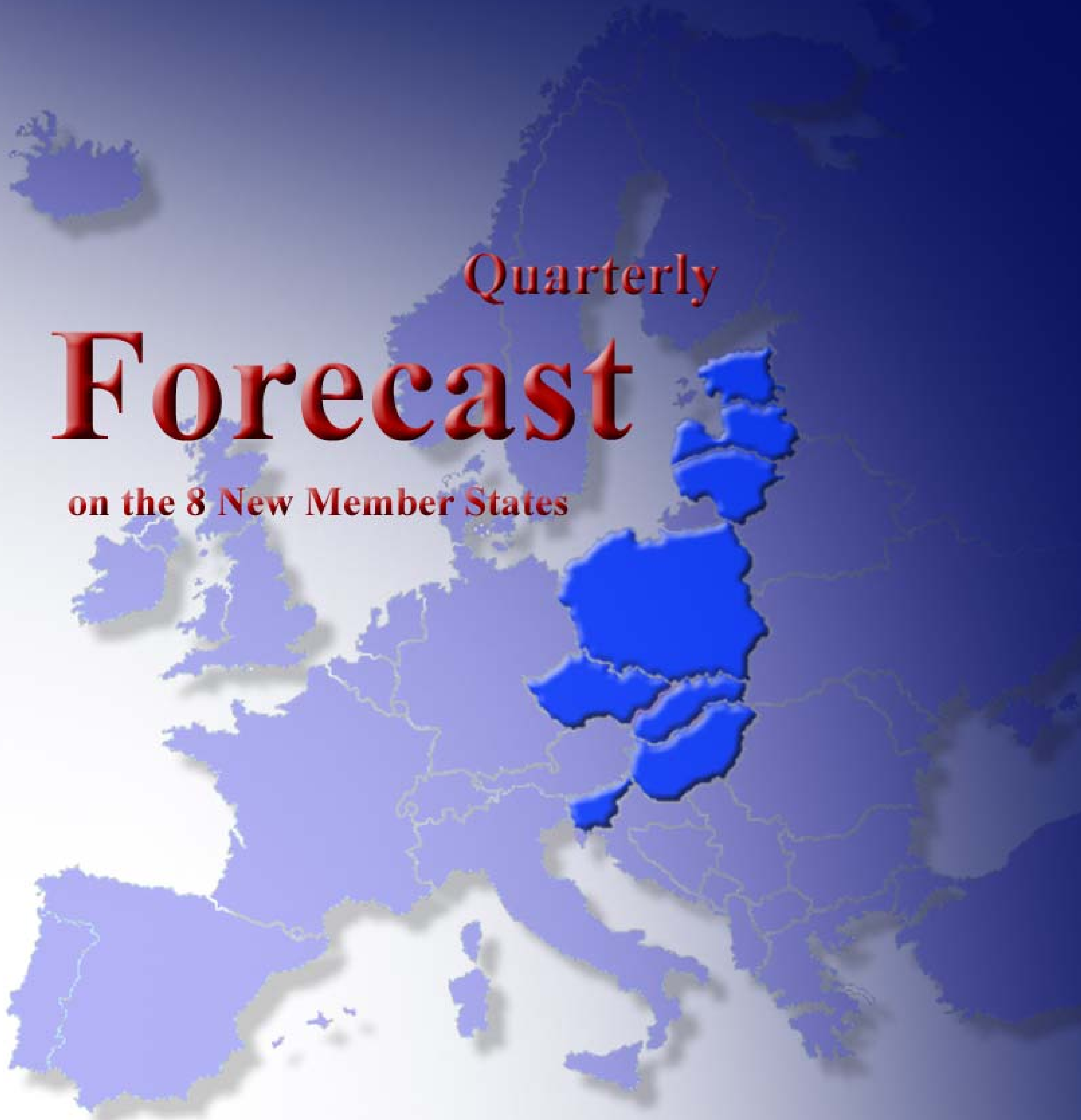
Quarterly Forecast

on the 8 New Member States



Autumn

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OVERVIEW OF THE NMS-8

External conditions

The economic developments in the NMS-8 country group are influenced by mixed exogenous conditions. While economic growth in 2005 in the Euro-zone and in the European Union is expected to slow down compared with 2004, most of the forecasts agree that output may expand faster in the forthcoming year, including in the main trading partners of the NMS-8 Germany, Austria and Italy. Rising and high oil prices may create certain problems for the NMS-8, less in the area of inflation than in the evolution of trade and current account balances. The recently observed weakening of the Euro vis-à-vis the Dollar is generally favourable for them (especially for the Baltic States even though it has a negative effect on their already high inflation) and the rise in the inflow of EU funds is an additional support for their growth.

Growth

In 2005 one could witness a general slow-down of the fast output growth recorded in 2004, which was closely connected to the one-off effects of the entry of these countries to the European Union. The slowdown has been more pronounced in the Central European economies, while economic growth remains vibrant in the Baltic States, driven partly by the fast increase in domestic demand and rise in the EU related transfers. Among the Central European economies the biggest slowdown has been recorded in Poland, while Hungary and Slovenia have also experienced above-the-average reduction in their output growth with Slovakia and the Czech Republic growing at rates close or similar to 2004. Slower output growth in the Central European economies is mainly associated with the slowdown in the growth of private and public consumption, which at the same time made growth more balanced in terms of the contribution of domestic and foreign demand. The marked slowdown of consumption, already observed in 2004, was in some countries associated with the slower growth of exports, especially in case of Poland and Slovenia. At the same time gross fixed capital formation is expected to grow less in 2005 almost in all countries adding to the slowdown of GDP growth.

On the other hand growth remained vibrant in the Baltic States driven primarily by the fast rise in private consumption and gross fixed capital formation. The former is the result of the above-the-average increase in real wages and incomes, the long-lasting positive effect of EU accession on private sector expectations, while the latter is linked to improved productivity, increasing FDI inflows in these countries.

In 2006 some acceleration of growth is expected in the Central European countries, due mainly to faster rise in exports and investments. At the same time 2006 will be an election year in several countries and therefore the rise in public consumption can not be ruled out. In the Baltic States a slight moderation of the rise in domestic demand driven by increasing real wages, EU transfers and increase of foreign currency denominated borrowing is expected which will reduce GDP growth by around half percentage points on average.

Monetary conditions

In 2005, compared to the previous years, one can observe a reversed inflation performance in the Baltic States and Central European countries as inflation has been rising in the former and declining in the latter. The acceleration of price increase in the Baltic States has been driven by various factors, including the fast credit expansion and related expansion of domestic demand and rise in non tradable prices, the above-the-average increase in producer prices, the depreciation of the Euro against the Dollar and the simultaneous increase in oil prices. The Baltic States (especially Latvia) were less able to mitigate the inflationary consequences of EU accession and the second round effects of price increases are still felt. At the same time price increases moderated in the Central European countries due to the slower wage increases, the almost overall appreciation of local currencies (except for the Slovenian Tollar, pegged to the Euro), firm stance of their monetary authorities and slow real wage increase due to high competition on the local markets following the entry to the Single Market.

Another marked feature of price developments in 2005 was the widening gap in the rise of consumer and producer price: in 2004 only Estonia and Poland recorded consumer price increases above producer prices. The acceleration of producer prices is related to the increase in import prices, in several countries to fast increases in wage levels and rise in inflation expectations.

Inflation is expected to remain low in 2006 though countries may be divided into two major groups. The Baltic States and the higher inflation countries in Central Europe (Hungary and Slovakia) will record declining inflation due to the gradual evaporation of the one-off price increases and slight slowdown in domestic demand in the Baltic States, reduction in indirect taxes and strong national currencies in Central Europe. Contrary to them, inflation may accelerate slightly in the Czech Republic and Poland, as the GDP and domestic demand continue to grow fast. The deceleration of price increases will be stimulated by the decline of VAT and other indirect taxes. Altogether all NMS-8 countries may be within the Maastricht limits with average consumer price inflation varying between 2-3% with the exception of Latvia.

Fiscal developments

With the exception of Poland and Hungary, the NMS-8 countries are expected to record general government deficits either lower or equal to 2004. In the Baltic States low fiscal deficits are due to the decline in public sector consumption and fast rise in revenues linked to the brisk GDP growth. Their fiscal position as usually has been supported by low levels of public debt. On the other hand, Czech Republic, Slovakia and to lesser extent Slovenia are expected to improve their fiscal position due to the positive cyclical effect of fast output growth.

In case of Poland and Hungary, fiscal balances seem to be out of the needed track partly as a result of discretionary fiscal policy measures and associated lack of prudent fiscal policies and the related inability to lower expenditure levels. In 2005 and 2006 both countries face(d) elections, which is another reason for imprudent fiscal policies. While even the Czech Republic and Slovakia seem to be on the right track in terms of meeting the fiscal criteria of the Maastricht Treaty, this has not been the case for Poland and Hungary, and they will have to carry out significant adjustments in their fiscal policies.

Concerning the forecast for 2006, fiscal deficits are likely to decline everywhere, while fiscal surplus will turn to a balanced budget in Estonia. Public debt levels are within the Maastricht criterion with the notable exception of Hungary, where it may exceed 60% by the end of this year.

Balance of payments

As a result of a fast rise in exports and slowdown in import demand due to weaker output growth, most countries are expected to improve their trade balances, which will also lead the improvement of the current account balance. The only exception in this respect in Slovakia, where both the trade and current account balances worsen due to the temporary positive impact of FDI on import demand. In the Baltic States current account deficits remain around 10% of GDP but they do not pose problems for the economies due to the size of capital inflows and monetary stability. In most countries FDI is expected to increase driven partly by new investments on the Single Market, expectations of continued fast economic and productivity growth. Therefore most of the New Member States will not experience rise in their net foreign debts as current account deficits are mainly covered by non debt creating inflows.

Unemployment and wage developments

The gaps among the NMS-8 countries in unemployment rates have remained significant. Unemployment levels are low and mainly unchanged in Hungary, the Czech Republic and Slovenia, while they have remained in the double digit range in the other NMS-8 countries. In 2005 the most remarkable shift has been observed in Slovakia and Poland where the unemployment rate which was persistently high and close to 20% started to decline. This decline is linked to the ongoing structural and labour market reforms, increasing flexibility of labour markets and rise in domestic demand. Both countries are expected to reduce their unemployment rates by around 2 percentage points in 2005.

Real wages are expected to accelerate in 2005 except for Lithuania and Slovenia: in some countries the acceleration is especially sizeable. This rise in real wages is linked to fast increases in nominal wages (due to slightly relaxed incomes policies, temporary or permanent labour supply shortages in some countries) and to the slowdown of inflation except the Baltic States.

Table 1. Summary indicators of the analysed 8 New Member States countries

	2003	2004	2005*	2006*
GDP growth (%)	5.1	5.6	5.1	5.2
Inflation (%)	3.1	4.3	3.2	2.8
General government balance/GDP (%)	-3.6	-2.5	-2.9	-2.7
Current account balance/GDP (%)	-5.8	-6.7	-6.2	-6.0
Unemployment (%)	11.3	11.1	10.9	10.6

** Forecasts*

CZECH REPUBLIC

The Czech Republic maintained its excellent economic performance in the second quarter of 2005, with a robust output and export growth as well as moderate inflation.

Growth

Robust output growth of 4.7 per cent in the first quarter of 2005 (on an annual basis) indicates a slight acceleration compared to the revised rate of GDP growth of the last quarter of 2004 (4.6 per cent), especially together with the preliminary estimate of a GDP increase of 5.1 per cent on a year-on-year basis in the second quarter. Thus, in the first half of 2005, GDP at constant prices rose by 4.9 per cent. This growth momentum may be sustained in the second half of 2005, based first of all on export growth, supplemented by a slim increase in private and probably public consumption, and counterbalanced slightly by the drop in GFCF. This makes highly probable, that the 2005 GDP growth will turn out to be significantly over the projected 4 per cent.

Export of goods and services remains the main engine of growth, similarly to the last four quarters. Net exports remained positive, and export growth rates are still among the highest among the NMS countries. Export growth this year has slightly slowed down compared to the period after May 2004, however, imports basically remained at their 2004 Q2 level. A slight depreciation of the Koruna and a pick-up in foreign demand may further improve the trade balance together with the realisation of export-oriented foreign direct investments, thus net exports are expected to contribute positively to growth, similarly to the previous quarters.

Investments were the other source of growth: their rate of increase has been decelerating on a quarterly basis to 5.5 per cent in the second quarter of 2005. This trend is likely to continue over the course of the year, resulting in lower investment dynamics at the end of 2005 compared to the previous year.

Compared to other countries of the region, domestic demand plays a smaller role in the GDP growth. Private consumption increased slightly and government consumption decreased significantly in the first quarter of 2005. In the second quarter, households spent slightly more, and the government also increased its spending, connected mainly to the renting of six Grippen fighters. The consumption of both is expected to increase in 2005 as a whole, because of real wage increases (private) and the coming elections (public consumption). This former trend is supported by the increase in the net disposable income, according to the Statistical Office. Similar tendencies, especially high export and lower import growth (except for higher public spending due to the general elections) may result in an above 4 per cent growth for 2006.

Monetary indicators

Inflation (CPI) remained at a low level, comfortably below the Maastricht criterion and it continued to be the lowest among the NMS countries. The CPI in the first quarter of 2005 has been declining to a rate below 2 per cent on a year-on-year basis, and remained at that level in the second quarter of 2005, which is significantly below the annual inflation forecast of the National Bank. However, CPI accelerated modestly at the end of the second quarter on an annual basis, driven mainly by fuel prices, an increase in certain regulated prices (telecommunication services prices) and a minor growth in food prices. This process will probably not be reinforced further in 2005 as preliminary July inflation data also indicate, thus CPI is expected to remain at around 2 percent. In 2006, a slight increase in the rate of inflation may be the result of persistently high oil prices and higher public spending.

Producer price indices (PPI) still grow faster (4 per cent annually) than consumer prices (the gap is one of the highest among the NMS countries), though the gap declines annually. This may exercise a gradual upward pressure on consumer prices.

The two-week repo rate was reduced two times in the first quarter, while in the second quarter the CNB Bank Board decided to lower the interest rates by 0.25 percentage points only once, at the end of April. At present it stands at 1.75 per cent. According to the Bank Board, anti-inflationary risks are present due to the further decrease in the GDP growth rates of the main partners of the Czech Republic, together with further appreciation of the Koruna. On the other hand, inflationary risks are associated with additional increases in oil prices and weaker pass-through of exchange rate changes into inflation. These two trends were evaluated as counterbalancing each other up till now, which resulted in leaving the two-week repo rate by the Bank Board as it stands.

The exchange rate – contrary to the tendencies in the first quarter - depreciated to some extent against the US Dollar and untill June, against the Euro. According to the Inflation Report of the Central Bank, the main driving factors behind the exchange rate developments were a change in investors' attitude towards the NMS region, the fall in returns on Koruna investments and the appreciation of the US Dollar against the Euro. Altogether, exchange rate changes now depend mainly on outside developments, thus our prediction for 2006 may change.

Fiscal policy

Monthly budget data show an improvement (lower deficits) compared to the first quarter. This is mainly due to higher than expected tax revenues and to a transfer of funds saved last year. Moreover, low interest rates reduce the interest burden on government debts. On the basis of that, it is unlikely that the Czech Republic would be unable to reach the deficit target of 4.7 per cent in 2005 predetermined in the convergence programme. It is even plausible, that more optimist forecasts of international organisations (OECD and World Bank) of a deficit in a range of 4.3-4.5 per cent will be realised. (It can be also assumed that unspent funds transferred from last year will not be used up fully.) According to the plans of the Ministry of Finance the deficit will be reduced to below 4 per cent in 2006. This is still above the Maastricht criterion, but indicates a track, which may lead comfortably to the fulfilment of it by the end of the decade.

Government debt and foreign debt both rose in the first quarter of 2005. (Data on the second quarter are not yet available.) While public debt is estimated to grow in 2005 as a whole, a slight decrease in the debt/GDP ratio is expected this year due to privatisation proceeds used for debt repayment and a relatively high GDP growth. The debt/GDP ratio has been comfortably in line with the Maastricht criterion and it is expected to remain so in 2006.

Balance of payments

Export growth is still the main engine of the increase in output in the Czech Republic. Preliminary trade data indicate a faster growth of exports (8.6 %) compared to imports (3.1 %) in the first half of 2005, resulting in a trade surplus of more than 1 billion Euros. This is the highest June surplus ever recorded by the Czech Republic, according to the report of the Statistical Office. The product group, which improved the most its trade balance, is "machinery and transport equipment", which is mainly due to a rise in the exports of computers and road vehicles.

Similarly to 2004, foreign direct investments are driven by two factors: first, by the reinvested earnings of companies already present in the Czech Republic, and second by some big privatisation deals. As far as privatisation to foreigners is concerned, in the second quarter, two big deals were concluded: in April, Cesky Telecom was sold for 2.9 billion Euros to the Spanish Telefonica, and in May, a 63 % stake in Unipetrol was sold for around 440 million Euros to the Polish PKN Orlen. These, and other planned deals secure to reach a significantly higher than 2004 inflow of FDI this year.

In the first quarter, the balance of payments showed a considerable change compared to the previous periods: the current account showed a surplus, while the financial account turned into a deficit. A drain of portfolio investments was the main reason behind the latter deficit. Data for the second quarter are not yet available, but the above tendencies are expected to continue over the course of the year.

Unemployment and wage dynamics

A slight improvement in the labour market was caused by the job-creating impact of the relatively fast economic growth, and of foreign direct investments. While methodological problems (a change in the methodology of statistics) makes comparisons problematic, all data show a slight drop in 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.

Data on the increase in monthly wages are available for the first quarter, which show a lower rate of increase compared to a year ago; however, its rise is faster than that of labour productivity. Notwithstanding, growth in real wages has been picking up mainly because of the easing of inflation, and is expected to result in a higher than 2004 growth rate this year. In 2006, an election year, a slightly higher rate of increase is expected.

Table 2. Major macroeconomic indicators for the Czech Republic 2003-2006

	2003	2004	2005*	2006*
GDP growth (%) (constant prices)	3.7	4.0	4.0	4.1
- Private consumption (%)	4.9	2.5	3.1	3.5
- Public consumption (%)	4.2	-3.2	2.7	3.0
- Gross fixed capital formation (%)	4.8	9.1	7.9	7.9
- Export (%)	7.3	20.9	12.2	12.5
- Import (%)	7.9	18.5	12.3	12.7
Consumer price index (average, %)	0.1	2.8	2.1	2.3
Consumer price index (dec/dec, %)	-0.1	2.6	1.9	2.1
Unemployment ratio (%)	7.8	8.3	8.2	8.0
Real wages	6.5	2.7	4.3	4.5
General government balance/GDP (%)	-11.7	-3.0	-4.3	-4.3
Public debt/GDP (%)	38.3	37.4	36.8	37.0
Current account /GDP (%)	-6.2	-5.2	-4.2	-4.4
Trade balance /GDP (%)	-2.7	-0.8	0.1	0.0
FDI (billion USD)	2.6	4.5	5.0	3.0
Gross foreign debt /GDP (%)	38.4	34.2	32.5	33.0
Exchange rate (Koruna/EUR, end of year)	31.846	31.891	29.6	28.0
2 week repo rate (%)	2.0	2.5	1.75	1.75

** Forecast , Sources: EU, IMF, Czech National Bank*

ESTONIA

Inflation is rising due to previous policy decisions and oil prices; evaluation of external balance debated

Growth

Estonia was the only new EU member to avoid a growth slowdown in the first half of 2005. The external environment was less favourable than anticipated; nevertheless, annual GDP growth reached 7.2% in the first quarter. Exports of goods and services accounted for a larger share of growth than in previous years; in the first quarter they rose by 26.5% compared to the 14.4% in the last quarter of 2004. The annual growth rate of industrial production has been above 10% since February (11.2% the second quarter), mainly caused by buoyant external demand.

Business and consumer confidence are both strong with positive expectations for the following six months. Private consumption rose by 7.7% in the first quarter (0.5 percentage points above the 5-year average) thanks to rising real wages and low interest rates.

The visiting IMF staff pointed out some possible bottlenecks: real estate and equity prices are rising rapidly and labour shortages appear in construction. As wage growth exceeds productivity growth, Estonia's competitiveness may decline, threatening exports in the coming year. On the other hand, domestic demand – underpinned by continuing credit growth and income tax cuts – will remain buoyant. Eesti Pank estimates an outstanding 8% GDP growth for 2005, while a slightly moderate 6.5% for 2006.

Monetary indicators

Inflation accelerated slightly in the first half of 2005, exceeding the Maastricht reference level. It first peaked at 3.1% in April, dropped to 2.8% in May, but by July accelerated again to 3.8%. The rising inflation is not a sign of overheating but rather a result of external conditions and the base effect of previous policy decisions: administered prices rose by 9.4% y-o-y in July compared with the 1.7% of non-administered prices. Tobacco and alcohol prices rose by 5.4% as a result of excise tax rises; transport prices rose by 9.9% as a result of soaring oil prices. The fact that core inflation (excluding energy and seasonal food prices) has dropped in the first half of 2005 also supports this view. The main uncertainties about Estonian inflation are future oil prices, and pressures to increase excise taxes.

The spread between short-term Estonian and Euro-area loans is relatively stable at 25-30 basis points; transition to ERM-II took place smoothly without disturbing the interest rates. Tight competition of banks drove down domestic rates; in April interest rates on settlement loans reached 3.6% and 3.0% for EEK and EUR denominations respectively. Cheap credit and rising income levels fuel loan demand; extremely low interest margins (2.3% in March 2005 for the banking sector) force financial institutions to take on bigger risks in order to maintain their market share.

Strong exports and stable tradable prices suggest that the current exchange rate peg is appropriate. The real effective exchange rate appreciated slightly, by 1.1% y-o-y in the second quarter (depreciating by 0.3% since the first quarter).

An annual inflation rate of 4.2% is expected for 2005; in 2006 inflation should decline to 3.1% provided that oil prices do not reach new record heights and domestic demand pressures remain under control. Under these circumstances interest rates are not expected to decline significantly in 2006.

Fiscal policy

The collection of state budget revenues in the first 7 months of 2005 reached 60% of planned annual revenues (31.8 billion EEK), while disbursements amounted to 54.1% of the planned annual value (28.7 billion EEK), resulting in a 3.2 billion EEK surplus by July 2005.

In 2006 a basic pension will be introduced, adding 0.5% of GDP to government expenditures. Measures to offset this additional fiscal burden (higher excise taxes, increased dividends from state-owned companies) can have undesirable side-effects (higher inflation and laggard investments in the electricity sector). Meanwhile, the flat personal income tax rate will gradually be reduced from the current 24% to 20% by 2009. Wage expenditures of the public sector also require attention: pay rises in education and health care coupled with increases in employment raised the wage bill by 0.5% of GDP in recent years.

The government of Estonia is preparing to implement medium term budgeting and has undertaken to eliminate off-budget operations to improve fiscal transparency and discipline. The IMF mission called against a too rapid implementation of the medium-term balanced budget goal as fiscal surpluses are still necessary to safeguard the external balance and to constrain domestic demand.

The 2005 budget is expected to result in a 0.9% surplus; the Eesti Pank argues that a larger surplus is necessary in 2006 to achieve lower inflation and more importantly, external stability.

Balance of payments

In the second quarter of 2005 the current account deficit amounted to 10.5% of the expected GDP. Higher-than-expected GDP growth accelerated domestic consumption, but due to the dynamic growth of exports, trade deficit decreased by one third since the second quarter of 2004. A rise in household deposits and the budget surplus are expected to ensure the continuing improvement of the external balance.

The visiting IMF mission reiterated in July 2005 that in their opinion the current account is at an unsustainable level even though some current account deficit is warranted by the import of capital goods driven by the expansion of productive capacity. Other institutions and researchers do not share this view: a recent ECFIN study[1] argues that even massive current account deficits can prove to be temporary in times of rapid growth. Massive outflows of incomes of profitable foreign-owned firms (over 6% of GDP in both 2003 and 2004) also added to recent deficits, but three-quarters of profits are still reinvested in the country. Finally, Estonia has not had any difficulties financing its deficit: in 2003-2004 FDI accounted for over half of the total current account deficit; 70% of inward FDI flows constituted reinvested earnings. The authors argue that budget surpluses are not paramount to external stability; credible and prudent fiscal practices are much more important. Estonia has a very good record in this respect; therefore investors perceive little risk in the current external imbalance.

The improvement of the current account balance may come to a halt if declining cost-based competitiveness affects exports and domestic demand is not offset by tight fiscal policy in 2006. Therefore a current account deficit around 11% is expected for both 2005 and 2006.

Unemployment

The number of unemployed decreased by 4100 in the first half of 2005 compared to the respective period of the previous year, thanks to active labour market policies initiated in the autumn of 2004 among others. The unemployment rate was at 9.5% in the first quarter, slightly up from 8.5% in the last quarter of 2004. Structural unemployment remains high and localised. The employment rate is fairly stable at a relatively low 56.7% in the first quarter.

Gross wages grew by 10.1% and real wages increased by 5%. This does not result in rising unit labour costs, but future income tax reforms should take the effect of wage increases on competitiveness into consideration. Widespread optimism about wage growth following the EU accession can also translate into an upward pressure on wages.

[1] Kutos, P. and Vogelmann, H.: Estonia’s external deficit: a sign of success or a problem? ECFIN Country Focus, Vol. 2 Issue 13, 07.07.2005.

Table 3. Major macroeconomic indicators for Estonia 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	5.1	6.2	8.0	6.5
- Private consumption (%)	5.4	6.1	4.7	7.5
- Public consumption (%)	5.8	5.2	5.6	0.5
- Gross fixed capital formation (%)	5.4	6.9	6.8	6.5
- Export (%)	5.8	16.0	13.4	10.5
- Import (%)	10.6	14.6	9.8	9.1
Consumer price index (average,%)	1.3	3.0	4.2	3.1
Consumer price index (dec/dec, %)	1.1	5.0	3.6	3.0
Unemployment rate (ILO, %)	10.1	9.7	9.7	9.5
Real wages	7.1	3.3	3.5	4.7
General government balance/GDP (%)	3.1	1.8	0.9	1.5
Public debt /GDP (%)	5.3	4.9	4.6	4.6
Current account balance /GDP (%)	-13.2	-12.7	-11.3	-10.9
Trade balance /GDP (%)	-18.2	-16.8	-15.6	-14.7
Gross foreign debt /GDP (%)	70.3	84.1	90.5	93.3
Exchange rate (EEK/EUR, end of year)	15.646	15.646	15.646	15.646
TALIBOR rate (12 months, %)	2.83	2.67	2.5	2.5

Sources: European Commission, Eesti Pank, Statistical Office of Estonia

** Forecasts*

HUNGARY

Fiscal problems undermining growth and macroeconomic performance

Economic Growth

After the significant slowdown in the first quarter (when real GDP increased by merely 2.9% on annual basis) economic growth accelerated in the second quarter of 2005. The acceleration in GDP growth was mainly driven by the recovery of manufacturing production, while construction industry also increased its output faster, thanks mainly to the increase in highway constructions. On the demand side the recovery in output growth was mainly driven by the rise of exports, which accelerated since the first quarter of 2005.

Altogether GDP growth in 2005 will be below the 4.2% rise in 2004 and may reach 3.7%. The main factor behind the slowdown is the slower growth in private investments and exports compared with 2004. The contribution of net external demand to GDP growth declines as export growth slows down, though import growth diminishes too. At the same time the slowdown of private consumption is counterbalanced by the rise of public consumption, while private investments grow more moderately compared to 2004.

In 2006 one may expect an acceleration of GDP growth as all major growth components seem to add momentum to growth. The growth rates in the EU and Euro area will be higher than in 2005 and this will increase export growth and the contribution of net foreign demand. On the other hand 2006 is an election year and the already announced incomes and fiscal policy measures reflect a more simulative approach, which will likely increase the growth of public and private consumption. As a result GDP may increase by around 4% in 2006.

Monetary indicators

In 2005 there has been a continuous disinflation in Hungary notwithstanding the negative effect of rising oil prices. The consumer price index in the last quarter of 2004 stood at 5,6% and it declined to 3,8% in the second quarter of 2005, while the same figures for the core inflation were 5.9% and 2.2%. Several factors have supported the slowdown of price increases including the intensified competition after entering the Single Market, the fast decline in inflation expectations and the continuous strength of the national currency. These trends are expected to prevail in 2006 as well, moreover the foreseen reduction in the VAT and other indirect taxes will have a one-off negative effect on price increases. Therefore we expect a sharp disinflation in the first half of 2006 and altogether the CPI index will be around 2% on average in 2006.

Notwithstanding the fiscal difficulties and the weakening prospects of fast entry to the Euro zone, the Hungarian currency has been stable and strong in 2005. The strength of the currency has been underpinned partly by regional developments (all Central European NMS countries have experienced an appreciation pressure on their currencies), by rise in both foreign direct and foreign portfolio investments, by the declining though still sizeable interest rate differentials on domestic and international returns. As a result the currency was mainly traded in the HUF/Euro 245-250 band and only the prospect of later entry to the Euro zone may weaken it.

Fiscal Developments

A serious concern for macroeconomic stability and policy is represented by fiscal developments, which are out of initial expectations. Fiscal deficit increased fast in the first half of the year reaching almost 100% of the planned annual target by the beginning of summer. While since then the growth of deficit slowed down and in some months it was even reversed, a recent decision by Eurostat concerning the accounting of revenues and expenditures related to highway construction modifies the plans of the government and the expected deficit figures. The Eurostat ruled out the way the expenditures and revenues related to the highway construction were calculated in the 2005 budget, requiring to count expenditures as above the line items, while revenues as below the line ones. This by itself raises the ESA 95 deficit by around 1.1.-1.2% of GDP.

Our previous forecast was more pessimistic than the forecasts of the government and the major analysts and therefore this revision will not have a significant change in our expectations concerning the general government deficit. In line with the fact that almost 100% of the deficit target has already been reached we expect that the general government ESA 95 deficit will be 6.0% of GDP in 2005, which is counted without the deduction of the temporary effects of pension reform (without that the total deficit would be 7.1% of GDP). This general government deficit represents no change in deficit indicator compared with 2004. As a result of that public debt is expected to rise further in line with our previous forecast and may exceed 59% of GDP.

In 2006 no improvement in fiscal balance is expected: while the cyclical effect of faster GDP growth will be felt, this positive impact may be counterbalanced by the rise in government expenditures due to the upcoming general elections. In the election year the evolution of local government balances represents and additional threat to the general government balance. Therefore we expect that the ESA 95 deficit of the general government will be 6.6% of GDP in 2006.

Balance of payments

In 2005 there is a marked improvement in trade balance thanks to a relatively robust growth of exports accompanied by a slowdown in import growth. While exports increased in nominal terms by more than 10% in the first half of 2005, the rise of imports reached only 4% in the same period. As a result of these changes the trade deficit is expected to decline compared with the previous years and the forecast is that it will be 2.5% of GDP.

On the other hand there is no improvement in the current account, which partly reflects the general dissaving in the domestic public and private sectors and accompanying increase in the demand for net foreign financing. The service balance will also improve in 2005 partly due to the better balance in tourism revenues and expenditures. On the other hand other items of the current account show a marked worsening, especially the income and unrequited transfers balances have worsened considerably compared with 2004. The increased co-payments to the EU budget are behind the first item, while the rise in net foreign debt and interest payments after it as well as the increase in profit repatriation is responsible for the worsening of the incomes balance.

Unemployment and wage dynamics

After declining slightly in 2004, employment is expected to decline further by 0,3-0,4% points in 2005. Simultaneously one may observe that unemployment started to increase in autumn 2004 and contrary to the previous years it has not declined since the end of the winter months but stabilised at 7% of the total labour force. Looking at the sector composition of changes in employment and unemployment, there are marked differences between the competitive and public sectors: while in the previous employment rises, there has been lay offs in the public sector. The rise in unemployment is thus attributed to the decline in public sector employment rate, which is linked to rationalisation inside the public sector and lay offs following the financial difficulties of certain public institutions. The faster than expected increase in real wages may have added to the rise in unemployment as both nominal wage increased faster than planned and inflation declined more than expected.

Table 4. Major macroeconomic indicators for Hungary 2003-2006

	2003	2004	2005*	2006*
GDP (%)	3.0	4.0	3.6	3.9
Private consumption (%)	8.0	3.5	3.1	3.5
Public consumption (%)	5.5	-1.5	2.5	2.8
Gross fixed capital formation (%)	3.5	8.2	6	7
Export (%)	7.5	15.5	11	9
Import (%)	10.5	14.0	8	10
Consumer price index (average, %)	4.7	6.8	3.6	2.1
Consumer price index (dec/dec, %))	5.7	5.5	3.2	2.8
Unemployment ratio (%, ILO definition)	5.8	6.1	7.0	7.0
Real Wages (%)	4.5	2.6	6.0	5.5
General government balance/GDP (%)	-6.2	-5.5	-6.0	-6.6
Public debt/GDP (%)	57.0	58.0	60	61.5
Current account/GDP (%)	-8.5	-8.9	-7.7	-8.5
Trade balance/GDP (%)	-4.0	-2.8	-2.9	-3.5
Exchange rate (HUF/EUR)	262	245	255	255
Base rate (%)	12.5	9.5	6	5

*Source: Eurostat, National Bank of Hungary, *Forecast*

LATVIA

Rising inflation requires special attention

Growth

After an exceptional performance in 2004, the Latvian economy continued to grow robustly in 2005, in the second quarter an all-time record of 11.6% y-o-y GDP growth was registered. This year growth is driven mainly by the expansion of services (especially retail trade, transport and telecommunication) and construction, while fading one-off elements and a high base constrain industrial growth. Industrial production increased by 3.8% in the first half of 2005; mining and quarrying and production of transport equipment registered the highest increases (both above 20%) while manufacturing of telecommunications equipment fell by 19.1%.

Strong domestic demand is expected to remain the main driving force of growth. Real age growth approached 10% y-o-y in the first quarter of 2005; investments continue to grow briskly led by a 16% growth of construction in the first half of 2005 compared to the respective period of last year. The accession to ERM-II is likely to have an indirect positive effect on growth through various channels, especially through positive expectations and declining interest rates.

All these developments suggest that the Latvian economy is overheating. The 2005 growth forecast is updated to 7.5%, while 2006 could see a restrictive economic policy and a corresponding slowdown to around 7%.

Monetary indicators

In August 2005 annual inflation reached 6.1%; the sharpest rises in the last 12 months were experienced in the commodity groups of transport (14.5%), health care (10.4%), hotels and public catering (9.1%) and education (9.0%). The base effects of rising regulated prices and EU entry-related tax increases, as well as recent oil prices all contribute to the acceleration of inflation. The appreciation of the Dollar against the Euro also adds to higher inflation (since the Latvian lat is pegged to the Euro). These price increases may prove persistent due to recent strong demand; fuel, unprocessed food and regulated energy are further sources of price increases this year. On the other hand, the deceleration of producer prices growth is a favourable sign: annual PPI fell from 10.9% in January to 6.2% in August. Overall, Latvia breaches the Maastricht inflation criterion by a large margin.

In order to facilitate financial stability and prevent any credit-driven overheating, the Bank of Latvia raised the reserve ratio of banks from 4% to 6%. The government is also contemplating on the reduction of VAT on foodstuff from 18% to 5%, although this would not tackle underlying inflationary pressures. The interest rate policy on the other hand appears to remain unchanged. Interest rates on the interbank market are stable. Tight competition of banks contributed to declining interest rates in 2005; in the first half interest rates on loans to households and enterprises declined by 0.1 and 0.2 percentage points respectively. The government also ponders the implementation of a comprehensive action plan to break down inflation.

As a result of recent price developments the Bank of Latvia raised its inflation forecast for 2005 to 6.0%. 2006 will see a reversal of CPI to the region of 5%. High inflation should keep interest rates up in 2006; no significant decline from their 2005 levels is expected.

Fiscal policy

Latvia has a good record of fiscal prudence and planned deficits have usually been undershot. The fiscal stance is expected to become more expansive in 2005 as the co-financing of EU structural funds burdens the expenditure side of the budget.

By June 2005 the general government consolidated budget registered a surplus of 16.8 million Lats. Revenues in the first half of the year increased by 50.6% y-o-y mostly as a result of indirect taxes: VAT revenues more than doubled thanks to a low revenue base in 2004 and robust economic activity. Excess revenues in 2005 are likely to be spent by means of a supplementary budget.

In June 2005 a new Law on Completion of Privatisation has been passed, clarifying the list of strategic enterprises remaining in state ownership. Privatisation of gas companies was postponed by 2010.

The budget deficit is expected to reach 1.5% in 2005. The public debt ratio is stable as the nominal growth of debt is accompanied by strong GDP growth. 2006 should see some fiscal restraint as an overheating economy requires fiscal discipline.

Balance of payments

By July 2005 exports expanded by 35.1% while imports grew by 23.7% compared to the corresponding period of 2004; clearly some of this growth is a result of last year's EU-accession. Trade with other Baltic countries and with Russia intensified to the largest extent. The sizeable trade deficit is expected to narrow in 2005 due to an improving export performance and the halving of the nominal growth rate of imports. The country has been able to sustain such trade deficits in recent years due to a better performance in the services' trade and received incomes.

After a widening of the current account deficit in 2004, this year brings a slow reversal, with an expected deficit of around 10% in 2005. 2006 should see further improvement as restrictive measures take effect and domestic demand slows down.

Unemployment

In the first quarter of 2005 62.2% of the population aged between 15 and 74 years was economically active; 0.4% points down from the respective period of the previous year.

Fast GDP growth results in increasing labour demand and an upward pressure on wages. On the other hand, overall unemployment is still high. Long-term structural unemployment remains an important problem for Latvia: in the first quarter of 2005 48.3% of all job-seekers (almost 5% of the economically active population) were long-term unemployed. Furthermore, 4.6% of the inactives are discouraged from job-seeking.

Gross and net wages increased by 6.7% and 17% respectively in the first quarter of 2005 compared to the respective period of last year. In 2005 wage increases are expected to remain moderate, especially if inflationary expectations can be broken down. This will have an indirect positive effect on employment. In 2006 secondary effects of inflation may exert an upward pressure on wages, while a more restricted growth could hamper job creation.

Table 5. Major macroeconomic indicators for Latvia 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	7.5	8.5	7.5	6.9
- Private consumption (%)	8.6	8.9	6.6	5.3
- Public consumption (%)	1.9	2.1	2.5	2.5
- Gross fixed capital formation (%)	10.9	17.3	16.3	14.6
- Export (%)	5.0	9.3	9.5	9.9
- Import (%)	13.0	15.6	7.4	9.1
Consumer price index (average, %)	2.9	6.2	6.0	5.1
Consumer price index (dec/dec, %)	3.6	7.3	6.0	5.0
Unemployment rate (%, ILO definition)	10.4	10.4	9.9	9.8
Real wages	8.2	3.1	10.1	
General government balance/GDP (%)	-1.5	-0.8	-1.6	-0.8
Public debt/GDP (%)	14.4	14.4	14.4	14.4
Current account /GDP (%)	-8.3	-13.2	-10.5	-9.4
Trade balance /GDP (%)	-13.5	-17.1	-16.3	-16.3
Gross foreign debt /GDP (%)	80.0	93.2	98.4	100.1
Exchange rate (Lats/EUR, annual average)	0.64	0.66	0.70	0.70
RIGIBOR rate (12 months, end of year, %)	4.48	4.26	2.9	2.7

Sources: European Commission, Latvian Statistical Office, Bank of Latvia, IMF
** Forecasts*

LITHUANIA

Economic growth more balanced in 2005; no time for complacency as rapid credit growth and the fiscal balance require attention

Growth

First estimates suggest that after a slowdown to 5.7% in the first three months of 2005, GDP growth reached 8.2% in the second quarter. A trend break appears to have taken place in mid-2004; since then economic growth appears to be more balanced. The growth of consumption started to decline; the growth of domestic wholesale trade peaked in mid-2004 and has declined since; on the other hand, retail trade is strong in 2005 as well, growing at 9.5% in the first half against the first six months of 2004. Investments in tangible assets rebounded in the second half of 2004, maintaining y-o-y growth rates of above 15% for three quarters, while ongoing construction works and the inflow of EU structural funds should keep fixed capital formation strong throughout the year. Foreign investments are rising since 2004 as a sign of increasing confidence in the Lithuanian economy: a beneficial effect of EU and ERM-II membership.

Services are the main driving factor on the production side of GDP as industrial production is growing slowly, at only 5.3% y-o-y in June 2005. According to government calculations the decommissioning of Unit 1 of Ignalina Nuclear Power Plant in 2005, export will drop by about 1 percentage point, while GDP growth will slow down by 0.3 percentage points. Business confidence reached its nadir in December 2004, and then rebounded: expectations of producers are mostly neutral or positive, while construction outlooks are especially favourable. A downside risk of GDP growth is apparent if the ambitious plans for absorbing EU funds cannot be fulfilled.

A GDP growth rate of 6.4% is expected in 2005; the following year could bring a slight slowdown to 6%.

Monetary indicators

Monthly CPI accelerated in the first quarter of 2005, driven mainly by increases in transport, clothing, health care and food prices; the trend reversed in March, and turned into a 0.2% monthly deflation in July. Meanwhile, 12-month inflation rate came down from 3.2% in February to 1.8% in July. Producer prices have increased especially fast in the previous 12 months, by an annual rate of 12.3% between July 2004 and July 2005; however, excluding refined petroleum products PPI is only 2.0%. Some further inflation is anticipated according to business surveys; the available data suggest that most inflation pressures stem from the services sector and high world oil prices. Lithuanian authorities' own forecast of 2.7% average annual inflation and 2.2% 12-month inflation in December appear realistic.

At present the 2007 adoption of the Euro seems realistic; an adverse external shock may cause inflation to breach its Maastricht limit however. In July 2005 the visiting IMF mission recommended restraint in public expenditure and actions that curb credit growth, but discouraged tax measures and the manipulation of administered prices to contain inflation.

The main factor of domestic demand growth remains a rapid expansion of borrowing; this is driven by the increasing income level of households, declining interest rates (as a result of prudent and credible economic policy and ERM-II membership more recently), wealth effects of rising stock and real estate prices, and tax incentives for housing purchasing on the demand side, and financial deepening and competition among banks on the supply side. The natural question arises whether this credit boom poses any risks to economic growth or financial stability. Concerns of overheating are mitigated by the fact that Lithuania (as well as its Baltic neighbours) started from a low base: the country is the second poorest in EU-25 with the lowest bank lending to GDP ratio at 30%. Also, the IMF has found no signs of exchange rate misalignment and the real exchange rate has only appreciated slightly in the past years, signalling healthy external competitiveness. Lithuania has a good record of prudential supervision, but so far the financial systems of the NMS countries have not been tested in time of severe economic difficulties. In the medium term, low domestic savings and an increased exposure of households to asset price and income shocks are sources of some concern.

Average annual inflation will reach 2.7% in 2005. In 2006 already-high oil prices could have a lower direct effect on inflation, while moderate domestic demand helps in keeping annual CPI around 2.5%.

Fiscal policy

Until July 2005, revenues of the budget reached 60.4% of the value planned for the year. At the end of July the stock of public debt amounted to 12 billion LTL, 17.6% of the projected GDP for 2005.

The main risks to the fiscal balance are higher than anticipated costs of the pension reform, and a higher than planned co-financing of better absorbed EU structural funds. Fiscal reforms laid down in the Convergence Programme may lose momentum as a result of complacency based on false information: according to authorities it is sometimes believed that only 2005 data determine the adoption of the Euro and the EU institutions are ready to make exemptions not provided by the EU treaty when deciding upon this matter. There are warning signs: the progress of the development of a Fiscal Responsibility Act (aimed at improving expenditure controls) has stalled, much to the dismay of the visiting IMF mission.

The Seimas finally ratified the personal income tax reform; the flat tax rate will be reduced from its current level of 33% to 24% by 2008. Revenue losses will be mitigated through a temporary social tax (imposed on corporate profits in 2006-2007) and a new tax on commercially used real estates owned by individuals (1% of its value). There are concerns over the long-term implications of the reform as government revenues will decrease by about 2% of GDP in 2008 at the latest.

In June the Privatisation Commission approved the sale of Lithuanian Airlines to three domestic companies; the deal requires the approval of the Lithuanian parliament.

The projected budget deficit for 2005 is 2.5% of GDP. The abovementioned tax cuts and government expenditures do not leave much space for deficit reduction and suggest that 2006 will bring a similar value.

Balance of payments

In the first half of 2005 exports increased by 24.2% while imports rose by 18.4% at current prices over the respective period of the previous year; however, excluding mineral oil, exports rose by 18.8% while imports increased by only 7.2%. The increase in the value of imported mineral fuel accounted for 67.3% of the total rise of imports. These data reveal that rising oil prices have a large negative contribution to the trade balance of Lithuania in 2005, and that domestic demand-led imports remain constrained. It is underpinned by the finding that the import of consumption goods rose below average at 10.1%, while the import of capital goods dropped by 6.1% in the first six months. On the other hand, the trade of intermediate goods increased to the largest extent (over 30% hikes in the value of both exports and imports).

There are clear signs that the trade deficit stopped widening at least; even the possibility of some improvement is signalled by favourable export expectations and the strong performance of services. On the other hand, one-off elements of EU-accession are fading away, and oil prices will have much to say regarding the external balance until the end of the year.

In the longer term, the competition of cheap Asian products erodes Lithuania’s advantage in low-technology products, while the move up the quality ladder proceeds slowly. Structural reforms and investments in the areas of education, labour market and infrastructure are required to improve productivity and competitiveness in the future.

The current account deficit will amount to 8.1% of GDP in 2005, while 2006 is expected to bring a slight improvement to 7.9%. The deterioration of the trade balance is expected to continue from a 32.5% deficit to around 33%.

Unemployment

In the first quarter of 2005 employment rate (amongst the population between the ages of 15-74) reached 61.4%, compared with 59.9%

the first quarter of 2004. Unemployment decreased from 13% to 10.2% during the same period as a consequence of increasing labour demand and emigration. Long term unemployment remains high; 57.7% of all unemployed fall into this category, with three-quarters of them aged 25-54. There are large regional disparities in unemployment. Meanwhile, wage rises in the public sector drove up wages in the whole economy in recent years; the mismatch of labour demand and supply may be another factor of wage increases coexisting with persistent unemployment. Strong economic growth is expected to ease unemployment slightly in 2005.

Table 6. Major macroeconomic indicators for Lithuania 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	9.7	6.7	6.4	5.9
- Private consumption (%)	12.5	9.3	6.7	6.5
- Public consumption (%)	4.0	5.4	5.9	3.8
- Gross fixed capital formation (%)	14.0	12.3	14.4	9.5
- Export (%)	6.9	4.4	8.7	7.8
- Import (%)	10.2	13.3	10.9	7.8
Consumer price index (average,%)	-1.1	1.1	2.2	2.5
Consumer price index (dec/dec, %)	-1.3	2.8	2.7	
Unemployment rate (%, ILO definition)	12.4	11.4	10.9	10.5
Real wages	9.3	6.1	4.5	
General government balance/GDP (%)	-1.9	-2.5	-2.5	
Public debt/GDP (%)	21.4	19.7	20.0	
Current account /GDP (%)	-6.9	-8.3	-8.1	-7.9
Trade balance /GDP (%)	22.9	-29.9	-32.5	-33.1
Gross foreign debt /GDP (%)	41.0	42.8		
Exchange rate (LTL /EUR, annual average)	3.45	3.45	3.45	3.45
VILIBOR rate (end of year, %)	2.98	2.88	2.50	

Sources: European Commission, Bank of Lithuania, Statistics Lithuania, Ministry of Finance, IMF

** Forecasts*

POLAND

Weaker than expected growth and improvement in labour market conditions.

Growth

The GDP growth rate in Q1 2005 in Poland was even lower than earlier expected, reaching only 2.1%. Investment outlays did not grow as fast as expected, on the contrary, a surprising decline in gross fixed capital formation occurred. A rise in consumption demand was also expected, as conditions in the labour market were improving, but in the first quarter its effects were still not visible. At the same time industrial performance was weak. As for the Q2 2005, after a period of decline a year-on-year increase was observable in real wages in May. The continuous recovery in the construction sector also persisted, which has a positive effect on the labour market, as employment in the sector is rising. This has an indirect positive effect on economic growth, through the resulting rise in private consumption. However in Q2 2005 GDP growth has not yet accelerated significantly yet. The growth of industrial production was slower in May than earlier expected, reaching only 0.9% compared to the same month in the previous year. However in June industrial production growth was strong, and even exceeded expectations, reaching 6.8%.

We expect that in H2 2005 GDP growth will be stronger than in the first half of the year. Rising private consumption due to the improvements in the labour market will be an important factor behind this. Consumer optimism has been rising already in Q2. At the same time there is considerable uncertainty concerning the estimates of private consumption due to the difficulties of accounting for the income and expenditure of Polish people working abroad. Retail sales were strong in June (growing by 10.5% in nominal terms, and 8.8% in real terms year-on-year), with almost all components showing a positive annual growth rate. Upward trends are expected to continue in the construction sector, as the business climate in housing construction is positive, and EU co-financed infrastructural investments should gain ground. Industrial output growth will also improve, due to the fading out of the base effect. However we expect, that the overall GDP growth rate for 2005 will be lower than our earlier projection (4.4%), and will reach only 3.7%. In 2006 the GDP growth rate is expected to reach 4.4%.

Monetary indicators

Contrary to earlier expectations, the Monetary Policy Council of the National Bank of Poland cut interest rates at its meeting at the end of June, which put the reference rate at 5%, and changed the monetary policy bias to easing. The monetary policy bias before the decision was neutral for a period of two months. The interest rate cut happened earlier, and was also bolder than expected. The strong move of the MPC was the result of the low GDP growth rate and the worse than expected industrial output experienced in Q1 2005. At its July meeting the MPC lowered the interest rates further by 0.25 percentage point. Thus the reference rate reached 4.75%. According to the MPC the interest rate cut was necessary, because the probability of inflation running below the inflation target in the monetary policy transmission horizon still exceeded the probability of its moving above the target. At its August meeting the MPC lowered interest rates again by 0.25 percentage point, excluding the rediscount rate, which was lowered by 0.50 percentage point. The reference rate reached 4.5%.

CPI has been continuously decreasing since the beginning of the year, reaching 2.5% year-on-year in May, which is exactly the inflation target. By June year-on-year CPI decreased to 1.4%. A trend of reduction also characterized the development of the PPI so far in 2005. In May the PPI growth rate turned negative, to -0.5% year-on-year. The decreasing trend in CPI will continue in the coming months, as the effects of the low PPI will circle in. Therefore CPI will fall below the inflation target, but will stay within the tolerance band. For the end of the year we predict a 1.1% year-on-year CPI. In 2006, the end of the year CPI is expected to reach 2.1%.

Inflation expectations of households have been following a downward trend in recent months, and they are predominantly adaptive in character. In June inflation expectation for the next 12 months reached only 2.6%, the lowest level for a year. Therefore no inflationary pressure can be expected from the side of households in the coming months. The improvement in the labour market has not been accompanied by significant wage pressure in May (only 0.5% year-on-year wage growth, in real terms in the enterprise sector). However in June a gradual acceleration in the wage growth rate was observed in the enterprise sector (4.5% in nominal, and 3% in real terms year-on-year). It is not yet clear whether the high wage growth rate experienced in June will be maintained for the rest of the year, bringing the danger of inflationary pressure.

Fiscal policy

In Q1 2005 the budget deficit reached 5.9% of GDP, which means a 0.1 percentage point rise year-on-year. After five months the budget deficit reached 52.3% of the full year plan. However some improvement is expected in June, as the central bank's profit is transferred to the state budget that month.

In July the Finance Minister, Miroslaw Gronicki presented the planned budget deficit for 2006 in the form of a range instead of a point target. The range has been revised to PLN29-33 billion from PLN28-34 billion. The assumptions underlying the budget targets for next year are relatively low GDP growth and low inflation. The realistic macroeconomic assumptions made by the government can be viewed as positive. However the planned budget may be changed after the elections are held in September. At the same time public finance reform that would make compliance with the fiscal indicators of the Maastricht criteria possible, did not yet start in Poland, and it is not expected to start before the elections are held. On the contrary, recently numerous legislative proposals were presented in Parliament that would lead to increasing expenditure, and widening the general government deficit.

The budget deficit by the end of 2005 is expected to reach 3.8% of GDP. The main risk factor for the execution of this year's budget are the inflows from indirect taxes, as a 12.8% rise in inflows was planned for the whole year. Lower economic growth is a risk factor for the inflow of indirect taxes, but in the second half of the year a pick up of growth is expected, compared to the first half year.

The success of the *Law and Justice* (PiS) and *Civic Platform* (PO) parties in the September elections raises questions about fiscal policy, as the two right wing parties forming the new coalition have different ideas about economic policy. While the former party is planning to cut expenditure by reducing administrative costs, the latter wants to achieve savings by reforming the system of social expenditures. While PO wants to introduce a system of flat taxes, PiS wants to use a system of three brackets regarding the income tax.

Balance of payments

In Q1 2005 the Polish current account showed a EUR379 million surplus. This was mainly the result of a low trade deficit (EUR 315 million), and a high (although lower than in previous quarters) level of current transfers. Foreign direct investment in Poland was significantly lower than in the previous quarter, reaching EUR 891 million, which is also lower than in the same period of the previous year. A reduction (to EUR 90 million) was also observed in direct investments made by Polish investors abroad compared to the previous quarter, but it was significantly higher than in the same period in the previous year (when it reached only EUR 5 million).

In April the current account also showed a surplus, which resulted from high net transfers, and a small surplus in the trade balance. At the same time the growth rate of both exports (to 5.6% year-on-year) and imports (-9.7% year-on-year) slowed down, due to the very high base effect. According to preliminary data both the current account and the trade balance turned negative in May. The surplus in net transfers and services was lower, while the deficit in the balance of incomes was higher than in the previous month. There was also a reduction in foreign direct investment in May, and an increase in Polish investments abroad. By June the current account deficit as a percentage of

GDP was reduced to 0.1%, and it was also 0.1% for the whole of the second quarter.

In the second half year a higher growth rate of both exports and imports is expected, as a result of the high level of economic activity, and the fading out of the base effect. By the end of the year the current account is expected to show a deficit amounting to 1.2% of GDP. In 2006 the current account deficit is expected to increase to 1.9% of GDP.

Unemployment and wage dynamics

The improvement in the labour market continued in the second quarter of 2005. This is visible both in the trend of employment and unemployment figures. The rise in employment in previous quarters is almost exclusively due to people working on a fixed term contract, while the number of permanent-contract employees has been continuously decreasing. The increase in of the share of flexible contracts in all job contracts seams to be of permanent nature.

In Q1 2005 the unemployment rate reached 19.3%. This was more than one percentage point lower than in the same quarter of the previous year (20.4%). In Q2 2005 the decreasing trend continued, with the unemployment rate reaching 18%. For the whole of 2005 the unemployment rate is expected to reach 17.7%, which is lower than our earlier prediction. According to labour offices, unemployment is noticeably lower than a year ago. In March 2005 the unemployment rate amounted to 19.3%, which means that the total number of unemployed reached 3,053,000. This means a 1.1% year-on-year decrease. By June the unemployment rate decreased to 18%. At the same time, in May 2005 employment increased 1.6% year-on-year, maintaining the rate observed in the previous months. However the share of unfilled vacancies has been increasing, which signals a possible mismatch between the expectations and qualifications of job seekers, and the types of vacancies. The sector in which employment growth has the most positive outlook is the construction sector, where the companies that intend to increase their workforce outnumber those who want to cut employment.

Wage dynamics have been favourable in H1 2005 in Poland. In the first quarter, real wages decreased by 1.4% year-on-year, in real terms. In April 2005 a real wage decrease in the enterprise sector was still observable (1.2% year-on-year), while in May a year-on-year increase of 0.5% was observable in real wages. In June there was a strong, 30% wage hike in the mining sector. The increase in the real value of the payroll fund in the corporate sector is a result of rising employment and decreasing inflation. We predict that the wage bill will follow a rising trend in the coming months, and the labour market could become a source of inflationary pressure later on in the year. Real wages are expected to rise by 1.3% overall in 2005, and by 1.8% in 2006.

Table 7. Major macroeconomic indicators for Poland 2003-2006

	2003	2004	2005*	2006*
GDP (%)	3.8	5.4	3.7	4.4
-Private consumption (%)	3.1	3.4	2.5	3.0
-Public consumption (%)	0.1	1.4	1.1	1.1
-Gross fixed capital formation (%)	1.1	7.3	4.0	7.4
-Export (%)	9.1	21.9	13.0	11.0
-Import (%)	3.3	19.1	12.0	12.0
Consumer price index (average, %)	0.8	3.5	2.0	2.0
Consumer price index (dec/dec, %))	1.7	4.4	1.1	2.1
Unemployment ratio (%, ILO definition)	20.0	19.1	17.7	17.5
Real Wages (%)	2.0	0.8	1.3	1.8
General government balance/ GDP (%)	-4.5	-4.7	-3.8	-3.4
Public debt/GDP (%)	48.4	46.7	50.2	52.2
Current account/GDP (%)	-2.2	-1.5	-1.2	-1.9
Trade balance/GDP (%)	-2.6	-2.3	-1.2 (Q2)	-1.4
Gross foreign debt/GDP (%)	45.1	47.6	41.5	40.5
Exchange rate (PLN/EUR)	4.4	4.53	4.08	4.21
Base rate	5.25	6.5	4.5	5.0

**Forecasts,*

Sources: EU, Central Statistical Office Poland, Deutsche Bank Research, Bank Zachodni WBK, National Bank of Poland, Bank Austria Creditanstalt,

SLOVAKIA

Slovakia is still characterised by one of the highest growth rates of the NMS economies – and at the same time by one of the highest unemployment rates.

Growth

Economic growth in Slovakia decelerated slightly in the first quarter compared to the last quarter of 2004, but its rate is still the fastest in the NMS region (excluding the Baltic States), and projections contain similarly favourable rates in regional comparison for 2005 as a whole, foreseeing a rate in the range of 4.8-5.1 per cent. Preliminary data for the second quarter indicate a year-on-year increase of 5.1 per cent, which makes the above predictions realistic. Domestic demand and investments are still the most important engines of growth. On the other hand, the expected contribution of net exports to growth – as projected in our last report on the basis of the launch of production of large FDI-related export-oriented projects[2] - has yet to be realised.

Private consumption remained vigorous both in the first and second quarters. Most probably, it will be similar in the remaining part of the year, because of strong growth in real wages, and in household spending. Public consumption is expected to increase as well, partly because co-financing of EU-funded projects was postponed from 2004 to 2005 and partly because of elections-related expansion in government consumption. The above forecast is supported by the fact, that consumption growth in the first quarter was the highest among the NMS countries (again excluding the Baltic States).

Investments (gross fixed capital formation, (GFCF)) are expected to grow quickly, due partly to the realisation of the already mentioned large, FDI-related greenfield projects and partly to the decision of the government to finance highway construction and FDI incentives from excess tax revenues. However, while data on the first quarter do not indicate a significant increase in the growth rate of GFCF, in the second quarter, its growth rate was above 10 per cent.

The favourable growth forecast is supported by the continued buoyant growth in domestic demand: however, the increase in fixed investments remained below the predicted level in the first quarter. Assuming a change in this latter factor to be caused by government investments and FDI, Slovakia is expected to maintain its outstanding growth rate in 2005. For 2006, higher public and private consumption growth may result in slightly higher rate of economic growth.

Monetary indicators

Inflation data for 2005, corresponding to the prediction in our last report, indicate a substantial decrease in the rate of price increases compared to the previous year. Headline inflation (both HICP and CPI) stayed at 2.5 per cent on a year-on-year basis in June. (Core inflation was 1.5 and 1.1 per cents, respectively.) Monthly rates in the first half of 2005 were also low, below 0.3 per cent (with the exception of January with 1.7 per cent). 2005 inflation data seem to continue to develop favourably, because of the appreciating Koruna and lack of additional increases in administered prices. However, real wage increases and higher PPI act as inflationary factors. Thus, inflation (CPI) is expected to remain in the 2.8-3.5 per cent range for the year as a whole. For 2006, similar developments are expected.

After appreciating in the first quarter, the Slovak Koruna weakened against the Euro in March and April and against the USD in April, May and June. At the end of June, the two-week repo rate stayed at 3.0 per cent, no changes were introduced in that respect in the second quarter. The monetary policy will be under further pressure this year because of large capital inflows connected to privatisation, FDI, portfolio and other (mainly short-term) investments, which all seem to be insensitive to the strong Koruna and the low interest rate. Data on the first quarter indicate a substantial net inflow of portfolio investments, and in the

[2] See our previous report.

second quarter, other short-term investments were large.

According to the developments in fulfilling the Maastricht criteria and GDP growth, it is highly likely that Slovakia will join ERM-II in 2007 and will introduce the Euro in 2009.

Fiscal developments

Up till now, the government succeeded in sticking to its spending plans: cumulative data at the end of the second quarter indicate a slight deficit, which is ahead of the targets. As our last report said, in 2005 new factors as EU-projects financing, the introduction of a pension reform, higher spending on health care funding due to new rules and a more than 600 million Euro payment obligation to a Czech private bank are expected to increase the fiscal deficit. In that respect, a ruling of Eurostat, according to which the payment to the Czech Bank will not be included in the deficit, improved the fiscal outlook. Moreover, privatisation proceeds may alter favourably the fiscal situation. Notwithstanding, a pre-election release of extra tax revenues, higher real wage increases, which endanger the inflation target and the higher than expected popularity of the second pillar of the new pension system may turn out to be risky from the point of view of the 2005 budget outcome, and may influence the fiscal developments of 2006 in a similar direction.

Budgetary control may be strengthened by the new law, which was approved by the government in May, and according to which new state guarantees will need parliamentary approval in the future.

Fiscal deficit is planned to be within the Maastricht criteria next year in order to enable Slovakia to join the ERM-II in 2007. Given the risks listed above, fiscal tightening may be needed if circumstances change (e.g. the Koruna starts to appreciate again or increase in real wages and domestic demand accelerates) in order to reach that goal.

Balance of payments

The current account deficit has been widening rapidly in 2005, mainly due to the expanding trade deficit, which was larger at the end of May, than in the same period of 2004. However, summer data indicate an improvement in that respect. (According to the data published by the Statistical Office, in the first five months of 2005 the growth rate of exports was 3.6 per cent, while imports expanded at 9.3 per cent. At the same time, preliminary data published in September indicate a year-on-year export growth of 8.9 per cent in the first seven month, while imports grew only at 5.9 per cent.) The main reason behind the trade deficit is the strong growth of domestic demand, on the basis of which a current account deficit of 5.5 per cent of GDP is assumed to be more realistic.

The current account deficit stood at 460 million USD at the end of April, while the trade balance was in the red by 615 million USD. Contrary to what was forecasted in our last report, tourism revenues have been growing dynamically up till the end of April, according to the balance of payments data of the National Bank. The number of foreign tourists increased considerably, together with their spending, compared to the same period of the previous year. Similar developments are expected for 2006, resulting in a similar current account deficit.

However, the current account deficit was more than counterbalanced by the capital and financial account’s surplus, which reached almost 4 billion USD at the end of the fourth month, mainly due to a significant amount of other, primarily short-term investments.

At the end of April, FDI inflow remained below expectations, at 150 million USD. This was mainly due to disinvestments (presumably repayment of intra-company loans) in the form of other capital, while reinvested earnings reached almost 340 million USD. This is contrary to what was forecasted in our last report, however, privatisation revenues connected to the sale of the Slovakian electric power company (around 900 million Euros) are expected to flow in only in the second half of the year. Moreover, another privatisation deal (the railway company Cargo Slovakia and probably some arms producers) is expected to take place also only in the second half of the year. These items, together with other announced but not yet or only gradually realised greenfield investments induce us to stick to the FDI prognosis of 2.8 billion USD for the whole year.. Similar developments (privatisation-related FDI, reinvested earnings and gradually realised projects) are expected to result in a similar magnitude of FDI inflows in 2006.

Unemployment

Relentlessly high unemployment eased to some extent during the first two quarters of the year; however, the favourable growth record has not been translated yet into a significantly lower unemployment rate. This trend is supported by the fact that industrial production basically stagnated in the first half of the year – its growth rate was among the lowest among the NMS countries. It may be chiefly the services sector, which was responsible for the extra jobs.

Unemployment rate is the highest among the NMS countries (excluding Poland), which, together with the low activity rate, indicates the existence of large unused resources. Registered unemployment is around 5 percentage points lower, which points to the fact that many unemployed have fallen out from the unemployment benefit system. Long-term unemployed still represent the overwhelming majority of total jobless. Other structural problems hinder significant reduction in the unemployment rate, thus, for the year as a whole, only a slight decrease in unemployment is predicted. The tendencies are not expected to change in 2006, thus the unemployment rate if forecast to remain above 17 per cent.

Table 8. Major macroeconomic indicators for Slovakia 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	4.5	5.5	4.9	5.4
- Private consumption (%)	-0.6	3.5	4.6	5.3
- Public consumption (%)	2.7	1.2	4.7	4.8
- Gross fixed capital formation (%)	-1.5	2.5	8.0	7.5
- Export (%)	22.5	11.4	11	12
- Import (%)	13.6	12.7	13	13
Consumer price index (average, %)	8.5	7.5	3.0	2.7
Consumer price index (dec/dec, %)	7.7	6.9	2.8	2.6
Unemployment ratio (%, ILO definition)	17.5	18.0	17.6	17.4
Real wages (%)	-1.5	3.4	3.6	3.8
General government balance/GDP (%)	-3.7	-3.3	-3.8	-3.2
Public debt/GDP (%)	42.6	43.6	44.2	44.4
Current account /GDP (%)	-0.8	-3.4	-5.5	-5.5
Trade balance /GDP (%)	-2.3	-3.5	-5.0	-5.2
FDI (billion USD)	0.6	1.0	2.8	2.5
Gross foreign debt /GDP (%)	55.6	53.9	49.8	50.0
Exchange rate (Koruna/EUR end of year)	41.5	40.0	38.9	37.0
Basic interest rate (%)	6.5	5	3	3

**2005: Forecast*

Sources: EU, IMF, Slovak National Bank

SLOVENIA

Economic Growth

Real GDP grew by 4.6 per cent in 2004, which was the highest growth rate in Slovenia in the last five years. It was driven by robust export activity and by the steady growth of domestic consumption. Economic growth in the first quarter of 2005 reached 2.6 per cent. This result marks a deceleration in y-o-y growth rates after the record high 5 per cent in Q3 of 2004 and 4.3 per cent in Q4 of 2004. All expenditure GDP components with the exception of general government expenditure recorded slower growth than at the end of 2004. The most prominent was a decrease in growth of the gross fixed capital formation, which decreased by 0.5 percent in real terms compared to the first quarter of 2004. Private final consumption expenditure increased by 2.7 percent and government expenditure by 2.9 percent.

Exports' and imports' growth also decreased; in the first quarter of 2005 exports increased by 8.9 percent compared to the same quarter of 2004 (in the fourth quarter of 2004 growth was 13.3 percent) and imports by 6.6 percent (in the fourth quarter of 2004 by 11.6 percent). Weaker export performance was due to modest economic activity in the EU countries and a slowdown of growth in South Eastern Europe. The external sector contributed 1.3 percentage points to the GDP growth rate in the first three months of 2005.

We expect a mild slowdown in growth over the forecast period, thus real GDP will rise around 3.5 per cent in 2005 and bounce back to 3.9 in 2006, with exports remaining the growth engine although at some lower rate as recorded in 2004.

Monetary Conditions

Maastricht inflation criterion has still not been met. After the high price increase in March (y-o-y inflation rose to 3.1 percent) consumer price inflation decelerated sharply in April and May 2005 reaching a historic low point (2.2 per cent y-o-y). Since Slovenia's accession to the exchange rate mechanism ERM II (28 June 2004) HICP inflation decreased by 1.4 percentage points and totaled 3 per cent in June 2005. We expect that the average inflation will decrease to 2.6 per cent in 2005 and probably to 2.4 per cent in 2006. According to the Bank of Slovenia's projections inflation should pick up to 2.6 by the end of 2006 mainly because the negative output gap is set to close and then become positive.

Rises in oil prices and the possible rise of the Dollar against the Euro could have an unfavourable effect on the movement of prices, while domestically the main risks come from possible excessive spending owning to low interest rates and stable Tolar/Euro exchange rate.

The Bank of Slovenia raised its base rate by 25 basis points on April 8 to 3.5 per cent, due to higher than expected consumer price inflation over the first quarter of 2005. The rate rise was the second in less than four months, following a similar 25-basis-point hike in late December 2004. Previously, the bank had not raised its refinance rate for more than three years, and in 2004, the bank had cut the rate seven times by a total of 2 percentage points. The raised interest rate continues to reflect the Bank of Slovenia's commitment to implement more restrictive monetary policy and its will to ensure that inflation falls below the Maastricht convergence criteria in time to adopt the Euro at the beginning of 2007. We expect that Slovenia will meet the price stability criterion in the middle of 2006. The Bank of Slovenia might cut its base rate to 3.25 per cent in the same year.

The Tolar's gradual depreciation contributed to the annual price increases in the last years prior ERM II entry. However we expect that the Bank of Slovenia will keep the Tolar exchange rate stable (thereby ensuring the fulfillment of the Maastricht criterion) until the adoption of the Euro, which is scheduled to take place on 1 January 2007. A stable Tolar will continue to preclude any price fluctuations resulting from changes in exchange rate in 2005 and 2006.

Fiscal Policy

Slovenia meets the Maastricht criterion concerning the sustainability of public finances. General government debt was slightly below 30 per cent of GDP in the last five years and it is expected to remain stable in 2005 and 2006. Although the general government deficit exceeded the reference value in 2000, but it has fallen gradually since then to 1.9 per cent of GDP in 2004.

The Slovenian government adopted a supplementary budget bill for 2005 with the aim of curbing public spending. The new budget sets the general government deficit at EUR 383.49 million or 1.4 per cent of GDP. The original 2005 budget passed by parliament in December 2003, anticipated budget deficit of EUR 467.37 million or 1.7 per cent of GDP.

We expect that general government deficit, as percentage of GDP will be close to 2 per cent in 2005. According to our forecast this will be due to the negative effects of slower growth on the revenue side. General government deficit might probably drop to 1.8 of GDP by 2006.

Balance of Payments

Slovenia's current account deficit amounted to EUR 238 million (0.9 per cent of GDP) last year. The trade deficit stood at EUR 840 million, while the services surplus reached EUR 672 million.

In the first quarter of 2005, Slovenia had a current account surplus of 13 million Euro, down by nearly two-thirds compared to the surplus in the same period of 2004. In the first three months of 2005, positive foreign trade trends have been maintained, with exports growing faster than imports. The value of exports was 11.6 per cent higher compared to the first quarter of 2004, while the value of imports increased by 10.1 per cent.

Slovenian merchandise exports rose by 10.5 per cent in nominal terms in the first quarter compared with the same period last year. In contrast to the relatively strong growth of goods exports, the volume of industrial production recorded a 2.6 per cent year-on-year drop. Merchandise imports were up 9 per cent in the first quarter year-on-year.

Trade in services increased at a slower pace in the first quarter than trade in goods. Exports of services were up 7.4 per cent while their imports rose by 7 per cent.

In spite of the surplus in the first quarter of 2005 the current account deficit is expected to shrink to 0.6 per cent of GDP in 2005. The main factor behind the negative balance of the current account will be the worsening of the merchandise trade deficit towards to end of the year, which will be due to a surge in private consumption and investments in the second half of 2005.

Unemployment and wage developments

The reasonably good general economic performance was reflected last year in developments on the labour market. However the figures in the national accounts report that employment rose by only 0.1 per cent over the year on average, with 1.9 per cent rise in the general government sector and no change in the rest of the economy.

In the first quarter of 2005, the unemployment rate was 6.9 per cent, 6.1 per cent for men and 7.7 per cent for women. Compared to the first quarter of 2004, employment increased by 0.7 percent and reached the level of 892 thousand persons. The fastest growth continues to be recorded in the general government sector (1.8 percent in the first quarter of 2005 compared to the first quarter of 2004).

Supported by favourable economic growth, the labour market's performance is expected to improve gradually in 2005 and 2006. The pick-up in employment that started last year after a two-year decline is set to continue by 0.5 per cent in 2005 and 0.4 per cent in 2006.

After a 2 percent real growth in 2004, wages rose faster in the first quarter of 2005 (3.1 per cent in real terms). Taking into account the Private Sector Wage Agreement 2004-2005 and counting on a further moderate wage growth in the public sector, the average real gross wage growth in Slovenia could reach slightly above 2 percent in 2005 and 2.5 percent in 2006.

Table 9. Major macroeconomic indicators for Slovenia 2003-2006

	2003	2004	2005*	2006*
GDP (%)	2.5	4.6	3.5	3.9
Private consumption (%)	2.7	3.5	3.4	3.2
Public consumption (%)	2.6	1.7	2.5	2.6
Gross fixed capital formation (%)	6.3	6.8	6.7	5.0
Export (%)	3.2	12.6	7.5	7.7
Import (%)	6.8	12.4	6.5	6.7
Consumer price index (average,%)	5.6	3.6	2.6	2.4
Consumer price index (Dec/Dec, %)	4.8	3.5	2.2	2.6
Unemployment ratio (%, ILO definition)	6.5	6.0	6.2	5.9
Real wages (%)	1.9	2.3	2.1	2.5
General government balance (% in GDP)	-2.0	-1.9	-1.9	-1.8
General government debt /GDP (%)	29.4	29.4	30	30.1
Current account balance / GDP (%)	-0.4	-0.7	-0.6	0.0
Trade balance /GDP (%)	0.0	-0.6	-0.7	0.4
Gross foreign debt /GDP (%)	54.3	59.3	62	59
Exchange rate (SIT/EUR end of year)	236.7	239.7	239.5	239.7
Base rate	5.0	3.2	3.5	3.25

Source: Bank of Slovenia, IMF, IMAD

**Forecast*

Special Topic: Relocation – Something New under the Sun?

Debates about the process of relocation have come to the forefront in recent years, especially in developed countries[3]. At first glance it seems that the process has been embracing more and more sectors and activities, it has become more and more pervasive in all economic fields and it has been responsible for an increasing number of job losses in developed economies. The perception of "pervasiveness" of relocation has been enhanced by the fact that its effect is concentrated regionally, sectorally and on certain groups of employees, especially those of un- and semi-skilled people.

The enlargement of the European Union and together with those highly publicised cases of relocations, carried out by well-known multinationals to the New Member States also strengthened the perception, that the frequency of job transfers has recently become higher. Some old member states are particularly sensitive to that issue, given their persistent competitiveness, unemployment and fiscal problems, which turned out to be especially acute in the last 2-3 years.

Relocation – definition and background

Relocation is a process, in which companies shift their production to a foreign location. The transfer of production can be realised through two mechanisms: either through off shoring, when the firm retains the ownership of the whole of the production process, i.e. it relocates parts of or the whole production to a foreign company, which is under the relocating company's control and in its ownership; or through international outsourcing, when parts of or the whole production process is contracted out to independent foreign suppliers. Relocation means a transfer of activity to a foreign location in two different forms: either when the closing down or reduction of domestic capacities is accompanied by foreign expansion or when instead of domestic capacity expansion, this is realised abroad.

Relocation is driven by various factors, which are also responsible for deep structural changes in the global economy. Multi- and unilateral steps of trade liberalisation, more unrestricted movement of capital, technology advances and reduction in transportation and communication costs, among others, make markets more integrated, and enable companies to divide production processes and locate parts of production to those (foreign or domestic) production sites, which are the most efficient. Thus, relocation is a response of companies to the more competitive business environment in the increasingly integrated global market and to the faster technology development.

Estimations about the extent of relocation in the global economy are numerous. However, almost all have their methodological shortcomings, and thus they can give only an upper or lower limit of the real size of the process. Levels of foreign direct investment flows, trade in parts and components, imported intermediate inputs, share of imported inputs in exports, intra-firm trade are used as proxies for the extent of off shoring and outsourcing. While the result differ in terms of their coverage (sectors and countries), all agree in the dynamic growth of this type of company cooperation starting already from the second quarter of the last century. Another common result is, that while these mechanisms were one of the main drivers of integrating developing (and transition) economies in the global economy, the overwhelming majority of them is realised between developed countries. Relocation is concentrated in certain manufacturing sectors, such as production of vehicles or electronics, but it is increasingly present in some hitherto non-traded services as well.

[3] Some of the recent studies dealing with the issue of relocation include:

Henk Kox and Arjan Lejour: The effects of policy heterogeneity on trade and investment in services: empirical analysis for the EU. CPB Netherlands Bureau for Economic Policy Analysis The Hague, Netherlands, 2004

Jean-Luc Gaffard-Michel Quéré: Relocation: What Matters? Competition or/and Co-ordination¦ Euroframe study, 2004

The most frequently analysed aspect of relocation is its impact on the number of jobs and wages in the developed countries. A widespread fear has arisen in the developed countries that the recently accelerated relocation implies an increasing number of job losses, a strong downward pressure on wages and deteriorating employment conditions, and these developments would not be confined to low skilled activities. However, on the basis of empirical evidence, provided by studies, these fears are largely unfounded. While the extent of job losses due to relocation may be significant, job creation in other sectors – connected to relocation – may counterbalance this impact. The net outcome depends to a great extent on the flexibility of the labour market and on the impact of government policies.

Relocation between EU-15 and NMS-8

Relocations are estimated to be relatively frequent in EU-15 and NMS-8 relation, especially between geographically closer countries. According to a survey of relocations, every fifth FDI project in the period between 2003 and 2005 was a clear-cut relocation in Hungary. Mainly USA and German investors are the most active in transferring their activities to the NMS countries from other, more costly locations; however, other Western European investors follow them relatively closely.

Relocations affect first of all the electronics and automotive sectors, which are interlinked to a great extent (there are many car parts and components, which are in essence electronic products). Business services are an emerging area of relocation in the NMS countries, which is backed by the fact that - according to a survey by McKinsey - suitable candidates for off shoring service jobs are more readily available in Central European NMS, than in other parts of the world, including China, Brazil, Russia or India, in view of language skills, practical skills or living relatively concentrated in major cities. Interestingly, traditional labour intensive sectors still figure highly on the list of relocation cases, however, these are the sectors (clothing, textile and footwear), where relocations from the NMS-countries to their neighbours (in the case of Hungary to Romania) with even cheaper labour are also relatively frequent. Chemical products and the production of household appliances witness relatively high numbers of relocations as well.

As survey results show, relocations are realised first of all from other Western European sites to NMS countries. Even non-European investors (especially US, Japanese, South-Korean ones) seem to restructure first of all their European activities by transferring production capacities from the Western part of the continent to its less costly (especially in terms of wages) Eastern part. The number of jobs relocated from outside Europe to NMS is insignificant. Inside Europe Germany and Austria are the two most affected countries, followed by other old EU-members. Contrary to expectations, relocations from the old "EU-periphery" (Greece, Ireland, Portugal and Spain) are realised only rarely.

While relocations resulted in relatively large market shares in the EU-15 (and EU-25) markets for some of the NMS countries (especially the Czech Republic and Hungary) in certain affected products, the transferred capacities are still relatively small compared to what has remained in the affected products in the EU-15 countries. For example in TV sets, the Hungarian market share increased to above 10 per cent in EU-15 (including intra-EU trade), notwithstanding, the Hungarian output of the sector does not reach 4 per cent of that of the EU-15.

As far as the host country's experience is concerned, both benefits and costs can be attached to relocation. It results in additional, usually export-oriented capacities, may result in spill-over to the local economy, thus accelerating growth; provides additional employment, wages and taxes. However, exports may become too concentrated both in terms of products and exporters, thus vulnerable to business cycles and changes in (foreign) demand. Large footloose, very cost-sensitive relocations may make foreign trade earnings highly volatile, and may cause quick changes in employment, especially of unskilled labour. Moreover, local value added may remain low if local embeddedness of the relocated companies stays low – either due to company strategies and/or to problems of local supplies and absorption of spill-over.