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NEWS OF THE MONTH

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PRICE STABILITY IN THE CZECH REPUBLIC

Despite the fact that the year-on-year inflation rate went up to 2.6% in October from 2.2% in September, the inflation targeting for this period was fulfilled. Based on the state that the price stability exist in Czech Republic was proved by the before presented dates. And the current inflation rate approach to the new target of headline inflation of 3% in effect from January 2006 too.

THE MONETARY REGIME OF THE CZECH REPUBLIC

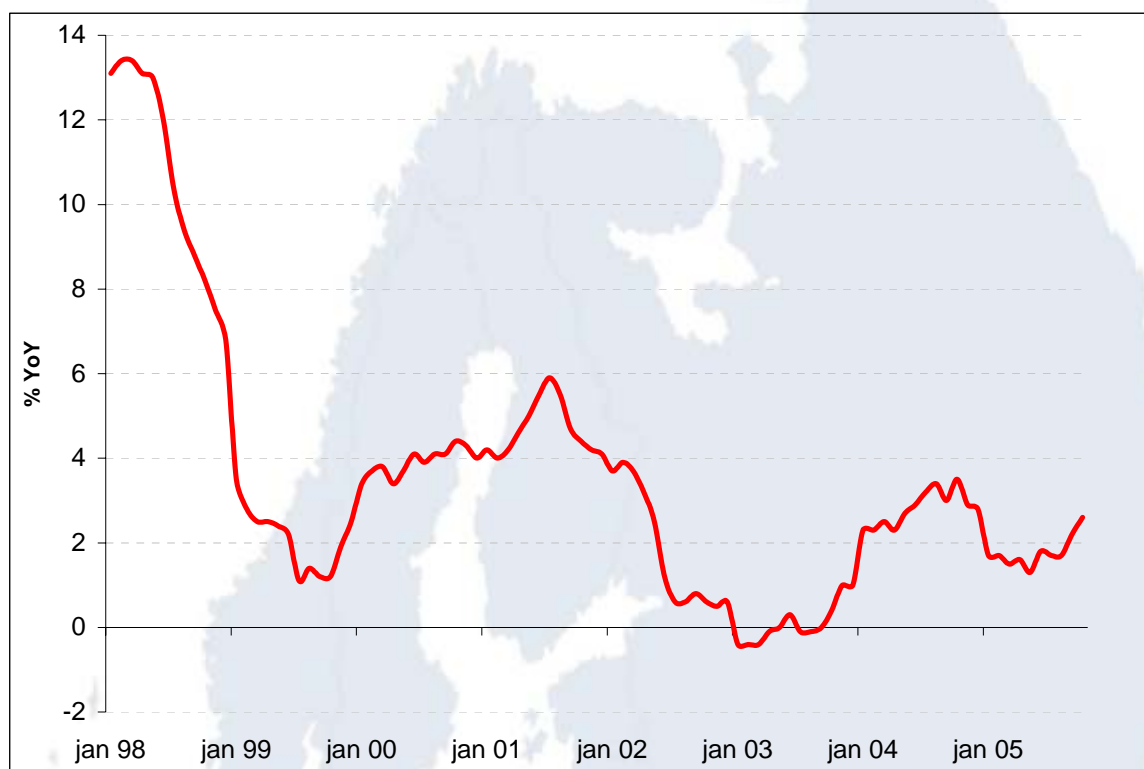
Like most of central banks in the world, the Czech National Bank (CNB) focuses on stability of Consumer Price Index (CPI). Nowadays this policy regime is known as inflation targeting. Of course in practice, price stability does not mean unchanging, but moderate growth in prices. So the first objective of the CNB is to maintain the price stability in the country, and to foster a stable environment for the development of entrepreneur activity. That reflects the central bank's responsibility for sustainable economic growth.

In the Czech Republic the target band for headlines consumer price inflation for December 2005 (the band was announced in April 2001) is between 2% and 4%. And the inflation target set in terms of headline inflation of 3% in effect from January 2006 until the Czech Republic's accession to the euro area. Moreover the CNB must ensure that the actual inflation rate does not differ from the target by more than one percentage point in either direction from this target.¹

DEVELOPMENT OF THE INFLATION RATE

According to figures the annual inflation rate reached 2.6% in October 2005 from 2.2% in September. Considering the month-on-month terms, the price level grown by 0.9% compared to September, which was the biggest increase since January 2004. The CNB's October forecast had expected this growth, but differed in its estimate of the structure of the rise. (The development of CPI is shown in the chart 1 for the period January, 1998 – October, 2005)

¹ Source: Czech National Bank, www.cnb.cz

Chart 1. Development of CPI 1998-2005

Source: Czech Statistical Office

The month-on month increase in consumer prices was influenced mainly by a rise in administered prices. This fact reflects the high world energy prices and within the consumer basket, is concentrated primarily in the area of housing costs. This increase in regulated prices, which was recorded particularly in “housing water, electricity, gas and other fuels”, comes out at almost 0.7 percentage points from the total increase of the CPI. The other significant factor was the increase in licence fees for television equipment and radio in “recreation and culture” category. The month-on-month drop in prices was observed only in “health” and “transport” sector, in which the prices of automotive fuel dropped by 2.0% in October after the marked rise in September (this decline in fuel prices had been fully expected by the forecast). In total the rise in prices of goods was 1.1% and services 0.4%.

Table I. Changes of the CPI in October 2005

	1999 constant weights	Previous month=100	Corresponding period of the previous year = 100			2000 average=100	Rate of inflation
			2005 Aug	2005 Sept	2005 Oct		
Total	1000.0	100.9	101.7	102.2	102.6	112.8	102.0
<i>Main factors:</i>							
Food and non-alcoholic beverages	197.6	100.6	99.2	99.7	100.3	102.9	99.9
Housing, water, energy, fuel	236.4	102.3	104.1	104.1	105.1	130.7	104.0
Health	14.4	99.2	107.6	107.6	107.4	125.8	107.0
Transport	101.4	99.5	102.2	106.8	105.6	106.6	101.1
Recreation and culture	95.5	101.0	100.9	101.1	102.6	109.8	101.7

*) Ratio of basic index averages (December 1999=100) for last 12 months and previous 12 months

Source: Czech Statistical Office

In October 2005 the CPI reached 2.6% year-on-year, which was the biggest rise from the beginning of this year. The acceleration in the growth of prices was caused significantly by a rise in prices of housing, in which prices of natural gas went up by 21.3%, and alike in the month-on-month figures prices of “recreation and culture”. The second biggest influence on the increase in the CPI was recorded for prices in “transport”. In total, the y-o-y CPI due to the goods went up by 1.9% and due to the services grew by 3.8%. An increase in the average CPI for last 12 months related to the average CPI for the previous 12 months stayed at the same level as in September (+2.0%).²

INFLATION EXPECTATIONS

According to the forecasts the annual CPI will be between 3% and 4.4% on September 2006, and between 2.3% and 3.7% on March 2007. We can see this trend from the development of the annual CPI in 2005. The expected rise in inflation in the remaining months of this year and at the start of next year should move annual CPI growth up, so the expectations are very positive in point of the fulfillment of the new inflation target in force January 2006. In the opinion of the analysts of the financial market, the latest data confirm that inflation still does not represent any problem for the Czech economy and is not currently threatened by demand-pull inflationary pressures. According to one of the comments, supposedly the impacts of oil and energy prices on prices of consumer goods will not emerge until January 2006.

In the future, the analysts argue that the main risk factors for the increase of the inflation are the same, as were in 2005. Oil prices and regulated prices are expected again to rise gradually. Beyond those elements we must mention another two inflationary factor, which are the more relaxed fiscal policy in the election year 2006 and the high wage claims of trade unions for next year. By contrast, the expected appreciation of the Czech Crown, which will diminish import prices and hereby the consumer prices, will remain the principal anti-inflationary factor.³

² Source: The Czech Statistical Office: Regulated prices pushed inflation up
<http://www.czso.cz/eng/csu.nsf/informace/aisc110805.doc>

³ Source: The Czech National Bank: Financial market inflation expectations 2005
http://www.cnb.cz/en/financial_markets/rules_related_info/inflation_expectations_ft/inflation_expectations_ft_2005/A_INFLOCEK_10_2005.pdf

HUNGARY – THE DILEMMA OF AGRICULTURAL AND RURAL DEVELOPMENT SUBSIDIES

The Hungarian Ministry of Agriculture and Rural Development decided to regroup EUR 107.2 million (HUF 26.8 billion) from the resources for subsidizing rural development to the national complement of the direct payments of the Common Agricultural Policy (CAP). The decision represents the dilemma faced by the new Member States originating from the reforms of the CAP of the EU.

THE ROOTS AND THE NEW VISION OF CAP

After The Second World War the main aim of the CAP was to modernize the European agriculture and restructure its old, uncompetitive structure. Afterwards, the fast technological development resulted in overproduction besides the original goal of modernization and restructuring.

The reforms (1992 and 2000) were forced out by three main factors. Firstly the EU could not defend its agricultural policy in the WTO negotiations. After seven rounds of negotiations the Uruguay Round (1986-1994) was a break-through for the supporter of trade liberalization. The Agreement on Agriculture signed at the end of the Uruguay Round in Marrakesh contained significant reductions of restricting regulations in the fields of market access, domestic support and export subsidies.

The second reason of the CAP reforms was the high proportion of CAP expenditure in the European budget. After two reforms it still amounts to 41% of the budget excluding rural development for the period of 2000-2006. It can be considered very high, especially being aware of the fact that the European average (EU-15) of the contribution of agriculture to the GDP was 1.6% and only 4% of the employed worked in the sector of agriculture in 2003 by data of Eurostat. These resources could support other important goals of the EU, which influence more citizens and more segments of the European economy like regional development and cohesion or the implementation of the Lisbon strategy.

Last but not least, unsatisfied consumers and citizens who had to pay the costs of the CAP in form of taxes and higher food prices faced the negative consequences of the intensive agricultural production, like animal diseases, chemicals in food and environmental pollution.

As an answer to these challenges a new model of agriculture was introduced that is based on family farms and the support of rural development. Family farms, which can be subsidized based on the multifunctional paradigm. This paradigm claims that farmers are not only food producers but also maintain the biodiversity, cultural heritage and a living countryside. Thus according to the Buckwell report CAP should focus more on rural development and the diversification of on-farm activities and less on market support. Till 2008 more than two thirds of the financial support should be spent on the second pillar of the CAP (rural development and environmental measures). It is hardly possible that the EU can fulfill this criterion as in the period of 2000-2006 only 10.2% of the CAP expenditure is for rural development. Although the EU could not achieve such an increase in rural development and environmental subsidies this new model of agricultural policy was the base of the subsidies provided to the new Member States before their accession in order to prepare these countries for receiving European funds.

MODERNIZATION OR RURAL DEVELOPMENT?

Hungary received pre-accession support from the EU under the program of SAPARD (Special Accession Program for Agriculture and Rural Development). The two priorities of SAPARD were handling the problems in the fields of agriculture and rural development and supporting the legal adaptation of the candidate countries. The implementation should have been decentralized according to the new vision of CAP.

It is questionable whether the farmers of Hungary are prepared for receiving rural development subsidies and become competitive in the European and world market. First of all, the farm structure of the EU and Hungary is very different. In the following table it can be seen that more than half of the European farms are smaller than 5 hectares but one third of the farms belong to the middle sized category.

Table 1. Farm structure of the EU and Hungary

Farm size class (ha)	Hungary (2003)		EU-15 (2000)	
	Holdings (×1000)	% of total	Holdings (×1000)	% of total
0-5	693.3	89.6	3903.3	57.6
5-10	33.5	4.3	834.3	12.3
10-20	21.6	2.8	691.3	10.2
20-50	14.2	1.8	738.4	10.9
≥ 50	10.7	1.4	603.4	8.9

Source: Eurostat

On the contrary, most of the Hungarian farms are very small. The average farm size of the EU-15 and Hungary represents the difference very well. In 2003 European farmers used 18.7 hectares on average compared to the 5.6 hectares of their Hungarian colleagues by the data of Eurostat. Thus the model based on family farms is not a viable concept under the recent conditions in Hungary. Farmers should be subsidized first for increasing size of farms and modernize the used technologies.

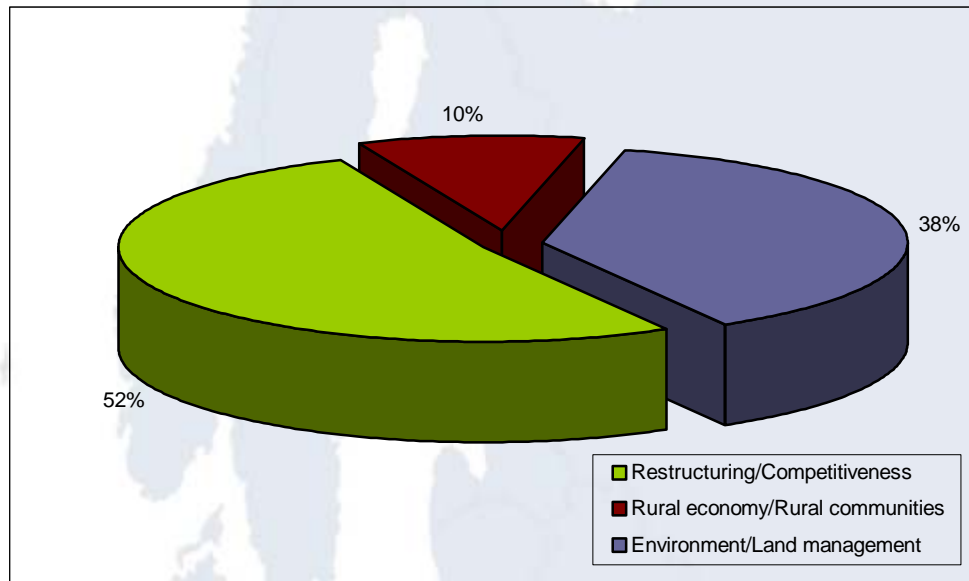
The situation of the farmers of the New Member States can be compared to the situation of European farmers after The Second World War. European farmers could develop technologies and change the structures of agriculture by support of CAP. Hungarian farmers would need these kinds of subsidies in spite of the fact that the overall system of CAP resulted in overproduction and negative environmental effects. These negative effects would be controlled well by setting a limit of these subsidies or attaching subsidies to fulfilling environmental requirements.

A COMPROMISE IS POSSIBLE

Beside the new Member States there are other countries having a low average farm size among the EU-15 countries like Spain, Portugal, Greece or Italy. These countries have to adapt to the new model of agricultural policy as well. These states have already received high-level agricultural payments, which could be used for modernization and restructuring, but they would need more for reaching the optimal structure for the new agricultural policy. Accordingly, these states face the same dilemma as the New Member States. They can be seen as an example for Hungary and the new members as the structure of their rural development expenditure shows how to cut the 'Gordian knot'.

The structure of rural development expenditure of the EU-15 for the period of 2000-2006 is shown in chart 1. Spending more on rural development does not mean that the resources for modernization and restructuring will cease. There are 12 measures such as investment in farms, vocational training, re-parceling, land improvement or development of agricultural infrastructure for these aims in this period. The spending pattern of old members having a low average farm size differs from the European average. These countries spend one and a half or even more than twice (Greece) as much on restructuring than the EU average and spend less on environmental measures.

Chart 1. Structure of rural development expenditure 2000-2006 EU-15



Source: Eurostat

Hungary can decide to spend less on rural development but then farmers will have a lag not only in competitiveness but also in rural development. The example of other members shows that spending more on rural development can sufficiently support modernization and restructuring.

Practice showed that Hungarian farmers are ready to use the new way of financing their farm development. The demand on rural development subsidies provided under three-year Agricultural and Rural Development Operative Program (Hungarian abbreviation: AVOP) is higher than the available budget of EUR 440 million (HUF 110 billion). Projects worth EUR 640 million (HUF 160 billion) were handed in and some measures (like supporting young farmers, vocational training, diversification of rural income resources or the development of agricultural infrastructure) were suspended because of the huge number of applicants.

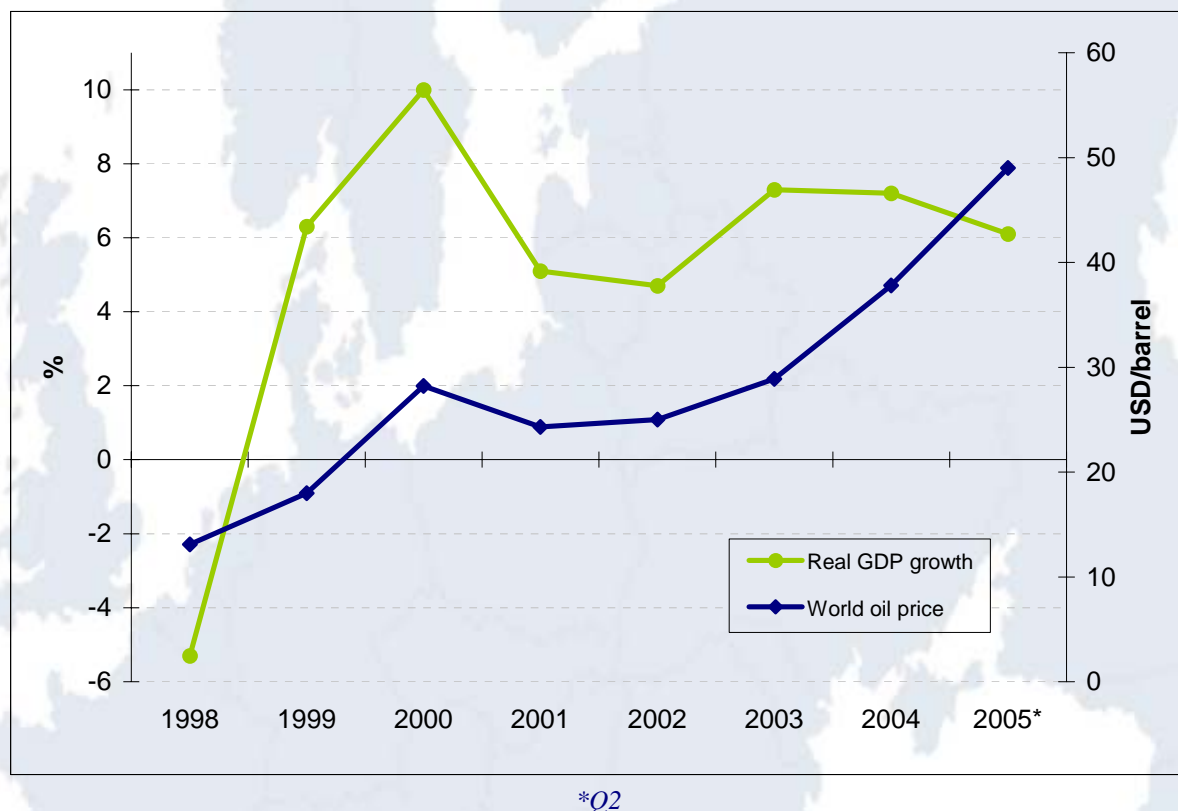
It can be concluded that Hungarian farmers could profit more from regrouping resources not between agricultural support and rural development but between the different categories of rural development programming. Increasing funds for restructuring and competitiveness from environment and land management could serve the objectives of modernization and rural development at the same time.

OIL PRODUCTION AND THE ECONOMY OF RUSSIA

Since the 1998 crisis and devaluation, the economy of Russia has been relatively stable and has shown remarkable progress with an average annual GDP growth rate of about 6%. Recently, the country's external balances have improved considerably too, together with a significant increase in foreign reserves. A huge budget surplus even made it possible for Russia to start repaying a part of its external debt. However, as we shall see, much of these remarkable results can be attributed to a single sector, namely, fuel production, and the production of oil in particular. This in turn means that the present favorable macroeconomic situation of Russia is quite precarious as it depends heavily on the fortunes of its oil industry.

According to studies by IMF and the World Bank, natural resources (mainly crude oil) make up about 50% of the *national wealth* of Russia, and about 25% of the GDP is produced by the oil sector itself. Therefore it should come as no surprise that the *growth of GDP* is closely linked to the level of oil prices in the world market (Chart 1).

Chart 1. GDP Growth and development of Oil Prices 1998-2005

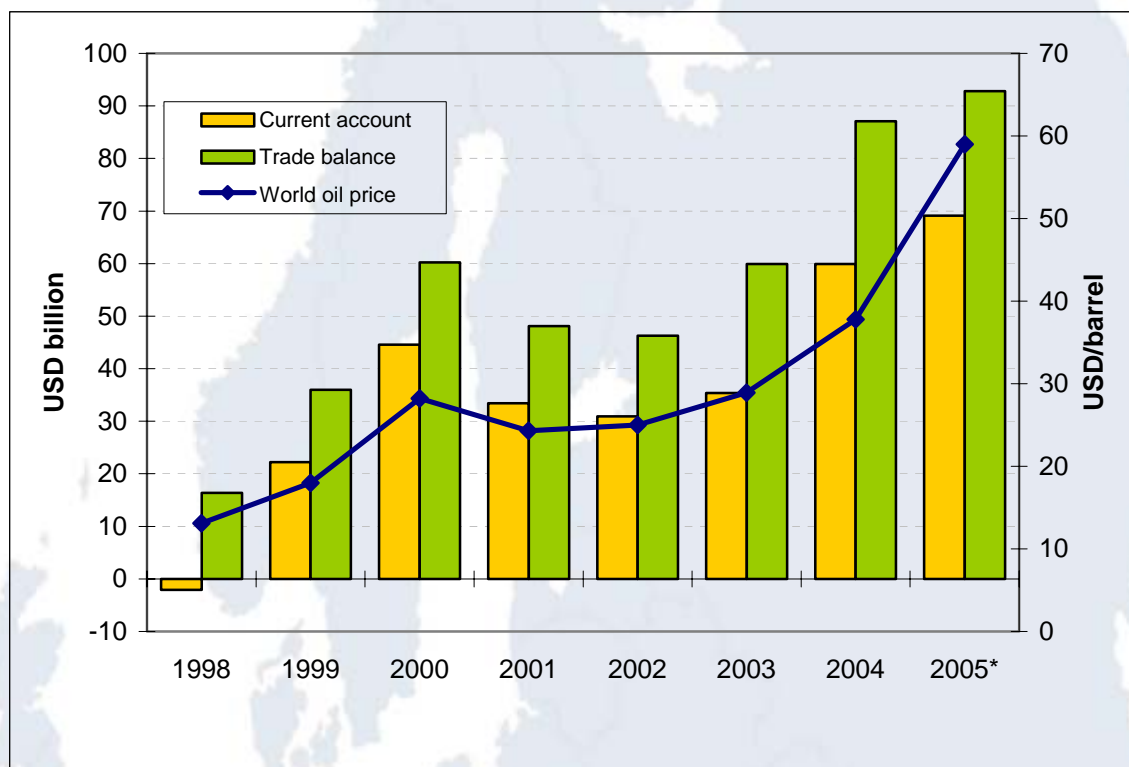


Source: IMF, Ministry of Economic Development and Trade

It should be noted, however, that once oil prices reach a certain threshold level (somewhere between USD 30-38 per barrel according to experts to the Russian Ministry for Economic Development and Trade), any further increases are unlikely to exert a positive influence on the GDP. The reason for this phenomenon is that a huge increase in oil export revenue results in either an appreciation of the Russian currency, the Ruble or the rise of inflation (depending on the response of monetary authorities), either of which has a negative effect on non-commodity exports. Since August 2004, world oil prices have been above the threshold level of about USD 38 per barrel, and GDP growth has indeed decreased notably.

In terms of external balance, the situation has improved significantly since 1998. The year 2004 has been spectacular in this respect, as the *current account* and *trade balances* rose to about USD 60 and 90 billion, respectively (Chart 2). *Foreign reserves* have increased dramatically in recent years too: they stood at about USD 165 billions in September 2005, compared to USD 50 billion at the end of 2002.

Chart 2. Current Account, Trade Balance and Oil Prices 1998-2005



*January to September

Source: IMF, Central Bank of Russian Federation

The correlation between the external balances and the world price of oil is extremely strong, which indicates that the positive changes are not to be attributed to some internal structural improvements but mainly to the exogenous event of rising world oil prices. A closer look at the structure of *exports* confirms this analysis. It can be seen that the rise of non-commodity exports has been far less spectacular than that of commodity exports. From 2001 to 2004, oil, gas and metal exports have grown by 93% in dollar terms, whereas the same rate for non-commodity exports was only 53%. What is more, if one excludes oil, gas and metal exports from the analysis, the trade balance of Russia has actually somewhat worsened recently. And a recent study by the World Bank indicates that while import has grown by 28% in US dollar terms in the first 9 months of 2005, non-commodity exports have actually declined.

Windfall export revenues raise complicated questions in terms of *monetary* and *fiscal* policy too. One problem is, how to deal with the effect the revenues exercise on the value of the currency. Russia follows a managed floating regime in theory, but has in fact been heavily intervening recently to hold the Russian Ruble's exchange rate against the US dollar relatively steady. This in turn automatically resulted in excess liquidity and increased consumption, which caused inflation to stuck over 10%. (Table 1)

Table 1 Development of Consumer Price Indices and Exchange Rate

	1998	1999	2000	2001	2002	2003	2004	2005*
CPI	27.7	85.7	20.8	21.5	15.8	13.7	10.9	11.8
Exchange rate (RUB/USD)	20.7	27	28.2	30.1	31.8	29.5	27.7	28.8

*Q2

Source: IMF

In terms of *fiscal policy*, by estimation of the IMF, Russia is to have a high budget surplus of about 8.9% of GDP in 2005 due to higher than expected oil revenues. The difficulty of such a situation is what the government should do with the extra revenue. Although Russia could well use these extra funds for several purposes (infrastructure development, structural reforms, social programs just to mention a few), the danger is that in the absence of a well-designed overall strategy, much of the money would actually be spent on inefficient investment and populist social schemes, something that happened all too often in the past. So far, Russia has successfully resisted this temptation: since 2004, an automatic saving mechanism has directed unexpected fiscal oil windfalls into the so-called Oil Stabilization Fund (OSF). (So far, part of the money in the Fund has been used to finance early repayment of parts of Russia's debt to IMF and the Paris Club.) The budget for 2006 is considerably prudent too. Nevertheless, several pitfalls still lie ahead: an approved increase in the reference oil price may weaken the automatic saving mechanism of OSF, and a recently proposed reduction of the VAT rate (from 18 to 13%) in order to enhance competitiveness is controversial as well since VAT is among the more stable sources of revenue for the government and could prove crucial if windfall commodity revenues started to decrease.

As far as the *oil industry* in Russia is concerned, the picture behind the soaring export revenues is rather bleak. Most of the growth in oil exports is due to price changes as Russia has already reached the maximum of its extracting capacities and cannot increase the volume of its exports any further to respond to the huge external demand. Large fixed investments would be necessary to increase the efficiency and volume of production. Instead of encouraging large-scale foreign investment, however, the government is more interested in consolidating state control over production: after the planned purchase of the company Sibneft by state-owned Gazprom, about one-third of oil production will be controlled by the government. The transportation of oil is a state monopoly, as pipelines owned by a state-owned company, Transneft (although there are plans of oil producers allying with Western firms to build new pipelines). Refining capacities are relatively small too. Moreover, known oil deposits are shrinking rapidly. What remains is less and less efficient to extract and without exploring new deposits (possibly on the sea-shelf), the Russian Ministry for Natural resources estimates that Russia would actually run out of its (profitable) resources of oil by 2015. In short, the oil industry of Russia is in need of more transparency, more investment and more efficient management.

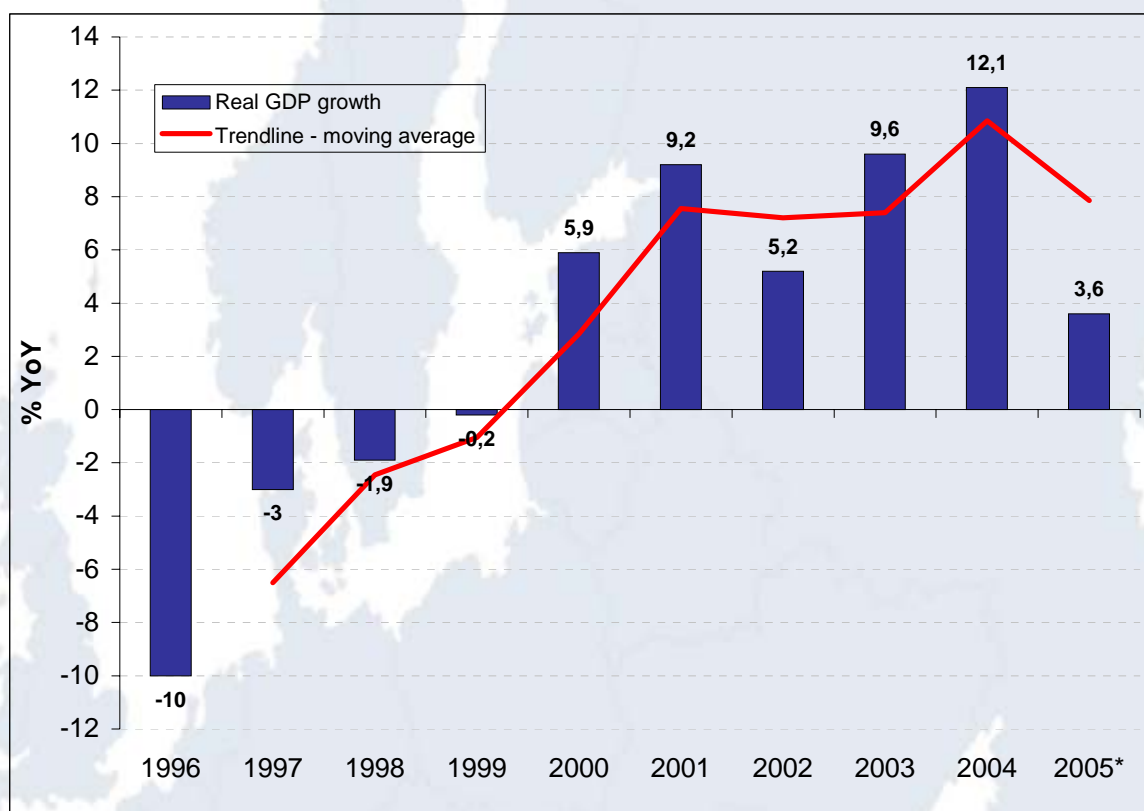
In sum, the recent good fortunes of the Russian economy are in large part attributable to the oil industry, and specifically, high world oil prices. This means that below the surface, the economy is still vulnerable: manufacturing is stagnating, more structural reforms are necessary and the investment climate should be improved further. Inflationary pressures remain to be high, and Russia is in risk of getting the 'Dutch disease': an appreciating currency, increasing import and less competitive exports. And in the long run, Russia should diversify its economy to reduce its dependence on oil. If Russia is indeed to double its GDP in a decade (a goal recently announced by President Putin), it should not let itself be deceived by the windfall oil revenues and should engage in serious economic reforms.

WORSENING ECONOMIC PERFORMANCE IN UKRAINE

In January-September 2005, the real GDP increased by moderate 2.8% in Ukraine as compared with the two-digit (13.4%) growth of relevant period in 2004.

After almost a decade of uninterrupted decline of GDP, Ukraine experienced first year of output growth in 2000, real GDP increased by 5.9% year-on-year. Ukrainian GDP in 2004 increased by the record high growth rate of 12.1% y-o-y. The year 2005 will perform a real GDP growth rate of 3.5-4% by the current tendencies, which is almost the half of the average rate of the previous five years.

Chart 1. The Ukrainian real GDP growth 1996-2005



**by expectation*

Source: State Statistics Committee of Ukraine

The consecutive growth rates show high volatility and vulnerable economic background as it is remarkably influenced by different shocks. The structure of economy is not balanced and diversified adequately and technically obsolete. The influences of political changes on the economic cycle in the country are still too significant compared with democracies on the west.

In 2005, from the beginning of the year a significant retardation of growth rates has been observable. This means that respectively from the month of April till September the indices of real GDP growth were: 5.0%, 4.7%, 4.0%, 3.7%, 2.8% and 2.8% (y-o-y cumulated, data source: IER). Available data in August 2005 shows even 1.6% decline in comparison with the similar month of the previous year.

The GDP in the first nine months of the 2005 was grown by 2.8% y-o-y, as compared with 6.5% and 13.4% growth of previous years respectively.

From statistical point of view it can be the reason of the base effect, that the rates of the previous years were extremely high and not sustainable in the long term.

FACTOR DEVELOPMENT OF UKRAINIAN GROWTH

Through having overview on the supply and demand side of GDP several unfavorable developments can be taken into consideration.

By the collected data on contribution of main activities to the GDP growth (Table 1.) it can be stated, that with exception of electricity, water and gas supply, all branches of economy performed less convincing than in the previous year.

Thus the energy sector, after decline in the first nine months in 2004, grew by 2.7% in current year. The slow down of the agriculture and forestry was the most remarkable in means of six times smaller growth rate. (Agriculture/GDP rate is 10.8%). The main reason behind was the almost similar harvested grain result. The manufacturing industry growth also did slow down as the real GDP grew only by 3.1% as compared with 16,6% of the previous year. This weaker performance is originated from weaker external demand for metal production and products of machinery building. There have been external sectors supporting the export dynamics as high oil prices that increased Russia's demand for machinery and strong steel demand coming from China that boosted metal prices and proved higher value for Ukrainian metal production. There are two sectors of the economy that bore considerable decline as compared with the previous year: construction (-7.2%) and wholesale and retail trade (-4.2%).

Table 1. Development of GDP by the main activities in January-September, 2003-2005

Activities	Jan-Aug 2005	Jan-Sept 2005	Jan-Sept 2004	Jan-Sept 2003
Agriculture, hunting, forestry	103.1	103.9	124.7	83.3
Mining and quarrying	103.1	103.5	105.7	104.4
Manufacturing	103.5	103.1	116.6	117.2
Electricity, gas and water supply	102.9	102.7	98.7	108.1
Construction	92.3	92.8	124.5	125.7
Wholesale and retail trade; trade in transport vehicles; repair services	95.7	95.8	121.1	111.0
Transport	106.3	106.3	110.2	110.5
Education	105.2	105.1	106.1	102.5
Health care and social assistance	104.7	104.5	105	102.3
Other sectors of economic activity	107.6	107.6	106.4	103.4
GDP	102.8	102.8	113.4	106.5

Source: State Statistics Committee of Ukraine

The development of demand side of the GDP shows parallel unfavorable processes, as it is an obvious shift occurred in favor of households' consumption from investment and export boosted economy. Households' expenditures have grown by 35% in real terms in January-September 2005 compared with the same period of 2004, when it has grown by 23%, expressing increasing importance of private consumption. This phenomenon is backed by rising wages (23.8% real wage growth in 2004 and 17.8% in first nine months of 2005) and

social benefits and mainly used for imported goods. The development of state consumption can be also evaluated as expansionary.

Parallel with this dynamic growth in consumption a decline is happened in investment expenditures. The gross fixed capital formation dropped significantly and it is expected thus remain in negative by the end of 2005. The main reason behind is the political uncertainty followed by presidential elections and a visible slow down in public investments traded-off by rising incomes of the households.

Finally regarding the trade data of State Statistics Committee of Ukraine, imports were increasing faster than exports. Furthermore, exports growth rate is negative. Nevertheless, it does not mean negative trade balance, as the value of exports still higher than of imports. The reasons behind this weak export performance are the steps taken towards the WTO entry, the weaker international demand for Ukrainian products, especially in the case of already mentioned metallurgical products and also the stronger Hryvnia vis-à-vis USD and EUR as well.

EXPECTATIONS

By the current trends of economic development in Ukraine, the GDP growth rate in the following time period will remain moderate. The consumption will be the main contributor of growth appearing in rising imports.

The political developments are crucially important as it caused arisen doubts about the property protection that was immediately expressed in fall of FDI inflow. The expected WTO entry also can cause negative shock in short-term for non-competitive branches of the economy, but in long term can boost export activity. The further development of EU-Ukraine relations and the quality of cooperation can be an anchor for more stable economic growth through attraction of foreign capital, quality branches, and new technologies. At least but not last, the cooperation with Russian Federation, mainly in the field of oil supply, in the case of worsening can cause damage in economic dynamics.