ICEG European Center

NEWS OF THE MONTH NR. 3

VIEWS ON THE REGION

A Report by the ICEG European Center

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News of the Month represents brief analyses prepared by the ICEG European Center on the latest macroeconomic developments in Eastern Europe. The analyses are published once in a month and assess some of the major news, developments in the region that occurred in the previous month.

1. INFLATION TRENDS IN THE CZECH REPUBLIC

Recent figures indicate that inflation in the Czech Republic is running at a broadly lower level than anticipated in the CNB’s October 2001 macroeconomic forecast. In the fourth quarter of 2001, the Czech economy experienced favorable trends, which fostered greater price stability. The unexpected development of exogenous inflation factors shifted December inflation down by 0.7 percentage points relative to the October 2000 forecast, so the December net inflation result of 2.4% was within the target range of 2%–4% set for the year-end.

This was followed by an adjustment in the CNB’s inflation targeting system: as from the beginning of 2002, the CNB’s inflation targets do not take the previous form of a year-end target range, but rather the form of a continuous band. (This also means that the CNB will assess the fulfillment of such inflation targets in every Inflation Report, and not only in the January Report as the practice had been.) Note also, that since April 2001 the CNB targets CPI inflation as opposed to the earlier targeted net inflation, which makes monetary policy more reliant on fiscal measures.

In January prices were up 0,7% as opposed to 1,4% last January, while industrial producer prices rose 0,2% in January over December, the lowest December-January increase since 1990. Czech consumer prices rose 1,5% month-to-month and that brought about a decrease in annual CPI to 3,7%. In February consumer prices grew 0.2% month-on-month and 3.9% year-on-year**.** The month-on-month growth of consumer prices was brought about by a 0.8% increase in regulated prices, while market prices remained flat. Regulated prices grew mainly in the wake of price increases in public telecommunication services (by 5.6%) and also due to higher railway transport prices (by 13.1%). The stagnation of market prices resulted from the fact that lower prices of food and non-alcoholic beverages, clothing and footwear, and automotive fuel, were compensated for by higher prices of 'recreation and culture', catering and out-patient services.

However, the rate of nominal appreciation recorded at the end of 2001 is inconsistent with either the real possibilities of the domestic economy or the inflation target and for this reason, the CNB, in co-operation with the Government, has adopted some measures to counter the excessive and unjustified appreciation of the nominal exchange rate. In October the CNB responded to this worryingly sharp appreciation by intervening on the foreign exchange market and lowering interest rates.

We assume that the Koruna’s exchange rate against the Euro will be affected by the measures adopted, but further interventions are not to be expected, because of the relatively little success in the CNB’s attempts at the weakening of the Koruna at the end of 2001. We expect very low growth in producer and consumer prices in the Euro-zone: 12 months inflation fell from the January value of 2,7 to 2,4% last month. These changes should reduce investment demand, economic growth and the rate of inflation in the Czech Republic even further.

Of the domestic factors, consumer price inflation has been restrained by a gradual weakening of the annual growth in agricultural producer prices in 2002, which changed into a sharp decline at the end of the year. Following a period of major growth in agricultural producer prices in 2001, when prices of some primary agricultural commodities had almost reached EU levels, prices first stopped growing and then even recorded a gradual year-on-year decline. This was mainly due to the weakening of the bargaining position of domestic producers, especially in the area of basic agricultural commodities, and was a result of the above-average harvest in 2001 and by the accelerating appreciation of the exchange rate. This trend should change into a year-on-year decline of up to 6% by the end of the year. Assuming modest growth in agricultural product prices, we can expect a return to very low annual growth of around 2% by 2003.

In February the largest downward effect on prices of food was exercised by price decreases in meat and fruit, 1.5% and 3.6% respectively. Other food prices went down moderately, in contrast to potato prices, which grew enormously, by 29.6%. 'Clothing and footwear' prices continued decreasing, while 'recreation and culture' prices were higher. In 'transport', prices of passenger railway transport grew, too, but the growth was offset by decrease of 1.8% in automotive fuel prices. Net rentals paid in rented dwellings remained unchanged.

There is little inflation pressure from the supply side of the economy. The declaration of wage targets by the trade unions for 2002 and the process of wage bargaining to date are signaling restraint on the part of the trade unions. Nevertheless, given the expected whole-economy labor productivity growth of 3%–3.5%, the declared average wage growth of around 8% in 2002 may lead to an annual rise in unit wage costs of 4.5%–5%. In the expected climate of anti-inflationary external factors, however, the difference between unit wage cost growth and inflation should not substantially modify the inflation trend.

The expected GDP trend should generate no major inflationary pressures overall. In 2002 the rate of economic growth is likely to be lower than in 2001, but in 2003 it is expected to be higher. Money supply growth rate, in line with the expected growth in gross domestic product, should be lower in 2002 and higher in 2003. Inflow of capital from abroad will continue to be the most important source of money supply growth, however, lending will also have a steadily rising influence.

Regulated prices in 2002 have been most affected by rises in electricity and gas prices and rents. The changes in regulated prices at the end of 2002 and in 2003 are difficult to predict, but the increase should be relatively moderate during the first half of this year given the elections to be held in summer 2002. For similar reasons, budget deficit problems are unlikely to be addressed in the short term. In the area of indirect taxes, no changes are expected until the Czech Republic has entered the EU.

Public finances continue to present the most serious medium-term risk to the stability of the Czech economy. Although the state budget approved for 2002 implies a lower deficit than in 2001, the public budgets deficit as a whole is likely to widen. In 2001 the size of the Czech public debt reached 345 billion Koruna, 55.7 billion higher than the year before. The CNB foresees modest growth in public debt in the years to come, an increase of 1.5 percentage points from around 24% of the GDP recorded last year.

2. DECREASING FOREIGN TRADE DEFICIT IN ESTONIA

According to the Statistical Office of Estonia the foreign trade deficit of Estonia was 1.1 billion Euro in 2001 (1.17 billion in 2000), equal to 17.5 percent of the estimated GDP (in 2000: 21.4%). The decrease is mainly due to the smaller deficit in the trade of machinery and equipment and in minor part to the improvement in the balance of agricultural and food products. Foreign trade balance showed up a better performance in the first two quarter of 2001, when, according to balance-of-payments data, only 43.7% of annual deficit was registered. From July the exports and from August the imports as well was smaller than in the same month of the previous year. Turnover of the entire year was up by 5.5% to 8492 million Euro of which exports amounted to 44%. The reason for moderate growth are the declining amount of inward processing and the weakening consumer confidence in the second half of 2001. An evidence for the openness of the Estonian economy is the trade turnover per GDP ratio, which was approximately 138% (about 10 percentage point lower than in 2000).

The Economist Intelligence Unit forecasts Estonia's exports to reach 3700 million US dollars in 2002 (€4214 million calculated on the current exchange rate), while the imports are estimated to $4600 million (€5239 million). Therefore the trade deficit is expected to decline to 1025 million Euro. A further considerable increase in foreign trade turnover is projected for 2003, with decreasing deficit.

A remarkable figure is that trade deficit against the EU amounts only to €183 million, while it was €255 million in 2000. The slowdown of the EU growth has implied a stronger decrease in Estonia's imports than in its exports. Estonia traditionally imports raw materials from the CIS and exports (as well as imports) manufactured goods (often in form of inward processing) to the EU. Thus not surprisingly, the deficit against the CIS is higher: amounts to 380 million Euro (389 million Euro in 2000). Concerning individual countries the most radical change occurred in the trade with Finland: after a considerable deficit of €152 million in 2000, last year the Estonian exports to Finland surpassed the imports by €386 million,. mainly due to the significant fall in imports. The surplus against Sweden meanwhile plunged from €249 million to €76 million. On the other hand, Germany and Russia are responsible for the half of the total deficit with 272 million and 285 million Euro respectively.

Chart 1.

Significant improvement in foreign trade balance is registered in two groups of commodities. The deficit of machinery and equipment is down by €102 million (1.6 percentage point), while the deficit of agricultural products declined by 32 million Euro. It wasn't offset by the growing deficit in transport equipment and in mineral products.

In January 2002 foreign trade turnover decreased by 15% compared to December 2001, and by 20% compared to January 2001. The deficit in m-o-m comparison grew by 2%, while in y-o-y comparison was up by 10%.

In 2001, Estonia's exports increased by 7.4 percent to 3700 million Euro (3444 million in 2000) due to the soaring exports in the first half of the year. The y-o-y growth in exports was about 40% in 2001 January and February, moderated at about 20% in the next four month, while in July already a decline was registered. The figures of the second half are disappointing: in August the decline reached 17%, then moderated to 0.6% in October, but touched the bottom at the end of the year by a negative change of 25.2%. Preliminary data shows the trend going on: in January 2002 the value of exports were by 24.6% smaller than in the same month of the previous year. Suffering exports don't have a negative impact on GDP growth, as the GDP in constant prices was up by 5.5% in 2001 fourth quarter. The share of inward processing, which traditionally plays an important role in Estonia's exports, fell to 38%, after having a ratio of 43.8% in 2000. The reason for declining figures was the weakness of subcontracting. From December 2001 to January the exports after inward processing in Estonia dropped by 23%.

The three main export commodity group are textile products (11.3%), wood products (13.4%) and machinery and equipment (37.5%). The latter has been the most sensitive to the recession experienced in the EU: compared to 2000, its export fell from €1290 million to 1220 million Euro (a change of -5.4%). In every other commodity group Estonia increased the value of its exports in 2001. The exports of agricultural and food products showed up a remarkable performance with 294 million Euro thus exceeds the 2001 figure by 43.8% (€89 million). Foreign sales of transport equipment also rose considerably compared to 2000, by 35.7% (32 million Euro), but still has a marginal share (3.3%) in total exports. The growth in raw materials as well as chemical products (25%) and textile products (8.2%) also surpassed the average growth of exports: in nominal terms both increased by 32 million Euro. Meanwhile the growth in value of exported wood products (6.9% or €32 million) and metal products (5.3%) remained slightly below the average. The available data from January 2002 indicates a further deterioration in the exports of machinery and equipment: compared to December 2001 it decreased by 35%, from €70 million to €45 million. Concerning other groups of commodities, exports of agricultural products and transport equipment plunged significantly (by 29% and 22% respectively). Only export of metal products improved in January, reaching an upward of 22%. Consequently total exports in January compared to the previous month dropped by 10% from €265 million to €241 million.

The main destination of Estonian exports are traditionally Finland and Sweden. The weight of Finland doesn't change significantly, slightly increased to 33.9% reaching €1254 million, but Sweden's share fell from 20.5% to 14% (which is equal to €518 million). The weight of EU countries was 69% (77% in 2000), while 4% (the same in 2000) went to CIS countries of which 2.8% to Russia. Latvia ranked third with a 6.9% ratio (7% in 2000) and Germany fourth with 6.9% after a remarkable fall, because its share was still 8.5% in 2000. The rapid adaptation to the slowdown in import demand of the EU (in the case of Estonia, especially of its Nordic member states), indicates increasing flexibility of Estonian firms. However, new President Minister Siim Kallas named the dependence on inward processing as the largest economic problem of Estonia. The m-o-m comparison between December 2001 and January 2002 shows an upward in the importance of some middle-weighted trading partner: Latvia exceed 9% (7.6% in December), and Germany also reached the same level (6.8% in December). The share of Finland meanwhile decreased slightly: from 26.3% to 23.7%.

Chart 2.

Estonia's imports rose in 2001 by 4% to €4800 million (€4613 million in 2000). The y-o-y change in exports compared with 2000 was 56.4% in 2001 January, then slowed down to 20-25% in the next three months. In May there was almost a stagnation: an increase of 1,3%, then in June an upward (14.4%), and in July again a moderated growth (by 2.7%). In the last five month figures indicated a decline. In September touched a decrease by 8.8% and reached the bottom in December with a negative change of 22.4%. The value of import in January 2002 compared to January 2001 was down by 16.6%, which is nevertheless better than figures of the two previous months. Therefore monthly performance of imports moved roughly in a parallel way with exports, but the improvement in January is remarkable, and m-o-m imports in January 2002 declined by 6%. The share of importation for inward processing in total imports decreased from 31% (in 2000) to 24.8%, by €243 million. As we have already mentioned above, the reason for the declining imports was the weakening consumer confidence after September and the drop of sub-contracting orders (both in number and in value). Due to the first months imports for domestic consumption increased by 13.4%, and was responsible for the 4% upward in annual imports. In January 2002 the trends followed: imports for inward processing decreased by 12%, meanwhile for domestic consumption by 5%.

The imports are still dominated by machinery and equipment (33.4% or 1600 million Euro), though its weight fell significantly since 2000 when its share was 38.5%. The diminution is equal to €172 million. The reason is the fell in imports from Finland. Each other commodity groups showed up higher imports in 2001 than in the previous year. Agricultural and food products were imported in the value of €454 million (by 14.5% higher than in 2000), and account for the 9.5% of total imports. The imports of transport equipment (first of all motor vehicles) grew by 34%, reaching 8.9% of total. The demand for mineral products rose only by 4.5% (6.1% of total), for metal products by 3.4% (8.1% of total). The low demand for raw materials and machinery is a consequence of the cooling world economy. Compared January data to December 2001 the decrease in imports was largest in imports of machinery and equipment (by 21 million Euro). There was a slight increase in imports of transport equipment, metal products as well as leather products.

The main origin of Estonia's imports remained Finland, but its share declined from 27.5% (in 2000) to 18.1% by €256 million. The import from Japan fell also significantly, by 64 million Euro. The share of China (from 3.6% to 8.7%) and Russia (from 5.8% to 8.1%) increased as Finland turned away from the import of highly processed machinery and equipment. Imports from Germany also grew by €90 million, thus in 2001 Germany covered 11% of the Estonian imports. The share of EU countries in total imports was 57% (63% in 2000). Imports from CIS countries accounted for 11%, which is equal of the rate in 2000. The only remarkable change in the structure of imports in January 2002 m-o-m is the recovery of Finland, because its share in the end of 2001 was only 15.4% and in January 17.2% which is still below the average ratio of 2001.

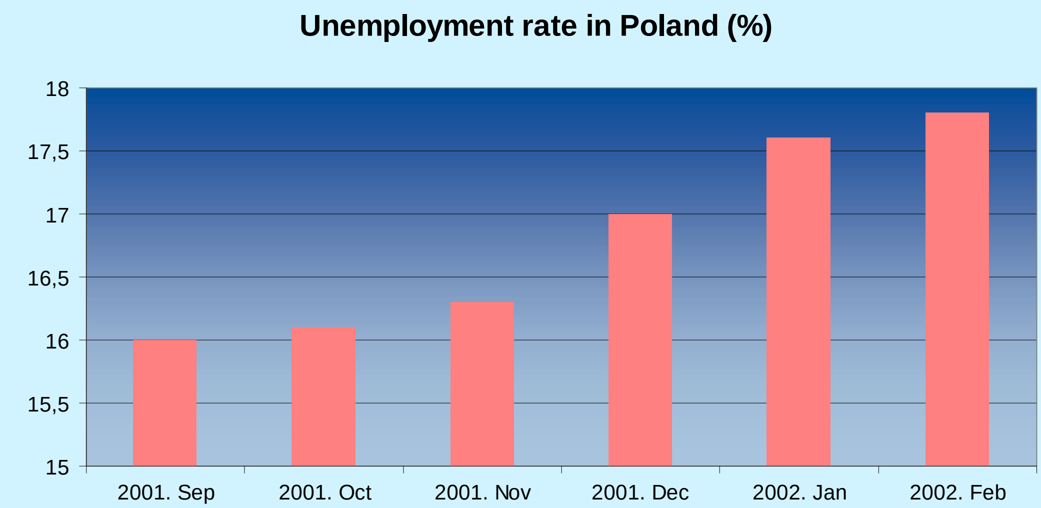
3. HIGH UNEMPLOYMENT IN POLAND

The growing rate of unemployment is currently the most serious problem, the Polish government has to face with. In February the rate rose to a record level and reached 18.1 percent.

The unemployment is not a new problem of the Polish economy; last year's rate was already 16 percent, mainly due to structural changes in the corporate sector, and the restructuring that followed the privatisation. The unemployment rate had already jumped to a new post-communist high of 18% in January, according to the Central Statistical Office (GUS). In January, the employment in the enterprise sector decreased by 0.2% as compared to December 2001, and it was lower by 4.7% than a year before. The strongest drop of employment was still in the construction sector just like during the last year.

The number of unemployed grew by 140,000 in the first month of the year and amounted to 3,253 million. Compared to the same period of 2001, the number increased by 418,000. The January 18 percent against the 17.4 percent in December and 16.8 percent in November 2001 indicates a further significant growth. The 5% percent February decline (in a year-on-year base) of employment in the enterprise sector in had attributed to the worsening situation., especially if we take into consideration Janusz Witkowski's (deputy chairman of GUS) remarks. He said that the real number of unemployed must be even higher, because more than 480,000 Poles benefit from pre-retirement programs, and according to the international standards, also these people should be classified as unemployed. What makes the picture even less rosy, that 80 percent of jobless people are not eligible for unemployment benefits. The one million graduates, who will leave the school this year are the next challenge. According to the former expectations 400,000 of them will continue to study while about 600,000 will enter the job market. It is very likely that they either will register themselves as unemployed or begin to work in the underground economy. According to Finance Minister Marek Belka this situation stems from the very high labour costs. Therefore the government has prepared a package called „First Job", which is supposed to reduce the entrepreneur's burden of hiring young people. The government's proposal is to reimburse the employer for some time for the costs of pension contribution paid on a hired graduate.

Chart 3.



The growing unemployment resulted a decreasing wage amount in real terms, even though in January 2002, the average gross wages in the enterprise sector were higher by 5.7% in nominal terms than in the same period of last year.

The deterring rate of unemployment has finally made the Polish government to approve amendments to the labour code. All the proposed amendments have failed so far. The decision should have been brought by a committee, where apart from the government, the trade unions and the employers are represented. The trade unions denounced the market reform proposals of Jerzy Hausner, the labour minister, but the government simply rejected all the objections. According to the trade unions, these 'reforms' are just going to lead to a higher unemployment because they ease the process of firing workers. The government claims the reforms will result decreasing unemployment, because they reduce the bureaucracy connected to employment. The changes include reducing overtime pay, making it easier for companies to hire and fire workers, regulating the weekend's extra money. An important change has risen the limit of workers from twenty to fifty, where the employer is obliged to form a social security fund. The orders for „mass firing" will be obligatory only for firms, which employ more then twenty workers. Tadeusz Sulkowski from the Polish Federation of Private Employers (PKPP) considered these changes will improve the competitiveness of Polish companies and reduce labour costs. The IMF as well as the World Bank have also welcomed the changes, hailing them as a stimulus to create new jobs.

Nevertheless, researchers and analysts do not expect the market to improve in short term: they anticipate a 18.2-19% unemployment rate for March, and 18.5-21% by the end of the year. Jerzy Hausner hopes March to be the first month showing decreasing rate, but he also predicts 19.7-19.9 percent by autumn, even though in the budget law the government set unemployment rate at 18.6 percent for the year 2002. The temporary decrease might be due to seasonal factors. The rising number of jobless people might make the EU-accession more complicated for Poland, because of the increasing fear of current member countries of the massive migration flow of Polish workers.

Most of the experts blame the restrictive monetary policy for the high unemployment and

the decelerating GDP growth, and regard Poland as a typical textbook case for high sacrifice ratio of disinflation.

The most recent data published by Eurotat shows that after the 10 new countries join the EU Poland will end up among the three poorest member states followed only by Latvia and Lithuania. In the second and third quarter of 2001, Poland's GDP growth settled at 0.9 and 0.8 percent compared to the EU's 1.7 and 1.5 respectively. Polish economy has not been catching up with the Union recently. The first month of 2002 did not show the signs of improvement, according to the GUS, production dropped 5% in January. Although January is never a good month for the economy, we still can regard the drop in industrial output as significant: this figure is 1.4 percent lower than in January 2001. The output of construction and assembling production was lower by more than 64% than in December 2001 and 21.3% lower than in January 2001; although the severe winter also contributed to this fall.

The tension is increasing further between the government and the National Bank of Poland (NBP).According to Finance Minister Marek Belka the economy has huge potential and acute need for growth; therefore the government gives priority to economic growth over disinflation. Mr Belka is critical of the current monetary policy, but he still supports the central bank and Monetary Policy Council (RPP) independence (though, as he mentioned, 'independence does not mean to be immune to criticism'). Susan Schadler, the chief of delegation of the recent 2-week IMF mission to Poland stressed that attacks on the NBP and RPP must come to an end. RPP had already lowered interest rates in January by an other150bp, bringing the refinancing rate down to 10% from a 19% peak. The IMF delegation has suggested that the RPP wait for an other cut until the effects of the previous ones can be seen. According to experts the public debt is expected to rise sharply and the public sector deficit will remain high in the coming years. Furthermore, the infrastructure plan of the government is supposed to stimulate the demand, therefore, concerning the strong commitment of RPP to inflation reduction, it is unlikely to expect monetary policy to ease considerably.

The government's economic strategy, called 'Belka Plan' which was introduced earlier this year, tries to tackle the debt problem. The key element of the program is the Strategy of Public Finance, which aim is to restore discipline to public finance. According to the Belka Plan the state expenditure should grow by just 1 percentage point more than the expected midyear CPI inflation between 2002 and 2006. The plan would make expenditure the anchor of the fiscal policy. The down point of this proposal is that it shifts the responsibility for lowering the public deficit (now standing at close to 6% of the GDP) onto the central bank. The budget gap will not fall unless the real GDP growth exceeds 1%, this is the reason why Mr Belka calls for an easier monetary policy with faster GDP growth. Despite the Belka Plan, in February the Parliament enacted an Act on the State Budget for 2002, which sets the revenues higher by PLN 1.2 billion than originally planned by the government, and the expenses have been raised by a similar amount as well. It means that the expenses may be in real terms higher by 2.4% than previous year against 'the inflation +1%' rule. The lower inflation than assumed in Belka plan might cause a further deterioration. The January and February year-on-year CPI index were 3.5 percent, which is the lowest level in more than 25 years. Analysts say however, that such a low level cannot be maintained for longer term; they expect a 4% price growth in March, especially because new excise tax will be introduced on electrical energy.

As a result the state expenditure is going to increase to some 24.5% of the GDP in 2002 from 23.8% last year. The plan earmarks a fall in the state budget deficit to 3.9% in 2006 from 5.3% of the GDP this year. This will result an amount still double the deficit registered in 2000. Analysts estimate that this process would raise the level of public debt up to 50% of the GDP by 2006, which is a significant growth compared to the 43% at the end of 2001. (Mr Belka predicted a 55-56% public debt by 2006.) The big lending needs of the public sector might result in a strong reduction of the lending to enterprises. It is assumed that investors will have to be offered decent yields, which is automatically leads to a situation in which the longer end of the profitability curve may imperfectly reflect the interest rate reductions made by RPP.

Although the Fitch rating agency kept the BBB+ rating, the agency emphasised that the Polish debt is already bigger than the standard level in the BBB category. A further problem is, that while debt in the BBB countries is stagnant its amount in Poland is constantly growing. The figure, which backed Fitch’s decision was the current account deficit, that is expected to fall to 3.2% of the GDP by the end of year 2002 from the 4% of 2001. The reasons are the weak domestic demand and the recovery of the Euro area. Furthermore in January 2002, the appreciation tendency of the Polish currency reversed. In January and February an average monthly rate amounted to PLN 4.06 and 4.19 for a dollar compared to the 4.01 last December.

The National Bank of Poland expects an economic boom in the latter half of the year when the growth rate may achieve two percent. According to Marek Belka, the economic boom might commence in the second quarter of the year but it is more likely in the third. The Ministry of Economy forecasts that real economic growth will be 1.2% in 2002. According to experts from the independent Center for Social and Economic Research Foundation (CASE), Poland’s GDP may grow by 1.9 percent in 2002 and the growth may jump to 3.2 percent in 2003. Behind these optimistic projections the basic condition is the improving global economy and growing export.

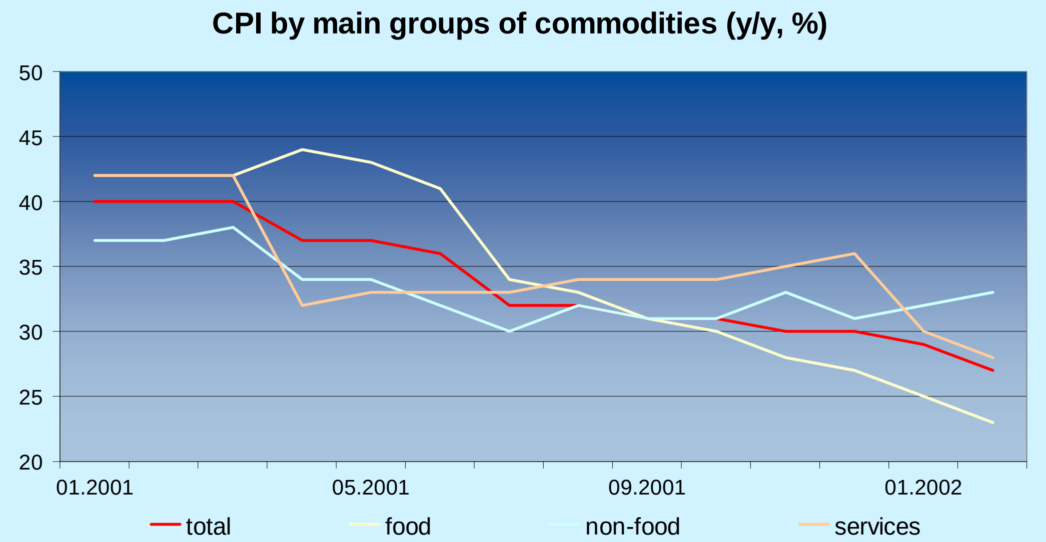
Nevertheless, Poland’s key business climate indices climbed in February and March. An index of current market conditions computed by the Market Economy Research Institute rose since January up to minus 13.3 points (in February 2001 it stood at minus 20.9). The manufacturing index of GUS inched up to negative 9 points in March from minus 12 last month. The construction climate index rose to minus three points from minus 15 on hopes for improving future demand.

4. SLIGHTLY DECREASING INFLATION RATE IN ROMANIA

The Consumer Price Index (CPI) increased by 27,2 % in year-on-year base in February 2002, which is now the second rise in the last few years that doesn't hit the 30 % (January 2002 was the first by 28,6 %).

The monthly inflation rate was 1,2 % as against 2,3 % in similar period of 2001. This favorable monthly data is due to the fact that the considerable rises of prices have occurred in the last months of 2001 and in January 2002.

Chart 4.



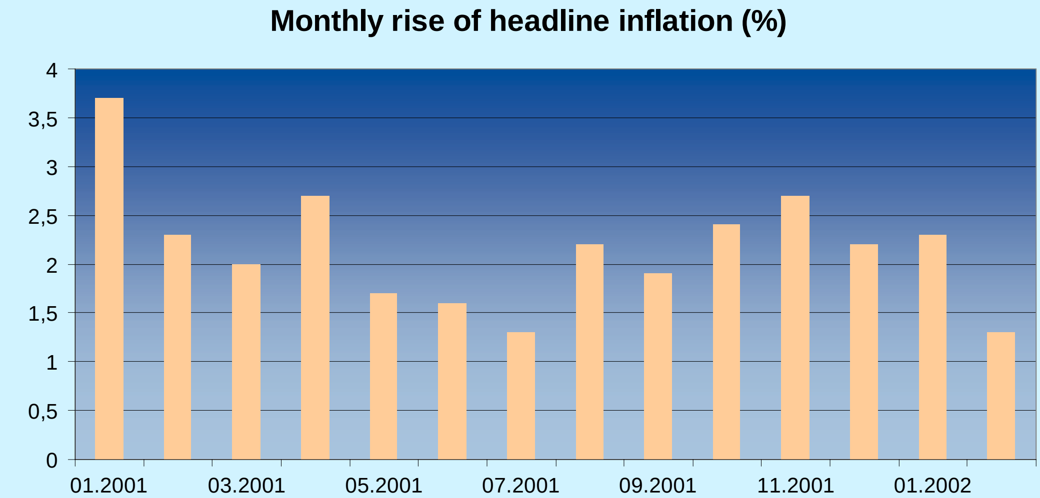
For the group of food goods, prices have registered a growth of 0,7 %. This group represents the largest share in CPI and that helped to arrive at a lower-level monthly inflation rate. The rise of prices of non-food goods was the most determining factor to the inflation rate in February, it reached 1,6 %. Non-food items have about 40 % shares in consumer basket. Within that, the higher prices for electric energy (+3,6 %) and tobacco, cigarettes (+2,2 %) were determinative. For the group of services, 1,4 % growth has been registered, close to the total CPI. However, the air transport prices rose by 16,6 % that data does not really relevant to CPI because of its very low weight in consumer basket (0,03%).

Both charts represent gradual and continuous decrease of inflation rate in Romania. While the inflation rate was about 40 % last January, it decreased under 30 % this year. The disinflation is connected with the slowing weakening of exchange rate. Maintaining the current framework of managed floating exchange rate is desirable to achieve further disinflation.

The targeted inflation rate was about 27 % for 2001 from the base of 40 % in the early period of the year. However, the CPI has not decreased by that rate, 34,5 % CPI means relevant decreasing. The original target would have been reachable if the inflation rate had not speed up in the end of the year. Some food goods, energy and transport prices rose much above the average.

The inflation target for 2002 is more or less the same as it was for 2001. The Central Bank of Romania targeted to reach 22 % inflation rate at the end of the year and 25 % average inflation in 2002. It is in line with the government's target, they expect that year-on-year CPI in December will not exceed 22 %. The average CPI in 2002 is expected to be approximately 25 %, while the rate expected by the Government is to decline in 2003 to about 18 %,and to one-digit level at the end of 2004.

Chart 5.



In order to achieve this improvement, the key policy points are as follows:

- One of the major reasons for high inflation rate is the backward-looking wage indexation. The authorities' duty is to eliminate that mechanism from the economy.
- As it was mentioned, managed floating exchange rate is helpful for further disinflation and it balances the objectives of reduced inflation and protecting external sustainability.

Firm financial discipline should be imposed in public enterprises and the labor cost in this sector is suggested to reduce.

- Finally, the consistence of monetary program with inflation target is also desirable condition.

Fulfilling the conditions, the inflation rate will further reduce gradually and it can approach the 10 % in 2005. The government's inflation forecasts for the future seem rather ambitious targets regarding the necessary structural changes in economy. The high inflation rate is one of the major problems in the economy and its reduction is necessary condition for sustainable growth, stable economy, and in long-term, becoming a member of the European Union. The IMF's Stand-by Credit (383 Million $) approved in last October is aimed to realize the macroeconomic program in Romania that includes reducing inflation.

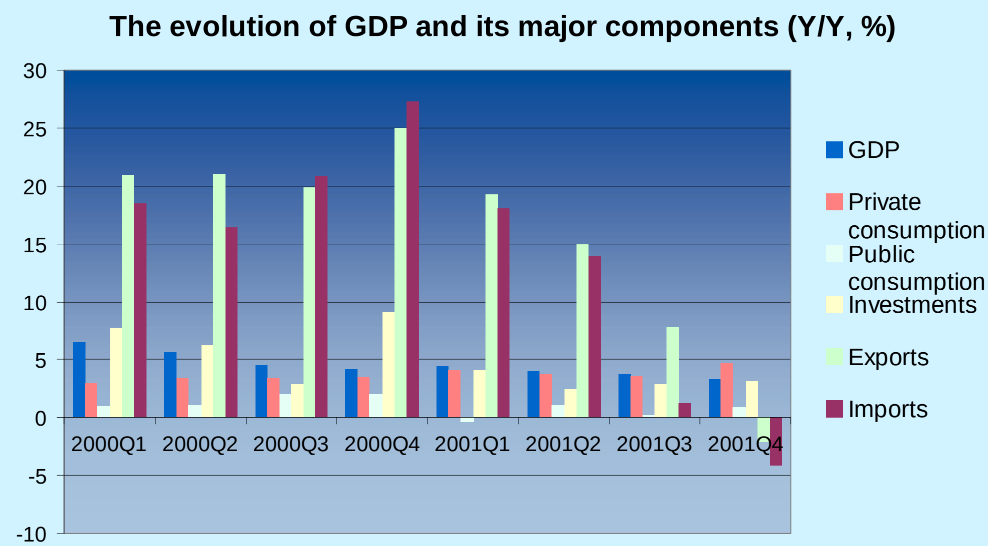
5. DECLINING GROWTH RATES IN HUNGARY

In the year of 2001 the economic recession became worldwide. The average GDP growth was about 1.6% in the EU. The economic growth of the U.S. was slightly more than 1%. The recession in Japan was continuous. An additional mark of this process is the shrinking of foreign trade turnover.

The recession also hit the CEFTA-countries especially Poland, where the economic growth cooled down to 1%.

In Hungary the gross domestic product rose by 3.8% in 2001, less than in 2000 (5,2%). In 2001, dynamics of GDP growth cooled down from the first quarter growth of 4.4% to 3.3% till the end of the year.

Chart 6.



Primarily the deterioration of the external economic condition contributed to this process, which had an unfavorable impact on the growth of industrial sector. The rise of industrial production reached 4.1% compared to the 18.1% expansion in2000. Not only the high basis caused this fallback in industrial production, but also the considerable deterioration of the demand could give a possible answer to the poor sector performance. The volume of industrial export sales rose by 8.9% in 2001 compared to the 27.4% rise of 2000, while domestic sales stagnated. The unfavorable evolution of industrial sector was in line with the slowdown of EU economy via narrowing export demand.

There is a continuously prosperity in the construction sector. This sector reached a 10% growth compares to the previous year. However we can notice that the dynamic of this growth reached a lower rate (7%) in the last quarter.

The sesquialter corn crops, which exceeded the average of 5 years with 20% contributed to the better performance of agriculture.

The volume of retail trade rose by 5.4%, this growth was only 2% in the previous year.

The volume of investments increased by 3.1% in 2001, which is lower by 2% than in 2000. In the last quarter of the year investments rose by 1.9% compared to the same period of the previous year. The tendency, experienced in the second half of 90's, seems to be over, because volume of investments increased slower than GDP. In sectors related to market segment investment activity stagnated or decreased, while growth of investments was driven by the soaring home buildings. This triggered structural changes in the accumulating of fixed capital formation.

There was a considerable decline in the volume of the exports and imports in the last quarter of 2001, which can be seen as a result of a medium-

-run process beginning at the end of 2000. The volume of exports increased by 8% and the imports by 4%, as a whole year. This is a significant fallback compared to the last year (exports increased by 22%, and the imports by 21% in 2000). Since the growth of the import was slower than the growth of export, the foreign trade deficit got lower. It amounts to EUR 3.6bn (this deficit is lower by EUR 0.8bn compared to the last year).

We think, that the sustainability of the outstanding export growth, experienced in the previous years, was doubtful in longer term, especially in the light of cooling down EU growth.

The foreign direct capital inflow amounted to EUR 2.7bn . This exceeded the last year's volume with HUF 236bn.

We found some inconsistency during analyzing the figures. The total final consumption increased by 4.2% and gross fixed capital formation rose by 3.1%. Moreover, the export volume exceeded import volume by 2%, therefore contribution of net exports to GDP was significant. There must be an explanation why increased the GDP slower than the result, which comes from the weighted components of GDP. A possible answer for this question could be that the firms considerably reduced their stockpiling.

Although activity has decreased due to a sharp slowdown in exports and in corporate investments, strong household consumption and public and private construction activities will allow the Hungarian economy to grow at a relatively healthy rate before the projected international recovery.