ICEG EUROPEAN CENTER

NEWS OF THE MONTH

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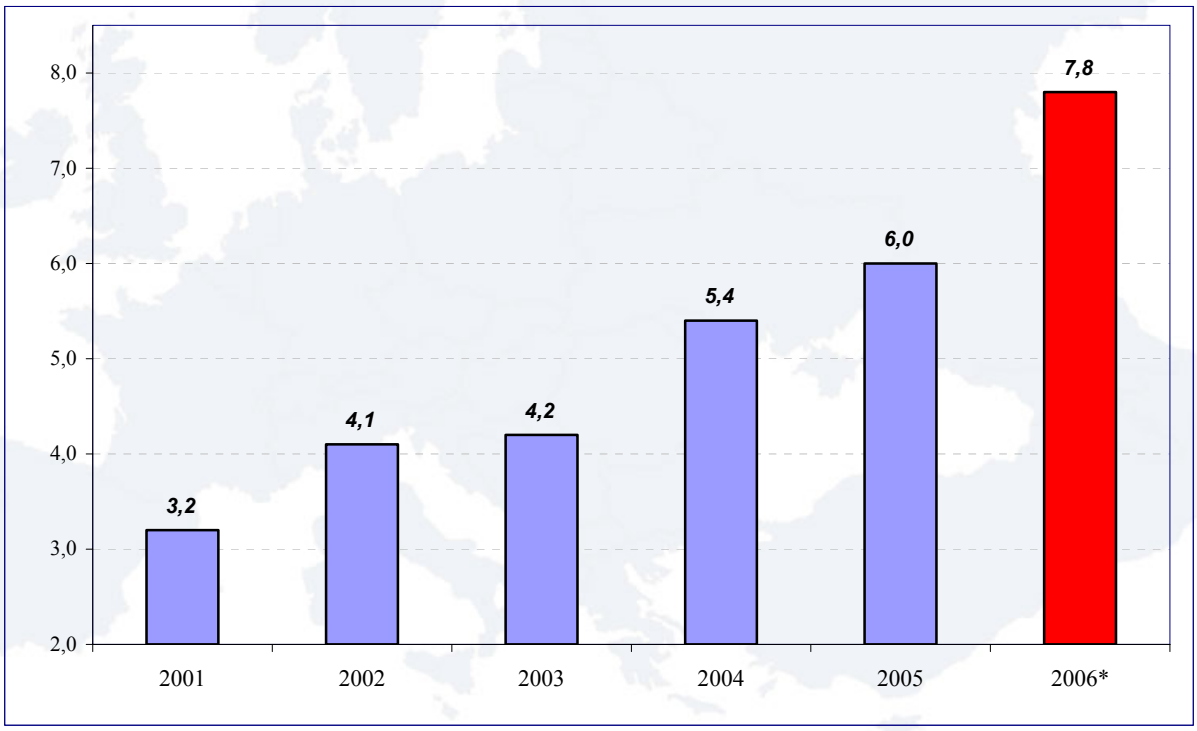
SLOVAKIAN TIGER OF TATRA – ALMOST DOUBLE-DIGIT GROWTH IN Q3

Slovakian economy grew by a record 9.8% year-on-year in the third quarter of 2006, which was 3.1 percentage points higher compared to the second quarter of the year. In the first three months of 2006 real GDP grew by 7.8% as compared to the corresponding period of previous year. New estimates predict that the Slovakian economy will grow by 7.7% in 2006. This estimation exceeds by 1.2 percentage points the earlier ones.

TENDENCIES OF REAL GDP GROWTH

After a four-year decline, strong export performance boosted GDP growth to 4.9% in 1994, followed by the highest growth rates among Central and Eastern European countries between 1995 and 1997 (above 5.8% each year). However, this pace of GDP growth was also due to huge debt-financed spending, overheating the economy. After 1999, domestic demand was depressed because of newly introduced austerity measures. The recovery process started in 2000, when yearly real GDP growth amounted only to 0.7%. In the following two years GDP growth accelerated and after a short stop it reached 9.8% in the third quarter of 2006 (7.8% in the first three quarters of 2006, year-on-year).

Chart 1. Real GDP Growth Rate in Slovakia 2000 – 2006



Source: Statistical Office of the Slovak Republic
Note: data on 2006 January-September year-on-year

Since the short 'throw-back' after 1999 Slovakian GDP growth was one of the highest among Visegrad countries (Czech Republic, Hungary, Poland and Slovakia). The difference between the first fastest growing Visegrad countries was only 0.1 percentage point between 2003 and 2005 however Slovakia was the only country being always in the top two during this period.

Based on new estimations, 2006 is the year of break-out for Slovakia, as GDP growth was at least 0.6 percentage point higher compared to other V4 countries.

COMPOSITION OF GDP GROWTH

GDP growth of the third quarter of 2006 was mainly led by the sectors electricity, gas and water supply and financial intermediation. These sectors achieved a more than 15 percentage point higher GVA growth compared to total GVA growth. The GVA growth in manufacturing and the sector of hotels and restaurants was also above average. On the contrary, the mining sector continued its backward trend, and achieved an almost 36 percentage point lower GVA growth in the third quarter compared to the corresponding period of the previous year. Public administration and health and social work were also lagging behind.

Including the first two quarters of 2006, it can be concluded that the leading sectors were electricity, gas and water supply (after a disastrous year of 2005), wholesale and retail trade, hotels and restaurants, and financial intermediation. Interestingly, agriculture could not perform above average this year, although the sector showed higher increase in GVA than the average in the period between 2001 and 2005.

GDP growth on demand side was mainly driven by domestic consumption and investments in the third quarter of 2006. Since 2002, Slovakian economic growth is no longer dependent on foreign demand, as the growth rate of household consumption accelerated and reached 6.8% in the first quarter of this year. Since the last quarter of 2004, household consumption grew by more than 5% each quarter. Gross capital formation became another important factor in GDP growth. However, it should be said that the growth rate of gross capital formation has been unpredictable and uneven in the last five years. The growth rate of export remained high and exceeded the growth rate of import in the second and third quarter of 2006; however the country still has to face a trade deficit. Net exports are expected to turn positive at the end of 2006 as exporting of large Greenfield FDI projects in the car industry will further boost the growth of Slovakian export.

Table 1. Decomposition of Slovakian GDP Growth on Demand Side

	2003	2004	2005	2006 Q1	2006 Q2	2006 Q3
Final consumption total	1.2	3.6	5.0	6.8	5.9	5.0
households	0.1	3.8	7.2	6.6	5.9	6.5
non-profit organizations	8.6	26.9	-3.1	0.5	95.6	-3.7
government	3.9	2.0	-0.6	7.8	6.6	1.2
Gross capital formation	-0.8	14.3	18.6	11.7	1.4	19.3
Export	15.9	7.9	13.8	17.7	18.1	23.8
Import	13.5	17.7	21.7	19.6	14.0	22.9

Sources: National Bank of Slovakia

The rapid and healthy economic growth is based on the successful development of the private sector. Thus, the economy does not need additional impetus from public finances in the near future.

EXPECTATIONS

According to the forecast of the Economist Intelligence Unit, a slowdown in annual average real GDP growth can be expected in the coming years. Real GDP growth will amount to about

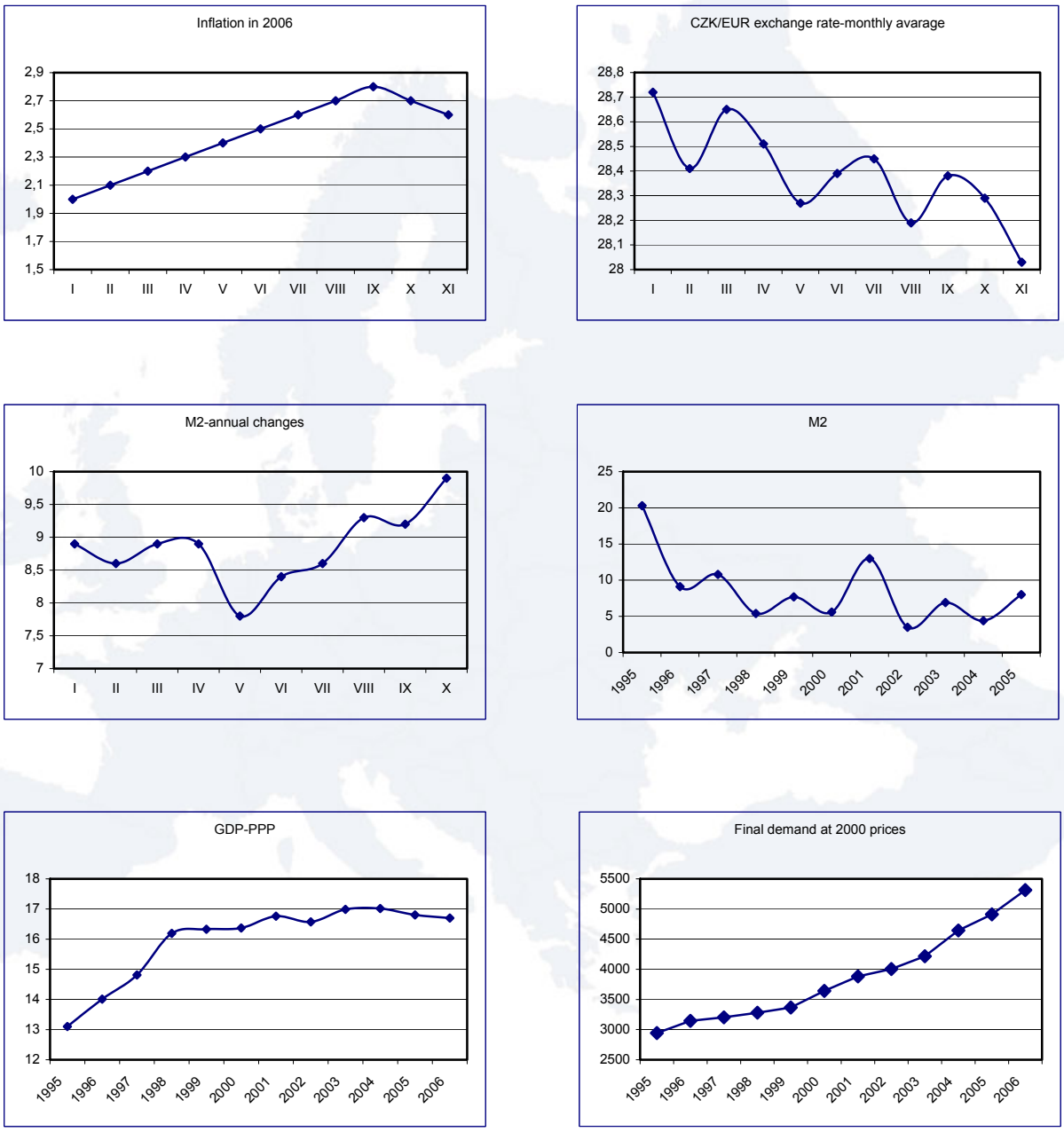
5.8% in 2007 and 2008, because of robust monetary tightening exerting a dampening effect on growth. More optimistic estimations of ICEG European Center forecast a 7% GDP growth for the coming year.

Perspectives of the Slovakian economy are encouraging. However, there are few factors which could endanger further dynamic GDP growth. In case of a slow down of Western European economies, export and production would face a set-back, and economic growth would lose its momentum. Another negative factor is the huge disparity between a developing western part and a lagging behind eastern part of Slovakia. By means of developing infrastructure in the eastern regions the high rate of GDP growth could be maintained in the future as well. Although the unemployment rate decreased from a peak of 19.2% in 2001 to 12.8% in November 2006 (LFS method), the remaining problem of high unemployment could pull back domestic consumption growth. The shadow economy could balance the negative consumption effects of unemployment so far, but whitening this 'sector' could contribute to lower budget deficits. In case the above mentioned factors will improve positively, and the government of Robert Fico can ensure political stability and an attractive business environment, the estimations can be exceeded, as it happened in 2006 as well.

BOHEMIAN MONETARY DEVELOPMENTS IN 2006

After the transition and relatively short transformational crisis, the Czech Republic passed through a dynamic and sharp development in the nineties. The development of macroeconomic indicators can emphasize it as well (*Chart 2*). The GDP and the final demand have been increasing, the nominal exchange rate has described an appreciating path from the mid-nineties, and the inflation has been getting lower.

Chart 2. Monetary Indicators in the Czech Republic (1995-2006)



Source: Own calculation by the Czech National Bank's data

Every Central-European transition country had the aim to catch up to well-developed Western countries, so they have adopted similar democratic and economic regulations, policies, and

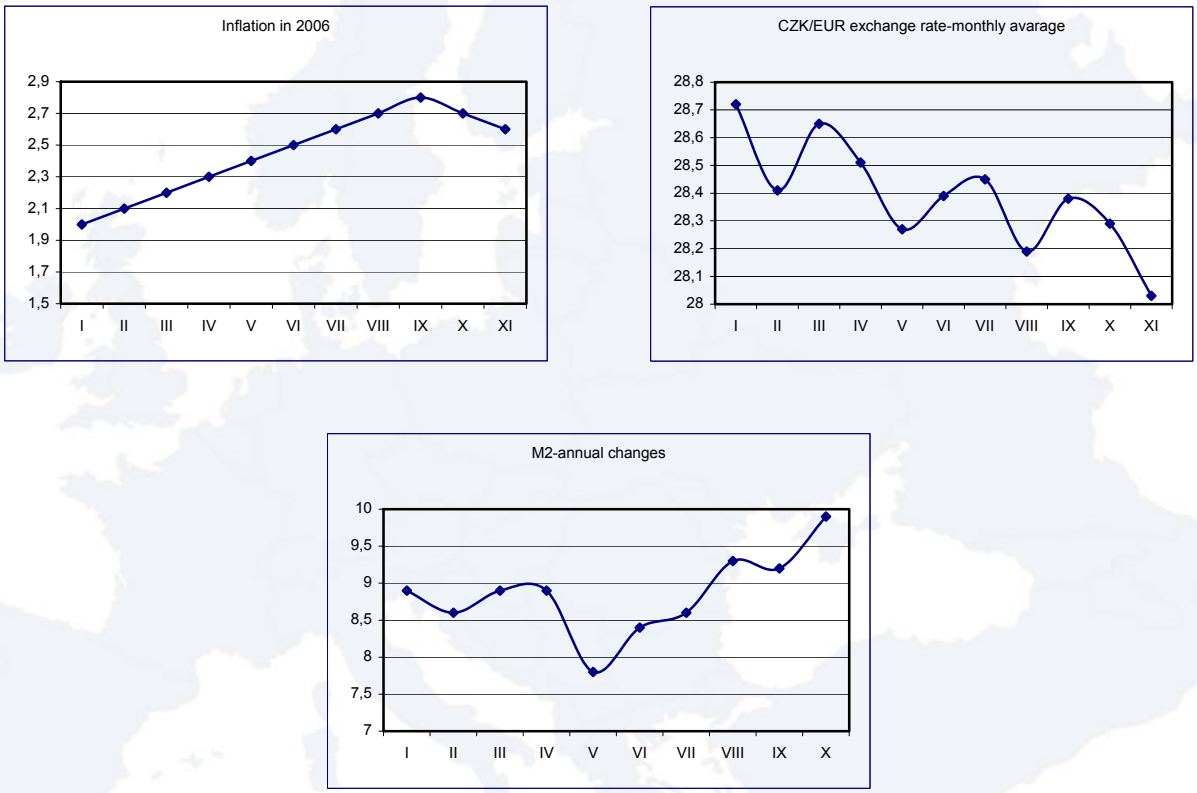
tools into their economies, unfortunately for different cultural, institutional background. It resulted, that these countries and the Czech Republic got to be ready to join the European Union, especially in political terms.

Now, Bohemia fulfils almost all of the Maastricht criteria excluding general government balance. The non-officially proclaimed euro area entry date is still 2010. Thus the situation of the country is not bad, if not taking into consideration the political turmoil.

FACTS

Although the tendency seems to be reversed from September of 2006, the inflation is getting higher from 2005, and it is near up to the 3% level. According to the increasing final demand, the money-demand and simultaneously the Czech inflation have been enhancing by a moderate growth. As we can see in the *Chart 3*, the M2 growth has got to be higher from the end of 2005 and has been stable at this elevated level till now.

Chart 3. Development of Selected Monetary Indicators in the Czech Republic in 2006



Source: Own calculation by the Czech National Bank's data

One of the main instruments of monetary policy is the exchange rate channel, which operates in the following way: for example, as the exchange rate get to be appreciating, it leads to lower import prices, which can generate a lower consumer prices in the home country. Summarizing, the national bank can influence the level of the inflation by altering exchange rate.

Although the inflation and the exchange rate usually moves together (lower exchange rate generate a lower inflation), mainly at long time; it is fairly strange, that the latest inflation

time-series is counter cyclical with the exchange rate's series in the Czech Republic (growing inflation with appreciating exchange rate). The exchange rate pass-through seems to be not at work in short-run, but it doesn't mean, there is no co-movement at longer time. The speed of the exchange rate pass through can be extremely different between countries. The charts just can show us the slow pass-through in 2005-2006.

The other monetary channel, the interest rate channel has been working as it is expected. The expectation about it is the following: in case the monetary authority enhances the interest rate as answering to the high inflation, the inflation will decrease.

In the Czech Republic, the interest rate has been following the inflation and trying to slack up the price rise. Consequently, the Czech monetary policy keeps and maintains an active policy by adjusting interest rates. As the *Chart* shows us, it's an effective policy, because during every inflationary period, the interest rate's increasing could help to lowering the price indexes. (Although there are a lot of other factors that have a strong effect on the inflation)

As the Czech monetary policy is based on the inflation targeting system, the third monetary channel, the expectation channel is very important and has to be effective on inflation. Namely, the national bank has an announced expectation and aim about the future inflation. In this targeting system the market usually gives credit to the monetary authority and we know, that inflation is mainly depend on the expectations of the market actors.

Summarizing all of the monetary indicators, the Czech inflation is very favourable and it is fairly low, although the emerging countries have to count with the Balassa-Samuelson effect. The interest rate is one of the lowest in its region, which may explain the higher investment level in the Republic.

The financial demand and the gross domestic product have been enhancing at a very outstanding speed. The final demand has been doubled since 1995; the real convergence to the euro area is also rather fast from the transition. The fast-developing Czech economy can contribute to the higher inflation level, as the enhancing supply-demand generates higher money demand, which leads to higher inflation. The economic growth is remarkable from the end of 2002; in 2005-2006 the growth level got to reach and exceed 5% year-on-year.

EXPECTATIONS

Now, the Czech inflation is predicted to be between 2.5 and 4.7 in 2007; it might mean, that the inflation will increase, compared to the year 2006. On the other hand, the GDP-growth expectation for 2007 is around 7 percent, which is much more than in the previous years and in the surrounding, similar countries.

The monetary policy activity will be depended on the deviation of inflation from its targeted level. It must be emphasized, that the Czech National Bank's communication policy will be the main factor of the inflation development in 2007 as well. In case, its communication is appropriate and will be able to convince the market, the market players will build it into their expectations and the inflation will be close to the targeted inflation level.

FOSSIL FUELS IN THE CAUCASUS – INDEPENDENT HYDROCARBON STATES

Azerbaijan conspicuously tops the list of fastest growing countries in 2006, and in 2007 it is widely expected to do the same, though with only a half as quick a pace, viz. 17.5% according to the Economist Intelligence Unit. As the country is usually grouped with Azerbaijan and Georgia in Western minds, speaking of the Caucasus, one might rush to the conclusion that the region is experiencing a boom thanks to its oil wealth and high oil prices. However, that impression would be false.

CAUCASUS IN GENERAL

The Caucasus is a key scene in today's global energy playing field. Yet when one looks for new and independent export capacities in a region short of those, surrounded by Russia, Iran and the Middle East, one should heed to *Caspian* oil, since most of the fields are under or around the Caspian Sea. As one of the littoral states, only Azerbaijan is an exporter of hydrocarbons, its capacities built up by foreign investors (mainly on the Azeri-Chirag-Guneshli, or ACG, deposit by BP) after the late nineties. Rather, the three post-Soviet countries of the Caucasus matter as important transit routes, providing for the West access to Caspian oil and gas without having to deal with Rosneft, Gazprom or, directly, the Kremlin. Crucially, the recently built pipelines connect the fields around the sea with the Mediterranean instead of the Black Sea patrolled by a recently reinforced Russian fleet.

Table 2. Primer on the Caucasus (2004)

Country	**Armenia**	**Azerbaijan**	**Georgia**
Population (million)	3 026	8 306	4 518
Net Oil Exports (barrels per day, 2003)	-39 900	213 900	-10 150
Net Natural Exports (billion cubic feet, 2003)	-46.62	-143.73	-35.67
GDP (current, million USD)	3 576.6	8 680.4	5 125.6
Present Value of Debt (current, million USD)	1 411.9	1 585.8	1 567.1
FDI, Net Inflows (BoP, current, million USD)	218.8	3 556.0	499.1
Exports of Goods and Services (% of GDP)	27	49	43
Imports of Goods and Services (% of GDP)	42	73	54
Consumption (% of GDP)	84	61	67
Government (% of GDP)	24	37	40
Investment (% of GDP)	13	29	9
Time Required to Start a Business (days)	25	123	25

Source: EIA, IEA, World Bank, Penn World Table 6.2

TRANSIT ENERGY

Though all countries are immersed in territorial disputes and sovereignty issues concerning several enclaves in each other, Georgia was trusted to host all the major pipelines linking the Caspian Sea and the West. Hence Armenia is left without either primary income or transit tariffs from the energy sector.

The three main pipelines that allow access to the Caspian region are the Baku-Tbilisi-Ceyhan (BTC), the South Caucasus Pipeline (SCP), and the Baku-Supsa, also known as the "Western Early Oil Route". These all go through Georgia, and can make smaller projects close to it

viable in the future. Georgia, with a GDP of USD 6.4 billion in 2005, is expected to earn USD 62.5 million a year from tariffs on the BTC and USD 17 million in kind from the SCP gas line. Still, 40% of the export of the main Azeri oil company, AIOC, goes to the Black Sea through a pipeline finished earlier.

Natural gas is imported to these states from Russia, where they have recently switched to a new supplier, the almighty Gazprom, renegotiated the (subsidised) prices - though first the Armenian government ceded a 40% stake in the state gas firm to Gazprom - and had some supply disruption with allegedly political motivation. The effort to diversify into Iranian gas sources is jeopardized by the fact that the new pipeline between Armenia and Iran will be controlled by the very same firm, now partly owned by Gazprom.

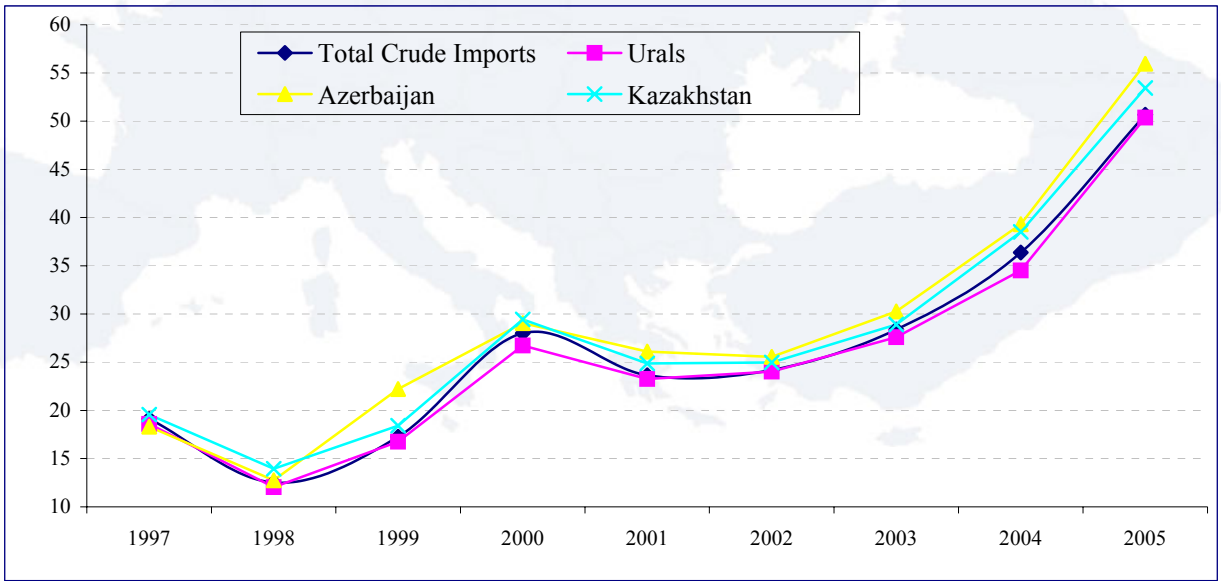
LIFE WITHOUT RESOURCES: ARMENIA AND GEORGIA

Oil consumption collapsed in these countries as in the Soviet Union did, and though it doubled in Georgia since then, in Armenia it has barely recovered because of an embargo of Turkey and Azerbaijan. Still, they consumed 12 and 44 thousand barrels per day in 2005, respectively. This demand is mainly met by Russian and Azeri oil. No surprise then, that natural gas plays a more important role in Armenia, with 50% of total energy consumption compared to Georgia's 24%. They are both dependent on imports for that.

IN THE SHADOW OF THE WINDFALLS: AZERBAIJAN

In Azerbaijan, though by its export volume alone remains a minor player globally (barrels per day 0.2 million on a market of 70 million), with a relatively high price (*see Chart 4*), the amount invested in the oil industry since the nadir of production in 1997, is six times the GDP of 2005, and the tapping of a beforehand underdeveloped offshore oil field (mainly from the ACG deposit and pumped through the BTC pipeline) is expected to double the GDP by 2010.

Chart 4. Crude Oil Import Costs by Source of Crude (USD/barrel)

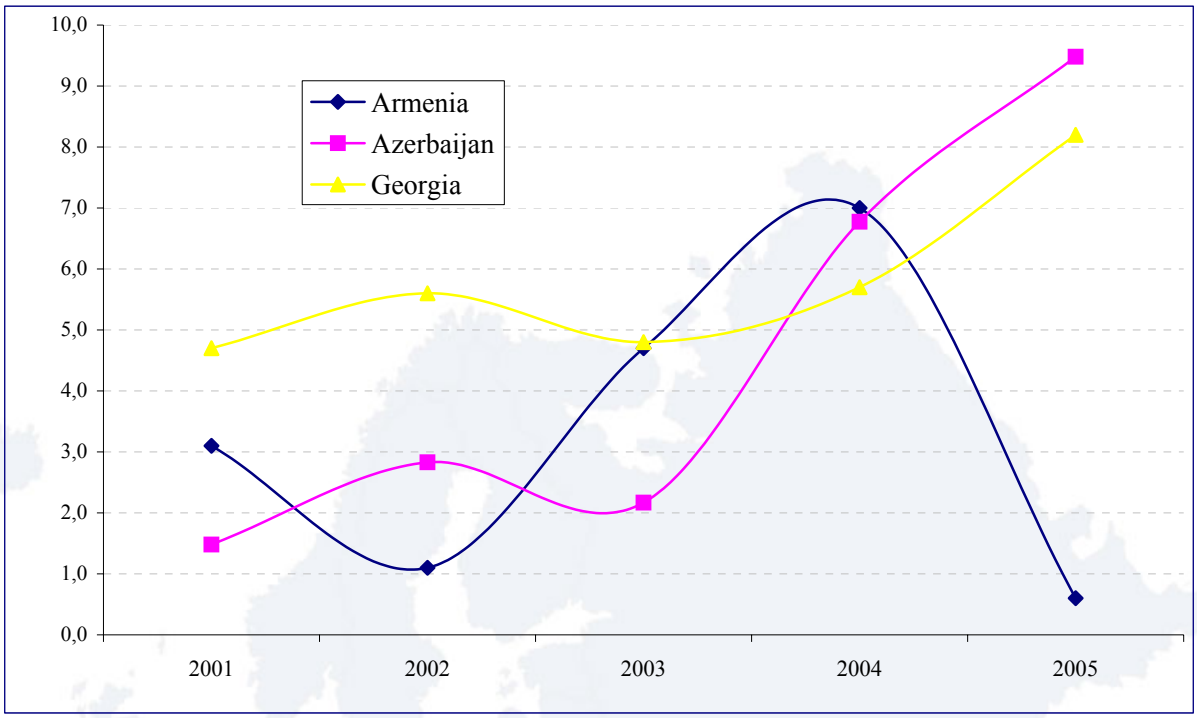


Source: IEA

Therefore, the main concern is probable overheating, unreasonable investing and possible Dutch Disease (*see Chart 5*). Careful macroeconomic management is hindered by

complacency and underinvestment in the non-oil sector due to the oil revenues, and the usual endemic corruption of post-Soviet, transition economies.

Chart 5 Development of CPI Inflation in the Region



Source: National Statistical Offices

Energy economists worry about the size of the assets to handle and the dependency on the oil sector. Concerning the first, the country's SOFAZ oil fund, single-handedly controlled by a president who succeeded his father dominating Azeri politics since 1969, is projected to swell to over USD 42.5 billion in 2010 from USD 2 billion in 2006. And the dependency is significant: the oil sector was responsible for already 41% of the GDP in 2005, before expected rises in production, and persistently responsible for more than 90% of FDI, around 95% of exports and more than half of revenues. The problem of diversification is apparent that after the completion of the BTC pipeline and some development of fields, FDI turned even negative in 2006, and is not projected to rise above the 25-50% of the levels of the decade before.

However, the oil boom conceals problems of extreme poverty in the Western regions (45% living below the poverty line), refugees and internally displaced people resulting from the war with Armenia that ended in 1994, and an authoritarian and corrupt regime usually ranked among the worst worldwide. What chances entrepreneurial initiatives have is transparent from *Table 2*: it takes three month more to start a business there than in the neighbours. How the oil revenue will change the regime does not only affect political culture, inequality or poverty but also the stability of the region: the unresolved conflict over the Nagomo-Karabakh region may heat up again if the government finds new vigour that Armenia lacks.

CONCLUSION

By and large, the region is something to watch. Energy drives politics in this part of the world both because of the dependency of importers, see the feuds of Georgia and Russia, and the potential effrontery of exporters, and see Azerbaijan. Still, most likely the region remains a major hub of independent hydrocarbon resources in a world desperate for oil once again.