



ICEG EC

**International Center for Economic Growth
European Center**



NEWS OF THE MONTH

December 2004

14 Korompai Street, H-1124 Budapest, Hungary

Tel: +36 1 248 1160 E-mail: icegec@axelero.hu Website: www.icegec.org

TABLE OF CONTENTS

<i>Recent Macroeconomic Trends in Poland</i>	<u>3</u>
<i>Czech Republic – Unchanged Key Interest Rates Reflect Optimism</i>	<u>6</u>
<i>Unstoppable Crown Firming</i>	<u>9</u>
<i>Kazakhstan: Tendencies in the Economy, and Sectoral Overview</i>	<u>13</u>

RECENT MACROECONOMIC TRENDS IN POLAND

The end of the year 2004 was characterised by a stronger than expected rate of growth, and higher than expected inflation in Poland. At the same time the development of the current account was quite favourable.

INFLATION ON THE RISE

Consumer prices have been increasing strongly throughout 2004 compared to the previous year. In July the CPI reached 4.6 percent YoY, and did not change significantly until November (4.5 percent year on year). The tendency of increases is expected to continue in the following months, with CPI reaching 4.6 percent in December, and 5 percent in January 2005, year on year. These values are above the upper tolerance limit for deviations from the inflation target.

The increase of consumer prices at the end of 2004 is happening while the development of the exchange rate and fuel prices would suggest otherwise. The appreciation of the zloty did not have a strong effect on inflation, and the fall in fuel prices in November seems to take its effect on CPI with larger lag than expected. The impact of the significant zloty appreciation could have been stronger, had its transmission into domestic fuel prices been more intensive. At the same time we cannot count on the beneficial impact of the zloty appreciation on the CPI, as the development of the exchange rate remains the subject of considerable uncertainty.

Table 1. CPI and Core Inflation Indices in 2004, Year on Year Change in %

	jan	feb	mar	apr	may
CPI	1,6	1,6	1,7	2,2	3,4
Core inflation indices after excluding:					
Regulated prices	1,3	1,5	1,7	2,3	3,2
Most volatile prices	0,9	1,1	1,3	2,2	3,7
Food and fuel prices (net inflation)	1,2	1,1	1,1	1	2
15% trimmed mean	1,5	1,5	1,5	2	2,7
	jun	jul	aug	sep	oct
CPI	4,4	4,6	4,6	4,4	4,5
Core inflation indices after excluding:					
Regulated prices	4,5	4,9	5	4,6	4,6
Most volatile prices	4,5	5,1	5,1	5,2	5,4
Food and fuel prices (net inflation)	2,3	2,3	2,3	2,4	2,4
15% trimmed mean	3,2	3,1	3,2	3,1	3,1

Source: National Bank of Poland

Core inflation indices stabilized in the autumn months. This was the result of the gradual weakening of the effects of Poland's accession to the EU in May, which brought along the membership in the customs union and indirect tax rises. The

stabilization of the differential between CPI and the „net“ inflation also indicate the weakening of influence of these temporary factors. The development of core inflation measures shows the persistently strong impact of food and fuel prices on the annual growth rate of prices in general. The annual CPI is still expected to remain at a relatively high level until Q2 2005, because the factors (the rise in food prices, changes in the indirect tax rates, new customs tariff) contributing to the inflation hike in the spring of 2004 are still influencing prices.

However some factors exist that contribute to the lowering of inflation. The situation on the labour market is one of these factors. The decreasing wage growth dynamics accompanied by the high growth in labour productivity is holding a break on inflation. At the same time the lower than expected increase in employment, which keeps a rein on private consumption also helps in pulling back the inflation rise.

As for inflation expectations of consumers, it still persists at a high level. Inflation expectations are currently effected by three major factors. The first one is the relatively high level of inflation. The second factor is the previously observed tendency of inflation expectations to return quickly to the level of current inflation, while the third one is the possible dying out of fears of price increases associated with Poland's EU accession. This latter factor has the potential to neutralize the upward tendencies mentioned before. Inflation expectations of consumers are most likely to remain relatively stable in the near term, and a stronger decrease is only expected to happen when the current price dynamics are diminished.

As a result of the price dynamics beginning from Q2 2004, not only the tolerance limit of the inflation target set by the National Bank of Poland has been breached in August, but Poland also ceased to comply with the Maastricht criterion on price stability. The latter was not only the consequence of the higher inflation dynamics in Poland, but was also influenced by the decrease in average inflation in the group of reference countries. The most significant drop in the reference value occurred in September 2004, with the value reaching only 1.9%.

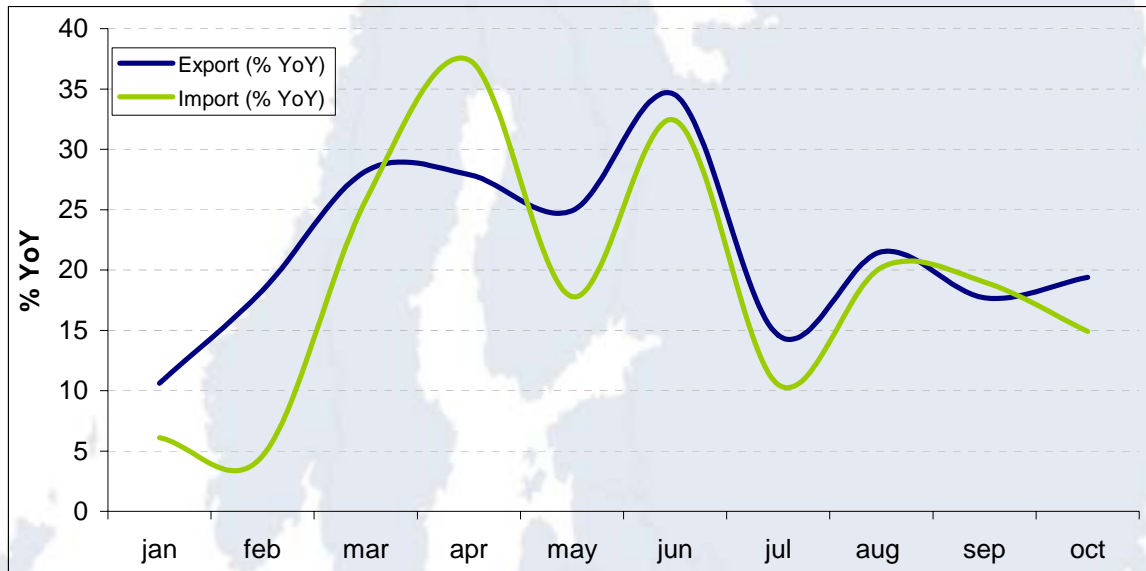
FAVORABLE EXTERNAL POSITION

The export performance of the Polish economy was exceptionally good in 2004. By October the trade deficit decreased to 15 million euros, from 326 million euros in September. The lowest trade deficit level in between January and October 2004 occurred in February, with the deficit reaching only 9 million euros. The highest level was observed in April, with 1,021 million euros. In October 2004 the current account showed a positive balance, amounting to 234 million euros.

The year on year growth rate of exports has been higher than the growth rate of imports in most months of 2004 (until the last available data from October). In October it reached 19.4%, while in the same month the growth rate of imports was

14.9%. The highest import growth rate was observed in April, amounting to 37.4%, as a result of Poland accession to the EU on the first of May. The highest growth rate of exports was observable in June, reaching 34.5%. The high growth rate of exports during 2004 was the result of a favorable external environment, with a high demand for Polish exports.

Chart 1. Exports and Imports Growth Rate, 2004 January-October



Source: National Bank of Poland

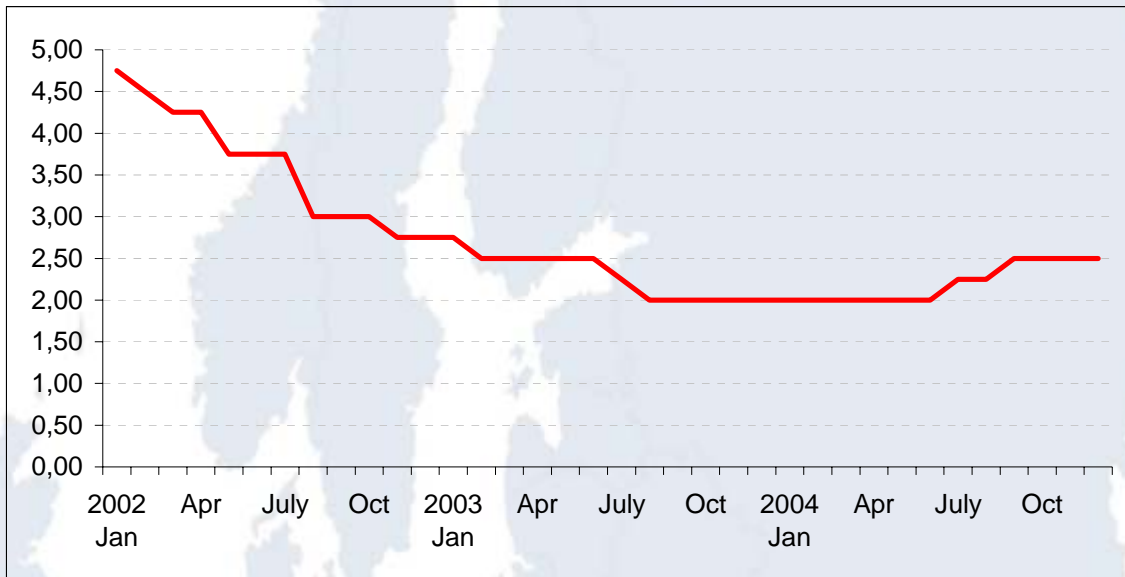
The balance of the current account as a percentage of GDP has been showing a stable, low deficit throughout 2004 (until the last available data in October). In October the deficit was 1.9 percent as a percentage of GDP, year on year. The composition of the 234 million euro surplus was as follows: 318 million euros from current transfers, 212 million euros from services, while -15 million euros in goods, and -281 million euros from income.

October saw a large net FDI inflow into the Polish economy, amounting to 2,164 million euros. Almost the whole amount came from one investor, in a one-off transaction. This was significantly higher than the FDI inflow of the previous months of 2004, with the second highest level observed in April, amounting to 647 million euros. Net direct investment outflow by Polish investors amounted to 34 million euros in October. FDI outflow has been largest in July, amounting to 87 million euros. Portfolio investment activity has not been strong in October, the larger transactions took place in the first half of the year.

CZECH REPUBLIC – UNCHANGED KEY INTEREST RATES REFLECT OPTIMISM

The Czech National Bank's Board Meeting in December left the CNB two-week repo rate unchanged at 2,5%. The rate has remained at 2,5% since the end of August. Is stability in the background? We can answer this question after studying the main economic indicators of the last few months.

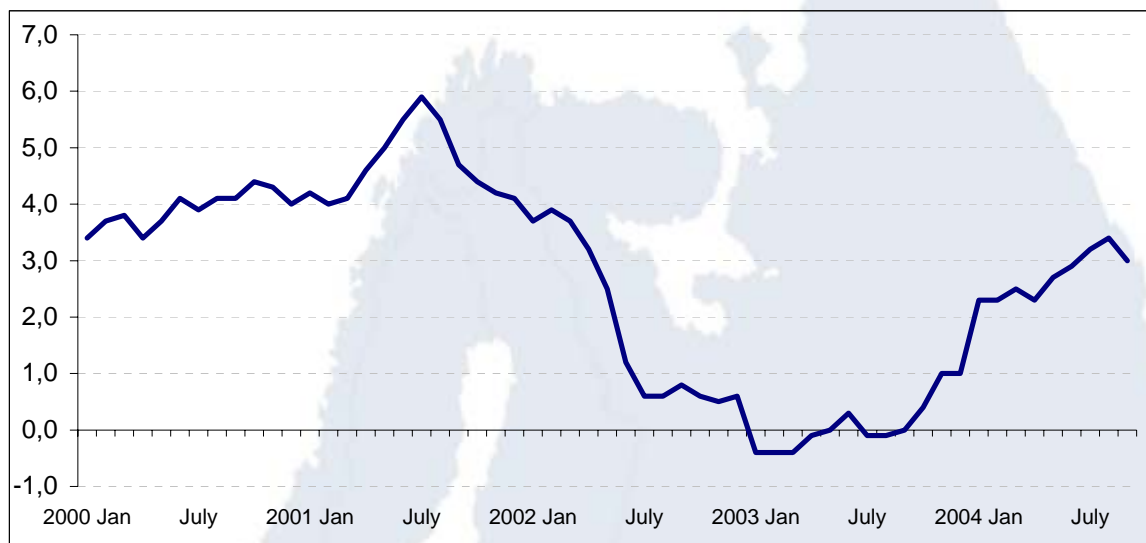
Chart 2. Czech National Bank's two-week repo rate (%)



Source: www.cnb.cz

Inflation reached a two year peak in October with 3,5%. Due to the fact that the figure in November showed 2,9%, it is expected that the price developments from November will probably start to moderate. Only slight deviations appeared from the forecast. Food prices rose at a faster pace than expected, probably due to the process of convergence after EU entry, which was accelerated by the intensified trade. On the other hand fuel prices rose at a slower pace than predicted. Generally we can say that significant accumulation of anti-inflationary or pro-inflationary risks are not expected. Stable, low inflation helped to maintain inflation expectations at a lower level, which thus helped to stabilise low inflation rate.

Chart 3. Consumer Prices (annual percentage changes)



Source: www.cnb.cz

Concerning the **exchange rate** the Czech koruna is generally considered to be stable against the euro, due to the favourable development of foreign trade and the continued inflow of foreign direct investments (FDI). In 2004 the koruna revaluated with 5,5% against the euro. After the board's decision – not changing the key interest rate – the Czech koruna almost reached its two year peak (30,375 EUR/SKK) against the euro with 30,580 EUR/SKK.

In the third quarter the Czech Republic's year-on-year **GDP growth** amounted to 3,6% instead of the predicted 3,9%. According to the Czech National Bank, the deviation can be explained with certain revisions of GDP data, which for the year 2004 changed the 2003 comparison base. Thus the earlier announced 4,1% for the second quarter has been modified to 3,9%. The new data for the first quarter's GDP growth is 3,5% and the data concerning 2003 has been increased from 3,1% to 3,7%.

In the third quarter the development in household consumption had grown at a slower pace (+2%) than predicted and public consumption significantly decreased (-5,5%). The export of goods and services was higher than expected. Other main growth indicators mainly developed as it has been forecasted in October.

Economic growth is supported with both foreign trade and **industrial output**. The latter grew (year-on-year) in October by 8,1%. The metal sector shows remarkable growth rates of over 20%, electrical and electronics industry and vehicle construction has rates around 10% - 15%.

The **trade deficit** in the third quarter was CZK 5 billion, which is down by almost CZK 13,4 billion from a year earlier. Other figures concerning trade are also remarkable. The export of goods and services in real terms increased by 10% in the first quarter. This figure was 26% in the second quarter, which means it more than

doubled, and in the third quarter it showed a 23% increase. Besides this, import growth lagged behind – for example in the third quarter it amounted to 19%.

The **foreign direct investment** inflow reached CZK 35,4 billion in the third quarter of 2004. More than 40% of the FDI went into manufacturing industries and investment was significant in real estate purchases, trade development, electricity, gas and water supply and financial intermediation as well. Direct investment by Czech business was around CZK 0,6 billion and it mainly headed to Slovakia and the United Kingdom. The current account deficit is easily financed by the constant FDI inflows to the Czech Republic. The FDI inflow also effects the strengthening of the Czech koruna.

The above factors justify the optimism, in spite the fact that the **general government deficit** is critical. The deficit is expected to be around 5,3% in 2004 and 4,9% in 2005 (in 2003 the figures showed a 12,6% deficit). Fiscal reforms cannot be avoided and should be boosted. Nevertheless the political environment is not favourable to such reforms since the restructuring and reorganization of public health and pension system, for example which cannot be delayed long, require painful decisions, for which the government does not have the political strength. The reforms need stable majority in the parliament, which the present government lacks.

The short term prospects of Czech economy are favourable. The growth of investments for the third quarter in 2004 increased to 9,7%, but the household consumption growth slowed down to 2%. Based on the dynamics of export growth, the GDP will increase by 3,9% in 2005, 3,7% in 2006 after this years rate of 3,8%. Nevertheless in the medium-term the growth rate is expected to return to the normal potential of the Czech economy, which is around 3% - 3,3%. This means that the growth will be less than the average rate of the Central-Eastern-European region.

CONTINUOUS CROWN APPRECIATION

The National Bank of Slovakia (NBS) has been fighting against the appreciation of the Slovak crown for couple of months. The Slovak Central Bank has been the most active in the CE4 region trying to curb the general firming trend. In the monetary framework of managed float system the bank has used all kind of tools from verbal intervention to direct FX intervention. Base rate had been cut by 200 bp last year, and the 5x5 forward spread has contracted to 30-40 bp. The Slovak unit is still under appreciation pressure, and the room for the NBS to manoeuvre got very limited, however further significant rate cuts are priced in the curve. NBS has just switched to an Inflation Targeting system, and set very ambitious targets for the following years. The bank will certainly need some nominal appreciation to meet its targets, and can not slash the base rate endlessly, because the domestic demand is already surging.

The Slovak crown firmed by 6.2% in nominal terms against the euro last year. This rate of appreciation lagged far behind the one Poland experienced, the 6% percent strengthening was rather in line with the Czech and Hungarian developments. The surge of the crown triggered stiff resistance from the central bank, which used all available tools to rein in the firming. The bank had cut the base rate by 200 bp, and also stepped directly into the FX market. The situation has not changed at all in 2005, the Slovak unit firmed by 1.8% in January despite the central bank actions.

Chart 4. EUR/SKK exchange Rate 2002-2005



Source: Slovak National Bank

The main factors behind the strengthening are the following. Slovakia has posted the strongest macro economic data recently in the region, and the favourable developments of the fundamentals definitely support the currency. GDP growth should be around 5% in 2004 and 2005 as well, this growth rate is much faster than in the euro-zone, and outpaces other countries in the CE4 region. The ministry of

finance has just upgraded its forecast for the economic growth for the next three years. The ministry has changed its growth projection for this year to 4.9%, up from the original 4.5%. The growth rate is expected to accelerate to 5.3% in 2006 compared to the previous 5.1% projection, and it is likely to peak at 6.1% in 2007 as carmaker PSA Peugeot Citroen and KIA Motors start their productions. Among the macro economic figures the only data, that shows some deterioration is the current account. The rising gap is due to the growing foreign trade deficit, which can be attributed to the rising domestic consumption and the technology import. The growing external imbalance could be worrisome amid the rapidly firming Slovak currency, but the future outlook is bright. Even though the finance ministry has just raised its C/A deficit projection for 2005, (the gap is expected to increase to 3.8% compared to the previous 2.3% forecast) and the external balance might worsen in 2006, the figures are expected to improve rapidly from 2007 onwards. The current worsening is mainly due to technology import and it will improve the country's export performance in the future. The higher C/A data do not mean any problem, because the shortfall is fully covered by the FDI inflow.

An other important fact concerning the firming of the Slovak unit is the rise of the labour productivity. Real labour productivity in the industrial sector has risen by 7.5% y/y on average in the last two years. The productivity will continue rising rapidly, improving the competitiveness of the economy.

The third factor behind the firming of the Slovak crown could be the structural reforms carried out by the government in the past few years. The government successfully completed a tax reform, the reform of the social security system and the reform of the pension system is right underway. Despite the radical reform developments the political scene remained relatively stable, even though the government still has a minority in the parliament independent deputies support the reform process. The World Bank also appraised Slovakia, according to its report called Doing Business, Slovakia is the country with the biggest improvement in the business environment. Fitch international credit rating agency upgraded its rating to A- in September 2004, Standard & Poor's followed the move, and also upgraded its rating to A- in December 2004.

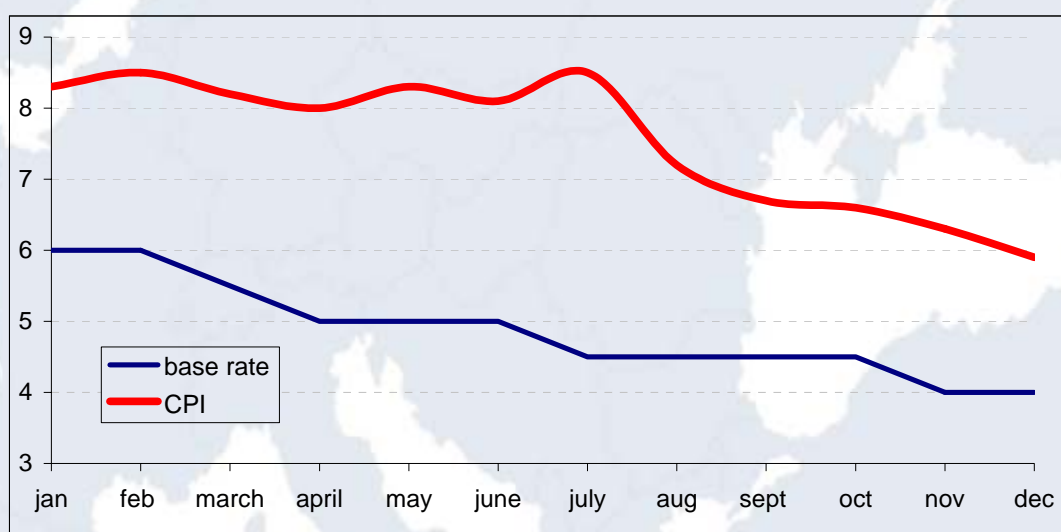
Despite the favourable macroeconomic and structural developments the Slovak Central Bank has claimed several times that the overwhelming firming of the crown was not in line with the fundamentals. The government and the NBS admitted that the currency should strengthen in the long run, but they added that the current pace of the firming was too fast. The Slovak story shows that the international capital flows can be problematic also for a country with strong, solid macro figures. The main concern of the central bank is that a possible overshooting could lead to increased volatility, and the larger swings of the exchange rate later on during the test period of ERM II could be fatal. Slovakia intends to join the ERM II in 2006, which would allow a euro adoption in 2008. The ERM II criteria means roughly that the participating

country's currency is not allowed to depreciate significantly beyond 2.25% below parity. There should not be any sign of pressure (no intervention and or significant interest rate differences) on the currency either during the two-year test period. In order to meet the ERM II criteria it seems reasonable for the participating countries to start the test period with a relatively undervalued currency, and let it appreciate later on to create a buffer against a possible abrupt easing.

NBS has used all of its available tools to slow down the appreciation. The central bank cut the base rate by 200 bp last year, but it had to realise that the monetary easing failed to deliver any success. The NBS resumed using direct FX interventions (the last time it used it was during the summer 2004), the central bank was estimated to be by 400-500 million euros in December. The bank stepped into the market when the EUR/SKK was testing the level of 38.500, and managed to keep the cross above 38.500 till the end of January. Central Bank board member Elena Kohutikova said that the bank was likely to carry on with FX interventions because it was not the interest rate spread that attracted the capital inflow to the country, but the expectations of future crown firming. Anyway the room for further rate cuts is quite limited.

Central Bank Vice Governor Martin Barto said earlier in January that the bank needs more information concerning the inflation developments to access possible room for rate slash. The bank left its 4.00% base rate unchanged on its January meeting, which was in line with the market concerns, however uncertainty increased following the surprise 25 bp cut in the Czech Republic. Current inflation trends look promising, but domestic demand is rising heavily, and the impact of the 200 bp slash has not emerged yet due to the longer transmission period. CPI dropped to 5.9% in December, and it was perfectly within the Central Bank's 5.5-7.0% target range.

Chart 5. Slovakian Base Rate and CPI in 2004



Source: Slovak National Bank

The disinflation has been going faster than expected mainly due to the declining food prices because of the strong retail competition. According the Statistical Office CPI is likely to be around 2.3% by end-2005 well below the central bank' 3.5% \pm 0.5% target. Inflation should slow down radically in the beginning of 2005, as the regulated price hikes last year provide a favourable base. The lower CPI could allow some further monetary easing, but the central bank has to be extremely cautious because it has just switched to an inflation targeting system, and can not risk credibility. The country has the most ambitious targets in the region, 2.5% and 2.0% for 2006 and 2007 respectively. It had been admitted that some nominal appreciation was needed to meet these targets, but it would be quite awkward to find the desired balance. Anyway the NBS still seems to concentrate more on the exchange rate than the inflation, and this is rather problematic in the framework of the IT.

By the end of January EUR/SKK broke through the level of 38.500 and headed towards 38.00. NBS remained silent for a while, but finally stepped into the market to defend the level of 38.00. The NBS also announced that it was going to hold regular weekly meetings on Tuesday to access the results of the repo tender. The bank already used this tool in 2004 against the firming by leaving some extra liquidity on the market. The effectiveness of this tool is quite doubtful, because the currency firming is rather boosted by the prospects of future currency gains instead of the high short term yields.

Central Bank Governor Ivan Sramko always said following the central bank actions, that the bank was satisfied with the results, though the efforts never proved to have long lasting effect. Crown will certainly strengthen further unless the regional sentiment changes abruptly. The pension reform, which has just started is likely to support the currency as well. Pension saving management companies have to invest 30% of the gained money in Slovak securities. Almost all of this money is going to be invested in government securities, because the Slovak stock market does not have sufficient liquidity. Slovakia is the most stable country in the region concerning the macro data, and the country is likely to be the first among the CE4 countries to join the euro zone.

KAZAKHSTAN: TENDENCIES IN THE ECONOMY, AND SECTORAL OVERVIEW

REGIONAL COOPERATION INITIATIVES IN CENTRAL ASIA

DEVELOPMENT OF THE MAIN ECONOMIC INDICATORS

During 2004 Kazakhstan, being an oil exporting country, benefited from the high oil prices in the world economy. The share of the oil economy, including associated services reached 25% of GDP, and 50% of exports. GDP growth remained strong: between January and September 2004 it reached 9.1%, compared to the same period in the previous year. The volume of industrial output also increased compared to 2003: between January and September 2004 it reached 2634 billion KZT, while it was only 1998 billion KZT in the same period of the previous year. A further increase is expected in industrial production in the last quarter. The growth rate of industrial production in the first nine months of 2004 was 10.3%, which was higher than the 7.8% growth rate observed in the same period of the previous year. Capital investments increased by 10.1% in the first nine months of 2003 reaching 730 million KZT, while from January to September of 2004 the increase was slightly lower, 10%, with the volume amounting to 920 billion KZT. The deficit of the budget amounted to 1.2% of GDP in the first nine months. Gross foreign debt reached 26,580 USD in September 2004. The CPI stood at 6.6% in June (compared to December of the previous year). As a result of the large revenues from oil exports, the Kazakh balance of trade has been positive in previous years. This is also true to the first nine months of 2004, when the foreign trade balance stood at 4952 million USD, while in the same period of 2003 it reached 3232 million USD.

In May 2004 Standard's and Poor's upgraded Kazakhstan's Foreign Currency Sovereign Credit Rating to investment grade/BBB-. FDI inflow has been picking up in recent years, reaching 9% of GDP on average. The main target of FDI inflows has been the oil sector, and resource extracting industries in general.

SECTORAL OVERVIEW OF THE KAZAKH ECONOMY

Besides the oil sector, two other sectors of the Kazakh economy have experienced significant growth in 2004. These sectors are retail and banking. The banking sector has been particularly successful, with some Kazakh banks expanding their activities beyond the borders of the country. Kazakh investors now control 50% of Kyrgyz banks. After Russia and Ukraine, Kazakh bank assets are the third largest in the CIS.

Some other sectors of the Kazakh economy are also developing gradually. This development is mainly fed by the income from oil revenues. It contributes to the expansion of housing construction, consumer services and restaurants. At the same time Kazakhstan relies on imports of several products, which could be produced

domestically, but the investments are lacking for the development of these activities. There are no incentives set by the government to draw foreign investors in the non-oil sector. At the same time the current Tax Code encourages investment in raw material extraction, instead of the development of the processing industry. The structure of the economy is asymmetric, with the extracting sector growing rapidly, and at the same time the processing sector staying behind. There are various disincentives for buying locally produced products, because foreigners buying from locals are indirectly forced to pay customs duties. However if they import the products from abroad, chances are that they receive significant tax privileges and preferences. In order to help local producers, changes are needed in this respect. Special emphasis has to be put on the development strategy for the local machine-building and petrochemical industry.

REGIONAL COOPERATION IN CENTRAL ASIA

Kazakhstan is the most developed of the Central Asian CIS countries. Therefore it can be expected that it will be the pulling force in a possible regional cooperation. A framework for cooperation already exists, in the form of the Central Asian Cooperation Organization (CACO). Member states of the organization are Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan, while from the end of May Russia has been participating as an observer. Kazakh trade with Kyrgyzstan, Uzbekistan, and Tajikistan has been strongly increasing in previous years, but the overall share of CACO member states in the foreign trade turnover of Kazakhstan still accounts for fewer than 3%.

Other regional cooperation initiatives in Central Asia are the Shanghai Cooperation Organization (SCO), the Central Asia Regional Economic Cooperation (CAREC-ADB), and the UN Special Programme for the Economies of Central Asia (SPECA).

The SCO was established in June 15th, 2001. It has six member countries, namely China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. The main aim of the SCO is to give a frame of cooperation in the case of external threats, and challenges to regional stability. It aims to solve the problems created by terrorism, extremism, and economic difficulties in the region.

The CAREC-ADB is an Asian Development Bank supported initiative that seeks to encourage economic cooperation among countries in Central Asia. Its member countries are China (focusing on Xinjiang Uigur Autonomous Region), Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. The main aims of the programme are to finance infrastructure projects and to improve the policy environment for promoting cross-border activities in the areas of transport, trade, and energy.

SPECA is a joint undertaking of the Central Asian countries (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan), the UN Economic

Commission for Europe (ECE), and the UN Economic and Social Commission for Asia and the Pacific (ESCAP). The main aim of the SPECA is mobilizing additional internal and external funds to solve the priority problems that can be solved efficiently by joint effort of the region's countries rather than at the level of one single country.

As we can see there are numerous initiatives for regional cooperation in Central Asia. However, in reality cooperation is much weaker than the number of organizations would suggest. According to Bakhtiyor Ergashev, initiator of an online discussion on Central Asian integration, there are a number of factors that are in the way of the integration process. Such factors are the different characteristics of the reforms in the countries in question, the noticeable distinctions in the national legislations, the different concepts of outward orientation, the distinction in the priorities and interests of the national elites, rivalry of the countries' leaders, and incompleteness of the interstate relations system. At the same time for the sake of the common interests (natural resources, new markets, increasing trade, common threats) the development of real cooperation between these countries is in the interest of them all. The building of real democracies instead of the currently operating, mostly authoritarian regimes would likely contribute to the region's economic integration.