ICEG EUROPEAN CENTER

NEWS OF THE MONTH

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Budapest, Hungary, Phone: +36 1 248 1160, +36 1 248 1161 Fax: +36 1 319 0628
E-mail: office@icegec.hu Website: www.icegec.org

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LABOUR MARKET PRESSURES IN THE BALTIC STATES

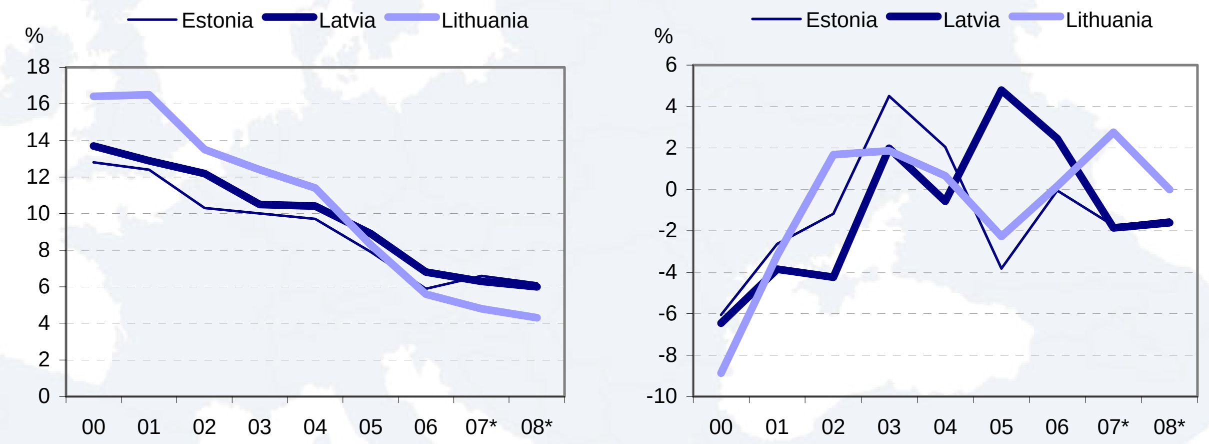
Fast economic growth brought rapidly declining unemployment rates in the Baltic countries. Strong real wage growth has largely been supported by productivity growth but tightening labour markets are pushing up wage inflation. Resulting labour shortages and declining cost competitiveness can be harmful for longer-term growth and add risks to the sustainability of large current account deficits. An orderly economic slowdown and a scale-back of income expectations are necessary to reverse unfavourable tendencies.

STRONG EMPLOYMENT AND WAGE GROWTH

Unemployment rates fell steadily in the Baltic countries since the millennium; between 2000 and 2006 they dropped by 6-10 percentage points to levels of around 6-7% as the number of employed rose by 11% in Estonia, 14% in Latvia and 6% in Lithuania. Labour market participation rates remained relatively stable: rising outward migration was more or less offset by the rising willingness to work thanks to better employment prospects. This remarkable performance was a consequence of sustained strong economic growth: these countries have consistently been among the fastest-growing New Member States in recent years. Besides the sheer pace of growth, its structure was also helpful: as domestic demand soared, labour-intensive services and construction expanded rapidly.

Chart 1. Unemployment and real ULC in the Baltic States

a) Unemployment **b) Real unit labour costs**



*Notes: * DG ECFIN forecast. Unemployment rate according to Eurostat definition.*
Source: AMECO

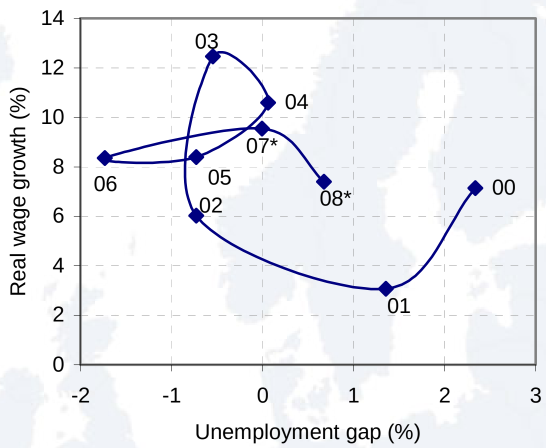
Rising employment has been accompanied by exceptional wage growth. Real wages (measured as real labour compensation per employee) rose by an average 7.5-8% a year in the Baltic trio since 2000. However, productive investments financed by massive capital inflows raised labour productivity as well. Therefore labour cost relative to output per worker declined until 2001-02. By 2003, wages outran productivity in all three countries. This was due to a number of factors including business cycle effects, public sector wage rises, and gradually tightening labour markets. 2005-06 brought adjustment in Estonia and Lithuania. On the other hand, real unit labour costs continued to rise in Latvia.

Rising Wage Inflation

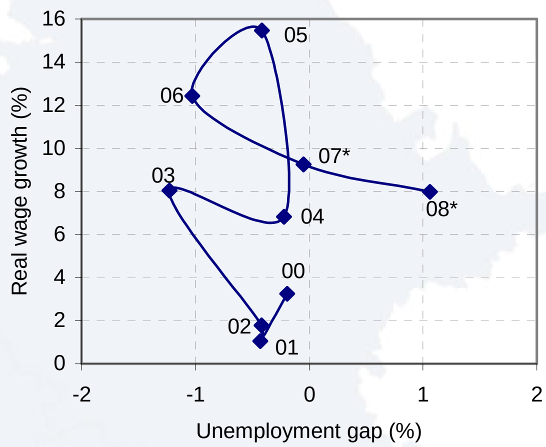
Labour market pressures can be characterised by looking at the gap between actual unemployment and the 'natural' rate. The natural rate of unemployment is determined by structural factors; at this level, there are no wage pressures to accelerate inflation. In practice, the natural rate can be approximated by the non-accelerating wage rate of unemployment (NAWRU). If unemployment is lower than NAWRU, labour shortages will bid up wages, resulting in higher production costs and rising inflation. Expensive labour will also discourage firms from hiring workers. Declining employment will restore labour market equilibrium in the end. *Chart 2* plots the difference between the actual and 'natural' unemployment rates against real wage growth in the Baltic States.

Chart 2. Unemployment gap and real wage growth in the Baltic States

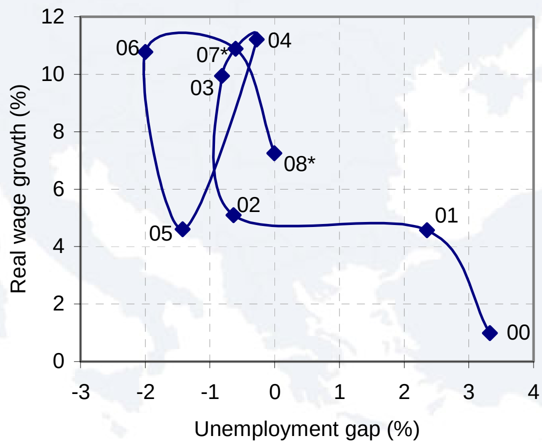
a) Estonia



b) Latvia



c) Lithuania



*Notes: * DG ECFIN forecast. Real wage = compensation per employee, deflated by private consumption deflator. Unemployment gap = actual employment – NAWRU*
Source: AMECO

Since 2000, all Baltic countries moved left- and upwards on the chart. Economic fundamentals (mainly strong growth) pushed NAWRU downwards over time: it stood around 7.6-7.8% in 2006 compared with rates of 10.5-14% in 2000. However, as a sign of tightening labour markets, actual unemployment fell even faster than NAWRU. Real wages accelerated simultaneously: growth rates reached 8.4% in Estonia, 10.8% in Lithuania and 12.4% in Latvia last year. The co-movement of the 'unemployment gap' and real wage growth indicates that emerging labour shortages have indeed influenced wages. The reversal of the downward trend of real unit labour costs supports this view, see panel b) of *Chart 1*.

What are the consequences of wage pressures? One obvious consequence is inflation. The 12-month index of producer prices climbed by 4.1% in Lithuania and 8.5% in Estonia in April; it rose by a whopping 16% in Latvia by March. Although energy prices, tax harmonisation and strong domestic demand boost consumer prices, higher production costs due to wage inflation also play their part in rising (consumer price) inflation in the Baltics.

Another consequence is the loss of external competitiveness. This could be dangerous as these countries already run double-digit current account deficits. Trade statistics show a recent deceleration of exports although temporary factors (such as long queues on the Russian border) are an excuse. Strong external demand also gives exporters some leeway. However, Baltic exporters are climbing slowly the technology ladder: the share of low-tech exports is still high and export unit value is relatively low, particularly in Latvia and Lithuania.[1] Therefore they might find it harder to compensate for rising production costs by squeezing profit margins.

EXPECTATIONS

ICEG European Center forecasts a gradual slowdown in the Baltics for 2007-08.[2] This entails an adjustment in wage expectations, slower pay rises and a gradual slowdown in employment growth. The European Commission also expects the unemployment gap to close and even turn positive in the near future. However, real wage growth can stay high in 2007 due to a number of recently adopted policy measures such as minimum wage increases and salary rises in the public sector. Although slowdown is likely to proceed in an orderly manner, a hard landing scenario still cannot be ruled out. This would materialise if credit growth collapsed or inflation could be contained, and would bring stagnation and a sharp adjustment on the labour market through rising unemployment and possibly falling real wages. Much depends on prudent economic policies: despite low budget deficits or even surpluses, fiscal stances have been pro-cyclical recently. As elections have passed, it is high time to slow down wage growth and tackle structural labour market problems to let the 'natural' rate of unemployment fall further.

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[1] See for example: World Bank EU8+2 Regular Economic Report, January 2007, p. 25.
[2] Quarterly Forecast on the Eastern EU Member States, Spring 2007. (www.icegec.org)

UPDATE OF THE CZECH CONVERGENCE PATH

In accordance with the Stability and Growth Pact, the government of the Czech Republic approved the update of the Czech Convergence Programme on 12 March 2007 for the period 2007 to 2009. The Czech common opinion witnessed special political development during the year 2006, as the election in June 2006 was followed by long and complicated negotiations because of the close result. The first government did not receive confidence, thus a new, coalition government had to be formed. The Convergence Programme was prepared by the first government, but due to time constraint it was accepted by the second government, which made only few amendments. The second government is committed to fiscal consolidation, which area was the main issue of the amendment.

ECONOMIC BACKGROUND OF THE CZECH REPUBLIC

The Czech economy faced several difficulties in the last decade, but from 1999, the economic growth is stable. The budget deficit was very high in two consecutive years (6.8% in 2002, 12.5% in 2003). (*ICEG European Center – News of the Month, January 2006*) Thus, public finance reform measures were implemented in 2004 in order to change the institutional and legal framework of public finance. Albeit the reform was successful, the government deficit was not stable, and could not reach the reference value of 3% set out in the Maastricht criterion. This played a significant role in the decision not to enter the ERM II in 2008 and therefore to enter the euro area in 2010, which was the purpose in the previous Convergence Programme. The recent, updated version of Convergence Programme does not contain an exact date of launching the Euro as legal currency, but 2012 is a realistic possibility according to experts. As a consequence of the fact that 2006 was an election year, fiscal policy was loosened – and not expected to tighten – which is shown in the expectations of the 4.0% government deficit projection for 2007 (*Table 1*). Fiscal consolidation is of prior importance in order to meet the Maastricht criterion in the future.

The unemployment rate has shown a stable level since 8.1% in 2001, but it is expected to decrease in the future. The labour market has developed in the past and unemployment rate has continually declined to 7.1% in Q2 2006. Expectations also improved, as the expected unemployment rate for 2008 is to be lower by 0.4% compared to the one in the last Convergence Programme. Employment growth also reached 1.6% in Q2 2006, while the most significant increase was registered in the manufacturing industry. Still though, the labour market is one of the most sensitive issues, as problems sill exist, such as flexibility and long-term unemployment etc.

Besides the above, the low-inflationary environment with the stable economic growth in the last years illustrate that the Czech economy is performing well. Inflation reached a 1.6% annual average in 2005, the slight increase for 2006 is due to administrative measure, energy and food prices. Although, expectations moved upwards comparing to the last Convergence Programme, but that is because of the higher-than-expected economic growth. Real GDP growth has exceeded 5% for the sixth consecutive quarter, which is far beyond the projections set out in the Convergence Programme 2005. The experienced growth of the economy is due to higher total productivity but in the long-term, the aim is that productivity growth should be supported by the quality of business environment, new technologies and higher FDI. Accession to the euro area would be a huge opportunity to support these long-term goals.

Table 1. Main Indicators and Projections Set Out in the Czech Convergence Programme

Indicators	2003	2004	2005	2006*	2007**	2008**	2009**
Real GDP (previous year = 100%)	103.2	104.4	106.1	106.0	104.9	104.8	104.8
Inflation rate (%)	0.1	2.8	1.6	2.4	2.6	2.5	2.5
Unemployment rate (%)	7.8	8.3	7.9	7.2	6.7	6.5	6.5
Government deficit (% of GDP)	-12.5	-3	-3.6	-3.5	-4.0	-3.5	-3.2
Government debt (% GDP)	36.5	36.8	30.4	30.6	30.5	31.3	32.2

**Based on data available in October 2006 **projection*
Sources: Central Statistic Office of the Czech Republic; Convergence Programmes

The update of the Convergence Programme is based on different assumptions of the ongoing economic growth and indicators of world economy, such as USD/EUR exchange rate, EU-25 GDP growth or oil prices.

UPDATED CONVERGENCE PROGRAMME

The main objectives of the government's economic policy are maintaining the economic growth, stability and increasing wealth. It aims to achieve these goals by a long-term sustainable productivity growth and by increasing employment. To be successful, it depends on a number of external factors as well, but the government's most important goal is to launch the Euro as soon as possible, which can happen realistically in 2012 - with given assumptions regarding the external environment. To keep this date, the government should follow a strict fiscal- monetary- and structural policy.

As it was mentioned above, the government's commitment to fiscal consolidation is strong. Although there is a stable growth in GDP, the level of government deficit is not stable. To be in accordance with EU fiscal rules, the public budget deficit should be kept at a low level, because it is an essential condition for the successful functioning of the economy. The contemplated trajectory of the Czech government deficit could not be held, to a certain extent because of the increasing spending in the election year. The medium-term budgetary target of the Czech Republic is -1.0% of the GDP by 2013, which is reasonable, if the government committed to fiscal consolidation. It is not just important because of the entry to the euro zone, but because of the long-term sustainability of public finances as well.

The government deficit for 2005 was expected to be 4.8% of GPD in the previous Convergence Programme, but the deficit was 3.6% of GDP, despite of two one-off transactions that affected the expenditure side: the lease of Gripen aircraft, 0.3% of GDP and forgiving Syria's debt, 0.6% of GDP, mainly due to the higher-than-expected tax collection. The preliminary data shows a deficit of 3.5% of GDP in 2006, which is slightly lower than the expected data in the previous Programme. However, in 2007, the last time estimated 3.3% deficit could not be complied. This is also shown in the projected 4.0% deficit for this year. Therefore, the fiscal consolidation in the Czech Republic is inevitable to get back to the contemplated trajectory of the economy, as the aim of the Czech Government is to enter the euro zone.

There is an inflation-targeting regime in charge, which operates successfully as the previous goals of a year-on-year 3% growth in CPI has happened since 1 January 2006 (*see Table 1*). Outlook for the future is still favourable and the fact that the 3% inflation target of the Czech National Bank is going to decline to 2% from 2010 shows that medium-term objectives of the inflation rate are realistic. (*Source: CNB*)

The decision on the ERM II entry was delayed because of low flexibility of the labour market – which is a traditional weak spot of the Czech economy –, the substantial difference in the cyclical development of GDP and price levels between the Czech Republic and the euro area.

To improve the situation, the ongoing structural reforms cover a spectrum of microeconomic policies (i.e. business environment, research and development, innovation, sustainable use of resources) and the labour market (flexible market, market integration, education). Structural problems in the labour market are still exist and are reflected in the strong regional disparity. The long-term unemployment has not declined, although these problems were mentioned as serious problems in the previous Convergence Programme as well. The first Report on Implementation of the National Lisbon Programme 2005-2008 indicates that legal- and business environment have been improved, which is of prior importance for entrepreneurs as administration and transparency was improved and a new insolvency act was adopted as well. As a part of the new EU Financial Perspective 2007-2013, contributions from structural funds and the Cohesion Fund should be significantly higher, especially in 2008, which will help structural reforms.

Among the New Member States, only Slovenia was able to launch the Euro, and fulfil the requirements of the Maastricht criterion. From this point of view, the Czech Republic is neither the best nor the worst in the region, as it is expected to entry the euro zone possibly in 2012. Hungary for example is only expected to be able to enter the euro area around 2014 according to expectations of experts. The differences in key indicators of the two economies (*Table 2*) underline these expectations. The GDP growth is substantially higher in the Czech Republic, although the expected gap is closing in by 2009. The inflation and the government deficit in 2007 in Hungary is apparently high and heavy fiscal adjustment package started in mid-2006, which explains the huge difference in these two indicators in this year. The gap also closes in by 2009, but a slight difference in the expectations of inflation still exists. The Czech Republic continues its already implemented reforms regarding the labour market, and public finances. The difference in the unemployment rate is stable; it is just under 1%. The huge difference is regarding the level of government debt. The Hungarian one is two times higher and it will exceed 70% of GDP. This level can be partly explained by differences in historical development between the two countries.

Table 2. Differences in Main Indicators of the Czech and Hungarian Convergence Programme 2007-2009

Indicator	Czech Republic			Hungary			Difference		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Real GDP (previous year = 100%)	4,9	4,8	4,8	2,2	2,6	4,2	-2,7	-2,2	-0,6
Inflation rate (%)	2,6	2,5	2,5	6,2	3,3	3	3,6	0,8	0,5
Unemployment rate (%)	6,7	6,5	6,5	7,5	7,4	7,3	0,8	0,9	0,8
Government deficit (% of GDP)	4	3,5	3,2	6,8	4,3	3,2	2,8	0,8	0
Government debt (% GDP)	30,5	31,3	32,2	70,1	71,3	69,3	39,6	40	37,1

Sources: Convergence Programmes of the Czech Republic and Hungary

SCENARIOS

The updated Convergence Programme contains a pessimistic and optimistic estimation for the future – depending on the assumptions set out in the Programme – besides the baseline projections (*Table 1*). Both of the scenarios confirm positive development in the key indicators, the differences are in the measure of development. The exogenous variables of the assumptions are oil prices, other raw material prices, economic development of the European Union, foreign demand and foreign inflation. (As the Czech economy is a small and open economy, these assumptions can affect the accuracy of projection)

The biggest difference to the previous Convergence Programme is the expected date of the entry to the euro area. Due to fiscal development, the 2010 entry shall be delayed until at least 2012, albeit the postponed entry is still appropriate taking into consideration the situation in other countries in the region.

If the Czech government stays committed to fiscal consolidation, than the long-term sustainability of economic development is feasible and the main objective of launching the euro area can happen in 2012.

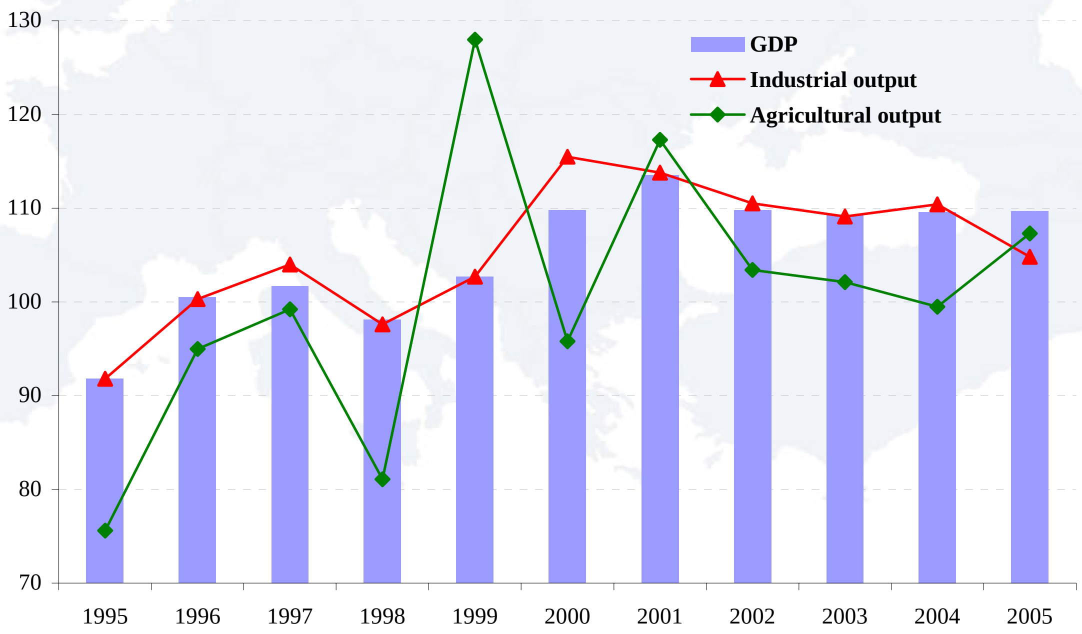
KAZAKHSTAN – AGRICULTURAL OR INDUSTRIAL SOCIETY?

Despite favourable conditions for agricultural production, the share of the agricultural sector in GDP significantly decreased in the last decade. Agricultural production provided only 6.7% of Kazakh GDP, which is by almost 30 percentage points lower compared to 1993.

AGRICULTURAL SECTOR OF KAZAKHSTAN

The richness of land resources (more than 74% of the country's territory is suitable for agricultural production) and historical roots determined the importance of agriculture for several centuries in Kazakhstan. Before the Russians conquered the country, herding was the major economic branch of the country. Main agricultural commodities were wool, meat, milk and other livestock products. As Russians were keen on farming, especially on the cultivation of rice, cotton and wheat, they transformed most of the pastures into fields after they took domination in the 19^{th} century in Kazakhstan. Soviets hade the same priorities, therefore, under the programme of Virgin Lands of the late 1950s and early 1960s 60% of pastureland became cultivated. The programme wanted to settle down remaining nomadic herdsmen in order to reduce Soviet grain imports to the country, however, approximately one third of the newly cultivated area was not suitable for grain production. Parallel to the Virgin Lands programme, Kazakh agriculture underwent collectivisation. Agricultural land occupies more than 220 million hectares. Because of the Soviet domination, the sector was characterized by high and inefficient capital intensity. Therefore, it is not surprising that the exposure of Kazakh agriculture to world prices for inputs and products revealed a high-cost structure of production.

Chart 3. GDP, Agricultural and Industrial Output of Kazakhstan 1995-2005 (as percentage of previous year)



Source: Agency on Statistics of the Republic of Kazakhstan

As Kazakhstan has long nomadic traditions, stockbreeding remained the traditional and dominant agricultural sector. 84% of the total agricultural area is devoted to pasturage, mainly of cattle and sheep. Animal husbandry accounts for about 40% of the production value in agriculture. Chief livestock products are dairy goods, leather, meat and wool. The output of the livestock sector is gradually growing (5% annual average) and herd sizes are recovering after a period of slaughtering animals for meat without replacement. However since much of the pastureland is degraded, herd sizes will need to be reduced to a sustainable level.

Most of the remaining land is used by large-scale wheat farms. Having five times the size of France, Kazakhstan is one of the world's largest (6^{th}) grain producer and exporter. However, sown grain area decreased by more than 5 million hectares as overall yields do not exceed 1 ton per hectare (one fourth of average yields in Eastern Europe) and problems of transportation and quality occurred. Low yields are due to environmental problems from mismanagement and overuse of groundwater resources and chemical fertilizers during the Soviet era. The main grain crop is wheat, accounting for one third of total sown area. Wheat export is among the leading commodities in Kazakh export.

Major problems of the agricultural sector are low productivity (five times lower labour efficiency compared to Eastern European countries) and profitability, weak competitiveness of national producers, the lack of implemented international quality standards and modern technologies and insufficient infrastructure.

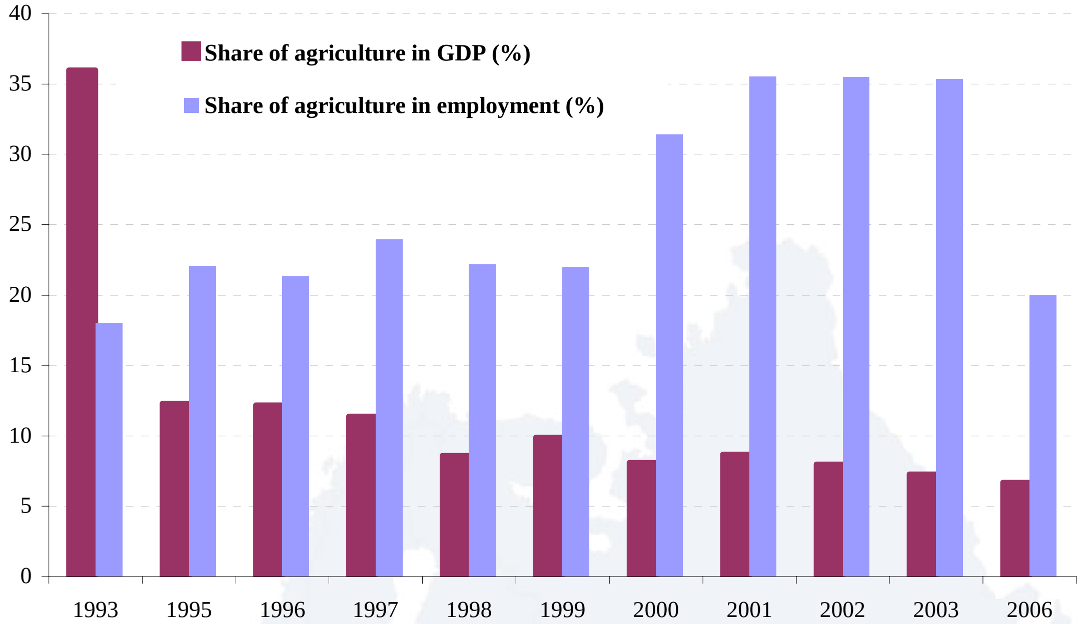
AGRICULTURAL OR INDUSTRIAL SOCIETY?

As nomadic Kazakhs were not willing to settle down and to build towns or villages, farming and manufacturing goods were not developed and the country did not have an industry at the beginning of the 20^{th} century. However, thanks to richness in mineral resources industries such as chemicals, steel, textile and machine building were present by the time of World War II. However, agricultural sector was dominant in the Kazakh economy, representing 36% of GDP in 1993. After becoming an independent state the role of agriculture started to decline.

One of the main sectors contributing to dynamic GDP growth (above 9% in the last 6 years) has been exploitation and export of oil. As other branches of industry developed (slowly) as well, the share of industry of GDP increased by 7 percentage points to 29.8% in the last decade, while the contribution of agriculture decreased to 6.7%. Services are growing and their share of GDP has just reached 55%.

The share of different sectors in total employment reveal productivity problem in agriculture. Services and industry employ less compared to their contribution to GDP, reaching 48% and 17% respectively. In case of agriculture, its share in employment is almost three times as much as its share of GDP.

Chart 4. Share of Main Sectors in GDP and Employment 1993-2006



Source: UNDP Kazakhstan

EXPECTATIONS

According to trends of the last fifteen years, Kazakhstan became an industrial society from a mainly agriculture based one. However, oil related industries and services are responsible for half of the Kazakh GDP. What is more, the country seems to be prone to the Dutch disease, in which heavy foreign investment in the energy sector causes the appreciation of the country's currency, damaging other sectors like manufacturing or agriculture.

The government is aware of dangers of the unbalanced economic structure, thus it developed the new Innovative Industrial Development Strategy until 2015 four years ago. The core element of the strategy is to direct investment in non-oil related sectors, including agriculture as well. The country has the necessary features like political and macroeconomic stability, natural resources, important geographic position, educated population and skilled labour force to attract foreign investment.

Additionally the government facilitates further economic reforms in agriculture in order to make it more profitable and productive. Projects like improving infrastructure, developing agricultural research centres and investing in bio-fuel are part of the rural revival strategy of Kazakhstan. Although the economic performance of the country does not depend on agriculture any more, the development of this sector is inevitable in order to ensure a balanced, long-term economic growth.