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I. 300 BASIS POINTS CENTRAL BANK RATE HIKE IN HUNGARY

The Monetary Council of the National Bank of Hungary (NBH) hiked rates by 300 basis points on its extraordinary meeting Friday 28. November 2003. The Ministry of Finance issued a supportive statement later on. The base rate increased to 12.5% from its previous 9.5% level. The drastic measure surprised the market, but its desired effect has failed so far. The extremely high key rate compared to other countries in the region could not stop the weakening of Forint, the situation is still fragile, further speculative attacks are expected. Regarding the underlying situation the market is divided, some attribute the turmoil to the weak fundamentals, while others emphasize destructive speculation.

Table 1.

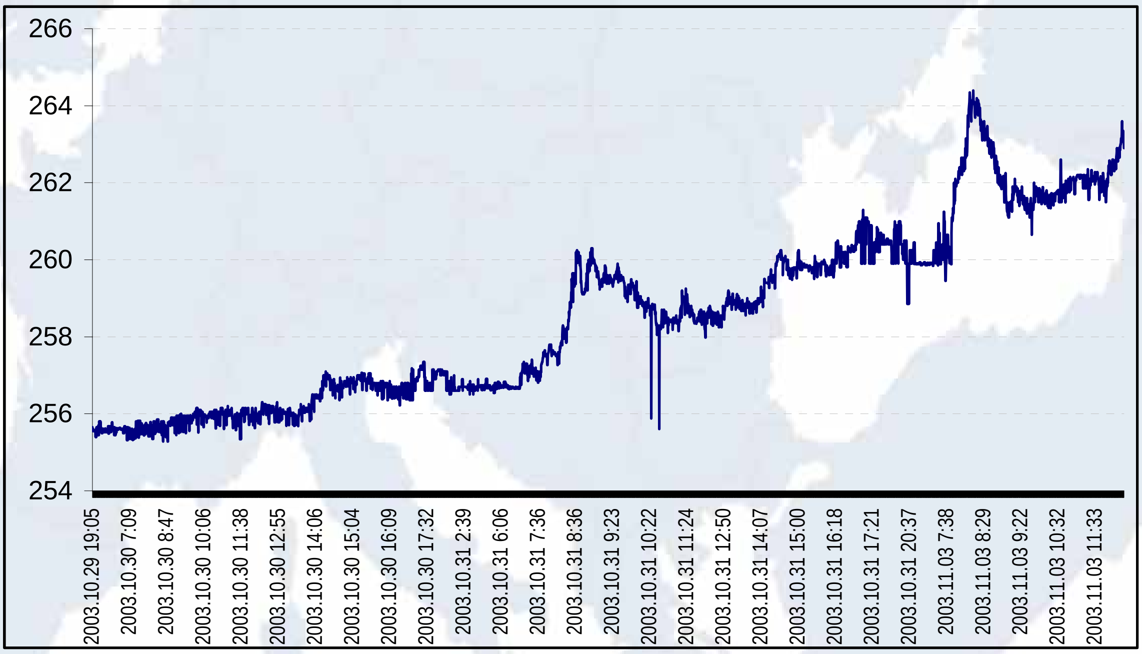
Base rates of central banks in international comparison

Euro zone	2%
USA	1%
Poland	5.25%
Slovakia	6.25%
Czech Republic	2%
Hungary	12.5%

The developments of the past few weeks on the FX and FI markets already indicated that some huge turmoil was about to emerge. Yields dropped across the board, the inversity of the curve completely disappeared. The NBH intervened and bought long maturity papers in order to curb the sharp rise of the yields. EUR/HUF broke out of the desired range of 250-260 several times.

Chart 1.

Exchange rate of the HUF vis-á-vis the EUR



The average yields of Thursday's 5Y and 10Y bond auctions (one day before the rate hike) were set much higher than a week ago. The sufficient demand did not reflect the improving fundamentals, it were rather the already huge spreads that attracted foreign demand. Thursday morning the daily outlook of the Deutsche Bank already recommended staying away from the auctions. The Bank's analysis mentioned the weakening Forint, and pointed to the fact that reaching the level of 265 has always made the NBH earlier to intervene somehow. According to the briefing the desired 250-260 range of the EUR/HUF was not compatible with the deteriorating external balance of the country.

Friday morning both sides, the government and the NBH used verbal intervention, and emphasized the temporary feature of the situation. The statements attributed the easing of the Forint to temporary speculation, and tried to draw to attention to the long awaited improvement of the fundamentals. The joint efforts seemed to be useless, EUR/HUF rose up to 270 shortly after the opening. NBH did not hesitate, and surprised the market with a 300 basis points rate hike. This drastic measure was a bit unexpected because as Mr. Járai Central Bank Governor just mentioned earlier that the temporary easing of the HUF did not make the Central bank nervous, and he also talked about the improving fundaments.

The rate hike did not have deep impact on the exchange rate developments, EUR/HUF temporarily rebounded and firmed up to 264, but later on it started to weaken again and finished the day almost at the same level just before the rate hike. The exchange rate developments did not reverse on Monday either. Before the MC meeting the Forint strengthened, but following the release of the statement, which evaluated the market reaction for the rate hike positive, EUR/HUF started to weaken again, and reached the critical 270 level.

According to the NBH and many analysts the weak fundamentals accounted for the weakening of the Forint, and made the rate hike inevitable. The economic growth based on domestic consumption, the lax fiscal policy, the mortgage loan system, demolished domestic savings and wage increases outpacing by far productivity growth all led to worsening external balance and high public sector deficit. Even though the current economic policy was about to restructure GDP growth and return to an export based growth path the measures taken by the government were not sufficient for the foreign investors. The foreign investors, who were counting on the convergence play have suffered huge losses recently because of the weakening Forint and the rate hikes. According to the NBH statement in order to secure the external financing for the overspending of the domestic households and the public sector the rate hike was inevitable, because foreign investors demanded higher risk premium.

Table 2.

Some macroeconomic indicators of Hungary in regional comparison

	2002	2002	2003*	2003*
	Public Sector def.	C/A def.	Public Sector def.	C/A def.
Hungary	-9.2%	-5.5%	-5.5%	-6%
Czech Republic	-7.1%	-5.3%	-8.1%	-6.5%
Slovenia	-2.3%	1.7%	-2.5%	0.5%
Slovakia	-7.2%	-8.5%	-5.5%	-4%
Poland	-3.9%	-3.5%	-4.5%	-3%

** forecast*

Apart from the disappointing fundamentals, the ongoing terrible communication of the NBH and Ministry of Finance contributed to the crises as well. The economic policy makers have got discredited during the past year, and this makes the situation completely different in Hungary compared to the Czech Republic with similar economic fundamentals. The high amount of government securities owned by the foreigners also makes the Hungarian market more volatile.

Some analysts argue that this abrupt weakening of the Forint was not due to the bad fundamentals, because the market already knew about the disappointing figures, and it is for these reasons that the NBH should have resisted the market speculation. According to them the rate hike did not have any impact at all, but pushed the NBH in a dangerous rate hike spiral. The speculators could force out rate hike at any time by building up short bond positions. Of course no one knows for sure what could have happened without the rate hike, but it is worth mentioning that EUR/HUF was strengthening significantly during the half an hour before the announcement. (Some say that the information about the rate hike could have trickled out.)

The turmoil is not over for sure, and it seems at the moment that NBH realized, hiking rate is not the best solution. It is likely that NBH intervenes on the FX market in order to keep EUR/HUF from rising above of 270, which is supposed to be a significant stop-loss level. An EUR/HUF around the 270 level might be more reassuring for the foreign investment banks regarding the external balance problems. NBH has resisted so far, and emphasized that weaker exchange rate could only temporarily boost competitiveness, it would rather increase inflation, which hinders economic growth and delays EMU accession. According to a joint statement of the NBH and Ministry of Finance the level of the exchange rate, that prevailed before the crises was in line with the fundamentals. However it has to be considered that a more stable exchange rate around 270 might be more beneficial regarding the 2005 CPI target and economic growth.

A basic problem of the current monetary regime is the sort of mix of an exchange rate target and the Inflation Targeting system (IT). This kind of mix makes the country extremely vulnerable and exposed for speculative attacks amid totally liberalized capital flows. NBH has always determined a certain exchange rate band in his inflation reports, which was compatible with its target. This explicit exchange rate target made the interest rate policy far too volatile. The high interest and exchange rate risk forced not only the foreign portfolio, but the real money investors as well to leave the country. NBH has tended to interpret the exchange rate target more flexibly following Friday's events, but the coexistence of the two targets are still uncertain. Regarding the question it is likely that NBH and the Ministry of Finance will have different views, which raises concerns again about the co-operation of the two institutions.

No one really knows how long the high base rate will last, the last Monetary Council meeting gave no clear guidelines about it. The possibility of further rate hikes can not be excluded, especially when NBH always underlines that all tools will be used to stop Forint from further weakening. According to J.P. Morgan the key rate is likely to be set at 15% by the end of the year. A long lasting high interest rate level could demolish the promising signs of the recovering economy. J.P. Morgan has already downgraded its next years GDP forecast for Hungary from 3% to 2.8%, and increased its public sector deficit projection from 4.8% to 5%.

Some analysts say that next year's ERM-II accession will calm the markets, but it is difficult to imagine at the moment how that system will work with such a volatile exchange rate. According to the latest Reuters's Poll the central parity will be at 267.71 (the previous was at 255) The outlook for next year's current account deficit, which is carefully watched by foreign investors are not reassuring either. The 1% fiscal contraction of the public sector is likely to be outweighed by the higher investment of the corporate sector. However a strong reversal of the recent developments can not be excluded either, the high level of the interest rate is likely to attract short term speculative capital flows which are known for being volatile. At the moment it seems that the convergence of the country has turned into a divergence that highly endangers the 2008 Euro accession.

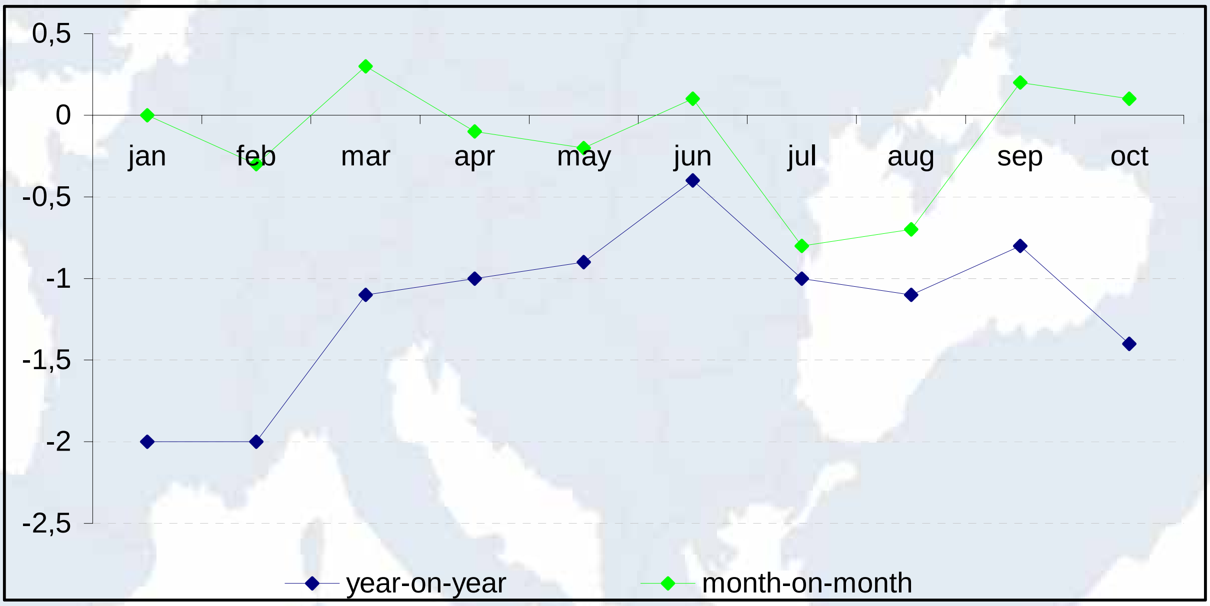
II. PERMANENT DEFLATION IN LITHUANIA

Deflation prevails in Lithuania in 2003. In October 2003 consumer prices were lower by 1,4% than a year before but increased slightly (by 0,1%) compared to September 2003. Even in 2002 the consumer price index accounted for only 0,3% and would have turned into deflation if an increase of world oil prices and the upward adjustment of the regulated prices of some services had not pushed up the CPI. Nonetheless, in each month of last year consumer prices declined compared to previous month. In the third quarter of 2003 consumer prices dropped by 1,0% compared to the same period of the previous year. Similar figures was recorded in the first two quarter as consumer prices declined by 1,7% and 0,8% respectively. Owed to seasonal factors quarterly CPI increase in the third quarter is traditionally low in Lithuania.

Lithuania was the first among the EU-candidate countries whose annual average inflation rate fell below that of Euro-zone in 1999. Since than annual average consumer price index stayed below 1,3%. Of course, currently Lithuania posts the lowest inflation rate among the candidate countries. Price-drop for food and clothing had the largest effect on deflation in the first half of the year. Analysts forecasted annual average inflation for 2003 around 0,3%. The Central Bank of Lithuania forecasts 1,5% annual inflation for December 2003. The figures mentioned in the above paragraph are likely to overwrite these forecasts. Very likely Lithuania will be the first country in Central and Eastern Europe who will record deflation for a whole year. Last forecast of EU Commission recognized this and estimated petty deflation (-0,9% annual average) for the current year.

Chart 2.

Consumer price index, 2003



Main factors behind the deflation are the appreciation of Lita, increasing competition on the domestic market (accompanied by quite fast productivity growth) and decreasing producer prices. Owed to the extremely fix exchange rate regime and the openness of the economy, prices are strongly dependent on external factors, e.g. appreciation of the anchor currency, oil prices, etc. Last few years the low CPI figures were largely influenced by the depreciation of main trading partners' currencies against the USD (and thus the Litas). In February 2002 the Lita was re-pegged to Euro. Since than the nominal effective exchange rate has continued to appreciate due to the appreciation of Euro. Consequently import price index declined gradually in 2002. Decrease of import prices stopped in the first quarter of the current year, but restarted in the second quarter. Thus prices of imported goods and services exerted a downward pressure on domestic prices.

Although Lithuania fulfilled the Maastricht inflation criterion in last 4 years this cannot be regarded as the end of the convergence process, as price level in Lithuania is equal only to 58% of EU average. Especially prices for services are well below the EU level. According to the Pre-Accession Economic Programme 2002 the government predicts an increasing trend of CPI. The forecasted figure for 2004 is 3,7% and CPI will slightly exceed 4% in 2005. EU Commission forecasts lower inflation, about 2,3% for 2004 and 2,6% for 2005. Main source of the higher inflation might be the relatively slow productivity growth in the tertiary sector, which lags behind the growth of real wages. Further price liberalization, adjustment of excise duties on fuel and tobacco (related to EU accession), amendment of controlled prices (elimination of reduced VAT on heating in 2004) and movement of nominal exchange rate might also have upward pressure on inflation. The government must be aware of the Maastricht criterion on inflation, consequently the sequencing of price liberalization and other governmental measures will have to be carried out with discipline.

Producer prices in industry decreased by 1,7% in the third quarter measured on year-on-year base. On the average producer prices remained almost unchanged in the first nine months because of a significant jump of PPI in the first quarter. Market participants expect 1,1% growth of producer prices for current year (-2,8% in 2002). There are no signs which forecasts an upward adjustment in PPI in the fourth quarter, consequently the PPI will likely to be slightly below under the experts' estimations. Construction costs have been stable for years. Thus far in 2003 construction costs were up by 0,9%.

Despite the deflation the economy is soaring. In the third quarter GDP rocketed by 8,4% (flash estimation of Statistics Lithuania). The average annual growth rate in the first half of the year reached 8,0%. Decline of export and the experienced drop in FDI cannot be regarded as side-effect of deflation, because these changes were influenced by the temporary closure of Mazeikai Nafta oil refinery and the postponement of some big privatization projects.

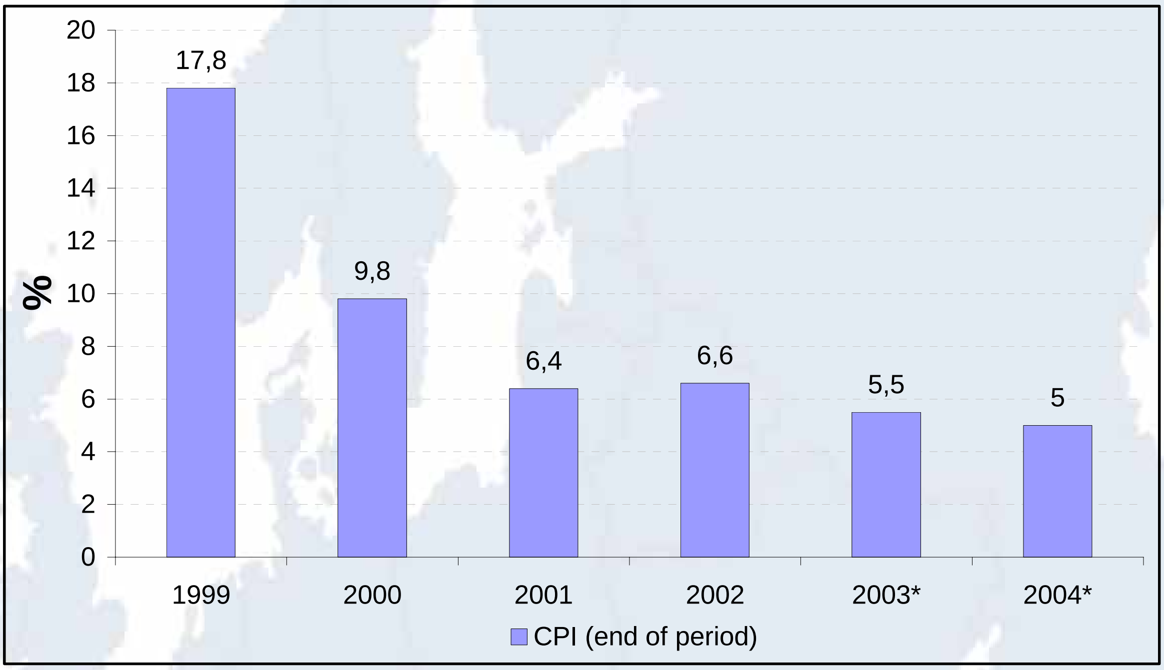
Since currently Lithuania fulfills all the Maastricht criteria it is very likely that there will be no obstacles to participate in the Euro-zone after the 2-year period in the ERM-2. Central Bank governor, Reinoldijus Sarkinas announced that Lithuania plans to join ERM-2 as soon as possible (i.e. in 2004), but contrary to Estonia the introduction of Euro will be implemented only in 2007.

III. INFLATION UNDER CONTROL IN KAZAKHSTAN

Monetary policy in Kazakhstan was successful in reducing CPI from 17.8% in 1999 to 6.6% in 2002. For 2003 a further decrease is expected, to 5.5%, and to 5% in 2004. Kazakhstan's inflation rate is one of the lowest in the CIS area. Contributing factors to the comparatively low inflation were the high rate of monetization (in part due to the advanced stage of financial sector reforms), and a decreasing non-oil fiscal deficit. Inflation is broad based in Kazakhstan, although relatively higher in the services sector. As a result of the falling inflation the National Bank of Kazakhstan lowered its refinancing rate from 14% in 2000, to 9% in 2001 and to 7.5% in 2002.

Chart 3.

CPI



(% changes to December of the previous year)

The rising oil revenues had a different impact on inflation in Kazakhstan and in Russia. In Kazakhstan rising oil revenues are absorbed by oil funds, large investment finance needs, and associated imports of capital goods and services, as well as repatriation of capital by foreign shareholders. In Russia, rising oil revenues had a different impact, as this country has a more mature oil sector, with higher profits and less financing needs. Therefore pressure from higher oil prices causes higher overall inflation, through the stronger impact on rising private and public wages, pensions, and consumption.

After Kazakhstan experienced currency crises in 1999, a free-floating exchange rate regime has been put into place. In 2003 the de jure exchange rate regime in Kazakhstan is the managed float. Because of the fear of loss of competitiveness, monetary policy has been trying to prevent the real appreciation of the tenge. This goal is potentially conflicting with the NBK's other aim: controlling inflation. In 2002 the authorities engineered a nominal depreciation against the US dollar through large-scale interventions, and with moderate inflation the real effective depreciation of the tenge was the result. However because of the associated large foreign exchange purchases, sterilization was costly.

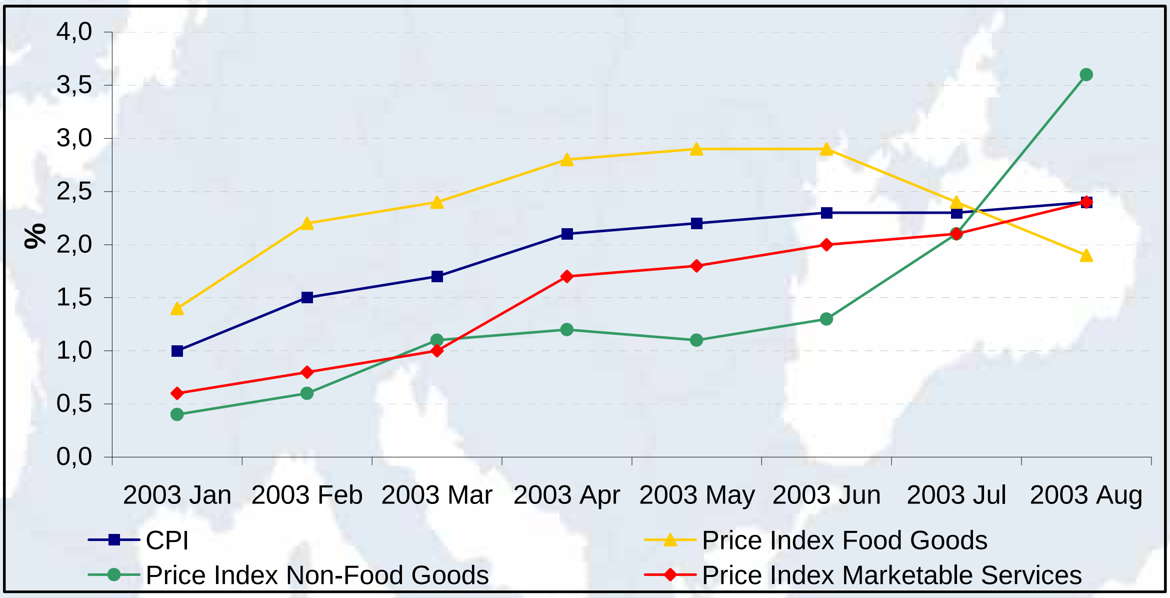
In the beginning of 2003 inflation started to show a slight upward trend. This is a sign that the intervention of the NBK should stop, and the nominal and real appreciation of the tenge vis-a–vis the US dollar should be allowed. The announcement was made by the NBK, that it projects a 5-6% nominal appreciation of the tenge against the US dollar for 2003. However this might not be enough to turn around the recent upward trend in inflation, as the US dollar is weakening against the Euro. As a result a greater degree of flexibility in the exchange rate of the tenge seems to be necessary.

The NBK is planning to adopt the direct inflation targeting monetary regime in the coming years. However this step could prove dangerous, as the Kazakh economy is too reliant on its export revenues from oil. If strong and unpredictable fluctuations in oil prices occur, that could cause serious problems to the operation of the direct inflation-targeting regime.

At the same time, if more exchange rate flexibility is allowed, the non-oil sector should be supported, because it will experience a loss of competitiveness in the medium-term. It is possible to increase productivity through the improvement in overall education, investments in infrastructure, improvement of the business climate and freer trade.

Chart 4.

CPI by main groups



(% changes to December of the previous year)

In the first quarter of 2003 CPI increased by 1.7% compared to December 2002. The main driving force behind the rise of CPI was the price increase of food goods (mainly the prices of fruits, vegetables and cereals) in January. The price increase of cereals was the result of lower than usual harvest in 2002.

From the second quarter of 2003 the main driving force of CPI growth was the price index of non-food goods. This development was the result of the significant rise in the price of gasoline. The sharp rise of non-food goods continued into the third quarter of 2003. Not only gasoline was becoming more expensive, but also cloths, hygiene goods, newspapers and office supplies.

The price index of marketable services has also been rising throughout 2003. In the first quarter the highest increase was observed in the price of legal services, followed by financial intermediation. In the third quarter there was a significant increase in the price of higher education.

IV. MODERATE BUDGET DEVELOPMENTS IN SLOVAKIA

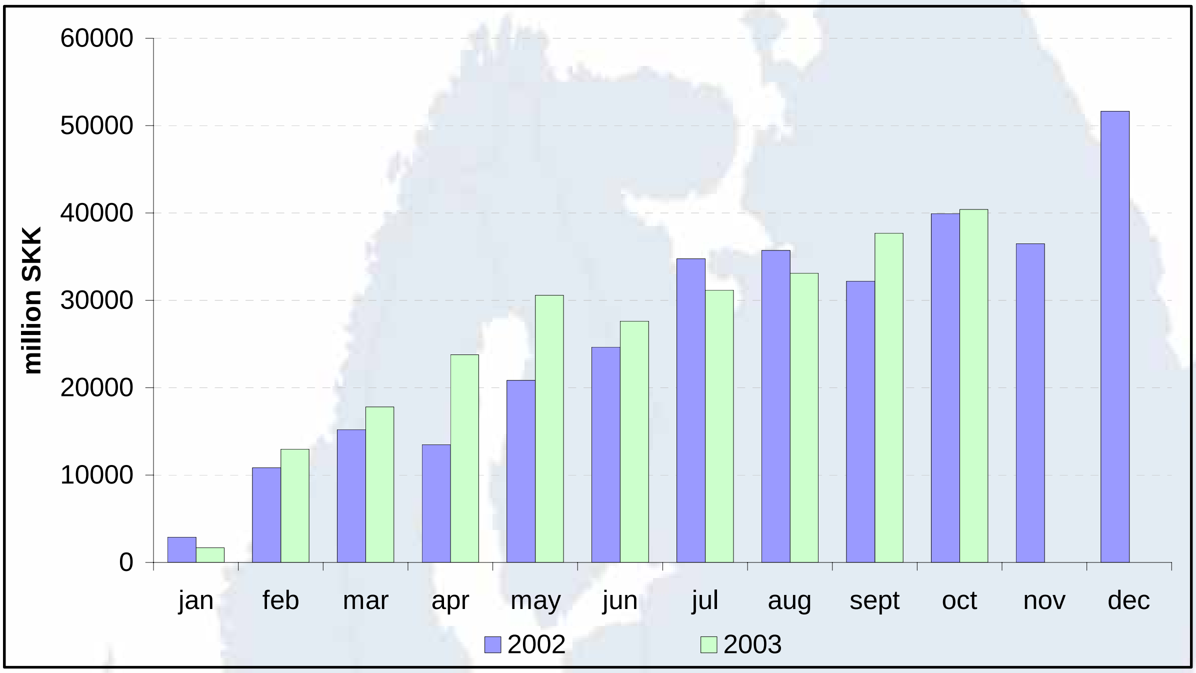
At the end of October the general budget deficit rose to SKK 40.4 billion in Slovakia, reaching a 72.1 per cent level of the officially planned deficit for the whole year. The fulfillment of revenues (79.3 %) was at a higher level than that of expenditures (77.9 %) at the time. As a result of the current outcome this year's deficit target of 5 per cent of GDP seems to be feasible in spite of several risks and uncertainties deriving from the macroeconomic developments and the public finance reform.

This year's budgetary developments are basically determined by favorable evolution of the macroeconomic environment, requirements of the forthcoming EU accession and preparation for the membership in the EMU. The introduction of the Euro ASAP strategy requires great efforts from the authorities to meet all the Maastricht criteria. In terms of fiscal policy it means a gradual improvement in the fiscal balance. One of the major challenges to the acceding countries is apparently to fulfil the 3 per cent deficit criterion while implementing vital structural reforms at the lowest costs.

The Maastricht criteria regarding the fiscal stance might appear considerably strict considering the fact that last year's budget deficit hit 7.2 per cent of GDP and the government intends to attain the deficit criterion by 2006. Nevertheless, last year's deficit was not in line with the expectations and the macroeconomic developments. In 2002 fiscal policy faced an improving economic performance despite rather weak and uncertain developments in the global economy. GDP growth reached 4.4 per cent thanks to the immense FDI inflows unseen earlier, the considerable growth in export activities and the stimulating measures taken by the fiscal authorities (reduction in the corporate and personal income tax burden). The strong growth was accompanied by an improving but still high current account deficit of 9 per cent. The labor market also showed favorable developments: first time after a long period of increase, the unemployment rate decreased (from 19.2 to 18.5 per cent) being accompanied by remarkable increments in labor productivity.

Chart 5.

General budget deficit (ESA95)



In spite of the auspicious macroeconomic indicators the fiscal imbalance widened last year, mainly as a result of three factors. First, some of the privatization revenues were used for covering current expenditures in the field of health care, education and municipalities, which does not emerge among the revenues according to the ESA95 method. Second, the government provided several state guarantees for loans with high risks that put additional burden on the budget. Finally, as a result of the political cycle the wages in the public sector increased more than twice as much as they did in the business one.

After the election the new government adopted a program (Policy Statement of the Government of the Slovak Republic, November 2002), which defined the basic elements of the medium-term fiscal framework. The final purpose of the government was to create an efficient, transparent and inexpensive public sector, that was able to provide facilities for achieving more effectively macroeconomic policy goals such as long-term sustainable economic growth, price stability, stable exchange rate, competitiveness, favorable environment for business, etc. On the path towards the final goals the government pays particular attention to the approaching EU accession and the commitments deriving from it, that certainly promotes the government efforts. In the medium run the top priority is therefore to prepare the economy for adopting the Euro till 2006. In order to attain the low budget deficit criterion (below 3 per cent of GDP) and a sustainable public finance system, the government has made strong commitments on implementing vital reforms and budgetary restrictions in almost all segments of the public sector.

Based on the aforementioned statement the government made the draft national budget for 2003[1]. After last year's 7.2 per cent general budget deficit the government set a deficit target of 5 per cent for this year. In order to achieve this target measurements were adopted both on the side of revenues and expenditures. The following measures were taken to reduce the deficit:

- the VAT rates were modified as the first step towards the single rate taxation concept (Slovak Republic – Tax Reform Concept 2004-2006). The reduced rate was increased from 10 to 14 per cent, while the normal rate was lowered from 23 to 20 per cent at the beginning of the year,
- legislative amendments were adopted regarding wage expenditures and social security benefits abating the growth of mandatory type expenditures. Access to child benefit allowances were restricted, and also pay rises in budgetary organizations were revised,
- increase of excise duties originally planned to become effective in January 2004 was brought forward to August 2003 in order to achieve the deficit target.

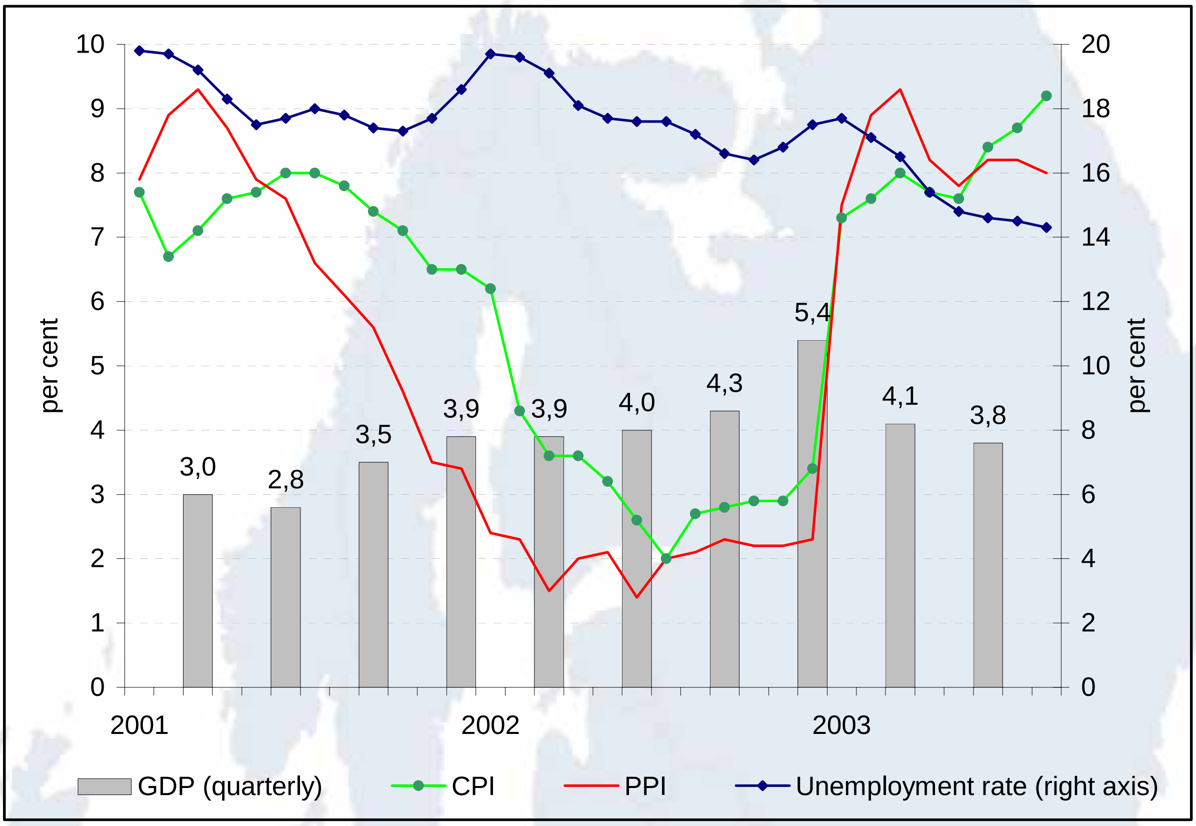
Alongside these measures the macroeconomic developments have also been promoting this year's budgetary goals. The growth continues to be maintained at the same level previously experienced, while the external balance improved significantly which both are the result of higher activity of foreign affiliates. Developments on the labor market also has a positive effect on the budget as the unemployment rate has been permanently declining since the beginning of the year.

The only one that seems to be unfavorable is the evolution of inflation rate. Nevertheless, it only reflects the impact of tax hikes and regulated price increases which are to be one-off (that seems to be confirmed by the development of core inflation). While the direct impact of the increases on the budget is positive, it has an indirect one through the decreasing real household incomes. Accordingly, private consumption has been increasing slightly since the beginning of this year resulting in a shortfall in revenues from value added tax, which was responded by the authorities through the aforementioned excise duty increases.

[1] For the first time the national budget was compiled according to ESA95 methodology

Chart 6.

Macroeconomic developments



In spite of the mostly favorable circumstances there remain potential risks for occurrence of a deficit higher than the 5 per cent target. The main uncertainties are arising from the expenditure side, namely from the final financial position of municipalities which is officially laid down in the assessment of the *IMF Staff Visit* carried out recently but also confirmed by the budgetary figures. The expenditures of local authorities have already exceeded the limit currently running at 107.47 per cent of the planned level. To ensure the fulfillment of the target, fiscal authorities should enhance the local governments' fiscal discipline.

For 2004 the government expects a further reduction of 1.1 percentage points in the general budget deficit. This objective is meant to be achieved by a simultaneous reduction in state revenues and expenditures. However, it seems to be rather ambitious for two reasons. First, many structural reforms are scheduled for next year in fields such as the social and healthcare system, the education system or the pension system etc. The public finance reform need to be mentioned separately because of its great relevance.

The achievement of next year's target highly depends on the pace and fluency of implementations of these reforms. Any delay in implementation would worsen efficiency and might easily deteriorate public finance position. Second, the EU accession might easily have a more unfavorable impact on the budget than currently planned. Although the fiscal authorities expect a net budgetary effect of –0.1 per cent of GDP due to the accession in 2004, in case of insufficient co-financing resources of certain chapters the government should cover these expenses, that might obviously worsen the budgetary position.

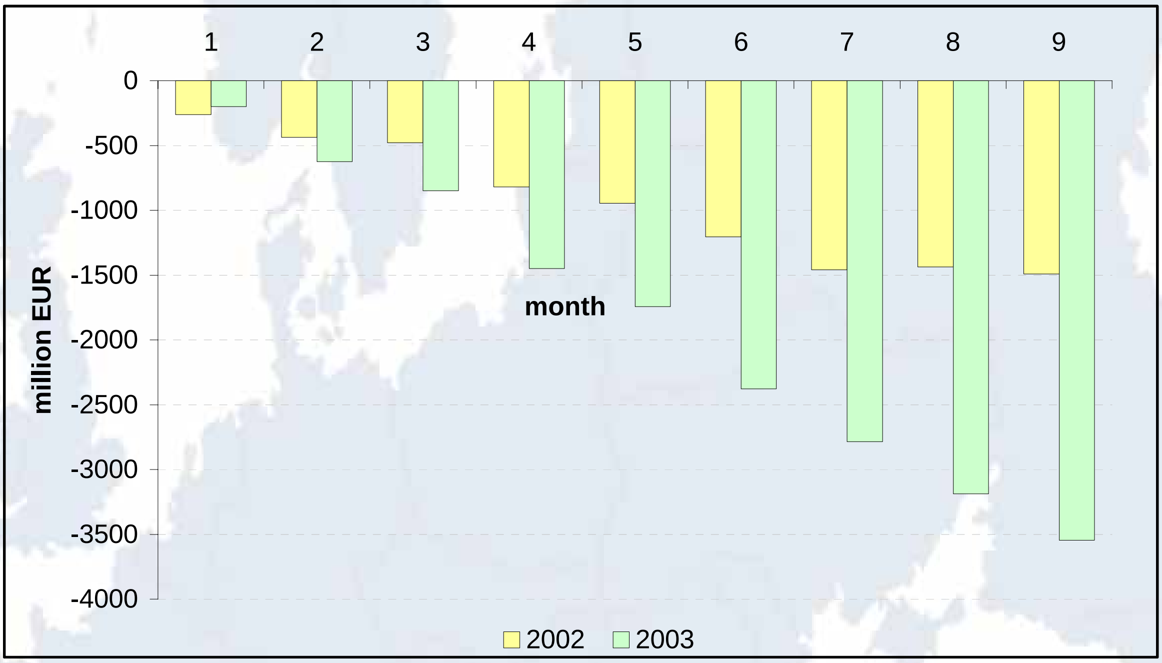
V. Increasing Current Account Deficit in Hungary

According to the announcement of National Bank of Hungary (NBH) the current account deficit amounted to 357 million EUR in September compared with 53 million in the same month last year. So in the first three-fourth of the year the CA deficit reached 3,5 billion EUR in comparison with 1,49 billion EUR during the same period in 2002. Analysts predict further increase in CA deficit in this year and balance of payment (BP) figures for the next one.

The 357 million EUR CA deficit is not an extreme data. There were worse months in the year, like June, but the main problem is the uncertainty concerning its evolution. The account was influenced significantly by the worsening balance of services due to record low tourism balance surplus, while trade balance recorded a smaller deficit compared with the previous month.

Chart 7.

Current Account deficit 2002-2003 Jan.-Sept. (million EUR)



As we know, the current account deficit affects the nominal exchange rate through devaluation according to increasing demand for the Hungarian currency, which heightens the worries of NBH to reach the optimal nominal exchange rate to realize inflation target.

The net amount of non debt creating financing in the first three-fourth in 2003 was 724 million EUR, consequently one-fifth of current account deficit was financed by FDI, FPI and the remaining part of it covered by debt creating financing, mainly by emission of government bonds. Foreign Direct Investments in Hungary amounted to

854 million EUR[2], which is a rather nasty performance. This is exacerbated with growing foreign direct investments carried out by Hungarian companies abroad, amounting to 533 million EUR since the beginning of this year. In conclusion, there will only be a modest net FDI inflow this year.

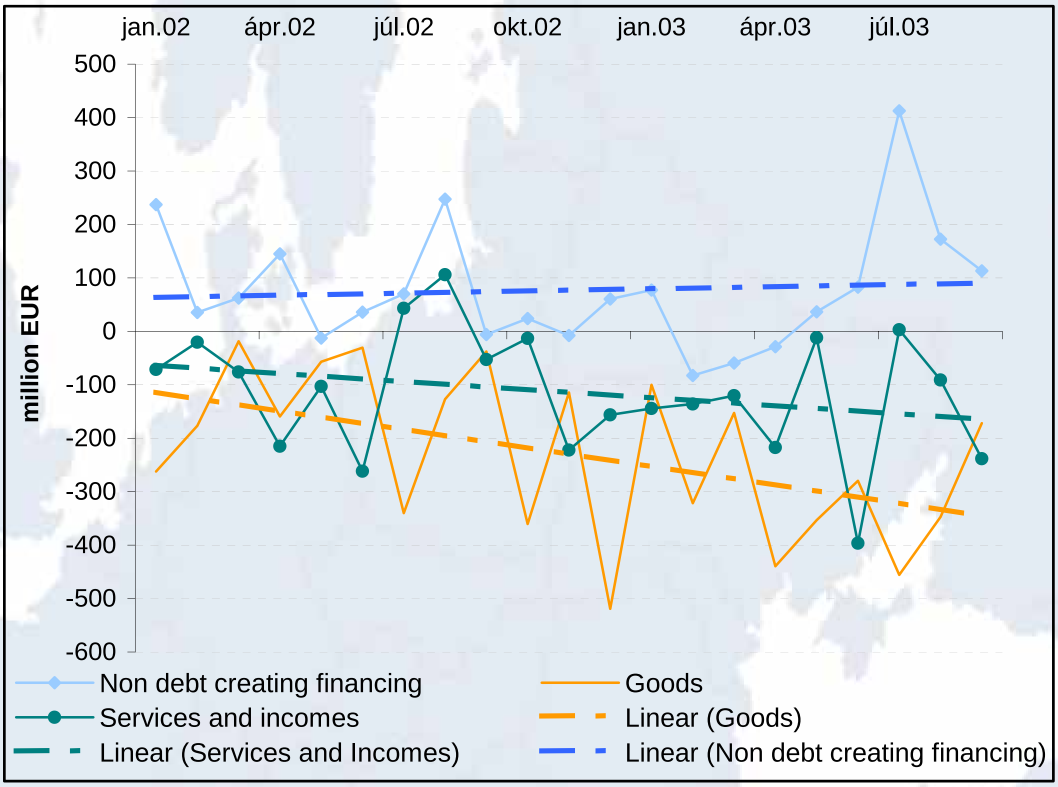
ECONOMIC CONSEQUENCES

It is apparent, that behind the increasing current account deficit we can observe two major factors. Import grow significantly faster than exports and the balance of tourism and services worsens intensively.

If the trend lines of goods, services and financing, observed on the second chart, show us future trends of these current account categories, than Hungary must carry out strict balance of payments correction, otherwise, excessive current account deficit may lead to rush of investors.

Chart 8.

Net balances and trendlines of main categories of CA 2002-2003 (million EUR)



The amount of CA deficit is not surprising in an emerging market, while the expanding country has to finance its deficit. Additionally, the sustainable size of deficit broadens due to EU enlargement and growing confidence, which has been slightly shocked as a result of turnover in external and internal equilibrium. Another problem is the increasing role of debt creating financing of current account deficit, which provides one-fifth of total financing in an unfortunate combination.

[2] Hungarian FDI data do not include reinvested profits

The rise in current account deficit shows us, that the net saving position of country worsens as a result of expanding private consumption. As a considerable improvement in government net saving position is not forecasted in the short run, the increasing investment activity of the business sector will have to be financed by external savings.

The balance of payments developments are made uncertain by two future developments. First it is an open question to what extent and in which direction will the EU transfers and payments influence current account balance. Second, it is an open issue how the reinvested earnings will influence balance of payment developments.