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International Center for Economic Growth
European Center

# NEWS OF THE MONTH
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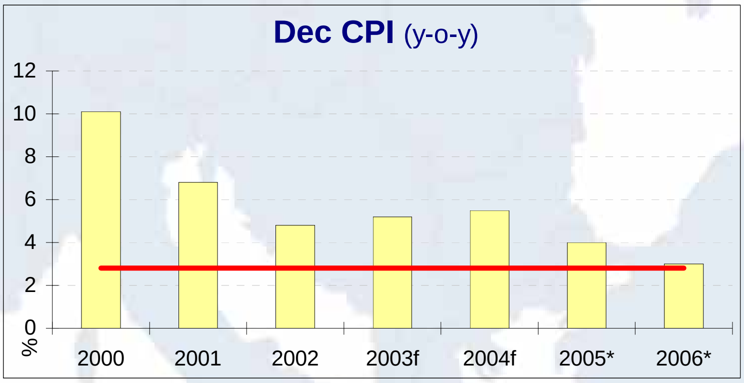
14 Korompai Street, H-1124 Budapest, Hungary
*Tel:* +36 1 248 1160 *E-mail:* icegec@axelero.hu *Website:* www.icegec.org

# CONTENT

# I. THE NEW INFLATION PATH TILL 2006

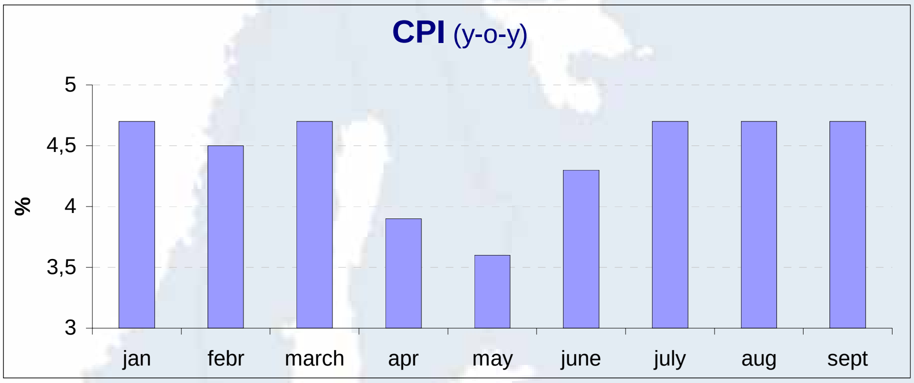
The Government and the National Bank of Hungary (NBH) jointly set a 4% end-2005 inflation target and agreed on a lower than 3% end-2006 CPI figure. However the 2005 target is well below the market expectation, at least it sounds credible, and it is still in line with the 2008 EMU accession. This was the first time in Hungary since the introduction of the inflation targeting system, when the NBH set jointly the target with the government.

Among the Maastricht criteria the inflation target is one of the most difficult to meet for Hungary. The country achieved a significant disinflation since 2001, which was mainly based on a strong forint policy following the introduction of a new exchange rate regime, the +/-15% the fluctuation band. Hungarian CPI dropped to an all time low in May 2003, the rate of inflation was only 3.7% on a y-o-y base. Several external factors helped the disinflation process: the low oil prices, favorable EUR/USD cross and the postponed changes of the administrative prices. However in the meantime there were several inconsistencies in the monetary system, because it proved to be difficult to match the inflation targeting regime with the exchange rate target. The lax fiscal policy made the situation even worse. The 3.5+/-1% target for end-2003 became endangered, NBH started to focus on the upper 4.5% target. Following the January events there was some chance that both the end-2003 and end-2004 target would be in reach. The disinflation process got finally derailed due to the May and June events (shifting the fluctuation band, significant devaluation of the Forint), and changes of the tax system. NBH projected 5.2% end-2003 and 6.5% end-2004 CPI figure in its latest August inflation report. The 5.2% projection for December 2003 significantly exceeds the earlier set 3.5 +-1% target. NBH's calculations were based on a 264 EUR/HUF and according to the Central Bank one off items, like the tax changes account for 1-1.5% increase of the CPI in 2004. Without these one-off items the NBH is currently targeting a 5.5% end 2004 CPI, however in the statement, released following the introduction of the new inflation path nothing was mentioned about 2004 target.




*f: forecast, *: target: 2,8% current Maastrict reference value*

The latest, 2003 September CPI figures did not confirm the expectations concerning a sudden rise of the CPI. The consumer prices increased by 0.6% compared to the previous month, and by 4.7% compared to September 2002. The price of services increased by 6.1%, above the average, consumer durables dropped by 1.2%, tobacco rose by 18%, electricity by 19%, and gas price by 12% compared to the same period last year. The effect of the higher gas and electricity prices were foreseeable.




Inflation is expected to rise further in the rest of the year. The latest Reuter's poll indicate a 5.1% end-2003 and a 5.5% end-2004 CPI.

In its recently set inflation path NBH has returned to the symmetric target band. There will be a +-1% tolerance band around the 4% end-2005 target, but Mr. Járai Central Bank Governor emphasized, that the upper part of the tolerance band was acceptable only in case of extraordinary events, and the NBH would seek to ensure that inflation fell into the lower half of the target range. Mr. Járai also noted that the current 250-260 EUR/HUF cross is coherent with the inflation path.

The end-2005 inflation target, which is only slightly tighter than the new 5.5% upper-limit implicitly targeted by the NBH for end-2004, surprised the market. The higher than expected figures should help ease fears that strong Forint policy would be applied again to achieve difficult inflation target, but according to some analysts, NBH's inflation fighting mission suffered credibility loss at the same time. The 5.5% target is not difficult to meet at all, because one-off items like tax changes will already fall out of the 12 months base by the beginning of 2005. Under favorable circumstances the inflation in January 2005 could be already at the level of the end of the year target. A successful ERM-II membership with credible central parity could also help to meet the CPI target.

There are also some problems with the new inflation path. Agreeing a range that includes outcomes as 5% it will be politically difficult for the NBH to conduct a policy targeting the lower half of the band. The second problem is that the 4% end 2005 target does not provide a smooth transition to Maastricht compatible inflation rate. There has to be a significant progress in the disinflation in the Q1 of 2006, because the test period runs from April 2006. (the actual Maastricht target depends on the euro-zone inflation rate, and the target is likely to be around 2.5-3%).

The sharp disinflation in the beginning of 2006 can not be taken for granted, expectations and wage settings will be crucial. The inflation inertia is still a problem in Hungary, the extent to which the temporary increase of the inflation in 2004 will form the expectations is highly uncertain. In Hungary the private sector usually perceives a significantly higher inflation than the actual rate, and this determines its wage setting policy. The high inflation figure for 2004 might be misinterpreted by the private sector, because the additional 1-1.5% inflation due to the tax changes provides extra revenues only for the budget.

Following the high wage increases of the previous years, which significantly exceeded productivity growth, and led to dangerous increase of the consumption regarding the external balance, everyone was waiting for this year's wage talks. Eventually this year's wage accord recommends a 7-8% nominal wage increase, and a 3000 Forint increase at the minimum wages. These numbers sounded reassuring for the market, and it was also favorable that this year the nominal wage increase was set instead of the real one.

Concerning the success of the disinflation process in Hungary, the country is facing many challenges in the future. There are still some administrative prices that have to be eliminated gradually. Due to the nominal and real convergence the price and wage levels are expected to rise. The Balassa-Samuelson effect will have its impact as well, and this means either strengthening nominal exchange rate or higher inflation, both are regulated by the Maastricht criteria. Our exposure to big capital inflows could also cause some problems in the future, concerning the inflation. The monetary policy will face severe tensions in the ERM-II system as well, because it is difficult to have the IT system and a strict exchange rate target at the same time. Fiscal and wage policies will have key roles in the disinflation.

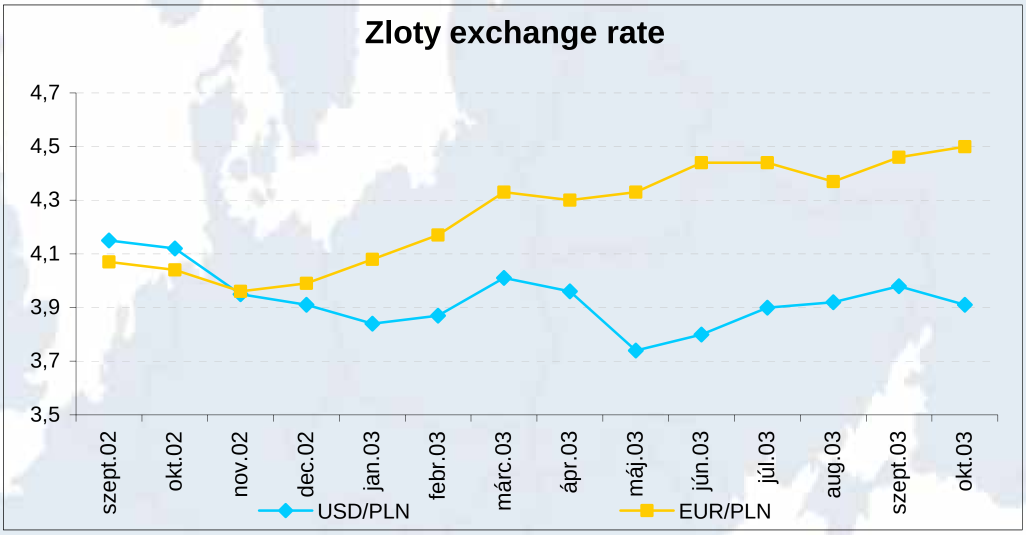
A disinflation based on a strong Forint policy would not be desirable, because it could divert the equilibrium exchange rate, and that might lead to a revaluation of the central parity. Joining the EMU with an overvalued currency would be probably the worst for the Hungarian economy. Some economists suggested some kind of social agreement, which could help to minimize the costs of disinflation. The latest wage talks and the jointly set inflation path could be a good start. The three percent or even lower inflation is not optimal for a converging economy but benefits of the EMU accession outweigh the emerging costs. The external environment is not too favorable as the base rates of leading economies are at their historical low, the yield curves are getting higher and the commodity prices are also rising.

The new inflation path is theoretically in line with the 2008 euro introduction, however the scope of the monetary policy is diminishing, and the responsibility of the fiscal policy is increasing.

**Prepared by: Dániel Bebesy**

# II. Continuing Uncertainty in Poland

After the political turmoil of the summer months, and the personal changes among the leaders responsible for fiscal policy in Poland, uncertainty continued in the autumn, as well. The draft budget for 2004 was adopted on the 27th of September by the Council of Ministers. At the beginning of October Deputy Prime Minister Hausner presented the medium-term strategy for public finances, which is based on major cuts in budget expenditure, and also presented a program for public spending reduction. Even after the publishing of these long-awaited documents, unrest continued in the financial markets, as the assumptions on which they are based are overly optimistic, and they do not provide a clear plan of action in order to stabilize Polish public finances. As a result of the continuing delays in the announcement of the medium-term fiscal policy, in the second half of September unrest in the markets continued, and the Zloty temporary, but deeply depreciated. At the same time the Euro has appreciated considerably against the dollar on international markets. As a result the Zloty depreciated substantially against the Euro (7%) and only marginally against the dollar. On the 30th of September the Zloty has reached its lowest level ever against the Euro, 4.6435 PLN/EUR.




*Source: National Bank of Poland*

A favorable recent tendency in the Polish economy is the growing dynamics of the economic recovery. Growth in 2Q03 was stronger than expected, at 3.8%. Overall GDP growth in 2003 is expected to reach 3.5%. Investment is showing an increasing trend, but it is still unsatisfactory. Therefore the growth in coming quarters will not be as high as in 2Q03, but the recovery seems to be steady. The sings of the recovery are also visible on the labor market. Unemployment rate in 2Q03 has been 17.8%, overall unemployment in 2003 is also expected to decline to 17.8% (from 18.1% in 2002).

**2004 State Budget Act** The 2004 State Budget Act caused unrest on the financial markets and was widely disapproved of by economists. Two main problems with the accepted draft of the 2004 State Budget Act are the very high budget deficit, and the rising borrowing requirements of the government. The state budget deficit will rise from PLN 39 bn. in 2003 to PLN 61 bn. in 2004, if the changes in the accounting system are taken into account (if not, the deficit will be PLN 45 bn.). A fiscal loosening of such a degree poses a risk to medium-term macroeconomic stability, as the economy is accelerating for cyclical reasons. Medium-term macroeconomic instability can easily delay meeting the Maastricht convergence criteria, and Euro-zone entry.

The act introduces a radical drop in the rate of corporate income tax: from 27% in 2003 to 19% in 2004. A new tax option will be provided to small businesses to pay the 19% tax. These tax reductions are expected to bring long-term positive economic effects, but the lower tax rates might not be sustainable, as there will be a necessity to reduce the budget deficit in coming years. Another change in the tax system in 2004 will be the diversification of income tax rates for various taxpayer groups, which introduces further uncertainty.

The Budget Act for 2004 is based on two main assumptions. First, that the average annual increase in prices of consumer goods and services will be 2%, and secondly, that the GDP growth rate will be 5%. The assumption about the CPI is realistic, but the forecast concerning economic growth is too optimistic, and raises concern, according to the Monetary Policy Council of the National Bank of Poland. The expansionary fiscal policy also limits the scope for monetary easing. As a result of the fiscal loosening and the unrest on the financial markets (which was also caused by the fiscal loosening) the MPC decided to leave interest rates unchanged in September. The reference rate remained at the 5.25% level, set in June 2003. The MPC decided to reduce the reserve requirements ratio from 4.5% to 3.5%. The main reason for the decision was to decrease the difference between the level of reserve requirements in Poland and the European Union, in order to improve the competitiveness of the Polish banking sector.

**Medium-term strategy** The release of the medium-term strategy after the 2004 Budget Act did not calm financial markets sufficiently, as it included plans to reduce social spending only from 2005. Therefore the danger of exceeding the second, 55% threshold of government debt as a percentage of GDP seems inevitable now, unless there is an amendment in the 2004 budget (which the government presently does not seem ready to do because of political pressure). Only the presence of such favorable circumstances will allow to remain below the 55% threshold as high nominal GDP, high privatization revenues, and Zloty appreciation. The higher scale of exceeding 55% to GDP ration in 2004 is, the higher would have to be a surplus in 2006, as the government is planning to meet the Maastricht criteria by 2007. The costs of achieving a surplus in 2006 will be very high: “blind” spending cuts and higher taxes.

**Scenario for public finances in case of *accelerated* economic growth**

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| GDP growth (% YoY) | 3.5 | 5.0 | 5.0 | 5.6 | 5.6 |
| Public debt (% of GDP) | 51.5 | 54.8 | 59.3 | 59.5 | 59.1 |
| Budget balance (% of GDP) | -4.8 | -5.3 | -4.2 | -3.3 | -2.6 |

*Source: Medium-term strategy for public finances*

**Scenario for public finances in case of *steady* economic growth**

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| GDP growth (% YoY) | 3.0 | 4.0 | 4.0 | 4.2 | 4.2 |
| Public debt (% of GDP) | 51.5 | 55.4 | 59.3 | 55.5 | 53.2 |
| Budget balance (% of GDP) | -4.8 | -5.3 | -2.7 | +1.5 | 0.0 |

*Source: Medium-term strategy for public finances*

If, according to the scenario of accelerated economic growth shown in the first table, public debt stays under 55% of GDP in 2004, it will still be very close to 60% in the following three years, but the Maastricht criteria will be met by 2007. By comparing the two scenarios shown in the tables, it can be seen how important the year 2004 is: if the favorable tendencies on which the first table is based do not arise and economic growth is lower, then in the years 2005 and 2006 a very strong tightening of the budget must take place. In 2006 a 1.5% of GDP budget surplus will be necessary to meet the Maastricht criteria by 2007.

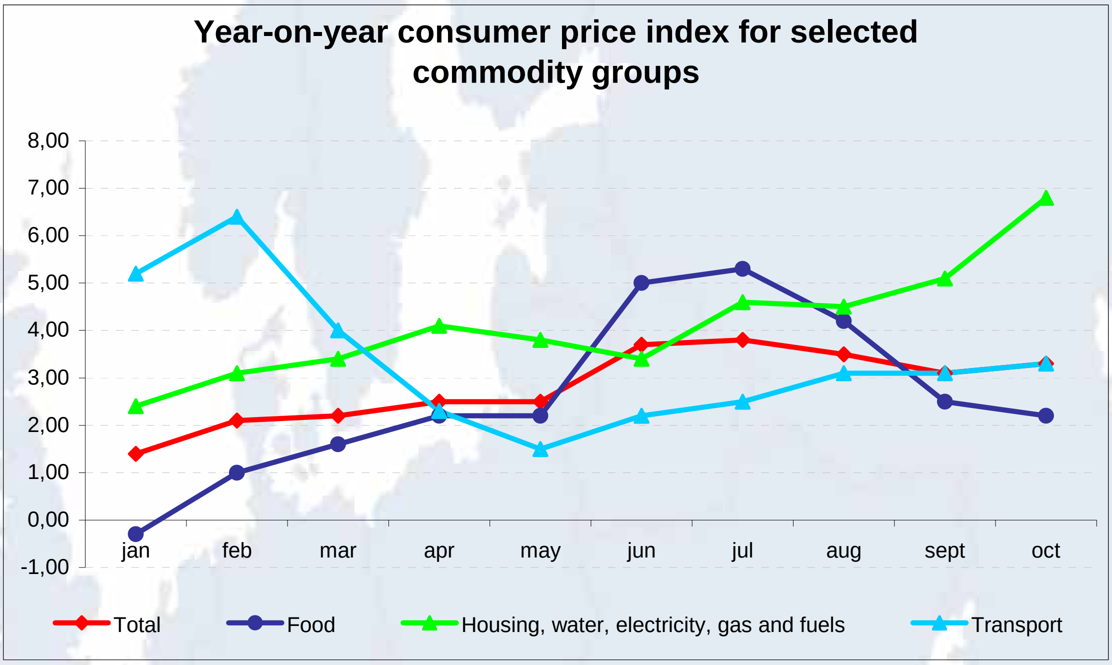
At the same time it is possible that while creating the budget the government has taken into account the use of the revaluation reserve of the NBP for the partial early repayment of the foreign debt. This can only be possible with the agreement of the members of the MPC, but in the beginning of 2004 the mandate of the current MPC members (who’s majority does not agree to the use of the revaluation reserve for such a purpose) expires. The new members are expected to be willing to agree to the use of these funds for debt reduction.

The methodology of public debt calculation is also expected to change next year (from domestic to ESA95), in which case the level of the public debt will be lower than using the current methodology. Such a way of artificially reducing debt might even be accepted by the markets, if it is accompanied by a radical reform of public spending. Minister of the Economy Hausner also presented the program for public spending reduction together with the medium-term strategy. The program consists of two main parts: changes in administration, and modification in social spending. However the changes in administration are not based on the reduction of spending, but on the increase of revenues by broadening the tax base. Such initiatives to broaden the tax base in the past have not been impressive. The program for public spending reduction also has to be approved by the parliament. The modification of social spending is a difficult, but necessary step to take. For uncertainty on the financial markets about the situation in Poland to be over, domestic political fights must be put aside and unpopular, but unavoidable steps to reduce public spending must finally be taken.

**Prepared by: Veronika Czakó**

# III. INCREASING, BUT STILL MODERATE INFLATION IN LATVIA

Latvia posted the highest inflation figure among the Baltic States in October 2003. Consumer prices increased by 3,3% compared to October 2002. Contrary to its Baltic neighbours, Latvia has experienced an upsurge of inflation in the first half of the year. During the first six months annual inflation accelerated from month to month. This trend was on the turn in August as the annual consumer price index dropped from 3,8% to 3,5%. Since July the 12-month inflation declined from 3,8% to 3,3%. While CPI in Estonia hit an all-time low, and in Lithuania turned into negative, this year Latvia recorded higher inflation figures than in 2002. Last year CPI rose by 1,9% (2,5% in 2001), in the first half of 2003 inflation accounted for 2,4%. In the third quarter consumer prices rose by 3,5%.




Last years' favorable inflation figures were owed to the low world oil prices and the moderate increase of administrated prices (e.g. water supply and sewage services) which accounts for about 20% of consumer basket. Increasing prices of foodstuffs (due to bad weather) and vehicles and household maintenance had an upward pressure on consumer prices.

This year increase of regulated prices has exceeded the inflation and oil prices rebounded from the level. Main determinants of CPI in 2003 are a hike in regulated prices, depreciation of the Lat against Latvia's main trading partners and the upsurge of producer price index. In the first quarter household maintenance, transport and health care exerted the biggest pressure on inflation. Then annual consumer price inflation accounted for 2,2%. In the second quarter the annual CPI increased to 2,9%. Among the mentioned factors increasing prices of foods and clothing contributed to inflation. In July, administratively regulated prices such as payment for natural gas, heating and rent increased. At the start of the new heating season tariffs increased. Thus, in October, prices of heating pulled inflation. Food, alcoholic beverages and tobacco recorded modest inflation. Regarding the monthly figures, one must point out education and clothing. Prices of education went up in September by 4% compared to August, due to the start of the new school year. Clothes for winter 2003 arrived at retail outlets in last two months and the new collection generated a remarkably price increase. Due to the special offers of mobile service providers prices of communication virtually has not changed since January, they are thus cheaper by 1,2% than a year ago.

Both the government and Council of the EU forecast 2,5% annual inflation for 2003 but it is strongly dependent on oil prices. The current trend is likely to generate slightly higher inflation. Next year not only the steadily fast-growing wages and the catch-up process to EU price level, but also the planned upward adjustment in excise duties on fuel and petrol will exert pressure on inflation. The expected inflation for 2004 is about 3,0%. According to the forecast of EU Commission core inflation will not accelerate in the near future.

The accelerating inflation did not accompany or derive from expansive monetary policy. Bank of Latvia has continued to follow the extremely conservative monetary policy, which is very similar to Currency Board arrangement. Both monetary base and broad-money expanded slower in the first quarter than a year ago, consequently growth of money supply is not responsible for the increasing inflation. On the other side due to the pegged exchange rate Bank of Latvia has to accommodate to interest rate cuts of ECB and Fed. Bank of Latvia’s refinancing rate has been standing at 3,0% since September 2003. Low deposit rates discourage savings and households are stimulated for borrowing by the loan rates. Low interest rates encourage investments. In the second quarter compared to the same period of the previous year gross capital formation increased by 30%. First of all capital formation is responsible for the current economic boom of Latvia. At the same time wages has been rising quite fast, thus the roots of the demand side of inflation can be found in part on the labor market. During the first half of 2003 net monthly wages rose by 10% compared to the same period of 2002.

Exchange rate is the most important monetary transmission mechanism in Latvia. The share of imported goods and raw materials plays a significant role in consumption, as well as manufacturing. Import unit value increased by 7% in the first 6 month of 2003 (5,8% in 2002 on average) – led by the depreciation of Lat. The excess of the expected CPI over the last year figure is equal to the difference between the current and former import unit value increase. Lat has been losing its ground against the Euro in the last one and a half year but experienced strengthening vis-a-vis the US dollar. Since Euro represents a bigger share in Latvia’s foreign trade than dollar, exchange rate of Lats against Latvia’s main trading partners has been gradually depreciated during this year, both in nominal and in real terms. Regarding the wage based real effective exchange rate the depreciation is negligible due to the quite fast wage growth. Export unit value rose remarkably in the first half of the year, by 8,8% (by 2,7% in 2002). Nonetheless, the export volume is not hurt by the price changes.

Producer price changes in industry show similar trends to consumer prices. The 12-months PPI peaked out in June at 4,7%, since then has fallen to 2,8%. Producer prices in the third quarter rose on average by 3,1%. Fast producer price inflation mainly derives from the price increase of exported goods. In September 20003 over September 2002 prices of industrial goods sold on domestic market rose by 1,4% while prices of exported products were up by 5,1%. For five years producer prices have not grow such fast as in 2003. Last year PPI accounted for only 1,0% while in the first half of 2003 producer prices increased by 2,8% on average. The average annual PPI is expected to be between 2,5-3,1%. Construction costs has been declining for years. In the first 9 months construction cost declined by 2,2% on average.

As Latvia pegs the national currency to the SDR, the participation in the ERM-2 will cause more change in the business area that in Estonia and Latvia. The Bank of Latvia recognized this and does not plan to introduce the Euro so early than its neighbors. As the first step of the exchange rate regime reform BoL envisages shifting the peg of the lats from SDR to Euro on January 1, 2005. Similar to its Baltic neighbors Bank of Latvia plans to maintain the very hard peg in the ERM-2 framework, thus ensures narrower fluctuation band than the prescribed +/- 15%.

**Prepared by: Gergely Baksay**

# IV. UKRAINIAN GDP GROWTH FORECASTS REVISED UPWARD

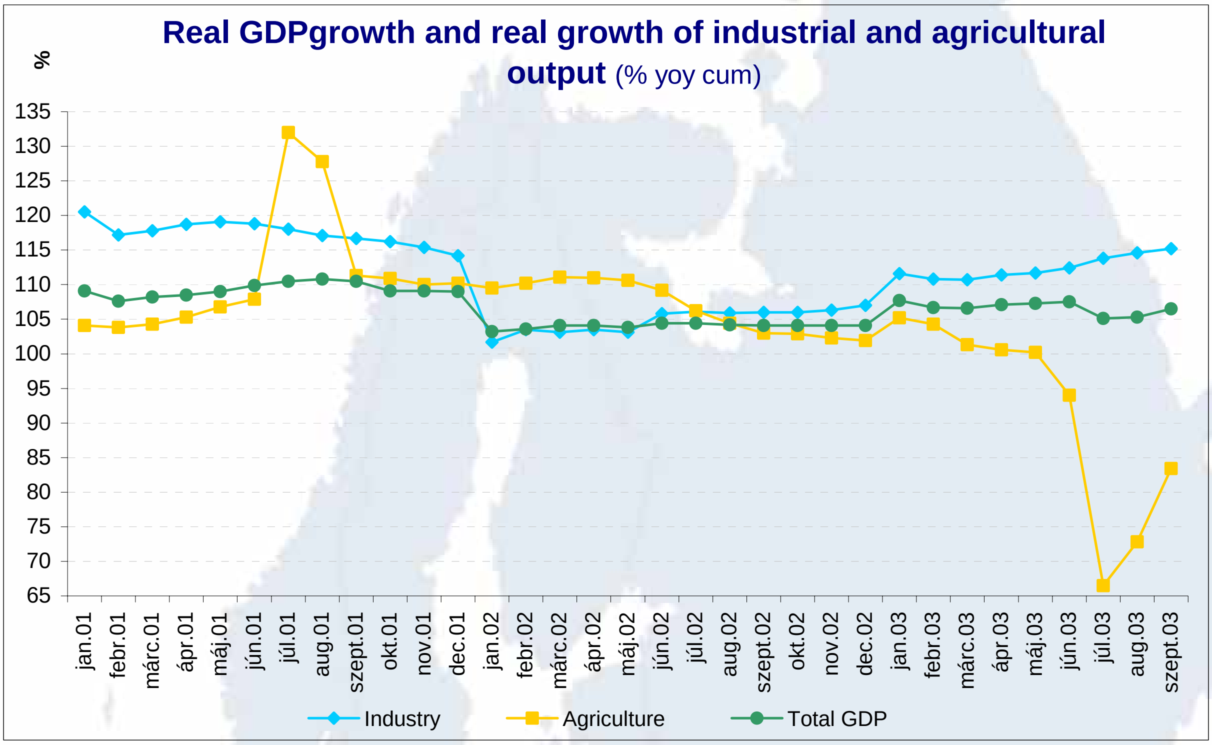
GDP is expected to grow by 7-7.5% in 2003 according to a new forecast of the Ukrainian government. GDP growth was 6.5-7% in January-October, said Finance Minister and First Vice-Premier Mykola Azarov at a press conference Friday. "Ukraine has come up to a stable and intensive pace of development," he pointed out. The government will revise its GDP growth forecast for 2004 in the draft national budget-2004 due to the better forecast of the GDP growth for 2003, he said. The government had raised the GDP growth forecast for 2003 from 4% to 6.5%.

After almost a decade of uninterrupted decline of GDP, Ukraine experienced first year of output growth in 2000, real GDP increasing by 5,9% year-on-year. Ukrainian GDP in 2002 increased by 4,8% y-o-y compared with 9,2% y-o-y in 2001. It would seem that this remarkable economic performance goes on in this and next years.

In October, the upward revision of the real GDP growth of Dershkomstat (State Committee of Statistics of Ukraine) for the first half of the year (the increase is from 7,5% to 8,6% y-o-y) is due to higher than previously expected economic expansion during the second quarter of the year. The real GDP grew by 6,5% y-o-y between January and September and by 7,2% y-o-y between January and October.

*Supply side of value added*. In September agriculture brought better results than in previous months due to delayed harvest and the better late grain-crops harvest. Thanks to this, the value added in agriculture declined by only 16,7% y-o-y cumulated compared to the previously estimated 24,6% y-o-y fallback during the first eight months. As the share of agriculture in GDP is 13,4%, it has a relatively considerable effect on growth.

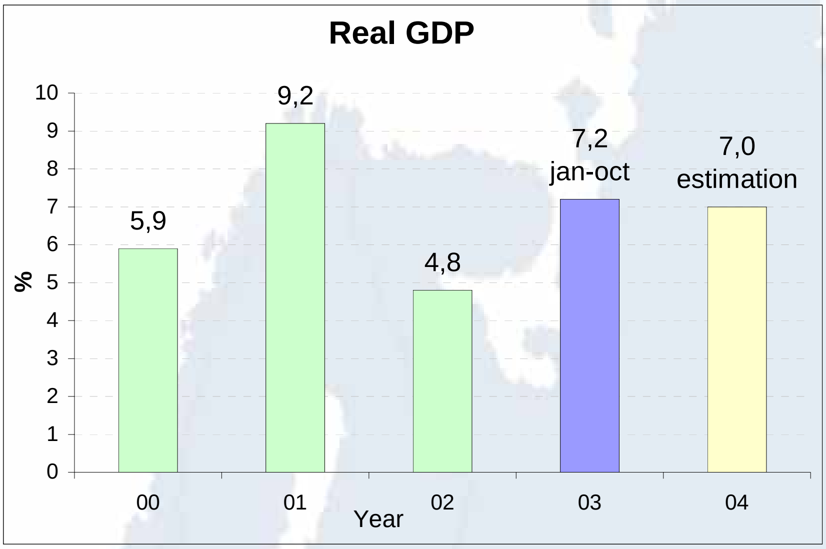
Industrial output increased by 15,2% y-o-y during the first nine months of the year and by 15.7% in 10 months of 2003 y-o-y. This is the highest growth in the past years. The main contributors were metallurgy, food industry and machine building: food industry output grew by 23% y-o-y and machine-building branch grew by 33% y-o-y cumulated (mainly due to transport equipment production). Contributions of these sectors are 25% in food and 30% in machine industry. Metallurgy continues its stable growth, due to favorable conditions on the world metal markets. The construction sector expanded according to expectations with a 25% increase, thanks to increased bank lending for housing start-ups.




*Demand side.* Consumption remained one of the main factors of economic growth in this year too as nominal wages increased by 12,4% y-o-y in the first ten months in 2003 and real wages grew by 5,1%. Simultaneously expenditures of population increased by 19,8% y-o-y reflecting the importance of consumption demand for growth.

Besides private consumption one can observe significant increase in private investments. Growing competition in advanced economic sectors with low government interference (food industry, retail trade, paper and printing industry, the output of which has increased swiftly over several years in a row) resulted in more investments and increasing productivity. Investments in construction and assembly works made by metallurgy and retail enterprises grew too.

Ukraine had a positive trade balance for the first eight months of the year. Imports grew by 31,2% y-o-y from January to August, while exports by 29,1% y-o-y in dollar terms. On the export side the main contributor was the export of ferrous metals, which increased by 29%, due to favorable global demand conditions and price competitiveness of Ukrainian metallurgy, which made up about 30% of total export growth. Another third is caused by export of mineral products, mainly gas and oil re-exports and sales of petroleum processing products. The growth of imports is mainly due by machinery and equipment in connection with increasing investments. Further important factor in import growth is the accelerating internal demand and higher world prices of raw oil.




*Forecasts*. As economic performance of Ukraine has been improving and GDP results are above expected, all institutions revise their expectations and estimations. Accordingly we predict a 7% real GDP growth in 2003 and a similar output expansion in 2004. These estimations will be influenced by the fragile world economic conditions, internal political events and commitment of economic and political circles to implement further necessary reforms (tax reform and further privatization). Especially important is the role of reforms, because the driving forces of economic growth are in depletion period and without further structural changes Ukraine is threatened with depression.

Besides global conditions other important questions that influence output growth in are the timing of Ukrainian entry to the WTO and the likely effects of the Single Economic Space agreement between the four CIS countries on economic development in the region.

**Prepared by: Tamás Borkó**

# V. ROMANIA: FUNCTIONING MARKET ECONOMY OR NOT?

The European Commission's 2003 Regular Report on Romania's progress toward accession was hardly waited by Romania. It was issued in the first week of November, and the main question was if the EU declared Romania had a functioning market economy or not. The EU announced an ambiguous statement, which was interpreted in numerous ways, even in Romania.

The existence of a functioning market economy is one of the accession criteria, accepted in 1993 in the Copenhagen EU Summit. The other economic criterion is the capacity to cope with the competitive pressure and market forces within the European Union. Since then, the new candidate countries needed to fulfill these criteria to be a member of the European Union. Certainly, the ten new members joining the EU next year have already passed this test.

The European Commission focuses on several factors when decide whether a country has a functioning market economy. To fulfill this criterion, the country needs to have liberalized prices and trade, and enforceable legal system, including property rights. Furthermore, the financial sector's development and the absence of any significant barriers to market entry and exit improve the efficiency of a functioning market economy. These are the main guidelines which are examined by EC before forming the opinion on a country.

In the 2002 Regular Report, the Commission's opinion was that the Romanian economy had not been a functioning market economy. However, the progress towards being a functioning market economy was acknowledged in the Report. Particularly, since 1997 that has been the statement about the Romanian economy.

In the first half of 2003, a little progress has been achieved when the United States granted Romania the market economy status. The US accordingly appreciated the significant reforms accomplished in Romania. This decision was based on an economic analysis which examined the Romanian economy. It investigated six criteria which included the extent of currency convertibility, free bargaining for wage rates, foreign investment, government ownership or control of production, government control over the allocation of resources, and other appropriate factors.

However, it has not meant that the EC would grant Romania the functioning market economy status in its Regular Report. By all means, that was the main target of the Romanian government. Another reason for achieving this goal is that Bulgaria, the other candidate country is declared as a functioning market economy. Bulgaria is the country to which Romania is usually compared, and Romania would not like to lag behind the other Balkan country.

As it was mentioned, in the 2003 Regional Report, an ambiguous statement was announced. The next two sentences were written in the Report: "*Romania can be considered as a functioning market economy once the good progress made has continued decisively. In addition, a vigorous and sustained implementation of its structural reform program is required in order for Romania to be able to cope with competitive pressure and market forces within the Union in the near term.*" Undisputedly, it was a progress comparing to the earlier statements when only the development was appreciated. In fact, the latest Report contains a future acceptance of the existence of the functioning market economy. It means if the significant reforms continue, the Commission will really grant Romania the functioning market economy status, maybe in the next year Regular Report.

The main market institutions required by the functioning market economy, exist in Romania, but there are several weaknesses like the lack of financial discipline, the insufficient enforcement of market regulations, the low transparency and stability of the regulatory framework, the inefficient public administration, an unsatisfactory judiciary, and so on. That is the reason why the EC has not stated directly that Romania had a functioning market economy. And that is why the Report contains the functioning market economy status depends on further reforms. However, the EC would have liked to appreciate the reforms made in last years, and a more favorable statement has been granted in the recent Report.

**Main Economic Indicators of the Romanian Economy**

| | 2000 | 2001 | 2002 | 2003* |
|---|---|---|---|---|
| GDP growth (%) | *1.8* | *5.7* | *4.9* | *4.3* |
| CPI (yearly average, %) | *45.7* | *34.5* | *22.5* | *15.5* |
| Fiscal balance/GDP (%) | *-3.6* | *-3.3* | *-2.7* | *-2.5* |
| Current account/GDP (%) | *-3.7* | *-5.9* | *-3.5* | *-4.4* |
| Trade balance/GDP (%) | *-4.6* | *-7.9* | *-5.8* | *-6.5* |
| Unemployment (%) | *11.2* | *9.0* | *10.2* | *8.5* |

** Forecast*

As it was mentioned, Bulgaria is the country to which Romania is usually compared. The recent Reports put Bulgaria ahead of Romania; the differences between the two economies are reflected. However, it does not mean that the two countries will be decoupled, it is stated by EC. According to the official statement of the EU, the decoupling of the two countries would not be useful; Bulgaria and Romania will become members of the EU at the same time.

In Romania, the statement on the functioning market economy status was interpreted in an overoptimistic way by some. President Iliescu said: "*Romania is in fact a functional market economy which just needs to fix a few loose ends.*" Prime Minister Adrian Nastase also welcomed the message, and spoke about that "*Romania got the designation*". But the opposition was not so optimistic, the president of National Liberal Party said that the "*verdict was negative*". The Bucharest Mayor also criticized the government, he said that "*the government did not stop boasting about its big success in Brussels; it is just a manipulation of the truth*". Obviously, there are political wills behind these comments, the truth is somewhere in the middle of these two views. The recent statement is better than the earlier reports, but it does not mean that Romania granted the functioning market economy status from the European Union. If the reforms continue in the future, the functioning market economy status can be given to Romania, maybe in the 2004 Regular Report.

**Prepared by: Péter Bilek**