



ICEG EC

**International Center for Economic Growth
European Center**



NEWS OF THE MONTH

May 2004

14 Korompai Street, H-1124 Budapest, Hungary

Tel: +36 1 248 1160 E-mail: icegec@axelero.hu Website: www.icegec.org

TABLE OF CONTENTS

<i>I. Excellent GDP Growth in the First Quarter in Romania</i>	<i>3</i>
<i>II. Inflation Forecast and Monetary Policy in Hungary</i>	<i>6</i>
<i>III. Continued Economic Revival and Rising Inflation in Poland</i>	<i>9</i>
<i>IV. Inflation in Slovakia: Driven by Authorities</i>	<i>13</i>

I. EXCELLENT GDP GROWTH IN THE FIRST QUARTER IN ROMANIA

In the first three months of 2004, the Gross Domestic Product (GDP) of Romania increased by 6.1% compared to the first quarter of 2003, according to the estimation of INS, the Romanian National Institute of Statistics. In Q1 2004, the value of GDP reached ROL 405 354.5 bn or approximately EUR 10 bn in current prices.

On the supply side, the construction sector has realized the highest pace of growth with its 7.2% increase. Besides construction, the industry sector also increased by above-the-average pace (6.6%). In addition, all the four major sectors grew rapidly in the first quarter of the year. The growth rates were above 5% in all four sectors, which reflects a rapid and balanced growth path considering only the supply side.

Table 1. Structure of GDP – Supply Side (Q1 2004)

Supply Side	bn ROL	m EUR	Q1/2003 = 100
Agriculture, sylviculture and pisciculture	11 692	289	105,4
Industry	129 562	3 199	106,6
Construction	15 381	380	107,2
Services	207 030	5 112	105,7
Financial intermediation services indirectly measured	-4 110	-101	103,5
Gross value added - total	359 556	8 878	106,1
Net taxes on product	45 798	1 131	106,0
Gross Domestic Product	405 354	10 009	106,1

Source: INS

The composition of GDP reflects that the growth of services sector had the highest contribution to the GDP growth. This sector's share reached the 57.5% of total gross value added, thus the above-mentioned statement is not surprising. In line with that the increase of the third sector accounts for more than the half of GDP growth.

According to the Q1 2004 data, the industry sector has the second largest share in gross value added, it is 36%, while construction and agriculture sectors account for 4.3% and 3.3% respectively. Certainly, these share figures are valid only for the first quarter and not for the whole year. The relatively low share of agriculture is reasonable by the special features of agriculture sector. The greater value of the sector is produced after the first quarter. Obviously, the main season of agriculture is rather the middle semester of the year than winter season.

On the demand side, primarily the (private) consumption was the main engine of the robust growth in the first quarter of the year. Households' consumption was higher by 8.4% than it was in the same period in the previous year, while government's consumption increased by "only" about 4%. The pace of growth of (private) consumption started to strengthen at the beginning of 2003. That was the time when minimum wage was increased significantly and the GDP growth was sustained in

the second consecutive year (2001 and 2002). The external demand started to decrease and the internal demand became the main engine of the economy.

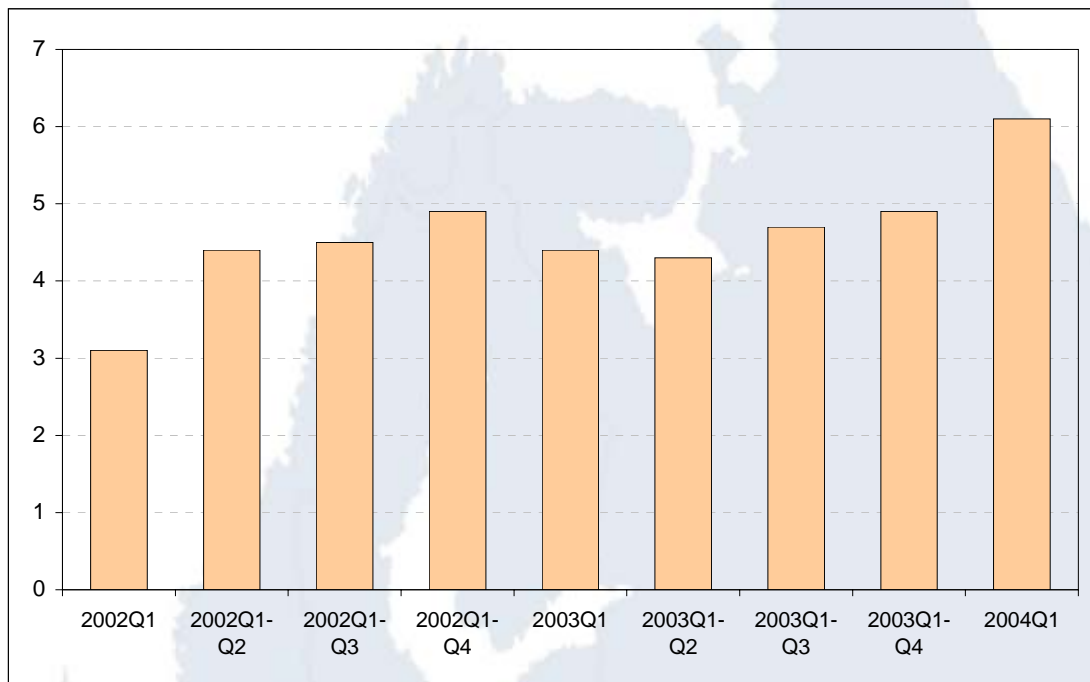
Gross fixed capital formation also increased significantly, by more than 7%. The growth rate of gross fixed capital formation started to rise in the middle of 2002 and since then the pace of growth has generally exceeded 7%. However, the consumption contributed to GDP growth by almost 7.3%-points, capital formation also contributed to GDP growth positively, its value was more than 1%-point. The investment rate calculated as the ratio of the fixed capital formation and the whole economy gross value added in Q1 of 2004 was 18.9% compared to 18.5% in Q1 of 2003.

Table 2. Structure of GDP – Demand Side (Q1 2004)

Demand Side	bn ROL	m EUR	Q1/2003 = 100
Total final consumption	362 574	8 952	108,1
..Households	336 356	8 305	108,4
..General government	26 218	647	104,1
Gross capital formation	67 154	1 658	-
..Gross fixed capital formation	67 815	1 674	107,3
Net exports of goods and services	-24 370	-602	-
..Export of goods and services	200 498	4 951	110,2
..Import of goods and services	224 869	5 552	112,4
Gross Domestic Product	405 354	10 009	106,1

Source: INS

As it was mentioned above, the external demand started to decrease at the beginning of 2003. Though the economies of Romania's main trading partners started to slow earlier (in 2001), the high pace of export growth remained until the end of 2002.

Chart 1. GDP growth (compared to previous period, %)

Source: INS

In the first three months of the year, the growth of imports overpaced that of exports. Thus, the current account balance worsened significantly via the worsening balance of foreign trade. The foreign trade deficit was almost 50% higher than a year before, it reached EUR 0.6 bn or 6% of GDP. The balance of trade of goods and services is similar, because the balance of services was in equilibrium in the first quarter of 2004.

For the whole year we expect that GDP growth will reach 5-5.5% again, which means that 2004 can be the fourth year in a row when growth rate is close to or exceeds 5%. In this year, the consumption remains the main engine of growth. Private consumption remains strong while public consumption is expected to strengthen due to the parliamentary elections that will be held in the second part of the year.

The recovery of the economies of Romania's main trading partners is slow, thus the growth of external demand remains weak. On the other hand, the strong consumption increases the import side of the trade balance and worsens the current account balance.

After the elections the GDP growth - and the contribution of consumption to the growth of GDP - is expected to decrease but remains high. In 2005, the GDP growth can be around 4.5% if the investments and exports become the main engines of growth and these factors can counterbalance the impact of the decreasing pace of consumption growth.

Prepared by: Péter Bilek

II. INFLATION FORECAST AND MONETARY POLICY IN HUNGARY

NBH revised its inflation forecast in its latest May Quarterly Inflation Report. Both the end-2004 and the end-2005 figures were changed downwards. Compared to the 6.9% end-2004 and the 4.3% end-2005 figures that were released in the February Report, the new forecasts are 6% and 4% respectively. While the Monetary Council had emphasized the upward risks in February, the latest report indicated that the risks were more leveled. According to the Council, in case of favourable market developments further monetary easing would be possible, however the role of the gradual and cautious interest rate policy was underlined. Since the publication of the May Inflation Report the optimistic market sentiment has worsened due to some poor domestic macro figures and changes of the global developments. May CPI data proved to be far worse than the market consensus, and the latest external balance figures raised some concerns, as well. Rate cut expectations priced out from the curve for a while, and most of the analysts do not forecast a single digit base rate by the end of the year.

CPI reached 6.8% in Q1 2004, which meant a substantial rise compared to the 5.4% of the previous quarter. The increase of the indirect taxes early this year accounted mostly for the rise. CSO introduced a new measure, the constant tax inflation figure, which indicated that the indirect tax measures accounted for a 1.6 percentage points rise of the CPI until March. According to the Inflation Report, the significant rise of the unprocessed food prices, that started last year came to an end, the prices actually fell excluding the higher VAT rates. The major source of the rising inflation was definitely the administrative prices. According to the analysts, inflation path could reach its peak around May-June and CPI is likely to drop back to 6.2-6.3% by the end of the year. Concerning the demand side, the slow down of the domestic household consumption could give a considerable impetus to the drop of the core inflation. Supply side is supposed to support the disinflation as well, due to the long awaited wage adjustments. Real wages rose by 0.1-0.2% in the first couple of months of this year. Inflation expectations still remained uncertain. According to the surveys, the corporate sector revised its expectations downwards compared to the previous quarter, but the high inflation expectations of the households prevailed.

In the May Report NBH said that one of the reasons for decreasing their CPI forecasts was the improvement of the risks related to Forint denominated assets. It has been a global trend recently, as investors' attitude towards the emerging market risks was positive. (However, it has to be taken into account that the interest rate cycle of the developed countries is going to enter an upward phase soon.) Regional risks have not decreased compared to February mostly due the political turmoil in Poland. The overall improvement of the investors' views mostly affected the short end of the yield curve. Longer maturities did not reflect the change of the market sentiment, the high spreads pointed to the ongoing uncertainties regarding the convergence path.

The revival of the export and the increasing industrial output figures moderated the concerns related to the unsustainability of the current account deficit. The assumed fiscal consolidation and a projected rise of the households savings could also lead to an improvement of the external balance. The 4% firming of the Forint in the Feb-May period, and the administrative controls on the medicine prices all contributed to the lower inflation pressure. However, the market reaction of the May Report was limited, because investors already priced in the favourable developments two weeks ago, when the MC cut the base rate by 50bp on its regular meeting.

The favourable developments came to a halt in June, the base rate had been left unchanged on three consecutive MC meetings. By the end of June the rate cut expectations got priced out of the curve for a while.

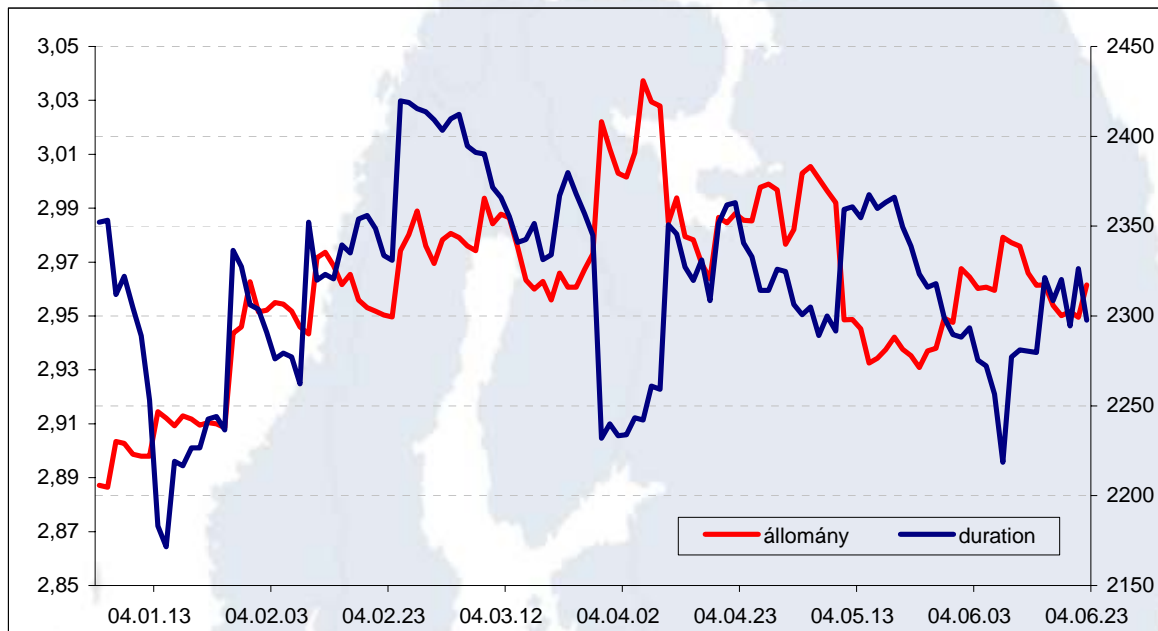
One of the reasons of the changing market sentiment was the poor macro figures that have recently been released. The 7.6% May CPI exceeded far the 7.1-7.2% market consensus. The pick up of the inflation rate could not be related to a specific product group, the rise of the CPI was perceivable in each component of the core inflation. Core inflation rose by 6.5% y-o-y, while the headline m-o-m CPI was 0.9% in May. Price of the consumer durables has not changed significantly compared to May 2003. Clothing and fuel prices rose below the average, while the price of the electricity, tobacco and gas soared radically by 21.8%, 21.9% and 19% respectively. According to the analysts the rise of the tobacco prices due to the delayed impact of the increased excise duties contributed significantly to the abrupt jump of the inflation rate. Another factor behind the rising CPI was the increasing food prices. Food prices increased by 1.7% compared to the previous month, the price of sugar rose by 11.3% in May, just like in many other countries that have just joined the EU. The rising oil prices pushed the CPI higher as well, and May fuel inflation over the longer term, too by increasing production costs and feeding through to market expectations.

The disappointing April trade deficit and C/A deficit figures have increased the investors' uncertainty. External trade performance still remains a source of concern despite the favourable developments at the beginning of the year. April C/A deficit widened drastically and proved to be much worse than the market consensus. Exports have posted a 14.4% y-o-y growth rate in April, but it was outweighed by the 19.1% y-o-y surge in imports. It has not reassured the investors that Hungary has not made much progress in reigning in its C/A deficit, despite the positive global growth environment. However, it has to be noted that the recent pick up of the import may reflect the advanced spending before the EU accession and the upsurge also indicates the rise of the corporate investment activity. The slowing consumption growth and the external demand driven recovery in the corporate sector in Q1 2004 reduces the risks related to the current account.

As a result of the latest poor macro figures NBH officials announced several prerequisites of the monetary easing. Declining C/A shortfall, growing amount and

increasing duration of the government security stock owned by the foreigners are necessary for further rate cuts.

Chart 2.



NBH moves will be dependent on the international developments as well. Interest rate cycle of the developed countries has come to an upward phase. Regarding our region the Polish FRA curve is pricing in a 150 bp rate hikes before the end of the year, while in the Czech Republic the market is pricing in a 75-100 bp tightening for this year.

In Hungary rate cut expectations have priced out, the curve has flattened, the next rate slash is expected to take place in September. The FRA curve is pricing in only a modest 125-150bp rate cut by the end of the year. It is obvious that the current developments do not allow the NBH to ease the monetary conditions, however in our view NBH had the opportunity earlier and could have influenced the market sentiment positively.

Prepared by: Dániel Bebesy

III. CONTINUED ECONOMIC REVIVAL AND RISING INFLATION IN POLAND

A significant acceleration of inflation was experienced in Poland in April 2004. While the annual price growth rate was around 1.6% in the first three months of the year, by April it reached 2.2%. This rise was a result of various factors, some of them thought to be temporary. Therefore the Monetary Policy Council (MPC) of the National Bank of Poland did not change interest rates at its meeting at the end of May. One of the main factors pointing to higher risk of stronger inflationary pressure was the rise of inflation expectations.

The MPC pointed out three factors, which favour a low inflation rate. These were the continued low growth rate of corporate loans, the continued high growth rate of labour efficiency and continued high unemployment, which could - to a certain degree - limit pressure on salary increases.

However, the number of factors causing inflationary pressure was higher. The inflation expectations of households, which had been rising since the beginning of the year, stabilised in May at a higher level. The inflation rate expectations of individuals rose from 1.6% in December 2003 to 2.4% in May 2004. There was a further very strong growth of price increases expectations in retail trade. In April the PPI rose significantly and all core inflation indices followed. This was mainly caused by an increase in producer prices in domestic sales, which was a consequence of the rise of oil prices on world markets.

The strong revival of the Polish economy is also causing inflationary pressure. It is mainly based on rapidly increasing export, but there are also strong signs of a significant revival of domestic demand. Retail sales have also been on the rise in recent months, reaching a growth rate of 30.6% in April, on an annual basis. Similarly to March, the highest growth (56.3% year on year) was observed in the motor vehicles section. This was due to the expected change in VAT regulations after joining the EU. The dynamism of retail sales in the months before May resulted partly from expectations of price increases after EU accession. Expectations of price increases in retail trade achieved the highest level since 1997. Investment activity is gaining momentum, as well.

A very high growth rate in construction-assembly production and in sales of construction materials was observed. It was most likely the result of the introduction of a significant increase in the VAT tax rate from May 2004 for materials and construction services. The supply side factors pushing inflation upwards were the continued high oil prices and significant increase in the price of foodstuffs, which amounted to 4.6% in April, on an annual basis. The MPC pointed out that political instability and the lack of public finances reform are the sources of continued

uncertainty on financial markets leading to an increase in the yield of treasury securities and the weakening of the Zloty exchange rate.

Table 3.

2004					
	Weights				
	%	I	II	III	IV
<i>corresponding month of the previous year = 100</i>					
Total, of which	100.0	101.6	101.6	101.7	102.2
Food and non-alcoholic beverages	27.0	102.2	102.7	103.3	104.6
Regulated prices	27.3	102.3	101.9	101.6	102.2
Incl. Fuels	3.8	105.4	102.7	101.3	104.7
Other goods and services, of which	45.8	100.8	100.7	100.7	100.8
Non-food products	27.3	99.8	99.7	99.8	100.0
Services	18.5	102.4	102.3	102.1	102.1
<i>previous month = 100</i>					
Total, of which	100.0	100.4	100.1	100.3	100.8
Food and non-alcoholic beverages	27.0	100.5	100.3	100.8	102.1
Regulated prices	27.3	100.6	100.2	100.3	100.4
Incl. Fuels	3.8	103.2	101.0	101.9	101.9
Other goods and services, of which	45.8	100.2	99.9	100.0	100.2
Non-food products	27.3	100.0	99.6	100.0	100.1
Services	18.5	100.5	100.3	100.1	100.3

Source: National Bank of Poland

The growth of food prices impacted inflation the most in the first four months of 2004, especially in April (Table 1). The impact of regulated prices and other goods and services was smaller. Food prices increased in April 2004 by 4.6%, compared to the corresponding month of the previous year, and 2.1% compared to March 2004. The main source of the food price increase was last year's lower than usual crop harvest. In addition to this livestock production (pork) had been reduced for many months. The statistical base effect also influenced food prices growth rate, as in the first four months of the previous year there was a downward trend of 3.4-3.5% year on year in this price group.

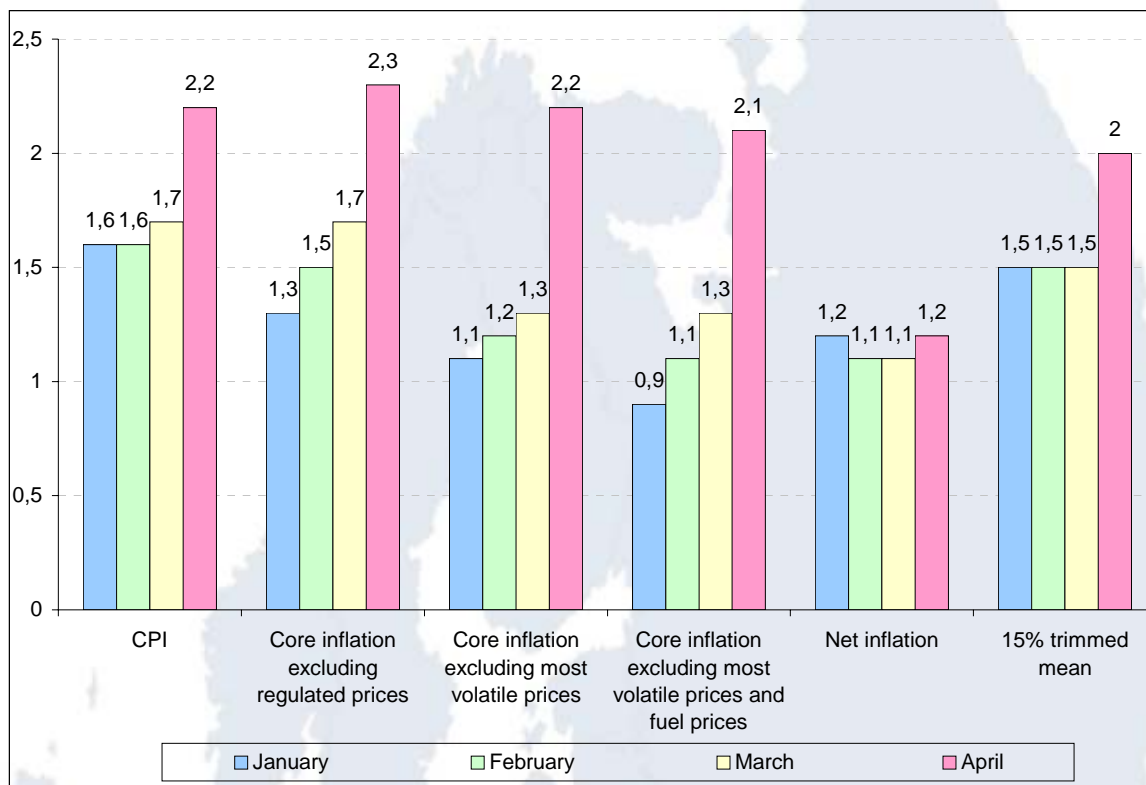
An increase in the purchases of certain food products was also experienced, as a result of consumers' fear of the possible rise in food prices following the EU accession. The NBP expects food prices to rise further in coming months, as crop harvest will be worse this year than in the two previous years, and pork production will remain lower than usual, as well. The introduction of the measures of the EU Common Agricultural Policy and Common Customs Tariff will also push food prices upwards in Poland.

As for regulated prices, they increased by 2.2% in April 2004, compared to April 2003. Fuel price increases (4.7% year on year in April), resulting of the surge in oil world prices, contributed to this the most. An increase in the excise tax and an introduction of fuel charge on 1 January 2004 were much weaker contributing factors. As for energy prices, only hot water charges increased in the first four months of 2004.

The annual price growth of other goods and services was significantly lower in January-April 2004 than in the previous year. The prices of non-food products have been decreasing in this period, while the tendency of gradual decrease in the growth rate of services price continued, reaching 2.1% year on year in April. In the category of non-food products the most significant falls were experienced in the prices of footwear (3.7%) and clothing (2.3%), in the first four months of 2004.

PPI increased sharper in April than it was previously expected. It rose by 2% on a monthly basis, while it reached a 7.5% growth rate year on year. The sharp increase resulted mainly from high commodity prices. The prices in the manufacture of coke and refined petroleum products (13.4%), in the manufacture of basic metals (13.1%), and in coal mining (9.2%) have all seen a significant increase. Still high fuel prices are expected to raise the PPI to 9% year on year in May.

Core inflation indices followed the rise of CPI in April 2004 as well (Figure 1). Each of them increased steeply, except net inflation, from which the prices of food and fuel are excluded. This proves that the current inflation surge results mostly from these two supply-side factors. One measure, the CPI excluding regulated prices, exceeded the CPI inflation rate. The increase in core inflation measures is a warning sign, that even if inflationary pressure comes mainly from the supply-side, they may contribute to the growth in prices of other goods and services, causing stronger inflationary pressure in the medium term.

Chart 3. CPI and core inflation indices in 2004 (Y/Y change, %)

Source: NBP

Provided that interest rates are unchanged, after the surge in inflation in April 2004, the probability of inflation exceeding the upper tolerance limit of deviations from the target of 2.5% +/- 1 percentage point is higher than 50%. The MPC did not raise interest rates at its meeting at the end of May, because it was still waiting for data that might prove the temporary nature of some of the factors of the experienced inflationary pressure. However, if economic data are published and the continuing high oil prices reveal processes that increase the risk of breaching the upper limit of acceptable deviation from the inflation target, then an interest rate rise is very likely in June.

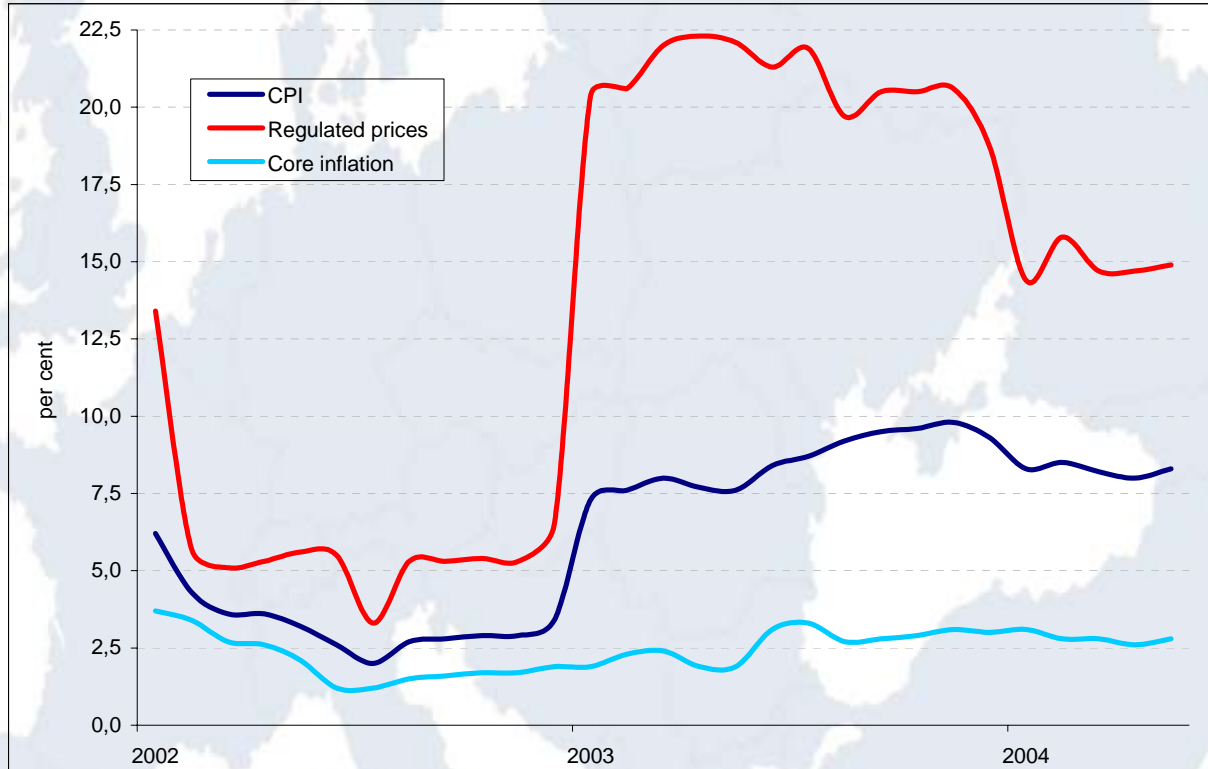
Prepared by: Veronika Czako

IV. INFLATION IN SLOVAKIA: DRIVEN BY AUTHORITIES

Consumer prices in Slovakia rose by 0.4 per cent in May resulting in a year-on-year overall inflation growth of 8.3 per cent. The core inflation accelerated slightly from previous month's 2.6 per cent to 2.8 per cent y/y, whereas regulated prices were up by a tremendous 14.9 per cent. Prices in the field of education, alcoholic beverages and tobacco, utilities and fuels and health care showed the strongest growth dynamics. The trend of consumer price index (CPI) is not expected to change until at least August this year.

Behind recent inflation developments one factor seems to be dominant. The Slovak economy has been undergoing remarkable structural changes for a couple of years. In line with preparation for the EU accession the Slovak Government braced itself up to adopt remarkable reforms in areas such as the tax system, public finances, education, health care or social security system. The government's ambitions have been to prepare the economy for a successful integration to the EU as well as to the EMU. In this framework series of regulated price adjustments and fundamental changes in the tax system have been substantially determining the price developments since 1999.

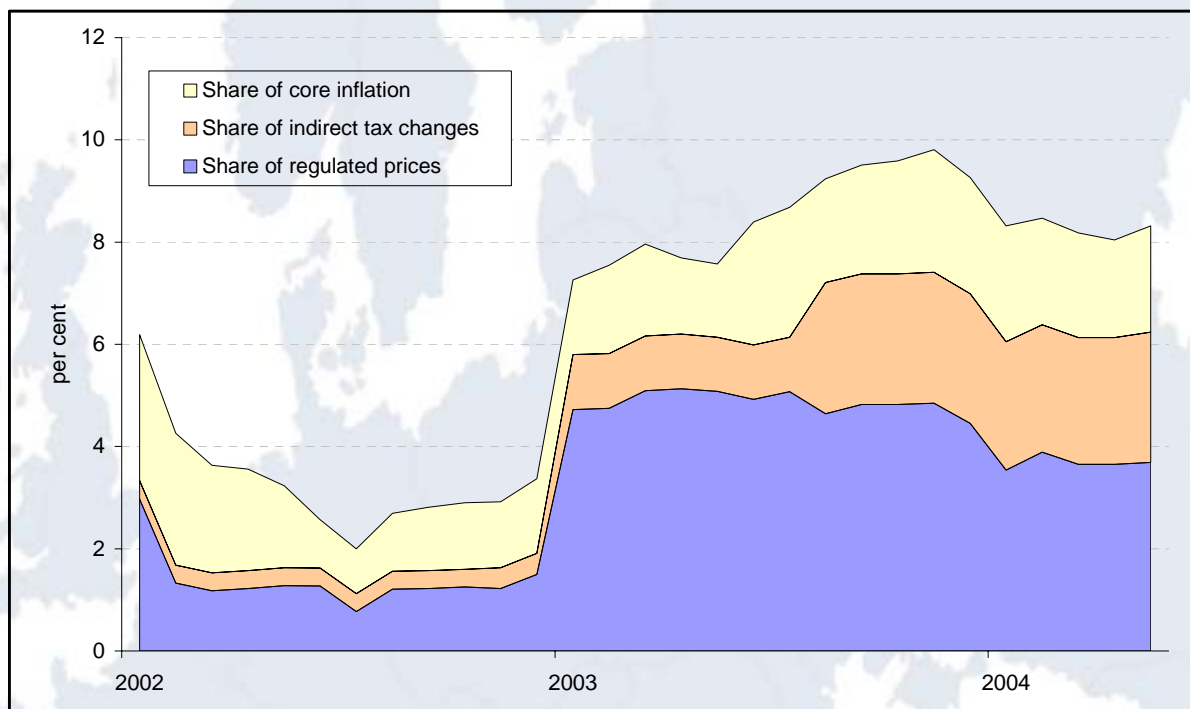
Chart 4. Inflation trends



Source: SOSR

Last year's inflation were boosted twice by administrative measurements. In January regulated prices were raised, while in August higher excise duties were released. Regulated price increases and higher excise duties accounted for 6.55 percentage points of the total 8.54 per cent overall inflation in 2003. This kind of development is also persisting this year. As from 1 January 2004 the new tax system came into force. Concerning inflation the most important change was the introduction of the flat 19 per cent VAT rate instead of the former 14 per cent reduced and the 20 per cent standard rates. Besides the tax reform further administrative price hikes took place in January. In May further hike in excise duty on tobacco and tobacco products was implemented in line with EU regulations. While core inflation has been fluctuating in a band of 1 and 3 per cent for years, regulated prices grown over 20 per cent y/y in 2003 and is growing around 15 per cent this year. The relative stability of core inflation confirms the lack of cost or demand side pressure on prices.

Chart 5. Brakedown of inflation (CPI)



Source: SOSR

Besides this sort of price developments the Slovak economy recorded a relatively good performance last year. Despite the unfavourable external environment (uncertainty in the main European economies) and the weaker domestic demand the real GDP growth reached 4.2 per cent in 2003 thanks to the increment in employment and productivity. The positive changes in the labour market are primarily due to the massive inflow of foreign investments particularly into the manufacturing and automotive industries. The excessive liquidity arising from foreign investments were sterilised by the National Bank of Slovakia (NBS). The additional production

capacities strongly influenced the current account in a positive manner. The boosted export performance was the main source of a 7.1 percentage points improvement of the current account.

Cost-related factors have basically not affected the course of inflation upwards. Real wages declined by 2 per cent last year as a whole. The impact of the volatile crude oil prices being on the rise were mainly offset by the gradual appreciation of the exchange rate of the Koruna against the US Dollar. The Koruna slightly appreciated against the Euro as well, delivering a positive effect via 'imported inflation'. Last year's tendencies are continuing this year with one exception. The exchange rate of the Koruna against the US Dollar seems to be reversing, it has been depreciating since February.

There were also no signs of a demand side pressure on inflation. As a result of last year's real wage decline household consumption turned out to be rather sluggish in 2003 and is expected to grow just slightly this year. Fiscal position was moderately expansive over last year running a primary balance of -1.2 per cent of GDP. The general government budget position in the first five months of 2004 has just turned into deficit accounting for only 2.89 per cent of the deficit target for the whole year. The current favourable fiscal position is a temporary result of the diverse fulfilment of expenditures and revenues.

Considering the nature of recent price developments and the macroeconomic performance of the Slovak economy the NBS has lowered its policy rate by 150 basis points on the whole to 5.5 per cent since the beginning of 2003. According to the NBS projections CPI y/y should be running at 6.4 per cent (± 0.9 pp.) this year with a core inflation being at a rate of 2.35 per cent (± 1.15 pp.). The regulated prices should be up by 13,8 per cent (± 0.4 pp.) year-on-year. The NBS projection reckons with the followings:

- average crude oil prices of 26 USD/barrel
- further increase of excise duty on tobacco and tobacco products
- further increase of regulated prices with a total contribution of 3.1 percentage points to the overall inflation
- the effect of the adoption of the common agricultural policy
- the cancellation of 10 and 20 Haler coins
- lower imported inflation
- the secondary effects of regulated price increases

The NBS projections seem to be well-founded and its targets are feasible. However, two things should be noted. First, last year's wage developments indicate the way how wage adjustments are carried out in Slovakia. This kind of backward looking

wage corrections (*adaptive expectations*) might be one of the factors that can delay the fade-out of the impact of administrative measures. Second, the assumption concerning the oil price may easily not be realized as the Middle-East crisis has not come to peace yet.

Prepared by: Szabolcs Patkó