ICEG European Center

NEWS OF THE MONTH NR. 2

VIEWS ON THE REGION

A Report by the ICEG European Center

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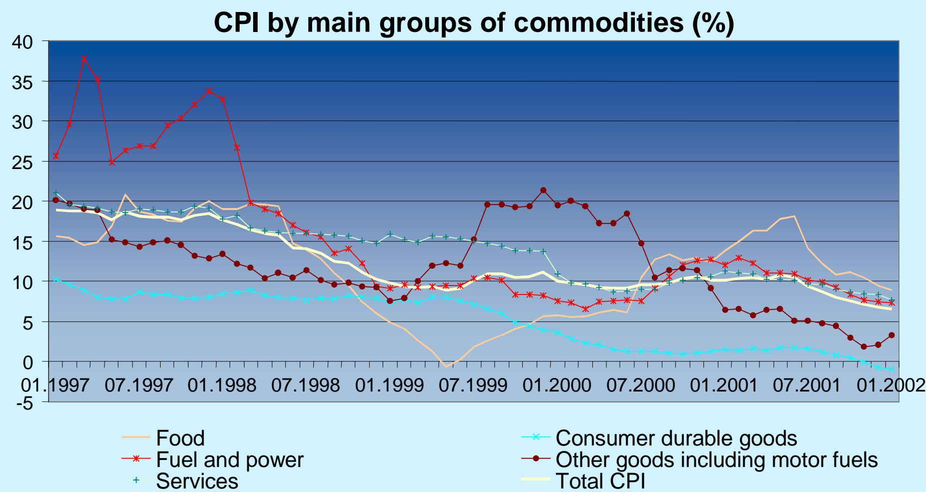
News of the Month represents brief analyses prepared by the ICEG European Center on the latest macroeconomic developments in Eastern Europe. The analyses are published once in a month and assess some of the major news, developments in the region that occurred in the previous month.

1. INFLATION DEVELOPMENTS IN HUNGARY

The Consumer Price Index rose by 6.6% in year-on-year base in January 2002, which is in line with expectations. The CPI reached 1.3% on monthly bases. The yearly rise of core inflation was 7.2%, which is 0.9% lower then in the previous month. Mainly domestic inflation pressure contributed to the rise of inflation, as prices of foods and services rose over the average. Consumer durable good prices fell by 1% on yearly basis as a result of the nominal appreciation of the Forint (HUF) and the slowdown of EU PPI in 2001.

Chart 1.



As far as the contribution of main groups of commodities to CPI is concerned, food prices raised the consumer price index by 1.7%, while services contributed to the rise by 1.8%. Prices of industrial products, which have approximately 27% share in the consumer basket, rose by 0.9%, well below the average. The decline of oil prices in 2001 had a strong impact on fuel and power prices, which pushed down inflation rate in January 2002. Inflationary contribution of administrative prices remained stable at 1.6%.

Table 1.

Contribution of main groups of commodities to CPI

	Food	Industrial products (tradable goods)	Services (non-tradable)	Power	Alcoholic, beverages and tobaco	Fuel	Administrative prices
Weight (2001)	*19,0%*	*26,8%*	*20,3%*	*1,3%*	*9,1%*	*5,0%*	*18,6%*
2000	1,9	1,4	1,9	0,3	1,0	1,4	1,6
2001	2,9	1,3	2,3	0,2	1,0	-0,0	1,6
2002. jan.	*1,7*	*0,9*	*1,8*	*-0,0*	*0,9*	*-0,5*	*1,6*

We categorized the main groups of commodities according to their effect on the CPI in the past years. Our method of calculation was following: We took the real price index in the main groups of commodities (real price index of food, real price index of industrial products…).

Than we focused on the total CPI and calculated the partial price indexes according to the weights of each group in the costumer basket. As a result, we got the difference between the real price indexes and the price indexes calculated by the weights in the basket.

Table 2.

Inflation pressure of main groups of commodities to CPI

	Food	Industrial products (tradable goods)	Services (non-tradable)	Power	Alcoholic, beverages and tobaco	Fuel	Administrative prices
Weight (2001)	*19,0%*	*26,8%*	*20,3%*	*1,3%*	*9,1%*	*5,0%*	*18,6%*
2000	*0,7*	*-1,5*	*0,4*	*0,3*	*0,1*	*0,3*	*-0,5*
2001	*0,6*	*-0,8*	*0,7*	*-0,1*	*0,3*	*-1,0*	*0,4*
2002. jan.	*0,5*	*-0,8*	*0,5*	*-0,1*	*0,3*	*-0,8*	*0,4*
Average (1995-2001)	*-0,4*	*-1,0*	*0,3*	*0,1*	*-0,0*	*-0,0*	*0,9*
Average (2000-2001)	*0,6*	*-1,2*	*0,5*	*0,1*	*0,2*	*-0,4*	*-0,0*

Our conclusion is that mainly industrial products (which can be identified by the tradable goods) contributed to the slowdown of the Hungarian inflation rate.

The group of foods is inconsistent. Between 1995 and 2001 on average the growth of food prices remained below the average. From 1999 food prices started to accelerate and became a significant source of inflation pressure in 2000 and 2001. In January 2002 the group of industrial products exerted the strongest anti-inflationary pressure.

The next considerable group contains services. Services typical belong to the non-tradable sector and along with the groups of foods, power and fuel represented a significant repressed inflation pressure.

The administrative and regulated prices remained a remarkable source of inflation until 1999, but from 2000 this group contributed to the slowdown of the CPI.

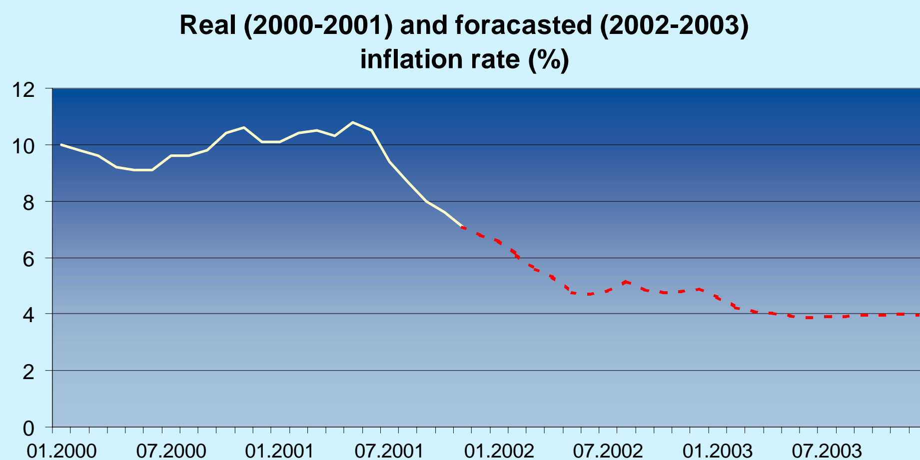
FORECAST

During the calculation of our forecast the assumptions were the following:

- The Forint is likely to appreciate by around 3% per year, and in itself may reduce the inflation rate by around 2.2% in 2002.
- Oil prices will slightly decrease in the first three quarters of 2002 and gradually rise afterwards;
- EU inflation rate will stagnate around 1,9% in 2002 and around 2.1% in 2003.
- Price index of services and foods will maintain the domestic inflation pressure. Repressed inflation will rise in line with the growth of domestic absorption;

According to our forecast year-end 2002 inflation rate will be 4.8% and the annual average CPI will reach 5.2%. We expect a December 2003 CPI of 4% and the whole year average consumer price index is likely to be around 4.1%.

Chart 2.



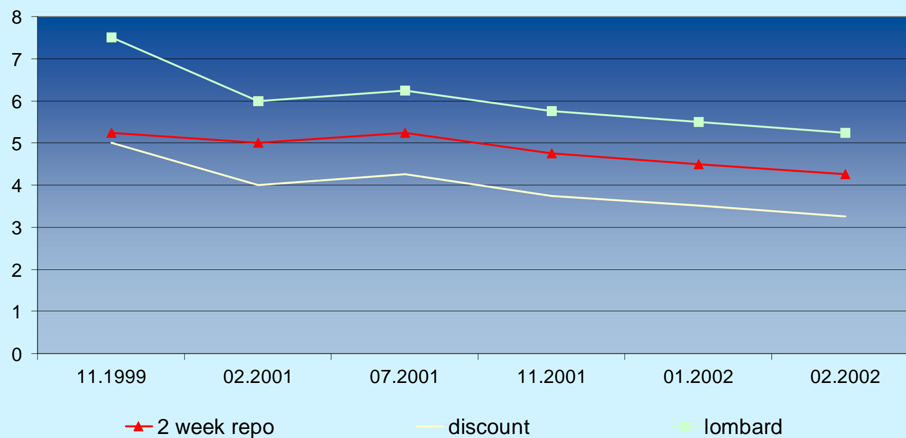
2. INTEREST RATE CUTS AND THEIR BACKGROUND IN THE CZECH REPUBLIC

In January 2002 the Czech National bank cut its interest rates twice by 25 bps. each times: while the first cut and the accompanying intervention on the foreign exchange market to weaken the domestic currency was expected, the second one was a surprise for investors and observers. With these recent two cuts the central bank reduced its interest rates by around 100 bps since November 2001.

The changes in the monetary policy and the interest rate cuts reflect two simultaneous concerns of monetary authorities. The first is linked to macroeconomic developments in 2002, especially to the expected evolution of GDP and inflation, which will differ from earlier expectations. The second is connected to the increasing concerns with exchange rate consequences of capital inflows, predominantly privatization linked foreign direct investments.

The recent developments in the EU and in the Czech Republic force the central bank to change for the current year the inflation and growth forecast. Both figures were lowered significantly, especially the growth one: earlier expected 3,4-4,5% GDP growth was replaced by 2,4-3,4%, while inflation figures were adjusted from 3,3-4,7% to 2,5-3,8%. The slower GDP growth reflects the slower than expected recovery in the EU and its weaker positive effect on the growth of Czech exports (which notwithstanding the low foreign demand and appreciation of the Koruna still grows favorably with improving structure). Besides less favorable foreign demand, growth of private consumption and especially private investments may slow down compared with 2001, and this will be another strain on GDP growth.

Chart 3.



Another factor which allowed the rate cuts is the good inflation performance. Currently there are no significant threats to inflation in the Czech Republic: imported inflation remains low thanks to favorable oil price and terms of trade developments, and to the dampening effect of Koruna appreciation. Moreover, the slower than expected increase in both external and domestic aggregate demand keep the demand factors of the inflation at modest level. Finally, in the current year less adjustments in the administrative prices are foreseen, which keep the increase of regulated prices under control. Relatively favorable inflation may be expected also from the recent developments of the producer price index: after falling for two months at the end of 2001, it increased with the

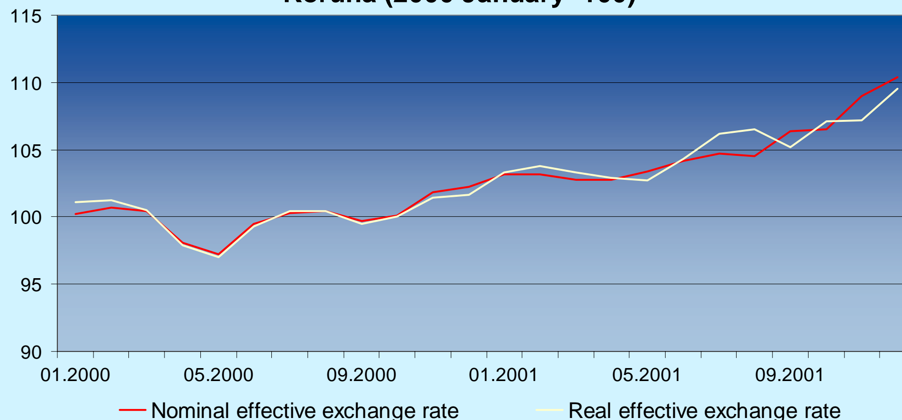
lowest speed in January this year since the beginning of transition in 1990.

The rate cuts are also associated with the strength of the Czech currency, and the decisive attempt of the central bank and the government to avoid the unduly and fast appreciation of the Koruna. It appreciated in the last 12 months almost 10 percent against the Euro and also on nominal effective terms. The high balance of payments surplus is the major reason behind the strengthening of the national currency, driven by the inflow of privatization and greenfield related foreign direct investments. In 2001 receipts from foreign direct investment inflows exceeded current account deficit by 3,2 bn. US dollars, equivalent to 5,8% of GDP.

In 2002 the gap is expected to widen further, as while the current account deficit will increase slightly, foreign direct investment may increase by more than 50% creating a gap between them and the current account balance, equal to 8,6% of GDP. The appreciation of the Koruna in 2001 has been partly driven by the high conversion of foreign currency receipts to Koruna, which put a constant pressure on the nominal exchange rate

From the last months of 2001 the underlying conversion was accompanied also by the expected increase of privatization and foreign direct investment related inflows in 2002 and their impact on the exchange rate following their expected conversion. The expected appreciation of the exchange rate put additional pressures on the local currency.

Chart 4.



Monetary and fiscal authorities regard the appreciation of the national currency an unhealthy and alarming development. They argue that the appreciation of the Koruna is not justified by the fundamentals as it is due only to the conversion and expected further capital inflows, while the effect of privatization on export supply and competitiveness in tradable sector will materialize with delays. Therefore the central bank and the government agreed to reduce the conversion demand in 2002 by various measures, including the absence of new foreign currency denominated bond issues by the Ministry of Finance, depositing privatization revenues at the central bank and stimulating payments in Koruna in the privatization private investments, and thus can mitigate the on transactions.

Besides that the central bank uses strong verbal intervention in arguing that the current exchange rate level is unsatisfactory and measures would be taken to bring it to a more favorable level. The cut of interest rates in January and the central bank intervention following the first cut was the sign of more decisive central bank approach.

The cut in interest rates will have only a partial expected effects. It can possibly contribute to more robust increase in domestic absorption primarily negative growth effects of the changes in external demand. However, it is highly questionable, whether interest rate cuts may reduce the pressure the appreciation of the national currency. First, by

these January cuts the room for reducing interest rates has almost been exhausted and further cuts could be considered only in case of better than currently expected inflation developments. Therefore the central bank doesn't have too much room for maneuvering with interest rate policy in influencing the markets' expectation on the evolution of the exchange rate.

Second, interest rate cuts should have a minor effect on the exchange rate because currently not the short term speculative debt creating flows are the major element of the surplus on the financial account, but foreign direct investments. These are less influenced by interest rate developments, (moreover the positive effect of the cuts on the domestic economy may increase attractiveness of and confidence in the Czech economy, driving new foreign investors to the country) and therefore interest rate cuts will have a minor effect on the financial account.

3. BANKING REFORMS IN SERBIA

In 2001, the new government set three major policy goals: banking sector rehabilitation, fiscal reform and privatization. The Serbian banking sector by the end of 2000 was weak, undercapitalized, poorly operating and financial intermediation was low, as the public confidence in banks was very limited. The system was further burdened by the soft budget constraint in the enterprise sector, lack of financial discipline, moral hazard, bad loans and the old foreign exchange savings deposits.

Several significant results were achieved in the economy during the year 2001 that supports the transformation in the banking sector. Inflation was substantially reduced reaching an annual average of 39% (retail price index), accompanied by the fall of interest rates. Additional steps included the introduction of full internal convertibility and the beginning of the liberalization of money and capital markets. The national currency was stabilized and the managed floating exchange rate system tries to balance competitiveness and price stability. The primary goal of the monetary policy is to maintain macroeconomic stability and control price increases and they were mostly met in 2001. The foreign exchange reserves increased substantially reaching over USD 1 bn. by the end of the last year.

In the banking sector, significant steps were also taken. At the beginning of the transformation, the banking sector was oligopolistic, as 6 banks dominated it, while there were relatively large number of small banks. It was considered that achieving a healthy banking system through restructuring requires stable macroeconomic environment, functioning legal system, financial discipline, economic restructuring, effective system of bank supervision, qualified personnel and political will to carry out reforms. By December 2001 significant changes took place. During the year all banks were thoroughly examined to draw a realistic picture about their financial situation and the Banking Rehabilitation Agency was strengthened. Then, the banks were divided to four groups:

A – healthy banks, requiring no further actions;

B – solvent but undercapitalized banks;

C – insolvent banks with some systemic importance;

D – insolvent banks with no systemic importance.

A and B banks were put under the supervision of the NBJ, C and D banks were put under the control of the Bank Rehabilitation Agency. 31 banks were considered as healthy, not requiring additional actions by the authorities, 8 were considered undercapitalized but otherwise healthy. 27 banks were put under the control of the Banking Rehabilitation Agency and 19 of them were declared bankrupt or were liquidated. Several smaller banks were merged in order to create viable banks. In 2000, 5 new licenses were issued. By December 2001, 54 banks were operating in Serbia, a significant drop compared to the 82 banks existing in December 2000.

The philosophy of the bank restructuring is pragmatic and efficient, as the authorities do not want to rehabilitate banks at any price. It is clear from the measures introduced that this philosophy is taken seriously. One very important characteristic of the banking rehabilitation process is that the donors finance the process. The international donor community supervises the banking rehabilitation process very strictly. The legal framework was strengthened, special emphasis was put on capital adequacy, large exposures, lending to related parties and shareholders, risk management. Banks are obliged to produce monthly reports to the supervisory authorities. The banking sector has become healthier and now it is much more reliable. Banks now participating in financial intermediation, in meeting requirements prescribed by laws increased substantially, capital base of the banking system was strengthened and new funds were channeled through the banks. As a result of the stabilization of the economy and the consolidation of the banking sector, in 2001 several foreign banks entered the market in Serbia.

There are several newly found subsidiaries (Micro Finance Bank, RZB, HVB, National Bank

tion vis-a-vis public authorities and institutions. Banks, bank owned institutions and nonresidents

of Greece, Alpha Bank), and new representative offices were also opened (WEST LB, BNPParibas, Bank Styria, Nova Ljubljanska Banka)

In 2002, the restructuring of the banking system entered its new phase. At the beginning of January, four large, insolvent banks were put under control pending their liquidation (Beobanka, Beogradska Banka, Investbanka and Jugobanka Belgrade). These banks are very large as they account for 55% of the book value of banking system assets but they had been insolvent for several years, and in domestic payment operations their share were under 20%. The closing of these four banks in 2002 will cost about 1,2% of annual GDP as a result of covering losses of depositors and severance payments to 9000 people working at these banks. According to the economic analyses prepared by the authorities, further rehabilitation would be an insane action, as it would cost minimum DEM 8.3 bn.

The compensation of depositors will vary according to type of depositors. Individuals and public sector entities and institutions (schools, hospitals) are fully paid. Enterprises will be compensated only partially. After a thorough evaluation, the Ministry of Finance has a right to decide on the scale of compensation case-by-case. The net credit position of enterprises is evaluated and paying is limited to the balance of credit positions are compensated only up to the deposit insurance limit (YUD 5000 = DEM 165) The assets of the closed four banks will be sold by the Bank Rehabilitation Agency and the revenues will be used to repay creditors.

In the end of 2001 and in 2002 a very ambitious program to strengthen bank supervision will be speeded up. The most important elements of the new supervisory activities are the strengthening of prudential regulations, introduction of on-site supervision, introduction of problem banks' unit, strengthening classification and provisioning regulations, staff training, and consolidation of internal control systems and introduction of Central Credit Registry.

To sum up, a very ambitious bank-restructuring program was initiated in Serbia. Currently, all the required components of the successful implementation are present. The government seems to be supporting the program without hesitation, the external pressure on the process is tough as the costs of rehabilitation are mostly covered by foreign donor assistance, and it is also realized that a sound banking system is a precondition for any successful economic transformation. Most of bad banks were closed, legal framework became strict, public confidence was increased and foreign banks also started to interest in the Serbian market.