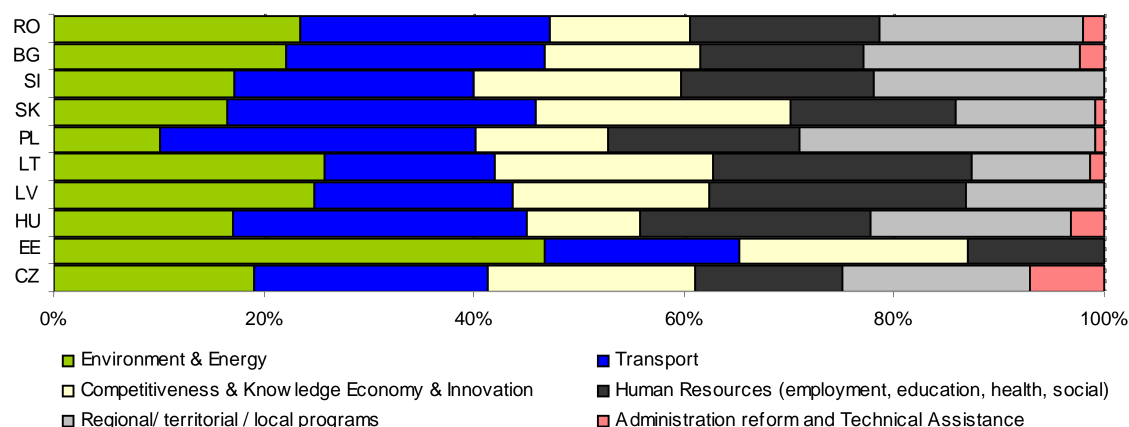
The consolidation of the governance and institutional framework is slower than expected and is a central cause of concern for the European institutions. Progress in strengthening the justice system and fighting corruption is limited, especially in Bulgaria. Modernizing the public sector and reforming public administration require additional sustained effort. Important capacity constraints at the level of implementing agencies and local governments limit the ability to absorb the large EU structural and cohesion grants that will be available after accession. Nevertheless, EU membership and the associated financial support place the two countries in a favorable position to address these challenges.

ANNEX 2. PREPARATION FOR EU STRUCTURAL FUNDS 2007-2013

All EU8+2 countries continue to prepare for the use of EU structural funds in the new financial perspective 2007-2013. The plans are outlined in the National Strategic Reference Frameworks[10] (NSRFs), key documents prepared in dialogue with the Commission, which will constitute the framework for preparing particular operational programs. The NSRFs must reflect the EU's strategic priorities and Lisbon objectives (sustainable growth, competitiveness and employment) as outlined in the Community Strategic Guidelines – CSG.[11] These guidelines set broad objectives for the structural funds in member states: (i) make Europe and its regions more attractive places to invest and work; (ii) improve knowledge and innovation for growth; and (iii) more and better jobs. These guidelines also refer to energy investments aimed at improving efficiency, which in some countries has over 20% of overall allocation. The documents are still subject to change (the deadline for submission is early March) and final appraisal by the Commission.

An overview of current versions of NSRFs and operational programs shows that allocation among the various strategic priorities in the EU8+2 countries differs significantly (Chart 58). While Estonia is clearly focused on environment and energy (46% of allocation), this priority received the lowest allocation in Poland (10%) and in other countries averaged 20%. However, as Poland targets 30% of funds on transport, the overall allocation for infrastructure investment exceeds 40% in all countries with Estonia being a clear outlier (65%). The allocation for the competitiveness and knowledge economy priority is somewhat higher in smaller countries (20% on average) while in Poland, Hungary, Bulgaria and Romania it is below 15%. On the other hand, the strategy to use structural funds in these four countries clearly has a more regional focus, notably in Poland with almost 30% of total structural funds to be under management of local governments in regions.

Chart 58. Allocation of EU Structural Funds (2007-13)



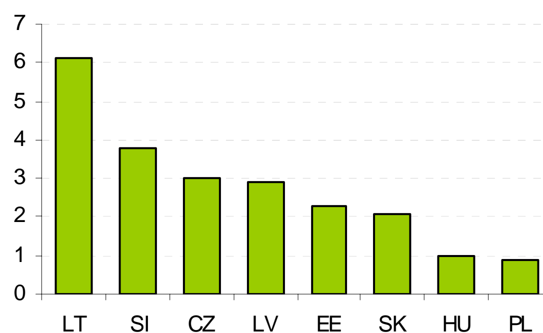
Source: National Strategic Reference Frameworks; draft Operational Programs; and staff calculations.

[10] Member states may also prepare a National Development Plan, but this is not obligatory.

[11] Community Strategic Guidelines proposed by the Commission were adopted by the Council on October 6, 2006. Following the adoption of the CSG, a member state has 5 months to present the NSRF and operational programs. The latter will be appraised by the EC based on their contribution to the goals and priorities of the NSRF and the CSGs. Within 2 months following the submission of the operational program, a member state may be invited to provide additional information or revise the proposed program.

Energy efficiency and renewable energy are at the top of the EU political agenda. These areas are also emphasized among the 12 priority headings for structural funds in the CSG. Furthermore, one of the 10 priority actions of the new EU Action Plan for Energy Efficiency is specifically targeted at spurring energy efficiency in the New Member States. However, these priorities have received limited attention in the draft operational programs. The analysis of energy measures and allocations suggests that sustainable energy issues featured substantially only in the Lithuanian draft plans (6% of total allocation) while in Poland and Hungary they received a mere 1% of total allocations.[12] This is in spite of the huge potential for energy savings in the NMS, where energy intensity is on average 50% higher than in the EU15.

Chart 59. Energy Efficiency/Renewable Energy Allocations (% of total structural funds allocation, 2007-13)



Source: Channeling EU funds into efficient and renewable energy. CEE Bankwatch and Friends of the Earth Europe, December 2006.

Czech Republic

Objective	Operational program	Share		Total allocation	million EUR, current prices		
					ERDF	ESF	CF
Convergence	OP Enterprise and Innovation	11.6	98.4	3041.3	3041.3		
	OP Research and Development for Innovation	7.9		2070.7	2070.7		
	OP Environment	18.7		4917.9	702.5		4215.4
	OP Transport	21.9		5759.1	1155.4		4603.6
	Integrated Operational Programme	5.9		1553.0	1553.0		
	7 Regional Operational Programs	17.7		4659.0	4659.0		
	OP Technical Assistence	1.0		258.8	258.8		
	OP Human Resources and Employment	6.9		1815.0		1815.0	
	OP Education	6.9		1811.8		1811.8	
Regional Competitivness	OP Prague Competitivness	1.1	1.6	294.9	294.9		
	OP Prague Adoptability	0.5		121.1		121.1	
Total		**100.0**	**100.0**	**26,302.6**	**13,735.7**	**3,747.9**	**8,819.0**
	ERDF		52.2	13,735.7			
	ESF		14.2	3,747.9			
	CF		33.5	8,819.0			

Source: National Strategic Reference Framework 2007-2013, November 2006.

Estonia

Operational program		Share	Total allocation	million EUR, current prices		
				ERDF	ESF	CF
OP Environment		46.7	1,578.8	952.5		626.3
OP Entrepreneurship, R&D, information society and transport infrastructure		40.3	1,360.7	859.7		501.1
OP Human Resources		13.0	440.8		440.8	
Total		**100.0**	**3,380.3**	**1,812.1**	**440.8**	**1,127.4**
	ERDF	53.6	1,812.1			
	ESF	13.0	440.8			
	CF	33.4	1,127.4			

Source: draft Operational Programs, November 2006.

[12] This confirms our earlier view that the orientation towards the reformed EU agenda remains unclear (World Bank EU8 Quarterly Economic Report, May 2006).

Hungary

Objective	Operational program	Share		Total allocation	million EUR, current prices ERDF	ESF	CF
Convergence	OP Economic Development	9.9	91.7	2437.4	2437.4		
	OP Transport	25.6		6289.8	1104.4		5185.4
	OP Electronic Public Administration	1.1		280.9	280.9		
	OP Social Infrastructure	7.9		1948.9	1948.9		
	OP Environment and Energy	15.7		3853.0	396.0		3456.9
	6 Regional Operational Programs	17.5		4304.3	4304.3		
	OP Implementation	1.4		343.1	343.1		
	OP Social Renewal	12.0		2957.5		2957.5	
	OP State Reform	0.4		101.8		101.8	
Regional Competitivness	OP Central Hungary	6.1	8.3	1506.8	1506.8		
	Central Hungary Region:	2.1		524.3	76.4	447.9	
	OP Electronic Public Administration	0.3		76.4	76.4		
	OP Social Renewal	1.6		404.2		404.2	
	OP State Reform	0.2		43.7		43.7	
Total		**100.0**	**100.0**	**24,547.7**	**12,398.3**	**3,507.1**	**8,642.3**
	ERDF		50.5	12,398.3			
	ESF		14.3	3,507.1			
	CF		35.2	8,642.3			

Source: The New Hungary Development Plan 2007-2013 (National Strategic Reference Framework), October 2006.

Latvia

Operational program		Share	Total allocation	million EUR, current prices ERDF	ESF	CF
OP Enterprise and innovation		18.6	743.7	743.7		
OP Infrastructure and services		70.0	2,800.3	1,440.3		1,360.0
OP Human resuorces and employment		11.4	457.0	0.0	457.0	
Total		**100.0**	**4,001.0**	**2,184.0**	**457.0**	**1,360.0**
	ERDF	54.6	2,184.0			
	ESF	11.4	457.0			
	CF	34.0	1,360.0			

Source: National Strategic Reference Framework 2007-2013, September 2006.

Lithuania

Operational program		Share	Total allocation	million EUR, current prices ERDF	ESF	CF
OP Human Resources Development		13.8	935.0		935.0	
OP Economic Growth		45.7	3,098.9	1,966.6		1,132.3
OP Cohesion Promotion		39.1	2,648.3	1,475.4		1,172.9
OP Technical Assistance		1.4	93.3		93.3	
Total		**100.0**	**6,775.5**	**3,442.0**	**1,028.3**	**2,305.2**
	ERDF	52.2	3,442.0			
	ESF	14.2	1,028.3			
	CF	33.5	2,305.2			

Source: National Strategic Reference Framework, November 2006.

Poland

Objective	Operational program	Share		Total allocation	million EUR, current prices		
					ERDF	ESF	CF
Convergence	16 Regional Operational Programmes	24.5	99.1	15,985.5	15,985.5		
	OP Development of Eastern	3.5		2,273.8	2,273.8		
	OP Infrastructure and environment	42.7		27,848.3	6,337.2		21,511.1
	OP Innovative economy	12.7		8,254.9	8,254.9		
	OP Technical assistance	0.8		516.7	516.7		
	OP Human resources	14.9		9,707.2		9,707.2	
European Cooperation	OP European territorial cooperation	0.9	0.9	557.8	557.8		
Total		**100.0**	**100.0**	**65,144.1**	**33,925.9**	**9,707.2**	**21,511.1**
	ERDF		52.1	33,925.9			
	ESF		14.9	9,707.2			
	CF		33.0	21,511.1			

Source: National Strategic Reference Framework 2007-2013, November 2006.

Slovakia

Objective	Operational program	Share		Total allocation	million EUR, current prices		
					ERDF	ESF	CF
Convergence	Regional OP	12.5	94.2	1,445.0	1,445.0		
	OP Environment	15.5		1,800.0	230.8		1,569.2
	OP Transport	27.7		3,206.9	877.4		2,329.5
	OP Informatization of society	8.6		993.1	993.1		
	OP Research and development	7.6		883.0	883.0		
	OP Competitiveness	6.7		772.0	772.0		
	OP Healthcare	2.2		250.0	250.0		
	OP Technical assistance	0.8		97.6	97.6		
	inclusion	7.5		864.0		864.0	
	OP Education	5.2		600.0		600.0	
Regional Competitivness	OP Bratislava	0.8	3.9	87.0	87.0		
	- transfer to Research and development	2.8		326.4	326.4		
	inclusion	0.2		17.8		17.8	
	OP Education	0.2		17.8		17.8	
European Cooperation		2.0	2.0	227.3	227.3		
Total		**100.0**	**100.0**	**11,587.9**	**6,189.6**	**1,499.6**	**3,898.7**
	ERDF		53.4	6,189.6			
	ESF		12.9	1,499.6			
	CF		33.6	3,898.7			

Source: National Strategic Reference Framework 2007-2013, December 2006.

Slovenia

Objective	Operational program	Share		Total allocation	million EUR, current prices		
					ERDF	ESF	CF
Convergence	OP Development of environmental and transport infrastructure	38.9	97.5	1,635.6	224.0		1,411.6
	OP Enhancement of regional development potential	40.7		1,709.7	1,709.7		
	OP Development of human resources	18.0		755.7		755.7	
European Cooperation	European territorial cooperation programs	2.5	2.5	104.3	104.3		
Total		**100.0**	**100.0**	**4,205.3**	**2,038.0**	**755.7**	**1,411.6**
	ERDF		48.5	2,038.0			
	ESF		18.0	755.7			
	CF		33.6	1,411.6			

Source: National Strategic Reference Framework 2007-2013, December 2006.

Bulgaria

Objective	Operational program	Share		Total allocation	million EUR, current prices ERDF	ESF	CF
Convergence	OP Competitiveness	14.8	100.0	987.9	987.9		
	OP Regional Development	20.4		1361.1	1361.1		
	OP Transport	24.3		1624.5	368.8		1255.7
	OP Environment	22.0		1466.5	439.1		1027.4
	OP Human Resources Developmen	15.5		1031.8		1031.8	
	OP Technical Assistance	0.7		48.3	48.3		
	OP Administrative Capacity	2.3		153.7		153.7	
Total		**100.0**	**100.0**	**6,673.6**	**3,205.2**	**1,185.5**	**2,283.1**
	ERDF		45.6	3,205.1			
	ESF		18.7	1,185.5			
	CF		33.3	2,283.1			

Source: National Strategic Reference Framework 2007-2013, December 2006.

Romania

Objective	Operational program	Share		Total allocation	million EUR, current prices ERDF	ESF	CF
Convergence	OP Economic Competitiveness	13.0	97.7	2,554.2	2,554.2		
	OP Transport	23.2		4,565.9	1,289.3		3,276.6
	OP Environment	22.9		4,512.5	1,236.7		3,275.8
	OP Regional Development	18.9		3,726.0	3,726.0		
	OP Technical Assistance	0.9		170.2	170.2		
	OP Human Resources Developmen	17.7		3,476.1		3,476.1	
	OP Administrative Capacity	1.1		208.0		208.0	
European Cooperation	Territorial Cooperation	2.3	2.3	454.6			
Total		**100.0**	**100.0**	**19,667.6**	**8,976.5**	**3,684.1**	**6,552.4**
	ERDF		45.6	8,976.5			
	ESF		18.7	3,684.1			
	CF		33.3	6,552.4			

Source: National Strategic Reference Framework 2007-2013, October 2006.

STATISTICAL ANNEX

	2002	2003	2004	2005	4Q 05	1Q 06	2Q 06	3Q 06	Aug-06	Sep-06	Oct-06	Nov-06
GDP, SNA (real, %, y/y)												
Czech Republic	1.9	3.6	4.2	6.1	6.9	7.1	6.2	5.8				
Estonia	7.2	6.7	7.8	9.8	11.3	11.7	11.7	11.3				
Hungary	4.3	4.1	4.9	4.2	4.3	4.6	3.8	3.8				
Latvia	6.5	7.2	8.6	10.2	10.6	13.1	11.1	11.8				
Lithuania	6.9	10.3	7.3	7.6	8.7	8.5	8.4	6.3				
Poland	1.4	3.8	5.3	3.4	4.3	5.2	5.5	5.8				
Slovakia	4.1	4.2	5.4	6.0	7.5	6.7	6.7	9.8				
Slovenia	3.5	2.7	4.4	4.0	3.9	5.1	4.8	5.6				
Bulgaria	4.9	4.5	5.7	5.5	5.5	5.6	6.6	6.7				
Romania	5.1	5.2	8.4	4.1	4.3	6.9	7.8	8.3				
Croatia	5.6	5.3	3.8	4.3	4.8	6.0	3.6	4.7				
Consumption, SNA (real, %, y/y)												
Czech Republic	3.5	6.3	0.8	1.8	2.0	3.4	2.3	2.0				
Estonia	9.5	7.2	5.0	8.1	8.3	13.1	11.9	13.5				
Hungary	9.2	7.5	2.8	3.4	4.6	1.5	0.9	0.0				
Latvia	6.1	6.7	7.7	9.1	13.5	13.7	14.1	13.2				
Lithuania	4.9	10.5	9.2	9.4	10.5	13.2	10.6	12.9				
Poland	2.9	2.5	4.0	2.7	3.7	5.1	4.0	4.5				
Slovakia	5.2	1.2	3.6	5.3	3.7	6.8	5.9	5.0				
Slovenia	1.8	3.0	2.8	3.1	2.5	3.4	3.3	3.2				
Bulgaria	3.6	6.6	5.1	6.8	5.5	4.8	6.7	6.7				
Romania		8.3	11.9	8.5	6.4	10.2	11.5	11.2				
Croatia	6.9	3.7	2.7	2.8	2.7	3.2	2.0	3.2				
Gross capital formation, SNA (real, %, y/y)												
Czech Republic	4.6	-1.4	8.2	2.9	4.8	7.6	16.2	13.6				
Estonia	20.0	8.7	5.2	13.2	7.6	14.2	10.9	20.6				
Hungary	-1.4	2.1	8.8	-4.4	-3.2	11.5	-3.4	-1.3				
Latvia	5.8	22.0	23.0	6.1	7.1	15.1	9.7	36.6				
Lithuania	12.3	18.7	25.5	8.6	4.2	0.7	-12.5	-1.3				
Poland	-7.2	3.3	14.7	-0.3	10.9	2.9	8.7	13.3				
Slovakia	1.3	-8.0	14.3	15.3	43.9	11.7	1.4	19.3				
Slovenia	4.0	10.1	11.4	-1.1	7.9	6.9	7.4	16.6				
Bulgaria	4.0	10.1	11.4	-1.1	18.0	37.5	12.2	23.1				
Romania												
Croatia	27.4	14.1	3.5	6.3	7.8	21.5	6.2	19.8				
Gross fixed capital formation, SNA (real, %, y/y)												
Czech Republic	5.1	0.4	4.7	3.6	3.2	6.1	6.7	7.2				
Estonia	17.2	8.5	6.0	13.9	18.9	18.9	10.0	27.3				
Hungary	10.1	2.1	7.7	5.6	2.3	10.2	-3.3	-4.1				
Latvia	13.0	12.3	23.8	18.6	12.9	19.5	13.1	10.0				
Lithuania	11.1	14.0	12.3	11.2	14.2	10.5	13.4	10.2				
Poland	-6.3	-0.1	6.4	6.5	10.1	7.7	14.8	19.8				
Slovakia	0.3	-2.3	5.0	13.8	24.4	13.8	3.6	6.7				
Slovenia	0.9	7.1	7.9	1.5	7.0	8.7	8.3	14.5				
Bulgaria	8.5	13.9	13.5	19.0	21.5	21.4	20.3	15.9				
Romania		8.6	10.8	13.0	21.3	11.4	12.2	15.6				
Croatia	13.9	24.7	4.4	4.8	9.9	18.1	8.4	9.3				

	2002	2003	2004	2005	4Q 05	1Q 06	2Q 06	3Q 06	Aug-06	Sep-06	Oct-06	Nov-06
Exports, SNA (real, %, y/y)												
Czech Republic	2.1	7.2	21.1	10.6	10.1	18.5	10.7	11.4				
Estonia	0.8	5.8	16.0	21.3	29.1	17.6	16.4	7.0				
Hungary	3.9	6.2	15.7	11.6	12.5	17.6	15.3	15.4				
Latvia	5.4	5.2	9.4	20.7	20.2	13.6	13.0	7.5				
Lithuania	19.5	6.9	4.2	14.3	16.9	20.3	18.1	13.8				
Poland	4.8	14.2	14.0	8.1	12.1	22.0	12.6	14.8				
Slovakia	4.7	15.9	7.9	13.5	16.6	17.7	18.1	23.8				
Slovenia	6.7	3.1	12.5	10.5	10.9	14.8	9.2	5.6				
Bulgaria	7.0	8.0	13.0	7.2	8.9	12.9	10.2	9.0				
Romania		8.4	13.9	7.6	9.8	13.0	10.5	11.0				
Croatia	1.2	11.4	5.4	4.6	4.9	14.0	5.2	2.2				
Imports, SNA (real, %, y/y)												
Czech Republic	5.0	8.0	18.2	4.9	4.9	16.3	11.0	10.6				
Estonia	3.8	10.6	14.6	17.4	20.6	20.1	15.4	11.7				
Hungary	6.8	9.3	14.1	6.8	8.4	15.1	9.1	8.8				
Latvia	4.7	13.1	16.6	13.5	18.8	15.7	15.9	24.0				
Lithuania	17.7	10.3	14.8	15.9	16.9	22.6	11.2	18.2				
Poland	2.7	9.3	15.2	4.9	15.0	20.9	10.7	15.3				
Slovakia	4.6	7.6	8.8	15.5	21.7	19.6	14.0	22.9				
Slovenia	4.8	6.7	13.4	7.0	10.7	13.7	8.6	7.0				
Bulgaria	4.9	15.3	14.1	14.6	12.9	20.0	11.4	13.7				
Romania		16.0	22.1	17.2	17.2	18.7	18.0	21.2				
Croatia	13.4	12.1	3.5	3.5	3.6	16.1	4.2	5.5				
Industrial production (%, y/y)												
Czech Republic	1.9	5.5	9.6	6.7	8.4	14.7	8.5	8.3	7.4	5.5	12.6	7.6
Estonia	8.3	11.1	10.5	9.1	8.3	8.4	7.1	6.3	11.3	0.9	9.5	4.8
Hungary	2.8	6.4	7.4	7.3	7.7	13.3	7.2	10.3	9.3	9.2	10.6	10.8
Latvia	5.8	6.5	6.0	5.6	7.4	8.4	3.6	4.8	7.9	2.5	3.9	0.7
Lithuania	3.1	16.1	10.8	7.3	8.1	12.5	12.9	6.9	5.4	3.5	6.2	-2.1
Poland	1.1	8.3	12.3	4.1	4.1	12.4	12.3	12.8	12.6	11.6	14.8	11.7
Slovakia	6.4	5.1	4.2	3.6	6.2	9.4	8.8	11.0	14.4	8.6	12.1	10.0
Slovenia	2.4	1.4	4.8	3.1	5.5	7.7	5.0	8.6	11.0	7.6	10.8	8.3
Bulgaria	4.7	14.1	17.1	6.7	7.8	7.4	6.2	6.8	10.6	6.8	5.0	3.5
Romania		3.2	5.4	2.2	1.8	4.7	9.1	7.7	6.8	6.2	10.2	7.4
Croatia	5.4	4.2	3.7	5.1	5.5	6.4	-0.1	5.9	9.8	3.0	8.3	6.9
Retail sales (excl. motor vehicles, automotive fuel, %, y/y)												
Czech Republic	3.2	4.0	3.0	3.7	4.3	6.9	7.2	5.9	6.6	4.0	7.8	5.7
Estonia	14.4	9.9	15.5	12.0	15.0	19.3	20.3	19.7	20.0	20.0	17.0	20.0
Hungary	8.7	8.9	5.7	5.6	5.6	5.3	5.0	4.3	5.1	3.7	2.3	
Latvia	12.1	13.4	12.5	21.2	22.3	15.8	18.6	19.4	20.6	19.0	27.2	22.5
Lithuania	7.9	11.1	10.7	12.9	17.1	9.3	6.0	7.1	8.7	5.3	6.3	
Poland	1.9	3.6	7.1	2.1	5.4	9.5	12.4	12.0	10.9	14.4	13.9	14.1
Slovakia	5.8	-5.2	6.2	9.7	11.0	7.7	9.5	9.0	8.0	10.6	7.6	7.4
Slovenia			3.8	6.8	7.3	2.9	2.8	-0.3	-2.1	0.1	4.0	1.7
Bulgaria	5.1	11.0	14.5	12.7	9.8	10.9	13.2	14.1				
Romania				17.6	17.3	25.4	25.6	25.4	21.5	26.1	24.7	22.3
Croatia	21.0	6.1	2.6	2.8	1.5	2.8	0.4	2.1	1.9	2.8	4.6	5.5

	2002	2003	2004	2005	4Q 05	1Q 06	2Q 06	3Q 06	Aug-06	Sep-06	Oct-06	Nov-06
Unemployment (%, NSA, LFS data)												
Czech Republic	7.3	7.8	8.3	8.2	7.8	8.0	7.1	7.0				
Estonia	10.3	10.0	9.7	7.9	7.0	6.4	6.2	5.4				
Hungary	5.7	5.9	6.1	7.2	7.3	7.7	7.2	7.5				
Latvia	12.0	10.6	10.4	10.0	7.8	7.8	7.2	6.2				
Lithuania	13.8	12.4	11.4	8.3	7.1	6.4	5.6	5.7				
Poland	19.6	19.7	19.0	18.6	16.7	16.1	14.1	13.0				
Slovakia	18.5	17.4	18.1	16.2	15.4	15.0	13.5	12.8				
Slovenia	6.7	6.7	6.3	6.4	7.2	6.9	5.9	5.6				
Bulgaria	14.8	13.7	12.0	11.5	9.9	9.7	9.0	8.8				
Romania	7.4	7.1	8.1	8.0	6.8	7.8	7.1	5.8				
Croatia	14.8	14.3	13.8	12.7	12.3	11.8	11.8					
CPI inflation (%, average y/y)												
Czech Republic	1.8	0.1	2.8	1.9	2.4	2.8	2.9	2.9	3.1	2.7	1.3	1.5
Estonia	3.6	1.3	3.0	4.1	4.0	4.4	4.4	4.4	5.0	3.8	3.7	4.6
Hungary	5.3	4.7	6.8	3.6	3.3	2.5	2.6	4.1	3.5	5.9	6.3	6.4
Latvia	1.9	2.9	6.2	6.7	7.3	7.0	6.3	6.5	6.8	5.9	5.6	6.4
Lithuania	0.3	-1.2	1.2	2.7	2.9	3.3	3.6	3.9	4.2	3.2	3.5	4.4
Poland	1.9	0.8	3.5	2.1	1.1	0.6	0.8	1.4	1.6	1.6	1.2	1.4
Slovakia	3.3	8.5	7.5	2.7	3.5	4.3	4.6	4.9	5.1	4.6	3.7	4.3
Slovenia	7.5	5.6	3.6	2.5	2.5	2.2	2.9	2.5	3.2	2.5	1.5	2.3
Bulgaria	5.8	2.3	6.1	5.0	6.6	8.0	8.3	6.7	6.8	5.6	5.7	6.1
Romania	22.8	15.3	11.9	9.0	8.5	8.6	7.1	5.9	6.0	5.5	4.8	4.7
Croatia	1.7	1.8	2.1	3.3	3.8	3.5	3.8	3.2	3.4	2.8	2.1	2.5
PPI (%, averagey/y)												
Czech Republic	-0.5	-0.3	5.7	3.0	0.0	0.3	1.3	2.6	2.7	2.4	1.9	2.0
Estonia	0.4	0.2	2.9	2.1	2.0	3.1	4.2	4.8	4.4	5.4	5.3	5.9
Hungary	-1.8	2.4	3.5	4.3	4.2	4.7	6.3	9.4	9.7	9.0	7.0	5.5
Latvia	1.0	3.2	8.6	7.8	6.8	7.5	9.5	11.4	11.1	11.8	12.3	13.0
Lithuania	-2.8	-0.5	6.0	11.5	12.7	13.1	10.3	6.2	7.6	1.8	-1.6	1.7
Poland	1.0	2.6	7.0	0.7	-0.4	0.6	2.3	3.5	3.3	3.6	3.2	2.7
Slovakia	2.1	8.3	2.6	5.3	5.5	6.8	6.5	6.8	7.6	5.0	2.9	2.6
Slovenia	5.1	2.5	4.3	2.7	1.8	1.6	2.4	2.7	2.4	2.7	2.7	2.6
Bulgaria			6.0	6.9	7.8	4.6	8.2	9.0	9.6	7.7	6.7	5.9
Romania			19.1	10.6	8.8	10.9	11.7	12.6	13.0	12.0	10.6	
Croatia	-0.4	1.9	3.5	3.0	2.3	3.5	3.6	2.7	3.1	2.0	1.5	1.6
Exchange rate (nominal, LCU/EUR, period average)												
Czech Republic	30.8	31.8	31.9	29.8	29.3	28.6	28.4	28.3	28.2	28.4	28.3	28.0
Estonia	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
Hungary	243.0	253.6	251.7	248.1	251.8	254.6	266.8	275.4	274.4	274.4	267.1	258.8
Latvia	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Lithuania	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Poland	3.9	4.4	4.5	4.0	3.9	3.8	3.9	4.0	3.9	4.0	3.9	3.8
Slovakia	42.7	41.5	40.0	38.6	38.5	37.5	37.7	37.8	37.7	37.5	36.8	35.9
Slovenia	226.0	233.9	239.1	239.6	239.5	239.5	239.6	239.6	239.6	239.6	239.6	239.6
Bulgaria	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Romania	31270.0	37551.0	40510.0	3.6	3.6	3.6	3.5	3.5	3.5	3.5	3.5	3.5
Croatia	7.4	7.6	7.5	7.4	7.4	7.3	7.3	7.3	7.3	7.4	7.4	7.3

	2002	2003	2004	2005	4Q 05	1Q 06	2Q 06	3Q 06	Aug-06	Sep-06	Oct-06	Nov-06
Exchange rate (nominal, LCU/USD, period average)												
Czech Republic	32.7	28.2	25.7	24.0	24.7	23.8	22.6	22.2	22.0	22.3	22.4	21.8
Estonia	16.6	13.9	12.6	12.6	13.2	13.0	12.4	12.3	12.2	12.3	12.4	12.1
Hungary	257.9	224.3	202.7	199.6	211.8	211.5	212.2	216.2	214.0	215.7	211.8	200.8
Latvia	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.6	0.5	0.6	0.6	0.5
Lithuania	3.7	3.1	2.8	2.8	2.9	2.9	2.8	2.7	2.7	2.7	2.7	2.7
Poland	4.1	3.9	3.7	3.2	3.3	3.2	3.1	3.1	3.0	3.1	3.1	3.0
Slovakia	45.3	36.8	32.3	31.0	32.4	31.2	30.0	29.7	29.4	29.4	29.2	27.9
Slovenia	240.2	207.1	192.4	192.7	201.5	199.3	190.9	188.0	187.1	188.1	190.0	186.2
Bulgaria	2.1	1.7	1.6	1.6	1.6	1.6	1.6	1.5	1.5	1.5	1.6	1.5
Romania	3.3	3.3	3.3	2.9	3.1	3.0	2.8	2.8	2.8	2.8	2.8	2.7
Croatia	7.9	6.7	6.0	5.9	6.2	6.1	5.8	5.7	5.7	5.8	5.9	5.7
Real effective exchange rate, CPI based (%, period average, y/y), (negative value= depreciation)												
Czech Republic	9.0	-2.7	3.0	2.3	3.9	3.4	5.7	5.3				
Estonia	3.4	2.4	1.7	0.5	-0.3	0.0	1.2	1.9				
Hungary	8.7	0.2	7.8	0.8	-3.7	-5.4	-6.7	-8.7				
Latvia	-4.6	-3.3	1.1	-1.2	-0.3	2.1	3.0	3.6				
Lithuania	2.8	1.3	-0.5	-0.9	-3.1	-2.5	-0.5	1.0				
Poland	-8.2	-10.4	7.0	5.3	4.5	1.6	2.9	0.9				
Slovakia	4.4	13.5	8.0	1.1	1.5	2.3	4.8	5.1				
Slovenia	3.0	2.5	-1.0	-0.7	-2.6	-2.5	-0.3	0.2				
Bulgaria	3.5	3.8	3.0	0.1	-0.4	1.7	4.7	5.0				
Romania	-2.5	-1.7	6.5	10.6	13.1	7.9	7.3	3.9				
Croatia	-1.1	-2.4	-3.3	-1.3	-1.2	-0.7	-0.6	-2.7				
Exports of goods (EUR, %, y/y)												
Czech Republic	9.3	5.8	28.8	13.2	12.7	24.9	17.7	17.6	15.8	15.2	29.3	21.3
Estonia	-1.6	9.9	19.4	29.2	31.9	26.4	29.6	18.9	24.8	14.1	7.2	5.1
Hungary	7.4	4.4	17.3	13.2	12.9	20.8	14.3	13.2	15.9	7.8	20.3	13.5
Latvia	8.2	5.8	26.0	28.7	28.0	18.8	17.9	17.8	24.1	15.0	16.5	13.9
Lithuania	15.8	11.2	21.4	26.9	28.7	32.6	29.3	16.3	20.7	7.1	5.8	-5.3
Poland	8.2	9.3	26.8	19.3	19.8	23.8	22.2	21.8	24.5	19.0	22.4	20.9
Slovakia	8.3	26.7	14.7	16.3	22.5	27.7	24.9	30.1	37.2	26.2	37.6	27.7
Slovenia	5.9	2.9	16.6	17.6	16.9	22.9	18.2	17.8	22.2	13.5	25.7	15.6
Bulgaria	6.0	10.0	19.5	18.4	21.9	28.4	31.8	32.1	36.4	35.8	15.8	17.8
Romania			21.3	17.5	17.2	22.0	18.8	8.0	18.0	6.1	15.8	20.9
Croatia	-0.6	5.4	18.1	9.6	13.0	33.2	5.4	12.1	25.2	3.6	40.5	4.5
Imports of goods (EUR, %, y/y)												
Czech Republic	6.1	6.3	23.0	9.3	9.3	25.2	19.4	16.7	13.4	14.5	29.2	19.2
Estonia	5.9	12.9	16.9	20.4	27.9	33.2	30.7	22.9	21.8	15.4	13.0	8.1
Hungary	6.4	5.9	15.2	9.9	12.2	21.0	12.1	9.4	10.0	7.1	16.8	12.0
Latvia	9.3	8.1	23.3	22.6	31.0	31.6	29.7	31.5	33.4	31.4	23.7	25.6
Lithuania	18.9	7.1	16.8	25.5	32.4	39.7	24.3	23.3	28.5	17.2	9.7	6.8
Poland	4.4	3.2	19.5	13.3	18.3	23.8	20.0	20.9	22.4	17.0	24.1	17.0
Slovakia	6.3	13.7	19.0	20.1	29.0	30.6	25.1	32.6	39.4	32.1	33.4	31.2
Slovenia	2.0	5.7	16.6	14.5	18.0	21.0	16.1	15.4	18.3	10.3	25.5	16.4
Bulgaria	3.4	14.3	20.6	26.1	25.5	32.9	22.0	26.1	30.4	21.8	19.9	16.5
Romania			24.0	23.9	24.4	28.6	22.7	22.2	24.0	18.8	26.0	23.1
Croatia	10.4	10.7	6.6	12.0	15.5	27.7	8.8	13.1	18.0	7.8	11.4	10.0

	2002	2003	2004	2005	4Q 05	1Q 06	2Q 06	3Q 06	Aug-06	Sep-06	Oct-06	Nov-06
Trade balance (% GDP)												
Czech Republic	-2.9	-2.7	-1.0	1.4	1.4	1.4	1.1	1.3				
Estonia	-15.2	-16.3	-17.4	-13.5	-13.5	-13.7	-14.3	-15.5				
Hungary	-3.1	-3.9	-3.0	-1.6	-1.6	-1.8	-1.5	-1.1				
Latvia	-15.8	-17.8	-20.3	-19.2	-19.2	-20.4	-21.5	-23.6				
Lithuania	-9.4	-9.1	-10.6	-11.4	-11.4	-12.4	-12.2	-13.2				
Poland	-3.7	-2.6	-2.3	-0.9	-0.9	-0.9	-0.9	-1.2				
Slovakia	-8.6	-1.9	-3.5	-5.2	-5.2	-5.7	-5.9	-6.5				
Slovenia	-1.1	-2.2	-3.8	-3.7	-3.7	-3.8	-3.8	-3.8				
Bulgaria	-11.6	-14.0	-12.1	-20.2	-20.2	-21.3	-20.5	-20.3				
Romania	-5.7	-7.6	-8.7	-9.8	-9.8	-10.2	-10.5	-11.4				
Croatia	-24.4	-26.6	-23.7	-24.3	-24.3	-24.5	-24.8	-25.1				
Current account (% GDP)												
Czech Republic	-5.5	-6.2	-6.0	-2.1	-2.1	-2.6	-3.2	-3.7				
Estonia	-10.6	-11.6	-12.5	-10.5	-10.5	-11.1	-11.5	-12.4				
Hungary	-6.9	-7.9	-8.4	-6.8	-6.8	-6.9	-6.9	-6.2				
Latvia	-6.6	-8.1	-12.9	-12.7	-12.7	-13.6	-15.4	-18.3				
Lithuania	-5.1	-6.8	-7.7	-7.2	-7.2	-8.4	-9.0	-10.4				
Poland	-2.5	-2.1	-4.3	-1.7	-1.7	-1.9	-2.0	-1.9				
Slovakia	-7.8	-0.8	-3.4	-8.6	-8.6	-9.5	-9.0	-10.4				
Slovenia	1.1	-0.8	-2.7	-2.0	-2.0	-1.9	-1.9	-2.8				
Bulgaria	-2.5	-5.6	-4.6	-11.3	-11.3	-13.6	-14.0	-14.0				
Romania	-3.4	-5.5	-8.4	-8.6	-8.6	-9.0	-9.4	-10.4				
Croatia	-8.7	-7.3	-5.2	-6.5	-6.5	-7.9	-8.1	-8.2				
FDI net (% GDP)												
Czech Republic	11.0	2.1	3.7	8.1	8.1	7.6	3.9	3.7				
Estonia	2.2	8.1	6.0	16.8	16.8	11.7	2.7	1.5				
Hungary	4.1	0.6	3.3	4.7	4.7	6.1	5.5	6.0				
Latvia	2.7	2.3	4.3	3.8	3.8	4.6	6.0	5.9				
Lithuania	5.0	0.8	2.3	2.7	2.7	2.5	1.7	2.1				
Poland	2.0	2.0	4.7	2.1	2.1	2.5	2.8	2.8				
Slovakia	16.8	2.2	3.3	3.7	3.7	4.6	5.3	6.6				
Slovenia	6.6	-0.6	0.9	-0.2	-0.2	0.1	0.3	0.8				
Bulgaria	5.9	10.6	9.2	11.2	11.2	12.5	15.5	14.8				
Romania	2.5	3.1	8.4	6.7	6.7	7.6	7.3	7.2				
Croatia	2.4	6.4	2.5	4.0	4.0	4.8	5.3	5.2				
Net portfolio investment (% GDP)												
Czech Republic	-1.9	-1.4	2.1	-2.4	-2.4	-1.9	-3.0	-2.2				
Estonia	2.0	1.8	6.2	-15.8	-15.8	-18.8	-7.5	-7.8				
Hungary	2.5	3.5	6.7	4.0	4.0	5.7	2.8	2.9				
Latvia	-2.2	-2.0	1.7	-0.7	-0.7	-1.6	-1.4	0.0				
Lithuania	0.1	1.5	0.9	-1.0	-1.0	-1.6	-1.7	-2.4				
Poland	1.0	1.1	3.7	4.1	4.1	3.1	0.0	-0.6				
Slovakia	2.3	-1.7	2.1	-2.1	-2.1	0.1	2.1	1.7				
Slovenia	-0.3	-0.9	-2.4	-5.9	-5.9	-5.8	-4.8	-4.9				
Bulgaria	-0.6	-1.1	-2.3	-6.3	-6.3	-2.4	-3.0	0.1				
Romania	0.8	1.0	-0.7	1.1	1.1	1.4	1.1	0.0				
Croatia	-1.8	3.4	0.8	-3.5	-3.5	-3.4	-2.5	-0.1				

	2002	2003	2004	2005	4Q 05	1Q 06	2Q 06	3Q 06	Aug-06	Sep-06	Oct-06	Nov-06
General government balance (ESA95, % GDP)												
Czech Republic	-6.8	-6.6	-2.9	-3.6								
Estonia	0.4	2.0	2.3	2.3								
Hungary	-8.2	-6.3	-5.3	-6.5								
Latvia	-2.3	-1.2	-0.9	0.1								
Lithuania	-1.5	-1.3	-1.5	-0.5								
Poland	-3.2	-4.7	-3.9	-2.5								
Slovakia	-7.7	-3.7	-3.0	-3.1								
Slovenia	-2.5	-2.8	-2.3	-1.4								
Bulgaria	0.1	0.3	1.9	3.1								
Romania	-2.0	-1.7	-1.3	-0.4								
Croatia	-4.1	-4.5	-5.0	-3.9								
General government revenue (ESA95, % GDP)												
Czech Republic	39.5	40.7	41.5	40.4								
Estonia	36.0	37.4	36.6	35.5								
Hungary	43.0	42.8	43.5	43.4								
Latvia	33.4	33.5	34.9	36.2								
Lithuania	32.9	31.9	31.8	33.0								
Poland	41.0	39.9	38.7	41.0								
Slovakia	35.7	35.6	35.9	33.9								
Slovenia	45.5	45.3	45.1	45.8								
Bulgaria												
Romania	36.7	36.1	36.0									
Croatia												
General government expenditure (ESA95, % GDP)												
Czech Republic	46.3	47.3	44.4	44.1								
Estonia	35.6	35.3	34.2	33.2								
Hungary	51.2	49.1	48.8	49.9								
Latvia	35.6	34.6	35.8	36.0								
Lithuania	34.4	33.2	33.3	33.6								
Poland	44.2	44.6	42.6	43.4								
Slovakia	43.3	39.4	38.9	37.1								
Slovenia	48.0	48.0	47.4	47.2								
Bulgaria												
Romania	38.7	37.9	37.4									
Croatia												
Public debt (ESA95, % GDP)												
Czech Republic	28.5	30.1	30.7	30.4								
Estonia	5.6	5.7	5.2	4.5								
Hungary	54.0	55.8	56.3	57.7								
Latvia	13.5	14.4	14.5	12.1								
Lithuania	22.2	21.2	19.4	18.7								
Poland	39.8	43.9	41.9	42.0								
Slovakia	43.3	42.7	41.6	34.5								
Slovenia	29.1	28.5	28.7	28.0								
Bulgaria	54.0	46.1	38.6	29.9								
Romania	23.8	20.7	18.0	15.2								
Croatia	40.0	40.9	43.7	44.3								
Oil (Brent) USD/BBL	26.8	28.8	35.8	50.9	56.9	61.9	69.8	70.1	73.6	62.8	58.4	58.5
Exch. Rate (USD/EUR)	0.946	1.131	1.244	1.244	1.188	1.202	1.258	1.274	1.281	1.273	1.261	1.288

Source: Eurostat; EC; WIIW; CSOs; national central banks; World Bank; IMF IFS; and staff calculations.