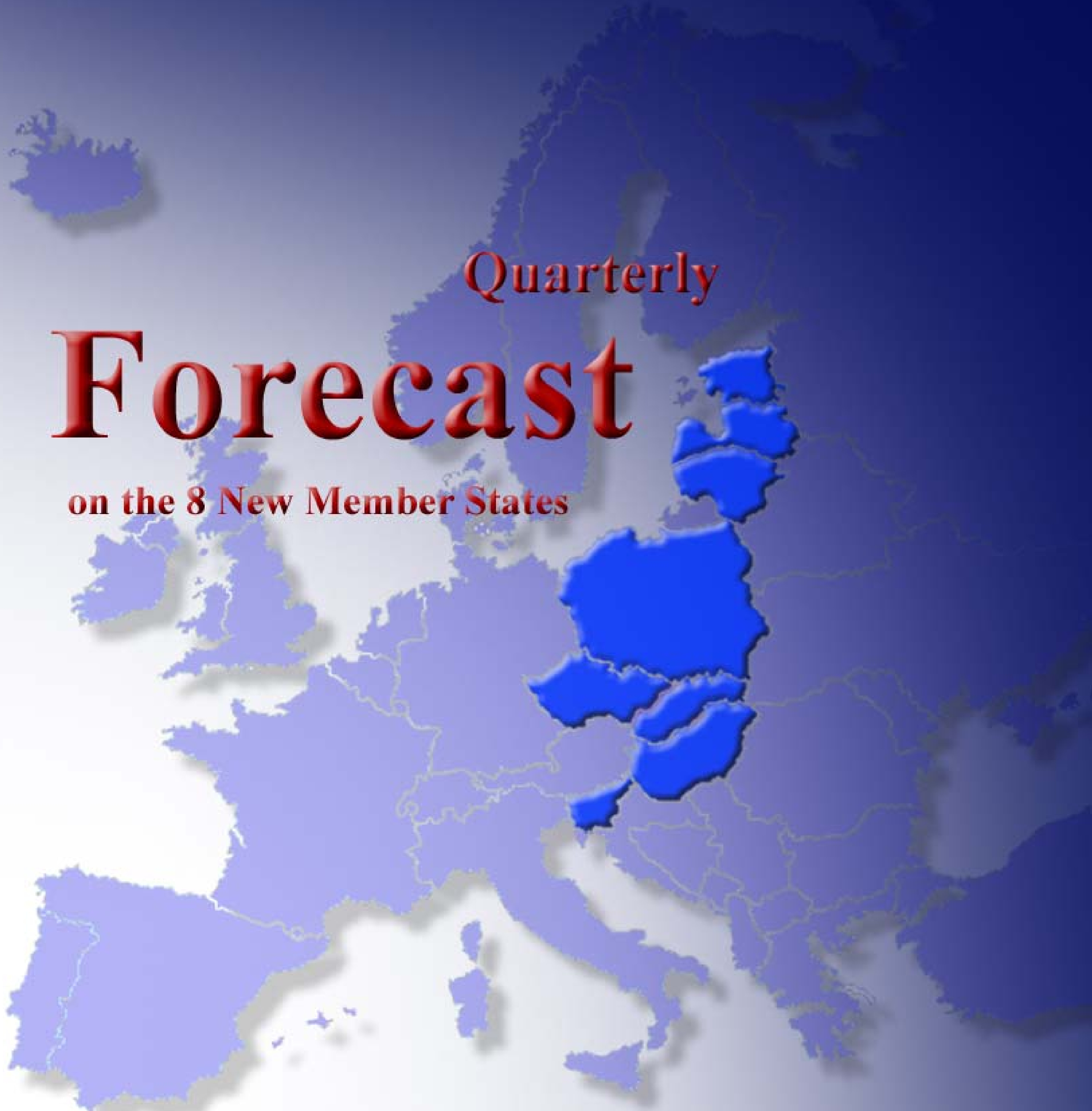
Quarterly Forecast

on the 8 New Member States



Summer

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Overview[1]

Fast but slightly lower than in 2004 economic growth accompanied by improving macroeconomic stability with remaining fiscal difficulties

Economic Growth

The New Member States of the European Union are expected to grow in 2005 somewhat slower than in 2004, when they experienced a simultaneous boom in their exports and domestic demand. The growth of exports and the rising contribution of net exports to GDP were driven by the positive effect of the entry to the Single Market and the improving competitiveness of tradable sector. The expansion of domestic demand was determined by sizeable income and wage increases, growth of household sector borrowing and improving profitability of enterprise sector, which together with increased inflow of foreign direct investments led to sometimes sizeable growth of private sector gross capital formation.

In 2005 economic growth may slow down in the New Member States by around 0,5% on average, with significant differences among the countries (and with the Baltic States still growing much faster than the Central European ones). On average these countries are expected to grow by 5%, which is almost 2,5 times higher than the average of EU-15. The slight slowdown in the NMS countries growth performance is partly due to the worsening growth prospects in the EU-15, which accounts for the most of their foreign trade. This and the gradually vanishing effect of the one-off rise in exports due to the entry to the EU will result in a slower export growth and weaker contribution of net exports to GDP growth. Most countries seem to experience also a slowdown in the growth rate of their domestic demand, as incomes and fiscal policies become somewhat tighter in 2005 compared to 2004.

Monetary Conditions

With the notable exception of Slovenia and Slovakia, NMS countries saw their inflation rates accelerating in 2004. The faster rise in consumer prices was mainly driven by one-off factors, including changes in indirect taxes and administrative prices. Beyond them, country-specific factors contributed to higher inflation, among others the weakening of Zloty in Poland, fast increase of regulated prices and public sector wages in the Baltic States.

In 2005 the reversal of this trend is expected as all countries are likely to experience disinflation except Estonia and Lithuania, where the combination of fast productivity growth with pegged exchange rate results in significant increase in non-tradable prices and the price level. Inflation in most of the NMS will decline to low levels with the exception of Latvia, where the above mentioned one-off factors seem to last longer.

Monetary policy will follow disinflation and loosening monetary conditions are expected to prevail in 2005. Central banks in the region have either already low interest rates (the Czech Republic, Estonia) or allow their policy rates to decline with disinflation (Hungary, Poland), while in countries that entered ERM-II keep them at unchanged levels. The loosening of monetary conditions is also driven by the general trend of currency depreciation in those countries, which remain outside the ERM-II, while the ones that have entered ERM-II in 2004 or in 2005 have so far experienced exchange rate stability.

Fiscal Policy

Fiscal balances remain the major macroeconomic problem for most of the NMS with the exception of Estonia, which has a budget surplus. While in 2004 most countries were able to reduce general government deficits, this seems to be no longer the case in 2005, as most countries will experience rising imbalances. Smaller deficits in 2004 were mainly caused by very good revenue performance (due to fast real GDP growth, temporary surge in inflation), while in some cases (Hungary, Slovakia, Poland) discretionary policy adjustments have also played a role.

[1] *Our forecast covers eight New Member States: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.*

Our expectations for 2005 imply that all countries seem to record worsening general government balance due to various reasons. First, growth and especially the expansion of domestic demand are to slow down in most countries, which reduce indirect tax revenues. Second, the effect of the EU entry on fiscal expenditures (co-financing requirements, the adjustment to the acquis, and other discretionary expenditure increases), the rise in public sector wage bills lead to higher fiscal expenditures. Finally, most countries face elections and the impact of the political cycle should also be accounted for.

As an outcome, fiscal deficits are expected to grow and to increase the already high imbalances in Poland, Czech Republic or Hungary. While fiscal deficits are growing, the public debt to GDP ratio is expected to either stabilize or decline slightly, thanks to fast increase of real GDP.

Balance of Payments

Trade and current account balances move very closely in most of the New Member States. After deteriorating in 2004, they are expected to improve with the exception of Slovenia, Slovakia and Poland, where the rise in domestic demand (partly investment driven as in Slovakia and Poland, and partly consumption one as in Slovenia) leads to different trend. In other NMS countries last year saw a worsening trade and current balance due to the rise in import demand associated with fast increases in private consumption and investments. Worsening trade balances let to deteriorating current account balances especially where the incomes balance worsened too due to higher profit repatriation or increased debt service expenditures.

In 2005 the forecast for current account and trade balance developments is very similar, as all countries will improve their balances with the exception of Poland, Slovakia and Slovenia. In these countries the rate of import growth will remain sizeable and they will record worsening trade balances leading to higher current account deficits. On the other hand other countries will have much lower rates of import growth in 2005 than in 2004 (thanks partly to the vanishing effect of the entry to the EU markets, somewhat tighter fiscal and incomes policies, etc.), which will reduce both their trade and current account deficits. Current account deficits are high in the Baltic states and Hungary, while are comfortably low in other New Member States.

Unemployment and labour market

Unemployment rates declined in most NMS in 2004, though the average of the rate was 11,2% compared to 7.9% of the EU-15. The decline was driven by the expansion of output and increased demand for labour in most countries. On the other hand that fast rise of output was not associated with sizeable increase in employment as both employment rates and unemployment improved only marginally. There were country-specific reasons behind this including the ongoing restructuring and corporate sector adjustment, structural changes in the public sector and related lay-offs, and generally rigid labour market conditions.

In 2005 a further gradual decline in unemployment rates is likely, though some countries (notably Hungary) may experience temporary increase. Notwithstanding the mentioned rigidities and restructuring at corporate and public sectors, 2005 will see declining unemployment rates and rise in employment. The differences in the level of unemployment of individual countries will however remain almost unchanged.

Table 1. Summary indicators of the analyzed 8 New Member States[2]

	2003	2004	2005*
GDP (%)	4,6	5,6	4,9
Inflation (%)	2,8	4,3	3,3
General government balance/GDP (%)	-3,65	-2,5	-2,95
Public debt/GDP(%)	31,6	31,4	32,1
Current account/GDP(%)	-5,8	-6,7	-6,4
Unemployment(%)	11,3	10,9	10,8

[2] *The sources of statistical information in the study are the European Commission, the World Bank, the IMF, the national statistical offices and central banks. The data for 2005 are the forecasts of ICEG European Center.*

Czech Republic

The Czech Republic's economic performance was excellent in the first quarter of 2005, marked by low inflation and high export growth

Economic Growth

The rate of GDP growth (4 percent) in 2004 was one of the slowest among the NMS, while it was higher than in 2003 and has been accelerating on a quarterly basis as it was already 4.3% in the last quarter of 2004. Data for the first quarter of 2005 are not yet available, however, the deceleration of the growth rate of industrial output and the fall in construction output indicates a slowdown of overall growth in the near future.

The main engine of growth was export of goods and services with a slightly slower growth in imports. Both rates were among the highest among the NMS, which resulted in the lowest trade deficit to GDP ratio since 1993 and this trend continued in the first quarter of 2005, resulting in a positive trade balance. Export growth is likely to slow down due to strong Koruna and worsening economic situation and thus decreasing import demand at main trading partners (especially Germany). On the other hand, in 2005, the entry of production and exports in the new car plant, connected to the Toyota investment, may affect the trade balance positively.

Investments were the source of growth, both in the business (partly due to the inflow of FDI, especially reinvested earnings) and in the household sectors, which is indicated by the high increase in gross fixed capital formation in 2004. This trend is likely to continue in 2005, however, the rate of growth is expected to be slower than in 2004.

At the same time, total final consumption grew modestly, especially because government consumption decreased significantly, while household one increased only by 2.5 percent, which both indicate a deceleration compared to the previous year. This year both consumptions are expected to increase, especially because the coming elections may induce an increase in public consumption, particularly in the second half of 2005. On the basis of the forecast for the components of growth, GDP growth is expected to be around 4 percent in 2005.

Monetary Conditions

Inflation (CPI) remained relatively low, even though it was higher in 2004 compared to the previous year. Growth in domestic demand and in indirect taxes (due to EU-accession) resulted in a higher inflation rate in 2004. Notwithstanding, the CPI in the first quarter of 2005 declined below 2 percent annual rate, which is in line with the annual inflation forecast of the National Bank. This disinflation will be reinforced in 2005 due to the weaknesses of factors of cost push inflation, moderate increase in consumption, low demand pressures and a continuing appreciation of the currency, while in the second half of the year, higher tobacco taxes and rent deregulation may push the CPI slightly upwards. Thus consumer prices are expected to increase by around 2 percent on an annual basis in 2005.

While industrial prices exhibit a below one percent monthly growth rate in the first quarter of 2005, a far higher year-on-year growth is the result of a higher base due to high oil prices. Among producer prices, there was a steep decline in the agricultural prices, while industrial ones grew by 6.4 compared to March 2004. Given the favourable CPI data, the Czech National Bank reduced in the first quarter of 2005 the two-week repo rate three times by 0.25 percentage point to 2.25 in January, to 2 % on March 31 and to 1.75 % on April 28.

The exchange rate continued to appreciate in the first quarter of 2005, and there is a risk of further appreciation, which would result in deflation and would be translated into a worse than expected foreign trade performance, thus hindering growth and worsening balance of payments.

Fiscal Policy

Higher economic growth, higher revenues from the increased VAT, from non-tax receipts and a change in fiscal rules resulted in a 3% general government deficit to GDP in 2004, which is in line with the Maastricht criterion and came as a surprise after the high deficit in 2003. Data on the budget for the first quarter of 2005 indicate similar averages as in 2004, thus up till now, keeping the budget deficit at the Maastricht criterion does not seem to be completely unrealistic. However, the allocation of the unspent funds from 2004 – due to the new budget rules – may alter the outcome. Notwithstanding, it is unlikely that the Czech Republic would be unable to reach the deficit target of 4.7 percent in 2005 predetermined in the convergence programme.

The government debt grew in the first quarter of 2005, and longer maturity bonds were issued for its financing, while the share of short-term financing falls below 25 % of the total. The average maturity of bonds increased to 5.6 years. In 2005 as a whole, a slight decrease of the debt to GDP ratio is expected due to privatisation proceeds used for debt repayment. The debt/GDP ratio has been in line with the Maastricht criterion.

Balance of Payments

The balance of payments showed a surplus in 2004, when a decreasing current account deficit was compensated by an increasing financial account surplus. Balance of payments developments were favourable in the first quarter of 2005. The current account showed an increasing surplus; however this trend may discontinue or at least the rate of the increase may slow down due to the real appreciation of the Czech Koruna and lower import demand on the main markets. At the same time, larger export-oriented foreign investment projects starting their production in 2005 may reverse the process. The product composition of exports changed towards the higher share and more dynamic growth of machinery and transport equipment, which will also be reinforced by the entry of production and export of the new car plant. While forecasts expect a current account deficit of around 4-5 percent compared to the GDP this year, developments so far do not exclude a significantly better performance of 2-3 percent.

As far as the services balance is concerned, developments were less favourable. In the fourth quarter of 2004, as in the whole year, there was a marked decline in its surplus. Transport services (air transport) and tourism contributed to the positive balance of services, while other services showed a deficit. These processes are likely to continue, with other services partly offsetting the high receipts from tourism, the result of which will be that the services surplus will stay this year at the same, relatively low level as in 2004.

In the financial account, the net inflow of foreign capital rose considerably, and with the further appreciation of the Koruna, this trend may continue in 2005. The financial balance will be positively affected by the inflow of EU funds.

Foreign direct investments in the Czech Republic came in the last quarter of 2004 mainly in the form of reinvested earnings, and their volume was in line with the result of the previous three quarters. At the same time, according to the CNB, a high outward FDI occurred in 2004 due to an acquisition in the electricity generation and distribution industry in Bulgaria. Compared to 2004, the 2005 data of FDI will surely be improved by the revenues from the sale of 51.1 percent of Cesky Telecom for around 2.7 billion Euros to Spanish Telefonica. It is also expected, that reinvested earnings of companies with foreign participation will continue to be another driving force behind FDI.

Unemployment

By the end of April 2005, the unemployment rate fell to 8.9 % (registered unemployed) – but it is not comparable with the indicator of the previous period because of a change in the methodology of statistics. The unemployment rate seems to be persistent, there are only few new jobs created, on average there are ten job seekers per vacancy. According to the recommendations of the OECD, the flexibility of the labour market and the ability of workers to move between jobs and locations must be improved in order to handle the inefficiencies of the labour market and to reduce the unemployment rate. However, the relatively high level of unemployment must be assessed together with the fact, that the Czech Republic has one of the highest activity rates in the enlarged EU.

Table 2. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	3.7	4.0	4.0
Private consumption (%)	4.9	2.5	3.1
Public consumption (%)	4.2	-3.2	2.7
Investments (GFCF, %)	4.8	9.1	7.9
Export (%)	7.3	20.9	12.2
Import (%)	7.9	18.5	12.3
Consumer price index (average,%)	0.1	2.8	2.1
Consumer price index (dec/dec, %)	-0.1	2.6	1.9
Unemployment ratio (%)	7.8	8.3	8.3
Real wages (%)	6.5	2.7	4.3
Real ULC (%)	0.9	-2.7	-1.4
General government balance (% in GDP)	-11.7	-3.0	-4.5
Public debt/GDP (%)	38.3	37.4	36.4
Current account /GDP (%)	-6.2	-5.2	-4.7
Trade balance /GDP (%)	-2.7	-0.8	0.1
Gross foreign debt /GDP (%)	38.4	34.2	32.5
Exchange rate (Koruna/EUR)	31.8	31.9	30.1
Base rate	2.0	2.5	1.75

Estonia

Strong growth performance with macroeconomic stability inside the ERM-II

Economic Growth

Economic growth accelerated in 2004 to 6.2%. Export was the main driver of growth with its 16.3% expansion; private consumption also increased while fiscal tightening constrained public consumption. This good performance can be attributed to the strength of the Scandinavian growth cycle, and is expected to continue in 2005 with only a slight slowdown to 5.7% due to external factors.

Real wages grew 3.3% in 2004, most significantly in the public sector. This and rapid credit expansion due to a postponed rise in interest rates as well as the heavy competition and aggressive marketing tactics of banks encouraged private consumption. The 2004 upswing in exports is a result of favourable external conditions: the EU accession was a major (positive) shock to the trade balance while it seems to have left the rest of the economy unaffected. High-tech sectors as well as dairy and meat products were the main sources of export growth. In 2005 export-driven growth is expected to continue despite the weakness of the Euro area while domestic consumption will slow down relatively. Import growth will slow down to a more sustainable level of 6.3%. Social policy measures in 2006 as well as recovering real wages could pace up private consumption in the coming years.

Monetary Conditions

Average headline inflation increased from 1.3% to 3.0% in 2004, 0.8% points above the Euro area. One full percentage point was caused by rising oil prices while 1.3 percentage points were resulted by food prices. Therefore rising inflation is not a sign of demand pressure in the economy; this view is supported by the fact that core inflation actually decreased from an average 2.3% in 2003 to 1.4% in 2004, remaining 0.4% points below the respective indicator for the Euro area. CPI is expected peak at 3.4% in May 2005 and should to return to 2% in the following years. Strict control over administered prices is necessary to control inflation. The greatest risk concerning inflation is the potential persistence of high fuel prices.

The low interest rates maintained by the ECB translated into expansive interest rate environment in Estonia. As usual, Kroon quotations on the Estonian money market follow EURIBOR rates closely; Kroon risk margins remain low. The average interest rate for long-term household consumption and housing loans fell to 4.6% and 3.5% respectively, while interest on long-term corporate loans averaged at 4.7% in 2004. Corporate debt growth slowed down in 2004, while housing loans spread rapidly. The rapidly increasing indebtedness increases the dependence of economic growth on changes in interest rates (approximately 98% of housing loans are based on a floating interest rate) and puts pressure on the external balance. Should this trend continue, authorities may tighten prudential regulations to safeguard the stability of the financial system. Capitalization of banks is good; credit expansion in 2004 was backed mainly by external bonds.

Estonia joined the ERM-II on 27 June 2004 while maintaining its currency board regime pegging the Kroon to the Euro, and the country is expected to adopt the common currency in 2007. The Kroon/Euro fixing currently appears to be around the equilibrium rate, but sustained high current account deficits may put pressure on the exchange rate. However, the Estonian labour market is very flexible, and it is believed that the economy is able to adjust without significant output losses.

Fiscal Policy

Government balance remained positive in 2004 although tax cuts and rapidly increasing wages in the public sector resulted in a diminishing budget surplus. The government reduced the flat income tax rate from 26% to 24% in 2005. The new government taking office in April aims to lower the income tax rate further to 20% by 2007. These tax cuts will be accompanied by accelerated pension rise, and increasing child and family benefits. These extra expenditures will need to be matched with decreasing government consumption to maintain budgetary balance, which is critical for the external stability of the economy. While the EBRD recommended tighter surveillance of government expenditures and urges greater transparency, the IMF suggested increasing indirect taxes (on tobacco and alcohol). Strong growth and a temporary delay of tax reforms reduce the burden by adding extra tax revenues for the time being (0.5% of GDP in 2005-2006).

The overall net impact of EU accession on the consolidated budget is estimated to be -0.1% for 2004, -0.4% for 2005. The effects of VAT changes were roughly neutral in 2004.

Balance of Payments

Consistency between domestic consumption and exports improved in 2004 – this is expected to improve trade balance slightly. Trade deficit reached 26.6% while current account deficit slightly improved from 13.2% to 12.7%, although the absolute amount increased from 16.5 billion to 17.5 billion Kroon. Gross external debt increased by one-third in 2004, mainly due to bond issues by Estonian banks.

The current account is the main source of concern. While of the current account deficit is a result of consumption smoothing, productivity-improving investments and one-off elements such as the reconstruction of Eesti Energia and the Estonian railways (in 2003), the IMF holds that the current account deficit will be unsustainable in the longer term. The current account deficit is not a consequence of decreasing external competitiveness however. With a low domestic saving rate (just 19%) and strong private consumption growth due to real wage increases and credit expansion, tight and credible fiscal policy is needed in the coming years to protect the external balance. Unit labour costs are expected to improve as productivity growth will exceed real wage growth in 2005; this might improve the trade balance through improving competitiveness.

Unemployment

Employment growth was modest in 2004; job creation in the tradable sector is a good sign, and inflows of Structural Funds and tax cuts also help. Unemployment decreased slowly but steadily to 9.7% in 2004. Structural unemployment and supply-side constraints might impede long-term economic growth however. Supporting small municipalities and SME development could boost employment and reduce significant regional income differences as well.

Table 3. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	5.1	6.2	5.7
Private consumption (%)	5.4	6.1	4.7
Public consumption (%)	5.8	5.2	5.6
Investments (GFCF, %)	5.4	6.9	6.8
Export (%)	5.7	16.3	9.1
Import (%)	11.0	13.8	6.3
Consumer price index (average,%)	1.3	3.0	3.4
Consumer price index (dec/dec, %)	1.1	5.0	3.2
Unemployment ratio (%)	10.1	9.7	9.7
Real wages (%)	7.1	3.3	3.5
Real ULC (%)	2.1	0.7	-0.4
General government balance (% in GDP)	3.1	1.8	0.9
Public debt/GDP (%)	5.3	4.9	4.6
Current account /GDP (%)	-13.2	-12.7	-11.3
Trade balance /GDP (%)	-21.3	-26,6	-25.1
Gross foreign debt /GDP (%)	70.3	84.1	90.5
Exchange rate (EEK/EUR)	15.646	15.646	15.646

Hungary

The country faces growth slowdown with sizeable fiscal pressures

Economic Growth

Economic growth in Hungary in 2004 was vigorous though declining quarter by quarter, allowing a 4% increase of GDP. Contrary to 2002-2003, when the growth was almost exclusively driven by the expansion of domestic demand and net exports played a negative role, in 2004 exports increase more than doubled compared with the previous year and net exports contributed positively to growth. At the same time private consumption growth declined from almost 8% in 2003 to 3,5% mainly due to slower real wage increases, rise in interest rates and increasing unemployment. The fast increase of exports driven primarily by the manufacturing sector was accompanied by significant rise in investments both in public and private sectors.

Notwithstanding the annual dynamism of GDP growth quarterly data reveal that growth started to loose it momentum in the second half of the last year. One reason behind this has been the decline in import demand from Hungary's major trading partners, leading to slower rise in exports and net exports' contribution to GDP. On the other hand the slowdown of domestic demand (mainly private sector consumption) in 2005 will intensify as private consumption is expected to grow by 3,5% and private investments by 6%. Private consumption is limited by slower wage increases (though the lower than expected inflation will result in real wage increases faster than thought initially), increasing unemployment and declining consumer confidence, constraints imposed on the household sector borrowing and increasing uncertainty on foreign currency borrowing due to higher exchange rate volatility and depreciation pressure on the Forint. Investments will grow less than in 2004 as public sector gross capital formation will be smaller and private investments will grow also slower due to worsening market confidence and expectations concerning the growth of internal and export markets.

Monetary Conditions

Similarly to other New Member States, consumer price increases accelerated in 2004 reaching on average 6,8% after 4,7% in 2003. One major factor behind this acceleration has been the adjustment of certain indirect taxes, which had a strong spill-over effect on prices in 2004. Another important factor fuelling inflation has been the fast rise in nominal and real wages in 2003 and partly also in 2004, while at the same time oil price increases added to inflationary pressure too.

In 2005 the reversal of inflation developments is expected and the inflation target of the central bank 3,5% with a tolerance band of 1% will be met. Disinflation is supported by the moderation of wage growth, small second round effects of last years tax increases, and by the downward pressure coming from imported inflation. At the same time the volatility of the exchange rate and its expected depreciation will not have a sizeable effect on domestic price increases.

The lower consumer price increases allow the central bank to reduce interest rates high in regional comparison. Interest rates were increased sharply in December 2003 to avoid a strong run on the domestic currency and they remained practically unchanged in 2004 due to rising inflation and pressures coming from the fiscal policy and current account deficit. The better than expected inflation performance allowed however the central bank to accelerate the reduction of interest rates in 2005, which may decline to 7% by the end of the year. The central bank finds itself however in a difficult situation: on the one hand disinflation would allow a faster than thought reduction of interest rates, while at the same time fiscal and current account imbalances prevent the central bank from a more ambitious reduction of interest rates.

The last year was characterized by the relative strength and almost uninterrupted appreciation of the domestic currency, which began after the EU accession: the Forint appreciated against the Euro in less than a year from 256 to 244, driven by the inflow of short and medium term capital stimulated by interest rate differentials, increased foreign currency borrowing by the private and public sectors. This strengthening resulted in sizeable real exchange rate appreciation and loss of price competitiveness. From March 2005 onwards the appreciation was reversed partly as a reflection of a broader regional trend, and partly of the worsening macroeconomic conditions and investors expectations concerning the sustainability of current macroeconomic policies. As a result, the last two months saw a significant depreciation and the annual developments are closer to the continued weakening of the Forint due to the mounting macroeconomic imbalances.

Fiscal Policy

The Achilles-heel of the domestic macro-economic developments is related to the state of public finances. In 2004 the revised deficit figures show that the general government deficit was 4,5% but this includes the possibility of temporary reclassification of second pillar pension funds inside the general government allowed by Eurostat, which reduces the deficit figure for 2004 by 0.9% of GDP. Moreover, the reclassification of VAT refund resulted in 0,7% increase of deficit for 2003, while the delays in certain current expenditures (postponement of the 13th month salary pay in the public sector for January) reduced the cash flow deficit but maintained the accrual based one at higher levels. While in 2004 the deficit was higher than expected, public debt declined somewhat due to high GDP growth, but remained 58% of GDP almost reaching the Maastricht criterion.

The expectations concerning 2005 are not much better notwithstanding the 3,9% target of the government for the general government balance. First, the assumptions underlying this target may prove to be too optimistic as revenue collection may fall short due to lower increase in GDP and lower than planned inflation. On the other hand the elections scheduled for 2006 may result in a political cycle driven fiscal policy, which would loosen the stance of fiscal policy further. Some measures announced already by the government imply that the deficit target may be breached and it is likely that the ESA 95 general government deficit may become 5,5% of the GDP unless adjustment measures are implemented. The fiscal difficulties and the need for fiscal adjustment is also reflected by the very recent downgrading of the Hungarian sovereign debt by S&P and the repeated calls by international agencies to adjust fiscal imbalances.

Balance of Payments

Thanks to fast rise in exports the trade balance improved in 2004 but the current account deficit remained almost unchanged, around 8,5% of GDP. The major factor of the high current account deficit is the deficit in incomes balance due to significant profit repatriation and increased costs of foreign debt service. While in 2002 and 2003 the country experienced almost identical current account deficit, the composition of its financing changed in 2004, as the increased inflow of foreign direct investments and higher net FDI allowed a more comfortable financing, and less reliance on debt creating flows.

In 2005 the trade deficit is expected to shrink further as the gap between the rise in exports and imports will remain unchanged, though both will rise at a lower pace. The trade deficit however will be accompanied by an almost unchanged current account deficit, which may reach 8,5% of GDP. This is mainly due to the performance on the incomes and services balance, which both result in sizeable increase of current account deficit. In 2005 the financing gap reflected by the current account deficit is driven by the increased net dissaving by the government sector not counter-balanced by higher private sector savings. The financing of current account in 2005 will be mainly through non debt-creating inflows as FDI is expected to be around 3,5 billion Euros and this will permit the stabilization of foreign debt to GDP ratio at the 2004 level.

Unemployment

Hungary has the lowest unemployment rate among the New Member States, which is partly overshadowed by its employment rate, which is one of the lowest among the NMS countries. The number of unemployed in March 2005 was 300.000, which exceeded the figure of March 2004 by 50.000. The main reason behind the increase of unemployment has been the ongoing lay-offs in the public sector, while at the same time the private sector was not able to increase employment due to the weakening external demand. This has especially affected the manufacturing sector, while in services some increase of employment was visible.

The forecast for 2005 is that there will be no increase in employment due to the further lay-offs in the public sector and the small increase in demand for labour in the private sector. The services are likely to record again increase in employment while manufacturing will suffer further lay-offs due to the weak demand conditions. Unemployment is likely to remain 7,2%, while activity rate 64,5%.

Table 4. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	3.0	4.1	3.2
Private consumption (%)	8.0	3.5	3.5
Public consumption (%)	5.5	-1.5	2.5
Investments (%)	3.5	8.2	6.0
Export (%)	7.5	15.5	8.0
Import (%)	10.5	14.0	6.5
Consumer price index (average, %)	4.7	6.8	3.3
Consumer price index (dec/dec, %))	5.7	5.5	3.2
Unemployment ratio (%)	5.8	6.1	7.2
Real Wages (%)	4.5	2.6	3.5
ULC (%)	7.5	4.0	3.5
General government balance (%)	-7.2	-5.5	-5.2
Public debt/GDP (%)	57.0	58.0	59.0
Current account/GDP (%)	-8.5	-8.9	-8.3
Trade balance/GDP (%)	-4.0	-2.8	-2.5
Exchange rate (HUF/EUR)	262	245	255
Base rate (%)	12.5	9.5	7.0

Latvia

Latvia has recorded the fastest growth among the 8 NMS driven by expansion of domestic demand with its obvious effect on trade balance

Economic Growth

In 2004 Latvia recorded the highest rate of economic growth among the New Member States with the 8,5% expansion of GDP. The major driving force behind this sizeable expansion was the fast rise of private consumption and the extreme increase in gross capital formation. The increase of private investments was mainly driven by the rise of bank lending, increasing inflow of EU funds and a further increase in foreign direct investments. The entry to the European Union opened new markets for the Latvian exporters, and the expected expansion of exports resulted in significant rise in private sector investments. At the same time the increase in real incomes, the loosening liquidity constraint due to the fast rise in banking sector lending to the households sector and the expectation effect of EU enlargement resulted in sizeable increase in private consumption. Due to these changes domestic demand expanded briskly and offset far the negative contribution of net exports to GDP. The latter was mainly related to the rise of imports due to the expansion of private sector absorption, exceeding by far the rise in exports.

The changes in GDP in the first quarter of 2005 confirm the continued vitality of the Latvian economy. Exports continue to expand fast, while at the same time private sector investment and consumption spending grows at an almost unchanged speed. There might be some slowdown in private consumption in 2005 due to the much slower rise in nominal wages and expected increase in savings propensity of the household sector, but this slowdown will remain quite moderate and will result in only slightly lower rates of GDP growth. The expectation is that GDP will grow by 7% driven similarly to the previous year (when its growth was fuelled by the expansion of non-tradable service sectors) by the growth of services followed by the expansion of manufacturing. The entry to the ERM-II is likely to have beneficial effects on expectations and may directly influence both the increase of private consumption and investments.

Monetary Conditions

Similarly to other New Member States Latvia experienced in 2004 a fast acceleration in inflation, which was however very significant (2.9% in 2003 and 6,2% in 2004 for consumer price increase) compared to other NMS. The major factors behind that were the fast rise of domestic demand, increase of labour costs and incomes. Besides that the entry to the EU resulted in tax and price adjustments as well as changes in regulated prices. In the last year the effect of the depreciation of the Lats pegged to the dollar against the Euro has also contributed to the acceleration of price increases. Finally, the significant increase of productivity as well as the rise in demand for services resulted in fast increasing demand for non-tradable products leading to their accelerated price increases.

Among these factors some seem to remain unchanged in 2005 as well. First, the rise in domestic demand remains almost unchanged, while at the same the moderation of wage increases will only partly be transformed to lower price increases. On the other hand it is likely that the pace of price adjustment, changes in administrative prices and in indirect taxes will have a much smaller effect on inflation. Moreover, the entry to the ERM-II will act as a moderating factor on future price increases and will contribute to disinflation. There is however one worry concerning price developments in Latvia. If the monetary and fiscal authorities are unable to put inflation under firm control, then the second round effects of price increases in 2004 may feed back to inflation in 2005. Balancing the potential challenges and favourable factors, consumer price inflation is likely to be around 4,8% on average.

The evolution of interest rates and of exchange rate is driven mainly by the entry to the ERM-II regime, which brings additional stability to the evolution of major macroeconomic variables. Exchange rate is expected to be stable and thus meet the Maastricht criteria, and interest rate policy of the central bank will remain basically unchanged.

Fiscal Policy

Latvia has always been among those New Member States, where fiscal prudence was one of the key macroeconomic assets. In 2004 the fiscal deficit declined sharply mainly driven by the fast rise in tax receipts connected with fast GDP growth and much higher than expected inflation. The positive cyclical effect was sufficient to outweigh the increased public expenditures, and the emerging co-financing needs of the government. Thanks to this the deficit in 2004 was just half of the previous year and further reduction is likely in 2005.

In the current fiscal year the government is likely to continue its tight fiscal policies, but the deficit is expected to worsen due to growing co-financing need to the EU supported funds. This rise in primary expenditures will be offset by the increase of primary revenues due to positive cyclical effects and growing funding from the European Union. As a result the deficit will increase and may reach 1,5% of GDP. On the other hand public debt ratio has been stabilized around 14% of GDP already in 2001 and has remained at the same level for many years. As long as the Latvian economy grows so fast and the gap between real growth and real interest rates remains sizeable, the debt ratio will remain broadly unchanged.

Balance of Payments and Current Account

Latvia has the biggest trade deficit among the New Member States reaching 20% of GDP in 2004. The country has been able to maintain trade deficit in excess of 15% of GDP for many years, partly due to much better and less worrying current account performance thanks to revenues from services and other incomes. Both trade and current account deficits increased significantly in 2004 due to the described expansion of GDP and the role played by private consumption and investments in it. In 2005 a reversal in the growth of trade and current account imbalances is expected as the increase of imports will decline to around half of its level (still sizeable in nominal terms) and this will feed back to trade balance. Due to this reversal in import trends the trade deficit is expected to be 20% of GDP, while the current account may decline to 10% from the 12,5% in 2004.

Unemployment and Labour Markets

The labour market situation is influenced by two simultaneous but diverging developments. On the one hand fast GDP growth has resulted in a significant increase in labour demand, which led to rise of employment, fuelling back to wage increases. On the other hand unemployment has remained considerably high, reflecting structural problems and labour market rigidities and also putting somewhat downward pressure on the rise in wages and incomes. The outlook for 2005 is influenced by the marked reduction of expected wage increases as incomes policies and private sector wage setting behaviour become more conservative. Slower wage increases and fast economic growth will allow the authorities the reduction of unemployment almost to 9% of the labour force, which is by 25% lower than in stood in 2001.

Table 5. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	7.5	8.5	7.0
Private consumption (%)	8.6	9.9	6.0
Public consumption (%)	1.9	2.7	2.5
Investments (%)	10.8	19.5	14.0
Export (%)	9.5	10.5	8.5
Import (%)	13.0	14.0	7.0
Consumer price index (average, %)	2.9	6.2	4.8
Unemployment ratio (%)	10.4	9.8	9.0
Real Wages(%)	7.9	9.6	2.8
ULC(%)	5.2	8.5	1.5
General government balance (%)	-1.5	-0.8	-1.5
Public debt/GDP (%)	14.5	14.5	14.5
Current account/GDP (%)	-8.5	-12.5	-10.0
Trade balance/GDP (%)	-18.0	-20.0	-20.0
Gross foreign debt/GDP(%)	79.6	91.7	95.5
Exchange rate (LVL/EUR)	0.60	0.69	0.7

Lithuania

Lithuania shows fast growth and stable macroeconomic situation on the road to the Euro-zone

Economic Growth

GDP growth recorded a slight slowdown in 2004 compared with the previous year, but it was still the second highest after Latvia with 6,7% increase. Last year witnessed a pronounced shift in the composition of growth from external to domestic sources as the contribution net exports declined sharply, while of domestic demand remained almost unchanged. Domestic demand was driven by the considerable rise in private consumption and investments.

The former was mainly fuelled by rising wages and widening household sector borrowing (stimulated by increased competition among the banks and increased lending to the household sector, low interest rates following successful disinflation, and increase reliance on foreign currency denominate borrowing), which considerably eased liquidity constraint of the household sector. Private investments were driven by the positive expectations surrounding EU enlargement, the rise of foreign direct investments and increase in domestic demand. Due to surging private investments and consumption imports grew fast and outpaced far the growth of exports, leading to a significant deterioration in the contribution of net exports to economic growth.

The developments in the first quarter show that here may be some change in growth performance of the economy. First, it is likely that the growth of private consumption will moderate in 2005 compared to the fast rise in the previous two years, mainly as a result of slower income growth and more cautious spending by the household sector. At the same time private sector investment will increase very fast as a result of inflow of foreign direct investments, improving profit prospects and ongoing reshaping of European production.

Thanks to the rise of investments seen in the last two years, export competitiveness is expected to improve and exports will rise much faster in 2005, than in 2004 reducing the negative contribution of net exports to GDP. At the same time the moderation of private consumption growth will result in a slower increase of imports, supporting the reduction of the gap between export and import growth. Altogether GDP is expected to rise by 6,5%, driven by 14% increase in private investments and 6% growth in private consumption.

Monetary Conditions

The evolution of monetary conditions is strongly influenced by the ERM-II membership and exogenous factors driving price changes. Lithuania was among the first New Member States to join the ERM-II in 2004 and since that time it has been successful in preserving the stability of its currency. Similarly to Estonia, Lithuania has also some experience with managing fixed exchange rate regime, thanks to its successful currency board arrangement. The underlying macroeconomic developments and the state of major macroeconomic fundamentals allow forecasting a smooth transition to the Euro zone by 2007 and no significant exchange rate pressure is likely to occur in 2005.

After recording deflation in 2003, price increases accelerated in 2004 leading to still low inflation of 1,2%, driven mainly by the rise in oil and the changes in administrative prices, certain indirect taxes that increased inflation in other New Member States too. Consumer prices are expected to grow faster in 2005 due mainly to the further increase of oil and other imported prices, to the rise of non-tradable prices driven by the fast increase of productivity and growth in nominal wages, and the remaining adjustments in administrative prices.

Finally, the changes in relative price structure following the EU accession have not yet been completed and this may also lead to pressures on prices. Altogether consumer price inflation is likely to be the highest in 2005 in the last five years but afterwards price increase may slow down from 2006 onwards.

Fiscal Policy

The changes in general government deficit and public debt were of different direction in 2004. The deficit of the general government deteriorated notwithstanding the significant growth of tax revenues due to fast GDP growth. The main factors leading to the worsening of the deficit were the rise in public investments, the emerging co-financing requirements, the growth in public sector wages and support given to certain sectors (health care among others). As a result, general government deficit increased to 2,5% still below the Maastricht reference value. On the other hand public debt declined in 2004 as the fast rise in growth and the low interest rates outweighed the negative effect of growing fiscal deficit on public debt dynamics.

Concerning fiscal developments in 2005, no change in deficit is expected and it is forecasted to remain 2,5% of the GDP. While fast economic growth will contribute to increase in tax revenues and the access to EU-transfers will increase non-tax revenues, these positive effects will partly be outweighed by the rise of expenditures. Part of that reflects the continuation of trends from 2004 (increase in public sector wages, growing public sector capital formation, etc.), but there are some new factors as well (among others the impact of pension reform on expenditures). Public debt is expected to remain mainly unchanged as the unchanged deficit to GDP ratio is matched by positive gap between real GDP growth and real interest rates.

Balance of Payments and Current Account

The current account dynamics are driven by the changes in trade balance. Lithuania has experienced in recent years a small increase in trade deficit from around 9% of GDP in 2001 to slightly above 10% in 2004. The main reason behind this increase has been the fast increase of domestic absorption, driven by the mentioned rise in private consumption and investments. The annual rise in imports in last four years on average was around 15% and exports could not keep the pace of this increase. At the same time current account deficit widened on par with the trade deficit as other items (income balance and transfers) remained unchanged.

The forecast for 2005 is the further growth of trade deficit reaching 11% of GDP, since the gap between import and export growth remains above 3 percentage points widening further the trade deficit. While the competitiveness of Lithuanian exports increases, and the one-off import effects of EU accession may gradually vanish, Lithuania will still have an increasing trade and current account deficit.

Unemployment and Labour Markets

Lithuania has traditionally been one of those New Member States which have had high unemployment rates. In recent years unemployment started to decline: it was reduced from 16,5% in 2001 to 11% in 2004 and a further slight decline is expected in 2005. The main factors behind the decline of unemployment were the increase of labour demand driven by fast GDP growth and the increasing emigration of the Lithuanian workforce mainly to the Scandinavian countries. The unemployment rate is expected to remain broadly unchanged, around 10,5% in 2005.

Table 6. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	9.7	6.7	6.5
Private consumption (%)	12.4	9.4	6.0
Public consumption (%)	4.0	5.6	5.0
Investments (%)	14.0	12.3	14.0
Export (%)	10.2	12.7	6.5
Import (%)	8.1	6.1	8.5
Consumer price index (average, %)	-1.1	1.1	2.7
Consumer price index (dec/dec, %))	-1.2	1.0	2.5
Unemployment ratio (%)	12.7	10.8	10.5
Real Wages(%)	9.3	6.1	4.5
ULC (%)	0.9	0.3	1.5
General government balance (% in GDP)	-1.9	-2.5	-2.5
Public debt/GDP (%)	21.4	19.7	20.0
Current account/GDP (%)	-6.9	-8.3	-8.5
Trade balance/GDP (%)	-9.2	-10.2	-11.0
Gross foreign debt/GDP (%)	47.0	46.0	44.0
Exchange rate (LTL/EUR)	3.45	3.45	3.45
Base rate(%)	3.00	3.00	3.00

Poland

Poland's economic performance in the first quarter of 2005 was characterized by lower than expected inflation, and weaker economic growth than in the previous year.

Economic Growth

The growth rate of GDP in the first quarter of 2005 was lower than in the same period of the previous year, when the annual real GDP growth rate reached 5.3 percent. In the first quarter of 2004 real GDP grew by 6.9 percent, and the growth rate gradually decreased to 3.9 percent by the fourth quarter, as the one-off effects of the accession to the EU have gradually diminished. The GDP growth of close to 3 percent (estimated value) in the first quarter of 2005 seems quite low compared to this. However, as the year unfolds, GDP growth rate is expected to increase slightly, compared to the first quarter.

GDP growth for the whole of 2005 is likely to reach 4.4 percent. The main driving force of growth will be the higher dynamics of investment, and rising overall domestic demand. The main driving force in 2003 and 2004 of growth was net exports, but in 2005 its role will be declining. The expected Zloty appreciation will have a weakening effect on economic growth. Growth of investments is increasing, although not enough to fully offset the fall in net exports. A high growth rate of investment outlays is expected, which will initially stem from a low reference base, and will subsequently result from the impact of investments co-financed with the EU-funds and a fall in capital costs. At the same time the uncertainty of consumer demand, which results from the gradual rebound in employment may have a slowing effect on investment growth. In case of positive developments in the labour market, faster real wage growth, and growing consumer confidence and consumer demand will happen, giving a further boost to investments. In the second half of 2005 GDP growth rate may accelerate.

Monetary Conditions

Yearly average CPI reached 3.5 percent in 2004 in Poland. This was a significant rise compared to the low level of CPI (0.8 percent on average year-on-year) observed in 2003. The inflation rise was mainly due to the rising food and oil prices, and the EU accession-related increases in indirect taxes.

In January 2005 surprising inflation developments occurred: the year-on-year CPI in the first month was significantly lower then earlier expected, reaching 4 percent (while the consensus forecast of the market was 4.6 percent, and even optimistic forecasts did not go below 4.4 percent). In February it decreased further, to 3.9 percent. This was mainly the result of a reduction in the dynamics of food and fuel prices. The reduction of fuel prices most likely stemmed from the strong Zloty appreciation at the end of 2004. The price rise of clothing and footwear was also lower then expected. PPI was also falling in the first quarter, reaching 4.4 percent year-on-year in January and 3.7 percent in February. The main reasons behind this development were similar to that of the fall in CPI (falling prices of fuels, metals, and other natural resources as a result of the strong Zloty). The fall in PPI will contribute to the reduction of CPI in subsequent months.

A surprising development in Polish monetary policy was the decision of the Monetary Policy Council of the National Bank of Poland to change bias from tightening straight to easing (the probability of a rate cut is higher then the probability of a rate hike), stepping over the possibility of keeping a neutral stance. The MPC justified its decision by pointing to the positive business climate, the improvements in the labour market, and inflation fall driven only by food and fuel prices declines.

The CPI is expected to drop further as the year unfolds, reaching about 2.3 percent by the end of the second quarter, and staying around that level by the end of the year. The strong Zloty will contribute to dampening inflationary pressures. At the same time Zloty appreciation may force the MPC to cut rates, which may increase the risks of future inflation. The MPC already made a 50 basis point rate cut on 31 March, which put the reference rate to 6 percent. At its April meeting the MPC changed its bias from easing to neutral, and made a further interest rate cut of 50 basis points, putting the reference rate to 5.5 percent. At its May meeting the MPC maintained its neutral bias, and decided to keep the interest rates unchanged. The change to neutral from easing bias in monetary policy in April was due to growing political uncertainty regarding the economic programme of the next government concerning the path of fiscal deficit reduction, and the path of joining the Euro zone. No further interest rate cut is expected until July, and by the end of the year, an NBP reference rate of 5.25 percent is likely.

Fiscal Policy

The general government deficit was lower in 2004 than earlier expected, reaching 4.8 percent of GDP. This was mainly the result of the better than expected performance of the social security sub-sector by 0.7 percent of GDP, and the better than expected position of the central government. After January 2005 the deficit of the state budget reached only 4.5 percent of the annual plan, while in 2004 the same monthly indicator was much higher, reaching 11.9 percent. This could increase the propensity of actors of the domestic debt market to invest in government bonds. In 2005 the general government deficit is expected to reach 4.4 percent of GDP.

General government gross debt reached 43% of GDP, which was lower than expected. This resulted mainly from the stronger than expected nominal GDP growth, higher than expected privatisation proceeds (mainly due to the privatisation of PKO BP, the biggest Polish bank) and favourable valuation effects following the appreciation of the Zloty. In 2005 the general government gross debt as a percentage of GDP is likely to increase to 46.8 percent. In 2005, just as in 2004, the budget deficit will be financed mainly by bonds, and 5.7 billion Zlotys of privatisation revenues are planned.

Balance of Payments

Poland's export performance was strong in 2004. The growth rate of exports was higher (22 percent) than of imports (19.1 percent) and trade deficit reached 4,5 million Euros, which was 570 million Euros lower than in the same period of 2004. The current account deficit narrowed to 1.5 percent of GDP. In 2004 FDI inflows were higher than in the previous year, reaching 4,841 million Euros (as opposed to 3,681 million Euros in 2003). Inflow of portfolio investment was 2.5 times higher than in the previous year. This resulted from a high demand for Polish government bonds stemming from increasing trust of foreign investors, as well as the appreciation of Zloty.

In the first quarter of 2005 the favourable external performance continued. In February both the current account and the trade account showed a surplus. The growth of imports and exports remained robust, but in Zloty terms growth rates of exports are close to zero, due to the strong Zloty appreciation during the last 12 months.

For the whole of 2005 a deterioration of the current account is expected, to a deficit of 2.4 percent of GDP. This will be the result of strengthening domestic demand, which will be pulling import growth. The capital account and the current account will both be positively affected by higher EU transfers in 2005.

Unemployment

Unemployment is still a serious, deep-seated structural problem in Poland, although since the second quarter of 2004 conditions appear to be improving. In 2004 the unemployment rate reached 18.8 percent, and in 2005 it is expected to drop further, to 18.3 percent, with employment growth becoming stronger in coming years. At the same time the ongoing restructuring process in heavy industry and agriculture, as well as unfavourable demographic conditions will remain the strong structural reasons underlying high Polish unemployment.

As for the beginning of 2005, there have been signs of improvement on the labour market. After seasonal growth of registered unemployment in December and January, the unemployment rate has been dropping gradually, to 19.4 percent in February. This means a 1.2 percentage point decrease compared to the same month of the previous year. The number of newly registered jobless has also been falling in the first quarter of the year 2005. In March the fall of the registered unemployment rate is expected to continue.

The pay rise in the beginning of 2005 was lower than expected, reaching 2.6 percent year-on-year in January. The wage bill in the corporate sector was almost the same as in the previous year (reaching 0.1 percent year-on-year in January). The real pension bill was 0.6 percent lower in January than in the same month of the previous year. Therefore in the beginning of 2005 there was not yet a driving force from the side of households' revenues to increase private consumption.

Table 7. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	3.8	5.3	4.4
Private consumption (%)	3.0	3.2	3.8
Public consumption (%)	0.1	1.4	1.1
Investments (%)	-0.5	5.6	10.0
Export (%)	14.7	11.4	10.1
Import (%)	9.3	8.7	11.1
Consumer price index (average, %)	0.8	3.5	2.2
Consumer price index (dec/dec, %))	1.7	4.4	1.6
Unemployment ratio (%)	19.2	18.8	18.3
ULC (%)	-4.1	-0.7	0.7
General government balance (% in GDP)	-4.5	-4.8	-4.4
Public debt/GDP (%)	45.4	43.6	46.8
Current account/GDP (%)	-2.2	-1.5	-2.4
Trade balance/GDP (%)	-2.7	-2.5	-3.0
Gross foreign debt/GDP (%)	50	44.2	36.5
Exchange rate (PLZ/EUR)	4.4	4.53	4.03
Base rate	5.2	6.5	5.3

Slovakia

Slovakia was one of the quickest growing economies of the Central European countries and is set to continue growing at the highest pace in regional comparison.

Economic Growth

Economic growth in Slovakia accelerated to the fastest pace in Central Europe in 2004, and our projection contains similarly favourable rates in regional comparison for 2005, foreseeing a rate of around 5 percent. Behind the high growth rate domestic demand and investments are the most important factors, and they are expected to remain so for 2005, with a more dynamic growth of exports and imports compared to the previous year, mainly because of the launching of production and exports of large FDI-related projects. Private consumption was especially vigorous in 2004, partly because of growth in real wages, and partly because of lower income taxes. In 2005, domestic demand will be fuelled by higher wages, a decrease in savings and a growth in household credits. Public consumption is expected to increase at the same pace as its private counterpart, partly because the co-financing of EU-funded projects was postponed from 2004 to 2005.

Investments (gross fixed capital formation) are expected to grow quickly, due partly to the realisation of the already mentioned large, FDI-related greenfield projects. Correspondingly, the growth rate of GFCF expected to be among the highest in the region, which makes the optimism of the growth forecasts credible.

Monetary Conditions

While inflation was high (close to 7 percent) in 2004, data for 2005 indicate a substantial decrease in the rate of price increases. Consumer prices inflation (HICP) stayed at a low level in the first quarter of 2005. In March, the year-on-year inflation was 2.3 percent, and core inflation was 1.8 percent. Monthly rates in 2005 are also low, with a deflation of 0.1 % in March. 2005 inflation data seem to develop favourably, compared to 2004, partly as indirect tax increases of 2004 are not repeated and the share of administered prices is lower in 2005 than in 2004. On the other hand, wage increases and (centrally administered) higher utility prices act as inflationary factors. On the basis of all the above-mentioned factors, attaining the Central Bank's firstly announced explicit inflation target of 3.5±0.5 % is feasible.

The Slovak Koruna has been appreciating, and the National Bank tried to stop that several times, when it intervened in the market in order to weaken the local currency and reduced interest rates, with mixed results as far as the appreciation of the Koruna is concerned. At the end of March, the two-week repo rate stayed at 3.0 percent.

Monetary policy will be under further pressure this year because of large capital inflows connected to privatisation, FDI and portfolio investments, all insensitive to the strong Koruna and the low interest rate.

The government set the date for the adoption of the Euro in January 2009 (or in 2010), thus the country should join the ERM-II in 2006.

Fiscal Policy

The fiscal deficit for 2004 was shaped by the highly praised (by experts and international organisations) and criticised (by other EU governments) introduction of a flat corporate, personal income and value-added tax rate of 19 %, supplemented by other reforms in the welfare system. The extent of the reduction of revenues was estimated to reach 1 percent of the GDP. Higher than planned revenues (mainly because of higher than expected growth) and lower expenditures due to the welfare reform and lower interest bill together with the postponement of co-financing for EU-funded projects resulted in a lower than planned fiscal deficit. In 2005, new factors as EU co-financing, the introduction of a pension reform, higher spending on health care funding due to new rules and a more than 600 million Euros payment obligation to a Czech private bank are expected to increase fiscal deficit. For example, the budgetary impact of the second-pillar pension reform in itself is estimated to reach at least 0.4 percent of GDP. Thus, the overall fiscal deficit is expected to increase to 3.8 percent in GDP, however, contrary to the forecasts, the central government budget showed a slight surplus at the end of March.

Public debt is comfortably below the Maastricht criterion of 60 percent and is set to increase slightly compared to GDP in 2005, due to the increase in the fiscal deficit.

Balance of Payments

2004 saw a widening of the current account deficit compared to the previous year, due mainly to the higher growth rate of import and increased profit repatriation. (A slower growth of exports was partly due to the introduction of the production of a new car model by Volkswagen, which underlines the high product concentration of exports and the determining role of companies with foreign participation in exports.) An increase in the current account/GDP indicator to between 5-6 percent is foreseen even for 2005, however, it still remains at a sustainable level. At the end of February 2005, the current account was in deficit, behind which a substantial deficit of the trade balance was the main factor. For the whole year, the trade balance is expected to remain in the red, because the quick growth of exports will be offset by a slightly higher growth of imports. This latter is the result of bigger private consumption and the large volume import of machinery and equipment for the above-mentioned greenfield FDI projects. Further appreciation of the Koruna may undermine export competitiveness, the risk of which is not very high given the high growth in productivity. Tourism revenues, which grew dynamically in 2004, will be hit this year by the windstorm in the Tatra Mountains in November last year, which had a devastating effect on a large part of the area. Profit repatriation is foreseen to remain at the same high level as in 2004.

FDI inflows are likely to climb high in 2005 and finance fully the current account deficit. First, Slovakia improved its overall business environment to a great extent in 2004. Second, privatisation-related FDI will be substantial. The government already sold a 66 percent stake in the leading Slovakian electric power company to the Italian Enel (for around 900 million Euros, according to newspaper articles, which is expected to be cashed in the second half of 2005). Privatisation of other state-owned utilities is planned for 2005. Third, the Ministry of Economy and Sario, the Slovakian investment agency is resolute to use generous incentives in order to fulfil the 3.3 billion USD target of FDI this year. On top of that, the gradual realisation (and connected inflows) of the big automotive projects (PSA Peugeot Citroen and Kia) provides itself a sufficiently large FDI for 2005. Notwithstanding, in the first quarter of 2005, the inflow of FDI was slightly lower than in the corresponding period of 2004, with Hungary being the biggest investor.

The financial account (especially other investment and FDI) in 2005 is expected to counterbalance the current account deficit.

Unemployment

In spite of the favourable growth record, employment grew only moderately and unemployment remained at a high level. The unemployment rate is among the highest in the NMS region, and is twice as high as the EU-15 average, which is especially unfavourable for the economy given the low activity rate. Thus, productivity growth was mainly responsible for the high rate of growth, which can be explained partly by the 2004 tax reform, which taxes labour more than capital, thus acting as a disincentive for job creation. Unemployment was at 18 percent at the end of 2004, and the overwhelming majority of unemployed are without job for long periods, despite the 2004 reforms of the welfare system, which were aimed at improving incentives to work. (Registered unemployment showed different extents – 13 percent at the end of the year – and trends in 2004.) Other unfavourable factors are the persistent labour shedding in the public sector, and strong regional differences in unemployment rates. Forecasts predict only a slight decrease in the relentlessly high unemployment rate in 2005, because structural factors still hinder growth in labour market flexibility. Among these, according to an IMF report, mismatch of demanded and supplied skill composition, regional differences in unemployment and low migration are the most important. Moreover, non-wage labour costs are among the highest in the region.

Table 8. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	4.5	5.5	4.9
Private consumption (%)	-0.6	3.5	4.6
Public consumption (%)	2.7	1.2	4.7
Investments (GFCF, %)	-1.5	2.5	9.9
Export (%)	22.5	11.4	11.7
Import (%)	13.6	12.7	12.9
Consumer price index (average,%)	8.5	7.5	4.0
Consumer price index (dec/dec, %)	7.7	6.9	3.6
Unemployment ratio (%)	17.5	18.0	17.6
Real wages (%)	-1.5	3.4	3.6
Real ULC (%)	-1.3	-2.0	-0.2
General government balance (%)	-3.7	-3.3	-3.8
Public debt/GDP (%)	42.6	43.6	44.2
Current account /GDP (%)	-0.8	-3.4	-5.0
Trade balance /GDP (%)	-2.3	-3.5	-4.8
Gross foreign debt /GDP (%)	55.6	53.9	49.8
Exchange rate (Koruna/EUR)	41.5	40.1	38.3
Base rate (%)	6.5	5.0	3.0

Slovenia

After entering the EU and ERM-II Slovenia has had strong economic performance and it already meets Maastricht criteria except inflation.

Economic Growth

Real GDP growth in 2004 surpassed expectations owing to a large swing in net exports, which was the aftermath of the favourable international environment. Domestic demand growth maintained momentum, but below anticipated pace. Private consumption strengthened appreciably, but to a lesser extent than expected. There was a marked restructuring of household financial assets and the propensity to save appears to have increased. In contrast, gross investment growth slowed somewhat owing to smaller contribution of inventories. Wage developments also played a positive role, as the pace of real wage increases lagged behind productivity growth by a wider margin than in 2003.

Looking ahead, a slowdown in economic growth can be expected. The likely contributory factors are slower export growth in line with the projected trend in import demand in Slovenia's main trading partners in the EU. Accordingly, real GDP is projected to grow by 4.6 percent in 2005 and by 3.7 percent in 2006, implying that the economy will continue to expand above or about its potential rate. A pick up in domestic demand growth is not foreseen on the assumption that factors propping up financial saving by households will continue to be present, bank credit growth will stabilize and the investment abroad by Slovene enterprises and mutual funds will persist. In the absence of major shocks and with supportive policies, inflation is likely to fall further, though risks remain.

Monetary Conditions

Progress with disinflation in 2004 was more rapid than envisaged (5.7% in 2003, 3.6% in 2004), notwithstanding higher oil prices, a pick-up in producer price inflation, and growth of prices of certain categories under the regulatory price regime (notably, municipal services).

Supply side and structural factors were important driving forces behind this trend: improved harvest, elimination of duties on imports from the European Union, and increased competition in the retail market resulted in falling food prices and more moderate increase in prices of non-food items. Disinflation was additionally reinforced by the elimination of the depreciation policy upon ERM-II entry and the subsequent maintenance of exchange rate stability (central parity set 239.640 SIT/EUR with a ±15% band on July the 28th).

Although the effects of higher producer price inflation on consumer prices have been muted thus far, they could be felt eventually with a lag. Another uncertainty is that the reference rate for the Maastricht criterion is not a firmly established target and depends on the actual inflation outturn in the relevant comparators during the assessment period. The reference rate based on the current inflation outturn of the comparators (2.2 percent) is below the BoS's projection of Slovenia's inflation during the assessment period (2.5 percent). Therefore, incomes and fiscal policies must provide the broadest support to disinflation, too.

Fiscal Policy

Fiscal policy in 2004 was prudent, though neutral to disinflation, as the cause of smaller than envisaged deficit was the higher-than-expected real GDP growth. A new methodological framework was set, which had an upward effect on the 2003 deficit by 0.2-0.5% of GDP. The aim of fiscal policy could be oriented towards supporting disinflation (including coping with the risk of inflation exceeding the targeted path) and securing sustained flexibility of the public finances. According to the IMF, targeting the same nominal headline deficit for the general government as that specified in the originally adopted budget for 2005 (SIT 109.5 billion) would be expansionary. To be supportive of disinflation, a withdrawal of stimulus would be in order (headline deficit to below SIT 80 billion). One of the main factors of the rising deficit is the new direct tax system effective from January 2005.

The flexibility of expenditure structure can be improved by reforms of social transfers, health and education sectors. These steps prevent also the shift from investments to current expenditures.

Changing the existing indexation mechanism (which has resulted in pension growth lagging behind wage growth) will have a serious negative effect on the financial soundness of the pension system and public finances in general. Without further reforms pension payments would rise from 13 percent of GDP in 2005 to about 18 percent of GDP in 2020.

Balance of Payments

The current account deficit will rise slightly further in the coming years. The deficit rose from 0.4% of GDP in 2003 to 0.9% of GDP in 2004. Although there were favourable export trends, slower demand from abroad will bring about a decline in exports of goods, while domestic spending also strengthened, and with it demand for imports. Nevertheless, the growth dynamics of imports and exports will gradually equalize over the course of the projection period with the recovery of foreign demand and a slowdown in domestic spending. The temporary weaker terms of trade will bear a negative impact on the current account in 2005 in particular, and will afterwards begin to improve and have a neutral effect on the current account. The estimated current account deficit will widen to approximately 1.6% of GDP (EUR 440 Mn) in 2005, representing a worsening in comparison with 2004, but should then begin to shrink in 2006 to reach approximately 1.3% of GDP.

It is forecasted that the financial account will be in balance over the next three years. This year a surplus of outflows over inflows is expected, primarily owing to the maturity of government Eurobonds in the amount of 2% of GDP, and an increase in outflows via portfolio investments abroad by residents, while in 2006 there should be again a net inflow reaching 0.7% of GDP.

Net inflows via direct investments will rise in the coming years, as will net outflows via portfolio investments by the private sector. With regard to direct investments, a rise is expected in both foreign investment in Slovenia and investments abroad by Slovenian companies. Higher inflows are expected from foreign direct investment in the context of investments in the car industry, while in the opposite direction certain major foreign investors have announced their withdrawal from Slovenia, which may be offset by the foreign investment promotion act adopted last year.

Unemployment

Favourable processes took place in the stance of labour market in 2004. The unemployment rate has been declining continuously, while the employment increasing this year. In 2006 the unemployment ratio will be substantially below 6%.

The main factor affecting the current rate of growth in employment will be jobs in the public sector. The reasonably good general economic outlook was reflected last year in developments on the labour market, although it can be seen that the predominant part was the 1.9% rise in the general government sector, while there was no change in the rest of the economy. This unfavourable trend of the first half of the year seems to shift, and the employment in the private sector will grow again in the second half by 2 percent, just like in the public sector, at least in this year.

The margin by which real wage increases lagged productivity gains widened in both the tradable and non-tradable sectors. However, an examination of the developments at a more disaggregated level shows greater productivity-based differentiation in wage setting. The widening of the real wage-productivity growth gap in the tradable sector is appropriate for maintaining competitiveness under ERM-II and following Euro adoption. With the stabilization of the exchange rate under ERM-II, the “protection” provided to enterprises by the earlier depreciation policy no longer exists, and needs to be compensated by a higher wage-productivity growth gap.

Table 9. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	2.5	4.6	3.7
Private consumption (%)	2.7	3.5	3.5
Public consumption (%)	2.6	1.7	3.0
Export (%)	3.2	12.6	6.7
Import (%)	6.8	12.4	7.2
Consumer price index (average,%)	5.6	3.6	3.0
Consumer price index (Q4/Q4, %)	4.8	3.5	2.5
Unemployment ratio (%)	6.5	6.0	5.9
Real wages (%)	1.9	2.3	1.9
Real ULC(%)	-0.6	-1.7	-1.7
General government balance (% in GDP)	-2.0	-1.9	-2.2
Public debt/GDP (%)	29.4	29.4	30.2
Current account /GDP (%)	-0.4	-0.7	-1.0
Trade balance /GDP (%)	-2.2	-3.1	-3.9
Gross foreign debt /GDP (%)	54.3	59.3	61.5
Exchange rate (SIT/EUR)	236.7	239.7	239.5
Base rate	5.0	3.2	3.5

Special Topic:

The rise of foreign currency denominated lending in Central European NMS

In recent quarters the growth of foreign currency denominated lending has vastly accelerated in Central European NMS

Background

Foreign currency borrowing has been a relatively new but fast spreading phenomenon in the Central European New Member States. Foreign currency borrowing has been driven by various factors including interest rates gaps between domestic and foreign currencies, appreciation of local currencies, weakening of liquidity constraint of consumers. While the stocks are still low, the flow figures reflect a sizeable shift in the borrowing pattern of both the household and the corporate sector and prompted several institutions and economists to warn concerning the likely undesired consequences of this trend.

The share of loans in foreign denominations to the private sector shows much variance in Central Eastern Europe, caused mainly by different monetary policies (interest rate spreads and exchange rate fluctuations), institutional settings (such as state-subsidized housing loan schemes), the willingness of banks to lend in foreign currencies (or their desire to offload FX risk), and the clients' awareness of the significance of FX risk.

The eight New Member States can be divided into three groups by the extent of lending in foreign denominations. In the three Baltic countries (Estonia, Latvia and Lithuania) with currency board regimes, loans in foreign currencies are natural choices for banks: these exchange rate regimes have proven to be stable and credible; foreign-owned banks in these countries can access cheap foreign resources from their parent companies. Lending in foreign currencies relieves them of FX risk while clients are willing to take this risk on due to the stability of the exchange rate.

In three countries – the Czech Republic, Slovakia and Slovenia – foreign-denominated loans are not significant. The third, intermediate group consists of Hungary and Poland, where foreign-denominated loans have gained much significance in recent years. The following analysis provides a brief glance at the four Visegrad countries (Czech Republic, Hungary, Poland, Slovakia).

Poland

In 2003-2004, the volume of household borrowings under instalment loans denominated in foreign currency declined significantly (down 59%). In conjunction with the repayment of foreign currency loans by the corporate sector, this accelerated the decline in foreign currency outstanding that had started in the first quarter of 2004 (these dropped 10%, as opposed to an increase of 23.6% in the first half of 2003). At constant exchange rates (as at December 2003), the decrease would have come to 8.3%. On the one hand, this was the result of banks tightening their criteria for assessing the creditworthiness of customers applying for foreign currency loans, while on the other hand it reflected ebbing demand for foreign currency loans as a result of the narrowing interest rate differential between these and Zloty loans, and also the high exchange-rate risk involved.

In consequence, the share of these loans in bank portfolios declined, which had a positive impact on average asset yields during the first half of 2004. Nevertheless, the change of trend observed in exchange rates, allied with the increases in NBP interest rates, may again swell demand for foreign currency loans.

The high share of foreign currency loans in housing loans to households is noteworthy; in general, these customers do not hedge against FX risk. In the case of foreign currency housing loans, banks are exposed in the long term to two types of risk at the same time, namely, the possibility of the customer's FX risk transforming itself into the bank's credit risk as a result of the depreciation of the Zloty, and the risk of a fall in property prices (with collateral values being reduced and increased specific provisioning expense). Since total outstanding to non-financial customers grew relatively slowly, the share of households' foreign currency borrowings under housing loans rose 0.5 points (to 9.6%).

Polish monetary policy could have affected the willingness to lend and borrow in foreign currencies significantly. Early this millennium the Polish central bank maintained high domestic interest rates in order to aid the process of disinflation. Even though the exchange rate was volatile, this encouraged borrowing in foreign currencies with lower interest rates. Indebtedness in foreign currencies rose dynamically until 2003, when the Polish Zloty depreciated against the Euro by 17%. This event resulted in rising instalment payments (in Zloty), decreasing willingness to borrow in foreign currencies, and a break in the rise of foreign-denominated borrowing.

Hungary

Between January 1998 and December 2004 loans and credits of monetary institutions increased (at current prices) from 3,525 bn HUF to 12,167 bn HUF; during the same period foreign-denominated credits and loans rose from 1,001 bn HUF to 4,064 bn HUF. Excluding monetary institutions and the government, total loans increased from 2,079 bn HUF to 9,241 bn HUF, while foreign denominations rose from 538 bn to 3,600 bn HUF. At the aggregate level, foreign denominations gained a share of around 5 percentage points (up from 28.4% to 33.3%); among private non-monetary clients they gained an extraordinary 13 percentage points (up from 25.9% to 38.9%). Credits to the non-monetary private sector in foreign currencies seem to exhibit strong pro-cyclical behaviour: during lending 'booms' (at the turn of 1999/2000 and early 2003) their growth rate is higher, during 'squeezes' (in 2001) they decline relatively faster. Since 2003 this pattern seems to change however: the growth rate of credits in HUF declined as if during a credit crunch, but credits in foreign currencies continued to expand at a rapid pace.

Non-financial companies loan significant amounts in foreign currencies, especially in the longer term. Short term foreign credits spread rapidly: while total -1 year loans rose by 9.9% between February 2003 and December 2004, such loans in foreign currencies increased by 61%. Therefore the share of foreign currencies in short-term loans rose by 10 percentage points. Mid-term (1-5 years) loans in foreign currencies increased in a less spectacular pace, their respective share stagnated. On the other hand, long-term (5- years) foreign loans grew by 54% (signalling a rise in investments), with foreign denominations accounting for roughly two-thirds of new credits. At the end of 2004 foreign denominations accounted for around one-third of short term, 40% of mid-term and 60% of long-term corporate loans.

Households have recently engaged in large scale borrowing in foreign currencies. While the share of foreign loans from monetary institutions in all household credits was just 3.5%, at the end of 2004 it was 12.6%. In absolute amounts the most significant increase was experienced in lending for housing purposes: 132.6 bn HUF worth of housing loans in foreign currencies have been issued in 2003-2004. In 2004, foreign denominations accounted for 123.8 bn HUF in a total rise of 357.8 bn HUF housing credits. In a relative sense, consumption and other credits gained even more significance: by the end of 2004 the share of foreign currencies in these categories approached 20% and 25% respectively. Due to the large increase in housing credits, the maturity of foreign loans to households is long on the average: 14% of all long-term (5- years) household loans are denominated in foreign currencies instead of the 2.5% just two years before.

Most foreign loans to non-monetary clients (close to 60%) are denominated in Euros. (Monetary institutions borrow exclusively in Forint and Euro.) The common currency has not lost much of its significance in the last two years, but loans Swiss Francs are on the rise at the expense of US dollars and Japanese Yens. At the end if 2004 Swiss Francs accounted for about a quarter of all foreign-denominated loans and credits of monetary institutions to non-monetary sector clients.

The most important driving factor behind the rise of foreign-denominated loans in Hungary is probably the change in the system of subsidized housing loans. The Hungarian government initialized program of subsidized Forint loans to households for housing purposes in 2001. Due to the low credit costs for households this program became very popular and resulted in a lending bonanza: housing loans/GDP increased from around 5% in 2000 to almost 18% by mid-2004. However, growing macroeconomic pressures forced the government to increase domestic interest rates by 3% points in December 2003 and to tighten credit conditions from 2004. Commercial banks responded by offering clients foreign (Euro and Swiss Franc-) denominated housing loans in order to maintain their level of profitability and utilize their capacities in household lending. Households seized the opportunity of cheap credit while ignoring the potential of future FX risk. As the Hungarian Forint has a rather volatile history these risks could be significant. The Polish experience shows that clients (especially households) become fully aware of FX risk only after negative experiences. However, such a shock would have adverse effects on the growth performance of the economy.

Czech Republic

The exchange rate should not be a source of banking sector instability in the near future provided that we see a continuation of the relatively low volatility of the Koruna-Euro rate. In terms of direct impact, foreign exchange risk is constrained by the banking sector's comparatively low exposure to foreign currency transactions (15% of total assets) together with the preponderance of activities geared towards inter-bank transactions (usually with parent banks) and the banks' generally low open foreign exchange position.

Foreign exchange risk could also indirectly bring about an increase in credit risk, if the stability of the corporate sector were to be endangered. Foreign currency loans, however, form only 16.2% of the total loan volume. The 2001–2002 experience moreover suggests that the corporate sector is able to withstand fairly sizeable exchange rate swings. What is more, the stability of the Koruna-Euro exchange rate up existed until the end of 2004 and an only moderate appreciation trend appeared in the second half of the year. Overall, then, the indirect exchange rate risk is much lower than, for instance, during the monetary turmoil in 1997.

In the non-financial corporate sector, we can see a stabilized level of foreign currency loan stock, approximately a proportion of 88% was denominated in Euro at the end of year 2004. Stable processes have been taking place in the household sector for a year, although there is structural realignment. Throughout the year 2004, the stock of foreign currency loans is relatively unchanged, whilst the proportion of Euro loans decreased from nearly 100% (beginning of 2004) to 70% (end of 2004).

Slovakia

Lending in foreign currencies has not expanded in recent years in Slovakia. At the beginning of 2003 the share of foreign currencies in loans of credit institutions was 117.7 thousand bn SKK (19.56% in a total stock of 601.5 thousand bn SKK loans); in November 2004 it was 130.5 thousand bn SKK (18.25% of the total loan amount of 714.7 thousand bn SKK).

While the aggregate level shows a relative decline in foreign currency credits, this has not been the case for all sectors. Loans in foreign currencies among banks decreased considerably (from 66 thousand bn SKK in January 2003 to 13 thousand bn SKK in November 2004), but loans to non-financial companies increased during the same period from 21.7% to 32.2% (from 51 thousand bn SKK to over 75 thousand bn SKK) with Euro loans taking the lead: while loans in SKK shrunk by 14% and loans in other currencies declined by 52.7%, Euro loans nearly doubled (91% rise). Two simultaneous effects have taken place: substitution from SKK to foreign currencies on one hand, and a strong substitution among these currencies towards Euro on the other.

Other sectors have not caught up in foreign credits however. The share foreign currencies in households and NGO credits remain well below 5%; most of these are concentrated in non-consumption, non-housing credit types. Foreign credits for consumption and housing purposes are virtually nil, although housing loans are rapidly rising (79% increase in 22 months).

The comparatively low share of foreign currencies in Slovakian banks' credit portfolios can partly be explained by the fact that the consolidation and privatisation of Slovak banks has just been finalized: commercial banks have only recently turned their attention toward households. Subsidies to housing loans only apply to loans in Koruna – these factors result in a low ratio of household debt in foreign currencies. Comparatively low interest rates do not motivate clients to borrow in foreign currencies either. The story of Hungary suggests however that once the system of housing loan subsidies changes, banks may choose to propose loans in foreign currencies, should this take place before the introduction of the Euro.