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European Center

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14 Korompai Street, H-1124 Budapest, Hungary

Tel: +36 1 248 1160 *E-mail:* icegec@axelero.hu *Website:* www.icegec.org

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I. ECONOMIC GROWTH AND OUTLOOK IN ESTONIA

The Bank of Estonia has modified its GDP growth forecast for 2003 from 5,0% to 4,4%. It is not the first modification: last December the prediction for 2003 was 5,3%. The main reason for the worsening prospects is the delaying recovery of the global economy. The IMF has judged the conditions more favourable and predicted a real growth of 4,9% in its revised forecast. However, somewhat surprising that the Estonian government seems to be the most pessimistic since its prediction in January for 2003 had not exceeded 4,3%. By the preliminary estimations of the Statistical Office of Estonia the economic growth was 5% in the first quarter of 2003. An IMF staff visit was carried out in Estonia in early May. According to the concluding statement Estonia's economic outlook continues to be favourable. The Estonian economy has however become more vulnerable due to the weaker global economic outlook and expansion of domestic credit.

As we already mentioned (News of the Month 2002 October) the performance of the Estonian economy in 2002 was sparkling. The GDP grew by 5,8% in real terms, which outnumbered even the most optimistic scenarios. But beneath the surface Estonia has shown the signs of an overheated economy. In the cooling climate of the global economy the growth was driven by the strong domestic demand. In 2002 the domestic demand component of the GDP increased by 12,1% of which the growth of gross fixed capital formation rocketed by 17,5%. One source of the investment boom can be found in the amendment of Income Tax Law. The Parliament abolished the income tax for reinvested profit. The average effective tax on capital has decreased from 35,1% to 10,9% since 1999. The expansive monetary conditions can be mentioned as the other source of extremely high capital formation. The 3-month interbank rate hit an all-time low in 2002 and still declining.

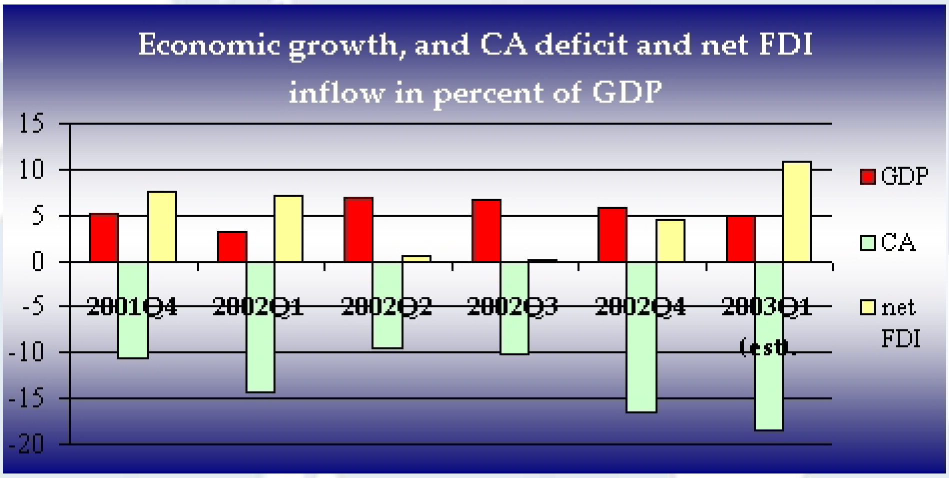
The low interest rates, the increasing wages and the nominal appreciation of the Estonian Kroon (which is pegged to the Euro) led to an increase in private consumption (by 8,2% in real terms) in 2002. The government had behaved in accordance with the principle of balanced government budget. The surplus of the general government budget accounted for the 1,2% of GDP, while the real growth of government final consumption expenditure was 5%.

The exports of goods and services (f.o.b.) increased by 5,5% in 2002 (-0,2% in 2001). The export to the euro area was not affected by the nominal appreciation. Despite the appreciation the share of non-EMU member countries included Sweden, United Kingdom and Denmark in the export has slightly increased. The EU15 are responsible for the 68% of Estonian export of which 24,5% goes to non-EMU members. The export performance can be regarded good if one takes into consideration that the share of re-exportation after inward processing (subcontracting) fell significantly to 31% from 38%. Due to the soaring domestic demand the import growth reached 10,6% and contributed to the very high current account deficit. The fastest growing commodity group was the transport equipment (first of all cars). The main trading partners remained Finland, Germany and Sweden while the total share of EU was 58%.

The most important risk factor for the economy is the high current account deficit generated by the trade balance. The CA deficit accounted for 12,2% of GDP in 2002. The figures for 2000 and 2001 were 5,8% and 6,1% respectively. The net FDI inflow fully covered the current account deficit before 2002. But last year deficit was four times higher than the net FDI inflow. The most important consequence is the growing foreign debt of private sector, which exceeded the 60% of GDP. At the same time government deficit is a strong point of the economy because it is equal only to the 4,4% of GDP.

What tendencies may influence the economic growth in 2003, why should have the Bank of Estonia revisited its forecasts? The external conditions will not improve in the first half of the year. The expected growth of EU in 2003 is only 1%. In the first quarter the Estonian export has increased by 7% compared to the same period of previous year, but the upsurge in import has reached 16%. Consequently the current account deficit is higher than the 15% of expected nominal GDP. The net FDI inflow has covered 59% of the current account deficit. The deficit was mainly financed by debt securities purchased by foreigners. In spite of the unfavourable CA figures for the first quarter researchers expect an improvement in the CA for 2003. It may derive from the declining import and increasing export. The forecasted export growth is based on the investment boom in 2002.

Chart 1



Contrary to the inverse effects of external conditions private consumption seems to be powerful enough to pull the economy in the first half of the year. Wages increased faster than consumer prices by 9,4-percentage point in the first quarter of 2003. Monetary conditions also support the private consumption. The stock of commercial banks' loans is EEK 51 billions, almost 50% of GDP. Year-on-year basis bank deposits has increased by 16% in March, while the loans has risen by 23%. Loans to individuals grew the fastest. At the same time the real interest rates for private persons' deposits is close to zero. The interest rate cut by ECB in June may strengthen further the borrowing inclination of households. In spite of these tendencies the ratio of non-performing loans remained low, 0,8%. The Estonian bank sector is stable and well performing. In the long term another boost to the private consumption can be given by the announced tax-reform of the new government. According to the plan the income tax rate will be reduced from 26% to 20% by 2006. The reduction will be carried out gradually by 2-percentage point per year.

The growth of government final consumption is hard to predict. A remarkable sign could be the approval of first ever deficit budget in January. The planned deficit is equal to the 0,3% of GDP. The expenditure side is strongly influenced by the NATO and EU membership and pension reform. Due to the more-than-expected tax revenues the new government approved a supplementary budget in 7. May. It is contrary to the recommendation articulated by the IMF and the Bank of Estonia. The new right-of-centre government is not planning to sell any of the strategic state-owned company (Port of Tallinn, Estonian Air, Estonian Energy).

In spite of the low (and declining) interest rates the investment boom is likely to come to the ends. The confidence of industrial and trade enterprises is worse than a year before, but better than that of customers. Confidence of customers is improving but still negative. The long-term outlooks are better. The World Economic Forum ranked Estonia for 27th in the Global Competitiveness Report, while the ranking in IMD competitiveness report is 17th. On both list Estonia is first among the EU candidate countries. The Eurostat estimates the price of Estonian labour force 7.5 times cheaper than EU average. The Federation of European Employers has judged Estonia and Croatia the most favourable countries from the employers' point of view.

In the real sector the three most important obstacles to the long-term stable economic growth are the lack of qualified labour force, the discrepancies between saving and investment and the not sufficient R+D expenditures. The Estonian economy spends only 0,7% of GDP on R+D while the European average is 1,9%. The share of private sector in R+D expenditure (30%) are also well below the European average.

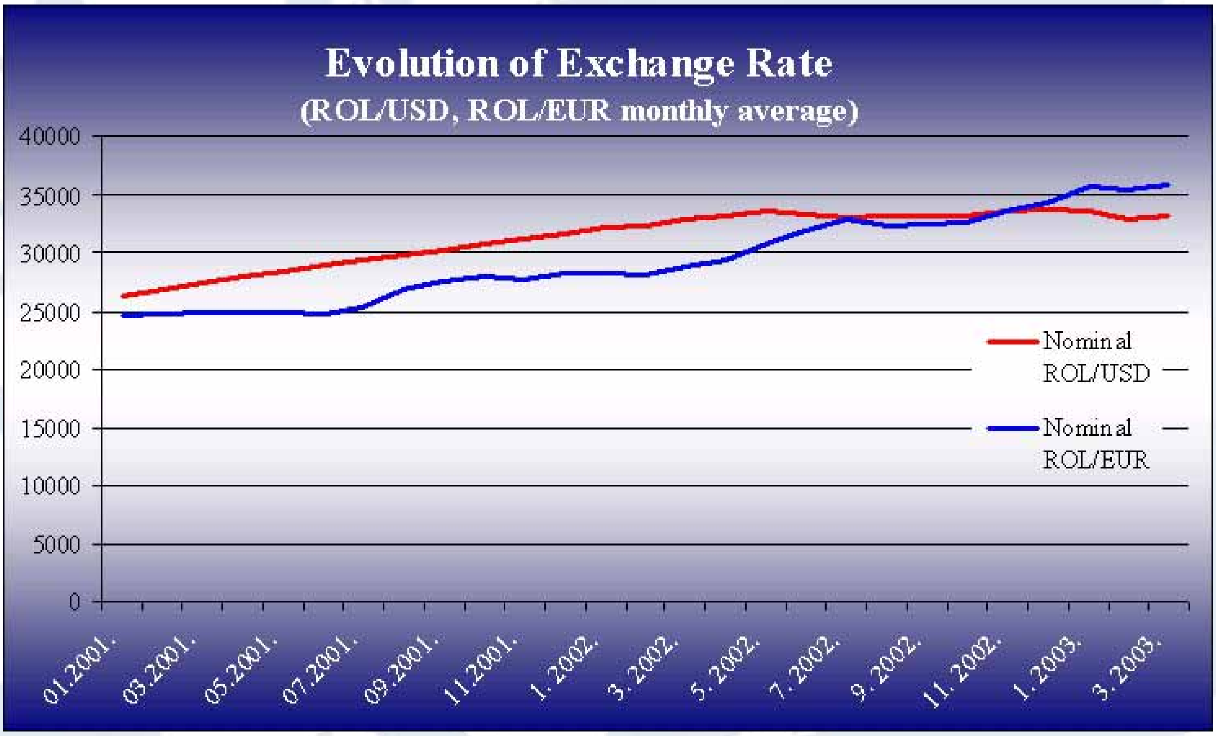
prepared by: Gergely Baksay

II. New reference currency in Romania

From March 2003, National Bank of Romania changed the reference currency for the ROL. BNR's Board of Directors decided to establish the euro as ROL's reference exchange rate from the first working day of March. As a result, Romania gave up the USD-related reference and was the one before the last EU candidate country that established in euro the national currency's reference exchange rate (only Latvia is the exception, its reference currency is the SDR – Special Drawing Rights, the IMF's currency basket). The exchange rate regime has not changed it is still managed floating.

This step was a part of a lengthy strategic process, initiated in 2000 by launching Romania's Strategy of Sustainable Development. In the summer of 2001, the daily step of devaluating the ROL against the USD was renounced, and in March 2002, a larger freedom for the hard currency market was allowed, without renouncing though the medium and long-term predictability. This move to the euro reference represents the latest step of the process, aimed at adopting by Romania the European single currency. For the 2004-2005 period, the BNR wants to finalize the process of harmonizing the banking legislation with the European one and moving to a direct attack on inflation. By the way, BNR estimates a 13-14% inflation for the end of the year and aims at reaching a one-digit inflation rate in 2004.

Chart 2



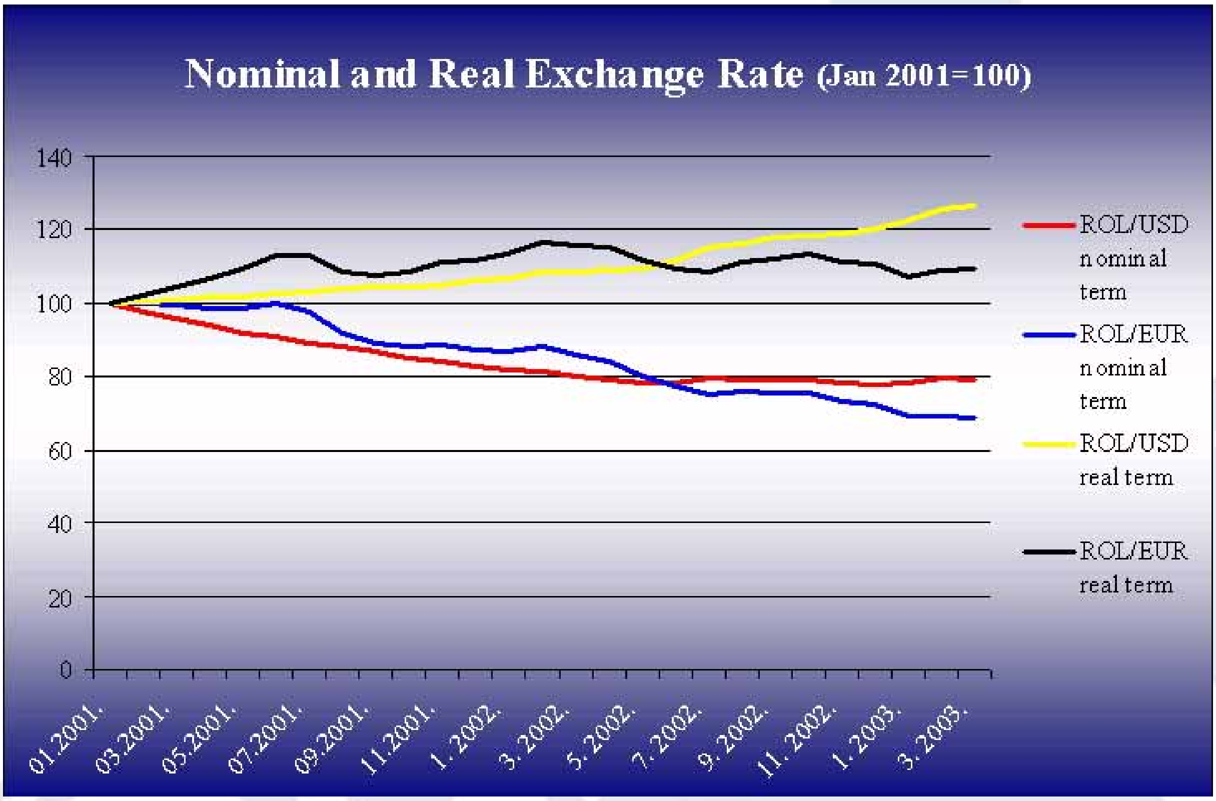
The BNR affirms that the appreciation of the European single currency against the USD internationally did not have effect on the change of reference currency. BNR's governor declared that the inflation in Romania is mostly created by domestic factors. The exchange rate factor is not an important one, it is not capable to generate inflation. However, the high USD/EUR exchange rate creates inflationary pressures on the Romanian economy. The appreciation of the single European currency against the US dollar and Romanian Leu might pose problems. According to experts, if the euro exceeds the USD 1.15 threshold it has inflationary impact in Romania. Undoubtedly the change of reference currency has positive effect, and the inflationary pressure may be compensated by the decline of crude oil price. The change of reference currency will have positive effect on disinflation process and stabilize the foreign trade balance in the future.

On short term, the move to the euro reference will demand only a range of technical changes. From March, the BNR's intervention currency is the euro on the hard currency market. The BNR sells and buys in euro and not in USD on the forex market as it happened before. The BNR's governor said that the controlled flexibility of the ROL remains the general framework at the level of National Bank of Romania.

One of the immediate advantages of the decision taken by BNR is reducing the transaction costs for economic agents, commercial banks and the public. The BNR's long-term reasons for change are next: Romanian exports in euro represented 58% in the total, whereas the imports represented 65% in 2002, and a higher acceptance of the euro by the public was noticeable. In addition to these internal reasons, there are also considerations related to Romania's objective of joining the European Union in 2007. BNR tries to receive a European bank status. The process will finish in the next decade, when Romania can adopt the European money as national currency.

In nominal terms, the ROL depreciated by 6% against the USD and by 20% against the EUR in 2002. In real terms, it means appreciation against USD and depreciation against EUR. The real depreciation of the ROL against the EUR had a favorable impact on export and current account balance.

Chart 3



For the next period, BNR maintains its strategic objective of ROL's appreciating in real terms. The 3-5% appreciation per year helps Romania's convergence to the EU average. Furthermore, BNR wants to continue the policy of encouraging the savings in ROL and of increasing the number of ROL loans given by the commercial banks. From now the BNR's hard currency reserve will be connected to the fluctuations of the foreign trade. BNR will increase no longer the hard currency reserve over the rate of the foreign trade.

Prepared by: Bilek Péter

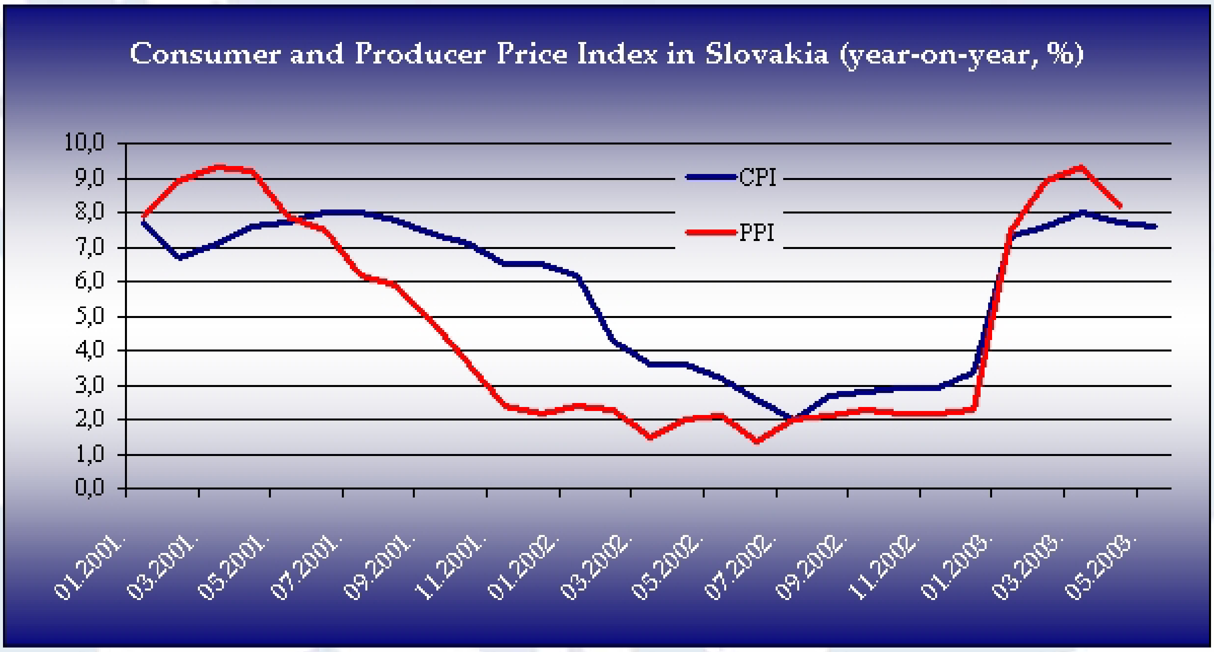
III. MODERATE SLOVAK INFLATION AGAIN

In May 2003, Slovak Consumer Price Index (CPI) was 7.6% year-on-year, a little lower than in April (7.7%). Comparing to 2002, CPI increased significantly in Slovakia. In April 2002, CPI stood at 3.6% and it fell to 2,3% in December. The inflation rate became larger in the beginning of 2003 when government increased regulated prices and changed excise taxes.

In line with expectations, the CPI rose to 7.3% in January. As it was mentioned, the two key factors were the hike in regulated prices and changes in excise taxes implemented by the government in January. The CPI increased further and it reached 8% in March. The Consumer Price Index has not been so high since July 2001. In the first month, the next major changes were realized by the government:

- Most prices previously regulated by the government, or the Ministry of Finance of the Slovak Republic, fell into the competence of regulatory authorities.
- Excise taxes were also changed. Under adopted revisions to relevant laws, the excise on beer and wine were adjusted.
- From 2003, the basic VAT rate was set to go down from 23% to 20%, and the lower VAT rate to go up from 10% to 14%. However, the change of VAT rate had no important effect on inflation; the main factor of the increase of consumer prices was the increased regulated prices. In April, the regulated prices rose by 22.9% year-on-year, the core inflation was 1.9% and net inflation, which excludes the impact of changes in indirect taxes, rose by 3.3%.

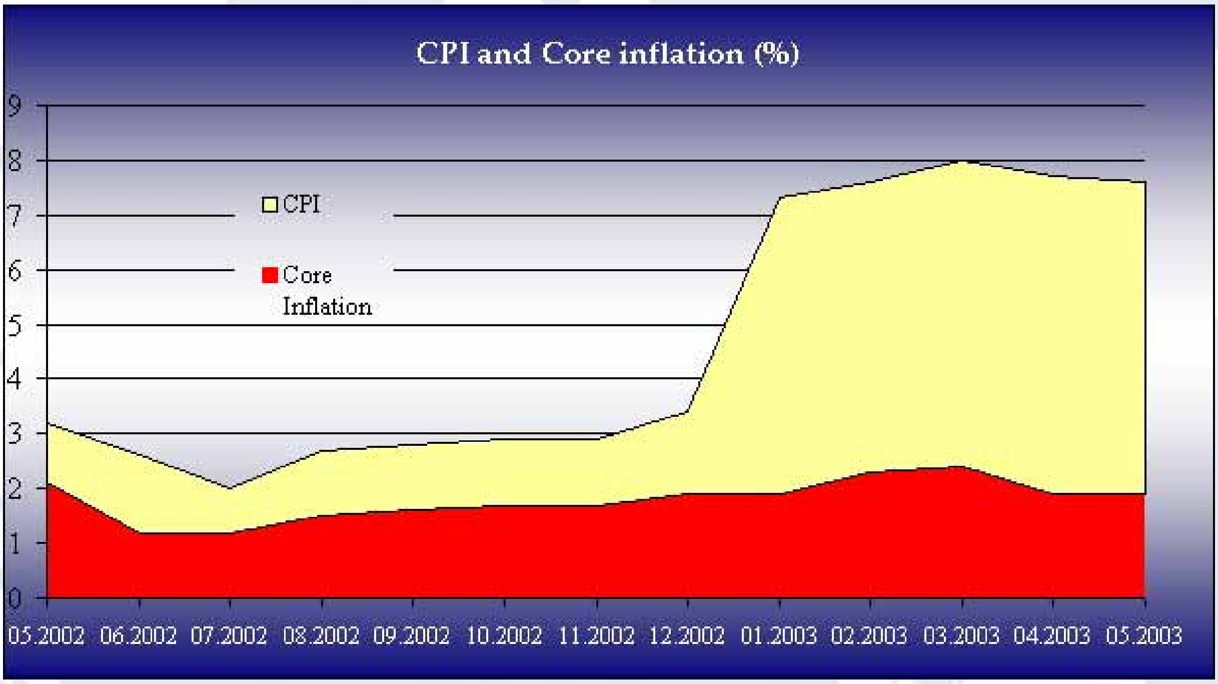
Chart 4



The Producer Price Index (PPI) accelerated from 8.9% in February to 9.3% in March, due to a steep rise in the price of electricity, gas, steam, and hot water (17.5%, compared with 17.4% in February), mineral-based raw materials (6.6%, compared with 6.3% in February) and industrial products (4.3%, compared with 3.7% in February). In industrial products, the greatest acceleration (5.6%-points) took place in the price of coke and refined oil products, which rose year-on-year by 22.9%.

In May, the development of consumer prices was in line with the Central Bank's expectations. The increase of both headline and core inflation was supported mainly by foodstuff prices while fuel prices decreased. In June, prices can be affected by the growth in consumer prices of cigarettes, due to the expected increase in excise duties as of July 2003. Thus, June inflation rate can be higher than in May because some retailers have already priced in the change of excise taxes. In July, CPI could rise above 9% year-on-year and it may hit a two-digit figure in the second half of 2003. On the other hand, it is true that core inflation can remain on low level.

Chart 5



According to NBS' Monetary Program, the headline inflation might reach 8.4-9.7% at the end of the year, with average inflation at 8.2-9.3% and core inflation at 2.1-3.6% in 2003. The estimation for inflation are based on the following assumptions:

- The direct impacts of the raise in regulated prices will cause a rise in headline inflation by some 4.5%-points. Increases in other administered prices are supposed to add plus 0.4%-points to inflation,
- The raise in excise taxes expected to add up to 0.5%-points to inflation,
- The reduction in the basic VAT rate from 23% to 20% and a raise in the lower VAT rate from 10% to 14% with an estimated impact on inflation of 0.3 percentage points,

- The cost inflation can play the main role in the development of consumer prices in 2003,
- The indirect impact of higher regulated prices of energy charged to firms will be translated into consumer prices,
- Relatively steady exchange rate of the Slovakian Crown against the euro as the benchmark currency and a stable EUR/USD exchange rate,
- Stable development in commodity prices on world markets; oil price ranging between 22 and 28 USD/barrel,
- No major demand inflationary pressure,
- Food prices growing faster in 2003, which will be the secondary impact of regulated energy prices,
- Low imported inflation and strong retail competition, which will be the impact on the pace of growth in tradable goods.

The National Bank of Slovakia originally aimed a quiet wide range for inflation target to the end of the year (7.7-9.7%), it was narrowed these days to 8.4-9.7% (the lower limit was increased); the core inflation target was also revised from 2.7-5.0% to 2.1-3.6% year-on-year. The reasons for the correction were the additional excise tax hikes announced by the government and will be introduced in July and the low-level core inflation process experienced in the first months of the year.

The assumptions listed above seem well-founded and the inflation target is accessible. However, the headline inflation will be closer to the higher limit of the target range, 8.9% is expected for 2003. The aggregate impact of the hike in regulated prices and the changes in excise taxes and VAT rate are the reason for moderate inflation in Slovakia, which is expected to start decreasing in 2004 again.

Prepared by: Péter Bilek

IV. KAZAKHSTAN, COUNTRY OF PROSPECTS

Kazakhstan on the path of transition

The Republic of Kazakhstan is a country rich in oil and other natural resources. It is the largest landlocked country in the world. After the Soviet Union fell apart, Kazakhstan stepped on the path of transition to market economics. It was not only oil wealth but also early structural reforms and prudent macroeconomic management that made Kazakhstan's presently strong economic performance possible. However, the transition towards multi-party democracy and pluralistic society did not match the achievements on the economic front. The developments from the beginning of this year raise concerns that the gap between the political and the economic dimension of the transition could increase, as the freedom of the independent media and the free functioning of the political opposition seemed to be in jeopardy in recent months.

Strong economic performance

In 2002 the economy grew by 9.5 percent, and by over 10 percent per year in the past three years. Inflation in 2002 was 6.5 percent, which was about the same level experienced in 2001. In the beginning of 2003 a slight acceleration of the inflation was observed. External performance was also strong. Exports grew by 12 percent in 2002, while imports grew by 2 percent during the same year. External trade turnover grew overall by 8 percent in 2002. The unemployment rate was 2.6 percent. Reserves of the National Bank reached US$3.1 billion, while assets of the National Fund exceed US$2 billion. The strong macroeconomic performance is expected to continue during 2003.

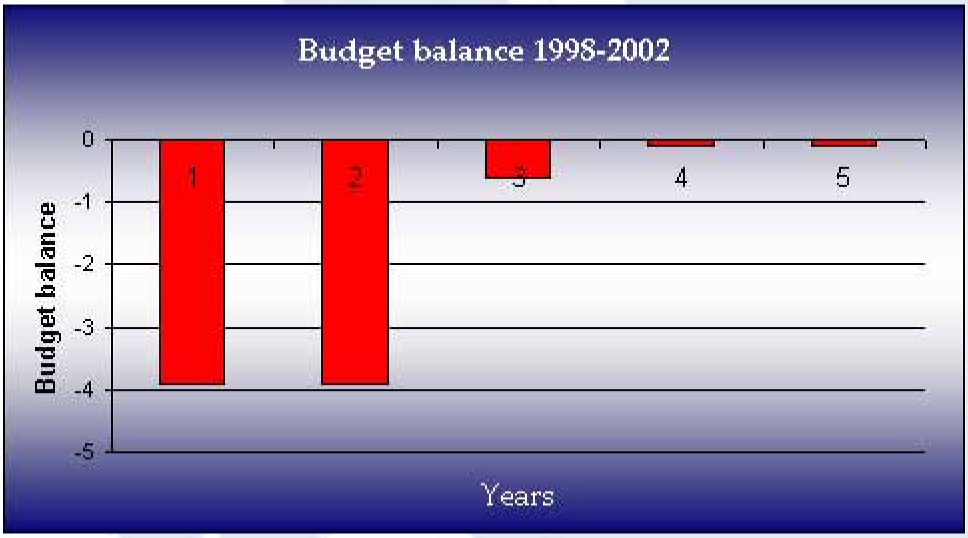
Saving for the future and the diversification of the economy

The National Fund for the Republic of Kazakhstan (NFRK) was formed for saving oil revenues for the future. It plays an extremely important role in managing the growing oil wealth. Some of the income from oil is used to address pressing social and economic needs. As the oil wealth is going to be depleted someday, the economy should be diversified. Another reason why diversification is necessary is that Kazakhstan's natural resource based economy is vulnerable to external (especially oil price) shocks. The development of the non-oil sector is crucial for the long time sustainability of a healthy economy.

According to the IMF Kazakhstan's non-oil fiscal balance in recent years has been well within the long-run sustainability path as measured relatively to GDP (0.01 percent budget deficit in 2002). The IMF, given the uncertainties associated with the discovery of the new oil reserves, their timing, and future evolution of oil prices, welcomed this prudence of fiscal policy stance. The external debt as a percent of GDP has also been low in recent years (17.7 percent in 2000).

In order to achieve competitiveness in the non-oil sector the acceleration of structural reforms, trade liberalization and further improvements in the business climate are necessary. A sustained rise in total factor productivity is needed in the non-oil economy. This should be achieved through policies that diversify the economy, create a productive capital stock, which should include physical and human capital.

Chart 6

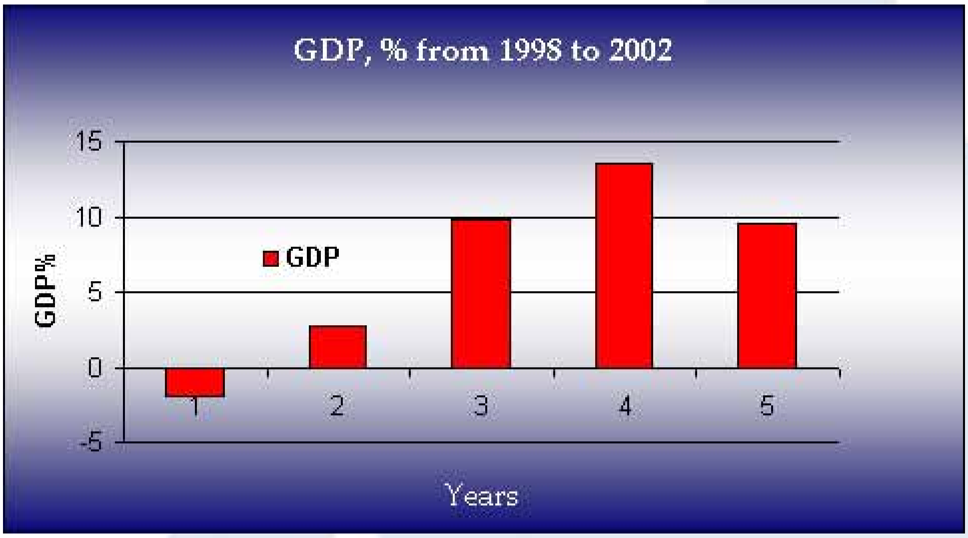


The currency crises of 1999

In April 1999 Kazakhstan has experienced a currency crisis. It was mainly caused by a series of external shocks. These included the weakness in oil and raw material markets, a poor grain harvest, turmoil in international financial markets, and spillovers of the Russian crises. As a result the economic activity contracted from the third quarter of 1998 through the first quarter of 1999. In late 1998 the fiscal policy has been loosened. The confidence in the tenge deteriorated and there was a considerable loss of competitiveness. Therefore the government announced a shift to a freely floating exchange regime on April 4, 1999. Following these events the tenge depreciated sharply.

Kazakhstan remains potentially subject to various external shocks, even tough its external position looks robust at present. The movement of the world oil price could affect Kazakhstan's external position through three channels. First of all a negative terms of trade shock would result in a loss of performance in Kazakhstan's exports, as well as a deterioration of the current account and fiscal balance. Second, as result of a negative terms of trade shock international capital could turn away from Kazakhstan. Third, the phenomenon called "Dutch disease" could cause problems, as a positive terms of trade shock might place upward pressure on the tenge, which would negatively affect the non-oil tradable sector.

Chart 7



Challenges

Kazakhstan is the largest landlocked country in the world. As a result of this it does not have easy access to markets for trade. Its infrastructure needs to be improved. Attracting foreign direct investment for the development of infrastructure is crucial for the country.

According to the EBRD Kazakhstan faces two critical transition challenges. First of all the economy has to become more diversified, in order for it to be able to withstand external shocks. Economic opportunities should be provided to the population outside the resource sector. The development of the rural economy should become more intensive, and the physical infrastructure should be improved. Further regional cooperation and trade opening, especially with neighboring countries should be achieved.

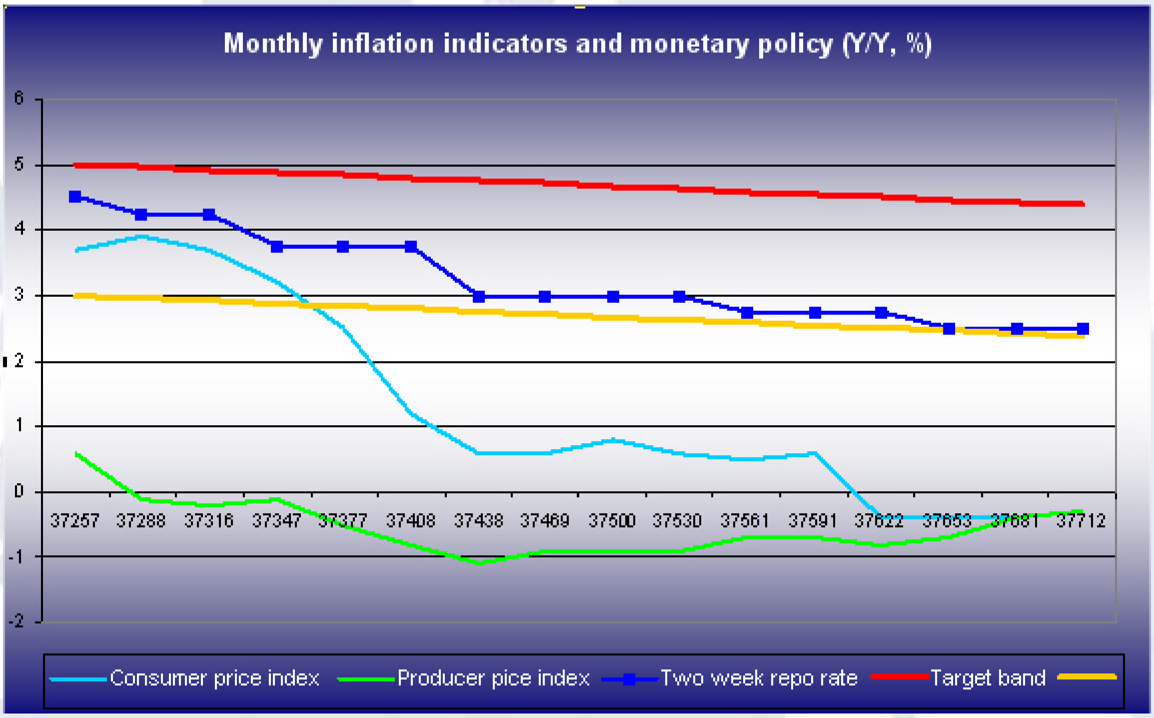
Governance should be improved both in the public and private sectors. The fight against corruption should continue, and should intensify. Public revenue management through the budget and the National Fund needs to remain transparent and accountable.

prepared by: Veronika Czakó

V. CZECH REPUBLIC: INFLATION UNDER CONTROL?

The Czech Republic not only remains the economy with the lowest rate of inflation in the group of Central European EU candidate countries but since January both its headline and industrial inflation rates (y-o-y and m-o-m) have been on the negative side. After successfully hitting the 2001 target, inflation wondered out of its target range in May 2002 and has been keeping away from it ever since. Part of the reason for missing the target is the modified inflation targeting framework: from January 2002 onward, 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, and even more importantly, headline inflation replaced core inflation as the targeted variable (the 2004 target is set at 2-4%). The targeting of headline inflation certainly makes the central bank more dependent on external factors (regulated prices, food and energy prices, etc.).

Chart 8



In April, consumer prices fell by 0.3% y/y while rising 0.2% m/m. The fall in prices slowed from 0.4% in the first three months of this year. The month-on-month increase inflation was due to a rise in regulated prices of 0.9%, while market prices dropped by 0.1%. The growth of regulated prices was for the most part due to higher prices of natural gas, which rose by 7.9%.

The April inflation figures confirmed that the Czech economy still lacks inflationary pressures these considerations led to intense speculation over further cuts of the two week repo rate. It must be clear however, that although inflation is subdued, it is hardly „under control", the negative values being the result of trends which do not fall under the influence of the Czech monetary authorities. Low and negative inflation in the Czech economy does not reflect a lack of demand but is rather a consequence of cost deflation. Cheaper imports of raw materials (especially energy producing raw materials), falling prices in the agriculture (falling food prices for the tenth consecutive month), cheaper telecommunication and regulated products such as household gas and electricity and last but not least deflationary trends in the Czech Republic's major trading partner Germany contribute mainly to the negative annual inflation rate. The strengthening (albeit at a considerably slower pace than before) currency also plays a role.

This deflationary trend is therefore is not to be treated by monetary policy tools and the present degree of uncertainty makes the CNB very cautious about easing monetary conditions. Uncertainty is also reflected in the fact that the publication of the April Report on Inflation is delayed by over a month. The two week repo rate has finally converged at 2.5% with the ECB's key instrument after a 25 bps cut in January, a response to the increased risk of undershooting the inflation target for 2003 and 2004.

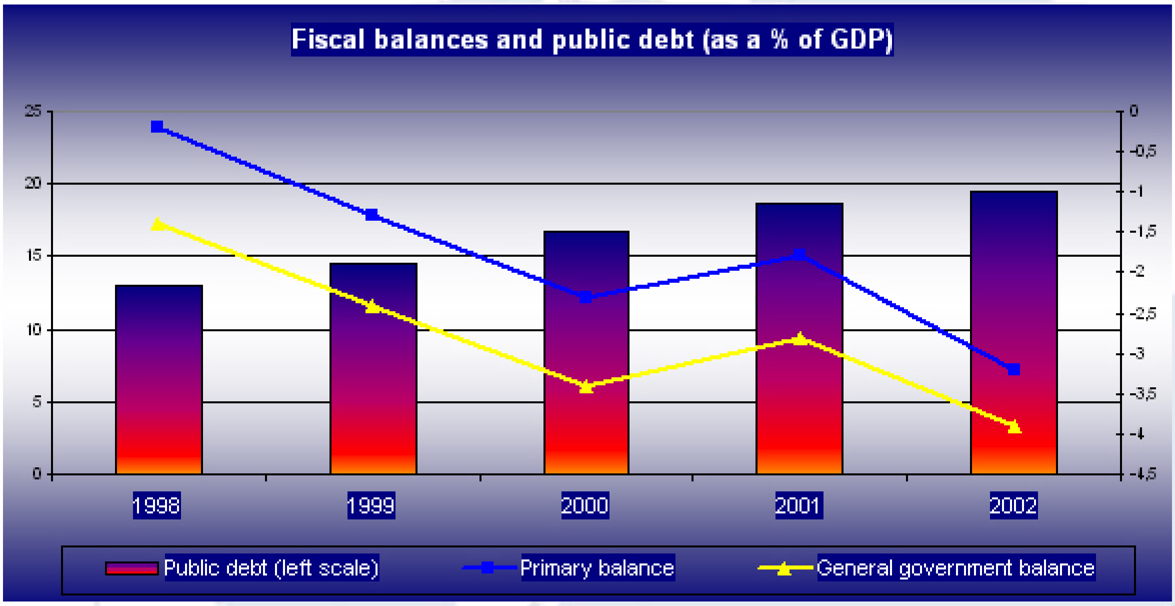
The falling trend in the year-on-year inflation is very likely to turn over by mid-2003 by itself and find its way back into the lower part of the target range in the period of most effective transmission (second half of 2004). The Ministry for Finance modified its 2003 inflation forecast to an optimistic 0.7% from the previous 1.6%, nevertheless, the central bank's prognostic for April 2004 inflation is 2.9-4.3%, which does not exclude the possibility of the rate of inflation even going temporarily above the target range by the middle of next year

First of all, an increase in the regulated prices of gas and of rents is expected in the near future. Secondly, a technical change in the payments system pushing up inflation will also occur: the CNB has postponed from May to October its plans to withdraw small coins from circulation, which may have an impact on inflation of up to several tenths of a percentage point.

In addition, oil prices are likely to rise back up later this year. Lower crown oil prices last year actually had the effect of reducing import volumes: although the average price of Brent in USD was raised by almost a dollar, as the crown strengthened against the USD by more than 16%, oil import prices decreased substantially. This largely offset the unfavourable trend of declining foreign demand for Czech products, as well. Rising oil prices have already showed their effect on the March inflation rate, in the form of rising prices in the transportation sector.

One of the most important factors affecting inflation in the medium term is the tax reform prepared by government in response to the more and more tense fiscal situation. The Czech Republic has been under pressure to undertake a major fiscal overhaul and this pressure became even stronger after the devastating floods of August 2002. Back then Parliament rejected a set of tax measures meant to help repair the damages from the floods, including the raising of excise duties, changes in the VAT system and the institution of a temporary "millionaires' tax". The rejection of the government's bill led to a crisis within the ruling coalition, worsening chances of fiscal consolidation.

Chart 9



The main underlying factors in the worsening budget deficit are the high share of mandatory expenditures, a costly pension system (also to be reformed in the copming two years), the financing of transformation and restructuring costs of the corporate sector and the increasing complexity of fiscal accounts, resulting from extra budgetary funds and an additional layer of local government. This year's deficit had been planned record high in the first place (CZK 111.3 bn. with expenditures up to CZK 795.4 bn. and revenues at CZK 684.1 bn) and the first four months' general government deficit has already reached 58% of the whole year's plan.

Recently Minister of Finance Bohuslav Sobotka threatened with resignation in case his three-year fiscal reform strategy was not supported by Parliament in June of this year. The plan aims at slashing public finance deficit to 5.2% in 2004, 4.2% in 2005 and 3.7% in 2006. This package includes a reduction of welfare expenditures and public employees' wages, a reform of the pension system within two years and changes in the tax system. This involves raising the lower VAT rate from 5 to 7%, lowering the upper from 22 to 21% and expanding the scope of the latter. The planned increase in the lower VAT bracket from 5% to 7% and moving a number of products and services into the higher one should increase inflation in the next years by around 0.3-0.5% points.

The cabinet's draft on raising excise taxes (on alcohol and tobacco), which would have brought CZK 1.5 bn. to the budget, was rejected for the second time in April. Nevertheless, government has already approved a new bill on raising excise duties as of 2004 in order to bring the tax gradually on par with the level required by the EU. The raising of excise duties should put additional pressure of about 0.5 pp. on the price index.

The tax reform involves changes in the corporate tax rate as well. As the first step of a 7% reduction of corporate taxes over the course of three years, the governing coalition has agreed to a cut from the current 31% to 28% as of 2004. This could cost the budget CZK 12 bn. in lost revenues but they may be recovered by limiting tax allowances, deductions and exemptions.

prepared by: Gábor Orbán

VI. UKRAINIAN GDP FORECAST TO RISE 4,8% - 8% IN 2004

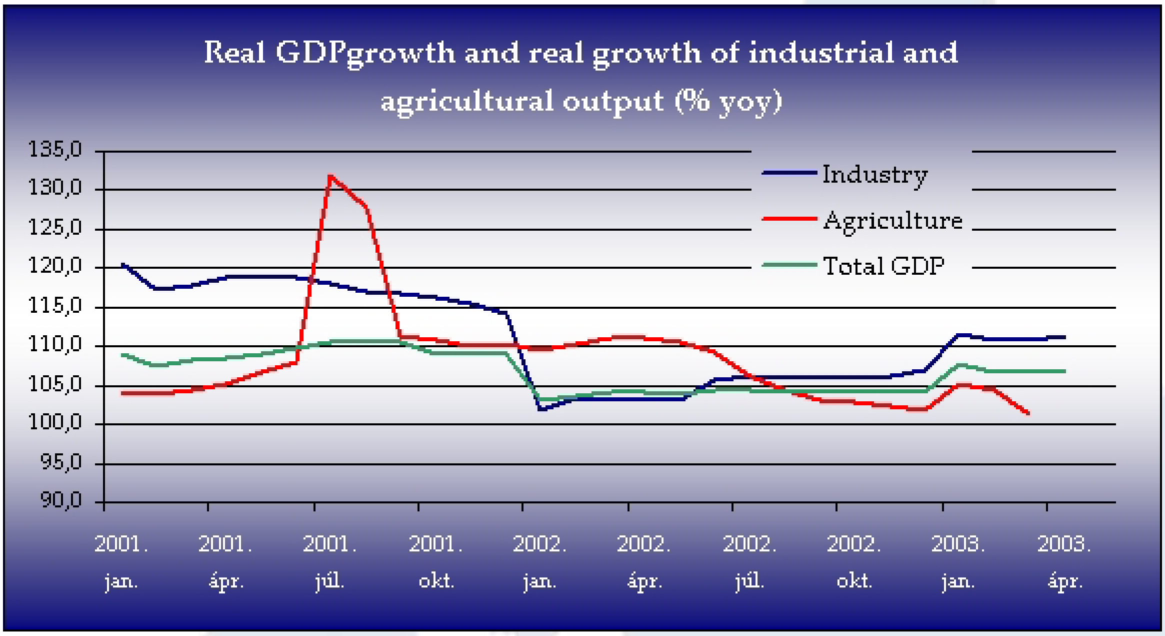
Ukraine's draft 2004 budget resolution envisages 4.8%-8% GDP growth, a 4.8%-17% increase in industrial output and 5%-6% inflation, Economy Minister Valeriy Khoroshkovskyy told Interfax. The government put GDP growth at 8%. But, acknowledging that forming a budget on optimistic forecasts is fairly risky, the government proposed a basic scenario, by which economic growth is 4.8%. Economy minister also reckon that production growth can be sustained at 15%-17%.

Ukrainian President Leonid Kuchma has sent a letter to parliament and the government in which he asks them to develop budget policy for 2004 and to ensure GDP growth in the country of not less than 6%-7% per annum, the presidential administration said in a press release. The letter also notes the need to create favorable conditions in the country for the development of an innovative-investment economic model, strengthen the competitiveness of the economy and its social aspects. Ukrainian GDP increased 4.1% in 2002. The country's government earlier forecast growth in 2003 of 4%. However, it is planned that this will increase to 6%.

In the first four month of 2003 the real GDP increased by 7,1% since the beginning of the year to a 4,1% increase during the corresponding period of the previous year. This prompted most experts to upgrade their earlier 2003 forecasts for economic growth to 5% on average, against 3,8%, forecasted in February. The remarkable growth was based on positive dynamics in the manufacturing industry, constructions and transport, while at the beginning of 2002 the major driving force were agriculture and the retail and wholesale trades. This events indicates a considerable change in sources of GDP growth and economy's demand structure, namely the growing account of investment demand in contrary to consumption demand.

In the first four months of present year performance of industrial branches grow by 11,4% from the beginning of the year.. The moving spirit of industrial output dynamic were the wood production, the food industry, metallurgy and machine building. Despite of international economic slowdown the metallurgy and his production is driven by the growing external demand on metal. The favourable processes of machine building forespeak the growing investment activity and the fortunate development of demand side of value added.

Chart 10



Further factors are the intensified competition in the most developed sectors of the domestic economy, in which government interference is comparatively low, like food industry, retail trade, pulp and paper and printing industry, the output of which has increased swiftly over several years in a row, which resulted in more investment to boost productivity; much longer and colder winter than last year, which triggered a significant surge in energy, gas and water production and distribution; gains in construction, thanks to increased in bank lending for housing starts, as well s investment in construction and assembly works made by metallurgy and retail enterprises.

By expectations, in the next two years the industrial output will grow by 6-7% per annum and the real growth of agriculture expected to reach the 3% in 2003, 4% in 2004 and 5% in 2005. In trade, building and transport will be expected growth accelerating too.

Demand side. In 2003, gross capital assets accumulation growth will stay at the 2002 level of 5% due shrinkage of sources for investment and deceleration of commercial bank lending. In 2004 investment growth will slown down to 4% due to risks of presidential elections. In 2005, presumably investment growth will speed up by 7% due to privatisation plans and Ukraine`s WTO membership.

Consumption growth was the main factor of economic growth of previous years. But in this year the worsened consumer confidence and the declining growth of personal incomes will bring a shift in the contribution of the major components to growth. But the faster growth and the tax and income reforms expected in 2004/2005 speed up the consumption again to 6% annual.

Ukraine solve a positive trade balance despite high import growth rates. For the first three months goods exports grew by 27,9% year on year in dollar terms, while imports increased by 28,0%. On the export side the, the major growth driving forces were ferrous metals due to favourable world market conditions and mineral products, mainly gas re-exports and sales of petroleum processing products. On the import side, the main goods were mineral fuel, oil and petroleum processing products. Considerable part of imports was the machinery and equipment, which indicates the growth of investments.

As we know the stable nominal exchange rate against the USD, low inflation rates and the events of EURO and USD relation lead to growing price competitiveness of Ukrainian industrial and agricultural products on external markets due to depreciating real effective UAH/USD exchange rate, which ensure favourable conditions for export oriented economic growth.

By the events of first half of the year there have been upgraded a 4-5% GDP growth for 2003. By forecasts the GDP dynamic will grow more slowly in the second part of the year. Behind this estimation there are some major assumptions: the decreasing production in agriculture; slower growth of global prices will lead to decline in Ukraine`s export growth rate, trimming the trade balance. The pronounced seasonal factor in Ukraine`s economic growth back up the pessimistic scenarios for 2003 year (4% real GDP growth).

Chart 11

In 2003-2004 foreign trade will be driven by economic growth in Ukraine`s major trading partners, like Russia and EU. Further economic reforms (tax reform expected to be undertaken) and privatisation will have positive effects on economic growth. Increasing of production in export oriented sectors and construction will proceed. But the smaller grain harvest, worsening price conditions of ferrous metals and chemicals on external markets, the risk of to high inflation rates and declining of investment activity due to political cycles will affect negatively the economic growth.

prepared by: Tamás Borkó