The National Bank of Poland

International Department
International Comparative Studies Division

Analysis of economic situation in the countries of Central and Eastern Europe in the second quarter of 2007

November 2007

Prepared by:
Marcin Grela
Adam Perz

Approved by:
Paweł Samecki

This report has been prepared on the basis of various research sources, independent from the National Bank of Poland, for information purposes.

Executive summary

The aim of this report is to present the economic situation of the NMS-9[1] group in 2007 Q2. The study covers the structure of economic growth, external imbalances, inflation, monetary policy and the situation on the labour market. The macroeconomic situation of new member states was compared with the situation of the emerging economies. The report also points to the change in export directions in individual NMS-9 and the change in the volume of foreign exchange reserves.

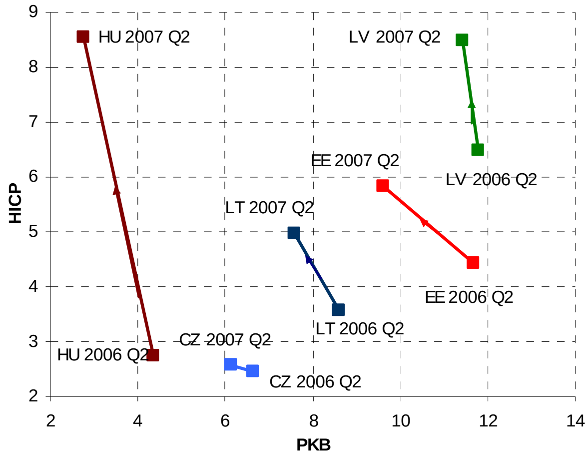
The economic growth rate in the NMS-9 region[2] remained high in 2007 Q2. However, as compared to the previous quarters, the real GDP growth rate decreased in the region. In 2007 Q2, it amounted to 6.0%, as compared to 6.6% in 2007 Q1 and 6.4% in the whole 2006.

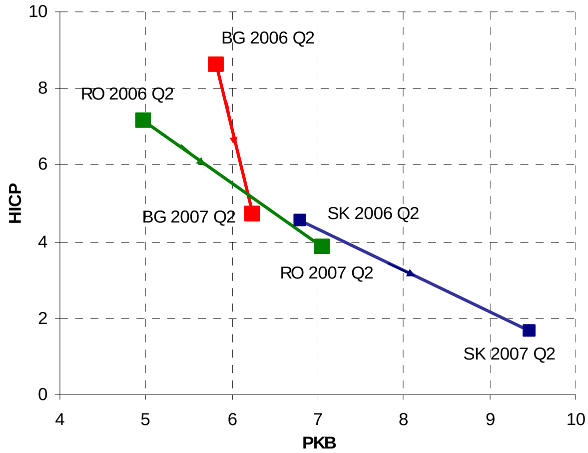
The Baltic states and the Czech Republic (though to a much lesser extent) experienced the decrease in the GDP growth rate in recent four quarters, accompanied by the growth of inflation. A similar situation occurred in Hungary.
In Slovakia, Romania and Bulgaria the opposite trends were observed. The increase in the GDP growth rate, especially in Romania and Slovakia, was accompanied by a substantial decrease in inflation.

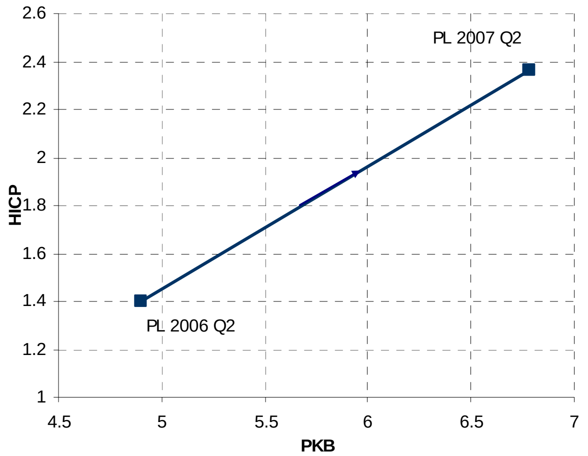
A significant increase in the GDP growth rate had been recorded also in Poland in the last four quarters, but inflation also significantly increased within that period.

In almost whole NMS-9 region (except for Bulgaria and Slovakia) the real GDP growth rate in Q2 decreased as compared to the previous quarter. The decrease was the highest in Estonia and Hungary. The structure of economic growth in the NMS-9 group did not change significantly in the last quarter. In the Baltic states and Romania, the contribution of consumption to the economic growth was still high while the contribution of net exports remained negative, despite a minor improvement. In other countries, the economic growth was driven almost equally by the consumption and investments.

Figure 1.1. Real GDP growth rate and HICP inflation. Change between 2006 Q2 and 2007 Q2 (average for 4 preceding quarters)







Source: Eurostat

[1] NMS-9 (New Member States): Poland, the Czech Republic, Slovakia, Hungary, Estonia, Lithuania, Latvia, Bulgaria, Romania.
[2] Weighted average for NMS-9.

In 2007 Q2, the external imbalances for the NMS-9 group slightly increased as compared to the previous quarter. The current account deficit for this group of countries, calculated as the percentage of GDP, amounted to 11.0% on average in 2007 Q2, as compared to 10.4% in 2007 Q1[3]. As in previous periods, the current account deficit in most countries resulted from the goods trade deficit (except for the Czech Republic and Hungary in the last several quarters) and the negative balance on income.

The high external imbalances, especially in the Baltic states, did not cause a significant decrease in the long-term debt ratings. Only in the case of Latvia, Fitch downgraded the rating from A- to BBB+ (foreign currency) and from A to A- (domestic currency).

Table 1.1. FITCH credit rating for long-term debt denominated in foreign currencies

	2002	2003	2004	2005	2006	September 2007
Poland	BBB+	BBB+	BBB+	BBB+	BBB+	A-
Czech Republic	BBB+	A-	A-	A	A	A
Slovakia	BBB-	BBB	A-	A	A	A
Hungary	A-	A-	A-	BBB+	BBB+	BBB+
Estonia	A-	A-	A	A	A	A
Lithuania	BBB	BBB	A-	A-	A	A
Latvia	BBB+	BBB+	A-	A-	A-	BBB+
Bulgaria	BB	BB+	BBB-	BBB	BBB	BBB
Romania	BB-	BB	BBB-	BBB-	BBB	BBB

Source: FitchRatings

Table 1.2. FITCH credit rating for long-term debt denominated in domestic currencies

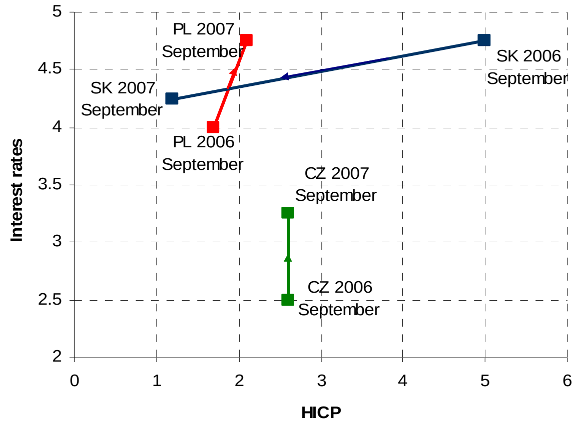
	2002	2003	2004	2005	2006	September 2007
Poland	A+	A+	A	A	A	A
Czech Republic	A	A	A	A+	A+	A+
Slovakia	BBB+	A-	A+	A+	A+	A+
Hungary	A+	A+	A+	A-	A-	A-
Estonia	A+	A+	A+	A+	A+	A+
Lithuania	A-	A-	A	A	A+	A+
Latvia	A	A	A	A	A	A-
Bulgaria	BB+	BBB-	BBB	BBB+	BBB+	BBB+
Romania	BB	BB+	BBB	BBB	BBB+	BBB+

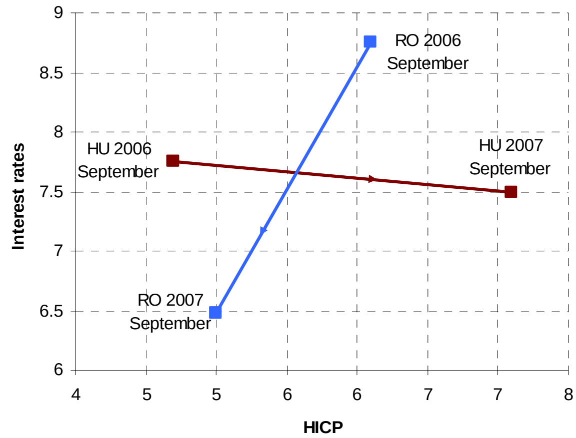
Source: FitchRatings

Between May 2007 and August 2007, the average inflation rate in NMS-9 increased. The average HICP growth rate within that period increased from 4.6% to 5.5%, i.e. by 0.9 percentage points. However, the changes of the price growth rate differed between the analysed countries. Inflation increased in Bulgaria, Romania, the Czech Republic and the Baltic states in the analysed period, and decreased in Poland, Slovakia and Hungary.

The interest rates policy of central banks in 2007 differed among the countries following the direct inflation targeting policy. The central bank interest rates in Poland and the Czech Republic have been raised since the beginning of 2007; they have remained unchanged in Slovakia and have been cut in Hungary and Romania[4].

Figure 1.3. Inflation and interest rates in NMS-9 applying the floating exchange rate policy between September 2006 and September 2007[5].





Source: Eurostat

[3] Arithmetic average for NMS-9.

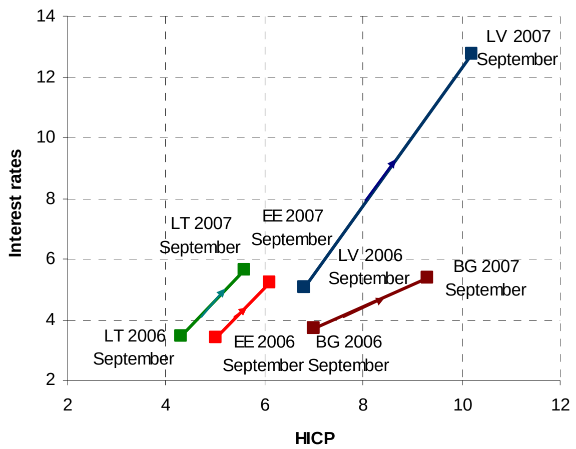
[4] In September 2007, the central bank of Romania decided to raise its interest rates (cf. Chapter 4).

[5] The inflation rate presented in the Figure concerns August 2007.

In the Baltic states and Bulgaria which apply the fixed exchange rate policy the market interest rates have increased significantly during 2007. It was particularly visible in Latvia where 3-month RIGIBOR increased from 4.2% to 12.7%, i.e. by 8.5 percentage points, between January and September 2007, including by 3.6 percentage points in September alone.

Taking into account the inflation rate in the Baltic states and Bulgaria, it is worth noticing that despite the growth of nominal interest rates, the real interest rates in those countries remain at an exceptionally low level.

Figure 1.4. Inflation and interest rates in NMS-9 applying the fixed exchange rate policy between September 2006 and September 2007.



Source: Eurostat

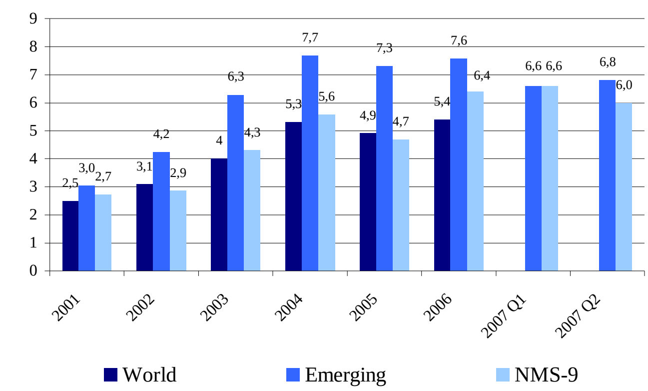
Similarly to previous quarters, also 2007 Q2 was characterised by the improvement of the situation on the labour market in NMS-9. The economic growth supported the increase in employment and the decrease in unemployment. Wages also increased and were the main reason for the increasing growth rate of unit labour costs (ULC).

The average employment growth rate in 2007 Q2 amounted to 2.5% in NMS-9 and was lower by 0.4 and 0.5 percentage points, respectively, as compared to 2007 Q1 and the whole 2006. The increase in employment was accompanied by the decrease in unemployment. The average unemployment rate in NMS-9 at the end of 2007 Q2 amounted to 6.6% and was lower by 0.9 and 1.4 percentage points, respectively, than in March 2007 and December 2006. The average wages in NMS-9 increased by 16.5% in 2007 Q2, as compared to the corresponding period of the previous year. The increasing growth rate of wages in the countries of the analysed region was the main reason behind the increasing ULC growth rate.

1. The NMS-9 economic situation as compared to the emerging economies

The years 2004-2006 saw a worldwide acceleration in economic growth. In 2006, the global economy grew by 5.4%. The emerging economies grew faster in the period. The average GDP growth amounted to 6.4% in 2006 in the NMS-9 group and to 7.6% in the rapidly developing countries.[6] In 2007 Q2, the economic growth rate in NMS-9 was lower than in the emerging markets and amounted to 6.0% and 6.8%, respectively.

Figure 1.1. Annual GDP growth rate

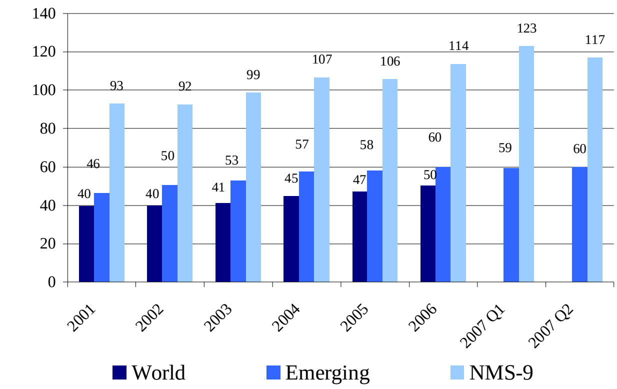


Sources: IMF WEO, Eurostat, EcoWin Economic.

In recent years, the global foreign trade volume also increased as compared to the value of global production[7]. Starting from 2004 the total value of exports and imports of NMS-9 was higher than the total GDP value in those countries. In 2006, the foreign trade volume of the NMS-9 region represented 114% of the GDP, while in 2007 Q2 this figure increased to 117%. In comparison with the emerging economies and the world average, the NMS-9 region was characterised by the largest openness of the economies.

A relatively small foreign trade volume in developing countries as compared to NMS-9 results from the inclusion of large economies (China, India, Russia, Indonesia and Brazil) in the group of the emerging economies. A significant part of production in the large economies goes to domestic markets. Thus, the exports to GDP ratio is lower than in on average much smaller economies of NMS-9.

Figure 1.2. Foreign trade volume, percentage of GDP[8].



Sources: IMF IFS, Eurostat, EcoWin Economic.

The average current account balance decreased along with the increase in the foreign trade volume of NMS-9. The average deficit in the NMS-9 region amounted to 10.4% of the GDP in 2006 and increased to 11% in 2007 Q2. In the same period, the emerging countries reported a current account surplus of 3.4% and 3.0% of the GDP in 2006 and 2007 Q2, respectively.

The surplus on the current account in the group of developing countries results from the export-oriented direction of the emerging economies, mostly Asian ones. In addition, some of the countries included in this group (Russia, Indonesia) are the global exporters of commodities. The recent growth of the world prices of commodities had a significant impact

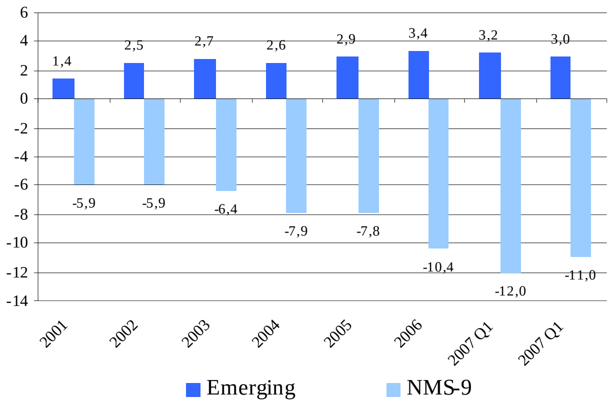
[6] Argentina, Brazil, Chile, China, the Philippines, India, Indonesia, Malaysia, Mexico, Russia and Turkey called "Emerging" in the Chart; according to the IMF classification, those countries are classified as the emerging countries. They were selected as a representative comparable group for NMS-9 countries due to their significant impact on the growth of the world economy and a similar level of GDP per capita.

[7] Foreign trade volume understood as the total of exports and imports.

[8] In the case of the emerging countries and NMS-9, it is calculated as a relation of the total of exports and imports of all countries from a given group to the total GDP of all the countries from that group.

on the improvement of the foreign trade balance in those countries.

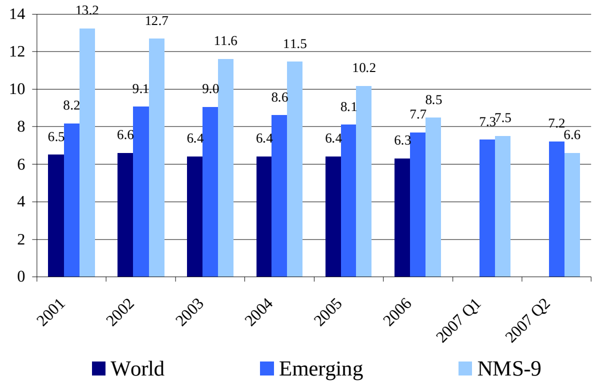
Figure 1.3. Current account balance, percentage of GDP[9]*.*



Sources: IMF WEO, EcoWin Economic, Eurostat.

The economic growth acceleration had a positive impact on the improvement of the situation on the labour market in the emerging countries. In 2007 Q2, the average unemployment rate amounted to 7.2% in the emerging countries and to 6.6% in NMS-9, which demonstrated the improvement of the unemployment rate as compared to previous years. The unemployment rate in the NMS-9 region became lower than in the group of the emerging economies.

Figure 1.4. Unemployment rate

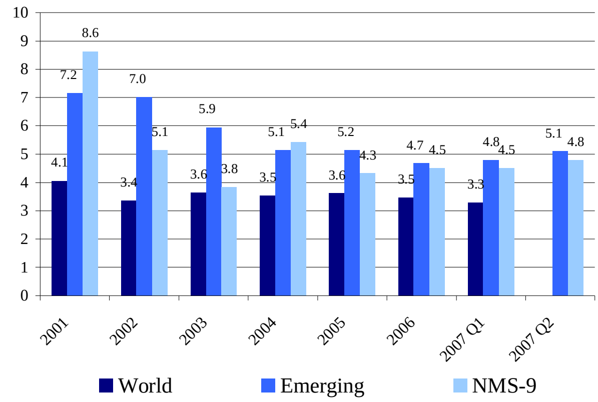


Sources: ILO, Eurostat, national statistics offices.

[9] Calculated as arithmetic average for a given group of countries.

Despite the recent economic growth acceleration, no worldwide inflation growth was observed. The average inflation in NMS-9 amounted to 4.8% in 2007 Q2 and was lower than in the emerging countries.

Figure 1.5. Annual average inflation rate



Sources: IMF WEO, Eurostat.

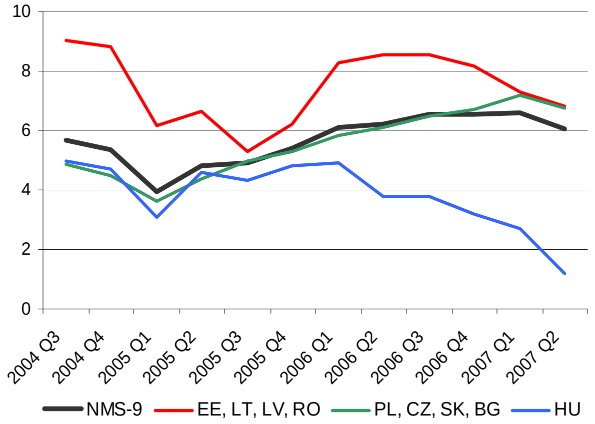
2. Economic growth

The economic growth rate in NMS-9 in 2007 Q2 decreased in comparison with previous periods. The real GDP growth rate in the region amounted to 6.0% in 2007 Q2, as compared to 6.6% in 2007 Q1 and 6.4% in 2006. Except for Bulgaria and Slovakia, the GDP growth rate in the remaining countries from the group decreased as compared to the previous quarter. The decrease was the largest in Estonia (-2.5 percentage points) and in Hungary (-1.5 percentage points).

As in previous years, the structure of economic growth in the NMS-9 group was diversified, which provided the basis for a division into the following groups:

A. the Baltic states and Romania – characterised by a high individual consumption growth rate and a large foreign trade deficit in the last quarters;
B. Poland, the Czech Republic, Slovakia and Bulgaria – characterised by a more balanced growth;
C. Hungary – the country struggling with a growing economic slowdown.

Figure 2.1. Real GDP growth rate in NMS-9



Source: Own analysis on the basis of: Eurostat, EcoWin, Economic, national statistical offices.

A. The economic growth rate in the Baltic states and Romania decreased further in 2007 Q2. In all countries, the real GDP growth rate decreased as compared to 2007 Q1, and in Estonia the decrease amounted to as much as 2.5 percentage points (from 10.1% to 7.6%). The average growth rate in those countries amounted to 6.8% in 2007 Q2, as compared to 7.2% in 2006 Q1 and 8.4% in 2006. The decrease was mainly the result of the drop of the contribution of consumption and net exports. A positive sign seems to be the increase in the contribution of investment outlays to the economic growth in the abovementioned group of countries.

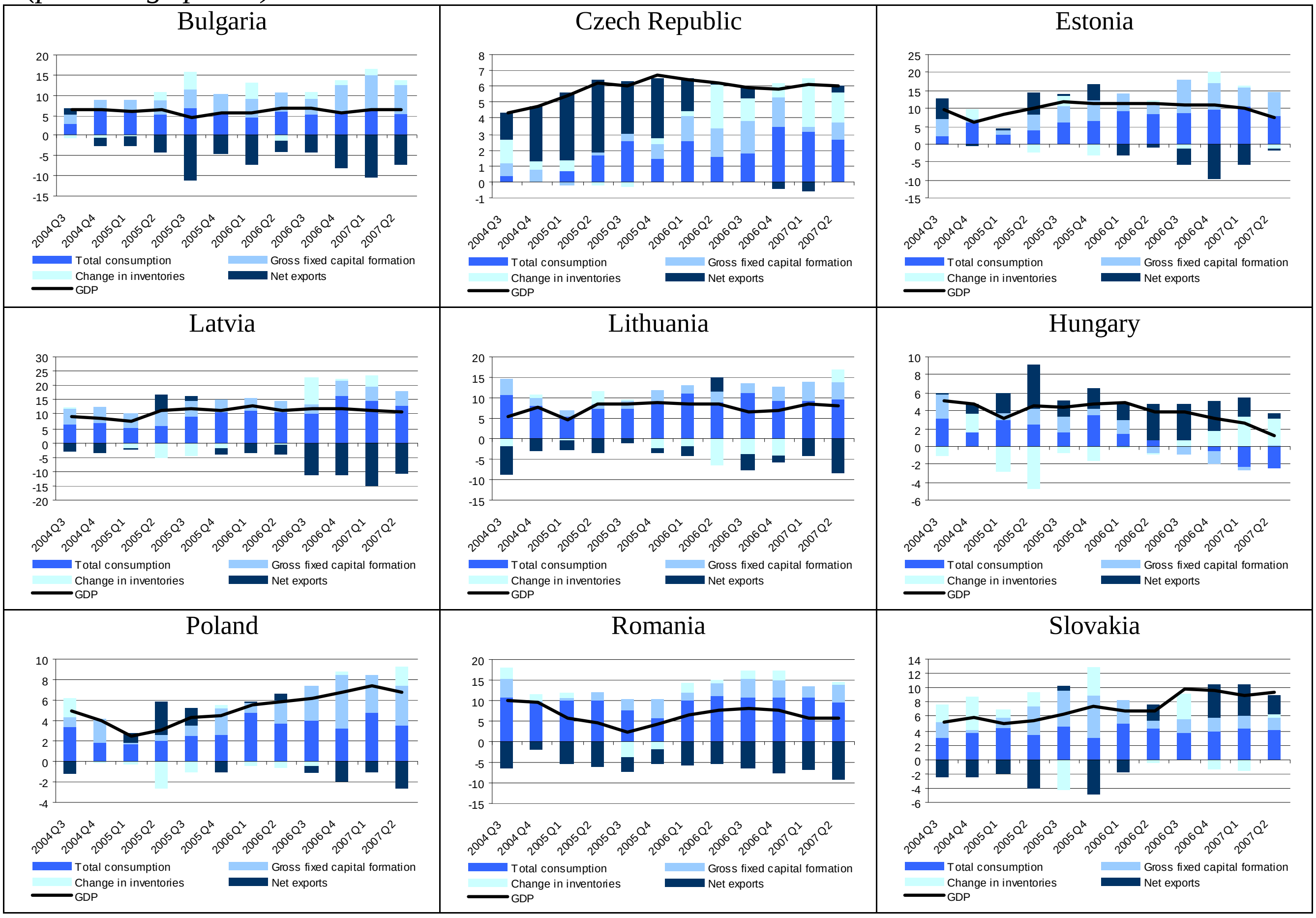
Consumption remained the main driver of the economic growth in those countries. The contribution of the consumption growth rate into the economic growth was the largest and amounted to 10.0 percentage points in 2007 Q2. However, it marked the decline, as compared to 11.4 percentage points in 2007 Q1. The contribution of consumption was considerably larger in the subsequent quarter than the average economic growth rate in this group of countries. The decline of the consumption growth rate had the largest impact on the slowdown of the economic growth rate in the Baltic states and Romania in the last quarter.

At the same time, the contribution of gross investment outlays to the economic growth in this group of countries increased. It amounted to 5.1 percentage points in 2007 Q2, as compared to 4.4% in 2007 Q1 and 4.1% in 2006.

Another common feature of this group of countries is a large, negative contribution of net exports to the economic growth. Although the contribution of net exports to the economic growth in 2007 Q2 increased to -7.1 percentage points, compared to -8.0 percentage points in 2007 Q1, it was still significantly lower than in 2006 (-4.8 percentage points). The improvement of the net exports contribution to the economic growth as compared to 2006 was visible only in Estonia.

In Lithuania and Latvia, the reason for deteriorating foreign trade balance was mainly an increase in the imports growth rate which in those countries is over 10 percentage points higher than the exports growth rate. The deficit grew even more in Romania but it was due to a significant decline in the exports growth rate in the last quarter (from 12.9% in 2007 Q1 to 2.4% in 2007 Q2).

Table 2.1. Decomposition of economic growth in Central and East European countries, 2004-2006 (percentage points)



Sources: Eurostat, EcoWin, national statistical offices.

In 2007 Q2, the Baltic states were characterised by a different import structure than other countries from the NMS-9 group. The imports of consumption goods and products amounted to approximately 28% of total imports in those countries in 2007 Q2, which market a decrease of 3 percentage points as compared to the previous quarter. The share of consumer imports in the Baltic states is still significantly higher than in other NMS-9; it amounted to 18% in the same period.

The foreign trade deficit which remains on a high level in the Baltic states and Romania (16% of the GDP in 2007 Q2) may be still attributed to strong internal demand, mainly consumer demand, despite its weakening in 2007 Q2. In addition, high inflation rate in the Baltic states translated into the strengthening foreign exchange rate in those countries. The real effective exchange rate (REER) in 2007 Q2 strengthened by 1.1% in Estonia, 0.9% in Lithuania and 1.8% in Latvia, which could have also contributed to the decrease in competitiveness of those economies and the weakening of exports.

The increasing foreign trade deficit in Romania, which amounted to almost 18% of GDP in 2007 Q2, as compared to 15% in Q1 and 11.6% in 2006 resulted from the decline in the exports growth rate. In Q2, it fell by over

10 percentage points compared to 2007 Q1, while the imports growth rate decreased by 3 percentage points. As a result the contribution of net exports to the economic growth in Romania decreased from -7.0 percentage points to -9.2 percentage points. Such a significant decline in the exports growth rate might have been caused by the strong appreciation of the domestic currency, which had continued since mid-2004, though in previous quarters it did not have an impact on the decrease in the exports growth rate. In 2007 Q2, REER strengthened by “only” 1%, and by over 42% since June 2004. Also in Romania, the deterioration of the foreign trade balance might have resulted from the increasing domestic demand, where the decreasing contribution of consumer demand was replaced, as in the Baltic states, by the increase in investment demand.

The threats faced by the Baltic states and Romania did not diminish in 2007 Q2. The structure of the economic growth, which is still based on consumption and the increasing external imbalances may be the signs of the “overheating” of the said economies, which may be demonstrated by the decrease in the GDP growth rate that has been recorded in Estonia and Romania from the beginning of 2007. Additional factors which point to such a possibility include: a strained situation on the labour market (the decreasing share of unused labour force and a very high rise of wages, exceeding 20% now), a high growth rate of loans for private sector and a relatively high inflation rate. In the Baltic states there are limited possibilities of the monetary policy’s impact on the alleviation of the overheating of the economy.

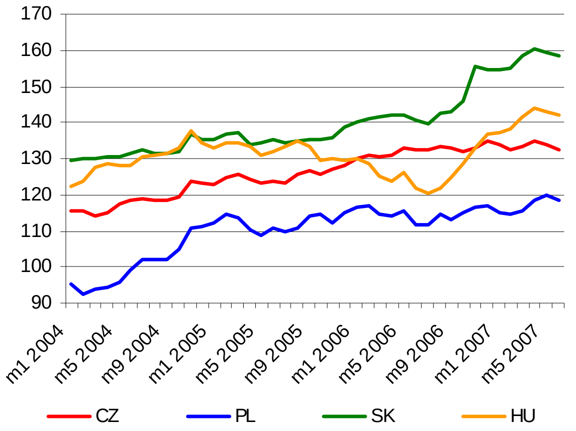
B. After the period of sustained growth since the beginning of 2005, in 2007 Q2 the average economic growth rate in Poland, Czech Republic, Slovakia and Bulgaria decreased. Those economies grew by 6.8% in 2007 Q2, as compared to 7.2% in 2007 Q1. The real GDP growth rate increased slightly in Bulgaria and Slovakia, while in the Czech Republic and Poland the economic growth rate decreased. Since 2007 Q1 the average economic growth rate in this group of countries has reached the same level as in the Baltic states and Romania. Economic growth in Poland, the Czech Republic, Bulgaria and Slovakia was more balanced and did not rely on the increase in consumption to a large extent.

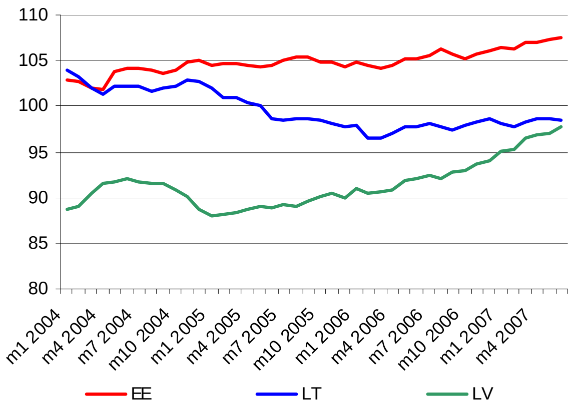
The decrease in the GDP growth rate in 2007 Q2 was wholly the result of the decrease in the contribution of consumption. The contribution of the total consumption growth rate to the economic growth declined in all the abovementioned countries and amounted on average to 3.9% in 2007 Q2, as compared to 4.7 percentage points in 2007 Q1. In addition, the individual consumption growth rate in the last quarter was lower than the GDP growth rate in all the countries from the group, as in previous quarters[10].

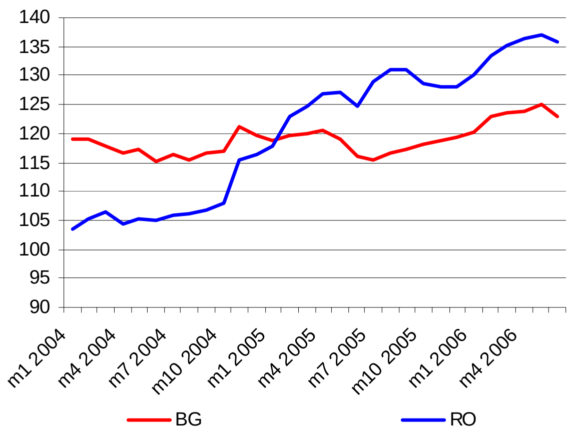
The contribution of investment outlays to the economic growth of Poland, the Czech Republic, Slovakia and Bulgaria in 2007 Q2 did not change as compared to Q1 and amounted to 3.6 percentage points. The contribution of the investment outlays growth rate did not change despite a large decrease in the investment growth rate in the analysed group of countries. It resulted from a largely seasonal nature of investments. The contribution of investment outlays in Q1 each year is lower than in the following quarters. In 2007, it amounted to 18% of GDP in Q1 and to 22% of GDP in Q2 in the analysed group of countries. The contribution of investment outlays to teconomic growth was particularly high in Poland and Bulgaria. Despite the decrease from the previous quarter, it exceeded the contribution of total consumption in those countries, and the investment growth rate remained over 20% (almost 30% in Bulgaria). The Czech Republic and Slovakia were characterised by a lower growth rate and contribution of investments.

[10] In 2006 Q4 and 2007 Q1, the total consumption growth rate slightly exceeded the GDP growth rate only in Bulgaria.

Figure 2.2. Real effective exchange rate in NMS-9 between January 2004 and June 2007, index 2000 = 100 (increase means appreciation)







Source: Own analysis on the basis of IMF IFS, Eurostat, central banks.

The contribution of net exports to the economic growth of Poland, the Czech Republic, Slovakia and Bulgaria increased slightly in 2007 Q2. It amounted to -1.7 percentage points as compared to -1.9 percentage points in Q1. However, it meant the decrease as compared to 2006 when the input amounted to -0.9 percentage points. The foreign trade balance improved only in the Czech Republic and Bulgaria, as compared to the previous quarter. The Czech Republic was the only country in the group with a surplus in the trade in goods and services and the positive contribution of net exports to the GDP growth rate. A positive contribution of net exports to the economic growth was also recorded, as in the previous four quarters, in Slovakia, where, however, the foreign trade deficit was recorded. The exports and imports growth rate both decreased in all countries from the group.

In all those four countries, REER strengthened during 2007 Q1. The appreciation was small in Bulgaria and the Czech Republic (0.3% and 1% respectively) and significantly higher in Poland and Slovakia (4.2% and 2.7% respectively). The strong appreciation of domestic currency may partly explain the deterioration of the foreign trade balance in Poland and Slovakia in the last quarter.

C. In 2007 Q2, Hungary, as in previous quarters, experienced a decrease in the real GDP growth rate. The GDP growth rate decreased from 2.7% in 2007 Q1 to 1.2% in 2007 Q2 and was at the lowest level from among the countries of the region. It was the fifth consecutive quarter in which the economic growth rate in Hungary decreased.[11] Contrary to previous quarters, the decrease was not the result of the lower internal demand growth rate but mainly the decrease in the net exports contribution to the GDP growth rate. In 2007 Q2, the total consumption growth rate decreased to -3.3% from -1.7% in the previous quarter and the contribution of the consumption growth rate to the GDP growth rate amounted to -2.4 percentage points (-2.2 percentage points in Q1). The contribution of investment outlays increased and amounted to almost 0.2 percentage points as compared to -0.4% in Q1. The gross investment outlays growth rate significantly increased in 2007 Q2 to over 12%, though it was negative in the previous quarters. Contrary to previous

[11] In 2006 Q1, the real GDP growth rate in Hungary amounted to 4.9%.

quarters when net exports were the only category with positive contribution to the GDP growth rate, this contribution decreased significantly in the last quarter (from 2 percentage points in Q1 to 0.5 percentage point in 2007 Q2), which was decisive for the further decline of the economic growth rate in Hungary. The decrease in the net exports contribution resulted first of all from the decline of the exports growth rate (17.6% in Q1 and 14.6% in 2007 Q2). This, in turn, might have been influenced by the strengthening REER which grew by 3.4% in the last quarter.

The economic growth forecasts for NMS-9 from 2007 point to a possible decline of the economic growth rate. According to the European Commission[12], the average GDP growth rate[13] for NMS-9 in 2007 will amount to 6.3% and in 2008 to 5.6%. The IMF projects that in the same years the average economic growth rate will amount to 6.6% and 5.6% respectively, and *Wiener Institut für Internationale Wirtschaftsvergleiche* (WIIW) forecasts that the said figures will stand at 6.2% and 5.9%. It is worth noticing that in 2007 all abovementioned institutions revised upward their forecasts of the GDP growth rate for the two coming years.

The projections show a decrease in the economic growth rate in the majority of NMS-9 (except for Bulgaria) in 2007 and 2008. The decrease in the economic growth rate will result from the forecast economic slowdown in the euro area which is the main trade partner of NMS-9. According to the forecast, the decrease in the GDP growth rate will be the largest in the Baltic states. It is also projected that in 2008, the GDP growth rate in Hungary will increase for the first time since 2005.

[12] The forecasts come from June 2007. The interim forecasts of the European Commission of August 2007 include only Poland from among NMS-9. According to the Commision, the economic growth rate in Poland in 2007 will be higher than forecast in spring and will amount to 6.5%, as compared to 6.1% projected in June 2007. The Commission explains the higher GDP growth rate in 2007 by unexpectedly good performance of the Polish economy in 2007 Q2.

[13] The arithmetic average of forecasts for all countries. According to this method, the average GDP growth rate in 2006 amounted to 7.4% in NMS-9.

Box 1

Export directions in the NMS-9 region

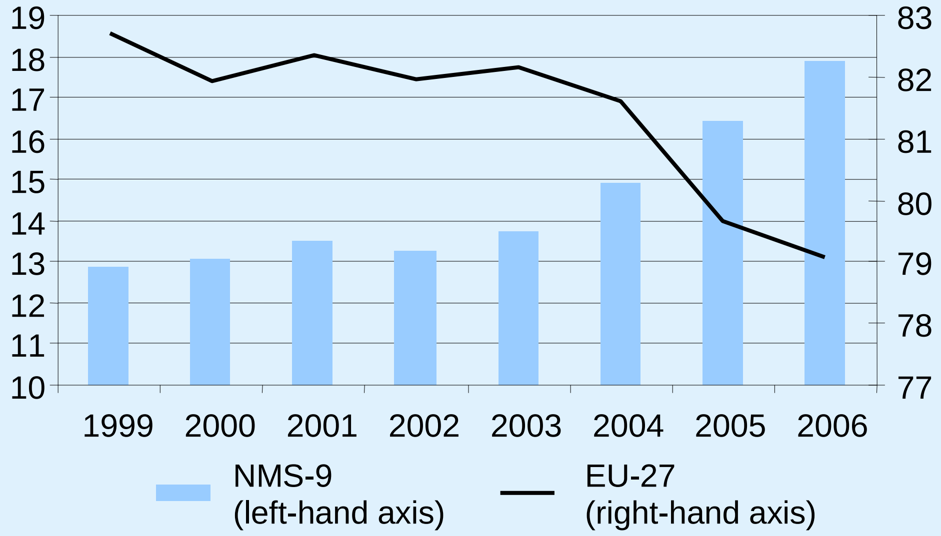
In recent years, NMS-9 recorded a very fast growth of foreign trade. The average real exports growth rate amounted to 10.9% in this group between 1999 and 2006, and to 13.6% between 2004 and 2006.

Figure 1. Foreign trade of NMS-9, percentage of GDP

Source: Eurostat

The countries of "old" European Union (EU-15) have been the main trade partner of NMS-9 for many years. Between 1999 and 2006, exports to EU-15 accounted for over 60% of the total exports of the NMS-9 region. Exports to EU-27 in the same period accounted for approximately 80% of total exports. Paradoxically, from 2004, i.e. from the accession of the majority of NMS-9 to the European Union, the share of exports to EU-15 has begun to decrease. In 2003, it accounted for 67.7% of the total exports of those countries, while in 2006 it fell to 60.5%. At the same time, the increase in trade within NMS-9 has been observed. In the same period, the share of exports within NMS-9 increased from 13.7% to 17.9% of total exports. Nevertheless, this increase did not compensate the decrease in the share of exports to EU-15. Between 2003 and 2006, the share of exports to EU-27 fell from 82.1% to 79.1%. A relative decrease in exports to EU-27 may be explained by the fast growth of exports to eastern neighbours. Between 2003 and 2006, the share of exports to Russia and Ukraine increased from 3.4% to 5.3% of total exports. Exports to Asian countries (China, India, Japan and Korea) also slightly increased.

Figure 2. NMS-9 exports to EU-27, percentage of total exports.



Source: Eurostat

There are groups of countries within the NMS-9 region whose mutual foreign trade is significantly higher than trade with other NMS-9. However, these tendencies have not emerged in recent years but have been present for a long time and seem to result from historical links. The only change is a slight increase in the intensity of the tendencies after 2004.

The Baltic states are the most characteristic group. The share of the Baltic states' exports within the group amounted to 18.2% of the total exports of those countries in 2006 and was over three times higher than to other NMS-9. It marked a growth of over 5 percentage points since 2003, while the share of exports to EU-15 in the same period decreased by almost 13 percentage points. The value of trade within that group, including trade with other NMS-9, increased significantly faster than trade with EU-15 in recent years. The annual exports growth rate within the Baltic states group between 2003 and 2006 amounted to 31% on average (32% to other NMS-9) and merely to 8.2% to EU-15.

Poland, the Czech Republic, Slovakia and Hungary form a somewhat different group. In these countries, foreign trade within the group was also larger than that with other NMS-9 and accounted for around 80% of the trade with the countries of the region (in 2006 the share of exports within the abovementioned group of countries amounted to 14.7%, while exports to other NMS-9 amounted to 3.7% of total exports). However, taking into account the fact that the total GDP of these countries accounted for 75% of the GDP of the whole region in recent years, those proportions seem to be more balanced than in the Baltic states, where the trade between these countries accounted for around 75% of the value of the trade with NMS-9, while their total GDP amounted to only 7.5% of the total GDP of the NMS-9 region. As in the Baltic states, also in Poland, the Czech Republic, Slovakia and Hungary the increase in exports to NMS-9 was significantly higher than to EU-15 and amounted to 23.4% and 11.2%, respectively, on average between 2004 and 2006.

The directions of foreign trade in Bulgaria and Romania resemble the situation in the Baltic states. Foreign trade between these countries accounted for approximately 33% of total foreign trade with NMS-9 in recent years (twice more than the ratio of the GDP of those countries to the region's GDP). In the case of Bulgaria and Romania, the share of exports to NMS-9 has increased since 2004, while the share of exports to the old EU countries has significantly decreased.

Figure 3. Foreign trade between Bulgaria and Romania as percentage of total foreign trade

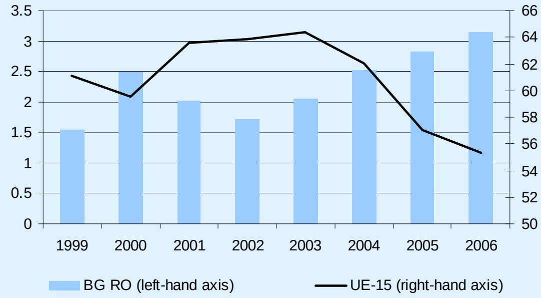


Figure 4. Foreign trade between Estonia, Lithuania and Latvia as percentage of total foreign trade

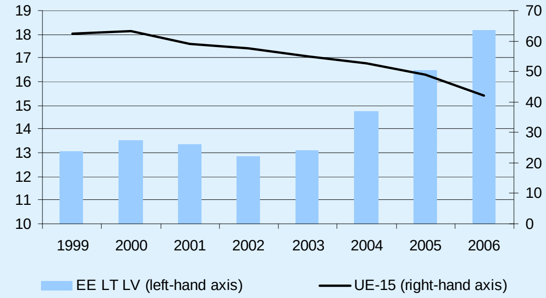
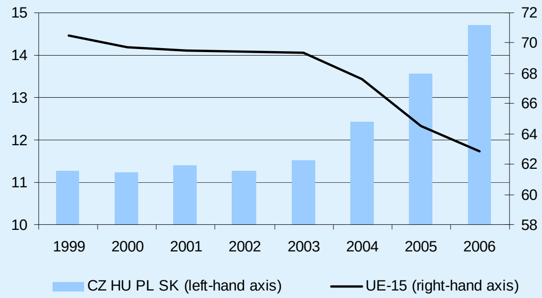


Figure 5. Foreign trade between the Czech Republic, Poland, Slovakia and Hungary as percentage of total foreign trade



Source: Eurostat

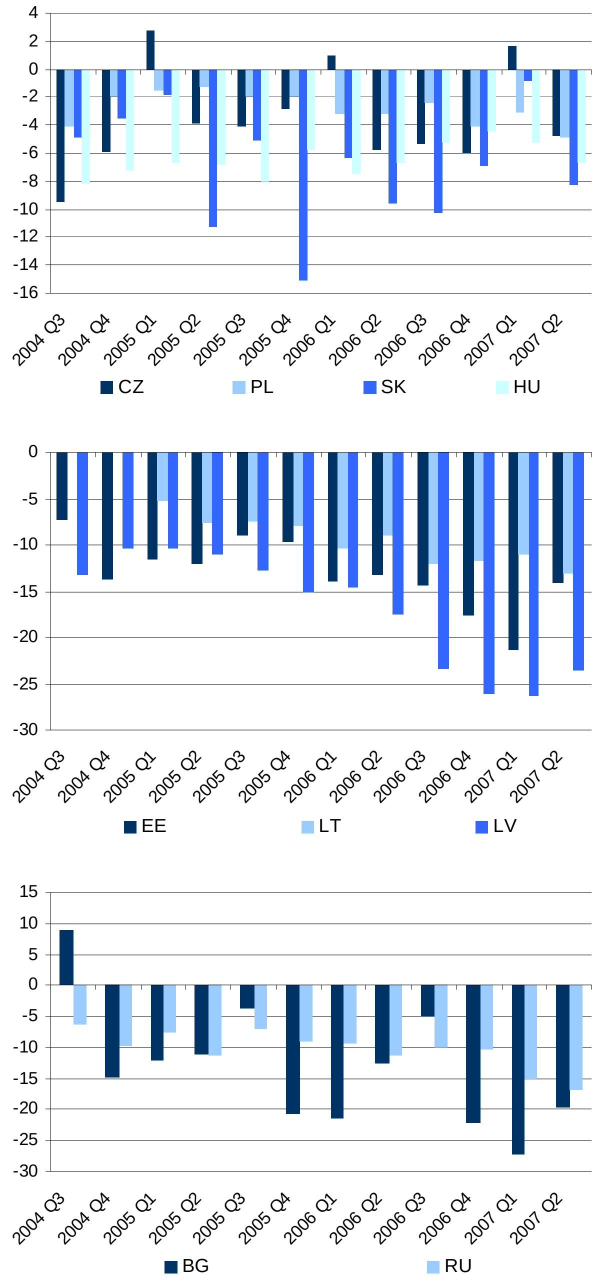
3. External imbalances

In 2007 Q2, the external imbalances for the NMS-9 group slightly increased as compared to the previous quarter. The current account deficit, calculated as a percentage of GDP for the said group of countries, amounted to 11.0% on average in 2007 Q2, as compared to 10.4% in 2007 Q1. As in previous quarters, the current account deficit in the majority of the countries resulted from the deficit in the trade in goods (the Czech Republic and Hungary have been exceptions for several quarters) and a negative income balance. All NMS-9 recorded a surplus in the services account which also has not changed as compared to the previous quarters. The current transfers balance in the majority of the countries (except for the Czech Republic and Slovakia) was positive. Current transfers had a significant impact on the current account deficit in Poland, Romania, Lithuania and Latvia, where it amounted to from 2.5 to 4.5% of GDP. In other countries, the current transfers balance did not exceed 1%.

The following groups of countries were distinguished taking into account the amount and structure of the current account deficit:

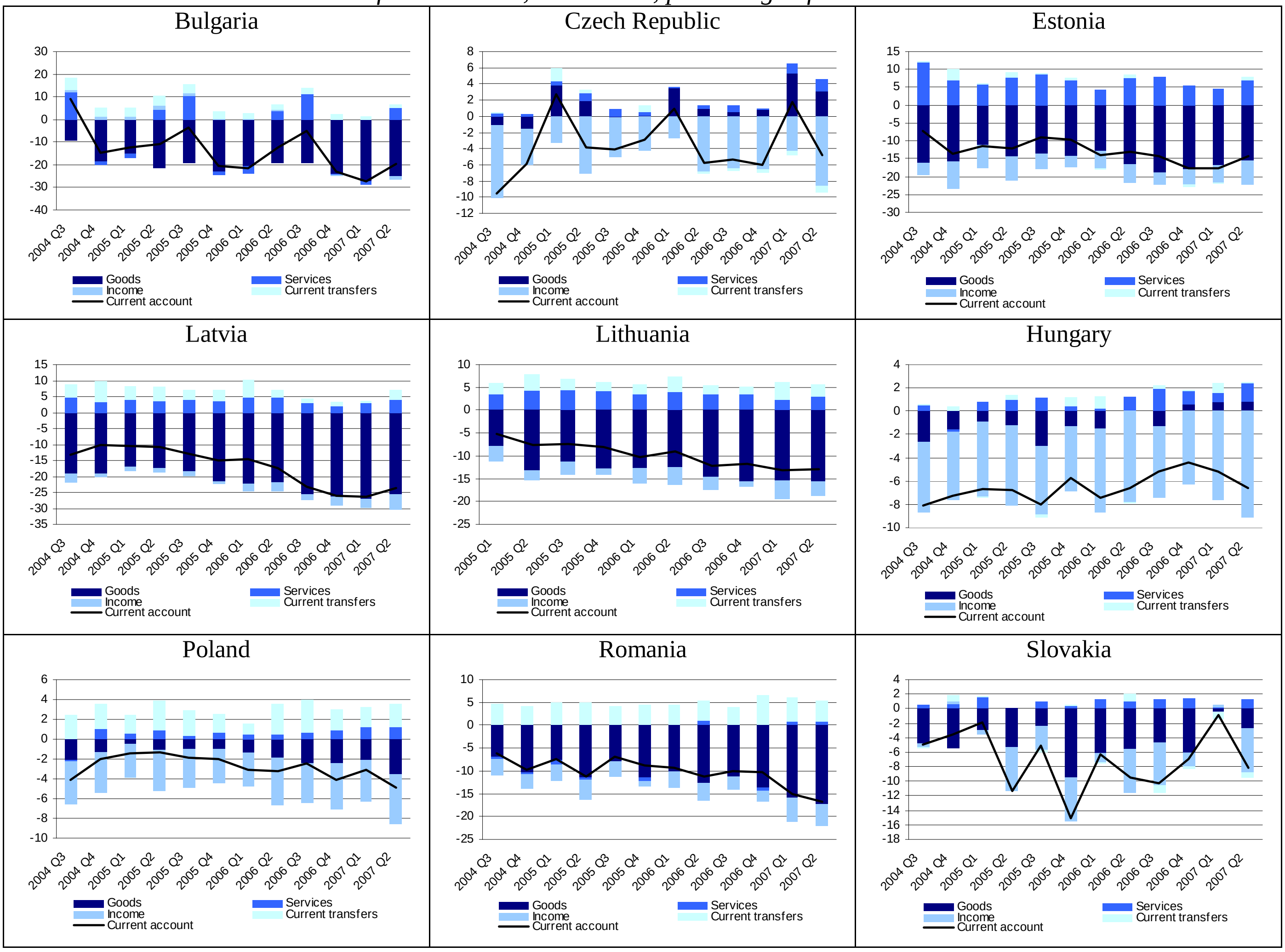
A. the Baltic states, Bulgaria, Romania – despite a decrease in 2007 Q2, the current account deficit was still the highest in this group of countries and resulted mainly from a deficit in the trade in goods;
B. Poland, the Czech Republic, Slovakia and Hungary – countries with a relatively lower deficit which, however, increased significantly in 2007 Q2. In this group of countries the income account balance remains the main reason for the current account deficit.

Figure 3.1. Current account balance in the NMS-9 group between 2004 and 2007, as percentage of GDP.



Source: Own analysis on the basis of Eurostat and national central banks.

Table 3.1. Current account deficit structure, 2004-2007, percentage of GDP.



Source: Own analysis on the basis of Eurostat and national central banks.

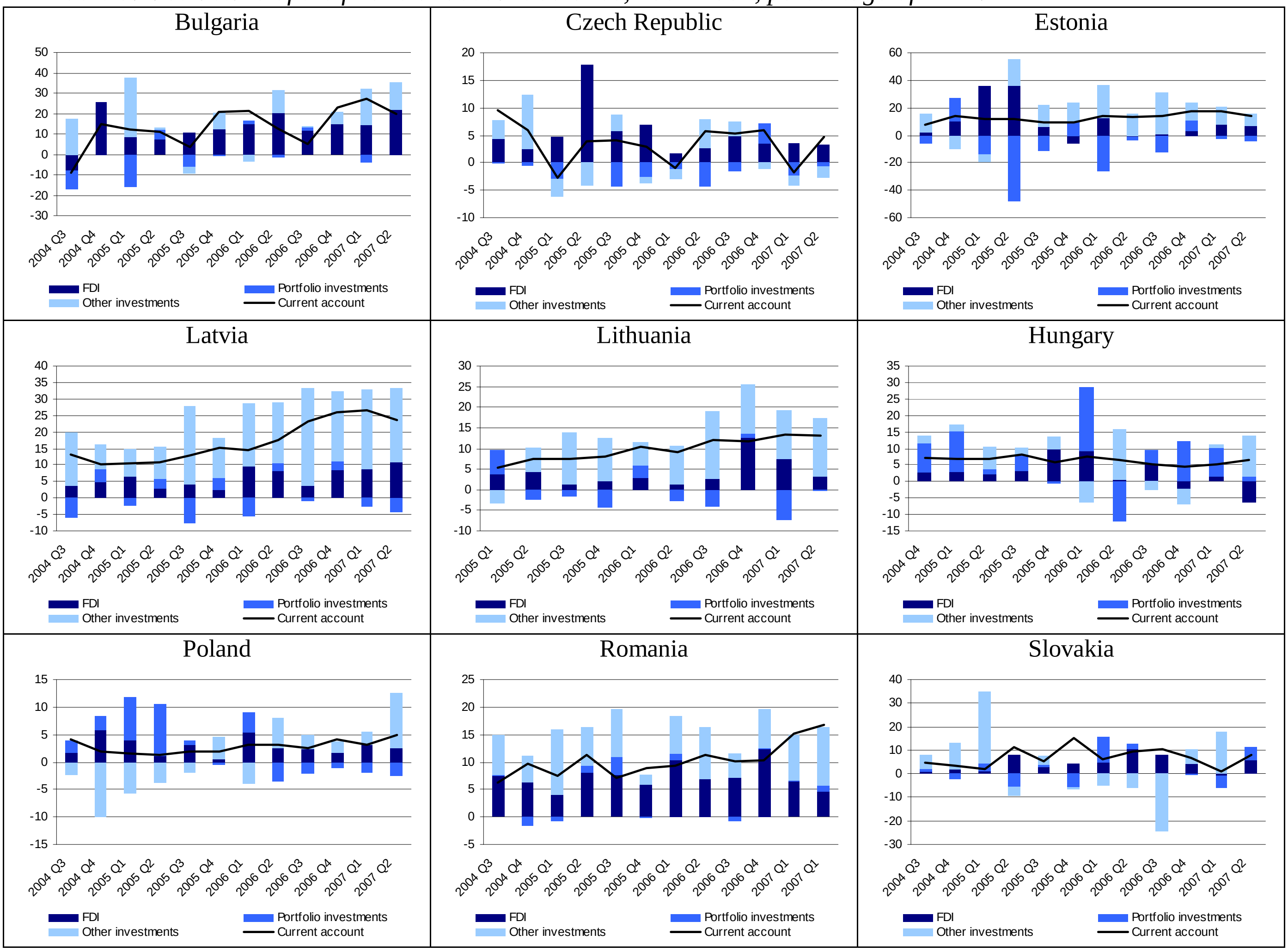
A. The Baltic states, Romania and Bulgaria continued to report the highest current account deficit. Such a situation continues despite a significant decrease in the deficit in the majority of the countries from the group (except for Romania). In 2007 Q2, the deficit amounted to 17.5% of GDP on average in this group of countries, as compared to 20% in 2007 Q1. As in previous quarters, the deficit was the highest in Latvia and Bulgaria, where it amounted to 23.5% and 19.6% of GDP, respectively. **In this group of countries, the current account deficit resulted mainly from a large deficit in trade in goods.** It amounted to 20% of GDP in 2007 Q2 and did not change significantly in comparison with the previous quarter. Thus, the decrease in the current account deficit was the result of other balance of payments categories, mainly the balance of services which in Q2 had an average surplus of 4.1% of GDP, as compared to the surplus of 1.8% of GDP in the previous quarter, and improved in all countries. In addition, in the last quarter the balance on incomes deteriorated in the Baltic states, Bulgaria and Romania, while the surplus on the current transfers account increased.

The main sources of the financing of the current account deficit in the Baltic states, Bulgaria and Romania included other investments, i.e. mainly loans for the banking sector. The average influx of other investments for the abovementioned group of countries amounted to 14.2% of GDP in 2007

Q2. Direct investments and portfolio investments recorded a lower position on the financial account (9.3% and -1.6% of GDP, respectively). Only in Bulgaria the influx of direct investments was higher in 2007 Q2 than the influx of other investments.

B. The current account balance in Poland, the Czech Republic, Slovakia and Hungary deteriorated significantly in 2007 Q2. The average deficit in that group of countries amounted to 6.1% of GDP in Q2, as compared to 1.9% of GDP in 2007 Q1 and 5.1% in 2006. The current account balance deteriorated most significantly in the Czech Republic and Slovakia, where the deficit calculated as a percentage of GDP increased by 6.4 percentage points and 7.3 percentage points, respectively, in Q2 as compared to Q1. **As in previous quarters, the largest part of the current account deficit was due to the deficit on the income account,** whose increase in 2007 Q2 (7.2% of GDP as compared to 3.9% in the previous quarter) accounted for the largest part of the total deficit increase. The balance of trade in goods also deteriorated, to the largest extent in the Czech Republic.

Table 3.2. Structure of the financial account balance, 2004-2007, percentage of GDP.



Source: Own analysis on the basis of Eurostat and central banks' data.

As in other countries from the region, other investments were the main source of the financing of the current account deficit in Poland, the Czech Republic, Slovakia and Hungary. As in 2007 Q1, also in Q2 the net influx of other investments amounted to 5.1% of GDP, while in the whole 2006 their balance was negative. The share of other investments in the financing of the current account deficit was still considerably lower than in the Baltic states. Apart from Slovakia, in all other countries the influx of foreign direct investments decreased. It was the most visible in Hungary where the balance of FDI amounted to -6.2% of GDP in Q2, as compared to 0.7% in Q1 and 3.1% in 2006. The balance of portfolio investments slightly increased in the abovementioned group of countries due to the significant increase in their influx in the Czech Republic and Slovakia.

According to current account forecasts, its balance will remain negative in the following years in all those countries. According to the European Commission, the current account deficit at the end of 2007 and 2008 in all the countries should be slightly lower than in 2007 Q2. The IMF forecasts that the deficit in the next two years will be higher than today only in Estonia, while in other countries the current account balance should slightly improve.

Box 2

Foreign exchange reserves in the NMS-9 region

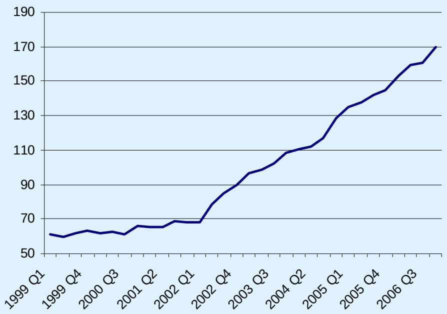
In recent years, there has been a noticeable surge in the level of official reserve assets in the world. In the years 2001-2006, the level of reserve assets increased over twofold from USD 2,200 billion to over USD 5,000 billion, while the increase has even been higher in developing countries. In the analogical period, the value of reserves in China increased almost fourfold and almost threefold in India.

A similar trend was visible in NMS-9 as the increase in the level of official reserve assets has been significant there since 2002. At the end of 2001, the level of reserve assets in the countries under research amounted to USD 68 billion and it increased to USD 170 billion at the end of 2006. The surge was due, on the one hand, to transactions in the balance of payments (the surplus in the financial account for NMS-9 was higher than the current account deficit in the years 2002-2006) and, on the other hand, to the currency translation and changes in valuation (depreciation of USD against the euro and other domestic currencies).

The highest increase in reserves among NMS-9 took place in Romania, where they increased sixfold in the years 2001-2006. In the analogical period, currency reserves increased by over 200% in Bulgaria, Slovakia and in the Baltic states.

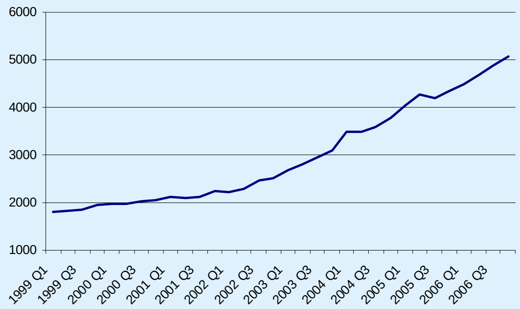
Despite the rapid increase in the level of currency reserves in Central and Eastern Europe in recent years, the reserves-to-GDP ratio has not changed considerably. In 2001, reserve assets amounted to 17.0% of GDP while the figure for 2006 is 18.5%. The rise in reserves as compared to GDP in the NMS-9 group in the years 2001-2006 was definitely lower than the global rise, where the ratio increased from 6.0% to 10.5% in the analogous period. This was mainly due to the pace of economic growth that was faster than the global one, as well as to higher inflation in NMS-9 (see: Chapter 1).

Figure 1. Official reserve assets in the NMS-9 group, USD billion



Source: EcoWin

Figure 2. Official reserve assets in the world, USD billion



Source: EcoWin

The increasing level of reserves in NMS-9 in recent years was accompanied by the increase in indebtedness that grew at an even faster pace. The short-term indebtedness of the NMS-7 group[14] increased twofold from USD 43 billion to USD 86 billion since mid-2003 until the end of 2006. AS a result, the ratio of reserves to the short-term indebtedness has deteriorated in NMS-9 in recent years – it was 239% in 2003 Q2 for NMS-7 while it dropped to 196.5% by the end of 2006. The

[14] NMS-9 states with Bulgaria and Romania excluded.

ratio increased only in Lithuania and Latvia, yet the level of their reserves compared to indebtedness was much lower than in the remaining economies of the NMS-9 group (see: Table 1).

Analysing the ratio of reserves to short-term indebtedness in the NMS-9 group it becomes clear that for most of the countries the ratio is over 100% (the *Greenspan-Guidotti Rule*), which indicates that their situation is rather stable. Among the countries under research, the ratio is definitely the lowest in the Baltic states. Its value did not exceed the safety threshold of 100% in Estonia and Latvia while in Lithuania it reached 100% only in 2006 Q4 (see: Table 1). Implementing the policy of a fixed exchange rate, the Baltic states seem to be most vulnerable to fast loss of reserves. Thus, the relatively low level of reserves as compared to the level of their indebtedness (due to the rapid increase in their foreign debt) may not be enough to safeguard the stable growth of their economies in the future.

Figure 3. The ratio of reserve assets to short-term foreign indebtedness in NMS-9, %

Figure 4. Short-term foreign indebtedness in NMS-9, USD billion

Sources: IMF IFS, Joint External Debt Hub[15]

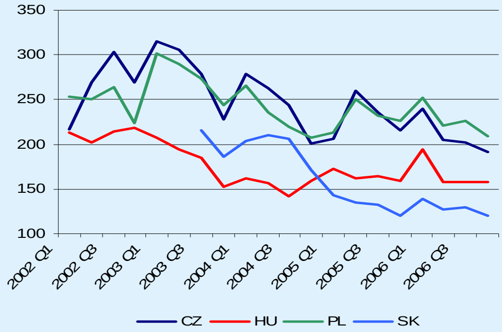
Table 1. Official reserve assets in NMS-9

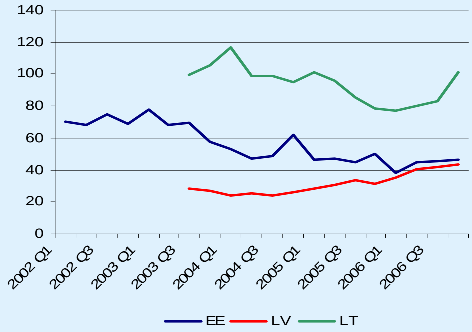
	The level of official reserve assets, USD billion		Change, %	The level of official reserve assets, percentage of GDP		The level of official reserve assets, percentage of short-term indebtedness	
	2001	2006		2001	2006	2003 Q3	2006
Bulgaria	3580	11756	228,4	26,6	35,6	203,1*	148,1
Czech R.	14364	31221	117,4	23,6	20,9	279,2	190,9
Estonia	823	2786	238,8	13,5	16,2	69,8	46,7
Hungary	10755	21590	100,7	130,8	101,3	184,9	158,4
Latvia	1218	4510	270,1	10,2	14,4	28,8	43,2
Lithuania	1669	5773	245,8	3,2	4,9	99,2	101,1
Poland	26563	48474	82,5	12,4	23,6	273,8	209,4
Romania	4861	30207	521,4	14,2	13,5	-	-
Slovakia	4186	13364	219,2	20,1	23,1	215,3	120,2
Total	68021	169680	149,5	17,0	18,5	239,1**	196,5**

* 2005 Q3
** Excluding Bulgaria and Romania.
Sources: Own calculations based on JEDH, Eurostat, IMF IFS

[15] Joint External Debt Hub (JEDH) is a database created jointly by the World Bank, IMF, OECD and BIS, that gathers data on foreign indebtedness.

Charts 5, 6. The ratio of reserve assets to short-term foreign indebtedness for individual NMS-9, %





Sources: IMF IFS, Joint External Debt Hub

4. Inflation and the monetary policy

Average inflation rose in the NMS-9 region in the period between May 2007 and August 2007. The average HICP growth rate increased from 4.6% to 5.5%, i.e. by 0.9 percentage points. However, **the changes in the price growth rate were different for countries under analysis:**

A. in Bulgaria, Romania and the Czech Republic inflation increased in the period under research;

B. in Poland, Slovakia and Hungary inflation decreased.

A. Of all the analysed countries Bulgaria saw the highest inflation increase. Its yearly HICP growth rate increased from 4.5% to 9.3%, i.e. by 4.8 percentage points in the period between May and August 2007. In August 2007 alone inflation grew by 2.5 percentage points, as compared to the previous month. Such a rapid increase in the HICP growth rate was mainly due to the increase in the growth rate of processed and unprocessed food prices. The analysis shows that the inflation growth in Bulgaria may have been attributed in 95% to the increase in the growth rate of both food categories (see: Table 4.1). Net inflation and the growth rate of energy prices were of little impact on inflation changes. The high growth rate of unprocessed food prices in recent months was caused by unfavourable weather conditions – high temperature and most of all drought during the crops' growing season. It is highly probable that the increase in the growth rate of unprocessed food prices was also conducive to the increase in the prices of processed food. The inflation growth was thus mainly due to negative supply shocks.

Similar to Bulgaria, the supply factors influenced the increase in inflation in Romania in recent months. The HICP growth rate increased in the period between May and August 2007 from 3.9% to 5.0%, i.e. by 1.1 percentage point. The analysis shows that practically all of the inflation growth was due to the increase in the growth rate of unprocessed food prices. Similar to Bulgaria, in Romania this was also caused by unfavourable supply shocks – heat waves and draughts, yet unlike Bulgaria, the increase in the growth rate of unprocessed food did not translate into the increase in the prices of processed food.

In the period between October 2006 and May 2007, both in Bulgaria and Romania the growth rate of (processed and unprocessed) food prices was conducive to the decrease in inflation, however the abnormal weather conditions reversed the trend.

Similar to the Balkans, in the period under research the HICP growth rate also rose in all the Baltic states. The highest inflation surge was posted by Latvia as its inflation increased from 7.8% to 10.2%, i.e. by 2.4 percentage points in the period between May and August 2007. Inflation in Lithuania is currently the highest among all the countries of the NMS-9 group as its HICP growth rate increased in the period under scrutiny by 0.6 percentage points and amounted to 5.6% in August 2007. Estonia's inflation increased only by 0.2 percentage points in the analysed period.

The inflation increase in the Baltic states was demand-driven, contrary to the Balkan states. In the case of Latvia, the increase in the cumulative HICP growth rate by 84% can be explained by the increase in core inflation as well as in the growth rate of processed food prices. Lithuania's total input in inflation changes of both groups expressed as the percentage of inflation changes was 110%. In both the above-mentioned countries, the changes of the growth rate of prices of unprocessed food and energy had only slight impact on inflation. This confirms the assumption that supply factors did not influence inflation in recent months.

In the Czech Republic, inflation increased in the period under analysis by 0.2 percentage points, which can be explained by the increase in the growth rate of processed food prices.

Box 3

The method of inflation decomposition employed in the analysis.

The HICP index was used to compare the growth rates of prices of consumer goods and services in the analysed countries. The main reason behind such a choice was the common methodology of the index for all analysed countries, which made comparison easier. While decomposing the HICP growth rate, goods and services were divided into four sub-groups: unprocessed food, processed food, energy and the remaining goods and services called net inflation. The category of processed food includes the growth rate of alcohol and tobacco products' prices. The reasons underlying the choice of this decomposition method were:

- Including goods and services characterised by significant price changes, i.e. unprocessed food and energy, in separate categories. The changes in the growth rate of prices in those categories are often linked with the so-called supply shocks, e.g. a global increase in oil prices or an increase in unprocessed food prices that is the effect of unusual weather conditions. Moreover, the prices of goods and services included in the 'energy' category often undergo direct or indirect administrative control as price changes depend on changes in the excise duty rates or administrative decisions.
- Dividing the overall growth rate of food into processed and unprocessed food. The analysis confirmed that the price growth rates of those two groups behave in a different way. The prices of unprocessed food undergo the so-called supply shocks, while the prices of processed food are less vulnerable and depend mostly on the increasing or decreasing demand.
- Assigning net inflation a separate category, that is the approximation of the core inflation, in which price growth rate depends mostly on demand. The change in demand for goods and services included in the core group is certainly not the only factor shaping their prices. Factors connected with the cost of manufacturing or changes to the rates of indirect taxes are also important here.

Table 4.1. Decomposition of HICP growth rate in countries where inflation increased in the period between May and August 2007.

Country	Price category	Input in inflation level: The beginning of the increase in the HICP growth rate – May 2007	Input in inflation level: The end of the increase in the HICP growth rate – August 2007	Input in changes: percentage points	Input in changes: percentage of inflation change	Average weights in the period, %
Bulgaria	**Total HICP**	**4.5**	**9.3**	**4.8**	**100**	**100**
	Net	3.3	4.0	0.7	14.6	58.3
	Energy	0.5	0.2	-0.3	-5.7	12.9
	Processed food	1.3	3.4	2.1	44.2	19.1
	Unprocessed food	-0.4	2.0	2.4	50.4	9.7
Czech Republic	**Total HICP**	**2.4**	**2.6**	**0.2**	**100**	**100**
	Net	1.1	0.8	-0.3	-147.1	58.8
	Energy	0.1	0.1	0.0	14.4	14.4
	Processed food	1.1	1.6	0.5	251.6	19.4
	Unprocessed food	0.2	0.1	-0.1	-44.4	7.4
Estonia	**Total HICP**	**5.9**	**6.1**	**0.2**	**100**	**100**
	Net	3.7	4.0	0.3	150.5	60.2
	Energy	0.4	0.6	0.3	136.7	11.4
	Processed food	1.2	1.3	0.1	38.2	19.1
	Unprocessed food	0.7	0.3	-0.4	-190.7	9.3
Lithuania	**Total HICP**	**5.0**	**5.6**	**0.6**	**100**	**100**
	Net	1.4	1.6	0.2	35.5	53.2
	Energy	0.9	0.7	-0.1	-20.0	13.3
	Processed food	1.9	2.4	0.4	73.4	22.0
	Unprocessed food	0.8	0.8	0.0	1.9	11.4
Latvia	**Total HICP**	**7.8**	**10.2**	**2.4**	**100**	**100**
	Net	3.9	4.9	1.0	42.6	56.8
	Energy	0.6	0.9	0.2	9.5	11.4
	Processed food	2.2	3.2	1.0	40.9	20.5
	Unprocessed food	1.1	1.3	0.2	7.1	11.3
Romania	**Total HICP**	**3.9**	**5.0**	**1.1**	**100**	**100**
	Net	1.7	1.3	-0.4	-34.9	38.4
	Energy	1.3	1.1	-0.2	-17.1	18.8
	Processed food	1.7	1.8	0.1	12.3	27.0
	Unprocessed food	-0.7	0.8	1.5	137.8	15.8

Source: Own summary on the basis of Eurostat data.

B. Out of NMS-9, insignificant inflation decreases were posted by Hungary, Poland and Slovakia in the period under analysis.

In Hungary, inflation amounted to 7.1% in August 2007 – it was lower by 1.3 percentage points than in May. The analysis shows that the drop in the HICP growth rate was almost entirely due to the drop in the growth rate of energy prices (see: Table 4.2). The decrease in energy prices was in turn related to the expiry of the so-called base effect. In August 2006, the Hungarian government decided to make initial increases of regulated prices aimed at improving the situation in the public finance sector.

In Poland, the yearly HICP growth rate amounted to 2.1% in August 2007 and was lower by 0.2 percentage points than in May 2007. The decrease in inflation was supply-driven and resulted from the decrease in the growth rate of unprocessed food and energy prices.

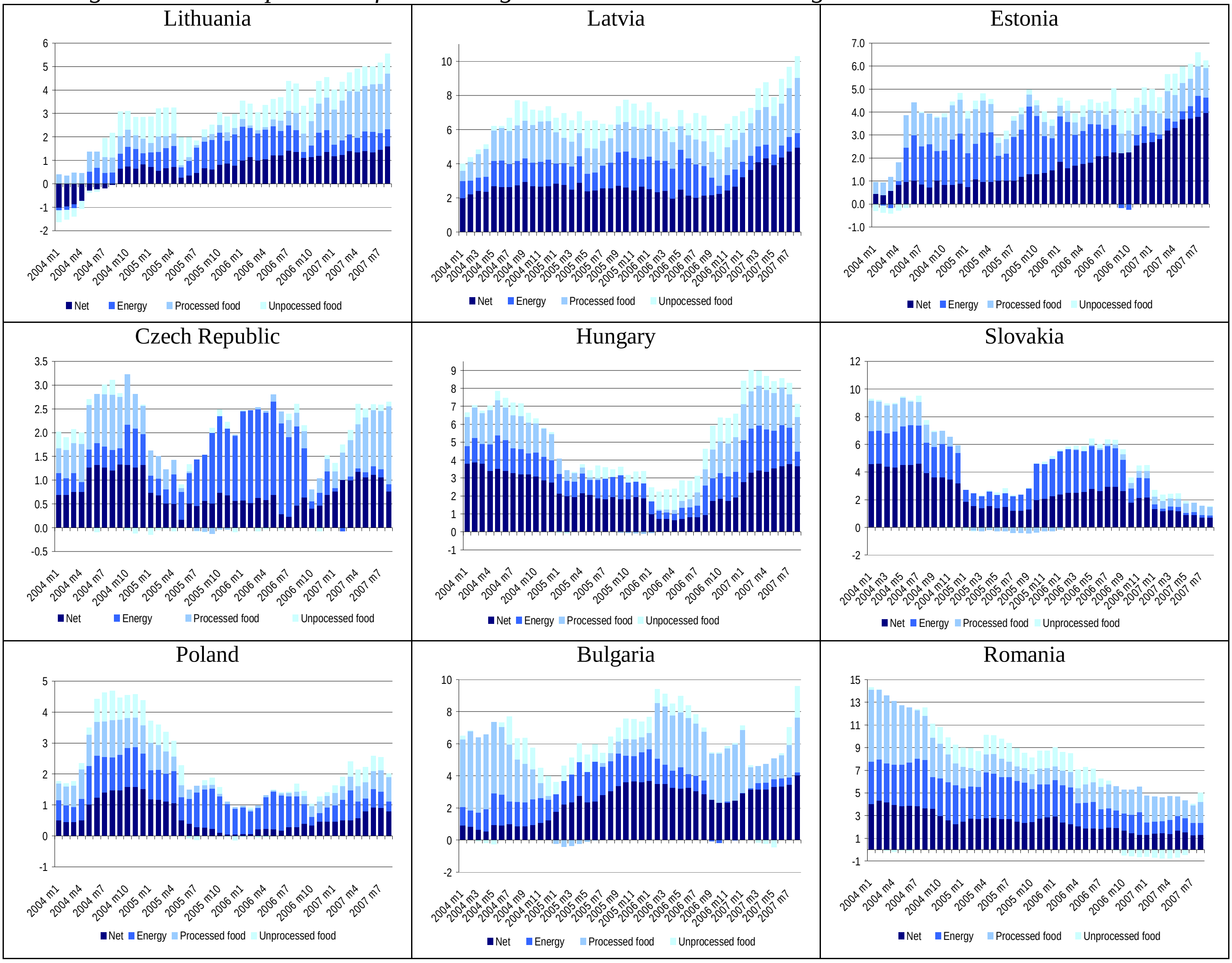
It is difficult to explicitly establish the reasons behind the drop in inflation in Slovakia. The HICP growth rate amounted to 1.2% in August and was lower by 0.3 percentage points than in May 2007. The drop in inflation was influenced by the changes in price growth rates in all the analysed categories. Currently, inflation in Slovakia is the lowest in NMS-9. Surely, the situation in the Slovak labour market was conducive to maintaining inflation on a low level. Slovakia was the only country of the NMS-9 group where labour productivity grew at a faster pace than wages and thus the only country where there was no wage pressures linked with the increase in unit labour costs.

Table 4.2. Decomposition of HICP growth rate in countries where inflation decreased in the period between May and August 2007.

Country	Price category	Input in inflation level		Input in changes		Average weights in the period, %
		The beginning of the decrease in the HICP growth rate – May 2007	The end of the decrease in the HICP growth rate – August 2007	percentage points	percentage of inflation change	
Poland	**Total HICP**	**2.3**	**2.1**	**-0.2**	**100**	**100**
	Net	0.8	0.8	0.0	0.0	56.7
	Energy	0.4	0.3	-0.1	48.6	16.2
	Processed food	0.5	0.8	0.3	-137.1	18.3
	Unprocessed food	0.5	0.1	-0.4	185.1	8.8
Slovakia	**Total HICP**	**1.5**	**1.2**	**-0.3**	**100**	**100**
	Net	0.9	0.7	-0.2	59.2	59.2
	Energy	0.2	0.1	0.0	12.3	18.4
	Processed food	0.7	0.6	0.0	15.0	15.0
	Unprocessed food	0.1	0.0	-0.1	37.1	7.4
Hungary	**Total HICP**	**8.4**	**7.1**	**-1.3**	**100**	**100**
	Net	3.5	3.7	0.1	-9.2	60.0
	Energy	2.1	0.8	-1.3	99.0	13.3
	Processed food	2.1	1.9	-0.2	15.1	19.6
	Unprocessed food	0.6	0.7	0.1	-7.1	7.1

Source: Own summary on the basis of Eurostat data.

Figure 4.2 Decomposition of the HICP growth rate in the NMS-9 region.



Source: Own calculations on the basis of Eurostat data.

Five out of the nine countries under research implement the strategy of the direct inflation targeting[16].

The inflation projections of the central banks of Poland and the Czech Republic presented in Table 4.3 assume a gradual increase in the growth rate of consumer prices above the countries' inflation targets. According to the projections, by the end of 2008 inflation should surpass 4% in the Czech Republic, thus surpassing the upper limit of the deviation range. According to the newest projections, inflation in Poland should stick to the upper limit of the acceptable deviation band by the end of 2008. In both countries, the probability of inflation exceeding the target is higher than the probability that it will be lower than the target. Due to that fact both central banks initiated a cycle of interest rate increases in 2007. There were three increases amounting to 75 basis points in both countries. By the end of September 2007, the main interest rate of the Polish central bank was 4.75% and of the Czech central bank – 3.25%.

The Slovak central bank also projects a gradual inflation increase in the country, yet unlike Poland and the Czech Republic, inflation in Slovakia should be lower than the

[16] The countries implementing the direct inflation targeting strategy are: Poland, the Czech Republic, Hungary, Slovakia and Romania.

assumed inflation target in the projection horizon. The main interest rate of the Slovak central bank remained unchanged at 4.25% in the last six months.

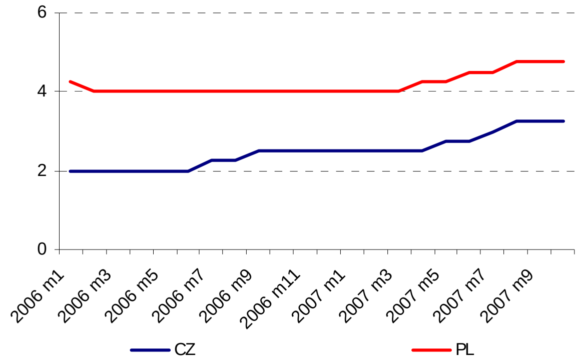
Table 4.3. Inflation projections in countries implementing the direct inflation targeting strategy.

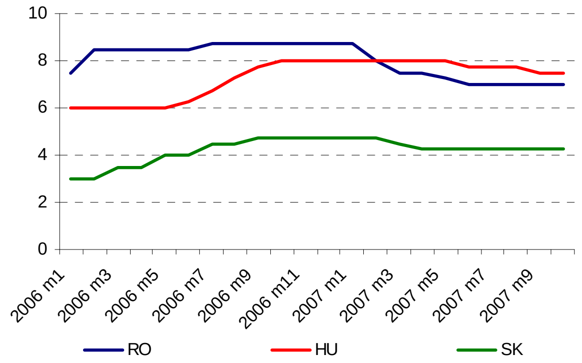
Country	Projection date	Inflation projections as at the end of: 2007	2008
Poland	October 2007	2.6	3.4
Czech Republic	July 2007	3.8	4.2
Hungary	August 2007	5.9	3.7
Slovakia	July 2007	1.5	2.0
Romania	August 2007	3.9	3.7

Source: National central banks.

In Hungary and Romania, the central banks project the gradual decrease in the growth rate of consumer prices. Their decrease in Hungary will be due to the expiry of the effect connected with the one-time increase in controlled prices and increasing the rates of indirect taxes for selected goods. In Romania, despite the inflation increase in recent months, the central bank projects a further decrease in the CPI growth rate within the horizon covered by the projections. By the end of 2007 and 2008, inflation should be lower than the assumed inflation target points. Since the beginning of 2007, the Hungarian central bank has lowered the interest rate twice by the total of 50 basis points. The central bank in Romania has lowered the main interest rate six times by the total of 190 basis points since the beginning of 2007.[17]

Figure 4.3. Main interest rates in countries implementing the direct inflation targeting strategy.





Source: National central banks.

The Baltic states and Bulgaria implement the currency board system. Between January and September 2007, market interest rates increased in all Baltic states as well as in Bulgaria.[18] This was especially visible in Latvia where the three-month RIGIBOR increased from 4.2% to 12.7%, i.e. by 8.5 percentage points and in September alone by 3.6 percentage points. Such a significant increase in the market interest rate during only one month has not been posted in Latvia since 1999. In Lithuania and Estonia, the market interest rates increased by 1.8 and 1.3 percentage points in the period between January and September 2007, respectively. Taking into account the level of inflation in the Baltic states, it should be noted that the real interest rates have remained very low in those

[17] In September 2007, the Romanian central bank made the decision to increase interest rates for the first time since August 2006.

[18] The market interest rate was assumed as the interest level of a three-month monetary loan in the inter-bank market.

countries.[19] In Bulgaria, the inflation increase in recent months triggered the increase in market interest rates, just like in the case of the Baltic states.

[19] Assuming that the real interest rate is the difference between the yearly inflation growth rate and the nominal market interest rate, apart from a few months, there have been negative interest rates in the Baltic states since the countries' accession to the European Union.

5. Labour market

Similarly to previous periods, Q2 of 2007 was also characterised by an improvement in the labour market situation in NMS-9. The economic growth was conducive to the increase in employment and the decrease in unemployment. The growth rate of wages also increased, triggered mainly by the increasing growth rate of unit labour costs (ULC). The average employment growth rate in 2007 Q2 was 2.5% in NMS-9 – it was lower by 0.4 and 0.5 percentage points than in 2007 Q1 and in the whole of 2006, respectively. The increase in employment was accompanied by the decrease in unemployment. The average unemployment rate in NMS-9 was 6.6% by the end of Q2 of 2007 – it was lower by 0.9 and 1.4 percentage points compared to March 2007 and December 2006, respectively. The average wage in NMS-9 increased in 2007 Q2 by 16.5% as compared to the analogous period of the previous year. The increasing growth rate of wages in the countries of the analysed region was the main reason behind the increasing growth rate of unit labour costs (ULC). The average nominal growth rate of ULC in Q2 was 12.1% – it was higher by 1.1 percentage points than in 2007 Q1 and by 4.4 percentage points than the average ULC growth rate in the whole of 2006. Similarly to previous periods, the increase in ULC growth rate in Q2 was the reason behind inflation pressure in certain NMS-9 and deteriorated the competitiveness of those countries in the international market. Just like in previous periods, changes in the labour market were not consistent across all the countries. However, the economies could not have been grouped according to similar trends related to changes in the labour market.

Taking into account the changes in the labour market in the NMS-9 region in 2007 Q2, Slovakia is the leading country. This is the only country where labour productivity[20] grew at a faster pace than the nominal average wage. Thus, Slovakia was the only country where nominal ULC growth rate in 2007 Q2 was lower than the average nominal ULC growth rate for the whole of 2006.

In all the remaining economies of the NMS-9 group, labour productivity increased at a slower pace than the average nominal wage in 2007 Q2. Also, the nominal ULC growth rate in 2007 Q2 was higher in NMS-9 except for Slovakia as compared to the average nominal ULC growth rate in the whole of 2006. This did not translate, however, into a consistent labour market trend in all of those economies. The remaining countries differed as to the trends in changes to the employment growth rate. In four countries (Bulgaria, Estonia, Latvia and Hungary), there was a decrease in employment growth rate in 2007 Q2 as compared to the whole of 2006. In the remaining four economies (the Czech Republic, Lithuania, Poland and Romania), the employment growth rate accelerated in comparison to 2006. Due to the diversity of labour market situations, NMS-9 were divided into three groups:

A. Slovakia – the only country where nominal ULC growth rate in 2007 Q2 was lower than the average nominal ULC growth rate for the whole of 2006 and where labour productivity grew at a faster pace than wages in 2007 Q2;
B. Bulgaria, Estonia, Latvia and Hungary – where the nominal ULC growth rate in 2007 Q2 accelerated and the employment growth rate decelerated as compared to the whole of 2006;
C. the Czech Republic, Lithuania, Poland and Romania – where the nominal ULC growth rate as well as the employment growth rate accelerated in 2007 Q2 in comparison with 2006.

A. The situation on the labour market in 2007 Q2 makes Slovakia exceptional among NMS-9. It was the only country where the productivity of workforce grew at a faster pace than wages in 2007 Q2. The effect was the negative value of nominal ULC growth rate that amounted to -0.6% in 2007 Q2, which

[20] The growth rate of productivity has been calculated as the difference between the real growth rate of GDP and the growth rate of employment.

translated into a decrease in unit labour costs as compared to the analogous period of the previous year. By way of comparison, the nominal ULC growth rate in 2007 Q1 was 1.0% and the average ULC growth rate in the whole of 2006 was 4.4%. Additionally, the negative real ULC growth rate[21] did not trigger inflation pressure on the part of the labour market, which was conducive to retaining HICP growth rate at a low level.

The negative nominal ULC growth rate in Slovakia in 2007 Q2 was the result of a decrease in employment, retaining the growth rate of wages on a relatively low level as well as a slight increase in GDP growth rate. The mployment growth rate was 1.9% by the end of Q2 of 2007 – it was lower by 1.2 and 1.9 percentage points compared to 2007 Q1 and the whole of 2006, respectively. The average wage growth rate was 7.0% by the end of Q2 of 2007 – it was higher by 0.1 percentage point compared to 2007 Q1 and lower by 1.6 percentage points than the whole of 2006. It has to be noted that in the first half of 2007 the average wage in Slovakia grew at the slowest pace out of all the countries in the region.

It is difficult to explicitly state the reasons behind the decrease in the growth rate in Slovakia in 2007 Q2. The Slovak economy was developing in recent quarters at the pace of ca. 10%. Retaining that pace in the long run would require faster creation of new jobs, otherwise the Slovak economy may slow down. On the other hand, the low professional activity of Slovaks compared to the 'old' Member States should be conducive to increasing labour supply.[22] Additionally, apart from the fact that the unemployment rate decreased significantly in recent quarters and amounted to 11.1% by the end of Q2 of 2007 according to Eurostat methodology, it is still the highest in the NMS-9 group. It seems that its main reason is the maladjustment of supply and demand on the labour market. This assumption is confirmed by the results of an analysis of the structure of unemployment, which show that 75% of all the unemployed in Slovakia were those unemployed for a long term.[23] This is due to the fact that three fourths of the unemployed workforce were either not interested in taking up a job or their qualifications were far from those demanded by potential employers, yet it is possible that both factors were of equal influence. Over 50% of the unemployed Slovaks finished only primary school and had no additional vocational training. Moreover, the social transfers paid out by the state limited their eagerness to take up legal jobs.

It seems that abandoning the labour market reforms introduced in 2003 may have negative effects on the Slovak economy. For the time being, Slovak companies manage to increase production without a significant increase in employment. Additionally, the moderate increase in wages as compared to the current standards of the remaining NMS-9 was conducive to the improvement of the Slovak economy's competitiveness. Yet if the supply of highly qualified workforce does not increase, retaining a 10% economic growth may be difficult. Shortages of highly qualified workforce may lead to wage pressures, which in turn may cause the low ULC growth rate to increase. Similar to the Baltic states, rising unit labour costs may lead to irregular inflation increase, which may also cause economic slowdown.

B. As opposed to Slovakia, , in 2007 Q2 the productivity of workforce in Bulgaria, Latvia and Hungary increased at a slower pace than the average wage. The effect was the positive value of ULC growth rate. In 2007 Q2, the average ULC growth rate was 15.9% – it was higher by 1.4 and 5.7 percentage points compared to 2007 Q1 and the whole of 2006, respectively.

---

[21] Real ULC growth rate has been calculated as the difference between the nominal ULC growth rate and the HICP growth rate.

[22] The employment rate for the population aged 15-64 amounted to 60% in Slovakia by the end of Q1 of 2007. By way of comparison, the average employment rate for the 'old' Member States was 66% in the same age range.

[23] According to Eurostat methodology, long-term unemployment is the unemployment that lasts longer than 12 months.

The main reason behind the increase in ULC growth rates in this group of countries was the increase in the average wage. In 2007 Q2, the yearly nominal growth rate of the average wage amounted to 20.3% for the analysed group of countries, against 19.1% in 2007 Q1 and 14.4% in the whole of 2006. A particularly high growth in wages took place in two Baltic states. In annual terms, the average wage increase in Latvia was 33.4% in 2007 Q2 (the highest in NMS-9), while the figure for Estonia was 21.2%.

The factor limiting the increase in ULC growth rate in Bulgaria, Estonia, Latvia and Hungary was the decelerating employment growth rate. The average employment growth rate in the analysed group was 2.1% in 2007 Q2 – it was lower by 0.8 and 1.9 percentage points compared to 2007 Q1 and the whole of 2006, respectively. A particularly high deceleration in the employment growth rate took place in Estonia, where employment increased by 6.4% in the whole of 2006 and later in 2007 Q2 the growth rate slumped to 1.3%.

The deceleration of the employment growth rate in 2007 Q2 was the common characteristic of the group, yet its reasons seem to differ. The dynamic economic growth in recent years in Estonia and Latvia was the main cause of the increase in employment in those countries. Additionally, the increasing real wages led to the increase in professional activity in those two countries. By the end of 2006, professional activity in Estonia and Latvia was 72.5% and 71.4%, respectively. By way of comparison, the average rate of professional activity in the 'old' EU countries amounted to 71.8% by the end of 2006. By the end of 2007 Q1, the employment rate was 68.6% in Estonia and 66.4% in Latvia. In the analogous period, the average employment rate for the 'old' Member States was 66.1%. This shows that the professional activity of Estonian and Latvian citizens is high and further increase in the supply of labour may turn out difficult. Due to the increasing demand on the labour market and a limited supply thereon, the countries experienced shortages that were characteristic of the construction market especially. The results of surveys indicate that 61% of construction companies in Estonia perceive shortages in the labour market as their main development obstacle.[24] Labour migration also had a significant impact on decreasing the labour resources in Latvia and Estonia.[25] All the above-mentioned factors influenced the employment growth rate as retaining its 2006 level turned out to be impossible in 2007. Shortages on the labour market, especially among qualified employees, led to a sudden increase in wages. The growing wages were conducive to the increase in ULC growth rate, which in turn led to inflation increase. Shortages on the labour market, growing unit labour costs and high inflation may be the main reasons behind the deterioration of competitiveness and economic slowdown in Estonia and Latvia

The deceleration of employment growth rate in Hungary was mainly due to economic slowdown. The main cause of the decelerating GDP growth rate was the lenient fiscal policy that resulted in high deficit in the public finance sector. In 2007 Q2, the yearly increase in the domestic product was 1.2% in Hungary, which was the lowest figure among all the countries of the region. As compared to 2007 Q1 and the whole of 2006, the growth rate of GDP decreased by 1.5% and 2.7% in 2007 Q2, respectively. This led to the decrease in the employment growth rate by 0.7% in the whole of 2006 to the level of 0.2% in 2007 Q2. Apart from the economic slowdown, the supply factors were also linked with the decrease in the employment growth rate. Among NMS-9, Hungary had the highest taxation of the labour factor as well as the highest monetary social transfers in relation to its GDP. In 2006, the so-called tax wedge amounted to 45.8% in Hungary,[26]while social transfers reached

[24] Source: Eurostat.
[25] Labour migration in NMS-9 has been described in detail in the previous Quarterly Report.
[26] The tax wedge is understood as the sum of obligatory social insurance premiums paid by the employer and the employee, and income tax, measured in relation to the total labour costs incurred by the employer.

17.8% of GDP (see: the Table). High taxation of the labour factor and the expenses of the public finance sector effectively deterred Hungarians from taking up legal jobs. It should be added that professional activity in Hungary was the lowest among all NMS-9 in recent months – by the end of Q1 of 2007 it amounted to 61.6%.

It is difficult to explicitly state the reasons behind the deceleration in the employment growth rate in Bulgaria in 2007 Q2 as compared to the whole of 2006. It seems that the slowdown might have been only temporary, especially taking into account that the employment growth rate in 2007 Q1 was higher by 2.4% than in the whole of 2006.

C. Similarly to the group of countries described above, also in the Czech Republic, Lithuania, Poland and Romania labour productivity grew at a faster pace than the average wage in 2007 Q2. The effect was the positive nominal value of ULC growth rate. Yet contrary to that group of countries, not only the accelerating growth rate of wages but also the accelerating employment growth rate influenced the increase in unit labour costs.

The average nominal ULC growth rate for the Czech Republic, Lithuania, Poland and Romania was 11.5% in 2007 Q2, against 10.0% in 2007 Q1 and 6.5% in the whole of 2006. The acceleration of the ULC growth rate was influenced by the acceleration in the growth rate of the average wage that was higher in 2007 Q2 in the analysed group of countries than in 2007 Q1 as well as in the whole of 2006 by 0.8 and 3.4 percentage points, respectively. In 2007 Q2, the average employment growth rate amounted to 3.1% against 2.8% in 2007 Q1 and 1.8% in the whole of 2006. The acceleration of the employment growth rate was mainly visible in Poland (see: Table 5.1). Moreover, the economies of the group of countries under scrutiny slowed down by 0.4 percentage points in 2007 Q2, as compared to 2007 Q1.

All countries of the group had lower rates of professional activity in comparison not only with Estonia and Latvia but also with the average level of the 'old' Member States. The ow employment rate was especially characteristic of Poland and Romania (see: Table 5.5), however, labour supply reserves were also present in Lithuania and in the Czech Republic. The analysis of the situation on the labour market shows that the employment growth rate has not accelerated in those countries as much as in Estonia and Latvia since their accession to the European Union. Although Polish and Latvian entrepreneurs indicated that it is the lack of highly qualified workforce that constitutes their main development obstacle, labour supply reserves due to the relatively low professional activity were nevertheless conducive to further increase in the employment growth rate.

Source: *Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia,* World Bank, 2007.

Table 5.1. Yearly growth rate of employment in NMS-9 economies, 2005-2007.

	2005				2006				2007		2006
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Average**
Bulgaria	2.0	1.3	2.4	2.4	3.6	4.3	3.3	5.9	6.6	3.6	4.2
Estonia	0.9	2.3	2.5	2.3	6.8	6.7	6.2	5.9	1.9	1.3	6.4
Latvia	1.3	0.7	1.3	2.9	4.1	4.2	7.2	5.1	2.6	3.4	5.0
Hungary	-0.5	-0.1	0.5	0.2	0.4	1.1	0.5	0.9	0.5	0.2	0.7
Czech Republic	1.1	1.5	2	1.7	1.7	1.6	0.9	1.2	1.7	1.8	1.3
Lithuania	3.2	2.5	2.8	3.0	2.7	1.9	1.3	0.9	1.6	2.8	1.6
Poland	2.2	1.9	2.8	2.4	2.4	3.7	3.9	3.6	5.3	4.8	3.3
Romania	3.0	2.8	2.4	2.3	1.0	0.8	1.2	1.6	2.7	2.8	1.1
Slovakia	2.3	2.1	1.6	2.5	3.7	4.5	3.8	3.5	3.1	1.9	3.8

Sources: Eurostat, EcoWin Economic, national statistical offices.

Table 5.2. Nominal yearly growth rate of the average wage in NMS-9, 2005-2007.

	2005				2006				2007		2006
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Average**
Bulgaria	7.2	9.1	8.2	7.4	9.9	9.6	11.7	12.8	16.9	17.9	10.9
Estonia	10.1	11.8	10.9	12.8	15.7	15.0	16.5	17.5	20.1	21.2	16.1
Latvia	15.8	15.5	17.5	16.9	19.2	21.5	22.5	27.9	32.4	33.4	22.6
Hungary	13.8	8.0	7.4	6.4	7.4	7.1	9.0	9.4	7.1	8.6	8.2
Czech Republic	5.7	5.4	6.2	3.9	7.0	6.6	5.9	6.1	7.9	7.4	6.4
Lithuania	10.8	9.0	9.4	10.9	13.2	14.1	19.9	19.1	20.9	20.2	16.3
Poland	3.6	3.9	3.4	5.1	4.7	4.7	5.0	5.3	7.1	8.9	4.9
Romania	16.6	17.4	18.0	16.1	17.2	16.9	17.6	23.7	21.0	23.5	18.6
Slovakia	10.2	8.2	9.9	8.4	8.1	9.5	8.3	8.6	6.9	7.0	8.6

Sources: Eurostat, EcoWin Economic, national statistical offices.

Table 5.3. Unemployment rate in NMS-9, 2004-2006.

	2005				2006				2007	
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
Bulgaria	11.1	9.6	9.0	10.1	9.3	8.5	8.6	8.7	7.6	6.4
Estonia	9.6	7.6	6.8	6.8	6.2	5.5	5.2	5.4	5.5	4.7
Latvia	9.8	8.9	8.6	7.7	7.7	7.1	6.1	6.1	6.7	5.8
Hungary	7.1	6.9	7.3	7.5	7.5	7.0	7.5	7.7	7.5	6.8
Czech Republic	8.2	7.7	7.8	7.9	7.8	6.8	7.0	6.6	5.8	5.1
Lithuania	10.1	7.8	6.7	7.5	6.2	5.2	5.9	5.3	4.9	3.7
Poland	18.8	17.7	17.2	16.9	15.9	13.5	12.8	12.3	11.0	9.1
Romania	8.3	7.0	6.1	7.3	7.6	6.9	7.0	7.7	6.8	6.4
Slovakia	17.2	16.0	16.0	15.7	14.7	13.2	12.8	12.2	11.4	11.1

Source: Eurostat.

Table 5.4. Nominal yearly ULC growth rate in NMS-9 economies, 2005-2007.

	2005				2006				2007		2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Average
Bulgaria	3.3	3.9	6.0	4.3	7.9	7.3	8.3	13.0	17.3	15.1	9.0
Estonia	2.7	4.0	1.5	3.8	11.1	10.5	11.6	12.4	11.9	14.9	11.3
Latvia	9.4	4.7	7.2	8.4	10.2	14.6	17.8	21.3	23.8	25.8	15.7
Hungary	10.2	3.3	3.6	1.8	2.9	4.5	5.6	7.0	4.9	7.6	4.9
Czech Republic	1.4	0.7	2.2	-1.1	2.1	1.7	0.5	1.2	3.2	3.2	1.3
Lithuania	9.4	3.2	3.9	5.2	7.4	7.6	14.8	13.1	14.2	15.0	10.4
Poland	3.4	2.7	1.9	3.1	1.6	2.5	2.7	2.2	5.0	7.0	2.2
Romania	13.7	15.7	18.0	14.2	11.3	9.8	10.5	17.6	17.7	20.7	12.1
Slovakia	7.6	4.9	5.2	3.4	5.0	7.2	2.3	2.4	1.0	-0.6	4.4

Sources: Eurostat, EcoWin Economic, national statistical offices.

Table 5.5. Indices linked with the situation in the labour market in NMS-9.

Country	Employment rate 2007 Q1	Tax wedge as percentage of the total employment cost 2006	Social transfers as percentage of GDP 2005	Minimum wage as percentage of the average wage, 2005-2006
Bulgaria	59.7	39.0	15.2	49.6
Estonia	68.6	41.4	11.0	33.2
Latvia	66.4	42.5	8.8	33.6
Hungary	56.9	45.8	17.8	39.6
Czech Republic	65.5	43.6	17.2	39.7
Lithuania	63.9	43.7	10.2	36.1
Poland	55.4	43.1	17.6	36.1
Romania	57.2	44.1	9.7	32.6
Slovakia	60.1	42.0	15.3	34.8

Sources: Eurostat, Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia, World Bank, 2007.