International Center for Economic Growth
European Center

ICEG EC

NEWS OF THE MONTH
NR 9.

March 2003

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NEWS OF THE MONTH

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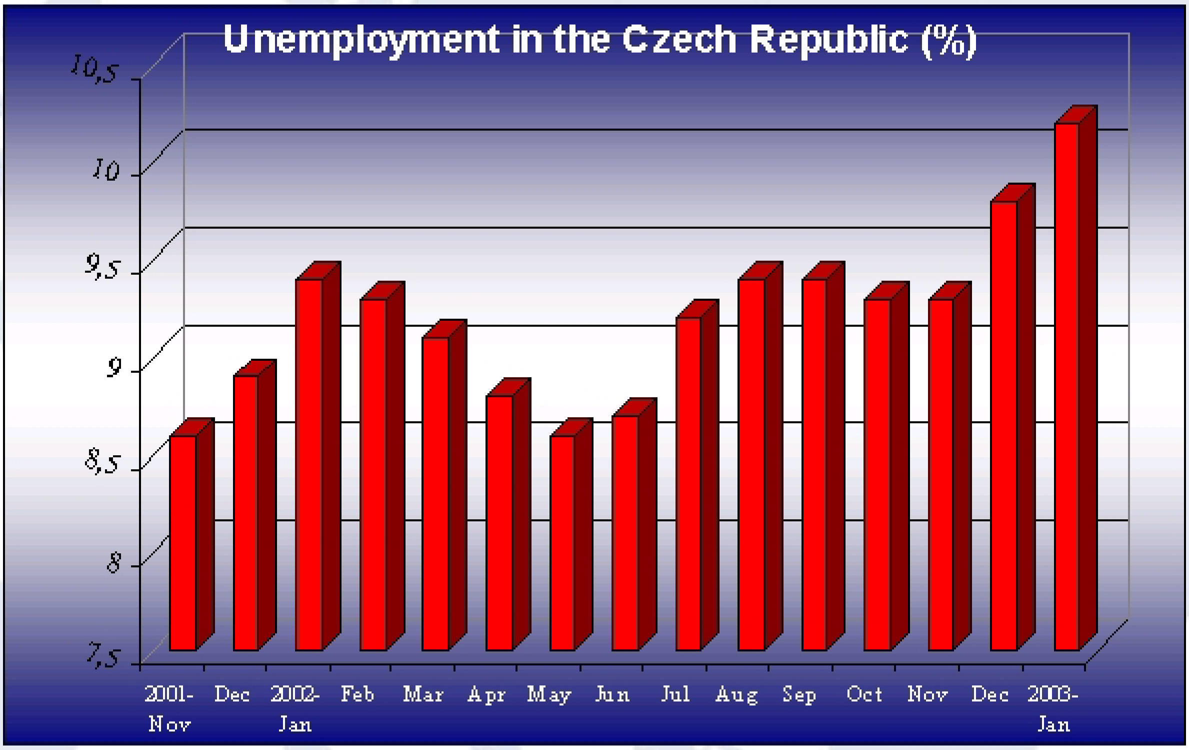
I. CZECH UNEMPLOYMENT REACHES RECORD HIGH LEVELS

Czech unemployment rate reached an all time high of 10.2 percent in January, according to he latest figures released by the Ministry for Labor and Social Affairs and the Czech Statistical Office (CSO). This is the first time that the unemployment rate broke the 10 percent psychological barrier since the fall of communism. Employment offices registered over 500.000 job seekers.

High unemployment is a growing concern in the whole region of the former Eastern block. In Poland for example the unemployment rate hit an unprecedented level of almost 20 percent last year. Earlier the Czech Republic used to be an exception in the region concerning labor market tensions. The transition from a centrally planned to a market economy was accompanied with low levels of unemployment, far below those of other former Eastern block nations. The average unemployment rate was 2.8 percent between 1990 and 1999. The ratio started to increase steadily from 1996, and the crisis in 1997 had only accelerated its pace, resulting in an 8 percent unemployment rate in 1999. Given its low unemployment in the mid 1990's, the Czech Republic had the opportunity to restructure its economy at a relatively low social cost. The incomplete restructuring due to the voucher privatization, the problems in the banking industry, the lack of financial regulation and the generous welfare benefits finally all contributed to the growing rate of unemployment towards the end of the decade.

Chart 1.



The developments in the past few years that lead to the worsening situation in the labor market might have been the strong disinflationary policy and the excessive appreciation of the Czech currency due to the convergence play, a common challenge of countries on their way to EU accession. It is remarkable that the release of the unemployment rate figures in January coincided with the first fall in consumer prices in the Czech Republic.

However, the recent backward revision of GDP data and the following upward adjustment of the growth forecast for 2003 implied that the vigorous appreciation of the crown and the disinflation policy did not influence the growth as negatively as expected. The revision of the data eliminated some inconsistencies. Low GDP in the past was not consistent with certain indicators like higher tax incomes or sales volumes. The modified GDP data also indicated a relative increase in the role of investment and net exports as sources of economic growth in the past. As previously the dominant source of economic growth was thought to be domestic consumption, the Czech National Bank (CNB) did not want to slash interest rates because of the fear of a growing external imbalance.

Knowing that the economy was not likely to cross the safety limit for the current account deficit, the CNB cut interest rates in January by 0.25 percentage points to a record low level of 2.5%. This measure is conducive to the return of inflation to the targeted band at a quicker pace. Since May 2002 the inflation is below its pre-specified corridor. According to Marketa Sichtarova, chief economist at the Volksbank, the interest rate slash was carried out to partially offset the effects of the unfavorable world economic situation, especially the drop in demand from Germany and the potential consequences of the conflict in Iraq.

Even though the GDP growth forecast for 2003 had been revised by about 1 percentage points to between 2.2 and 3.5 percent, the unemployment rate is expected to go on growing in the rest of the year, reaching a final value of 10.3 percent.

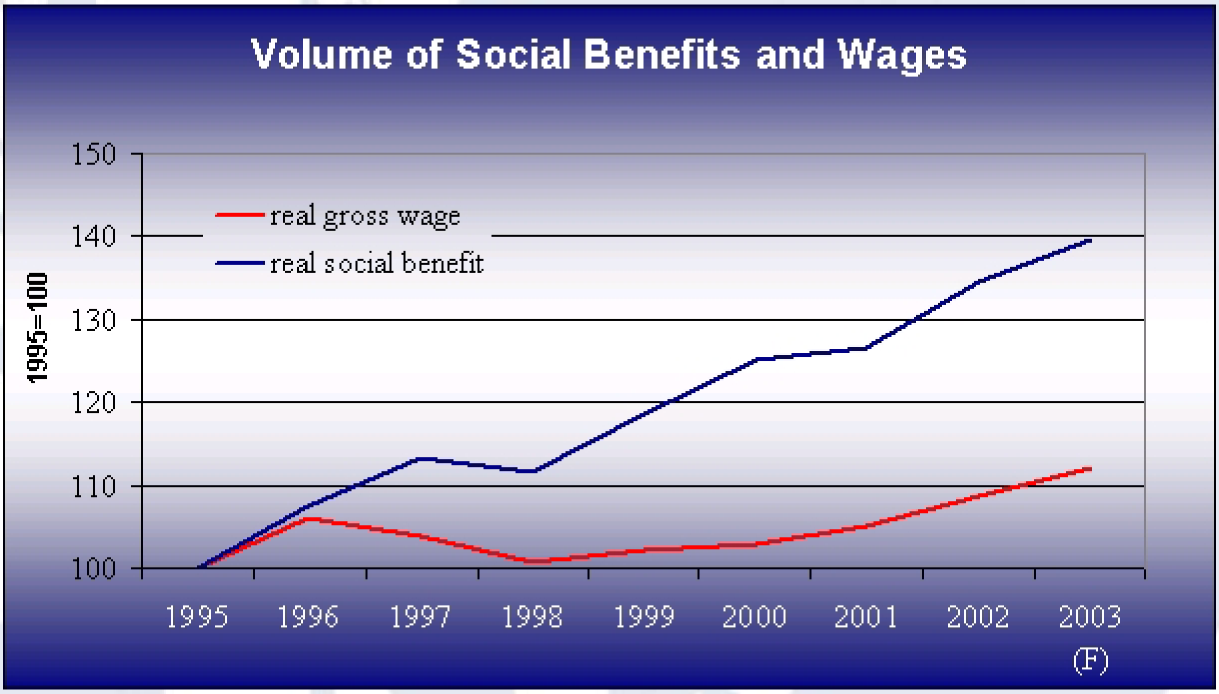
The Czech unemployment has a strong structural component, as there is a severe discrepancy in the supply and demand side of the qualification structure. The increase in the number of unemployed was accompanied by a decrease in the number of jobs offered by the labor office, so there are more than 13 applicants per one vacancy. About 40 percent of the unemployed are long-term unemployed (over 12 months). The possible wage rate of long-term unemployed is decreasing over time as their productivity decreases, because they are losing their skills and working habits.

Many proposals have come up to tackle the unemployment problem, some of them refer to the aforementioned problem of economic slowdown, and suggest a more diversified export structure for the Czech Republic. Currently about 40 percent of the export revenues come from the stagnant German economy.

Many analysts blame the overgenerous welfare system, which attracts more and more people to stay unemployed for longer-term, collect benefits and work in the informal sector where they are not taxed. The level of unemployment benefits *per se* is not especially high. When a job is lost, however, and the family's income declines, they become eligible for number of other means-tested programs including child allowance, social allowance and housing allowance. The combined effect of the social benefits and unemployment insurance is that the recipients receive 47 percent of their gross earning, a figure that is the second highest among OECD nations. Whereas consumer prices grew by some 45 percent in 2002 as against 1995, and the wage bill increased by 55 percent, the welfare benefit bill exploded more than 90 percent. In 2002 the real wage bill grew by approx. 4.5%, while welfare benefits in real terms amounted to 6.3%.

Labor and Social Affairs Minister Zdenek Skromach proposed that only those should be eligible for unemployment benefits who participate in retaining programs or state subsidized jobs. On the other hand Mr. Skromach said that he was considering increasing unemployment benefits so that the unemployed should receive 60 percent of their original monthly salary for the first three Month they are without job, as opposed to the current 50 percent. After these initial months a benefit would be paid, which amounts to half of the original salary instead of the current 40 percent. The effects of these forthcoming measures are quite ambiguous. The final draft of the new labor bill is not expected to get in front of the government for consideration until April.

Chart 2.



Many experts urge that the state focus much more on active employment policy. The government currently spends annually 11 billion Kc ($379 million) on unemployment benefits and only 4 billion Kc on job creation. The Ministry of Labor and Social Affairs has launched a new national plan, which includes two new schemes called "First Chance" and "New Start". The former will focus on fresh graduates and the latter is supposed to prevent jobless people from remaining unemployed.

The cabinet has also approved a package of measures to improve the business environment in the Czech Republic. The measures include speeding up the process of registering a new company in the commercial register, and there are some changes concerning the tax system in order to encourage investment and support small and medium sized businesses. A controversial part of the package is about the expropriation of private land and property for the construction of strategic industrial zones. Under current law expropriation can be carried out only under strict conditions, in the name of public interest.

The new draft law would extend these measures for private interests as well. The government claims this change would speed up the process for foreign investors to buy out the land from individuals, which used to cause delays in constructions of their plant. However opponents of the law claim that this new legislation would violate the principle of equality in market competition.

The other often voiced reason for high unemployment is the low mobility of the labor force in the Czech Republic, which is why the unemployment has not been spread evenly throughout the country. According to a former survey 77 percent unemployed stated that they would found it unacceptable to move somewhere else solely for work-related reasons. There is also a shortage of adequate housing in those regions where the unemployment is lower and the lack of adequate public transport for commuters worsens the situation. Prague and Central Bohemia are the regions with the lowest unemployment around 3 and 4 percent.

On the other hand unemployment rate is over 20 percent in North Bohemia and North Moravia, in these regions there are more than 100 applicants for one single job. These areas were hit most severely by the close down of the coal mines and steel-mills. This situation might get even worse because the Czech Republic must scale down its steelworks to produce no more than 6 million tons a year because of the EU limits. Last year steel production increased by 3 percent compared to 2001, reaching 6.5 million tons.

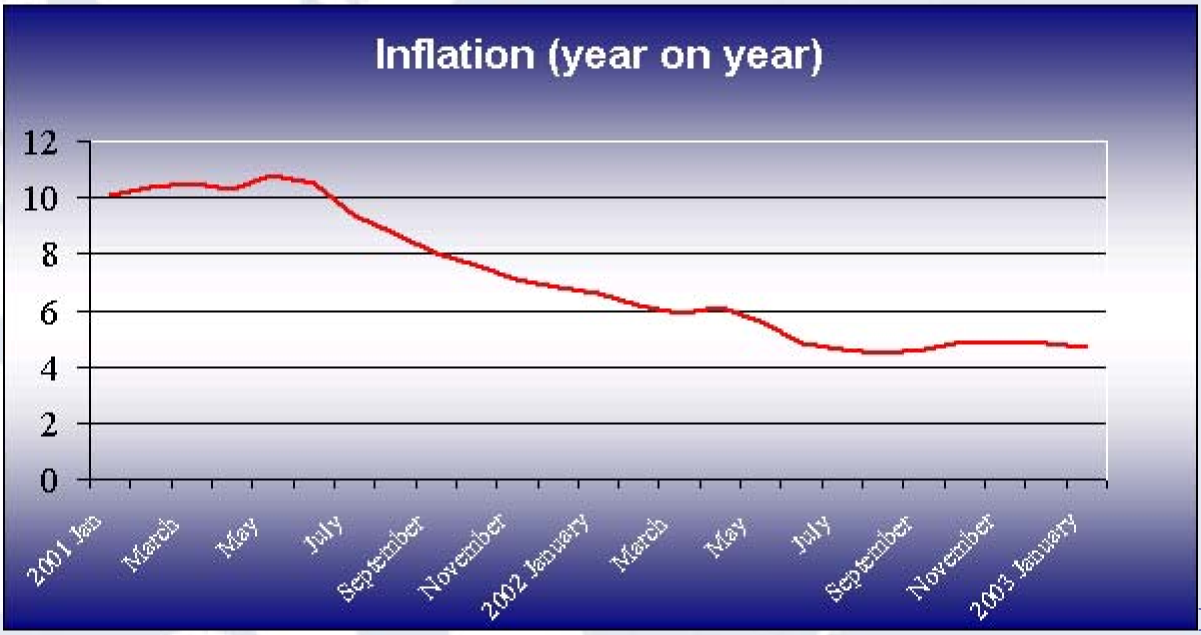
The spring months will bring some temporary relief to the situation. Temporary jobs in agriculture and construction might lower the unemployment rate. However most economists claim that the rate will hover around 10 percent for the rest of the year. Restructuring and privatization of the Czech companies might result in further layoffs.

II. MODIFIED INFLATION-TARGET IN HUNGARY

Hungary introduced a new exchange rate regime in May 2001. Since that time the exchange rate of the Hungarian Forint has been floating in a ±15 per cent band around the 276,1 Ft/€ central parity against the Euro. In the regime of floating in a wide band, the exchange rate was not able to act any more as a nominal anchor to control inflation, the primary objective of the national bank. Thus the monetary authority applied a new tool to continue disinflation: inflation targeting was introduced in June 2001. The fulfillment of some preconditions is essential for the success of this system: among them a credible and independent central bank is needed, whose main target is price-stability. National Bank of Hungary targets a band with ±1 per cent width around the central target, and publishes a quarterly inflation forecast.

After the regime change in 2001, the National Bank of Hungary had a successful disinflationary period: inflation, which had been permanently around 10 per cent before the new regime was introduced, decreased by 6 percentage points in the past one and a half years, while core inflation was reduced by 5 percentage points in that same period. The freely and constantly appreciating Hungarian Forint has played a significant, although much debated role in this process. The risk-reducing effect of the forthcoming EU-accession, the now fully liberalized capital-account and the high interest rates have been attracting foreign capital generating a constant demand for the Hungarian currency.

Chart 3.



In 2002 the National Bank of Hungary successfully achieved the set 4.5±1 per cent inflation target: the rise in annual price-index in December was 4.8 per cent, close to the 4.5 per cent target. However, some problems, already visible in 2002, led to a

NBH announcement on 10 February 2003 in which a new, modified inflation forecast was announced for 2003 and 2004. Inflation is now expected to be as high as 5.2 per cent in December 2003 instead of the previously calculated 4.6 per cent, which means price level increase is out of 3.5±1 per cent range previously announced for 2003.

The inflation forecast for 2004 was modified downward by 0.2 percentage points to 4.0 per cent and Zsigmond Járai, President of the National Bank of Hungary announced that the central bank is concentrating on the inflation of 2004 and will not try to lower it this year due to lack of influence. Several factors may justify the more cautious approach of the central bank:

- Unfavorable world business cycle, lower GDP-growth makes the high interest rate policy increasingly unpopular due to the trade-off between inflation and competitiveness,
- Loose fiscal policy makes monetary tools ineffective,
- Too fast average rise in wages creates additional internal demand,
- High level of liquidity due to massive capital inflow,
- Rising oil-prices in world markets as a result of the uncertainty related to the Iraqi-crisis.

Until January 2003 in the new exchange rate regime the Hungarian currency showed trend appreciation as a result of high interest rates, forthcoming EU-accession and the high yields on the quickly liberalized bond markets. These factors attracted foreign investors and while Forint appreciated by 10 per cent and inflation did not follow it immediately and thus due to the real appreciation of the Forint, concerns related to competitiveness have become the issue of the day.

The National Bank of Hungary faced a trade-off between inflation and keeping competitiveness. Although the pressure had increased, the central bank insisted on the previous disinflationary path and did not cut back on interest rates until speculative capital betting on the dislocation of the exchange band forced it to do so in January 2003. As a result of the large foreign currency inflow, the exchange rate hit the strong side of the exchange rate band and the national bank used intervention and bought Euro to protect the exchange rate. At the same time interest rates were cut back by 2 percentage points in two days. Speculation failed and the Hungarian national currency started to weaken.

The other option to deal with the situation would have been to move the exchange rate band and allow the national currency to strengthen. This would no doubt have allowed for better inflation, but a stronger Forint could have resulted in, and in fact in 2002 it did result in, higher current account deficit because of deteriorating competitiveness. As a sign of the problems caused by the strong Forint and the much too fast rise of wages, some multinational companies, like IBM, left the country.

Altogether as the Balassa-Samuelson effect cannot be neglected in Hungary, less steep disinflation can be regarded as an inevitable part of convergence. Too rapid disinflation has sizeable costs in terms of GDP-growth : Poland is a case in point. Slower disinflation may be a reasonable compromise, and for an accession country inflation by 2-3 percentage points higher than in the member countries may serve real convergence better.

However the already mentioned circumstances as loose fiscal policy and rising oil-prices reduce the alternatives available for monetary authorities. Tools of the national bank are squeezed as higher interest rates would draw capital-inflows with stronger Forint, weaker competitiveness, a deteriorating current account and increasing budget deficit.

Loose fiscal policy (9.4 per cent deficit of GDP in 2002) and the 7.8 per cent expected average rise in wages in 2003, well over GDP-growth, attracted the attention of IMF. The rise in wages, as a result of last year's elections and the new government's social policy, leads to an almost unmanageable rise in demand resulting in higher inflation. These factors creating excess demand forced the national bank not to try to meet the inflation target of 2003 but concentrate on the target of 2004. The IMF called upon the Hungarian government to take the necessary steps which are unavoidable to comply with the estimated 4.5 per cent budget deficit for 2003, including the freeze of wages in the public sector.

By intervening and cutting policy rates, monetary authorities trapped the speculative capital inflow in mid-January. The Forint weakened and the speculative capital converted into Forints flooded into bond and money (interbank) markets causing over-liquidity in the economy and turned financial markets upside down for more than a week. Most of the foreign short term investors chose the Hungarian bond market trying to avoid a big loss converting their Forints into Euro. There is a threat of inflation due to over-liquidity but it would not have been very sensible to convert this speculative capital back immediately to absorb inflationary effects, because this would have led to similar problems with the national currency at the strong edge of the band. Instead, the national bank tried to get rid of its Euro reserves gradually in small volumes and so the currency picked back up (though it is still further away from the strong edge) and investors have been so far discouraged from further speculation.

Although this solution at the moment seems viable, some problems may arise. The present exchange rate system is analogous to the one which is compulsory before joining the EMU (ERM-2). There is likely to be a pressure on national currencies of the ten accession countries at least for two years, especially until their interest rates stay higher than those in the Euro-zone. Exchange rates might hit the strong side of exchange rate band forcing the national banks to pursue the rather costly policy of sterilized intervention. The rapid introduction of Euro could smooth this process and protect the Hungarian financial system from further destabilizing speculative attacks.

Finally, currently one of the most pressing problems for inflation is the evolution of oil prices. Since the price of petrol is the highest in the region in Hungary, (higher than in Austria) a 10 per cent increase, as expected due to the Iraqi crisis, would have negative real effects and produce higher inflation as well. Excise tax on fuel is very high and thus a cut-back on the tax could weaken this effect, but this would lead to higher fiscal gap, which already limits monetary policy effectiveness.

Altogether from the above mentioned factors it is not yet clear how the lower inflation rate than the recently predicted 5.2 per cent can be reached for December 2003. Factors like rising oil-prices, loose fiscal policy and accelerating wage-outflow worsen the outlook. Moreover, it can be assumed that if the pressure from high government expenditures and the rise in wages is not eased, even 5.2 per cent would be difficult to achieve.

III. RUSSIA'S FOREIGN TRADE IN 2002

Foreign trade turnover in Russia hit ten year record $151.8 billion in 2002 according to the press service of the Russian State Customs Committee. It is the highest level since 1992 although $14.6 billion less than the corresponding preliminary data of the Ministry of Economic Development (MED) and the Central Bank of Russia (CBR).

The CBR predicted earlier this year that total foreign trade turnover in the last year would amount to $166.4 billion, with exports increased by 4.4% to $106.1 billion and imports increased by 12.1% to $60.3 billion compared to their year-end level in 2001. It would have come to a $45.8 billion surplus, a 21.2% drop from the $58.1 billion plus of 2001.

In contrast to the expectations of the CBR and the MED Russia's export turnover totaled $105.8 billion (a 5.8% increase), while imports of goods increased by only 9.8% to $46 billion. Thus the trade balance reached $59.8 billion, which represents a $1.7 billion (or 2.9%) growth from the previous year.

Table 1: Total trade turnover in Russia

	2000	2001	2002
Total trade turnover	150,4	156,4	151,8
Exports	105,5	103,0	105,8
Imports	44,9	53,4	46,0
including:			
Without of CIS countries	122,8	128,0	126,0
exports	91,3	87,7	90,2
imports	31,5	40,3	36,2
CIS countries	27,6	28,4	25,8
exports	14,2	15,3	15,6
imports	13,4	13,1	10,2

The main reason of the growth of exports is the significant expansion in the volume of exported oil, petroleum products, natural gas, nickel, ferrous metals, timber products and motor cars. This expansion made an increase in exports possible although prices for main export products fell compared to 2001 on a y/y basis. In 2002, the price situation was worse for Russian exporters than in 2001, mainly because of a significant fall (by 27%) in the price of natural gas.

According to Bank of Russia estimates (January-November 2002 data compared to the same period of the previous year) the composite world price index for major Russian exports, adjusted for their structure, registered 0.91 relative to 2001. The price of Urals crude oil decreased by 0.3%, while Brent was down by 1.1%. Petroleum product prices fell by 0.3% on average as the price of diesel fuel sank by 8.9% and gasoline by 3.8%. Non-ferrous metal prices were down by 1.8% on average. Not all export products showed this tendency, since the price of fuel oil rose by 13.0%, while the price of nickel rose by 11.9%.

Oil exports in 2002 amounted to 186.7 million tons, up 19% y/y. Export revenue increased by 16% to $28.7 billion. Most oil exports outside the CIS went to Germany (20.6 million tons), Italy (19.5 million tons), the Netherlands (15.6 million tons) and Poland (15.1 million tons). Exports to CIS countries totaled 32 million tons ($3.56 billion) or 17% of total oil exports, which ratio represents exactly the share in CIS countries of total trade turnover.

Growth in imports resulted, above all, from the expansion of volumes of most of imported products. Imports grew mainly as a result of an increase in the imports of machinery, equipment and transport vehicles, non-food products and some foodstuffs. Pulled by the industrial output growth of the fuel sector, non-ferrous metallurgy and the expansion of freight turnover of transport companies, demand for machinery and transport vehicles rose in comparison to 2001.

The structure of Russian foreign trade is still a main problem in the transformation process. The bulk of exports is made up of raw materials and semi-processed goods. Mineral products, metals, timber, cellulose, pulp and paper account for more than 75% of exports, while engineering and manufacturing represents only 10%. Moreover, this unfavorable structure seems to be rather stable over time, it has not experienced any fundamental change since 1992.

We can find the same unfavorable characteristics as we turn to the other side of the trade balance. Russia imports mainly highly-processed goods such as machinery, equipment, transport vehicles and chemical products. This group of products accounts for more than 60% of the total import turnover. The share of food products and agricultural raw materials runs to nearly 25%.

The main problem lies in the lack of productive investment during the first seven years of transition. Instead of thinking in long-term projects, upgrading productive capacities, enterprises have struggled to find short-term solutions. Even in potential international competitive export branches there has been no strategy of modernization. To reduce the international vulnerability of the productive structure of Russian foreign trade, one possible solution is to try to increase the value-added and the quality of Russian products, but that seems hard to be carried out without foreign direct investments.

Meanwhile the geographic orientation of trade has been transformed in an advantageous way during the same period. In the first years of transition the dominant trade partners of Russia were the former Soviet countries, but after that foreign trade oriented more and more westwards. Today, Russia's main trade partners are non-CIS countries, with a huge share of 83% of total turnover, 85.3% of exports and 77.8% of imports. EU countries contribute to 36.6% of total trade turnover, specifically to 35.3% of exports and 39.6% of imports.

The main trade partners inside the EU are Germany, Italy and the Netherlands, and it's important to pay attention to the fact, that Germany accounts for 14.3% of the imports – far the highest level among all trading partners. EU candidates account for 11.1% of total foreign trade turnover, relations with Poland and the Baltic States are traditionally strong.

Table 2. The structure of Russia' foreign trade

Country	Imports ($billion)	Imports (%)	Exports ($billion)	Exports (%)	Total trade turnover ($billion)	Total trade turnover (%)
Germany	6,6	14,3%	8,0	7,6%	14,6	9,6%
Italy	2,2	4,8%	7,4	7,0%	9,6	6,3%
France	1,9	4,1%	2,6	2,5%	4,5	3,0%
Finland	1,5	3,3%	2,9	2,7%	4,4	2,9%
Great Britain	1,1	2,4%	3,7	3,5%	4,8	3,2%
Netherlands	1,1	2,4%	7,2	6,8%	8,3	5,5%
Sweden	1,0	2,2%	1,0	0,9%	2,0	1,3%
EU	**18,2**	**39,6%**	**37,4**	**35,3%**	**55,6**	**36,6%**
Poland	1,3	2,8%	3,7	3,5%	5,0	3,3%
Baltics	0,6	1,3%	4,1	3,9%	4,7	3,1%
EU entries 2004	**3,3**	**7,2%**	**13,6**	**12,9%**	**16,9**	**11,1%**
Belarus	4,1	8,9%	5,8	5,5%	9,9	6,5%
Ukraine	3,2	7,0%	5,8	5,5%	9,0	5,9%
Kazakhstan	1,9	4,1%	2,4	2,3%	4,3	2,8%
CIS countries	**10,2**	**22,2%**	**15,6**	**14,7%**	**25,8**	**17,0%**
United States	3,0	6,5%	4,0	3,8%	7,0	4,6%
China	2,4	5,2%	6,8	6,4%	9,2	6,1%
Brazil	1,3	2,8%	0,2	0,2%	1,5	1,0%
Japan	1,0	2,2%	1,8	1,7%	2,8	1,8%
South Korea	0,9	2,0%	1,3	1,2%	2,2	1,4%
Turkey	0,7	1,5%	3,3	3,1%	4,0	2,6%
Switzerland	0,4	0,9%	5,3	5,0%	5,7	3,8%
Others	**14,2**	**30,9%**	**39,2**	**37,1%**	**53,4**	**35,2%**
TOTAL	**46,0**	**100,0%**	**105,8**	**100,0%**	**151,8**	**100,0%**

The most interesting re-orientation – not shown in the table - is towards Central Europe, with which trade is regaining intensity after the collapse of COMECON. CIS nations accounted for only 17% of Russia's goods turnover, specifically 14.7% of exports and 22.2% of imports. The contribution of "other" countries is also significant, and moreover, the 37.1% share of exports exceeds that of the EU. Trade with the United States is still insignificant, with modest $7 billion.

IV. BULGARIA – POLICIES IN 2003

Bulgaria has shown an impressive macroeconomic performance and robust growth since currency board agreement (CBA) and prudent fiscal policy were introduced in 1997. The financial help from international organizations like the International Monetary Fund (IMF) and the World Bank played a significant role in this economic progress.

In February 2002 the IMF and Bulgaria signed a two-year Stand-By Arrangement with a total credit amount of SDR 240 million (about US$ 330 million) to supporting the program of the Government and the Bulgarian National Bank. In 2002, Bulgaria drew about a third amount of the credit. In January 2003 the IMF enabled Bulgaria to call in SDR 26 million as the second review was completed and the Bulgarian Government and the National Bank launched a macroeconomic program for 2003 in accordance with the policies settled in the original agreement.

The IMF welcomed and accepted the program but drew attention to some key points that need to be taken additional care:

- The recent and actual reforms of the financial sector are essential for the further, private sector generated economic growth but the fast rise in private credits requires strict supervision of the bank sector.
- More developed tax administration and tax collection are the preconditions of the intended reforms of the fiscal sector and taxation system.
- Privatization should be accelerated.
- Drawing more investment into the country is a key element of further development. To facilitate it, business regulations should be eased and the increased workforce-flexibility is essential. Although unemployment rate has been sinking, it is still too high.

According to the program, economic policy will further be based on the CBA, which is justified as it is supported by strict fiscal policy, robust growth and better and better external position. The GDP-growth was the highest amongst EU accession candidates in 2002 and it remains high according to the expectations. According to the Letter of Intent addressed to the IMF GDP is forecasted to grow annually at 5-6 per cent in the medium term. However, if the global recession does not turn it will be an optimistic scenario. In this case the fiscal prudence has to be emphasized again. Future structural reforms are highly built on the fast growth of GDP. If it does not happen the medium-term macroeconomic program will have to be supervised. On the other hand accession economies have been producing higher growth than ever expected before when recession apparently turned up.

One of the most important and challenging elements of the economic reforms is the program to balance the budget deficit over the next three years. The program is strict, sensitive to external and internal shocks. The main elements of the program are:

- Structural rearrangement of tax-base contains easing direct taxes on natural persons and business enterprises,
- Reduction of revenues counter-balanced by higher excise taxes,
- The reform of tax and custom administration,
- Decreasing level of subsidies.

The government uses an efficient tool to control the budget-deficit. The expenditures of government are monitored and it is not allowed to exceed 88% (of total governmental expenditures in the year) until October 2003. Revenues are monitored monthly and a difference generates immediate action. This hard policy must establish credibility, however, accidental and especially continuous rectifying of the system can lead to suspiciousness.

Personal income taxes of low and middle-income earners will be lowered to create a better climate for personal savings. To counter-balance the decline of revenues, excise taxes on tobacco, alcohol and petrol will rise. The improvement in tax administration helps to keep up revenues as well: whose income is in the higher level, the tax burden will be hardened. Altogether the growing excise taxes will not neutralize the effect of the falling personal income tax for the low and middle-income range, although we know excise taxes hit mostly them.

The new tax policy also aims at decreasing the current account deficit to 4.5 per cent of GDP by raising savings. According to expectations gradually decreasing corporate taxes (to 15 per cent until 2005) will attract more foreign investment that will help finance the current account deficit. The policy of easing corporate taxes and reducing unemployment are connected as zero tax grants are given for those companies that work in regions with high unemployment rate.

The plans, which improve business climate and ease business regulations, will help and boost investments. According to plans not only the establishment of new enterprises will be easier but their exit as well. Simpler and more efficient bankruptcy law will be provided for non-viable companies. Giving more rights to creditors will help to reduce the already declining rate of bad credits, and declining credit risks help the corporate sector.

The program includes structural reforms: among them infrastructure developments and reform of the health care sector. The energy sector is another sensitive point. Recent and forthcoming increases in prices of district heating and household electricity reduce budget deficit, but the prices are still far below their market levels, as they have not reached cost-recovery levels. The losses of two state-owned electricity and natural gas companies will worsen budget balance. To minimize them a new draft of the Energy Law is already on the way with the purpose of fast privatization and inspiring competition.

The unemployment rate looks like it is on track, but without further labor market reforms and active labor policies it will be difficult to reduce it further. Unemployment in Bulgaria has reached its lowest rate since 1999, according to the Labor and Social Policy Minister Lydia Shouleva. The unemployment was 16.8 per cent in November and it decreased by 10% since the beginning of 2002.

V. UKRAINIAN GDP UP BY 7,7% IN JANUARY

Ukrainian GDP increased by 7.7% year-on-year in January according the Ukrainian State Statistics Committee. The source said that in January the most remarkable growth was reached in construction (24.4%), manufacturing (13.8%), wholesale and retail trade (8.3%). According to preliminary estimates, nominal GDP amounted to 15.021 billion Hryvnia in the first month of the year.

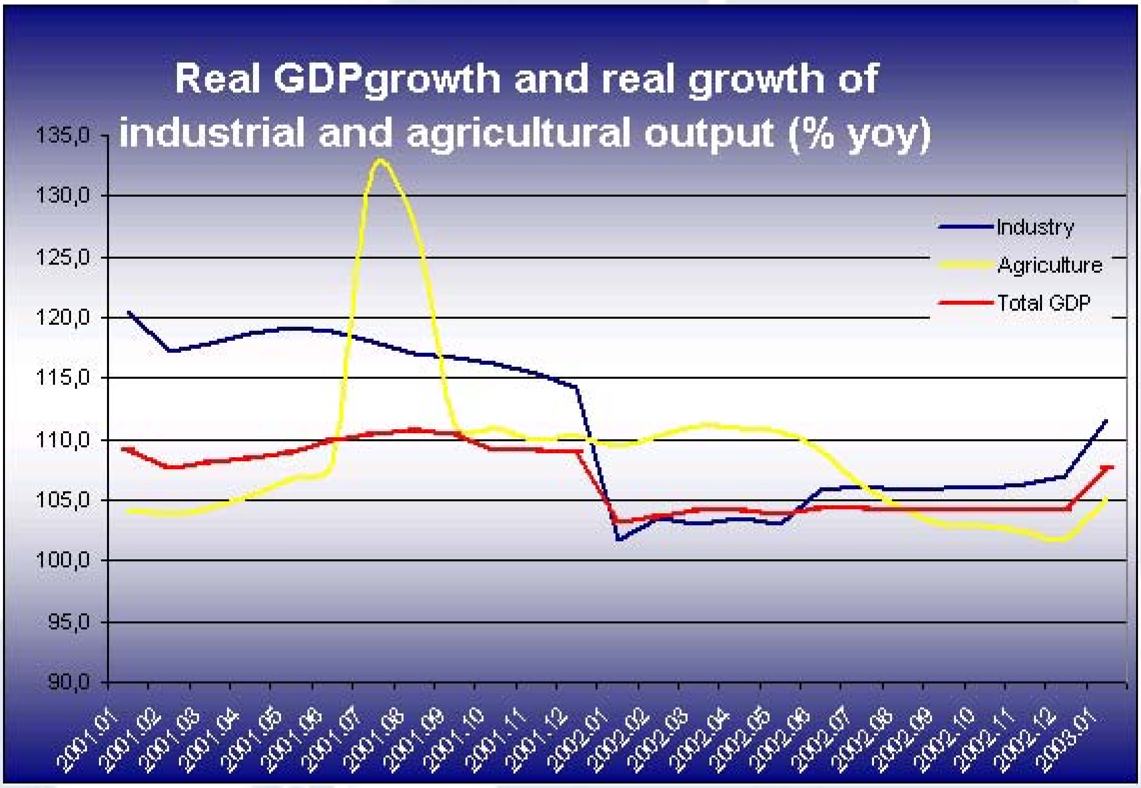
In January 2003, industrial output grew by 11.6% year-on-year to 14.8 billion Hryvnia: the leading sector was the metallurgy with its highest 22% y-o-y growth responding to favorable conditions on the world metal markets. The share of industrial value added in GDP is about 31%, which shows the importance of this sector. Industrial growth was 14.3% in December 2002 and 7% in 2002 as a whole. However, output fell by 10% in January 2003 compared with December 2002 as output usually falls at the start of the year due to public holidays. The first month of the year was also marked by a 21,6 % y-o-y growth in construction after a yearlong muddling through in the sector caused by political uncertainty. The volume of signed annual contracts increased by one fifth in nominal terms when compared with the respective period of the previous year. In agricultural sector a 5,2 % y-o-y cumulative growth is expected and if we consider that agriculture gives about 14% of all value added, it is an important element of GDP growth.

Thanks to inescapable reforms in energy sector, monetary system and banking sector, as well as to favorable situation on the external markets, after almost a decade of uninterrupted decline of GDP, Ukraine experienced first year of output growth in 2000. Ukrainian GDP in 2002, according to early figures, increased by 4.1% compared with 9.1% in 2001.

In 2002, the considerable slowdown compared to 2001 was related to deteriorating global conditions. As before, major contributors to growth were food and petroleum-refining industries, metallurgy and machine building. Altogether these industries accounted for two thirds of annual industrial growth. In agriculture large slowdown, was observed due to significant decline of plant production.

On the demand side, final consumption remained a dominant source of aggregate demand in Ukraine. In 2002, there were significant changes in the contribution of the major demand components to growth. Similarly to many other Eastern European economies a shift from external to domestic demand components occurred. Investments in the Ukraine contribute to growth less (though they have also increased stimulated by the decline of interest rates. Consumption was stimulated by higher real wage increases : the index of real wages of employed in the Ukrainian economy was 115,7% in December 2002 compared to December of the previous year. Further stimuli of consumption were the reduction of wage arrears in the public sector and the very low and almost unchanged savings propensity of households. This kind of propensity to save is an obvious consequence of large deferred consumption.

Chart 4.



While internal demand increased, the contribution of external one did not decline significantly as the growth rate of exports in real terms was twice higher than of imports. An important factor in this respect is that NBU pursues a policy of step-by-step devaluation of Hryvnia. NBU is resisting the Hryvnia's rise against the U.S. dollar and the Euro : since the beginning of the year, the Hryvnia's inter-bank exchange rate has gone down by 0.01% from 5.3365 Hryvnia to 5.3370 UAH/USD. In 2002, it declined by 0.72% from 5.2985 UAH/USD to 5.3365 UAH/USD. There is a bit different situation against the Euro. As is known, the depreciation of the US dollar against the Euro had a further impact on rising competitiveness of Ukrainian industrial and agricultural products. It is important to mention that the main export destinations of Ukrainian economy are Russia (22%) and the European Union (17%).

Under a stable nominal exchange rate the real effective UAH/USD exchange rate in 2002 (as the main indicator of competitiveness) have depreciated because of declining inflation in 2002 (see ICEG EC, News of the Month N.7), which established favorable conditions for export-orientated economic growth.

Forecasts. The Ukrainian Cabinet of Ministers forecasts 4% GDP growth in 2003. A report prepared by the IMF mission that visited Ukraine in February also forecasts that real GDP growth will reach 4% both in 2003 and 2004. Nominal GDP can hit 240 billion Hryvnia in 2003 and 262 billion Hryvnia in 2004. The largest growth can be in metal industry, food industry and machine building. In addition, the output of construction industry output growth is expected to accelerate in 2003.

The balance of payments on current account is expected to result in a surplus of 2.113 billion USD (4.8% of GDP) and 1.289 billion USD (2.7%) in 2003 and 2004, and the inflation rate is expected to remain low (6% and 4%)..

There are some risks in this prediction because of the existing political risks, which will cause delays in economic and political reforms. Finally, these expectations depend on the nowadays very fragile world economic conditions and include high levels of uncertainty.