ICEG EUROPEAN CENTER

NEWS OF THE MONTH
on EU-8 and CIS

April 2008

Budapest, Hungary, Phone: +36 1 248 1160, +36 1 248 1161 Fax: +36 1 319 0628
E-mail: office@icegec.hu Website: www.icegec.org

News of the Month, *on EU-8 and CIS*

The ICEG European Center issues its monthly publication, which includes 3-4 brief analyses dealing with underlying macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Countries of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and *Eight New Member States – EU-8* (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia).

Editor

Tamás Borkó, tborko@icegec.hu

Contact information

ICEG European Center, 6/B Dayka Gábor utca, Budapest, 1118 Hungary. Phone: (+36) 1 248 1160/108. E-mail: office@icegec.hu. Webpage: www.icegec.org

Disclaimer

Table of Contents

The effect of global slowdown on exports from the new EU members

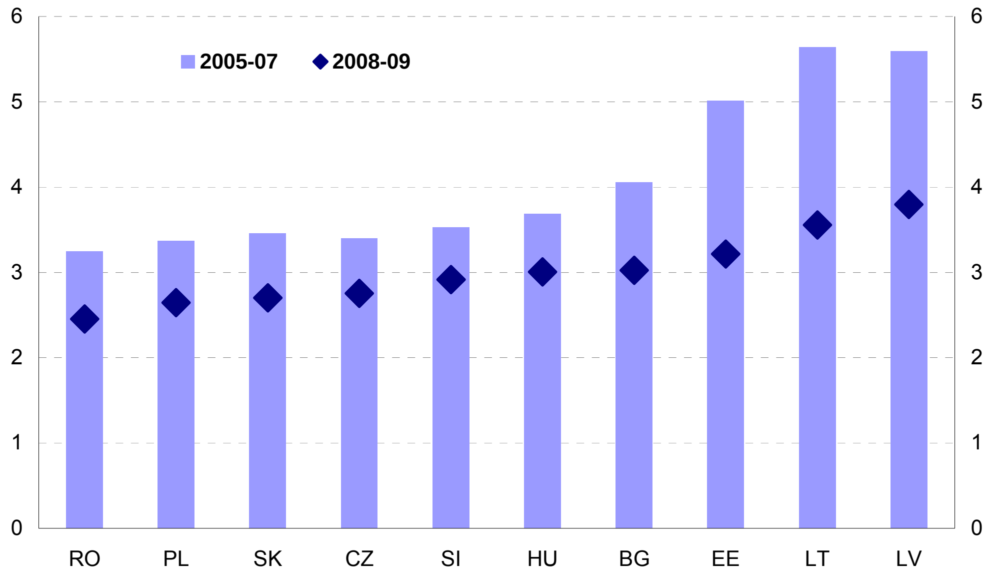
Gábor Pellényi

The new EU member states are small, open economies firmly integrated into the European economy. Trade has been an engine of their economic growth. That's why the ongoing global and European slowdown can have a large impact on their performance.

Decelerating export markets

A useful and simple method of analysing export prospects is to look at the growth of major export markets. For each new EU member the top 20 export destinations in 2007 were selected and their weighted average GDP growth rates were calculated for the 2005-07 and 2008-09 periods, using their 2007 export shares as weights. These top 20 destinations covered at least 90% of exports in 2007 from each new member state. GDP growth forecasts were taken from the most recently available ICEG EC, European Commission and IMF publications. The resulting figures give an indication of potential export growth if market shares remained stable.

Chart 1. Growth of main export destinations (%)



Note: weighted average GDP growth of top 20 export destinations in each country (covering at least 90% of exports in 2007).

Source: Eurostat for trade data, Eurostat and IMF for actual GDP growth figures, European Commission, ICEG EC and IMF for GDP growth forecasts.

Export markets are indeed slowing down in 2008-09, by around 0.7-0.8 percentage points (in other words, by a fifth) compared to 2005-07 (*Chart 1*). This is a significant, although not disastrous loss of pace. The slowdown is more pronounced in the Baltic countries, where it amounts to 1.8-2.1 percentage points, albeit from a higher base. Still, there are reasons to claim that the deceleration of export markets will not have a major impact on either domestic growth rates or on external balances.

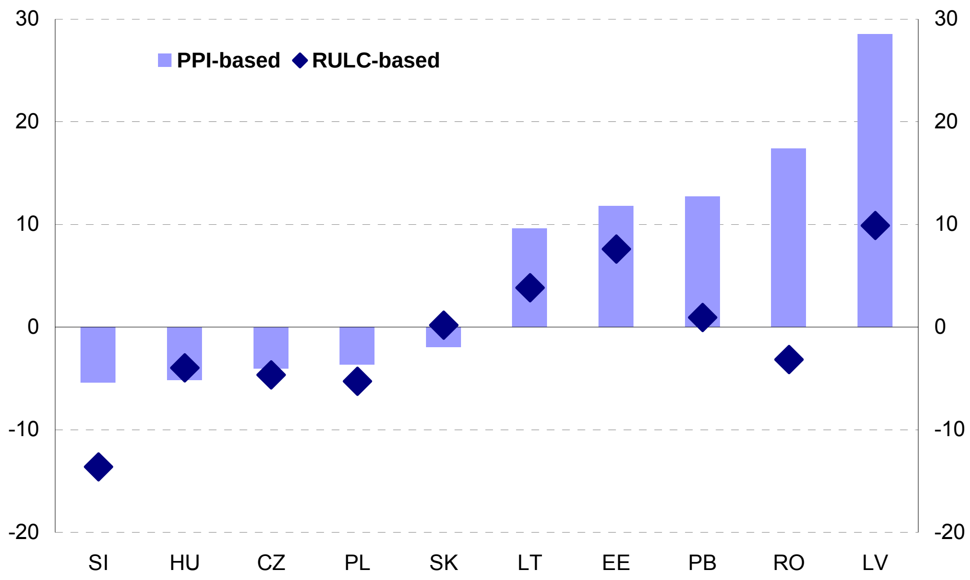
Mitigating factors

First, the European slowdown is itself moderate, and the region's exposure to more vulnerable economies (e.g. Spain, Ireland) is limited. Growth in Germany, a major destination for most new member states will come down by a half percentage point from 2005-07 to 2008-09 according to the European Commission; still, it will remain faster than in the years before 2006.

Second, new member states trade a lot among themselves. Between 2003 and 2007 exports from the region (except for Bulgaria and Romania) to the EU15 grew by 80%, while exports to other newly acceded countries rose by 165%. There is every reason to believe that this trend will continue. Domestic demand grows robustly in Central and Eastern Europe and geographical proximity will be conductive to further trade integration. In the Baltic States trade relations currently have a contagious effect: they are already highly integrated in terms of trade and import demand will dwindle in Estonia and Latvia in the near future. However, these countries export more than other new member states to Russia, Belarus and Ukraine who are expected to maintain high growth rates thanks to strong global demand for commodities.

Third, most countries in the region managed to gain market shares in Western Europe in recent years. This process is partly a consequence of relocation from the West to the new member states, and partly that of good price and cost competitiveness (*Chart 2*). Labour costs typically grew in line with productivity in recent years with the exception of the overheating Baltic economies while the growth of industrial prices has also been subdued.

Chart 2. Real exchange rate developments relative to the euro area, 2005-07 (%)



Source: Eurostat, European Commission

A long-term problem for the new member states is that technological upgrading proceeds slowly. The share of high- and medium high-tech and products within exports is generally below 50% and typically involves low local content and high import shares. Still, it is not obvious that commodity exporters should suffer in a period of high resource prices and strong demand from the developing world. Likewise, a high import share means that net exports – which statistically matter for GDP growth and the external balance – may not fall as much as (gross) exports do.

Exporters in the new member states must prepare for considerably weaker external demand. However, it is expected to have a moderate impact on macroeconomic performance. The evolution of growth and the external balance will rather depend on domestic factors in 2008-09.

Cooperation with other economic actors and company competitiveness in the EU-8

Magdolna Sass[1]

Various factors determine the level of and change in company competitiveness, among them various types of interactions between economic and non-economic actors. Among these latter, cooperation with local authorities, associations, institutions, agencies can play an important role from the point of view of companies.[2] The relevant literature concentrates mainly on the macro- or sectoral level, examination of company level data is hardly available. Company surveys can give important insights into the development of this cooperation. The survey of companies in four sectors (electronics, food, pharmaceutical and automotive), in three countries, carried out in the framework of a research project in 2004 are presented below.[3]

The role of local authorities in Hungary

Local authorities in Hungary handle investors and companies in many different ways. Some of them have a proactive approach, providing various incentives, institutions (e.g. industrial parks) in order to attract investments to their municipalities and to keep those, which are already there with the aim of creating and securing jobs. Differences in approaches are highlighted in the Bakács et al (2005).[4]

It is also important to note, that unlike other countries in the region, Hungary introduced local taxation, in the framework of which municipalities can levy a local industry tax on companies, among others. This highly criticised tax is paid on the turnover of the company (not on profit), thus it is detrimental to companies with lower local value added and higher value output. On the other hand, it is an important source of financing for certain municipalities.

While this is considered to be an important factor, reducing the attractiveness of the country in attracting foreign and local investment, this seems to be true only the electronics and automotive industries, while not playing an important role in the other two sectors. Around every third automotive or electronics companies indicated, that municipalities contributed to improving their competitiveness by reducing or abolishing the local tax.

In all sectors, expediting the necessary formalities is the first or second main area, where municipalities improved the competitiveness of a high number of companies. That may indicate the relatively high level of bureaucracy as a negative factor in the Hungarian business environment.

When ownership differences are taken into account, it is obvious, that reducing or abolishing the local tax is mainly the tool for attracting companies with foreign participation. That type of municipality support is much

[1] Senior research fellow of the Institute of World Economics Hungarian Academy of Sciences and the ICEG European Center

[2] Woodward, R., Yoruk, D. E., Bohata, M., Mesa, A. F., O'Donnell, M. , Sass, M. (2003), Critical synthesis, review of the main findings, methodologies and current thought on the role of foreign and domestic firms in changes in competitiveness. (Deliverable 1) Project title: Changes in Industrial Competitiveness as a Factor of Integration: Identifying Challenges of the Enlarged Single European Market. Work Package 6: Foreign and domestic firms as catalysts in changes in competitiveness. Contract no. HPSE-CT-2002-00148. Center for Social and Economic Research, Warsaw. Manuscript.

[3] Fifth Framework SERD-2002-00111; „Changes in Industrial Competitiveness as a Factor of Integration: Identifying Challenges of the Enlarged Single European Market" 6. Work package: Foreign and domestic firms as catalysts in changes in competitiveness in manufacturing.

[4] Bakács A., Czakó V., Sass M. (2005), Beszállítók és hálózatosodás: az Electrolux-Lehel Kft. példája. (Suppliers and networking: the case of Lehel-Electrolux) Külgazdaság, 7–8, pp. 44–59.

less important for domestically owned companies. Expediting necessary formalities at the municipalities has basically the same importance in both ownership groups.

It is also important to note, that foreign owned companies appreciate the help of municipalities in assisting them in negotiations with central authorities concerning incentives offered by these latter. This calls the attention to the uncoordinated nature of the FDI incentive regime in Hungary.

Perceptions on the role of local authorities

Table 1 helps to compare Hungarian results with those in the Czech Republic and Poland, obtained from the same project. Help from local government arrives in the other two countries in the form of abolition or reduction of local taxes, contrary to Hungary. While in Hungary and in the Czech Republic, the number of companies receiving any form of support from local governments is relatively high, this affects a much smaller number of companies in Poland. In the Czech Republic, an important form of support from local governments is the transfer of land for free or at a reduced price. In the Czech Republic and Hungary, local governments are relatively active in "lobbying" for investment incentives at the central authorities. The bureaucratic hurdle (expediting the necessary formalities) seems to be the most significant in Hungary.

Table 1. (Beneficial) support from local governments by country (% of companies)

	Czech Republic	Hungary	Poland
Reduction or abolition of local taxes	35.1	21.4	16.3
Reduction or waiver of rental fees	2.7	3.8	0.9
Assistance in negotiations with central authorities concerning tax incentives	10.8	10.8	2.2
Transfer of land for free or at a reduced price	18.9	4.4	1.3
Taking over burdensome property	0.0	3.1	5.3
Expediting the necessary formalities	8.1	26.3	7.9
Other form of help	10.5	1.9	8.4

Source: based on data in Woodward–Wójcik (2005)[5]

The role of NGOs and public institutions

From the point of view of company competitiveness, the role of various NGOs and public institutions is much more beneficial than that of local governments. Food and electronics companies appreciated the role of the chambers of commerce, and pharmaceutical and automotive companies underlined the positive role of industry associations. Besides these, the assessments of employers' associations in the automotive sector and local and regional business associations in the food sector were significantly positive.

Differences between the foreign owned and domestic owned companies are smaller. In both groups, the role of the chambers of commerce is evaluated positively. Moreover, domestically owned companies gave positive marks to industry associations, and foreign owned companies to embassies and industry associations and regional/local industry associations.

[5] Woodward, R., Wójcik, P. (2005), Networks and Competitiveness in foreign and domestic firms. Paper prepared in the Fifth Framework Programme project entitled „Changes in Industrial Competitiveness as a Factor of Integration: Identifying Challenges of the Enlarged Single European Market". HPSE-CT-2002-00148

Table 2. (Beneficial) support from various organisations by country (percentage of companies)

	Czech Republic	Hungary	Poland
Industry associations, organisations	67.2	18.6	32.2
Employers' associations	0.0	7.5	9.7
Local or regional industry associations, organisations	9.8	16.9	13.2
Local or regional development agencies	11.5	9.3	11.5
Enterprise incubators	0.0	0.0	0.0
Institutions providing loan guarantees	0.0	7.5	0.4
Chambers of commerce	6.6	30.4	14.1
Embassies	4.9	12.4	5.3
Other	1.7	0.0	4.4

Source: *based on data in Woodward–Wójcik (2005)*[6]

Differently from Hungary, Czech, and to a lesser extent, Polish industry associations are outstandingly active in providing support for their members, and this is evaluated positively from the side of the companies. In Hungary, chambers of commerce are taking that place, and local/regional industry associations are more active compared to the other two countries. While the share of foreign owned companies was similar in the three samples, in Hungary, embassies seem to be a more important source of information. Development agencies played a limited role in 2004 in all the three countries, in which respect there may have been a change in the last 2-3 years.

Conclusions

It is obvious, that on one hand, the role of local governments can influence the local business environment in many ways and in most cases effectively. On the other hand, their approach differs to a great extent in the three countries, reflecting mainly the characteristics of the economic policy of the central government.

It is important to note here, that according to that survey, bureaucracy at least at the local level, is one of the most hindering factors of the local business environment in Hungary. It is also important, that the role of various NGOs and public institutions is much more beneficial than that of local governments in the three analyzed countries. Reflecting the traditions, financial strength and networking of these institutions, their beneficial role varies in the analysed countries, though industrial associations (both central and local) and to a lesser extent, chambers of commerce play an important role in the three countries. The high share of companies getting beneficial support from these institutions calls the attention to the fact, that this type of (at least partly) self-organised and self-financing elements of the market economy are already in place and functioning relatively well in these countries. They seem to represent well the interests of local companies, and thus their invitation in the discussion of the planned changes in the regulatory system is advisable to all governments.

[6] Woodward, R. and Wójcik, P. (2005), Networks and Competitiveness in foreign and domestic firms. Paper prepared in the Fifth Framework Programme project entitled „Changes in Industrial Competitiveness as a Factor of Integration: Identifying Challenges of the Enlarged Single European Market". HPSE-CT-2002-00148

Slovakian silver medal in the rally for euro area membership

Gábor Kutasi

The European Commission recommended Slovakia for euro area membership in 7th of May 2008. Carrying-on is unambiguous: the European Council will accept the candidate, too. However, for this success, many social and political groups made their mostly unwanted sacrifice.

Antecedents

Slovakia went through a fundamental turn during the pre-accession period before the EU membership, in fiscal sense. Till 1998, the Mečiar-government's loyalty-focused policy completely undermined the fiscal discipline and sensitivity for inflationary pressure. It can do this easily, since Slovakia started as a low indebted transition country in 1992 that created large room for medium-term fiscal loosening. However, the Dzurinda-government gotten into power in 1998 determined completely new economic targets, what were based on the principal of fiscal balance and the prevalence of market rationality. Not only the quick EU-accession became a purpose, but also the introduction of the euro as soon as possible, which one's sense is to use the competitiveness and catching-up advantages of the Single European Market as broad as possible. Slovakia harvests the yield of this process.

Slovakia was able to use the advantage of late comer in public finance reform, as she could copy the completed scenarios of other countries. Meanwhile, to achieve catch-up in the improvement of the business environment, the option of gradual reform was off the table. Thus, but then the shock therapy lifted the national economy up the top countries in the CEE region, and Slovakian policy became a good practice for the neighbours reluctant in reforms. The second Dzurinda-government was able to improve the reforms even in a minority government situation when in 2004 coalition break up because of debates. At the same time, it must be admitted, that this government lost in the next election in 2006.

Inflation threats

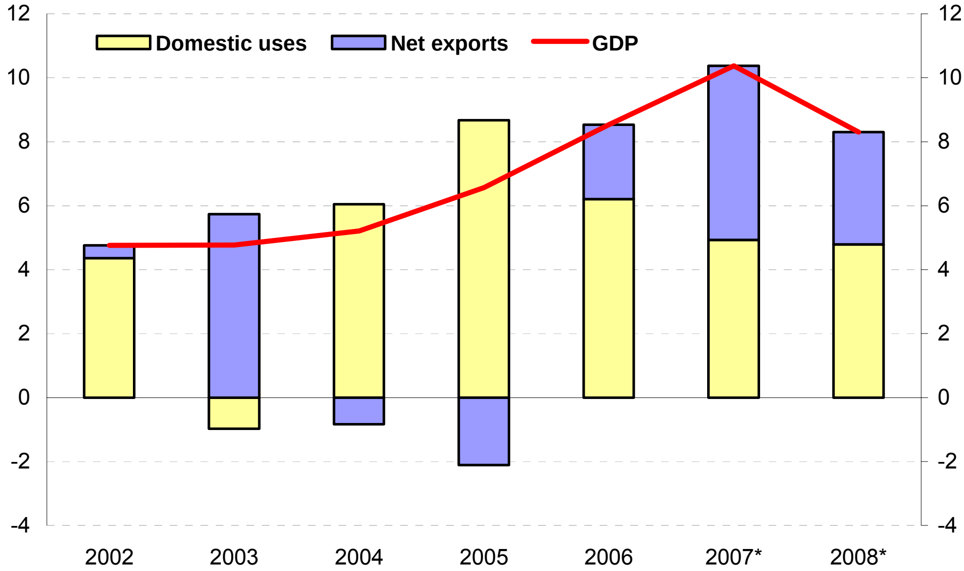
However, before the decision of the Commission, many forecasts were doubtful about the acceptance of the candidate for euro zone membership. Especially as the Fico-government – ruling since 2005 – revised particularly the structural changes of financial mechanisms in the public budget, what ruined the balanced budget and has caused higher inflationary pressure.

But besides, the increasing inflation has been particularly a result of increasing energy and food world market prices, what affected in the whole euro area as a reference point. The level of fiscal deficit itself makes no need to worry as it will not exceed the 3% GDP-ratio limit and the medium-term sustainability is still ensured.

Moreover, the economic catching-up of Slovakia contains also an additional inflationary threat. At the moment, the Slovakian development level is the 60% of the euro area average. During the economic growth, in the so called non-tradable sector, the growth of wages expected to exceed the improvement of productivity (it is indicated as Balassa-Samuelson effect). The higher inflation is a natural process during catching-up, but it is not sure, that there will be enough room for the Slovakian economy comparing to the reference limit of inflation.

The inflation difference between old and new member states raise the dilemma, whether involving a region with higher inflation level into the currency area, thus, increasing generally higher inflation level in the whole single currency region together with stricter monetary policy, or being more cautious with the enlargement of the monetary union, and keeping new member states out until the inflation threat from catching-up exists.

Chart 3. Slovakian growth and its components, 2002-2008 (%)



Source: Eurostat, ICEG EC forecast

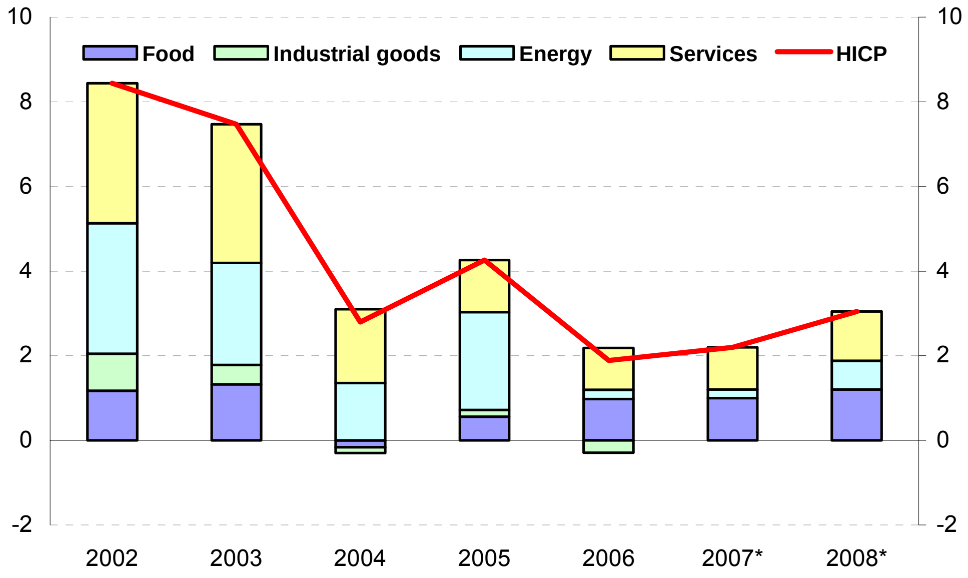
In the Slovakian case, the inflation in 2007 was relatively modest 2.2%, much below the reference value of 3.2%, while in the second quarter of 2008 it speeded up to 3.6%, and even this is the result beside an appreciating national currency what counterweight the world market inflation impacts. The European Central Bank (ECB) called the attention, also, on regulated energy prices, thus, the last year energy world market inflation could not completely show up in the Slovakian price. There is inflationary threat also in the Slovakian labour market. Wage increase is very dynamic, while the improvement of productivity is slowing down, as the less competitive and less productive work force is also got involved into the employment.

Short term expectations

The GDP growth remains high, what will strengthen the inflation pressure from catching-up process. Beside the inflationary pressure, Slovakia will face to such a monetary policy which will not be strict enough for the local price instability situation to improve it. So, just as in the Slovenian experience after 1.5 year euro zone membership, Slovakia should find another way to keep the price stability.

What instruments can be applied? The strong increase of wages will continue as the direct investments demand more labour and the wage convergence will quicken under GDP per capita convergence. Thus, the labour market channel will not be able to adjust the economy and to counterweight the inflationary pressure. In case of fiscal channel, short-term adjustment is very unlikely before a parliamentary election year, just to restrict the local and import consumption. In 2008 and 2009, there is a very good chance that the inflation will speed up. This might will decide, also, the above mentioned dilemma of the European Central Bank, and such experience will make the EMU to run a slower euro zone enlargement, what is bad news for the other new member states.

Chart 4. Slovakian inflation and its components



Source: Eurostat, ICEG EC forecast

Short-sighted politics

However, the short-term political considerations are not over yet. As it can be read from news, the politicians are running campaign for the strong exchange when Slovakian crown gets replaced with euro, with the accordance of a better purchasing value transformation of local savings. Meanwhile, they forgot, that this will also result higher value of wages and investment costs, and their level has played very important role in the dynamic economic growth. The EMU membership will harmonise the Slovakian and the EMU business cycle much more, what will raise the weight of euro zone in the Slovakian export and narrow the opportunities to exceed the growth of EMU productivity, thus, endanger the quick catch-up. Just to avoid the excessive inflation, the fiscal and income policy should be also restrictive, at once discipline the local demand.

So, there are harmful short-term political interests hiding behind the Slovakian success – just like the fiscal easing or the evaluated exchange rate – that will accumulate structural stresses and hamper many other eastern member states to achieve stable business environment, where the introduction of the single currency is just one of the possible useful outcomes.

Permanent problems associated with inflation in Slovenia

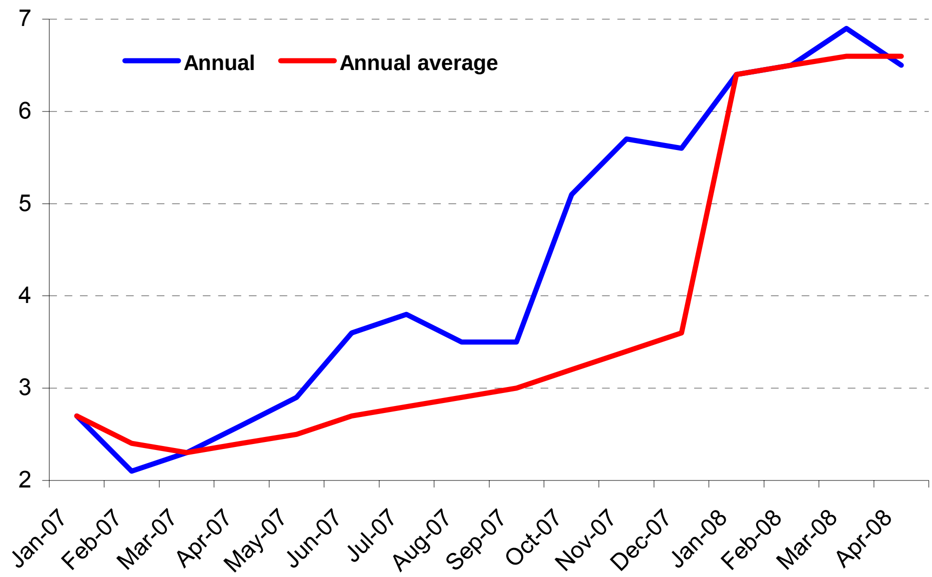
Ákos Réger

The relatively high year-on-year inflation rate seems to be the only serious existing problem of the Slovenian economy. Before the accession to the euro zone, Slovenia performed very well regarding the price level. By the time the country introduced the euro as national currency, the Maastricht criteria on inflation rate had been for years fulfilled. Previously[7] it was revealed what kind of market effects caused the high level of consumer prices. Now, a short summary is made if any alteration has happened in the consumer price index lately and the main components of the highest level of inflation rate in the euro area are pointed out. Thereafter, it is analysed why policy-makers are unable to curb this phenomena.

Statistical data

Whereas the annual inflation rate remained under 3% in the first half of the year 2007, since June 2007 a massive increase could be observed. So far, that has peaked in March 2008, when the year-on-year inflation rate was 6.9% which fell to 6.5% until April, however this short period cannot be appointed as a significant reversal.

Chart 5. CPI inflation (%)



Source: Statistical Office of the Republic of Slovenia

The majority expected a more important role of the rounding-up effect which was a straight consequence of the euro adoption. The rounding-up effect had only slight impact on consumer prices (approximately 0.3%). External prices and internal circumstances are much more influential. According to the data of the *Statistical Office of Slovenia*, the price of non-durable goods showed the most dynamic growth rate last year (8.8% y-o-y). Among non-durable consumption goods, fuels and energy (10.6%), foodstuffs (10.6%), catering services (10.1%) and housing & overheads – gas, water, electricity – (9.3%) have the most significant increases.

[7] News of the Month, November, 2007

Reasons of the high inflation

The Slovenian economy largely depends on the international environment. As a small open economy it has to adopt world market prices. The heavy rise of oil and food prices on the world market contributes to higher inflationary pressures on imported goods. Although it has non-disputable effects on inflation rate, the increasing oil and food prices themselves cannot play the most significant role. This disadvantageous phenomenon raises its head in other countries of the euro area too. The inflation in the single currency zone exceeded the maximum level in March (3.5% y-o-y[8]) which considerably lags behind that of Slovenia.

Although the EU as a whole has been experiencing higher food inflation, food prices in Slovenia have raised twice as much as in other member states. In the case of Slovenia, the increase of the world market prices is combined with inadequate domestic market conditions. On the retail market three international companies (Mercator, Spar, and Tuš) possess the leading position. They have an accumulated market share of over 80% in the domestic market. The lack of competition creates the opportunity to subject costumers to higher food prices. This is the first reason why Slovenia has to face higher inflation regarding to foodstuffs comparing to the other states in the euro zone.

Higher food and energy prices can contribute to higher Consumer Price Index (CPI) in East European countries than in West European ones: the consumer basket with which the CPI is measured includes higher proportion of foodstuffs and energy-related goods. Therefore, in Slovenia the CPI presumably shows higher changes in price in case of boost on food and energy prices on the world market.

Another significant internal aspect of the high inflation rate is the unreal high level of nominal wages. Nominal wages have been rising, while real GDP is sluggish. (*See Table*)

Table 3. Growth of domestic product and national income (%)

Year, quarter	**GDP growth**	**GNI growth**
2006, I	4.7	5.3
2006, II	6.4	4.8
2006, III	6.0	4.0
2006, IV	7.2	5.1
2007, I	6.3	5.4
2007, II	6.1	5.6
2007, III	5.1	5.8
2007, IV	5.4	6.7

Source: Statistical Office of the Republic of Slovenia

From July until December 2007, nominal income growth exceeded the rate of GDP growth. Inflationary pressures are generated in the economy if the productivity growth remains below the increase of salaries. On the one hand, companies have to pay more wages which induces higher production costs: if they intend not to lose profits, firms do have to raise the price of the products (cost-push inflation). On the other hand the increasing wages cause demand-pull inflation, too. In Slovenia the strong power of trade unions creates an additional barrier which hinders the decrease of unsustainable nominal income growth: the threats of employees do not allow the firms to take measures in favour of the economy to stop the raise of salaries.

[8] ECB Statistics

Inflation adjustment mechanisms

The relatively high price and wage levels are not only the consequences of present inflationary pressures and the composition of the consumer good basket. Inflationary expectations have the same or even more significant role concerning the evolution of the current inflation rate. If market stakeholders have rational expectations and they believe that the future inflation remains high, it is nearly impossible to keep down the inflation today. The only possibility to avoid the inflation circle is to announce a credible and accountable anti-inflationary economic policy.

Normally it is the assignment of the national central bank to pursue the anti-inflationary monetary policy (e. g. inflation targeting system). As Slovenia is the member of the euro area, the Slovenian Central Bank does not have the policy instruments to control the undesirable growth of price level. As the basic ECB interest rate is still remaining 3% (the ECB develops the monetary strategy based on the inflation rate of the euro area as a whole), it does not seem to be an effective instrument to deepen the Slovenian inflation.[9]

The possibility to break high inflation expectations solely depends on the fiscal policy. Although the budget deficit of the year 2007 has almost hit the state of equilibrium (0.1% to the GDP), parliamentary elections in October 2008 could bring inclinations to raise governmental expenditures. Latest results of opinion polls on party preferences show little difference between the governing Slovenian Democratic Party (SDS) and its main rival, the Social Democrats (SD). If SDS tries to convince the voters by raising governmental expenditures, the artificially accelerated economy would cause supplementary demand-pull inflationary pressures. Hence, the forthcoming elections hardly foster the implementation of anti-inflationary policy.

[9] See more: News of the Month, November, 2007