ICEG EUROPEAN CENTER

NEWS OF THE MONTH
on EU-8 and CIS

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News of the Month, *on EU-8 and CIS*

The ICEG European Center issues its monthly publication, which includes 3-4 brief analyses dealing with underlying macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Countries of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and *Eight New Member States – EU-8* (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia).

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Services trade of selected Visegrád countries – data problems

Magdolna Sass, IE HAS and ICEG EC[1]

Services constitute an increasingly high share of economic activities, reaching a majority share in contribution to the GDP in more developed countries. With technological advancements, especially in the field of information and communication technologies, and with the liberalisation of trade in services, similarly to manufacturing, fragmentation in certain services activities has been made possible. This induced a process of relocation of certain services activities to locations where they can be carried out at lower costs and/or in better quality. Moreover, in the environment which can be characterised with a more and more acute competition, companies concentrate to a greater extent on their core activities, outsourcing non-core activities to dependent or independent suppliers. This outsourcing of services activities, especially those of business services, is a relatively new though more and more widespread phenomenon in the world economy. Due to that process, new countries have been increasingly appearing on the map of trade in services. Among others, countries of East Central Europe, especially the Czech Republic, Hungary and Poland are affected to a great extent, and they have become hosts to various business services through relocations of these activities from other, higher cost locations, especially from Western Europe as well as through the establishment of new capacities.

Services trade as an indicator of the extent of outsourcing and relocation

There are many attempts to determine the relative role of these "new" countries in services relocation and outsourcing. However, many data problems hinder such analysis. Basically, services trade data would provide a good and relevant source for calculating and determining the extent of relocation and outsourcing, because these services activities are highly export-oriented, their export/sales intensity in most of the cases is close or equal to 100%. However, highly aggregated services trade data do not allow to separate those activities, which are involved in the relocation and outsourcing process. (Moreover, even existing services classifications have their shortcomings from that point of view, because at the given level of aggregation, outsourced and "outsourceable" activities are classified together with those, which are not affected by this process.)

Services trade of the three new members

Having a look at the inside-EU-25 services trade of the three selected countries shows, that their share is increasing and that it is higher than their share in the population or GDP of EU-25. It is also apparent, that their turnover shows a positive balance with other EU countries, which is gradually increasing. Moreover, data also show that their services trade is concentrated on other EU-member countries: the share of inside EU-25 services trade compared to outside EU-25 services trade is considerably higher for these three countries, than the average for the EU as a whole. Moreover, at a lower level of aggregation it can also be shown, that the share of "Other Services" and inside that, "Other business services", which are expected to

[1] *This article based on a research financed by the Visegrád Fund in the framework of the project „"Foreign Direct Investment in Central and Eastern Europe: What Kind of Competitiveness for the Visegrád Four?" and by the Hungarian research fund OTKA (68435).*

contain those activities, which are affected the most by the outsourcing and relocation processes, grew dynamically.

Table 1. Share of selected countries in total EU-25 services trade, % (inside EU-25 flows)

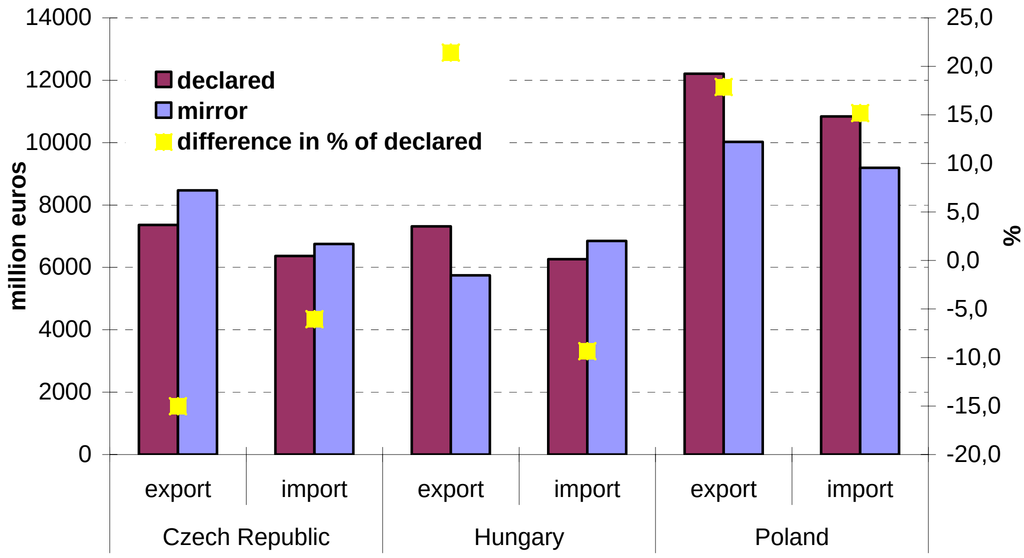
Export	**2004**	**2005**	**2006**
Czech Republic	1.07	1.22	1.24
Hungary	1.10	1.21	1.23
Poland	1.54	1.75	2.06
EU25	*100.00*	*100.00*	*100.00*
Import	**2004**	**2005**	**2006**
Czech Republic	0.91	1.08	1.14
Hungary	1.09	1.14	1.12
Poland	1.52	1.64	1.93
EU25	*100.00*	*100.00*	*100.00*

Source: Eurostat

How reliable are services trade data?

However, the above trends can be taken only as indications, and they tell us nothing about the real extent of the outsourcing and relocation process and the involvement of the Czech Republic, Hungary and Poland in it. As an illustration, let us have a look at the difference between reported (by the above three countries) and mirror statistics. First, *Chart 1* presents data for total services trade in 2006 between the selected countries and other EU member states. It is obvious, how big the differences are between reported data and mirror statistics, especially for Hungarian exports, Polish exports and imports and Czech exports.

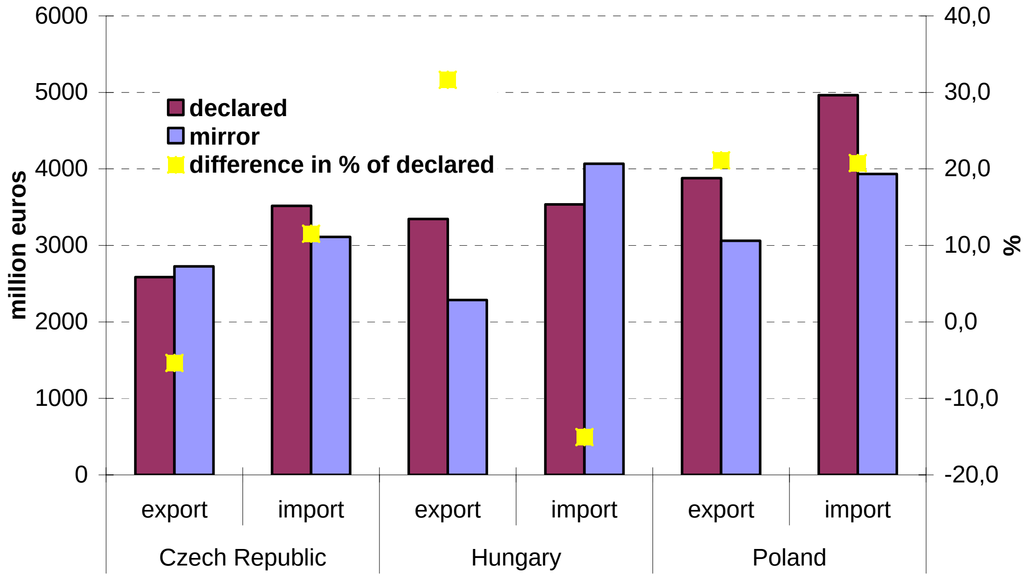
Chart 1. Differences between declared and mirror statistics, total intra-EU27 trade in services, 2006 (million euros and %)



Source: own calculations based on Eurostat data

Differences are not smaller for trade in “Other business”, which contains most of those services activities, which are outsourced and/or affected by relocations. Here, the biggest differences characterise Hungarian exports, Polish exports and imports and Hungarian imports.

Chart 2. Differences between declared and mirror statistics, intra-EU27 trade in “other services”, 2006 (million euros and %)



Source: own calculations based on Eurostat data

Differences between reported and mirror statistics

There is always a difference between reported and mirror statistics, for which the reasons are the following. Time lag between reporting in the two affected countries, different thresholds of reporting, different methods of reporting, impact of the different currencies used in reporting, methods of CIF-FOB conversions, impact of intermediary trade, lack of reporting from some companies and differences in the “inclination” to reporting in the member countries, and different correction mechanisms applied for missing data.

These “usual” problems are aggravated in the case of services by the fact that compared to manufacturing products, it is more difficult to measure trade flows in services because their crossing of the border is mainly unobservable. Recently, the use of the internet-email for “transporting” the results of various services (e.g. consultancy) activities through borders, which is basically unnoticed, also presents a problem. It also poses a problem, that some services activities became digitised and stored and thus can be traded in the form of a good (music, software, films etc.). It is not yet decided whether these are classified as goods or services. However, while some differences between reported and mirror statistics is explainable and can be accepted, these are too big between these two data sets in the European Union that is why it is problematic to use them in trying to assess the extent of changes in relative positions of countries.

Conclusions

Certain services activities are more and more affected by outsourcing, where companies buy these services from foreign service-providers, and also capacities supplying these service activities are in some cases relocated to lower cost locations. The new member states, among them especially the Czech Republic, Hungary and Poland are involved in this process, on the receiving end, namely as hosts to service suppliers or relocated service activities. It would be important to assess the extent of these processes, especially to show what share of service activities is relocated to these lower cost locations. Because of the high export intensity of these projects, data on foreign trade in services would give a good basis for estimation. However, there is a big gap between reported and mirror statistics, which makes estimations based on these data highly unreliable. Though there are serious attempts at reducing the gap between reported and mirror statistics, thus to draw data closer to the “reality”, their results are not satisfactory yet.

Post-war economic prospects of Georgia

Mihály Borsi

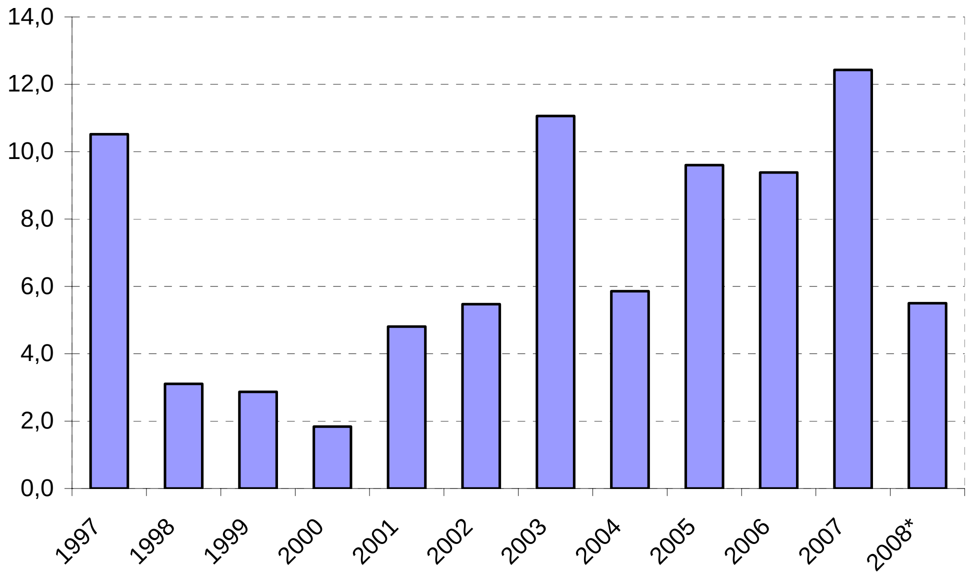
After the failed attack against South Ossetia to regain control over the breakaway province on 7 August, Georgia's six-day war with Russia has led to a downturn in its recently booming economy. Georgia had been considered as one of the region's greatest economic successes despite the two-year-old economic blockade imposed by Russia. The small CIS country's economy has been flourishing since the takeover of President Mikheil Saakashvili in 2004; GDP grew by 12.4% in 2007[2] and was projected to rise approximately 10% this year. Meanwhile, business climate was at its best, reaching USD 2 billion of FDI in the end of 2007. There were even plans to establish Georgia as a Singapore-type financial centre to attract and support foreign investments; however this is frozen for the moment.

As the consequence of war, Georgia has to face new economic problems due to the USD 1.5-2 billion worth of direct and indirect losses estimated by the Economy Minister, Eka Sharashidze. Although international assistance will facilitate the economic reconstruction of the sovereign neighbour of Russia, the investor confidence is broken now as the country's economy is racked with uncertainty.

Effects of war

The war in Georgia did not destroy the economy of the country, but losses are substantial. Sharashidze said on 3 September that the government had revised economic growth forecasts for 2008. A significant slowdown in the economic growth to 5-6% is expected, from the previously estimated double digit growth.

Chart 3. Real GDP Growth of Georgia (%, y-o-y)



**Georgian government estimate*

Source: National Bank of Georgia

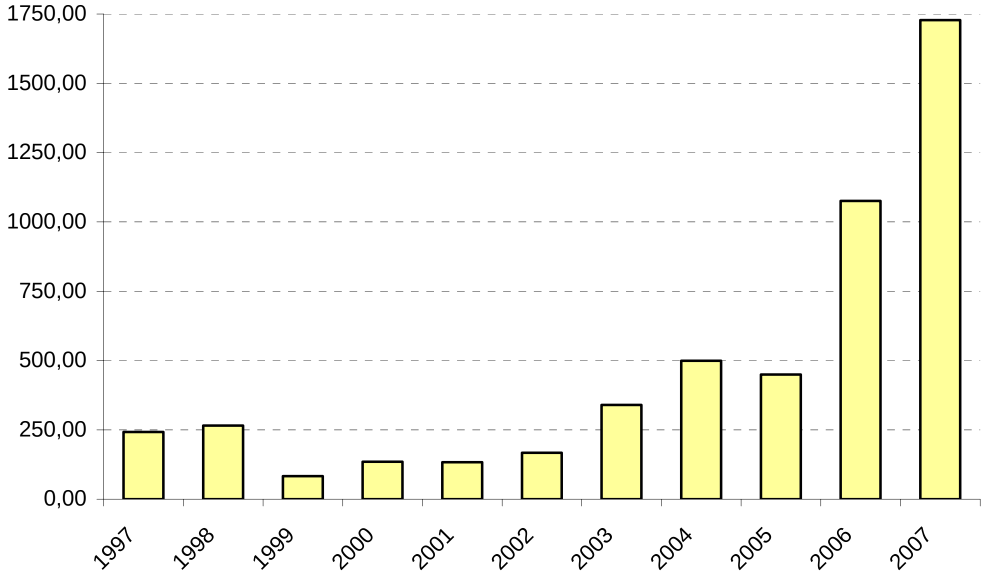
[2] The GDP of Georgia was USD 10 billion in 2007

Russian bombings resulted in the total destruction of military and civil infrastructure in Georgia, including roads, railroad bridges and ports, while factories and residences have been damaged to varying degrees. Most damage is to the country's military, since the recent recipient of USD 2 billion in modernisation has been completely eliminated; Georgia has no more military aerodromes, bases or other necessary objects. According to Michael Davey, regional director for the European Bank for Reconstruction and Development (EBRD), the major impact on business have been these war-related obstructions as logistical issues appeared.

When fighting broke out, the government closed banks for one day in order to prevent citizens from causing a run on the banks, triggering financial collapse of the banking sector. Even so, some USD 100 million has been withdrawn, which equals 5% of the USD 2.1 billion pre-war deposits. Fortunately, most of the money returned to the banks in the following two weeks. Intervention in defence of the stability of the Lari - the Georgian currency - was needed, which involved a cost of USD 300 million[3] for the Central Bank of Georgia, a very high amount relative to the nearly USD 1.5 billion reserves of the country. By lowering interest rates and raising money supply during war, the central bank increased the risk of divergence of the inflationary escalation, one of the weakest points of Georgia's economy.[4]

Concerning public revenues, decline in customs incomes hit the Georgian economy the most, although the situation is gradually improving. The collapse in exports and transit of goods through the country was followed by a 20% fall respective to the forecast. Losses from export difficulties are estimated to be USD 200 million. On the contrary, tax revenues have not decreased that much, they are 3% lower than the previous year at the same period, though a turn for the worse is possible due to difficulties at the borders. Impact on privatisation proceeds was not so harsh either, most privatisation projects planned for 2008 - such as the port of Poti - were completed already before the war has started.

Chart 4. Foreign Direct Investment in Georgia (USD million)



Source: United Nations Conference on Trade and Development (UNCTAD)

The conflict's major effect on Georgia's economy will manifest in the decisions of foreign investors, leading to a significant reduction in foreign inflows in the future. Since 2004, net FDI has quadrupled to nearly USD 2

[3] Russia has spent USD 16 billion to defend the Rouble

[4] Inflation could reach two digit figures this year in Georgia (2008. June): ICEG European Center – News of the Month, page 14.

billion, attracted by untapped markets and the country's willingness for Western integration, which in fact, has contributed to the absorption of the recent shock. Though fights have ended in the country, political uncertainty and continuing tensions still dominate the region, bringing fear to companies that invest especially in the fuel and energy sector.

On the other hand, the government believes that withstanding Russia's embargo for two years and surviving this war proves how strong Georgia's economy really is. Since coming to power, President Mikheil Saakashvili has done much to build up an economy less dependent on Russia. Today, economic relations between the two countries have been reduced to the minimum; Georgia needs about 1.8 billion cubic metres of gas per year, receiving almost all of its oil and gas from Azerbaijan instead of Russia.[5] Moreover, Russia was only main supplier of electricity until the end of last year, when the electric power station in Inguri has reached capacity. This resulted in the stoppage of the 100 megawatts of electricity per year getting to the country through the Kavkasioni transmission lines.

Foreign assistance

Without the substantial aid that Western countries provide, Georgia would probably remain in a difficult situation for a very long time. Aid packages of the sum of USD 3.5-4 billion include humanitarian support for refugees as well as funding reconstruction of infrastructure and the restoration of economy. Political and economic assistance was mainly pledged by the United States and the International Monetary Fund (IMF), amounting USD 1 billion and USD 750 million, respectively.

Since the conflict began, the United States had already allocated USD 30 million in humanitarian aid, and a package of roughly USD 570 million announced on 4 September will come from funds already budgeted for 2008 and 2009. The rest of the USD 1 billion would have to be approved by the successor of President George W. Bush in the White House. In addition, Condoleezza Rice, United States Secretary of State stressed that the assistance is aimed at reconstructing the country and stabilising its economy, and that no military component was planned.

The IMF, whose mission visited Georgia on 23 August, has agreed to allocate the credit of USD 750 million – in the form of an 18-month stand-by arrangement. Main objectives of the arrangement include the moderation of adverse economic and financial consequences of the war as well as support to help sustain the confidence of markets and investors by promoting macroeconomic stability and economic growth.

Overall, the Georgian economy has proved to be flexible and resilient as a result of reforms carried out in recent years, and experts agree that the "unimaginable" amount of foreign assistance provided will help to recover in a short period of time. Nevertheless, foreign direct inflows should not freeze due to political uncertainty, and Shota Makatsaria, Vice President of the Georgian Chamber of Commerce and Industry also pointed out that changes in the composition of private investment are also needed; "the level of investment from the U.S. is very small. America does not even rank in the top 10 investor countries in Georgia. Unfortunately, Russia is No.1."

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[5] Georgia gets another 210 million cubic meters of gas, as a transit fee for the pipeline pumping Russian gas to Armenia, passing through Georgian territory.

Robust but vulnerable economic growth in Azerbaijan

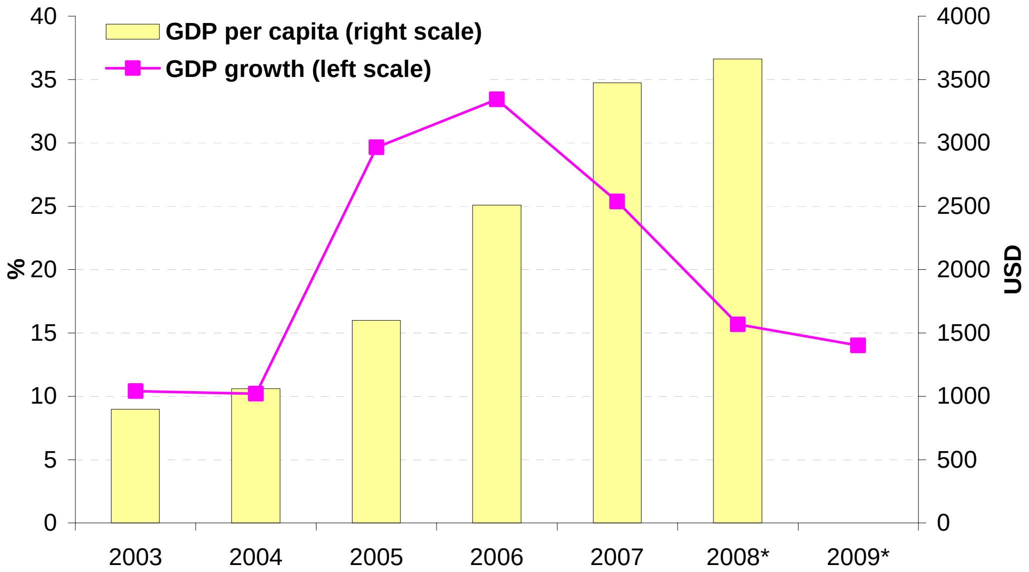
Magai Ágnes

The economy of Azerbaijan has fundamentally restructured since the increase in oil production and operating of the Baku-Tbilisi-Ceyhan (BTC) pipeline. While the economy grew by about 10% during 2002-2005, the annual GDP growth was 29.6% in 2005 and since then Azerbaijan has experienced a robust economic growth. The Azeri economic growth reached an unprecedented 33.4% in 2006, making the Central Asian country the fastest expanding economy in the world. 2007 was the third consecutive year with an economic growth of above 20%, namely 25.4%. *(Chart 5)* In January-August of 2008 the Azeri GDP was 13.2% higher as compared to the same period of the previous year. Strong economic growth has been fuelled by the booming oil sector. The high oil revenues have had positive and negative consequences as well. Exports of oil and gas have led to a significant current account surplus and strong currency appreciation in real terms. Budget revenues increased significantly, allowing a large increase in public spending. Large currency inflows from oil exports and increasing government expenditures have contributed to accelerating inflation.

Economic growth remained high

A GDP growth of 25.4% in 2007 was propelled by surging crude oil production and exports, which grew by 31.5 and 39.1%, respectively. This performance is attributable to the increased production of the largest oil exporter, the Azerbaijan International Operating Company. GDP per capita income more than doubled in the last 3.5 years. It made USD 3 662 in January-August 2008, while it stood at USD 1 060 before oil production boom in 2004 and at USD 665 in 2000. *(Chart 5)*

Chart 5. Real GDP growth and GDP per capita, 2003-2009

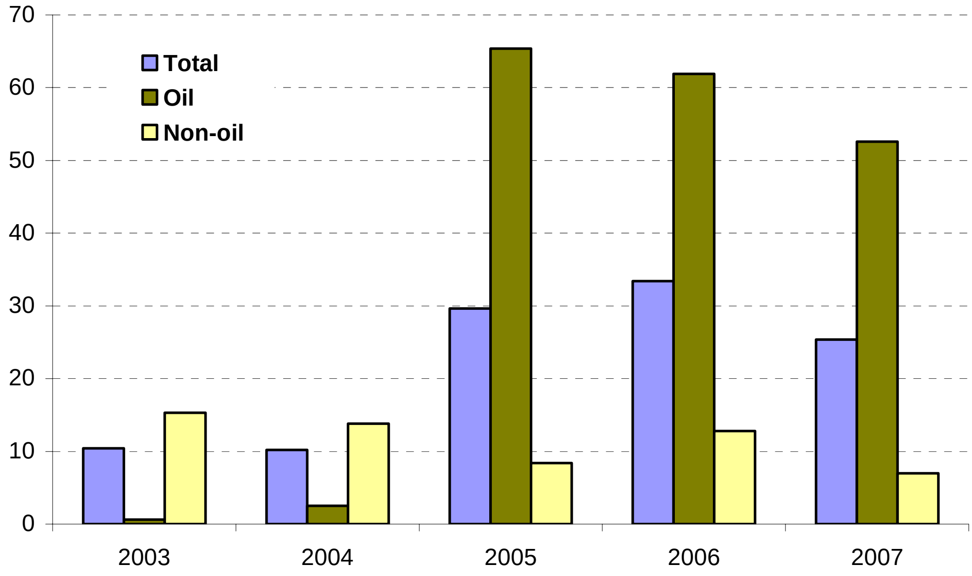


**forecasts for real growth in 2008 and 2009, GDP per capita data of 2008 refers to the first eight months*

Source: State Statistical Committee of Azerbaijan, Asian Development Bank, Asian Development Outlook 2008

Dominant role of oil sector in economic performance is eye-catching since 2005. Before the opening of the BTC growth of non-oil GDP growth was higher than that of oil-GDP. *(Chart 6)* Last year oil and gas extraction accounted for 52.9% of gross value added. *(Chart 7)* and more than 60% of manufacturing GDP, reflecting the economic dependency on hydrocarbons. The oil plays a significant role in the non-oil sector as well; spill-over effects can be well observed in machinery, chemical industry, construction and telecommunication.

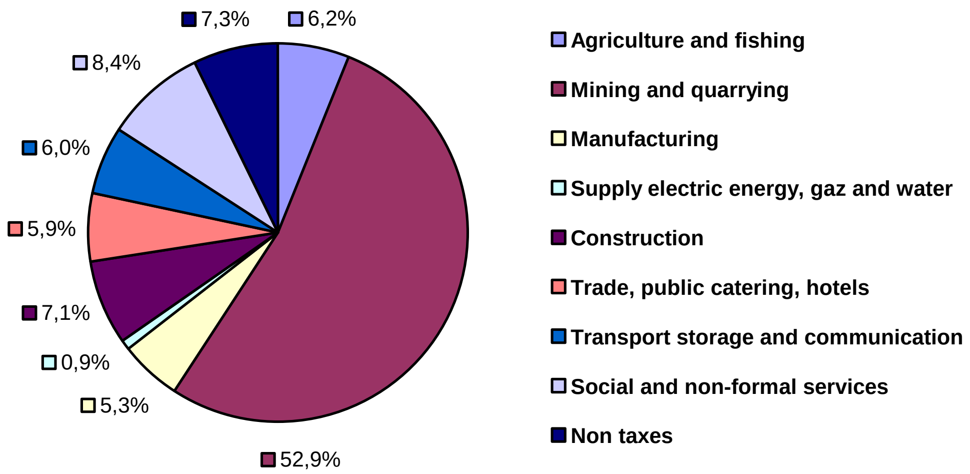
Chart 6. GDP growth by sectors, 2003-2007 (%)



Source: Asian Development Bank, Asian Development Outlook 2008 Database

Economic diversification would be essential in Azerbaijan; production growth of the non-oil sector is inevitable for long term sustainability. Last year weight of non-oil sector in economic growth declined again despite of strong expansion in services and construction. Production of services in 2007 was 25.1% higher than in 2006, construction grew by 19%. Communication and transport services were the main drivers within services, which account for 6% of the total GDP. Gross value added of agriculture declined by 1.7%. This can be partly explained by the appreciation of the manat, which stimulated import of agricultural commodities.

Chart 7. Structure of GDP by main sectors of economy in 2007 (% of total)



Source: State Statistical Committee of Azerbaijan

On the demand side net export and consumption underpinned economic growth, while gross fixed capital formation in 2007 was at lower level than in the previous year.

Economic prospects and main policy challenges

Economic growth has remained also robust this year. According to the *State Statistical Committee of Azerbaijan* in January-August gross domestic product grew by 13.2% as compared to the same period of the previous year. Strongest increase was reported in construction (38%). Within services postal services and communication as well as hotel and catering services grew by 31.7% and 34.1%, respectively. In 2008 and 2009 real GDP growth rate is projected at 15.7% and 18.0%, respectively.[6] *(Chart 5)*

Foreign direct investments have contributed to investment growth in the past decade, but it declined significantly in 2007. Further decline in FDI is expected, since several oil and gas exploration projects have already completed. During the first eight months of 2008 fixed investments were up 36.6% as compared to the same period of the previous year and domestic investments exceeded foreign investments. Investments of state-owned units were relative high, they accounted for 62% of total investments in this period. Increase in domestic private sector investments (and particularly in the non-oil sector) would be essential for sustaining economic growth in the long term. For this it is necessary to improve the business environment. The government made already efforts to improve the business climate in the country; Azerbaijan has been declared as the world leader in economic reforms and ranks currently at 33rd place in the global ranking[7] according the latest *Doing Business Report*.[8] Due to better conditions in doing business domestic and foreign investors are expected to become increasingly interested in setting up business and realising investments in Azerbaijan.

While economic growth remains impressive, risks to macroeconomic stability have intensified. One of the most important tasks is to cut inflation, which turned to be double digit at the end of 2004. After some deceleration of consumer prices in 2006, fiscally induced demand pressures and foreign currency inflows from hydrocarbon exports as well as high import commodity prices and raised public utility tariffs caused acceleration in inflation in 2007. The external environment and substantial increases in wages and social transfers put further pressure on inflation during this year. Azerbaijan, however not alone in the region, experienced more than 20% inflation rate in summer of 2008. Consumer prices are not expected to decline, the Asian Development Bank projects 16.0% inflation rate in 2008 and 18.6% in 2009.

Continuing growth in oil export volumes in the next year, accompanied by high global oil prices, will maintain current account surplus at 38-40% of GDP. Recent years can be characterised by an expansionary fiscal policy in Azerbaijan. It is essential to moderate the growth of public expenditures in order to keep the non-oil fiscal balance at a sustainable level.

Reducing dependency on the oil-sector and diversifying the non-oil sector are important development challenges. Further improvement of the business environment through sustained anti-corruption measures is also essential for sound development.

6 Asian Development Outlook 2008 Database

7 Out of 181 economies

8 www.doingbusiness.org