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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Monetary restriction in a non-supportive environment in Hungary

Gábor Kutasi

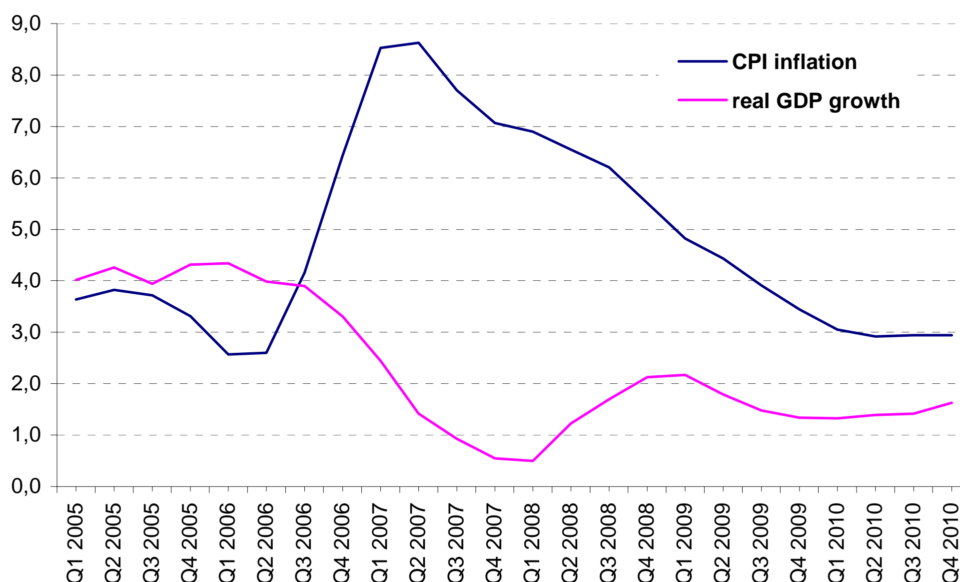
In the last one month the Hungarian political parties created an unintended occasional "coalition" in bringing the National Bank of Hungary (NBH) to book for insisting on low inflation target and strict monetary policy to keep the target, when, in the global economy, the international inflation trends moving toward a higher level. The politicians considered the ongoing increase of central bank rate to be questionable in such a situation.

However, the first question should be, why the high inflation is considered to be trouble, and then the raise of the interest rate will not be questionable. On one hand, the higher inflation supporters are right that the increase of prices can raise tax revenues and have the wage competitiveness to be improved, as the real wage gets inflated, moreover, the export competitiveness will be also strengthened through the depreciating forint. At least, that is in the focus of the politicians' thinking about the monetary channel.

Inflation threats

However, the inflation is considered to be a source of economic risk in the mind of market participants: the risk of worsening predictability and declining calculability, what means threat for owners of direct investments generating economic growth and jobs. Besides, the loss in purchasing power of real wage is counterweighted by nominal wage increase. And the case of export competitiveness is any way favourable, as the trade balance has shown surplus already in 2007.

Chart 1. GDP and inflation, 2005-2010 (%)



Note: 2005-2007 facts, 2008-2010 NBH projection, Source: NBH

Although it is true, that the boom dynamics of oil and food prices created a higher inflationary level in most of the countries in the world during the last one and a half years, but it must be clear that the non-monetary channels of adjustment to international inflationary shocks are not working well enough to ensure the achievement of price stability target in the next three years. Which channels are mentioned? The change of wages, what should not rise so much to create less real money supply for consumers, and the fiscal adjustment, what could counterweight the increase of prices by threatening from consumption.

Policy environment of the NBH decisions

The efficiency of non-monetary channels mentioned above is fairly doubtful. The increasing minimum wage gives a push to any wages, as it is a reference level for the higher added value jobs, especially among the upper-secondary, technician workforce. The NBH recognised significant relation especially in case of skilled workers.

The temporary results of fiscal consolidation in 2006 and 2007 is unambiguous, but it must be kept in mind, that the Hungarian political business cycle got now over its half term, and after that, according to the past experiences, the promised fiscal discipline in the coming years should be treated carefully.

Besides, the existing national tax system does not help the anti-inflationary targets. Many economic research institutes and advisor bodies suggested uselessly to the government to counterweight a possible corporate or payroll tax cut with VAT increase, these recommendations have not been applied. However, raising the VAT would cause less worries, that the too high national bank rate motivates the Hungarian households to get indebted in foreign currency, since increasing tax on consumption would restrict the household purchases.

Otherwise, the latest publication of inflation data on May acknowledged the pessimism of the monetary decision makers, as – unlike the expectation – it started to speed up instead of slowing down, mostly because of world market impacts.

There is a serious reason why monetary restriction is criticised very much, the appreciating national currency rate. First of all, in long term, a permanently undervalued exchange rate just ease the pressure of cost efficiency on producers, so the comfortable situation could result lagging behind. Besides, if the purchasing power value and the exchange rate of the Forint get compared, it will be clear, that even a 240 HUF/EUR rate is also favourable for the Hungarian economy. Thus, it is possible, that Hungary can achieve improving trade balance beside an appreciating currency.

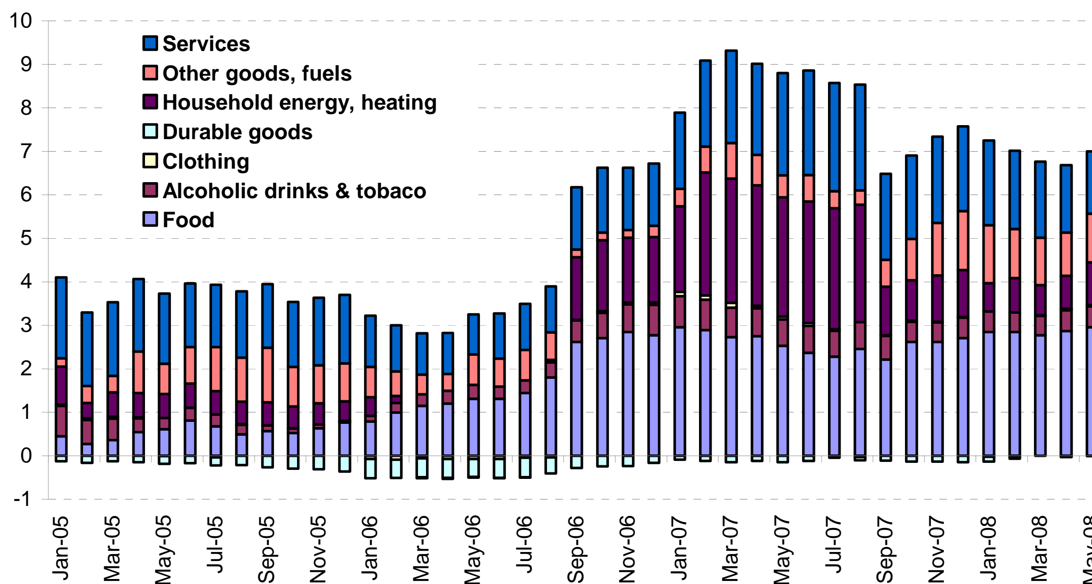
The raise of central bank rate is also very costly for the public budget, as it is very seriously indebted, and half percentage in the rate means about 0.2-0.3% of the GDP. But this can not be a primary aspect in policy decision making, since the debt is a stock resulted by the past decisions, however, central bank rate targets future procedures. However, the repurchase of bonds denominated in foreign exchange gets cheaper for the debt managing government.

How disadvantageous could be the increasing central bank rate?

The increasing central bank rate – 8.5% during the writing of the paper, but it may be 8.75 when it will be issued, and 9% till the end of 2008 – will have significant impact on inflation what will be shown at least in the core inflation as the oil and food price boom are quite independent from the national economic policies. This will improve the predictability and calculability of the national economy, thus, result more favourable business environment. At least, this can be read from the market expectations. Since, meanwhile, the short term interest rates rising in parallel way with the central bank rate, decline can be approached in the long term (over-year) rates. This is the so called expansionary effect, what has been still only mentioned in case of fiscal policy. The meaning is that consolidation and restriction in the present project more favourable business environment in the future for the market participants.

So, the market participants send a positive feed-back to the strict Monetary Council of NBH. There is also a reasonably strong conviction that the monetary decision making based on long term economic rationality will resist the pressure of parliamentary parties based on short sighted political rationality.

Chart 2. Hungarian inflation and its components, 2005-2008 (%)



Source: KSH, ICEG EC forecast

Otherwise, the monetary policy will be more or less disciplined; the inflationary forecasts worsened the expectations in one year view. Actually, the higher inflation was hidden already in the data of April just the cancellation of visit fee cut significantly the price of health care services. In May, the speed up of energy and food prices affected on the consumption of households that has about one third share. Also, the gradual liberalisation of official prices got built in the prices in May. Generally it seems that the inflationary pressure generated by global market trends will remain also in 2009.

Skyrocketing inflation threatens Ukraine

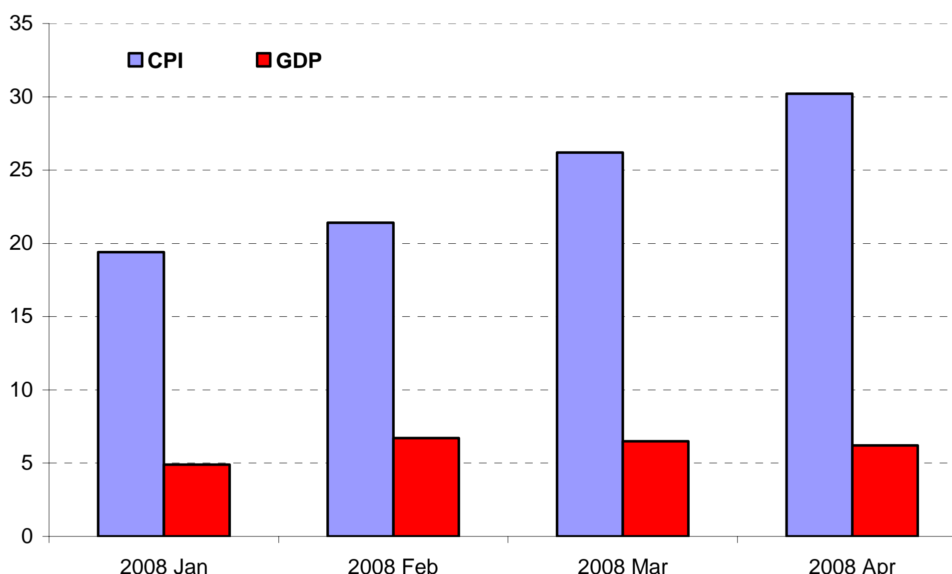
Mihály Borsi

Ukraine had the highest inflation rate among the CIS (Commonwealth of Independent States) countries in the first quarter of 2008, fuelled by high costs of imported energy and constantly rising food prices as well as other relevant factors. Inflation rate hit 30.2% year-on-year in April, - exceeding all official and experts' predictions – becoming Ukraine's most urgent economic issue to be solved. Besides populist social expenditures of the newly elected Prime Minister, Yulia Tymoshenko, Ukraine's peg to US dollar could be the real reason for the extreme heights in consumer prices. The US dollar peg not only makes Ukraine import inflation but also generates additional increase in prices that undermines the country's competitiveness. The government targets 2008 inflation at a 9.6% annual average with yet unveiled anti-inflationary measures, although final results remain dubious.

Factors contributing to the spike in inflation

Ukraine reported a strong economic growth of 7.3% based on high private domestic demand combined with an annual inflation of 16.6% in 2007, according to official statistics. Record heights in consumer prices continued in 2008, registering an inflation rate of 30.2% in April, up from 26.2% in March and 21.9% year-on-year in February.

Chart 3. CPI inflation and real GDP growth (%, monthly, y-o-y)



Source: State Statistics Committee of Ukraine

Current spike in inflation is a result of several factors, such as rising global food prices, higher charges for imported gas, significant increase in budgetary spending and inflationary expectations. While food prices and rising energy costs have a severe impact on inflation, most of the pressure can be attributed to the National Bank of Ukraine's (NBU) low exchange rate policy, pegging the local currency to US dollar since 2000. With the exchange rate fixed, Ukraine imports the inflation of rising international prices through its US dollar peg.

The surge of food prices is a global problem at present; however the case of Ukraine is exacerbated by the devastating drought and exceptionally poor harvest seen in 2007. Existing export quotas for grain harvested

in 2007 was extended in order to fill up the grain reserves and achieve bread price stability. Even more, sunflower seeds and oil export quotas[1] were introduced for the period from 22 March until 1 July, which took negative effects on the economic competence of Ukraine concerning its foreign trade. The price of bread has risen by more than 20% in each month this year, and the price of vegetables by an average of 57%. The largest gains have been registered in the price of eggs and edible oils, by a quarterly average of 68% and 115% respectively. Sharp increases in meat and fruit prices in March have boosted inflation as well; hence a Memorandum with meat-processors was signed by the government to limit further acceleration. Fortunately it is expected that inflation decelerates in the second half of 2008 given improved harvest conditions for the season.

Gas prices have also played a major role in Ukraine's inflationary tendencies. The country relies on imports for about 70% of its energy, mostly from Russia. Consumer prices rose immediately after Russia doubled the cost of natural gas sold to Ukraine in 2006 and raised it another 38% in 2007. In 2006 imported gas was USD 95 per thousand cubic meters (tcm), while most recent agreement signed between the government and Russian Gazprom raised prices to USD 179.5/tcm in 2008[2].

Above all, current government policy is rather stoking inflation instead of soothing it. Over the past years the Ukrainian fiscal policy has been characterised as pro-cyclical; total pension payments have been recently set to the subsistence minimum level, whilst sharp increases in state salaries and minimum wages have boosted consumption. Real household incomes grew by 16.7% in 2007. Excessive social expenditures are partly attributable to populist policies of Yulia Tymoshenko, the new Prime Minister approved on 18 December. Within weeks of forming the government, Tymoshenko began to execute a previously pledged compensation paid to those who lost Soviet-era savings when the state savings bank collapsed in the 1990s. So far, 2.7 million people have received the one-time payment. Moreover, it is commonly assumed that she wants to become president in 2010, when the next election is due; therefore on average, social spending will increase by approximately 30% this year. Given the positive dynamics of the state revenue collection and the development of strong privatisation trends, a state budget deficit of 2% of GDP is projected for 2008. According to Finance Minister Viktor Pynzenyk, a budget surplus of 0.6% of GDP was recorded during the first quarter of 2008.

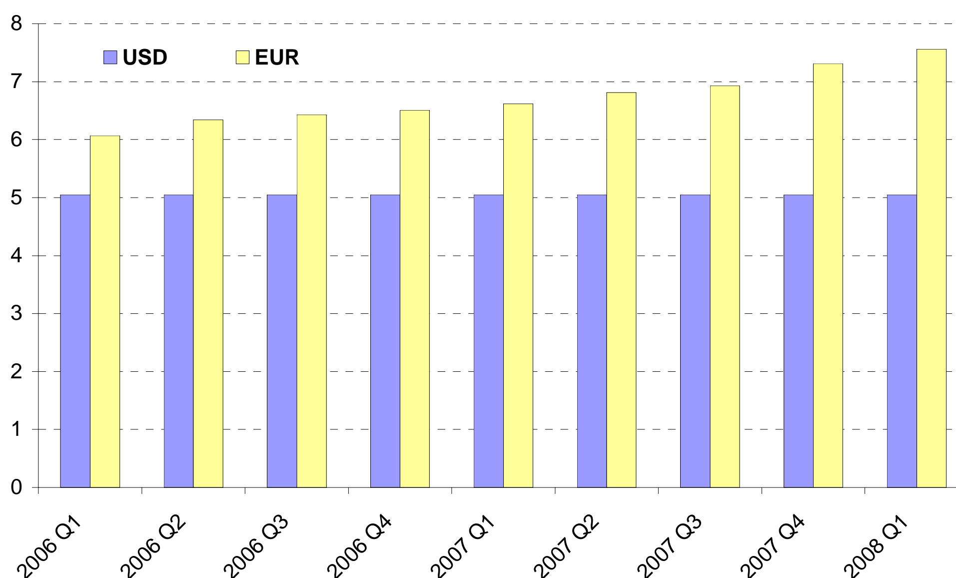
Low exchange rate policy

The official currency rate has been *de facto* pegged to US dollar since 2000, fluctuating within a narrow band of 5.0 and 5.05 UAH/USD since 2005. The International Monetary Fund (IMF) has called on Ukraine to free its exchange rate and introduce and inflation targeting regime several times before to avoid a possible financial crisis, since the hryvnia is significantly undervalued and the huge amount of inflow of foreign capital continues to put even more pressure on the exchange rate. The NBU rejected the idea, making Ukraine the last country in the region to tie its currency to the US dollar. As a result, Ukraine imports inflation of rising international food and energy prices through its peg due to constant devaluation of US dollar against the euro.

[1] 1000 tons for seed and 300 000 tons for oil

[2] Ukraine buys gas from Russia at the rate of $179.5 per thousand cubic meters, 40% cheaper than global prices of $250 per unit

Chart 4. Official Exchange Rate (quarterly, average of the period)



Source: State Statistics Committee of Ukraine

Experts as well as the Organisation for Economic Cooperation and Development (OECD) agree on liberalising the Hryvnia and allowing it to appreciate against the US dollar as soon as possible.. However, despite the fact that the Governor of the NBU, Volodymyr Stelmakh has already talked about the relaxation of the currency band last year, no measures have been introduced yet. The peg has also constrained the central bank to maintain a loose monetary policy that led to a negative real interest rate of 10% a year. Consequently, Ukraine's monetary base increased by 45.6% year-on-year while money supply by 52.4% in April 2008, inducing higher rate of inflation combined with an excessive fiscal policy

Future Prospects

According to Yulia Tymoshenko, Ukraine needs approximately five or six months to overcome the ongoing crisis and reach the official target of 9.6%, although Ukrainian and international analysts are sceptical about the pledge of the new Prime Minister. The International Monetary Fund forecasts a much higher average annual inflation rate of 20-22% for 2008. Ihor Shumylo, the executive director on economic issues at the NBU said that a more stable political situation in Ukraine should help to balance supply and demand for foreign currency, while capital inflows and foreign direct investment should remain at last year's level due to the government's privatisation programme. Thus the bank expects a 15-16% inflation rate, still significantly above the target of 9.6% set by the previous cabinet.

Anti-inflationary measures must include persuasion of higher tax collection rates, liquidation of corruption, moderate wage rises and the maintenance of a broader target of 4.95-5.25 UAH/USD until the final liberalisation of the exchange rate. Furthermore, the government should lower its economic growth forecast for 2008 in order to accommodate anti-inflation. Keeping the domestic gas prices low despite rises in Russian imports is considered one of the hardest decisions, whilst excessive spending will continue in 2008. Although this year's improved harvest is favourable for the development of consumer prices in 2008, it is still doubtful that inflation rate hits the official target; most likely, price growth will be close to double that level.

Major shifts in the country composition of Hungarian goods export

András Oszlay

Up until the middle 1990s, the share of the fifteen ‘old’ member states of the European Union was continuously increasing in the country composition of Hungarian goods export. This was partly explained by huge direct investment inflows from these economies resulting in intense trade activity between affiliates located in Hungary and their parent companies. Another source of this increasing share of ‘old’ EU member states (hereafter EU-15) was very depressed demand on part of the economies of the former Eastern bloc. By the middle of the previous decade, the EU-15 country group became the destination of almost 80% of Hungarian goods export.

This ratio began to slowly decrease, as Central and Eastern European economies turned on a stable, rapid growth path at the end of the 1990s and their demand for Hungarian goods increased. Multilateral agreements and Treaties (most notably CEFTA) also contributed positively to external trade links between these economies. Finally, in May 2004 eight former centrally planned economies entered the European Union, and this created a further push for intensifying trade relations.

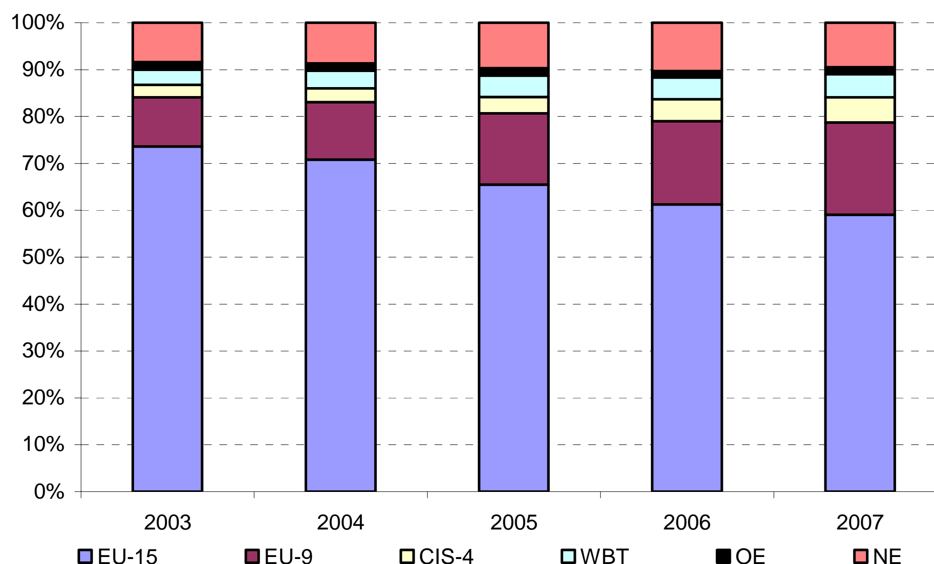
Where does Hungarian goods export go?

The main destination of Hungarian goods export – as is the case for all Central European economies – is Germany, which possessed a 28.3% share of all Hungarian goods export in 2007. It should be noted, however, that this is almost 10 percentage points lower share, than in 1999, and it is still declining quite rapidly. With a share of 5.5% Italy comes as the second largest export market for Hungarian goods and France has the ‘bronze’ with a 4.7% share. Austria, which in the middle of 1990s was the destination of close to 12% of Hungarian goods export, now only has a share of 4.5%, and was also overtaken by Romania and Slovakia (each had a 4.6% share) in 2007.

While these figures themselves clearly exhibit, that the country composition of Hungarian goods export underwent a major shift in recent years, it is indeed revealing to take a look at Hungarian exports by country groups and track the period between 2003 (the last complete calendar year before Hungary joined the EU) and 2007 (the last annual data available). When a country joins an economic union, usually two effects are expected to take place in the case of foreign trade: a trade-enhancing and a trade-switching effect. The first is the direct result of the abandonment of customs duties and non-tariff trade barriers (e.g. quotas) among countries that are now member countries in the same economic union. Trade-switching is partly also explained by this, as in the absence of these trade barriers the direction of trade changes: new trade links will be created with other member countries of the union, while older trade links with countries that remained outside the union will lose their significance or even completely disappear. This is further complicated by direct investments: enlargement of an economic union may lead to relocations, increased mergers and acquisitions, the outcome of which is not obvious a priori.

As the chart below clearly shows, the EU-15 country group gradually lost its share in the country composition of Hungarian goods export. In 2003 73.6% of Hungarian exported goods was landed in this country group, but in 2007 this ratio fell below 60%. This loss of share masks the fact, that the value of Hungarian export into this country group increased by more than 40% in this period (at current prices), thus trade with the older countries of the European Union indeed accelerated as expected, but in other directions the expansion of trade links were even stronger.

Chart 5. The composition of Hungarian goods export by country groups, 2003-2007



NE: non-European countries; OE: other European countries (e.g. Iceland, Norway, Switzerland); WBT: West Balkan countries (Albania, Bosnia, Croatia, Macedonia, Montenegro, Serbia) and Turkey; CIS-4: Belarus, Moldova, Russia and Ukraine; EU-9: Bulgaria, Czech Rep., Estonia, Latvia, Lithuania, Poland, Romania, Slovak Rep. and Slovenia; EU-15: the 'old' member states.

Source: KSH (Central Statistical Office)

This is especially marked in the case of the EU-9 country group that consists of the seven Central and Eastern European countries that joined the EU together with Hungary plus Bulgaria and Romania who became members in 2007. Their share in Hungarian goods export was hardly above 10% in 2003, but was just below 20% last year. Slovakia and Romania are respectively the fourth and fifth largest destinations for Hungarian export; they were also the most important targets for outward foreign direct investments as well. Poland and the Czech Republic also has a considerable share (around 4%) of Hungarian goods export. Bulgaria and Slovenia each has a share of about 1%, while the combined share of the Baltic States is not more than 0.5%. In the four years between 2003 and 2007 the value of Hungarian goods export to EU-9 more than tripled.

Another direction of outstanding export growth is the European CIS economies (Belarus, Moldova, Russia and Ukraine), the CIS-4. The value of exports to these countries increased by 260% between 2003 and 2007, and thus their combined share reached 5.4% by the end of the period. Especially Russia becomes an ever more important destination for Hungarian goods export.

West Balkan countries' (Albania and the former Yugoslav republics apart from Slovenia) and Turkey's importance as export destinations also increased in the period, from a share of 3.2% in 2003 to 4.9% in 2007. This country group also has further potential to dynamically increase their demand for Hungarian exports, as Croatia, Macedonia and Turkey are all candidates for a relatively close EU accession.

The remaining European countries (Cyprus, Iceland, Malta, Norway, Switzerland) are more similar to the EU-15 from the viewpoint of Hungarian exports, as export growth to these countries was lower in this four-year period than the average, thus they also lost some share. Non-European economies have a fairly stable share of around 9% in Hungarian goods export. Within this, however, a small shift is taking place: the United States' share fell further to just 2.4%, while Asian economies (especially China) were increasing their shares.

Are there any implications of this shift?

Hungary's recent growth performance is one of the weakest in Europe, and was certainly the weakest in the region in 2007. The only reason, growth remained positive at all last year was the good export performance that was supported by strong external demand.

The global business cycle, however, peaked out in the middle of last year, and Hungary's most important trading partners now face a deceleration of their GDP-growth. Rising energy, raw materials and food prices even increase the likelihood of a sharp deceleration. As this could translate into weaker external demand for Hungarian export, there is a danger that the net export component could no longer contribute to Hungarian GDP-growth considerably for a while.

However, the above depicted shift in the country composition of Hungarian goods export partly offsets the overall deceleration of external demand. As we could see, the shares of the EU-9, CIS-4 and WBT country groups as destinations for Hungarian export were dynamically increasing, i.e. Hungarian export was redirected into those country groups that, where economic growth remains rapid.

Indeed, while according to the latest official forecasts the EU-15 country group can – on average – increase by somewhat less than 2% in 2008 (and probably somewhat slower than that in 2009), EU-9 countries will still expand at a rate of close to 5% (among them Slovakia at 7%, Romania and Bulgaria at close to 6%), and CIS-4 and WBT countries will also enjoy average GDP-growth in the range of 4-6%. The changes in the Hungarian export's country structure thus imply that a decreasing share of exports is directed to countries where growth rates are expected to be low, while fast growing economies' share is increasing.

Thus, constructing an index of external demand by multiplying the forecast GDP-growth of Hungary's most important trading partners by their shares in Hungary's goods export and summing up, the slowdown derived from the evolution of this index based on the recent country weights is significantly smaller than on the older weights. This partially offsets the negative consequences of the overall slowdown in the external business cycle on the external demand for Hungarian goods and services.

Revalued national currency in Slovakia

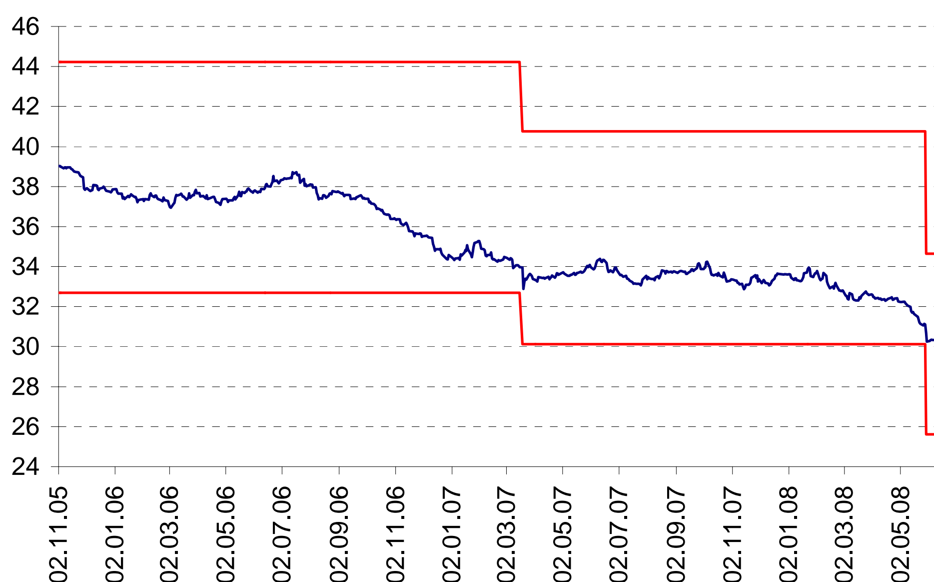
External expert

The markets were surprised by the decision of the European Commission at the request of the Slovak government - especially Robert Fico. Namely, by the appointment, the intervention band of Slovak koruna was re-valuated and the central parity was strengthened by about 15 percentage points from 35.4424 to SKK/EUR 30.126. Not the strengthening, but its unexpected measure, which caused the surprise besides the market analysts. 30.126 is exactly the previous lower rate of the fluctuation band.

Imminent euro zone accession

At 7 May 2008, the European Commission approved the intention of the Slovak Government for the euro zone accession on 1 January 2009. It means if Slovakia fulfils the requirements, they are entitled to adopt the euro next year. The exchange-rate-relevant requirement is keeping national currency at a relatively stable level, thus spending at least two years in the Exchange Rate Mechanism II (ERM II). In this system, the national government and the European Central Bank (ECB) set a central parity for the national currency against the euro with a ±15 percentage-point range for free floating. During the mentioned two years, the national currency is allowed to float free in this 30-percentage territory, but it mustn't go beyond either the upper or the lower limit.

Chart 6. Development of the SKK/EUR exchange rate, 2005-2008 (daily)



Source: National Bank of Slovakia

Slovakia joined the ERM II system on 26 November 2005 with a central parity of 38.455. From the setting time, the koruna was stable around the central parity till the second half of 2006, after that, it has been getting much stronger. Decision makers first had to confront the danger that the exchange rate can go beyond the strong side of the fluctuation band at the beginning of 2007. As a reaction, the European Commission in arm with the Slovak Government shifted the exchange rate band to the stronger direction by setting the central parity at 35.4424 SKK/EUR. This implies new band limits of 30.126 and 40.758.

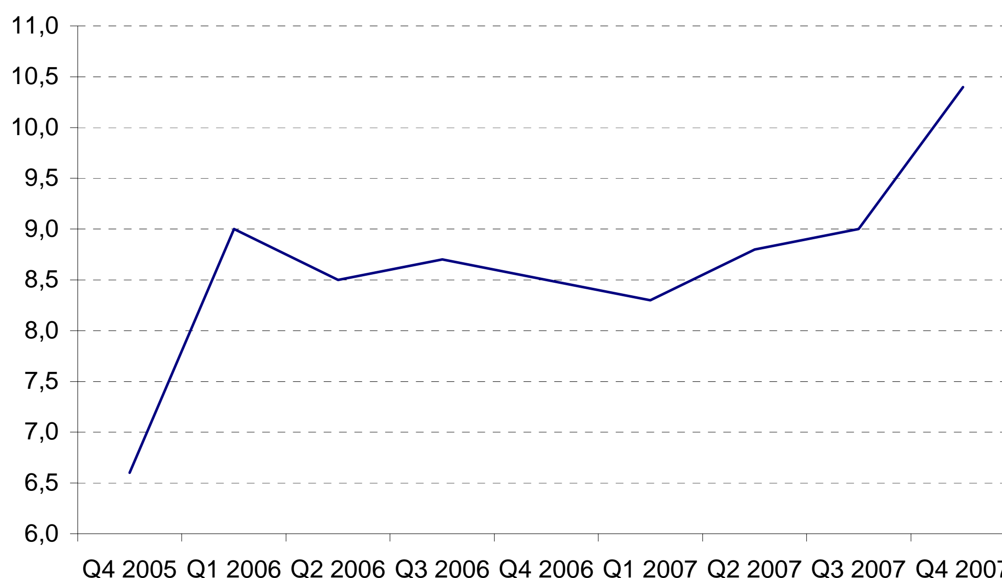
At the beginning of 2008 the situation shaped very similar to the above detailed case in 2007. Namely, the exchange rate started to strengthen intensively and hit a historical high level. Thus, the Slovak koruna's central parity was decided to revaluate second time since Slovakia accessed to the ERM II. In this manner, the central parity is 30.126 and the limits of the band are 25.6071 and 34.6449 SKK/EUR since 30 May 2008. Countries are entitled to shift the exchange rate band to a stronger level, because strengthening is thought to be one factor of the natural catching up process. On the other hand, the depreciating of the tolerance band is not accepted. In this context, Slovakia seemed to be a special case regarding the two modification of the exchange rate central parity. There is no historical example for the multiple changes.

Other factors

The European Central Bank's view about the revaluation can be summarised as follows. "The revaluation of the central rate of the Slovak koruna is justified by ongoing improvements in underlying fundamentals." ….."The revaluation is based on a firm commitment by the Slovak authorities to pursue appropriate supportive policies, aimed in particular at maintaining price stability in a sustainable manner, underpinning external competitiveness and strengthening economic resilience."

Neither the ECB, nor the Slovak Government is afraid of the appreciating currency.

Chart 7. Real GDP growth in Slovakia, 2005-08 (y-o-y change, %)



Source: National Bank of Slovakia

As known, the strong home currency could have two main effects on inflation and on the economic growth. The first channel is the import price channel, which - during an appreciating period - lowers the home inflation gradually by decreasing the price of the foreign goods – measured by home currency.

On the other hand the strengthening currency affects exporters sensitively, because of their diminishing revenue from abroad.

In the case of Slovakia, the Government and ECB emphasize the fact, that the Slovak economic productivity is as high as it doesn't hurt the competitiveness of the country - indirectly the economic growth. As *Chart* shows, besides the continuous currency appreciation, the Slovak economic developments is quite high and seemed to be fairly stable.

The other effect in the medium term is the inflation-lowering effect of the strengthening home currency. It is named as the exchange rate pass-through. As the enhancing global inflation amplifies the inflation fears also in Slovakia, the stronger SKK/EUR exchange rate could help in inflation-lowering process by making foreign goods much cheaper – denominated in the home currency.

Further questions

There's no a whole year till Slovakia's euro zone accession. Thus the main question around the new central parity is, if it will also be used as the ultimate conversion rate between the Slovak koruna and the euro or will be changed. The final decision is expected to set at the ECOFIN meeting on July 8.

There are risks also of using too strong or too week exchange rate as the conversion rate, although the prime minister, Robert Fico expressed his preference as joining euro zone with as strong exchange rate as it is possible. Too strong exchange rate is able to lower home inflation too fast besides it hurts the competitiveness of the Slovak economy, which can be as harmful as the too week rate, which has reversal effects. Thus, the good choice of conversion rate is a very critical point regarding the forward economic developments after the accession to the euro zone.

As the date of the second revaluation is fairly close to the final decision date about the ultimate conversion rate, it is reasonable to assume, that the ECOFIN won't really change it.

The other question if how the koruna's appreciation affects the other currencies in the region. In the most case, it is relevant to assume, that investors treat the region as one. The latest trends in the currencies' developments strengthen this assumption, as these currencies have been appreciating along with the koruna. Thus, regional currencies can gain from the stronger Slovak koruna.