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I. POLAND ON THE WAY OF RECOVERY, BUT STILL IN THE NEED OF STRUCTURAL REFORMS

ACCELERATING GROWTH, ACCOMPANIED BY FISCAL PROBLEMS.

The stagnation of the Polish economy has finally ended. After 1% of real GDP growth in 2001, followed by 1.4% in 2002, in 2003 real GDP grew by 3.5%. In the last two quarters of 2003 GDP grew by 4% (Q3) and 4.1% (Q4). This acceleration was the result of good export performance and growing investment demand. In 2004 real GDP growth is expected to reach 4.3%.

Growing exports and at the same time the stagnation of imports (due to weak output growth) contributed to the decrease of the current account deficit. In 2002 the current account deficit was 3.6% of GDP, the 2003 value is 2.9% of GDP, lower then earlier expected. In 2004 the current account deficit is expected to increase to 3.1% of GDP.

	2002	**2003**	**2004***
GDP (%)	*1.4*	*3.5*	*4.3*
Current account deficit as % of GDP	*3.6*	*2.9*	*3.1*
Budget deficit as % of GDP	*5.7*	*4.6*	*6.3*
CPI	*1.9*	*0.8*	*2.8*
Unemployment rate	*18.1*	*17.8*	*17.3*

At the same time the acceleration of GDP growth in 2003 could have been more rapid. Fiscal policy, the delays in structural reforms, and increasing political risk stood in the way of an even better performing economy. The budget deficit in 2003 amounted to 4.6% of GDP. The government's 2004 budget is further ground for concern on markets. The budget deficit is expected to reach 6.3% in 2004. As a result of this it will be unavoidable to break the constitutional limit on government debt (it cannot exceed 60% of GDP) in coming years. However when Poland adopts the European methodology in measuring public debt, it's current level of public debt will decrease significantly. This way the issue of exceeding the constitutional limit will be solved, and markets can calm down.

At the same time a more serious problem will remain: structural issues of Polish public finances have to be addressed. The current state and structure of public finances poses risk for the Polish economy to meet the EMU criteria. Although it is clear which structural problems have to be solved, it is unlikely that the current government will step on the way of serious reforms. Only the most pressing structural problems are addressed in the government's strategy, starting with the reforms of social transfers. The reforms of the public administration, the health service, education, taxation, and state-owned enterprises are still being put aside.

Political uncertainty also stood in the way of even more dynamic growth in 2003. On the 14th of November 2003 there was a vote of confidence in the Sejm on Poland's Deputy Prime Minister, and Minister of the Economy, Jerzy Hausner. He survived the vote. According to opinion polls the Democratic Left Alliance (SLD) party of Prime Minister Leszek Miller had the support of only 19% to 25% of the voters in 2003 October, down from 41% during the parliamentary elections in September 2001. The next elections are due to take place in the autumn of 2005, but there is uncertainty about the current government being able to hold on to power until that time.

SITUATION ON THE ZLOTY MARKET

In January the EUR/PLN rate reached an all time high, 4.7737. The USD/PLN rate increased to 3.7975. These exchange rate movements meant that the zloty's deviation from its former parity reached 0.8% on the weak side. (This reflects the strength of the Polish currency in relation to a basket of currencies: Euro 55%, dollar 45%.)

Both external and internal factors contributed to the weakening of the Zloty. The most important external factor was the financial turmoil Hungary was experiencing in December, with the tense situation still present in January. The diminishing hope of markets, that the new Monetary Policy Council of the National Bank of Poland would implement rapid cuts in interest rates was one of the internal factors contributing to the weakening of the Polish currency. At the same time Minister for the Economy, Jerzy Hausner was not successful in reaching an agreement with trade unions. Therefore in 2004 pensions and allowances will be computed according to the old rules. This outcome made it clear Hausner will face even more difficulty in implementing his planned spending cuts, which are an important first step in order to put the public finances of Poland right.

OUTLOOK

Poland is now on the path of moderate GDP growth, which is expected to reach 4.3% in 2004. In the medium term it is assumed to stabilize at 4-4.5%. This forecast is however below the 5% level that the government assumed when making its 2004 budget plans, and the government's medium-term 5-6% GDP growth expectation. This ambitious GDP forecast could put pressure on the 2004 budget.

With the moderate GDP growth disequilibria will stay under control, but it will not lead to a considerable fall in unemployment (17.8% in 2003). CPI continues to be low, but it is expected to rise compared to its 0.8% rate in 2003 to 2.8% in 2004. (In 2003 CPI was rising mainly as a result of rising prices of dwellings and transport.) The main driving force behind the rise in 2004 will not be market pressure, but changes in taxation and the law.

	Jan-Dec 2003
Specification	Jan-Dec 2002=100
Total	**100.8**
of which:	
Food, non-alcoholic and alcoholic beverages, tobacco	98.8
Clothing and footwear	97.5
Dwelling	102.8
Transport	104.5

The current account deficit is expected to increase (to 3.1% of GDP in 2004), but it will stay at a safe level. The increase of the current account deficit will be the result of higher investment demand bringing higher imports of capital goods, and will pose no risk, as the current account deficit declined to very low levels (2.7% of GDP in 2003) during the economic slowdown.

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II. CHANGE AT THE HEAD OF THE MINISTRY OF FINANCE, DOES THAT MEAN NEW STRATEGY?

The allegations concerning the change at the head of the Ministry of Finance finally came true in January 2004. Mr. Tibor Draskovics, formerly being a chief political aide had been named as Mr. László's successor. As a headline move Mr. Draskovics had changed the 2004 budget deficit target to 4.6% of the GDP from the earlier 3.8%. The announcement was coupled with plans for additional spending cuts for this year, worth of 150 Bln Forint. Mr Draskovics has also been asked to review the possibility of the 2008 Euro zone accession. The market reaction has proved to be cautiously positive so far, however it is obvious that market players are willing to get concrete steps concerning the fiscal policy and would like to see clear guidelines regarding the timing of the Euro zone entry.

Following the outcome of the disappointing 5.6% public sector deficit figure for 2003 even the Prime Minister seemed to be surprised. The amount of the shortfall exceeded the latest forecast, made by the Ministry of Finance in December, by 80 bln Forint, about 0.4% of the Hungarian GDP. Missing the target was especially awkward because the estimates of the Ministry had been changed many times during the last year, and the aim of the latest 5.2% forecast, released by the Ministry on the 16th of December was to regain credibility with a more realistic figure. Missing the target was rather due to miscalculations of the revenue side according to the Ministry of Finance, however this can not be an excuse because several analysts drew the attention earlier to the lower than expected growth rate of the economic.

The external balance, and its financing are probably the biggest problems, Hungary is facing nowadays. The adjustment can not be expected from the private sector, it has to fall inevitably on the public sector. The incoming Finance Minister pledges to tighten policy, but the question is whether he will be able to deliver. The accomplishment of the fiscal cut, worth of 150 bln Forint is going to be a crucial regarding the future market sentiment. On one hand the expenditure cut will test the political support of the incumbent Finance Minister. His predecessor Mr. László was lacking the support of the socialist party group, and this could have accounted for his indeterminate policy. Mr. Draskovics however as a former chief political aide has better relationship with the party, (the minister is willing to meet and negotiate regularly with the socialist group) and his reputation of being determined and strict could also help him to meet his goals. Mr. Draskovics underlined that he was not aiming for popularity, but trying to overcome the problems instead. The upcoming EU parliamentary elections could hinder his efforts.

On the other hand the fiscal tightening will be a key test in rebuilding credibility. This is going to be a difficult task, because one has to bear in mind that budgetary

forecasts in the past few years were met usually with upwardly revised estimates, instead of corrective measures, so the track record of the ministry is rather poor in this respect. Foreign analysts also mentioned that the 2004 4.6% budget target following the 5.6% shortfall in 2003 seemed to be arbitrary, and resembles the earlier strategy, where the 4.8% target for 2003 had been followed by a 1pp lower, 3.8% forecast for 2004. Taking into account the significant overshoot in 2003, the revised 4.6% target seems to be much more realistic, it is for these reasons the market did not get shocked by the change.

Meeting the 4.6% target requires strong efforts as the minister designate remarked, especially because the figures of the initial 2004 budget plan, calculating with a 12% rise of the revenues, while expecting just a 5% increase of the expenditures seem to be unrealistic. The concrete measures of Mr. Draskovics's fiscal package are still unknown. The plan is supposed to call for cuts to funds distributed to government funded institutions and reductions in operational costs of ministries. The later will have the choice how to conduct the cuts. Mr Draskovics emphasised that the fiscal tightening will not influence the social benefits, investment funding and EU funds.

Apart from the serious credibility loss, the rethinking of the Euro zone accession strategy could have been the other reason for the change at the head of the ministry. The year 2008 target will be under review until the end of March, and this indicates the shifting of the accession date. Nevertheless Mr Draskovics committed himself to join the single currency as soon as possible with a competitive Hungarian economy. A formal adoption of a possible later target would not neccessary trigger turmoil on the markets, because the market consensus is already 2009-2010. Probably announcing a later target without any austerity package could have been more damaging. By the end of March the concrete measures of the fiscal tightening will take place, and that could provide some credibility for a new strategy. The Ministry of Finance should avoid giving an exact date for the Euro zone entry, because that could lead to a similar situation, we had just experienced. A two years interval could be a better solution because it reflects the commitment, but provides more flexibility at the same time. Even the best performing countries regarding the Maastricht criteria did not hurry to reveal their concrete intentions. (One has to admit at the same time that unfortunately in Hungary because of the recent credibility loss, a two years interval might indicate the later date.)

Regarding the near-term monetary issues, Mr Draskovics mentioned that joining the ERM II was desirable shortly after the EU accession. The incoming Finance Minister did not comment the earlier 250-260 target. (Even the monetary policy makers seem to concentrate on the their medium term target instead of the short term goals since the November-December turmoil.) Regarding the ERM II exchange rate mechanism, most of the working papers suggest that the member country should spend the possible shortest time, only the necessary two years in the mechanism. An early ERM II accession and a later than 2008 Euro zone entry could expose the country for

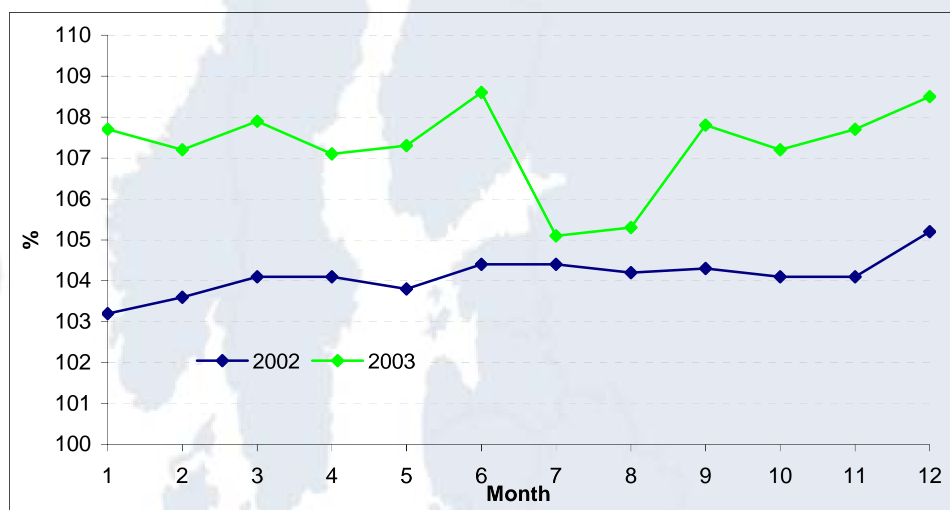
speculative attacks instead of the desired stability. Even though the measuring of the exchange rate stability criteria runs only for two years, high volatility in the first few years could deteriorate the credibility of the system. The framework of the ERM II are still not clear. The allowed fluctuation of the currency has not been clearly determined, the possibility of a narrower, 2.25% band, proposed by Mr. Solbes had been raised instead of the official +-15%. The intervention of the ECB is not automatic either, which damages the credibility of the system. The ERM II allows the revaluation of the central parity, which could be dangerous if the Central Bank wants to use the strong Forint policy for the disinflation. The resistance against a possible speculative attack on the strong end of the band is likely to be less powerful. Revaluations could lead to an exchange rate, which is not coherent with the economic fundamentals, and using that rate as the final conversion rate would be the worst for the economy.

The extremely high key interest rate makes the situation even more difficult. The significant spread would lead to a sharp appreciation of the Forint as soon as the exchange rate is locked in by the ERM II. A sudden firming of the Forint could force the NBH to cut rates in spite of the weak balance of payment outlook. Entering the ERM II with a bad policy mix makes the system crises prone. Some foreign analysts claim that allowing the interest rates to drop, while strengthening the fiscal commitment are the prerequisites of the credible and sustainable ERM II. After telling about the dangers of an early ERM II accession it has to mentioned as well that delaying the accession should not mean the postponement of the fiscal adjustment, because that would be destabilizing for the financial markets, and we already experienced it last year.

The two major announcements of the incoming Finance Minister regarding the budget plan and timing of the Euro zone accession has had positive impact on the market so far. The outcoming 5.7% end 2003 CPI figure, which was in line with expectations, and the far better than expected November C/A deficit both improved the market sentiment. The disappointing January budget preview temporarily shocked the market, but later on Forint firmed again and stabilized around 262. Yields dropped along the curve mostly on the 1-3Y segment, which is dominated by foreign investors.

III. Foreign trade in Ukraine in 2003

2003 was an attractive year of Ukrainian economy. In the previous year the real GDP of the country increased by 8,5% year on year (yoy) compared to 5,2% yoy rise over the same period in 2002. Manufacturing, construction, trade and transport caused this fast growth in value added. The industrial production reached double figured expansion (more than 16%), backed by high internal and external demand. Contemporaneously agriculture cut a poor figure (approximately -15% in production) during the whole last year in connection with poor grain harvest, which slowed down overall GDP growth.



Source: Derzskomstat – The State Statistics Committee of Ukraine

The economic growth of last years have an observable connection with movement of Ukrainian foreign trade performance.

External Sector

The main topic of this short analysis is the Ukrainian foreign trade events and the improvement of external economic sector. We can observe only the first eleven months of 2003 in consequence of barriers of statistical data gathering.

The export during the first eleven months of 2003 amounted to 20679,4 million USD, the import 20344,3 million USD. These nominal figures show us an export growth by 27,9% and an import growth by 33,6% in comparison with figures observed in the first eleven months of 2002. Due to these facts the merchandise trade balance from January till November in 2003 amounted to 335,1 million USD in comparison with the 940,7 million USD balance of the previous year.

The main export destinations were Germany, Italy, China, Turkey, Hungary, Poland and the USA with their 30% contribution and Russia, as the main trade partner of Ukraine with 18%. From the other side the main import origins were Germany,

Turkey, Poland, Italy, the UK, China and France with 30,5% relative weight and naturally Russian Federation with 38,1%.

The following table shows us the structure of export and import classified by main regions of the world.

	EXPORT			IMPORT			
	Export 2003 jan-nov (Thousand	2003 jan-nov/2002 jan-	Distribution of exports (%)	Import 2003 jan-nov (Thousand	2003 jan-nov/2002	Distribution of imports (%)	Balance
CIS	5385910,15	136,13	26,04%	10311033,6	127,43	50,68%	-4925123,45
Europe	8180500,93	139,77	39,56%	7064982,99	137,97	34,73%	1115517,94
Asia	4869503,01	106,37	23,55%	1735947,4	-	8,53%	3133555,61
Africa	1120386,09	120,81	5,42%	222556,51	139,55	1,09%	897829,58
America	1118773,04	132,01	5,41%	961094,56	125,19	4,72%	157678,48
Australia-	4282,87	107,74	0,02%	48260,54	98,19	0,24%	-43977,67
WORLD	**20679356,09**	**127,92**	**100,00%**	**20344254,16**	**133,62**	**100,00%**	**335101,93**

Source: Derzskomstat – The State Statistics Committee of Ukraine

As for the product structure of exports and imports, we can observe, that metallurgy still remained the main contributor to all exports with 36,7%, but from the side of import metallurgy plays a less important role. The main contributor to import side is the group of mineral products with 38% (crude oil, gas, energy etc., mainly from Russia) and these products have considerable influence on export development, due to its 15,28% portion. We must mention the products of chemical industry, which are responsible for 7-9% of whole foreign trade.

Practically the metallurgy and the chemical industry with their remarkable surplus in export-import relationship cause overall surplus, because of large net importer position in other groups of products.

These tradable products came mainly from following regions: Kiev, Donetsk, Dnepropetrovsk, Zaporozets, Odessa.

Export and Import by main product classes

	EXPORT			IMPORT			Balance
	Export 2003 jan-nov (Thousand USD)	2003 jan-nov /2002 jan-nov (%)	Contribution to whole export (%)	Import 2003 jan-nov (Thousand USD)	2003 jan-nov /2002 jan-nov (%)	Contribution to whole import (%)	
Mineral products	3159645,11	-	15,28	7695523,13	121,29	37,83	-4535878,02
Chemical products	1743488,12	138,42	8,43	1548091,17	126,14	7,61	195396,95
Products of metallurgy	7582675,94	117,08	36,67	1063726,18	144,39	5,23	6518949,76
Products of mashine indurtry	2121903,91	136,03	10,26	3052288,91	135,44	15,00	-930385
Vehicles of transportation	855486,29	141,12	4,13	1608599,69	-	7,91	-753113,4
Other	5216156,72	-	25,23	5376025,08	-	26,42	-159868,36
ALL	20679356,09	127,92	100,00	20344254,16	133,62	100,00	335101,93

Source: Derzskomstat – The State Statistics Committee of Ukraine

POLITICAL AND OTHER EVENTS MIGHT INFLUENCE UKRAINIAN EXPORT SECTOR

WTO MEMBERSHIP. As Ukraine wants to be the member of WTO, this country has signed several bilateral protocols required to negotiations with more than 20 countries. But with some countries, among others with the USA, the negotiations are moving slowly, mainly because of special regards of USA in taxation, intellectual property rights, sanitary measures and technical barriers.

PRIVATIZATION. In 2003 Ukraine managed to realize the annual revenue target of 2,15 billion UAH noted in budget. The State Property Fund privatized several enterprises. For example UMC, which is a mobile operator company and the Nikopol Ferroalloys plant. The new 2004 target is also 2,14 billion UAH and if the political and economical situation remains favorable, the state owned sector will be smaller till the end of 2004. This backs the formulation of operating competitive market economy.

FDI ABROAD. A Ukrainian corporation, the Industrial Union of Donbas together with the multinational company Duferco succeeded in acquiring 80% of state owned Hungarian Dunaferr, having offered near 400 million EUR of investment obligations. This is the largest Ukrainian foreign direct investment abroad since independence. Due to Current Account surpluses and to accumulated capital in Ukraine, the companies will try to expand and arrange further acquisitions abroad, financing CA deficits of other countries as a net foreign investor.

FDI INFLOW. The inflow of foreign direct investments from January to September reached the amount of 935 million USD and reached the 6,9 billion of FDI since independence. This is equal with 144 USD per capita index.

PRICE COMPETITIVENESS MEASURED BY REAL EXCHANGE RATES (RER_{USD} AND RER_{EUR}). As the nominal exchange rate of Ukrainian national currency, the hryvnia remained stable against USD, as a fixed exchange rate by NBU (National Bank of Ukraine) and depreciated against EUR. (caused mainly by EUR/USD nominal exchange rate development) As the Ukrainian inflation was 8,2% in 2003, which is 3-4 times higher than in Europe and the USA, the real exchange rate as an index of competitiveness decreased. This means, that the overall price competitiveness (CPI) of Ukraine deteriorated. This can be said in connection with real exchange rate counted by PPI too, as PPI inflation reached 11% in 2003.

Due to these facts and accelerated process of transition and reforms Ukraine will be able to establish and improve his position on the region, due to accumulating assets (CA surplus has reached the amount of 2,49 billion USD in the first 9 month in 2003, which is more than 10% of GDP). These developments are observed in barely starting world economic growth.