World Bank EU8+2 Regular Economic Report January 2008[1]

EU8+2

HIGHLIGHTS OF THE REPORT

---MAIN REPORT---

While the disturbances originating in the sub-prime mortgage market in the US have widened to affect other countries and other markets, and prospects for US growth have become less clear, the fundamentals for the EU8+2 are broadly unchanged, although the level of uncertainty has risen. A prolonged period of globally lower risk appetite is likely along with continuing volatility as reflected in sharp swings in virtually all equity markets, particularly over the last several weeks. This will be challenging for the EU8+2, and the soundness and credibility of policy frameworks will be appreciated by market participants. With the exception of higher-than-expected inflation, the remaining economic fundamentals in the EU8+2 remain in this respect broadly unchanged. GDP growth is still robust, but concerns remain for those countries where large current account gaps persist.

The economic outlook for the EU8+2 in 2008 and 2009 is generally positive. However, similar to advanced economies, the baseline scenario is subject to substantial downside risk to economic growth and upside risk to inflation. In 2008-2009, the region will take further, albeit shorter steps on its long road of catching-up to the EU15. GDP growth rates have probably peaked in many countries in the first half of 2007, even they remained robust in the second half of the year. This deceleration is likely to continue through 2008. The slowdown is most pronounced in the Baltic countries. Growth should recover gradually in Hungary which has been undergoing a protracted fiscal consolidation and from mid-2007 has been struggling with weak GDP growth and relatively high inflation.

In some respects passing through the turning point in the business cycle is a good thing. The rate of growth was clearly unsustainable in some countries, resulting in the buildup of internal and external imbalances. The challenge going forward is to ensure that this turning point marks the entry into a period of orderly adjustments. Success or failure in rising to this challenge will have an important bearing on the ability of the EU8+2 to continue along a steady income convergence path.

Inflationary trends are reasserting themselves across the region despite somewhat weaker pressure on the demand side. Food and oil price rises are a main factor. If these are one-off changes due to such things as the effect of unusual weather on crop yields, the impact should dissipate or reverse relatively quickly. However, to the extent that they reflect more deeply rooted shifts in global energy supply and demand patterns, progressive displacement of food production by biofuel agriculture and the changing tastes and rapid income growth in food deficit countries, more lasting effects are likely. Moreover, unit labor costs are rising in much of the region. This is partly attributable to emerging labor shortages. Credit growth has slowed somewhat in the region but remains high. Finally, the inflation damping effects of currency appreciation in some of the countries with floating rate regimes have now reversed (Romania).

Current account deficits (CADs) stabilized in the Baltic countries but are still widening in Bulgaria and Romania. These CADs represent the greatest vulnerability to deteriorating international conditions and are particularly worrisome for those countries with high levels of foreign currency debt. The external imbalances may come down in line with slower GDP growth

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expected in the Baltic countries in 2008, but in Romania and Bulgaria there is little prospect of a turnaround in the near future. FDI coverage of the CADs varies across the region with full or substantial coverage in Bulgaria, the Czech Republic, Poland, and Slovakia. But there is higher reliance on (debt) portfolio flows (Hungary) and other loans (the Baltic countries, Slovenia and increasingly Romania).

It is important however to look beyond the immediate market gyrations to see the bigger picture. The ability of the EU8+2 so far to withstand the global turbulence is attributable to several factors. Their banks were not as exposed to the subprime market. Their economies are linked more directly to the EU than the US. While credit has increased rapidly, private borrowers were under-leveraged to start with. Moreover, with the possible exception of Bulgaria and Romania the most exposed countries are beginning to adjust. Still with expected global slowdown, exports may lessen as a driver of growth. Fiscal adjustments will therefore be needed to bring domestic demand under control.

Policy responses have so far been relatively muted. The trend has been towards moderate monetary tightening in Poland, the Czech Republic, and Romania. But countries maintaining fixed or tightly managed exchange rate regimes are limited in the extent to which they can rely on monetary policy for demand management, and they will have to use fiscal policy more actively to deal with the reemerging inflationary pressures and still high CADs. While solid growth in 2007 did improve headline fiscal positions compared to initial plans, structural balances were reduced by more than 0.5 percentage points only in Hungary, Poland, Slovakia, Slovenia. Moreover, the latest Convergence Programs (CPs) suggest that only Hungary plans a consolidation of more than 1 percent of GDP, and even the CPs may prove optimistic. Generally, it would appear that budgets for 2008 (and 2009) do not contribute sufficiently to curbing inflation and external imbalances. At the same time, efforts to improve the efficiency and effectiveness of public spending could be stepped up.

---SPECIAL TOPIC---

The special topic looks at satisfaction with life and the provision of public services in the EU8+2. It draws from the Life in Transition Survey (a joint initiative of the European Bank for Reconstruction and Development and the World Bank), conducted in 2006. Overall satisfaction with life in the EU8+2 countries and Croatia is quite high. People who report themselves as being satisfied with their lives outnumber those that do not by 3 to 2. The survey data reveal somewhat mixed findings regarding the impact of transition on peoples' lives. On the one hand, in only five out of the ten EU member states – Estonia, Slovenia, Lithuania, Czech Republic and Poland do more respondents agree rather than disagree that their "household lives better now than in 1989". Support for a market versus planned economic systems is highest in Slovenia, Estonia and Slovakia. The level of support for democracy is highest in Slovakia, Slovenia and Hungary.

Satisfaction with public service delivery in EU8+2 is generally quite high. On questions regarding quality and efficiency of the interaction with public officials when requesting official documents (e.g. passport, visa, birth or marriage certificates, land register, etc.), satisfied respondents outnumbered the dissatisfied by more than 2:1. After requests for official documents, the public education system receives the next best ratings overall, followed by the public health system. However, there is significant variation across countries, with satisfaction highest in Estonia and lowest in Romania.

In terms of priorities for additional government investment, healthcare was rated as the highest: by 43 percent of respondents, followed by education (22 percent), pension (17 percent), housing (10 percent), and infrastructure (4 percent). An overwhelming majority of people in the region favor moderate to strong state involvement in reducing the gap between the rich and the poor.

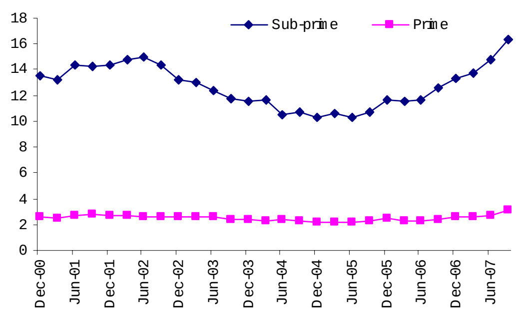
On a more sobering note, the issue of higher corruption seems to figure prominently in public perceptions. In all the countries surveyed, an overwhelming majority of respondents disagree with the statement: "There is less corruption now than in 1989".

EXTERNAL ENVIRONMENT

The external environment for the EU8+2 remains unsettled, dominated by continued repricing of risk and tighter global credit conditions, signs of increasing weakness in the US economy, rising global inflation and volatile equity markets. Closer to home, confidence within the eurozone has slipped further of late, and together with the rapid appreciation of the euro against the dollar and the pound makes it likely that economic expansion will slow in the eurozone as well. The new member states of the EU have yet to be more substantially affected by these external developments, but risks have risen that a slowdown in output expansion in the US and eurozone will contribute to slowing growth of EU8+2 exports and output. For the countries most dependent on foreign capital inflows to finance external deficits, these effects will be compounded by tighter global credit conditions and growing risk aversion among market participants.

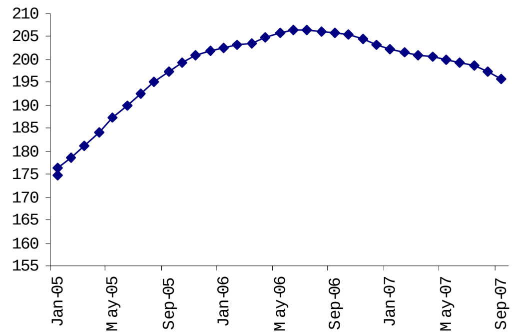
1. **Financial turbulence has continued, intensifying risks to output growth in the U.S. and other developed countries.** The eruption of the subprime crisis in the U.S. during the summer of 2007 followed a long period of lax monetary policy and loose credit standards, primarily in the U.S., and accelerated financial innovation. With falling U.S. house prices, the pace of delinquencies on sub-prime mortgages has accelerated sharply in 2007, to about 16 percent of all outstanding securitized loans compared with a recent low of 10 percent reached in the middle of 2005 (Chart 1). The pace of delinquencies does not appear to be abating with negative consequences for the future. U.S. house prices, which declined at the fastest pace in almost twenty years during the third quarter of 2007 (contributing to a 4.5 percent decline year-on-year), are predicted by most market participants to continue declining in 2008 (Chart 2). Most market participants are of the view that the plan by the U.S. administration to offer some relief to households with sub-prime mortgages will at best have only a modest impact in slowing the decline in house prices.

Chart 1. Delinquencies as Percent of All Loans, U.S. (in percent)



Source: Bloomberg.

Chart 2. U.S. House Prices, S&P/Case Shiller Home Price Index (Feb'97=100)

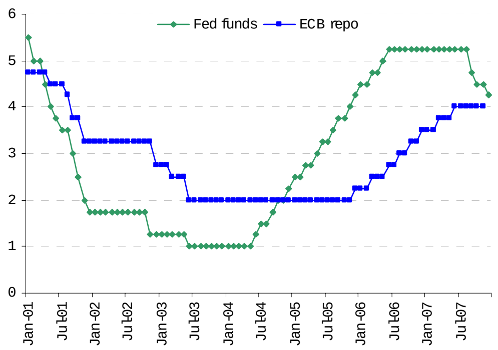


Source: S&P through Bloomberg.

2. **Losses on collateralized debt obligations (CDOs) backed by mortgages have sharply reduced bank capital and curbed bank willingness and ability to lend, resulting in substantially tighter credit conditions.** Marking down CDOs has resulted in about $50 billion in losses for banks in the U.S. thus far and caused large losses for some banks in Europe. Estimates of further losses vary substantially, from about $150 billion (U.S. Federal Reserve) to as much as $445 billion in a worst case scenario envisaged by a U.S. investment bank. Concerns

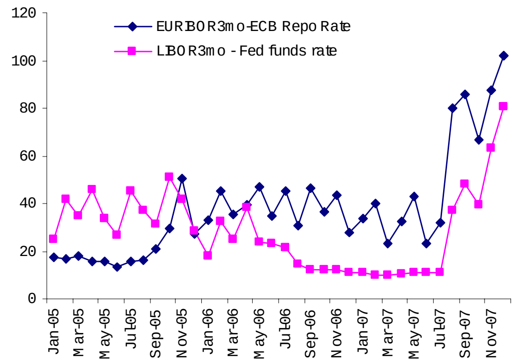
about bank losses and cash flows have boosted interbank rates[2] despite cuts in central bank rates in the U.S. and large injections of liquidity by the Federal Reserve, the ECB and the Bank of England since August 2007. The U.S. Federal Reserve cut its fed funds rate by 100 basis points last year and a further 75 basis points in January. The Bank of Canada and the Bank of England also cut rates by 25 basis points in early December 2007. Further, in mid-December the major central banks[3] joined forces to inject additional liquidity into interbank markets and ease pressure on market rates (Chart 3 and Chart 4).

Chart 3. Central Bank Interest rates: U.S. and ECB, in percent



Source: FED and ECB through Bloomberg.

Chart 4. Three-month Interbank Rate Less Central Bank Rates, in basis points



Source: Bloomberg.

3. Rate cuts by central banks and injections of liquidity do not appear to have resolved the fundamental problem. Lack of clarity on the amounts of CDOs backed by mortgages that the largest commercial banks hold spawned fears that the losses may spread to other types of mortgages and bank credit as the decline in house prices in the U.S. continues and similar corrections begin in the UK and other developed countries. The outlook for growth and inflation in the U.S. and the eurozone remains subject to substantial risks - on the downside for growth and on the upside for inflation.

4. The impact of tighter credit conditions on economic growth in the EU8+2 has been muted thus far, but it is becoming increasingly likely that expansion in the U.S. and the eurozone will be slower in the near term, with adverse implications for imports from emerging markets, including the EU8+2. Real GDP growth in the U.S. surged 4.9 percent in the third quarter (seasonally-adjusted), the fastest pace in four years, reflecting in part stronger exports due to the depreciation of the dollar. However, forecasts are for real GDP growth in the U.S. to slow substantially in the fourth quarter of 2007 and decelerate in 2008 as a whole from 2007 (Table 1). Eurozone forecasts are for economic expansion to slow further to 2.2 percent in 2008 from 2.6 percent in 2007. Declining confidence indicators in Germany suggest the slowdown in the eurozone may be deeper still. Slower eurozone growth is likely to have negative implications for EU8+2 export and output growth. The impact on the EU8+2 may also reflect tighter financial conditions, with the potential of slowing capital inflows and output growth.

Table 1. Real GDP Growth Forecasts, 2007-2008

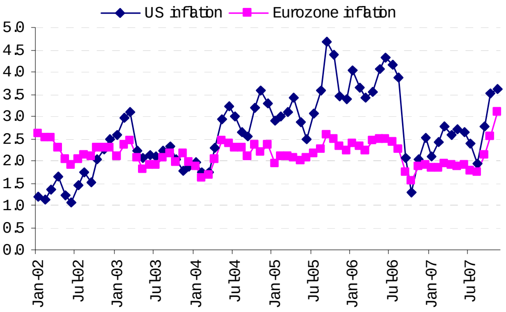
	2007			2008		
	IMF 1/	EC 2/	OECD 3/	IMF 1/	EC 2/	OECD 3/
U.S.	1.9	2.1	2.2	1.9	1.7	2.0
Eurozone	2.5	2.6	2.6	2.1	2.2	1.9
Japan	2.0	1.9	1.9	1.7	1.9	1.6

Source: ' 1/ October 2007, 2/ Autumn Forecasts, November 2007, 3/ OECD Economic Outlook No. 81, December 2007.

[2] Spreads have narrowed somewhat in early January but they remain high by historical standards.
[3] The Federal Reserve, the ECB, the Bank of England, the Swiss National Bank and the Bank of Canada.

5. Concerns about the impact of financial turbulence on economic expansion, coupled with rising inflation and inflation expectations, are confounding monetary policy choices for the central banks. Due in part to higher prices for food, imported oil and the weaker dollar, inflation in the U.S. has risen from 2.5 percent year-on-year in December 2006 to 3.6 percent in late 2007, with the surge most pronounced in the fourth quarter of 2007. Inflation in the eurozone has similarly accelerated from 1.9 percent year-on-year in December 2006 to 3.1 percent in late 2007, well above the 2 percent targeted by the ECB, reflecting higher prices for food (Chart 5).

Chart 5. Inflation, U.S. and Eurozone, (in percent, year-on-year)



Source: FED and ECB through Bloomberg.

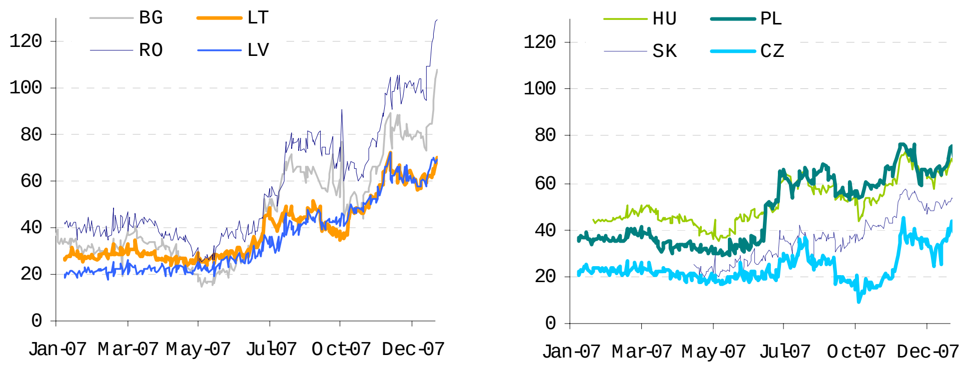
6. Risk aversion has increased markedly during the financial turmoil, boosting demand for U.S. and other government bonds and contributing to a sharp decline in equity market prices during the last quarter of 2007 and January 2008. Demand has been particularly buoyant for shorter-term securities. For example, yields on one-year U.S. Treasury bills fell to 3.1 percent by early December from 5 percent in late July after remaining broadly unchanged from the start of the year (Chart 9). U.S. equity prices fell 7 percent in the fourth quarter, leaving prices up only 3 percent for the full year, as measured by the S&P500 index; equity prices in the eurozone posted somewhat smaller declines. (Chart 10) By contrast, markets in emerging markets rose strongly last year, with large price increases in the BRICS (Brazil, Russia, India and China) accompanied by surges in other smaller markets, reflecting in large part investor perceptions about improved fundamentals in many of these economies. However, the new year has seen sharp reductions in equity market prices across the globe and volatility close to the highest levels of recent years.

Chart 6. Implied volatility, VIX

Source: Reuters.

7. Vulnerability to external developments is greatest for countries with widening CADs. The sovereign bond spreads for Romania and Bulgaria have widened much more sharply this year than is the case for other EU8+2 members with lower or at least moderating CADs.

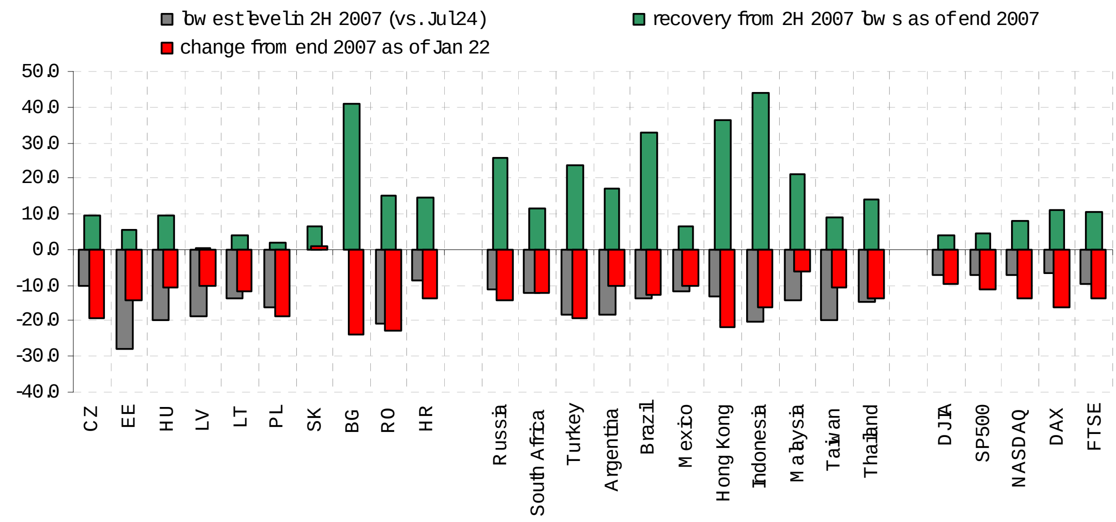
Chart 7. Selected EU8+2 bond spreads, in bp



Notes : 10Y eurobonds, vs. Eurozone

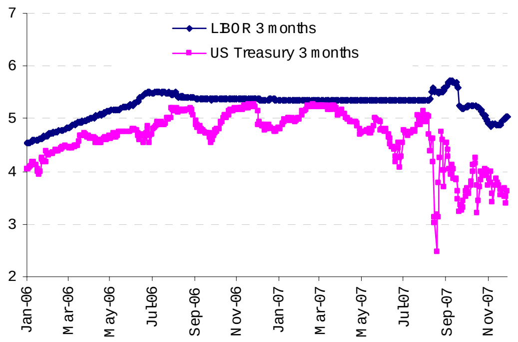
Source: Reuters.

Chart 8. Equity markets performance



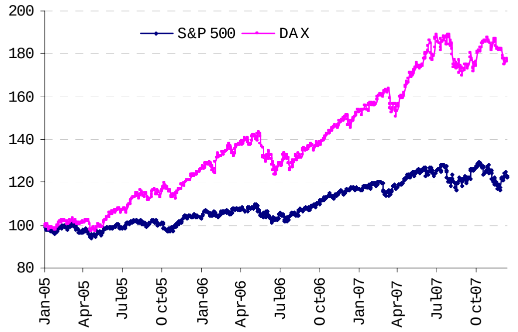
Source: Reuters.

Chart 9. Yields on U.S. Treasury Securities and LIBOR (in percent)



Source: Federal Reserve and ECB through Bloomberg.

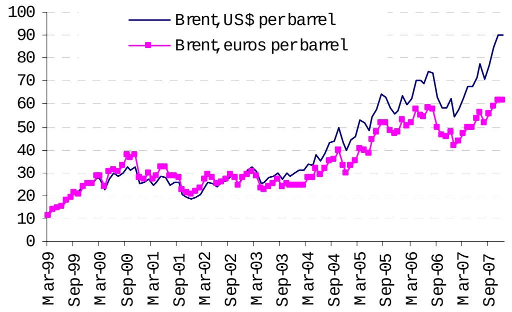
Chart 10. Equity Prices, S&P-500 and DAX (Rebased index)



Source: Bloomberg.

8. The unsettled external environment also reflects elevated and, of late, volatile prices for oil and other commodities. Oil prices have risen substantially, in part due to geopolitical concerns and rising demand among developing countries. Oil prices approached US$100 per barrel recently and were roughly 11 percent higher in dollar terms in 2007 than in 2006 (but little changed in euro terms (Chart 11). Poor harvests caused in part by drought were an important factor in boosting world wheat prices by 30 percent last year in dollar terms (19 percent in euro terms). Higher prices for oil, natural gas and other energy, together with the surge in cereal prices, have added to inflation in developed and emerging economies.

Chart 11. Oil Prices, Brent (in dollars and euros per barrel)



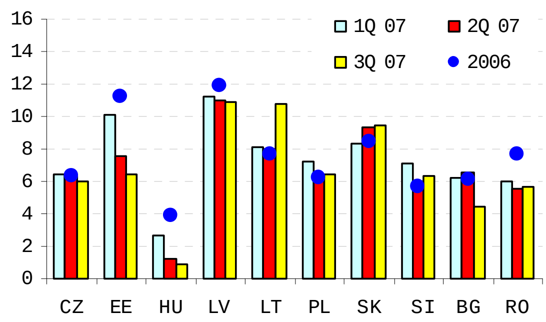
Source: IFS

OUTPUT DEVELOPMENTS

While strong growth dynamics were maintained in 3Q in most of EU8+2 countries, with domestic demand remaining the main driver of growth, signs of weakening are visible on the horizon. Consumption seems to be moderating due to weaker overall consumer confidence, slower real wage growth and some deceleration of credit to the private sector which is also affecting investment. Although a slowdown is on the way in a number of the EU8+2 in 2008-2009, growth will still remain solid.

9. In 3Q 2007, strong growth dynamics were maintained in most of the EU8+2, and only Estonia and Bulgaria recorded a sharp slowdown as compared to the 2Q 2007. Output growth even accelerated in Lithuania, Romania, Slovakia, and Slovenia. In the latter country, as indicated by the Bank of Slovenia, overheating may become an issue. In Lithuania, growth sped up partly due to a base effect relating to oil refining capacity problems in late 2006. Output growth remained strong in Poland as well, surprising on the upside in 3Q. By contrast, a sharp slowdown continued in Estonia after a period of overheating. In Hungary, growth slowed further reaching historic lows, and decelerated also in Bulgaria, due to a huge slump in agriculture and a slowdown in investment. Meanwhile, in Latvia, which developed the deepest imbalances in the region, GDP growth has not moderated yet, although early indicators suggest a turning point may be approaching.

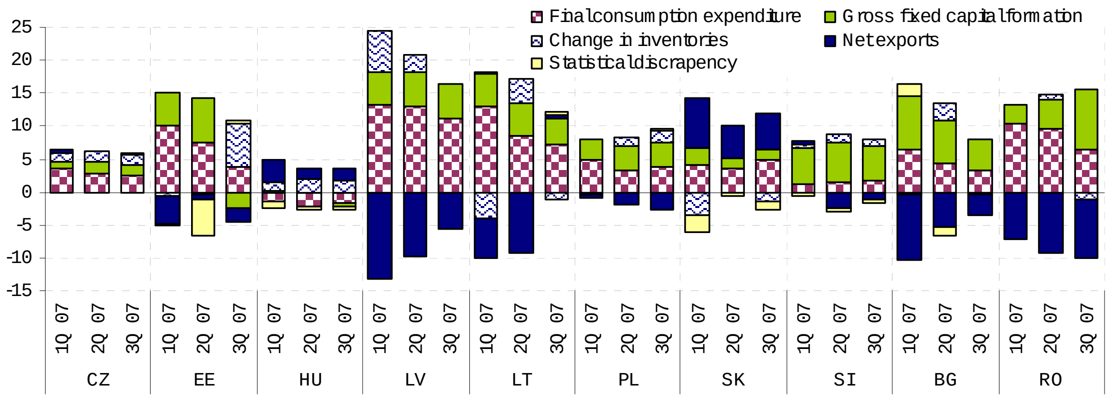
Chart 12. GDP growth rates (% yoy)



Source: CSOs.

10. Domestic demand, which remains the main driver of growth across the region, shows signs of weakening in countries with the most unbalanced growth structure (Chart 13). Hungary remains an exception as only net exports and stocks contributed positively to GDP growth. In the Czech Republic, growth in 3Q was fuelled by domestic demand with a marginal contribution from net exports. Growth in Slovakia was broadly balanced with the highest positive contribution from external demand in the region. In the remaining countries, only domestic demand contributed to growth, although the negative contribution from net exports varied significantly across countries. External imbalances have started to narrow in the Baltic countrie and Bulgaria but widened in Romania and Poland.

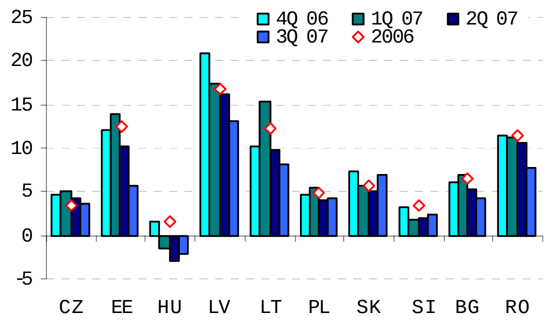
Chart 13. Contribution to GDP growth, yoy, percentage points



Source: CSOs, Eurostat, ISI, staff calculations.

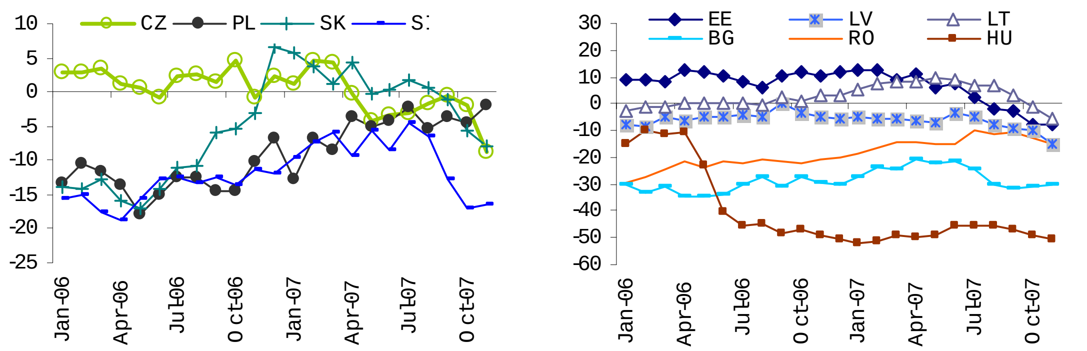
11. With the exception of Poland, Slovakia and Slovenia, consumption started to moderate on the back of a slowdown in real wage and credit growth and overall weaker consumer confidence (Chart 14). In Hungary, the year-on-year decline in 3Q was a bit lower than in 2Q. Consumption growth is weakening because of higher interest rates and tighter lending conditions, introduced internally by banks. Overall consumer sentiment is weakening, as evidenced by retail sales and confidence indicators. In late 2007, in all countries in the region consumer confidence indicators were in negative territory (Chart 15). However, sentiment improved markedly in Poland and may be related to the outcome of general elections and expectations regarding the new government.

Chart 14. Final consumption (%, yoy)



Source: CSOs.

Chart 15. Consumer confidence indicator

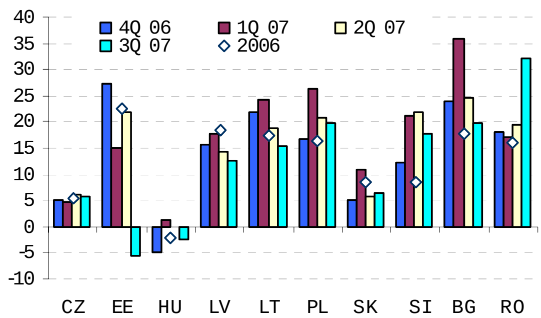


Note: The consumer confidence indicator is constructed as the average of the balances (positive less negative answers, in percentage points) of the answers to the questions on the financial situation of households, the general economic situation, unemployment expectations (with inverted sign) and savings, all over the next 12 months; balances are seasonally adjusted.

Source: EC.

12. Weakening business confidence indicators also reflect developments in the enterprise sector. Investment growth slowed further in most countries of the region or remained relatively stable (the Czech Republic and Poland). It accelerated only slightly in Slovakia and markedly in Romania, mainly due to construction investment.

Chart 16. Gross fixed investment (%, yoy)

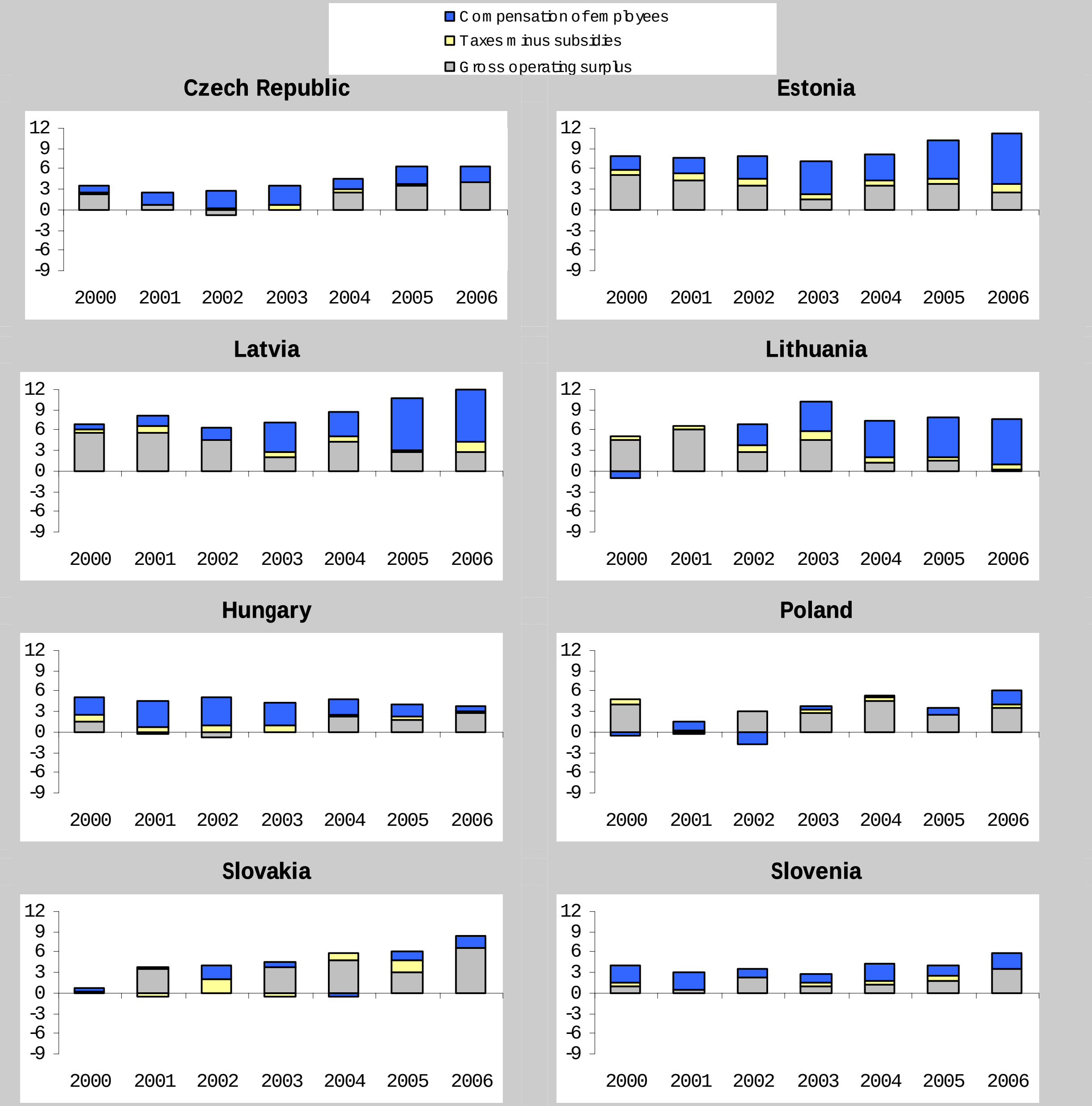


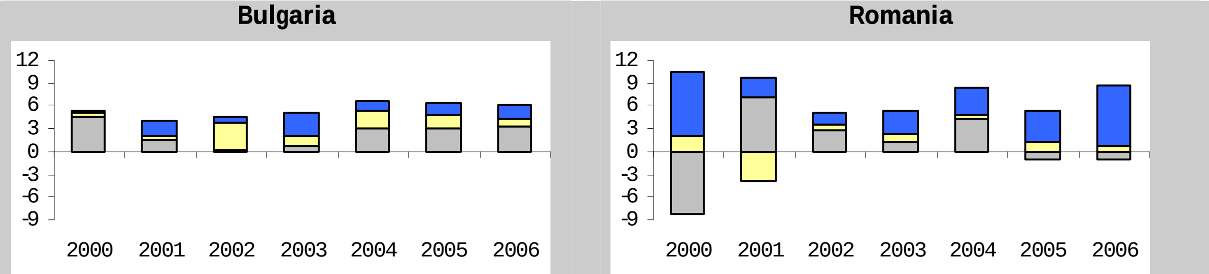
Source: CSOs.

Box 1. Real GDP growth in income approach in 2000-2006

The analysis of economic growth using the income approach confirms that in countries with the tightest labor markets, growth is increasingly driven by employee compensation (the Baltic countries and Romania). In other EU8+2 countries growth is mainly due to rising gross operating surpluses of enterprises. However, over recent years the contribution of employee compensation to overall growth increased in Bulgaria, Poland and Slovakia. In the Czech Republic and Slovenia, the relative contribution of the two components of income remained relatively stable over the last few years. In Hungary, by contrast, labor market easing in 2006 was reflected in a sharply lower contribution of employee compensation to GDP growth.

Chart 17. Contribution to GDP growth, income approach





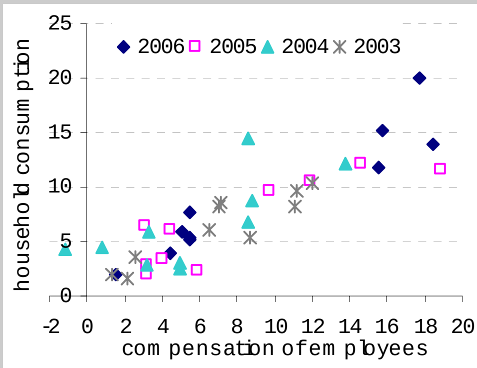
Notes: The contribution to real GDP growth was calculated assuming the following deflators provided by Eurostat: for compensation of employees - final consumption of households and for taxes linked to imports and production minus subsidies - taxes less subsidies (from supply side of GDP decomposition). Gross operating surplus in constant prices was calculated as residual, GDP minus compensation of employees minus taxes less subsidies (all indicators in constant prices).

Source: AMECO, Eurostat; and staff calculations.

The findings above are reflected in expenditure developments: employee compensation and consumption expenditure of households are closely correlated across the region in recent years (Chart 18). Countries where the contribution of employee compensation to overall growth was increasing (the Baltic countries, Romania and recently Poland) experienced an upsurge in household consumption.

At the same time, the increasing contribution of employee compensation usually means a diminishing contribution of gross operating surplus of companies, as a sustained increase in wages (for labor which is increasingly scarce) tends to drive up production costs.

Chart 18. Link between employee compensation and consumption



Real growth rates, yoy.

Source: CSOs.

13. In 2008-2009, a moderate slowdown is on the way in all EU8+2 except Hungary, which should eventually recover. But growth well above 5% across the region can be still regarded as robust (Table 2). Following the period of overheating, growth in the Baltic countries will start to ease, with the 2008 forecast for Estonia being revised downwards to 5.2% (in the latest CP). Latvia will also pass a turning point, while in Lithuania consumption will still remain relatively strong in 2008 on the back of the January 2008 cut in the income tax rate from 27% to 24%. Some easing is also expected in Slovenia and the Visegrad countries, except Hungary, which should perform better after bottoming out in the second half of 2007. Only in Bulgaria and Romania is strong growth expected to remain broadly at the 2007 level.

14. Global supply-side factors will sustain inflationary pressures despite some easing of domestic demand. In 2008, an upturn in inflation is projected in all EU8+2 except Hungary on the back of global trends in food and energy prices and increases in excise duties and regulated prices in some countries. Thus, supply-side developments are likely to dominate and weakening domestic demand may not translate into inflation easing. However, domestic demand moderation in most countries, except Poland, Bulgaria and Lithuania, will result in trimming of current account deficits. On the fiscal front, most of the EU8+2 officially plan to maintain broadly neutral positions in 2008.

Table 2. Macroeconomic projections for the EU8+2, %

		Ouput growth				Inflation (HICP average)				Current account (% of GDP)				Fiscal balance (GG, % of GDP)			
		2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
CZ	EC	6.4	5.8	5.0	4.9	2.1	3.0	3.8	3.2	-3.1	-2.8	-2.4	-2.3	-2.9	-3.4	-2.8	-2.7
	IMF		5.6	4.6			2.9	4.4			-3.4	-3.5					
	CP		5.9	5.0	5.1		2.4	3.9	2.3		-2.6	-2.2	-1.2		-3.4	-2.9	-2.6
EE	EC	11.2	7.8	6.4	6.2	4.4	6.3	7.3	4.8	-15.5	-14.6	-12.3	-10.9	3.6	3.0	1.9	1.0
	IMF		8.0	6.0			6.0	7.0			-16.9	-15.9					
	CP		7.4	5.2	6.1		6.6	8.6	5.6		-15.6	-11.7	-10.2		2.6	1.3	1.0
HU	EC	3.9	2.0	2.6	3.4	4.0	7.7	4.9	2.8	-6.5	-4.4	-3.4	-2.7	-9.2	-6.4	-4.2	-3.8
	IMF		2.1	2.7			7.6	4.5			-5.6	-5.1					
	CP		1.7	2.8	4.0		7.9	4.8	3.0		-4.9	-4.0	-3.3		-6.2	-4.0	-3.2
LV	EC	11.9	10.5	7.2	6.2	6.6	9.6	9.8	6.0	-22.3	-23.8	-21.6	-19.8	-0.3	0.9	0.8	0.5
	IMF		10.5	6.2			9.0	8.9			-25.3	-27.3					
	CP		10.5	7.5	7.0		10.1	12.5	7.2		-23.5	-20.3	-18.3		0.3	0.7	1.0
LT	EC	7.7	8.5	7.5	6.3	3.8	5.6	6.5	5.2	-10.8	-13.9	-14.4	-14.6	-0.6	-0.9	-1.4	-0.8
	IMF		8.0	6.5			5.2	4.6			-14.0	-12.6					
	CP		9.8	5.3	4.5		5.8	6.5	5.1		-13.5	-14.2	-15.4		-0.9	-0.5	0.2
PL	EC	6.2	6.5	5.6	5.2	1.3	2.5	2.8	2.9	-3.2	-4.3	-5.5	-6.2	-3.8	-2.7	-3.2	-3.1
	IMF		6.6	5.3			2.2	2.7			-3.7	-5.1					
	CP		6.5	5.5	5.2		2.4	2.4	2.5	-2.3*	-4.0	-5.2	-5.9		-3.0	-3.0	-2.8
SK	EC	8.5	8.7	7.0	6.2	4.3	1.7	2.5	3.0	-7.0	-4.4	-2.9	-2.0	-3.7	-2.7	-2.3	-2.4
	IMF		8.8	7.3			2.4	2.0			-5.3	-4.5					
	CP		8.8	6.8	5.8		1.7	2.3	2.6	-8.3*	-4.0	-2.6	-1.9		-2.5	-2.3	-1.8
SI	EC	5.7	6.0	4.6	4.0	2.5	3.5	3.7	2.9	-2.5	-3.5	-2.6	-1.8	-1.2	-0.7	-1.0	-0.8
	IMF						3.2	3.1			-3.4	-3.1					
	CP		5.8	4.6	4.1		3.4	3.5	2.8		-3.5	-3.1	-2.0		-0.6	-0.9	-0.6
BG	EC	6.1	6.3	6.0	6.2	7.4	7.1	7.3	5.8	-15.7	-18.1	-17.7	-17.6	3.2	3.0	3.1	3.1
	IMF		6.0	5.9			8.2	7.9			-20.3	-19.0					
	CP		6.4	6.4	6.8		7.2	6.9	4.4		-21.0	-21.9	-21.2		3.1	3.0	3.0
RO	EC	7.7	6.0	5.9	5.8	6.6	4.7	5.6	4.6	-10.3	-13.7	-15.5	-16.2	-1.9	-2.7	-3.2	-3.9
	IMF		6.3	6.0			4.3	4.8			-13.8	-13.2					
	CP		6.1	6.5	6.1		4.8	5.7	4.0		-12.6	-10.5	-10.1		-2.9	-2.9	-2.9

*Notes: *Current account deficit projections and historical figures in Poland and Slovakia as provided in Convergence Programs and are based on data available data before statistical revisions.*

Source: EC: Economic Forecast, Autumn 2007; IMF: World Economic Outlook, October 2007; CPs: Convergence Programs 2007.

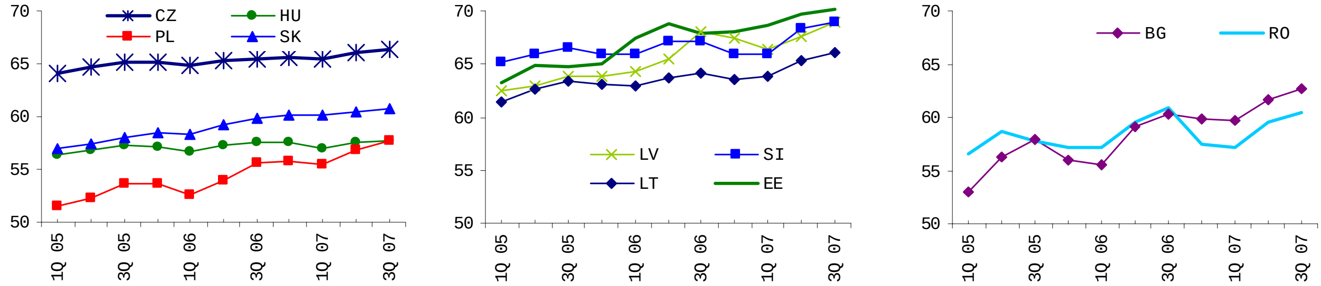
LABOR MARKET DEVELOPMENTS

Labor market performances in the region have further improved with unemployment rates reaching historically low levels and employment rates increasing. Real wage growth is slowing in most countries in the region, but remains strong especially in Latvia and Romania. Despite the wage moderation, unit labor costs continue to rise in much of the region.

15. With the exception of Hungary unemployment rates in the EU8+2 are now at the lowest level since 1Q 2000. While in 1Q 2000 unemployment rates across the region ranged from 7 to 19%, and the average rate was at almost 13%, in 3Q 2007 unemployment rates were in single digits in all countries but Slovakia (11.3%). Poland has made the most significant progress by reducing the unemployment rate by half within the past 3 years.

16. Lower unemployment rates result mainly from higher demand for labor and go hand in hand with higher employment rates (Chart 19). Still, only the Baltic countries, Slovenia, and the Czech Republic come close to the Lisbon Strategy target of a 70% employment rate. Significantly, three out of these five countries (Estonia, Slovenia, and the Czech Republic) are the best performers in the PISA assessment in the region (see Box 2). Although labor market performance is improving in the remaining countries too, their employment rates remain 10 percentage points or more below the Lisbon target.

Chart 19. Employment rates, %



Source: Eurostat, staff calculations.

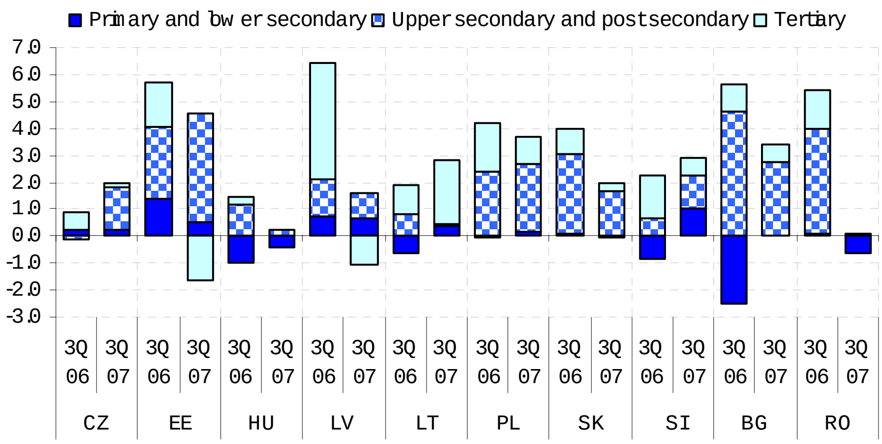
17. Educational attainment and quality of education are significant determinants of employment rate differentials within countries. Tertiary education gives at least an 80% guarantee of employment in all EU8+2 while employment rates of those with primary and lower secondary education vary strongly across the region (from 15% in Slovakia to almost 50% in Slovenia). In the Baltic countries, the Czech Republic, Slovenia, and Bulgaria, 70% or more of the labor force with upper secondary and post secondary education is employed (see Table 3). People from this category and those with higher education contributed positively to overall employment growth between 3Q 2006 and 3Q 2007 in all countries with the exception of Estonia and Latvia (Chart 20).

Table 3. Employment rate by educational attainment, %

		Total	Primary and lower secondary	Upper secondary and post secondary	Tertiary
CZ	3Q 06	65.4	24.0	71.7	83.0
	3Q 07	66.3	25.1	72.6	83.3
EE	3Q 06	67.9	32.0	72.6	87.0
	3Q 07	70.2	34.9	75.4	87.3
HU	3Q 06	57.6	28.1	65.3	80.8
	3Q 07	57.7	28.3	64.9	79.6
LV	3Q 06	68.0	38.0	73.4	88.1
	3Q 07	69.0	39.5	74.8	87.9
LT	3Q 06	64.2	25.2	68.5	87.0
	3Q 07	66.1	27.4	69.5	88.2
PL	3Q 06	55.6	25.1	59.2	82.2
	3Q 07	57.8	26.4	61.6	82.1
SK	3Q 06	59.9	14.8	67.9	83.3
	3Q 07	60.7	15.2	68.7	81.8
SI	3Q 06	67.2	43.7	69.8	87.3
	3Q 07	69.0	47.5	71.5	86.5
BG	3Q 06	60.3	31.7	69.0	82.0
	3Q 07	62.7	33.6	71.0	83.8
RO	3Q 06	60.9	43.1	66.1	86.5
	3Q 07	60.5	43.4	65.0	85.8

Source: Eurostat.

Chart 20. Contribution to employment growth by educational attainment, %



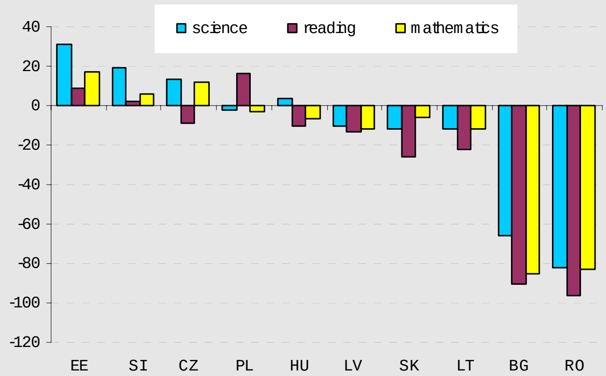
18. PISA 2006 reveals that 15-year old students in the region generally perform below the OECD average. Only young Estonians and Slovenians performed above the OECD average in science, reading and mathematics. The Czechs performed better than the OECD average in two areas, while Poles and Hungarians did in one (reading and science, respectively). The remaining five countries in the region scored below the OECD average in all three areas (see Chart 21). The very sizeable gaps for Romania and Bulgaria are particularly disturbing.

Box 2. Performance of the EU8+2 and Croatia in PISA 2006

PISA (Program for International Student Assessment) was launched in 1997 by the OECD. It represents a commitment by governments to monitor the outcomes of education systems in terms of student achievement on a regular basis and within an internationally agreed common framework. PISA has now become the most comprehensive and rigorous international program for assessing student performance and providing data on the student, family and institutional factors.

The first PISA survey was conducted in 2000 and focused on reading literacy. PISA 2003 focused on mathematics and PISA 2006 focused on science, but also examined student attitudes towards science and their awareness of the opportunities that science competencies may bring, and of science learning opportunities and environments offered by their schools. It also placed student performance in the context of other factors, such as gender, socio-economic background and school policies and practices, providing insights into how they influence the development of knowledge and skills at home and at school and analyzing what the implications are for policy development.

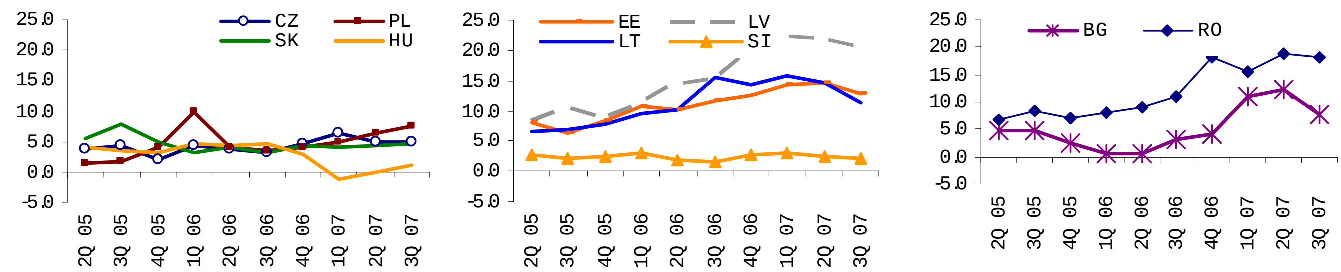
Chart 21. A distance of the national score from the OECD average, points



Notes: Positive distance stands for better than OECD average performance.
Source: OECD (2007).

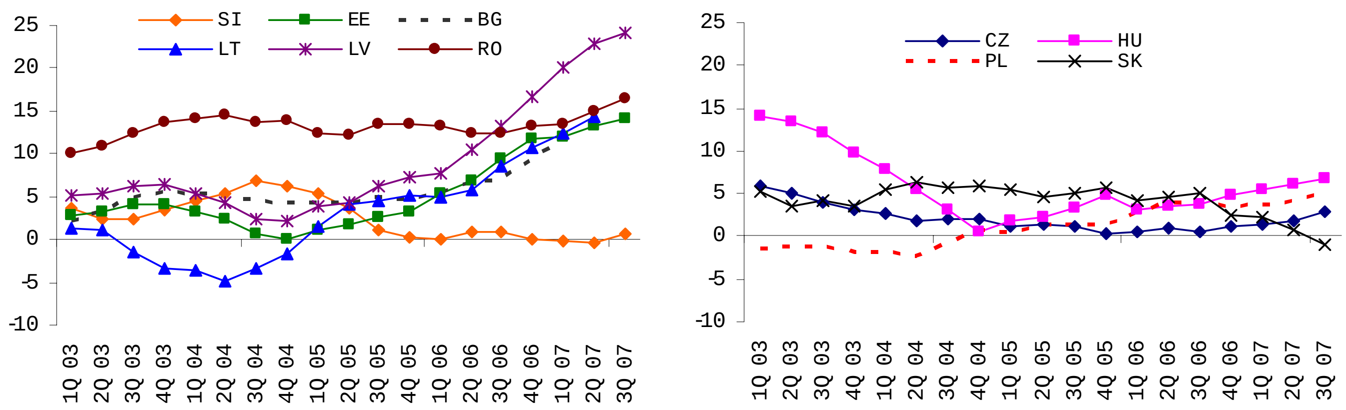
19. Labor markets are tightening as labor shortages become more evident. The resulting increase in real wages in 3Q 2007 varies considerably across the region. Wage pressure remains high in the EU8+2, and even the where there has been some moderation of real wages (Baltic countries, Bulgaria, and Romania) it results largely from an acceleration of inflation rather than deceleration of nominal wages. Unit labor cost dynamics in the Visegrad countries and Slovenia still remain moderate as compared with the Baltic countries, Bulgaria, and Romania (Chart 22- Chart 23). The persistence of wage pressure may undermine countries' competitiveness and weaken their prospects for high and sustainable economic growth.

Chart 22. Real wage growth, yoy, %



Note: Data in line with CSO methodology
Source: CSOs, staff calculations.

Chart 23. ULC economy wide (4Q moving average), yoy, %



Source: CSOs, Eurostat, WIIW, staff calculations.

20. Regional differences within individual EU8+2 countries are considerable and may interact with country-wide minimum wage rates. These regional differences are also related to educational attainment as people with lower education levels are overrepresented in lagging regions. Hence, uniform economy-wide minimum wages may prevent the local labor market from clearing at a lower level of wages (see Box 3).

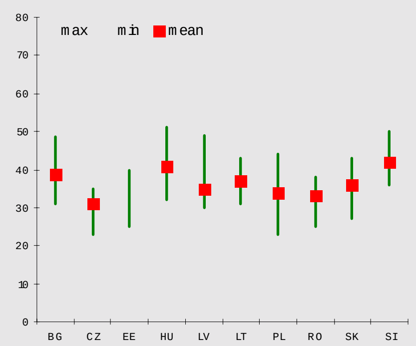
Box 3. The minimum wage may be too high for unqualified workers in lagging regions

Does the minimum wage matter? Twenty EU member states have a statutory national minimum wage despite the potentially negative impact on employment. While on average the minimum wage is too low – compared to the average wage – to affect a significant number of workers in the economy as a whole, it could affect unqualified workers in lagging regions.

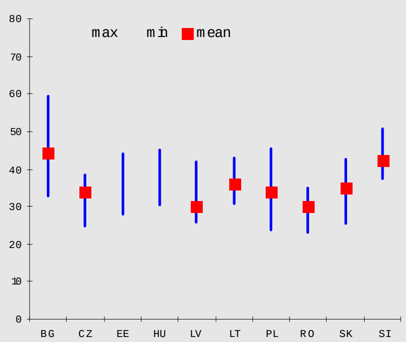
Regional data for EU8+2 from 2002-2006 indicate that the ratio of the minimum to the average wage is low in the regions surrounding capital cities, but is as high as 59% in some regions of Bulgaria. The ratio is falling in almost all countries, but especially in Hungary and Latvia. Bulgaria, is one of a few countries where the ratio increased, on average by 3.4 percentage points every year. More importantly, the variance of regional ratios has fallen in half of the countries – in Estonia, Hungary, Latvia, Romania and Slovenia.

The ratio of minimum to average wages for unqualified workers is much higher than the economy-wide average. It reached 64% in the Czech Republic in 2006 and 68% in Slovakia in 2005. Unfortunately, regional figures are not available for more countries, but it seems reasonable to assume that the ratio for unqualified workers could be at about 60 to 80% of the economy and nation-wide average. This could drive unqualified workers in lagging regions out of the formal labor market.

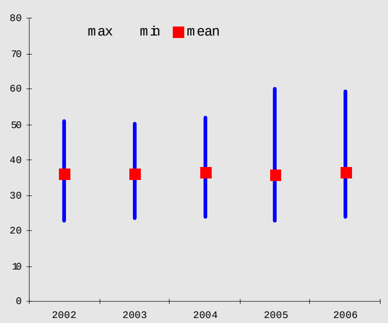
Minimum to average wage, 2002



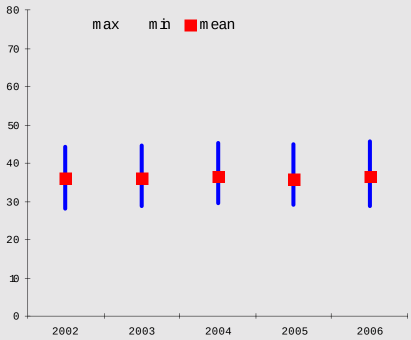
Minimum to average wage, 2006



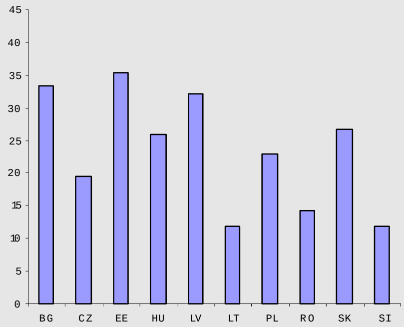
Minimum to average wage, whole region, 2002-06, extreme values



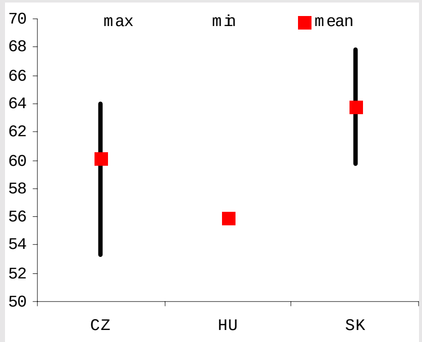
Minimum to average wage, whole region, 2002-06, averages



Variance of minimum to average wage, 2006



Minimum to average wage, unqualified workers, 2006



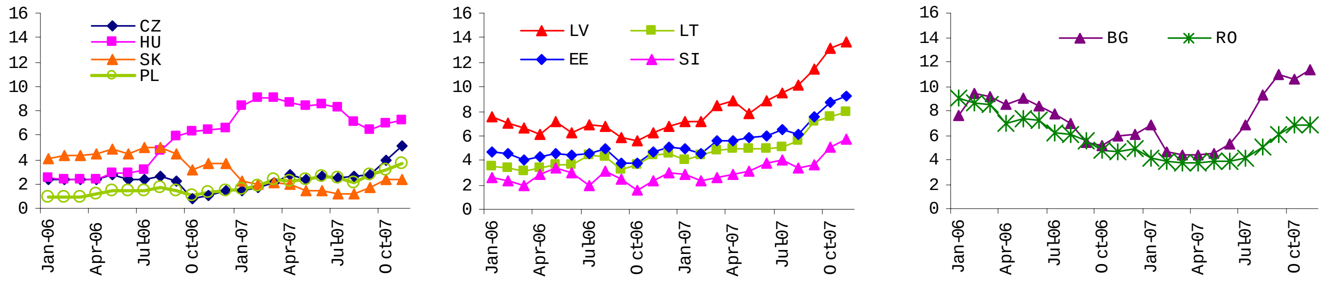
Source: CSOs, staff calculations

Note: in %. Romania only 2002-05, Lithuania 2003-2006. Source: Eurostat, CSOs and WB staff.

INFLATION, EXCHANGE RATE DEVELOPMENTS, AND MONETARY POLICIES

21. Inflation, both headline and underlying rates, accelerated sharply in late 2007 throughout the region, driven by a combination of supply and demand factors. While the upturn in inflation was largely anticipated, the magnitude of the increase generally was not. Rising food and energy prices are common drivers in all countries. Persistently high consumption fuelled by credit and some country-specific factors (such as a sharp Romanian Leu depreciation in November) and energy price adjustments, have also contributed. By December 2007[4], inflation reached double digit levels in Latvia and Bulgaria. It was getting close to double digits in Estonia; it was persistently high in Lithuania, Romania and Hungary, and above inflation targets in the Visegrad countries, except Slovakia.

Chart 24. HICP- all, y/y, %



Source: Eurostat.

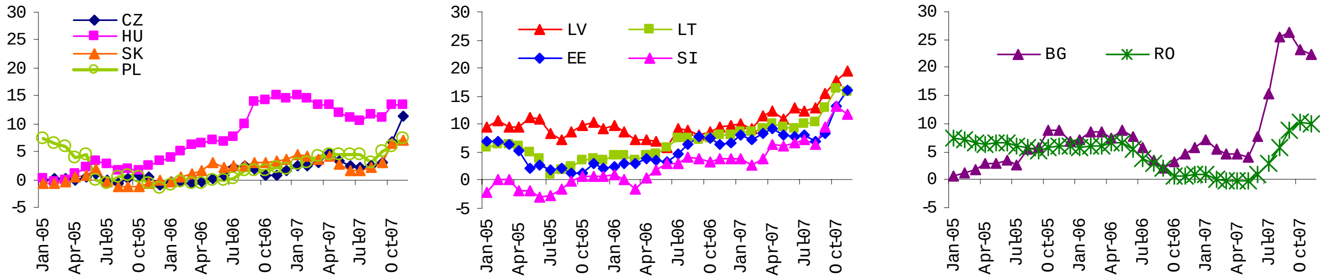
22. Food prices are a main driver of accelerating inflation. This may be partly explained by the catch-up of relatively low levels of food prices in EU 8+2 vis-à-vis EU 15[5] and the greater weight of food in the EU8+2 consumption basket (see Chart 27). As of November 2007, year-on-year food price increases ranged from 7% in Slovakia and 7.4% in Poland to 19.5% in Latvia and

[4] At end-December CPI inflation was 14.1% in Latvia, 12.5% in Bulgaria, 9.6% in Estonia, 8.1% in Lithuania, 7.4% in Hungary, 6.6% in Romania, 5.6% in Slovenia, 5.4% in the Czech Rep., 4.0% in Poland and 3.4% in Slovakia.

[5] According to Eurostat, prices of food and non-alcoholic beverages were, in 2006, 56% in Bulgaria, 64% in Lithuania, 67% in Poland and Slovakia, 69% in the Czech Rep. and Latvia, 71% in Hungary and Romania, 75% in Estonia and 87% in Slovenia, relative to the EU 27 average.

21.1% in Bulgaria. However, with the exception of Bulgaria, the steepest food price hikes do not seem to have occurred in the countries with the lowest initial price levels, suggesting that domestic market competition and structures, as well as subsidy schemes promoted by national governments[6] have an important contribution to the formation of food prices. High food prices have prompted some calls for the reintroduction of price controls (Lithuania) and VAT cuts (Romania). Also the EC decision to abolish import tariffs for cereals in order to streamline imports from third countries, while welcome, may offer only limited relief from internal price pressures, as international prices themselves are high.

Chart 25. HICP-food, y/y, %



Source: Eurostat.

23. Increased demand from emerging markets, adverse supply shocks and the pickup in the demand for biofuels are the main factors behind booming global food prices[7]. The impact of these factors on inflation has been felt both directly and indirectly. The direct effect reflects the fact that the share of food in total consumer expenditure and headline inflation is significant in the EU8+2 and tends to be negatively correlated with income. The indirect effect stems from the tendency for food price dynamics to feed through to demands for non-food prices including higher wage compensation. IMF simulations suggest that worldwide food price inflation has been a significant determinant of non-food inflation in emerging and low income economies, while it has had a negligible impact in developed economies.

[6] See the May 2007 issue of the EU 8+2 RER Special Topic for a detailed analysis of agriculture in EU 8+2.
[7] See the *IMF World Economic Outlook October 2007* for a detailed discussion.

Chart 26. Food and energy contribution to HICP in Jan-Nov 2006 and 2007, %

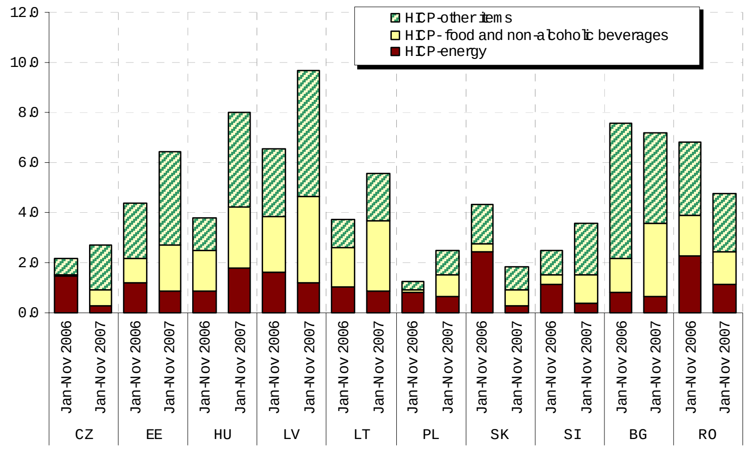
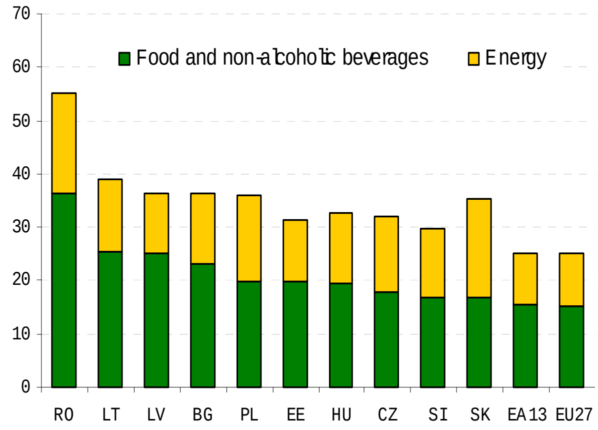


Chart 27. Share of food and energy in HICP basket (%)



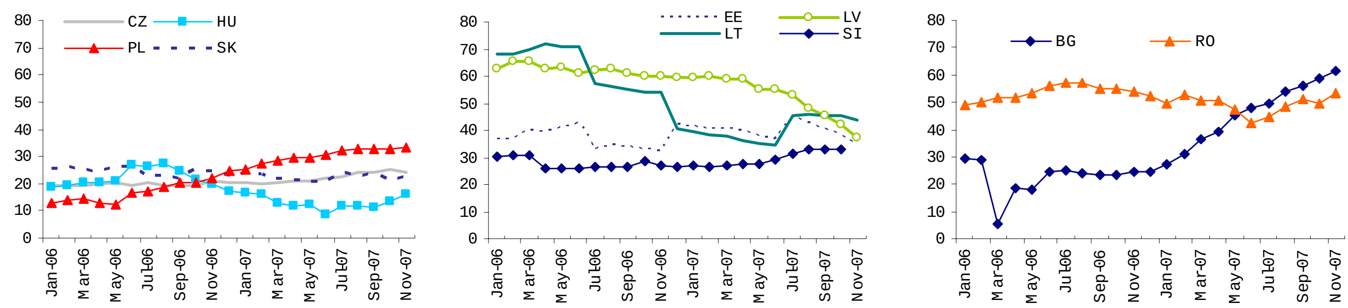
Source: Eurostat.

24. The record high global energy prices - especially - oil, have also contributed to the pickup in inflation. These have led to upward fuel price adjustments, also linked to the protracted weakness of the USD, given the relatively high dependence of the region on imported fuels. Housing, electricity and water costs increased by 20.1% y/y in Latvia and by 11.3% y/y in Lithuania in November 2007. Strong inflationary effects from energy price increases were also discernable in Estonia, Poland and the Czech Republic.

25. Upward adjustments in administered prices are contributing further to overall price increases. Gas and electricity tariff increases are anticipated in the Baltic countries and Poland. Further pressures arise from the gradual harmonization of excise duties to the EU levels (e.g. on tobacco and in some countries on fuels).

26. High credit growth remains an important source of excess demand, though signs of deceleration are visible in some countries. On the back of higher interest rates and weakening sentiment, credit growth is slowing in Latvia and Estonia, but borrowing is largely in euros (Chart 28). Over 75% of outstanding household credit in these two countries is euro-denominated. In Lithuania, credit growth (although slowing) remains strong, with household lending growing at around 60% y/y. There are no convincing signs of a credit slowdown in Bulgaria or Romania. In Poland, domestic credit growth appears to have stabilized at around 30%, and household lending continues to expand quickly.

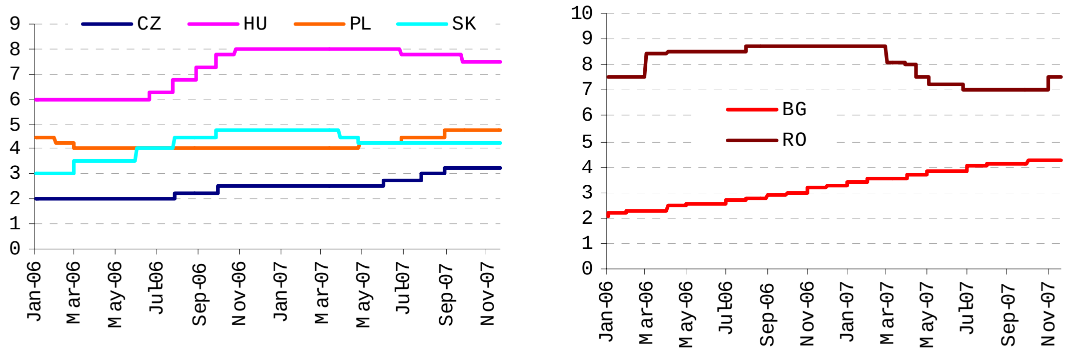
Chart 28. Credit to private sector growth, yoy, %



Source: CBs, staff calculations.

27. The rapid and possibly protracted upswing in inflation is feeding into inflation expectations, complicating macroeconomic management. This has already been reflected in collective wage negotiations, renewing calls for monetary policy to stay on a tightening path to keep inflation expectations anchored to the targets. A tighter monetary stance would also serve to improve savings-investment ratios which remain low in some countries.

Chart 29. Central Bank Base Rates, %



Source: CBs.

28. While the balance of risks for future inflation remains on the upside, policy responses need to find a balance between a manageable slowdown and overshooting. As most countries are approaching the end of their cyclical upswing, the policy challenge is to achieve a soft landing by avoiding an excessively tight stance while still containing inflation. With GDP growth slowing and inflation picking up, central banks find themselves in a difficult position in terms of policy trade-offs. The fragility of eurozone growth and uncertainties surrounding the interest rate cycle of the ECB augment the challenges. Sudden swings in foreign capital flows could put substantial pressure on currencies (as in Romania in November-December) causing debt to soar in local currency terms.

29. Inflationary pressures stemming from both cyclical and structural factors complicate the euro adoption agenda. Slovakia is expected to join the EMU in 2009. But although fiscal outcomes are solidly on track, remaining inflation pressures are complicating its path to the euro and demanding greater policy focus on structural adjustment. And once inside the euro zone, as the example of Slovenia suggests, the process of real convergence can still lead to overheating and the resurfacing of inflation. International comparison of price levels suggest that the catching up process will continue to contribute to price convergence pressures (see Box 4).

Box 4. Preliminary Results of the International Comparison Program 2005 (ICP) on Purchasing Power Parities and price levels

Purchasing power parities (PPPs) and price level benchmarks can provide valuable insight into the nature and magnitude of inflationary pressures transition economies are likely to encounter as part of the convergence process.

In mid-December 2007, the ICP and the Eurostat-OECD PPP program released preliminary estimates of internationally comparable purchasing power parities (PPPs) and price levels benchmarked to the year 2005 for 146 economies. The ICP collected data on prices of more than 1,000 goods and services. PPPs are used instead of exchange rates to convert national economic measures such as gross domestic product into a common currency, unaffected by transitory movements of market exchange rates. By taking account of price level differences between countries, PPPs allow comparisons of market size, the structure of economies, and what money can buy.

The ICP shows which economies are the most and the least expensive. The Price Level Index (PLI) is the ratio of a country's PPP divided by its exchange rate to the US dollar. An index over 100 means prices are higher on average than in the US, and one less than 100 means prices are relatively lower. The most expensive economies in the world are Iceland, Denmark, Switzerland, Norway, and Ireland with indices ranging from 154 to 127 percent. The range is greater at the other end of the spectrum with more than 40 economies showing a PLI of 40 percent or below. The cheapest economies are Tajikistan, Ethiopia, Gambia, Kyrgyz Republic, and Bolivia

Table 4. Price levels of GDP components

Country	Price level index, US level = 100			
	GDP	Private Consumption	Collective consumption	Gross Fixed Capital Formation
Bulgaria	38	38	22	60
Czech Rep.	60	56	46	81
Estonia	62	59	40	88
Hungary	65	60	51	89
Latvia	53	52	32	81
Lithuania	53	50	34	85
Poland	59	57	42	75
Romania	49	49	28	71
Slovakia	56	52	38	83
Slovenia	77	77	66	80
Croatia	66	66	49	81
Cyprus	91	92	86	91
Malta	72	71	55	82
USA	100	100	100	100

Source: ICP 2005.

Comparison of price level indices by GDP and its three main components show the existence and wide-ranging nature of price convergence gaps in the EU8+2. The well-known "Balassa-Samuelson effect" explains that poorer countries experience higher inflation during the catch-up process as these price gaps are closed *. GDP price levels in the region vary from 38% of the US level in Bulgaria to 77% in Slovenia (Table 4). This suggests that the need for price convergence in the first euro area entrant from the region - Slovenia - was moderate: its relative price level was high to start with. By comparison the rest of the EU8+2 had price levels equal to just on average 55% of the US level (56% in Slovakia - the next country hoping to join the Eurozone).

Prices of collective consumption component exhibit the greatest dispersion across EU8+2 countries, while prices of gross capital formation vary the least. The price level index for private consumption appears similar to that for overall GDP, because it is the largest component of GDP. Because government services are not traded across countries, there is little pressure for these prices to converge. At the same time, investment consists of a larger share of traded goods – such as equipment goods - so there is less price variation across countries because of international competition. While the prices of investment goods in the EU8+2 have largely converged to the EU average level, prices of consumption goods and services, in particular public ones, will have to adjust during the catching-up process.

* On Balassa-Samuelson effect see also the previous edition of the Regular Economic Report, September 2007.

30. Relatively tight labor markets, continuing strong credit expansion, and gradual adjustment of non-tradable good prices are expected to remain inflationary factors over the medium term. Because of these factors and rising uncertainty concerning supply-side developments, inflation is expected to be higher in 2008 than in 2007 across the region with the exception of Hungary.

31. There has been a cooling off of the housing markets in some countries. Scattered evidence from Estonia and Latvia points in this direction, while housing still remains the fastest growing sector in Romania, and is growing strongly in Bulgaria.

EXTERNAL SECTOR DEVELOPMENTS

Considerable current account deficits (CADs) and high external debt still raise concerns. In 2007, current account positions deteriorated in most of the EU8+2, particularly in the Baltic countries, Romania, and Bulgaria. Rapid credit growth, financed by substantial borrowing abroad contributed to widening current account deficits and pushed external debt levels higher. Short-term debt increased in most of the countries in recent years, with attendant rollover risks.

32. The underlying external vulnerabilities, current account deficits and high external debt, are large and mostly rising. The largest external imbalances in the region, recorded in the Baltic countries, Romania, and Bulgaria, are primarily generated by the private sector. Public sectors do not contribute to them at all in Bulgaria, Estonia and Latvia (Chart 30-Chart 31).

Chart 30. Savings-Investment Gap, % of GDP, 2006-2007e

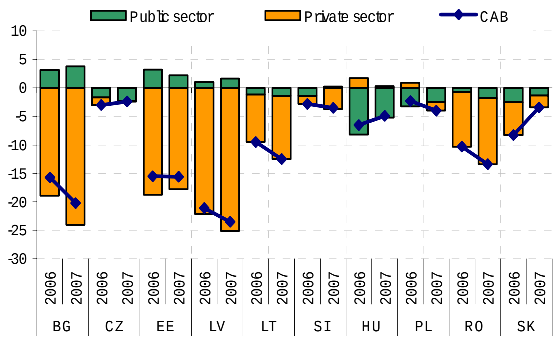
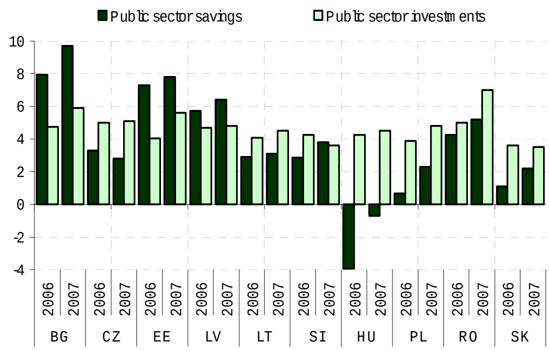


Chart 31. Public Sector Savings and Investments, % of GDP, 2006-2007e



The current account balance is the difference between a country's savings and its investment (CAB= S-I), which can be divided into public and private sector CAB = (Sg-Ig)+(Sp-Ip). Private sector investments are calculated as gross capital formation minus public sector investments; the latter is derived from the GFS - Capital Investments. Country's savings is calculated as the sum of country's investments and public sector savings. Public sector savings is derived from GFS, as a difference between current revenues and current expenditures.

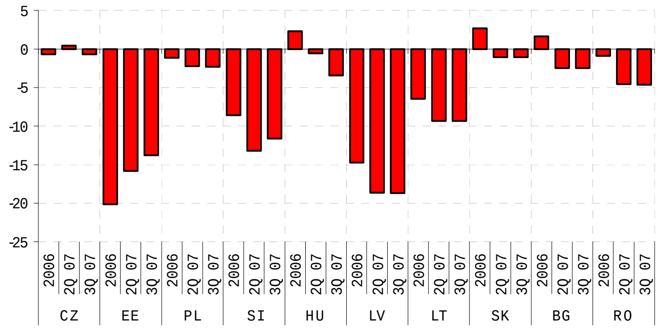
Source: EUROSTAT, NCB's, MoF, staff calculations.

33. In 3Q 2007, current account deficits (4-quarter cumulative) stabilized in the Baltic countries but are still widening in Bulgaria and Romania. However, according to forecasts from the Convergence Programs, for 2007 as a whole, CADs in Lithuania and Latvia should have widened further as compared to 2006 (Chart 30). In 3Q 2007, export growth picked up in all countries in the region, except in Romania, but imports advanced even faster. In Estonia, for the first time in the last year and a half, an improvement in merchandise trade was noted, as domestic demand growth slowed and exports grew faster than imports.

34. Rising current account deficits are largely attributable to negative trade balances, particularly in the Baltic countries, Bulgaria, Romania and Slovenia. In the Czech Republic, the deterioration of the factor income account played a significant role in increasing the current account deficit, mainly because of rising returns on FDI and interest payments. By contrast, because of prior FDI inflows, Slovakia managed to boost its export capacity and recorded a marked improvement in its trade balance, thus lowering the current account deficit. However in Bulgaria sizable FDI inflows over the last several years have not affected as much export performance.

35. In most cases deficits were largely covered by private capital inflows. Along with foreign direct investment, these capital inflows have primarily consisted of credit intermediated by banks and have fueled rapid credit growth, mostly in foreign currency. In Bulgaria, the Czech Republic, and Poland FDI fully financed the CADs. Portfolio investment was buoyant in Hungary, where strong inflows of foreign capital in debt instruments easily compensated the large outflow from equities. In the Baltic countries and Slovenia, banking sector foreign borrowing remains the primary source of financing. In Slovakia and Romania the CAD coverage by FDI was significant, but the latter also increasingly relied on debt flows.

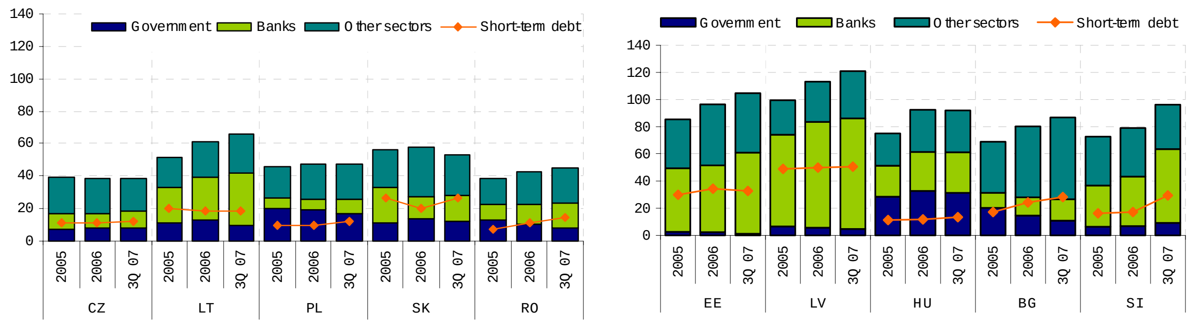
Chart 32. Basic Balance (CA+FDI+portfolio investments) in 2006-2007, % of GDP



Source: CBs, Eurostat, staff calculations.

36. Large borrowing abroad was reflected in rising gross external debt levels in 2007. Gross external debt-to-GDP ratios ranged from 36.1 percent in Romania, through around 90 percent in Bulgaria and Slovenia, to over 100 percent in Estonia and Latvia. In the Baltic countries, a growing share of the external debt is created in the banking sector, while in Hungary the growth of banks' external debt was matched by that of the government, and gross external debt reached 91.2 percent of GDP. The widening current account gaps are also financed by parent bank funding. Inter-company lending formed a significant portion of the overall gross external debt in the region ranging from around 8 (Latvia) to 34 (Bulgaria) percent. Short-term debt has increased in most of the countries in recent years, raising rollover risks.

Chart 33. External debt in 2005-2007, % of GDP



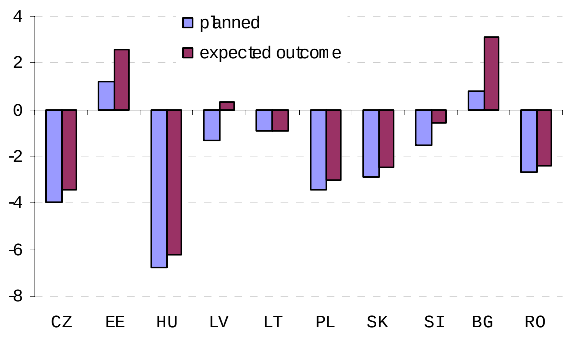
Source: NCB's, staff calculations.

PUBLIC FINANCE

All countries in the region have taken advantage of the solid growth in 2007 to save some of the unanticipated revenue increases and improve their headline fiscal positions relative to the initial plans. However, structural deficits were reduced by more than 0.5 percentage points only in Hungary, Poland, Slovakia and Slovenia. Official plans for 2008 budget from the latest Convergence Programs (CPs) reveal that only Hungary plans a consolidation of more than 1 of GDP, while the fiscal positions of the rest would be similar to 2007. However, the EC autumn forecasts suggest that fiscal positions in 2008 may be slightly worse (by 0.2-0.3% of GDP) than officially projected in Hungary, Poland, and Romania and almost 1% of GDP worse in Lithuania. Heightened risks of a worsening global environment and a slowdown of the world economy could adversely affect the execution of budgets this year. In addition, countries with substantial external current account deficits need to keep fiscal accounts flexible to counteract to increased vulnerabilities. At the same time, efforts to improve the efficiency and effectiveness of public spending could be stepped up. Generally, it seems that budgets for 2008 (and 2009) do not contribute sufficiently to curbing inflation and external imbalances.

37. All countries in the region anticipate better fiscal outcomes in 2007 in their revised convergence programs compared to the initial targets presented a year before. Bulgaria, Estonia, Latvia and Slovenia, project to outperform their fiscal targets by a higher margin than the others. Lithuania did not take advantage of robust economic growth to improve its fiscal stance and left its planned deficit for 2007-09 unchanged. Mainly on the back of higher than expected revenues, Poland should have ended 2007 with a fiscal deficit below the Maastricht threshold, while Hungary and the Czech Republic will likely have improved their deficits to 6.2% and 3.4% of GDP, respectively[8]. Slovakia expects to achieve a better fiscal outturn despite higher than planned spending related with the pension reform.

Chart 34. Fiscal Positions in 2007: planned v/s expected outcome (% of GDP)



Note: The date includes costs of pension reforms.
Source: Convergence Programs, November, December 2007.

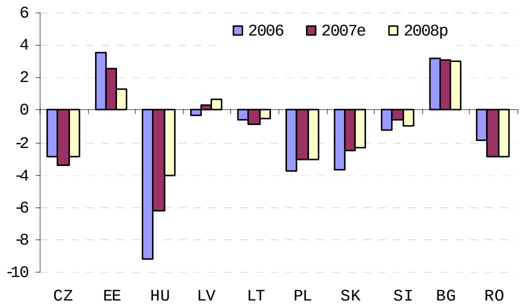
38. Improvements in fiscal balances in 2007 (based on convergence programs' estimates) were driven mostly by higher-than-planned revenues due to robust economic growth and rising inflation rather than efforts to consolidate spending. The revenue over-performance in most of the countries was concentrated in direct taxes, and in the Czech Republic, Hungary, and Romania, in social contributions on the back of better labor market performance and rising salaries. Improvements in compliance with tax legislation in Bulgaria, the Czech Republic, and Hungary reflected changes in tax policy or enhanced revenue administration. Expenditure execution was more or less as planned with a few exceptions, mainly related to savings from interest payments (Hungary, Slovakia, and Bulgaria), subsidies (Hungary, Romania), and lower than expected capital spending, mainly in Romania. The latter country revised downwards its estimate of capital spending of 9.7 percent of GDP to 7 percent while Bulgaria revised upwards capital spending by 2 percentage points of GDP. Execution of expenditures during the first 10-11 months of 2007, however, suggests that neither Bulgaria nor Romania are likely to achieve the levels projected for the year owing to lower than expected absorption of EU funds.

[8] As of mid-January, the Finance Minister sees Hungary's ESA95 budget deficit shrinking even to 5.7-5.8% of GDP in 2007.

39. In 2007, fiscal tightening was most pronounced in Hungary, while Poland, Latvia, and Slovakia expect to narrow their fiscal deficits by close to 1 percentage point of GDP (Chart 35**).** Latvia should even achieve a small surplus for the first time since 1997 although even greater fiscal tightening is warranted to help contain domestic demand pressures. Improvements in fiscal positions were achieved through adjustments in operations and maintenance, and wage spending, which reached 1 percentage point of GDP in Hungary, Latvia, and Slovakia. Hungary and Slovakia adjusted downwards their public investment spending. Only some countries experienced a slight worsening of their fiscal balances because of higher social spending (the Czech Republic) and higher capital spending and the contribution to the EU budget (Romania). Estonia had a fiscal surplus although it was lower than in 2006, while Bulgaria is expected to achieve the same or slightly higher fiscal surplus.

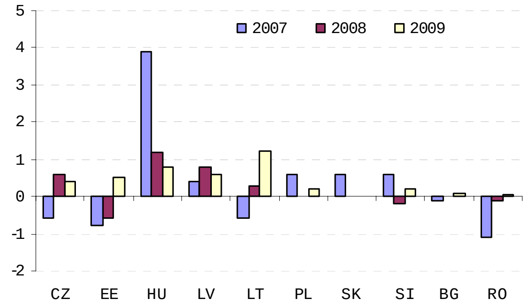
40. Nevertheless, only half of the EU8+2 (Hungary, Poland, Latvia, Slovakia, and Slovenia) reduced their structural deficits in 2007 (Chart 36). The remaining countries had either a broadly neutral position (Bulgaria) or loosened their structural positions (the Czech Republic, Estonia, Lithuania, and Romania).

Chart 35. General Government Balance (% of GDP)



Source: Convergence Programs, November, December 2007

Chart 36. Fiscal Consolidation Effort in 2007 (pps of GDP)



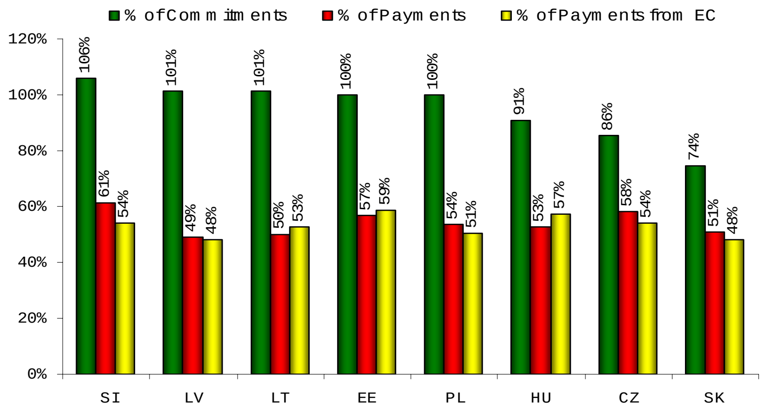
Notes: Consolidation effort is the difference between structural balance in 2007 and 2006. A positive consolidation indicates fiscal tightening.

Source: Convergence Programs, November, December 2007.

41. Official fiscal plans for 2008 show a mixed picture with all countries but Hungary remaining below or at the 3 percent of GDP deficit threshold. Hungary aims to have the most improvement in its high fiscal deficit, the Czech Republic projects reaching a deficit compliant with the Maastricht criteria, while Latvia and Lithuania expect improvements in their fiscal balances of 0.4 percentage points of GDP. Slovakia is planning a smaller decrease in the fiscal balance, which is projected to reach 2.3 percent of GDP. Romania, Poland, and Bulgaria envisage unchanged fiscal positions in 2008 compared with 2007 while Estonia and Slovenia plan for a worsening of their fiscal balances. To achieve these fiscal targets, Romania, Bulgaria, and Estonia expect to raise additional revenues of over 1 percentage point of GDP with Romania aiming highest (an increase of 2.4 percentage points of GDP) assuming improved compliance with social security legislation as a result of lowering the rates. (Details of the structural changes planned for 2008 are provided in Annex 1).

42. Some of the planned revenue increases may not materialize given the worsening global environment and its potential dampening effect on growth. There is also uncertainty associated with the effect of planned tax cuts[9] on revenue performance. On the expenditure side, most of the adjustment will take place in non-interest current spending with a continuing decline in wage spending, albeit one that is moderate compared to 2007 (and in social spending in the Czech Republic). Slovakia and Slovenia will rely on small expenditure cuts in almost all items, while the Czech Republic plans sizeable spending cuts). Romania and Bulgaria have ambitious capital spending plans reaching 8.2 percent of GDP in Romania as the absorption of EU structural funds is expected to pick up substantially. Given the absorption capacity track record, it is not certain if these plans will be realized in these two countries. In 2008, the EU8+2 will have to absorb from 40-60% of funds from the financial perspective 2004-2006 or they will lose the assigned funds. (Chart 37).

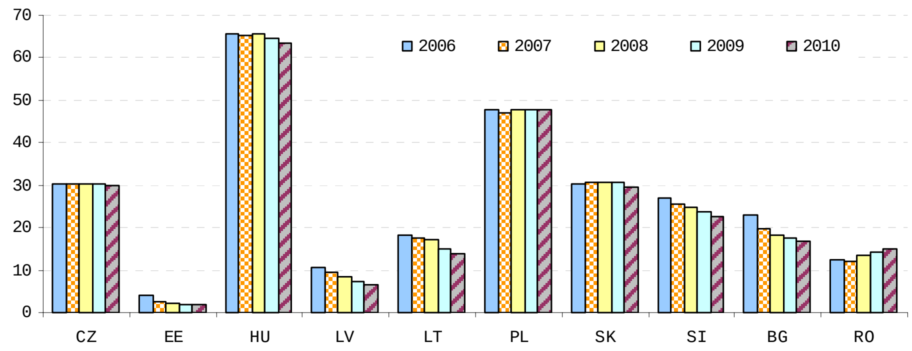
Chart 37. Absorption of the EU Structural and Cohesion Funds in the EU8 (2004-2006 EU financial perspective), as of 31 October, 2007



Source: Ministry of Regional Development, Poland, 2007.

43. In line with improved fiscal positions and strong GDP growth, almost all EU8+2 (but the Czech Republic and Slovakia) managed to reduce their debt to GDP ratios (Chart 38-Chart 39**).** Bulgaria, Estonia, Latvia, and Slovenia which achieved primary surpluses were able reduce their debt to GDP ratios the most. Active debt management transactions and cautious new borrowing policy in 2007 and earlier years led to a decline in interest spending from 1.3 to 1.2 percent of GDP in Bulgaria. Poland also reduced its interest spending which contributed to a decline in the debt-to-GDP ratio in 2007 compared to a slight increase in 2006.

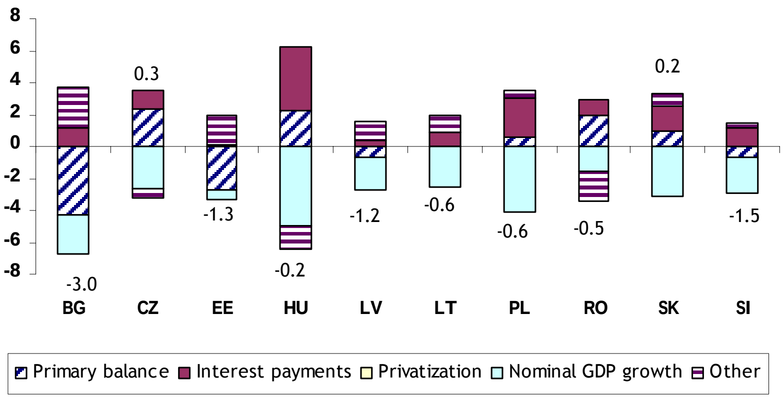
Chart 38. Gross General Government Debt, % of GDP



Source: Convergence Programs, November, December, 2007, and staff calculations.

[9] The corporate income tax rate is reduced in the Czech Republic, social contribution rates go down in Poland and Romania, personal income tax rates are cut in Bulgaria, the Czech Republic, Estonia, and Lithuania, while Slovakia is introducing lower VAT rates on medicines and selected medical tools.

Chart 39. Contributions to Changes in General Government Debt to GDP Ratio, 2007



Source: Convergence Programs, November, December, 2007, and staff calculations.

44. Medium term fiscal plans seem more ambitious than the 2008 budgets with all countries (but Romania and Estonia) planning fiscal consolidation and most of them strengthening their public expenditure management systems. (For a detailed presentation of medium-term fiscal plans see Table 7 in the Annex). Medium-term institutional improvements in the fiscal accounts focus on introducing more stringent fiscal rules (Bulgaria, the Czech Republic, Hungary, and Slovakia), strengthening or introducing performance-oriented budgeting (Bulgaria, Poland) or improving the accounting system (Slovakia).

STRUCTURAL REFORMS

Rapid economic growth has reduced the sense of urgency for reform and with a few exceptions there has been little progress on broader structural reforms recently. With the first-phase ("market-enabling') and second-phase ("market-deepening") reforms almost completed across the region, progress on the third-phase of reforms, centered on business-friendly regulations, infrastructure, enhanced competition and good governance has been erratic.

Ease of doing business

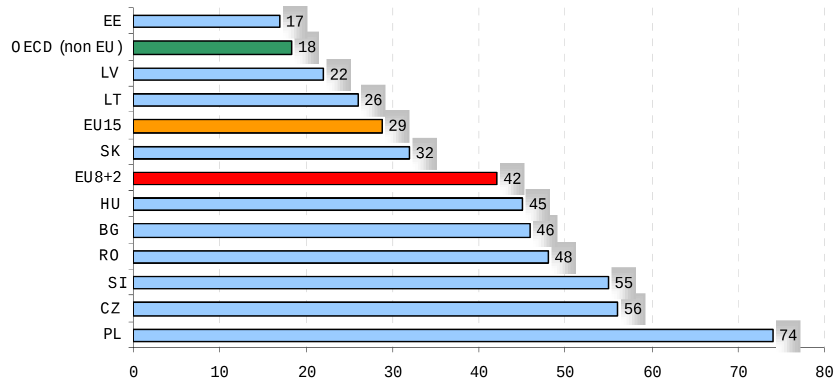
45. Changes in the *Ease of Doing Business* show a mixed picture as since last year. Doing Business currently ranks Bulgaria among the top global reformers, improving in many areas, including dealing with licenses, paying taxes and enforcing contracts. It was also the top reformer in paying taxes in 2006/07, due to a sizable reduction of the tax burden and a significant simplification of the process of paying taxes. The Czech Republic was the runner-up among labor law reforms, adopting a new labor code that replaced its 1965 code. In contrast, some countries slipped backward. Slovenia (in the area of employing workers and getting credit) and Hungary (in the area in paying taxes) are among the countries with the largest negative reforms.

Table 5. Positive changes in ranking of Doing Business Indicators in 2006/2007										
	Starting a business	Dealing with Licenses	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
CZ		✓	✓	✓						✓
EE	✓			✓			✓		✓	✓
HU	✓	✓	✓	✓						
LV		✓					✓	✓		
LT			✓				✓			✓
PL				✓					✓	
SK		✓	✓		✓				✓	
SI		✓		✓						✓
BG			✓	✓	✓		✓	✓		
RO					✓		✓	✓		✓

Source: Doing Business database.

46. The Baltic countries remain the most "business friendly" countries in the region (all are above EU15 average rank), with Estonia ranking highest: in 17th place among the 178 countries reviewed. The worst regional performer is Poland, followed by the Czech Republic and Slovenia. The most common reforms in the region, occurring in half the countries, involved: easing property registration, simplifying tax administration and increasing the flexibility of employment regulations. At the same time, some indicators of business regulation have worsened. These include protecting investors, getting credit and starting a business.

Chart 40. Ranking on ease of doing business in 2006/2007



Source: Doing Business database.

Improving infrastructure and enhancing competition

47. The 2007 EBRD Transition Report found limited reform progress in the EU8+2. The only upgrades were financial sector development (Latvia, Lithuania and Romania). In Latvia there were improvements to banking regulations, particularly anti-money laundering procedures while in Lithuania securities legislation and regulation were both improved. In Romania, development of the financial sector was largely a market-based response to earlier reforms and privatizations. There were also some notable developments in specific areas of infrastructure. Hungary received an infrastructure score upgrade for railways following the establishment of a regulatory office and freight service, and an increase in competition in railway freight transportation.

48. Although all EU8+2 countries are close to the maximum of the EBRD index on progress of transition, there are further challenges to increase private sector involvement in infrastructure and introduce more effective competition (see Chart 41 and Chart 42).

Chart 41. Infrastructure transition scores in 2007

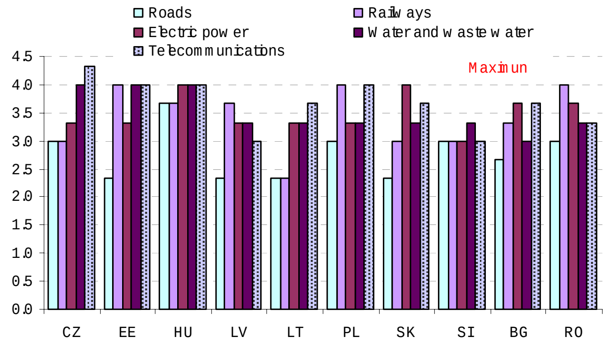
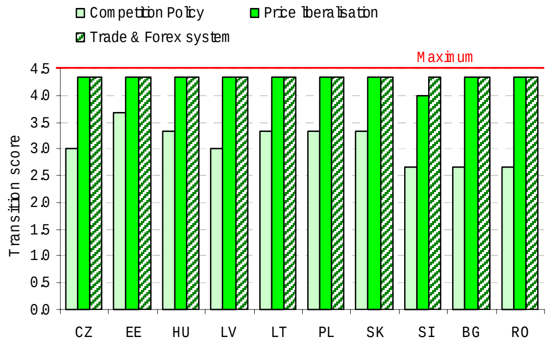


Chart 42. Market and trade transition scores in 2007



Source: EBRD.

ANNEX 1. STRUCTURAL CHANGES IN PUBLIC FINANCES

Fiscal reform agendas concentrated more on tax policy and tax administration than on expenditures or public expenditure management. Thus, the pace of improvement in the efficiency and quality of public service delivery, mainly in health and education, has been slow.

- **Bulgaria** plans to continue accumulating surpluses while increasing substantially its public capital spending and other items, mainly related to EU-funded projects. Capital spending is expected to reach 6.2 percent of GDP in 2008 with overall government spending remaining below 40 percent of GDP. To accommodate higher public investment and increased absorption of EU funds, the Government plans to reduce the costs of public administration by 12 percent while allowing for a rise in wages of public sector employees. In addition, a contingency of around 1 percent of GDP has been set aside to provide a buffer for unforeseen circumstances, including further widening of external imbalances. This contingency replaces the 90 percent rule[10] and is expected to improve the transparency and accountability of public spending. The government introduced a flat 10 percent PIT rate and continued the harmonization of excise rates with the increase in rates of some fuels frontloaded in 2008. The government is continuing to strengthen fiscal decentralization.
- **In the Czech Republic**, a substantial improvement in the public budget is expected, on the back of the Act on Public Budget Stabilization which was approved by the Parliament in August 2007. The key consolidation measures concentrate on expenditures, particularly social transfers including lowering or canceling a number of welfare benefits and introduction of health care service charges. On the revenue side, the tax burden is being decreased and shifted from direct to indirect taxation. Major changes in tax policy include a flat PIT rate of 15% on gross wages and bonuses, gradual reduction of the CIT rate by 3 percentage points to 21%, and an increase in the preferential VAT rate from 5% to 9%. The pension reform, however, was postponed again.
- **Estonia** plans to maintain a general government budget surplus in 2008, although on at a lower level (1.3% of GDP) than in previous years and with deteriorating structural balance. The state budget expenditure is set to increase by 25%, with the most significant increases in the categories of social protection (33%), education (29%, a large part of which is to finance a 20+ percent rise in teachers' wages) and public order and safety (48%, notably for personnel expenses). As for revenue policies, the plans show further shifting from taxation of income to taxation of consumption and environment exploitation. Tax amendments for 2008 show the strongest negative impact from the reduction of income tax rates and increase of basic allowance (-0.9% of GDP). This will be more than offset by increases of many of excise duty rates (for inflation-controlling purposes brought forward to 2008), increase VAT rates for selected products, and increases in the minimum social tax obligation. All in all the total impact of tax amendments on the budget is to reach 0.19% of GDP.
- **In Hungary**, the 2008 budget represents further steps towards fiscal consolidation including reductions in subsides (for rail and road passenger transport and for gas and district heating), reductions in personnel costs and a slow-down in real wage growth. Pressures for higher spending are coming from an expected increase in the number of pensioners, higher co-financing requirements for EU-financed projects, and increased interest payments. After earlier austerity measures and some initial structural reforms (including introduction of fees for doctor and hospital visits and higher education tuition fees) in 2006/2007, further progress on pensions coming into force from 2008 (changes in pension calculation and in the disability pension system) are expected to reduce the expenditures in the medium and longer term. In the field of health care the insurance based approach has been strengthened and the new Bill

[10] According to this rule spending units were allowed to spend up to 90 percent of allocated funds until the third quarter of the year. Spending units could spend the withheld amount in the fourth quarter of the year provided that budget execution was good and external current account level has not increased more than expected.

on health care is before the Parliament. However, the government had to backtrack on closing railway lines, the proposal to make civil servants' wages performance-based.

- **Latvia** plans to increase its budget surplus to 0.7% of GDP in 2008 with stabilization of the economy set as one of the most important tasks. But the cost of structural reforms is pushing up expenditures. Pension reform will require social security contributions to the funded pension scheme to increase to 8% in January 2008 (from 4% in 2007), amounting to 1.5% of GDP in 2008, in comparison to 0.8% in 2007. Other social transfers are increasing slightly. Significant funding is also planned for the ongoing healthcare reform (0.3% of GDP for healthcare promotion, including 0.2% of GDP for raising the wages and salaries of medical personnel) as well as for completion of administrative and territorial reform (0.3% of GDP). Public investment spending is to increase to 5.4% of GDP (from 4.8% in 2007), including large investments from the Cohesion Fund. However, total expenditure will decrease by 0.2 p.p. to 36.8% of GDP, mainly on the back of a 1 p.p. reduction in collective consumption expenditure, including on wages and salaries. On the revenue side, the tax burden will decrease with a continued shift from direct to indirect taxation. To comply with fiscal policy objectives, privatization receipts as well as unanticipated revenue (except foreign financial assistance as well as revenue from service charges and other self-generated revenue of budget institutions) are to be placed in the long-term stability reserve fund.
- **In Lithuania**, general government sector deficit is planned at 0.5% of GDP in 2008 with implementation of education, health and tax reforms restricting possibilities to reduce fiscal deficit. The first stage of science and education system reform, starting in 2008, includes increase in salaries for teachers and researchers by 20%.The highest growth (by 1.1p.p. of GDP) is expected in social transfers, and also, owing to the absorption of EU support, in gross fixed capital formation. On the tax reform, a shift from direct to indirect taxation continues, with further reduction of personal income tax (from 27% to 24% from January 2008) reducing budgetary revenues by 2.3% of GDP. Several favorable amendments were also introduced to corporate income tax regulations. Nevertheless, the government plans to increase the share of GDP of these revenue sources, on the back of further improved tax administration. Additional budgetary revenues (by 1.6p.p. of GDP) will be generated by increases in excise rates on cigarettes and alcohol and, as a result, in 2008 general government revenue is planned to grow by 2p.p. of GDP yoy (to 37.4%). More restrictive fiscal discipline rules are envisaged further in the medium term, as stipulated in the Law on Fiscal Discipline (which pursues close-to-balanced or a surplus budget, and provides numerical and procedural rules for limitation of expenditure growth).
- **In Poland**, because of the urgent budget preparation agenda the new government had limited opportunity to introduce any major changes in the budget 2008 inherited from its predecessor. The nominal state budget deficit for 2008 was adjusted downwards marginally as compared to the draft prepared by the former cabinet. Adjustments on the expenditure side were rather minor (e.g. higher pay increases for teachers). Despite serious reservations, the new cabinet maintained the further reduction of social security contribution rates (disability) by 4 percentage points from January 2008. Due to various commitments from the election period (higher social spending, tax cuts), fiscal policy in 2008 is to be relaxed as compared to surprisingly good fiscal performance in 2007[11].

During the parliamentary budget debate in late November, the new Minister of Finance J. Rostowski highlighted six pillars of fiscal policy for coming years: (1) reducing public debt by 4 to 7 percentage points by 2011; (2) upholding the previous government's decision to cut the disability contribution rate and PIT in 2009 (further tax cuts are also on the agenda); (3) raising development expenditure – on roads, education, science, and "reasonable social spending"; (4) accelerating privatization; (5) economic liberalization: simplification of the tax system, reform of administration, improvement of EU fund utilization, and better functioning of economic judiciary; (6) preparing the Polish economy for euro adoption. In his view, however, euro adoption will exceed the term of the current Parliament ending in 2011.

[11] In mid-January, Deputy Minister of Finance K.Zajdel-Kurowska stated that there was a high probability that general government deficit in 2008 would be lower than 3 percent of GDP. She stated that Poland might exit excessive deficit procedure in May 2008.

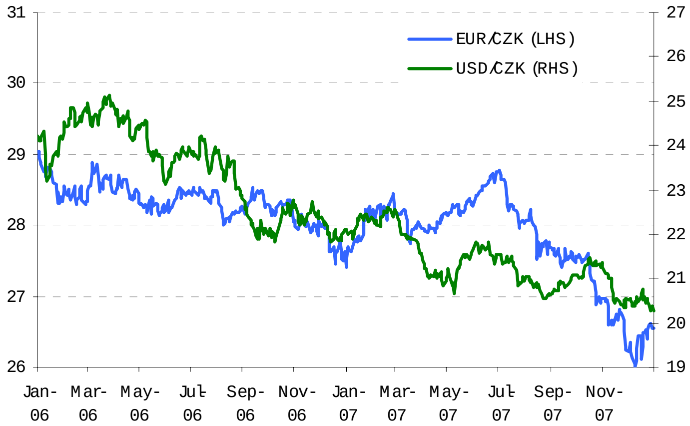
- **Romania** continues its expansionary fiscal policy and plans substantial increases in government spending while keeping the fiscal deficit unchanged compared to 2007. This is to be achieved by a sizable improvement in revenue collection based on increased compliance with social security legislation supported by a 6 percentage point cut in social contribution rates. While current spending is projected to decline reflecting a lower wage bill and subsidies, capital spending is expected to expand to over 8 percent of GDP. Both revenue and capital spending projections are overly optimistic.
- **Slovakia** envisages further consolidation of its fiscal accounts by reducing the cyclically adjusted deficit to 2.5 percent of GDP. The cost of the planned launch of the fully funded pension pillar in 2008 is expected to reach 1.2 percent of GDP on a net basis. In addition, substantial investments are planned in road infrastructure which would be financed through PPPs.
- **Slovenia** is continuing its fiscal consolidation plans following a comprehensive tax reform that started in 2006 and led to a significant decline in revenues. The less ambitious fiscal deficit planned in 2008 reflects one-off spending items related to financing of railway infrastructure and implementation of the law on public sector wages. The policy agenda envisages the full implementation by 2010 of the comprehensive tax reform initiated in 2005 and changes in tax administration. Gradual introduction of performance-based budgeting is also planned.

ANNEX 2. ADDITIONAL CHARTS AND TABLES

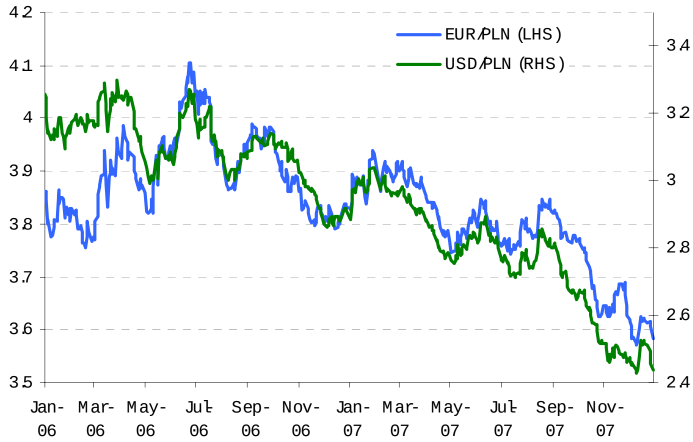
External environment

Chart 43. Nominal exchange rates, LCU per EUR and USD

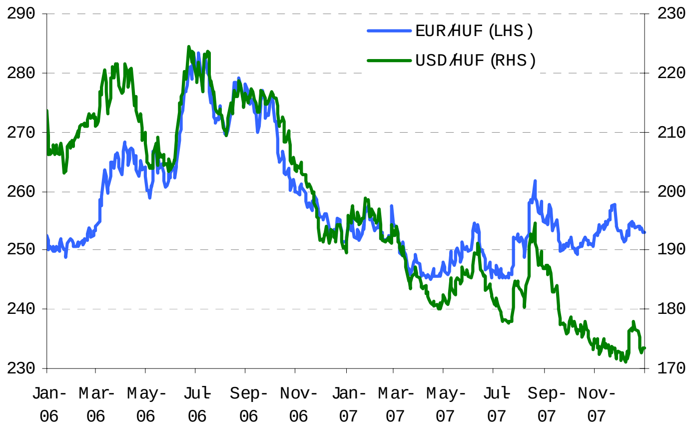
CZECH REPUBLIC



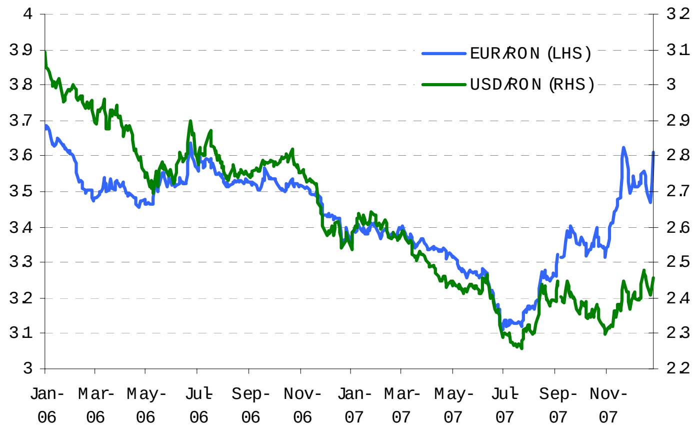
POLAND



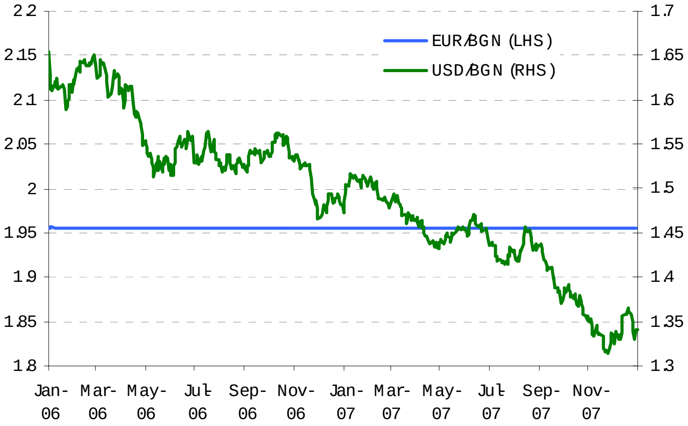
HUNGARY



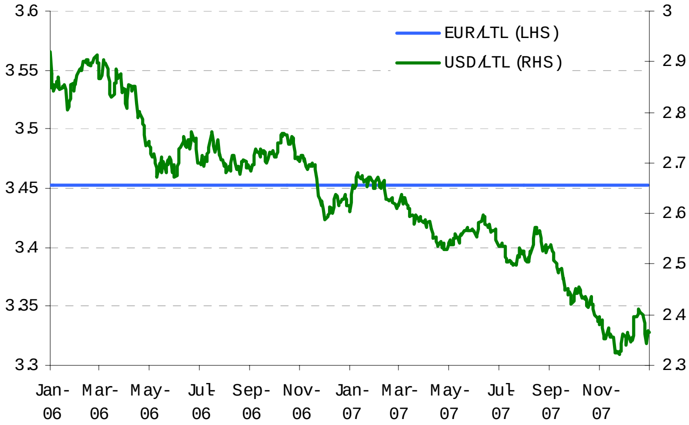
ROMANIA



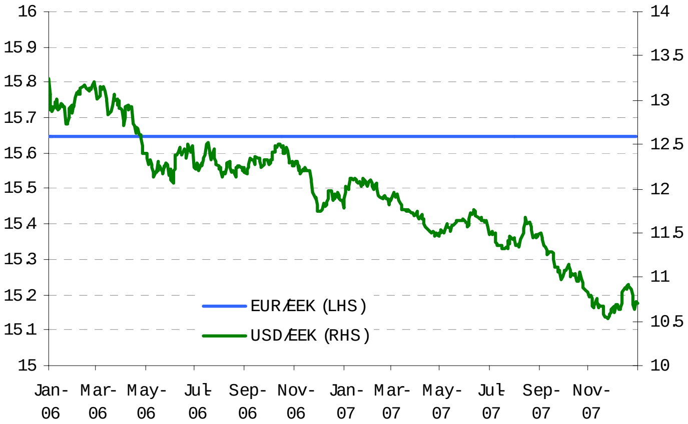
BULGARIA



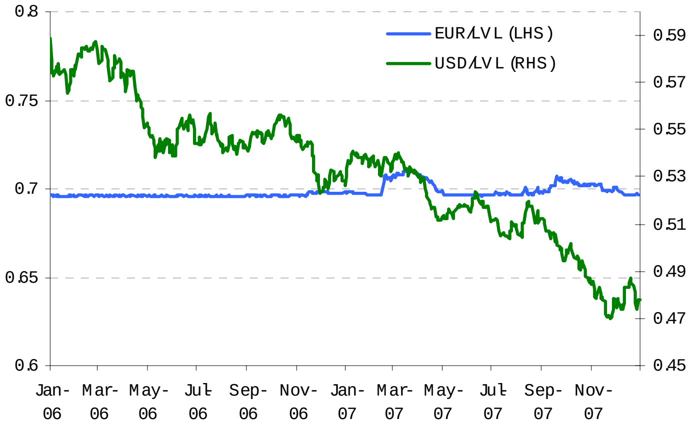
LITHUANIA



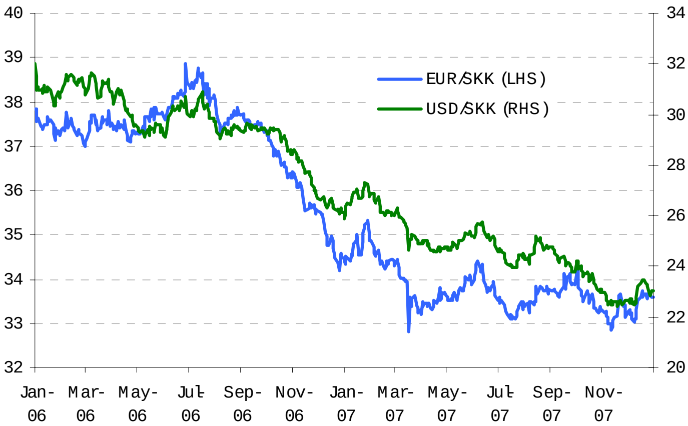
ESTONIA



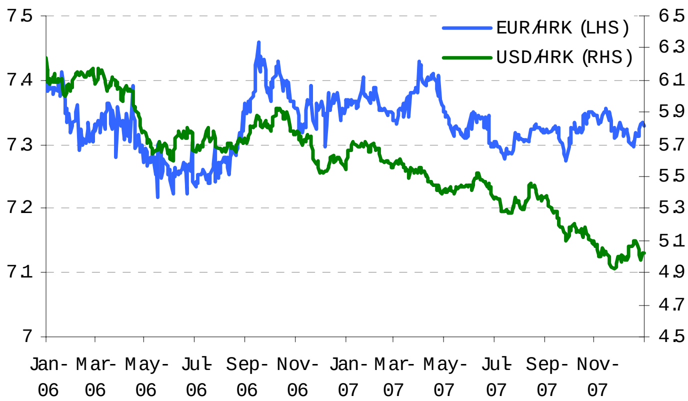
LATVIA



SLOVAKIA

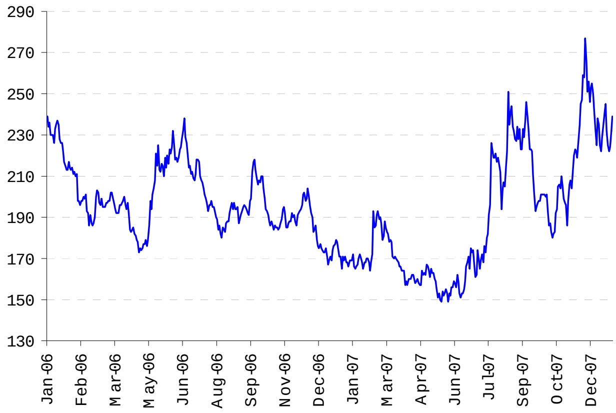


CROATIA



Source: Reuters.

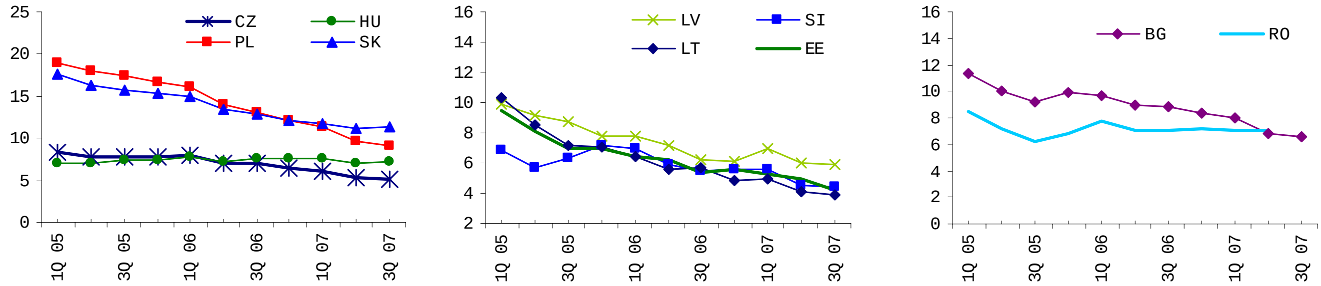
Chart 44. EMBI spreads, basis points



Source: Reuters.

Labor

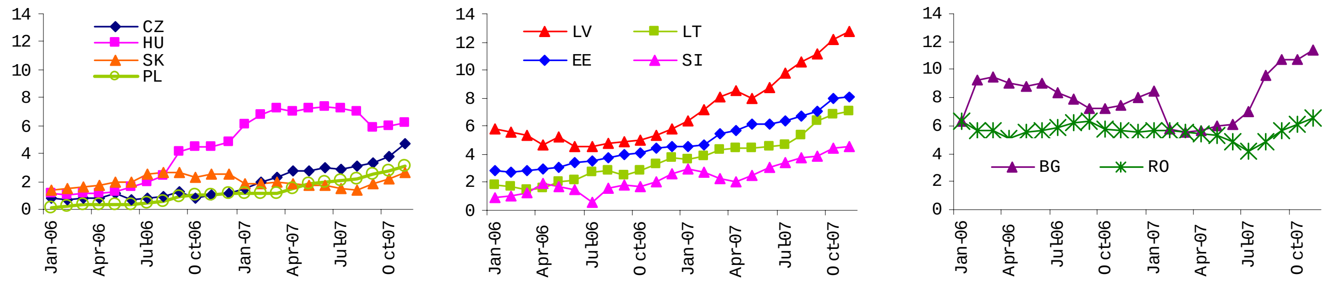
Chart 45. Unemployment rates, %



Source: Eurostat, staff calculations.

Inflation

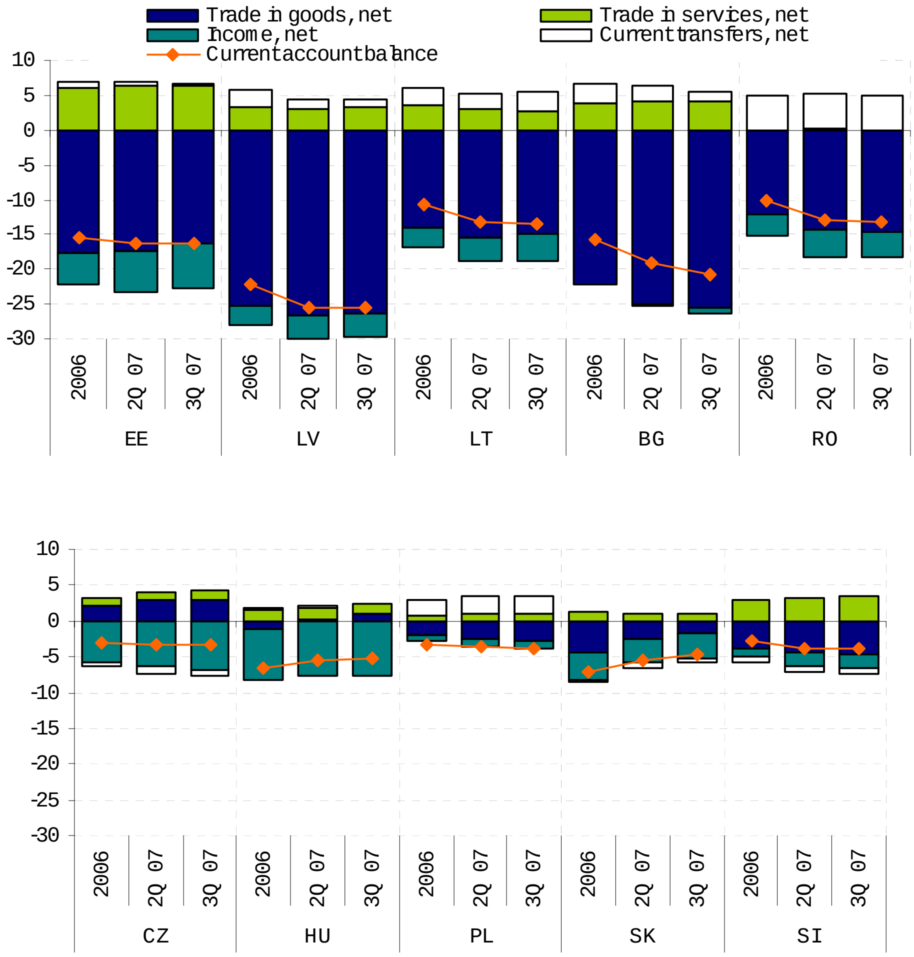
Chart 46. HICP-Core Inflation, y/y, %



Source: Eurostat.

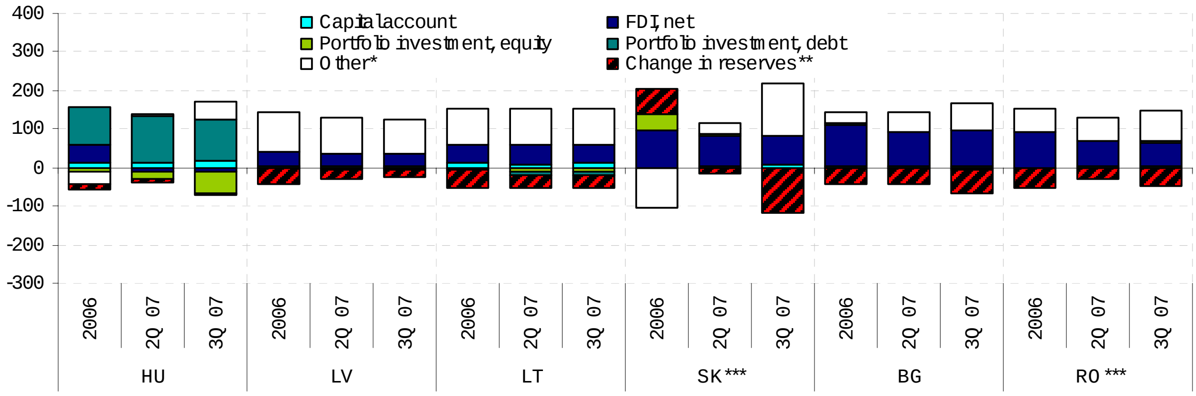
External sector

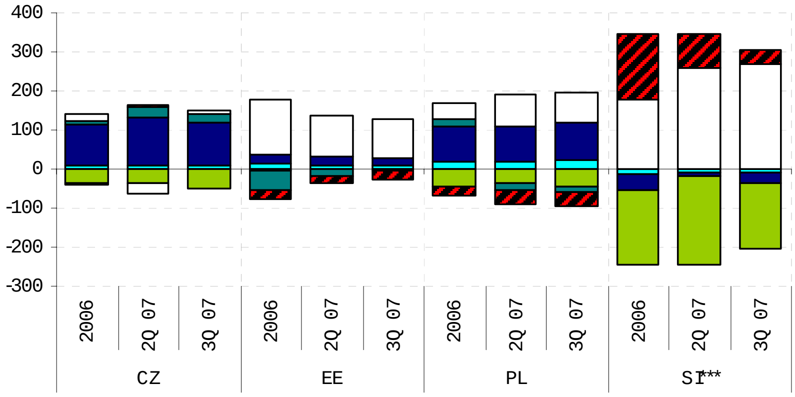
Chart 47. Current Account Balance, % of GDP



Source: CBs, Eurostat, staff calculations.

Chart 48. Current Account Deficit financing





Notes: The sum of flows above and below the horizontal axis sums up to 100% (equals the value of the current account deficit)
**) financial derivatives, other investment and net errors and omissions; **) negative values denote increase of reserves;*
****) portfolio investment include equity and debt.*
Source: CBs, Eurostat, staff calculations.

Table 6. Selected Vulnerability Indicators in the EU8+2 in 3Q 2007

	CZ	EE	HU	LT	LV	PL	SK	BG	RO
GDP growth, SNA (real, %, yoy)	6.0	6.4	0.9	10.8	10.9	6.4	9.4	4.5	5.7
Current account balance, (4Q cumulative, % of GDP)	-3.5	-16.2	-5.4	-13.4	-25.4	-3.7	-4.8	-20.7	-13.3
FDI (4Q cumulative, % of GDP)	3.8	3.2	-0.5	6.6	8.1	3.7	3.6	19.2	8.1
Total gross external debt (eop, % of GDP)	37.7	108.4	95.1	68.1	130.6	48.1	52.5	91.3	29.9
Change of international reserves in euro (eop, relative to previous period, %)	0.1	16.5	-2.9	3.0	4.8	1.7	0.2	22.3	14.1
Reserves-to-short-term debt ratio (eop, %)	156.4	48.3	120.8	65.3	74.8	114.9	128.1	145.4	161.3
Money Supply-to-Reserves ratio (eop, %)	351.9	300.1	327.9	252.4	224.5	346.2	235.1	167.0	140.6
Credit to private sector (eop, % of GDP)	44.8	91.7	57.4	58.4	92.4	38.4	40.9	61.6	34.0
Growth rate of credit to the private sector (avg, %)	24.4	40.4	11.2	45.2	45.3	33.0	23.9	55.9	51.3
Foreign currency loans to the private sector (eop, % of loans to priv. sect.)	10.0	78.3	54.9	49.2	83.9	24.7	21.2	48.5	51.5
Short-term (3M) interest rates spreads to euro area (avg, basis points)	-123.0	46.0	331.0	77.0	404.0	42.0	-17.0	41.0	231.0
Change of stock exchange index (avg, relative to previous period, %)	-1.1	1.6	7.8	10.7	9.3	0.4	5.4	21.7	16.0
*Sovereign credit rating according to S&P's	A/S/A-1	A/N/A-1	BBB+/S/A-	A/N/A-1	BBB+/N/A-2	A-/S/A-2	A/S/A-1	BBB+/S/A-2	BBB-/N/A-3

*Current S&P Rating. The symbols in line with S&P ratings denote the outlook, S= Stable, N=Negative, P=Positive

Source: CBs, CSOs, ISI, S&P.

Fiscal policy

Table 7. Medium-Term Fiscal Plans based on the latest Convergence Programs, % of GDP

Bulgaria	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**3.2**	**3.1**	**3.0**	**3.0**	**3.0**
Total revenue	**40.3**	**42.2**	**43.7**	**43.9**	**43.9**
Total expenditure	**37.1**	**39.1**	**40.7**	**40.9**	**41.0**
Collective consumption	17.0	16.8	16.8	16.2	15.9
Total social payments	12.8	12.1	12.2	11.9	11.5
Interest	1.3	1.2	1.1	1.0	1.0
Subsidies	0.9	1.4	1.5	1.7	1.8
Gross fixed capital formation	4.0	5.7	6.2	7.0	7.6
Other	1.1	1.7	3.0	3.1	3.1
(compensation of employees)	9.0	8.8	8.7	8.4	8.4
Czech Republic	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-2.9**	**-3.4**	**-2.9**	**-2.6**	**-2.3**
Total revenue	**40.7**	**39.8**	**39.5**	**38.1**	**37.1**
Total expenditure	**43.6**	**43.3**	**42.4**	**40.7**	**39.4**
Collective consumption	14.4	13.4	12.8	12.1	11.5
Total social transfers	17.9	18.2	17.4	16.8	16.3
Interest	1.1	1.2	1.3	1.2	1.2
Subsidies	1.9	2.0	2.2	1.9	1.8
Gross fixed capital formation	5.0	5.1	5.3	5.4	5.6
Other	3.3	3.4	3.6	3.3	3.1
(compensation of employees)	7.8	7.6	7.3	7.0	6.7
Estonia	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**3.6**	**2.6**	**1.3**	**1.0**	**0.9**
Total revenue	**36.6**	**37.2**	**38.2**	**38.2**	**37.4**
Total expenditure	**33.0**	**34.6**	**36.9**	**37.2**	**36.5**
Collective consumption	15.3	15.5	16.5	16.2	15.9
Total social transfers	10.6	11.1	11.9	12.1	12.0
Interest	0.2	0.1	0.1	0.1	0.1
Subsidies	1.0	1.0	1.1	1.1	1.1
Gross fixed capital formation	4.5	5.6	5.8	6.1	5.9
Other	1.4	1.3	1.5	1.6	1.5
(compensation of employees)	3.6	2.6	1.3	1.0	0.9
Hungary	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-9.2**	**-6.2**	**-4.0**	**-3.2**	**-2.7**
Total revenue	**42.6**	**44.1**	**44.2**	**43.3**	**42.4**
Total expenditure	**51.8**	**50.3**	**48.2**	**46.5**	**45.1**
Collective consumption	19.1	18.1	16.8	16.1	16.3
Total social transfers	18.5	18.4	18.2	17.8	17.3
Interest	3.9	4.0	4.1	3.8	3.5
Subsidies	1.4	1.7	1.5	1.3	1.2
Gross fixed capital formation	4.4	3.5	3.5	3.2	3.3
Other	4.5	4.6	4.1	3.8	3.5
(compensation of employees)	12.2	11.5	11.0	11.0	10.7

Latvia	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-0.3**	**0.3**	**0.7**	**1.0**	**1.2**
Total revenue	**37.0**	**37.3**	**37.4**	**37.7**	**37.9**
Total expenditure	**37.2**	**37.0**	**36.8**	**36.7**	**36.7**
Collective consumption	16.5	15.5	14.5	14	13.7
Total social transfers	8.5	8.7	9.0	9.1	9.2
Interest	0.5	0.4	0.3	0.3	0.3
Subsidies	0.6	0.5	0.5	0.4	0.4
Gross fixed capital formation	4.3	4.8	5.4	5.6	6.0
Other	6.8	7.1	7.1	7.3	7.3
(compensation of employees)	10.1	9.7	9.2	8.9	8.8

Lithuania	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-0.6**	**-0.9**	**-0.5**	**0.2**	**0.8**
Total revenue	**33.4**	**35.5**	**37.4**	**38.6**	**39.4**
Total expenditure	**34**	**36.4**	**37.9**	**38.5**	**38.6**
Collective consumption	16.5	16.5	16.9	16.9	17.1
Total social transfers	10	10.8	11.9	12.4	12.3
Interest	0.7	0.8	0.8	0.7	0.6
Subsidies	0.7	0.8	0.8	0.7	0.7
Gross fixed capital formation	4.2	4.5	5.1	5.3	5.3
Other	2.7	3.8	3.1	3.2	3.3
(compensation of employees)	10.5	10.8	11.1	11.1	11.2

Poland	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-3.8**	**-3.0**	**-3.0**	**-2.8**	**-2.5**
Total revenue	**40.0**	**39.9**	**39.3**	**38.7**	**38.3**
Total expenditure	**43.8**	**42.9**	**42.3**	**41.5**	**40.8**
Collective consumption	15.8	15.3	14.6	14.3	13.7
Total social transfers	17.3	16.8	16.4	15.8	15.5
Interest	2.7	2.4	2.4	2.5	2.5
Subsidies	0.6	0.7	0.8	1.0	0.9
Gross fixed capital formation	3.9	4.8	5.1	5.2	5.3
Other	3.5	2.8	3.0	2.9	2.9
(compensation of employees)	9.8	9.6	9.3	9.0	8.6

Romania	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-1.9**	**-2.9**	**-2.9**	**-2.9**	**-2.4**
Total revenue	**33.2**	**37.4**	**39.8**	**39.9**	**40.8**
Total expenditure	**35.0**	**40.3**	**42.7**	**42.8**	**43.2**
Collective consumption	15.5	16.9	16.7	16.0	15.8
Total social transfers	9.6	10.0	11.5	12.0	11.9
Interest	0.8	0.9	0.9	0.8	0.8
Subsidies	1.8	1.7	1.4	1.2	0.9
Gross fixed capital formation	4.9	7.0	8.2	8.6	9.2
Other	2.3	3.9	4.0	4.2	4.5
(compensation of employees)	9.1	9.1	8.6	7.8	7.3

Slovakia	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-3.7**	**-2.5**	**-2.3**	**-1.8**	**-0.8**
Total revenue	**33.5**	**33.2**	**33.0**	**31.8**	**31.8**
Total expenditure	**37.2**	**35.7**	**35.3**	**33.7**	**32.6**
Collective consumption	13.1	12.1	11.9	11.9	11.5
Total social transfers	16.3	16.4	16.2	15.5	15.4
Interest	1.5	1.5	1.4	1.5	1.3
Subsidies	1.3	1.3	1.2	1	0.9
Gross fixed capital formation	2.2	1.6	1.8	1.4	1.3
Other	2.8	2.7	2.8	2.4	2.2
(compensation of employees)	7.4	7.4	7.0	6.7	6.6

Slovenia	**2006**	**2007**	**2008**	**2009**	**2010**
General Government balance	**-1.2**	**-0.6**	**-1.0**	**-0.6**	**0.0**
Total revenue	**44.1**	**43.0**	**42.2**	**41.5**	**41.3**
Total expenditure	**45.3**	**43.6**	**43.2**	**42.1**	**41.3**
Collective consumption	17.8	17.3	17.2	16.8	16.6
Total social transfers	17.6	17.1	17.0	16.7	16.4
Interest	1.4	1.2	1.1	1.1	1.1
Subsidies	1.7	1.7	1.6	1.6	1.6
Gross fixed capital formation	3.7	3.6	3.6	3.5	3.3
Other	3.0	2.7	2.6	2.4	2.3
(compensation of employees)	11.4	11	10.9	10.7	10.6

Source: National Convergence Programs, November, December 2007.

ANNEX 3. STATISTICAL ANNEX

	2003	2004	2005	2006	4Q 06	1Q 07	2Q 07	3Q 07	Sep-07	Oct-07	Nov-07	Dec-07
GDP, SNA (real, %, y/y)												
Czech Republic	3.6	4.5	6.4	6.4	6.2	6.4	6.3	6.0				
Estonia	7.2	8.3	10.2	11.2	11.0	10.1	7.6	6.4				
Hungary	4.2	4.8	4.1	3.9	3.7	2.7	1.2	0.9				
Latvia	7.2	8.7	10.6	11.9	11.7	11.2	11.0	10.9				
Lithuania	10.3	7.3	7.9	7.7	7.4	8.1	8.0	10.8				
Poland	3.9	5.3	3.6	6.2	6.6	7.2	6.4	6.4				
Slovakia	4.8	5.2	6.6	8.5	8.2	8.3	9.3	9.4				
Slovenia	2.8	4.4	4.1	5.7	6.3	7.2	6.0	6.3				
Bulgaria	5.0	6.6	6.2	6.1	5.7	6.2	6.6	4.5				
Romania	5.2	8.5	4.1	7.7	7.7	6.0	5.6	5.7				
Croatia	5.3	4.3	4.3	4.8	4.8	7.0	6.6	5.1				
Consumption, SNA (real, %, y/y)												
Czech Republic	6.3	1.1	2.4	3.4	4.6	5.0	4.2	3.7				
Estonia	7.4	5.8	8.7	12.4	12.0	14.0	10.3	5.6				
Hungary	7.5	2.4	3.1	2.6	1.5	-3.1	-3.4	-2.3				
Latvia	6.7	7.9	9.6	16.7	20.9	17.4	16.2	13.0				
Lithuania	8.7	11.2	8.8	12.3	10.3	15.3	9.7	8.2				
Poland	2.6	4.0	2.7	4.9	4.7	5.5	4.1	4.3				
Slovakia	1.2	3.6	5.3	5.6	7.3	5.7	5.0	6.9				
Slovenia	3.0	2.8	3.1	3.4	3.2	1.8	1.9	2.5				
Bulgaria	5.9	5.4	5.3	6.5	6.1	7.0	5.2	4.3				
Romania	8.3	10.2	9.5	11.5	11.5	11.2	10.6	7.8				
Croatia	3.7	3.5	2.8	3.1	4.1	6.0	5.6	5.7				
Gross capital formation, SNA (real, %, y/y)												
Czech Republic	-1.4	9.1	-0.2	11.7	10.2	8.3	10.2	9.4				
Estonia	17.2	11.1	8.1	23.5	28.6	10.8	17.1	9.9				
Hungary	2.5	8.2	-4.2	-3.9	-1.2	13.3	10.9	8.5				
Latvia	22.1	23.0	8.5	18.9	16.5	29.3	22.6	13.6				
Lithuania	24.6	18.7	9.3	-6.1	7.1	3.7	38.4	9.9				
Poland	3.3	14.7	1.4	14.1	22.0	20.8	27.6	19.6				
Slovakia	-8.0	14.3	15.3	8.2	-6.6	-3.1	5.6	1.1				
Slovenia	10.1	11.4	-1.1	11.4	13.5	20.0	26.6	19.4				
Bulgaria	18.2	14.7	27.3	22.0	26.6	26.5	30.5	14.2				
Romania	8.7	19.4	2.5	17.6	18.1	16.4	45.1	30.1				
Croatia	14.1	4.8	6.3	10.5	-0.9	7.9	5.7	1.6				
Gross fixed capital formation, SNA (real, %, y/y)												
Czech Republic	0.4	3.9	2.3	7.6	8.1	4.7	6.0	5.7				
Estonia	19.2	4.4	9.9	22.4	27.2	15.0	21.8	-5.7				
Hungary	2.2	7.6	5.3	-2.8	-5.5	1.9	0.8	-1.8				
Latvia	12.3	23.8	23.6	18.3	15.8	17.9	14.4	12.7				
Lithuania	14.1	15.5	9.2	11.9	21.9	24.4	18.7	15.3				
Poland	-0.1	6.4	6.5	16.5	16.6	26.2	20.8	19.8				
Slovakia	-2.3	5.0	13.8	7.3	5.0	11.0	5.9	6.5				
Slovenia	7.1	7.9	1.5	11.9	12.3	21.2	21.8	17.7				
Bulgaria	13.9	13.5	23.3	17.6	23.8	35.9	24.7	19.7				
Romania	8.6	11.1	12.6	16.1	18.0	17.2	19.4	32.2				
Croatia	24.7	5.0	4.9	10.9	9.2	11.2	5.8	5.7				

	2003	2004	2005	2006	4Q 06	1Q 07	2Q 07	3Q 07	Sep-07	Oct-07	Nov-07	Dec-07
Exports, SNA (real, %, y/y)												
Czech Republic	7.2	20.7	11.8	15.9	17.1	15.4	13.5	14.8				
Estonia	8.0	16.6	20.5	8.3	-0.7	6.5	3.3	-2.9				
Hungary	6.2	15.6	11.5	18.9	22.3	17.5	14.8	14.9				
Latvia	5.2	9.4	20.3	5.3	-3.0	8.4	8.7	11.1				
Lithuania	6.9	4.4	14.5	15.4	2.9	3.5	3.2	13.0				
Poland	14.2	14.0	8.0	14.5	10.1	11.7	6.5	9.3				
Slovakia	15.9	7.9	13.5	20.7	23.1	22.7	18.1	8.5				
Slovenia	3.1	12.5	10.5	10.0	13.0	14.7	13.2	15.8				
Bulgaria	10.7	12.7	8.5	9.0	5.4	2.2	5.7	6.2				
Romania	8.4	13.9	8.1	10.6	8.6	12.9	2.4	1.7				
Croatia	11.4	5.7	4.6	6.9	11.1	3.0	8.9	7.3				
Imports, SNA (real, %, y/y)												
Czech Republic	8.0	17.9	5.0	15.2	17.1	15.3	13.4	14.2				
Estonia	10.4	15.5	16.3	17.1	10.8	9.8	3.5	-0.4				
Hungary	9.3	13.4	6.8	14.5	17.7	13.1	13.4	14.6				
Latvia	13.1	16.6	14.8	17.5	16.6	29.5	23.0	15.5				
Lithuania	10.4	14.9	16.0	15.4	6.8	10.6	14.7	9.5				
Poland	9.3	15.2	4.7	15.8	17.5	12.8	10.8	11.4				
Slovakia	7.6	8.8	15.5	17.8	14.9	14.5	13.2	3.0				
Slovenia	6.7	13.4	7.0	10.4	12.3	14.1	16.9	17.4				
Bulgaria	16.4	14.5	13.1	15.1	13.9	13.2	10.7	9.6				
Romania	16.0	22.1	16.6	23.0	25.3	23.8	20.8	22.4				
Croatia	12.1	4.6	3.5	7.3	5.0	3.7	6.4	7.0				
Industrial production (%, y/y)												
Czech Republic	5.5	9.6	6.7	9.7	7.7	11.7	9.3	6.3	1.3	8.4	6.7	
Estonia	11.1	10.5	10.9	7.0	5.5	8.8	7.7	4.9	3.4	8.4	4.4	
Hungary	6.4	7.4	7.0	10.0	10.0	9.2	7.5	9.2	6.2	8.5	5.5	
Latvia	6.8	5.4	5.9	5.1	3.0	1.3	1.4	1.8	-0.4	-1.6	1.1	
Lithuania	16.4	11.2	7.1	7.8	-1.0	-0.7	3.2	8.7	0.1	6.7	3.2	
Poland	8.3	12.3	4.1	12.1	10.9	13.2	8.8	8.2	5.4	10.8	8.3	
Slovakia	5.1	4.2	3.6	9.8	10.0	15.3	14.2	13.4	15.9	18.2	13.2	
Slovenia	1.4	4.8	3.1	6.2	6.6	9.1	8.0	6.9	2.1	10.9	2.4	
Bulgaria	14.1	17.1	6.7	6.1	3.4	7.0	8.8	10.5	8.9	11.3	7.1	
Romania	3.2	5.4	2.2	7.1	7.1	7.6	4.6	5.1	3.2	5.8	4.5	
Croatia	4.2	3.7	5.1	4.5	6.1	7.9	7.0	4.5	2.1	5.5	2.5	
Retail sales (excl. motor vehicles, automotive fuel, %, y/y)												
Czech Republic	4.0	3.0	3.7	6.5	6.1	8.6	7.3	6.4	5.6	7.9		
Estonia	9.9	15.5	12.0	19.0	20.2	23.8	17.5	13.5	11.8	8.9	5.0	
Hungary	9.0	5.8	5.5	4.1	2.0	0.0	-3.1	-4.3	-5.3	-3.4	-4.2	
Latvia	13.4	12.5	21.2	19.7	25.2	28.4	23.8	20.2	17.3	9.1	12.3	
Lithuania	11.1	10.7	12.9	7.2	6.2	12.7	14.6	12.4	12.4	12.2	9.3	
Poland	3.6	7.1	2.1	12.0	13.9	17.0	13.8	14.4	12.2	16.3	15.1	
Slovakia	-5.2	6.2	9.7	8.8	8.8	3.8	7.8	4.3	1.9	2.1	2.0	
Slovenia		3.8	6.8	1.7	1.4	6.1	3.9	5.8	7.9	9.3	4.4	
Bulgaria	11.0	14.5	12.7	13.0	14.0	14.5	11.3	6.4				
Romania			17.6	24.3	21.0	3.9	13.4	29.6	31.9	17.1	17.8	
Croatia	6.1	2.6	2.8	2.4	4.1	5.9	3.8	1.6	-0.4	2.7	1.6	

	2003	2004	2005	2006	4Q 06	1Q 07	2Q 07	3Q 07	Sep-07	Oct-07	Nov-07	Dec-07
Unemployment (%, NSA, LFS data)												
Czech Republic	7.8	8.3	7.9	7.1	6.5	6.0	5.3	5.1				
Estonia	10.0	9.7	7.9	5.9	5.6	5.3	5.0	4.2				
Hungary	5.9	6.1	7.2	7.5	7.5	7.5	7.0	7.2				
Latvia	10.5	10.4	8.9	6.8	6.1	6.9	6.0	5.9				
Lithuania	12.4	11.4	8.3	5.6	4.8	5.0	4.1	3.9				
Poland	19.6	19.0	17.7	13.8	12.2	11.3	9.6	9.0				
Slovakia	17.6	18.2	16.3	13.4	12.1	11.7	11.2	11.3				
Slovenia	6.7	6.3	6.5	6.0	5.6	5.6	4.5	4.4				
Bulgaria	13.7	12.0	10.1	9.0	8.4	8.0	6.8	6.6				
Romania	7.0	8.1	7.2	7.4	7.2	7.0	6.5	6.0				
Croatia	14.1	13.6	12.6	11.2	10.5	11.2	9.1					
CPI inflation (%, average y/y)												
Czech Republic	0.1	2.8	1.9	2.5	1.5	1.6	2.5	2.5	2.8	4.0	5.0	5.4
Estonia	1.3	3.0	4.1	4.4	4.5	5.2	5.7	6.4	7.2	8.5	9.1	9.6
Hungary	4.7	6.8	3.6	3.9	6.4	8.5	8.6	7.7	6.4	6.7	7.1	7.4
Latvia	2.9	6.2	6.7	6.5	6.3	7.6	8.6	10.3	11.4	13.2	13.7	14.1
Lithuania	-1.2	1.2	2.7	3.7	4.2	4.3	4.8	5.9	7.0	7.5	7.8	8.1
Poland	0.8	3.5	2.1	1.0	1.3	2.0	2.4	2.0	2.3	3.0	3.6	4.0
Slovakia	8.5	7.5	2.7	4.5	4.1	2.8	2.5	2.5	2.8	3.3	3.1	3.4
Slovenia	5.6	3.6	2.5	2.5	2.2	2.4	3.0	3.6	3.5	5.1	5.7	5.6
Bulgaria	2.3	6.1	5.0	7.3	6.1	5.3	4.7	11.2	13.1	12.4	12.6	12.5
Romania	15.3	11.9	9.0	6.6	4.8	3.8	3.8	5.0	6.0	6.8	6.7	6.6
Croatia	1.8	2.1	3.3	3.2	2.2	1.6	2.1	2.9	3.9	4.3	4.6	5.8
PPI (%, averagey/y)												
Czech Republic	-0.3	5.7	3.0	1.6	2.2	3.2	4.1	3.9	4.0	4.4	5.4	
Estonia	0.2	2.9	2.1	4.5	5.7	7.0	8.5	8.7	9.0	9.1	8.6	
Hungary	2.4	3.5	4.3	6.5	5.7	3.5	-0.5	-2.6	-2.7	-1.4	0.4	
Latvia	3.2	8.6	7.8	13.2	12.8	15.8	17.8	16.7	15.5	15.9	14.0	
Lithuania	-0.2	6.8	13.5	2.8	1.0	1.1	4.8	5.4	8.1	13.4	17.2	
Poland	2.6	7.0	0.7	2.3	2.8	3.3	2.0	1.7	1.8	2.0	2.6	
Slovakia	8.3	2.6	5.3	5.7	2.8	0.1	-1.7	-3.0	-2.2	-1.2	0.1	
Slovenia	2.5	4.3	2.7	2.3	3.1	4.3	4.7	4.1	3.9	3.7	3.5	
Bulgaria		6.0	6.9	6.9	5.9	7.6	6.3	8.1	8.8	10.3	13.3	
Romania		19.1	10.6	11.6	11.0	9.4	7.5	6.1	7.0	8.2	9.2	
Croatia	1.9	3.5	3.0	2.9	1.7	2.0	2.5	3.7	4.5	4.9	5.4	
Exchange rate (nominal, LCU/EUR, period average)												
Czech Republic	31.85	31.89	29.78	28.34	28.04	28.04	28.27	27.94	27.57	27.34	26.73	26.32
Estonia	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65
Hungary	253.6	251.7	248.1	264.3	260.3	252.3	248.3	251.8	253.3	251.0	254.5	253.2
Latvia	0.641	0.665	0.696	0.696	0.697	0.702	0.699	0.699	0.702	0.703	0.701	0.698
Lithuania	3.453	3.453	3.453	3.453	3.453	3.453	3.453	3.453	3.453	3.453	3.453	3.453
Poland	4.400	4.527	4.023	3.896	3.848	3.886	3.801	3.790	3.789	3.706	3.658	3.602
Slovakia	41.5	40.0	38.6	37.2	35.9	34.3	33.8	33.6	33.8	33.6	33.2	33.4
Slovenia	233.8	239.1	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6	239.6
Bulgaria	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956
Romania	3.755	4.051	3.621	3.526	3.479	3.381	3.279	3.232	3.348	3.354	3.474	3.535
Croatia	7.564	7.496	7.400	7.325	7.366	7.366	7.349	7.308	7.313	7.328	7.337	7.318

	2003	2004	2005	2006	4Q 06	1Q 07	2Q 07	3Q 07	Sep-07	Oct-07	Nov-07	Dec-07
Exchange rate (nominal, LCU/USD, period average)												
Czech Republic	28.21	25.70	23.96	22.60	21.74	21.39	20.93	20.31	19.81	19.21	18.20	18.10
Estonia	13.86	12.60	12.58	12.47	12.13	11.94	11.60	11.38	11.25	11.00	10.66	10.75
Hungary	224.4	202.6	199.7	210.5	201.6	192.6	184.2	183.2	182.4	176.3	173.1	173.9
Latvia	0.571	0.540	0.565	0.560	0.546	0.536	0.518	0.508	0.505	0.494	0.477	0.479
Lithuania	3.061	2.781	2.774	2.752	2.679	2.634	2.560	2.511	2.481	2.427	2.353	2.374
Poland	3.889	3.658	3.235	3.103	2.984	2.965	2.816	2.759	2.729	2.604	2.492	2.475
Slovakia	36.77	32.26	31.02	29.70	27.88	26.19	25.02	24.42	24.31	23.62	22.65	22.98
Slovenia	207.1	192.4	192.7	191.0	185.9							
Bulgaria	1.733	1.575	1.574	1.559	1.517	1.492	1.451	1.422	1.406	1.374	1.333	1.344
Romania	3.320	3.264	2.914	2.809	2.696	2.580	2.431	2.354	2.409	2.357	2.365	2.425
Croatia	6.704	6.031	5.950	5.839	5.713	5.616	5.454	5.314	5.254	5.149	4.998	5.029
Real effective exchange rate, CPI based (%, period average, y/y), (negative value= depreciation)												
Czech Republic	-2.7	3.0	2.2	4.2	3.9	2.1	0.7					
Estonia	2.4	1.7	0.5	2.2	2.4	3.3	3.6					
Hungary	0.2	7.7	0.6	-1.4	1.6	8.2	14.3					
Latvia	-3.3	1.1	-1.2	3.7	3.8	4.6	5.6					
Lithuania	1.3	-0.5	-0.9	1.4	2.2	2.9	2.6					
Poland	-10.4	7.0	5.2	1.1	1.5	-1.1	4.0					
Slovakia	13.5	7.9	1.0	7.1	9.1	9.7	10.9					
Slovenia	2.5	-1.1	-0.8	0.2	0.4	0.9	0.9					
Bulgaria	3.8	2.9	-0.1	2.4	4.9	-5.9	-10.5					
Romania	-1.7	6.5	10.6	7.2	8.6	8.7	9.0					
Croatia												
Exports of goods (EUR, %, y/y)*												
Czech Republic	5.8	28.8	13.2	20.4	22.4	20.1	16.8	18.4	16.1	20.6		
Estonia	9.9	19.3	29.6	25.1	12.9	1.7	6.2	-0.4	-7.3	13.3		
Hungary	4.4	17.3	13.2	18.5	21.1	18.6	15.7	16.1	11.1	15.9		
Latvia	5.8	26.0	28.7	18.2	16.2	26.4	23.1	21.6	17.9	23.4		
Lithuania	11.2	21.4	26.9	18.7	0.6	6.3	8.0	15.5	7.3	12.2		
Poland	9.3	26.9	19.2	22.7	19.7	15.3	13.9	13.8	7.6	14.5		
Slovakia	26.7	15.5	15.5	29.4	32.7	37.5	30.0	21.6	19.5	26.0		
Slovenia	2.9	16.6	17.6	19.6	19.6	21.7	18.1	20.0	12.5	19.9		
Bulgaria	10.0	19.7	18.6	26.6	13.8	6.7	8.7	12.1	16.5	25.1		
Romania	6.4	21.3	17.5	16.2	15.4	12.5	10.9	12.7	11.1	23.9		
Croatia	5.4	18.1	9.6	16.7	19.2	1.9	17.3	13.5	7.3	7.6		
Imports of goods (EUR, %, y/y)*												
Czech Republic	6.4	23.0	9.3	20.7	21.9	17.8	15.2	17.0	12.3	17.5		
Estonia	12.9	16.9	22.5	30.4	19.8	7.5	5.7	-0.4	-3.0	4.8		
Hungary	5.9	15.2	9.9	16.5	17.7	14.0	12.1	11.4	7.4	12.1		
Latvia	8.1	23.3	22.6	31.5	28.7	35.0	27.1	20.5	8.0	11.3		
Lithuania	7.1	16.8	25.5	23.5	10.7	13.7	17.5	13.7	6.3	10.6		
Poland	3.2	19.5	13.3	23.8	23.4	18.4	18.2	14.3	10.9	13.4		
Slovakia	13.7	20.6	18.5	25.4	23.6	29.0	26.5	19.3	10.2	19.3		
Slovenia	5.7	16.7	14.5	17.6	17.6	19.8	23.5	21.4	19.4	22.6		
Bulgaria	14.3	20.9	7.6	23.4	26.9	50.3	38.3	43.2	47.3	41.1		
Romania	12.3	24.0	23.9	25.1	26.5	33.5	25.4	23.5	22.2	29.0		
Croatia	10.7	6.6	12.0	14.4	11.2	7.9	10.9	10.1	6.4	12.8		

*Based on Eurostat data.

	2003	2004	2005	2006	4Q 06	1Q 07	2Q 07	3Q 07	Sep-07	Oct-07	Nov-07	Dec-07
Trade balance (% GDP)**												
Czech Republic	-2.7	-0.5	2.0	2.1	2.1	2.5	2.8	3.0				
Estonia	-15.8	-17.0	-13.7	-17.7	-17.7	-18.1	-17.5	-16.4				
Hungary	-3.9	-3.0	-1.7	-1.0	-1.0	-0.3	0.2	0.9				
Latvia	-17.8	-20.2	-18.9	-25.4	-25.4	-26.3	-26.8	-26.4				
Lithuania	-9.0	-10.6	-11.4	-14.1	-14.1	-14.6	-15.5	-15.0				
Poland	-2.6	-2.3	-0.9	-2.0	-2.0	-2.2	-2.6	-2.8				
Slovakia	-1.9	-3.6	-5.0	-4.5	-4.5	-3.1	-2.5	-1.7				
Slovenia	-2.2	-3.8	-3.6	-3.8	-3.8	-3.8	-4.5	-4.7				
Bulgaria	-13.7	-14.9	-20.2	-22.2	-22.2	-23.6	-24.9	-25.5				
Romania	-7.6	-8.7	-9.8	-12.1	-12.1	-13.2	-14.4	-14.7				
Croatia	-26.6	-23.4	-24.0	-24.4	-24.4	-24.7	-24.7	-24.6				
Current account (% GDP)**												
Czech Republic	-6.2	-5.2	-1.6	-3.1	-3.1	-3.1	-3.3	-3.5				
Estonia	-11.3	-12.3	-10.0	-15.5	-15.5	-17.0	-16.4	-16.2				
Hungary	-7.9	-8.4	-6.8	-6.5	-6.5	-5.8	-5.5	-5.4				
Latvia	-8.1	-12.9	-12.6	-22.3	-22.3	-24.5	-25.4	-25.4				
Lithuania	-6.8	-7.7	-7.2	-10.8	-10.8	-11.5	-13.3	-13.4				
Poland	-2.1	-4.3	-1.6	-3.2	-3.2	-3.2	-3.6	-3.7				
Slovakia	-5.9	-7.8	-8.4	-7.0	-7.0	-5.7	-5.5	-4.8				
Slovenia	-0.8	-2.7	-2.0	-2.8	-2.8	-3.0	-3.9	-3.9				
Bulgaria	-5.5	-6.6	-12.0	-15.7	-15.7	-17.3	-19.1	-20.7				
Romania	-5.9	-8.4	-8.6	-10.3	-10.3	-11.6	-12.9	-13.3				
Croatia	-7.2	-5.1	-6.4	-7.7	-7.7	-7.8	-7.8	-7.6				
FDI net (% GDP)**												
Czech Republic	2.1	3.6	9.4	3.2	3.2	3.8	4.0	3.8				
Estonia	7.9	5.8	15.6	3.5	3.5	3.2	3.4	3.2				
Hungary	0.6	3.3	4.8	3.1	3.1	1.4	-0.5	-0.5				
Latvia	2.3	4.3	3.7	7.4	7.4	7.3	8.0	8.1				
Lithuania	0.8	2.3	2.7	5.1	5.1	6.2	6.5	6.6				
Poland	2.0	4.8	2.3	2.9	2.9	3.0	3.3	3.7				
Slovakia	5.8	7.2	4.1	6.8	6.8	5.4	4.4	3.6				
Slovenia	-0.6	0.8	-0.2	-0.7	-0.7	-0.6	-0.3	-1.1				
Bulgaria	10.3	11.3	14.5	16.8	16.8	16.7	17.1	19.2				
Romania	3.7	8.4	6.6	9.3	9.3	8.4	8.3	8.1				
Croatia	6.3	2.3	4.1	7.5	7.5	9.5	9.7	9.3				
Net portfolio investment (% GDP)**												
Czech Republic	-1.4	1.9	-2.7	-0.8	-0.8	-1.2	-0.2	-1.0				
Estonia	1.8	6.0	-15.7	-8.1	-8.1	-2.5	-2.9	-0.7				
Hungary	3.5	6.7	4.0	5.7	5.7	3.2	5.5	2.4				
Latvia	-2.0	1.7	-0.7	0.2	0.2	0.5	-1.3	-1.3				
Lithuania	1.5	0.9	-1.0	-0.8	-0.8	-3.0	-2.5	-2.5				
Poland	1.1	3.7	4.1	-0.9	-0.9	-2.1	-1.9	-2.2				
Slovakia	-1.7	2.1	-2.0	2.9	2.9	-0.9	0.1	0.2				
Slovenia	-0.9	-2.4	-5.2	-4.7	-4.7	-5.8	-8.9	-6.6				
Bulgaria	-1.1	-2.5	-5.9	0.5	0.5	-0.7	-0.5	-0.9				
Romania	1.0	-0.7	1.0	0.1	0.1	-0.1	0.1	0.6				
Croatia	3.3	0.9	-3.8	-1.6	-1.6	-0.9	-1.0	-1.3				

** Quarterly data on 4Q rolling basis.

	2003	2004	2005	2006	4Q 06	1Q 07	2Q 07	3Q 07	Sep-07	Oct-07	Nov-07	Dec-07
General government balance (ESA95, % GDP)												
Czech Republic	-6.6	-2.9	-3.5	-2.9								
Estonia	1.8	1.8	1.9	3.6								
Hungary	-7.2	-6.4	-7.8	-9.3								
Latvia	-1.6	-1.0	-0.4	-0.3								
Lithuania	-1.3	-1.5	-0.5	-0.6								
Poland	-6.3	-5.7	-4.3	-3.8								
Slovakia	-2.7	-2.4	-2.8	-3.7								
Slovenia	-2.7	-2.3	-1.5	-1.2								
Bulgaria	0.0	2.3	2.0	3.2								
Romania	-1.5	-1.5	-1.4	-1.9								
Croatia	-4.5	-5.0	-3.9	--								
General government revenue (ESA95, % GDP)												
Czech Republic	40.7	42.2	41.3	40.7								
Estonia	36.4	35.9	35.4	36.6								
Hungary	41.9	42.4	42.1	42.6								
Latvia	33.2	34.7	35.2	37.0								
Lithuania	32.0	31.8	33.1	33.4								
Poland	38.4	36.9	39.0	40.1								
Slovakia	37.4	35.4	35.3	33.5								
Slovenia	44.4	44.2	44.5	44.1								
Bulgaria	40.3	42.0	41.6	40.3								
Romania	32.1	31.2	32.2	32.9								
Croatia												
General government expenditure (ESA95, % GDP)												
Czech Republic	47.3	45.1	44.9	43.6								
Estonia	34.6	34.1	33.4	33.0								
Hungary	49.1	48.9	49.9	51.9								
Latvia	34.8	35.8	35.6	37.2								
Lithuania	33.2	33.4	33.6	34.0								
Poland	44.6	42.6	43.3	43.9								
Slovakia	40.2	37.8	38.1	37.2								
Slovenia	47.1	46.5	46.0	45.3								
Bulgaria	40.3	39.7	39.6	37.1								
Romania	33.6	32.7	33.6	34.8								
Croatia												
Public debt (ESA95, % GDP)												
Czech Republic	30.1	30.4	30.2	30.1								
Estonia	5.5	5.1	4.4	4.0								
Hungary	58.0	59.4	61.6	65.6								
Latvia	14.4	14.5	12.5	10.6								
Lithuania	21.2	19.4	18.6	18.2								
Poland	47.1	45.7	47.1	47.6								
Slovakia	42.4	41.4	34.2	30.4								
Slovenia	27.9	27.6	27.4	27.1								
Bulgaria	45.9	37.9	29.2	22.8								
Romania	21.5	18.8	15.8	12.4								
Croatia												
Oil (Brent) USD/BBL	28.8	35.8	50.9	65.4	60.1	58.3	68.7	74.7	76.8	82.5	92.7	89.1
Exch. Rate (USD/EUR)	1.131	1.244	1.244	1.244	1.289	1.311	1.348	1.374	1.390	1.423	1.468	1.457

Source: Eurostat, EC, WIIW, CSOs, NCBs, World Bank, IMF IFS, staff calculations.

World Bank EU8+2
Regular Economic Report
PART II: Special Topic
January 2008[12]

EU8+2

SATISFACTION WITH LIFE AND PUBLIC SERVICE DELIVERY IN EU8+2 COUNTRIES: SOME KEY FINDINGS FROM THE 2006 EBRD-WORLD BANK LIFE IN TRANSITION SURVEY

There has been a resurgence of interest recently among social scientists in studying subjective measures of individual well-being, and in analyzing how peoples' sense of their personal welfare is impacted by not just their level of incomes, but also other diverse factors like health, income inequality, and employment status. Much research has been carried out to better understand why some people say they are satisfied with their lives, and others are not. Data from the 2006 Life in Transition Survey (LiTS)—a joint initiative of the European Bank for Reconstruction and Development and the World Bank[13]—provides a unique opportunity to investigate the extent to which citizens of EU8+2 countries and Croatia are satisfied with their lives as well as with public service delivery in their home countries, and to study some of the key factors influencing their outlook.[14] This note summarizes some of the main findings emerging from ongoing work at the World Bank researching these topics.

I. Satisfaction with Life and Surroundings

1. The LiTS data from EU8+2 countries and Croatia show that overall satisfaction with life in these countries is, in general, quite high: people who report themselves as being satisfied with their lives outnumber those that are not, 3 to 2. However, there is considerable heterogeneity in response pattern across countries, as the ratio varies from a high of 8:1 in Slovenia to roughly 1:2 in Hungary (Chart 49).

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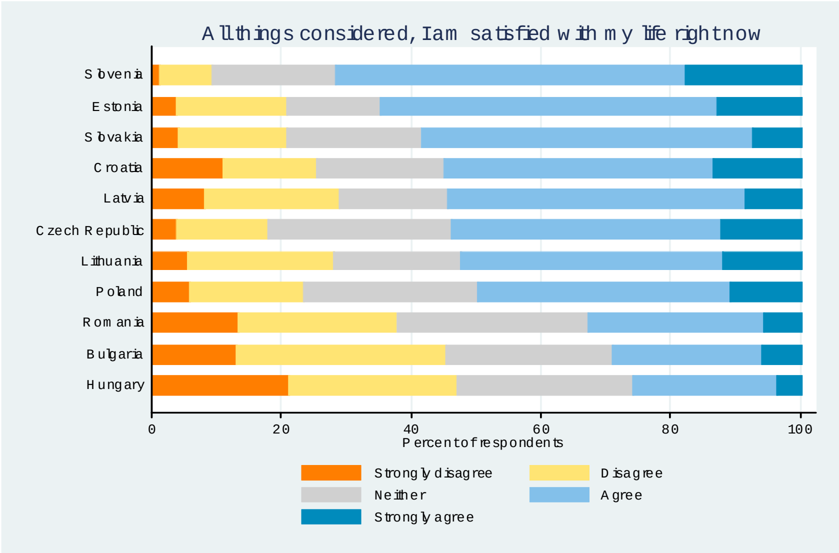
[12] Prepared by Salman Zaidi.

[13] Altogether 29 countries were covered in the survey (Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Former Yugoslav Republic of Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkey, Ukraine, Uzbekistan). In each country, the survey questionnaire was administered to a nationally representative sample of 1,000 households. Within each household, after collecting the basic household-level information, one person aged 18 years or older was selected at random for the main individual interview.

[14] The LiTS was carried out between September and November, 2006, and the survey questionnaire comprised 6 main modules: (i) Household Roster, (ii) Housing and Expenses, (iii) Attitudes and Values, (iv) Current Activities, (v) Education and Labor, and (vi) Life History; the first two of these were conducted at the household level, while the remainder were administered at the individual level.

Chart 49. A high share of Slovenians, Estonians, and Slovaks are satisfied with their lives



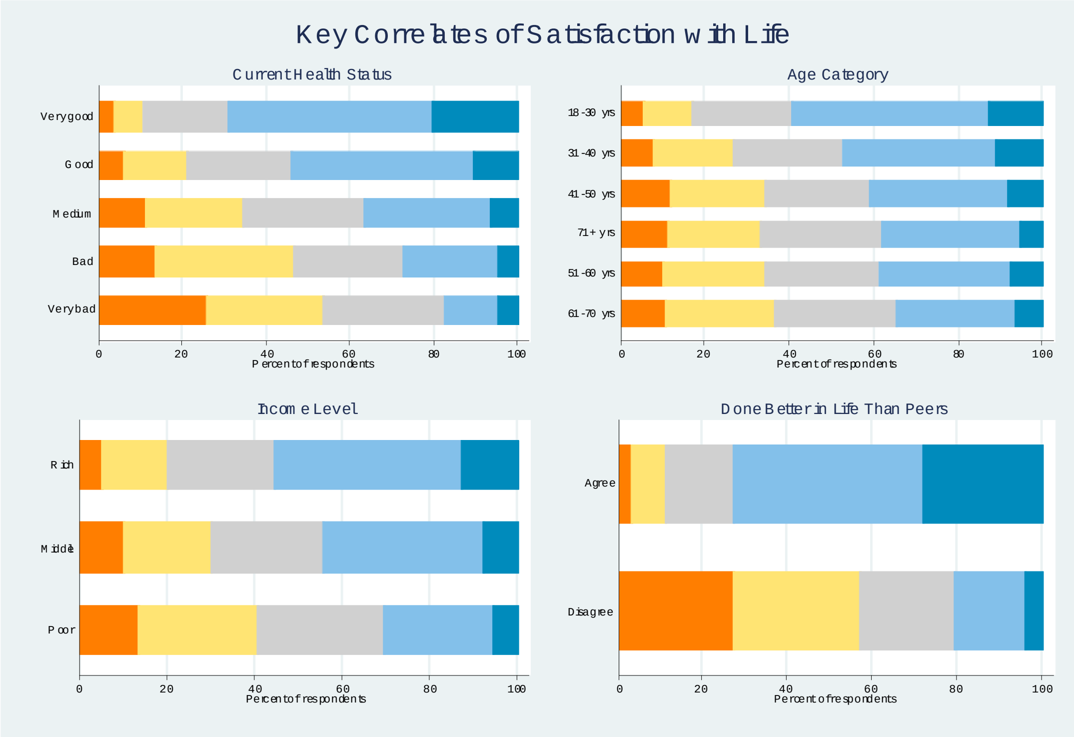
2. What are some of the main correlates of individual-level responses to the satisfaction with life question? Results from ordered probit regressions of the overall satisfaction-with-life variable confirm the influence of factors such as expenditure-per-capita, youth, working status, non-agricultural employment, urban living, and better education. However, the analysis also highlights the important role played by subjective factors like as self-assessed health status, level of trust in people, relative economic status compared to peers and own perception of improvement in economic status over time in determining overall satisfaction levels.[15]

3. Variation in level of satisfaction by selected characteristics of LiTS respondents, such as current health status, age category, and income level, is illustrated in Chart 50. These data show clearly that the (self-reported) health status of respondents has a strong bearing on reported level of satisfaction with life. In addition, one of the striking contrasts observed is the clear divide across age groups: overall satisfaction rates among the youth are considerably higher than amongst the elderly. This is not surprising given that it has been the adult population which lived through the economic decline and dislocations of the 1990s and for whom the economic transition, with its attendant uncertainties and insecurities, has been the most acute.[16]

[15] Asad Alam, Pradeep Mitra, and Salman Zaidi (forthcoming) "Key Factors affecting Satisfaction with Life in Eastern Europe and the former Soviet Union," The World Bank, Washington DC.

[16] Ibid.

Chart 50. Key correlates of satisfaction with life



4. Satisfaction with life depends, it seems, not just on (self-perceived absolute welfare), but rather also on how individuals seem to think they have done relative to their peers. As expected, satisfaction with life was positively associated with economic background: rich respondents were much more likely to report themselves as being satisfied with their lives as compared to the poor.[17] Respondents were also asked whether they had done better in life than most of their high school classmates:[18] As Chart 50 (south-east panel) clearly illustrates, responses to this question are a very good predictor of the satisfaction with life responses: amongst respondents that reported they had done better in life than their peers, two-thirds reported being satisfied with their lives, compared to only about one-fifths of those that disagreed with the statement that they had done better in life than their classmates / earlier work colleagues.

5. This being said, income levels do matter. At the country level, average responses to the satisfaction with life question in EU8+2 countries and Croatia are strongly correlated with average income level, and inversely correlated to the prevailing level of income inequality in the country (Chart 51).

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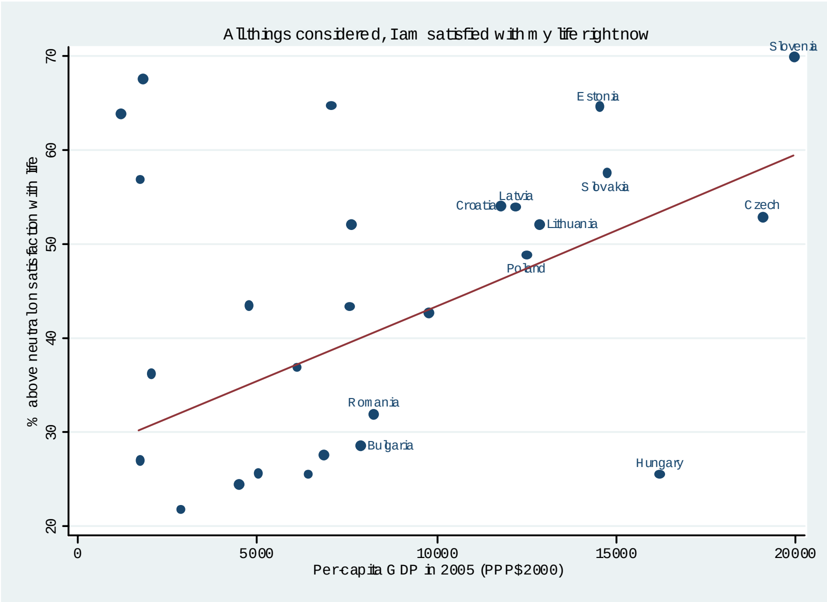
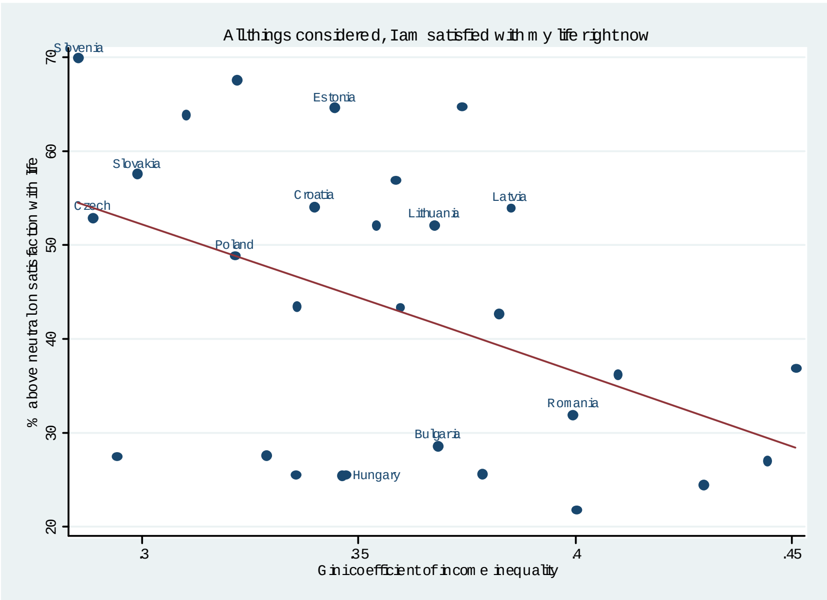
[17] The rich, middle-class, and the poor are defined respectively as the top, middle, and bottom one-third of the population in each country ranked by annual expenditures per-equivalent adult.

[18] Where responses were blank (for example because the respondent did not complete high school, responses to the question: "I have done better in life than most of the colleagues I had around 1989" were taken instead.

Chart 51. Satisfaction with life, average incomes, and level of income inequality





6. Not only income levels, but also their growth rates influence peoples' satisfaction with life. Comparing the level of satisfaction rates by country reported in the 2006 LiTS with similar such data from earlier rounds of the World Values Survey reveals some interesting patterns (Table 8). As in 2006, Slovenia also had the highest reported satisfaction rates in the 1990s. Focusing on changes over time, however, there appears to be a fairly close conformance between changes in average scores and performance of the economy. For instance, the Baltic states, which have recorded relatively high growth rates in recent years have witnessed the greatest increase in recent years; by contrast, other countries where performance of the economies has been relatively weaker (e.g. Poland, Hungary) are also the ones where average scores have either stagnated or declined over time.

Table 8. Changes over Time in Life Satisfaction Rates

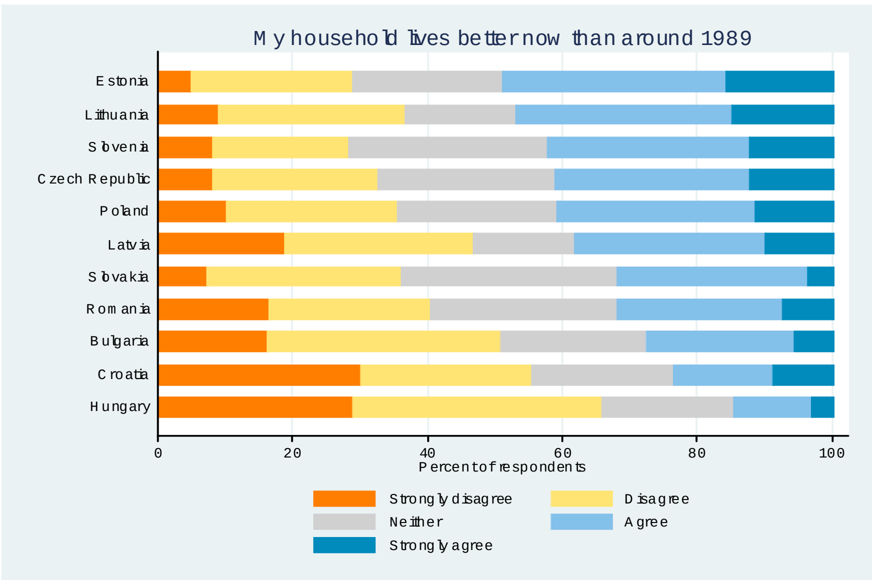
	World Values Survey Score	Year	2006 LiTS	Change in score
Bulgaria	2.6	1997	2.8	0.2
Croatia	3.3	1996	3.3	0.0
Czech Republic	3.4	1998	3.4	0.0
Estonia	2.8	1996	3.5	0.7
Hungary	3.2	1998	2.6	-0.6
Latvia	2.7	1996	3.3	0.6
Lithuania	2.8	1997	3.3	0.5
Poland	3.4	1997	3.3	-0.1
Romania	2.7	1998	2.9	0.2
Slovakia	3.3	1998	3.4	0.1
Slovenia	3.4	1995	3.8	0.4

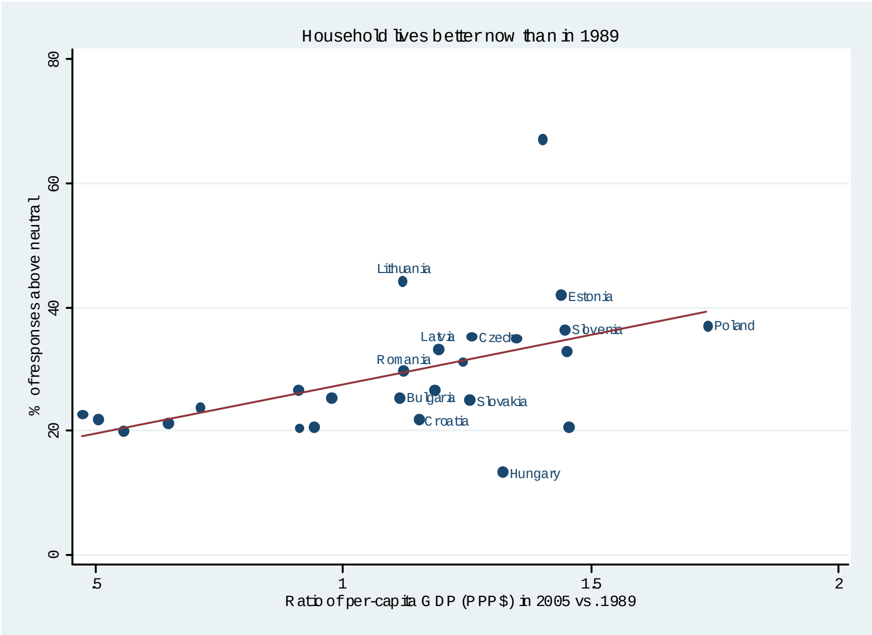
Source: World Values Survey, various rounds (data rescaled to 1-5 scale), and 2006 LiTS.

Changes in living conditions

7. With hindsight, how do people see the experience of transition? The survey data reveal somewhat mixed findings. On the one hand, in only five out of the ten EU member states—Estonia, Slovenia, Lithuania, Czech Republic and Poland—do more respondents agree rather than disagree that their "household lives better now than around 1989" (Chart 52, upper panel). While such perceptions are at odds with other more objective measures of improved living conditions, like as changes in per capita GDP between 1989 and 2005 (using this yardstick, all EU10 countries have a higher standard of living in 2005 compared to 1989) the pattern of responses across countries is quite consistent across the two sets of indicators (Chart 52, lower panel).

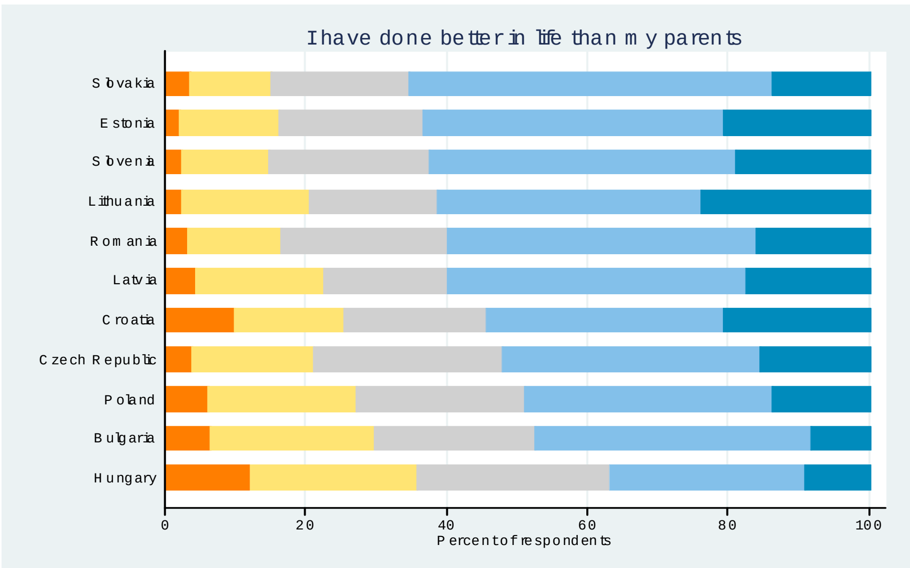
Chart 52. Have overall living conditions improved during transition?



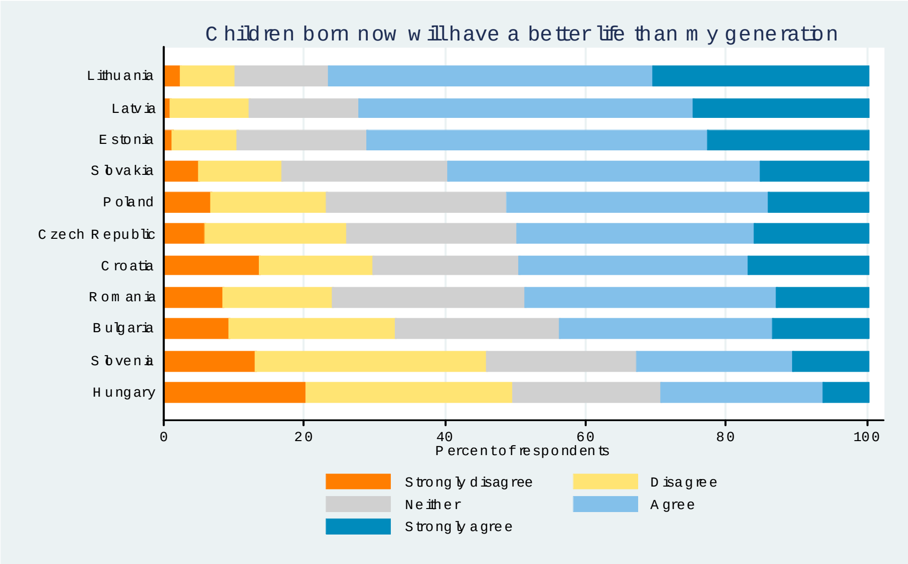


8. A majority of respondents in all EU8+2 countries, however, feel they have done better in life than their parents (Chart 53). Similarly, the majority of respondents express optimism that children born now will have a better life than their generation, particularly those living in the Baltic countries.

Chart 53. Indications of improvements in living conditions in all EU8+2 countries



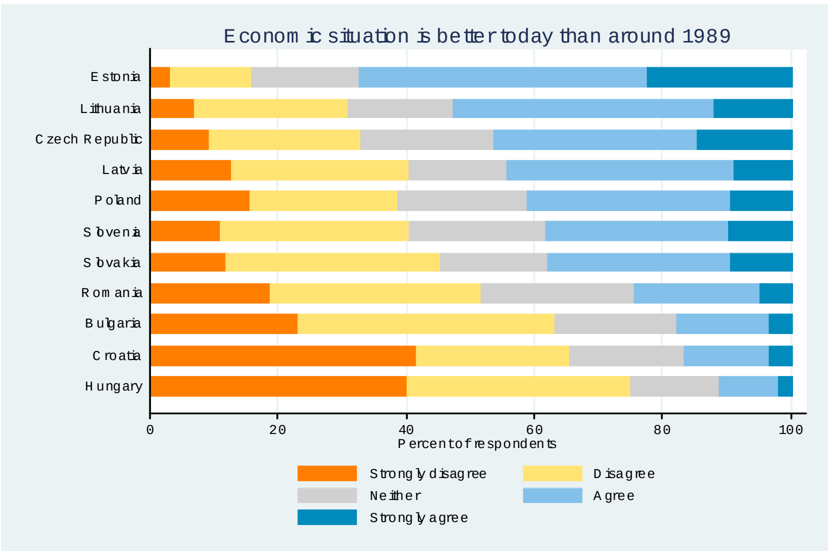
... and considerable optimism about the future

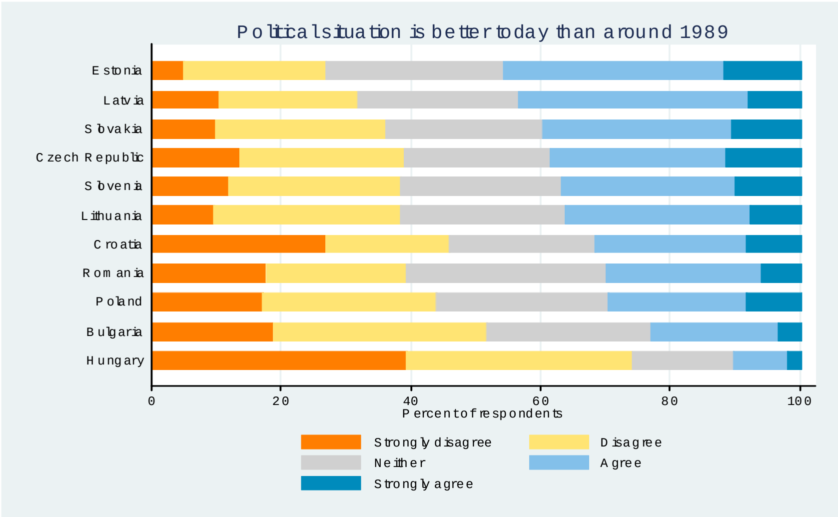


Changes in economic and political situation

9. Overall perceptions regarding the prevailing political situation were, in general, slightly more pessimistic than those about the state of the economy. Respondents in the LiTS were also asked if the economic and political situation in their country was better now than in 1989 (Chart 54). In only five out of the ten EU8+2 countries—Estonia, Lithuania, Czech Republic, Latvia, and Poland—did number of respondents who agree that the economic situation is better today than in 1989 exceed those disagreeing. The assessment of political factors is more subdued. In Bulgaria and Hungary in particular, respondents in 2006 appeared to be particularly despondent regarding the prevailing economic and political situation in their countries today relative to 1989.

Chart 54. High dissatisfaction with prevailing situation in Hungary and Bulgaria

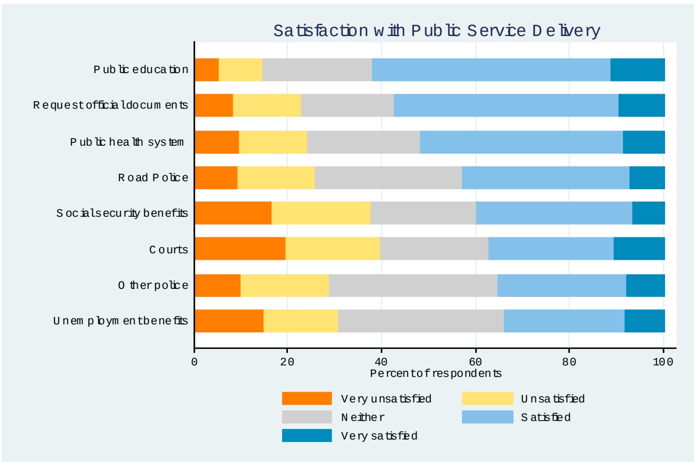




II. Satisfaction with Public Service Delivery

10. Respondents appear also to be moderately satisfied with public services, particularly public education. The LiTS includes questions on whether respondents have personally used a variety of different public services offered by the government during the past 12 months, and if so, on the extent to which they were satisfied with the quality and efficiency of the service provided to them. Reponses for each particular service used during the past 12 months were recorded on a 5-point scale, ranging from 1:"Very unsatisfied" to 5:"Very satisfied." Satisfaction with public service delivery in EU8+2 and Croatia is generally quite high (Chart 55), and is on the whole better than in other countries in the ECA region. For instance, when asked about how satisfied they were with the quality and efficiency of the interaction with public officials when requesting official documents (for example passport, visa, birth or marriage certificates, land register, etc.), satisfied respondents outnumbered the dissatisfied by more than 2:1. After requests for official documents, the public education system receives the next best ratings overall, followed by public health system.

Chart 55. Generally High Satisfaction with Public Service Delivery



11. Satisfaction with public services varies however widely across countries: on the whole Romania does quite poorly in comparison to other countries, and Estonia does quite well (Chart 56).

Chart 56. Variation in Satisfaction Rates by Country

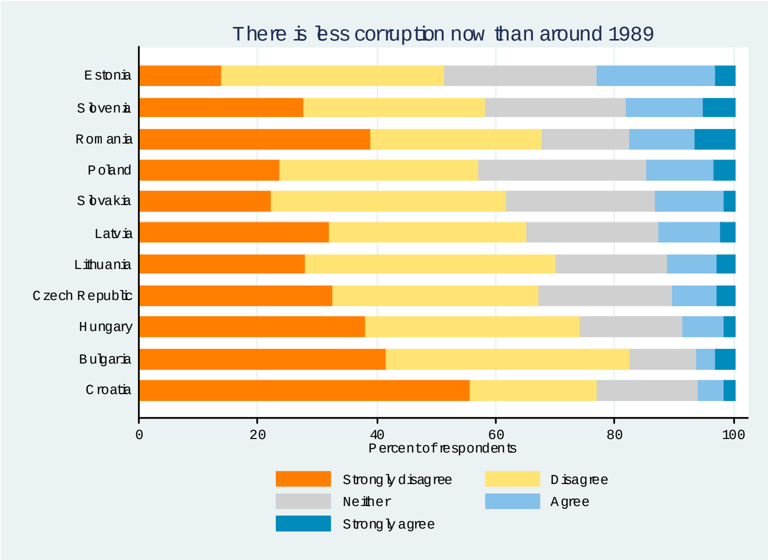
12. On satisfaction with health services, recent research work at the World Bank has focused on examining three inter-linked questions using 2006 LiTS data for the ECA region: (i) why are some people more likely than others to use the public health system (ii) what are some of the key influences on users' satisfaction with quality and efficiency of medical treatment received and (iii) how does the prevalence of informal payments impact people's decision on using the public health system, and upon use (i.e. the level of satisfaction with services received)[19] The main findings of this work indicate that the elderly, the relatively better-off, and those who have confidence in the government are more likely to use the public health system, while those with compulsory/secondary education as well as those with some tertiary education are less likely to access the system.

Perceptions of Corruption

13. On a more sobering note, the issue of higher corruption seems to figure prominently in public perceptions: in all the countries surveyed, an overwhelming majority of respondents disagree with the statement: "There is less corruption now than around 1989" (Chart 57).

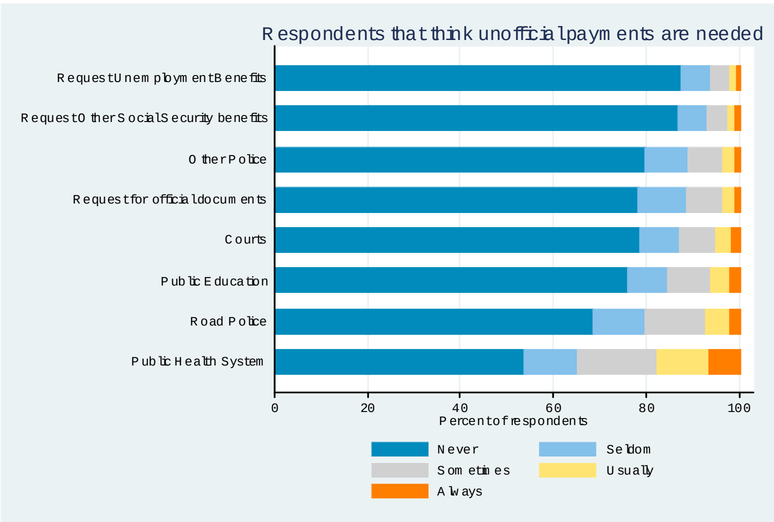
[19] Ramya Sundaram and Salman Zaidi (forthcoming) "Satisfaction with the Public Health System in Eastern Europe and the former Soviet Union", The World Bank, Washington DC.

Chart 57. An overwhelming majority disagree there is less corruption now than around 1989



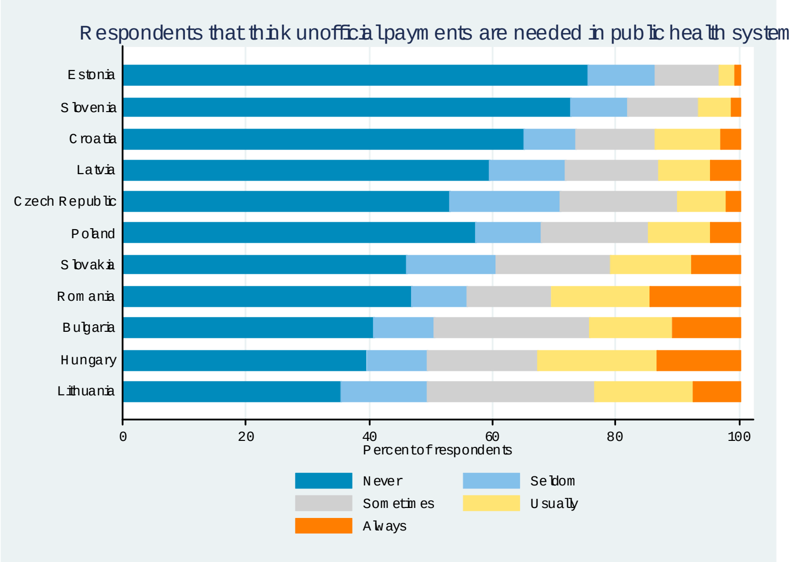
14. However, when asked their opinion about how often it is necessary for people to have to make unofficial payments when using public services or interacting with various officials, a large majority of respondents in EU8+2 countries say such payments are never needed (Chart 58), though the public health system appears to be a notable exception.

Chart 58. Positive Opinion about Low Prevalence of Unofficial Payments



15. The proportion of respondents in EU8+2 countries that say they think informal payments are needed in the public health system is generally lower than in Europe and Central Asia region overall. Reports of informal payments being needed in the public health system are lowest in Estonia and Slovenia, and highest in Romania and Hungary (Chart 59).

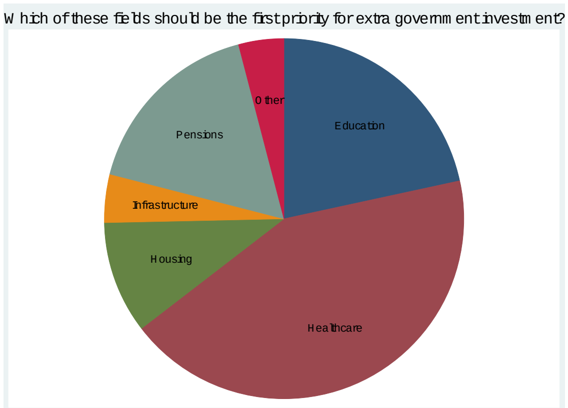
Chart 59. Positive Opinion about Unofficial Payments in Public Health System



Priorities for Extra Government Investment

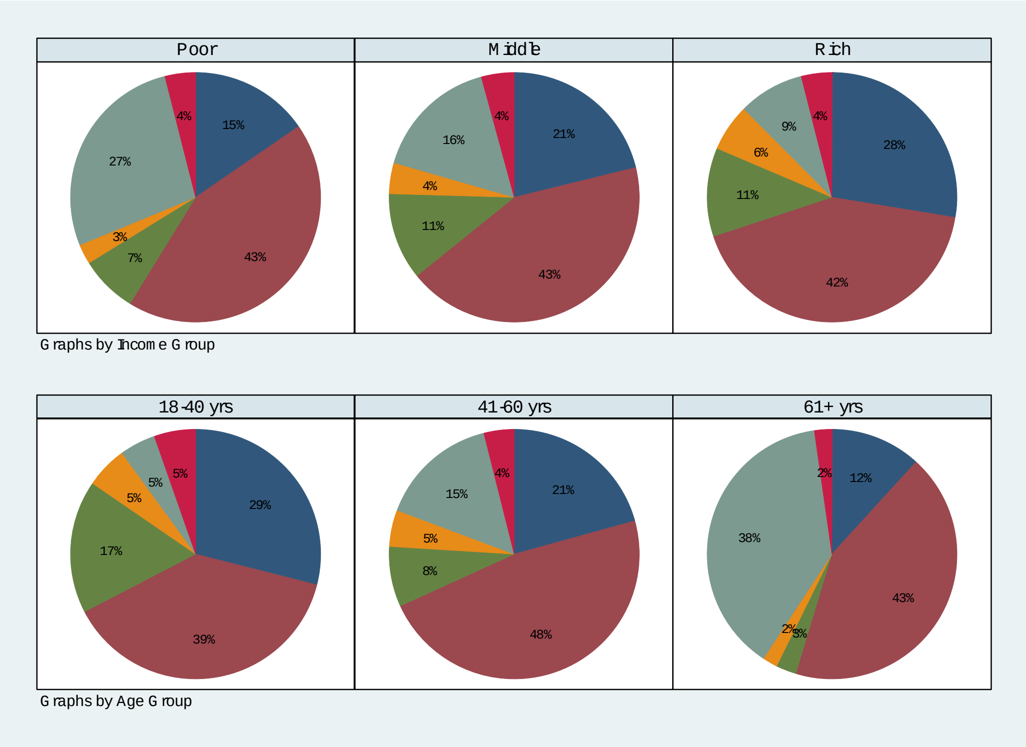
16. Health tops peoples' priorities for extra government spending. When provided with the list of possible options that included education, environment, healthcare, housing, pensions, and public infrastructure, respondents were asked in their opinion which of these fields should be the first priority for extra government investment. The pattern of responses to this question in EU8+2 countries is summarized in Chart 60. Healthcare was rated as the top priority for extra spending by 43 percent of respondents, followed by education (22 percent), pension (17 percent), housing (10 percent), and infrastructure (4 percent).

Chart 60. Healthcare ranks as the top priority.



17. Different age categories root however for different pattern of spending. Analysis of the pattern of responses by different demographic and personal characteristics of respondents shows that public support for additional spending on education, housing, and infrastructure higher among the young and well-off. By contrast, as one might expect, support for pensions tends to be highest among the poor and elderly (Chart 61).

Chart 61. Priorities for Public Investment by Income Group and Age Group



18. Support for extra government investment in healthcare is relatively stronger in Bulgaria, Hungary, and Slovakia, and is comparatively weaker in Latvia and Slovenia (Chart 62: however, of the various options provided, healthcare is rated as the top priority in all EU8+2 countries).

Chart 62. Support for healthcare is strong in all EU8+2 Countries

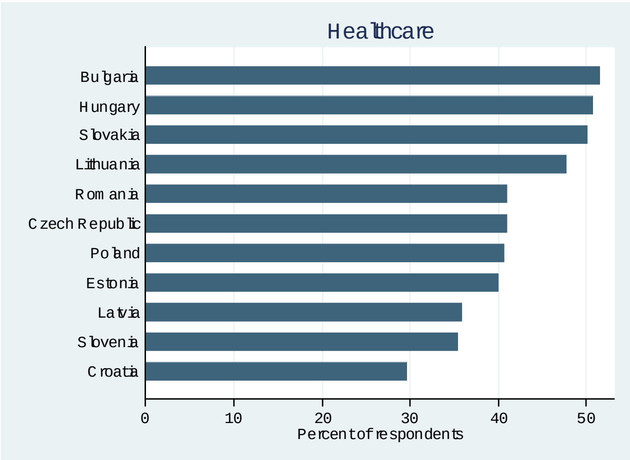
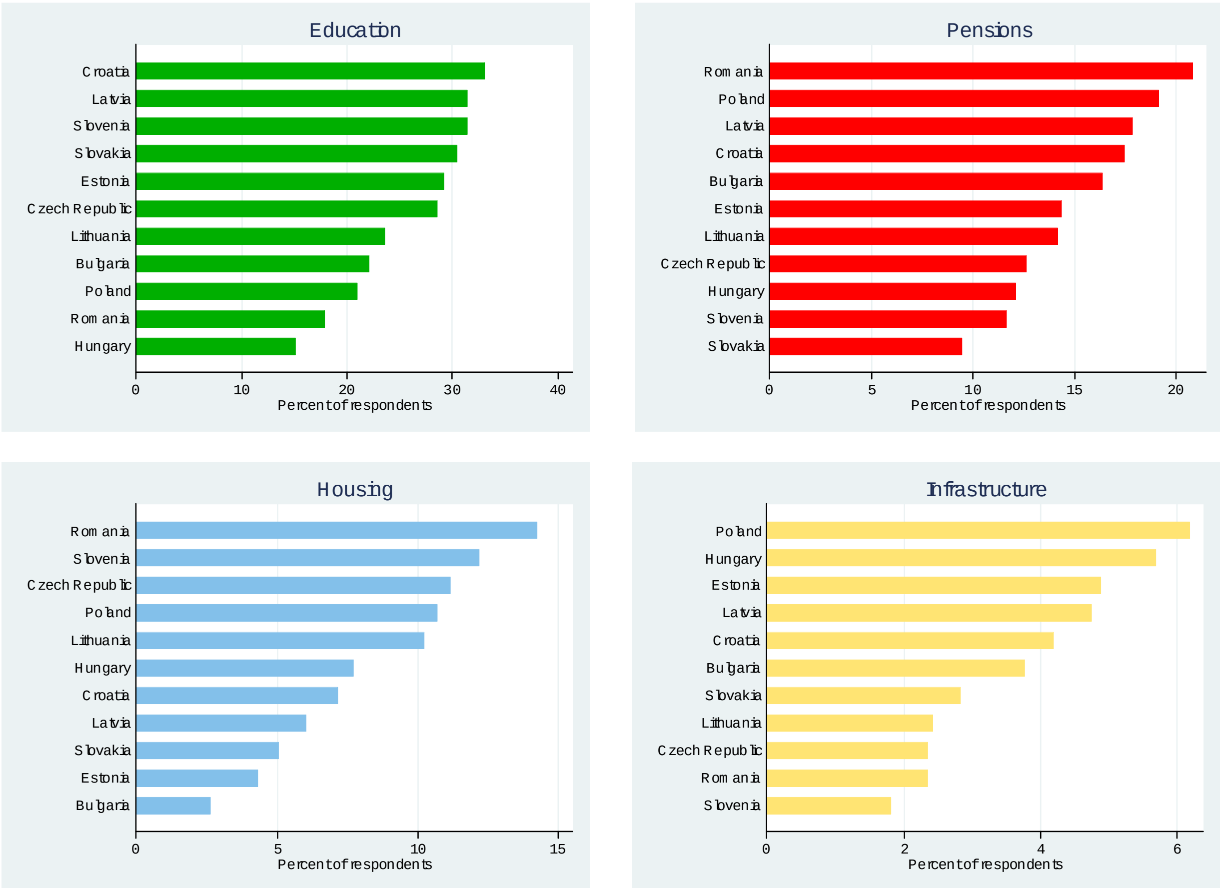


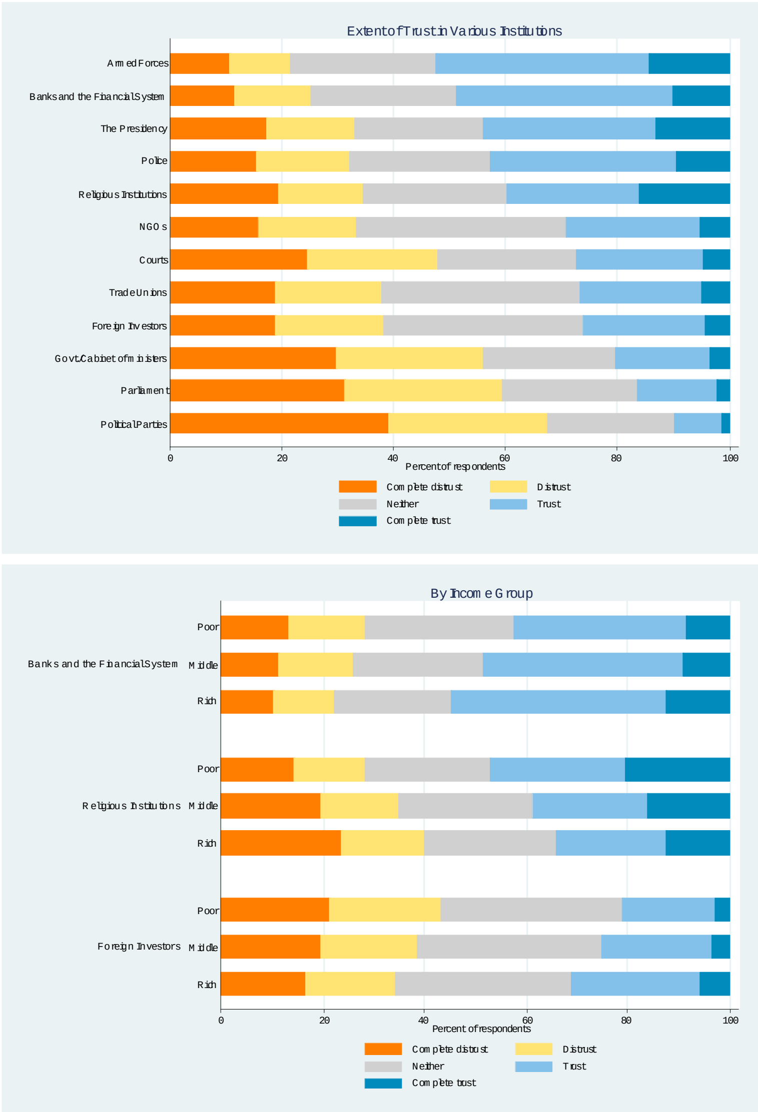
Chart 63. Support for extra government spending in other sectors varies by country



Trust in Institutions and People

19. When asked to what extent they trust different institutions, respondents in the EU8+2 give the most favorable ratings to the armed forces, banks and financial system, police, and the presidency, while political parties, parliament, and the government/cabinet of ministers receive the lowest ratings (Chart 64). Compared to the non-poor, the poor tend to have relatively greater trust in religious institutions, and less so in Banks and the financial system and foreign investors.

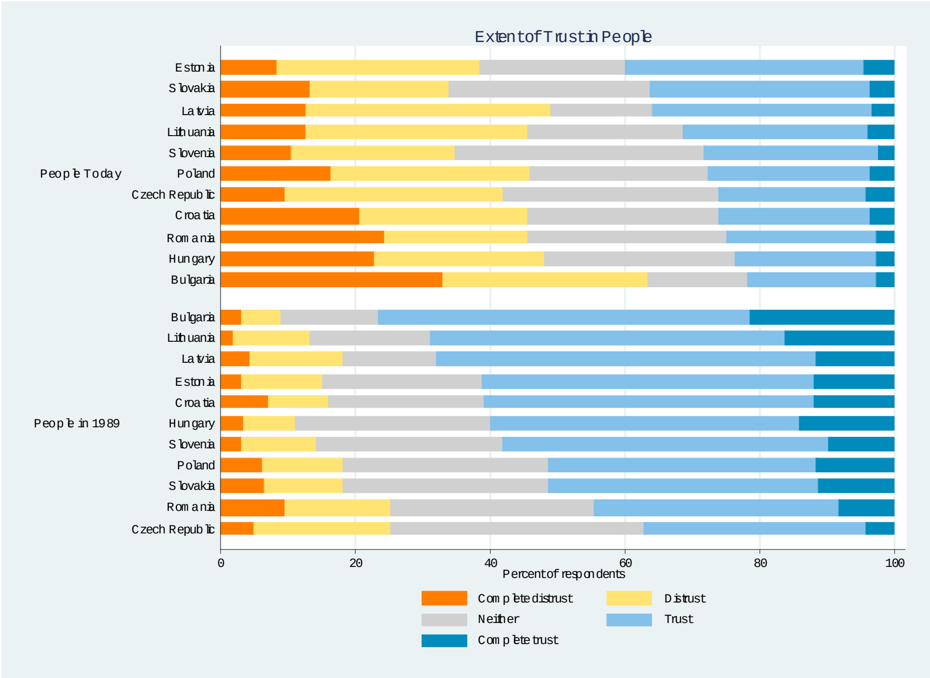
Chart 64. Extent of trust in various institutions



Note: Poor defined as bottom one-third in the income distribution in each country. Response pattern for other institutions quite similar across income groups, hence not shown here.

20. On the whole, respondents in virtually all countries report the level of trust in people to have gone down considerably compared to that in 1989 (Chart 65). Trust appears to be particularly low in Bulgaria, Hungary, and Romania and somewhat higher in Estonia, Slovakia, and Latvia.

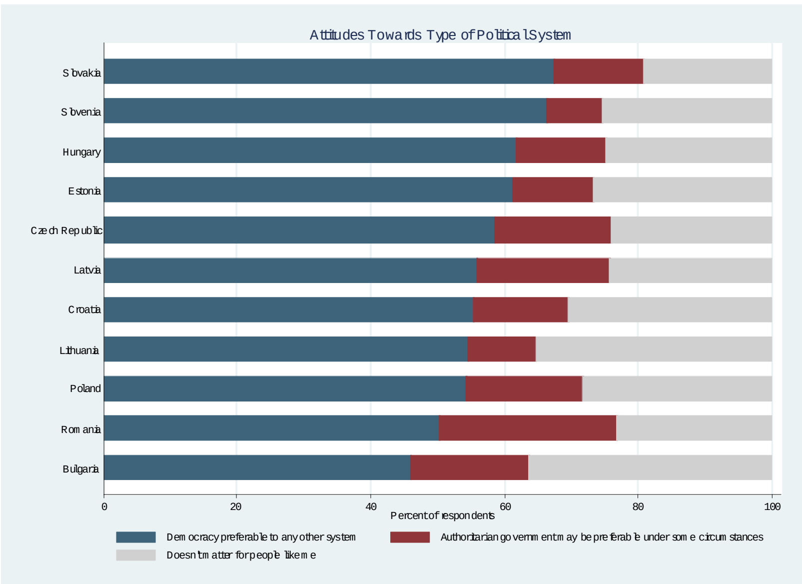
Chart 65. Extent of Trust in People



Attitudes towards Market Economy and Democracy

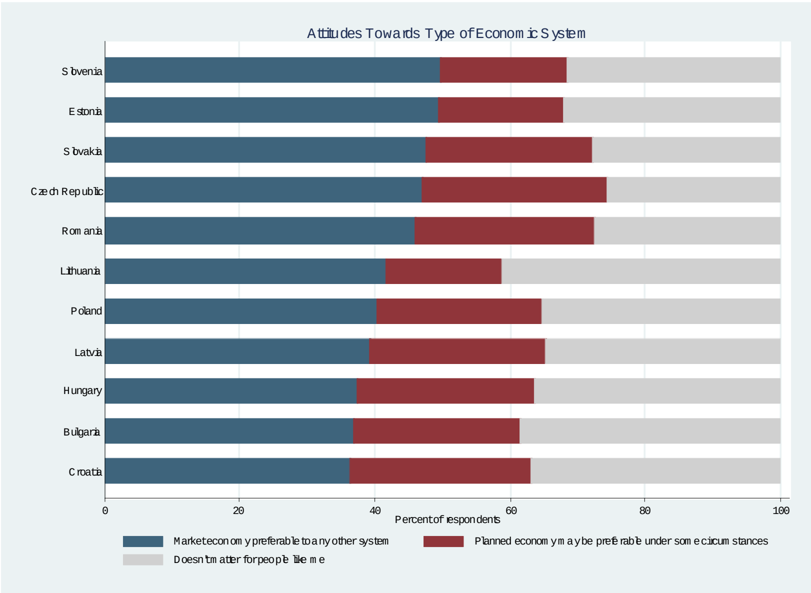
21. The idea of democracy appears however to have grown stronger roots than that of a market economy system. The level of support is highest in Slovakia, Slovenia, and Hungary; even where support is the weakest (for example, Bulgaria, Romania), Those in favor outnumber those who are not 2:1 (Chart 66).

Chart 66. Attitudes towards Type of Political System



22. Support for a market economy remains in contrast somewhat shakier. It is highest in Slovenia, Estonia, and Slovakia (Chart 67).

Chart 67. Attitudes towards Type of Economic System



Support for Redistribution

23. An overwhelming majority of people in the region favor moderate / strong state involvement in reducing the gap between the rich and the poor (Chart 68). Further analytic work is currently underway at the World Bank to better understand how income inequality in EU8+2 countries has evolved in recent years, and the main economic and social forces behind the observed dynamics.[20]

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[20] This analysis is based on data from the 2005 EU-Survey of Income and Living Conditions (EU-SILC) as well as various country-level household budget surveys.

Chart 68. Strong Public Support for Redistribution