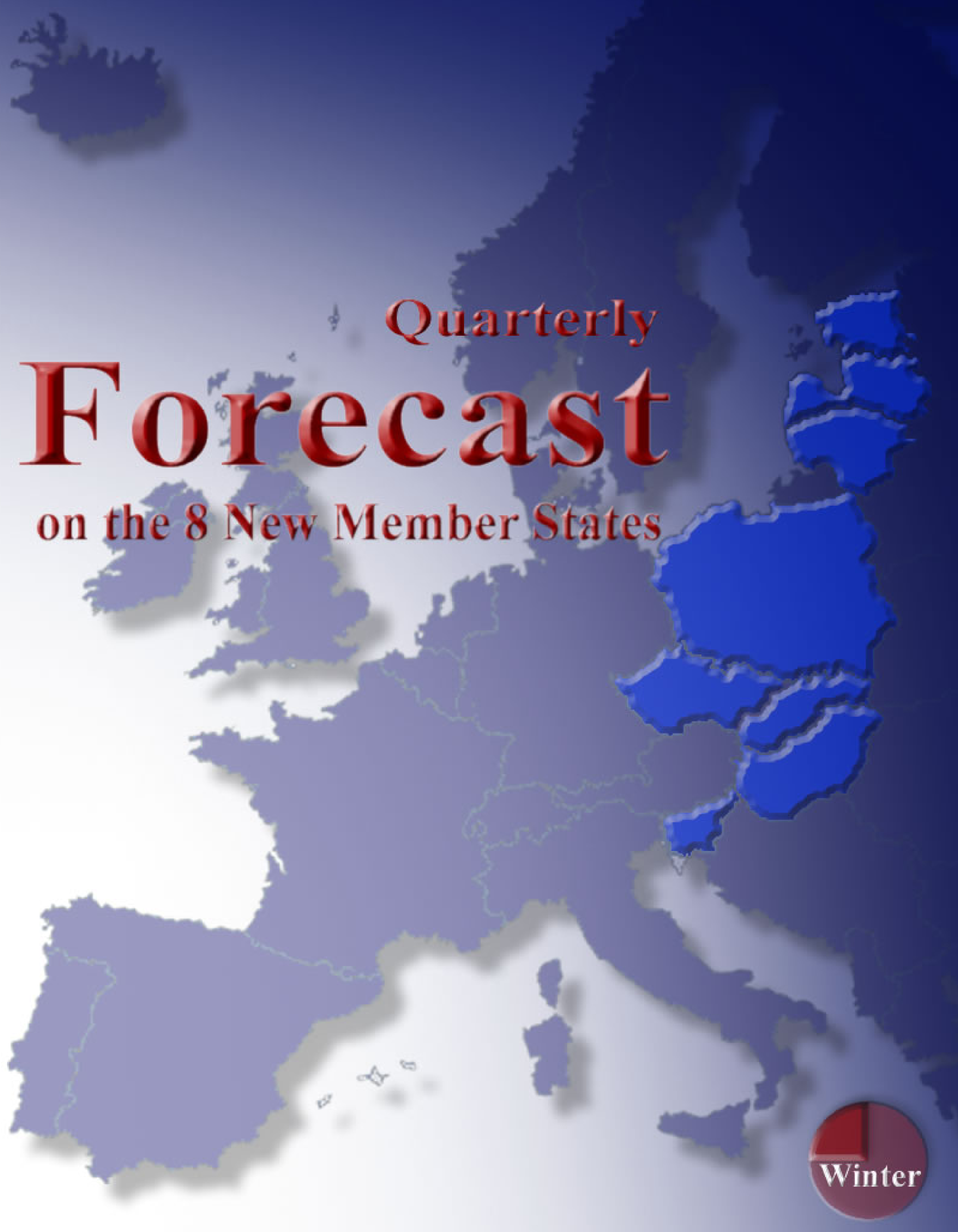
ICEG European Center

# Quarterly Forecast on the 8 New Member States



Winter

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# OVERVIEW OF THE NMS-8

## Growth

The average growth of GDP in the eight New Member States slightly accelerated in 2005 compared to the previous year, which reflects that the initial one-off positive effect of EU accession on GDP growth was maintained in 2005, though the composition of growth changed slightly during the course of the year. While the aggregate performance remained basically unchanged, growth decelerated in Poland, Slovakia and Slovenia, while slightly accelerated in the two other Central European economies and remained especially vibrant in the Baltic States.

Slower output growth in the mentioned Central European economies is mainly associated with the slowdown in the growth of private and public consumption, which at the same time made growth more balanced in terms of the contribution of domestic and foreign demand. The marked slowdown of consumption, already observed in 2004, was in some countries associated with the slower growth of exports, especially in case of Poland and Slovenia. At the same time gross fixed capital formation is expected to grow less in 2005 almost in all countries reducing the rate of GDP growth.

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

In 2006 some deceleration of growth is expected on average in the analysed countries. This deceleration will be more pronounced in the Baltic States and the Czech Republic, while the other four countries will record either unchanged or slightly even higher GDP growth rates. Looking at the composition of growth, the major reason behind the deceleration of GDP growth is the smaller contribution of net exports to GDP. This contribution declines partly because imports are expected to rise faster in most of the countries and some (Estonia, Hungary and Latvia) may also experience a slowdown in their export growth rates. The contribution of net exports to GDP slows down especially in the Baltic States, where the still sizeable increase in private capital formation and consumption maintain the rise in imports. Another factor that seems to add negatively to GDP growth is the slowdown in the rise in private fixed capital formation, which is especially pronounced in Hungary, Latvia and Slovakia.

On the other hand most countries seem to experience further rise in their public and private consumption. This is partly driven by still significant increases in nominal wages and incomes and associated rise in private sector borrowing and debt. At the same time 2006 will be an election year in several countries and therefore the rise in public consumption can not be ruled out.

## Monetary conditions

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

Confirming the observations of the previous report, second marked feature of price developments in 2005 was the widening gap in the rise of consumer and producer prices. The acceleration of producer prices is related to the increase in import prices, in several countries to fast increases in wage levels and rise in inflation expectations.

Inflation is expected to decline further in 2006, though countries may be divided into two major groups. The Baltic States and the higher inflation countries in Central Europe (Hungary and Slovakia) will record declining inflation due to the gradual evaporation of the one-off price increases, reduction in indirect taxes and in the Baltic States some slowdown in domestic demand. In the Czech Republic and Poland inflation may decelerate notwithstanding the fact that domestic demand continues to grow fast thanks to low inflation expectations, firm monetary policy. Altogether all NMS-8 countries may be within the Maastricht limits with average consumer price inflation varying between 2-3% with the exception of Latvia.

## Fiscal developments

With the exception of Poland, Lithuania and Slovenia all other countries are expected to record higher general government deficits in 2005 than in 2004. The rise in fiscal imbalances occurs simultaneously with the fast GDP growth and its positive cyclical effect on the primary balances. The worsening of general government balances is mainly due to one-off fiscal measures increasing in a discretionary manner the primary expenditures of the governments. In the Baltic countries (Estonia and Latvia) this has occurred with the adoption of supplementary budget measures raising the expenditures of the general governments, while in others through higher spending driven mainly by the rise of public sector wages and growth of outlays before the elections due in 2006. The impact of discretionary spending measures on the general government balance has been exceptionally significant in Hungary and the Czech Republic.

Concerning the forecast for 2006, fiscal deficits are likely to decline in Slovenia and Slovakia due to the cyclical effect of fast GDP growth and some extra measures to keep the balances in line with the long-term fiscal convergence. In other countries we expect either no change in fiscal position or some increases of general government deficit in Hungary and decline of surplus in Estonia, mainly due to the continuing increase of public expenditures.

## Balance of payments

In 2005 all countries in the region with the exception of Slovenia and Slovakia seem to improve their current account balances. The major reason behind that was the fast rise in exports outpacing the rise in imports, which resulted in improvement in the trade balance of most countries, adding to the improvement of the current account. In case of Slovakia the worsening current account is due to two factors: both the trade and current account balances worsen due to the temporary positive impact of FDI on import demand and there has been a slight increase in the deficit of incomes balance due to the higher profit repatriation after the increased FDI stock. In Slovenia the slight worsening of the current account is mainly due to the smaller revenues from services. In the Baltic States current account deficits remain around 10% of GDP but they do not pose problems for the economies due to the size of capital inflows and monetary stability.

In most countries FDI is expected to increase in 2005 driven partly by new investments on the Single Market, expectations of continued fast economic and productivity growth. Therefore most of the New Member States will not experience rise in their net foreign debts as current account deficits are mainly covered by non debt creating inflows.

In 2006 the average of the current account balance will decline compared to 2005. The decline will be the biggest in the Baltic States where the slowdown of domestic demand will result in smaller increase in imports (while at the same time exports are also expected to decelerate). Among the eight countries Czech Republic and Hungary are expected to increase their current account deficits mainly due to the stance of their fiscal policies and increasing general government deficit.

## Unemployment and wage developments

The gaps among the NMS-8 countries in unemployment rates have remained significant. Unemployment levels are low and mainly unchanged in Hungary, the Czech Republic and Slovenia, while they have remained in the double digit range in the other NMS-8 countries. On the other hand countries with high unemployment level seem to be able to reduce their rates fast in 2005. The decline of unemployment has been driven by two factors: fast output growth resulted in increasing labour demand and led simultaneously to declining unemployment and slightly increasing employment rates in many countries. At the same time declining unemployment in the Baltic States is partly due to the increased labour flow to the Scandinavian countries following the entry of the NMS countries to the European Union, which created labour shortages and increased the demand for the pool of unemployed.

The other factor driving the decline of unemployment rates is the impact of labour market and other structural reforms, which is the most visible in Slovakia and Poland, where the unemployment rate which had been persistently high and close to 20% started to decline to 16.5 and 17.5% respectively. Besides the impact of fast GDP growth this decline in the two countries is linked to the ongoing structural and labour market reforms, increasing flexibility of labour markets. In 2006 some further decline of unemployment is expected in most of the countries with the exception of Slovakia and the Czech Republic, but the average unemployment level declines less than it did in 2005.

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

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

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP growth (%) | 5.08 | 5.61 | 5.76 | 5.44 |
| Inflation (%) | 3.11 | 4.31 | 3.44 | 2.80 |
| General government balance/GDP (%) | -3.55 | -2.49 | -2.74 | -2.70 |
| Current account balance/GDP (%) | -5.81 | -6.74 | -6.08 | -5.86 |
| Unemployment (%) | 11.31 | 11.13 | 10.39 | 10.25 |

** Forecasts*

# CZECH REPUBLIC

*Export-led GDP growth rate is higher than expected in the Czech Republic, while other growth components (consumption and investment) continued to remain relatively weak.*

## Growth

Output growth of 5.1 per cent in the second quarter, and an estimated just below 5 per cent (National Bank) in the third quarter induces an upward revision of the 2005 annual rate to around 4.6 per cent. It is the more so, because the growth momentum is expected to be sustained in the remaining part of 2005, based first of all on export growth, supplemented by a slim increase in private and probably public consumption and in GFCF.

Export of goods and services remains the main engine of growth. While net exports remained positive – though imports may be significantly underestimated, a slowdown in the growth rate of both exports and imports can be observed. This resulted in smaller trade surplus than expected. GFCF played a smaller than expected role in growth, with a decelerating and low rate in 2005. This trend is likely to continue over the course of the year, resulting in lower investment dynamics at the end of 2005 compared to the previous year.

Growth in domestic demand has been moderate, only 1.4 per cent on a year-on-year basis. However, contrary to previous tendencies, faster year-on-year growth in the third quarter was observed in industrial and construction output. Industrial production rose by 8.9 per cent on a year-on-year basis in Q3 2005. The increasing volume of new orders points to the continuation of these tendencies. Moreover, because of higher than expected real wage increases the growth of private consumption may accelerate, and the coming elections may result in increasing public consumption. Similar tendencies are expected for next year, with lower growth of net exports and higher public spending due to the general elections, which is expected to result in an above 4 per cent growth for 2006.

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## Monetary indicators

Inflation is still at a low level, comfortably below the Maastricht criterion and it is the lowest among the NMS countries. However, CPI accelerated modestly, at the end of October it stood at 2.6 per cent on an annual basis, fuelled mainly by an increase in certain regulated prices (energy, gas, steam and water and postal services) and a relatively high growth in fuel prices. At the same time, agricultural producer prices decreased considerably, by 8.8 in Q3 on an annual basis, and connected to this, food products, beverages and tobacco were sold at 2.1 per cent lower prices. Industrial producer price indices (PPI) still exhibit a higher level compared to CPI, with 4.1 per cent at the end of Q3. This may still exercise an upward pressure on consumer prices. For 2006, a slightly higher CPI (around 2.5 per cent) is expected due to further adjustment in regulated prices.

At the end of November, the two-week repo rate stood at 2 %. According to the Bank Board, inflationary developments were in line with its forecasts. The exchange rate of the Koruna appreciated again in Q3. However, exchange rate changes now depend mainly on outside developments.

## Fiscal policy

The budget deficit stood at the same level in terms of GDP at the end of August 2005, as in the corresponding period of 2004. This is mainly due to higher than expected tax revenues and social security contributions. At the same time, expenditures did not surpass the pre-planned levels, partly due to the low interest rates, which reduce the interest burden on government debts. However, government consumption is predicted to grow significantly before general elections take place next year, thus the 2005 budget deficit is expected to be larger than it was in 2004, though the deficit target of 4.7 per cent is still likely to be fulfilled at the end of the year. For 2006, a 3.8 per cent of deficit is planned (ESA), though planned increases on the expenditure side (increase in public sector wages, pensions and R&D spending) make the target somewhat unrealistic. That is the reason why the majority of international organisations predict a slightly higher (4-4.2 per cents) deficit compared to GDP.

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

## Balance of payments

Export growth is still the main engine of the increase in output in the Czech Republic. On an annual basis, exports grew 8.6 per cent and imports by 3.8 per cent in Q3. However, according to the World Bank, imports data must be seriously underestimated. Thus very favourable data on trade balance must be handled with caution. According to the data of the Central Statistical Office, the export growth rates have been decelerating and trade surplus has been shrinking on a quarterly basis, in Q3 trade surplus stood at 0.7 per cent of total exports. The same ratio was 6.1 per cent in Q1 and 3.2 per cent in Q2. Behind the favourable trade developments, high inflow of (export-oriented) FDI is one of the decisive factors. On the other hand, trade developments were negatively influenced by worsening terms of trade and the one-off imports of Gripen fighters in April and August. In terms of product groups, machinery and transport equipment were “responsible” for the majority of export growth.

In foreign direct investments, two big privatisation deals represented the bulk of the inflow. Cesky Telecom was sold to Telefonica, Spain, while Unipetrol was acquired by the Polish PKN Orlen. This is reflected also in the fact, that the most important investors this year are Spain and Poland. These are very big deals, Cesky Telecom was sold for 2.9 billion euros, and a 63 % stake in Unipetrol was sold for around 440 million euros, and they are estimated to be responsible for more than half of the 2005 inflow. An upward revision of FDI for this year is made necessary by high privatisation-related FDI. The substantial inflow of FDI (and weak outflow) more than counterbalances the current account deficit in the Czech Republic. In the second quarter, the balance of payments changed again: besides the current account, the capital and financial account also showed a surplus. The capital account showed a slight surplus due to the inflow of funds from EU structural operations. In the financial account, privatisation to foreigners more than counterbalanced the outflow of portfolio investments.

Further privatisation in 2006 may affect FDI inflows and the balance of payments positively, even though a deceleration in the growth of exports, and thus much lower trade balance surplus (or even deficit) is expected for the next year.

## Unemployment and wage dynamics

Employment rose more than expected in the third quarter, however, the unemployment rate was falling only slightly. A slight improvement in the labour market was caused by the job-creating impact of the relatively fast economic growth, and of foreign direct investment. However, the relatively high level of unemployment must be assessed together with the fact, that the Czech Republic has one of the highest activity rates in the enlarged EU.

Growth of average wages was higher than in Q2, and on a year-on-year basis real wages grew by 4.2 per cent. Wage increases in industry and construction remained moderate in the third quarter. At the same time, the highest increase characterised public administration, defence and compulsory social security, where nominal wages increased by 9 per cent. However, because labour productivity went up by 9 per cent by Q32005 in manufacturing, quicker than the rise in wages, it resulted in lower unit wage costs (by 3.9 per cent).

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

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP growth (%) (constant prices) | 3.7 | 4.0 | 4.6 | 4.1 |
| - Private consumption (%) | 4.9 | 2.5 | 3.1 | 3.5 |
| - Public consumption (%) | 4.2 | -3.2 | 2.7 | 3.0 |
| - Gross fixed capital formation (%) | 4.8 | 9.1 | 4.0 | 7.9 |
| - Export (%) | 7.3 | 20.9 | 8.0 | 12.5 |
| - Import (%) | 7.9 | 18.5 | 3.0 | 12.7 |
| Consumer price index (average, %) | 0.1 | 2.8 | 2.4 | 2.3 |
| Consumer price index (dec/dec, %) | -0.1 | 2.6 | 1.9 | 2.1 |
| Unemployment ratio (%) | 7.8 | 8.3 | 7.8 | 8.0 |
| Real wages | 6.5 | 2.7 | 4.3 | 4.5 |
| General government balance/GDP (%) | -11.7 | -3.0 | -4.5 | -4.3 |
| Public debt/GDP (%) | 38.3 | 37.4 | 36.8 | 37.0 |
| Current account /GDP (%) | -6.2 | -5.2 | -4.2 | -4.4 |
| Trade balance /GDP (%) | -2.7 | -0.8 | 0.1 | 0.0 |
| FDI (billion USD) | 2.6 | 4.5 | 8.0 | 3.0 |
| Gross foreign debt /GDP (%) | 38.4 | 34.2 | 32.5 | 33.0 |
| Exchange rate (Koruna/EUR, end of year) | 31.846 | 31.891 | 24.580 | 28.0 |
| 2 week repo rate (%) | 2.0 | 2.5 | 2 | 1.75 |

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

# ESTONIA

*Economic growth based on domestic demand is approaching its potential; containing inflation to fulfil the Maastricht criterion is the main challenge for 2006*

## Growth

Estonian economic growth was strong in 2005 with annual real GDP growth reaching 8%. Thanks to the favourable external conditions net exports contributed positively to economic growth in 2005, a break from the trend of recent years. However, domestic demand remained the key driving force of economic growth. Household consumption has been fuelled by durable goods in recent years; investments into housing have also been considerable. This spending has been facilitated by cheap and easily accessible credit. Corporate investments were more contained in 2005 but favourable export outlooks and high business confidence suggest a pick-up of investments in 2006.

Productivity, income and profitability have all exhibited a healthy growth in recent years and these trends are expected to continue in the medium term. A GDP growth rate close to 7% is expected for 2006 and 2007. Domestic demand is going to remain a major driving factor of the economy, but recovery in the European Union should boost exports as well. Non-tradable sectors including real estate and financial intermediation are expected to contribute significantly to growth.

## Monetary indicators

Headline CPI reached 4.6% by October largely as a result of high fuel prices (the share of motor fuels in the Estonian consumption basket is much larger than elsewhere in Europe). Early in 2005 oil prices of 45 USD per barrel were anticipated for 2005; by now prices of 50 to 60 dollars per barrel are expected for 2006. Inflation should reach 4.2% by the end of 2005, and will slow down to 3.4% in 2006 and 2.9% in 2007 as the base effect of oil price increases fades out. Regulated price increases (especially heated water) can add as much as one percentage point to inflation in 2006. Although producer prices growth is low (just 0.7% year-on-year), cost and especially demand-induced inflation pressures are mounting as the cyclical position of the economy is not favourable for inflation. As a consequence, core inflation is also expected to rise slightly in 2006.

The 12-month TALIBOR interbank rates remained around 2.5-2.6% throughout 2005, resulting in negative real interest rates since inflation started picking up in 2004. This among other factors has been a catalyst of buoyant credit growth and domestic consumption. Due to the currency board system of Estonia the monetary authority cannot influence interest rates therefore other instruments – most notably fiscal measures – are needed to control domestic demand and inflation.

## Fiscal policy

A supplementary budget was accepted in October 2005, raising public expenditure by 1.3% of GDP. Nonetheless, strong economic activity, efficient tax collection and windfall gains from higher-than-anticipated inflation resulted in an overshoot of revenue targets by 1% of GDP, therefore the overall balance did not deteriorate significantly. Small surpluses (with some room for manoeuvre) are expected in the 2006 and 2007 budgets, although it is worth mentioning that this fiscal easing unfortunately coincides with economic growth reaching its potential and inflation on the rise.

## Balance of payments

The external balance was better than expected in the first half of 2005 thanks to sound export growth and cooling domestic demand. The current account deficit is expected to reach 9.4% of GDP in 2005, and should decrease to 8.5% under favourable circumstances. As one-off effects of EU accession on exports fade away the trade balance will improve at a slower pace; meanwhile the income account now contributes more to the current account deficit than in previous years. The improvement of the external balance is also a result of increased private savings (boosted by strong income growth).

The loans-to-GDP ratio is expected to reach 75% in 2005, up 15 per cent from last year. As domestic deposits are insufficient to satisfy credit demand banks borrow from abroad. Therefore gross external debt will reach 90% of GDP in 2005 and is expected to increase further in 2006-2007. On the other hand, inflows from EU structural funds also help financing the current account deficit.

## Unemployment

Employment growth is expected to reach 1.4% by the end of 2005 but should slow down in 2006 to 1.1% and to as little as 0.4% in 2007. Labour market tightness exerts an upward pressure on wages resulting in an 11.7% nominal wage growth in 2005, although higher-than-expected inflation moderates real wage growth to 7.3%. Real unit labour costs remain stable in 2005 after a sharp downward adjustment in 2004. Strong real wage growth surpassing productivity increases is expected to rise the real ULC by 1% in 2006. This is a short and medium term risk for economic growth; structural unemployment and low labour market activity pose further threats in a longer term.

**Table 3. Major macroeconomic indicators for Estonia 2003-2006**

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP growth (%) | 6.7 | 7.8 | 8.4 | 7.2 |
| - Private consumption (%) | 7.6 | 4.4 | 6.5 | 6.5 |
| - Public consumption (%) | 5.9 | 6.9 | 5.7 | 5.9 |
| - Gross fixed capital formation (%) | 8.5 | 6.0 | 8.3 | 6.5 |
| - Export (%) | 5.8 | 16.0 | 18.5 | 16.0 |
| - Import (%) | 10.6 | 14.6 | 13.7 | 11.6 |
| Consumer price index (average, %) | 1.3 | 3.0 | 4.2 | 3.4 |
| Consumer price index (dec/dec, %) | 1.1 | 5.0 | 3.6 | 3.0 |
| Unemployment rate (ILO, %) | 10.1 | 9.7 | 9.0 | 8.8 |
| Real wages | 8.8 | 5.1 | 7.3 | 6.8 |
| General government balance/GDP (%) | 2.6 | 1.7 | 1.1 | 0.6 |
| Public debt /GDP (%) | 6.0 | 5.5 | 5.1 | 4.0 |
| Current account balance /GDP (%) | -12.0 | -12.5 | -9.4 | -8.5 |
| Trade balance /GDP (%) | -18.2 | -16.8 | -15.6 | -14.7 |
| Gross foreign debt /GDP (%) | 68.7 | 81.2 | 90.3 | 97.0 |
| Exchange rate (EEK/EUR, end of year) | 15.646 | 15.646 | 15.646 | 15.646 |
| TALIBOR rate (12 months, %) | 2.83 | 2.67 | 2.6 | 2.6 |

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

** Forecasts*

# HUNGARY

*Twin deficit amidst accelerating GDP growth*

## Economic Growth

After the significant slowdown in the first quarter (when real GDP increased by merely 2.9% on annual basis) economic growth accelerated since the second quarter of 2005. The acceleration in GDP growth was mainly driven by the recovery of manufacturing and construction production driven by the increased growth of exports and highway construction.

Altogether GDP growth in 2005 will be around the level of 4.5% reached in 2005 and its composition will not change considerably compared with the previous year. Private consumption increases by 3.5% driven by somewhat more moderate increase of wages and significant growth of private sector credit demand. At the same time private investments are expected to increase by 8% slightly below their expansion in 2004 and the contribution of net exports (with somewhat more moderate rates of growth of both of imports and exports) will be similar to the previous year.

The forecasted GDP growth for 2006 equals 4.5% with somewhat changing composition. Private consumption is expected to be the main driving factor driven both by the elections influenced increase of nominal wages and by the further growth of consumer credits. At the same time the contribution of net exports is likely to diminish as faster rise of imports will outweigh the growth of imports for the first time after 2004 and 2005. Though this is an election year, the growth of investments is expected to remain at the level of 2005 as accelerating public investment growth will be accompanied by slow-down of private investments.

## Monetary indicators

A marked decline is expected in inflation in the first half of 2006 due to the decline of the standard VAT rate. After the significant fall the annual consumer price index may be around 1,8%, while the December/December index may decline even to 1.6%. The decline of VAT rate suppresses the inflationary effect of increasing administrative prices, rising real wages and expected weakening of the national currency.

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

Currently the exchange rate is in the state of dual equilibrium, when the likelihood of remaining at the given level equals the likelihood of a significant nominal depreciation. In case the financing of the public sector borrowing requirement and of the current account deficit is satisfied by the increasing net foreign borrowing of the private sector, than the currency may remain at the current level. In case an exogenous shock hits the country or the expectations concerning the sustainability of fiscal policy worsens, this may lead to sizeable depreciation of the domestic currency.

The currency pressures as well as the consumer price developments put the national bank in a difficult situation s the inflation targets could be reached with lower nominal and real interest rates, the twin deficits prevents the central bank from reducing the nominal rate in line with the accelerated disinflation, It is likely that the central bank's base rate will either remain unchanged or may even rise slightly in 2006.

## Fiscal Developments

The ESA'95 deficit of the general government in 2005 will be 6,3% with the adjustment to the effect of pension reform and

7,5% without the adjustment. Further increase of general government deficit is likely in 2006, driven mainly by the worsening primary balance. Increasing primary deficit is due to the almost 1,5% GDP decline of tax revenues influenced by the reduction of the standard VAT rate from 25% to 20% effective of 1 January. At the same time the election year prevents the decline of expenditures and neither the accrual nor the cash based balance improve notwithstanding the decline of interest expenditures.

According to the forecast the ESA'95 deficit of the general government with the adjustment of the pension reform will be 6.6% of GDP, without it 8%. The share of Forint denominated debt will increase in 2006 in the financing of the public sector borrowing requirement. The debt/GDP ratio is expected to increase further as the impact of the primary deficit outweighs the positive effect of privatisation revenues used to retire public debt.

## Balance of payments

The current account deficit is still sizeable, exceeding 8% of GDP in 2005. The deficit reflects the varying financing and saving capacity of different sectors of the economy: net financing capacity of the private sector improved in 2005 following the rise of gross private savings which was however more than balanced by increased public sector borrowing requirements. On the other hand the unchanged current account deficit has been accompanied by slightly improving trade and services balances, mainly due to the fast increase of exports. At the same time the income balance worsened both due to increasing debt service expenditures on the increasing net foreign debt and growing profit repatriation of foreign investors.

In 2006 the current account deficit of 8,6% of GDP will be determined by slightly improving net financing capacity of the private sector and growing borrowing requirements of the public sector. At the same time unchanged goods and services balance will be accompanied by increasing incomes balance deficit.

Net foreign financing requirement reflected in the current account deficit was financed in 2005 to smaller extent by non debt generating capital flows.

In 2005 the volume and share of debt generating capital inflows increased simultaneously with the improvement of the net FDI balance due to the increasing gross foreign direct investment inflows. The process is expected to continue in 2006 as increasing gross FDI inflows will be accompanied by rising debt creating capital inflows due to the increase of gross and net debt to GDP ratio.

## Unemployment and wage dynamics

The number of unemployed has been increasing almost continuously and will reach 7,3% of the working age population. At the same time employment remained unchanged and stabilised at a very low level. In 2006 no significant increase in public sector employment is expected, while at the same time employment may slightly accelerate in the private sector. While in 2005 real wage growth was around 6% in 2006 some moderation of real wage and income growth is expected.

**Table 4. Major macroeconomic indicators for Hungary 2003-2006**

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP (%) | 3,4 | 4,6 | 4,5 | 4,5 |
| Private consumption (%) | 8 | 3,5 | 3,5 | 3,7 |
| Public consumption (%) | 5,5 | -1,5 | -1,5 | 0,5 |
| Gross fixed capital formation (%) | 3,5 | 8,2 | 8 | 7,5 |
| Export (%) | 7,5 | 15,5 | 11 | 9 |
| Import (%) | 10,5 | 14 | 8 | 10 |
| Consumer price index (average, %) | 4,7 | 6,8 | 3,6 | 1,8 |
| Consumer price index (dec/dec, %)) | 5,7 | 5,5 | 3,6 | 1,6 |
| Unemployment ratio (%, ILO definition) | 5,8 | 6,1 | 7,3 | 7,1 |
| Real Wages (%) | 4,5 | 2,6 | 6,0 | 5,5 |
| General government balance/GDP (%) | -7,2 | -5,5 | -6,3 | -6,6 |
| Public debt/GDP (%) | 57 | 58 | 60 | 61,5 |
| Current account/GDP (%) | -8,5 | -8,9 | -8,3 | -8,7 |
| Trade balance/GDP (%) | -4 | -3,1 | -2,9 | -3,1 |
| Exchange rate (HUF/EUR) | 262 | 245 | 255 | 255 |
| Base rate (%) | 12,5 | 9,5 | 6 | 6,5 |

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

# LATVIA

*Fastest GDP growth and highest inflation in 2005 among the NMS, dangers of overheating*

## Growth

Buoyant economic growth persisted in Latvia throughout 2005, exceeding all prior expectations: under favourable conditions in December GDP growth can reach 9.3%, the fastest rate in the European Union. Growth was primarily driven by consumption and fixed capital formation; net exports contributed marginally to growth as demand-driven import growth counterbalanced the strong export performance. High real wage growth and the rapid expansion of bank credits were the main sources of consumption growth, while fixed capital formation was driven by construction and strong demand for equipment.

Consumption and housing investments will be the main contributors to growth in 2006 due to the same factors as in 2005: income and employment growth, easy credit. Import growth may slow down while exports are expected to gain a boost from high productivity growth and investments despite a bleak outlook for demand in the European Union. On the other hand, a more restrictive fiscal policy – needed to combat inflation – should ease demand pressures. GDP growth in 2006 is expected at 7%, close to the potential output growth rate.

## Monetary indicators

The inflation rate of Latvia is the highest in the European Union with 7.4% in November and an estimated annual average of 6.7% for 2005. Meanwhile, core inflation has also reached 6.0%. Unfavourable external conditions (especially high fuel prices) and rising administered prices also contributed to high inflation; still, as the Bank of Latvia points out, this inflation is mainly a result of demand pressures in an overheating economy.

The credit boom in Latvia is an important underlying factor of this overheating: between September 2004 and September 2005 broad money (M3) increased by 34.1% as a consequence of a 57.8% growth in loans to residents during the same period. 85% of new loans were denominated in foreign currencies; therefore the share of foreign-denominated loans rose by 8 percentage points in one year to reach 68% in September 2005. This is the result of a very credible exchange rate fixing and the anticipated introduction of the euro coupled with high domestic interest rates as a consequence of high inflation.

Under a currency board regime the number of policy instruments to tackle rising inflation is limited. As of December 24, 2005 the reserve ratio of banks is raised from 6% to 8% in an attempt to curb credit growth. It is doubtful whether the manipulation of the reserve ratio has a significant effect on the behaviour of banks: as these financial institutions are usually owned by foreign banks and can finance their lending from abroad, their ability and willingness to lend should not depend on the reserve requirements on their deposits. Therefore another instrument, fiscal policy needs to be applied. Higher-than-expected budget revenues in 2005 were spent by a supplementary budget – such a fiscal stimulus should be avoided in 2006 to contain demand pressures.

Depending on external factors, inflation is expected to come down to 6% in 2006. Therefore the inflation criterion is going to remain the soft spot of Latvia's compliance with the Maastricht criteria in the foreseeable future.

Both ex post and ex ante real interest rates are negative with the RIGIBOR interbank rate standing at 3.33% in December 2005 compared with the 3.56% in December 2004. Persistent high inflation and low ECB interest rates will keep real interest rates negative in 2006 as well; this in turn will boost credit expansion, domestic consumption and investments.

## Fiscal policy

As a result of strong growth fiscal targets were exceeded. A supplementary budget increasing spending on agriculture, investments and health care increased expenditures by 1.5% of GDP, but the 2005 target of 1.6% general government deficit is expected to be met. The

2006 budget allows for a 19.2% increase in revenues and a 17.6% rise in expenditures, mainly consisting of public sector wage rises and additional educational and health care expenditures. Under present inflationary pressures excess revenues should not be spent in the coming year. In this case the deficit target of 1.5% is easily achievable in 2006.

## Balance of payments

Export performance was strong in the first half of 2005, growing by over 30%, outpacing imports around 25%. The trade deficit is expected to reach 18.5%, while the current account deficit will amount to 11% in 2005; strong economic growth helped to bring down these measures relative to GDP. Continuing strong growth, a slight slowdown of exports and healthy export growth will contribute to a one percentage point decline in the trade deficit and a 0.5 percentage point decrease of the current account deficit in 2006.

As a result of extensive lending activity, the stock of foreign liabilities of the country increased by about 50% between 2003 and 2005; however, due to fast economic growth its value relative to GDP is expected to rise by 15 percentage points to 112% be the end of 2005.

## Unemployment

Thanks to strong economic growth unemployment (by domestic definition) declined by 1.1 percentage points since the beginning of 2005 and reached 7.5% in October. The employment outlook is positive as economic growth is expected to be high in 2006 as well. The effects of high, 17.4% nominal (gross) wage growth were mitigated by rising inflation, resulting in a 10.7% rise of real wages between the third quarters of 2004 and 2005. Plans of public sector wage rises should lead to high real wage growth in 2006 although productivity growth will remain faster than that of wages.

**Table 5. Major macroeconomic indicators for Latvia 2003-2006**

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP growth (%) | 7.2 | 9.8 | 9.1 | 7.7 |
| - Private consumption (%) | 8.2 | 9.3 | 8.4 | 7.8 |
| - Public consumption (%) | 1.9 | 2.1 | 2.4 | 2.6 |
| - Gross fixed capital formation (%) | 12.3 | 23.8 | 16.5 | 10.0 |
| - Export (%) | 5.2 | 9.4 | 13.6 | 12.3 |
| - Import (%) | 13.1 | 16.6 | 9.5 | 10.5 |
| Consumer price index (average, %) | 2.9 | 6.2 | 6.7 | 5.1 |
| Unemployment rate (%, ILO definition) | 10.4 | 9.8 | 9.7 | 9.4 |
| Real wages | 8.2 | 3.1 | 10.1 | 7.0 |
| General government balance/GDP (%) | -1.2 | -0.9 | -1.2 | -1.5 |
| Public debt/GDP (%) | 14.6 | 14.7 | 12.8 | 13.0 |
| Current account /GDP (%) | -8.2 | -12.6 | -11.1 | -10.5 |
| Trade balance /GDP (%) | -13.5 | -17.1 | -16.3 | -16.3 |
| Gross foreign debt /GDP (%) | 80.0 | 93.2 | 98.4 | 100.1 |
| Exchange rate (Lats/EUR, annual average) | 0.64 | 0.66 | 0.70 | 0.70 |
| RIGIBOR rate (12 months, end of year, %) | 4.48 | 4.26 | 3.33 | 3.3 |

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

** Forecasts*

# LITHUANIA

*Robust growth is expected to continue in 2006*

## Growth

Economic growth remained strong in 2005 with annual GDP growth expected at 7%. After the closure of the Ignalina nuclear power plant electricity exports of the country dropped sharply, but strong growth in the CIS stimulated exports and high oil prices were favourable for the only refinery of the Baltic region, Mazeikiu Nafta. On the other hand, domestic demand (both consumption and investment) fuelled imports as well therefore the overall effect of net exports to growth was negative.

Growth in 2006 is expected to reach 6.2%. Income tax cuts and real wage growth will encourage private consumption while EU structural funds will continue to boost investments. While favourable external conditions in the CIS and neighbouring Baltic countries are expected to persist, import growth is expected to remain high as well.

## Monetary indicators

Consumer price inflation reached 2.9% in November 2005, reflecting rising energy, health care and transport prices. Annual inflation is expected to reach 2.6% in 2005; the same pace will persist throughout 2006 as well with a slower first half (due to the fade-out of previous price increases) and a faster growth in the second half of the year. Energy prices and the secondary effects of wage growth are the main upside risks to inflation in 2006.

Monetary conditions have continuously been easing in recent years. The 12-month VILIBOR interbank rate stood at 2.82% at the end of 2005 and is expected to remain stable in 2006. Real interest rates came down to zero in 2004-2005, acting as a catalyst to credit growth which exceeded 40% in 2003 and 2004 albeit remained somewhat contained (but still over 30%) in 2005.

## Fiscal policy

Tax revenues exceeded expectations in 2005 although the tax reform accepted in 2004 called for a reduction of taxes. Temporary high corporate taxes were responsible for these extra revenues, especially from the highly profitable oil refinery Mazeikiu Nafta. The government plans to buy the refinery from the bankrupt Russian oil company Yukos to sell it together with its own stake at a higher price eventually.

A supplementary budget was accepted in June 2005 increasing public spending on social transfers, health care and public investments. As a result, the public deficit should have risen to 2% in 2005. This deficit will decrease by 0.2 percentage points both in 2006 and 2007 on the back of strong economic activity and rising tax receipts.

## Balance of payments

The current account balance improved in 2005 thanks to a stable trade balance and the improvement of the terms of trade. These favourable trends are expected to continue in 2006 resulting in a slow reduction of the current account deficit. Meanwhile, strong credit growth is financed by foreign borrowing therefore the gross foreign debt stock of the country is rising rapidly, surpassing 50% of the GDP in 2006.

## Unemployment

Economic growth boosted job creation to 1.6% in Lithuania. New jobs and a decrease in the labour market participation rate brought unemployment below 10% in 2005. Job creation is believed to have reached its peak in 2005 but the future outlook is still positive and an 8% unemployment rate is achievable in 2006. However, high long-term structural unemployment makes the unemployment rate an unreliable indicator of labour market conditions.

Real wage growth slowed down in 2005, dampened by rising inflation. Public sector wage increases in 2005 exert an upward pressure on salaries and the decrease of the income tax will also raise net wages. Nominal wage increases are expected to surpass productivity growth in 2006, but higher inflation will ensure that the real unit labour cost does not rise. Meanwhile, active labour market policies may not be sufficient to mobilise labour, therefore shortages and wage pressures will remain in the short term.

**Table 6. Major macroeconomic indicators for Lithuania 2003-2006**

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP growth (%) | 10.5 | 7.0 | 7.0 | 6.2 |
| - Private consumption (%) | 12.6 | 9.7 | 8.2 | 8.0 |
| - Public consumption (%) | 3.8 | 7.5 | 5.2 | 4.9 |
| - Gross fixed capital formation (%) | 14.0 | 12.3 | 10.1 | 8.2 |
| - Export (%) | 6.9 | 4.2 | 10.7 | 10.9 |
| - Import (%) | 10.3 | 14.8 | 11.5 | 11.4 |
| Consumer price index (average,%) | -1.1 | 1.1 | 2.6 | 2.6 |
| Consumer price index (dec/dec, %) | -1.3 | 2.8 | 2.7 | |
| Unemployment rate (%, ILO definition) | 12.7 | 10.9 | 9.0 | 8.1 |
| Real wages | 9.3 | 6.1 | 4.5 | 5.5 |
| General government balance/GDP (%) | -1.2 | -1.4 | -2.0 | -1.8 |
| Public debt/GDP (%) | 21.4 | 19.6 | 20.7 | 20.2 |
| Current account /GDP (%) | -6.9 | -8.0 | -7.4 | -7.1 |
| Trade balance /GDP (%) | -9.1 | -10.6 | -10.8 | -10.7 |
| Gross foreign debt /GDP (%) | 41.0 | 42.8 | 49.0 | 52.0 |
| Exchange rate (LTL /EUR, annual average) | 3.45 | 3.45 | 3.45 | 3.45 |
| VILIBOR rate (end of year, %) | 2.98 | 2.88 | 2.82 | 2.8 |

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

** Forecasts*

# POLAND

*Weaker than expected growth and improvement in labour market conditions.*

## Growth

In line with expectations GDP growth was stronger in Q2 2005, than in Q1 reaching 2.8% year on year. In Q3 annual GDP growth increased to 3.7%. Net exports were the main driving factor behind GDP growth in Q3 2005.

In June the growth rate of retail sales amounted to 10.5%, and in August it was still 7.9%, after the year on year decrease experienced in March and April (the negative growth rates in the spring months were due to the base effect caused by strong retail sales in the same months of the preceding year, before Poland's accession to the EU in May 2004). A year on year decrease was experienced in domestic demand in Q2. A positive change came in the form of a pronounced increase in the sale of durable goods (household appliances and furniture) in the summer months, while a downturn was experienced in the sales of motor vehicles. Fixed investments increased by 3.8% year on year in Q2 2005. The increase is expected to continue towards the end of the year. The growth in industrial production was weaker in Q2 than earlier expected (reaching 2.3% year on year). Q3 brought much better results with industrial production growth reaching, 7.6% year on year. At the same time recovery in construction, which started in 2004, continued.

GDP growth is expected to increase towards the end of the year, in Q3 it was already stronger than in Q2, but we still make a down side change in our overall yearly forecast to 3.5%, for 2005. This is due to the weaker than expected improvement in Q2. Increasing consumption demand growth is going to support the acceleration of GDP growth in the second half of the year. We maintain our 2006 GDP growth forecast of 4.4%. Investments and private consumption will be the main driving factors of GDP growth in 2006.

## Monetary indicators

The zloty weakened rapidly and broke the 4 EUR/PLN level after it became clear that Law and Justice would govern from a minority position with the support of populist Self Defence and the League of Polish Families, and the first announcements of the new government were made. The euro introduction has been postponed into the indefinite future, which also contributed significantly to the weakening of the zloty.

The year on year inflation rate rose in August by 1.6% putting an end to its continuous trend of reduction, which lasted from October 2004 (4,5%) to July 2005 (1.3%). In September 2005 the annual growth of consumer prices increased further to 1.8%, but in October a decrease occurred again, to an annual 1.6%. Core inflation indicators remained low, while the inflation expectations of households increased a bit, but where still well below the inflation target of 2.5%. The Monetary Policy Council of the National Bank of Poland left interest rates unchanged at its October and November meeting, therefore the reference rate remained at 4.5%. Despite the weakening of the zloty in November, the inflation environment can still be characterized as stable. No interest rate rise (from the current 4.5% reference rate) is expected in the next half year. A cut is possible however early next year, if end of year GDP results are disappointing.

CPI is expected to reach 2.2% at the end of 2005 (which means we increased our earlier forecast). We maintain our 2006 CPI forecast at 2%. This means that CPI is expected to stay well below the 2.5% inflation target both this year and the next.

## Fiscal policy

The new prime minister, Kazimierz Marcinkiewicz made it clear in his first statements, that the government wants to stabilize the level of general government deficit, and does not intend to make reductions on the expenditure side. On the contrary, some social expenditure will even be increased. At the same time the privatisation process will be stalled in some sectors, and some previously finished privatisations will be reviewed (for example in the case of PGNiG gas and oil company). The new government also intends to make personal income tax reductions, and introduce a three-bracket tax system (18% for those in the lower and middle income brackets, 28% and 32% for those in higher income brackets).

As the way things now look, fiscal reforms will be postponed in Poland while the conservative Law and Justice (PiS) party governs. The public finance reform, which would make compliance with the Maastricht criteria possible, will not be started in the near future. This will also delay the date of euro introduction, which now cannot be expected to take place before 2012.

The 2005 budget performed well until August, the month before the elections, when the deficit reached only 52.8% of the full-year plan. A strong inflow of both direct and indirect taxes has been experienced. It is yet to be seen whether the PiS government will increase spending towards the end of the year.

## Balance of payments

In Q3 2005 there was an improvement in the current account deficit as a percentage of GDP, reaching 1.9% in August. This was a larger gap than earlier expected, but at the same time it means the continuation of the gradual improvement that has been going on since autumn 2004. The current account deficit as a percentage of GDP is expected to reach 1.4% at the end of 2005, which is slight worsening compared to our earlier forecast.

The growth rates of imports and exports were high in Q3, both above 15% in August. High growth rates will be maintained for the rest of the year, as a result of the higher economic activity and the fading out of the base effect, reaching 11.7% in the case of imports and 14.2% in the case of exports (year on year). In the first seven months year on year the growth rate of exports reached 19.9% on a euro basis. As German markets are currently able to take a lower share of Polish exports than desirable, other, faster growing export markets, such as Russia, Hungary, the United Kingdom and the Czech Republic are gaining in importance.

Net FDI inflow is expected to be lower in 2005 than in 2004, reaching 3410 million euros. In 2006 the net FDI inflow is expected to reach a higher level.

## Unemployment and wage dynamics

The increase in the demand for labour continued in Q3. Since January 2005 the unemployment rate has been continuously decreasing, reaching 17.6% in September. The trend of reduction is expected to continue. Average employment growth in August, in the enterprise sector was the fastest in seven years, reaching 2% year on year, and increased further to 2.2% (year on year) in September.

Wage growth has been following a downward trend (year on year 3.2% in July, 2.8% in August and 0.6% in September) in the months of Q3 2005. Therefore there was no danger of inflationary pressure coming from the labour market in Q3. In addition to this, labour productivity growth is still higher than wage growth in Poland.

We maintain our end of year unemployment forecast at 17.7%, and the 2006 forecast at 17.5%. Growth in nominal wages in the enterprise sector is expected to reach 0.6% in 2005, which is a reduction compared to our earlier forecast. Rising employment and the gradual growth of real wages will contribute to the rise in private consumption, which will support GDP growth.

**Table 7. Major macroeconomic indicators for Poland 2003-2006**

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP (%) | 3.8 | 5.4 | 3.5 | 4.4 |
| -Private consumption (%) | 3.1 | 3.4 | 2.5 | 3.0 |
| -Public consumption (%) | 0.1 | 1.4 | 1.1 | 1.1 |
| -Gross fixed capital formation (%) | -0.2 | 5.3 | 4.0 | 9.3 |
| -Export (%) | 9.1 | 21.9 | 14.2 | 11.0 |
| -Import (%) | 3.3 | 19.1 | 11.7 | 12.0 |
| Consumer price index (average, %) | 0.8 | 3.5 | 2.2 | 2.0 |
| Consumer price index (dec/dec, %)) | 1.7 | 4.4 | 1.5 | 1.5 |
| Unemployment ratio (%, ILO definition) | 20.0 | 19.1 | 17.7 | 17.5 |
| Real Wages (%) | 2.0 | 0.8 | 0.6 | 1.3 |
| General government balance/ GDP (%) | -4.5 | -4.7 | -3.3 | -3.4 |
| Public debt/GDP (%) | 48.4 | 46.7 | 50.2 | 52.2 |
| Current account/GDP (%) | -2.2 | -4.3 | -1.4 | -1.8 |
| Trade balance/GDP (%) | -2.6 | -2.3 | -1.4 | -1.4 |
| Gross foreign debt/GDP (%) | 45.1 | 47.6 | 41.5 | 40.5 |
| Exchange rate (PLN/EUR) | 4.4 | 4.53 | 4.03 | 3.92 |
| Base rate | 5.25 | 6.5 | 4.5 | 4.75 |

**Forecasts,*

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

# SLOVAKIA

*The Slovak Koruna joined the ERM II in November 2005, first among the Visegrad countries.*

## Growth

After a slight deceleration in the second quarter, according to the flash estimate of the Statistical Office of the Slovak Republic, GDP growth in Slovakia accelerated again in the third quarter and its rate is still the fastest in the NMS region (excluding the Baltic states). Compared to the same period of the previous year, GDP increased by 5.8 per cent, thus the projections of international organisations in the range of 4.8-5.1 per cent will certainly be fulfilled, if not surpassed by the end of the year. Domestic demand is still the most important engine of growth (highest rate among the Visegrad countries) and it is expected to remain so because of the possibility of pre-electionary fiscal loosening. GFCF has been robust in the first half of the year, compared to the previous quarters, and is the other engine behind growth. The contribution of net exports to growth has yet to be realised, though the foreign trade deficit halved by September, compared to the corresponding period of 2004.

Private consumption remained vigorous both in the first and second quarters, for which data are available. Most probably, it will remain so in the remaining part of the year, because of strong growth in real wages, and in household spending. An improving indicator of consumer's confidence in October and November (published by the Statistical Office) is also pointing into that direction. Public consumption is expected to increase as well, partly because co-financing of EU-funded projects was postponed from 2004 to 2005 and partly because of elections-related expansion in government consumption. The above forecast is supported by the fact, that consumption growth in the first half of 2005 was the highest among the NMS countries (excluding Baltic states).

Investments (gross fixed capital formation) is expected to grow quickly, due partly to the realisation of large, FDI-related greenfield projects and partly the decision of the government to finance highway construction and FDI incentives from excess tax revenues. The rate of growth of GFCF indicates a substantial increase compared to 2004 in the first half of 2005.

On the basis of the developments in domestic consumption and GFCF, Slovakia is expected to maintain its outstanding growth rate in 2005, and may even surpass the predicted 4.8-5.1 per cent level, if growth continues to be as strong in the fourth quarter as it was in the third.

For 2006, the predictions of international organisations vary in the range between 5.0 and 5.7 per cent, in general, a slightly higher rate is expected than in 2005, with a stronger contribution of net exports and weaker role of domestic consumption in determining the growth rate.

## Monetary indicators

The level of consumer prices – after a substantial decrease in the rate of price increases compared to the previous year – increased again in the third quarter. In October, headline inflation (HICP) stayed at 3.5 per cent on a year-on-year basis. (Core inflation – without energy and unprocessed foodstuff prices - was 1.1 per cent.) The largest increases affected regulated prices: those of housing, water, electricity, gas and other fuels and education. Furthermore, real wage increases and higher PPI act as inflationary factors. Producer prices increased by 5.8 per cent in October 2005, on a year-on-year basis. These factors may increase the level of inflation (CPI) slightly above the expected 2.8-3.5 per cent range for the year as a whole. However, for 2006, lower increase in regulated prices may result in a below 3 per cent price increase.

The most important development on the exchange rate side was the sudden joining of the Slovak Koruna of the ERM II. The central rate of the euro was set at 1 euro=38.455 koruna, which was determined on the level of the market exchange rate. The standard fluctuation band of +- 15 per cent will be observed around the central rate. The exchange rate of the Koruna was influenced by outside developments (e.g. other Visegrad countries currencies and USD/euro cross rates), and was not in line with the expectations of the national bank. In October, this provoked intervention on the interbank market, and it contributed in November to the decision on the early inclusion of the Koruna in the ERM II.

At the end of November, the two-week repo rate stayed at 3.0 per cent, no changes were introduced in that respect. The monetary policy will be under further pressure this year because of large capital inflows connected to privatisation, FDI, portfolio and other (mainly short-term) investments, which all seem to be insensitive to the strong koruna and the low interest rate. Frictions by the difference between ECB and SNB rates may cause problems for the monetary policy. Short-term other investments exceeded USD 3 billion at the end of August.

## Fiscal developments

Up till now, the government succeeded in sticking to its spending plans, cumulative data at the end of October indicate a slight deficit. As our last report said, in 2005, new factors as EU-projects financing, the introduction of a pension reform, higher spending on health care funding due to new rules and a more than 600 million euros payment obligation to a Czech private bank are expected to increase the fiscal deficit. In that respect, a ruling of Eurostat, according to which the payment to the Czech Bank will not be included in the deficit, improved the fiscal outlook. Moreover, privatisation proceeds may alter favourably the fiscal situation. Notwithstanding, a pre-election release of extra tax revenues, higher real wage increases, which endanger the inflation target and the higher than expected popularity of the second pillar of the new pension system may turn out to be risky from the point of view of the 2005 budget outcome. However, the level of fiscal deficit is not expected to increase the projected 3.8 per cent of GDP.

Fiscal deficit is planned to fulfil the Maastricht criterion next year. According to the plans of the government, expenditures would be reduced by 0.7 per cent next year and by a further 1 per cent in 2007, while revenues are projected to decrease by 0.2 and 1.1 per cents, respectively. According to the World Bank, in 2006, higher spending will be realised for education and Lisbon targets, and for subsidizing large foreign investors.

## Balance of payments

The current account deficit has been widening rapidly in 2005, however, after the summer, developments were more favourable, and in the first nine months, exports grew by 8.3 per cent, while imports grew by 10 per cent, which resulted in a lower trade deficit than in September 2004. The main reason behind the trade deficit is the strong growth of domestic demand, on the basis of which the prognosis of the current account deficit must be put higher, than in our previous report. However, it is still among the moderate rates among the NMS countries. The current account deficit is expected to be lower in 2006 compared to this year, backed by the more favourable developments in net exports.

The current account deficit stood at USD 2 billion at the end of August, while the trade balance was in the red by USD 1.2 billion USD. However, the current account deficit was more than counterbalanced by the capital and financial account’s surplus, which reached almost USD 4.5 billion at the end of the eighth month, mainly due to a significant amount of other, primarily short-term investments.

At the end of August, FDI inflows increased significantly, they stood close to USD 1.5 billion. This was mainly due to an increase in reinvested earnings (half of the inflows), to other capital and to privatisation related projects. Though this number presumably does not contain privatisation revenues connected to the sale of the Slovakian electric power company (around 900 million euros) and other bigger privatisation related projects. These items, together with other announced but not yet or only gradually realised greenfield investments induce us to stick to the FDI prognosis of 2.8 billion USD for the whole year.

## Unemployment

Unemployment is still among the highest among the NMS countries, though there was a substantial fall in its rate compared to a year ago, which may be attributed to the favourable growth record. Jobs were created mainly in the service sector (especially in wholesale, in sale and maintenance of motor vehicles, in retail trade, hotels and restaurants. In spite of the acceleration of the growth rate of industrial production (5.4 per cent in September on a year-on-year basis), employment rose only by 0.1 per cent in this sector.

Unemployment stands at around 15 per cent, which indicates a substantial decrease in the last twelve months. However, this rate is still the second highest among the NMS countries and must be evaluated against the low activity rate characterising the country. Long-term unemployed represent 70 per cent of total jobless. Other structural problems hinder significant reduction in the unemployment rate, thus, for the year as a whole, only a slight further decrease in unemployment is predicted.

**Table 8. Major macroeconomic indicators for Slovakia 2003-2006**

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP growth (%) | 4.5 | 5.5 | 5.1 | 5.4 |
| - Private consumption (%) | -0.6 | 3.5 | 4.6 | 5.3 |
| - Public consumption (%) | 2.7 | 1.2 | 4.7 | 4.8 |
| - Gross fixed capital formation (%) | -1.5 | 2.5 | 8.0 | 7.5 |
| - Export (%) | 22.5 | 11.4 | 11 | 12 |
| - Import (%) | 13.6 | 12.7 | 13 | 13 |
| Consumer price index (average, %) | 8.5 | 7.5 | 3.2 | 2.7 |
| Consumer price index (dec/dec, %) | 7.7 | 6.9 | *3.2* | 2.6 |
| Unemployment ratio (%, ILO definition) | 17.5 | 18.0 | 16.5 | 17.4 |
| Real wages (%) | -1.5 | 3.4 | 3.8 | 3.8 |
| General government balance/GDP (%) | -3.7 | -3.3 | -3.8 | -3.2 |
| Public debt/GDP (%) | 42.6 | 43.6 | 44.2 | 44.4 |
| Current account /GDP (%) | -0.8 | -3.4 | *-5.7* | -5.5 |
| Trade balance /GDP (%) | -2.3 | -3.5 | -4.8 | -5.2 |
| FDI (billion USD) | 0.6 | 1.0 | 2.8 | 2.5 |
| Gross foreign debt /GDP (%) | 55.6 | 53.9 | 49.8 | 50.0 |
| Exchange rate (Koruna/EUR end of year) | 41.5 | 40.0 | 38.5 | 37.0 |
| Basic interest rate (%) | 6.5 | 5 | 3 | 3 |

**2005: Forecast*

*Sources: EU, IMF, Slovak National Bank*

# SLOVENIA

## Economic Growth

After 2.6 percent growth at the beginning of the year (Q1), real GDP grew by a remarkable 5.2 percent y-o-y in the 2nd quarter. The upswing was mainly due to strong external demand. Exports (mainly to the EU15) grew by 10 per cent in Q2 compared to the same period of last year. The rise in import was only 3.6 per cent y-o-y. Due to the strong external demand inventories shrank thus domestic consumption's real growth reached only 0.5 per cent y-o-y. Looking ahead we expect that the economy will grow by 4 percent in 2006.

## Monetary Conditions

After year-on-year price increases went below 2 percent in the summer, inflation reached 3.1 per cent in October. However average inflation keeps on slowing down throughout 2005. The government adjusted the excise duty of petrol in order to counter the impact of the oil price on inflation. Oil price developments could be the only major price-driving factor in the following months prior EMU entry. Inflation is projected to decline further in 2006. We expect that the average rate of inflation will reach around 2.5 per cent in 2006. Thus price developments will not hinder Slovenia's accession to the EMU.

Monetary policy played a major role in the slowing down of inflation by stabilising the tolar's exchange rate upon entering ERM II. The nominal euro exchange rate keeps on being stable on the spot foreign exchange market. Fluctuations around the central rate do not even reach 0.1 percent. We expect that the tolar's exchange rate will remain stable throughout 2006, and the Maastricht criterion for exchange rate will be easily met.

## Fiscal Policy

In spite of the remarkable economic growth the budget deficit in the first six months was slightly higher than planned. The overshooting of the deficit target was mainly due to higher wage and pension expenses. The average gross salary per employee amounted to SIT 279,507 (EUR 1,166) in August, which is 2.8% over July and 7.2% more than a year ago. In real terms, the August gross salary rose 3.4% compared to July, and 5% compared to August 2004. According to the government plans the consolidated budget deficit will be kept below 1.5 per cent in 2006. We expect that the Maastricht criterion for fiscal deficit will be met. Financing pension is the major medium and long term challenge for Slovenian public finances. Pension spending is projected to increase by about 5 percentage points of GDP, with spending on pension potentially reaching 18 percent of GDP.

## Balance of Payments

According to the revised balance of payments data for the year 2004, the current account deficit exceeded the originally published figures by 305 million Euros thus reaching 544 million Euros or 2.1 per cent of the GDP. Although the total FDI inflow will not even reach 1 percent of GDP in 2005, it will be still sufficient to cover the deficit of the current account. We expect that the current account deficit will shrink below 1 percent of GDP.

## Unemployment and wage developments

Slovenia's registered unemployment rate stood at 10% in August, down 0.1 percentage points over July, while the ILO-compatible rate was 5.8% in the second quarter of 2005, according to the latest data released by the Statistics Office. The Statistics Office data shows that 8.3% of men and 12.2% of women were registered as jobless. The rate for the first eight months of this year averaged 10.1%. Slovenia's labour force numbered 903,314 in August, with 813,496 persons in paid employment. This is 0.1% less than the month before and up 0.7% on August 2004.

**Table 9. Major macroeconomic indicators for Slovenia 2003-2006**

| | 2003 | 2004 | 2005* | 2006* |
|---|---|---|---|---|
| GDP (%) | 2.5 | 4.6 | 3.9 | 4.0 |
| Private consumption (%) | 2.7 | 3.5 | 3.6 | 3.2 |
| Public consumption (%) | 2.6 | 1.7 | 2.5 | 2.5 |
| Gross fixed capital formation (%) | 6.3 | 6.8 | 4.0 | 4.6 |
| Export (%) | 3.2 | 12.6 | 8.6 | 7.7 |
| Import (%) | 6.8 | 12.4 | 6.0 | 6.6 |
| Consumer price index (average,%) | 5.6 | 3.6 | 2.6 | 2.5 |
| Consumer price index (Dec/Dec, %) | 4.8 | 3.5 | 2.2 | 2.6 |
| Unemployment ratio (%, ILO definition) | 6.5 | 6.0 | 6.1 | 5.7 |
| Real wages (%) | 1.9 | 2.3 | 2.1 | 2.5 |
| General government balance (% in GDP) | -2.0 | -1.9 | -1.9 | -1.4 |
| General government debt /GDP (%) | 29.4 | 29.4 | 30 | 30.1 |
| Current account balance / GDP (%) | -0.4 | -2.1 | -1.0 | -0.8 |
| Trade balance /GDP (%) | 0.0 | -0.6 | -0.7 | 0.4 |
| Gross foreign debt /GDP (%) | 54.3 | 59.3 | 62 | 59 |
| Exchange rate (SIT/EUR end of year) | 236.7 | 239.7 | 239.5 | 239.7 |
| Base rate | 5.0 | 3.2 | 3.5 | 3.25 |

*Source: Bank of Slovenia, IMF, IMAD*

**Forecast*