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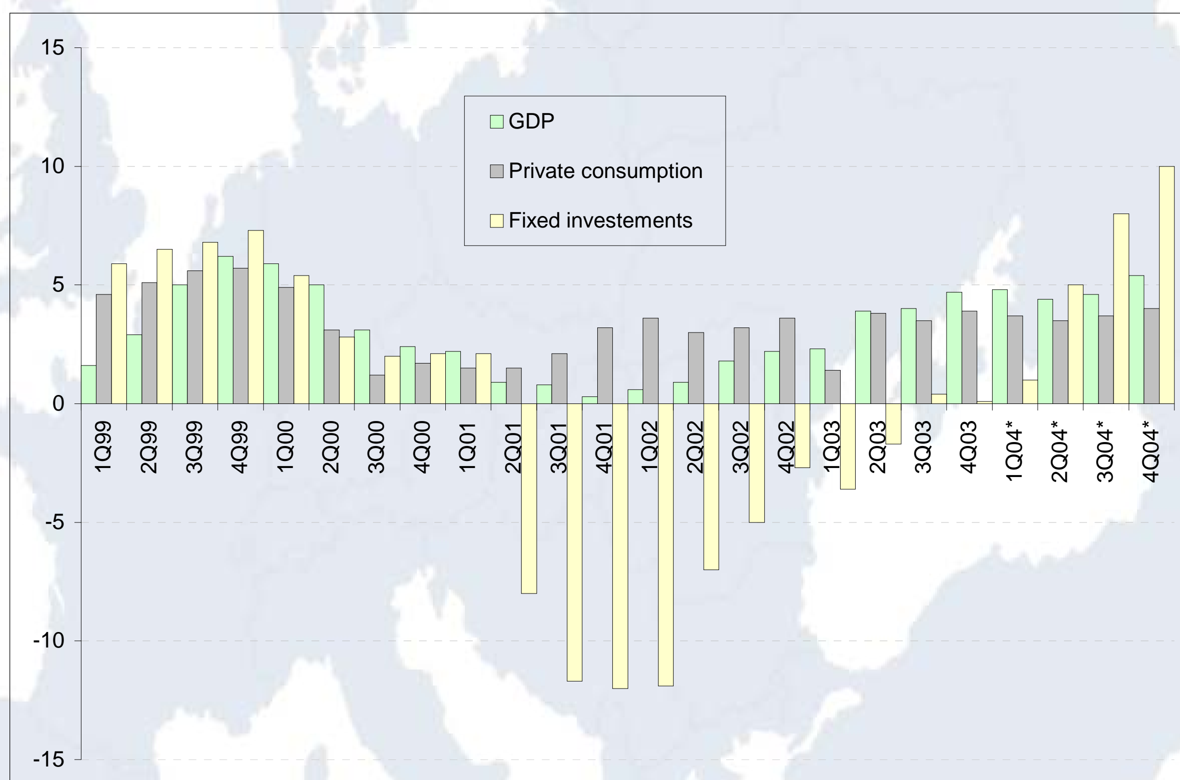
I. STRENGTHENING ECONOMY AND RISING INFLATION EXPECTATIONS IN POLAND

GDP growth is gaining momentum In the first quarter of 2004 the economic recovery continued in Poland. The foundation of the economy is becoming stronger. The Q3 2003 GDP growth rate was revised upwards to 4.7%. As a result of this, the overall GDP growth rate in 2003 also turned out to be more favorable than earlier expected, reaching 3.7%. During last year exports acted as the main driving force of the economy. The expansion of export-oriented branches was promoted by the slight economic improvement in EU countries and the extremely favorable Zloty exchange rate against the Euro. Strong consumption growth has been a contributing factor, as well. This is a result of increased social benefits and loans. It is important to note that wage pressure is still under control. In the second half of 2003 investment demand also picked up, although the situation is still far from ideal. In 2002 the year on year change in fixed investment was –5.8%, which improved in 2003 to –0.9%. The growth rate of fixed investments is expected to reach 7% in 2004, continuing the favorable upward trend. Domestic demand is still rising slower than aggregate GDP, which is positive for the economy's external imbalance. The growth rate of private consumption is expected to reach 4% by the last quarter of 2004. The corrected estimate for the overall GDP growth rate for 2004 is 4.8%.

GDP growth and its components (% YoY)



Source: GUS (Polish Official Statistics)

The year started with high dynamics of industrial output and retail sales. Industrial output growth reached 14.3%YoY in January. However, the results in the construction industry are still disappointing. All groups of construction companies are experiencing difficulties. Construction output fell 9.5%YoY in January. Retail sales were strong at the beginning of 2004, despite the downturn compared to the end of 2003, when changes in the tax system resulted in a strong increase in car sales. The enthusiasm lowered by January, when the growth rate of overall retail sales reached (the still strong rate of) 7.6%YoY, compared to 17.3%YoY in December 2003.

Unfortunately, the situation in the labor market has not improved yet. Despite the high rate of GDP growth (compared to the stagnation of the previous years), and the robust growth of retail sales, enterprises still do not hire more workers. The unemployment rate at the end of 2003 was 20%. In January 2004 the unemployment rate jumped to 20.6%, due to strong seasonal effects. By March it decreased again to 20.4%. This was partly caused by seasonal effects, and partly by an annual drop in the registered unemployment rate. At the end of 2004 an overall drop is expected, with the rate of unemployment reaching 19.2%.

Increasing inflationary expectations and new members in the MPC According to the statement of the National Bank of Poland „growth trends in the economy are clearly consolidating, and this will gradually increase inflationary pressure". In January this pressure was not yet observable on the CPI, which was lower than earlier expected, reaching 1.7%YoY. The factors contributing to inflation are still the ones on the supply side, notably high oil prices pushing up transport costs (increasing by 3.6%YoY in January), housing costs (2.6%YoY) and food prices (2.2%YoY). Controlled prices are also pushing the inflation upwards. PPI is also accelerating. The growth rate of producer prices reached 4.2%YoY in January. Poland's entry in the EU on the 1st of May fuels inflationary expectations, as well, because fears are arising concerning the possible price growth that the accession might bring. The Monetary Policy Council of the NBP again emphasized the danger that the current condition of public finances poses on the stabilization of inflation at a low level. At the same time there are a number of factors that still contribute to keeping the rate of inflation low. These are the continued moderate money supply level and the continued low growth rate of loans in the economy. Wage pressure still seems to be under control. After the acceleration of salary growth trends in December, the January statistics do not confirm a weakening of corporate salaries discipline.

Signs have been given by the MPC, that monetary easing might soon be halted, due to the increasing inflationary pressure. After the monetary policy strategy of gradual interest rate reduction in 2003, in February the MPC kept all interest rates unchanged. Therefore the reference rate remained at 5.25%. The MPC mentioned in its statement a possible „tightening bias" in interest rate moves in the future. However, such a move seems unlikely, and the statement of the MPC should only be taken as a warning, because at the current level of inflation a more restrictive monetary policy would pose

the danger of undershooting the inflation target. Therefore the MPC is likely to have mentioned the possible tightening of monetary policy in the future only for the purpose of increasing its credibility.

The three new MPC members appointed by President Kwasniewski (Dariusz Fillar, Andrzej Slawinski, and Andrzej Wojtyna) took office in February. The new members were positively perceived by the market. They are expected to support the opinions of the Governor of the NBP, Leszek Balcerowicz in the MPC.

Public finance reform The uncertainty about the public finance reform still prevails. It seems that the plans of the Minister of Economy, Labor and Social Policy, Jerzy Hausner have not been watered down. At the same time it is still not certain that it will get sufficient political support in the parliament. The Civic Platform (PO), whose support would be necessary to implement the proposed changes, refused to back Hausner's reform program fully. A positive political development is the SLD-UP's new coalition with the small FKP party, which increases the chances of pushing through the plan in the Lower House.

According to the new version of the Hausner Plan, between the years 2004 and 2007 total savings will amount to PLN54.4-54.6bn, instead of the earlier figure of PLN49.4bn. Most of the savings will be made in the social area, while a smaller proportion will be made in the administration. In the social area mostly reduced spending will contribute to the savings, while in the administration an increase in revenues will be the stronger contributing factor (67% of „savings" will come from higher revenues). A negative change in the Hausner Plan, compared to its earlier version is that according to it the obligatory contribution of businesses to the social security fund should increase.

Savings according to the Hausner Plan, PLN billions

	Savings in social area			Savings in administration area		
	Savings in spending	Increase in revenues	Total	Savings in spending	Increase in revenues	Total
2004	*0,07*		*0,87**	*0,11*		*0,11*
2005	*5,86*	*2,64*	*8,49*	*1,89*	*4,37*	*6,26*
2006	*9,89*	*3,04*	*12,93*	*2,26*	*4,58*	*6,84*
2007	*8,60*	*3,18*	*11,78*	*2,49*	*4,80*	*7,28*
Total	***24,41***	***8,86***	***34,08***	***6,75***	***13,74***	***20,49***

Includes PLN808m savings in system of support for disabled, which were already included in the 2004 Budget Act.
Source: Ministry of Economy, Labor and Social Policy

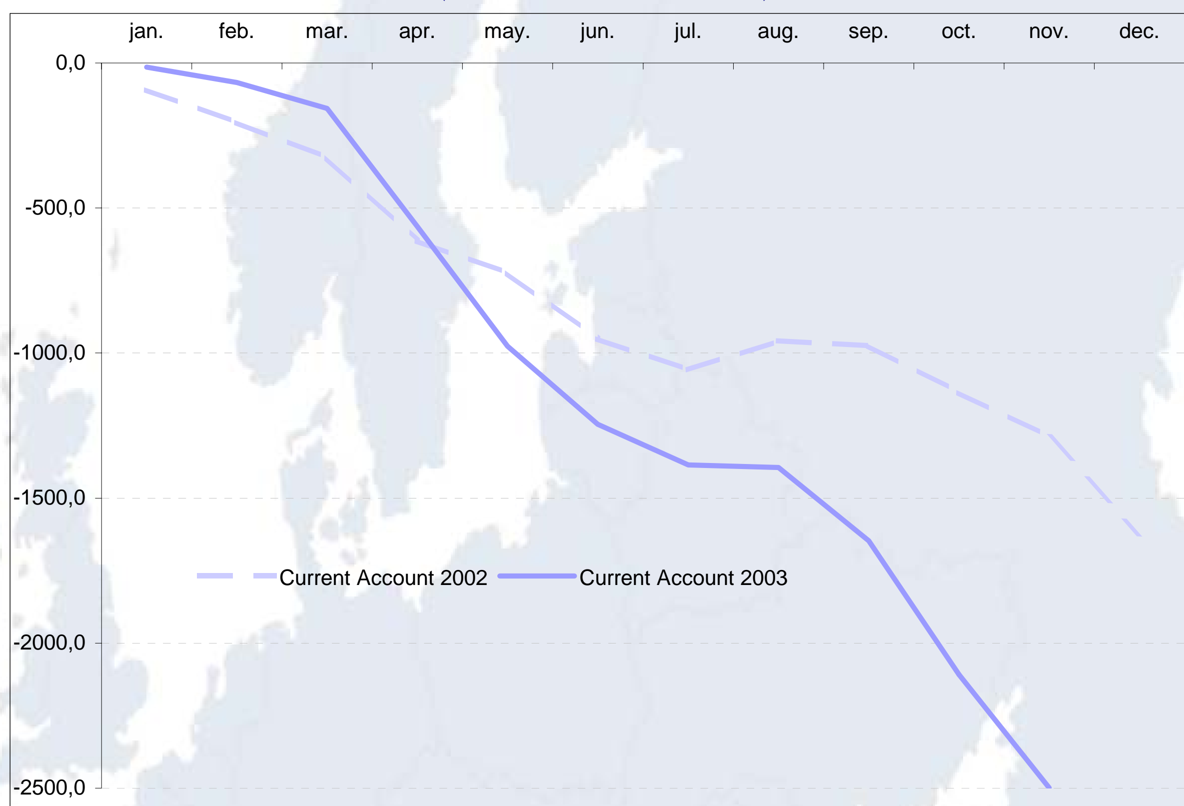
Prepared by: Veronika Czakó

II. Worsening trade balance and increasing current account deficit in Romania

Although the current account figures of December 2003 have not been released yet, it is obvious that the Romanian current account deficit increased significantly in last year. While the CA deficit recorded a relatively low level of EUR 1623 million in 2002 – or 3.5% of GDP –, the deficit was expected to be around EUR 2.9-3 billion last year. In the first 11 months the CA deficit reached the EUR 2.5 billion, mainly due to the worsening trade balance.

Current Account Deficit in Romania

(millions of EUR, 2002-2003)



Source: National Bank of Romania

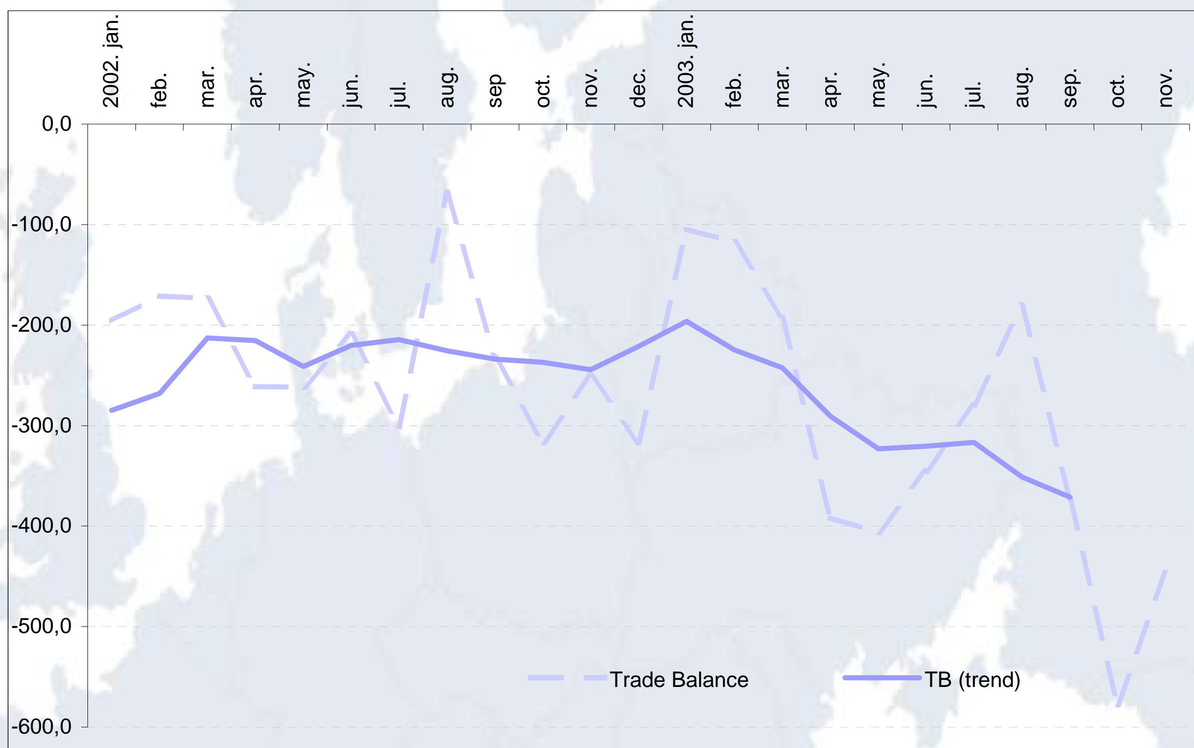
At the beginning of 2003, the figures of the current account did not reflect that the positive trend of the improving CA was close to the change. However, there were some signals which revealed that the trade balance could worsen. Firstly, the minimum wage was increased in January 2003, which generated extra private consumption. Considering the whole year, it is noticeable that the growth of household consumption increased even more and more. While in the first quarter of 2003, the consumption of households increased by a relatively moderate pace (3.8%), it accelerated to 6.4% in the third quarter of 2003. Thus, the total consumption increased by 6% in this period, due to the fact that the growth of public consumption remained on a low level (1%). Certainly, the higher level of consumption boosted the import side of the trade balance.

Secondly, the economic growth of trade partners of Romania remained low. Not only the economy of the European Union stagnated, but the economies of CEFTA partners also produced lower economic growth[1]. It meant that these countries' import demand could not boost the Romanian export. Thus, the export increased by only 7-8% in 2003 (in Euro terms), while it was one of the main engines of the economy last year when export grew by more than 20%. On the other hand, the growth of import greatly overpaced that of export, it increased by about 12%.

The structure of the export sector also had a negative impact on the trade balance. A large part – more than one third of total export – of the export is produced by the light industry, like clothes and textile industry, footwear, etc. The growth of foreign demand for these products was much lower than the growth of total export or some more modern sectors, like machinery or electric machinery[2].

Monthly Foreign Trade Deficit in Romania

(million Euro, 2002-2003)



Source: National Bank of Romania

The constant appreciation of the single European currency also had a negative impact on the trade balance. It increased the prices of import, which was fueled by

[1] The top ten trading (export) partners are: Italy (24.5%), Germany (16%), France (7%), UK (7%), Turkey (5%), USA (3.5%), Hungary (3.5%), Netherlands (3.5%), Austria (3%) and Greece (2.5%).

[2] In January-November 2003 period, the export of footwear increased by 3%, export of wearing apparel made of fabrics, knitted or crocheted, textile matters increased by 6.5%, while, the export of machinery and mechanical devices, electric machinery, appliances and equipments grew by almost 9%.

the high domestic consumption. At the same time, the positive effect of the weaker Romanian currency could not be exploited because of the weak foreign demand. Thus, the value of import increased while the growth of export could not keep the pace with it[3].

As it was mentioned, high growth of consumption was one of the main engines of the significant rise of import. The other main factor was the high increase of investments. In the first three quarters, investments increased by 7.1% in real terms, and investments are generally known as import–increasing factors. Furthermore, in case of transport equipments and means, investments increased by almost 10%, which reflects the investments' increasing impact on import. The above-mentioned factors are the reasons for the trade balance deficit of EUR 3.4 billion in the January-November 2003 period.

Besides the trade balance, the progress of the other components of the current account balance also had a negative impact on the CA balance. The surplus of the services balance declined from EUR 39 million to EUR 19 million in the first 11 months of 2002 and 2003, respectively. Moreover, the incomes balance had even larger negative impact on CA balance, the deficit of incomes increased by EUR 100 million.

Thus, the current account deficit is expected to reach EUR 2.9-3.0 billion or 5.8-6.0% of GDP. It means that the deficit is almost doubled last year, due to the worsened trade balance. In 2004, the decline of the households' consumption is required to decrease the CA deficit. Furthermore, public consumption also needs to remain tight in the year of the parliamentary election when governments are willing to ease the tightness of budget.

It is hard to forecast the 2004 CA deficit, because the negative trend has not stopped considering the latest CA figures. However, it is obvious that the deficit cannot be reduced to the level of 2002, but it is rather expectable that the 2004 deficit will be lower than that of last year. In fact, the economies of the most important trading partners of Romania are expected to increase their pace of economic growth, and it may help reducing the widened trade balance deficit. In addition, the National Bank of Romania (NBR) is committed to stop the high level of private consumption, and last year the NBR increased its reference rate by 300 b-points between April and December (in several steps), while the disinflation process continued. It can help reduce the high growth rate of private consumption. Thus, these are the reasons why we forecast that the current account deficit in 2004 may reduce to 5% of GDP.

Prepared by: Péter Bilek

[3] Between November 2002 and November 2003 the Romanian Leu depreciated against the Euro by 20% nominally, while the CPI was 14.5% in this period.

III. Attempts at reducing public deficits in Central and Eastern Europe

While in Hungary the debate on fiscal adjustment still goes on after the austerity measures introduced by the new minister of finance, in the Czech Republic, Poland and Slovakia the same issues are of current concern. Each country faces the problem of reducing the high public deficit and the increasing public debt. There are several similar developments that lead to the common problems and the way to solve them might be similar as well. The way out to be chosen by these countries could have short and long term effects on their competitiveness, capacity to attract FDI and their position in the new economic structure of the region after the accession.

Currently in Hungary constrains are placed on the expenditures of the central administration. Cutting down the operation costs of the public administration is necessary and will lead to lasting improvements, but the improvements are rather small as a whole. Although it has been a current issue for a long time, the reform of public administration - including the restructuring of revenues and expenditures of local governments and the establishment of a system of regions providing public services - seems to have been postponed. The same is true for the reform of the healthcare sector. There are no improvements in secondary and tertiary education either, although the system of education finances would need transformation. The reform of the social security and welfare transfer system is considered as a 'taboo topic'. Thus the reform of those distribution systems is stuck in Hungary that would most need the increase in the effectiveness of the service. Though the main aim of these reforms would not be the simple reduction of the overall level of government expenditures, the increased effectiveness and the transformation of financing systems would free up financial sources.

In Poland public deficit has increased in the last few years and no decrease is expected this year either. The deficit in Poland reached unexpected levels because there were tax cuts without cutting down expenditures at the same time. Together with the declining growth in the past few years and the slowing down of FDI inflow, this step has contributed to the increase of the deficit (in 2003 it was 5,3% of the GDP) and public debt. Public debt is nearly 60% in Poland, as well. This led to the sharp fall in the exchange rate of the Zloty. Almost at the same time when the Hungarian minister of finance was dismissed[4], the same happened to the Polish Treasury Minister. The reason for the discharge was the fact that privatization did not progress at the rate expected by the government. Accelerating privatization is an agenda item in Poland now.

The Polish government has realized the necessity of the constraints and the adjustment package that had been prepared by the Minister of Economy and Labour

[4] The official justification for the dismissal was the excessive deficit of 2003.

for three months was accepted at the end of January. Constraints in Poland are focused on public administration and social distribution systems. The government plans to save 20 billion PLZ by 2007 in the public administration (equal to approximately 1120 billion HUF), and 12 billion PLZ (672 billion HUF) in the social- and pension distribution. This package of austerity measures was approved by the Polish Parliament with a 1 billion cut. Based on this package the advanced pension system and new indexation will be introduced in the pension system. The problem of high unemployment is intended to be tackled by early retirements and the shift in the retirement age for women. In the summer of 2003 there was a plan to introduce a flat tax rate, but it was not carried out in the end. Protests from the society against the reforms were the strongest among trade unions, but pensioners and people receiving social benefits were against them as well. Political support of the government committed to carry out the reforms was low as well. However, the reforms were approved, otherwise the financing of government would have been exposed to danger. Standard&Poors has already downgraded Polish public debt.

In the Czech Republic the size of public deficit was even bigger than that of Poland (in 2003 the central public deficit was 6,9%, total public deficit was nearly 8%), though public debt was much lower (24%). Public debt in 2003 increased significantly and constraints planned for this year are expected to moderate the pace of the increase. Austerity measures include reducing social expenditures (for example shifting of the costs of the first two weeks of the sickness benefit), tax rise and pension reform. Based on that 115 billion CZK deficit is expected by the Czech government compared to the 132 billion last year. Meanwhile unemployment has significantly risen in the Czech Republic and it is not expected to fall this year, probably only in 2005. Similarly to the Polish situation, political support of the Czech government is not high either.

In Slovakia public finance reforms related to transition started later and macroeconomic conditions were worse than in the other three countries. However, as a result of the quick and extensive reforms conditions in Slovakia are improving much faster than in the neighbouring countries. While in 2002 public deficit in Slovakia was 7,2%, in 2003 it was reduced to 4,9%.

Slovak reforms are widely discussed nowadays. The most spectacular step was the transformation of the tax system: the introduction of a 19% flat rate in different types of taxes, that is in corporate tax, value added tax and income tax as well. Incomes under 80 thousand Krowns are tax-free. Child benefit has risen significantly, however a part of that can be realized by tax credit. Reforms of the healthcare system, education and the pension system took place last year. Financing of hospitals was transformed, the operation of the education system was taken over by local governments, and retirement age was fixed at the age of 62 for all. 50 % of pension contributions go to private pension funds, after 2005 career-starters have 18 months to decide whether they want to transfer the whole amount of their pension contributions. Incentives to invest in voluntary pension funds increased too. Pension

funds are obliged to invest half of the contributions in the domestic market. Unemployment and social security distribution systems have also changed. There was a change in the system of employment that raised unemployment, however productivity is constantly growing in Slovakia. Minimum wages became higher, real wages became lower. Standard of wages is still low in Slovakia compared to the other Visegrád countries. In public administration instead of the 79 district offices 250 new central administration offices were established. Besides having the required qualifications, leaders of these offices must have political support, so the system of public administration has not been completely transformed.

In Slovakia, there is resistance among parts of society affected by the reforms. The effects of the transformation of the tax system on the size of the distribution cannot be forecasted yet, some say that the flat rate system favours the richest ones and the differences between groups of society become bigger. Inflation is high (8 %), the prices of public services have gone very high since January. The price of gas increased by 31,6%, price of water-and sewage by 30%. The price of electricity went up last year. Due to the high inflation rate manufacturers and traders cannot shift the burden of the increase in value added tax and inflation at the same time, so a part of these costs must be carried by producers. Domestic consumption has considerably decreased.

As a result of the discontent of the Slovak society, advanced elections are expected in the country. At the same time, Slovak Krown is strengthening, investors' credit has grown and several foreign companies have decided to establish new settlements in Slovakia. Fitch has improved the rating of Slovak public debt (to BBB+), rewarding the efforts made to lower the twin deficit. Analysts hope that domestic investments will soon become the pulling power of the Slovak economy instead of exports.

Changes in Slovakia are wide-ranging, and the new tax structure may carry some risks for government finances. For example, in the beginning of this year public deficit rose quickly, partly due to tax changes, partly because of the people had carried out several purchases in advance as they have expected the price increases. The distribution effects of the reforms will become visible only after a longer period.

For all the examined countries, the main challenge is the introduction of the Euro. While the Baltic countries and Cyprus and Malta hope to become members of the Euro-area as early as 2008, the Czech and Polish decision makers do not plan entry in 2008. Since the European Union usually supports the common treatment of Central and Eastern European countries, the entry date of Hungary will also strongly depend on the Czech and Polish decisions. For entry it is not enough to temporarily fulfil the Maastricht criteria, but rather a sustainable functioning of government is needed that is continuously fulfilling them. It makes a difference, what choices governments make in reducing their deficits.

Prepared by: Anita Halász