ICEG European Center

Quarterly Forecast on the 8 New Member States

Summer

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OVERVIEW OF THE NMS-8

Growth

The NMS-8 countries continued their good growth performance in the first quarter of 2006 and may expect fast GDP growth both in 2006 and 2007. Growth is expected to accelerate in the Central European economies, while double-digit growths of the Baltic States may moderate to one digit output expansion. The average growth of the NMS-8 may reach 6.3% in 2006 and 5.6% in 2007 after the 6.4% expansion in 2005.

The vibrant growth in the Baltic States is been driven primarily by the fast rise in private consumption and gross fixed capital formation. The still sizeable increase in private consumption is due to the fast rise of real wages and incomes, the declining liquidity constraint due to fast financial deepening[1], while investments increase mainly due to improvements in productivity. The Baltic States will however not maintain the fast increase of their exports and their GDP growth is expected to decelerate somewhat mainly due to the slowdown of export growth and smaller contribution of net exports to GDP growth.

In Central Europe most economies experience some acceleration of GDP growth with the exception of the Czech Republic and Hungary, where GDP growth on average will be around last years' performance. Growth is expected to accelerate especially in Poland, where both the contribution of domestic demand (both private consumption and private capital formation) as well as of exports is increasing. Contrary tot he Baltic States most of the Central European NMS are able to utilise the somewhat faster output growth and rising demand in their main export markets the EU-15 and this is reflected to somewhat stronger contribution of net exports to growth.

Concerning the medium term forecast, the expectation is that GDP growth will moderate to an average 5.6%, mainly due to the ongoing slowdown of the Baltic States. In these three small NMS countries the major factor explaining slower growth is the continuing slowdown of their export growth and the expected negative effect on aggregate demand of policy measures aimed at reducing inflation below the Maastricht criteria. In Central Europe Hungary will experience sharp reduction of output growth due to the negative demand effects of its stabilisation package, while in other countries growth will either accelerate (Poland) or decelerate somewhat (other three countries) but without significant changes.

As mentioned in the earlier forecasts output growth will be strongly influenced by the evolution of the stance of fiscal policies. In Hungary sizeable fiscal adjustment is needed to put the fiscal developments on a sustainable track, while in the Baltic States in general tight fiscal policy is needed to help in achieving the Maastricht inflation criterion in a currency board monetary framework. The long-term impact of tighter fiscal policies on growth is uncertain depending on the composition and extent of fiscal tightening but in short-term it is likely to have significant negative effect on growth.

Monetary conditions

Consumer price increases seem to represent a renewed challenge for policy makers in several NMS countries. While consumer price increases on average will be the same in 2006 as in 2005, only two countries (Poland and Slovenia) meet the Maastricht inflation criteria, while some need to face significant adjustment requirements to cope with growing inflationary pressures.

In the short-term the major challenges are faced by the Baltic States, where the currency board monetary arrangements bind the hands of monetary authorities and make inflation developments dependant on fiscal and income policy stance. On the other hand supply side pressures (fast increase in productivity, increase of intermediate input costs, energy prices, wages, etc.) contribute to price increases. The Baltic States seem to be unable in the short-term to reduce their inflation rates: this has been the major factor behind the inability of these countries to join together with Slovenia the ERM-II. Inflation seems to be very persistent in these countries which are another challenge as

[1] On this aspect see the last chapter of this report

its second round effects may have a negative spill over effect on inflation expectations.

Another special case is Hungary, where inflation has declined by early 2006 to historically low levels, but where the tax increases and adjustment of regulated prices will give a new impetus to inflation. The acceleration of inflation will be gradual and will appear in 2007, which is the main explanation why the average of CPI increases is higher in 2007 than in 2006.

In the other Central European economies – with the exception of Slovenia entering soon the euro-zone – inflation will slightly accelerate reflecting the cyclical effect of fast output increases on prices as well as the ongoing adjustment of administrative prices. This is especially strongly observed in Poland and Slovakia, but the Czech National Bank may also face higher than expected price increases in 2006.

Since the major factors of cost push and demand pull inflation will remain in place in 2007, the deceleration of price increases will be moderate in most countries and the majority of the NMS-8 will still be remain unable to meet the Maastricht criteria.

Fiscal developments

In 2005 the NMS-8 countries on average and some economies in particular experienced an improvement in their general government deficits. The two factors explaining the decline of average general government deficit from 2.5 per cent in 2004 to 1.9 per cent in 2005 were the fast output expansion and tighter fiscal policies. The fast rise of output resulted in a favourable cyclical impact, improved the primary balance, while tighter fiscal policies (especially in the Baltic States) tried to reduce the negative effects of increase in domestic demand on inflation.

In 2006 the positive cyclical effect of output growth on fiscal balance will remain, while the tightness of fiscal policies will change significantly. As a result the average deficit will increase to 2.3% of GDP mainly due to the sizeable increase in Hungary's general government deficit and declining surplus of the Baltic States. Hungary's general government balance went out of control and even with current stabilisation package an 8 % deficit is likely. In the Baltic States fiscal surpluses of Estonia will decline while deficit in Latvia and Lithuania will increase somewhat. In the remaining NMS no sizeable changes are expected though countries cope with increasing difficulties with the cofinancing of the incoming EU funds, and with the need of reforming their public sectors.

Balance of payments

In 2006 we expect that the average current account deficit will slightly worsen in the NMS-8 and will reach 6.5 per cent of the GDP after last years' 6.1 per cent. The Baltic States still have very high current account deficits reaching and even exceeding 10 per cent of their GDPs. The buoyant growth of investments, the lack of domestic private savings and the stability of net foreign capita inflows explain the high reliance on foreign savings by the Baltic States. As long as they had stable exchange rates and tight fiscal policies, these countries were able to maintain and finance their current account deficits. Their position will basically remain unchanged though some decline in current account deficits is likely in the next years.

In Central Europe the Slovak case differs from the current pattern of most NMS-8 countries, though it resembles earlier developments in other Central European NMS-8. The recent significant rise in Slovakia's current account deficit is due to the temporary positive impact of FDI on import demand and the increase in the deficit of incomes balance due to the higher profit repatriation after the increased FDI stock. Poland, Slovenia and the Czech Republic are expected to have very moderate current account deficits, thanks to the rapid increase of their exports and also favourable developments in case of the incomes balance.

In most countries FDI inflows have been increasing driven partly by new investments on the Single Market, expectations of continued fast economic and productivity growth. Therefore most NMS-8 doesn't experience a rise in their net foreign debts as current account deficits are covered by non debt creating inflows.

Labour markets

The gaps among the NMS-8 in unemployment rates have remained significant in recent years. Unemployment levels are low in Hungary, the Czech Republic and Slovenia, while they have remained high (in Slovakia and Poland in the double digit range) in the other NMS-8.

A positive ongoing development of recent years has been the decline of unemployment rates in the Baltic States, which is explained by various factors: fast increase of GDP and rise in labour demand, increased labour outflow to Scandinavian countries following the entry to the European Union, increased flexibility of labour market regulations. As a result of that average unemployment in the three countries declined from 10.5 per cent in 2004 to 8.6 per cent in 2005 and a further decline to 7.4% for 2006 is foreseen which a remarkable change is considering the experience of the previous decade.

There are still two countries (Poland and Slovakia), which have double digit unemployment rates but they also seem to be able to reduce them in 2006. The decline of unemployment has partly been driven by the fast output growth, which resulted in increasing labour demand and led simultaneously to declining unemployment and slightly increasing employment rates. Besides cyclical effects structural reforms also play a role as labour market and other structural reforms in Slovakia and Poland increased the flexibility of labour markets.

In 2006 further decline of unemployment is expected in all countries and the average unemployment rate of the NMS-8 may decline from above 10 per cent for the first time below 10 per cent.

Real wages accelerated in 2005 except for Slovenia, which was linked to fast increases in nominal wages (due to slightly relaxed incomes policies, temporary or permanent labour supply shortages in some countries) and to the fast decline of inflation in most countries, which was only gradually and partially followed by and reflected in changing inflation expectations of the private sector. In some cases the rise in public sector wages was another factor that kept real wages on fast increase.

In 2006 we expect a significant moderation of real wage growth as inflation expectations adjust downward and private sector wage increases will moderate accordingly, while inflation may slightly accelerate.

Table 1. Summary indicators of NMS-8

	2004	2005	2006*	2007*
GDP growth (%)	5,6	6,4	6,3	5,6
Inflation (%)	4,3	3,4	3,4	3,6
General government balance/GDP (%)	-2,5	-2,0	-2,3	-2,3
Current account balance/GDP (%)	-6,7	-6,1	-6,5	-6,1
Unemployment (%)	11,1	10,1	9,5	8,9

Czech Republic

Fast growth and improving macroeconomic performance

The first quarter of 2006 brought about a high GDP growth, the highest rate since 1995, led mainly by fast value added growth in manufacturing on the supply side. While growth prospects for the year as a whole remain bright, economic-political uncertainties may reduce to some extent the rate of growth.

Growth

Output growth in the Czech Republic further accelerated to 7.4 per cent in the first quarter of 2006, on a year-on-year basis. While export of goods and services remains the main engine of growth, their contribution declined. Stronger than expected and higher than in 2005 investment spending and private consumption also contributed to the high pace of growth, and inventories reached a higher level as well. In spite of the May elections, government consumption showed a year-on-year decrease.

Net export remain the main contributor to growth, however, the growth rate of imports is catching up gradually with that of exports. According to the data of the Statistical Office, the growth rate of exports in January-April 2006, on a year-on-year basis was 13.7 per cent, while that of import reached 13.9 per cent, which resulted in a still positive trade balance, the volume of which is at a lower level compared to the corresponding period of the previous year.

Private consumption in the first quarter grew at a higher pace than in 2005, by 3.4 per cent in constant prices. The main factor behind the growth in private consumption was the increase in real wages. Private consumption is expected to grow at an even higher pace in 2007, due to the planned cuts in personal income taxes. Government consumption decreased by 1 per cent, in spite of the elections. GFCF grew at a much higher pace than in 2005, by 7.1 per cent on a year-on-year basis. Inventories also grew at a relatively high pace. However, 2006 and 2007 developments are surrounded by an uncertainty factor caused by the uncertain outcome of the May elections.

International organisations expect a lower rate of growth in 2007, due mainly to accelerating imports and thus lower contribution of net exports to GDP growth, which would counterbalance the growth in consumption.

Monetary developments

In spite of the growth in household consumption and strong GDP growth, inflationary pressures remained modest in the first quarter of 2006. In May, annual inflation was at 3.1 per cent, slightly higher than the 3 per cent target of the Czech National Bank, and higher than forecasted by international organisations. The rise was mainly due to higher food, telecommunication services and fuel prices and the seasonal increase in prices of package holidays, according to the data of the national bank. Higher food prices reflect seasonal tendencies; elevated fuel prices are a result of the increase of oil prices in the world economy, while telecommunications prices are the consequences of changes in regulated prices. However, for the year as a whole, and for 2007, forecasts expect a higher level of inflation, due mainly to the growth in consumption, regulated prices and indirect taxes.

At mid-June 2006, the two-week repo rate stood at 2 per cent. According to the Bank Board, inflationary developments were basically in line with its forecasts, while the exchange rate of the Koruna appreciated and remained stronger than forecasted, thus they have not changed the repo rate. As a result, the Czech Republic has a negative repo rate in real terms. The OECD forecast expects a tightening in Czech monetary policy starting in the third quarter of 2006.

While the exchange rate of the Koruna appreciated in real terms in the period as a whole, turbulences in the regional currency market have not left it untouched. However, exchange rate changes were much less significant than in the case of the Hungarian or Polish currencies.

Fiscal policy

2004 and 2005 were successful years in terms of the general government deficit, which reached the levels of 2.9 per cent and 2.6 per cent compared to the GDP, respectively. While government consumption declined by 1 per cent in the first quarter of 2006, forecasts for the year as a whole expect a modest growth to 3.3 per cent of GDP. For 2007, similar tendencies are expected with the level of the budget deficit reaching 3.5 per cent, and thus in both years surpassing the Maastricht criterion. The main reason is that 2005 revenue surprises were used as a basis for forecasting 2006 revenues and thus planning higher social spending and a decrease in certain taxes. However, political uncertainties about the economic policy stance of the new government may change this forecast to a significant extent. Approach to the badly needed pension and health care reform is still also uncertain.

The Czech Republic's external debt increased slightly in the fourth quarter of 2005, and it represented 38.4 per cent of GDP. The growth was concentrated on short-term maturity liabilities, which represented 31 per cent of total debt. The external liabilities of the government accounted for 24 per cent of total debt, while the corporate sector was responsible for 56 per cent.

External balance

Concerning the current account, in the first quarter of 2006, the trade balance recorded a surplus, according to the data of the national bank. The trade surplus was mainly due to higher exports than imports to EU countries, while trade with non-EU countries showed a deficit. With advanced non-EU countries, the trade deficit narrowed, while with the NMS, emerging economies and developing countries it continued to widen. In terms of product breakdown, trade surplus in machinery and transport equipment continued to grow, while in chemicals and energy, the deficit increased. Behind the favourable trade developments, high inflow of (export-oriented) FDI is one of the decisive factors, part of which can be attributed to relocations. Companies with foreign participation are especially responsible for the good export performance of the machinery and transport equipment sector.

The terms of trade deteriorated, mainly due to the higher growth of import prices, this is confined to the increase in oil and gas prices. Trade in services resulted in a slightly lower surplus in a comparison on a year-on-year basis. The income balance was in a red, which can be explained by the growth in reinvested earnings, while current transfers were in surplus due to transfers from the EU budget through structural funds. Altogether, at the end of the first quarter, the current account showed a deficit of 2.7 per cent of GDP, which is higher than the data for the last quarter of 2005. Tendencies are expected to improve somehow, resulting in an end-year deficit at a slightly lower level, than in 2005. For 2007, international organisations expect an even lower deficit, due to large EU transfers, high GDP growth and lower, but still positive net exports,

On the capital and financial account, the inflow of foreign direct investments was responsible for the 5 per cent (compared to GDP) surplus in the first quarter of 2006, similarly to 2005. FDI came mainly in the form of reinvested earnings, while investment in the form of equity capital was negative and that of other capital negligible. The FDI inflow affected mainly the manufacturing sector, especially the production of motor vehicles, the metal-working industry, and the chemical sector, and its country origin was predominantly the EU. Further planned privatisations in 2006 may affect FDI inflows and the balance of payments positively. Czech direct investment abroad was higher than in the previous quarters; however, it remained at a low level. Its main destinations were various service activities, and in terms of countries: Slovakia and the "financial heavens" of Cyprus and the Netherlands.

The balance of portfolio investments was slightly positive in the first quarter of 2006, due to an issue of government bonds. The international reserves of the Czech National Bank grew by 0.7 billion Czech koruna in the first quarter of 2006.

Labour market

At the end of May 2005, the number of registered job applicants was lower by 30 thousand, compared to the same date in 2005. This resulted in a lower unemployment rate of 7.9 per cent, or 7.1 per cent according to Eurostat methodology. At the same time, there was a decrease in the unemployment rate of graduates and young unemployment, and the number of applicants per available job opportunity declined as well. The main reason behind the decrease is the strong increase in economic activity; however, its impact on the labour market and on the reduction of unemployment remained restrained because of the relatively high share of long-term unemployed, whose reintegration in the labour market is still problematic.

Labour productivity in industry increased by 1.6 per cent, monthly wages were up in real terms by 2.2 per cent in industry, while unit labour costs increased by 3.4 per cent, according to the data of the Statistical Office.

Table 2. Main macroeconomic indicators for the Czech Republic, 2004-2007*

	2004	2005	2006*	2007*
GDP growth (%)	4.0	6.0	6.0	5.5
Private consumption (%)	2.5	2.6	3.5	2.9
Public consumption (%)	-3.2	-0.5	0.8	0.2
Investments (GFCF, %)	9.1	3.7	3.8	3.9
Export (%)	20.9	8.7	9.0	8.7
Import (%)	18.5	6.0	9.2	8.9
Consumer price index (average,%)	2.8	2.4	2.9	2.8
Unemployment ratio (%)	8.3	7.9	7.6	7.2
Real wages	2.7	4.4	5.0	0.8
Real ULC	-2.7	-0.7	1.0	0.5
General government balance (%)	-3.0	-1.9	-3.0	-3.0
Public debt/GDP (%)	36.8	30.5	30.8	30.7
Current account /GDP (%)	-5.2	-2.1	-2.8	-2.9
Trade balance /GDP (%)	-0.8	0.1	-0.5	-0.5
Gross foreign debt /GDP (%)	34.2	38.4	38.5	38.5
2-week repo rate (%)	2.5	2.0	2.0	2.0

Forecasts by ICEG staff.

Sources: EU, IMF, OECD, Czech National Bank, Czech Statistical Office

ESTONIA

Another year of strong economic growth is expected; fulfilment of the Maastricht inflation criterion is the key policy challenge in 2006

Growth

After last year's outstanding performance economic growth accelerated even further to reach 11.6 per cent in the first quarter of 2006. A methodological review is under process therefore data will be subject to revision soon. Although the nominal value of exports continued increasing at 20.7 per cent in the first quarter, the key driving factor of economic growth was domestic demand. Consumption rose thanks to the 18 per cent increase in net wages; this is highlighted by a 17 per cent retail sales growth. Construction volume growth reached 23.8 per cent year-on-year in the first quarter supporting fixed capital formation, while industrial production rose by 8.2 per cent. Rapid credit growth continued to help financing consumption and investment expenditures.

Consumer confidence reached a record high in May; business sentiment is positive. However, concerns about high wage growth are appearing in expectations. Private consumption and fixed capital formation are and will remain key factors of growth with 7.7 and 11.9 per cent expected growth rates in 2006 according to Eesti Pank. GDP growth is expected to cool down in 2006 although estimates have been revised upwards to 8.1 per cent. Overheating of the economy is now a major concern for officials and analysts alike.

Monetary indicators

Inflation exceeded previous expectations by reaching 4.7 per cent in May; producer prices grew by 4.3 per cent. Fuel price increases put an upward pressure on prices in the first half of the year while food prices rose faster than expected.

Fast credit expansion continued; the value of bank credit to the private sector rose by 69 per cent year-on-year in May. The 34 per cent rise of housing prices in 2005 was an important factor behind the growing volume of housing loans; according to available data 2006 seems to bring a stabilisation of property prices. Loans are being financed mainly from abroad: net foreign liabilities of the banking sector doubled since May 2005. As a consequence of rapid income growth the serviceability of loans has not declined yet, thus the loan quality of Estonian banks remained good. The 1-month TALIBOR interbank rate stands at 2.8 per cent while the average lending rate of credit institutions was 5.35 per cent in May.

On 1 June the government approved the fourth version of the National Changeover Plan; the planned date of euro adoption was postponed from 1 January 2007 to 1 January 2008, the main reason being the persistently high inflation. Due to high fuel prices and demand pressures inflation is expected to remain at 3.6 per cent in 2006. Estonia appears to planning 'weighing in' to meet the Maastricht inflation criterion in 2007 (possibly by postponing alcohol and tobacco excise duty increases) but the growth of consumer prices might accelerate again in 2008.

Fiscal policy

In May the government adopted a four-year budget plan. This document is an important strategic guideline for fiscal policy; the main aim is to gradually reach a balanced budget by increasing spending on social care and defence while reducing the overall tax burden from 33.2 per cent of GDP to 31.6 per cent.

Given the circumstances a large fiscal surplus is necessary to offset private sector demand in the short run; according to Eesti Pank estimates the budget should aim to achieve at least a 1.6 per cent surplus in 2006. Cancellation of tax incentives for housing loans and the moderation of wage growth are among the key recommendations. The Ministry of Finance plans a 1.8 per cent surplus for 2006 which is achievable as exceptionally strong economic growth creates additional tax revenues. However, the planned balanced budget for 2007 may be too early if the overheating economy cannot be slowed down this year.

External balance

The growth of goods and services exports reached 20.7 per cent while imports increased at 27.6 per cent in the first quarter. As a result of strong domestic demand the current account deficit did not improve since 2005 and its four-quarter average reached 12 per cent (7.5 per cent without reinvested earnings). Net direct investments exceeded the current account deficit in the last four quarters and covered almost 88 per cent of the deficit of the first three months in 2006. Financial intermediation, real estate and business services remain the favourite sectors for foreign investment. These two sectors combine for two-thirds of the total FDI stock in Estonia, while other services combine for over 20 per cent; the share of manufacturing remains below 10 per cent. Gross external debt rose 10 per cent in the first quarter to reach 95 per cent of expected GDP, while net external debt amounts to 21 per cent.

While domestic demand fuels imports, exports may be harmed by increasing labour costs. The Eesti Pank projects a 9.6 per cent current account deficit for 2006, over a full percentage point more than half a year ago. Given the trends of recent months this value might be exceeded if strong domestic demand persists and real wage growth persistently exceeds productivity growth. As strong borrowing continues, gross foreign debt will rise in 2006 to exceed 100 per cent of GDP.

Labour markets

Strong economic growth gave rise to high employment growth; the number of employed increased by 40.2 thousand (6.8 per cent) in the first quarter. Unemployment dropped three percentage points in a year to a record low 6.4 per cent. Wages are rising steeply; gross monthly wages and salaries increased by 15.7 per cent year-on-year in the first quarter; net wages rose at 18 per cent. In the first quarter a 10.8 per cent real wage growth exceeded the 4.5 per cent productivity growth by far; the continuation of this trend would soon be detrimental to the competitiveness of Estonian enterprises.

Unemployment is expected to decline further in 2006. Real wage growth will peak this year and is expected exceed labour productivity growth in 2006 and 2007.

Table 3. Actual and forecasted major macroeconomic indicators 2004-2007*

	2004	2005	2006*	2007*
GDP (%)	7.8	9.5	8.9	7.9
Private consumption (%)	4.2	8.1	7.7	7.2
Public consumption (%)	6.9	7.5	9.4	7.0
Investments (GFCF, %)	6.0	13.9	11.9	8.6
Export (%)	16.0	21.3	15.0	14.1
Import (%)	14.6	17.4	15.1	13.7
Consumer price index (average,%)	3.0	4.1	3.6	3.0
Consumer price index (Dec/Dec, %)	5.0	3.6	3.0	3.0
Unemployment ratio (%)	9.7	7.9	7.0	6.4
Real wages (%)	5.1	7.7	8.3	7.1
General government balance (% in GDP)	1.7	1.8	1.8	0.0
General government debt /GDP (%)	5.5	5.1	4.0	2.9

Sources: European Commission, Eesti Pank, Statistical Office of Estonia

* Projections, expectations

HUNGARY

New stabilisation package aiming at avoiding currency crisis

Economic Growth

Though GDP expanded briskly in the first quarter of 2006, the short-term expectations reflect significant slowdon of economic activity. While external demand for Hungarian products and services has already been risen slower due to higher oil prices and increasing interest rates, the major reason behind the slowdown is the announced stabilisation package.The changes in fiscal stance and the indirect effects of the stabilisation program will appear only marginaly in 2006, but they will have a strong impact on growth performance in 2007.

The announced stabilisation measures will reduce the growth of private consumption from the last quarter of 2006 and their full effect will be felt in 2007. Simultaneously with the slowdown of the growth of private consumption, gross private capital formation is also expected to slow down in the second half of 2006 due to less room for public infrastructure investments following the announced spending cuts and slower increase of private sector investments. While with somewhat slower pace, the growth of exports will continue in 2006 and 2007 supported by the generally weaker domestic currency.

Altogether GDP may icnrease in 2006 by 4 percent, while in 2007 by only 2.1 percent. The contribution to GDP growth of gross capital formation (investments and changes in stocks) may increase, while of net exports will significantly decline. At the same time the major factor contributing to the slowdown of GDP growth will be the slower increase of private consumption.

Monetary indicators

After hitting its decade low increase in the first quarter of 2006, consumer price inflation started to accelerate in the second quarter. This was partly due to the vanishing effect of the favourable impact of VAT decrease on price increases, higher oil and imported prices and slight reversal of the downward adjustment of private sectors' inflationary expectations.

Consumer price increases will receive a new boost from the recently announced stabilisation package which contains tax increases and upward adjustment of the regulated prices. The increase of the 15% VAT rate to 20%, increases in excise taxes and the significant increase of gas and other regulated prices will add significant momentum to price increases already in 2006. Besides them the almost 10% depreciation of the Hungarian currency in June 2006 and the expected weak forint together with increasing oil and imported prices will sustain the likely price increases. As a result inflation will accelerate step by step and may reach 5% by the end of the year.

Generally indirect tax increases have a temporary effect on inflation while the growth of regulated prices may have persistent ones. These price factors may also lead to secondary effects on inflation, including the rise in wages and reversal of inflationary expectations. As a result further acceleration of inflation is expected for the first quarter of 2007 (partly also due to the base effect as inflation was especially low in the first quarter of 2006) reaching 7% after which a gradual decline is likely.

Interest rates developments are determined by three factors: changes in domestic underlying and expected inflation, evolution of international monetary conditions and the additional measures needed to avoid further depreciation of Forint. In the second quarter of 2006 both the FED and the ECB raised their prime rates and this significantly reduced the interest rate gap between Forint and Euro denominated investments. The recent turbulence on the Forint market already prompted the central bank to raise its key rate from 6 to 6.25 per cent and further increases are likely. According to our expectations the central bank will need to raise its prime rate by additional 100 basis points in 2006 and keep the interest rate level above 7 per cent for the whole next year.

As mentioned already Forint depreciated significantly in June following its earlier weakening in March and April. The currency trade against the Euro in the 250-255 band in January-February first weakened in March-early April to 260-265 band and in June to 280-282 band. Both global factors (increase of dollar and euro interest rates, renewed pressures in several emerging markets including Poland, Slovakia, Brazil and Turkey with their contagion effect) and domestic ones (higher deficit figures, downgrading of sovereign debt, later likely adoption of Euro) contributed to the mentioned weakening. The evolution of the exchange rate depends on the interest rate policies of key central banks and the effects of the announced stabilisation package. It is likely that the Forint will not appreciate in 2006 significantly and the risks are on the depreciation side. We expect some slight depreciation in the third quarter followed by stabilising exchange rate afterwards.

Fiscal Developments

The previous quarterly report on the Hungarian economy included a projection from ICEG European Center on the general government deficit which was expected to reach 6.6% with the adjustment to the pension reform and 8% without it emphasizing the risks related to even higher deficit. The announcement of the stabilisation package in early June coincided with new official figures, according to which the general government deficit would be without the effect of stabilisation 9.5% with the adjustment to the pension reform and 11% without it. According the government the stabilisation and fiscal adjustment may reduce general government deficit to 8% in 2006 and further to 5% in 2007.

The bulk of the adjustment package is the increase of revenues through tax increases, introduction of new taxes and increase of various social security contributions. Expenditure reducing measures for 2006 include the freezing of the from above open ended Medicine Fund, of the administrative expenditures of various government units and announced dismissals from the public sector. The deficit reduction for 2007 foresees further increases in taxes and social security fees and decline of expenditures due to public sector wage freezes and reduction of public sector employment.

Besides having an unfavourable composition (as adjustment mostly relies on revenue increases and less on expenditure reduction) there is a danger that the final general government deficit may exceed in both years the announced figures. In 2006

In 2007 the deficit may be higher as some of the announced tax revenue increases (especially corporate income tax, VAT) may be too optimistic in the light of expected slowdown of real GDP growth, as the increasing interest rate level will significantly increase debt service related expenditures, as some of the announced restructuring measures in the government sector may have less positive effect ton shirt-term expenditures (severance and other payments may rise). As a result we expect that in 2006 the ESA'95 deficit of the general government will be 8.2 percent of the GDP, which will decline in 2007 to 6 percent.

Higher primary deficit, narrowing gap between real growth and average real interest rates on public debt generate further increases government debt. Public debt reached 61 percent in 2005 and it is expected to grow further to 63.5 percent in 2006 and 67 percent in 2007.

Balance of payments

The cumulative deficit of the capital and current accounts in the first quarter of 2006 was 1.3 billion €, which was however more than fully covered by 1,5 billion € inflow of non debt generating capital. In 2006 the continued worsening of the trade balance is expected because of the unfavourable terms of trade developments. At the same time the trade balance may significantly improve from 2007 due to the adverse effect of the announced stabilisation measures on the growth of import demand.

Altogether the current account deficit in 2006 may reach 6.9 per cent of the GDP, which is likely to decline to 5.1 per cent in 2007. This current account deficit may be easily financed with non-debt generating capital inflows unless the perception of markets will worsen.

Unemployment and wage dynamics

There has been some increase in activity rate in the first quarter of 2006 and this has been accompanied by slight increase in the number of unemployed. The unemployment rate in June 2006 stood at 7.3 per cent of the labour force.

Economic growth is expected to remain significant in 2006 and therefore no sizeable effect on employment and unemployment is likely. At the same time the consequences of the stabilisation package on employment may become negative in 2007. First, the announced dismissals from the public sector will significantly reduce the number of employees in the public sector and the private sector will most likely not able to absorb the inflow of unemployed to the labour markets. Besides labour market frictions,. Mismatch of the demanded and supplied labour, this is also due to the worsening expectations of the companies and shifts in the demand composition of growth.

In 2007 domestic consumption, private and public investments will grow less, while exports are expected to accelerate: however exports are the least labour intensive part of production, while investments (especially public infrastructure ones) are the biggest. Therefore one may expect further dismissals from the corporate sector as well leading to rise in unemployment rate.

Table 4. Major macroeconomic indicators for Hungary 2004-2007*

	2004	2005	2006*	2007
GDP (%)	4.6	4.1	4.0	2.1
Private consumption (%)	3.5	1.4	3.1	0.7
Public consumption (%)	-1.5	-0.9	1.5	0.3
Gross fixed capital formation (%)	8.2	6.6	5.5	4.1
Export (%)	15.5	10.8	11.5	9.2
Import (%)	14	6.5	10.9	8.2
Consumer price index (average, %)	6.8	3.6	3.5	6.5
Consumer price index (dec/dec, %))	5.5	3.6	5.0	6.0
Unemployment ratio (%, ILO definition)	6.1	7.3	7.5	8.0
Real Wages (%)	2.6	6.0	1.5	-3.5
General government balance/GDP (%)	-6.3	-8.2	-6.0	-6.3
Public debt/GDP (%)	61.0	63.5	67.0	61.0
Current account/GDP (%)	-7.4	-6.9	-5.1	-7.4
Trade balance/GDP (%)	-2.9	-3.0	-2.1	-2.9
Base rate (%)	9,5	6.0	7.25	7.0

Source: Eurostat, National Bank of Hungary, *Forecast

LATVIA

Fast economic growth is accompanied by high inflation and wide current account deficit: fulfilling the Maastricht inflation criterion and safeguarding the external balance are the most important tasks ahead

Economic growth

Economic growth remains buoyant, GDP growth rate reached a record high 13.1 per cent in the first quarter. This exceeds previous expectations of a 10 per cent growth rate, raising concerns among officials and analysts. Growth is driven by domestic demand; real wages increased by 11.4 per cent and the volume of retail sales expanded by 22.3 per cent year-on-year in the first quarter, mostly as a result of motor vehicles and fuel sales. Investments in fixed assets rose by 16 per cent in the first quarter. The year-on-year volume growth of real estate, personal services, and trade and construction sectors exceeded 17 per cent while financial intermediation grew at 13.4 per cent – all these signs indicate very robust domestic demand. The composition of growth gives rise to imbalances as export growth cannot keep pace with domestic demand; the value of net imports increased by 63.6 million lats (by 43 per cent) year-on-year in the first quarter. Business and consumer confidence is high.

Strong economic growth will persist this year. Given the higher-than-anticipated growth data of the first quarter previous estimates of 2006 economic growth may need to be revised upwards; a 9.0 per cent growth rate is realistic for this year.

Monetary indicators

Although inflation is moderating, it is still high: consumer prices recorded a 6.6 per cent annual growth in May. Demand pressures, rising food and energy prices as well as higher tariffs on natural gas since May all exercised upward pressures on inflation.

Credit growth is still very fast at 61.7 per cent in April. Housing and consumption purposes still lead credit demand: loans to households increased by 81.7 per cent. Loans denominated in euros growth the fastest indicating that borrowers anticipate a smooth transition to the euro and underestimate exchange rate risk still present until the adoption of the common currency. Interest rates for loans in domestic currency are increasing: lending rates to non-financial enterprises stand at 7 per cent while average lending rates to households are at 9.3 per cent; on the other hand, lending rates in foreign currencies are stable at around 5 per cent. Banks finance domestic lending from abroad: net foreign liabilities of banks rose in May by almost 89 per year-on-year. Independent analysts voiced concerns about a potential property price bubble.

There is currently no explicit target date for euro adoption; estimates range between 2009 and 2011. The main obstacle is the Maastricht inflation criterion which Latvia cannot hope to comply with in the near future. The government resists increasing fuel excise duties at current price levels in an attempt to control inflation.

Fiscal policy

The state budget produced a sizeable, 106 million lats surplus in the first four months; strong economic growth boosts tax revenues therefore fiscal policy can lean against the wind to offset domestic demand. If windfall revenues are not spent mid-year, the budget deficit could reach 1 per cent in 2006. A critical element for next year is the planned reduction of the flat personal income tax rate from 25 to 15 per cent; this measure would boost disposable income and add further demand pressures to an already overheating economy.

In June the visiting IMF mission recommended a front-loaded fiscal adjustment to reach a balanced budget. The proposals included the saving of windfall tax receipts this year, freezing of the real value of expenditures in coming years, rationalising self-financed spending and the co-financing of EU structural funds as well as the postponing of personal income tax cut.

Government debt is gradually declining and is expected to approach 11 per cent in 2006 and 2007.

External balance

The external competitiveness of the economy is declining; in the first quarter goods exports rose at 13.8 per cent while imports increased by 27.2 per cent. The trade deficit widened by 63.6 million lats to reach 210.4 million lats year-on-year by March 2006. Loss of competitiveness is due to the structure of exports: the share of products with a high share of value added is low, while foodstuff, base materials and light industry products (clothing, paper, etc.) constitute three quarters of total exports. These sectors are hit harder by increasing energy prices and labour costs.

The current account deficit started widening in the first four months of 2006, the deficit of the first quarter rose by 43 per cent year-on-year. Net FDI covered half of the current account deficit in the first quarter; 45 per cent of inward FDI were reinvested earnings.

Due to strong domestic demand and weakening exports the trade balance and the current account is expected to deteriorate in 2006, the latter reaching 13 per cent of GDP. 2007 will bring only slight improvements.

Labour markets

Unemployment has declined to 7.4 per cent in the first quarter, down 1.2 percentage points from the respective period in 2005. Strong growth contributes to job creation, and as employment outlook of business enterprises is favourable, unemployment is expected to decline further in 2006.

Gross wages in the economy increased by 19.2 per cent year-on-year in the first quarter; increases in the private sector were even higher at 20.8 per cent. Rapid real wage growth (exceeding 10 per cent) fuels expectations of a fast catch-up in income levels to the EU average; however, a wage-price spiral may arise if these expectations become self-fulfilling.

Table 5. Actual and forecasted major macroeconomic indicators 2004-2007*

	2004	2005	2006*	2007*
GDP (%)	9.8	10.2	9.0	8.0
Private consumption (%)	9.3	8.4	8.0	8.0
Public consumption (%)	2.1	2.4	2.8	3.0
Investments (GFCF, %)	23.8	16.5	14.0	9.2
Export (%)	9.4	13.6	12.8	11.7
Import (%)	16.6	9.5	10.0	8.6
Consumer price index (average,%)	6.2	6.7	6.6	5.6
Consumer price index (Dec/Dec, %)	7.3	7.0	6.5	5.0
Unemployment ratio (%)	9.8	9.7	7.8	7.5
Real wages (%)	3.1	10.1	7.0	6.5
General government balance (% in GDP)	-0.9	-1.2	-1.0	-1.0
General government debt /GDP (%)	14.7	12.8	11.9	11.3
Current account /GDP (%)	-12.9	-12.5	-13.1	-12.6
Trade balance /GDP (%)	-15.9	-15.1	-16.3	-15.7
Gross foreign debt /GDP (%)	93.2	98.4	100.1	110.0
RIGIBOR (12-month, end of period)	4.26	3.33	4.5	4.5

*forecast

Source: European Commission, Eesti Pank, Statistical Office of Estonia

Lithuania

Slower growth amidst slightly accelerating inflation

While overall economic performance remains more than satisfactory, developments in CPI-inflation led to the postponement of euro adoption, originally planned to 2007. Continuing consumer credit boom pose a further risk to the stability of the financial system.

Growth

Real GDP growth hit 8.8 per cent in the first quarter of 2006 compared to the same quarter of the previous year. While this figure in itself is indeed remarkable, it partially reflects a relatively low base value in the first quarter of 2005. Seasonally adjusted data unveil a minor deceleration in real GDP growth in the first quarter of 2006 from its end-2005 rates. On the production side construction and industrial output were the main driving forces of growth, but financial intermediation and real estates-related services also expanded at an above average rate. On the expenditure side private consumption growth further accelerated, this, however, was accompanied by clearly moderating investment growth. Net exports have again deteriorated somewhat with both exports and imports expanding above 20 per cent compared to the first quarter in 2005.

In the rest of 2006 and further into 2007 we expect private consumption to lose some pace. It will nevertheless remain robust, as wage increases (due to labour market tightness) and personal income tax reductions will keep disposable income growth high. The current slowdown in investment probably proves to be temporary, since financial conditions are still favourable and EU funds also create further opportunities. Exports (on ground of the numerous investment projects of the past years) and imports (reflecting steady consumption growth) will both expand rapidly, with net exports continuing to contribute negatively to overall GDP growth. We thus expect real GDP growth to moderate to slightly above 6.5 per cent in 2006 and to approximately 6 per cent by 2007.

Monetary developments

12-month CPI-inflation rose to 3.6 per cent in May 2006. Earlier in April the European Commission did not recommend euro adoption for Lithuania by 2007, since the average inflation rate over the preceding twelve months has slightly exceeded the one, prescribed in the Maastricht convergence criteria. Besides, an upward trend in CPI-inflation is expected in the coming period, since disposable income will be higher due to wage increases and also tax reductions. Average annual inflation can reach 3.6 per cent in 2006, than slow gradually to 3.4 per cent in 2007.

Interest rates are on the rise too (though, in a currency board regime this is not so indicative about the stance of monetary policy). Since the Lietuvos Bankas (the central bank) establishes its overnight repo rate to be equal to the ECB's marginal lending facility rate, this was also raised by 25 basis points to 3.75 per cent on the 15^{th} of June. Overnight VILIBOR (the Vilnius Interbank Offered Rate) exhibited a parallel move. Longer-term interest rates have also risen since the middle of March by approximately 20 to 25 basis points. We expect further interest rate increases in 2006, as – based on their own comments – the ECB also considers further rises in their policy rate.

The outstanding amount of domestic credit was more than 60 per cent higher in May 2006 than a year before. Within it bank credit to households increased by close to 75 per cent, while credit to non-financial corporations increased by some 48 per cent. Fast credit growth will continue in the rest of 2006, but moderation can not be excluded, since policy measures will be taken to cool down especially the housing market.

Fiscal policy

Due mainly to higher revenues than anticipated, the fiscal deficit amounted to a mere 0.5 per cent of GDP in 2005. Both tax and social contributions revenues increased by well above 10 per cent, grants and other revenues also increased considerably. On the other hand, the biggest expenditure biggest item, social benefit payments were reduced compared to their 2004 level. There were, however, significant increases in the compensation of employees and public consumption.

On the back of good growth prospects, the developments on the revenue side are very promising also for 2006, but due to the planned tax reductions the growth dynamics may be smaller than in 2005. This will also be the case in 2007. On the expenditure side wage increases might be a potential risk, but even that will certainly not lead to strong expenditure growth. Taken together, we expect a minor deterioration in the budget balance in 2006 (to -0.6 per cent of GDP), and a further deterioration in 2007 (close to -1 per cent of GDP).

Public debt stood at 18.7 per cent of GDP at the end of 2005 (well below the Maastricht criteria of 60 per cent), and is expected to remain below 20 per cent on through 2007.

External balance

The current account deficit amounts to 2.2 billion litas in the first four months of the year. This is well above the 1.85 billion deficit of the same period last year. While both exports and imports increased considerably, the trade deficit widened by more than 200 million litas and further 200 million litas deterioration is observed in the services balance. On the back of decreasing profit repatriation after foreign direct investment (also reflected in higher reinvested earnings), the income balance improved compared to the first four months of the previous year.

Contrary to the higher amount of reinvested earnings, incoming foreign direct investment almost halved from January to April compared to the same period in 2005, falling to LTL 500 million from LTL 950 million. Taking into consideration that net portfolio equity flows turned well into negative territory, non-debt generating financing was virtually zero. The main element of C/A-financing was again the accumulation of short-term liabilities by the banking sector.

Despite the moderation of GDP growth in the forecast horizon, we expect that the current account deficit will widen both in 2006 and 2007, reflecting mainly developments in goods trade. Private consumption and gross fixed capital formation will all increase at markedly high rates that will keep import growth at double-digit rates. Though exports (based on investments realized in the recent past) will also increase considerably, the balance on goods will further deteriorate, and the income balance will also exhibit higher deficit as profit repatriation and interest payments on short-term debt will increase. For 2006 we expect a C/A-deficit around 7.3 per cent of GDP, this will further rise to around 7.5 per cent of GDP in 2007.

The stock of gross foreign external debt was 50.8 per cent of GDP at the end of 2005. Since both in 2006 and in 2007 at least 50 per cent of the C/A-deficit will be financed by debt-generating inflows, the stock of gross external debt will marginally grow to approximately 52-53 per cent of GDP.

Labour market

Tightening labour supply remains a challenge in Lithuania, as the labour force further shrinked in 2005 and will continue to do so in 2006 and 2007 as well. Under these circumstances (which partly reflect emigration) growing labour demand led to upward pressures on wages. At the same time the unemployment ratio considerably moderated to just above 8 per cent by the end of 2005.

As the economy continues booming, job creation will further reduce the unemployment ratio that can be as low as 7 per cent by 2007. At the same time productivity growth will partly offset wage increases that will lead to a deceleration in the growth rate of unit labour costs. Real ULC actually will decrease both in 2006 and 2007.

Besides shortages in labour supply, sectoral mismatches between labour supply and demand will sustain the tightness of the Lithuanian labour market. Thus in the forecast horizon, inflationary pressures from the labour market will remain a factor, that the economic policy can not fully neglect.

Table 6. Main macroeconomic indicators for Lithuania, 2005-2007*

	2004	2005	2006*	2007*
GDP growth (%)	7.0	7.5	6.6	6.0
Private consumption (%)	9.7	10.4	8.9	7.9
Public consumption (%)	7.5	5.6	5.0	4.5
Investments (GFCF, %)	12.3	11.2	7.6	7.1
Export (%)	4.2	14.3	11.4	10.2
Import (%)	14.8	15.9	12.1	10.7
Consumer price index (average,%)	1.1	2.7	3.6	3.4
Unemployment ratio (%)	11.4	8.3	7.4	7.0
Real ULC		0.3	-1.3	-0.5
General government balance (%)	-1.4	-0.5	-0.6	-1.0
Public debt/GDP (%)	19.6	18.7	19.0	19.8
Current account /GDP (%)	-7.7	-7.0	-7.3	-7.5
Trade balance /GDP (%)	-7.0	-11.2	-11.7	-11.8
Gross foreign debt /GDP (%)	42.8	50.8	51.9	53.2
1-year VILIBOR (%)	2.88	2.82	3.6	3.3

* Forecasts by ICEG staff.

POLAND

Strong economic performance despite unstable political situation in Poland

Growth

GDP growth remained strong in Q1 2006. It amounted to 5.2 per cent year-on-year, which was higher than expected. It exceeded the 4.3 per cent year-on-year real GDP growth rate experienced in the last quarter of 2005. The main drivers behind strong growth in Q1 2006 were retail sales and improvement in the labour market. The rise in gross fixed capital formation and public consumption was lower than in the previous quarter. Net exports contributed by 0.7 percentage points to GDP growth in Q1 2006, which is a positive development compared to Q4 2006.

On the supply-side industrial production was strong in Q1 2006, showing a 12.1 per cent year on year rise. However, in April, a deceleration was recorded in industrial production, with its growth rate reaching only 5.8 per cent year-on-year, compared to 16.4 per cent in March. In seasonally adjusted terms industrial output growth remained at the high level of 10.2 per cent year-on-year (13.6 per cent year-on-year in March).

On the demand side continuous improvement in the labour market will contribute to higher private consumption, which will cause the acceleration of domestic demand. Entrepreneurs and consumers optimism was strong, and business climate indicators showed an optimistic picture in May 2006. The mood of consumers and entrepreneurs is expected to remain positive throughout the year.

The rate of growth is expected to be slightly lower in the last two quarters of 2006, due to a lower number of working days. Overall in 2006 a 5 per cent year on year real GDP growth rate is expected. Growth is expected to remain strong in 2007 and accelerate to 5.3 per cent. The main driving force will be industrial production, retail sales, improvement in the labour market, and high investment growth.

Monetary indicators

The rise of consumer prices remained low in Q1 2006, with the CPI reaching only 0.6 per cent year-on-year (lower than the 1.1 per cent year-on-year rise of consumer prices in the previous quarter). In April acceleration occurred in the year-on-year CPI, compared to March (0.7 per cent, and 0.4 per cent respectively), which was mainly the result of an increase in energy prices, especially the increase of fuel prices and natural gas prices. A hike in the price of natural gas tariffs was an important underlying factor.

Core inflation measures also increased in April, although their levels are still quite low. In April net inflation increased to 1 per cent year-on-year, from 0.7 per cent in March.

In Q1 2006 PPI turned positive, reaching 0.9 per cent year-on-year (-0.4 per cent year-on-year in the previous quarter). In April producer prices rose by 1.8 per cent year-on-year (0.9 per cent in March). The rise in PPI was mainly due to the rise in commodity prices, and occurred despite the strengthening of the zloty (compared to the previous year). At the same time inflationary pressure continues to be low, similarly to the inflationary expectations of households.

As a result the Monetary Policy Council of the National Bank of Poland left interest rates unchanged at its May meeting. Therefore the reference rate remained at the (record low) level of 4 per cent. Due to the current and expected favourable economic situation interest rates are expected to remain unchanged until at least next spring (according to the forecast of Polish commercial banks). Households' inflation expectations remain at a very low level, the expansion of the economy has not yet put pressure on prices. We expect interest rates to stay unchanged until the end of 2007. The zloty has been weakening vis-à-vis the euro in May and June, but the extent of the weakening has been small, as the general economic situation is favourable, with strong fundamentals. The market reacted with a sell-off of zlotys, to the resignation of the Finance Minister, Ms. Zyta Gilowska, as she was seen as a guarantor of fiscal responsibility in Poland. Markets stabilized after the name of her replacement (Mr. Pawel Wojciechowski) was announced.

Fiscal policy

The liberal Finance Minister, Ms. Zyta Gilowska presented a proposal on tax changes. (Ms.Gilowska has since been dismissed amid allegations that she covered up communist-era collaboration.) In the beginning of June government approved the package, which will not bring significant changes. Its overall impact in 2007 will be neutral, as effective taxation of labour income will decrease, but this effect will be offset by the rise of some indirect tax rates.

The tax changes will not result in a significant reduction of labour costs. There are not yet signs of adjustment on the spending side, either. According to the Finance Minister Poland must make fiscal savings amounting to 1.2 per cent of GDP by 2007-08, but she did not give details about how this would be achieved.

Budget deficit in April reached 32.8 per cent of the annual plan, which is lower than in previous years for the same period. Revenues were strong, especially revenues from indirect taxes, which experienced a powerful increase. At the same time acceleration was experienced in spending, as a result of higher costs of foreign debt service.

The Polish Government set a 2.6 per cent of GDP general government deficit target in the 2006 January Convergence Programme. General government deficit as a percentage of GDP is likely to be above target however, reaching 3 per cent in 2006. In 2007 a further worsening is expected in the general government deficit, to reach 3.1 per cent of GDP.

Balance of payments

The current account deficit reached 458 million euros in March. The higher than expected current account deficit were the result of the 272 million euro trade deficit and the lower surplus of current transfers. At the same time the current account deficit as a percentage of GDP was still at the quite low level of 1.5 per cent in March. It is not expected to exceed 2 per cent of GDP by the end of the year.

In March export growth reached 23 per cent, while import growth was also strong, reaching 21.6 per cent (both in euro terms). Strong improvement in import and export growth also indicates the ongoing acceleration in economic activity. Exports to non-EU countries are expected to increase, along with imports growing as a result of strengthening domestic demand.

As a result a rise is expected both in the trade and in the current account deficit in 2006 and 2007. At the same time higher transfers from the EU will have a moderating effect on the capital account and the current account. The current account deficit is expected to reach 1.9 per cent of GDP in 2006 and 2.3 per cent in 2007. The trade deficit is expected to reach 1.5 per cent of GDP in 2006 and 2.2 per cent in 2007.

Labour markets

The improvement in the labour market continued in Q1 2006. The unemployment rate was 17.8 per cent. In April employment in the corporate sector rose by 2.8 per cent year-on-year. The favourable tendencies in the labour market are the result of accelerating economic growth and increase in demand for labour. However heavy structural unemployment remains a problem. The high tax wedge, the undiversified level of minimum wage, insufficiently flexible forms of employment, and low job reallocation in regional and trans-professional terms are all impediments on the way of unemployment reduction.

Wage growth is still not a source of inflationary pressure, as year-on-year total labour productivity growth in industry was higher than the growth rate of average nominal wages in the time period between January and April 2006. However, rising wage demands of the public sector could lead to increased tension in public finance.

The unemployment rate is expected to decrease to 16.2 per cent by the end of 2006, and a further decrease to 15.2 per cent is expected by the end of 2007.

Table 7. Major macroeconomic indicators for Poland 2004-2007*

	2004	2005	2006*	2007*
GDP (%)	5.4	3.3	5	5.3
-Private consumption (%)	3.4	2.0	3.2	3.7
-Public consumption (%)	3.5	2.2	2.0	2.0
-Investments (%)	5.3	3.5	6.9	6.8
-Export (%)	22.3	17.1	18.9	18.0
-Import (%)	19.5	12.6	20.2	20.0
Consumer price index (average, %)	3.5	2.1	0.8	1.3
Consumer price index (dec/dec, %))	4.4	0.7	1.5	1.5
Unemployment ratio (%)	19.1	17.6	16.2	15.2
Real Wages (%)	0.8	1.2	3.9	4.3
General government balance (% in GDP)	-4.5	-2.9	-3.0	-3.1
Public debt/GDP (%) ESA 95	43.6	46.3	47.0	46.0
Current account/GDP (%)	-4.1	-1.6	-1.9	-2.3
Trade balance/GDP (%)	-2.3	-0.9	-1.5	-2.2
Gross foreign debt/GDP (%)	46.2	43.5	40.6	41.7
Base rate	6.5	4.5	4.00	4.00

Sources: National Bank of Poland, World Bank, Bank Zachodni WBK, Bank Austria Creditanstalt, OECD, Deutsche Bank Research, EU *Predictions, expectations

Slovakia

Slower growth and increasing inflationary pressures

The rate of economic growth is expected to remain high in 2006, based on the results of the first quarter.

Growth

The rate of economic growth in the first quarter of 2006 reached 6.3 per cent in Slovakia, which is lower than in the last quarter in 2005, however, in this latter period, one-off factors influenced the growth performance (because of the planned increase in excise taxes in 2006, retailers accumulated stocks in tobacco products and beverages, which contributed by 1.5 percentage point to the growth rate in the last quarter of 2005). In 2006, there is a shift between the contribution of foreign and domestic demand to growth, the former becoming more pronounced than in previous years and dominating over domestic demand. High GFCF also contributed significantly to economic growth. High investment rate can be partly attributed to FDI (especially in the automotive sector). Government and household consumptions' growth contribution was lower, however, their rate of increase is still significant (above 6 per cent).

There seems to be a change in the contribution of growth factors. While the growth rate of private consumption shows some deceleration, it is expected to remain close to 5 per cent, and an increase in government consumption is expected for 2006 and 2007 to around 3 per cent – however, this latter is dependent on changes in the government's economic policy stance after the June elections. At the same time, the growth contribution of both types of domestic consumption is forecast to decrease in 2006 and 2007. At the same time, GFCF (with an above 8 per cent growth rate) and this factor can be the most important in domestic demand. At the same time, the growth contribution of net exports is expected to become stronger in 2006 and in 2007. The mixture of these factors is expected to keep the rate of increase in GDP above 6 per cent in both years.

Monetary developments

The level of consumer prices increased by 4.8 per cent on a year-on-year basis in May 2006, according to the data of the Statistical Office. It is mainly the prices of public services (housing, water, electricity, gas, health care, education), which increased the most. (Regulated prices increased the most in the Slovak Republic last year compared to other Visegrad countries, according to the estimations of the World Bank.) Inflation (CPI) is expected to increase to above 4 per cent in 2006. Data for the first quarter indicate an increase in inflationary pressures in the Slovakian economy. Both cost-push and demand-pulled elements of inflation are present, together with one-off impacts. However, predictions by international organisations assume a weaker inflationary pressure for 2007, resulting in a below 3 per cent rate of inflation for that year.

At mid-June, the two-week repo rate stayed at 4 per cent. At the end of May, the Monetary Council decided for a half percentage point increase. The main reason behind the decision is the increase in inflationary tendencies. The monetary policy will be under further pressure this year because of strong output growth, large capital inflows connected to privatisation, FDI, portfolio and other (mainly short-term) investments, which all seem to be insensitive to the strong koruna and the relatively low interest rate. It is also a problem, the despite of the entering of the koruna in the ERM-II, investors do not differentiate between Slovakia and other Visegrad countries. Frictions by the difference between ECB and SNB rates may cause problems for the monetary policy.

Fiscal policy

Slovakia is expected to continue to fulfil the Maastricht criterion of a budget deficit of below 3 per cent of GDP in 2006 and 2007 as well. In 2006, a lower than 2005 budget deficit is expected, due to the strong growth record and large tax revenue growth. However, on one hand, if the assumption about purchases brought forward because of the increase in excise taxes proves to be true, and the impact of the pension reform and the budgetary impact of EU transfers are taken into account, the budget deficit may exceed 3 per cent at the end of this year. On the other hand, a one-off decline in government spending in 2006 will be the result of a debt writeoff in 2005, benefiting Iraq, Sudan and Syria, according to the OECD. Altogether, these factors may result in a below 3 per cent budget deficit compared to GDP in 2006. In March, the Ministry of Finance announced a new fiscal framework for public discussion, according to the OECD, which assumes that Slovakia will fulfil all Maastricht criteria in 2007.

Other positive impacts of the fiscal reform are appearing in the budget data of the Slovak republic. By 2006, among Visegrad countries, Slovakia has the lowest level of budget revenues and expenditures compared to GDP. The significant decreases of the budget deficit from the 7.8 per cent of GDP in 2002 to 2.9 per cent in 2005 are also signs of the improvement, connected to the reform. However, the reform did not aim directly at reducing the deficit by decreasing expenditures and increasing revenues, but more at structurally "redefining" the fiscal system. That is why its impact can be traced only on a longer run.

External balance

The current account deficit has been widening rapidly in 2005, which tendency is about to ease only slightly in 2006. In April, there was a year-on-year increase of 10.3 per cent in exports and 12.3 per cent in imports, which indicates an acceleration of import growth compared to 2005, while export growth remained at the same level. This resulted in a higher deficit of the trade balance compared to the same period of last year. Higher imports are mainly due to the (possibly one-off) impact of FDI inflow in Slovakia (especially car industry investments).

The current account deficit is expected to be lower in 2006 than in 2005, backed by the more favourable developments in net exports. This year, exports are forecasted to grow quicker, than last year, by 11.7 per cent; while import growth is put to 10.7 per cent; resulting in a slightly lower trade deficit. Exporting of large greenfield FDI projects in the car industry may contribute to high growth of exports. Partly fuelled by this latter factor, net exports are expected to turn positive and the current account balance is forecasted to narrow further in 2007.

Balance of payments data are available for the first two months of 2006. These show similar tendencies than in 2005: a significant trade deficit, a slight surplus of the services trade. However, the capital and financial accounts show a negligible deficit, while in 2005 it was they more than counterbalanced the deficit of the current account. Foreign direct investment amounted to 380 million USD, which mainly came from reinvested earnings. The balance of portfolio investments showed a deficit of 126 million USD, while other, especially short-term investments surpassed 200 million USD, both at a lower level than in 2005.

Labour market

In the first quarter of 2006, total employment went up by 2.1 per cent, which may be attributed to the favourable growth record. The strong employment growth of the fourth quarter thus continued into 2006 as well. There is an increase in the number of vacancies. This contributed to a further reduction in the number of unemployed, however, the unemployment rate is still among the highest among the NMS countries, though it continued to fall in the first quarter and dropped to 14.9 per cent, to its lowest level since the first quarter of 1999, according to the data of the Statistical Office. Unemployment went down in all branches of the economy. In terms of the length of unemployment, the decrease was the lowest among the long-term unemployed (unemployed for more than 2 years). For 2006 as a whole and 2007, a further decrease in unemployment is expected due to strong economic growth.

Real wages increased by 3.1 per cent, which indicates a deceleration in the rate of wage increases. Services are characterised by higher rates of increases, while in industry the corresponding rate is far below the average.

Table 8. Main macroeconomic indicators for Slovakia, 2004-2007*

	2004	2005	2006*	2007*
GDP growth (%)	5.5	7.5	6.5	6.0
Private consumption (%)	3.5	5.8	4.9	4.5
Public consumption (%)	1.2	1.6	3.3	3.8
Investments (GFCF, %)	2.5	11.5	9.5	7.5
Export (%)	11.4	10.2	11.7	10.6
Import (%)	12.7	9.3	10.7	11.2
Consumer price index (average,%)	7.5	2.7	3.6	3.6
Unemployment ratio (%)	18.0	16.2	15.4	14.3
Real wages	3.4	6.3	3.2	4.0
Real ULC	-2.0	n.a.	1.0	1.5
General government balance (%)	-3.3	-2.9	-2.8	-3.0
Public debt/GDP (%)	43.6	44.2	44.0	44.0
Current account /GDP (%)	-3.4	-6.1	-6.5	-6.6
Trade balance /GDP (%)	-3.5	-4.8	-4.6	-4.6
Gross foreign debt /GDP (%)	53.9	49.8	48.0	47.5
Basic interest rate (%)	5	3	4	3

Sources: EU, IMF, OECD, Slovak National Bank, Slovak Ministry of Finance
* Forecasts by ICEG staff.

SLOVENIA

Unchanged stability of growth and macroeconomic conditions

Growth

Real GDP grew by 3.9 percent in 2005. Last year's growth was mainly based on strong export performance and a slower growth of imports. Slovenia's per capita gross domestic product measured at purchasing power parity reached 80 per cent of the EU25 average in 2005. This value is higher than Portugal's GDP per capita and only 2.2 percentage points lower than the GDP per capita of Greece.

Real GDP increased by 5.1 per cent in the first quarter of 2006 compared to the same period of last year. This remarkable growth in the first three months of 2006 was driven mainly by strong gross fixed capital formation.

We expect that real GDP is about to increase by 4.1 per cent in 2006. The growth will be mainly driven by domestic demand. The external demand will have a positive but a less pronounced contribution to GDP growth.

As the euro introduction draws nearer household consumption is expected to strengthen. This will be due to favourable credit opportunities and increasing employment. Accelerated construction of motorways and surging housing construction will boost investment spending in 2006.

Monetary indicators

Average inflation amounted to 2.5 per cent in 2005. The inflation went below the Maastricht reference value for the first time in January 2006. Since then Slovenia keeps on fulfilling the Maastricht inflation criterion. Consumer prices rose by 0.9 per cent in May over April 2006. Year on year totalled 3.2 per cent in May this year. Higher prices of petroleum products and food added the most to the total growth of prices. HICP was at 2.4 per cent in May 2006. The Maastricht inflation criterion (the average inflation rate in the three member states with the lowest inflation plus 1.5 percentage points) stood at 2.7 per cent in the same period.

Since the publication of ICEG EC last forecast the Bank of Slovenia left its key tolar interest rates unchanged. Thus the refinancing rate remains at 3.25 per cent.

The Slovenian tolar has been participating in ERM II since 28 June 2004. Slovenia joined ERM II at a central rate of 239.64 tolars per euro. Deviations from the central parity have been negligible (less than 0.12 per cent) since the entering of ERM II entry. The Slovenian tolar remained on the strong side of +-15 per cent fluctuation band. The irrevocable fixing of the tolar/euro exchange rate is will be adopted at the ECOFIN Council meeting on 11 July 2006.

The Convergence Report which was published by the European Commission and the ECB on May 16 2006 gave a positive assessment on Slovenia's preparations to join the Economic and Monetary Union. The report concluded that Slovenia has achieved a high degree of sustainable economic convergence with the other Member States and that it fulfils the necessary conditions to adopt the euro. On the basis of this report the 16 June 2006 European Council meeting approved Slovenia's bid to join the euro zone on 1st January 2007.

Fiscal policy

According to the Statistical Office of the Republic of Slovenia the general government deficit amounted to 115 447 million tolars or 1.8 per cent of GDP in 2005. At the end of 2005 the general government debt reached 1.9 billion tolars or 29.1 per cent of GDP. Slovenia easily met both Maastricht criteria concerning the sustainability of public finances.

General government deficit is estimated to reach 1.6 per cent of GDP in 2006. However the abolishment of payroll tax might worsen the general government deficit. We expect that the deficit will amount to 1.4 per cent of GDP in 2007 as the loss of revenues from the phasing out of payroll tax might be offset be an increase in VAT.

Balance of payments

The current account deficit improved significantly reaching 1.1 percent of GDP in

2005. However the relatively modest deficit in the current account at the beginning of 2006 rose to EUR 157 million in March, increasing by 25 percent in year-on-year terms.

We expect that the current account deficit will reach 1.6 percent of the GDP in 2006. This will be mainly due to strong merchandise imports. As current transfers from the EU budget increase, the current account balance will improve in 2007. We expect that the deficit will amount to 1.2 percent of GDP next year.

Labour markets

The unemployment rate was 6.5 percent in 2005. According to the latest data unemployment rate stood at 6.9 percent in the first quarter of 2006. Favourable economic conditions and the phasing out of the payroll tax will positively contribute to employment growth in 2006. Owning to the high activity rate and the increasing population the unemployment rate will stay around 6.5-6.6 percent in 2006 and 2007.

Table 9. Major macroeconomic indicators for Slovenia 2004-2006

	2004	2005	2006*	2007*
GDP (%)	4.6	3.9	4.1	4.0
Private consumption (%)	3.5	3.4	3.2	3.3
Public consumption (%)	1.7	2.5	2.6	2.7
Export (%)	12.6	8.6	8.1	8.0
Import (%)	12.4	6.0	7.4	7.2
Consumer price index (average,%)	3.6	2.5	2.2	2.2
Consumer price index (Dec/Dec, %)	3.2	2.3	2.1	2.2
Unemployment ratio (%)	6.0	6.5	6.5	6.5
Real wages (%)	2.0	2.1	2.3	2.6
General government balance (% in GDP)	-1.9	-1.8	-1.6	-1.4
General government debt /GDP (%)	29.5	29.1	29.5	29.8
Current account /GDP (%)	-0.7	-1.1	-1.6	-1.2
Trade balance /GDP (%)	-0.6	-0.4	-0.1	0.5
Gross foreign debt /GDP (%)	59.3	69.0	75.0	78.3
Base rate (end of period)	3.25	3.75	3.0	3.0

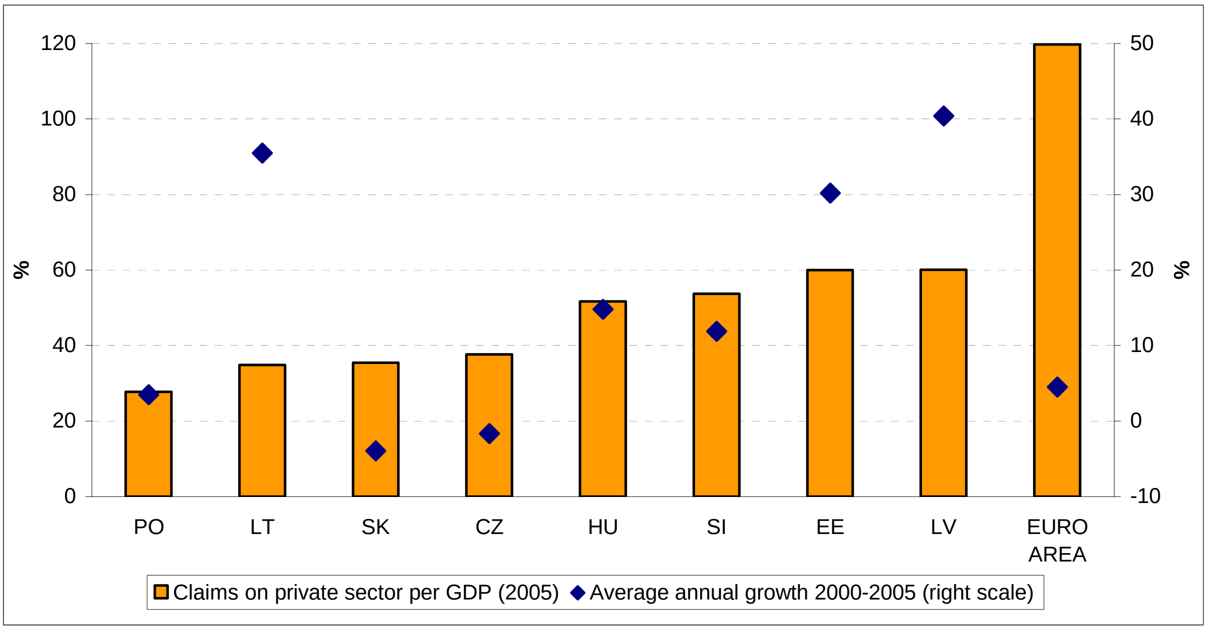
Source: Bank of Slovenia, IMF, European Commission, IMAD, Statistical Office of RS

*Forecast

Special topic: Credit growth in the EU-8 countries

In recent years bank lending has surged in most EU-8 countries. Credit growth reached annual real growth rates between 10 and 15 per cent in Slovenia and Hungary, while exceeding 30 per cent in the Baltic countries (see Graph 1). On the other hand, credit growth remained sluggish in the Czech Republic, Poland and Slovakia.[2] As a consequence of high growth rates, banks' claims on the private sector relative to GDP are now approaching 60 per cent, half of the euro-zone average. An important engine of credit growth have been mortgages for housing purposes, but consumption loans and loans to (small and medium-sized) enterprises have also increased substantially. Another special feature is the importance of foreign currency borrowing, most notably in the Baltic countries and Hungary.

Graph 1. Bank lending to the private sector



Source: International Financial Statistics

Causes of credit growth

What are the main causes of this phenomenon? It is useful to decompose credit growth to three components: trend, cycle and boom.[3] The trend reflects an equilibrium process of financial deepening, which naturally accompanies economic growth. EU-8 countries have some special characteristics that can accelerate credit growth.[4] On the supply side, financial liberalisation and the restructuring of the banking sector have spurred competition. Successful macroeconomic stabilisation after transition also contributed to declining inflation and interest rates, while improving legal systems helped creating a favourable business climate. Under these circumstances banks started to focus on previously neglected

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[2] Negative growth rates in the Czech Republic and Slovakia are a consequence of shrinking corporate loans. Household loans are increasing roughly at the pace of Poland.

[3] See: Terrones, Marco and Enrique Mendoza: Are Credit Booms in Emerging Markets a Concern? *IMF World Economic Outlook*, April 2004.

[4] See for example: Backé, Peter and Tina Zumer: Developments in Credit to the Private Sector in Central and Eastern European Countries: Emerging from Financial Repression – A Comparative Overview. Österreichische Nationalbank, Focus on European Economic Integration 2/2005.

retail segments, households and SMEs. On the demand side, income growth eased borrowers' liquidity constraints and prospects of sustained economic growth encouraged borrowing.

Cyclical movements in credits arise because firms' investments and working capital fluctuate with the business cycle, while household spending follows the movements of income. Rising asset prices boost borrowers' wealth and increase their capacity to borrow. The growth of real estate prices in recent years was one key reason why households in developed managed to increase their mortgage-backed borrowing[5]; the same developments are unfolding in Central Eastern Europe as well. As EU-8 countries prepare for the euro zone accession, interest rate convergence coupled with some excess inflation (stemming in part from the Balassa-Samuelson effect) will push real interest rates downwards, creating a transitory spur in credit growth, similar to the experience of non-core euro zone countries. In the cases of Greece, Ireland, Portugal and Spain exceptionally rapid credit growth began 1 to 4 years before the introduction of the euro.[6]

Finally, credit booms are excessive and unsustainable tendencies. They can be triggered by the financial accelerator mechanism, where shocks are amplified through balance sheet effects because of asymmetric information, imperfect regulation, herding behaviour, etc. For example, over-optimism about housing prices boosts expected household wealth (strengthens their balance sheet), increasing households' capacity to borrow.

Economic consequences

Financial deepening and credit growth has beneficial effects but bears risks as well. As borrowers' liquidity constraints ease, their ability to smooth consumption over time increases, and productive investments can be financed better. Therefore credit growth can contribute to a higher and more stable economic growth rate. The linkage between finance and growth has been established in the economic literature, although it is difficult to estimate.[7]

The main risks of rapid credit growth entail macroeconomic imbalances and stability risks to the financial sector. Rapid credit growth can overheat economies; an excessive economic growth can raise inflation and harm the external balance. There is no clear link between credit growth and inflation based on studies on emerging market economies, inflation is often due to supply side factors (e.g. fuel prices).[8] The present deterioration of the current account balance is a natural consequence of anticipated future income growth as consumption is smoothed over time, and the extra current consumption is financed from abroad. However, current account deficits may prove unsustainable, if the competitiveness of the economy declines. Finally, credit growth can trivially affect financial stability: rising interest rates or a cyclical downswing of incomes can affect debt servicing ability. Over-enthusiasm about future asset prices can trigger the financial accelerator and result in excessive

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[5] See: Debelle, Guy: Household Debt and the Macroeconomy. *BIS Quarterly Review*, March 2004, pp. 51-64.

[6] Brzoza-Brzezina, Michał: Lending Booms in the New EU Member States: Will Euro Adoption Matter? ECB Working Paper No. 543, November 2005. Others argue there is little evidence that the timing of euro adoption affects the timing or speed of credit growth; see: Schadler, Susan, Zuzana Murgasova and Rachel van Elkan: Credit Booms, Demand Booms and the Euro Adoption. IMF Policy Discussion Paper, prepared for Conference on Challenges for Central Banks in an Enlarged EMU, Österreichische Nationalbank, Vienna, 20-21 February 2004.

[7] See for example: Beck, Thorsten, Ross Levine and Norman Loayza (2000): Finance and the Source of Growth. *Journal of Finance and Economics*, Vol. 58, pp. 261-300. A critique is given by Favarra, Giovanni: An Empirical Reassessment of the Relationship between Finance and Growth. IMF Working Paper No. 123, June 2003.

[8] Terrones and Mendoza, op. cit.

asset-backed lending. Despite its intuitive appeal however, rapid credit expansion is not a good predictor of banking crises.[9]

Foreign currency borrowing creates additional macroeconomic risks. It makes borrowers more exposed to exchange rate fluctuations if they are not necessarily hedged against exchange rate risk: besides financial derivatives, savings in foreign currencies and exports are natural hedges. Households may be less protected against exchange rate movements. This has implications for the stability of the financial system, and increases the sensitivity of domestic demand to exchange rate movements. Finally, monetary policy will work less through the credit channel and more through the exchange rate.

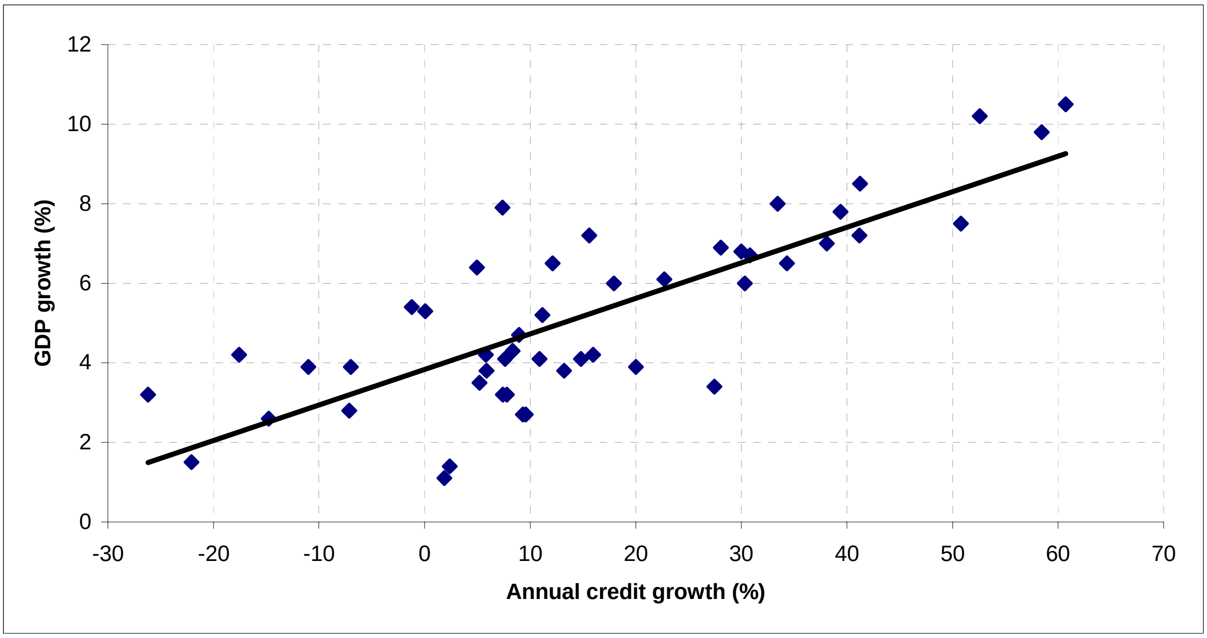
Unsustainable credit booms have more dramatic effects. According to IMF calculations[10], credit booms in emerging markets are typically synchronised across a group of countries, usually coincide with consumption and investment booms, and are very often associated with banking and currency crises. Many of these findings suggest that international capital flows play a prominent role in the creation and propagation of booms and busts.

What are the consequences of credit growth in the EU-8 countries? Faster credit growth has generally been accompanied by faster economic growth, especially in the Baltic countries where concerns of overheating economies are mounting (see Graph 2). Although inflation is also relatively higher in Estonia, Latvia and Lithuania, this need not be the direct consequence of overheating: fixed exchange rates offer less protection to these countries against supply side shocks. Fuel and food prices possibly account for more price increases than demand pressures. However, higher credit growth does come hand-in-hand with higher current account deficits (Graph 3), and the sustainability of external imbalances has come under increased scrutiny in the Baltic countries and Hungary. Fast economic growth also leads to wage rises; if productivity cannot keep pace, competitiveness declines and the external balance can deteriorate further. Regarding financial stability, although the indebtedness of households compared to their income level is low, the proportion of basic costs of living in these countries is relatively large. Nevertheless, the loan quality of banks in the EU-8 has not deteriorated much in recent years. Finally, the risks of foreign currency borrowing are generally underestimated by borrowers and hedging is not widespread among households and small enterprises (this is in part due to less developed financial markets). Despite fixed exchange rates some risk is present even in the Baltic countries until the adoption of the euro. In countries with flexible exchange rates disinflation was achieved with the help of strong currencies and high domestic interest rates; while this environment is favourable for foreign currency borrowing, any unexpected change in the course of monetary policy may be harmful. The 17 per cent depreciation of the Polish zloty in 2003 was a major shock for debtors and set back foreign currency borrowing; the recent drop of the Hungarian forint may have similar consequences.

9 A working paper of the Estonian National Bank finds only weak statistical link between debt indicators and banking crises in CEE countries, a finding consistent with much of the related literature. See: Uusküla, Lenno, Peeter Luikmel and Jana Kask: Critical Levels of Debt? Eesti Pank Working Paper No. 305, October 2005.

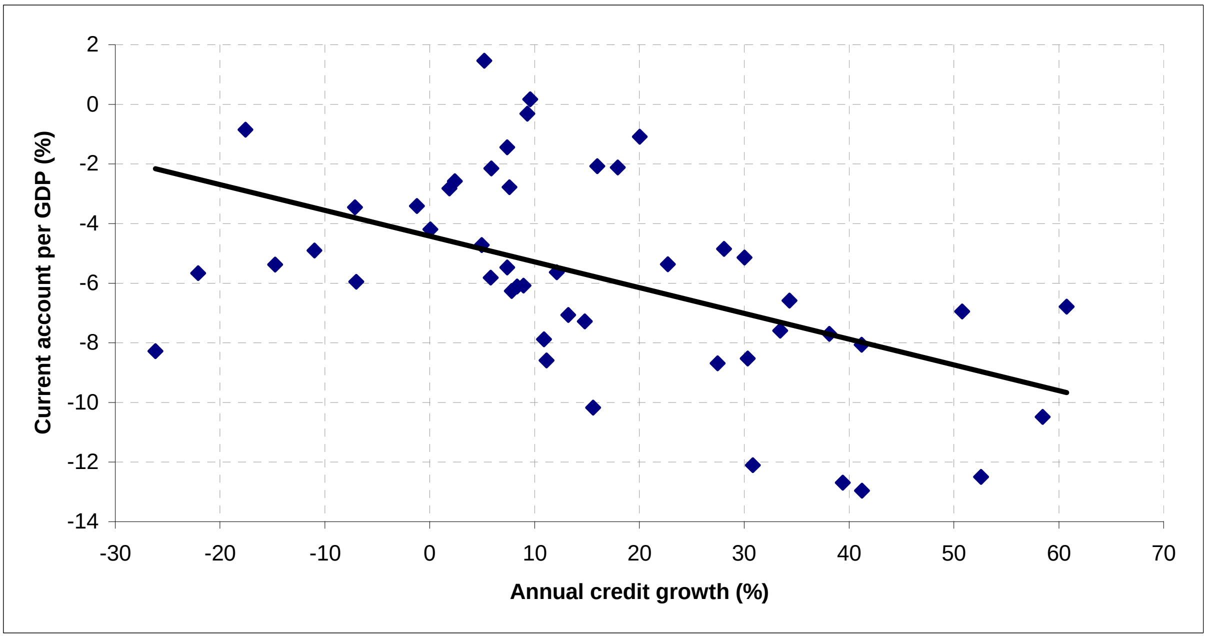
10 Terrones and Mendoza, op. cit.

Graph 2. Private sector credit and economic growth (CEE-8, 2000-2005)



Source: Eurostat, International Financial Statistics

Graph 3. Private sector credit and the current account (CEE-8, 2000-2005)



Source: Eurostat, International Financial Statistics

Identifying credit booms

Credit booms can be identified by three methods: by setting up simple "speed limit" rules for growth rates of credit, by filtering the trend of univariate time series (e.g. a Hodrick-Prescott filter), or by estimating the equilibrium level of debt with the help of macroeconomic variables and structural characteristics of economies. The definition of booms is subjective, it generally refers to an unusual deviation from the trend or equilibrium.

The literature on credit booms is growing rapidly as central banks of the region are becoming increasingly aware of the potential dangers of excessive credit growth. In an earlier paper Cottarelli and others[11] could identify three country groups: "early birds" (Estonia, Hungary, Latvia, Poland, Slovenia from the region), "late risers" (Lithuania) and "sleeping beauties" (the Czech and Slovak Republics), but did not consider credit growth excessive in any of these countries.

A recent paper by economists of the Hungarian National Bank[12] finds that credit growth in Estonia and Latvia throughout 2004-2005 was the most risky but there is no indication of a boom in other CEE countries. A similar result is found by Boissay and others[13] who conclude that credit growth in the Baltic countries is faster than the rise economic fundamentals warrant.

As asset prices can trigger the financial accelerator leading to lending booms, a brief look at property prices may be useful. According to a recent UNECE study[14] housing prices grew exceptionally in some CEE countries, especially in capital cities: between 2002 and 2004 prices doubled in Tallinn and trebled in Riga, and more than doubled between 1999 and 2003 in Budapest. However, due to lack of reliable, longer data series it is difficult to tell whether a property price bubble is appearing. Strong growth of real estate prices may as well be a consequence of favourable but volatile expectations of future income growth. The price per earnings ratio for housing (calculated from property prices and rents) ranges between 7 and 10 per cent in Baltic countries, well above mortgage interest rates. As income from property covers mortgage payments, residential property prices do not appear overvalued. Hence, excessive mortgage-backed lending based on irrational property valuation may not be a risk currently.

To sum up: is credit growth in the EU-8 unsustainable? Clearly not all countries are affected. The three Baltic economies are concerned the most, where credit growth has been one of the reasons behind overheating economies and apparent macroeconomic imbalances. The case of Hungary is different: the key danger here is the exchange rate risk of foreign currency borrowing, amplified by ailing public finances and a twin deficit. As for the rest of EU-8, credit growth in recent years cannot be called excessive.

Policy options

The policy toolkit to avoid credit booms and their negative consequences includes fiscal, monetary and regulatory instruments. Monetary policy can influence credit growth through reserve requirements and interest rates. However, if domestic borrowing is financed from abroad, reserves on deposits may have little effect; or if any, borrowers may simply switch to foreign lenders instead of domestic banks. Likewise, a rise in interest rates can lead to a substitution to foreign currency borrowing, as in Hungary since 2004. Furthermore, interest rates as instruments are unavailable in countries with currency boards. Capital inflows present a pressure to appreciate currencies; this has helped central banks with flexible exchange rates in bringing down inflation.

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[11] Cottarelli, Carlo, Giovanni Dell'Ariccia and Ivanna Vladkova-Hollar: Early Birds, Late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and the Balkans. IMF Working Paper No. 213, November 2003.

[12] Kiss, Gergely, Márton Nagy and Balázs Vonnák: Credit Growth in Central and Eastern Europe: Trend, Cycle or Boom? Prepared for the Finance and Consumption Workshop, Florence, 16-17 June 2006.

[13] Boissay, Frederic, Oscar Calvo-Gonzalez and Tomasz Kozluk: Is Lending in Central and Eastern Europe Developing Too Fast? Paper presented at the Second Conference of the Second Phase of the ECB-CFS Network, Vienna, 14-15 November 2005.

[14] Palacin, José and Robert C. Shelburne: The Private Housing Market in Eastern Europe and the CIS. UNECE Discussion Paper No. 6, December 2005.

Tighter prudential controls include (among others) capital adequacy, liquidity and loan-to-value requirements. In extreme cases administrative capital controls and credit ceilings may be applied. While prudential regulation may put domestic financial intermediaries at a disadvantage, administrative controls can only be considered a very short term measure.

Fiscal policy can be central to controlling domestic demand and hence credit demand. Tax incentives have proven a major boost for housing loans in a number of countries including the Baltic countries and Hungary, while subsidised loans appeared as well. Cutting such benefits is not politically attractive and has not been used extensively so far.

Recent examples of measures include raising the risk weight of housing loans in capital adequacy calculations and potentially including housing loans in the reserve requirement base in Estonia as of March 2006, or the rise of the reserve requirement ratio from 6 to 8 per cent in Latvia in December 2005. The Hungarian government tightened conditions of subsidised housing loans in December 2003 and tax incentives are expected to be cut from 2007.

Conclusions

In short, the evidence on credit booms in mixed. Strong credit growth in some CEE countries is in part due to a natural catch-up process to the depth of financial intermediation experienced in developed countries. Cyclical components and the upcoming adoption of the euro give further impetus to the process. The identification of booms is difficult; the newest results suggest that developments in the three Baltic countries may demand some attention. Although episodes of rapid credit expansion are unlikely to cause banking crises, the overheating of economies and especially the deterioration of the external balance are significant macroeconomic risks. Foreign currency borrowing adds further vulnerabilities by increasing the sensitivity of domestic demand to exchange rate movements. In a worst-case scenario the burst of credit booms can lead to recession, currency and banking crises, according to the experience of developing countries.

A number of policy tools are available to avoid the adverse effects of a credit boom. However, these instruments are far from perfect and may not prevent a credit boom, but only change the composition of debt instead. Fiscal policy could be the most effective (but politically least attractive) instrument to cool credit demand.