ICEG European Center

NEWS OF THE MONTH NR. 5

VIEWS ON THE REGION

A Report by the ICEG European Center

July 2002

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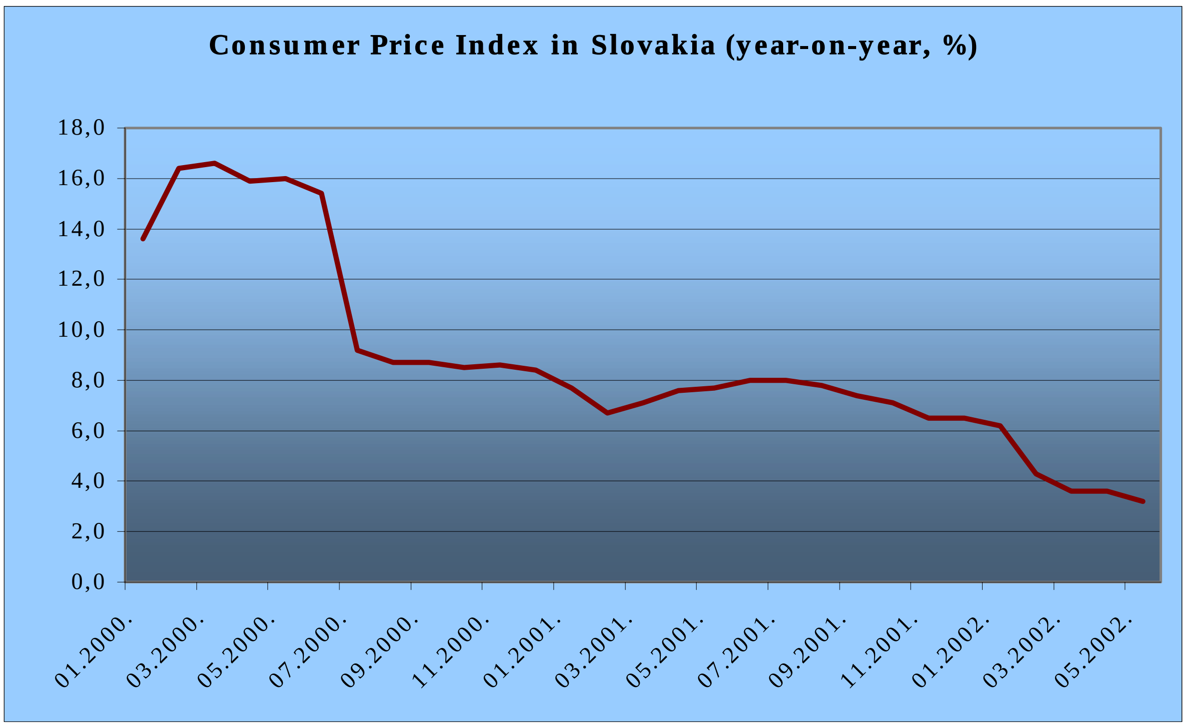
1. RECORD INFLATION RATE IN SLOVAKIA

In May 2002, headline inflation, which includes all prices for consumer goods and services, fell to 3.2% on year-on-year base, down from 8% in July 2001 and 16.6% in March 2000. This rate was the lowest monthly inflation rate in Slovakia for more than ten years. The drop was received with some skepticism by analysts, who said that the tendency reflected the government's desire to increase real wages before September elections by avoiding increases to regulated prices connected with EU integration.

In April 2002, consumer prices increased by 3.6% year-on-year and 0.4% month-on-month, with the prices of the components of core inflation rising by 0.5% and regulated prices by 0.1%. The level of oil prices on the world market and the seasonally volatile price of foods determined the raise in consumer prices. The other factors had no remarkable inflationary effects. The steepest month-on-month increase was recorded in price levels in transport (3.1%). The price of recreation and culture fell by 0.2% and that of post and telecommunications services by 0.1%. In several categories (e.g. electricity, and gas; other fuels; education) price levels remained unchanged.



The National Bank of Slovakia (NBS) immediately said the figure gave a false picture of the direction of the Slovak economy, which faces tough price increases after elections as well as after Slovakia joins the European Union. The NBS has also emphasized that EU entry, which Slovakia hopes to achieve in 2004, will give an extra boost to price increases, and urged the government to increase inflation now to cushion the shock. According to the central bank the current inflation figures could not be considered a reliable indicator of economic development, and also attributed the record lows to delayed deregulation of regulated prices. According to the NBS Governor Marián Jusko, the postponed deregulation has depressed price increases this year by approximately two percentage points and the inflation would increase next year with the continuation of price deregulation.

In the central bank's 2002 monetary program, the NBS wrote: "Besides the fact that deregulation is a condition for EU entry, the Slovak economy needs to adjust price levels to those common in EU countries. We consider higher price levels in the pre-accession period as desirable."

An interesting study of the impact of EU entry on the Slovak economy by the Slovak Academy of Sciences, which published partial results in May, predicted an inflation jump of 15-16 per cent following admission to the 15-member bloc.

All analysts predicted record low inflation figures when they learned that price deregulation would not be carried out to the same extent as in previous years. While they understood why the government was unwilling to continue increasing prices before the vote, at the same time, economic analysts urged the state to continue deregulation. Among other factors, analysts expect that an 8% weakening of the Slovak crown against its Euro peg since April this year, as well as public sector wage growth will bring an unavoidable increase in inflation.

According to Ludovik Ódor from the Slovak rating agency, in normal economic conditions inflation would be higher than it is now. Even core inflation excluding regulated prices should grow in the future. The current inflation figures are unusual for a transitional economy with 4 per cent growth in gross domestic product (GDP). “If you look at other transition economies, you see that they have higher GDP growth - compared to economically more developed countries -, and therefore higher demand, resulting in higher inflation," he said.

Ódor, however, saw exchange rate developments as more important than wages for inflation. He said they criticized the planned wage increase even when it was proposed at the end of last year. The government applied restrictive policies during its first two years, and now is trying to compensate for them.

Ódor said that the most important question is the impact of the weakening crown. The real risk is imported inflation, which would come from price increases resulting from an exchange rate increase. He emphasized that while the exchange rate and lagging deregulation have kept inflation low, they are not the only factors at play. Another factor is increased competition in the retail sector which is preventing great price growth, said Ódor in connection with an entry of foreign supermarket chains to Slovakia in the last three years. “This competition is a guarantee that we do not have to fear significant inflation pressures, either now or in the near future," said Ódor.

According to the Slávia Capital, while record inflation lows created the risk that the NBS would miss even its revised inflation target of 3.6 to 4.2 per cent, a weaker Slovak crown could help. A weakened Slovak crown could increase inflation figures, thus making it fit into the planned values.

2. GROWTH IN CZECH REPUBLIC BELOW MARKET EXPECTATIONS

The Czech economy is heading down: in the first quarter of this year gross domestic product at constant prices grew by 2.5% year-on-year, and by 0.6% (seasonally adjusted) quarter-to-quarter. Even less promising are the expectations of the Czech Statistical Office for the second quarter of 2002: 2.4%. These values would suggest that Czech growth has been going out of trend in the past six months. In the knowledge of the revised GDP time series recently published by the Czech Statistical Office, however, they only reflect a steady but decelerating GDP growth.

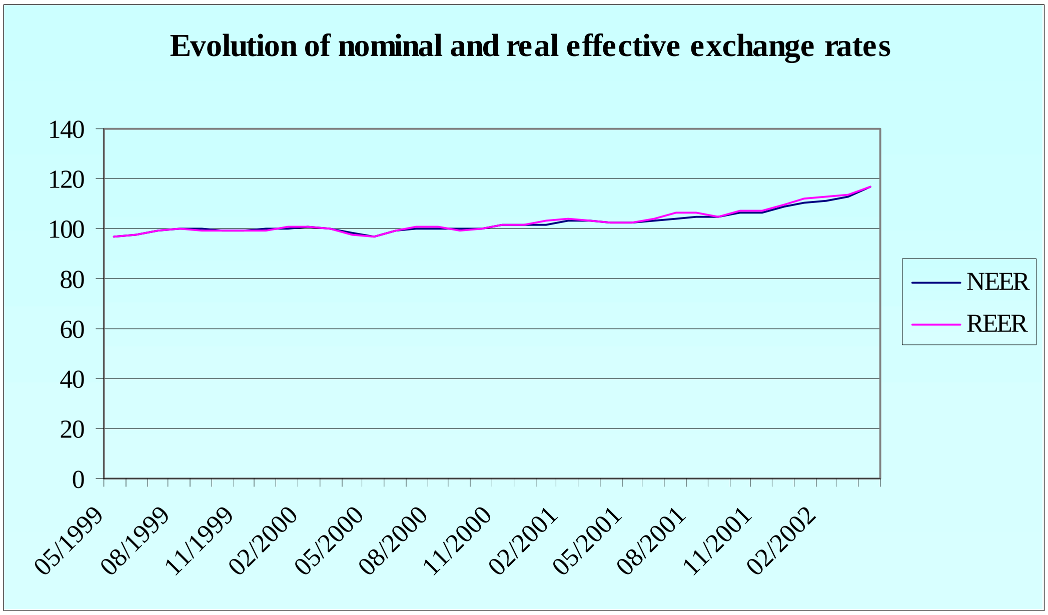
Higher values for economic growth in individual quarters of 1999 and 2000 after revision were mainly a result of adjustments in annual national accounts, while the slowing in 2001 was caused by adjustments to estimates of indirect taxes. The change in the share of individual quarters in annual totals in favor of the first half describes, with respect to the structure of working time availability and seasonality reappraisal, the real situation better than before the revision.

Although the 2.5% value for the first quarter y-o-y is not much below the revised indicator for the previous quarter (2.7%), it remains well below expectations, the market consensus being around 3-3.4%, and it is at its lowest since the last quarter of 1999. The y-o-y increase at constant prices GDP (CZK +8.9 billion) was influenced positively by higher final consumption (+8.1 billion) and gross capital formation (+1.5 billion). An important factor slightly slowing growth, however, was declining foreign demand, the result of which was a worsening services balance (-1.3 billion), which outweighed the improvement of the trade balance (+0.6 billion).

This underlines the fact that growth in the Czech Republic was mainly driven by domestic consumption (4.1%) as both household consumption and fixed capital formation kept their growing trend from the previous year. However, a decrease in inventories was observed, resulting from the previously mentioned lower external demand, further slowing growth in GDP. Of a strong negative influence was the consequently growing deficit of net exports including exports and imports of goods and services.

Exports declined substantially (from 9.2% in the previous quarter to 2.7%), the most important reasons for which were the slowdown of the Czech's main trading partner, Germany, and the continued strengthening of the currency. The Eurozone's first quarter GDP rose only by 0.1% y/y and by 0.2% q/q. The same indicator for the European Union rose by 0.2% y/y and by 0.2% in comparison with the previous quarter. The rise was driven by exports, while consumer spending and investments fell. It is also worth noting that neighboring countries have, too, suffered from the low economic performance in the EU: Hungary reached a long-time low with 2.9% GDP-growth in the first three months of 2002, and especially so Poland, whose increase was a mere 0.5%, though in line with expectations.

The Czech Koruna appreciated by 13% in the last 12 months (it crossed the "magic" 30.00 limit on the 25th of June) and by 15% in the past three years. This means that the CZK seems to have appreciated the fastest in the past years among the Central-Eastern European currencies. In countries such as Hungary, Poland or Slovakia, currencies showed smaller appreciation over a longer period, which follows that there was a larger scope for increases in productivity to compensate for this appreciation. In the case of the Czech Republic, the 15% strengthening of the exchange rate would have required productivity gains of 5 percentage points above the German rate in order to make up for the loss in competitiveness. Now this has to be offset by a rise in labor productivity or a fall in unit wage costs (in April this indicator fell year-on-year by 1.9%), which would in one form or another reduce living standards.



The hasty appreciation of the Koruna may be one explanation for lower growth perspectives in the Czech economy as shown by the composition and tendencies in the current account as well. The share of imported services in the current account have risen, export of machinery fell and the surplus of the trade balance of consumer goods diminished. There are good reasons to expect Czech foreign trade to stay out of the trend observed hitherto, which explains the concern of authorities for the Koruna. The only way these processes are hoped to be compensated for is by keeping privatization revenues offshore, that is separating them on a special account. This is the solution they opted for in the case of the 4 million Euro received from selling Transgaz in May, and the line they are expected to follow with the income from Cesky Telecom later this year. The authorities are likely to prevent any major currency depreciation by bringing this saved FDI onshore to the currency market.

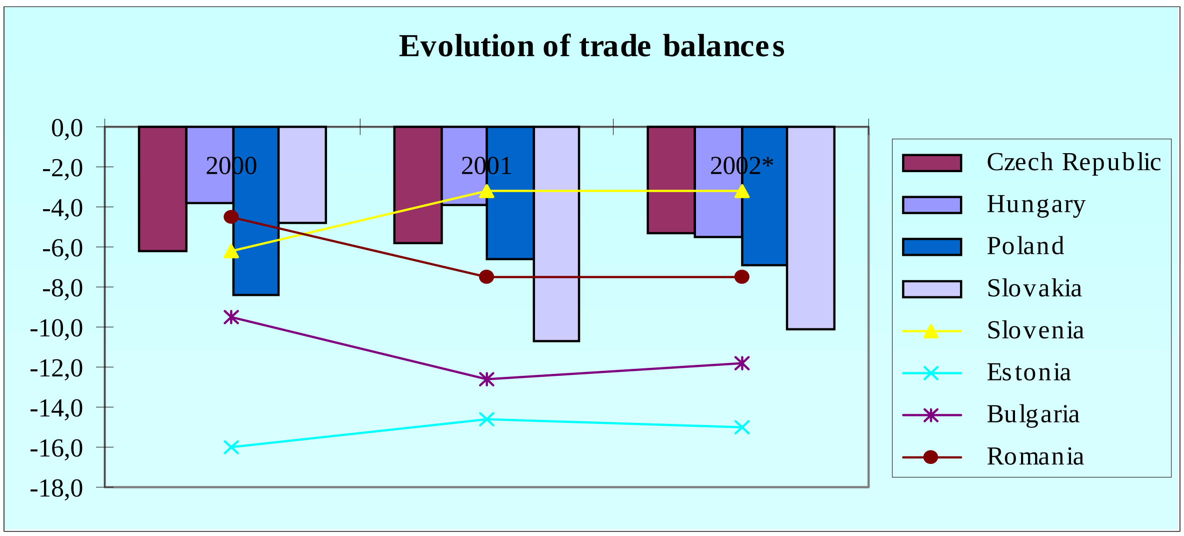
Although the slowdown was mainly due to the high comparison basis in 2001, the news caused the Czech currency to weaken to the Euro slightly (from 30.45 to 30.47). Bond yields did not rise, however, which is explained by broadly shared expectations that the Czech National Bank will not raise its key rates on the upcoming Board meeting (actually, a cut is considered more likely in the near future). On the other hand, the Koruna hit a three and a half years peak against the dollar, breaking the level of 32.00 as the Euro strengthened in world markets. Stock exchange indicators also dropped because of the worse than expected domestic Q1 GDP (and the generally weak economic performance in Europe).

According to recent news releases of the Czech Statistical Office, industrial production increased by 8.2%, year-on-year in April, or 5.9% WDA (working days adjusted – there was one more working day in April 2002 than in April 2001) beating the market forecast of 5.7%. Month-per-month, however, the industrial production index fell by 0.1%, which reflects a continued deceleration of the Czech industrial sector’s growth.

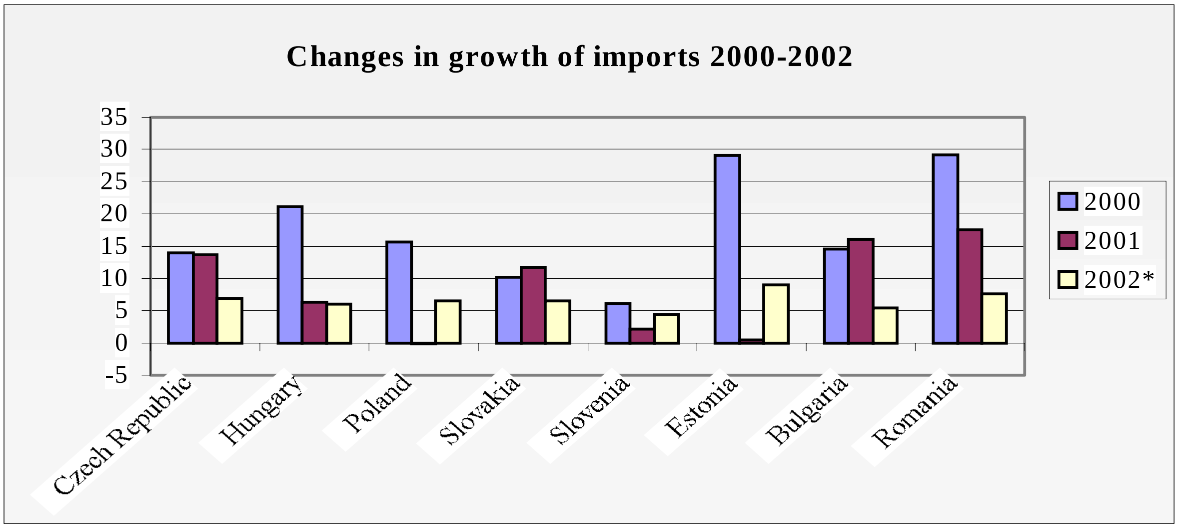
Sales in industry at constant (2000) prices went up by 7.2% (or 4.9% WDA). April saw a marked increase in the production of capital goods (index 117.8%) and a fall in the production of energy (97.7%). The main contributors to the rise in industrial production were the manufacture of rubber and plastic products and the manufacture of electrical and optical equipment. Decreases only occurred in the manufacture of leather and chemical products, and in the production of different raw materials. Export sales of industrial production increased by 19.2%. These indicators, consistent with the processes observed in the first quarter, also reflect a steady but declining growth, which is likely to continue in the next period.

3. TRADE AND CURRENT ACCOUNT BALANCES IN EASTERN EUROPE

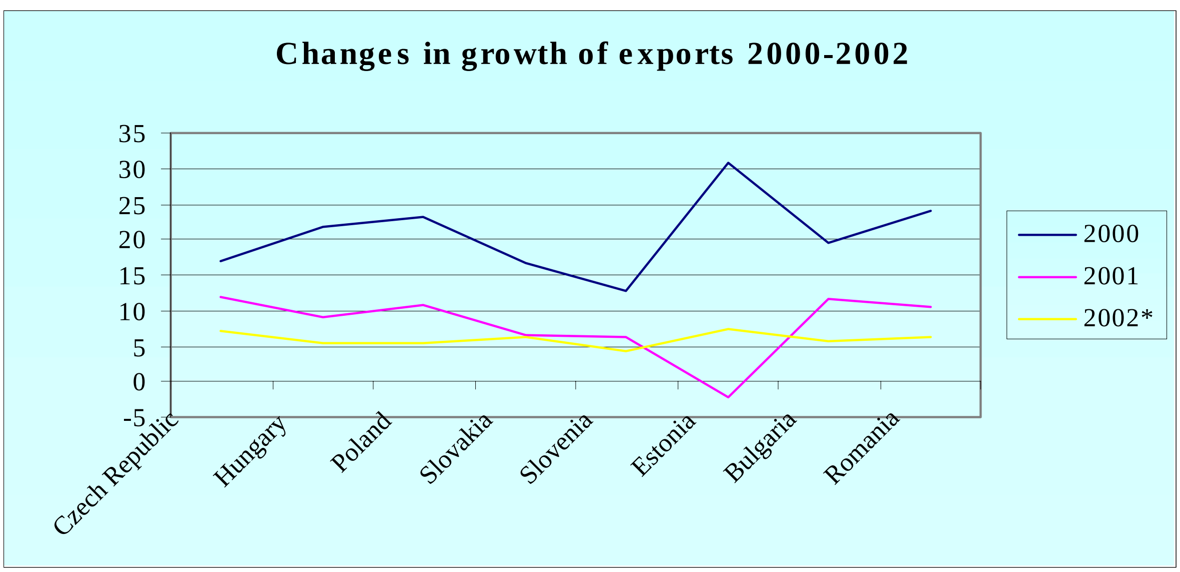
Two major factors drive trade balances of Central and Eastern European economies. One of them is global slow-down and the decline of import demand for Eastern European products, which have affected these countries differently, depending on the commodity and geographical composition of their exports and competitiveness. This channel has worked primarily through the slow-down of exports, which have directly reduced import demand due to the high import content of exports and indirectly via the slow-down of domestic GDP growth. Another major factor determining trade balance has been the effect of recent increases in aggregate domestic demand, which differed in its extent and structure between the economies. Both the sustainability of trade deficits and its level depended on whether private and public consumption or private investments grew faster than before.



Looking at these differences three groups of countries can be distinguished according to their trade performance. In Central Europe trade deficits declined due to the unchanged or positive gap between the rate of growth of exports and imports. In these countries trade balances were mainly determined by the direct and indirect effect of worsening growth: exports declined, which was however followed by even bigger decline of imports. The only exception to that pattern was Slovakia, where domestic demand (and especially FDI driven investments) expanded fast, and to lesser extent the Czech Republic, where also FDI-driven private investments maintained the rate of import growth at levels close to the growth of exports. In Poland trade balance improved thanks to declining domestic demand, while in Hungary and Slovenia mainly due to the slow-down of private investments, which was caused by weaker export performance. In 2002 Hungary may however experience worsening trade balance thanks to appreciation of domestic currency and slow-down in the growth of international competitiveness of its exports.

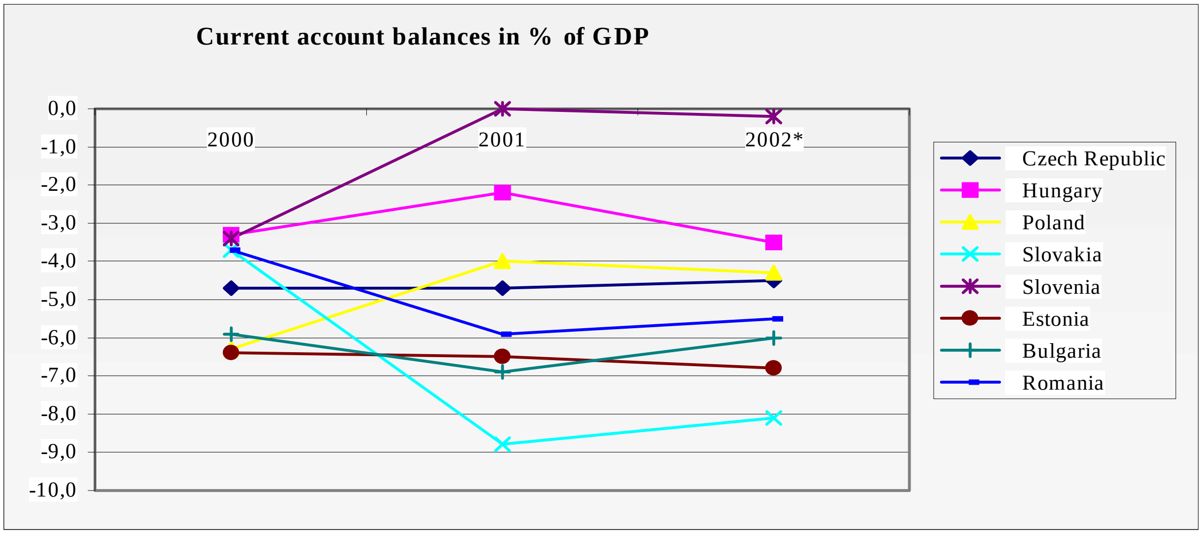


In terms of trade performance the Baltics are the most heterogeneous group of countries. As it can be seen from the chart above, Estonia followed the pattern of Central European economies, as its exports growth was reversed and exports declined by 2% due to declining export prices, and this was followed by a similar adjustment of imports (decline of 0,5% following 29% growth in 2000). In 2002 less exogenous shocks affect the tradable sector and the country experiences recovery of both its exports and imports, though growth rates remain well below the pre-2001 levels. The Latvian and Lithuanian foreign trade has developed quite differently as they were affected less by exogenous shocks due to the differences in their structure and geographical destination of exports. Besides that the growth of domestic demand has been much stronger, which has resulted in a sizeable expansion of imports and repeated increase of trade deficit to sizeable levels.



In the South-Eastern European economies trade balances worsened, as both foreign import and domestic demand behaved differently. Exports of these countries have declined steeply, mainly because of supply side competitiveness problems and due to their geographical composition (for example significant part of Bulgarian and Romanian exports was directed to Turkey, which experienced a currency crash in 2001). The exports of these economies are more sensitive to changes in foreign import demand, as they are less diversified and sophisticated, and declining EU demand had a stronger negative effect on exports than the case of the Central

European economies. On the other hand domestic demand in all countries increased rapidly. This was fuelled in Bulgaria by the extremely fast increase of private investments reflecting FDI- related investments and recovery of earlier delayed private capital formation, in Romania by the expansion of private and public consumption due to the loosening fiscal and incomes policies. As an outcome, declining export growth rates were accompanied by accelerating import growth except Romania, which widened trade deficits in Bulgaria to high levels in GDP.



Contrary to trade balance, there has been less change in current account balance with the exception of those economies, which have recorded significant increases of domestic demand: in all economies except Slovakia, Lithuania and Romania current account deficits remained unchanged or declined in 2001 compared to 2000. The main reason behind that has been the improvement of trade balances, which – as mentioned in our first report - are strongly correlated with the exception of Estonia, which has however huge surplus on services balance. Current account deficits are now much lower than before in economies, which had persistently high imbalances (Poland for example) are high in economies having hard pegs (the Baltics and Bulgaria) and are on rise in countries, which have recently been recipients of foreign direct investments.

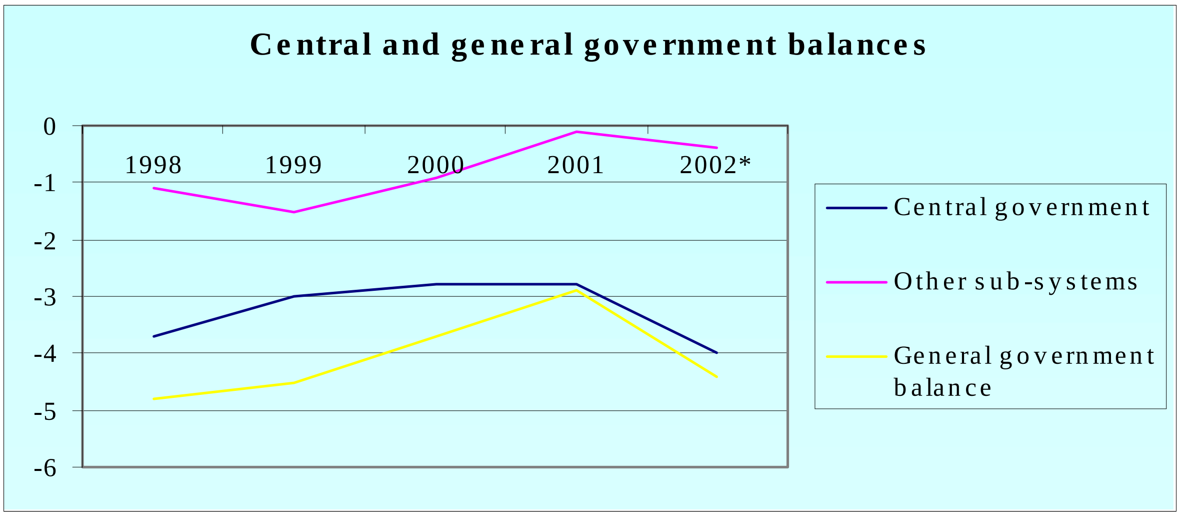
In the recent changes in current account balances more attention should be paid to two structural changes that characterize their evolution. The first is the gradual growth of surplus in the services balance, which is related to either tourism revenues or transfer payments. The increase in the service surplus shows the accelerated catch-up of that sector.

Another important factor is the increasing effect of foreign direct investment on current account balance. One of them has already been mentioned: economies which have been recipients of significant foreign capital have experienced rapid rates of investment growth, which increased their import demand, too. On the other hand the growth of foreign direct investments in flow and stock terms has also led to the increased repatriation of profits and worsening of the income balance. The recent recipients of FDI inflows (Czech Republic, Slovakia and Bulgaria among others) start to experience increasing outflows on their incomes balance similarly to economies with higher stock of foreign capital (Estonia, Hungary and Poland). They are, however, at the beginning of this process, and they may expect worsening current account balances unless their trade or services balances remain unadjusted.

4. FISCAL DIFFICULTIES IN HUNGARY

According to recent figures released by the Ministry of Finance at the end of May central government deficit reached most of the level planned for 2002.

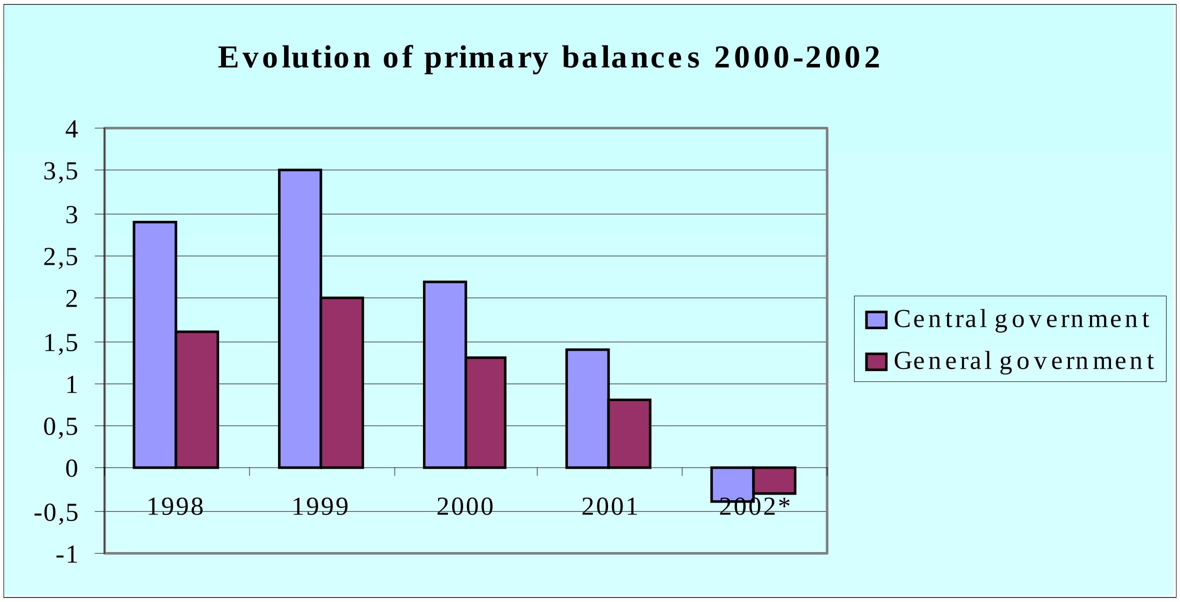
Within the general government the balances of social security funds were especially bad and they have recorded sizeable deficits, while the underlying trends show further increase of imbalances due to the huge expenditures of the Health Insurance Fund.



When one divides central and general government balance into primary balance and interest expenditures, the causes of worsening fiscal performance become clearer. After the stabilization package of 1995 Hungary had huge and gradually increasing surplus in the primary balance of both central and general governments. This was initially caused by the stabilization adjustment followed by the revenue enhancing effect of high, on average 4,5% GDP growth between 1997-2000.

However, from 2000 fiscal policy loosened to counterbalance the negative demand shocks of global slow-down and to finance the increasing fiscal expenditures associated with government led investments and programs. As a result the primary balance worsened significantly: while in 2000 general government recorded a surplus slightly above 3% of GDP, this fell to 1% in 2001 and primary balance in 2002 will be in deficit after many years of surplus.

Worsening primary balance was accompanied by declining debt and interest service expenditures. While in 1997 general government debt service expenditures reached 7,7% of GDP, they declined to 4,4% thanks to lower interest rates and significant decline of public debt.



There are diverse reasons explaining the recent worsening of fiscal balances in Hungary. First, as many other emerging economies, the Hungarian government tried to pursue counter-cyclical fiscal policy to mitigate the decline of foreign demand and slowdown of net export growth by more expansive fiscal policies. Both capital (new public investments) and current expenditures (increase of wage and other income related expenditures of the general government) were significantly raised to weaken the negative effect of exogenous shocks on the Hungarian economy and maintain growth rates achieved between 1997 and 2000.

Moreover, the unique practice of preparing a two-year budget proposal and the change of macroeconomic conditions from the ones outlined in the budget figures allowed the government to realize extra revenues and to spend them. The major difference in the underlying economic trends from the projected one was in the evolution of inflation as disinflation was much flatter. As a result higher than expected increase of nominal GDP resulted in extra revenues reaching in 2001 almost 1,5% of GDP. Major increases were recorded in indirect taxes, but due to the high increase of nominal and real wages personal income taxes also grew above the planned level.

The effect of inflation on the primary balance would have been positive had the government allowed the effect to materialize as expenditures did not increase in line with inflation. However, these extra revenues were spent in a discretionary way and they have contributed to the increase of fiscal imbalances.

Besides the modified macroeconomic developments and expansive fiscal policy the increase of the deficit measured according to European standards (ESA95) was also due to the growth of off-budget operations of the government. These off budget operations executed either through the development banks or special funds added to actual expenses and resulted in a much faster increase of ESA 95 consistent expenditures.

THE NEED FOR AND DIFFICULTIES OF FISCAL CONSOLIDATION

The new government should proceed fast with fiscal consolidation. The current fiscal year will not bring the required adjustment due to previous commitments and the promises made by the incoming government in its 100 day program. But the budget for the next fiscal year should include sizeable reduction of fiscal deficit and should be the first year of fiscal consolidation finally lowering the deficit to below the 3% threshold set forth in Maastricht treaty. Both short- and medium term considerations call for fiscal consolidation.

Among the short-term ones the major reason is the shift in the stance of macroeconomic policy mix from loose fiscal and strict monetary to looser monetary and stricter fiscal policy. Fiscal loosening resulted in increased short-term capital inflows, added to the pressures on the central bank to harden its monetary policy.

As increasing fiscal deficit was accompanied by worsening trade and current account balance and has recently been an increasing concern related to the meeting of the inflation targets set for 2002, the central bank had to increase interest rates breaking thus the previous long period of declining interest rates.

Loose fiscal policies have also added indirectly to inflationary pressures and to the appreciation of domestic currency. Part of fiscal expansion was spent on the increase of wages in public sector and this has significantly contributed to the 6,5% increase of net real wages in 2001 ands their likely further acceleration to above 10% in 2002. Increasing public consumption has added to the strength of domestic currency both via increasing demand for non-tradable and via the increase of real returns for foreign portfolio investors.

Among the longer term considerations, the meeting of Maastricht criteria is the key factor that should influence the timing and extent of fiscal consolidation. As Hungary is likely to join the European Union in 2004 and could candidate for the early (2007) introduction of the Euro, the benefits of which exceed its potential costs according to a recent detailed study by the National Bank of Hungary, this gives only three years for the government to make the necessary adjustment. In this short period of time general government deficit should be reduced by almost 4 percentage points to meet besides the nominal deficit criteria the requirements of the Stability and Growth Pact, meaning at least 1,3 percentage point annual decline in fiscal deficit. While this reduction is desirable and possible, one should also consider the difficulties.

First, as inflation declines, budget planning returns to its usual annual frequency there is less scope for unplanned ”surprise” revenues coming from higher than planned inflation and its positive short term, effect on nominal and real revenues.

Second, institutional reforms and the absorption of expenditures related to EU-accession will likely increase fiscal expenditures, the co-funding of EU structural programs will require significant structural changes in the budget plus may lead to higher expenditures. While interest expenditures will decline further as debt levels decline and domestic interest rates actively converge to EU levels also on the short end of the yield curve, this could partly be offset by the increase of primary expenditures. On the other hand tax cuts needed to align tax regimes to the ones prevailing in the EU and to increase competitiveness may not be matched by the increase of tax revenues due to cyclical position better than in 2001-2002.

5. WEAKENING SLOVAK CROWN

The value of the Slovak crown has recently fallen back to 2001 levels, but despite public fears of a currency crisis, analysts emphasize that the currency remains stable and that the National Bank of Slovakia can smooth any unwanted deviations.

Over April and May 2002, the Slovak currency dropped around 2.5 crowns against its Euro benchmark, an intense loss in a short period that sparked alarm in the Slovak media of an Argentina-like breakdown, but which analysts have called a "correction", in line with trade and fiscal deficit warnings.

The exchange rate went from SKK41.30 to the Euro in mid-April to almost SKK44.30 in recent days. According to several analysts it is not worth dramatizing the temporary weakening, it was just the influence of a certain sentiment. A different sentiment could strengthen the crown any time.

Actual exchange rate levels were quite normal over the past year. The Slovak crown is stable; its exchange rate has not deviated from the range of SKK41.30 to SKK44.00 to the Euro since 1999, which is less than 3 crowns. That is a stability that no other currency in the region seen.

The crown's recent drop stems both from uncertainty surrounding September's parliamentary elections as well as recent criticism of Slovakia's economic policies by international financial groups. Both the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) this May have criticized Slovakia's loose fiscal policies and expanding budget deficit, reiterating warnings by the European Union in April.

International Monetary Fund (IMF) has issued a stern warning that the Slovak government needs to tighten its fiscal belt to avoid currency pressures and interest rate rises, as well as damage to its ambition to join the European Union. The mission released preliminary findings on May 22 from its regular mission to Slovakia that predict growth in gross domestic product (GDP) of 4% this year, up from 3.3% in 2001, but also urge key fiscal reforms, without which the county's current account deficit could reach USD 2 billion, 9% of GDP in 2002. There is a risk that the deficit will remain at an unsustainable level, or may even increase, because of excessive domestic demand pressures, which reflect too expansive a fiscal policy. Slovakia aims to join the European Union in 2004, but remains far from meeting an EU rule that member countries keep fiscal deficits within 3% of GDP.

The bad trade deficit also had a negative impact. Moreover, the Slovak crown is bound to the Czech crown to some extent, and the Czech crown was weakening, too. The inflexibility of enterprises to respond to changing demand conditions may have contributed to the recurring external current account deficits. For instance, many large enterprises have difficulties finding reliable good quality domestic suppliers and need to rely primarily on imported intermediate goods. That factor also increased the trade deficit.

Another problem was that the National Bank of Slovakia (NBS) did not assume any attitude towards the crown's weakening. The NBS has the greatest power to affect the crown exchange rate through its own currency dealings as well as through the setting of the key interest rate, which it raised by 50 basis points in April in response to government failure to curb spending. NBS spokesman Ján Onda explained that the NBS never releases information about the level at which it intervenes, but does not consider current developments as favorable.

However, the NBS has the resources and the know-how to stave off any crisis. Even if unfavorable sentiments on the market prevail, the central bank can easily stop the crown's decline. The NBS can do it without any problems; its pre-election foreign currency reserves will be twice as big compared to the last pre-election period in 1998.

The Slovak forex market is small, so a relatively small amount can visibly affect the exchange rate. NBS intervention with a few hundred million dollars can smooth the market really well. It all depends on the NBS deciding on an exchange rate intervention level.

In June, the NBS intervened on the currency market several times, spending millions of Euro to bring the Slovak crown back up to 44.50 SKK/EUR. In current days, the exchange rate is SKK 44.30; the central bank’s target has been realized considering the exchange rate was close to 45 SKK/EUR before the intervention.

With the current negative sentiment combined with the relative inaction of central bankers, exchange rate development prior to September's parliamentary elections is difficult to estimate. If Slovakia becomes a member of NATO and the EU, and the new government introduces an austere economic program, we can expect a long term strengthening of the crown. The exchange rate is constantly changing. It would make no sense to try to estimate some trend **-** at least before elections. The crown will react to different factors that appear.

The IMF report declares that if a strong program of adjustment were not to be implemented, the economic costs would include a depreciated currency and higher inflation, higher interest rates, lower investor confidence, and a potential setback in Slovakia's ambitions for EU accession. The authorities should recognize that delays, especially in those areas where there has been limited progress over the last few years, would be harmful for Slovakia's ambitions for early EU accession and adoption of the Euro.