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SIGNIFICANT BUDGET OVERSHOOT, AN OTHER SERIOUS CREDIBILITY LOSS

Hungarian Finance Ministry revised upwards its fiscal deficit target for 2005 for the second time this year. The full year deficit forecast had been changed to 5.0-5.3% of the GDP from the 4.6% projected earlier and 3.8% planned initially. The 5.0-5.3 forecast is the ESA deficit, which is counted under EU methodology, and it means a 6.2-6.5% shortfall if it is converted into the GFS methodology. The extent of the upward revision was broadly in line with the market consensus, however some analysts did not expect the revised deficit to exceed the 5% psychological level significantly. The overshoot was largely in line with NBH's 5.4% forecast, which already came out in the Central Bank's latest Inflation Report. The market reaction was moderate, some of the analysts expected the forint to weaken significantly following the disappointing figures, but it seemed the market already priced in the overshoot and the high carry managed to prevent EUR/HUF from falling.

The ministry enumerated several reasons for the overshoot, which amounts to 160 bn. Forint, 0.8% of the GDP. Roughly 90 bn.. Forint of the overshoot can be attributed to the lower than expected revenues especially the VAT income shortage. One of the main was the introduction of a new system for VAT collection. The unexpected cross-border shopping which resulted in the erosion of the VAT tax base also led to the lower than expected VAT income. The ministry also pointed out to the strange experience of Spain and Portugal, those countries simply lost VAT revenues worth of 0.1-0.2% of the GDP unexpectedly following their EU accession. The rest of the overshoot, 70 bn. Forint (0.35% of the GDP) was due to higher than expected housing and pharmaceutical subsidies. According to the ministry the high interest rate level put an extra 140 bn. debt servicing cost on the budget.

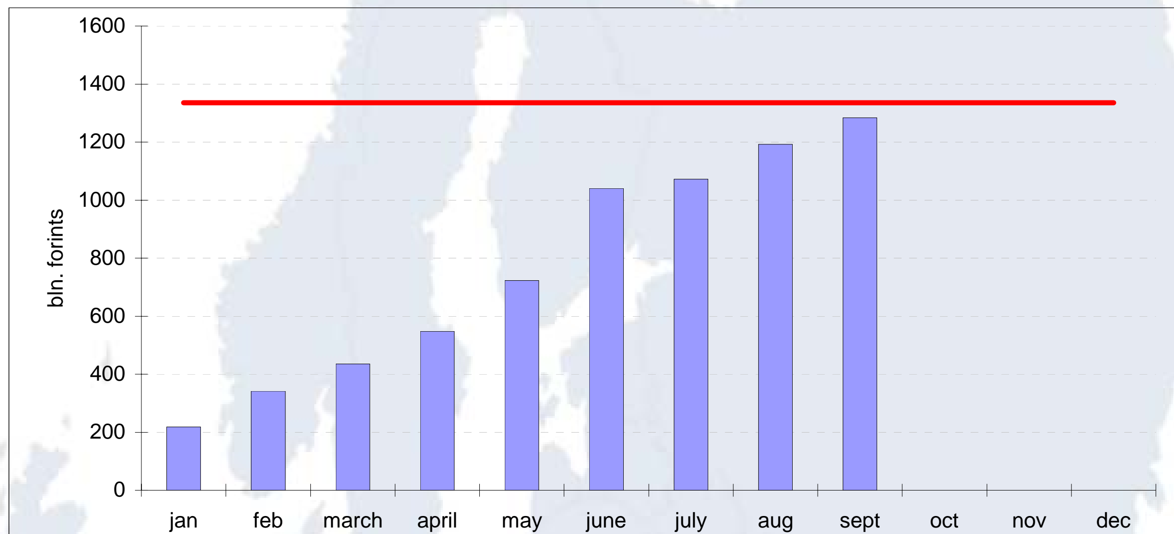
Finance Minister Mr. Draskovics, whose place in the new government had been confirmed by the Minster President during the press conference introduced a „mini" austerity package worth of 43 bn. HUF (0.2% of the GDP). 25 bn. Forint of the savings is expected from one off measures like the sale of state property and higher dividend payments from state owned companies. The rest of the money is supposed to be generated from stricter controls on the ministry's budgets. Mr. Draskovics also announced the change of the corporate income tax rates of the financial institutions. The rate would have been raised to 24% from the original 16%, and the goal was to generate an extra 30 bn. Forint for the budget. Since then, following some negotiations with some bank officials the initiation had been cancelled. The corporate income tax rate will remain the same, but the banks will still be obliged to provide 30 bn. Forint for the budget in the following two years.

Some concerns regarding the "compensation package" emerged right after the announcements. It is doubtful whether the measures introduced at the ministry level

will generate enough savings in the short run. It is also not sure that the sale of state property will result in extra revenues for the budget, because those proceeds are usually below the line financing items.

The September cash flow budget deficit proved to be higher than the Finance Ministry's forecast. The January-September aggregate shortfall has amounted to 1248 bn. Forint, which was more than 96% of the revised 2004 target.

General Government deficit (GFS)



Originally the government estimated a surplus for the Q4 period, but the revised target counts with an 51 bn. Forint deficit in Q4. The government calculates with a surplus in December, just like last year when it was 77 bn. Forint. The small deficit in Q4 can be attributed to the frontloaded interest payments, and the thirteenth month wage will also be paid only in January 2005. Revenues tend to increase towards the end of the year as well. Approximately 40% of the corporate tax revenues are expected to flow in December, and income tax revenues also rise by the end of the year. Despite these favorable trends even the upper 5.3% limit of the revised 2004 deficit target can be endangered.

Government has just submitted the 2005 budget to the parliament. Next year's deficit target will be 4.7% of the GDP (on ESA-95 basis) instead of the 4.1%, that had been set in the convergence program. A reserve of 100 bn. Forint will be separated in case of an overshoot. Defense expenditure is expected to be cut, central budget institutes will receive 5% less subsidy next year, the housing subsidy has been cut back to 214 bn. Forint next year, and the highway program is expected to be financed by private investors through concession contracts. The budget calculations were based on a 4% GDP growth, 4,5% average inflation, 3-4% real wage growth, 6-7% increase of VAT revenues, 6% increase of the personal income tax revenues, and significantly lower base rate for next year. According to the Finance Minister Mr. Draskovics, Central Bank Governor Mr. Járai saw the assumptions, underlying the budget realistic, with

the main risks coming from the shortfall in VAT revenues and higher debt servicing costs. According to Finance Ministry officials the ministry expects the base rate to be cut by 50 bp this year, which could be followed by another 150bp by February 2005. Further risks arise due to the change of the personal income tax rates, namely the abolition of the middle 26% rate, which is expected to lead to 100 bn. Forint less revenue next year. 2006 will be a general election year in Hungary, so political pressure can also amount on the 2005 budget.

The main problem with the Hungarian fiscal developments is that while other countries in the region benefited from the upturn of the Western European economies and managed to meet their deficit targets due to the higher growth rates, Hungary simply missed the opportunity and suffered serious credibility losses. Meeting next year deficit target will be crucial concerning our 2010 euro-zone accession date.

Gen. Gov. balance/GDP	2004	2005*
Hungary	5.4%	4.7%
Czech Republic	5.3%	4.9%
Poland	5.3%	4.2%
Slovakia	3.8%	3.4%

**targets of the convergence programmes*

Slovenia Joined the ERM II

On 28 June 2004 Slovenia together with Lithuania and Estonia joined the European exchange rate mechanism (ERM II). As a result of negotiations with the EU institutions the central parity of the Tolar against the Euro was set at 239.64. The entry took place according to plans and was interpreted by the Government as an evidence of Slovenia's readiness for the EU membership and the common monetary policy. Two years participation at least in ERM II in order to prove exchange rate stability is one of the requirements for adopting the common currency. However, Slovenia as well as other countries facing the adoption of the Euro would like to avoid exceeding the obligatory two years. The introduction of the Euro is therefore officially planned at the beginning of 2007. This entry is of great importance in two aspects. On the one hand it has substantial consequences to the conduction of monetary policy and indirectly to the fiscal policy as well. On the other hand it determines the nominal convergence path on condition that the Government will not participate in ERM II any longer than the compulsory period.

The monetary policy conducting by the National Bank of Slovenia (NBS) has substantially changed by the ERM II entry. The former applied managed floating exchange rate regime was substituted by a fixed central parity with a ±15 % fluctuation band. Whereas formerly the exchange rate policy was subordinated to disinflation and a relatively stable real exchange rate was maintained with a continuous depreciation practice, at present in line with the Maastricht criteria the main objective of monetary policy is to maintain a stable nominal exchange rate. As it is well known, the coexistence of a stable exchange rate and an open capital market can only be maintained without independent monetary policy. In this way the independence of monetary policy has been enormously reduced after the ERM II entry. The setting of interest rates determined by the ECB's policy is mainly restricted to maintain exchange rate stability. To create conditions for a smooth entry the NBS adjusted the interest rate level through several policy rate cuts and also gradually reduced the depreciation rate of the Tolar. Since January the refinancing rate has been lowered six times from 5 % to 3.5 %. In accordance with the principle of uncovered interest parity the domestic level of interest is to represent the risk premia over the euro zone's yield level. These substantial changes regarding the independence and the relevance of monetary policy put forward the fiscal policy and heighten its responsibility on disinflation and managing asymmetric shocks.

Fiscal position

	General government balance (ESA 95)	Government Debt
2000	-3,11	24
2001	-2,69	25,9
2002	-2,39	26,9
2003	-1,83	28,6

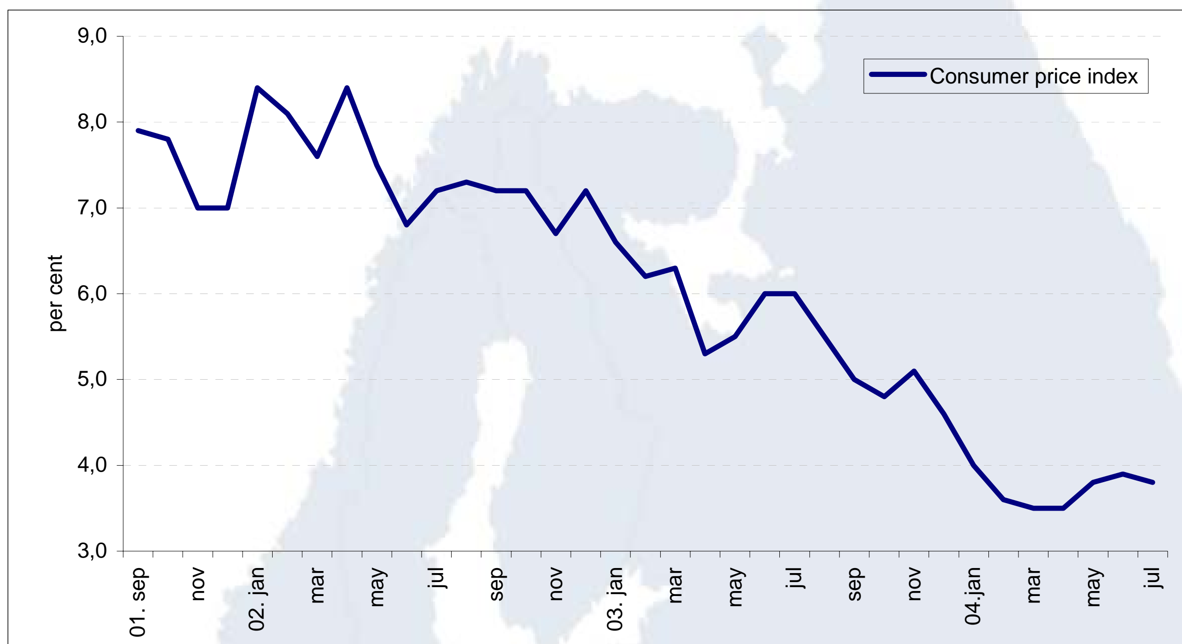
As far as the Maastrich criteria are concerned, Slovenia has a leading position in the region. Three out of the four conditions have already been fulfilled. The criterion on budget deficit has already been met, however, in recent years Slovenia's general government deficit has been very close to the 3 per cent threshold. Nevertheless, last year significant improvement was recorded in the fiscal position. According to ESA95 methodology the general government deficit dropped by 0.56 percentage points to 1.83 per cent of GDP in 2003 and is projected by the Government to diminish further in medium term. The government debt is currently amounting to 28-29 per cent of GDP which is far below the 60 per cent threshold. The long term interest rate in Slovenia was roughly 50 basis points higher than the lowest comparable one in the euro zone (yields of government bonds in Germany or Finland).

Long term interest rates

	May 03	May 04
Belgium	3.95	4.40
Denmark	4.09	4.46
Germany	3.82	4.25
Greece	4.02	4.49
Spain	3.88	4.33
France	3.89	4.34
Ireland	3.89	4.31
Italy	4.04	4.49
Luxembourg	3.55	3.05
Netherlands	3.91	4.37
Austria	3.85	4.36
Portugal	3.91	4.42
Finland	3.91	4.25
Sweden	4.37	4.68
United Kingdom	4.31	5.15
Slovenia	**6.65**	**4.77**

The inflation rate is the only criterion that has not yet been fulfilled. In July 2004 the year-on-year inflation was 3.8 per cent which has been the first decrease since April. According to the joint program of the NBS and the Government the inflation will decline below 3 per cent by 2005.

Inflation



In the run-up to the adoption of the Euro the authorities have to face several risks concerning the maintenance of exchange rate stability and attaining price stability. Under the circumstances the fiscal and income policies have greater responsibility on disinflation. Undoubtedly the speculative capital inflows impose the biggest challenge for the NBS. Even in case of consistent macroeconomic policies speculators may appear and cause excess exchange rate volatility in the hope of capital gains. The asymmetric nature of ERM II, i.e. the correction of the central parity is acceptable upward only without extended participation, may easily urge speculators to run an attack. However, the cooperation with the ECB provides greater resistance for the NBS against speculation.

In the field of the planned disinflation path three factors seem to be challenging. First, the difference of price growth between the tradable and the non-tradable sectors (Balassa-Samuelson effect). The BS effect according to the NBS's estimation deteriorates the inflation by 1-1.5 percentage points. Accordingly, there can be no additional inflationary pressure in the economy to meet the Maastricht criterion concerning the inflation.

In this respect administered price policy and wage settings in the public sector are of even greater importance as the second factor. Although only 24 per cent of prices are either directly controlled by the state or determined by tax- and/or administrative measures, which is the lowest proportion among the acceding countries, price setting in this sector if not in line with price developments in the competitive sector may result in higher inflation. To avoid such developments the Government adopted a program according to which administered price growth will not exceed the inflation target. In addition wage indexation method in the public sector was radically

changed last year. The new concept is characterized more as forward looking rather than adaptive. It takes into account the expected inflation in Slovenia as well as in the euro zone and the change in the exchange rate of the Tolar. Hence wage increases are expected to reach 3.1 per cent in 2004 and 3 per cent in 2005. This agreement is supposed to contribute substantially to disinflation.

Finally, additional inflationary pressures from the demand side could not be handled by the monetary policy. Higher budget deficit and/or consumption related borrowing boom caused by low interest rates would lead to increased domestic demand and at last higher inflation. Hence, restrictive fiscal policy needs to be adopted in order to control any potential of a demand side inflationary pressure.

Prepared by Szabolcs Patkó

PRIVATIZATION OF FINANCIAL SECTOR IN POLAND

THE POLISH BANKING SECTOR

The dynamics of privatization in the banking sector has been developing with a considerable time lag relatively to other economies, which recently joined the European Union, as well as in comparison with most of other sectors of the Polish economy. Despite that, the ownership transformation process as the current moment is in its final stage.

The name of the bank and year of its privatization in the Polish banking sector

Bank	Privatization date
BRE Bank S.A.	1992
Weilkopolski Bank Kredytowy S.A. (Bank Zachodni WBK S.A.)	1992
ING Bank Slaski S.A.	1993
Bank Gdanski S.A. (BIG Bank Gdanski S.A.)	1995
Bank Handlowy w Warszawie S.A. (member of Citigroup)	1997
Powszechny Bank Kredytowy S.A. (BPH PBK S.A.)	1997
Polski Bank Rozwoju S.A.	1991
Bank Pekao S.A.	1998
Bank Przemyslowo-Handlowy S.A. (BPH PBK S.A.)	1994
Bank Zachodni S.A. (Bank Zachodni WBK S.A.)	1999

As the Table above shows so far, privatization process have comprised 10 banks. On September 30, 2003, Polish capital controlled, directly or indirectly, 14 banks, while foreign capital controled 45 banks. The state (through the Ministry of the Treasury) held 17.1% of the banking sector's equity (statutory funds), while foreign investors held 59.9% of the sector's equity.

THE PRIVATIZATION IN THE BANKING SECTOR

Out of 60 commercial banks currently operating in the banking sector (57 of them conduct operational activity), the Treasury directly controls 3 banks (Bank Gospodarstwa Krajowego, PKO BP SA, Bank Gospodarki Zywnosciowej SA) and indirectly controls 4 (Bank Rozwoju Budownictwa Mieszkaniowego SA, a housing development bank which does not conduct operational activity, Bank Inicjatyw Spoleczno-Ekonomicznych SA [supporting social-economic initiatives], Bank Pocztowy SA [postal bank], Bank Ochrony Srodowiska SA [natural environment protection]).

Out of 3 banks directly controlled by the Treasury, two are undergoing the process of privatization: Bank Gospodarki Zywnosciowej SA and Bank PKO BP SA. The sale of PKO BP, the largest Polish bank, was supposed to take place in 1990's, but it was postponed due to disagreement within governments. On March 30, 2004, the

Ministry of the Treasury signed an agreement with Credit Suisse First Boston Sp. and BGZ SA – Biuro Maklerskie as privatization advisers.

As a result, the Treasury raised 7.6 billion zloty by selling shares in the biggest domestic bank, PKO BP, on November 10. Notably, the sale appeared to be the nation's biggest initial public offering. The Treasury planned to gain as much as zł.7.9 billion from the sale of the 38.5% stake in PKO BP. However, discounts granted to individual investors were expected to bring down the total amount heading for state coffers to zł.7.7 billion.

Individual investors received excess to 168 million shares, or 16.8% of the bank's capital. Foreign investors purchase 85 million shares, or 8.5%. The bank's shares were set to enter Warsaw's broad-share WIG index on November 16, and later will be added into the WIG20, representing the WSE's 20 largest companies, after December 20. The privatization of PKO BP has been highly profitable for the Treasury as besides the offer which is now expected to raise zł.7.6 billion, the Treasury can enjoy receiving the 19% capital gains tax from both individual and corporate investors' income: the price per share exceeded the prior subscription price straight after the trading had started.

According to the Privatization Program until 2006, PKO BP SA will remain a universal bank, specializing in services for individuals, as well as fulfilling a leading role in providing services for small and medium size enterprises and housing loans. Bank Gospodarki Zywnosciowej SA will become a universal commercial bank, simultaneously retaining its role of the bank serving the agricultural sector and rural areas, focused on maximization of capital returns for its shareholders.

NATIONAL INVESTMENT FUNDS PROGRAM

In 1994, there were established 15 National Investment Funds with the aim to create a new ownership transformation mechanism, which would accelerate the pace and extend the scope of state assets' privatization.

The statutory objective of the National Investment Funds is asset restructuring of companies and their privatization. The 512 companies that joined the NIF Program immediately before their shares were contributed to the Funds accounted for approximately 8% of the production capacity of the Polish public sector.

Currently, the most important objective of the Treasury in regard of the NIF is to complete privatization of both the NIFs themselves and the companies that had been brought to their portfolios. Sale of Treasury shares (started in November 1998) in portfolio companies of the NIF Program will continue until 2006. Dynamic of transactions conducted by the Treasury (along with its revenues) will depend to a large extent on activities of NIFs, which carry out valuation of their portfolio

companies and select investors willing to purchase the shares in those companies from the leading Fund and the funds holding minority stakes.

The provisions of the NIF Act, as well as statutory provisions in the Funds' articles and contracts concluded by the Treasury, envisage ending of the Program by the end of 2004 / beginning of 2005. Steps taken in particular Funds to increase assets liquidity and buyback of own shares conducted since 2000 seem to ensure that the Funds' management boards aim at the completion of the Program within that period or want to transform them, in accordance with existing regulations, into other types of funds.

THE INSURANCE SECTOR

At present, 72 insurance companies operate on the market; the largest share of the insurance market in Poland, approximately 58% is controlled by PZU SA. The Ministry of the Treasury launched the privatization process of the largest Polish insurance company, PZU SA, in 1999.

The Polish government is trying to prepare PZU for sale by resolving a dispute with Dutch insurer Eureko BV. Poland owns 55% of PZU, which had net income of $460 million in the first nine months, while Eureko, based in Amsterdam, owns 30%, for which it paid $700 million in 1999. Eureko last year filed a complaint with an international arbitration panel in Brussels, saying Poland failed to sell it a further 21% of PZU as agreed when it purchased a stake in the company. The Polish government is now seeking to find amicable solution with Eureko.

CONCLUSIONS

Important reason explaining considerable lag in the privatization of financial sector relative to most of other sectors of the Polish economy was prevailing political resistance during 1990's toward foreign ownership in several strategic sectors, including financial services. Nevertheless, taking into account the decrease of state's shares in two large banks it controls and expected sale of 21% stock of PZU SA, the main stage of privatization process in the sector will come to its end.

As a result of boosted privatization activity, in large part thanks to the recent sell-off of a minority stake in bank PKO BP, the Treasury will raise approximately 10 billion zloty selling state assets this year, more than the 8.8 billion zloty targeted.

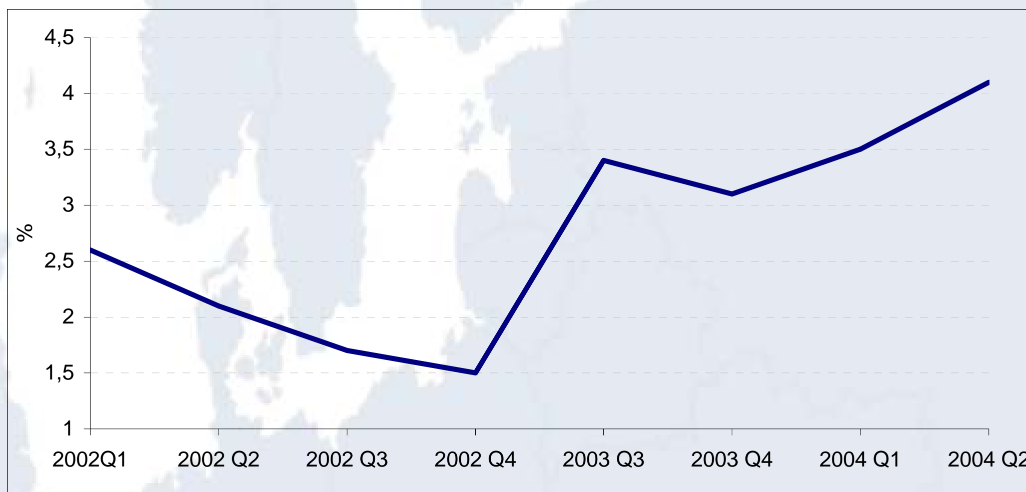
These additional receipts recently prompted Deputy Prime Minister Jerzy Hausner to suggest that the 2004 budget deficit could be zł.2 to zł.5 billion below the budgeted plan of zł.43.5 billion. Next year, revenue may also exceed the target if sales of shares in PZU SA, the nation's biggest insurer, and energy industry assets will be privatized.

Prepared by: Evgeny Plaksen

RISING GDP GROWTH, MONETARY TIGHTENING IS ON THE WAY IN THE CZECH REPUBLIC

The Czech economy is picking upstream, judging from the latest 2004 Q2 GDP figures. According to the Czech Statistical Office (CSO) the growth rate of the GDP in Q1 2004 amounted to 4.1% y-o-y, outpacing the 3.6% market consensus. The revision of the Q1 growth figure from 3.1% to 3.5% was also a pleasant surprise. The 4.1% growth rate was the highest rate for the past three and a half years, the last time the economy grew at such a fast rate was in 2000, before the global slowdown. The growth rate of the Czech Republic outpaced its regional peer Hungary, but still lagging behind Poland and Slovakia, where Q2 growth rates proved to be 6,1% and 5,4% respectively.

GDP growth

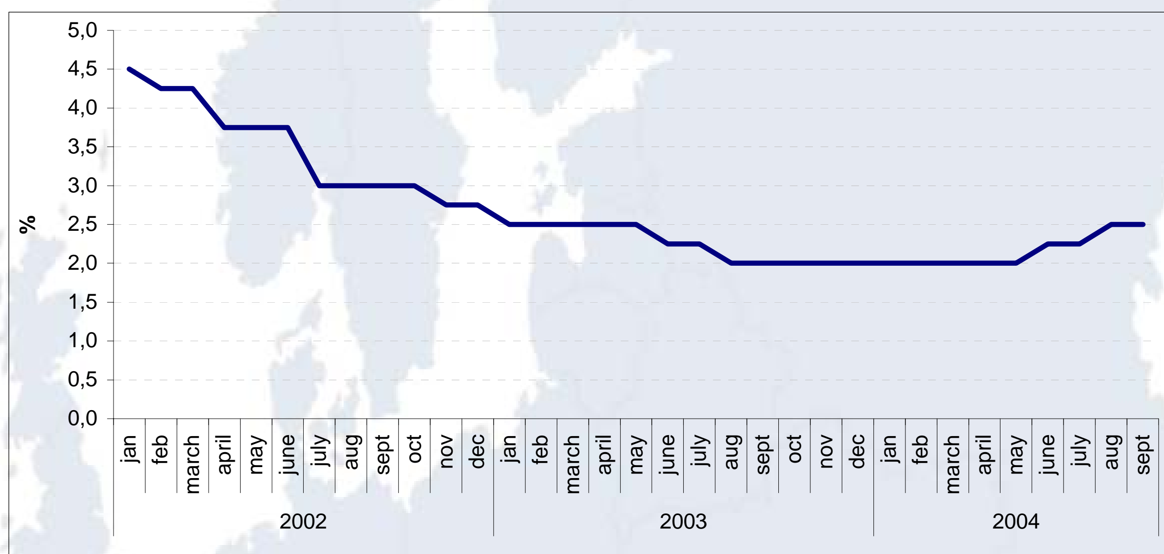


The structure of the growth proved to be really favorable, because investment, which rose by 12.8% became the driving engine of the expansion. Consumer demand remained subdued, and eased from 4% in Q1 to 3.4% in Q2. The low rate of final consumption is not pointing to any inflation pressure at the moment. The recovery of the global, and especially the Western European economy encouraged the Czech economy. Industrial output was up by 11% y-o-y in July (the latest published figure), the proved to be the higher than the 8.0% forecast. The growth rate is even higher if the adjusted data are taken into account. Data adjusted to the working days showed that industrial output rose by 18% in July. The overall industrial growth has been over 10% for five consecutive months. Mainly the improving foreign demand is driving the industrial sector. Export has surged up, the trade balance showed only a 4.9 bn. CZK deficit in July (for the whole year the trade deficit is supposed to amount to 60 bn. CZK, compared to last year's 69 bn.), but still the July current account posted a record high deficit. The 32.1 bn. shortfall in July was almost the double of the market consensus, and the main reason for this was the dividend payments to the

foreigners. An unexpected 21.1 bn. CZK in dividends paid out by domestic firms went to foreign countries in July, and these developments shed light to a big concern of the Czech balance of payments, i.e. the increasing repatriation of foreign investor's profits. Some more dividend payments can be expected in August, than the effect is likely to diminish. One more noticeable data from July BOP figures was the outflow of foreign direct investments, occurring for the first time since December 2003. The overall balance of foreign investments still remained in surplus, due to the reinvested profits, but the 3.5 bn. CZK surplus marked the lowest amount since December 2003.

The higher than expected growth figures support the trend of rising base rate, however it has to be taken into account that the relatively low rate of final consumption is not pointing to any inflation pressure.

Base rate



In its August Inflation report the Czech National Bank (CNB) already emphasized the accelerating economic activity accompanied with a rising inflation. CNB hiked rates late August for the second time this year. Central bank expects the CPI to rise to 3% or a bit above in 2005 H2, which is roughly the middle of its 2-4% target range. According to the latest release of the Czech Statistical Office (CSO) the August y-o-y CPI figure increased by 3.4% while the price level remained unchanged m-o-m. The data were completely in line with the market consensus, however the 3.4% figure proved to be the highest rate since 2002 March. The rise of the CPI could partly attributed to the base effect just like in the previous month. In August the y-o-y price growth acceleration mainly occurred in food and non-alcoholic beverages, and the change of the VAT rate in case of the public telecommunication services also boosted the inflation. CPI is expected to peak in October close to 4% due to the announced increase of gas prices. On the last Board Meeting of the CNB the Board warned that the higher fuel prices had not been fully reflected in the CPI yet, and they also pointed out that the fuel price growth could affect inflation expectations during the

wage negotiations. It has to be mentioned that the net adjusted inflation rate, which strips out food, fuel and tax distortions also reflect the rise of the inflation, that indicates that the CNB will remain in tightening mood. The august PPI index also reflected the accelerating price increase. The 8.1% y-o-y proved to be the highest since 1993. The main reason for the surge was the increasing trend of the metal and oil prices as the global economy expanded. The latest, better than expected Q2 GDP figure and the rising CPI and PPI make the rate hike imminent in the coming months. Mr. Pavel Racocha, member of the central bank board also commented the higher than expected PPI growth as another argument for further rate hikes. Market started to price in a 25 bp rate hike in the coming months and expected a 75bp rise until mid-2005.

Later on the expectations cooled down a bit since CNB Vice Governor Oldrich Dedek stated, that the muted demand price pressure in the economy should let the central bank to conduct the monetary tightening at a measured pace. According to the Vice Governor the 3.4% rise of the prices in August y-o-y was due to one off factors like external shocks and administrative changes. He said that just like in other CEE countries the EU related tax increases boosted the price index. Regarding the future interest rate tightening he stated that his view was less bullish than that of the markets. The market priced in a 50 bp hike by the end of the year and further hikes towards 4.0% in the following two years.

Later on another CNB Vice Governor Ludek Niedermayer made some more hawkish comments. He criticized the government for loosing its credibility because of the overshoot of the budget. Niedermayer also pointed to the danger of the wage increases approved by the government in next year's budget. According to him public wage increases could trigger higher wage demand in the economy and fuel inflation pressure.

Finally the Czech Central Bank left the 2.50% base rate unchanged on its September meeting. The move was in line with the expectations, however the dovish statement and some comments, that indicated that the bank would not hurry with the tightening must have prompted the investors to revise their former interest rate outlook. Central Bank Governor Zdenek Tuma said that the current level of interest rate was consistent with the economic developments and it might remains so for a longer period, he added. He said rates could remain on hold for "one two three, four months or longer", but he also admitted that the next move was going to be a hike. Mr. Tuma talked about the subdued price pressure, confirming Oldrich Dedek's earlier statements, but he also added that compared to the bank's July prognosis the conditions had changed slightly and got bit more pro-inflationary. He mentioned at the same time that the recent high PPI (8.1% in August and 7.3% in July) would not spill over to the headline inflation. Central Bank's move muted rate hike expectations, and beliefs about a 3% base rate by the year end are fading. Regarding the future interest rate path it has to be mentioned that President Klaus will select

four of the seven members of the CNB board in February next year. The President supposedly does not agree with the monetary tightening. Governor Tuma's term will also expire so the attitude of the newly composed board is uncertain at the moment.