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1. Eventful Summer in Poland

The Polish economic and political life has been quite eventful this summer. One of the most important political events was the resignation of the Minister of Finance, Grzegorz Kolodko. A couple of days after his resignation a vote of confidence in the government headed by Leszek Miller took place in the Sejm. As a result of this vote (with 236 votes for, and 213 against them) Miller and his government remained in power. At the same time, after two years of recession the Polish economy has been experiencing a subtle economic upturn, although this recovery reflected a lessening of negative influences, instead of a significant strengthening of the economy. Therefore its robustness remains in doubt. Currently the most pressing problem for Poland is the need for a sufficiently radical reform of public finances.

Differences between Kolodko's and Hausner's strategy Before his resignation on the 11th of June 2003, Grzegorz Kolodko has set very ambitious macroeconomic targets for the year 2004. The targeted 5% GDP growth rate is quite unrealistic. A 3.2% growth rate for 2004 is more likely, after an expected 2.9% growth rate in 2003.

As the Minister of Finance, Kolodko supported the idea of joining the euro-zone as soon as possible (in 2007), and fulfilling the Maastricht convergence criteria by 2006. At the same time he emphasized that early euro-zone membership is only desirable if it does not call for solutions that might prove "lethal for the economy".

Jerzy Hausner, Minister of the Economy, Employment and Social Policy has always been on the opinion in this debate that economic revival, and giving a boost to the GDP growth rate is more important than early entry into the euro-zone. This divergence of opinions has been referred to as the "euro or growth" debate. Delaying euro-zone entry would also be favorable for the current government, as a victory in the upcoming elections is more likely if strict and unpopular cuts in public spending can be postponed. At the same time the effects of such delays can bring serious difficulties in the long run for the Polish economy.

The resignation of Kolodko came one day after the cabinet backed his budget proposal. The most likely reason why Kolodko resigned is that after the exception of the budget proposal, Prime Minister Leszek Miller announced that the control of overall macroeconomic policy would shift from the Minister of Finance (Kolodko) to the Minister of the Economy (Hausner). As Kolodko has also been Deputy Prime Minister, after his resignation this post was also given to Hausner. The Minister of Finance from now on will be Andrzej Raczko, a little known economist, EU-fund expert, and former deputy finance minister.

Another change in the cabinet has been the resignation of the Minister of Agriculture, Adam Tanski, due to the lack of political support. Tanski has only been on this post since March 2003.

The 2004 draft budget and the opinion of the NBP The 2004 draft budget assumes a 5% growth rate and a 2.2% inflation rate. Such a high GDP growth rate is unrealistic, as neither domestic, nor foreign economic developments give ground for such optimism. The 2.2% inflation rate seems too high with the present restrictive monetary policy.

The expenditure in next year's budget will amount to PLN 192bn, while PLN 159bn is expected on the revenue side. This means a PLN 33bn deficit. On the revenue side the Ministry of Finance has counted on the use of the PLN 9bn revaluation reserve of the National Bank of Poland. The use of the revaluation reserve has been a question of debate in recent months between the cabinet and the NBP. The Monetary Policy Council of the NBP has so far been against the use of the revaluation reserve. According to observers now it seems likely that Hausner and Raczko will come to an understanding on this matter with the NBP. If the revaluation reserve will not be used, then there will be an increase either in the budget deficit, or taxation. At the same time the IMF directors stressed the importance of ensuring the ability of the NBP to conduct monetary policy independently. The IMF emphasized the fact that the use of the revaluation reserve is only desirable if it improves the management of public assets and liabilities, including those of the NBP, but undesirable if it merely reduces government debt issue and delays fiscal adjustment. If the revaluation reserve is used, then a number of other issues also have to be addressed, such as the appropriate capitalization and foreign exchange reserve holdings of the NBP, details of NBP accounting procedures, and the scope for and cost of sterilization operations.

The second controversial topic between the government and the NBP is the desired date of euro-zone entry. The early entry in 2007 is no longer a government target, while the NBP would still prefer for the entry to take place in 2007. This is in sharp contrast with Hausner's economic policy aimed at higher rate of economic growth, which is tolerant of deficit increases, and which therefore delays the planned 2006 compliance with the Maastricht convergence criteria.

Monetary policy in Poland is still the most restrictive in Central-Eastern-Europe, if we take into account the extent of macroeconomic imbalances and GDP growth. The opinion within the MPC is divided over further interest rate cuts. Poland is expected to end the year 2003 with an NBP reference rate of 4.75% (its current level is 5.5%). The mandate of nine members of the MPC expires in February 2004. As a result of this an easing in the monetary policy is expected, as new members, close to the governing party, the Democratic Left Alliance (SLD) start their mandates in the beginning of 2004.

Waiting for public finance reform Currently the most pressing problem for the Polish economy is the urgent need for a thorough reform of public finances. There is a particular need for a deep reform of public expenditure policies.

The Polish pension system has already been reformed in 1999. Before that it had a similar structure as the pension systems in the majority of the member states of the European Union. Through the reform savings-based financing replaced tax-based financing, and pensions social security has been separated from the rest of the social security system. Therefore Poland will be better prepared for meeting the challenge of the growing problem of the aging population. At the same time the Polish pension reform has some faults that should be corrected.

A well-structured fiscal reform must be based on prudent growth assumptions (unlike the 2004 draft budget), and must focus on pensions and social benefits, including farmer pensions and support, further reductions in subsidies, and cuts in public employment. At the same time measures to widen the tax base and to further improve tax administration are required as well. If these measures are successfully implemented, the fiscal deficit can be contained, and sources can be redirected into infrastructure investment.

Hausner, the Minister of the Economy only intends to make the expenditure cuts, when economic growth strengthens and unemployment declines. Currently there is more tolerance for a rise in the deficit, than for cuts in expenditure. Hausner's strategy involves tax reductions (the major CIT rate was cut by 8% points to 19%) to foster growth, and limited expenditure cuts. At the same time PIT rate reduction is only possible as a part of a comprehensive public finance reform package. The obligation of co-financing of EU projects, when Poland joins the EU, puts additional pressure on the budget.

As no fiscal reform strategy has yet been adopted, the medium term fiscal outlook seems uncertain at the moment. At the same time it seems very likely that the fiscal deficit will rise above the projected figure in the coming years.

The zloty weakens There were three main contributing factors to the weakening of the zloty in June 2003. The unrest in the Hungarian markets followed by the devaluation of the Forint on the 26th of May; the political uncertainty in Poland; and the uncertainty about the public finance reform have all resulted in the investors' loss of confidence.

The political uncertainty in Poland involved the vote of confidence for the government lead by Leszek Miller, the resignation of the Finance and Deputy Prime Minister Grzegorz Kolodko, and the resignation of the Minister of Agriculture Adam Tanski.

The most serious medium term problem influencing investors' confidence in the zloty is the growing budget deficit, which is likely to cause a delay in Poland's euro-zone entry. Uncertainty about the public finance reform plans adds to the loss of confidence. The Standard and Poor rating agency has downgraded Poland from stable to negative on the 23rd of June. The Monetary Policy Council of the NBP has maintained a neutral stance in policy, and cut interest rates by 25 base points on June 25th, as a result of the low inflation.

	2000	**2001**	**2002**F	**2003**F	**2004**F
GDP real % growth	4.0	1.0	1.4	2.9	3.2
Unemployment %	15.0	17.4	18.1	18.3	18.3
CPI total (average)	10.1	5.5	1.9	1.1	2.2
USD/PLN e-o-p	4.14	3.99	3.83	3.60	3.70
PLN/EUR e-o-p	3.85	3.52	4.02	4.30	4.25
NBP reference rate %	19	11.5	6.75	4.75	4.25
Fiscal balance, % of GDP	-2.2	-4.6	-5.4	-4.8	-5.1
Pub. sector balance, % of GDP	-3.2	-5.2	-6.7	-6.4	-6.8
Current account, % of GDP	-6.2	-4.0	-3.6	-3.6	-4.2

Sources: Commerzbank Securities, National Bank of Poland, Polish Statistical Office, in: PMR.

Prepared by: **Veronika Czakó**

2. CONTUMACIOUS BUT EASING BUDGET DEFICIT PROBLEMS IN CROATIA

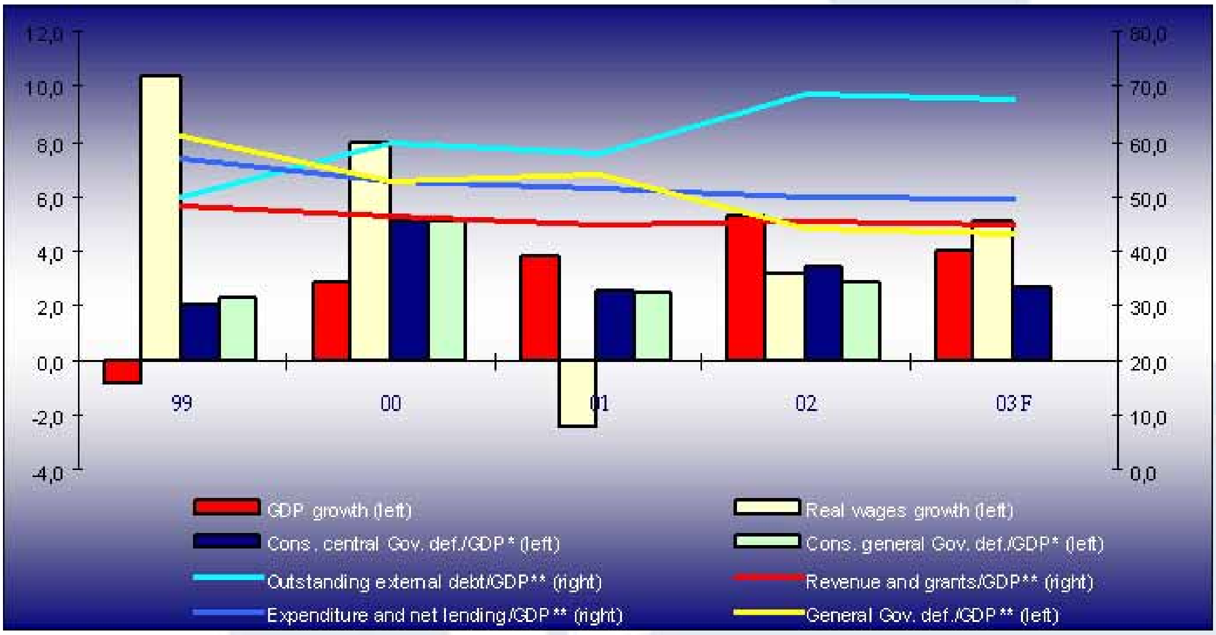
Recent years several Central and Eastern European countries have serious fiscal difficulty. (In the Czech Republic the deficit expected to be over than 6% of GDP in 2003 and in Hungary it was 9.6% in 2002.) This article tries to put the spotlight on the Croatian budget developments taking into account that the general elections will be held in late 2003.

The first thing which has to be mentioned after analysing the deficits is that the reasons are different. In those countries which will join the European Union in the first round, governments try to spend more because of the further strict convergence criteria, and because they can finance their deficit cheaper since the expected introduction of Euro (convergence game).

On the contrary Croatia has just handed in her application to the EU. The more probable explanation of the deficit could be that there was an unexpected decline in GDP in 1999 (Russian crisis, GDP fell by 0.9%), after a year while the budget had surplus. Then the deficit reached its highest level in 2000, and consolidation began. The 2003 budget has planned with a primary surplus after a four-year-long period of primary deficit.

This period had a very bad effect on external debt, now it's over 68% of GDP. To prevent higher exchange rate volatility, Croatia signed a 15 months stand-by agreement with the IMF at the beginning of this year. The IMF required fiscal strict and privatisation.

Chart 1: **Main macroeconomic indicators of Croatia**



** source: Ministry of Finance*
*** source: IMF*
F: forecast

The most positive trend is that the consolidation of the budget is being carried out by continuously reducing revenue and expenditure ratio, which suggests strong determination. This is more meaningful if the forthcoming elections has taken considered.

The political cycle's effect appears in the budget's details, like the expenditures on wages in the 2002 budget, it increased by 33.8% as compared to the year before. In 2003 budget it is planned to increase by 2%, which means only a slight real growth.

In four years distance the unemployment rate is continuously decreasing but still above 20%, while the number of employed persons grew by 2.7% from July 2001. The year on year changes of real wages in the economy in 2001 and 2002 is -2.4% and 3.2% respectively, and the forecast for 2003 is 5%.

This growth of real wages is not likely to hurt competitiveness, because the gap between the increase of productivity (In the last 2 years it increased by a yearly 10%) and real wages expanded from 1995 till 2002, and has just started to shrink since the end of 2002. As for the real effective exchange rate deflated by CPI, appreciated by around 10% in the last 3 years, and Unit Labour Costs are also catching up to other competitors' in the region.

To sum up, the next government has to continue reducing budget deficit, in order to get below the 60% external debt ratio, which might be important if Croatia join the EU in 2007. Reducing budget deficit can strength investor-confidence, make interest rates lower, reduce interest costs, boost FDI, and through exchange rate appreciation, could help keeping inflation low in an economic upsurge.

Prepared by: **Péter Sulán**

3. Slovenia: End of Persistent Inflation?

In August the monthly inflation trend turned into negative: consumer prices fell by 0.4 per cent. As a result of these favourable price developments the year-on-year inflation also dropped to 5.5 per cent. The negative figure of the monthly overall inflation in August is foremost the result of sizable fall in prices of consumer goods. Prices of clothing and footwear goods were down radically (by 6 %) last month, whereas prices of food and beverages just slightly decreased (by 0.3 %).

Behind the current developments two different factors seem to be determining. First, the short period up to the accession pursue the government to rethink its economic policy priorities. As a result of this process changes in fiscal policy framework have been made, favourably influencing the price trends. These changes concern the field of administered price policy, tax policy and income policy. Second, besides some difficulties developments of the international environment have been particularly promoting the dezinflation path for the last few years. Hindrances may arise from the situation in Iraq and the Middle East. In 2003 economic projections of Slovenia's main trading partners (especially Germany and the EU as a whole) show still no risks in terms of inflation.

Chart 2: **Inflation trends**

Since the establishment of the new government in December last year one of the main tasks of the finance minister has been to tackle with the problem of persistent inflation witnessed in the second half of 2002. As it was expressed several times, further reduction in inflation might only be attainable with more consistency between monetary and fiscal policy. The new commitment of bringing inflation down made by government representatives provided facilites for conducting a better coordinated economic policy.

Last year's inflation was significantly determined by several government measures relating to tax and excise duty regulations and administered prices. Contrary to these arrangements the government adopted a more restrictive fiscal policy framework for this year. In line with its principles the administered prices were raised only by 2.5 per cent in the first half of 2003 and are supposed to rise at the most by 5.1 per cent on an annual basis. In the first six months the increase of market prices were much higher than that of the prices controlled by the state. This specifically moderate price setting contributed this year's dezinflation so far.

Furthermore, excise duties on fuels were adjusted in order to neutralize the volatility of the world oil prices. Movements of oil prices have a quite strong effect on the Slovenian inflation, because any excursion in world oil prices comes up immediately to the prices of refined petroleum products. In this way the smooth-out of fuel prices played a decesive role in this year's dezinflation. In comparison to 2002 the last factor in the field of tax policy that positively affected the inflation trend was the considerably less tax increases carried out in the first half of this year. They consist of the compulsory tax adjustment on tobacco prescribed by the EU and the increase of vine's VAT rate (from 8.5 % to 20 %). Both were laid down in 2002.

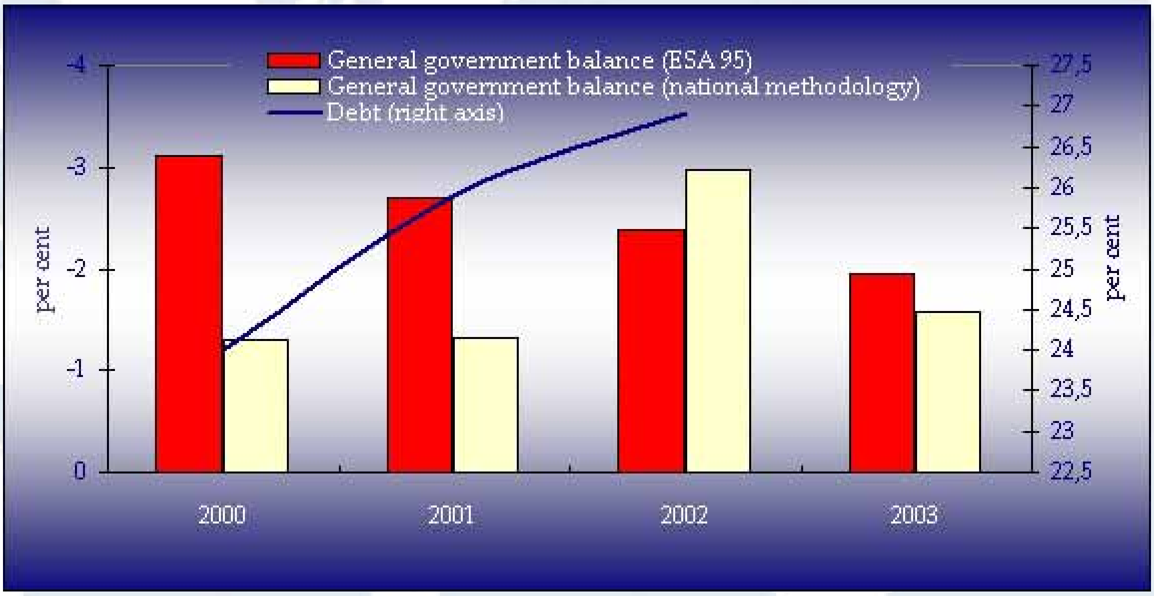
As a result of the negotiations with social partners a new Public Sector Wage System Act was made containing directions for wage adjustments in 2004 and 2005. These adjustments will be carried out according to certain mechanism taking the level of the eurozone's inflation into consideration. The system is supposed to promote further reduce in inflation. A replacement of the 2.4 per cent basic wage adjustment having been due in August is also comprised in the agreement concluded with the trade unions. In return the employees have received premium pension insurance. All these changes had and will have positive effects on inflation.

As far as the external environment is concerned the current stance is also favourable taken as a whole. Nevertheless, if we look at the developments of the last twelve months in detail, the picture becomes more coloured. On the one hand the growing volatility of world oil prices witnessed last year and to some extent also currently made it more difficult to maintain the dezinflation path. As we mentioned earlier the government achieved to eliminate the deteriorative impact of these hectic price movements in the first half of 2003. The economic consequences of the Middle East crisis from 2001 onwards and of the current situation in Iraq also hold considerable risks through affecting the world oil supply.

On the other hand the Euro/Dollar exchange rate developments have been favourably drifting since early 2002. The ever-strengthening Euro against the Dollar has been continuously contributing to cheapening import. In additon the general recession in the eurozone (especially in Germany) has been accompanied by a slight deflation pushing import prices downwards. It is well represented in the developments of the producer price index (PPI), which stood currently at 2.5-2.7 per cent (y/y).

The monetary authority has been conducting a restrictive monetary policy complemented by the new fiscal policy framework. In the line with the commitment on improving co-oridnation between fiscal and monetary authorities the National Bank of Slovenia (NBS) lowered the Tolar's depreciation rate from 3.5 per cent to 3.3 per cent in March. This step has also had a positive influence on the inflation. In accordance with the developments of financial inflows and the actions taken by the ECB the NBS lowered its interest rates twice this year. First in May as followes: 60-day Tollar bills from 7.5 to 7.25 per cent and 270-day Tollar bills from 8.75 to 8.25 per cent. In June after the ECB's interest rate cut the former was further reduced to 6.5 per cent, while the latter to 7.5 per cent. With these measures the NBS managed to keep the money supply under control paying particular attention to the development of capital inflows. Last year's FDI inflows and the current account surplus posed a great challenge of maintaining the money supply. In order to prevent monetary shocks arising from heavy capital inflows mainly connected to privatization transactions the NBS withdrew the excess money by means of sterilization instruments.

Chart 3: **Fiscal stance** (% of GDP)



According to the NBS' projections inflation is expected to slow down to around 5 per cent by the end of 2003. The key factor to meet the target is probably the current co-operation between the government and the NBS. A suitable fiscal policy provide facilities to adjust the Tolar's depreciation rate, which is currently the key instrument to maintain a constant real exchange rate trend. Further reduction in the deprecitation rate fasters dezinflation. Thus, it seems that government must pursue itself to continue its announced policy. The current fiscal stance provides the government enough room to do so.

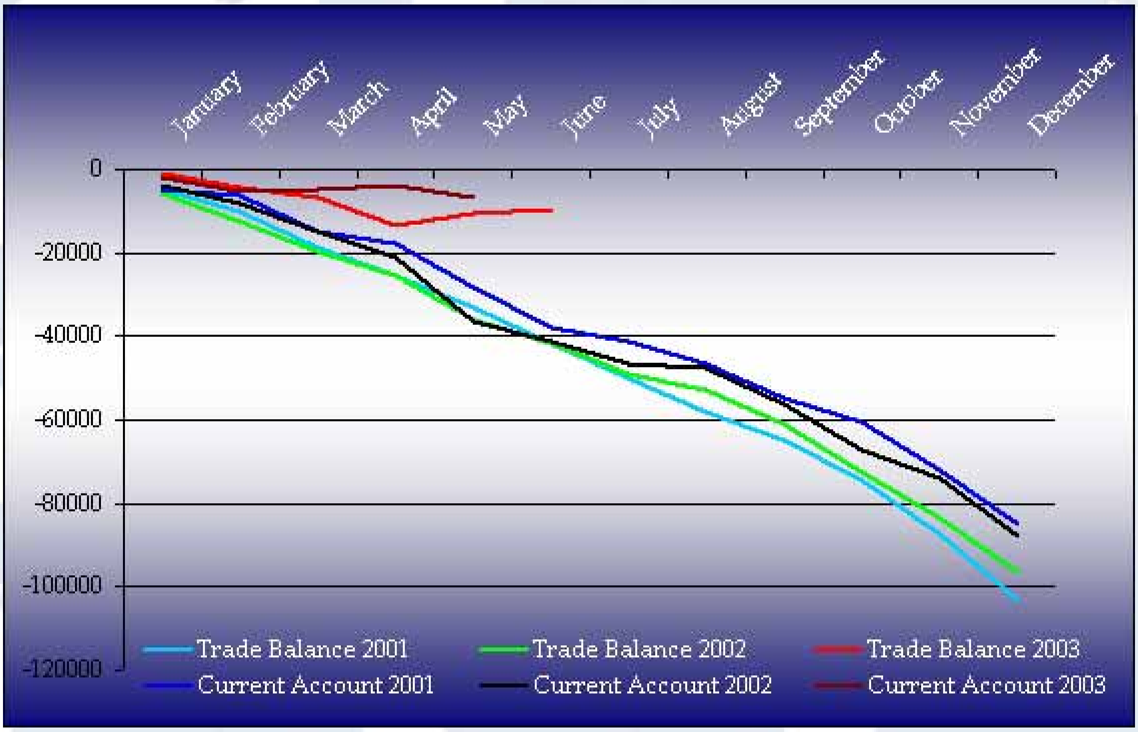
Prepared by: **Szabolcs Patkó**

4. IMPROVING TRADE BALANCE AND CURRENT ACCOUNT IN SLOVAKIA

In the first half of 2003, the Slovakian current account deficit was SKK 7.4 bn., which means a great improvement comparing with the same period of last year. In the first six month of 2002, the deficit reached SKK 40.9 bn., which was five and a half times higher than the recent figure.

In 2003, almost all the main parts of the current account improved significantly. The development of the trade balance was the key reason for the much better result. The growth of export greatly overpaced that of import, thus, the deficit narrowed from SKK 41.6 bn. to SKK 9.7 bn. While the export expanded by 22.2% (54.3% in USD and 25.4% in EUR), the import grew by 10.4% (39.4% in USD and 13.3% in EUR). Furthermore, in two months of the six, the monthly current account resulted in a surplus (in March and May) which is remarkable considering the fact that the current account deficit reached 8.2% of GDP last year.

Chart 4: **Trade Balance and Current Account in Slovakia** (mill. SKK)



The balance of income also improved in the first half of the year. The deficit decreased from SKK 11.1 bn. to SKK 5.2 bn., while the balance of services recorded no remarkable improvement. The fall in the positive balance of transport and the increase in the deficit in ‘other services in total’ were offset partly by growth in net income from tourism.

According to the Statistics Office, the export accelerated in all the main economic sectors but the strongest increase was performed by automobile industry. The proportion of the export of machinery and transport equipment in total export grew considerably from 40.2% to 45.6% while the proportion of the other categories diminished. It was due to the remarkable performance of the export of machinery and transport equipment which increased by nearly 40%.

The reasons for the growth of import were mainly the increased imports related to the automobile industry and the increased price of oil. However, the latter factor has been greatly counterbalanced by the strengthening Slovak crown.

The destination of the expanded export was a surprise: the growth of exports was stimulated by sales to EU countries that are showing weak economic performance. Exports from Slovakia to EU countries rose by more than 25% over the first six months of 2003, while imports from the Union over the same period grew by almost 10%.

According to some analysts, the expansion can be explained by the investments, which were realized in the last two or three years by foreign investors like Volkswagen, Sony or US Steel. Their investment aimed at increasing the volume of the production. As the world economy slowed down, it forced the multinational corporations to reduce their production by closing some of their subsidiaries. It is obvious that the closures were executed at subsidiaries with higher costs, while Slovakia still has the advantage of low labor cost. Among the Visegrad-4 countries, Slovakia is the cheapest. That can be the reason why the Slovakian enterprises were able to boost their export even to the sluggish Western European economies like Germany and Italy.

In the beginning of the year, an announcement assured that the Slovak export will improve further in the near future. The PSA Peugeot-Citroen - Europe's second-largest car producer - decided to choose Slovakia to open a factory in 2006, and investing EUR 700 million. Some say that the new car producer will be too close to the VW factory and it may have negative effect on labor costs. The two car-maker will be competitors on the labor market and it may rise the wages and decrease the advantage of Slovakia. On the other hand, the growth of the wages is a natural component of Slovakia’s convergence.

As it was mentioned, the current account deficit reached 8.2% of GDP in 2002. That is why the National Bank of Slovakia (NBS) targeted the deficit nearly 6% for 2003. In the beginning of the year, the NBS has not expected that the trade balance would improve so remarkably. On June 3, the NBS reduced its current-account deficit forecast for this year from 6.2% of GDP to 4.5%. In line with this correction, the bank raised its 2003 growth forecast from 3.9% to 4.4%.

Considering the figures of the first six months, the forecast of the NBS seems reachable. Furthermore, it may be more favorable and close to 3% in 2003. As the May current account surplus was still not publicized on June 3, the NBS has carefully revised its prognosis. We expect that deficit will reach 3.1% of GDP in 2003. After two years of high current account deficit (8.5% and 8.2% of GDP in 2001 and 2002, respectively) the Slovakian economy has a manageable current account balance which can be even better than it was in 2000 (when the deficit narrowed to 3.6% of GDP). The reason for the increased current account deficit was the slow rate of economic growth in the countries of Slovakia's major trading partners, on the export side. On the other hand, imports were affected by the continued growth in final household consumption, the relatively dynamic growth in investment. In this year, the trade balance became more favorable mainly because of the trading partners higher import growth and the good economic performance. The trend is expected to continue and the further improvement of the current account balance is forecasted in 2004.

Prepared by: **Péter Bilek**

5. Shift Towards Reform in Kazakhstan

The leaders of Kazakhstan have initiated a set of reforms in the spring and summer of 2003. The natural resource rich country has been so far successful in economic transition, thanks to well-implemented and prudent economic policies. The IMF has withdrawn from Kazakhstan, with the expiration of the period of the last resident representative in August 2003. From now on Kazakhstan will maintain a cooperative relationship with the Fund.

One of the most important issues in the Kazakh economy now remains the need for economic diversification, as the country is too reliant on income from oil. The Kazakh government now seems to be ready to make significant steps in this regard. An agricultural reform program has recently been initiated, along with a new industrial policy, social development program and financial development program. A large proportion of the population lives in poverty, especially in the rural areas (43% of all inhabitants live in rural areas). One of the main goals of the agricultural reform is to tackle this problem, along with improving the productivity in the agricultural sector. The rising oil wealth has not yet benefited significantly the majority of the population.

The IMF suggested in its report, that the rule of law should be improved further, as well as the investment climate outside the oil and financial sectors, in order to make business activity in Kazakhstan easier for domestic and foreign small and medium size enterprises. The transparency of the operations of the NFRK (National Fund for the Republic of Kazakhstan), the organization responsible for saving oil revenues for the future, should be increased, and its operating rules should be simplified. According to the IMF, the Kazakh government should invest more in the development of infrastructure, healthcare and education. The opinion of the Kazakh government and the IMF differs about the role played by institutions like the Kazakhstan Development Bank (KDB) and Kazakh Investment Fund (KIF) in the development of non-mineral sectors. The KDB will be crediting the domestic non-commodity sector enterprises, and the KIF will stimulate the formation and the development of, and participate in the stock capital of the domestic companies producing the goods with high value added. The Kazakh government bases its development strategy on their work, while the IMF warns that the use of such institutions can cause serious distortions and wrong allocation of resources in the economy.

The GDP growth estimated by the President’s office was 10% year on year in H1 2003. The GDP growth rate was also high in previous years, an average 11% in the period between 2000 and 2002. The GDP growth rate is expected to reach 8.3% year on year overall in 2003, against 9.5% year on year in 2002. Industrial output grew by

9.6% year on year in H1 2003, agricultural output by 5.2%, and foreign trade turnover by 36%. Inflation was just over 7% in March 2003, while in 2002 it was 6.5%. Inflation was broad based. Unemployment has been declining since 2000, in 2002 it was 9.25%.

President Nazarbayev announced the start of a new rural development program, which will be emplemented between 2003 and 2005. Within the framework of this program more money will be invested by the state in order to revitalize and develop the agricultural and rural areas. The program will aim to increase the land productivity, which is 5-6 times lower than can be expected, and investments will be made to improve the rural education system, healthcare and sewage water facilities. In June 2003 the Land Code came into force after much controversy. This is regarded as the first step of agricultural reform. The main importance of the Land Code is that it will institute for the first time the private ownership of land. Within the priorities of the agricultural reform, there has been a contradiction between its two most important goals: the increase of production efficiency, and poverty alleviation. To increase production efficiency, land to be privatized has to be sold in large plots, in order to make further investments into new machines and production techniques worthwhile. But the rural population, who currently cultivate the land can neither afford the larger plots, nor the efficiency increasing machine equipment. After much controversy the decision of the parliament has been that land should be sold to companies or rich individuals who want to invest in the agricultural sector. At the same time, to help the poor people, who currently cultivate the land, ideas of a rural development program are being considered. One likely solution could be to increase the level of government subsidies, but currently there is not enough money in the budget to sufficiently improve the situation. Another idea is that the population should be optimized by regions. Carrying out this idea in reality is likely to prove problematic however. Before the privatization of land starts, technical issues have to be addressed, such as the preparation of a new land cadastre (in which the existing land plots and their parameters will be described). Regional governors and the government will decide the maximum size of the sold land plots.

Decisions have been made about the reduction of the tax burden. This will improve the business climate, and the government hopes to legalize part of the grey economy through the tax cuts. The VAT rate has been decreased by 1pp to 15% and the maximum rate of the personal income tax has been decreased from 30% to 20%. The government hopes that revenue losses resulting from the cuts will be compensated by the expansion of the tax base.

In May-June 2003 there was a 1.3% budget surplus in Kazakhstan. The public debt was around 14% of GDP at the end of 2002, and Kazakhstan's official sector became a net creditor to the rest of the world. The external debt was 12%. Thanks to these favorable developments, Moody's upgraded Kazakhstan's credit rating in September 2002 to minimum investment grade.

Standard & Poor's Ratings Services raised its long-term counterparty credit and certificate of deposit ratings of Kazkommertsbank (KKB) to "BB-" from "B+' on March 28th 2003. This was the result of the improved economic environment in Kazakhstan, the better funding profile of KKB, and the slower loan growth in 2002. On the 7th of April Fitch Ratings upgraded KKB's long term rating to "BB" from "BB-". Moody's upgraded to Ba1 from Ba2 the long-term issuer rating of Kazakhstan Temir Zholy (KTZ), the national railway company of the Republic of Kazakhstan.

Trade liberalization and capital account liberalization is on the way in Kazakhstan. The authorities plan to liberalize the capital account completely by 2007. Kazakhstan is expected to join the World Trade Organization by 2005.

	1997	1998	1999	2000	2001	2002*
Real GDP (changes in %)	1.7	-1.9	2.7	9.8	13.5	9.5
CPI (changes in %)	11.2	1.9	17.8	9.8	6.4	6.6
General gov. bal. (% of GDP)	-6.9	-7.8	-5	-0.8	2.7	1.5
General gov. debt (in % of GDP)		22.7	30.6	27.2	20.5	17.6
Trade balance (in % of GDP)	-1.2	-3.6	2.8	14.3	6.9	10.4
Current account balance (in % of GDP)	-3.5	-5.6	-0.2	4.8	-4	-1.9

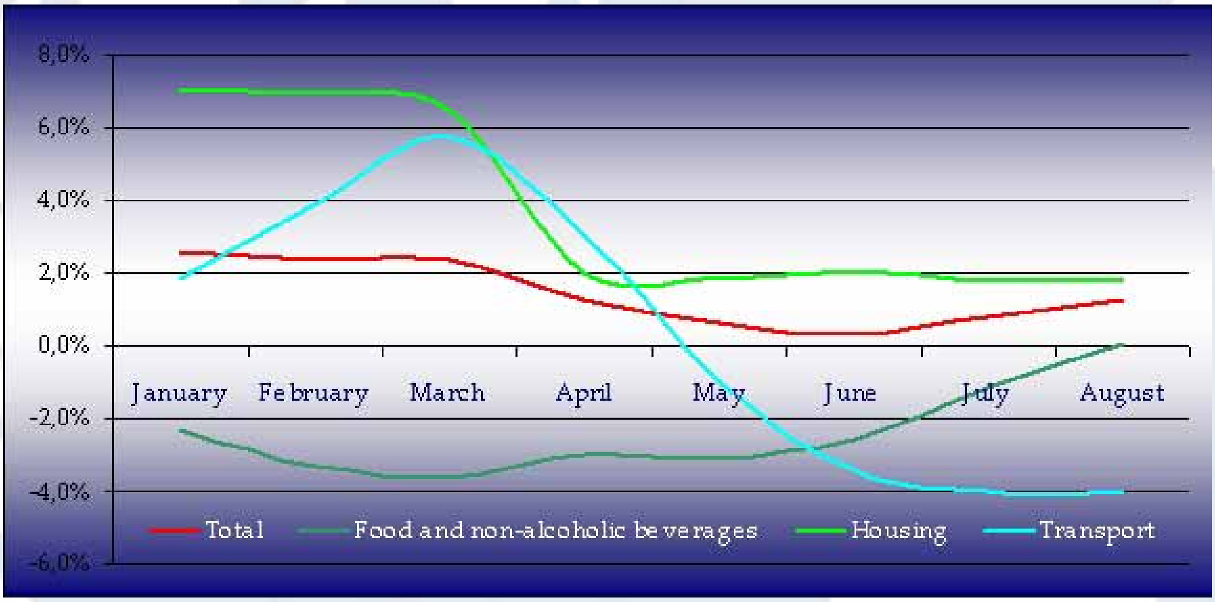
** Preliminary Estimates*
Source: IMF

Prepared by: **Veronika Czakó**

6. Rapid Disinflation in Estonia

In September Bank of Estonia lowered its inflation forecast for 2003 from 3,2% to 1,5%. The new figure is based on the lower-than-expected price increase in the second quarter. The inflation gap against the Euro-zone became negative for the first time. In the Euro-zone the HCPI in the second quarter accounted for 2,0% while in Estonia only for 0,7%. In summer the year-on-year inflation rate increased, due to the lower basis, and reached 1,3% in August. This is still well below the reference Maastricht criterion. Low inflation figure was characteristic also for the last year. Consumer prices in Estonia went up by 3,6% in 2002. Only in 1999 was the inflation lower, namely 3,3%. Among the two main components of the inflation the prices of services (which represents one-third of the total consumption) have consistently outpaced the price-growth of goods (incl. foodstuffs and manufactured goods). Hence, Estonia is a good example for the so-called Balassa-Samuelson effect. This year the slowdown of inflation has been continuing.

Chart 5: **Year-on-year inflation for selected groups of customer goods in 2003**



Regarding the month-on-month inflation one can observe a sharp change after January. In the first month of 2003 the price level jumped up by 1,2% compared to December 2002. Since then the monthly price changes have balanced out, thus the price level has remained unaltered. The increase of consumer prices in January resulted from the 12,2% rose of prices of communication. The mobile communication services provided special offers in December. The termination of these offers pushed up the cost of communication.

The year-on-year inflation is mainly influenced by declining food prices which were more or less outweighed by increasing housing prices in the first quarter. Since the cost of housing resulted from a hike in electricity prices jumped up in April 2002, the higher basis in the second quarter implied a more moderate price increase in the area of household maintenance. Consequently the year-on-year inflation dropped from 2,4% to 0,7% between the first and second quarter. It is worth to note, that Estonian households spend 28% of their total expenditures for food and 15% for housing. Their shares in consumer price index basket are 25,1% and 17, 4 %, respectively. Due to the lower fuel prices the declining cost of transportation has also pushed down the inflation since May.

Estonian Kroon is pegged to Euro thus the strengthening of the common European currency has implied a continuously appreciation of the nominal effective exchange rate since mid-2001. Due to the nominal appreciation import price index in August accounted for -1,0%.

Administrative prices in Estonia were mostly abandoned in the early 90's, consequently a further price liberalization does not threat seriously the favorable inflation rate. Share of administratively regulated prices in consumer goods basket account for 15%. Release of flat rent margins is expected to bring up the inflation by more than 1 percentage-point. Small rise of excise duty levied on tobacco, alcohol and petrol will also contribute to a higher inflation rate. In August 2003 compared to the same period of the previous year regulated prices remained unchanged while the price of non-regulated goods and services grew only by 1,8%.

The convergence of price levels to Euro area levels has an important and long-lasting effect on inflation. Price level in Estonia is only half to that of the EU, in case of services even lower. Thus in the terms of price level convergence Estonia lags behind the other two Baltic states. Nonetheless, the convergence process is faster because of the higher inflation figures.

Very likely Estonia will be the first candidate country which joins the Euro zone. Vahur Kraft, governor of Bank of Estonia said that Estonia wants to introduce the Euro as soon as possible. Estonia would like to join the ERM-2 in May 2004. Hence, the most earlier date for change the Estonian Kroon for Euro would be the summer of 2006.

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