ICEG EUROPEAN CENTER

NEWS OF THE MONTH

May 2007

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

TABLE OF CONTENTS

Further Need for Fiscal Adjustment in V4 Countries 3

Positive Trends In The Polish Labour Market 7

Moldova: High Potential, Weak Performance 10

Further Need for Fiscal Adjustment in V4 Countries

Four countries of Visegrád Cooperation (V4 – the Czech Republic, Hungary, Poland and Slovakia) are in position of permanent need of fiscal adjustment and public finance reforms. The situation of individual countries is however dissimilar from several aspects.

Initial Conditions

Fiscal policy of new EU member states has to face several challenges under the continuing integration process. As a legal constraint, the Stability and Growth Pact (SGP) and its public finance criteria on deficit and debt means serious burden. Additionally, the correspondence to obligations taken by accession puts pressure particularly on budgetary expenditures parallel with growing demographic, and consequently political reasons led fiscal biases. In the same time, the region faces an accelerating "race for the bottom" as concerning taxes particularly connected with international FDI movements. Traditionally however fiscal policy tries to boost economic growth, convergence and cohesion, particularly through public investments attempting to make up leeway in infrastructures (environment, education, transport, healthcare etc).

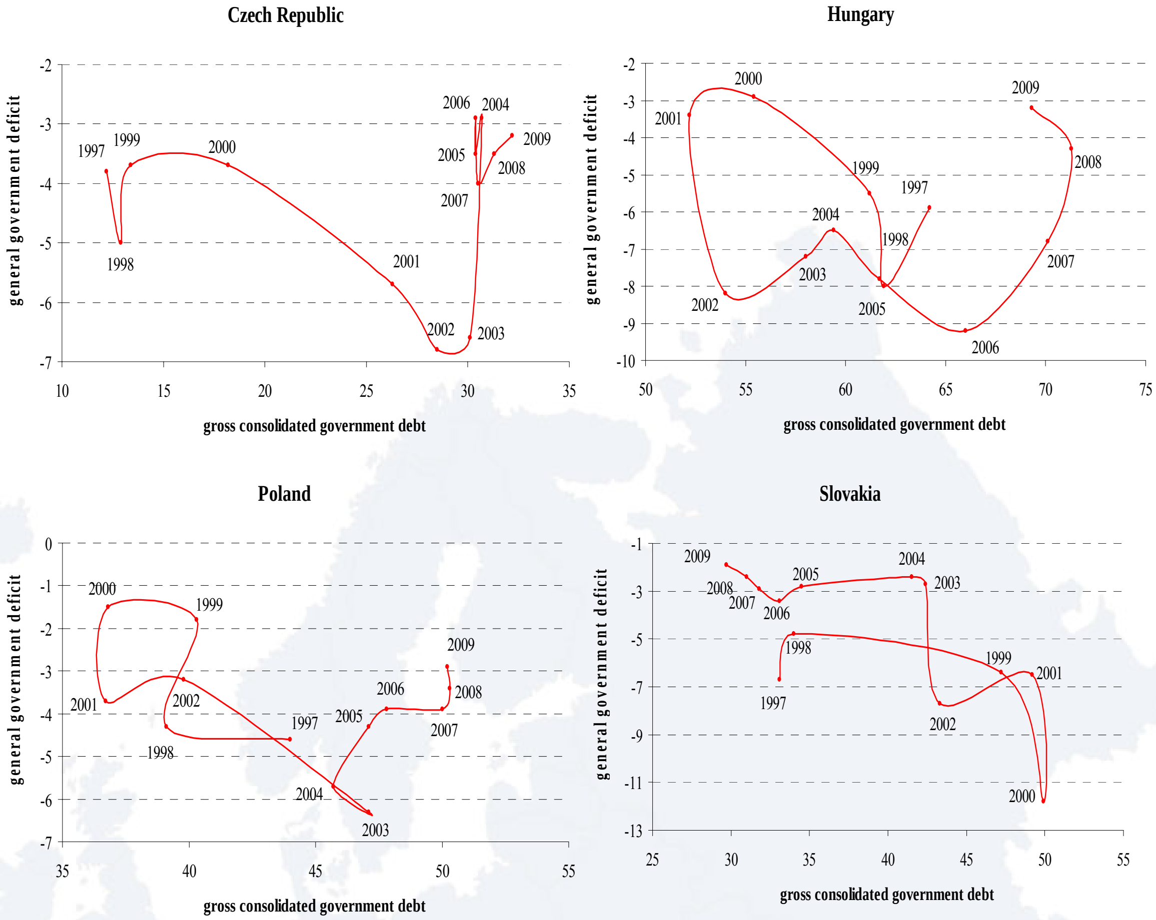
Facts and Plans

Hereby, budgets of V4 countries operate under remarkable pressure. This pressures are embodied in disperse adjustment efforts both reflected in fiscal performance, or in Convergence Programmes accepted by European Commission. *Chart 1* shows the development of main public finance indicators and its planned values relative to GDP during the convergence path towards the single currency.

The investigation of convergence path concerning V4 countries reflects that seemingly only Slovakia has been able to sustain closed to 3% general government deficit since 2003 causing decrease of general government debt. The Czech Republic and Poland have converged near to the target limit, but parallel with a considerably increasing debt. After successful adjustment by the millennium, Hungary has been getting far not only from deficit limit, but (what is more problematic) from debt criterion.

It is worth to mention that all four countries are under Excessive Deficit Procedure (EDP - *European Union Treaty, Article 104*) since 12 May 2004, but in different stages.

Chart 1. Adjustment Path of V4 Countries 1997-2009 (% of GDP)



Source: Eurostat (Date of extraction: Mon, 11 Jun 07 03:51:29), Convergence Programmes of the Czech Republic, Hungary, Poland and Slovakia

Having taken into consideration these processes, the Convergence Programmes of these countries designated different convergence paths with varying ambitions, i.e. adjustment size. This way the Hungarian venture with its 6 percentage points of planned cut of GDP related general government deficit from 2006 to 2009 would mean the most radical effort. The same data for Slovakia 1.5 percentage points, while 1 percentage point for Poland. The Czech Republic seems to adjust by -0.3 percentage points that means that the deficit will increase from 2006 to 2009.

Thus, countries of V4 have to continue their adjustment efforts in order to enter the euro area and to be able to achieve public finance reforms. At the same time, as the structure of adjustment is matter, the image of deficit cuts has to attract some attention.

According to data of *Table 1* a diverse picture can be drawn. Taking the period of 1998-2006, Slovakia has done considerable effort in adjustment, cutting not only expenditures, but revenues as well. On expenditure side this affected even the investments, measured by gross fixed capital formation. Poland also made efforts to cut its expenditures that gave floor for revenue side decrease. Public investments however have not changed significantly. Hungary decreased revenues parallel with increasing expenditures. The public investments increased considerably. Finally, the Czech Republic achieved slight adjustment in expenditures, while increasing public investments.

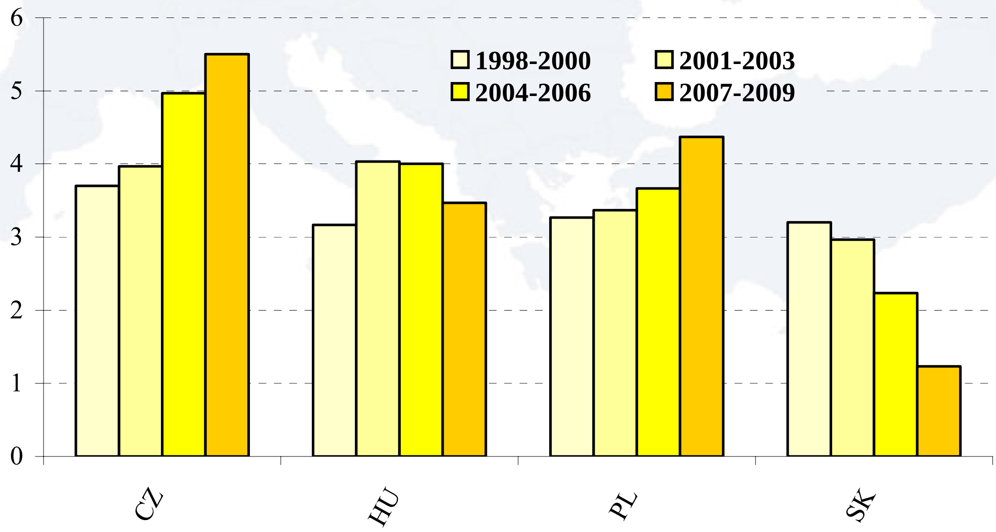
Table 1. Development of revenues, expenditures and investments 1998-2009

Gross fixed capital formation	1998-2000*	2001-2003*	2004-2006*	*2007-2009***	*1998-2009*
Czech Republic	3,7	4,0	5,0	*5,5*	***4,2***
Hungary	3,2	4,0	4,0	*3,5*	***3,4***
Poland	3,3	3,4	3,7	*4,4*	***3,4***
Slovakia	3,2	3,0	2,2	*1,2*	***2,2***
Total general government expenditure	**1998-2000**	**2001-2003**	**2004-2006**	***2007-2009***	***1998-2009***
Czech Republic	42,4	46,0	43,6	*43,7*	***40,6***
Hungary	49,7	49,2	50,6	*47,9*	***45,6***
Poland	42,7	44,3	43,3	*42,1*	***39,8***
Slovakia	48,1	42,3	37,7	*33,8*	***37,3***
Total general government revenue	**1998-2000**	**2001-2003**	**2004-2006**	***2007-2009***	***1998-2009***
Czech Republic	38,3	39,6	40,5	*40,2*	***36,6***
Hungary	44,2	42,5	42,8	*43,2*	***39,8***
Poland	39,5	38,8	38,6	*39,0*	***36,0***
Slovakia	40,4	36,7	34,8	*31,3*	***33,0***

** Factual, **Planned Note: averages of periods*
Source: Eurostat (Date of extraction: Mon, 11 Jun 07 03:51:29), Convergence Programmes of the Czech Republic, Hungary, Poland and Slovakia

As of future expectations, Slovakia continues its general expenditure cut, influencing public investments. Poland accelerates its efforts to reach the target criteria by not affecting significantly public investments. Hungary, however is going to adjust its expenditures remarkably, putting in place the cut of public investments. The Czech Republic will rather accelerate investments. (*Chart 2*)

Chart 2. Gross fixed capital formation 1998-2009 (% of GDP)



Note: averages of periods, 2007-2009 planned
Source: Eurostat, Convergence Programmes of the Czech Republic, Hungary, Poland and Slovakia

CONCLUSIONS

The favourable conjuncture of V4's target markets (EU-15) gives good opportunity for further adjustment by good times. In the same time, this means considerable risk as concerning public finances in case of changing global cycle. The 3% threshold of general government balance is the minimal objective, rather a closed to balance or surplus budgetary position has to be achieved in medium-term (*Council Regulation (EC) No 1466/97 of 7 July 1997*).

Among others, Alessina – Perotti (1999)[1] investigated fiscal adjustments in OECD countries. They came to conclusion that most of adjustments were realised through cuts in investments. (This can be favourable if the crowding out effect of government decreases, giving chance and better conditions for private investments. In countries of V4 the corruption also concentrated in public investments.) However, they argue that a successful adjustment has to be carried out by cuts in non-investment expenditures (social transfers, wages etc).

[1] Alessina, Alberto – Perotti, Roberto [1995]: Fiscal Expansions and Fiscal Adjustments in OECD Countries, NBER Working Paper 5214

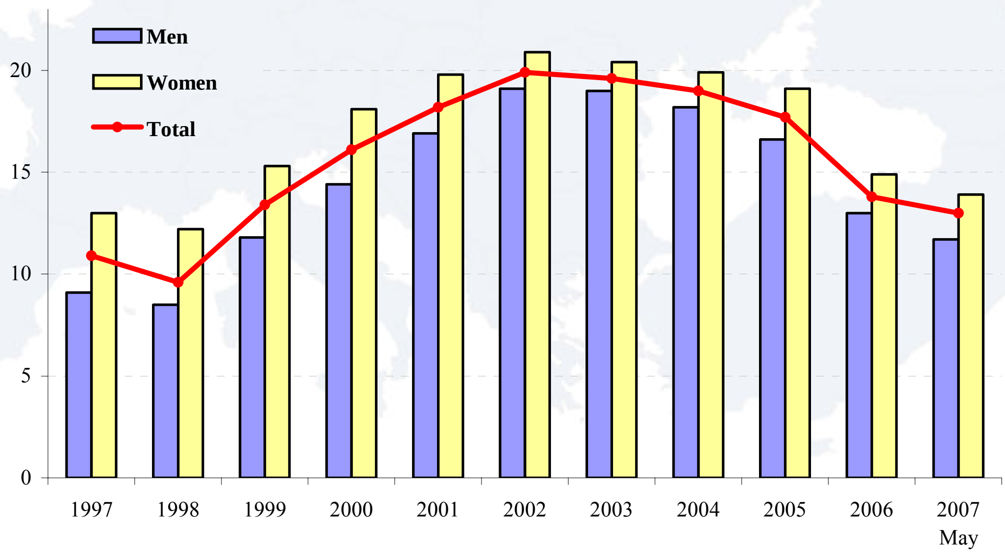
Positive Trends In The Polish Labour Market

According to the Ministry of Labour and Social Policy, the number of people registered as unemployed dropped to 1.99 million people at the end of May 2007, which equals a 0.7 percentage point decrease compared to the unemployment rate of 13.7% in April. There were 590 thousand less people registered compared to the same period of the previous year. Although, official unemployment data of May will be issued by the Polish Central Statistical Office (GUS) only at the end of June, the figures of GUS seldom diverge by more than 0.1 percentage points from the estimates of the Ministry of Labour and Social Policy, thus the decreasing trend of unemployment surely continued in the fifth month of 2007.

Tendencies of Employment and Unemployment

Since the transformation of the political system in 1989, the trends of unemployment have been like a rollercoaster in Poland. The rationalisation of the economy and the decrease in the demand for Polish products in former Soviet countries made latent unemployment visible in the country. In the first three years of the new economic system, unemployment grew rapidly and reached a peak of 16.4% in 1993, becoming the highest in Europe at that time. Newly started private companies were not able to provide sufficient employment opportunities in those years. Thanks to economic stabilisation and dynamic GDP growth between 1994 and 1997 (GDP grew by 27.4% over those four years) 41 thousand new jobs were generated by every 1% growth in GDP and registered unemployment declined. However, new employment opportunities occurred in traditional sectors like industry, construction, agriculture and transport instead of services. After a record low (9.6% in 1998) unemployment rate since the change of regime difficulties started to grow again, as Poland faced again economic slow-down resulting in higher unemployment, with a peak at 19.6% in 2003.

Chart 3. Unemployment rate in Poland 1997 – May 2007



Source: Central Statistical Office of Poland

Because of the introduction of new technologies in industry, the modest GDP growth of the period (14.6% over five years) was not transformed into higher employment. Other reasons for increasing unemployment were privatisation going in hand with rationalising employment, the continued low growth of the services sector (employing only around 45% of the workforce), the decrease in the number of small and medium-sized private enterprises and the reform of the pension and health insurance system encouraging people working in the grey economy. Since the economic recovery started in 2003, Polish unemployment has been continuously decreasing, reaching 13% at the end of May, which is 6.6 percentage points lower compared to the peak of 2003.

Areas mostly affected by unemployment areas are large urban centres and industrial areas. Additionally rural unemployment tends to be of a more permanent character in Poland. Other people facing higher and long-term unemployment are young people, school-leavers, women and people with lower vocational skills and unskilled workers. In case of Polish younger than 25 years old, the unemployment rate was more than double of the national average (26.9%). People with lower vocational skills and unskilled workers are facing a 7 percentage points higher unemployment compared to total unemployment in Poland. In addition, people with a vocational specialisation of retail sale or metalwork have difficulties to find a job within 12 months.

Parallel to decreasing unemployment, average employment increased by 2.2% in 2006. A high rise in employment was experienced in sectors where in 2005 a decrease had been observed such as real estate and renting (3.9%), construction (3.8%) and transport, storage and communication (2.1%). In the branches of trade and repair (5%), financial intermediation (3.3%), manufacturing (3%) and hotels and restaurant (2.6%) dynamic growth continued in 2006, while mining and quarrying (-2.1%), and electricity, gas and water supply sectors (-1.8%) could not break the decreasing trend of employment.

Wages and Labour Cost

Polish average monthly gross wage and salary grew by 4.9% in 2006, reaching EUR 654. Wages of the private sector increased at a faster pace (5.4%), however, from lower basis compared to the public sector (4.7%). The highest growth in wages occurred in construction (9.9%), health care and social work (7.3%), manufacturing (5.3%) compared to 2% in agriculture and 3% in transport, storage and communication.

The minimum wage in Poland is significantly higher compared to other transition countries. Polish minimum wage was at the same level than the Hungarian, but was almost three times as much as the Bulgarian and Romanian one at the end of 2006. In the first five years of transition, Polish minimum wage was revised and increased 21 times. During the same period, there were only 9 revisions in Hungary and Estonia, 2 in the Czech Republic, 5 in Romania and 10 in Bulgaria. However, comparing monthly minimum wages with average monthly wages, it reached 35% in 2004 in Poland being at the lower end of the range among transition countries.

Expectations

The Polish government started several programs in order to decrease unemployment and motivate job creation. In the first years of the transition, it tried to alleviate the difficult situation in the labour market by starting an early retirement program. Because of the high number of unemployed the government had to decrease the funding of passive labour market policies, thus introduced some restrictions on applying for unemployed status and obtaining unemployment benefits. Several active labour market instruments (there were around 100 special programs) were introduced and funded by the Labour Fund before 2002. This number was increased to 238 programs in the period when unemployment rates became again high. However, these programs could produce only little effect on their own. A large-scale revitalisation of the economy was needed to tackle the problem. Other fields of facilitating success could be increasing the flexibility of labour laws and supporting the development of the private services sector.

According to the estimations of the ministry, thanks to booming economy and seasonal employment the unemployment rate is likely to fall to a low of 12.2 – 12.3% in June. In case of continued positive trend, unemployment could drop below 10% by the end of the year, reaching single digits for the first time since November 1998. However, besides economic slowdown, and failures in active labour market instruments, the mobility of Polish workforce could also be a barrier in solving the problem of unemployment. The current unemployment rate takes into account those, who work abroad, but register in Poland, as unemployed, thus official unemployment rates are higher than reality. In case several Polish go back to Poland because of improving opportunities thanks to the economic boom, the unemployment rate could drop significantly in the coming years.

MOLDOVA: HIGH POTENTIAL, WEAK PERFORMANCE

Looking at the basic economic situation of the Republic of Moldova, one can observe what is suspected in advance: Moldova is relatively poor country, especially comparing to other European states. The GDP per capita is USD 2 000 (2006, estimated) whereby Moldova stays at the 152nd place in the world ranking, making the country Europe's poorest entity. In this analysis, the basic economic indicators of Moldova are going to be outlined.

ECONOMIC GROWTH

In case of Moldova one would expect a dynamic economic growth – as it happens in numerous small and poor countries all over the world. From 1995 to 1999 the annual economic growth rates were stable or rather descending. The deepest decline was in 1998 when GDP reduced by 6%. The reason was the Russian financial crisis while the Russian market was closed to the products from Moldova. From 2000, we can observe an average 6-7% annual growth in GDP. Recently, the GDP growth has slowed down to 4% in 2006.

The main reason of last year slowdown was the worsening international trade performance exacerbated by external shocks, above all the actions of the Russian Federation. The price of import gas was considerably increased last year. Additionally, Russia, as the most important economic partner of Moldova, imposed a ban on agricultural and wine products, which are imported from Moldova – alleged that Moldavian law on food production is not sufficient. This appeared in reduction of exports of goods. Thence, representatives of the countries have resumed the ban, which can contribute to the future development, as Russia is the main export market of Moldova.

Regarding to the structure of GDP, proportion of the industrial sector recently dropped to 15% from 71% of GDP. Services sector has become dominant with the share of 56%, whilst the share of agriculture has fallen: in 2006, it was 15.1% (2005: 16.4 %); the remained proportion is filled by net taxes: 16.8%. GDP growth was determined by the increase of GDP in services sector (including in constructions by 14.8%) and net taxes.[2]

FOREIGN DIRECT INVESTMENTS

As the average monthly wage of an employee is relatively low (MDL 1 697 ≈ USD 130-135), foreign investors could have use the advantage of cheap labour. The lack of educated people and the weak performance of institutions despite of low wages do not make attractive the country for investments, not mentioning the political uncertainties. Although according to the survey of Heritage Foundation on Economic Freedom, Moldova ranks 31st (overtaking Poland and Greece), but regarding to the freedom of investments (one element of the index) Moldova performs deeply below the average in Europe. It could be due to weak enforceability of property laws which making the investments vulnerable to take over by the government or the organised criminal structures.

In spite of these, fixed capital investments have been growing rapidly each year (17% in 2006, as compared to 2005). In fact, domestic public and private investments cover more than 60 % of total investments. The share of fixed foreign investments just exceeds 20%, which is relatively low proportion in a developing country like Moldova.

[2] Source: National Bank of Moldova, Annual Report, 2006

Foreign direct investments are growing rapidly. USD 222 million FDI came into the country last year. This includes USD 117 million equity capital and USD 84 million reinvested earnings. Comparing to other countries in the Central-East-European region, this amount of FDI-flow is still very scarce (*Table 2*).

Table 2. Inward FDI Performance, 2005

Country	**Inward FDI (Million USD)**	**GDP per capita (PPP, Million USD)**	**Rank**
Moldova	225	2 818	27
Hungary	6 699	19 559	40
Romania	6 388	9 869	24
Ukraine	7 808	7 637	33
Albania	260	5 702	56
Belarus	305	8 862	113

Sources: www.unctad.org, en.wikipedia.org

The rank-number is a combined index: it is based on FDI inflows comparing to the country's GDP per capita rate. This real index shows that Moldova does not perform badly if we consider the level of GDP.

Wages and Inflation

Wages have a propelling force on development. Higher relative wages mean stronger purchasing power, which promotes higher consumption, private investment level. Nevertheless higher wages motivate people to enter employment and attract skilled workforce. The mentioned aspects foster the long-lasting development of a country. Whereas lower wages can be competitive edge just in the short run – as effect of international equalisation of wages.

As previously mentioned, the average wage in Moldova is relatively low. The real growth rate of annual wage has been increased recently, but the purchasing power of salaries is still very slight. As an obvious effect, in the last decade thousands of people have migrated to find better working conditions. The unofficial number of workers working abroad is estimated to be between 120 000 and 1 000 000: 3-23 % of the whole population (the large deviation of data is caused by the lack of official statistics). Indeed it has a positive impact on poverty rate. Whilst in the late 90s 70 % of the Moldavian population lived in penurious living conditions, until 2006 it fell to 30 %. The remarkable melioration is due to remittances of people working abroad. The problem is that well educated people try to find jobs in other countries, therefore Moldova is poor in qualified and skilful labour.

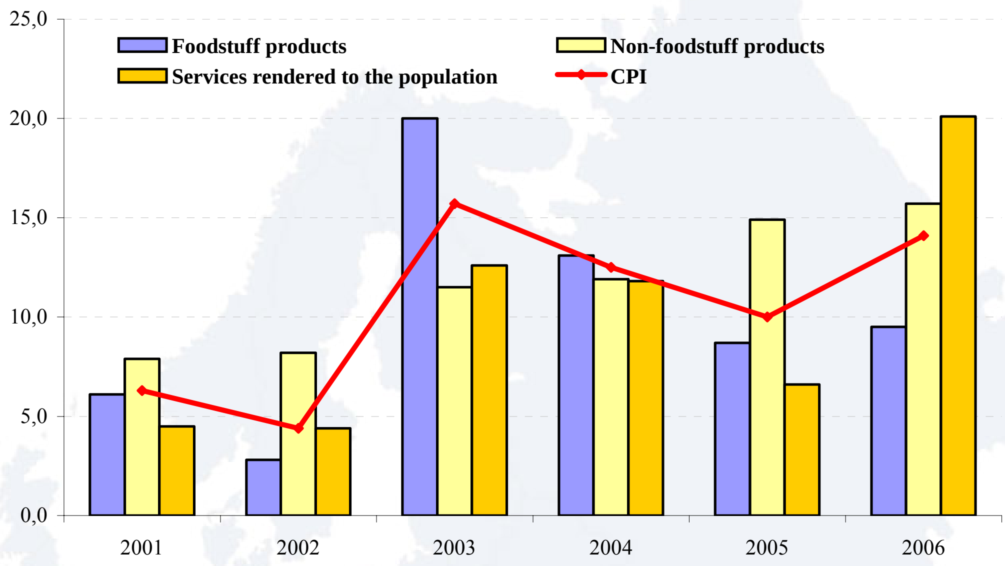
In the last three years the reduction of poverty rate stopped, even the higher GDP-growth could not foster further improvement. The situation is worsened by the desperate stance of rural workers. As world-market prices of foods are increasing and the Moldavian government cannot afford such subsidies as other countries, the rural population is going to be poorer again.

As of labour force, in 2002 the active portion of the population was altogether 45 %. As the average wage was less than the price of minimum basket of commodities, people were not motivated to work. Nowadays the situation is going to be better, but Moldova still needs to be brought into line regarding to wages.

Concerning price developments, the annual inflation rate was 15,7% last year and it was not less than 10 % in the last four years (*Chart 4*). The increasing prices are observable in all sectors of the economy. Last year the prices of services have been increased which foreshadows the further rising of prices in the non-tradable sector – as Moldova is going to be indulged in the stream of world market.

Subsequently Moldova can expect further increase of wages and prices (Purchasing Power Parity).

Chart 4. Inflation Rate and Its Main Components, 2001-2006



Source: National Bank of Moldova

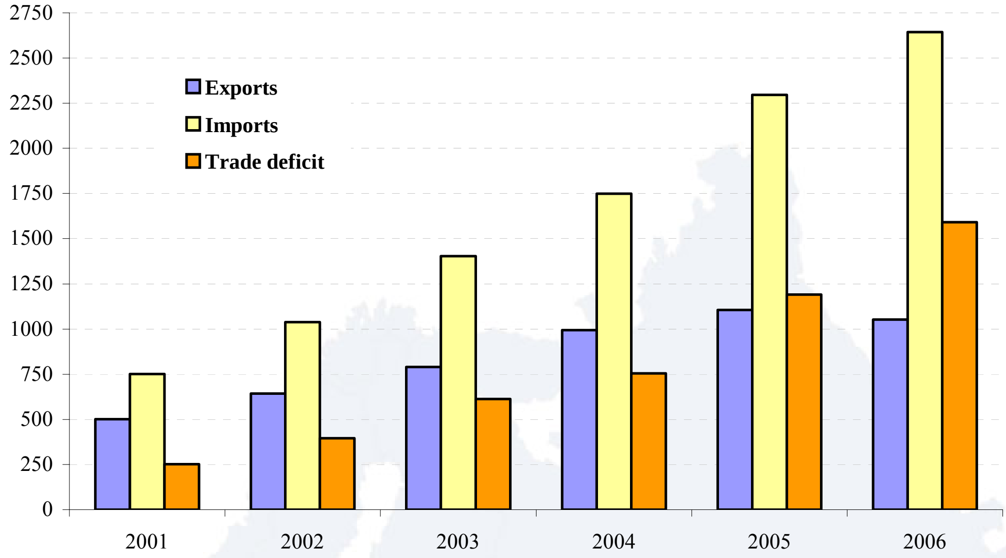
External Relations

Moldavia possesses the attributes, which a developing country has concerning trade balance. Exports and imports are expanding but imports widen with higher rate. Export goods are mainly raw materials, import goods are principally mechanic tools, which accelerate production and development.

The amount of export and import has been increasing rapidly last years. While in 2001 the total nominal value of external trade was USD 1 500 million, it increased to USD 3 600 million last year (*Chart 5*). The more opened an economy is, the more goods and services are imported from abroad. The trade balance of goods was net minus USD 1 590 million last year. The ratio of trade balance to GDP reached -47 %.

The staple exports are agricultural foodstuffs and wine, textiles and textile articles. The country imports are above all mineral products, machineries, electrical equipments. The main partner countries are Ukraine (19 % of total external trade) and Russia (19 % which was dropped to 10 % last year due to the embargo, but it is expected to raise back this year), Romania (14 %), Germany (6,5 %), Belarus (4,5 %).

Chart 5. Development of Exports and Imports and Trade Balance (USD million)



Source: National Bank of Moldova, www.fao.org

CONCLUSION

Moldova is the poorest state in Europe. It means that the country can expect significant development in the future, if one believes in neoclassical convergence theory. Although the Moldavian market is going to be increasingly opened, it is not enough to attract foreign investors – who could help the country's advance. Moldova could not follow the development of other countries in the region. The conditions were not sufficient to become an attractive market to Western countries. The dominance of Russia (including trade problems) also did not help the situation of Moldova. It is high time to exploit the opportunity that the country has low wages, indeed, it can be only a short-run solution. For further development the government should build up a reliable system of institutions, which promotes the security of rights and investments.

In addition they should inhibit the migration of skilled labour. In case of a developing country the educated labour is very important. Effective tool could be the subsidies of IMF aim at poverty and broaden job opportunities, even for skilful workforce.