ICEG European Center

NEWS OF THE MONTH NR. 4

VIEWS ON THE REGION

A Report by the ICEG European Center

© ICEG European Center

April 2002

TABLE OF CONTENTS

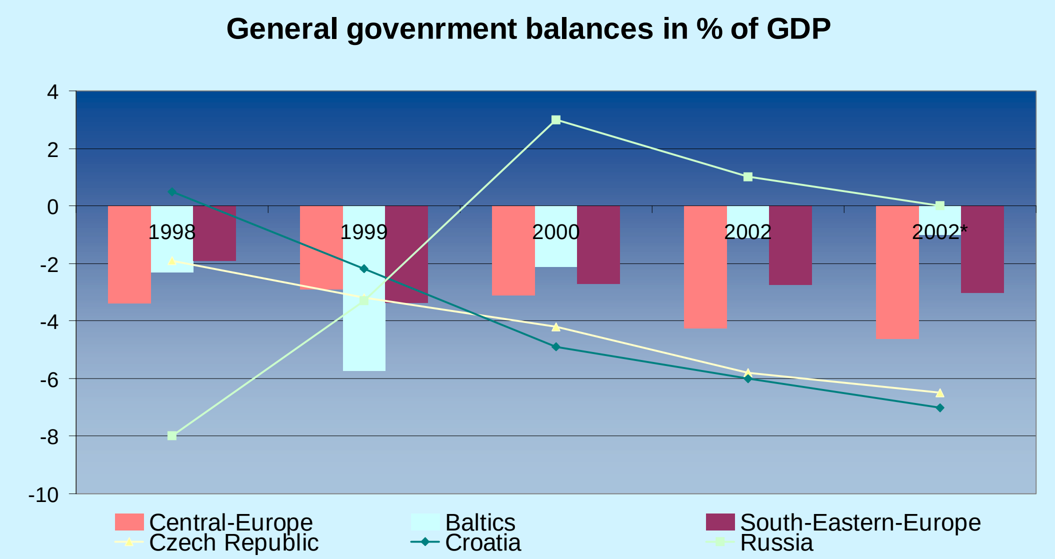
News of the Month represents brief analyses prepared by the ICEG European Center on the latest macroeconomic developments in Eastern Europe. The analyses are published once in a month and assess some of the major news, developments in the region that occurred in the previous month.

1. CENTRAL-EUROPE: INCREASING FISCAL TENSIONS

Prior to the current worsening the balance of the general government in most of central European economies improved considerably in 1999-2000. This was caused by the positive cyclical effect of rapid growth based on the expansion of exports and increasingly domestic demand. Fiscal balances were favorably affected by gradual acceleration of economic growth in the Czech Republic, by higher than expected inflation in Poland and Hungary, which generated additional revenues and contributed to the improvement of primary balances. The second factor that improved balances were the adjustment programs implemented after the Russian and Brazilian crises with the aim of reducing the pressures on local currencies and financial vulnerability.

These favorable trends were reversed in 2001, as balances started to worsen except the Baltic states and the South-Eastern European economies, though in the latter improvements in Bulgaria and Romania were mainly caused by temporary one-off factors. The worsening of fiscal balances meant in some cases the reduction of the earlier accumulated significant surpluses (Russia), while in other cases the sizeable increase of fiscal effects (Czech Republic, Poland and Slovakia). This trend is expected to continue in 2002: average general government deficit is expected to reach in the five Central European economies 4,6.% of GDP, and in some cases it may reach critical levels, especially if the balance is accounted according to international standards.

Chart 1.



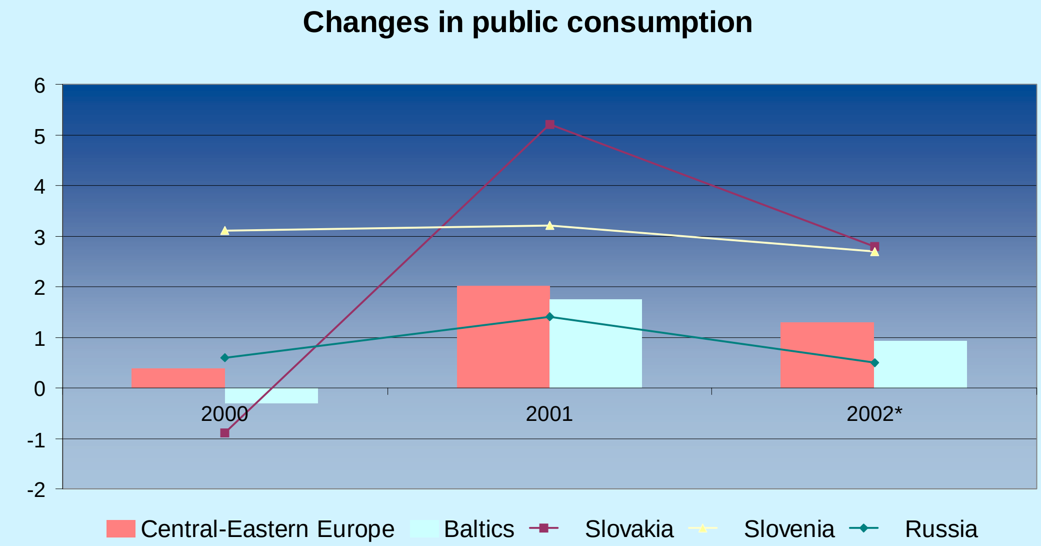
While there are several country specific factors behind the worsening of fiscal imbalances, the presence of several general ones may be determined.

First, the cyclical effects have a very strong impact on primary balances: economic slow-down and the negative effect of exogenous shocks can be observed from the lower than expected growth of tax revenues. While the slow-down in the region is smaller than in other emerging economies, the negative cyclical effect is especially strong in those countries, where growth rates declined above the regional averages (Russia or Poland).

The slow-down in growth rates coincides with a rapid decline of average inflation rates and their dispersion between the countries, which also has a short-term negative impact on primary revenues and balances, thanks to the slower than planned growth of nominal GDP amidst unchanged revenue centralization. The fiscal costs of disinflation are especially strong in economies, where the decline in inflation was recently spectacular: in Poland, Slovakia, and Bulgaria.

Besides cyclical factors worsening fiscal balances are due also to policy related factors, which reflect the counter-cyclical fiscal policies applied by the governments to weaken the growth effect of negative exogenous shocks. Governments increased their spending to balance the negative effects of declining net exports and slowly increasing (Hungary and Czech Republic) or declining (Poland) private investments. After declining for some years, real public consumption grew in most of economies and the reversals in certain cases have been significant.

Chart 2.



Looser fiscal policies have been stimulated in many countries by the political cycle as well as all major central European economies faced or face elections in late 2001 and during 2002. The loosening of fiscal policies is clearly visible from the increased central and general government deficits, to which the decline of revenues and increases of primary expenditures contributed to equal extent.

The impact of structural reforms has been the last major contributing factor to the recorded worsening of fiscal balances. These structural reforms, implemented both in the corporate and banking sectors, have increased financial discipline, and accelerated restructuring, but have sizeable short-term fiscal costs. In the Czech Republic and Slovakia, fiscal balances were worsened as the governments assumed the costs of banking sector consolidation and restructuring of the non-performing banking loans after the privatization of major commercial banks. In Poland and Bulgaria fiscal balances worsened due to the accelerated restructuring in the corporate sector, which was stimulated by the inflow of foreign direct investments, and associated downsizing of inefficient enterprises.

The longer term effect of these reforms is positive, but in the short-term they lead to increased fiscal expenditures devoted to finance the rehabilitation of the corporate and banking sectors, increase of unemployment and pension expenditures. In some cases these expenditures have also contributed to the growth of public debt as they were financed by below-the line items: the growth of public debt in Croatia, the Czech Republic and Slovakia was partly due to this factor. While these expenditures are partly related to the progressive restructuring-privatization and capital inflows, which provide the revenues for governments, one may expect a general deceleration of privatization related capital inflows and associated fiscal revenues, which calls for fiscal adjustment.

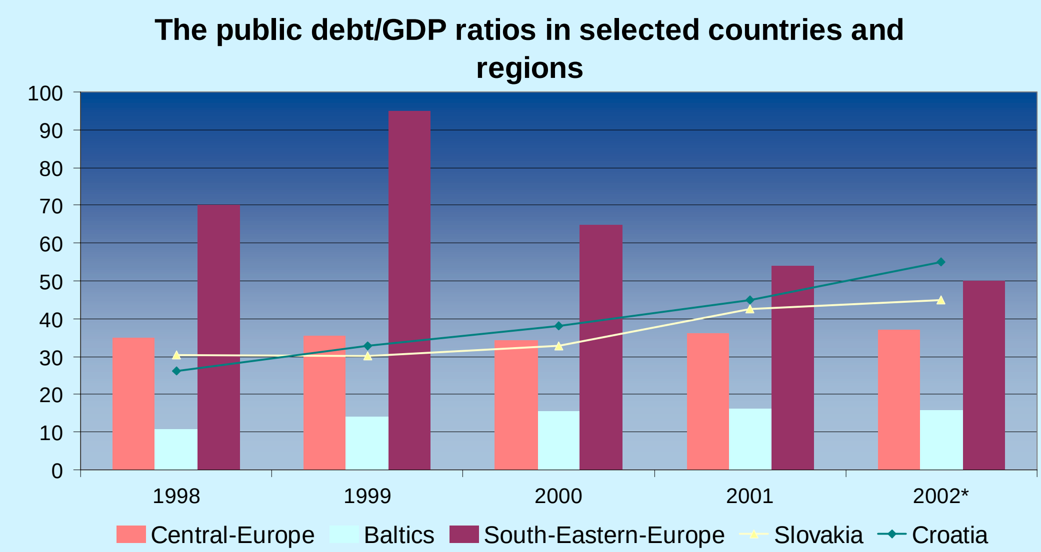
What have been the consequences of the loosening fiscal policies and increasing general government deficits? First, their macroeconomic effects in general have mainly been negative. While in the short-term increased fiscal spending was able to mitigate the negative growth effects of declining net exports, this effect remained modest, while the medium terms costs of fiscal expansion on growth may be significant. Fiscal expansion contributes to the growth of interest sensitive capital flows, and accelerates the ongoing appreciation of local currencies. Besides that fiscal expansion may crowd out some private investments in those economies, where private consumption and investments are highly interest sensitive. Another unfavorable effect of fiscal expansion is that while its contribution to growth is insignificant it has in many economies increased current account deficits.

Second, and closely related to the aforementioned effects fiscal expansion resulted in shift of in policy mix as looser fiscal policies were followed by much stricter monetary ones. Central banks were forced to follow monetary policies resulting in increased real interest rates in order to weaken the negative effect of fiscal loosening on disinflation (Poland), or on current account deficits (Czech Republic, Croatia, Slovakia). Loose fiscal and strict monetary policies represent a very bad policy mix as they increase the costs of disinflation, have negative growth effects through increasing interest rates and appreciation, and weaken the credibility of policies.

Third, in pre-accession economies the recent worsening of fiscal balances is unwelcome as they should show increased flexibility in their fiscal policies to be able to absorb the accession related expenditures, which is disallowed by growing deficits. Moreover, fiscal policies are affected by the future EMU membership too, as they should progressively reduce their fiscal imbalances to the levels permitted by the Maastricht criteria. But the recent increase in deficits and the structural and institutional reasons behind it make it increasingly difficult to achieve a sizeable reduction of fiscal imbalances, required by the membership in a monetary union. This adjustment should however be achieved in a period , when some of the economies will experience the decline of privatization-related and capital revenues, or when the growth and cyclical effects are less favorable than they were in the past.

Simultaneously with the sometimes significant increase of fiscal deficits, public debt levels evolve much more favorably in transition economies. Compared to the advanced and numerous middle income economies public debt levels are small: while the average public debt/GDP ratio in the Euro-zone was 57,5% in 2001, the same figure was 36,1% for the central European pre-accession and only 16,2% for the Baltic pre-accession economies. Besides their low level one may observe some decline of dispersion of public debt levels between transition economies.

Chart 3.



Where public debt level shave been high in some cases unmanageable and unsustainable there has been a significant decline in recent years. In Poland and Hungary the decline was mainly due to the fiscal adjustment, based on primary surpluses and the use of privatization revenues for debt reduction. In Bulgaria and Russia the reduction of high debt levels was caused by their restructuring after the currency and debt crisis of 1997 and 1998, which was followed by rapid increase of output. Thanks to favorable primary balances and rapid income growth, public debt/GDP ratio in all economies declined below 60% and this trend is to continue further in 2001-2002.

There is however another group of economies, where public debt/GDP ratios were low in mid 1990s, but afterwards have increased very rapidly. The growth was partly caused by the mixture of high fiscal deficits and low economic growth, which affected the build-up of public debt through unfavorable primary balance and increasing interest expenditures (Slovakia prior 1999 and Croatia). Another reason of the growing public debt levels was related to the accumulation of non-deficit debt items linked to the consolidation and restructuring of the banking and corporate sectors.

While in some cases these expenditures were accounted as above the line items, the level of the problems and the application of prudential accounting rules led to the increase of public debt levels, mainly in the Czech Republic, Slovakia and Croatia. In Slovakia and Croatia the speed of growth ahs been alarming as public debt more than doubled in a relatively short period of time between 1996 and 1999.

2. THE LONG EXPECTED INTEREST RATE CUT IN POLAND

On April 25th the National Bank of Poland's Monetary Policy Committee (RPP) cut a key interest rate by 50 basis points to 9,5%. The last interest rate cut was in January, when the RPP cut interest rates by 150 basis points bringing the refinancing rate down to 10 percent from a 19 percent peak. There has been an ongoing tension in Poland between the fiscal and monetary policy. The non-optimal policy mix means, that the tight monetary policy is supposed to counterbalance the overly lax fiscal policy.

Despite falling inflation, weak domestic demand, low investment and rising unemployment (see News of the Month-March) the RPP has resisted repeated government calls for interest rates reductions. Since its inception, the RPP has always resisted political pressure with regard to inflation, and made its decisions on rate cuts conditional on both the current and future state of the economy. This was a sort of demonstration of its independence, which is an absolute requirement for the entry into the European Union. Politicians have repeatedly tried to change the RPP's line-up, hoping that this will make it more willing to bend to their demands. Opponents of the restrictive monetary policy argue that the exaggerated battle against inflation has contributed to slower rates of economic growth. But Marek Dabrowski from Center for Social and Economic Research (CASE), said that consistent disinflation should continue because low inflation helps economic growth. Finance Minister Marek Belka claimed that inflation would fall even with a relaxed monetary policy and he also emphasized that the government expects reduction in key interest rates by 300 basis points in this year.

In September 1998, the Monetary Policy Council adopted a Medium-Term Monetary Policy Strategy for 1999-2003. In this it declared that the strategic monetary policy target was to bring down inflation, as measured by the CPI, below 4% by the end of 2003. In working towards this, the RPP will seek to attain an inflation target of 5% (year on year consumer price growth) at the end of 2002. The council has set a permissible bandwidth around this target of plus-minus one percentage point. The experience gathered so far in implementing the Medium-Term Strategy indicates that inflation can be strongly influenced in the short term by temporary supply shocks. It is for this reason that the RPP emphasized that the strategic monetary policy target has priority over the target for 2002. The central bank's goal is to cut inflation from a moderate to low level, which is probably the most difficult task. The RPP draws attention that attaining an inflation target will signify a relatively small reduction in price growth over the period to end 2002. According to the council, the period should see steady inflation and a more durable adjustment of inflation expectations to the level of actual price increase.

There were already growing expectations among the analysts in March for an interest rate cut, but finally the RPP decided not to change, and maintained its neutral position. The RPP acted so in spite the already relatively low level of inflation in March. The CPI fell to a record low of 3,3%. Core inflation measures declined further, indicating that lower inflation does not only result from favorable temporary prices. The real interest rates were high, industrial output fell by 3,2% in March, which indicated the lack of inflationary pressures. The stabilization of the expectations of both bank analysts and individuals was good news for future inflation. What could have made the RPP not to change the interest rates?

The main reason was that the full results of interest rate cut by 9 percent points in total since February 2001 to January 2002 have not been revealed yet. There was also a suggestion that the country's year long easing cycle was coming to an end with the economy on the verge of recovery, which might stimulate inflation. The outlook of economic situation improved world-wide, which was favorable for the Polish exporters and the economic growth. The other worrisome thing was the drop of the dynamics of deposits in March and the increase of the dynamics of cash in circulation that maintained high pace of money supply growth.

The hopes that the RPP will reduce interest rates in April have risen markedly on the financial markets, triggering a drop in T-bill yields and a strengthening of the Zloty. The reduced offer from the Ministry of Finance compared to March also contributed to a sharp increase in prices and a drop of the yield on the primary market. Bond yields were strongly affected by the auction of the first 20-year bond of Poland's financial market-record demand and limited supply reduced its yield to the lowest level that analysts had expected (7,2%). The Ministry had 13-, 26- and 52-week bills worth a total of PZL 2,7 bn on offer at its three April tenders compared to the PZL 6,1 billion available in March. Demand reached PZL 8,7 billion, 3,2 times outstripping the supply. The last time yields fell this far was in January, when debt securities market discounted the cut in basic interest rates that ultimately took place at the end of January. Despite the strong expectations of a rate cut, the WIBOR rates in April remained horizontal with no serious fluctuations. The only slight drop was immediately before the meeting of the RPP, reflecting the expectations.

April saw strong gains in the value of Zloty. The main reason for the increase in the value of the Polish currency was the inflow of foreign portfolio investment on the debt securities market in connection with the expected reduction in the base interest rates. Fundamental factors like the clear drop in inflation were also in the Zloty's favor in April.

Data regarding external conditions in April indicated more clearly than a month ago that the boom in world economy began. The other concern was the growing political risk in the Middle East and Venezuela, which made the oil prices rise on the world market.

Signals coming from the Polish economy were not explicit. Some data indicated that a gradual economic boom should start. There is a strengthening tendency of the growth of retail sales and the consumer loans dynamics also rose. On the other hand the industrial output and the construction and assembling production was lower in March this year than a year before.

The difficult situation on the labor market was maintained that should reduce the wage pressure. Within the period January-March this year, average gross wages in the enterprise sector were by 5,3% higher than in the same period last year and the real increase amounted to 1,8%. (as compared to the increase by 5,7% in nominal terms and 2,2% in real terms in January-February of this year) Based on the March data there is an assumption that the income at disposal in the first quarter 2002 can be smaller in real terms.

The public sector deficit has not changed too much: it will reach in 2002 very high levels (approximately 5% of the GDP). With high deficit and small revenues from privatization the government has to issue considerable amounts of government securities to finance public sector borrowing requirements. In the first quarter 2002 the total of new issues of Treasury bills amounted to PZL 6,7 billion and PZL 12 billion of Treasury bonds, which means a 116,1% growth compared to the same period in last year in the first case and a 128,7% in the later. This situation contributes to the maintenance of a high level of long-term market interest rates and limits the possibilities to finance the development of enterprises. Moreover, the inflow of foreign portfolio capital invested in government bonds affects the exchange rate of Zloty: its appreciation comes without advances in the competitiveness of exporters.

As compared with the previous month, the scale of threats to future inflation from monetary factors decreased in April. The annualized growth of money supply (M3) lowered from 7,2% in February to 3,1 % in March. The annualized dynamics of cash in circulation dropped as well, and the growth rate of lending to businesses on the twelve-month scale lowered from 4,4% a month before to 2%. At the same time the decline of deposits continued, moreover March was the second month in a row when, annualized dynamics of loans to individuals increased. The last thing concerning interest rates and money supply is that the banks made further cuts of interest rates on loans in reaction to the interest rate cut by RPP in January. With the simultaneous maintenance of interest rates on deposits this meant a reduction in commercial bank's margins.

The annualized consumer price index in March amounted to 3,3%, which was by 0,2 percentage points less than a month ago. The role of temporary factors in the drop of inflation became weaker, the evidence for that was that core inflation measures lowered with net inflation ones the most. Net inflation (excluding foods and fuel prices) fell from 4,7% to 4,1%. Inflation excluding the most variable and the fuel prices fell from 3,3% to 2,9%. Prices of industrial processing were lower than a year before, but there is a significant increase of energy, natural gas and water (by 6,4%) as well as mining (by 5,2%) prices. These are the sections where the wage is the highest in the enterprise sector. It results from the fact that in these sections state ownership dominates and there is a lack of competition and enterprises easily shift their growing costs on the clients.

Table 1.

Price indices of consumer goods and services in March 2002

Specification		March 2002		Jan.-March 2002
	Dec. 2001= =100	*March 2001= =100*	*Feb. 2002= =100*	*Jan.-March 2001=100*
Total	**101.2**	**103.3**	**100.2**	**103.4**
of which:				
Food, non-alcoholic and alcoholic beverages, tobacco	101.6	102.6	100.4	102.6
Food and non-alcoholic beverages	101.7	102.2	100.4	102.2
Alcoholic beverages, tobacco	100.8	104.2	100.4	104.5
Clothing and footwear	98.6	99.5	99.7	99.7
Dwelling	101.6	105.7	100.1	106.6
Housing, water, electricity, gas and other fuels	101.9	106.4	100.1	107.6
of which electricity, gas and other fuels	100.4	106.2	36373	107.9
Furnishings, household equipment and routine maintenance of the house	100.5	102.5	100.1	102.7
Transport	101.2	36373	100.6	35886
of which fuels for personal transport equipment	100.3	35096	101.0	34029

Considering all these facts and arguments the Monetary Policy Council (RPP) decided at its meeting on April 24-25, 2002 to:

- Cut minimum yield on 28-day open market operations from 10% to 9,5%;
- Cut the rediscount rate from 12% to 11%;
- Cut the Lombard rate from 13,5% to 12,5%;
- Maintain the deposit rate on the same level (6,5%).

Within the next months a further drop of CPI is probable. The lowest level should be reached in May. In the remaining part of the year a gradual increase of the CPI is forecasted that will result from inter alia, the rise of controlled prices. In April the percentage of individuals who expect the prices to grow slower than now increased (by 0,5 percentage point), or that they will be maintained on the existing level (by 2,3 percentage points).

The number of people in the remaining groups decreased, including the most pessimistic who expect that prices will grow faster than so far (by 0,8 percentage points). The inflation rate expected by bank analysts in the 11 month horizon lowered by 0,2 percentage point (to 4,4%) as compared to the situation a month before

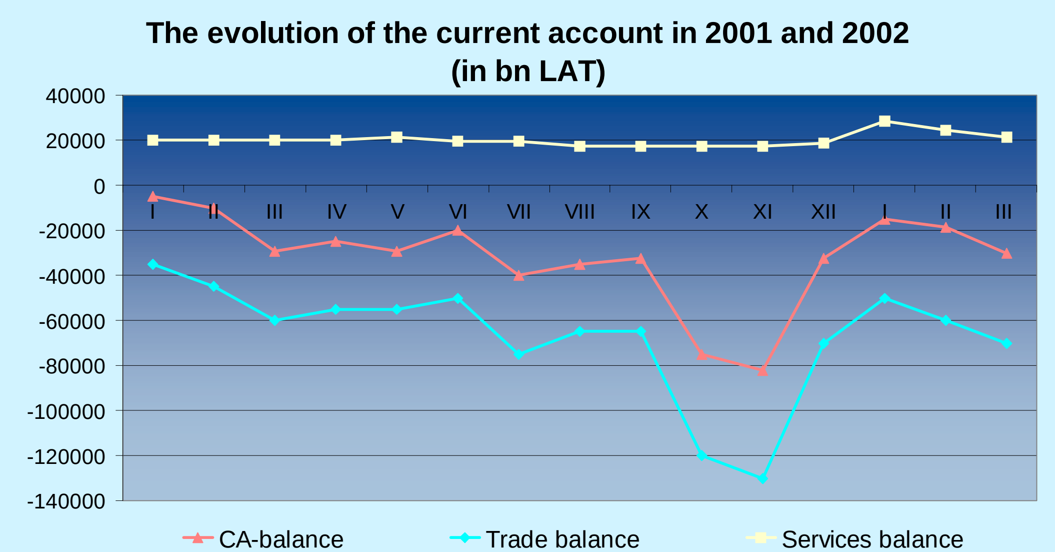
3. LATVIAN CURRENT ACCOUNT DEFICIT ON RISE IN THE FIRST QUARTER OF 2002

Following a period of decline at the end of 2001, the recent data by the Bank of Latvia indicate that Latvian current account deficit is on the rise again. In the first quarter of 2002, the deficit of the current account was 56.7 million Lats (or 4.8% of the gross domestic product), 30.6 million of which was produced in March. The same value for the first quarter of 2001 was 47.1 million Lats or (4.2% of GDP), which means that on a year-on-year comparison, the deficit increased by 9.4 million Lats. This increase is due primarily to the fact that the slight increase in the positive balance of services did not compensate for the fast growing imports in the first three months of this year. The deficit of the current account was closely related to the negative balance of goods, which increased by 9.6 million Lats. The export of goods in the first quarter stagnated around 336 million Lats, while imports increased by 4.3% (to 509.2 million Lats).

In comparison to the corresponding period of last year, the surplus in the balance of services increased by 10 million Lats, reaching 90.4 million, which is mostly accounted for by the favorable transport services balance. Nevertheless, the positive balance of services covered only 52.3% of the negative balance of goods.

The income balance of the first quarter was substantially narrower (5.4 million) than of 2001 (12.4 million Lats), thereby contributing less to the balancing of the current account deficit. The income balance in January even showed a deficit of 0.4 million Lats, but this is probably also due to the well-known January-effect, that is, investors tend to give up their positions at the turn of the year in order to avoid taxes. In absolute values, the income balance indicates a significant increase of economic integration, being almost one and a half times the size of that of the corresponding period of the previous year. Changes in the balance of current transfers reflect similar trends: current transfers turnover recorded a two-fold increase.

Chart 4.



The surplus in the capital and financial account in the first quarter of 2002 was 64.9 million Lats, which comfortably covers the current account deficit. Direct investment in Latvian businesses by non-residents amounted to 83.9 million Lats, and mostly took the form of raising the equity capital of enterprises and reinvesting the earnings of previous years. Net foreign direct investment in the first quarter of 2002 reached 86 million Lats, which, added to the positive services balance almost entirely covers the widening trade gap.

The surplus of the portfolio investment account reached 32.2 million Lats in the first quarter not so much because of massive capital inflow, but rather as a result of declining foreign asset value in terms of both equities and bonds. The surplus of the "other investment" account was 183 million Lats; most of the funds were attracted by the banking sector, adding up to a total of 174 million.

Latvia's balance of payments was positive in the first quarter and reserve assets increased by 10 million Lats in total, even though they declined by 3.6 million in March. This is explained by the substantial trade deficit aggravated by a (though minor) decrease in the surplus of the services balance.

Foreign position is a particularly important indicator of the state of the Latvian economy, because the path toward European integration followed by Latvia, (similarly to other Baltic states) differs in several aspects from the path taken by the rest of the pre-accession countries. The Baltic economies are extremely small and open, still maintain fixed exchange rate regimes chosen in the early '90-s and have liberalized their capital accounts relatively early and fast, well before having a strong financial system. This has been combined with permanently high levels of current account deficit, which combination is usually regarded as a source of external vulnerability.

A very hard peg (Latvia pegged the Lats to the SDR in 1994) allows efficient nominal convergence to European levels through the decreasing of country and exchange rate risk, lowering inflation and interest rates, while growth is supported by lower nominal and real interest rates and exchange rate stability. Nevertheless, there are considerable risks involved, the most relevant being potential exchange rate misalignment, that is real exchange rate appreciation and the resulting current account sustainability problems. This, coupled with the losing of investor confidence have resulted in the case of many emerging economies in financial crises, which had a long-term impact on growth and welfare. A banking crisis can be especially damaging with the central bank deprived of its function as lender of last resort. The recent example of Argentina has shown that although economies with hard pegs may be more resistant to sudden speculative attacks coming from capital markets, the real costs of adjustment are higher.

In spite of the large foreign deficit, there has been no significant external financial shock or currency crisis in the Baltic region. This can be explained by the responsible fiscal stance and the fact that budget deficits are more easily treated at the low levels of public debt (well below the 60% criterion required by the Maastricht treaty). As long as the foreign deficit is financed by non-debt generating capital inflows and sufficient foreign asset reserves are available to support the peg, the presently high levels of Latvian current account deficit do not justify any major concerns. These requirements for sustainable balance of payments seem to be met in the case of Latvia.

Consumer price index compared to that of the previous months has remained at reasonable levels in the first three months of the year (0.9%, -0.3% and 0.4% respectively), which resulted in declining levels of core inflation (3.5%, 3.3% and 3.2% respectively). The favorable inflation trends correspond to the substantial increase in broad money (4.1% in March), compensated for by continued growth observed both in the industrial and the trade sector. The decline in the net foreign assets of the banking sector (by 5.7 million Lats) was accompanied by a marked increase in net domestic assets (71 million Lats), which is a source of higher import demand.

The high deficit of the trade balance is not so much the result of real exchange rate appreciation, but is rather explained by massive FDI-inflow and growing monetary aggregates generating higher demand for imported goods. The EU and the UK being the major trade partners of Latvia, a decline in the nominal exchange rate against the Euro and the pound could explain the growing trade deficit. This is clearly not the case. In line with global trends, the exchange rate of the Lats to the US dollar fell in March by 0.5%, but weakened compared to the Euro and the British pound by 0.6% and 0.1%, which, together with low inflation corresponds to a relatively stable real exchange rate.

According to the report of the Bank of Latvia, reserves cover 118% of M0, which allows for high credibility of the exchange rate peg. Budget, on the other hand, also appears to be well under control:

March brought a fiscal surplus of 2.9 million Lats, while in the first quarter of 2002 general government consolidated budget showed a deficit of 3.2 million Lats (as opposed to 9.0 million in the first quarter of the previous year). The improvement of the fiscal situation was facilitated by an increase in tax revenues, which also reflects high economic activity. In March, government debt shrank to 703.5 million Lats. Lending rates reflecting successful convergence to EU-levels are also an important factor in fostering investment growth and financing of budget deficit.

Although the current account deficit of the first quarter, and particularly the wide trade gap in March, pose no threat to macroeconomic stability and keep external vulnerability low, other indicators are less favorable. In spite of outstanding growth results, unemployment stagnated around 8.2% in February and March, rising from January's 7.9%, and fell by only one tenth of a percentage point in April. The increase in real wages has remained below the general rise in productivity. These numbers support the conclusion that growing domestic absorption is mainly driven by investment demand as opposed to private or government consumption, but they also reflect the fact that positive returns of stability and high investor confidence are yet to be felt in terms of increasing living standards and the rise of general welfare.

4. HUNGARY: ACCELERATING GROWTH OF FREE TRADE ZONES' EXPORTS AND IMPORTS

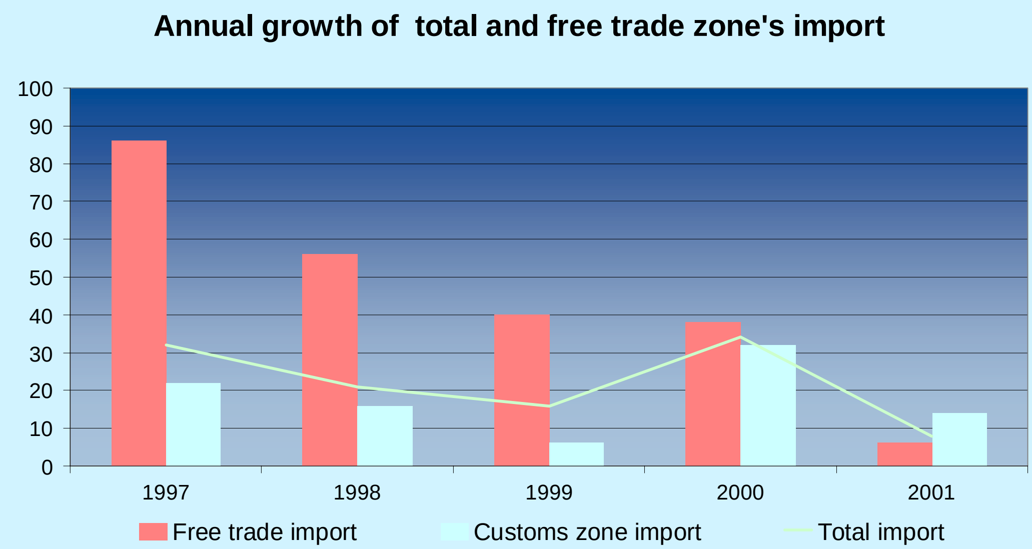
Due to the high level of foreign direct investments and real openness of the Hungarian economy, free trade zone companies play a significant role in foreign trade. In the second half of 1990s, the foreign trade turnover of these companies increased rapidly and they have become the key contributors to export growth and trade balance developments.

This trend of increasing contribution was however reversed in 2001, which was the first year, when the export volume of customs zone companies grew faster (12 percent), than of free trade zone ones (8 percent). The worsening global conditions affected free trade zone companies first, and this led to declining rates of growth in their export sales in the second half of 2001. Especially machinery exports were responsible for the declining dynamism: their quarterly rates of growth in 2001 were 18, 14, 6 and 3 percent respectively. Since the increase in the role of free trade zone companies, 2001 was the first year, when machinery output by free zone companies grew slower, than the average. Free trade zone companies produced one third of machinery output, but that reached only quarter of the whole machinery export value.

Chart 5.

After last years' decline in the free zone companies' productivity, forecasts expected a decreasing contribution of these companies to the growth of exports, but that this trend was reversed, according to the developments in the first two months of 2002. Despite the mentioned decline in the second half of 2001, in the first two months of 2002 free zone companies played an important role in the growth of exports.

Chart 6.



They increased their exports by 10 percent, while their imports stagnated. In spite of that the spread between import and export seems to be opening, and reached 5 percent, but it has to be noticed, that there is a high basis effect from 2001. The volume of exports grew especially in the group of finished and food products, while imports grew in all product groups.

ALL-TIME HIGH BALANCE OF PAYMENTS DEFICIT IN THE FIRST TWO MONTH OF 2002

In accordance with the advance data of the National Bank of Hungary, the two-month's trade deficit reached EUR 577 million. After the EUR 390 million deficit in January, it amounts to EUR 187 million in February, which was a considerable worsening compared to the EUR 14 million deficit in the second month of 2001. The final data show also a significant difference between the market anticipations (EUR 421 million) and the advance data. The mentioned foreign trade deficit emerged as an outcome of stagnating imports and declining (by 2,4 percent) exports.

There are several reasons that explain the increasing trade deficit: among them the most important are the strong domestic currency, the increase of consumption-related import demand and growth of stockpiling by the enterprise sector. The appreciation of the domestic currency is caused by the last years shift from crawling peg to managed float and significant capital inflows, which brought the domestic currency almost to the stronger end of the widened exchange rate band.

The increase of stockpiling by the enterprise sector is explained by the improved expectations concerning medium term growth prospects and to the considerable decline of stocks in the second half of 2001. Finally, the major factor boosting import demand is the increase of private and public consumption, which is driven by looser than expected fiscal and incomes policies. Spending by the general government has been above the planned and real wages increased very fast in the first quarter of 2002.

As these developments have a longer-term effect on the trade balance, there is a change in expectations concerning the likely evolution of foreign trade balance in 2002. While most analysts thought in early 2002 that the worsening of trade balance would be temporary, now the consensus opinion is that this is a long-term process. The majority of experts anticipate a significant rise in deficit compared to the previous year, and both trade and current account deficit to GDP ratios will worsen considerably.

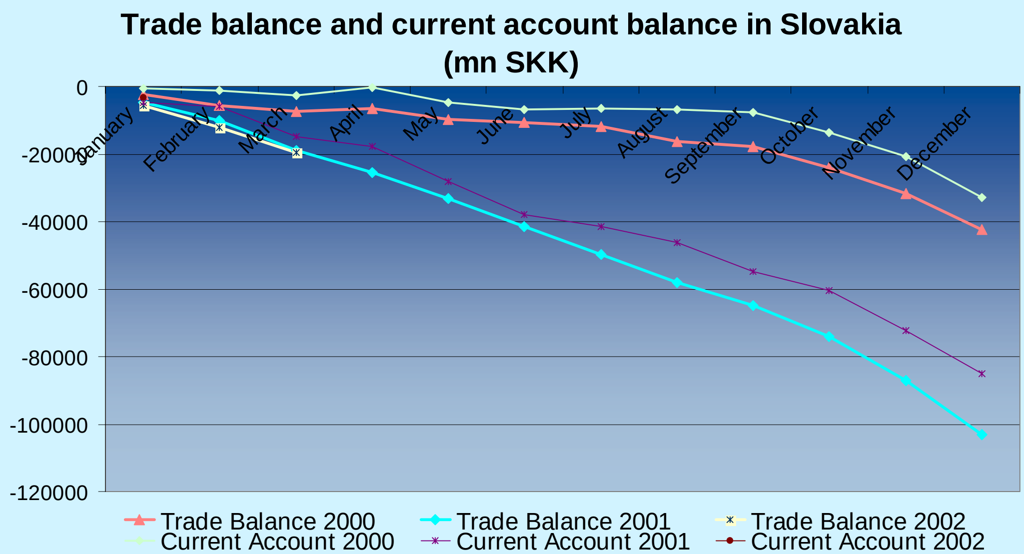
While trade and current account balance is to worsen, one favorable aspect is related to the steady increase of foreign direct investments. Their growth has contributed to a positive shift in financing current account deficit. This non-debt generating source of financing covers now 44 percent of the current account deficit.

5. HIGH CURRENT ACCOUNT DEFICIT IN SLOVAKIA

In January, the current account deficit amounted to SKK 4.0 billion (1 Euro = 43 Slovak crown) and remained at the level of January 2001. The individual components of the current account followed a different path as the continued growth in trade deficit was accompanied by increase in deficit of income balance. These two items in the current account were partly compensated by a surplus in the balance of services and balance of current transfers.

In the first month of 2002, the trade deficit amounted to SKK 5.8 billion, representing a worsening of SKK 1.0 billion compared with January 2001. During that period, exports reached SKK 45.2 billion and imports SKK 51.0 billion.

Chart 7.



The balance of services resulted in a surplus of SKK 1.3 billion in January, and it increased by SKK 0.8 billion in year-on-year base. The increase took place mainly in transport services, where income from the transit of gas increased and expenditure on other freight transport (except railway traffic) decreased. However, the beginning of 2002 was not particularly bright in the area of foreign tourism, due mainly to a fall in receipts from foreign tourists. The balance of 'other services in total' developed in a stable way, with deficit remaining at the level of 2001. The structure of individual services changed slightly, when the continued trend of increase in the deficit of business services in the second half of 2001 was offset by the excess of growth in receipts over payments in legal, accounting, and consultancy services.

In the balance of income, receipts equaled in January expenses (in January 2001, revenues exceeded expenses by SKK 0.5 billion). While on the revenue side the key role was played by interest incomes on securities (securities are part of the reserves of the banking sector), the expenditure side was dominated by interest paid on loans.

In February, trade deficit deteriorated again compared with February 2002, which was offset by the balance of trade in next month. The aggregated trade deficit of the first quarter in 2002 is higher by about SKK 800 million. It seems that the current account deficit remains as high as in 2001: it is expected to be about 10% of GDP, though it may remain slightly below it.

The major reasons for the worsening trade deficit and high current account imbalances have been the development of domestic demand and the slowdown in economic growth of Slovakia's major trading partners. The growth in imports has been mainly driven by the accelerated increase of investment demand, which was primarily stimulated by the sizeable inflow of foreign direct investments, and accelerated restructuring of private companies. The effect of foreign direct investments on trade and current account balance is also indicated by the relatively high share of machines and instruments in the growth of imports.

The dynamic import growth is also linked to the persistent high material intensity of the Slovak economy and the resulting import of semi-finished goods and raw materials. Imports intended for final consumption were dominated by car imports. Besides investment growth, imports are also affected by the sizeable increase of private and public consumption, which have been stimulated by the relatively loose incomes and fiscal policies.

As yet, for 2002, it is not realistic to expect a marked improvement in the current account balance. Foreign trade will be affected by the persistent slow growth of Slovakia's major trading partners, which is expected to accelerate only in the second half of 2002. On the other hand, imports will be affected by the continued growth in final household consumption, the relatively dynamic growth in investments, and still inadequate supply side restructuring of the economy. The National Bank of Slovakia expects that the current account deficit can reach 7.9% of GDP in 2002.

In middle term, the expected revival of economic growth of Slovakia's major trading partners in 2003 – 2005 will probably lead to relatively stable growth in Slovak exports. This can be connected with the favorable effect of Slovakia's integration into the EU, which will be supported by increased productivity growth thanks to investments made in previous years. At present, the relatively rapid investment growth improves the supply side of the economy, decreases its dependence on imports, and slows down import growth. These changes in the tradable sector may lead to a gradual decline of trade and current account deficit.