ICEG EUROPEAN CENTER

NEWS OF THE MONTH

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Decreasing Disparities and Altering Relative Positions Among Eight New Member States

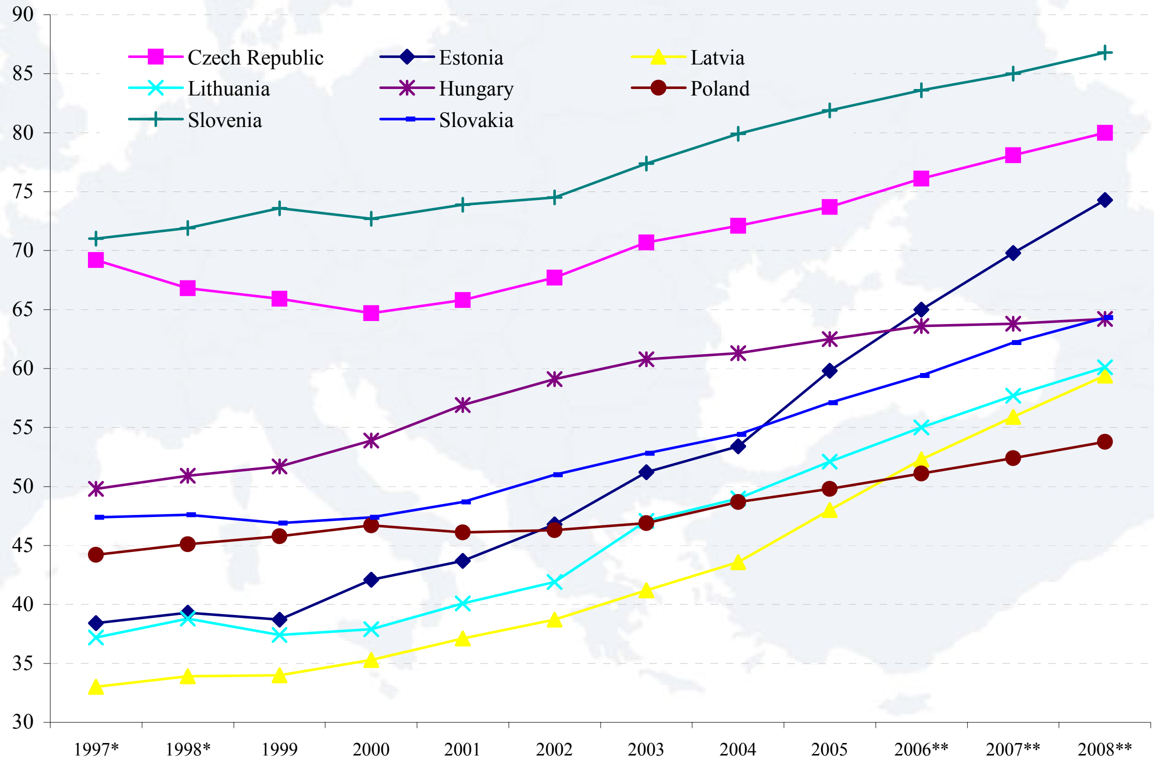
The current year will end with changes in ranking of Eight New Member States (NMS-8), measured by GDP per capita in Purchasing Power Standards (PPS). By forecasted data of *Eurostat* for the year 2006, Poland will be the least developed country, outpaced by Latvia. Hungary will loose its third place behind Slovenia and the Czech Republic, because Estonia passes its relatively sluggish economy.

Realignment of relative positions is likely to continue, as by *Eurostat* estimations at the end of 2008, Slovakia will possibly catch Hungary, Estonia will strengthen its third position and converge to the Czech Republic and Slovenia, while Poland will continue its divergence from the club.

Statement of Facts

Right after the beginning of transition period a big rush evolved among the Central European States willing to join the European Union in order to overcome the lost decades of communist era. After painful conversion losses of first years, 1997 ended with the following ranking of countries measured in GDP per capita in PPS: Slovenia, the Czech Republic, Hungary, Slovakia, Poland, Estonia, Lithuania and Latvia. (*See Chart 1.*)

Chart 1. Development of GDP per capita in PPS 1997-2008 (EU-25 = 100%)



** Estimated Value **Eurostat forecast*
Source: Eurostat

The difference between the first Slovenia and the last Latvia was 38 percentage points in 1997, as Slovenia stayed on 71% of the EU-25 average and Latvia on 33%. At the end of 2006, this gap between the first Slovenia and the last Poland will sinter to 32.5 percentage points. This will be frozen by the end of 2008. However, one can assume having a look on given data that some real convergence happened among NMS-8, although with different performances within the group.

The most spectacular performance has realized by Baltic States, especially by Estonia that has overrun three countries in the period 1997-2006, improving its relative to EU-25 average position by 26.6 percentage points, followed by Latvia (19.3) and Lithuania (17.8). This is in line with the basic theory that countries starting from lower development level converge faster. However, there has been no signs of slowing down yet, as by the theory it would have to happen.

The second cluster of converging countries is represented by Hungary, Slovenia, and Slovakia. Hungary is the group leader, by its 13.8 percentage point increase over 1997-2006, followed by Slovenia (12.6) and Slovakia (12.0).

The file-closer team consists of two countries: the Czech Republic and Poland. Their performance is quite weak, as Bohemia and Poland came out with a 6.8 percentage point growth. It is worth to mention however, that the Czech Republic started from a much higher, 70% of EU-25 average position and had lived through a financial crisis in 1997-1999 accompanied with recession of two consecutive years.

So by convergence speed NMS-8 were clustered into three groups and ranked by its success in converging to EU-25 average.

REASONS BEHIND CONVERGENCE PERFORMANCE

If investigating the background of such performances, one can find some evidence on factors contributing to long run performance. Without having in mind all aspects, some of them will be counted, like monetary and especially price stability, fiscal performance (as indirect factors) and growth performance (as direct factor) and their indicators. (*Table 1.*)

Table 1. Key Indicators of NMS-8

	Convergence to EU-25 1997-2006 GDP per Capital PPS		Real GDP growth 1997-2006 annual average %	HICP 1997-2005 annual average %	Public Balance 2000-2005 annual average % of GDP
	Ranking	Percentage points			
Estonia	1	26.6	7.8	4.7	1.1
Latvia	2	19.3	7.5	4.2	-1.5
Lithuania	3	17.8	6.5	2.5	-1.7
Hungary	4	13.8	4.7	9.0	-5.4
Slovenia	5	12.6	4.0	6.6	-2.8
Slovakia	6	12.0	4.0	7.2	-6.0
Czech Republic	7	6.9	2.7	3.7	-4.9
Poland	8	6.9	4.1	6.3	-3.3

Sources: Eurostat, own calculations

Starting on growth rates, during the period of 1997-2006, the annual average real GDP growth rates of the best performing Baltic States were extremely high, as Estonia grew annually by 7.8%, Latvia by 7.5% and Lithuania, by 6.5%. Hungary leads the second group of countries with its 4.7%; Slovenia and Slovakia have the same data of 4.0%. The last group, in essence has the same growth performance. The Czech 2.7% real GDP growth is due to 1997-1998 crisis.

As concerns the indirect factors considered as important, the inflation, as the indicator of monetary and price stability, was the lowest in Baltic countries, referring to good monetary environment for economy. The worse performer in this view Hungary, with its annual average HICP rate of 9%, but this data is biased by 1995 exchange rate based stabilization. It is true, however, that the second and third group is more inflationary than the first.

Finally, taking the fiscal performance, one can observe, that the Baltic countries came out with close to balance public balance over the cycle. Estonia for instance in the period of 2000-2005 reached annual surplus of 1.1% of GDP in average, while Latvia and Lithuania 1.5 and 1.7 deficit, respectively. The remaining countries are less prudent, as with the exception of Slovenia, all of them exceeded the 3% Maastricht threshold.

CONCLUSIONS

As of summary, the best performing countries in convergence to the EU-25 average (GDP per capita level measured in PPS) and growth were those ones, which were able to keep monetary and fiscal stability over the long-run, as the price stability and the prudent fiscal behaviour are crucial in ensuring stabile and sustainable economic growth. Countries that were not able to ensure macro stability over the cycle experienced slower convergence, thus worse growth performance.

Rapidly Increasing Inward FDI in Russia

According to Bank of Russia (central bank), inward FDI reached USD 20 billion in the first nine months of 2006, which is already by 36.9% higher compared to total inward FDI in 2005. Interestingly, a row has broken out between Bank of Russia and Federal State Statistics Service, as the latter estimated inward FDI to USD 35.4 billion in the same period.

Key Indicators of the Russian Economy

Since 2006, Russia reinforced its credentials as an increasingly stable economy. Decrease of inflation rate and unemployment rate continued in the first nine months of 2006. Inflation fell back under the level of 10%, while unemployment rate reached the lowest rate of last eleven years. Thanks to high prices of natural resources, Russian budget has maintained its surplus position in the fifth consecutive year. Increasing trend continued in the first three months of 2006, but it seems to model the previous year, thus budget surplus will probably amount to approximately 10 % this year.

Table 2. Key Indicators of Russia 1995-2006

Indicator	1995	1998	2000	2001	2002	2003	2004	2005	2006
GDP growth (%)	-4.1	-5.3	10	5.1	4.3	7.3	7.2	6.4	5.5
Inflation (%)	297.0	127.0	20.8	21.5	15.8	13.7	11.7	10.9	9.9
Budget balance (% of GDP)				-2.9	-1.4	1.7	4.4	7.5	10.8
Unemployment rate (%)	9	13.2	7.5	6.4	8.1	8.6	8.2	7.6	6.6

Source: Central Bank of Russia

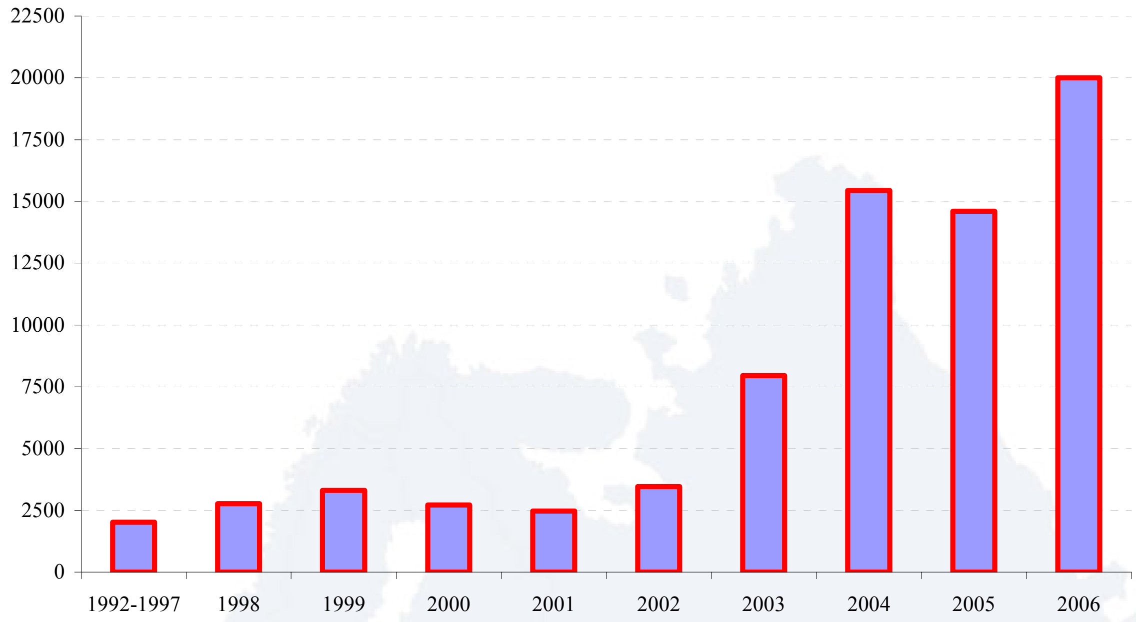
Stability was rewarded by portfolio and strategic investors as well. Even though Russian equities were unable to withstand the cruel downturn, impacting each stock market (especially emerging markets) in May and June, Russian equities remained overvalued. However, Russian real GDP growth has been slowing down in the last three years, and dropped by 0.9 percentage points in the first nine months of 2006 compared to the previous year.

Tendencies of Inward FDI

Increasing trend of Russian inward FDI started in 2001, experiencing a small throw-back in the previous year. Despite the throw-back, the Russian Federation alone, accounted for more than one third of the regions South-eastern Europe and the CIS (Commonwealth of Independent States), thanks to its large natural and human resources. The improvement of USD 7.5 billion between 2003 and 2004 was the result of high prices of natural resources. In 2004 petroleum and natural gas extraction attracted large investments in Russia. The other reason of FDI increase was the Russian capital backflow from Cyprus and Luxembourg (in 2005 28% of inward FDI came from Cyprus).

In 2005 inward FDI was only USD 844 million lower compared to 2004. At the same time, inward FDI was attracted by a wider range of activities in all three sectors. Natural resources in the primary sector remained an important attracting industry in 2005, but significant investments targeted some manufacturing activities in the secondary sector (such as Coca Cola's USD 501 million investment in food and beverages) and services (for example the USD 1.3 billion real estate and trading project in St. Petersburg by the Chinese company Baltic Pearl).

Chart 2. Inward FDI in Russia 1992-2006



Source: UNCTAD

Some high value-added activities also appeared on the inward FDI palette. In the previous year, General Motors decided to locate a high-tech activity, development of its new generation electric vehicles in a new research centre in Moscow. Such R&D investments reflect the relatively well-developed skills base of Russia. However, most FDI projects do not have high-tech content. Large part of inward FDI is attracted by low wages in low value-added activities such as assembly manufacturing.

According to a survey conducted by PBN (in 2006), a major international business consulting firm, Russia is becoming more competitive with China, India, Brazil and other emerging countries as a magnet for FDI. Two-thirds of the 155 CEOs of major companies, asked about the country's investment climate, said they plan to invest in Russia in the next three years. The size of the market (90%), the Russian sustained economic growth (82%), the high quality and low cost of human resources (57%) and overall political (48%) and macroeconomic (46%) stability were named as attracting factors. Most investors experienced decreasing investment risk compared to 2005.

Although trends of inward FDI are promising, and more investors seem to arrive in the coming three years, Russia still attracts relatively little compared to OECD countries and other emerging economies relative to the size of its economy and level of development. Inward FDI accounted for only 3% of GDP, compared to the level of 4.9% in Poland for instance. Yearly per capita FDI increased from around USD 20 in the last decade to USD 140 in the first nine months of 2006. Projecting it to the whole year per capita FDI will probably reach USD 182 in 2006. Comparing it with Hungary, where yearly per capita FDI has fluctuated between USD 200 and 400 recently, the level of Russian inward FDI cannot be considered as satisfactory.

EXPECTATIONS

The Russian government faces two challenges. One of them is the image of the country reflected abroad. The government transmits positive but also negative messages concerning investment climate, which makes prospective investors uncertain and slows down the inflow of FDI. Negative messages of the last two years included the government's efforts to increase its influence in already privatized firms, or even to take back state control of some key companies. Gazprom, the country's largest natural gas producer, is one of the examples, as the government increased its share from 39.27% to 50.01% in June 2005. Additionally liberalization of foreign equity investment in key companies is advancing slowly and limitations on foreign ownership will be raised to a maximum of 49% in order to maintain state control. Another negative signal arrived from the Ministry for Natural Resources in February 2005, in the form of a decision to restrict new tenders for oil and metal deposits to companies that are at least 51% Russian-owned. Despite the significantly clarified new Tax Code, tax enforcement remained political and often arbitrary. 75% of firms, invested in Russia, consider the interpretation of regulations by authorities as unpredictable. The example of the second largest Russian company Yukos affirms the existence of this phenomenon. Corruption and administrative obstacles in the field of acquiring working permits and registering land or property are further frightening factors.

Some positive signals have also appeared recently. The weakening opposition to foreign shareholding in local companies, direct acceptance of foreign minority shareholding, the removal of all exchange controls on the rouble on 1 July this year and the evolution of the tax system towards flat and lower taxes (set to 24% in 2002) can encourage investors.

The other challenge faced by the Russian government is the diversification of FDI into activities not connected to its natural resources. Corresponding to this challenge will not be easy as the adverse possible impact of the so called "Dutch disease" type phenomena on production costs in other industries (large oil and gas exports may lead to a real appreciation of the local currency, thus production costs of other industries expressed in dollars may increase to internationally uncompetitive levels) makes diversification difficult. In order to facilitate the diversification process the government adopted a Law on Special Economic Zones in 2005, which will allow the creation of special zones for up to 20 years. Companies in the zone will be allowed customs-free imports and will receive certain tax benefits.

In case the government can solve both challenges, the potential combination of natural resources, huge markets and cost efficiency will be able to attract an amount of inward FDI fitting the economic size and development of Russia.

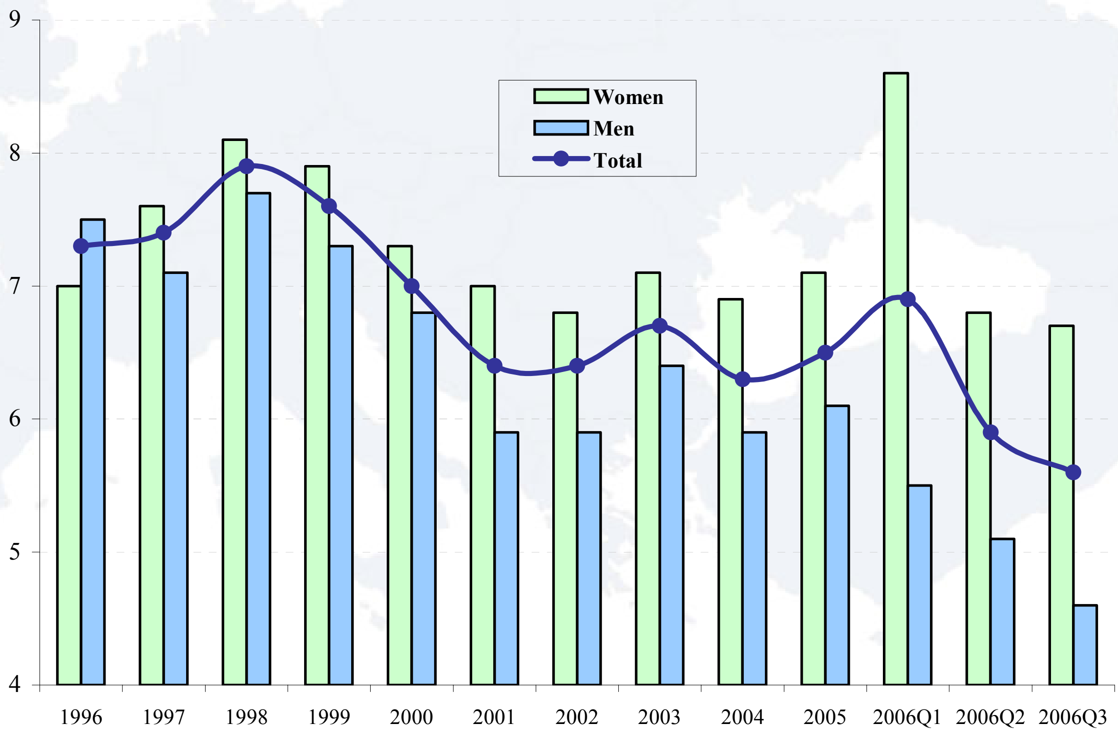
Promising Trends in the Slovenian Labour Market

Number of employed persons increased by 23.4 thousand between the first and second quarter of 2006 and by 22.4 thousand compared to the same period of the previous year. The unemployment rate in the third quarter of 2006 decreased by 0.3 percentage points to 5.6% compared to the second quarter of the year, as a result of an increase in the number of employed (plus 5 thousand) and a decrease in the number of unemployed (minus 3 thousand).

Employment Tendencies

Number of employed has been increasing since 1996 almost continuously in Slovenia. There was only a slight throw-back of two years, starting in 2002, when the number of employed decreased by 6.7 thousand compared to the previous year. Negative trend continued in 2003 as well, having 12.4 thousand less employed persons compared to 2002. Since 2003 employment statistics have improved. All things considered the number of employed increased by 9.3% in the last ten years. The drive of labour market seems to continue, as the number of employed persons reached 969.4 thousand in the second quarter of 2006, which is 2.4% higher compared to the same period of the previous year. The reason for the increase was the starting summer season, providing more working opportunities in tourism and agriculture. Additionally, more student work was registered as lectures at universities finish at the end of May. Parallel, there was a decrease in the number of entrepreneurs and their employees. The third quarter of 2006 experienced an increase of 4 thousand in the number of employed persons, thanks to the higher number of entrepreneurs and their employees. The activity rate amounted to 59.7% in this period.

Chart 3. Unemployment Rate in Slovenia 1996-2006



Source: Statistical Office of the Republic of Slovenia

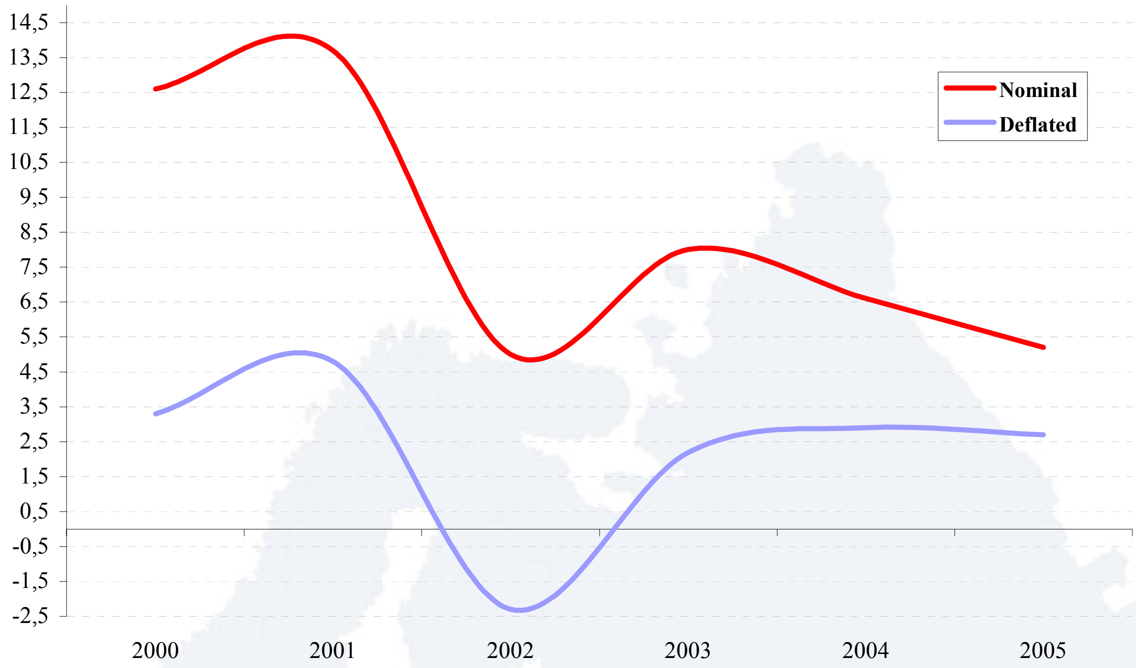
The unemployment rate decreased between 1993 and 1996 and after reaching a peak of 7.9% in 1998 it has been slowly decreasing. The trend is not only due to increasing employment but also to decreasing unemployment. The number of unemployed fell back by 21.2%, to 67 thousand in the last ten years. However, this progress has slowed down, as the number of unemployed has been fluctuating between 62 and 68 thousand since 2000. Although the unemployment rate was higher among men until 1996, the situation turned and the gender gap increased to two percentage points in the last ten years. The highest unemployment rate has been measured among people aged between 15 and 24 years. The rate varied from 18.8% in 1996 to 15.9% in 2005. The youth unemployment (14.5%) of the second quarter of 2006 is misleading because of the seasonal effects. However, a slight decrease of youth unemployment can be expected in 2006.

WAGES AND LABOUR COST

Wages in Slovenia were more than twice as much than average wages in NMS-10. Slovenian average annual gross wages reached almost EUR 14 000 in 2005 compared to EUR 6 500 in the new member states. In the 12 months period from September 2005, average monthly gross wages increased by 3.67% to EUR 1 200. Adding up the average gross wages of the first nine months of 2006, it amounts to 76.2% of the average annual gross wages of 2005, thus a slight annual increase of average wages can be expected this year. The real change of average monthly gross earnings amounted to only 0.8% between September 2005 and the same month of 2006. In the last 6 years, real wages grew by 12.3%. Average net earnings amounted to 63.7% of average gross wages in September 2006. This proportion has been relatively stable in the last 3 years, fluctuating between 62% and 64%. The sector of financial intermediation offers the highest average wages. A person, employed in this sector, can earn on average EUR 1786 a month, which is 1.5 times bigger than the country average, and 17.6% higher than in the educational sector offering the second highest salary. The gap between the lowest paying sector (hotels and restaurants) and the sector of financial intermediation was 100 percentage points.

Nominal labour costs have been increasing in the last five years. However, the pace of increase slowed down in 2002, resulting in decreasing real labour costs. In the third quarter of 2006 labour costs per hour worked in Slovenia grew by 1.4% compared to the same period of the previous year. Compared to the average of 2000, labour cost per hour worked increased by 64.1%, which is an 18 percentage points higher change than the one occurred in the second quarter of the year (46.1%). Such a huge increase in the third quarter is the result of changes in the educational sector, as in school holidays the number of hours worked is lower.

Chart 4. Labour Cost Index in Slovenia 2000-2005



Source: Eurostat

EXPECTATIONS

One of the four fundamental areas - the Slovenian social reform focuses on - is the labour market. Reforms aim to improve flexibility on labour market, to encourage employment and to increase active job search and employment. Measures focus on creating additional opportunities for the unemployed to remain active, in order to enable them finding work more easily and faster. Labour policy encourages unemployed people and beneficiaries of social transfers to actively seek work and develop their potential. Unemployed will be compelled after six months unemployment to accept a job that may require a lower level of education (up to two levels lower), even if it is only occasional or temporary employment. Unjustified refusal of employment offered will result in cessation of financial benefits for a period of six months, in order to ensure that recipients of benefits develop working habits, gather experience and improve their social inclusion. Employers hiring an unemployed person will be eligible for a state subsidy of approximately EUR 6 250. Besides these measures administrative obstacles and employers' fears of employing new labour are planned to be eliminated and re-entering formal and informal education and retraining will be stimulated. In addition, the Slovenian government wants to reduce obstacles to employment for indefinite periods, and encourage part-time employment and other types of flexible employment.

In case the government would like to reach the objectives of 12 thousand more employed and 15 thousand fewer unemployed by 2008, reforms should succeed in increasing part-time employment and the flexibility of the labour market (easing temporary contracts) and matching the demand and supply side of the labour market by means of education. After a stagnant period between 1999 and 2003, the proportion of part-time workers and employees with temporary contracts experienced a sharp increase in 2004. Already 9.3% of employed people had a part-time job (3 percentage point growth) and 17.8% had a temporary contract (an increase of 4 percentage points). These positive trends continued in the second quarter of

2006, as the proportion of employed having a part-time job increased to 9.7%, and that of employed with temporary contract to 18.1%. However, further efforts are needed. Should the government stop the increase of job vacancies, which doubled between 2002 and the second quarter of 2006 (reaching 9560 places), by means of education and retraining, structural unemployment could decrease as well. Taking into consideration the buoyant GDP growth (4.9% in the second quarter of this year), the growing world economy and the good progress of the reforms of the Slovenian labour market, it can be concluded that farther objectives of creating 50000 more jobs and having 35000 less unemployed by 2013 are achievable.