ICEG European Center

MACROECONOMIC ANALYSIS AND FORECAST FOR EASTERN EUROPE 2001-2002

A Report by the ICEG European Center

November 2001

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1. OVERVIEW AND SUMMARY OF MACROECONOMIC TRENDS AND FORECAST FOR EASTERN EUROPE IN 2001-2002

As the majority of Eastern European economies are very open both in real and financial terms, there are four factors which strongly influence their macroeconomic performance: economic growth in advanced economies, especially in the EU, terms of trade changes, global monetary conditions and the changes in global capital flows.

Concerning the effect of these factors, 2001 will be a mixed year for transition economies. While the slow-down of the world economy gradually affects the region, this effect on Eastern Europe will altogether be much weaker, than in other emerging economies, since the growth of the region depends more on the EU and less on USA and Japan, to which the East Asian and Latin American economies are more exposed. After suffering serious terms of trade losses in 2000, this year the changes in terms of trade will affect the region relatively favorably.

While there has been a gradual easing of monetary conditions in the advanced economies, this didn't help too much to the economies of the region, as there monetary policies were generally tightened in a reaction of central banks to worsening internal imbalances. Finally, capital flows to the region have also declined due to the losses suffered by investors in other markets, and the generally increased risk of investments in emerging markets.

Looking at the evolution of the major macroeconomic variables, there are four distinct groups of countries within the analyzed 14 economies. The first group of economies comprises the five Central European pre-accession economies (Czech Republic, Hungary, Poland, Slovakia, Slovenia). The second group includes the small but very diverse economies in the Baltics, which have sizeable differences in terms of structural and institutional reforms, macroeconomic performance, but are similar in terms of real and financial openness, their size and level of development.

The third group includes the South-Eastern-European economies of Bulgaria, Croatia, Romania and Serbia, which lag behind other economies in terms of structural and institutional changes, but which have recently all embarked on significant reforms measures. The last group in our analysis includes the two major economies of the former Commonwealth of Independent States (CIS), Russia and Ukraine, which have patterns of economic performance very distinct from each other and other transition economies.

Table 1.1.

GDP growth rates (%)

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	-1,2	-0,4	2,9	3,5
Hungary	5,1	4,5	5,2	4,0
Poland	4,8	4,1	4,1	2,0
Slovakia	4,1	1,9	2,2	3,0
Slovenia	3,8	5,2	4,8	3,3
Baltics				
Estonia	5,0	-0,7	6,9	4,5
Latvia	3,9	1,1	6,6	7,2
Lithuania	5,1	-4,2	3,9	4,7
South-Eastern-Europe				
Bulgaria	3,5	2,4	5,3	4,5
Croatia	2,5	-0,4	3,7	4,2
Romania	-5,4	-3,2	1,6	4,4
FRY	2,5	-17,7	7,0	5,0
CIS				
Russia	-5,5	3,2	8,3	4,0
Ukraine	-1,9	-0,2	5,8	7,5

DECLINING BUT STILL ROBUST GROWTH PERFORMANCE, INCREASING DOMESTIC DEMAND

While 2000 was one of the most successful years for the Eastern European economies in terms of growth and real convergence since the beginning of transition, in 2001 growth continued to be robust with a gradual decline in average growth rates in three out of the four country groups. But even with this slowdown, the growth performance of the region will be better than it was on average during 1997-1999, the period of currency crises.

Growth performance is robust in international comparison as well, as growth rates in the region remain higher than in most of advanced or emerging market economies. Simultaneously with the expected slowdown of world economic growth, (according to the IMF world output is expected to increase by 2.6% after last years' 4.7%), growth rates are expected to decline in case of Asian crisis economies (Indonesia, Korea, Malaysia, Philippines, Thailand) from 5.8% (2000) to 2.4%(2001), in the major Latin-American economies (Argentina, Brazil, Chile, Mexico, Uruguay) from 3% to 1.3%. Output growth is expected to weaken in the Central European pre-accession economies from 3.8% to 3.3%, in the Baltics from 5.8% to 5.4%, in the 2 former CIS economies from 7% to 4.5%, and it will increase in South-Eastern Europe from 3.6% to 4%.

Looking at the demand composition of growth, relatively small slow-down in export sales is generally accompanied by sizeable increases in domestic absorption. While export growth rates decline in comparison with the previous year, this decline is moderate except Russia and Ukraine, whose exports depend on terms of trade changes and some South-Eastern-European economies, which face general competitiveness problems and are more sensitive to cyclical factors. In case of pre-accession economies average export growth rates are expected to decline from 15.8% in 2000 to 11.9% in 2001. The good export performance despite the worsening global conditions can be explained by the so far weak effect of the declining EU growth and import demand on export sales, by mostly unchanged price competitiveness of tradable sectors.

The still robust export growth is accompanied by acceleration of imports, reduction of the contribution of net exports to GDP. This is however partially compensated by the increase of domestic demand. While their contribution to GDP and growth rates vary country from country, all major components of domestic demand are expected to grow in 2001. Private consumption can grow significantly: in the Central European pre-accession economies by 3.2% on average following 0,9% in 2000, in South-Eastern-Europe by 4.8% and 1.9% in 2001 and 2000 respectively, in the 2 former

CIS economies by 4.5% after last years' 3.5%, and the growth rates are expected to decline only in the Baltics from 5.6% to 4.7%.

Private consumption growth in the region is partly driven by the rapid increase of nominal wages and incomes, which translates itself to sizeable real wage growth. Moreover, private savings continue to decline, as households increase their consumption to compensate for earlier losses and reduce their gross savings because of the unattractive returns. The stimulating effect of these factors on growth of private consumption is not neutralized by the negative impact of the stubbornly high and in some countries even increasing unemployment.

Besides private, the contribution of public consumption to growth increases too, except in those countries, where structural problems and fiscal imbalances require adjustment measures (Croatia and Czech Republic for example). Public consumption growth is partly a counter-cyclical response to weaker global conditions, partly is a result of the political cycle (forthcoming elections in many countries in the next 12 months) driven demand stimulus. Altogether, however the contribution of public consumption to growth increased modestly, well below private one.

Table 1.2.

The changes in fixed capital formation (%)

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	0,1	-0,6	4,2	6,5
Hungary	11,4	5,9	6,6	4,6
Poland	14,5	6,6	3,3	1,5
Slovakia	11,1	-18,8	-0,7	8,0
Slovenia	12,4	18,9	1,2	-2,3
Baltics				
Estonia	11,3	-15,2	2,0	5,9
Latvia	44,0	-4,0	10,8	8,2
Lithuania	n.a.	n.a.	-9,3	5,8
South-Eastern-Europe				
Bulgaria	32,9	25,8	9,8	5,5
Croatia	2,5	-1,1	-3,5	8,0
Romania	-5,1	-10,8	5,5	10,0
CIS				
Russia	-6,7	5,3	17,2	6,0
Ukraine	6,1	0,4	11,2	12,5

An encouraging sign from the perspective of long-term competitiveness and sustainability of growth rates is the behavior of private investments. They increased almost everywhere except Poland, where structural problems and worsening growth prospects, and Russia where the unfavorable terms of trade changes reduced the growth of private capital formation compared with the previous year. In some countries (Czech Republic, Slovakia, Slovenia) investment growth is stimulated by higher stock of FDI, acceleration of post-privatization restructuring: In other economies investment grow because of the accelerated growth of capital formation in the non-tradable sectors, which so far lagged behind tradable ones.

Finally, the increased contribution of capital formation to growth is also driven by the relatively moderate, although slightly growing real interest rates, and the generally improving expectation of the private sector on the future growth prospects. In Central Europe investments are expected to grow this year by 6.2% following the average of 2.6% in 1999 and 2000, in South-Eastern-Europe they are expected to accelerate from 3.6% in 1999-2000 to 7.6 % in 2001, while in the Baltics' from 1.5% to 6.6%.

Notwithstanding the general growth of investments, there are sizeable differences in the investment rates between the individual economies. In Central Europe, investment rates are high and in accordance with their level of development, while in South-Eastern Europe and the CIS-2 economies they are very low and far below their catch up and growth

Table 1.3.

The investment rates in % of GDP

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	28,9	27,9	28,2	29,0
Hungary	23,6	23,9	24,5	24,6
Poland	25,1	25,4	25,3	25,2
Slovakia	38,0	30,7	29,8	31,2
Slovenia	24,5	27,3	26,6	25,2
South-Eastern-Europe				
Bulgaria	13,2	15,9	16,1	16,2
Croatia	23,3	22,5	21,0	21,8
Romania	16,4	13,5	13,3	14,1
CIS				
Russia	14,8	14,0	16,4	16,7
Ukraine	13,5	13,7	11,0	11,6

requirements. Among the pre-accession economies a slight convergence of investment rates between the individual economies could be observed: Czech Republic and Slovakia have recently experienced slight decline of their high investment rates, while Hungary, Poland and Slovenia show gradually picking up private capital formation.

This convergence is linked to the timing of corporate restructuring, privatization, and strengthening of financial discipline: this is a key development in the former countries reducing their high and sometimes inefficient investments, while the lagged effect of earlier structural adjustments is reflected in the growing investment rates in the latter group. While Central-European economies have relatively high and increasingly efficient investments, the capital stock is obsolete, undervalued and underdeveloped in South-Eastern-Europe and the former CIS economies, which is one of the major obstacles for their sustained high growth.

The mentioned changes in the demand composition of growth provide some explanation to the shifts in the contribution of different sectors to GDP. The most notable change is the decline of manufacturing growth and the difference in the growth rates between industrial and service sectors. The weaker performance of manufacturing is associated with the decelerating growth of exports, as both the majority of export growth has come from manufacturing and manufacturing output was mostly driven by export sales. The co-movement of export sales and manufacturing growth was very strong in Hungary, Poland, Czech Republic: this year sizeable declines in the manufacturing output growth in these economies could be observed.

Slower manufacturing growth is partly compensated by the accelerated expansion of services. Growing output of the service sector is stimulated by increasing private consumption, which falls mostly on these sectors and by investment growth in the underdeveloped non-tradable sectors. The growth of services is also driven by price and market liberalization, adjustment of regulated prices and privatization of major suppliers in telecommunications, public utilities and banking. These sectors require significant investments and fresh (mostly foreign) capital inflows are a significant stimulus for the expansion of their output. Finally, accelerated changes in the retail sector stimulate the growth of services, besides contributing to the expansion of the construction sector.

Table 1.4.

Unemployment rates (%)

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	7,5	9,4	8,8	8,0
Hungary	7,8	7,0	5,9	5,7
Poland	10,4	13,0	15,0	17,5
Slovakia	15,6	19,2	17,9	18,0
Slovenia	14,6	13,0	6,6	5,8
Baltics				
Estonia	9,6	11,5	13,7	13,2
Latvia	13,8	14,1	14,4	13,3
Lithuania	14,0	15,3	16,1	16,5
South-Eastern-Europe				
Bulgaria	12,2	16,0	17,5	18,5
Croatia	18,1	20,4	21,1	22,0
Romania	10,4	11,8	10,8	9,0
FRY	25,4	25,5	26,8	28,0
CIS				
Russia	13,3	13,2	10,2	8,5
Ukraine	3,7	4,3	4,5	5,0

HIGH AND PERSISTENT UNEMPLOYMENT

Notwithstanding the good growth record of Eastern European economies unemployment remains a serious and in some cases growing problem, as registered unemployment increases further. The average rate of unemployment for the analyzed economies may reach by the end of 2001 12.3%, compared with 12.5% in 2000 and 11.6% in 1999. The average unemployment rate is higher than in industrial economies, but there are significant differences between the individual countries.

One factor explaining the week effect of robust growth on unemployment is related to the accelerated privatization-cum-restructuring as in Poland, Czech Republic, Slovakia and Croatia restructuring is accompanied by sizeable lay-offs. Moreover, new investments following privatization are labor-substituting ones, and they reduce labor demand, with significant differences between the sectors, depending on the skills of the labor force. Altogether, the negative effect of downsizing and restructuring on employment following privatization sometimes still exceeds the positive effect of higher output growth.

The reduction of unemployment in several economies is hampered by long-term structural weaknesses. The high share of agricultural labor force in Poland and Romania (its share in total labor force exceeds 20%) may prevent the decline of unemployment as the inevitable structural changes in that sector will reduce employment and thus add to the pool of unemployed.

Besides inherited and unresolved structural problems the differences in unemployment ratios between the individual economies are also due to differences in labor market rigidities. In that respect the differences between Poland and Hungary are of good example: besides earlier progress with restructuring and privatization, the weaker labor market rigidities in Hungary contribute to much lower (one third) unemployment rate compared with Poland, notwithstanding the worse growth record in recent years. Similarly, Slovenia and Slovakia embarked on privatization and restructuring later than other pre-accession economies, but labor is more mobile in Slovenia, and the service sector is more robust, absorbing easier the unemployed: the unemployment ratio is less than 60% of Slovakia.

Table 1.5.

Annual average changes in consumer price index (%)

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	10,7	2,1	4,0	5,1
Hungary	14,3	10,0	9,8	9,2
Poland	11,6	7,2	10,1	7,5
Slovakia	6,7	10,6	12,0	7,6
Slovenia	7,9	6,1	8,9	8,1
Baltics				
Estonia	8,1	3,3	4,0	5,8
Latvia	4,5	2,4	2,6	3,4
Lithuania	5,1	0,8	0,9	2,3
South-Eastern-Europe				
Bulgaria	18,7	2,6	10,3	5,5
Croatia	5,7	4,2	6,2	5,1
Romania	59,1	45,8	45,7	34,0
FRY	29,9	44,9	85,7	45,0
CIS				
Russia	84,4	36,5	20,2	21,0
Ukraine	20,0	19,0	26,0	13,0

DECLINING INFLATION, HELPED BY BETTER EXTERNAL CONDITIONS AND RENEWED FIGHT AGAINST PRICE INCREASES

Following the acceleration of price increase in 2000, average inflation rates in the four group and in the majority of countries will be lower in 2001. higher price increases in 2000 were mainly caused by external factors: increases in oil prices and unfavorable terms of trade changes, appreciation of the US dollar with their high passthrough effect on domestic prices. Cost push pressures were reflected in producer price increases exceeding consumer prices, and the gap sometimes was sizeable.

There are sizeable differences between the Eastern European economies in the level of headline and core inflation caused by the diverging success of stabilization policies, nature of macroeconomic policy mix, extent of exogenous shocks. Besides the differences in price levels, countries can also be divided to two groups in terms of the speed of disinflation. There is one group of economies which are stacked with high or moderate inflation rates and experience sizeable downward price rigidity, while others are able to achieve gradual but constant disinflation. The first group of countries includes economies with different levels of price increases (among others Romania, Russia and Slovakia with their inflation rates of 40%, 20% and 10% respectively), while the second group includes Poland, Slovakia, Hungary and Slovenia among others.

Several factors contribute to the downward rigidity of inflation rates in 2001 in the first group of countries. One of them is the significant cost pressure stemming from the increases of energy prices and nominal wages. Inflation persistence is also associated with the liberalization of administrative prices, as these economies generally lag behind in the liberalization process and step-by-step liberalization provides continuous pressure for price increases. Finally, some economies with higher inflation persistence experienced problems associated with high net reserve inflows and their effect on the increase of money supply. As instruments to sterilize net capital inflows are in several economies underdeveloped, these inflows frequently spilled-over and resulted in sizeable increases in money supply.

The other group of countries in 2001 was in more favorable position and experienced continued disinflation. One factor behind their inflation performance is the weaker effect of imported inflation on price increases, as those unfavorable shocks that persisted in 2000 weakened. Second, monetary policies were tightened or remained relatively tight in this group of countries and central banks have widened the tolerance band for output losses in order to accelerate disinflation. This was most pronounced in Poland, but monetary policy became tighter in Hungary, Czech Republic and Croatia among others.

Finally, the relative currency stability, in some cases the nominal appreciation of local currencies helped disinflation as the exchange rate remains generally the strongest transmission channel of monetary policy in Eastern Europe. Central banks accepted the relative tighter policies more willingly than earlier and exogenous exchange rate movements were also more favorable, helping disinflation via high passthrough ratios.

While inflation performance continued to improve, several factors remain a source of concern in these economies. One of them is the still incomplete liberalization of administrative and adjustment of regulated prices, which remains an important source of inflation in Slovenia and to lesser extent in the Czech Republic. Associated with that is the ongoing adjustment of price structures, which is reflected in the increase of non-tradable prices.

Second, fiscal performance has considerably worsened in some of these economies, and the increased fiscal stimulus may be later a concern for disinflation in Poland, Czech Republic and to a lesser extent in Hungary. More expansive fiscal policies and structural weaknesses persistently maintaining fiscal deficit on high levels increase the danger of direct and indirect inflationary pressures. Finally, one should also consider that in some cases the output losses associated with disinflation are much higher, than expected and this may weaken the determination of monetary authorities for a rapid disinflation.

TIGHTER MONETARY POLICIES AND STRICTER MONETARY CONDITIONS

Monetary policies were gradually relaxed between early 1999 and late 2000 in almost all economies. Central banks followed with their monetary policy decisions the international trends as global monetary conditions eased too as a reaction of the leading central banks to the currency turmoil's of 1998-1999 in emerging markets. Another factor that helped Eastern European central banks to relax their monetary policies was the easing of pressures on local currencies following the turbulent period between the third quarter of 1998 and first quarter of 1999.

Since late 2000 monetary policies in the region behave differently from advanced economies, as tightening could be observed, while in advanced economies the worsening global growth prospects led to further easing of monetary policies. In Eastern Europe however central banks face different pressures, and they either increased interest rates in 2001, or let them decline below the decline in inflation rates.

One reason behind the shift in monetary policies is linked to the renewed fight against inflation. As mentioned earlier central banks were willing to accept higher sacrifice ratios in order to bring inflation down and to reduce price rigidity. A related reason for more restrictive monetary policies is associated with the gradual change of exchange rate regimes towards more flexible arrangements, which gave central banks more independence in their policy decisions.

More restrictive monetary policies are also linked to worsening fiscal and current account balances. As in many economies looser fiscal policies prevail, and the growth of domestic private demand increased significantly, central banks reacted with tightening of their policies to keep fiscal and current account balances within sustainable limits.

It is interesting to note that the monetary conditions have been tightened more in Central-European economies, compared to South-Eastern-Europe and the former CIS economies. One reason behind this may be that these economies are more exposed to changes in global conditions, investors sentiment due to their higher real and financial openness. Besides that, there are country specific reasons that prevented stricter monetary policies in less advanced economies, like the sizeable reserve inflows and expansion of broad money supply in Russia.

Table 1.6.

Nominal exchange rate against the USD

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	32,3	34,7	38,6	38,9
Hungary	214,5	237,3	282,3	285,5
Poland	3,5	4,1	4,3	4,2
Slovakia	35,2	41,4	46,2	48,9
Slovenia	166,1	181,8	222,7	241,1
Baltics				
Estonia	14,1	14,7	17,0	17,9
Latvia	0,6	0,6	0,6	0,6
Lithuania	4,0	4,0	4,0	4,0
South-Eastern-Europe				
Bulgaria	1,8	1,8	2,1	2,2
Croatia	6,4	7,1	8,3	8,5
Romania (1000)	8,9	15,3	21,7	31,0
FRY	9,3	11,0	37,5	67,0
CIS				
Russia	20,7	27,0	28,2	29,5
Ukraine	2,5	4,1	5,4	5,4

INCREASED NOMINAL EXCHANGE RATE STABILITY

One general trend experienced in all economies of the region is the relative stability of nominal exchange rates both against the major currencies and in nominal effective exchange rate terms. This is equally true for those economies, which experienced accelerated loss of the value of their currencies in 2000 and for those, where depreciation declined following the 1998-1999 currency turmoil's. As the table shows the average value of national currencies vis-a-vis the US dollar declines much less in all economies, and as the majority of these economies in one or another way implicitly shadow the Euro, this is translated to more effective exchange rate stability too. There are several, partly country specific, partly region wide reasons for this enhanced exchange rate stability.

The major reason behind it is again linked to the fight against inflation after the poor inflation record of 2000. Central banks put in 2001 greater emphasis on accelerating disinflation and the exchange rate policy plays a crucial role in that respect. This is surprisingly true for such diverse economies as Russia, Hungary or Croatia, which have significant differences in their structural and openness indicators, in their existing monetary arrangements and in the level and dynamics of inflation. The strength of exchange rate channel is due to the relative openness of these economies (except Russia and Ukraine), the still high degree of dollarization and role of shadow currencies, and in the more advanced economies to the problems or weaknesses of other transmission channels of monetary policy, including the interest rate.

Another reasons for the shift towards greater nominal exchange rate stability is related to the changes in the applied exchange rate arrangements, as the shift towards more flexible ones allowed the appreciation pressures, present in the past exchange rate arrangements, to materialize. Besides that, as the current account balances improved, central banks were concerned less with the evolution of the current account and thus of real exchange rate indicators. This factor contributed the most to exchange rate stability in Poland, Slovakia, and Hungary among others.

The third, closely related to the previous factor of exchange rate stability is the still relatively sizeable capital (or if Russia is considered with its special balance of payments structure reserve) inflows, which put a constant pressure on nominal exchange rates. Central banks in the region try to sterilize most of these inflows to avoid rapid increase in real money supply and loosening their monetary policies.

The consequences of the increased strength of currencies are mixed. On the one hand, enhanced exchange rate stability has had its positive effect on price increases, and frequently stimulated further capital inflows due to expected capital gains. On the other hand, it contributed to competitiveness problems in several economies and thus to worsening trade and current account balances, and further decline of the contribution of net exports to output growth. Balance of payments difficulties could arise in economies, where domestic demand expands robustly, while where it grows less rapidly, economic agents could be forced temporarily to shift their sale to external markets, even if price competitiveness worsens, thus improving the current account balance.

Concerning the evolution of price and cost competitiveness, data availability allows us to make some general conclusions only. First, the trend real exchange rate appreciation continues in 2001. The reasons behind this process are manifold and well-known, including the Balassa-Samuelson-effect, the strength of which is disputed, the liberalization of administrative and regulated prices, the expansion of the demand for services. In 2001 the available evidence suggests that with significant country differences in its size, CPI and PPI based real exchange rates experience further appreciation. Second, in 2001 the appreciation comes via less inflation and devaluation of local currencies, than in the previous two years. Concerning the evolution of costs competitiveness, one may experience some worsening compared to previous years due to smaller increase of output and labor productivity.

Table 1.7.

General government balance in % of GDP	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	-1,9	-3,2	-4,2	-5,8
Hungary	-6,3	-3,4	-3,5	-3,4
Poland	-3,2	-3,7	-3,2	-4,5
Slovakia	-4,8	-3,6	-3,4	-5,5
Slovenia	-0,8	-0,6	-1,4	-2,9
Baltics				
Estonia	-0,3	-4,7	-0,7	-0,2
Latvia	-0,8	-4,0	-2,8	-1,7
Lithuania	-5,9	-8,5	-2,8	-1,4
South-Eastern-Europe				
Bulgaria	0,9	-0,9	-1,0	-0,5
Croatia	0,5	-2,2	-4,9	-6,0
Romania	-3,6	-1,9	-4,0	-3,5
FRY	-5,4	-8,4	-0,9	-1,0
CIS				
Russia	-8,0	-3,3	3,0	1,0
Ukraine	-2,7	-2,4	-1,2	-1,0

WORSENING FISCAL BALANCES

In 1999 and 2000 there was an improvement in general government balances, which reflected adjustment policies implemented either as a part of broad reform package (Slovakia and Croatia) or as precautionary measure in order to avoid renewed pressures on domestic currencies following the currency crashes of 1998 and 1999 (Hungary, Slovenia, Bulgaria). Cyclical factors (improving terms of trade in case of Russia, good growth record and higher inflation, generating extra revenues in many countries) contributed too to the improvement of general governments' balances.

This year a reversal of these recent trends is expected, as fiscal balances worsen in the majority of economies: either surpluses decline (Russia), or deficits increase and reach sometimes (especially if they are accounted properly, according to international accounting standards) alarming levels (Czech Republic and Poland among others).

While the reasons of worsening, as well as the policy measures required to reverse the trend, are diverse and country specific, some general factors contribute to this development. First, fiscal balances reflect the negative effect of the slow-down in growth rates and/or adverse external shocks, which have a negative effect through the worsening primary balances due to lower than expected revenues. The unfavorable cyclical effect is especially strong in economies, which have experienced above-the-average slowdown: Russia, Poland.

Worsening of fiscal balances also reflects the stimulus provided by governments to weaken the negative cyclical effects. Looser fiscal policies are visible from worsening primary balances, which come almost equally from higher expenditures and lower revenues. These primary balances also reflect the effect of political cycle and the upcoming elections in several economies (Hungary, Slovakia, Czech Republic and recently Poland).

In several transition economies fiscal balances worsen because of the growth of transition related expenditures. Some countries embarked on reforms costly from fiscal point only recently (Croatia, Slovakia), while elsewhere these essential reforms (banking sector restructuring, enhanced financial discipline) were inconsistent and they have to be implemented now (Czech Republic, Romania), leading mostly to the increase of fiscal expenditures (higher unemployment outlays, financing of the restructuring and rehabilitation of ailing financial and cooperate sectors, etc.). Besides being a burden for fiscal balances, these measures also contribute to the growth of public debt, as some expenditures are financed from below-the-line.

Finally, in several economies fiscal balances are influenced by the reform of public finance, which besides its expected long-run benefits in the short-run may have a negative effect on the primary balance. These reforms include among others tax reform and the reduction of average and marginal tax rates, pension reform and the reduction of contributions to the publicly funded pillars. This factor deepened fiscal problems in 2001 in Poland, Russia and Croatia.

Where worsening fiscal imbalances exceeded threshold levels deemed sustainable, they led to adjustment measures: Croatia, Poland have implemented or are working on adjustment packages and significant adjustments will be soon required in the Czech Republic, Slovakia to avoid the build-up of unsustainable deficits, and in Russia to adjust the budget to the decline of windfall revenues.

While fiscal deficits have sometimes reached alarming magnitudes, the evolution of public debt is much better in all Eastern European countries. Public debt levels in the region are generally moderate, compared with the level of advanced and several other emerging economies. While the levels are moderate, two trends in the evolution of public debt result in their convergence between Eastern European economies.

Those economies, which had in the first half of 1990s high debt levels experience rapid decline, driven either by the combination of earlier strong fiscal adjustment and high growth (Hungary and Poland until recently), or restructuring of debt and high output growth (Russia). In these economies, debt levels have declined below 60% of GDP, and in 2001 this trend is expected to continue.

On the other hand, there are several economies (Czech Republic, Croatia, Slovakia), which had low debt levels in the middle of 1990s, and then have been experiencing its rapid build up. This has partly been caused by the combination of high fiscal deficits and low economic growth, which has a negative effect on debt levels through both the worse primary balance and higher interest expenditures. Another source of debt accumulation is the management of corporate and banking sector distresses. While frequently these expenditures have been included as above-the-line items, the extent of the problem and the application of prudent accounting principles led to higher debt levels too. Finally, in some economies (Russia most notably, but also in Croatia and Poland) public debt has been affected by its accumulation outside the realm of central government by other levels of general government, by different public entities carrying out fiscal or quasi-fiscal activities.

Altogether, public debt generally varies between 30 and 55% of GDP in the more indebted economies, while in low debt countries the rate is around 10-15% of GDP.

Table 1.8.

Public debt in % of GDP

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	26,7	29,0	29,2	31,0
Hungary	60,1	59,8	55,5	53,0
Poland	42,9	44,5	42,5	40,5
Slovakia	30,4	30,2	32,9	42,7
Slovenia	14,6	13,7	12,5	13,4
Baltics				
Estonia	5,9	6,6	5,2	4,9
Latvia	10,0	13,0	13,0	15,0
Lithuania	16,6	22,4	28,3	28,8
South-Eastern-Europe				
Croatia	26,2	32,7	38,1	45,0
Romania	30,6	34,7	31,2	-
FRY	n.a.	n.a.	183,0	161,0
CIS				
Russia	70,0	95,0	64,9	54,0

Table 1.9.

Export growth (%)

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	13,4	6,5	20,1	16,8
Hungary	16,0	13,1	21,8	13,5
Poland	10,4	-8,1	14,9	7,5
Slovakia	11,5	-4,7	16,7	9,2
Slovenia	6,7	1,7	12,7	7,5
Baltics				
Estonia	18,5	-4,6	30,7	11,0
Latvia	9,4	-6,1	9,4	11,7
Lithuania	-2,9	-16,4	28,7	17,1
South-Eastern-Europe				
Bulgaria	-12,4	-4,7	19,4	4,5
Croatia	8,9	-5,3	3,0	2,0
Romania	5,9	10,8	23,9	14,8
FRY	20,7	-47,6	15,6	3,5
CIS				
Russia	-15,8	0,8	40,0	5,0
Ukraine	-13,5	-8,0	20,1	5,0

INCREASING TRADE AND CURRENT ACCOUNT IMBALANCES

This year brings a reversal in developments in trade balance observed in 2000, when they generally improved following the very disappointing export performance in 1999. The major exception to this development in 2000 were the South-Eastern-European economies and Czech Republic, which experienced worsening trade balances, due to increasing imports driven by accelerating domestic demand. The improvement of trade balances in other economies was driven either by the relatively favorable terms of trade changes (for the exporters of raw materials and energy as Russia and Ukraine), or by the increasing import demand of advanced economies (Central-European countries).

In 2001 worsening trade balances may be expected in the region except the Central European economies, where the expected average trade deficit will remain at 5.6% of GDP similar to 2000. The trade deficit will increase in Southern-European economies from 13.1% to 20.5%, in the Baltics from 15% to 17% of GDP, while in case of CIS-2 economies the trade surplus will decline from its high (13.6%. of GDP in 2000) to much more moderate level (8% of GDP) level.

The major and uniform reason of worsening trade balances is the reduced growth of exports, due to the changes in exogenous conditions. Export growth rates in Central European economies declined everywhere in real terms, but the rates differ significantly between the individual economies. The growth rate of their exports is still double-digit or close to it, and is based on manufacturing sales and good international competitiveness.

Other economies with less developed export structures and more vulnerable to the changing exogenous conditions experience higher variance of export growth rates and they may expect their sizeable decline in 2001 (Bulgaria, Romania, Russia). Both the high volatility of their exports and the low level of increase in 2001 shows that there are long-term structural problems, and these economies were so far unable to upgrade their export structure and reduce their exposure to exogenous shocks.

Besides declining export growth rates, worsening trade balances are linked to imports too, which don't behave uniformly across the countries. Some economies, interestingly mainly the more advanced Central European ones, experience drop in their import demand (with the exception of Slovakia, where imports grow slightly more robustly, than in 2000). There are two reasons for moderating import growth.

Table 1.10.

Changes in imports (%)	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	9,1	3,3	21,3	17,7
Hungary	22,2	12,3	21,1	12,7
Poland	17,2	-0,6	4,6	6,5
Slovakia	12,0	-13,7	13,3	14,8
Slovenia	10,4	8,2	6,1	2,9
Baltics				
Estonia	12,6	-8,5	29,0	12,6
Latvia	17,0	-7,2	7,5	9,3
Lithuania	1,8	-15,9	13,2	14,4
South-Eastern-Europe				
Bulgaria	2,2	11,1	16,9	3,5
Croatia	-7,1	-6,1	1,6	12,0
Romania	14,3	-1,1	29,1	25,0
FRY	1,0	-32,1	12,6	20,7
CIS				
Russia	-19,4	-31,5	12,8	25,0
Ukraine	-17,0	-19,1	18,9	7,0

Table 1.11.

Trade balances in % of GDP	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	-4,5	-3,5	-6,5	-7,6
Hungary	-5,8	-6,0	-3,6	-3,3
Poland	-8,7	-9,3	-8,2	-7,0
Slovakia	-11,5	-6,5	-4,8	-5,5
Slovenia	-4,0	-6,2	-6,0	-4,7
Baltics				
Estonia	-21,4	-17,2	-16,0	-22,3
Latvia	-18,6	-15,4	-15,0	-14,5
Lithuania	-23,5	-24,0	-14,7	-14,2
South-Eastern-Europe				
Bulgaria	-3,1	-8,7	-9,5	-9,0
Croatia	-17,7	-17,4	-18,4	-20,0
Romania	-6,3	-3,2	-4,5	-7,5
FRY	-8,1	-11,9	-19,9	-25,0
CIS				
Russia	6,5	17,0	25,1	14,5
Ukraine	-4,2	-0,9	1,9	1,5

First, in these economies the share of inward processing industries in total export sales is high and the decline of export supply brings a lagged decline of import demand. Second, declining import demand is also associated with the reduction of growth rates and slight decrease of domestic demand, most notably in Poland and Slovenia.

In other former CIS and South-Eastern-European economies import demand is on rise mostly because of the sizeable real exchange rate appreciation and booming domestic absorption. As in these economies there are supply side capacity constraints, expanding domestic absorption has always been associated with increasing import demand, which is expected to accelerate on annual basis in Russia, Croatia and Ukraine.

Trade deficit may reach alarming size in some economies and its sustainability is increasingly under question in Croatia and Romania, which seem to approach the threshold regarded dangerous. Trade balances are also a source of concern for policy makers in Poland and Slovakia, especially due to their persistently high level.

As trade balances determine predominantly the current account in the majority of these economies, general worsening of current account balances is observed, with the notable exception of Hungary, Slovenia and Bulgaria. In terms of their current account performance, the economies of the region in 2001 may be divided to three groups. In the first group (Bulgaria, Romania, Slovenia and Croatia) revenues from services exports increase significantly and the improvement of the services balance compensates for the worsening of the trade one. Increased service revenues stem either from higher tourism or transport receipts. These economies have generally balanced incomes balances, as they have relatively modest foreign debt levels and interest payments (except Bulgaria), and also relatively low levels of foreign direct investments, thus low profit repatriation.

The second group of economies comprises advanced Central-European economies, where current account balances are much better than trade balances. The major reason for this is that the surplus on service balances exceeds the deficit on incomes balances, which comes from two sources: one is associated with interest payments on foreign debt, while the second is due to the profit outflows after invested foreign capital. Since both are sizeable and above the average of Eastern European economies, their management represent a challenge for policy makers.

The final group of countries includes Russia and Ukraine, where the trade balance is much better than the current account, which is worsened by the huge deficit on incomes balance. This deficit comes from significant interest payments on the accumulated net foreign debt, while profit outflows play a marginal role due to the low level of foreign direct

Table 1.12.

Current account balances in % of GDP	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	-2,3	-2,9	-4,7	-6,5
Hungary	-4,8	-4,4	-3,3	-2,5
Poland	-4,3	-7,5	-6,1	-5,1
Slovakia	-10,4	-4,9	-3,5	-5,2
Slovenia	-0,8	-3,9	-3,3	-2,4
Baltics				
Estonia	-9,2	-4,7	-6,4	-6,0
Latvia	-10,6	-9,7	-6,9	-6,3
Lithuania	-12,1	-11,2	-6,0	-6,2
South-Eastern-Europe				
Bulgaria	-0,5	-5,5	-5,1	-5,5
Croatia	-7,0	-6,9	-2,8	-3,0
Romania	-7,2	-4,2	-3,7	-6,5
FRY	-6,4	-8,9	-7,6	-14,8
CIS				
Russia	-0,5	12,3	18,4	9,5
Ukraine	-3,0	2,6	4,6	3,2

Table 1.13.

Financial account balance in % of GDP	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	5,1	5,6	6,6	5,9
Hungary	6,2	9,9	5,2	5,4
Poland	6,9	5,4	4,9	6,0
Slovakia	9,8	11,4	7,5	6,0
Slovenia	0,4	3,8	3,0	2,6
Baltics				
Estonia	9,3	8,9	8,7	8,0
Latvia	-8,6	12,0	7,1	-9,6
Lithuania	13,4	10,0	-5,7	6,0
South-Eastern-Europe				
Bulgaria	-0,3	6,0	6,4	3,5
Croatia	7,4	9,4	4,7	2,0
Romania	4,9	2,1	2,5	3,0
FRY	0,1	0,1	3,2	0,9
CIS				
Russia	-2,6	-8,8	-8,9	-10,5
Ukraine	-1,9	-0,2	5,8	7,5

investments.

Altogether the worsening of current account balances will not be very significant this year compared to 2000. Current account deficits seem to be manageable in 2001 and their level could vary between 2.5% and 6.6% of GDP. While these levels are not a source of immediate concern, there are some warning signals for policy-makers too. One of them is the coincidence of worsening fiscal and current account balances, which may lead to twin deficits, which are difficult and costly to adjust. Another concern is related to the depth and length of current downturn in world and especially European economic growth, as this heavily influences the timing and costs of current account reversals. Third, in some countries real exchange rates may be misaligned, which may have a long-term adverse effect on the competitiveness of tradable sectors.

DECLINING CAPITAL INFLOWS WITH STABLE FDI FLOWS

While current account deficits are on rise, financial account surpluses have been declining in 2000-2001, compared to their levels in 1998-1999. The major reason behind smaller capital inflows is related to the decline of foreign portfolio investments, which has been caused by several factors. First, looking at the global data, one may observe a general decline of foreign portfolio investments to emerging economies, while other forms of capital inflows have recently remained more stable and sizeable. Second, the decline of FPI to Eastern Europe is also the outcome of increased risk aversion of foreign investors, due to their bad experiences in recent currency crises and their aftermath.

Foreign portfolio investors wanted to reduce their exposure to this region by reducing the net inflows of foreign portfolio investments. Finally, there is general shift in capital flows to emerging and within it to Eastern European economies from FPI to FDI. Foreign direct investments are the most stable and increasing component of the financial account in this region, with the exception of Russia.

Within declining net capital inflows, one good news for Eastern Europe is the increasing share of foreign direct investments in total capital inflows. The region also experiences increase in its share in global FDI flows: while the share of these economies in the GDP of all emerging countries is around 10%, they received in 1999-2000 15% of total FDI flowing to emerging economies and they are likely to get 16% of total inflows in 2001. The total inflows of foreign direct investments to the region are stable with sizeable differences between the individual economies in the amount of received capital. In 2001 the region will receive once again sizeable amounts of foreign direct investments, although the FDI/GDP ratio may decline a bit.

Table 1.14.

FDI inflows in % of GDP

	1998	1999	2000	2001
Central-Eastern Europe				
Czech Republic	4,7	11,8	8,7	9,0
Hungary	4,3	4,1	3,7	2,5
Poland	5,1	2,4	3,8	3,5
Slovakia	1,5	4,5	10,2	9,3
Slovenia	1,0	0,4	0,1	1,9
Baltics				
Estonia	10,9	4,3	4,9	4,5
Latvia	4,7	5,0	5,6	5,5
Lithuania	8,6	4,5	-2,7	4,5
South-Eastern-Europe				
Bulgaria	4,4	6,4	7,4	5,5
Croatia	3,9	7,2	4,4	3,0
Romania	4,9	3,1	3,0	2,9
FRY	0,1	0,1	0,0	1,1
CIS				
Russia	0,8	1,7	1,1	-0,3
Ukraine	1,7	1,7	1,9	1,9

One reason of significant gross and net FDI inflows is the privatization of public assets and the support governments provide for new greenfield investments. Compared to previous years, when many countries refrained from supporting FDI, now there is an increasing competition between the economies to influence the destination of foreign investors. Their investments are also stimulated in some of the recipient economies by the low unit labor costs and high labor productivity increases, which make them attractive for longer-tem investments. Finally, one may also observe some increase of investments driven by the expected gains from the likely EU membership of several pre-accession economies.

While there is a generally favorable picture for FDI in the region, there are some countries which perform extremely badly in terms of attracting foreign direct investments. In Russia, Ukraine, Serbia and also Slovenia the per capita amount of FDI and the yearly inflows are very low, far below the investment and technology needs of these economies. Moreover, in case of Russia the amount of gross inflows is so low, that due to foreign investments by Russian enterprises the net balance on FDI is negative, which is a very bad sign for long-term economic growth.

OUTLOOK FOR 2002

Looking ahead, the forecast for 2002 is burdened by several uncertainties shaping the development of the global economy and thus effecting strongly the Eastern European region. We expect that GDP growth rates in 2002 will be close to current ones, with slight changes in the individual economies depending on their exposure to global conditions, domestic policy mix and external imbalances. Out of the analyzed economies a sizeable slow-down could be expected only in Ukraine, while the Russian economy will continue the gradual deceleration of its output growth.

Fiscal balances will generally slightly worsen as fiscal policies remain relaxed and public consumption expands in many countries. At the same time some economies will see the improvement of their fiscal balances as a result of inevitable adjustment measures, which need to be implemented in order to keep the fiscal policies sustainable.

The same applies to the current account, where relatively good growth performance, expanding domestic demand will lead to increasing deficits. These deficit may reach a sizeable levels in the Czech Republic, Slovakia and Estonia, while in other countries they are kept within well manageable limits, except the very special case of Serbia.

Finally, further decline in inflation rates is expected in the economies of the region, driven simultaneously by favorable imported inflation and stronger disinflation policies of central banks. More sizeable disinflation may be expected in the advanced Central European economies, reflecting their enhanced efforts at converging to the Maastricht criteria, and in the higher inflation economies of Romania and Serbia.

Table 1.15.

Forecast for 2002

	GDP growth			CPI			Fiscal balance			Current account		
	2000	2001*	2002*	2000	2001*	2002*	2000	2001*	2002*	2000	2001*	2002*
Central-Eastern Europe												
Czech Republic	2,9	3,5	3,6	4,0	5,1	4,6	-3,3	-5,2	-6,5	-4,7	-6,5	-6,3
Hungary	5,2	4,0	4,3	9,8	9,2	6,1	-3,5	-3,4	-3,2	-3,3	-2,5	-2,8
Poland	4,1	2,0	2,5	10,1	7,5	6,2	-3,2	-4,5	-3,5	-6,1	-5,5	-5,0
Slovakia	2,2	3,0	3,5	8,4	7,4	6,4	-3,4	-5,5	-5,2	-3,7	-8,2	-8,5
Slovenia	4,8	3,3	3,5	8,9	8,4	6,3	-1,4	-2,9	-2,7	-3,3	-2,4	-3,3
Baltics												
Estonia	6,9	4,5	5,0	4,0	5,8	3,8	-0,7	-0,2	-0,7	-6,4	-6,0	-6,7
Latvia	6,6	7,2	5,5	2,6	3,4	3,8	-2,8	-1,7	-1,0	-6,9	-6,3	-5,8
Lithuania	3,9	4,7	5,2	0,9	2,3	3,0	-2,8	-1,4	-1,3	-6,0	-6,2	-5,9
South-Eastern-Europe												
Bulgaria	5,3	4,5	4,5	10,3	5,5	5,0	-1,0	-0,5	-1,0	-5,1	-4,8	-4,5
Croatia	3,7	4,2	4,3	5,3	5,1	4,8	-4,9	-6,0	-7,0	-2,8	-2,5	-3,0
Romania	1,6	4,4	4,0	45,7	34,0	25,0	-4,0	-3,5	-3,1	-3,7	-6,5	-5,5
FRY	-7,0	5,0	6,0	85,7	45,0	25,0	-0,9	-1,0	-1,0	-7,6	-14,8	-18,6
CIS												
Russia	8,3	4,0	3,5	20,2	21,0	15,0	3,0	1,0	0,0	18,4	9,5	6,0
Ukraine	5,8	7,5	5,0	26,0	13,0	11,0	-2,5	-1,0	-2,5	4,6	3,2	1,5

Looking at the individual economies in *Bulgaria* we expect that in 2002 the growth of GDP will remain on the level expected for 2001 around 4,5% of GDP. There will be a further shift in the demand factors of growth from external to internal demand, although the bulk of adjustment takes place already in 2001. With relatively good growth performance the decline of unemployment ratio from its current high level seems to be unrealistic, so it will remain around 18%. On the other hand inflation may decelerate further, while the decline will be smaller than it was it 2001, when the decline of imported inflation helped a lot.

Relatively fast growth will allow to keep the good position of the budget, which is an essential element for the credibility of the currency board arrangement. While export and import growth rates will decelerate markedly, the difference between the two will remain unchanged and therefore no deterioration in other trade or current account balance is expected in 2002 compared to 2001. Simultaneously we may expect a slight acceleration of capital inflows and this will lead to higher reserves of monetary authorities.

In *Croatia* supposing no major setbacks in reforms GDP growth remain around it level in 2001, fuelled by increasing investments and exports (stimulated by the interim agreement with EU and stabilization in South-Eastern Europe) with declining contribution of private consumption. With maintaining nominal exchange rate stability and controlling wage increases, inflation is expected to decrease further and average retail price increase fall below 5%. The budget will remain a major concern for 2002 as rapid increase to extra-budgetary funds will threaten fiscal balance especially with the decreasing privatization revenues. Without strict consolidation of government finances, the current budgetary trends are unsustainable.

Current account deficit may depend on trade developments. The experience of Central European countries show that after Interim Agreement with the EU enters into force, this results in a growing trade deficit. It may be compensated partly by the trade with South-Eastern Europe and by further increasing the export of services. We forecast a 4% current account deficit and think that reviving foreign direct investments will finance this. Gross foreign debt may increase, however its ratio to GDP will slightly decrease.

In the *Czech Republic* GDP growth is expected to accelerate in 2002, reflecting the recovery in the EU, which should result in a positive contribution of net exports. Outlook for domestic demand components are mixed, private consumption will grow at a slightly faster rate than this year, while investments are forecasted to slow down. In line with the robust economic performance, unemployment rate should decrease.

Headline inflation will remain relatively subdued with a downward trend that makes the Czech Republic the best performer in the region, though still far from the Maastricht criteria. The moderated inflation targeting framework makes the monetary policy more reliant on fiscal measures. The widening deficit of the public sector and prevailing interest rate premium for the Koruna puts upward pressure on the currency. The forecasted fall in inflation could thus result in cuts of the policy rate next year.

Balance indicators, both internal and external remain of major concern. We expect loose and pro-cyclical fiscal policy to prevail until the elections in September 2002; however, a readjustment seems unavoidable afterwards. Increasing deficit may result in an oversupply of government bonds, which, dumped on the bond market, may risk a downgrading of the sovereign debt. A surge in EU import demand should have a positive impact on the trade performance, though continuous real (and to a lesser extent nominal) appreciation could offset this. FDI inflow will finance the growing deficit of the current account via the ongoing privatization, and portfolio investment is likely to become less attractive.

In *Estonia* a slight acceleration of output growth is expected, which will be driven mainly by the growth of domestic demand. Export growth is more uncertain as the

European markets will grow slowly and there will be further slowdown of the Russian economy following this years' sizeable decline in growth rates. The growth of GDP may accelerate from the expected 4.5% in 2001 to 5%, which is a slightly less than the average of other two Baltic economies. As the major source of growth will be the increase of domestic private and public absorption, worsening current and fiscal balances are expected. But the increase in general government and current account deficits will remain moderate and will well below the threshold values deemed dangerous.

On the other hand deceleration of price increases is expected, due to lower imported inflation and relatively moderate wage increases. The expectation is that the average annual price increase will decline to 3,8% from this years' expected 5,8%.

We expect that *Hungarian* real economic growth will reach 4.3% in 2002: value added of net exports seem to decrease but domestic demand is likely to revive due to the growing demand from the public sector. Both private consumption and investments may accelerate in 2001 and 2002. In the longer term we expect economic growth to be over 4%, further driven by EU-focused industrial and export growth.

After the CPI is likely to moderate in the rest of the year, its annual growth may reach 9.2%, while year-end figure is expected to down to 7.4%. If imported inflation doesn't speed up and Forint appreciates by around 1-2% against Euro on yearly basis, downward trend of inflation will be maintained and average CPI may decline to 6.1% in 2002. In line with estimated slowdown of CPI, nominal interest rates are likely to decrease, while real interest rates may remain unchanged. In long-term view we calculate with 0.7% yearly Forint appreciation. In this case, real effective exchange rates of Hungary will appreciate by around 3% and productivity of Hungarian economy can be maintained.

In 2002 the deficit of general government will be around 3.2%, as elections usually are followed by provision of balanced fiscal position. Simultaneously we expect a further deterioration of the current account as the acceleration of GDP and increase of domestic demand will worsen the trade balance significantly.

Latvia may expect marked deceleration of its growth rates, mainly due to lower increases in private investments and worsening of trade balance and thus net exports' contribution to GDP. Export growth will remain basically on its current level, restricted by worse performance of the European and Russian economies. The slow-down of growth will be accompanied by improving fiscal and current account balances, although trade deficit will remain very high, still above 14% of GDP.

A slight increase of annual inflation rate is expected, though the dec./dec. index shows that there will be a temporary rise in price increases, followed by decline of price increases over the year and the end year inflation rate will be lower than the average one. Thanks to their still robust inflows, FDI will almost fully cover current account deficit and no rise in foreign debt levels is expected.

In *Lithuania* a slightly higher GDP growth is projected for 2002, mostly because of the growth of domestic demand. The contribution of net export to GDP will decline, owing mainly to pronounced deceleration of export growth. On the other hand both private investments and private consumption will grow robustly and will be the driving force of output growth. Owing to declining import demand we expect a slightly better trade and current account balance than in 2001. Net foreign direct investments won't be sufficient to cover current account deficits, but due to other non-debt generating inflows we don't expect the rise of foreign debt.

On the other hand inflation may slightly increase reflecting the increased domestic demand pressures and accelerated wage growth. But the inflation rate is very low compared to other transition economies and price increases will remain around 3% for the whole year.

Poland seems to face a difficult year, as GDP will increase only by 2,5% in 2002 as three factors restrain it from more rapid acceleration. First, the worse than expected global conditions will reduce the contribution of net exports to GDP. Second, sizeable fiscal adjustment is needed to avoid high fiscal imbalances and keep progress with meeting the Maastricht criteria. Finally, structural problems will keep private consumption and investments from rising robustly.

Fiscal adjustment will play a key role in avoiding a fiscal crisis, and reducing the deficit to a more manageable level. After the improvement of the trade and current account balances this year, their ratios to GDP are expected to remain unchanged in 2002, as both imports and exports could expand at the same rate. Poland may expect slight decline in foreign direct investments, but FDI inflows will remain the highest in the region.

After substantial decline in 2001, further, albeit slower disinflation is expected for 2002, bringing the central bank increasingly closer to its medium term inflation target.

In *Romania* the main forecasts of the government for 2002 are 5% economic growth, 22% annual inflation rate, 50,000 increase in the employment, 3% of GDP budget deficit, and USD 180, at the current exchange rate, gross monthly salary. This program seems very ambitious, since the economy is still burdened with heavy structural tensions and imbalances.

Possible slow-down in the economic growth could not be excluded since the sustainability of the current strong recovery might be questionable. Some deterioration in the external economic environment, especially in the European Union markets, can adversely influence the maintenance of the domestic demand-based development that has a strong external financial condition. The government would be forced to further restrict fiscal spending and accelerate restructuring in the public sector.

Lowering the inflation requires to considerably cut deficit financing that inevitably raises social costs of the transition, and produces heavy burden on the constituency of the ruling Party of Social Democracy. International financial sources could be more available due to the IMF new loan facility. High current account deficit is increasingly financed from workers' remittances and from the surplus of the error and omissions, which should be complemented with more foreign capital inflows. To accelerate growth, lower the inflation, improve the balance and better the job market could be simultaneously too much for the government and the sill weak Romanian economy.

In *Russia* we expect output growth to moderate further in 2002 and GDP may expand by 3.5%. Trade surplus will moderate and the contribution of net exports to GDP growth will diminish. Simultaneously, the major components of aggregate domestic demand will expand slower due to lower real income growth and public consumption. While private investment growth may remain robust, it won't be sufficient to offset declining net exports and consumption growth.

Declining oil prices and external demand will lead to smaller trade and current account surplus, but they will remain still sizeable. While one may expect acceleration of foreign direct and portfolio inflows their level remain low and slower increase in the reserves is expected. Besides that weaker balance of payments surplus will end the period of strong Rubble and one may expect accelerating depreciation in 2002 with a more neutral real exchange rate. We expect the inflation rate to decelerate to 13% and the end year dollar value of Rubble to be around 31.5. Slower output growth will have a negative cyclical effect on fiscal balances.

In *Slovakia* we expect GDP growth to accelerate next year as while domestic absorption continues to fuel the economy, the negative contribution of net exports will be more modest. Both growing real wages and decreasing unemployment will strengthen private consumption dynamics. Up to the elections in September 2002 public spending is expected to boom, and the fiscal policy will add another 1% of GDP to domestic demand next year. However, after the elections a socially painful reform package combined with a fiscal adjustment policy is the most likely scenario.

Headline inflation is forecasted to remain moderate in 2002. as political concerns will prevent raising the regulated prices up to the elections. This may in itself help to keep CPI inflation down, but likely to cause problems later on. It is widely accepted that utility prices set by the government do not cover costs. This state-of-affairs and a lack of transparent price policy jeopardize privatization projects for the utility sectors. The performance of the sector is crucial as USD 2-3 bn. privatization receipts are projected to finance the 2002 budget deficit.

External balance will also have to readjust or be readjusted in 2002. Part of this is expected to happen due to the projected recovery in the EU, offering better prospects for Slovak exports. However, given the steady growth prospects of domestic demand, imports should be scaled down by exchange rate policy and some domestic, basically fiscal policy adjustment may also be required.

In *Slovenia* domestic demand may increase but there is a slight chance that external economic conditions will boost export growth too: altogether the contribution of domestic demand to GDP growth will rise. Slovenia will face stubborn inflation in the coming years. Imported inflation pressure is likely to decrease due to appreciation and declining oil prices, but remaining relative price adjustments, and price convergence of services and foods mean additional domestic inflationary source. For 2002. inflation may decrease gradually and we estimate an average CPI of 6.1%, and year-end consumer price index of 5.4%.

The consumption of the general government will burden the expenditure side of fiscal balance, which will be balanced by increasing revenues from personal and corporate income taxes and privatization. We expect fiscal deficit of 2.7% for 2002. while external position will remain stable. A 3.3% current account deficit is expected and direct investments will improve financial account.

In *Ukraine* in light of good macroeconomic and growth performance one may expect that both high rates of economic growth and increased macroeconomic stability will prevail. GDP in 2002 is expected to increase by 5% and the reason for slowdown vis-a-vis 2001 is related to the deteriorating global conditions. GDP growth will be driven as in 2001 by the increase of domestic demand, which comes via the growth of private consumption.

There might be a slightly different monetary condition in 2002 compared to the current year, as the central bank will have to deal with the consequences of accelerating money and credit growth. Credit demand will be stimulated by the high GDP growth rates and by the easing of monetary policy. Disinflation will slow down and the depreciation of the national currency may slightly accelerate compared to 2001. This depreciation will fuel back to price increases and therefore in 2002 we may expect only a slight drop in the inflation rate.

Notwithstanding the stronger depreciation of the hrivnya we may expect further worsening of trade and current account balances. Following the shift in growth rates observed in 2001. import growth will exceed exports in 2002 and will lead to deteriorating trade and closely linked to it current account balances. We may expect that the current account surplus of 3.2% in 2001 will decline to less than half of it especially if the growth of domestic demand remains so robust. The increase of domestic demand may also accelerate structural changes in the industrial sector and could lead to the robust increase of retail trade sales.

In *Yugoslavia* the outlook for 2002 is influenced by three risks. The first is the question of foreign debt as external relation remain uncertain pending on the restructuring of debt obligations: if debt agreement is reached, then this won't be a concern for policy makers. The second is the structural reforms (including privatization) and the inflow of foreign aid, credits and investments, as without them no sustainable output growth is expected. Third factor is political stability and the support of the electorate for the program.

If these preconditions are met positively, than a slightly higher GDP growth is expected for 2002. which will seriously depend on foreign capital inflows. Exports and imports are expected to increase substantially and current account deficit to widen. Private consumption remains depressed, as real wages in the public sector will be controlled. Results of industrial restructuring may be felt by the end of 2002 earliest. However, due to restructuring, unemployment rate is expected to increase further. At the same time, the pick up of FDI inflows is also foreseen. Inflation is expected to decelerate due to price adjustments taking place in 2001. If foreign exchange rate remains stable, the inflation rate is expected to be around 1% monthly.

2. BULGARIA

SHOCKS MODERATE GROWTH

Hit by several unfavorable exogenous shocks, ranging from the political and military conflicts in the neighboring economies to the increased exposure of emerging economies to financial crises, the Bulgarian economy has been experiencing a gradual slowdown of its output growth. This slowdown has been driven by lower export and manufacturing sales and is accompanied by declining inflation, slightly better current account and trade balance. On the other hand, some major structural reforms have been under way, which may reduce the share of public sector in output and employment and could lead to enhanced efficiency of public expenditures. The forecast for 2002 depends crucially on the regional political and economic developments and also on the improvement in the growth prospects of the EU.

NEW ADMINISTRATION HAS THE CHANCE AND TIME TO CARRY OUT ESSENTIAL REFORMS

The landslide victory of the National Movement has changed completely the political scene of Bulgaria. On the June elections the ruling UDF part suffered a serious defeat and slide back to the second-third position with the Bulgarian Socialist Party. While the victory of the recently formed alliance was partly related to the dissatisfaction of the voters with the former government and opposition parties, the new government has been given a unique opportunity to implement the major structural and policy reforms the country needs. With its comfortable position in the parliament and sizeable political support from the population, the new government has time to proceed with the essential reforms, while maintaining the achieved degree of macroeconomic stability. The new government gives full support to EU and NATO membership of Bulgaria, expressed its intention to maintain the currency board arrangement and to speed up market reforms.

SLOW-DOWN IN OUTPUT GROWTH

The Bulgarian economy has to face serious exogenous shocks, which have their effect on the evolution of output. The first of them is related to the political turmoil on the Balkans, especially in Macedonia, which directly hampers exports, and negatively influences the general confidence and perceptions of foreign investors about Bulgaria. Second, the country, similarly to Poland,. has been exposed more than other transition economies to the volatility and financial vulnerability of emerging market economies, especially in the

Chart 2.1.

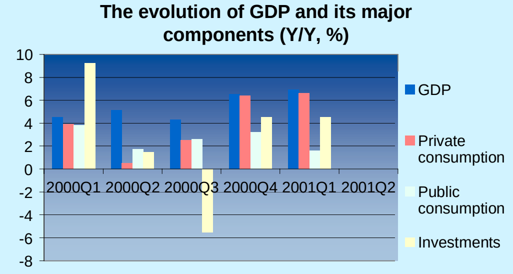


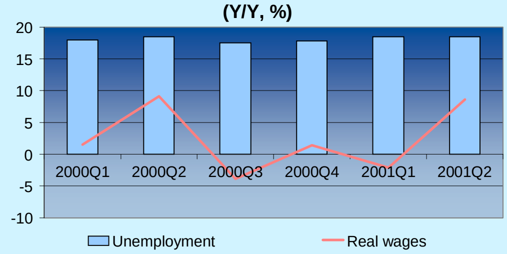
Table 2.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	3,5	2,4	5,3	4,5
Private consumption	8,2	5,2	2,8	3,5
Public consumption	4,0	2,0	7,9	5,5
Investments	32,9	25,8	9,8	8,5
Export	-12,4	-4,7	19,4	4,1
Import	2,2	11,1	16,9	3,3
GDP output	n.a.	n.a.	n.a.	-
Agriculture	1,4	0,6	-15,5	2,5
Industry	4,3	-4,4	12,0	4,5
Services	0,5	5,8	10,3	5,5

Chart 2.2.

Real wages growth and unemployment rate (Y/Y, %)



case of the Turkish crisis. Finally, the general increase of the risk premium on emerging economies borrowing affected badly Bulgaria, and may create additional costs for foreign debt service.

While output growth accelerated in 2000 thanks mostly to the robust increase of exports, GDP growth will likely to moderate in 2001 to 4,5% from last year 5,3%. The major factor in the slow-down is the reduced contribution of net exports to GDP, as the slowdown of the major export markets has a strong and direct spillover effect on Bulgarian exports. Among the domestic component of aggregate demand, the slow-down in both exports and manufacturing output is followed by a gradual slow-down in investments, although private capital formation still grows relatively robustly. On the other hand one may see declines in the growth rate of private consumption, while public consumption has remained relatively buoyant. On the supply side the gap between the manufacturing and service sector growth narrowed and in 2001 services may expand more than the manufacturing output.

One endemic problem of the Bulgarian economy is the very high rate of unemployment, which has been growing continuously since 1998 from 12,2% of the labor force to 17,5% in 2000. According to the labor statistics, in the first two quarters in 2001 a further slight increase was observed and the rate may reach 18,5% by the end of the year.

There are several factors which explain the persistently high unemployment. One has to do with the post-privatization restructuring in the corporate sector which leads to lay-off and reduces the demand for labor. Another longer-term problem is the low level of capital formation in Bulgaria: the investment rate, which stood at 16,5% of GDP in 2000 is low both compared to the majority of transition economies and to the growth requirements of the economy. Low investment rates reduce both GDP growth and prevent the reduction of unemployment. Finally, unemployment is also caused by the relatively sizeable increase of real wages: average gross real wages between 1998 and 2000 increased by 13% annually, which has been a significant pressure on the corporate sector, leading to the decline of labor demand.

In 2001 the further growth of unemployment is caused partly by the ongoing restructuring in the corporate sector and partly by the slowdown of the economy. Real wage increases have remained sizeable both in 2000 and so far in 2001, although there has been significant within the year volatility in both nominal average and real average wages.

Chart 2.3.

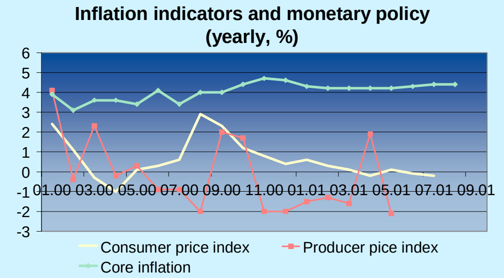
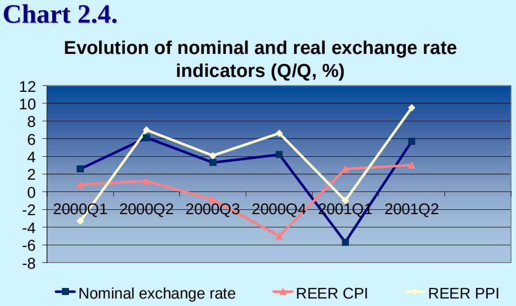


Table 2.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	*1,8*	*1,8*	*2,1*	*2,2*
Consumer price index (average, %)	*18,7*	*2,6*	*10,3*	*5,5*
Producer price index (average, %)	*16,5*	*3,1*	*17,2*	*5,0*
Broad money growth (dec/dec, %)	*9,6*	*11,4*	*17,2*	*8,5*
Real broad money growth (dec/dec, %)	*7,7*	*4,2*	*5,2*	*3,5*
Domestic credit growth (dec/dec, %)	*-19,0*	*0,2*	*9,8*	*5,5*
Real domestic credit growth (dec/dec, %)	*-29,0*	*-2,9*	*-6,7*	*0,5*
Nominal interest rates (3 month TBs, %)	*4,8*	*6,4*	*5,1*	*4,5*

Chart 2.4.



SHARP DISINFLATION COMPARED TO 2000

In 2001 we may expect a significant reversal in the changes of both producer and consumer price indices. In the last year they increased explosively, especially the producer prices, which jumped by more than 17%. The major reason for the accelerated price increases, which reversed for the first time the disinflation under the currency board arrangement, was the unfavorable global conditions: increasing energy prices and worsening terms of trade, appreciation of the dollar and associated weakening of the leva passed through on domestic prices.

In 2001 these exogenous pressures are more moderate: terms of trade may actually improve, the leva has remained more stable against the USD and other major currencies. The contribution of imported inflation to price increases has therefore significantly declined in 2001 compared to 2000. On the other hand, domestic sources of inflation are moderate too: fiscal policy is balanced, there are no sizeable reserve inflows which could put an upward pressure on price increases, and real wage growth has been kept also under control.

Due to these factors and considering the price developments in the first half of the year sizeable decline of inflation is expected for 2001. In the first half of 2001 both the consumer and the producer prices increased and declined in equal number of months. Looking at the major groups within the CPI basket, the very moderate price increases in case of food products are remarkable, caused partly by higher base in 2000 and better agricultural output growth. On the other hand service prices increase far above the average, showing a longer-term trend of price convergence in non-tradable sectors. Altogether, it can be reasonably expected that the average increase in consumer prices will remain around 5,5%, while in case of producer prices around 5%.

While inflation has moderated, the growth of major monetary aggregates remains robust: in 2001 we may expect further real growth in both broad money and domestic credit. This is partly related to the increase of the degree of monetisation, which has been observed since the introduction of the currency board arrangement and replaced earlier trends of financial disintermediation. In 2001 we may expect a deceleration of both credit and money supply growth compared to 2000.

The currency board arrangement has been operated successfully since its introduction and served effectively the purpose of reducing inflation and establishing fiscal and monetary discipline. While there were occasions when its sustainability and benefits were questioned, the authorities have adhered to it and will continue to do so. While in 2000 the leva depreciated in nominal terms against the US dollar

Chart 2.5.

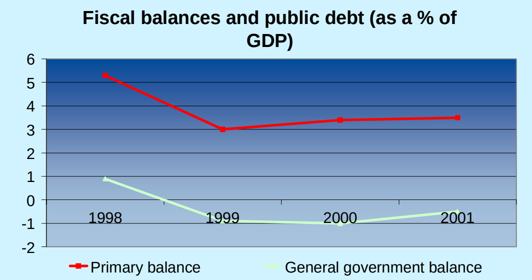


Chart 2.6.

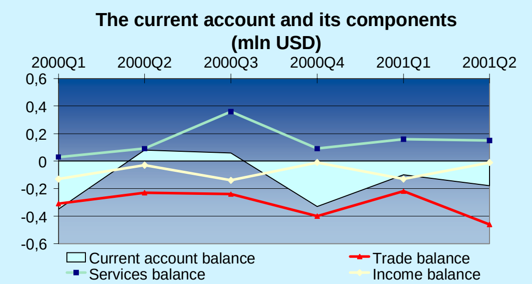


Table 2.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	-0,5	-5,5	-5,1	-4,8
Trade balance/GDP	-3,1	-8,7	-9,5	-9,5
Export growth	-12,4	-4,7	19,4	4,1
Import growth	2,2	11,1	16,9	3,3

Table 2.4.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	-0,5	-5,5	-5,1	-4,8
Financial account/GDP	-0,3	6,0	6,4	3,5
FDI/GDP	4,4	6,4	7,4	5,5

and the major currencies, more stability could be foreseen for 2001. While the nominal effective exchange rate depreciates less, the real exchange rate calculated both by using the CPI and the PPI as deflators has been almost continuously appreciating.

STABLE FISCAL BALANCES

One precondition for the successful operation of the currency board arrangement is the maintenance of a balanced budget. Simultaneously with the introduction of the currency board, Bulgaria has managed to accomplish significant fiscal adjustment and has since 1998 maintained basically balanced budget with sizeable primary surpluses. In 1999-2000 the total deficit was on average 0,9% of the GDP, and the primary balance was around 3%.

Looking at the evolution of fiscal indicators in the first half of the year and also considering the seasonal effects, it could be expected that the fiscal balance will slightly improve compared to 2000. This improvement comes notwithstanding the worse growth prospects, and the negative spillover effect of slower growth on the primary balance. Expenditures are generally under control, notwithstanding the fact that they increased prior to the elections, reflecting the political cycle. More room is needed however to carry out structural reforms, which could involve the reform of tax system, health care and pension reform on the expenditures side.

SLIGHTLY BETTER CURRENT ACCOUNT DEFICIT COVERED BY FDI INFLOWS

The current account balance is expected to improve slightly compared with 2000, reflecting better services balance and unchanged trade balance. The trade deficit, equal in GDP terms to last year, reflects markedly decelerating export and import growth after their robust increase in 2000. Bulgaria has been one of those economies in the region, which have suffered a strong decline in their growth rates following the reduction of EU import demand. This shows that the bulk of Bulgaria’s exports is very sensitive to cyclical changes and its competitiveness is weak. This is related both to price and costs competitiveness, as real wages increased above the growth of labor productivity, and one could observe a general appreciation of real effective exchange rates.

The current account balance has been determined mainly by the evolution of the trade balance. On the other hand, in 2001 one may expect higher net revenues from the service balance and also less deficit on the income balance: these factors also contribute to the gradual and moderate improvement of the current account balance. The current account position of Bulgaria could be improved further, if exports could accelerate and if the regional stability could

Chart 2.7.

The financial account and its components (mln USD)

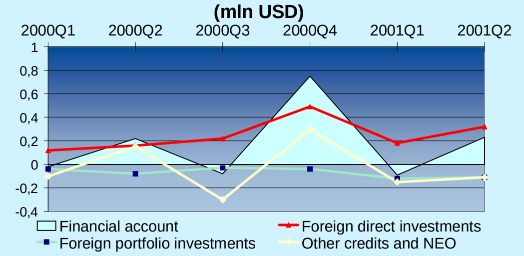


Table 2.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	83,6	82,9	86,5	73,5
Short-term foreign debt/GDP	8,2	4,9	5,4	4,5
Short-term foreign debt/	9,8	5,4	6,2	6,1
Debt/Exports	174,9	178,5	148,3	165,5
Debt-service ratio	20,0	16,8	16,7	21,5
Reserves/GDP	23,4	25,0	24,6	23,8

Table 2.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	0,9	-0,9	-1,0	-0,5
Current account/GDP	-0,5	-5,5	-5,1	-4,8
Short-term foreign debt/GDP	8,2	4,9	6,3	4,5
Short-term foreign debt/ Total foreign debt	9,8	5,4	6,8	6,1
M2/Reserves	n.a.	n.a.	n.a.	-
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

Table 2.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	5,3	4,5	4,5
-Private consumption (%)	2,8	3,5	3,5
-Public consumption (%)	7,9	5,5	4,0
-Investments (%)	9,8	8,5	6,5
-Export (%)	19,4	4,1	7,5
-Import (%)	16,9	3,3	6,5
Consumer price index (average, %)	10,3	5,5	5,0
Consumer price index (dec/dec, %))	17,5	18,5	18,0
Unemployment ratio (%)	-1,0	-0,5	-1,0
General government balance (%)	-0,5	-0,6	-0,6
Public debt/GDP (%)	-5,1	-4,8	-4,5
Current account (bn USD)	-1,1	-1,2	-1,1
Current account/GDP (%)	-9,5	-9,5	-8,5
Trade balance (bn USD)	1,0	0,8	0,8
Trade balance/GDP (%)	86,5	73,5	71,5
FDI (bn USD)	n.a.	-	-
Gross foreign debt/GDP (%)	n.a.	-	-

support the growth of service incomes.

The current account deficit has been more than covered by the inflows of foreign direct investments. These inflows have been mostly stimulated by the privatization deals, but recently the amount of greenfield investments increased too. On the other hand, the non-debt creating flows and the financial account surplus are insufficient to cover the current account deficit, due mainly to negative balance on foreign portfolio and other investment flows.

GOOD FOREIGN DEBT AND VULNERABILITY INDICATORS

Bulgaria has been since the beginning of transition one of the most seriously indebted economies in Eastern-Europe and the high foreign debt and associated debt-service expenditures played a significant role in generating the hyperinflation and currency collapse of 1997. While the reduction of foreign debt and the more robust expansion of both exports and GDP helped in reducing the debt/GDP and debt-service ratios, they still represent a major concern for both investors and policy makers.

While the total debt/GDP ratio may decline by almost 13 percentage points of GDP to 73,5% in 2001 compared with 2000, the debt-service ratio is again on rise, due to the weaker export performance. In relation to foreign debt, the good news are related to the low share of short-term debt: short-term debt has constantly declined both as a fraction of GDP and of total foreign debt, and its level can be regarded as satisfactory and safe.

The same applies to the major vulnerability indicators: since the introduction of the currency board these indictors have almost constantly improved and currently neither of them represents an immediate challenge or concern for policy makers.

MOSTLY UNCHANGED CONDITIONS AND PROSPECTS FOR 2002

Looking ahead in 2002 no sizeable changes in external conditions for Bulgaria could be expected. The slowdown on its major export markets could be a longer lasting factor hampering the recovery of exports and output: therefore no significant rise in the contribution of net exports could be envisaged. Domestic demand could increase with the same unchanged dynamism with changes in its structure, as private consumption could be more robust and investment growth may slightly moderate further.

In terms of fiscal and current account balances, no sizeable worsening is expected: fiscal policy will remain prudent, primary surplus will not decline, being almost sufficient to cover the high interest expenditures. In case of current account, services balance may improve, as well as the trade balance, providing the relatively low growth rates of import.

Inflation will remain moderate as both external and internal factors will be subdued. The only concern with inflation is the growth rate of nominal and real wages, which should be kept further under control.

3. CROATIA

PROSPECTS ARE GOOD, BUT STILL FRAGILE

The priority of Croatian economic policy both in short and long term perspective is the maintenance of macroeconomic stability and speeding up of structural changes amidst achieving fast and sustained economic growth. Prospects are good, but still fragile. While output increased by 3.7% in 2000, and a higher rate is expected in 2001, unemployment continues to average around 22% with big regional differences. The first half of 2001 was also characterised by reforms aimed at reducing the level of government spending, which besides the poor export performance seems to be the most pressing problem of the economy.

DOMESTICSPOLITICAL STABILITY, BUT CHALLENGES ARE INCREASING

The Croatian government has achieved significant political results during the past one and a half year. Several measures were taken for improving business climate, speeding up privatisation and strengthening fiscal sustainability. The country has made important steps in joining Euro-Atlantic structures: it joined the NATO Partnership for Peace, became a member of WTO, fully integrated into Stability Pact and recently has initialled the Stabilisation and Association Agreement with the EU. Risks to political stability may come with economic policy measures focusing on structural reforms and driven by IMF programme, which aims at consolidating government finances. The second challenge is the reform of public institutions. The quality of public administration should be improved rapidly as it is lagging behind the standards of successful Central European countries.

Stabilization and Association Agreement

Stabilization and Association Agreement is a new generation of Europe Agreements offered to the countries of South-East Europe in the framework of the Stabilization and Association Process. The agreement between Croatia and the European Union was initialed on 14 May.

The SAA provide for a far-reaching co-operation and will support Croatia's gradual approach to the EU structures. The SAA aims at establishing a framework for political dialogue and supporting economic and trade relations with the perspective of establishing a free trade area after a transitional period of 6 years. The agreement will also provide a basis for cooperation in the field of Justice and home affairs, and identify the "acquis communautaire" which Croatia will have to adopt in order to be able to effectively participate in the European integration Process. The government of Croatia targets 2007 as Croatia's EU accession.

Table 3.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	2,5	-0,4	3,7	4,2
Private consumption	-0,6	-2,7	4,0	6,0
Public consumption	2,3	0,8	-0,7	-4,0
Investments	2,5	-1,1	-3,5	8,0
Export	3,9	0,7	8,7	3,0
Import	-4,9	-2,7	4,2	12,0
GDP output	2,5	-0,4	3,7	4,2
Agriculture	5,6	-2,0	1,3	1,2
Industry	4,7	0,1	1,5	4,0
Services	2,0	-0,3	5,0	2,0

SUSTAINED AND HIGHER THAN EXPECTED GROWTH WITH HIGH UNEMPLOYMENT RATE

In the first quarter of 2001 a sixth consecutive quarterly growth in GDP was recorded, with relatively high growth rate of 4.2 %. GDP growth speeded up in the second quarter, industrial production increased by 6.2%, retail trade turnover by 12.1% and tourist nights by 22.9%, compared to the same period of the previous year. The volume of industrial production has maintained its upward trend starting in September 2000 with manufacturing growing above average. Private consumption and investments are the driving forces behind economic growth, while government consumption is a negative demand component. Imports this year increased significantly, there is a very high demand for imported durable

Chart 3.1.

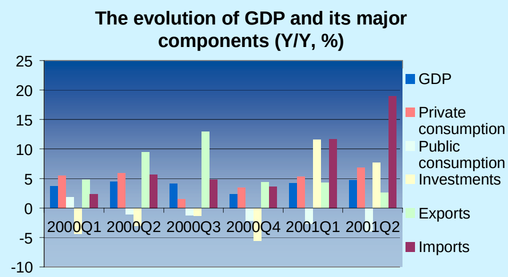


Chart 3.2.

Reform steps during 2001.

Tax reform: The rates on income tax have been changed from 25% and 35% to 15, 20 and 35% while profit tax from 35% to 20%.

Fiscal decentralization: From 1 July financing of education (primary and secondary), welfare and health care was passed to local units.

Wage system: The new wage system for government employees was introduced in May. The aim was to reduce the total amount of wages by 10% compared to its 2000 level.

Efficiency of public work: Steps were undertaken to increase efficiency of civil service work.

Extra-budgetary funds: From July 1 pensions are run as an integral part of the state budget.

Cuts on privileges: The rights of veterans started to be more strictly regulated in order to decrease government spending on them.

Government finances: A new law on the Central Bank prohibited government borrowing from it. Previously it was possible up to 5% of yearly revenue.

consumer goods, while exports of goods increased only slightly. The increased merchandise trade deficit is expected to reduce the contribution of goods and services trade to GDP growth.

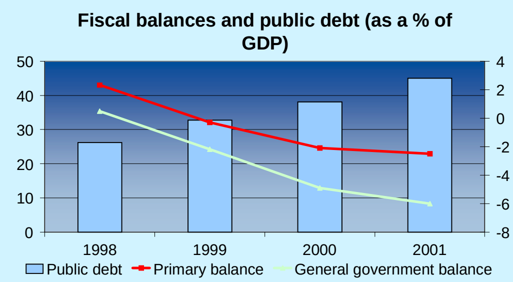
The situation of merchandise exports is even more alarming, as the majority of it is inward processing. Wages grew by 1.8% in real terms during the first seven months of the year, while aggregate loans granted by banks to households exceeded by 16% in real terms their last December's level. In the second half of 2001 the slow-down of private consumption is expected, partly because of the suspension of certain privileges and cut on public sector wages. GDP growth is not reflected in labor market developments as registered unemployment has increased and in June its rate was 21.5%. Registered unemployment was on average 7.8% higher in the first half of 2001 than in 2000 with significant regional differences ranging from 9% to 40%.

In view of the 4.5 percent growth of the economy in the first half of 2001 and on the basis of the available monetary and economic development indicators for the third quarter of the year, it is expected that real GDP growth for 2001 could be around 4.2-4,3 percent. The growth of private consumption may be at the same level as last year, as a result of lower increase of real wages in the second half of 2001, total export growth will be lower as merchandise exports show unfavorable trends, and finally investments are on rise. On the supply side, the increase of industrial production is a positive sign compared to the last year.

BUDGET PROBLEMS WITH INCREASING PUBLIC DEBT

The major problem of the economy in 2001 is associated with the imbalances in public finances. Budget situation worsened in the last few years and fiscal problems are partly the heritage of economic policy of the previous regime, which tried to increase its popularity with huge fiscal transfers. Due to delays in privatization, government had to tap international capital markets, thus the sustainability of public finances is dependent very much on the ability of the government to borrow abroad. Originally USD 1 bn. was planned as privatization revenue because of the privatization of

Chart 3.3.



Dubrovacka and Croatia Banka, Croatia Osiguranje and the second round of Telecom privatization. However, opposition from political circles, uncertain developments on stock markets and technical difficulties will cause delays and thus lower revenues.

The first half of 2001 was characterized by several measures aimed at reducing government spending, fiscal deficit and public debt. Croatia this year runs very high level of current and primary deficit. The unsustainable growth of public debt in the first half of the year forced the government to start reforms to improve fiscal management, stop excessive borrowing and prevent potential debt crisis. The growing fiscal deficit in the first months of this year forced amendments to the budget. The most important task has been to reduce the deficit of extra budgetary funds, mainly of the healthcare and pension funds. The pension reform, which has already started and the restructuring of healthcare sector will result in short run costs, however from 2003 they unburden the budget. From April 2001 the new law on Croatian National Bank (CNB) prohibited short-term government borrowing from CNB. According to previous provisions it was allowed up to 5% of current year's revenues.

The level of public debt has grown significantly in line with the increasing budget deficit. While it was HRK 29.9 bn. in December last year, in June this year it was around HRK 66.3 bn., of which 65% was external debt. A further problem is that from 1998 onward the government has issued government guarantees both at home and abroad that may increase government debt. Data on guarantees however differ considerably according to CNB and Ministry of Finance (MF). According to CNB total guarantees were close to HRK 19 bn., while according to MF data they were HRK 13.3 bn. in July.

Due to the amendments to the law on budget with increasing expenditure and borrowing and decreasing privatization revenues, the government plans to achieve consolidated budget deficit around 5.3% of GDP in 2001. However, this requires strict control of wage-related costs and tight measures to control the deficit of extrabudgetary funds, which run higher than planned.

Table 3.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	6,4	7,1	8,3	8,5
Consumer price index (average, %)	5,7	4,2	6,2	5,1
Producer price index (average, %)	-1,2	2,5	9,7	5,8
Broad money growth (dec/dec, %)	11,3	-1,1	29,3	20,0
Real broad money growth (dec/dec, %)	7,2	-5,3	20,4	14,0
Domestic credit growth (dec/dec, %)	19,1	-1,5	9,3	10,0
Real domestic credit growth (dec/dec, %)	13,9	-5,7	3,1	8,0
Nominal interest rates (3 month TBs, %)	n.a.	n.a.	n.a.	-

Chart 3.4.

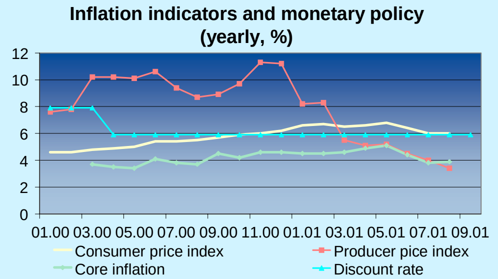
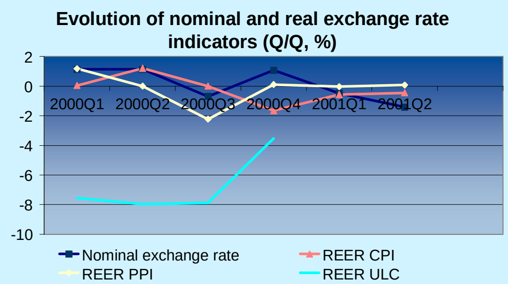


Chart 3.5.



INCREASING INTERNATIONAL RESERVES, MAINTAINING RELATIVE PRICE STABILITY

In June, the year on year inflation rate measured in changes in retail prices was 4.9% and in July 3.8%. In August a sharp increase was experienced, the year on year retail price inflation was 5.8% due to sharp increase of certain administrative prices. Just to mention some, the price of local telephone calls was increased by 211%, telephone subscription by 50%, heating by 7.9%. The trend of inflation reflected in core inflation was not affected substantially by the price increases of services, as its year on year rate was 3.9% compared to 3.8% in July. Yearly developments in prices are crucially influenced by their 1.8% growth in August. This could result in inflation rate for 2001 being slightly higher than previously expected, even with less dynamic movements of prices in the last quarter of the year.

Due to the central bank's interventions on the foreign exchange market and other measures introduced for the purpose of stopping speculative behavior on the foreign exchange market, exchange rate fluctuations were gradually reduced, while keeping interest rates stable. With the help of managed float regime the Croatian National Bank (CNB) can secure exchange rate stability and make adjustments as necessary. The level of international reserves enables the central bank to maintain a satisfactory stability of the exchange rate: the international reserves of the CNB in August reached USD 4.27 bn., which is close to USD 1 bn. more than a year ago.

Monetary policy in the fourth quarter of the year will largely depend on the amount and the way of financing the budget deficit. Another problem with reliability of monetary forecasts is the uncertainty related to global developments, especially those referring to the USD /Euro exchange rate. In addition, at this moment it is not possible to determine the amount of foreign currency to be transferred from Croatian households into banks with the intention of being exchanged for Euro.

There is a long debate over the necessity of the devaluation of Kuna, as it would help domestic industry to improve export performance. However, a big proportion of domestic loans is indexed to HRK/DEM exchange rate that makes this option difficult. According to some analyses, the strong domestic currency forces domestic enterprises and the government to speed up structural modernization.

Taking into account the prudent policy of the CNB, Croatia will further be considered as a country with relative price stability. As a result of the CNB policy and the slowly decreasing wage pressure in addition to the favorable energy prices, inflation on an average may be lower than in the last year and in December year on year inflation is expected to be within the range of 4.5-5%.

DISAPPOINTING TRADE BALANCE, LOWER FDI BUT FURTHER IMPROVING SERVICES BALANCE

Export and import dynamics were extremely divergent during the first seven month of this year as exports rose by only 1.7% amounting to USD 2.6 bn., while imports by 21% amounting to USD 5.3 bn., resulting in a USD 2.7 bn. merchandise trade deficit, a 48% increase compared to the same period of last year. Among export sectors, the biggest growth rate was observed in textiles and wearing apparel by 10% and 1.5% respectively. These sectors are generally those where inward processing is substantial. Big export fall has been experienced in chemicals and other transport equipment, by 16% and 8.5% respectively. On the import side 40% increase was experienced in case of motor vehicles, while 70% growth in trailers and semi trailers. The growth machinery imports was also substantial (38%). Imports slowed down only in July, when they were 10% higher than in July 2000, while at the same time exports were 6.5% lower than a year earlier. Service exports are expected to increase even compared to the very good results of last year, which may compensate partly the larger merchandise trade deficit.

In the first quarter current account deficit was USD 596 mn., USD 200 mn. higher than a year ago. In the first quarter the capital and financial accounts showed a 50% decline as the surplus decreased from USD 520 mn. to USD 236 mn. between the first quarters of 2000 and 2001. The capital and financial accounts balance (excluding reserves) dropped from USD 482.8 mn to USD 401.6 mn. Due to the slow inflow of privatization revenues, the steepest decline was experienced in FDI. In the first quarter they were USD 55 mn. compared with USD 408 mn. in the same period of 2000. Portfolio investments reached USD 574 mn. compared to USD 444 mn. last year. As privatization related FDI has been decreasing, Croatia has to embark on a policy aimed at attracting green-field FDI.

Table 3.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-7,0*	*-6,9*	*-2,8*	*-2,5*
Trade balance/GDP	*-17,7*	*-17,4*	*-18,4*	*-20,0*
Export growth	*8,9*	*-5,3*	*3,0*	*2,0*
Import growth	*-7,1*	*-6,1*	*1,6*	*12,0*

Chart 3.6.

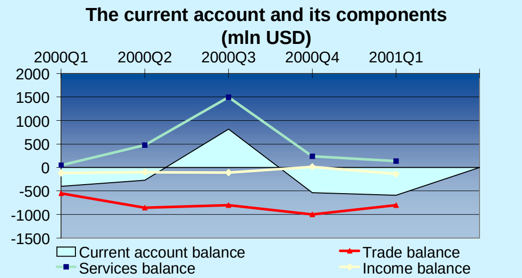


Table 3.4.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	*-7,0*	*-6,9*	*-2,8*	*-2,5*
Financial account/GDP	*7,4*	*9,4*	*4,7*	*2,0*
FDI/GDP	*3,9*	*7,2*	*4,4*	*3,0*

Chart 3.7.

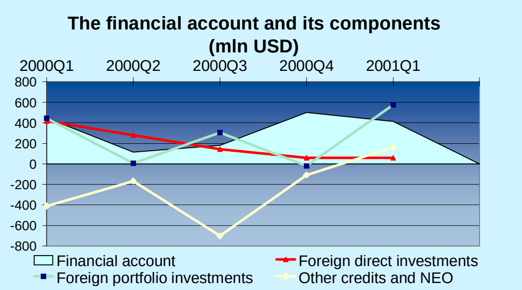


Table 3.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	45,0	48,5	56,3	55,0
Short-term foreign debt/GDP	3,0	2,7	3,6	3,5
Short-term foreign debt/	6,9	5,5	6,3	6,2
Debt/Exports	112,7	121,6	124,8	126,0
Debt-service ratio	19,4	29,5	20,0	20,0
Reserves/GDP	13,0	15,0	18,4	22,5

It is expected that merchandise trade balance for the second half of 2001 will be better than in the first half of 2001 as imports slow down, while no pick up in exports could be foreseen. Services balance, due to high tourism revenues, can partly offset merchandise trade deficit. Inflows of foreign direct investments will be lower than it was anticipated and they will not be enough to cover current account deficit. This in turn may result in slight increase of foreign debt. TABLE 5.

Table 3.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	0,5	-2,2	-4,9	-6,0
Current account/GDP	-7,0	-6,9	-2,8	-2,5
Short-term foreign debt/GDP	3,0	2,7	3,6	3,5
Short-term foreign debt/ Total foreign debt	6,9	5,5	6,3	6,2
M2/Reserves	321,0	265,0	250,0	140,0
Foreign currency liabilities/ total liabilities of the banking sector	47,7	44,7	46,4	45,0

VULNERABILITY INDICATORS AND RISKS

Vulnerability indicators show different trends. While the current account indicator may improve due to large tourism revenues (in spite of the worsening merchandise trade balance), general government debt indicator shows a worsening trend. At the same time the debt service ratio declines to 20% in 2001 and 2002 compared to that of 2000, meaning about USD 2 bn. repayment obligation. A slight nominal increase of external debt is expected for 2001 and 2002, however in relation to GDP it will decrease. At the same time, Croatia has built up a considerable level of foreign exchange reserves, amounting to USD 4.27 bn. in August. Risks are associated especially with the fiscal consolidation. In addition, weak export performance may induce devaluation risk, especially if international conditions are worsening or destabilization in South-East Europe reappears. The success of required structural reforms is also not guaranteed.

Table 3.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	3,7	4,2	4,3
-Private consumption (%)	4,1	6,0	5,0
-Public consumption (%)	0,8	-4,0	-4,0
-Investments (%)	-3,5	8,0	7,0
-Export (%)	8,7	3,0	4,0
-Import (%)	4,2	12,0	8,0
Consumer price index (average, %)	5,3	5,1	4,8
Consumer price index (dec/dec, %))	6,2	4,7	4,5
Unemployment ratio (%)	21,1	22,0	22,0
General government balance (%)	-4,9	-6,0	-7,0
Public debt/GDP (%)	38,1	45,0	55,0
Current account (bn USD)	-0,5	-0,8	-1,0
Current account/GDP (%)	-2,8	-2,5	-3,0
Trade balance (bn USD)	-3,5	-4,0	-4,0
Trade balance/GDP (%)	-18,4	-20,0	20,3
FDI (bn USD)	0,9	0,5	1,2
Gross foreign debt/GDP (%)	56,3	55,0	54,0

CROATIA 2002

The forecast for 2002 depends very much on the evolution of the risk factors mentioned above. If there are no major setbacks in necessary reform steps and the international environment remains favorable, GDP growth could be around the same level as in 2001. Growth may be fuelled by investments and trade, while the contribution of private consumption may be smaller. Exports may be increasingly important, as entering into force of the interim agreement with EU and stabilization in South East Europe may increase demand, while services exports may further increase.

With maintaining stable exchange rate and controlling the increase of wage related costs, inflation is expected to decrease further slowly and average retail price inflation to fall below 5%. Different processes will affect the unemployment rate. The expected GDP growth indicates improving conditions for employment, which could further be strengthened by potentially increasing green-field foreign direct investments. On the other side, however, if government strictly executes the cuts in labor force of government sector services, this may offset potential favorable unemployment trends. This implies that no major improvement in unemployment is expected.

The budget will remain a major concern for 2002 and even for following years. The rapid increase to extra-budgetary funds will threaten fiscal balance especially with the decreasing privatization revenues. This will increase public debt considerably, although the remaining privatization deals in 2002 may offset it. Without strict consolidation of government finances, the current budgetary trends are unsustainable.

Current account deficit may depend on trade developments. The experience of Central European countries show that after Interim Agreement with the EU enters into force, this results in a growing trade deficit. It may be compensated partly by the trade with South-Eastern Europe and by further increasing the export of services. We forecast a 4% current account deficit and think that reviving foreign direct investments will finance this. Gross foreign debt may increase, however its ratio to GDP will slightly decrease.

4. CZECH REPUBLIC

STABLE GROWTH PROSPECTS, WORSENING PUBLIC SECTOR PERFORMANCE

After three years of recession the Czech economy was accelerating over the course of the year in 2000. This tendency – quite opposite to the trends of other major Central European economies – has continued for the first half of 2001. However, the main determinant of the economic upturn is shifting from external to domestic demand. In line with the slowdown on the major export markets net exports are expected to scale down, while the trade and current account balances are forecasted to deteriorate. Though, the ongoing widening of the current account is still more than covered by FDI inflows. The acceleration of domestic demand led to concerns about inflation. With parliamentary elections approaching, worsening budgetary discipline and the re-emergence of non-transparent methods are of concern.

UNCERTAIN FUTURE FOR THE "OPPOSITION AGREEMENT" AND OUTLOOK FOR COMING ELECTIONS

The minority government of the Czech Social Democratic Party (CSSD) is expected to remain in place until parliamentary elections in June 2002 largely due to an "opposition agreement" with the Civic Democratic Party. However, the CSSD's incline to increase spending before the elections has led to a precarious situation, since the 2002 draft budget presented to the parliament late September seems to lack majority support. The opposition believes that the budget projection violates the "opposition agreement" since deficit exceeds the agreed limit of CZK 10 billions.

The outcome of next year's elections is pretty uncertain. The ruling Social Democrats led by prime minister Milos Zeman are likely to lose the elections, while ODS led by former prime minister Vaclav Klaus is forecasted to gain more support. However, given the fragmented political landscape, no party has the slightest chance to win absolute majority in the next parliament, and the winner will be forced to make a coalition.

Chart 4.1.

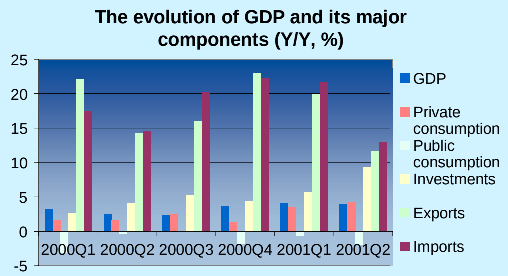


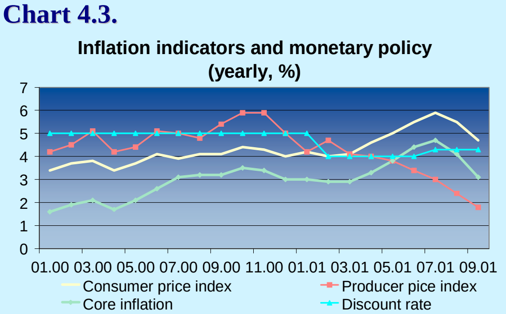
Table 4.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	*-1,2*	*-0,4*	*2,9*	*3,5*
Private consumption	*-2,0*	*1,9*	*1,9*	*3,2*
Public consumption	*-2,4*	*-0,1*	*-1,3*	*0,2*
Investments	*0,1*	*-0,6*	*4,2*	*6,9*
Export	*13,4*	*6,5*	*20,1*	*16,8*
Import	*9,1*	*3,3*	*21,3*	*17,7*
GDP output	*n.a.*	*n.a.*	*n.a.*	-
Agriculture	*-0,5*	*5,0*	*-2,0*	*1,0*
Industry	*-0,1*	*-3,3*	*5,3*	*6,8*
Services	*n.a.*	*n.a.*	*n.a.*	-

Chart 4.2.

Chart 4.3.



GROWTH FUELLED BY DOMESTIC DEMAND

Following the three-year contraction of the GDP in 1997-99, the Czech economy started to grow last year, and quarterly data indicated an acceleration of growth over time. The upturn in economic activity has continued in the first half of 2001. The Czech Statistical Office reported a year-on-year growth of 4.1% in the first quarter, while the second quarter GDP growth rate was only marginally down to 3.9%. In line with prior expectations domestic demand has replaced external as the driving force of growth. Growth was fuelled by gross fixed investments and private consumption as both are growing faster throughout the year.

On the other hand, net exports continued to make negative contribution to GDP growth, although exports remained relatively buoyant compared to sluggish import volume growth on major external markets. This points to the fact that the Czech economy has yet managed to avoid most of the consequences of the slowdown in the EU, however a further deceleration of exports and GDP seems inevitable for 2001.

On the supply side, the picture is mixed. Foreign-owned firms provided most of the dynamism of industrial production (8,7% growth in the first seven months). After stagnating for the first quarter, the trade and transport sectors recorded positive gross value added growth in the second quarter, while agricultural production, construction and financial intermediation were all down in the first half of the year.

The unemployment rate was falling almost continuously for the last six quarters, and reached 8,5% in August. However, significant regional disparities remain: the ratio is close to 3% around Prague and substantially higher, reaching 20% in the periphery regions. The decreasing rate in the second quarter corresponds to the usual cyclical behavior; while the low figure of August indicates that the inflow of new graduates to the labor market was more than offset by new job creation, especially at firms with foreign ownership.

INFLATION SHIFTING FROM COST-PUSH TO DEMAND-PULL

Similarly to the experiences of other Central European economies, the Czech inflation accelerated in 2000. The factors underlying that were mostly on the supply side and partly connected to rising oil prices. The fact that PPI inflation was rising more steadily than CPI was an indication of a typical cost-push inflation. However, from the beginning of 2001 inflationary pressures appear on the demand side, and inflation is shifting from cost-push to demand-pull. Consequently, CPI is rising faster than PPI and is expected to continue to do so until the end of the year.

CPI inflation was rising steadily in the second quarter of this year in line with strong domestic demand and rising real wages, while year-on-year PPI rates were continuously falling. Imported inflation remained subdued given the real appreciation of the Koruna and moderate fuel prices. In August the rising trend of CPI inflation returned (5.5%); reflecting the 1.4% decline in food prices. Net inflation (excluding the impact of changes in regulated prices and indirect taxes) reached 4.1% in August, making the 2-4% target band for net inflation feasible for the end of the year. However, the Czech National Bank (CNB) identified an increase in the upside risks, mostly connected to ongoing pro-cyclical fiscal expansion and excessive wage increases.

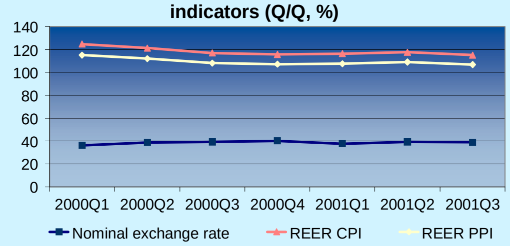
Table 4.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	32,3	34,7	38,6	38,9
Consumer price index (average, %)	10,7	2,1	4,0	5,1
Producer price index (average, %)	4,9	1,0	4,9	4,1
Broad money growth (dec/dec, %)	5,4	8,1	6,5	9,0
Real broad money growth (dec/dec, %)	-4,8	5,9	2,4	3,7
Domestic credit growth (dec/dec, %)	-2,4	-1,3	1,9	4,0
Real domestic credit growth (dec/dec, %)	-11,8	-3,3	-2,0	-1,0
Nominal interest rates (3 month TBs, %)	9,8	5,7	5,6	5,9

Chart 4.4.

Evolution of nominal and real exchange rate indicators (Q/Q, %)



Banking sector restructuring: end of an era?

By the recent selling of Komercni banka, which is the country's second largest commercial bank, the Czech government has completed the privatization of the banking sector. The consolidation program, which was put in place after the 1998 currency crisis in order to clean banks' portfolios from bad loans, has succeeded in strengthening the banking sector. The inevitable tightening of credit conditions has severely restrained economic activity in the short term, but has been successful in inducing a structural adjustment in the business sector.

MODIFIED MONETARY FRAMEWORK, ONGOING APPRECIATION PRESSURES

The Czech monetary policy is based on inflation targeting pursued by CNB. However, in April 2001 the central bank decided to change the targeted variable from net to headline inflation from 2002 on. On one hand, targeting headline inflation is expected to improve the credibility of the medium-term target, which was higher than actual price increase in the last years. On the other hand, however, the shift to headline rate makes monetary policy more dependent on fiscal measures, and the government less motivated to liberalize prices. The initial conditional inflation target band for end-2002 is set for 3–5%.

Annual broad money growth has been accelerating quickly during the course of the year, from 7.8% in February to over 13% in June and July. The increase in M2 growth, reflecting the growth of domestic demand, was financed by the strong inflow of foreign capital and growing public debt. Domestic lending has risen substantially and in line with M2 since the start of the year, though the growth rate has declined from May. During the summer lending was flat in nominal terms and decreased by around 3% in real terms.

After cutting the discount rate in February by 1 percentage point to 4%, the CNB raised it again to 4.3% in July in response to higher than expected inflation figures for the second quarter of the year. The rise of the monetary policy rate has coincided with continuous rate cuts in the US and the euro-zone in an attempt to fight recession, that is, interest rate differentials against both the US dollar and the Euro in favor of the Koruna widened. This raised external demand for the Czech currency. Still, in spite of ongoing appreciation pressures, the movements in the Euro/dollar exchange rate affect the exchange rate of Koruna against the main currencies. The Koruna remained stable against the EUR, while there is no clear trend in the CZK/USD nominal rate.

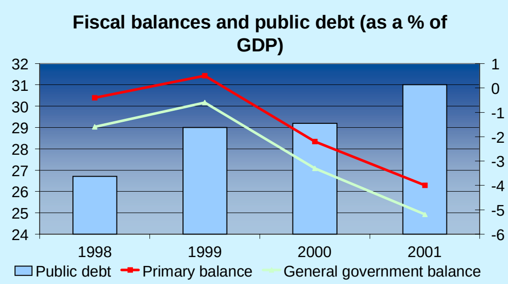
However, the value of bad debt still corresponds to 25% of the GDP, and 44% of industrial companies have overdue liabilities. Other consequences of the bad debt problem can be harmful as well. First, it may limit the possibility to raise interest rates, and thus complicates a straightforward implementation of monetary policy. Secondly, state-owned restructuring institutions hold most of the overdue loans (estimated at 15% of GDP). They are even more burdened by a huge amount of bad debts than the banking sector itself. The remaining net fiscal costs from nonperforming loans are estimated to reach 11% of the 2001 GDP.

INCREASING CONCERNS ABOUT FISCAL STANCE

It is rather difficult to evaluate fiscal stance in the Czech Republic. The official figures on general government deficit are quite low (3.3% of the GDP in 2000, which is expected to rise to over 5% in 2001), though, contrary to the European standards, the government accounting includes privatization receipts as current revenues. When excluding privatization receipts, the deficit to GDP is likely to surge over 10%. Moreover, taking into account off-budget items (mostly transition-related costs) and contingent liabilities, the overall public sector balance would be still higher.

However, the central government deficit for the first eight months reached only 52% of the planned annual figure and has been better than expected, reflecting robust growth in internal demand and to some extent surprise inflation. But the deficit is expected to grow rapidly by the end of the year, as it is highly unlikely that the government could meet its projection for privatization revenues. Moreover, with parliamentary elections approaching, the worsening budgetary discipline and the re-emergence of non-transparent methods are of concern.

Chart 4.5.



BETTER THAN EXPECTED EXTERNAL PERFORMANCE

The unfavorable developments in the balance of payments have continued during the first half of 2001. However, the figures for the second quarter indicate that the performance was not as bad as previously expected, and in dollar terms even a bit better than in the first quarter. Still, the current account deficit in the first half of the year widened to USD 1.1 bn. representing a 64% growth over the same period of last year. The merchandise trade deficit rose to USD 1.4 bn., and thus recorded a lower growth rate of 23%. The deterioration of the external environment resulted in a more moderate export volume growth. This was partly offset by favorable terms-of-trade developments due to decreasing import, mostly oil and gas prices. Other elements of the current account also deteriorated in the first half of 2001.

Chart 4.6.

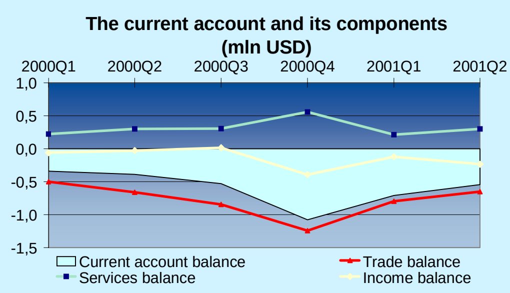


Table 4.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-2,3*	*-2,9*	*-4,7*	*-6,5*
Trade balance/GDP	*-4,5*	*-3,5*	*-6,4*	*-8,0*
Export growth	*13,4*	*6,5*	*20,1*	*16,8*
Import growth	*9,1*	*3,3*	*21,3*	*17,7*

Table 4.4

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	-2,3	-2,9	-4,7	-6,5
Financial account/GDP	5,1	5,6	6,6	7,5
FDI/GDP	4,7	11,8	8,7	9,0

Chart 4.7.

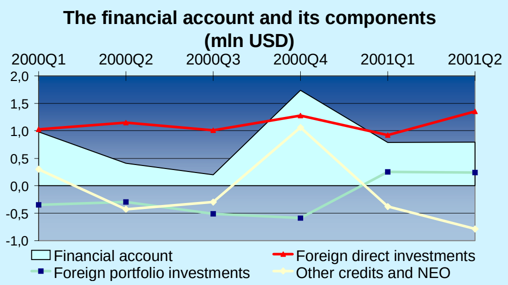


Table 4.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	43,6	43,4	42,0	40,0
Short-term foreign debt/GDP	16,3	16,7	17,5	15,9
Short-term foreign debt/	37,4	38,4	41,6	40,9
Debt/Exports	92,2	86,9	74,2	66,7
Debt-service ratio	15,1	10,3	13,4	15,1
Reserves/GDP	22,6	24,5	25,5	23,0

Table 4.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-1,6	-0,6	-3,3	-5,2
Current account/GDP	-2,3	-2,9	-4,7	-6,5
Short-term foreign debt/GDP	16,3	16,7	17,5	15,9
Short-term foreign debt/ Total foreign debt	37,4	38,4	41,6	42,9
M2/Reserves	31,0	37,0	36,0	34,0
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

The surplus of the financial account reached USD 1.6 bn. in the first half of 2001, representing a 14% increase over the corresponding period of the last year. Inward foreign direct investment amounted to USD 2.2 bn., and the great majority of funds is invested in greenfield production sites. However, the rise in FDI can slow down, because too few privatization projects take place, and to a lesser extent due to growing global uncertainties. Net portfolio investments shifted from a deficit of USD 0.7 bn. during the first half of 2000 to a surplus of USD 0.5 bn. this year. Foreign investors on capital markets were mostly attracted by the growing interest rate differentials and were interested in bonds. The CNB estimated the financial account surplus to reach 6.8% of GDP, based on annual moving aggregates.

WIDENING BUDGET DEFICIT MAY CAUSE OVERSUPPLY OF GOVERNMENT BONDS

The main issue that influences the fixed income market remains the loose fiscal policy and soaring public debt. Apart from the large widening of the narrowly defined budget deficit, public sector deficit including off-budget items and contingent liabilities is expected to boost. Thus, concerns about oversupply of government securities prevail, and have long-term negative impact at the long end of the yield curve.

Moreover, persistent fiscal policy problems risk Czech assets to be downgraded by one or more of the influential rating agencies. The first signs should be rather warning; Fitch, an international rating agency downgraded the long-term Koruna-denominated assets of the Czech Republic from A+ to A in March this year. Deficit financing clearly burdens the bond market, and increases the possibility of a Eurobond issue (the Czech Republic has not yet issued sovereign bonds on international markets).

The recent developments of the yield curve can be characterized by flattening and increasing volatility at the long end. On a currency-adjusted basis, the current level of long-term returns gives annualized returns close to the Hungarian ones, though volatility of the 5 – 10 years maturity securities has risen above the corresponding behavior of the Hungarian bond market. As the Czech Republic has the longest maturity domestic bond in the region, as soon as transparent public financing becomes reality and the securitization process is over, the country has good chance to attract more foreign portfolio investment.

FAVORABLE GROWTH PROSPECTS

GDP growth is expected to accelerate in 2002 reflecting the recovery in the EU. This should result in a positive contribution of net exports. The outlook for domestic demand components is mixed: private consumption will grow at a slightly faster rate than this year, while investments are forecasted to slow down. In line with the robust economic performance, unemployment rate should decrease. TABLE 7.

Headline inflation will remain relatively subdued with a downward trend that makes the Czech Republic the best performer in the region, though still far from the Maastricht criteria. The moderated inflation targeting framework (shift from net to headline inflation for the targeted variable) makes the monetary policy more reliant on fiscal measures. The widening deficit of the public sector and the prevailing interest rate premium for the Koruna puts upward pressure on the currency. The forecasted fall in inflation could thus result in cuts of the policy rate next year.

Balance indicators, both internal and external remain of major concern. We expect loose and pro-cyclical fiscal policy to prevail until the elections in September 2002; however, a readjustment seems unavoidable afterwards. The increasing deficit may result in an oversupply of the government bonds, which, dumped on the bond market, may risk a downgrading of the sovereign debt. A surge in EU import demand should have a positive impact on the trade performance, though continuous real (and to a lesser extent nominal) appreciation could offset this. FDI inflow will finance the growing deficit of the current account via the ongoing privatization, and portfolio investment is likely to become less attractive.

Table 4.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	*2,9*	*3,5*	*3,6*
-Private consumption (%)	*1,9*	*3,2*	*3,3*
-Public consumption (%)	*-1,3*	*0,2*	*0,0*
-Investments (%)	*4,2*	*6,9*	*5,5*
-Export (%)	*20,1*	*16,8*	*14,0*
-Import (%)	*21,3*	*17,7*	*13,0*
Consumer price index (average, %)	*4,0*	*5,1*	*4,6*
Consumer price index (dec/dec, %))	*4,0*	*5,6*	*4,3*
Unemployment ratio (%)	*8,8*	*8,0*	*7,7*
General government balance (%)	*-3,3*	*-5,2*	*-6,5*
Public debt/GDP (%)	*29,2*	*31,0*	*34,0*
Current account (bn USD)	*-2,4*	*-3,5*	*-4,0*
Current account/GDP (%)	*-4,7*	*-6,5*	*-6,3*
Trade balance (bn USD)	*-3,3*	*-4,5*	*-5,0*
Trade balance/GDP (%)	*-6,4*	*-8,0*	*-8,2*
FDI (bn USD)	*4,1*	*5,1*	*5,7*
Gross foreign debt/GDP (%)	*42,0*	*40,0*	*38,0*

5. ESTONIA

BUOYANT ECONOMY, BUT CONCERNS ABOUT LABOR MARKET REMAIN

After the decline in 1999 the Estonian economy has produced fast economic growth. The short-term negative consequences of the Russian financial crisis are surpassed, and with the help of recovering foreign demand, Estonia emerged from the recession stronger than ever. Export of goods and services was the accelerator of the prosperity, while financing conditions have been improving considerably. Basic structural changes are already completed, which is reflected in the increasing competitiveness of Estonian firms. However, as majority of foreign direct investments are targeted to enhance the already existing production, labor market problems are hardly moderating. Despite the surprising win of opposition candidate in recent presidential election, foreign policy goals of membership in the European Union and NATO are expected to remain unchanged. Further cooling of world economic climate will cause a deceleration in Estonian economic growth as well, but negative external impacts will be partly offset by rise in domestic demand.

STABLE POLITICAL ENVIRONMENT AND BROAD CONSENSUS ON STATE POLICY GOALS

At first glance, political elite has to manage a delicate situation after 21 September, as Arnold Rüütel, candidate of opposition parties was selected by the Electoral College to serve a 5-year term as Estonia’s president. However, the president’s role is defined in the constitution as mostly ceremonial. Besides, there is a general consensus within the political leadership on state policy, the main aim of which is EU membership. Although the center-right coalition government (Pro Patria Union, Reform Party and the People’s Party Moderates) enjoys only a small majority and policy preferences over fiscal issues differ significantly, we do not forecast any major turmoil until 2003 legislative elections. Recent mishandling of railway and energy privatization has certainly created tensions among coalition partners, nevertheless, we expect that minor reshuffle of the Mart Laar (Pro Patria Union) cabinet could ensure the survival of the current political configuration.

Table 5.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	5,0	-0,7	6,9	4,5
Private consumption	6,2	-2,4	8,2	6,1
Public consumption	3,9	-7,9	0,8	4,5
Investments	11,3	-15,2	2,0	5,9
Export	12,5	-2,3	30,7	11,0
Import	12,5	-6,1	29,0	12,6
GDP output	5,2	-0,5	6,5	4,5
Agriculture	-4,7	-5,6	-2,8	3,5
Industry	4,1	-7,7	9,1	5,8
Services	4,8	2,6	4,0	4,3

Chart 5.1.

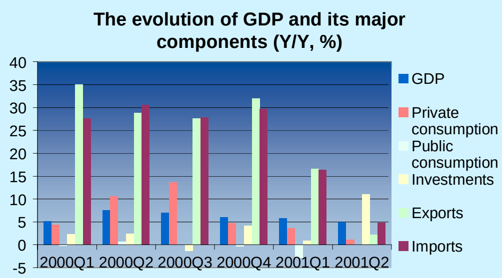


Chart 5.2.

STRENGTHENING DOMESTIC DEMAND CAN PARTLY OFFSET UNFAVORABLE EXTERNAL CONDITIONS

After the initial period of stabilization, and the record growth of 1997 (10.4%), the Estonian economy contracted again in 1999, due to the Russian financial crisis and the slowdown in the import demand of Western Europe. Recovery started in the last quarter of 1999, as important structural reforms (privatization and concentration in the banking, as well as in the corporate sector) were completed. Booming foreign trade promoted a new phase of prosperity, and from the second quarter of 2000 consumption of households increased too. However, this year slowdown of world economy, especially the rapid deceleration of Finnish, Swedish and German economies (Estonia's main trading partners) are reflected in the Estonian economic performance as well: in the second quarter of 2001, real GDP grew by 5.0%, while in the first quarter growth was still 5.8%.

A further deceleration of exports seems unavoidable for the remaining part of 2001, therefore net exports will likely have a negative contribution to GDP growth. This year driving force of economic growth is rather domestic demand, although both private consumption and investment figures continue to show surprisingly high volatility from one quarter to another. Household consumption could expand further thanks to the resumption of disinflation, while continuing restructuring and expanding of productive capacity in manufacturing can maintain a relatively strong investment activity. According to the recent investment poll of Estonian Institute of Economic Research, favorable business climate can at least partly offset unfavorable external conditions.

On the supply side, key manufacturing sectors grew briskly in the first half of 2001; especially machinery and equipment manufacturing which was up nearly 60%. Transportation and trade rose also markedly, and even agriculture has been showing clear signs of recovery.

Despite the recurrence of economic growth, the year of 2000 didn't bring about improvement of labor market situation. However, in the second quarter of 2001 employment showed a strong increase, while boosting investment and subsequent new job creations in manufacturing industry resulted a slight moderation of unemployment rate (12,4%). This level of unemployment is still stubbornly high, and as real wage growth has surpassed real growth of productivity, we cannot expect a further significant decrease.

Chart 5.3.

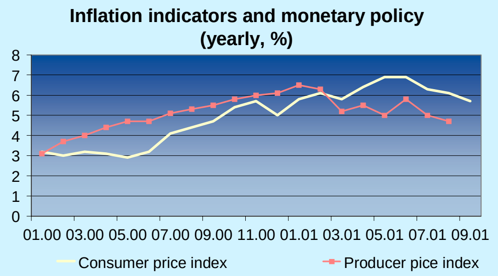


Table 5.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	14,1	14,7	17,0	17,9
Consumer price index (average, %)	8,1	3,3	4,0	5,8
Producer price index (average, %)	4,2	-1,2	4,6	4,5
Broad money growth (dec/dec, %)	0,1	23,6	27,5	27,0
Real broad money growth (dec/dec, %)	23,1	10,4	30,3	32,5
Domestic credit growth (dec/dec, %)	16,0	8,7	7,6	8,4
Real domestic credit growth (dec/dec, %)	n.a.	n.a.	n.a.	-
Nominal interest rates (3 month TBs, %)	n.a.	n.a.	n.a.	-

INFLATION CULMINATED IN SPRING, A NEW PERIOD OF DISINFLATION IS EXPECTED

As in most of other transition economies, inflation in Estonia accelerated last year. Producer prices rose more than the consumer price index which was a clear sign of a cost-push inflation, reflecting the rapid pass-through of increasing oil prices. External price pressures together with domestic and foreign demand affected both prices of tradable and non-tradable goods. In 2001, producer prices have been gradually moderating, meanwhile in the first half-year the increase of consumer prices reached 6.7%. This alarmingly high level of year-on-year growth in CPI was caused mainly by an 11% rise of housing prices. The principal reason for this was an increase of VAT for heating.

In the second quarter of 2001 food and transport prices also contributed markedly to the strong increase of consumer price index. Epidemics in Western Europe and increase of export quotas for milk products into the European Union inevitably led to rising domestic food prices. Year-on-year PPI has been falling since February, as imported inflation is subdued thanks to the currency board arrangement and moderate fuel prices. Since June, also consumer prices has been decreasing, and a new period of disinflation is expected for the remaining months of the year. However, assumed excessive increase of wages and subsequent demand-pull inflation expectations could endanger ambitious disinflation targets of Estonian monetary authorities.

CURRENCY BOARD ARRANGEMENT REMAINS UNCHANGED, BANKING SECTOR IS STABLE

Adoption of the currency board arrangement played an essential role in the initial stabilization of the Estonian economy. At the beginning of the 90's, price liberalization and absence of control over monetary aggregates led to a hyperinflation (in 1992 the rise of consumer prices reached 1076%). Introduction of a currency board, pegging the Estonian Kroon (EEK) with a fixed exchange-rate to the German Mark (later to the Euro), together with a strict fiscal policy stabilized price level and lowered interest rates. Although stability of financial institutions is crucial for efficient working of currency board regime, Estonian financial sector was very vulnerable even in time of the Russian financial crisis. Nevertheless, restructuring process was speeded up in 1998: the Deposit Insurance Foundation was set up in order to raise confidence in the banking sector. Strategic participation of Swedish and Finnish foreign banks in local commercial banks led by the end of 2000 to over 90% foreign ownership in the banking sector. The recent rapid growth of domestic deposits evidently reflects the increase of

Chart 5.4.

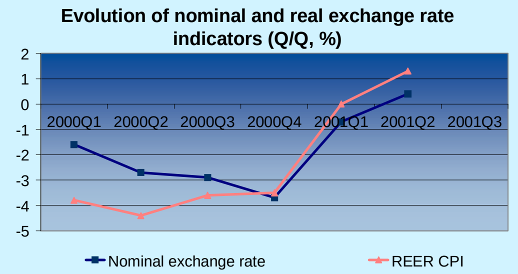


Chart 5.5.

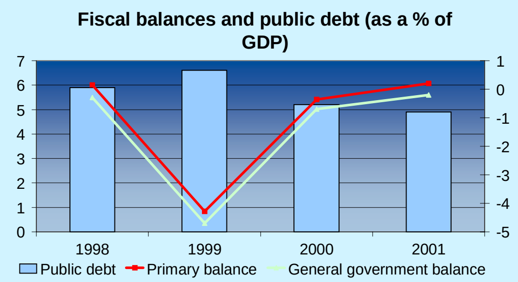


Chart 5.6.

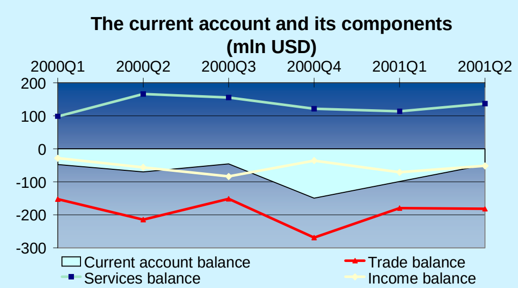


Table 5.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-9,2*	*-4,7*	*-6,4*	*-6,0*
Trade balance/GDP	*-21,4*	*-17,2*	*-16,0*	*-22,3*
Export growth	*18,5*	*-4,6*	*30,7*	*11,0*
Import growth	*12,6*	*-8,5*	*29,0*	*12,6*

trustworthiness in Estonian banks.

Estonian decision-makers consider maintaining the currency board arrangement as one of the key principles to achieve main economic policy objectives (namely: sustainable, socially and regionally balanced economic growth). Current monetary policy goals are to achieve long-term price stability and to support economic convergence with systems of the European Union as well as the Economic and Monetary Union. Fixed exchange rate regime is intended to continue until joining the Euro-zone; under this framework, to fulfill the Maastricht convergence criteria fiscal policy got the central role in macroeconomic policy.

TIGHT FISCAL POLICY CONTINUES

Estonian government pays special attention to a balanced budgetary policy. A conservative lending policy, cutting of expenditures non-related to the implementation of structural reforms, establishing a unified cost planning and assessment system as well as enhancing financial control are the main features of the current tight approach.

In the first half of 2001, general government budget revenues exceeded expenditures; surplus made up 0.3% of the projected gross domestic product. Compared to the last year, collection of tax revenues has grown by 8.1%. The increase has come mostly from VAT and excise taxes and the social tax, while collections of personal and corporate income taxes were somewhat less than expected. Nevertheless, due to the good overall collection of revenues, the Ministry of Finance has increased the tax revenue forecast by 1.5%. Better than expected revenue was collected in case of non-tax revenues as well, therefore keeping budgetary balance in 2001 seems plausible even under unfavorable economic conditions and the subsequent slowdown of economic growth.

SUSTAINABLE EXTERNAL BALANCES

Estonian exports have slowed markedly in recent months as markets abroad weakened. In real terms, merchandise exports grew less than 1%. Subcontractors, mainly in electronic industry, are suffering the most from the cooling of the main trading partner's economy. On the other hand, growth in export of services achieved 6%. Imports also slowed down, meanwhile terms-of-trade development was favorable. Therefore trade and current account deficits diminished: the latter was only 3.5% in relation to GDP.

Table 5.4.

The financial and current accounts (%)	1998	1999	2000	2001
Current account/GDP	-9,2	-4,7	-6,4	-6,0
Financial account/GDP	9,3	8,9	8,7	8,0
FDI/GDP	10,9	4,3	4,9	4,5

Chart 5.7.

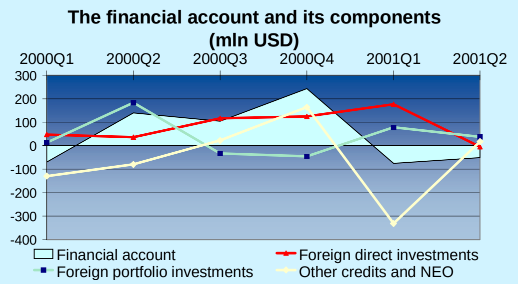


Table 5.5.

The evolution of foreign indebtedness indicators (%)	1998	1999	2000	2001
Gross foreign debt/GDP	53,5	59,5	60,0	62,2
Short-term foreign debt/GDP	16,6	20,0	22,2	24,2
Short-term foreign debt/	31,0	33,6	37,0	38,9
Debt/Exports	66,9	77,3	62,7	61,8
Debt-service ratio	7,9	13,0	7,2	9,0
Reserves/GDP	14,9	17,7	18,4	19,5

Table 5.6.

The financial vulnerability indicators between 1998 and 2001 (%)	1998	1999	2000	2001
General government balance/ GDP	-0,3	-4,7	-0,7	-0,2
Current account/GDP	-9,2	-4,7	-6,4	-6,0
Short-term foreign debt/GDP	16,6	20,0	22,2	24,2
Short-term foreign debt/ Total foreign debt	31,0	33,6	37,0	38,9
M2/Reserves	195,5	241,1	263,8	317,7
Foreign currency liabilities/ total liabilities of the banking sector	44,4	43,1	46,1	45,5

Unlike last year, the financial account also produced a deficit in the first half of 2001. While foreign direct investments to Estonia increased, FDI outflows from Estonia doubled, which caused a slight deficit in second-quarter direct investment balance. Most of the capital outflow went to investment projects in Latvia and Lithuania, as multinational corporations extended their operations to Estonia's Baltic neighbors.

GROWTH PROSPECTS ARE STILL FAVORABLE

Given the trends in the world economy, in the remaining parts of 2001 as well as in 2002 economic growth will mainly be based on domestic demand components, both consumption and investment. Continuing structural reforms, investment needs of recently privatized infrastructure enterprises generate high investment demand, while strong increase in private consumption will be supported by further real wage growth. Growth rates of exports and imports will be moderate, and imports will slightly outpace exports because of strong

Table 5.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	6,9	4,5	5,0
-Private consumption (%)	8,2	6,1	7,5
-Public consumption (%)	0,8	4,5	3,4
-Investments (%)	2,0	5,9	9,6
-Export (%)	30,7	11,0	4,0
-Import (%)	29,0	12,6	5,4
Consumer price index (average, %)	4,0	5,8	3,8
Consumer price index (dec/dec, %))	5,0	5,0	3,5
Unemployment ratio (%)	13,7	13,2	12,9
General government balance (%)	-0,7	-0,2	-0,7
Public debt/GDP (%)	5,2	4,9	4,9
Current account (bn USD)	-0,3	-0,3	-0,4
Current account/GDP (%)	-6,4	-6,0	-6,7
Trade balance (bn USD)	-0,8	-0,9	-0,9
Trade balance/GDP (%)	-16,0	-22,3	-23,5
FDI (bn USD)	4,9	4,5	4,5
Gross foreign debt/GDP (%)	60,0	62,2	66,0

investment demand. A moderate increase in the current account deficit is forecasted, but it will remain on a sustainable level, and will be covered almost entirely by non-debt creating capital inflow. Despite robust economic performance, given its basically structural nature, unemployment rate will not decrease considerably in the short run. Nevertheless, both a small increase of employment and a moderate decrease of unemployment is expected.

Consumer prices will be slightly above the Euro-zone average, for two reasons. On the one hand, still administratively regulated prices will rise significantly and VAT exemptions will be gradually abolished. On the other hand, convergence towards Euro-zone price level continues; this means a CPI growth by 3-4% even in the medium-term.

Changes in the currency board arrangement are very unlikely until joining the EMU. Concerning fiscal issues, we expect that the government will continue pursuing a conservative budgetary policy. General government deficit will be near zero, because increase of expenditures related to EU pre-accession requirements will be accompanied of strict cutting in other budget chapters.

6. HUNGARY

HUNGARIAN ECONOMY HAS FARED WELL FOR YEARS

At the beginning of 1997 the Hungarian economic growth started to accelerate. Since then, ignoring the first half of 1999, economic growth was constantly above 4%, while financial indicators improved. In Central Europe Hungary is still on the top in economic performance, its corporate structure as well as its banking sector are sound in terms of profitability, quality of assets and growth potential.

Although soaring industrial output and export growth cooled down in the first half of 2001, Hungary's real economic performance is still encouraging. Reflecting a slowdown in EU growth and import demand export growth gradually declined in 2001. Dynamics of the domestic demand slightly increased in this year, however this will not balance the decrease of value added of net exports. Altogether, there is no concern about Hungary's external position, as the current account deficit is in much better shape than it was in 2000 and non-debt-creating financing seems to be able to cover the deficit.

Although, CPI turned into downward trend after the peak of 10.8% in May, inflation is likely to remain the toughest challenge for Hungary in the next couple of years. Under the current floating exchange rate regime, monetary policy is able to efficiently fight against inflation. While inflation rate is still far from price stability, the economy is developing on the favorable way to reach the Maastricht criteria without real economic deceleration on longer term.

COALITION LIKELY TO REMAIN INTACT UNTIL ELECTIONS

The Hungarian political scene was stable in the past few months. We see slight reason to be concerned about the coalition losing its majority or breaking up before the next elections. Otherwise, the most decisive debate on the two-year budget plan was accepted in 2000. Currently, the Socialist Party practically has the same support as the governing coalition leader Fidesz in public opinion polls as the pre-election period gets underway. Outcome of elections is unclear, it depends directly on the pre-election campaign.

INDUSTRIAL GROWTH FOLLOWED BY SLOWDOWN OF EXPORT DYNAMIC

Hungarian GDP grew by 4% y/y in the second quarter of 2001 after the 4.4% rise in the previous quarter. The slight slowdown of GDP growth is primarily due to the decline in industrial output growth. Unfavorable evolution of manufacturing is in line with the deteriorating of export sales

Table 6.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	5,1	4,5	5,2	4,0
Private consumption	3,8	4,6	3,3	4,3
Public consumption	3,0	1,8	1,6	2,3
Investments	11,4	5,9	6,6	4,6
Export	16,0	13,1	21,8	13,1
Import	22,2	12,3	21,1	12,5
GDP output	4,9	4,2	5,2	4,0
Agriculture	-1,5	0,9	-3,5	4,1
Industry	12,2	7,2	9,2	4,2
Services	4,5	3,2	2,9	3,7

Chart 6.1.

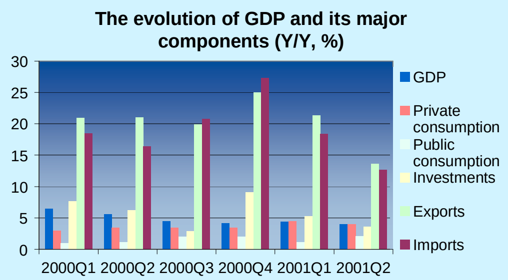


Chart 6.2.

manufacturing is in line with the deteriorating of export sales of industrial products. Industrial export sales grew by over 30% y/y in the first eight months in 2000 and by less then 14% during the same period in 2001. The Hungarian economy depends to a large extent on industrial export sales, which declined from the January year-on-year growth of 33.6% to 5.9% in August. The slowdown of export sales was constant and corresponds to the slowdown of EU economic growth and EU's import demand. Furthermore, domestic sales figures also showed a decline of Hungary's main sector.

Absorption figures of GDP show, that domestic demand growth moderated to 3.5% in the second quarter of 2001. Dynamic of total domestic absorption reached 4.3% in the first quarter of 2000 and peaked 6% in the 4Q2000. This slowdown can be primarily explained by the decline in investment growth. Corporate sector is in net saving position in 2001, and narrowing export markets account for delayed investments.

In the 1H2001 private consumption accelerated by 1.1% compared to the same period of 2000. The increase is in line with real wages, which grew by 6.6% in the same period. Retail sales figures also confirm the slight acceleration in domestic consumption, as dynamic of domestic sales speeded to 6% y/y growth in the first half of 2001. Private consumption is growing in a healthy rate and there is no sign of overheating, and we are on the view that domestic absorption will not able to balance the decline of export growth. General government consumption revived in the second quarter of this year, as it posted a growth of 2.1% y/y compared to the 1.2% /y in the first quarter.

Foreign trade is in decline. From the first quarter of 2001, growth of exports and imports declined corresponding to the slowdown of EU growth. While export growth reached 25% on a yearly base at the end of 2000, the increase moderated to 13.6% y/y in the second quarter of 2001. Decline of export affected Hungary's industrial growth, which also deteriorated. Import grew by 12.7% y/y in the 2Q2001 after the 27.3% in the 4Q2001. Slowdown of import growth was followed by the unfavorable evolution of investments, as investment related import fell back.

Number of unemployed persons decreased by 32 thousands during the period of June-August in 2001 compared to the same period of 2000. This three-month average unemployment rate was 5.6% (ILO), the same rate as it was in the previous months.

Chart 6.3.

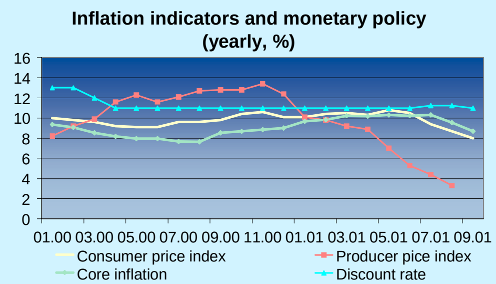
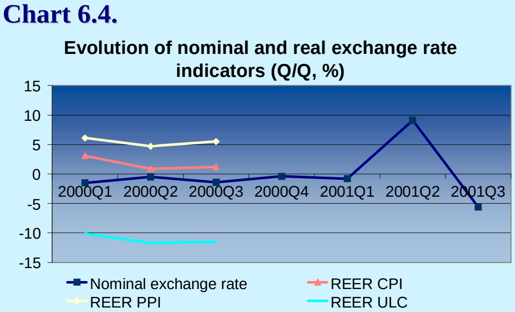


Chart 6.4.



INFLATION IS ON A FAVORABLE TREND AS EXTERNAL AND DOMESTIC PRESSURE ON DECLINE

Hungarian consumer price index turned into downward trend from June. CPI decreased to 8% y/y in September from 10.8% in May. On monthly basis prices were up by 0.5% from August to September. Slowdown of core inflation is definitely the sign of easing inflationary pressure.

There are several reasons explaining the favorable evolution of the CPI. First, in August 2000 consumer price index started to grow, which meant higher comparative basis. Second, with Forint appreciation, acceptable oil prices and relatively stable Euro, imported inflation pressure remained at a low level compared to the previous year. The only negative external factor was the acceleration of EU-CPI and producer price index, which rolled over Hungarian prices in the first half of 2000. Third, domestic source of inflation has eased, as growth food prices sharply slowed, which mainly attributable to seasonal factor.

Producer price index rose by 3.3% y/y in August compared to the 12.7% growth in the same period of 2000. Reducing cost of production was primarily driven by significant drop of export PPI. While production costs of tradable goods rose by 9.4% y/y at the end of 2000, this indicator showed 1.3% decline in year-on-year terms in August, which is attributable to the high comparative basis and partially to Forint appreciation. With appreciation, the growth of domestic production costs also moderated via the favorable external inflation factors. PPI figures show that Hungarian economy can maintain its high productivity, and Forint appreciation is not harmful for the real economy.

FORINT APPRECIATION AFTER THE BAND WIDENING

Hungarian monetary policy can be described as relatively tight, with an inflation targeting monetary arrangement. On the 4th of May, the National Bank of Hungary (NBH) abolished the narrow band (+/- 2.25%) crawling-peg exchange rate regime and widened the fluctuation band. After this step, the domestic currency started to appreciate against the Euro and dollar due to the accelerated demand on Forint and Forint-denominated assets. In June NBH introduced the inflation targeting monetary system with currency liberalization, which abolished the existing obstacles of full convertibility.

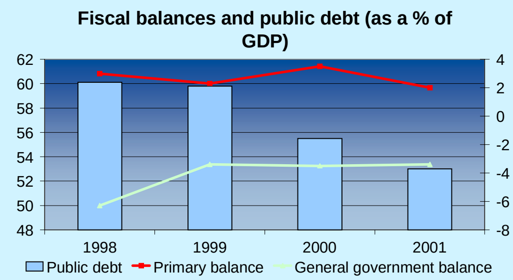
Soaring Forint has positive impact on inflation through decrease of imported inflation pressure, which rolled over the consumer price index from the third quarter of 2000. The central bank could use the exchange rate as an anti-inflationary tool. Hungary’s real economic performance supports our opinion that floating currency will not significantly hurt growth and external balance. Real effective exchange rates did

Table 6.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	214,5	237,3	282,3	285,5
Consumer price index (average, %)	14,3	10,0	9,8	9,2
Producer price index (average, %)	11,3	5,2	11,7	5,9
Broad money growth (dec/dec, %)	15,6	15,8	12,2	10,6
Real broad money growth (dec/dec, %)	5,3	4,6	2,1	5,6
Domestic credit growth (dec/dec, %)	13,9	-5,5	15,8	12,0
Real domestic credit growth (dec/dec, %)	6,8	-14,2	3,4	4,6
Nominal interest rates (3 month TBs, %)	16,1	12,4	11,6	10,1

Chart 6.5.



not show strong appreciation and there is no sign of overflowing current account deficit.

Inflation targeting monetary system requires relatively strict monetary policy with clearly interpreted inflation target, properly controlled intermediate indicators and support of fiscal policy. As Hungarian inflation turned into downward trend and real economic growth is still stable, NBH can focus on inflation. On the other hand, Forint nominal exchange rate is responsive to external shocks and global trends, which affects Hungarian companies. The regime requires NBH to increase accountability and credibility in order to strengthen market confidence. Real broad money grew by around 4% in the first half of 2001, and NBH cut its interest rate by 100bp. in September in response to the favorable inflation figure.

STABLE FISCAL BALANCE

Hungary had a consolidated budget deficit of HUF 202.4 bn. in the first eight months of 2001, which represents 41% of the whole year budget plan. Revenues reached 66.7% of the annual target, while expenditures amounted to 63.8% of the approved expenses. Central budget deficit fared well: it amounted to HUF 135.8 bn. compared to the HUF 481 bn. as a whole year plan.

On the revenue side, value added and personal income tax revenues improved fiscal balance. The most considerable overflow accrued from duties and import revenues. VAT revenues are slightly over the time-proportional projected figure. Better than expected revenues can be explained by hikes in real wages and higher then expected inflation rate, as the government's two-year budget was based on 5-7% expected CPI in 2001. We think that the government underestimated inflation by more then 2%, which may result in additional income for the budget in the rest of the year.

Although, hike in minimum wages triggered some additional layoffs, and year-end expenditures are likely to soar, targeted fiscal deficit of 3.5% of GDP is maintainable. Surplus of primary balance amounted to HUF 172 bn. in the first half of 2001, compared to the surplus of HUF 267 bn. during the same period of 2000. Slight easing of fiscal policy and higher outflow of nominal wages can explain this. Therefore, demand impact of public finance will significantly rise this year. The fact, that the deficit of the consolidated government reached only 41% of the target of money-bill, can imply that expenditures are likely to soar in the rest of the year. But there is no sign of excessive fiscal easing and we believe that consolidated budget will be in line with the budget target for 2001, despite the pre-election period. This is more than important, because strict monetary policy without fiscal support could lead to financial distortions.

Chart 6.6.

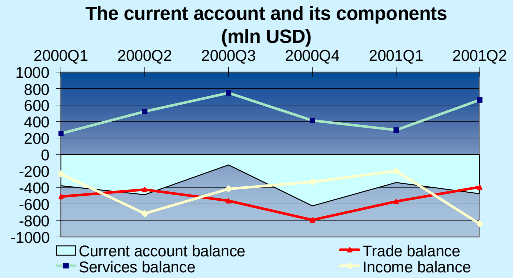


Table 6.3.

The dynamics in the current account (%)	1998	1999	2000	2001
Current account/GDP	-4,8	-4,4	-3,3	-2,5
Trade balance/GDP	-5,8	-6,0	-3,6	-3,3
Export growth	16,0	13,1	21,8	13,5
Import growth	22,2	12,3	21,1	12,7

Chart 6.7.

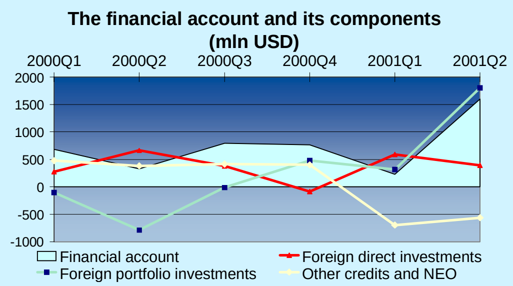


Table 6.4.

The financial and current accounts (%)	1998	1999	2000	2001
Current account/GDP	-4,8	-4,4	-3,3	-2,5
Financial account/GDP	6,2	9,9	5,2	5,4
FDI/GDP	4,3	4,1	3,7	2,5

Table 6.5.

The evolution of foreign indebtedness indicators (%)	1998	1999	2000	2001
Gross foreign debt/GDP	50,7	58,0	59,9	59,0
Short-term foreign debt/GDP	7,7	9,4	11,8	11,5
Short-term foreign debt/	14,0	14,0	17,8	17,5
Debt/Exports	89,4	101,2	86,3	85,0
Debt-service ratio	16,5	16,3	12,9	11,0
Reserves/GDP	19,1	24,1	24,4	26,0

FAVORABLE CURRENT ACCOUNT BALANCE

Hungary's current account deficit amounted to EUR 365.2mn. in the first eight months of 2001, which is much better then the deficit of EUR 682.2mn. during the same period of 2000. Favorable balance is primarily due to the high surplus of services balance. Evolution of foreign trade balance is almost in line with the processes in 2000 with the cumulated deficit of EUR 1170.5mn. over January to August. The growth gap between exports and imports narrowed from June to August as decline of import growth exceeded the slowdown of exports. Deficit on income balance was also in line with expectations, although outflow of portfolio and direct investment related profit (profit repatriation) slightly increased in the second quarter of 2001.

Financial account surplus amounted to EUR 1789mn. in the first seven months of 2001, which is higher by almost EUR 837mn. compared to the same period of 2000. Favorable figures were due to portfolio investments, which ran a surplus of EUR 2054.5 mn. during the period. In 2000 non-debt-creating financing was harmed by portfolio capital outflows, which amounted to EUR 957.7mn. over January. While big portfolio investment deficit was largely attributable to global sentiment and the deteriorating inflation outlook, speculation on potential widening of the Forint fluctuation band, and from May (with the band widening) Forint appreciation attracted more portfolio capital. Monthly balance of portfolio investment has been in surplus until June, and then the balance turned into deficit due to growing volatility of Forint and discouraging US and EU economic conditions. Cumulated FDI inflow reached EUR 1023mn. from January to July in 2001, the same as it was in 2000.

Non-debt creating financing covered the current account deficit up to August. With the EU and global economy unlikely to recover in the coming months, the short-term prospects for the balance of payments are less favorable.

Table 6.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-6,3	-3,4	-3,5	-3,4
Current account/GDP	-4,8	-4,4	-3,3	-2,5
Short-term foreign debt/GDP	7,7	9,4	11,8	11,5
Short-term foreign debt/ Total foreign debt	14,0	14,0	17,8	17,8
M2/Reserves	57,4	48,9	49,4	46,0
Foreign currency liabilities/ total liabilities of the banking sector	39,4	36,8	34,7	36,0

Appreciating Forint did not represent a breaking risk for exports, because Hungarian exports are mostly high value added with high import content. Inward processing of manufacturing shows that strong Forint appreciation reduced both production costs and export prices, however, the whole impact did not roll over the import and export prices. Otherwise, largest exporters are multinational companies, which are under shelter against Forint appreciation and worsening productivity. This situation allows major exporters to remain competitive even when the Forint appreciates. Minor and medium exporters are more vulnerable to the appreciation and therefore see deterioration of their productivity.

MARKET ACTIVITY WAS DETERMINED BY FORINT APPRECIATION AND EXTERNAL FACTORS

Fixed income market activity started to pick up in May after the widening of Forint fluctuation band. European funds bought primarily long-term (2-5-year) maturity papers, and growing foreign interest can be explained by speculation on Forint appreciation. This bullish sentiment boosted the market until July, when worsening global market confidence and Forint depreciation changed interest rate expectations. In September market focused on August inflation, which was better than expected. On 10th of September NBH cut its key interest rate by 100bp, which pushed short-term yield down by about 15bp. However, the sad American events of 11th of September broke down the rising market confidence. Short-term yields moved up by about 22-31bp for a week, and interest has been growing since then. As far as long-term maturity papers concerned, yields soared by about 27-44bp. after the global sentiment collapsed. The 2-5-year and 10-year maturity papers reacted most sensitively to the growing market sentiment, as majority of these papers were owned by foreign investors, primarily converge players.

Evolution of global market confidence and the convergence story will likely become very important. In the longer term, the market will be focusing on the central bank's anti-inflationary tools. Activity of convergence players will determine long-term yields and expectations on inflation. We are optimistic about Hungary's real economic performance and inflation trend, but the global financial market is likely to be unfavorable.

From July the one-year real yield increased from zero to about 4%. Unexpected trend of inflation reduced real interest rates in the second half of 2000. With the slowdown of consumer price index, real yields moved up and the floating currency increased the expected yield premium, as exchange rate risk accelerated. We expect that nominal yield of benchmark one-year maturity treasury bill will follow the inflation expectations. Therefore, real interest rates will remain

Table 6.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	5,2	4,0	4,3
-Private consumption (%)	3,3	4,3	4,2
-Public consumption (%)	1,6	2,3	2,4
-Investments (%)	6,6	4,6	5,3
-Export (%)	21,8	13,1	14,0
-Import (%)	21,1	12,5	14,0
Consumer price index (average, %)	9,8	9,2	6,1
Consumer price index (dec/dec, %))	10,1	7,4	4,8
Unemployment ratio (%)	5,9	5,7	5,7
General government balance (%)	-3,5	-3,4	-3,2
Public debt/GDP (%)	55,5	53,0	52,0
Current account (bn EUR)	-1,6	-1,4	-1,8
Current account/GDP (%)	-3,3	-2,5	-2,8
Trade balance (bn EUR)	-2,3	-1,9	2,1
Trade balance/GDP (%)	-3,6	-3,3	-3,2
FDI (bn EUR)	1,2	1,4	1,6
Gross foreign debt/GDP (%)	59,9	2,5	2,5

at around 4-4.5%, and expected yield premium is unlike to fall, until global market confidence encourages foreign investors.

EXPORT AND INDUSTRY DRIVEN GROWTH AS INVESTMENTS ARE EXPECTED TO SLIGHTLY ACCELERATE

With Hungarian export largely focused on EU and its main trade partner is Germany, EU growth determines Hungarian GDP growth vis-à-vis demand for its exports. On historical basis, a 0.5% drop in German GDP triggers a 4-5% decline in Hungarian exports. US recession could have an indirect impact on the Hungarian economy. Direct effect seems to be small, as the US accounts for 4% of Hungarian exports and 5% of its imports. We expect that Hungarian real economic growth will reach 4% in 2001 and 4.3% in 2002. Value added of net export seems to decrease but domestic demand is likely to revive due to the growing demand impact of public finances. Dynamics of household consumption growth could reach 4.3% in 2001, which is 1% higher compared to 2000. Rise of investments is expected to accelerate in the rest of the year and we assume their yearly increase of 4.6%. Accelerating investments may be generated by the state related investments and high utilization of corporate capacities. In long-term view we expect economic growth to be over 4%, further driven by EU-focused industrial and export growth.

Due to the very high comparative basis and expected slight decline of domestic inflation pressure, CPI is likely to moderate in the rest of the year. As such, yearly CPI growth may reach 9.2%, while year-end figure is expected to be down to 7.4%. If imported inflation pressure will not speed up and Forint will appreciate by around 1-2% against Euro on yearly basis, the downward trend of inflation will be maintainable. Although, domestic inflation factors (rise of food and services prices) will keep inflation rate at a relatively high level, we expect average CPI of 6.1% in 2002.

Although, fiscal reins seem to be eased in 2001, we think that consolidated budget deficit will be 3.4% of GDP, in line with the target. For 2002 we estimate that the deficit of general government will be around 3.2%.

Current account balance is likely to be very favorable, even though trade gap may widen in the rest of the year. Profit repatriation traditionally burdens the income balance at the end of the year, and services balance is also likely to be less favorable in the forthcoming months. Therefore, we expect a current account deficit of EUR 1.05bn over September to December. The yearly deficit may reach EUR 1.42bn, which represents 2.5% of GDP. While the current account deficit is much lower than most optimistic outlooks estimated, a downturn in market confidence could put a damper on non-debt creating financing, which could be reversed only by favorable inflation performance. Lower inflation would strengthen market confidence and improve the balance of portfolio and FDI investments. Therefore, if inflation performs well we think the financial account will be able to generate enough revenues to cover the current account deficit during the whole year, without raising external debt.

Monetary conditions are expected to help NBH to reach its inflation target. In line with estimated slowdown of CPI, nominal interest rates are likely to decrease, while real interest rates may remain unchanged. In long-term view we calculate with 0.7% yearly Forint appreciation. In this case, real effective exchange rates of Hungary will appreciate by around 3% and productivity of the Hungarian economy can be maintained.

7. LATVIA

STRONG GROWTH REMAINS SUSTAINABLE, WHILE FISCAL STANCE CLOSELY WATCHED

The Latvian economy seemed to have fully recovered from the sharp slowdown triggered by the Russian crisis, and embarked on a sustainable growth path. Despite the marked deceleration of import demand on major external markets, i.e. the EU, the prospects for economic growth remain stable, though a deceleration is unavoidable over time. Tight monetary policy contributed to moderating inflation, while the strict exchange rate peg remained sustainable. Weakening export performance and relatively buoyant domestic demand may result in a widening of the current account deficit, but strong inflow of foreign capital is expected to cover the gap.

"OUTSIDE ANCHORS" CONTINUE TO INFLUENCE DOMESTIC POLICY

The center-right government led by Andris Berzins (Latvia's Way) is likely to remain in power until the next elections in October 2002. Though the coalition partners disagree on several key policy issues, there is no clear alternative for the ruling coalition, which is to assure the unity of the government. Some fiscal loosening is forecasted, given the coming parliamentary elections, and unpopular policy measures are most likely to be delayed.

EU accession remains the major driving force behind policy reforms. Though, apart from the European Union major international financial institutions, most importantly the International Monetary Fund (IMF) and the World Bank (WB), also serve as "outside anchors" for domestic policies. As Latvia is heavily dependent on loan arrangements with the IMF and lending programs from the WB, the launch of politically difficult reform measures, though painful, are expected to proceed.

Table 7.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	3,9	1,1	6,6	7,2
Private consumption	6,2	5,1	5,6	4,0
Public consumption	6,1	0,0	-2,9	1,0
Investments	44,0	-4,0	10,8	8,2
Export	4,9	-6,4	12,8	9,0
Import	19,0	-5,2	4,8	6,3
GDP output	n.a.	n.a.	n.a.	-
Agriculture	-5,3	-7,3	9,2	3,5
Industry	4,0	-5,8	5,8	6,5
Services	5,6	6,5	8,9	7,5

DOMESTIC DEMAND CONTINUES TO FUEL ECONOMIC GROWTH

Following the sharp deceleration in 1999, the Latvian economy recorded robust economic growth of 6.6% in 2000. The strong upturn was primarily driven by boosting exports, reflecting the flourishing external demand, which has more than offset the worsening of price competitiveness. As for domestic demand components, gross fixed investments provided the main impetus for GDP growth. The picture is substantially different this year, or, at least, assumed to be so (as no figures on demand decomposition of GDP are available for the first two quarters). In line with the sluggish external

Chart 7.1.

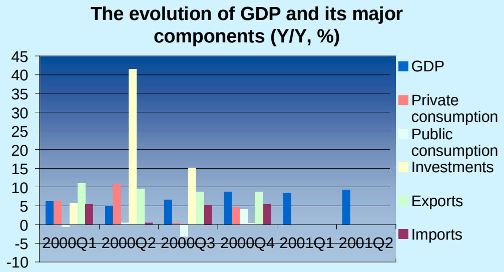


Chart 7.2.

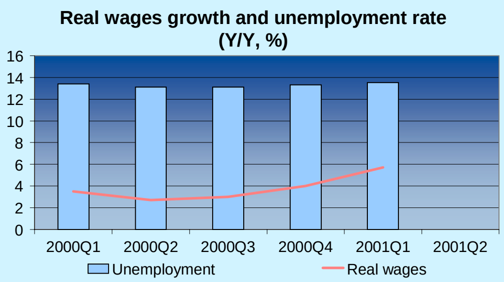
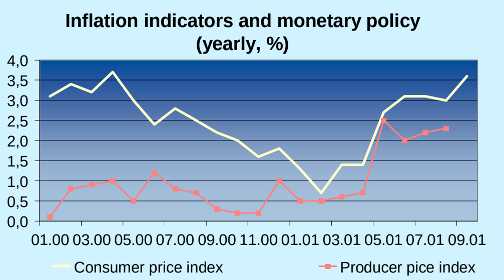


Chart 7.3.



for the first two quarters). In line with the sluggish external demand, the foreign balance has negative contribution to GDP growth, while total domestic demand is growing, though in a highly different structure. Investment activities remain relatively flat, while private consumption continues to grow at a steady rate of over 4%. Most interestingly, stockbuilding has positive contribution, in sharp contrast with last year's performance, when the decline in stocks amounted to 3.4%.

Supply side developments are rather promising as well, manufacturing and services being the most dynamic categories. Manufacturing industry, which has been slowing down markedly in the aftermath of the Russian crisis, has continued to grow rapidly, at a similar pace as last year (11%). The traditionally most important manufacturing areas (furniture making, wood processing, textiles and metal fabrication) all enjoyed higher than average growth rates. Transport, in particular transit trade, which has long been crucial for Latvia in terms of sectoral value added, as well as wholesale and retail trade recorded brisk upturn. In line with favorable supply side developments, unemployment rate decreased slightly in the first half of the year to a still critical level of 13.5%.

RISING INFLATIONARY PRESSURES

Inflation, as measured by the CPI, has decreased markedly in 2000. The strong currency, in line with the continuous appreciation of the dollar, has largely contributed to weakening inflationary pressures via moderating import prices, and this effect has more than offset the rise in imported fuel prices. However, this year the trend seems to have returned, as both consumer and producer prices were accelerating considerably during the course of the year. Most of the acceleration of headline inflation was due to exogenous factors, such as continuing high fuel and increasing food prices, as well as cross-movements in the USD/EUR exchange rate. Still, the boost in domestic demand exerts upward pressure on costs of housing services. The expected depreciation of the dollar will also have negative impact on the inflationary outlook.

Table 7.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	0,6	0,6	0,6	0,6
Consumer price index (average, %)	4,5	2,4	2,6	3,4
Producer price index (average, %)	1,9	-3,9	0,6	1,1
Broad money growth (dec/dec, %)	6,0	8,0	28,0	27,0
Real broad money growth (dec/dec, %)	1,2	5,0	26,2	22,2
Domestic credit growth (dec/dec, %)	59,0	15,0	37,0	29,0
Real domestic credit growth (dec/dec, %)	54,0	14,0	36,0	26,9
Nominal interest rates (3 month TBs, %)	7,9	5,1	4,5	5,0

Chart 7.4.

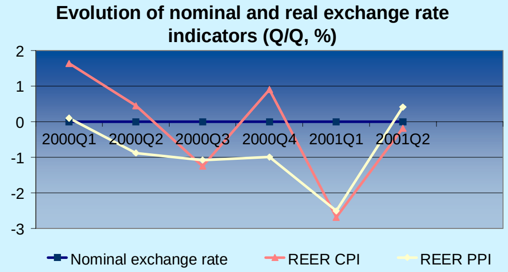
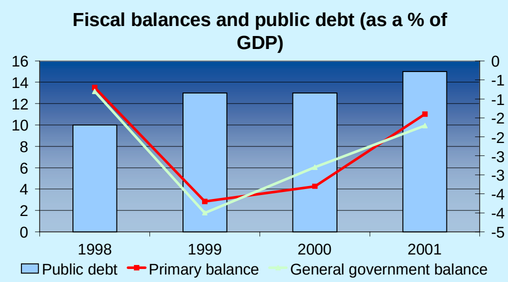


Chart 7.5.



STABLE MONETARY CONDITIONS, THE PEGGED EXCHANGE RATE CAN BE MAINTAINED

Similarly to the other two Baltic states, Latvia has pegged its national currency, the lat to a reference currency. The latter is the IMF's currency basket, the SDR (Special Drawing Rights), thus Latvia has, since 1994. a quasi currency board regime. Under the given monetary policy framework, the Bank of Latvia (BOL) has several policy tools at its disposition, though their use remain limited (the refinancing rate has last been modified in March 2000). Thus, capital movements affect the level of liquidity in the banking sector relatively freely. Still, the Lat has been stable and is projected to remain, as despite the widening current account deficit, the BOL has sufficient foreign-currency reserves to cover the monetary base, as capital inflows continue. This state-of-affairs reduces significantly the speculative pressures on the lat.

Moreover, in the absence of speculative pressures on the exchange rate, broad money has continued to grow at a healthy rate of around 25% this year. Monetary developments reflect both the deepening of the financial markets and increased confidence in the economy (indicated by, among others, boosting retail sales). More importantly, credits to the private sector remain robust after the annual growth rate of 37% in 2000, though the levels are still low. At the same time, deposits to the banking sector are increasing even more rapidly, which indicates that the strengthening of the financial sector, in line with improvements in the regulatory framework, is proceeding.

EU DEMANDS AND SOCIAL REFORMS PUT MUCH PRESSURE ON PUBLIC EXPENDITURE

The Latvian fiscal policy is closely watched by the "outside anchor" institutions, mostly by the IMF. In 2000, the general government deficit, though decreasing, has been 1.25 percentage point higher, than the ceiling under the previous stand-by agreement with the Fund, which resulted in a non-observance of the fiscal performance criteria. Similar developments are foreseen for the next year, as the IMF stand-by program requires the consolidated deficit to reach no more than 1% of GDP, while the preliminary budget accepted by the Latvian government projects a deficit amounting to 2.8% of GDP.

The government argues that EU accession, as well as the additional expenditures related to NATO membership will put much pressure on public spending. Implementing the requested EU standards, particularly in the area of environmental protection, will definitely be translated to extra, though inevitable costs. Moreover, as the first country among the Baltics, Latvia has introduced a pension reform, which is changing the pay-as-you-go system to a three-pillar pension system. The reform, while definitely benign on the long run, will have a negative short-term impact on the budgetary balance, as an increasing share of contributions are directed to a mandatory pension fund, and thus reducing Social Security revenues.

The general government budget for 2001 has envisaged a deficit of 1.75% of GDP in line with the IMF target. Though, the deficit target has been raised to 1.8% of the GDP in June, it is still most likely that the final figure will not be higher than the IMF ceiling. Although the budget does not take into account the impact of amendments to the pension law, it is widely accepted that the revenue assumptions were made on a very conservative basis. (The projected increase in tax receipts is slower than the nominal GDP growth.) Moreover, the end-June deficit figure was better than the time-proportional one, and thus fell below the deficit ceiling set by the IMF.

WORSENING EXTERNAL PERFORMANCE

In line with the deterioration of external conditions, Latvian exports decelerated markedly during 2001. Though, the slowdown was not as pronounced as previously expected. While exports to the EU were growing at a much more moderate rate, the increase in value of exports was still up by almost 10%. This indicates a slight change in the structure of export destination, the robust growth in the domestic demand of the CIS countries, as well as other transition economies resulted in an increase of non-EU countries share in Latvian exports. This, together with the fact that Latvian companies could expand export sales despite the strengthening national currency, is a promising sign for international competitiveness.

Though, imports picked up rather strongly this year. The upturn in import demand reflects the boost in private consumption, and the need for capital inputs. The increased demand for inputs, though has negative impact on the external balance on the short run, represents a channel for technology transfer, and has positive implications on quality competitiveness in the longer term.

The merchandise trade balance reached 10% of the GDP in the first quarter, down from an annual figure of 15% in 2000. In the second quarter the balance has widened further, though still remained below the corresponding level of last year. The rising gap between export and import volumes was partly offset by more favorable terms-of-trade developments, as the import unit values remained more subdued than in the previous year due to slightly moderating fuel prices. Other elements of the current account developed in line with both expectations and last year’s figures.

The financial account continues to cover most of the current account deficit, as foreign direct investment remains

Table 7.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-10,6*	*-9,7*	*-6,9*	*-6,3*
Trade balance/GDP	*-18,6*	*-15,4*	*-15,0*	*-14,5*
Export growth	*9,4*	*-6,1*	*9,4*	*11,7*
Import growth	*17,0*	*-7,2*	*7,5*	*9,3*

Chart 7.6.

The current account and its components (mln USD)

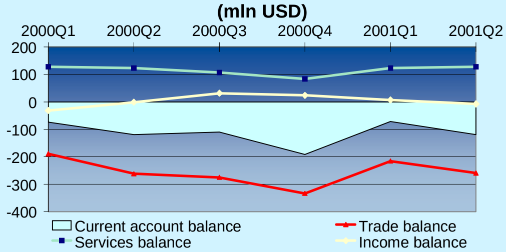


Table 7.4.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	*-10,6*	*-9,7*	*-6,9*	*-6,3*
Financial account/GDP	*9,8*	*12,0*	*7,1*	*7,5*
Net FDI/GDP	*4,7*	*5,0*	*5,6*	*5,5*

Chart 7.7.

The financial account and its components (mln USD)

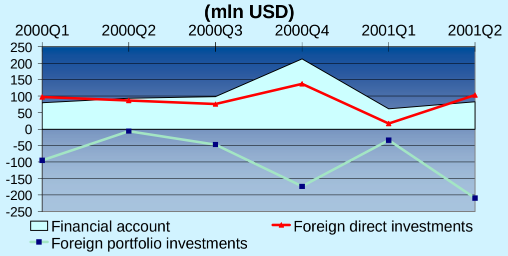


Table 7.5.

The evolution of foreign indebtedness indicators (%)	1998	1999	2000	2001
Gross foreign debt/GDP	50,9	57,8	63,5	65,0
Short-term foreign debt/GDP	27,9	31,2	35,3	32,4
Short-term foreign debt/	55,0	54,0	55,6	49,9
Debt/Exports	92,5	132,0	138,6	135,4
Debt-service ratio	6,0	15,0	10,4	8,8
Reserves/GDP	12,7	15,9	13,0	12,6

Table 7.6.

The financial vulnerability indicators between 1998 and 2001 (%)	1998	1999	2000	2001
General government balance/ GDP	-0,8	-4,0	-2,8	-1,7
Current account/GDP	-10,6	-9,7	-6,9	-6,3
Short-term foreign debt/GDP	27,9	31,2	35,3	32,4
Short-term foreign debt/ Total foreign debt	55,0	54,0	55,6	49,9
M2/Reserves	145,8	181,0	226,0	240,0
Foreign currency liabilities/ total liabilities of the banking sector	45,0	36,5	42,2	37,8

Table 7.7.

Major underlying and expected macroeconomic indicators	2000	2001*	2002**
GDP (%)	6,6	7,2	5,5
-Private consumption (%)	5,6	4,0	4,9
-Public consumption (%)	-2,9	1,0	1,0
-Investments (%)	10,8	8,2	7,3
-Export (%)	12,8	9,0	9,5
-Import (%)	4,8	6,3	7,7
Consumer price index (average, %)	2,6	3,4	3,8
Consumer price index (dec/dec, %))	1,8	4,8	3,1
Unemployment ratio (%)	14,4	13,3	13,0
General government balance (%)	-2,8	-1,7	-1,0
Public debt/GDP (%)	13,0	15,0	15,0
Current account (bn USD)	-0,5	-0,5	-0,5
Current account/GDP (%)	-6,9	-6,3	-5,8
Trade balance (bn USD)	-1,1	-1,1	-1,2
Trade balance/GDP (%)	-15,0	-14,5	-14,1
FDI, net (% of GDP)	5,6	5,5	5,0
Gross foreign debt/GDP (%)	63,5	65,0	65,0

strong, although the World Bank has expressed dissatisfaction with Latvia's progress in privatization. Still, more attractive privatization projects are offered with the projected sale of a 39% stake in the country's major oil terminal in the near future. The steady net outflow of portfolio investment continues, as – given the relatively low interest rate differentials – depositors continue to invest abroad.

GOOD GROWTH PROSPECTS FOR 2002

In line with the projected pick-up of global economy, the external environment will support growth in the small and open Latvian economy next year. The foreign balance is expected to have increasingly positive contribution to GDP growth, while the domestic demand components should continue to grow as well. With steady output growth, employment is forecasted to increase, though the stubbornly high unemployment ratio still indicates serious structural problems.

Inflation is projected to remain moderate, although it will still outpace the reference EU levels. As in the case of other transition economies, Latvia still has to adjust domestic prices to international levels, as non-tradable prices lag excessively behind Western standards. The currency could remain stable during the forecasted period, as the likelihood of a successful speculative attack remains limited.

Balance indicators, both budgetary and external are more concerning. Under the fixed exchange rate regime, the fiscal policy should remain especially prudent to limit negative impacts of external shocks, given the large current account deficit. As the latter is unlikely to be reduced in the short run (due to the need of technology-intensive inputs to production), fiscal stance should be tightened, and we expect fiscal policy to become more prudent.

8. LITHUANIA

STRONG REBOUND OF ECONOMY, BUT DEEP CONCERNS ABOUT UNEMPLOYMENT

After the external shock of 1998-1999, although later than its Baltic neighbors, Lithuania has managed to return to the fast economic growth track. Monetary policy based on the currency board arrangement and tight fiscal policy created a stable macroeconomic policy framework for long-term sustainable economic development. Structural changes have been speeded up and privatization is nearly over.

The pick-up in economic growth is mainly driven by increase of exports, but there is a gradual recovery of domestic demand as well. The surplus on service balance has been growing fast through increased exports of trade, financing and communication services. Trade and current account deficits have been gradually shrinking, meanwhile foreign direct investment finances an increasing part of the current account. Consumer price inflation has remained extremely low, but labor market problems are hardly moderating.

The re-pegging of the national currency, the Litas to the Euro from 2002 is supported by international institutions, and reflects a desire of stronger integration with the European Union. Despite the recent change in government, economic and foreign policy measures are expected to continue, as membership in the EU and NATO remain priorities. Unfavorable world economic conditions will not necessarily cause a deceleration in the Lithuanian growth, as the slowdown in Western European import demand will likely be offset by a rebound in the economies in the Commonwealth of Independent States and a rise in domestic demand.

GOVERNMENT OF TECHNOCRATS HAS BEEN INSTALLED, CONSENSUS ON STATE POLICY GOALS REMAIN UNCHANGED

As former prime minister Rolandas Paksas resigned on June 20, the New Policy bloc coalition government collapsed. Disagreements on privatization of the energy sector as well as on reform of taxes, agriculture and pensions were accompanied by personal rivalry between party leaders. Arturas Paulauskas, leader of the New Union-Social Liberals (NU), announced an establishment of a center-left coalition with the Social Democratic Party (SDP); and former president Algirdas Brazauskas, leader of the SDP was nominated as the new prime minister. The new government reaffirmed its commitment to pursuing rapid membership of NATO and EU. Technocrats were selected to key economic policy posts (finance and economy ministers), and the new government is

Table 8.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	*5,1*	*-4,2*	*3,9*	*4,7*
Private consumption	*n.a.*	*n.a.*	*2,9*	*3,8*
Public consumption	*n.a.*	*n.a.*	*n.a.*	*-*
Investments	*n.a.*	*n.a.*	*-9,3*	*5,8*
Export	*-2,9*	*-16,4*	*28,7*	*17,1*
Import	*1,8*	*-15,9*	*13,2*	*14,4*
GDP output	*5,1*	*-4,2*	*3,9*	*4,7*
Agriculture	*-2,6*	*-12,3*	*1,9*	*-6,5*
Industry	*6,2*	*-8,7*	*3,5*	*15,0*
Services	*5,4*	*2,1*	*4,2*	*2,5*

Chart 8.1.

The evolution of GDP and its major components (Y/Y, %)

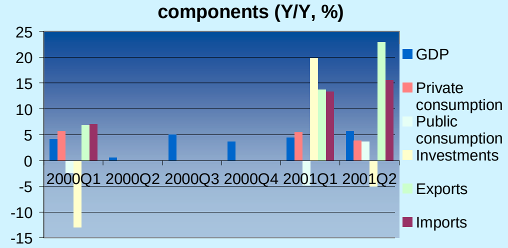
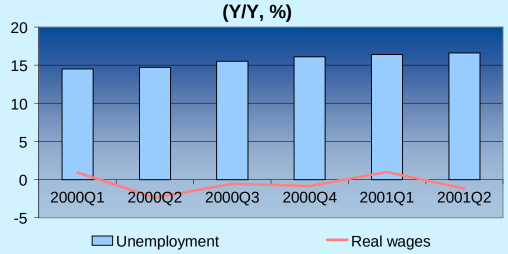


Chart 8.2.

Real wages growth and unemployment rate (Y/Y, %)



expected to continue similar economic policy than its predecessor.

ACCELERATION OF ECONOMIC GROWTH THANKS TO SUCCESSFUL RE-ORIENTATION OF EXPORTS

Due to adverse external changes and mishandling economic policy, Lithuanian real GDP dropped by 3.9 percent in 1999. The low profitability of the industrial sector caused a slower recovery from the negative impacts of the Russian crisis than in the other Baltic states. From the second half of 2000, the fast development of financial intermediation services, transportation, wholesale and retail trade sectors was the main source of the gradual economic rebound. While the appreciation of the Litas (pegged to the USD) compared to other European currencies damaged considerably Lithuania's export competitiveness, significant increase in labor productivity has offset it. In the second quarter of 2001 the pick-up in economic growth was driven by rising (23%) exports of goods and services. The overall GDP has accelerated in a spectacular way, and in the second quarter of 2001 it grew by 5.7%.

Booming foreign trade has been the main factor behind this new phase of prosperity, but consumption of households also increased markedly. Exports to the United Kingdom more than doubled, especially thanks to the buoyant inward processing of textile products; after Latvia, now the UK is the second most important export destination. However, fixed investments were down 5% compared to a year earlier, which indicates that the Lithuanian economy has still remained fragile and vulnerable by adverse effects of the international economy.

Industrial output rose 25% in the second quarter of this year; the largest growth was registered in oil refining, textiles and wood processing. Trade and real estate services, renting and business activities rose also markedly, but agricultural output declined by 9%.

Despite the recurrence of economic growth, the year of 2001 hasn't brought about improvement of labor market situation. The high and still increasing unemployment rate (16.6% according to International Labor Organization methodology) is determined by structural features: inappropriate qualification and limited mobility opportunities of labor force are the most important causes. Retraining programs are unavoidable to improve unskilled laborers qualification who are in desperate search for employment even in case of new job creation of foreign investors in manufacturing. Moreover, further labor market tensions can arise as Lithuania's potential membership in the European Union requires closing down the nuclear power plant at Ignalina, which is the largest employer of the country.

Chart 8.3.

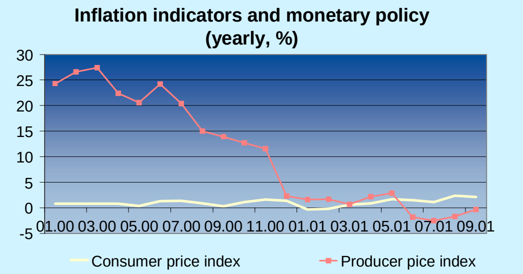
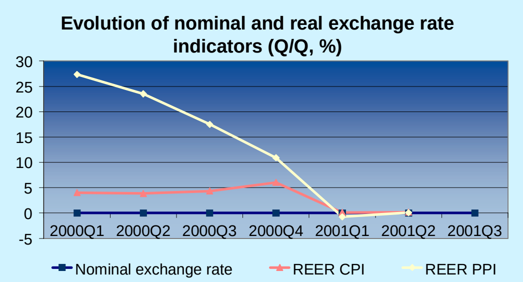


Table 8.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	*4,0*	*4,0*	*4,0*	*4,0*
Consumer price index (average, %)	*5,1*	*0,8*	*0,9*	*2,3*
Producer price index (average, %)	*-3,9*	*3,0*	*18,0*	*0,3*
Broad money growth (dec/dec, %)	*14,5*	*7,7*	*16,5*	*19,0*
Real broad money growth (dec/dec, %)	*16,9*	*13,8*	*-1,2*	*9,5*
Domestic credit growth (dec/dec, %)	*n.a.*	*6,3*	*3,6*	*3,5*
Real domestic credit growth (dec/dec, %)	*n.a.*	*n.a.*	*n.a.*	*-*
Nominal interest rates (3 month TBs, %)	*n.a.*	*n.a.*	*n.a.*	*-*

Chart 8.4.



AFTER A STRONG PERIOD OF DISINFLATION, MODERATE PRICE INCREASE IS EXPECTED

Inflation rates in recent years have been the lowest ever. The slowdown of increase in consumer prices was based on two factors: the appreciation of US Dollar against the Euro and the declining demand for food products on Eastern markets. Consumer price index in Lithuania has remained very moderate throughout the year of 2001; without the influence of higher food prices, inflation has been practically nonexistent. However, gradual deregulation of state administered prices – electricity, gas, hot water supply, heating and transport prices, which together account for 20 percent of the current CPI basket – as well as adaptation of excise rates on fuels and tobacco according to EU pre-accession requirements will boost consumer price level in the following years.

On the other hand, imported inflation will remain subdued thanks to the currency board arrangement and moderate fuel prices. The elimination of barriers for entrance has created a more competitive market environment, therefore pass-through of lower import prices will be pushing the CPI level down. These impacts have already been reflected in the decrease of producer prices from June 2001, which means that average CPI will likely be maintained within the upper limit of 3 percent.

CURRENCY BOARD ARRANGEMENT REMAIN UNCHANGED, BUT LITAS WILL BE REPEGGED TO THE EURO

Application of currency board arrangement (CBA) played an essential role in the stabilization of the Lithuanian economy. Pegging the national currency, the Litas to the US Dollar while introducing a currency board, had essentially contributed to bringing the former hyperinflation under control. The LTL/USD exchange rate was maintained stable even in the most critical periods of the last two years, when the negative impacts of the Russian crisis were followed by the strong appreciation of US Dollar against the Euro, which temporarily undermined international competitiveness of Lithuanian firms. The CBA is considered to anchor macroeconomic policies: providing a stable monetary framework, helping to keep inflation low and bolstering confidence.

As of February 2, 2002, while maintaining the currency board arrangement, the Litas will be repegged to the Euro, without any devaluation or revaluation. This switch is consistent with the progressive orientation of Lithuanian trade towards the Euro zone and is supported by the IMF as well. The adopted monetary policy framework has contributed basically to the relative long-term price stability, and besides cutting the consumer price inflation it also helped in declining interest rates.

FISCAL RESTRAINT IS THE CORNERSTONE OF THE ECONOMIC POLICY

After rapidly increasing fiscal deficits in 1998-1999, budgetary policy tightened considerably. As a demand-containing consequence of the fiscal adjustment, the current account deficit shrank sharply as well. According to the plans of the Ministry of Finance, a further gradual reduction of the general government budget deficit will result from the optimization of public expenditures. Continuing structural reforms, first of all costs of the pension reform together with a comprehensive tax reform and costs of preparation to EU and NATO membership require spending cuts and reallocation.

In the first half of 2001, general government budget revenues were 0.7% below projections. Although the finance minister announced that the government could slightly surpass its fiscal deficit target of 1,4% of GDP, we believe that original target can be completed thanks to stronger than expected economic buoyancy and strengthening expenditure control. Financing needs should be met comfortably as access to international capital markets has been changing in a favorable way, while domestic market for government securities is deepening.

SHRINKING EXTERNAL DEFICITS

Unlike most transition economies, Lithuanian exports have accelerated in the second quarter of 2001. The value of exports for the first half was up 25% year-on-year, and the trade deficit was down about 10%. Mineral products, particularly oil registered the highest export growth (54%), but key product groups such as textile production as well as machinery and equipment expanded also steadily. Diminishing trade deficit resulted shrinking current account deficit: as a percentage of GDP, from 6.1% of 2000 to 4.6%. Surplus of services increased slightly as well.

Chart 8.5.

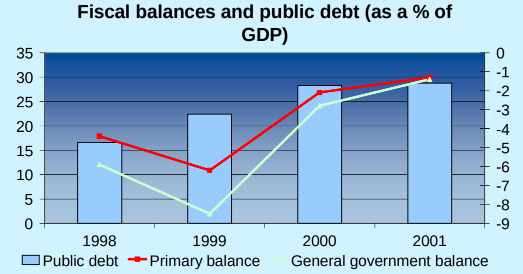


Table 8.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-12,1*	*-11,2*	*-6,0*	*-6,2*
Trade balance/GDP	*-23,5*	*-24,0*	*-14,7*	*-14,2*
Export growth	*-2,9*	*-16,4*	*28,7*	*17,1*
Import growth	*1,8*	*-15,9*	*13,2*	*14,4*

Chart 8.6.

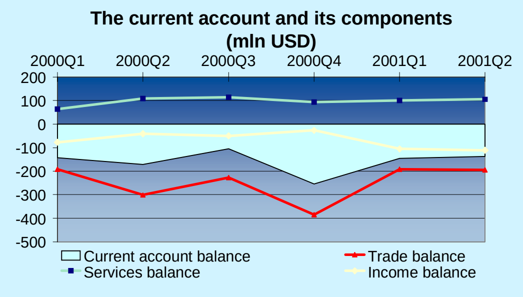


Table 8.4.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	-12,1	-11,2	-6,0	-6,2
Financial account/GDP	13,4	10,0	4,9	6,0
FDI/GDP	8,6	4,5	3,3	4,5

Chart 8.7.

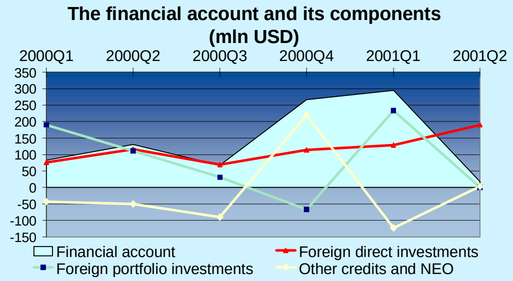


Table 8.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	34,8	42,4	43,2	44,8
Short-term foreign debt/GDP	16,1	17,8	14,3	14,3
Short-term foreign debt/	46,3	42,0	33,1	31,9
Debt/Exports	94,4	127,7	119,9	121,4
Debt-service ratio	18,3	20,0	20,9	13,5
Reserves/GDP	13,6	11,7	12,1	12,4

Table 8.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-5,9	-8,5	-2,8	-1,4
Current account/GDP	-12,1	-11,2	-6,0	-6,2
Short-term foreign debt/GDP	16,1	15,6	16,6	14,3
Short-term foreign debt/ Total foreign debt	46,3	36,6	37,1	31,9
M2/Reserves	142,6	180,6	192,4	188,0
Foreign currency liabilities/ total liabilities of the banking sector	45,9	41,0	37,9	35,5

As privatization of remaining firms has markedly speeded up, foreign direct investment inflow will almost entirely cover this year current account deficit. The privatization of Taupomasis Bankas (Lithuanian Savings Bank) and the investment into LISCO (Lithuanian Shipping Company) will be followed by selling gas company Lietuvos Dujos and Lietuvos Zemes Ukio Bankas (Lithuanian Bank of Agriculture).

Looking at the foreign debt indicators, Lithuania can be regarded as modestly indebted economy, while however the share of short-term debt in total foreign debt and in relation to GDP is high similarly to other Baltic economies. Notwithstanding that there has been a gradual improvement of the major vulnerability indicators, a trend which seems to continue in 2001 as all analyzed indicators improve, except the basically unchanged current account balance.

Table 8.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	3,9	4,7	5,2
-Private consumption (%)	2,9	3,8	3,7
-Public consumption (%)	n.a.	n.a.	-
-Investments (%)	-9,3	5,8	7,2
-Export (%)	28,7	17,1	11,0
-Import (%)	13,2	14,4	9,5
Consumer price index (average, %)	0,9	2,3	3,0
Consumer price index (dec/dec, %))	1,4	2,4	2,3
Unemployment ratio (%)	16,1	16,5	16,0
General government balance (%)	-2,8	-1,4	-1,3
Public debt/GDP (%)	28,3	28,8	27,4
Current account (bn USD)	-0,7	-0,7	-0,7
Current account/GDP (%)	-6,0	-6,2	-5,9
Trade balance (bn USD)	-1,7	-1,6	-1,6
Trade balance/GDP (%)	-14,7	-14,2	-13,2
FDI (bn USD)	3,3	4,5	4,5
Gross foreign debt/GDP (%)	43,2	44,8	44,8

STABLE GROWTH PROSPECTS WITHOUT THREAT OF INCREASING IMBALANCES

Compared to the acceleration in the first half of 2001, GDP growth is expected to slowdown somewhat in the remaining part of the year, but we forecast a new rebound in 2002. Growth of domestic components, both consumption and investment will be stabilized, and growth of exports will slightly outpace imports. However, a moderate increase in the current account deficit is forecasted, but it will remain on a sustainable level, and will be covered in increasing part by non-debt creating capital inflow. Despite robust economic performance, given its basically structural nature, unemployment rate will remain alarmingly high, causing deep economic and social concerns.

Consumer prices will increase moderately, as gradual deregulation of state administered prices will be completed. Changes in the currency board arrangement are very unlikely until joining the EMU. Concerning fiscal issues, we expect that the government will maintain a prudent fiscal stance while leaving room for financing expenditure priorities related to requirement of membership in EU and NATO. Briefly, we expect that Lithuania's macroeconomic indicators will slightly improve further in 2002, despite assumption about unfavorable environment of world economy.

9. POLAND

SLOWER GROWTH AND FISCAL PROBLEMS

After eight years of fast growth, in the last twelve month the Polish economy had to face new challenges. Growth decelerated firmly as domestic demand lost impulse, unemployment rose to 16%, and increasing fiscal deficit demands for adjustment. At the same time the appreciating currency did not cause concerns for export growth and trade balance. Furthermore, capital inflows have been still high, although their structure changed, as foreign direct investments decreased and portfolio inflows increased due to high interest rate differential. According to the results of the recent elections the left-wing Democratic Left Alliance will be the determinant force of the new government.

SOCIALISTS WON THE ELECTIONS

The elections at the end of September resulted in a new coalition led by the Democratic Left Alliance, which received 46% of votes. As the party is strongly committed to the EU-accession and market economy, radical change in the policy stance is not expected. Regarding economic policy, an adjustment package is planned to deal with fiscal deficit. The extent of the fiscal problems envisages further privatization. We expect that the coalition partner will be the populist and pro-farmer Peasant's Party, which may hinder the necessary acceleration of negotiations on EU-accession and the introduction of austerity measures, leading to delayed solution of current economic problems.

Elections in Poland and EU-enlargement

The Polish parliamentary elections on 23rd of September led to unexpected results in some extent. Although no one was surprised that the Democratic Left Alliance (DLA), led by Leszek Miller, won the elections, most of opinion polls suggested that they would get the absolute majority of the votes. Since they received only 46% of the seats in Parliament, they won't be able to form the first one-party government of the new Polish democracy. However, forming the coalition is not easy. Regarding only their program, their natural partner would be the Civic Platform under Anrzej Olechowski, but they are the natural opposition in parliament. Most probably the Peasant's Party (PP) will join the DLA, which took nearly 10% of the votes. The problem is that they have formed a coalition together once already, and their cooperation was full of tensions.

Another surprise was that the extreme parties received high support. The xenophobic and eurosceptic party of Andrzej Lepper (called Self-Defense) got more than 10%, the populist Law and Justice Party, which supports the return to death penalty got nearly 10%, while the ultra-nationalist and often anti-Semitic League for Polish Families almost 8%. The league claims that the EU is the "civilization of death", because of its policy on abortion and euthanasia.

Finally, the Solidarity, the former governing party was not able to take even 6% percent, which would have been necessary to stay in the Parliament. This was a clear consequence of the series of economic policy errors during their term, and corruption scandals during the Summer.

An important task of the new government will be the fastening of the negotiations on EU-accession. The negotiations went so slow during the last year that they have raised the possibility that Poland may not enter the EU with other first-round countries, despite the political support by Germany. At the same time PP is a populist pro-farmer party, so if their presence in the government will certainly make the negotiations on EU-accession more difficult, as one of the key issues is the cut of the generous agricultural subsidies of the EU by the time of the enlargement. The eurosceptic opposition may also lead to problems.

Table 9.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	4,8	4,1	4,1	2,0
Private consumption	4,9	5,4	2,0	3,0
Public consumption	1,4	1,0	1,5	3,2
Investments	14,5	6,6	3,3	1,5
Export	17,2	-0,6	4,6	7,6
Import	10,4	-8,1	14,9	8,5
GDP output	n.a.	n.a.	n.a.	-
Agriculture	0,0	-4,0	-5,0	-2,5
Industry	4,9	4,7	6,8	3,5
Services	n.a.	n.a.	n.a.	-

Chart 9.1.

The evolution of GDP and its major components (Y/Y, %)

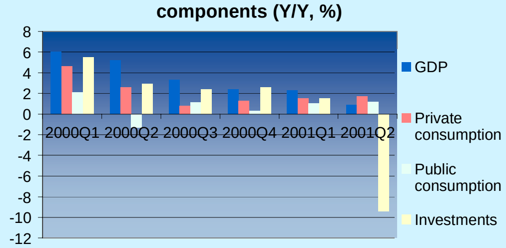
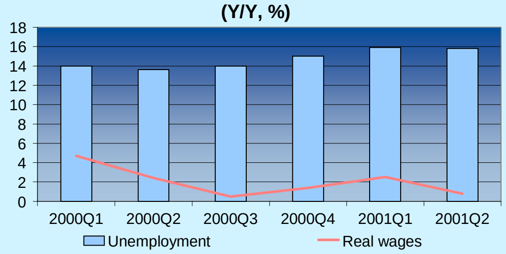


Chart 9.2.

Real wages growth and unemployment rate (Y/Y, %)



STRICT MONETARY POLICY BEHIND DECELERATING GROWTH

Poland experienced a definite slow-down in output growth during the last year. While since middle of 1992 growth rate was within the 4-7% range, the year-by-year growth in the last quarter of 2000 was only 2.4% and it remained at the same level in the first quarter of this year. In this period Poland was almost the only country in the region – apart from Russia – with decelerating growth performance. The main reason of this has been the slackening domestic demand.

The causes of the decreasing domestic demand and especially private consumption and investment were twofold. One was the restrictive monetary policy of the National Bank of Poland (NBP), and in that respect the slowdown reflects the high sacrifice ratio of disinflation. On the other hand, growth of private incomes significantly declined due to increasing unemployment and slower wage growth. On the supply side, the level of construction output declined, while the manufacturing sector experienced a lower rate of growth. Only agricultural growth rate increased.

In contrast with the unfavorable changes in the international climate, net exports performed well notwithstanding the currency appreciation. As Poland is relatively closed compared to other advanced transition economies, and the productivity growth is still high, the country is less sensitive to the weakening of foreign demand. However, we expect that the slower growth in the EU and the recession in the USA will affect adversely the Polish economy in the near future.

In the last year the unemployment ratio started to increase again and it is still rising. As in the first quarter of this year it reached 16%, it is undoubtedly one of the major economic problems that the new government has to face. The rise was due to structural changes in the corporate sector which were partially related to the restructuring that followed recent rounds of privatization, and to the expiration of guarantees given to earlier privatized companies. Furthermore, the sharp nominal appreciation of the Polish Zloty (PZL) in the first half of the year crowded out import competing industries and sectors.

SUCCESSFUL DISINFLATION

Poland has experienced sharp disinflation since the second half of the last year. Both CPI and PPI declined significantly. CPI may decline below 6.5% by the end of the year from over 10% in third quarter of 2000. Disinflation is an outcome of various simultaneous factors. First of all, the restrictive monetary policy of the NBP had a strong effect on price

Chart 9.3.

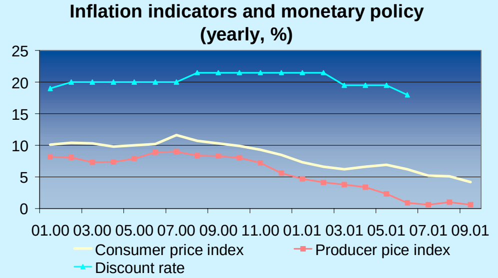
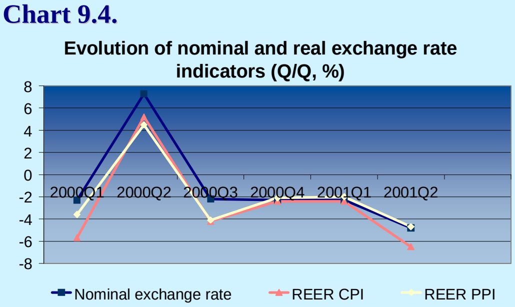


Table 9.2.

Evolution of monetary conditions	1998	1999	2000	2001
Average USD exchange rate	3,5	4,1	4,3	4,1
Consumer price index (average, %)	11,6	7,2	10,1	6,5
Producer price index (average, %)	7,3	5,7	7,8	3,5
Broad money growth (dec/dec, %)	25,9	23,2	15,1	13,5
Real broad money growth (dec/dec, %)	12,8	14,9	4,5	6,5
Domestic credit growth (dec/dec, %)	21,9	20,5	7,2	7,5
Real domestic credit growth (dec/dec, %)	13,6	14,0	-0,6	3,8
Nominal interest rates (3 month TBs, %)	13,6	16,2	16,8	15,5

Chart 9.4.



monetary policy of the NBP had a strong effect on price increases. While nominal and real interest rates have for long period been much higher in Poland than elsewhere in Central-Eastern-Europe, the central bank tightened further its policy to combat the persistent moderate inflation, and to bring it in line with plans laid down in the medium-term monetary strategy. Second, declining aggregate demand and moderating wage increases affected prices in the same direction.. Finally, cost pressures declined too, as the Polish currency strengthened considerably during the first half of the year and oil prices dropped. Simultaneously, it has to be considered that seasonal factors contributed to disinflation too: therefore inflation may increase in the forth quarter of this year.

A remarkable feature of the Polish disinflation of the last year is that it was achieved with very high interest rates, which had strong adverse effects on economic activity. From that point the Polish development is a textbook-case of high sacrifice ratio of disinflation: inflation was reduced at the expense of sharply increasing unemployment and decelerating GDP growth.

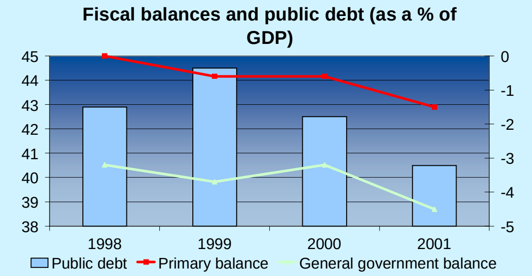
SIZEABLE APPRECIATION IN THE FLOATING REGIME

As mentioned above, since the end of 1999, the National Bank of Poland conducted an extremely restrictive monetary policy. Discount rate peaked at 21,5%, which led to the highest real interest rate level in the region, and the slowest domestic credit growth. The motivation of the NBP was to fight the persistent inflation and to counterbalance fiscal policy, considered to be too expansive. Interest rates were cut three times in the first half of the year, leading to a 450 basis point decrease altogether. However, monetary policy remained restrictive and further cuts may be necessary. In the first half of this year average real interest rates on loans were 12%, while on deposits about 6%.

Nominal exchange rate appreciated firmly until July both against the USD and the Euro. The main reasons behind this were the high portfolio investment inflows due to interest rate differential, and the decreased, but still high FDI inflows. Nominal appreciation was accompanied by real appreciation both on CPI and PPI bases. As inflation decreased almost to 6 percent, the real appreciation was mainly the consequence of nominal effective exchange rate appreciation, and not the differences in foreign and domestic inflation rates.

At the beginning of July a sharp crises-like correction occurred, and the exchange rate of PZL dropped by almost 15 percent within one week. Having in mind that all the floating currencies in the region have depreciated at that time, the contagion effect of the Argentinean crises and the consequence of increasing risk sensitivity of the foreign investors are clear. Still, the drop of the Zloty was the sharpest in the region, which is certainly connected with the relatively high current account deficit and budgetary problems. Although nominal exchange rate against the Euro has not recovered yet to its pre-crisis level, we expect that after the new government is established and the first elements of the austerity package are introduced, the Zloty will start to strengthen again.

Chart 9.5.

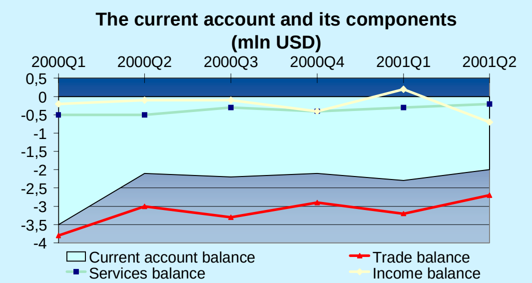


PROBLEMS WITH THE BUDGET

Budget deficit was higher than planed already in 1999 and 2000, even though it remained in the reasonable range of 3-4%. However, by May 2001 the government has reached 100% of the deficit planed for the whole year. We can identify four factors, which contributed to this unfavorable outcome. First, the slower growth and lower inflation led to smaller than expected tax revenues. Second, privatization revenues lagged behind the plans as the third-phase of the sale of the major telecommunication company brought much less revenues than expected. Third, there are expenditure problems related to structural reforms, as education and pension reforms were more costly than planned. Finally, higher interest rates made deficit financing more costly and increased further interest rate expenditures.

These factors together forced the Minister of Finance to announce in August that deficit could reach 11% of the GDP in 2002 without any adjustment. Austerity measures are planned by the new government in order to keep fiscal balances controlled.

Chart 9.6.



IMPROVING TRADE BALANCE, DECREASING FDI

Current account balance improved in the first quarter of 2001 compared to the same period of the last year. This improvement was driven by the declining trade deficit. Increasing productivity and a shift from the domestic markets to foreign ones explain that exports increased despite the slowing growth in the European Union and appreciating PZL. Imports decreased due to slackening domestic demand and improvement of terms of trade. In the second quarter, trade balance slightly worsened, as both exports and imports decreased compared to the first quarter. At the same time the indicators were still more favorable if compared with the same period of 2000.

Regarding the regional distribution of trade, exports were growing towards Germany and EU, and to the CIS too, as output and import demand was recovering there. However, the overall deficit of the current account is still high and worsening is likely, when the effect of the European slow-down reaches fully the Polish economy.

Table 9.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-4,3*	*-7,5*	*-6,1*	*-5,1*
Trade balance/GDP	*-8,7*	*-9,3*	*-8,2*	*-7,0*
Export growth	*10,4*	*-8,1*	*14,9*	*7,6*
Import growth	*17,2*	*-0,6*	*4,6*	*10,0*

In the financial account, the non-debt-generating inflows were still high in the first half of the year, although the

Table 9.4.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	-4,3	-7,5	-6,1	-5,1
Financial account/GDP	6,9	5,4	4,9	6,0
FDI/GDP	5,1	2,4	3,8	3,3

Chart 9.7.

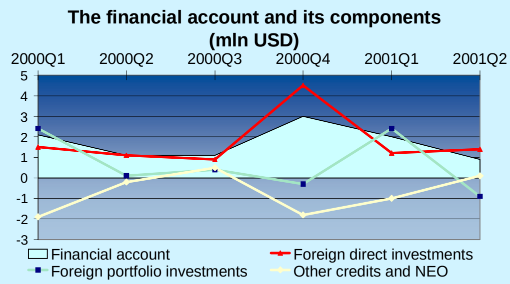


Table 9.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	37,3	42,5	40,3	40,0
Short-term foreign debt/GDP	5,3	6,9	6,7	5,3
Short-term foreign debt/	14,2	16,3	16,6	13,2
Debt/Exports	193,3	241,4	227,9	219,5
Debt-service ratio	17,9	17,8	17,1	15,8
Reserves/GDP	n.a.	n.a.	n.a.	-

Table 9.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-3,2	-3,7	-3,2	-4,5
Current account/GDP	-4,3	-7,5	-6,1	-5,1
Short-term foreign debt/GDP	5,3	6,9	6,7	5,3
Short-term foreign debt/ Total foreign debt	14,2	16,3	16,6	13,2
M2/Reserves	229,2	237,9	221,3	245,5
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

structure changed. Foreign investors postponed significant FDI-s waiting for the results of elections, while foreign portfolio investment increased due to the high interest rate differentials. In contrast to the expectations, the introduction of the floating exchange regime did not reduce the inflow of hot money to the country, causing further problems for monetary authorities.

IMPROVING FOREIGN DEBT AND VULNERABILITY INDICATORS

The major indicators of foreign indebtedness didn't change significantly in the last years and reflect favorable net foreign position. Gross foreign debt to GDP is moderate, while the share of short-term debt both in total and in GDP is low by international standards. The central bank is also in favorable position concerning the growth of reserves, which have increased sizably following the significant net capital inflows and conversion by the monetary authorities. Reserves currently cover almost 8 months of imports and they are high in relation to GDP too.

Looking at the major vulnerability indicators, their further improvement is likely with the exception of fiscal balance, and currently Poland with all difficulties may be regarded as a country, which is outside the red zone of financial vulnerability.

BOND MARKETS AFFECTED BY POLITICAL AND ECONOMIC UNCERTAINTY

Bond market prices have been heavily influenced for several months by political and economic problems. Between early July and mid August the yield curve flattened significantly due to uncertainties with economic policy. Price of T-bonds decreased as a clear consequence of growing fiscal concerns of the market and expectations of higher than planned issues in the last quarter of 2001. Conversely, in September all bonds strengthened firmly, because of the increasing hopes of electoral victory of SDL and fast and efficient introduction of an adjustment package as its result.

As further interest rate-cuts are not expected in this year and a radical change in exchange rate developments is also unlikely, most probably the political developments will determine the yields in the bond market until the end of the year. The role of fiscal correction for bond market development is essential, as this is the only way to keep the inflation in track, to make further interest rate cuts possible and not to increase excessively the supply of T-bonds. If the new government is able to fulfill the expectations and make strict measures to keep the 2002 budget deficit at an acceptable level, than the inverted nature of the yield curve will increase. The present high yield on long-maturity bonds will decline as a result of low inflation, relatively weak PZL and substantial bond supply.

GRADUAL RECOVERY WITH MANAGEABLE INTERNAL AND EXTERNAL IMBALANCES IN 2002

Table 9.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	4,1	2,0	2,5
-Private consumption (%)	2,0	3,0	3,0
-Public consumption (%)	1,5	3,2	0,5
-Investments (%)	3,3	1,5	3,5
-Export (%)	4,6	7,6	7,0
-Import (%)	14,9	8,5	7,0
Consumer price index (average, %)	10,1	6,5	5,2
Consumer price index (dec/dec, %))	8,5	5,5	4,5
Unemployment ratio (%)	15,0	17,5	17,0
General government balance (%)	-3,2	-4,5	-3,5
Public debt/GDP (%)	42,5	40,5	40,0
Current account (bn USD)	-9,9	-8,7	-9,2
Current account/GDP (%)	-6,1	-5,1	-5,1
Trade balance (bn USD)	-13,2	-11,9	-13,0
Trade balance/GDP (%)	-8,2	-7,0	-7,2
FDI (bn USD)	6,4	5,5	4,5
Gross foreign debt/GDP (%)	40,3	40,0	38,5

Next will be a difficult year for the Polish economy. After this years' very modest growth, GDP will recover only gradually in 2002, as three major factors restrain it from more rapid acceleration. First, the global conditions are worse than earlier expected and this will reduce the contribution of net exports to GDP. Second, sizeable fiscal adjustment is needed to avoid high fiscal imbalances and keep progress with meeting the Maastricht criteria. Fiscal adjustment in 2002 will definitely reduce the contribution of public sector to output growth. Finally, structural problems (high unemployment, persistently high real interest rates) will keep private consumption and investments from rising robustly. Altogether, this explains the expected growth of 2,5%, which may however mean gradually improving growth performance in the course of the year.

The mentioned fiscal adjustment will play a key role in avoiding a fiscal crisis, and reducing the deficit to a more manageable level. After the improvement of the trade and current account balances this year, their ratios to GDP are expected to remain unchanged in 2002, as both imports and exports could expand at the same rate. Both the current account and trade deficits could remain within the sustainability threshold level. On the other hand, Poland may expect slight decline in foreign direct investments as the major privatization related inflows took already place and some time is needed for further pick-up of greenfield investments. But FDI inflows will remain the highest in the region.

After substantial decline in 2001, further, albeit slower disinflation is expected for 2002, bringing the central bank increasingly closer to its medium term inflation target. In 2002 imported inflation will remain moderate, as no significant external pressures could be expected. Second, the central bank will maintain its tight disinflation policy, and will only gradually, in tandem with fiscal improvements, reduce nominal and real interest rate levels. Third, in 2002 no significant demand or cost push pressure is foreseen, which would undermine the speed and costs of disinflation.

Contrary to inflation, unemployment won't decline significantly, as slow growth, ongoing restructuring, labor market rigidities will keep it at very high, almost unchanged levels.

10. ROMANIA

The IMF mission chief in Romania announced in September that a stand-by arrangement has been reached for the period 2001-02. The Romanian government and the IMF staff have agreed on a program of macroeconomic policies and structural reforms. In order to stabilize the current account deficit and to reduce inflation, the government decided to tighten fiscal policy in the remaining period of 2001, and to target a fiscal consolidation of 0.5 percentage point of GDP in 2002, when the general government deficit will decline to 3 percent. There has been an agreement to address the financial performance of the public utilities and state-owned enterprises which remains one of the main structural problems of the economy. The agreed measures include the following: implementation of prudent wage policy in 2002, substantial improvement in the payment collection of the electricity, gas and heating utilities, and further adjustment in energy prices. The program includes measures to improve the legal and regulatory framework of the financial sector. The government's program for 2002 contains an ambitious schedule of privatization, including the largest state-owned firms and several utilities. In the banking sector the government has decided to give the highest priority to the privatization of the Romanian Commercial Bank (BCR). The stand-by loan may amount to USD 400 million. The agreement needs to be approved by the IMF management and the IMF Board.

ACCELERATING GROWTH WITH INCREASING IMBALANCES AND SLOW STRUCTURAL REFORMS

The Romanian economy got into a strong recovery stage after several years of decline. Economic growth is currently based on domestic demand that is reflected in big import growth. Inflation is decelerating, although it is still high. Fast growth has a negative effect on the trade balance. Macroeconomic stabilization is achieving some progress, although it should be underpinned with serious structural reforms. Privatization is still progressing slowly and there is no breakthrough in foreign capital inflows. The government is more unified than its predecessor in the implementation of the necessary reforms. International monetary organizations are more positively considering the Romanian developments. A new IMF stand-by arrangement is in the pipeline.

RELATIVE POLITICAL STABILITY

The ruling Party of Social Democracy will hold out as a minority government, even its popularity according to opinion polls has been rising and its self-confidence is strengthening due to certain improvements in general economic conditions. However, the government faces huge social and economic challenges, which require that it constraints his center-left political orientation and gives way to real market-based reforms. This may bring about some conflicts between the party's strongly socially oriented constituency and its new policy approach.

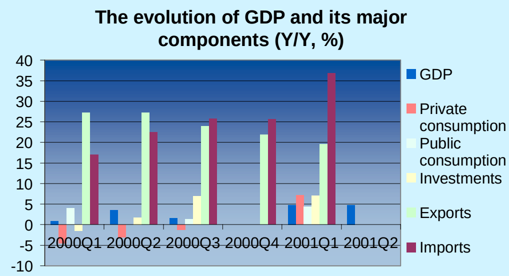
The Nastase-government has realized that the economic situation is not suitable to implement a full-fledged social-democratic program. Dire economic conditions force the government to accept some continuity with the previous Isarescu-government's reform policy. The former Prime Minister, Mugur Isarescu, who was a challenger to Ion Iliescu at the latest presidential election, took back his position as the Governor of the Romanian National Bank. Analysts forecasted clashes between the liberal central bank and the social-democratic government, but so far their cooperation seems fairly smooth. This does not mean a full agreement in all the measures. The government could not avoid implementing some income-boosting steps that led to a surge in consumer spending and kept financing state-owned loss-maker firms. The Social Democratic Party still enjoys the tacit support of the Hungarian Democratic Union in Romania (HDUR) which is in the opposition but in exchange for getting minority rights is ready to back the government's budget.

Table 10.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	-5,4	-3,2	1,6	4,4
Private consumption	-4,6	-4,9	-1,2	4,4
Public consumption	14,1	-2,4	4,2	3,2
Investments	-5,1	-10,8	5,5	10,0
Export	5,9	9,7	23,9	14,8
Import	14,3	-5,1	29,1	25,0
GDP output	-5,4	-3,2	1,6	4,4
Agriculture	-7,6	3,4	-5,8	2,9
Industry	-17,3	-8,7	8,2	9,0
Services	n.a.	-2,5	3,9	4,7

Chart 10.1.



HIGH GROWTH FUELLED BY EXPANDING DOMESTIC DEMAND

Following three consecutive years of decline (1997-1999) when the country went through the second transition crisis, the economy began to recover in 2000. The modest growth in 2000 was mainly driven by strong export activity: GDP increased in 2000 by 1.6% against previous year. Economic recovery accelerated in 2001. Romania is likely to approach 4-4.5 per cent rise in GDP, which could be one of the highest in the region. The government has just revised upwards its projection from 4.1 to 4.5% that could be slightly overoptimistic. Some caution is required since an artificial growth stimulus could be dangerous and the slowdown in the EU will inevitably affect the Romanian economic performance.

The estimated GDP growth for the first semester of 2001 was 4.9% in real terms, compared to the same period of 2000. The boom in growth was driven by the industry (+11.2%), constructions (+9.4%) and services (+2.3%). Gross value added from agriculture slightly declined. On the demand side, final consumption growth was mainly fuelled by the increase in household consumption (+7.6%). Gross fixed capital formation expanded also considerably (+6.7%). Investment to GDP ratio was 19% the same as in the first semester of 2000. Real average salary in July 2001 recorded 9.1% increase as against July 2000. Government was rather compliant in relation of public sector wages. In the first seven months, public sector pay rose 10 percent in real terms, compared with 7 per cent in the private sector. The government promises to have stricter spending controls in the future.

During the first seven months in 2001, industrial production increased by 10.8%. Within the industry manufacturing grew by 13.0%. Significant dynamism was recorded in industries with higher export share, such as electric appliances, machinery, clothing and furniture. In the same period, exports grew by 15.4% in dollar terms, while imports were by 26.9% higher than a year ago. Changes in the export structure suggest that higher value-added activity is gaining ground. On the other hand there has been a very significant rise in the imports of minerals and fuels, which indicates still high energy intensity of production.

Trade deficit in the first seven months jumped to USD 2.3bn. that was 78% bigger than a year ago. A good sign was that export growth to the European Union was well above the average. The explosion of imports can be a dangerous phenomenon, since the current trend will continue: by the end of the year the deficit may rise to 8% of GDP that may create liquidity problems. The trade deficit increased further in August, and in the first eight months it expanded to USD 2.5bn

Chart 10.2.

Real wages growth and unemployment rate (Y/Y, %)

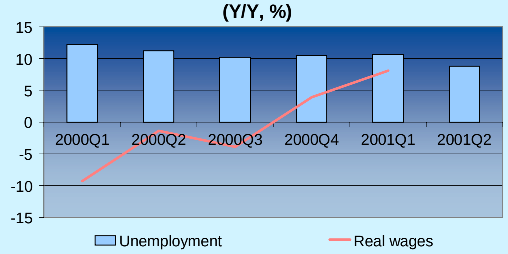


Chart 10.3.

Inflation indicators and monetary policy (yearly, %)

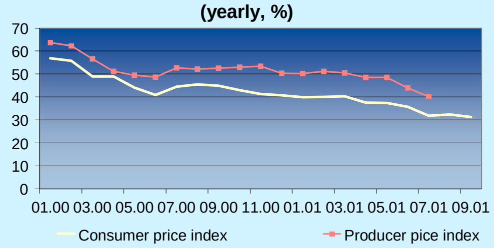
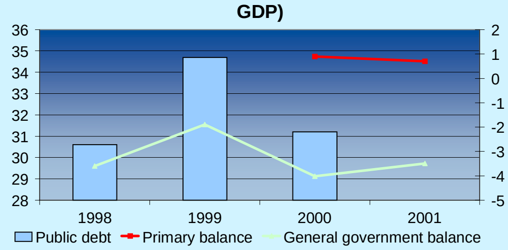


Chart 10.4.

Fiscal balances and public debt (as a % of GDP)



against USD 1.46bn a year ago.

Unemployment is continuously falling. The rate of unemployment plunged to 8.4% in July while a year ago it was 10.4%. The total number of unemployed shrank from 1,028 thousand to 798 thousand. Meanwhile the number of employed persons rose by 57 thousand. The government is envisaging some job cuts in the public sector. According to the plans, there will be 8% job cuts in the public administration, while the state-owned firms will reduce their employment by 2%, which reflects the Nastase-government's cautious approach to massive lay-offs. According to the National Agency for Employment and Training, the decrease in the unemployment rate was mainly determined by the pick up of the economic growth, the implementation of active labor market measures, and the re-launch of seasonal activities during Spring and Summer. Unemployment will go up slowly as the industrial sector is being restructured and privatization is continued.

TARGETED AND HEADLINE INFLATION EXCEEDING THE PLANS

Eight months into 2001, it became increasingly clear that this year's inflation target incorporated in the national budget (25%-27%) could not be reached. Recently, the government abandoned its initial 25 per cent inflation target for the year-end and aims instead for 30 per cent. Presently, the consumer price index is showing deceleration, and in July it was 31.8% higher than a year ago, while producer prices increased by 40.2%. At the end of December 2000 the CPI indicated 45.7%, the PPI 53.4% rise. The government's policy on inflation stipulates a gradual decrease, which means that inflation will be 22% in 2002, 15-18% in 2003, 11-15% in 2004, and less than ten per cent in 2005. This target seems rather ambitious regarding the necessary structural changes in the economy.

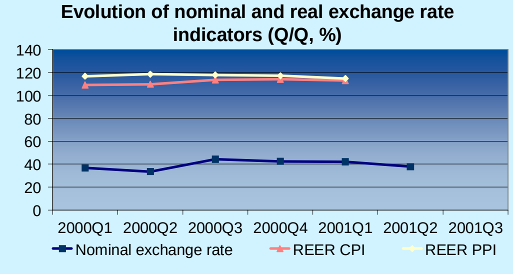
FISCAL DIFFICULTIES AHEAD

The government managed to pass the budget through the Parliament in April 2001. The budget was characterized as prudent by most analysts. The planned deficit equals 3.72% of the estimated GDP. The budget is built on average exchange rate of 28,500 ROL/US$ for the year that seems too optimistic. Fiscal deficit to GDP ratio in the first quarter of 2001 was higher than the target for the whole year. The stage budget deficit in July reached ROL 26.0bn that was 20% higher in nominal terms than a year ago, well under the inflation increase. Nominally the expenditures were rising by 25%, while the revenues went up by 26%. This indicates strictness as the government has kept control of the fiscal deficit with the use of a package of spending cuts agreed mid-year. The eight-month consolidated budget deficit stood at 2.4% of GDP, in line with projections. The surpluses of local budgets and unemployment fund had advantageous effect on the consolidated general government balance. The consolidated budget gap is aimed at the IMF-agreement is 3.5% of GDP this year.

The high level of inefficiency in the big state-run enterprises represents a heavy burden on the whole economy. So-called commercial arrears in the economy have grown to 50 per cent of GDP, of which the biggest elements are unpaid energy and tax bills of the public sector. In September, Prime Minister Adrian Nastase acknowledged that there was a financial and economic bottleneck generated by the big companies. He mentioned that the high level of the internal public debt forces the government to finance it from privatization revenues. There is an urgent need to reduce arrears and ease money circulation.

The deficit of the 2002 draft budget stands at 3% of the GDP. Less than a half of the deficit would be financed from internal sources, but the growing uncertainty that effects the international financial markets in the wake of the terror attacks on the United States, may result in higher-than-predicted interest rates for foreign loans. The currently envisaged 59% financing from external sources may cause problems. If the government concluded the new stand-by loan agreement with the IMF, it could give positive signal for the private capital markets.

Chart 10.5.



EXCHANGE RATE POLICY UNDER DOUBLE PRESSURES

The current exchange rate regime is managed floating and the USD is being used as the reference currency. This regime has been associated with quantity controls, meaning targeting the volumes of monetary aggregates. The National Bank of Romania officially targets the exchange rate: still the ROL has fluctuated extensively in real terms over the last few years. The real depreciation of 9% in 1999 contributed largely to the exports boom in 2000. In 2000, the ROL appreciated by 10%. The central bank envisaged in 2001-02 to maintain a constant real exchange rate against the US dollar, but it did not exclude some real appreciation to reduce inflationary pressures. In fact the exchange rate policy has to face two competing objectives. Gradual real appreciation curbs inflation, while real depreciation may promote export competitiveness. The recently formulated anti-inflation program suggests that the ROL should be allowed to appreciate in real terms, as an anti-inflationary anchor. The currency depreciated by 11.1%, in nominal terms, against the US dollar in the first six months of 2001, translating into a real appreciation of 2%. However, the high level of the external deficit, and the possible deceleration in export growth may force the central bank to change its policy.

The National Bank of Romania reduced the minimum

Table 10.2.

Evolution of monetary conditions	1998	1999	2000	2001
Average USD exchange rate (1000)	8,9	15,3	21,7	31,0
Consumer price index (average, %)	59,1	45,8	45,7	34,0
Producer price index (average, %)	33,2	42,2	53,4	39,5
Broad money growth (dec/dec, %)	48,8	44,9	37,9	38,0
Real broad money growth (dec/dec, %)	-6,5	-0,6	-5,4	2,9
Domestic credit growth (dec/dec, %)	68,5	26,8	11,4	10,6
Real domestic credit growth (dec/dec, %)	5,9	-13,1	-23,5	-17,5
Nominal interest rates (3 month TBs, %)	64,0	74,2	51,9	34,5

Table 10.3.

The dynamics in the current account (%)	1998	1999	2000	2001
Current account/GDP	-7,2	-4,2	-3,7	-6,5
Trade balance/GDP	-6,3	-3,2	-4,5	-7,5
Export growth	5,9	10,8	23,9	14,8
Import growth	14,3	-1,1	29,1	25,0

Chart 10.6.

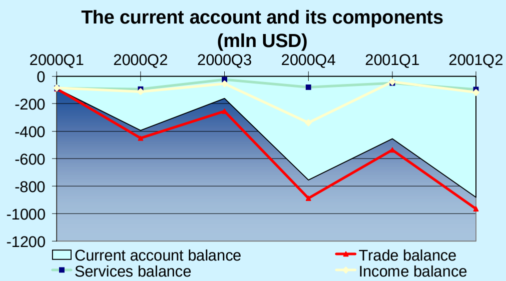
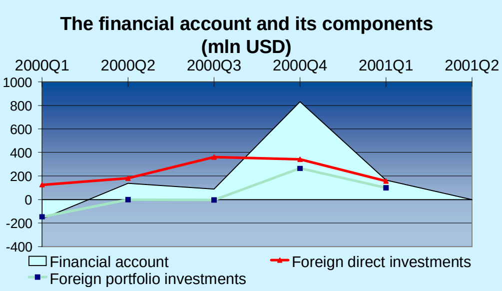


Table 10.4.

The financial and current accounts (%)	1998	1999	2000	2001
Current account/GDP	-7,2	-4,2	-3,7	-6,5
Financial account/GDP	4,9	2,1	2,5	3,0
FDI/GDP	4,9	3,1	3,0	2,9

Chart 10.7.



compulsory reserves of commercial banks from 27% to 25% of total ROL denominated bank deposits starting in October 2001. Lowering the level of reserves would release around ROL 2000 billion (USD 25 million), which can be used for lending to the real economy.

The central bank's hard currency reserves, excluding 105 tons of gold, edged up to USD 3.68 billion at the end of September. The NBR has built up substantial foreign exchange reserves mainly as a result of successful Eurobond issues. Medium- and long-term external debt reached USD 10.8 bn. in July, about USD 2.2 bn. higher than a year ago. The majority of this borrowing occurred in the second semester 2000. Public and publicly guaranteed debt as of end June 2001, accounted for 69.2% of the total. Private debt amounted to USD 3.3 bn. in the first semester 2001. Debt service ratio ran at 15.0 per cent as end June 2001, while it was 16.1 per cent at end-2000.

WIDENING CURRENT ACCOUNT DEFICIT WITH UNCHANGED CAPITAL FLOWS

At the end July 2001, the current account deficit stood at USD 1.4 bn., compared with USD 0.8 bn. for the same year-ago period. The rise was due to several factors: a 81.1% widening of the deficit for goods and services, a 30.3% narrowing of the income deficit, and a 17.5% increase in the surplus of current transfers. The current account deficit is officially projected to expand to 6% of GDP this year from around 4% in 2000, when it amounted to USD 1.4 billion.

An important part of the current account is the current transfer that showed USD 0.5 bn. surplus. Remittances have contributed increasingly to financing its balance of payments. Romania is increasingly supplying highly skilled and low-skilled labor. In the last two years remittances were close to USD 1 bn.

In the balance of payments the share of the unstable flows (portfolio; error and omissions) is representing a considerable amount. During the first seven months net errors and omissions amounted to USD 0.8 bn. that was 58% of the current account deficit. Most foreign direct investments are due to the privatization deals. In the last years FDI inflows were annually just above USD 1 bn.

During the first seven months USD 0.6 bn. net FDI came in the country. Romania needs substantial flows from the multilateral organizations, although private capital markets can

Table 10.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	25,6	24,9	27,4	30,4
Short-term foreign debt/GDP	2,8	2,8	n.a.	-
Short-term foreign debt/	12,1	10,6	n.a.	-
Debt/Exports	104,0	89,1	81,7	95,0
Debt-service ratio	23,4	31,3	19,2	0,0
Reserves/GDP	6,9	7,9	12,3	13,1

Table 10.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-3,6	-1,9	-3,7	-3,5
Current account/GDP	-7,2	-4,2	-3,7	-6,5
Short-term foreign debt/GDP	2,8	2,8	n.a.	-
Short-term foreign debt/ Total foreign debt	12,1	10,6	n.a.	-
M2/Reserves	n.a.	n.a.	n.a.	-
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

multilateral organizations, although private capital markets can play very important role. This year, government borrowed about 0.6 bn. Euro through bond issues to finance the budget deficit.

NEW PRIVATIZATION DEALS IN SIGHT

The government brought an important decision to sell Sidex steel mill, the country's largest industrial plant and the biggest loss-maker. As a buyer, Ispat International, the UK-based steel group promised USD 500 million investment. The deal owed much to the personal support of the Prime Minister. The Sidex deal set a precedent since it involves the conversion of the public sector's debt into Sidex equity, which is being sold to the customer. According to the privatization minister about 600 companies are on the sale list, although most of them are small and it will be hard to find foreign buyers. The government will be committed to sell more than 60 big companies under a restructuring loan to be extended by the World Bank. There are many controversial cases and disputes from previous privatization.

The PSD government should boost its credibility with the international business sector. It should not be overgenerous with facilities and tax breaks which later withdraw. Business surveys are still showing legal and institutional instability.

SLIGHT SLOW-DOWN AND IMPROVING MACROECONOMIC BALANCES ARE EXPECTED

The main macroeconomic projections of the government for 2002 are 5% economic growth, 22% annual inflation rate, 50,000 increase in the employment, 3% of GDP budget deficit, and USD 180, at the current exchange rate, gross monthly salary. This program seems very ambitious, since the economy is still burdened with heavy structural tensions and imbalances.

Possible slow-down in the economic growth could not be excluded since the sustainability of the current strong recovery might be questionable. Some deterioration in the external economic environment, especially in the European Union markets, can adversely influence the maintenance of the domestic demand-based development that has a strong external financial condition. The Nastase-government would be forced to further restrict fiscal spending and accelerate restructuring in the public sector.

Lowering the inflation requires to considerably cut deficit

Table 10.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	1,6	4,4	4,0
-Private consumption (%)	-1,2	4,4	3,8
-Public consumption (%)	4,2	3,2	3,0
-Investments (%)	5,5	10,0	9,7
-Export (%)	23,9	14,8	10,4
-Import (%)	29,1	25,0	15,0
Consumer price index (average, %)	45,7	34,0	25,0
Consumer price index (dec/dec, %))	40,7	30,0	24,0
Unemployment ratio (%)	10,8	9,0	9,5
General government balance (%)	-4,0	-3,5	-3,1
Public debt/GDP (%)	31,6	32,2	30,6
Current account (bn USD)	-1,4	-2,4	-2,0
Current account/GDP (%)	-3,7	-6,5	-5,5
Trade balance (bn USD)	-1,7	-2,7	-2,5
Trade balance/GDP (%)	-4,5	-7,0	-7,0
FDI (bn USD)	1,1	1,2	1,5
Gross foreign debt/GDP (%)	27,4	30,4	30,9

financing that inevitably raises social costs of the transition, and produces heavy burden on the constituency of the ruling Party of Social Democracy. International financial sources could be more available due to the IMF new loan facility. High current account deficit is increasingly financed from workers' remittances and from the surplus of the error and omissions, which should be complemented with more foreign capital inflows. To accelerate growth, lower the inflation, improve the balance and better the job market could be simultaneously too much for the government and the sill weak Romanian economy.

11. RUSSIA

WINDFALL GAINS DRIVEN GROWTH AMIDST GRADUAL STRUCTURAL REFORMS

The recent performance of the Russian economy resembles a typical post currency crisis economy: the steep currency depreciation resulted in huge price and cost competitiveness gains, which together with favourable terms of trade shocks led to rapid export growth, trade and current account surplus and rapid GDP growth. But the rate of output growth has been diminishing, as the two major stimulus (improved price competitiveness and higher oil prices) weakened, and it has increasingly been sustained by expanding domestic demand. As windfall gains diminish, this may increase financial vulnerability, the risks related to the evolution of the balance of payments, and may endanger exchange rate stability and fiscal performance. Amidst favourable macroeconomic developments and increased expectations of future WTO membership there has been a mixed picture in terms of structural reforms, as public finance reform accelerated and financial discipline in the corporate sector were strengthened.

POLITICAL STABILITY WITH GRADUAL BUT PERSISTENT REFORMS

Russia enjoys relative political stability under President Putin, compared with the turbulent and shaky period under the former President. Besides maintaining political stability the President and his economic team have been able to launch a gradual but consistent reform package, which includes long waited reform of intergovernmental relations, bankruptcy procedures, judicial system. However some crucial reform measures including the banking sector reform are still under preparation and the political will to carry them out is yet missing.

GOOD BUT DECELERATING GROWTH PERFORMANCE

After years of disappointing growth performance and deep output loss related to the August 1998 crisis, output expanded in last 2 years at its highest rates since the beginning of transition. The growth was initially stimulated in 1999 by the increased competition of tradable sectors following the sizeable real appreciation of the Rubble in 1998, while later by the favourable terms of trade shock caused by increasing oil prices. In 1999 growth was driven by the real depreciation supported import substitution and the growth of consumer goods sector (light industry), while in 200-2001 investment goods sectors expanded more rapidly.

Table 11.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	-5,5	3,2	8,3	4,0
Private consumption	-3,6	-5,3	3,4	6,5
Public consumption	0,6	0,9	1,2	-1,0
Investments	-6,7	5,3	17,2	6,0
Export	n.a.	n.a.	n.a.	-
Import	n.a.	n.a.	n.a.	-
GDP output	-4,9	3,5	7,7	4,2
Agriculture	-13,2	4,3	5,0	8,5
Industry	-6,7	5,3	7,7	5,2
Services	n.a.	n.a.	n.a.	-

Chart 11.1.

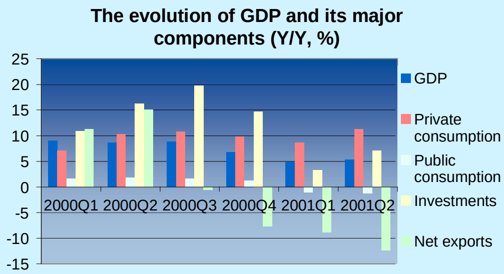


Chart 11.2.

Balance of payments, monetary policy and the inflation.

The balance of payments in Russia is special compared with most of economies with similar income level as sizeable current account surplus is accompanied by negative financial account due to high registered and also unregistered capital outflows. Current account balance is driven exclusively by the trade balance, and especially by the export growth. Balance of payments has a very strong impact on the monetary policy and money supply. First, as exporters have to surrender 75% of their export revenues, this creates sizeable conversion demand for the central bank when exports expand.

goods sectors expanded more rapidly.

In 2001 both the slowdown in output growth and the change in its factors are expected, as net exports decline and the contribution of domestic demand increases. The smaller contribution of net exports is due to the declining output growth in the extraction sectors, due to less favourable price changes (the average price of Brent oil increased by around 50% in 2000, while is likely to decline by 8% this year and the price of Urals oil follows similar pattern). Besides that the real appreciation of the Rubble weakened the competitiveness of tradable sectors, leading to Dutch disease problems. Finally, real appreciation and the growth of the private sectors' disposable income leads to growing import demand both in case of consumption and investment goods.

Contrary to net exports, domestic demand expands as private consumption increases driven by rapid real wage growth (see the chart below) and the growth of after-tax incomes, due to the introduction of flat personal income taxes this year. The growth of private investments remains robust, although it has decreased compared to 2000, mainly because of price competitiveness problems and squeezing profits. On the supply side, the expansion of output is primarily driven by the manufacturing sector, while there has been a gradual shift towards the production of extracting industries away from manufacturing consistently with the mentioned Dutch disease problem.

The rapid expansion of output has been reflected on the labour market too as it has fuelled employment creation and resulted in sizeable decline of the registered unemployed: the unemployment ratio declined from 13,3% after the August 1998 crisis to below 9% in the second quarter of 2001 and it may remain around 8,5% by the end of the year. Declining unemployment has been accompanied in 2000 by accelerating real wage growth, exceeding 10% on annual basis. This year nominal wage increases moderated but real disposable incomes may grow more due to the mentioned tax changes and there has been sizeable increases in other non-wage incomes, especially pensions in the last 2 years.

CONFLICTING GOALS FOR THE CENTRAL BANK

The monetary policy of the central bank was directed in this year at preserving the stability of the Rubble, supporting the accumulation of foreign reserves to reduce financial vulnerability and at stimulating output growth. The mentioned goals have mostly been met, but at significant costs. Due to the balance of payments surplus and sterilisation difficulties (more on that see the Box) the central bank had to accept a very robust increase in money supply, which shows less the accelerated financial deepening, but more the inability of the CBR to control money supply.

On the other hand Russia has huge debt service obligations averaging for the next five years annually 15 bn. USD, which is equal to 30% of its central government revenues. Debt-service requirements strongly affect the demand of the CBR for foreign currency, thus fuelling conversion demand further.

The high levels of currency conversion lead inevitably to rapidly expanding money supply, which the central bank is unable to sterilise due to the lack of appropriate instruments. Following the August 1998 crisis the liquidity of government securities collapsed, and the central bank has rather rudimentary tools to sterilise the excessive liquidity, including the transfer of government and public banks deposits to the central bank, and the rarely used changes in required reserves. New efforts at establishing the stabilisation fund may help not only the fiscal authorities but also the central bank to manage this problem. But as long as the trust for public debt instruments remains unrestored one may expect further problems with sterilisation.

Real money supply has been increasing rapidly since the August crisis: its growth amounted to 15%, 35% and 17% in 1999, 2000 and 2001 respectively. The major factor behind this growth has been the increase of net foreign assets of the central bank, while it was unable to reduce its net domestic assets.

Chart 11.3.

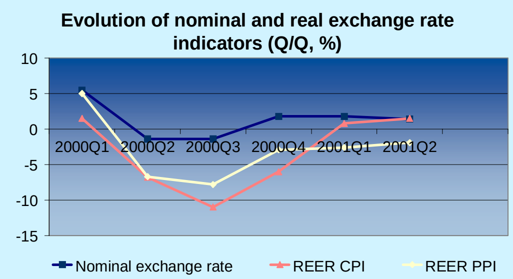


Table 11.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	20,7	27,0	28,2	29,5
Consumer price index (average, %)	84,4	36,5	20,2	21,0
Producer price index (average, %)	23,2	23,2	31,9	17,0
Broad money growth (dec/dec, %)	20,9	57,2	62,4	30,0
Real broad money growth (dec/dec, %)	-34,5	15,1	35,0	10,8
Domestic credit growth (dec/dec, %)	68,2	34,0	13,7	10,0
Real domestic credit growth (dec/dec, %)	36,5	8,9	-13,8	-5,9
Nominal interest rates (3 month TBs, %)	60,0	55,0	25,0	15,0

Rapid monetary expansion is accompanied by very low, in real terms sharply negative interest rates. Moreover, the interest rate spread has increased over time and currently is above 10%, showing the problems with the efficiency of banking intermediation. The real returns on government treasury bills will remain negative too, and their liquidity is still ver limited following the default in 1998.

Compared with the last two year we don't expect a significant depreciation of the Rubble in 2001. This is partly the result of balance of payments developments and increased conversion of foreign currency which maintained the high demand for local currency. The strong Rubble is also the outcome of the central banks' deliberate policy which saw it as an important factor in disinflation due to the strength of the exchange rate channel, which seems to be the only effective transmission mechanism of monetary policy.

Following an almost 14% depreciation of the average dollar value of the Rubble last year we expect in this year a gradually accelerating depreciation which in total will remain below 7,5% this year leading to 31,5 RBL/USD rate at the end of the year (while the average nominal exchange rate would be 29,5 RBL/USD). The depreciation accelerates in the course of the year as balance of payments surplus diminishes quarter to quarter. Relative nominal exchange rate stability results in a very sizeable real appreciation based on both price and cost competitiveness measures.

Chart 11.4.

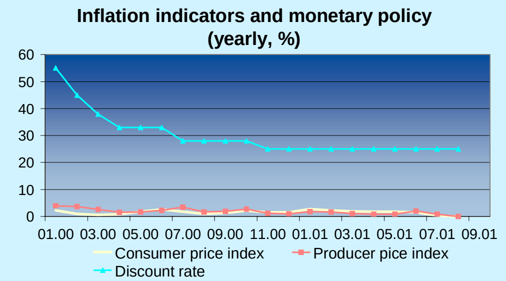
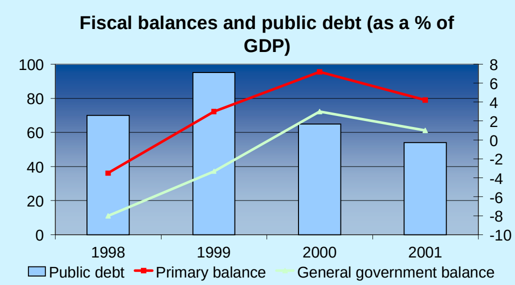


Chart 11.5.



INFLATION HAS REMAINED A SERIOUS CONCERN

While there has been sizeable disinflation in 1999 and 2000 following the price jumps after the currency crisis, this process was reversed this year: while monthly inflation rates declined over the year the annual price increase will be around 20 similar to 2000. There are several factors which disallow the drop of inflation in 2001. First, the significant balance of payment surplus resulted in rapid increase in money supply and this has a strong inflation effect. Second, supply-side factors also contribute to inflation: real wage growth is sizeable, oil prices and producer price increase accelerated, leading to very rapid increase in producer prices. Finally, the gradual liberalisation of administratively regulated prices has also fuelled inflation.

Besides high consumer price increases the rapid growth of producer prices is increasingly worrisome as it reflects that the difficulties with disinflation will be of longer-term and one may expect only a gradual decline in consumer prices. A relatively favorable development compared to 2000 is that producer price increases will remain in 2001 below the CPI index, contrary to 2000, when they exceeded it by a wide margin.

IMPROVING FISCAL PERFORMANCE

The favourable cyclical effect and the windfall gains from terms of trade improvement have benefited general government balances, mostly due to the increase of revenues (central government revenues exceeded in 2000 for the first time the threshold level of 15% of GDP). The growth of public revenues was stimulated besides the booming exports and revenues from tradable sector by improved tax compliance of major corporations, which has allowed the simultaneous growth of indirect and direct tax revenues. Increasing revenues helped in achieving sizeable primary and also total surplus for the general government.

In 2001 the primary surplus will decline due to the weaker growth performance and to the negative effect of tax reform on direct tax revenues. One may expect that the total combined effect of these factors will reach 3% of GDP, thus reducing the primary surplus to 4% of GDP, while the total one to 1%. The primary and interest expenditures of the general government are stable and the worsening of the total balance comes only from the worse primary balance.

Simultaneously with the decline in the fiscal deficit one may observe declining public debt to GDP ratios. After increasing steeply in 1999 and reaching almost 95% of GDP, public debt declined in 2000 and in 2001 too: this year we expect to diminish to 54% of GDP. The decline is driven by the favourable effect high growth rates and primary surplus exerts on public debt.

Table 11.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	-0,5	12,3	18,4	9,5
Trade balance/GDP	6,5	17,0	25,1	14,5
Export growth	-15,8	0,8	40,0	5,0
Import growth	-19,4	-31,5	12,8	25,0

Chart 11.6.

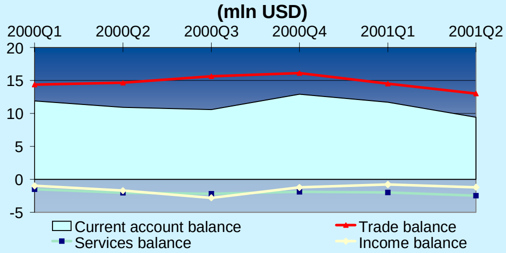


Table 11.4.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	-0,5	12,3	18,4	9,5
Financial account/GDP	-2,6	-8,8	-8,9	-10,5
FDI/GDP	0,8	1,7	1,1	-0,3

Chart 11.7.

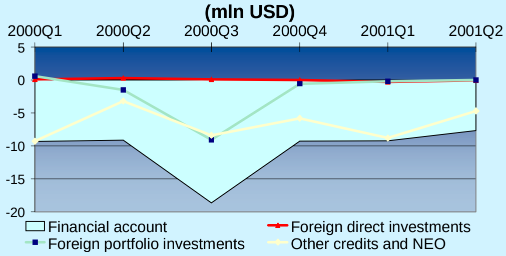


Table 11.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	60,1	99,9	69,4	55,0
Short-term foreign debt/GDP	9,1	12,5	8,3	6,5
Short-term foreign debt/	15,1	12,5	11,9	11,8
Debt/Exports	217,5	218,7	150,2	166,5
Debt-service ratio	27,6	21,8	8,4	12,5
Reserves/GDP	4,3	6,7	10,2	10,5

SIZEABLE BALANCE OF PAYMENTS SURPLUS

Russia's improving trade and current account balance has been stimulated by favourable terms of trade changes, and this led to unprecedented surplus in both trade and current account. We expect this surplus to moderate this year due to the smaller windfall gains from oil prices and negative effect of real appreciation on net exports.

Contrary to the current account, the financial account records huge deficit as low net inflows of foreign direct investment are crowded out by negative balance on foreign portfolio investments and other capital flows. The huge deficit on net errors and omissions shows that the endemic problems of capital outflows is still present, and their magnitude reaches 30% of export revenues.

The dynamics on the current account allowed sizeable accumulation of reserves depleted after the August 1998 crisis: total reserves are three times higher than in 1999, import coverage has more than doubled in this period and the coverage of broad money by reserves has also improved.

These positive developments are clouded by several difficulties and problems however. First export growth ate diminishes and imports pick up and there is a broadening gap between their growth rates. Moreover, 65% of total export revenues are made up by natural products and are very sensitive to external demand and shocks. Second, both total and (due to outflows especially) net FDI flows are very low, while foreign portfolio investments didn't recover following the crisis.

Third, the balance of payments developments will be influenced by increasing debt service expenditures, which will peak with 3,3 bn. US dollars to Paris Club in 2003. Increasing debt service expenditures may coincide with declining trade and current account surplus and diminishing central bank reserves which may once again increase exchange rate and interest risks.

Table 11.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-8,0	-3,3	3,0	1,0
Current account/GDP	-0,5	12,3	18,4	9,5
Short-term foreign debt/GDP	9,1	12,5	8,3	6,5
Short-term foreign debt/ Total foreign debt	15,1	12,5	11,9	11,8
M2/Reserves	285,7	308,6	151,7	130,0
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

Table 11.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	8,3	4,0	3,5
-Private consumption (%)	3,4	6,5	5,0
-Public consumption (%)	1,2	-1,0	-2,0
-Investments (%)	17,2	6,0	4,5
-Export (%)	n.a.	-	-
-Import (%)	n.a.	-	-
Consumer price index (average, %)	20,2	21,0	15,0
Consumer price index (dec/dec, %))	20,5	17,5	13,5
Unemployment ratio (%)	10,2	8,5	9,0
General government balance (%)	3,0	1,0	0,0
Public debt/GDP (%)	64,9	54,0	50,0
Current account (bn USD)	46,3	30,5	20,0
Current account/GDP (%)	18,4	9,5	6,0
Trade balance (bn USD)	60,6	45,5	35,0
Trade balance/GDP (%)	25,1	14,5	10,5
FDI (bn USD)	2,7	2,6	2,5
Gross foreign debt/GDP (%)	69,4	55,0	50,0

IMPROVING BUT STILL FRAGILE VULNERABILITY INDICATORS

All major indicators of financial fragility have improved in recent years in Russia. Their improvement is driven by the higher output and export growth: the GDP related relative indicators (fiscal balance, public debt, foreign debt to GDP) improve thanks to strong growth performance and appreciating Rubble, while other indicators (debt service ratio, etc.) due to export expansion. While these indicators improve one may expect their worsening after the cyclical upswing comes to halt. From that point of view especially the M2/Reserves ratio and the fiscal balance are expected to worsen from 2002 onwards.

SLOWER GROWTH AND RENEWED BALANCE OF PAYMENTS PROBLEMS ARE EXPECTED IN 2002

We expect that output growth will moderate further in 2002 and GDP may expand by 3,5%. This stems partly from the worsening external conditions, as both the demand and the price developments on the oil and other natural resources market are less favourable than in the last two years. Trade surplus will moderate and the contribution of net exports to GDP growth will diminish. Simultaneously the major components of aggregate domestic demand will expand slower due to lower real income growth and public consumption. While private investment growth may remain robust, it won't be sufficient to offset declining net exports and consumption growth. Moreover, investment growth and investment rates are too low considered the obsolete state of the capital stock and much higher investments are needed to accelerate their growth, which however depends on still slowly progressing structural reforms.

Declining oil prices and external demand will lead to smaller trade and current account surplus, but they will remain still sizeable. While one may expect acceleration of foreign direct and portfolio inflows their level remain low and will be neutralised by high capital outflows reaching in last year 30% of export revenues. Therefore one may expect slower increase in the reserves of central bank, which together with increasing and in 2003 mounting debt service expenditures may increase concerns over the sustainability of debt and debt services. The positive side of the diminishing balance of payments surplus and reserve accumulation by the central bank will be the smaller sterilisation pressure on CBR and its inflationary effect. Besides that weaker balance of payments surplus will end the period of relatively strong Rubble and one may expect accelerating depreciation in 2002 with a more neutral real exchange rate. We expect the average inflation rate to decelerate to 15% and the end year one to 13,5%, while the end year exchange rate to be 32,5 RBL/USD. Disinflation will be supported by lower net reserve accumulation of the central bank, by declining rate of exports and output growth and moderating wage increases.

Slower output growth will have a negative cyclical effect on fiscal balances. Lower inflation may also worsen fiscal balance due to its negative impact on indirect tax revenues. Finally, the full effect of declining tariffs, personal and income tax rates will lead to decreasing primary revenues. Therefore it can be expected that the fiscal balance will worsen in 2002 compared the favourable 2001 and 2000 developments.

12. SLOVAKIA

SLOWDOWN IN GROWTH, CONCERNS ABOUT BALANCE INDICATORS

After a relatively sharp deceleration in 1999, the Slovak economy recorded accelerating year-on-year growth rates for five consecutive quarters up to the first quarter of 2001. Economic growth is still lagging behind the average rate of the region, and signs of the slowdown are clearly visible. Growth is primarily driven by gross fixed investments largely due to the inflow of foreign capital, and to a lesser extent by government spending signaling the impact of the upcoming elections. Sharp disinflation in 2000 came to a halt this year. Balance indicators are worrying, as both the current account and the general government deficit are widening rapidly.

RULING COALITION IN PRECARIOUS SITUATION

The Hungarian Coalition Party (SMK) continued to threat the ruling coalition led by the Slovak Democratic and Christian Union (SDKU) to leave, the government is likely to remain in power until the next parliamentary elections due in September 2002. Since SMK has been strong and disciplined to support the economic program of the broad-based government, its departure from the coalition would impede the further implementation of still needed economic reforms, the most burning of which is privatization. Still, even if SMK decides to leave they are expected to support the ruling coalition on the most important reform issues, as well as on the approval of the 2002 budget, presented to the Parliament on 15 October.

According to recent opinion polls the ruling coalition, with the outstanding exception of the SMK, has lost much of her electoral support. Moreover, two of the four coalition partners have even fell below the 5% threshold that is needed to be present in the parliament. The continuous and remarkable loss in electoral confidence puts pressure on the government to speed up economic growth, hence further fiscal expansion seems unavoidable.

Moreover, the opposition Movement for Democratic Slovakia (HZDS) led by former prime minister Vladimir Meciar is the most likely to win next elections. Though, the party has little chance to get absolute majority, and potential coalition partners are expected to restrain the authoritarian, anti-market and anti-EU traditions of the HZDS.

Chart 12.1.

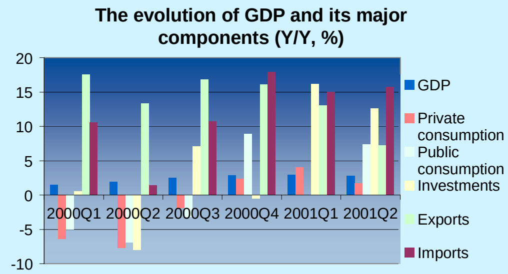


Table 12.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	*4,1*	*1,9*	*2,2*	*3,0*
Private consumption	*5,3*	*0,1*	*-3,4*	*3,2*
Public consumption	*0,0*	*-6,9*	*-0,9*	*1,5*
Investments	*11,1*	*-18,8*	*-0,7*	*8,0*
Export	*11,9*	*3,4*	*15,9*	*11,0*
Import	*12,3*	*-6,1*	*10,2*	*14,0*
GDP output	*n.a.*	*n.a.*	*n.a.*	*-*
Agriculture	*-5,9*	*-1,8*	*-6,0*	*2,0*
Industry	*4,8*	*-3,5*	*9,1*	*7,0*
Services	*n.a.*	*n.a.*	*n.a.*	*-*

Chart 12.2.

SLUGGISH EXPORTS, GROWTH DRIVEN BY DOMESTIC DEMAND

Unlike in Hungary and Poland, where we observed a fast GDP growth becoming slower or more moderate this year, in Slovakia growth was picking up this year compared to the previous one. However, within the year it is far from being evenly distributed. Similarly to other countries of the region we expect quarterly data to show a slowdown in the second half of the year. In the second quarter, real growth was 2.8%, which is 0.2 percentage points lower than in the first, and both are below expectations. In the second quarter, the share of private consumption has hardly grown within real domestic demand, while real public spending increased significantly. Increasing real domestic demand this year compared to the last two year bears witness to a successful stabilization three years ago, and signals the upcoming elections as well.

Last year, the growth of GDP on the demand side was driven by good external performance. This year, exports are sluggish, reflecting the decrease in import demand on major external markets, while stocks are increasing which hints at competitiveness problems. Imports are still dynamic, driven by the upturn of private investments, which is the most import-intensive demand component. Consequently, net exports continue to have increasingly negative contribution to growth, and domestic demand takes over as the driving force of GDP growth.

The past pattern of growth on the supply side shows that most of the growth has been achieved by the service sector, and while the performance of industry was remarkable, its share in GDP has still been stagnant The role of construction and agriculture, however, is rapidly going down. There is no reason to expect that the agricultural decline would stop in the near future, however, construction can be expected to flourish, provided GDP continues to grow in the future. Surprisingly, industrial output showed negative growth for a few months at the beginning of the year, which has more than offset last year's good performance. Despite this, this year's industrial output is still expected to grow at a remarkable, though slower pace than last year's.

Employment has been up for the third consecutive quarter in the second quarter of 2001. It is worth noting that the most dynamic category is not employees, but entrepreneurs both with and without employees. This signals both the structural transformation and passive restructuring of traditional industries (loss of jobs) and also the possibility that reforms have opened up new opportunities for many. Acute structural problems are indicated by the high and still increasing unemployment rate (19.2% in the second quarter).

Chart 12.3.

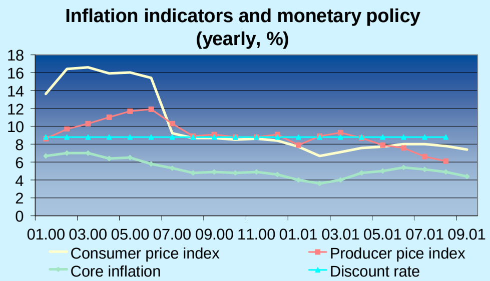
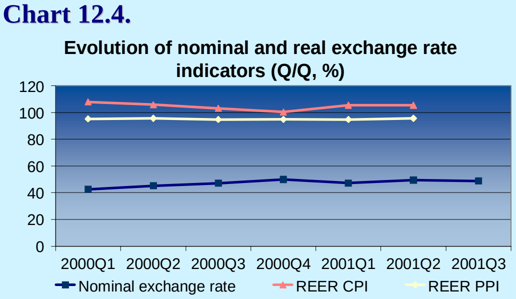


Table 12.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	35,2	41,4	46,2	48,9
Consumer price index (average, %)	6,7	10,6	12,0	7,6
Producer price index (average, %)	3,3	3,8	9,8	7,6
Broad money growth (dec/dec, %)	6,8	9,8	14,4	20,0
Real broad money growth (dec/dec, %)	0,1	-0,7	2,1	11,5
Domestic credit growth (dec/dec, %)	10,9	14,8	2,1	5,0
Real domestic credit growth (dec/dec, %)	3,9	3,8	-8,9	-2,4
Nominal interest rates (3 month TBs, %)	n.a.	n.a.	n.a.	-

Chart 12.4.



OPPOSING PRESSURES ON PRICE MOVEMENTS

The sharp disinflation starting from the second half of last year resulted in a 6.7% year-on-year rise in the CPI in February. However, the dynamics of consumer prices picked up in the second quarter in line with the targeted monetary variable (core inflation). Most recent figures from September point to a drop in CPI inflation, while core inflation returned to the central bank's official year-end target range. Broader price indicators remained also subdued: PPI dropped to 6.1% in August, the growth rate of nominal wages was 1 percentage point down compared to the first half of the year, and the dynamics of the money supply decelerated markedly. Opposing pressures do and will affect price movements in the near future. Real wage increases, price liberalization, and most importantly rapidly widening government deficit exert upward pressures on prices. At the same time retail competition, real appreciation and moderate fuel prices are partly expected to offset this.

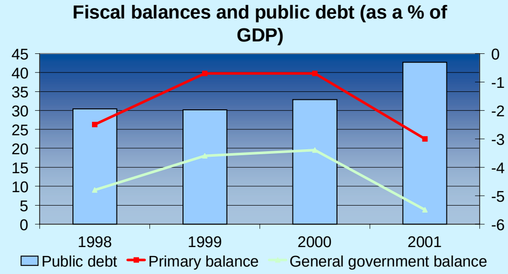
INFLATION TARGET SEEMS REALISTIC

Slovakia has an inflation targeting monetary regime with core inflation (CPI without regulated prices and indirect taxes) being the targeted variable. Despite the moderate increase in core inflation, the National Bank of Slovakia (NBS) held policy rates unchanged during the year, as the year-end target band of 3.6–5.3% seems realistic. As inflation slows down continuously, and unemployment remains stubbornly high, this will put pressure on the monetary policy to cut interest rates.

Money supply growth has remained relatively limited, and decelerated during the course of the year, despite the redemption of privatization bonds with the total amount of USD 600 mn. (3% of GDP). Apart from this, the stronger growth in M1 items reflects the boost in retailer's confidence and the upward trend in private consumption. Quasi-money items, and most markedly foreign currency deposits, have been decreasing throughout the year.

The Slovak exchange rate regime is managed float, and similarly to the Czech regime the Euro is used informally as a reference currency for the central bank for intervention. Foreign direct investment inflows funding privatization and rising portfolio investment result in appreciation pressures for the Koruna. However, the exchange rate against the major currencies has been rather determined by the EUR/USD cross rate. A minor appreciation is expected vis-a-vis the Euro on an annual basis, while the opposite holds for the US dollar. Price competitiveness, as measured by the real effective exchange rate, is forecasted to deteriorate.

Chart 12.5.

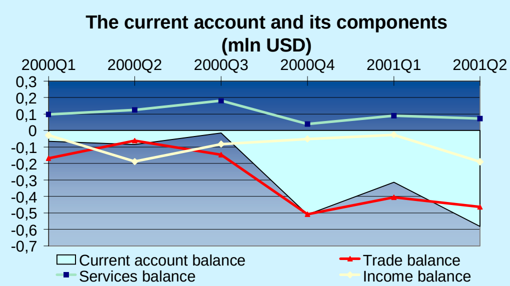


CONTINUING PRO-CYCLICAL EXPANSION, CONCERNS ABOUT BUDGETARY IMBALANCE

Though the public consumption component of the demand side of GDP has been falling markedly in the last two years, fiscal loosening has characterized budgetary policy, and is expected to continue to do so. Hence, as in the case of the Czech Republic, it is difficult to measure fiscal stance in Slovakia, due to quite extended off-budget activities. Apart from the political will to limit the increase in regulated prices, which is in itself a considerable implicit subsidy, the Slovak government has already taken sizeable measures to stimulate aggregate demand. Public consumption increased by 7.4% in the second quarter, up from –0.9% in 2000. Temporary public work programs having a benign, though short-term effect on unemployment continue, and the originally proposed 5% increase in pensions has just been upgraded to 7% (outside the original budget plan) by the Parliament.

In the first seven months the gap in the state budget in real terms has more than tripled compared to the similar period of the last year, which, in the context of accelerating growth, is indicating pro-cyclical expansion. Fiscal policy adds around 1% of GDP to the aggregate demand this year, although the official budgetary numbers do not reflect fully the true demand stimulus. Apart from the central budget large other public funds are expected to finance the ongoing reform of the health care and social security system, as well as the costs of bank restructuring and contingent liabilities on loans to publicly-owned enterprises. As in the case of last year, the deficit of general government (including social security and extra-budgetary funds) is expected to widen more than of the central one.

Chart 12.6.



RAPIDLY WIDENING EXTERNAL DEFICIT

The current account balance deteriorated markedly. In the first half of the year, the deficit increased fivefold compared to the level in the corresponding period of the previous year. The sharp widening was primarily due to the worsening of the merchandise trade balance, which has more than quadrupled in the first seven months. Most of this increase was due to trade with the EU, reflecting mostly the slowdown in import volume growth for the Euro area. However, the real appreciation of SKK vis-a-vis both the dollar and the Euro combined with the increase in wages hints at the possibility of competitiveness problems. Last year inflation slowed down significantly, however, this year this decline stopped.

Table 12.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-10,4*	*-4,9*	*-3,5*	*-5,2*
Trade balance/GDP	*-11,5*	*-6,5*	*-4,8*	*-5,5*
Export growth	*11,5*	*-4,7*	*16,7*	*9,2*
Import growth	*12,0*	*-13,7*	*13,3*	*14,8*

The sustained and unmitigated inflation differential between Slovakia and her main trading partners is a cause for concern if this goes together with weak trade performance. We observe a sluggish growth of exports and dynamic imports

Table 12.4.

The financial and current accounts (%)	1998	1999	2000	2001
Current account/GDP	-10,4	-4,9	-3,7	-8,2
Financial account/GDP	9,8	11,4	7,5	6,0
FDI/GDP	1,5	4,5	10,2	9,3

Chart 12.7.

The financial account and its components (mln USD)

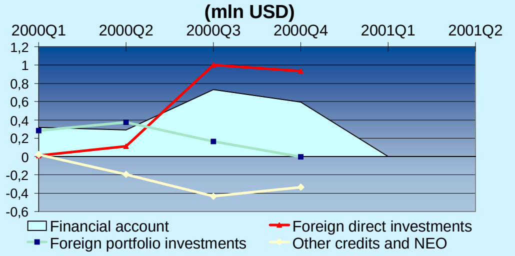


Table 12.5.

The evolution of foreign indebtedness indicators (%)	1998	1999	2000	2001
Gross foreign debt/GDP	58,1	62,3	58,4	54,7
Short-term foreign debt/GDP	22,5	16,0	12,9	9,8
Short-term foreign debt/	38,7	25,7	22,1	17,9
Debt/Exports	111,0	103,0	91,4	82,4
Debt-service ratio	15,0	13,6	16,8	17,0
Reserves/GDP	14,2	16,4	21,6	20,2

Table 12.6.

The financial vulnerability indicators between 1998 and 2001 (%)	1998	1999	2000	2001
General government balance/ GDP	-4,8	-3,6	-3,4	-5,5
Current account/GDP	-10,4	-5,8	-3,7	-8,2
Short-term foreign debt/GDP	22,5	16,0	12,9	9,8
Short-term foreign debt/ Total foreign debt	38,7	25,7	22,1	17,9
M2/Reserves	22,4	27,0	33,9	31,0
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

together. This reflects a quite solid growth in domestic demand, particularly in investments. The rapidly rising import of foreign capital goods can be a concern in the short run. At the same time this import embodies technology transfer, and thus can contribute to a promising supply side based export growth in future.

In the short term the loss in price competitiveness could be offset by attracting more FDI via privatization, however, due to coming elections this looks an unlikely policy option. The buoyancy of foreign demand, too, could compensate weak price competitiveness, however, growth prospects in the main EU markets are rather grim. More can be expected from the performance in the CEFTA-market, but it is still too small to make a difference.

FDI inflow may slow down due to the prospects of the upcoming election (investors wait), and hence, balance of payments could further worsen unless the budget adjusts its spending policy. This is an unlikely event for the same reason. Still, according to most recent estimations, 60% of the current account deficit is financed by long-term capital inflows, mostly privatization proceeds.

Table 12.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	2,2	3,0	3,5
-Private consumption (%)	-3,4	3,2	3,4
-Public consumption (%)	-0,9	1,5	1,5
-Investments (%)	-0,7	8,0	7,0
-Export (%)	15,9	11,0	6,0
-Import (%)	10,2	14,0	9,0
Consumer price index (average, %)	12,0	7,6	6,5
Consumer price index (dec/dec, %))	8,4	7,4	6,4
Unemployment ratio (%)	17,9	18,0	17,0
General government balance (%)	-3,4	-5,5	-5,2
Public debt/GDP (%)	32,9	42,7	45,0
Current account (bn USD)	-0,7	-1,6	-1,8
Current account/GDP (%)	-3,7	-8,2	-8,5
Trade balance (bn USD)	-0,9	-1,8	-1,7
Trade balance/GDP (%)	-4,8	-9,2	-8,0
FDI (bn USD)	1,9	2,0	0,8
Gross foreign debt/GDP (%)	58,4	54,7	51,4

POLICY READJUSTMENT UNAVOIDABLE AFTER NEXT YEAR'S ELECTIONS

In line with improving external condition we expect GDP growth to accelerate next year. Though domestic absorption continues to fuel the economy, the negative contribution of net exports will be more modest. Both growing real wages and decreasing unemployment will strengthen private consumption dynamics. Up to the elections in September 2002 public spending is expected to boom, and the fiscal policy will add another 1% of GDP to domestic demand next year. However, after the elections a socially painful reform package combined with a fiscal adjustment policy is the most likely scenario.

Headline inflation is forecasted to remain moderate in 2002, as political concerns will prevent raising the regulated prices up to the elections. This may in itself help to keep CPI inflation down, but likely to cause problems later on. It is widely accepted that utility prices set by the government do not cover costs. This state-of-affairs and a lack of transparent price policy jeopardize privatization projects in the utility sectors. The performance of the sector is crucial as USD 2-3 bn. privatization receipts are projected to finance the 2002 budget deficit.

External balance will also have to readjust or be readjusted in 2002. Part of this is expected to happen due to the projected recovery in the EU, offering better prospects for Slovak exports. However, given the steady growth prospects of domestic demand, imports should be scaled down by exchange rate policy and some domestic, basically fiscal policy adjustment may also be required.

13. SLOVENIA

LEADER IN TRANSITION

Slovenia is one of the most successful countries in transition: favorable geographical position, diverse industrial history, a tradition of openness to the world and a well-managed economic policy contribute to this.

Slovenia has the lowest level of risk (A/A2 rating) among the group of countries heading for EU membership. Domestic and external debt are both below 30% of GDP. Although, economic growth is stable, dynamics of real GDP growth is slowing in line with EU economic slowdown. Domestic demand weakened in the first half of 2001, but growth-oriented economic policy is likely to accelerate it in the rest of the year.

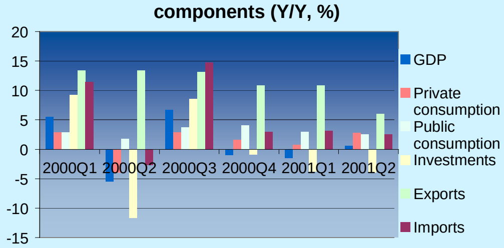
External balance is stable, current account deficit is under most optimist expectations, and direct and portfolio inflows surged in 2001. Inflation seems to remain Slovenia's main risk in the forthcoming year with respect to the Maastricht criteria. The Bank of Slovenia is determined to push inflation down by keeping its currency under strict control and by targeting broad money.

ECONOMIC POLICY IS FOCUSING ON PRIVATIZATION OF BANKING SECTOR

Political situation can be described as stable. The central-left government targeted economic revitalization policy, whose effect on the real economy is likely to be perceptible in the second quarter of 2001. Privatization of the banking sector is in progress and there are no signs of serious economic instability. Although the Slovenian economy is slowing in line with global economic recession, as long as economic performance is meritorious, coalition crisis is unlike to emerge.

Chart 13.1.

The evolution of GDP and its major components (Y/Y, %)



Slovenia achieved 2.7% y/y GDP growth in the second quarter of 2001 after the 3.1% increase in 1Q 2001. The growth was still driven by export growth, which rose by 6% in real terms in the second quarter, compared with the same period of 2000, but the year-on-year dynamics is likely to slow. The reasons for this is the high openness of the Slovenian economy, which makes it vulnerable to external economic conditions, especially to EU cyclical position, as over 63% of its export is directed to the European markets. Although Slovenia's market shares grew in Russia, Croatia and CEFTA countries in 2000, the export-surge economic growth is unequivocally determined by the evolution of EU exports.

The slowdown of EU growth influenced Slovenian industrial output growth, which is showing a sharp drop in its

Table 13.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	3,8	5,2	4,8	3,3
Private consumption	3,3	6,1	0,8	2,2
Public consumption	5,8	4,6	3,1	2,9
Investments	12,4	18,9	1,2	-2,3
Export	6,7	1,7	12,7	7,0
Import	10,4	8,2	6,1	3,2
GDP output	3,8	5,2	4,8	3,3
Agriculture	3,1	-2,1	-1,0	-1,1
Industry	4,1	2,7	8,7	4,0
Services	3,4	4,8	4,3	3,4

Chart 13.2.

dynamics. Output of manufacturing goods shows downward tendency depending strongly on the development of the export demand. Estimated narrowing of foreign markets is likely to be against accelerating industrial output growth, but the privatization of banks and insurance companies could increase the investment related industrial production.

According to several real effective exchange rate indicators, external competitiveness of the Slovenian economy has been improving for years. CPI based real effective exchange rate showed, that Tolar depreciated in real terms by 1% from January to July in 2001. Euro denominated Slovenian unit labor cost (ULC) has also decreased compared to the basket of currencies measured by weights of foreign trade.

In line with the slowdown of EU expansion in 2000 the Slovenian import growth moderated and reached 2.7 y/y in the second quarter of 2001 from the 14.8% y/y rise in the third quarter of 2000. We expect further drop in import dynamics in the 3Q2001 besides external factors also because of the comparative basis effect. Due to the slowing import dynamism we expect further decline in growth of investments in the 3Q2001, however privatization of banking and telecom sectors is ahead, which may increase investments at the end of the year. This is supported by foreign direct capital inflows, which remained at its relatively low level in the first half of 2001.

Final consumption rose by 2.8% y/y after the 1.4% y/y growth in the first quarter of 2001. Domestic demand was driven by revived household consumption, which grew by 2.8% in the second quarter of 2001 compared to 0.8% in the previous quarter. As real wages grew sharply (over 4%) between January and June 2001, we expect stronger domestic demand. The increase is in line with a safe-growth scenario, and private consumption seems to be growing at healthy rate vis-à-vis GDP growth.

Unemployment rate fell by 0.7% from 2000 year-end figure of 6.6% to 5.9% in the 2Q2001. Those unemployed are in critical situation, who are out of work for more than one year. With healthy structure of the labor market the traditionally favorable level of unemployment rate (around 7% for years) is likely to remain low in the rest of 2001.

WHILE INFLATION IS ON DECLINE, DOMESTIC INFLATION PRESSURE SEEMS TO RISE

The inflation is the sensitive point of the Slovenian economy. From mid 1999 consumer price index started to rise due to the hike of centrally regulated prices and accelerated growth of food prices. Domestic inflation pressure held CPI over 8%, while oil prices jumped in 2000 and Euro showed a constant depreciation against the dollar. Negative influence of external factors, which pushed Slovenia's CPI up in 2000, eased in 2001, however cost-push inflationary pressures

Chart 13.3.

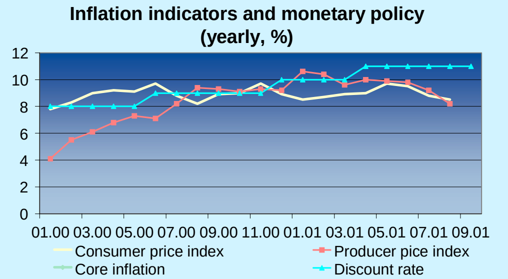
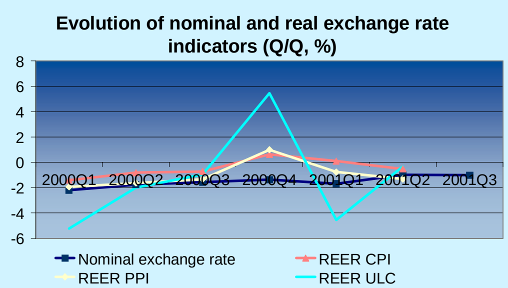


Table 13.2.

Evolution of monetary conditions

	1998	1999	2000	2001
Average USD exchange rate	*166,1*	*181,8*	*222,7*	*241,1*
Consumer price index (average, %)	*7,9*	*6,1*	*8,9*	*8,1*
Producer price index (average, %)	*6,0*	*2,2*	*7,6*	*8,8*
Broad money growth (dec/dec, %)	*32,9*	*24,9*	*11,2*	*17,0*
Real broad money growth (dec/dec, %)	*29,3*	*21,4*	*2,0*	*10,8*
Domestic credit growth (dec/dec, %)	*14,6*	*15,8*	*13,4*	*18,4*
Real domestic credit growth (dec/dec, %)	*8,2*	*7,7*	*4,2*	*12,4*
Nominal interest rates (3 month TBs, %)	*10,4*	*7,1*	*8,2*	*10,9*

Chart 13.4.



persisted and fuelled by spill-over effect of imported inflation. Major problem is the existence of constant domestic inflation pressure, which strengthened in the second quarter of 2001. According to the latest figures August CPI showed a rise of 8.5% compared to the 8.8% in July and 9.5% in June. CPI is primarily fuelled by food prices. Implicit price indices of domestic demand rose by 10.2% in the 2Q2001 compared to the 9.9% in the 1Q2001, while GDP deflator decreased by 0.2% to 9.3% in the 2Q2001.

Producer price index rose by 8.2% y/y in August showing downward trend from April. Production costs were pushed up by external shocks in 2000. Soaring oil prices had negative impact on Slovenia's chemical industry, which is among the most successful branches in Slovenia, employing 23,000 workers in some 596 companies, which generate 15 percent of all revenues of the Slovenian manufacturing industry and more than a quarter of its profits.

STABLE MONETARY CONDITIONS

Slovenia's monetary system targets broad money (M3), which grew on year-on-year basis by 21.2% in August of 2001 compared to the 16.3% the year before. As real broad money growth is over 10% in the first 8 months of 2001, Bank of Slovenia (BoS) kept its primary rate at a level of 11%. Significant capital inflows in the first 8 months of 2001 raised foreign currency deposits by 14% and M3-money growth was in line with it. Faster increase of money supply with rising real wages could revive weak domestic demand. We are not concerned about economic overheating, but current monetary conditions support our opinion on expected rise of domestic inflationary pressure.

The Slovenian Tolar (SIT) is officially a floating currency, but Bank of Slovenia intervenes on the foreign exchange market and issues USD or DEM-denominated exchange bills. While interventions of BoS dilute the pressure of capital inflows, SIT depreciated by 3.8% against Euro in the period of January-September 2001. Real effective exchange rates showed stable depreciation, which maintained competitiveness of Slovenian economy.

In reply to the unfavorable inflation process BoS raised its discount rate by 100bp. to 11% in April 2001. Inter-bank interest rates remained stable, such as yields on Tolar bills.

Chart 13.5.

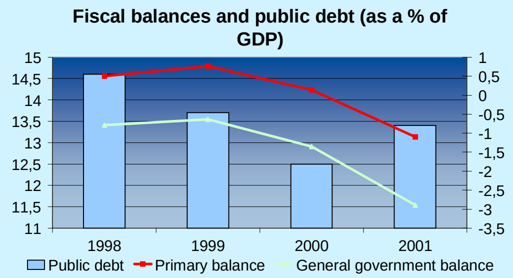
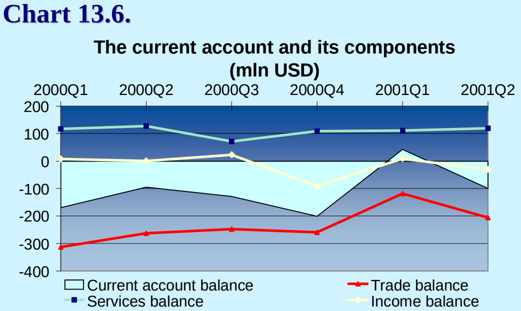


Table 13.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	*-0,8*	*-3,9*	*-3,3*	*-2,4*
Trade balance/GDP	*-4,0*	*-6,2*	*-6,0*	*-4,7*
Export growth	*6,7*	*1,7*	*12,7*	*7,5*
Import growth	*10,4*	*8,2*	*6,1*	*2,9*

Chart 13.6.



STABLE BALANCE DESPITE SLIGHTLY LOWER THAN EXPECTED REVENUES

Cumulated deficit of the general government amounted to SIT 106.6 bn. in the first half of 2001. Deficit is higher by SIT 60 bn. compared to the same period of 2000. Revenues from personal and corporate income taxes are in line with the time-proportional target of SIT 185bn. Taxes on goods and services, international and transactions under-performed the plans in the first half of 2001. The reason of lower than expected VAT and duty revenues is the decline of domestic private consumption and external trade volume.

On the expenditure side, the subsidies and transfers to households burdened primarily the balance. In addition, interest payments increased by SIT 11.6bn. to SIT 49.4 bn. in the first half of 2001 compared to the same period of 2000. Government consumption reached SIT 80bn. in this period, and it was by SIT 11bn. higher than in the first half of 2000. According to figures, fiscal policy seems to ease in 2001, which is not necessarily a bad sign, especially as the domestic demand declined over 4Q2000 to 2Q2001.

In line with the slight deterioration of public finance, domestic debt grew by SIT 229.2mn. by the end of June from December of 2000. As a percentage of GDP, domestic debt ratio increased from 25% by about 3%. We think that internal balance remains stable and higher growth of domestic debt is just the sign of soaring activity of economic policy.

FOREIGN TRADE BALANCE IMPROVED THE CURRENT ACCOUNT BALANCE

Slovenia's current account deficit amounted to USD 50.2mn. from January to July in 2001 compared to the USD 328.7mn. during the same period in 2000. The figure is much better than expectations due to the foreign trade balance, of which cumulative deficit amounted to USD 354.7mn. in the first seven months of 2001, compared to the gap of USD 665.7mn. in the same period of 2000. Narrowing trade gap can be explained by the sharp decay of import growth.

Services balance reached a surplus of USD 235.7 mn. in the first seven months: favorable figures are mainly due to the balance of transport related services and tourism, which are stable income for Slovenia for years.

Table 13.4.

The financial and current accounts (%)	1998	1999	2000	2001
Current account/GDP	-0,8	-3,9	-3,3	-2,4
Financial account/GDP	0,4	3,8	3,0	2,6
FDI/GDP	1,0	0,4	0,1	1,9

Chart 13.7.

The financial account and its components (mln USD)

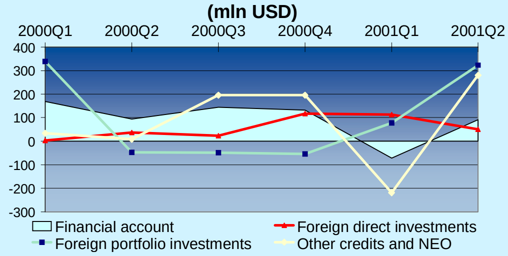


Table 13.5.

The evolution of foreign indebtedness indicators (%)	1998	1999	2000	2001
Gross foreign debt/GDP	25,1	26,9	34,2	35,7
Short-term foreign debt/GDP	0,6	0,6	0,5	0,5
Short-term foreign debt/	2,3	2,2	1,6	1,4
Debt/Exports	42,5	49,3	56,0	60,0
Debt-service ratio	14,0	8,0	10,0	12,0
Reserves/GDP	74,0	58,7	51,4	56,0

Table 13.6.

The financial vulnerability indicators between 1998 and 2001 (%)	1998	1999	2000	2001
General government balance/ GDP	-0,8	-0,6	-1,4	-2,9
Current account/GDP	-0,8	-3,9	-3,3	-2,4
Short-term foreign debt/GDP	0,6	0,6	0,5	0,5
Short-term foreign debt/ Total foreign debt	2,3	2,2	1,6	1,4
M2/Reserves	17,4	17,7	18,8	20,5
Foreign currency liabilities/ total liabilities of the banking sector	8,5	9,7	10,2	10,0

At the beginning of 2001, the financial account deficit was largely attributable to global sentiment and to the deterioration of the inflation outlook during the first half of 2001. Non-debt creating financing and other investments declined. Unfavorable figures were due to portfolio and other investments, which ran a deficit of USD 178mn. in January of 2001.

From February the position of financial account balance started to recover. Capital inflows were generated by direct and portfolio investments. The most important projects within foreign direct investment were investments in telecommunications and banking. Although, FDI inflow speeded up from cumulated USD 44.8mn. in the first seven months in 2000 to USD 158.2mn., it still remained at a very low level compared to the other countries in the region. Increased capital mobility was driven by portfolio inflows, which accelerated in the second quarter of 2001 and were driven by the reopening of last year's Eurobonds in February.

YIELDS FOLLOW INFLATION EXPECTATIONS

Fixed income market regained its former confidence from July. Unfavorable inflation and elections discouraged foreign investors in the forth quarter of 2000. At the beginning of 2001 the government exhilarated the market by increasing both its short term treasury bills and long-term Tolar and Euro-denominated bonds. In line with inflation, yields moved up in the first half of 2001. From July markets started to recover, and the CPI was followed by decreasing yield. Over time, we expect Slovenian spreads to converge with those of AA ranked countries, which trade 30-40bp. over German benchmark papers.

We think that activity of convergence players will be driven by economic policy. Slovenian economy is very successful and if the government can keep the balance between stability- and growth-oriented policy, and the Bank of Slovenia is able to push inflation effectively down and ensure currency stability, then long-term investors are likely to boost the Slovenian fixed income market.

Table 13.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	4,8	3,3	3,5
-Private consumption (%)	0,8	2,2	2,5
-Public consumption (%)	3,1	2,9	3,1
-Investments (%)	1,2	-2,3	3,2
-Export (%)	12,7	7,0	8,2
-Import (%)	6,1	3,2	6,9
Consumer price index (average, %)	8,9	8,4	6,3
Consumer price index (dec/dec, %))	9,2	6,9	5,4
Unemployment ratio (%)	6,6	5,8	5,7
General government balance (%)	-1,4	-2,9	-2,7
Public debt/GDP (%)	12,5	13,4	13,6
Current account (bn USD)	-0,6	-0,4	-0,6
Current account/GDP (%)	-3,3	-2,4	-3,3
Trade balance (bn USD)	-1,1	-0,9	-1,2
Trade balance/GDP (%)	-6,0	-4,7	-6,6
FDI (bn USD)	0,2	0,4	0,4
Gross foreign debt/GDP (%)	34,2	35,7	36,5

DOMESTIC DEMAND IS EXPECTED TO SOAR

After the 4.8% real GDP growth in 2000, we expect 3.3% for 2001 and 3.5% for 2002. Slowdown of economic growth is attributable to the decline of EU import growth and investments and weak private consumption. However, expansion of industrial output is likely to accelerate in the rest of the year: we calculate with 4% annual growth in 2001. As domestic demand and investments growth may speed up in the forthcoming months, export growth is unlikely to soar until EU import demand will boost. Import growth will be generated by FDI inflows, which is likely to rise in line with privatization. In 2002, domestic demand may accelerate, but we see only slight chance that external economic conditions will increase Slovenia’s export growth. Therefore, contribution of domestic demand to GDP growth will rise, but that can’t balance the expected decreasing weight of net exports in GDP absorption.

Slovenia will face stubborn inflation in the coming years. In the medium term, we expect presumable decline in oil prices and stable Tolar justified by favorable current account. As such, imported inflation pressure is likely to decrease, but remaining relative price adjustments, and price convergence of services and foods should mean a stubborn domestic inflationary source. Therefore, we think that CPI will be in slight downward trend in the rest of 2001. Our estimation is a 6.9% year-end growth, while annual rise of CPI is around 8.4%. Inflation is likely to be a tough challenge for Slovenia in the next couple of years with respect to the Maastricht criteria.

International experience supports the view that currency appreciation is the appropriate monetary tool for reaching CPI of around 3%. Therefore, with respect to Slovenia’s accession to the EU, the country will have to improve domestic monetary conditions and give significant responsibility to the central bank’s monetary targeting. For 2002, inflation may decrease gradually and we estimate an average CPI of 6.3%, and year-end consumer price index of 5.4%. According to our calculations, the rise of producer prices will moderate in the rest of the year to 6.2% y/y in December. Our yearly average estimation on PPI is 8.8%, which is 1.2% higher than in 2000.

Fiscal deficit is expected to amount to about SIT 128mn. in 2001. This means 2.9% of GDP, compared to the 1.4% GDP-proportional deficit in 2000. Although, fiscal balance is likely to be less favorable in 2001, than it was in 2000 and we see less chance to maintain the state budget projections, we are not concerned about fiscal stability, as general government deficit is still at a very low level. We think, that general government consumption will burden the expenditure side of fiscal balance, which will be balanced by increasing revenues from personal and corporate income taxes and privatization. We expect fiscal deficit of 2.7% for 2002.

External position of Slovenia will remain stable. Current account deficit is likely to be under USD 500mn.. Widening of the trade gap could mean the only risk in forthcoming months due to the estimated acceleration of import-related consumption and investments. We expect 2.4% GDP-proportional current account deficit for 2001, and 3.3% deficit for 2002. We believe, that direct investments will improve financial account. However, if current account balance fares well, on the financial side we are concerned about portfolio outflows in line with external economic conditions. Even though non-debt creating financing could deteriorate at the end of 2001, balance of payments may be favorable both in 2001 and 2002.

14. UKRAINE

ACCELERATING GROWTH DESPITE STRUCTURAL WEAKNESSES AND POLITICAL UNCERTAINTY

The Ukrainian economy in 2001 may achieve the best growth performance among all countries in the forecast, notwithstanding the structural weaknesses and the negative spillover effect of the spring political turmoil. The economy is expected to accelerate its growth from the already high levels reached in 2000, thanks mainly to the increase of domestic demand accompanied by less favorable export performance. Rapid economic growth allows the authorities to improve the fiscal balance further and general government deficit may decline below 1% of GDP. Rapid increase of exports in 2000 increased the very low level of reserves of the central bank, and while their growth will diminish in this year, the central bank may expect still sizeable current account surplus, which will help to increase them further which is a crucial factor for improving expectations and the investment climate.

POLITICAL UNCERTAINTY FOLLOWED BY A NEW GOVERNMENT

The political crisis of Spring 2001 created serious concerns about political stability and future of economic reforms in Ukraine. The crisis was finally resolved in mid May, when the President nominated the head of the Association of Industrialists and entrepreneurs Anatoly Kinakh to replace the former Prime Minister Viktor Yushchenko. The new administration promised to pursue budget-hardening reforms and to make steps against vested interests, but the credibility and political will behind these measures has been still in question. While the political turmoil has been managed and the new administration has assumed its position, we don’t expect significant major reforms before the Parliamentary elections of 2002.

ACCELERATING ECONOMIC GROWTH DRIVEN BY EXPANDING DOMESTIC DEMAND

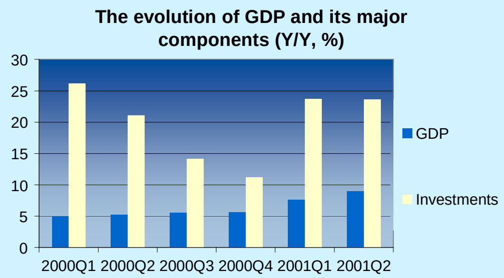
After almost a decade of uninterrupted decline of GDP, Ukraine experienced first year of output growth in 2000, which seems to hold for this and forthcoming year too. The major reason behind the recovery of output in 2000 was the effect of the depreciation of the hrivnya following the Russian currency crisis of August 1998. Similarly to Russia, the real depreciation increased the competitiveness of tradable sectors reflected both in the expansion of exports and output of import substituting industries (this is reflected in almost 13%

Table 14.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	-1,9	-0,2	5,8	7,5
Agriculture	-9,8	-5,7	7,6	7,0
Industry	-1,0	4,3	12,9	9,0

Chart 14.1.



expansion of industrial output in 2000 following slight higher increase in 1999). One positive sign behind accelerating industrial output growth is that the growth is decreasingly dependent on the output performance of the traditionally very energy intensive steel sector. The recovery in 2000 was also fueled by the robust increase of import demand on the major markets of Ukraine: besides the EU, import demand accelerated in Russia too.

Growth is expected to accelerate in 2001: over January–June, GDP increased by 9.1% year- on-year basis, while there are significant changes in the contribution of the major demand components to growth. The first reason of this change is - similarly to many other eastern European economies - the shift from external to domestic demand components of growth. The contribution of external demand to growth will see deep changes over the year. In the first half of the year exports increased significantly, while on the other hand there was a drop in imports, which was much larger than expected. On the other hand trends may reverse in the second half of the year due to the slowdown of the USA and European economies, which will decrease the cyclically very sensitive export sales (for example of steel products).

On the other hand private consumption and investment growth are accelerating. Consumption is being stimulated by higher real wage increases, by the reduction of wage arrears in the public sector and by very low and almost unchanged savings propensity of households: private consumption increased by almost 12% year over year in the first half of 2001. Investment is stimulated by the low real interest rates and expansion of output: investments may even accelerate compared to their already robust growth in 2000.

It can be anticipated that output will stabilize in the second half of 2001, and together with the higher than expected growth rates in the first two quarters, real GDP growth this year may reach 7,5%. On the supply-side growth is driven by the expanding output of manufacturing and trade sectors: while industrial output is still mainly driven by export sales, the main contributors to the accelerated growth in trade (13% in first half of 2001) were the changes in the tax regime adopted to stimulate small and medium size enterprises (SMEs). One important difference compared to the previous years is the positive contribution of the agricultural sector to GDP growth: in 2001 the agricultural output may increase around 6%, approaching the dynamics of industrial output growth. The reason behind the improved performance of the agriculture is the increased growth of investments and productivity, the increased although still very weak lending by banks to agricultural units.

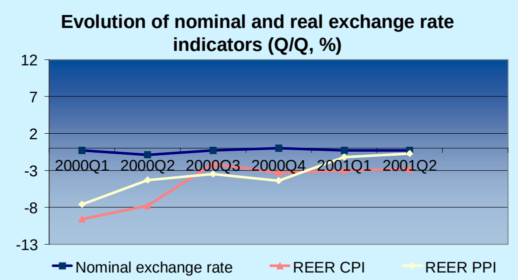
Unemployment ratio is low in Ukraine compared both to the average of advanced transition economies and countries of the former CIS. The major reason behind that is the lack of

Chart 14.2.

Table 14.2.

Evolution of monetary conditions	1998	1999	2000	2001
Average USD exchange rate	2,5	4,1	5,4	5,4
Consumer price index (average, %)	20,0	19,0	26,0	13,0
Producer price index (average, %)	35,0	16,0	21,0	13,0
Broad money growth (dec/dec, %)	25,0	40,0	44,0	35,0
Real broad money growth (dec/dec, %)	4,0	17,6	14,2	19,4
Domestic credit growth (dec/dec, %)	21,0	33,0	62,0	40,0
Real domestic credit growth (dec/dec, %)	-10,4	14,6	33,5	23,5
Nominal interest rates (3 month TBs, %)	50,0	n.a.	n.a.	-

Chart 14.3.



progress with structural reforms, especially with the handling of accumulated payment arrears and inter-enterprise debts. Policy makers didn't deal so far very efficiently with this problem and the lack of hard budget constraint and genuine restructuring stand behind good unemployment record. However, some progress in that respect may be expected in the second half of the year and there could be slight increase in the unemployment rate, notwithstanding the robust output growth.

EASING MONETARY CONDITIONS AND ACCELERATED DISINFLATION

Monetary conditions seem to ease in 2001, as there is a relatively sizeable increase of broad money supply both in nominal and real terms. Eased monetary policy together with robust growth of domestic absorption leads to the increase of real domestic credit, which will grow much faster than in the previous year.

One reason behind the accelerated growth in broad money has to do with the reserves inflow from the current account surplus. When these reserves are converted to domestic currency, the central bank has to accept some increase in real money supply, as it is unable to sterilize fully the monetary consequences of reserve inflows.

The national currency was stable in 2000, thanks to the policy of central bank, which tried to use nominal exchange rate stability to promote disinflation. Other reason behind exchange rate stability in 2000 was the build up of reserves from their very low levels in 1998-1999. In 2001 the hrivnya will be less stable and the average annual depreciation of currency will very likely be around 10%. The factors that produced relative stability in 2000 are now reversed, the current account surplus declines and the central bank pays after the success in disinflation more attention to the accumulation of reserves. Notwithstanding the nominal depreciation of the hrivnya, there will be some real appreciation on both CPI and PPI basis, while costs competitiveness improve thanks to large expansion of output.

IMPROVING FISCAL BALANCES THREATENED BY ENDEMIC PAYMENT ARREARS

The balance of the general government will improve in 2001 for the third consecutive year: total deficit may decline below 1% of GDP and primary revenues may equal expenditures. This in the general government balance is related to the increase of revenues, which in 2001 may exceed 27% of GDP, compared to last years 24%. The growth of revenues comes mostly from the favorable cyclical effect of higher GDP growth. On the other hand the payment discipline in corporate

Chart 14.4.

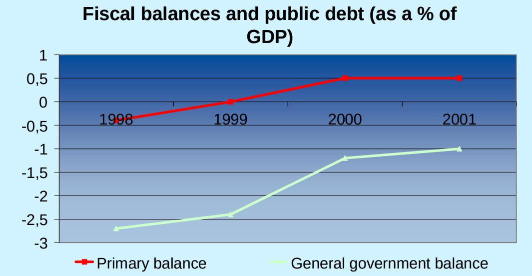


Table 14.3.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	-3,0	2,6	4,6	3,2
Trade balance/GDP	-4,2	-0,9	1,9	1,5
Export growth	-13,5	-8,0	20,1	5,0
Import growth	-17,0	-19,1	18,9	7,0

Chart 14.5.

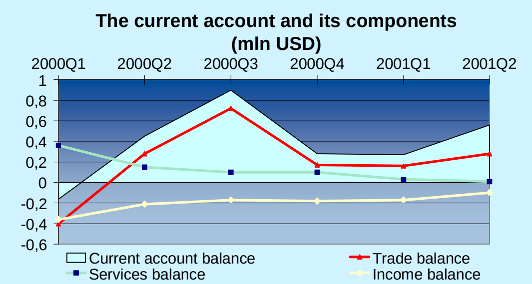


Table 14.4.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	-3,0	2,6	4,6	3,2
Financial account/GDP	-1,6	-2,2	-2,7	-2,5
FDI/GDP	1,7	1,7	1,9	1,9

Table 14.5.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	44,5	61,5	54,5	56,5
Short-term foreign debt/GDP	8,7	15,9	18,8	19,9
Short-term foreign debt/	19,5	26,0	34,5	35,5
Debt/Exports	122,6	144,0	106,5	109,5
Debt-service ratio	13,5	28,0	17,7	12,9
Reserves/GDP	1,4	3,6	4,4	3,5

sector didn't improve and this makes further increases unlikely. As long as payment arrears are not reduced the budget will heavily depend on cyclical factors.

Furthermore, the government has to make steps in reforming the tax system, which will shrink the tax base and revenues. At the same time expenditures will increase this year, as the government has reduced by almost one third the amount of pending wage arrears.

SLIGHT BUT DECLINING CURRENT ACCOUNT SURPLUS WITH LOW ATTRACTIVENESS TO FOREIGN CAPITAL INFLOWS

Thanks to rapid growth of exports both trade and current account balances have improved significantly in Ukraine in 2000. The trade balance recorded its surplus for the first time after many years and current account surplus reached almost 5% of GDP. The favorable outcome was the result of increased price competitiveness following the currency depreciation in 1998 and 1999 and of the growth of external demand. Export growth turned around too: after several years of negative growth, exports sales increased by more than 20%, while imports picked up too. Besides this favorable growth, the structure of exports remained very distorted and heavily dependent on the sale of energy intensive and cyclically very vulnerable products.

In 2001 one may expect moderation of export growth due to the changes in world economic conditions and more protectionist sentiment in the EU and the US against Ukrainian steel exports, major item in her exports. Therefore in 2001 export growth will moderate considerably, and will grow by one fourth of its growth rate in 2000. Moreover, in 2001 one may also expect that import growth will exceed exports due to the rapid increase of domestic absorption. Therefore trade surplus will decline to half of last year, but the current account surplus will worsen less due to the favorable effect of the services balances.

One major weakness of Ukraine is its low ability to attract foreign capital. The financial account has been in deficit for many years, reflecting capital outflows associated with its net foreign debt position exceeding inflows of fresh capital, either in the form of portfolio or direct investments. Foreign direct investment is very low both in nominal aggregate terms, or in relation to GDP, or on per capita basis due to political risks and hesitation with privatization and other structural reforms.

Chart 14.6.

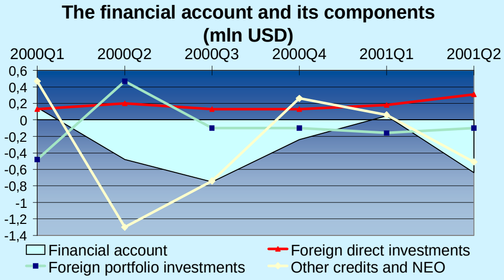


Table 14.6.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-2,7	-2,4	-1,2	-1,0
Current account/GDP	-3,0	2,6	4,6	3,2
Short-term foreign debt/GDP	8,7	15,9	18,8	19,9
Short-term foreign debt/ Total foreign debt	19,5	26,0	34,5	35,5
M2/Reserves	857,0	480,0	400,0	275,0
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

Table 14.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	5,8	7,5	5,0
-Private consumption (%)	n.a.	-	-
-Public consumption (%)	n.a.	-	-
-Investments (%)	n.a.	-	-
-Export (%)	n.a.	-	-
-Import (%)	n.a.	-	-
Consumer price index (average, %)	26,0	13,0	11,0
Consumer price index (dec/dec, %))	n.a.	-	-
Unemployment ratio (%)	4,5	5,0	6,5
General government balance (%)	-2,5	-1,0	-2,5
Public debt/GDP (%)	n.a.	-	-
Current account (bn USD)	2,1	1,5	0,8
Current account/GDP (%)	4,6	3,2	1,5
Trade balance (bn USD)	0,6	0,7	0,5
Trade balance/GDP (%)	1,5	1,2	0,8
FDI (bn USD)	0,6	0,9	0,9
Gross foreign debt/GDP (%)	54,5	56,5	59,0

While rapid growth and increasing domestic demand could in principle stimulate inflows, they won't increase in relation to GDP in 2001, compared to their very low average level of 1,8%. Ukraine's balance of payment looks very similar to the Russian one with one significant difference being in the size of current account surplus and financial account deficit.

IMPROVING VULNERABILITY INDICATORS

In the last 18 months one may observe a very gradual improvement in the major vulnerability indicators of the Ukrainian economy. One reason behind this is the rapid increase of exports and GDP, which led to the accumulation of foreign exchange reserves and improved all relative indicators. Ukraine is modestly indebted to foreign creditors, and the problems have been more with its very low level of international reserves, which periodically put under pressure the debt service abilities of the country. But thanks to the growth of exports and current account surplus, reserves/GDP and the coverage of imports by reserves improved in 2001 and Ukraine is now in a much better position compared to the difficult situation of 1999.

STILL ROBUST GROWTH AMIDST CHANGING MONETARY CONDITIONS

In light of good macroeconomic and growth performance one may expect that both high rates of economic growth and increased macroeconomic stability may prevail. While GDP in 2001 is expected to increase by almost 7,5%, in 2002 there may be some decline in growth rates to slower, but still very robust 5%. The major reason for this slowdown has to do with the deteriorating global conditions, as this reduce the growth rate of Ukrainian exports. GDP growth in 2002 will be driven like in 2001 by the increase of domestic demand, which will mainly come from the growth of private consumption. The major reason behind this is the rapid growth of real wages and incomes, and the generally unchanged propensity to save. The growth of private consumption could also be forecasted from the expected tax reforms, which will slightly reduce the centralization of incomes by the general government. TABLE7

There might be slightly different monetary conditions in 2002 compared to the current year, as the central bank will have to deal with the consequences of accelerating money and credit growth. Credit demand will be stimulated by the high GDP growth rates and by the easing of monetary policy. Disinflation will slow down and the depreciation of the national currency may slightly accelerate compared to 2001. This depreciation will fuel back to price increases and therefore in 2002 we may expect only a slight drop in the inflation rate.

Notwithstanding the stronger depreciation of the hrivnya we may expect further worsening of trade and current account balances. Following the shift in growth rates observed in 2001, import growth will exceed exports in 2002 and will lead to deteriorating trade and closely linked to it current account balances. We may expect that the current account surplus of 3,2% in 2001 will decline to less than half of it, especially if the growth of domestic demand remains so robust. The increase of domestic demand may also accelerate structural changes in the industrial sector and could lead to the robust increase of retail trade sales.

15. YUGOSLAVIA

IMPROVING ECONOMIC POLICY FRAMEWORK, BUT MODEST REAL ECONOMY ACHIEVEMENTS

Economic policy has reduced inflationary pressures and strengthened foreign exchange reserves, while supporting the recovery of output. Important steps have been taken this year: exchange–rate, foreign trade, and price systems were substantially liberalized, in Serbia an important fiscal program was introduced with the aim of elaborating a tax reform and integrating extra–budgetary funds into the budget. The regulatory framework for market oriented transformation was strengthened by adopting a new privatization law and elaborating a bank rehabilitation strategy.

One of the major goals of economic policy is to carry out quick privatization of state and socially owned enterprises, improve their efficiency and create a sound banking system. The country has very large foreign debt comparing to any economic indicator that requires efforts from donors and creditors to secure sustainable growth and external viability. External prospects however remain highly uncertain until the external debt is restructured, the current level of risk associated with that does not make possible fast increase of investments and strengthening of growth. In the short run the lack of financial resources is a substantial barrier to stronger production growth as the financing needs of economic agents exceed several times the available funds.

Almost a year has passed since the economic sanctions against Yugoslavia were lifted, but its stimulation has not been strong due to the tightening of stabilization oriented macroeconomic policy, beginning of structural reforms, end of monetary financing of quasi fiscal deficit and capacity problems as a result of ten year long disinvestment.

GOOD POLICY OBJECTIVES BUT CONCERNS ABOUT SOCIAL TENSIONS

The political situation was calming down step-by-step after the turbulent period following the extradiction of Mr Milosevic. In July a new federal government was formed and negotiations started between Montenegro and Serbia on a new constitutional framework. Strict and fast implementation of reform steps are considered to be crucial for sustained economic growth, but as a result of slow recovery of output and real wages, living standards didn’t increase as it had been expected by the population. There is a potential danger of declining support for reforms exactly at the time when the most difficult tasks of bank and enterprise restructuring and

Chart 15.1.

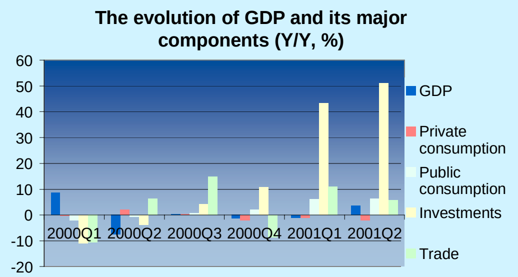


Table 15.1.

GDP growth and its major components 1998-2001 (%)

	1998	1999	2000	2001
GDP	*2,5*	*-17,7*	*7,0*	*5,0*
Private consumption	*3,6*	*-22,5*	*12,2*	*4,0*
Public consumption	*-3,2*	*-0,9*	*-19,7*	*10,0*
Investments	*3,9*	*-15,1*	*7,7*	*7,0*
Export	*20,7*	*-47,6*	*15,6*	*3,5*
Import	*1,0*	*-32,1*	*12,6*	*20,7*
GDP output	*n.a.*	*n.a.*	*n.a.*	-
Agriculture	*n.a.*	*n.a.*	*n.a.*	-
Industry	*n.a.*	*n.a.*	*n.a.*	-
Services	*n.a.*	*n.a.*	*n.a.*	-

Chart 15.2.

consolidation should be implemented. In addition, serious political tensions may appear within the governing coalition. Breaking lines can be observed between the federal and republican levels too.

WEAK INDUSTRIAL PRODUCTION RECOVERY

The main characteristic of trade and production was the instability in the first half of 2001. In the first quarter of 2001 year on year GDP decrease was 9%, but in the second quarter a 12.1% growth was observed and as a result, in the first half of 2001 year on year GDP grew by 1.2%. Behind the total GDP growth there was an increase of activity in the sectors of communications (47.2%), agriculture (6.2%) a decrease in industry (-1.6%), in construction (-6.5%) and in trade (-2.7%). In the first half of 2001 GDP growth decelerated in comparison to the first half of 2000, in which it was around 5%.

In the first half of 2001 industrial output was slightly lower, than during the same period of the last year, production was higher in light manufacturing and output of heavy industry further declined. After last years nearly 20% decline, agricultural output increased substantially. Agriculture has an important role in Yugoslavia, as its contribution to the GDP increased from 8% at the beginning of 1990s to about 20% by the end of the decade.

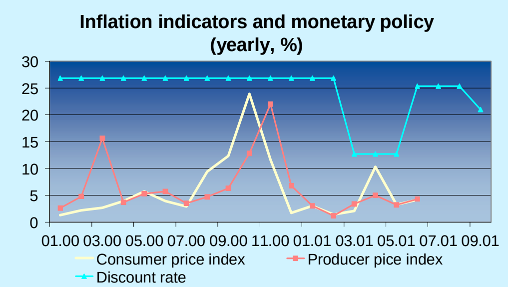
Foreign trade deficit during the first six months of 2001 amounted to USD 1.3 bn., which is 13.3% higher than in the same period last year. This deficit is the result of USD 0.9 bn. exports and USD 2.2 bn. imports, exports are up by 3.2% and imports by 9.1% comparing to the same period last year respectively. The target for 2001 was 26% export and 28% import growth that can not be achieved, although as a result of industrial recovery in the second half of 2001 turnover results will improve. Export coverage for the first two quarters equaled 39.9%, which is a significant (13.4 percentage point) decrease compared to the previous year. The largest deficit was realized in the trade with transition countries (USD 0.7 bn.).

Unemployment rate (registered) during the first seven months increased by 5.8% and by the end of July it was 28.3%. There is a tremendous imbalance between the number of registered vacancies and the number of unemployed. This fact and the slow recovery of industrial output are indicating that economic activity this year does not offer any substantial impetus for reducing unemployment rate. In the whole year a strict wage policy has been pursued, part of that was the wage freeze at the beginning of the year in the state owned enterprises that was relaxed a bit only in September. Real average net personal incomes in the social sector decreased by 10.1% within the first five-month of the year and grew by

5.8% year on year. What is new comparing to previous years is that the budget now pays wages and pensions more-less on time. Year on year retail trade turnover in the first five months grew by 7% and it corresponds to real wage trends. Stocks of manufactured products concerning the January-May period were 3% up.

In the fourth quarter of 2001 a significant increase of industrial production can take place, which will strengthen the positive impact of agriculture on growth, thus in 2001 the government targeted GDP growth of 5% can be achieved, despite the disappointing performance of industrial activity and moderate foreign trade performance in the first half of this year. If in the fourth quarter additional foreign financial support becomes available, even higher rate of growth can be expected. With strengthening industrial activity, foreign trade turnover is expected to improve. Unemployment rate this year is expected to stabilize at the current rate and real wages will decline somewhat.

Chart 15.3.



HIGHER THAN TARGETED INFLATION WITH THE MODERATION OF PRICE DISPARITIES

The primary goals of the monetary policy this year have been the reduction of inflation and the maintenance of exchange rate stability. Inflation accelerated by the end of last year, as many of directly controlled prices were liberalized. At that time more than 60% of prices were controlled. Year on year inflation in December 2000 was three-digit (115.7% CPI). After the high price growth in the forth quarter of 2000 moderate price increase was experienced in the first quarter of 2001 (6.2%, CPI) that accelerated in the second quarter (18.7% CPI compared to the previous quarter) due to further price liberalization in April. CPI was 26.5% in the first sixth months.

Producer prices in manufacturing in the first two quarters were up by 21.7%. The main contributor to price increase during the last twelve months were the measures aimed at moderating price disparities that had developed earlier. This component was accounted for about 65% of total price increases while core inflation is estimated to be around 20% this year. There has been a huge increases in regulated prices: electricity prices this year cumulatively would increase by close to 140%. Further moderation or elimination of disparities considered to be a necessary measure in order to cut expectations and thus creating stable environment, its implementation however increases costs of living substantially that my be unbearable for many. Partly this consideration led to the modification of the previously agreed further 40% price increase with the IMF resulting in just 15% price increase this fall.

The dinar is becoming more stable currency as confidence has strengthened due to tightened credit conditions, increases

Table 15.2.

Evolution of monetary conditions

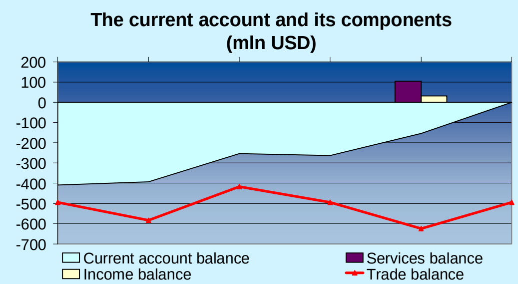
	1998	1999	2000	2001
Average USD exchange rate	9,3	11,0	37,5	67,0
Consumer price index (average, %)	29,9	44,9	85,7	45,0
Producer price index (average, %)	29,8	42,4	74,5	50,0
Broad money growth (dec/dec, %)	60,0	21,0	173,3	53,4
Real broad money growth (dec/dec, %)	30,0	-24,0	87,4	8,5
Domestic credit growth (dec/dec, %)	20,0	22,5	276,7	11,6
Real domestic credit growth (dec/dec, %)	-10,0	-27,0	191,0	-33,5
Nominal interest rates (3 month TBs, %)	n.a.	n.a.	n.a.	-

Table 15.3.

The financial vulnerability indicators between 1998 and 2001 (%)

	1998	1999	2000	2001
General government balance/ GDP	-5,4	-8,4	-0,9	-1,0
Current account/GDP	-6,4	-8,9	-7,6	-14,8
Short-term foreign debt/GDP	6,6	6,6	6,6	6,6
Short-term foreign debt/ Total foreign debt	5,7	5,7	5,7	5,3
M2/Reserves	555,0	333,0	200,0	169,0
Foreign currency liabilities/ total liabilities of the banking sector	n.a.	n.a.	n.a.	-

Chart 15.4.



in foreign exchange reserves and stabilization of exchange rate expectations. At the beginning of this year a managed floating exchange rate system was introduced with a 5% intervention band instead of free floating as this latter option would have generated expectations of the free fall of the currency. After the introduction of the new exchange rate regime, the National Bank of Yugoslavia (NBY) became a net purchaser at the forex market as net domestic assets started to decrease. The exchange rate has depreciated only very slowly against the Euro. The NBY carries out its exchange rate policy to protect external competitiveness. Foreign reserves by September reached USD 1.1 bn., which is a USD 0.5 bn. increase compared to their end 2000 level. The increase includes the distributed gold and foreign exchange deposits held with the BIS.

In line with monetary policy targets, discount rate this year has decreased and from the end of September its monthly rate is 1.3%. The lending rates of banks in real terms were positive except for April and June, the average weighted interest paid on household deposits reached 3.6% in August that was 0.9 percentage point above CPI. Commercial banks also started to offer commercial loans based on mostly foreign credits and the NBY forces commercial banks to supervise their borrowers strictly. Real broad money grew by around 6.3% in the first half of 2001. Total foreign exchange reserves/M1 by the end of August was 128.6% while total foreign exchange reserves/reserves money ratio was about 180%.

It would be important for the economic policy to further moderate the price disparities this year as it is necessary to create stable environment and weaken inflationary expectations. In 2001 we expect higher then targeted inflation rate and it could be around 45%. As far as exchange rate policy is concerned, in view of real appreciation of dinar the slight depreciation of the nominal exchange rate is expected in order to preserve price competitiveness of exports.

HUGE IMBALANCES IN BALANCE OF PAYMENT, CHALLENGES ON FISCAL POLICY

There are several hardly manageable imbalances present currently in the economy. According to revised data, current account deficit in 2000 was close to 7.6% of GDP and the ratio this year expected to be around 14.8%. Balance of payment financing gap amounts to USD 10.3 bn., which is due to foreign debt repayment arrears and current maturities.

Table 15.4.

The dynamics in the current account (%)

	1998	1999	2000	2001
Current account/GDP	-6,4	-8,9	-7,6	-14,8
Trade balance/GDP	-8,1	-11,9	-19,9	-25,0
Export growth	20,7	-47,6	15,6	3,5
Import growth	1,0	-32,1	12,6	20,7

Table 15.5.

The financial and current accounts (%)

	1998	1999	2000	2001
Current account/GDP	-6,4	-8,9	-7,6	-14,8
Financial account/GDP	0,1	0,1	3,2	0,9
FDI/GDP	0,1	0,1	0,0	1,1

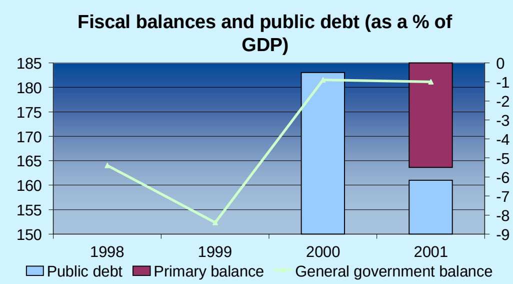
Table 15.6.

The evolution of foreign indebtedness indicators (%)

	1998	1999	2000	2001
Gross foreign debt/GDP	62,2	82,7	125,0	120,0
Short-term foreign debt/GDP	3,6	4,4	6,6	6,2
Short-term foreign debt/	5,8	5,5	5,5	5,0
Debt/Exports	304,9	634,8	532,6	620,0
Debt-service ratio	n.a	n.a	n.a.	-
Reserves/GDP	6,6	8,8	11,1	13,0

Foreign debt ratio to GDP is about 140% (the current level of GDP is highly debated) and debt/export ratio is more than 500%. It is obvious that given the ruined production base and very low level of exports, the solution for debt problem is a precondition for any substantial economic recovery. Foreign direct investments up till now are hardly observable: the amount of FDI flows this year is projected to be around USD 120 mn. and next year USD 300 mn.

Chart 15.5.



General government deficit of FRY (including the federal, the republican and local governments (excluding local governments in Montenegro) is set to be about 4% of GDP. Fiscal policy however is challenged in the second half of 2001 by the much lower than expected privatization revenues. Privatization revenues at the beginning of the year were projected to be about 1.4% of the GDP, current data show that they won’t exceed 0,4% of GDP. A further problem is associated with the enormous inter-enterprise arrears in the economy that requires urgent measure. Salaries have been frozen at the January level for the federal administration, while wage payments in the whole federal government will be limited from 13 to 12 months' salaries. A further problem is associated with the banking sector. A rehabilitation process has been initiated with the adoption of the bank restructuring strategy.

All these factors show that several problems should be addressed simultaneously leaving limited room for the economic policy. With successful handling of these issues, relatively stable macroeconomic conditions cannot be achieved before 2003. As the most important step, FRY badly needs a substantial debt relief as soon as possible.

PRIVATIZATION AND BANKING SECTOR REHABILITATION

Privatization in Serbia is based on a new privatization law that was adopted in June 2001. and by-laws and other regulations were put in place by mid-July. In addition, the establishment of the Agency for Privatization and Agency for Small and Medium-Size Enterprises was also successfully completed. On the basis of the framework, at the moment, 40 companies are tendered for sale, and the privatization of those companies will be finalized by May 2002 and by the end of the year additional 20 companies are expected to be sold by auction. The privatization process for the remaining 4.000 socially owned enterprises is expected to accelerate in 2002-03. A new bankruptcy law will also be drafted. The consolidation and restructuring of large corporations is underway: the first on the list is the Zastava and four other large enterprises (whose names weren't published yet) are included in the program. The distribution of privatization revenues is as follows: 10% is earmarked for pensions, and 5% will be used for compensating former owners. The remaining amount of revenues will be used for the development of small and medium enterprises.

In Montenegro a mass privatization program provides vouchers to 95% of the population that can be used to buy shares in companies or in 4-6 privately managed licensed privatization funds and the funds using the vouchers can buy shares. In 2001 29% of the shares of 227 companies can be bought within the mass privatization scheme and foreign investors will be offered a majority share in 15 large enterprises and a minority share in other enterprises that can be increased to a majority interest.

Bank Rehabilitation

Bank rehabilitation is one of the major aims of the economic policy. Earlier this year 28 banks had been classified as insolvent. Later these banks were categorized according to the following classification: A – healthy; B – requiring strict supervision; C – insolvent with some systemic importance or potential economic value; D – insolvent in need of liquidation.

Out of the 28 banks, 7 banks were found to be category D, their licenses were revoked and liquidation procedures initiated; 11 banks (including 5 of the largest banks) were put in category C, for possible treatment by the Bank Rehabilitation Agency (BRA). At the beginning of October the NBY revoked the licenses of two commercial banks from this category. 6 banks, including one of the largest banks, were considered to be category B and were placed under strict NBY supervision. 4 banks were considered to be healthy not requiring any further measures. NBY sent 4 of the largest banks (Beobanka, Beogradska Banka, Investbanka and Yugobanka, classified as category C) to the BRA for possible rehabilitation. These banks now have new management and controlled by the BRA.

UNCERTAIN PROSPECTS FOR 2002

The outlook for 2002 is influenced by three major groups of risk factors. The first is the question of foreign debt, as external relation will remain highly uncertain pending on the restructuring of debt obligations to official and commercial creditors. In this regards a new agreement with the IMF next March is also crucial. If debt agreement is reached, then the prospects are at least not affected by this risk factor.

The second factor is related to structural reforms (including privatization) and to the inflow of foreign aid, credits and investments, since without them the maintenance of external stability and increase of output can not be achieved simultaneously. Third important factor is political stability and the population's support for continuing reform program. These incalculable risk factors make almost impossible the forecast.

Provided that no major problems do appear regarding the above-mentioned factors, a slightly higher GDP growth is expected for 2002. However, it depends on the inflow of

Where the foreign assistance could come?

The IMF approved a stand by credit of a total of SDR 200 mn (USD 259 mn.) for FRY in June 11 that will expire March 31 2002. On September 19 the IMF approved to draw USD 65 mn. immediately as IMF considered that authorities "have made good progress in stabilization and reform".

Donor and creditor support is also key for FRY's success in reform. During the Donor Conference that was held on June 29 in Brussels, USD 1.3 bn. was pledged that is about 13% of the GDP. The timely disbursement of these funds is crucial, given the need to cover the social costs of the rapid transformation of large sectors of the economy.

On May 16 Paris Club creditors announced that they provide debt relief for the country, but no decision has been taken yet. Debt relief is also necessary from London Club creditors.

FDI would be a crucial factor in speeding up the economic restructuring. This year its amount is lower than expected and for the next year USD 300 mn. is forecast.

Table 15.7.

Major underlying and expected macroeconomic indicators

	2000	2001*	2002**
GDP (%)	-7,0	5,0	6,0
-Private consumption (%)	12,2	4,0	6,0
-Public consumption (%)	-19,7	10,0	10,0
-Investments (%)	7,7	7,0	7,0
-Export (%)	15,6	3,5	5,0
-Import (%)	12,6	20,7	20,0
Consumer price index (average, %)	85,7	45,0	25,0
Consumer price index (dec/dec, %))	115,6	25,0	20,0
Unemployment ratio (%)	26,8	28,0	29,0
General government balance (%)	-0,9	-1,0	-1,0
Public debt/GDP (%)	180,0	183,0	161,0
Current account (bn USD)	-0,6	-1,5	-2,0
Current account/GDP (%)	-7,6	-14,8	-18,6
Trade balance (bn USD)	-1,8	-2,5	-2,8
Trade balance/GDP (%)	-17,9	-24,0	25,0
FDI (bn USD)	0,0	0,1	0,3
Gross foreign debt/GDP (%)	125,0	120,0	60,0

foreign capital, partly due to the expected speeding up of privatization. Exports and imports are expected to increase substantially and current account deficit to widen. Private consumption remains depressed, as real wages in the public sector will be controlled. Results of industrial restructuring may be felt by the end of 2002 earliest. However, due to restructuring, unemployment rate is expected to increase further. At the same time, the pick up of FDI inflows is also foreseen, but the inflow of foreign assistance and a new IMF agreement aimed at maintaining macroeconomic balance is necessary. Inflation is expected to decelerate due to price adjustments taking place in 2001. If foreign exchange rate remains stable, the inflation rate is expected to be around 1% monthly.